Transition report 2003

Integration and regional cooperation

European Bank
for Reconstruction and Development

Country groupings

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

Central and eastern Europe	Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, Serbia and Montenegro, Slovak Republic and Slovenia.
Commonwealth of Independent States	Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.
Central eastern Europe and the Baltic states (CEB)	Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia.
South-eastern Europe (SEE)	Albania, Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Romania, and Serbia and Montenegro.
Countries of operations	The EBRD's member countries in central and eastern Europe and the CIS.

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ISBN: 1 898802 23 8
ISSN: 1356-3424
price £30

Designed and produced by the EBRD – *ref: 5790 Transition Report* – November 2003.

Cover and interior printed on environmentally responsible paper. Printed on Ikono Matt, Totally Chlorine Free (TCF), manufactured with pulp from sustainable forests. Printed in England by Moore, using environmental waste and paper recycling programmes.

Cover photograph: Liberty Bridge, Budapest – Christian Sappa, 2000.

Transition report 2003

Integration and regional cooperation

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Foreword

This *Transition Report*, the tenth in an annual series, is dedicated to the memory of John Flemming, Chief Economist of the EBRD from its inception in 1991 to 1993. His many contributions to the economics of transition in eastern Europe include initiating the EBRD Annual Economic Outlook, the natural predecessor of the *Transition Report*, and contributing to the first *Transition Report* in 1994. He helped to establish the framework for understanding and measuring progress in transition that has been a central feature of all subsequent *Transition Reports*.

The *Transition Reports* chart the progress of transition from a command to a market economy in each of the 27 countries of central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) in which the European Bank for Reconstruction and Development (EBRD) operates. They also identify and analyse the challenges of the coming years.

The EBRD seeks to foster the transition to an open market-oriented economy and to promote private and entrepreneurial initiative in all 27 of its countries of operations. It 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. For the EBRD to perform this task effectively, it needs to analyse and understand the complex process of transition. The *Transition Reports* contribute to this learning process and allow the Bank to share its analyses with its partners, other investors, policy-makers in the region, the research community and the public at large.

Part I of the Report focuses on progress in transition over the last year along its key dimensions – liberalisation, stabilisation, privatisation, governance and enterprise restructuring. Complemented by detailed country-by-country assessments, the Report also tracks developments on financial sector, infrastructure and social sector reform.

The Report seeks to identify drivers of reform and the factors that may influence the direction of future reforms and aggregate economic performance, including initial conditions, early reform choices and success in building market-supporting institutions. This analysis helps to identify the characteristics of countries that have pressed ahead steadily with reforms and that have realised the benefits of these measures in sustained economic growth. It also highlights the pitfalls in transition that have impeded reforms in other countries. Central to this analysis is an assessment of the role of democratic political processes in helping to sustain progress in market-oriented reform.

Part II of each *Transition Report* is devoted to a special theme. Jointly these themes represent a focused analysis of the transition and the forces shaping its progress. They also provide an examination of the policies that help to develop the institutions and practices required to support well-functioning markets and private enterprise. It is important, therefore, to consider the Reports as a series, in which each instalment represents both a self-contained thematic study and an interlocking contribution to a wider analysis.

The special themes of the previous *Transition Reports* have been:

- 1994 – Institutional reform and economic openness;
- 1995 – Fixed investment and enterprise development;
- 1996 – Commercial infrastructure and contractual savings institutions;
- 1997 – Enterprise performance and growth;
- 1998 – Financial sector in transition;
- 1999 – Ten years of transition (a special issue);
- 2000 – Employment, skills and transition;
- 2001 – Energy in transition; and
- 2002 – Agriculture and rural transition

This year's *Transition Report*, with its special theme of integration and regional cooperation, draws from and builds on this previous work.

As accession to the European Union approaches for eight countries of the region – the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia – the second part of the Report looks at the role that economic cooperation and integration have played in fostering transition. The prospect of EU accession has undoubtedly been a key factor behind the strong reform progress and macroeconomic performance in the EU accession countries. A key challenge for the region is to strengthen the process of international integration in those countries that are not EU candidate members, including through accelerated accession to the World Trade Organization.

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 end-September 2003.

Willem Buiter
Chief Economist and Special Counsellor to the President

1 October 2003

Executive summary

Chapter 1: From misdirected integration to reintegration

Under central planning, the countries of central and eastern Europe and the former Soviet Union were the victims of misdirected integration. The potential gains from liberalisation were accordingly large. The expansion of the European Union has been central to the process of reintegration into the global economy of many countries of the region. This is clearly the case for the eight transition countries that will become EU members in 2004, as well as for Bulgaria and Romania, which could join the EU as early as 2007.

The accession of some transition countries to the European Union while others remain outside will have a significant impact on the structure of trade and capital flows as well as on the pattern of migration, both legal and illegal. EU expansion is likely to have both trade creating and trade diverting effects. It will also influence investor assessments of the business environment in the transition countries and therefore the pattern of foreign direct investment (FDI) and other cross-border capital flows. Implementation of EU external border controls by the new members will alter the pattern of seasonal and permanent migration among transition countries as well as between transition economies and existing EU member countries.

There is a danger that EU expansion may reinforce the marginalisation of some of the Commonwealth of Independent States (CIS) countries so that they remain on the fringes of the international economy with relatively little foreign investment and little opportunity for legal migration. Further integration of the large CIS countries, particularly Russia but also Kazakhstan and Ukraine, into the international economy is necessary to avoid this outcome. This can be achieved through accession to the World Trade Organization (WTO) along with greater regional cooperation by the smaller CIS countries with their larger neighbours.

Part I: Transition and economic performance

Chapter 2: Progress in transition and the development of democracy

The transition countries have continued to make progress in structural and institutional reform over the past year. The countries of central eastern Europe and the Baltics (CEB) moved further forward from their already advanced position as they finalised the accession negotiations with the European Union. However, EU accession is not the end of the transition process. Reforms in the new member countries will have to continue – especially in the financial sector, public administration and the business environment – if they are to be competitive in the single market.

The prospect of further economic integration has also encouraged reform in other countries with aspirations for closer ties with the EU. Most notably this has been evident in south-eastern Europe (SEE), where the leading reformers continued to catch up in 2002–03. However, countries such as Bosnia and Herzegovina and Serbia and Montenegro are improving from a very low base and their reform achievements are still fragile. Russia has made progress on a number of fronts although the implementation of reforms remains an issue. Elsewhere in the CIS, reform progress has been uneven – with encouraging developments in some countries and virtual stagnation or back-tracking in others – and the transition process continues to be held back by poor governance and weak institutions.

These divergent patterns of economic reform are mirrored by political developments. The advanced transition countries are in the process of developing high levels of liberal, constitutional democracy while the countries that lag behind in transition are increasingly characterised by weak constitutional orders and, in some countries, political repression. The evidence suggests that there is a strong link between the depth of democracy and the level of economic reform, particularly with respect to the institutional aspects of transition. While a handful of countries with less liberal political regimes have made significant progress in transition over the past years, this progress has been limited to initial phase reforms – price and trade liberalisation and small-scale privatisation. Only countries that have established high levels of political and civil liberties and the effective rule of law have made significant progress in the more crucial area of institution-building or “second phase” reforms.

Chapter 3: Macroeconomic performance and prospects

Transition countries have remained resilient to the continued sluggishness of the global economy. Growth in the region as a whole could reach as much as 4.7 per cent in 2003. The CEB economies are forecast to grow by 3.3 per cent, spurred by a continued rise in consumption, steady investment and a recent pick-up in exports. Continued restructuring and economic integration underlie the strong performance in the SEE economies, which could grow by around 3.9 per cent this year. The CIS economies continue to benefit from high natural resource prices and are forecast to grow by 6.2 per cent in 2003.

In some parts of CEB, recent growth has been spurred by rapid increases in government consumption, which has led to very high fiscal deficits. However, continued reliance on public consumption is not viable over the medium term, as EU accession will impose additional demands on public expenditure as well as strict criteria for future eurozone accession. Some fiscal tightening may also be desirable to retain the flexibility to respond to macroeconomic shocks.

Further trade and financial integration may help SEE countries to sustain recent high growth rates. However, the countries have to push forward with the institutional reforms needed for increased integration into the enlarged EU market and continue to address macroeconomic imbalances. High fiscal deficits, persistently large current account deficits and substantial debt levels pose risks at a time when foreign assistance to most SEE countries (except Bulgaria and Romania) is being reduced.

Recent growth in the CIS was largely based on favourable commodity prices, in particular for oil and gas. Sustainable growth in the CIS countries rich in natural resources will depend on their ability to foster growth outside the core natural resources sector and manage the large and volatile foreign currency flows associated with this sector.

Growth in the non-resource-rich CIS countries is strongly linked to the performance of their resource-rich neighbours, particularly Russia, on which they depend for cheap energy (mainly natural gas) and which act as their chief trading partners. Further trade diversification and deeper regional cooperation would help to improve the medium-term outlook for these countries.

Part II: Integration and regional cooperation

Chapter 4: Trade and integration in transition countries

The process of integration into the world economy has not been uniform across transition countries. Integration has been rapid and deep in the countries of CEB. SEE and CIS countries are far less integrated into the world's product and capital markets for different reasons. In SEE the violent break-up of former Yugoslavia has prevented more rapid integration by its successor states. Slow economic reform during the early 1990s in Bulgaria and Romania has also delayed the process of economic integration with western Europe. CIS trade is limited by obstructive domestic and regional policies and distance from other markets. Moreover, some of the artificial Soviet trade links remain entrenched even after more than a decade of transition.

This chapter proposes a three-pronged solution to the problem of limited international integration in SEE and the CIS. The first issue is to improve market access – in particular, to the region's most important present and future market, the EU. Restrictions to market access remain significant in several sectors compared with those faced by many other countries. Moreover, with the completion of accession, remaining EU trade barriers against the accession countries will be lowered. As a result, trade with the non-accession countries may be reduced unless their market access is improved.

The second area is the link between improved market access and the introduction of structural and institutional reforms. Neither the WTO nor the EU's commercial relations with non-EU members are likely to generate the same depth of domestic reform as EU accession. However, both could indirectly provide a significant boost to reform by providing incentives for more liberal trade policies and better economic governance. This implies that better market access should be granted in parallel to, rather than conditional on, deep institutional reform.

The third area is closer regional cooperation to complement the process of international integration. This is reflected in the EU's Stabilisation and Association Process with the countries of SEE. In the CIS, efforts at regional harmonisation and coordination of policies may be welcome if they provide political momentum for improved cooperation on trade and transit issues, and if they do not delay the simultaneous efforts to complete WTO accession and pursue a general liberalisation of trade policies. Throughout the region, preferential trade arrangements and other forms of closer regional integration need to focus on enhancing, rather than diverting trade, transit and transition.

Chapter 5: Integration through flows of capital and labour

Mobility of capital and labour is an important aspect of integration. While labour mobility has remained quite limited throughout the region, some countries have been able to attract significant capital flows, mainly in the form of FDI. In general, trade and capital flows move together, as the policies that have been conducive to better trade integration have also promoted FDI. As a result, most FDI has been received by the advanced reformers of CEB where trade integration has proceeded furthest. FDI has also been increasing in those countries of the CIS that are rich in natural resources. However, most other transition countries have failed to benefit to any notable degree from capital inflows and FDI, in particular. This is due not simply to deficiencies in economic policy – although these have been important – but also to location and lack of resources. There are a number of ways in which such deficiencies can be addressed, including steps towards greater regional integration, which not only improve the flow of goods but may also have a positive influence on inward investment.

With regard to labour flows – contrary to many expectations – the movement of labour westwards from the transition countries has been quite limited and may well remain that way, even after EU accession. This is partly due to the presence of immigration barriers but also to the lack of effective integration of domestic labour markets.

As transition has proceeded, not only have unemployment rates tended to rise but the regional variation in unemployment has also grown. Policies designed to improve the flow of information, to promote the functioning and affordability of the rental housing market and to eliminate benefits that reduce labour mobility will be essential to address these problems. In short, gains from greater integration will require far more progress in the integration of domestic labour markets. However, an uncritical acceptance that cross-border mobility will necessarily be good for the transition countries is unwarranted. Particularly in the context of low domestic mobility, the types of workers who are likely to move will be young, skilled and relatively affluent. The obvious danger is that their migration will result in a "brain drain". Using temporary contracts for skilled workers may mitigate this risk but raises major problems of enforcement as well as ethical issues.

Acknowledgements

The *Transition Report* was prepared primarily by the EBRD's Office of the Chief Economist, with important contributions by the Office of the General Counsel (see Annex 2.2) and the Environment Department (see Annex 5.1). The editorial team, under the general direction of Willem Buiter and Steven Fries, consisted of Simon Commander, Julian Exeter, Samuel Fankhauser and Alan Rousso.

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The transition assessments and the macroeconomic indicators were prepared by the country economists of the Office of the Chief Economist, whose responsibilities are as follows: Alan Bevan – Azerbaijan, Russia; Nicolas Doisy – Slovak Republic, Slovenia; Julian Exeter – Belarus, Ukraine; Elisabetta Falcetti – Bulgaria, Romania; Samuel Fankhauser – Moldova; Kunil Hwang – Turkmenistan; Rika Ishii – Kazakhstan, Kyrgyz Republic; Libor Krkoska – Czech Republic, Poland; Vanessa Mitchell-Thomson – Estonia, Latvia, Lithuania; Francesca Pissarides – Hungary; Martin Raiser – Turkmenistan, Uzbekistan; Toshiaki Sakatsume – Armenia, Tajikistan; Peter Sanfey – Bosnia and Herzegovina, FYR Macedonia, Serbia and Montenegro; Ivan Szegvari – Russia; Anita Taci – Albania, Georgia; Maria Vagliasindi – Croatia.

The structural and macroeconomic indicator tables were prepared by Tatiana Lysenko and Svitlana Maslova under the guidance of Elisabetta Falcetti. Lucie Ryan provided valuable secretarial and organisational support.

Anthony Martin and Angela Hill of the EBRD's Publications Unit expertly prepared the text for publication and managed the publication process. Steven Still, Jon Page and Adrian Jonker of the Design Unit designed the Report and saw it through the production process.

The Report benefited significantly from discussions with colleagues both inside and outside the EBRD. Many helpful comments and suggestions were received from members of the EBRD's Board of Directors and Executive Committee. The Country Teams and Resident Offices made important contributions to the preparation of the Country Assessments, and provided comments on Chapters 2 and 3. The EBRD's Sector Teams and Legal Transition Team provided valuable feedback on Annex 2.1. Bossan Annaeva, Anne-Maria Cronin, Polina Pimenova and Anna Schin from the EBRD Environment Department researched the country case studies in Annex 5.1.

Staff of the European Commission, the International Monetary Fund and the World Bank generously provided valuable comments on the Report. Philippe Aghion, Nauro Campos and Alan Winters reviewed Chapters 4 and 5. The data on EU trade protection in Chapter 4 was provided by the International Trade Centre in Geneva, coordinated by Mondher Mimouni. Nadezhda Aleshina, Yury Andrienko, Nauro Campos, Sergei Guriev, Peter Huber, Ella Kallai, Janos Kollo, Cristina Negrut, Mariella Nenova, Katherine Terrell, Clementina Ivan Ungureanu, and Ruslan Yemtsov provided some of the data used in Chapter 5.

Background studies for this *Transition Report* were funded by the Japan-Europe Cooperation Fund. The governments of Japan, the United Kingdom and the United States provided support for the preparation of Annex 2.2. This funding is very gratefully acknowledged.

Integration and regional cooperation

Chapter 1

From misdirected integration to reintegration

1

Under communism and central planning, the countries of eastern Europe and the former Soviet Union were the victims of misdirected regional and international integration. The Council of Mutual Economic Assistance (CMEA) and even more so the Soviet Gosplan – the state planning authority – imposed an excessive degree of specialisation in production and an artificial division of labour, which often conflicted with the resources and productive capabilities of CMEA member countries and the Soviet republics. This system of planned specialisation was sustained economically only by maintaining a high degree of self-sufficiency within the CMEA and conducting little trade with the rest of the world.

While there was a need for a radical restructuring of production and international and inter-regional trade in all post-communist countries following the fall of the Berlin wall and the break-up of the Soviet Union, the nature and difficulty of the required restructuring differed between countries and regions. Of the eight central eastern European and Baltic countries that will join the European Union in May 2004, all except Slovenia were part of the Soviet bloc. Together with Bulgaria, which is due to accede to the EU in 2007, they required a drastic reorganisation of their external trade towards western Europe. The same was true for Romania, the other candidate for EU accession in 2007, and for Albania, which had both been the victims of their own self-sufficient forms of central planning.

The countries of the Commonwealth of Independent States (CIS) also needed to reduce their trade dependence on Russia but the latter would continue to play a significant role as an origin and destination of trade. This is due not only to its geographical proximity but also to the high degree of production specialisation in the former Soviet republics and their interdependence as a result of the communist system. The six former Yugoslav republics were more integrated into the global trading system prior to the break-up of Yugoslavia. Except for Slovenia, their further integration into the regional and global economies was delayed by conflict and sanctions.

While initial conditions varied, all countries stood to gain from liberalisation – freeing domestic markets from administered prices and opening them to international trade – following the misallocated and wasted resources under the old system. Recognising this potential and the need to weaken state control, many early reformers embraced comprehensive internal and external liberalisation. The pace and scope of this liberalisation varied widely, however.

In some cases, the collapse of the old regime and national independence resulted in only limited liberalisation of domestic markets and the introduction of new artificial barriers to trade and transit. These barriers either have been self-imposed (as in Belarus, Turkmenistan and Uzbekistan) or are the result of barriers erected by others. For example, regional infrastructure in the CIS, including roads, railways and power grids, has been starved of investment and maintenance, often for reasons of political rivalry among countries. Large-scale, partly seasonal migration between Tajikistan and Russia has been disrupted by administrative interventions by the Kazakh and Russian authorities. Some of these restrictions are due to legitimate concerns about terrorism and drug trafficking but mutual mistrust, nationalistic rivalry and trade protectionism also play a role.

In contrast to the retreat towards self-sufficiency in some CIS countries, the expansion of the EU has been central to the reintegration into the global economy of many countries of the region. This is clearly the case for the eight transition countries that will become EU members in 2004, and for Bulgaria and Romania, which could join the EU in 2007. The eight first-wave accession countries have done much to prepare themselves for this historic step. They have undertaken major structural and institutional reforms that have been chronicled by the EBRD's *Transition Reports* since 1994 and by the European Commission's annual reports on the preparedness of the candidate countries since 1998.

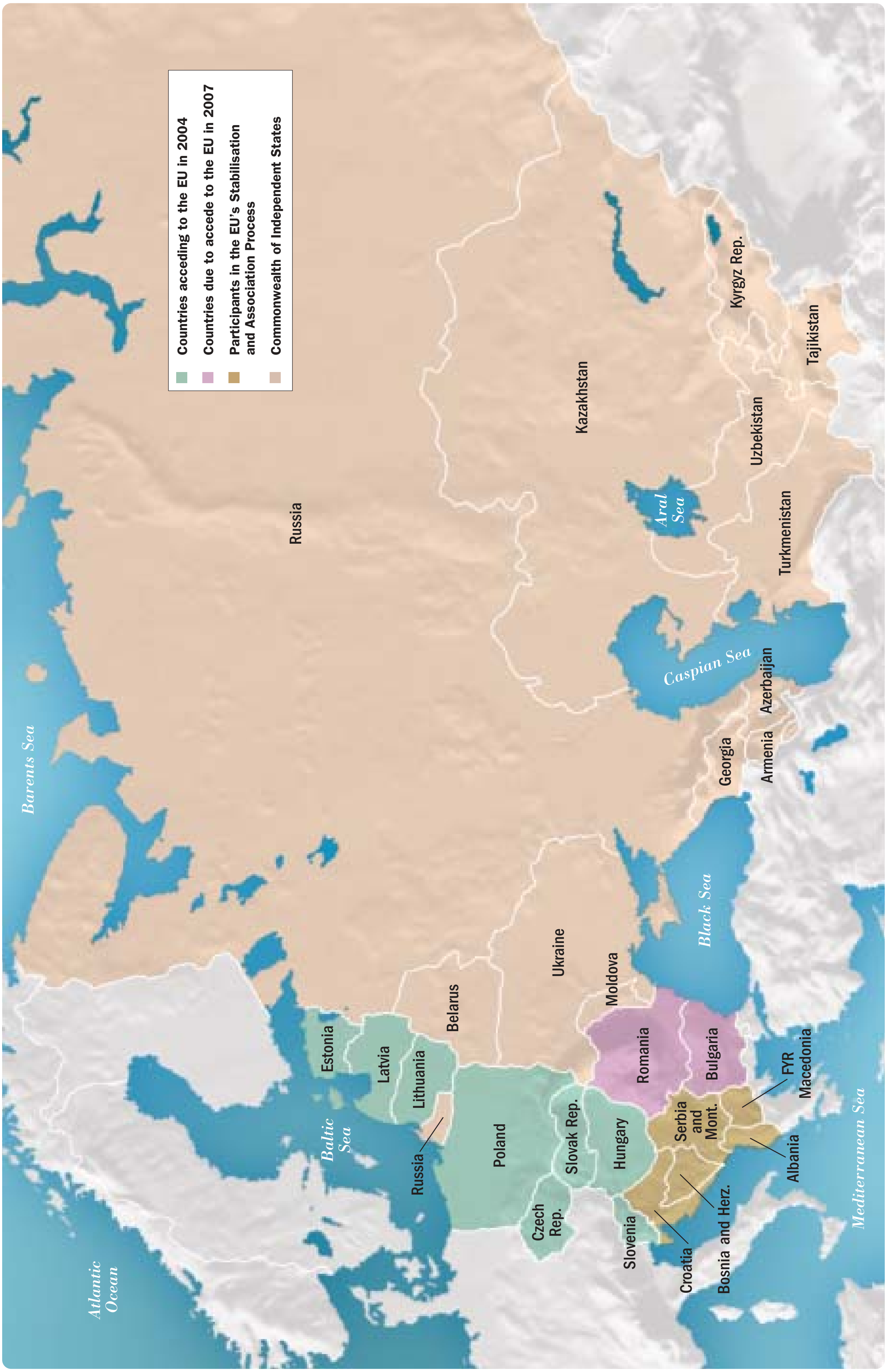
Building on these reforms, the countries have redirected their trade towards existing EU members and away from former CMEA members (see Chapter 4). They have increased significantly their overall openness to trade and have attracted large capital inflows primarily in the form of foreign direct investment (FDI – see Chapter 5). These processes of structural and institutional reform, greater openness to trade and increased FDI tend to be mutually reinforcing in terms of their impact on overall economic performance, helping to sustain further progress in transition and to support integration into the single European market. However, the transition is not yet complete and more remains to be done in terms of further structural and institutional reform.

This chapter assesses key policy issues in promoting the transition to an open market economy in the region. The analysis draws on the experiences of western Europe since the Second World War as well as the recent experiences of the accession countries that have responded well to the challenges of international integration and regional cooperation. However, it recognises that there are important differences among countries in terms of location, history and culture and that one approach to international integration cannot be simply emulated in other countries.

The chapter tries to identify some of the underlying factors for success and to draw some implications for other countries in the region. This analysis suggests that the EU's Stabilisation and Association Process in south-eastern Europe is well-founded on past

Map 1.1

Regional integration in the transition countries



experiences and that it could eventually expand to include the opportunity for EU membership for a further five countries (see Map 1.1). For the western CIS countries, EU membership is a more distant prospect.

The histories and cultures of the CIS countries differ significantly from those of the EU accession countries. In particular, the CIS countries experienced over 70 years of communism and central planning compared with about 40 years for the countries of central and eastern Europe and the Baltic region. The EU's Wider Europe initiative, which covers Belarus, Moldova, Russia and Ukraine among other countries, attempts to encourage "good neighbourly" relations between these countries, which are unlikely to be candidate EU members in the foreseeable future, and the enlarged EU, without ruling out their eventual membership.

Other countries that lie outside of Europe, in particular those in Central Asia, are ineligible for membership in the EU under its founding agreements. The three Caucasus countries – Armenia, Azerbaijan and Georgia – are also excluded from the Wider Europe initiative, although they lie within Europe. Countries unlikely or unable to become EU members in the foreseeable future will need to develop policies that foster greater international integration and regional cooperation outside of the EU context.

1.1 Approaches to international integration and policy cooperation

A simple strategy to promote greater international integration is unilateral liberalisation. In principle, benefits from trade liberalisation do not depend on trading partners also removing barriers to trade.[1] The traditional gains from trade liberalisation arise first from the country adopting greater economic specialisation in a market economy based on international prices and using its resources more efficiently. The second benefit results from the greater diversity of consumer goods and raw materials that may become available. The benefits of trade liberalisation do not depend on a country having an absolute productivity advantage in producing any particular goods. In addition to these traditional gains from trade, there are potential gains arising from the need to improve efficiency and to develop new products and production processes in response to more intense competitive pressures from abroad.[2]

In central and eastern Europe, where democratic revolutions brought new political regimes to power at the start of transition, unilateral liberalisation of markets and trade was used not only to promote more productive use of domestic resources but also to weaken the political power of the old state apparatus. In this case, trade liberalisation served to advance both broad economic interests and to further the political interests of the new regimes. However, this period was short lived. Unilateral liberalisation was sustained for just a few years and in most countries of central and eastern Europe was partially reversed.[3]

In less extraordinary periods, reciprocal trade liberalisation can help to strengthen domestic political support for liberalisation. In most countries, domestic producers can have a significant impact on trade protection policy, exceeding the influence of other interest groups and consumers. However, in democratic systems, reciprocal liberalisation can help to overcome the resistance to reform in at least three ways.[4] First, it increases the economic benefits from reform, resulting from the country's own liberalisation and from its trading partner's reciprocal measures. Secondly, it suggests fairness and makes adjustment to liberalisation more acceptable to those who will lose out from liberalisation. Thirdly, foreign trade concessions help to mobilise support from potential exporters who would profit from expanding foreign markets and to counter the arguments from domestic producers who would profit from restricting trade. It is also important to recognise that an open and liberal trade regime can strengthen support for structural and institutional reforms that allow domestic producers to compete more effectively in integrated markets. These factors may have been at work in the accession countries in encouraging domestic support first for free trade with the EU and then for EU accession.

A pattern of market integration followed by policy cooperation can also be seen in the evolution of the EU itself, which began as a customs union among developed countries and a mechanism to coordinate policies in the coal and steel sectors. It now covers many aspects of policy cooperation and institutional harmonisation. At the centre of the EU are four basic liberties – the free movement of goods, persons, services and capital. Policy cooperation and institutional harmonisation were originally confined by the founding treaties to areas closely linked to market integration. This included policies covering trade (a common commercial policy), agriculture, transport and competition.

The harmonisation of policies was further extended by adoption of the Single European Act of 1987 and the Maastricht Treaty of 1993. The former treaty eliminated many barriers that remained to the free movement of goods, services, people and capital while the latter laid the foundations for economic and monetary union (EMU). The EU establishes, therefore, a framework for economic policies that emphasises EMU-wide price stability and limits the scope for member governments to engage in deficit financing. The efficiency of markets is promoted through the creation of a single internal market and limits on competition-distorting subsidies.[5]

[1] Reciprocal trade liberalisation will enhance the potential gains from trade for all parties involved.

[2] This assumes that the liberalising country does not have a monopoly on international trade.

[3] See, for example, Messerlin (2002).

[4] See Bhagwati (2002). It must, however, be recognised that demands for reciprocity in trade liberalisation can also reflect simple mercantilist views in which one country's liberalisation imposes a cost that must be compensated by reciprocal measures by trading partners.

[5] EU treaties and laws also cover a range of issues broadly related to the functioning of the single market and to other forms of political cooperation. They include consumer protection, trans-European infrastructure networks, regional policies aimed at promoting greater economic and social cohesion, policies fostering research and development, and social and environmental policies. In addition to economic policies, member states cooperate in areas such as defence, justice and home affairs.

The gains from international integration are not exhausted by regional integration. Their full realisation requires integration at the global level. However, for the potential gains from international integration to materialise and to be distributed fairly requires certain supra-national arrangements or institutions. Harmonising policies at a global level is only feasible to a limited extent. Regional integration offers a way forward, provided that it does not involve the creation of additional trade barriers between the integrating region and the rest of the world.

In the case of the EU, trade creation has outweighed the loss of trade in most areas, with the common external tariff of the EU being lower than the average national external tariff that had previously existed. There has also been significant progress in reducing non-tariff barriers to trade in most sectors.

Exceptions to this positive assessment include agriculture and other "sensitive" sectors. Many observers hold the view that the Common Agricultural Policy (CAP) taxes European consumers by imposing trade barriers on imports and undercuts farmers in the rest of the world, including in poor countries without preferential access to EU markets, both through these import barriers and by directly or indirectly subsidising exports.[6] In industries such as textiles, footwear and other semi-skilled manufactured goods, tariffs, quotas and other non-tariff barriers to trade have hampered the efficient allocation of global resources and caused hardship in many emerging markets and developing countries. However, such patterns of protectionism in agriculture and "sensitive" manufactured products are not unique to the EU among industrialised countries, and similar trade barriers can also be found elsewhere. Developing countries also maintain high levels of trade protection, including barriers to trade with other developing countries.

The free movement of capital among EU member states and among OECD member countries is another important aspect of international integration. The industrialised market economies have experienced a period of rapid financial integration since the mid-1980s, owing largely to the easing of capital controls. This process has been supported by the OECD's Capital Movements Code and the introduction of the EU's internal market. It has now reached the point where virtually all OECD countries have abolished capital controls and adopted sound frameworks for prudential regulation and supervision of their financial sectors. As the elimination of capital controls is a requirement of the *acquis communautaire*, the countries acceding to the EU have also largely liberalised their capital accounts.

The liberalisation of capital controls and international financial integration, however, do not necessarily go hand in hand. A country can maintain extensive controls on capital flow and yet still experience a high degree of financial integration through capital flight. For example, Russia is a resource-rich country that has maintained significant capital controls but it has experienced several bouts of capital flight. This is an example of largely ineffective capital controls. Conversely, a country can maintain virtually no capital controls and attract no private capital flows. For example, some African countries maintain few capital controls but have experienced only minimal private capital flows.[7] This can be due to factors such as their remote location or an unfavourable business environment. The most financially integrated transition economies are the eight countries set to join the EU in 2004. They have virtually no remaining capital controls, benefit from close proximity to and imminent integration with EU markets and have relatively attractive business environments and acceptable frameworks for prudential regulation and supervision of the financial sector.

1.2 International integration and regional cooperation in transition countries

Several efforts at regional economic integration are under way in the transition countries. The EU enlargement process is the most significant of these and many of the requirements of the *acquis communautaire* for EU accession support the transition process for these countries. EU accession directly involves ten transition countries (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia) and indirectly concerns the remaining 17 countries not included in the process. Other regional initiatives under way include the Stability Pact for South-eastern Europe, the Eurasian Economic Community and various other economic, political or security arrangements that bring together different groups of CIS countries. These initiatives vary widely in their aims and effectiveness, with some offering the prospect of a wider EU expansion and others being largely symbolic and ineffective in promoting greater market integration and policy cooperation.

EU enlargement

European economic and political integration, including the current phase of EU enlargement, is partly a way of ending a millennium of conflicts within Europe. The initial impetus for the EU arose during reconstruction of Europe following the Second World War and its largest single expansion follows the fall of the Berlin Wall in 1989. Economic integration – the creation of a customs union and single European market and the adoption of a common currency (by 12 of the 15 existing EU members) – has been instrumental in achieving a more stable Europe. European economic integration has also helped western Europe to achieve the benefits from freer trade, enhanced financial integration, common regulatory and supervisory rules, and greater mobility of people.

[6] See, for example, Watkins (2003). Trade preferences under the Cotonou convention with African, Caribbean and Pacific states and the Everything But Arms initiative with least developed countries mitigate the effects of agricultural protection on some poor countries. However, product coverage under these initiatives remains selective.

[7] See Prassad et al. (2003).

The recent process of EU enlargement has followed the broad pattern of evolution of the EU itself, albeit on a much more compressed timescale. During the mid–1990s the EU concluded a series of Europe Agreements (Association Agreements) with ten countries of central and eastern Europe that established the basis for bilateral relations between these countries and the EU. An important aspect of these agreements was the establishment of free trade in goods over a period of ten years, with the EU reducing trade barriers more quickly than the associated countries. Further concessions on trade in agricultural products were applied on a reciprocal basis. The Europe Agreements provided for a stand-still on the introduction of new trade restrictions, safeguard clauses and anti-dumping provisions. As a means of pre-empting other forms of non-tariff protection, the Europe Agreements also provided for some harmonisation of laws and institutions governing competition policy and state aid. In addition, the Agreements opened the possibility of EU membership without specifying the membership criteria or timetable.

At the 1993 Copenhagen Summit of the European Council, agreement was reached among existing EU members to allow associated countries of central and eastern Europe to join the EU if they wanted to do so. The summit also agreed the political, economic and institutional criteria for membership. They include stability of the institutions guaranteeing democracy and the rule of law, existence of a functioning market economy and the capacity to cope with the competitive pressures within the internal market. They also include adoption of the *acquis communautaire,* its introduction into national legislation and its effective implementation through appropriate administrative and judicial systems. Beginning in 1998, the progress of each EU candidate member was monitored by the European Commission and its findings were published in regular monitoring reports.

The 15 EU members and the 12 countries in the process of joining the EU (the ten transition countries plus Cyprus and Malta) will create the largest single market in the world. Enlargement means the removal of artificial (legal, regulatory or tax) obstacles to the movement of goods, services and capital. After a transitional period this will also apply to the movement of EU residents looking for work in the EU. Enlargement also entails the implementation of the *acquis communautaire* throughout the enlarged EU. It should be an example of many of the potential benefits of globalisation.[8] The existing EU members and the accession countries have enough in common through geography, history and culture to create the institutions that will help to distribute fairly the potential gains from international integration.

Ineffective public administration at the regional, provincial and municipal levels, however, constrains the effective implementation of the *acquis communautaire* and limits the capacity of accession countries to absorb EU financial support following accession. Civil service structures are too large, lack the right management skills and do not offer selective, targeted financial rewards to attract the best people to public service. In addition to these structural weaknesses, there has been a loss of fiscal control in the four largest accession countries (the Czech Republic, Hungary, Poland and the Slovak Republic) over the past two years (see Chapter 3). Without renewed emphasis on further structural reform and the determination to implement fiscal tightening, EU accession will not result in economic convergence with existing EU members. The new and existing members must also continue to adapt EU institutions and governance to ensure that the expanded Union functions effectively.

For the past decade the EU has been an area of relatively low growth and high unemployment and of unrealised economic potential.[9] However, throughout that decade, some EU countries, large and small, have outperformed the relatively poor EU average by a significant and sustained margin. There are two lessons to be learned from this. The first is for the accession countries. Even after EU membership has been achieved, economic success or failure will be decided overwhelmingly “at home”. The mere adoption of the *acquis communautaire* does not guarantee growth and widely shared prosperity. The second lesson is for all EU members, new and old. The Lisbon agenda adopted in 2000, which aims to make the EU the most dynamic and competitive region in the world, has fallen badly behind schedule. If it is to be realised, it needs the early implementation of far-reaching structural reform and institutional change within the EU and in some key member states. The enlarged EU itself will be in transition to a more competitive and effective market economy for some time to come.

It is, moreover, essential for EU enlargement to be outward-looking and inclusive. In the field of trade, care must be taken to ensure that the enlarged EU is “trade creating” also for the countries left outside the enlarged EU. It must not divert the accession process to the acceding countries at the expense of the 17 transition countries that are not candidates for accession. This challenge associated with EU expansion is recognised in the EU’s Wider Europe initiative, which is discussed on the following pages. However, implementation of this initiative remains at a formative stage.

In addition, visa and work permit arrangements with countries adjacent to the expanded EU borders will need to be adapted in view of the requirements of the Schengen Agreement (regarding the free movement of people between EU countries) so that current opportunities for employment in and trade with countries on the new EU border will not be overly restricted. For example, beginning in October 2003 new reciprocal visa requirements started to be applied on the eastern border of Poland. Citizens of Belarus, Russia and Ukraine will now

[8] For empirical estimates of the net trade creation and trade diversion effects associated with EU enlargement, see Baldwin et al. (1997), Sulamaa and Widgrén (2003), and Koukhartchouk and Maurel (2003).

[9] See European Commission (2000) and European Commission (2003).

need to obtain visas to enter their new EU neighbour. Under a new agreement between Poland and Russia, both countries will charge each other's citizens €10 for a single entry visa and €50 for a multiple entry visa. A similar arrangement applies to Belarus. In the case of Ukraine, its citizens will be able to secure visas for entry into Poland free of charge, as will inhabitants of the Russian enclave of Kaliningrad, the only part of Russia that borders Poland.

Stability Pact for South-eastern Europe

The Stability Pact aims to foster greater political stability in south-eastern Europe and to prevent further conflict in this region, which has seen several wars and conflicts since the start of transition. While the idea of the Stability Pact predates the conflict in Kosovo, the NATO intervention in 1999 acted as a catalyst for the international effort to prevent further conflict. Beneficiary members of the Pact are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Moldova, Romania and Serbia and Montenegro. Other signatories to the Pact include all EU member states, Canada, Japan and the United States as well as a number of transition countries and international institutions. The conflict prevention strategy of the Pact is based on three pillars: the creation of a secure environment, promotion of sustainable democratic systems, and promotion of economic and social development.

In founding the Pact, the EU aimed to bring south-eastern Europe towards full integration with EU structures, including eventual full membership, provided that the countries satisfy the economic, political and institutional criteria for membership set out in the Copenhagen Treaty. Around the same time as the signing of the Stability Pact, the EU introduced a new initiative – the Stabilisation and Association Process – for the five south-east European countries that were not yet part of the EU accession process – Albania, Bosnia and Herzegovina, FYR Macedonia, and Serbia and Montenegro – as well as Croatia. A key part of the process is the formal signing of a Stabilisation and Association Agreement (SAA) between each country and the EU. The first SAA was signed with FYR Macedonia in April 2001, followed by Croatia in October 2001. Negotiations with Albania began in early–2003 but Bosnia and Herzegovina and Serbia and Montenegro are still at the stage of feasibility studies. Bulgaria and Romania, which already had association agreements with the EU, were admitted to full EU membership negotiations in December 1999.

In addition to their bilateral negotiations with the EU, all eight Stability Pact countries have signed a memorandum of understanding on trade liberalisation.[10] A key feature of this commitment is the creation of a network of bilateral free trade agreements in south-eastern Europe. These are consistent with their obligations to the World Trade Organization (WTO) and will facilitate their integration into EU structures. In February 2003, negotiations of the 21 agreements were completed and almost all became effective in mid–2003. This will create a more integrated market for goods in south-eastern Europe, with a population of 55 million people, and may help to attract greater foreign direct investment to serve this market. Moreover, the EU summit for the western Balkans in Thessaloniki in June 2003 reaffirmed that EU accession remained the ultimate aim of the Stabilisation and Association Process for the five participating countries. At the same time, the countries of the western Balkans committed themselves to implementing the recommendations of the annual review of the process based on the European Commission reports.

Regional cooperation in the CIS

The two basic objectives in establishing the CIS were first to allow the former Soviet republics to pursue genuine political independence and secondly to preserve the economic cooperation between most countries of the former Soviet Union. An inherent contradiction between these two objectives soon emerged as national independence became synonymous with economic independence in many countries. The provisions of the 1991 CIS Agreement were intended to overcome the problems of separate and potentially conflicting national interests by creating mechanisms to coordinate monetary, customs, employment, tax and investment policies on a region-wide basis. However, this and the many subsequent CIS agreements failed to incorporate effective sanctions and enforcement mechanisms or to create working practices for cooperation in economic policy.

In the absence of region-wide progress, some CIS states with similar economic and political aims began to adopt separate agreements. For example, in July 1995 a customs union among Belarus, Kazakhstan and Russia came into effect. The Kyrgyz Republic joined this group in December 1995 and Tajikistan became a member in February 1999. In practice, however, the sub-regional customs and trade arrangements functioned only marginally better than the CIS arrangements.

The Eurasian Economic Community (EAEC) was established in May 2001 by the five countries that were parties to the customs union agreement while Moldova and Ukraine gained observer status in the organisation in 2002. The treaty establishing the community was based on the existing customs union agreements but sought to reinforce these agreements by creating an institutional mechanism for policy coordination. Decision-making within the organisation is based on weighted voting, with Russia holding 40 per cent of the voting rights, Belarus and Kazakhstan 20 per cent each, and the Kyrgyz Republic and Tajikistan 10 per cent each. Approval of major policy issues requires a two-thirds majority of the votes. The main sanction for member countries that do not abide by the EAEC agreements is exclusion from the union, which may be too blunt an instrument to be effective. The EAEC has so far achieved little in the way of effective policy coordination.

A further attempt to promote greater economic integration and policy cooperation among CIS countries is the Single Economic Area (SEA) involving Belarus, Kazakhstan, Russia and Ukraine. A draft agreement was reached in August 2003

[10] The agreement was signed in June 2001 by the seven countries that were members of the Stability Pact at that time. Moldova, which joined the Stability Pact in June 2001, has since committed itself to the principles of the agreement, but on a later time schedule for signing bilateral free trade agreements.

and the four heads of state signed this agreement at the CIS summit meeting in September.

Some CIS countries also participate in other country groupings, such as the GUUAM (Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova) Group. This association of countries focuses on a range of economic, political and security issues. However, like the EAEC, the GUUAM Group has achieved little in terms of concrete results.

Wider Europe

In March 2003 the European Commission set out a new framework for relations with transition countries bordering the expanded EU – Belarus, Moldova, Russia and Ukraine – and with countries in the southern Mediterranean. This framework recognises that the EU and its neighbouring countries have a common interest in promoting stability and economic prosperity beyond the new borders of the EU. Instead of establishing new dividing lines, the aim is to foster deeper cooperation between the EU and its neighbouring countries. The approach proposes that further measures to enhance liberalisation and integration be implemented gradually in response to progress in the neighbouring countries. The basic proposal in the Wider Europe Initiative is to offer the neighbouring countries a stake in the EU's internal market in return for progress in implementing political, economic and institutional reforms, including aligning domestic legislation with the *acquis communautaire*. However, this proposal stops short of offering the neighbouring countries the prospect of EU membership or giving them a voice in shaping EU policies and rules.

The existing relationships between the EU and nine CIS countries (which pre-date the Wider Europe Initiative and include all CIS countries except Belarus, Tajikistan and Turkmenistan) are governed by a series of bilateral Partnership and Cooperation Agreements. These agreements are based on democratic principles and respect for human rights and contain trade provisions on improved market access. These provisions reduce some quantitative restrictions, safeguards and anti-dumping measures and provide for asymmetric market opening by the EU through the inclusion of some CIS exports into the Generalised System of Preferences (GSP).[11] Under these agreements, future negotiations on free trade agreements are conditional on the CIS country acceding first to the WTO. They also provide a framework for economic cooperation and assistance through the EU's TACIS programme. In addition, the EU and Russia have intensified their dialogue and cooperation in recent years, and have articulated the concept of a common economic space.

1.3 WTO accession

To ensure that the gains from international integration are widely distributed among countries of the region, further progress is needed in liberalising trade and in harmonising the rules governing trade between countries and regions. This is particularly relevant for the CIS countries. A substantial number of transition countries have already acceded to the WTO, including all countries in central and eastern Europe except for Bosnia and Herzegovina and Serbia and Montenegro. However, only four CIS countries – Armenia, Georgia, the Kyrgyz Republic and Moldova – have done so. Other CIS countries – Kazakhstan, Russia and Ukraine – have made some progress in their negotiations but major challenges remain for these countries if accession to the WTO is to be achieved in the near future.

There are several benefits that would result from expanding WTO membership in the region. First, many developed countries have classified the CIS countries as non-market economies. Consequently, as permitted by WTO rules, they have imposed quantitative trade restrictions and anti-dumping actions – in particular, against iron and steel and non-ferrous metal exports from Russia and Ukraine. Meeting the membership requirements of the WTO would help to improve the status of CIS countries, and membership would also provide these countries with access to dispute settlement procedures.

Secondly, the WTO ministerial conference in Doha, Qatar, in 2001 raised the possibility of significant liberalisation of agriculture, including the possible phasing-out of export subsidies, cuts in domestic farm supports and reductions in tariffs. The Doha negotiations also raised the prospect of improved market access for industrial goods, including so-called "sensitive sectors", such as textiles and clothing. Also included are tariff escalations applied to semi-finished and finished products made from raw materials produced in developing countries.

The failure of the WTO ministerial conference in Cancún, Mexico, in September 2003 was a significant setback to the Doha round of negotiations and reduced the possibility of completing the round successfully. However, there is the potential to revive the negotiations if developed countries are prepared to rethink their position on agricultural policies and if developing countries reconsider complementary, market-oriented reforms that will help them to participate in more integrated and competitive markets. Membership of the WTO would help to ensure that the CIS countries benefit from any further multilateral liberalisation of trade.

Thirdly, accession to the WTO of all CIS countries may help to reduce some of the obstacles to trade and transit within the CIS. This could arise from the WTO placing more uniform disciplines on the trade rules and customs procedures of some countries.

Regarding prospects for WTO accession of the non-member CIS countries, much depends on Russia's accession. This is partly due to the example it would set to other countries in the CIS but also to the sheer size and economic importance of the country. Recently there have been encouraging signs. On a multilateral level, Russia has made substantial progress in harmonising its legislation with WTO requirements. In bilateral negotiations with current WTO members, Russia has increased market access for industrial products. Nevertheless, discussions regarding both agriculture and services

[11] The GSP is a provision in the General Agreement on Tariffs and Trade (GATT) and WTO that allows countries to extend trade preferences to developing countries without extending the same preferences to all WTO member countries under the Most Favoured Nation (MFN) principle.

have barely begun. Discussions concerning agriculture remain complicated by the ongoing debate about agricultural reform currently under way in Russia. More generally, in many of the CIS countries existing legislation and practices in important areas, such as industrial subsidies, taxation, customs policy and anti-dumping, remain substantially different from the requirements of the WTO.

1.4 Sustaining progress in international integration and regional cooperation

Europe's experience with international integration and regional cooperation has varied significantly over the years. There are, for example, potential lessons to be learned from the experience of building the EU following the Second World War. This experience points to a feasible and desirable sequence of reforms, with the establishment of a customs union as a first step towards greater economic policy coordination and institutional harmonisation. The evolution, however, is neither automatic nor inevitable. In the case of western Europe, this evolution from integration of markets to cooperation on policies and institutions occurred against the backdrop of two devastating world wars. It was also accompanied by a strong and widely shared political commitment following the Second World War to prevent a third global conflict and a firm security guarantee provided by the United States.

As important as these factors were, there are likely to be additional forces that have helped sustain the evolution of the EU. Growing benefits from mutual economic interdependence can create further demands for expanded economic cooperation to extend the competitive advantages of integrated markets. Such demands can arise from business interests seeking to exploit the profit opportunities of large and fully integrated markets and from consumers benefiting from higher living standards. The coordination of economic policies and the harmonisation of market-supporting institutions can strengthen the efficiency of the market and many – but not all – policies of the EU have this effect.

Economic and political factors similar to those that shaped the evolution of the EU have been at work in the new accession countries, albeit in different ways and on a tighter timescale. The free trade agreements between the EU and the accession countries were implemented only a decade ago as part of the original association agreements and as a first step towards EU accession. These agreements were reached shortly after the fall of the Berlin wall and the collapse of the Soviet Union and were partly due to the widely shared political objective in the candidate countries to "rejoin the West". For the EU, it was a way of promoting political stability and economic prosperity on its eastern border. The prospect of EU accession has proved to be a powerful incentive for reform, contributing to substantial progress in the eight countries that are set to join the EU in 2004. However, the importance of the extraordinary politics of seeking to "join the West" may diminish once these eight countries accede to the EU, and more conventional factors will influence reform choices.

Several important lessons can be drawn from these two experiences with international integration and regional cooperation. First, a period of extraordinary politics can advance initial market liberalisation when in more normal political circumstances vested interests may oppose greater openness. Secondly, free trade areas or customs unions, particularly involving large markets, can help to strengthen domestic support for sustained international integration by emphasising the fairness of an open trading system and by expanding the beneficiaries from free trade – in particular, exporters and consumers. Thirdly, fairness and a level playing field across countries will require policy cooperation and institutional harmonisation in key areas. Based on these lessons, the approach being followed by the western Balkans is a well-structured response to the period of extraordinary politics that has followed conflicts in the region and the eventual fall of the Milosovic regime in the Federal Republic of Yugoslavia.

Similar strategies for CIS countries, however, do not appear to be feasible, at least for the foreseeable future. The period of extraordinary politics in the CIS was largely confined to Russia in the early 1990s. In this period, important policy breakthroughs were achieved. These appear to have placed Russia on a path towards greater international integration, albeit with some setbacks along the way. One way to consolidate these achievements would be to pursue greater international integration with a large affluent trading partner that could help to generate support within Russia for sustained openness and structural and institutional reform. However, the EU's Partnership and Cooperation Agreement with Russia is dependent on the country's accession to the WTO. In addition, the EU's Wider Europe Initiative and common economic space concept require progress in structural and institutional reforms (specifically in relation to adopting the *acquis communautaire*).

For such a strategy to be sustained economically and politically, it must offer a strong prospect for greater participation in the single European market. Implementation of such a strategy would need to agree intermediate points between full participation in the single European market and full adoption of the *acquis communautaire*. Reciprocal trade liberalisation between Russia and the United States and between Russia and Japan could reinforce this approach.

For the remainder of the CIS, the prospects for greater international integration and regional cooperation are much less certain. First, there has been no period of extraordinary politics in these countries that would promote greater openness. The dissolution of the former Soviet Union created 12 nation states, most of which had little or no recent experience as independent countries. Much of their history was of Russian imperialism or Soviet domination. Moreover, the political revolution that led to the dissolution of the Soviet Union was largely confined to Russia. Therefore, the political leadership in most CIS countries changed little from the previous regime.

This helps to explain their hesitant and largely ineffective approaches to international integration. Vested interests in maintaining the status quo and rivalries among countries and their leaders remain strong. Progress in Russia towards WTO accession and greater integration with the EU and potentially the United States and Japan could change this by demonstrating the benefits of integration and cooperation.

1.5 Conclusion

International integration and regional cooperation have transformed the world economy in the past half century. Nowhere have these two processes been more dramatic in their scope and speed than in the transition countries. They have emerged from long periods of communism and self-sufficiency within the CMEA. Their transition towards a market economy has involved in most cases a commitment to trade liberalisation and openness to foreign investment. The resulting changes in the structure and direction of trade and the inflow of capital have been substantial. The change in the structure of production has also been dramatic. Initial disruptions to production were severe and sometimes prolonged but the region has seen a strong recovery in recent years (see Chapter 3).

The impact of international integration and regional cooperation, however, is not confined simply to changes in output. International integration increases freedom and scope of choice for consumers and producers as well as for savers, enterprises and employees. This is important in its own right and fundamental to achieving comparable living standards across countries. This in turn has a significant influence on what is required of government and in a democratic system is demanded from it (see Chapter 2). For example, producers require from government economic policies that are predictable and effective market-supporting institutions that enable them to compete in the international economy. At the same time, employees require access to education and training, health care and a “safety net” that enables them to participate in the market economy. This includes government policies that facilitate adjustments in the labour market.

A key factor in greater international integration and policy cooperation in the transition countries has been the process of EU accession. The importance of EU enlargement and the policy and reform challenges posed by it are not confined to the prospective and existing EU members. The accession to the EU will have a significant impact on the structure of trade and capital flows to transition countries and on patterns of migration, both legal and illegal. The expansion of the EU to eight transition countries in 2004, a further two in 2007 and eventually perhaps more will have both trade creating and diverting effects. EU expansion will also influence investor interest in the transition countries and alter the pattern of foreign direct investment and other cross-border capital flows. Implementation of external border controls by the new EU members will change the pattern of seasonal and permanent migration among transition countries and to existing EU countries.

While the net overall effect of trade creation and trade diversion resulting from EU expansion is estimated to have a positive effect on the transition economies remaining outside the EU, there will be restricted access to some of the key potential markets. These include the markets for temperate zone agricultural products and “sensitive” manufactured goods. Moreover, care must be taken that EU expansion does not reinforce the marginalisation of some transition countries in the CIS that remain on the fringes of the international economy with relatively little foreign investment and little opportunity for legal migration. Further integration of the large CIS countries, such as Kazakhstan, Russia and Ukraine, into the international economy and greater regional cooperation within the CIS are necessary to avoid this outcome.

Even the countries that will accede to the EU in the near future will not have reached the end of their economic history.[12] Achieving EU membership is not enough to ensure economic success or even real economic convergence with the existing EU members. There is, in particular, a risk that the pressure for reform in these countries will diminish once they accede to the EU because the incentive for reform will no longer exist. However, a push for further reform in the new member countries of the EU will arise from competition in the single European market faced by domestic producers, constraints on state aid in the *acquis communautaire* and limits on fiscal deficits associated with the eventual adoption of the euro.

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[12] See Fukuyama (1992) on the “end of history”.

Part I

Transition and economic performance

Chapter 2

Chapter 3

Progress in transition and the development of democracy

2

Over the past year the transition countries have continued to make progress in structural and institutional reform. In particular, the countries of central eastern Europe and the Baltics (CEB) have moved further forward from their already advanced position, as they prepare for accession to the European Union. After the EU's Copenhagen summit in December 2002 and a series of referenda, all CEB countries except Croatia are now set to join the EU in May 2004. Bosnia and Herzegovina, Bulgaria and Serbia and Montenegro made most progress in south-eastern Europe (SEE) while Russia leads reforms in the Commonwealth of Independent States (CIS). However, in parts of the CIS progress in transition has virtually stalled. In two countries – Moldova and Uzbekistan – the reform process has actually moved into reverse in some areas.

The patterns of reform in 2002 and 2003 reflect the general trends in transition over the past five years. The advanced transition countries in CEB continue to make progress, while in SEE the fastest reformers are increasingly catching up. Within the CIS the division between intermediate reformers, such as Russia, Kazakhstan and the Kyrgyz Republic, and slow reformers, such as Belarus, Turkmenistan and Uzbekistan, is beginning to widen.

If these trends continue, there is a danger that the divisions which have already become apparent in the region may become permanent. While one group of countries is increasingly integrated into the world economy and the single European market – in the case of CEB and the most advanced SEE countries – a second group is in danger of being caught in a trap of slow reform, low productivity and high vulnerability similar to low- and medium-income developing countries outside the EBRD's region of operations.

These divergent patterns of economic reform are mirrored by political developments. The advanced transition countries have made steady progress in the development of liberal, constitutional democracy while the countries that lag behind in transition are increasingly characterised by weak constitutional orders and, in some countries, political repression.

The chapter assesses reform progress over the past 12 months and updates the EBRD transition indicators (see p. 16). It begins with a review of reform progress so far and the key challenges that lie ahead. The chapter then asks what role the development of constitutional liberalism – meaning not just electoral democracy but also the rule of law and the institutionalisation of civil and political rights – has in promoting and sustaining the transition from command to market economies.

2.1 Transition indicators and reform progress in 2003

The EBRD's transition indicators lie at the core of the Bank's assessment of progress in transition. These have been published since 1994, tracking reform developments in all 27 countries of the region since the beginning of transition.[1] Progress is measured against the standards of industrialised market economies, while recognising that there is neither a "pure" market economy nor a unique end-point for transition. The measurement scale for the indicators ranges from 1 to 4+, where 1 represents little or no change from a rigid centrally planned economy and a 4+ represents the standards of an industrialised market economy (see Table 2.1).

Assessments are made in nine areas which, when combined, cover the four main elements of a market economy – markets and trade, enterprises, infrastructure and financial institutions:

- The reform of markets and trade is measured by the liberalisation of prices, the liberalisation of trade and access to foreign exchange, and the effectiveness of competition policy in combating the abuses of market dominance and anti-competitive practices.
- The reform of enterprises includes two indicators for privatisation, which measure progress in transferring state-owned small and large-scale enterprises into private ownership. For large-scale privatisation, the scores also reflect the standards of corporate behaviour among privatised large corporations. The governance and enterprise restructuring score indicates progress in cutting production subsidies and introducing effective bankruptcy procedures and sound corporate governance practices.
- Infrastructure reform is measured as the composite score of progress in five areas: telecommunications, electric power, railways, roads, and water and waste water. For each of these areas, the indicator covers issues such as commercialisation, the extent of tariff reform, the quality of the regulatory framework and involvement of the private sector.
- For financial institutions, the indicators measure reform and development of the banking sector (including the extent to which interest rates have been liberalised) as well as the creation of securities markets and non-bank financial institutions. They also show the extent to which banking and financial regulations have been raised to international standards, whether they have been enforced effectively and if procedures exist for resolving the failure of financial institutions.

Table 2.1 presents the scores for reform progress in these areas for 2003. Past ratings can be found in the country assessments at the back of the Report.

[1] In 2001 the transition indicators were backdated to cover the period 1989-93 as well.

Table 2.1

Progress in transition in central and eastern Europe and the CIS

			Enterprises			Markets and trade			Financial institutions		Infrastructure
Countries	Population mid–2001 (million)	Private sector share of GDP mid–2002 (EBRD estimate in %)	Large-scale privatisation	Small-scale privatisation	Governance & enterprise restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Infra-structure reform
Albania	3.4	75	2+	4	2	4–	4+	2–	2+	2–	2
Armenia	3.0	70	3+	4–	2+	4+	4+ ↑	2	2+	2	2+
Azerbaijan	8.1	60	2	4–	2+ ↑	4	4–	2	2+	2–	2–
Belarus	10.0	25	1	2+ ↑	1	3–	2+	2	2–	2	1+
Bosnia and Herz.	4.3	50	2+	3	2 ↑	4	4– ↑↑	1	2+	2–	2+
Bulgaria	8.1	75	4–	4–	3– ↑	4+	4+	2+	3+	2+	3–
Croatia	4.6	60	3+ ↑	4+	3–	4	4+	2+	4–	3–	3–
Czech Republic	10.3	80	4	4+	3+	4+	4+	3	4–	3	3
Estonia	1.4	80	4	4+	3+	4	4+	3–	4–	3+	3+
FYR Macedonia	2.0	60	3	4	2+	4	4+ ↑	2	3	2–	2
Georgia	5.4	65	3+	4	2	4+	4+	2	2+	2–	2+
Hungary	10.0	80	4	4+	3+	4+	4+	3	4	4–	4–
Kazakhstan	14.9	65	3	4	2	4	3+	2	3 ↑	2+	2+
Kyrgyz Republic	4.7	65	3	4	2	4+	4+[1]	2	2+	2	1+
Latvia	2.4	70	3+	4+	3 ↑	4+	4+	3– ↑	4–	3	3–
Lithuania	3.7	75	4–	4+	3	4+	4+	3	3	3	3–
Moldova	4.3	50	3	3+	2– ↓	4–	4+	2	2+	2	2
Poland	38.7	75	3+	4+	3+	4+	4+	3	3+	4–	3+
Romania	22.3	65	3+	4–	2	4+	4	2+	3–	2	3
Russia	145.4	70	3+	4	2+	4	3+ ↑	2+	2	3– ↑	2+
Serbia and Mont.	8.6	45	2+ ↑	3	2	4	3+	1	2+	2 ↑	2
Slovak Republic	5.4	80	4	4+	3	4+	4+	3	3+	3– ↑	2+
Slovenia	2.0	65	3	4+	3	4	4+	3–	3+	3–	3
Tajikistan	6.2	50	2+	4–	2–	4–	3+	2–	2–	1	1+ ↑
Turkmenistan	5.4	25	1	2	1	3–	1	1	1	1	1
Ukraine	49.3	65	3	4 ↑	2	4	3	2+	2+	2	2
Uzbekistan	25.0	45	3–	3	2–	3–	2–	2– ↓	2–	2	2–

Note: The private sector share of GDP is calculated using available statistics from both official (government) and unofficial sources. The share includes income generated from the formal activities of registered private companies, as well as informal activities where reliable information is available. The term "private company" refers to all enterprises in which private individuals or entities own the majority of shares.

The accuracy of EBRD estimates is constrained by data limitations, particularly in the area of informal activity. EBRD estimates may, in some cases, differ markedly from official data. This is usually due to differences in the definition of "private sector" or "non-state sector". For example, in the CIS, "non-state sector" includes collective farms as well as companies in which only a minority stake has been privatised.

↑ and ↓ arrows indicate change from the previous year in that sectoral transition indicator. One arrow indicates a movement of one point (from 4 to 4+, for example), two arrows a movement of two points. Up arrows indicate upgrades, down arrows downgrades.

[1] The Kyrgyz Republic's trade and foreign exchange system score was revised upward to 4+, backdated to 1999, to reflect that country's WTO accession.

Classification system for transition indicators[1]

Large-scale privatisation

1 Little private ownership.
2 Comprehensive scheme almost ready for implementation; some sales completed.
3 More than 25 per cent of large-scale enterprise assets in private hands or in the process of being privatised (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance.
4 More than 50 per cent of state-owned enterprise and farm assets in private ownership and significant progress on corporate governance of these enterprises.
4+ Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.

Small-scale privatisation

1 Little progress.
2 Substantial share privatised.
3 Comprehensive programme almost ready for implementation.
4 Complete privatisation of small companies with tradable ownership rights.
4+ Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.

Governance and 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. 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 Some lifting of price administration; state procurement at non-market prices for the majority of product categories.
3 Significant progress on price liberalisation; state procurement at non-market prices remains substantial.
4 Comprehensive price liberalisation; state procurement at non-market prices largely phased out; only a small number of administered prices remain.
4+ Standards and performance typical of advanced industrial economies: complete price liberalisation with no price control outside housing, transport and natural monopolies.

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 and current account convertibility.
4+ Standards and performance norms of advanced industrial economies: removal of most tariff barriers; membership in WTO.

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.

Infrastructure

The ratings are calculated using the average reform process ratings in telecommunications, electric power, water and waste water, roads and railways. (See Annex 2.1 for the individual scores and the definitions of thresholds.)

"+" and "–" ratings are treated by adding 0.3 and subtracting 0.3 from the full value. The average is obtained by rounding down, e.g. a score of 2.6 is treated as 2+, but a score of 2.8 is treated as 3-.

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

Box 2.1

Revised indicator for price liberalisation

The move from state-controlled to market prices is a key step on the road from communism to market economies. It is a step that most transition countries undertook early on. Within a short period of time the majority of price controls were lifted and the tell-tale queues and product shortages disappeared as market prices began to give a better indication of the scarcity of goods.

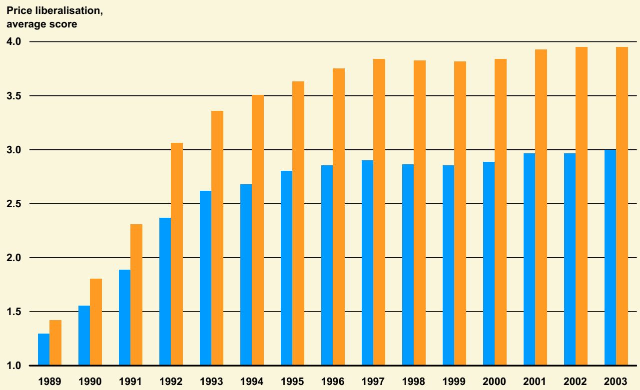
The EBRD transition indicator for price liberalisation tracked progress in this area but combined it with developments in utility tariffs. The price for water, power, heat and other utility services cannot be liberalised as long as the service is provided by monopolies. What the indicator therefore tracked was progress in moving to transparent tariff regulation that allows utilities to cover their costs fully. Unlike the abolition of price controls, this has proven to be a very difficult task, with most countries failing to charge utility prices that cover all costs. Consequently, most countries were stuck on a rating of 3 or 3+, even though they had effectively liberalised most commodity prices.

The revised price liberalisation index seeks to separate the issue of state price controls from utility price regulation. The revised price liberalisation index focuses exclusively on the abolition of price controls and state procurement, while tariff issues are tracked in the infrastructure indicators. The separation was made possible by the extension of the infrastructure series undertaken in the 2002 *Transition Report*. The new series draws on the EBRD survey of administered prices, a similar series by de Melo et al. (2001) and country-specific information.

The difference between the new and old series for the region as a whole is shown in the adjacent chart. The updated series for individual countries can be found in the country pages at the end of the Report.

The chart confirms that on the whole the region moved swiftly in freeing prices and abolishing state procurement, allowing the majority of countries to reach a level of 4 or 4+ by the late 1990s. Most of the remaining controls concern state procurement in the agricultural sector, a system that is still in place, for example, in Turkmenistan and Uzbekistan.

Price liberalisation series



Old series   New series

Source: EBRD.

Note: The chart reports the average price liberalisation score across all 27 countries of the region. "Old series" refers to the price liberalisation series before the 2003 revisions. "New series" refers to the price liberalisation series after the 2003 revisions.

These assessments also contain the in-depth country-by-country analyses that form the basis of the scores presented here. Detailed definitions of the scores can be found in the notes to Table 2.1 while the sector-by-sector assessment of infrastructure reform is provided in Annex 2.1.

This year's assessment also contains a revised series for price liberalisation, which excludes utility price reform. Utility tariff regulation and the phasing out of administered prices raise fundamentally different issues and the new series distinguishes between them. Utility regulation is also an integral part of the infrastructure indicators (see Annex 2.1). The new series therefore reduces the overlap between the two indicators. The new price liberalisation indicator is further explained in Box 2.1.

Reform progress by country

There is significant cross-country variation in progress along the nine indicators presented in Table 2.1. Chart 2.1 summarises the average change in the transition indicator scores between 2002 and 2003 for each country. Fourteen out of 27 countries recorded increases in their reform scores last year, with eleven countries remaining at the same level.[2] A reduction was recorded in the governance and enterprise restructuring score in Moldova and the competition policy indicator in Uzbekistan, reflecting ongoing difficulties with government interference in the economy.

As in previous years, the largest improvements were recorded in the SEE region. However, countries such as Bosnia and Herzegovina and Serbia and Montenegro are improving from a very low base and their reform achievements are still fragile. In Bulgaria, progress has been prompted by the prospect of EU membership in the medium term. In the CIS, Russia made significant progress across a range of sectors, while Armenia, Azerbaijan, Belarus, Kazakhstan, Tajikistan and Ukraine all improved in one area. Latvia, historically one of the slower reformers in the first-wave EU accession group, progressed fastest among the CEB countries.

With the exception of Croatia, the emphasis in the advanced reform countries of CEB has been on finalising the accession negotiations with the EU, a process which culminated in formal offers for admission being issued to the four Visegrad countries (the Czech Republic, Hungary, Poland and the Slovak Republic), the Baltic states and Slovenia at the end of 2002. These countries are now set to join the EU in May 2004. This is a milestone for the region both economically and politically. However, it does not signify the end of the transition process, which started 14 years ago. The economies of CEB have made substantial progress on the road to becoming efficient, well-functioning market economies but important gaps remain – for example, in the breadth and depth of these countries' financial markets and regarding the restructuring of strategic sectors, such as energy,

2 Some of these countries recorded changes for individual infrastructure scores (see Annex 2.1) but they did not result in changes in the overall infrastructure indicator, which is the average of its five constituent parts.

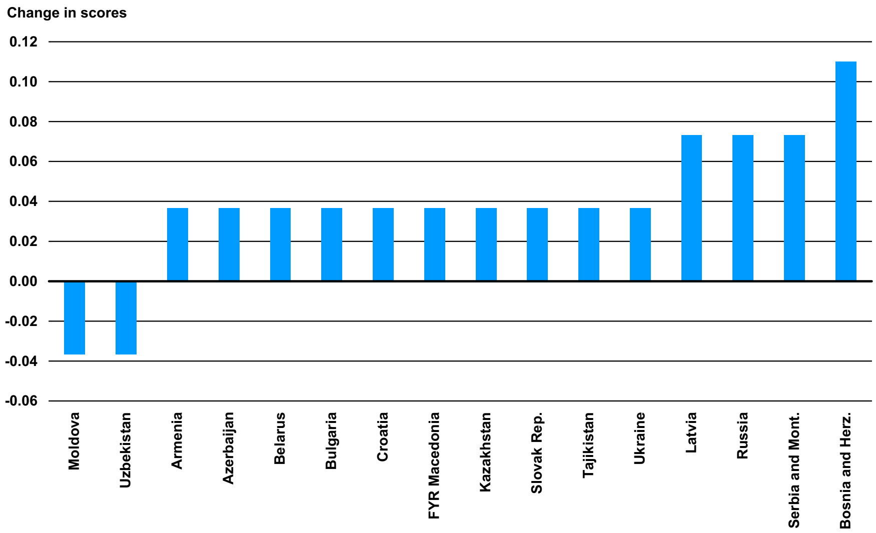
heavy industry and agriculture. There are also deficiencies in the quality of public administration (including the judiciary), especially at the regional and municipal levels. These weaknesses raise questions about the accession countries' capacities to absorb and use effectively the post-accession grants from the EU's cohesion and structural funds.

For these reasons, the conclusion of the accession negotiations has only led to selected adjustments in the transition ratings, and not a wholesale upgrade across several areas for all countries. As Box 2.2 shows in more detail, a substantial part of the EU negotiations concerned the adjustment of existing market-compatible systems to the *acquis communautaire* and other issues not directly covered by the transition indicators. Progress was nevertheless recorded, in particular in the Slovak Republic and Latvia, which has started to close the gap on enterprise restructuring and competition policy with its Baltic neighbours. The only non-accession country in CEB, Croatia, was upgraded on the strength of road sector reform and the part-privatisation of the important INA refinery.

In SEE, reforms are moving ahead in Bulgaria which, despite delays in key privatisations, is on course for EU membership in the next accession round in 2007. In the other accession country, Romania, the implementation of reforms has slowed down, and there have been no upgrades in the transition score for the third year in a row. In the western Balkans – Albania, Bosnia and Herzegovina, FYR Macedonia, and Serbia and Montenegro – the EU reaffirmed its commitment to the Stabilisation and Association Process (SAP) at the Thessaloniki summit in June 2003, which may continue to serve as an anchor for reform in these countries (see Chapter 4). In 2002 and 2003, Bosnia and Herzegovina and Serbia and Montenegro have made progress along a number of dimensions, including small-scale privatisation and measures to improve the business environment. However, both countries started transition later than most others, and are improving from a low level.

Chart 2.1

Change in average transition indicator scores, 2002–03



Source: EBRD.

Note: The chart reports the change in simple unweighted averages across all dimensions of transition reported in Table 2.1. No change was recorded in Albania, Czech Republic, Estonia, Georgia, Hungary, Lithuania, Poland, Romania, Slovenia, Tajikistan and Turkmenistan.

In Serbia and Montenegro the pace of reform has slowed relative to the previous two years, as a result of the long delay in forming the new union and political disagreements among key reformers in the country. The assassination of the Serbian Prime Minister, Zoran Djindjic, in March 2003 initially led to an overdue crackdown on crime and corruption but some of the reform momentum has since been lost as political parties vie for position in advance of presidential and parliamentary elections. In Bosnia and Herzegovina, much of the impetus to reform comes from the Office of the High Representative rather than from local politicians, and the economic integration of the two entities is progressing only slowly.

In Russia, market confidence in the economy has further strengthened, with declining capital flight, increased levels of foreign investment and booming bond and equity markets. There have been encouraging new achievements in advancing electricity sector reform, further steps on trade and currency liberalisation and some progress in developing the institutional framework for pension reform. However, there are also indications that the pace of change has slowed in the run-up to the Duma elections in December 2003 and the presidential elections in March 2004. This is particularly evident in banking sector restructuring, where Duma consideration of key reform measures, such as the deposit insurance law, has been repeatedly delayed. Gas sector reform has been held up by the lack of agreement about the pace and direction of reform. Among the key risk factors for the short and medium term, recent events surrounding the oil company Yukos serve as an important reminder of the potential uncertainties of the Russian business environment.

Elsewhere in the CIS the picture is mixed. Ukraine has made progress on small-scale privatisation and has approved reductions in corporate and personal income tax. The government is also considering reductions in the VAT rate. Azerbaijan has taken an important step forward in terms of governance and transparency by making many quasi-fiscal energy subsidies explicit and bringing them on budget. Progress was also recorded in Armenia, Kazakhstan, Tajikistan and Belarus. Despite this improvement, Belarus remains at an early stage of reform. In all CIS countries reform is held back by weak institutions, lack of implementation capacity at all levels of the state and often political commitment to reform. Over the last year, shortcomings in this respect were most strongly felt in Georgia and

Box 2.2

Progress in EU accession and transition

During the Copenhagen European Council of 12 and 13 December 2002, eight transition countries – the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia – completed all 31 chapters of the EU's *acquis communautaire*, the set of principles, policies, laws, practices, objectives and obligations on which the EU is based. Following the successful conclusion of the accession negotiations, an official date for enlargement was set for 1 May 2004. Romania and Bulgaria, which have completed 19 and 25 chapters respectively, will not accede with the first wave of entrants but a roadmap has been put forward by the European Commission, which envisages the accession of these two countries to the EU in 2007.

Despite the fact that the eight first-wave countries have closed accession negotiations, they have not all achieved top scores according to the EBRD transition indicators for each transition category. The reasons for this are outlined below.

- There is a qualitative difference between transition progress, as measured by the transition indicators, and the process of accession. While the transition indicator scores are awarded on the basis of concrete measures taken by countries in a number of sectors, the criteria for the accession negotiations are less clear-cut. Unlike the transition indicators, the 31 chapters of the *acquis communautaire* are not concrete benchmarks. The specific content of each chapter of the *acquis* is based on negotiations between the individual accession country and the EU, and the closure of the chapter is dependent on acceptance of the conditions negotiated.
- A large number of chapters of the *acquis* deal with issues not taken into consideration by the transition indicators, namely those chapters dealing with legislative and executive institutions, internal and external policy, customs union, and financial and budgetary provisions.
- While harmonisation with EU legislation is in progress, it is not a completed process. According to EU law, the entire *acquis* becomes national legislation as of the official date of accession. However, the accession countries were granted temporary postponements on certain aspects of the *acquis* on the basis of a "promise of acceptance". Particularly for the most complicated chapters – namely those having financial implications or those involving large-scale restructuring – a number of "transitional arrangements" were agreed. New member states were granted grace periods in certain areas, allowing them to introduce EU laws progressively. For example, in the area of competition policy, the Czech Republic, Hungary, Poland and the Slovak Republic have all been granted grace periods for the phasing-out of fiscal subsidies to sectors such as small and medium-sized enterprises (SMEs) and large-scale enterprises over the next eight years, with particular exemptions for the steel sector.

For these reasons, EU accession has not resulted in automatic upgrades in the EBRD transition indicators. Even for the future EU members, transition is not yet over.

Moldova – which have seen the discontinuation of their IMF programmes as a result – as well as in Turkmenistan and Uzbekistan. In Moldova and Uzbekistan, continuing problems of government harassment have resulted in a downgrade in overall reform performance.

Progress along the different dimensions of reform

Earlier *Transition Reports* have highlighted the difference in the speed of reform along the various dimensions of transition. In particular, a distinction is often made between "initial phase" or "liberalising" reforms, which take priority during the early years of transition, and subsequent "second phase" or institution-building reforms, which take longer to implement. In 2003 there has been a continuation of the shift towards second phase reform (see Chart 2.2).

Initial phase reforms include price and trade liberalisation as well as small-scale privatisation. They are more straightforward to implement in the sense that they primarily require a reduction in state activity while the second, more difficult, phase of transition focuses on the development of market-based structures and institutions. These reforms include competition policy, enterprise restructuring, the development of financial institutions and the reform of infrastructure. Large-scale privatisation is also included in this group, as it can involve extensive political struggles to overcome the resistance of vested interest groups.

In all but a few laggards, initial phase reforms have largely been completed. The new series on price liberalisation, which excludes utility prices (see Box 2.1), confirms that with a few exceptions full price liberalisation was substantially achieved by the late 1990s, even though many countries continue to control some prices, in particular rent and petrol.

Perhaps the most prominent initial reform challenge that remains is the consolidation of trade liberalisation through accession to the World Trade Organization (WTO). WTO accession has some of the institutional features of second phase reforms, and progress has been slow. After protracted negotiations, Armenia and FYR Macedonia both acceded to the WTO in 2003, bringing the total of WTO members in the region to 17 out of 27. Kazakhstan, Russia and Ukraine remain prominent candidates for WTO membership, and all three countries have made some progress towards eventual accession. However, as the experience of countries such as Georgia, the Kyrgyz Republic and Moldova shows, WTO membership on its own does not guarantee unhindered access to international and regional markets, or the removal of key trade barriers. Chapter 4 looks in more detail at the benefits and challenges of trade integration.

In terms of second phase reform, the measure for governance and enterprise restructuring is a broad indicator that captures key issues, such as the quality of the business environment, the hardness of budget constraints and the quality of corporate governance. In 2002 and 2003 several countries, including Bosnia and Herzegovina, Bulgaria and Latvia, have improved their bankruptcy laws or procedures. If implemented successfully (and in some cases further adjustments will be required), the new provisions should help to facilitate market exit and advance enterprise restructuring. Several other countries have launched initiatives to tackle corruption, reduce licensing requirements or streamline the tax code. However, in most cases it is still too early to judge the success of these measures. Shortcomings in the legal and regulatory framework, high administrative barriers and weaknesses in the judicial system remain important obstacles to a functioning enterprise sector in many countries, including the most advanced EU accession countries.[3]

The speed of large-scale privatisation has slowed down, with only two countries obtaining upgrades in this category – Croatia and Serbia and Montenegro, where sales included the privatisation of two important tobacco companies. This partly reflects the fact that most of the "easy" privatisations have been completed and what is left in state hands are either ailing companies that are difficult to sell or strategic assets over which governments are reluctant to relinquish control. However, progress was also held back by a difficult global economic climate which has caused many potential investors to scale down their operations in emerging markets.

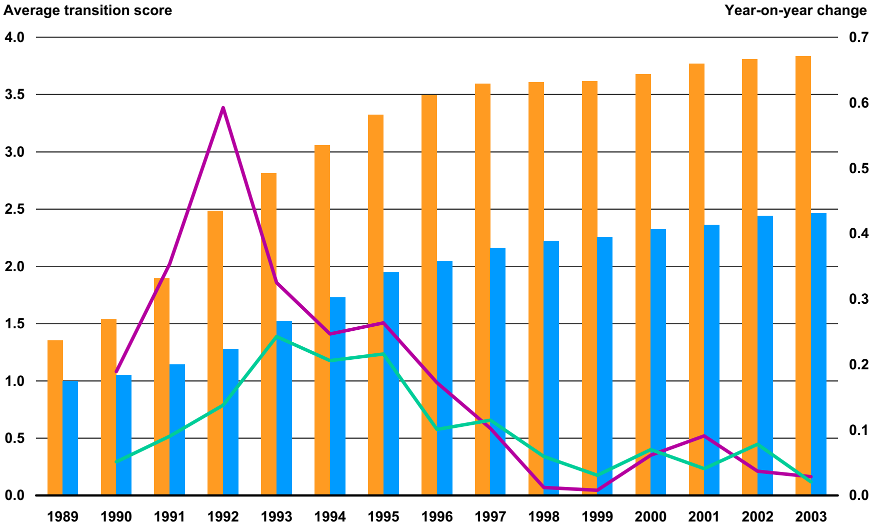
Partly for this reason there has been a shift towards privatisation to investors from within the region. A good example is the sale of the Croatian refinery INA to Hungary's MOL. Similarly, Croatian and Slovenian investors have begun to look at investment opportunities in neighbouring SEE countries, while Russian investors have become increasingly active in the CIS. Some of these sales have political undertones, particularly if the buyers are partially or wholly state-owned enterprises. However, to the extent that regional investors can deliver the expected improvements in corporate governance, business practices, profitability and access to markets, this development should be welcomed as a sign of the maturing enterprise sector in the region.

In the financial sector, most progress has been in non-bank financial institutions. Improvements in one or several areas, such as the legal and regulatory framework for pension funds and the insurance sector or the growing transparency, efficiency and sophistication of the securities market, have warranted transition indicator score upgrades in Russia, Serbia and Montenegro and the Slovak Republic but overall the financial sector is still underdeveloped.

Compared with Western economies, the level of financial intermediation in the region remains low. In the CIS and much of SEE, domestic credit to the private sector, a measure of financial intermediation, tends to be less than 15 per cent of GDP, compared with over 45 per cent in Croatia, the most advanced country in this respect, and 160 per cent in Western economies. Particularly in the CIS, the banking sector also remains fragmented and individual banks are weak: a low level of financial intermediation coexists with too many banks. The banking sector in CEB, much of it foreign-owned, is more sophisticated and banks are diversifying their product range by introducing mortgage lending, leasing and other products. However, with much of the recent growth in consumer lending, bottlenecks in enterprise financing, particularly to small and medium-sized enterprises, are only slowly being overcome.

Chart 2.2

Reform progress since 1989



Source: EBRD.

Note: The chart reports the average score across all 27 transition countries in the two broad dimensions of reform between 1989-2003. Initial phase reforms include price liberalisation, foreign exchange and trade liberalisation, and small-scale privatisation. Second phase reforms include large-scale privatisation, governance and enterprise restructuring, competition policy, infrastructure reforms, banking and interest rate liberalisation, and non-bank financial institutions. Reforms are measured using the EBRD transition indicators. Scores range from 1 to 4. For a full explanation of the classification system, refer to Table 2.1.

Reform challenges and trends

The broad patterns of reform across the region have changed little over the last 12 months. Benefiting from EU accession as an incentive to reform, the CEB countries continue to set the pace. Behind them a group of second tier reformers has emerged, comprising Russia and the fastest SEE reformers, spearheaded by Bulgaria. The CIS is increasingly fragmented, with a growing gap between the fastest reformers and a group of stragglers where reform has virtually stalled or is even regressing. The implementation of reform has also slowed down in Romania, which has been less able to take advantage of the reform pull provided by EU accession.

Chart 2.3 shows that this geographical pattern dates back to the beginning of transition. The countries of CEB established their reform advantage over the first five years of transition. After that, transition advanced at roughly the same speed across the region until the setback in Russia after the 1998 financial crisis. Only over the last four or five years have the second tier reformers started to catch up with the CEB frontrunners.

[3] See, for example, the results of the Business Environment and Enterprise Performance Survey (BEEPS) presented in the 2002 *Transition Report* and Fries et al. (2003).

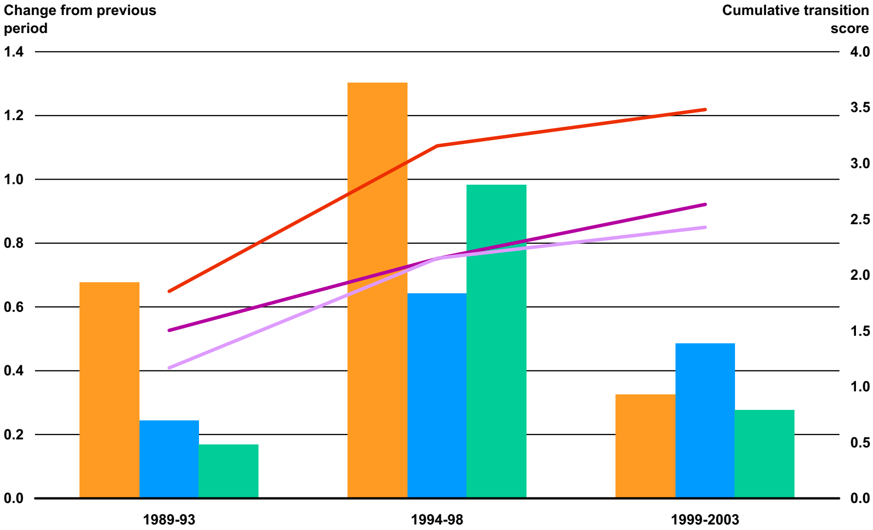
What is striking about these developments is the continuing gulf between CEB and the CIS. Although the laggards are still gradually "catching up" with the advanced reformers across the transition countries as a whole, when divided into regions it becomes clear that SEE is gaining on CEB and pulling steadily ahead of the CIS. Chart 2.4 shows this pattern clearly. As SEE kept up with the pace of the CEB frontrunners and eventually began to catch up, they widened the gap between themselves and the CIS, where not all countries have progressed at the same pace.

A continuation of these trends could lead to the eventual split of the region into two distinct groups of countries. The first group, including CEB and the leading SEE and CIS reformers, would be increasingly integrated into the world economy, with a gradual convergence of socio-economic indicators towards those of other industrialised countries. For many countries, this would also mean deepening integration with the European single market. The second group of countries is in danger of becoming trapped in a position of slow growth, low productivity and high economic vulnerability, with weak institutions and lack of access to private international capital. Thus, they could increasingly come to resemble the vast majority of other low- and medium-income developing countries.

The risk of falling behind permanently is perhaps most acute for the countries that have made little progress in implementing political democracy, the rule of law and safeguards for civil rights. In particular, the countries that have implemented electoral democracy but have not made any progress in the other associated arenas of an open society – predominantly countries in the CIS – seem to be most in danger of being "left behind". These limitations on political freedom are often associated with the absence of trust in the state and its institutions, another factor which seems to undermine efforts at implementing structural and economic reforms. The following sections explore this issue in more depth.

Chart 2.3

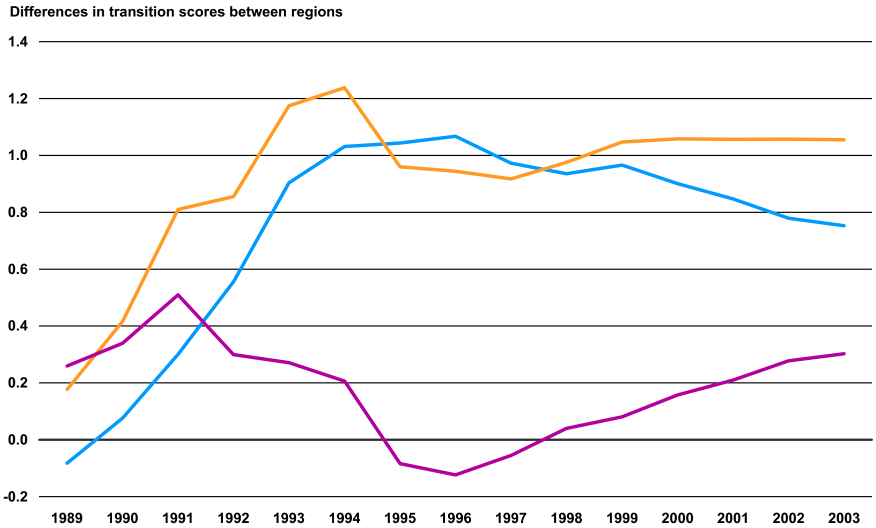
Regional patterns in progress in transition



CEB (left axis) SEE (left axis) CIS (left axis)
CEB (right axis) SEE (right axis) CIS (right axis)
Source: EBRD.
Note: The regional average from 1989-93 was calculated using 1989 as the "previous period".

Chart 2.4

Regional patterns in transition progress



CEB and SEE CEB and CIS SEE and CIS
Source: EBRD.

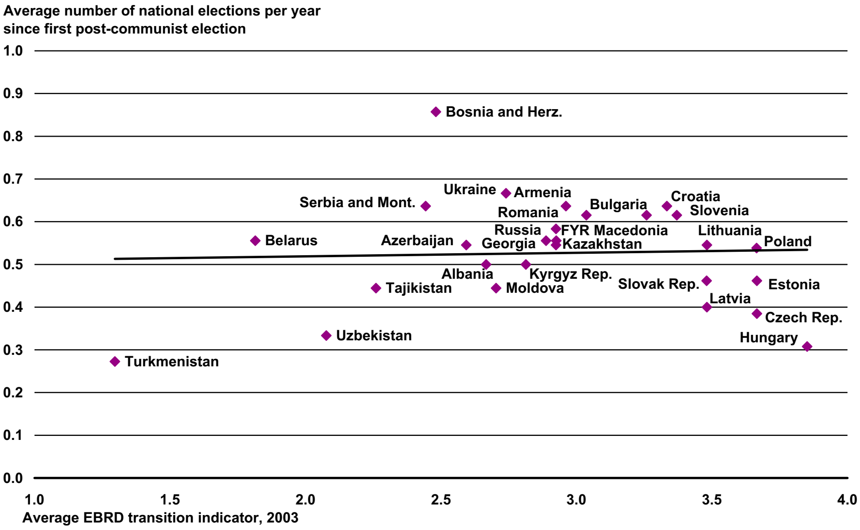
2.2 Development of democracy and progress in transition

The relationship between market liberalisation and democratic reform has been examined in past editions of the *Transition Report*, revealing important connections between these two processes. For some time many scholars and policymakers promoted the idea that market reform in developing countries can only be sustained by suspending democratic rule and/or strengthening executives in order to insulate policy-makers from a political backlash by the losers from reform.[4] However, it is now increasingly accepted that democratic political governance – along with good public and corporate governance – is a critical ingredient for

[4] This was the underlying message in the findings presented in Przeworski (1991) although he did not promote the idea of curtailing democratic freedoms. Haggard and Kaufmann (1995) advocate the importance of strong, insulated executives during the early transition phases.

Chart 2.5

Electoral democracy and progress in transition



Source: EBRD.

Note: The chart reports the number of elections per year, including both parliamentary and presidential elections, held since the first national election of the post-communist period.

sustainable growth over the medium and long term.[5] The experience of transition countries seems to support this second point of view. The most advanced reformers in the region have also been the countries that have moved the furthest along the road to fully democratic political regimes.

Why does economic modernisation in the transition countries appear to go hand in hand with liberal democratic norms? The focus until now has been mainly on the effects of political competition on reform, on the intermediation among competing interests, and on public attitudes towards and support for reform. According to these arguments, countries with more political competition are more accountable and therefore have greater legitimacy with voters. More frequent changes of government reduce the likelihood that vested interests will capture key policy-making institutions, such as the government, the legislature, or the courts. More checks and balances within and among governing institutions help to generate more effective solutions to difficult policy problems.[6] In other words, competitive elections – or "electoral democracy" – are needed for effective policy-making and reform.

There is some evidence to suggest, however, that elections (even "free and fair" elections) alone are not enough. Building a modern democracy requires more than the establishment of a modicum of political competition and electoral institutions.[7] It also requires freedom of expression and openness. It requires the establishment of the rule of law and the firm guarantee of property rights. Moreover, there seems to be a close connection between these aspects of political liberalisation and market reform.

Countries that have made the most progress in market reform are also those that have made the greatest strides in enhancing the rule of law, strengthening institutions of governance, protecting property and contract rights, and guaranteeing basic freedoms and civil liberties.[8] Countries where democratic institution-building has stopped with the introduction of elections, by contrast, have not moved as far up the transition ladder and, in some cases, have been prone to falling into a partial reform trap.[9] Chart 2.5 illustrates this problem. All post-communist countries have held periodic contested elections from the beginning of the transition to the present day but the frequency of such elections is not linked with progress in transition.

While elections have become the norm in most of the transition region, there is considerably wider variation in the extent to which liberal principles have taken root. The remainder of this section looks at specific measures of what has been called "constitutional liberalism". As distinct from electoral democracy, this includes the characteristics of "constitutionalism", which refers broadly to limitations on the power of the state, and "liberalism", meaning the protection of basic individual and group rights. Constitutionalism includes the institutions of rule of law, a separation of powers and other institutions of good governance, while liberalism includes such things as freedom of speech, assembly and property.[10] Without these, the quality of elections – that is, adherence to international standards for free and fair democratic elections – is likely to suffer. Moreover, as the next section suggests, progress in transition – particularly second phase transition – has been slower without them.

Constitutional liberalism and market reform

The breakdown of countries according to their implementation of political and civil liberties corresponds closely to their progress in market reform. The most advanced reformers in CEB are also the most liberal and open. Indeed, what separates the most advanced reformers from the rest in political terms is not so much the way they choose their

5 Political governance refers to both regime types (democratic vs. authoritarian) and institutions of government (electoral procedures, party systems, presidential vs. parliamentary, coalition vs. majority ruled government). Public governance refers to the institutional framework and economic environment within which private firms operate. It can include such factors as macroeconomic stability, the rule of law, enforcement of contracts, protection of private property, effective regulation, a fair and equitable tax regime, effective public administration, and policy effectiveness. See, for example, Kaufmann et al. (2003), World Bank (2003), and recent versions of the UN Human Development Reports.

6 See 1999 *Transition Report*, Chapter 5; 2000 *Transition Report*, Chapter 2; 2002 *Transition Report*, Chapter 1.

7 "Democracy" is formally defined as "rule of the people" but in the current context is understood to encompass concepts of political competition and constitutional liberalism.

8 A similar conclusion is reached by Dethier et al. (1999).

9 See Hellman (1998).

10 Zakaria (1997) made the distinction between liberal and illiberal democracies and defined the term "constitutional liberalism".

governments but rather the way those in power govern. This can be seen by looking at measures of different aspects of constitutional liberalism, including the rule of law and control of corruption, protection of property rights and freedom of the media. These four characteristics have been selected because they directly address the key issues of enforced limitations on the power of the state and the protection of a range of individual and group rights.[11]

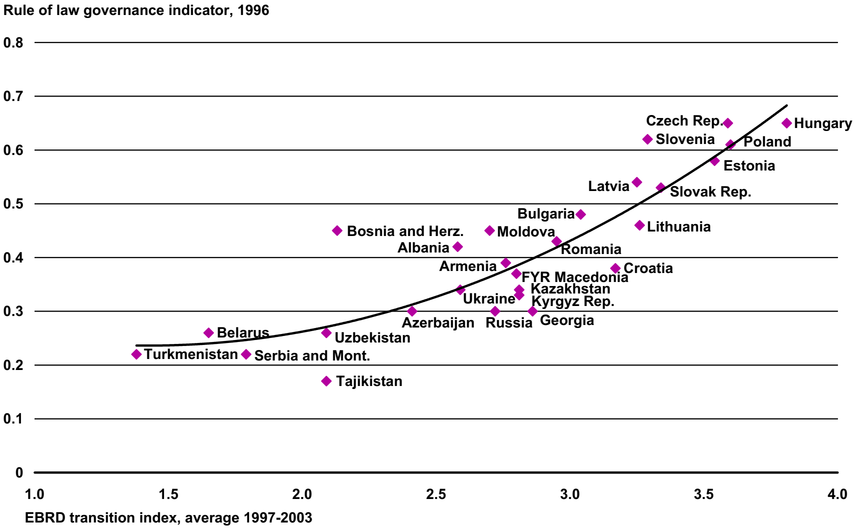
Rule of law, property rights and control of corruption

There is a growing understanding about the importance of the rule of law for the effective functioning of market economies. Without effective rule of law, contracts are less enforceable and therefore businesses are more likely to trade only with a small circle of firms connected by family or friendship ties. Without the rule of law, criminal behaviour and racketeering may prevent the creation of new businesses, impede the economic performance of existing ones, and deter foreign investors from entering a local market. A court system that cannot be relied on to render fair and honest judgments in commercial disputes, that is prone to corruption or undue influence by government officials or that dispenses justice to achieve politically motivated ends rather than uphold the constitution and laws of the state will impair the functioning of, and hinder the transition to, a well-functioning market economy.

Chart 2.6 uses the World Bank's "rule of law" indicator and pairs it with the average EBRD transition score for each country. The rule of law indicator measures perceptions of the effective-ness of the judiciary, the enforceability of contracts and the incidence of crime.[12]

Chart 2.6

Rule of law and progress in transition



Sources: EBRD and World Bank.

Note: The rule of law governance indicator measures perceptions of the effectiveness of the judiciary, the enforce-ability of contracts and the incidence of crime. In the chart, 0 represents the lowest and 1 the highest level of rule of law.

Comparing the 1996 rule of law score with the average transition indicator score over the period 1997-2003, there is a close link between rule of law and market reform.[13]

The rule of law is also important for the building of trust – in the institutions of the state, among ordinary citizens and among firms. Trust has been described as an "important lubricant" in a social and economic system, present in virtually every commercial transaction, especially those conducted over a period of time.[14] Trust lowers transaction costs and allows efficient trade to take place even under conditions of relative uncertainty and limited information. In the transition countries, legacies of distrust in the state and governing institutions, combined with a pattern of closed social and business networks, have slowed down the adjustment process.[15]

One way to measure trust among firms is to ask suppliers how much prepayment (or advance payment) they demand in commercial transactions with their customers. A firm's willingness to forgo prepayment may be seen as an indication that its managers believe they will be paid fully and on time, either due to trust in the customer or to trust in the legal system and its ability to fairly adjudicate business disputes. High prepayment demands, conversely, can be seen as a measure of distrust in a customer or lack of confidence in the contract enforcement regime.[16]

An indicator of trust based on pre-payment demands can be drawn from the 2002 Business Environment and Enterprise Performance Survey (BEEPS).[17] Country averages for this measure of trust are closely linked with economic reform, as measured by the EBRD transition

[11] Constitutional liberalism also refers to other values and principles, such as freedom of religion and the separation of powers. However, much of the existing literature shows a robust correlation between these and the aspects of constitutional liberalism used here.

[12] The rule of law indicator draws on 15 independent sources, eight of which are survey-based, with the remaining seven based on expert opinion. The indicator includes measures on various aspects of the rule of law, such as losses due to costs of crime, the prevalence of organised and violent crime, the level of money laundering and direct financial fraud, the extent of the black market, the prevalence of tax evasion, the enforceability of government and private contracts, the quality of the police, the fairness of judicial processes, and the independence of the judiciary from political influence. Although three of the nine EBRD transition indicators are used to construct a separate governance indicator on "regulatory quality" in the World Bank's database, the EBRD transition indicators are not used in the estimation of the rule of law indicator.

[13] 1996 is the earliest date for which the World Bank's governance indicators are available.

[14] See Arrow (1972) and Arrow (1974).

[15] See Raiser (1999).

[16] See Raiser et al. (2003).

[17] See Raiser et al. (2003). The BEEPS was conducted by the EBRD and the World Bank and covers more than 6,000 firms in 26 of the 27 transition countries. See 2002 *Transition Report* for detailed results.

indicators, as well as other factors normally associated with high trust societies, such as wealth and good governance (see Chart 2.7).

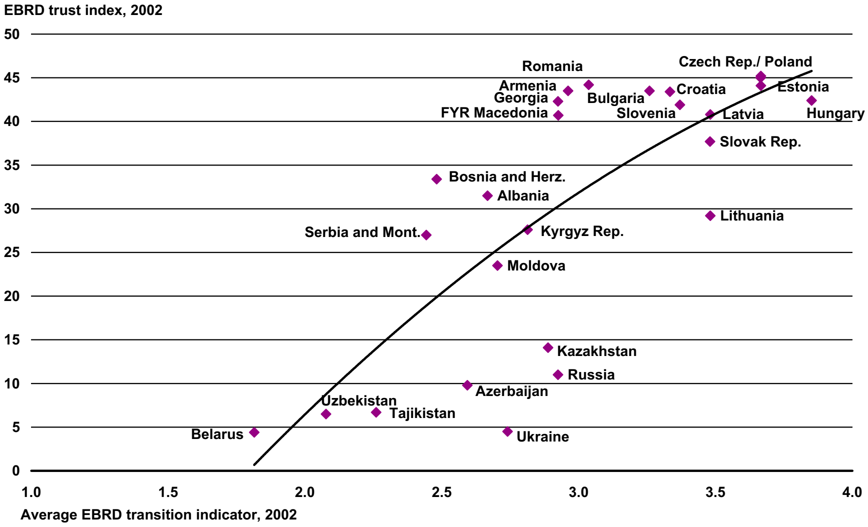
Moreover, prepayment is strongly linked with firms' assessment of the fairness and honesty of the courts. The BEEPS contains several questions on the quality of the legal system, including specific questions about firms' assessments of the fairness and impartiality of the courts, the absence of corruption, the speed and affordability of legal procedures, and the courts' ability to enforce judgments. Prepayment demands are lower where courts are perceived as fair and honest but higher where courts are seen as fast and affordable, suggesting that justice is more important for building trust than the accessibility of the court system.

Another aspect of constitutional liberalism that is related to rule of law is the protection of property rights. These must be delineated and protected to encourage the efficient allocation of resources and production.[18] An efficient property rights regime is critical to encourage individuals and businesses to engage in the types of activities that lead to growth: investment and innovation.[19] To the extent that these activities are facilitated by progress in market reform, countries with better protection of property rights should have higher overall scores on the EBRD transition indicators. The strength of property rights protection, as measured by the Heritage Foundation's index of economic freedom, is closely linked with EBRD transition scores.[20]

Control of corruption is also closely related to the rule of law. High levels of corruption indicate that the state has a low capacity to uphold the constitutional order, and this weakness leads to inadequate protection of citizens' civil and political rights. Both the World Bank's

Chart 2.7

Trust in the business environment and progress in transition



Source: Business Environment and Enterprise Performance Survey (2002).

Note: The trust score represents the country's average proportion of firms demanding advance payment for sales. This score has then been inverted so that low trust countries appear at the bottom of the y-axis and high trust countries appear at the top of the y-axis.

"control of corruption" variable and, as reported in Chart 2.8, Transparency International's corruption perceptions index are closely linked with EBRD transition scores from 1999 to 2003.

Media freedom

The importance of media freedom for good governance has received increasing attention in recent years.[21] Elections are more likely to be free and fair if the media are free to report on the candidates and the campaign process. Elected officials are required to have higher standards when information on their behaviour is freely available and the media develop a culture of investigative journalism. Corruption is more likely to come to light and guilty officials punished appropriately when freedom of information laws are in place, "whistle blowers" are protected and the independent media have the ability and incentive to report the truth about officials in power.[22]

Although most of the transition countries no longer have a state monopoly on the press and official censorship that prevailed under communism, not all have achieved a fully free press. The average freedom of media score for 1994 for the transition countries, as measured by Freedom House, is strongly linked with the EBRD's average transition scores for the period 1995-2003, as Chart 2.9 illustrates.

Another sign of decentralisation of the media is the percentage of the media still owned by the state. Data from the World Bank and Harvard University regarding the ownership of the media in 22 transition countries in 1998[23] suggest that independent media ownership goes hand in hand with progress in transition, as measured by the Bank's transition scores. The higher the share of print and broadcast media owned privately, the more advanced countries are in transition.

[18] The absence of a formal property system and a legal framework to back it up is the central explanation proffered by de Soto (2000) for why many developing and post-communist countries remain poor.

[19] See North and Thomas (1973), and North (1981).

[20] The Heritage Foundation property rights indicator scores the degree to which private property rights are protected, to what extent the government enforces laws that protect private property and the risk that private property will be expropriated. It includes seven sub-component variables: freedom from government influence over the judicial system; the existence of a commercial code defining contracts; the sanctioning of foreign arbitration of contract disputes; the experience of government expropriation of property; the level of corruption within the judiciary; delays in receiving judicial decisions; and legally granted and protected private property. See O'Driscoll et al. (2002).

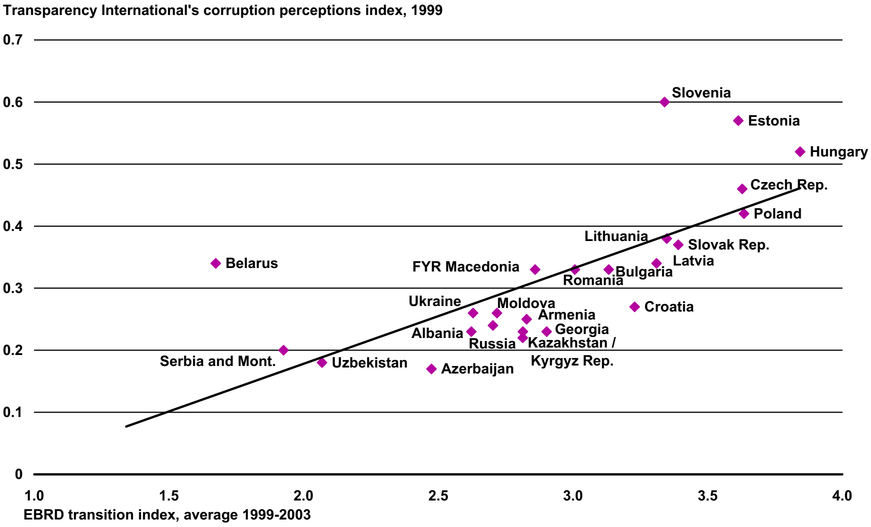
[21] See Sen (1999).

[22] See Stapenhurst (2000).

[23] See Djankov et al. (2002).

Chart 2.8

Corruption and progress in transition

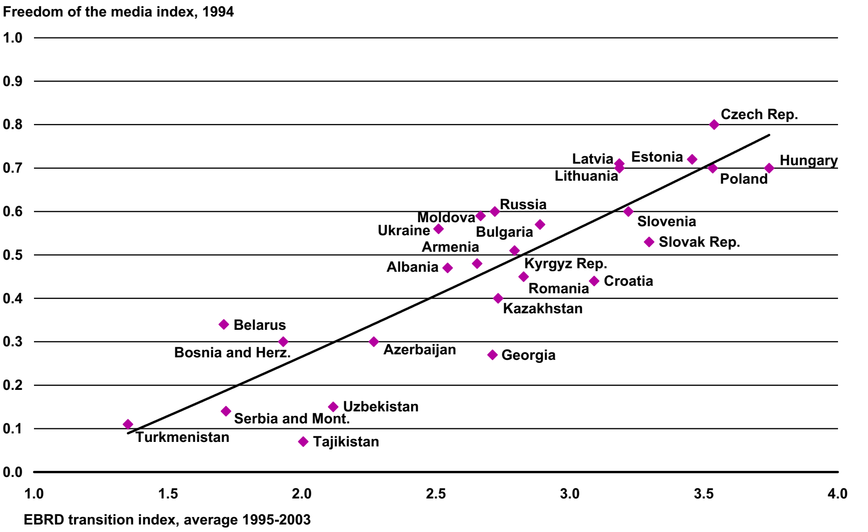


Sources: Transparency International and EBRD.

Note: Data for Bosnia and Herzegovina, Tajikistan and Turkmenistan were not available. The Transparency International corruption perceptions index has a scale of 0–10, with 0 representing the highest and 10 the lowest level of perceived corruption. To facilitate comparison with the other charts in this chapter, this scale has been converted to 0-1.

Chart 2.9

Media freedom and progress in transition



Sources: Freedom House and EBRD.

Note: Data for FYR Macedonia were not available. The Freedom House freedom of the media index has a scale of 0–100, with 0 representing the highest and 100 the lowest level of media freedom. To facilitate comparison with the other charts in this chapter, this scale has been inverted and scaled to 0-1. In this chart, 0 represents the lowest and 1 the highest level of media freedom.

Progress in transition and political liberalism

The level of constitutional liberalism can be measured by taking an unweighted average of the scores for rule of law, property rights protection, control of corruption and media freedom, as described earlier. Chart 2.10 shows that there is a strong link between this measure of constitutional liberalism and progress in transition. CEB countries are positioned mainly at the top of the curve, having achieved high levels of transition and constitutional liberalism. At the bottom and middle sections of the slope are mainly countries from the CIS and SEE.

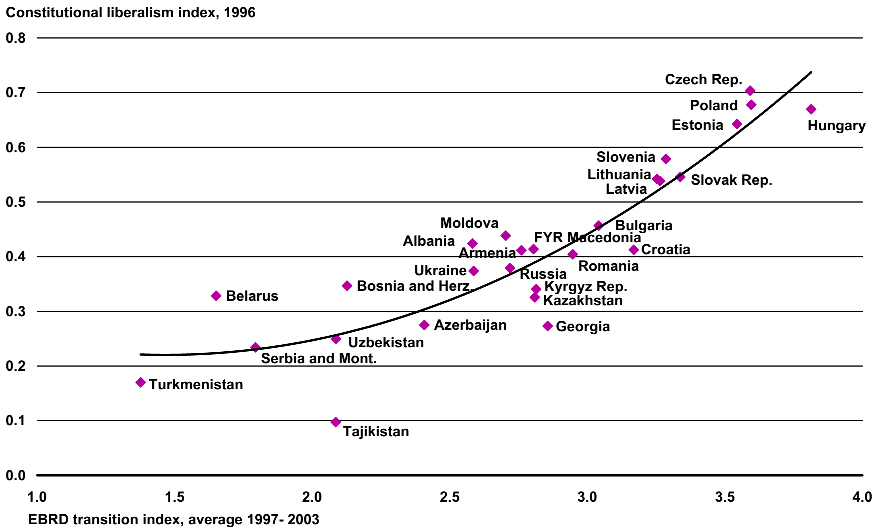
If constitutional liberalism and market transition go hand in hand, a key question is how countries can make progress along this curve. The countries that have achieved the highest transition scores and enjoy the greatest degree of political freedom have a number of characteristics in common. Almost all of the countries in this group chose to develop parliamentary forms of government rather than the strong presidential systems adopted in most of the CIS. They are all located in the centre of Europe rather than at its periphery. Most had some experience prior to the communist era with some aspects of constitutional liberalism (private property rights, the impartial rule of law) and the institutions of a market economy. None had to deal with territorial disputes or armed conflicts following the fall of communism. They are all comparatively better off economically, with per capita GDP between US$ 3,600 and US$ 11,000 by 2002. Perhaps most importantly, they have been the strongest candidates for EU accession from the earliest stages of transition, which has acted as a firm incentive for economic, political and social reform.

The linkages between these initial conditions and external incentives, and progress in both political and economic reform are complex and not easily disentangled. A look at reform progress in several SEE and CIS states that have started to “catch up” over the past two years shows that advances in market transition and progress in democratic freedoms have not always occurred at the same pace.

There are some countries where progress in market transition is matched by progress in implementing constitutional liberalism. In Bulgaria and Croatia, for example, rapid transition progress since 1998 has been closely mirrored by a steady rise in these countries’ constitutional liberalism scores. In Romania, improvements in the protection of property rights, the control of corruption and freedom of the media have been less pronounced. This is generally in line with the slower improvements in Romania’s transition rating over the past five years. As several of the former Yugoslav states

Chart 2.10

Constitutional liberalism and progress in transition

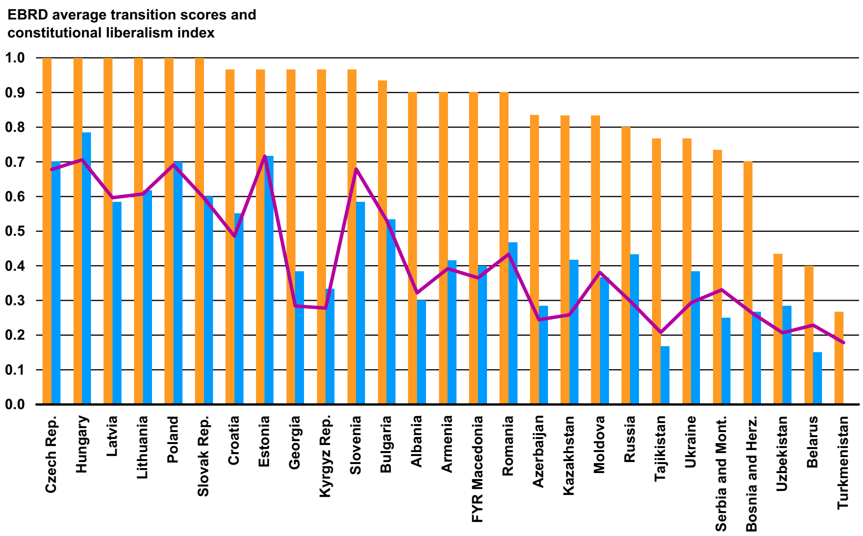


Source: EBRD.

Note: The constitutional liberalism index represents the unweighted average of four indicators: the Freedom House freedom of the media score; the World Bank's rule of law governance indicator; the World Bank's control of corruption governance indicator; and the protection of property rights score from the Heritage Foundation's index of economic freedom. These indicators have been standardised and in the chart 0 represents the lowest and 1 the highest levels of constitutional liberalism.

Chart 2.11

Initial and second phase reform and constitutional liberalism, 2003



Initial phase (scaled) Second phase (scaled) Constitutional liberalism index

Source: EBRD.

Note: The initial and second phase EBRD transition scores have been re-scaled to a range of 0-1 to facilitate comparison with the constitutional liberalism index. See Chart 2.10 for an explanation of the constitutional liberalism index.

emerged from a period of protracted violence and suspended transition, the catch-up process in market reform has been swift but the implementation of constitutional liberalism – in particular, rule of law and control of corruption – has been more halting. Nevertheless, both Bosnia and Herzegovina and Serbia and Montenegro have, since 1999-2000, made consistent improvements in both market reform and political liberalisation.

In other countries, reform progress has been matched with a retreat on some measures of liberalism. In Armenia, Russia and Ukraine, for example, progress in transition and robust growth over the past few years have occurred at the same time as a general tightening of state control in the political realm. All three countries were downgraded by Freedom House's freedom of the media index from "Partly Free" status to "Not Free". In addition, the rule of law in these countries has been tarnished by cases of perceived arbitrary state intervention in court proceedings at the expense of private business. This includes cases of hostile business takeovers during the process of industrial consolidation and the use of the courts to pressure the media through exorbitant libel awards or to quash opposition voices by recentralising state control.

Can the countries where progress in transition has not been accompanied by improved constitutional liberalism continue to make progress in market transition, or will they reach a threshold of reform that ultimately cannot be crossed without further political liberalisation? As the transition countries are limited to just over a decade of political and economic reform, it is difficult to reach firm conclusions. However, comparing progress in initial phase reforms, which are generally seen as less politically complex and simpler to implement, and second phase reforms, which are more likely to encounter political opposition from vested interests, helps to clarify the situation.

The bars in Chart 2.11 represent the average for initial phase and second phase reforms, and the line shows the constitutional liberalism score for each country. This chart illustrates clearly that countries with lower ratings in the constitutional liberalism index have succeeded mainly in initial phase reform but have been less successful in second phase reform. In general, the differences in initial phase reform among the CEB, SEE and CIS countries are far less pronounced than the differences in second phase reform, where SEE and CIS lag further behind the advanced transition countries.

If deeper political democratisation facilitates the introduction of second phase reform, another critical question arises. Can countries move from conditions of electoral democracy to full liberal democracy, and if so, how? On the one hand, some recent studies have suggested that the transition to liberal democracy works best if the rule of law, protection of property rights and other aspects of constitutional liberalism are introduced first and elections held only later.[24] This is what occurred in the transition process in some countries in East Asia and in Chile, which many still refer to as models for successful economic development. This argument is based on the assumption that political leaders, even enlightened ones, need to be insulated from electoral pressures if they are to succeed in introducing progressive reforms that ultimately unlock a country's economic potential.[25]

On the other hand, there are many cases of countries that introduced elections first and then gradually increased constitutional liberalism.[26] In these cases, over time the elected governments responded to incentives to protect the individual and commercial interests of the voters that put them in power. Likewise, in the advanced transition countries political reform began with electoral institutions, and then proceeded to introduce and strengthen liberalising reforms. Electoral democracies can move towards higher degrees of political liberalism but the internal and external conditions for this process are not in place in every country.

Progress in democracy and transition can result from a variety of factors. For example, there is strong evidence that countries with high per capita income are more likely to experience democratic consolidation – that is, they have embraced liberal democratic governance and are less prone to regime reversals.[27] In effect, growth may create the conditions that lead to more effective democratic governance. However, growth based primarily on natural resource extraction may be an exception. Many resource-dependent economies have experienced macroeconomic volatility, high levels of income inequality, slow institutional development and problems in governance which inhibit political and economic liberalisation.[28]

In these and other cases, political will is needed to liberalise the media, accelerate freedom of information legislation, and engage civil society to help counteract the tendencies towards corruption among bureaucrats and insiders. A step-by-step attack on the roots of misgovernance – including lack of transparency, distorted incentives and remuneration policies in the court systems, and non-competitive privatisations – should be undertaken by governments. It is not clear, however, whether systematic anti-corruption programmes are needed to get results, as often these programmes are more successful in satisfying donors than in fighting corruption on the ground.[29] A concerted effort to reduce corruption in specific spheres – for example, through comprehensive administrative reform – can help to reduce bribery levels just as effectively.

In the legal system, reforms are more likely to succeed where the demand for law already exists and the ground has been laid for new laws to be implemented effectively.[30] Evidence from the transition countries suggests that simply increasing the number of good laws on the books will not necessarily lead to the emergence of effective legal and market institutions.[31] Furthermore, as noted earlier, reforms to reduce corruption in the courts may be more effective in building business confidence and trust than reforms designed to make the court system more accessible and affordable. Finally, the prospect of membership of the EU, the Council of Europe and to some extent NATO (which insists that member countries meet democratic criteria) provide important incentives for both political liberalisation and market reform.[32] While a weaker incentive for reform than the EU's *acquis communautaire*, WTO accession criteria can also promote more open trade and deeper commercial integration. Together with a stronger institutional framework, this can spur stronger economic performance (see Chapter 4).

2.3 Conclusion

The accession in 2004 of eight transition countries to the European Union is among the most significant achievements of the EBRD's region of operations since the beginning of transition. However, even for the accession countries EU membership will not be the end of the transition process. Reforms in the new member countries will have to continue – especially in the financial sector, in public administration and in the business environment – if these countries are to be competitive in the single market. There can be little doubt that the prospect of EU membership has been a major spur for structural reform in the accession countries. This was shown again in 2002-03, when the EU accession negotiations helped the CEB countries to consolidate reform progress and maintain their position as the front-runners of transition.

The prospect of further economic integration also encouraged reform in other countries with aspirations for closer ties with the EU. Most notably this has been evident in SEE, where the leading reformers continued to catch up in 2002-03. However, the effect may start to spill over into part of the CIS as

[24] See Zakaria (2003).

[25] Ibid. The supporting evidence of "liberal autocracies" that eventually embraced representative government is limited to historical examples in nineteenth century Europe, as the only modern country that fits this description is the colonial case of British-ruled Hong Kong before 1999.

[26] Cases often cited include the Dominican Republic, El Salvador, Mexico, Nicaragua, the Philippines, South Korea and Taiwan.

[27] See Lipset (1959), and Przeworski and Limongi (1997).

[28] See Sachs and Warner (1995) and 2001 *Transition Report*.

[29] See Rousso and Steves (2003).

[30] "Demand for law" refers to the extent to which the reform of key laws and legal institutions give rise to increasing use of the law, as well as the participation of civil society in the law-making process and the agitation for new laws and legal institutions emanating from citizens and grassroots organisations. See Berkowitz et al. (2003) and Hendley (1999).

[31] See Pistor et al. (2000).

[32] See Berglof and Roland (1997).

the enlarged EU begins to pay closer attention to its new neighbours to the east. This would be a welcome development for a region where reform performance is becoming increasingly uneven – with encouraging progress in some countries and virtual stagnation or backtracking in others – and progress continues to be held back by poor governance and weak institutions.

Another important factor for successful transition is the establishment of strong democratic institutions, openness and trust among market participants and between governments and society. While all of the transition countries except Turkmenistan have established the minimal form of electoral democracy, there is a very high level of variation among countries in the development of constitutional liberalism. Countries where the rule of law, the control of corruption, the protection of property rights and the freedom of the media are approaching the levels of stable democracies are also the countries that have achieved the most progress in transition to market economies.

While a handful of late starters and resource-dependent economies have made significant progress in transition over the past three or four years, the evidence suggests that this progress has been limited to comparatively less politically sensitive initial phase reforms – price and trade liberalisation and small-scale privatisation. Only those countries which have established high levels of political and civil liberties and the effective rule of law have made significant progress in the more crucial area of second phase reforms. These include the establishment of new, market-supporting institutions and good corporate governance, which are likely to attract high levels of foreign direct investment and improve these countries' competitiveness in regional and global markets.

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Annex 2.1: Progress in infrastructure reform

Transition in the management of infrastructure requires progress in the key areas of tariff reform, commercialisation, competition, privatisation in the provision of infrastructure services (where appropriate), and regulatory and institutional development. The EBRD transition scores in infrastructure reflect developments in these areas in five sectors – telecommunications, electric power, roads, railways, and water and waste water.

This annex summarises recent developments in these five sectors, which underlie the transition indicator scores shown in Table A.2.1.1. It also asks whether progress in infrastructure reform has resulted in the expected improvements in service standards, drawing on evidence from the 2002 EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS).[1]

Telecommunications

Following liberalisation of the telecommunications sector in central eastern Europe and the Baltic states (CEB), there have been a number of interesting developments, including cross-sector activity and increased competition in the fixed-line market, led by power and railway operators. The advantage of railway or power companies offering telecommunications services is that they already have the rights to run their own fibre-optic network and therefore do not have to lease capacity from the incumbent operator.

A number of Internet Service Providers (ISPs), mobile operators and new companies have already entered the fixed-line market or are preparing to launch voice services, especially in CEB but also to a lesser extent in south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS). This enables operators to provide a more attractive service package, particularly to the corporate sector. Any increase in digital subscriber line (DSL) roll-outs by incumbents is likely to encourage cable TV operators to increase their high-speed roll-outs, allowing them to provide broadband Internet access over the medium term.

However, in some countries, including Latvia, effective liberalisation has been delayed by the failure to reach agreement on interconnection, even though new fixed-line licences have been awarded. In Hungary a proposal by the incumbent operator, Matav, to calculate interconnection fees according to long-run incremental costs (the cost of providing extra capacity in the long term) was approved in June 2003. In Lithuania, reduced interconnection fees were also approved in June following complaints by non-incumbent operators. Poland's international calls sector was opened to competition at the beginning of 2003 but due to capacity constraints only a limited number of subscribers had access to alternative service providers.

SEE has seen some progress on privatisation. The Bulgarian government is expected to finalise shortly the sale of a 65 per cent share in the Bulgarian Telecommunications Company (BTC) to a financial consortium after a controversial privatisation process that started in April 2002. In Bosnia and Herzegovina the authorities are committed to privatising the state-owned operator in Republika Srpska by the end of 2004 but there have been delays in the preparation of the sale (including the appointment of a privatisation advisor). In Albania the privatisation process is about to be resumed following earlier unsuccessful attempts to sell the fixed-line incumbent Albtelecom.

In the CIS the Kyrgyz telecommunications market was fully liberalised in January 2003, in accordance with the country's agreement with the World Trade Organization. The independent regulator has already awarded eight licences to alternative providers of international services. In June 2003 a consortium of PriceWaterhouseCoopers and a subsidiary of Sweden's Telia was declared the winner of the first stage of the tender for a 51 per cent stake in the fixed-line incumbent, Kyrgyz Telecom. Some progress in the development of a regulatory framework was also made in Kazakhstan, Tajikistan and Ukraine, where the government adopted a new sector action plan. However, in Ukraine the adoption of a new framework telecommunications law was vetoed by the President over concerns about the accountability of the independent regulator.

Power

Electricity liberalisation has now been implemented across a number of CEB countries. EU accession, in particular the need to meet the Electricity Directive, has been a key driver in this process. The Czech electricity market has reached its second phase of gradual liberalisation. Since January 2003, industrial customers with annual consumption of over 9 gWh are allowed to choose power suppliers. They account for 40 per cent of total power sales. The Hungarian electricity market was opened for competition in January 2003, allowing large industrial customers with annual consumption of over 6.5 gWh to choose their suppliers, albeit only for 50 per cent of their power consumption. In the Slovak Republic the market was opened up for large industrial customers with annual consumption of more than 40 gWh. However, in many of the EU accession countries, especially in Hungary and Poland, the main barrier to the creation of a competitive market

[1] See 2002 *Transition Report*.

remains the unresolved issue of existing long-term contracts, which prevent buyers from seeking better offers in the liberalised market.

In an important move towards further regional integration, the SEE countries, together with Croatia and Moldova, have committed to the introduction of a regional electricity market by 2005, sparking a series of regulatory adjustments. In FYR Macedonia a new independent regulatory agency for the energy sector was established in July 2003. In Montenegro a new energy law setting out a framework for an independent regulator and liberalisation of the sector came into force in July 2003 while the Serbian energy law is currently under discussion.

In the CIS the picture is mixed. Substantial progress was made in Russia. A package of six laws and amendments, which constitute the legal foundation for power sector reform, was enacted in April 2003. A more detailed plan for 2003–05 was subsequently approved by the government in June, mapping out the legal and corporate steps needed to restructure the industry. The government further approved the restructuring plans for a number of regional, vertically integrated electricity companies and the creation of ten wholesale generation companies. The approval of the rules and regulations for the wholesale power market is expected in late autumn 2003. The full liberalisation of the wholesale market is envisaged by 2006 and the retail market by 2008.

In contrast, reform has regressed in Moldova and Georgia, which were once at the forefront of power sector reform in the CIS. In both countries the new institutions set up a few years ago have experienced growing government (as well as court) interference and there have been costly delays in the adjustment of tariffs. In Georgia, regulatory uncertainty coupled with financial problems led to the withdrawal of AES, the strategic investor responsible for the Tbilisi distribution network.

Railways

Restructuring in the railways sector has moved ahead, particularly in CEB but also in a number of SEE and CIS countries. In the Czech Republic, railway operations were separated from the railway infrastructure, and non-core activities are being divested. In Poland the railway companies continue their commercialisation efforts following the unbundling of the sector and the implementation of a staff retrenchment programme. In 2003, Croatia adopted a new railway law which brings its railway legislation in line with EU directives, including the separation of infrastructure from operations and the establishment of a railway regulator. In Slovenia strong support for railway restructuring was confirmed by a recent referendum.

In SEE the Romanian railway companies have continued their commercialisation efforts following major restructuring over previous years. The restructuring process in FYR Macedonia is supported by an action plan, developed in consultation with the World Bank, which includes targets for labour restructuring and the separation of operations from infrastructure. In Bosnia and Herzegovina the railway company is developing its business plan and initiating the painful process of labour restructuring.

In Russia the implementation of the extensive railway restructuring programme is proceeding slowly. The first stage of reforms entails the separation of the Ministry of Railways from the railway operations, which will be transferred to a new state-owned company, Russian Railways (RZD). This complex process is expected to be finalised by the end of 2003. The second stage of reforms, lasting until 2005, will result in the creation of train operating and maintenance and repair subsidiaries, with potential privatisations in the third stage of reforms, between 2006 and 2010. Elsewhere in the CIS, passenger operations in Uzbekistan were transformed into a separate subsidiary and the (temporary) cross-subsidies were made transparent. The divestiture of non-core assets and the exit from social activities has been completed.

Roads

Croatia has made most progress in road sector development in CEB over the last year, strengthening the agencies in charge of tolled and non-tolled roads and beginning to raise sector funding entirely from road-user charges. In Poland, in contrast, there was a reversal in progress when the motorway agency was absorbed back into the national road administration. Road sector funding is also still unclear and attempts to introduce public-private partnerships (PPPs) have not been successful so far.

In SEE, Romania is preparing PPP concessions for sections of its motorway network. However, the management of the Road Fund is now under the Ministry of Finance. In Serbia a new road law is expected to be implemented by the end of 2003, creating a Motorway Agency.

The Russian State Road Administration is currently developing proposals to introduce heavy vehicle charges on the federal road network and is committed to developing a long-term strategy for moving towards self-financing of the road sector. The State Road Administration has also pledged to develop a strategy for restructuring the state-owned road maintenance companies and to encourage greater private sector participation in this activity. A framework concession law is currently being developed which will facilitate PPPs in many sectors, including roads.

Water and waste water

In the EU accession countries, reform of the water and waste-water sector has benefited from substantial support from the EU's Instrument for Structural Policies for Pre-Accession (ISPA). Although focused on capital expenditure, ISPA projects generally include components for tariff reform and institutional support for utilities. There has also been some progress in sector restructuring. The Slovak Republic, for instance, has largely completed the transformation of the state-owned water company into regional water companies. Some have already been transferred to municipal owners and the remaining companies are scheduled to be transferred in the near future.

Table A.2.1.1

Infrastructure transition indicators, 2003

	Telecommunications	Electric power	Railways	Roads	Water and waste water
Albania	3+	2+	2	2	1
Armenia	2+	3+	2	2+	2
Azerbaijan	1	2+	2+	2+	2
Belarus	2	1	1	2	1
Bosnia and Herz.	3+	3	3	2	1
Bulgaria	3	3+	3	2+	3
Croatia	3+	3	2+	3 ↑	3+
Czech Republic	4	3+ ↑	3 ↑↑	2+	4
Estonia	4	3	4+	2+	4
FYR Macedonia	2	2+	2	2+	2
Georgia	2+	3 ↓	3	2	2
Hungary	4	4	3+	3+	4
Kazakhstan	2+	3	3-	2	2-
Kyrgyz Republic	3 ↑	2+	1	1	1
Latvia	3	3	3+	2+	3+
Lithuania	3+	3	2+	2+	3+
Moldova	2+	3 ↓	2	2	2
Poland	4	3	4	3 ↓	3+
Romania	3	3	4	3	3
Russia	3	3 ↑↑	2+	2+	2+
Serbia and Mont.	2	2+ ↑	2+	2+	2
Slovak Republic	2+	4	2+	2+	2+
Slovenia	3	3	3	3	4
Tajikistan	2+	1	1	1	1
Turkmenistan	1	1	1	1	1
Ukraine	2+	3+	2	2	2-
Uzbekistan	2	2	3	1	2-

Source: EBRD.

Note: ↑ and ↓ arrows indicate change from the previous year in that sectoral transition indicator. One arrow indicates a movement of one point (from 4 to 4+, for example), two arrows a movement of two points. Up arrows indicate upgrades, down arrows downgrades.

Classification system for transition indicators[1]

Telecommunications

1 Little progress has been achieved in commercialisation and regulation. There is a minimal degree of private sector involvement. Strong political interference takes place in management decisions. There is a lack of cost-effective tariff-setting principles, with extensive cross-subsidisation. Few other institutional reforms to encourage liberalisation are envisaged, even for mobile phones and value-added services.

2 Modest progress has been achieved in commercialisation. Corporatisation of the dominant operator has taken place and there is some separation of operation from public sector governance, but tariffs are still politically set.

3 Substantial progress has been achieved in commercialisation and regulation. There is full separation of telecommunications from postal services, with a reduction in the extent of cross-subsidisation. Some liberalisation has taken place in the mobile segment and in value-added services.

4 Complete commercialisation (including privatisation of the dominant operator) and comprehensive regulatory and institutional reforms have been achieved. There is extensive liberalisation of entry.

4+ Implementation of an effective regulation (including the operation of an independent regulator) has been achieved, with a coherent regulatory and institutional framework to deal with tariffs, interconnection rules, licensing, concession fees and spectrum allocation. There is a consumer ombudsman function.

Electric power

1 The power sector operates as a government department. There is political interference in running the industry, with few commercial freedoms or pressures. Average prices are below costs, with external and implicit subsidy and cross-subsidy. Very little institutional reform has been achieved. There is a monolithic structure, with no separation of different parts of the business.

2 The power company is distanced from the government. For example, it operates as a joint-stock company, but there is still political interference. There has been some attempt to harden budget constraints, but management incentives for efficient performance are weak. Some degree of subsidy and cross-subsidy exists. Little institutional reform has been achieved. There is a monolithic structure, with no separation of different parts of the business. Minimal, if any, private sector involvement has occurred.

3 A law has been passed providing for full-scale restructuring of the industry, including vertical unbundling through account separation and setting-up of a regulator. Some tariff reform and improvements in revenue collection have been achieved and there is some private sector involvement.

4 A law for industry restructuring has been passed and implemented, with separation of the industry into generation, transmission and distribution. A regulator has been set up. Rules for cost-reflective tariff-setting have been formulated and implemented. Arrangements for network access (negotiated access, single buyer model) have been developed. There is a substantial private sector involvement in distribution and/or generation.

4+ Business has been separated vertically into generation, transmission and distribution. An independent regulator has been set up, with full power to set cost-reflective effective tariffs. There is large-scale private sector involvement. Institutional development has taken place, covering arrangements for network access and full competition in generation.

Railways

1 Monolithic organisational structures still exist. State railways are still effectively operated as government departments. Few commercial freedoms exist to determine prices or investments. There is no private sector involvement. Cross-subsidisation of passenger service obligations with freight service revenues is undertaken.

Classification system for transition indicators[1] (continued)

2 New laws distance rail operations from the state, but there are weak commercial objectives. There is no budgetary funding of public service obligations in place. Organisational structures are still overly based on geographic or functional areas. Ancillary businesses have been separated but there is little divestment. There has been minimal encouragement of private sector involvement. Initial business planning has been undertaken, but the targets are general and tentative.

3 New laws have been passed that restructure the railways and introduce commercial orientation. Freight and passenger services have been separated and marketing groups have been grafted onto traditional structures. Some divestment of ancillary businesses has taken place. Some budgetary compensation is available for passenger services. Business plans have been designed with clear investment and rehabilitation targets, but funding is unsecured. There is some private sector involvement in rehabilitation and/or maintenance.

4 New laws have been passed to fully commercialise the railways. Separate internal profit centres have been created for passenger and freight (actual or imminent). Extensive market freedoms exist to set tariffs and investments. Medium-term business plans are under implementation. Ancillary industries have been divested. Policy has been developed to promote private rail transport operations.

4+ Railway law has been passed allowing for separation of infrastructure from operations, and/or freight from passenger operations, and/or private train operations. There is private sector participation in ancillary services and track maintenance. A rail regulator has been established. Access pricing has been implemented. Plans have been drawn up for a full divestment and transfer of asset ownership, including infrastructure and rolling stock.

Roads

1 There is a minimal degree of decentralisation and no commercialisation has taken place. All regulatory, road management and resource allocation functions are centralised at ministerial level. New investments and road maintenance financing are dependent on central budget allocations. Road user charges are based on criteria other than relative costs imposed on the network and road use. Road construction and maintenance are undertaken by public construction units. There is no private sector participation. No public consultation or accountability take place in the preparation of road projects.

2 There is a moderate degree of decentralisation and initial steps have been taken in commercialisation. A road/highway agency has been created. Initial steps have been undertaken in resource allocation and public procurement methods. Road user charges are based on vehicle and fuel taxes but are only indirectly related to road use. A road fund has been established but it is dependent on central budget allocations. Road construction and maintenance is undertaken primarily by corporatised public entities, with some private sector participation. There is minimal public consultation/participation and accountability in the preparation of road projects.

3 There is a fairly large degree of decentralisation and commercialisation. Regulation, resource allocation, and administrative functions have been clearly separated from maintenance and operations of the public road network. Road user charges are based on vehicle and fuel taxes and are related to road use. A law has been passed allowing for the provision and operation of public roads by private companies under negotiated commercial contracts. There is private sector participation either in road maintenance works allocated via competitive tendering or through a concession to finance, operate and maintain at least a section of the highway network. There is limited public consultation and/or participation and accountability in the preparation of road projects.

4 There is a large degree of decentralisation of road administration, decision-making, resource allocation and management according to government responsibility and functional road classifications. A transparent methodology is used to allocate road expenditures. A track record has been established in implementing competitive procurement rules for road design, construction, maintenance and operations. There is large-scale private sector participation in construction, operations and maintenance directly and through public-private partnership arrangements. There is substantial public consultation and/or participation and accountability in the preparation of road projects.

4+ A fully decentralised road administration has been established, with decision-making, resource allocation and management across road networks and different levels of government. Commercialised road maintenance operations are undertaken through open competitive tendering by private construction companies. Legislation has been passed allowing for road user charges to fully reflect costs of road use and associated factors, such as congestion, accidents and pollution. There is widespread private sector participation in all aspects of road provision directly and through public-private partnership arrangements. Full public consultation is undertaken in the approval process for new road projects.

Water and waste water

1 There is a minimal degree of decentralisation and no commercialisation has taken place. Water and waste-water services are operated as a vertically integrated natural monopoly by a government ministry through national or regional subsidiaries or by municipal departments. There is no, or little, financial autonomy and/or management capacity at municipal level. Heavily subsidised tariffs still exist, along with a high degree of cross-subsidisation. There is a low level of cash collection. Central or regional government control the tariffs and investment levels. No explicit rules exist in public documents regarding tariffs or quality of service. There is no, or significant, private sector participation.

2 There is a moderate degree of decentralisation and initial steps have been taken in commercialisation. Water and waste-water services are provided by municipally-owned companies, which operate as joint-stock companies. There is some degree of financial autonomy at the municipal level but there is heavy reliance on central government for grants and income transfers. Partial cost recovery is achieved through tariffs and initial steps have been taken to reduce cross-subsidies. General public guidelines exist regarding tariff-setting and service quality but these are both still under ministerial control. There is some private sector participation through service or management contacts or competition to provide ancillary services.

3 A fairly large degree of decentralisation and commercialisation has taken place. Water and waste-water utilities operate with managerial and accounting independence from municipalities, using international accounting standards and management information systems. A municipal finance law has been approved. Cost recovery is fully operated through tariffs and there is a minimum level of cross-subsidies. A semi-autonomous regulatory agency has been established to advise on tariffs and service quality but without the power to set either. More detailed rules have been drawn up in contract documents, specifying tariff review formulae and performance standards. There is private sector participation through the full concession of a major service in at least one city.

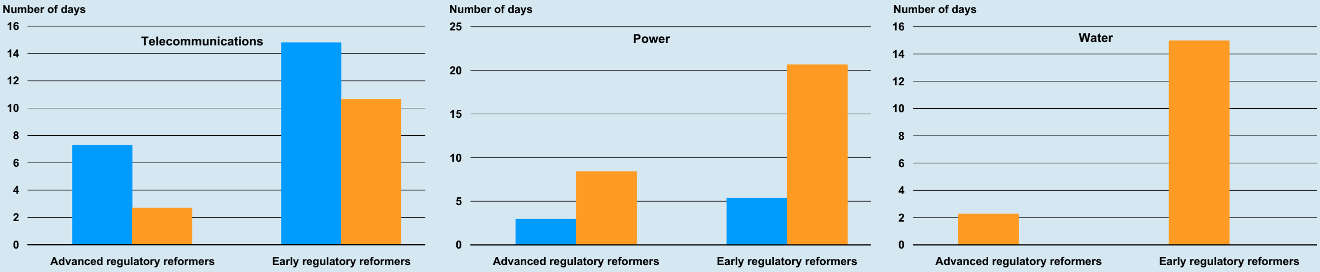
4 A large degree of decentralisation and commercialisation has taken place. Water and waste-water utilities are managerially independent, with cash flows – net of municipal budget transfers – that ensure financial viability. A municipal finance law has been implemented, providing municipalities with the opportunity to raise finance. Full cost recovery exists and there are no cross-subsidies. A semi-autonomous regulatory agency has the power to advise and enforce tariffs and service quality. There is substantial private sector participation through build-operator-transfer concessions, management contacts or asset sales to service parts of the network or entire networks. A concession of major services has taken place in a city other than the country's capital.

4+ Water and waste-water utilities are fully decentralised and commercialised. Large municipalities enjoy financial autonomy and demonstrate the capability to raise finance. Full cost recovery has been achieved and there are no cross-subsidies. A fully autonomous regulator exists with complete authority to review and enforce tariff levels and performance quality standards. There is widespread private sector participation via service management/lease contracts, with high-powered incentives and/or full concessions and/or divestiture of water and waste-water services in major urban areas.

[1] The classification system is a stylised reflection of the judgement of the EBRD's Office of the Chief Economist. More detailed descriptions of country-specific progress in transition are provided in the Transition indicators at the back of this Report. The classification system presented here builds on the 1994 *Transition Report*. To refine further the classification system, pluses and minuses have been added to the 1–4 scale to indicate countries on the borderline between two categories.

Chart A.2.1.1

Performance indicators for early and advanced regulatory reformers



Source: Business Environment and Enterprise Performance Survey, 2002.

Note: See Table A.2.1.2 for definitions of waiting times and outages. Advanced countries are those scoring at least 3 on the relevant infrastructure indicator. Early countries are those scoring less than 3.

These changes should facilitate greater involvement by the private sector. However, examples of private sector participation remain limited, not least because of a lack of interest by international investors, many of whom have started to scale back their involvement in the region.

Against this trend, a tender for the water and waste-water network in Constanta, Romania, has enjoyed a strong response, suggesting that – if structured well – private sector participation can be attractive even in a difficult international environment. Some progress has also been made towards the introduction of the private sector in the Tbilisi Water Utility in Georgia. The tendering commission is currently evaluating the technical and financial proposal of the only bidder which participated in the January 2003 tender. Elsewhere in the CIS, tariff levels and the financial and managerial strength of utilities remain a problem. In Moldova, for instance, the Chisinau City Council rescinded its decision on a tariff increase for the municipal water utility ahead of the local elections in spring 2003. In Uzbekistan household tariffs for water are expected to rise to cost-recovery levels by 2006, and a metering programme to improve collection rates is under way.

Infrastructure reform and service quality

The objective of infrastructure reform is to improve service quality, increase efficiency and ensure the sectors are on a sound financial footing. The 2002 BEEPS provides evidence from enterprises on whether reform has indeed resulted in better infrastructure services in terms of access and quality. The BEEPS provides information about waiting time – the average number of days it takes to connect to mainline telecommunications, electricity and water services – which can serve as an indicator of access to service. As an indicator of service quality, the BEEPS provides information on outages – that is, the average number of days per year when enterprises experienced power outages and mainline telecommunications services were unavailable.

For both of these indicators there are substantial differences across sub-regions, as summarised in Table A.2.1.2. Moreover, there is evidence that in countries where reforms are more advanced – defined as countries scoring at least 3 in the relevant infrastructure transition indicator – enterprises enjoyed better access to, and reliability of, utility services.

Table A.2.1.2

Performance indicators for the infrastructure sectors

	Telecommunications		Power		Water
	Waiting times [1]	Outages [2]	Waiting times [1]	Outages [2]	Outages [2]
CEB	4.1	1.3	2.1	2.6	0.8
SEE	14.0	5.6	4.4	13.6	7.8
CIS	15.0	11.6	5.6	23.0	19.0

Source: Business Environment and Enterprise Performance Survey, 2002.

[1] Number of days enterprises wait for connection to the relevant infrastructure service in 2001.

[2] Number of working days disrupted due to interruption of the relevant infrastructure service in 2001.

In countries with a more advanced telecommunications regulatory framework, waiting times are only about half as long as in the less advanced reform countries (seven days versus 15 days; see Chart A.2.1.1). The difference in terms of telecommunications outages is even more significant, with advanced countries recording three days of outages per year compared with 11 days for the other transition countries.

A similar pattern can be observed in the power sector, where countries with a more advanced regulatory framework experience connection waiting times of less than three days compared with more than five days in the remaining countries. The gap between the two sets of countries is even bigger in terms of outages (eight versus 21 days). The difference in water outages between fast and slow reformers is also shown in Chart A.2.1.1. Overall, the BEEPS provides evidence of a clear link between service quality and infrastructure reform.[2]

[2] The results of Chart A.2.1.1 are confirmed in more detailed statistical analysis, which also takes account of other factors affecting performance, such as the original quality of the network.

Annex 2.2:
New Legal Indicator Survey 2003

In 2003 the EBRD launched a New Legal Indicator Survey (NLIS), which introduces a new way of measuring legal progress in the transition countries. Previously, the EBRD asked lawyers working in the region to assess the current state of law (legal extensiveness) and the degree to which those laws were enforced (legal effectiveness).[1]

The NLIS substitutes the extensiveness ratings with sector assessments prepared by the Bank's own legal staff assisted by expert consultants. The main objective of these assessments is to measure "laws in transition" – that is, the extent to which legal rules comply with international standards. The legal effectiveness ratings are replaced by empirical case studies measuring "laws in action" – that is, the extent to which the legal regime provides an efficient outcome in a given area of the law. These two aspects of the legal framework (laws in transition and laws in action) are essential benchmarks to measure legal reform and the strengths and weaknesses of individual countries.

This year the NLIS focuses on secured transactions.[2] It makes cross-country comparisons of progress in legal reform and highlights areas where further efforts are needed to adopt and implement reforms in this area. The EBRD has extensive experience in secured transactions and has been working since 1992 to make improvements in the region through policy advice and technical assistance.

The purpose of secured transactions is to mitigate the risk of providing credit and therefore to enhance creditors' confidence that they can recover real value from mortgaged or charged assets. As a result, the availability of credit should increase and the terms on which it is available should improve. These include the amount of the loan, the period for which it is granted and the interest rate.

Laws in transition – Regional Survey of Secured Transactions Laws

The Bank's assessment of secured transactions is based on the EBRD Regional Survey of Secured Transactions Laws, which was first produced in 1999. The survey aims to:

- provide basic information about secured transactions to help credit providers and their advisors assess the potential advantages of taking security;
- highlight the strengths and weaknesses of the legal framework for collateral in each country; and
- give a basis for objective comparison and encourage mutual assistance in legal reform among the transition countries.

The survey reveals lawyers' responses to 34 questions covering the use of non-possessory security over movable assets.[3] The survey is based on the premise that a sound secured transactions regime should:

- allow for the quick, cheap and simple creation of a proprietary security right without depriving the person giving the security of the use of his assets;
- be available over all types of assets to secure all types of debts and between all types of persons and organisations – as far as possible, the parties should be able to adapt security to the needs of their particular transaction;
- provide an effective means of publicising the existence of security rights, and establish clear rules governing competing rights of persons holding security and other persons claiming rights in the assets given as security;
- allow the assets given as security to be realised at market value, with the proceeds applied towards satisfaction of the secured creditor's claim prior to other creditors; and
- impose a low cost for taking, maintaining and enforcing security.[4]

In general, there has been significant progress in creating a basic legal framework for secured transactions in the transition economies. However, some areas are still problematic in a wide range of countries, including the scope of assets that can be given as security, publicity, enforcement and priority.

For example, most countries in principle allow security to be granted over most types of movable property and rights (Estonia is a notable exception), yet restrictions often exist in the general law, particularly regarding the need for a specific description of each asset included in the collateral (as, for example, in FYR Macedonia). Such restrictions preclude the use of many modern financing techniques which involve granting security over groups or pools of assets. The only countries in the region which do not have problems in this area are Bulgaria, Hungary and the Slovak Republic.

A notification or registration system is needed in any effective regime for security over movables. It serves to publicise the security and to alert others that the creditor has a prior right in the collateral. Much work has been carried out in the region in recent years to establish efficient registration systems but the survey shows failings in the effectiveness of these systems for most countries in the region. In Russia the lack of any form of registration or notification

[1] See Ramasastry (2002).

[2] The EBRD has published a number of sector assessments in other areas, including corporate governance and insolvency, see www.ebrd.com/law.

[3] The survey also covers possessory security but this is not taken into account in the context of this annex.

[4] This is based on the EBRD Core Principles for a secured transactions law, which comprise ten principles.

system has been one of the main reasons for the ineffectiveness of the 1992 pledge law.

Between countries there is considerable variation, reflecting differences in other areas of economic and structural reform. The countries can be divided into five groups: advanced reform countries, major reform countries, minor reform countries, deficient reform countries and unreformed countries (see Table A.2.2.1). The more advanced transition countries generally fall into the category of advanced or major reformers for secured transactions but these two groups also include several less advanced countries in SEE and CIS.

Table A.2.2.1

Levels of reform in secured transactions law

Advanced reform countries	Major reform countries	Minor reform countries	Deficient reform countries	Unreformed countries
Hungary	Albania	Armenia	Azerbaijan	Bosnia and Herzegovina
Lithuania	Bulgaria	Belarus	Georgia	Serbia and Montenegro [1]
Slovak Republic	Czech Republic	Croatia	Tajikistan	
	Kazakhstan	Estonia	Turkmenistan	
	Kyrgyz Republic	FYR Macedonia	Uzbekistan	
	Latvia	Russia		
	Moldova	Slovenia		
	Poland			
	Romania			
	Ukraine			

Source: EBRD Regional Survey of Secured Transactions, 2003.

[1] Data for Serbia and Montenegro are for the Republic of Serbia (excluding Kosovo) only.

Advanced reform countries

Advanced reform countries have undertaken major reform of the law and the institutional framework to ensure the efficient use of collateral for securing credit. For example, Hungary and Lithuania introduced major reforms in 1997. However, secured creditors in Hungary still suffer from a weak position in insolvency while in Lithuania formal requirements for defining the collateral restrict the scope of financing instruments available. The Slovak Republic has carried out the most far-reaching reform in the region, which became effective in January 2003. This is being implemented successfully to date but, as in Hungary, the position on insolvency is less satisfactory. Nonetheless, all three countries have a modern and efficient regime for secured transactions.

Major reform countries

Major reform countries have carried out a major overhaul of their laws but still have shortcomings or significant limitations either in the laws themselves or in their implementation. For example, in the Czech Republic the legal framework limits the type of collateral available. In Poland the time required for registration and the complexity of the process discourage the use of security. In the Kyrgyz Republic and Moldova the establishment of a reliable registry still remains a problem.

Minor reform countries

Minor reform countries have carried out some reform but have a far from adequate legal framework for secured transactions. Russia, for example, made a promising start with a new law as early as 1992, which provided a model for other countries in the Commonwealth of Independent States (CIS). However, the failure to implement the law fully means that taking security in Russia is still problematic. Estonia only allows security over certain types of assets and over the whole enterprise. FYR Macedonia has been making considerable efforts to reform its law but the rules for creation of security remain incompatible with the requirements of a modern market for secured credit. Slovenia has only allowed the taking of security in a very limited way although it has recently introduced new provisions on collateral.[5] Croatia offers only a rudimentary system of non-possessory charges over movable property.

Deficient reform countries

The deficient reform countries are all from the Caucasus or Central Asia. In all of them there are serious shortcomings in the legal framework for secured transactions. Azerbaijan made a serious attempt at reform in 1998 but the status of that reform has become unclear following the introduction in 2001 of the new Civil Code. This is also a problem in Tajikistan, where Civil Codes containing general provisions on security rights for property are not always well coordinated with specific secured transactions law.

Unreformed countries

Only two countries fall into the unreformed group and both of them are currently undertaking reform. Serbia passed a new law in May 2003, which has yet to enter into force. If properly implemented, this reform could propel Serbia into the category of advanced reform countries. In 2000 and 2002 the two entities of Bosnia and Herzegovina (the Federation of Bosnia and Herzegovina and the Republika Srpska) adopted separate laws on registered pledges on movables and shares but it is not clear whether these laws have entered into force. There is an ongoing reform project to amend and implement these laws.

Laws in action[6]

The assessment of laws in transition provides a good overview of progress in legal reforms, measured against best international practice. However, it is too broad to reflect fully how the law works in practice. To complement its assessment of laws in transition, the EBRD conducted

[5] This has not yet been covered in the 2003 survey. This new law may move Slovenia to the major reform countries group.

[6] The results should be interpreted with some caution. They reflect the views of a small number of lawyers.

a case study of secured transactions with lawyers working in the region to find out how the law works in practice.[7]

To assess laws in action, legal practitioners were presented with a typical scenario regarding the enforcement of a security interest over movable tangible assets (see Box A.2.2.1). Under the scenario, a creditor (local bank) has lent money to a debtor (privately owned local company with limited liability). The creditor decides to enforce its security when the debtor fails to pay on time. The key issues for a creditor whose claim is not satisfied is how much and how fast he can recover through realisation of the charged assets, and how simple the whole process will be. Therefore, the primary evaluation concentrates on these three dimensions of enforcement.

The EBRD worked with two law firms in the region, Allen & Overy and Chadbourne & Parke LLP. Where these firms did not have an office or an associate, the EBRD contacted local law firms.[8] Local lawyers were requested to treat the case as if it were a real-life situation involving a client and to add any practical advice they would normally give in these circumstances. Consistency of the information was ensured by a thorough review of the individual replies and follow-up with the local counsel on any questions that arose.

Respondents were asked to assess the creditor's ability to initiate an enforcement procedure and recover from the charged assets (equipment only if inventory could not be used as collateral), giving an indication of the amount of any likely recovery and the time it would take for enforcement. The case also requested the respondent to provide additional information on various aspects of enforcing a security right:

- status of debtor – the extent to which the procedure would vary if the debtor were to be declared insolvent;
- extent of charged assets – what is included in the collateral and what is excluded (replacement assets, added assets, related rights, proceeds);
- differences in the process if the charged assets were immovable (for instance, a flat in a non-residential building) or receivables (the claims of existing customers);
- extent of secured debt – whether damages, penalty clause, interest and costs would be included in the secured debt;
- external threat – competing claims to charged assets or proceeds (priority creditors, such as tax claims or employees, judgment creditors, other charges or liens); and
- recovery procedure – simplicity, costs, speed, creditor ability to influence the process, scope for debtor obstruction.

Additional questions also covered the existing institutional context (courts, bailiffs, notaries, auctioneers, accountants, experts) and their integrity and the existing practice of enforcement in the country (in general and also in terms of the number of cases that the respective law firms had handled in the past).[9]

The complete results will be published in detail on the EBRD's Web site (see www.ebrd.com/law) together with the full text of the scenario and the methodology for analysing responses. Secured transactions is a complex area of the law. Application of the law varies according to the specifics of each case. The scenario is as close as possible to a standard situation to ease cross-country comparisons. In the following analysis, cross-country comparisons are first made on the amount a debtor could be expected to recover from the case, the time needed to realise recovery and the

Box A.2.2.1

Case study scenario

"We are a bank registered in your country. One of our customers, a local privately owned limited company specialising in manufacturing, has failed to repay a loan of €100,000. There was no invalidity to the underlying loan agreement: the default is due to cash flow problems. The debtor therefore has no valid defence to the non-payment of the loan. Our customer has given us security over €120,000 worth of:

- production equipment and machinery used in its factory; and
- inventory consisting of finished products.

We now ask you for advice on how we can enforce our rights over the assets given as security in order to recover our claim."

The firms participating in the case study scenario were: Allen & Overy (Albania, Croatia, Czech Republic, Hungary, Poland, Russia, Slovak Republic); Grant Thornton Amyot LLC (Armenia); BM Law Firm in cooperation with Chadbourne & Parke LLP (Azerbaijan); Borovtsov & Salei in cooperation with Chadbourne & Parke LLP (Belarus); Advokat Maric Branko (Bosnia and Herzegovina); Spasov & Bratanov in cooperation with Allen & Overy (Bulgaria); Luiga & Mugu (Estonia); Mgaloblishvili, Kipiani, Dzidziguri (MKD) Law Firm (Georgia); Zanger Law Firm in cooperation with Chadbourne & Parke LLP (Kazakhstan); Dignitas Law Firm in cooperation with Chadbourne & Parke (Kyrgyz Republic); Sorainen Law Offices (Latvia); Lideika, Petrauskas, Valiunas & Partners (Lithuania); Law Office Polenak (FYR Macedonia); Turcan & Turcan (Moldova); Nestor Nestor Diculescu Kingston Petersen in cooperation with Allen & Overy (Romania); Chadbourne & Parke LLP (Russia, Uzbekistan); Karanovic & Nikolic (Serbia); Colja, Rojs & partnerji (Slovenia); Medet Company Ltd (Turkmenistan); Grischenko & Partners in cooperation with Chadbourne & Parke LLP (Ukraine). It was not possible to secure the support of a law firm in Tajikistan, so the survey does not provide any data for that country.

7 A case study has the advantage of concentrating on the facts as opposed to the rules. Using cases to survey legal systems follows the approach taken by the World Bank's Lex Mundi project. See Simeon Djankov, Rafael La Porta, Florencio Lopez De Silanes, and Andrei Shleifer, "Courts: The Lex Mundi Project" (March 2002) at http://rru.worldbank.org/DoingBusiness. Case studies are also employed in the Trento project on "The common core of European private law". See http://www.jus.unitn.it/dsg

8 The EBRD is indebted to all the law firms, which participated on a pro bono basis. Initially answers were obtained to a set of 15 questions relating to the facts of the case. Subsequently, the answers were clarified and elaborated through follow-up exchanges. In addition, Allen & Overy and Chadbourne & Parke LLP both reviewed and co-ordinated the work with their own offices and associates to ensure the quality and timeliness of the responses. A full list of NLIS participating firms is provided in Box A.2.2.1 above.

9 The assessments of the respondents have been taken into consideration at their face value. In most countries the lawyers gave quick and clear answers to the case questions, based on their own practice of enforcement. When respondents could not provide any basis for a realistic estimate, the lowest score was given on the basis that such uncertainty is bound to reflect negatively on the creditor's expectations.

simplicity of the legal process. These comparisons are then refined and qualified by looking at how results might be affected if the circumstances of the case changed (scope) and how the process of enforcement is affected by other interested parties as well as the quality and integrity of the courts.

Realising a charged asset: Amount, time and simplicity

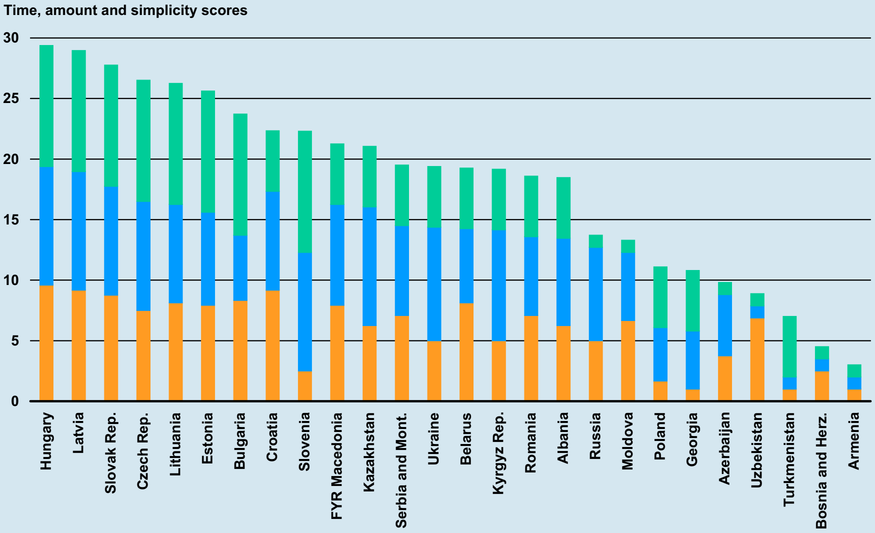
The initial assessment focuses on the recovery prospects of a creditor based on enforcement of his security right over production equipment and machinery. The application of the law to immovables, inventory or receivables is considered in the refined results below. Chart A.2.2.1 shows the initial assessment of how much a secured creditor can expect to recover (amount), how quickly (time) and how simply (simplicity). Each of these criteria is assessed on the basis of 0 (worst) to 10 (best). The taller the bar, the more efficient and creditor-friendly the system is.

The amount indicator reflects the likely return on the realisation of the assets minus the enforcement costs (since the costs will be recovered out of the sale price and will therefore diminish what the secured creditor will recover from the collateral). The amount has been adjusted on a scale of 0-10, where 10 equals the maximum possible return (€120,000, the assets' market value). The time indicator reflects the estimated length of the process for successful enforcement, from the commencement of the enforcement procedure to the collection of the proceeds of sale. The time has been adjusted on a scale of 0-10, where 0 equals the longest possible time (24 months) and 10 the shortest (one month).

The simplicity indicator summarises a range of factors. These include the number of procedural steps to be taken, the number of places to visit or persons to contact, the availability of information, the clarity of the law and regulations, the uniformity of practice, the adoption of necessary implementing regulations and the ease of ascertaining the existence of competing claims. To simplify the scoring, countries were given a 10 where the enforcement process was considered to be clear and with only a minor level of

Chart A.2.2.1

Enforcement of charged asset, by country



Time Amount Simplicity

Source: EBRD New Legal Indicator Survey, 2003.

Note: Data for Tajikistan were not available. Data for Serbia and Montenegro are for the Republic of Serbia (excluding Kosovo) only. Ratings for each dimension range from 0 (worst) to 10 (best).

complexity. A score of 5 was given where there was a significant likelihood of complexity or uncertainty, which might prejudice the enforcement process. A score of 1 indicates there was a major level of complexity or uncertainty, which could deter creditors from commencing enforcement.

The results give a surprisingly positive picture of enforcement. They indicate that it is possible to recover at least 80 per cent of the market value of the assets taken as security in six months or less in nine countries (the Czech Republic, Croatia, Estonia, Hungary, Latvia, Lithuania, FYR Macedonia, Kazakhstan and the Slovak Republic). A recovery of at least 60 per cent of the market value of the assets taken as security can be expected in nine months or less in 16 countries (the above plus Albania, Belarus, Bulgaria, Moldova, Romania, Serbia and Slovenia).

Countries that score high on the amount recovered and the time required usually have a simple process in place. In only one of the 16 countries that achieved the best results for amount and time (Moldova) was the process judged to be very complex or uncertain. By contrast, in countries with high complexity ratings, such as Bulgaria, a quick procedure (8.3 on a scale of 10) is accompanied by a mediocre return (a score of 5.3). The variation is even more marked for Slovenia, where the return is assessed at 9.7 but the time involved receives a score of 2.5. The Kyrgyz Republic, Ukraine and to some extent Russia also record reasonably high scores for the amount recovered but low scores for the time involved and the simplicity of the process.

The results are summarised in Chart A.2.2.2, which presents an unweighted average of the three dimensions of time, amount and simplicity, presented by region. Chart A.2.2.2 shows better performance in central eastern Europe and the Baltic states (CEB) than in the remainder of the region. Six out of eight countries of CEB scored 8 or more (out of 10) on the overall results. A noticeable exception is Poland, where the system does not provide a good amount of recovery for the secured creditor enforcing his security over movable property (4.4 on a scale of 10) and the time required is worryingly long (1.6 out of an optimum score of 10). This may be due to the over-burdening of the courts, which are, in practice, the only available method for pursuing enforcement. Although the 1998 Law on Registered Pledge and Pledge Registry provided for a possible out-of-court procedure, the necessary implementing regulations were never adopted. Note, however, that in some of the CEB countries (Hungary, the Slovak Republic and Slovenia) security enforcement rules have recently been changed and the evaluation may reflect expectations of positive changes rather than accumulated experience.

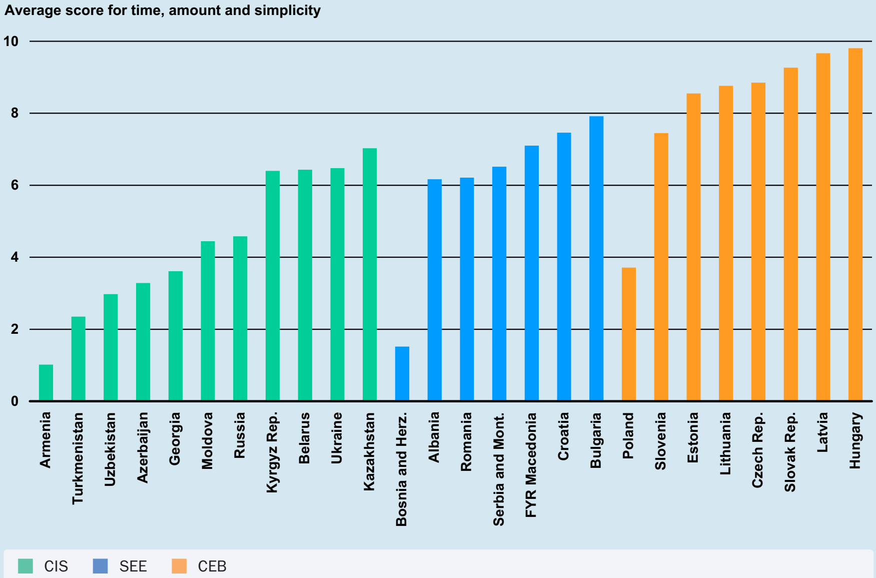
In south-eastern Europe (SEE), six out of seven countries fare relatively well, with scores between 6 and 8 (average of 6.88 out of 10). The clear exception to this is Bosnia and Herzegovina, where a creditor's prospects for enforcing a security right are limited. The only way to contract a non-possessory charge over movable property is to use the Law on Enforcement, by which a court-ordered seizure of the assets constitutes a charge, pending its enforcement upon the debtor's default. The procedure is ill-designed for commercial transactions. Furthermore, the use of public auctions is the only method to realise the collateral, and these are often unsuccessful, leaving the creditor unable to collect any proceeds or to take title of the assets. A new Law on Enforcement and a complete overhaul of the secured transactions legal framework currently in preparation in Bosnia and Herzegovina should improve the system.

In Serbia the case study provides a favourable assessment of the law and a creditor's ability to recover from debtor's assets, despite the absence of a secured transactions law in force. This point underscores the complementarity of assessing both laws in transition and laws in action.

In the CIS countries the results are mixed, with an average score of 4.84 out of a possible 10. At one extreme is Kazakhstan, which has a well-implemented system for secured transactions over movable property. The creditor's position on enforcement of a charge is made stronger by registration, as the debtor consequently has fewer grounds for challenging the validity of the charge. Upon default, the creditors can choose the extrajudicial procedure for enforcement, through which their authorised representative conducts a public auction. This procedure is generally slightly faster than court-led enforcement but even court-led enforcement is not particularly long.

Chart A.2.2.2

Enforcement of charged asset, by region



Source: EBRD New Legal Indicator Survey, 2003.

Note: Data for Tajikistan were not available. Data for Serbia and Montenegro are for the Republic of Serbia (excluding Kosovo) only. This graph shows the unweighted average scores for time, amount and simplicity, ranging from 0 (worst) to 10 (best).

The Kyrgyz Republic, Russia and Ukraine, by contrast, all have a time-consuming process, which makes enforcement more difficult for the secured creditor. In Moldova the return that a creditor can expect on enforcement and the time involved are quite reasonable. However, the whole process lacks simplicity and certainty. For instance, the newly created registration system for charges lacks a centralised pledge numbering system. Public notaries appointed to operate the registry use their own numbering system when making entries into the registry. This means that several entries could have the same number, leading to confusion. At the bottom of the scale are Armenia, Uzbekistan and Turkmenistan, where the position of the secured creditor is unclear in terms of time or in some cases amount. The uncertainty is also shown in the complexity of the process.

Scope and process of enforcement

As noted above, the results alone do not tell the whole story. The efficiency of the enforcement process may be influenced by many other factors, or "qualifiers", that affect amount, time and simplicity. Six qualifiers relate to difficulties encountered in the process of enforcement (see Table A.2.2.2) – for example, whether some preferential creditors (such as tax offices) may supercede the secured creditor's claim. Some of these factors may be reflected in the scoring (for example, a high likelihood of debtors experiencing obstruction would have influenced the assessment of the time needed for the enforcement process) but it is useful to assess them separately to gain a better understanding of each country's legal regime.

Another six qualifiers relate to the scope of enforcement. These include insolvency procedures and ranking of creditors under insolvency, the variation in enforcement procedure for receivables, immovables and inventory, and the scope of collateral (see Table A.2.2.2). The relevance of insolvency is self-evident. A creditor's assessment of his security will change if it appears that enforcement would be radically curtailed should the debtor be declared insolvent. Certainly, in terms of credit risk, poor enforcement return in cases of bankruptcy must be taken into account since the debtor's default may well lead to insolvency. Limitations on the kinds of assets that can be pledged and variations in the legal procedures relating to different classes of assets similarly need to be taken into account in addition to the overall score.

Table A.2.2.2

Qualifying factors in the enforcement process

	Process						Scope					
	Debtor obstruction	Preferential creditors	Creditor control	Practical experience	Corruption[1]	Institutions	Scope of collateral	Insolvency procedure	Insolvency ranking	Inventory	Immovables	Receivables
Albania	1	2	1	3	3	3	2	1	2	1	3	1
Armenia	3	3	2	2	3	2	1	2	3	2	2	2
Azerbaijan	2	3	3	3	3	3	2	1	3	2	3	3
Belarus	2	3	2	1	2	2	2	2	3	1	3	2
Bosnia and Herz.	3	3	3	1	2	3	3	2	2	3	3	3
Bulgaria	3	2	2	1	3	2	2	1	1	2	2	1
Croatia	2	1	1	2	1	2	3	2	1	3	2	2
Czech Republic	1	1	3	2	1	1	3	3	3	3	2	1
Estonia	2	1	2	2	1	1	2	2	3	2	2	2
FYR Macedonia	1	2	2	3	3	2	1	1	1	1	1	1
Georgia	2	3	2	3	3	3	3	1	3	3	3	3
Hungary	1	2	1	2	1	1	1	3	3	1	1	1
Kazakhstan	3	1	2	2	3	3	2	2	2	1	1	2
Kyrgyz Republic	3	1	2	3	3	2	1	1	1	1	2	2
Latvia	1	1	1	1	2	2	1	2	1	1	2	2
Lithuania	1	1	1	1	1	1	2	2	1	1	1	1
Moldova	1	2	1	3	3	3	1	2	2	1	1	2
Poland	3	2	3	2	1	3	1	1	1	1	2	1
Romania	1	2	2	2	2	2	1	1	3	1	2	1
Russia	3	2	2	2	1	1	3	2	2	2	2	2
Serbia and Mont.	3	1	3	1	2	3	3	2	1	3	3	1
Slovak Republic	2	1	1	3	1	2	1	3	3	1	1	1
Slovenia	3	3	1	2	1	3	3	2	3	2	3	2
Turkmenistan	2	3	3	2	–[2]	–[2]	1	2	3	2	2	3
Ukraine	3	1	3	1	3	2	2	3	1	1	2	2
Uzbekistan	3	3	2	3	3	3	1	2	3	1	3	1

Source: EBRD New Legal Indicator Survey, 2003.

Note: Data for Tajikistan were not available. Data for Serbia and Montenegro are for the Republic of Serbia (excluding Kosovo) only. Scores range from 1 to 3, where 1 indicates no significant problem, 2 indicates a relatively minor problem and 3 indicates a major problem.

[1] Although the assessment was based on the replies from the respondents, reference was also made to the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS) and the Transparency International corruption perception index. For Turkmenistan, which was not covered by these surveys, no assessment was given for corruption or institutions.

[2] No assessment carried out.

Definitions:

Debtor obstruction: Possibility for the debtor to prevent, slow down or otherwise obstruct the enforcement proceedings to the detriment of the chargeholder. Legitimate exercise of right of defence or appeal is not included.

Preferential creditors: Impact of claims of other creditors (other than prior-ranking secured claims) on the satisfaction of the secured creditor's claim.

Creditor control: Ability of the creditor to control or influence the conduct of the enforcement procedure.

Practical experience: The general level of practical experience with the enforcement process in the country in question.

Corruption: The impact of corruption within the court system on the enforcement process.

Institutions: Reliability of the courts and other institutions necessary to support the enforcement process.

Scope of collateral: The possibility to enforce against replacement and subsequently acquired assets included in the general description of the collateral.

Insolvency procedure: The impact of the debtor's insolvency on the enforcement process.

Insolvency ranking: The priority of the secured creditor's claim upon insolvency of the debtor.

Inventory: An assessment of the simplicity and certainty of the enforcement process for a charge over inventory.

Immovables: An assessment of the simplicity and certainty of the enforcement process for a charge over immovables.

Receivables: An assessment of the simplicity and certainty of the enforcement process for a charge over receivables.

Table A.2.2.2 shows country scores for these 12 factors rated on a scale of 1 to 3, with 1 indicating no significant problems or limitations, 2 relatively minor problems or limitations, and 3 major problems or limitations. In general, there is a relatively close link between the overall score for amount, time and simplicity and the scores on scope and process presented in Table A.2.2.2. Lithuania and Latvia, for instance, which both received high scores on time, amount and simplicity, reveal no particular underlying problems which could challenge these good results. Similarly, Azerbaijan and Georgia received a 2 or 3 score on almost all factors relating to scope and process, matching their low overall ratings.

The importance of examining the scope of the law comes out more clearly for countries such as the Czech Republic, Hungary and the Slovak Republic, where there are severe limitations in recovering charged assets from a debtor in insolvency. In both the Czech Republic and the Slovak Republic, the chargeholder only retains priority for 70 per cent of the secured debt – for the remaining amount, he ranks as an unsecured creditor. In Hungary part or all of the liquidation costs rank ahead of the secured claim. Moreover, in the Czech Republic, taking security over inventory is not possible, nor does the law allow for a flexible description of the collateral, which would allow parties to add or replace the assets. In Estonia, as seen already, the law on secured transactions also has restricted application.

These qualifications reflect limitations in the law itself, as noted in the Regional Survey. They indicate that for these countries, the major issue relates to extending the scope of secured transactions law to cover a broader class of assets and to deal with the issue of insolvency. The case study suggests that there are no particular problems with implementing and using the law in practice in these countries.

Further difficulties in recovering a charged asset are evident in Bulgaria, FYR Macedonia and Kazakhstan, for example, where the weakness of the courts, and in particular the problem of corruption, is regarded as a serious limitation. In the Kyrgyz Republic and Moldova, similarly, the comprehensive laws on secured transactions are being undermined by a deficient institutional framework. In Poland the good ratings received regarding the scope of the law confirms the generally positive assessment of the legal framework provided by the regional survey. If Poland were to improve its institutional framework for the enforcement of pledges, this could in principle have a major positive impact on secured lending.

Conclusion

In broad terms, the results of the sector assessment of secured transactions (laws in transition) and of the case study (laws in action) coincide. This suggests that most countries with a sound legal framework for secured transactions have effective mechanisms in place for enforcing the law. There are exceptions, however, which will require further research. Nevertheless, a few observations can be made at this stage.

The case study results have highlighted some practical features only partly revealed by the survey. In some countries where the secured transactions law has been reformed (resulting in a relatively good evaluation in the survey), enforcement remains a serious problem. This is true of Albania, the Kyrgyz Republic, Moldova, Poland and Romania. Evidence of institutional weaknesses comes through more clearly in the case study results. The combination of the survey results and case study evidence suggests that legal reform needs to be accompanied by institutional changes to allow effective enforcement to be undertaken.

Conversely, in other countries where there are limitations in the secured transactions law, there is still a basis for effective enforcement. This is true of Croatia, the Czech Republic and Estonia. Although the legal regime in these countries remains imperfect, the market has found a way around it, and charged assets can be realised with relative confidence. However, it is unlikely that these systems would be sufficiently flexible for sophisticated transactions.

This represents a lost opportunity for creditors and borrowers. There could be greater use of secured credit if the rules were widened to allow security to be taken, for example, over a broader range of assets, including inventory.

Comparison between laws in transition and laws in action suggests the need to refine country groupings. Belarus, for instance, scores significantly higher than Russia in the scenario outcome whereas they both fall into the minor reform category in the Regional Survey of Secured Transactions. Careful examination of the details of regulation and actual practice is needed to gain a better understanding of the particularities and/or inefficiencies in each country. To assess how secured transaction laws work in action requires the type of empirical work undertaken through the case study.

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Macroeconomic performance and prospects

3

The transition countries of central eastern Europe and the Baltics (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) continue to show a remarkable resilience despite continuing weakness in much of the global economy. For the second year in a row, a sustained recovery in the global economy did not materialise in 2002. Global growth in 2002 was a mere 3 per cent, reflecting continued sluggishness in the US and EU economies, an ongoing recession in Japan and turmoil in some emerging markets, particularly in South America.

The pace of the global recovery slowed further at the beginning of 2003 amid rising uncertainty caused by the conflict in Iraq and continued volatility in equity markets. However, a consensus is now emerging that a sustained upturn may start towards the end of 2003 and gain further momentum in 2004. Unfortunately, in the EU, the transition countries' main export market, growth is unlikely to pick up until next year.

Against this backdrop, the transition economies recorded solid growth of 3.8 per cent in 2002. The expansion was primarily fuelled by rapid growth in domestic demand. A factor behind this resilience may be the continuing progress with institutional reforms and economic restructuring (see Chapter 2), which has raised competitiveness and boosted household and business confidence. Falling unemployment across the region has underpinned growth in private consumption, which together with public demand and growing investment has helped offset the dampening effects from abroad.

The outlook for 2003 is again relatively favourable. The EBRD expects the transition economies to expand by 4.7 per cent this year. Growth in the CEB economies is forecast to reach 3.3 per cent, spurred by a continued rise in private consumption, strong investment and a recent pick-up in exports. Some of the same factors also underlie economic expansion in SEE, where growth rates should be around 3.9 per cent. The CIS economies are expected to grow by about 6.2 per cent, fuelled primarily by the continued strength in oil prices, but also by a rapid growth in industrial production and by the recovery in investment in non-oil sectors.

However, reliance on domestic demand in CEB is not a viable growth strategy in the long term if strong domestic demand is driven by unsustainable government budget deficits. In the four largest CEB economies, public expenditure which has driven recent demand growth has contributed to rapidly rising fiscal deficits. The costs of meeting the standards set by the EU's *acquis communautaire* further complicate fiscal management for the eight CEB countries that will accede to the EU in 2004.[1] EU accession in May 2004 underpins the growing confidence in the future prospects of these economies. However, the difficulty now facing these countries is to balance recent surges in fiscal expenditure with the budgetary and monetary restraint required to achieve medium-term sustainability and, eventually, to qualify for full membership of the eurozone. With fiscal deficits at worryingly high levels in the larger central European countries, and lack of action so far to remedy this, many of these countries may well require long transition periods before they can achieve accession to the eurozone under current rules.

Increased economic integration also poses important challenges in SEE, not only for the accession candidates – Bulgaria and Romania – but also for the western Balkans countries – Albania, Bosnia and Herzegovina, FYR Macedonia, and Serbia and Montenegro. They need to take advantage of the enhanced Stabilisation and Association Process (SAP) with the EU, as affirmed at the recent summit for the western Balkans in Thessaloniki, and push forward with the institutional reforms needed for increased integration into the enlarged EU market. However, even these countries have to continue efforts to keep macroeconomic imbalances in check to ensure increased convergence with EU markets.

For the CIS countries, strong reliance on exceptionally favourable prices for natural resources is a high-risk and unsustainable growth strategy. The CIS countries that are rich in natural resources have not done enough to advance economic diversification and to decrease their dependence on a narrow commodity sector. Their vulnerability to resource price movements consequently limits their medium-term growth prospects.

In the other CIS economies, the lack of regional cooperation, evident in widespread artificial barriers to trade and transit, and the continued dependence on a single export market, Russia, restrict their growth potential. Sustainable diversified growth throughout the CIS also hinges on more rapid progress in structural reform and institution-building and on the reversal of the alarming decline in educational and training standards over the past decade.

The macroeconomic performance of the region and its medium-term challenges are described in more detail in this chapter. An annex provides tables on the main macroeconomic indicators and includes forecasts from a variety of institutions for growth and inflation in 2003 and 2004 (see Annex 3.1).

[1] These are the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia.

3.1 Recent developments and short-term outlook

Overall performance: Strong growth in a difficult environment but long-term sustainability is uncertain

In 2002 and the first half of 2003 the transition countries were among the fastest growing regions in the global economy (see Chart 3.1). Despite this rapid growth and high oil prices, annual inflation continued to decrease steadily last year. This is due to supply-side driven growth and conservative monetary policies in most of the region. Average annual inflation reached 8.3 per cent for the region as a whole. The average continues to be skewed by a few high-inflation countries, such as Belarus, Tajikistan and Uzbekistan. Median inflation is only 5 per cent across the region. Many of the EU accession countries have achieved price stability, with inflation rates under 3 per cent. However, these could go up again if these countries continue to experience higher productivity growth than their EU neighbours while trying to maintain stable nominal exchange rates, or if other factors come into play (notably food and energy prices).

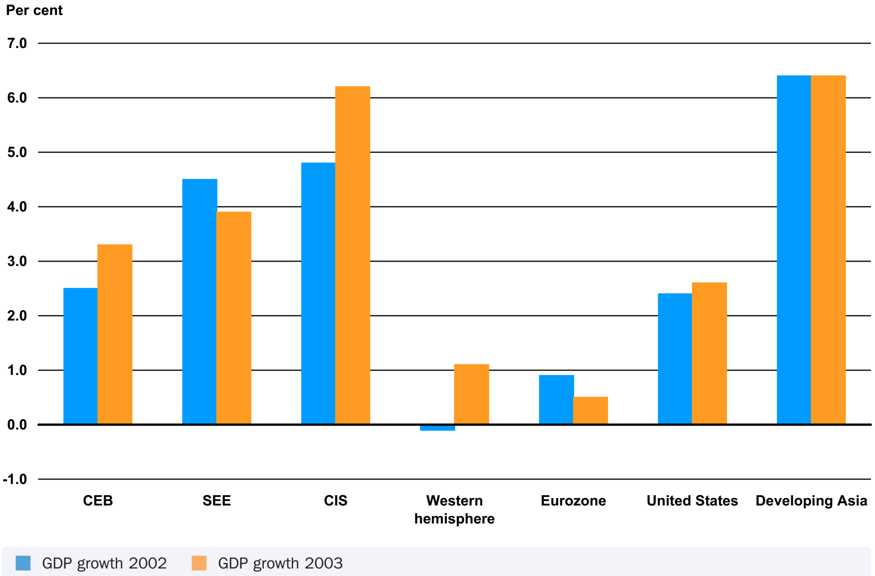
These favourable developments were reflected in continued investor confidence in the region. Net foreign direct investment (FDI) inflows amounted to US$ 28 billion in 2002, slightly up from the previous year. The MSCI (Morgan Stanley Capital International) stock market index for eastern Europe was up by 14 per cent in 2002 and over 40 per cent in the first eight months of 2003 in dollar terms (see Chart 3.2).

However, the current growth rates and composition of output growth may not be sustainable in the long run. In the CIS growth is driven by highly favourable oil prices, which are unlikely to last, while much of CEB growth has been fuelled by fiscal expansion, leading to a worrying deterioration in fiscal balances in the larger CEB countries. Given the persistently large current account deficits in much of the region, this could lead to the recurrence of substantial twin deficits at a time when privatisation-related investment in CEB has started to level off and grant finance to the western Balkans is decreasing. Alternative sources of finance and increased international integration are likely to expose these countries to more volatile capital flows.

Global demand is unlikely to make a significant contribution to growth in transition countries. Although forecasters expect the global economy to gain speed in the second half of 2003, this recovery is mainly driven by improved conditions in the United States, whose economy grew at an annualised rate of 3.3 per cent in the second quarter (helped, in part, by the surge in defence expenditure), and in Japan, which grew at 3.9 per cent (at an annual rate) in the second quarter of 2003. According to the IMF, the US economy is now forecast to grow by 2.6 per cent in 2003 as a whole. The US

Chart 3.1

International comparison of growth, 2002–03

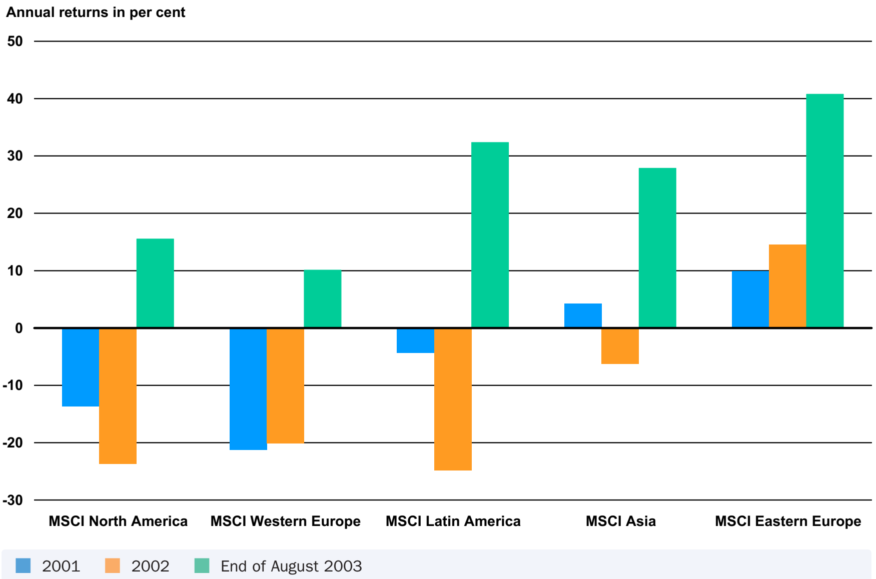


Sources: EBRD and IMF *World Economic Outlook*.

Note: Data for CEB, SEE and CIS are taken from the EBRD. Data for eurozone, United States, Developing Asia and Western hemisphere (which includes Central and Latin America) are taken from the *World Economic Outlook*. Data for 2003 represent EBRD and IMF projections. Regional aggregates are weighted averages.

Chart 3.2

Stock market performance by region



Source: Morgan Stanley Capital International (MSCI).

Note: Returns are calculated in US$ terms.

outlook could be affected by a potential decrease in consumer confidence and spending, weakness of fixed investment, continuing strength in oil prices, concern about fiscal sustainability and the limited opportunity for monetary policy intervention, with the Federal Funds rate at 1.0 per cent. Although the Japanese outlook is now slightly more optimistic than it was at the end of 2002, the medium-term prospects remain uncertain due to continued monetary and fiscal policy problems and delays with structural reforms, including a solution for the large non-performing loan portfolio of Japanese banks. The outlook for the eurozone, the transition countries' main export market, has been repeatedly adjusted downwards since the last *Transition Report*. Growth could now be as low as 0.5 per cent for the year as a whole, as the German, French and Italian economies are still stagnating and the effect of the planned pension, tax and labour market reforms will take time to filter through.

Until these key imbalances are resolved, both consumption and investment in the advanced industrialised countries are likely to remain weak. This implies that exports to, and financial investment from, these countries cannot be relied on as the main source of demand growth and external funding in the transition countries for some time. The limited resources that will become available will be directed at those countries with the best macroeconomic policy and the strongest commitment to structural reforms. Growth will have to be driven by continued productivity improvements at home supported by sustainable growth in domestic demand.

CEB: Growth momentum may pick up but fiscal imbalances are on the rise

The eight accession countries in CEB received a major boost with the long-awaited invitation by the EU to join the Union in May 2004. The historic decision, formally taken at the Copenhagen Summit in December 2002, is an acknowledgement of the progress made to date. Over the past year, the CEB economies have again displayed resilience to the difficult external environment. However, at 2.5 per cent their aggregate growth in 2002 (on a weighted average basis) has been modest considering the amount of catching up – or real convergence – still required to reach average EU income levels. This is partly due to the continued poor performance of Poland, whose economy has been virtually stagnant for more than two years.

The best performing countries in 2002 were again the Baltic states, which together with Croatia were the only economies to grow by more than 5 per cent. On the back of rapidly rising private consumption and foreign investment, the Baltic states have been the fastest growing economies in the whole of eastern Europe for three years running, and the rapid expansion has continued into 2003. In the first quarter of 2003, Lithuania recorded a remarkable growth rate of 9.4 per cent year-on-year. Latvia and Estonia grew by 8.8 per cent and 5.2 per cent respectively over the same period, earning the three countries the nickname "Baltic tigers".[2]

For 2003 an average growth rate of 3.3 per cent (weighted average basis) is expected for the whole of CEB, aided by an upturn in the Polish economy, which is at last showing signs of recovery. Following substantial monetary and fiscal easing, Poland's industrial output and retail sales picked up in the first half of the year, and the economy could grow by around 3 per cent in 2003. In addition, Polish exports have been boosted by the significant real depreciation of the zloty. Except for the Baltic states, where growth is likely to continue at last year's rapid pace, the rest of the CEB economies are expected to grow by 3 to 4 per cent in 2003. In many CEB countries growth is supported by buoyant private and public consumption, whereas investment and exports, albeit increasing, remain weak. Growth has also been supported by strong improvements in productivity. However, this effect could be offset in Hungary by a rise in unit labour cost and a decline in international competitiveness.

Moreover, the large and rapid fiscal expansion in the larger CEB countries, which has supported growth over the last few years, constitutes a major macroeconomic risk for that region. In the largest four CEB economies – the Czech Republic, Hungary, Poland and the Slovak Republic – consolidated general government deficits for the past two years have exceeded 4 per cent of GDP (see Box 3.1). A large part of the deficits are structural in nature and point to the urgent need for fiscal reforms. Most of the correction will have to come through cutting expenditure, including on social security, since the overall tax burden in many countries is already high. Much of the recent expansion is also the result of increased discretionary spending, particularly increases in public sector wages (Hungary provides a clear example). However, cutting expenditure will be difficult in an environment where unemployment levels are still extremely high.

The fiscal demands of EU accession further highlight the need for fiscal tightening. Fiscal consolidation will be complicated by EU-related expenditure, such as the topping up of direct payments to agriculture, implementing the Schengen border, and the potential fall in trade tax revenues. Higher expenditure will only be partly financed through EU structural and cohesion funds, and countries will have to contribute substantial resources to co-finance investments. Moreover, the magnitude and effectiveness of these grants may be reduced by the limited "absorption capacity" of public administrations in accession countries – that is, their limited capacity for processing grants. Much of the funds will be administered and spent by regional and local authorities – generally the weakest link in the public administration chain. Unless swift and significant improvements take place in the effectiveness of public administration and governance, there is a risk that much of these funds will disappear in corruption and waste.

Several governments have recently expressed their resolve to tackle their fiscal problems but doubts will remain until the necessary measures are implemented in full. Both the Czech and Hungarian governments, for instance, have announced wide-ranging fiscal plans. However, so far, the authorities and parliaments in question have not demonstrated any real appetite for fiscal tightening, and budget deficits are likely to remain above the 2003 targets of

[2] *The Economist*, 19 July 2003, p. 32.

Box 3.1

Fiscal sustainability in first-wave accession countries

The next step for accession countries, after they join the EU, is to prepare their entry in the eurozone. This requires them to fulfil the fiscal criteria contained in the Maastricht Treaty. According to these criteria, the countries are required to record general government deficits not higher than 3 per cent of GDP and gross general government debt not exceeding 60 per cent of GDP.

At present, all the accession countries due to join the EU in 2004 satisfy the public debt criterion but many of them have a general government budget deficit that is much higher than the limit imposed by the Maastricht Treaty (see table). A significant tightening of their fiscal policy will have to be implemented if these countries are to fulfil the budget deficit criterion by the time they expect to join the eurozone.

A simple but stringent public debt sustainability test asks whether the government's current primary (non-interest) budget surplus (as a percentage of GDP) is sufficient to stabilise the general government debt-to-GDP ratio at its current level. This requires an assumption about the growth rate of real GDP and the real interest rate on government debt. Setting these at their average values of the past four years, for illustrative purposes, only Estonia's fiscal policy can be deemed sustainable under this test. According to this methodology, the four largest CEB economies appear to be pursuing particularly unsustainable policies.

Without fiscal adjustments, the most indebted accession countries will soon breach the public debt ceiling of 60 per cent of annual GDP. Hungary and Poland already have public debt to GDP ratios of around 50 per cent, and the Slovak Republic is not far behind.

The countries need to decide for themselves whether the unavoidable fiscal tightening will be implemented mainly through spending cuts or tax increases. It is worth noting, however, that the share of public expenditure in GDP stands already at a relatively high level. Equally, revenues as a percentage of GDP are high in these countries. Raising tax revenues by increasing effective average tax rates could therefore become more and more difficult, as disincentives increase and tax compliance worsens.

Other sources of financing, mainly sales of public sector assets, are inherently one-off opportunities and are nearing their end. It will therefore be difficult to implement the ambitious plans for fiscal adjustment announced by the respective governments for the coming years without significant cuts and changes to public expenditure.

Selected fiscal indicators for accession countries in 2002

Country	Government debt / GDP	Government expenditure / GDP	Government balance / GDP
Czech Republic	20.0	46.6	-6.7
Estonia	5.2	38.4	1.2
Hungary	54.3	53.5	-9.2
Latvia	14.6	38.8	-2.7
Lithuania	29.5	31.4	-1.2
Poland	46.0	44.1	-6.7
Slovak Republic	42.7	48.4	-7.2
Slovenia	26.9	42.6	-3.2

Source: EBRD.

6.5 per cent of GDP in the Czech Republic and 4.8 per cent in Hungary. In Poland the current 2003 fiscal deficit target of 3.9 per cent is also likely to be revised upwards. The actual deficit could be as high as 7 per cent. In contrast, the Slovak Republic is forecast to record a deficit close to its target of 5 per cent of GDP this year, as a first step in a long-term strategy to reduce the fiscal deficit to 3 per cent by 2006, as required by the Maastricht Treaty.

With measures to ensure fiscal tightening unlikely to be implemented in full and on schedule, CEB economies could see an aggravation of their twin deficit problem – growing shortfalls in both the government budget and the current account (see Chart 3.3). Although exports are showing signs of recovery across the region, all countries except Poland and Slovenia are forecast to record current account deficits of 4 per cent or more this year. In almost half of the CEB countries the deficits are 6 per cent or higher, with particularly high deficits of over 7 per cent this year forecast in Estonia, Latvia and Hungary.

Successful convergence will require high rates of investment. With unchanged and rather low national savings rates, sizeable current account deficits can still be part of a sustainable long-term process of catching up with the existing EU members' levels of productivity. It is key, however, that the resources borrowed from abroad are invested at home and that, in the medium and longer term, the country is able to generate external primary surpluses that permit the servicing of these external liabilities.

It is a cause for concern that in many CEB countries current account deficits are high while FDI inflows have started to decline. The forecast for aggregate net FDI into CEB in 2003 is around US$ 14 billion, down from US$ 21 billion in 2002. So far the financing of high current account deficits is not at risk, since increased portfolio and loan flows have compensated for the decrease in direct investment. However, these flows are subject to higher volatility, which may be compounded by increased "convergence plays" as eurozone accession nears.[3] In Hungary the combination of high fiscal and current account deficits has already heightened investor risk perceptions following the small devaluation of the central parity and subsequent interest rate hikes in June 2003, which were not expected by investors.

The situation in CEB calls for urgent fiscal corrections and better coordination of monetary and fiscal management. In the context of volatile capital flows, there is a premium on a consistent policy framework and careful communication. The importance of fiscal tightening is heightened by the need for budgetary and monetary restraint to secure membership in the eurozone in the medium term. Fiscal restraint is likely to have a dampening effect on growth in the short-run but it is necessary to lay the foundations for more sustained growth in the future.

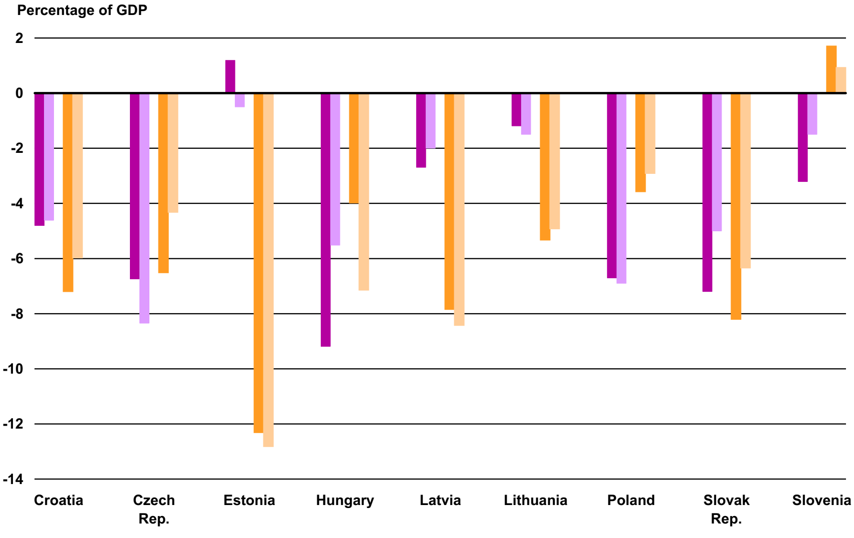
SEE: Political stability and integration foster growth but official finance is decreasing

The recent stability fostered by increasing cooperation between SEE countries and

[3] Convergence plays are investment strategies that seek to profit from differentials between interest rates in CEB economies and those in the EU and US, based on the expectation of relatively stable or even appreciating exchange rates in the region. See the 2003 *Transition Report Update*, Chapter 2.

Chart 3.3

Fiscal and current account balance in CEB countries



Source: EBRD.

Note: Data for 2002 are actuals. Data for 2003 represent EBRD projections.

closer ties to the EU has helped SEE to achieve substantial growth over the past three years. This has also been assisted by ongoing domestic restructuring. Last year the region grew by 4.5 per cent, with particularly strong growth in the two largest economies, Bulgaria and Romania. All countries grew by at least the 3.8 per cent recorded for the transition region as a whole, with the exception of FYR Macedonia which was still recovering from the inter-ethnic conflict of 2001. In Albania, growth was held back by a prolonged drought which affected agriculture and led to a supply crisis in the largely hydro-based power sector. However, the country still recorded the third-highest growth rate in SEE, after Bulgaria and Romania.

In Serbia and Montenegro, growth of 4 per cent derived mostly from the upswing in the services sector, while industrial production remained weak. Over recent months there have been tentative signs of a modest recovery in the industrial sector, especially in Montenegro. However, overall economic growth is sluggish and on present trends is likely to fall short of the government's target range of 3.5 to 4.5 per cent for 2003. Long-term growth and prosperity in Serbia and Montenegro requires tough decisions, especially with regard to large state-owned and socially owned enterprises. With the exception of some large-scale privatisations, there is little sign yet of the sustained inflow of investment required to generate higher growth rates in the medium term.

Two SEE countries, Romania and Serbia and Montenegro, have seen a significant improvement in their inflation performance. For the other four countries, inflation has remained at low levels. In Romania inflation declined faster than projected, and by June 2003 had fallen to 14.1 per cent. The end-year target of 12 per cent seems within reach, as recent increases in energy and other services have only modestly affected the consumer price index. Serbia and Montenegro also witnessed an impressive fall in inflation from 91.3 per cent in 2001 to 21.4 per cent in 2002. By end-2003 the annual inflation rate may be close to a single-digit figure.

Over the past few years, several SEE countries have initiated a painful process of fiscal adjustment. Albania maintains the largest budget deficit in SEE, even though its general government deficit has come down from over 12 per cent of GDP in 1997 to 6.3 per cent last year. In Romania the fiscal deficit has gradually declined from a peak of 5 per cent of GDP in 1998 to 2.7 per cent last year. Fiscal performance has also improved in Serbia and Montenegro, owing to much higher revenue collection and hardened budget constraints for public enterprises. Nevertheless, fiscal deficits in SEE remain high, and have averaged close to 4 per cent of GDP since 1997.

As in CEB, large government deficits tend to be mirrored in large and persistent current account deficits. Current account deficits have increased significantly over recent years. The average for the region was 9.7 per cent in 2002 – with a particularly high deficit of close to 20 per cent of GDP in Bosnia and Herzegovina. Current account deficits of this magnitude are especially problematic since the state relies heavily on fiscal transfers from the entities and generous but declining grants from abroad.

The risk associated with twin deficits is exacerbated by the region's big expenditure requirements, falling aid flows and an already substantial debt burden. The SEE region has so far had limited success in financing high investment requirements through private capital flows.[4] Except in Bulgaria and Romania, most of the recent inflows in capital have been in the form of official aid. To bridge the gap created by falling official flows and to push the region onto a higher growth path, the SEE region will have to attract higher private investment. However, in 2002 the SEE countries received little more than 15 per cent of the total net capital inflows to transition economies, down by about a fifth from 2001.[5]

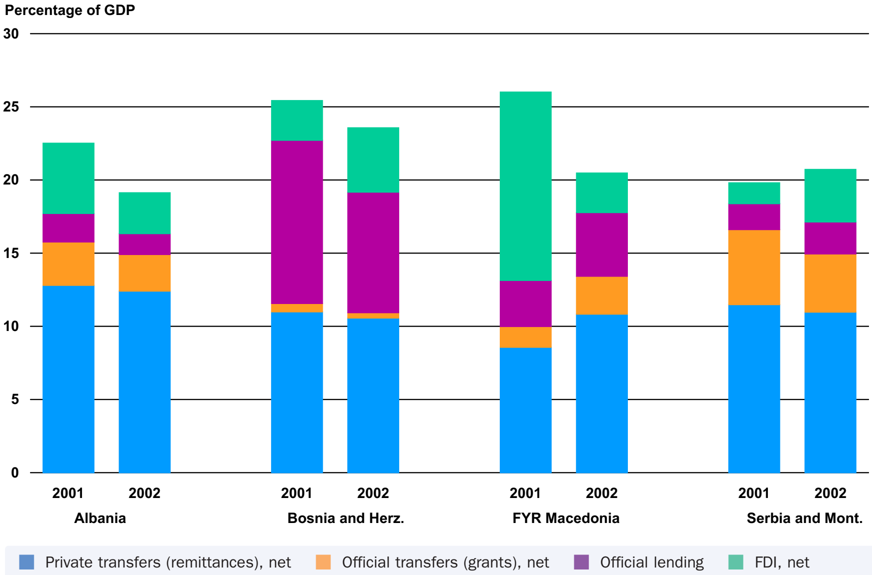
Net foreign direct investment inflows fell by about 7 per cent between 2001 and 2002 (see Chart 3.4), and in some countries remittances – money transfers from expatriates – are a more significant source of inflows than FDI (see Chapter 5). However, while remittances are sometimes channelled into small business creation and investment, it is primarily used for the consumption of imports, and is usually associated with high trade deficits.

[4] See Falcetti et al. (2003).

[5] See the 2003 *Transition Report Update*.

Chart 3.4

Official capital flows, FDI and remittances in western Balkan countries



Sources: EBRD and IMF country reports.

Table 3.1

Resource dependence, selected transition economies

	Azerbaijan [1]		Kazakhstan [1]		Russia [2]	
	1999	2002	1999	2002	1999	2002
Oil and gas export (in per cent of total merchandise exports)	78.1	88.8	35.5	50.6	41.0	52.5
Oil and gas export (in per cent of GDP)	17.5	33.6	12.9	21.1	16.0	16.3
Oil and gas revenues (in per cent of total government revenues)	23.2	55.8	5.4	19.5	24.3	24.9
Memorandum						
Oil production, thousand barrels per day	278	308	631	989	6,178	7,698
Gas production, billion m^3 per annum	5.0	4.3	8.4	11.0	495.9	499.4

Sources: Oil and gas production and oil price are from *BP Statistical Review of World Energy, 2003.* Other sources as indicated.
Note: Average oil price (Brent) in 1999 was US$ 18.25 per barrel; in 2002 it was US$ 25.19 per barrel.
[1] Data from the IMF.
[2] Figures for oil and gas exports are from the Central Bank of the Russian Federation. Figures for oil and gas revenues are from Kwon (2003).

CIS: Continuing strong growth but high oil prices discourage reform

Recent growth in the CIS has been even more robust than in the rest of the region. The CIS economies as a whole grew by 4.8 per cent in 2002 and are on track to record even higher expansion of 6.2 per cent this year on a weighted average basis. Much of this growth was achieved because of high commodity prices. However, there are also signs of investment recovery in non-oil sectors. This is particularly the case in Russia, the region’s largest economy and, because of its significance as an export market, the growth engine of the entire sub-region.

The Russian economy has expanded by an average of over 6 per cent per annum in the past three years, with 4.3 per cent growth recorded last year and an estimated 7.2 per cent in the first half of 2003. The country could grow by 6.2 per cent in the year as a whole. On the demand side, household consumption continues to be strong but encouragingly there are also signs that private fixed investment is starting to pick up. Investment growth accelerated to 12 per cent year-on-year in the first seven months of 2003, boosting industrial production growth by 7 per cent and construction by 14 per cent. The challenge is to capitalise on these improvements, and push forward with the reform agenda and the diversification of the economy. However, in the short term the economy will remain highly dependent on natural resources (see Table 3.1).

The other main oil-exporting countries also recorded rapid growth last year because of oil windfalls and rising investment. Azerbaijan registered official GDP growth of 10.6 per cent in 2002. Although growth was spread across many sectors, the economy remains highly dependent on oil and gas-related activity, which accounts for around 30 per cent of GDP. In Kazakhstan, growth reached 9.5 per cent in 2002, led by industry and capital investments. Oil and gas production was up 15 per cent, and continues to be a crucial part of the Kazakh economy (see Table 3.1).

High prices for natural resources have resulted in budgetary revenue windfalls across the resource-based economies of the region. Russia recorded a general government surplus of 1.4 per cent of GDP in 2002, slightly lower than in 2001. The same size of surplus is expected this year, according to a revised government forecast. The end-year financial reserve projection is also expected to remain substantial, at around RUR 180 billion (about US$ 6 billion) according to official forecasts. Similarly in Kazakhstan, the general government surplus (including National Fund revenues) narrowed from 2.7 per cent of GDP in 2001 to 1.4 per cent of GDP in 2002. Azerbaijan recorded a slight deterioration in its general government deficit (as conventionally measured) last year, as quasi-fiscal subsidies to state-owned companies were brought on budget.

The current account balances continue to vary significantly among oil and gas-producing countries. The Russian current account surplus remains high, although it fell from 11 per cent of GDP in 2001 to 9 per cent in 2002, as imports soared following an increase in real wages. Private capital outflows, including capital flight, declined in the first half of 2003, while foreign investment, mainly in the form of corporate loans and bonds, increased by over 50 per cent against the same period last year. In a major turnaround, there was therefore a net private capital inflow into the country during the first half of 2003. Central Bank reserves increased to a record US$ 62.8 billion by the end of August 2003.

Kazakhstan's current account deficit declined from 4.9 per cent of GDP in 2001 to 2.4 per cent in 2002. In contrast, Azerbaijan's current account deficit increased sharply because of oil-sector related imports, as efforts to develop the country's oil and gas reserves gain speed. Turkmenistan, another major gas exporter, witnessed a significant turn-around in its current account position from 2001 and recorded a surplus of 4.5 per cent in 2002. Managing the macroeconomic risks associated with these flows – upward pressure on inflation and the real exchange rate and volatile fiscal positions – is perhaps the key medium-term challenge for these countries, as will be discussed in Section 3.2.

Among the non-resource-rich economies, Armenia and Tajikistan have recorded GDP growth close to or above 10 per cent for the second year in a row, based on a strong performance of the industrial sector and, in the case of Tajikistan, cotton. In Ukraine, GDP growth is up from 4.8 per cent in 2002 to 5.3 per cent year-on-year in the first eight months of 2003. Strong growth in the first half of the year was moderated by the poor harvest, but given the continued strength of industrial output GDP should grow by 5 per cent or more for the year as a whole. In Belarus GDP rose by 4.4 per cent over the first seven months of 2003, compared with the same period last year, reflecting continued growth in industrial production but also a fall in agricultural output.

The Kyrgyz Republic was the only country in the region to record negative growth in 2002, due to a reduction in gold output following an accident at the Kumtor mine in July 2002 (which accounts for around 10 per cent of GDP) and adverse weather that affected the production of hydro-electricity. However, the country is recovering strongly this year.

Despite good growth rates over the last few years, the income levels in most of the non-resource CIS countries are still very low. Poverty is widespread and the countries are increasingly dependent on external sources of finance, much of it on a grant basis. They also continue to have very high external debt burdens.

In the last year growing concern about macroeconomic imbalances and lack of reform in some of these countries has put in jeopardy their access to international assistance. In July 2003 the International Monetary Fund (IMF) and the World Bank suspended further disbursements under their poverty reduction and structural adjustment programmes for Moldova following concerns over medium-term fiscal sustainability, trade issues and the poor business environment. In Georgia the IMF postponed the third review under the Poverty Reduction and Growth Facility three times (most recently in August 2003) following the failure of the Georgian authorities to implement necessary fiscal reforms and to reduce government arrears.

The absence of an active IMF programme will make it difficult for both Georgia and Moldova to obtain an agreement with the Paris Club on rescheduling their bilateral external debt, further aggravating already substantial debt problems. In addition, it has proved difficult for the IMF to support Uzbekistan with a financing arrangement. Although there has been progress in some reform areas, the government has backtracked in others (such as trade and by introducing restrictions on the availability of cash).

These episodes highlight the difficulties faced by many of the poorer CIS countries in maintaining access to official finance, which is increasingly important in the absence of sufficient private investment.

3.2 Medium-term policy challenges

CEB: Increasing cyclical convergence with the EU and significant macro-economic challenges ahead of euro membership

The expected accession to the EU of eight CEB countries in May 2004 marks only the beginning of a process of increasing integration into the EU economy. Their next macroeconomic challenge after EU membership will be the eventual adoption of the euro.[6] Under current rules, accession to the eurozone can take place only after fulfilment of the Maastricht criteria. Among other things, this will require two years of successful participation in the ERM-2 exchange rate mechanism.[7]

For a new member that joins ERM-2 immediately after EU accession this could imply accession to the eurozone in late 2006. However, only the Baltic states currently fulfil all the criteria. Whatever the speed of eurozone accession, the prospect of eventual membership raises questions about the degree of macroeconomic convergence between the accession countries and the current members of the EU, both in terms of their business cycles and macroeconomic policy.

As the accession countries become increasingly integrated with the EU as regards trade and capital flows (and possibly, but to a much smaller extent, through labour flows, see Chapter 5), their business cycles should become more and more synchronised. There should be greater cyclical convergence and possibly more similarity in their responses to demand shocks, such as a change in fiscal or monetary policy. Recent evidence suggests that there is already a significant degree of symmetry between the accession countries and the eurozone – or at least its largest economy, Germany – both in demand shocks and in the response to these shocks. The link seems to be particularly strong for Hungary and Slovenia (see Chart 3.5). Increasing synchronisation

[6] Accession countries cannot opt-out of eurozone accession as current member states, such as Denmark, Sweden and the United Kingdom, have done.

[7] The five Maastricht criteria are the following: 1) average annual inflation should be no more than 1.5 per cent above the average inflation rate of the lowest three inflation countries in the eurozone; 2) the long-term interest rate should be no more than 2 per cent above the average of the three countries with the lowest inflation rates; 3) the budget deficit should be no more than 3 per cent of GDP; 4) the national public debt should be no more than 60 per cent of GDP; and 5) the currency should have stayed stable within the normal bands around the central parity to the euro within the exchange rate mechanism with no re-alignments for at least two years.

in business cycles appears to have been driven primarily by growing intra-industry trade (trade in similar products) and deeper financial market integration. Inter-industry trade (trade in different products), which is a reflection of country specialisation, has played less of a role.[8]

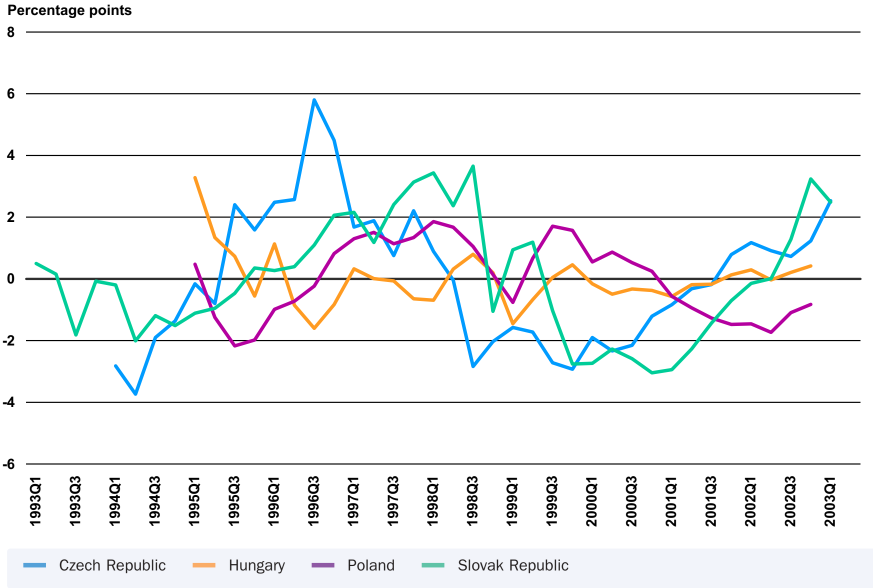
While the accession countries have achieved some degree of business cycle synchronisation with the eurozone, they remain prone to supply-side shocks, such as a major change in import prices or technological innovation. These are more idiosyncratic than demand shocks because of the continued catching-up process and the unfinished process of transition (which can itself be seen as a form of long-lasting supply shock). Indeed, studies still find continuing divergence between current EU members and the accession candidates in terms of supply shocks.[9] Labour mobility is unlikely to play an important role in lessening this divergence, not least because some current EU members will retain restrictions on labour mobility during the first years of accession (see Chapter 5).

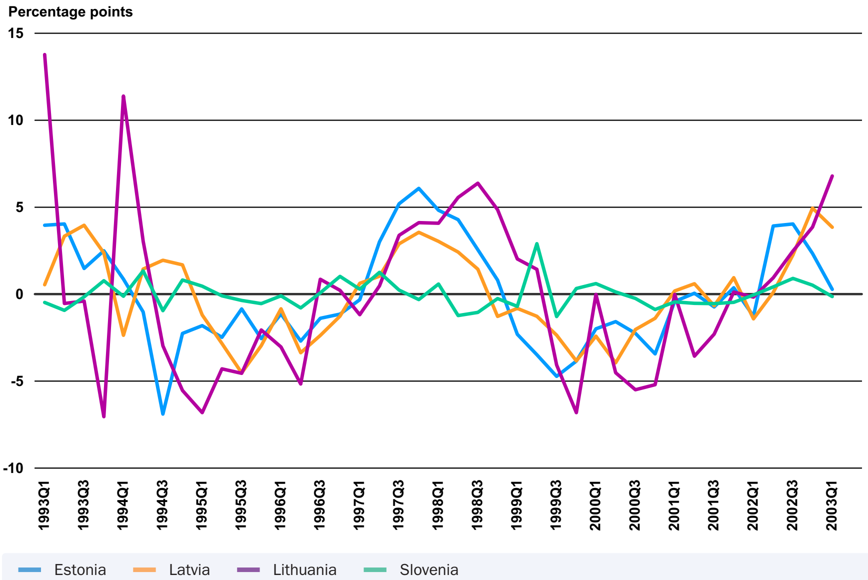
The main way of limiting the impact of shocks will therefore be the traditional macroeconomic policy tools – monetary (including exchange rate) and fiscal policy. The stated aim of many accession countries to join the eurozone quickly will limit the extent to which both monetary and fiscal policy can be used to offset demand fluctuations. The objective of an early entry will limit the scope of monetary policy since the eurozone candidates will be required to satisfy the Maastricht criteria on exchange rate stability and inflation convergence. Managing the exchange rate under conditions of unrestricted financial capital mobility strictly limits the extent to which monetary policy can be used to pursue cyclical stabilisation. Indeed, with mobile financial capital, using monetary policy to achieve exchange rate stability and disinflation in the pursuit of eurozone membership may actually heighten the countries' vulnerability to external factors and speculative attacks. This could happen if it encouraged "convergence plays" similar to those that took place in ERM-I during the 1990s, and more recently in Hungary and the Slovak Republic.

The ability of fiscal policy to compensate for the inflexibility of monetary policy is similarly limited, given the high fiscal deficits in many of the accession countries. As things stand currently, most countries will have to achieve a significant fiscal consolidation to bring their budget deficits in compliance with the Maastricht deficit criterion (see Box 3.1). On the other hand, most accession countries would not at this point have serious problems meeting the Maastricht debt criterion, although debt levels in some countries are approaching the Maastricht threshold rapidly.

Chart 3.5

Co-movements in business cycles





Sources: IMF International Financial Statistics and OECD for the eurozone.

Note: Co-movements in the business cycle are calculated as the difference between output gaps in each CEB country and the eurozone. Output gaps are calculated as the difference between actual and trend output. Trend output was obtained by applying a Hodrick-Prescott filter to the respective series of volume GDP (see Giorno et al. 1995).

[8] See Babetskii (2003), Babetskii et al. (2002), Fidmurc (2001), Frankel and Rose (1998), and Gros and Hobza (2003).

[9] See Babetskii (2003) and Babetskii et al. (2002).

Fiscal policy will have to play an increasingly central role in addressing external factors over the medium term, as monetary policy will already be overburdened trying to achieve the two objectives of exchange rate stability and inflation convergence. Some room for fiscal manoeuvre in response to shocks would therefore be extremely valuable, a fact that further heightens the urgency for early fiscal tightening. The necessary adjustments will undoubtedly be painful. Early eurozone accession is therefore a serious challenge for many of the new EU members, given the need to achieve a sustainable government fiscal position and to reconcile the goals of nominal and real convergence.

SEE: Macroeconomic imbalances need to be addressed to accelerate convergence with EU and CEB income levels

The SEE economies are much less integrated with the EU than the CEB countries. Only two of the SEE countries, Bulgaria and Romania, are candidates for accession to the EU, with both aiming to join in the next accession round in 2007. For the rest, the main framework for enhancing integration with the EU has been the Stabilisation and Association Process (SAP) launched in 1999.[10]

Economic performance in the region has improved in recent years but in terms of GDP per capita, most of the region lags far behind the countries scheduled to join the EU in 2004. Further integration with the EU should help the region to narrow the gap but the transition process of the SEE countries includes formidable challenges for monetary, fiscal and external trade policy if their growth potential is to be achieved.

In general, SEE countries have operated prudent monetary policies in recent years, contributing to low inflation in most cases. Nevertheless, all countries face challenges in deciding on the appropriate exchange rate policy over the medium term. At present, several exchange rate regimes are operated: currency board arrangements (Bulgaria and Bosnia and Herzegovina), unilateral “euroisation” (Kosovo and Montenegro), de facto pegged exchange rate (FYR Macedonia) and floating exchange rates with various degrees of management (Albania, Romania and Serbia).

In Bulgaria the authorities are committed to retaining the currency board until the country is a member of the EU and ready to join the eurozone, since adopting the euro provides a natural exit from the currency board. This is a challenging strategy since a currency board regime is extremely sensitive to any loss of fiscal discipline. For this strategy to be successful, it is essential that the strict fiscal discipline of recent years is maintained up to the point of entry into the eurozone.

For Bosnia and Herzegovina, full EU membership is a distant prospect. However, the currency board arrangement has been successful in promoting acceptance of the new currency and has contributed to price stability. These benefits may outweigh risks such as the vulnerability to speculative attacks, and the authorities are unlikely to jeopardise these achievements by moving to an alternative arrangement in the foreseeable future. However, the weak fiscal position of the entity governments in Bosnia and Herzegovina complicates the management of the currency board, as does the state’s continuing dependence on grant funds from abroad.

In both Serbia and FYR Macedonia, the central banks are considering ways in which the current policies could be modified slightly, without causing turmoil in the markets. In Romania the authorities are considering the adoption of a more explicit nominal anchor for macroeconomic policy instead of its current array of (sometimes implicit) nominal and real objectives. A leading candidate for such a nominal anchor is the adoption of an inflation target, once inflation has decreased to a single-digit figure.

The fiscal challenges facing the SEE region are daunting. Most government spending in the region goes towards public sector wages, subsidies and benefits, and very little is spent on infrastructure investment. Furthermore, in most countries the primary balances excluding interest payments on public debt are negative.[11] Bulgaria and Romania are facing the additional cost of bringing standards and institutions in line with the EU’s *acquis communautaire*. For this, they will receive substantial pre-accession funds from the EU, which are projected to rise to a cumulative €1.2 billion for Bulgaria and €2.8 billion for Romania over the pre-accession period. For the rest of the region, donor funding is being scaled down, and a reduction in public spending seems inevitable. The transition will be easier if private sector development advances, and if more of the large informal economy can be brought into the formal, tax-paying sector.

In addition, current account deficits in the region have averaged between 8 and 10 per cent of GDP in the last two years. In the western Balkans, high current account deficits reflect the low level of exports, limited trade within SEE and dependence on imports, which are often financed by private transfers from abroad. Typically the official settlements balance of payments for SEE countries has been in surplus thanks to substantial capital inflows, either in the form of FDI (Bulgaria and Romania) or in the form of official assistance and loans (western Balkans). This assistance is drying up in several cases, highlighting the need to attract more private investment and to encourage exports. Recent free-trade agreements among SEE countries may raise the level of cooperation within the region from its current low level (see Chapter 4) by giving a modest boost to exporters and making the region more attractive to potential investors.

Governments have a key role to play in fostering private sector development. In an environment where FDI continues

[10] Stabilisation and Association Agreements (SAAs) are similar but not identical to the Europe Agreements signed during the 1990s between the accession countries and the EU. SAAs were signed in 2001 by Croatia and FYR Macedonia. Negotiations on an SAA for Albania began in early-2003 but have not yet started with Bosnia and Herzegovina or Serbia and Montenegro. See also Chapter 4.

[11] See Gligorov et al. (2003).

to be weak, domestic investment rates are low and productivity is only just recovering, governments need to tackle the continuing problems of taxation, corruption and the slow progress in institutional reform. While each country is at a different stage of transition and economic development, and therefore faces different challenges, there is a common need to strengthen financial intermediation, improve the business environment, and enhance trade and cross-border cooperation.[12] It is also crucial to bring the informal sector as much as possible into the formal economy. This requires predictable, broadly based taxes and a minimally intrusive licensing, registration and administrative regime.

CIS: Resource-rich CIS countries need to manage wealth from natural resources and promote the development of other sectors

The integration of the CIS countries into the world economy has come largely on the back of capital flows and trade relating to the natural resources sector. The vast majority of private capital flows to the CIS has been to the big resource-exporting countries, such as Russia, Kazakhstan and, more recently, Azerbaijan. Trade has also been predominantly commodity-based, with the focus on fossil fuels and other natural resources, such as minerals and gold, and agricultural produce (see Chapter 4). Given this dependence on commodity-related flows, the macroeconomic challenges for the region are quite distinct.

For the resource-rich CIS countries, the twin challenge is to foster growth outside the core natural resources sector while managing the large and volatile foreign currency flows associated with this sector. In most of these countries, there is still only a limited capacity to absorb the high currency flows. The level of monetisation continues to be low compared with advanced economies and other transition countries. Banking and financial markets in much of the region remain underdeveloped, and this limited degree of financial intermediation makes it difficult to manage the domestic liquidity resulting from high capital inflows and to spread the gains from the natural resources sector across the economy.

Moreover, there are few market instruments available to the national authorities to sterilise the large inflows. Under these conditions it is difficult to control upward pressure on the nominal and real exchange rates. Faced with net inflows of foreign currency, the monetary authorities can either allow the national currency to appreciate directly or buy up the foreign currency, thereby expanding the money supply. However, if the potential for sterilisation is limited, the ensuing inflationary pressure will again lead to pressures for real exchange rate appreciation. This can only be avoided if, at given current and future price levels, money demand grows in step with the rate of monetary expansion. As long as the domestic absorption capacity is insufficient and sterilisation options are not available, the net effects of large foreign currency inflows are to increase inflationary pressure and to weaken the competitiveness of the non-natural resources sector, thereby undermining prospects for economic diversification.

A further challenge facing CIS countries rich in natural resources is to limit the extent to which commodity price volatility is transmitted to volatility in fiscal positions. Fluctuations in oil prices have an immediate impact on government finances, as the oil-related revenues account for a large part of government revenues (see Table 3.1). In a period of exceptionally and temporarily high revenues, governments may be tempted to increase expenditure in line with rising revenues, especially if there is a substantial back-log in investment or pressing social needs. However, should oil prices then fall, a corresponding reduction in expenditure is likely to be more difficult to achieve.

In an attempt to address these significant monetary and fiscal challenges, several countries rich in natural resources have established “stabilisation funds” (see Box 3.2).[13] Broadly speaking, these funds have two functions: a short-term stabilisation function and/or a long-term savings function. By accumulating (depleting) revenue according to target commodity prices and non-oil fiscal balance criteria, a fund with a stabilisation objective transfers the volatility of, or uncertainty surrounding, commodity prices from the government’s fiscal position to the oil fund itself. Funds with a savings function are designed to save revenues derived from the depletion of a country’s natural resources capital through their investment in alternative financial or real assets in order to share the benefits from natural resources with future generations. By investing these reserves in international assets, both types of oil funds can also help reduce real exchange rate fluctuations and pressures associated with large foreign exchange inflows deriving from the extraction of natural resources.

For such funds to be fully effective, however, they need to be managed transparently and to be integrated into an overall fiscal expenditure framework including all general government sources and uses of funds. This is important both to maintain overall macroeconomic stability – that is, to prevent spending without due consideration of the overall fiscal stance which could result in “overheating” – and to ensure that expenditures from the fund are in accordance with public expenditure priorities.

Among the transition countries, stabilisation funds were introduced in Azerbaijan in 1999 and Kazakhstan in 2000. So far Russia has largely exercised sterilisation policy through repayment of foreign debt but the authorities are currently considering plans to establish a stabilisation fund (see Box 3.2). Turkmenistan, the second-largest gas producer of the region after Russia, has so far not established a clear policy framework for managing its natural resource wealth.

The creation of transparent, integrated oil funds constitutes an important step towards a better management of natural

[12] For a more detailed description of the policy recommendations, see Falcetti et al. (2003).

[13] See Davis et al. (2001) for further details on such funds.

Box 3.2

Savings and stabilisation funds in the CIS

Faced with the challenge of managing growing revenues from their natural resource endowments, resource-rich countries around the world have established dedicated funds. Among the transition countries, two such funds are currently in operation – in Azerbaijan and Kazakhstan – while a third is being considered in Russia.

Azerbaijan
The State Oil Fund of the Azerbaijan Republic (SOFAR) was established in December 1999. SOFAR was established as a savings fund, with the objective of preserving some of the country's natural resources wealth for future generations. The authorities are currently considering extending SOFAR's role to include saving excess revenues when oil prices are above their budgeted levels and using these revenues if oil prices fall below their budgeted levels. The assets of SOFAR totalled US$ 810 million at the end of June 2003.

SOFAR provides quarterly status and operating reports to its Supervisory Board and to the President of Azerbaijan. It is audited annually by an internationally recognised auditing firm. Information on SOFAR's revenues and expenditures are required to be reported in the local media. Reports are also published on SOFAR's Web site. Asset management guidelines determine the currency composition, the balance between liquid and long-term investments, and fixed and equity income instruments. The authorities have developed a medium-term expenditure framework and accompanying annual public investment programme, which sets the priorities for public expenditure (including SOFAR resources). These will be education, health, development of a social safety net and infrastructure development aimed at improving long-term economic growth prospects. Following an amendment to the budget system law in early 2003, expenditure from SOFAR is to be included within the overall target for fiscal balance.

Kazakhstan
The National Fund of the Republic of Kazakhstan (NFRK) was created in August 2000. NFRK is both a savings and stabilisation fund under the governance of the National Bank of Kazakhstan. The fund receives revenues in the form of tax payments from the nine largest petroleum companies and the three largest mining companies. The outflows from the fund are used to stabilise the country's budget although additional expenditure from the NFRK is at the discretion of the President. There is no regulatory cap on expenditure. The NFRK's investment strategy is to invest 75 per cent of its assets in a saving portfolio composed of bonds and high-rated stocks while the rest of the assets – the stabilisation portfolio – consists of liquid short-term instruments. Regular reports on the activities of the NFRK as well as the levels of accumulated funds are published on the Internet. Summaries of the annual report are periodically reported in the local media. By the end of August 2003, the funds accumulated in the NFRK had reached US$ 2.7 billion.

Russia
Russia is currently in the process of transforming its fiscal reserve fund into a fully-fledged stabilisation fund. Initial proposals surrounding the operational details of the fund were outlined by the government in amendments to the budget code submitted to the Duma at the end of August 2003. The fund will be purely for stabilisation rather than savings purposes. The fund is intended to be fully integrated into the budgetary process, with reports on fund activities contained within the federal budget reports. This should enhance transparency relative to the current fiscal reserve.

Following the initial transfer of reserves from the financial reserve (expected to be around US$ 5.8 billion at the end of 2003), the main revenues for the fund will be derived from export duties for oil and oil products and oil extraction taxes. Revenues will be accumulated when the average oil price of the previous two months exceeds the average for the previous 10 years (this would currently be equivalent to US$ 20 per barrel). In addition, the proposal suggests that the government may transfer part or all of the end-year fiscal surplus to the fund, irrespective of source. Under current proposals, the government expects the fund to accumulate assets of around 5 per cent of GDP over the next four years. The accumulated funds will be invested in "AAA" rated foreign securities. The fund will be drawn on to finance shortfalls in the federal budget resulting from lower than budgeted oil prices. In addition, it may be used to even out expenditure peaks (for example, peak external debt payments) once accumulated fund reserves exceed a certain limit, which is still to be defined.

resource wealth. However, sustainable diversified economic growth also requires accompanying progress in structural reforms and the development of institutional capacity to make effective use of the wealth generated from natural resources. It is particularly vital to develop a financial sector that is able to intermediate these funds and to create a business environment that is conducive to private sector growth outside the natural resources sector.

Non-resource-rich CIS countries need to manage their dependence on Russian markets and energy

CIS countries without their own oil and gas reserves import substantial amounts of energy, most of it provided by their resource-rich neighbours, especially Russia, and delivered through the old Soviet pipeline system. As net energy importers, these countries should be vulnerable to an increase in oil and gas prices but they have been surprisingly resilient to the high world energy prices of the last few years. Two main factors explain this resilience.

The first factor concerns the trade patterns prevailing in the CIS. The non-oil CIS economies remain poorly integrated into the world economy, and most of their exports are destined for other CIS countries. Russia in particular remains by far the largest export market for most CIS countries (see Chart 3.6 and Chapter 4). The export industries of the CIS therefore obtained a significant boost when Russia's oil income grew and its currency appreciated as a consequence of the oil price boom.

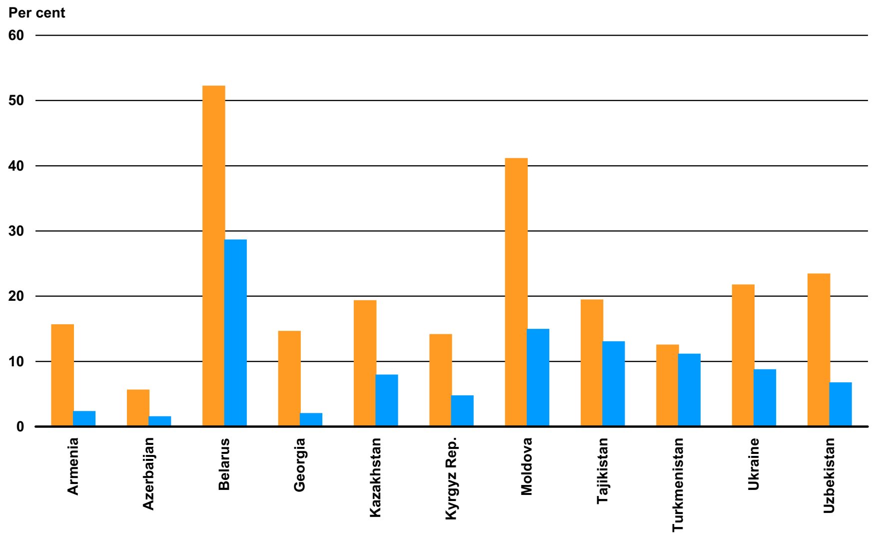
The second factor relates to the terms of energy trade within the CIS. Most CIS countries import gas, and to a lesser extent other fuels, from the resource-rich economies of the region at prices that are fixed well below the world market level. Payment is often through barter arrangements, either involving goods or, in the case of gas transit countries such as Ukraine, the payment of transit fees in kind. Where the settlement is in cash, payment discipline has been notoriously poor.[14] As a consequence, energy trade between CIS countries is usually unaffected by fluctuations in world market prices.

However, neither of these two factors is based on permanent arrangements, and the vulnerability of these countries to oil price fluctuations could grow over

[14] See 2001 *Transition Report*.

Chart 3.6

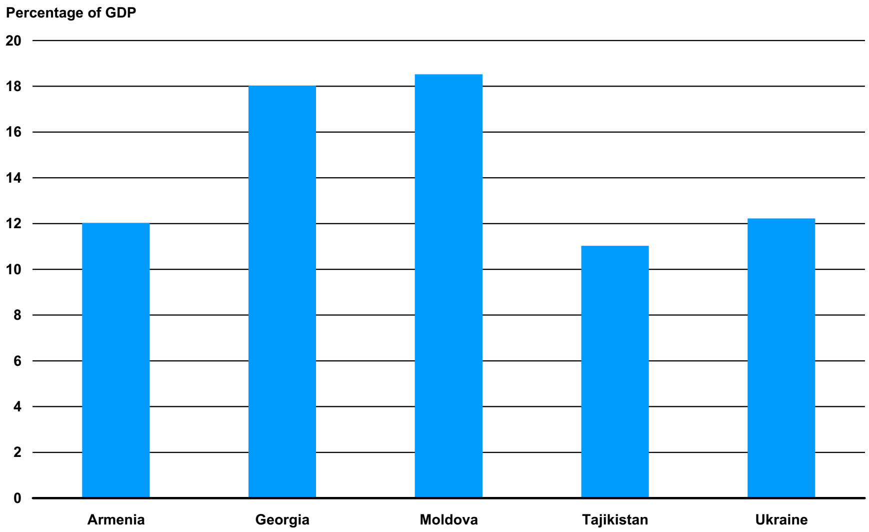
Share of exports to Russia, average 1999–2002



Source: IMF *Direction of Trade Statistics.*

Chart 3.7

Energy sector debt in selected CIS countries



Source: IMF country reports.
Note: Data are for 2000 except Ukraine, where data are from 2002.

the medium term. With respect to exports, there is evidence that as income levels rise in Russia, consumers are beginning to replace CIS goods with more expensive but higher-quality imports from Western countries. To counter this trend and remain competitive, CIS exporters will have to increase their productivity and improve the quality of their products. This will improve their competitiveness not only in Russia but in the entire world market, providing a wider export market and deepening the region's integration into the global economy.

The sustainability of the current energy trade arrangements is equally question-able. The current system is neither transparent nor efficient, and this is increasingly recognised by the Russian authorities, despite the presumption that the arrangement brings political benefits. The abolition of the system would expose the non-resource-rich CIS countries to a potentially grave terms-of-trade shock in the form of higher import prices. The call for government support to soften the blow is unlikely to be effective, given the already precarious fiscal position of most of these countries. The additional strain on government expenditure and further accumulation of debt would undermine overall macroeconomic stability. A more effective strategy would be to accelerate the restructuring of domestic industry to increase its competitiveness on the international market and to prepare it for the inevitable end of subsidised energy imports.

A related challenge is the eradication of the large energy arrears that these countries have accumulated (see Chart 3.7). The debt is mostly owed by state-owned enterprises to their Russian or Turkmen gas suppliers but some of it has also been assumed by the state. In Georgia and Moldova, which already have precarious public and external debt positions, energy arrears account for some of the most urgent and costly external liabilities. In Moldova, energy debt accounts for about 15 per cent of total external debt, and almost two-thirds of it relates to penalties owed for late payment. For both countries, finding a solution to the arrears problem is a necessity. It would also help them to regain access to official finance from the IMF and the World Bank. However, without complementary reform in the heat and power sectors and harder budget constraints for state-owned enterprises there is no guarantee that the problem would not reoccur.

3.3 Conclusion

The transition economies have performed remarkably well during the current global economic downturn, and growth prospects for 2003 are again relatively favourable. However, over the medium term, the increased integration into the global economy, and for some countries the EU, raises diverse challenges for the region.

CEB countries have achieved a sub-stantial degree of cyclical convergence with the EU although they remain vulnerable to specific supply shocks. The fulfilment of the Maastricht criteria, ahead of entry in the eurozone, will limit the effective use of monetary and fiscal policies to even out fluctuations in the economic cycle. In the medium term, fiscal policy should play an increasingly important role as monetary policy will have to focus on exchange rate management and inflation convergence. Significant fiscal tightening will be required in all the larger CEB countries before fiscal policy can play this stabilising role.

By comparison, the ties between the SEE economies and the EU are less developed and further trade and financial integration is required to help reduce the income gap with the EU. At the same time, changes in monetary, fiscal and trade policies are needed to address significant macroeconomic imbalances. The high fiscal outlays of these countries relative to government revenue collection, persistent external deficits and high debt levels need to be addressed, especially as foreign assistance for most SEE countries is on a downward trend. Increased integration with the EU will also require ongoing improvements to political stability and the business environment, continued progress with reform and higher inflows of FDI.

The integration of the CIS countries into the world economy has taken place predominantly through the development of trade in natural resources and the financial flows associated with the development of the natural resources sector. The resource-rich countries of the region face the twin challenge of managing the macroeconomic impact of large and volatile foreign capital inflows and diversifying their production towards a wider range of tradable goods and services. While few instruments are available to limit the trend appreciation of the real exchange rate, the management of fiscal policy can be improved by the adoption of explicit and transparent rules, including stabilisation funds as long as their revenues and outlays are transparently integrated in a comprehensive medium-term state budget.

The non-oil CIS countries are highly dependent on Russian markets for their exports while they import energy from their resource-rich CIS neighbours, especially Russia, at artificially low prices. This situation is unlikely to be sustainable. The restructuring of domestic industry is essential to prepare industry and households for the end of subsidised energy imports and to diversify the composition and quality of exports for a wider export market beyond Russia.

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Annex 3.1:
Macroeconomic performance tables

Table A.3.1

Growth in real GDP in central and eastern Europe and the CIS

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Estimated level of real GDP in 2002
				(in per cent)										*(1989=100)*
Croatia	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.5	2.5	-0.9	2.9	3.8	5.2	4.2	**87**
Czech Republic	-11.6	-0.5	0.1	2.2	5.9	4.3	-0.8	-1.0	0.5	3.3	3.1	2.0	3.0	**105**
Estonia	-13.6	-14.2	-8.8	-2.0	4.3	3.9	9.8	4.6	-0.6	7.3	6.5	6.0	4.5	**93**
Hungary	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	3.7	3.3	3.0	**112**
Latvia	-10.4	-34.9	-14.9	2.2	-0.9	3.7	8.4	4.8	2.8	6.8	7.9	6.1	6.5	**77**
Lithuania	-5.7	-21.3	-16.2	-9.8	3.3	4.7	7.0	7.3	-1.8	4.0	6.5	6.7	6.0	**77**
Poland	-7.0	2.6	3.8	5.2	7.0	6.0	6.8	4.8	4.1	4.0	1.0	1.4	3.0	**130**
Slovak Republic	-15.9	-6.7	-3.7	5.2	6.5	5.8	5.6	4.0	1.3	2.2	3.3	4.4	3.8	**109**
Slovenia	-8.9	-5.5	1.7	5.8	4.9	3.5	4.6	3.8	5.2	4.6	3.0	3.2	2.3	**118**
Central eastern Europe and the Baltic states	*-10.4*	*-2.2*	*0.2*	*3.9*	*5.4*	*4.7*	*4.9*	*3.6*	*2.8*	*4.0*	*2.5*	*2.5*	*3.3*	***113***
Albania	-28.0	-7.2	9.6	8.3	13.3	9.1	-7.0	12.7	8.9	7.7	6.8	4.7	6.0	**121**
Bosnia and Herzegovina	-12.1	-80.0	-10.0	0.0	20.8	86.0	37.0	15.6	9.6	5.6	4.5	3.8	3.5	**54**
Bulgaria	-11.7	-7.3	-1.5	1.8	2.9	-9.4	-5.6	4.0	2.3	5.4	4.0	4.8	4.5	**80**
FYR Macedonia	-7.0	-8.0	-9.1	-1.8	-1.2	1.2	1.4	3.4	4.3	4.5	-4.5	0.7	3.0	**76**
Romania	-12.9	-8.8	1.5	3.9	7.1	4.0	-6.1	-4.8	-1.2	1.8	5.3	4.9	4.2	**87**
Serbia and Montenegro	-11.6	-27.9	-30.8	2.5	6.1	7.8	10.1	1.9	-18.0	5.0	5.5	4.0	2.0	**50**
South-eastern Europe	*-14.9*	*-9.2*	*-1.6*	*3.9*	*6.1*	*3.6*	*-0.5*	*0.0*	*-2.4*	*3.6*	*4.6*	*4.5*	*3.9*	***82***
Armenia	-11.7	-41.8	-8.8	5.4	6.9	5.9	3.3	7.3	3.3	6.0	9.6	12.9	9.0	**78**
Azerbaijan	-0.7	-22.6	-23.1	-19.7	-11.8	0.8	6.0	10.0	9.5	11.1	9.9	10.6	9.4	**64**
Belarus	-1.2	-9.6	-7.6	-12.6	-10.4	2.8	11.4	8.4	3.4	5.8	4.7	4.7	4.0	**93**
Georgia	-20.6	-44.8	-25.4	-11.4	2.4	10.5	10.8	2.9	3.0	1.9	4.7	5.6	8.0	**38**
Kazakhstan	-11.0	-5.3	-9.3	-12.6	-8.2	0.5	1.7	-1.9	2.7	9.8	13.5	9.5	9.0	**86**
Kyrgyz Republic	-5.0	-19.0	-15.5	-20.1	-5.4	7.1	9.9	2.1	3.7	5.4	5.3	-0.5	5.2	**70**
Moldova	-17.5	-29.1	-1.2	-30.9	-1.4	-5.9	1.6	-6.5	-3.4	2.1	6.1	7.2	5.5	**39**
Russia	-5.0	-14.8	-8.7	-12.7	-4.0	-3.6	1.4	-5.3	6.4	10.0	5.0	4.3	6.2	**71**
Tajikistan	-7.1	-29.0	-11.0	-18.9	-12.5	-4.4	1.7	5.3	3.7	8.3	10.3	9.1	8.0	**57**
Turkmenistan	-4.7	-5.3	-10.0	-17.3	-7.2	-6.7	-11.3	7.0	16.5	17.6	11.8	5.1	9.7	**91**
Ukraine	-10.6	-9.7	-14.2	-22.9	-12.2	-10.0	-3.0	-1.9	-0.2	5.9	9.2	4.8	5.5	**47**
Uzbekistan	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	2.5	4.3	4.3	3.8	4.2	4.2	0.5	**106**
Commonwealth of Independent States	*-5.6*	*-14.2*	*-9.1*	*-13.4*	*-4.8*	*-3.6*	*1.4*	*-3.9*	*5.2*	*9.1*	*6.0*	*4.8*	*6.2*	***69***
Central and eastern Europe and the CIS[1]	**-7.9**	**-9.2**	**-4.9**	**-5.6**	**-0.1**	**0.2**	**2.5**	**-1.0**	**3.4**	**6.0**	**4.3**	**3.8**	**4.7**	80

Note: Data for 1991-2001 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2002 are preliminary actuals, mostly official government estimates. Data for 2003 represent EBRD projections.

[1] Estimates for real GDP represent weighted averages. The weights used for the growth rates were EBRD estimates of nominal dollar-GDP lagged by one year; those used for the index in the last column were EBRD estimates of GDP converted at PPP US$ exchange rates in 1989.

Table A.3.2

GDP growth by components in selected countries

(real change, in per cent)

	1999	2000	2001	2002
Bulgaria				
Real GDP growth	2.3	5.4	4.0	4.8
Private consumption	9.3	4.9	4.5	3.9
Public consumption	4.1	13.3	4.7	6.2
Gross fixed capital formation	20.8	15.4	19.9	9.3
Exports of goods and services	-5.0	16.6	8.5	6.2
Imports of goods and services	9.3	18.6	13.0	4.7
Croatia				
Real GDP growth	-0.9	2.9	3.8	5.2
Private consumption	-2.9	4.2	4.6	6.6
Public consumption	-1.0	-8.9	-4.3	-1.8
Gross fixed capital formation	-3.9	-3.8	9.7	10.1
Exports of goods and services	0.7	12.0	8.7	1.2
Imports of goods and services	-3.5	3.7	9.3	8.8
Czech Republic				
Real GDP growth	0.5	3.3	3.1	2.0
Private consumption	1.9	2.3	3.8	3.9
Public consumption	2.3	-1.0	5.3	5.7
Gross fixed capital formation	-1.0	5.3	5.5	0.6
Exports of goods and services	6.1	17.0	11.9	2.8
Imports of goods and services	5.4	17.0	13.6	4.3
Estonia				
Real GDP growth	-0.6	7.3	6.5	6.0
Private consumption	-2.9	6.5	4.8	9.3
Public consumption	3.8	1.5	0.9	5.0
Gross fixed capital formation	-14.8	13.3	12.2	16.1
Exports of goods and services	0.5	28.6	-0.2	6.0
Imports of goods and services	-5.4	27.9	2.1	10.2
Hungary				
Real GDP growth	4.2	5.2	3.7	3.3
Private consumption	4.6	4.1	5.0	8.8
Public consumption	1.8	1.2	4.4	1.5
Gross fixed capital formation	5.9	7.7	3.5	5.8
Exports of goods and services	13.1	21.8	9.1	3.8
Imports of goods and services	12.3	21.1	6.3	6.1
Latvia				
Real GDP growth	2.8	6.8	7.9	6.1
Private consumption	3.7	7.4	7.8	7.2
Public consumption	0.0	-1.9	0.3	1.4
Gross fixed capital formation	-4.0	20.0	17.0	10.4
Exports of goods and services	-6.4	12.0	6.9	6.3
Imports of goods and services	-5.2	4.9	12.6	4.5

	1999	2000	2001	2002
Lithuania				
Real GDP growth	-1.8	4.0	6.5	6.7
Private consumption	3.3	6.6	3.9	4.2
Public consumption	-8.1	3.9	0.3	4.3
Gross fixed capital formation	-6.1	-9.0	13.5	12.4
Exports of goods and services	-16.8	9.8	21.2	19.4
Imports of goods and services	-12.4	4.7	17.7	16.1
Poland				
Real GDP growth	4.1	4.0	1.0	1.4
Private consumption	5.2	2.7	2.0	3.3
Public consumption	1.0	1.1	2.0	4.0
Gross fixed capital formation	6.8	2.7	-9.8	-6.8
Exports of goods and services	1.0	17.5	8.0	5.0
Imports of goods and services	6.0	12.0	7.0	3.0
Romania				
Real GDP growth	-1.2	1.8	5.3	4.9
Private consumption	-1.1	0.1	6.4	3.0
Public consumption	-19.1	15.8	-1.9	1.0
Gross fixed capital formation	-4.8	4.6	6.6	8.5
Exports of goods and services	9.7	23.9	10.6	16.0
Imports of goods and services	-5.1	29.1	17.5	12.0
Russia				
Real GDP growth	6.4	10.0	5.0	4.3
Private consumption	-2.9	7.2	9.7	8.5
Public consumption	3.1	2.0	-1.7	2.4
Gross fixed capital formation	6.4	18.1	10.5	3.0
Exports of goods and services	11.2	9.5	3.6	10.2
Imports of goods and services	-17.0	32.4	18.0	19.1
Slovak Republic				
Real GDP growth	1.3	2.2	3.3	4.4
Private consumption	3.3	-3.4	4.0	5.4
Public consumption	-7.7	-0.9	5.2	4.0
Gross fixed capital formation	-18.5	-0.7	11.6	-0.9
Exports of goods and services	5.2	15.9	6.5	5.9
Imports of goods and services	-6.3	10.2	11.7	5.3
Slovenia				
Real GDP growth	5.2	4.6	3.0	3.2
Private consumption	6.1	0.8	2.6	1.9
Public consumption	4.6	3.1	4.0	2.7
Gross fixed capital formation	19.1	0.2	-0.8	3.1
Exports of goods and services	1.7	12.7	6.4	6.1
Imports of goods and services	8.2	6.1	3.0	4.8

Source: EBRD.

Note: Data for 1999-2001 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2002 are preliminary actuals, mostly official government estimates.

Table A.3.3

Inflation in central and eastern Europe and the CIS

(change in annual average retail/consumer price level, in per cent)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Central eastern Europe and the Baltic states													
Croatia	123.0	665.5	1,517.5	97.6	2.0	3.5	3.6	5.7	4.2	6.2	4.9	2.4	2.4
Czech Republic	52.0	11.1	20.8	9.9	9.1	8.8	8.5	10.7	2.1	3.9	4.7	1.8	0.2
Estonia	210.5	1,076.0	89.8	47.7	29.0	23.1	11.2	8.1	3.3	4.0	5.8	3.6	1.4
Hungary	35.0	23.0	22.5	18.8	28.2	23.6	18.3	14.3	10.0	9.8	9.2	4.8	4.7
Latvia	172.2	951.2	109.2	35.9	25.0	17.6	8.4	4.7	2.4	2.6	2.5	1.9	3.3
Lithuania	224.7	1,020.5	410.4	72.1	39.6	24.6	8.9	5.1	0.8	1.0	1.3	0.3	-0.8
Poland	70.3	43.0	35.3	32.2	27.8	19.9	14.9	11.8	7.3	10.1	5.5	1.7	0.5
Slovak Republic	61.2	10.0	23.2	13.4	9.9	5.8	6.1	6.7	10.6	12.0	7.1	3.3	8.5
Slovenia	117.7	207.3	32.9	21.0	13.5	9.9	8.4	7.9	6.1	8.9	8.4	7.5	6.1
Median [1]	*117.7*	*207.3*	*35.3*	*32.2*	*25.0*	*17.6*	*8.5*	*7.9*	*4.2*	*6.2*	*5.5*	*2.4*	*2.4*
Mean [1]	*118.5*	*445.3*	*251.3*	*38.7*	*20.5*	*15.2*	*9.8*	*8.3*	*5.2*	*6.5*	*5.5*	*3.0*	*2.9*
South-eastern Europe													
Albania	35.5	226.0	85.0	22.6	7.8	12.7	33.2	20.6	0.4	0.1	3.1	5.4	3.5
Bulgaria	333.5	82.0	73.0	96.3	62.0	123.0	1,082.0	22.2	0.7	9.9	7.4	5.9	2.0
FYR Macedonia	114.9	1,664.4	338.4	126.5	16.4	2.5	0.8	2.3	-1.3	6.5	5.3	2.4	1.5
Romania	170.2	210.4	256.1	136.7	32.3	38.8	154.8	59.1	45.8	45.7	34.5	22.5	14.5
Serbia and Montenegro	121.0	9,237.0	16.5x10^{12}	3.3	78.6	94.3	21.3	29.5	37.1	60.4	91.3	21.4	12.0
Median [1]	*121.0*	*226.0*	*170.6* [2]	*96.3*	*32.3*	*38.8*	*33.2*	*22.2*	*0.7*	*9.9*	*7.4*	*5.9*	*3.5*
Mean [1]	*155.0*	*2,284.0*	*188.1* [2]	*77.1*	*39.4*	*54.3*	*258.4*	*26.8*	*16.5*	*24.5*	*28.3*	*11.5*	*6.7*
Commonwealth of Independent States													
Armenia	274.0	1,346.0	1,822.0	4,962.0	175.8	18.7	14.0	8.7	0.7	-0.8	3.2	1.2	6.1
Azerbaijan	107.0	912.0	1,129.0	1,664.0	412.0	19.7	3.5	-0.8	-8.5	1.8	1.5	2.8	2.1
Belarus	94.1	970.8	1,190.2	2,221.0	709.3	52.7	63.8	73.2	293.8	168.9	61.4	42.6	29.0
Georgia	79.0	887.4	3,125.4	15,606.5	162.7	39.4	7.1	3.6	19.2	4.1	4.6	5.6	5.0
Kazakhstan	78.8	1,381.0	1,662.3	1,892.0	176.3	39.1	17.4	7.1	8.3	13.2	8.4	5.8	6.1
Kyrgyz Republic	85.0	855.0	772.4	180.7	43.5	31.9	23.4	10.5	35.9	18.7	6.9	2.1	2.4
Moldova	98.0	1,276.4	1,184.0	487.0	30.2	23.5	11.8	7.7	39.3	31.1	9.6	5.2	10.0
Russia	92.7	1,526.0	875.0	311.4	197.7	47.8	14.7	27.6	86.1	20.8	21.6	15.7	13.9
Tajikistan	112.0	1,157.0	2,195.0	350.0	609.0	418.0	88.0	43.2	27.6	32.9	38.6	12.2	16.0
Turkmenistan	103.0	493.0	3,102.0	1,748.0	1,005.3	992.4	83.7	16.8	24.2	8.3	11.6	10.6	9.6
Ukraine	91.0	1,210.0	4,734.0	891.0	377.0	80.0	15.9	10.6	22.7	28.2	12.0	0.8	5.1
Uzbekistan	109.7	645.2	534.2	1,568.3	304.6	54.0	70.9	29.0	29.1	25.0	27.2	27.6	12.4
Median [1]	*96.1*	*1,063.9*	*1,426.3*	*1,616.2*	*251.2*	*43.6*	*16.6*	*10.5*	*25.9*	*19.8*	*10.6*	*5.7*	*7.9*
Mean [1]	*110.4*	*1,055.0*	*1,860.5*	*2,656.8*	*350.3*	*151.4*	*34.5*	*19.8*	*48.2*	*29.4*	*17.2*	*11.0*	*9.8*
Central and eastern Europe and the CIS													
Median [1]	*105.0*	*899.7*	*534.2*	*131.6*	*41.6*	*24.1*	*14.8*	*10.5*	*9.2*	*9.9*	*7.2*	*5.0*	*5.1*
Mean [1]	*121.8*	*1,080.3*	*1,013.6*	*1,254.5*	*176.3*	*85.6*	*69.0*	*17.2*	*27.2*	*20.5*	*15.3*	*8.3*	*6.8*

Note: Data for 1991-2001 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2002 are preliminary actuals, mostly official government estimates. Data for 2003 represent EBRD projections.

The figure for Albania for 1997 is based on the limited country data available. Estimates of inflation from parts of Bosnia and Herzegovina (for the Federation and Republika Srpska separately) are provided in the selected economic indicators at the back of this Report.

1 The median is the middle value after all inflation rates have been arranged in order of size. The mean (unweighted average) tends to exceed the median, due to outliers caused by very high inflation rates in certain countries.

2 The value for Serbia and Montenegro in 1993 is not included in the mean and median totals.

Table A.3.4

General government balances in central and eastern Europe and the CIS

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Change	Change
												Estimate	*Projection*	2001-02	2002-03
						(in per cent of GDP)								*(in percentage points)*	
Croatia	na	-3.9	-0.8	1.2	-1.4	-1.0	-1.9	-1.0	-8.2	-6.5	-6.8	-4.8	-4.6	2.0	0.2
Czech Republic	-1.9	-3.1	2.6	-1.2	-1.1	-1.7	-2.7	-2.4	-2.8	-4.4	-5.1	-6.7	-8.3	-1.6	-1.6
Estonia	na	na	na	1.3	-1.3	-1.5	2.2	-0.3	-4.3	-0.7	0.7	1.2	-0.5	0.5	-1.7
Hungary	-2.9	-6.1	-6.0	-7.5	-6.7	-5.0	-4.8	-4.8	-3.4	-3.4	-4.7	-9.2	-5.5	-4.5	3.7
Latvia	na	na	na	-4.4	-4.0	-1.8	0.3	-0.8	-3.9	-3.2	-2.0	-2.7	-2.0	-0.7	0.7
Lithuania	na	na	-5.3	-4.8	-4.4	-4.5	-1.8	-5.8	-8.5	-2.8	-2.0	-1.2	-1.5	0.8	-0.3
Poland	-2.1	-4.9	-2.4	-2.2	-3.1	-3.3	-3.1	-3.2	-3.3	-3.5	-5.5	-6.7	-6.9	-1.2	-0.2
Slovak Republic	na	-11.9	-6.0	-1.5	0.4	-1.3	-5.2	-5.0	-6.3	-10.4	-7.3	-7.2	-5.0	0.1	2.2
Slovenia	2.6	0.3	0.6	-0.2	-0.3	-0.2	-1.7	-1.4	-0.9	-1.3	-1.1	-3.2	-1.5	-2.1	1.7
Central eastern Europe and the Baltic states[1]	*-1.1*	*-4.9*	*-2.5*	*-2.1*	*-2.4*	*-2.3*	*-2.1*	*-2.7*	*-4.6*	*-4.0*	*-3.8*	*-4.5*	*-4.0*	*-0.8*	*0.5*
Albania	-20.7	-23.1	-15.5	-12.6	-10.1	-12.1	-12.9	-9.7	-9.1	-7.9	-7.6	-6.3	-5.8	1.3	0.6
Bosnia and Herzegovina	na	na	na	na	-0.3	-4.4	-0.5	-5.2	-5.8	-5.9	-4.9	-4.5	-2.4	0.4	2.1
Bulgaria	-4.5	-2.9	-10.9	-5.7	-5.6	-10.3	-2.4	1.0	-0.9	-1.0	-0.9	-0.6	-0.7	0.2	0.0
FYR Macedonia	-4.5	-9.8	-13.4	-2.7	-1.0	-1.4	-0.4	-1.7	0.0	1.8	-7.2	-5.8	-1.5	1.4	4.3
Romania	na	-4.6	-0.4	-2.2	-2.5	-3.9	-4.6	-5.0	-3.5	-3.7	-3.5	-2.7	-2.7	0.8	0.1
Serbia and Montenegro	na	na	na	na	na	na	na	na	na	-0.9	-1.3	-4.5	-4.6	-3.3	-0.1
South-eastern Europe[1]	*-9.9*	*-10.1*	*-10.1*	*-5.8*	*-3.9*	*-6.4*	*-4.2*	*-4.1*	*-3.8*	*-2.9*	*-4.2*	*-4.1*	*-2.9*	*0.1*	*1.2*
Armenia	-1.9	-13.9	-54.7	-16.5	-9.0	-8.5	-5.8	-4.9	-7.4	-6.3	-3.8	-0.6	-2.5	3.2	-1.9
Azerbaijan	na	2.7	-15.3	-11.2	-3.1	-2.4	-4.0	-3.9	-4.7	-0.6	0.9	-0.5	-2.0	-1.4	-1.5
Belarus	na	-2.0	-5.5	-3.5	-2.7	-1.6	-0.7	-1.0	-2.0	-0.2	-1.9	-1.8	-1.5	0.1	0.3
Georgia	-3.0	-25.4	-26.2	-7.4	-5.3	-7.3	-6.7	-5.4	-6.7	-4.0	-2.0	-2.0	-1.7	0.0	0.2
Kazakhstan	-7.9	-7.3	-4.1	-7.4	-3.4	-5.3	-7.0	-8.0	-5.2	-1.0	-0.9	-0.3	-0.5	0.6	-0.2
Kyrgyz Republic	na	na	-14.4	-11.6	-17.3	-9.5	-9.2	-9.5	-12.7	-9.9	-5.5	-5.3	-4.8	0.3	0.5
Moldova	0.0	-26.6	-7.5	-10.6	-5.8	-7.0	-9.3	-5.7	-5.4	-2.6	-0.5	0.0	-0.8	0.5	-0.8
Russia	na	-18.9	-7.3	-10.4	-6.6	-9.4	-8.5	-8.2	-3.1	2.7	2.9	1.4	2.0	-1.5	0.6
Tajikistan	-20.2	-31.2	-22.3	-10.1	-6.1	-5.8	-3.3	-2.7	-2.3	-1.6	-1.1	-0.1	-0.9	1.0	-0.8
Turkmenistan	3.0	-9.4	-4.1	1.7	0.4	0.3	-0.2	-2.6	0.0	0.3	1.0	-2.7	-1.5	-3.7	1.2
Ukraine	na	-25.4	-16.2	-8.7	-6.1	-3.2	-5.4	-2.8	-2.4	-1.3	-1.6	0.5	-1.0	2.1	-1.5
Uzbekistan	-3.6	-18.5	-18.3	-4.4	-4.1	-7.3	-2.2	-3.3	-2.6	-2.2	-1.5	-1.7	-2.5	-0.3	-0.8
Commonwealth of Independent States[1]	*-4.8*	*-16.0*	*-16.3*	*-8.3*	*-5.7*	*-5.6*	*-5.2*	*-4.8*	*-4.5*	*-2.2*	*-1.2*	*-1.1*	*-1.5*	*0.1*	*-0.4*

Note: Data for 1991-2001 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2002 are preliminary actuals, mostly official government estimates. Data for 2003 represent EBRD projections.

[1] Unweighted average for the region.

Table A.3.5

General government revenue

(in per cent of GDP)

	1996	1997	1998	1999	2000	2001	2002
Croatia	44.3	42.5	45.6	48.4	46.2	44.7	45.2
Czech Republic	40.5	39.0	38.6	39.1	39.3	39.1	39.8
Estonia	39.0	39.8	40.2	38.9	37.8	37.7	39.6
Hungary	49.6	47.7	44.2	44.0	43.7	45.5	43.0
Latvia	37.6	41.3	42.6	40.1	37.3	35.3	36.1
Lithuania	29.6	32.5	32.2	32.1	30.7	30.1	28.1
Poland	43.1	42.7	39.5	39.5	38.2	38.1	37.4
Slovak Republic	45.6	41.1	38.3	39.7	41.8	43.5	43.3
Slovenia	42.7	42.1	43.0	43.6	40.9	41.5	39.4
Central eastern Europe and the Baltic states [1]	*41.3*	*41.0*	*40.5*	*40.6*	*39.6*	*39.5*	*39.1*
Albania	18.3	17.3	23.4	24.7	22.9	22.8	22.7
Bosnia and Herzegovina	0.5	39.2	56.7	61.3	56.1	51.8	51.8
Bulgaria	31.7	30.7	38.0	38.7	38.7	37.7	36.5
FYR Macedonia	35.7	34.8	33.3	35.4	36.6	34.4	35.9
Romania	28.9	27.1	27.9	30.7	31.2	30.1	29.9
Serbia and Montenegro	na	na	na	na	36.7	38.9	42.8
South-eastern Europe [1]	*23.0*	*29.8*	*35.9*	*38.2*	*37.0*	*36.0*	*36.6*
Armenia	17.6	19.7	20.7	22.7	19.5	17.1	18.9
Azerbaijan	14.4	15.2	19.6	17.9	21.2	21.5	28.0
Belarus	40.8	45.5	44.4	45.3	45.7	44.9	44.0
Georgia	13.8	14.3	13.7	15.4	15.2	16.3	15.8
Kazakhstan	13.2	13.5	18.0	18.0	22.2	22.5	21.9
Kyrgyz Republic	23.9	23.9	24.4	21.3	18.5	20.4	22.8
Moldova	31.7	33.9	33.1	27.1	27.6	26.9	28.6
Russia	35.9	39.3	34.3	33.6	37.1	37.1	38.4
Tajikistan	12.1	12.1	11.2	12.5	13.6	15.2	16.7
Turkmenistan	16.6	24.9	22.0	22.7	29.2	25.2	21.8
Ukraine	36.7	38.8	35.6	31.9	33.4	33.5	36.4
Uzbekistan	34.3	30.1	31.1	29.3	28.0	25.9	25.7
Commonwealth of Independent States [1]	*24.2*	*25.9*	*25.7*	*24.8*	*25.9*	*25.5*	*26.6*
Memorandum:							
Germany	46.9	46.6	46.6	47.3	47.0	45.5	45.0
Greece	40.3	42.4	44.1	44.7	47.0	45.6	45.1
Japan	31.6	31.6	31.0	30.9	31.1	31.9	31.4
Portugal	41.0	41.2	41.0	42.4	42.3	42.1	43.5
United States	33.7	33.9	34.3	34.4	35.1	34.4	32.2

Sources: EBRD for transition economies and *OECD Economic Outlook* for OECD countries.

Note: Data for 1996-2001 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2002 are preliminary actuals, mostly official government estimates.

[1] Unweighted average for the region.

Table A.3.6

General government expenditure

(in per cent of GDP)

	1996	1997	1998	1999	2000	2001	2002
Croatia	45.3	44.4	46.7	56.6	52.7	51.5	50.0
Czech Republic	42.2	41.7	40.9	41.9	43.7	44.2	46.6
Estonia	40.5	37.6	40.5	43.2	38.5	37.0	38.4
Hungary	48.8	49.5	50.4	44.8	47.1	51.9	53.5
Latvia	39.5	41.0	43.3	44.1	42.0	37.2	38.8
Lithuania	34.2	33.5	37.6	40.3	33.6	31.7	31.4
Poland	46.4	45.8	42.7	42.8	41.7	43.6	44.1
Slovak Republic	47.0	45.5	42.9	43.3	45.4	47.7	48.4
Slovenia	42.9	43.8	44.4	44.5	42.2	42.6	42.6
Central eastern Europe and the Baltic states[1]	*43.0*	*42.5*	*43.3*	*44.6*	*43.0*	*43.1*	*43.8*
Albania	30.3	30.2	33.2	33.9	30.7	30.4	29.0
Bosnia and Herzegovina	52.7	39.7	61.8	67.1	62.0	56.7	56.3
Bulgaria	42.0	33.1	37.0	39.6	39.7	38.6	37.2
FYR Macedonia	37.1	35.1	35.0	35.4	34.9	41.6	41.7
Romania	33.8	34.0	34.7	35.2	34.8	33.4	32.7
Serbia and Montenegro	na	na	na	na	37.6	40.2	47.3
South-eastern Europe[1]	*39.2*	*34.4*	*40.3*	*42.2*	*40.0*	*40.1*	*40.7*
Armenia	26.1	25.5	25.6	30.1	25.9	20.8	19.5
Azerbaijan	16.7	19.2	23.7	23.6	20.8	20.3	28.3
Belarus	42.4	46.2	45.4	47.3	45.9	46.8	42.0
Georgia	21.1	21.0	19.1	22.1	19.4	18.2	17.8
Kazakhstan	18.6	20.4	26.1	23.2	23.2	23.4	22.3
Kyrgyz Republic	33.4	33.1	33.9	34.0	28.5	25.9	28.0
Moldova	38.7	43.2	38.7	32.5	30.2	27.4	31.5
Russia	45.3	47.8	42.6	36.7	34.3	34.1	37.0
Tajikistan	17.9	15.5	13.9	14.9	15.2	16.3	16.8
Turkmenistan	16.3	25.0	24.6	22.6	28.8	24.2	24.5
Ukraine	39.9	44.2	38.4	34.2	34.7	35.1	35.9
Uzbekistan	41.6	32.3	34.3	32.0	30.2	27.4	27.4
Commonwealth of Independent States[1]	*29.8*	*31.1*	*30.5*	*29.4*	*28.1*	*26.7*	*27.6*
Memorandum:							
Germany	50.3	49.3	48.8	48.8	45.9	48.3	48.6
Greece	47.7	46.4	46.6	46.5	48.9	47.0	46.3
Japan	36.6	35.4	36.5	38.1	38.6	38.0	38.6
Portugal	45.8	44.8	44.1	45.3	45.2	46.3	46.1
United States	35.9	34.8	34.0	33.7	33.6	34.9	35.6

Sources: EBRD for transition economies and *OECD Economic Outlook* for OECD countries.

Note: Data for 1996-2001 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2002 are preliminary actuals, mostly official government estimates. General government expenditure includes net lending.

[1] Unweighted average for the region.

Table A.3.7

Current account balance in central and eastern Europe and the CIS

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Change 2001-02	Change 2002-03
						(in per cent of GDP)								(in percentage points)	
Croatia	-3.4	3.2	5.7	5.9	-7.7	-5.5	-11.6	-6.7	-7.0	-2.5	-3.7	-7.2	-6.0	-3.5	1.2
Czech Republic	na	na	1.3	-1.9	-2.6	-7.1	-6.7	-2.2	-2.7	-5.3	-5.7	-6.5	-4.3	-0.8	2.2
Estonia	na	3.3	1.3	-7.2	-4.4	-9.2	-12.1	-9.2	-4.7	-5.7	-6.1	-12.3	-12.8	-6.2	-0.5
Hungary	0.8	0.9	-9.0	-9.4	-5.6	-3.7	-2.1	-4.9	-4.3	-2.8	-2.2	-4.0	-7.1	-1.8	-3.2
Latvia	na	na	19.1	5.5	-0.4	-5.5	-6.1	-10.7	-9.8	-6.9	-9.5	-7.8	-8.4	1.7	-0.6
Lithuania	na	na	-3.2	-2.2	-9.9	-9.2	-10.2	-11.9	-11.2	-6.0	-4.8	-5.3	-5.5	-0.5	-0.2
Poland	-2.6	1.1	-0.7	0.7	4.5	-1.0	-3.2	-4.3	-7.5	-6.1	-3.9	-3.6	-2.9	0.3	0.7
Slovak Republic	na	na	-4.7	4.6	2.1	-10.6	-9.6	-9.7	-5.5	-3.7	-8.8	-8.2	-6.3	0.6	1.9
Slovenia	1.0	6.1	1.5	4.0	-0.4	0.3	0.3	-0.6	-3.5	-2.9	0.2	1.7	0.9	1.5	-0.8
Central eastern Europe and the Baltic states [1]	*-1.0*	*2.9*	*1.3*	*0.0*	*-2.7*	*-5.7*	*-6.8*	*-6.7*	*-6.2*	*-4.7*	*-5.0*	*-5.9*	*-5.8*	*-1.0*	*0.1*
Albania	na	na	-30.1	-14.4	-7.2	-9.1	-12.4	-6.6	-7.5	-7.1	-6.2	-9.1	-8.0	-2.9	1.1
Bosnia and Herzegovina	na	na	na	na	-10.3	-27.3	-31.0	-27.0	0.1	-12.7	-15.8	-20.0	-15.0	-4.3	5.0
Bulgaria	-1.0	-4.2	-10.1	-0.3	-0.2	0.2	4.1	-0.5	-5.3	-5.6	-6.5	-4.4	-4.9	2.1	-0.6
FYR Macedonia	-5.5	-0.8	0.6	-5.3	-5.0	-6.5	-7.8	-7.5	-0.9	-2.1	-6.8	-8.6	-7.4	-1.8	1.1
Romania	-3.5	-8.0	-4.5	-1.4	-5.0	-7.3	-6.1	-6.9	-3.6	-3.6	-5.8	-3.5	-4.7	2.4	-1.2
Serbia and Montenegro	na	na	na	na	na	-11.6	-7.7	-4.8	-7.5	-7.0	-9.7	-12.9	-11.7	-3.2	1.2
South-eastern Europe [1]	*-3.4*	*-4.3*	*-11.0*	*-5.4*	*-5.5*	*-10.3*	*-10.1*	*-8.9*	*-4.1*	*-6.4*	*-8.5*	*-9.7*	*-8.6*	*-1.3*	*1.1*
Armenia	na	na	-14.3	-16.0	-17.0	-18.2	-18.0	-21.3	-16.6	-14.6	-9.5	-7.4	-6.5	2.0	1.0
Azerbaijan	na	na	-10.2	-10.3	-13.2	-25.8	-23.1	-30.7	-13.1	-3.5	-0.9	-12.6	-30.4	-11.8	-17.8
Belarus	na	na	-11.9	-9.1	-4.4	-3.7	-6.1	-6.7	-1.6	-2.5	-2.3	-2.5	-2.6	-0.2	-0.1
Georgia	na	na	-40.2	-22.3	-7.5	-9.1	-10.6	-8.9	-7.8	-5.8	-5.6	-6.0	-11.1	-0.4	-5.1
Kazakhstan	na	na	-7.9	-7.8	-1.3	-3.6	-3.6	-5.6	-1.0	3.7	-4.9	-2.4	-2.1	2.5	0.3
Kyrgyz Republic	na	na	-10.0	-7.6	-15.7	-23.3	-7.8	-22.1	-14.7	-6.6	-3.3	-2.6	-3.3	0.7	-0.7
Moldova	na	na	-14.5	-8.4	-6.8	-9.8	-12.5	-17.3	-3.6	-8.4	-5.0	-6.0	-5.9	-0.9	0.0
Russia	na	na	na	2.8	2.2	2.8	0.0	0.1	12.6	18.0	11.3	9.0	9.9	-2.3	0.9
Tajikistan	na	na	-28.8	-20.1	-14.8	-7.1	-5.4	-9.1	-3.4	-6.4	-7.0	-2.8	-4.9	4.2	-2.1
Turkmenistan	na	na	na	4.0	0.9	0.1	-25.3	-37.4	-28.9	15.2	-2.4	4.5	9.2	6.9	4.7
Ukraine	na	na	na	-4.9	-3.1	-2.7	-2.7	-3.1	5.2	4.7	3.7	7.7	5.5	4.0	-2.2
Uzbekistan	na	na	-8.4	2.1	-0.2	-7.8	-5.4	-0.9	-2.0	3.2	-1.8	2.8	4.7	4.6	1.9
Commonwealth of Independent States [1]	*na*	*na*	*-16.2*	*-8.1*	*-6.7*	*-9.0*	*-10.1*	*-13.6*	*-6.2*	*-0.2*	*-2.3*	*-1.5*	*-3.1*	*0.8*	*-1.6*
Central and eastern Europe and the CIS[1]	**na**	**na**	**-8.1**	**-4.8**	**-5.1**	**-8.2**	**-9.0**	**-10.2**	**-5.8**	**-3.1**	**-4.6**	**-4.8**	**-5.3**	**-0.3**	**-0.4**

Note: Data for 1991-2001 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2002 are preliminary actuals, mostly official government estimates. Data for 2003 represent EBRD projections.

[1] Unweighted average for the region.

Table A.3.8

Indicators of competitiveness in selected countries

(change as a percentage, unless indicated)

	1998	1999	2000	2001	2002	1998-2002
Bulgaria						
Manufacturing gross output	-8.2	-5.7	-0.7	-2.8	-4.2	-20.0
Productivity in manufacturing	-2.2	-6.2	14.6	11.7	na	na
Real wage in industry (PPI-based)	14.1	8.8	-5.2	2.5	-1.3	19.0
Real euro exchange rate index (1995=100)	136.9	137.4	147.8	155.2	160.6	-
Euro unit labour costs index in industry (1995=100)	132.4	159.5	154.4	147.1	na	-
Wage share in GDP	0.39	0.47	0.38	0.32	na	-
Croatia						
Manufacturing gross output	3.2	-2.9	2.9	6.4	5.2	15.5
Productivity in manufacturing	7.3	0.7	6.0	8.3	9.0	35.2
Real wage in manufacturing (PPI-based)	11.4	2.8	-1.6	5.0	na	na
Real euro exchange rate index (1995=100)	103.8	100.5	103.9	108.8	109.7	-
Euro unit labour costs index in manufacturing (1995=100)	98.3	96.4	95.8	98.5	90.3	-
Wage share in GDP	0.49	0.51	0.53	0.59	0.64	-
Czech Republic						
Manufacturing gross output	2.5	-2.7	4.8	7.8	6.0	19.4
Productivity in manufacturing	4.7	-0.2	7.0	5.4	5.4	24.1
Real wage in manufacturing (PPI-based)	5.6	6.3	0.7	8.2	6.5	30.2
Real euro exchange rate index (1995=100)	119.5	118.3	124.7	133.4	146.7	-
Euro unit labour costs index in manufacturing (1995=100)	115.8	121.0	124.7	137.3	153.9	-
Wage share in GDP	0.36	0.37	0.36	0.38	0.39	-
Estonia						
Manufacturing gross output	5.4	-2.3	16.7	10.5	10.0	46.0
Productivity in manufacturing	9.2	4.8	10.8	6.7	14.5	54.9
Real wage in manufacturing (PPI-based)	10.7	3.5	9.2	4.3	11.2	45.2
Real euro exchange rate index (1995=100)	141.1	144.2	146.8	151.8	153.8	-
Euro unit labour costs index in manufacturing (1995=100)	121.2	116.6	122.0	123.4	118.5	-
Wage share in GDP	0.49	0.48	0.47	0.46	0.43	-
Hungary						
Manufacturing gross output	22.6	2.1	20.6	4.3	3.6	63.1
Productivity in manufacturing	16.1	-9.1	20.3	1.6	3.8	34.0
Real earnings in manufacturing (PPI-based)	7.4	8.5	3.2	9.9	11.1	46.7
Real euro exchange rate index (1995=100)	107.5	111.6	116.6	126.1	136.5	-
Euro unit labour costs index in manufacturing (1995=100)	101.2	122.9	114.7	131.2	148.3	-
Wage share in GDP	0.27	0.27	0.25	0.26	na	-
Latvia						
Manufacturing gross output	4.0	-5.9	6.8	10.2	7.2	23.5
Productivity in manufacturing	3.8	1.2	6.9	13.3	6.2	35.1
Real wage in manufacturing (PPI-based)	4.8	7.7	2.1	3.6	3.9	24.1
Real euro exchange rate index (1995=100)	133.0	142.8	160.1	159.5	153.4	-
Euro unit labour costs index in manufacturing (1995=100)	114.1	121.9	130.6	121.0	115.5	-
Wage share in GDP	0.46	0.47	0.45	0.41	0.40	-
Lithuania [1]						
Manufacturing gross output	14.1	-5.4	9.8	13.1	5.5	41.4
Productivity in manufacturing	12.7	-1.8	15.7	15.2	1.9	50.5
Real wage in manufacturing (PPI-based)	28.6	-10.4	-14.9	5.9	6.6	10.6
Real euro exchange rate index (1995=100)	159.7	168.1	192.5	195.8	200.0	-
Euro unit labour costs index in manufacturing (1995=100)	180.6	178.4	203.8	185.6	193.2	-
Wage share in GDP	0.43	0.40	0.38	0.35	0.37	-

Table A.3.8 (continued)

Indicators of competitiveness in selected countries

(change as a percentage, unless indicated)

	1998	1999	2000	2001	2002	1998-2002
Poland						
Manufacturing gross output	5.1	5.3	7.3	0.0	4.0	23.5
Productivity in manufacturing	4.7	9.5	8.3	1.9	6.0	34.0
Real wage in manufacturing (PPI-based)	8.4	5.8	8.1	4.8	4.0	35.1
Real euro exchange rate index (1995=100)	119.0	116.9	133.1	150.0	142.1	-
Euro unit labour costs index in manufacturing (1995=100)	112.0	104.8	118.2	139.5	133.0	-
Wage share in GDP	0.33	0.33	0.33	0.37	0.36	-
Romania						
Manufacturing gross output	-18.1	-6.1	8.0	10.6	na	na
Productivity in manufacturing	-15.9	6.6	10.7	9.3	na	na
Real wage in manufacturing (PPI-based)	10.7	1.8	-23.1	-21.0	na	na
Real euro exchange rate index (1995=100)	143.6	125.9	146.9	148.3	148.4	-
Euro unit labour costs index in manufacturing (1995=100)	128.4	107.5	109.1	116.1	na	-
Wage share in GDP	0.33	0.33	0.26	0.26	0.20	-
Russia						
Industrial gross output	-5.2	8.1	9.0	4.9	3.5	21.3
Productivity in industry	0.8	7.3	7.2	5.0	6.6	29.9
Real wage in industry (PPI-based)	-5.9	-2.7	25.7	23.9	na	na
Real euro exchange rate index (1995=100)	110.2	86.4	103.3	121.7	121.8	-
Euro unit labour costs index in industry (1995=100)	111.2	67.1	94.2	135.2	126.9	-
Wage share (industry) in GDP	0.23	0.20	0.19	0.26	na	-
Slovak Republic						
Manufacturing gross output	6.5	-3.0	10.0	6.0	8.5	30.7
Productivity in manufacturing	11.5	2.0	7.8	3.9	8.3	38.0
Real wage in manufacturing (PPI-based)	6.1	-3.9	1.9	6.2	6.5	17.5
Real euro exchange rate index (1995=100)	118.3	115.1	130.7	134.5	137.7	-
Euro unit labour costs index in manufacturing (1995=100)	116.0	109.3	115.5	120.5	116.1	-
Wage share in GDP	0.29	0.29	0.33	0.36	na	-
Slovenia						
Manufacturing gross output	4.6	3.1	8.6	4.4	4.0	27.2
Productivity in manufacturing	6.1	4.9	8.9	3.3	5.5	32.1
Real wage in manufacturing (PPI-based)	5.0	6.3	3.3	0.7	4.4	21.3
Real euro exchange rate index (1995=100)	102.1	102.9	103.6	103.6	104.6	-
Euro unit labour costs index in manufacturing (1995=100)	93.5	93.4	90.6	91.7	91.7	-
Wage share in GDP	0.36	0.35	0.34	0.34	na	-

Sources: Production, employment and wages figures are taken from various publications from national authorities, the IMF, the OECD, the ILO and the Vienna Institute for International Economic Studies. Data on the euro exchange rate on CPI and PPI are based on national authorities, the IMF and EBRD estimates.

Note: Data for 1998-2001 represent the percentage change of annual averages based on actual data. Figures for 2002 represent preliminary official estimates.

Productivity is calculated as the ratio of manufacturing / industry production over manufacturing / industry employment.

Real wages in manufacturing (industry) are calculated as average monthly wages, deflated by PPI in manufacturing (industry).

The real euro exchange rate is calculated as the domestic CPI divided by the product of the euro area HICP index and the exchange rate. An increase in the index represents a real appreciation.

Euro unit labour costs are calculated as wages in euro divided by productivity.

The wage share is the ratio of wages and value added in manufacturing, unless specified.

[1] Output and PPI refers to mining, quarrying and manufacturing. Production data for 1999 refer to sales.

Table A.3.9

Foreign direct investment

(net inflows recorded in the balance of payments)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 Estimate	2003 Projection	Cumulative FDI inflows 1989-2002	Cumulative FDI inflows per capita 1989-2002	FDI inflows per capita 2001	FDI inflows per capita 2002	FDI inflows 2001	FDI inflows 2002
	(in US$ million)													*(in US$ mln)*	*(US$)*	*(US$)*		*(in per cent of GDP)*	
Croatia	na	13	102	110	109	486	347	835	1,420	1,085	1,407	383	673	6,296	1,419	316	86	7.2	1.7
Czech Republic	na	983	563	749	2,526	1,276	1,275	3,591	6,234	4,943	5,476	9,029	5,000	36,645	3,554	531	876	9.6	13.0
Estonia	na	80	156	212	199	111	130	574	222	324	342	153	200	2,503	1,846	252	113	6.1	2.3
Hungary	1,459	1,471	2,328	1,097	4,410	2,279	1,741	1,555	1,720	1,123	2,255	598	1,341	22,534	2,253	222	60	4.4	0.9
Latvia	na	na	50	279	245	379	515	303	331	400	151	388	350	3,040	1,304	65	166	2.0	4.6
Lithuania	na	na	30	31	72	152	328	921	478	375	439	714	550	3,540	1,024	126	207	3.7	5.2
Poland	117	284	580	542	1,134	2,741	3,041	4,966	6,348	8,171	6,928	3,700	4,000	38,552	1,007	179	97	3.8	2.0
Slovak Republic	82	100	107	236	194	199	84	374	701	2,058	1,460	4,007	1,500	9,636	1,791	271	745	7.3	16.9
Slovenia	-41	113	111	129	161	167	303	221	59	71	371	1,748	100	3,396	1,702	187	876	1.9	7.9
Central eastern Europe and the Baltic states	*1,617*	*3,044*	*4,027*	*3,386*	*9,048*	*7,789*	*7,763*	*13,339*	*17,513*	*18,550*	*18,829*	*20,720*	*13,714*	*119,846*	*1,767*	*239*	*358*	*5.1*	*6.1*
Albania	na	20	45	65	89	97	42	45	51	143	204	135	150	936	303	66	44	4.8	2.8
Bosnia and Herzegovina	na	na	na	0	0	0	0	67	177	150	130	230	320	753	198	34	61	2.7	4.4
Bulgaria	56	41	40	105	98	138	507	537	789	1,003	641	430	900	4,390	560	79	55	4.7	2.8
FYR Macedonia	0	0	0	24	12	12	18	118	32	176	442	101	100	935	467	221	50	12.9	2.7
Romania	37	73	87	341	417	415	1,267	2,079	1,025	1,051	1,154	1,080	1,350	9,008	415	52	50	2.9	2.4
Serbia and Montenegro	na	na	na	na	na	0	740	113	112	25	165	562	850	1,717	206	20	67	1.4	3.6
South-eastern Europe	*93*	*134*	*172*	*535*	*616*	*662*	*2,574*	*2,959*	*2,186*	*2,549*	*2,737*	*2,538*	*3,670*	*17,739*	*358*	*79*	*54*	*4.9*	*3.1*
Armenia	na	0	1	8	25	18	52	221	122	104	70	110	135	730	243	22	37	3.3	4.6
Azerbaijan	na	na	0	22	330	627	1,115	1,023	510	149	299	1,048	2,300	5,124	625	37	128	5.2	17.2
Belarus	na	na	18	11	15	105	350	201	443	119	96	434	250	1,789	181	10	44	0.8	3.0
Georgia	na	na	0	8	6	54	236	221	60	152	100	131	190	969	210	22	28	3.1	3.9
Kazakhstan	na	100	473	635	964	1,137	1,320	1,143	1,584	1,278	2,796	2,138	2,500	13,568	938	188	148	12.6	8.8
Kyrgyz Republic	na	na	10	38	96	47	83	87	38	-7	-1	16	25	407	85	0	3	-0.1	1.0
Moldova	na	17	14	18	73	23	78	76	154	128	160	108	97	849	199	37	25	10.0	6.6
Russia	na	na	na	409	1,460	1,657	1,679	1,496	1,103	-463	-64	-328	2,500	6,949	48	0	-2	0.0	-0.1
Tajikistan	na	9	9	12	10	18	18	25	21	24	9	36	18	191	30	1	6	0.9	3.0
Turkmenistan	na	na	79	103	233	108	108	62	125	126	170	100	100	1,214	210	30	17	5.6	2.7
Ukraine	na	na	na	151	257	516	581	747	489	594	769	698	850	4,802	99	16	14	2.0	1.7
Uzbekistan	na	9	48	73	-24	90	167	140	121	75	83	65	70	847	33	3	3	1.3	0.8
Commonwealth of Independent States	*na*	*135*	*652*	*1,488*	*3,445*	*4,400*	*5,787*	*5,442*	*4,771*	*2,278*	*4,486*	*4,556*	*9,035*	*37,439*	*242*	*31*	*38*	*3.7*	*4.4*
Total	**1,710**	**3,314**	**4,850**	**5,409**	**13,110**	**12,850**	**16,123**	**21,740**	**24,470**	**23,377**	**26,052**	**27,814**	**26,419**	**175,024**	**788**	**108**	**158**	**4.5**	**4.9**

Sources: IMF, central banks and EBRD estimates.

Note: For most countries, figures cover only investment in equity capital and in some cases contributions-in-kind. For those countries where net investment into equity capital was not easily available (for example Azerbaijan, Estonia, Kazakhstan and Slovak Republic), more recent data include reinvested earnings as well as inter-company debt transactions. Gross inflows of FDI are in some cases considerably higher than net inflows on account of increasing intra-regional investment flows.

Table A.3.10

GDP growth forecasts for 2003

(in per cent)

	Average[1]	Range[2]	EBRD (Sep 2003)	European Union (Apr 2003)	IMF (Sep 2003)	OECD (Apr 2003)	United Nations DESA[4] (Sep 2003)	CSFB[5] (Sep 2003)	Davidson Institute[6] (Sep 2003)	Dun & Bradstreet (Aug 2003)	Economist Intelligence Unit (Aug 2003)	Global Insight, Inc.[7] (Aug 2003)	IWH[8] (Sep 2003)	JP Morgan (Sep 2003)	Kopint-Datorg[9] (Oct 2003)	Vienna Institute[10] (Jul 2003)
Central eastern Europe and the Baltic states																
Croatia	4.3	1.3	4.2	-	4.6	-	4.0	-	4.3	4.2	4.3	3.7	-	-	5.0	4.0
Czech Republic	2.5	1.3	3.0	2.8	1.7	3.0	2.7	2.4	2.5	2.5	2.8	2.5	2.5	2.5	2.5	2.3
Estonia	5.0	1.0	4.5	4.9	5.0	-	5.5	-	4.5	5.2	5.2	5.2	5.0	-	5.2	-
Hungary	3.0	1.1	3.0	3.7	3.0	3.1	3.0	2.7	2.6	3.5	3.0	3.0	3.2	2.7	2.7	3.2
Latvia	6.0	1.3	6.5	5.5	5.5	-	6.8	-	6.2	6.5	5.5	6.2	5.5	-	6.0	-
Lithuania	6.3	3.0	6.0	4.5	5.8	-	7.5	-	7.0	6.2	6.5	6.8	6.0	-	6.5	-
Poland	2.9	1.3	3.0	2.5	2.9	2.3	2.8	3.4	3.6	2.7	3.1	2.8	2.8	3.0	3.4	2.5
Slovak Republic	3.8	0.7	3.8	3.7	4.0	3.6	4.0	4.0	4.0	3.7	4.1	3.4	3.8	3.6	4.0	4.0
Slovenia	2.8	1.2	2.3	3.4	2.2	-	3.0	-	2.5	3.0	2.9	2.7	3.2	-	3.1	2.5
Average	*4.1*	*1.4*	*4.0*	*3.9*	*3.8*	*3.0*	*4.4*	*3.1*	*4.1*	*4.2*	*4.2*	*4.0*	*4.0*	*3.0*	*4.3*	*3.1*
Weighted average[3]	*3.2*	*1.3*	*3.3*	-	*3.0*	-	*3.2*	-	*3.4*	*3.2*	*3.3*	*3.1*	-	-	*3.4*	-
South-eastern Europe																
Albania	5.9	0.8	6.0	-	6.0	-	6.0	-	-	6.0	6.0	5.2	-	-	-	-
Bosnia and Herzegovina	3.7	0.9	3.5	-	-	-	3.6	-	-	4.3	3.7	3.4	-	-	-	-
Bulgaria	4.6	0.7	4.5	4.5	5.0	-	4.3	4.8	4.4	4.3	4.5	4.4	5.0	4.3	5.0	4.5
FYR Macedonia	2.8	1.6	3.0	-	3.0	-	2.6	-	-	2.5	2.8	3.6	-	-	-	2.0
Romania	4.5	1.0	4.2	4.9	4.7	-	4.3	4.6	4.5	4.9	4.5	5.0	4.6	4.0	4.2	4.0
Serbia and Montenegro	2.9	2.0	2.0	-	4.0	-	2.5	-	-	3.5	2.5	3.6	-	-	2.9	2.0
Average	*4.1*	*1.2*	*3.9*	*4.7*	*4.5*	-	*3.9*	*4.7*	*4.4*	*4.3*	*4.0*	*4.2*	*4.8*	*4.2*	*4.0*	*3.1*
Weighted average[3]	*4.2*	*1.1*	*3.9*	-	-	-	*4.0*	-	-	*4.5*	-	*4.1*	-	-	-	-
Commonwealth of Independent States																
Armenia	9.7	5.0	9.0	-	7.0	-	12.0	-	-	-	11.0	9.3	-	-	-	-
Azerbaijan	9.3	2.5	9.4	-	9.2	-	10.0	-	-	7.5	10.0	9.9	-	-	-	-
Belarus	4.4	2.3	4.0	-	4.0	-	5.2	-	-	5.5	3.2	4.4	-	-	-	-
Georgia	6.6	4.1	8.0	-	4.7	-	8.5	-	-	6.0	8.0	4.4	-	-	-	-
Kazakhstan	9.0	2.2	9.0	-	9.0	-	10.4	-	-	8.3	9.1	8.2	-	-	-	-
Kyrgyz Republic	4.8	2.6	5.2	-	5.6	-	6.0	-	-	3.4	5.0	3.8	-	-	-	-
Moldova	5.6	1.0	5.5	-	6.0	-	6.0	-	-	-	5.0	5.5	-	-	-	-
Russia	5.8	1.4	6.2	-	6.0	5.0	5.9	6.4	6.1	5.7	6.0	5.4	5.5	6.2	6.2	5.0
Tajikistan	7.7	4.0	8.0	-	6.0	-	8.2	-	-	7.0	7.0	10.0	-	-	-	-
Turkmenistan	13.4	11.5	9.7	-	-	-	12.0	-	-	8.5	20.0	16.7	-	-	-	-
Ukraine	5.9	2.8	5.5	-	5.3	-	7.9	5.5	5.7	7.0	5.5	5.3	-	-	5.1	6.0
Uzbekistan	2.4	3.5	0.5	-	0.3	-	3.8	-	-	2.7	3.2	3.8	-	-	-	-
Average	*7.0*	*3.6*	*6.7*	-	*5.7*	*5.0*	*8.0*	*6.0*	*5.9*	*6.2*	*7.8*	*7.2*	*5.5*	*6.2*	*5.7*	*5.5*
Weighted average[3]	*6.0*	*1.8*	*6.2*	-	-	-	*6.4*	-	-	-	*6.2*	*5.7*	-	-	-	-
Central and eastern Europe and the CIS																
Average	*5.4*	*2.3*	*5.2*	*4.0*	*4.8*	*3.4*	*5.9*	*4.2*	*4.5*	*5.0*	*5.7*	*5.5*	*4.3*	*3.8*	*4.4*	*3.5*
Weighted average[3]	*4.6*	*1.5*	*4.7*	-	-	-	*4.8*	-	-	-	*4.8*	*4.4*	-	-	-	-

Note: All forecasts quoted here were published or reported to the EBRD between April and October 2003. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial delays between preparation and publication of forecasts.

1 The number at the bottom of this column is calculated as the mean of all the average forecasts shown in this column.

2 Data show the difference between the highest and the lowest of the forecasts.

3 Weighted average based on EBRD estimates of nominal US dollar GDP in each country in 2002.

4 United Nations, Department of Economic and Social Affairs (DESA).

5 Credit Suisse First Boston.

6 William Davidson Institute at the University of Michigan Business School.

7 Global Insight Inc, formerly DRI-WEFA.

8 Institute for Economic Research, Halle, Germany.

9 Kopint-Datorg is the Institute for Economic and Market Research Information, Hungary.

10 Vienna Institute for International Economic Studies (WIIW).

Table A.3.11

GDP growth forecasts for 2004

(in per cent)

	Average[1]	Range[2]	EBRD (Sep 2003)	European Union (Apr 2003)	IMF (Sep 2003)	OECD (Apr 2003)	United Nations DESA[4] (Sep 2003)	CSFB[5] (Sep 2003)	Davidson Institute[6] (Sep 2003)	Dun & Bradstreet (Aug 2003)	Economist Intelligence Unit (Aug 2003)	Global Insight, Inc.[7] (Aug 2003)	IWH[8] (Sep 2003)	JP Morgan (Sep 2003)	Kopint-Datorg[9] (Oct 2003)	Vienna Institute[10] (Jul 2003)
Central eastern Europe and the Baltic states																
Croatia	4.3	1.2	4.0	-	4.5	-	4.0	-	4.0	4.5	4.0	4.2	-	-	5.2	4.5
Czech Republic	3.4	1.4	4.0	3.9	2.6	3.5	3.8	3.3	3.0	3.1	4.0	3.5	3.5	3.0	3.1	2.7
Estonia	5.8	1.1	5.5	5.1	5.1	-	6.2	-	5.9	6.0	6.0	6.2	6.0	-	5.8	-
Hungary	3.6	2.5	5.0	4.1	3.5	3.7	3.6	2.5	2.9	3.6	3.4	3.9	4.0	3.4	3.3	3.5
Latvia	6.1	1.5	5.5	6.0	6.0	-	6.0	-	6.2	7.0	6.0	6.2	6.0	-	6.2	-
Lithuania	6.1	1.7	6.0	5.0	6.2	-	6.5	-	6.4	6.5	6.7	5.7	6.0	-	6.0	-
Poland	3.9	1.5	4.0	3.7	4.1	3.5	3.8	4.4	4.1	3.3	4.2	3.9	3.5	4.0	4.5	3.0
Slovak Republic	4.4	1.0	4.1	4.5	4.0	4.3	4.6	4.4	4.5	4.2	5.0	4.6	4.2	4.3	4.2	5.0
Slovenia	3.6	1.1	3.1	3.7	3.0	-	3.3	-	3.8	4.1	3.5	3.8	3.8	-	3.8	3.5
Average	*4.6*	*1.4*	*4.6*	*4.5*	*4.3*	*3.8*	*4.6*	*3.7*	*4.5*	*4.7*	*4.8*	*4.7*	*4.6*	*3.7*	*4.7*	*3.7*
Weighted average[3]	*3.9*	*1.6*	*4.2*	-	*3.8*	-	*4.0*	-	*3.9*	*3.7*	*4.2*	*4.0*	-	-	*4.2*	-
South-eastern Europe																
Albania	6.1	1.4	6.5	-	6.0	-	6.0	-	-	6.5	6.5	5.1	-	-	-	-
Bosnia and Herzegovina	3.7	1.6	3.0	-	-	-	4.0	-	-	4.5	3.9	2.9	-	-	-	-
Bulgaria	5.0	1.2	5.0	5.0	5.5	-	4.6	5.5	4.9	4.7	4.8	4.3	5.0	4.6	5.5	5.0
FYR Macedonia	3.5	1.4	3.0	-	4.0	-	3.6	-	-	3.0	3.8	4.4	-	-	-	3.0
Romania	4.9	2.1	5.0	5.0	5.0	-	4.6	4.9	5.0	5.0	5.0	6.1	4.8	5.0	4.5	4.0
Serbia and Montenegro	4.4	1.0	4.0	-	5.0	-	4.0	-	-	5.0	4.0	4.8	-	-	4.5	4.0
Average	*4.6*	*1.5*	*4.4*	*5.0*	*5.1*	-	*4.5*	*5.2*	*4.9*	*4.8*	*4.7*	*4.6*	*4.9*	*4.8*	*4.8*	*4.0*
Weighted average[3]	*4.8*	*1.7*	*4.7*	-	-	-	*4.5*	-	-	*4.9*	*4.8*	*5.3*	-	-	-	-
Commonwealth of Independent States																
Armenia	7.4	4.0	6.0	-	6.0	-	10.0	-	-	-	7.0	7.8	-	-	-	-
Azerbaijan	8.3	2.3	9.0	-	9.1	-	9.0	-	-	6.8	8.0	8.1	-	-	-	-
Belarus	3.4	2.4	3.5	-	3.2	-	4.5	-	-	4.1	3.0	2.1	-	-	-	-
Georgia	6.4	6.0	4.0	-	4.5	-	7.5	-	-	7.0	10.0	5.2	-	-	-	-
Kazakhstan	7.6	4.0	7.0	-	8.0	-	6.0	-	-	6.5	10.0	7.9	-	-	-	-
Kyrgyz Republic	4.2	1.3	4.1	-	4.0	-	5.0	-	-	4.2	4.0	3.7	-	-	-	-
Moldova	5.0	1.5	5.5	-	5.0	-	5.0	-	-	-	4.0	5.3	-	-	-	-
Russia	4.6	1.9	5.0	-	5.0	3.5	5.4	5.0	4.2	5.0	4.0	4.3	5.0	4.6	4.5	4.5
Tajikistan	6.2	3.5	6.0	-	4.0	-	7.5	-	-	7.0	6.0	6.6	-	-	-	-
Turkmenistan	9.8	8.5	7.7	-	-	-	10.0	-	-	6.5	10.0	15.0	-	-	-	-
Ukraine	5.0	2.0	4.5	-	4.8	-	6.0	4.8	5.5	6.0	5.5	4.6	-	-	4.0	4.0
Uzbekistan	2.8	2.0	2.0	-	2.5	-	4.0	-	-	2.4	3.0	2.6	-	-	-	-
Average	*5.9*	*3.3*	*5.4*	-	*5.1*	*3.5*	*6.7*	*4.9*	*4.8*	*5.6*	*6.2*	*6.1*	*5.0*	*4.6*	*4.3*	*4.3*
Weighted average[3]	*4.9*	*2.1*	*5.0*	-	-	-	*5.6*	-	-	-	*4.6*	*4.6*	-	-	-	-
Central and eastern Europe and the CIS																
Average	*5.2*	*2.3*	*4.9*	*4.6*	*4.8*	*3.7*	*5.5*	*4.4*	*4.6*	*5.1*	*5.4*	*5.3*	*4.7*	*4.1*	*4.7*	*3.9*
Weighted average[3]	*4.4*	*1.9*	*4.7*	-	-	-	*4.8*	-	-	-	*4.4*	*4.4*	-	-	-	-

Note: All forecasts quoted here were published or reported to the EBRD between April and October 2003. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial delays between preparation and publication of forecasts.

1 The number at the bottom of this column is calculated as the mean of all the average forecasts shown in this column.

2 Data show the difference between the highest and the lowest of the forecasts.

3 Weighted average based on EBRD estimates of nominal US dollar GDP in each country in 2002.

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8 Institute for Economic Research, Halle, Germany.

9 Kopint-Datorg is the Institute for Economic and Market Research Information, Hungary.

10 Vienna Institute for International Economic Studies (WIIW).

Table A.3.12

Average annual inflation forecasts for 2003

(change in the average consumer price level, in per cent)

	Average[1]	Range[2]	EBRD (Sep 2003)	European Union (Apr 2003)	IMF (Sep 2003)	OECD (Apr 2003)	United Nations DESA[3] (Sep 2003)	CSFB[4] (Sep 2003)	Davidson Institute[5] (Sep 2003)	Dun & Bradstreet (Aug 2003)	Economist Intelligence Unit (Aug 2003)	Global Insight, Inc.[6] (Aug 2003)	IWH[7] (Sep 2003)	JP Morgan (Sep 2003)	Kopint-Datorg[8] (Oct 2003)	Vienna Institute[9] (Jul 2003)
Central eastern Europe and the Baltic states																
Croatia	1.9	1.0	2.4	-	2.0	-	2.0	-	1.9	1.9	1.8	1.4	-	-	2.1	2.0
Czech Republic	0.6	1.9	0.2	1.5	0.6	2.0	0.5	0.2	0.3	0.5	0.4	0.3	1.0	0.1	0.2	0.7
Estonia	2.3	2.1	1.4	3.5	1.7	-	3.5	-	1.9	3.5	1.5	1.7	2.0	-	2.0	-
Hungary	4.7	1.1	4.7	5.0	4.7	5.2	4.6	4.5	4.2	4.5	4.7	4.5	5.0	4.6	4.6	5.3
Latvia	2.8	1.3	3.3	2.5	3.0	-	2.0	-	3.1	3.0	2.7	2.9	2.5	-	2.7	-
Lithuania	0.2	2.0	-0.8	1.0	0.0	-	1.0	-	-0.5	1.2	-0.8	0.1	0.8	-	0.3	-
Poland	1.0	1.5	0.5	1.1	0.8	1.4	1.2	0.7	0.5	1.3	0.8	0.8	1.0	0.7	1.0	2.0
Slovak Republic	8.4	1.0	8.5	8.8	8.5	8.7	7.8	8.5	8.3	8.3	8.2	8.3	8.5	8.4	8.6	8.0
Slovenia	5.8	0.7	6.1	6.0	5.9	-	5.8	-	5.8	6.0	5.6	6.2	5.5	-	5.5	5.5
Average	*3.1*	*1.4*	*2.9*	*3.7*	*3.0*	*4.3*	*3.2*	*3.5*	*2.8*	*3.4*	*2.8*	*2.9*	*3.3*	*3.5*	*3.0*	*3.9*
South-eastern Europe																
Albania	2.9	1.4	3.5	-	3.0	-	2.5	-	-	2.3	2.5	3.7	-	-	-	-
Bosnia and Herzegovina	1.0	0.7	1.0	-	-	-	0.6	-	-	0.7	1.3	1.3	-	-	-	-
Bulgaria	2.9	2.6	2.0	4.5	2.6	-	2.5	2.1	2.3	4.5	2.4	1.9	4.0	2.7	3.0	3.0
FYR Macedonia	2.4	1.5	1.5	-	2.5	-	2.5	-	-	3.0	2.3	2.7	-	-	-	2.0
Romania	15.2	6.0	14.5	16.0	15.1	-	15.0	15.0	15.2	16.0	15.2	14.7	15.0	16.2	12.0	18.0
Serbia and Montenegro	12.6	3.3	12.0	-	12.2	-	12.0	-	-	14.0	11.7	12.1	-	-	12.0	15.0
Average	*6.2*	*2.6*	*5.8*	*10.3*	*7.1*	-	*5.9*	*8.6*	*8.7*	*6.8*	*5.9*	*6.1*	*9.5*	*9.5*	*9.0*	*9.5*
Commonwealth of Independent States																
Armenia	4.2	3.8	6.1	-	2.2	-	4.0	-	-	-	5.0	3.6	-	-	-	-
Azerbaijan	2.6	0.9	2.1	-	2.7	-	3.0	-	-	-	3.0	2.2	-	-	-	-
Belarus	34.3	21.0	29.0	-	29.0	-	35.0	-	-	50.0	30.0	32.5	-	-	-	-
Georgia	4.9	1.3	5.0	-	4.4	-	5.0	-	-	5.5	5.0	4.2	-	-	-	-
Kazakhstan	6.6	1.1	6.1	-	6.4	-	7.0	-	-	-	6.1	7.2	-	-	-	-
Kyrgyz Republic	4.0	5.1	2.4	-	3.3	-	4.0	-	-	7.5	3.3	3.8	-	-	-	-
Moldova	9.4	1.9	10.0	-	8.1	-	9.5	-	-	-	10.0	9.6	-	-	-	-
Russia	14.0	2.0	13.9	-	14.4	14.0	14.5	13.8	13.8	14.0	14.3	14.1	14.0	14.3	12.5	14.0
Tajikistan	15.6	5.6	16.0	-	14.5	-	17.5	-	-	12.0	16.0	17.6	-	-	-	-
Turkmenistan	21.9	40.4	9.6	-	-	-	18.0	-	-	50.0	20.0	11.9	-	-	-	-
Ukraine	6.0	5.1	5.1	-	5.5	-	6.0	4.9	6.3	6.0	6.0	5.5	-	-	5.0	10.0
Uzbekistan	25.3	41.6	12.4	-	21.9	-	25.0	-	-	54.0	19.5	19.0	-	-	-	-
Average	*12.4*	*10.8*	*9.8*	-	*10.2*	*14.0*	*12.4*	*9.4*	*10.1*	*24.9*	*11.5*	*10.9*	*14.0*	*14.3*	*8.8*	*12.0*
Central and eastern Europe and the CIS																
Average	*7.9*	*5.8*	*6.6*	*5.0*	*7.0*	*6.3*	*7.9*	*6.2*	*4.8*	*11.7*	*7.4*	*7.2*	*5.4*	*6.7*	*5.1*	*7.1*

Note: All forecasts quoted here were published or reported to the EBRD between April and October 2003. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

1 The number at the bottom of this column is calculated as the mean of all the average forecasts shown in this column.
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3 United Nations, Department of Economic and Social Affairs (DESA).
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6 Global Insight Inc, formerly DRI-WEFA.
7 Institute for Economic Research, Halle, Germany.
8 Kopint-Datorg is the Institute for Economic and Market Research Information, Hungary.
9 Vienna Institute for International Economic Studies (WIIW).

Table A.3.13

Average annual inflation forecasts for 2004

(change in the average consumer price level, in per cent)

	Average[1]	Range[2]	EBRD (Sep 2003)	European Union (Apr 2003)	IMF (Sep 2003)	OECD (Apr 2003)	United Nations DESA[3] (Sep 2003)	CSFB[4] (Sep 2003)	Davidson Institute[5] (Sep 2003)	Dun & Bradstreet (Aug 2003)	Economist Intelligence Unit (Aug 2003)	Global Insight, Inc.[6] (Aug 2003)	IWH[7] (Sep 2003)	JP Morgan (Sep 2003)	Kopint-Datorg[8] (Oct 2003)	Vienna Institute[9] (Jul 2003)
Central eastern Europe and the Baltic states																
Croatia	2.5	2.5	2.8	-	3.5	-	2.5	-	3.0	2.3	2.3	2.6	-	-	2.3	1.0
Czech Republic	2.5	2.0	1.5	2.8	3.5	3.1	2.0	3.0	1.6	3.0	1.9	2.5	2.0	2.4	2.7	3.5
Estonia	3.0	2.0	3.0	4.0	2.0	-	4.0	-	2.5	2.8	3.1	3.3	2.5	-	2.7	-
Hungary	5.2	2.3	4.0	4.5	5.5	4.6	5.8	6.0	5.9	4.2	6.3	4.4	5.0	5.8	5.7	5.0
Latvia	3.0	1.5	3.5	3.0	3.0	-	2.5	-	2.5	2.3	3.0	3.8	3.0	-	2.9	-
Lithuania	1.8	1.9	2.7	2.5	2.5	-	2.0	-	0.8	1.4	0.9	2.4	1.0	-	1.4	-
Poland	2.0	1.5	1.6	2.3	2.2	2.3	2.0	2.1	1.5	2.0	1.7	2.0	2.0	2.0	1.8	3.0
Slovak Republic	6.6	3.4	7.5	7.4	8.1	7.4	6.0	6.9	5.1	7.5	4.6	6.4	6.0	5.0	7.4	7.0
Slovenia	4.7	1.5	5.2	5.5	5.0	-	4.0	-	4.9	5.0	4.2	5.1	4.5	-	4.1	4.5
Average	*3.5*	*2.1*	*3.5*	*4.0*	*3.9*	*4.4*	*3.4*	*4.5*	*3.1*	*3.4*	*3.1*	*3.6*	*3.3*	*3.8*	*3.4*	*4.0*
South-eastern Europe																
Albania	3.3	3.4	5.0	-	3.0	-	2.3	-	-	2.1	2.0	5.4	-	-	-	-
Bosnia and Herzegovina	2.0	4.2	2.0	-	-	-	1.0	-	-	0.6	1.5	4.8	-	-	-	-
Bulgaria	3.6	2.0	2.6	4.0	4.2	-	3.0	4.5	3.1	4.0	3.3	2.9	3.5	4.2	2.5	4.0
FYR Macedonia	2.9	2.0	2.0	-	3.0	-	2.5	-	-	2.8	2.6	3.1	-	-	-	4.0
Romania	11.9	5.0	11.5	11.8	12.0	-	12.0	11.8	11.6	13.0	12.7	11.8	10.0	12.0	10.0	15.0
Serbia and Montenegro	8.8	3.4	8.0	-	7.6	-	8.0	-	-	10.0	8.0	10.9	-	-	7.5	10.0
Average	*5.4*	*3.3*	*5.2*	*7.9*	*6.0*	-	*4.8*	*8.2*	*7.3*	*5.4*	*5.0*	*6.5*	*6.8*	*8.1*	*6.7*	*8.3*
Commonwealth of Independent States																
Armenia	4.0	2.0	4.9	-	3.0	-	3.0	-	-	-	5.0	4.1	-	-	-	-
Azerbaijan	3.2	1.0	3.2	-	2.5	-	3.5	-	-	-	3.5	3.2	-	-	-	-
Belarus	35.9	38.0	22.0	-	24.1	-	40.0	-	-	60.0	39.0	30.4	-	-	-	-
Georgia	5.0	2.8	5.0	-	5.0	-	6.0	-	-	5.0	5.5	3.2	-	-	-	-
Kazakhstan	6.1	1.8	5.5	-	5.9	-	6.0	-	-	-	5.7	7.3	-	-	-	-
Kyrgyz Republic	4.8	3.5	3.4	-	3.8	-	5.0	-	-	6.9	5.0	4.9	-	-	-	-
Moldova	8.4	6.0	9.0	-	4.5	-	8.0	-	-	-	10.5	10.0	-	-	-	-
Russia	11.5	2.9	10.8	-	12.9	11.0	12.0	11.8	11.8	10.0	12.0	12.6	12.0	12.9	10.0	10.0
Tajikistan	10.6	10.7	10.0	-	5.0	-	12.0	-	-	10.0	11.0	15.7	-	-	-	-
Turkmenistan	24.2	47.6	12.4	-	-	-	15.0	-	-	60.0	21.0	12.5	-	-	-	-
Ukraine	6.5	4.0	6.0	-	5.3	-	5.0	5.6	7.3	5.0	9.0	7.3	-	-	8.0	7.0
Uzbekistan	26.5	47.8	18.1	-	20.7	-	20.0	-	-	64.0	20.0	16.2	-	-	-	-
Average	*12.2*	*14.0*	*9.2*	-	*8.4*	*11.0*	*11.3*	*8.7*	*9.5*	*27.6*	*12.3*	*10.6*	*12.0*	*12.9*	*9.0*	*8.5*
Central and eastern Europe and the CIS																
Average	*7.8*	*7.7*	*6.4*	*4.8*	*6.3*	*5.7*	*7.2*	*6.5*	*4.7*	*12.3*	*7.6*	*7.4*	*4.7*	*6.3*	*4.9*	*6.2*

Note: All forecasts quoted here were published or reported to the EBRD between April and October 2003. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

[1] The number at the bottom of this column is calculated as the mean of all the average forecasts shown in this column.

[2] Data show the difference between the highest and the lowest of the forecasts.

[3] United Nations, Department of Economic and Social Affairs (DESA).

[4] Credit Suisse First Boston.

[5] William Davidson Institute at the University of Michigan Business School.

[6] Global Insight Inc, formerly DRI-WEFA.

[7] Institute for Economic Research, Halle, Germany.

[8] Kopint-Datorg is the Institute for Economic and Market Research Information, Hungary.

[9] Vienna Institute for International Economic Studies (WIIW).

Part II

Integration and regional cooperation

Chapter 4

Trade and integration in transition countries

Chapter 5

Integration through flows of capital and labour

Trade and integration in transition countries

4

Over the past two decades, the world economy has become increasingly integrated. The transition countries are particularly striking examples of this process. Formerly a largely isolated trade bloc, with few interactions with the world economy, the region now sends and receives more than two-thirds of its goods and services to and from the rest of the world. The transition countries are also now attracting significant amounts of external investment (see Chapter 5). Transition and integration have therefore been closely linked over the past decade and a half.

However, the process of international integration has not been uniform across countries. Integration has been rapid and deep in the countries of central eastern Europe and the Baltics (CEB), most of which will accede to the EU in 2004. In south-eastern Europe (SEE) and in the Commonwealth of Independent States (CIS) there is far less integration into the world's product and capital markets. Both regions remain relatively closed to international trade, albeit for different reasons. In SEE the violent break-up of former Yugoslavia has prevented more rapid integration by its successor states. Slow economic reform during the early 1990s in Bulgaria and Romania has also delayed the process of economic integration with western Europe. CIS trade is limited by obstructive domestic and regional policies and distance from other markets. Moreover, some of the artificial Soviet trade links remain entrenched even after more than a decade of transition. Consequently, it has taken longer than in central and eastern Europe to redirect trade to the rest of the world.

Openness and international integration can lead to a dramatic improvement in economic performance through the introduction of new technologies and access to larger markets. For the past two decades, world trade has expanded much more quickly than world output. Countries benefiting from this increase in trade are also likely to do well economically. Moreover, those countries which have successfully expanded their participation in global trade have generally done so on the basis of liberal trade policies. Multilateral organisations, such as the World Trade Organization (WTO), have supported this process.[1]

At the same time, international integration places significant demands on a country's economic, political and social institutions. Trade across long distances and between new trading partners requires confidence in the enforcement of contracts.[2] The increased competition resulting from participation in global markets can force costly adjustment on some previously protected sectors. Open trade policies need to be accompanied, therefore, by a strong institutional framework that can enforce contracts and support the process of adjustment – particularly in the labour market – if international integration is to be lasting and successful.[3] The challenge is to find a way of encouraging the developing and transition countries to undertake the necessary institutional reforms together with the liberalisation of trade.

The link between integration and domestic institutional reform is particularly clear in the requirements for EU accession. The enlargement process has played a crucial role over the past decade in supporting far-reaching institutional reforms in the accession countries and strengthening the foundations for their integration into the EU and the world economy. For those countries of the region for which EU membership prospects are either distant or absent altogether, we must ask whether there are alternative modes of interacting with the wider regional and global communities that would trigger similar institutional reforms. In particular, the question is to what extent improved market access to industrialised countries should be conditional on strengthening domestic institutions. Increased integration with regional neighbours could be another option, although the merit of such regional arrangements remains hotly debated.[4]

This chapter analyses the integration of the transition countries into international commerce – trade in goods and services. The integration of the region into global capital and labour markets is covered in Chapter 5. The chapter begins by examining the differences in the degree of international trade integration achieved across the region and looks at the major causes for these differences. It examines in particular the role of transport and transit costs, trade policy and institutional quality on the extent of trade. Transport and transit costs are a major factor limiting trade in the CIS, for example. However, trade policies and, in particular, the quality of a country's institutions and public governance are also critical. If the CIS countries were to adopt the trade policies of the accession countries and achieve the same level of institutional quality, their level of trade with the world economy would increase significantly. In SEE the low level of integration cannot be explained by geography and domestic economic policies alone. The low trade flows probably owe much to the political turbulence of the early and mid-1990s.

The chapter subsequently examines some of the policy options for increasing the international integration of SEE and the CIS. It starts by reviewing the role of international institutions, such as the WTO or the EU, in supporting institutional

1 See Subramanian and Wei (2003). However, Subramanian and Wei (2003) also shows that the positive effects of WTO membership are smaller in sensitive sectors, such as textiles or agriculture, which are regulated by special trade protocols.

2 For an interesting recent test of the idea that the confidence in a trading partner's legal system affects trade levels and the sector composition of trade, see Berkowitz et al. (2003).

3 See Rodrik et al. (2002) and Acemoglu et al. (2000).

4 For a comprehensive review of the literature and some new evidence, see Schiff and Winters (2003).

and trade policy reforms in the non-accession countries. WTO accession requires a certain amount of regulatory and policy adjustments but it stops short of deeper institutional reform. However, WTO membership and especially free access to industrialised markets can have a significant indirect impact on the pace of reform by increasing the incentives for openness and by strengthening support for economic and institutional reform.

There is considerable scope, therefore, for the EU and other trading partners to encourage greater openness and reform in the CIS through offers of improved market access. This would have the greatest impact if the EU sought in return a reduction in trade barriers in the CIS and trade facilitation measures, such as improved customs procedures. Linking improved market access to more ambitious domestic institutional reforms, such as competition policy or investment support, could be a longer-term goal. But it should not be allowed to delay or derail the process of granting improved market access. To underline this conclusion, the chapter draws on work by the International Trade Centre (ITC) in Geneva, which shows that EU trade barriers encountered by SEE and CIS are still very high for some "sensitive" goods. The CIS, in particular, is granted fewer trade preferences than most developing economies.

Finally, this chapter considers how closer regional cooperation could support international integration. Regional cooperation to reduce transit and transport costs is particularly important in the CIS because of the geographic isolation of many CIS countries. Such regional cooperation could in principle be achieved without the need for preferential trade arrangements, such as those currently planned by several CIS countries. However, provided regional trade blocs pursue generally open trade policies with the rest of the world, they may provide a political basis for improved regional cooperation at limited economic cost. Moreover, should the non-accession countries aim to conclude a free trade agreement with the EU, the benefits of such an agreement would be greatly enhanced by reducing the trade barriers among the non-accession countries themselves. The EU has already insisted on greater regional cooperation within SEE before it increases integration with that region. The chapter considers the relevant trade-offs between regional and international integration, drawing on the experience of other regional trade blocs. Annex 4.1 contains detailed country-by-country tables on trade flows and integration.

4.1 Extent of integration

The extent of a country's integration into the world economy can be measured by comparing exports and imports with GDP. Chart 4.1 presents this ratio,[5] with GDP measured at Purchasing Power Parity (PPP) exchange rates.[6] The choice of PPP rates for converting GDP into US dollars is important because the transition countries are much richer when measured in PPP rather than at current market exchange rates. Consequently, the ratio of exports and imports to GDP is lower at PPP rates than at market rates. One way to interpret the results is in terms of the long-term trade potential of the region compared with current trade levels. In the long term, the difference between GDP in PPP and in current US dollars is likely to narrow (and it has already done so since the early years of transition).[7]

The data used in this chapter reflect only officially recorded trade flows. In many transition countries, notably at the eastern border of Poland, in the western Balkans, in the Caucasus and in Central Asia, there are substantial unrecorded flows or so-called "shuttle" trade.[8] At the same time, these countries have important domestic "informal" sectors, meaning that some economic activity is not included in official GDP statistics. Because of these data inaccuracies, real openness could differ from the statistics presented in this chapter.

Chart 4.1 reveals clearly the different levels of integration across the region and how these have evolved since the mid–1990s. In the accession countries in CEB there is a clear improvement in openness, as measured by the ratio of trade to GDP, and these countries are now considerably more open than most emerging markets. In SEE and Croatia there is also an improvement but the trend is more moderate, and the openness ratio remains at a much lower level. In the CIS there is hardly any change in openness between 1995 and 2002. According to the measure used in Chart 4.1, openness in SEE and the CIS is around the same level as in Mercosur (comprising Argentina, Brazil, Paraguay and Uruguay) but much lower than in the EU or in the Association of South East Asian Nations (ASEAN).

In addition to a change in the volume of trade, the transition countries have experienced a significant movement of trade away from the Council of Mutual Economic Assistance (CMEA) and towards the OECD and other global markets. Excluding intra-bloc trade (the trade conducted with other countries in the same region), openness to the rest of the world has increased in all transition countries. Chart 4.2 shows total trade growth since 1995 in terms of intra-bloc trade and trade with the rest of the world. It shows clearly that trade with the rest of the world has been the driving force behind the increasing openness of the

[5] The data pre-1995 are often incomplete and exclude significant barter transactions among CIS countries in particular. The chapter therefore restricts attention to the post-1995 period.

[6] The literature on openness offers no clear guidance on this point. This chapter follows Berg and Krueger (2003) in the use of GDP in PPP. As these authors point out, the use of GDP at market rates can lead to the counter-intuitive result that openness declines with rises in productivity in the tradable goods sector because of the effect of such productivity gains on the real exchange rate. Moreover in the transition economies, market rates have been quite volatile in recent years, leading to significant changes in measured openness from year to year. In the gravity model literature both nominal GDP and GDP in PPP are used by different authors.

[7] All the calculations in this chapter were also carried out using GDP at market rates. While the quantitative results change, the qualitative results remain unaffected. There is an increase in openness in the accession countries, a smaller increase in SEE and no increase in the CIS since 1995 (in fact, openness declines in the CIS because of real exchange rate appreciation). Moreover, the results of the gravity model presented in this chapter are also robust to the choice of exchange rates in their main conclusions regarding the causes of slower integration in SEE and the CIS.

[8] Shuttle trade tends to mean unrecorded trade in otherwise legal commodities. There is also a vast amount of trade in illegal commodities (drugs, humans and so on) that is not normally counted in shuttle trade.

transition countries, particularly in the accession countries. Table A.4.1.1 in Annex 4.1 presents data on a country-by-country basis, and shows the extent to which trade has been redirected from intra-bloc trade to the EU and other non-transition countries.

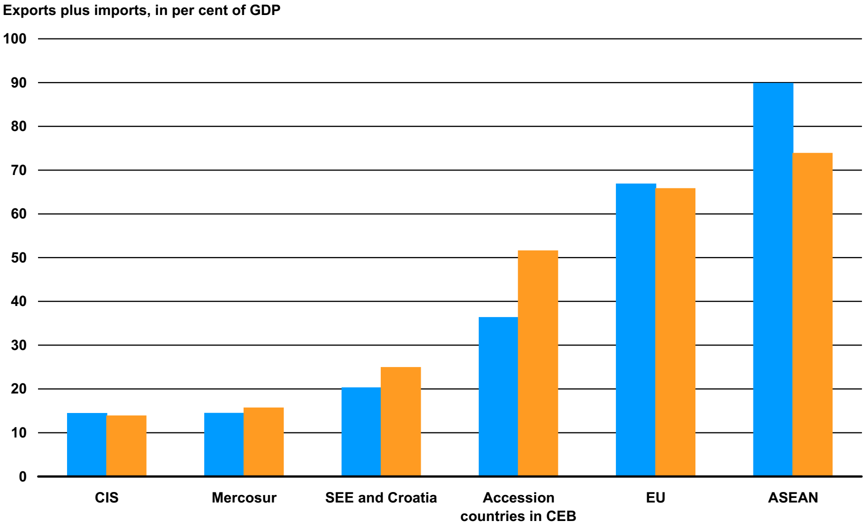
The degree of integration for each country is influenced by a variety of factors, such as its size, its location, its level of income and its level of reform. The impact of these factors on the extent of integration can be estimated in a so-called "gravity model". This is an empirical model that relates the level of trade between two specific countries to the size of their respective economies and the costs of shipping goods from one country to another. These costs are influenced by geographical distance as well as the costs of transport and any policy-related obstacles to trade.

The gravity model is consistent with different (and conflicting) theories of why countries trade with each other, such as differences in resource endowments or technologies as well as for reasons of product specialisation resulting from imperfect competition and increasing returns to scale. The gravity model is, therefore, quite flexible, and numerous variables can be added to assess other factors governing trade between countries.

Table 4.1 compares the actual level of trade in the region with the level predicted by the gravity model.[9] This ratio is derived by measuring the extent to which trade flow between a particular region and all its trading partners differs from all the other trade flows in the sample. The table shows the result of several estimations, where factors have been progressively added to correct for the effects of geography, policy and institutions. The first column shows the results of a baseline model, which includes each country's GDP in PPP, the distance between capitals, and a measure of bilateral exchange rate volatility.[10]

Chart 4.1

Openness of the transition countries relative to other regions, 1995–2002



1995 2002

Sources: IMF Direction of Trade Statistics (2003) and EBRD staff calculations.

Note: Openness is defined as an unweighted average ratio of total trade to GDP in Purchasing Power Parity (PPP) for each region: (exports + imports) / GDP PPP. Results are not greatly affected by the use of weighted averages.

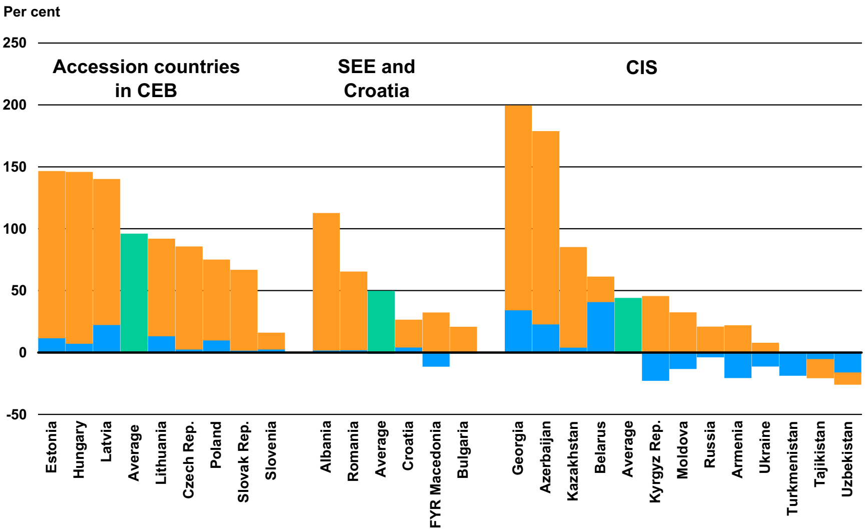
Definitions:

ASEAN – Association of South East Asian Nations (six out of ten member countries are included: Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam).

Mercosur – Mercado Comun del Cono Sur (Southern Cone Common Market: Argentina, Brazil, Paraguay and Uruguay).

Chart 4.2

Changes in trade between 1995 and 2002



Trade within the sub-region Trade outside the sub-region Average

Sources: IMF Direction of Trade Statistics (2003) and EBRD staff estimates.

Note: Data for Bosnia and Herzegovina and Serbia and Montenegro were not available.

In this baseline model, actual trade is only around 60 per cent of the predicted trade in the accession countries in CEB, and around 25 per cent in SEE, Croatia and the CIS.[11] In other words, there is a lack of integration. Transition countries

[9] The model was estimated for 83 countries, accounting for around 95 per cent of the world's GDP, in a panel from 1997 to 2002. They included the transition countries, the EU, the North American Free Trade Area (NAFTA), Mercosur, North Africa, ASEAN and 24 other countries, mainly in East and South Asia. Sub-Saharan Africa was not included because of concerns over data quality and missing variables – see Babetskii et al. (2003) for details.

[10] Frankel and Rose (2000) established the profound effects of a common currency on trade flows between two countries. The inclusion of a variable measuring exchange rate volatility takes into account a similar effect. See Koukhartchouk and Maurel (2003).

[11] The results are sensitive to the use of GDP at PPP rather than market exchange rates, although the qualitative conclusions and the ranking in the degree of openness are not affected. Further sensitivity analysis, including specifications with country fixed effects, is reported in Babetskii et al. (2003). The qualitative results are robust to changes in specification.

on average trade between 40 and 75 per cent less than the average non-transition country when the three factors listed above are taken into account. The lack of integration in the CIS is even more striking when considering the importance of energy trade in these countries, for which there are few alternative providers.

The following five factors are then added to this baseline estimation to see whether they can account for at least some of the lack of integration of the transition countries:

- the size of a country – larger countries face higher internal transport costs and may therefore trade less;
- the number of borders a country has to cross to get to a target market – landlocked countries and countries surrounded by neighbours with cumbersome border controls face higher transport and transit costs and are likely to trade less;
- the quality of transport infrastructure – the greater the road and rail network in a country, the easier it is to trade;
- the extent of trade liberalisation, measured by WTO membership and a trade restrictiveness index constructed by the IMF – countries with more liberal trade regimes tend to trade more;
- the quality of a country's institutions, measured by the average of the World Bank's governance indicators for rule of law, the extent of corruption and the quality of regulation[12] – countries with better governance provide a more secure environment for the exchange of goods and services across borders.

For the accession countries in CEB, the gap between actual and potential trade is not reduced significantly by taking these additional factors into account. The only significant impact comes from the number of borders. This suggests that following accession, trade in these countries – in particular, with the EU and among themselves – is likely to increase further as border controls vanish. There is little for the accession countries to gain from policy improvements since they already have better than average trade policies and governance ratings. Overall, there is probably some potential, however, for increased trade in these countries following EU enlargement in May 2004.[13]

For SEE, Croatia and the CIS, the introduction of these additional factors has a bigger impact. Taking all of them into account, the gap between actual and potential trade diminishes to around 60 per cent for SEE. For the CIS, Table 4.1 suggests that the combination of geographical constraints, border controls, restrictive trade policies and weak institutions explains almost entirely its lack of integration in the world economy. As the CIS contains the largest group of land-locked countries in the world, it faces the key challenge of overcoming obvious constraints to transit and transport, particularly in Central Asia.[14]

For the CIS the actual level of trade with other CIS countries is several times higher than the level predicted by the gravity model, and CIS trade with the rest of the world is correspondingly lower than predicted.[15] This indicates that mutual dependencies still exist in the CIS. The implications of this for regional cooperation are examined in more detail below.

SEE still lies significantly below its trade potential even once all other factors are taken into account. One possible explanation for this gap is the continuing impact from the break-up of former Yugoslavia in 1991. Of course, this gap also suggests a significant potential for increased trade from and within SEE as the regional instability in the western Balkans is overcome. Trade within the region should also increase as bilateral relations improve and a network of free trade agreements is established.

Table A.4.1.2 in Annex 4.1 reveals the gaps between actual trade and the level predicted by the gravity model. It shows that the general regional trends hide some important variation between countries. In the CIS, for instance, Kazakhstan and Russia are quite open to trade once geographical constraints are taken into account while the Caucasus and Moldova are particularly closed. Elsewhere, Bulgaria, Croatia and Romania are more open than the poorer recently war-torn economies of the western Balkans. The estimated "trade gaps" shown in Table A.4.1.2 are quite sensitive, however, to the precise way that the regression analysis was specified and provide no more than a rough pointer to differences across countries in the degree of integration.

Table 4.1

Ratio of actual to predicted gravity model results by sub-region

(in per cent)

Model	1	2	3	4	5	6
	Baseline	Baseline Country size	Baseline Country size Border	Baseline Country size Border Infrastructure	Baseline Country size Border Infrastructure Policy	Baseline Country size Border Infrastructure Policy Institutions
Accession countries in CEB	63	65	73	75	62	68
SEE and Croatia	24	27	30	32	30	42
CIS	28	39	47	46	55	83

Source: EBRD staff estimates.

Note: Figures are derived from a gravity model including regional dummies. Columns 1-6 refer to different specifications, where additional variables have been progressively added to the basic model. For variable definitions, see text. For details of the estimation, see Babetskii et al. (2003).

[12] The indicators can be found at www.worldbank.org/governance.

[13] One important source of future trade growth in the accession countries is likely to be increased regional trade with other new member states, given the reduction of trade barriers (both towards EU members and countries with which the EU has free trade agreements) that accession to the EU implies. See *Revue Elargissement*, No. 30 at www.dreee.org/elargissement.

[14] See Grafe et al. (2003).

[15] For similar findings, see Firdmuc and Firdmuc (2000) and Koukhartchouk and Maurel (2003). Note that mutual dependence is not just dependence on Russia. For instance, the smaller economies of Central Asia continue to be highly reliant on their regional neighbours as export markets and also suppliers of energy. There are persistent supply chains from raw material producers to processing factories across the entire former Soviet Union.

Restricted trade policies and the poor quality of governance are key factors in explaining the low levels of integration in SEE and the CIS. The gravity model shows that CIS trade would increase by around 20 per cent if countries in the region adopted trade policies similar to those in the accession countries and became WTO members. Moreover, trade would almost double if the CIS also had the same quality of governance as the accession countries. For SEE and Croatia the impact of these factors would be 10 per cent and 50 per cent respectively. This result suggests that trade liberalisation alone may be insufficient to improve the prospects of these countries.

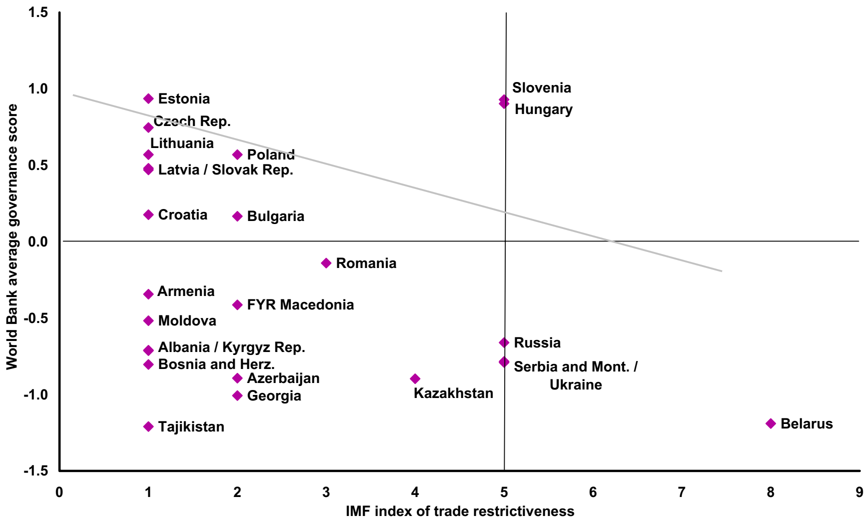
However, the results of the gravity model have to be interpreted carefully. It is possible that increased openness and trade create a higher demand for good governance. If this is the case, the impact of good institutions on trade has probably been over-estimated. The same is probably true for the impact of trade liberalisation. Nevertheless, the results of the gravity model suggest that more open trade policies need to be accompanied by deeper institutional reforms if trade performance in the non-accession countries is to improve significantly.

4.2 Integration and institutional reform

Trade policy reform – in particular, improvements in governance and the quality of institutions – is key to increasing the integration of SEE and the CIS into the world economy. Chart 4.3 provides a snapshot of the shortfall in trade policy and institutional reform in these two regions by comparing their scores for trade restrictiveness and governance with those from a large sample of developed and developing economies.[16] In the chart, the world benchmark is represented by the diagonal line, showing that on average more liberal trade policies are also associated with better economic governance. Points below the line indicate that a country's progress on liberalising trade is not matched by similar improvements in economic governance.

Chart 4.3

Trade policy and quality of institutions in transition countries, 2002



Sources: IMF, World Bank and EBRD staff estimates.

Note: The IMF trade restrictiveness index varies from 1 to 10. A higher rating means a more restrictive policy. The World Bank governance indicator is the average of three indicators: corruption, rule of law and quality of regulation. Each of the three indicators varies from –2.5 to 2.5. A high score implies a better institutional quality. The diagonal line in the chart represents all points on a regression of the World Bank governance scores against the IMF trade restrictiveness index. The line can be read as the world average pattern of how the quality of governance relates to the openness of the trade regime. Countries below the line have better than average trade policies or below average governance scores and vice versa. Data for Turkmenistan and Uzbekistan were not available. Turkmenistan and Uzbekistan do not permit disclosure of their trade restrictiveness scores, but are rated the least open transition economies by the EBRD transition indicators.

Apart from Belarus, Turkmenistan and Uzbekistan, the SEE and CIS countries have relatively open trade policies compared with other countries around the world but suffer from weak institutions. This result is consistent with the transition ratings prepared by the EBRD (see Chapter 2). In the gravity model used in the previous section, it is difficult to pinpoint the most important institutions for trade performance. However, they probably include customs and transit procedures, access to trade finance and the quality of law enforcement.

The importance of institutional reform is undisputed but there is no clear blueprint for how to reform institutions. One key factor is the importance of "external anchors", such as the WTO or the EU, in promoting institutional reform.[17] WTO membership has a number of requirements that relate directly to the quality of institutions. In addition to trade policy and customs reform, licensing requirements and the use of state aid have to be brought into line with international practices.

A commitment to liberalise trade in services – such as banking and finance – can help to improve access to trade finance. This often requires reform of regulatory systems to improve credit allocation and to stabilise the financial system. Industrialised countries, such as the United States and EU members, are concerned about a country's ability to protect intellectual property rights. Moreover, during negotiations, existing WTO members may seek reassurance that a country's legal and regulatory institutions are able to implement the commitments made to the WTO.[18]

In practice, the WTO has limited scope for enforcing its standards on members unless complaints are brought by other

[16] The sample is the same 83 countries used earlier in this chapter (see footnote 9). The indicators for trade restrictiveness and governance were developed by the IMF and the World Bank respectively.

[17] See Di Tommaso et al. (2001) on the positive impact of EU accession prospects for institutional reform in the transition countries.

[18] The EU, the OECD and the WTO have recently launched the Integrated Framework for Trade to enhance technical assistance to developing countries either in preparation of WTO membership or following membership to improve domestic institutions and the conditions for private investment and trade. This may further increase the potential role of the WTO as an anchor for institutional reform.

Box 4.1

EU relations with SEE and the CIS

Within SEE and the CIS three country groupings emerge in terms of their relations with the EU. The first group includes the EU accession countries, Bulgaria and Romania, which are in the process of concluding accession negotiations. The EU and these two countries have agreed a road map that would see them join the EU in 2007. To help them meet this target, the EU has agreed to increase significantly pre-accession assistance.

Countries in the second group share the ultimate goal of EU membership and are part of the EU's Stabilisation and Association Process (SAP). They comprise Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, and Serbia and Montenegro. As part of this process, they negotiate Stabilisation and Association Agreements (SAAs), which include the gradual implementation of a free trade area and the harmonisation of national legislation with EU standards. The SAAs establish benchmarks – for example, for competition policy, state aid, harmonisation and trade liberalisation – against which their progress towards integration with the EU is measured. Financial assistance to support these obligations is provided by the EU CARDS (Community Assistance for Reconstruction, Development and Stabilisation) programme.

Experience with the SAP has been mixed so far. In some cases, the SAP has achieved concrete results – for example, in Albania – but its impact is clearly weaker than formal accession requirements. In FYR Macedonia, for instance, institutional reforms have proceeded slowly since the SAA was signed in April 2001. Although membership of the EU is the ultimate goal for the countries engaged in the SAP, the uncertainty surrounding this goal makes it a weaker incentive than the clear accession timetable for Bulgaria and Romania, for example.

Relations between the EU and partner countries in the CIS – the third group – have been formalised through Partnership and Cooperation Agreements (PCAs), which apply to nine CIS countries. The exceptions are Tajikistan, where no PCA has been agreed, and Belarus and Turkmenistan, where the PCAs have not yet entered into force. As well as promoting respect for democratic principles and human rights, the PCAs grant CIS countries the status of Most Favoured Nation (MFN) for market access to the EU and aim to bring the trade policies of partner countries in line with WTO requirements.

However, the trade preferences granted under the PCAs are limited compared with those granted to the EU's southern Mediterranean neighbours and some developing countries in Africa and the Caribbean. The scope for influencing institutional and structural reforms through the PCAs is clearly narrow despite the considerable levels of grant funding provided through the EU's TACIS programme.

members. In addition, it has limited resources to support institutional reform directly. For a large country, such as Russia, WTO accession may be a key catalyst in accelerating and maintaining institutional reform. For small transition countries, however, WTO membership may have a limited impact on the quality of institutions. This is because the countries may have a poor capacity to implement reform and may attract limited interest in enforcement by other WTO members and insufficient external support. For example, the Kyrgyz Republic was the first CIS country to join the WTO in 1999. However, in 2002 it received an average score for governance (-0.71) not much better than Kazakhstan's (-0.90) and worse than Russia's (-0.66) even though the latter are not WTO members. In the Caucasus, Georgia's governance score is very poor (-1.01), Armenia's is considerably better (-0.34) and Azerbaijan's lies in the middle (-0.89) even though the latter is the only one of these countries not in the WTO.

Compared with WTO requirements, the institutional reforms required by EU accession are considerably more rigorous. In the accession countries many of the recent advances in institutional reform – in the areas of banking, finance, competition policy, and legal and administrative reform, for example – have resulted directly from the requirements of the EU's *acquis communautaire*. Following enlargement, the question is to what extent cooperation and integration with the EU can be extended to non-accession countries. Box 4.1 reviews the EU's existing agreements with SEE and the CIS. Without the realistic prospect of eventual EU membership, however, the EU's role is likely to be limited.

In recent years the EU has advocated "deeper" integration with the countries of SEE and the CIS. At the western Balkans summit in Thessaloniki in June 2003, the EU emphasised that there is a real prospect of EU membership for the SAP (Stabilisation and Association Process) countries. It reiterated its commitment to greater political cooperation, better support for institution-building, improved market access, and the possibility of participation by the western Balkans in certain EU programmes. This may invigorate the process of institutional reform in SEE and lead to greater integration not just with the EU but with the world economy.

The EU's vision of deeper integration also extends to countries without the current prospect of EU membership but with a common border with the enlarged European Union, namely Russia, the western CIS (Belarus, Moldova and Ukraine) and the Mediterranean countries of North Africa and the Middle East. In March 2003 the European Commission adopted the Communication on Wider Europe, which offers neighbouring countries a stake in the EU's internal market in return for concrete progress at political, economic and institutional level.[19]

The EU's increasing cooperation with the non-accession countries is clearly welcome but questions remain over the timing of market opening and institutional integration. Even if introduced gradually, the adoption of EU-compatible rules and regulations will pose substantial institutional and political challenges for many CIS countries. The reciprocal opening of markets can help to overcome

[19] See European Commission (2003). The EU has also recently appointed a special envoy for the Southern Caucasus. At present, Armenia, Azerbaijan and Georgia are, however, not part of the Wider Europe process.

some of the obstacles to domestic reform. As Mexico's experience with the North American Free Trade Area (NAFTA) suggests, improved market access to a country's major trading partner can significantly strengthen the reform process by increasing the incentives for structural and institutional reforms.[20] If export opportunities exist, domestic entrepreneurs require policies that enhance their competitiveness and reduce obstacles to investment. If improved market access is granted on condition that reciprocal reductions are made to trade barriers in the home country, this can increase competition in the domestic market and erode the power of those with vested interests in protectionism.

The target of establishing a free trade area between the EU and the CIS could lead to greater integration with Europe and enhanced institutional reform even without a rigid coupling of the two processes. To ensure that the CIS countries follow good international practice in trade policy, WTO membership could be made a requirement for the start of negotiations on a free trade agreement with any CIS country. The experience with other such free trade agreements shows that they can significantly boost trade.[21]

However, their successful implementation would be difficult, both politically and administratively – for example, to ensure compliance with rules of origin requirements. As the next section demonstrates, the EU's level of protection against exports from the transition countries remains relatively high even for the accession countries, which benefit from free trade agreements. Offering improved market access for the non-accession countries represents, therefore, a significant challenge.

4.3 Improved market access

It has long been recognised that developing and transition countries would benefit significantly from improved access to the markets of western Europe, North America and Japan. Although general levels of protection through tariffs and quotas have declined to relatively low levels in recent years, the industrialised countries have increasingly used anti-dumping measures, complicated rules of origin and other technical barriers to protect their producers from competitors in developing and transition countries. Moreover, in a number of sectors, such as agriculture and textiles, tariffs are still relatively high. Tariff rates for agriculture vary significantly between products and can reach 100 per cent or more in some cases, creating large economic distortions.[22] In addition, domestic producers are protected through significant subsidies.

Over the past two decades, there has been a dramatic increase in regional trade agreements granting their members preferential market access. The EU has been at the forefront of this trend. Since the creation of NAFTA, the United States has also created a number of regional trade blocs.[23] The existence of regional concessions means that average levels of tariff protection are not a good indication of a country's market access. The following analysis focuses on trade between the transition countries and the EU, the main market for these economies (see Table A.4.1.1 in Annex 4.1). The conclusions regarding levels of protection are also applicable to other industrialised markets, such as Japan and North America.

The International Trade Centre (ITC) in Geneva has examined market access for a range of key products.[24] It has found that aggregate rates of protection for primary products exported from Brazil and China to the EU, Japan and the United States are roughly similar (about 18 per cent of the goods' value). In the textiles and clothing sector, aggregate rates of protection are lower on average in the EU than in Japan or in the US but protection rates in the EU differ considerably (0 per cent for Morocco, 6.2 per cent for Brazil and 31 per cent for China). The same pattern of differentiation is true for the United States, highlighting the importance of analysing market access on a bilateral basis. Furthermore, developing countries – such as Brazil, China or India – still have much higher levels of protection than either the EU or North America. Reducing these could contribute significantly to improved market access for both transition and developing countries. Higher levels of trade protection are also in force among the transition countries.

Table 4.2 shows the different levels of access to the EU market, including Most Favoured Nation (MFN) status, which is accorded to all WTO members and to CIS countries with Partnership and Cooperation Agreements (PCAs). SEE and CIS countries also benefit from the EU's Generalised System of Preferences (GSP) but exports of particular products are no longer covered by the GSP when they reach a certain market share, and the GSP does not cover agricultural commodities or textiles. This considerably reduces its economic significance. As Table 4.2 reveals, the most preferential access to the EU market, as of the late 1990s, was granted to countries with free trade agreements with the EU or to the least developed countries, mainly in Africa and the Caribbean.[25] Table 4.2 shows the nominal rates of protection faced by exporting countries However, in practice, the "take-up" of regional preferences varies. Once this is taken into account,

[20] See Thacker (2000).

[21] See, for instance, Subramanian and Wei (2003). For a balanced discussion of the pros and cons of regional free trade agreements, see Schiff and Winters (2003).

[22] It is well-known from trade theory that economic distortions resulting from trade protection are amplified if tariffs are non-uniform across product categories. When tariffs on final goods are higher than on inputs, even relatively low nominal tariffs on final goods can lead to high effective rates of protection.

[23] See Messerlin (2001).

[24] See Bouët et al. (2001).

[25] The most important regional preferences with competitors of the transition countries include the free trade agreements with the Mediterranean countries (Algeria, Egypt, Israel, Jordan, Lebanon, Morocco and Tunisia – in addition to Cyprus and Malta, which accede to the EU in 2004), agreements with the Caribbean Common Market Countries (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama) and the Andean Group (Bolivia, Colombia, Ecuador, Peru and Venezuela) as well as the customs union with Turkey and a free trade agreement with South Africa.

the differences between protection rates offered under preferential trading regimes and under MFN status tend to narrow significantly.[26]

For a more precise indication of market access, ITC data have been used to compare protection levels in the EU market across different exporting countries (see Table 4.3). For the purposes of comparison, all tariff and non-tariff barriers have been aggregated to one single number (see note to Table 4.3). The results in the first column show that the average rate of protection faced by CIS exporters to the EU market is among the highest in the world, whereas SEE faces a lower level of protection than the accession countries. The impact of trade preferences for the least developed countries and particular trade blocs is also shown.

Average protection rates are not a good measure, however, of the economic costs of protection and the benefits of improved market access. This is because the impact of protection is greater if it affects products in which an exporting country specialises rather than products that a country produces in smaller quantities. To take this into account, a corrected average rate of protection was calculated, using export volumes to the EU as an indicator of a sector's economic importance. Because actual exports to the EU depend on the rate of protection against that country in the EU market, the weights used are based on EU imports from a group of countries. This reference group consists of countries with similar levels of GDP per capita. For example, a country may face a prohibitively high tariff against its export of rolled steel to the EU market and hence does not export steel to the EU. If steel is a commodity produced by several other countries with similar income levels and these countries do export steel to the EU because of lower tariff barriers, their average share of steel exports to the EU is used as the weighting factor.

The corrected data in the table show that the accession countries face some of the highest rates of protection in the EU. This is surprising considering the commitment to free trade under the accession process. A key factor behind these results is agriculture. The EU accession countries are middle-income countries, which tend to export a high share of temperate zone agricultural products. However, the accession countries export a relatively low level of these products to the EU, and the agricultural sector is much smaller than in typical middle-income countries.[27] By placing the accession countries within the middle-income category, the table emphasises the potential obstacles facing these countries. The weighted data also increase the rate of protection faced by CIS countries, albeit by less than in the accession countries. Belarus, Russia and Ukraine face particularly high rates and are also the most affected by anti-dumping measures from industrialised countries.

As a final measure of market access, Table 4.3 shows by how much the rate of protection would decline if all tariffs were capped at 15 per cent. This calculation gives an indication of the importance of tariff peaks (very high tariffs on particular goods) in the structure of protection. The results in column three of the table show that tariff peaks frequently affect imports from SEE and developing countries in North Africa and the Caribbean. This reflects the fact that most exports from these countries enter the EU market duty free, and protection is concentrated on a few tariff lines. In the CIS, tariff peaks are less prominent, reflecting a higher but less varied level of protection in the EU market.

The calculations in Table 4.4 show that the EU as a whole is a relatively open market but there is a high incidence of protection in sectors where transition economies and developing countries would appear to have a comparative advantage. Table 4.4 compares average levels of protection across a number of sectors where transition countries experience discrimination. For instance, for meat products Moldova faces tariffs of over 100 per cent, the highest of all countries in the ITC database. Consequently, as shown in Table 4.4, Moldova's meat exports to the EU are zero. Belarus faces the fifth-highest duty on sugar exports to the EU. Although this is a significant export product for Belarus, exports to the EU are again zero.

Transition countries would benefit significantly from improved access to EU markets. The EU could use market access as a means of encouraging domestic reform by offering increased benefits to pro-reform constituencies in the non-accession countries. The benefits of free trade with the EU are likely to be far higher for the non-accession countries if they operate free trade among themselves. A web of bilateral free trade agreements with the EU might divert trade

Table 4.2

EU's pyramid of trade preferences, 1999

(simple average tariff rates, in per cent)

	MFN [1] bound	MFN applied	GSP [2] and MFN	FTA [3] and MFN	LDC [4] and MFN	ACP [5] and GSP and MFN	ACP [5] and LDC and MFN
All products	7.0	6.9	4.9	3.5	1.9	1.9	1.8
Agricultural products	17.4	17.3	15.7	16.7	10.3	10.3	9.5
Non-agricultural products	4.6	4.5	2.3	0.5	0.0	0.0	0.0

Source: Messerlin (2001), p. 206.

Notes: The table shows the tariff rates for different groups of countries.

1 Most Favoured Nation status (WTO members).

2 Generalised System of Preferences applies to all developing countries if their market share in a specific product category, relative to other countries in the group, does not exceed a certain level.

3 Average for all countries having signed a free trade agreement with the EU.

4 Least developed countries benefiting from special trade preferences.

5 African-Caribbean and Pacific countries covered by the Lomé accords, replaced in 2001 by bilateral reciprocal trade preferences under the Cotonou agreements.

[26] See Gallezot (2003).

[27] See 2002 *Transition Report* and Babetskii et al. (2003).

to the EU and reduce trade between the transition countries.[28] Because many of the transition countries are landlocked and rely on transit through third countries for access to the EU market, regional cooperation on trade facilitation issues is critical. Consequently, the recent free trade agreements between the EU and SEE have been linked explicitly to the adoption of bilateral free trade agreements among the SEE countries themselves. This could usefully be extended into a unified free trade area for SEE. The CIS would also benefit from this type of arrangement, as explained below.

4.4 Regional integration as a catalyst for global integration

In recent years the transition countries have shown increasing interest in the potential benefits of regional cooperation and integration. In the CIS in particular, Belarus and Russia have been making progress, albeit slow and inconsistent, towards the establishment of a monetary union. Together with Kazakhstan, the Kyrgyz Republic and Tajikistan, they have created the Eurasian Economic Community (EAEC), based on an earlier agreement to establish a customs union. In September 2003 Belarus, Kazakhstan, Russia and Ukraine signed a declaration calling for the creation of a Single Economic Space, with the ultimate goal of achieving a high level of integration among its members. The Kyrgyz Republic has already voiced its intention to join.

The CIS also has several other regional trade and economic cooperation arrangements, such as the Central Asian Cooperation Organisation and the GUUAM Group (Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova). Most of these regional arrangements are, however, ineffectual.[29] For instance, a free trade agreement has been in place between all CIS countries since 1994 but its implementation has been sketchy. While imports from other CIS countries sometimes benefit from tariff reductions, even these are inconsistently applied. A particular problem is that some CIS countries have much lower levels of protection than others and are already WTO members, with MFN commitments to a large number of countries. The more protectionist CIS countries often view their more liberal neighbours as a "Trojan horse" for the unprotected entry of cheap consumer goods, mainly from China and other parts of Asia. This has led to a series of trade barriers against neighbouring countries.[30]

Table 4.3

Average level of protection of EU against transition countries and selected competitor countries

(in per cent)

Country	Simple average rate of protection	Weighted average rate of protection (ITC weights)	Tariff peaks
Accession countries in CEB	**4.9**	**8.8**	**34.3**
Czech Republic	4.3	6.1	41.8
Estonia	4.9	13.7	32.8
Hungary	4.7	4.1	26.9
Latvia	5.5	10.0	37.9
Lithuania	5.5	7.8	38.0
Poland	4.3	6.5	47.4
Slovak Republic	4.9	12.8	11.0
Slovenia	5.4	9.9	38.3
SEE and Croatia	**2.1**	**3.6**	**43.9**
Albania	1.2	1.9	51.6
Bosnia and Herzegovina	1.1	1.8	45.9
Bulgaria	4.6	8.5	10.7
Croatia	1.1	1.5	59.4
FYR Macedonia	0.8	1.5	65.2
Romania	4.6	8.4	28.6
Serbia and Montenegro	1.1	2.0	45.6
CIS	**6.1**	**8.1**	**20.2**
Armenia	5.7	6.9	16.4
Azerbaijan	5.6	7.0	14.7
Belarus	7.1	9.2	27.2
Georgia	6.1	8.6	17.1
Kazakhstan	6.6	7.1	22.3
Kyrgyz Republic	5.6	6.8	14.3
Moldova	5.9	6.8	20.9
Russia	7.1	11.1	30.4
Tajikistan	5.6	7.6	10.2
Turkmenistan	5.9	6.5	22.1
Ukraine	7.0	12.5	30.2
Uzbekistan	5.6	6.7	16.4
North Africa			
Morocco	4.3	5.8	48.7
Tunisia	4.6	6.3	49.8
Caribbean			
El Salvador	5.0	3.9	40.6
Nicaragua	3.2	1.1	36.7
Latin America			
Brazil	6.0	11.1	34.0
Chile	6.5	7.6	25.4
Asia			
China	5.6	6.9	11.9
Pakistan	4.0	3.3	64.7
Other			
Cameroon	3.3	1.1	51.5
Turkey	3.1	3.9	36.1

Sources: International Trade Centre (ITC) and EBRD staff estimates.

Note: The average rate of protection is the sum of *ad valorem* tariffs, specific tariffs, tariff quotas and anti-dumping measures, all converted into *ad valorem* equivalents. Simple averages are calculated on the basis of UN standard trade classification system aggregation of Harmonised Schedule level 2 (HS2) data, by sector, provided by the ITC. ITC's sectoral aggregation uses ITC weights and is therefore not equivalent to aggregation and averaging over all individual tariff lines. ITC weights are the structure of EU imports from a reference group of countries, determined by per capita income. The impact of tariff peaks shows the difference in the overall rate of protection, if all tariffs and tariff quotas were capped at 15 per cent.

[28] Similarly, the risk following enlargement is that – although trade barriers in the accession countries are currently higher than they will be after accession – the abolition of protection in the EU could lead new members to reduce their trade with non-members.

[29] See Pomfret (2003) for an analysis of regional cooperation in Central Asia.

[30] For details, see Grafe et al. (2003) and Molnar and Ojala (2003).

Table 4.4

Average level of protection in selected sectors, transition countries and competitor countries

Sector name (HS2 level[1])	Transition countries and selected competitors	Total rate of protection (per cent)	Share of exports to the EU in total sector exports (per cent)	Share of sector in total country exports (per cent)
Meat and edible meat offal	**Moldova**	123.4	0.0	2.87
	Nicaragua	108.2	0.0	8.92
	Australia	97.4	4.1	4.65
	New Zealand	90.7	38.2	13.18
	Brazil	66.6	38.4	2.91
Edible fruit and nuts, peel of citrus fruit or melons	Ecuador	33.9	32.2	17.46
	Moldova	31.9	65.2	4.64
	Georgia	30.1	78.3	6.73
	Romania	23.0	53.7	0.20
	Hungary	22.8	78.9	0.25
	Tunisia	16.0	82.4	0.82
	Morocco	9.7	64.9	3.32
Preparations of meat, fish and crustaceans	Iceland	25.5	96.7	7.07
	United States	25.0	11.1	0.11
	Hong Kong (SARC)	24.9	7.2	0.01
	Russia	23.8	12.8	0.07
	Poland	23.2	41.7	0.56
	Uruguay	20.9	47.2	1.05
	Canada	18.5	13.5	0.21
	Norway	12.7	82.1	0.32
Sugars and sugar confectionery	El Salvador	135.2	1.1	5.23
	Peru	122.6	1.3	0.29
	Lebanon	116.9	9.2	0.99
	Russia	114.8	2.1	0.06
	Belarus	111.2	0.0	1.47
	Jamaica	108.7	99.8	6.56
	Fiji	70.8	74.2	25.11
	Cuba	69.3	na	na
	Gambia	69.1	40.8	7.69
	Moldova	61.3	9.6	0.66
	Poland	58.3	18.3	0.48
	India	51.3	12.9	0.27
	Nicaragua	38.6	4.3	5.73
	Czech Republic	12.3	47.4	0.19
Fertilisers	**Ukraine**	24.6	2.4	0.25
	Russia	9.5	10.8	1.53
	Chile	6.6	12.1	0.70
	Belarus	5.9	2.7	6.65
	United States	4.8	1.5	0.32
Iron and steel	**Slovak Republic**	12.5	30.5	8.56
	Republic of Korea	10.3	7.4	3.46
	Singapore	9.6	1.5	0.30
	United States	9.1	9.2	0.70
	Czech Republic	8.7	57.8	3.47
	Russia	1.2	21.5	6.09
	Kazakhstan	1.0	9.0	12.92
	Ukraine	0.9	1.1	2.52

Sources: International Trade Centre (ITC) data for 2003 and EBRD staff estimates.

Note: The total tariff rate is the sum of *ad valorem* and specific tariffs, tariff quotas and anti-dumping measures, converted into *ad valorem* equivalents. The table shows those sectors where transition economies face the highest levels of protection.

[1] UN standard trade classification system aggregation level 2 (HS2).

The lack of regional cooperation is a significant obstacle to international integration. For instance, Armenia, Georgia, the Kyrgyz Republic and Moldova are all WTO members but more than a quarter of their trade is with other CIS countries (see Table A.4.1.1 in Annex 4.1). This is because transport and transit links remain geared towards the old trade patterns within the Soviet Union, and alternative trade routes are blocked either by regional instability or geographic barriers, such as high mountain ranges. However, following the break-up of the Soviet Union, the use of traditional transport routes now involves several border crossings. Lack of cooperation among the CIS countries regarding transport and transit issues can, therefore, dramatically increase transport costs.[31] Chart 4.4 illustrates the importance of the "border effect" based on the gravity model described earlier in this chapter. Although the border effect is significant in countries such as the Czech Republic and Hungary, it is generally largest in the CIS, and in particular in Central Asia. Box 4.2 lists some of the present obstacles to transit from the CIS and discusses potential solutions.

Regional cooperation on trade facilitation and transit could be achieved without the need for regional trade preferences. This is particularly important because the track record of regional trade blocs among

[31] See Djankov and Freund (2000) on the role of the break-up of the Soviet Union in reducing trade between CIS countries.

Box 4.2

Transit problems in the Caucasus and Central Asia

Crossing borders involves transaction costs. These are particularly significant when a country is landlocked and has difficult relations with neighbouring countries. Lack of cooperation at the regional level can not only limit trade within the region but more importantly it may increase transit costs to major markets beyond the region. Following the break-up of the Soviet Union, transport and transit costs have risen dramatically across the CIS.

Railways remain the main method of international transport in the CIS but state monopolies have maintained inefficiencies and raised the costs of transport for private shippers. Inconsistent tariff-setting is common, with private enterprises often subsidising state-owned companies. In the road sector, truckers face high traffic charges and additional unofficial demands from numerous traffic police checks. Although the railway and road network is reasonably well-developed by the standards of developing countries, the railway and haulage fleet is outdated, and transport bottle-necks exist on some key routes. Moreover, investment policy has not been coordinated among countries, leading to duplication of transport routes and inefficient operation of the transport system.

According to World Bank estimates, transport can add around 15 per cent to the cost of goods supplied to and from Central Asia, and up to 50 per cent in the Caucasus for certain commodities. The costs of trade within the region are particularly high. For instance, the transport cost of a container from Yerevan in Armenia to Bandar Abbas in Iran is US$ 1,700 for 2,800 km while the cost from Yerevan to Poti in Georgia is US$ 1,845 for just 650 km. Kyrgyz truck drivers quote a total of US$ 1,500 per truck in unofficial payments in transit through Kazakhstan to Russia. Armenian truckers have to pay US$ 1,800-2,000 for transport to Russia through Georgia for security services to protect them from the traffic police and organised crime.

These costs affect not just regional trade but transit trade as well. Transit costs are increased by the lack of mutual recognition of customs clearance forms, leading to delays, and the high transaction costs of using international certification and insurance schemes, such as the 1975 TIR Convention. This convention provides for the unhindered passage of certified road traffic in transit and dispenses with the need for customs inspection.[1]

However, shippers have to provide financial and insurance guarantees to national authorities that TIR clearance will not be abused and that the goods will not be sold into the domestic market. The absence of domestic insurance companies and banks able to provide financial guarantees greatly increases the costs of using TIR certification, and there is considerable evidence that the convention is being violated by customs officials in CIS countries. Finally, the limited presence of private shippers greatly reduces competition and adds to costs in road transport within, to and from the CIS.

Source: Molnar and Ojala (2003).

[1] See http://www.iru.org/TIR/TirSystem.E.htm

developing countries is mixed.[32] The main risk is that they lead to trade diversion – regional trading partners trading with each other instead of using cheaper suppliers worldwide. While consumers may pay less because goods travel without trade duties within the regional market, governments lose tariff revenues, which may be greater than the consumers' gains. For the CIS, there is also a danger that a regional trading arrangement would merely increase these countries' mutual dependence on each other, which could be inefficient in the longer term.[33]

The renewed impetus behind the creation of a regional trade bloc among CIS countries is not necessarily a bad thing, however. Closer regional integration may help to attract investment to the smaller peripheral CIS countries, in particular to industries that remain structurally tied to customers or suppliers in other CIS countries. Over time, closer regional integration among key CIS countries could also integrate countries that have adopted largely isolationist policies so far, such as Turkmenistan and Uzbekistan.

The prospect of liberalising initially within a regional context with some form of external protection may appear less daunting than adopting multilateral liberalisation.

The creation of a regional CIS trade bloc could also provide the political momentum to start discussions about regional cooperation on trade facilitation measures. The large CIS countries, such as Russia, Kazakhstan and Uzbekistan, have little economic interest in improving market access and transit terms for their smaller regional neighbours. Imports from the smaller neighbours and revenues earned from their transit trade are too small to provide strong incentives for cooperation. Yet, these larger countries do have an interest in preventing their more liberal regional neighbours from acting as a port of entry for third parties into the CIS market. Agreement on the application of rules of origin or on a common external tariff could provide sufficient incentives for these larger countries to stop using border controls as a means of blocking imports from third parties. Because of the adminis-trative costs of applying a rules of origin system, the more feasible option may be the creation of a customs union.

The net benefits for the smaller countries would depend crucially on the level of the external tariff. Recent experience of trade blocs among developing countries offers some encouragement. Closer regional integration in Mercosur, for instance, which has taken place alongside general trade liberalisation during the 1990s, has not only boosted trade within South America but also trade with the rest of the world. If Russia were to accept a lower level of trade protection than at present as part of its effort to join the WTO, the costs of adopting the Russian tariff as a common external tariff would be reduced.

A customs union also has its downsides, however. For CIS countries that are not currently WTO members, the creation of a customs union would require agreement on a joint negotiation position with the WTO. Membership might be delayed for

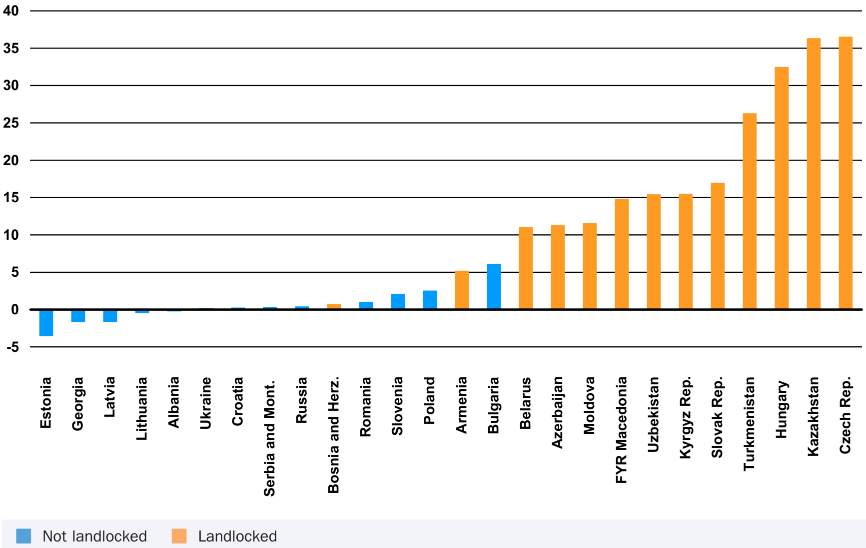
[32] See Schiff and Winters (2003).

[33] See Michalopoulos (2003).

Chart 4.4

Impact of being landlocked on a country's predicted trade with the world

Percentage point increase in the ratio of actual to predicted trade



Source: EBRD staff estimates.

Note: The chart shows the difference in countries included in a gravity model estimation, with and without border effects. The border effects are measured by a variable for being landlocked and a variable measuring the number of borders a country needs to cross to reach a trading partner. For details on the gravity model, see Babetskii et al. (2003).

countries such as Ukraine, which are currently more advanced in their WTO negotiations than Russia or Kazakhstan. Countries that are already WTO members may find that the common external tariff in a CIS customs union would be above their own commitments to the WTO.

If progress on regional cooperation could be achieved without the need for regional trade preferences, this would probably be better than the creation of a customs union. Without this possibility, the prevalence of transit and border obstacles might provide a sufficient reason to opt for closer regional integration to kick-start the process of general liberalisation. However, the efforts currently under way will need to be monitored closely to check whether this assessment is justified.

4.5 Conclusion

The integration of the transition countries into the world economy remains incomplete. Although trade has been significantly redirected from the CMEA towards Western market economies over the past decade, the transition countries as a group still trade less than might be expected in view of their income levels and location. This is true in particular for SEE and the CIS. In SEE it is largely due to the enduring legacy of regional conflict in the Balkans whereas in the CIS the main reason for the lack of integration is the weakness of economic institutions. Moreover, the lack of regional cooperation, particularly in the Caucasus and in Central Asia, greatly increases transport and transit costs to world markets and acts as an obstacle to international integration.

Overcoming the limited international integration in SEE and the CIS requires change in three areas. The first need is to improve market access – in particular, to the region's most important present and future market, the EU. Restrictions to market access remain significant in several sectors compared with those faced by many other countries. Moreover, with the completion of accession, remaining EU trade barriers against the accession countries will disappear, while in some sectors and for some non-accession countries the degree of protection they faced may increase.

The second area is the link between improved market access and the introduction of structural and institutional reforms. Neither the WTO nor the EU's commercial relations with non-EU members are likely to generate the same depth of domestic reform as EU accession. However, indirectly both could provide a significant boost to reform by providing incentives for more liberal trade policies and better economic governance. This implies that better market access on the basis of limited reciprocal trade liberalisation might be an effective approach to encourage greater openness and reform.

The third area is support for closer regional cooperation and integration to complement the process of international integration. This is reflected in the EU's Stabilisation and Association Process with the countries of SEE and could also form part of its dialogue with the CIS. Efforts at regional harmonisation and coordination of policies may be welcome if they do not delay the simultaneous efforts to complete WTO accession and if they are accompanied by a general liberalisation of trade policies. Throughout the region, preferential trade arrangements and other forms of closer regional integration need to focus on enhancing rather than diverting trade, transit and transition.

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Annex 4.1: Trade flow tables

Table A.4.1.1

Direction of trade by country between 1995 and 2002, in per cent

			Exports				Imports			
			Transition countries (TC)		Non-transition countries		Transition countries (TC)		Non-transition countries	
			Within the sub-region	Other TCs	EU	Others	Within the sub-region	Other TCs	EU	Others
Accession countries in CEB	Czech Republic	1995	25.4	6.5	54.0	14.1	14.8	11.0	55.9	18.2
		2002	15.8	4.8	68.8	10.6	8.7	8.2	71.7	11.4
	Estonia	1995	13.1	25.2	54.7	7.0	3.0	20.6	66.0	10.4
		2002	13.5	7.2	61.8	17.6	4.0	28.4	52.1	15.4
	Hungary	1995	8.4	14.0	62.8	14.9	5.6	16.7	61.5	16.3
		2002	6.6	7.2	73.5	12.8	5.1	14.2	57.5	23.2
	Latvia	1995	12.3	38.3	44.2	5.3	12.4	24.6	50.0	13.0
		2002	13.8	8.3	62.3	15.7	15.0	17.8	52.3	14.8
	Lithuania	1995	14.1	42.9	36.4	6.6	5.8	40.0	37.2	17.0
		2002	24.1	16.1	47.1	12.7	4.0	30.2	51.2	14.6
	Poland	1995	6.7	11.0	70.1	12.2	6.3	9.8	64.7	19.2
		2002	11.8	9.0	67.6	11.6	8.0	13.2	67.5	11.2
	Slovak Republic	1995	45.8	8.7	37.4	8.2	30.6	19.6	34.8	15.0
		2002	28.4	4.9	59.5	7.2	19.9	17.9	52.3	9.9
	Slovenia	1995	5.0	19.1	67.3	8.6	6.2	10.4	69.3	14.0
		2002	7.7	21.4	61.9	9.0	6.8	10.2	72.0	11.0
SEE and Croatia	Albania	1995	5.2	2.7	79.5	12.7	9.0	3.4	76.9	10.7
		2002	2.7	0.5	89.7	7.1	5.1	5.4	78.2	11.2
	Bosnia and Herzegovina	1995	16.7	16.0	55.7	11.6	44.5	25.7	23.8	6.0
		2002	20.1	9.4	64.8	5.8	24.7	28.1	42.2	5.0
	Bulgaria	1995	13.3	19.5	38.6	28.6	1.4	37.0	38.4	23.2
		2002	9.5	7.1	55.6	27.7	2.8	23.8	51.3	22.1
	Croatia	1995	10.1	20.9	57.7	11.3	0.7	19.0	62.1	18.2
		2002	16.4	14.2	52.3	17.2	2.5	22.3	55.8	19.3
	FYR Macedonia	1995	27.2	18.6	34.0	20.3	19.8	16.1	40.2	23.8
		2002	10.0	4.3	40.5	45.2	9.7	22.3	48.9	19.1
	Romania	1995	1.9	8.9	54.4	34.7	0.9	21.9	50.9	26.3
		2002	3.1	7.5	68.0	21.5	1.5	18.3	63.9	16.3
	Serbia and Montenegro	1995	0.4	0.6	57.8	41.2	8.2	0.1	72.2	19.5
		2002	4.2	7.1	81.5	7.3	8.7	11.0	68.5	11.8
CIS	Armenia	1995	47.5	0.1	22.2	30.2	47.7	2.1	15.0	35.2
		2002	33.5	0.5	32.8	33.3	25.2	1.8	24.2	48.8
	Azerbaijan	1995	39.4	2.1	17.1	41.4	30.8	3.2	12.7	53.4
		2002	13.0	1.0	63.6	22.4	29.2	1.5	31.4	37.9
	Belarus	1995	62.6	17.0	12.5	7.9	68.4	4.8	15.7	11.1
		2002	59.1	19.9	9.5	11.5	72.2	3.0	16.6	8.2
	Georgia	1995	62.5	4.1	4.8	28.6	40.1	15.9	16.1	27.9
		2002	23.8	2.6	40.1	33.4	28.6	11.3	27.8	32.3
	Kazakhstan	1995	54.9	5.1	21.4	18.6	69.7	2.3	13.5	14.5
		2002	27.3	3.1	27.6	41.9	47.2	2.6	24.7	25.5
	Kyrgyz Republic	1995	73.2	9.2	11.9	5.8	50.2	0.0	1.6	48.2
		2002	31.4	2.8	4.0	61.8	34.2	1.3	15.1	49.4
	Moldova	1995	62.6	20.4	11.6	5.4	61.7	12.7	13.7	12.0
		2002	50.7	9.6	30.1	9.6	36.0	15.1	31.3	17.5
	Russia	1995	18.5	13.3	33.6	34.6	19.3	7.2	38.8	34.7
		2002	13.4	15.0	36.0	35.6	12.5	5.3	43.2	39.0
	Tajikistan	1995	33.6	7.5	46.3	12.6	56.0	0.9	25.9	17.2
		2002	33.6	18.2	9.3	38.8	61.7	2.3	4.1	31.9
	Turkmenistan	1995	49.4	1.4	7.6	41.6	51.6	1.4	10.9	36.2
		2002	42.9	5.1	12.0	40.0	36.0	2.8	21.7	39.4
	Ukraine	1995	48.9	10.0	11.4	29.7	41.6	7.5	15.6	35.3
		2002	25.9	13.6	23.5	36.9	42.5	6.4	29.3	21.9
	Uzbekistan	1995	55.3	9.5	21.5	13.6	50.0	3.7	19.4	26.9
		2002	46.3	9.8	19.6	24.3	50.1	3.4	18.4	28.1

Source: IMF *Direction of Trade Statistics* (2003).

Table A.4.1.2

Ratio of trade by country, gravity model results, in per cent

		Baseline	Baseline Country size	Baseline Country size Border	Baseline Country size Border Infrastructure	Baseline Country size Border Infrastructure Policy	Baseline Country size Border Infrastructure Policy Institutions
Accession countries in CEB	Czech Republic	70	64	100	100	72	83
	Estonia	113	135	131	131	78	86
	Hungary	69	68	100	100	130	110
	Latvia	64	79	77	75	44	59
	Lithuania	55	64	63	64	42	56
	Poland	45	50	53	52	31	40
	Slovak Republic	43	42	59	66	49	63
	Slovenia	90	76	78	82	87	85
SEE and Croatia	Albania	8	9	8	9	7	13
	Bosnia and Herzegovina	11	14	20	22	23	34
	Bulgaria	59	72	72	75	62	81
	Croatia	47	51	51	54	36	52
	FYR Macedonia	35	40	55	60	80	100
	Romania	33	38	39	39	28	42
	Serbia and Montenegro	18	20	20	21	30	42
CIS	Armenia	13	15	20	21	23	31
	Azerbaijan	27	33	44	47	71	100
	Belarus	24	28	39	42	141	168
	Georgia	26	33	31	31	24	46
	Kazakhstan	60	133	169	163	230	269
	Kyrgyz Republic	40	62	78	79	58	100
	Moldova	25	29	41	43	38	58
	Russia	100	188	188	175	172	251
	Tajikistan	56	100	100	100	100	203
	Turkmenistan	51	100	126	124	347	465
	Ukraine	57	80	80	80	100	168
	Uzbekistan	37	53	69	71	400	385

Source: EBRD staff estimates.
Note: See Table 4.1.

Table A.4.1.3

Ratio of actual over predicted trade by country (excluding trade within the sub-region), in per cent

		Baseline	Baseline Country size	Baseline Country size Border	Baseline Country size Border Infrastructure	Baseline Country size Border Infrastructure Policy	Baseline Country size Border Infrastructure Policy Institutions
Accession countries in CEB	Czech Republic	70	60	68	75	52	53
	Estonia	115	124	125	125	79	80
	Hungary	73	67	75	71	100	75
	Latvia	62	70	70	68	43	51
	Lithuania	53	56	57	57	37	43
	Poland	46	48	50	49	33	39
	Slovak Republic	43	39	44	50	37	40
	Slovenia	100	74	78	82	100	88
SEE and Croatia	Albania	7	7	7	7	6	9
	Bosnia and Herzegovina	10	12	13	14	12	13
	Bulgaria	63	69	71	74	67	80
	Croatia	42	42	44	46	30	39
	FYR Macedonia	32	32	35	38	39	38
	Romania	34	36	37	38	29	40
	Serbia and Montenegro	17	17	18	18	20	24
CIS	Armenia	9	8	9	10	9	9
	Azerbaijan	17	19	20	21	25	28
	Belarus	14	16	17	18	43	41
	Georgia	17	19	19	19	14	22
	Kazakhstan	39	80	86	81	86	83
	Kyrgyz Republic	23	33	35	35	24	31
	Moldova	16	17	19	20	15	18
	Russia	61	123	126	116	100	120
	Tajikistan	29	42	45	44	34	43
	Turkmenistan	25	42	46	44	100	100
	Ukraine	38	50	52	51	55	75
	Uzbekistan	22	30	33	33	125	100

Source: EBRD staff estimates.
Note: See Table 4.1.

Integration through flows of capital and labour

5

Trade plays a critical role in fostering greater integration of the transition countries into the international economy. Significant progress has been made but it has been far from uniform across the transition countries (see Chapter 4). In particular, the Commonwealth of Independent States (CIS) and south-eastern Europe (SEE) have achieved far lower degrees of trade integration than the EU accession countries and this is only partly due to differences in policies.

This chapter looks at how the movement of capital and labour has aided the overall process of integration. Many of the features needed for greater trade integration are also beneficial to the mobility of capital but the same may not be true for labour mobility, which remains highly regulated.

The chapter explores the role that capital inflows can play in improving economic performance and greater integration. The main emphasis is on explaining the size and distribution of foreign direct investment (FDI), the dominant form of capital inflow across the region. As with trade, the principal beneficiaries of capital inflows have been the advanced reformers of central eastern Europe and the Baltic states (CEB) and the resource-rich countries of the CIS. A significant number of transition countries, however, have failed to attract FDI to any notable degree. These are mostly in the Caucasus and Central Asia, where shortcomings in policy as well as location and other factors have hindered inward investment.

As well as examining why capital has flowed to particular countries and not to others, the chapter looks at the impact of FDI on the performance of firms, using data from the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS). There is also a discussion of the wider benefits of FDI and the policies for realising these benefits, including steps towards greater regional cooperation (see Chapter 4).

The chapter also examines the issue of labour mobility across borders, including likely migration westwards following EU accession. The chapter looks in depth at the extent to which domestic labour markets have been integrated and the implications not only for employment but also for cross-border mobility. It concludes that labour mobility in the domestic labour markets of the transition countries remains very limited. As a consequence, movement across regions or provinces appears to play a very small part in the response to factors such as local unemployment. Unlike in the United States, for example, labour is largely immobile and this has meant that shocks to unemployment and employment have tended to persist. The reasons include lack of a functioning rental housing market and inadequate institutions for transmitting labour market information to job seekers across regions.

As well as contributing to persistent unemployment, this internal immobility has also limited cross-border mobility. Despite substantial differences in income, there has been limited movement from the transition countries to western European neighbours. This is partly due to immigration controls but it also reflects the lack of mobility in the domestic labour market. Furthermore, with such immobility, the danger is that any cross-border movement that does happen will mainly comprise skilled workers, leading to a "brain drain" from the region.

5.1 Capital flows to the region

Capital flows can play a vital role in transition. Access to foreign capital can directly enhance economic performance for a number of reasons. These include increasing the level of financing available for investment, the transfer of technology and skills, improving risk management between domestic and foreign investors, as well as accelerating the development of the domestic financial sector. Increased access to international financial markets can also lead to more stable consumption and therefore encourage more efficient specialisation. In addition, it can impose external discipline and increase a country's ability to attract further capital inflows.[1]

Since the start of transition, the region has become increasingly integrated into international capital markets. Total net (that is, inflows less outflows) private capital flows to the transition countries expanded from US$ 6.2 billion in 1989 to around US$ 23 billion in 2002. Annual net inflows peaked in 1995 at US$ 46 billion, before dropping by almost 90 per cent by 2000 following the Russian financial crisis in 1998. They have made a steady recovery since then. Chart 5.1 shows that between 1989 and 2002 the transition countries received around US$ 218 billion in cumulative net private capital inflows. While substantial, these totals are relatively small by international standards. Chart 5.1 also illustrates the uneven distribution of the net private capital flows within the region. A total of 72 per cent of net private capital inflows to the region has been received by CEB, with SEE receiving 13 per cent and the CIS 14 per cent – the latter still slowly recovering from the impact of the Russian crisis.

Better access to international capital flows can provide significant benefits but globalisation and greater mobility of international capital pose potential macroeconomic risks to recipient countries if foreign investment suddenly dries up or if there are wider global disturbances. Chapter 3 of this Report has, for example, outlined the risk of "convergence plays"[2] in the EU accession countries and the need for the transition

[1] See Prasad et al. (2003) for further evidence of the benefits and risks resulting from global financial integration.

[2] Convergence play strategies seek to profit from the differentials between interest rates in CEB countries and those in the EU and the US, based on the expectation of relatively stable or even appreciating nominal exchange rates in the region.

countries to hedge appropriately as they expand their international financial exposure.[3]

Naturally, this potential volatility differs according to the type of international capital flow. In view of its longer-term nature, FDI tends to be less volatile than most other forms of capital inflow. Moreover, studies have found that the link between FDI and economic growth has been more robust than that between all other forms of capital inflows and growth.[4]

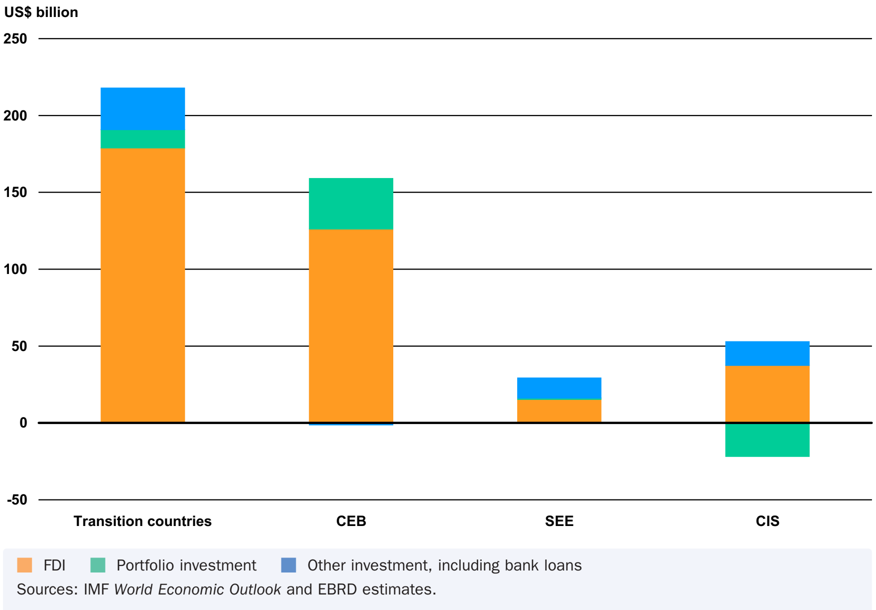
Chart 5.1 illustrates that FDI constitutes by far the largest share of total cumulative net private capital inflows to the transition countries, accounting for 82 per cent of this total. Net portfolio inflows and other net private inflows – international bank lending less deposit taking and other private flows – account for only 6 per cent and 12 per cent of total cumulative private capital inflows to the transition countries respectively. The relatively small contribution of net portfolio flows arises from the net outflow of portfolio capital from the CIS region in the aftermath of the Russian crisis. Given the importance and size of FDI relative to other capital flows, the analysis below concentrates on FDI and the ways that it can aid integration.

Chart 5.2 shows that between 1996 and 2002 the region received cumulative gross FDI inflows of US$ 177.2 billion. This represents an increasingly large share of global FDI flows.[5] Much of this was concentrated in CEB. By the end of 2002, more than 64 per cent of cumulative gross FDI inflows to the region had been received by CEB, of which almost 78 per cent was received by the Czech Republic, Hungary and Poland. Although the CIS managed to attract almost 27 per cent of cumulative gross FDI to the region, this was heavily concentrated in Kazakhstan and Russia. These two countries accounted for almost 70 per cent of gross FDI inflows to the CIS, with Azerbaijan and Ukraine accounting for a further 19 per cent. Even so, given the potential size of the Russian market, FDI receipts remain remarkably small, with cumulative FDI of only around US$ 147 per capita. This is less than 14 per cent of Poland's cumulative per capita FDI inflow over the same period. The countries of SEE have also been less successful in attracting FDI. They have received 9 per cent of cumulative gross FDI inflows from 1996 to 2002, with more than 74 per cent of this concentrated in Bulgaria and Romania.

Chart 5.3 illustrates the major sources of FDI. Germany and the Netherlands have accounted for more than 50 per cent of cumulative FDI in the Czech Republic and around 44 per cent in Hungary. Austria has also made a substantial investment in these two countries. These figures show that geographical and cultural proximity plays a key role in the investment decisions of multinational

Chart 5.1

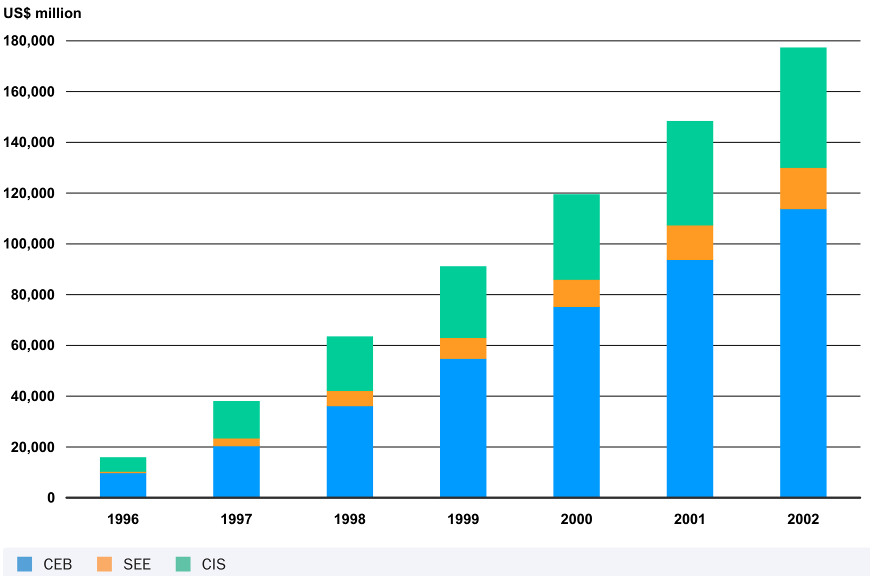
Cumulative net capital flows, 1989–2002



Sources: IMF *World Economic Outlook* and EBRD estimates.

Chart 5.2

Cumulative total gross FDI inflows by sub-region, 1996–2002



Sources: United Nations Conference on Trade and Development (UNCTAD), Vienna Institute for International Economic Studies (WIIW) and EBRD estimates.

3 See also Chapter 2 of the 2003 *Transition Report Update*.

4 See Prasad et al. (2003).

5 See Chapter 2 of the 2003 *Transition Report Update* for more details of the impact of global investor sentiment on capital flows to the transition countries.

corporations. Similarly, Italian FDI accounts for a significant proportion of cumulative FDI inflows to Bulgaria and Romania. Although the United States has a significant presence in CEB, most US investment is directed to Russia, where the United States is the largest single investor.

Chart 5.4 shows that manufacturing and general industry accounts for the bulk of FDI across the region. Among service sector activities, trade and financial intermediation have received a significant proportion of FDI in the Czech Republic and Poland. However, financial intermediation accounts for a surprisingly small proportion of FDI received by Hungary. FDI in Russia has been relatively limited, with FDI inflows to the natural resources sector accounting for around 16 per cent of cumulative gross inflows in the last three years. The fuel, food, trade and transport sectors have together received 69 per cent of cumulative FDI inflows over this period. However, the significance of the fuel sector in total FDI is likely to increase. These patterns show that investment in CEB tends to be more export-oriented while FDI attracted by the CIS tends to be directed towards domestic supply, substituting for imports.

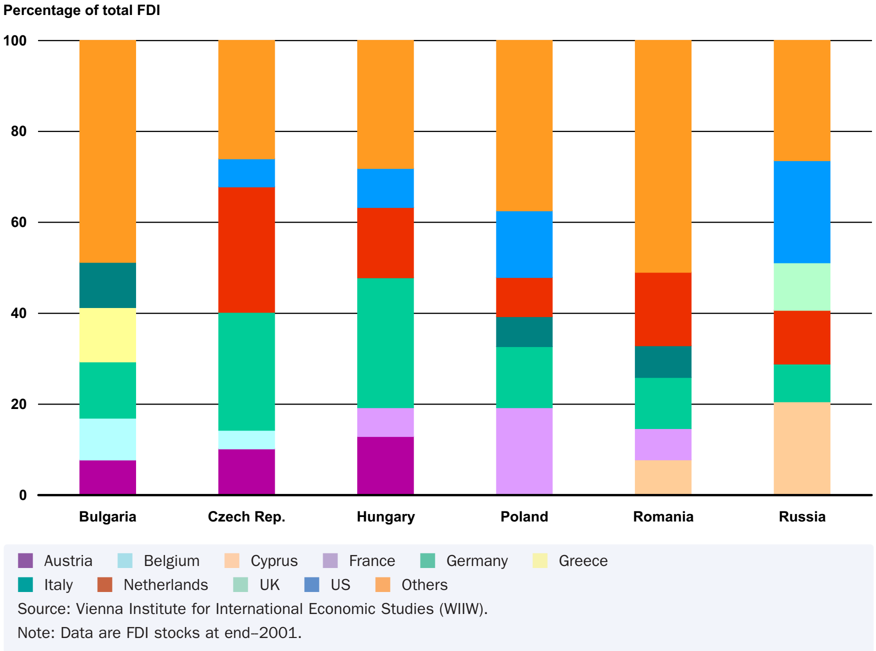
5.2 Reasons for FDI

Companies choose to operate in multiple countries for three key reasons:

- ownership advantages – these include specific assets, such as patents or brands, that provide the foreign investor with an advantage over existing local players;
- location advantages resulting from factors such as lower production and transport costs or access to specialised labour or local skills – these may also include institutional factors, such as the strength of the regulatory environment and levels of corruption;
- "internalisation" advantages resulting from market failure – the firm will benefit from retaining assets within a single corporate structure rather than licensing or franchising.[6]

Chart 5.3

Sources of FDI in selected countries

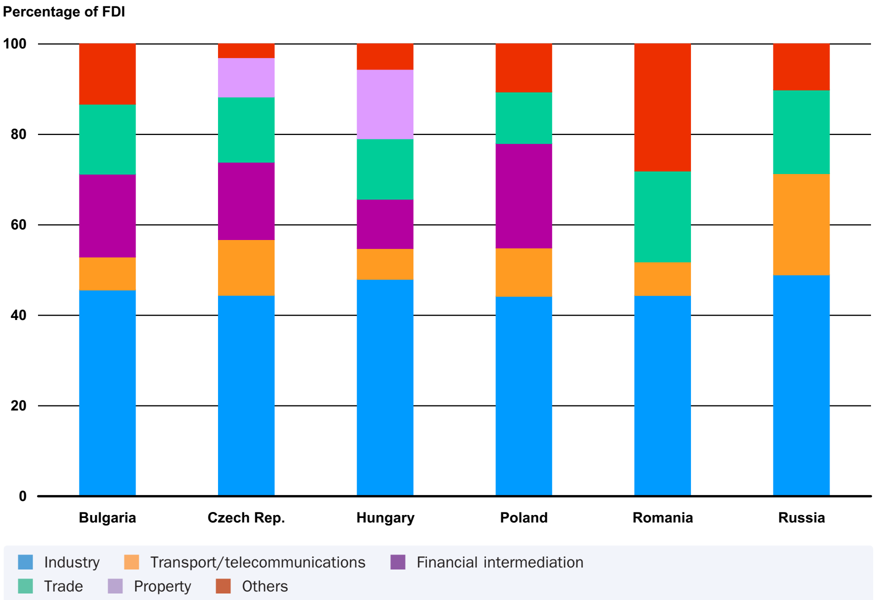


Source: Vienna Institute for International Economic Studies (WIIW).

Note: Data are FDI stocks at end-2001.

Chart 5.4

Distribution of FDI, by sector in selected countries



Sources: EBRD estimates and Vienna Institute for International Economic Studies (WIIW).

Note: For Romania, "others" includes the general category "services". Figures for Russia represent the cumulative inflow from 1999 to 2001. Data for all other countries represent FDI stocks at end-2001.

In this framework, FDI will take place only if the firm also has ownership and internalisation advantages while the location advantages determines where the investment takes place. In contrast, a firm with only an ownership advantage will tend to rely on exports, licences and the sales of patents rather than invest abroad. This suggests that there are three motivations for FDI.[7] It may be "resource-seeking" in the sense that the investment is triggered by the availability of natural resources. It may also be "market-seeking", with the aim of establishing businesses that serve a local market because of its size or growth rate,

6 Known as the OLI paradigm. See Dunning (1974, 1980).

7 See Dunning (1993).

or to overcome trade barriers. Finally, FDI may take advantage of local assets, such as a skilled or less expensive labour force or cheaper assets and infrastructure, to achieve efficiency gains.

Table 5.1 shows the relationship between these factors and the value of FDI inflows into transition countries. The results highlight the importance of the market-seeking and resource-seeking motives as well as the significance of transaction costs.[8] FDI is shown to be positively linked with the market size of the recipient country. Efficiency-seeking motives are illustrated by the negative correlation between unit labour costs and FDI. This suggests that the interaction between wages and productivity, rather than wage levels alone, is important. Finally, FDI diminishes in line with the distance between source and recipient country. Levels of FDI are typically bigger between relatively large economies but lack of familiarity with the local business environment also discourages FDI as distance increases. Other research has highlighted the importance of macroeconomic and political stability for FDI inflows.[9] The risk of instability is, for example, one of the reasons why production-sharing agreements have been developed in the natural resources sector.

Table 5.1

Impact of various factors on FDI inflows

Variables	Impact on FDI
Panel 1	
Source market size (GDP)	+***
Host market size (GDP)	+***
Relative cost of capital	+
Share of transition economy imports from EU (in per cent of GDP)	+
Transition economy risk	-
Distance between source and host country	-***
Unit labour costs in host country	-***
Panel 2	
Transition index (aggregate of reported indicators)	+*
Small-scale privatisation	+*
Large-scale privatisation	+*
Banking sector reform	+**
Non-bank financial sector reform	+
Price liberalisation	+
Foreign exchange and trade liberalisation	+***
Competition policy	+
Legal development	+***

Note: + or - indicates a positive or negative correlation and *, **, or *** show that the regression coefficient is significant at the 10, 5 or 1 per cent level respectively.

Panel 1 shows the results of analysis in Bevan and Estrin (2003). The results report findings from a random effects panel estimation of the determinants of FDI flows from 18 market economies to 11 transition countries.

Panel 2 presents the results of regression analysis by Bevan et al. (2003) which supplements the same variables as in Panel 1 with transition indicators from the EBRD.

Regional integration through regional trading blocs, for example, can have a positive impact on FDI.[10] There appears to be a significant positive link between FDI and several key milestones in the EU accession process, for example. Together with the other results, this suggests that FDI in the accession countries may have been motivated by increased market size and the reduced transaction costs of trading with an enlarged market following accession. It also implies that small, isolated countries that currently receive limited FDI could benefit from establishing liberalised regional trading blocs as FDI would be attracted by the wider regional market size. This is particularly likely in regions where transport costs are high as foreign producers will be encouraged to invest and produce locally. These regional blocs may also stimulate investment between member states (as with the EU), which could be particularly important for countries that are distant from major international sources of foreign investment.

Table 5.1 also shows that general progress in economic reform and the creation of supporting institutions – as measured by the EBRD’s transition indicators – has a positive impact on FDI in the transition countries.[11] Four factors are closely linked with FDI: private sector development; banking sector reform; foreign exchange and trade liberalisation; and legal development.

Private sector development is important because increasing private activity creates opportunities for acquisition. However, foreign investors are also attracted to firms with objectives more closely aligned to their aims. Banking sector reform is significant because it leads to reduced transaction costs and lower risk to the investor as well as future market growth through the availability of domestic credit. Similarly, foreign exchange and trade liberalisation reduces transaction costs and risk for the foreign investor and allows the foreign company to serve regional markets through trade. Finally, the positive impact of legal development and particularly enforcement highlights the importance of applying laws effectively through the courts. Transaction costs and risk will be reduced by the establishment of property rights and arbitration procedures but only if foreign investors are confident that the rule of law will be properly enforced.

These findings emphasise that the policies required to advance the transition process more generally are often, but not always, key in attracting FDI. The insignificant impact of domestic price liberalisation and competition policy suggests that foreign investors are attracted by the possibility of market power. Furthermore, foreign investors seeking competitive advantage as a result of legislative weakness in areas such as competition policy, labour law and environmental safeguards may have considerable power to lobby governments

[8] See Bevan and Estrin (2003) for more detailed analysis.

[9] See, for example, Holland and Pain (1998).

[10] See, for example, Yeyati et al. (2003).

[11] See Bevan et al. (2003).

against improving their legislation. In turn, this may reduce the quality and rate of economic growth. Unfair competition biased towards foreign investors may lead to unbalanced growth and the danger of instability if the foreign investor withdraws at a later stage.

The analysis above helps to explain the success of CEB in attracting FDI though a combination of market size, geographical proximity, low unit labour costs, supporting institutions and rapid overall progress in transition. The interaction between regional integration and the development of supporting institutions, as outlined in Chapter 4, suggests a dual problem can result from weak institutional development.

Poor progress with the development of supporting institutions appears to reduce FDI while the reduced scope for regional integration detracts from the potential for attracting FDI to serve a larger market. At the same time, the resource-seeking motive has stimulated FDI in the countries of the CIS rich in natural resources, despite their typically slower progress in transition.

Table 5.2

Impact of FDI on enterprise performance

Variables	Sales per worker (2001)
FDI	+***
Control variables	
High competition	-
Number of employees	+***
Domestic sales	-*
Reinvested profits	+***
Capacity utilisation	+*
Selection (dependent variable: FDI)	
Type of establishment (relative to the privatisation of the state-owned firm)	
Originally private	+***
Joint venture	+***
Other	+**
International accounting standards	+***
High competition	-**
Number of employees	+***
Domestic sales	-***
Number of firms	3,225
Number receiving FDI	555

Source: Business Environment and Enterprise Performance Survey, 2002.

Note: Estimated jointly using full maximum likelihood technique. + or – indicate a positive or negative coefficient. *, **, and *** denote significance at the 10, 5, 1 per cent level. Estimates include control variables for countries and sectors. The performance regression also includes controls for location (size of city). Standard errors are computed allowing for correlation of the errors within countries.

5.3 FDI inflows and enterprise performance

A common assumption is that FDI leads to the transfer of technological know-how from foreign to local firms. This could be expected to result in improved performance by the firm that receives the investment. However, the introduction of these assets may lead to a transfer of technology beyond the firm that receives the investment. For example, new processes or standards may be applied to suppliers and customers outside the sector. These are known as backward or forward linkages. Alternatively, within the sector competitive pressures and imitation of the new methods may lead to a general improvement in efficiency.

Data from the joint EBRD-World Bank BEEPS allow these theories to be tested. The latest round of the survey was conducted in 2002 and involved 6,153 enterprises in the EBRD's 27 countries of operations. Of these enterprises, 15 per cent had significant levels of FDI, as measured by foreign ownership of 25 per cent or more.[12] There was a positive link between firms receiving FDI and performance, as measured by sales per worker. The mean value of sales per worker in firms receiving FDI was more than 17 per cent greater than in other firms. There was also a positive link between FDI and restructuring measures. Moreover, the proportion of firms receiving FDI increased with the sophistication of the restructuring activity. Furthermore, firms receiving FDI were 10 per cent more likely to have successfully developed a new product line, and these firms were also twice as likely to have obtained quality accreditation.

Table 5.2 indicates that FDI enhanced the performance of enterprises in the survey, as illustrated by a positive and highly significant correlation between sales per worker and FDI. The analysis takes account of whether the enterprise has operated in a competitive environment, the number of employees, the share of sales directed at the domestic market, the percentage of profits reinvested by the firm and the extent to which capacity has been utilised. The table also provides information on the characteristics of firms that have attracted FDI. This information is important because it is necessary to take account of the fact that firms with better initial performance may be more attractive to foreign investors in the first place.[13] Some factors – such as type of establishment, its size and the extent of competition – clearly influence whether the firm has received FDI. Other studies that take account of past performance, for example, also find that enterprise performance is enhanced by FDI.[14]

There is substantial evidence that FDI has a positive impact on the enterprise receiving the investment but overall growth depends on the impact of this investment on the wider economy. The key issue is to what extent new corporate practices and technology associated with the foreign investment affect the wider economy. This can happen either "horizontally" – within the sector where the FDI firm operates – or "vertically" – outside the sector. Many case studies find evidence of horizontal benefits but

[12] The results do not change significantly if FDI is defined as including only firms with majority foreign ownership.

[13] The econometric results are obtained from a joint estimation procedure using the selection equation to control for the main regression.

[14] See, for example, Djankov and Hoekman (2000) and Smarzynska (2002).

there is limited empirical support for this finding in other studies.[15] While this may partly reflect lack of available data,[16] it may also be explained by the fact that foreign investors tend to invest in industries where their competitors are least likely to copy technological advances and where the investor can maintain a dominant position.[17] This mirrors the finding that development of competition policy does not appear to attract FDI.

There are few studies of the wider benefits of FDI in the transition economies but there is some evidence to indicate its importance.[18] A study of linkages up the supply chain from foreign investors to supplier firms in Lithuania found that the firms supplying sectors with high levels of foreign investment tended to have greater productivity, irrespective of whether the suppliers had themselves received foreign investment.[19] Moreover, this impact increased if the supplier and company receiving the investment were targeting domestic markets. On the supplier side, this suggests that domestic firms involved in international trade benefit from the use of new technological practices and adopt reverse engineering (that is, taking the final product or process to emulate the original input or technique).

For firms receiving FDI, the higher productivity reflects the fact that companies targeting the domestic market tend to source more of their supplies locally, hence improving standards in the supply chain. Finally, there is evidence to suggest that the wide-ranging benefits of FDI have been more pronounced if the foreign investor has entered into a joint venture with a local firm rather than started a new operation. This may be due to the fact that a foreign investor often forms a joint venture in order to benefit from local knowledge and access to local supplier and distribution channels. It could also reflect foreign firms entering as majority owners when they wish to minimise technology transfer to local competitors.

In short, FDI can provide substantial benefits in two ways. The introduction of a foreign investor appears to enhance the performance of firms receiving investment. There is also evidence to suggest that FDI can confer more far-reaching benefits through wider linkages in the recipient country.

5.4 Attracting FDI and encouraging linkages

The analysis above has shown that many of the measures that are important for attracting FDI are similar to those required for a successful transition process. In recent years, however, countries have increasingly attempted to attract FDI by providing incentives to multinational corporations. Fiscal incentives have been one of the most common measures, and many transition economies have employed general tax cuts (Estonia), discounts (Czech Republic, Romania and the Slovak Republic) or tax breaks and customs duty exemptions (Bulgaria and Romania). There is substantial evidence that these incentives play an increasingly important role in allowing governments to compete for FDI.[20]

The challenge is to ensure that these incentives are introduced in a non-distortionary manner. For example, targeting only foreign firms or particular sectors of the economy may reduce the competitiveness of local firms and lead to a biased allocation of resources across sectors. While FDI incentives may also be used to target specific disadvantaged regions of a country, these incentives need to be accompanied by other measures, such as improvements in infrastructure and the labour force. Moreover, given the likely importance of political objectives, governments may provide excessive subsidies that erode the fiscal base and return a substantial share of the benefit from the foreign investment to the multinational corporation. EU accession countries will also need to ensure that any fiscal incentives are compatible with EU rules on the permissible size and duration of incentives and comply with EU anti-discrimination rules. Some accession countries, such as Poland, which adopted fiscal incentives when accession was a distant prospect, are likely to come under increasing pressure to harmonise with EU law.

At the same time, governments should recognise that wider benefits do not automatically result from foreign investment. Additional policies may be required to maximise the benefits from FDI. Some countries have attempted to negotiate, for example, requirements on the proportion of local goods or labour that a foreign investor should utilise, or the level of technology transfer. However, many of these mechanisms are incompatible with World Trade Organization agreements – for example, the Trade Related Investment Measures Agreement. In addition, they may be relatively easy to circumvent, and may place an unacceptable burden on foreign investors if the local industrial base is insufficiently developed. Key therefore to encouraging linkages and using incentives effectively is the capacity of local industry.

Financial constraints can be a major obstacle in many of the less advanced transition countries but the provision of finance is only one precondition for spreading the benefits of FDI. At the national level, many of the policies required to encourage linkages also enhance economic development generally.[21] These include measures to improve the investment climate through development of the legal system, infrastructure, business conduct and corporate governance practices, and to improve skill levels and provide training

[15] Djankov and Hoekman (2000) find a significant negative effect among certain firms in their sample.

[16] See Blomström and Wolff (1994) and Kokko (1994) for examples that attempt to test this factor.

[17] See Kugler (2000).

[18] Fries and Taci (2003) find evidence of positive "spillovers" from the entry of foreign-owned banks in the financial sector in 15 transition countries.

[19] See Smarzynska (2002). This result is supported by similar studies of established market economies – for example, Kugler (2000) and Blomström (1996).

[20] See, for example, Taylor (2000). Chapter 3 of the 2001 *Transition Report* gives further details of the various incentive schemes that have been employed by the transition countries and their relative success.

[21] See UNCTAD (2001).

that can raise business standards. Government policy can also address market failures that limit the potential for linkages. Useful initiatives include establishing one-stop shops to raise local awareness of tendering opportunities and using training programmes to help local businesses win tenders.

5.5 Integration of labour markets and cross-border mobility of labour

Greater mobility of labour has not been a hallmark of transition. The reasons for this have not been fully investigated. This is surprising, given that many transition countries could benefit substantially from the easing of restrictions on cross-border mobility of labour. Indeed, the extent of labour mobility across borders is clearly important for integration, particularly for the accession countries. Yet, greater mobility also raises difficult political considerations, such as significant opposition in the countries likely to attract labour. In addition, the loss of skilled labour could have adverse consequences for the transition countries. Mobility is subject to substantial institutional barriers, including explicit controls on immigration, but another reason is the lack of integration in the national labour markets of the transition countries and the very low levels of labour mobility within the transition countries. The analysis below shows that labour mobility has not played a big part in the transition process. While there is scope for more cross-border mobility, a priority must be to ensure that national labour markets are better integrated.

Transition should have created opportunities for people from the transition countries to work abroad. Certainly, there was a great demand for travel once restrictions were lifted. Given the large differences in income and employment levels between the transition and neighbouring industrialised economies, substantial cross-border movement could have been expected. Indeed, a survey from 1997 found that in the first-wave accession countries between 20 and 25 per cent of respondents wished to work abroad on a temporary basis for several years. Much larger numbers wished to work abroad for shorter periods but the share declined substantially when asked about permanent migration.[22] Although this is only a rough guide, it suggests that migration should have risen sharply.

Yet, to date the number of people moving from the transition countries to western Europe, or the OECD in general, has been much less than predicted. Among OECD countries, Germany has attracted the largest number of people from transition countries, with an estimated 1.68 million living there in 2002, or 29 per cent of the country's total number of emigrants.[23]

Furthermore, even with the approach of EU accession, estimates of the likely flow of workers from the accession countries to current EU member countries are quite low (see Box 5.1). This is partly due to the lack of integration in domestic labour markets and the absence of information, networks and contacts that can encourage migration in the accession countries. In addition, opportunities for legal migration to OECD countries remain extremely restricted. Even so, a number of transition countries – especially in SEE and the Caucasus – have seen substantial movement of people to other countries.

The consequences of cross-border movement are complex for all countries involved. On the positive side, migration can help the transition countries integrate into global labour and capital markets with access to networks, information and finance. In addition, emigration may reduce social and fiscal pressures in countries that have seen limited improvements in economic performance and employment. A further benefit can be the remittances that migrants send back to their country of origin. Indeed, for all developing countries, in 2001 these amounted to US$ 72.3 billion, including approximately US$ 6.1 billion to the 27 transition countries.[24] This figure conceals a wide variation across the region. Most remittances have been to SEE and the Caucasus. In Albania, Bosnia and Herzegovina, Moldova, and Serbia and Montenegro remittances account for between 10 and 18 per cent of GDP. By contrast, the first-wave accession countries have on average received less than 1 per cent of GDP.

Given the difficulties faced by many countries in attracting FDI, remittances from emigrants may provide an additional route for greater integration into the international economy. These inflows tend to be stable whereas FDI inflows can be volatile and may depend on one or two large deals. A survey of enterprises in Albania suggested that remittances accounted for about 17 per cent of total capital sources for the establishment of firms. This is significantly larger than financing available through the banking system.[25] However, in general these remittances have mostly been used to finance the consumption of imports, with only a small percentage of this funding used for investment purposes. They are unlikely, therefore, to provide a sustainable substitute for other forms of capital.

The effect on the country that people are leaving also depends on the length of migration as well as the educational level of the migrants. Much of the migration from the transition countries appears to have been temporary. The 1997 survey mentioned above indicated that most respondents were considering a short stay of up to a few months. Certainly, temporary migration has potential benefits for both countries and is less likely to be associated with a brain drain.

Information about the education and skills of migrants is unfortunately limited. Some labour force data suggest that migrants are mostly qualified and represent the more skilled part of the labour force.[26] But other evidence – as for Albania – points to migration involving all skill categories. An obvious issue for the countries that people are leaving

[22] See International Organisation for Migration (1998). See also Papapanagos and Sanfey (2001).

[23] See Statistisches Bundesamt (2003).

[24] See World Bank (2003, Chapter 7).

[25] See Kule et al. (2002).

[26] See Boeri et al. (2002).

Box 5.1

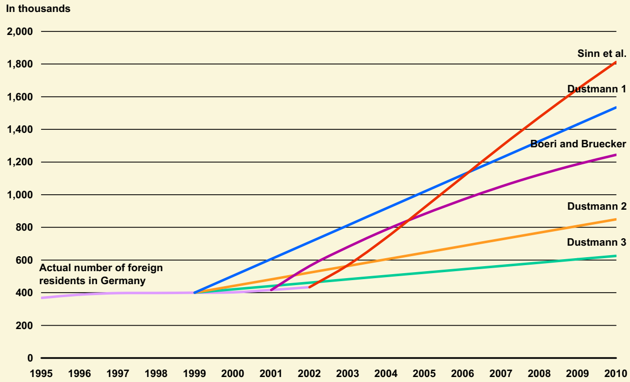
EU accession and the implications for cross-border migration

The accession of eight transition countries to the European Union[1] in 2004 has raised questions about the likely migration from new to existing EU members. In line with the earlier EU enlargement southwards, free mobility of labour from the East will be delayed for up to five years, with Austria and Germany having the right to extend this for an additional two years. Even so, the level of migration that can be expected after enlargement remains an important political issue.[2]

Estimating the likely number of migrants following accession is not easy. The experience of the EU's expansion southwards provides some insights but the difference in income between countries was much larger and other factors were significantly different from the current situation. Thus, at the time of enlargement southwards per capita income in terms of purchasing power parity for the new countries was around 60 per cent of the EU mean at that time compared with 30-45 per cent for the current accession countries. The institutional environment was also different. Finally, all the existing studies have run into problems of lack of data and have mostly relied on information on migration to Germany. The chart presents the wide range of estimates generated by some of the existing studies. It shows the number of people from the accession countries living in Germany has the potential to rise from 417,000 in 2001 to between 600,000 and 1.8 million by 2010.

Most of the predictions assume free movement of labour, which will not be introduced until the end of the decade. Predicted flows come to a halt as the income gap narrows between sending and receiving countries. Furthermore, different assumptions on employment opportunities in the relevant countries and alternative rates of convergence alter the predictions considerably. Taking all of this into account and noting that the number of migrants from central and eastern Europe living in Germany remained fairly stable over the past few years, eastern enlargement should not lead to mass migration to the EU, despite large income differences.

Actual and predicted number of foreign residents from EU accession countries in Germany



Source: EBRD.

Note: In the three scenarios from Dustmann (2003) the average estimated inflow is assumed to be equally distributed over the time span 2000-10. The study covers eight first-wave accession countries in the region, as well as Cyprus and Malta. The Boeri and Bruecker (2000) estimate is based on their baseline scenario, where missing years are interpolated linearly. It covers the eight first-wave accession countries, that is excluding Bulgaria and Romania. The Sinn et al. (2001) study covers the Czech Republic, Hungary, Poland and the Slovak Republic. Projections are linked to the actual data assuming the year of accession to be 2003, again interpolating missing years.

[1] Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia. Also acceding are Cyprus and Malta.

[2] See Boeri et al. (2002).

is the potential brain drain.[27] If better qualified – and mostly younger – workers leave the transition countries, this could hamper productivity and overall performance. Furthermore, as most transition countries face the same demographic problems of western Europe – including an ageing population – loss of young workers could have a negative impact. Loss of the relatively educated could also be expected to have political consequences. Yet, most west European countries – the principal destinations of migrants from the transition countries – openly declare the need to bring in skilled labour from the East, often employing "cherry-picking" visa programmes to facilitate this.

The likelihood of a brain drain depends on a variety of factors, such as the size of the country and the extent of skills in the workforce. People leaving the country may also offset some of the fiscal costs that arise by sending remittances – as indicated above – and, in some cases, by returning at a later date. Furthermore, much depends on how other workers and students respond to migration. If they are prompted to acquire further education or upgrade skills, this can have a positive impact on growth and performance in the country that people are leaving. This is probably the most important way of offsetting any adverse consequences of migration.[28] However, in the transition countries, the education factor has been weak and there is little evidence of emigration leading to higher enrolments and improvements in skills. Furthermore, any wider benefits from migration will be diminished if highly skilled workers move to lower skill jobs in richer countries.

In conclusion, cross-border migration has been less than expected. There is a clear need for the reform of immigration policy in OECD countries – not least to tackle the problem of illegal migration – but the introduction of immigration policies aimed at attracting skilled workers from the transition countries would have an adverse impact. There is a clear danger that integration limited to those with skills would result in a brain drain from the transition countries. Although this could be limited by the use of temporary contracts for migrants,[29] these would be difficult to enforce. Evidence from other countries suggests that skilled migrants tend to move with their families and to stay in the new country. Furthermore, for many transition countries, the principal gainers from cross-border mobility are likely to be unskilled labour. Yet it is

[27] For example, in western Europe, Mauro and Spilimbergo (1999) find that in Spain the mobility of skilled workers in response to economic shocks has been significantly greater than for unskilled workers.

[28] See Commander et al. (2003) and Beine et al. (2001).

[29] As proposed in Boeri et al. (2002).

precisely this category of workers that faces major political and immigration barriers in the recipient countries.

5.6 Integration of national labour markets

The relatively limited movement of labour westwards from the transition countries reflects the impact of immigration restrictions and domestic labour markets' lack of integration. This can be seen in the way that the labour market has coped with the challenges of transition.

Labour mobility within a country can be a key way of adjusting to macroeconomic or structural changes. But the response of market economies differs enormously. For example, in the United States a fall in employment tends to result in wages and unemployment moving in opposite directions while workers in adversely affected regions start to move to other regions. This mobility of labour creates an incentive for new employment to be created. After a major economic shock, employment tends to return eventually to its underlying rate of growth but at a lower level. Furthermore, labour mobility reduces the extent to which unemployment persists in a region after a major shock. In the United States, migration appears to be more important than job creation in the region in the adjustment to shocks.[30] By contrast, in western Europe there is much less mobility with the result that workers who are unemployed for a long period often become discouraged and stop seeking work.[31]

Compared with western Europe and even more so with the United States, the transition countries had a history of limited mobility of labour – excluding the forced migrations of the Soviet epoch. With full employment, there was constant pressure to limit turnover and restrict mobility. Particularly in the former Soviet Union, salaries often included substantial benefits, such as housing,[32] which encouraged attachment to firms. Labour market institutions did not generally make information available about vacancies in other regions. Furthermore, the absence of an effective housing market and lack of finance restricted mobility. With these initial conditions, it was always likely that significant changes in employment in a particular region would not necessarily lead to movement of labour across regions. Indeed, research conducted in the first years of transition found that mobility was not only low across the region but also there was very limited evidence of "equilibrating mechanisms", such as changes in wages and job creation, that could help lower unemployment and reduce its regional dispersion.[33]

Large differences in regional unemployment rates have remained common to all the transition countries. Table 5.3 provides measures of regional unemployment for two years – mostly 1991 and 2001. Aside from providing the national unemployment rate at both points in time, it also reports measures of regional variation.

It is clear that the differences in regional unemployment rates have not only been quite large but have also tended to grow over this period. For example, in Bulgaria the standard deviation rose from 6.1 to 7.1 while the gap between the highest and lowest regional unemployment rates rose from 16 to 23 percentage points. Further east, in Russia, not only did national unemployment more than double, but there was a substantial increase in regional differences. In short, Table 5.3 suggests that there has been very little, if any, reduction in regional disparities for unemployment.

Table 5.3
Regional unemployment

Country	Regions (NUTS) [1]	Year	National average (per cent)	Standard deviation [2]	Coefficient of variation [3]	Minimum (per cent)	Maximum (per cent)
Bulgaria	6 (II)	1991	7.4	6.1	83.4	4.1	20.8
		2001	19.9	7.1	35.8	9.7	32.8
Czech Republic	8 (II)	1991	4.3	1.4	32.6	1.2	6.2
		2001	8.0	3.3	41.1	3.0	13.6
Estonia	5 (III)	1998	9.6	3.2	33.5	7.0	16.8
		2001	12.4	3.8	30.3	9.9	21.4
Hungary	7 (II)	1991	4.1	2.0	48.6	1.7	7.0
		2001	8.5	4.8	56.3	3.2	16.0
Latvia	5 (III)	1998	14.5	7.7	53.2	8.5	31.1
		2001	13.1	7.3	55.4	7.5	28.6
Lithuania	10 (III)	1998	12.5	3.1	24.8	8.7	17.8
		2001	16.5	4.5	27.3	12.4	22.7
Poland	16 (II)	1995	12.3	2.8	23.1	8.9	20.7
		2001	18.4	3.4	18.5	12.8	24.1
Romania	8 (II)	1991	3.0	1.0	33.1	1.4	4.6
		2001	8.8	1.8	20.4	4.7	10.6
Russia[4]	74 (oblasts)	1992	4.8	1.0	20.8	2.6	9.1
		2000	12.5	3.8	30.5	4.3	24.4
Slovak Republic	8 (III)	1998	13.9	5.5	39.2	4.1	21.2
		2001	19.4	5.3	27.2	8.4	25.0
Slovenia	12 (III)	1994	17.1	4.5	26.6	12.9	26.2
		2001	5.7	2.0	34.7	2.9	8.7
Memorandum:							
France	22 (II)	1997	12.0	2.5	20.5	7.8	18.1
Spain	17 (II)	1997	21.1	5.6	26.5	10.0	31.9
US	51 (states)	1997	5.5	1.1	19.5	3.0	8.6

Sources: Accesslab (2003), OECD (2000), NewCronos Database and Goskomstat.

1 NUTS is the French acronym for Nomenclature of Territorial Units for Statistics, developed by Eurostat to measure administrative units. The number of regional levels is indicated in the parentheses.

2 Standard deviation weighted by employment or population.

3 Computed as the standard deviation, divided by the mean and multiplied by 100.

4 Throughout the analysis 15 regions were excluded from the Russian sample.

30 See Blanchard and Katz (1992). There is, however, some debate concerning measurement error – in particular, the use of census data – and the possible differences in adjustment over different time periods. See Rowthorn and Glyn (2003).

31 See OECD (2000).

32 See Commander and Schankerman (1997).

33 See Commander and Yemstov (1995).

Comparable figures for several OECD countries are also included in Table 5.3. These show that the variation in unemployment for France and the United States is roughly half the level for the Czech Republic and one-third of Hungary's level. In short, the accession countries have a much higher degree of variation than most west European countries, let alone the United States. The data for Russia also indicate a higher regional variation than can be found in most OECD countries.

Persistently higher levels of national and regional unemployment have also been accompanied by changes in labour force participation,[34] as workers have become discouraged. Table 5.4 shows that by 2000 withdrawal from the labour force – or non-participation rates – had become generally high in the transition countries. While these rates varied much less than unemployment rates across regions, they were closely linked with the level of unemployment in that region in almost all the countries reported in Table 5.4. For example, in Russia this correlation rose substantially between 1992 and 2001 from 0.39 to 0.66. In other words, high unemployment and the participation rate in a region have tended to move in opposite directions.

Part of this may be explained by changes in labour force participation rates – for example, by females wishing to work less than in the planned economy. However, the main reason appears to be that high unemployment discourages job search. In this regard, the transition countries appear to have more in common with parts of western European than with the United States.[35]

In response to economic shocks, a number of equilibrating mechanisms could be expected to operate. Indeed, the sensitivity of regional wages to regional unemployment has grown in all the countries for which data are available. There is a strong association between a region's unemployment rate and the rate at which wages increase in relative terms. This is particularly evident in CEB. However, in Russia this relationship remained very weak over the 1990s.[36] In addition, differences in rates of net job creation should also play a major role over time. Yet, regions that have experienced relatively large increases in unemployment have not subsequently experienced greater increases in employment. This suggests that unemployment has had a weak, delayed impact on net job creation in the region.[37]

With these large differences in regional unemployment rates, greater movement of labour within national boundaries might have been expected as workers move to areas where jobs can be found. However, data suggest that there has been limited movement of labour across regions in response to economic signals.

Table 5.5 provides migration rates for a number of transition countries as well as some OECD countries for the early 1990s and 2000. What is immediately

Table 5.4

Non-participation rates in the labour force

Country	Regions (NUTS)[1]	Year	National average (per cent)	Standard deviation	Coefficient of variation	Minimum (per cent)	Maximum (per cent)	Correlation with unemployment rates
Bulgaria	6 (II)	2001	38.1	2.1	5.4	35.5	40.9	0.65
Czech Republic	8 (II)	2001	28.8	2.3	8.0	23.4	31.9	0.80
Estonia	5 (III)	2001	23.6	2.6	11.1	18.2	27.1	0.29
Hungary	7 (II)	2000	40.6	4.2	10.4	34.7	46.7	0.96
Latvia	5 (III)	1999	29.2	3.7	12.5	26.4	35.9	0.72
Lithuania	10 (III)	2000	27.0	3.3	12.1	22.1	35.1	-0.24
Poland	16 (II)	2000	34.8	9.2	26.5	21.0	52.8	0.47
Romania	8 (II)	2001	38.9	3.2	8.2	34.6	46.2	-0.27
Russia	74 (oblasts)	1992	11.4	6.7	58.4	2.5	34.3	0.39
		2001	18.1	3.8	20.8	10.2	32.9	0.66
Slovak Republic	8 (III)	2000	30.7	3.6	11.8	23.9	33.4	0.97
Slovenia	12 (III)	2000	31.0	1.8	5.7	28.8	33.6	0.28

Sources: Accesslab (2003), OECD (2000), NewCronos Database and Goskomstat.

1 NUTS is the French acronym for Nomenclature of Territorial Units for Statistics, developed by Eurostat to measure administrative units. The number of regional levels is indicated in the parentheses.

Table 5.5

Migration rates in selected countries

Country	Gross migration rate (per cent)		Ratio of net to gross migration	
	1990	2000	1990	2000
Czech Republic	0.6 [a]	0.5	5.3 [a]	13.1
Estonia	1.2	0.5 [b]	4.9	4.6 [b]
Hungary	1.9	1.4	7.4	3.6
Poland	0.4	0.3	14.5	14.4
Romania	na	0.3	na	7.2
Russia	2.4 [c]	1.8	12.8 [c]	8.2
Slovak Republic	3.0	0.2	na	10.3
Slovenia	0.3 [d]	0.3	5.6 [d]	8.5
Memorandum:				
France	1.4	1.6 [e]	na	na
Spain	0.7	na	11.7 [f]	na
US	3.3	2.2 [e]	15.4	na

Sources: Accesslab (2003), OECD (2000), NewCronos Database and Goskomstat.
Notes: a: 1993; b: 1999; c: 1992; d: 1991; e: 1998 and f: 1996.
The gross migration rate is defined as the fraction of internal departures (or arrivals) to the population of the country. Net to gross migration is calculated as the ratio of the sum of absolute values of regional net migration, multiplied by 0.5 to gross migration, multiplied by 100. Regional levels are defined in Table 5.3.

34 See Huber (2003).

35 See Decressin and Fatas (1995).

36 If wage arrears could be taken into account, it is possible that a more conventional inverse relationship would be found. However, wage arrears have been declining in recent years.

37 This section is based on findings in Bornhorst and Commander (2003).

obvious is that – even in the advanced reformers of CEB – gross migration rates have remained very low.[38] Apart from Russia, the highest gross rate is in Hungary. Yet, this was lower than the rates for France and the United States. Migration rates in the Czech Republic, Poland, Romania and the Slovak Republic have remained even lower than for France and the United States, with the Czech and Polish rates roughly comparable to Spain.

Furthermore, in most of the transition countries reported in Table 5.5, migration rates either declined or remained stable through the 1990s. The ratio between net and gross migration in the Czech Republic, Poland and the Slovak Republic shows that a relatively high share of migration has resulted in actual population change. These ratios are comparable to many west European countries, including Spain, but they are clearly lower than the United States.[39] Russia had a fairly high gross migration rate in the early 1990s but this has dropped to European levels. The ratio of net to gross flows has also fallen considerably below the 1990 west European levels.

Although migration rates within the region have remained low, the question is whether this migration has been driven by job opportunities and, in particular, whether regions with relatively low unemployment rates and relatively high income levels have attracted more people seeking work. The evidence suggests that in CEB net migration has indeed been greater in regions with lower unemployment and higher per capita incomes.[40] However, the relationship is not strong. In Russia there is some evidence that migration flows increased over the 1990s, albeit from very low levels. This movement has been partly in response to differences in regional income levels and other economic incentives but the link remains weak.

Furthermore, for many regions very low income levels have been associated with "mobility traps" which keep workers in long-term poverty. Up to one-third of the Russian population may be in such a position.[41] In conclusion, migration has remained quite limited in the transition countries. Any movement tends to be from relatively poor or high unemployment areas to regions with relatively low unemployment and higher incomes. However, the scale of movement has not been large, nor is there a strong link between migration and economic conditions.[42]

A number of factors explain these low rates of migration. In Russia and the CIS there was little voluntary migration throughout the Soviet period and as a consequence little or no institutional support for those wishing to move. As salaries were skewed towards non-monetary benefits, such as housing and child care, workers have tended to remain attached to particular firms even if the actual value of those benefits has tended to decline over time. Relocation costs, poor information about job opportunities in other regions and the importance of local cultural and social ties have also limited migration.

In much of central and eastern Europe the fact that owner-occupied housing was always dominant may also have limited migration.[43] In market economies, it has been argued that owner-occupation can impede mobility through high transaction costs and large differences in house prices across regions.[44] Even in countries where owner-occupation has been less prevalent – as in Russia – lack of clarity over property rights, coupled with the low average quality of the housing stock, have combined to make relocation difficult.

The inability to improve the functioning of the housing market has been a major factor in limiting mobility. On the supply side, new housing has remained generally low. Public sector construction has declined sharply, with only limited activity by the private sector. This is partly due to problems with land title and affordability and the lack of long-term finance for prospective purchasers. By 2000 the volume of outstanding housing loans did not exceed 5 per cent of GDP in any transition country.[45] By comparison, in Germany, the United Kingdom and the United States such loans exceeded 50 per cent of GDP. At the same time, continuing uncertainties regarding land title, cost-sharing arrangements for communal areas and energy provision for apartment blocks – particularly in the CIS – have held back the development of a housing rental market. This remains a key constraint to increasing mobility and ultimately to reducing regional disparities in employment.

5.7 Conclusion

Integration of the transition countries into the international economy has proceeded at different speeds and with different degrees of success. Parts of the region have been able to attract significant capital flows, mainly in the form of FDI. By contrast, movement of labour has remained quite limited. Using data at the firm level, FDI can have a notable impact on the performance of recipient firms and on the overall performance of the economy. However, FDI has remained concentrated in terms of location and, to a lesser extent, sector. In general, policies conducive to better integration through trade have also promoted FDI.

[38] This gives the share of the population that moved across region in a given year.

[39] See OECD (2000).

[40] See Bornhorst and Commander (2003).

[41] See Andrienko and Guriev (2003).

[42] The numbers reported above do not take account of commuting – which appears to have become more prevalent over time – but this would not significantly modify the overall picture of limited internal labour mobility.

[43] In Hungary, Poland, Romania and Slovenia, owner occupancy in 1999 ranged between 70 and 90 per cent of the housing stock – see OECD (2002).

[44] See Oswald (1999).

[45] See OECD (2002).

Indeed, most FDI has been directed towards the advanced reformers of CEB and, to a lesser extent, the resource-rich countries of the CIS. The majority of the transition countries have failed to benefit to any notable degree from FDI or other capital inflows. This is due not simply to deficiencies in economic policy but also to location and relative lack of natural resources.

While these deficiencies can be addressed in a number of ways – including through careful use of investment incentives – a number of transition countries, principally in the Caucasus and Central Asia, face major hurdles in increasing inward investment. It is possible that steps towards greater regional integration could not only improve the flow of goods but also encourage investment. Although mostly beneficial, capital inflows can also carry serious macroeconomic and financial sector risks, particularly for countries with weak domestic financial systems and poor supervision and regulation. As regards the EU accession countries, the acquisition by investors of high-yielding assets in the expectation that they will appreciate in value with the advent of accession could be reversed suddenly if the expectations are no longer held with sufficient confidence. There is also a danger of excessive borrowing by accession countries in the expectation of a decline in loan costs through an appreciation of the real exchange rate.

In terms of labour flows, movement westwards from the transition countries has been quite limited and may well remain that way, even with the advent of EU accession. This fairly low mobility of labour is puzzling considering the potential gains for individuals and countries from greater mobility. One of the stumbling blocks may be the immigration barriers in the recipient countries. These barriers reflect political pressures and result in increasing illegal immigration. Another reason for limited movement of labour is the lack of effective integration in domestic labour markets in the source countries.

As transition has proceeded, recorded unemployment rates have tended to rise and the differences in regional unemployment rates have grown. Unemployment has tended to be persistent and job creation or labour mobility have had little impact. A large number of regions in the transition countries have high unemployment, a declining workforce and limited labour mobility. Workers in these regions can easily be caught in a poverty trap. To prevent this, policies are needed to improve information about job opportunities, to introduce an affordable rental market for housing and to eliminate benefits that discourage mobility.

Gains from wider integration will require far more progress towards the integration of domestic labour markets. Without this, employment rates will remain low and any gains from greater cross-border mobility are unlikely to be realised. Furthermore, it is not necessarily the case that cross-border mobility will be good for the transition countries. The types of workers who are likely to move will be young, skilled and relatively affluent, leading to the danger of a brain drain. One way of reducing this danger would be to use temporary contracts for skilled workers to ensure that they return to their home countries or incur a penalty directed at both worker and employer. Such proposals are, however, difficult to implement. Enforcement will remain a major problem, as does the issue of differences in worker rights in national labour markets.

An obvious remaining concern is the ability of capital flows, particularly FDI, to boost capital formation, job creation and growth in the transition countries. While the ratio of FDI to GDP has been about 5 per cent over the past five years in the accession countries, it remains far higher than in the non-accession countries, which are not likely to attract comparable inflows, even with the adoption of better policies.

Furthermore, although greater movement of capital can have a positive impact on labour demand in the country receiving capital, high mobility of financial capital alongside low mobility of labour can also accentuate fluctuations in employment as only capital can respond to external shocks. This is obviously less true for real capital formation. However, it emphasises the point that the remaining challenges of transition and integration are not only for countries to attract inward investment but also to address the reasons why mobility of labour remains so restricted.

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Annex 5.1: Foreign investment and the environment

Integration affects not only the economies of transition countries but also their natural environment. However, there are conflicting views about whether integration will have a positive or negative impact on the environment. On the one hand, there is concern that economic integration may promote "pollution havens", with polluting industries relocating to areas that offer more lenient environmental regulation. Moreover, countries competing for foreign direct investment (FDI) might use lower environmental standards to attract investors in an environmental "race to the bottom". On the other hand, FDI is associated with skill and technology transfer and can act as a channel through which cleaner technologies, superior environmental management and good corporate behaviour can be introduced. There is no firm evidence to indicate which of the two views is more accurate.[1] However, the performance of foreign investors in particular countries gives some indication.

This annex presents the experience of Hungary, Kazakhstan and Ukraine as case studies to explore how the behaviour of foreign investors, stakeholder pressure and government regulations have combined to affect the environment. The case studies tackle two questions:

- To what extent has FDI helped to improve environmental performance? To answer this, the case studies look at the nature of the FDI (for example, greenfield or brownfield investment and current levels of pollution in the target sector) and the environmental policies of the foreign investors (including their approach to transparency and public participation).
- What has influenced the environmental performance of the foreign investors? A distinction is made between domestic pressures (such as government regulation and local stakeholder pressure) and external factors (for example, concern about the company's global image, and shareholder demands).

Overview

The case studies of Hungary, Kazakhstan and Ukraine suggest that the environmental impact of FDI is less severe than the "pollution haven" view proposes but it has not been uniformly positive.

The inflow of FDI since the beginning of transition has been too modest to significantly affect the economic structure of the three countries. However, FDI may have helped to shift Hungary and, to a lesser extent, Ukraine towards less polluting activities, such as services, finance and trade, which have attracted a high proportion of FDI relative to their share in GDP (see Chart A.5.1.1). In resource-rich Kazakhstan, by contrast, FDI has clearly been targeted at the oil and mineral sector, and has therefore supported the country's concentration on a sector with inherent environmental risks. However, the presence of foreign investors seems to have at least enhanced the management of environmental risks, even if further improvement is still needed, particularly in the disclosure of information and the involvement of local people.

FDI in brownfield sites and the modernisation of existing plants have generally led to environmental improvements – either as a condition of foreign investment or as part of the investment – and the installation of better technology. However, a large proportion of FDI has been in greenfield projects, particularly in Hungary. These can lead to wider environmental improvements if the investors impose environmental standards on their suppliers or demonstrate best practice. However, these benefits are difficult to measure.

A useful indicator of the good environmental behaviour of foreign investors is their inclusion in corporate social responsibility (CSR) indices, such as the FTSE4Good Global Index or the Dow Jones Sustainability Index (DJSI).[2] As Chart A.5.1.2 shows, Hungary has attracted an above average proportion of firms included in these two indices. In Ukraine the ratio is about average and in Kazakhstan it is below average. This suggests that Hungary may have derived greater environmental benefits from foreign investment than the other two countries.

However, foreign investors do not automatically apply the same standards imposed in their home country to their foreign operations. Additional incentives, such as regulatory requirements or stakeholder pressure, are usually needed. In Hungary these include the standards imposed by trading partners in Western export markets, regulatory requirements and pressure from local people and non-governmental organisations (NGOs). NGO pressure can be particularly effective when firms have a brand name to protect or if there is a highly visible operation, such as a large oil and gas investment.

In Kazakhstan and Ukraine the main driving force for good environmental practices has been the investors' concern about their global reputation whereas local pressure has been absent or weak, and environmental regulation and/or enforcement have been uneven. The environmental standards imposed by international financial institutions (IFIs) have also helped to improve the environmental performance of companies with IFI backing. However, where IFIs have been less active – for instance, in Hungary and in the Kazakh natural resources sector – their influence has been limited.

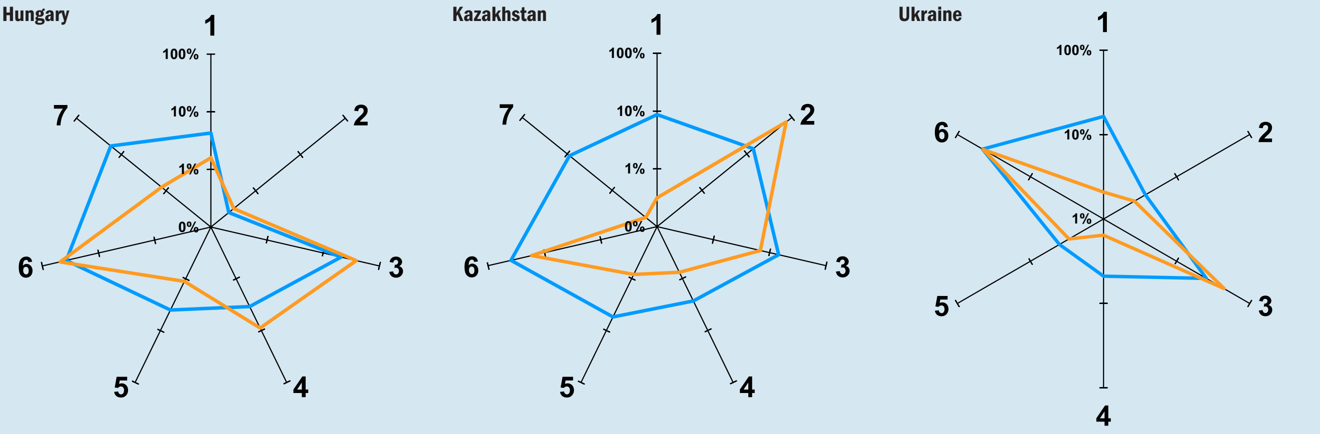
1 Empirical tests of the "pollution haven" hypothesis with respect to FDI in transition countries include Auer and Reuveny (2001) and Smarzynska and Wei (2001). For a more general discussion, see Fredriksson (1999), OECD (1999) and Ötgüçü (2001).

2 These two "best in class" indices include the firms listed in the FTSE Developed and the Dow Jones Global indices, which follow good practice in their social and environmental, health and safety policies.

Chart A.5.1.1

Sectoral breakdown of FDI and GDP

(in per cent)



GDP 1999 — Cumulative FDI until 2001

1 – Agriculture, forestry and fishing
2 – Mining and quarrying
3 – Manufacturing
4 – Electricity, gas and water supply
5 – Construction
6 – Market services
7 – Non-market services

Sources: EBRD and United Nations Conference on Trade and Development (UNCTAD).

Note: The axes show the fraction of total FDI reaching a particular sector and that sector's share in GDP. The axes are scaled logarithmically. In Ukraine, axis six represents both market and non-market services.

The risk of "pollution havens" appears to be highest in countries where there is little domestic pressure – that is, where environmental regulation is insufficient or poorly enforced and where local NGOs are ineffective. The risk is also high if FDI is provided by investors with neither CSR credentials nor IFI co-lenders. The absence of domestic pressure is particularly problematic in many of the less advanced transition countries. However, in these countries investors are also more likely to invest alongside IFIs, which in turn will insist on sound environmental procedures. Environmental problems are therefore more likely to be associated with domestic enterprises, particularly the unreformed state conglomerates.

In general, environmental regulation is a minor consideration for investors when deciding where to invest. Investor surveys such as the EBRD-World Bank 2002 Business Environment and Enterprise Performance Survey (BEEPS) rarely list environmental regulation as a key concern of investors. Investors tend to look at other issues, such as the business environment, the tax regime, labour supply, and the size of the domestic market.[3]

As in other areas of regulation, industry is more concerned about the predictability, transparency and equal application of environmental regulation rather than the severity of the regulations. Lower environmental standards seem to have been caused not so much by using lenient regulations to attract investors than by a lack of regulatory capacity to properly monitor and enforce the regulations. This indicates that there is a need to address these regulatory shortcomings rather than try to restrict the inflow of much-needed investment.

In the following case studies, the relationship between foreign investors' environmental policies and their actual environmental performance in Hungary, Kazakhstan and Ukraine is explored in more detail.

Hungary case study

Composition of FDI

Between 1990 and 2002, FDI in Hungary exceeded US$ 25 billion or US$ 2,500 per capita. About 45 per cent of the investments were absorbed by "clean" industries (telecommunications, banking and finance, retail and food packaging – see Chart A.5.1.1). Most of the FDI in manufacturing was directed towards greenfield investments to avoid the environmental liabilities associated with existing facilities, and to allow new plants to be built to the highest technical and environmental specifications.

Environmental policies of investors

Of the 32 largest foreign investors in Hungary, 13 are currently listed on either the DJSI or the FTSE4Good Global Index, and five are listed on both (see Chart A.5.1.2). The majority of large foreign firms in Hungary have stated their commitment to continuous environmental improvement. Most of the Hungarian subsidiaries of foreign firms publish environmental information in Hungarian on their Web sites, including environmental policies and annual reports. This is because firms sometimes need to demonstrate transparency to be eligible for environmental grants – especially in the case of utility companies – but it also indicates that companies wish to maintain a good public image in terms of their environmental performance.

Most greenfield investors in Hungary subscribe to ISO 9000 quality and ISO 14000 environmental management

[3] See OECD (1999). For a general discussion of the BEEPS results, see 2002 *Transition Report*.

standards and require their suppliers to do the same.[4] The environmental impact of these investments therefore covers the whole supply chain of an investment.

Foreign investors in brownfield sites have contributed significantly to the clean-up and reconstruction of outdated technologies. Some foreign-owned property developers have also contributed to clean-up – for example, by building shopping centres on derelict industrial sites. In total, an estimated US$ 5 billion has been spent on environmental remediation in Hungary since the beginning of transition.[5]

Compared with the positive environmental impact of FDI in the manufacturing sector, its impact in privatised utility companies has been modest. Most foreign-sponsored utilities were able to negotiate the same exemptions from national environmental standards that their state- or municipality-owned predecessors enjoyed. However, after the exemption period elapses, foreign investors should be in a better financial position than the cash-strapped public utility companies to finance the necessary environmental investments.

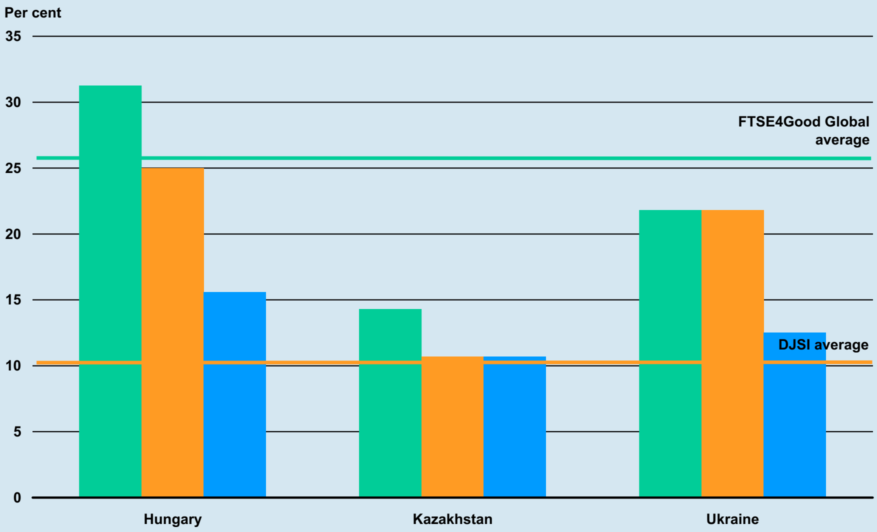
Incentives for environmental performance

There is strong pressure within Hungary to ensure good environmental performance by both foreign and domestic firms. Hungary has strict environmental standards which conform to EU rules, and their enforcement is stringent. Foreign investors do not enjoy preferential treatment. Environmental pressure groups have been active in Hungary for almost two decades. The level of public awareness of environmental problems is high, and "green" issues are regularly covered in the media. Public expectations of both environmental information and high environmental performance have prompted companies to increase their environmental transparency and accountability.

The key external incentive for environmental compliance seems to be market demand. Hungary's main export market is the EU, where ISO 14000 certification is often a requirement for market access. More than 400 companies in Hungary – about half of them foreign-owned – have obtained this certification so far. The environmental standards imposed by IFIs have had less influence on environmental performance, as IFI investment has been comparatively small.

Chart A.5.1.2

Proportion of largest foreign direct investors listed on environmental indices



FTSE4 Good Global Index DJSI Both

Source: EBRD.

Note: The graph shows the percentage of foreign investors included in either, or both, the FTSE4Good Global Index and the DJSI. The results are compared with the percentage of firms on the FTSE Developed and Dow Jones Global indices that qualify for the FTSE4Good and DJSI, respectively.

Kazakhstan case study

Composition of FDI

FDI in Kazakhstan has reached over US$ 12 billion. Foreign investment is heavily biased towards the natural resources sector, which received over 85 per cent of FDI in 2000 (see Chart A.5.1.1). The oil and gas sector has a number of major greenfield projects sponsored by international consortia while brownfield projects dominate in the mining and industry sectors.

Environmental policies of investors

Of the 28 largest investors in Kazakhstan, five are listed on the FTSE4Good Global Index, and three are listed on both the FTSE4Good and the DJSI. All of these are European oil companies (see Chart A.5.1.2).

In the mining sector, after years of under-investment and weak regulatory supervision, increased foreign investment has helped to introduce advanced technology and management in a sector that poses huge environmental challenges. The corporate environmental policies of foreign investors operating in the oil and gas sector state that they will meet or exceed local and national environmental requirements. Many commit themselves to "promoting best practice" but without stating any specific international guidelines or performance standards.

Very limited information is publicly available on the environmental performance of foreign investors, as performance standards are typically defined under Production Sharing Agreements or concessions, which are not public documents. The information released to the public has been criticised by national, regional and international NGOs as being too general. The need for investors to release environmental information is all the more important since there is limited access to environmental information through governmental channels.

[4] The International Standards Organisation (ISO) 9000 Series relates to Quality Management Systems and the ISO 14000 Series to Environmental Management Systems. In both series, 001 sets the standard for production, 002 for product development and design, and 003 for services.

[5] Estimated by Növekedéskutató Intézet (Development Research Institute), Budapest.

The local environmental regulator claims that the involvement of foreign investors has generally reduced the level of emissions from the industrial sector. However, regulators are also aware of cases where foreign investors have breached the environmental provisions of their licences.

Incentives for environmental performance

For smaller – and less well-known – investors, environmental performance is prompted primarily by the need to comply with national environmental legislation. However, in general terms regulation does not provide a strong incentive for environmental compliance. The system of pollution charges is complex and collection has been inconsistent. In addition, environmental charges, fines and penalties provide significant revenue for the state and regional environmental authorities, so government pressure on companies to cut pollution has been limited.[6]

The local NGO community, while still underdeveloped, is becoming more vocal, and the environmental performance of foreign investors is increasingly scrutinised. However, the major factor for large international investors remains external pressure resulting from the high visibility and risks to their reputation associated with projects in the natural resources sector. OECD-based companies in particular are under pressure from regional and international groups to implement the commitments in their corporate policies on sustainable development. Companies also like to include social measures or programmes that raise their public image locally.

The environmental and social standards of IFIs have not been a major influence on environmental performance to date, as IFI investment in the natural resources sector has been small. However, where IFIs have been involved, their requirements have helped to make environmental and some social improvements. Importantly, IFIs also promote improved transparency and demand more extensive public information and disclosure than required under national law.

Ukraine case study

Composition of FDI

Since the start of transition, cumulative FDI in Ukraine has amounted to US$ 5.6 billion or about US$ 117 per capita. This has been channelled primarily into relatively clean sectors, such as trade, food processing, and to a lesser extent, light industry and financial services (see Chart A.5.1.1). Substantial sums have also been invested in the small oil and gas sector, mostly by Russian companies. Compared with Hungary, more investment was channelled into the modernisation of existing facilities although the share of start-up companies is still substantial.[7]

Environmental policies of investors

Many of the largest OECD-based foreign investors in Ukraine publicise their CSR credentials through the publication of periodic Corporate Environmental Reports or Sustainability Reports. Some have implemented good environmental management practices and received ISO 14001 certification for parts of their business. Of the 32 largest investors in Ukraine, ten are currently listed on either the DJSI or the FTSE4Good Global Index, and four are listed on both indices (see Chart A.5.1.2).

Publicly available information on the environmental aspects of specific investments is limited. However, the majority of foreign investors in Ukraine claim that their foreign operations comply with national health, safety and environmental laws and standards.

Incentives for environmental performance

Over the past ten years, regulation has not provided an effective incentive for companies (whether locally owned or foreign-owned) to improve their environmental performance. Environmental fines have traditionally been lower than the cost of introducing environmental measures, and the rate of enforcement has been low and inconsistent. Arguably, regulation is gradually becoming more important as environmental charges increase and the level of environmental enforcement improves. However, recent recommendations from the OECD suggest that a fundamental reform of the charges system is required to make it more effective.[8]

There is no evidence to suggest that foreign investors have experienced significant pressure from local consumers or NGOs relating to their environmental performance. In general, the level of local NGO activity in Ukraine is low compared with other CIS countries, and international NGOs have focused primarily on the nuclear sector.

The willingness of foreign investors to adopt high environmental standards in their operations in Ukraine appears to be due primarily to corporate policy commitments and the environmental requirements of IFIs, such as the International Finance Corporation and the EBRD. These have a significant influence because of their high level of activity in the country.

[6] See OECD (2002, 2003).

[7] See Bilsen and Van Meldegem (1999).

[8] See OECD (2002, 2003).

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Country assessments

Transition assessments, structural and institutional indicators and macroeconomic indicators

Since 1994 the EBRD has charted the transition progress of each of its countries of operations in the *Transition Report*. The Bank's annual assessments have highlighted key developments and issues central to transition in a wide range of areas, including liberalisation, macroeconomic stabilisation, privatisation, enterprise, infrastructure, financial and social sector reform. The key challenges facing each country are summarised at the beginning of the text. The assessment is complemented by a timeline of important historical events in the transition process.

To provide a quantitative foundation for analysing progress in transition, each country assessment includes a set of tables containing structural and institutional indicators, an overview of selected institutional and legal arrangements, as well as macroeconomic indicators. Compared with earlier Reports, this year's tables contain a revised series for the price liberalisation transition indicator (as explained in Box 2.1) and a new indicator on poverty, which is based on the US$ 2 per day international poverty line published in the World Development Indicators. All data are as of September 2003.

These data help to describe the process of transition in a particular country, but they are not intended to be comprehensive. Given the inherent difficulties of measuring structural and institutional change, they cannot give a complete account or precise measurement of progress in transition. Moreover, some entries, such as the exchange rate regime and the privatisation methods, are useful only for information and carry no normative content. Other variables may have normative content, but their evaluation may vary depending on the specific country context.

The data should be interpreted with caution also because their quality varies across countries and categories. The data are based on a wide variety of sources, including national authorities, EBRD staff estimates and other international organisations. To strengthen the degree of cross-country comparability, some of the data were collected through standardised EBRD surveys of national authorities. The technical notes at the end of this section provide definitions of the variables, along with country specific qualifications.

Albania

Key reform challenges

- Implementation of the government's action plan to improve the business environment, by combating corruption and strengthening law enforcement, is central for private sector development and foreign investment.
- Accelerating energy sector reform, including further liberalisation of tariffs and privatisation, are crucial to resolving the energy crisis.
- The dominant position of the sole remaining state-owned bank continues to restrict competition in the banking sector. The completion of its privatisation will help to improve banking services.

Liberalisation

Negotiations on a Stabilisation and Association Agreement commence.
Albania began formal negotiations with the EU on a Stabilisation and Association Agreement (SAA) in January 2003. The focus of the SAA will be to improve standards of governance, strengthen state institutions and the legal framework, and increase Albania's international economic cooperation. To this end the government is accelerating reforms, especially in the fight against corruption and organised crime.

Bilateral free trade agreements signed with all neighbouring countries.
By May 2003 Albania had signed free trade agreements (FTAs) with all neighbouring countries in south-eastern Europe. An agreement with Kosovo was also signed in July 2003. While FTAs with FYR Macedonia and Croatia were applied in July 2002 and June 2003 respectively, and with Bulgaria and Kosovo in September 2003, the remainder of the agreements are to come into force by the end of the year. As part of the SAA negotiations, Albania has started talks with the EU on trade liberalisation. A gradual decrease of domestic customs duties by 2009 is envisaged.

Stabilisation

Efforts to improve tax collection and broaden the tax base continue.
Tax and customs revenue collection continue to be low relative to GDP, although revenues were close to the government's target in the first half of 2003. The government has taken a number of steps to improve revenue collection, including a restructuring of the tax administration and the introduction of a new excise law in July 2003. It is anticipated that the new law will result in higher revenues, following a change in the methodology for calculating excise duties from *ad valorem* to fixed rates per unit. The new law also unifies the excise duty on both imported and locally produced goods, in line with WTO rules. Further, the tax directorate will gradually replace the Social Insurance Institute as the collector of social and health insurance contributions from September 2003. This is expected to boost revenues and decrease income tax evasion.

Privatisation

Large-scale privatisation delayed.
Political uncertainty during 2002 and the continuing low level of interest shown by foreign investors have contributed to delays in the large-scale privatisation programme, especially in the oil sector. Preparations for the privatisation of the Albanian Petroleum Company (Albpetrol, oil and natural gas extraction) and Albanian Refining and Marketing Oil (ARMO, refining) were postponed in 2002 and are now expected to be completed by end-2003.

Enterprise reform

Efforts to improve the business environment continue.
Despite visible improvements in the business environment, including an improved dialogue between government and the business community, private enterprises still encounter many obstacles to their development. During the second half of 2002 the Foreign Investment Advisory Service (FIAS), in agreement with the government, undertook a study on administrative barriers to entry and the regulatory costs to business. The study was based on a survey of 500 companies and also included interviews with government authorities responsible for business regulation. The main findings were that poor governance, especially corruption and inadequacies in the legal framework, remained the main obstacles to both private sector development and foreign investment. In response, the government is expected to establish a high level task force to address these issues by the end of the year. Other initiatives include the establishment of the Foreign Investment Promotion Agency in December 2002, which will support an increase in non-privatisation related FDI.

Infrastructure

Reforms in the energy sector introduced.
The energy crisis, which was acute during the winter of 2001-02, has eased. The financial situation of the Albanian Electric Corporation (KESH), the main energy supplier, has improved with the company meeting its tariff collection target for the first half of 2003. About 93 per cent of bills were collected and the reported losses and theft from the network were reduced to around 37 per cent of production. These targets are in line with the two-year energy sector action plan put in place in 2002. Favourable weather conditions have also contributed to the improvement of KESH's financial position in 2003, with the company increasing production of hydro electricity. In addition, high domestic production has contributed to lower energy imports.

Long-term development plan for the energy sector drafted.
The government has drafted a national strategy, in cooperation with the World Bank and USAID, for the long-term development of

Liberalisation, stabilisation, privatisation

1993
- Apr — Restitution law for non-agricultural land adopted
- May — Privatisation of housing begins
- Jun — Privatisation agency established

1994
- Jan — Modernisation of tax administration begins
- Aug — Treasury bills market initiated
- Dec — Most small-scale privatisation completed

1995
- Apr — Voucher privatisation begins
- Jul — Land titles introduced

1996
- Feb — Central Bank independence law adopted
- Jul — VAT introduced

1997
- Mar — Widespread rioting and looting
- Oct — VAT increased
- Nov — Emergency IMF assistance approved

1998
- May — Three-year ESAF programme agreed with IMF
- Dec — Comprehensive tax reforms adopted

1999
- Apr — Major influx of refugees from Kosovo

2000
- Sep — WTO membership granted
- Sep — Indirect monetary policy instruments adopted

2002
- Jun — Three-year PRGF programme agreed with IMF

2003
- Jan — Negotiations on an SAA with EU commence

Enterprises, infrastructure, finance and social reforms

1993

Jul	First foreign-owned bank opened
Jul	Enterprise restructuring agency established

1995

Jul	Competition law enacted
Oct	Bankruptcy law enacted

1996

Mar	Securities and exchange commission established
May	Stock exchange established
Jul	First large enterprise liquidated
Dec	First pyramid scheme collapsed

1997

Jul	Law on transparency adopted
Nov	Pyramids placed under international administration

1998

Mar	State-owned Rural Commercial Bank closed
Jul	Banking law amended

1999

May	Capital adequacy ratio raised to 12 per cent
Nov	Credit ceilings lifted for private banks

2000

Jan	Secured transaction law enacted
Jun	National Commercial Bank sold to foreign investor
Jul	Mobile telecommunications company sold to foreign investor

2001

Feb	Second mobile licence awarded to foreign investor

2002

Oct	Bankruptcy law enacted
Oct	Deposit insurance system put in place

the energy sector. Reducing the dependence on hydro electric power and developing alternative sources of energy (thermal power plants) is a priority. The strategy also envisages the full liberalisation of energy tariffs and the integration of Albania into the regional power market (an EU initiative, sponsored by the Stability Pact for SEE). In April 2003 the electricity regulatory body increased energy tariffs by 33 per cent for some industries and by 7.5 per cent on average for households. The increase in energy tariffs on households will be accompanied by measures to alleviate the burden on vulnerable groups of consumers.

Privatisation of the state-owned fixed-line telecommunications company resumed.
Following the failed privatisation tender of the state-owned fixed-line telecommunications company Albtelecom in January 2002, the government has recommenced the process with pre-privatisation restructuring in February 2003. Progress has been made with the company's financial claims being settled and, in an attempt to make Albtelecom more attractive to foreign investors, the government has offered a third mobile operator licence to potential buyers. As of July 2003 Albtelecom lost its monopoly on local fixed-line services, although it will maintain its monopoly position in international fixed-line services until the end of 2004.

Financial institutions

Efforts made to increase the share of transactions channelled through the banking system …
Confidence in the banking sector has increased with local and foreign currency deposits growing during the first quarter of 2003, despite lower interest rates. The Bank of Albania has started a campaign to reduce the volume of cash transactions and has urged banks and public companies, such as Albtelecom and KESH, to make it easier for citizens to use their bank accounts when paying bills. A deposit insurance scheme became operational in October 2002 and the establishment of an operational Real Time Gross Settlements (RTGS) is also envisaged by end-2003. Nevertheless the level of bank lending to the private sector, about 5 per cent of GDP at the end of 2002, remains very low.

… while privatisation of the last state-owned bank advances.
Following the failure of earlier attempts to privatise the Savings Bank, Albania's largest and last remaining state-owned bank, the government announced plans in September 2003 to sell it via a tender. To make the bank more attractive to foreign investors, the government has launched a marketing campaign for the sale of treasury bills to non-bank customers, transferred the pension functions to Albpost (the state-owned post operator) and has agreed to resume private sector lending, albeit at modest levels, subject to the introduction of safeguard measures.

Privatisation of state insurance company progresses.
In July 2003 the government reached an agreement with the EBRD and the IFC, whereby each IFI would buy a 20 per cent stake in the large state insurance company, INSIG. It is intended that 51 per cent of the company's capital will be sold to a strategic investor within the next two years.

Social reform

Social reforms progress.
Despite relatively strong growth in recent years, poverty levels remain high with 25 per cent of the population living on less than US$ 2 per day, according to a study conducted in 2002 by the Institute of Statistics (INSTAT). Poverty reduction, health and education are the main priorities under the government's Poverty Reduction and Growth Strategy (PRGS), adopted in November 2001. Following government approval of the first annual progress report on the PRGS in May 2003, public spending on health care is to increase and school enrolment levels are to be raised.

New draft law on private pension schemes approved.
As part of pension reform, being developed in cooperation with the World Bank, in June 2003 the Albanian parliament approved a draft law allowing for the establishment of supplementary pension schemes for various professions. It is intended that this change will improve the long-term financial viability of the basic pension system. In July 2003 the government increased pensions to urban pensioners by 10 per cent and for those living in rural areas by 20 per cent so that the minimum monthly pension now stands at US$ 60 in urban areas and about US$ 25 in rural areas.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **17.1 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **vouchers**
Tradability of land – **limited de facto**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**[1]
Separation of railway accounts – **no**
Independent electricity regulator – **yes**[1]

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **na**[2]
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	an	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket[3]	4.0	3.0	3.0	3.0	3.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	86.6	88.5	90.9	95.6	96.3	95.2	91.2	90.6	na
Share of trade in GDP (in per cent)	35.8	42.9	38.3	36.6	39.5	34.7	38.5	37.6	na
Tariff revenues (in per cent of imports)	26.3	13.1	10.9	14.0	11.9	14.7	11.7	10.9	na
EBRD index of price liberalisation [4]	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
EBRD index of forex and trade liberalisation	4.0	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	3.1	3.3	3.6	3.6	3.9	7.0	9.1	9.1	na
Private sector share in GDP (in per cent)	60.0	75.0	75.0	75.0	75.0	75.0	75.0	75.0	na
Private sector share in employment (in per cent)	74.1	78.6	79.6	80.4	81.1	82.2	82.1	na	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	0.6	0.4	0.5	0.5	0.4	1.0	1.3	0.9	na
Share of industry in total employment (in per cent)	8.3	7.6	8.0	7.8	5.7	5.5	5.2	na	na
Change in labour productivity in industry (in per cent)	23.8	26.5	-8.8	9.0	na	9.7	na	na	na
Investment rate/GDP (in per cent)	18.0	15.5	16.0	16.0	16.8	18.6	19.4	na	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	1.0	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	1.2 (na)	1.7 (0.1)	2.3 (0.1)	3.0 (0.2)	3.6 (0.3)	3.9 (0.8)	6 (8.8)	5.5 (12.9)	na
Internet penetration rate (per 10,000 inhabitants)	0.1	0.2	0.3	0.4	0.6	0.6	0.6	0.5	na
Railway labour productivity (1989=100)	33.3	35.8	21.4	28.5	32.1	34.9	38.3	39.8	na
Electricity tariffs, USc kWh (collection rate in per cent)	4.8 (na)	4.3 (na)	3.0 (72)	3.2 (70)	3.5 (58)	2.8 (60)	2.9 (76)	3.8 (93)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	7.7	7.7	8.6	8.3	6.3	6.7	na	na	na
EBRD index of infrastructure reform	1.3	1.3	1.3	1.3	1.3	2.0	2.0	2.0	2.0
Electric power	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Railways	na	na	na	2.0	2.0	2.0	2.0	2.0	2.0
Roads	1.7	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	1.0	1.0	1.0	1.0	1.0	3.3	3.3	3.3	3.3
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Financial institutions									
Number of banks (foreign-owned)[5]	6 (3)	8 (3)	9 (3)	10 (8)	13 (11)	13 (12)	13 (12)	13 (12)	na
Asset share of state-owned banks (in per cent)	94.5	93.7	89.9	85.6	81.1	64.8	59.2	54.1	na
Non-performing loans (in per cent of total loans)[6]	34.9	40.1	91.3	35.4	32.7	42.6	6.9	5.6	na
Domestic credit to private sector (in per cent of GDP)	3.6	3.9	3.9	0.6	2.1	2.9	3.8	4.7	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
EBRD index of reform of non-bank financial institutions	1.0	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Social sector									
Expenditures on health and education (in per cent of GDP)	na	na	na	na	5.7	5.5	5.8	6.3	na
Life expectancy at birth, total (years)	71.3	71.7	71.7	na	74.0	74.0	74.0	na	na
Basic school enrolment ratio (in per cent)	96.8	96.0	94.6	92.6	89.8	105.5	103.1	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

1 Independent regulators are in place, but most regulatory functions are still carried out by the government.
2 Internationally comparable poverty data were not available.
3 Series were revised by Albanian authorities.
4 New series (see Box 2.1 for explanation).
5 Includes branches of foreign banks.
6 Includes loans of banks under forced administration.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure					*(Percentage change in real terms)*				
GDP [1]	13.3	9.1	-7.0	12.7	8.9	7.7	6.8	4.7	6.0
Private consumption	9.3	21.4	-9.2	7.0	2.7	5.3	na	na	na
Public consumption	9.3	2.6	-16.5	4.7	15.9	7.4	na	na	na
Gross fixed capital formation [2]	11.6	-4.5	-5.0	11.5	14.9	17.9	na	na	na
Exports of goods and services	21.9	15.4	-24.5	-3.5	47.0	5.8	na	na	na
Imports of goods and services	3.3	34.8	-19.8	9.3	11.3	6.5	na	na	na
Industrial gross output	6.0	13.6	-5.6	4.1	6.4	5.0	6.5	2.0	na
Agricultural gross output	13.2	3.0	1.0	5.0	3.7	4.5	1.4	2.1	na
Employment					*(Percentage change)*				
Labour force (end-year)	1.8	1.8	-23.6	1.5	-1.1	-1.8	-2.7	-12.3	na
Employment (end-year)	5.7	-2.5	-0.8	-2.0	-0.4	-1.3	-0.2	-13.5	na
					(In per cent of labour force)				
Unemployment (end-year) [3]	13.9	9.3	14.9	17.8	18.0	16.8	14.6	15.8	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	7.8	12.7	33.2	20.6	0.4	0.1	3.1	5.4	3.5
Consumer prices (end-year)	6.0	17.4	42.1	8.7	-1.0	4.2	3.5	2.1	3.0
Producer prices (annual average)	na	na	na	na	na	na	na	na	na
Producer prices (end-year)	na	na	na	na	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	25.6	20.0	0.0	26.1	-0.3	14.3	13.0	28.1	na
Government sector [4]					*(In per cent of GDP)*				
General government balance	-10.1	-12.1	-12.9	-9.7	-9.1	-7.9	-7.6	-6.3	-5.8
General government expenditure	33.4	30.3	30.2	33.2	33.9	30.7	30.4	29.0	na
General government debt	57.5	55.2	75.6	70.9	67.5	71.6	67.6	62.9	na
Monetary sector					*(Percentage change)*				
Broad money (M2, end-year)	51.8	43.8	28.5	20.6	22.3	12.1	19.9	7.6	na
Domestic credit (end-year)	-10.0	47.2	42.2	20.2	9.8	39.0	7.5	10.6	na
					(In per cent of GDP)				
Broad money (M2, end-year)	46.8	55.0	59.6	56.3	59.9	59.5	64.4	62.5	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinancing rate [5]	20.5	24.0	32.0	22.9	17.8	10.8	7.0	8.5	na
Treasury bill rate (3-month maturity)	13.8	17.8	32.6	27.5	17.5	10.8	8.0	11.2	na
Deposit rate (1 year) [6]	13.7	19.1	28.5	16.5	9.1	7.7	7.7	8.5	na
Lending rate (1 year) [7]	21.0	28.8	43.0	25.0	25.8	23.7	24.0	14.5	na
					(Leks per US dollar)				
Exchange rate (end-year)	94.5	103.7	149.8	141.4	135.2	142.6	136.6	133.7	na
Exchange rate (annual average)	93.0	104.8	149.6	151.2	138.1	143.7	143.8	140.2	na
External sector					*(In millions of US dollars)*				
Current account	-177	-245	-276	-186	-265	-274	-263	-440	-471
Trade balance	-475	-692	-518	-621	-846	-821	-1,027	-1,155	-1,292
Merchandise exports	205	229	167	205	275	255	305	330	391
Merchandise imports	680	921	685	826	1,121	1,076	1,332	1,485	1,683
Foreign direct investment, net	89	97	42	45	51	143	204	135	150
Gross reserves, excluding gold (end-year)	240	275	306	384	485	620	754	860	na
External debt stock	787	845	877	1,007	1,109	1,173	1,199	1,183	na
					(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.7	4.0	3.8	3.7	3.8	4.1	4.5	4.4	na
					(In per cent of exports of goods and services)				
Debt service	2.5	6.0	6.1	6.2	3.8	4.0	4.2	6.4	na
Memorandum items					*(Denominations as indicated)*				
Population (annual average, million)	3.2	3.3	3.4	3.4	3.4	3.4	3.1	3.1	na
GDP (in millions of leks)	229,793	280,998	333,071	425,356	488,611	551,282	611,622	677,272	739,048
GDP per capita (in US dollar)	761	817	664	834	1,040	1,119	1,378	1,565	na
Share of industry in GDP (in per cent)	11.7	12.2	12.4	11.9	11.9	11.5	11.7	11.4	na
Share of agriculture in GDP (in per cent)	54.6	51.5	56.0	54.4	52.6	51.0	49.0	48.1	na
Current account/GDP (in per cent)	-7.2	-9.1	-12.4	-6.6	-7.5	-7.1	-6.2	-9.1	-8.0
External debt - reserves (in US$ million)	547	570	571	623	624	553	445	323	na
External debt/GDP (in per cent)	31.9	31.5	39.4	35.8	31.3	30.6	28.2	24.5	na
External debt/exports of goods (in per cent)	259.1	235.9	380.0	345.4	203.7	166.8	142.7	140.2	na

[1] Data for 1998-2000 are based on published national accounts, where GDP includes an estimate of the grey economy of 30 per cent. Data for other years are from IMF estimates.

[2] Includes changes in inventories. Disaggregated data on gross fixed capital formation are not available.

[3] Figures do not include emigrant workers abroad who accounted for an estimated 27.4 per cent of the total labour force in 2000.

[4] General government includes the state, municipalities and extra-budgetary funds. Budget balance on a commitment basis.

[5] From 2001 the figures show the repo rate of the Central Bank.

[6] For 1995 the figures show the floor of the band set by the Central Bank. Thereafter, data refer to weighted average interest rates on new one-year deposits in commercial banks.

[7] For 1995 data refer to the guideline rate announced by the Central Bank. Thereafter, data refer to weighted average interest rates for one-year loans by commercial banks.

Armenia

Key reform challenges

- Advances in enterprise, tax and judicial reform and the effective implementation of financial disclosure and anti-corruption legislation, especially within the civil service and customs administration, are required to further improve the business environment.
- While progress towards reducing the external debt burden has been made, larger tax collections and higher export revenues will be required to finance planned PRSP spending on infrastructure and the social sector.
- The development of SMEs and micro enterprises, and their access to finance, are a pre-requisite for poverty alleviation.

Liberalisation

Armenia joins WTO.
After 10 years of negotiations, Armenia formally joined the WTO in February 2003. WTO membership should provide an opportunity to expand trade, especially with the EU and the United States. The trade data for both 2002 and 2003 have shown a significant increase in both imports and exports (particularly diamonds). However, the benefits of a liberal trade regime continue to be partly offset by high transport costs arising from inadequate infrastructure and shortcomings in customs procedures. Moreover, progress in settling the political conflict over Nagorno-Karabakh has slowed, owing to the elections in both Armenia and Azerbaijan. All these factors continue to affect the volume of regional trade in the Caucasus.

Stabilisation

Fiscal performance and the external situation improves …
The fiscal deficit has declined from 3.8 per cent in 2001 to 0.6 per cent of GDP in 2002, reflecting lower than expected expenditures and stronger fiscal revenues. The government recorded a fiscal surplus of 1.9 per cent of GDP in the first quarter of 2003 meeting both revenue and expenditure targets in the budget. This is partly due to improved fiscal management, including increases in tax collection rates and reductions in customs duty exemptions. External debt is set to decline as a result of a debt-to-equity swap with Russia (US$ 98 million of debt has been written off in exchange for shares in five enterprises). Nevertheless, the public debt service burden remains high, particularly in relation to fiscal revenues.

… but inflation target is unlikely to be met.
Inflation, which fell from 3 per cent in 2001 to 2 per cent in 2002, was volatile in early 2003. Inflation reached 4 per cent year-on-year in the first half of 2003, mainly because of increases in utility tariffs, public sector wages and food prices. There will be seasonal deflation in the third-quarter, but the Central Bank is unlikely to achieve its inflation target of 3 per cent this year.

Privatisation

Progress on privatisation mixed.
There have been a number of large-scale privatisations and concessions in 2002 and 2003, particularly in the power sector and in infrastructure. The government concluded a concession agreement with Argentina's Corporation America Group for the operation of the Yerevan Zvartnots International Airport and there are plans to sell the Zangezur copper-molybdenum combine by the end of 2003. By March 2003 a total of 1,758 large and medium-sized enterprises and 7,161 small businesses had been privatised. These included 280 enterprises that were privatised in 2002 and 40 enterprises this year. Despite recent progress, the targets set by the privatisation programme have not been met, with only one-third of the medium and large-scale enterprises listed in the programme being privatised. This was due, in part, to lack of investor interest, as well as the holding of elections in the first half of 2003. Moreover, recent privatisations have been criticised for lacking transparency.

Enterprise reform

Business climate improves.
The Business Council, intended to promote improvements in the business and investment climate with the participation of local and foreign companies, has begun to operate more effectively. The government is also formulating an anti-corruption strategy to tackle bribery and corruption, though this has taken more time to implement than expected. There are some areas, however, where progress has stalled and additional measures are needed to accelerate growth of the private sector and stimulate foreign investment. According to a survey of regulatory and administrative costs among Armenian companies, conducted by the World Bank and the government in 2002, the main problems faced by business include the quality of regulations and bureaucratic behaviour (including corruption), tax administration infrastructure and access to affordable financing.

Liberalisation, stabilisation, privatisation

1992
- Jan — VAT introduced
- Jan — Foreign trade registration abolished
- Aug — Privatisation law adopted

1993
- Nov — New currency (dram) introduced

1994
- Jan — First privatisation programme adopted
- Feb — Tradability of land permitted
- May — Cease-fire in Nagorno-Karabakh announced
- Oct — Voucher privatisation begins

1995
- Apr — Large-scale privatisation begins
- Apr — Export surrender requirement eliminated
- Jul — Most prices liberalised
- Sep — Treasury bills market initiated

1997
- May — Full current account convertibility introduced
- May — Major tax reform undertaken
- Nov — First international tenders launched
- Dec — New privatisation law adopted

1998
- Dec — New customs law adopted

1999
- Apr — New law on property rights adopted
- Jun — EU Partnership Agreement signed

2000
- Jun — New law on simplified tax adopted

2001
- Jan — New customs code enters into force
- Jan — Council of Europe membership granted
- Jul — New privatisation programme approved
- Oct — Law on joint-stock companies adopted
- Nov — Last state-owned bank privatised

2003
- Feb — WTO membership granted

Infrastructure

Post-privatisation restructuring in telecommunications sector remains slow.
The telecommunications operator Armentel was sold to the Greek firm OTE in 1997 with exclusive monopoly rights for fixed and mobile operations until 2013. Post-privatisation restructuring and improvements in service quality, however, have been disappointing and the company has been criticised by the authorities. Following

Enterprises, infrastructure, finance and social reforms

1993

May	Stock exchange established

1995

May	Bankruptcy law adopted
Jun	Foreign bank ownership allowed
Sep	Banking crisis peak

1996

Mar	First foreign-owned bank opened
Jun	Banking law amended
Jul	IAS audit of banking system conducted

1997

Jan	Bankruptcy law enacted
Jun	Energy Regulatory Commission established
Jun	Energy law adopted
Jul	Financial rehabilitation plan for the energy sector adopted
Dec	National telecommunications operator privatised

1998

Feb	Telecommunications law adopted
Feb	Transport law adopted
Mar	IAS accounting for banks introduced
May	Law on accountancy adopted
Nov	Securities and Exchange Commission established

1999

Jan	New poverty benefits system introduced
Jan	New civil code introduced
Jan	Energy tariffs increased
Apr	New reserve requirements for commercial banks established

2000

Jun	New securities market law adopted
Jul	Yerevan water utility transferred to private management
Dec	New competition law adopted
Dec	Business Council established

2001

Mar	New energy law adopted
Jul	Bank capital requirements raised

2002

Jul	Bank capital requirements raised further
Aug	Electricity distribution company sold

discussions with the government, OTE indicated its intention to sell its 90 per cent stake in Armentel and there have been reports that talks with a Russian operator are at an advanced stage.

Energy sector reform progressing. After two unsuccessful attempts, Armenia's sole power distribution company was finally sold to a UK investor, British Midland Resources, in 2003 and operations were subsequently contracted out to a Korean operator. Most of the country's power-generating companies are expected to be sold by end-2003, including the Hrazdan thermal power plant and the Sevan-Hrazdan hydropower cascade. These companies will be transferred to Russia as part of a debt-for-equity swap and will be operated by UES. The annual deficit in the energy sector declined from 2.5 per cent of GDP in 2001 to 0.4 per cent in 2002, reflecting the introduction of energy efficiency measures, improved tariff collection rates (from 81 to 90 per cent) and higher tariff levels. The price of electricity is already high in comparison with other CIS countries and it is set to rise from 25 dram/kWh to 30 dram/kWh in 2004. Efficiency is likely to improve further following the privatisation of the distribution company and generation companies. After privatisation, relations between the power generators and the distribution company are likely to be on a direct contract basis and Armenergo, a dispatching company, may be no longer necessary.

Financial institutions

Bank restructuring proceeds. The Central Bank continues to strengthen banking regulation and encourage consolidation, with the aim of building up public confidence in the sector. All banks are now under private control. Consolidation has been encouraged by raising the minimum capital requirements to the Armenian dram equivalent of US$ 2 million in July 2003 and will reach US$ 5 million by 2005. The US$ 5 million level already applies to new banks. In 2002, and the first half of 2003, six banks were either closed through liquidation or converted into non-bank financial institutions, while 20 banks remain in operation. A further two banks remain under administration. Moreover, the Central Bank is currently establishing a deposit insurance scheme which will become operational in 2005. However, the banking system remains small and under-capitalised, with assets of US$ 360 million (equivalent to about 15 per cent of GDP) and a total capital of US$ 61 million. Over 50 per cent of bank assets are concentrated in the top five banks. The ratio of domestic credit to GDP is currently about 10 per cent.

Social reform

Poverty Reduction Strategy approved. Armenia is one of the lowest income countries in the region with a per capita GDP of US$ 789. The average monthly salary is about US$ 45. Strong growth has been instrumental in reducing poverty, down from 58 per cent of the population in 2001 to 50 per cent in 2002 according to the latest survey by the National Statistics Service. The share of those in extreme poverty declined from 22 per cent to 16 per cent over the same period. The unemployment rate has also fallen to 9.1 per cent. Social assistance programmes, such as the poverty family benefit, have helped to alleviate extreme poverty. To increase real incomes and living standards, the government approved a Poverty Reduction Strategy Paper (PRSP) in 2003. The new coalition government placed poverty reduction as the top priority and committed to reduce the poverty ratio below 35 per cent in its action plan for 2003-07.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **14.6 per cent**
Exchange rate regime – **floating**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **MEBOs**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **49 per cent (1998)**[1]
Private pension funds – **no**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	6.2	7.7	7.0	8.5	10.6	6.3	6.3	8.1	8.7
Number of goods with administered prices in EBRD-15 basket	2.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	52.4	55.5	55.4	60.0	62.0	78.4	79.8	76.4	na
Share of trade in GDP (in per cent)	73.4	65.8	62.7	54.7	52.5	56.5	53.1	59.7	na
Tariff revenues (in per cent of imports)	1.0	1.9	2.7	2.8	2.1	2.1	2.3	na	na
EBRD index of price liberalisation [2]	3.7	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	3.4	3.4	3.4	5.6	6.7	8.8	9.4	9.7	na
Private sector share in GDP (in per cent)	45.0	50.0	55.0	60.0	60.0	60.0	60.0	70.0	na
Private sector share in employment (in per cent)	48.8	59.9	61.7	68.5	71.7	72.9	na	na	na
EBRD index of small-scale privatisation	2.7	3.0	3.0	3.3	3.3	3.3	3.7	3.7	3.7
EBRD index of large-scale privatisation	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	0.9	0.1	0.6	0.1	1.4	0.8	0.6	0.6	na
Share of industry in total employment (in per cent)	20.5	17.8	16.7	15.7	15.0	14.3	14.0	na	na
Change in labour productivity in industry (in per cent)	19.0	20.4	12.4	6.6	12.9	13.2	6.5	13.9	na
Investment rate/GDP (in per cent)	16.2	17.9	16.2	19.1	18.4	19.7	19.2	20.4	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	2.0	2.0	2.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	15.4 (na)	15.4 (0.0)	15.0 (0.1)	15.7 (0.2)	15.5 (0.2)	15.2 (0.5)	14.0 (0.7)	14.0 (1.2)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	1.2	2.5	6.1	7.0	7.8	9.4	na
Railway labour productivity (1989=100)	20.3	16.9	19.9	20.1	16.2	15.2	17.2	20.6	na
Electricity tariffs, USc kWh (collection rate in per cent)	1.5 (na)	2.2 (76)	3.3 (80)	4.9 (87)	4.7 (88)	4.6 (80)	4.4 (87)	4.5 (98)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.2	4.1	4.1	4.2	4.6	4.5	na	na	na
EBRD index of infrastructure reform	1.7	1.7	2.0	2.0	2.3	2.3	2.3	2.3	2.3
Electric power	1.0	1.0	2.0	2.3	3.3	3.3	3.3	3.3	3.3
Railways	na	na	na	2.0	2.0	2.0	2.0	2.0	2.0
Roads	2.0	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Water and waste water	1.7	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial institutions									
Number of banks (foreign-owned)	35 (3)	33 (4)	30 (4)	31 (10)	32 (11)	31 (11)	30 (14)	20 (8)	na
Asset share of state-owned banks (in per cent)	2.4	3.2	3.4	5.7	3.5	3.8	0.0	0.0	na
Non-performing loans (in per cent of total loans)	36.1	22.6	7.9	10.4	4.7	7.2	6.8	4.9	na
Domestic credit to private sector (in per cent of GDP)	na	na	na	5.3	5.8	7.1	6.0	4.8	na
Stock market capitalisation (in per cent of GDP)	na	0.2	1.0	1.0	1.3	1.3	1.2	1.0	na
EBRD index of banking sector reform	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	5.1	3.5	3.4	4.5	3.7	3.7	3.6	na	na
Life expectancy at birth, total (years)	72.3	72.7	73.7	74.4	73.0	73.6	74.2	na	na
Basic school enrolment ratio (in per cent)	81.4	82.8	82.9	82.6	80.3	79.5	79.5	na	na
Earnings inequality (GINI-coefficient) [3]	38.1	na	na	38.0	na	48.6	na	na	na

[1] Based on the latest available internationally comparable poverty figures reported in the World Bank's *World Development Indicators 2003*. See methodological notes for definition.

[2] New series (see Box 2.1 for explanation).

[3] Based on the latest available internationally comparable poverty figures. The poverty rate based on the national poverty line is 50 per cent.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	6.9	5.9	3.3	7.3	3.3	6.0	9.6	12.9	9.0
Private consumption	9.0	3.8	7.3	5.3	1.4	5.9	15.2	5.8	na
Public consumption	0.2	-2.4	-2.3	-2.2	1.3	-0.3	3.3	-3.2	na
Gross fixed capital formation	-17.3	10.3	2.1	12.0	0.6	8.7	24.8	19.9	na
Exports of goods and services	-7.8	-9.7	28.9	8.9	6.5	16.6	20.8	25.0	na
Imports of goods and services	-10.3	-5.5	24.4	5.0	-8.1	5.1	1.2	9.4	na
Industrial gross output	1.5	1.4	0.9	-2.5	5.2	6.4	3.8	14.2	na
Agricultural gross output	4.7	1.8	-5.9	13.1	1.3	-2.3	11.6	4.4	na
Employment				(Percentage change)					
Labour force (end-year)	-0.8	0.1	-2.8	-4.0	-0.9	-1.0	-2.5	0.3	na
Employment (end-year)	-0.8	-2.8	-4.4	-2.5	-2.9	-1.6	-1.0	1.4	na
				(In per cent of labour force)					
Unemployment (annual average)[1]	6.7	9.3	10.8	9.4	11.2	11.7	9.6	9.4	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	175.8	18.7	14.0	8.7	0.7	-0.8	3.2	1.2	6.1
Consumer prices (end-year)	32.2	5.8	21.8	-1.3	2.1	0.4	3.0	2.0	7.8
Producer prices (annual average)	275.4	22.4	19.0	13.4	2.3	0.8	-0.4	2.5	na
Producer prices (end-year)	38.3	9.6	12.4	8.2	3.8	0.4	-4.3	0.9	na
Gross average monthly earnings in economy (annual average)	243.6	45.7	37.8	31.0	19.2	22.5	5.4	8.1	na
Government sector[2]				(In per cent of GDP)					
General government balance	-9.0	-8.5	-5.8	-4.9	-7.4	-6.3	-3.8	-0.6	-2.5
General government expenditure	28.9	26.1	25.5	25.6	30.1	25.9	20.8	19.5	na
General government debt	na	na	na	na	na	na	na	na	na
Monetary sector				(Percentage change)					
Broad money (M3, end-year)	68.7	35.1	29.2	36.0	13.6	25.8	15.8	40.3	na
Domestic credit (end-year)	68.0	27.8	6.3	60.8	7.7	22.2	-3.9	2.9	na
				(In per cent of GDP)					
Broad money (M3, end-year)	7.7	8.2	8.7	10.0	11.0	13.2	13.4	16.4	na
Interest and exchange rates				(In per cent per annum, end-year)					
Refinancing rate	52.0	60.0	54.0	39.0	43.0	25.0	15.0	13.5	na
Money market rate[3]	na	48.6	36.4	27.8	23.7	18.6	19.4	12.3	na
Deposit rate[4]	63.2	32.2	26.1	24.9	27.4	18.1	14.9	9.5	na
Lending rate[4]	111.9	66.4	54.2	48.1	34.5	28.6	27.7	23.4	na
				(Drams per US dollar)					
Exchange rate (end-year)	402.0	435.1	495.0	522.0	523.8	552.2	561.8	584.6	na
Exchange rate (annual average)	405.9	414.0	490.8	504.9	535.1	539.5	555.1	573.4	na
External sector				(In millions of US dollars)					
Current account	-218	-291	-295	-403	-307	-278	-201	-176	-163
Trade balance	-403	-469	-559	-577	-474	-464	-420	-380	-362
Merchandise exports	271	290	234	229	247	310	353	516	583
Merchandise imports	674	760	793	806	721	773	773	896	945
Foreign direct investment, net	25	18	52	221	122	104	70	110	135
Gross reserves, excluding gold (end-year)	100	171	243	298	305	314	329	439	na
External debt stock	387	533	679	787	855	862	905	1,025	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	1.5	2.1	2.9	3.9	3.8	3.8	3.6	4.5	na
				(In per cent of exports of goods and services)					
Debt service	20.9	20.3	14.2	19.0	14.3	10.7	9.7	10.2	na
Memorandum items				(Denominations as indicated)					
Population (end-year, million)[5]	3.1	3.2	3.1	3.1	3.1	3.1	3.1	3.0	na
GDP (in billions of drams)	522.3	661.2	804.3	955.4	987.4	1,033.3	1,177.2	1,357.0	1,474.0
GDP per capita (in US dollar)	408.9	507.0	522.2	605.1	589.8	615.4	679.8	788.9	na
Share of industry in GDP (in per cent)	24.2	23.8	23.9	21.6	21.5	22.0	20.2	20.5	na
Share of agriculture in GDP (in per cent)	40.7	33.0	30.4	30.8	25.4	22.5	25.5	23.1	na
Current account/GDP (in per cent)	-17.0	-18.2	-18.0	-21.3	-16.6	-14.6	-9.5	-7.4	-6.5
External debt - reserves (in US$ million)	287.4	362.3	435.5	489.0	550.0	548.0	576.2	586.0	na
External debt/GDP (in per cent)	30.1	33.4	41.4	41.6	46.3	45.0	42.7	43.3	na
External debt/exports of goods and services (in per cent)	129.2	144.9	205.5	218.6	223.2	192.9	167.8	146.4	na

1 Registered unemployed. Unofficial estimates indicate substantially higher unemployment.

2 Consolidated accounts of the Republican government and the local authorities.

3 Average of one to three month Treasury bills.

4 Weighted average rate for maturities of 15 days to less than one year.

5 Official figures. Based on 2001 census.

Azerbaijan

Key reform challenges

- **Ongoing fiscal reform, including the control of public spending, is essential for the effective management of substantial revenues arising from oil and gas development.**
- **Continued reform of power, gas and water utilities, and progress with the reform of the State Oil Company, is vital to encourage more widespread enterprise restructuring.**
- **Reform measures aimed at strengthening the financial sector and deepening financial intermediation are key to the development of the non-oil private sector.**

Liberalisation

Energy price liberalisation advances. Following a February 2003 Cabinet of Ministers decree, the government of Azerbaijan has set the domestic prices of natural gas, oil and oil products equal to estimated long-run world market prices. Under this scheme the prices of all products are now set in accordance with a medium-term world oil price forecast of US$ 20/bbl recommended by the World Bank. The prices of kerosene and diesel fuel are exempt from this new legislation, but the government has announced its intention to include them in 2004 once an appropriately targeted subsidy system is in place. The government has signalled its intention to design by end-2003 an automatic mechanism to periodically adjust domestic prices for oil products and natural gas, keeping them in line with world market prices.

Stabilisation

Ongoing fiscal reform and energy subsidies brought on-budget. In implementing the 2003 budget, the government has continued its efforts to reduce the tax burden and broaden the tax base. The payroll tax rate has been reduced to 28.5 per cent from 30.5 per cent and the corporate profits tax rate has been cut to 25 per cent from 27 per cent. Depreciation allowance changes are expected to offset the resulting revenue reduction. In January 2003 the authorities introduced regional and sectoral differentiation to the corporate profits tax rate to encourage regional diversification. As a result, profits tax rates vary from 25 per cent in Baku to 10 per cent in some highland regions. However, following IMF concerns that this could have negative fiscal implications, the government has agreed to re-unify the profits tax rates in the 2004 budget. Financial discipline in the energy sector was further improved by bringing many quasi-fiscal energy subsidies on-budget. The 2003 budget explicitly includes subsidies paid to Azerigaz and Azerenerji, while the State Oil Company (SOCAR) has been granted tax credits to compensate for non-payment of fuel supplied to these two companies. In addition, the budget includes an explicit cash subsidy for the state-owned chemicals company Azerchemia and SOCAR is no longer required to provide this company with free feed stock.

New budget systems law passed. A December 2002 dispute between the authorities and the IMF over progress under the Poverty Reduction and Growth Facility (PRGF) was subsequently resolved and the third tranche of the Facility (US$ 18 million) was released in May 2003. Central to this resolution was the decision by Azerbaijan's authorities to amend the budget systems law to ensure that activities of the State Oil Fund are considered within the country's consolidated fiscal programme, thereby enhancing macroeconomic management. Fiscal management was further improved by a February 2003 presidential decree that clarifies the revenue accumulation and expenditure rules for the State Oil Fund. Further, the government has announced its intention to save higher than budgeted tax revenues from SOCAR in the event of the oil price remaining high.

Privatisation

Large-scale privatisation remains slow. Small and medium-scale privatisation is virtually complete in Azerbaijan. However, successful large-scale privatisation remains a challenge. Preparation of gas and water utilities has continued and, in September 2002, four newly established regional electricity distribution networks were placed under 25-year private management contracts. Progress with the planned large-scale privatisations in the telecoms, aviation, chemical and manufacturing sectors has been slow. The government, however, has recently announced its intention to divest its interests in the cellular telephone companies Azercell and Bakcell by end-2003.

Liberalisation, stabilisation, privatisation

1992

Jan	Most prices liberalised
Jan	VAT introduced
Apr	Foreign investment law adopted
Aug	Central Bank law enacted
Aug	New currency (manat) introduced

1993

Jan	Small-scale privatisation law adopted
Aug	Trading on inter-bank currency exchange begins

1994

Jan	Manat becomes sole legal tender
May	Cease-fire in Nagorno-Karabakh announced

1995

Mar	Exchange rate unified
Apr	First IMF programme approved
Sep	Law on large-scale privatisation adopted

1996

Mar	Small-scale privatisation begins
Jun	Export surrender requirement abolished
Jun	Central Bank law amended
Aug	Land reform law adopted
Sep	Treasury bills market initiated

1997

Mar	Voucher privatisation begins
Jun	New customs code adopted
Jul	New simplified tariff schedule adopted

1999

Feb	New labour code adopted
Dec	Decree for establishing Oil Fund signed

2000

Feb	State property ministry created
May	New privatisation law adopted
Jul	New tax code adopted

2001

Jan	New customs tariff codes adopted
Jan	Council of Europe membership granted
Apr	Ministries of Economic Development and Energy created
Jul	New IMF programme approved

2002

Mar	Second World Bank structural adjustment credit approved
Jun	New foreign currency transactions rules issued
Jul	First audit of Oil Fund completed

2003

Jan	Regional profits tax differentiation introduced
Feb	Domestic prices of key energy products unified with world prices
May	New budget systems law passed

Enterprises, infrastructure, finance and social reforms

1994

Jul	Bankruptcy law adopted
Jul	Bank consolidation begins
Sep	First international oil PSA signed
Nov	Law on joint-stock companies adopted

1995

Jun	Law on unfair competition adopted
Aug	Railway law adopted

1996

Jun	Banking law adopted
Aug	Law on natural monopolies adopted
Sep	Bank restructuring commences

1997

Feb	Law on competitive government procurement adopted
Jun	BIS capital adequacy enacted
Jun	Amended bankruptcy law adopted
Jul	Telecommunications law adopted
Dec	Northern pipeline to Novorossiisk opened

1998

Apr	Electricity law adopted
Aug	Pledge law adopted
Sep	New securities law adopted
Nov	Tender for privatisation of International Bank authorised
Dec	Western pipeline to Georgia opened

1999

Oct	Water law adopted
Dec	Decree on Oil Fund issued

2000

Mar	Baku-Ceyhan pipeline agreement ratified

2001

Mar	Shah Deniz gas purchase agreements with Turkey signed
May	Agroprom's banking licence revoked
Dec	Revised law on chamber of accounts passed

2002

Mar	Energy sector reform plan passed by President
Jul	Minimum capital requirements increased by National Bank
Aug	Minister of Transport appointed
Aug	State SME development programme adopted
Sep	BTC and ACG Phase 1 projects agreed

2003

Jan	Presidential decree initiating reform of SOCAR issued
Feb	Phase 1 of Shah Deniz gasfield development agreed
Apr	Presidential decree initiating privatisation of IBA issued

Enterprise reform

Restructuring of the State Oil Company (SOCAR) initiated.
The reform of SOCAR was initiated with a January 2003 presidential decree. The aim of the reform programme is to define the core activities of SOCAR, amalgamate some units and open others for privatisation. As the first stage of this process, SOCAR has begun a financial restructuring programme, with the assistance of Ernst & Young. This restructuring will improve the company's financial information systems and enable auditing in compliance with international accounting standards.

New measures implemented to encourage private sector development.
The authorities have implemented a number of initiatives to encourage enterprise development and aid economic diversification. A state SME development programme, launched in August 2002, aims to reduce licensing and regulatory requirements and thereby curb corruption and other impediments to business development. The programme has been supported by presidential decrees issued in September 2002 and May 2003. A newly established Business Council is also expected to make recommendations which will further improve the investment climate.

Tax administration reformed to level the competitive playing field.
In accordance with the 2003 budget, all taxpayers are fully subject to the existing tax laws and all tax bills are non-negotiable. Consequently, in 2003 SOCAR paid its tax obligations, in accordance with the tax code, for the first time. These standards will help level the playing field across enterprises and enhance the investment climate. The government has also made significant progress in reforming the tax administration, reducing staff numbers by around 40 per cent and increasing salaries by up to 200 per cent. The enforcement of additional measures to improve the investment climate – including, among others, further public administration reform – remains a challenge.

Infrastructure

Reform of the transport sector progresses, with the role of the newly established Ministry of Transport further defined.
Following the appointment of a Minister of Transport in August 2002, a June 2003 presidential decree further specified the Ministry's areas of competence. The Ministry will take an active role in the regulation of the sector, policy formulation and will oversee the operation of state-owned transport companies. The Ministry has also been tasked with identifying and preparing transport enterprises for privatisation.

Major oil and gas projects move forward.
Progress was made with major oil and gas projects during 2002-03. Construction of the Baku-Tbilisi-Ceyhan (BTC) pipeline began in early 2003, while the associated Phase 1 development of the Azer-Chirag-Guneshli (ACG) oilfield was formally agreed by all parties in September 2002. Stage 1 of the Shah Deniz gasfield development was also agreed in February 2003. These projects are expected to contribute around US$ 8 billion in investment by the end of 2004.

Financial institutions

Financial sector consolidation proceeding, with progress made on the privatisation of IBA and BUSbank.
The financial sector is dominated by the 51 per cent state-owned International Bank of Azerbaijan (IBA), though consolidation among the smaller banks in the first half of 2002 has corrected some of the sector's past weakness. Two presidential decrees issued in April 2003 confirmed the government's commitment to the full privatisation of IBA and United Universal Bank (BUSbank) by the end of 2004. The National Bank has expressed an aim of privatising BUSbank to a strategic foreign investor. These privatisations are essential for the development of both the financial sector and the non-oil private sector. Separately, the EBRD, together with other IFIs, has established the Microfinance Bank of Azerbaijan, which opened in October 2002.

Social reform

Ongoing measures address the key challenges of poverty reduction and economic growth.
The State Programme for Poverty Reduction and Economic Growth (SPPREG) was adopted in October 2002 and approved by the President in February 2003. Full implementation of the public investment programme, within the context of the SPPREG, is likely to benefit from the expected increase in revenues to the State Oil Fund, following the realisation of major oil and gas projects. The assets of the State Oil Fund totalled US$ 810 million at the end of June 2003. The management of these assets has been further enhanced through the hiring of international asset management companies. In July 2003 the State Committee for Refugees and Internally Displaced People announced that it had spent around US$ 50 million of the US$ 75 million allocated from the State Oil Fund in 2002 on constructing 7,000 new homes for refugees and internally displaced people.

Liberalisation

Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation

Share of general government tax revenue in GDP – **24 per cent**
Exchange rate regime – **managed float**

Privatisation

Primary privatisation method – **cash auctions**
Secondary privatisation method – **vouchers**
Tradability of land – **limited de jure**

Enterprises and markets

Competition Office – **yes**

Infrastructure

Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector

Capital adequacy ratio – **8 per cent**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform

Share of the population in poverty – **9.1 per cent (2001)**[1]
Private pension funds – **no**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	8.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Number of goods with administered prices in EBRD-15 basket	12.0	4.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Share of trade with non-transition countries (in per cent)	58.3	53.1	43.8	43.7	59.2	78.2	79.3	75.0	na
Share of trade in GDP (in per cent)	67.6	67.0	55.1	54.0	53.7	63.3	61.5	67.8	na
Tariff revenues (in per cent of imports)	15.2	7.2	5.5	5.8	7.3	8.8	12.5	9.1	na
EBRD index of price liberalisation [2]	3.7	3.7	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	2.0	2.0	2.3	3.0	3.3	3.3	3.3	3.7	3.7
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.1	0.3	0.9	1.5	1.7	2.0	2.4	na
Private sector share in GDP (in per cent)	25.0	25.0	40.0	45.0	45.0	45.0	60.0	60.0	na
Private sector share in employment (in per cent)	42.8	48.5	53.6	57.9	63.7	na	na	na	na
EBRD index of small-scale privatisation	1.0	2.0	3.0	3.3	3.3	3.3	3.3	3.7	3.7
EBRD index of large-scale privatisation	1.0	1.0	2.0	2.0	1.7	1.7	2.0	2.0	2.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	8.1	8.6	8.5	10.4	8.6	7.4	6.6	6.8	na
Share of industry in total employment (in per cent)	9.7	7.7	6.6	6.8	7.0	6.7	6.6	6.8	na
Change in labour productivity in industry (in per cent)	-16.6	-66.2	17.5	-1.5	0.3	10.6	6.5	1.5	na
Investment rate/GDP (in per cent)	15.6	29.1	38.0	40.6	40.0	26.0	21.2	na	na
EBRD index of enterprise reform	1.7	1.7	1.7	1.7	1.7	2.0	2.0	2.0	2.3
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	9.4 (0.1)	8.5 (0.2)	8.6 (0.5)	8.9 (0.9)	9.5 (4.8)	10.4 (5.6)	11.1 (8.0)	12.1 (10.7)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	0.4	0.5	0.8	1.9	1.6	1.4	na
Railway labour productivity (1989=100)	8.5	9.2	11.7	16.4	17.5	23.7	25.4	29.4	na
Electricity tariffs, USc kWh (collection rate in per cent)	1.98 (na)	2.48 (na)	2.7 (na)	na	na	1.3 (15)	2.1 (30)	2.3 (45)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.1	1.3	1.4	1.4	1.5	1.9	na	na	na
EBRD index of infrastructure reform	1.0	1.3	1.3	1.3	1.3	1.7	1.7	1.7	1.7
Electric power	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3
Railways	na	na	na	2.0	2.0	2.3	2.3	2.3	2.3
Roads	1.0	1.0	1.0	1.0	1.0	2.3	2.3	2.3	2.3
Telecommunications	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Water and waste water	1.7	1.7	1.7	1.7	2.0	2.0	2.0	2.0	2.0
Financial institutions									
Number of banks (foreign-owned)	180 (5)	136 (6)	99 (6)	79 (4)	70 (5)	59 (5)	53 (5)	46 (4)	na
Asset share of state-owned banks (in per cent)	80.5	77.6	80.9	65.5	82.5	60.4	na	62.0	na
Non-performing loans (in per cent of total loans)	22.3	20.2	19.9	19.6	37.2	na	na	19.7	na
Domestic credit to private sector (in per cent of GDP)	na	na	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	na	na	0.0	0.1	na	0.1	0.1	na	na
EBRD index of banking sector reform	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.7	1.7	1.7	1.7	1.7	1.7
Social sector									
Expenditures on health and education (in per cent of GDP)	4.9	5.2	4.8	4.2	5.2	4.7	4.3	4.0	na
Life expectancy at birth, total (years)	69.0	70.0	67.5	71.4	71.5	65.2	65.2	na	na
Basic school enrolment ratio (in per cent)	91.8	91.2	92.1	86.7	86.1	90.6	91.4	na	na
Earnings inequality (GINI-coefficient)	45.9	45.8	46.2	46.2	na	50.6	50.1	na	na

[1] Based on the latest available internationally comparable poverty figures reported in the World Bank's *World Development Indicators 2003*. See methodological notes for definition. By contrast, the State Statistics Committee reports 49 per cent of the population were in poverty in 2001. Poverty is defined by the national authorities as households with a budget of less than AZM 120,000 (US$ 25) per month.

[2] New series (see Box 2.1 for explanation).

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	-11.8	0.8	6.0	10.0	9.5	11.1	9.9	10.6	9.4
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output [1]	-21.4	-6.7	0.5	2.2	3.5	6.8	5.2	3.6	na
Agricultural gross output	-6.8	3.0	6.1	6.2	7.0	12.1	11.1	6.4	na
Employment				*(Percentage change)*					
Labour force (end-year)	1.0	2.5	-11.0	0.3	0.1	0.0	0.4	0.4	na
Employment (end year)	-0.5	2.0	0.2	0.2	0.1	-0.1	0.3	0.3	na
				(In per cent of labour force)					
Unemployment (end-year)	0.7	0.8	1.0	1.1	1.1	1.1	1.3	1.3	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	412.0	19.7	3.5	-0.8	-8.5	1.8	1.5	2.8	2.1
Consumer prices (end-year)	85.0	6.5	0.4	-7.6	-0.5	2.2	1.5	3.3	2.2
Producer prices (annual average)	1,734.0	122.7	29.8	0.0	-6.1	27.4	na	na	na
Producer prices (end-year)	na	87.2	2.2	-21.5	17.9	14.5	-4.4	-5.2	na
Gross average monthly earnings in economy (annual average)	307.6	43.1	58.5	18.9	9.5	20.2	17.3	21.2	na
Government sector				*(In per cent of GDP)*					
General government balance [2]	-3.1	-2.4	-4.0	-3.9	-4.7	-0.6	0.9	-0.5	-2.0
General government expenditure [2]	21.1	16.7	19.2	23.7	23.6	20.8	20.3	28.3	na
General government debt	19.6	14.1	13.5	14.9	24.2	25.7	29.4	32.4	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	na	17.1	41.4	-13.3	8.7	27.1	31.8	14.3	na
Domestic credit (end-year)	61.0	33.2	11.1	13.0	-15.2	17.6	-0.9	17.9	na
				(In per cent of GDP)					
Broad money (M2, end-year)	12.3	11.3	13.8	11.0	10.9	11.0	12.9	13.3	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Refinance rate (6 months)	80.0	20.0	12.0	14.0	10.0	10.0	10.0	7.0	na
Inter-bank interest rate (3 months) [3]	na	36.0	22.9	23.2	20.5	22.5	19.8	19.7	na
Deposit rate [4]	90.0	13.0	11.5	10.9	9.9	12.2	12.0	na	na
Lending rate [4]	107.0	33.0	21.5	27.7	27.5	27.2	28.1	na	na
				(Manats per US dollar)					
Exchange rate (end-year)	4,440.0	4,098.0	3,888.0	3,890.0	4,378.0	4,565.0	4,775.0	4,894.0	na
Exchange rate (annual average)	4,413.5	4,301.3	3,985.4	3,869.0	4,120.2	4,474.2	4,656.6	4,860.8	na
External sector				*(In millions of US dollars)*					
Current account	-318	-821	-915	-1,364	-600	-187	-49	-770	-2,046
Trade balance	-275	-549	-567	-1,046	-408	260	581	482	-415
Merchandise exports	680	789	808	678	1,025	1,799	2,046	2,305	2,685
Merchandise imports	955	1,338	1,375	1,724	1,433	1,539	1,465	1,823	3,100
Foreign direct investment, net	330	627	1,115	1,023	510	149	299	1,048	2,300
Gross reserves, excluding gold (end-year) [5]	119	214	467	447	673	680	897	722	na
External debt stock	321	438	507	708	870	1,169	1,268	1,384	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year) [5]	1.1	1.5	2.7	2.2	4.2	4.0	5.1	2.8	na
				(In per cent of exports of goods and services)					
Debt service	5.2	7.4	7.3	4.7	4.8	4.6	4.9	4.4	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	7.7	7.8	7.9	8.0	8.0	8.0	8.1	8.2	na
GDP (in millions of manats)	10,669,000	13,663,200	15,791,400	17,203,000	18,875,000	23,591,000	26,578,000	29,602,000	33,064,562
GDP per capita (in US dollar) [6]	313	407	503	559	571	659	705	743	na
Share of industry in GDP (in per cent)	21.6	28.8	24.9	22.2	22.2	36.0	37.6	34.9	na
Share of agriculture in GDP (in per cent)	25.1	24.7	20.0	18.0	18.2	15.9	14.8	14.2	na
Current account/GDP (in per cent)	-13.2	-25.8	-23.1	-30.7	-13.1	-3.5	-0.9	-12.6	-30.4
External debt - reserves (in US$ million)	202	224	40	261	197	489	371	662	na
External debt/GDP (in per cent)	13.3	13.8	12.8	15.9	19.0	22.2	22.2	22.7	na
External debt/exports of goods and services (in per cent)	37.7	46.7	44.1	70.1	67.9	56.8	54.3	na	na

1 Industrial output excludes crude oil production.

2 General government consolidates all levels of government except for municipalities and SOEs, and includes the Oil Fund and other extra-budgetary funds.

3 90 day interbank offer rate in manats, nominal.

4 For 1995 minimum rate for household time deposits and minimum lending rate for private enterprises are given. From 1996 data refer to three-month deposit and lending rates to "bank clients".

5 By end June 2003 there were additional foreign exchange assets of approximately US$ 810 million in the account of the State Oil Fund.

6 The manat became official legal tender in January 1994. An improved method of calculating value-added in the oil sector has led to a sharp upward revision in nominal GDP and related variables for 2000 and beyond relative to previous estimates.

Belarus

Key reform challenges

- **Private sector involvement in the economy should be increased through faster and more consistent privatisation and by reducing impediments to private business activity.**
- **Reducing inflation, through a combination of tighter monetary and fiscal policies, lower wage increases and greater competition, is necessary especially if the proposed monetary union with Russia is to succeed.**
- **Increasing the competitiveness of Belarussian enterprises should be boosted through enterprise restructuring incentives. Removing the "golden share" provision will also contribute to larger FDI flows.**

Liberalisation

Negotiations on WTO accession continue.
A fourth round of negotiations on WTO accession was held in April 2003. These negotiations focused on the level of tariffs and the amount of access foreign companies have to the market for services. The important issues to be resolved include the harmonisation of laws with WTO requirements and the extent of agricultural support. At the current time many of the farms in Belarus (a large proportion of which continue to operate as collectives) are unprofitable and are highly dependent on subsidies and other forms of state support. In September 2003 further progress was made towards creating a common economic area with Russia, Ukraine and Kazakhstan following the initial agreement between the presidents of the four countries in February.

Stabilisation

The authorities aim to lower both inflation and interest rates …
During 2002 the rate of CPI inflation slowed, but at 35 per cent remained the highest in the CIS. This reflected relatively loose monetary policy and strong wage increases (up 8 per cent in real terms), as well as the decision to raise tariffs for household utilities. The latter improved cost recovery and also resulted in some reduction in the extent of cross subsidisation in the power and gas sectors. Inflation in the first half of this year remained above the government's target of 18-24 per cent for the year as a whole, although the National Bank of Belarus (NBB) continued to lower its refinancing rate to 30 per cent by mid-August.

… ahead of the proposed peg of the currency to the Russian rouble.
Negotiations on the proposed monetary union with Russia have continued with an agreement between the Belarussian and Russian premiers in June 2003 aiming to introduce the Russian rouble as the common currency in January 2005. It was also agreed that the Russian Central Bank would have the dominant role in the conduct of monetary policy, but Belarus would have two seats on the CBR Board of Directors. A number of uncertainties remain, however, including President Lukashenko's subsequent statement that the responsibility for implementing monetary policy should be shared. The use of the Russian rouble for non-cash settlements between legal entities in Belarus from the beginning of July 2003 has been postponed. Pegging the domestic currency to the Russian rouble will require further progress on lowering inflation and a decision on the exchange rate to minimise any adverse affects on competitiveness. Progress is also required on several structural measures, including the implementation of the decision to end NBB funding of the budget from 2004, greater harmonisation of taxes and the unification of customs tariffs.

General part of the tax code to be introduced at the beginning of 2004.
The general part of the tax code, approved by the parliament at the end of 2002, seeks to clarify the tax structure and also achieve greater unification with Russian tax laws. Some tax and customs privileges were cancelled following the introduction of the code. However, at the beginning of 2003, sharp increases in land taxes were introduced, following amendments to the law on land payments. The budget law has also provided local authorities with the scope to introduce additional rate increases.

Privatisation

Progress with small-scale privatisation continues …
Over 80 per cent of commercial and 64 per cent of communal entities were privatised by end-2002. A new version of the privatisation law is currently under consideration by parliament. The new law includes a proposal to conclude voucher privatisation at the end of 2003, while employees could also have the right to purchase additional shares beyond their initial allocation.

… but progress with large-scale privatisation remains stunted.
The privatisation programme includes the conversion of state companies to joint-stock companies, as well as the sale of state shares. During 2002 progress with privatisation was slow and the eventual revenues of BYR 406 billion (US$ 227 million) mainly reflected the sale of the government's 10.8 per cent stake in Slavneft. Slavneft was sold to the Russian oil company Sibneft for US$ 207 million in December. In 2003 the government planned to either corporatise

Liberalisation, stabilisation, privatisation

1993	
Jan	Privatisation law adopted
1994	
Feb	Treasury bills market initiated
Apr	Voucher privatisation begins
Aug	Belarussian rouble becomes sole legal tender
1995	
Jan	Customs Union with Russia and Kazakhstan established
Jun	Most prices liberalised
1996	
Jan	Currency corridor established
Apr	Interbank currency exchange nationalised
Dec	Price controls re-introduced
1997	
Feb	Currency corridor abandoned
Apr	Belarussian-Russian Union Treaty signed
1998	
Mar	Central Bank control transferred to government
Jul	New customs code adopted
Jul	First voucher auction held in two years
Nov	Dual exchange rates introduced
1999	
Mar	Profit and income tax laws amended
Mar	Dual exchange rates abolished
Dec	Interbank exchange market liberalised
2000	
Feb	Presidential decree on land purchases announced
Mar	Currency exchange trading liberalised
Sep	Exchange rate unified
2001	
Jan	Crawling peg to Russian rouble introduced
Jan	Some prices liberalised
Nov	IMF Article VIII (Sections 2, 3 and 4) accepted
Nov	Presidential Decree No.40 on state interference repealed
2002	
May	New investment programme adopted
Dec	Government stake in Slavneft sold
2003	
Jun	Further steps towards monetary union with Russia taken

Enterprises, infrastructure, finance and social reforms

1991
May — Bankruptcy law adopted

1992
Dec — Competition law adopted

1993
Mar — Stock exchange established

1995
Apr — Investment funds' licences suspended

1996
Feb — All enterprises required to reregister
May — State share in commercial banks increased

1997
Dec — Energy regulation transferred to Ministry of Economy

1998
Jan — "Golden share" rights for state in private companies introduced
Jul — Belarus stock exchange nationalised
Sep — Registration of new private businesses suspended

1999
Jan — Railway law adopted
Jan — New civil code adopted
Jan — New land code adopted
Mar — New (unfavourable) business registration procedures adopted

2001
Apr — Directed credits eliminated
Apr — Staff Monitored Programme with IMF initiated
Jun — New World Bank programme introduced

2002
Jan — Minimum banking capital requirements increased to €10 million
May — New National Bank programme agreed by president
Dec — Majority stake in Priorbank sold to Raiffeisen Bank

or privatise 315 companies, raising BYR 430 billion in privatisation revenues (equivalent to 1.3 per cent of projected GDP). This was to be achieved mainly through the sale of shares in four of the main petrochemical companies. In April the government announced it would sell 43 per cent of the shares in each of these companies, but by May no bids had been received. Amendments to the budget law are expected later in the year reflecting the shortfall in privatisation receipts.

FDI flows remain low.
The sale of Slavneft contributed to FDI flows of US$ 434 million in 2002, a marked increase compared with the US$ 96 million recorded in 2001. The government hopes to raise US$ 1.5 billion in FDI during 2003 and is considering changes in taxation and to the investment code. However, in February, the Foreign Investment Advisory Council reported that a large proportion of foreign investors in the country remained concerned over the investment climate, especially the instability of legislation and the tax burden. The continued existence of the "golden share" rule (which can be applied even after a company has been privatised) remains a serious impediment to further foreign investment.

Enterprise reform

Progress in enterprise reform remains limited …
Thirty-six per cent of all industrial companies were classified as loss making at the beginning of July 2003, while unsold stocks of industrial goods remained at a high level. Although wage arrears were reduced to almost zero in 2002, the stock rose to over BYR 63 billion (US$ 30.7 million) in June, over 9 per cent of the payroll. Some two-thirds of these arrears were in agriculture. However, it remains difficult to implement bankruptcy procedures, partly because of weak accounting standards. The introduction of a number of amendments to the bankruptcy law, with the aim of improving procedures, is planned.

… and the growth of SMEs continues to be affected by tax and regulatory constraints.
Despite earlier measures to simplify tax and regulations of small and medium-sized enterprises, the number of operating SMEs has remained fairly static in recent years. In 2002, 24,500 SMEs were recorded, slightly lower than the number recorded in 1996. These businesses accounted for some 7 per cent of GDP and 12 per cent of the labour force in 2002, with many concentrated in the retail trade and catering sectors. These estimates exclude the number of individual entrepreneurs, which has grown steadily to over 180,000 at the end of 2002. Towards the end of last year, the government approved the Small Business Support and Development Plan for 2002-05 and in July 2003 a presidential decree reduced the number of business activities subject to licensing from 165 to 49.

Infrastructure

Energy arrears to Russia fall …
During the first quarter of 2003, energy arrears to Russia fell to US$ 191 million (of which US$ 148 million was for gas and the balance for electricity), compared with arrears of US$ 314 million at the beginning of 2002. This follows a revised agreement in November 2002 over the terms of gas supplies from Gazprom to Belarus. However, much of the reduction is the result of a US$ 40 million loan from the Russian government. In addition, domestic banks have also funded some of the repayment of arrears to Gazprom, owed by the state-owned gas distribution company Beltransgaz.

… but plans to reorganise Beltransgaz stall.
Beltransgaz was registered as a joint-stock company in May 2003, following the agreement in November 2002 with Russia. The plan to privatise the company in July 2003, however, was postponed following disagreements between the government and Gazprom over terms. Specifically, Gazprom wanted a majority share compared with the government's intention to sell only 20-48 per cent of its stake. Respective valuations of the company also differ substantially.

Financial institutions

Banking reform continues, but directed credits remain a problem.
From the beginning of 2003, banks were required to meet national accounting standards that in some areas, such as foreign currency operations, are based on international standards. In addition, the NBB temporarily suspended the licences of a number of banks whose capital fell below the required minimum (€10 million) and in June announced its intention to examine banks' policies on managing bad debts. Notwithstanding these improvements in accounting standards and supervision, some commercial banks were required to provide loans to support loss-making enterprises including for repayment of wage arrears.

Social reform

Strong wage growth contributes to decline in poverty.
The proportion of the population in poverty is below 2 per cent, according to World Bank estimates based on international poverty lines. According to the preliminary results of a new World Bank study (based on data from household surveys), the share of the population in poverty fell during 1995-2002 owing to the extensive system of social protection and administrative wage increases.

Liberalisation
Current account convertibility – **limited**
Interest rate liberalisation – **limited de facto**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenue in GDP – **36.3 per cent**
Exchange rate regime – **crawling peg with band to Russian rouble**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **vouchers**
Tradability of land – **limited de jure**

Enterprises and markets
Competition Office – **no**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **10 per cent**
Deposit insurance system – **yes**
Secured transactions law – **restricted**
Securities commission – **no**

Social reform
Share of the population in poverty – **<2 per cent (2000)**
Private pension funds – **no**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	45.0	30.0	27.0	27.0	27.0	27.0	25.0	24.0	21.0
Number of goods with administered prices in EBRD-15 basket[1]	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	4.0
Share of trade with non-transition countries (in per cent)	20.5	19.0	19.3	17.3	22.6	22.9	45.7	21.9	na
Share of trade in GDP (in per cent)	98.9	91.9	108.8	91.6	98.0	111.3	124.3	118.7	na
Tariff revenues (in per cent of imports)[2]	3.2	3.5	4.1	4.2	3.9	1.7	2.0	2.4	na
EBRD index of price liberalisation [3]	3.7	3.7	4.0	2.7	2.3	2.3	2.7	2.7	2.7
EBRD index of forex and trade liberalisation	2.0	2.0	1.0	1.0	1.0	1.7	2.0	2.3	2.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.5	0.7	0.9	1.0	1.1	1.1	1.2	2.9	na
Private sector share in GDP (in per cent)	15.0	15.0	20.0	20.0	20.0	20.0	20.0	25.0	na
Private sector share in employment (in per cent)	6.8	9.3	12.0	16.4	18.6	na	na	na	na
EBRD index of small-scale privatisation	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.3
EBRD index of large-scale privatisation	1.7	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	na	16.2	17.1	17.2	18.4	18.8	13.6	na	na
Share of industry in total employment (in per cent)	27.6	24.8	24.5	24.3	24.4	24.2	23.4	22.7	na
Change in labour productivity in industry (in per cent)	-0.9	29.4	19.8	12.3	9.2	8.8	10.1	9.2	na
Investment rate/GDP (in per cent)	25.0	22.0	24.7	26.0	24.0	25.4	22.2	na	na
EBRD index of enterprise reform	1.7	1.7	1.0	1.0	1.0	1.0	1.0	1.0	1.0
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	19.2 (0.1)	20.8 (0.1)	22.6 (0.1)	24.3 (0.1)	25.7 (0.2)	26.9 (0.5)	27.9 (1.4)	29.9 (4.7)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	0.7	1.0	0.9	2.0	3.3	4.0	na
Railway labour productivity (1989=100)	29.9	28.8	32.6	32.2	35.9	37.5	35.1	38.3	na
Electricity tariffs, USc kWh (collection rate in per cent)	na	1.5 (na)	1.1 (na)	0.8 (na)	0.4 (na)	1.4 (50)	1.3 (na)	3.2 (98)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.0	2.1	2.3	2.6	2.8	3.0	na	na	na
EBRD index of infrastructure reform	1.0	1.0	1.0	1.0	1.3	1.3	1.3	1.3	1.3
Electric power	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Railways	na	na	na	1.0	1.0	1.0	1.0	1.0	1.0
Roads	1.7	1.7	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Financial institutions									
Number of banks (foreign-owned)	42 (1)	38 (2)	38 (2)	37 (2)	36 (4)	31 (6)	29 (9)	28 (12)	na
Asset share of state-owned banks (in per cent)	62.3	54.1	55.2	59.5	66.6	66.0	53.2	67.6	na
Non-performing loans (in per cent of total loans)	11.8	14.1	12.5	16.5	13.1	15.2	11.9	8.3	na
Domestic credit to private sector (in per cent of GDP)	6.2	6.7	8.3	16.1	9.3	na	na	na	na
Stock market capitalisation (in per cent of GDP)	na	na	4.4	3.5	3.4	4.1	2.9	na	na
EBRD index of banking sector reform	2.0	1.0	1.0	1.0	1.0	1.0	1.0	1.7	1.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	10.4	11.2	12.6	11.4	11.1	11.1	11.6	11.7	na
Life expectancy at birth, total (years)	68.5	68.6	68.5	68.4	67.9	68.0	68.1	na	na
Basic school enrolment ratio (in per cent)	94.6	94.3	94.9	94.6	94.8	95.4	91.5	na	na
Earnings inequality (GINI-coefficient)	37.3	35.6	35.4	35.1	33.7	33.7	34.3	na	na

1 Data on price controls for coal, wood, rents and inter-city bus services were not available. Adding these to the number of controlled prices would bring the total up to 9.

2 Refers to taxes on international trade.

3 New series (see Box 2.1 for explanation).

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	-10.4	2.8	11.4	8.4	3.4	5.8	4.7	4.7	4.0
Private consumption	-12.3	4.5	11.4	14.1	9.5	8.0	17.9	6.1	na
Public consumption	-2.6	0.0	6.8	6.3	5.5	5.8	3.1	0.5	na
Gross fixed capital formation	na	na	21.7	10.1	-4.0	2.3	-2.3	7.0	na
Exports	90.8	27.1	23.9	-3.4	-2.3	na	na	na	na
Imports	79.8	26.5	24.9	-1.2	-8.6	na	na	na	na
Industrial gross output	-11.7	3.5	18.8	12.4	10.3	7.8	5.9	4.3	na
Agricultural gross output	-4.7	2.4	-4.9	-0.7	-8.3	9.3	1.8	1.5	na
Employment				*(Percentage change)*					
Labour force (end-year)	-5.7	0.1	-4.1	0.0	0.3	-0.1	-0.4	-1.3	na
Employment (end-year)	-6.2	-1.0	0.1	1.1	0.6	0.0	-0.5	-1.7	na
				(In per cent of labour force)					
Unemployment (end-year) [1]	2.7	3.9	2.8	2.3	2.1	2.1	2.3	3.0	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	709.3	52.7	63.8	73.2	293.8	168.9	61.4	42.6	29.0
Consumer prices (end-year)	244.2	39.3	63.4	181.7	251.3	107.5	46.1	34.8	27.5
Producer prices (annual average)	462.0	33.6	88.0	72.0	356.0	186.0	72.0	40.0	na
Producer prices (end-year)	122.0	29.0	89.0	200.0	245.0	168.0	39.0	43.0	na
Gross average monthly earnings in economy (annual average)	668.9	60.5	88.0	102.0	322.4	200.9	108.8	54.0	na
Government sector [2]				*(In per cent of GDP)*					
General government balance	-2.7	-1.6	-0.7	-1.0	-2.0	-0.2	-1.9	-1.8	-1.5
General government expenditure	43.0	42.4	46.2	45.4	47.3	45.9	46.8	42.0	na
General government debt	18.0	11.4	11.1	21.9	13.9	12.6	8.6	7.1	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	158.4	52.4	111.4	276.0	132.7	210.9	66.1	50.4	na
Domestic credit (end-year)	226.5	58.5	115.5	297.4	143.2	181.4	67.4	53.7	na
				(In per cent of GDP)					
Broad money (M2, end-year)	15.0	14.8	15.8	30.9	16.7	17.2	15.2	15.4	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Refinancing rate [3]	66.0	35.0	42.0	48.0	120.0	80.0	48.0	38.0	na
Treasury bill rate (3-month maturity)	70.0	37.0	38.4	43.2	80.0	na	na	na	na
Deposit rate (1 year) [4]	100.8	32.3	15.6	14.3	23.8	37.6	34.2	26.9	na
Lending rate (1 year) [5]	175.0	62.3	31.8	27.0	51.0	67.7	47.0	36.9	na
				(Belarussian roubles per US dollar)					
Official exchange rate (end-year)	11.5	15.5	30.7	106.0	320.0	1,180.0	1,580.0	1,920.0	na
Official exchange rate (annual average)	11.5	13.2	26.0	46.1	248.8	876.8	1,390.0	1,791.0	na
External sector				*(In millions of US dollars)*					
Current account	-458	-516	-859	-1,017	-194	-323	-285	-352	-420
Trade balance	-666	-1,149	-1,407	-1,501	-570	-884	-807	-915	-900
Merchandise exports	4,803	5,790	6,919	6,172	5,646	6,641	7,256	7,985	8,100
Merchandise imports	5,469	6,939	8,326	7,673	6,216	7,525	8,063	8,900	9,000
Foreign direct investment, net	15	105	350	201	443	119	96	434	250
Gross reserves, excluding gold (end-year)	377	469	394	345	309	357	352	601	na
External debt stock [6]	1,527	991	976	1,011	886	812	763	813	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	0.8	0.8	0.5	0.5	0.6	0.5	0.5	0.7	na
				(In per cent of exports of goods and services)					
Debt service	2.9	2.3	2.3	2.6	3.9	4.2	3.5	3.9	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	10.2	10.1	10.1	10.1	10.0	10.0	10.0	9.9	na
GDP (in millions of Belarussian roubles)	119,813	184,174	366,830	702,161	3,026,064	9,134,000	17,173,000	25,518,000	34,234,949
GDP per capita (in US dollar)	1,021	1,367	1,388	1,504	1,208	1,274	1,239	1,437	na
Share of industry in GDP (in per cent)	31.4	34.6	34.3	33.4	31.9	30.1	29.9	30.1	na
Share of agriculture in GDP (in per cent)	17.7	16.0	15.4	13.9	14.6	14.2	11.9	10.9	na
Current account/GDP (in per cent)	-4.4	-3.7	-6.1	-6.7	-1.6	-2.5	-2.3	-2.5	-2.6
External debt - reserves (in US$ million) [6]	1,150	481	582	666	577	455	411	212	na
External debt/GDP (in per cent) [6]	14.7	7.2	7.0	6.7	7.3	6.4	6.2	5.7	na
External debt/exports of goods and services (in per cent)	29.0	14.8	12.5	14.2	13.8	10.6	9.2	10.0	na

1 Figures do not include emigrant workers abroad, who accounted for an estimated 27.4 per cent of the total labour force in 2000.

2 General government includes the state, municipalities and extra-budgetary funds. Budget balance on a commitment basis.

3 From 2001 the figures show the repo rate of the Central Bank.

4 For 1995 the figures show the floor of the band set by the Central Bank. Thereafter, data refer to weighted average interest rates on new one-year deposits in commercial banks.

5 For 1995 data refer to the guideline rate announced by the Central Bank. Thereafter, data refer to weighted average interest rates for one-year loans by commercial banks.

6 Medium and long-term public and publicly guaranteed debt.

Bosnia and Herzegovina[1]

Key reform challenges

- Progress towards the creation of a single economic space across Bosnia and Herzegovina continues, but this needs to be supported by major reforms including the introduction of a single customs administration and VAT at the state level.
- To increase investment, the state government and the governments of the two Entities should work to improve the business environment by strengthening the legal framework, accelerating large-scale privatisation and improving corporate governance.
- Essential improvements to physical infrastructure require the authorities to move ahead with utility restructuring and privatisation, and strengthen the ability of local authorities to finance and implement municipal infrastructure projects.

Liberalisation

Harmonisation of indirect taxes advances.
The economic integration of Bosnia and Herzegovina – the two Entities and the district of Brčko – continues, but more needs to be done to create a single economic space. A significant step in this direction occurred in February 2003 with the establishment of the Indirect Tax Policy Commission (ITPC). The ITPC will focus on the best way to set up a single customs administration and administer the value added tax (VAT), both at state rather than Entity level. The ITPC's work will also lead to the establishment of an Indirect Taxation Administration. VAT is scheduled to be introduced in January 2005.

Feasibility study for an SAA begins.
In September 2002 the EU declared that Bosnia and Herzegovina had substantially met the conditions of the road map towards a Stabilisation and Association Agreement (SAA). A feasibility study to assess whether the country was ready to enter formal negotiations on an SAA with the European Commission (EC) is in progress and, by July 2003, three rounds of talks between the authorities and the EC had taken place. These talks focused on issues such as trade, investment, crime and asylum. Bosnia and Herzegovina's application for WTO membership has also progressed, with the WTO expected to submit its final report by mid-2004.

Stabilisation

Currency board arrangement extended.
Under the agreement establishing the Central Bank of Bosnia and Herzegovina in 1997, a currency board was put in place for six years, after which its position would be reviewed. In February 2003 the authorities announced that the currency board would be maintained and new members of the governing board were nominated to take over in August 2003. The present governor, an expatriate appointed by the IMF, has taken Bosnian-Herzegovinian citizenship and will remain in place until December 2004. At this time, he will be replaced by one of the present vice-governors. The currency board has successfully helped reduce annual inflation in both Entities to approximately zero per cent and foreign exchange reserves now cover nearly five months of imports.

Plans to settle domestic debt claims advance.
Both Entities in Bosnia and Herzegovina have substantial amounts of domestic debt, estimated by the IMF to be at least 45 per cent of GDP. Most of the debt has arisen from frozen foreign currency deposits, war damage claims and arrears to invalids, wages and pensions. The authorities are trying to measure these claims, as well as work on a comprehensive strategy to restructure them. Funds from privatisation and from the succession agreements with other former Yugoslav states have been put into escrow accounts and will be used in the debt restructuring programme.

Privatisation

Small-scale privatisation advances in both Entities, but large-scale strategic privatisation lags behind.
The small-scale privatisation programme, which mainly involves cash auctions, has advanced significantly over the past year. By May 2003 about 78 per cent of small enterprises in the Federation, and 55 per cent in the RS, had been privatised. However, large-scale privatisation, and in particular the sale of strategic enterprises, is proceeding at a very slow pace. By May 2003 only 15 enterprises out of 56 in the Federation, and only 4 out of 52 in the RS, had been sold, highlighting the problems of vested interests and corruption in blocking sales. The authorities in both Entities are committed to accelerating the process, but concrete results have not yet been achieved.

Liberalisation, stabilisation, privatisation

1992
Mar — Independence from Yugoslavia declared

1995
Dec — Civil war ends

1996
Oct — Law on privatisation agencies in the Federation enacted

1997
Aug — Currency board established
Aug — Central Bank of Bosnia and Herzegovina established
Dec — Federation law on privatisation enacted

1998
Jun — Enterprise privatisation law adopted in RS
Jun — Konvertible Marka bank notes introduced
Jul — State umbrella law on privatisation adopted

1999
Apr — Markas becomes convertible abroad
May — Preferential trade regime with Croatia and FR Yugoslavia abolished
Jun — Small-scale privatisation begins

2000
Mar — Excise taxes between Entities harmonised
May — Framework privatisation law amended

2002
Jul — Double taxation on inter-entity trade ended

2003
Aug — Currency board extended

Enterprise reform

Obstacles to investment tackled.
A major initiative to improve the business environment in Bosnia and Herzegovina was launched by the Office of the High Representative in November 2002. This initiative saw the establishment of the "Bulldozer Committee". The committee includes local business people and politicians, as well as representatives of the international community. It is charged with identifying specific laws and regulations that impeded job creation and business expansion. After a period of consultation, the committee identified 50 measures for rapid adoption, either at state or Entity (including Brčko) level. By end-May 2003 all 50 measures had been adopted and

Enterprises, infrastructure, finance and social reforms

1996

Jan	Federation banking agency established

1998

Mar	RS banking agency established
Apr	Bank privatisation law enacted in the Federation
Jun	New company law adopted
Jun	Federation bank privatisation agency established
Jul	RS bank privatisation agency established
Sep	New telecommunications law adopted
Oct	New banking law adopted in the Federation
Dec	Joint Power Coordination Centre (JPCC) established

1999

Apr	Minimum bank capital requirements increased
Apr	Securities Commission in the Federation established
Apr	Banking law adopted in RS

2001

Jan	Payments bureaux closed
Feb	Deposit insurance introduced in the Federation
Jun	Minimum bank capital requirements increased further

2002

Mar	Banja Luka stock exchange opened
Mar	State electricity law approved
Apr	Sarajevo stock exchange opened
Sep	State deposit insurance agency formed
Oct	State communications law enacted

2003

Jan	Bankruptcy law enacted in RS
Apr	Bankruptcy law enacted in the Federation

preparations are now under way to identify 50 new reforms for adoption in Phase II of the initiative.

New legislation to strengthen bankruptcy procedures enacted.
In January 2003 new laws on bankruptcy and liquidation proceedings entered into force in the RS. The former is designed to streamline the process and ensure that a decision on the future of an insolvent debtor can be taken quickly. In addition, the new legislation allows the insolvent debtor to submit a reorganisation plan together with a proposal for opening bankruptcy proceedings. In April 2003 a new bankruptcy law in the Federation was adopted and is currently being harmonised with RS legislation. However, further amendments to the bankruptcy laws, limiting priority claims of labour, may be necessary to ensure that competitiveness is improved.

Infrastructure

Investment in the power sector continues to be delayed.
Further delays to a major investment programme in the power sector (known as Power III), led by the World Bank and including financing from the EBRD and EIB, have occurred. This is due to the authorities failing to implement the necessary reforms. Both Entities have adopted action plans for the restructuring, unbundling and privatisation of the sector, but further revisions are required to ensure full compliance with IFI standards. In addition, the programme requires the establishment of an institutional structure at state level, comprising a state regulatory commission for electricity transmission, an independent system operator and a transmission company. Further, independent audits of the three integrated electricity companies in BH, published in March 2003, highlighted problems of fraud, mismanagement and conflicts of interest in all three.

New communications law adopted.
Significant changes to the regulatory framework for telecommunications have occurred in the past year. The main change followed the imposition of the state communications law by the High Representative in October 2002, while there was also some progress in the implementation of the regulatory framework. The new law clarifies the allocation of responsibility in the sector between the state and the Entities and includes many international standard practices for the sector. The successful adoption and implementation of these practices would bring the regulatory framework in the country much closer to the telecommunications regulatory standards of the EU. However, much responsibility remains with the Entities for implementing privatisation and liberalisation in the sector. More progress has been made in the RS, where the state-owned telecommunications company, Telekom Srpske (TS), received a €30 million pre-privatisation loan from the EBRD in December 2002, along with a commitment by the RS government to privatise TS by end-2004.

Financial institutions

Consolidation in the banking sector continues.
There has been a further reduction in the large number of banks in BH. By end-2002 there were 29 banks in the Federation and 10 in the RS, down from 34 and 15 respectively a year earlier. The main reason for the decline is further consolidation, a process which is being aided by the increase in the minimum capital requirement to KM 15 million (€7.6 million) from January 2003. This requirement has forced some banks to make merger plans. Privatisation is now virtually complete in the RS and close to completion in the Federation. In both cases, about two-thirds of the capital is in foreign ownership. Increases in consumer credit in 2002 contributed to strong growth in credit, particularly in the Federation, and prompted measures to curb lending. These measures, introduced in June 2003, included an amendment to the Central Bank law to include foreign currency liabilities and exclude cash in vaults as eligible assets for reserve requirements. To partly offset the contractionary effects of these measures, reserve requirements were lowered in June 2003 from 10 per cent to 5 per cent.

Deposit insurance introduced.
A state level deposit insurance agency was established in August 2002, with its headquarters in the capital of the RS, Banja Luka. By end-July 2003, 13 banks were participating in the programme, including two from the RS. All banks in BH are required to apply for membership of the agency by mid-August 2003, and those that do not meet the criteria for membership will be required to submit an action plan for compliance.

Social reform

Poverty Reduction Strategy being prepared.
According to a World Bank survey in late-2001, 19 per cent of the total population are living below the general poverty line of KM 1,843 (€940) per annum. A further 30 per cent are living only just above this poverty line and are, therefore, highly vulnerable to adverse economic shocks. To address these problems, the BH authorities, in close cooperation with the international community, are preparing a comprehensive Poverty Reduction Strategy (PRS). The first draft of this strategy was circulated among the local and international community in late-2002 and a final version is expected by the end of 2003.

1 The territorial constitutional entities distinguished in this assessment include the State of Bosnia and Herzegovina (BH), the Federation of Bosnia and Herzegovina (FBH), the Republika Srpska (RS) and the cantons of the Federation. The FBH and the RS are referred to as the “Entities”. The District of Brčko enjoys a special status based on an Arbitration Award in accordance with the Dayton Peace Agreement.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **41.6 per cent**
Exchange rate regime – **currency board pegged to euro**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises and markets
Competition Office – **no**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **yes**
Secured transactions law – **no**
Securities commission – **yes**

Social reform
Share of the population in poverty – **na**[1]
Private pension funds – **no**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	na	na	na	na	na	5.0	4.0	4.0	na
Share of trade with non-transition countries (in per cent)	67.3	57.2	53.9	59.0	67.4	75.5	52.8	50.8	na
Share of trade in GDP (in per cent)	66.1	80.9	85.0	102.9	106.0	78.4	77.5	80.5	na
Tariff revenues (in per cent of imports)	na	10.5	5.3	5.6	10.2	10.2	12.2	13.9	na
EBRD index of price liberalisation [2]	1.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	1.0	1.0	3.0	3.0	3.0	3.0	3.0	3.0	3.7
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.0	0.0	0.0	0.7	2.0	2.8	2.9	na
Private sector share in GDP (in per cent)	na	na	na	35.0	35.0	35.0	40.0	45.0	na
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	2.0	2.0	2.0	2.0	2.0	2.3	2.7	3.0	3.0
EBRD index of large-scale privatisation	1.0	1.0	1.0	2.0	2.0	2.0	2.3	2.3	2.3
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	na	1.1	0.1	0.4	0.5	0.8	0.4	na	na
Share of industry in total employment (in per cent)	na	na	na	na	na	na	na	na	na
Change in labour productivity in industry (in per cent)	na	na	na	na	na	na	na	na	na
Investment rate/GDP (in per cent)	20.0	41.9	41.3	37.0	20.6	na	na	na	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.7	1.7	1.7	1.7	1.7	2.0
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	5.4 (na)	9.0 (0.0)	8.0 (0.2)	9.1 (0.7)	9.6 (1.4)	10.3 (3.0)	11.1 (5.7)	12.0 (9.2)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	0.0	0.0	0.0	0.0	7.6	13.3	na
Railway labour productivity (1996=100)	na	100.0	85.5	111.3	153.7	177.2	245.9	267.2	na
Electricity tariffs, USc kWh (collection rate in per cent)	na	4.4 (60)	3.6 (60)	3.5 (86)	5.1 (94)	4.3 (75)	5.6 (95)	6.2 (86)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	5.2	7.9	6.5	4.9	5.8	5.2	na	na	na
EBRD index of infrastructure reform	1.0	1.3	1.3	1.3	1.3	2.0	2.0	2.3	2.3
Electric power	1.0	2.0	2.0	2.0	2.0	2.3	2.3	3.0	3.0
Railways	na	na	na	2.0	2.0	2.0	2.3	3.0	3.0
Roads	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	1.0	1.0	1.0	1.0	1.0	3.3	3.3	3.3	3.3
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Financial institutions									
Number of banks (foreign-owned)	na	na	na	na	na	56 (14)	na	na	na
Asset share of state-owned banks (in per cent)	na	na	na	na	75.9	55.4	17.3	6.2	na
Non-performing loans (in per cent of total loans)	na	na	na	na	58.7	15.8	20.7	11.5	na
Domestic credit to private sector (in per cent of GDP)	na	na	na	na	8.9	7.4	9.5	12.0	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	2.3	2.3	2.3	2.3	2.3	2.3
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.7	1.7
Social sector									
Expenditures on health and education (in per cent of GDP)	na	na	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	72.7	na	73.0	73.3	73.0	73.3	73.6	na	na
Basic school enrolment ratio (in per cent)	97.6	96.8	96.1	92.4	86.4	na	na	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

1 Internationally comparable poverty data were not available.
2 New series (see Box 2.1 for explanation).

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	20.8	86.0	37.0	15.6	9.6	5.6	4.5	3.8	3.5
Total consumption	4.8	52.5	15.0	7.6	na	na	na	na	na
Gross fixed capital formation [1]	67.1	175.1	61.3	5.2	na	na	na	na	na
Industrial gross output	33.0	38.1	33.0	23.3	12.1	9.4	2.8	7.6	na
Agricultural gross output	-9.7	28.4	22.8	8.6	na	na	na	na	na
Employment				*(Percentage change)*					
Labour force (end-year)	-12.5	-12.5	4.1	-2.7	1.3	-0.6	0.2	-0.7	na
Employment (end-year) [2]	na	na	na	0.0	0.6	-0.9	-1.4	-0.6	na
				(In per cent of labour force)					
Unemployment (end-year)	na	na	na	38.0	38.5	39.7	39.7	40.6	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)									
Federation (KM based)	-4.4	-24.5	14.0	5.1	-0.9	1.9	1.9	-0.2	na
Republika Srpska (KM based)	12.9	16.9	-7.3	-14.0	14.1	14.0	7.0	1.7	na
Consumer prices (end-year)									
Federation (KM based)	na	7.7	13.6	1.8	-1.0	4.0	2.4	0.7	na
Republika Srpska (KM based)	na	-17.7	-10.0	5.6	14.0	16.0	2.5	2.4	na
Gross average monthly earnings in economy (annual average)									
Federation	na	289.5	66.6	2.7	8.8	10.2	7.4	9.2	na
Republika Srpska	na	41.7	62.4	47.1	22.3	18.5	13.8	2.4	na
Government sector				*(In per cent of GDP)*					
General government balance	-0.3	-4.4	-0.5	-5.2	-5.8	-5.9	-4.9	-4.5	-2.4
General government expenditure	39.3	52.7	39.7	61.8	67.1	62.0	56.7	56.3	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	8.5	96.2	52.0	31.3	39.9	13.9	89.3	7.0	na
Domestic credit (end-year)	na	na	na	16.2	-1.3	10.0	5.3	25.6	na
				(In per cent of GDP)					
Broad money (M2, end-year)	14.8	18.8	19.3	20.5	25.2	25.7	44.6	45.9	na
Exchange rates				*(Dinar/KM per DM)*					
Exchange rate (annual average) [3]	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	na
External sector				*(In millions of US dollars)*					
Current account	-193	-748	-1,060	-1,167	3	-574	-755	-1,048	-970
Trade balance	-930	-1,546	-1,758	-3,116	-1,852	-1,678	-1,793	-2,089	-2,144
Merchandise exports	152	336	575	664	831	932	957	1,059	1,273
Merchandise imports	1,082	1,882	2,333	3,780	4,126	2,610	2,750	3,148	3,417
Foreign direct investment, net [4]	0	0	0	67	177	150	130	230	320
Gross reserves, excluding gold (end-year)	na	235	80	175	455	488	1,241	1,322	na
External debt stock	3,361	3,620	4,076	2,985	3,095	2,969	2,500	2,450	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	0.6	1.2	0.4	0.5	1.3	2.1	5.0	4.7	na
				(In per cent of exports of goods and services)					
Debt service	134.6	87.1	38.4	13.0	13.8	11.2	5.8	9.0	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million) [5]	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	na
GDP (in millions of markas)	2,676	4,125	6,116	7,559	8,603	9,611	10,480	10,879	11,342
GDP per capita (in US dollar)	491	721	901	1,136	1,231	1,189	1,259	1,376	na
Share of industry in GDP (in per cent)	23.9	21.4	22.6	22.5	na	na	na	na	na
Share of agriculture in GDP (in per cent)	24.6	20.5	17.5	16.0	na	na	na	na	na
Current account/GDP (in per cent)	-10.3	-27.3	-31.0	-27.0	0.1	-12.7	-15.8	-20.0	-15.0
External debt - reserves (in US$ million)	3,154	3,162	3,996	2,810	2,640	2,481	1,259	1,128	na
External debt/GDP (in per cent)	180.0	132.1	119.1	69.2	66.2	65.7	52.2	46.9	na
External debt/exports of goods and services (in per cent)	882.2	550.2	406.8	297.0	268.9	213.3	179.7	165.4	na

1 Includes changes in inventories. Disaggregated data on gross fixed capital formation are not available.

2 Bosnian-majority area prior to September 1996, state thereafter. Before September 1996 data include personnel who were not actually working but for whom contributions (pension, health) were paid.

3 Pre-1997 refers to Bosnian dinar in units of 100. Since August 1997 Bosnia and Herzegovina has had a common Central Bank. The new currency, the Konvertible Marka (KM), was pegged to the Deutschmark at 1:1 under currency board rules (approximately 1.96 per euro).

4 Excludes capital transfers for reconstruction.

5 Excludes refugees abroad.

Bulgaria

Key reform challenges

- **Strengthening the implementation capacity of the public administration and the judiciary is crucial to improving the business environment.**
- **Completion of the much delayed privatisations of Bulgartabac and the Bulgarian Telecommunications Company in a transparent manner, as well as accelerating the privatisation of other public utilities, are important for preserving foreign investors' confidence and attracting further FDI.**
- **Successful completion of the privatisation of the first seven electricity distribution companies, and further deregulation in the energy sector, is important to attract much needed private investment in the sector.**

Liberalisation

EU accession process advances.
Bulgaria was invited to join NATO in November 2002 and is a candidate to join the EU in 2007. By end-July 2003 the country had provisionally closed 25 out of the 30 chapters of the *acquis communautaire*. Entry to the EU, however, depends on progress in implementing the road map for accession and on a significant improvement in the public administration's ability to manage and make effective use of EU funds. These funds will increase considerably prior to accession, up to an estimated €1.2 billion over the 2004-06 period through various programmes. Although a strategy aimed at improving the transparency, efficiency and accountability of public administration was recently adopted, considerable effort is still required to implement it.

Stabilisation

Strengthened customs administration boosts revenues.
Improved collections by the customs administration and rapid import growth were important factors in increasing fiscal revenues during the first half of 2003. This, in turn, has contributed to a surplus in the consolidated fiscal balance for the first half of 2003, amounting to Lv 627 million (about US$ 363 million or 1.8 per cent of projected GDP). The government's target this year is for a consolidated budget deficit of 0.65 per cent of GDP.

Draft amendments on fiscal reserve management presented.
In July 2003 the Ministry of Finance (MoF), the Bulgarian National Bank and the IMF agreed on draft amendments to the budget law regulating the structure of the annual budget and the management of the fiscal reserve. According to this draft, which has yet to be approved by the parliament, the minimum amount in the fiscal reserve for a particular year will be stipulated in the budget law. The MoF will be allowed to invest any amount exceeding the minimum fiscal reserve requirement, subject to the parliament's approval. The government's fiscal reserve fund (set up to help preserve the stability of the currency board against external shocks) stood at Lv 4.3 billion (US$ 2 billion) at the end of June 2003, more than double the amount specified as the minimum under the IMF Stand-By Programme.

Privatisation

Despite some setbacks, privatisation advances.
The privatisation of two of the largest state-owned monopolies – the tobacco company Bulgartabac and the Bulgarian Telecommunications Company BTC – has been delayed by a series of court decisions. The privatisation of Bulgartabac is likely to be relaunched later this year. The government is currently considering a new privatisation strategy, which envisages the break-up of the company into different production units before its sale to strategic investors. Despite delays in these two sales, small and medium-scale privatisation has progressed and the private sector share in GDP is estimated at about 75 per cent. A total of about 275 companies were privatised last year, and an additional 95 were sold in the first half of 2003. The state still holds majority shares in about 355 companies.

Enterprise reform

Commercial code amended.
Bulgaria's ineffective, unreliable and slow civil courts have been increasingly recognised by investors as the most serious obstacles to market entry/exit. Combating corruption also remains a primary concern. Amendments to the commercial code were, however, introduced in June 2003 to amend the insolvency section of the code and to introduce more detailed merger regulations. These amendments enable a company to be presumed "insolvent" when it has not performed within 60 days of the due date. The amendments also provide for the creation of regional legal chambers to deal with bankruptcy procedures. The government has had some success in addressing the burden of administrative procedures, as

Liberalisation, stabilisation, privatisation

1992
Feb Restitution law enacted
Apr Privatisation law adopted

1993
Jan Small-scale privatisation law adopted
Feb Large-scale privatisation begins
Jul EFTA membership granted

1994
Mar Currency crisis ensues
Apr VAT introduced
Nov Debt-equity swaps added to privatisation

1995
Jan EU Association Agreement signed
Oct Price controls reinstalled

1996
Oct First voucher privatisation round begins
Dec WTO membership granted

1997
Feb Macroeconomic crisis peaks
Jul Currency board introduced
Oct New Foreign Investment Act adopted

1998
Jan Comprehensive tax reform begins
Mar Privatisation law amended
May First company privatised through the stock exchange
Sep Full current account convertibility introduced

1999
Jan CEFTA membership granted
Jan Second voucher privatisation round begins
May First municipal Eurobond issued
Jul Currency re-denominated

2000
Jan Extra-budgetary funds closed
Jan Export tax abolished
Mar EU accession negotiations begin

2001
Nov First government Eurobond issue

2002
Jan VAT introduced on drugs, alcohol and coffee
Jul Electricity and heat tariffs increase

2003
Apr Privatisation of thermo-power generation commences
Jul Electricity and heat tariffs increased

Enterprises, infrastructure, finance and social reforms

1992

Mar	Banking law adopted
Mar	Loan classification and provisioning introduced
May	Stock exchange begins trading

1993

Mar	BIS capital adequacy enacted

1994

Jul	Bankruptcy law adopted

1995

Feb	Railway law adopted
Jul	Securities law adopted
Jul	Securities Commission established
Dec	Social insurance law adopted

1996

May	Bankruptcy law amended
May	Special restructuring programme enacted

1997

Feb	Financial crisis peaks
Jul	First bank privatised
Jul	New banking law adopted
Oct	Stock exchanges consolidated

1998

Jul	New telecommunications law adopted
Sep	Energy sector reform begins

1999

Jul	Law on additional voluntary pension insurance passed
Jul	New energy law enacted
Jul	Health Insurance Fund established
Aug	First corporate Eurobond issued
Dec	Law on reformed state pension scheme passed

2000

Jul	Health care reform initiated

2001

Mar	Labour code amended
Apr	Cadastre and Property Register Act passed

2002

Mar	New Privatisation Act passed
Apr	Privatisation of Bulgarian Telecommunications Company launched
Jun	Amendments to the Security Act approved by parliament
Jul	National energy strategy adopted by parliament

2003

May	Former savings bank privatised
Jun	Commercial code amended

indicated by the adoption of the “silent approval” principle in June 2003. This principle, which enters into force in December 2003, allows businesses to assume official consent for new permits or certificates (but not licences) should the relevant authorities not respond within 30 days of the application.

Infrastructure

Privatisation and restructuring in the energy sector commences.
The energy strategy adopted by the government in 2002, and the new draft energy law under discussion in parliament, could provide for the further restructuring of the sector. The previous government had commenced this process with the break-up of NEK, the vertically-integrated national electricity company which was split into separate generation, distribution and transmission companies. While NEK will retain its regulated monopoly in transmission functions, the government plans to privatise hydro and thermal generation capacity first, followed by power distribution and other power generation facilities. The sale of existing assets started successfully in April 2003 with the finalisation of the Maritsa East III investment project (co-financed by the EBRD). This project involves the modernisation of four existing generation units at the thermal power plant and includes an investment worth €580 million. The government also plans to sell a 67 per cent stake in seven regional electricity distribution companies by end-2003. As part of a three-year schedule intended to achieve cost recovery prices in 2004, electricity prices were raised by an average of 15 per cent in July 2003. District heating prices also increased by about 10 per cent.

Financial institutions

Privatisation in banking sector largely complete …
In May 2003 the Bank Consolidation Company (BCC) signed the contract for the sale of DSK Bank, the former savings bank and second largest bank in Bulgaria in terms of assets, to OTP Hungary for €311 million. Following this sale, foreign banks control about 84 per cent of total bank assets in Bulgaria. The sale also virtually completes the privatisation of the banking sector. The Encouragement Bank (state-owned) and the Municipal Bank of Sofia (owned by the Municipality of Sofia) are the last two remaining non-private banks. These banks hold less than 3 per cent of total banking assets in the country and do not have clear privatisation strategies at this point. Although banks remain very cautious in their lending activities, increased competition has led to a narrowing in spreads and to an increase in bank lending, particularly to the private sector. Starting from a very low base, domestic credit to the private sector increased (in real terms) by 38 per cent in 2002, compared with growth of 27 per cent the previous year. However, total domestic credit as a percentage of GDP remains low by international standards, amounting to just 25 per cent of GDP at end-2002.

… but the stock exchange is at an early stage of development.
The Bulgarian Stock Exchange is still underdeveloped. Despite a large number of quoted companies, total market capitalisation was about 5 per cent of GDP by mid-2003. Turnover also remains low. To boost the security market, the Privatisation Agency decided to sell minority stakes in 11 large state-owned Bulgarian companies on the stock exchange this year. These include up to a 30 per cent stake in the Bulgarian Maritime Shipping Company, 20 per cent in both BTC and the State Insurance Institute (DZI), and up to 12.8 per cent in Bulgartabac, the national tobacco company.

Social reform

Government schemes boost employment.
In the first half of 2003 registered unemployment was more than 3 percentage points lower than the previous year, reaching 13.7 per cent in June. The active social policies undertaken by the former Minister of Labour and Social Affairs are partly responsible for the decline in the unemployment rate. The policies include the provision of incentives to encourage job creation in areas of high unemployment by granting profit tax exemptions. In addition, several national programmes targeting specific groups of unemployed people were created to reduce the skills mismatch. Although concerns have been raised about the long-term financial sustainability of these programmes, so far they have had a positive impact on the labour market.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenue in GDP – **27.4 per cent**
Exchange rate regime – **currency board**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **23.7 per cent (2001)**[1]
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	46.0	52.0	14.4	15.8	17.2	20.0	20.6	21.3	22.0
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	2.0	1.0	1.0	1.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	65.4	66.2	72.0	76.9	80.4	76.0	72.1	76.4	na
Share of trade in GDP (in per cent)	80.6	96.9	91.2	68.8	70.2	85.7	86.8	82.1	na
Tariff revenues (in per cent of imports)	12.7	7.7	9.5	13.9	10.2	9.9	8.9	10.0	na
EBRD index of price liberalisation [2]	2.7	2.7	4.0	4.0	4.0	4.0	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.7	1.5	4.6	6.2	8.4	9.7	10.3	11.2	na
Private sector share in GDP (in per cent)	50.0	55.0	60.0	65.0	70.0	70.0	70.0	75.0	na
Private sector share in employment (in per cent)	41.0	47.0	55.0	61.0	65.0	70.9	80.8	na	na
EBRD index of small-scale privatisation	3.0	3.0	3.0	3.0	3.3	3.7	3.7	3.7	3.7
EBRD index of large-scale privatisation	2.0	2.0	3.0	3.0	3.0	3.7	3.7	3.7	3.7
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	1.1	0.8	1.1	2.0	1.6	0.9	2.4	2.4	na
Share of industry in total employment (in per cent)	28.1	27.5	26.6	24.7	24.6	25.6	25.4	na	na
Change in labour productivity in industry (in per cent)	-3.3	-10.1	-6.9	1.4	-1.8	18.7	1.5	na	na
Investment rate/GDP (in per cent)	15.7	8.4	11.4	14.7	19.0	18.0	20.4	20.7	na
EBRD index of enterprise reform	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.7
EBRD index of competition policy	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	30.6 (0.3)	31.3 (0.3)	32.3 (0.8)	33.1 (1.5)	34.2 (4.2)	35.0 (9.0)	35.9 (19.1)	37.5 (19.1)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	8.7	12.5	19.4	22.7	33.4	41.1	na
Railway labour productivity (1989=100)	76.9	74.0	80.7	73.4	65.3	71.2	70.3	65.9	na
Electricity tariffs, USc kWh (collection rate in per cent)	2.18 (85)	3.5 (85)	1.9 (89)	2.4 (110)	2.8 (112)	na	3.7 (85)	3.7 (>95)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.2	2.1	2.2	2.3	2.6	2.8	na	na	na
EBRD index of infrastructure reform	1.3	1.7	2.0	2.0	2.3	2.7	2.7	2.7	2.7
Electric power	2.0	2.0	2.0	2.0	3.0	3.3	3.3	3.3	3.3
Railways	na	na	na	3.0	3.0	3.0	3.0	3.0	3.0
Roads	1.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	2.3	2.3	2.7	3.0	3.0	3.0	3.0	3.0	3.0
Water and waste water	1.0	1.0	1.0	1.0	2.0	3.0	3.0	3.0	3.0
Financial institutions									
Number of banks (foreign-owned)	41 (3)	42 (3)	28 (7)	34 (17)	34 (22)	35 (25)	35 (26)	34 (26)	na
Asset share of state-owned banks (in per cent)	na	82.2	66.0	56.4	50.5	19.8	19.9	14.1	na
Non-performing loans (in per cent of total loans)	12.5	15.2	13.0	11.8	17.5	10.9	7.9	10.4	na
Domestic credit to private sector (in per cent of GDP)[3]	21.1	35.3	12.3	12.2	14.0	11.6	14.6	18.0	na
Stock market capitalisation (in per cent of GDP)	0.5	0.2	0.0	7.4	5.8	4.8	3.7	4.3	na
EBRD index of banking sector reform	2.0	2.0	2.7	2.7	2.7	3.0	3.0	3.3	3.3
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3
Social sector									
Expenditures on health and education (in per cent of GDP)	7.7	6.5	7.2	7.1	na	na	na	na	na
Life expectancy at birth, total (years)	70.9	70.8	70.7	71.1	71.4	71.5	71.7	na	na
Basic school enrolment ratio (in per cent)	93.7	93.6	94.0	94.3	94.8	95.3	97.1	na	na
Earnings inequality (GINI-coefficient)	na	29.1	na	na	na	na	na	na	na

[1] The official 12.8 per cent poverty rate, reported in the Bulgaria 2001 Poverty Assessment published by the World Bank, is based on a different poverty line. The latter was fixed at two-thirds of the 1997, average per capita consumption, deflated by 2001 prices.

[2] New series (see Box 2.1 for explanation).

[3] Credit expansion in 1995 and 1996 was followed by a banking crisis in 1997, greatly reducing the stock of credit to the enterprise sector.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	*Projection*
Output and expenditure				*(Percentage change in real terms)*					
GDP	2.9	-9.4	-5.6	4.0	2.3	5.4	4.0	4.8	4.5
Private consumption	-0.5	-5.7	-10.0	2.6	9.3	4.9	4.5	3.9	na
Public consumption	-8.2	-33.2	-3.9	23.4	4.1	13.3	4.7	6.2	na
Gross fixed capital formation	16.1	-21.2	-20.9	35.2	20.8	15.4	19.9	9.3	na
Exports of goods and services	na	na	12.8	-4.7	-5.0	16.6	8.5	6.2	na
Imports of goods and services	na	na	10.9	12.1	9.3	18.6	13.0	4.7	na
Industrial gross output	-5.4	-11.8	-13.7	-5.8	-4.3	12.0	0.7	2.6	na
Agricultural gross output	16.0	-10.9	13.7	-0.6	2.7	-9.1	-0.3	na	na
Employment				*(Percentage change)*					
Labour force (end-year)	-6.9	-0.7	-2.3	0.5	-1.2	-9.1	0.9	6.9	na
Employment (end-year)	1.3	0.1	-3.9	-0.1	-2.1	-9.5	-3.4	10.9	na
				(In per cent of labour force)					
Unemployment (end-year)	13.7	13.0	14.5	15.0	15.7	16.1	19.7	16.8	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	62.0	123.0	1,082.0	22.2	0.7	9.9	7.4	5.9	2.0
Consumer prices (end-year)	32.9	310.8	578.6	0.9	6.2	11.4	4.8	3.9	3.8
Producer prices (annual average)	52.7	126.9	901.8	17.1	4.4	17.3	7.4	3.4	na
Producer prices (end-year)	38.9	356.7	472.6	0.5	14.0	14.7	-3.3	6.3	na
Gross average monthly earnings in economy (annual average)	53.2	89.4	815.9	46.5	5.1	15.7	11.9	4.2	na
Government sector				*(In per cent of GDP)*					
General government balance [1]	-5.6	-10.3	-2.4	1.0	-0.9	-1.0	-0.9	-0.6	-0.7
General government expenditure [1]	41.3	42.0	33.1	37.0	39.6	39.7	38.6	37.2	na
General government debt [2]	114.9	319.8	122.2	95.6	98.7	88.8	69.7	55.1	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	40.3	117.2	356.8	11.9	13.0	12.2	49.3	12.2	na
Domestic credit (end-year)	18.0	216.5	93.6	-8.4	5.8	31.4	24.1	31.4	na
				(In per cent of GDP)					
Broad money (M2, end-year)	65.4	71.0	32.8	28.5	30.3	30.3	40.9	42.0	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Base interest rate [3]	34.0	180.0	6.7	5.1	4.5	4.6	4.7	3.3	na
Inter-bank interest rate (up to 1 month)	53.1	119.9	66.4	2.5	2.9	3.0	3.7	2.5	na
Deposit rate (1 month)	25.3	211.8	3.0	3.3	3.3	3.1	2.9	2.8	na
Lending rate (less than 1 year)	51.4	480.8	13.9	13.3	14.1	11.5	11.1	9.4	na
				(Leva per US dollar)					
Exchange rate (end-year) [4]	0.071	0.487	1.777	1.675	1.947	2.100	2.219	1.885	na
Exchange rate (annual average) [4]	0.067	0.178	1.674	1.760	1.836	2.123	2.185	2.077	na
External sector				*(In millions of US dollars)*					
Current account	-26	16	428	-62	-685	-701	-878	-679	-965
Trade balance	121	188	380	-381	-1,081	-1,175	-1,566	-1,619	-1,825
Merchandise exports	5,345	4,890	4,940	4,193	4,006	4,812	5,099	5,578	5,895
Merchandise imports	5,224	4,703	4,559	4,574	5,087	5,988	6,665	7,197	7,720
Foreign direct investment, net	98	138	507	537	789	1,003	641	430	900
Gross reserves, excluding gold (end-year)	1,236	518	2,121	2,679	2,900	3,460	3,591	4,407	na
External debt stock	10,148	9,602	9,760	10,274	10,204	11,202	10,616	10,933	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	2.3	1.0	4.4	5.4	5.3	5.4	5.0	5.8	na
				(In per cent of exports of goods and services)					
Debt service	13.5	16.8	13.8	19.0	18.0	16.8	20.2	15.8	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	8.4	8.3	8.3	8.2	8.2	8.1	8.1	7.8	na
GDP (in millions of leva) [4]	880	1,761	17,433	22,421	23,790	26,753	29,618	32,324	34,334
GDP per capita (in US dollar)	1,563	1,187	1,257	1,548	1,582	1,551	1,679	1,984	na
Share of industry in GDP (in per cent) [5]	31.0	29.0	25.0	22.3	25.1	25.8	25.2	24.5	na
Share of agriculture in GDP (in per cent) [5]	12.7	14.2	23.4	16.8	14.5	12.3	12.1	11.0	na
Current account/GDP (in per cent)	-0.2	0.2	4.1	-0.5	-5.3	-5.6	-6.5	-4.4	-4.9
External debt - reserves (in US$ million)	8,912	9,084	7,639	7,595	7,304	7,742	7,025	6,526	na
External debt/GDP (in per cent)	77.4	97.0	93.7	80.6	78.7	88.9	78.3	70.3	na
External debt/exports of goods and services (in per cent)	149.8	153.5	155.5	171.8	176.1	160.3	141.1	133.9	na

1 General government includes the state, municipalities and extra-budgetary funds.

2 From April 2001 direct debt to the Bulgarian National Bank (BNB) is excluded from domestic debt to avoid double reporting of IMF credit extended through the BNB.

3 Effective interest rate at end-month, based on the average annual yield attained at three-month government securities primary actions.

4 On 5 July 1999 the lev was re-denominated. The post-July rate is equal to 1,000 of the pre-July 1999 leva. All data are expressed in terms of post-5 July 1999 lev.

5 From 1995 the industrial classification changed. Using the old classification, industry as a share of GDP was 32.4 per cent in 1996 and the share of agriculture in GDP was 12.8 per cent.

Croatia

Key reform challenges

- Strengthening the judiciary and public administration are key policy priorities that should help improve the business environment.
- Accelerating the small-scale privatisation programme and resolving ownership issues, particularly for real estate assets, is crucial for an economy heavily dependent on revenues from tourism.
- Infrastructure reforms should focus both on privatisation of the remaining state-owned utilities and on the creation of a more competitive environment, lifting any remaining terms of exclusivity for the main operators.

Stabilisation

Fiscal consolidation on track, but the current account deficit and external debt have increased.

In May 2003 the IMF completed the first review of the US$ 140 million Stand-By Arrangement, approved in February 2003. The process of gradual fiscal consolidation is broadly on track, with the general government deficit estimated at 4.8 per cent of GDP in 2002, down from 6.8 per cent in 2001. However, the IMF warned about the widening of the current account deficit and the increase of external debt. The current account deficit widened to 7.2 per cent of GDP in 2002, up from 3.8 per cent in 2001. Gross external debt increased to US$ 19 billion, or 71 per cent of GDP at end-July 2003, from 58 per cent of GDP at end-2001. The increase in the dollar value of the debt was largely driven by exchange rate move ments, as the dollar weakened. While most of Croatia's debt is denominated in euros, it was spurred by commercial banks borrowing abroad to finance growing demand for credit. Croatia also made a formal application to join the EU in February 2003.

Privatisation

Landmark privatisation of INA boosts privatisation receipts ...

In July 2003 the government approved the sale of 25 per cent plus one share in INA. The company holds a monopoly in gas distribution and also engages in oil exploration and refining. The stake was sold to MOL, the Hungarian oil and gas company, for US$ 505 million, well above the initial tender bid of US$ 360 million. According to the privatisation agreement, MOL cannot sell INA's shares over the next five years without the government's approval. In addition, MOL will be required to reinvest all its profits in INA over the next three years. The privatisation of INA enabled the government to exceed its 2003 target for privatisation revenues of HRK 2.5 billion (US$ 360 million).

... while small-scale privatisation makes limited progress.

The dismissal of the management board of the Croatian Privatisation Funds (CPF) in February 2003, following the controversial privatisation of Suncani Hvar (a tourism company), has substantially slowed the pace of privatisation. The slowdown has been marked among companies in the tourism sector. The privatisation law is currently under review, with a number of proposed changes intended to improve transparency. These include restructuring the CPF into a State Property Fund which would manage state property, such as real estate, besides implementing the privatisation of state-owned companies.

Enterprise reform

Crucial amendments to the commercial companies law and Bankruptcy Act adopted ...

The parliament adopted a number of changes, both to the law on commercial companies and to the Bankruptcy Act, in July 2003. Amendments to the law on commercial companies are intended to enhance protection of minority shareholders, as well as further define responsibilities of members of the executive and supervisory boards. The amendments to the Bankruptcy Act are aimed at simplifying the overall process, by reducing the number of procedures linked to company liquidation. Some of the amendments are also part of the broader programme of judicial reform and aim to reduce the burden of the courts by transferring the execution of foreclosure procedures from state courts to public notaries. It is estimated that foreclosure cases currently account for around 30 per cent of court cases.

... but land registry reforms proceed at a slow pace.

Contracts involving real estate can be particularly hard to enforce. This is partly because of the poor state of the land register, but in particular is caused by the continuing doubts over the ownership of land and property that was confiscated by the communist-era authorities. The World Bank Real Property Registration and Cadastre Project is expected to help establish an efficient land administration system. It will also contribute to the process of clarifying land rights and property ownership. This, in turn, should lead to faster registration, sales and mortgages, contribute to the resolution of property disputes and eventually reduce the backlog of court cases involving land issues.

Liberalisation, stabilisation, privatisation

1991
- Apr — First privatisation law adopted
- Jun — Independence from Yugoslavia declared
- Dec — New currency (Croatian dinar) introduced

1992
- Jul — Large-scale privatisation begins

1993
- Jan — Croatian Privatisation Fund established
- Oct — Macroeconomic stabilisation programme established

1994
- May — New currency (kuna) introduced

1995
- May — Full current account convertibility introduced

1996
- Mar — New privatisation law adopted
- Jul — Most non-tariff import barriers removed
- Jul — Treasury bills market initiated

1997
- Jan — Restitution law enacted
- Feb — First sovereign Eurobond issued

1998
- Jan — VAT introduced
- Jun — Voucher privatisation programme begins

2000
- Jul — WTO membership granted

2001
- Mar — IMF Stand-By Arrangement agreed
- Jun — Capital accounts restrictions eased

2003
- May — First Eurobond in local currrency issued

Infrastructure

Institutional reforms in road sector advance ...

Road sector reforms are a key priority for the government, with sector funding now fully independent of central budget allocation. Hrvatske Ceste, the authority in charge of development and maintenance of non-tolled

Enterprises, infrastructure, finance and social reforms

1993
- Jan — IAS becomes effective
- Oct — Banking law adopted
- Nov — Company law adopted

1994
- Mar — Stock exchange begins trading
- Jun — Railways established as joint-stock company
- Jun — Bank rehabilitation law adopted

1995
- Jan — Electricity law adopted
- Jun — Competition law adopted
- Nov — Bank rehabilitation begins
- Dec — Capital adequacy requirement takes effect
- Dec — Securities and investment fund laws adopted

1996
- Mar — Pliva lists on London stock exchange
- Oct — Securities and Exchange Commission established

1997
- Jan — New bankruptcy law adopted
- Mar — Competition agency established

1998
- Apr — Dubrovačka Banka crisis occurs
- Jul — First pension reform law adopted
- Jul — First rehabilitated bank privatised
- Dec — New banking law adopted

1999
- Jan — Post and telecommunications operations separated
- Mar — New bankruptcy law adopted
- Jun — Telecommunications privatisation law adopted
- Oct — Croatia Telecommunications partially privatised

2001
- Apr — New Central Bank law enacted
- May — Independent pensions regulator established
- Jul — New energy laws adopted

2002
- Jan — Mandatory private pension system launched
- Apr — New energy regulator established
- Jul — Energy company HEP unbundled
- Jul — New banking law adopted

2003
- Jul — Major amendment to bankruptcy law adopted
- Jul — New labour law adopted

state roads, is funded mainly from a dedicated fuel levy, which accounts for around 98 per cent of its income. Hrvatske Autoceste, the authority in charge of development and maintenance of motorways and other tolled roads, is funded from a separate fuel levy (accounting for around 70 per cent of its total income) and motorway tolls.

... while privatisation of HEP and HT postponed to next year.
The privatisation of the Croatian Electricity Company (HEP) and the sale of the government's remaining 7 per cent share in Croatian Telecom (HT) have been postponed until 2004. This is mainly due to the restructuring and unbundling of the companies, required prior to privatisation. In July 2003 the parliament adopted a new telecommunications bill, which merged the Telecommunications Council and the Telecommunications Institute into a single regulatory agency. The bill also opened up fixed-line services to competition, though it granted the dominant operator, Croatian Telecom, a one-year transition period until the end of 2004. An international tender for a third mobile operator was announced in May 2003 and is expected to be launched in September 2003.

Financial institutions

Consolidation in the banking sector advances further ...
Following a successful round of acquisitions and mergers last year, eight foreign banking groups control over 90 per cent of total banking assets. The Unicredito/ Allianz group holds over 33 per cent of the market, followed by Intesa-BCI which controls around 20 per cent through Privredna Banka Zagreb. The government announced that it would not merge the two remaining state-owned banks – Croatia Banka and Croatian Post Bank – as previously announced and would instead proceed with the privatisation of the two banks on a separate basis. This followed a recommendation by the IFC, which had undertaken a comprehensive assessment of the issue.

... but risks remain from foreign currency-based borrowing.
During the first quarter of 2003 domestic credit growth increased 5 per cent, compared with the last quarter of 2002, despite the introduction of measures by the Central Bank to limit credit expansion. These measures included the compulsory purchase of CNB bills if bank loans expand at a rate higher than 16 per cent per annum (or 4 per cent per quarter), as well as other measures designed to limit the extent of foreign currency lending. All of these are due to expire at the end of 2003. The CNB intends to replace them with tighter prudential and more market-based measures, currently being discussed with the IMF.

Social reform

New labour law finally adopted ...
A new labour law came into effect in July 2003 which will reduce the amount of severance pay and shorten the redundancy notice period. Further provisions relating to severance pay will be introduced at the beginning of 2004. The adoption of the labour law was one of the pre-conditions for the extension of the second tranche of the World Bank's US$ 100 million structural adjustment loan (SAL).

... and pension reform successfully launched.
Croatia's three-pillar pension system, which includes a mandatory, privately-managed second-pillar pension that was introduced last year, has been one of the most successful among all the transition economies. The system has managed to preserve as much as 98 per cent of all contributions for actual capital utilisation. This is the highest percentage any transition country has managed to achieve in the first year of pension reform. The private pension funds have had an impact on the local capital markets, primarily through an increase in the volume of trading of government bonds. In 2002, 97 per cent of the funds under management were in state-backed securities. By the first half of 2003, this share had dropped to 85 per cent, indicating a greater interest in equity investment. The Agency for Control of Pension Funds (HAGENA) expects that the range of instruments that pension funds can invest in will increase as a number of municipal authorities begin to issue long-term bonds.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **39.7 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **vouchers**
Tradability of land – **full**[1]

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **10 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **<2 per cent (2000)**
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	6.8	6.5	3.9	3.3	3.0	5.6	0.0	0.0	0.0
Number of goods with administered prices in EBRD-15 basket	4.0	4.0	2.0	2.0	2.0	2.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	68.9	65.1	61.3	64.9	69.8	68.9	73.0	72.6	na
Share of trade in GDP (in per cent)	66.6	64.0	67.7	61.2	60.7	67.0	69.7	68.2	na
Tariff revenues (in per cent of imports)[2]	9.5	8.9	8.1	7.7	8.1	6.1	5.7	4.8	na
EBRD index of price liberalisation [3]	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	4.0	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)[4]	0.9	1.4	2.0	3.6	8.2	10.2	13.5	15.8	na
Private sector share in GDP (in per cent)	40.0	50.0	55.0	55.0	60.0	60.0	60.0	60.0	na
Private sector share in employment (in per cent)	48.0	53.0	54.0	54.0	58.0	56.0	na	na	na
EBRD index of small-scale privatisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	na	4.7	6.1	7.5	10.1	11.4	16.9	na	na
Share of industry in total employment (in per cent)[5]	34.4	31.5	32.1	28.8	28.3	27.7	27.7	27.1	na
Change in labour productivity in industry (in per cent)[5]	5.7	12.6	6.6	7.4	1.8	4.3	7.7	7.7	na
Investment rate/GDP (in per cent)	15.7	20.5	24.2	23.7	23.6	22.7	23.8	na	na
EBRD index of enterprise reform	2.0	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
EBRD index of competition policy	1.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	26.9 (0.7)	30.9 (1.4)	33.2 (2.7)	34.8 (4.1)	36.5 (6.6)	36.5 (23.1)	36.5 (37.7)	38.8 (47.0)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	18.0	21.1	31.9	37.9	49.3	66.8	na
Railway labour productivity (1989=100)	49.4	44.1	46.0	52.1	52.9	58.2	70.9	78.1	na
Electricity tariffs, USc kWh (collection rate in per cent)	8.2 (na)	7.9 (na)	7.0 (na)	7.0 (na)	6.8 (na)	7.3 (na)	9.8 (101)	5.57 (na)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.1	4.4	4.3	4.3	4.4	4.9	na	na	na
EBRD index of infrastructure reform	1.7	1.7	1.7	2.0	2.3	2.3	2.7	2.7	2.7
Electric power	2.3	2.3	2.3	2.3	2.3	2.3	3.0	3.0	3.0
Railways	na	na	na	2.3	2.3	2.3	2.3	2.3	2.3
Roads	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3	3.0
Telecommunications	1.0	1.0	1.0	2.0	3.0	3.0	3.3	3.3	3.3
Water and waste water	2.0	2.3	2.3	2.3	3.0	3.0	3.3	3.3	3.3
Financial institutions									
Number of banks (foreign-owned)	54 (1)	na	61 (7)	na	53 (13)	43 (21)	43 (24)	46 (23)	na
Asset share of state-owned banks (in per cent)	51.9	36.2	32.6	37.5	39.8	5.7	5.0	4.0	na
Non-performing loans (in per cent of total loans)[6]	12.9	11.2	8.2	12.6	20.6	19.8	15.0	11.5	na
Domestic credit to private sector (in per cent of GDP)	22.9	21.4	25.3	26.6	22.1	27.8	34.2	45.0	na
Stock market capitalisation (in per cent of GDP)	3.1	15.3	21.6	14.5	14.0	14.5	16.8	16.1	na
EBRD index of banking sector reform	2.7	2.7	2.7	2.7	3.0	3.3	3.3	3.7	3.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.7	2.7
Social sector									
Expenditures on health and education (in per cent of GDP)[7]	12.5	11.2	10.4	11.2	12.4	14.0	13.2	na	na
Life expectancy at birth, total (years)	72.1	72.4	72.5	72.8	73.0	73.3	73.5	na	na
Basic school enrolment ratio (in per cent)	80.4	82.4	82.3	82.8	80.7	82.5	95.2	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

1 Land is tradable but the right to trade land applies to foreigners only on a reciprocity basis and foreigners cannot acquire certain types of land (including agricultural) from the state.
2 Refers to all taxes on international trade.
3 New series (see Box 2.1 for explanation).
4 Excludes swaps with frozen currency deposits.
5 Based on Employment Service and enterprise data. Until 1996 data are according to UCEA classification standards. From 1997 data are according to NCEA classification standards.
6 Changes in non-performing loans data compared with previous *Transition Reports* are due to the change of loan categories included in non-performing loans (see definitions).
7 Refers to expenditures by the central government on education and expenditures by the health insurance fund.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	6.8	6.0	6.5	2.5	-0.9	2.9	3.8	5.2	4.2
Private consumption	na	0.4	12.9	-0.6	-2.9	4.2	4.6	6.6	na
Public consumption	na	-5.9	3.0	1.6	-1.0	-8.9	-4.3	-1.8	na
Gross fixed capital formation	na	na	na	2.5	-3.9	-3.8	9.7	10.1	na
Exports of goods and services	na	9.8	7.6	3.9	0.7	12.0	8.7	1.2	na
Imports of goods and services	na	6.8	25.2	-4.9	-3.5	3.7	9.3	8.8	na
Industrial gross output	0.3	3.1	6.8	3.7	-1.4	1.7	6.0	5.4	na
Agricultural gross output	0.7	1.3	4.0	10.2	-3.5	2.8	8.7	na	na
Employment [1]				*(Percentage change)*					
Labour force (end-year)	-1.3	0.9	3.4	-1.5	-1.0	7.2	-5.6	2.7	na
Employment (end-year)	-3.3	-1.4	3.4	-3.1	-3.4	4.1	-5.4	4.0	na
				(In per cent of labour force)					
Unemployment (end-year)	14.5	10.0	9.9	11.4	13.6	16.1	15.8	14.8	na
Prices and wages				*(Percentage change)*					
Retail prices (annual average)	2.0	3.5	3.6	5.7	4.2	6.2	4.9	2.4	2.4
Retail prices (end-year)	3.8	3.4	3.8	5.4	4.4	7.4	2.6	2.9	2.7
Producer prices (annual average)	0.7	1.4	2.3	-1.2	2.6	9.7	3.6	-0.4	na
Producer prices (end-year)	1.6	1.5	1.6	-2.1	5.9	11.2	-3.1	0.2	na
Gross average monthly earnings in economy (annual average)	34.0	12.3	13.1	12.6	10.2	7.0	3.9	6.0	na
Government sector [2]				*(In per cent of GDP)*					
General government balance	-1.4	-1.0	-1.9	-1.0	-8.2	-6.5	-6.8	-4.8	-4.6
General government expenditure	44.9	45.3	44.4	46.7	56.6	52.7	51.5	50.0	na
General government debt	19.3	29.2	31.9	38.8	50.1	53.4	54.9	57.5	na
Monetary sector				*(Percentage change)*					
Broad money (M4, end-year)	39.3	49.1	38.3	13.0	-1.2	28.9	45.2	9.5	na
Domestic credit (end-year)	10.9	1.0	15.9	19.1	-1.5	9.3	21.6	28.4	na
				(In per cent of GDP)					
Broad money (M4, end-year)	25.0	34.0	41.0	41.7	40.0	47.9	65.1	65.8	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Refinancing rate (3 months)	27.0	9.5	9.0	10.5	11.6	7.0	4.3	2.7	na
Inter-bank interest rate (daily)	27.2	10.4	9.4	15.8	12.7	4.5	2.7	2.2	na
Deposit rate [3]	6.1	4.2	4.4	4.1	4.3	3.4	2.8	1.6	na
Lending rate [3]	22.3	18.5	14.1	16.1	13.5	10.5	9.5	11.2	na
				(Kuna per US dollar)					
Exchange rate (end-year)	5.3	5.5	6.3	6.2	7.6	8.8	8.4	7.3	na
Exchange rate (annual average)	5.2	5.4	6.2	6.4	7.1	8.3	8.3	7.9	na
External sector				*(In millions of US dollars)*					
Current account	-1,442	-1,091	-2,325	-1,453	-1,397	-469	-726	-1,613	-1,718
Trade balance	-3,259	-3,624	-5,196	-4,071	-3,299	-3,204	-4,101	-5,305	-6,022
Merchandise exports	4,633	4,546	4,210	4,581	4,395	4,567	4,759	4,995	5,369
Merchandise imports	7,892	8,169	9,407	8,652	7,693	7,771	8,860	10,300	11,392
Foreign direct investment, net	109	486	347	835	1,420	1,085	1,407	383	673
Gross reserves, excluding gold (end-year)	1,895	2,314	2,539	2,816	3,025	3,525	4,704	5,886	na
External debt stock	3,809	5,308	7,452	9,685	9,978	11,055	11,317	15,355	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	2.4	2.8	2.7	3.2	3.7	4.4	5.2	5.5	na
				(In per cent of exports of goods and services)					
Debt service	9.6	8.9	10.4	13.0	21.7	22.1	18.8	22.3	na
Memorandum items				*(Denominations as indicated)*					
Population (mid-year, million)	4.7	4.5	4.6	4.5	4.6	4.4	4.5	4.4	na
GDP (in millions of kuna)	98,382	107,981	123,811	137,604	141,579	152,519	162,909	176,429	189,909
GDP per capita (in US dollar)	4,029	4,422	4,398	4,805	4,371	4,206	4,385	5,053	na
Share of industry in GDP (in per cent)	22.8	21.6	21.9	21.1	20.7	20.7	20.7	19.8	na
Share of agriculture in GDP (in per cent) [4]	8.6	8.4	7.8	7.9	8.1	7.4	7.1	6.9	na
Current account/GDP (in per cent)	-7.7	-5.5	-11.6	-6.7	-7.0	-2.5	-3.7	-7.2	-6.0
External debt - reserves (in US$ million)	1,914	2,994	4,913	6,869	6,953	7,530	6,612	9,469	na
External debt/GDP (in per cent)	20.2	26.7	37.1	44.8	50.1	60.0	57.9	68.5	na
External debt/exports of goods and services (in per cent)	53.7	67.7	90.7	113.3	122.9	127.6	117.5	145.6	na

[1] Employment service and enterprise data until 1996. From 1997 based on labour force surveys.

[2] Consolidated central government. Government expenditures include net lending.

[3] Weighted average over all maturities.

[4] Includes hunting, forestry and fishing.

Czech Republic

Key reform challenges

- **Increased transparency for public procurement and clearer rules for private sector involvement in public sector projects are needed to enable the effective implementation of large infrastructure projects planned over the next few years.**
- **Stronger growth in the enterprise sector is dependent on improvements in the business environment, including greater consistency of law enforcement and further legislative changes to improve corporate governance.**
- **Implementation of fiscal reform, especially rationalisation of government expenditure, is necessary to avoid a rapid build up of public debt.**

Stabilisation

Fiscal deficits remain large.
The general government deficit reached 6.7 per cent of GDP in 2002, according to ESA95 methodology and including the losses of the Czech Consolidation Agency (CCA). The deficit is expected to remain above 5 per cent of GDP in the medium term unless comprehensive fiscal reform is implemented. The ratio of public debt to GDP is below 25 per cent, but could double in the next four to five years if high fiscal deficits persist. The government has agreed on the need to cut the fiscal deficit over the medium term, lowering it to 4 per cent of GDP by 2006 through spending cuts and tax reforms. Successful implementation of the planned consolidation is critically dependent on parliamentary approval of the necessary legislation and favourable macroeconomic developments.

Privatisation

Workout of assets managed by the CCA progresses.
The CCA manages certain state assets, mostly impaired assets transferred from commercial banks as part of the restructuring of the banking sector. Although there was little change in the value of the CCA's total assets between the end of 2001 and 2002 (when they amounted to CZK 250 billion, over €8 billion), there was a significant change in their composition. The CCA successfully proceeded with workouts of its existing assets, including sales of claims on a few large companies, such as Zetor and Tatra, to strategic investors. These sales were balanced by the completion of transfers of impaired assets from the banking sector to the CCA. In 2003 the block sales continued, including a package of claims to bankrupt companies originally worth a total of CZK 62 billion (€2 billion), sold in July 2003 to a local financial group, PPF, for about 2 per cent of its nominal value.

Privatisation of industrial companies continues.
The government has retained ownership in 11 large enterprises, but has proceeded to sell-off stakes in four companies, including engineering company Vitkovice, mining companies Sokolovska Uhelna and Severoceske Doly, and major petrochemical conglomerate Unipetrol. The sale of a 67 per cent state share in Vitkovice to local strategic investor Lahvarna Ostrava was signed in August 2003. The strategy for the sale of the mining companies was approved by the government in July 2003. The completion of the privatisation is expected within a year. The contract with the advisers for the privatisation of Unipetrol was signed in July 2003. This is the second attempt to sell Unipetrol. The first sale was cancelled in September 2002.

Enterprise reform

Development of corporate sector hindered by complex business regulations.
Transparent and comprehensive state support for larger and mostly foreign-owned companies, introduced in 1998 and executed through the investment promotion agency CzechInvest, has resulted in the Czech Republic recording the highest stock of foreign direct investment per capita in central and eastern Europe by the end of 2002. However, the expansion of market interactions between enterprises and a deepening of financial intermediation has been affected by the slow and sometimes inconsistent judiciary. The lack of transparency in public procurement and corruption have also posed a significant problem for enterprise development, including private sector participation in public projects. In addition, industrial restructuring and enterprise development, in particular the development of smaller local companies, have been held back by complex administrative rules, especially those relating to registration and the awarding of permits and licences. The newly established procedures for the use of EU transfers after accession have also been described as unnecessarily complicated by the European Commission and may need to be simplified.

Liberalisation, stabilisation, privatisation

1990
Jul First Czechoslovak Eurobond issued

1991
Jan Exchange rate unified
Jan Fixed exchange rate regime adopted
Jan Most prices liberalised
Jan Most foreign trade controls lifted
Jan Small-scale privatisation begins
Feb Restitution law adopted
Mar Skoda Auto sold to Volkswagen

1992
Feb Treasury bills market initiated
May First wave of voucher privatisation begins
Jul EFTA agreement signed

1993
Jan Czechoslovakia splits into Czech and Slovak Republics
Jan VAT introduced
Jan Income tax law adopted
Feb New currency (koruna) introduced
Mar First Czech Eurobond issued
Mar CEFTA founded

1994
Mar Second wave of voucher privatisation begins

1995
Jan WTO membership granted
Oct Full current account convertibility introduced
Dec OECD membership granted

1996
Feb Exchange rate band widened

1997
Apr Austerity package announced
May Currency crisis ensues
May Managed float exchange rate regime adopted
May Second austerity package announced

1998
Mar EU accession negotiations commence
Apr Investment incentives adopted

2002
Dec EU accession negotiations completed

New bankruptcy legislation prepared.
A new bankruptcy law, based on German and US bankruptcy legislation, is currently being prepared. The law seeks to clarify the rules, strengthen the rights of creditors and speed up the process. The current bankruptcy legislation, which came into force in 1991 and has been amended many times since, has failed to provide a framework for the

Enterprises, infrastructure, finance and social reforms

1993
Apr Stock exchange begins trading
Apr Bankruptcy law amended

1994
Sep First pension fund obtains licence
Nov First corporate Eurobond issued

1995
Jan Bad loan provisioning regulation adopted
Jan Energy law adopted
Jun Telecommunications privatisation begins
Jul Mortgage banking law adopted

1996
Jan BIS capital adequacy regulation enacted
Jul Securities law amended
Oct Largest private bank forced into administration
Nov Competition agency established

1997
Oct First large power company sold

1998
Jan Bankruptcy law amended
Apr Independent securities regulator established
Jun Law on investment funds adopted
Jul Utility prices increased significantly
Sep Banking law amended

1999
May Enterprise restructuring agency established

2000
Mar Largest savings bank privatised
May New bankruptcy law adopted
May New telecommunications law adopted
Jun IPB, major Czech bank, forced into administration

2001
Jan New capital market legislation adopted
Feb First package of Consolidation Bank's bad loans sold
Jun Bank privatisation completed

2002
Apr Gas sector privatisation completed
Jun Major steel company privatised
Jul Telecommunications liberalisation completed

2003
Jan Railways reform started

quick and efficient restructuring of insolvent companies. According to the World Bank, a typical bankruptcy procedure in the Czech Republic lasts over nine years, the greatest length of time among all the 23 transition countries included in the World Bank's survey.

Infrastructure

Power sector liberalisation progresses.
Liberalisation in the power sector to date has largely focused on industrial users. Companies whose electricity consumption exceeds 9 gWh/year have been free to choose their supplier since January 2003. In July 2003 the parliament approved an amendment to the energy law, allowing companies equipped with meters to choose their suppliers from January 2004, a year earlier than enterprises without meters. Liberalisation of the household electricity market is planned from January 2006.

Energy sector ownership changed.
Following the failure of power sector privatisation in early 2002, the authorities focused on restructuring the sector, including strengthening the links between power generation and distribution while separating power transmission from generation. The Anti-monopoly Office approved a strategy, conditional on further changes in ownership to promote effective competition in the power sector after EU accession. As a result, in July 2003 the dominant Czech power generating company CEZ fully divested from two regional distributors (out of a total of eight). CEZ is also expected to fully divest one minority and one majority stake in other regional distributors and sell its remaining minority stake in the power transmission company.

Controversial contract for privately financed motorway cancelled.
A controversial project to build and maintain a motorway in Northern Moravia, awarded without an open tender to a private contractor in June 2002, was cancelled by the new government in March 2003. The project will now be financed from public resources. A decision has also been made to ensure all future public-private partnerships in road construction will be examined and approved by the parliament to increase transparency.

First steps in restructuring railways taken.
In January 2003 the national railways company was split into an infrastructure company and a company operating rolling stock. As part of the plan, in July 2003 the authorities announced plans to sell off or lease some railway assets (worth about CZK 2 billion, €65 million). In November 2002 a contract to outsource modernisation and management of three major railway stations to the private sector was awarded to a consortium of Italian companies in an open international tender.

Telecom privatisation cancelled.
The government's decision to sell its 51 per cent stake in the former monopoly fixed-line provider, Czech Telecom (CT), was cancelled in December 2002. This was mainly due to legal issues relating to the rights of minority shareholders in its mobile subsidiary Eurotel. An important step to overcoming these problems was taken in June 2003 when CT purchased the 49 per cent stake in Eurotel, held by a consortium of US telecommunications firms, to become the sole owner. This should enable the privatisation of CT to be relaunched.

Financial institutions

Banking sector restructure progressing, despite collapse of two small banks.
Following the transfer of bad loans from large state-owned commercial banks to the CCA, and the subsequent privatisation of these banks, the share of bad loans fell to 9 per cent of total bank loans by the end of 2002. In addition, the financial performance of the banks also improved. Loan quality is likely to further improve as a result of the establishment of the Central Register of Credit in November 2002. The register currently includes information on around 2 million loans to 1.6 million borrowers, including loans to both enterprises and consumers and impaired loans managed by the CCA. During 2003 two small private banks were closed. In February, Union Banka was closed to customers and its banking licence withdrawn as a result of financial problems. Another small bank, Plzenska Banka, was closed in March following the conclusion of a protracted criminal case relating to fraud in an investment fund.

Social reform

Health care providers transferred to regional authorities.
Control of the majority of hospitals was transferred from the central government to regional authorities in January 2003. Reforms in the health sector are expected to continue with some rationalisation among health care providers, including the transformation of some general hospitals into specialised facilities. Improvements in the financial management of the health care facilities and the possible introduction of co-payments by patients are also expected. Private health payments account for less then 10 per cent of total expenditures on health care.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **36.6 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **<2 per cent (1996)**
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	17.4	17.4	13.3	13.3	13.3	13.3	12.4	12.4	10.9
Number of goods with administered prices in EBRD-15 basket	4.0	4.0	2.0	2.0	2.0	2.0	2.0	2.0	1.0
Share of trade with non-transition countries (in per cent)	68.1	71.3	72.1	74.3	73.9	76.8	79.9	80.7	na
Share of trade in GDP (in per cent)	89.4	85.9	93.6	95.3	99.0	119.2	122.1	113.2	na
Tariff revenues (in per cent of imports)	2.6	2.6	1.7	1.5	1.2	1.1	0.7	0.7	na
EBRD index of price liberalisation [1]	4.0	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	4.6	6.3	7.1	7.9	9.3	10.3	13.1	18.7	na
Private sector share in GDP (in per cent)	70.0	75.0	75.0	75.0	80.0	80.0	80.0	80.0	na
Private sector share in employment (in per cent)	57.2	58.9	59.7	60.6	65.0	65.0	70.0	70.0	na
EBRD index of small-scale privatisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)[2]	8.1	7.3	7.1	6.7	7.0	7.1	7.4	7.9	na
Share of industry in total employment (in per cent)	32.7	32.1	31.4	31.2	30.8	30.2	31.0	30.7	na
Change in labour productivity in industry (in per cent)	12.2	12.7	3.2	4.9	3.1	8.0	4.2	4.9	na
Investment rate/GDP (in per cent)	34.0	36.6	35.1	33.6	32.6	33.5	34.5	34.0	na
EBRD index of enterprise reform	3.0	3.0	3.0	3.0	3.0	3.3	3.3	3.3	3.3
EBRD index of competition policy	2.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	23.6 (0.5)	27.3 (1.9)	31.8 (5.1)	36.4 (9.4)	37.1 (19.0)	37.8 (42.4)	37.4 (65.9)	37.8 (84.9)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	55.2	84.0	118.6	154.5	209.0	219.6	na
Railway labour productivity (1989=100)	84.0	83.2	80.2	73.0	69.2	74.1	71.9	68.2	na
Electricity tariffs, USc kWh (collection rate in per cent)	3.73 (95)	3.83 (95)	3.69 (95)	4.96 (na)	5.12 (na)	4.5 (na)	6.0 (na)	7.96 (na)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.0	3.2	3.1	3.2	3.5	3.6	na	na	na
EBRD index of infrastructure reform	2.3	2.3	2.7	2.7	2.7	2.7	3.0	3.0	3.0
Electric power	2.0	2.0	2.0	2.0	2.0	2.0	3.0	3.0	3.3
Railways	na	na	na	2.3	2.3	2.3	2.3	2.3	3.0
Roads	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	3.3	3.3	3.7	4.0	4.0	4.0	4.0	4.0	4.0
Water and waste water	2.7	2.7	2.7	3.3	4.0	4.0	4.0	4.0	4.0
Financial institutions									
Number of banks (foreign-owned)	55 (23)	53 (23)	50 (24)	45 (25)	42 (27)	40 (26)	38 (26)	37 (26)	na
Asset share of state-owned banks (in per cent)	17.6	16.6	17.5	18.6	23.1	28.2	3.8	4.6	na
Non-performing loans (in per cent of total loans)[3]	26.6	21.8	19.9	20.3	21.5	19.3	13.7	9.4	na
Domestic credit to private sector (in per cent of GDP)	46.7	47.2	54.3	47.0	42.3	36.6	24.3	20.0	na
Stock market capitalisation (in per cent of GDP)	30.2	31.4	26.4	19.7	22.3	20.9	15.3	21.0	na
EBRD index of banking sector reform	3.0	3.0	3.0	3.0	3.3	3.3	3.7	3.7	3.7
EBRD index of reform of non-bank financial institutions	2.7	2.7	2.7	3.0	3.0	3.0	3.0	3.0	3.0
Social sector									
Expenditures on health and education (in per cent of GDP)	10.6	10.7	10.1	9.6	9.7	9.6	9.8	10.3	na
Life expectancy at birth, total (years)	73.4	73.8	73.9	74.5	74.7	74.8	74.9	na	na
Basic school enrolment ratio (in per cent)	99.6	97.3	97.6	97.6	97.7	98.4	98.0	na	na
Earnings inequality (GINI-coefficient)	28.2	25.4	25.9	25.8	25.7	27.0	27.3	na	na

1 New series (see Box 2.1 for explanation).

2 Subsidies to enterprises and financial institutions, including the Czech Consolidation Agency.

3 Excludes loans on the books of the former Kosolidacni Banka, banks in receivership and the loan of CSOB to Slovenska Inkasni. Changes in non-performing loans compared with previous *Transition Reports* are due to the change of loan categories included in non-performing loans (see definitions).

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP [1]	5.9	4.3	-0.8	-1.0	0.5	3.3	3.1	2.0	3.0
Private consumption	5.9	7.9	2.4	-1.8	1.9	2.3	3.8	3.9	na
Public consumption	-4.3	3.6	-4.4	-4.4	2.3	-1.0	5.3	5.7	na
Gross fixed capital formation	19.8	8.2	-2.9	0.7	-1.0	5.3	5.5	0.6	na
Exports of goods and services	16.7	8.2	9.2	10.0	6.1	17.0	11.9	2.8	na
Imports of goods and services	21.2	13.4	8.1	6.6	5.4	17.0	13.6	4.3	na
Industrial gross output	11.8	11.1	0.1	2.8	-0.4	5.1	6.8	4.8	na
Agricultural gross output	3.2	2.5	-1.5	-1.8	2.3	-2.0	1.8	-2.0	na
Employment				*(Percentage change)*					
Labour force (end-year)	0.8	0.7	0.1	0.5	0.4	0.2	0.0	1.0	na
Employment (end-year)	0.7	0.2	-0.7	-1.4	-2.1	-0.7	-0.1	0.8	na
				(In per cent of labour force)					
Unemployment (end-year)	2.9	3.5	5.2	7.5	9.4	8.8	8.9	9.8	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	9.1	8.8	8.5	10.7	2.1	3.9	4.7	1.8	0.2
Consumer prices (end-year)	7.9	8.6	10.0	6.8	2.5	4.0	4.1	0.6	1.2
Producer prices (annual average)	7.6	4.8	4.9	4.9	1.0	4.9	2.9	-0.5	na
Producer prices (end-year)	7.2	4.4	5.7	2.2	3.4	5.0	0.8	-0.7	na
Gross average monthly earnings in economy (annual average)	18.5	18.4	10.5	9.4	8.2	7.0	8.6	7.5	na
Government sector				*(In per cent of GDP)*					
General government balance [2]	-1.1	-1.7	-2.7	-2.4	-2.8	-4.4	-5.1	-6.7	-8.3
General government expenditure [2]	43.0	42.2	41.7	40.9	41.9	43.7	44.2	46.6	na
General government debt [3]	15.3	13.2	12.9	13.0	14.5	16.7	18.5	20.0	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	20.3	9.1	10.8	5.4	7.7	5.6	13.0	3.2	na
Domestic credit (end-year)	16.5	12.1	9.9	-4.1	-1.7	-2.6	-9.7	-10.0	na
				(In per cent of GDP)					
Broad money (M2, end-year)	75.3	70.6	72.5	69.6	72.8	74.5	73.4	72.4	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
2-week repo rate	11.3	12.4	14.8	9.5	5.3	5.3	4.8	2.8	na
3-month PRIBOR	10.9	12.7	17.5	10.1	5.6	5.4	4.7	2.6	na
Deposit rate [4]	7.0	6.8	7.7	8.1	4.5	3.4	3.0	2.2	na
Lending rate [4]	12.8	12.5	13.2	12.9	8.7	7.2	7.0	6.2	na
				(Korunas per US dollar)					
Exchange rate (end-year)	26.7	27.3	34.7	30.0	35.7	38.8	36.5	30.7	na
Exchange rate (annual average)	26.5	27.1	31.7	32.3	34.6	38.6	38.0	32.7	na
External sector				*(In millions of US dollars)*					
Current account	-1,369	-4,121	-3,564	-1,255	-1,462	-2,718	-3,273	-4,523	-3,700
Trade balance	-3,678	-5,706	-4,893	-2,603	-1,903	-3,131	-3,068	-2,286	-2,000
Merchandise exports	21,463	21,947	22,359	25,853	26,265	29,052	33,378	38,198	42,000
Merchandise imports	25,140	27,654	27,252	28,456	28,167	32,183	36,446	40,484	44,000
Foreign direct investment, net	2,526	1,276	1,275	3,591	6,234	4,943	5,476	9,029	5,000
Gross reserves, excluding gold (end-year)	14,023	12,435	9,774	12,677	12,825	13,139	14,464	23,709	na
External debt stock	17,190	21,181	21,617	24,348	22,861	21,608	22,374	26,281	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	5.6	4.4	3.6	4.5	4.5	4.2	4.1	6.1	na
				(In per cent of current account revenues, excluding transfers)					
Debt service	8.9	10.4	15.2	14.6	14.2	9.6	6.4	6.3	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	10.3	10.3	10.3	10.3	10.3	10.3	10.3	10.3	na
GDP (in millions of korunas)	1,381,049	1,566,968	1,679,921	1,839,088	1,902,293	1,984,833	2,175,238	2,275,609	2,348,760
GDP per capita (in US dollar)	5,049	5,601	5,143	5,535	5,332	4,984	5,547	6,742	na
Share of industry in GDP (in per cent)	33.3	33.8	35.9	36.9	35.5	36.0	37.3	38.4	na
Share of agriculture in GDP (in per cent)	4.7	4.9	5.0	4.8	3.9	3.9	3.8	3.7	na
Current account/GDP (in per cent)	-2.6	-7.1	-6.7	-2.2	-2.7	-5.3	-5.7	-6.5	-4.3
External debt - reserves (in US$ million)	3,167	8,746	11,843	11,671	10,036	8,469	7,910	2,572	na
External debt/GDP (in per cent)	33.0	36.7	40.8	42.7	41.6	42.1	39.1	37.8	na
External debt/current acc. revenues, excl. transfers (in per cent)	58.5	67.7	69.9	69.2	65.0	57.1	52.4	55.4	na

1 GDP and GDP component data in 1995 constant prices.

2 General government excludes privatisation revenues.

3 Consolidated outstanding debt including state budget, health insurance, extra-budgetary funds and local governments, but excluding the indirect debt of special state financial institutions (the Czech Consolidation Agency) and publicly guaranteed debt.

4 Weighted average over all maturities.

Estonia

Key reform challenges

- **Fiscal policy needs to remain tight to ensure macroeconomic stability, in light of the large current account deficit.**
- **The efficiency of public administration should be further enhanced by improving budgetary planning and reducing the number of local governments.**
- **Although Estonia has been granted a long transition period by the EU, restructuring of the oil shale sector and liberalisation of the energy market remain important priorities.**

Stabilisation

Maintenance of tight fiscal policies is key to controlling the current account deficit.
In view of the rapid credit growth and very high current account deficit (over 12 per cent of GDP in 2002), tight fiscal policies at the central and local government level are essential for the maintenance of macroeconomic stability. Although the central government recorded a surplus in 2002 of 1.2 per cent of GDP (on an ESA95 basis), this was largely offset by the sizeable and unexpected deficit of local governments, amounting to close to 1 per cent of GDP. The deteriorating trend of local budgets continued in the first half of 2003 and has limited the flexibility of the central government to plan fiscal policy effectively. In addition, the IMF is concerned that the 2004 budget, currently being prepared, appears to be predicated on the receipt of large grants from the EU. (Past experience has shown that these grants take a long time to materialise.) The authorities still need to make a significant effort to accelerate preparations and capacity for managing EU grant funds. The EU and IMF have been urging the government to continue general budgetary surpluses at this point in the business cycle, especially in view of the forthcoming increase in expenditure requirements for EU accession and the constraints imposed by the Stability and Growth Pact and euro accession.

Improving budgetary planning and rationalising municipalities remain priorities.
Continuing the policy of a balanced budget requires effective coordination between central and local government, in terms of both budget planning and execution. According to the EU, reform of the current framework should be regarded as essential for improving the effectiveness of fiscal policy, especially in light of the pending accession to ERMII and EMU. In addition, there still has not been any progress with local government reform, since the consolidation of municipal governments continues to be delayed by political resistance.

Legislation prepared for income tax changes.
The government has prepared a bill foreseeing the lowering of the income tax rate and changes to the social tax. The bill sets out a timetable whereby the income tax rate will be reduced to 20 per cent, from the present 26 per cent, over the next three years. Simultaneously, the tax-free monthly income will increase from EKr 1,000 to EKr 2,000. From 2004 tax-free income will rise to EKr 1,400 per month and the income tax rate will drop to 24 per cent. From the beginning of 2005 tax-free income will rise to EKr 1,700 per month and the income tax rate will drop to 22 per cent. These changes will ensure that the goals of EKr 2,000 in tax-free monthly income and an income tax rate of 20 per cent are achieved by 2006. The bill also calls for the gradual increase of revenue from physical individuals' income tax to be given to local government budgets. This measure is intended to temper the negative effect the tax cuts and the exemption of a larger proportion of personal income from taxation will inevitably have on the budgets of local governments.

Enterprise reform

Changes to court system improve the business environment and may further limit corruption.
A new Courts Act, which entered into force in July 2002, introduced a number of improvements in the judiciary, including enhanced independence and administration of the courts system. The new Act has also led to the merger of a number of district courts in January 2003, reducing the number of courts to 20 from 22. A new law on contractual and non-contractual relations entered into force in July 2002. However, the backlog of cases continues to be high, the number of decisions upheld at appeal is increasing only slowly and the penalties continue to be low, undermining the effectiveness and enforcement of the law.

Liberalisation, stabilisation, privatisation

1990
- Dec — State trading monopoly abolished
- Dec — Law on small-scale privatisation enacted
- Dec — Government decree on SOE transformation passed

1991
- Jun — Law on ownership reform enacted
- Aug — Independence from the Soviet Union declared
- Oct — Law on private ownership of land adopted
- Oct — Tradability of land rights enacted
- Dec — Small-scale privatisation begins

1992
- Jun — New currency (kroon) and currency board introduced
- Nov — Large-scale privatisation commenced via tender method
- Dec — Most consumer prices liberalised

1993
- May — Central Bank independence granted
- Jun — Law on compensation fund adopted
- Jun — Law on property rights adopted
- Jun — Privatisation Act adopted
- Aug — Estonian Privatisation Agency established
- Nov — Remaining tariffs abolished

1994
- Jan — VAT introduced
- Jan — Non-tariff trade restrictions removed
- Jan — Flat-rate income tax introduced
- Aug — Government decree on the public offering of shares in SOEs passed
- Aug — Full current account convertibility introduced

1996
- Oct — Law on property rights amended

1998
- Apr — EU accession negotiations begin

1999
- Nov — WTO membership granted

2000
- Jan — Corporate income tax on reinvested profits abolished

2001
- May — Capital controls fully liberalised

2002
- Jun — First Eurobond issued by government

Enterprises, infrastructure, finance and social reforms

1994
Sep BIS capital adequacy requirements introduced

1995
Jan IAS introduced
Feb First state-owned bank privatised
Feb Commercial code adopted

1996
May Stock exchange established
May Electric power pricing reformed
May Money laundering regulations adopted
Jun Trade in fully listed shares begins
Nov Energy law approved
Dec Insolvency law amended

1998
Apr Utility prices adjusted
Jun Pension reform law adopted
Jul Third pension tier introduced
Oct Deposit insurance law adopted
Oct EU compatible competition law adopted

1999
Jan First pension tier becomes operational
Feb First Estonian Eurobond issued by Uhispank
Feb Eesti Telekom floated
Feb Telecommunications law amended
Feb Banking law amended

2000
Jun Last state-owned bank privatised

2001
Jan Telecommunications market liberalised
May Law on unified financial sector supervisory agency passed
Aug Railways privatised
Sep New Act on Contractual and Extra-contractual Obligations passed
Sep Legislation for second pension pillar passed
Oct New Competition Act adopted
Oct New Securities Market Act adopted

2002
Jan Integrated financial sector supervisory agency established
Jan New unemployment insurance scheme adopted
Feb Merger of the Tallinn Stock Exchange with Helsinki Exchange completed
Jul First Eurobond issued by Eesti Energia

2003
Feb New Energy Market Act passed

Infrastructure

Electricity market granted long transition period for full liberalisation …
Estonia's dominant source of fuel is oil shale, but the industry requires restructuring to address issues of efficiency and environmental damage. As part of its final EU accession negotiations, Estonia won important concessions for its oil shale industry. The EU has acknowledged the special role that the fuel plays in guaranteeing Estonia's self-sufficiency in energy generation and the industry's role in protecting employment in an already depressed region. Estonia has been given until 2012 to liberalise its electricity market fully. The EU also made oil shale eligible for research finance from its Coal and Steel Fund. Estonia has until the end of 2009 to establish a compulsory 90-day fuel oil and petrol reserve. This provides the government ample time to restructure the energy sector. As a start, the government has invested heavily in Narva Power, with its modernisation programme amounting to approximately 7 per cent of GDP. The Narva Power facility, which runs on domestically mined oil shale, requires the upgrade of equipment and technologies to bring it in line with international standards. Renovation has continued in 2003. The restructuring costs are being funded by the debut Eurobond issue of Eesti Energia in July 2002 of €200 million and by EU funds.

… but important reforms in the energy sector still necessary.
In February 2003 the government adopted the Electricity Market Act. Although broadly intended to advance liberalisation, in practice the Act introduces several conditions that actually delay market opening. This includes restrictions on importing electricity from countries that have not liberalised their markets enough, have lower environmental standards, or have different pricing mechanisms. In addition, the regulatory powers and independence of the Energy Market Inspectorate (EMI) still need to be enhanced. The Inspectorate remains under the control of the Ministry of Economic Affairs and is subject to repeated interference by the government. The Ministry of Economic Affairs is currently overhauling the tariff-setting mechanisms and hopes to arrive at a new scheme by October 2003.

Financial institutions

Financial sector supervision further strengthened.
The new regulator, the Financial Supervision Authority (FSA), has initiated wide ranging changes to the supervisory framework in Estonia. The FSA has significantly enhanced supervision over issuers of securities, the provision of investment services, disclosure of information, insider dealing and the securities settlement system. The FSA has also forced the exit of two insurance companies which failed to comply with the amended legislation and oversaw the smooth transfer of their portfolios to two other companies. Moreover, the FSA has imposed stricter standards on insurance brokers, which have led to the removal of several brokers from the registration list. In the summer of 2002 the Guarantee Fund Act, the Investor Protection Fund and the Pension Protection Fund became effective, stipulating the participation of market players in the financing schemes of these funds. New legislation was also approved in 2002 for the prevention of money laundering.

Social reform

Pension sector developing, albeit from a low base.
By the middle of 2003, one year since the start of payment collections to the second pillar, 300,000 people had joined the system. This amounts to roughly one-third of all those eligible to join, with total assets invested of over €50 million. So far a total of six institutions have been licensed to manage mandatory pension funds in Estonia, and they have set up 15 new pension funds. Estonia's largest fund manager as of end-2002 was Hansa Investeerimisfondid (Hansa Investment Funds) with a market share of 57.3 per cent. By June 2003 the assets of the Hansapank pension funds surpassed EKr 270 million (€17.5 million), accounting for nearly half of the money placed in all Estonian-funded pension funds.

Measures introduced to address high unemployment.
Although the Estonian unemployment rate has decreased markedly in recent years, this has been primarily due to a decline in the size of the labour force rather than through significant job creation. There are still a large number of long-term unemployed. New labour market policies were set out in the employment action plan in 2002 and the joint assessment paper of March 2003, placing particular emphasis on reintegrating the long-term unemployed, promoting vocational training and job creation. However, labour market flexibility still needs to be enhanced.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **34.4 per cent**
Exchange rate regime – **currency board**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **full**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **10 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **5.2 per cent (1998)**
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)[1]	18.0	24.0	24.0	25.6	25.6	25.6	28.9	28.5	24.9
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Share of trade with non-transition countries (in per cent)	61.6	59.5	73.1	64.3	76.3	84.7	74.3	71.8	na
Share of trade in GDP (in per cent)	113.8	106.6	123.8	124.3	112.5	143.4	134.7	125.1	na
Tariff revenues (in per cent of imports)	0.2	0.0	0.0	0.0	0.0	0.1	0.1	0.0	na
EBRD index of price liberalisation [2]	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	4.0	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.0	0.2	0.3	4.2	5.2	7.2	7.6	na
Private sector share in GDP (in per cent)	65.0	70.0	70.0	70.0	75.0	75.0	75.0	80.0	na
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	0.5	0.4	0.3	0.9	0.9	0.8	0.8	1.1	na
Share of industry in total employment (in per cent)	28.8	27.9	25.9	25.7	25.3	26.3	26.1	24.7	na
Change in labour productivity in industry (in per cent)	4.2	7.1	18.2	5.2	1.9	11.5	8.6	13.4	na
Investment rate/GDP (in per cent)	26.0	27.8	31.0	29.3	24.5	27.8	28.9	31.4	na
EBRD index of enterprise reform	3.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3	3.3
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.7	2.7	2.7	2.7	2.7
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	27.7 (2.1)	29.9 (4.7)	32.1 (9.9)	34.4 (17.0)	35.7 (26.8)	36.3 (38.7)	35.2 (45.5)	35.1 (65.0)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	113.9	175.1	219.7	298.6	375.3	465.9	na
Railway labour productivity (1989=100)	50.8	55.0	74.2	98.6	124.6	148.7	172.2	287.4	na
Electricity tariffs, USc kWh (collection rate in per cent)	3.0 (100)	3.2 (98)	3.4 (97)	4.1 (99)	4.1 (na)	4.1 (na)	4.9 (97)	5.6 (>90)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.9	1.8	2.1	2.3	2.5	2.9	na	na	na
EBRD index of infrastructure reform	2.3	2.3	2.3	3.0	3.0	3.3	3.3	3.3	3.3
Electric power	2.0	2.0	2.0	3.0	3.0	3.7	3.7	3.0	3.0
Railways	na	na	na	4.0	4.0	4.0	4.0	4.3	4.3
Roads	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3	2.3
Telecommunications	3.0	3.0	3.3	4.0	4.0	4.0	4.0	4.0	4.0
Water and waste water	2.7	2.7	3.0	3.0	3.0	4.0	4.0	4.0	4.0
Financial institutions									
Number of banks (foreign-owned)[3]	19 (5)	15 (4)	12 (4)	6 (3)	7 (3)	7 (4)	7 (4)	7 (4)	na
Asset share of state-owned banks (in per cent)[4]	9.7	6.6	0.0	7.8	7.9	0.0	0.0	0.0	na
Non-performing loans (in per cent of total loans)[5]	2.4	2.0	2.1	4.0	2.9	1.3	1.2	0.8	na
Domestic credit to private sector (in per cent of GDP)	14.0	18.1	25.6	25.9	26.0	25.5	27.4	29.8	na
Stock market capitalisation (in per cent of GDP)	na	na	24.7	9.4	36.6	34.4	26.6	33.6	na
EBRD index of banking sector reform	3.0	3.0	3.3	3.3	3.7	3.7	3.7	3.7	3.7
EBRD index of reform of non-bank financial institutions	1.7	2.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3
Social sector									
Expenditures on health and education (in per cent of GDP)	9.6	13.4	12.2	12.2	13.1	11.7	10.6	na	na
Life expectancy at birth, total (years)	67.8	69.8	70.1	69.8	70.6	70.6	70.6	na	na
Basic school enrolment ratio (in per cent)	95.0	95.8	96.9	993.0	100.9	102.8	103.8	na	na
Earnings inequality (GINI-coefficient)	na	na	33.6	38.4	40.1	37.6	na	na	na

1 The high share can be explained by the inclusion of gasoline (on which there are excise taxes) in the calculations of the statistical office.

2 New series (see Box 2.1 for explanation).

3 Includes Merita-Nordbanken branch and investment banks.

4 Increase in 1998 is due to renationalisation of Optiva Bank, following its insolvency in late 1998.

5 Changes in non-performing loans data compared with previous *Transition Reports* are due to the change in the definition of non-performing loans (see definitions).

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	*Projection*
Output and expenditure				*(Percentage change in real terms)*					
GDP	4.3	3.9	9.8	4.6	-0.6	7.3	6.5	6.0	4.5
Private consumption	3.3	9.2	7.8	4.3	-2.9	6.5	4.8	9.3	na
Public consumption	16.3	-1.0	1.8	4.5	3.8	1.5	0.9	5.0	na
Gross fixed capital formation	4.1	11.4	17.6	11.3	-14.8	13.3	12.2	16.1	na
Exports of goods and services	5.3	2.4	29.5	12.0	0.5	28.6	-0.2	6.0	na
Imports of goods and services	5.4	7.6	29.1	12.9	-5.4	27.9	2.1	10.2	na
Industrial gross output	11.0	1.6	15.4	2.8	-4.2	14.6	8.5	8.6	na
Agricultural gross output	2.6	-1.2	5.8	1.1	-2.6	0.9	-5.4	1.4	na
Employment [1]				*(Percentage change)*					
Labour force (annual average)	-4.0	-2.0	3.8	-1.5	-1.9	0.4	-0.2	-1.2	na
Employment (annual average)	-6.2	-2.2	4.0	-1.7	-4.5	-1.2	0.9	1.4	na
				(In per cent of labour force)					
Unemployment (annual average)	9.7	10.0	9.6	9.8	12.2	13.6	12.6	10.3	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	29.0	23.1	11.2	8.1	3.3	4.0	5.8	3.6	1.4
Consumer prices (end-year)	28.9	14.8	12.5	4.2	3.8	5.0	4.2	2.6	2.2
Producer prices (annual average)	25.6	14.8	8.8	4.2	-1.2	4.9	4.4	0.4	na
Producer prices (end-year)	21.8	9.9	7.7	0.1	2.2	6.0	1.7	1.4	na
Gross average monthly earnings in economy (annual average)[2]	37.0	25.7	19.7	15.4	7.6	10.5	12.3	11.5	na
Government sector [3]				*(In per cent of GDP)*					
General government balance	-1.3	-1.5	2.2	-0.3	-4.3	-0.7	0.7	1.2	-0.5
General government expenditure	41.5	40.5	37.6	40.5	43.2	38.5	37.0	38.4	na
General government debt	8.6	8.0	6.7	6.8	7.7	6.1	6.4	5.2	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	27.8	37.2	37.8	4.2	23.5	25.1	23.8	11.1	na
Domestic credit (end-year)	59.0	92.5	78.3	16.5	9.6	27.2	24.4	27.6	na
				(In per cent of GDP)					
Broad money (M2, end-year)	26.5	28.3	32.0	29.0	34.5	37.7	41.7	42.0	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Inter-bank interest rate (up to 30 days maturity)	na	7.9	15.8	18.5	5.1	6.1	4.0	3.5	na
Deposit rate (over 12 months)[4]	8.7	10.5	10.8	8.9	8.9	6.8	4.5	3.7	na
Lending rate (over 12 months)[5]	15.8	13.9	11.2	16.3	8.6	8.9	10.1	6.4	na
				(Kroons per US dollar)					
Exchange rate (end-year)	11.5	12.4	14.3	13.4	15.6	16.8	17.7	14.9	na
Exchange rate (annual average)	11.5	12.0	13.9	14.1	14.7	17.0	17.6	16.6	na
External sector				*(In millions of US dollars)*					
Current account	-158	-398	-563	-478	-247	-294	-339	-800	-1,047
Trade balance	-666	-1,019	-1,125	-1,115	-822	-767	-788	-1,103	-1,400
Merchandise exports	1,697	1,813	2,294	2,690	2,515	3,309	3,359	3,516	3,700
Merchandise imports	2,363	2,832	3,419	3,806	3,337	4,076	4,148	4,619	5,100
Foreign direct investment, net	199	111	130	574	222	324	342	153	200
Gross reserves, excluding gold (end-year)	650	703	821	876	944	921	820	1,000	na
External debt stock[6]	626	1,534	2,562	2,924	2,879	3,007	3,279	4,704	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	2.7	2.5	2.4	2.2	2.7	2.2	1.9	2.0	na
				(In per cent of exports of goods and services)					
Debt service	1.7	2.6	4.3	7.5	12.1	8.7	10.3	10.2	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	na
GDP (in millions of kroons)	40,897	52,423	64,045	73,538	76,327	87,379	97,895	108,024	114,481
GDP per capita (in US dollar)	2,503	3,098	3,312	3,788	3,790	3,767	4,094	4,795	na
Share of industry in gross value added (in per cent)	22.0	21.1	20.3	20.3	19.1	20.1	20.2	20.3	na
Share of agriculture in gross value added (in per cent)	7.8	7.5	7.0	6.5	6.1	5.5	5.1	4.8	na
Current account/GDP (in per cent)	-4.4	-9.2	-12.1	-9.2	-4.7	-5.7	-6.1	-12.3	-12.8
External debt - reserves (in US$ million)	-24	831	1,742	2,048	1,935	2,087	2,458	3,703	na
External debt/GDP (in per cent)	17.5	35.2	55.5	56.0	55.4	58.5	58.8	72.3	na
External debt/exports of goods and services (in per cent)	24.3	52.5	70.9	70.1	71.9	62.6	65.5	85.5	na

1 New series based on ILO methodology. Population aged 15-74.
2 Starting in 1998 the data on average monthly gross wages do not include compensations from the Health Insurance Fund.
3 General government includes the state, municipalities and extra-budgetary funds. General government expenditure includes net lending.
4 Weighted average annual interest rate on time deposits.
5 Weighted average annual interest on kroon loans.
6 The debt data from 1996 onwards are from the Bank of Estonia. The data include non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

FYR Macedonia

Key reform challenges

- To accelerate growth and lower unemployment, a renewed effort is necessary to improve the business environment. Reducing bureaucracy, strengthening the judiciary and improving corporate governance standards are key.
- Modernisation of infrastructure, including the power and railway sectors, will require further regulatory reform to attract strong investment flows to these sectors.
- Although bank supervision has been tightened, financial intermediation remains low and several small banks are facing difficulties. Further consolidation and the continued enforcement of prudential regulation are needed.

Liberalisation

FYR Macedonia joins WTO.
In April 2003 FYR Macedonia joined the WTO. Along with initialling free trade agreements with all neighbouring countries by end-2002, accession to the WTO has reinforced the country's relative openness to trade. The average import tariff rate is 14.6 per cent and all quantitative restrictions on imports have been removed, with the exception of some tariff-free quotas consistent with WTO rules. To reduce the scope for discretion, these quotas are now allocated on a first-come, first-served basis and the government has committed to awarding them quarterly, rather than semi-annually.

Stabilisation

New IMF Stand-By Arrangement in place.
Under the new Stand-By Arrangement, approved by the IMF in April 2003, the government intends to reduce the general government deficit from 5.8 per cent of GDP in 2002 to 1.5 per cent in 2003. To achieve this target, the government will use a combination of economic growth, cuts in expenditure on goods and services, and measures to enhance revenues. The latter includes the recent reforms to the structure of VAT, which involved the rate on most non-food goods being raised from 5 per cent to a new standard rate of 18 per cent (down from 19 per cent) in April 2003. In December 2002 the temporary tax on financial transactions, which was introduced in July 2001 at the time of inter-ethnic conflict, was eliminated. The tax had been levied at both ends of a transaction and was a significant burden on the enterprise sector. As the yield from the tax was MKD 6.3 billion (€105 million), about 2.6 per cent of GDP in 2002, its abolition has added to the fiscal challenges faced by the government.

Privatisation

Privatisation of large loss-making enterprises relaunched.
While small-scale privatisation is close to completion, the sale or liquidation of large loss-making enterprises remains slow. This is due to the lack of investor interest and the government's reluctance to add to the already very high levels of unemployment. Under the World Bank's FESAL II programme, there were still 24 companies awaiting sale or liquidation in mid-2003. Eight were reported to have been sold by late August 2003. The Privatisation Agency has also relaunched the privatisation programme to restore momentum. A new privatisation timetable has been published for 22 loss-making enterprises and, in most instances, an adviser has been appointed for the sale. In each case, the asset will be sold to the highest bidder, who will not be required to give commitments either on future investment or on retaining current employees. The government aims to complete the programme by end-2003, after which the Privatisation Agency will be closed down.

Enterprise reform

The fight against endemic corruption continues.
Corruption remains a serious impediment to business in FYR Macedonia and the new government, formed in October 2002, is giving high priority to addressing the problem. In November 2002 the authorities established an independent Anti-Corruption Commission reporting to parliament. In June 2003 the State Programme for the Prevention and Repression of Corruption was adopted, including an action plan. By August 2003 several cases had been considered and proposals for criminal investigations submitted. However, the campaign to improve standards in public life is in the early stages and implementation will be the key challenge.

Liberalisation, stabilisation, privatisation

1991
Sep Independence from Yugoslavia declared

1992
Apr New currency (denar) introduced

1993
Jun Privatisation law adopted
Nov First credit auction undertaken by Central Bank

1994
Jan Sales taxes streamlined
Feb Greek embargo imposed

1995
Sep Greek embargo lifted

1996
Feb Major tax reforms introduced
Apr Agriculture privatisation law adopted
Jul Tariff structure rationalised
Aug Import restrictions eliminated

1997
Jul Denar devalued
Jul New land law adopted

1998
Jan EU Partnership and Cooperation Agreement signed
Jun Full current account convertibility introduced

1999
Apr Large influx of Kosovar refugees enter country
Jul Major oil refinery sold to foreign investor

2000
Apr VAT introduced
Oct Bread and flour prices liberalised

2001
Apr EU Stabilisation and Association Agreement signed
Jun Emergency tax on financial transactions introduced
Jul Oil imports liberalised

2002
Oct Foreign exchange operations liberalised
Dec Emergency financial tax ended

2003
Apr Standard rate of VAT extended
Apr WTO membership granted

Enterprises, infrastructure, finance and social reforms

1992	
Apr	Two-tier banking system established
Jun	Securities and Exchange Commission established
1993	
May	BIS capital adequacy adopted
1994	
Jan	Bank credit ceilings introduced
1995	
Mar	Banking rehabilitation law adopted
1996	
Mar	Stock exchange begins trading
Apr	Banking law adopted
Jun	Telecommunications law adopted
1997	
Mar	TAT Savings House collapsed
Jul	Securities law adopted
Nov	Electricity law adopted
1998	
May	New bankruptcy law adopted
1999	
Dec	Competition and anti-monopoly laws adopted
2000	
Mar	Pension reforms introduced
Apr	Credit ceilings on domestic banks lifted
Apr	Largest bank fully privatised
Jul	New mortgage law adopted
Jul	Law on banks adopted
Jul	Law on securities adopted
Oct	Bankruptcy law amended
2001	
Apr	Minimum bank capital requirements raised
Jul	New payments system adopted
2002	
Jan	Central Bank law adopted
Mar	Law on money laundering adopted
2003	
Aug	Railway company separated

A one-stop shop for registration to be introduced.
To simplify the business environment and overcome obstacles to registration, the government is planning to introduce a "one-stop shop". This is part of a package of measures designed to encourage businesses to move from the informal economy (currently estimated at around 40 per cent of GDP) to the formal sector. The new concept will require the modification of several laws before it can become operational and is scheduled to start in the second half of 2003. In addition, the government plans to present to parliament amendments to the foreign investment law, to advance the creation of an investment promotion agency.

Infrastructure

State railway company faces restructuring.
The restructuring of the largest state-owned enterprise in the country, Macedonian Railways, has begun. In May 2003, following consultations with the World Bank, the government adopted an action plan to separate the company into two units. One unit will be responsible for the sector's infrastructure, while the other will focus on operations. Previous studies had identified major inefficiencies in the company, resulting in large losses. Substantial layoffs are envisaged during the restructuring and in April 2003 the company announced the first retrenchment of 90 employees.

The reform of the energy sector proceeds slowly.
The government is proceeding with plans to restructure and eventually privatise the integrated monopoly, the Electric Power Company of Macedonia (ESM). Progress, however, has been slow. A law on the creation of an independent energy regulator was adopted in early 2003 and regulators were appointed in July 2003. A reorganisation plan, proposed by the government's restructuring and privatisation adviser (a consortium led by Meinl Bank of Austria), is due in the second half of 2003. USAID-sponsored consultants are also advising on sector restructuring, market design and tariff reform. In April 2003 ESM announced that it would cut supply to persistent debtors and in July 2003 electricity prices for all consumers were increased by 7 per cent. However, this price increase did not compensate ESM for having absorbed the full impact of the increase in the VAT rate. In November 2002 the government, along with other governments in the region, signed the Athens memorandum of understanding (MOU) on the creation of a regional electricity market in south-eastern Europe by 2005. Under the terms of the MOU, the government has committed to a number of reforms, including the establishment of an independent regulatory agency and the separation of transmission and distribution operators. Tariff reform and arrears reduction are also on the agenda.

Financial institutions

Quality of the loan portfolio improves, but the amount of new lending remains low.
FYR Macedonia has a relatively large number of banks – 22 as at mid-2003 (including the microfinance Pro-Business Bank which opened in May 2003) and 17 savings houses. By end-2002 the share of privately owned bank capital had risen slightly to 84.3 per cent and eight banks were 100 per cent privately owned. A programme to restructure and develop the only state-owned bank, the Macedonian Development Bank, is expected to be in place by end-2003. The banking sector has recovered well from the security crisis and economic downturn in 2001, although interest rates on loans remain high, typically around 13-15 per cent. The quality of banks' loan portfolios has improved. However, several small banks are reported to be in difficulty. Some consolidation in the sector is necessary. A new methodology for risk classification, which broadens the definition of risk assets and introduces new risk assessment criteria, became effective as of end-March 2002. By March 2003 the share of doubtful or non-performing loans was 16.4 per cent compared with 15.9 per cent at the end of 2002. The foreign exchange law was amended in July 2003, enabling banks to place their funds into foreign currency loans.

Social reform

Unemployment being tackled through labour market reform and job subsidies.
Throughout the transition, the unemployment rate in FYR Macedonia has been among the highest in the whole region. The current unemployment rate is officially estimated at over 36 per cent of the labour force, although the true rate may be lower owing to informal sector employment. However, labour force surveys show that more than 90 per cent of the unemployed have been without a job for over a year. In response, the government plans to introduce a subsidy programme to encourage enterprises to hire long-term unemployed. The cost of this programme will be capped at MKD 1.7 billion (€27.6 million) during 2003-05. In addition, in April 2003 the government introduced a number of labour market reforms, including tighter eligibility criteria for claiming unemployment benefit, a reduction in the maximum length of time that anyone can draw unemployment benefit from 18 to 14 months, and a reduction in the legally required terms of severance pay.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **34 per cent**
Exchange rate regime – **fixed to euro**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises and markets
Competition Office – **no**

Infrastructure
Independent telecoms regulator – **no**
Seperation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **4 per cent (1998)**
Private pension funds – **no**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	15.0	19.6	19.6	19.6	19.5	11.9	8.3	10.9	13.4
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	1.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	54.2	74.7	75.6	83.1	84.7	63.4	57.6	56.6	na
Share of trade in GDP (in per cent)	58.7	59.2	76.9	86.6	78.3	92.9	82.4	79.3	na
Tariff revenues (in per cent of imports)	12.7	11.4	6.8	6.9	8.7	5.8	5.4	5.3	na
EBRD index of price liberalisation [1]	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	na	na	na	na	na	na	na	na	na
Private sector share in GDP (in per cent)	40.0	50.0	50.0	55.0	55.0	55.0	60.0	60.0	na
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	na	na	1.7	1.3	1.2	1.4	1.4	1.9	na
Share of industry in total employment (in per cent)	38.3	28.9	27.4	28.2	27.7	27.1	26.5	24.8	na
Change in labour productivity in industry (in per cent)	5.2	-7.8	7.7	-0.2	0.7	1.3	-12.1	8.3	na
Investment rate/GDP (in per cent)	16.5	17.4	21.0	22.3	19.7	21.4	16.7	na	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	16.5 (na)	17.0 (0.1)	20.5 (0.6)	21.9 (1.5)	23.4 (2.4)	25.5 (5.7)	26.4 (10.9)	26.4 (10.9)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	2.5	5.6	11.2	7.9	13.0	13.0	na
Railway labour productivity (1989=100)	24.8	47.8	50.9	68.6	66.7	89.7	78.9	59.2	na
Electricity tariffs, USc kWh (collection rate in per cent)	2.81 (90)	3.1 (90)	3.54 (90)	3.73 (88.8)	3.30 (86.5)	5.3 (60)	4.1 (80)	4.7 (75)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	na	na	na	na	na	na	na	na	na
EBRD index of infrastructure reform	1.3	1.7	1.7	1.7	1.7	2.0	2.0	2.0	2.0
Electric power	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Railways	na	na	na	2.3	2.0	2.0	2.0	2.0	2.0
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Water and waste water	1.0	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0
Financial institutions									
Number of banks (foreign-owned)	6 (3)	22 (5)	22 (5)	24 (6)	23 (5)	22 (7)	21 (8)	20 (7)	na
Asset share of state-owned banks (in per cent)[2]	na	0.0	0.0	1.4	2.5	1.1	1.3	2.0	na
Non-performing loans (in per cent of total loans)[3]	na	66.1	59.5	50.3	62.6	46.5	44.4	35.7	na
Domestic credit to private sector (in per cent of GDP)	23.1	26.5	27.3	17.7	10.4	10.5	12.8	14.4	na
Stock market capitalisation (in per cent of GDP)	na	2.3	0.3	0.2	0.2	0.2	1.3	4.8	na
EBRD index of banking sector reform	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.7	1.7	1.7	1.7	1.7	1.7
Social sector									
Expenditures on health and education (in per cent of GDP)	13.8	10.9	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	71.9	72.2	72.4	na	72.5	72.8	73.1	na	na
Basic school enrolment ratio (in per cent)	97.9	98.4	99.1	98.8	99.6	100.1	98.6	na	na
Earnings inequality (GINI-coefficient)	27.0	25.0	25.9	27.1	27.7	27.7	28.6	na	na

1 New series (see Box 2.1 for explanation).
2 Increase in 1998 due to the establishment of the Macedonian Bank for Development Promotion.
3 Includes loans of banks under forced administration.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	-1.2	1.2	1.4	3.4	4.3	4.5	-4.5	0.7	3.0
Industrial gross output	-8.9	5.0	-2.8	4.5	0.0	-0.1	-6.2	-5.3	na
Agricultural gross output	2.3	-2.9	0.0	3.2	0.8	1.0	-11.1	na	na
Employment [1]				*(Percentage change)*					
Labour force (end-year)	-1.5	na	1.4	2.9	-2.1	0.6	3.9	na	na
Employment (end-year)	-9.9	na	-4.7	5.4	1.0	0.9	8.9	-6.3	na
				(In per cent of labour force)					
Unemployment (end-year)	37.7	31.9	36.0	34.5	32.4	32.2	28.9	31.9	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	16.4	2.5	0.8	2.3	-1.3	6.5	5.3	2.4	1.5
Consumer prices (end-year)	9.0	-0.6	2.6	0.8	2.3	6.0	3.7	1.1	3.1
Producer prices (annual average)	3.9	-0.3	4.2	4.0	-0.1	8.9	-1.2	na	na
Producer prices (end-year)	2.2	-0.6	8.6	-0.2	4.2	7.9	-2.5	1.1	na
Gross average monthly earnings in economy (annual average)	10.4	2.7	2.8	3.7	2.9	5.5	3.6	6.9	na
Government sector [2]				*(In per cent of GDP)*					
General government balance	-1.0	-1.4	-0.4	-1.7	0.0	1.8	-7.2	-5.8	-1.5
General government expenditure	39.0	37.1	35.1	35.0	35.4	34.9	41.6	41.7	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	na	-1.1	22.9	14.4	29.7	24.4	66.3	-8.0	na
Domestic credit (end-year)	-48.8	-11.5	6.8	-31.7	12.8	-10.7	-11.5	28.8	na
				(In per cent of GDP)					
Broad money (M2, end-year)	11.0	10.5	12.2	13.3	16.1	17.7	29.8	26.7	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Basic rate of the National Bank [3]	16.0	11.0	8.9	8.9	8.9	8.9	10.7	10.7	na
Inter-bank interest rate	35.7	22.5	21.1	18.1	11.6	7.2	11.9	14.4	na
Deposit rate	24.1	12.8	11.6	11.7	11.3	10.7	10.0	9.2	na
Lending rate [4]	46.0	21.6	21.4	21.0	20.0	19.0	19.2	17.7	na
				(Denars per US dollar)					
Exchange rate (end-year)	38.0	41.4	55.4	51.8	60.3	66.3	69.2	58.9	na
Exchange rate (annual average)	37.9	40.0	50.0	54.5	56.9	65.9	68.0	64.4	na
External sector				*(In millions of US dollars)*					
Current account	-222	-289	-289	-269	-33	-75	-234	-319	-300
Trade balance	-221	-317	-386	-515	-496	-690	-522	-752	-725
Merchandise exports	1,204	1,147	1,237	1,292	1,190	1,321	1,155	1,105	1,236
Merchandise imports	1,425	1,464	1,623	1,807	1,686	2,011	1,677	1,857	1,961
Foreign direct investment, net [5]	12	12	18	118	32	176	442	101	100
Gross reserves, excluding gold (end-year)	257	240	256	304	469	703	741	735	na
External debt stock	1,062	1,118	1,167	1,447	1,493	1,487	1,368	1,507	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	1.7	1.6	1.6	1.8	2.9	3.7	4.6	4.1	na
				(In per cent of exports of goods and services)					
Debt service	10.4	11.1	8.7	10.1	13.7	13.0	19.3	16.5	na
Memorandum items				*(Denominations as indicated)*					
Population (mid-year, million)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in millions of denars)	169,521	176,444	186,019	194,981	209,010	236,389	233,841	240,227	254,592
GDP per capita (in US dollar)	2,276	2,226	1,860	1,790	1,837	1,793	1,718	1,866	na
Share of industry in GDP (in per cent)	19.6	19.5	19.9	19.0	18.4	18.1	17.5	na	na
Share of agriculture in GDP (in per cent)	10.6	10.7	10.9	11.4	11.0	10.0	9.8	na	na
Current account/GDP (in per cent)	-5.0	-6.5	-7.8	-7.5	-0.9	-2.1	-6.8	-8.6	-7.4
External debt - reserves (in US$ million)	805.0	878.5	910.8	1,143.1	1,024.4	784.3	627.3	772.0	na
External debt/GDP (in per cent)	23.7	25.3	31.4	40.4	40.6	41.5	39.8	40.4	na
External debt/exports of goods and services (in per cent)	76.5	85.9	85.5	100.4	102.1	90.9	97.9	110.8	na

1 Figures on employment and labour force for 1995 are based on census data and are not comparable with later years, which are based on the ILO definition of unemployed.

2 General government includes the state, municipalities and extra-budgetary funds.

3 Weighted interest rate of credits sold at auction (seven days maturity). The figure for 2000 is from the October auction, the last one of the year.

4 Minimum lending rate offered to small enterprises until 1995, mid-point rates for short-term lending to all sectors thereafter.

5 The large increase in FDI for 2001 is mainly due to the sale of a majority stake in the fixed-line telephone company.

Georgia

Key reform challenges

- **Successful implementation of the government's strategy to improve the investment climate through tax and legal reforms and anti-corruption measures is essential for private sector development.**
- **Important public finance reforms are necessary to enable a possible rescheduling of bilateral debt by the Paris Club. This would improve the country's difficult external position and help with debt sustainability.**
- **Improving payment discipline in the power sector remains a key challenge. Management contracts granted to the private sector both in transmission and distribution companies should assist in addressing this challenge and improving their financial performance.**

Liberalisation

Initial steps taken towards regional trade liberalisation.
In December 2002 the parliament ratified the GUUAM (Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova) agreement, forming a free trade zone among the member countries. A resolution on establishing a free trade zone within the CIS has also been adopted but, in general, implementation of CIS agreements has been slow.

Stabilisation

Concerns remain regarding external debt position.
Georgia's external debt of around 50 per cent of GDP is large for an economy with weak public finances. An anticipated Paris Club debt rescheduling on Houston terms – conditional on an IMF programme being in place – would lower the debt service due by some US$ 50 million in both 2003 and 2004. The debt service ratio would also drop to 15.6 per cent (from 23.4 per cent at end-2002) and make the country's external debt burden more sustainable. However, the authorities failed to comply with the IMF conditions under the current three-year Poverty Reduction and Growth Facility (PRGF), in particular the budgetary spending cuts, and the third review could not be completed. This means that debt rescheduling will be delayed beyond 2003. The country will also continue to accumulate arrears in bilateral external debt obligations, which reached US$ 31 million by the end of August 2003. Nevertheless, if key reforms in public finance are carried out by the government, another IMF programme may be negotiated by the end of the year and debt rescheduling under the Paris Club may be reached early in 2004.

Comprehensive tax reforms initiated as tax revenue remains low.
The ratio of tax revenue to GDP, at less than 15 per cent in 2002, is among the lowest in the region. Only 84 per cent of the revenues targeted for collection in the first six months of 2003 were raised. A large grey economy and corruption in public administration are the major reasons cited for low tax and customs revenue collections. A study prepared by the American Chamber of Commerce in 2002 showed that if the issues of tax avoidance and corruption are properly addressed, the government of Georgia could realise as much as US$ 250 million per year from the petroleum sector alone. Some progress has been made to develop more comprehensive tax reform, simplify the tax code and to improve collection rates, all of which are required under the current IMF three-year PRGF. The new code proposed by the Ministry of Finance, approved by the parliament in August 2003, envisages no net losses to the government budget. The main changes in the tax code involve a four-fold increase in the VAT threshold, introduction of a small business tax and elimination of various nuisance taxes.

Privatisation

Some progress made with large-scale privatisation.
While small-scale privatisation, which commenced in 1993 has been largely completed, the large-scale privatisation process has been moving more slowly. This is due to concerns over conditions relating to the social obligations of potential investors and the investment climate. Nonetheless, the first half of 2003 saw some progress with privatisation of the largest enterprises. After several past failures, 90 per cent of the shares in the chemical plant JSC Azot were sold to the Russian company Itera in March 2003. In June, 51 per cent of the shares of the metallurgical plant Zestafoni Ferro Alloys were privatised by direct sales to the Austrian company DECOmetal. In March 2003 Tbilaviamsheni Ltd won a tender for a 10 year management contract with the aircraft manufacturing company Tbilaviamsheni. A concession for some parts of the operation of Poti Port was given in August 2003 and the tender for the remaining parts has been opened.

Liberalisation, stabilisation, privatisation

1991
- Apr: Independence from Soviet Union declared
- Aug: Exchange rate unified
- Aug: Interest rates liberalised

1992
- Jan: Personal income tax and corporate profit taxes introduced
- Feb: Most prices liberalised
- Mar: Controls on foreign trade lifted
- Mar: VAT introduced

1993
- Mar: Small-scale privatisation begins

1994
- Dec: Export tax to non-CIS countries abolished
- Dec: Unified import tariff structure introduced

1995
- Jan: Trade regulations streamlined
- Jun: State order system abolished
- Jun: Voucher privatisation begins
- Jun: Large-scale privatisation commences
- Oct: New currency (lari) introduced

1996
- Mar: Tradability of land rights enacted
- Jun: Voucher privatisation ends
- Dec: Full current account convertibility introduced

1997
- May: New privatisation law adopted
- Aug: Treasury bills market initiated

1998
- Dec: Freely floating exchange regime adopted

1999
- Jan: Registration of agriculture land titles begins
- Apr: Council of Europe membership granted
- May: Privatisation law amended

2000
- Jun: WTO membership granted

2001
- Apr: Paris Club debt rescheduled

2002
- Dec: Customs tariffs law amended in accordance with WTO regulations

2003
- Jun: Two large chemical and metalurgical companies privatised
- Sep: New tax code adopted

Enterprises, infrastructure, finance and social reforms

1994
- Jan First foreign-owned bank opened

1995
- Jun Two-tier banking system established

1996
- Jun Competition law adopted
- Jul Basel capital adequacy requirement introduced
- Aug Loan classification and provision requirements introduced
- Sep Anti-Monopoly Office established (not independent)
- Dec First bank privatised

1997
- Jan Bankruptcy law adopted
- Apr Securities regulator established (not independent)
- Jun Electricity law adopted
- Jun Independent electricity regulator established

1998
- Oct Law on non-state pension insurance adopted
- Nov Major electricity utility privatised
- Dec Law on securities market adopted

1999
- Apr Oil pipeline Baku-Supsa completed

2000
- Jan Minimum capital requirements for banks increased
- Mar Stock exchange trading commences
- May Baku-Ceyhan pipeline agreement ratified
- Jun Independent telecommunications regulator established

2001
- Feb IAS accounts introduced for all banks

2002
- Jan Anti-corruption strategy approved by government

2003
- May Baku-Tbilisi-Ceyhan pipeline construction commences
- Jul Law on mandatory insurance pensions adopted
- Jul Law on mandatory social insurance adopted

Enterprise reform

Investment climate remains difficult.
Despite the approval of an anti-corruption strategy at the beginning of 2002, corruption and continued arbitrary implementation of laws and regulations continue to hamper private sector development and foreign investment. The government has made improving the investment climate a priority, signalled by a presidential decree issued in July 2002 authorising an action plan to remove administrative barriers to investment. The recommendations in the action plan, which derive from a study carried out by the Foreign Investment Advisory Service (FIAS), were also included in the Poverty Reduction and Strategy Paper (PRSP). Increasing transparency in tax rules, raising salaries for government administration and strengthening the judiciary are outlined as essential to improving the business environment.

Infrastructure

Collection rates in the power sector remain low …
Although tariff collection rates by the privatised Telasi power distribution company in Tbilisi were around 70 per cent in 2002 and the first half of 2003, elsewhere collection rates (in particular from commercial entities) remain well below this level. The introduction of a private contractor to manage the wholesale market from late 2001 (Iberdrola, a Spanish power company) has had little impact on payments discipline to date. This is largely because the state-owned network operator did not implement orders to cut off non-paying customers. A private operator (ESBI, an Irish power company) recently took over management of the transmission and dispatch network, which may improve the situation. The planned privatisation of Georgian United Distribution Company, which serves all the country excluding Tbilisi, was halted while a tender for a five-year management contract was commissioned. Eight companies have already expressed interest and PA Consulting was awarded an interim management contract for 18 months.

… and AES exits to a Russian buyer.
In July 2003 the American power company AES Corporation sold its 75 per cent stake in Telasi to Russia's Unified Energy Systems (UES). The company's financial problems stemmed from their inability to raise profits since the start of operations in 1998. However, these were also exacerbated by the March 2003 Constitutional Court ruling that limited the increase in energy tariffs from 12.2 tetris (5.7USc) to 13.7 tetris (6.6 USc), effective from end-2002.

Mixed results on privatisation in utilities.
The process of bringing in private sector management at the Tbilisi Water Utility is under way. The tendering commission is evaluating the technical and financial proposals of Compagnie Generale des Eaux of France, the only company to bid in January 2003. However, privatisation in the telecommunications sector has stalled, as a failed tender in late 2001 has again been delayed.

Construction of the Baku-Tbilisi-Ceyhan pipeline begins.
Construction of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, with a planned capacity of 1 billion barrels per day and providing revenues for Georgia of up to US$ 50 million per annum, started in May 2003. This project is likely to boost local construction and should attract significant FDI. Additional benefits to Georgia would flow from the realisation of the South Caucasus gas pipeline project. Under this project, Georgia is due to receive up to 0.5 billion cubic metres of gas per annum for free (with a further option to buy 0.3 billion cubic metres at reduced rates), in total worth in the range of US$ 30-40 million per annum. Both pipelines are expected to be in operation by 2006.

Financial institutions

Banking intermediation remains low.
The assets of the banking sector rose by 12 per cent during the first half of 2003, indicating an increase in confidence in the sector. Although lending to the private sector has increased (mostly to SMEs), the level of total bank lending to the private sector remains low at 8 per cent of GDP. In addition, 85 per cent of the assets and lending in the banking sector is in a foreign currency due to the increasing dollarisation of the economy over the past eight years. With 25 banks, most of which are under-capitalised, strengthening capital requirements as well as further sector consolidation is necessary. Banking supervision has been considerably strengthened (with IMF assistance) through the adoption of a new analytical framework for the resolution of insolvent banks and through "fit and proper" criteria for bank managers and owners. In December 2002 the law regulating commercial banks was amended to reflect this new framework, imposing a 25 per cent ceiling for the largest shareholders and requiring them to meet the "fit and proper" criteria.

Social reform

Reform of the pension system commences.
The government has commenced the reform of the pension system, including the introduction of a three-pillar pension system which was envisaged in the PRSP. In July 2003 the parliament approved several new laws, including the law on mandatory insurance pensions and the law on mandatory social insurance, that would provide the necessary legal framework for introducing the new pension system and social insurance system.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **14.4 per cent**
Exchange rate regime – **floating**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **limited for foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **yes (not independent)**

Social reform
Share of the population in poverty – **12.4 per cent (1998)**
Private pension funds[1] – **no**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	13.0	13.0	8.3	3.0	3.0	3.0	3.0	3.0	3.0
Number of goods with administered prices in EBRD-15 basket	4.0	3.0	3.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	33.1	27.6	35.7	58.7	70.0	72.4	68.4	64.5	na
Share of trade in GDP (in per cent)	37.0	39.1	43.8	39.6	53.1	48.0	45.2	42.8	na
Tariff revenues (in per cent of imports)	0.5	2.0	4.4	4.2	1.7	2.9	2.8	na	na
EBRD index of price liberalisation [2]	3.7	4.0	4.0	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	2.0	3.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	19.1	19.8	20.5	21.8	22.7	23.0	23.1	na	na
Private sector share in GDP (in per cent)	30.0	50.0	55.0	60.0	60.0	60.0	60.0	65.0	na
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	2.0	3.0	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	1.1	1.5	2.2	2.1	2.5	2.8	2.1	na	na
Share of industry in total employment (in per cent)	14.5	10.4	5.8	6.7	na	na	na	na	na
Change in labour productivity in industry (in per cent)	-0.6	49.9	-2.5	-7.3	na	na	na	na	na
Investment rate/GDP (in per cent)	4.0	10.8	11.2	12.3	19.2	17.1	18.8	na	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	10.3 (na)	10.5 (0.0)	11.3 (0.6)	11.6 (1.1)	12.3 (1.9)	13.9 (3.4)	15.9 (5.4)	13.1 (10.2)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	0.8	1.4	1.7	3.2	3.9	5.7	na
Railway labour productivity (1989=100)	18.9	18.1	28.4	38.9	47.7	59.5	65.1	71.9	na
Electricity tariffs, USc kWh (collection rate in per cent)	3.5 (35)	2.8 (na)	3.1 (na)	3.5 (na)	3.0 (32)	4.4 (35)	4.2 (32)	6.5 (>90)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	6.5	4.9	4.8	4.5	4.6	4.5	na	na	na
EBRD index of infrastructure reform	1.0	1.0	1.7	2.0	2.3	2.3	2.3	2.3	2.3
Electric power	1.0	1.0	2.0	3.0	3.3	3.3	3.3	3.3	3.0
Railways	na	na	na	3.0	3.0	3.0	3.0	3.0	3.0
Roads	1.0	1.0	1.7	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	1.0	1.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Water and waste water	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
Financial institutions									
Number of banks (foreign-owned)	101 (3)	61 (6)	53 (8)	42 (9)	36 (9)	30 (8)	27 (7)	25 (5)	na
Asset share of state-owned banks (in per cent)	48.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	na
Non-performing loans (in per cent of total loans)[3]	33.3	6.7	6.6	6.5	4.9	7.2	8.5	7.9	na
Domestic credit to private sector (in per cent of GDP)	3.4	3.8	5.0	na	5.8	6.5	7.0	7.7	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	0.8	2.9	2.9	na
EBRD index of banking sector reform	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7
Social sector									
Expenditures on health and education (in per cent of GDP)	1.7	2.8	4.1	4.0	na	na	1.0	na	na
Life expectancy at birth, total (years)	72.5	na	72.5	na	na	73.0	73.2	na	na
Basic school enrolment ratio (in per cent)	79.8	80.6	81.0	81.2	85.2	86.1	90.8	na	na
Earnings inequality (GINI-coefficient)	na	na	49.8	na	na	na	na	na	na

1 At early stages of development.
2 New series (see Box 2.1 for explanation).
3 Changes in non-performing loans data compared with previous *Transition Reports* are due to the change of loan categories included in non-performing loans (see definitions).

	1995	1996	1997	1998	1999	2000	2001	2002 Estimate	2003 Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	2.4	10.5	10.8	2.9	3.0	1.9	4.7	5.6	8.0
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output	-10.0	7.7	2.5	-2.7	3.4	3.2	-1.1	4.9	na
Agricultural gross output	19.9	5.1	3.9	-6.6	6.9	-12.6	8.2	-0.1	na
Employment [1]				*(Percentage change)*					
Labour force (end-year)	9.9	5.0	13.5	-4.8	-1.4	10.0	-3.6	-5.3	na
Employment (end-year)	-1.1	0.6	12.5	-9.9	-6.0	13.2	-2.2	-6.4	na
				(In per cent of labour force)					
Unemployment (end-year)	3.1	2.8	7.7	12.3	12.7	10.3	11.1	12.3	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	162.7	39.4	7.1	3.6	19.2	4.1	4.6	5.6	5.0
Consumer prices (end-year)	57.4	13.7	7.3	10.7	11.0	4.6	3.4	5.4	4.5
Producer prices (annual average)	36.8	32.4	29.0	2.3	na	na	na	6.0	na
Producer prices (end-year)	na	na	na	3.7	15.7	na	na	1.6	na
Gross average monthly earnings in economy (annual average)	122.6	110.1	46.6	30.4	21.8	7.1	30.8	9.0	na
Government sector [2]				*(In per cent of GDP)*					
General government balance	-5.3	-7.3	-6.7	-5.4	-6.7	-4.0	-2.0	-2.0	-1.7
General government expenditure	12.3	21.1	21.0	19.1	22.1	19.4	18.2	17.8	na
General government debt	na	na	na	29.9	72.0	69.7	67.0	64.9	na
Monetary sector				*(Percentage change)*					
Broad money (M3, end-year)	138.7	41.4	44.0	-1.1	21.0	39.4	18.5	17.1	na
Domestic credit (end-year)	51.7	66.9	85.5	33.6	39.9	17.5	2.3	5.0	na
				(In per cent of GDP)					
Broad money (M3, end-year)	5.0	6.7	8.0	6.4	7.9	10.4	11.1	11.6	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Money market rate [3]	na	43.4	26.6	43.3	34.6	18.2	17.5	26.7	na
Treasury bill rate (3-month maturity) [4]	na	43.4	26.6	43.3	na	26.0	33.2	48.5	na
Deposit rate (3-month) [5]	17.9	31.1	13.7	17.0	12.0	12.0	12.0	9.9	na
Lending rate (3-month)	69.8	58.2	50.6	46.0	35.0	32.8	35.0	34.9	na
				(Laris per US dollar)					
Exchange rate (end-year)	1.2	1.3	1.3	1.7	1.9	2.0	2.1	2.1	na
Exchange rate (annual average)	1.3	1.3	1.3	1.4	2.0	2.0	2.1	2.2	na
External sector [6]				*(In millions of US dollars)*					
Current account	-216	-275	-375	-370	-219	-176	-179	-203	-409
Trade balance	-338	-351	-559	-685	-537	-410	-462	-476	-710
Merchandise exports	363	417	494	478	476	527	473	468	530
Merchandise imports	700	768	1,052	1,164	1,013	937	935	944	1,240
Foreign direct investment, net	6	54	236	221	60	152	100	131	190
Gross reserves, excluding gold (end-year)	157	158	173	118	132	109	161	198	159
External debt stock	1,217	1,357	1,508	1,634	1,706	1,613	1,712	1,858	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	2.3	2.2	1.5	1.0	1.3	1.0	1.5	1.7	na
				(In per cent of current account revenues, excluding transfers)					
Debt service	7.2	9.2	4.7	13.7	16.1	17.1	18.2	22.3	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	5.4	5.4	5.4	5.4	5.4	4.6	4.6	4.6	na
GDP (in millions of laris)	3,694	3,847	4,679	5,741	5,665	6,013	6,638	7,457	8,126
GDP per capita (in US dollar)	535	563	657	771	524	661	694	736	na
Share of industry in GDP (in per cent) [7]	na	20.3	19.1	18.1	18.2	18.5	17.1	16.0	na
Share of agriculture in GDP (in per cent) [7]	na	33.2	31.2	28.3	29.4	25.4	26.3	25.1	na
Current account/GDP (in per cent)	-7.5	-9.1	-10.6	-8.9	-7.8	-5.8	-5.6	-6.0	-11.1
External debt - reserves (in US$ million)	1,060	1,199	1,334	1,516	1,574	1,504	1,551	1,640	na
External debt/GDP (in per cent)	63.7	44.9	42.8	39.4	60.6	52.9	53.4	54.6	na
External debt/exports of goods and services (in per cent)	251.2	265.7	228.0	226.8	230.7	154.7	175.6	188.6	na

1 Figures from 1997 onwards are from the World Bank and consistent with ILO methodology.

2 General government includes the state, municipalities and extra-budgetary funds.

3 Interest rate on the interbank market from the International Financial Statistics (IFS). The National Bank regulates liquidity through credit auctions. At the latest auction in June 2003, 7-day bills had a 15 per cent yield.

4 Treasury bills were introduced in August 1997. The market was suspended from September 1998 to August 1999. The data for 1998 relate to August. The data from 2000 relate to the average auction rates during that year.

5 Data refer to average rates for local currency from the IFS.

6 Forecasts for 2003 do not take the construction of the Baku-Tbilisi-Ceyhan (BTC) pipeline into account.

7 Data in constant prices from World Bank.

Hungary

Key reform challenges

- Targeted action, including reducing the tax burden for SMEs, is necessary to support and prepare local enterprises for stronger competition once Hungary accedes to the EU.
- Improving economic performance will require a significant tightening of fiscal policy and greater wage moderation.
- Public administration and health sector reforms are essential for long-term fiscal sustainability. The former is also crucial in ensuring adequate administrative capacity to absorb EU funds.

Stabilisation

Fiscal deficit remains high …
The general government deficit, according to ESA95 standards, reached 9.2 per cent of GDP in 2002, driven in part by one-off expenditures (around 3 per cent of GDP) and generous public wage increases. It is expected that these wage increases will help the government retain the human capital needed to improve administrative capacity and absorb EU funds in the years to come. The government expects to cut the deficit to 4.8 per cent of GDP this year and then lower it to 2.5 per cent of GDP by 2006. These targets are ambitious, especially as the deficit has remained high on a 12-month rolling basis. However, the deficit is expected to fall sharply in December when the one-off expenditures, introduced in late-2002, fall out of the calculation. Fiscal expenditure cuts introduced in June 2003 have been largely offset by additional spending measures, introduced a month later, as a result of Supreme Court and Constitutional Court rulings.

… while wage settlements outstrip inflation.
A loss of competitiveness occurred with gross average monthly earnings increasing by over 18 per cent for the second year running in 2002 (19 per cent in euro terms) and by 14.1 per cent in June 2003 on a 12-month basis. This may be compared with CPI inflation, which was 4.7 per cent in the year to July. The current account deficit widened to around 5 per cent of GDP in May 2003 on a 12-month rolling basis, the result of buoyant domestic demand, loss of competitiveness and weaker activity in Hungary's traditional export markets. This represents an interruption of the downward trend over the past three years. In 2002 net FDI coverage fell to 23 per cent of the current account deficit, from over 200 per cent in 2001.

Privatisation

Plan to complete privatisation adopted.
The government has announced its intention to complete the privatisation process within the next three years. The state assets to be sold include Dunaferr (steelworks), Malev (airline), Mahart (shipping), Babolna (agribusiness), MVM (electricity utility), FHB (mortgage bank), Postabank, Konzumbank, 22.7 per cent of the shares in MOL (Hungarian Oil Company) and Richter (Hungary's largest pharmaceutical company). By the end of the three-year period, just 37 companies will remain permanently in state ownership. Bids have been invited for Konzumbank, a privatisation adviser is being selected for the sale of the stake in MOL and Postabank is to be sold to Austria's Erste Bank.

Enterprise reform

Foreign direct investment slows dramatically.
Since 1998 Hungary has entered the post-privatisation phase of foreign investment, with the vast majority of FDI related to green-field developments. As a result of the global slowdown, the loss of competitiveness and the practice of the previous government to limit procurement contracts for large infra-structure projects to local enterprises, net FDI inflows fell to about 1 per cent of GDP in 2002 from 4.4 per cent in 2001. These trends have intensified and net FDI became negative in the first six months of this year (-2 per cent of GDP). The reduction in competitiveness has provoked a shift in the composition of FDI, with some manufacturers moving their production to lower cost countries. Others, either unable to upgrade their services or shift their production to more sophisticated, higher value products, have left Hungary.

Government sets up fund to attract investment in higher value-added activities.
Hungary continues to attract capital intensive methods of production, owing to the wide availability of skilled and "knowledge workers" and also because of the implementation of supportive economic policies. In an effort to boost competitiveness, the government is planning to set up a fund of about €130 million to support companies' investments in research and development, especially in areas such as IT, biotechnology, healthcare, social sciences and agriculture.

Liberalisation, stabilisation, privatisation

1990
- Mar Large-scale privatisation begins
- Mar State property agency established

1991
- Jan Most prices liberalised
- Jan Small-scale privatisation begins

1992
- Jan Treasury bills market introduced
- Mar EU Association Agreement signed

1993
- Mar CEFTA membership granted
- Oct EFTA membership granted

1995
- Jan WTO membership granted
- May Privatisation law adopted
- May State property agency and asset management company merged
- Dec Restitution law enacted

1996
- Jan Full current account convertibility introduced
- Apr Customs law enacted
- May OECD membership granted

1997
- Jan Currency basket changed
- Jan Corporate and personal income tax rates reduced
- Jul Import surcharge abolished

1998
- Jan Capital account liberalised
- Feb IMF programme completed

2000
- Jan Currency basket changed

2001
- May Forint fluctuation band widened
- Jun Inflation targeting introduced
- Jun Full convertibility of the forint introduced
- Oct Forint in fixed band with euro peg introduced

2003
- Jun Central parity of forint peg to euro devalued

Local corporate sector lagging behind.
Whereas the economic sectors in which the presence of foreign investors is significant have grown at rapid rates, the local corporate sector, dominated by SMEs, has lagged well behind both in terms of growth and export performance. Shortages of finance and

Enterprises, infrastructure, finance and social reforms

1991
Jan Competition law adopted
Jul Matav transformed into joint-stock company
Sep Bankruptcy law adopted
Dec Electricity board transformed into joint-stock company

1992
Nov Telecommunications law adopted

1993
Jan BIS capital adequacy adopted
Sep Bankruptcy law amended
Oct Railway law enacted
Dec First major utility partially privatised (Matav)

1994
Apr Electricity law adopted
Apr Independent electricity regulator established
Jul First state bank privatised

1995
Dec Securities and Exchange Commission established
Dec Matav becomes majority privately owned

1996
Jan Restructuring of MAV (national railway) begins
Dec Financial sector supervision law adopted
Dec IAS introduced

1997
Jan New banking law adopted
Jan Competition law amended
Jul Pension reform adopted
Oct Land Credit and Mortgage Bank established

1998
Apr Venture capital law enacted
Aug Health insurance fund reformed

2000
Jun Insurance law amended
Dec Competition Act amended

2001
Jan Capital gains tax introduced
Jun New telecommunications law approved
Jul New Central Banking Act introduced
Jul Take-over law amended

2003
Jan Electricity market partially liberalised (large customers only)

a high tax burden are the main reasons. Although Hungary's corporate tax rate, at 18 per cent, is one of the lowest among OECD countries, the burden of taxes on labour and of local taxation on enterprises is high. Local authorities charge enterprises between 0 and 2 per cent of their turnover in local taxes. Only some costs, such as the purchase of capital equipment, can be deducted. Moreover, Hungary's medium-sized enterprises are small by European standards and affected by weak corporate governance.

New legislation to reduce corruption approved.
In April 2003 the Hungarian parliament approved the "glass pockets" programme, aimed at making the use of public funds more transparent. One essential element of the programme is the expansion of the State Auditing Office's role. The new law stipulates that private sector contractors must divulge the state contracts they have been entrusted with and how they use public funds. The law also states that all government contracts involving large sums of money must be made public by state and local authorities.

Infrastructure

Deregulation of the electricity market still in early stages.
In January 2003 the electricity market was opened for around 200 large industrial customers with consumption over 6.5 gWh. These customers, accounting for 33 to 35 per cent of total power sales, can now choose their suppliers for 50 per cent of their power consumption. However, because 95 per cent of import capacity is locked into long-term contracts and generation capacity is tied to long-term agreements with MVM (the electricity grid and wholesale company), competition in the electricity market will increase only gradually. The Energy Office estimates that the recent increase in regulated electricity prices should allow MVM to cover its costs and halt its dependency on government subsidies. From 2004 preferential pricing will be eliminated in the natural gas market, where prices for residential users and small businesses are well below European levels. Full liberalisation of the market is scheduled to be completed in 2007.

Financial institutions

Local enterprises constrained by low degree of bank intermediation ...
Most financial sector institutions are well capitalised and profitable. However, the relative importance and market share of these institutions differs from that of financial institutions in advanced market economies. Domestic credit accounted for 52 per cent of GDP (December 2002), only one-quarter of the eurozone average. Similarly, at 34 per cent of GDP, domestic credit to the private sector is still very low compared with Hungary's western neighbours. The low level of bank intermediation is not of particular concern for those enterprises where widespread foreign ownership facilitates access to sources of finance abroad. However, this is not the case for the smaller, locally owned companies. Many of these firms, especially those at the smaller end of the size spectrum, have been dependent on heavily subsidised, government-supported programmes in recent years. Nevertheless in the past year there has been fast growth of SME lending, albeit from a very low base. This is mainly the result of competition in the banking sector, which has resulted in an increase in the number of banks seeking new lending opportunities in the SME sector. Medium-sized companies, which have not benefited from either the subsidy programmes or FDI, are most affected by the lack of bank finance.

... and by the declining role of the equity market.
Capitalisation of the equity section of the Budapest Stock Exchange, in terms of GDP, has steadily declined over the past three years. It amounted to 17.4 per cent at the end of 2002, down from 36.4 per cent in 1999. Turnover of the equity section of the stock exchange fell sharply in 2001 and at end-2002. (In 2000 equity accounted for just 44 per cent of the turnover, with government securities now accounting for the largest share.) The abolition of the punitive capital gains tax from January 2001 has not helped boost the capitalisation of the stock exchange. The past two years have been characterised by several de-listings of locally owned medium-sized companies, while several large enterprises have continued to be listed on Western stock exchanges.

Social reform

Pension and health care reforms overdue.
The second stage of pension reform has not yet been carried out and some elements of the previous stage of pension reform, which had been weakened under the previous government, have now been reinstalled. New entrants to the labour market have been obliged to enter the second pillar of the pension system since the beginning of January 2003. The government has announced its intention to improve the delivery of quality health services, partly by addressing the issue of under-investment in the sector as a whole, but also by reducing excess capacity in hospitals. However, a recent attempt to merge two hospitals ran into strong public opposition, while new legislation allowing private sector participation in the hospital system is the subject of intense debate.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **38.3 per cent**
Exchange rate regime – **fixed with band to euro**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **MEBOs**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **7.3 per cent (1998)**
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	12.9	12.8	15.9	17.0	18.2	18.3	18.5	18.9	19.4
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Share of trade with non-transition countries (in per cent)	77.7	77.0	81.2	84.3	87.9	87.2	84.4	84.5	na
Share of trade in GDP (in per cent)	62.8	68.6	90.2	93.2	95.5	114.9	112.5	108.9	na
Tariff revenues (in per cent of imports)	13.0	9.7	4.0	2.7	2.5	1.8	1.1	1.0	na
EBRD index of price liberalisation [1]	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	20.8	23.4	27.5	28.6	29.8	30.2	30.6	30.6	na
Private sector share in GDP (in per cent)	60.0	70.0	75.0	80.0	80.0	80.0	80.0	80.0	na
Private sector share in employment (in per cent)	71.0	76.8	83.3	81.4	82.1	84.0	na	na	na
EBRD index of small-scale privatisation	3.7	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	4.9	5.6	4.9	5.2	4.9	na	na	na	na
Share of industry in total employment (in per cent)	32.6	32.6	32.6	33.9	34.0	33.7	34.2	34.1	na
Change in labour productivity in industry (in per cent)	7.7	4.3	11.1	8.6	8.0	17.9	1.8	2.7	na
Investment rate/GDP (in per cent)	20.0	21.4	22.2	23.2	28.5	30.1	26.6	26.8	na
EBRD index of enterprise reform	3.0	3.0	3.0	3.3	3.3	3.3	3.3	3.3	3.3
EBRD index of competition policy	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	21.1 (2.6)	26.1 (4.6)	30.4 (6.9)	33.6 (10.5)	37.1 (16.2)	37.3 (30.2)	37.4 (49.8)	36.1 (64.6)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	66.9	94.7	118.9	103.6	164.6	194.5	na
Railway labour productivity (1989=100)	92.6	93.2	108.4	112.9	117.0	122.8	123.3	130.3	na
Electricity tariffs, USc kWh (collection rate in per cent)	5.85 (90)	5.96 (90)	6.75 (90)	6.97 (na)	7.26 (na)	5.9 (na)	6.8 (na)	8.7 (>90)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.7	3.7	3.9	4.2	4.4	4.9	na	na	na
EBRD index of infrastructure reform	3.0	3.0	3.0	3.3	3.7	3.7	3.7	3.7	3.7
Electric power	3.7	3.7	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Railways	na	na	na	3.3	3.3	3.3	3.3	3.3	3.3
Roads	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Telecommunications	3.3	3.3	3.3	4.0	4.0	4.0	4.0	4.0	4.0
Water and waste water	2.0	2.3	2.3	3.3	4.0	4.0	4.0	4.0	4.0
Financial institutions [2]									
Number of banks (foreign-owned)	43 (21)	42 (24)	45 (30)	44 (28)	43 (29)	42 (33)	41 (31)	38 (27)	na
Asset share of state-owned banks (in per cent)	49.0	15.3	3.5	9.8	7.8	7.7	9.1	10.8	na
Non-performing loans (in per cent of total loans) [3]	na	na	6.6	7.9	4.4	3.1	2.9	4.6	na
Domestic credit to private sector (in per cent of GDP)	22.7	21.9	24.2	24.2	25.8	30.2	31.5	34.0	na
Stock market capitalisation (in per cent of GDP)	5.8	12.4	35.2	29.9	36.4	25.8	19.2	17.4	na
EBRD index of banking sector reform	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of reform of non-bank financial institutions	3.0	3.0	3.3	3.3	3.3	3.7	3.7	3.7	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	9.5	8.9	9.2	9.3	9.2	9.0	8.5	na	na
Life expectancy at birth, total (years)	69.8	70.3	70.6	70.6	70.6	71.2	71.5	na	na
Basic school enrolment ratio (in per cent)	96.6	96.3	96.1	96.6	97.8	99.2	99.1	na	na
Earnings inequality (GINI-coefficient)	na	na	35.0	na	na	na	38.6	na	na

1 New series (see Box 2.1 for explanation).

2 Entries changed compared with previous *Transition Reports* due to changes in definitions by the Hungarian authorities.

3 Changes in non-performing loans data compared with previous *Transition Reports* are due to the change of loan categories included in non-performing loans (see definitions).

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure [1]					*(Percentage change in real terms)*				
GDP	1.5	1.3	4.6	4.9	4.2	5.2	3.7	3.3	3.0
Private consumption	-7.1	-3.4	1.7	4.9	4.6	4.1	5.0	8.8	na
Public consumption	-4.1	-4.2	5.7	-0.3	1.8	1.2	4.4	1.5	na
Gross fixed capital formation	-4.3	6.7	9.2	13.3	5.9	7.7	3.5	5.8	na
Exports of goods and services	13.4	8.4	26.4	16.7	13.1	21.8	9.1	3.8	na
Imports of goods and services	-0.7	6.6	24.6	10.1	12.3	21.1	6.3	6.1	na
Industrial gross output	4.3	3.6	12.8	13.7	10.7	18.1	3.6	2.6	na
Agricultural gross output	2.6	6.3	-1.8	-0.3	0.9	-7.9	10.4	na	na
Employment [2]					*(Percentage change)*				
Labour force (annual average)	-2.6	-1.2	-1.3	0.4	2.1	0.4	-0.5	0.4	na
Employment (annual average)	-1.9	-0.8	0.0	1.4	3.1	1.0	0.3	0.3	na
					(In per cent of labour force)				
Unemployment (end-year)	10.2	9.9	8.7	7.8	7.0	6.4	5.7	5.8	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	28.2	23.6	18.3	14.3	10.0	9.8	9.2	4.8	4.7
Consumer prices (end-year)	28.3	19.8	18.4	10.3	11.2	10.1	6.8	5.3	5.3
Producer prices (annual average)	28.9	21.8	20.4	11.3	5.1	11.6	5.2	-1.1	na
Producer prices (end-year)	30.2	20.1	19.5	7.1	8.2	12.4	7.3	-1.3	na
Gross average monthly earnings in economy (annual average)	16.8	20.4	22.3	18.3	13.9	13.5	18.2	18.3	na
Government sector [3]					*(In per cent of GDP)*				
General government balance	-6.7	-5.0	-4.8	-4.8	-3.4	-3.4	-4.7	-9.2	-5.5
General government expenditure	52.6	48.8	49.5	50.4	44.8	47.1	51.9	53.5	na
General government debt	86.4	72.8	62.9	61.1	60.7	57.6	52.1	54.3	na
Monetary sector					*(Percentage change)*				
Broad money (M2, end-year)	18.4	40.9	19.8	15.5	15.6	12.1	16.8	13.5	na
Domestic credit (end-year) [4]	13.7	7.6	12.0	13.2	-6.4	14.8	6.2	20.5	na
					(In per cent of GDP)				
Broad money (M2, end-year)	41.9	48.1	46.5	45.5	46.6	45.3	46.9	46.5	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinance rate	28.0	23.0	20.5	17.0	14.5	11.0	9.8	8.5	na
Inter-bank interest rate (up to 30-day maturity)	27.8	23.2	19.7	17.3	14.5	11.9	10.0	8.9	na
Deposit rate weighted average (fixed for less than 1 year)	24.4	18.6	16.3	14.4	11.9	9.9	9.4	7.6	na
Lending rate weighted average (maturing within 1 year)	32.2	24.0	20.8	18.8	19.4	12.8	12.0	10.3	na
					(Forints per US dollar)				
Exchange rate (end-year)	139.5	164.9	203.5	219.0	252.5	284.7	279.0	225.2	na
Exchange rate (annual average)	125.7	152.6	186.8	214.5	237.3	282.3	286.5	258.0	na
External sector					*(In millions of US dollars)*				
Current account [5]	-2,480	-1,678	-981	-2,298	-2,081	-1,325	-1,118	-2,618	-5,226
Trade balance [5]	-2,442	-2,645	-1,963	-2,353	-2,176	-1,771	-2,029	-2,082	-4,368
Merchandise exports [5]	12,810	14,183	19,637	20,749	21,844	25,861	28,074	34,792	40,201
Merchandise imports [5]	15,252	16,828	21,600	23,102	24,020	27,632	30,103	36,874	44,569
Foreign direct investment, net	4,410	2,279	1,741	1,555	1,720	1,123	2,255	598	1,341
Gross reserves, excluding gold (end-year)	11,967	9,681	8,400	9,312	10,948	11,202	10,894	9,437	na
External debt stock	31,655	27,956	24,395	27,280	29,336	30,528	33,647	36,453	na
					(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	7.6	5.7	4.0	4.1	4.6	4.0	3.7	2.6	na
					(In per cent of exports of goods and services)				
Debt service	na	na	na	na	na	na	na	na	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, million)	10.2	10.2	10.2	10.1	10.0	10.2	10.0	10.0	na
GDP (in millions of forints)	5,614,042	6,893,934	8,540,669	10,087,357	11,393,508	13,145,717	14,824,000	16,980,000	18,302,897
GDP per capita (in US dollar)	4,359	4,425	4,495	4,641	4,757	4,637	5,083	6,581	na
Share of industry in GDP (in per cent)	23.1	23.5	25.0	25.9	26.7	27.9	27.2	na	na
Share of agriculture in GDP (in per cent)	5.9	6.1	5.8	5.4	5.3	4.6	4.9	na	na
Current account/GDP (in per cent)	-5.6	-3.7	-2.1	-4.9	-4.3	-2.8	-2.2	-4.0	-7.1
External debt - reserves (in US$ million)	19,688	18,275	15,995	17,968	16,332	19,326	22,753	27,016	na
External debt/GDP (in per cent)	70.9	61.9	53.3	58.0	61.1	65.6	65.0	55.4	na
External debt/exports of goods and services (in per cent)	176.3	138.6	96.2	102.3	106.7	94.9	94.0	85.6	na

1 National accounts data for 2002 refer to 2002 Q1-Q3.
2 Data from the Labour Force Survey.
3 Government sector data are official fiscal balance data. For the period 2001-03 data are calculated according to Eurostat methodology (ESA95).
4 Changes in domestic credit adjusted to account for bank recapitalisation in 1995.
5 Data from balance of payments.

Kazakhstan

Key reform challenges

- **Further trade liberalisation and WTO accession would help to promote further economic diversification and greater market competition.**
- **Important progress has been achieved in the development of a tariff methodology in the water and power sectors, but these efforts need to be extended to telecommunications and transport.**
- **Improvements in corporate governance and financial transparency are key to channel domestic excess liquidity into the corporate sector, where money is needed to finance much-needed investments.**

Liberalisation

WTO accession still faces significant hurdles.
After eight years of negotiations, there is still no clear target date for WTO accession. Kazakhstan has been unwilling to offer significant concessions on market access for goods. Protection of agriculture, including through high tariffs, domestic support to various sectors and export subsidies have been particularly difficult issues in the negotiations. Moreover, Kazakhstan has been effectively benchmarking its tariff offer to that of Russia, its main trading partner, risking further delays to its accession. Both countries are concerned that access to world markets would remain constrained even following accession, while the corporate sector could suffer from stiff foreign competition.

Stabilisation

Size of foreign exchange inflows poses a challenge.
Over the past three years, the National Bank of Kazakhstan (NBK) has intervened strongly in the forex market to stem upward pressure on the tenge. This pressure has resulted from the oil revenue windfall. The combination of a prudent fiscal policy and the continued transfer of international assets to the National Fund (NFKR) limited base money growth to 19 per cent in 2002, compared with 30 per cent in 2001. However, base money growth accelerated in the first half of 2003, as gross international reserves grew by over 43 per cent, exerting further strain on monetary policy. Following rapid productivity growth in recent years, the economy is now more resilient to real currency appreciation. However, as a natural resource-based economy, the challenge in the long-term is to address the risk of “Dutch disease”.

Privatisation

New land code heralds private ownership of agricultural land.
The new land code, which legalises the privatisation of agricultural land, came into force in June 2003. Under the previous law, farmers only had access to lease rights to agricultural land. While lease rights are tradable in theory, in practice land leases were not accepted as loan collateral and significantly restricted access to financing by farmers and agricultural enterprises. The new land code is expected to lead to productivity increases in agriculture, through enhanced access to financing for working capital and investment. The code restricts agricultural land ownership to Kazakh residents and applies to approximately one-third of the total land area in the country.

Large-scale privatisation progresses at moderate pace.
Given the fiscal surplus, the government is not under financial pressure to speed up the process of large-scale privatisation. Still, in late 2002 the government sold its residual 34.6 per cent stake in Kazakhmys, a copper mining company, largely through public tenders. The sale raised around US$ 199 million. In April 2003 the government sold its 31.8 per cent stake in Aluminium of Kazakhstan for US$ 21 million to Corica, a subsidiary of Swiss J&W Holding AG. In May the government auctioned its 25.1 per cent state share in an oil exploration joint venture between the Chinese National Petroleum Company (CNPC) and Aktobemunaigas, which CNPC purchased for US$ 150 million. Two more large companies in the mining sector are planned for privatisation during the remainder of 2003.

Enterprise reform

New law on joint-stock companies adopted.
The new company law was adopted and became effective in May 2003. Under the new law, the minimum capital requirement for joint-stock companies (JSC) was increased tenfold to approximately US$ 290,000. Only around 600 companies, out of 5,000 registered joint-stock companies, presently meet the new minimum capital criteria. After a two-year transition period, companies that do not meet the new requirement will be forced to reregister as limited liability companies. This releases them from supervision by the securities commission. The main purpose of the

Liberalisation, stabilisation, privatisation

1991

Dec	Independence from Soviet Union declared

1993

Nov	New currency (tenge) introduced

1994

Apr	Mass privatisation begins; first voucher auction held
Apr	First treasury bills issued
Nov	Most prices liberalised
Dec	Law on foreign investment enacted

1995

Jan	Customs union with Russia and Belarus established
Feb	Directed credits eliminated
Feb	Most foreign trade licences abolished
Apr	Central Bank law adopted
Jun	State orders in agriculture abolished
Jul	New tax code introduced
Jul	Customs code introduced
Jul	Barter trade prohibited
Aug	Foreign exchange surrender abolished
Dec	Edict on land enacted
Dec	Privatisation law adopted

1996

Jun	IMF programme agreed
Jun	Last voucher auction held
Jun	Cash sales to strategic investors begin
Jul	Full current account convertibility introduced
Dec	First sovereign Eurobond issued

1999

Jan	Temporary trade restrictions on neighbours introduced
Jan	Major budgetary reforms introduced
Apr	Export surrender requirement re-introduced temporarily
Sep	First sovereign Eurobond issued in CIS following Russian crisis

2000

Jan	Oil export quota introduced temporarily
Jul	Lifelong privileges granted to President
Aug	Minority stake in TC Oil sold to Chevron
Aug	National Fund set up

2001

Jul	Capital amnesty decreed
Jul	Simplified new tax code enacted

2002

Jan	New transfer pricing law adopted
Jun	Revised foreign investment law adopted

2003

Jun	New land code enacted

Enterprises, infrastructure, finance and social reforms

1993

Apr	Law on banking adopted

1994

Jan	Prudential regulations introduced
Jun	Competition agency established
Dec	New civil code enacted

1995

Apr	Presidential decree on bankruptcy issued
Apr	Bank and enterprise restructuring agency established
Apr	Anti-monopoly legislation introduced
Dec	Telecommunications law adopted

1996

Jan	Subsoil code enacted
May	First major power sector utility privatised
Nov	New accounting standards adopted

1997

Jan	New bankruptcy law enacted
Jun	Pension reform law adopted
Jul	First ADR issued
Jul	National power grid formed
Oct	Stock exchange begins trading

1998

Jan	Pension reform launched
Apr	Turan-Alem Bank privatised, largest to date
Sep	Law on natural monopolies adopted
Dec	Small business support programme approved

1999

May	New telecommunications law adopted
Jul	New energy law introduced
Jul	First municipal bond issued
Aug	First domestic corporate bond issued
Oct	Decree on inspections passed

2000

Jan	New civil service law adopted
Jun	Tractebel leaves Kazakhstani energy sector
Jul	Wholesale power trading company (KOREM) established
Dec	National Development Bank established

2001

May	Gas and oil transport companies merged, creating Kaztransneftegas
Jul	Railway law adopted

2002

Apr	National oil and gas company created
Jul	New tariff methodology for utilities adopted

2003

May	New law on joint-stock companies effective

new law is to encourage the establishment of public companies that have a stronger capital base and better corporate governance practices.

Strategy for economic diversification adopted.
Despite relatively broad based growth in recent years, the weight of the oil sector in the national economy has been increasing. In May 2003 the government adopted a comprehensive industrial strategy for economic diversification. The priority areas are sectors that have linkages with the oil extraction sector, high value-added sectors (such as space, nuclear and information technology) and agriculture. To support diversification and investment in the non-oil sector, a Kazakhstan Investment Fund, a Science Foundation, an Innovation Fund and an Export Insurance Corporation have been created in addition to the existing Kazakhstan Development Bank. However, for all the government's activism, a difficult business climate, including widespread bribery and other forms of corruption, and limited competition on the domestic market continue to be the biggest obstacles to additional investment and innovation outside oil and gas.

Infrastructure

New tariff methodology for public utilities takes effect …
Following the adoption of a new tariff methodology for public utilities in the water, electricity and municipal services sectors by the government in June 2002, the Kazakh Agency for Regulation of Natural Monopolies and Promotion of Competition (AMA) began to apply the new methodology for the retail tariffs in February 2003. In June 2003 AMA began financial and technical due diligence of 27 companies to determine the respective total cost-base (operating and investment costs) on which tariffs under the new price cap methodology are to be based. Once the financial and technical due diligence is completed, companies are expected to submit mid-term tariff requests to AMA by the beginning of November 2003.

… and telecommunications reform moves forward.
In February 2003 the government adopted a programme for Kazakhstan's Telecoms Sector Development 2003-05, containing an aggressive legislative timetable for policy reform adoption and implementation. The programme envisages full liberalisation of the telecommunications market by the end of 2005, provided that appropriate regulation is in place. Following a government decree in June 2003, a new regulatory agency was established. However, state-owned Kazakhtelecom (KTC) still has exclusive rights over domestic long distance and international voice communication.

Financial institutions

Consolidation of banking sector proceeds.
The closure of two failed banks in 2002 contributed to a reduction in the number of banks in the country from 37 at the end of 2002 to 34 by July 2003. Following a tightened regulatory regime, including more stringent loan classification and provisioning requirements, the Central Bank seems to have so far been successful in reining in imprudent lending practices. Growth in private sector credit slowed from 80 per cent in 2001 to 40 per cent during the first half of 2003, while sub-standard loans have remained roughly constant at around one-third of the total. However, the rapid pace of credit expansion continues to call for tight surveillance to avoid excessive risk taking by banks. The NBK has planned further improvements in bank regulation with the creation of an independent consolidated supervisory agency by 2004.

Social reform

Replacement rates remain a concern for pension funds …
According to studies by the World Bank, under the current regime of a 10 per cent contribution rate, the Kazakh pension funds will only generate a 33 per cent replacement rate for males with 30 years of work history at the time of retirement. This is under the optimistic assumption of a 5 per cent annual rate of return. This indicates that the current rate of contribution needs to be increased if the system is to begin to approximate the replacement rates of 70 per cent or more, similar to those in advanced industrialised countries.

… and attractive investment opportunities are in short supply.
The rate of return from pension funds ranged between 5 and 7 per cent in 2002. Returns fell, however, in 2003 due to the appreciation of the tenge against the US dollar. (A significant proportion of assets held by the pension funds are denominated in foreign currency.) The availability of acceptable domestic assets is constrained by a shrinking government debt market and lingering doubts about the corporate governance and financial transparency standards in the corporate securities market.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **22.3 per cent**[2]
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **full except foreigners**[1]

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**[3]
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**[3]

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **15.3 per cent (1996)**[4]
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	39.9	41.7	52.4	47.3	58.7	64.2	57.3	61.8	na
Share of trade in GDP (in per cent)	64.9	61.8	63.6	56.9	69.3	88.3	74.7	72.6	na
Tariff revenues (in per cent of imports)[5]	3.9	2.0	1.5	1.9	1.7	1.9	2.2	3.3	na
EBRD index of price liberalisation [6]	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	3.0	4.0	4.0	4.0	3.0	3.3	3.3	3.3	3.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	3.7	5.9	9.2	13.0	14.8	15.6	16.1	16.6	na
Private sector share in GDP (in per cent)	25.0	40.0	55.0	55.0	60.0	60.0	60.0	65.0	na
Private sector share in employment (in per cent)	na	na	na	73.0	77.1	78.8	74.9	na	na
EBRD index of small-scale privatisation	3.0	3.3	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)[7]	3.6	2.6	1.8	0.8	1.3	1.2	0.8	0.4	na
Share of industry in total employment (in per cent)	20.5	20.9	22.2	14.7	14.8	13.8	12.4	12.3	na
Change in labour productivity in industry (in per cent)	0.3	12.3	18.5	na	2.6	22.2	17.3	10.6	na
Investment rate/GDP (in per cent)	20.5	11.8	15.6	17.3	14.6	14.0	18.0	18.0	na
EBRD index of enterprise reform	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	11.8 (0.0)	11.6 (0.1)	11.0 (0.1)	10.9 (0.2)	10.8 (0.3)	11.3 (1.2)	11.3 (3.6)	12.1 (3.6)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	0.8	1.0	2.5	5.0	7.4	11.5	na
Railway labour productivity (1989=100)	32.6	30.4	30.0	31.2	27.6	42.5	46.3	51.0	na
Electricity tariffs, USc kWh (collection rate in per cent)	3.2 (75)	3.0 (70)	3.8 (50)	4.7 (na)	3.2 (na)	2.7 (na)	2.6 (na)	2.7 (92)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.3	1.5	1.8	1.8	2.0	2.2	na	na	na
EBRD index of infrastructure reform	1.7	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3
Electric power	3.0	3.3	3.3	3.3	3.3	3.0	3.0	3.0	3.0
Railways	na	na	na	2.0	2.0	2.3	2.7	2.7	2.7
Roads	1.7	1.7	1.7	1.7	2.0	2.0	2.0	2.0	2.0
Telecommunications	1.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3	2.3
Water and waste water [8]	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7	1.7
Financial institutions									
Number of banks (foreign-owned)	130 (8)	101 (9)	81 (22)	71 (20)	55 (18)	48 (16)	44 (15)	na	na
Asset share of state-owned banks (in per cent)[9]	24.3	28.4	44.8	23.0	19.9	1.9	3.5	na	na
Non-performing loans (in per cent of total loans)	na	na	na	na	na	na	na	na	na
Domestic credit to private sector (in per cent of GDP)	6.1	4.3	4.3	5.4	7.4	10.6	15.1	na	na
Stock market capitalisation (in per cent of GDP)	na	na	6.1	8.2	15.5	7.5	5.6	5.6	na
EBRD index of banking sector reform	2.0	2.0	2.3	2.3	2.3	2.3	2.7	2.7	3.0
EBRD index of reform of non-bank financial institutions	1.7	1.7	1.7	2.0	2.0	2.3	2.3	2.3	2.3
Social sector									
Expenditures on health and education (in per cent of GDP)	7.5	6.2	6.5	6.2	6.1	5.3	5.3	5.3	na
Life expectancy at birth, total (years)	64.9	64.1	64.5	64.6	65.5	64.2	63.0	na	na
Basic school enrolment ratio (in per cent)	94.4	94.7	94.2	94.1	94.3	99.6	100.1	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

1 Ownership of agricultural land is limited to Kazakh residents and only applies to one-third of the total land area.
2 Excludes revenues into the national oil fund.
3 The regulator does not have financial independence.
4 World Bank data for 1996. In 2002 the share of people in poverty had fallen to 10 per cent according to a household survey using a national poverty line.
5 Refers to taxes on international trade.
6 New series (see Box 2.1 for explanation).
7 Data for 1998 and 1999 refer to expenditures on the economy (fuel and energy, agriculture and mining).
8 Series has been corrected for ratings after 1999.
9 The state share of banking sector assets increased in 1997 following the merger of privately-owned Alem Bank and a state-owned institution. In 1998 the merged bank was reprivatised. In December 2000 the state reduced its stake in the Savings Bank to less than 50 per cent.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	-8.2	0.5	1.7	-1.9	2.7	9.8	13.5	9.5	9.0
Private consumption	-21.5	-4.0	2.5	-0.5	0.1	2.5	8.9	na	na
Public consumption	-7.3	-13.2	-12.1	-15.2	10.9	14.0	19.8	na	na
Gross fixed capital formation	-37.5	-24.4	5.9	-7.2	0.5	16.1	27.6	19.0	na
Exports of goods and services	5.0	2.0	1.2	-11.9	3.0	28.8	-0.1	na	na
Imports of goods and services	-19.9	-17.1	7.5	-7.2	0.6	28.5	1.0	na	na
Industrial gross output	-8.2	0.3	4.0	-2.4	2.7	15.5	13.8	9.8	na
Agricultural gross output	-24.4	-5.0	-0.8	-18.9	28.0	-4.2	17.3	2.7	na
Employment [1]				(Percentage change)					
Labour force (end-year)	3.4	14.6	0.4	na	0.0	0.7	5.2	-1.1	na
Employment (end-year)	-7.8	-12.3	-17.1	na	-0.4	1.6	8.0	0.2	na
				(In per cent of labour force)					
Unemployment (end-year)	13.0	8.6	7.3	13.1	13.5	12.8	10.4	9.3	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	176.3	39.1	17.4	7.1	8.3	13.2	8.4	5.8	6.1
Consumer prices (end-year)	60.4	28.6	11.2	1.9	17.8	9.8	6.4	6.6	4.3
Producer prices (annual average)	231.2	24.3	15.6	0.8	18.8	38.0	0.3	0.4	na
Producer prices (end-year)	40.2	18.5	11.7	-5.5	57.2	19.4	-14.1	11.9	na
Gross average monthly earnings in economy (annual average)	177.3	42.9	24.9	13.4	13.4	30.9	20.8	16.9	na
Government sector [2]				(In per cent of GDP)					
General government balance [3]	-3.4	-5.3	-7.0	-8.0	-5.2	-1.0	-0.9	-0.3	-0.5
General government expenditure [4]	20.8	18.6	20.4	26.1	23.2	23.2	23.4	22.3	na
General government debt	14.6	13.9	17.1	22.4	31.5	25.5	20.4	17.8	na
Monetary sector				(Percentage change)					
Broad money (M3, end-year)	109.0	16.6	28.2	-14.1	84.4	45.0	45.1	32.8	na
Domestic credit (end-year) [5]	-21.5	15.6	-2.8	38.6	35.4	57.3	17.1	30.2	na
				(In per cent of GDP)					
Broad money (M3, end-year)	11.4	9.5	10.3	8.6	13.6	15.3	17.7	20.4	na
Interest and exchange rates				(In per cent per annum, end-year)					
Refinancing rate	52.5	35.0	18.5	25.0	18.0	14.0	9.0	7.5	na
Treasury bill rate (3-month maturity) [6]	49.0	28.9	15.2	23.6	14.3	7.9	5.8	5.9	na
Deposit rate [7]	44.4	29.3	12.0	14.5	13.5	15.6	12.8	11.0	na
Lending rate [7]	58.3	53.6	22.8	17.0	20.8	18.8	15.3	14.1	na
				(Tenges per US dollar)					
Exchange rate (end-year)	64.0	73.8	75.9	84.0	138.3	145.4	150.9	155.9	na
Exchange rate (annual average)	61.1	67.8	75.6	78.6	120.1	142.3	146.9	153.5	na
External sector				(In millions of US dollars)					
Current account	-213	-750	-799	-1,225	-169	675	-1,093	-596	-621
Trade balance [8]	114	-335	-276	-801	344	2,440	1,320	2,420	3,040
Merchandise exports	5,440	6,292	6,899	5,871	5,989	9,288	8,928	10,066	11,375
Merchandise imports	5,326	6,627	7,176	6,672	5,645	6,848	7,607	7,646	8,335
Foreign direct investment, net	964	1,137	1,320	1,143	1,584	1,278	2,796	2,138	2,500
Gross reserves, excluding gold (end-year)	1,136	1,295	1,697	1,461	1,479	1,594	1,997	2,551	na
External debt stock [9]	4,765	5,807	7,750	9,932	12,081	12,685	15,101	18,042	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year) [10]	2.2	2.1	2.5	2.2	2.6	2.2	2.3	2.7	na
				(In per cent of exports of goods and services)					
Debt service	7.9	15.9	24.5	22.4	27.3	50.8	62.6	67.4	na
Memorandum items				(Denominations as indicated)					
Population (end-year, million)	16.0	15.7	15.5	15.2	14.9	14.8	14.8	14.5	na
GDP (in millions of tenges)	1,014,190	1,415,750	1,672,142	1,733,264	2,016,456	2,599,902	3,250,593	3,747,200	4,335,478
GDP per capita (in US dollar)	1,040	1,333	1,429	1,452	1,127	1,231	1,491	1,688	na
Share of industry in GDP (in per cent)	23.5	23.5	24.0	23.9	23.9	25.2	25.2	na	na
Share of agriculture in GDP (in per cent)	12.3	11.7	11.4	9.4	11.1	9.8	10.1	na	na
Current account/GDP (in per cent)	-1.3	-3.6	-3.6	-5.6	-1.0	3.7	-4.9	-2.4	-2.1
External debt - reserves (in US$ million)	3,630	4,512	6,052	8,471	10,602	11,091	13,104	15,492	na
External debt/GDP (in per cent)	28.7	27.8	35.0	45.0	71.9	69.4	68.2	73.9	na
External debt/exports of goods and services (in per cent)	79.8	83.4	100.1	146.6	174.5	121.7	147.6	154.8	na

1 Employment data are based on labour force surveys from 1998, leading to a break in the series.

2 General government includes the state, municipalities and extra-budgetary funds and is on a cash basis.

3 Government balance includes quasi-fiscal operations (zero after 1995). Balance excludes privatisation revenues and transfers to the National Fund.

4 Expenditures include extra-budgetary funds after 1998, leading to a break in the series. Following the old series, expenditures increased by only 1.4 per cent of GDP in 1998.

5 Domestic credit from International Financial Statistics. Break in series in 1997 and 2001.

6 Three-month T-bill rate until December 1998, average effective yield of short-term NBK notes thereafter.

7 Deposit rate refers to the weighted average of interest rates on time deposits of individuals in tenge by maturity. Lending rate refers to weighted average of interest rates on credits extended to legal entities excluding banks in tenge by maturity.

8 Exports are at declared customs prices and are not corrected for under-invoicing of oil and gas exports.

9 Includes inter-company debt by branches of non-resident foreign enterprises and short-term debt.

10 Excluding National Fund.

Kyrgyz Republic

Key reform challenges

- Recent measures to improve governance should be implemented and followed by improvements in the judiciary and stepped up efforts to reduce the size of the informal economy.
- To attract the private sector in infrastructure investments, further progress towards improving cost recovery in the utilities sector is needed.
- The effectiveness of bank regulation has been strengthened, but the removal of legal uncertainties over the liabilities of shareholders is crucial to unleash strategic interest.

Liberalisation

Trade barriers in neighbouring countries remain a concern.
The Kyrgyz Republic, a member of the WTO since 1998, has one of the most liberal trade regimes among the CIS countries. However, it has failed to benefit fully from its policies as the country is surrounded by non-WTO members through which its imports and exports must pass. This is one of the main reasons why the share of trade in GDP in both nominal dollar and PPP terms has declined in the past five years. Although some protectionist measures were introduced, following the third review of the IMF's Poverty Reduction and Growth Facility (PRGF) these were later reversed and the authorities reconfirmed their commitment to liberal trade policies.

Stabilisation

IFI support and further fiscal reforms strengthen macroeconomic outlook.
Despite the dip in economic growth during 2002, following an accident at the Kumtor gold mine, the Kyrgyz Republic maintained macroeconomic balance through fiscal adjustment and prudent monetary policies. This has kept the IMF's PRGF on track, which in turn is a pre-condition for returning to the Paris Club for further restructuring of the country's large external debt. With some delay, the law extending VAT to large-scale agricultural producers, as well as a new law on property tax, were adopted in April 2003. These measures will further strengthen the tax base and help generate additional revenues for a much-needed increase in spending in the social sector.

Privatisation

Change in shareholding structure at Kumtor gold mine under consideration.
In 2002 the government was presented with a proposal to restructure ownership of the Kumtor gold mining company. Currently, the government owns 67 per cent of the gold mine through a state-owned company, KyrgyzAltin. The remainder is owned by CAMECO, a Canadian mining company. The government is examining a proposal to exchange its shareholding into fixed royalty streams. It is expected that the restructuring will enable the government to "lock-in" the current high level of gold prices. This would insulate the government from the effects of future accidents and/or a price decline. In addition, it would provide a fixed income stream, at the expense of the potential upside if gold prices increase further. The final decision is expected by the end of September. The government is also pushing ahead with efforts to relaunch large-scale privatisation mainly in the infrastructure sector, which came to a halt following the Russian crisis. So far, efforts have not yielded significant revenues – a total of just US$ 1.4 million was raised in 2002 from 14 sales. However, this may change with the expected privatisation of Kyrgyz Telecom.

Enterprise reform

Government takes action to reduce corruption ...
Corruption and weak governance at both the corporate and state levels are the most important internal impediments to growth. Bureaucratic red tape, tax harassment and other discretionary interventions are pushing an increasing number of firms into the informal sector. In response to these problems, a new anti-corruption law was adopted in March 2003 and the President established a National Integrity Council in April 2003 to strengthen the implementation capacity of the government to fight corruption. Several IFI and donor-supported programmes are also targeted at reducing corruption, which remains a serious problem, and improving the business climate.

... and adopts new commercial legislation to strengthen corporate governance.
A new law on joint-stock companies, effective in April 2003, strengthens the rights of shareholders against management and other insiders. The competencies of the general meeting and the board of directors have been strengthened and the new law prohibits members of the parliament, government officials and public servants to serve on the board of directors, the executive body or the audit committee of joint-stock companies. The minimum charter capital has been increased tenfold from US$ 230 to US$ 2,300. Following the adoption of the law on arbitration tribunals in July 2002, the first arbitration tribunal was created in September 2002. It is expected that arbitration tribunals will settle commercial disputes more effectively than the courts.

Liberalisation, stabilisation, privatisation

1991
- Aug: Independence from Soviet Union declared
- Dec: Small-scale privatisation begins

1992
- Jan: Most prices liberalised

1993
- Apr: Free trade agreement with Russia signed
- May: Exchange rate unified
- May: New currency (som) introduced
- May: Treasury bills market initiated

1994
- Apr: Interest rates liberalised
- May: Most export taxes eliminated
- Jul: First IMF ESAF programme introduced

1995
- Mar: Full current account convertibility introduced

1996
- Jan: VAT introduced
- Jul: New tax code introduced

1997
- Jul: Customs union with Russia, Kazakhstan and Belarus established

1998
- Jan: New Central Bank law adopted
- Jul: All remaining foreign exchange controls abolished
- Oct: Private land ownership passed in referendum
- Dec: WTO membership granted

1999
- Jul: Comprehensive Development Framework initiative launched

2001
- Jun: Interim Poverty Reduction Strategy adopted

2002
- Feb: New privatisation law approved by parliament
- Mar: Paris Club debt rescheduled

2003
- Apr: VAT extended to agricultural sector

Enterprises, infrastructure, finance and social reforms

1991

Jun	Banking laws adopted

1992

Dec	Comprehensive Central Bank law adopted

1994

Jan	Kyrgyz State Energy Holding Company established
Feb	Telecommunications company corporatised
Apr	Competition law introduced
May	Enterprise restructuring agency established

1995

May	Stock exchange begins trading
Jun	BIS capital adequacy enacted
Oct	First enterprises liquidated

1996

Sep	Securities and Exchange Commission established

1997

Jan	Electricity law adopted
May	Utilities privatisation suspended
Jun	State energy company restructured
Jul	IAS introduced
Oct	New bankruptcy law adopted
Oct	National Agency for Communication established

1998

Jun	Pension law amended significantly
Oct	New telecommunications law adopted
Dec	Foreign investor advisory council established

1999

Feb	Largest bank placed under conservatorship

2003

Mar	Law on banks and banking activity amended
Mar	Anti-corruption law adopted
Apr	New joint-stock company law adopted

Infrastructure

Privatisation of Kyrgyz Telecom finally moves ahead.
Efforts to privatise Kyrgyz Telecom were first launched, unsuccessfully, in 1998. In November 2002 a new public tender for a 51 per cent stake in the company was announced. It attracted interest from 13 strategic investors. In June 2003 a consortium of PriceWaterhouseCoopers and Swedish Swedtel, a subsidiary of Telia, was declared the winner of the first stage of the tender with a bid of US$ 15.6 million. The tender commission has studied the technical terms of the bid and is in the process of negotiating the final terms and conditions. Since 1 January 2003 the telecommunications market has been liberalised further and, according to the independent regulator, eight licences have been issued in the past year to companies offering international services.

Power tariff increases and improved collection rates are pushed to the front of the government's reform agenda.
The quasi-fiscal deficit resulting from below cost recovery tariffs in the electricity sector was estimated at 13 per cent of GDP in 2002, one of the highest in the region. Despite increases in recent years, average tariffs for electric power at 1.2 US cents/kWh are just 50 per cent of cost recovery levels. The level of cash collection remains low at 33 per cent and losses in the system reached 40 per cent of total generation. The authorities aim to reduce this deficit to 11.7 per cent of GDP by the end of 2003. This will be achieved primarily through improved cash collection and strengthening targeted subsidies to the poor. With World Bank support, an 11 per cent tariff increase in both 2004 and 2005 are planned. This is expected to generate sufficient cash flow to finance much-needed investments to reduce network losses. In addition, it may put the power utilities on a more sustainable financial footing in the future. For Sever-elektro, a regional distribution company serving Bishkek and the Chui Valley, a concession is now planned instead of privatisation.

Financial institutions

Banking supervision strengthened.
The supervisory powers of the National Bank of the Kyrgyz Republic (NBKR) have improved under the amended law on banks and banking activity, which came into effect in March 2003. In accordance with the amended law and changes in the law on licensing, NBKR is now the sole institution authorised to issue and revoke banking licences. It is also the sole institution responsible for banking sector supervision and is authorised to take preventive actions. The minimum capital requirement – defined as Tier 1 capital minus cross shareholdings – was initially set under IMF conditionality at KGS 25 million (US$ 625,000). It was later increased to KGS 30 million (US$ 750,000), effective from the end of July 2003. The amount will be further increased to KGS 60 million (US$ 1.5 million) by the beginning of 2006. The authorities are also considering providing the Central Bank with a greater role in supervising bank audits. With domestic credit (excluding the government sector) growing by 11 per cent year-on-year at the end of 2002, compared with 4 per cent in 2001, the situation in the banking sector is gradually improving. However, the level of financial intermediation remained low at 4 per cent of GDP. A privatisation tender for the state-owned Kairat Bank is scheduled for the coming months.

Social reform

Despite the recent reduction, the poverty rate remains high.
Addressing poverty will continue to be one of the key policy challenges for the Kyrgyz Republic, the second-poorest country in the CIS both in terms of per capita income and poverty incidence. According to the World Bank, 44 per cent of the population lived below the poverty line in 2002, down from 52 per cent in 2000, driven at least in part by buoyant growth in the rural economy. Under the National Poverty Reduction Strategy, supported by the PRGF, fiscal expenditures have focused on increasing government salaries in the bottom categories and moving to targeted social transfers. In 2003 government wages in the social sector were raised by 15 per cent and pensions by 10 per cent on average. In 2002 key social benefits, such as unified monthly benefit and social allowances, increased by 20 per cent. Overall social spending is expected to increase by 0.7 per cent of GDP in 2003.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **17.6 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **MEBOs**
Tradability of land – **limited de facto**

Enterprises and markets
Competition Office – **no**

Infrastructure
Independent telecoms regulator – **yes**[1]
Separation of railway accounts – **no**
Independent electricity regulator – **yes**[1]

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **no**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **34.1 per cent (2000)**[2]
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	17.6	19.4	33.5	57.7	55.7	56.9	52.5	53.8	na
Share of trade in GDP (in per cent)	63.0	72.1	72.3	78.4	81.1	74.3	60.2	65.5	na
Tariff revenues (in per cent of imports)	2.3	2.0	2.2	2.4	1.4	1.1	1.4	1.6	na
EBRD index of price liberalisation [3]	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation [4]	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.9	1.3	1.4	1.6	1.9	2.1	2.5	2.7	na
Private sector share in GDP (in per cent)	40.0	50.0	60.0	60.0	60.0	60.0	60.0	65.0	na
Private sector share in employment (in per cent)	68.5	72.5	74.2	76.2	77.7	78.2	79.1	na	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	2.3	1.8	2.2	2.5	2.3	na	na	na	na
Share of industry in total employment (in per cent)	12.5	11.1	10.2	10.1	9.0	10.0	10.0	11.0	na
Change in labour productivity in industry (in per cent)[5]	-11.4	16.5	48.8	5.1	3.6	18.5	5.8	na	na
Investment rate/GDP (in per cent)	20.7	22.6	12.6	12.2	18.0	20.0	18.0	18.5	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	7.6 (na)	7.5 (0.0)	7.6 (0.0)	7.8 (0.0)	7.6 (0.1)	7.7 (0.2)	7.7 (0.5)	7.8 (1.0)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	0.3	0.5	3.2	3.6	9.6	12.3	na
Railway labour productivity (1990=100)	16.9	18.8	18.4	17.4	15.4	15.3	15.0	16.2	na
Electricity tariffs, USc kWh (collection rate in per cent)	1.00 (na)	2.25 (na)	2.00 (na)	0.48 (na)	0.37 (na)	0.40 (45)	0.59 (na)	1.32 (41)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.7	3.4	4.1	4.0	4.9	5.4	na	na	na
EBRD index of infrastructure reform	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Electric power	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Railways	na	na	na	1.0	1.0	1.0	1.0	1.0	1.0
Roads	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Telecommunications	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.7
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Financial institutions									
Number of banks (foreign-owned)	18 (3)	18 (3)	20 (3)	23 (6)	23 (5)	22 (6)	20 (5)	20 (6)	na
Asset share of state-owned banks (in per cent)	69.7	5.0	10.3	10.4	25.8	15.8	16.6	9.7	na
Non-performing loans (in per cent of total loans)[6]	72.0	26.1	7.6	0.2	6.4	16.4	13.8	13.3	na
Domestic credit to private sector (in per cent of GDP)	12.5	8.7	3.0	5.0	3.0	2.2	2.0	2.6	na
Stock market capitalisation (in per cent of GDP)	na	3.0	0.5	0.8	0.4	0.3	0.3	0.5	na
EBRD index of banking sector reform	2.0	2.0	2.7	2.7	2.3	2.3	2.3	2.3	2.3
EBRD index of reform of non-bank financial institutions	1.7	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	10.5	8.4	8.1	7.7	6.2	5.5	5.7	6.3	na
Life expectancy at birth, total (years)	65.8	66.5	66.9	67.1	67.0	68.5	68.8	68.1	na
Basic school enrolment ratio (in per cent)	88.0	89.4	89.9	90.3	89.8	97.0	97.0	97.0	na
Earnings inequality (GINI-coefficient)	39.5	42.8	43.1	42.9	46.6	47.0	51.2	na	na

1 The regulator does not have financial independence.
2 Based on the latest available internationally comparable poverty figures reported in the World Bank's *World Development Indicators 2003*. See methodological notes for definition.
3 New series (see Box 2.1 for explanation).
4 Series has been corrected for ratings after 1999.
5 The increase in industrial labour productivity in 1997 was primarily due to the rise in production at the Kumtor gold mine.
6 In 1998 all bad loans in the banking system were transferred to a special bank managed by NBKR. The data reported by the Central Bank are likely to exclude these bad loans.

	1995	1996	1997	1998	1999	2000	2001	2002 Estimate	2003 Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	-5.4	7.1	9.9	2.1	3.7	5.4	5.3	-0.5	5.2
Private consumption	-17.8	6.0	-8.9	17.8	0.3	-4.2	1.7	na	na
Public consumption	-8.7	7.3	-4.5	4.2	4.1	7.5	0.0	na	na
Gross fixed capital formation	55.4	-13.0	-29.2	-1.1	27.7	26.4	-1.9	na	na
Exports of goods and services	-17.4	6.7	21.1	-8.7	-10.4	10.5	-3.2	na	na
Imports of goods and services	-18.4	6.9	-20.2	1.5	-4.9	0.4	-13.8	na	na
Industrial gross output	-24.7	3.9	39.6	5.3	-4.3	6.0	5.4	-13.1	na
Agricultural gross output	-2.0	15.2	12.3	2.9	8.2	2.6	7.3	3.3	na
Employment				*(Percentage change)*					
Labour force (annual average) [1]	1.4	2.1	2.1	2.2	2.1	1.7	1.8	na	na
Employment (annual average) [2]	-0.2	0.6	2.3	0.9	3.5	0.2	1.1	3.5	na
				(In per cent of labour force)					
Unemployment (annual average) [1]	14.5	15.8	15.6	16.7	15.5	16.7	17.4	na	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	43.5	31.9	23.4	10.5	35.9	18.7	6.9	2.1	2.4
Consumer prices (end-year)	32.1	34.8	13.0	16.8	39.8	9.5	3.7	2.3	3.3
Producer prices (annual average)	37.6	23.0	26.3	7.9	53.7	30.7	12.0	4.8	na
Producer prices (end-year)	17.0	23.0	2.4	31.3	43.6	22.9	5.2	6.0	na
Gross average monthly earnings in economy (annual average)	57.8	33.3	38.6	23.6	24.9	16.9	18.6	11.2	na
Government sector [3]				*(In per cent of GDP)*					
General government balance [4]	-17.3	-9.5	-9.2	-9.5	-12.7	-9.9	-5.5	-5.3	-4.8
General government expenditure [4]	42.1	33.4	33.1	33.9	34.0	28.5	25.9	28.0	na
General government debt [5]	53.0	60.6	68.5	90.8	118.8	118.9	100.3	108.4	na
Monetary sector				*(Percentage change)*					
Broad money (M3, end-year)	na	14.8	32.2	17.5	33.7	11.7	11.3	33.9	na
Domestic credit (end-year)	na	41.8	-5.6	22.6	5.0	10.0	-8.1	18.9	na
				(In per cent of GDP)					
Broad money (M3, end-year)	17.2	13.6	13.7	14.5	13.6	11.3	11.1	14.7	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Official rate [6]	64.1	43.1	43.2	54.0	51.6	32.8	10.7	4.4	na
Money market rate [7]	na	na	na	44.0	43.7	24.3	11.9	7.8	na
Deposit rate [8]	na	36.7	39.6	35.8	35.6	18.4	12.5	5.9	na
Lending rate [8]	na	65.0	49.4	73.4	60.9	51.9	37.3	24.8	na
				(Soms per US dollar)					
Exchange rate (end-year)	11.2	16.7	17.4	29.4	45.8	48.4	47.7	46.2	na
Exchange rate (annual average)	10.8	12.8	17.4	20.8	39.0	47.7	48.3	46.9	na
External sector				*(In millions of US dollars)*					
Current account	-234.7	-424.8	-138.5	-364.0	-183.9	-90.9	-51.1	-42.4	-60.2
Trade balance	-122.0	-251.7	-15.3	-220.7	-88.5	4.0	40.0	-52.1	-37.4
Merchandise exports	408.9	531.2	630.8	535.1	462.6	510.9	480.3	502.4	567.2
Merchandise imports	531.0	782.9	646.1	755.7	551.1	506.9	440.3	554.5	604.6
Foreign direct investment, net	96.1	46.8	83.0	86.6	38.4	-6.9	-1.1	16.0	24.6
Gross reserves, excluding gold (end-year)	81.0	94.6	169.8	163.8	229.7	239.0	263.5	288.8	na
External debt stock [9]	913.8	1,301.3	1,711.7	1,962.5	2,125.9	2,134.5	2,125.0	2,163.0	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	1.3	1.1	2.3	1.9	3.5	3.8	4.9	4.7	na
				(In per cent of exports of goods and services)					
Debt service	22.3	15.5	12.0	21.8	24.8	41.8	46.3	39.5	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	4.5	4.6	4.6	4.7	4.7	4.7	4.8	4.8	na
GDP (in millions of soms)	16,145	23,399	30,686	34,181	48,744	65,358	73,883	75,240	81,019
GDP per capita (in US dollar)	330.7	398.4	382.1	350.2	266.1	289.5	320.9	333.6	na
Share of industry in GDP (in per cent)	10.8	10.1	16.4	16.1	21.4	23.3	23.1	19.1	na
Share of agriculture in GDP (in per cent)	36.6	42.4	40.8	35.6	34.3	34.2	34.5	35.6	na
Current account/GDP (in per cent)	-15.7	-23.3	-7.8	-22.1	-14.7	-6.6	-3.3	-2.6	-3.3
External debt - reserves (in US$ million)	833	1,207	1,542	1,799	1,896	1,895	1,861	1,874	na
External debt/GDP (in per cent)	61.2	71.4	96.9	119.3	170.1	155.8	138.9	134.9	na
External debt/exports of goods and services (in per cent)	203.9	231.3	253.3	328.3	403.0	372.7	378.9	340.7	na

1 Based on labour force data from World Bank World Development Indicators.
2 The number of employed in legal entities which excludes employment in agriculture and forestry. Based on data from the National Statistics Committee (NSC).
3 General government includes the state, municipalities and extra-budgetary funds. It also includes expenditure under the foreign financed Public Investment Programme. General government expenditure includes net lending.
4 Cash basis until 1998 and accural basis thereafter.
5 Excludes debt by Kumtor gold mine.
6 Lombard rate from International Financial Statistics.
7 Weighted average rate on interbank loans in soms with 1-90 days maturity, from International Financial Statistics.
8 Weighted average over all maturities from International Financial Statistics.
9 External debt stock is the total liabilities of the country based on the international investment position from International Financial Statistics. It includes equity investments and reinvested earings relating to direct investments.

Latvia

Key reform challenges

- **Improvements in medium-term budgetary planning, increased tax collection rates and control of local government finances remain essential to the twin tasks of reducing budget deficits and large current account deficits.**
- **While the authorities have made efforts to improve the investment climate, continued efforts are needed to strengthen public administration and judicial capacities and continue the fight against corruption.**
- **In the energy sector, the main outstanding tasks are to accelerate progress in the restructuring of Latvenergo, strengthen the independence of the Public Utilities Commission and raise prices towards cost-recovery levels.**

Stabilisation

Pace of fiscal consolidation slow, despite strong growth in GDP.
Although the current government has reiterated its commitment to achieving balanced budgets over the medium term, it has so far not been able to implement a strategy for fiscal consolidation. The general government deficit reached 2.7 per cent of GDP in 2002 and the government approved a budget with a 3 per cent deficit forecast for 2003. This is significantly above the levels advised by the IMF. Expenditures rose sharply in 2002 as a result of substantial supplementary spending and increases in public sector wages ahead of elections. The higher fiscal deficit target in the 2003 budget was due mainly to the authorities' decision to proceed with the reduction in corporate income and social tax rates from January 2003. However, revenue performance in the first half of 2003 has been very strong despite the tax reductions. This could lead to a slightly lower deficit than foreseen under the budget. The slow pace of fiscal consolidation will put Latvia in a more difficult position to meet future spending needs related to EU and NATO accession, while remaining within the constraints of the Maastricht criteria and the Stability and Growth Pact.

Privatisation

Privatisation plans for Ventspils Nafta still to be agreed.
The privatisation of the state's remaining 38.6 per cent share in the Ventspils Nafta oil terminal has been complicated by the Russian state-owned pipeline operator Transneft's decision to stop supplying oil via the pipeline to the terminal from the start of 2003. Transneft is allegedly seeking to increase its leverage in a potential takeover of Ventspils Nafta. In line with the original privatisation agreement, the government in June 2003 had to concede an additional 5 per cent stake to the private Latvian company Latvijas Naftas Tranzits (LNT), making it the largest shareholder with 48 per cent. However, the government is currently investigating the legality of the original privatisation. Maintaining the objective of maximising revenues, the government hopes to sell its stake in Ventspils Nafta by the end of 2003.

Enterprise reform

Business environment improves, but corruption remains a problem.
According to a World Bank FIAS survey published in January 2003, small and medium-sized enterprises in Latvia continue to complain about difficulties in the area of tax and customs administration, various problems with red tape at the municipal level, and administrative corruption in construction, customs and the police. In October 2002 the government approved a revised action plan to improve the business environment. This plan includes measures aimed at improving tax policy and administration, central and local government procurement procedures and confidence in the rule of law. Judicial capacity is currently being improved by introducing higher remuneration, better qualification criteria, training and social guarantees for judges. Moreover judicial reform is progressing, with the establishment of administrative courts expected from January 2004. Following the creation of the new Corruption Prevention Bureau in May 2002 (whose tasks are to investigate corruption, conflict of interest and political party finance), the government approved a new strategy to fight corruption in December 2002.

Infrastructure

Restructuring of Latvenergo progressing slowly, but energy prices set to rise.
Restructuring of the state-owned electricity company Latvenergo has been delayed while the government evaluates the existing restructuring plan. Possible reforms include establishing separate and independent companies for power generation, transmission and distribution. Latvenergo has recently applied to the Public Services Regulatory Commission for an increase in electricity tariffs by an average of 14.2 per cent starting in January 2004. This tariff increase would be the first since 1998, since previous increases have been denied. The largest tariff growth – by 20 per cent – is planned for households, whereas for industrial consumers the tariffs could remain unchanged or even decrease. Latvia currently has one of the lowest electricity prices of EU accession countries.

Liberalisation, stabilisation, privatisation

1990
- Nov – Unified exchange rate introduced

1991
- Jan – Personal income tax introduced
- Aug – Soviet trade equalisation tax abolished
- Sep – Independence from Soviet Union declared
- Oct – Restitution law adopted
- Nov – Foreign investment law adopted
- Nov – Small-scale privatisation commenced

1992
- Jan – Most consumer prices liberalised
- Jan – VAT introduced
- Jan – Wages liberalised
- Jun – Privatisation law adopted
- Jun – Large-scale privatisation commenced
- Jun – Most controls on foreign trade removed
- Jul – Interest rates liberalised

1993
- Feb – Tradability of land rights enacted
- Mar – New currency (lat) introduced
- Dec – Treasury bills market initiated

1994
- Feb – Privatisation law amended
- Feb – Privatisation agency established
- Jun – Full current account convertibility introduced

1996
- Jun – EFTA membership granted

1999
- Feb – WTO membership granted
- May – First sovereign Eurobond issued
- Dec – EU accession negotiations commence

2000
- Apr – Agricultural tariffs reduced

2002
- Feb – Last state stake in Latvijas Gaze sold
- Apr – Privatisation of Latvian Shipping Company initiated

2003
- Jan – Corporate income and social taxes reduced
- May – Remaining state stake in Latvijas Krajbanka privatised

Enterprises, infrastructure, finance and social reforms

1993
- May — Company law adopted
- Dec — Stock exchange established

1994
- Jan — BIS capital adequacy requirement introduced

1995
- May — Banking crisis ensues
- Jul — Stock exchange begins trading
- Oct — New banking law adopted
- Oct — IAS accounting for banks introduced
- Oct — First state-owned bank privatised

1996
- Jun — Energy Regulation Council established
- Sep — Bankruptcy law adopted

1997
- Jun — New competition law adopted
- Aug — First corporate Eurobond issued
- Nov — Electricity tariffs adjusted significantly
- Dec — First corporate GDR issue undertaken

1998
- Jan — Anti-monopoly office established
- Jul — Private pension law adopted
- Sep — New energy law adopted
- Sep — New insurance law adopted
- Nov — Railway law adopted

1999
- Aug — PAYG pension system reformed

2000
- Feb — Law on second pension pillar passed
- May — Law on unified financial sector supervision adopted

2001
- Jul — Financial and Capital Markets Commission commences operations
- Jul — First contributions to second pillar of pensions scheme made
- Jul — European Social Charter adopted
- Sep — Single regulatory agency for public utilities created

2002
- Jan — New commercial code enacted
- Apr — New law on credit institutions adopted
- May — Corruption prevention bureau created
- Jun — Riga Stock Exchange acquired by Helsinki Exchange

2003
- Jan — Fixed-line telecommunications market liberalised
- Jan — Private pension fund management commences

Fixed-line monopoly of Lattelekom ends, but entry of new operators deterred by high inter-connection fees.
Since Lattelekom lost its fixed-line monopoly rights in January 2003, at least 12 companies have been licensed for operating fixed-line telecommunications in Latvia. However, only one company has managed to negotiate inter-connection agreements for using the Lattelekom network. Licences for fixed-line telecommunications services have already been obtained by the country's two mobile telecom operators LMT and Tele2, as well as Latvenergo and the Latvian railway company. According to the new operators, failure to reach inter-connection agreements has mainly been the result of unacceptably high inter-connection rates of LVL 0.017 (€0.0255) per minute for local networks. The average rate in Europe is less than one-third that, at LVL 0.0048 (€0.0072) per minute. Until now, the public regulator has not set specific inter-connection rates between the new operators and the largest market player. It argues that it does not have the legal authority to intervene.

Financial institutions

Messy privatisation of Latvijas Krajbanka reveals continued lack of transparency in privatisation process.
In May 2003 an offshore company registered in the British Virgin Islands, Doxa Fund Limited, obtained a 25 per cent stake in Latvijas Krajbanka, Latvia's ninth largest bank in terms of assets. Doxa Fund was the only bidder and offered the minimum price of LVL 4.12 million (€6.3 million). The privatisation was marked by serious infighting among the shareholders.
Doxa Fund appears to be linked to the Netherlands-registered Macasyng Holding, which already holds 29 per cent of the bank under direct and indirect control. Three large private owners in Latvijas Krajbanka tried to stop the privatisation from proceeding through court appeals. Another minor shareholder in the bank is also being investigated by the Corruption Prevention Bureau for legal infractions committed during the privatisation. Meanwhile, an attempt by the Finance and Capital Market Commission (FCMC), Latvia's financial market regulator, to curtail the rights of the new shareholder was struck down by a local court in June 2003. The FCMC had tried to prevent Doxa Fund Ltd from using its voting rights to make changes to both Krajbanka's board and charter capital. The FCMC declined to explain the exact basis for its decision, saying it does not comment on individual market players. Though the attempt failed, it underscored the continuing conflict among the government, the regulatory authorities and non-transparent, offshore entities.

Social reform

Pension reform advances with the start of private pension fund management.
Contributions to the compulsory funded pension scheme ("second pillar") started in July 2001. From January 2003 the management of the pension assets has been entrusted to licensed private pension fund managers. Contributions to the second pillar are planned to rise gradually from 2 per cent of income to 10 per cent by 2010, with the first pillar being reduced accordingly. There are now five domestically registered asset managers: Hansa Fonds, Optimus Fonds, the Parekss Investment Company, Baltkimus Asset Management and the Latvian Leading Insurers Investment Company. All are competing for market share. Second pillar benefits are earmarked in individual accounts, accruing on a money purchase basis. Investment restrictions apply with the only permitted investments for second pillar funds being Latvian state bonds and deposit accounts. The current value of second pillar assets exceeds LVL 6.5 million (€9.8 million).

Changes in labour market policies introduced, but challenges remain.
In February 2003 Latvia signed a joint declaration with the European Commission, emphasising the need to raise skills and qualification levels of the workforce, examine the unemployment benefit system, improve the targeting of labour market policies and ensure wage growth is kept in line with productivity improvements. Although the government is now implementing some constructive measures, problems remain with high structural unemployment, regional immobility and skills mismatches.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **30.5 per cent**
Exchange rate regime – **fixed peg**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **10 per cent**
Deposit insurance system – **yes**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **8.3 per cent (1998)**
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	16.6	17.8	19.6	20.4	22.0	22.3	22.0	20.7	16.3
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Share of trade with non-transition countries (in per cent)	49.5	50.0	56.7	66.4	72.9	79.8	68.6	67.7	na
Share of trade in GDP (in per cent)	75.1	74.1	80.4	84.6	72.3	72.2	75.4	78.5	na
Tariff revenues (in per cent of imports)	1.8	1.5	1.4	1.1	0.9	0.8	0.7	0.6	na
EBRD index of price liberalisation [1]	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.7	0.8	2.2	3.3	3.5	4.1	4.7	5.4	na
Private sector share in GDP (in per cent)	55.0	60.0	60.0	65.0	65.0	65.0	65.0	70.0	na
Private sector share in employment (in per cent)	60.0	63.0	66.0	68.0	70.0	72.0	73.0	75.0	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	0.4	0.8	5.2	4.7	5.2	5.0	5.2	6.0	na
Share of industry in total employment (in per cent)	20.4	21.8	20.6	21.1	19.9	20.5	19.4	19.5	na
Change in labour productivity in industry (in per cent)	8.1	5.8	13.9	1.6	1.7	3.3	10.7	2.1	na
Investment rate/GDP (in per cent)[2]	17.6	18.8	22.8	27.6	26.3	26.7	30.6	29.5	na
EBRD index of enterprise reform	2.0	3.0	2.7	2.7	2.7	2.7	2.7	2.7	3.0
EBRD index of competition policy	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.7
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	28.0 (0.6)	29.8 (1.2)	29.8 (3.1)	30.2 (6.8)	30.0 (11.3)	30.3 (16.6)	30.8 (27.9)	30.1 (39.4)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	28.8	59.7	79.3	110.1	106.4	155.7	na
Railway labour productivity (1989=100)	50.2	65.6	75.4	72.0	73.6	84.5	90.5	108.6	na
Electricity tariffs, USc kWh (collection rate in per cent)	4.7 (85)	5.6 (94)	6.4 (98)	6.6 (99)	6.7 (na)	6.4 (na)	6.5 (99)	4.9 (99.5)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.2	3.2	3.2	3.4	4.0	4.6	na	na	na
EBRD index of infrastructure reform	2.0	2.3	2.3	2.7	2.7	2.7	2.7	2.7	2.7
Electric power	2.3	2.3	2.3	2.3	3.0	3.0	3.0	3.0	3.0
Railways	na	na	na	3.3	3.3	3.3	3.3	3.3	3.3
Roads	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	2.7	2.7	2.7	3.0	3.0	3.0	3.0	3.0	3.0
Water and waste water	2.0	2.3	2.7	2.7	3.0	3.0	3.3	3.3	3.3
Financial institutions									
Number of banks (foreign-owned)	42 (11)	35 (14)	32 (15)	27 (15)	23 (12)	21 (12)	19 (12)	19 (12)	na
Asset share of state-owned banks (in per cent)	9.9	6.9	6.8	8.5	2.6	2.9	3.2	4.0	na
Non-performing loans (in per cent of total loans)	19.0	20.0	10.0	6.8	6.8	5.0	3.1	2.1	na
Domestic credit to private sector (in per cent of GDP)	7.5	6.9	10.6	15.1	16.0	19.5	26.4	33.4	na
Stock market capitalisation (in per cent of GDP)	0.2	3.0	6.1	6.1	5.9	8.0	9.1	8.0	na
EBRD index of banking sector reform	3.0	3.0	3.0	2.7	3.0	3.0	3.3	3.7	3.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.3	2.3	2.3	2.3	2.3	3.0	3.0
Social sector									
Expenditures on health and education (in per cent of GDP)	10.9	9.7	9.5	11.0	12.4	11.6	10.3	10.5	na
Life expectancy at birth, total (years)	66.8	69.3	69.9	69.7	70.4	70.4	70.4	na	na
Basic school enrolment ratio (in per cent)	89.3	91.4	92.2	92.4	93.3	96.5	99.4	na	na
Earnings inequality (GINI-coefficient)	34.6	34.9	33.6	33.2	33.3	33.7	32.2	na	na

[1] New series (see Box 2.1 for explanation).

[2] World Bank Development Indicators. Gross capital formation.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	*Projection*
Output and expenditure				*(Percentage change in real terms)*					
GDP	-0.9	3.7	8.4	4.8	2.8	6.8	7.9	6.1	6.5
Private consumption	0.6	9.9	4.9	1.1	3.7	7.4	7.8	7.2	na
Public consumption	7.7	1.8	0.3	6.1	0.0	-1.9	0.3	1.4	na
Gross fixed capital formation	na	22.3	20.7	44.0	-4.0	20.0	17.0	10.4	na
Exports of goods and services	3.3	20.2	13.1	4.9	-6.4	12.0	6.9	6.3	na
Imports of goods and services	1.3	28.5	6.8	19.0	-5.2	4.9	12.6	4.5	na
Industrial gross output	1.6	2.5	12.5	3.5	-5.7	3.2	6.9	5.8	na
Agricultural gross output	11.7	-7.1	6.6	-3.5	-3.4	11.3	8.2	4.2	na
Employment				*(Percentage change)*					
Labour force (end-year)	-1.9	-6.3	-2.4	-1.6	-1.6	-2.7	0.6	1.5	na
Employment (end-year)	-3.5	-9.3	4.4	-0.4	-1.8	-2.8	2.2	2.8	na
				(In per cent of labour force)					
Unemployment (end-year)	18.1	20.6	15.1	14.1	14.3	14.4	13.1	12.0	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	25.0	17.6	8.4	4.7	2.4	2.6	2.5	1.9	3.3
Consumer prices (end-year)	23.1	13.1	7.0	2.8	3.2	1.8	3.2	1.4	4.9
Producer prices (annual average)	11.9	13.7	4.1	1.9	-4.0	0.6	1.7	1.0	na
Producer prices (end-year)	15.9	7.7	3.6	-1.9	-1.1	1.0	1.8	0.8	na
Gross average monthly earnings in economy (annual average)	24.5	10.3	21.6	11.1	5.8	6.1	6.5	8.5	na
Government sector [1]				*(In per cent of GDP)*					
General government balance	-4.0	-1.8	0.3	-0.8	-3.9	-3.2	-2.0	-2.7	-2.0
General government expenditure	41.5	39.5	41.0	43.3	44.1	42.0	37.2	38.8	na
General government debt	16.3	14.5	12.0	10.4	13.1	13.1	14.8	14.6	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	-23.1	19.9	38.7	5.9	8.0	27.9	20.8	21.0	na
Domestic credit (end-year)	-28.2	6.0	39.3	30.6	15.2	43.6	35.6	39.8	na
				(In per cent of GDP)					
Broad money (M2, end-year)	22.5	22.4	26.6	25.7	25.6	29.3	32.0	35.9	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Refinancing rate	24.0	9.5	4.0	4.0	4.0	3.5	3.5	3.0	na
Inter-bank market rate [2]	21.1	9.7	3.9	7.0	2.7	3.3	5.4	2.7	na
Deposit rate (short-term, under 1 year)	15.0	10.0	5.3	6.5	4.2	4.2	5.7	5.2	na
Lending rate (short-term, under 1 year)	31.1	20.3	12.1	16.4	12.5	11.8	9.9	7.4	na
				(Lats per US dollar)					
Exchange rate (end-year)	0.54	0.56	0.59	0.57	0.58	0.61	0.64	0.59	na
Exchange rate (annual average)	0.53	0.55	0.58	0.59	0.59	0.61	0.63	0.62	na
External sector				*(In millions of US dollars)*					
Current account	-16	-279	-345	-650	-654	-493	-732	-659	-879
Trade balance	-580	-798	-848	-1,130	-1,027	-1,058	-1,351	-1,444	-1,589
Merchandise exports	1,368	1,488	1,838	2,011	1,889	2,058	2,216	2,576	2,833
Merchandise imports	1,947	2,286	2,686	3,141	2,916	3,116	3,567	4,020	4,422
Foreign direct investment, net	245	379	515	303	331	400	151	388	350
Gross reserves, excluding gold (end-year)	506	622	704	728	840	851	1,149	1,241	na
External debt stock [3]	na	2,091	2,756	3,098	3,821	4,702	5,570	6,974	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	2.8	2.5	2.5	2.2	2.8	2.6	3.2	3.2	na
				(In per cent of exports of goods and services)					
Debt service	8.1	10.0	10.5	10.1	13.5	15.5	19.9	14.3	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	2.5	2.5	2.5	2.4	2.4	2.4	2.3	2.3	2.3
GDP (in millions of lats)	2,329	2,807	3,269	3,592	3,890	4,348	4,813	5,195	na
GDP per capita (in US dollar)	1,764	2,054	2,289	2,538	2,792	3,032	3,269	3,605	na
Share of industry in GDP (in per cent)	24.5	23.2	23.9	20.2	17.4	16.4	16.6	16.6	na
Share of agriculture in GDP (in per cent)	9.9	8.2	5.6	4.4	4.3	4.9	4.7	4.5	na
Current account/GDP (in per cent)	-0.4	-5.5	-6.1	-10.7	-9.8	-6.9	-9.5	-7.8	-8.4
External debt - reserves (in US$ million)	na	1,469	2,052	2,370	2,981	3,851	4,421	5,733	na
External debt/GDP (in per cent)	na	41.0	49.0	50.9	57.5	65.6	72.6	83.0	na
External debt/exports of goods and services (in per cent)	na	80.0	96.0	99.3	131.1	143.7	163.6	182.2	na

1 General government includes the state, municipalities and extra-budgetary funds. Privatisation revenues are not included in revenues. General government expenditure includes net lending.

2 Weighted average interest rates in the interbank market.

3 Includes non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

Lithuania

Key reform challenges

- **Recent efforts to improve the investment climate could be enhanced by increasing efficiency in public administration and reforming the judicial system.**
- **Regulatory frameworks need to be further strengthened to enhance commercialisation and restructuring in the infrastructure sector.**
- **Supervision of banking and non-banking segments should be unified and further reforms are needed to establish a well-capitalised second pension pillar and develop the non-bank financial sector.**

Stabilisation

Fiscal reforms bring tax system more into line with EU requirements.
Over the past year, Lithuania has built on previous progress in tax reform by introducing a new law on personal income tax, effective from January 2003. In addition, changes have been made to improve the financial management of municipalities by amending the law on the state and municipalities' budget. Moreover, a number of cost saving measures were made to the Health Insurance Fund from March 2002 until March 2003. These are estimated to have reduced costs by around LTL 120 million and eliminated all arrears by the end of 2003. Nevertheless, the IMF remains concerned that the government will have to improve budgeting and planning, prioritise expenditures, find alternative revenue sources, improve tax administration and control municipal finances in the run-up to EU and euro accession. In particular, much remains to be done to accelerate preparations and increase institutional capacity for the management of EU cohesion and structural funds.

Privatisation

Privatisations move ahead, albeit with some setbacks.
Privatisation revenue in 2003 should exceed the LTL 246 million earned in 2002, with privatisation revenues from the sale of 409 Lithuanian companies reaching LTL 108.97 million in the first six months of this year. The biggest privatisations in the first half of 2003 included the sale of an 80.9 per cent holding in the Klaipeda Transport Company for LTL 48.7 million (€14 million) and sale of a 92.4 per cent stake in liquefied gas distributor Suskystintos Dujos for LTL 7.15 million (€2 million). Most of the remaining medium and large-scale privatisations are in the transport and energy sectors. However, the sale of a 34 per cent stake in Lithuanian Airlines failed in April 2003 when the only bidder, Scandinavian Airlines System, pulled out. The government has also launched the sale of a 66.6 per cent stake in Lietuvos Juro Laivininkyste (LJL), a cargo shipping company with 19 vessels spun off in 2001 from the Lithuanian Shipping Company before its privatisation in 2002. Following the sale of Williams International's stake in Mazeikiu Nafta to the Russian oil major Yukos in 2002 (the latter now owns 53.7 per cent of the company), the government has also announced its intention to sell up to 18 per cent in the company from its existing 40.7 per cent share. In the consumer sector, the government is set to privatise four alcohol manufacturers by the end of 2003 and plans are advancing for further privatisations in the energy sector (see below).

Enterprise reform

Amendments to existing laws made to facilitate restructuring in the corporate sector.
Lithuania's medium-sized enterprises are small by European standards and are affected by weak corporate governance. However, the process of enterprise restructuring was given a boost in late 2002 with changes in legislation to improve the enterprise restructuring law (in November 2002) and the bankruptcy law (in December 2002). Changes to the bankruptcy law are intended to enhance the process of appointing administrators and introduce simplified bankruptcy procedures. These changes have already had visible impact on the pace of bankruptcy proceedings. The number of bankruptcy cases filed at courts increased substantially from 2001 to 2003. Moreover, Lithuania has taken significant steps to combat corruption through the adoption of a national anti-corruption action plan and creation of independent monitoring and enforcement mechanisms.

Infrastructure

Sale of second stake in Lithuanian Gas postponed.
Following the sale of an initial 34 per cent stake in the gas transmission and distribution monopoly Lithuanian Gas, to a consortium of Germany's Ruhrgas and E.ON Energie in May 2002, the sale of a second 34 per cent stake to Gazprom has been postponed. The postponement has come as a result of disagreements over the conditions of the sale, mainly concerning price and future supply routes to Lithuania. Gazprom missed the original deadline for submitting

Liberalisation, stabilisation, privatisation

1990
Feb Central Bank established
Mar Independence from Soviet Union declared
May Personal income tax introduced

1991
Feb Privatisation law adopted
Feb Voucher privatisation begins
Jul Restitution law adopted

1992
Apr Export surrender requirement abolished
Oct Most prices liberalised

1993
Jul Litas becomes sole legal tender
Jul Trade regime liberalised
Nov Free trade agreement with Russia signed

1994
Apr Currency board introduced
May VAT introduced
May Full current account convertibility introduced
Jul Treasury bills market initiated
Jul Land law adopted
Oct Export duties abolished
Dec Law on Central Bank adopted

1995
Jan EFTA membership granted
Jun First phase of privatisation completed
Jul Cash privatisation begins
Dec First sovereign Eurobond issued

1997
Nov Privatisation law amended

1998
Oct Tariffs increased on imports from CIS countries

1999
Jan Capital gains tax introduced

2000
Mar IMF Stand-By Arrangement reached
Dec WTO membership granted

2002
Feb Currency repegged from US dollar to euro
Jun Mazeikiu oil refinery privatised

2003
Jan New law on personal income tax effective
Apr Klaipeda Transport Company privatised

Enterprises, infrastructure, finance and social reforms

1995

Jan	New law on commercial banks adopted
Mar	Energy law adopted
Dec	Banking crisis ensues
Dec	Energy utilities and railways corporatised

1996

Jan	IAS accounting for banks introduced
Feb	Independent securities regulator established
Mar	BIS capital adequacy requirement introduced
Jul	First GDR issue undertaken
Aug	First major bank becomes majority foreign-owned

1997

Feb	Independent energy regulator established
Feb	First corporate Eurobond issued
Jul	Lithuanian Telecom corporatised
Oct	New bankruptcy law adopted

1998

Apr	Company law amended
Apr	Pledge law enacted
Apr	Mortgage registry established
Jun	Lithuanian Telecom privatised
Jun	IAS accounting for listed companies introduced
Aug	New telecommunications law adopted

1999

Apr	New competition law adopted
Jun	Private pension funds law adopted

2000

Oct	New gas law adopted
Dec	New electricity law adopted

2001

May	Independent telecommunications regulator established
Jul	Bankruptcy and restructuring laws strengthened
Dec	Lithuanian Energy Company unbundled

2002

Jan	Anti-corruption programme adopted
Mar	Banking sector privatisation completed
Jun	New labour code adopted
Nov	Enterprise restructuring law amended
Dec	Amendments to bankruptcy law approved
Dec	New law on pension system reform approved

2003

Jan	New labour code effective
Jan	Fixed-line telecommunications market liberalised
Sep	New law on insurance adopted

an offer, but the government has extended this deadline. The privatisation of the company will enhance competition, but the regulatory authorities still have to ensure third-party-access.

Privatisations in the electricity sector proceeding more smoothly.
Following the unbundling of the electricity sector into separate distribution, generation and transmission companies, the privatisation of the two regional distribution companies – Vakaru Skirstomieji Tinklai (VST) and Rytu Skirstomieji Tinklai (RST) – was launched in July 2003. The Lithuanian government has offered a 71.4 per cent stake in RST and a 77 per cent stake in VST. The move comes after Germany's E.ON Energie, which already owns a 10.9 per cent stake in both distributors, reached a deal with the Lithuanian government to swap its stakes in power utility Lietuvos Energija and thermal power plant Lietuvos Elektrine for additional equity in RST and VST. This gives the German company a 20.27 per cent share in RST and a 14.62 per cent stake in VST. The sale is expected to be completed by the end of this year. The terms of the two privatisations are designed to attract quality strategic investors with a proven track record in the region. A number of European utility companies, including E.On, Electricité de France, Finland's Fortum and Eestii Energija of Estonia, have all expressed their interest in bidding for the RST stakes. Meanwhile the Lithuanian investors NDX Energija, as well as Achema, have expressed their interest in the VST stakes, which can only be sold to companies with at least one year's experience operating in Lithuania and a turnover of LTL 450 million.

Financial institutions

Supervision in the banking sector improved …
A number of changes were made in 2003 to further enhance banking sector supervision, in line with recommendations from the IMF and the EU. The authorities have revised the law on banks to enhance the supervisory capacity of the Credit Institutions Supervision Department of the Bank of Lithuania. Further anti-money laundering procedures have also been introduced. In July 2003 the Commission for Regulation and Supervision of Financial Institutions and Insurance Companies was formed, aimed at unifying supervision of the whole financial sector. In September 2003 a new law on insurance was adopted, which addresses many of the weaknesses identified by the International Association of Insurance Supervision (IAIS).

… and the non-bank financial sector should get a boost from reforms to the pension system.
The capital market in Lithuania continues to be underdeveloped, reflecting in part a weak institutional investor base. Stock market capitalisation at the end of 2002 was only 10 per cent of GDP, lower than in most of the other advanced transition countries. At the same time, there are nine life insurance companies and 26 non-life insurance companies, but the total insurance premiums underwritten in 2002 were less than 2 per cent of GDP. Following the adoption of the law on pension accumulation in July 2003, four management companies were authorised to manage pension funds and four life insurance companies were authorised to engage in pension activities.

Social reform

Pension reforms implemented, but are insufficient to ensure the long-term sustainability of the system.
In December 2002 parliament adopted a new law on pension reform which establishes a voluntary contribution second pension pillar, instead of the compulsory participation type that was originally envisaged. The reforms, however, fall short of establishing a well-capitalised contribution-defined second pillar. Starting in January 2004 private individuals will be able to direct a portion of their social security contributions from the state-run social insurance fund, Sodra, to private pension funds and life insurance companies on a voluntary basis. In addition, the contribution rate has initially been set at a low level of 2.5 per cent of earnings, although it is set to increase to 5.5 per cent by 2007. The fact that the second pillar has been made voluntary and that contributions start at a very low rate could endanger the long-term sustainability of the system.

New labour code becomes effective.
Given the persistence of still high unemployment (a large part of which is structural), a new labour code became effective in January 2003 aimed at modernising the existing system and incorporating key principles of international labour legislation. Amendments also have been made to the law on support to the unemployed, designed to stimulate employment in depressed areas through subsidised job creation and other policies. However, key challenges remain in bringing about a long-lasting recovery in the labour market.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **27.6 per cent**
Exchange rate regime – **currency board (euro)**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **full**[1]

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **10 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **13.7 per cent (2000)**
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	2.0	2.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	43.0	38.8	54.6	46.6	50.9	65.9	59.9	61.5	na
Share of trade in GDP (in per cent)	98.6	98.0	99.0	86.7	72.3	82.4	91.7	97.2	na
Tariff revenues (in per cent of imports)[2]	1.4	1.2	1.3	1.1	1.1	0.7	0.6	0.5	na
EBRD index of price liberalisation [3]	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	1.4	1.4	1.6	6.8	8.0	9.8	10.8	11.3	na
Private sector share in GDP (in per cent)	65.0	70.0	70.0	70.0	70.0	70.0	70.0	75.0	na
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.3	3.7	3.7
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	1.1	1.3	0.9	0.5	0.4	0.2	0.2	0.2	na
Share of industry in total employment (in per cent)	20.9	20.7	21.6	21.2	20.7	20.8	20.8	20.9	na
Change in labour productivity in industry (in per cent)[4]	14.1	6.5	2.4	8.0	-8.8	na	19.9	0.6	na
Investment rate/GDP (in per cent)	23.0	23.0	24.4	24.4	23.1	20.2	21.0	22.6	na
EBRD index of enterprise reform	2.0	3.0	2.7	2.7	2.7	2.7	2.7	3.0	3.0
EBRD index of competition policy	2.0	2.0	2.3	2.3	2.3	2.7	3.0	3.0	3.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	25.4 (0.4)	26.8 (1.4)	28.3 (4.5)	30.1 (7.2)	31.2 (9.0)	32.1 (14.7)	31.3 (25.3)	27.1 (47.2)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	10.9	26.5	38.4	48.2	101.0	150.8	na
Railway labour productivity (1989=100)	32.3	35.9	38.2	36.3	34.9	41.3	39.1	54.4	na
Electricity tariffs, USc kWh (collection rate in per cent)	5.0 (85)	5.0 (85)	5.5 (85)	5.5 (90)	5.5 (90)	6.1 (na)	6.3 (91)	7.9 (>90)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.6	2.6	2.9	2.9	3.3	3.9	na	na	na
EBRD index of infrastructure reform	1.7	1.7	2.0	2.3	2.3	2.7	2.7	2.7	2.7
Electric power	2.3	2.3	2.3	2.3	2.3	3.0	3.0	3.0	3.0
Railways	na	na	na	2.3	2.3	2.3	2.3	2.3	2.3
Roads	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	1.0	1.0	2.3	3.3	3.3	3.3	3.3	3.3	3.3
Water and waste water	2.3	2.3	2.3	2.3	2.7	3.0	3.3	3.3	3.3
Financial institutions									
Number of banks (foreign-owned)	15 (0)	12 (3)	12 (4)	12 (5)	13 (4)	13 (6)	14 (4)	14 (4)	na
Asset share of state-owned banks (in per cent)	61.8	54.0	48.8	44.4	41.9	38.9	12.2	0.0	na
Non-performing loans (in per cent of total loans)	17.3	32.2	28.3	12.5	11.9	10.8	7.4	5.8	na
Domestic credit to private sector (in per cent of GDP)	12.3	9.5	9.3	9.5	11.1	10.2	11.7	14.2	na
Stock market capitalisation (in per cent of GDP)	2.5	11.4	17.7	9.9	10.7	14.2	10.1	9.5	na
EBRD index of banking sector reform	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.3	2.3	2.7	3.0	3.0	3.0	3.0
Social sector									
Expenditures on health and education (in per cent of GDP)	9.0	8.8	9.6	11.1	11.1	10.5	10.5	10.5	na
Life expectancy at birth, total (years)	69.3	70.4	71.2	71.6	72.1	72.6	72.7	na	na
Basic school enrolment ratio (in per cent)	92.7	93.0	94.9	95.9	95.5	101.4	102.3	na	na
Earnings inequality (GINI-coefficient)	37.4	35.0	34.5	35.7	36.8	na	38.2	na	na

1 Full for non-agricultural land, but ownership of agricultural land is constitutionally prohibited for foreigners and partially restricted for Lithuanian legal persons.

2 Refers to all taxes on foreign trade.

3 New series (see Box 2.1 for explanation).

4 There is a break in the series. Data from 2000 are based on the population census and previous data have not been recalculated.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	3.3	4.7	7.0	7.3	-1.8	4.0	6.5	6.7	6.0
Private consumption	na	6.5	5.3	4.7	3.3	6.6	3.9	4.2	na
Public consumption	na	2.5	6.3	6.0	-8.1	3.9	0.3	4.3	na
Gross fixed capital formation	na	15.2	24.5	21.8	-6.1	-9.0	13.5	12.4	na
Exports of goods and services	na	19.3	18.7	4.6	-16.8	9.8	21.2	19.4	na
Imports of goods and services	na	23.3	25.0	6.2	-12.4	4.7	17.7	16.1	na
Industrial gross output	5.3	5.0	3.3	8.2	-11.2	5.3	15.9	5.0	na
Agricultural gross output	2.6	-1.2	5.8	1.1	-2.6	0.9	-4.6	6.1	na
Employment [1]				*(Percentage change)*					
Labour force (end-year)	0.7	-2.1	-5.7	0.8	1.0	na	-2.1	-0.3	na
Employment (end-year)	-1.9	-0.7	-3.1	1.7	0.1	na	-3.3	4.0	na
				(In per cent of labour force)					
Unemployment (end-year)	17.5	16.4	14.1	13.3	14.1	16.4	17.4	13.8	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	39.6	24.6	8.9	5.1	0.8	1.0	1.3	0.3	-0.8
Consumer prices (end-year)	35.7	13.1	8.4	2.4	0.3	1.4	2.0	-1.0	0.6
Producer prices (annual average) [2]	28.3	16.5	6.0	-3.9	1.7	16.0	-3.0	-2.8	na
Producer prices (end-year) [2]	20.3	12.3	0.9	-8.3	23.3	-7.8	1.9	2.1	na
Gross average monthly earnings in economy (annual average)	47.8	28.5	25.9	19.5	6.2	-1.7	1.2	13.9	na
Government sector [3]				*(In per cent of GDP)*					
General government balance	-4.4	-4.5	-1.8	-5.8	-8.5	-2.8	-2.0	-1.2	-1.5
General government expenditure	35.8	34.2	33.5	37.6	40.3	33.6	31.7	31.4	na
General government debt	na	na	na	22.5	29.0	29.5	28.3	29.5	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	28.9	-3.5	34.1	14.5	7.7	16.5	21.4	16.9	na
Domestic credit (end-year)	na	1.8	37.6	16.8	24.5	1.7	13.7	22.3	na
				(In per cent of GDP)					
Broad money (M2, end-year)	22.7	17.2	18.9	19.1	21.1	23.4	26.7	29.3	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Inter-bank interest rate	na	na	na	na	7.7	10.4	5.5	10.0	na
Treasury bill rate (3-month maturity)	10.7	7.6	5.8	6.1	4.6	4.7	3.0	3.5	na
Deposit rate [4]	7.4	4.3	1.9	2.4	1.6	1.0	0.8	0.3	na
Lending rate [5]	10.4	14.7	10.9	9.5	10.1	10.7	8.1	6.1	na
				(Litai per US dollar)					
Exchange rate (end-year)	4.0	4.0	4.0	4.0	4.0	4.0	4.0	3.4	na
Exchange rate (annual average)	4.0	4.0	4.0	4.0	4.0	4.0	4.0	3.7	na
External sector				*(In millions of US dollars)*					
Current account	-614	-723	-981	-1,298	-1,194	-675	-574	-734	-947
Trade balance	-698	-896	-1,147	-1,518	-1,405	-1,104	-1,108	-1,337	-1,517
Merchandise exports	2,706	3,413	4,192	3,962	3,147	4,050	4,889	6,031	6,513
Merchandise imports	3,404	4,309	5,340	5,480	4,551	5,154	5,997	7,368	8,031
Foreign direct investment, net [6]	72	152	328	921	478	375	439	714	550
Gross reserves, excluding gold (end-year)	757	772	1,010	1,409	1,195	1,312	1,618	2,041	na
External debt stock [7]	1,374	2,401	3,299	3,795	4,540	4,884	5,268	6,199	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	2.3	1.9	1.9	2.7	2.7	2.7	2.9	2.9	na
				(In per cent of current account revenues, excluding transfers)					
Debt service	3.7	6.9	10.5	17.8	19.4	20.1	34.0	38.1	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	3.6	3.6	3.6	3.5	3.5	3.5	3.5	3.5	na
GDP (in millions of litai)	24,781	31,529	38,520	43,555	42,608	44,698	47,498	50,679	53,295
GDP per capita (in US dollar)	1,714	2,197	2,703	3,079	3,033	3,205	3,417	3,988	na
Share of industry in GDP (in per cent)	23.9	23.7	22.5	21.1	20.4	23.3	25.6	26.0	na
Share of agriculture in GDP (in per cent)	10.7	11.2	10.5	9.1	7.5	7.0	6.3	6.0	na
Current account/GDP (in per cent)	-9.9	-9.2	-10.2	-11.9	-11.2	-6.0	-4.8	-5.3	-5.5
External debt - reserves (in US$ million)	617	1,628	2,289	2,386	3,345	3,573	3,650	4,158	na
External debt/GDP (in per cent)	22.2	30.5	34.3	34.9	42.6	43.7	44.4	45.0	na
External debt/exports of goods and services (in per cent)	43.1	57.0	63.2	74.8	107.1	95.6	87.1	82.5	na

1 Based on the labour force survey data. There is a break in the series. Data from 2000 are based on the population census and previous data from the labour force survey have not been recalculated.

2 Producer prices excluding electricity, gas and water until 1995; total industry from 1996.

3 General government sector includes the state, municipalities and extra-budgetary funds. General government expenditure includes net lending.

4 Average interest rate on demand deposits in litai.

5 Average interest rate on loans in litai.

6 Covers equity capital and reinvested earnings.

7 Includes non-resident currency and deposits and loans to foreign subsidiaries.

Moldova

Key reform challenges

- **A clear commitment by the authorities to the market economy, including placing limitations on state interference, is needed to reclaim investor confidence.**
- **To ensure debt sustainability, Moldova needs to bring its energy arrears under control, regain access to official lending and seek an agreement with the Paris Club.**
- **To take advantage of the trade opportunities that could emerge at the border of the enlarged EU, Moldova should seek to maintain an open trade regime and diversify into new export markets.**

Liberalisation

Export barriers limit economic integration.
Moldova was one of the first CIS countries to join the WTO. However, trade integration has so far been limited by a number of export restrictions imposed by either Moldova's trading partners – for example, agricultural trade barriers – or by the country itself. Moldova maintains restrictions on the export of scrap metals, but has agreed to remove these barriers as part of its discussions with the IMF. Under the European Commission's "wider Europe" initiative, aimed at the future EU border states, Moldova could benefit from increasing trade and capital flows if the momentum for reform is regained.

Stabilisation

Official lending again comes to a halt …
The IMF suspended its Poverty Reduction and Growth Facility (PRGF) in December 2002 over concerns about the medium-term fiscal outlook, the implementation of pre-shipment inspections for imports and the presence of export restrictions. In addition, the second tranche of the World Bank's Structural Adjustment Credit (SAC III) was not disbursed due to continuing problems in the energy sector, the business environment and with other disbursement conditions. Negotiations to resume the IMF programme broke down in July 2003, when the Fund announced it would not make additional disbursements under the PRGF, which expires in December 2003. There were also no further disbursements under SAC III, which ended in September 2003. In addition, the country may lose substantial budgetary support from bilateral sources, raising doubts about the government's ability to meet all its obligations over the remainder of the fiscal year.

… delaying a debt rescheduling agreement with the Paris Club.
Moldova's external debt burden is a key risk to medium-term macroeconomic stability. By the end of 2002 external debt amounted to almost 180 per cent of exports, and close to 100 per cent of GDP. To ease the debt burden, the government had planned to initiate negotiations on a rescheduling of its US$ 198 million of debt with the Paris Club. However, any Paris Club agreement would require an active IMF programme. In addition, negotiations with the Russian gas giant Gazprom over Moldova's energy arrears are continuing. The debts have been assumed partly by the government, but are mostly owed by state-owned energy companies.

Privatisation

Privatisation all but stalled.
The implementation of the third privatisation programme was extended for a second time in 2002. It will now be completed in 2005. By early 2003 some 470 enterprises and 160 unfinished structures remained to be sold. The list includes strategically important enterprises in telecommunications, energy and agribusiness (in particular, tobacco and the wineries), but mostly consists of loss-making enterprises which are difficult to sell. Recent controversies over past privatisations, some of which have been challenged or overturned, have also had repercussions for the pace of current privatisation. Several important sales planned for 2002 failed, or had to be postponed, due to lack of interest from strategic investors. Total privatisation revenues for 2002 came to just under MDL 160 million (US$ 11.7 million). The consolidated budget for 2003 originally anticipated privatisation revenues of some MDL 795 million (approximately US$ 56 million), which included revenues from the sale of Moldtelecom and the remaining power distribution networks. However, this target for privatisation revenues is unlikely to be achieved in the current economic climate.

Enterprise reform

Government interference deters investors, despite modest improvements in some aspects of the business environment.
The government is taking an increasingly interventionist approach in the economy, which has caused important foreign investors either to stop production or leave the country altogether. Some of the remaining investors have come under pressure from government regulators, tax authorities and the judiciary. High-profile clashes between the government and some investors have contributed to a drop in foreign direct investment, which fell from US$ 156 million in 2001 to US$ 110 million in 2002. However, against this trend there has been some interest from Russian investors, while the Turkish brewing company EFES took over the largest local brewery

Liberalisation, stabilisation, privatisation

1991
- Aug: Independence from Soviet Union declared

1992
- Jan: Most prices liberalised
- Jan: State trading monopoly abolished
- Jun: New tax system introduced
- Sep: Exchange rate unified

1993
- Mar: Cash privatisation begins
- Mar: Privatisation with patrimonial bonds begins
- Apr: Most quantity controls on exports removed
- Nov: New currency (leu) introduced

1995
- Jan: VAT introduced
- Mar: Treasury bills market initiated
- Jun: Full current account convertibility introduced

1996
- Jan: New Central Bank law adopted

1997
- Jun: First sovereign Eurobond issued
- Jul: New VAT law enacted
- Jul: New land law adopted
- Sep: New privatisation law adopted

1998
- Feb: National land cadastre introduced
- Jun: Open market operations begin
- Aug: Most tax and duty exemptions removed
- Dec: VAT and income taxes amended

1999
- Apr: All remaining trade restrictions removed

2000
- May: IMF EEF programme expires
- Jul: Parliamentary republic introduced
- Dec: PRGF programme agreed with IMF

2001
- Jun: WTO membership granted

2002
- Oct: Eurobond restructured

Enterprises, infrastructure, finance and social reforms

1992
Feb Competition law adopted

1994
Jul Securities and Exchange Commission established

1995
Jun Stock exchange established
Jun Trade in listed shares begins
Jun Enterprise restructuring agency established

1996
Jan New financial institutions law adopted

1997
Aug Independent energy regulator established

1998
Jan IAS introduced
Oct Restrictions on bank accounts abolished
Dec Law on energy sector privatisation adopted
Dec Pension reform launched

1999
May Moldovgaz privatised

2000
Jan Minimum bank capital requirements raised
Feb Electricity distribution companies privatised
Jun Regulation on bank mergers approved
Aug Independent telecommunications regulator established

2001
Nov Bankruptcy and pledge law amended

2002
Nov Supreme court rejects challenge to power privatisations

2003
Jan Tariff rebalancing programme in telecommunications sector commences

Vitanta Intravest. According to World Bank surveys, there has been some improvement in the business environment in the past year, including reductions of administrative barriers in business registration, import-export barriers, licensing and tax administration. Administrative corruption has been reduced, but remains widespread. Even with these improvements, Moldovan businesses still operate under less favourable conditions than their peers in neighbouring countries.

Infrastructure

A high profile dispute concerning the electricity operator Union Fenosa may at last be resolved …

The privatisation of three electricity distribution companies to the Spanish operator Union Fenosa in 2000 has continued to be controversial. Union Fenosa has succeeded in stabilising the networks, both financially and technically. However, the legality of the privatisation has been contested in the courts. The company has also been subject to various forms of arbitrary government interference. Following a number of court rulings at several levels, including the Supreme Court, the state prosecutor declared in June 2003 that the transaction was legal. However, the Court of Accounts, with which the case now rests, has yet to issue its final ruling. The protracted proceedings have affected both the performance of the utility and Moldova's reputation among investors. Given the difficult sector environment, both locally and internationally, the privatisation of the remaining two distribution companies has been delayed. However, a new privatisation adviser was selected in July 2003.

… while regulators hesitate to implement tariff adjustments.

The 2002-03 tariff increases envisaged for both energy and water were delayed. In the power sector, the regulator ANRE initially objected to the annual adjustment foreseen under the privatisation agreements with Union Fenosa. An 11 per cent increase was eventually approved in June, but within days ANRE reduced the adjustment to 8 per cent. The new tariffs on natural gas, introduced in July 2003, distinguish between power producers, who obtained a small reduction, and all other consumers, who saw their bills rise by 28 per cent. In the water sector, the Chisinau City Council approved a tariff increase for the municipal water utility in November 2002. However, in spring 2003 the Council rescinded its decision ahead of the local elections. The reversal has so far been upheld by the new Council, leaving the water company with an inadequate cash flow and causing it to default its debt obligations. The government has recently floated a proposal to merge the electricity and telecommunication regulators, along with the competition authority, into a single agency, a plan that could heighten regulatory uncertainty.

Privatisation of Moldtelecom fails, but preparation for sector liberalisation continues.

The telecom regulator ANRTI has embarked on a comprehensive tariff rebalancing exercise, in preparation for full liberalisation of the sector in 2004. However, the regulator has run into interference from the Telecommunications Ministry and Moldtelecom, who have sought to maintain special privileges for some customers. Moldtelecom, the state-owned, fixed-line operator, is expected to maintain its dominant position in the liberalised market. A renewed attempt to privatise Moldtelecom failed in November 2002, when the government rejected the offer of the only remaining bidder, a Russian telecommunications operator. In early 2003 Moldtelecom was awarded Moldova's third GSM licence, joining private operators Moldcell and Voxtel, which have around 200,000 customers each. The licence was awarded without a tender and at the lowest permissible amount.

Financial institutions

Banking sector performance improves.

The financial sector has seen some modest consolidation, with the number of Moldovan banks falling to 16. This is still a large number given the size of the market, but the five largest banks account for over 70 per cent of assets and their market share is growing. The National Bank of Moldova intends to keep minimum capital requirements at the MDL-equivalent of €5 million. This means an adjustment to correct for exchange rate movements can be expected shortly. Helped by falling interest rates and high liquidity, banks have substantially increased their lending volume over the past 12 months and the ratio of loans to GDP has risen to 17 per cent. However, lending is restricted to short maturities. A deposit insurance system has also been introduced with assistance from the IMF.

Social reform

Poverty Reduction Strategy being finalised.

Moldova remains one of the poorest countries in the region. According to a 2002 household survey, just over 40 per cent of Moldovans live in absolute poverty, defined as a monthly income of less than MDL 271 (about US$ 20). In addition, over a quarter of the population lives below the food poverty line of MDL 212 per month (about US$ 15). At the same time, there are large regional disparities. The incidence of food poverty in small towns is four times higher than in the bigger cities and food poverty in the rural population is 60 per cent higher than in urban areas. The government is finalising a Poverty Reduction Strategy to address these issues. The launch of the strategy, originally due for mid-2003, has been delayed until the end of the year to allow more time for further public consultations.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenue in GDP – **19.7 per cent**
Exchange rate regime – **floating**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **full**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **yes**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **63.7 per cent (2001)**[1]
Private pension funds – **no**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	11.0	11.0	11.0	10.0	10.0	10.0	8.0	7.0	7.0
Share of trade with non-transition countries (in per cent)	16.5	15.4	19.4	29.2	40.3	44.0	42.9	43.4	na
Share of trade in GDP (in per cent)	91.2	98.9	97.1	86.8	82.7	88.0	90.8	106.4	na
Tariff revenues (in per cent of imports)[2]	1.4	1.9	2.2	2.0	3.3	na	na	na	na
EBRD index of price liberalisation [3]	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
EBRD index of forex and trade liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.8	1.3	3.6	4.4	5.4	11.1	11.1	na	na
Private sector share in GDP (in per cent)	30.0	40.0	45.0	50.0	45.0	50.0	50.0	50.0	na
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	3.0	3.0	3.0	3.3	3.3	3.3	3.3	3.3	3.3
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	na	na	na	na	na	na	na	na	na
Share of industry in total employment (in per cent)	16.0	14.7	14.3	14.3	na	na	na	na	na
Change in labour productivity in industry (in per cent)	12.0	8.6	10.5	-7.5	na	na	na	na	na
Investment rate/GDP (in per cent)	16.0	19.4	19.9	22.9	23.9	20.0	na	na	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	1.7
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	13.1 (na)	14.0 (0.0)	14.4 (0.1)	15.0 (0.2)	12.7 (0.4)	13.3 (3.2)	15.4 (4.8)	14.6 (5.1)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	0.6	3.2	3.0	4.9	4.9	4.9	na
Railway labour productivity (1989=100)	28.3	26.5	27.6	25.2	15.6	18.7	23.2	27.5	na
Electricity tariffs, USc kWh (collection rate in per cent)	3.2 (na)	3.1 (na)	4.7 (na)	5.2 (na)	4.4 (na)	4.0 (55)	5.2 (na)	5.6 (91)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.3	2.0	2.0	2.1	2.6	3.1	na	na	na
EBRD index of infrastructure reform	1.0	1.3	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Electric power	1.0	1.0	2.3	3.0	3.0	3.3	3.3	3.3	3.0
Railways	na	na	na	2.0	2.0	2.0	2.0	2.0	2.0
Roads	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Water and waste water	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial institutions									
Number of banks (foreign-owned)	25 (na)	22 (na)	22 (na)	23 (7)	20 (10)	20 (11)	19 (10)	16 (10)	na
Asset share of state-owned banks (in per cent)	na	na	na	0.3	7.9	9.8	10.2	13.4	na
Non-performing loans (in per cent of total loans)[4]	36.0	45.5	26.0	32.0	29.3	20.6	10.4	7.6	na
Domestic credit to private sector (in per cent of GDP)[5]	5.8	6.8	14.8	15.8	11.1	12.6	14.8	18.7	na
Stock market capitalisation (in per cent of GDP)[6]	na	na	na	na	32.3	27.2	22.3	24.9	na
EBRD index of banking sector reform	2.0	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	12.6	14.9	14.1	9.9	6.6	6.5	7.1	na	na
Life expectancy at birth, total (years)	65.7	66.6	66.5	66.5	67.8	67.5	67.2	na	na
Basic school enrolment ratio (in per cent)	79.0	79.2	92.5	92.5	94.1	93.5	94.0	na	na
Earnings inequality (GINI-coefficient)	39.0	41.4	na	42.6	44.1	39.2	39.1	na	na

1 Based on the latest available internationally comparable poverty figures reported in the World Bank's *World Development Indicators 2003*. See methodological notes for definition.
2 Refers to all taxes on foreign trade.
3 New series (see Box 2.1 for explanation).
4 Changes in non-performing loans data compared with previous *Transition Reports* are due to the change of loan categories included in non-performing loans (see definitions).
5 Credits to individuals and enterprises excluding banks and government.
6 Data from survey to Moldovan Stock Exchange, including government securities.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	-1.4	-5.9	1.6	-6.5	-3.4	2.1	6.1	7.2	5.5
Private consumption	0.4	11.2	5.0	5.1	-13.8	27.6	na	na	na
Public consumption	24.3	-2.5	12.7	-18.9	-28.1	-17.9	na	na	na
Gross fixed capital formation [1]	-14.9	-8.3	-0.2	1.5	-14.7	-0.7	na	na	na
Exports of goods and services	25.5	13.9	21.3	-22.1	-22.7	6.8	na	na	na
Imports of goods and services	27.7	29.7	23.0	-11.0	-36.4	29.8	na	na	na
Industrial gross output	-3.9	-6.5	0.0	-15.0	-11.6	7.7	13.7	10.8	na
Agricultural gross output	1.9	-11.9	11.4	-11.6	-8.4	-3.3	6.4	3.0	na
Employment				*(Percentage change)*					
Labour force (end-year)	-24.2	-6.5	-6.5	-5.4	-17.5	-15.1	na	na	na
Employment (end-year)	-24.7	-6.7	-6.5	-6.4	-18.2	-15.6	-5.8	2.3	na
				(In per cent of labour force)					
Unemployment (end-year) [2]	na	na	na	9.2	11.1	8.5	7.3	7.4	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	30.2	23.5	11.8	7.7	39.3	31.1	9.6	5.2	10.0
Consumer prices (end-year)	23.8	15.1	11.2	18.3	43.7	18.4	6.3	4.4	13.0
Producer prices (annual average)	52.9	31.2	14.9	9.7	44.0	28.5	5.7	na	na
Producer prices (end-year)	46.6	20.4	13.6	13.6	58.6	24.2	5.9	na	na
Gross average monthly earnings in economy (annual average)	32.1	31.2	16.3	14.6	21.6	33.9	27.3	na	na
Government sector [3]				*(In per cent of GDP)*					
General government balance	-5.8	-7.0	-9.3	-5.7	-5.4	-2.6	-0.5	0.0	-0.8
General government expenditure	39.6	38.7	43.2	38.7	32.5	30.2	27.4	31.5	na
General government debt	46.0	50.8	55.6	67.0	85.0	81.2	69.9	72.0	na
Monetary sector				*(Percentage change)*					
Broad money (M3, end-year)	65.2	12.8	37.0	-8.6	42.6	40.1	36.4	36.0	na
Domestic credit (end-year)	64.7	18.8	26.8	29.2	18.1	14.4	29.6	26.0	na
				(In per cent of GDP)					
Broad money (M3, end-year)	16.5	15.9	19.0	16.9	18.1	19.7	23.3	29.5	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Refinancing rate	21.0	19.5	16.0	32.7	na	31.0	na	13.0	na
Inter-bank interest rate (up to 30 days maturity)	na	na	28.1	30.9	na	32.6	na	11.0	na
Deposit rate (1 year)	32.5	25.4	23.5	21.7	na	27.5	na	20.9	na
Lending rate (1 year)	41.9	36.7	33.3	30.8	na	35.5	na	28.7	na
				(Lei per US dollar)					
Exchange rate (end-year)	4.5	4.7	4.7	8.3	11.6	12.4	13.1	13.9	na
Exchange rate (annual average)	4.5	4.6	4.6	5.4	10.5	na	12.9	na	na
External sector				*(In millions of US dollars)*					
Current account	-115	-188	-275	-334	-47	-121	-80	-97	-105
Trade balance	-55	-252	-348	-388	-135	-307	-314	-371	-390
Merchandise exports	739	823	890	644	475	477	569	678	710
Merchandise imports	794	1,075	1,238	1,032	610	783	883	1,050	1,100
Foreign direct investment, net	73	23	78	76	154	128	160	108	97
Gross reserves, excluding gold (end-year)	257	312	366	144	186	230	229	269	na
External debt stock	668	815	1,335	1,466	1,457	1,547	1,505	1,586	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	3.0	3.0	3.1	1.4	2.9	2.8	2.5	2.5	na
				(In per cent of exports of goods and services)					
Debt service	8.2	5.7	13.0	25.1	49.3	16.3	14.9	12.4	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	na
GDP (in millions of lei)	7,550	8,830	10,120	10,370	13,800	17,815	20,572	22,040	25,577
GDP per capita (in US dollar)	387	443	507	449	306	334	375	381	na
Share of industry in GDP (in per cent)	25.0	26.2	23.3	19.5	18.8	18.5	20.5	na	na
Share of agriculture in GDP (in per cent)	29.3	31.4	30.2	30.5	27.9	29.0	26.0	na	na
Current account/GDP (in per cent)	-6.8	-9.8	-12.5	-17.3	-3.6	-8.4	-5.0	-6.0	-5.9
External debt - reserves (in US$ million)	412	503	969	1,322	855	1,317	1,277	1,317	na
External debt/GDP (in per cent)	39.7	42.5	60.9	75.9	105.7	108.0	94.2	97.7	na
External debt/exports of goods and services (in per cent)	77.2	87.0	126.3	184.7	238.2	241.6	203.1	178.4	na

1 Includes changes in inventories. Disaggregated data on gross fixed capital formation are not available.

2 Unemployment rate according to the International Bureau of Labour.

3 General government includes the state, municipalities and extra-budgetary funds.

Poland

Key reform challenges

- **The privatisation process should be reinvigorated to facilitate enterprise restructuring, improve corporate governance and increase competitiveness in view of EU accession.**
- **Job creation and stronger growth depend on improvements in the business environment. This requires further action to simplify business regulations, improve the efficiency and capacity of the judiciary, and curb corruption.**
- **Fiscal policy needs to be tightened urgently to reduce large fiscal deficits and avoid increases in public debt which could breach the limits set out in the Public Finance Act.**

Stabilisation

Large fiscal deficits lead to increase in public debt.
The general government deficit increased from 3.2 per cent of GDP in 2000 to an estimated 6.7 per cent in 2002, according to the IMF. This increase was a result of slow economic growth and fiscal policy slippages. The latter reflects weak budget planning, an inefficient social security system and significant government support for struggling sectors of the economy (agriculture, mining, steel, shipbuilding, railways). The fiscal deficits are expected to remain above 5 per cent of GDP in the medium term. Deficits of this order will result in an increase in the ratio of public debt to GDP, from the current level of approximately 50 per cent of GDP (the first benchmark defined by the Public Finance Act to trigger mandatory fiscal tightening) towards the constitutional limit of 60 per cent of GDP. Fiscal risks have been further increased by the government's continuing use of state guarantees. These are expected to be 3 per cent of GDP in 2003, compared with the stock of outstanding guarantees which already amounts to 4.2 per cent of GDP as at end-2002. The government is aware of the need to lower the fiscal deficits, but the measures to achieve fiscal stabilisation have yet to be proposed. The government's need to absorb financial flows related to EU accession, including the local co-financing component, also emphasises the urgency of fiscal reform.

Privatisation

Privatisation process slows significantly.
Privatisation proceeds in the first half of 2003 amounted to PLZ 1.5 billion (€350 million). The government's target for the year as a whole is PLZ 9.1 billion (more than €2 billion). These current results follow a poor performance in 2002, when privatisation revenues, generated by 158 deals, amounted to PLZ 2.9 billion (€725 million), just 44 per cent of the original target. Furthermore, almost half of these proceeds were accounted for by one major privatisation deal completed during the year – the sale of Stoen, a power distribution company, to German RWE in December 2002.

Privatisation of the second largest oil refinery cancelled.
In July 2003 the government cancelled the privatisation tender to sell the state share in Gdanska Refinery, the second largest oil refinery (which has a market share of 23 per cent). Although privatisation of the company was launched in 1998, the government has been unable to find an acceptable strategic investor. The government's new strategy for Gdanska Refinery, announced in July 2003, aims to merge the company with three smaller refineries in southern Poland. Restructuring of the merged entity, with a view to an eventual sale through an initial public offering on the Warsaw Stock Exchange, will commence following this merger.

Enterprise reform

Government acts to simplify bankruptcy and business regulations.
New bankruptcy legislation was approved in February 2003 and is expected to come into force in October 2003. The legislation will improve the protection of creditors, although it remains to be seen whether the commercial courts have sufficient administrative capacity to ensure effective implementation of the legislation. The government is also planning to streamline a number of regulations affecting enterprises, including those relating to registration and licensing. According to estimates from the World Bank, the registration of an enterprise requires the completion of 11 individual procedures and takes two months. Small and medium-sized enterprises, including start-ups, continue to be affected by these business environment problems and, as a result, fail to generate a sufficient number of jobs to absorb the outflow of workers from declining industries.

Liberalisation, stabilisation, privatisation

1991
- May — Treasury bills market initiated
- May — Crawling peg exchange rate regime introduced

1992
- Jan — Corporate and personal income taxes reformed
- Mar — EU Association Agreement signed

1993
- Mar — CEFTA founded
- Apr — Mass privatisation programme begins
- Jul — VAT introduced
- Nov — EFTA agreement signed

1994
- Oct — Major external debt restructuring
- Dec — National investment funds (NIFs) established

1995
- Jan — Wage restrictions redefined
- May — Agricultural import restrictions changed
- May — Managed float with fluctuation band introduced
- Jun — First sovereign Eurobond issued
- Jun — Full current account convertibility introduced
- Jul — WTO membership granted
- Jul — State enterprises allocated to NIFs

1996
- Aug — New privatisation law adopted
- Nov — OECD membership granted

1997
- Jun — NIF shares listed on WSE

1998
- Feb — Independent Monetary Policy Council established
- Mar — EU accession negotiations commence

1999
- Jan — New foreign exchange law enacted
- Dec — Import tariffs on agricultural products increased

2000
- Jan — Corporate tax reform implemented
- Apr — Exchange rate floated

2002
- Jan — Capital gains tax introduced
- Dec — EU accession negotiations completed

Enterprises, infrastructure, finance and social reforms

1992
- Dec — Banking law amended

1993
- Feb — Financial restructuring law adopted
- Apr — First bank privatised
- May — BIS capital adequacy adopted

1994
- Sep — IAS introduced

1995
- May — Telecommunications law amended
- Jul — Railway law adopted
- Oct — Insurance law amended

1996
- Apr — First corporate Eurobond issued
- Aug — Gdansk Shipyard declared bankrupt

1997
- Mar — First toll motorway concession awarded
- May — Energy law adopted
- Jun — Securities law amended
- Dec — Electricity law adopted

1998
- Jan — Banking Act amended
- Jan — Independent banking regulator established
- Jan — Bankruptcy law amended
- Feb — Investment funds law adopted
- Nov — Telecommunications privatisation begins
- Nov — Mine restructuring law adopted

1999
- Jan — Pension reforms implemented
- Jan — Health care system reformed
- Jan — Insurance law amended

2000
- May — New telecommunications law adopted
- Jul — Stake in TPSA acquired by strategic investor
- Jul — Railway reform plan approved

2001
- Jan — New commercial legislation adopted

2002
- Apr — New power sector strategy approved

2003
- Feb — New bankruptcy code adopted

Corruption remains serious issue.
Several cases of alleged corruption occurred over the past 12 months, resulting in the resignations of some senior officials. A new strategy to fight corruption was adopted in September 2002 and the General Inspectorate of Financial Information (GIFI), whose main task is to curb money laundering, was established. The GIFI is part of the Ministry of Finance, although its head is appointed by the Prime Minister.

Steel sector restructuring and privatisation advance.
The government approved a strategy for the restructuring of the steel sector in January 2003 and subsequently merged four large steelmakers into Polish Huta Stali (PHS). The new company accounts for over 70 per cent of Polish steel production. The tender for the privatisation of PHS was launched in January 2003 and the international steel company LMN Holding was chosen as the preferred bidder in July 2003. The government expects the successful bidder to assume US$ 400 million of PHS's debt, increase capital by at least US$ 100 million and purchase state shares worth at least US$ 200 million. In addition, the sale will include social clauses on layoffs agreed with the workforce as PHS employs about 16,000 people in a region where unemployment is close to 20 per cent.

Coal sector restructuring programme approved.
The government approved a new coal sector restructuring plan in November 2002 and amended it further in June 2003. In February 2003 Kompania Weglowa SA was established, which took over responsibility for PLZ 3.8 billion of assets in 23 state-owned coal mines, their combined labour force of 85,000 miners and PLZ 4 billion of debts (approximately equivalent to €1 billion). The government is currently negotiating a €200 million loan from the World Bank to help finance the costs of restructuring in the mining sector. It is expected that the loan will be conditional on closing seven mines (out of the total 37 operating mines) and reducing employment in the sector by about 35,000 (out of a total of over 200,000) by the end of 2006. The sector normally produces a surplus of coal for export each year, but the cost of producing one tonne of coal – some PLZ 140 – is well in excess of the export price of about PLZ 80 per tonne.

Infrastructure

Gas distribution split from the Polish oil and gas company PGNiG.
In January 2003 six regional distribution companies were spun-off from the gas monopoly company PGNiG. The distributors will focus on storage, transmission and servicing long-term contracts. There are also plans to spin-off research and exploration activities and float a 30 per cent stake in the company on the local stock exchange. The exploration department of PGNiG recently discovered a new oil field in the Wielkopolski region of Poland. The field is estimated to have reserves of about 100 million tonnes of oil, equivalent to approximately six years of domestic oil consumption. The EU rules require that at least 20 per cent of the gas sector should be opened up to competition once Poland joins the EU. However, PGNiG's management announced that the company would need a transition period because of the ongoing restructuring of the sector.

Financial institutions

Share of non-performing loans increases.
The banking sector has suffered from the economic slowdown and the related deterioration of the financial performance of enterprises. Net profits of commercial banks declined by one-third in 2002 and fell further in the first half of 2003. At the end of 2002 the share of non-performing loans was almost 25 per cent of total loans. The annual growth in credit to the private sector declined from an average 11 per cent in 2001 to less than 5 per cent in the second half of 2002. However, consumer finance, mortgage lending and leasing are growing strongly, while lending to the corporate sector declined in 2002.

Pension reform spurs capital market development.
As a result of the pension reform launched in 1999, private pension funds at the end of June 2003 held about 20 per cent of the equity listed on the Warsaw Stock Exchange. This is up from 10 per cent at the end of 2001. However, while pension funds are expanding mostly due to mandatory pension savings, voluntary pension plans are underdeveloped. The authorities are currently discussing possible tax incentives to promote the development of voluntary pension funds.

Social reform

Health care sector indebtedness increases.
The public health care system is funded by an 8 per cent deduction from the gross wage. Delivery of health care was based on service contracts between both public and private health care providers and public regional health funds until April 2003. At that time the government replaced the 17 regional health funds with a single entity, the National Health Fund (NHF). The aim of the NHF is to increase the efficiency of public health care provision. However, the revenues of the NHF have so far been insufficient to cover expenditures and, as a result, the health care sector debt is estimated to have grown to PLZ 5.5 billion by mid-2003, equivalent to 0.7 per cent of GDP.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **34.7 per cent**
Exchange rate regime – **floating**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **MEBOs**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **<2 per cent (1998)**
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	12.0	11.6	10.6	10.6	9.0	2.6	1.2	1.0	1.0
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	1.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	82.3	79.3	75.5	77.4	79.3	81.1	80.9	81.3	na
Share of trade in GDP (in per cent)	40.0	42.4	48.5	46.7	43.3	42.5	39.4	40.5	na
Tariff revenues (in per cent of imports)	9.6	7.4	5.6	4.0	3.4	2.8	2.4	2.2	na
EBRD index of price liberalisation [1]	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	2.6	3.6	5.1	6.4	7.7	11.4	12.2	12.6	na
Private sector share in GDP (in per cent)	60.0	60.0	65.0	65.0	65.0	70.0	75.0	75.0	na
Private sector share in employment (in per cent)	61.4	63.0	66.7	69.2	70.9	72.0	72.0	72.0	na
EBRD index of small-scale privatisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.0	3.0	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	1.1	0.8	3.3	2.9	2.7	2.2	2.3	2.5	na
Share of industry in total employment (in per cent)	23.1	22.2	21.9	21.9	21.0	21.1	20.6	20.6	na
Change in labour productivity in industry (in per cent)	6.5	9.1	11.6	4.3	9.1	10.4	4.4	3.7	na
Investment rate/GDP (in per cent)	18.7	20.9	23.6	25.2	25.4	25.0	21.0	19.2	na
EBRD index of enterprise reform	3.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3	3.3
EBRD index of competition policy	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	14.8 (0.2)	16.9 (0.6)	19.4 (2.1)	22.8 (5.0)	26.0 (10.2)	28.2 (17.4)	29.5 (26.0)	29.5 (36.3)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	22.8	33.9	44.2	87.9	126.7	170.0	na
Railway labour productivity (1989=100)	77.4	78.2	80.8	78.2	78.4	84.3	86.7	93.1	na
Electricity tariffs, USc kWh (collection rate in per cent)	6.19 (95)	6.53 (97)	6.24 (97)	6.68 (na)	6.42 (na)	8.4 (na)	7.8 (na)	8.75 (>90)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.7	2.6	2.9	3.2	3.6	4.0	na	na	na
EBRD index of infrastructure reform	2.3	2.7	2.7	3.0	3.0	3.3	3.3	3.3	3.3
Electric power	2.3	2.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Railways	na	na	na	3.3	3.3	4.0	4.0	4.0	4.0
Roads	2.7	2.7	2.7	3.0	3.3	3.3	3.3	3.3	3.0
Telecommunications	2.7	3.0	3.0	3.3	3.3	4.0	4.0	4.0	4.0
Water and waste water [2]	2.3	2.3	3.0	3.0	3.0	3.0	3.3	3.3	3.3
Financial institutions									
Number of banks (foreign-owned)[3]	81 (18)	81 (25)	83 (29)	83 (31)	77 (39)	74 (47)	64 (46)	59 (45)	na
Asset share of state-owned banks (in per cent)	71.7	69.8	51.6	48.0	24.9	23.9	24.4	26.6	na
Non-performing loans (in per cent of total loans)	23.9	14.7	11.5	11.8	14.5	16.8	20.1	24.6	na
Domestic credit to private sector (in per cent of GDP)	12.7	15.9	17.1	17.5	18.7	18.1	18.0	15.2	na
Stock market capitalisation (in per cent of GDP)	3.9	6.6	9.6	13.0	19.9	18.1	13.7	14.3	na
EBRD index of banking sector reform	3.0	3.0	3.0	3.3	3.3	3.3	3.3	3.3	3.3
EBRD index of reform of non-bank financial institutions	3.0	3.0	3.3	3.3	3.3	3.7	3.7	3.7	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	9.4	10.0	10.4	9.3	9.4	10.5	10.6	11.0	na
Life expectancy at birth, total (years)	71.9	72.2	72.6	73.0	73.0	73.3	73.5	na	na
Basic school enrolment ratio (in per cent)	97.2	97.4	98.0	98.1	98.3	98.6	na	na	na
Earnings inequality (GINI-coefficient)	29.0	30.2	30.0	29.4	30.5	na	na	na	na

1 New series (see Box 2.1 for explanation).
2 Series has been corrected for ratings after 1995.
3 Data for 2000 include Slaski Bank Hipoteczny SA, a banking organisation that previously did not file reports on ownership.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	7.0	6.0	6.8	4.8	4.1	4.0	1.0	1.4	3.0
Private consumption	3.2	8.7	6.9	4.8	5.2	2.7	2.0	3.3	na
Public consumption	2.9	2.0	3.1	1.4	1.0	1.1	2.0	4.0	na
Gross fixed capital formation	16.5	19.7	21.7	14.2	6.8	2.7	-9.8	-6.8	na
Exports of goods and services	23.6	12.5	9.9	11.0	1.0	17.5	8.0	5.0	na
Imports of goods and services	24.3	28.0	16.7	14.0	6.0	12.0	7.0	3.0	na
Industrial gross output	9.6	8.3	11.5	4.8	4.4	7.1	-0.5	2.0	na
Agricultural gross output	10.7	0.7	1.0	1.0	-2.0	0.0	2.0	3.0	na
Employment				*(Percentage change)*					
Labour force (end-year)	-0.9	1.4	-2.7	1.4	2.7	-1.1	0.2	-0.7	na
Employment (end-year)	0.3	3.5	1.3	0.6	-0.3	-3.5	-2.4	-1.7	na
				(In per cent of labour force)					
Unemployment (end-year)	14.9	13.2	8.6	10.4	13.0	15.1	17.3	18.1	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	27.8	19.9	14.9	11.8	7.3	10.1	5.5	1.7	0.5
Consumer prices (end-year)	21.6	18.5	13.2	8.6	9.8	8.5	3.6	0.8	0.9
Producer prices (annual average)	25.4	12.4	12.2	7.3	5.7	7.9	5.5	1.0	na
Producer prices (end-year)	18.9	11.2	11.5	4.9	8.1	5.7	5.0	2.2	na
Gross average monthly earnings in economy (annual average)[1]	31.6	26.5	21.5	16.7	10.6	11.4	8.0	3.5	na
Government sector[2]				*(In per cent of GDP)*					
General government balance	-3.1	-3.3	-3.1	-3.2	-3.3	-3.5	-5.5	-6.7	-6.9
General government expenditure	49.2	46.4	45.8	42.7	42.8	41.7	43.6	44.1	na
General government debt	57.9	51.2	49.8	42.9	44.2	41.2	43.7	46.0	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	34.9	34.3	28.1	24.7	20.1	11.8	9.2	-2.6	6.3
Domestic credit (end-year)	35.2	50.6	34.7	27.4	27.2	13.6	9.2	5.6	na
				(In per cent of GDP)					
Broad money (M2, end-year)	36.1	38.6	40.3	40.4	43.7	42.2	43.8	41.6	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Rate on 28-day open market operations[3]	29.0	26.0	28.0	15.5	16.5	19.0	11.5	6.8	na
3-months WIBOR[4]	24.2	21.7	25.4	15.2	17.9	19.5	12.3	6.7	na
Deposit rate[5]	19.5	17.0	18.0	12.8	12.9	14.3	7.9	4.3	na
Lending rate[6]	24.0	20.5	22.5	20.4	20.3	21.5	16.2	12.8	na
				(Zlotys per US dollar)					
Exchange rate (end-year)	2.5	2.9	3.5	3.5	4.2	4.3	4.0	3.9	na
Exchange rate (annual average)	2.4	2.7	3.3	3.5	4.0	4.3	4.1	4.1	na
External sector				*(In millions of US dollars)*					
Current account	5,310	-1,371	-4,312	-6,858	-11,569	-9,946	-7,166	-6,734	-6,000
Trade balance	-1,912	-8,179	-11,320	-13,720	-14,380	-13,168	-11,675	-10,294	-10,000
Merchandise exports	22,878	24,453	27,229	30,122	26,347	28,256	30,275	32,998	35,000
Merchandise imports	24,790	32,632	38,549	43,842	40,727	41,424	41,950	43,292	45,000
Foreign direct investment, net	1,134	2,741	3,041	4,966	6,348	8,171	6,928	3,700	4,000
Gross reserves, excluding gold (end-year)	14,963	18,033	20,298	27,325	26,354	26,564	25,649	28,460	na
External debt stock	52,511	47,541	49,647	59,135	65,365	69,465	71,797	81,946	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	6.5	6.0	5.8	6.8	6.9	6.8	6.6	7.1	na
				(In per cent of current account revenues, excluding transfers)					
Debt service	11.8	7.5	7.4	6.9	9.5	8.8	8.1	8.5	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	38.6	38.6	38.7	38.7	38.7	38.6	38.6	38.3	na
GDP (in millions of zlotys)	288,700	362,800	445,100	553,560	615,115	712,322	749,311	769,426	796,572
GDP per capita (in US dollar)	3,085	3,483	3,511	4,096	4,011	4,241	4,739	4,924	na
Share of industry in GDP (in per cent)	29.2	27.1	28.1	28.1	28.2	29.0	28.6	28.8	na
Share of agriculture in GDP (in per cent)	6.4	6.0	5.7	5.5	5.2	5.0	5.0	5.1	na
Current account/GDP (in per cent)	4.5	-1.0	-3.2	-4.3	-7.5	-6.1	-3.9	-3.6	-2.9
External debt - reserves (in US$ million)	37,548	29,508	29,349	31,810	39,011	42,901	46,148	53,486	na
External debt/GDP (in per cent)	44.1	35.3	36.6	37.3	42.2	42.4	39.2	43.5	na
External debt/exports of goods and services (in per cent)	201.4	170.8	160.4	175.0	220.4	218.6	209.5	221.4	na

1 Gross wages are gross of income taxes.
2 General government includes the state, municipalities and extra-budgetary funds. General government balance excludes privatisation receipts.
3 Refinancing rate until 1997; rate on 28-day open market operations (reference rate) since 1998.
4 Yield on 28-day Treasury bills until 1995; three-month WIBOR since 1996.
5 The lowest rate offered on six-month time deposits.
6 The lowest rate charged by commercial banks to prime borrowers.

Romania

Key reform challenges

- **Measures to improve the business environment, including reform of the public administration and the judiciary, are needed to attract higher capital inflows and increase the capacity to absorb EU pre-accession funds.**
- **Stronger financial discipline in state-owned enterprises and public utilities is required to reduce tax and inter-company arrears and sizeable quasi-fiscal deficits.**
- **Acceleration of privatisation and structural reforms, especially in the energy and financial sectors, is expected to contribute to macroeconomic stabilisation.**

Liberalisation

Prospect of EU accession continues to spur reform, but the ability to absorb EU pre-accession funds remains limited.
Romania was invited to join NATO in November 2002 and is a candidate to join the EU in 2007. By the end of July 2003 the government had provisionally closed 19 of the 30 chapters of the *acquis communautaire*. Entry to the EU is, however, conditional on the attainment of significant progress in various fields. These include the strengthening of the judicial system, fighting corruption, improving the quality of the state and local public administration, and advancing economic reform. Although a programme of reform for the public administration was launched in 2002, the overall capacity to implement and enforce the newly adopted legislation remains limited. This may constrain the country's ability to absorb EU pre-accession funds, which could amount to €2.8 billion over the 2004-06 period.

Stabilisation

Loose financial discipline in state-owned enterprises and public utilities threatens fiscal sustainability.
Large wage increases in state-owned enterprises and the high level of tax and payment arrears to public utilities contributed to a sizeable quasi-fiscal deficit in 2002. The failure to address these concerns led the IMF to postpone the completion of the third review of the 18-month Stand-By Arrangement (SBA) from end-September 2002 to the first quarter of 2003. The programme has also been extended until mid-October 2003. In the energy sector, payment collection rates from large industrial customers have improved, following the government's threat to cut-off the major non-payers. However, payment arrears from households have increased, following sharp increases in tariffs.

Interest rates raised to curb demand.
The National Bank of Romania's (NBR) policy of intervening to target a modest real appreciation of the national currency against a 60/40 basket of euro and US dollars has been successful in reducing inflation. The rate had dropped to 14 per cent by end-June 2003, from 30 per cent at end-2001. From March 2003 the NBR switched to the euro as its reference currency for open market operations. This change reflects the relative weight of the currency in the economy and prepares the ground for EU accession and, eventually, EMU entry. The capital account has been gradually liberalised, accompanied by lower interest rates. However, starting in August 2003, the NBR raised the reference and intervention rates to stop the fall in foreign reserves, which has been caused by increased import demand and fuelled by sharp increases in real wages and rapid credit expansion to the non-government sector. As of June 2003 imports were growing faster than exports (at 33 and 24 per cent year-on-year respectively), contributing to a widening of the trade deficit.

Privatisation

Privatisation advances slowly.
While most small and medium-sized enterprises have been privatised, the restructuring and privatisation of several large state-owned enterprises and utilities is running behind the schedule agreed with both the World Bank and the IMF under their respective programmes. About 1,342 companies remain in the portfolios of the Authority for Privatisation and Administration of State Assets, the Ministry of Industry and Trade, and the Ministry of Finance. For most industrial companies which are loss-making, the prospects for a successful privatisation have not improved significantly, despite the government's decision to dismiss over 22,800 employees in the first half of 2003. However, the privatisation of SNP Petrom, the integrated state-owned oil and gas company, commenced earlier this year and is proceeding according to the schedule agreed with both the EBRD and the World Bank.

Enterprise reform

Despite some improvement, the business environment remains weak.
Although steps have been taken recently to increase tax compliance and simplify tax and registration procedures for both foreign and locally owned businesses, VAT payment and reimbursement procedures are still slow and problematic. There is also some way to go before a stable and transparent tax and business regulatory system is in place.

Liberalisation, stabilisation, privatisation

1992
Jan Small-scale privatisation begins
May State trading monopoly abolished
May Price liberalisation commences

1993
May EFTA membership granted
Jul VAT introduced

1994
Mar Treasury bills market initiated

1995
Jan WTO membership granted
Mar New privatisation law adopted
Jun Restitution law adopted
Jul Most prices liberalised
Aug Second voucher privatisation round begins

1997
Mar Exchange rate unified
Mar Large-scale privatisation begins
Jun First sovereign Eurobond issued
Jul CEFTA membership granted

1998
Mar Full currency convertibility

1999
Jan Temporary import surcharge introduced
Jan Local public finance law adopted
May New privatisation law adopted
Aug IMF agreement reached

2000
Jan Corporate and income tax reform introduced
Mar EU accession negotiations begin

2001
Jan New privatisation agency (APAPS) established
Jul Largest steel-maker privatised
Oct New IMF Stand-By Arrangement signed

2002
Apr New privatisation law approved by parliament
Jun New VAT law adopted
Jul New profit tax law adopted

2003
Mar Euro becomes reference currency for open market operations

Enterprises, infrastructure, finance and social reforms

1994

Jan	BIS capital adequacy enacted
Dec	Securities and exchange commission established

1995

Jun	Bankruptcy law adopted
Nov	Stock exchange trading begins

1996

Jan	Bank deposit insurance scheme enacted
Oct	OTC market established

1997

Jan	Competition law adopted
Feb	First corporate Eurobond issued
Feb	Enterprise liquidation programme begins
Mar	Utility prices adjusted significantly
Dec	Law on reorganisation of utilities adopted

1998

Mar	New banking legislation adopted
Jun	First corporate GDR issue undertaken
Jul	Restructuring of railway begins
Nov	Public property and concession laws adopted
Dec	Energy law adopted
Dec	Telecommunications company privatised

1999

Jan	Agreement on mine restructuring signed
Mar	First state bank privatised
Apr	Second-largest state bank placed under administration
May	Amendments to bankruptcy law adopted
Jun	First large farm liquidated
Oct	Independent energy regulator established

2000

Apr	New law on public pensions adopted

2001

Mar	Second-largest state bank privatised
Apr	Electricity prices increased
Jun	New secondary market regulation issued
Oct	Reserve requirement on lei deposits reduced

2002

Jan	Minimum income guarantee becomes effective
Mar	Privatisation of largest state-owned bank begins

2003

Jan	New loan classification and provisioning rules introduced
Jan	IAS accounting for listed companies introduced
Mar	New labour code enacted

The legal framework is subject to frequent changes, due to the widespread practice of introducing amendments through government emergency ordinances. Existing laws leave considerable room for interpretation, their enforcement is often arbitrary and the appeal procedures are lengthy. Indeed, the weak judicial system is ranked by foreign investors as one of the most serious obstacles to doing business in Romania. However, the introduction of the “silent approval procedure” in mid-May 2003, which applies to the issuing of about 477 licences by the public administration, is likely to reduce bureaucracy and eliminate administrative delays. This procedure allows businesses to assume official consent and undertake certain activities if the relevant authorities have not responded within 30 days of the application. Combating corruption also remains a primary concern, with the autonomy of the National Prosecutor’s Office being reinforced recently, as part of the government’s National Programme for the Prevention of Corruption.

New draft bankruptcy law aims to simplify procedures.
A new draft law on bankruptcy and reorganisation procedures was approved by the government in April 2003 and sent to parliament. Its main objective is to expedite and simplify bankruptcy and reorganisation procedures, given that current procedures tend to favour re-organisation by the debtor over the ability of creditors to file for bankruptcy.

Infrastructure

Privatisation in the energy sector has started ...
The privatisation of the first two electricity distribution companies, Electrica Banat and Electrica Dobrogea, was launched in January 2003. The Italian company, Enel, submitted the only non-binding offer at the end of July. In March, the Bank of America was selected as the government’s adviser for the privatisation of two other electricity distributors, Electrica Oltenia and Electrica Moldova. Credit Suisse First Boston was selected as the government’s adviser for the privatisation of the two natural gas distributors, Distrigaz Sud and Distrigaz Nord. A readiness to increase energy prices will be an important factor in the successful completion of these privatisations.

... but key challenges still lie ahead.
Romania became a full member of the Union for the Co-ordination of Transmission of Electricity (UCTET) in May 2003, securing interconnection with western Europe. The country is also a member of the Southeast Europe Regional Energy Market. However, the thermal generating plants, which produce about 60 per cent of domestic electricity, are ageing and in critical need of rehabilitation and investment to meet EU environmental requirements.

Financial institutions

Plans to privatise Banca Comerciala Romana (BCR) proceed.
The government’s attempts to sell BCR (the largest of the three remaining state-owned banks, with about one-third of total banking assets) to a strategic investor failed in November 2002. No expressions of interest were submitted in the second privatisation round. Previous bids from Bank Eulia (France) and a consortium of Bank Austria and OTP Hungary were rejected because the candidates failed to qualify as potential buyers, according to Romanian banking regulations. The new privatisation strategy for the sale of BCR envisages the sale of 25 per cent plus two shares to the EBRD and the IFC. A further reduction of the government’s stake will follow, with a sale to a strategic investor by 2006.

Bank lending increases ...
Starting from a very low base, bank credit to the non-government sector increased by 45 per cent year-on-year at the end of July 2003. As foreign currency lending accounted for an important part of the increase, the NBR increased mandatory reserve requirements on foreign currency deposits (from 22 to 25 per cent) and decreased those on lei deposits (from 22 to 18 per cent) in November 2002.

... and banking sector regulation and prudential supervision are strengthened.
From January 2003 new banking regulations were introduced to allow for more prudent loan classification and provisioning. More information about the borrower will be taken into account when classifying and provisioning banks’ loans, including their payment history and financial performance. While banking sector supervision has been extended to cover the former credit cooperatives and housing savings banks, growing non-banking financial activities, like leasing, remain largely unregulated.

Social reform

New labour code to be amended.
A new labour code, designed to improve employee legal protection and bring Romania into line with EU legislation, came into force in March 2003. According to the new law, all employers will have to establish a staff register by December 2003. Dismissal on the basis of gender, nationality, race and a number of other specified criteria will be prohibited. In addition, employees will have the right to a minimum of 20 days annual leave. However, concerns have been raised that some of the provisions are too restrictive and could amplify labour market rigidities, thus hampering further private sector development by increasing labour costs.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenue in GDP – **28 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de facto**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **20.5 per cent (2000)**
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	18.0	18.0	7.0	7.0	8.5	10.5	13.0	20.4	na
Number of goods with administered prices in EBRD-15 basket	5.0	5.0	2.0	0.0	0.0	0.0	0.0	0.0	na
Share of trade with non-transition countries (in per cent)	88.8	88.9	86.5	88.0	89.5	87.5	83.2	84.0	na
Share of trade in GDP (in per cent)	49.0	52.7	53.4	45.7	50.8	60.5	64.1	66.9	na
Tariff revenues (in per cent of imports)	6.2	5.1	4.5	5.9	5.5	3.3	2.2	1.7	na
EBRD index of price liberalisation [1]	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	1.2	2.2	4.6	6.4	7.6	8.2	8.9	9.0	na
Private sector share in GDP (in per cent)	45.0	55.0	60.0	60.0	60.0	60.0	65.0	65.0	na
Private sector share in employment (in per cent)	51.0	52.0	58.0	62.0	72.0	75.0	75.0	na	na
EBRD index of small-scale privatisation	2.7	3.0	3.3	3.3	3.7	3.7	3.7	3.7	3.7
EBRD index of large-scale privatisation	2.0	2.7	2.7	2.7	2.7	3.0	3.3	3.3	3.3
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	15.5	15.8	15.8	14.8	14.7	14.4	14.4	14.7	na
Share of industry in total employment (in per cent)	28.6	29.2	27.2	26.3	24.4	23.2	23.6	22.2	na
Change in labour productivity in industry (in per cent)	16.3	8.7	5.6	-12.6	2.9	10.9	7.5	13.4	na
Investment rate/GDP (in per cent)	24.3	24.7	21.5	21.4	20.2	21.6	22.6	23.1	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	1.0	1.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	13.1 (0.0)	14.0 (0.1)	15.1 (0.9)	16.0 (2.9)	16.7 (6.1)	17.5 (11.2)	18.3 (17.2)	18.4 (17.2)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	60.2	104.5	161.6	185.0	207.9	184.1	na
Railway labour productivity (1989=100)	53.2	74.7	51.5	54.2	46.0	48.9	48.7	50.4	na
Electricity tariffs, USc kWh (collection rate in per cent)	2.1 (na)	1.9 (na)	2.3 (na)	3.4 (na)	4.7 (na)	4.9 (45)	5.2 (62)	5.1 (95.7)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.7	2.6	2.8	2.9	3.2	3.4	na	na	na
EBRD index of infrastructure reform	1.0	1.0	1.7	2.7	2.7	3.0	3.0	3.0	3.0
Electric power	1.0	1.0	1.0	2.3	2.7	3.0	3.0	3.0	3.0
Railways	na	na	na	4.0	4.0	4.0	4.0	4.0	4.0
Roads	1.0	2.0	2.3	2.3	2.3	3.0	3.0	3.0	3.0
Telecommunications	1.0	1.0	2.7	3.0	3.0	3.0	3.0	3.0	3.0
Water and waste water	1.0	1.0	1.0	2.0	2.3	3.0	3.0	3.0	3.0
Financial institutions									
Number of banks (foreign-owned)	24 (8)	31 (10)	33 (13)	36 (16)	34 (19)	33 (21)	33 (24)	31 (24)	na
Asset share of state-owned banks (in per cent)	84.3	80.9	80.0	75.3	50.3	50.0	45.4	43.6	na
Non-performing loans (in per cent of total loans) [2]	37.9	48.0	56.5	58.5	35.4	3.8	3.4	2.3	na
Domestic credit to private sector (in per cent of GDP)	7.8	11.5	8.4	11.6	8.1	7.2	7.7	8.4	na
Stock market capitalisation (in per cent of GDP) [3]	0.4	0.2	2.0	3.0	2.9	3.4	5.8	10.2	na
EBRD index of banking sector reform	3.0	3.0	2.7	2.3	2.7	2.7	2.7	2.7	2.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	6.3	6.3	5.8	6.2	6.5	3.9	4.0	4.0	na
Life expectancy at birth, total (years)	69.5	69.1	69.0	69.3	69.8	69.9	69.9	na	na
Basic school enrolment ratio (in per cent)	93.7	94.2	96.3	97.9	98.5	98.9	100.0	na	na
Earnings inequality (GINI-coefficient)	28.7	30.5	35.2	35.8	37.2	40.6	38.8	na	na

[1] New series (see Box 2.1 for explanation).

[2] Data for non-performing loans for Credit Bank between 1994 and 1996 and Dacia Felix Bank in 1997 are not included. The large decrease in 2000 is due to the imposition of NBR regulations on loan classification and transfer of non-performing loans of Bancorex and Banca Agricola to the Banking Assets Recovering Agency. Changes in non-performing loans data compared with previous *Transition Reports* are due to the change of loan categories included in non-performing loans (see definitions).

[3] Includes listings on the Bucharest Stock Exchange and RASDAQ over-the-counter market.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP [1]	7.1	4.0	-6.1	-4.8	-1.2	1.8	5.3	4.9	4.2
Private consumption	12.9	7.6	-6.6	1.4	-1.1	0.1	6.4	3.0	na
Public consumption	1.0	1.5	-8.4	1.8	-19.1	15.8	-1.9	1.0	na
Gross fixed capital formation	6.9	5.7	1.7	-5.7	-4.8	4.6	6.6	8.5	na
Exports of goods and services	17.0	2.0	11.4	-1.7	9.7	23.9	10.6	16.0	na
Imports of goods and services	16.4	8.7	7.5	11.4	-5.1	29.1	17.5	12.0	na
Industrial gross output, unadjusted series	9.5	9.8	-5.6	-17.3	-8.8	8.2	8.2	6.0	na
Agricultural gross output	4.5	1.3	3.4	-7.6	5.5	-14.1	na	na	na
Employment				*(Percentage change)*					
Labour force (end-year)	-6.6	-4.3	-1.3	-0.7	-2.9	0.9	-2.6	-1.4	na
Employment (end-year)	-5.2	-1.2	-3.8	-2.3	-4.5	2.5	-0.8	-0.7	na
				(In per cent of labour force)					
Unemployment (end-year) [2]	9.5	6.6	8.9	10.4	11.8	10.5	8.8	8.2	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	32.3	38.8	154.8	59.1	45.8	45.7	34.5	22.5	14.5
Consumer prices (end-year)	27.8	56.9	151.4	40.6	54.8	40.7	30.2	17.9	11.8
Producer prices (annual average)	35.1	49.9	156.6	33.2	42.2	51.5	40.9	24.6	na
Producer prices (end-year)	32.0	60.4	154.3	19.8	62.9	48.6	29.9	21.9	na
Gross average monthly earnings in economy (annual average)	50.5	54.2	98.2	60.3	44.3	46.9	48.9	27.3	na
Government sector				*(In per cent of GDP)*					
General government balance	-2.5	-3.9	-4.6	-5.0	-3.5	-3.7	-3.5	-2.7	-2.7
General government expenditure	34.7	33.8	34.0	34.7	35.2	34.8	33.4	32.7	na
General government debt	17.6	28.1	27.7	27.6	33.2	31.3	28.8	28.9	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	71.6	66.0	104.9	48.9	45.0	38.0	46.2	38.1	na
Domestic credit (end-year)	123.6	82.1	82.1	95.2	26.8	7.5	31.5	39.9	na
				(In per cent of GDP)					
Broad money (M2, end-year)	25.3	27.9	24.6	24.8	24.6	23.0	23.2	24.9	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Discount rate	35.0	35.0	40.0	35.0	35.0	35.0	35.0	29.0	na
1-week BUBOR	na	51.7	102.4	159.0	68.9	47.3	39.3	20.0	na
Deposit rate (average)	36.5	38.1	51.6	38.3	45.4	32.7	23.4	12.8	na
Lending rate (average)	48.6	55.8	63.7	56.9	65.9	53.5	40.6	28.9	na
				(Lei per US dollar)					
Exchange rate (end-year)	2,578	4,035	8,023	10,951	18,255	25,926	31,597	33,500	na
Exchange rate (annual average)	2,033	3,083	7,168	8,875	15,333	21,693	29,061	33,055	na
External sector				*(In millions of US dollars)*					
Current account	-1,774	-2,584	-2,137	-2,917	-1,296	-1,347	-2,349	-1,573	-2,630
Trade balance	-1,577	-2,494	-1,980	-2,625	-1,092	-1,684	-2,969	-2,613	-3,520
Merchandise exports	7,910	8,061	8,431	8,302	8,503	10,366	11,385	13,869	15,150
Merchandise imports	9,487	10,555	10,411	10,927	9,595	12,050	14,354	16,482	18,670
Foreign direct investment, net	417	415	1,267	2,079	1,025	1,051	1,154	1,080	1,350
Gross reserves, excluding gold (end-year)	278	547	2,194	1,375	1,526	2,497	3,960	6,145	na
External debt stock	6,484	8,345	9,502	9,902	9,091	10,602	11,822	15,084	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	0.3	0.5	2.1	1.3	1.6	2.1	2.9	3.9	na
				(In per cent of exports of goods and services)					
Debt service [3]	10.5	13.5	20.4	23.3	28.5	25.3	20.5	18.3	na
Memorandum items				*(Denominations as indicated)*					
Population (mid-year, million)	22.7	22.6	22.6	22.5	22.5	22.4	22.3	21.7	na
GDP (in billions of lei)	72,136	108,920	252,926	373,779	545,730	803,773	1,167,243	1,499,908	1,790,201
GDP per capita (in US dollar)	1,564	1,563	1,565	1,872	1,585	1,651	1,804	2,091	na
Share of industry in GDP (in per cent)	32.9	34.2	35.6	26.3	24.8	27.3	28.2	na	na
Share of agriculture in GDP (in per cent)	19.8	19.1	18.8	14.4	13.3	11.1	13.2	na	na
Current account/GDP (in per cent)	-5.0	-7.3	-6.1	-6.9	-3.6	-3.6	-5.8	-3.5	-4.7
External debt - reserves (in US$ million)	6,206	7,798	7,308	8,527	7,564	8,105	7,862	8,940	na
External debt/GDP (in per cent)	18.3	23.6	26.9	23.5	25.5	28.6	29.4	33.2	na
External debt/exports of goods and services (in per cent)	68.9	86.7	95.4	104.0	92.1	87.5	88.7	93.1	na

1 From 2001 growth rates are calculated by the National Statistical Institute using a new methodology in compliance with European standards of national accounting. As a result, the official growth figure for 2000 was revised upwards to 1.8 per cent from 1.6 per cent.

2 Registered unemployed. Based on ILO methodology, unemployment was lower (8.0, 6.7, 6.0, 6.3 and 6.8 per cent for 1995, 1996, 1997, 1998 and 1999 respectively).

3 Debt service payments on private and public external debt.

Russia

Key reform challenges

- **Increased momentum and consistency in structural and institutional reforms, in particular reform of the natural monopolies and rule of law, are needed to strengthen the business environment and restructuring process.**
- **Reform of the state bureaucracy and civil service is necessary to address the key problem of weak policy implementation and improve public sector management.**
- **Acceleration of financial sector reforms would help to deepen financial intermediation, reduce vulnerability to large-scale capital flows and promote economic diversification.**

Liberalisation

New customs code moves Russia closer to WTO standards.
The new customs code was adopted in May 2003 and comes into force beginning-2004. This long overdue reform will address one of the key weaknesses of the Russian business environment. The new code aims to limit the authority of the Customs Committee to issue special rules, shortens the maximum time for customs clearance and defines more clearly the documentation required by the customs authorities. The code also brings Russia's customs procedures closer to WTO standards and is an important step towards Russia's accession to the WTO. Amendments to the law on trademarks in January 2003, which clarify the existing legislation and toughen penalties for production of counterfeit goods, and amendments to the patent law in February were important additional developments in the WTO accession process, although enforcement remains a problem.

Currency liberalisation under way, but some capital account controls may remain.
The draft law on foreign currency regulation was adopted by the Duma at first reading in March 2003. Further discussion will follow in the autumn session. The draft includes a series of important liberalisation measures. These include purchase and sale of currency up to US$ 1,500 by individuals in the internal currency market without identification, the right of Russian citizens to purchase foreign securities up to US$ 75,000 and the right of citizens to open foreign currency accounts in OECD and Financial Action Task Force (FATF) member countries. The draft law envisages full capital account liberalisation from 2007 and the introduction of a tighter regulatory regime involving zero interest deposit requirements.

Stabilisation

Fiscal stimulus package adopted and stabilisation fund proposed.
In June 2003 the government and the Duma agreed on most of the key tax changes to be adopted. These changes are aimed at encouraging investment and promoting diversification. From 2004 VAT will be reduced from 20 per cent to 18 per cent and the sales tax will be eliminated with some special compensation for the regions. The planned changes in the taxation regime will result in a reduction in the tax burden of about 1 per cent of GDP. A detailed proposal towards the creation of a stabilisation fund from 2004 has been submitted to the Duma. New rules on a clearer delineation of fiscal authority and responsibilities between different levels of government and the related amendments to the budgetary code are also at an advanced stage of consideration. However, these are likely to be phased in only in the 2005 budget.

Privatisation

Large-scale privatisation proceeding, with major new round ahead.
In December 2002 the government sold 5.9 per cent of its stake in LUKoil to international investors. During the same month, the government also sold its 75 per cent stake in Slavneft to a consortium of Sibneft and TNK. Investigations launched in July 2003 into past transactions of the Yukos/Menatep group opened debate on the merits of reviewing (and potentially reversing) previous privatisations. The government firmly opposes sweeping reversals of previous privatisation deals, although investigations into the legality of some individual corporate transactions – including recent hostile takeovers – may well occur. In summer 2003 the government adopted its privatisation programme for 2004-06. The programme foresees selling most state-owned stakes below 25 per cent by end-2004, the stakes between 25 to 50 per cent by end-2005 and starting the divestiture of majority stakes in 2006. Privatisation is expected to be completed by 2008.

Enterprise reform

Bankruptcy rules revised, but implementation at an early stage.
A new bankruptcy law was enacted in October 2002, replacing the largely dysfunctional 1998 legislation. The new rules make it more difficult to initiate bankruptcy, make valuation and sale of the debtor's assets more transparent and strengthen the right of secured creditors in the bankruptcy process. In addition, the new law will have a wider scope of application, encompassing such sectors as agriculture and defence as

Liberalisation, stabilisation, privatisation

1993

May	Treasury bills market initiated
Jul	New currency (rouble) introduced
Nov	Rouble zone collapsed

1994

Jul	Cash-based privatisation begins
Oct	Currency crisis ensues

1995

Jun	First shares-for-loans auctions conducted
Nov	Currency corridor introduced

1996

Mar	IMF three-year programme agreed
Apr	Foreign trade liberalisation completed
Jun	Full current account convertibility introduced
Nov	First sovereign Eurobond issued

1997

May	First regional Eurobond issued
Sep	Admission to Paris Club granted

1998

Jun	Western financing package provided
Aug	Financial crisis ensues

1999

Jan	New tax code (Part I) enacted
Jan	Dual exchange rate regime introduced
Jun	Exchange rate re-unified
Aug	New IMF programme approved
Dec	Parliamentary election held

2000

Feb	Agreement with London Club on long-term debt restructuring reached
May	New government appointed
Jul	Government reform programme adopted

2001

Jan	Income and social tax regime reformed
Jun	Large-scale privatisation resumed

2002

Jan	Land code enacted
Jul	Law on farmland sale adopted

2003

May	New customs code adopted
Jul	Privatisation programme adopted

Enterprises, infrastructure, finance and social reforms

1995

Aug	Inter-bank market crisis ensues
Aug	Law on natural monopolies adopted
Dec	Law on joint-stock companies adopted
Dec	Securities law adopted

1996

Jan	Federal telecommunications regulator established
Feb	Federal transport regulator established

1997

Jul	First corporate Eurobond issued

1998

Mar	New bankruptcy law adopted
Aug	Banking crisis ensues, following GKO default
Oct	Agency for bank restructuring established

1999

Feb	Law on insolvency of financial institutions adopted
Feb	Law on protection of securities market investors adopted
Jul	Law on restructuring of credit organisations adopted
Jul	Law on foreign investment adopted
Jul	Mortgage law introduced

2000

Jun	Anti-oligarch campaign commences
Jul	Law on reforming the federal power structure adopted

2001

May	Banking laws amended
Jun	Judiciary reform initiated
Jul	Deregulation package adopted
Jul	Law on profit tax adopted
Sep	Agency for regulating natural monopoly tariffs established

2002

Jan	Amendments to joint-stock company law enacted
Jan	Pension reform begins
Feb	New labour code adopted
Apr	Corporate governance code endorsed
Oct	New bankruptcy law adopted

2003

Jan	Law on private pension funds adopted
Apr	Electricity sector reform programme enacted

well as the securities and insurance markets which were excluded under the old regime. However, full and effective implementation of the new bankruptcy law will need complementary advances in supporting legislation and related reform areas.

Restructuring of many large-scale companies ongoing.
Both domestic and foreign investment have increased sharply since the beginning of the year. This indicates the accelerated modernisation and restructuring of significant segments of the Russian economy, mainly driven by the large commodity-based companies and the associated financial industrial groups. Increases in the share of machinery and equipment in imports and more widespread layoffs are additional signs of this process. However, for much of the corporate sector, enterprise restructuring and technological modernisation remain at an early stage. This reflects the continued lack of an appropriate incentive structure (including still unsettled ownership and control issues in many large companies), limited access to investment finance and insufficient managerial capacity. The restructuring process is also inhibited by weak competition and protectionism at the regional level, high levels of corruption, poorly functioning market entry and exit mechanisms, and continued subsidisation through low energy prices.

Infrastructure

Power sector restructuring advances.
The package of six laws and amendments that constitute the legal foundation for the reform of the electricity sector was adopted in March 2003 and enacted in April 2003. A more detailed plan for 2003-05 was subsequently approved by the government in June, setting the timetable for the legal and corporate steps needed to overhaul the industry. This includes spinning off UES's generation and distribution arms, while keeping the transmission grid and dispatch centre under state control. Concerns raised by minority shareholders about the terms of the restructuring have been eased by the adoption of rules allowing them to swap their shares for stakes in the wholesale generation companies on a pro rata basis. The government, in turn, will use the swapped shares to acquire 100 per cent in the system operator company and at least a 75 per cent stake in the federal grid company. The government has also approved the restructuring plan of six regional power distribution companies. The decree concerning the creation of 10 wholesale generation companies and the wholesale power market is expected by late autumn.

Financial institutions

Consolidation of the banking sector continues, but pace of reform remains slow.
The banking sector has continued to strengthen in the past 12 months, with the asset base increasing by close to 40 per cent, year-on-year, by mid-2003. Lending to the real economy has also increased, with loans to non-financial private enterprises and households up 42 per cent, year-on-year, in June 2003. However, the fast credit growth may result in a major reduction in the quality of the banks' loan portfolios. The implementation of the end-2001 banking sector reform strategy has proceeded slowly. The transition to international financial reporting standards, originally planned for early 2004, has been delayed until 2006-07. The continued low level of financial intermediation remains a key bottleneck in the overall economic diversification and reform process. An essential component of the overall sector reform programme, the passage of the deposit insurance law, has been repeatedly postponed by the Duma.

Corporate bond and equity markets booming.
With the banking sector still constraining the ability of enterprises to raise finance, both the domestic corporate bond market and the corporate Eurobond market have continued to expand rapidly. The total value of outstanding rouble-denominated bonds increased to US$ 2 billion by the end of 2002 from US$ 0.8 billion at end-2003. It is expected to reach US$ 3.5-4 billion by end-2003. The market has developed in other dimensions as well, with maturities increasing and pricing mechanisms becoming more efficient. However, at around 0.6 per cent of GDP, the corporate bond market remains very small. The Russian equity market has kept its place among the world's best performers over the past year.

Social reform

Pension reforms moving ahead.
The law on private pension funds entered into force in January 2003, allowing the funds to compete with state-owned entities in investing the savings portions of workers' mandatory pension contributions. In June-July 2003, the government issued a package of implementation decrees regarding the regulation and investment activities of this segment of the industry. In September 2003, 55 private fund managers were selected, though the selection criteria used was weaker than originally envisaged. By November 2003 Russian employees are expected to receive information from the state pension fund about the amount of their pension savings accumulated as of end-2002. Subsequently, every citizen has to designate an investment company they wish to handle the savings portion of their pension starting in 2004.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **38 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de facto**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **no**[1]
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **23.8 per cent (2000)**
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	5.0	5.0	5.0	2.0	2.0	2.0	2.0	na	na
Share of trade with non-transition countries (in per cent)	68.2	67.0	65.4	66.9	70.5	68.5	71.4	71.6	na
Share of trade in GDP (in per cent)	43.1	37.9	37.6	48.3	59.4	57.8	50.3	48.6	na
Tariff revenues (in per cent of imports)[2]	10.7	7.9	7.2	7.1	8.9	18.5	21.1	16.9	na
EBRD index of price liberalisation [3]	3.7	3.7	3.7	3.3	3.3	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	3.0	4.0	4.0	2.3	2.3	2.3	2.7	3.0	3.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	1.5	1.7	2.7	3.4	3.5	3.8	4.2	4.5	na
Private sector share in GDP (in per cent)	55.0	60.0	70.0	70.0	70.0	70.0	70.0	70.0	na
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	3.0	3.0	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)[4]	na	na	na	na	5.3	na	na	na	na
Share of industry in total employment (in per cent)	24.1	22.6	21.7	20.7	22.4	22.7	20.5	19.6	na
Change in labour productivity in industry (in per cent)	12.2	2.9	8.6	0.8	7.3	7.2	5.0	6.6	na
Investment rate/GDP (in per cent)	20.9	21.0	19.1	18.0	14.0	16.0	18.0	18.0	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	1.7	2.0	2.3	2.3	2.3
EBRD index of competition policy	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	17.0 (0.1)	17.5 (0.2)	19.2 (0.3)	19.9 (0.5)	21.0 (0.9)	21.8 (2.2)	24.3 (3.8)	24.2 (12.1)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	1.1	1.2	6.3	22.5	24.5	28.4	na
Railway labour productivity (1989=100)	56.8	54.6	58.6	60.9	72.1	78.8	85.0	90.1	na
Electricity tariffs, USc kWh (collection rate in per cent)[5]	2.33 (50)	3.00 (50)	3.20 (50)	2.7 (87)	1.1 (na)	0.9 (85)	na	2.4 (102)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.4	1.3	1.4	1.4	1.5	1.6	na	na	na
EBRD index of infrastructure reform	1.7	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3
Electric power	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.3	3.0
Railways	na	na	na	2.3	2.3	2.3	2.3	2.3	2.3
Roads	1.0	1.7	2.0	2.0	2.0	2.0	2.0	2.3	2.3
Telecommunications	2.3	2.7	2.7	3.0	3.0	3.0	3.0	3.0	3.0
Water and waste water	1.7	1.7	2.0	2.0	2.3	2.3	2.3	2.3	2.3
Financial institutions									
Number of banks (foreign-owned)	2,297 (21)	2,029 (22)	1,697 (26)	1,476 (30)	1,349 (32)	1,311 (33)	1,319 (35)	1,329 (37)	na
Asset share of state-owned banks (in per cent)	na	na	37.0	41.9	na	na	na	na	na
Bad loans (in per cent of total loans)	12.3	13.4	12.1	30.9	28.1	16.1	12.2	11.4	na
Domestic credit to enterprises (in per cent of GDP)	8.7	7.4	9.5	12.6	10.9	11.9	15.4	17.3	na
Stock market capitalisation (in per cent of GDP)[6]	4.8	9.7	31.0	16.2	41.7	15.3	25.7	36.5	na
EBRD index of banking sector reform	2.0	2.0	2.3	2.0	1.7	1.7	1.7	2.0	2.0
EBRD index of reform of non-bank financial institutions	2.0	3.0	3.0	1.7	1.7	1.7	1.7	2.3	2.7
Social sector									
Expenditures on health and education (in per cent of GDP)	6.3	7.4	8.7	7.4	6.6	6.3	6.3	6.6	na
Life expectancy at birth, total (years)	64.8	66.0	66.7	67.0	66.0	65.3	65.6	65.3	na
Basic school enrolment ratio (in per cent)	88.4	88.7	88.7	88.5	88.8	89.4	90.1	na	na
Earnings inequality (GINI-coefficient)	47.1	48.3	na	na	na	na	52.1	na	na

1 Although there is no general deposit insurance, deposits in Sberbank are covered by a formal deposit insurance scheme.
2 Refers to all taxes on international trade.
3 New series (see Box 2.1 for explanation).
4 Expenditures on national economy of the consolidated budget (including industry, agriculture, the energy sector and housing subsidies of regional budgets).
5 Figures are averages of the Siberian, Northern, Southern, Volga, Far East and Ural regions and the Federation; collection ratios are estimated.
6 Includes listings on the Moscow Interbank Currency Exchange, Moscow Stock Exchange and RTS Stock Exchange.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	*Projection*
Output and expenditure	*(Percentage change in real terms)*								
GDP	-4.0	-3.6	1.4	-5.3	6.4	10.0	5.0	4.3	6.2
Private consumption	-4.6	-4.7	4.8	-3.3	-2.9	7.2	9.7	8.5	na
Public consumption	1.1	3.1	-2.4	1.0	3.1	2.0	-1.7	2.4	na
Gross fixed capital formation	-7.5	-21.2	-7.9	-12.4	6.4	18.1	10.5	3.0	na
Exports of goods and services	7.3	3.7	-0.5	1.9	11.2	9.5	3.6	10.2	na
Imports of goods and services	16.6	1.3	0.4	-17.4	-17.0	32.4	18.0	19.1	na
Industrial gross output	-3.3	-4.5	2.0	-5.2	11.0	11.9	4.9	3.7	na
Agricultural gross output	-8.0	-5.1	1.5	-13.2	4.1	7.7	7.5	1.7	na
Employment	*(Percentage change)*								
Labour force (end-year)	-1.5	-0.6	0.1	-0.3	-0.5	-1.0	-0.7	1.3	na
Employment (end-year)	-3.0	-0.7	-1.9	-1.6	-0.9	2.2	0.3	-0.4	na
	(In per cent of labour force)								
Unemployment (end-year)	9.2	9.3	11.1	12.3	12.6	9.8	8.9	8.6	na
Prices and wages	*(Percentage change)*								
Consumer prices (annual average)	197.7	47.8	14.7	27.6	86.1	20.8	21.6	15.7	13.9
Consumer prices (end-year)	128.6	21.8	10.9	84.5	36.8	20.1	18.6	15.0	12.4
Producer prices (annual average)	236.5	50.8	19.7	21.5	56.3	18.4	22.7	na	na
Producer prices (end-year)	175.0	25.6	7.4	23.2	67.0	32.0	10.7	17.1	na
Gross average monthly earnings in economy (annual average)	94.6	67.3	20.2	10.7	47.7	43.2	45.8	36.2	na
Government sector [1]	*(In per cent of GDP)*								
General government balance	-6.6	-9.4	-8.5	-8.2	-3.1	2.7	2.9	1.4	2.0
General government expenditure	43.3	45.3	47.8	42.6	36.7	34.3	34.1	37.0	na
General government debt (domestic)	63.5	59.0	66.0	88.7	102.4	69.5	56.4	50.0	na
Monetary sector	*(Percentage change)*								
Broad money (M2, end-year)	125.8	30.6	29.8	19.8	57.2	62.4	40.1	32.3	na
Domestic credit (end-year)	87.8	48.3	22.2	68.2	34.1	13.7	30.0	29.6	na
	(In per cent of GDP)								
Broad money (M2, end-year)	15.5	14.4	16.0	17.0	14.6	15.7	17.7	19.5	na
Interest and exchange rates	*(In per cent per annum, end-year)*								
Central Bank refinance rate (uncompounded)	160.0	48.0	28.0	60.0	55.0	25.0	25.0	21.0	na
Treasury bill rate (all maturities) [2]	104.1	33.6	36.6	48.1	na	na	na	na	na
Lending rate	320.0	146.8	32.0	41.8	39.7	24.4	17.9	15.7	na
Deposit rate	102.0	55.1	16.8	17.1	13.7	6.5	4.9	5.0	na
	(Roubles per US dollar)								
Exchange rate (end-year) [3]	4.6	5.6	6.0	20.7	26.8	28.2	30.2	31.8	na
Exchange rate (annual average) [3]	4.6	5.1	5.8	10.0	24.6	28.2	29.2	31.4	na
External sector	*(In millions of US dollars)*								
Current account [4]	6,963	10,846	-81	218	24,615	46,839	34,958	31,090	42,000
Trade balance [4]	19,816	21,593	14,912	16,429	36,014	60,171	48,120	46,281	55,000
Merchandise exports [4]	82,419	89,685	86,895	74,444	75,551	105,033	101,884	107,247	127,000
Merchandise imports [4]	62,603	68,092	71,983	58,015	39,537	44,862	53,764	60,966	72,000
Foreign direct investment, net	1,460	1,656	1,681	1,492	1,102	-463	-64	-328	2,500
International reserves, excluding gold (end-year)	14,383	11,276	12,895	7,801	8,457	24,264	32,542	44,054	na
External debt stock	148,000	143,600	180,600	185,700	177,100	158,300	150,400	152,100	na
	(In months of imports of goods and services)								
International reserves, excluding gold (end-year)	2.1	1.6	1.7	1.3	1.9	4.8	5.3	6.4	na
	(In per cent of current account revenues, excluding transfers)								
Public debt service due [5]	19.7	16.7	12.4	14.4	16.4	9.9	15.1	12.3	na
Public debt service paid [5]	6.6	6.4	5.6	12.0	13.6	9.8	14.4	12.3	na
Memorandum items	*(Denominations as indicated)*								
Population (end-year, million) [6]	148.0	147.5	147.1	146.4	145.7	145.4	144.8	144.2	na
GDP (in millions of roubles)	1,428,500	2,007,800	2,342,500	2,629,600	4,823,200	7,305,600	9,039,400	10,863,400	13,137,016
GDP per capita (in US dollar)	2,111	2,647	2,743	1,802	1,346	1,785	2,137	2,400	na
Share of industry in GDP (in per cent)	29.0	29.5	28.3	29.9	30.8	31.4	28.1	26.5	na
Share of agriculture in GDP (in per cent)	7.2	7.3	6.5	5.7	7.7	6.7	6.8	6.1	na
Current account/GDP (in per cent)	2.2	2.8	0.0	0.1	12.6	18.0	11.3	9.0	9.9
External debt - reserves (in US$ million)	133,617	132,324	167,705	177,899	168,643	134,036	117,858	108,046	na
External debt/GDP (in per cent)	47.3	36.7	44.6	70.4	90.3	61.0	48.6	44.0	na
External debt/exports of goods and services (in per cent)	159.2	139.5	178.9	213.9	209.3	138.1	133.5	126.4	na

[1] General consolidated government includes the federal, regional and local budgets and extra-budgetary funds and excludes transfers.

[2] The 1998 figure is the yield on obligations of the Central Bank of Russia.

[3] Data in new (denominated) roubles per US dollar. From 1 January 1998, one new rouble = 1,000 old roubles.

[4] Data from the consolidated balance of payments, which covers transactions with both CIS and non-CIS countries.

[5] Difference between due and paid arises from accumulation of arrears on debt servicing.

[6] Data as of 1 January of the following year.

Serbia and Montenegro[1]

Key reform challenges

- **Authorities at both Union and republic level should push ahead with further legislative reforms, especially on bankruptcy and competition, to enhance enterprise performance and improve the climate for both domestic and foreign investment.**
- **Acceleration of the privatisation programme for large enterprises is essential, but procedures must be open and transparent to ensure that the sluggish performance of industry is improved.**
- **The financial sector has been transformed, but much remains to be done to strengthen regulatory procedures, sell the remaining state equity in banks and encourage financial deepening.**

Liberalisation

Trade regulations harmonised ahead of EU SAA talks ...
Serbia and Montenegro has made substantial progress in harmonising tariff rates, a pre-requisite for the EU to consider opening negotiations on a Stabilisation and Association Agreement (SAA). An action plan to harmonise trade, customs and excise regimes between the two republics by end-2005 was approved by the parliaments of both republics in the first half of the year and by the Union parliament in August. Following this approval, the EU has begun a feasibility study on the country's readiness for an SAA. However, some key issues concerning a single trade policy, notably the harmonisation of agricultural tariffs and the alignment of import levies, remain unresolved.

... while external trade liberalisation progresses further.
Serbia and Montenegro is an active participant in the Stability Pact initiative which establishes bilateral free trade agreements (FTAs) with other countries in the region. By May 2003 the country had initialled FTAs with all other Stability Pact countries (except Moldova, which is on a later schedule). Other liberalisation measures in the past year have included the phasing out of most non-tariff barriers on exports, the planned elimination by end-2004 of practically all import quotas and the liberalisation of crude oil imports from May 2003. However, the year also saw a considerable increase in the number of import levies, especially on agricultural products. Trade relations with the EU were affected by the temporary suspension in May 2003 of the preferential tariff regime on sugar exports from Serbia and Montenegro to the EU. This suspension followed evidence of inadequate controls on the origin of some sugar exports.

Stabilisation

Prudent fiscal and monetary policies maintained ...
The authorities in both republics continue to observe prudent fiscal and monetary policies, within the framework of an IMF three-year extended arrangement signed in May 2002. The closure of the payments bureaux in Serbia from January 2003 initially disrupted revenue collection in the first two months of the year. These problems, however, have since been resolved. Fiscal reforms include the adoption of VAT in Montenegro in April 2003 and the scheduled introduction of VAT in Serbia in January 2004. Monetary policy in Serbia remains based on prudent credit policies, including tight restraint on credit to the government, notwithstanding the new Central Bank law and change of Central Bank governor announced in July 2003. Meanwhile, Montenegro continues to use the euro as its sole currency. Both republics are likely to have single-digit annual inflation levels by end-2003.

... but debt service costs set to rise.
Although Serbia and Montenegro's debt servicing burden is modest at present, the costs of servicing the debt will rise sharply from 2005, highlighting the need for care in contracting new debt, especially on non-concessional terms. Negotiations with the London Club of commercial creditors on outstanding debts of around US$ 2.5 billion are ongoing. However, by mid-September 2003 a resolution had not yet been reached, with a reported large gap between the proposal of the authorities for a deal consistent with the terms of the Paris Club and the offer of a much smaller reduction from creditors.

Privatisation

Small-scale privatisation makes good progress ...
The results of the privatisation programme in 2002 were mixed. In Serbia, a combination of tenders and auctions contributed to overall privatisation receipts of €360 million. This was about twice the projected level under the IMF programme. The auctions of small and medium-sized companies have

Liberalisation, stabilisation, privatisation

1991
Jun Socialist Federal Republic of Yugoslavia disintegrates

1992
Apr Sovereignty proclaimed
May Economic sanctions introduced by UN

1993
Dec Hyperinflation reaches peak

1994
Jan Widespread price controls introduced
Jan Stabilisation programme introduced

1997
Oct Privatisation law enacted in Serbia

1998
Jun Economic sanctions tightened
Dec Privatisation council established in Montenegro

1999
Mar Kosovo conflict begins
Jun Kosovo placed under UN administration
Nov Deutschmark becomes legal tender in Montenegro

2000
Oct Milosevic rule ends
Oct Most price controls relaxed
Nov Deutschmark adopted as sole currency in Montenegro

2001
Jan Export surrender requirement abolished
Jan Exchange rate unified and managed float introduced
Jan Partial current account convertibility introduced
Jan Economic sanctions lifted
May Most non-tariff import restrictions abolished
Jun IMF Stand-By Arrangement approved
Jun Comprehensive tax reform implemented in Serbia
Jun Privatisation law adopted in Serbia
Nov Paris Club external debt written off
Dec Three cement plants sold in Serbia

2002
Jan Federal foreign investment law enacted
Feb Mass voucher programme completed in Montenegro
May Full current account convertibility adopted

2003
Apr VAT introduced in Montenegro
Aug Two tobacco companies sold in Serbia
Aug Tariff harmonisation plan adopted

Enterprises, infrastructure, finance and social reforms

1993

Jan	Montenegro stock exchange established

1997

Jun	49 per cent of Serbian fixed-line telecommunications operator sold
Oct	Banking code adopted

2000

Dec	Montenegro Central Bank established
Dec	New telecommunications law enacted in Montenegro

2001

Mar	First foreign bank granted licence
Apr	Energy prices increased in Serbia
Jun	Extra profit tax adopted
Jun	Energy prices increased further in Serbia
Nov	Energy prices increased significantly in Montenegro
Dec	Labour law adopted in Serbia

2002

Jan	Four largest insolvent banks closed
Jan	Payments law adopted
Jun	Banking law amended
Aug	Interim Poverty Reduction Strategy adopted
Oct	Debt-for-equity swaps in 16 banks in Serbia

2003

May	Secured transactions law adopted
May	Law on concessions adopted
May	Law on telecommunications adopted
May	Law on financial leasing adopted
Jul	Energy law adopted in Montenegro

continued in 2003 and the government intends to sell about half of all socially owned enterprises by the end of the year.

… but large-scale privatisation advances slowly.
The tender process in Serbia for the sale of larger companies has been less successful. In March 2003 parliament approved a number of amendments to the privatisation law to speed up the process. These include measures to help ensure that company insiders cannot block the sale indefinitely and that existing owners and managers cannot artificially raise the cost to buyers of social programmes and redundancy packages. Some flagship deals have taken place, including the sale of the major steel conglomerate Sartid to US Steel in June 2003. Another example was the sale of two tobacco companies in August 2003 to Philip Morris and BAT. In Montenegro, the largest privatisation to date was the sale of 54 per cent of the oil company Jugopetrol to Hellenic Petroleum of Greece in October 2002. In February 2003 the government opened 11 tenders for hotels, but these attracted little interest from foreign investors. The privatisation of the giant aluminium conglomerate KAP has been initiated and a tender for the Niksic steel mill is under way.

Enterprise reform

Legislation to improve the business environment finally passed.
As part of the ongoing effort to transform the legal framework, the government of Serbia prepared a number of laws in the past year dealing with concessions, secured transactions on movable assets and financial leasing. After some delays, parliament finally approved the laws in the spring of 2003. Implementation of these laws through the establishment of adequate registries remains a key challenge. However, other important legal reforms are still pending, including a new bankruptcy law and the enactment of comprehensive new legislation on competition. The new laws, in conjunction with enhanced efforts to tackle corruption, are designed to attract much-needed foreign investment to the country, as well as enhance domestic investment.

Infrastructure

Power sector reform progresses.
The governments of both republics have continued their efforts to rehabilitate the power sector. In Montenegro, a new energy law that sets out a framework for an independent regulator and liberalisation of the sector came into force in July 2003. Average electricity prices were raised in April 2003 from 3.35 to 3.68 euro cents/kWh (plus an import surcharge of 0.65 euro cents). The large aluminium company KAP, however, continues to pay a much lower tariff. In Serbia, the draft energy law has been prepared, while electricity prices were raised by 15 per cent in July 2003. The power company in Serbia, EPS, is planning substantial reductions in the core labour force during 2003.

Part of fixed-line telecommunications company bought back by the government.
In January 2003 the Serbian government bought back a 29 per cent stake in the fixed-line company Telekom Serbia from STET of Italy for €195 million. The original deal with STET was part of a non-transparent sale of 49 per cent of the company in 1997 under the Milosevic regime. The Greek company OTE has retained its 20 per cent stake in the company. Plans for the liberalisation of the sector have advanced with the enactment of a new law on telecommunications in May 2003. The law allows for the setting up of an independent telecommunications agency that should result in greater competition.

Financial institutions

Overhaul of banking sector continues.
In late 2002 the Serbian government acquired majority stakes in 16 banks through debt-for-equity swaps of Paris and London Club debt. The government intends to offer the first three of these banks for sale in the first half of 2004. In Montenegro, the largest bank, Montenegro Banka, was sold in July 2003 to Nova Ljubljanska Banka of Slovenia. Meanwhile a large number of offshore banks that had been registered in the republic have been closed, following legislation adopted in late-2002. Confidence is slowly returning to the banking sectors of both republics. Reserve requirements have been progressively reduced and credit growth during 2002 was substantial, especially in Serbia, although lending to the private enterprise sector remains limited.

Bank supervision is being strengthened.
The Central Banks of both republics have made substantial progress in the past year towards implementing international standards in bank supervision and regulation. In Serbia, the supervisory role of the National Bank of Serbia has been strengthened and a new accounting law has been adopted. This law requires all banks to adopt IAS as the permanent accounting framework. In Montenegro, the supervisory powers of the Central Bank are also being enhanced and preparations for the adoption of IAS in banks are progressing.

Stock market activity increases.
Activity on the Belgrade Stock Exchange increased significantly during 2002, though from a very low base. Total turnover approximately doubled in 2002 relative to the previous year, partly because of the requirement in the privatisation law that all residual state-owned shares in enterprises must be sold through the stock exchange.

Social reform

Pension reform commences.
Similar to other countries in the region, Serbia and Montenegro has inherited pension systems that were expensive to run and inefficient, leading to widespread arrears. The authorities in both republics are preparing new pension laws, with assistance from the World Bank, that will introduce a number of reforms. These will include strengthening the link between contributions and benefits, and tightening the eligibility for disability pensions. Important pension reform legislation has already been adopted in Serbia and is expected to be adopted soon in Montenegro.

[1] In February 2003 the Federal Republic of Yugoslavia was renamed Serbia and Montenegro. The country consists of two republics: Serbia and Montenegro. Kosovo, a province of Serbia, has been under UN administration since June 1999.

Liberalisation

Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation

Share of general government tax revenue in GDP – **39.4 per cent**
Exchange rate regime – **managed float (Serbia); euro (Montenegro)**

Privatisation

Primary privatisation method – **auctions (Serbia); vouchers (Montenegro)**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises and markets

Competition Office – **no**

Infrastructure

Independent telecoms regulator – **no**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector

Capital adequacy ratio – **8 per cent**
Deposit insurance system – **no**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform

Share of the population in poverty – **na**
Private pension funds – **no**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	25.1	25.1	25.1	25.4	25.6	2.3	5.0	5.0	5.0
Number of goods with administered prices in EBRD-15 basket	13.0	13.0	13.0	12.0	13.0	1.0	2.0	3.0	4.0
Share of trade with non-transition countries (in per cent)	na	78.8	87.8	80.7	80.0	73.2	78.1	82.9	na
Share of trade in GDP (in per cent)	na	41.1	45.8	56.7	48.7	65.5	59.1	55.8	na
Tariff revenues (in per cent of imports)	na	78.8	87.8	80.7	80.0	73.2	78.1	82.9	na
EBRD index of price liberalisation [1]	2.7	2.7	2.7	2.3	2.3	2.3	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	1.0	1.0	1.0	1.0	1.0	1.0	3.0	3.3	3.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	na	na	na	na	na	na	na	na	na
Private sector share in GDP (in per cent)	na	na	na	na	na	40.0	40.0	45.0	na
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	1.0	1.0	1.0	2.0	2.3
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	na	na	na	na	na	2.1	3.1	4.4	na
Share of industry in total employment (in per cent)	36.6	36.0	35.2	36.5	36.1	na	na	na	na
Change in labour productivity in industry (in per cent)	6.7	-3.7	13.8	2.4	-16.4	na	na	na	na
Investment rate/GDP (in per cent)	na	na	na	na	11.6	14.5	13.5	na	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0	2.0	2.0
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	19.1 (na)	19.7 (0.0)	20.6 (0.8)	21.8 (2.3)	21.4 (5.7)	22.6 (12.3)	22.9 (18.7)	23.3 (25.7)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	4.6	7.3	12.6	17.5	18.3	19.8	na
Railway labour productivity (1990=100)	36.6	38.3	43.2	43.2	23.1	35.8	48.5	48.5	na
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	na	na	na	na	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	na	na	na	na	na	na	na	na	na
EBRD index of infrastructure reform	1.3	1.3	1.7	1.7	1.7	2.0	2.0	2.0	2.0
Electric power	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.3
Railways	na	na	na	na	na	na	2.0	2.3	2.3
Roads	1.7	1.7	1.7	1.7	1.7	2.0	2.0	2.3	2.3
Telecommunications	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Water and waste water	1.7	1.7	1.7	1.7	1.7	2.0	2.0	2.0	2.0
Financial institutions									
Number of banks (foreign-owned)	112 (3)	103 (3)	106 (3)	104 (3)	75 (3)	81 (3)	54 (8)	50 (12)	na
Asset share of state-owned banks (in per cent)	94.7	92.0	89.8	90.0	89.0	90.9	68.0	35.6	na
Non-performing loans (in per cent of total loans)	12.0	12.3	15.1	13.1	10.2	27.8	24.4	28.5	na
Domestic credit to private sector (in per cent of GDP)	na	9.2	10.8	11.2	9.8	7.6	5.6	na	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0	2.3	2.3
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.7	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	na	na	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	72.0	72.0	72.1	72.2	na	72.5	72.6	na	na
Basic school enrolment ratio (in per cent)	72.9	71.9	70.6	69.9	99.2	96.9	96.5	na	na
Earnings inequality (GINI-coefficient)	31.9	33.8	na	na	na	na	na	na	na

[1] New series (see Box 2.1 for explanation).

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	6.1	7.8	10.1	1.9	-18.0	5.0	5.5	4.0	2.0
Industrial gross output	3.8	7.6	9.5	4.4	-24.4	11.1	0.0	1.7	na
Agricultural gross output	4.1	1.5	7.3	-3.2	-2.0	-13.7	23.2	na	na
Employment				*(Percentage change)*					
Labour force (end-year)	0.9	1.1	-1.2	-0.5	-7.2	-2.2	8.9	na	na
Employment (end-year)	-0.9	-0.4	-1.4	-1.8	-8.6	-2.9	10.3	na	na
				(In per cent of labour force)					
Unemployment (end-year)	24.6	25.7	25.9	26.8	27.9	28.4	27.5	28.9	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	78.6	94.3	21.3	29.5	37.1	60.4	91.3	21.4	12.0
Consumer prices (end-year)	120.4	58.6	9.5	44.5	36.5	113.5	39.3	14.3	9.0
Producer prices (annual average)	57.7	90.1	19.5	25.5	44.2	44.5	na	na	na
Gross average monthly earnings in economy (annual average)[1]	na	na	48.2	117.7	18.2	117.0	99.5	na	na
Government sector				*(In per cent of GDP)*					
General government balance	na	na	na	na	na	-0.9	-1.3	-4.5	-4.6
General government expenditure	na	na	na	na	na	37.6	40.2	47.3	na
Monetary sector[2]				*(Percentage change)*					
Broad money (M2, end-year)	na	na	na	na	67.6	58.5	67.6	76.6	na
Domestic credit (end-year)	na	na	na	na	130.1	58.2	10.0	-37.6	na
				(In per cent of GDP)					
Broad money (M2, end-year)	na	na	na	16.6	21.0	16.9	14.0	18.9	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Discount rate	90.2	68.2	33.7	33.7	26.3	26.3	16.4	9.5	na
Commercial banks' money market rate	1,267.6	424.0	190.4	124.8	64.5	97.4	55.3	32.2	na
Deposit rate	na	34.3	19.1	16.2	13.1	8.3	4.1	2.6	na
Lending rate (long-term)	na	196.7	71.8	60.3	45.4	77.9	32.5	19.2	na
				(Dinars per US dollar)					
Exchange rate (official, end-year)[3]	4.7	5.1	5.9	10.0	11.7	63.2	67.7	59.0	na
Exchange rate (official, annual average)	1.8	5.0	5.7	9.3	11.1	33.0	66.8	64.2	na
External sector				*(In millions of US dollars)*					
Current account	na	-1,670	-1,282	-660	-764	-598	-1,119	-2,012	-2,273
Trade balance	-1,135	-2,260	-2,070	-1,816	-1,619	-1,788	-2,834	-3,908	-4,750
Merchandise exports	1,531	1,842	2,756	3,033	1,676	1,923	2,003	2,412	3,185
Merchandise imports	2,666	4,102	4,826	4,849	3,295	3,711	4,837	6,320	7,935
Foreign direct investment, net	na	0	740	113	112	25	165	562	850
Gross reserves, excluding gold (end-year)	na	na	na	na	289	516	1,169	2,280	na
External debt stock	11,058	11,477	9,770	10,539	10,744	11,403	11,948	11,839	na
				(In months of current account expenditures, excluding transfers)					
Gross reserves, excluding gold (end-year)	na	na	na	na	1.0	1.5	2.7	4.0	na
				(In per cent of current account revenues, excluding transfers)					
Debt service[4]	na	0.7	3.0	1.8	4.6	2.2	3.9	5.6	na
Memorandum items				*(Denominations as indicated)*					
Population (mid-year, million)[5]	10.5	10.6	10.6	10.6	8.4	8.3	8.3	8.3	na
GDP (in millions of dinars)	na	84,191	112,400	146,300	192,900	381,700	771,800	1,006,900	1,220,000
GDP per capita (in US dollar)	na	1,367	1,562	1,308	1,216	1,032	1,390	1,879	na
Share of industry in GDP (in per cent)	na	na	26.0	26.1	25.5	na	na	na	na
Share of agriculture in GDP (in per cent)	31.1	29.4	29.4	19.0	25.1	na	na	na	na
Current account/GDP (in per cent)	na	-11.6	-7.7	-4.8	-7.5	-7.0	-9.7	-12.9	-11.7
External debt - reserves (in US$ million)	na	na	na	na	10,455	10,887	10,779	9,559	na
External debt/GDP (in per cent)	na	79.4	59.0	75.9	105.2	132.5	103.2	75.6	na
External debt/exports of goods and services (in per cent)	na	453.6	273.4	267.0	500.4	447.7	435.6	365.3	na

Note: Data from 1999 onwards exclude Kosovo.

1 Data from 1999 refer to net wages.

2 Data refer to Serbia only.

3 Exchange rate was re-denominated to 1 Din:1 DM on 24 January 1994. The exchange rate regime was unified in December 2000. The unofficial rate in October 2000 was 30 Din:1 DM, compared with an official rate of 6 Din:1 DM.

4 Serbia and Montenegro was in default on virtually all of its external debt between 1992 and 2001.

5 Population decrease in 1999 is the result of excluding Kosovo population from the total.

Slovak Republic

Key reform challenges

- The first steps in a medium-term strategy of fiscal adjustment have been taken, including reform of the tax, health care and pension systems. Tax reform will, however, need to be complemented by cuts in expenditure in the near future.
- Despite the progress achieved in recent years with the completion of banking sector restructuring and the implementation of new legislation on security markets, the supervisory framework of the financial sector needs further strengthening.
- As accession to the EU draws near, a significant effort is required by the authorities to accelerate preparations for the management of cohesion and structural funds which are crucial for upgrading the country's infrastructure.

Stabilisation

Medium-term fiscal strategy announced, with a view to the eventual adoption of the euro.
Important reforms to the tax system have been initiated, aiming to introduce a uniform rate of 19 per cent for both personal income and corporate profit taxes in 2004. The reform will also unify the rate of the two-tier value-added tax (VAT) to 19 per cent. The planned increase in excise taxes has been brought forward, as fiscal revenues have been lower than expected since the beginning of this year. The government has also announced a multi-year fiscal strategy to lower the general government deficit from the levels of 6 to 10 per cent of GDP recorded in 1999-2002 to 3 per cent of GDP, the level required for joining the eurozone, by 2006. Beyond addressing the short-term risks posed by the tax reform on revenue, cuts in expenditure will most likely be needed in the coming years for the Slovak Republic to meet its deficit target. In addition, the envisaged introduction of mandatory pension funds will put further pressure on the budget.

Monetary policy aims to bring inflation down to Maastricht level.
In the weeks following the parliamentary elections in September 2002 the koruna regained all the ground it had lost during the six previous months. In November, the koruna was subjected to strong appreciation pressures owing to a surge in capital inflows. The Central Bank was successful in responding to these pressures by intervening in the market and lowering its key interest rates by 175 basis points. The Central Bank intervened again this year in response to developments in the currency markets of other central European countries. In addition, in January large hikes in energy prices and, more recently, the increase in excise taxes led to an increase in headline inflation. This combination of lower interest rates and high inflation has resulted in a substantial reduction in the level of real interest rates since the beginning of 2003. In the medium term, the implementation of the multi-year plan for fiscal adjustment (see above) and a reduction in the current account deficit will be important in enabling the Central Bank to reduce inflation and meet the Maastricht criteria by 2006.

Enterprise reform

Revisions to the labour code introduce more flexibility.
A series of amendments to the labour code came into force in July 2003, following a first revision in April 2002, which brought the Slovak Republic closer to compliance with the *acquis communautaire*. The new legislation is intended to improve the flexibility of the labour market. The amendments simplify the procedures for making an employee redundant (regarding both severance payments and advance notice), offer the possibility of raising the cap on overtime hours and relax the use of fixed-term and part-time contracts. These changes should contribute to a lowering of the persistently high unemployment level, which has fluctuated between 17 and 20 per cent since 1999, according to the Labour Force Survey. To increase regional labour mobility, additional measures (especially with respect to housing and transport) are required. A reduction in the share of the mandatory contributions in wages is also planned.

Infrastructure

Energy prices raised closer to cost recovery levels, accompanied by further liberalisation of the sector.
In 2003 the energy market (electricity and gas) was opened further to internal and external competition. Around 50 large customers are now free to select their electricity provider, as long as they consume more than 40 gWh per year in 2003 (and more than 20 gWh from 2004). These customers can also import up to one-third of their consumption in 2003 (and up to two-thirds from 2004). In the gas market, 50 large customers are now able to choose their supplier if they consume more than 15 million cubic metres annually. In January this year, energy prices were significantly adjusted by the regulator to bring them closer to full cost recovery levels. Electricity prices

Liberalisation, stabilisation, privatisation

1990

Jan	First Czechoslovak Eurobond issued

1991

Jan	Exchange rate unified
Jan	Fixed exchange rate regime adopted
Jan	Most foreign trade controls lifted
Jan	Most prices liberalised
Jan	Small-scale privatisation begins
Feb	Restitution law adopted

1992

Feb	Treasury bills market initiated
May	Voucher privatisation begins
Jul	EFTA agreement signed

1993

Jan	Czechoslovakia splits into Czech and Slovak Republics
Feb	New currency (koruna) introduced
Mar	CEFTA membership granted

1994

Jul	First sovereign Eurobond issued

1995

Jan	WTO membership granted
Sep	Second wave of voucher privatisation cancelled
Sep	Strategic enterprises excluded from privatisation
Oct	Full current account convertibility introduced

1997

Sep	New wage regulation enacted

1998

Oct	Koruna floated
Dec	New wage regulation cancelled

1999

Apr	Investment incentives adopted
Jun	Import surcharge introduced
Jul	Austerity measures introduced
Dec	Foreign Exchange Act amended

2000

Mar	EU accession negotiations commence
Dec	OECD membership granted
Dec	Import surcharge abolished

2002

Dec	Slovak Republic invited to join EU

2003

Aug	Comprehensive tax reform initiated

Enterprises, infrastructure, finance and social reforms

1994
Jan First corporate Eurobond issued
Feb New banking law adopted
Aug New competition law enacted

1995
Dec First municipal Eurobond issued

1996
Dec BIS capital adequacy requirements adopted

1997
Aug Enterprise revitalisation law enacted
Dec IRB (third-largest bank) collapses

1998
Feb Bankruptcy law amended
Nov Enterprise revitalisation law cancelled
Nov Steel producer VSZ defaults

1999
Aug Restructuring programme approved
Sep Privatisation law amended

2000
Jan New investment law adopted
Feb Utility prices increased significantly
May New telecommunications law adopted
Jul Slovak Telecom acquired by strategic investor
Aug New bankruptcy law adopted
Sep Major steel company sold to strategic investor
Nov Independent financial markets regulator established
Dec Largest bank sold to strategic investor

2001
Jul New banking law adopted
Dec Dominant insurance company privatised

2002
Jan Commercial code amendments enacted
Jan Independent network industries regulator established
Jan Electricity market partially opened
Jan New investment funds law adopted
Mar Gas monopoly privatised
Apr Power distribution companies privatised
Apr New financial market regulation enacted
Apr New labour market legislation adopted

2003
Jan Energy market further opened; prices substantially increased
Jun Reform of health and pension system initiated
Jul Amended labour market legislation enacted

were increased by around 20 per cent for end users and 25 per cent for households, while the average price of gas was raised by 33 per cent.

Constraints on the ability to absorb EU structural funds identified.
In its monitoring report on the capacity of the new member states to manage cohesion and structural funds, published in July 2003, the European Commission noted that considerable efforts are required by the Slovak authorities to strengthen the country's capacity to absorb EU structural funds. Among the problems mentioned were weaknesses in both administrative capacity and in the monitoring system of the funds. In addition, problems in the coordination between different levels of the administration were identified. The degree of project preparation is also an area where the Slovak Republic has been lagging behind, as its programme documents are still to be completed and revised. Thus, there is a risk that some of the funds which the Slovak Republic is entitled to during the period 2004-06 will not be drawn when they become available in May next year. The lack of infrastructure, especially transport links, is starting to hold back investment by foreign companies in many parts of the Slovak Republic outside the Bratislava region.

Financial institutions

Soundness of the banking sector increased.
Reports published in late 2002, both by the European Commission and the IMF, praised the completion of the privatisation and restructuring process in the banking sector. In 1999-2001 bad loans worth SKK 112 billion (13 per cent of GDP) were transferred to the Consolidation Agency. In September 2003 the Consolidation Agency put 40 per cent of this portfolio out to tender. However, the cost of the banking sector restructuring remains significant, representing between 1 and 1.5 per cent of GDP annually in 2002 and 2003. The trend is, however, decreasing. Foreign ownership now accounts for more than 85 per cent of the sector. The capital adequacy ratio of the banking sector has been considerably strengthened and is now close to 20 per cent. The share of non-performing loans has fallen to slightly above 10 per cent of total loans. Although profitability of the sector has been restored, it remains under pressure and increased competition is expected to lead to further consolidation. Overall the volume of credit to the economy has started to grow again, as banks are increasingly in a position to redirect their free liquidity from low-yield state securities to loans for households and firms.

Supervisory framework of the financial markets strengthened, but some potential weaknesses remain.
The new security law, in force from January 2002, has significantly increased the supervisory powers of the Financial Market Authority (UFT). While UFT's institutional capacity is being built up, further enhancements are required, according to an assessment made by the IMF in late 2002. There is also scope for further clarification regarding the definition of securities (covered by the Securities Act), the protection of minority shareholders (commercial code) and the rules concerning market manipulation (Stock Exchange Act). Some potential weaknesses in the latter legislation may have been revealed during the take-over of a large Slovak company in which a strategic foreign investor recently acquired a majority stake. The investor's subsequent mandatory bid for the remaining shares was suspended following a dispute over alleged price manipulations and the impact on the share price paid to minority shareholders. Although there have been a number of rulings by the UFT, the issue has yet to be resolved. The authorities do, however, intend to fully transpose the provisions of the EU directive on market abuse during the first half of next year. In addition, the government intends to unify the supervision of the financial sector under the jurisdiction of the Central Bank by 2005.

Social reform

Following tightening of access to social assistance, reform of both the health care and pension systems has been launched.
After the rules for qualification for full social benefits and the maximum amount of allowances were tightened, a first step to the reform of the health care system was taken. This reform is intended to prepare for the eventual reorganisation of the financing and management of the highly indebted public health system. Flat-rate fees for a range of health services were introduced in June, including stays at hospitals and visits to general practitioners and specialists. This is to be complemented by other amendments to the legislation, notably aimed at linking the remuneration of health care employees to their performance. The government has also launched a reform programme for the pension system, aimed at strengthening the link between contributions and benefits of the current pay-as-you-go system. Following this first step, the creation of mandatory pension funds (second pillar) is envisaged, in addition to the existing optional pension funds (third pillar).

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **32.2 per cent**
Exchange rate regime – **managed floating**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **2.4 per cent (1996)**
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	21.8	21.8	20.8	17.8	17.8	17.8	17.8	21.1	20.7
Number of goods with administered prices in EBRD-15 basket	5.0	5.0	5.0	4.0	4.0	3.0	3.0	3.0	3.0
Share of trade with non-transition countries (in per cent)	45.6	49.4	54.2	62.0	62.0	64.0	62.0	63.5	na
Share of trade in GDP (in per cent)	94.7	100.9	104.6	110.9	109.1	128.4	137.3	130.3	na
Tariff revenues (in per cent of imports)[1]	3.3	2.9	3.3	2.6	2.7	2.2	0.5	0.5	na
EBRD index of price liberalisation [2]	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.3	4.0	4.3	4.3	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	8.4	10.2	10.8	11.5	11.8	16.3	20.1	35.1	na
Private sector share in GDP (in per cent)	60.0	70.0	75.0	75.0	75.0	80.0	80.0	80.0	na
Private sector share in employment (in per cent)	59.6	63.1	64.6	68.9	70.0	75.0	75.0	na	na
EBRD index of small-scale privatisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	2.6	2.3	2.4	2.0	1.9	4.0	2.7	1.7	na
Share of industry in total employment (in per cent)	28.1	27.7	25.0	26.6	24.4	23.0	25.1	26.7	na
Change in labour productivity in industry (in per cent)	4.0	2.5	3.8	7.8	2.6	7.2	3.6	6.4	na
Investment rate/GDP (in per cent)	27.4	36.9	38.6	40.8	30.1	na	na	na	na
EBRD index of enterprise reform	3.0	3.0	2.7	2.7	3.0	3.0	3.0	3.0	3.0
EBRD index of competition policy	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	20.8 (0.2)	23.2 (0.5)	25.8 (3.7)	28.5 (8.8)	30.7 (12.3)	31.4 (20.5)	28.8 (39.7)	26.1 (54.4)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	27.0	41.2	55.2	70.2	134.4	159.3	na
Railway labour productivity (1989=100)	68.7	60.8	63.1	60.8	53.0	61.0	62.4	61.7	na
Electricity tariffs, USc kWh (collection rate in per cent)	3.1 (95)	3.2 (95)	2.9 (95)	2.8 (na)	3.5 (na)	5.9 (na)	5.0 (102)	7.5 (95)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.7	2.9	3.1	3.2	3.4	3.6	na	na	na
EBRD index of infrastructure reform	1.7	1.7	1.7	1.7	2.0	2.0	2.3	2.3	2.3
Electric power	2.0	2.0	2.0	2.0	2.0	2.0	3.0	4.0	4.0
Railways	na	na	na	2.0	2.0	2.3	2.3	2.3	2.3
Roads	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3	2.3
Telecommunications	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Water and waste water	1.0	1.0	1.0	1.0	2.3	2.3	2.3	2.3	2.3
Financial institutions									
Number of banks (foreign-owned)	33 (18)	29 (14)	29 (13)	27 (11)	25 (11)	23 (14)	19 (13)	18 (15)	na
Asset share of state-owned banks (in per cent)	61.2	54.2	48.7	50.0	50.7	49.1	4.9	2.9	na
Non-performing loans (in per cent of total loans)	41.3	31.8	33.4	44.3	32.9	26.2	24.3	11.2	na
Domestic credit to private sector (in per cent of GDP)	26.3	30.4	42.1	43.9	40.5	37.6	27.6	25.2	na
Stock market capitalisation (in per cent of GDP)[3]	6.7	11.5	9.3	4.7	3.8	3.9	3.3	7.0	na
EBRD index of banking sector reform	2.7	2.7	2.7	2.7	2.7	3.0	3.3	3.3	3.3
EBRD index of reform of non-bank financial institutions	2.7	2.7	2.3	2.3	2.3	2.3	2.3	2.3	2.7
Social sector									
Expenditures on health and education (in per cent of GDP)	8.9	11.1	10.7	10.2	9.9	9.6	9.5	9.8	na
Life expectancy at birth, total (years)	72.3	72.7	72.7	72.6	72.9	73.1	73.2	na	na
Basic school enrolment ratio (in per cent)	97.5	96.8	98.7	101.3	107.5	107.4	107.2	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

[1] Refers to import tariffs, customs duties and import surcharge.
[2] New series (see Box 2.1 for explanation).
[3] Data from Bratislava Stock Exchange.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	*Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	6.5	5.8	5.6	4.0	1.3	2.2	3.3	4.4	3.8
Private consumption	4.0	8.8	5.7	6.3	3.3	-3.4	4.0	5.4	na
Public consumption	2.1	17.4	-4.5	11.5	-7.7	-0.9	5.2	4.0	na
Gross fixed capital formation	1.8	30.9	14.3	11.0	-18.5	-0.7	11.6	-0.9	na
Exports of goods and services	4.8	-1.3	19.0	13.2	5.2	15.9	6.5	5.9	na
Imports of goods and services	11.5	19.8	13.8	16.9	-6.3	10.2	11.7	5.3	na
Industrial gross output	8.3	2.5	1.7	3.4	-3.4	9.1	4.6	6.6	na
Agricultural gross output	2.3	2.0	-1.0	-5.9	1.0	3.2	0.0	na	na
Employment					*(Percentage change)*				
Labour force (end-year)	1.2	2.1	1.0	0.9	0.9	2.0	2.0	0.3	na
Employment (end-year)	2.4	-1.4	-2.3	-1.0	-1.8	-1.4	-1.0	0.0	na
					(In per cent of labour force)				
Unemployment (end year)	13.1	12.8	12.5	15.6	19.2	17.9	19.8	18.8	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	9.9	5.8	6.1	6.7	10.6	12.0	7.1	3.3	8.5
Consumer prices (end-year)	7.2	5.4	6.4	5.6	14.2	8.4	6.5	3.4	9.0
Producer prices (annual average)	9.0	4.1	4.5	3.3	3.8	9.8	6.6	2.1	na
Producer prices (end-year)	7.1	4.7	4.4	1.6	7.7	9.1	3.4	2.3	na
Gross average monthly earnings in economy (annual average)	14.3	13.3	13.1	8.4	7.2	6.5	8.2	9.3	na
Government sector [1]					*(In per cent of GDP)*				
General government balance	0.4	-1.3	-5.2	-5.0	-6.3	-10.4	-7.3	-7.2	-5.0
General government expenditure	45.2	47.0	45.5	42.9	43.3	45.4	47.7	48.4	na
General government debt	24.6	24.5	23.7	26.0	28.4	30.4	34.2	42.7	na
Monetary sector					*(Percentage change)*				
Broad money (M2, end-year)	19.1	16.6	9.1	2.7	13.0	16.2	11.1	3.4	na
Domestic credit (end-year)	7.6	14.4	3.1	11.2	7.5	9.1	13.3	-12.7	na
					(In per cent of GDP)				
Broad money (M2, end-year)	65.4	68.7	66.2	62.1	64.6	69.0	70.5	65.5	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinancing rate	na	9.7	19.2	11.3	8.7	8.0	7.8	6.5	na
3-month BRIBOR	na	14.9	26.5	18.3	14.3	7.9	7.8	6.0	na
Deposit rate [2]	8.2	6.2	8.7	10.4	9.9	5.6	4.8	3.5	na
Lending rate [2]	14.8	13.2	16.2	16.2	13.5	10.8	9.8	8.8	na
					(Korunas per US dollar)				
Exchange rate (end-year)	29.6	31.9	34.8	36.9	42.1	48.6	48.2	40.0	na
Exchange rate (annual average)	29.7	30.7	33.6	35.2	41.4	46.2	48.4	45.3	na
External sector					*(In millions of US dollars)*				
Current account	391	-2,098	-1,952	-2,059	-1,083	-713	-1,756	-1,939	-2,062
Trade balance	-228	-2,293	-2,081	-2,293	-1,103	-917	-2,135	-2,131	-2,292
Merchandise exports	8,579	8,831	9,639	10,667	10,197	11,870	12,632	14,365	17,669
Merchandise imports	8,807	11,124	11,720	12,959	11,301	12,786	14,766	16,497	19,961
Foreign direct investment, net	194	199	84	374	701	2,058	1,460	4,007	1,500
Gross reserves, excluding gold (end-year)	3,306	3,403	3,204	2,867	3,366	4,077	4,189	9,196	na
External debt stock	5,678	7,670	9,896	11,902	10,518	10,804	11,269	13,188	na
					(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.7	3.1	2.8	2.3	3.1	3.4	3.0	5.9	na
					(In per cent of current account revenues, excluding transfers)				
Debt service due	9.1	10.6	12.4	11.2	16.5	17.1	19.1	11.5	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, million)	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4	na
GDP (in millions of korunas)	546,000	606,100	686,100	750,800	815,300	887,200	964,600	1,073,613	1,209,135
GDP per capita (in US dollar)	3,423	3,676	3,788	3,951	3,651	3,554	3,696	4,403	na
Share of industry in GDP (in per cent)	29.1	29.5	26.8	25.5	24.2	25.8	26.1	25.9	na
Share of agriculture in GDP (in per cent)	5.3	4.9	4.6	4.2	4.2	4.2	4.1	4.6	na
Current account/GDP (in per cent)	2.1	-10.6	-9.6	-9.7	-5.5	-3.7	-8.8	-8.2	-6.3
External debt - reserves (in US$ million)	2,372	4,267	6,692	9,035	7,152	6,727	7,080	3,993	na
External debt/GDP (in per cent)	30.9	38.8	48.5	55.9	53.4	56.3	56.5	55.7	na
External debt/exports of goods and services (in per cent)	51.8	70.4	83.8	91.8	86.3	76.5	74.5	76.9	na

[1] General government includes the state, municipalities and extra-budgetary funds. The general government balance excludes privatisation revenues and is calculated according to Eurostat methodology (ESA95) since 1999 inclusive.

[2] Weighted average over all maturities. Lending rate excludes loans at zero interest rate since 1995.

Slovenia

Key reform challenges

- The government needs to accelerate implementation of its privatisation programme for large companies in the financial and other key sectors to avoid further delays ahead of EU membership.
- The effective de-indexation of wages, with a tighter fiscal policy and stronger competition policy, will be crucial to securing lower inflation ahead of EMU accession. Fiscal policy is likely to be further constrained by the financial terms of EU membership.
- Clarification of the corporate take-over laws is required following recent controversies surrounding corporate acquisitions.

Stabilisation

Fiscal pressures expected to mount after EU membership.

Despite cuts in expenditure being decided in 2003, the fiscal deficit target for the year was revised up from 1.1 per cent to 1.5 per cent of GDP (1.9 per cent of GDP according to Eurostat methodology). This was due to the prolonged cyclical slow down in the EU, affecting budget revenues for a second year in a row, as well as spending slippages. According to the draft budget adopted by the government in September, the general government deficit could increase to 1.6 per cent of GDP in 2004, in the absence of further corrective measures. As mandatory expenditures account for 80 to 85 per cent of total spending, further budgetary pressures will be experienced after EU accession. In addition to the cohesion and structural funds, agricultural direct payments will be co-financed by the government. Slovenia has been allowed to complement EU transfers up to 75 per cent of the levels paid to farmers in the current member states. These developments, combined with other commitments such as the costs of joining NATO, have led the government to envisage adjustments to both the level and composition of expenditure for Slovenia to meet its international commitments.

Privatisation

Privatisation prioritised ahead of EU membership, but progress remains limited.

In November 2002 the government presented a programme to the parliament, aimed at accelerating the preparations for the sale of major state-owned companies in 2003 and 2004. Progress with the privatisation of the telecom operator Telekom Slovenije, which is still in its initial stages, will require improved market conditions, according to the government. The sale of an 80 per cent stake in three core companies of the Slovenian Steelworks group (Acroni Jesenice, Metal Ravne and Nozi Ravne) was suspended in August, following a decision by the Privatisation Commission that the economic climate was not suitable. A number of other companies will be restructured, in some cases after the failure of the initial attempt to sell them. These include footwear makers Peko and Planika, and the oil refinery Nafta Lendava. Several legal issues remain to be settled, including concession agreements and land lease contracts, before the privatisation of Ljubljana Airport and the Port of Koper can take place.

Enterprise reform

Take-over laws to be amended following disputed acquisitions.

Foreign direct investment rose to the exceptional level of US$ 1.8 billion in 2002, as several take-overs of large Slovenian companies were led by foreign investors. In November 2002 the Swiss multinational group Novartis acquired a 99 per cent stake in the pharmaceutical producer Lek. Since then more than 30 instances of alleged insider trading and price manipulation related to this takeover were handed over to the judicial authorities by the Security Market Agency (AVTP). The battle for ownership of the second largest domestic brewery Pivovarna Union, between Interbrew of Belgium and Slovenia's largest domestic brewery Pivovarna Laško, has yet to be settled. Although neither of the potential buyers formally owns a majority control in Union, concerns were raised about the possible concerted control of Union by Laško with third parties. These concerns, combined with the risk to competition in the sector, generated a series of legal claims which have so far blocked the conclusion of the bid that started two years ago. In response to these developments, in July the government announced a series of legislative amendments intended to increase the transparency and control of take-over operations. They aim at improving the definition of these operations and the cooperation between the Competition Protection Office and the Security Market Agency.

Laws on state aid brought further into line with the *acquis communautaire*.

A law on public support for restructuring troubled companies was adopted in November 2002. It defines a framework (in compliance with EU regulations) for the allocation of state aid to assist enterprises dealing with short-term problems (liquidity

Liberalisation, stabilisation, privatisation

1992

Nov	Law on privatisation of socially owned enterprises adopted

1993

Mar	Foreign trade law adopted
Jun	Paris Club agreement signed
Jun	Law on privatisation of socially owned enterprises amended

1994

Apr	Wage guidelines introduced
Jun	Most prices liberalised
Oct	GATT membership granted
Nov	New law on privatisation adopted

1995

Feb	Capital account restrictions tightened
Apr	Inter-bank cartel on deposit rates established
Jun	EU Association Agreement signed
Jun	EFTA agreement signed
Sep	Full current account convertibility introduced

1996

Jan	CEFTA membership granted
Jan	London Club agreement signed
Jul	First sovereign Eurobond issued
Jul	Capital account restrictions tightened

1997

Feb	Capital account restrictions tightened further
Jun	Minimum wage law adopted
Jun	Capital account restrictions eased

1998

Jan	Minimum wage law amended
Apr	Law on privatisation of socially owned enterprises amended
Dec	Excise tax law adopted
Dec	VAT law adopted

1999

Feb	Capital account restrictions eased
Mar	Foreign exchange law adopted
Sep	Capital account restrictions eased

2001

Jul	Restrictions on foreign investment in long-term securities removed

2002

Jan	Most capital account restrictions removed
Dec	Slovenia invited to join EU

2003

Feb	Capital account restrictions for individuals removed
Feb	EU citizens allowed to acquire property

Enterprises, infrastructure, finance and social reforms

1992

Sep	Socially owned enterprises restructured

1993

Jan	Bank rehabilitation begins
Apr	Competition law adopted
Jun	Company law adopted
Jul	Electric power sector law adopted
Dec	Railway law adopted

1994

Jan	IAS introduced
Jan	Bankruptcy law adopted
Jan	Investment company law adopted
Mar	Securities law adopted
Aug	BIS capital adequacy adopted
Sep	Insurance law adopted

1995

Jan	Telecommunications and postal services separated
Sep	Competition agency established

1996

Jan	First privatised company listed on stock exchange
Jul	First bank bankruptcy initiated

1997

Feb	First GDR issue undertaken
May	Telecommunications law adopted
Jul	Bank rehabilitation concluded
Jul	Take-over law enacted

1999

Feb	New banking law adopted
Apr	Securities dematerialisation law adopted
Jul	New securities law adopted
Sep	Energy law adopted

2000

Jan	Pension reform introduced
Jun	Independent insurance regulator established
Jul	Independent energy regulator established

2001

Apr	New telecommunications law adopted
Jul	Independent telecommunications regulator established

2002

Jan	Electricity market liberalised for large users
Apr	New labour law adopted
May	Largest commercial bank privatised
Nov	New law on mutual funds adopted

2003

Jan	Law on state aid to troubled enterprises enacted
Jan	Energy market further liberalised

crises), as well as for long-term purposes (industrial restructuring). However, in March the European Commission stated that the liquidation of the Slovene Development Corporation (SRD), which has been delayed in recent years, remained a key issue to be resolved. Following the closure of accession talks in mid-2003, the government indicated that it expected to complete the liquidation of SRD by 2004.

Infrastructure

Railway restructuring law adopted.
In March 2003 the parliament adopted legislation permitting changes in the ownership structure of the public railways operator Slovenske Zeleznice. These changes are expected to facilitate its restructuring and future partial privatisation. In June, the government adopted a plan to restructure and split the operator into three distinct companies, managing passenger transport, cargo freight and the network infrastructure. The three entities will be combined into a holding company with limited liability. The restructuring plan also includes the conversion of a portion of the new holding's liabilities into capital, along with the injection of fresh capital, as well as proposals for a significant reduction of the labour force. In the longer term, the passenger and cargo transport operators are to be partially privatised. The third entity will remain in state hands and receive a concession fee from the two other companies for use of the railway network.

Financial institutions

Several new acts to improve financial sector legal framework introduced.
A law on investment and pension mutual funds, enacted in January 2003, requires the compulsory transformation of the current investment funds into mutual funds before the end of the year. The investment funds were created at the beginning of the 1990s to facilitate the transfer of ownership of the newly privatised companies to the population. The law also defines the conditions for establishing such funds and regulates their operations and supervision, including minimum capital requirements and out-of-court settlement of disputes. Amendments to the Banking Act, adopted by the government, are intended to make a number of important modifications to the conditions for acquiring stakes in Slovenian banks. Authorisation from the Bank of Slovenia will have to be obtained before, rather than after, the acquisition. The criteria for the nomination of members to banks' boards will be tightened and the maximum level of guarantees for deposits increased. In a separate move, individuals have been permitted to hold bank accounts abroad without prior authorisation from the Bank of Slovenia as of February 2003.

Constitutional Court ruling removes barrier for the privatisation of insurance companies.
In February a decision by the Constitutional Court validated the law, adopted last year, allowing changes to the ownership structure of leading insurance company Zavarovalnica Triglav and the reinsurance company Pozavarovalnica Sava. This process had been stalled for 12 years. The ruling confirmed the transfer of majority stakes in both companies to two state funds (the Restitution Fund and the Pension Fund). In July, the government declared its intention to promote the creation of two financial groups around Zararovalnica Triglav and the second largest bank Nova Kreditna Banka Maribor (NKBM), before proceeding with their privatisation. After suspending the sale of a 65 per cent stake in NKBM last year, the government is considering merging the bank with the state-owned postal bank Postna Banka Slovenije (PBS) and the reinsurance company Pozavarovalnica Sava.

Social reform

New social agreement aims at gradually de-indexing the wage setting mechanisms.
At the end of 2002 the employers' organisations, the trade unions and the Ministry of Labour and Social Affairs reached an agreement on several social issues for the period 2003-05. These issues included wages, the reform of obligatory health insurance and the taxation of personal income. Negotiations on wages in the private sector have been aimed at de-indexing the wage setting mechanism from past inflation. This move will support the government's disinflation strategy, which was initiated in 2002, with the de-indexation of short-term financial contracts. The new wage indexation mechanism will take into account two further elements in addition to the past level of domestic inflation. These include the level of inflation in Slovenia's trading partners in the EU and changes in the tolar-euro exchange rate. Negotiations on the modalities, however, remain to be completed. In the public sector, the government has succeeded in neutralising the impact of wage growth by negotiating the setting-aside of the wage increases due this year for pension funding purposes. In 2004 and 2005 wage settlements in the public sector will be determined using the same mechanism as has been agreed for the private sector.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenue in GDP – **39.38 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **vouchers**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **<2 per cent (1998)**
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	22.5	22.4	20.4	17.0	14.3	13.7	13.2	14.0	15.4
Number of goods with administered prices in EBRD-15 basket	5.0	5.0	4.0	2.0	2.0	1.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	76.0	73.9	73.3	74.1	75.5	73.1	76.7	77.6	na
Share of trade in GDP (in per cent)	94.2	92.9	96.6	96.9	92.1	98.9	98.8	96.3	na
Tariff revenues (in per cent of imports)	7.1	6.2	4.0	2.9	2.5	1.7	1.2	1.2	na
EBRD index of price liberalisation [1]	3.7	3.7	3.7	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.4	0.9	1.4	2.2	2.5	2.5	2.7	4.9	na
Private sector share in GDP (in per cent)	50.0	55.0	60.0	60.0	60.0	65.0	65.0	65.0	na
Private sector share in employment (in per cent)	48.0	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	2.7	2.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	1.9	1.4	1.4	1.5	1.7	1.4	1.3	1.1	na
Share of industry in total employment (in per cent)	43.2	42.1	40.5	39.5	37.8	37.4	38.2	38.5	na
Change in labour productivity in industry (in per cent)	-3.9	4.0	2.7	5.4	5.7	7.2	-1.5	0.7	na
Investment rate/GDP (in per cent)	21.4	22.6	23.5	24.2	27.4	26.7	na	na	na
EBRD index of enterprise reform	2.7	2.7	2.7	2.7	2.7	2.7	2.7	3.0	3.0
EBRD index of competition policy	2.0	2.0	2.0	2.3	2.3	2.7	2.7	2.7	2.7
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	30.9 (1.4)	33.3 (2.1)	35.8 (4.7)	36.3 (8.1)	37.3 (31.8)	38.6 (61.2)	40.1 (76.0)	40.7 (83.5)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	97.5	114.5	118.0	109.5	147.8	179.0	na
Railway labour productivity (1989=100)	119.2	103.4	117.0	120.2	118.4	123.0	122.7	133.6	na
Electricity tariffs, USc kWh (collection rate in per cent)	7.36 (95)	7.40 (95)	9.37 (97)	9.75 (99)	8.73 (99)	7.6 (na)	6.4 (na)	8.0 (95-98)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.2	4.2	4.1	4.3	4.7	5.0	na	na	na
EBRD index of infrastructure reform	1.7	2.0	2.0	2.7	3.0	3.0	3.0	3.0	3.0
Electric power	2.3	2.3	2.3	2.3	3.0	3.0	3.0	3.0	3.0
Railways [2]	na	na	na	3.0	3.0	3.0	3.0	3.0	3.0
Roads	2.3	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Telecommunications	1.0	1.0	1.0	2.3	2.3	2.3	3.0	3.0	3.0
Water and waste water	1.7	2.0	2.0	3.3	3.7	3.7	4.0	4.0	4.0
Financial institutions									
Number of banks (foreign-owned)[3]	39 (6)	36 (4)	34 (4)	30 (3)	31 (5)	28 (6)	24 (5)	22 (6)	na
Asset share of state-owned banks (in per cent)	41.7	40.7	40.1	41.3	42.2	42.5	48.9	48.6	na
Non-performing loans (in per cent of total loans)[4]	9.3	10.1	10.0	9.5	9.3	9.3	10.0	na	na
Domestic credit to private sector (in per cent of GDP)	27.3	28.4	28.3	32.6	38.0	38.7	40.4	41.0	na
Stock market capitalisation (in per cent of GDP)	1.8	3.6	9.3	12.2	11.8	13.7	14.7	19.1	na
EBRD index of banking sector reform	3.0	3.0	3.0	3.0	3.3	3.3	3.3	3.3	3.3
EBRD index of reform of non-bank financial institutions	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Social sector									
Expenditures on health and education (in per cent of GDP)	13.2	13.1	13.3	13.3	13.1	13.5	na	na	na
Life expectancy at birth, total (years)	73.4	74.4	74.7	74.8	74.9	75.3	75.6	na	na
Basic school enrolment ratio (in per cent)	96.7	96.9	97.1	97.4	100.4	100.9	na	na	na
Earnings inequality (GINI-coefficient)	35.8	29.8	30.7	30.6	30.5	30.6	31.0	na	na

1 New series (see Box 2.1 for explanation).
2 Series has been corrected for ratings after 1998.
3 First foreign branch in Slovenia, established in 1999, is included in the figure.
4 Changes in non-performing loans data compared with previous *Transition Reports* are due to the change of loan categories included in non-performing loans (see definitions).

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	4.9	3.5	4.6	3.8	5.2	4.6	3.0	3.2	2.3
Private consumption	9.9	2.0	2.8	3.3	6.1	0.8	2.6	1.9	na
Public consumption	2.2	3.3	4.3	5.8	4.6	3.1	4.0	2.7	na
Gross fixed capital formation	16.6	8.9	11.6	11.3	19.1	0.2	-0.8	3.1	na
Exports of goods and services	1.1	3.6	11.6	6.7	1.7	12.7	6.4	6.1	na
Imports of goods and services	12.1	2.1	11.9	10.4	8.2	6.1	3.0	4.8	na
Industrial gross output	2.0	1.0	1.0	3.7	-0.5	6.2	2.9	2.4	na
Agricultural gross output [1]	1.6	1.1	-2.9	3.1	-2.1	-1.0	-2.1	1.1	na
Employment [2]				(Percentage change)					
Labour force (mid-year)	1.7	-0.6	2.1	1.8	-2.0	0.0	0.9	0.9	na
Employment (mid-year)	3.6	-0.5	2.3	1.0	-1.7	0.2	2.2	0.9	na
				(In per cent of labour force)					
Unemployment (mid-year)	7.4	7.3	7.1	7.6	7.4	7.2	5.9	5.9	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	13.5	9.9	8.4	7.9	6.1	8.9	8.4	7.5	6.1
Consumer prices (end-year)	9.0	9.0	8.8	6.5	8.0	8.9	7.0	7.2	6.4
Producer prices (annual average)	12.8	6.8	6.1	6.0	2.1	7.6	9.0	5.1	na
Producer prices (end-year)	7.9	5.8	6.8	3.6	3.5	9.2	7.5	3.7	na
Gross average monthly earnings in economy (annual average) [3]	18.4	15.3	11.7	9.6	9.6	10.6	11.9	9.7	na
Government sector [4]				(In per cent of GDP)					
General government balance	-0.3	-0.2	-1.7	-1.4	-0.9	-1.3	-1.1	-3.2	-1.5
General government expenditure	43.4	42.9	43.8	44.4	44.5	42.2	42.6	42.6	na
General government debt	18.8	22.7	23.2	23.7	24.5	24.0	25.9	26.9	na
Monetary sector				(Percentage change)					
Broad money (M2, end-year)	25.9	21.8	34.1	25.4	12.1	9.0	26.7	22.2	na
Domestic credit (end-year)	35.1	13.2	14.2	22.4	19.3	16.7	16.9	13.9	na
				(In per cent of GDP)					
Broad money (M2, end-year)	27.8	29.4	34.6	38.8	38.8	36.5	41.2	45.2	na
Interest and exchange rates				(In per cent per annum, end-year)					
Discount rate	10.0	10.0	10.0	10.0	8.0	10.0	11.0	10.0	na
Inter-bank market rate (average)	15.9	10.2	9.8	5.6	6.9	7.2	4.7	4.7	na
Deposit rate (31-90 days)	20.8	11.2	13.9	7.0	9.6	10.9	8.5	7.6	na
Lending rate (short-term working capital)	28.0	18.3	20.3	12.3	15.2	16.3	13.7	11.8	na
				(Tolars per US dollar)					
Exchange rate (end-year)	126.0	141.5	169.2	161.2	196.8	227.4	250.9	221.1	na
Exchange rate (annual average)	118.5	135.4	159.7	166.1	181.8	222.7	242.7	240.2	na
External sector				(In millions of US dollars)					
Current account	-75	55	51	-118	-698	-548	31	375	256
Trade balance	-954	-826	-775	-792	-1,235	-1,139	-620	-243	-382
Merchandise exports	8,350	8,353	8,406	9,091	8,623	8,808	9,343	10,473	11,834
Merchandise imports	9,304	9,179	9,181	9,883	9,858	9,947	9,962	10,716	12,216
Foreign direct investment, net	161	167	303	221	59	71	371	1,748	100
Gross reserves, excluding gold (end-year) [5]	1,821	2,297	3,315	3,639	3,168	3,196	4,330	6,980	na
External debt stock	2,970	3,981	4,123	4,915	5,400	6,217	6,717	8,799	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year) [5]	2.0	2.6	3.8	3.8	3.3	3.4	4.5	6.7	na
				(In per cent of current account revenues, excluding transfers)					
Debt service [6]	6.5	8.5	8.4	13.1	7.7	9.1	14.0	12.3	na
Memorandum items				(Denominations as indicated)					
Population (end-year, million)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in millions of tolars)	2,221,459	2,555,369	2,907,277	3,253,751	3,648,401	4,222,404	4,740,995	5,284,501	5,736,194
GDP per capita (in US dollar)	9,418	9,501	9,172	9,900	10,098	9,528	9,873	11,026	na
Share of industry in GDP (in per cent)	28.3	27.9	28.0	28.1	27.3	27.7	27.4	na	na
Share of agriculture in GDP (in per cent)	3.9	3.9	3.7	3.6	3.2	2.9	2.7	na	na
Current account/GDP (in per cent)	-0.4	0.3	0.3	-0.6	-3.5	-2.9	0.2	1.7	0.9
External debt - reserves (in US$ million)	1,149	1,684	808	1,277	2,232	3,021	2,387	1,819	na
External debt/GDP (in per cent)	15.8	21.1	22.6	25.1	26.9	32.8	34.4	40.0	na
External debt/exports of goods and services (in per cent)	28.6	38.0	39.5	44.2	51.4	58.1	59.4	68.9	na

1 Agricultural value added.

2 Based on labour force survey data. Those figures have been consistently lower than those calculated as officially registered unemployed.

3 Data for all enterprises employing three or more persons.

4 General government includes the state, municipalities and extra-budgetary funds. Privatisation revenues from state and socially-owned enterprises are placed below the line. Balances from 1999 are based upon the new budget classifications. Due to the adoption of a cash basis methodology from 1 January 2002 the figure for 2002 is not directly comparable to those for previous years.

5 Total reserves excluding gold of the Bank of Slovenia.

6 Long-term debt only.

Tajikistan

Key reform challenges

- To improve conditions for private sector development, the government needs to promote the restructuring and advance privatisation or liquidation of large state-owned enterprises.
- The financial system needs further strengthening to better service the financing needs of private domestic enterprises, in particular small and medium-sized companies.
- Further improvements in financial and operational management in remaining public sector enterprises, especially in transparency, would help to reduce quasi-fiscal deficits and create the conditions for additional investment in infrastructure.

Liberalisation

Positive effects of liberalisation remain limited by regional disputes.
Tajikistan remains geographically isolated and poorly integrated into global markets, despite fairly liberal trade policies. A memorandum on the foreign trade regime, a first important step in the accession process, was submitted to the WTO in February 2003. The average tariff is relatively low at 8.3 per cent, but the authorities intend to increase it in line with the standards of the Eurasian Economic Community, a regional trade organisation. Moreover, the repeated closure of the Uzbek border for transit and imports of Tajik goods, in particular agricultural products and light consumer goods, has greatly limited export opportunities. Conflicts also exist with Kazakhstan over the transit of Tajik migrant workers and more recently with the Kyrgyz Republic over inter-ethnic disputes in several contested border areas. Given its geographical isolation, Tajikistan is particularly dependent on cooperative neighbours for its future economic development.

Stabilisation

New IMF programme launched supporting improved macroeconomic policies …
In December 2002 the IMF launched a new three-year Poverty Reduction and Growth Facility (PRGF) worth US$ 87 million. The first review was completed in July 2003. The new agreement follows the successful completion of a Staff Monitored Programme (SMP), placing particular emphasis on monetary discipline, improved fiscal performance and several structural reform benchmarks. Bilateral debt rescheduling agreements, mainly with Russia and Uzbekistan, also brought Tajikistan's external debt down to US$ 1 billion (82 per cent of GDP), further improving macroeconomic conditions. Fiscal performance was further strengthened during the first half of 2003, with revenues 17.2 per cent above the government's target. These improvements follow a series of past reforms aimed at strengthening tax collection and expenditure management.

… but stubbornly high inflation points to underlying weaknesses.
Inflation remained above target throughout 2002 owing to lax monetary and credit policies, as well as increases in public sector salaries and energy prices. The 8.2 per cent increase in consumer prices in the first six months of 2003 was driven by weather-related supply shocks and increased demand for food products from Uzbekistan. Many of the structural performance targets under the first review of the PRGF have been delayed and two criteria waived. There is, therefore, a risk that the PRGF could go off-track again in the future, with implications for other aid programmes and for underlying macroeconomic stability.

Privatisation

Privatisation of medium and large enterprises slows.
During the first half of 2003, 209 state-owned enterprises (30 of which are medium and large-scale enterprises) were privatised and 11 million somoni (US$ 3.6 million) was generated in privatisation receipts. The state committee for the management of state-owned property held two international tenders in the first half of 2003 and sold a salt plant and an ore refinery. But at this pace, privatisation receipts at end-2003 will be well below those in 2002. Only half of the medium and large-scale state enterprises scheduled for privatisation have been sold thus far, leaving more than 300 medium and large-scale enterprises fully state-owned.

Enterprise reform

Restructuring of state-owned farms slows…
As of 2002, around 50 per cent of co-operative farm lands had been converted into dekhan farms (individual land plots). A land registry was established in 2001 and land registration fees were reduced in 2002, thereby easing the process of registration. In 2002, 40 of the large state-owned farms were restructured. However, the process seems to have stalled over the past months.

One critical obstacle is that many of the remaining large state farms have sizeable debts outstanding. Without restructuring or writing off these debts, private farmers are unlikely to be able and willing to take over these state farms.

Liberalisation, stabilisation, privatisation

1993

Jan	Price liberalisation partially reversed
Dec	Wage indexation introduced

1994

Sep	Interim cease-fire arranged

1995

May	New currency (Tajik rouble) introduced
May	Exchange rate unified
May	State trading monopoly abolished
Jun	Most consumer prices liberalised
Aug	Licences for agricultural trade eliminated
Dec	Interest rates fully liberalised

1996

Feb	Export surrender requirement abolished
Mar	Price controls on grain and bread lifted
May	Large-scale privatisation programme launched
May	IMF programme adopted
Dec	Land privatisation started

1997

May	Privatisation law revised
Jun	Peace agreement concluded
Sep	Treasury system reformed

1998

Apr	Customs union membership granted
Jul	Free tradability of land rights granted
Nov	Regular credit auctions introduced

1999

Jan	New tax code adopted
Jun	State cotton trading company liquidated

2000

Jul	Official exchange rate unified with curb market rate
Aug	Privatisation of cotton ginneries completed
Oct	New currency (somoni) introduced
Dec	New treasury system established

2001

May	WTO observer status granted

2002

May	Import tariff rates unified
Jul	New privatisation strategy approved
Dec	New IMF programme (PRGF) approved

Enterprises, infrastructure, finance and social reforms

1993
Dec Competition law adopted

1994
Jun Law on mortgages adopted

1995
Aug Banking regulations adopted

1996
Jul Electricity tariffs reduced below average cost

1998
Apr Banking regulations amended
May New banking law adopted

1999
Apr Major bank liquidated
Jul Financial audit of state banks completed
Sep Road link to China completed
Oct Decree prohibiting National Bank from direct lending issued

2000
Jan Prudential regulations on banks tightened
Feb Directed credits by NBT renewed
Oct Energy and transport sector restructured
Oct Anti-monopoly agency established

2001
Mar Public audit office established

2002
Apr New telecommunications law adopted
May Poverty Reduction Strategy Paper adopted

2003
Mar Capital amnesty granted

… and little progress has been made on the restructuring of TADAZ.
One of the important conditions under the World Bank's second Structural Adjustment Credit (SAC II) was an IAS audit of the aluminium smelter TADAZ, the country's largest firm, and the development of an action plan for its restructuring. The action plan has been drafted and has received World Bank approval, but it remains unclear how foreign investment will be attracted. The IAS audit has been delayed significantly due to disagreements between the government and the accounting firm chosen to perform the audit. These problems, however, were resolved in early 2003. Overall, progress on the restructuring has been slow.

Infrastructure

Utility prices increasing.
In recent years, the fiscal deficit has declined while the quasi-fiscal deficit has remained large, owing to low tariffs and collection rates that were sustained by arrears and capital depreciation. To correct this trend, the authorities have started to increase utility tariffs and collection rates. Prices for electricity went up by 200 per cent in early 2003 and gas tariffs were raised by 21 per cent in April 2003, and 11 per cent in July 2003, nearing cost recovery levels. The collection rate for non-household users has increased to nearly 100 per cent, but for households it remains at only 30 per cent. In the telecommunications sector, local call and related charges were raised three times between June 2002 and January 2003 by a total of 160 per cent, while collection rates are nearly 90 per cent of total billings. A new billing system will be implemented with the completion of the digital switching network by the end of 2003. Alongside tariff increases, the authorities have also introduced a compensation scheme to protect low-income households.

Tajikistan set to expand power generation capacity.
Tajikistan has vast hydro electric potential, but currently only about 85 per cent of domestic demand for electricity is met. The country still needs to import electricity from Uzbekistan in winter, when hydro generation is low. The government is seeking investors to finance the completion of several hydro electric power plants. In October 2002 the government signed a contract with the Baltic Construction Company of Russia for an investment of US$ 100 million in the Rogun hydro electricity plant.

Financial institutions

Capital amnesty brings in significant sums, but highlights banking sector weakness.
The government decreed a two-month capital amnesty from April 2003 aimed at bringing some of the estimated large private holdings of cash into the banking system and making it available for investments in the economy. After a ten day extension, approximately US$ 170 million were legalised, but most of the deposited money was withdrawn from the banks shortly after it was declared. While the amnesty has had some positive impact on the domestic deposit base, the large withdrawals highlight the lack of trust in the domestic banking system. Moreover, the amnesty has raised concerns in respect of money laundering and the incentives for tax evasion.

Restructuring of largest banks progressing.
The National Bank of Tajikistan (NBT) has prepared restructuring plans for the two largest banks. Agroinvestbank (AIB), the largest commercial bank, was separated into two corporate entities, responsible for cotton and non-cotton finance. Moreover AIB was recapitalised with long-term government bonds against the large amount of outstanding non-performing cotton loans. The state-owned Amonatbank, which has been serving as a fiscal agent for the government, started operating as a commercial entity. The bank has returned to profitability after local authorities began paying fees for banking services. The NBT itself is undergoing restructuring, with a focus on improving administrative controls, centralising all accounting functions and reducing staff levels by 20 per cent. To improve the governance structure and enhance the effectiveness of monetary policy, a Monetary Policy Committee made up of representatives from the Ministry of Finance, Ministry of State Revenues and Customs and the NBT was established in early 2003. The Committee has sole responsibility for designing and overseeing the implementation of monetary policy.

Social reform

Tajikistan secures significant new donor pledges, against the promise of more reform.
During the fourth Consultative Group meeting in Dushanbe in May 2003, multilateral and bilateral donors pledged US$ 900 million over the next three years, two-thirds of which are in grants. Although this amount is more than twice that secured at the last consultative meeting held in Tokyo in 2001, less than half of the earlier pledges (excluding the World Bank) had been disbursed by May 2002. Donor pledges are largely based on the Poverty Reduction Strategy Paper (PRSP) approved in July 2002. This strategy focuses on improving social conditions (health, education and poverty), infrastructure, governance and public services. However, donors have made it clear that they expect greater prioritisation and improved implementation capacity before making good on their financial commitments.

Liberalisation

Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Stabilisation

Share of general government tax revenue in GDP – **14.7 per cent**
Exchange rate regime – **managed floating**

Privatisation

Primary privatisation method – **direct sales**
Secondary privatisation method – **MEBOs**
Tradability of land – **limited de facto**

Enterprises and markets

Competition Office – **yes**

Infrastructure

Independent telecoms regulator – **yes, limited**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector

Capital adequacy ratio – **12 per cent**
Deposit insurance system – **no**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform

Share of the population in poverty – **50.8 per cent (1998)**
Private pension funds – **no**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Number of goods with administered prices in EBRD-15 basket	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	58.9	52.7	44.7	47.9	36.2	33.4	38.3	32.7	na
Share of trade in GDP (in per cent)	241.8	147.8	138.5	99.4	125.1	163.7	135.2	126.6	na
Tariff revenues (in per cent of imports)	1.2	0.7	2.4	2.2	2.1	1.8	2.8	2.4	na
EBRD index of price liberalisation [1]	3.3	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
EBRD index of forex and trade liberalisation	2.0	2.0	2.0	2.7	2.7	3.3	3.3	3.3	3.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	1.5	1.7	2.3	2.8	3.6	4.6	4.8	5.8	na
Private sector share in GDP (in per cent)	25.0	30.0	30.0	30.0	40.0	40.0	45.0	50.0	na
Private sector share in employment (in per cent)	53.0	55.0	58.0	57.0	63.0	60.0	62.8	65.3	na
EBRD index of small-scale privatisation	2.0	2.0	2.3	3.0	3.0	3.3	3.7	3.7	3.7
EBRD index of large-scale privatisation	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3	2.3
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP) [2]	8.4	0.7	1.1	0.6	0.8	0.7	0.5	0.5	na
Share of industry in total employment (in per cent)	9.9	10.5	9.2	8.2	7.7	6.9	7.2	na	na
Change in labour productivity in industry (in per cent)	-3.2	-23.1	8.0	19.8	16.8	21.2	5.7	na	na
Investment rate/GDP (in per cent)	28.7	22.3	16.1	15.4	17.3	11.6	na	na	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.7	1.7	1.7	1.7	1.7	1.7
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	1.7	1.7	1.7
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	4.5 (na)	4.2 (0.0)	3.8 (0.0)	3.7 (0.0)	3.5 (0.0)	3.6 (0.0)	3.6 (0.0)	3.7 (0.2)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	0.0	0.1	0.4	0.4	0.5	0.5	na
Railway labour productivity (1994=100)	121.7	87.3	70.8	75.5	62.9	62.9	57.2	50.3	na
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	na	na	na	na	0.2 (na)	1.7 (65)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.0	1.5	1.7	1.7	1.8	2.3	na	na	na
EBRD index of infrastructure reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.3
Electric power	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Railways	na	na	na	1.0	1.0	1.0	1.0	1.0	1.0
Roads	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Telecommunications	1.0	1.0	1.0	1.0	1.0	1.0	2.3	2.3	2.3
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.7
Financial institutions									
Number of banks (foreign-owned)	18 (na)	23 (na)	28 (5)	20 (5)	20 (3)	17 (4)	17 (3)	17 (2)	na
Asset share of state-owned banks (in per cent)	na	5.3	30.3	29.2	6.9	6.8	4.8	4.5	na
Non-performing loans (in per cent of total loans)	na	2.9	3.0	3.2	15.8	10.8	12.5	na	na
Domestic credit to private sector (in per cent of GDP)	na	4.0	4.8	7.7	10.0	11.3	13.6	11.5	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.7	1.7
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Social sector									
Expenditures on health and education (in per cent of GDP)	3.6	3.5	3.4	3.3	3.1	2.9	3.5	3.5	na
Life expectancy at birth, total (years)	68.3	68.4	68.4	na	na	67.3	66.9	na	na
Basic school enrolment ratio (in per cent)	87.0	85.9	85.8	89.7	89.1	88.5	91.1	na	na
Earnings inequality (GINI-coefficient)	na	na	na	35.0	na	na	na	na	na

[1] New series (see Box 2.1 for explanation).

[2] Data from IMF. Excludes special cotton financing from the National Bank of Tajikistan.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	-12.5	-4.4	1.7	5.3	3.7	8.3	10.3	9.1	8.0
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output	-13.6	-24.0	-2.1	8.1	5.0	10.3	14.4	8.2	na
Agricultural gross output	-25.9	2.0	3.6	6.3	3.8	12.4	11.0	15.0	na
Employment				*(Percentage change)*					
Labour force (end-year)	0.2	-6.0	3.5	0.8	-3.5	0.2	4.3	5.0	na
Employment (end-year)	0.5	-6.6	3.4	0.3	-3.3	0.5	4.8	5.0	na
				(In per cent of labour force)					
Unemployment (end-year) [1]	2.0	2.6	2.8	3.2	3.0	2.7	2.3	2.4	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	609.0	418.0	88.0	43.2	27.6	32.9	38.6	12.2	16.0
Consumer prices (end-year)	2,133.3	40.5	163.6	2.7	30.1	60.8	12.5	14.5	13.0
Producer prices (annual average)	1,080.0	449.0	95.7	27.8	41.2	43.5	28.7	10.1	na
Producer prices (end-year)	628.3	77.7	121.7	5.9	64.0	33.9	9.4	18.8	na
Gross average monthly earnings in economy (annual average)	164.2	219.6	68.3	84.8	35.2	30.6	50.7	33.6	na
Government sector [2]				*(In per cent of GDP)*					
General government balance	-6.1	-5.8	-3.3	-2.7	-2.3	-1.6	-1.1	-0.1	-0.9
General government expenditure	24.4	17.9	15.5	13.9	14.9	15.2	16.3	16.8	na
General government debt	na	70.0	73.0	63.0	83.0	94.0	88.0	77.8	na
Monetary sector				*(Percentage change)*					
Broad money (M3, end-year) [3]	-19.4	93.2	110.7	53.9	39.0	64.5	33.4	37.4	na
Domestic credit (end-year)	na	94.0	201.8	363.6	-6.0	90.2	54.3	20.2	na
				(In per cent of GDP)					
Broad money (M2, end-year) [3]	19.1	8.3	8.6	8.1	7.4	8.6	9.5	8.2	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Monetary policy rate	152.5	72.0	81.0	36.4	20.1	20.6	23.4	21.0	na
Deposit rate (up to 3 months) [4]	100.0	109.0	89.0	15.7	11.4	41.3	25.5	12.1	na
Lending rate (up to 3 months) [4]	500.0	122.0	74.0	49.7	30.6	18.3	21.3	12.1	na
				(Tajik somoni per US dollar)					
Exchange rate (end-year) [5]	0.294	0.328	0.748	0.977	1.436	2.200	2.510	3.000	na
Exchange rate (annual average) [5]	0.104	0.293	0.564	0.777	1.238	1.823	2.383	2.783	na
External sector				*(In millions of US dollars)*					
Current account	-99	-75	-61	-120	-36	-63	-74	-34	-66
Trade balance	-59	-16	-60	-139	-27	-46	-121	-124	-98
Merchandise exports	779	770	746	586	666	788	652	699	766
Merchandise imports	838	786	806	725	693	834	773	823	864
Foreign direct investment, net	10	18	18	25	21	24	9	36	18
Gross reserves, excluding gold (end-year)	4	14	30	65	58	87	96	96	na
External debt stock	869	867	1,106	1,179	1,233	1,226	1,024	985	na
				(In months of imports of goods and services, excluding alumina and electricity)					
Gross reserves, excluding gold (end-year)	0.1	0.3	0.6	1.5	1.7	2.1	1.9	1.8	na
				(In per cent of exports of goods and services, excluding alumina and electricity)					
Debt service	36.1	34.1	15.1	15.7	11.9	17.5	25.6	23.4	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	5.9	5.9	6.0	6.1	6.2	6.2	6.3	6.4	na
GDP (in millions of somoni)	69.8	308.5	632.0	1,025.2	1,345.0	1,806.8	2,512.1	3,344.6	4,050.0
GDP per capita (in US dollar)	114.1	177.0	186.6	216.3	174.1	160.6	167.6	187.4	na
Share of industry in GDP (in per cent) [6]	34.0	25.7	19.7	18.1	19.1	20.4	22.6	19.3	na
Share of agriculture in GDP (in per cent) [6]	36.2	36.0	27.1	19.8	16.8	17.4	26.7	21.1	na
Current account/GDP (in per cent)	-14.8	-7.1	-5.4	-9.1	-3.4	-6.4	-7.0	-2.8	-4.9
External debt - reserves (in US$ million)	865.0	853.0	1,076.0	1,113.7	1,174.9	1,138.8	928.3	888.8	na
External debt/GDP (in per cent)	130.0	82.4	98.7	89.4	113.5	123.7	97.2	81.9	na
External debt/exports of goods and services (in per cent) [7]	217.2	169.1	218.3	290.2	303.7	297.3	321.0	300.3	na

1 Officially registered unemployed. The World Bank estimates the true unemployment rate in 1998 at about 30 per cent of the labour force.

2 Excludes transfers from the state budget to the Pension Fund and Employment Funds.

3 Series before 1998 is for broad money only, subsequently includes foreign currency deposits.

4 Interest rates were set by the parliament until June 1995. Thereafter, rates refer to one to three-month maturity.

5 Both Russian roubles (until 1994) and Tajik roubles (until October 2000) are converted to Tajik somoni.

6 Figures are based on current prices. Variations in the shares reflect changes in relative prices.

7 Export of goods and services excluding alumina and electricity.

Turkmenistan

Key reform challenges

- Reduced state control in all spheres of economic activity is needed to create the basis for sustained private sector-led growth.
- Following a second poor cotton harvest, the authorities should accelerate plans for land reform and reduce state procurement to increase efficiency in agricultural production.
- The expected increase in gas export earnings points to the urgent need for improvements in the transparency and accountability of public finances.

Liberalisation

State control has not diminished.
Rich resource endowments have allowed Turkmenistan to resist calls by the international community to accelerate reforms. In addition, the apparent improvement in economic performance in recent years seems to have encouraged the government to extend rather than reduce its control over all spheres of the economy. Exchange rate restrictions remain in place and the extensive system of subsidisation of the population, through the free provision of basic goods and public services, persists. In addition, the freedom of movement for individuals has been further tightened in the wake of the November 2002 assassination attempt on President Niyazov. Exit visas have been reintroduced and, since March 2003, foreigners wishing to travel to Turkmenistan need to undergo extensive security vetting. In general, the government has created an environment that is not conducive to dissent and continues to censor all media outlets, control access to the Internet and prevent free functioning of independent civil society organisations.

Stabilisation

Gas exports continue to fuel growth and public revenues …
There are no reliable statistics on GDP growth in Turkmenistan, but projected gas production points to an acceleration of growth this year to maybe 9 to 10 per cent. Energy production accounts for around one-third of GDP, a significantly higher share of public revenues and over 80 per cent of total exports. Increased gas export volumes and higher oil prices pushed the trade surplus to US$ 736 million in 2002 and US$ 679 million during the first six months of this year. Improved external performance has failed to reduce the distortions on the foreign exchange market. The parallel market was at TMM 21,600 in September against an official rate of TMM 5,200 to the dollar.

… but opaque fiscal management risks waste these revenues.
Energy export earnings are largely accumulated in the Foreign Exchange Reserve Fund (FERF), under the control of the President. Spending from the fund is discretionary and national wealth is channelled to support questionable infrastructure projects, such as the planned Turkmen lake estimated to cost between US$ 4.5 billion and US$ 6 billion. Moreover, discretionary fiscal spending and repeated directed credits risk undermining price stability, one of the main macroeconomic achievements of the past years. Wages in the public sector were doubled in February 2003 following a similar increase in March 2001, although in practice few employees actually receive these wage increases. Following a large credit injection in June 2001, new subsidised credits of TMM 1 trillion (around 16 per cent of broad money) were provided to the agricultural sector in November 2002. According to official data, the impact on inflation has been muted so far.

Privatisation

Failed cotton crop rekindles plans for land reform.
In July 2003 President Niyazov announced new measures to decrease government interference in crop management and to transfer land ownership to farmers in 5-10 years. However, in August the Council of Elders deferred implementation to 2004. Similar policy directives were issued in 1997, but were never implemented. After recovering to a peak of 1.1 million tonnes in 2001, the cotton harvest declined to 600,000 tonnes last year and is estimated to have fallen further below that level in 2003. Privatisation of industrial enterprises was halted in 2001 and, in October 2002, a further 15-year ban on privatisation in the energy sector was declared.

Enterprise reform

Oil majors stay away from Turkmenistan.
Following the departure of ExxonMobil in mid-2002, due to disappointing drilling results, in April 2003 Shell announced a reduction of operations in the country. This was due to the company seeing no real prospects for

Liberalisation, stabilisation, privatisation

1991

Oct	Independence from Soviet Union declared

1993

Oct	Gas exports to Europe interrupted
Oct	VAT introduced
Nov	New currency (manat) introduced
Nov	Foreign exchange law adopted

1994

May	Small-scale privatisation begins
Aug	State trading monopoly reinforced
Sep	National privatisation programme adopted

1995

Jan	State treasury system introduced
Jul	Flat rate income tax introduced

1996

Jan	Exchange rate unified legally
Jan	Most prices liberalised
May	Barter trade in cotton, oil and wool banned
Aug	First Treasury bill issued
Dec	Land reform decreed

1997

Mar	Gas deliveries halted to non-paying CIS customers
Apr	Large-scale privatisation law adopted

1998

Apr	Exchange rate unified
Sep	Large forex premium on parallel market re-emerges

1999

Jan	Gas exports to Ukraine resumed
Apr	Gas exports to Ukraine interrupted
Dec	Gas export agreement with Gazprom concluded
Dec	Niyazov made President for life
Dec	Soviet-style ten-year plan adopted
Dec	Public sector wages doubled

2000

Nov	Gas exports to Ukraine resumed

2002

Oct	Energy sector privatisation banned for 15 years

2003

Apr	Long-term gas export agreement with Russia reached

Enterprises, infrastructure, finance and social reforms

1992

Jun	Bankruptcy law adopted

1993

Oct	Company legislation enacted
Nov	Two-tier banking system established

1995

Dec	Inter-bank market established

1996

Apr	BIS capital adequacy enacted

1997

Mar	Hydro carbon resources law adopted
Dec	Gas pipeline to Iran opened

1998

Dec	Directed credits officially abolished
Dec	Merger of private and state bank decreed by government
Dec	New civil code adopted

1999

Mar	Gas sale agreement signed with Turkey
Jul	Construction agreement for Trans-Caspian gas pipeline signed
Dec	President Bank created

2000

Jun	Trans-Caspian pipeline consortium (PSG) presence reduced
Jun	Directed credits renewed
Jun	Citizens banned from holding foreign bank accounts
Dec	Private licences for Internet services revoked

2002

May	Trans-Afghan pipeline plans revived
Oct	Correspondent accounts of commercial banks in foreign banks closed

2003

Aug	Construction of new gas pipeline to Russia agreed

significant investments in Turkmenistan. Shell had led a consortium in 1997 to construct a gas pipeline to Turkey and Europe via Iran. This project, however, did not materialise. The company also participated in the Trans-Caspian pipeline (TCP) project, which stalled in 2000 following disagreements with Azerbaijan over the allocation of pipeline capacity. Despite the departure of the majors, however, oil production under PSAs operated by smaller independent companies is set to increase fourfold this year from 0.5 million to 2.6 million tonnes, after doubling last year. Turkmenistan is reportedly making some progress in coming to an understanding with Azerbaijan, Kazakhstan and Russia on the division of the Caspian Sea, but the difficult business environment, including concerns over corruption, is likely to limit foreign investor interest.

Infrastructure

Gas exports to Russia may run into pipeline capacity constraints …
In April 2003 Turkmenistan concluded a 25 year agreement on delivery of gas to Russia, amounting to total deliveries of around 2,000 billion cubic metres (bcm) or 70-80 bcm per annum from 2007. Existing export commitments for 2003 also include 36 bcm to Ukraine, 10 bcm to Russian gas trader Itera, and another 8 bcm to Iran. Apart from the latter, all these exports need to go through the Central Asia Centre (CAC) pipeline route, the capacity of which is just 47 bcm according to its main operator, Russian gas giant Gazprom. Investments of US$ 2 billion overall might restore the CAC to its nameplate capacity of 80 bcm, but much of these investments are needed in Kazakhstan and Uzbekistan. Both countries have either already agreed or plan for significant gas sales to Gazprom through the same pipeline. As an initial signal of the increasing scramble for pipeline capacity, Uzbekistan announced that it might not allow Itera to use the CAC for exports of Turkmen gas to CIS customers. Pipeline capacity constraints give significant market power to Gazprom to press for lower prices for gas exports and could derail the April deal.

… leading to renewed emphasis on alternative routes.
In June 2003 Turkmenistan, Afghanistan and Pakistan, with the Asian Development Bank (ADB) as their strategic partner, approved a detailed plan for the Trans-Afghanistan pipeline project. The route will run 1,500 km to central Pakistan from the Dovletabad field in Turkmenistan. The pipeline will have a capacity of 30 bcm per annum and cost an estimated US$ 2-3 billion. Although some observers maintain that the project remains unviable unless it is extended to India, final agreements on the formation of a consortium to build and finance the pipeline, and arrangements for a gas off-take, are to be signed in October this year. In addition to the Trans-Afghan pipeline, Turkmenistan has mooted the possibility of a new 30 bcm per annum route through western Kazakhstan and southern Russia to Ukraine. The route, which would be built by Ukraine in partial compensation for gas deliveries, would shorten the distance that Turkmen gas must travel to reach Ukraine. There are doubts, however, over Turkmenistan's capacity to produce all the gas needed to fill the proposed pipeline projects.

Financial institutions

State control over the financial system tightened further.
Turkmenistan has many commercial banks, but the financial system is still largely oriented towards the provision of directed credits to state enterprises. These enterprises account for 95 per cent of all loans and are typically refinanced through the Central Bank of Turkmenistan (CBT). The CBT is also the main financing source for the budget deficit, through automatic, non-interest bearing overdrafts provided to the government. The chairman of the CBT was dismissed in September 2002 and a replacement has not been formally appointed yet. President Niyazov has effectively assumed direct control over the CBT, especially over foreign currency transactions. A decree was issued in October 2002 mandating that all commercial banks close their correspondent accounts in foreign banks and make international payments through the network of the CBT or the state bank for foreign economic relations (VEB). From November 2002 the foreign currency of all banks in the country had to be concentrated in the CBT.

Social reform

Despite positive headline rates, growth is not trickling down to the poor.
With expenditures on health and education at 10 per cent of GDP, Turkmenistan spends more on social programmes than most in the CIS. In line with this, UNICEF statistics for 2003 indicate a marked improvement in the infant mortality rate to 20.1 per 1,000 live births in 2001 from 54.7 in 1989. However, official demographic statistics may be overstated. Moreover, rising inequality and the poor state of agriculture mean that increased national income is not trickling down to the poor.

Education of particular concern.
The quality of education is far below international standards and even below those of the Soviet era. Despite high expenditure levels, a severe shortage of teaching materials prevails in most primary and secondary schools and existing text books promote the personality cult around President Niyazov. In 2001, 12,000 teachers were reportedly dismissed and many research institutions including the Academy of Science were shut. Partly in response to high rates of youth unemployment, the government decided in July 2003 that all students must work for two years in the government sector before entering university. Moreover, university education is split into only two years of teaching and two years of practical work experience, reducing further the standard of higher education. This year only 3,880 students have been accepted to university, a tenth of the number before independence.

Liberalisation
Current account convertibility – **limited**
Interest rate liberalisation – **limited de jure**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenue in GDP – **21.8 per cent**
Exchange rate regime – **fixed**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises and markets
Competition Office – **no**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **10 per cent**[1]
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **no**

Social reform
Share of the population in poverty – **44 per cent (1998)**[2]
Private pension funds – **no**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	18.8	18.8	16.7	6.3	6.4	6.0	6.0	6.0	6.0
Number of goods with administered prices in EBRD-15 basket	5.0	5.0	5.0	4.0	4.0	3.0	3.0	3.0	3.0
Share of trade with non-transition countries (in per cent)	31.8	32.4	38.8	72.6	61.0	51.3	59.5	56.8	na
Share of trade in GDP (in per cent)	137.2	140.9	72.7	68.1	125.7	162.2	154.9	132.7	na
Tariff revenues (in per cent of imports)[3]	0.3	0.3	0.4	0.3	0.5	na	na	na	na
EBRD index of price liberalisation [4]	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
EBRD index of forex and trade liberalisation	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.2	0.2	0.2	0.2	0.3	0.6	0.6	0.6	na
Private sector share in GDP (in per cent)	15.0	20.0	25.0	25.0	25.0	25.0	25.0	25.0	na
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	1.7	1.7	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of large-scale privatisation	1.0	1.0	2.0	1.7	1.7	1.7	1.0	1.0	1.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	1.7	0.8	0.6	1.6	na	na	na	na	na
Share of industry in total employment (in per cent)	10.1	10.3	11.2	12.5	12.6	na	na	na	na
Change in labour productivity in industry (in per cent)	14.0	25.9	-39.5	11.4	11.0	33.0	na	na	na
Investment rate/GDP (in per cent)	na	na	38.7	45.5	46.3	39.7	36.9	na	na
EBRD index of enterprise reform	1.0	1.0	1.7	1.7	1.7	1.0	1.0	1.0	1.0
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	7.1 (na)	7.4 (0.0)	8.0 (0.1)	8.2 (0.1)	8.2 (0.1)	8.2 (0.2)	8.0 (0.2)	8.0 (0.2)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	0.0	0.5	0.9	2.3	2.9	3.5	na
Railway labour productivity (1991=100)	34.0	28.7	27.9	27.8	26.9	27.3	26.9	32.7	na
Electricity tariffs, USc kWh (collection rate in per cent)[5]	na	na	na	0.8 (na)	0.5 (na)	0.5 (30)	0.5 (na)	0.5 (63)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.1	1.1	1.0	1.1	1.1	1.4	na	na	na
EBRD index of infrastructure reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Electric power	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Railways	na	na	na	1.0	1.0	1.0	1.0	1.0	1.0
Roads	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Telecommunications	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Financial institutions									
Number of banks (foreign-owned)[6]	67 (3)	68 (4)	67 (4)	13 (4)	13 (4)	13 (4)	13 (4)	13 (4)	na
Asset share of state-owned banks (in per cent)	26.1	64.1	68.3	77.8	96.9	97.1	96.5	95.7	na
Non-performing loans (in per cent of total loans)	11.2	11.4	13.9	2.2	0.5	0.2	0.3	0.3	na
Domestic credit to private sector (in per cent of GDP)[7]	na	5.7	7.8	2.0	1.7	2.4	2.3	2.2	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Social sector									
Expenditures on health and education (in per cent of GDP)	5.1	4.4	8.0	9.8	8.3	10.8	9.7	na	na
Life expectancy at birth, total (years)	65.7	na	65.7	na	na	65.1	64.8	na	na
Basic school enrolment ratio (in per cent)	81.5	81.0	80.6	79.9	78.9	79.7	79.9	na	na
Earnings inequality (GINI-coefficient)	na	na	na	40.8	na	na	na	na	na

1 Calculated with a risk weight of zero for all loans to state-owned enterprises, which are thus assumed to be implicitly guaranteed by the state.
2 1998 estimate.
3 Refers to differential excise taxes on imports; Turkmenistan does not levy import tariffs.
4 New series (see Box 2.1 for explanation).
5 Households are entitled to a free electricity allowance of 35 kWh per family member per month; excess usage is charged at just under 1 US cent per kWh (at the official exchange rate).
6 The number of banks until 1997 includes all branches of Agricultural Bank. In 1998 these were unified into one Agricultural Bank.
7 Manat credit to state-owned and private firms.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure	*(Percentage change in real terms)*								
GDP	-7.2	-6.7	-11.3	7.0	16.5	17.6	11.8	5.1	9.7
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na	na	na
Exports of goods and services	-4.2	-14.9	-41.1	-18.6	61.7	101.6	na	na	na
Imports of goods and services	-4.3	-14.2	-6.4	9.9	10.9	14.9	20.1	na	na
Industrial gross output	21.4	30.7	-33.0	25.8	13.0	29.0	13.6	5.9	na
Agricultural gross output	4.5	-45.2	123.7	8.7	35.0	17.0	8.0	-6.6	na
Employment	*(Percentage change)*								
Labour force (end-year)	9.2	-0.1	0.2	5.5	-1.6	3.1	5.0	2.6	na
Employment (end-year)	5.0	1.8	2.0	1.3	0.7	na	na	na	na
	(In per cent of labour force)								
Unemployment [1]	na	na	na	na	na	na	na	na	na
Prices and wages	*(Percentage change)*								
Consumer prices (annual average)	1,005.3	992.4	83.7	16.8	24.2	8.3	11.6	10.6	9.6
Consumer prices (end-year)	1,261.5	445.8	21.5	19.8	21.2	7.4	11.7	7.8	11.1
Producer prices (annual average)	na	na	na	na	na	na	na	na	na
Producer prices (end-year)	1,293.0	na	na	10.3	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	639.8	757.1	220.0	46.3	21.9	60.3	35.0	30.0	na
Government sector [2]	*(In per cent of GDP)*								
General government balance	0.4	0.3	-0.2	-2.6	0.0	0.3	1.0	-2.7	-1.5
General government expenditure	20.1	16.3	25.0	24.6	22.6	28.8	24.2	24.5	na
General government debt	na	na	na	na	na	na	na	na	na
Monetary sector	*(Percentage change)*								
Broad money (M3, end-year)	448.0	411.7	81.2	83.2	22.6	81.9	17.5	15.0	na
Domestic credit (end-year)	402.8	1,389.3	88.4	77.8	24.6	24.4	15.0	15.0	na
	(In per cent of GDP)								
Broad money (M3, end-year)	18.8	8.1	10.2	14.9	14.9	20.3	17.6	16.6	na
Interest and exchange rates	*(In per cent per annum, end-year)*								
Refinance rate	15.0	105.0	35.0	30.0	27.0	20.0	12.0	12.0	na
Inter-bank market rate	55.0	121.4	45.2	30.0	27.0	15.0	7.7	7.0	na
Deposit rate (1 year) [3]	80.0	130.0	41.1	24.2	27.1	na	na	na	na
Lending rate (1 year) [3]	70.0	200.0	52.6	58.6	41.8	11.3	na	na	na
	(Manats per US dollar)								
Exchange rate (end-year) [4]	2,442	5,126	5,222	8,148	8,200	9,790	10,060	10,150	na
Exchange rate (annual average) [4]	240	3,546	4,627	5,500	8,524	9,013	10,158	10,094	na
External sector	*(In millions of US dollars)*								
Current account	24	2	-608	-952	-583	386	-74	167	439
Trade balance	441	304	-259	-539	-210	644	325	737	1,039
Merchandise exports	2,084	1,692	743	597	1,162	2,383	2,526	2,856	3,370
Merchandise imports	1,644	1,388	1,003	1,136	1,372	1,739	2,201	2,119	2,331
Foreign direct investment, net	233	108	108	62	125	126	170	100	100
Gross reserves, excluding gold (end-year) [5]	1,165	1,172	1,285	1,379	1,555	1,808	2,055	1,992	na
External debt stock	550	668	1,356	1,749	2,047	2,230	2,400	2,550	na
	(In months of imports of goods and services)								
Gross reserves, excluding gold (end-year) [5]	5.8	7.0	9.2	9.0	9.1	9.3	8.8	8.5	na
	(In per cent of exports of goods and services)								
Debt service	11.7	13.6	28.1	41.0	38.6	18.7	30.9	18.6	na
Memorandum items	*(Denominations as indicated)*								
Population (end-year, million)	4.6	4.7	4.9	5.0	5.2	5.4	5.6	5.8	na
GDP (in millions of manats)	652,000	7,751,700	11,108,800	13,994,000	17,187,245	22,900,000	31,000,000	37,836,315	47,755,609
GDP per capita (in US dollar)	591.9	464.1	495.1	509.9	387.8	473.3	541.1	648.0	na
Share of industry in GDP (in per cent)	62.6	68.8	48.0	44.1	46.1	50.0	50.7	50.0	na
Share of agriculture in GDP (in per cent)	17.2	13.3	21.6	26.0	27.8	27.3	28.8	21.0	na
Current account/GDP (in per cent)	0.9	0.1	-25.3	-37.4	-28.9	15.2	-2.4	4.5	9.2
External debt - reserves (in US$ million)	-615.0	-504.0	70.5	370.0	492.0	422.0	345.0	558.0	na
External debt/GDP (in per cent)	20.2	30.6	56.5	68.7	101.5	87.8	78.6	68.0	na
External debt/exports of goods and services (in per cent)	22.9	33.5	133.5	209.9	150.3	84.2	86.4	81.6	na

Note: Data dissemination by Turkmen authorities has become increasingly restrictive. Recent data are, therefore, subject to considerable uncertainty. Data for 2001 and 2002 are EBRD estimates.

1 Every Turkmen citizen is guaranteed employment. Therefore, official unemployment does not exist. According to a household survey, unemployment was 19 per cent in 1998.

2 Significant off-budget expenditures occur through extra-budgetary funds and direct lending. The overall public sector borrowing requirement was estimated at 8 per cent of GDP in 2001.

3 Deposit and lending rates are quoted for legal entities at joint-stock banks. For 1996-99 data are average for loans and deposits of three to six months maturity. Lending and deposit rates for 1995 are the highest of the total range. All interest rates are annual uncompounded.

4 Turkmenistan operates a dual exchange rate system. The series refers to a weighted average between the official exchange rate and the commercial rate, given as the buying rate offered at commercial banks until September 1998 and the black market rate thereafter. Weights are variable depending on the relative size of official and shuttle trade.

5 Foreign exchange reserves of the Central Bank plus the foreign exchange reserve fund.

Ukraine

Key reform challenges

- Encouraging progress has been made to lower corporate and income tax rates with effect from 2004. Further action to limit VAT exemptions and payment arrears is required to preserve the revenue base.
- Early completion of the WTO accession negotiations would contribute to the further integration of Ukraine into the world trading system. Separate negotiations on a common economic area with Russia, Belarus and Kazakhstan should not be allowed to slow the progress towards WTO accession.
- To stimulate FDI, the government and the parliament need to speed up privatisation under transparent procedures and adopt a suitable law on joint-stock companies, thereby promoting stronger corporate governance.

Liberalisation

Negotiations on WTO accession advance …
By September 2003 the government had signed 15 bilateral protocols on market access, necessary for WTO accession. These include the signing of an agreement with the EU in March 2003. Several bilateral agreements, however, have yet to be concluded, including one with the United States. In May, the US Trade Representative announced that Ukraine remained on its list of countries which had seriously violated intellectual property rights, especially in the production of optical media products. In addition, further rounds of multilateral negotiations are likely to focus on the limits of state support, especially for sectors such as agriculture and auto production. Negotiations are also expected to cover the compatibility of domestic legislation with the WTO requirements, including the opening of foreign bank subsidiaries in Ukraine. In June the government permitted some regional authorities to impose temporary price controls to minimise the impact of the low grain harvest on food prices.

… and continue on the formation of a common economic area.
In September 2003 the government agreed to establish a common economic area (CEA) with Russia, Belarus and Kazakhstan following an initial agreement between the Presidents of the four countries, negotiated earlier in the year. Although the CEA envisages closer economic integration between the four countries, Ukraine has indicated its main interest is in the creation of a free trade zone. The implications for Ukraine's accession to the WTO are unclear.

Stabilisation

Significant progress with tax reform.
The President approved important changes to both corporate tax and income tax, which will take effect from the beginning of 2004. The rate of corporate tax was lowered from 30 to 25 per cent and depreciation allowances were enhanced. The new law on income tax introduces a flat rate of 13 per cent (15 per cent from 2007) to replace the former progressive tax system. Although the parliament in June approved a reduction in the VAT rate from 20 to 17 per cent, the President subsequently vetoed the bill. The government expects that the overall reduction in tax rates will increase incentives and reduce the size of the shadow economy (estimated at over 40 per cent of the official economy, according to the Ministry of the Economy), thus broadening the tax base. However, without further action to abolish the remaining tax exemptions and lower the burden of social taxes, the revenue base will not be maintained.

Privatisation

Some progress with both large and small-scale privatisation.
The State Property Fund (SPF) plans to sell shares in 37 large industrial entities, with the aim of generating receipts of HR 2.15 billion (US$ 400 million) in 2003. By the end of August, total receipts were HR 1.6 billion (US$ 310 million). Almost half of this was made up of proceeds from the sale of Ukrtelecom's majority stake in Ukraine Mobile Communications (UMC) to Russia's largest mobile telephone company. However, in a number of other cases, progress has been affected by limited interest from investors and legal disputes. Small-scale privatisation, which in recent years has focused on the sale of social facilities which used to belong to larger entities, is nearing completion. During the first seven months of 2003 only 617 enterprises were privatised, compared with more than 4,000 per year in recent years.

SPF proposes completion of large-scale privatisation by 2008.
The SPF published its programme to complete large-scale privatisation by 2008. There are over 14,900 companies in which the state retains a stake. The measures will include a reduction in the number of companies legally prohibited from privatisation. The programme also includes measures to simplify privatisation procedures, as well as an attempt to limit "shadow" privatisation (the sale of assets to meet creditors' claims). However, in both June and September 2003 the Rada failed to approve the plan, in part due to disagreements over privatisation in certain sectors, including oil and gas.

Liberalisation, stabilisation, privatisation

1997

Apr	Full current account convertibility introduced
Jun	Export surrender requirement revoked
Jul	New corporate tax rate introduced
Oct	VAT rate changed

1998

Mar	Limits on auto imports imposed
Sep	Foreign exchange restrictions re-introduced
Sep	Currency band widened
Sep	Domestic debt rescheduling starts
Dec	Agricultural sector given VAT exemption

1999

Feb	Currency band widened further
Mar	Interbank currency market liberalised
Jun	New Central Bank law approved
Dec	Presidential decree on reform of agricultural collectives issued

2000

Feb	Introduction of floating exchange rate regime confirmed
Mar	Commercial debt rescheduling agreement signed

2001

Jan	National programme for SME support initiated
Jan	VAT exemption for agricultural products extended
Feb	Law on settlement of tax liabilities signed
Jul	External debt restructuring agreement signed
Jul	Budget code enacted

2002

Feb	Amended law on competition policy enacted
Jul	Revised customs code signed by President
Jul	Law on grain market approved
Dec	Introduction of customs code delayed until 2004

2003

Feb	Amendments to corporate tax law approved
Jul	Law introducing flat rate of income tax signed

Enterprises, infrastructure, finance and social reforms

1996

Mar	Grado Bank placed under forced administration

1997

Mar	Land code amended
Aug	First sovereign Eurobond issued

1998

Jan	IAS introduced for commercial banks
May	Limits on foreign ownership of banks lifted

1999

Apr	Utility tariffs increased
Jul	Law on concessions adopted
Aug	Presidential decree on privatisation of electric power utilities issued
Oct	Law on production sharing agreement adopted

2000

Jan	New bankruptcy law adopted
Feb	Law providing tax breaks to joint ventures repealed
Jun	Law on payments reform in the electricity sector adopted
Jul	Law on telecommunications privatisation enacted
Jul	Presidential decree on development of the banking sector issued
Oct	Rights of minority shareholders improved, following adoption of Securities Commission regulation
Dec	Law on banks and banking approved by Rada
Dec	Chernobyl nuclear plant closed

2001

Apr	Majority stakes in six power utilities sold to strategic investors
Apr	Law on mutual investment institutions adopted
Jul	Licence of Bank Ukraina withdrawn
Jul	Presidential decree on measures to improve investment climate issued
Sep	Law on individual deposit insurance adopted
Dec	Poverty alleviation strategy approved

2002

Jan	Land code adopted
Dec	FATF recommends introduction of sanctions on money laundering
Dec	Law on prevention of money laundering signed (effective June 2003)

2003

Feb	FATF recommends removal of sanctions
Mar	Revised civil and commercial codes approved
Jul	Laws on mortgage lending signed
Aug	Laws on pension reform signed

Enterprise reform

New civil and commercial codes approved …

The revised civil and commercial codes, signed by the President in March, will take effect at the beginning of 2004. Although some ambiguities with regard to the articulation of these two codes and existing legislation remain, they mark an improvement over previous legislation, enhancing protection of property rights and, in general, providing a more market-friendly legal framework. According to a survey of 300 enterprises, conducted during the first quarter of 2003 by the Institute for Economic Research, the unfavourable regulatory environment has been an impediment to the business environment for 40 per cent of those surveyed. The main reason was the high regulatory burden, although corruption was also a factor.

… but progress remains slow in establishing institutional framework.

There has been little progress in strengthening corporate governance, in particular the rights of minority shareholders, with the new draft law on joint-stock companies yet to be adopted. The number of bankruptcy cases resulting in completion has increased since the law was revised in 2000, indicating that insolvency is being used more actively. However, weaknesses remain in the implementation of the law, especially in relation to enterprises where the state owns 25 per cent or more.

Infrastructure

Preparations for the privatisation of the main power and telecom utilities continue …

The main obstacle to the privatisation of the power distribution companies remains their outstanding debts to the Energomarket, estimated at HR 15.3 billion (US$ 2.9 billion) by end-June 2003. The Rada is currently considering legislation to restructure these debts. Meanwhile, collection rates in the Energomarket remain high, amounting to over 97 per cent by the end of July 2003, almost all of which is cash. The delays to the privatisation of Ukrtelecom have reflected adverse market conditions and the lack of a suitable regulatory framework. Although the Rada approved a new telecommunications law in July 2003, which provides for the establishment of an independent regulator, the President vetoed the law. The government has clarified the criteria for strategic investors who would participate in the eventual privatisation.

… but progress in other infrastructure sector remains slow.

The pace of reform in other infrastructure sectors, especially with respect to raising tariffs towards cost recovery levels and strengthening regulatory institutions, remains slow. However, in the water sector the State Committee on Public Utilities now has the right to license water companies in cities with populations in excess of 100,000. Both the World Bank and the EBRD are involved in the sector, though progress partly depends on the development of legislation to permit municipal borrowing.

Financial institutions

Regulation of the financial sector strengthened …

In June 2003 the NBU announced that the capital adequacy ratio for banks would be raised to 10 per cent from March 2004. The Commission for the Regulation of the Market for Financial Services was formally established in December 2002. It will assume responsibility for the regulation of non-bank financial services, including insurance, credit unions, leasing companies and non-state pensions. Previously only the insurance sector was regulated by the Finance Ministry. Separately, in July 2003 the President signed two laws on mortgages, which take effect at the beginning of 2004 and which should lead to the development of a mortgage market.

… and action is being taken to combat money laundering.

The anti-money laundering law took effect in June 2003. Both the NBU and government are currently working to implement the latest recommendations from the Financial Action Task Force (FATF) to ensure that the implementation of the law is in line with international standards. Meanwhile, Ukraine remains on the FATF's list of non-cooperating countries.

Social reform

Three-pillar pension system to be introduced.

An important step towards reform of pensions occurred in August 2003 when the President signed two laws allowing for the eventual introduction of a three-pillar system. The law on compulsory state pension insurance confirms the current retirement age for the basic state pension and also allows for individuals to make voluntary contributions. The law on non-state pension provisions envisages the establishment of private pension funds. The minimum monthly pension was raised to HR 50 (US$ 9.40) from July 2003, although with many groups receiving higher payments, the average monthly pension is estimated to be about HR 140 (US$ 26).

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **31.0 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **MEBOs**
Tradability of land – **limited de facto**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**[1]
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **45.7 per cent (1999)**[2]
Private pension funds – **yes**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	na	na	na	na	na
Share of trade with non-transition countries (in per cent)	40.3	45.5	57.1	53.6	57.4	52.0	49.6	47.5	na
Share of trade in GDP (in per cent)	84.1	79.4	69.9	71.7	82.7	98.1	89.4	88.4	na
Tariff revenues (in per cent of imports)[3]	1.7	1.2	1.9	2.4	2.3	1.9	2.1	2.5	na
EBRD index of price liberalisation [4]	3.7	3.7	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	3.0	3.0	3.0	2.7	3.0	3.0	3.0	3.0	3.0
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	1.4	1.7	1.8	2.3	2.9	4.3	5.5	6.0	na
Private sector share in GDP (in per cent)	45.0	50.0	55.0	55.0	55.0	60.0	60.0	65.0	na
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	2.0	3.0	3.3	3.3	3.3	3.3	3.3	3.7	4.0
EBRD index of large-scale privatisation	2.0	2.0	2.3	2.3	2.3	2.7	3.0	3.0	3.0
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)[5]	5.8	6.5	5.0	na	na	1.4	na	na	na
Share of industry in total employment (in per cent)	26.2	25.6	24.6	21.2	19.7	19.3	18.5	na	na
Change in labour productivity in industry (in per cent)	-4.5	2.5	9.0	2.1	13.4	19.1	20.0	na	na
Investment rate/GDP (in per cent)	23.3	20.7	19.8	19.3	17.5	20.3	20.4	na	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	2.0	2.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	16.1 (0.0)	18.1 (0.1)	18.5 (0.1)	19.1 (0.2)	19.9 (0.4)	20.7 (1.6)	21.2 (4.4)	21.2 (4.4)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	2.7	3.9	5.8	7.3	11.9	14.7	na
Railway labour productivity (1989=100)	46.1	40.7	42.4	42.2	41.7	44.9	46.5	49.9	na
Electricity tariffs, USc kWh (collection rate in per cent)	na (65)	2.46 (70)	3.13 (80)	2.89 (79)	2.25 (84)	2.0 (na)	2.21 (78)	2.6 (83.3)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.2	1.1	1.2	1.2	1.3	1.4	na	na	na
EBRD index of infrastructure reform	1.0	1.0	1.7	1.3	1.3	2.0	2.0	2.0	2.0
Electric power	2.0	2.0	2.0	2.3	2.3	3.0	3.3	3.3	3.3
Railways	na	na	na	1.0	1.0	2.0	2.0	2.0	2.0
Roads	1.0	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0
Telecommunications	1.0	1.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Water and waste water [6]	1.0	1.0	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Financial institutions									
Number of banks (foreign-owned)	230 (1)	229 (6)	227 (12)	175 (12)	161 (15)	154 (14)	152 (16)	na	na
Asset share of state-owned banks (in per cent)	na	na	13.5	13.7	12.5	11.9	11.8	na	na
Non-performing loans (in per cent of total loans)[7]	na	na	na	34.6	34.2	32.5	na	na	na
Domestic credit to private sector (in per cent of GDP)	1.5	1.4	2.5	7.8	8.6	9.9	11.9	na	na
Stock market capitalisation (in per cent of GDP)[8]	na	na	7.4	1.9	4.5	6.0	3.6	7.5	na
EBRD index of banking sector reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	10.0	8.7	9.5	6.5	5.3	5.9	6.5	8.0	na
Life expectancy at birth, total (years)	67.1	67.3	67.3	68.2	68.2	68.2	68.2	na	na
Basic school enrolment ratio (in per cent)	90.8	91.2	90.7	89.9	89.9	91.7	93.7	na	na
Earnings inequality (GINI-coefficient)	na	41.3	40.6	39.1	42.7	46.2	45.2	na	na

1 Capital adequacy ratio to be increased to 10 per cent from March 2004.
2 Based on an international poverty line. The poverty rate based on the national poverty line is 26.7 per cent.
3 Refers to taxes on international trade and transactions.
4 New series (see Box 2.1 for explanation).
5 Refers to consumer and producer subsidies.
6 Series has been corrected for ratings after 1997.
7 Changes in non-performing loans data compared with previous *Transition Reports* are due to the change of loan categories included in non-performing loans (see definitions).
8 Data from Stock Market Survey.

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	*Projection*
Output and expenditure				*(Percentage change in real terms)*					
GDP	-12.2	-10.0	-3.0	-1.9	-0.2	5.9	9.2	4.8	5.5
Private consumption	5.1	-9.5	-1.6	1.3	-2.2	2.3	8.9	5.1	na
Public consumption	-0.3	-5.4	-2.3	-3.5	-7.9	1.0	10.4	-0.7	na
Gross fixed capital formation [1]	-11.3	-25.7	2.1	2.6	0.1	12.4	6.2	4.9	na
Exports of goods and services	-16.9	16.9	-5.4	1.2	-2.2	21.5	3.5	9.1	na
Imports of goods and services	20.0	15.8	-4.6	2.0	-16.7	23.8	6.0	3.7	na
Industrial gross output	-12.0	-5.1	-0.3	-1.0	4.0	12.4	14.2	7.0	na
Agricultural gross output	-3.6	-9.5	-1.8	-9.6	-6.9	7.6	10.2	1.9	na
Employment				*(Percentage change)*					
Labour force (end-year)	2.4	-0.7	-0.5	-5.3	0.3	0.1	-0.7	-0.7	na
Employment (end-year)	3.0	-2.1	-2.7	-1.1	-1.6	-3.3	-0.9	na	na
				(In per cent of labour force)					
Unemployment (end-year)	0.3	1.3	2.3	3.7	4.3	4.2	3.7	3.8	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	377.0	80.0	15.9	10.6	22.7	28.2	12.0	0.8	5.1
Consumer prices (end-year)	181.7	39.7	10.1	20.0	19.2	25.8	6.1	-0.6	7.1
Producer prices (annual average)	488.0	52.0	7.7	13.2	32.0	20.9	8.9	3.0	na
Producer prices (end-year)	172.0	17.3	5.0	35.1	15.7	20.8	0.9	5.7	22.8
Gross average monthly earnings in economy (annual average)	483.9	71.4	13.3	7.1	6.6	29.2	35.2	20.9	na
Government sector [2]				*(In per cent of GDP)*					
General government balance	-6.1	-3.2	-5.4	-2.8	-2.4	-1.3	-1.6	0.5	-1.0
General government expenditure	37.8	39.9	44.2	38.4	34.2	34.7	35.1	35.9	na
General government debt	26.7	25.0	30.1	37.6	50.7	45.1	37.5	34.7	na
Monetary sector				*(Percentage change)*					
Broad money (M3, end-year)	na	35.1	33.9	25.2	40.6	45.3	42.0	41.7	41.0
Domestic credit (end-year)	191.2	42.3	32.5	58.0	30.5	23.1	18.7	28.9	na
				(In per cent of GDP)					
Broad money (M3, end-year)	12.7	11.5	13.4	15.3	16.9	18.9	22.3	29.2	37.1
Interest and exchange rates				*(In per cent per annum, end-year)*					
Refinancing rate	110.0	40.0	35.0	60.0	45.0	27.0	12.5	7.0	na
Treasury bill rate (3-month maturity) [3]	164.0	51.0	22.1	40.4	45.0	18.0	16.6	5.5	na
Deposit rate [4]	70.0	33.6	18.2	22.3	20.7	13.7	11.0	7.9	na
Lending rate [4]	123.0	79.9	49.1	54.5	55.0	41.5	32.3	25.4	na
				(Hryvnas per US dollar)					
Exchange rate (end-year) [5]	1.79	1.89	1.90	3.43	5.22	5.44	5.29	5.33	na
Exchange rate (annual average) [5]	1.47	1.83	1.86	2.45	4.13	5.44	5.37	5.33	na
External sector				*(In millions of US dollars)*					
Current account	-1,152	-1,185	-1,335	-1,296	1,658	1,481	1,402	3,173	2,530
Trade balance	-2,702	-4,296	-4,205	-2,584	244	779	198	710	370
Merchandise exports	14,244	15,547	15,418	13,699	13,189	15,722	17,091	18,669	19,750
Merchandise imports	16,946	19,843	19,623	16,283	12,945	14,943	16,893	17,959	19,380
Foreign direct investment, net	257	516	581	747	489	594	769	698	850
Gross reserves, excluding gold (end-year)	1,051	1,960	2,374	795	1,094	1,505	3,089	4,417	5,500
External debt stock [6]	7,941	8,839	9,634	11,093	12,482	10,349	10,118	10,191	9,990
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	0.7	1.1	1.3	0.5	0.9	1.0	1.8	2.5	2.9
				(In per cent of exports of goods and services)					
Debt service [7]	8.0	6.6	7.5	11.2	16.6	10.4	6.7	5.4	7.9
Memorandum items				*(Denominations as indicated)*					
Population (end-year, million)	51.5	51.3	50.9	50.5	50.1	49.3	49.0	48.7	na
GDP (in millions of hryvnas)	54,516	81,519	93,365	102,593	130,442	170,070	204,190	220,932	244,971
GDP per capita (in US dollar)	720	869	985	828	631	634	776	851	na
Share of industry in GDP (in per cent)	34.4	na	29.7	25.2	27.2	26.7	27.1	30.5	na
Share of agriculture in GDP (in per cent)	14.5	12.2	12.4	11.9	11.7	14.4	14.4	13.4	na
Current account/GDP (in per cent)	-3.1	-2.7	-2.7	-3.1	5.2	4.7	3.7	7.7	5.5
External debt - reserves (in US$ million)	6,890	6,879	7,260	10,298	11,388	8,844	7,029	5,774	na
External debt/GDP (in per cent)	21.4	19.8	19.2	26.5	39.5	33.1	26.6	24.6	na
External debt/exports of goods and services (in per cent)	46.5	43.4	47.3	63.0	73.2	53.0	48.0	43.6	na

1 Includes changes in inventories. Disaggregated data on gross fixed capital formation are not available.

2 General government includes the state, municipalities and, from 1994, extra-budgetary funds. Data are on a cash basis until 1995 and on an accrual basis thereafter.

3 Treasury bills were introduced in March 1995.

4 Weighted average over all maturities.

5 The hryvna replaced the karbovanets in September 1996, but the rates prior to 1996 are shown in hryvna for convenience.

6 Public and publicly guaranteed debt only.

7 Refers to payment due on public debt only.

Uzbekistan

Key reform challenges

- **Further measures to open the economy to effective competition are needed, including the reduction of trade barriers, improvements to the protection of private property rights and the reduction of state interference at all levels.**
- **The action plan for convertibility must be implemented if the government's credibility is not to be further impaired. The plan alone, however, will have limited impact unless restrictions on access to cash are abolished and measures are taken to introduce a market-based allocation of credit.**
- **The reduction of quasi-fiscal deficits in the banking system and in the energy sector is critical to promote an internationally competitive private sector and to support trade and foreign exchange liberalisation.**

Liberalisation

Government publishes action plan to achieve convertibility by end-2003 ...
The government has missed several deadlines for current account convertibility in the past. Since early 2002, however, the authorities have managed to progressively reduce the black market premium to below 10 per cent. This has been largely achieved through tight monetary policy, including restrictions on access to cash. Following an IMF mission in June 2003, the authorities have committed themselves, in a published action plan, to abolishing all remaining restrictions on foreign exchange for current account transactions (in line with the obligations under the IMF's Article VIII sections 2a, 3 and 4) by end-2003. Export and import pre-payment restrictions were abolished in July, although the requirement to pre-register all import contracts with the Agency for Foreign Economic Relations remains in place.

... but trade barriers erected to protect domestic producers.
In the past, the government has collected significant implicit taxes by converting export receipts at an overvalued exchange rate. Recently, however, it has turned to an alternative method of generating rents by increasing the level of protection on the domestic market. This includes a combination of raising various trade barriers and restrictions against shuttle traders and increased capital requirements for private wholesale traders. Effective rates of protection are well above 100 per cent for many consumer goods, creating significant implicit subsidies for domestic producers and those importers able to circumvent official trade controls.

Reforms to state procurement in agriculture still await full implementation.
Under the IMF's Staff Monitored Programme (SMP), state procurement of cotton and grain was changed to 50 per cent of the actual harvest, up from 30 per cent of the (usually over-optimistic) output target. In addition, prices paid by the state to farmers were to be raised close to world market levels. Evidence on implementation is patchy. In the wheat sector, record harvests have brought the share of state procurement down in 2002 and 2003. This year, against an expected harvest of 5.4-5.6 million tonnes, the state target was reportedly set at 2.5 million tonnes. For cotton, state procurement accounted for over 90 per cent of the harvest in 2002, while a reliable forecast for 2003 is not yet available.

Stabilisation

Official data show the current account and the budget in surplus ...
Uzbekistan recorded a 1.7 per cent budget deficit in 2002, while according to official data the budget moved into a 0.5 per cent surplus during the first half of 2003. High cotton and gold prices have raised both fiscal and export revenues, although reports of growing wage and payment arrears from the budget suggest the underlying fiscal position is weaker. The current account recorded a US$ 370 million surplus in the first half of 2003. Exports were up 25 per cent due to higher cotton and gold prices, the sale of an aeroplane to India and the start of gas exports to Russia. Rising external surpluses, however, are the flipside of a stagnant domestic economy.

... but the underlying fiscal and external position is weaker.
Concerns remain that the government has not yet assumed the full cost of subsidies to ailing large industrial enterprises, including debt service on government-guaranteed foreign loans. According to the Ministry of Finance, for 2003, UZS 70 billion (US$ 70 million) has been budgeted for such subsidies, of which UZS 43 billion had already been spent by June. Impaired assets have been building up in the banking system and bank restructuring costs could significantly worsen the reported fiscal position. Underpricing of domestic energy further adds to the deficit in the consolidated public sector. At the same time, excess non-cash liquidity has been accumulating in the banking sector. Should cash and convertibility restrictions be lifted, this could spill over into the currency market and lead to further pressure on the exchange rate. The Central Bank does have, at present, sufficient reserves to accommodate such pressure.

Liberalisation, stabilisation, privatisation

1991
Sep Independence from Soviet Union declared

1994
Jan New currency (som) introduced
May Foreign investment law adopted

1995
May Foreign investment law amended
Oct IMF programme adopted

1996
Jun Privatisation programme adopted
Oct IMF programme suspended

1997
Nov Custom duties and export licensing abolished; tariffs increased
Dec Customs code enacted

1998
Jan Tax code enacted
Feb Import tariffs further increased
Dec Tender for six large enterprises announced

1999
Jan Export surrender increased to 50 per cent
Feb Trade barriers against Kazakh and Kyrgyz imports introduced
Jun Tender for large copper plant cancelled
Jul EU partnership and cooperation agreement adopted
Dec New privatisation programme for 27 large enterprises initiated

2000
May Two administrative exchange rates unified
Jun Access to subsidised hard currency restricted

2002
Apr Cash currency market partially liberalised
Aug Tariffs on consumer goods raised; restrictions against shuttle traders introduced

2003
Jul Further changes to currency market (part of convertibility action plan) introduced

Enterprises, infrastructure, finance and social reforms

1993
- Sep: Securities law adopted

1994
- Apr: Stock exchange established
- May: Bankruptcy law adopted
- Jul: Decree on securities market issued

1995
- Aug: Telecommunications law adopted

1996
- Mar: First Treasury bills issued
- Apr: Banking law adopted
- Apr: Land law amended
- Aug: Bankruptcy law amended

1997
- Mar: Bank accounting standards adopted

1998
- Aug: Law on depositories enacted
- Oct: Presidential decree to reform commercial banks issued

1999
- Apr: Largest commercial bank partially privatised

2000
- Jul: National and international telecommunications companies merged

2001
- Mar: State railway company restructured

2002
- Jan: Utility price adjustments initiated

Privatisation

No major acceleration of privatisation in sight.
Results for the first half of 2003 suggest that the pace of privatisation remains quite slow. While 698 objects were sold, only US$ 22.5 million (0.2 per cent of GDP) was raised. In January, the government issued a decree calling for the sale during 2003-04 of residual state stakes (25 per cent or lower) in existing privatised firms and a reduced role for state-led industrial associations. It is not clear to what extent this has been implemented yet. The bulk of privatised businesses continue to be small-scale, often spin-offs from larger state entities. Some new joint ventures with foreign investors have been created, notably in food processing and in the auto supply industry – both of which benefit from high external protection. Russian investors are increasingly active in these deals, while Western investors are often discouraged by the country's opaque administrative structures, the reluctance of the government to cede effective control and difficulties in repatriating profits and obtaining access to critical inputs.

Enterprise reform

Gradual restructuring of collective farms continues.
Following the transformation of former sovkhozes and kolkhozes into cooperatives (shirkats), whose subdivisions are farmed by extended families, the government is now transforming shirkats into private farms. The former household plots of farm labourers have been turned into peasant farms (dekhan), which have become the main source of dynamism in the agriculture sector. In 2002, 152 shirkats were transformed into private farms, which have grown in number from 60,000 to 82,000 in the last year. However, the government continues to interfere in farmers' decisions on what to grow on their plots, which together with state production targets, the lack of private marketing channels and the dependence on state agencies for most non-labour inputs, limits the incentives and the scope for productivity improvements.

Government harassment and "state capture" are major constraints on private sector.
The government has adopted a clear policy focus on supporting domestic SMEs through simplified tax rules, IFI-financed SME credit lines and exemptions from foreign exchange surrender requirements. SMEs pay just one unified 12 per cent turnover tax in lieu of VAT, profit tax and other taxes. Nonetheless, the domestic private sector has been suffering from increased government harassment, particularly in the trade and services sector. Several key officials are known to be associated closely with domestic business interests, and private entrepreneurs that pose a competitive threat run the risk of being taken over or closed down. Private firms are also restricted in their access to key inputs, which are still centrally allocated, and as in other CIS countries, are restricted by corruption in the government and in the courts. At the same time, state supported showcase projects, such as Uzdaewoo, are facing significant difficulties, often operating at less than a third of capacity.

Infrastructure

Tariff reform begins, but implicit subsidies in the fuel and energy sector remain large.
Under a government plan, household tariffs for water and heating are to rise to cost recovery levels by 2006, and a metering programme to improve collection rates is under way. Municipal governments have also been urged to improve collection. In the power sector, tariffs were raised by 60 per cent in 2002 and another 40 per cent during January-August 2003. These adjustments, however, are far from sufficient to move the sector to full cost recovery. IMF estimates indicate that the quasi-fiscal deficit in the energy sector declined only by around US$ 100 million last year to just under US$ 2 billion (20 per cent of GDP), of which two-thirds fell on the power sector.

Financial institutions

Bank privatisation delayed.
The planned sales of a majority stake in Asaka Bank and 40 per cent of National Bank of Uzbekistan have been delayed by the problem of non-performing state-guaranteed loans on the banks' balance sheets. Acknowledging these losses is politically difficult, although both banks are generously capitalised and should be able to withstand a write-off against their equity. More fundamentally, in the case of bank privatisation, the government would need to move to a market-based allocation of investment and working capital finance, putting further strains on the finances of priority investment projects. Despite the professed policy of tight money, bank lending reportedly increased 36 per cent during the first half of 2003, although to some extent this may reflect capitalisation of interest in arrears. Confidence in the banking system remains low, given restrictions on cash withdrawals and the continued use of banks as agents of the tax administration to enforce timely payment.

Social reform

Government aims to move towards targeted assistance.
Uzbek citizens benefit from an extensive system of social support, including access to cheap public utilities services, a relatively generous pension system and a system of targeted social transfers administered through the local "Malhallas". While the Ministry of Finance acknowledges the need to move away from implicit subsidies to a system of targeted transfers, the Malhalla system has suffered from reduced budget outlays, while implicit subsidies through low public utility tariffs remain high. Some social privileges in the form of reduced tariffs to specific groups (such as teachers) were abolished in spring 2003. The pension system is paid for by the highest payroll taxes in the CIS at 37.5 per cent, down slightly from 39 per cent since 2002.

Liberalisation

Current account convertibility – **limited**

Interest rate liberalisation – **limited de jure**

Wage regulation – **yes**

Stabilisation

Share of general government tax revenue in GDP – **25 per cent**[1]

Exchange rate regime – **managed float**[2]

Privatisation

Primary privatisation method – **MEBOs**

Secondary privatisation method – **direct sales**

Tradability of land – **limited de jure**

Enterprises and markets

Competition Office – **yes**

Infrastructure

Independent telecoms regulator – **no**

Separation of railway accounts – **yes**

Independent electricity regulator – **no**

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Secured transactions law – **yes**

Securities commission – **yes**

Social reform

Share of the population in poverty – **44.2 per cent (1998)**[3]

Private pension funds – **no**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	34.9	47.3	38.2	47.4	53.5	45.3	48.4	48.6	na
Share of trade in GDP (in per cent)	73.2	62.1	69.3	55.7	65.0	79.8	83.3	59.6	na
Tariff revenues (in per cent of imports)[4]	2.6	1.6	1.6	2.3	1.3	1.9	1.6	2.6	na
EBRD index of price liberalisation [5]	3.7	3.7	3.3	2.7	2.7	2.7	2.7	2.7	2.7
EBRD index of forex and trade liberalisation	2.0	2.0	1.7	1.7	1.0	1.0	1.7	1.7	1.7
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	1.6	2.4	2.5	2.6	2.6	2.8	2.9	3.0	na
Private sector share in GDP (in per cent)	30.0	40.0	45.0	45.0	45.0	45.0	45.0	45.0	na
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of large-scale privatisation	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Enterprises									
Budgetary subsidies and current transfers (in per cent of GDP)	3.4	4.0	3.2	3.2	2.9	2.2	2.1	1.9	na
Share of industry in total employment (in per cent)	12.9	12.9	12.8	12.7	12.7	12.7	12.7	12.7	na
Change in labour productivity in industry (in per cent)	-1.6	4.4	6.3	5.3	5.2	1.6	7.2	5.7	na
Investment rate/GDP (in per cent)	24.2	23.0	18.9	10.6	10.8	11.0	11.0	11.0	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	1.7	1.7	1.7	1.7
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	1.7
Infrastructure									
Fixed-line (mobile) penetration rate (per 100 inhabitants)	6.7 (0.0)	6.7 (0.0)	6.5 (0.1)	6.4 (0.1)	6.6 (0.2)	6.7 (0.2)	6.6 (0.3)	6.7 (0.7)	na
Internet penetration rate (per 10,000 inhabitants)	na	na	0.0	0.1	0.1	0.1	0.1	0.1	na
Railway labour productivity (1989=100)	28.1	27.3	26.9	27.1	26.6	34.2	35.5	51.1	na
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	1.7 (na)	1.9 (80)	1.2 (90)	0.7 (na)	na	1.4 (72)	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.1	1.1	1.1	1.0	1.1	1.2	na	na	na
EBRD index of infrastructure reform	1.0	1.0	1.0	1.3	1.3	1.3	1.7	1.7	1.7
Electric power	1.0	1.0	1.0	1.0	1.0	1.0	2.0	2.0	2.0
Railways	na	na	na	2.0	2.0	2.3	3.0	3.0	3.0
Roads	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Telecommunications	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.7	1.7
Financial institutions									
Number of banks (foreign-owned)	31 (1)	29 (2)	30 (4)	33 (4)	35 (5)	34 (6)	na	na	na
Asset share of state-owned banks (in per cent)	38.4	75.5	70.6	67.3	65.8	77.5	na	na	na
Non-performing loans (in per cent of total loans)	0.0	0.0	0.4	0.1	0.1	0.0	na	na	na
Domestic credit to private sector (in per cent of GDP)	na	na	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	na	0.4	0.5	2.1	1.9	1.0	0.6	0.4	na
EBRD index of banking sector reform	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	11.0	11.1	10.4	10.7	10.4	9.3	7.0	9.2	na
Life expectancy at birth, total (years)	69.2	na	69.2	na	na	67.9	67.4	na	na
Basic school enrolment ratio (in per cent)	88.0	88.4	88.9	89.2	88.9	97.0	97.8	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

[1] Including tax revenues of extra-budgetary funds would raise the ratio to 30 per cent of GDP.

[2] Following the unification of the "over the counter" (OTC) and official exchange rates in June 2003 only one official exchange rate exists, but the sum still trades at a discount on the parallel market.

[3] Based on the latest available survey data reported in the World Bank's *World Development Indicators 2003.* See methodological notes for definition. A more recent World Bank living standards assessment from 2000, using an internationally comparable poverty line, reported 27.3 per cent of the population was living below the poverty line.

[4] Refers to custom duties and export taxes.

[5] New series (see Box 2.1 for explanation).

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP [1]	-0.9	1.6	2.5	4.3	4.3	3.8	4.2	4.2	0.5
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output	0.2	6.3	6.5	5.8	6.1	3.5	8.1	8.5	na
Agricultural gross output	2.3	-6.5	5.8	4.0	5.9	3.2	4.5	6.1	na
Employment				*(Percentage change)*					
Labour force (end-year)	3.7	1.4	1.4	1.4	1.0	1.1	1.5	2.4	na
Employment (end-year)	3.7	1.3	1.4	1.4	1.0	1.1	1.5	2.4	na
				(In per cent of labour force)					
Unemployment (end-year) [2]	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	304.6	54.0	70.9	29.0	29.1	25.0	27.2	27.6	12.4
Consumer prices (end-year)	116.9	64.3	50.0	26.1	26.0	28.2	26.4	21.6	11.5
Producer prices (annual average)	499.0	107.0	52.0	48.4	38.0	61.1	42.2	46.0	na
Producer prices (end-year)	217.4	75.4	40.3	48.4	34.5	70.2	44.0	36.7	na
Gross average monthly earnings in economy (annual average)	282.1	102.4	65.7	49.0	33.4	47.4	58.2	32.9	na
Government sector [3]				*(In per cent of GDP)*					
General government balance	-4.1	-7.3	-2.2	-3.3	-2.6	-2.2	-1.5	-1.7	-2.5
General government expenditure	38.7	41.6	32.3	34.3	32.0	30.2	27.4	27.4	na
General government debt	na	23.1	26.6	32.9	50.2	60.9	64.1	52.8	na
Monetary sector				*(Percentage change)*					
Broad money (M3, end-year)	144.3	113.3	45.6	28.1	32.1	37.1	54.3	29.7	na
Domestic credit (end-year)	80.0	188.8	51.2	79.5	34.5	88.8	90.8	40.9	na
				(In per cent of GDP)					
Broad money (M3, end-year)	18.2	21.0	17.5	15.4	13.6	12.2	12.4	10.6	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Refinancing rate	84.0	60.0	48.0	48.0	42.6	26.8	26.8	34.5	na
Treasury bill rate (3-month maturity)	na	36.0	26.0	16.6	na	na	na	na	na
Deposit rate (1 year)	90.0	28.0	14.8	13.1	13.5	18.8	21.2	26.0	na
Lending rate (1 year)	105.0	49.7	28.0	33.1	32.7	27.6	27.6	33.4	na
				(Soms per US dollar)					
Exchange rate (end-year) [4]	39.3	65.7	108.5	178.7	348.4	631.3	937.6	935.3	na
Exchange rate (annual average) [4]	33.0	44.7	90.7	131.8	257.2	483.5	774.8	947.5	na
External sector				*(In millions of US dollars)*					
Current account	-21	-980	-584	-102	-164	216	-113	222	390
Trade balance	237	-706	-72	111	203	494	186	324	700
Merchandise exports	3,475	3,534	3,695	3,049	2,790	2,935	2,740	2,510	2,900
Merchandise imports	3,238	4,240	3,767	2,938	2,587	2,441	2,554	2,186	2,200
Foreign direct investment, net	-24	90	167	140	121	75	83	65	70
Gross reserves, excluding gold (end-year)	815	772	374	533	763	684	678	709	na
External debt stock	2,004	2,357	2,864	3,473	4,777	4,419	4,684	4,763	na
				(In months of imports of goods and services)					
Gross reserves, excluding gold (end-year)	na	2.0	1.0	1.9	2.9	2.8	2.5	3.1	na
				(In per cent of export of goods and services)					
Debt service	na	9.3	13.5	11.1	16.5	25.9	25.4	23.0	na
Memorandum items				*(Denominations as indicated)*					
Population (annual average, million)	22.7	23.1	23.6	24.0	24.3	24.7	24.9	25.6	na
GDP (in millions of soms)	302,787	559,072	976,830	1,416,157	2,128,659	3,255,567	4,925,000	7,469,300	8,437,832
GDP per capita (in US dollar) [5]	404.4	541.0	457.1	448.6	340.5	273.2	255.0	308.4	na
Share of industry in GDP (in per cent)	17.1	17.8	15.6	14.9	14.3	14.2	14.1	14.1	na
Share of agriculture in GDP (in per cent)	28.1	22.4	28.3	26.8	29.0	30.1	30.0	30.6	na
Current account/GDP (in per cent)	-0.2	-7.8	-5.4	-0.9	-2.0	3.2	-1.8	2.8	4.7
External debt - reserves (in US$ million)	1,189	1,585	2,490	2,940	4,014	3,735	4,006	4,054	na
External debt/GDP (in per cent)	21.8	18.8	26.6	32.3	57.7	65.6	73.7	60.4	na
External debt/exports of goods and services (in per cent)	na	61.4	72.9	103.8	154.5	131.5	144.0	159.6	na

[1] Official growth estimates. Independent estimates put growth at around two-thirds of official rates and around 3 per cent for 2002.

[2] Officially registered unemployed. No labour force survey-based estimates available.

[3] Includes extra-budgetary funds, but excludes local government.

[4] Since 1996 dual exchange rates have been in operation. Data show the weighted average of the official exchange rate (40 per cent), the bank rate (30 per cent) and the parallel market rate (30 per cent). Starting from 2001 the weights have changed to the official rate (20 per cent), the so-called "over the counter" (OTC) rate (50 per cent) and the black market rate (30 per cent).

[5] Calculated at the weighted exchange rate. At the official rate, GDP per capita was US$ 380 in 2002.

Methodological notes

Definitions and data sources for country snapshot variable indicators

Liberalisation

Current account convertibility
Options: full (full compliance with Article VIII of IMF Agreement), limited (restrictions on payments or transfers for current account transactions).

Source: International Monetary Fund, International Financial Statistics.

Interest rate liberalisation
Options: full (banks are free to set deposit and lending rates), limited de facto (no legal restrictions on banks to set deposit and lending rates, but limitations arise from substantial market distortions, such as directed credits or poorly functioning or high illiquid money or credit markets), limited de jure (restrictions on the setting of interest rates by banks through law, decree or central bank regulation).

Source: EBRD staff assessments.

Wage regulation
Restrictions or substantial taxes on the ability of some enterprises to adjust the average wage or wage bill upward; options: yes, no.

Source: EBRD staff assessments.

Stabilisation

Share of general government tax revenue in GDP
General government includes central government, extra-budgetary funds and local government.

Source: See the Macroeconomic indicator tables.

Exchange rate regime
Options: currency board, fixed, fixed with band, crawling peg, crawling peg with band, managed float, floating.

Source: International Monetary Fund, International Financial Statistics.

Privatisation

Primary privatisation method since the start of transition
Options: vouchers (distribution of investment coupons at a symbolic price), direct sales (sales to outsiders), MEBOs (management /employee buy-outs), liquidations.

Source: EBRD staff assessments.

Secondary privatisation method since the start of transition
Options and definitions as above.

Source: EBRD staff assessments.

Tradability of land
Options: full (no substantial restrictions on the tradability of land rights beyond administrative requirements; no discrimination between domestic and foreign subjects), full except foreigners (as "full", but with some differential treatment of foreigners), limited de facto (substantial de facto limitations on the tradability of land, for example due to the lack of enforceability of land rights, a non-existent land market, or significant obstruction by government officials), limited de jure (legal restrictions on the tradability of land rights), no (land trade prohibited).

Source: EBRD staff assessments.

Enterprises and markets

Competition Office
Competition or anti-monopoly office exists separately from any ministry, though it may not be fully independent; options: yes, no.

Source: EBRD staff assessments.

Infrastructure

Independent telecommunications regulator
Independent body, but the scope of power may differ across countries; options: yes, no.

Source: EBRD staff assessments.

Separation of railway accounts
Accounts for freight and passenger operations are separated; options: yes, no.

Source: EBRD staff assessments.

Independent electricity regulator
Independent body, but the scope of power may differ across countries; options: yes, no.

Source: EBRD staff assessments.

Financial sector

Capital adequacy ratio
Ratio of bank regulatory capital to risk-weighted assets; regulatory capital includes paid-in capital, retentions and some forms of subordinated debt.

Source: EBRD staff assessments.

Deposit insurance system
Deposits in all banks are covered by a formal deposit insurance scheme; options: yes, no.

Source: EBRD staff assessments.

Secured transactions law
Non-possessory security over movable assets permitted; options: yes, restricted, no.

Source: EBRD regional survey of secured transactions laws.

Securities commission
Securities and exchange commission exists separately from any ministry, although it may not be fully independent; options: yes, no.

Source: EBRD staff assessments.

Social reform

Share of the population in poverty
Percentage of population living on less than US$ 2.15 (at 1993 US$ at PPP) a day per person. Survey year in parenthesis.

Source: World Bank, World Development Indicators.

Private pension funds
Options: yes, no.

Source: EBRD staff assessments.

Liberalisation

Share of administered prices in CPI (in per cent)
Administered prices are defined as those prices subject to regulation by the state.

Sources: EBRD survey of national authorities and IMF country reports.

Number of goods with administered prices in EBRD-15 basket
The EBRD-15 basket consists of flour/bread, meat, milk, gasoline/petrol, cotton textiles, shoes, paper, cars, television sets, cement, steel, coal, wood, rents, intercity bus service.

Source: EBRD survey of national authorities.

Share of trade with non-transition economies (in per cent)
Ratio of merchandise exports and imports with non-transition economies to total trade (exports plus imports).

Source: IMF, Directions of Trade Statistics. Data for CIS countries suffer from under-reporting of intra-CIS trade for the early 1990s and are reported for 1994 onwards only.

Share of trade in GDP (in per cent)
Ratio of exports plus imports to GDP.

Source: See the Macroeconomic indicator tables.

Tariff revenues (in per cent of imports)
Tariff revenues include all revenues from international trade. Imports are those of merchandise goods.

Sources: EBRD surveys of national authorities and IMF country reports.

Definitions and data sources for structural and institutional indicators

Privatisation

Privatisation revenues (cumulative, in per cent of GDP)
Government revenues from cash sales of enterprises, not including investment commitments.

Sources: EBRD survey of national authorities and IMF country reports.

Private sector share in GDP (in per cent)
The "private sector shares" of GDP represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies, as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available.

Sources: EBRD staff estimates, 1994-2000, and IMF staff estimates, 1989-93.

Private sector share in employment (in per cent)
The "private sector shares" of employment represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector employment includes employment in private registered companies, as well as in private entities engaged in informal activity in those cases where reliable information on informal activity is available.

Sources: EBRD staff estimates, 1994-2000, and IMF staff estimates, 1989-93.

Enterprises

Budgetary subsidies and current transfers (in per cent of GDP)
Budgetary subsidies and other current transfers to enterprises, excluding social transfers.

Sources: EBRD and IMF country reports.

Share of industry in total employment (in per cent)
Industry includes electricity, water, power, mining and manufacturing.

Sources: ILO, Labour Statistics Yearbook, UN, National Account Statistics, national statistical publications and IMF country reports.

Change in labour productivity in industry (in per cent)
Labour productivity is calculated as the ratio of industrial production to industrial employment and the changes in productivity are calculated on the basis of annual averages.

Sources: National statistical publications and IMF country reports.

Investment rate/GDP (in per cent)
Gross capital formation (formerly gross domestic investment) consists of additional outlays to the economy's fixed assets, plus net changes in inventory levels. Fixed assets include land improvements (fences, ditches, drains, etc.); plant, machinery and equipment purchases; and the construction of roads, railways, schools, offices, hospitals, private residential dwellings, commercial and industrial buildings etc. Inventories are stocks of goods held by firms to meet temporary or unexpected fluctuations in production or sales and "work in progress". Net acquisitions of valuables are also considered capital formation.

Source: World Bank, World Development Indicators.

Infrastructure

Fixed-line (mobile) penetration rate (per 100 inhabitants)
Fixed line refers to the number of telephone lines connecting a customer to the Public Switched Telephone Network (PSTN). Mobiles refer to the number of cellular mobile telephone subscribers.

Source: International Telecommunications Union.

Internet penetration rate (per 10,000 inhabitants)
Internet penetration rate is calculated as the number of Internet hosts (number of computers directly linked to the worldwide Internet network) per 10,000 inhabitants.

Source: International Telecommunications Union.

Railway labour productivity (1989=100)
Productivity measured as the ratio of the number of traffic units (passenger-kilometres plus freight tonne-kilometres) and the total number of railway employees.

Sources: National authorities and World Bank.

Electricity tariffs, USc kWh (collection rate in per cent)
The average retail tariff; the collection rate is defined as the ratio of total electricity payments received in cash and total electricity charges.

Sources: National authorities and World Bank.

GDP per unit of energy use (PPP in US dollars per Kgoe)
The ratio of GDP in Purchasing Power Parity terms and total energy consumption.

Source: World Bank, World Development Indicators.

Financial institutions

Number of banks (foreign-owned)
Number of commercial and savings banks, excluding cooperative banks. Foreign-owned banks are defined as those with foreign ownership exceeding a 50 per cent share, end-of-year.

Source: EBRD survey of central banks.

Asset share of state-owned banks (in per cent)
Share of total bank assets of majority state-owned banks in total bank sector assets. The state is defined to include the federal, regional and municipal levels, as well as the state property fund and the state pension fund. State-owned banks are defined as banks with state ownership exceeding 50 per cent, end-of-year.

Source: EBRD survey of central banks.

Non-performing loans (in per cent of total loans)
Ratio of non-performing loans to total loans. Non-performing loans include substandard, doubtful and loss classification categories for loans, but excludes loans transferred to a state rehabilitation agency or consolidation bank, end-of-year.

Source: EBRD survey of central banks.

Domestic credit to private sector (in per cent of GDP)
Ratio of total outstanding bank credit to the private sector at end-of-year, including households and enterprises, to GDP.

Sources: IMF, International Financial Statistics and IMF country reports.

Stock market capitalisation (in per cent of GDP)
Market value of all shares listed on the stock market as a percentage of GDP, end-of-year.

Source: EBRD survey of national stock markets. In some cases, the data differ notably from capitalisation as reported by the Standard & Poor's/IFC Handbook of Emerging Markets. The difference in most cases is due to the exclusion in the Standard & Poor's/IFC data of companies listed on the third tier.

Social sector

Expenditures on health and education (in per cent of GDP)
Expenditures of general government, excluding those by state-owned enterprises.

Sources: EBRD survey to ministries of finance, IMF country reports, World Bank, World Development Indicators.

Life expectancy at birth, total (years)
Life expectancy is defined as the average age reached by an individual after the first day of life, excluding deaths at birth.

Source: World Bank, World Development Indicators.

Basic school enrolment ratio (in per cent)
Gross rates of school enrolment in per cent of the relevant population between 7 and 15 years old. Basic school includes eight years of schooling from the age of 7/8 to 14/15.

Sources: UNICEF, International Child Development Centre, TransMONEE Database.

Methodological notes (continued)

Earnings inequality (GINI coefficient)
The GINI coefficient measures the distribution of employees' earnings. A higher coefficient implies a higher degree of earnings inequality. The GINI coefficient is derived from the cumulative distribution of earnings across the workforce ranked in order of ascendance. It is defined as one half of the mean difference between any two observations in the earnings distribution divided by average earnings. Its possible values range between 0 and 1. The GINI coefficients presented in the table are calculated using monthly earnings data as reported by employers. Small employers are often excluded, and some data refer to the public sector only.

Sources: UNICEF, International Child Development Centre, TransMONEE Database.

EBRD transition indicators

The transition indicator scores range from 1 to 4 with 0.3 decimal points added or subtracted for + and – ratings. These ratings were first introduced in 1997 and retroactively added to years 1989-96 in the 2000 *Transition Report*. For definitions of the rating scores, see Table 2.1 and Annex 2.1. The infrastructure rating is an unweighted average of four sector-specific reform ratings (power, roads, telecommunications and water) for the period 1993-97 and five sector-specific reform ratings (power, railways, roads, telecommunications and water) from 1998 onward.

Source: EBRD staff assessments.

Definitions and data sources for macroeconomic variables

Data for 1995-2002 represent official estimates of out-turns as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, the Institute of International Finance and Tacis Economic Trends. Data for 2003 reflect EBRD staff assessments, based in part on information from these sources. Because of frequent revisions to official data sources, there may be changes to all series published in the *Transition Report* and *Transition Report Update* from year to year.

Country-specific notes can be found under each country table.

Output and expenditure

Official estimates of GDP, industrial and agricultural production. Growth rates can lack precision in the context of transition due to large shifts in relative prices, the failure to account for quality improvements and the substantial size and change in the informal sector. In some countries, national authorities have started to incorporate the informal sector into their estimates of GDP.

Employment

For most countries, data reflect official employment records from the labour registries. In many countries, small enterprises are not recorded by official data. A number of countries have moved towards ILO-consistent labour force surveys in recording changes in labour force, employment and unemployment. Where available these data are presented.

Prices and wages

Data from the statistical offices or IMF. In some countries, official CPI data may underestimate underlying inflation because of price controls and inadequate measurement of price increases in informal markets. Wage data are from national authorities and often exclude small enterprises as well as the informal sector.

Government sector

Data for the general government, including local government and extra-budgetary funds, where available. Data for most countries are from IMF country reports. Budget balance data can differ from official estimates due to different budgetary accounting, in particular with respect to privatisation revenues and foreign lending.

Monetary sector

Broad money is the sum of money in circulation outside banks and demand deposits other than those of the central government. It also includes quasi-money time, savings and foreign currency deposits of the resident sectors other than the central government. Data from IMF, International Financial Statistics, IMF country reports and monetary authorities.

Interest and exchange rates

Deposit and lending rates from most countries are weighted averages across maturities. For some countries, weighted averages are not available and rates are quoted for the most frequently used instruments. Turkmenistan and Uzbekistan operate dual exchange rate systems or have substantial parallel markets with significant premiums on the official exchange rate. Please refer to the table footnotes for details on the reported exchange rates. Data from the IMF, International Financial Statistics, IMF country reports and monetary authorities.

External sector

Trade data in many countries can differ between balance of payments and customs statistics, because of differences in recording and of informal border trade, which is typically not recorded by customs statistics. Country notes provide further details. Trade data are on a balance of payments basis as published by the monetary authorities and IMF country reports. External debt are EBRD staff estimates based on IMF country reports and national authorities.

Abbreviations

The Bank, EBRD	The European Bank for Reconstruction and Development
BEEPS	Business Environment and Enterprise Performance Survey
CAP	Common Agricultural Policy
CEA	common economic area
CEB	central eastern Europe and the Baltic states (see country groupings inside front cover)
CEFTA	Central European Free Trade Agreement
CIS	Commonwealth of Independent States (see country groupings inside front cover)
CMEA	Council of Mutual Economic Assistance
CPI	consumer price index
EAEC	Eurasian Economic Community
EC	European Commission
EFTA	European Free Trade Area
EMU	Economic and monetary union
ERM	Exchange Rate Mechanism
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
FDI	foreign direct investment
FESAL	Financial and Enterprise Sector Adjustment Program
FSA	Financial Supervision Authority
FTAs	free trade agreements
FYR	Former Yugoslav Republic
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GSP	Generalised System of Preferences
GUUAM	Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova
IFC	International Finance Corporation
IFI	international financial institution
ILO	International Labour Organization
IMF	International Monetary Fund
ISPA	Instrument of Structural Policies for Pre-Accession
ITC	International Trade Centre
MFI	mutual financial intermediary
MFN	Most Favoured Nation
na	not available
NAFTA	North American Free Trade Area
NATO	North Atlantic Treaty Organisation
NGOs	non-governmental organisations
NLIS	New Legal Indicator Survey
OECD	Organisation for Economic Cooperation and Development
PCA	Partnership and Cooperation Agreement
PPP	purchasing power parity
PRGF	Poverty Reduction and Growth Facility
PSA	production sharing arrangements
SAA	Stabilisation and Association Agreement
SAC	structural adjustment credit
SAL	structural adjustment loan
SAP	Stabilisation and Association Process
SBA	Stand-By Arrangement
SEE	south-eastern Europe (see country groupings inside front cover)
SMEs	small and medium-sized enterprises
SMP	Staff Monitored Programme
SOEs	state-owned enterprises
TACIS	Technical assistance for CIS countries (EU)
TIR	*Transports Internationaux Routiers*
UN	United Nations
USAID	United States Agency for International Development
VAT	value added tax
WTO	World Trade Organization

Transition report 2003

The *Transition Report* is an invaluable source of information on developments in central and eastern Europe and the Commonwealth of Independent States. Drawing on the EBRD's experience in the region, the Report offers comprehensive analysis of progress in the transition to open market economies. Country-by-country assessments provide detailed information on the key areas of reform and the latest macroeconomic data, making this annual publication essential reading for investors, policy-makers and researchers.

The special theme of this year's report is "Integration and regional cooperation". As accession to the European Union approaches for eight countries of the region, the Report focuses on the impact that this will have not only on the new member countries but also on the countries left outside. How will it affect current trade patterns both within the region and between the region and the rest of the world? How can the non-EU members be better integrated into the world economy? And what role can regional trade blocs play?

As well as addressing these key questions, the Report looks at how EU accession will affect the movement of capital and labour. In particular, it examines current levels of foreign direct investment and assesses the policy changes that are needed to increase investor interest throughout the region. It also looks at probable labour flows following EU enlargement and investigates what is needed to encourage greater mobility across the region.

ISBN: 1 898802 23 8 ISSN: 1356-3424 £30.00