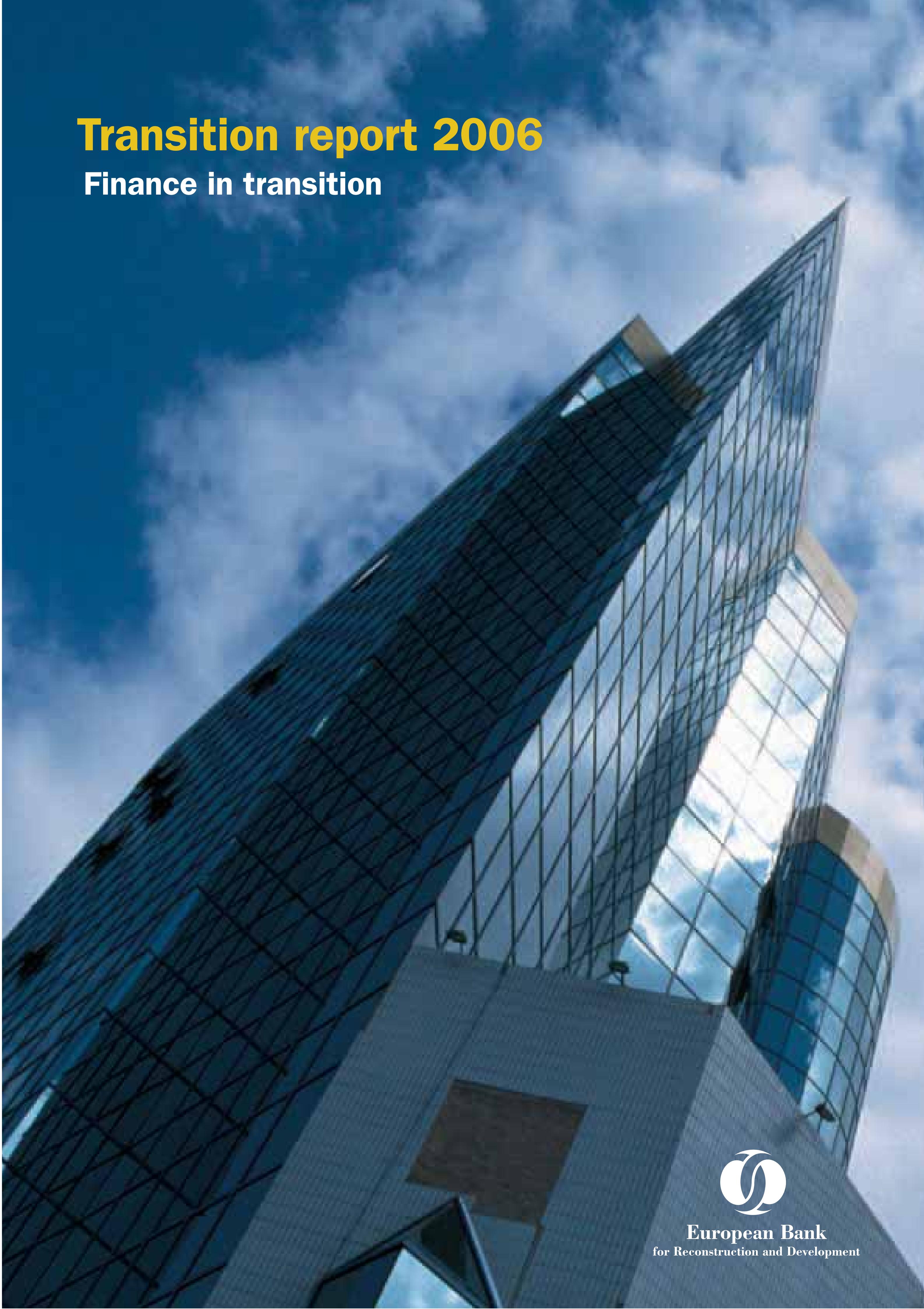
Transition report 2006

Finance in transition



European Bank
for Reconstruction and Development

About this Report

The European Bank for Reconstruction and Development seeks to foster the transition to an open market-oriented economy and to promote private and entrepreneurial initiative in central eastern Europe and the Baltic states, south-eastern Europe, the Commonwealth of Independent States and Mongolia. To perform this task effectively, the Bank needs to analyse and understand the process of transition. The purpose of this Report is to advance this understanding and to share our analysis with our partners.

The responsibility for the content of the Report is taken by the EBRD's Office of the Chief Economist. The assessments and views expressed in the Report are not necessarily those of the EBRD.

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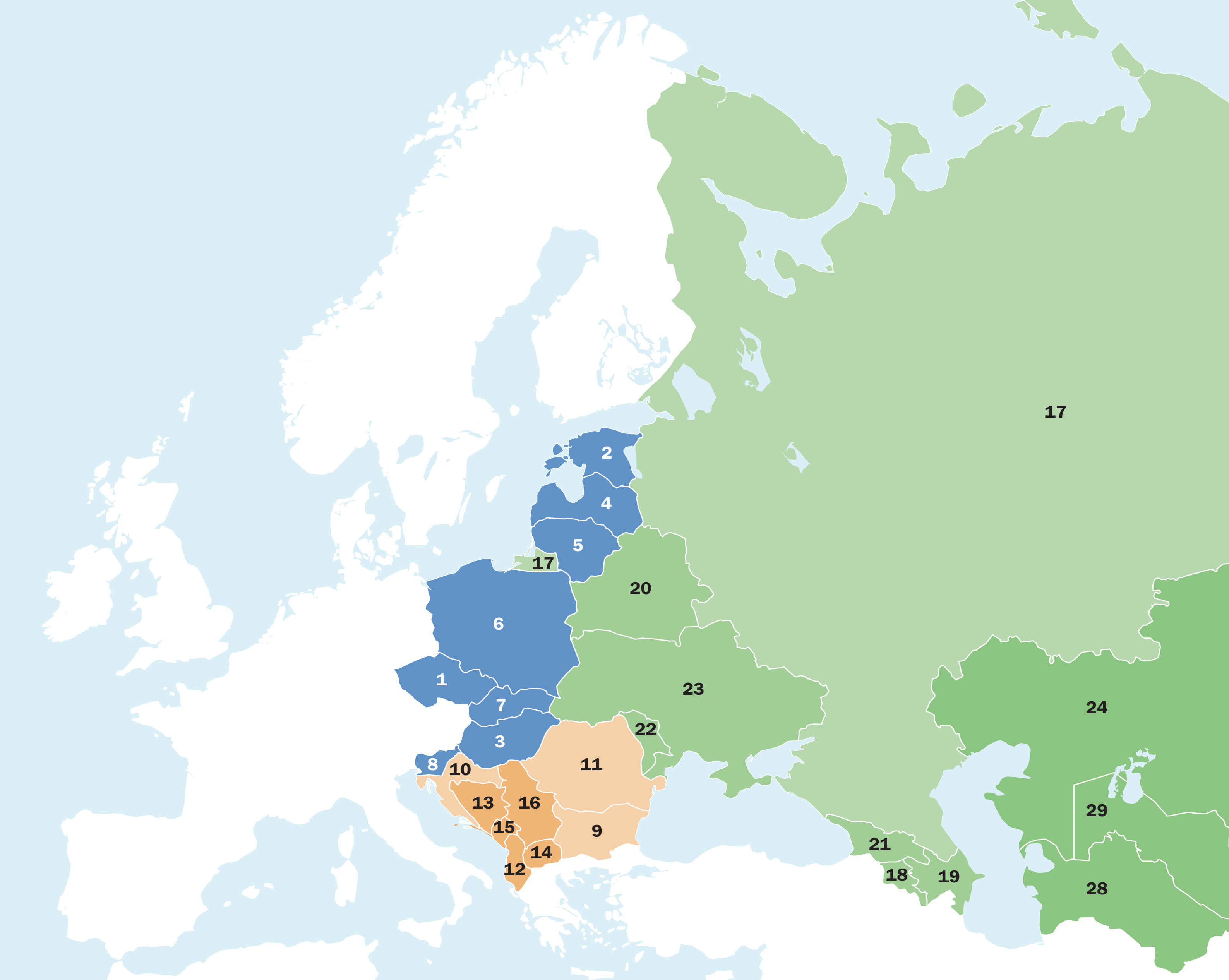


Transition countries

Central eastern Europe and the Baltic states

2005 GDP growth (estimated)* | 2006 GDP growth (projected)*

Country	2005	2006
1. Czech Republic	6.1	6.2
2. Estonia	10.5	8.9
3. Hungary	4.1	3.5
4. Latvia	10.2	9.0
5. Lithuania	7.5	7.0
6. Poland	3.4	5.0
7. Slovak Republic	6.1	6.4
8. Slovenia	4.0	4.5
CEB average	4.7	5.3

* in per cent

South-eastern Europe

2005 GDP growth (estimated)* | 2006 GDP growth (projected)*

SEE-3

Country	2005	2006
9. Bulgaria	5.5	6.0
10. Croatia	4.3	4.6
11. Romania	4.1	6.5

SEE-5

Country	2005	2006
12. Albania	5.5	5.0
13. Bosnia and Herzegovina	5.8	5.0
14. FYR Macedonia	4.0	4.0
15. Montenegro	4.1	5.5
16. Serbia	6.3	6.5

	2005	2006
SEE average	4.7	5.9

* in per cent

Commonwealth of Independent States and Mongolia

2005 GDP growth (estimated)*
2006 GDP growth (projected)*

Russia

17.
6.4
6.5

CIS and Mongolia average
6.6
6.9

* in per cent

Western CIS and Caucasus

18. Armenia
14.0
8.5

19. Azerbaijan
26.4
25.0

20. Belarus
9.2
9.5

21. Georgia
9.3
7.5

22. Moldova
7.1
3.5

23. Ukraine
2.6
6.0

Central Asia

24. Kazakhstan
9.4
8.5

25. Kyrgyz Republic
-0.6
4.0

26. Mongolia
6.2
6.0

27. Tajikistan
6.9
7.0

28. Turkmenistan
9.6
9.0

29. Uzbekistan
7.0
7.0

All transition countries

2005 GDP growth (estimated)*
2006 GDP growth (projected)*

Average
5.7
6.2

* in per cent

Executive summary

- Transition is being driven increasingly by competitive markets rather than by governments, particularly in the financial sector and in the mobile phone market.
- Strong economic growth has been maintained and is forecast to reach 6.2 per cent in 2006. It is being generated primarily by domestic consumption although countries rich in natural resources are also benefiting from high energy and commodity prices.
- Financial markets have grown in size and complexity, and the performance of banks is improving. However, due to failings in the legal framework, financial markets are less developed than in other countries with comparable income.
- Foreign banks are more efficient than domestic banks and their presence can accelerate financial sector development. However, this is not a substitute for institutional reform.
- Banks continue to dominate the financial sector. However, stock markets, bond markets and a small private equity industry are becoming important elements of the financial system.

1

Chapter 1: Progress in transition

The transition countries continued to make progress in reforms in 2005-06. The countries in south-eastern Europe (SEE) made the most headway, spurred on by their aspirations to join the European Union (EU). Pressure from the European Commission gave a particular boost to reform in Bulgaria and Romania as the two countries sought to fulfil the requirements for EU accession in January 2007. The Former Yugoslav Republic of Macedonia also made significant strides over the past year. Serbia had another strong year of reform but still lags behind most other countries in the region due to its late start in the transition process.

In central eastern Europe and the Baltic states (CEB), Estonia has made the greatest advances. Although market confidence in the CEB countries has been maintained since they joined the EU in 2004, their governments have not always kept up the reform momentum as public support for further restructuring and fiscal constraint has weakened. In the Commonwealth of Independent States (CIS), change has been concentrated mainly in the wealthier countries (Russia, Ukraine and Kazakhstan) as institutional strengthening has attracted a positive market response. Across the transition region as a whole, market pressure has underpinned significant reform in the financial and telecommunications sectors.

2

Chapter 2: Macroeconomic overview

Robust growth in the transition countries has been driven largely by domestic demand, which in turn has been spurred by growth in credit and rising wages. The resource-rich countries of the CIS have continued to benefit from high energy and commodity prices. Strong demand and high energy prices are, however, contributing to inflationary pressures throughout the transition region. Moreover, domestic savings are insufficient to cover investment, resulting in large and persistent current account deficits at a time when foreign direct investment is projected to decline slightly from the levels recorded in 2004–05. Several countries' currencies have come under pressure in foreign exchange markets during 2006. This reflects a more critical foreign investor assessment of vulnerabilities in emerging market economies. Furthermore, central banks in the United States, the eurozone and Japan have recently raised their interest rates, making investment in these countries more attractive than before.

Central banks across the transition region have been trying to grapple with the problem of rapidly expanding credit markets combining with rising inflationary pressures. Many central banks have decided to raise interest rates, to introduce stricter regulations on minimum reserves or to take other anti-inflationary measures. Meanwhile, fiscal policy has generally been too loose to stem domestic demand pressures effectively. The case for more restrictive fiscal policies becomes more compelling as ageing populations increasingly put pressure on public budgets.

3

Chapter 3: Finance and growth

Financial markets in the transition countries have grown in size and complexity. They are still dominated by the banking sector but stock markets, bond markets and even private equity have become important aspects of the region's financial systems. Nevertheless, financial markets are still less developed than in other countries at comparable levels of income.

Further development of the financial sector would yield significant returns in terms of economic growth, particularly in the countries with the lowest current levels of financial depth. Access to finance has a significant effect on the ability of firms to invest and increase revenues, particularly smaller firms.

Institutional improvements, such as effective systems for taking collateral and repossessing assets in cases of default, will play a fundamental role in the development of the financial sector. However, while such changes are beginning in the more advanced countries, progress has been less apparent in others. The entry of foreign banks into the market is helping to accelerate development of the financial sector by introducing the skills and financial services available in more advanced countries. However, the presence of foreign banks does not replace the need for legal and institutional reforms.

4

Chapter 4: Banking in transition

Banks in transition countries are gradually reaching the standards of their counterparts in more mature market economies. In recent years they have made remarkable advances and have diversified their services. Institutional reforms have helped to reduce bank costs, particularly those associated with risk management and the evaluation of credit information. However, for smaller and private domestic banks, risk management techniques need to improve further. Foreign-owned banks are still more cost efficient than their domestic competitors.

The highest growth in lending has been in the less advanced countries (although from a low base) and among newly established foreign banks. Banks have reduced their focus on large and foreign-owned enterprises and are lending increasingly to retail clients. Foreign banks have been particularly active in household lending although they are starting to turn their attention to small and medium-sized enterprises (SMEs). Smaller banks have a higher share of SME loans in their portfolio than larger banks.

Lending is influenced by how banks perceive the legal environment and the level of protection it provides. Banks with a favourable view of the institutional framework are more inclined to lend to SMEs and households. Similarly, mortgage loans become more attractive to banks once a legal framework for mortgage lending is in place. A better institutional environment also encourages more frequent use of collateral to secure a loan.

5

Chapter 5: Private equity

There have been considerable improvements in the private equity industry in the transition countries in recent years, as shown by easier exits from investments and higher returns. The industry has moved increasingly towards larger funds, which tend to realise the highest returns. Returns from investments dating back to the early 1990s have outperformed equivalent investments on the London Stock Exchange and have exceeded the average for private equity investments in western Europe.

Although the opportunities for private equity funds to exit from their investments have improved – due to the development of domestic stock markets and better access to foreign stock markets – the presence of a co-investor has helped funds to exit from some less successful investments.

The expansion of private equity funds has had a significant effect on economic development in the transition region. Private equity is not only an additional source of finance for enterprises, but also has a direct impact on the performance of companies. The active involvement of fund managers in the firms receiving investment helps enterprises to devise new strategies, reorganise and improve the performance of management. Intervention by equity funds has a positive effect on returns and reduces the probability of the firm going bankrupt.

Foreword by the EBRD's Chief Economist

Better access to finance fuels growth and improves livelihoods.

The transition region as a whole is gradually catching up with western Europe and other mature market economies. Economic growth, at 5.7 per cent in 2005 and around 6.2 per cent in 2006, is several percentage points higher than in the eurozone. Following the opening of the Baku-Tbilisi-Ceyhan oil pipeline, Azerbaijan has become the fastest growing economy in the world. High prices and demand for oil and gas, metals and agricultural commodities are the reasons for the strong performance of many resource-rich countries but economic growth across the transition region has mostly been driven by domestic consumption.

Nevertheless, the transition countries still face risks as global imbalances persist and interest rates in the main OECD economies increase, diminishing the appetite for investment in emerging markets. While countries with weaker macroeconomic foundations may be the first to feel the pressure, the experience of the Asian and Russian crises in the late 1990s has taught us that a poor institutional framework also deters inward investment. Capital may be withdrawn very quickly in a crisis, and in this respect the increasing level of short-term debt, particularly in central eastern Europe and the Baltic states, is a cause for concern. We have also learned that foreign direct investment is more mobile than conventional wisdom suggests. Although foreign investors have so far kept faith in the transition region (with net inflows of foreign direct investment estimated at US$ 50 billion in 2006), they are likely to discriminate between strong and weak reformers.

Encouragingly, the reform process in the transition region as a whole is continuing apace. Our annual assessment of progress in transition – outlined in the EBRD's transition scores – reveals a similar rate of progress to the last few years. Increasingly, transition is driven by markets rather than governments. We see this market pressure particularly in the mobile phone sector and in the financial sector, where lending continues to grow and new products, such as mortgages, are being introduced at a remarkable pace. Increasingly, institutional change is also bringing about the growth of other financial services, such as stock markets, leasing and insurance activities.

The extraordinary transformation of the financial sector is the focus of this year's *Transition Report*. In a little over a decade this sector has moved from a state-controlled system to one in which a diverse range of financial institutions increasingly provides finance to aspiring entrepreneurs, larger firms striving to enhance their competitiveness and households wishing to improve their living conditions. Despite considerable variation in the approaches to financial sector reform, the key driving forces across the region have been broad improvements in the institutional environment, privatisations and market entry by foreign banks.

From the early 1990s, privatisations ended the system of state-owned banks lending exclusively to governments and public enterprises. New banks also started to enter the market throughout the region. By the mid-1990s, basic regulatory and supervisory frameworks were in place, allowing a steady increase in the availability of finance, particularly in central eastern Europe and the Baltic states. At the end of the decade, however, growth in bank credit mostly involved lending to large enterprises and in a significant number of countries – particularly in south-eastern Europe and the Commonwealth of Independent States – the financial sector continued to be underdeveloped.

Nevertheless, a number of key changes had taken place. Most striking was the emergence of foreign banks as major players, either through the acquisition of existing banking assets or as new entrants. Indeed, the entry of foreign banks in the transition region is unique in both its scale and coverage. These changes have increasingly been associated not only with improvements in bank performance but also with widening access to banking services and greater diversity in the types of services being offered to customers. This Report charts the financial development that has occurred and highlights the large variation across the transition countries in terms of how credit is provided to the private sector.

The institutional framework affects both access to finance and the services that banks provide to their clients. Better institutional quality increases lending to small businesses and households and broadens the range of services provided by banks. Most strikingly, lending to households, particularly through mortgage loans, has grown rapidly throughout the region. This reflects not only the emergence of private housing markets but also the increasing ability of the financial sector to take collateral and to rely on legal systems for effective enforcement. Improvements in the quality of the legal system have resulted in greater lending to households while better regulatory quality is associated with more lending to small businesses (as regulators require banks to have lower exposures to large firms).

Access to finance for small businesses, a crucial engine of growth in the transition economies, is still lower than expected. There is a concern that foreign banks lack local market knowledge and are reluctant to lend to small businesses. Smaller local banks have to some extent filled this vacuum with what appears to be highly profitable financing. Survey evidence from four transition countries presented in this Report indicates that access to bank credit has a positive impact on the performance and growth of small businesses.

The main focus of this Report is on the banking system, reflecting the dominance of banking within the financial sector in the transition region. However, it is also interesting to observe the strong, parallel growth in other areas of finance. These developments are highly inter-connected. For example, the improved functioning of stock markets brings transparency and better valuation to financing activities, and bond markets help to develop inter-bank markets which are critical to the liquidity of the financial system. Corporate bond markets are much harder to develop and have generally only emerged in response to failures in the banking system. In the long term, they serve as an important check on the dangers of excessive lending by banks to client companies.

Another development is the gradual emergence of the private equity industry in the transition region. The share of total assets held by local private equity firms remains small and the volumes provided by firms operating in the advanced market economies are modest. Nevertheless, private equity is becoming an important source of financing and means of restructuring that is not provided through the banking system. Unique data available from EBRD investments are used in this Report to document the evolution of private equity in the transition region.

A better institutional framework has helped to improve the performance of private equity funds, which have also learned from experience. The time taken to break even and exit from investments has diminished significantly since the early 1990s. Improvements in the functioning of equity markets have increased the exit options for funds. The study in this Report also provides insight into the process of corporate restructuring. In the early and intermediate stages of transition, for example, the main priority is to improve the quality of general management. The study also reveals that diversified funds seem to do better than funds specialising in individual industries. As the institutional environment improves and individual firms restructure, however, industry-specific funds are likely to become more effective.

The increasing availability of finance for the private sector raises the obvious issue of its impact on growth. This relationship has been widely studied, with very mixed results. Evidence from the 1990s suggested that the link between financial development and economic growth was not strong in the first decade of transition. This link appears to have strengthened as the general institutional framework has improved. Nevertheless most countries, even the advanced countries of central eastern Europe and the Baltics, have lower levels of financial development than their levels of income would imply. This suggests that financial systems must develop further before the full growth potential of these economies can be exploited.

Investment in improving the functioning of the financial system is likely to accelerate growth. This potential is present even in the most advanced transition countries. For example, Slovenia, which was recently admitted into the European Economic and Monetary Union in recognition of its strong macroeconomic performance, still has a comparatively opaque financial system.

Considerable challenges remain for the transition countries. This Report shows that, despite rapid financial development, most firms in the region still rely on internally generated funds and contributions through informal channels – for example, loans from friends and relatives of the owner/entrepreneur. A large number of firms, even in some of the most developed transition countries, have no link whatsoever to the formal financial system. Improving access to financial resources for these enterprises and for new businesses is still a fundamental challenge for the transition countries. Widening financial access requires a variety of measures, such as improving the quality of supervision of the banking system, enforcing competition policy and encouraging the growth of other financial services. As the transition region develops, growth will increasingly need to stem from innovation, requiring riskier and longer-term investments from financial institutions.

The experience of the transition region offers a fascinating insight into the broader aspects of financial development, clearly demonstrating how changes in the institutional environment are the driving force for both financial and economic growth. This Report highlights the remarkably positive impact of foreign commercial banks in the region but the evidence also shows that micro and small enterprises do not benefit to the same degree.

Moreover, as the foreign-controlled banks become integrated into their parent institutions, their impact on financial access and the development of the financial sector in the transition countries looks uncertain. There are also broader concerns that activities such as research and product development will be centralised in corporate headquarters in the world's financial capitals, leaving local institutions with less demanding tasks and a less dynamic local workforce. In the long term, this may slow down growth in the transition region. Maintaining skill levels will require investment in improving the business climate, including development of higher education and improvements to social infrastructure. Addressing these weaknesses will be key in sustaining the strong growth performance of the region.

Erik Berglöf

Chief Economist of the EBRD

1 October 2006

Progress in transition

1

The transition countries have continued to make progress in structural and institutional reform over the past 12 months. The pace of reform in south-eastern Europe picked up again after a slowdown in 2005, with significant progress in both the less advanced countries of the region and the EU accession candidates. Reforms in the Commonwealth of Independent States were undertaken across the region but the strongest results were in some of the wealthier countries. In central eastern Europe and the Baltic states, where transition has gone furthest, progress in the past year was modest. Across the transition region there was marked progress in reform of the financial sector and telecommunications, resulting from a strong market reaction to recent institutional strengthening.

The EBRD tracks reform developments in 29 transition countries through a set of nine transition indicators. These cover four main elements of a market economy – markets and trade, enterprises, financial institutions and infrastructure. Markets and trade reform is measured by the liberalisation of prices, the liberalisation of trade and access to foreign exchange, and the effectiveness of competition policy. Enterprise reform includes separate indicators for large and small-scale privatisation and a measure of governance and enterprise restructuring. Reform of financial institutions is measured by the development of the banking sector, including the quality of financial regulation, as well as the creation and development of securities markets and non-bank financial institutions. Infrastructure reform is measured by progress in five sectors – electricity, railways, roads, telecommunications, and water and waste water – covering such issues as commercialisation, tariff reform, quality of the regulatory framework and involvement of the private sector.

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 4+ represents the standards of an industrialised market economy. The reform scores reflect the assessments of EBRD country economists using the criteria described in the methodological notes at the back of this Report.

1.1 Reform progress by country

Significant progress in reform has been achieved in the transition countries during the past year. A total of 24 transition score upgrades were awarded to 16 countries and there were no downgrades among the nine main indicators. South-eastern Europe earned 12 upgrades, the Commonwealth of Independent States earned eight, and four upgrades were spread across three countries in central eastern Europe and the Baltics.

The number of upgrades for each country over the past year is illustrated in Chart 1.1. Table 1.1 lists the transition indicator scores for all 29 countries and Table 1.2 summarises the reasons for this year's upgrades by country.

Within central eastern Europe and the Baltic states (CEB), Estonia has made the most progress in reform with transition indicator upgrades for competition policy and development of securities markets and non-bank financial institutions. Estonia has earned at least one upgrade in four of the past five years (despite considerably slower overall progress in CEB during that period – see Chart 1.2). Estonia's upgrade for securities markets and non-bank financial institutions was awarded for progress in the creation of private insurance and pension funds and for attracting investment into those funds. At the same time, the country's independent competition authority has had a strong track record of enforcement of the country's anti-trust laws, which has eased the entry of new domestic firms and foreign companies into key sectors of the economy.

Estonia's transition scores are consistent with indicators from other organisations regarding the country's competitiveness and development of a market economy. Estonia is the highest ranking transition country in the World Economic Forum's Growth Competitiveness Index (and the only one in the top 20 of the index) and is among the top ranked transition countries in the World Bank's Doing Business surveys.

Elsewhere in CEB, reforms have been largely put on hold due to weakening public support in many countries for further painful restructuring. While markets have shown confidence lately in the new EU member states, as seen in the large number of transition indicator upgrades in 2004–05, governments have not kept pace with reform legislation and implementation. Elections in the Czech Republic, Hungary, Poland and the Slovak Republic in the past year have resulted in governments with a less clear mandate for market and fiscal reform. Nevertheless, the Slovak Republic earned an upgrade this year for the development of securities markets and non-bank financial institutions, reflecting advances in pensions and insurance while Lithuania was upgraded for infrastructure reform thanks to liberalisation in the telecommunications sector.

The advanced countries in south-eastern Europe (SEE) – Bulgaria, Croatia and Romania – have made noteworthy progress in reforms. This followed a slowdown in reform in Bulgaria and Romania in 2004–05 after both countries had completed negotiations on the remaining chapters of the EU's *acquis communautaire* – the body of EU law that all candidate countries must complete. Further reform efforts over the past year may have been prompted by the European Commission exerting strong pressure on the two countries to fulfil the requirements for EU accession by their target date of 1 January 2007. Romania's competition authority has tightened the application of its anti-monopoly laws, and governance has improved through firmer implementation of bankruptcy legislation as well as judicial and administrative reforms. Romania was among the top 10 reforming countries in the World Bank's Doing Business survey for 2007. Bulgaria has also made progress in judicial reform and has stepped up the fight against corruption but concerns remain in this area for both countries.

Bulgaria gained transition score upgrades for small-scale privatisation, which is nearing completion, and for development of securities markets and non-bank financial institutions (reflecting stronger supervision of leasing and insurance companies). Both Bulgaria and Romania were awarded upgrades in the telecommunications sector for increased competition, greater private sector involvement and development of the mobile phone market. Croatia received an upgrade for its securities markets and non-bank financial institutions due to the creation of a new supervisory body and further development of pension and investment funds.

In the Western Balkans – Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Montenegro and Serbia – FYR Macedonia was the leading reformer with two transition score upgrades. These were for governance and enterprise restructuring and for securities markets and non-bank financial institutions. It also received two infrastructure sub-sector upgrades (in electric power and water and waste water). FYR Macedonia's new status as an EU candidate, which came into effect in December 2005, has helped to keep reforms on track despite parliamentary elections in July 2006.

Following the legal separation of Serbia and Montenegro, progress in transition in these two countries can now be monitored independently. Despite being comparatively less advanced than other SEE countries, Serbia has made significant reform progress in the past year and is catching up after years of political turmoil in the 1990s. Small-scale privatisation is approaching completion and a new competition law has come into effect (although its implementation remains unproven). In infrastructure, Serbia received transition score upgrades for telecommunications and roads due to progress in privatisation but government intervention in water pricing led to a downgrade for the water and waste-water sector.

Montenegro is beginning independence with an economy that is liberal in some areas, such as trade policy, but at an early stage of reform regarding institutions and infrastructure. The country's banking sector has made significant progress, however. This is reflected in a transition score upgrade for the country's banking reform. Elsewhere in the Western Balkans, there were upgrades for Albania (for governance and enterprise restructuring) and Bosnia and Herzegovina (for competition policy).

Within the Commonwealth of Independent States (CIS), Kazakhstan, Russia and Ukraine each received two transition score upgrades. Improvements in the financial sector in all three countries accounted for four of the six upgrades while advances in telecommunications merited two more. In both the financial and telecommunications sectors, markets are driving the transition process in the wealthier CIS countries as much as government policies. Russia and Kazakhstan have dynamic financial markets with rapidly increasing bank lending to the private sector (although from a low base), growing corporate bond markets and more liquid domestic stock markets. Regulatory supervision of these markets has also improved in recent years, along with better corporate governance among listed companies. Russia has also made progress in the liberalisation of the capital account and has achieved full convertibility although this has been counterbalanced by trade disputes over energy exports and wine and food imports with Ukraine, Georgia and Moldova.

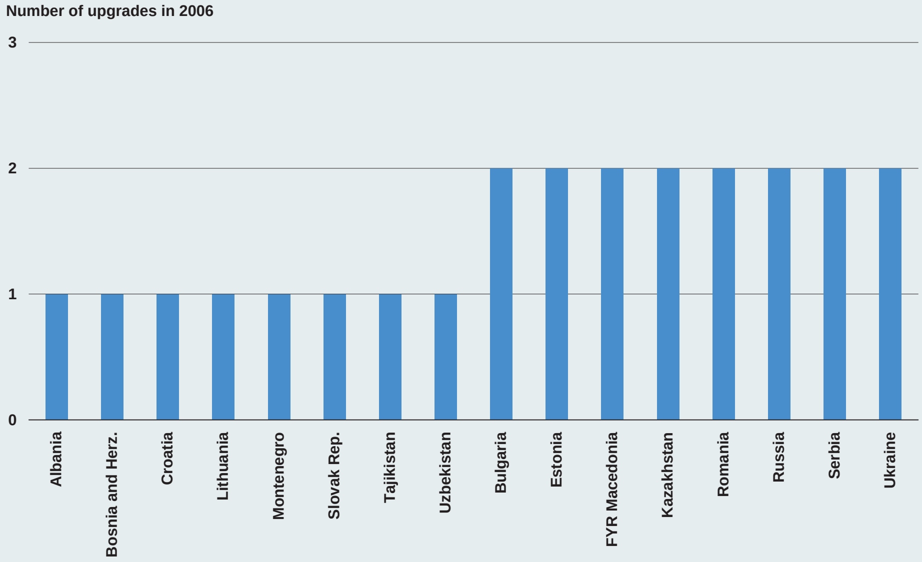
Market reform outside the financial sector in Kazakhstan, Russia and other resource-rich countries has been largely deferred. High and rising energy and commodity prices in the past five years have generated a revenue windfall that continues to restrain the urgency for structural and institutional change (see Chart 1.2). At the same time, increased state involvement in certain sectors and the creation of national state-owned "champions" have raised questions about the role of foreign investment in these countries.

The Ukrainian banking sector has progressed in the past year, with greater foreign participation and further credit provision to the private sector. Foreign capital now accounts for 24 per cent of total assets in the banking system, up from 12 per cent at the end of 2004. Two of the top five banks in terms of assets are under majority foreign ownership. The sharp rise in credit to the private sector, against a background of continuing weaknesses in banking regulation and supervision, poses a risk of future financial instability. However, this may be offset by increasing foreign investment in the banking sector. Ukraine's infrastructure upgrade reflects increased competition in mobile telecommunications together with tariff rebalancing and improved supervision.

Elsewhere in the CIS, Tajikistan and Uzbekistan have made progress in banking reform and small-scale privatisation respectively. Both countries are still at a very early stage of transition and need to accelerate reform to attract and retain foreign investment and to advance the process of economic restructuring. Although Uzbekistan earned an upgrade in 2006, the environment for foreign investment has suffered from uncertainty about the government's policy agenda and the unpredictable nature of state intervention in the economy.

Chart 1.1

Progress in transition

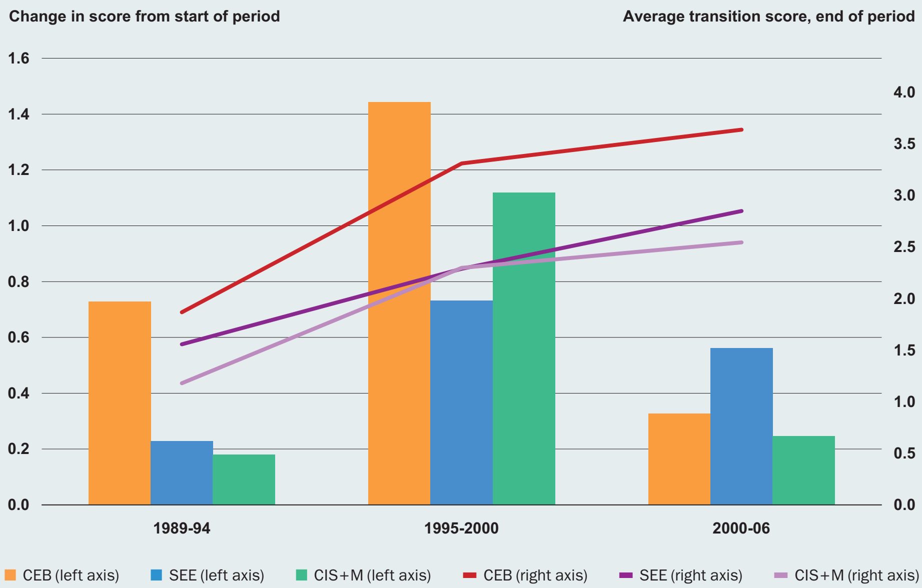


Source: EBRD.

Note: The chart reports the total number of upgrades in the nine areas of reform covered by the transition indicators (see Table 1.1). No change was recorded in Armenia, Azerbaijan, Belarus, Czech Republic, Georgia, Hungary, Kyrgyz Republic, Latvia, Moldova, Mongolia, Poland, Slovenia and Turkmenistan.

Chart 1.2

Regional patterns of progress in transition



Source: EBRD.

Table 1.1

Transition indicator scores, 2006

			Enterprises			Markets and trade			Financial institutions		Infrastructure
Country	Population mid-2006 (million)	Private sector share of GDP mid-2006 (EBRD estimate in per cent)	Large-scale privatisation	Small-scale privatisation	Governance and enterprise restructuring	Price liberalisation	Trade and foreign exchange system	Competition policy	Banking reform and interest rate liberalisation	Securities markets and non-bank financial institutions	Infrastructure reform
Albania	3.2	75	3	4	2+ ↑	4+	4+	2	3–	2–	2
Armenia	3.2	75	4–	4	2+	4+	4+	2+	3–	2	2+
Azerbaijan	8.3	60	2	4–	2	4	4	2	2+	2–	2
Belarus	9.8	25	1	2+	1	3–	2+	2	2–	2	1+
Bosnia and Herzegovina	3.8	55	3–	3	2	4	4–	2– ↑↑	3–	2–	2+
Bulgaria	7.7	75	4	4 ↑	3–	4+	4+	3–	4–	3– ↑	3
Croatia	4.4	60	3+	4+	3	4	4+	2+	4	3 ↑	3
Czech Republic	10.3	80	4	4+	3+	4+	4+	3	4	4–	3+
Estonia	1.3	80	4	4+	4–	4+	4+	4– ↑	4	4– ↑	3+
FYR Macedonia	2.0	65	3+	4	3– ↑	4+	4+	2	3–	2+ ↑	2
Georgia	4.6	70 ↑	4–	4	2+	4+	4+	2	3–	2–	2+
Hungary	10.1	80	4	4+	4–	4+	4+	3+	4	4	4–
Kazakhstan	15.1	65	3	4	2	4	4–	2	3	3– ↑	3– ↑
Kyrgyz Republic	5.1	75	4–	4	2	4+	4+	2	2+	2	2–
Latvia	2.3	70	4–	4+	3	4+	4+	3	4–	3	3
Lithuania	3.4	75	4	4+	3	4+	4+	3+	4–	3	3 ↑
Moldova	3.4	65 ↑	3	4–	2	4	4+	2	3–	2	2+
Mongolia	2.7	70	3	4	2	4+	4+	2	2+	2	2
Montenegro	0.7	65	3+	3	2	4	3+	1	3– ↑	2–	2–
Poland	38.1	75	3+	4+	4–	4+	4+	3	4–	4–	3+
Romania	21.7	70	4–	4–	3– ↑	4+	4+	3– ↑	3	2	3+
Russia	144.1	65	3	4	2+	4	3+	2+	3– ↑	3 ↑	3–
Serbia	8.3	55	3–	4– ↑	2+	4	3+	2– ↑↑	3–	2	2
Slovak Republic	5.4	80	4	4+	4–	4+	4+	3+	4–	3 ↑	3–
Slovenia	2.0	65	3	4+	3	4	4+	3–	3+	3–	3
Tajikistan	6.5	55	2+	4	2–	4–	3+	2–	2+ ↑	1	1+
Turkmenistan	6.5	25	1	2	1	3–	1	1	1	1	1
Ukraine	47.1	65	3	4	2	4	4–	2+	3 ↑	2+	2+ ↑
Uzbekistan	26.0	45	3–	3+ ↑	2–	3–	2	2–	2–	2	2–

Source: EBRD.

Note: The transition indicators range from 1 to 4+, with 1 representing little or no change from a rigid centrally planned economy and 4+ representing the standards of an industrialised market economy. For a detailed breakdown of each of the areas of reform, see the methodological notes on page 198.

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. 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.

Past scores for the following have been revised this year: governance and enterprise restructuring for Azerbaijan, price liberalisation for FYR Macedonia and Moldova, trade and foreign exchange systems for Kazakhstan and Serbia, and competition policy for Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Slovak Republic.

Table 1.2

Changes in transition scores

Country	Transition indicator	Change in score	Reason for change
Albania	Governance and enterprise restructuring	2 to 2+	Successful implementation of simplified business registration procedures and further cuts in enterprise subsidies.
Bosnia and Herzegovina	Competition policy	1 to 2–	New law on competition and evidence of effective implementation by the Competition Council.
Bulgaria	Small-scale privatisation	4– to 4	Effective completion of the privatisation programme, except for the tradability of land.
	Securities markets and non-bank financial institutions	2+ to 3–	Strong growth in leasing and insurance market matched by improved regulatory supervision.
Croatia	Securities markets and non-bank financial institutions	3– to 3	Further development of pension and investment funds and strengthening of supervision through the creation of a single non-bank supervisor.
Estonia	Competition policy	3+ to 4–	Strong and consistent enforcement of the law by the competition authority.
	Securities markets and non-bank financial institutions	3+ to 4–	Increase in volumes of investment and pension funds, presence of private insurance funds and efficient operation of joint stock market with neighbouring Baltic states.
FYR Macedonia	Governance and enterprise restructuring	2+ to 3–	Approval of new bankruptcy legislation and implementation of a one-stop shop for business registration from January 2006.
	Securities markets and non-bank financial institutions	2 to 2+	Adoption and effective implementation of pension reform, creating private pension funds.
Kazakhstan	Securities markets and non-bank financial institutions	2+ to 3–	Increased capitalisation of stock and bond markets; emergence of pension funds and private operators.
	Infrastructure	2+ to 3–	Improvements in the telecommunications sector (see Table 1.4).
Lithuania	Infrastructure	3– to 3	Improvements in the telecommunications sector (see Table 1.4).
Montenegro	Banking reform and interest rate liberalisation	2+ to 3–	Growth in credit to the private sector, financial deepening and presence of an independent supervisor as well as the introduction of deposit insurance.
Romania	Governance and enterprise restructuring	2+ to 3–	Improved bankruptcy framework, enforcement of corporate governance legislation and further steps in adoption of judicial reform and anti-corruption measures, although subsidies to specific sectors are still high.
	Competition policy	2+ to 3–	Strengthening of the competition office and tightened application of sanctioning policy; alignment of competition law with EU anti-trust legislation.
Russia	Banking reform and interest rate liberalisation	2+ to 3–	Continued strong growth in private credit, especially to households; rise in foreign ownership in the sector, albeit from a low base; implementation of regulatory reform by the Central Bank.
	Securities markets and non-bank financial institutions	3– to 3	Further improvements in the institutional and regulatory framework for capital markets; introduction of new products and innovation; volume increases in stock, bond and insurance markets.
Serbia	Small-scale privatisation	3+ to 4–	Ongoing auctions of small enterprises; government on track to complete small-scale privatisation in 2007.
	Competition policy	1 to 2–	Adoption of competition law establishing the competition authority and some initial work on merger control cases.
Slovak Republic	Securities markets and non-bank financial institutions	3– to 3	Introduction of a mandatory second pillar of the pension system and active development of private pension funds.
Tajikistan	Banking reform and interest rate liberalisation	2 to 2+	Further consolidation along with deregulation of foreign participation in the banking sector; increase in minimum capital requirements; de-licensing of banks under the deposit insurance scheme.
Ukraine	Banking reform and interest rate liberalisation	3– to 3	Continued growth in credit to the private sector and development of consumer finance instruments; increased foreign participation.
	Infrastructure	2 to 2+	Improvements in the telecommunications sector (see Table 1.4).
Uzbekistan	Small-scale privatisation	3 to 3+	Nearly complete privatisation of collective farms into leaseholds, leading to increased efficiency in the cotton sector.

Source: EBRD.

Note: See Table 1.1 for transition indicator scores for all countries.

1.2 Reform progress by sector

Market liberalisation – or initial-phase reform – is virtually complete in the advanced countries of central eastern Europe and the Baltics and of south-eastern Europe but there is still room for improvement in the Western Balkans and in the Commonwealth of Independent States and Mongolia. Second-phase reform – dealing with building market-supporting institutions, such as large-scale privatisation, governance and enterprise restructuring, competition policy, financial sector development and infrastructure – is still far from complete.

In 2005–06, very little progress was made in initial-phase reform – small-scale privatisation, price liberalisation and trade and foreign exchange liberalisation – in the countries where this is still to be completed. Out of 24 indicator upgrades, there were only three for small-scale privatisation. Second-phase reforms were far more prominent, particularly in the financial sector (see Chart 1.3).

In the past year, ten countries earned transition score upgrades for reforms in banking, securities markets and non-bank financial institutions. This achievement builds on financial sector reforms undertaken in 2005 and owes much to the positive market reaction to improvements in the institutional framework and macroeconomic environment across the region. In particular, there have been strong advances in leasing, insurance and pension funds in Bulgaria, Croatia, Estonia and the Slovak Republic, all of which were upgraded in this area in 2006. The creation of mandatory funded (“second pillar”) pension schemes in many transition countries has the potential to advance the development of capital markets. These pension funds will provide additional sources of longer-term investment and will encourage better financial market regulation and higher standards of corporate governance among listed companies (see Box 2.2 in Chapter 2).

Upgrades in the financial sector were also achieved by Kazakhstan and Russia due to the expansion of financial services and increased liquidity in capital markets. Market capitalisation in both countries has increased sharply in the past year and many growing enterprises have sought new capital through initial public offerings. There has also been a related improvement in transparency and disclosure among larger companies as they meet the listing requirements of their own or foreign stock exchanges. Improvements in accounting standards and corporate transparency among publicly listed companies have occurred on a broad scale, according to a study completed in 2006 covering 12 transition countries. The study shows that the number of reported accounting items among the top ten listed firms in the non-financial sector in these countries went up significantly from 1996 to 2004.

Four transition score upgrades were awarded in the banking sector. Greater foreign bank participation and the sharp growth of credit to the private sector reflects in many instances an improved legal framework for creditor protection, better credit information and improvements in banking regulation. The creation of pledge and mortgage laws and their effective implementation have led to increased lending to households and small and medium-sized enterprises (SMEs) in the more advanced countries (see Chapter 4).

Deposit growth has taken off in recent years, contributing to the rapid increase in bank loans. This reflects growing domestic confidence in the stability of the economy and the financial system. In Russia, moreover, the growing share of domestic currency in total deposits is a further sign of confidence. Increased channelling of savings into investment in countries such as Kazakhstan, Russia and Ukraine is also promoting the process of economic diversification. Liberalisation of the financial system and improving access to credit will in turn promote further reform as existing and potential borrowers press for even wider access to finance. In countries where transition in the financial sector is still at an early stage, such as Montenegro and Tajikistan, the upgrades in banking reform in 2006 could accelerate this process.

Outside the financial sector, progress in competition policy, governance and enterprise restructuring in Albania, Bosnia and Herzegovina, FYR Macedonia, Romania and Serbia is a sign that these countries are starting to take the necessary steps to encourage easier market entry and exit for enterprises. However, Albania, Bosnia and Herzegovina and Serbia are starting from a very low base in this respect and much more remains to be done. They have established the appropriate agencies but now they need to show that these can be effective. FYR Macedonia and Romania are more advanced in these areas. Their commitment to further reform is probably linked to their EU accession aspirations and the need to increase the competitiveness of domestic firms as they become more integrated into European markets.

Despite only three upgrades being awarded for overall infrastructure in 2006, a great deal of reform was undertaken in particular sub-sectors, such as telecommunications. Table 1.3 lists the infrastructure scores for all 29 transition countries and Table 1.4 summarises the reasons for this year’s upgrades.

Nine telecommunications upgrades were awarded: five in the Commonwealth of Independent States (CIS), three in south-eastern Europe (SEE) and one in central eastern Europe and the Baltic states (CEB). The upgrades reflect increasing competition in the telecommunications market in the region, particularly in the mobile phone market. Countries that have opened up mobile telecommunications to private capital have generally benefited from dynamic market expansion. This has been driven mainly by competitive pressure, which has led to broader availability of telecommunications services (as measured by the number of mobile phones per 100 inhabitants) and a gradual reduction in tariffs. There has also been an increase in private sector involvement in fixed-line services (particularly in Bulgaria, Georgia, Kazakhstan, Lithuania, Moldova and Romania). Internet usage has also risen sharply in many countries, supported by the arrival of independent private service providers.

Chart 1.4 shows the rise in mobile phone ownership over the past five years across the transition region. As mobile phone usage has increased, fixed-line usage has declined, suggesting that for many consumers better-quality mobile phones are taking the place of unreliable land lines.

The rise in mobile phone ownership is also likely to deliver broader benefits, as recent studies have demonstrated the positive impact of mobile telecommunications on economic growth. Greater mobile phone usage eases information flows, opens new markets and reduces transaction costs for businesses.

Infrastructure upgrades were also awarded for improvements in electric power, transport and water services. Most of the electric power reforms (regulatory improvements in Estonia and privatisation in FYR Macedonia) have been driven by the EU integration agenda. The EU regulatory framework strives to establish a competitive internal market for electricity and identifies key reform milestones. Compliance with EU regulations continues to drive implementation of reform in the new EU member states of CEB.

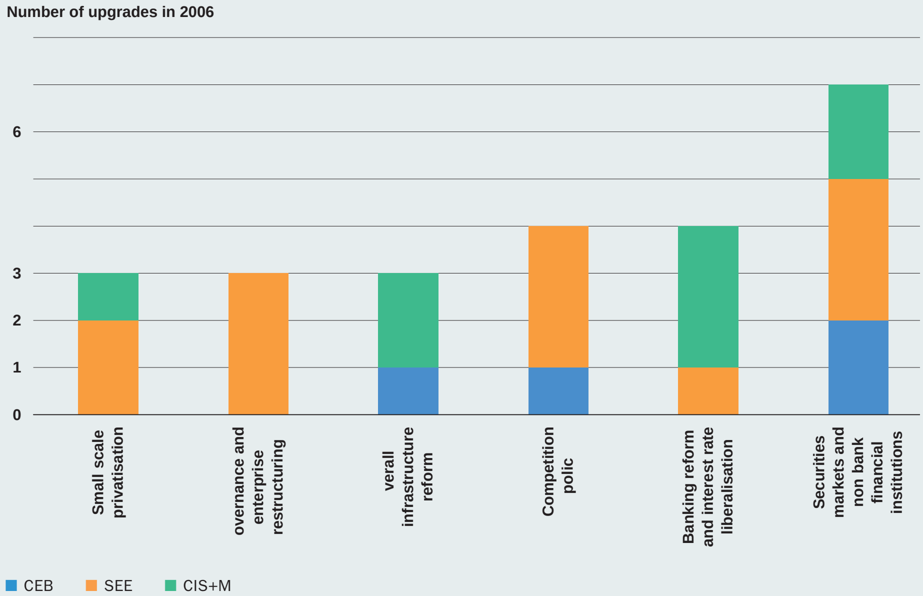
In SEE, energy sector reform is motivated by the European Commission's Athens Process, which seeks to create a regional energy market among the smaller countries of the Western Balkans that may find it difficult to develop their own national markets. The Athens Process encourages harmonisation of legislation with the EU and benchmarks progress in energy sector reform with respect to commercialisation, institution-building and regulation.

The other infrastructure upgrades were awarded to Latvia (railways), FYR Macedonia and Slovak Republic (water and waste water) and Serbia (roads). At the same time, Serbia received a downgrade in the water and waste-water sector. This was due to government intervention in tariff setting. Recentralisation of tariff setting in the municipal sector represents a step backwards in terms of municipal sector reform.

Over the preceding years a number of municipalities in Serbia had decided to increase local water tariffs to bring water prices closer to the cost of supply. This contributed to above-expected levels of inflation. As a result, the government decided to take charge of water tariff setting and approval for the entire sector, removing a key tool for utility regulation from Serbian municipalities. Some of the consequences are already apparent: the weakening position of municipalities regarding local water utilities, lack of incentives for improved financial management and an additional burden placed on public finances.

Chart 1.3

Transition progress by sector, 2005-06

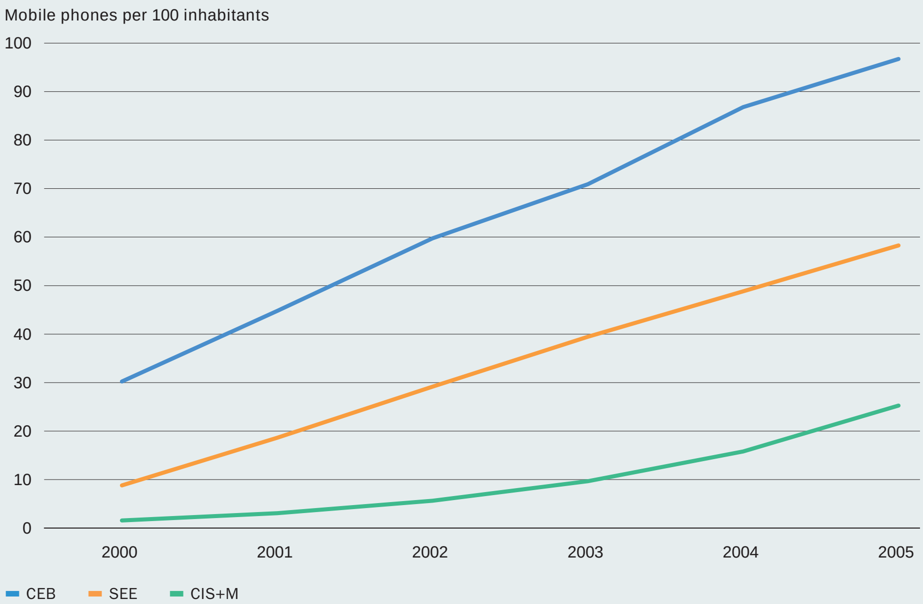


Source: EBRD.

Note: The chart reports the number of upgrades in each of the areas of reform in CEB, SEE and the CIS (see Table 1.1). Price liberalisation, large-scale privatisation and trade and foreign exchange systems are not included as there was no change recorded for the year.

Chart 1.4

Mobile phone ownership



Source: International Telecommunication Union.

Table 1.3

Infrastructure transition scores

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

Source: EBRD.

Note: ↑ and ↓ arrows indicate a change from the previous year. 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. Past scores for the following have been revised this year: telecommunications for Albania, Bosnia and Herzegovina, FYR Macedonia, Kazakhstan and Slovak Republic; roads for Croatia, Czech Republic and Hungary; railways for Bulgaria; and water and waste water for Albania, Azerbaijan, Bosnia and Herzegovina, Kazakhstan and Slovak Republic.

Table 1.4

Changes in infrastructure transition scores

Country	Transition indicator	Change in score	Reason for change
Armenia	Telecommunications	2+ to 3–	Increased competition due to launch of the second mobile operator in 2005. Some competition in internet provision and growing internet usage.
Bulgaria	Telecommunications	3+ to 4–	Increased competition resulting in improvements in quality and availability of service following the privatisation of the fixed-line operator. Fixed-line and mobile operators are private with a mobile ownership rate of over 80 per cent.
Estonia	Electric power	3 to 3+	Cumulative effect of reforms stemming from implementation of the Electricity Act 2003, including establishment of separate subsidiaries for transmission and distribution networks.
FYR Macedonia	Electric power	3– to 3	Privatisation of electricity distribution company through an open competitive tender.
	Water and waste water	2 to 2+	Improved tariff setting methodology for water and waste water.
Georgia	Telecommunications	2+ to 3–	Increased competition in provision of fixed-line telecommunications services. Establishment of an increasingly competitive privately owned mobile sector.
Kazakhstan	Telecommunications	3– to 3	Increased competition in mobile, international and long-distance communication services.
Latvia	Railways	3+ to 4–	Recent establishment of three subsidiaries for infrastructure, cargo and passenger services.
Lithuania	Telecommunications	3+ to 4–	Increased competition in provision of mobile telecommunications services. High rate of mobile phone ownership.
Moldova	Telecommunications	3– to 3	Increased competition in the mobile sector and entry of local alternative fixed-line service providers.
Romania	Telecommunications	3 to 3+	Competition in the sector resulted in price decreases, improved quality and availability of services, and substantial growth of subscribers to various telecom services, including widespread internet access.
Serbia	Telecommunications	2 to 2+	Privatisation of the mobile operator and the launch of a regulatory authority.
	Roads	2+ to 3–	Privatisation of 20 out of 25 maintenance companies in 2005. Presence of above-cost-recovery consolidated road user charges.
	Water and waste water	2 to 2–	Downgrade due to government control over tariffs to control inflation since 2005.
Slovak Republic	Water and waste water	3 to 3+	Elimination of cross subsidies in water tariffs across all major operators in the country.
Tajikistan	Electric power	2– to 2	Formulation of a restructuring and unbundling strategy by the government, transfer of the state electricity company away from the Ministry of Energy to become a joint-stock company.
Ukraine	Telecommunications	2+ to 3–	Increased competition in provision of mobile telecommunications services. Improvements in the capacity of the sector regulator.

Source: EBRD.

Note: See Table 1.3 for infrastructure scores for all transition countries.

1.3 Outlook and risks

Market reform in the transition countries was at its peak from 1995 to 2000. Central eastern Europe and the Baltic states and the Commonwealth of Independent States in particular made rapid progress in both initial-phase and second-phase reforms. Since then, reforms have continued in most countries but at a slower pace. Past trends and future prospects are outlined below.

CEB

Central eastern Europe and the Baltic states (CEB) had by far the best starting point for transition. Many countries had already embraced the concept of private property and market-based prices and there was strong popular support for rapid economic and political change that would hasten integration into European and transatlantic institutions. Much was achieved in the first 10 years of transition, prompted partly by the need to harmonise legislation with the EU before becoming member states. Over the past few years, CEB countries have concentrated on completing the reforms that will allow them to compete effectively in the European and global market. Despite swift progress in most areas, certain aspects of transition remain unfinished.

Although initial-phase reforms have been virtually completed in all CEB countries, some second-phase reforms have stalled in areas such as governance and enterprise restructuring, competition policy and infrastructure. These reforms are often difficult to design and will take some time to implement. Declining political support for painful reforms (and, in some countries, increasing populist pressure to reverse reforms already undertaken) is also delaying the pace of change. Although market forces have driven the CEB countries forward in many respects – for example, the development of capital markets and telecommunications – changes in government policy will ultimately be needed to complete the transition agenda. This includes areas that are not captured by the EBRD's transition indicators – for example, health, housing and education as well as reforms in public administration and the judiciary.

SEE

Most countries in south-eastern Europe (SEE) started the transition process with some basic elements of a market economy. In particular, the former Yugoslav republics had a model of social ownership as opposed to the Soviet system of state ownership of all property. Recent years have seen a strong revival of market forces throughout the region. The crucial factor has been the relative stability of the region after the turmoil of the 1990s. Institutions such as the Stability Pact for South-eastern Europe, established in 1999, have helped to foster an atmosphere of cooperation among all countries in the region, a process greatly helped by the peaceful overthrow of the Milosevic regime in Serbia in 2000.

The outlook for SEE is a continuation of progress in reform. The success of Bulgaria and Romania in reaching the target of full EU membership by January 2007 provides encouragement to other countries that they too can become members. In this regard, the EU's Stabilisation and Association Process plays an important role in encouraging key reforms in areas such as trade policy and food and safety standards. As a result, SEE has begun to close the gap with CEB in terms of progress in transition and has surged ahead of the CIS and Mongolia (see Chart 1.2).

The reform agenda in the SEE-3 countries (Bulgaria, Croatia and Romania) is far from complete. Much needs to be done in restructuring enterprises, strengthening competition authorities, lowering market entry barriers, developing financial institutions and upgrading infrastructure networks. Establishing an effective legal framework for private sector participation in infrastructure services would help to advance the reform agenda in this aspect of transition (see Annex 1.1). The prospect of EU membership should continue to encourage reform in the SEE-5 countries of the Western Balkans, most of which lag well behind the SEE-3 average. However, uncertainty over when, or even whether, another round of EU enlargement will take place could dampen the incentives for some countries. It will be important to provide a credible alternative to full EU membership if transition progress in aspiring countries is to be sustained.

CIS and Mongolia

The Commonwealth of Independent States (CIS) and Mongolia started transition with the least advantageous initial conditions, including geographic isolation from the centre of Europe, lack of experience of market economics and of democratic institutions and years spent under communism. Nevertheless, they made significant strides from 1995 to 2000. However, progress in reform has tapered off sharply since then, especially in the oil and gas producing countries of the region (Azerbaijan, Kazakhstan, Russia, Turkmenistan and Uzbekistan).

Since 1992, the non-energy producing countries in the CIS have outpaced the energy producers in both initial-phase and second-phase reforms. There is a strong link between the rise in oil prices and the slowdown in reforms in the energy-producing CIS countries. Most reforms in these countries occurred from 1992 to 1997, when oil prices ranged from US$5 to US$20 dollars per barrel. Since 1999, when oil prices began to rise dramatically, reforms have slowed and in some years have actually gone into reverse in a few countries. Moreover, the investment climate in the energy-producing countries in the CIS has worsened as oil prices have risen, as shown by the EBRD/World Bank Business Environment and Enterprise Performance Surveys. Similarly, most corruption indices, including the Transparency International Corruption Perceptions Index, suggest that corruption is a bigger problem in the energy-producing CIS countries than in the countries without energy resources.

Major challenges remain for the CIS and Mongolia but the countries benefiting from high energy and commodity prices will face the greatest hurdles. Sustainable growth and further economic diversification for these countries depends on their willingness to implement the difficult reforms needed to restructure enterprises, encourage entrepreneurship and strengthen market-supporting institutions.

Box 1.1: The informal sector

According to some estimates, at least one-third of official GDP in most transition countries is generated by workers who do not pay regular taxes and who are excluded from the social security framework. This "informal" economy, which varies widely in size from country to country, arose because of the collapse of traditional sectors in the early years of transition, when many people were forced to take on any kind of job in order to survive. Informal activities persist partly because taxes, social security contributions and other requirements for operating legitimately can be onerous but also because many people need some job, however poorly paid, to survive.

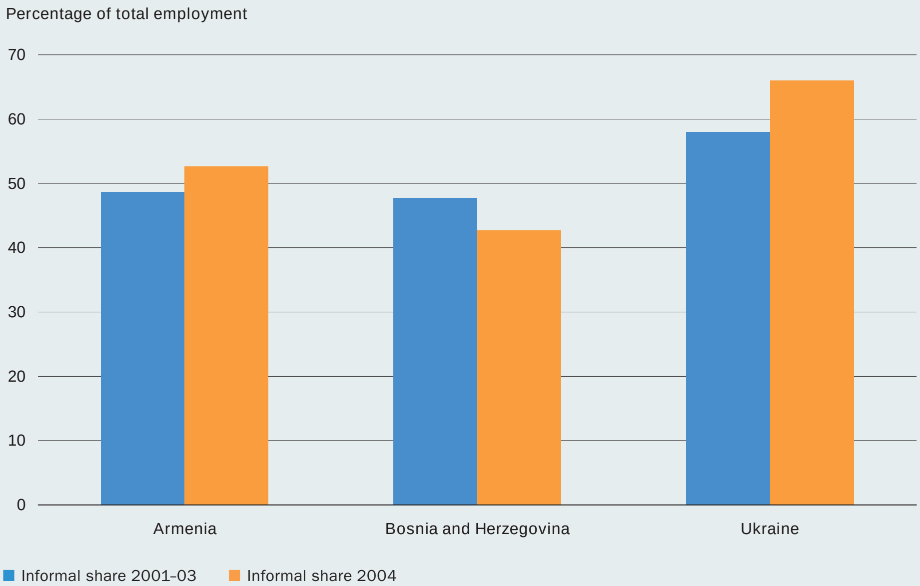
But what type of people operate in the informal economy, what are the rewards and how easy is it to move from an informal to a formal job? These questions can be addressed by analysing household surveys, which have become increasingly common throughout the region. The EBRD has recently carried out a study of the informal sector in Armenia, Bosnia and Herzegovina and Ukraine, drawing on surveys conducted over several years.

The study confirms that the informal sector forms a large part of the economy. However, including or excluding the agricultural sector makes a big difference to the results. Agriculture makes a key contribution to informal activities since most activity in this sector is counted as informal. In Armenia, employment in the informal sector in 2004 constituted 52.6 per cent of total employment if agriculture is included but only 34.1 per cent if excluded (see Chart 1.1.1). In Ukraine, 66 per cent of total employment was informal (including agriculture) but only 17 per cent if agriculture is excluded. Agriculture is also a significant source of informal employment in Bosnia and Herzegovina although the overall size of this sector is less important here than in the other two countries.

The proportion of informal employment has been relatively stable over the years. In Ukraine the percentage of informal employment has remained at about 65 per cent since 1996 although it dipped to 58 per cent in 2003, possibly because the survey was conducted at a time of the year when informal activities (especially in agriculture) are less common. In Armenia it rose from 48.7 per cent in 2002 to 52.6 per cent in 2004 while in Bosnia and Herzegovina it fell from 47.7 per cent in 2001 to 42.7 per cent in 2004. However, these figures include individuals employed in the public sector who did not pay social security contributions. If such people are excluded, the share of employment within the informal economy appears to have risen between 2001 and 2004 in the case of Bosnia and Herzegovina, for example. During this period the public sector declined significantly and many workers consequently ended up in informal employment.

Chart 1.1.1

Share of informal employment



Source: EBRD.

Note: Data for Armenia are 2002 and 2004; for Bosnia and Herzegovina, 2001 and 2004; for Ukraine, 2003 and 2004.

The study shows that, in general, younger people find themselves in informal jobs before finding, in some cases, a job in the formal sector. Secondly, there is a clear link between informal activity and lack of education (although many highly educated people in Armenia are also in informal work). Thirdly, there is little relation between gender and informal activity but a strong link between informal employment and rural location or regions where industrial output has collapsed. For example, western Ukrainian regions, such as Volynskaya and Vinnickaya, suffered sharp declines in industry and as a result have particularly high levels of informal employment.

For two countries, Bosnia and Herzegovina and Ukraine, the data follow some individuals over time, permitting an analysis of movement across jobs and sectors. People who start in formal employment typically stay formally employed for several years. Chart 1.1.2 looks at the mobility of those employed in two different periods. In Ukraine, 82 per cent of those initially employed in the formal sector in 1997 had not changed their status by 2003. In Bosnia and Herzegovina 89 per cent remained in the formal sector between 2001 and 2004. Of the informal workers in Ukraine in 1997, 57 per cent were in a formal job by 2003 while in Bosnia and Herzegovina 33 per cent of the informally employed in 2001 had found a formal job by 2004.

The differences in salary between the formal and informal sectors vary from country to country. In Ukraine, those in informal employment earn substantially more on average than those in the formal sector – more than twice as much in 2004 when comparing average monthly wages. Similarly, in Armenia informal employment provides a slightly higher wage and generally higher benefits than formal employment, especially at higher paid levels. In 2003 the average formal monthly wage was US$65, compared with US$68 in the informal sector.

In Bosnia and Herzegovina, however, wages were much higher in the formal sector. In the 2004 survey, about 9 per cent of formal employees were defined as poor, compared with 26 per cent of informal employees. Those who made the transition to formal work between 2001 and 2004 more than doubled their real monthly earnings whereas those who stayed in informal employment saw an increase of about 50 per cent.

Another way of looking at the relative rewards of informal activities is to compare self-reported estimates of life satisfaction. In the latest round of the Bosnian survey, the informally employed are shown to be less satisfied with their lives than any other labour market category (taking account of other relevant factors). In Ukraine, even though people in formal jobs tend to be paid less, they report higher levels of satisfaction. The difference is slight in 2003 – 49 per cent of the formally employed are either fully or quite satisfied compared with 46 per cent of informally employed – but the difference widens in 2004 to 63 per cent and 47 per cent respectively. One possible explanation is that those in the informal sector have higher aspirations for their lives, and are therefore frustrated by being in an informal job.

In summary, there is widespread agreement about the importance of the informal economy across the region. But there is little consensus about what should be done about it. The decisions facing policy-makers are complicated. They involve a careful balance of the employment generation and poverty-alleviating benefits of informal activities against the lost revenues to the government and the unfair competition faced by firms that operate legitimately and pay taxes and social contributions. Nevertheless, a number of important policy conclusions can be drawn from the research programme.

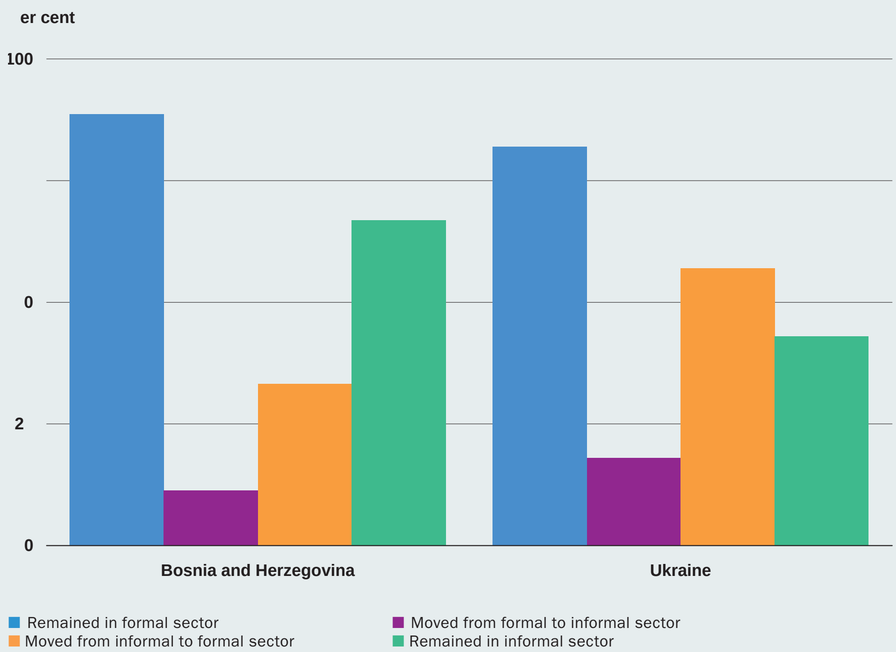
In many countries, a range of social insurance contributions acts as a disincentive for employers to take on workers and declare them to the authorities. Similarly, an increase in payroll taxes tends to encourage part-time work both in the state sector (where non-financial benefits are significant) and in the informal sector. High payroll taxes and social security contributions should therefore be reduced. In 2005 the Ukrainian authorities tackled the problem by raising the minimum wage (to eliminate under-declarations) and introduced re-registration of the pension fund. In general, however, any reforms in this area need to be combined with corresponding reforms in the health and pension sectors (see Box 2.2).

Lengthy procedures for setting up a business can also deter people from joining the formal economy. Bosnia and Herzegovina has the longest procedures in south-eastern Europe according to World Bank evidence. The adoption of VAT in Bosnia and Herzegovina in January 2006 has, however, been an important step in promoting tax efficiency and giving firms an incentive to register. It is already yielding results in terms of business registration. Procedures for setting up businesses should therefore be simplified across the region, possibly involving an "amnesty" period for those businesses that have been operating informally.

Finally, evidence shows that many highly educated people are forced to work in low-skilled, informal jobs, with little prospect of better employment. In Armenia, for example, the study shows that the majority of people with university education either work without a contract or take a second job ("moonlight") to make ends meet. The most likely way to escape their situation is through setting up their own business. Entrepreneurship should therefore be encouraged by governments.

Chart 1.1.2

Movement between the formal and informal sector



Source: EBRD.

Note: The chart shows the probability (in percentage terms) of workers moving from one sector to another. In Ukraine, those who hold both formal and informal jobs are classified as being in the informal sector. The chart covers 2001 to 2004 for Bosnia and Herzegovina and 1997 to 2003 for Ukraine.

Sources

S. Commander and Y. Rodionova (2006), "A model of the informal economy with an application to Ukraine", EBRD Working Paper, forthcoming.

H. Ghukasyan (2006), "Informal sector profile in Armenia", EBRD Working Paper, forthcoming.

G. Krstić and P. Sanfey (2006), "Mobility, poverty and well-being among the informally employed in Bosnia and Herzegovina", EBRD Working Paper, forthcoming.

Box 1.2: The regional impact of reform

The transition from central planning to market economies has differed across the transition region. Even within the same country, transition has had a very different impact on different localities. This is partly because, even in the most centralised countries, the reforms of central government tend to be implemented differently in different parts of the country. However, reforms have also had a different regional impact depending on the starting point and socio-economic conditions in a particular region.

Most countries collect data on a range of socio-economic indicators at regional level. These include:

- average household income – despite well-documented problems in measuring income, this is a good guide to a region's relative well-being
- employment rate (the ratio of working age people in employment) – this is a more precise indicator of the labour market than the unemployment rate, which does not cover people who have dropped out of the labour force
- access to fixed-line telephone services – since information on transport, energy and water supply is incomplete, this is a reasonable measure of infrastructure quality
- social welfare, covering health and education – a good measure of the quality of health care is the number of doctors per inhabitant.

These four indicators should reflect how structural reform decisions taken centrally affect regional welfare and development within a given country. They complement the transition scores in Table 1.1, which measure progress in these reforms for the country as a whole. Information on these indicators is available across at least seven localities for 17 transition countries.

The public services and infrastructure indicators show the largest degree of regional variation (see Chart 1.2.1). There is a much lower degree of variation for household income while the employment rate has the lowest variation of all.

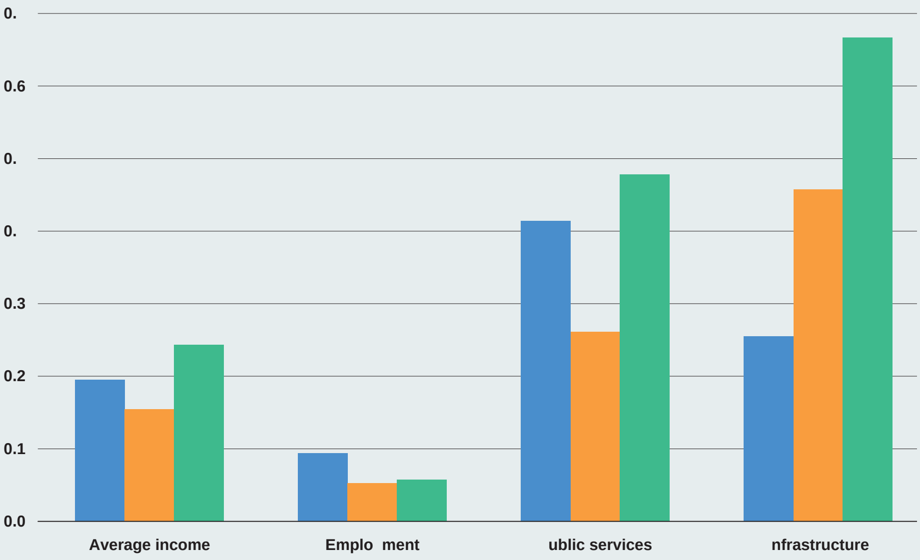
Countries that display a high degree of variation for one indicator also tend to show high regional differences for the other three indicators. This makes it possible to look at the average variation over the four indicators and use it as a broader indication of regional differences within a country. Chart 1.2.2 shows the distribution of regional scores relative to the national average.

Regional variations are highest in the Commonwealth of Independent States (CIS), particularly in the Caucasus but also in Kazakhstan and Russia. However, large variations can also be found in some of the more advanced countries, notably in Latvia. In the Kyrgyz Republic and the Slovak Republic, in contrast, there is little variation between regions, except in the capital cities.

Capital cities typically have much higher scores than the national average. In the

Chart 1.2.1

Regional differences

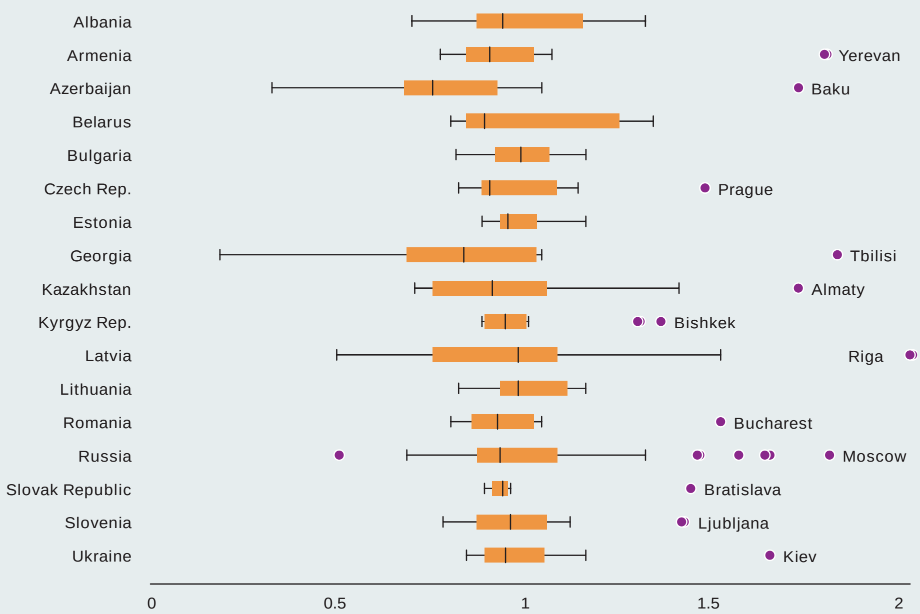


Source: EBRD based on national statistics.

Note: Regional variation is measured by the coeffficient of variation (the ratio of standard deviation to the mean). The larger the ratio, the higher the degree of variation. The chart shows the distribution of regional scores relative to the national average for four socio-economic indicators.

Chart 1.2.2

Regional differences by country



Source: EBRD based on national statistics.

Note: The chart shows the distribution of regional scores relative to the national average. For each country, 50 per cent of the regional scores fall within the orange bar, while the solid line shows the entire distribution of values. Regions that differ markedly from the national average are shown with a dot.

majority of countries surveyed, the capital region scores 50 to 100 per cent higher than the rest of the country (see Table 1.2.1). The three Caucasus countries and Latvia show the largest gaps. The high degree of variation exists because capital cities were generally the first to attract investment. Capitals also tend to have fewer infrastructure bottlenecks, better institutional capacity and a larger pool of qualified labour. They can therefore adapt much faster to the demands of a market economy.

An alternative way to assess local differences is to focus on the least developed region in each country. Table 1.2.1 compares the lowest score in a country to the national average. In the least developed region the scores are typically some 20 to 35 per cent lower than the national average. Latvia and Russia stand out as countries with particularly large regional disparities. In both countries, the score of the lowest region is less than one-third of the national average.

Regional disparities mostly reflect historical, political and socio-economic factors. The size of a country is also significant. However, with the notable exception of Russia, the countries exhibiting the largest degree of regional variation are mostly small. Progress in transition may also play a role but the exact link is difficult to ascertain without precise information about the situation at the beginning of the transition process.

Another important factor is the proportion of ethnic minorities in the regional population. In regions where ethnic minorities form less than 50 per cent of the population, the indicators are about the same as the national average. However, regions where ethnic minorities constitute over 60 per cent of the population score considerably lower than the national average (see Chart 1.2.3). For instance, in Latvia the district of Daugavpils, where ethnic minorities comprise over 60 per cent of the population (of which 63 per cent are Russians), has the second-lowest score in the country.

In summary, all four indicators used to assess the performance of regions within a particular country show that there are significant disparities. These are particularly marked for capital cities, which do better than the national average, and for regions with large ethnic minorities, which do significantly worse. Bringing the benefits of market reforms to the regions is an important transition challenge.

Table 1.2.1

Differences within countries

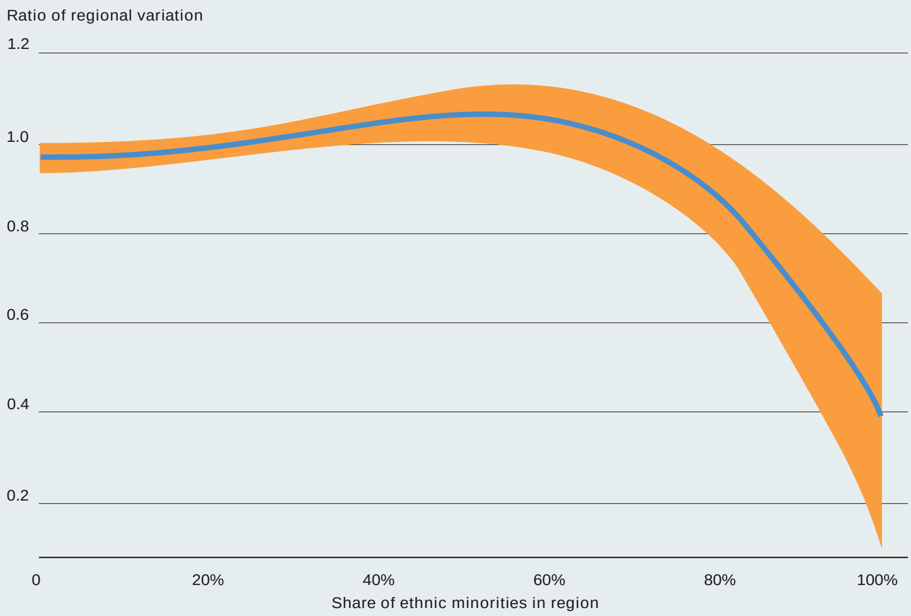
	Number of regions surveyed	Ratio of capital city to average of other regions	Ratio of lowest region to national average
CEB			
Czech Republic	14	1.59	0.65
Estonia	16	1.20	0.70
Latvia	33	2.10	0.29
Lithuania	10	1.49	0.73
Slovak Republic	8	1.57	0.83
Slovenia	12	1.52	0.72
SEE			
Albania	12	1.34	0.58
Bulgaria	28	1.12	0.75
Romania	8	1.70	0.79
CIS			
Armenia	11	2.09	0.62
Azerbaijan	11	2.09	0.57
Belarus	7	1.32	0.77
Georgia	12	2.02	0.52
Kazakhstan	16	1.87	0.66
Kyrgyz Republic [1]	8	1.38	0.80
Russia	89	1.85	0.29
Ukraine	27	1.71	0.75

Source: EBRD based on national statistics.

[1] The average for the Kyrgyz Republic covers three indicators – no data are available for infrastructure.

Chart 1.2.3

Regional differences and ethnicity



Source: EBRD.

Note: The blue line shows the “best fit” for the relationship between the share of ethnic minorities in a region and that region’s score relative to the national average. The predicted values lie within the shaded area around the fitted line with 95 per cent probability.

Annex 1.1: Concessions law

Concessions law is an important component of the legal framework in market economies. The quality of these laws in transition countries and how they work in practice are examined below. The extensiveness – or quality – of concessions law has been evaluated against well-established international benchmarks. Account has also been taken of the EBRD's own experience in implementing projects in the transition countries. The effectiveness of these laws has been evaluated by analysing the results of the EBRD's Legal Indicator Survey for 2006. This survey asked lawyers in the region to assess the award, implementation and termination of concessions contracts.

Concessions law plays a vital part in many types of public-private partnerships (PPPs), which are used by the public sector to attract large-scale investment to infrastructure development, municipal projects, education, health and other public services. Under a concession arrangement, a public authority entrusts to a private sector operator total or partial management of services which would normally be the responsibility of the local authority and for which the private company assumes the risk. Concession arrangements are usually entered into following a transparent tender exercise. Since the early 1990s the volume and number of PPPs have increased significantly worldwide. When regulated effectively, PPPs allow flexible risk sharing between the public and private sectors.

The following analysis focuses on a particular category of PPP – concession-type and Build Operate Transfer (BOT)/Design Build Finance Operate (DBFO)-type arrangements and does not address privatisation (outright assets sale) or procurement contracts. The BOT/DBFO category of PPP is regarded as the most complex since it involves risk responsibility, risk sharing and financing. Under a BOT arrangement, a private operator receives a franchise from the public sector to finance, design, construct and operate a facility for a specified period, after which ownership is transferred back to the public sector. During the time that the private company operates the facility, it is allowed to charge users appropriate tolls, fees and charges, as agreed in the contract, to allow it to recover its investment in the project and its operating expenses.[1]

Quality of legislation

In 2005 the EBRD undertook an Assessment of Concessions Law. This involved a detailed analysis of concessions law in selected core areas:

(i) the general policy framework; (ii) the general concessions legal framework; (iii) definitions and scope of concessions law; (iv) selection of the concessionaire (the company that operates the concession); (v) the project agreement; (vi) availability of security instruments and state support; and (vii) settlement of disputes and applicable law.[2]

The selection of core areas[3] and the questionnaire used in the 2005 Assessment were based on international standards developed by the United Nations Commission on International Trade Law (UNCITRAL) and other organisations,[4] and on the EBRD's experience in implementing PPP projects. For those countries that do not have a general concessions law (eight in 2004, seven in 2005) – that is, where rules governing concessions are contained in contract laws and/or sector-specific legislation – a separate, less detailed checklist of questions was prepared. Rules in these countries were benchmarked against internationally accepted principles only. Using the answers provided by lawyers in the transition countries, the relevant laws for all countries were assigned a rating of their compliance with internationally accepted standards or principles, ranging from "very high" to "very low".

As can be seen from Table A.1.1.1, only Lithuania achieved a "very high" compliance rating. Three countries were rated "very low" while the majority achieved "medium" compliance. This illustrates the need for reform of concessions legislation in virtually every transition country.

In many of the transition countries, a general policy framework for PPPs was not identified. The existence of such a framework is not necessarily linked to the quality of the law (as, for example, in Latvia). Very few countries have legislation clearly regulating the granting of concessions in a particular sector. Certain laws do not define the term "concession" and most laws contain unsatisfactory definitions (such as "the right to use").

Most countries scored well for settlement of disputes and applicable law, due in part to the ratification by many countries of the relevant international treaties (on enforcement of arbitral awards and protection of foreign investments). However, few countries scored well on the availability of reliable security instruments for lenders regarding the assets and cash flow of the concessionaire. This includes the rights of

Table A.1.1.1

Compliance with internationally accepted standards or principles

Very high compliance/ Fully conforms	High compliance/ Largely conforms	Medium compliance/ Generally conforms	Low compliance/ Partly conforms	Very low compliance/ Does not conform
Lithuania	Bulgaria	Bosnia and Herzegovina	Albania	Belarus
	Czech Republic	FYR Macedonia	Croatia	Georgia
	Slovenia	Moldova	Hungary	Tajikistan
		Romania	Kyrgyz Republic	
		Russia	Latvia	
		Serbia and Montenegro	Poland	
		Slovak Republic	Turkmenistan	
		Ukraine	Uzbekistan	
		Armenia		
		Azerbaijan		
		Estonia		
		Kazakhstan		

Source: EBRD Assessment of Concessions Law 2005.

Note: Countries in blue did not have a general law on concessions when the assessment was undertaken in 2005. For these countries, the assessment rated the level of conformity of other relevant laws – such as contract law or sector-specific legislation – with internationally accepted principles.

lenders to select a new concessionaire to take over an existing project agreement in the event of a breach of contract by the initial concessionaire. The survey also found that state financial support or guarantees were generally entirely omitted from the law or contained unnecessary restrictions. Among the few exceptions were Lithuanian and Albanian law, which contain specific reference to a concessionaire's entitlement to create securities and to obtain government support.

Although the majority of laws include provisions on competitive procedures for the selection of the concessionaire, very few contain enough guidance in this respect. Provisions relating to direct negotiations and unsolicited proposals are often not regulated with sufficient precision and leave room for uncertainties (for example, in Turkmenistan).

Only a few countries (Ukraine, for instance) have a model project agreement. An ideal agreement is one which is non-binding and used for guidance only. Also, legal provisions regarding the terms of the project agreement are often prescribed too narrowly, giving rise to inflexibility and uncertainty over what can be included.

Contrary to general perceptions of the quality of their investment climate and private sector development legislation, a number of countries (for example, Croatia, Hungary, Latvia and Poland) were rated "low compliance". However, with the exception of Hungary, there has been recent progress in reform of the relevant areas of their legal and/or policy framework. Since the completion of the Concessions Law Assessment in July 2005, progress in reform has been achieved in a number of countries.

In CEB the Czech Republic has adopted a Concessions Law, which came into force on 1 July 2006. Latvia has drafted a new Concessions Law, and responsibility for developing and implementing PPP projects has been given to the Ministry of Economy and the Latvian Investment and Development Agency. Poland's new law on PPPs came into force at the end of 2005 and three ordinances to deal with PPPs have been issued since then. The Slovak Republic has continued to develop its policy framework for PPPs.

In SEE, Albania is in the process of reforming its concessions legal framework. Bulgaria has adopted a new Concessions Law, which came into force on 1 July 2006. Romania has adopted the Ordinance on Granting of Public Procurement Concession of Public Works and Concession of Service Agreements, which came into force on 30 June 2006. Croatia is in the process of adopting PPP Guidelines.

In the CIS, Kazakhstan has adopted a Concessions Law, which came into force on 19 July 2006. Russia has adopted a model concessions agreement for the transport sector.

How the law works in practice

To complement the 2005 Assessment, the EBRD's 2006 Legal Indicator Survey (LIS) measures the effectiveness of concessions law in the transition countries.

The LIS used a case study to assess how a country's legal and institutional framework for concessions functions in practice. Lawyers in each country were presented with a typical scenario for the award and implementation of a concession and were asked a series of questions about how the legal and institutional framework in their country would operate in such a situation (see Box A.1.1.1).[5] Given the nature of concessions and related agreements (involving long-term partnerships between a public and private sector party), the scenario was divided into two parts, the second taking place two years after the first.

Scores for effectiveness were based on four core areas of the concessions legal and institutional framework:

- presence – whether concessions have been implemented successfully
- process – whether there is a fair and transparent selection process, measured by the possibility of challenging a concession award effectively
- implementation – whether there is fair and transparent implementation of the concession, measured by how effectively the Contracting Authority adheres to the project agreement terms and by the efficiency of remedial action in cases of non-compliance
- termination – whether an investment can be recovered in cases of early termination, measured by the capacity to enforce arbitral awards and counter obstruction by the Contracting Authority.

Each of the four core areas was rated out of 10. Effectiveness for all areas was graded as follows: "very low" (less than 30 per cent of the maximum total score); "low" (30 to 49 per cent); "satisfactory" (50 to 69 per cent); "high" (70 to 89 per cent); and "very high" (90 per cent and above).[6]

Although the findings of this survey give an indication of the effectiveness of concessions law in the transition countries, the results must be treated with some caution. First, they are based on the analysis of one law firm in each country and are not fully representative of the entire country. Secondly, they relate to a specific set of circumstances and may not apply to all types of concessions. Thirdly, even though the focus of the survey was limited to certain types of concession arrangements, it involved projects of different size and scale and in different sectors. Lastly, not all countries have had experience with the types of concessions described in the chosen scenario and therefore answers from these countries are speculative.[7]

Chart A.1.1.1 shows that four countries with experience of concessions were rated as highly effective: Bulgaria, Lithuania, Romania and Slovenia. The Czech Republic was rated as potentially highly effective as its survey was based on a hypothetical implementation rather than actual experience of concessions. Five countries received a very low effectiveness rating: Azerbaijan, Belarus, the Kyrgyz Republic, Tajikistan and Uzbekistan. Most countries fell into the medium categories.

The strongest performance was recorded in central eastern Europe and the Baltic states, followed by south-eastern Europe (SEE). Montenegro, however, was well below the norm for the SEE region. The country has a weak legal framework for concessions and is inefficient in implementing concession projects. In Bulgaria and Romania, on the other hand, numerous concessions have been successfully implemented since the late 1990s on the basis of concessions law. In most cases these have followed a transparent competitive procedure with the possibility to challenge the award,[8] and project agreements have been executed without serious claims. Following recent reforms of the legal framework in these two countries, the situation should progress even further.

In the Commonwealth of Independent States and Mongolia the results are generally worse than in the rest of the transition region. The number of concession projects implemented by each country differs significantly. In Kazakhstan several concessions have been successfully implemented, particularly in the energy and transport sectors but transparency of the award process has not always been respected and several concessions were terminated early. Belarus, the Kyrgyz Republic, Tajikistan and Uzbekistan have implemented very few projects (for example, a gold deposit concession in the Kyrgyz Republic and an energy concession in Tajikistan) or none at all. The overall framework for the implementation of these projects is poor, evidenced by a non-

Box A.1.1.1

Concessions law scenario

Your client is an international operator involved in a concessions project in a municipal utility (for example, water distribution, bus transportation, solid waste collection) in your country.

Scenario 1

Your client has been informed that the concession he is bidding for has been awarded to a local competitor who, to your client's knowledge, did not meet the qualification criteria. Your client considers that his proposal should have won under a fair and transparent selection process and has, moreover, spent more than €100,000 in the preparation of his proposal.

Is there any action that your client can take under concessions law or any other applicable law to challenge the award? Would you advise your client to proceed with the challenge? If the chances of a successful challenge to the award are small, is there a chance to recover a substantial proportion of the client's development costs?

Scenario 2

Your client has been awarded the concession. Two years later the project generates the expected cash flow and your client is making the anticipated profit. However, he faces difficulties in getting the Contracting Authority's acceptance of the tariff increase provided for under the project agreement. This is due to political and social opposition to such an increase.

When faced with a complaint by your client, is the Contracting Authority most likely to: (i) refuse to implement the tariff increase without providing compensation to your client; (ii) refuse to implement the increase but provide your client with adequate compensation; or (iii) abide by the terms of the project agreement despite the social and political opposition?

If the Contracting Authority refuses to implement the tariff increase, is there any action that your client can take (outside of the settlement of dispute procedure included in the project agreement) to challenge the Contracting Authority's decision and to oblige the Authority to comply with the tariff increase?

In the event that the tariff issue cannot be resolved and your client decides to terminate the project agreement and obtains an international arbitration award entitling him to recover the non-depreciated value of his investment, are there any efficient means of enforcing the arbitral award? Can the Contracting Authority delay or otherwise obstruct the enforcement process?

competitive award practice, lack of judicial independence and the impossibility of effective enforcement of arbitral awards.

Chart A.1.1.1 also shows the levels of effectiveness for each core area. For all countries, the costs incurred in the preparation of proposals by bidders are not generally recoverable. In the majority of countries a concession award can be challenged. However, local lawyers would not always advise proceeding with such a challenge, mainly because of the partiality of the court system or the length of time involved. In the great majority of countries, the Contracting Authority cannot be forced to comply with the tariff increase mechanism in the project agreement if it refuses to allow such an increase.

However, the results give a surprisingly positive picture of the overall level of adherence by Contracting Authorities to contractual terms. Respondents in 16 out of 26 countries said that the Contracting Authority would abide by the terms of the project agreement or provide adequate compensation despite social and political pressures. Effective enforcement of arbitral awards is regarded as especially difficult in the Kyrgyz Republic, Moldova, Russia, Tajikistan, Ukraine and Uzbekistan.

Conclusion

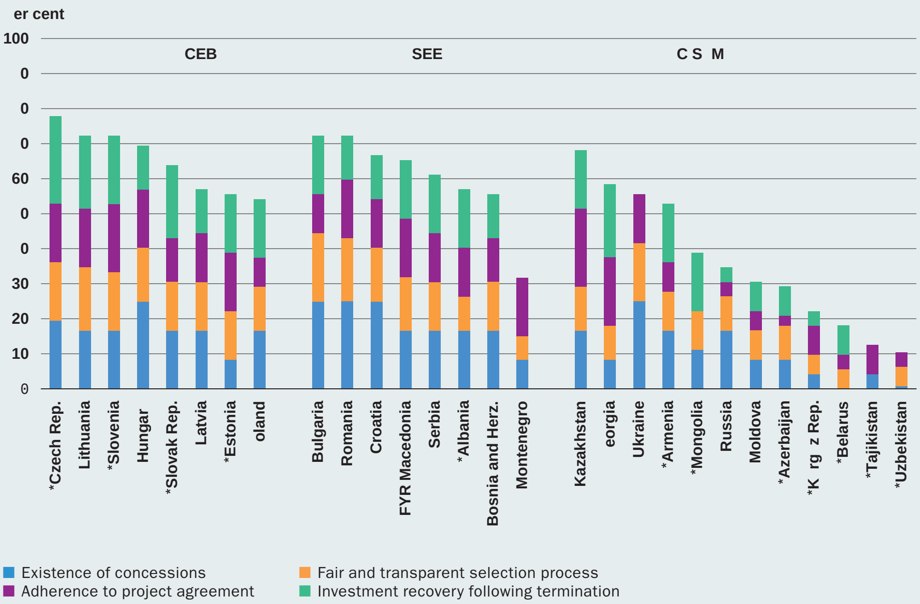
The 2005 Assessment of the quality of concessions legislation and the 2006 Survey on how these laws work in practice have produced similar findings (see Chart A.1.1.2). This suggests that most countries with a sound legal framework for concessions have effective mechanisms in place to enforce the law. There are, however, exceptions.

For example, in Azerbaijan, Moldova and Russia, concession legal frameworks generally conform with relevant international standards but they do not permit projects to be implemented effectively. This is mainly due to the poor functioning of the court system and a negative attitude towards international arbitration.

Conversely, in some countries where there are serious limitations in the concessions legal framework, concession projects can be implemented fairly successfully. This is true for Albania, Croatia, Georgia, Hungary and Latvia. The explanation for this could be the existence of an efficient court system or a more developed institutional

Chart A.1.1.1

Effectiveness of the concessions legal framework

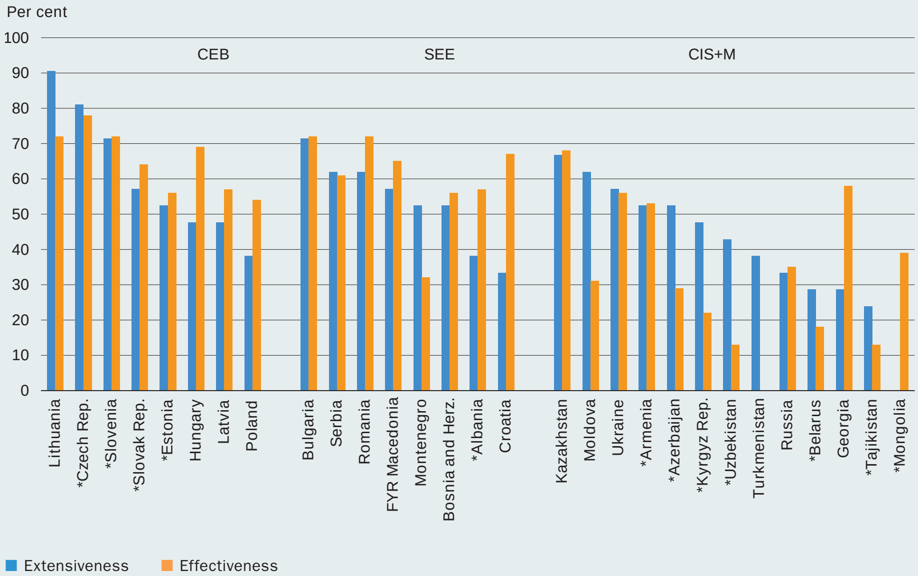


Source: EBRD Legal Indicator Survey 2006.

Note: Countries indicated with an asterisk did not have a concessions law at the time of the survey. Results for these countries are based on relevant comparable data. Effectiveness is measured on the following scale: very high (90 per cent and above); high (70 to 89 per cent); satisfactory (50 to 69 per cent); low (30 to 49 per cent); very low (less than 30 per cent). Data on effectiveness for Turkmenistan were not available.

Chart A.1.1.2

Extensiveness and effectiveness of concessions law



Sources: EBRD Assessment of Concessions Law 2005 and the EBRD Legal Indicator Survey 2006.

Note: Countries indicated with an asterisk did not have a concessions law at the time of assessment. See note to Chart A.1.1.1 for an explanation of the ratings. Data on effectiveness for Turkmenistan were not available.

infrastructure that is essential for day-to-day implementation and enforcement. However, all these countries were rated as satisfactory rather than highly effective, suggesting some limitations in implementing projects.

Overall, the concessions legal environment in the transition countries has much scope for improvement. Most countries still need to implement further legal and institutional reform if they wish to allow PPPs to work effectively.

Endnotes

1 The EBRD Assessment of Concessions Law was completed in July 2005 while the main part of the 2006 Concessions Legal Indicator Survey was conducted in July 2006. Changes in the concessions legal framework in some transition countries since July 2005 are not taken into account in the results and analysis presented here. The complete results of the 2005 Assessment are published on the EBRD web site together with the Cover Analysis Report and the full text of the EBRD Core Principles of a Modern Concessions Law. See www.ebrd.com/country/sector/law/concess/assess/index.htm and www.ebrd.com/country/sector/law/concess/core/mcl.pdf

For more detailed LIS results, see the Spring 2007 issue of *Law in Transition*. Also, the complete LIS results will be published on the EBRD's web site at www.ebrd.com/law

2 The EBRD worked with Gide Loyrette Nouel to finalise the concessions checklist, to undertake initial assessments of each national law, to develop a methodology for rating concession laws, to arrange for verification of the assessments by experts from each of the 27 transition countries surveyed and to ensure consistency of information and scoring. The project team comprised Alexei Zverev (EBRD), Bruno de Cazalet and Milica Zatezalo (Gide Loyrette Nouel).

3 For a more detailed description of these core areas and the EBRD Core Principles of a Modern Concessions Law, see www.ebrd.com/country/sector/law/concess/assess/index.htm

4 See UNCITRAL Model Legislative Provisions on Privately Financed Infrastructure Projects, 2003. Other international standards used are: Commission Interpretative Communication on Concessions Under Community Law, 2000; UNIDO BOT Guidelines, 1996; European Commission Guidelines for Successful Public-Private Partnerships, 2003; and OECD Basic Elements of a Law on Concession Agreements, 1999-2000.

5 In countries where the consultant on this project, Gide Loyrette Nouel, did not have an office, the EBRD contacted local law firms. Consistency of information was ensured through a review of the individual replies and a follow-up of any questions that arose. The EBRD is indebted to all the law firms which participated on a pro bono basis: Associate Kalo & Associates; Ameria CJSC; Chadbourne & Parke LLP; Mr Branko Marić, advocate; Djingov, Gouginski, Kyutchukov & Velichkov; Šavorić i Partneri; Luiga Mody Hääl Borenius; Mgaloblishvili, Kipiani, Dzidziguri; Assistance, LLC Law Firm; Law Offices of Klavins & Slaidins; Lideika, Petrauskas, Valiunas & Partners; Law Office Polenak; Turcan & Turcan; International Trade Centre, Mongolia; Vujacic Law Office; Linklaters, Bratislava; Jadek & Pensa; Akhmedov, Azizov & Abdulhamidov, Attorneys; Denton Wilde Sapte, Tashkent.

6 For countries that had only implemented one concession project or none at all by July 2006, the potential for an effective concessions regime was assessed by posing questions designed to highlight the reasons for the absence of such a regime and any recent developments towards establishing one. The countries in this category comprised Belarus, the Czech Republic, the Kyrgyz Republic, Mongolia, the Slovak Republic, Tajikistan and Uzbekistan.

7 In some countries (for example, Bulgaria, Romania and Hungary) numerous concessions have been implemented, enabling practitioners to treat the case as a real case. In others, the limited number of concession projects implemented (as in Georgia and Estonia) or their absence led necessarily to theoretical/hypothetical answers.

8 Challenges were recently launched in two major projects in Bulgaria: Varna and Bourgas airports and Trakia highway.

Macroeconomic overview

2

The transition countries have continued to show robust growth. This has been driven by strong domestic demand, which has in turn been spurred by real growth in credit and wages. Domestic demand and high energy prices are, however, putting pressure on inflation throughout the region. Moreover, domestic savings are currently insufficient to cover investments, resulting in large current account deficits, especially in countries that are not rich in natural resources. At the same time, foreign direct investment is projected to taper off slightly from the levels recorded in 2004–05. In 2006, several countries' currencies have come under pressure in foreign exchange markets. This reflects a more critical assessment by foreign investors of vulnerabilities in the region's emerging market economies. Furthermore, central banks in the United States, the eurozone and Japan have recently raised their interest rates, making investments in these countries more attractive.

Central banks across the region have been trying to grapple with the problems of rapid development of the financial sector combined with rising inflation. Many central banks have decided to raise interest rates, to introduce stricter regulations on minimum reserves or to initiate other anti-inflationary measures. Against this backdrop, fiscal policy has generally been too loose to stem domestic demand effectively. The case for more restrictive fiscal policies is becoming more pressing in view of the long-term implications of ageing populations, which will put significant pressures on public budgets in the future.

2.1 Central eastern Europe and the Baltic states

The economies of central eastern Europe and the Baltic states have continued to grow strongly, driven mainly by domestic demand and also by export growth. However, demand pressure is combining with high energy and commodity prices to spur inflation and generate large current account deficits. The monetary authorities are focusing increasingly on ensuring price and exchange rate stability. Nevertheless, fiscal policy is too expansive in some countries to cap domestic demand effectively.

Economic activity

Although real GDP growth in central eastern Europe and the Baltic states (CEB) fell to 4.7 per cent in 2005 from 5.2 per cent in 2004, the decline was due largely to a 2 percentage point slowdown in Poland. The Baltic states, the Czech Republic and the Slovak Republic recorded growth rates of at least 6 per cent in 2005. In 2006, average real growth across the region is forecast to reach 5.3 per cent, reflecting to a large extent a recovery in Poland.

Rising private consumption in the Baltic states, the Slovak Republic and, to a lesser extent, in Poland has been supported by real wage growth, with significant increases in unit labour costs. Low interest rates and financial service innovations have meanwhile fuelled consumer credit, especially through credit cards and mortgage financing. The increasing presence of foreign banks has also had a major impact (see Box 2.1). Total real credit in the region grew on average by 23 per cent in 2005, and by over 50 per cent in Latvia and Lithuania. Increasing mortgage financing has also led to higher residential investment while European Union (EU) funds have supported investment growth more generally.

Unemployment rates have fallen in most countries (except in Hungary) since 2001. However, the overall level remains relatively high and a significant proportion of the jobless have been out of work for a year or more, reducing the likelihood of re-employment (see Table 2.1). In 2005 the short-term unemployment rate (covering those out of work for less than a year) was lower than the eurozone average in six of the eight CEB countries. Many countries are experiencing labour shortages in fast-growing sectors of the economy, such as the construction sector in the Baltic states and the Slovak Republic's automotive sector. Emigration of skilled labour (for example, health care staff) has added to the shortages although a couple of CEB countries (the Czech Republic and Poland) are also benefiting from immigration into the low-skilled sector. These trends are contributing to strong wage pressures and may fuel further inflation.

Inflation

Growth in domestic demand, combined with rising energy and food prices, has led to rising inflation since mid-2005 in the Czech Republic, Estonia, Lithuania and the Slovak Republic. In Hungary and Latvia the upward trend started in the second quarter of 2006. In Poland inflation also appears to be on an upward trend even though the latest monthly inflation figures for August 2006 were quite low.

Headline inflation exceeds the Maastricht inflation criterion in a number of CEB countries. Rising energy and food prices are largely responsible for this acceleration, as illustrated by the difference between the overall inflation rate and the "core" inflation rate (which excludes energy and food). In all CEB countries, core inflation is significantly below the overall inflation rate. However, higher energy and food prices can have an impact on other prices and wages, and in some countries (the Baltic states, for example) core inflation has been increasing in 2006.

Foreign trade and FDI

Demand pressures in CEB are generating strong import growth and domestic savings are currently insufficient to cover investments, resulting in current account deficits. This is in contrast to most other emerging market countries in Asia or Latin America. Estonia, Latvia and the Slovak Republic registered current account deficits ranging between 8.6 per cent and 12.5 per cent of GDP in 2005 while Lithuania and Hungary had deficits of 7 to 8 per cent. In 2006 the current account deficits are likely to be even larger, reflecting rising private consumption. Real exchange rates have been appreciating since 2001 as a result of strong capital inflows and the resulting boost to productivity in the tradable sector relative to the non-tradable sector.

Financing current account deficits has not yet caused significant problems in CEB (see Chart 2.1) as foreign direct investment (FDI) and, to a lesser extent, net portfolio investments continue to be strong. Following steep increases in 2004 and 2005, net FDI is projected to decline to US$ 22.1 billion in 2006 from US$ 27.5 billion the previous year. A fall in net FDI into Estonia, Hungary and particularly the Czech Republic is being partially offset by increases into Latvia, Lithuania, Poland, the Slovak Republic and Slovenia. In Estonia, Hungary, Latvia and Lithuania the FDI coverage of the current account deficit in 2006 is forecast to be below 50 per cent, making these countries more vulnerable to a sudden reversal of capital flows.

FDI not only provides long-term financing but can also add to export capacities and may therefore help to lower the trade deficit. Substantial investment in the automotive industry in the Czech Republic has contributed in this respect to a decline in the current account deficit, and similar positive effects are anticipated in the Slovak Republic. Other countries, such as Hungary and Poland, recorded a rising share of portfolio investment inflows in 2004 and 2005. However, relatively high net portfolio inflows can make countries more vulnerable to a sudden reversal of capital flows when adverse economic and financial developments occur abroad or at home.

During 2006, several countries' currencies have come under pressure in foreign exchange markets. This reflects a generally more critical assessment by foreign investors of vulnerabilities in the region's emerging market economies. Furthermore, central banks in the United States, the eurozone and Japan (the G-3) have recently raised their interest rates, making investments in the G-3 more attractive.

The Hungarian forint, the Polish zloty and the Slovak koruna depreciated by 12, 6 and 2 per cent respectively against the euro between 1 January and 30 June 2006 although there has been some reversal since then. In the case of the Slovak koruna, the National Bank intervened heavily in the currency market between May and June 2006 to support the currency.

Nominal exchange rates remain fixed in the Baltic states, with Estonia and Lithuania maintaining currency boards. Rates are also fixed in Slovenia, which has already set its permanent entry rate of the tolar to the euro in advance of formal adoption of the euro on 1 January 2007.

Domestic policies

Policy-makers are facing significant challenges regarding monetary and fiscal policy, and central banks in CEB have had to take strong measures to ensure price and exchange rate stability. In the Czech Republic, Hungary, Latvia and the Slovak Republic, central banks have all increased their interest rates since January 2006 – responding to interest rate increases in the eurozone. Poland is the only country in the region to have decreased its interest rate over this period but this was from a strictly restrictive stance. This decrease followed on from a stronger than expected decline in inflation and a more favourable inflation outlook. On 31 January 2006 the Central Bank of Slovenia initially dropped its rate (to bring it closer to eurozone levels prior to euro adoption in 2007) but it has increased it twice since then in response to inflationary pressures. In Estonia and Latvia the central banks have introduced stricter regulations on minimum reserves and other anti-inflationary measures in response to strong credit growth.

Average general government deficits across the region were 1.7 per cent of GDP in 2005 compared with a 2.7 per cent target. Although these deficits are better than expected, they mainly reflect a strong macroeconomic environment and overcautious target-setting rather than an improvement in the underlying structural budget balance. The case for more restrictive fiscal policies, which have generally been too loose to stem domestic demand effectively, is becoming more pressing in view of the long-term implications of ageing populations, which will put significant pressures on public budgets in the future (see Box 2.2). Hungary stands out as the only country that has missed its fiscal targets by a wide margin for the past four years. In December 2004 the authorities predicted a decline in the deficit of 1.2 per cent of GDP while in reality the fiscal deficit increased from 5.4 to 6.1 per cent of GDP in 2005. The country's persistent fiscal difficulties have been reflected in declining investor interest and downgrades by the main rating agencies.

Table 2.1

Unemployment rate

	Unemployment rate		Long-term unemployment rate [1]		Short-term unemployment rate [2]	
	2004	2005	2004	2005	2004	2005
Czech Republic	8.3	7.9	4.2	4.2	4.1	3.7
Estonia	9.7	7.9	5.0	4.2	4.7	3.7
Hungary	6.1	7.2	2.7	3.2	3.4	4.0
Latvia	10.4	8.9	4.6	4.1	5.8	4.8
Lithuania	11.4	8.3	5.8	4.3	5.6	4.0
Poland	19.0	17.7	10.3	10.2	8.7	7.5
Slovak Republic	18.2	16.3	11.8	11.7	6.4	4.6
Slovenia	6.3	6.5	3.2	3.1	3.1	3.4
Eurozone	8.9	8.6	4.0	3.8	4.9	4.8

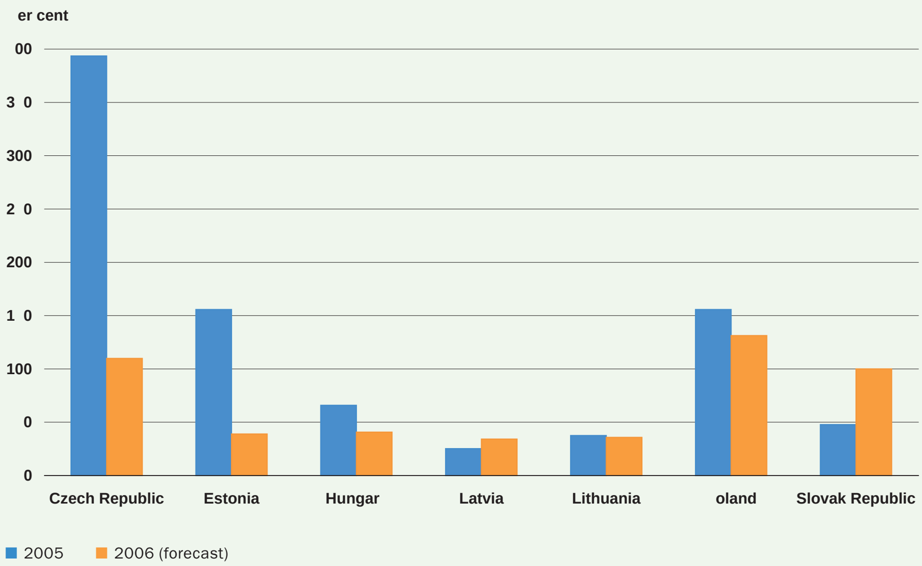
Source: Eurostat.

[1] Long-term unemployment signifies unemployment for a year or more.

[2] Short-term unemployment signifies unemployment for less than a year.

Chart 2.1

Net FDI coverage of current account deficits



Source: EBRD.

Note: Slovenia is not included due to negative net FDI in 2005.

2.2 South-eastern Europe

South-eastern Europe continued to grow robustly during 2005 and the first half of 2006. The region is benefiting from an industrial revival and expanding export opportunities while the prospects of EU accession are attracting record inflows of foreign capital. Inflation is generally subdued but rapid credit growth and high levels of public spending are posing challenges for governments and central banks. Continued large current account deficits may be problematic in the future if remittances from workers living abroad and foreign direct investment slow down.

Economic activity

Real GDP growth in south-eastern Europe (SEE) was 4.7 per cent in 2005 (compared with 6.9 per cent in 2004) and is projected to increase slightly to 5.9 per cent in 2006. Serbia had the strongest growth rate at 6.3 per cent while Albania, Bosnia and Herzegovina and Bulgaria all recorded growth of 5 per cent or more in 2005.

Indications from the first half of 2006 show no slowdown in the SEE economy. Instead, economic growth, especially in the largest economies, appears if anything to be accelerating. Both Bulgaria and Romania are benefiting in macroeconomic terms from a pre-EU accession boost. The Bulgarian economy rose by more than 6 per cent in the first half of the year, boosted by strong consumption and investment growth. In Romania the rebound was even stronger – 7.4 per cent in the first half of the year, indicating possible signs of overheating.

Croatia and Serbia are both on track to emulate the previous year's growth. Meanwhile, economic developments among the smaller countries of the region are also favourable. In its first year of full independence, Montenegro may even exceed last year's record growth while the Albanian and Bosnian economies are continuing to grow strongly. Only in the Former Yugoslav Republic of Macedonia is there a sign of some minor slowdown but even here the rate of growth is expected to pick up again in the second half of the year.

Several factors have underpinned the economic revival of SEE since 2000. The first is a recovery in industrial growth, influenced in large part by a strong inflow of foreign direct investment (FDI) into key industries. In some industries, once-moribund enterprises have been regenerated by substantial investments – for example, in the metals sector in Bosnia and Herzegovina, FYR Macedonia and Serbia. In the EU accession candidates – Bulgaria, Croatia and Romania – industrial production has been influenced significantly by FDI although much of this has gone to the services sector.

A second factor underpinning economic revival is strong domestic demand, fuelled by credit growth. Starting from a low base, credit has been expanding very rapidly in SEE (by 23 per cent in 2005) and the resulting consumer demand has prompted an increase in imports. A third factor is the revival of export markets. For several years, countries in the region have had duty-free access to the EU for most goods. Also, trade within SEE is recovering on the back of renewed links among former Yugoslav republics and a region-wide network of bilateral free trade agreements. This network of agreements is being converted into a regional free trade accord, which should lead to further expansion of trade over the medium term. Despite these positive developments, however, unemployment is generally high across the region, especially in the Western Balkans.

Inflation

Inflationary pressures have increased over the past year in SEE. The average inflation rate in the region in 2005 was low at 5.7 per cent. However, Serbia was a significant exception, with inflation rising to 17.2 per cent by the end of 2005 from 9.5 per cent in 2004. While higher energy prices have had an influence, the main causes of inflation in Serbia appear to be strong wage growth, rapid credit expansion and, in some industries, a consolidation of monopoly power and protectionism that is keeping prices above world levels. In Bulgaria, inflation rose during the first quarter of 2006, reaching almost 9 per cent, mostly due to higher fuel and food prices and an increase in excise taxes but it has fallen since then. In Romania, which expects to join the EU in January 2007 along with Bulgaria, inflation is still above 6 per cent. Elsewhere in SEE, inflation remains at low single-digit levels.

In response to inflationary pressures, several countries are relying on various types of fixed exchange rate regimes adopted over the years. Montenegro's policy of unilateral adoption of the euro some years ago, when it was still part of the Federal Republic of Yugoslavia, has been successful in bringing about low inflation. However, this policy is not an option for other countries in the region; it is explicitly ruled out by the EU for countries either in accession negotiations or within the Stabilisation and Association Process. Most countries have a stable nominal regime, either through a currency board (as in Bosnia and Herzegovina and Bulgaria), a fixed peg exchange rate (FYR Macedonia) or a managed float (Albania, Croatia, Romania and Serbia).

Foreign trade and FDI

SEE continues to run high current account deficits, ranging in 2005 from 1.3 per cent of GDP in FYR Macedonia to 17.3 per cent in Bosnia and Herzegovina. Strong doubts persist about the quality of the data, however, for Bosnia and Herzegovina. Nevertheless, a deficit of this magnitude, even if overstated, is a cause for concern, especially in a currency board regime. Bulgaria similarly has a double-digit current account deficit (above 14 per cent of GDP in mid-2006). As noted above, SEE is generally experiencing strong export growth, all countries in the region having recorded expansion in excess of 7 per cent in 2005. However, this is being offset by rising demand for imports, reflecting not only higher consumption but also the significant investment needs of the region.

Large current account deficits are not a new development in SEE. Most countries had strong inflows of investment-related capital in 2005 and all of them had a balance of payments surplus. FDI inflows to the region are at record levels, having risen from US$12 billion in 2004 to US$13 billion in 2005 (see Chart 2.2). They are on course to reach US$19.3 billion in 2006. The inflows are related mainly to privatisation and acquisitions as the banking sectors of several countries (notably in Croatia, Romania and Serbia) have attracted great interest from foreign banks.

Two further considerations are likely to sustain the momentum of FDI in the short term. First, all SEE countries have been making significant progress in the EU accession process, sending a strong signal to investors that the region's long-term future lies in European integration. The second factor is the region's improved image. Most countries have received upgrades from the main international rating agencies, again indicating an improved economic climate and increasing opportunities. Recognising this potential, foreign investors are increasingly prepared to disregard the region's problematic past.

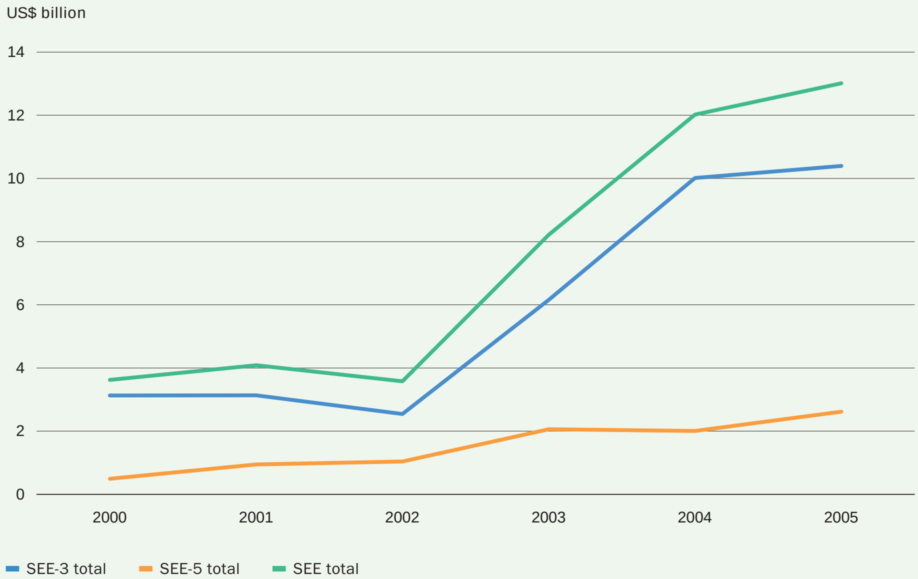
Domestic policies

The main macroeconomic challenges facing policy-makers in SEE are on the fiscal side. While fiscal discipline has generally been maintained in 2005-06 across the region, government spending in several countries, such as Bosnia and Herzegovina, Croatia, Montenegro and Serbia, is large relative to GDP and out of line with other countries and regions of similar economic size. In addition, although all countries in the region have major investment needs, government spending is weighted heavily towards current rather than capital spending. The region as a whole recorded an average general government deficit of 0.8 per cent of GDP in 2005 (see Chart 2.3) and, in general, fiscal discipline is being maintained in 2006.

Central banks across the region have been trying to grapple with the problems posed by the development of the financial sector and credit growth. The main tools available to address this have been bank reserve requirements and interest rates although these have had generally limited effect so far. Reserve requirements have been raised substantially in Bosnia and Herzegovina, Croatia and Serbia while Romania's Central Bank has had to raise interest rates on several occasions since mid-2005. Nevertheless, the banking system in the region has become progressively stronger. Not only have established foreign banks entered the markets in all countries but supervisory powers have been strengthened and are enforced more rigorously (see Box 2.1).

Chart 2.2

Net foreign direct investment

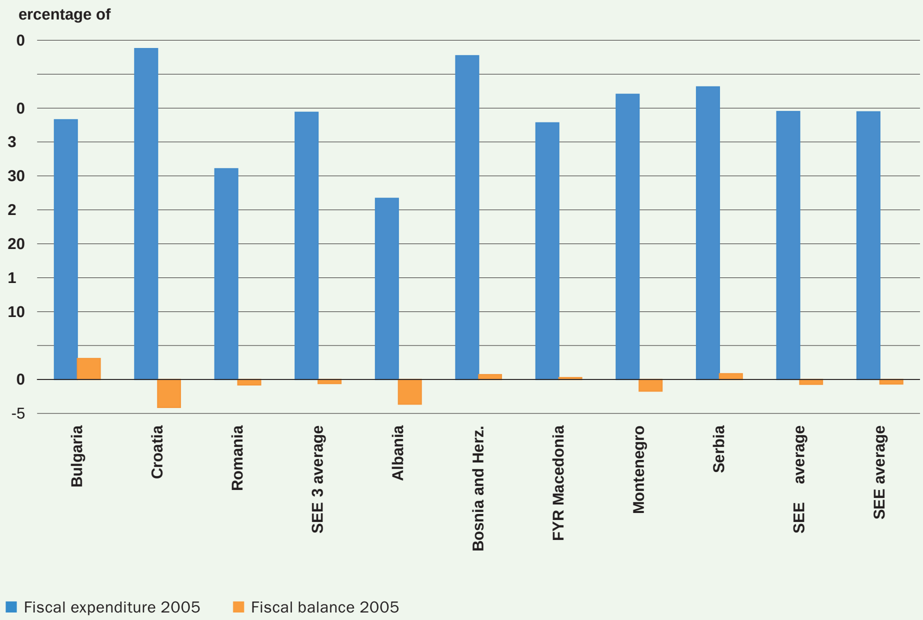


Source: EBRD.

Chart 2.3

Government expenditure and deficits

(as a percentage of GDP)



Source: EBRD.

2.3 Commonwealth of Independent States and Mongolia

The Commonwealth of Independent States and Mongolia have continued to reap the benefits of high energy and commodity prices, reflecting the strength of global demand for the region's natural resources. The growth in domestic demand has been fuelled by a combination of accelerating credit, higher employment and wages, remittances from workers living abroad, a booming construction sector and, in 2006, expansionary fiscal policies. Inflation is still high in several countries, contributing to a further real appreciation of domestic currencies.

Economic activity

The economies of the Commonwealth of Independent States (CIS) and Mongolia grew by 6.6 per cent on a weighted average basis in 2005. This was lower than the 8 per cent recorded in 2004 but higher (for the seventh year in a row) than the growth rate in CEB or SEE. The region is projected to grow at almost 7 per cent in 2006, reflecting continued buoyancy in key energy and commodity prices (see Chart 2.4).

Azerbaijan in particular has become one of the fastest-growing economies in the world due to the major expansion of its oil sector. Real GDP in Azerbaijan rose by 26 per cent in 2005 and by just over 36 per cent year-on-year in the first half of 2006. In Ukraine real growth is likely to double in 2006 from the relatively depressed rate recorded in 2005 following a rebound in international steel and metal prices and strong domestic demand. In the region's largest economy, Russia, real GDP growth remained strong at 6.4 per cent in 2005 (only slightly below the levels in the previous two years) and this trend is continuing in 2006.

As Chart 2.4 illustrates, the link between increases in oil prices and CIS growth rates was particularly strong between 1999 and 2004. However, from 2005 onwards, this link has weakened. This could be an indication that oil-rich countries are making efforts to manage their resources better by saving oil revenues in funds but it may also point to growth being limited by capacity constraints in the region and by lack of progress in structural reforms.

A key source of growth has been private consumption, which has risen particularly strongly in the countries that are not rich in natural resources, such as Armenia, Georgia and Ukraine. The increase has been spurred by rising wages, growth in employment, rapid credit growth and strong inflows of remittances from workers living abroad. Real wage growth across the region averaged 15.9 per cent in 2005 and has remained close to this level in 2006. In many cases, growth in public sector wages has contributed to a country-wide rise in real wages. Moreover, the increasing use of financial services, such as credit cards and mortgages, has fuelled growth in consumer credit.

Growth in gross fixed investment has been a significant factor in GDP expansion, particularly in resource-rich countries. In Uzbekistan the economy has been benefiting from new Russian and Chinese investment in the oil and gas sector during 2006. A recovery in investment is also underlying the rebound in real GDP growth in Russia and Ukraine this year.

There has also been notable growth in residential investment in most countries of the region, with the construction sector benefiting from a housing boom. This has been bolstered by rising personal incomes, mortgage loans, tax exemptions and relatively low interest rates.

Inflation

High levels of inflation continue to affect many CIS countries. Annual consumer price inflation in the region averaged 10 per cent in 2005 and is expected to fall only modestly in 2006. This reflects rising costs for producers and strong demand from domestic consumers. Energy and commodity prices are at record levels and are adversely affecting non-resource-rich countries. For example, in Armenia – the country with the lowest inflation rate in the region in 2005 – rising energy prices have been the primary cause of the rise in inflation from –0.2 per cent at the end of 2005 to 6.7 per cent year-on-year in July 2006.

However, even the resource-rich countries have been experiencing persistently high or rising inflationary pressures. Energy-related revenues and income flows have boosted domestic spending while central bank purchases of foreign exchange have not been offset by an equivalent sale of government securities or increased government deposits in the central banks. This has resulted in rapid growth of money supply, in many cases exceeding nominal GDP growth. In view of the relatively underdeveloped domestic money and capital markets, this has contributed to an increase in financial asset prices across the region.

Foreign trade and FDI

High energy and commodity prices led to a small current account surplus in 2005 in the CIS and Mongolia but there was wide variation across countries (see Chart 2.5). Russia and Turkmenistan recorded surpluses of 11.0 and 7.4 per cent of GDP respectively in 2005, due mainly to high prices for minerals and metal products. Uzbekistan's surplus increased to just over 13 per cent of GDP on the back of favourable gold and cotton prices.

In non-resource-rich economies, with the exception of Belarus and Ukraine, the combination of record import prices for energy and commodities and a marked rise in import demand (reflecting the buoyancy of domestic consumption and investment) led to substantial current account deficits of between 3 and 8 per cent of GDP in 2005. Moreover, Ukraine's current account is expected to swing into deficit in 2006 for the first time since 1998.

Remittances from workers living abroad have continued to bolster economies across the region, especially in those countries with deficits, although it is possible that these deficits are overstated because of under-recording of remittances. Many expatriate workers from Armenia, Georgia, the Kyrgyz Republic, Moldova and Tajikistan regularly send home earnings amounting to well over 5 per cent of GDP each year (see *Transition Report Update* 2006).

Net foreign direct investment (FDI) in the region in 2005 stood at US$13.3 billion, almost unchanged from the previous year. However, it is likely to fall to US$8.9 billion in 2006, mainly reflecting the one-off effect of Ukraine's record privatisation revenues in 2005 (including the sale of Kryvorizhstal to Mittal Steel). Russia is increasingly acting as a source of FDI into other countries in the region. Russian companies have accumulated substantial cash reserves and are increasingly investing abroad, motivated by the wish to diversify their portfolios and to integrate with associated industries and services in these countries. This process is likely to intensify following the liberalisation of the capital account in July 2006.

Domestic policies

The strong growth enjoyed across the CIS and Mongolia (although from a low base) has brought increasing prosperity but also significant policy dilemmas. Monetary authorities in resource-rich countries may seek to manage the strong inflow of foreign currency and prevent the currency from appreciating in nominal terms in order to protect the competitiveness of non-energy/non-commodity export industries, at least in the short run. On the other hand, a stronger currency can help to dampen inflationary prices by making imports cheaper. This is a difficult balancing exercise, made more problematic by the lack of sufficiently developed domestic money and capital markets. This makes the impact of interest rate changes on the real economy less effective.

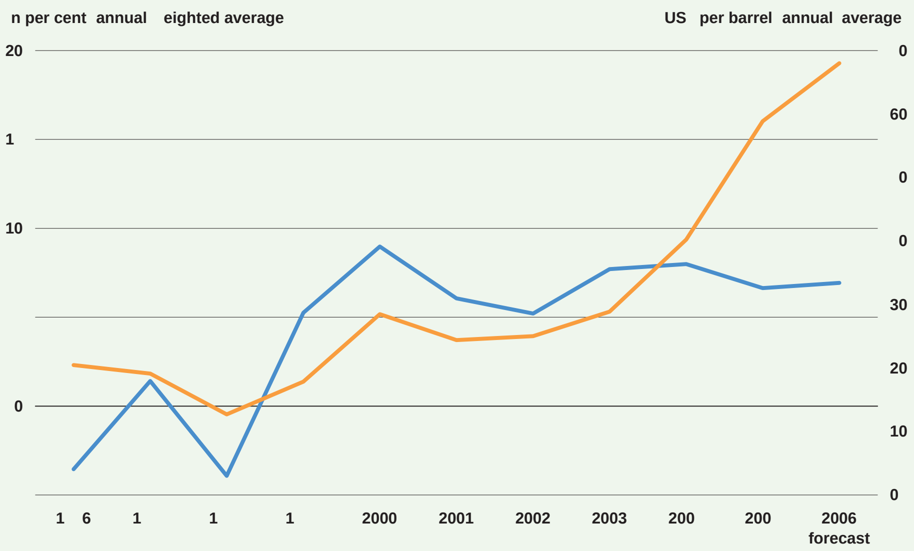
As inflation rates have risen, several countries (including Azerbaijan, Kazakhstan and the Kyrgyz Republic) have increased their interest rates or introduced more direct ways of controlling the money supply (as in Kazakhstan) although the effectiveness of these measures remains to be seen.

Restrictive fiscal policy is needed to support monetary policy and to stem inflationary pressures. The CIS countries and Mongolia recorded on average a fiscal surplus of 0.4 per cent of GDP in 2005, compared with a deficit of 0.2 per cent in 2004. However, a slight deterioration in fiscal balances is forecast for 2006. This would be avoidable if the growth dividend from buoyant economic activity was used to reduce the deficit.

Resource-rich countries, such as Kazakhstan and Russia, are largely managing their fiscal windfall with restraint. Russia's Oil Stabilisation Fund is a good example of how budgetary surpluses can be set aside for possible future downturns. The fund is estimated to reach US$84 billion by the end of 2006. However, fiscal policy across the region generally remains too loose to support strong counter-inflationary measures.

Chart 2.4

Oil prices and average GDP growth

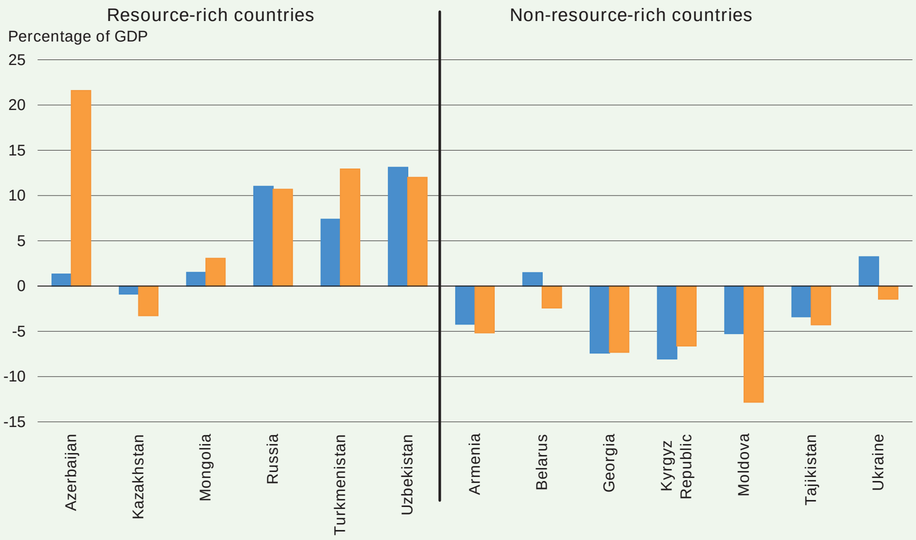


CIS and Mongolia GDP growth (left axis) Oil price – Brent (right axis)

Sources: Bloomberg and EBRD.

Chart 2.5

Current account balances



2005 2006 (forecast)

Source: EBRD.

2.4 Medium-term outlook and vulnerabilities

Continued growth is forecast for the transition countries in the medium term, reflecting sustained progress in structural reforms and increasing integration into the world economy. However, growth rates similar to those achieved in recent years cannot be assured and important risks remain. CEB prospects are increasingly tied in with performance in the eurozone while SEE, the CIS and Mongolia still face substantial reform hurdles.

CEB

Over the medium term, GDP growth should remain robust although a slight slowdown is forecast from 2007. Export growth is likely to continue but domestic demand is expected to remain the key source of economic growth. High energy and commodity prices and strong domestic demand could put further pressure on inflation. Central banks in CEB may have to raise domestic interest rates in the short term even though this could have an adverse effect on domestic growth.

The substantial current account deficits in the region need to be monitored carefully, especially as global liquidity has declined and foreign investors are paying more attention to macroeconomic fundamentals. An additional uncertainty is the increasing competitive pressure from Asian producers. These factors highlight the need for responsible fiscal policy. However, for political reasons, further deficit reductions are unlikely in the short term.

With the exception of Slovenia, the CEB countries face growing uncertainty regarding adoption of the euro (see Table 2.2). Two years after joining the EU, progress has slowed down significantly and Slovenia remains the only CEB country to adhere to the initial timetable. Lithuania applied for adoption of the euro in May 2006 but this was rejected because the country's average rate of inflation had slightly exceeded the target level since April 2005. Lithuania's inflation rate is expected to rise gradually until the end of 2006. The other Baltic states are also struggling to meet the Maastricht inflation criterion. Like Lithuania, Estonia postponed adoption of the euro beyond its target date of January 2007. The Latvian authorities have also publicly stated that they will not achieve their initial target date of January 2008 for adoption of the euro.

The Slovak Republic was clearly on track to adopt the euro (in 2009) until rising inflation and policy statements by the new government on fiscal priorities raised doubts about this schedule. Since then, the Slovak government has striven to signal to the markets its firm commitment to euro adoption in 2009. In 2005, Poland was also aiming for euro adoption in 2009 but this no longer appears to be a government priority. In the Czech Republic the government recently announced that adoption of the euro will be delayed beyond 2010 mainly because of the high public deficit planned for 2007. Hungary's Convergence Programme released in September 2006 does not specify a date for euro adoption or membership of the Exchange Rate Mechanism (ERM) II. The Finance Minister has stated that Hungary could join ERM II between 2007 and 2009 while adoption of the euro might be possible between 2011 and 2013.

Eventual euro adoption is not only a formal requirement for new EU members, it is also important for macroeconomic stability. Further delays could increase macroeconomic risks. CEB has much higher current account and government deficits than other EU countries outside the eurozone. They are small, open economies with strong trade linkages to eurozone countries. In many cases, their debt (both private and public) is largely denominated in euro. The CEB countries face high currency risk, and a loss of investor confidence in the euro adoption timetable could potentially cause substantial economic turbulences. These risks are much higher than for other EU members outside the eurozone.

SEE

Prospects for SEE over the medium term are generally favourable. Overall, growth is projected to match present levels, driven by continuing strong domestic demand and a probable expansion of exports. Increased stability in the region and the prospects of EU accession are encouraging record inflows of investment. Although these inflows are likely to decline as privatisation programmes are completed, their benefits will be long-lasting. Policy considerations should focus on fiscal issues. Governments in all SEE countries will face sustained pressure for extra spending, especially to upgrade infrastructure.

Two principal challenges in the medium term are EU membership for all SEE countries and the lasting settlement of unresolved conflicts. For the SEE-3 countries, membership is either imminent (Bulgaria and Romania) or likely in the short term (Croatia) but for the rest of the region (SEE-5) EU membership is not as clear cut.

The SEE-3 countries are likely to benefit substantially from considerable EU assistance, which should lead to improvements in infrastructure and public administration. For the remaining countries, EU aid will be provided through the Instrument of Pre-Accession Programme. While funding under this programme will be significant, there is a risk that the SEE-5 will lag behind the rest of the region. More generally, these countries are vulnerable to the growing sense of "enlargement fatigue" among existing EU member states. To maintain reform momentum in SEE, it is vital that all countries in the region have the prospect of full EU membership in the medium term.

The main unresolved political issue is the status of Kosovo. The general economic situation in the province is precarious and unlikely to improve significantly while a stalemate continues. Talks brokered by the United Nations are under way to attempt to resolve the impasse but a compromise satisfying all sides remains elusive. Nevertheless, it is most unlikely that SEE will see any repeat of the conflicts of the 1990s. The countries of the region have become far more integrated and interdependent, which should provide a safeguard against future upheaval.

CIS and Mongolia

GDP growth rates in the CIS and Mongolia over the medium term should be similar to those expected in 2006, allowing the region to continue to catch up with CEB and SEE. Global demand for energy and commodities, especially from the growing economies of Asia, is likely to stay buoyant. While principally benefiting the resource-rich economies, this trend will also help countries such as Armenia and

Ukraine which depend on exports of non-precious metals or semi-precious stones and metals.

Private consumption will remain a key source of economic momentum. Across the region, credit is growing rapidly as financial services develop but this also raises concerns about future financial stability. High energy and commodity prices in the global market, coupled with strong domestic demand that is fuelled by growth in wages, will continue to put pressure on the inflation rate. However, the impact on inflation of energy and commodity price increases is likely to fall from 2007 (see Chart 2.6).

The persistent strength of economic growth across the region has made some countries complacent about the need for further reform and fiscal discipline. As Chapter 1 demonstrated, the CIS and Mongolia continue to lag behind in terms of structural reform and this is likely to lead to low productivity increases. This becomes all the more important in view of the pressure that ageing populations will place on public finances (see Box 2.2). Delaying reforms to the social welfare system will mean a greater upheaval in the future and could jeopardise macroeconomic stability.

Over the medium term, China is likely to have an increasing economic influence on the Central Asian states. Trade volumes between China and Central Asia (particularly Kazakhstan, the Kyrgyz Republic and Mongolia) have expanded significantly and this trend should continue. Central Asia's rich natural resources hold considerable attraction for energy-hungry China, which is consequently becoming a significant investor in the region. China is already the main source of FDI for Mongolia and, to a lesser but increasing extent, for Kazakhstan.

In Uzbekistan a large-scale oil and gas exploration project involving the National Petroleum Corporation of China is in the planning process. To gain more influence in the region and to ease the transport of commodities, China is providing state loans for transport projects in Kazakhstan, the Kyrgyz Republic, Tajikistan and Uzbekistan.

Table 2.2

Comparison of euro adoption plans

	Number of Maastricht criteria met (as of September 2006)[1]	**Status of Exchange Rate Mechanism II membership** (as of September 2006)	**Euro adoption plans** (as of September 2005)	**Euro adoption plans** (as of September 2006)	**Current plans compared with September 2005**
Czech Republic[2]	4	No date planned	2010	No date	Delayed
Estonia	3	Joined on 28 June 2004	1 January 2007	1 January 2008	Delayed
Hungary	1	No date planned	2010	No date[3]	Delayed
Latvia	3	Joined on 2 May 2005	1 January 2008	No date	Delayed
Lithuania	3	Joined on 28 June 2004	1 January 2007	No date	Delayed
Poland[2]	4	No date planned	2009	No date	Delayed
Slovak Republic[2]	3	Joined on 28 November 2005	1 January 2009	1 January 2009	Unchanged
Slovenia	4	Joined on 28 June 2004	1 January 2007	1 January 2007	Unchanged

Sources: EBRD and national sources.

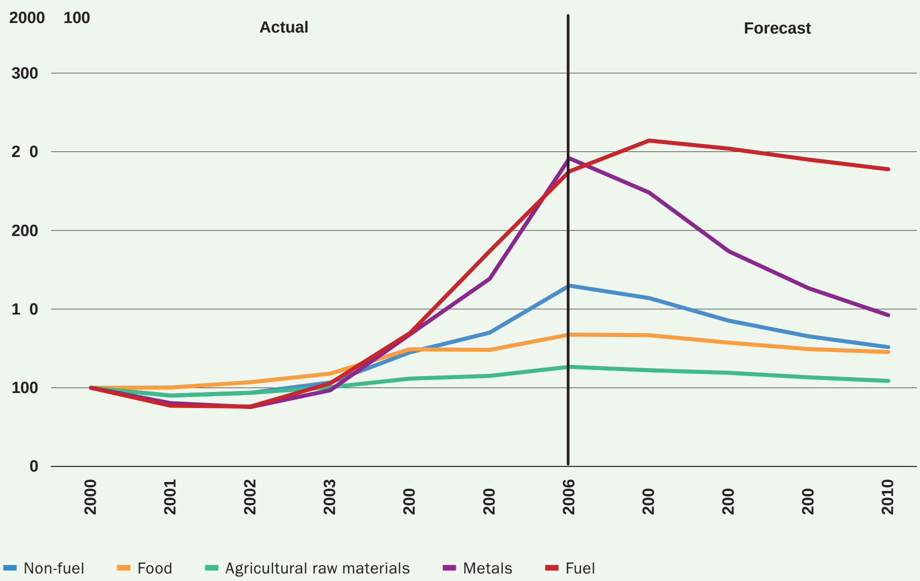
[1] The four Maastricht criteria reviewed here are the inflation rate (for August 2006), the government deficit (for 2005), the government gross debt (for 2005) and the long-term interest rate (for August 2006). For a definition of the Maastricht criteria, please see the *Transition Report Update* 2006.

[2] Although the Czech Republic, Poland and the Slovak Republic recorded general government deficits below the Maastricht criterion in 2005 (counted as one criterion met in column one), according to the Treaty establishing the European Community, these countries do not fulfil the deficit criterion legally as the ECOFIN Council has not abrogated the Excessive Deficit Procedure.

[3] Hungary's latest Convergence Programme (September 2006) does not specify a date for euro adoption or ERM II membership. The Finance Minister has stated that Hungary could join ERM II between 2007 and 2009 while euro adoption might be possible between 2011 and 2013.

Chart 2.6

Fluctuations in energy and commodity prices



Source: IMF.

Box 2.1: Macroeconomic implications of foreign bank entry

In the past 15 years many foreign banks have expanded into central eastern Europe and the Baltic states (CEB) and south-eastern Europe (SEE), attracted by the fact that growth prospects and interest margins are generally higher in these countries than in their home markets in western Europe. In many transition countries, foreign bank subsidiaries are now the largest banks.

Chart 2.1.1 shows the asset share of foreign banks across the banking sector, highlighting in particular the share of foreign banks in the three largest institutions in a transition country. By May 2006 foreign ownership was above 80 per cent in Albania, Bosnia and Herzegovina, Croatia, the Czech Republic, Estonia, Hungary, Lithuania and the Slovak Republic. Foreign ownership is spread relatively evenly over a number of foreign banks in Hungary and the Slovak Republic whereas in the Czech Republic, Lithuania and Estonia a small number of large foreign banks own high market shares. When foreign ownership is highly concentrated in the largest banks, this may have important implications for local macroeconomic stability.

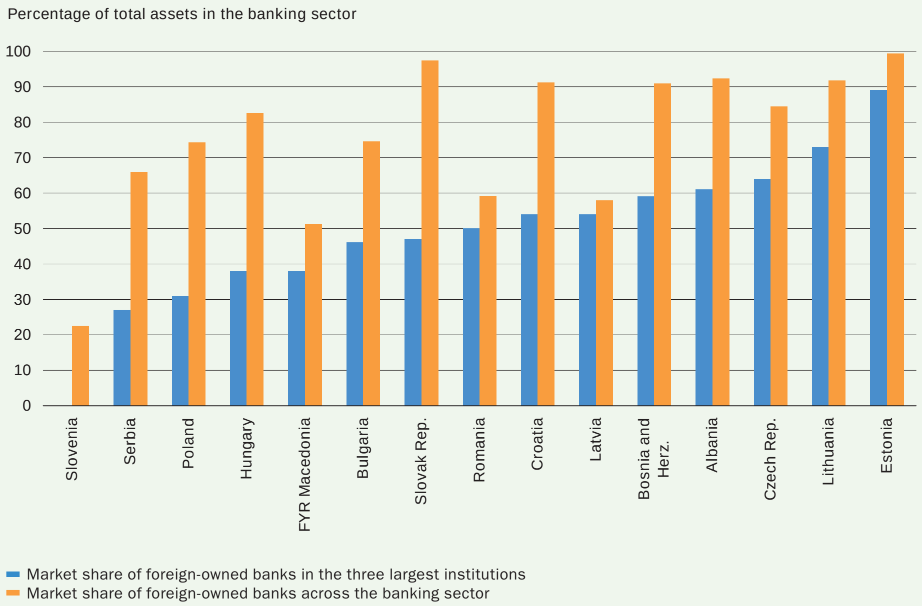
Foreign banks tend to expand initially into countries that are close in geographical, legal or historical terms. Chart 2.1.2 shows the transition countries where subsidiaries of Austrian, Italian and Scandinavian banking groups are among the three largest banks in the country. The map shows that Scandinavian banks have expanded into the nearby Baltic states while Italian banks have initially focused on the Western Balkans region. Austrian banks have followed a broader geographical strategy. Further consolidation took place in 2005 when Italy's UniCredit took over Germany's HVB Group, including its activities in transition countries.

The map indicates that foreign banks from a small number of countries own many of the most important (top three) banks in many transition countries. Sweden's Swedbank and SEB each own three major banks in the Baltic states while Italy's Banca Intesa and UniCredit own three and eight large subsidiaries respectively in CEB and SEE. Austria's Erste Bank and Raiffeisen Bank own some of the largest banks in many transition countries, with four and six of these subsidiaries respectively.

Because foreign banks are part of a multinational banking group, the internal organisation of such groups influences the lending behaviour of the subsidiary. Parent banks with affiliates across a range of countries often set credit growth targets for each subsidiary and, in some cases, provide substantial internal funding. Local affiliates are also integrated into the parent group through the introduction of standardised risk management and information technology systems.

Chart 2.1.1

Foreign ownership of banks in CEB and SEE



Sources: EBRD and UniCredit.

Financial assistance from parent banks

Parent banks may provide local subsidiaries with capital and liquidity support. For example, Belgium's KBC Bank backed its Polish subsidiary, Kredytbank, with capital after the subsidiary had suffered significant losses in 2002-03.

Evidence suggests that during banking crises in transition countries the subsidiaries of foreign banks have been able to maintain lending while domestic banks have had to reduce their lending levels. Foreign bank ownership may therefore diminish the likelihood and negative consequences of possible future financial crises in the region.

However, support of parent banks for foreign subsidiaries cannot be taken for granted. During the Argentinian crisis in 2002, for example, some foreign banks fled the country, selling their operations to smaller local banks. Also when Bayerische Landesbank found out in 2002 about a fraud in its 60 per cent Croatian subsidiary Rijecka Banka, it decided to withdraw.

Financial support from parent banks may also have less desirable implications. In particular, when parent banks support foreign subsidiaries in order to meet credit growth targets, this may contribute to excessive credit growth. Indeed, loan growth in Bulgaria and Romania has been higher than deposit growth for several years, partly due to the subsidiaries of foreign banks borrowing from their parent groups (see also Chapter 4). Erste Bank, HVB, Raiffeisen Bank, Sampo Bank and Swedbank have all provided their subsidiaries with capital support to maintain credit growth.

A potential danger is that the objective of gaining local market share may, in some cases, contribute to macroeconomic imbalances. In a number of transition countries, rapid growth in household lending has contributed to rising current account deficits and asset price inflation.

The transmission of economic downturns

Evidence suggests that when the economy in a parent bank's home country underperforms in comparison with the transition country where a foreign subsidiary is located, the subsidiary's credit growth tends to speed up as lending in the transition country becomes more attractive for the parent bank. However, this apparently inverse relationship may change in the case of large economic setbacks in the home country. The capital base of the parent bank may then come under severe pressure, necessitating a decrease in bank lending across all its countries of operations. More generally, economic research shows that when the financial health of a parent bank deteriorates, this tends to have negative implications for the ability of its foreign subsidiaries to expand local lending.

This may have important implications in particular for countries where foreign banks from a single home country own substantial market shares. For instance, two large Swedish banks provide about 80 per cent of all credit in Estonia while Italian banks own more than 50 per cent and 40 per cent of all banking assets in Bosnia and Herzegovina and Bulgaria respectively. This suggests that the banking sectors in these transition countries may be vulnerable to a protracted recession in Sweden or Italy or to substantial financial problems in one of the parent banks.

Moreover, economic setbacks in another of the parent bank's countries of operations can also have spill-over effects on the credit supply of foreign bank subsidiaries, as the parent bank is forced to rebalance its portfolio in response to unexpected losses in a particular country. The Asian financial crisis, for instance, spread in part because Japanese banks reduced their lending across the Asian region in reaction to the initial crisis in Thailand. Since many transition countries are dominated by the same western European banking groups, the potential contagion effects could be quite significant. However, the parent banks would need to be relatively weak and the economic upheaval large-scale for this to become a major danger.

It is important to differentiate between foreign banks that lend through local affiliates (as discussed in this box) and foreign banks that lend directly from their headquarters. Cross-border credit tends to be less stable than lending by foreign banks with a local presence as the latter have generally taken a more strategic decision to do business in a particular country.

Banking supervision

The presence across the transition region of large foreign bank subsidiaries, integrated closely with their parent groups, has regulatory implications. Within the European Union, the so-called home country principle currently applies. Under this principle, the supervisors in the parent bank's home country are responsible for the consolidated supervision of multinational banking groups. The host country supervisors have a responsibility to supervise foreign subsidiaries on a stand-alone basis.

A new European Capital Requirements Directive, taking effect on 1 January 2007, will give the home country supervisors responsibility for coordinating the exchange of information and cooperation between national authorities involved in the supervision of multinational banks. In addition, it has been acknowledged that the degree of cooperation between home and host country authorities should reflect the importance of a foreign subsidiary both within the parent group and the host country.

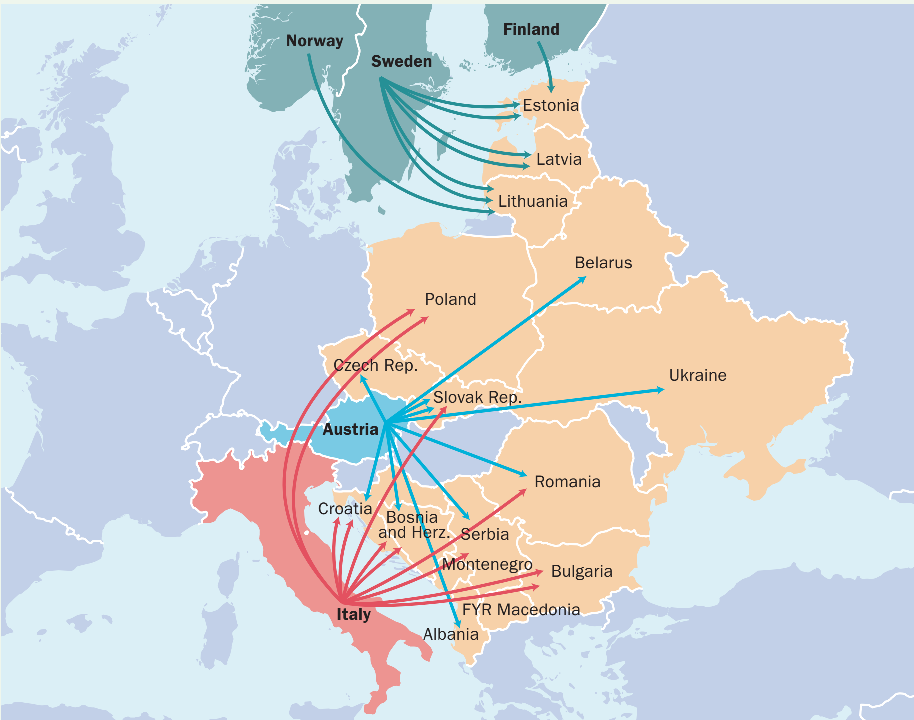
Conclusion

The large-scale entry of foreign banks has profoundly transformed the banking systems in transition countries. Foreign strategic investors have introduced new products to the region and have increased the efficiency and quantity of bank lending (see also Chapter 4). Foreign banks have also proven to be relatively stable providers of finance.

However, the dominance of a relatively small number of large multinational banking groups has introduced the possibility of economic downturns or financial crises being transmitted from one country to another. This underlines the need for adequate cooperation between home and host country supervisors in order to reduce the likelihood of such knock-on effects. This is especially important in view of the further regional banking consolidation that is expected to take place through mergers of foreign-owned banks.

Chart 2.1.2

Austrian, Italian and Scandinavian ownership of large local banks



Sources: EBRD and UniCredit.

Note: The map shows the transition countries where subsidiaries of Austrian, Italian and Scandinavian banking groups are among the three largest banks in the country.

Sources

R. De Haas and I. Van Lelyveld (2004), "Foreign bank penetration and private sector credit in central and eastern Europe", *Journal of Emerging Market Finance*, Vol. 3, No. 2, pp. 125-51.

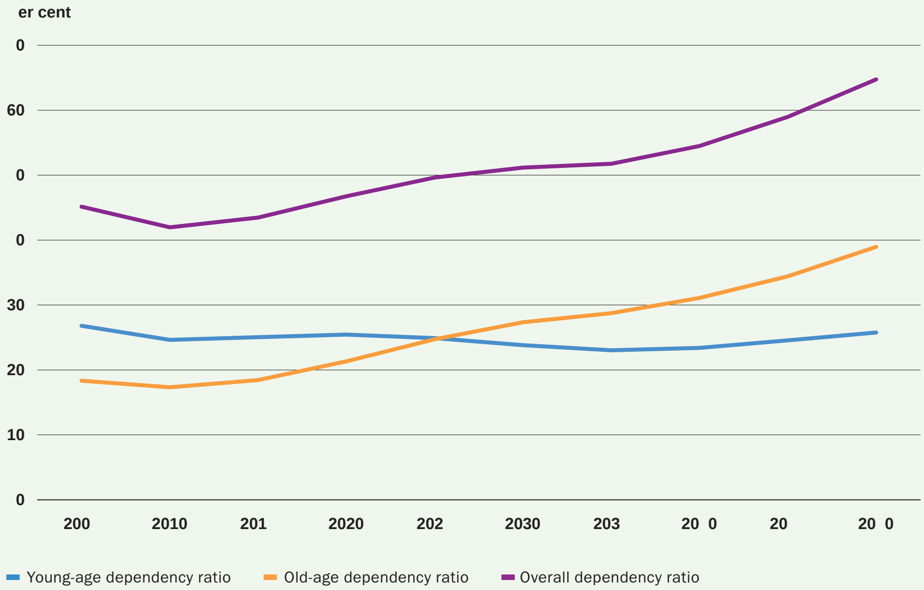
R. De Haas and I. Van Lelyveld (2006), "Foreign banks and credit stability in central and eastern Europe. A panel data analysis", *Journal of Banking & Finance*, Vol. 30, No. 7, pp. 1927-52.

Box 2.2: Ageing, pension reforms and capital market developments

The transition countries are increasingly faced with an ageing population. This is reflected in an increasing old-age dependency ratio – the ratio of the population aged 65 and above to the population aged 15 to 64. According to UN projections, this ratio is likely to rise continuously from the present level of less than 20 per cent to almost 40 per cent by 2050. The young-age dependency ratio – the ratio of the population aged below 15 to the population aged 15 to 64 – is expected to remain relatively stable at around 25 per cent from now until 2050 (see Chart 2.2.1).

Chart 2.2.1

Dependency ratios in transition countries



Source: UN.

Note: The young-age dependency ratio signifies the ratio of the population aged below 15 to the population aged 15 to 64. The old-age dependency ratio signifies the ratio of the population aged 65 and above to the population aged 15 to 64.

The rise in the old-age dependency ratio indicates longer life expectancy and fertility rates falling below the rate of approximately 2.1 children per woman at which population size (in the absence of migration) remains stable. According to the UN projections, life expectancy in transition countries will increase from 69 to about 75 years in 2050. Male life expectancy will increase from about 64 to 72 years while female life expectancy will rise from 74 to 79 years. Fertility rates are expected to stay at low levels. In 2005 the average fertility rate was 1.5 (ranging from 1.15 in Ukraine to 2.5 in Turkmenistan).

Assumptions regarding migration affect projections of old-age dependency ratios but not to a significant degree. In a few countries (for example, Hungary, Russia and Slovenia) positive net migration up to 2050 is expected to have a moderately positive impact on population size according to UN projections. In most cases, however, the impact is expected to be negative, in particular in Albania, Kazakhstan, the Kyrgyz Republic and Tajikistan. Although population projections are inherently prone to large margins of error given the long period of time that they cover, the trends identified by the UN are consistent with other research (for example, by Eurostat for central eastern Europe and the Baltic states – CEB).

Public finances and pension reforms

An ageing population and a rise in the dependency ratio will have dramatic effects on public finances. Public pension systems based on the pay-as-you-go (PAYG) principle, whereby current contributions are used to finance current pensions, will come under pressure as the ratio between the number of pensioners and the number of contributors rises. Public expenditure on health and long-term care is also set to increase as medical advances continue and the demand for services rises with the growing numbers of elderly people. Revenue from taxes on labour is likely to decline because of the shrinking working-age population. Discounting issues such as the impact of a more experienced workforce on productivity, this decline in the workforce is also likely to reduce output.

The overall impact of these developments will be considerable, particularly on unreformed pension systems. Although there is no comprehensive research covering all transition countries, a study carried out by the European Commission and the Economic Policy Committee for the eight CEB countries has estimated that the projected impact on public expenditure by 2050 from a change in pension, health care and long-term care provisions varies from a fall of 4.4 percentage points of GDP in Poland to a rise of 10 percentage points of GDP in Slovenia. The forecast reduction in public expenditure for Poland is a result of the sweeping pension reforms undertaken since 1998. The Czech Republic may also record a similarly high increase to Slovenia. While both countries have undertaken moderate reforms, pensions continue to be financed entirely on a PAYG basis.

Expenditure projections may underestimate, however, the challenges faced by transition countries, especially those outside the EU which face a greater burden from ageing populations. First, the projections are based on favourable assumptions about future labour market developments and the ability of the new EU members to move towards the economic standards of other member states. Secondly, the health expenditure projections focus only on the demographic impact rather than factors such as new medical technologies, rising per capita demand for health services and increasing prices of health-related goods and services. Lastly, institutional weaknesses make the challenge of ageing populations even greater because they lead to low rates of tax compliance and hence low rates of participation in public pension schemes.

Coping with the fiscal effects of ageing populations requires comprehensive reforms of social security, principally pension systems but also health and long-term care provision and labour markets. Many transition countries – Bulgaria, Croatia, Estonia, FYR Macedonia, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Russia and the Slovak Republic – undertook extensive pension reforms in the late 1990s and in the early years of the present decade. All of them have introduced a multi-pillar model, characterised by three basic elements: a mandatory PAYG "first pillar" that is to some degree linked to earnings; a mandatory "second pillar" that is essentially an individual savings

Table 2.2.1

Volume and structure of assets held in pension funds of the mandatory pillar

	Year of introduction of second pillar	Total assets under management as of Dec 2005 (US$ million)	Total assets as percentage of nominal GDP (2005)	Percentage of assets in foreign currency	Asset allocation by category as percentage of total assets: Bank deposits	Bonds	Stocks	Investment funds	Other
CEB									
Estonia	2002	376	2.8	90.0	4.0	48.0	37.0	9.0	2.0
Hungary	1998	5,717	5.2	5.3	1.0	81.5	7.7	na	9.8
Latvia	2001	138	0.9	28.4	30.4	50.3	6.6	12.8	0.0
Lithuania	2004	147	0.6	80.6	1.0	62.0	9.0	28.0	0.0
Poland	1999	26,394	8.7	0.9	3.8	63.7	32.1	0.0	0.4
Slovak Republic	2005	283	0.6	4.3	80.8	10.9	7.8	0.0	0.6
SEE									
Bulgaria	2000	266	1.0	1.5	17.0	75.3	7.0	na	1.7
Croatia	2002	1,924	0.8	11.0	4.1	79.0	3.9	9.8	3.2
CIS									
Russia	2002	6,129	0.8	0.0	16.8	82.6	0.6	0.0	0.0
Kazakhstan	1998	4,849	8.6	7.5	19.5	70.5	9.8	0.1	0.2
Total/Average		**46,222**	**3.0**	**22.9**	**17.8**	**62.4**	**12.1**	**7.5**	**1.8**

Sources: EBRD and national sources.

Note: FYR Macedonia's mandatory funded pillar was only introduced in January 2006 and is therefore not listed.

account; and a voluntary "third pillar" that can take many forms (for example, individual, employer sponsored, defined benefit or defined contribution). Most of the other transition countries that have not introduced a multi-pillar model have nevertheless altered important parameters of their PAYG system – for example, raising retirement ages, extending required contribution periods and lowering benefits. The main thrust of the reforms was to achieve a stronger link between contributions and benefits.

The countries that have undertaken multi-pillar reform have kept a (reformed) PAYG earnings-related scheme. Despite extensive reforms of the PAYG system, most transition countries retained the idea of a defined benefit scheme, where pensions are calculated as a fixed proportion of the individual's earnings or final salary. Croatia, Kazakhstan, Latvia, Poland and to some extent Russia have transformed their public systems from a defined-benefit scheme into a notional defined contribution system. In such a system, pensions are financed on a PAYG basis but individual contributions generate future pension claims that are accumulated in an individual's notional account. At the time of retirement, benefits are calculated by taking account of individual contributions and the growth of the economy. In effect, the pension benefit is an annuity drawn from the notional accumulated capital.

Capital market development

As well as helping to improve fiscal sustainability, multi-pillar pension reforms can also stimulate capital market development in so far as the creation of mandatory pension schemes generates long-term savings. Managed by professional investors and with a long-term orientation, pension funds have the potential to create more competition to existing commercial and investment banks, to stimulate financial innovation, to promote greater market integrity and modern trading facilities and to encourage more robust regulation in the financial sector as a whole.

Within the transition region, accumulated savings are still small – about US$46 billion in net assets under management or 3 per cent of GDP (see Table 2.2.1) – but growing rapidly, on average by about 50 per cent per year. Given the small size of the assets under management, it is too early to assess conclusively the impact of multi-pillar pension reform on capital market development.

Mandatory pension funds face considerable challenges in diversifying their portfolios since they operate in fledgling capital markets and are hampered by numerous investment restrictions (in particular with regard to overseas investment). In the early stages of reform the introduction of the mandatory funded pillar provides a boost to the existing banking sector as a sizeable share of assets are held by commercial banks. Over time, portfolios tend to become more diversified, with a large share of assets invested in bonds. In the Baltic states, where small capital markets provide a limited number of investment opportunities and euro adoption is a medium-term objective, pension funds have gone the furthest in diversifying their portfolios internationally. In Estonia and Lithuania, the majority of assets are denominated in foreign currency, mainly in euros. This is a positive strategy for risk diversification but not necessarily for development of the domestic capital market.

In many countries, pension fund management is highly concentrated. In Bulgaria, for example, two companies managed almost 70 per cent of net assets in the pension system at the end of 2004. In Russia the large number of funds competing for capital has led to a number of funds operating far below efficiency levels, resulting in high management costs. Nevertheless, the introduction of pension reform has in many countries been accompanied by new legislation regarding the management of pension funds, indicating that countries are well aware of the need for robust regulation in this area.

Source

C. Nickel and J. Almenberg (2006), "Ageing, pension reform and capital market development", EBRD Working Paper, forthcoming.

Annex 2.1: Macroeconomic performance tables

Table A.2.1

Growth in real GDP (in per cent)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection	Estimated level of real GDP in 2005
Central eastern Europe and the Baltic states														*(1989=100)*
														121
														130
														129
														101
														98
														148
														127
														132
Average [1]	*3.9*	*5.4*	*4.8*	*5.0*	*3.9*	*3.5*	*4.4*	*2.5*	*2.5*	*4.0*	*5.2*	*4.7*	*5.3*	***133***
South-eastern Europe														
SEE-3														
														94
														100
														105
SEE-5														
														137
														70
														88
														69
														60
Average [1]	*3.9*	*6.0*	*2.1*	*1.1*	*0.5*	*-2.2*	*3.7*	*4.7*	*4.9*	*4.6*	*6.9*	*4.7*	*5.9*	***97***
Commonwealth of Independent States and Mongolia														
Russia														88
Western CIS and the Caucasus														
														111
														91
														123
														49
														47
														59
Central Asia														
														113
														84
														123
														74
														163
														123
Average [1]	*-13.5*	*-5.0*	*-3.6*	*1.4*	*-3.9*	*5.3*	*9.0*	*6.1*	*5.2*	*7.7*	*8.0*	*6.6*	*6.9*	***87***
All transition countries														
Average [1]	***-5.2***	***0.1***	***0.2***	***2.7***	***-0.8***	***3.6***	***6.1***	***4.3***	***4.0***	***5.8***	***6.7***	***5.7***	***6.2***	***97***

Table A.2.2

GDP growth by components in selected countries

(real change, in per cent)

	2002	2003	200	200 *Estimate*
Bulgaria				
Real GDP growth	4.9	4.5	5.7	5.5
Private consumption	3.9	7.1	4.9	7.4
Public consumption	6.2	3.0	6.7	2.2
Gross fixed capital formation	9.3	13.9	13.5	19.0
Exports of goods and services	6.2	8.0	13.0	7.2
Imports of goods and services	4.7	15.3	14.1	14.6
Croatia				
Real GDP growth	5.6	5.3	3.8	4.3
Private consumption	7.7	4.6	3.9	3.4
Public consumption	4.9	1.3	-0.3	0.8
Gross fixed capital formation	13.9	24.7	4.4	4.8
Exports of goods and services	1.2	11.4	5.4	4.6
Imports of goods and services	13.4	12.1	3.5	3.5
Czech Republic				
Real GDP growth	1.9	3.6	4.2	6.1
Private consumption	2.2	6.0	2.5	2.4
Public consumption	6.7	7.1	-3.2	0.7
Gross fixed capital formation	5.1	0.4	4.7	3.6
Exports of goods and services	2.1	7.2	21.1	10.6
Imports of goods and services	5.0	8.0	18.2	4.9
Estonia				
Real GDP growth	8.0	7.1	8.1	10.5
Private consumption	10.3	5.7	4.4	9.2
Public consumption	5.9	5.8	9.1	7.5
Gross fixed capital formation	17.2	5.4	9.1	13.9
Exports of goods and services	0.6	6.0	16.5	21.3
Imports of goods and services	5.4	9.0	14.7	17.4
Hungar				
Real GDP growth	3.8	3.4	5.2	4.1
Private consumption	9.7	7.8	3.1	2.1
Public consumption	6.6	7.9	0.9	-1.4
Gross fixed capital formation	9.3	2.5	8.4	6.6
Exports of goods and services	3.9	7.8	16.4	10.6
Imports of goods and services	6.6	11.1	13.2	5.8
Latvia				
Real GDP growth	6.5	7.2	8.5	10.2
Private consumption	7.4	8.6	9.8	11.4
Public consumption	2.4	2.5	1.5	2.7
Gross fixed capital formation	13.0	7.4	29.5	18.6
Exports of goods and services	6.3	4.3	9.8	20.7
Imports of goods and services	4.5	13.3	16.0	13.5

	2002	2003	200	200 *Estimate*
Lithuania				
Real GDP growth	6.8	10.5	7.0	7.5
Private consumption	5.8	11.1	9.7	10.4
Public consumption	1.4	3.8	7.5	5.6
Gross fixed capital formation	8.7	11.4	12.3	11.2
Exports of goods and services	19.5	6.9	4.2	14.3
Imports of goods and services	17.7	10.3	14.8	15.9
oland				
Real GDP growth	1.4	3.8	5.3	3.4
Private consumption	3.3	1.9	4.0	2.0
Public consumption	1.5	4.7	3.9	2.7
Gross fixed capital formation	-6.3	-0.1	6.3	6.5
Exports of goods and services	4.8	14.2	14.0	7.1
Imports of goods and services	2.7	9.3	15.2	3.4
Romania				
Real GDP growth	5.1	5.2	8.4	4.1
Private consumption	5.3	8.5	14.1	9.8
Public consumption	3.0	7.5	5.0	4.4
Gross fixed capital formation	8.2	8.6	10.8	13.0
Exports of goods and services	17.5	8.4	13.9	7.6
Imports of goods and services	12.0	16.0	22.1	17.2
Russia				
Real GDP growth	4.7	7.3	7.1	6.4
Private consumption	8.5	7.5	11.6	11.1
Public consumption	2.6	2.2	2.1	1.8
Gross fixed capital formation	2.8	12.8	11.3	10.5
Exports of goods and services	10.3	12.5	11.9	5.6
Imports of goods and services	14.6	17.7	22.5	16.2
Slovak Republic				
Real GDP growth	4.1	4.2	5.4	6.1
Private consumption	5.2	0.2	4.2	7.0
Public consumption	5.2	3.9	2.0	0.5
Gross fixed capital formation	0.3	-2.3	5.0	13.8
Exports of goods and services	4.7	15.9	7.9	13.5
Imports of goods and services	4.6	7.6	8.8	15.5
Slovenia				
Real GDP growth	3.5	2.7	4.4	4.0
Private consumption	1.3	3.5	2.6	3.4
Public consumption	3.2	1.6	3.4	2.2
Gross fixed capital formation	0.9	7.1	7.9	1.5
Exports of goods and services	6.7	3.1	12.5	10.5
Imports of goods and services	4.8	6.7	13.4	7.0

Note: Data for 2002-04 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2005 are preliminary actuals, mostly official government estimates.

Table A.2.3

Inflation

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

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
												Estimate	*e ti*
Central eastern Europe and the Baltic states													
e ia													
ea													
South eastern Europe													
SEE-3													
SEE-5													
e ia													
ea													
Common ealth of ndependent States and Mongolia													
Russia													
Western CIS and the Caucasus													
Central Asia													
e ia													
ea													
All transition countries													
Median [1]	***126.5***	***50.2***	***28.3***	***15.4***	***10.6***	***9.2***	***10.0***	***7.7***	***5.2***	***5.0***	***6.5***	***5.9***	***5.0***
Mean [1]	***1,211.2***	***169.2***	***83.6***	***66.3***	***17.3***	***28.5***	***23.7***	***16.0***	***8.9***	***6.6***	***6.4***	***7.0***	***6.4***

Table A.2.4

General government balances

(in per cent of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Central eastern Europe and the Baltic states													
Czech Republic	-7.8	-15.0	-4.9	-2.4	-4.2	-1.4	-3.8	-5.8	-6.8	-6.6	-2.9	-2.6	-3.3
Estonia	1.2	-1.2	-1.5	1.9	-0.3	-3.7	-0.6	0.3	0.9	2.3	1.4	1.6	0.1
Hungary	-7.5	-6.7	-5.0	-6.8	-8.0	-5.6	-3.0	-3.5	-8.4	-6.4	-5.4	-6.1	-8.6
Latvia	-3.9	-3.6	-1.7	0.7	-0.6	-4.9	-2.8	-2.1	-2.3	-1.2	-0.9	0.2	-1.5
Lithuania	-4.8	-4.2	-4.4	-1.1	-3.0	-5.6	-2.5	-2.0	-1.4	-1.2	-1.5	-0.5	-1.8
Poland	-2.8	-3.1	-3.3	-4.4	-3.9	-3.1	-2.3	-3.7	-3.2	-4.7	-3.9	-2.4	-2.8
Slovak Republic	-1.4	0.4	-1.3	-5.2	-5.0	-7.1	-12.2	-6.5	-7.7	-3.7	-3.0	-2.9	-2.7
Slovenia	0.0	0.0	0.3	-1.1	-0.7	-0.6	-1.3	-1.3	-2.9	-1.3	-1.4	-1.1	-1.5
Average [1]	-3.4	-4.2	-2.7	-2.3	-3.2	-4.0	-3.6	-3.1	-4.0	-2.9	-2.2	-1.7	-2.8
South-eastern Europe													
SEE-3													
Bulgaria	-5.7	-5.6	-10.3	-0.3	1.7	0.4	-0.5	1.9	0.1	0.3	1.9	3.1	3.0
Croatia	0.6	-0.7	-0.4	-1.3	-3.5	-8.2	-7.5	-6.8	-4.9	-6.2	-4.9	-4.1	-3.0
Romania	-2.2	-2.5	-3.9	-4.5	-4.4	-2.1	-3.8	-3.5	-2.0	-2.0	-1.4	-0.8	-2.5
SEE-5													
Albania	-12.6	-10.1	-9.7	-12.4	-11.8	-12.1	-9.2	-8.5	-7.2	-4.3	-5.1	-3.6	-4.1
Bosnia and Herzegovina	na	-0.3	-4.4	-0.5	-5.2	-4.8	-3.1	-2.5	-4.1	-1.7	-1.9	0.7	-0.6
FYR Macedonia	-2.7	-1.0	-1.4	-0.4	-1.7	0.0	2.5	-6.3	-5.6	-0.1	0.7	0.3	-0.6
Montenegro	na	na	na	na	na	na	-6.9	-4.0	-3.8	-4.9	-2.6	-1.7	-0.3
Serbia	na	na	na	na	na	na	-1.0	-4.9	-8.3	-3.4	0.0	0.9	2.7
Average [1]	-4.5	-3.4	-5.0	-3.2	-4.2	-4.5	-3.7	-4.3	-4.5	-2.8	-1.7	-0.7	-0.7
Commonwealth of Independent States and Mongolia													
Russia	-10.4	-6.6	-9.4	-8.5	-8.1	-3.1	3.2	2.7	0.6	1.1	5.0	7.5	6.7
Western CIS and the Caucasus													
Armenia	-16.5	-9.0	-8.5	-5.8	-4.9	-7.2	-6.4	-3.8	-0.4	-1.1	-1.8	-2.6	-2.8
Azerbaijan	-11.2	-3.1	-2.4	-4.0	-3.9	-4.7	-0.6	-0.4	-0.5	-1.2	0.8	-0.7	-0.9
Belarus	-3.5	-2.7	-1.5	-0.7	-1.0	-2.0	-0.1	-1.9	-2.1	-1.7	0.0	-0.7	-0.3
Georgia	-7.4	-5.3	-7.3	-6.7	-5.4	-6.7	-4.0	-2.0	-2.0	-2.5	2.3	-1.5	-1.1
Moldova	-10.6	-6.7	-8.0	-10.5	-7.4	-6.2	-1.8	-0.3	-2.2	1.0	0.4	1.6	-1.7
Ukraine	-8.7	-4.7	-3.2	-5.4	-2.5	-2.3	-1.1	-0.9	0.1	-0.7	-4.5	-2.8	-3.2
Central Asia													
Kazakhstan	-7.4	-3.4	-5.3	-7.0	-8.0	-5.2	-1.0	2.7	1.4	2.9	2.6	6.0	5.7
Kyrgyz Republic	-11.6	-17.3	-9.5	-9.2	-9.5	-12.7	-11.4	-5.6	-5.3	-5.2	-4.1	-4.0	-3.1
Mongolia	-13.0	-5.2	-7.5	-9.1	-14.3	-12.2	-7.0	-5.4	-5.9	-4.2	-2.1	3.2	-3.1
Tajikistan	-10.1	-6.1	-5.8	-3.8	-3.8	-3.1	-5.6	-3.2	-2.5	-1.8	-2.4	-2.9	-4.5
Turkmenistan	1.7	0.4	0.3	-0.2	-2.6	0.0	-0.3	0.6	0.2	-1.3	0.0	0.9	0.0
Uzbekistan	-4.4	-4.1	-7.3	-2.2	-3.3	-2.6	-2.5	-1.3	-1.9	0.1	0.6	1.2	0.1
Average [1]	-8.7	-5.7	-5.8	-5.6	-5.7	-5.2	-3.0	-1.4	-1.6	-1.1	-0.2	0.4	-0.6
All transition countries													
Average [1]	-6.3	-4.7	-4.7	-4.1	-4.6	-4.7	-3.3	-2.7	-3.0	-2.1	-1.2	-0.5	-1.2

Note: Data for 1994-2004 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2005 are preliminary actuals, mostly official government estimates. Data for 2006 represent EBRD projections.

[1] Unweighted average for the region.

Table A.2.5

General government expenditure

(in per cent of GDP)

	1999	2000	2001	2002	2003	2004	2005 Estimate
Central eastern Europe and the Baltic states							
e a e							
South eastern Europe							
SEE-3							
SEE-5							
e a e							
Common ealth of ndependent States and Mongolia							
Russia							
Western CIS and the Caucasus							
Central Asia							
e a e							
All transition countries							
A era e [1]	***37.7***	***36.8***	***35.4***	***36.2***	***35.8***	***35.4***	***35.7***

Table A.2.6

Current account balances

(in per cent of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
												Estimate	Projection
Central eastern Europe and the Baltic states													
Czech Republic	-1.9	-2.5	-6.6	-6.2	-2.0	-2.4	-4.8	-5.3	-5.5	-6.2	-6.0	-2.1	-2.9
Estonia	-6.9	-4.2	-8.6	-11.4	-8.6	-4.4	-5.2	-5.5	-9.8	-11.6	-12.3	-10.3	-9.0
Hungary	-9.4	-3.7	-4.0	-4.5	-7.2	-7.8	-8.5	-6.1	-7.1	-8.7	-8.6	-7.4	-7.8
Latvia	5.0	-0.3	-5.0	-5.6	-9.8	-9.1	-4.8	-7.5	-6.7	-8.2	-12.9	-12.5	-14.1
Lithuania	-2.2	-9.6	-9.0	-10.0	-11.7	-11.0	-5.9	-4.7	-5.2	-6.9	-7.7	-7.0	-7.9
Poland	1.0	0.6	-2.1	-3.7	-4.0	-7.4	-5.8	-2.8	-2.5	-2.1	-4.2	-1.5	-2.0
Slovak Republic	4.3	2.0	-10.1	-9.2	-9.3	-5.3	-3.4	-8.3	-7.8	-0.8	-3.6	-8.6	-6.3
Slovenia	4.0	-0.4	0.3	0.3	-0.6	-3.2	-2.8	0.2	1.5	-0.3	-2.1	-1.1	-2.0
Average [1]	-0.8	-2.3	-5.6	-6.3	-6.7	-6.3	-5.2	-5.0	-5.4	-5.6	-7.2	-6.3	-6.5
South-eastern Europe													
SEE-3													
Bulgaria	-0.3	-1.5	1.7	10	-0.5	-5	-5.6	-7.2	-5.3	-9.3	-5.8	-11.8	-13.7
Croatia	4.8	-7.5	-4.8	-12.5	-6.7	-7.1	-2.5	-3.6	-8.3	-7.2	-5.2	-6.6	-6.8
Romania	-1.4	-5.0	-7.3	-6.1	-6.9	-3.6	-3.6	-5.8	-3.4	-5.8	-8.4	-8.8	-10.1
SEE-5													
Albania	-14.3	-7.1	-7.3	-11.5	-6.7	-7.6	-7.4	-6.3	-9.7	-8.0	-4.7	-6.6	-7.5
Bosnia and Herzegovina	na	na	-27.3	-30.0	-27.0	-17.9	-13.1	-16.1	-21.7	-17.8	-17.3	-17.3	-15.7
FYR Macedonia	-7.8	-6.7	-7.7	-7.7	-7.5	-0.9	-1.9	-7.1	-9.5	-3.2	-7.8	-1.3	-1.0
Montenegro	na	na	na	na	na	na	-4.5	-15.2	-12.9	-7.4	-7.8	-8.6	-5.0
Serbia	na	na	-9.8	-6.5	-4.2	-4.4	-5.1	-5.0	-17.5	-16.4	-14.8	-10.0	-8.8
Average [1]	-3.8	-5.6	-8.9	-9.2	-8.5	-6.6	-5.5	-8.3	-11.0	-9.4	-9.0	-8.9	-8.6
Commonwealth of Independent States and Mongolia													
Russia	2.8	2.2	2.8	0.0	0.1	12.6	18.0	11.1	8.4	8.3	10.1	11.0	10.7
Western CIS and the Caucasus													
Armenia	-16.0	-17.0	-18.2	-18.0	-22.1	-16.6	-14.6	-9.4	-6.2	-6.7	-4.5	-4.2	-5.1
Azerbaijan	-10.3	-13.2	-25.8	-23.1	-30.7	-13.1	-3.5	-0.9	-12.3	-27.8	-29.8	1.3	21.6
Belarus	-9.1	-4.3	-3.6	-6.1	-6.7	-1.6	-3.2	-3.3	-2.2	-2.4	-5.2	1.5	-2.4
Georgia	-22.3	-7.5	-9.1	-10.6	-8.9	-7.7	-4.5	-6.6	-5.8	-7.4	-8.3	-7.4	-7.3
Moldova	-8.4	-8.0	-11.1	-14.2	-19.7	-5.8	-7.6	-1.7	-4.0	-6.6	-4.4	-5.2	-12.8
Ukraine	-3.2	-3.1	-2.7	-2.7	-3.1	5.2	4.7	3.7	7.5	5.8	10.5	3.2	-1.4
Central Asia													
Kazakhstan	-7.6	-1.3	-3.6	-3.6	-5.5	-1.4	2.0	-6.3	-4.2	-0.9	1.1	-0.9	-3.3
Kyrgyz Republic	-7.6	-15.7	-23.3	-7.8	-22.2	-14.7	-5.7	-1.6	-3.1	-4.2	-3.4	-8.0	-6.6
Mongolia	5.5	2.0	-3.2	5.4	-7.7	-6.7	-5.8	-7.6	-9.6	-7.7	1.6	1.5	3.1
Tajikistan	-20.6	-15.2	-7.8	-4.0	-7.3	-0.9	-6.0	-5.0	-3.6	-1.3	-4.0	-3.4	-4.3
Turkmenistan	4.0	0.7	0.1	-24.8	-34.3	-23.3	13.6	3.2	13.0	5.2	1.2	7.4	12.9
Uzbekistan	2.1	-0.2	-7.8	-5.4	-0.9	-2.0	2.4	-1.5	3.0	8.9	10.0	13.1	12.0
Average [1]	-7.0	-6.2	-8.7	-8.8	-13.0	-5.8	-0.8	-2.0	-1.5	-2.8	-1.9	0.8	1.3
All transition countries													
Average [1]	-4.5	-4.9	-7.9	-8.2	-10.1	-6.2	-3.3	-4.6	-5.2	-5.4	-5.3	-3.8	-3.6

Note: Data for 1994-2004 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2005 are preliminary actuals, mostly official government estimates. Data for 2006 represent EBRD projections.

[1] Unweighted average for the region.

Table A.2.7

Foreign direct investment (net inflows recorded in the balance of payments)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection	Cumulative FDI inflows 1989-2005	Cumulative FDI inflows per capita 1989-2005	2004	2005	2004	2005
Central eastern Europe and the Baltic states						(in US$ million)													
ta																			
South eastern Europe																			
SEE-3																			
SEE-5																			
ta																			
Common ealth of ndependent States and Mongolia																			
Russia																			
Western CIS and the Caucasus																			
Central Asia																			
ta																			
All transition countries																			
Total	**6 3**	**1 1**	**1 62**	**1 0**	**2 363**	**26 1**	**2 32**	**26 3 6**	**30 330**	**22 0**	**3 0**	**3 2**	**0 30**	**32 32**	**06**	**11**	**132**	**.**	**.**

Table A.2.8

GDP growth forecasts for 2006 (in per cent)

	Average[1]	Range[2]	EBRD (Sep 2006)	European Union (Apr 2006)	IMF (Sep 2006)	OECD (May 2006)	United Nations DESA[4] (Sep 2006)	CSFB[5] (Aug 2006)	Dun & Bradstreet (Sep 2006)	Economist Intelligence Unit (Aug 2006)	Global Insight, Inc.[6] (Aug 2006)	IWH[7] (Sep 2006)	JP Morgan (Sep 2006)	Kopint-Datorg[8] (Sep 2006)	Vienna Institute[9] (Jul 2006)
Central eastern Europe and the Baltic states															
Czech Republic	6.0	1.2	6.2	5.3	6.0	5.7	6.0	na	5.8	6.2	6.2	6.0	6.5	6.0	5.5
Estonia	9.4	2.5	8.9	8.9	9.5	na	9.0	na	8.0	9.5	10.4	10.0	na	10.5	8.9
Hungary	4.0	1.3	3.5	4.6	4.5	4.6	4.0	4.0	3.3	3.9	4.2	4.0	3.8	4.0	4.0
Latvia	9.5	3.0	9.0	8.5	11.0	na	9.5	na	8.0	9.7	10.6	10.0	na	9.8	8.5
Lithuania	7.1	1.8	7.0	6.5	6.8	na	6.8	na	6.2	7.9	7.4	7.8	na	8.0	6.5
Poland	5.0	0.9	5.0	4.5	5.0	4.4	5.0	5.3	4.8	5.2	5.2	4.9	5.3	5.3	5.0
Slovak Republic	6.3	0.5	6.4	6.1	6.5	6.3	6.0	na	6.0	6.2	6.0	6.4	6.5	6.3	6.5
Slovenia	4.3	0.8	4.5	4.3	4.2	na	4.0	na	4.2	4.0	4.1	4.6	na	4.8	4.0
e a e															
ei te a e a e						*a*		*a*					*a*		
South eastern Europe															
SEE-3															
Bulgaria	5.5	1.0	6.0	5.4	5.6	na	5.2	5.6	5.4	5.0	5.0	6.0	5.5	5.5	5.5
Croatia	4.3	0.7	4.6	4.4	4.6	na	4.3	4.3	4.2	4.5	3.9	4.5	na	4.5	4.0
Romania	5.9	1.9	6.5	5.5	5.5	na	6.0	6.5	5.5	6.2	5.8	5.8	6.9	5.4	5.0
SEE-5															
Albania	5.2	0.7	5.0	na	5.0	na	5.4	na	5.7	5.0	5.2	na	na	na	5.2
Bosnia and Herzegovina	5.4	1.0	5.0	na	na	na	5.0	na	5.0	5.3	6.0	na	na	na	6.0
FYR Macedonia	3.9	0.6	4.0	na	4.0	na	4.0	na	4.1	4.0	3.7	na	na	na	3.5
Montenegro	5.4	1.0	5.5	na	na	na	na	na	na	6.0	5.2	na	na	na	5.0
Serbia	5.8	2.7	6.5	na	na	na	6.0	6.7	5.5	6.0	5.8	na	na	5.9	4.0
e a e						*a*									
ei te a e a e				*a*	*a*	*a*	*a*	*a*	*a*			*a*	*a*	*a*	
Common ealth of ndependent States and Mongolia															
Russia	6.3	1.5	6.5	6.1	6.5		6.5	6.7	5.5	6.5	6.0	6.1	7.0	6.0	5.8
Western CIS and the Caucasus															
Armenia	9.2	4.0	8.5	na	7.5	na	11.5	na	na	9.0	9.6	na	na	na	na
Azerbaijan	30.6	13.0	25.0	na	25.6	na	35.5	na	38.0	33.0	26.4	na	na	na	na
Belarus	8.4	4.0	9.5	na	7.0	na	10.0	na	6.0	8.8	9.0	na	na	na	na
Georgia	8.3	2.5	7.5	na	7.5	na	8.0	na	10.0	8.8	8.1	na	na	na	na
Moldova	4.2	3.2	3.5	na	3.0	na	6.2	na	na	4.0	4.1	na	na	na	na
Ukraine	4.9	3.3	6.0	na	5.0	na	5.5	5.4	3.0	6.3	5.5	na	4.0	na	3.5
Central Asia															
Kazakhstan	8.6	1.9	8.5	na	8.3	na	9.3	9.0	7.4	9.0	8.6	na	na	na	na
Kyrgyz Republic	3.7	3.6	4.0	na	5.0	na	3.5	na	5.5	2.0	1.9	na	na	na	na
Mongolia	5.5	2.6	6.0	na	6.5	na	na	na	na	na	3.9	na	na	na	na
Tajikistan	7.6	2.5	7.0	na	8.0	na	8.0	na	9.0	7.0	6.5	na	na	na	na
Turkmenistan	10.6	11.3	9.0	na	9.0	na	6.5	na	8.0	13.0	17.8	na	na	na	na
Uzbekistan	6.9	2.0	7.0	na	7.2	na	6.5	na	8.0	6.5	6.0	na	na	na	na
e a e															
ei te a e a e	*a*	*a*		*a*	*a*	*a*	*a*	*a*	*a*	*a*	*a*	*a*	*a*	*a*	*a*
All transition countries															
e a e															
ei te a e a e	*a*	*a*		*a*	*a*	*a*	*a*	*a*	*a*	*a*	*a*	*a*	*a*	*a*	*a*

Note: All forecasts quoted here were published or reported to the EBRD between April and September 2006. 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 Weighted average based on EBRD estimates of nominal US dollar GDP in each country in 2005.

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

5 Credit Suisse First Boston.

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.2.9

GDP growth forecasts for 2007 (in per cent)

	[1]	[2]	(Sep 2006)	(Apr 2006)	(Sep 2006)	(May 2006)	[4] (Sep 2006)	[5] (Aug 2006)	(Sep 2006)	(Aug 2006)	[6] (Aug 2006)	[7] (Sep 2006)	(Sep 2006)	[8] (Sep 2006)	[9] (Jul 2006)
Central eastern Europe and the Baltic states															
Average	5.8	1.6	5.6	5.7	5.9	5.0	6.3	3.4	5.3	5.6	6.0	6.2	4.9	5.6	5.5
Weighted average[3]	4.9	1.2	4.7	4.9	4.8	na	5.3	na	4.7	4.8	5.2	5.1	na	5.0	4.6
South-eastern Europe															
SEE-3															
SEE-5															
Average	5.2	1.0	5.2	5.1	5.2	na	5.1	5.4	5.4	5.2	5.2	5.4	6.1	5.7	4.8
Weighted average[3]	5.4	1.2	5.5	na	na	na	na	na	na	5.0	5.1	na	na	na	4.7
Commonwealth of Independent States and Mongolia															
Russia															
Western CIS and the Caucasus															
Central Asia															
				na		na	6.5	na		7.2		na	na	na	na
				na		na	6.5	na				na	na	na	na
				na		na	6.0	na				na	na	na	na
Average	7.9	3.7	8.0	5.9	7.4	5.7	9.2	6.5	9.8	7.6	7.3	5.8	4.9	5.8	5.2
Weighted average[3]	na	na	na	na	6.3	na	na	na	na	na	na	na	na	na	na
All transition countries															
Average	6.5	2.2	6.5	5.6	6.4	5.1	7.1	5.3	6.8	6.2	6.2	6.0	5.2	5.6	5.2
Weighted average[3]	5.7	1.7	5.8	na	na	na	na	na	na	na	na	na	na	na	na

Table A.2.10

Average annual inflation forecasts for 2006 (change in the average consumer price level, in per cent)

	Average[1]	[2]	(Sep 2006)	(Apr 2006)	(Sep 2006)	(May 2006)	[3] (Sep 2006)	[4] (Aug 2006)	(Sep 2006)	(Aug 2006)	[5] (Aug 2006)	[6] (Sep 2006)	(Sep 2006)	[7] (Sep 2006)	[8] (Jul 2006)
Central eastern Europe and the Baltic states															
e a e															
South eastern Europe															
SEE-3															
SEE-5															
				a		*a*						*a*	*a*		
e a e						*a*									
Common ealth of ndependent States and Mongolia															
Russia															
Western CIS and the Caucasus															
Central Asia															
e a e				*a*											
All transition countries															
e a e															

Table A.2.11

Average annual inflation forecasts for 2007 (change in the average consumer price level in per cent)

	Average[1]	Range[2]	EBRD (Sep 2006)	European Union (Apr 2006)	IMF (Sep 2006)	OECD (May 2006)	United Nations DESA[3] (Sep 2006)	CSFB[4] (Aug 2006)	Dun & Bradstreet (Sep 2006)	Economist Intelligence Unit (Aug 2006)	Global Insight, Inc.[5] (Aug 2006)	IWH[6] (Sep 2006)	JP Morgan (Sep 2006)	Kopint-Datorg[7] (Sep 2006)	Vienna Institute[8] (Jul 2006)
Central eastern Europe and the Baltic states															
Czech Republic	2.9	1.2	3.1	2.7	3.3	3.7	2.9	na	2.5	3.3	2.8	2.9	2.9	2.5	2.5
Estonia	3.2	0.9	3.4	2.9	3.8	na	3.0	na	3.0	3.2	3.5	3.5	na	3.0	3.0
Hungary	4.8	3.9	6.8	3.3	5.8	2.9	5.0	4.0	4.0	6.0	6.3	3.0	3.8	5.7	6.0
Latvia	4.9	2.1	4.2	5.6	6.3	na	5.0	na	4.2	4.8	4.7	5.5	na	4.2	4.5
Lithuania	2.9	1.8	3.0	3.3	3.3	na	2.5	na	1.5	3.3	3.1	3.0	na	3.2	2.8
Poland	2.1	1.4	2.2	2.0	na	1.7	2.5	2.5	2.2	2.0	2.5	2.2	1.1	2.2	2.0
Slovak Republic	3.0	2.4	2.9	2.7	na	2.2	3.0	na	2.4	2.8	2.7	2.8	4.6	3.2	3.5
Slovenia	2.4	0.5	2.3	2.5	na	na	2.5	na	2.0	2.4	2.4	2.5	na	2.2	2.4
Average	3.3	1.8	3.5	3.1	4.5	2.6	3.3	3.3	2.7	3.5	3.5	3.2	3.1	3.3	3.3
South-eastern Europe															
SEE-3															
Bulgaria	4.7	5.0	2.5	3.5	3.8	na	5.0	na	4.1	4.3	4.8	5.0	6.5	7.5	5.0
Croatia	2.9	1.6	2.8	na	2.8	na	3.0	na	2.2	2.7	3.8	2.9	na	2.9	3.0
Romania	5.9	4.0	4.5	5.7	na	na	5.5	4.0	5.8	na	5.1	6.5	7.0	6.6	8.0
SEE-5															
Albania	2.8	1.0	3.0	na	3.0	na	2.6	na	2.5	2.5	3.5	na	na	na	2.5
Bosnia and Herzegovina	3.8	3.5	na	na	na	na	4.0	2.5	2.5	4.0	3.9	na	na	na	6.0
FYR Macedonia	2.4	1.5	2.0	na	2.0	na	2.5	na	2.0	2.0	3.5	na	na	na	3.0
Montenegro	3.1	0.8	2.7	na	na	na	na	na	na	3.5	3.3	na	na	na	3.0
Serbia	11.3	7.0	8.0	na	na	na	12.0	11.5	11.0	10.7	9.5	na	na	12.5	15.0
Average	4.6	3.1	3.6	4.6	2.9	na	4.9	6.0	4.3	4.2	4.7	4.8	6.8	7.4	5.7
Commonwealth of Independent States and Mongolia															
Russia	9.1	2.1	9.3	na	na	10.0	8.5	8.5	9.0	9.3	8.7	8.0	10.1	9.0	10.0
Western CIS and the Caucasus															
Armenia	3.2	2.0	4.5	na	3.0	na	3.0	na	na	2.8	2.5	na	na	na	na
Azerbaijan	9.0	2.8	9.0	na	10.5	na	9.5	na	7.7	7.7	9.7	na	na	na	na
Belarus	9.9	7.5	8.0	na	9.0	na	9.5	na	14.0	12.6	6.5	na	na	na	na
Georgia	7.0	2.6	8.0	na	6.0	na	7.5	na	5.5	8.1	7.0	na	na	na	na
Moldova	10.8	4.4	12.5	na	10.5	na	10.5	na	na	12.5	8.1	na	na	na	na
Ukraine	10.3	5.0	9.6	na	13.5	na	12.2	9.3	9.5	10.0	9.3	na	8.5	na	11.0
Central Asia															
Kazakhstan	7.5	2.8	7.5	na	7.9	na	8.5	7.9	5.7	7.1	7.7	na	na	na	na
Kyrgyz Republic	5.6	2.6	4.4	na	4.5	na	5.5	na	6.0	7.0	5.9	na	na	na	na
Mongolia	5.3	1.2	6.0	na	4.8	na	na	na	na	na	5.1	na	na	na	na
Tajikistan	6.6	4.8	6.3	na	5.0	na	5.5	na	6.5	6.5	9.8	na	na	na	na
Turkmenistan	10.4	7.0	8.5	na	8.0	na	8.5	na	15.0	11.3	11.1	na	na	na	na
Uzbekistan	12.7	12.1	20.0	na	14.5	na	12.5	na	13.0	8.1	7.9	na	na	na	na
Average	8.3	4.4	8.7	na	8.1	10.0	8.4	8.5	9.2	8.6	7.6	8.0	9.3	9.0	10.5
All transition countries															
Average	5.9	3.3	6.0	3.4	6.3	4.1	6.0	6.3	5.8	5.9	5.7	4.0	5.6	5.0	5.2

Note: All forecasts quoted here were published or reported to the EBRD between April and September 2006. 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 Global Insight Inc, formerly DRI-WEFA.

6 Institute for Economic Research, Halle, Germany.

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

8 Vienna Institute for International Economic Studies (WIIW).

Finance in transition

The special theme of this year's *Transition Report* is the evolution of the financial sector in the transition countries. The following three chapters examine the scale and characteristics of financial systems across the transition region, the extent of their integration into the wider economy and their impact on growth and private sector development.

Over the last 15 years financial systems have changed in a radical way. In the early 1990s they were still largely dominated by state-owned banks, whose main function was to provide finance to either government or state-owned enterprises. By the mid to late 1990s, more diverse financial institutions had emerged, which have functioned increasingly on market principles. The consequence has been a rapid expansion in lending to the private sector, in particular to households, and a greater range of services provided by banks. Improvements in the legal framework have made it easier to make effective use of collateral and to repossess assets in cases of default.

Chapters 3 and 4 focus principally on banking, which dominates the financial sector. Other financial institutions play a less significant role although there has been strong growth in recent years in non-bank financial services, such as leasing, public equity and bonds. There has also been the gradual emergence of a small private equity industry, which is analysed in Chapter 5.

3 Finance and growth

Financial markets in the transition countries have grown in scope and complexity in recent years. Bank lending has increased, particularly from foreign-owned banks lending to households. Stock markets are becoming an important complement to the banking system and a private equity industry is emerging. Nevertheless, financial markets in many transition countries remain underdeveloped. The following analysis assesses the reasons for this and considers the impact of financial markets on the growth rates of transition economies. It also looks at the role of finance in supporting company performance, based on a survey undertaken in a small group of transition countries.

Financial sector development is found to have a significant effect on growth, especially in economies with low initial levels of financial development. The key challenge for the transition countries is to identify and implement the policies that will encourage further growth of the financial sector.

There is a clear relationship between the development of the financial sector and a country's rate of economic growth.[1] In addition to mobilising savings and diversifying risks, financial markets can boost growth by providing credit to households and companies, by encouraging efficient allocation of resources and by financing innovation. A developed financial market can protect consumption and investment from excessive fluctuations. At the same time, competition in financial markets can stimulate competition in goods markets, promoting greater efficiency and higher growth.[2] Furthermore, financial sector development can help to reduce constraints on small business expansion.[3]

Although the link between financial development and growth has been acknowledged, there has been less agreement about which types of financial markets – bank-based (as adopted by the transition countries) or market-based (stocks and bonds) – are more conducive to growth. However, recent research suggests that the characteristics of financial markets are less relevant than previously thought. The provision of financial services, irrespective of the channels through which they are provided, is more important.[4] Indeed, it may be the total amount of finance that matters more than its composition.[5]

Various forms of financing may complement each other. For instance, stock markets, even when small, may affect the functioning of the financial sector as a whole by increasing competition and the level of information available in the system. Other forms of finance, such as private equity, may be most effective when there is a public equity market and bank-based lending (see Chapter 5).

Chapter 3 at a glance

- Financial markets in the transition countries have achieved rapid growth and diversified in recent years but countries with comparable levels of income still have a far greater level of financial development.
- A large proportion of firms do not receive bank loans. Small firms, in particular, have limited access to finance.
- Lack of institutional reform in areas such as creditor rights and credit registries is the main factor holding back further financial development.
- Further development of financial markets would significantly increase economic growth, especially in the less advanced countries.
- Access to bank credit significantly increases a firm's revenue, regardless of the size of the loan. Larger firms tend to use credit more effectively than smaller firms.

3.1 Financial markets in transition countries

Financial markets in the transition countries remain underdeveloped (see Table 3.1) in spite of the increase in credit and stock markets in recent years.[6] There are also significant differences across countries.

Central eastern Europe and the Baltic states (CEB) has much greater diversity in the financial sector than either south-eastern Europe (SEE) or the Commonwealth of Independent States (CIS), especially for banking. Differences in stock market capitalisation across countries are smaller. Russia has the highest stock market capitalisation of all transition countries. Compared with credit markets, stock markets are large in CIS countries whereas in CEB countries the financial sector is mainly bank-based. Financial markets in the SEE countries are more developed than the CIS but less so than CEB.

In countries where the overall development of markets has been lagging behind, stock markets have out-performed other components of the financial system in recent years. However, stock market capitalisation does not necessarily represent a reliable indicator of its importance for enterprise financing, in as much as capitalisation in transition countries continues to reflect privatisation operations. Nevertheless, in some countries stock market capitalisation has reached levels comparable with those of advanced economies, signalling an important link between growth of the banking sector and stock market development.[7]

Progress in banking reform has been much faster in CEB countries. Reform in securities markets has similarly been faster in CEB but reform in this area lags behind banking reform in most other transition countries. In 2000–05 credit markets grew very rapidly. CEB countries have narrowed the gap with the rest of the European Union, and match the level of credit markets in a number of emerging economies, such as Brazil or the Philippines (see Table 3.1). Credit to the private sector has increased by more than 70 per cent in CEB, and almost doubled in SEE. In contrast, bank financing to the private sector has been stagnating in the CIS countries. There is wide variation, therefore, in ratios of credit to GDP but the greatest increases since 2000 have generally been in countries starting from lower levels.

Households have been the biggest beneficiaries of the increase in bank loans. From 2000 to 2005 the growth rate of household credit as a proportion of GDP was high throughout the transition region and much higher than the growth in loans to enterprises. Household loans accounted for around half of total loans over this period, with their share being particularly high in SEE and CEB (see Table 3.2).

Table 3.2 shows that although mortgage lending has been growing at a fast pace in recent years (see also Chapter 4), its share of total lending to the private sector remains small, particularly in the CIS. In contrast, non-mortgage consumer loans have reached levels comparable with advanced market economies. In the eurozone, for instance, the ratio of consumer loans to GDP is on average around 9 per cent, which is similar to the ratios in CEB and SEE. Foreign banks have been particularly active in this market. This is probably because this form of lending does not require investment in information gathering, provides high margins and is perceived as relatively low-risk.

The relatively low level of mortgage loans seems to reflect the continuing need to clarify property rights and to establish clear systems of title deeds. The need to develop effective institutions for the valuation of non-financial assets appears even more pressing given the low level of financial wealth in the transition countries. If measured in terms of GDP, mortgage loans are at a very low level. However, they appear much higher, and often in line with advanced economies, if measured in terms of financial wealth. The ratio of household debt to financial wealth in the transition countries ranges from a low of 21 per cent for the Czech Republic to a high of 46 per cent for Croatia. In the eurozone the average is 25 per cent.[8] A high ratio of debt to financial wealth suggests that households would have difficulties repaying their loans if their income levels fall.

The currency denomination of lending is also an important issue. An increasing share of loans have been denominated in foreign currency and this can lead to other risks for household lending. This is a particularly serious problem in the Baltic states, Bulgaria, Croatia, Romania, and to a lesser extent in Poland and Hungary. In the Baltic states and Bulgaria the presence of currency boards significantly reduces the currency risks but these risks will be fully eliminated only when these countries adopt the euro.

In Croatia more than 70 per cent of household loans are denominated in euros but for the banks involved, there is little currency mismatch in their asset-liability position as a large share of household deposits are also denominated in foreign currency. However, this does not completely protect households from exchange rate risk as households with foreign currency loans are not necessarily the same as those with foreign currency deposits. In the event of a currency devaluation, the burden for indebted households is aggravated by the risk of insolvency. In addition, a large number of household loans are in the form of other arrangements, such as leasing loans, that are largely provided by non-bank institutions that may not be effectively regulated or financially sound.

Credit to enterprises has grown at a much slower pace than household credit. In the Czech Republic and the Slovak Republic, for example, it has actually fallen as a share of GDP due to the writing off of bad loans from bank balance sheets. In general, broadening the market for loans to enterprises has proven a difficult task although there have been signs of progress, particularly in lending to smaller firms (see Chapter 4). There is still scope, however, for improving the ability of banks to evaluate credit risk. More importantly, there is also room for improvement in the institutional framework governing the quantity and quality of credit information, the valuation of collateral and the protection of creditor rights.

Although financial markets in general and credit markets in particular remain underdeveloped in many transition countries, there has been a clear improvement over the past five years. However, rapid growth in credit in recent years in Bulgaria, Hungary and the Baltic states has raised concerns over stability and risk-taking. High growth in credit in transition economies, even if welcome in terms of long-term development, can trigger serious financial and balance of payments problems.

The available evidence confirms that growth in credit has a significant effect on the external accounts of transition countries, especially the trade balance.[9] However, drawing on data from a number of CEB and SEE countries between 2000 and 2004, it was found that only in three out of 10 credit booms was there an accompanying consumption boom (as in Hungary in 2003 and Romania in 2003–04).[10] Although in some cases credit growth has created financial and macroeconomic risks, in most cases the increase in credit has had the positive effect of expanding the financial sector.

Table 3.1

Domestic credit to private sector and stock market capitalisation

	Domestic credit to private sector (in per cent of GDP)		Stock market capitalisation (in per cent of GDP)	
	2000	2005	2000	2005
Albania	3.0	10.3	na	na
Armenia	7.1	8.0	1.3	0.9
Azerbaijan	5.9	9.5	0.1	na
Belarus	8.6	16.2	4.1	na
Bosnia and Herzegovina	5.6	22.6	na	na
Bulgaria	11.6	44.5	4.8	20.1
Croatia	36.0	55.6	14.5	35.2
Czech Republic	49.9	37.6	19.3	31.8
Estonia	23.9	60.0	32.4	26.5
FYR Macedonia	10.5	18.6	0.2	11.4
Georgia	6.4	9.5	0.8	5.5
Hungary	32.0	51.7	25.8	31.9
Kazakhstan	11.2	26.7	7.5	21.6
Kyrgyz Republic	11.2	8.0	0.3	1.8
Latvia	16.9	60.7	7.4	17.4
Lithuania	10.0	34.0	13.9	31.8
Moldova	12.6	21.2	30.3	na
Poland	26.6	27.8	17.9	31.6
Romania	7.2	11.3	3.4	22.3
Russia	13.3	25.7	15.3	71.9
Slovak Republic	51.3	36.2	3.5	9.5
Slovenia	35.8	53.8	13.6	23.8
Tajikistan	19.2	17.1	na	na
Turkmenistan	2.1	1.4	na	na
Ukraine	11.2	31.2	6.0	31.3
Uzbekistan	27.9	20.4	1.0	0.3
CEB	26.4	42.3	16.7	26.0
SEE	12.3	23.9	5.8	23.0
CIS	8.4	9.4	6.7	17.0
World	45.7	55.8	53.2	57.7
European Union	74.4	85.8	78.7	67.0

Sources: EBRD banking survey, Capital Markets survey, World Bank Financial Sector Development Indicators 2006.

Note: Data for domestic credit for Georgia and Moldova are from 2000 and 2004 EBRD banking surveys. Data for Azerbaijan, Kyrgyz Republic and Ukraine are from official country sources. Data for Kazakhstan are for 2000 and 2004 from EBRD official sources. Data for World and European Union are for 2000 and 2004 from the World Bank Financial Sector Development Indicators 2006.

3.2 Finance for enterprises

The EBRD/World Bank Business Environment and Enterprise Performance Surveys (BEEPS) in 2002 and 2005 provide information on how easy it is for enterprises to gain access to finance. Table 3.3 shows that a large proportion of firms in the transition countries do not receive bank loans. The proportion is much higher than in advanced market economies, such as Germany.

Small firms are the most likely to lack access to finance: around 60 per cent of these firms across the region do not have bank loans. Access to finance increases as firms grow but problems remain even for medium-sized firms. In CIS countries, even within the large firm category, 45 per cent of enterprises do not have bank loans (compared with around 30 per cent in CEB and SEE). Between 2002 and 2005 there was some progress in SEE and the CIS but the situation in CEB actually deteriorated.

Firms without bank loans are not necessarily constrained by lack of finance as they may have decided to fund their activities from other sources. Table 3.3 indicates the proportion of firms without loans that claimed in the survey that a bank loan was not needed. The proportion is much higher for large firms. Among small firms without loans, more than half claimed that they did not need them. However, between 25 to 34 per cent of small firms claimed that they were unable to obtain a loan compared with only 7 to 14 per cent of large firms. The proportion of firms without bank loans was lower in CEB than in SEE or the CIS but for the region as a whole the percentage was twice as high as in Germany.

The BEEPS also provides information on the different types of financing available to enterprises (see Table 3.4). Internal finance accounted for the largest share of total financing for both working capital and fixed investment. In the CIS internal finance made up 77 per cent of working capital financing while in SEE and CEB it constituted 73 per cent and 68 per cent respectively. The breakdown for fixed investment financing was very similar.

It is striking that in transition countries even working capital is financed primarily by internal funds. While this might reflect high profit margins for firms in rapidly growing economies, reliance on earnings for financing both fixed investment and working capital can make firms vulnerable to interruptions in their cash flow. A temporary decline in profits and cash flow can have a negative effect on output and hamper investment.

Borrowing from banks to finance working capital accounted for around 10 per cent of total financing in CEB and the CIS and 13 per cent in SEE. Bank loans for financing fixed investment ranged from 12 per cent in the CIS to 14 per cent in CEB and 18 per cent in SEE. Trade credit, which mainly applies to working capital finance, accounts for similar shares across the transition regions. In Russia and Ukraine, trade credit is actually more important than bank credit as a source of financing working capital. Only in CEB did equity account for a significant share of external finance. In the Baltic states, leasing represents a large share of investment financing, especially in Estonia and Lithuania where it accounts for 14 and 23 per cent of total financing for investment respectively. Combining these data with those on trade credit, it appears that a significant role is played in these countries by non-bank sources of external finance.

Across the transition region, small firms have a much lower proportion of their working capital and fixed investments financed by bank loans. They also have lower shares of credit from suppliers, suggesting that bank loans and trade credit are more important for medium-sized and large firms. Small firms also tend to finance a much larger share of their working capital and investments through internal resources. The BEEPS confirms that, despite some regional variation, bank loans still play a limited role in enterprise financing while in several countries (especially in CEB, Russia and Ukraine) trade credit provides a partial alternative.

Table 3.2

Domestic credit to households and mortgage lending

(in per cent)

	Average 2000-05			
	Domestic credit to households		Mortgage lending to households	
	As a share of GDP	As a share of total domestic credit to private sector	As a share of GDP	As a share of total domestic credit to private sector
CEB	10.1	31.5	5.2	15.7
SEE	15.8	52.2	4.6	11.8
CIS	1.8	18.7	0.7	5.4

	Growth 2000-05	
	As a share of GDP	As a share of GDP
CEB	192.6	457.4
SEE	42.9	69.6
CIS	585.4	377.4

Source: EBRD banking survey.

Note: SEE includes only Bulgaria, Croatia and Romania and refers to 2003-05. CIS countries include only Georgia, Kazakhstan, Kyrgyz Republic, Moldova and Russia while data availability differs across countries and over time.

Table 3.3

Financially constrained firms

(as a percentage of the sample)

	Small firms		Medium firms		Large firms	
	Without bank loans	Unable to obtain bank loans	Without bank loans	Unable to obtain bank loans	Without bank loans	Unable to obtain bank loans
CEB	60.8	27.3	41.9	13.1	29.2	7.4
SEE	59.7	29.1	39.8	15.9	32.1	11.0
CIS	67.5	34.9	51.5	24.4	45.8	13.4
Germany	37.2	14.6	24.6	9.8	15.3	4.8

Source: EBRD/World Bank Business Environment and Enterprise Performance Survey 2005.

Note: A firm is classified as “small” with fewer than 49 employees, “medium” with between 50 and 249 employees, and “large” with more than 250 employees. A firm is “financially constrained” if it does not have a loan, if it is in the process of applying for a loan, or has already applied but has been rejected, or has never applied for a loan but reports that it would need one.

3.3 The role of institutions in financial development

There is clear evidence that financial development increases with the level of economic development. However, transition countries have smaller financial sectors than would be expected on the basis of their income levels. This suggests that other factors have constrained the development of financial markets in the transition region.

Establishing financial markets and effective institutions is a slow process. However, this cannot fully explain the significant differences in the level of financial sector development across transition countries, suggesting that policy reforms may be significant factors in speeding up the process. Since the transition period has been too short to assess the impact of such reforms conclusively, a large sample of countries worldwide has been analysed to evaluate the main factors determining financial market development. For many developing and transition countries, stock markets and private bond markets still play a minor role, so credit to the private sector acts as the relevant measure of financial depth.

The analysis takes account of macroeconomic factors, such as the growth rate of the economy and the rate of inflation, and institutional factors, such as the length of legal procedures in cases of debt default. In addition, the economic size of countries, measured by their GDP, has been included.[11] The effects of institutional factors are particularly important. Protection of creditor rights and the existence of credit registries explain much of the difference in financial development across countries.

Using these factors, the current status of the transition countries and the potential impact of reforms on financial development can be assessed. Chart 3.1 shows that there is a large gap between the actual and potential levels of financial development. This gap could be sharply reduced through institutional reforms.

The scope for policy reform in terms of providing credit registries and protecting creditor rights varies across the transition countries. Most CEB countries have already made progress on credit registries. However, most CIS and SEE countries have a poor record in this area and would benefit from reform. Improving the functioning of secured transactions and increasing the recovery rates on defaulted loans would enhance creditors' confidence and lead to greater availability of credit at a lower cost.

Table 3.5 shows the large differences across the transition countries in the efficiency of secured transactions. CEB and SEE countries appear to perform better than CIS countries even though there are significant exceptions, such as the poor standard of systems in Croatia, the Czech Republic, Estonia and Slovenia. A similar picture emerges for the recovery rates on defaulted loans, as reported by the World Bank's Doing Business Survey 2006. Recovery rates are much higher in CEB and SEE countries than in CIS countries. Overall, there is considerable scope for improvement in this area.

A striking feature in the financial evolution of the transition countries has been the rapid growth of foreign banks. In the more advanced countries (with the exception of Slovenia), foreign banks account for a dominant share of assets in domestic markets (see Chapter 2). Foreign ownership of local banks remains much lower in the CIS. It has been argued that foreign banks introduce into the host country the skills and range of services prevailing in the home country. This is discussed in greater depth in Chapter 4. However, foreign banks – particularly new entrants to an existing market – tend to have poor information on local borrowers, especially small firms, and may restrict their lending to larger enterprises (often branches of multinational firms).[12] Moreover, foreign banks tend to focus on household loans, as relatively little information is needed for these and no collateral is generally required.

Despite these possible limitations, foreign banks appear to have a positive effect

Table 3.4

Financing available to enterprises

(as a percentage of total financing)

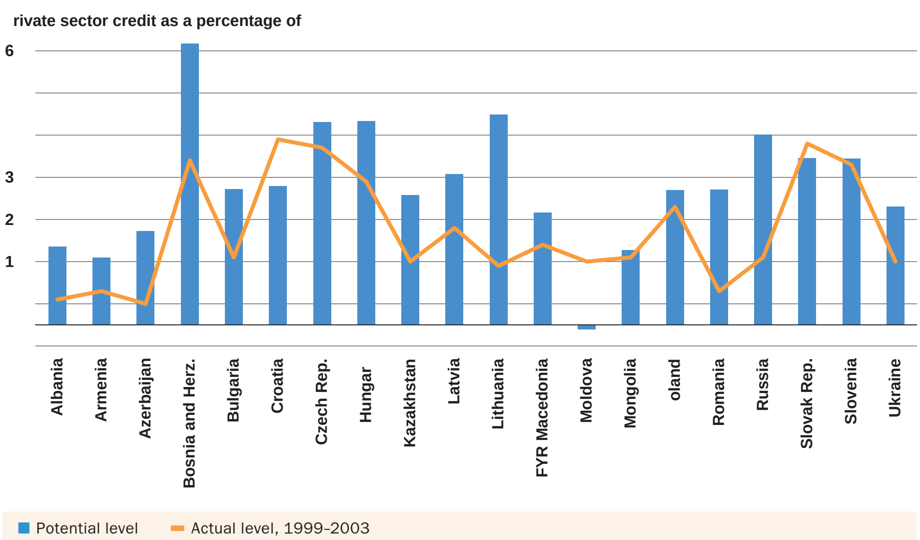
	Working capital financing				
	Internal finance	Borrowing from banks	Equity	Trade credit	Other
CEB	68.0	10.1	6.9	6.2	6.6
SEE	73.2	12.9	1.0	5.6	5.8
CIS	77.3	10.1	2.0	4.0	6.0

	Fixed investment financing				
	Internal finance	Borrowing from banks	Equity	Trade credit	Other
CEB	62.4	14.3	6.5	1.9	12.0
SEE	70.8	17.7	0.9	2.4	6.8
CIS	77.2	11.6	1.9	1.8	6.9

Source: EBRD/World Bank Business Environment and Enterprise Performance Survey 2005.

Chart 3.1

Actual and potential levels of financial development



Source: Djankov *et al* (2005).

Note: The chart shows the potential impact that reforms, such as protection of creditor rights and the creation of credit registries, could have on financial development.

on financial development. An alternative explanation would be that foreign banks are entering markets that have already achieved a high level of development and have no discernible impact. The quality of institutional development also affects both the level of financial development and the entry of foreign banks. Chart 3.2 shows that in countries with low ratios of credit to GDP – for example, many CIS countries – foreign banks appear to have no positive effect on financial development. This suggests that domestic financial markets need to achieve a sufficiently high level of development before foreign banks can have an impact.

In addition to attracting foreign banks to domestic markets, countries can potentially compensate for the lack of credit in domestic markets by borrowing from abroad.[13] This is particularly applicable to the transition countries belonging to the European Union, where there are no barriers to capital flows.[14] Direct loans from foreign banks play a significant role in many transition countries. The share of foreign loans in total domestic credit is high in several CIS countries with underdeveloped domestic markets, such as Azerbaijan and Georgia.

However, in most CIS countries, foreign markets do not offer a major alternative to domestic markets. The factors impeding the development of local markets also limit access to foreign markets and deter the entry of foreign banks. As a result, cross-border transactions tend to be undertaken in more advanced transition countries, such as Croatia, Estonia, Lithuania and Poland, which have more extensive domestic credit markets and a significant presence of foreign banks.

3.4 Finance and growth in transition

When determining how financial sector development in the transition countries affects growth, it is important to distinguish whether low levels of financial development reflect lower financing needs or the existence of financing constraints, both in terms of the cost of credit and its lack of availability. Rather than credit encouraging economic growth, it might be that growth leads to an increase in credit. This conundrum is not easily resolved by looking purely at data at the country level. Different economic activities require different levels of external finance. If a country concentrates production on activities requiring little external finance, output growth can occur with low levels of credit.

Industry data, however, are more informative. A sector's need for external finance depends on its level of technology. However, the actual use of such finance in a given country is affected by the constraints on its availability and the cost of external finance in that country. To identify where the need for external finance depends on purely technological factors, it is necessary to pinpoint a country with relatively complete financial markets.[15]

Using the United States as a benchmark, it is possible to calculate the need for external finance that arises from purely technological factors. The impact of finance on the growth of certain sectors in the transition countries can be measured against these US benchmarks. Finance affects growth by reducing constraints in those sectors for which external finance is more relevant. This approach also clarifies causality – that it is finance that affects growth rather than growth that affects finance. By measuring the impact of finance on individual sectors, an aggregate result can be calculated by weighting each sector by its share in total output.

The following analysis also considers whether the same amount of credit can exert different effects on growth in countries with different levels of financial development. As discussed above, different levels of financial development are associated with different levels of institutional development and possibly different levels of efficiency of financial markets. The objective is to test whether the "growth dividend" brought about by financial sector development may be higher for countries with underdeveloped financial markets (as in the CIS, for instance).

Whereas earlier research relied on data covering the period from the 1960s to the 1980s, this analysis concentrates on the period from 1994 to 2003. It uses a sample of 83 countries and 28 industries to analyse the effects of financial sector development on real output growth. Starting from 1994 also avoids the problem of the sharp drop in output experienced by transition countries at the start of the transition process.

Two different measures of financial sector development are considered. First, development is measured by the ratio of credit to the private sector in terms of GDP.[16] The second takes a broader measure by adding stock market capitalisation to private sector credit. The analysis takes account of country factors that affect growth rates for reasons other than financial development.

The analysis indicates that financial sector development has a large effect on growth. Countries with low levels of financial development could attain a much higher rate of growth if their financial sector were more developed. This holds true for both

Table 3.5

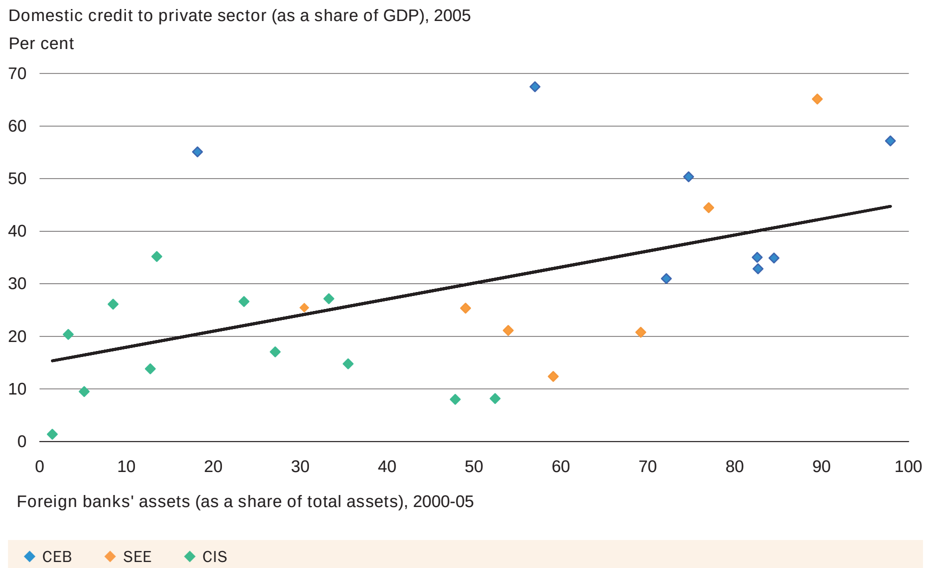
Secured transactions systems

Malfunctioning secured transactions systems	Inefficient secured transactions systems	Modern secured transactions systems with some defects	Advanced modern secured transactions systems
Armenia	Croatia	Bosnia and Herzegovina	Albania
Azerbaijan	Czech Republic	FYR Macedonia	Bulgaria
Belarus	Estonia	Kyrgyz Republic	Hungary
Georgia	Kazakhstan	Moldova	Latvia
Russia	Slovenia	Poland	Lithuania
Tajikistan		Serbia	Romania
Turkmenistan		Ukraine	Slovak Republic
Uzbekistan			

Source: EBRD Regional Survey of Secured Transactions, 2005.

Chart 3.2

Foreign banks' impact on financial development



Source: EBRD banking survey.

the role of credit and the broader measure of financial development that includes stock markets. The analysis estimates the gains in growth of industrial output that transition countries would achieve by improving their financial development.

Two targets are considered. The first envisages an increase in the credit-to-GDP ratio of transition countries to the levels prevailing in the top 25 per cent of countries in the sample in terms of financial development.[17] The second target envisages a rise in the sum of both credit and stock market capitalisation in terms of GDP to the level of the top 25 per cent of the sample countries.

The analysis assesses the size of the increase in financial development needed to reach the target value. Discounting the effect of industrial specialisation, countries that are lagging behind in their financial development show the largest potential gains from financial expansion. Similarly, for a particular increase in financial development, countries with an industrial specialisation heavily reliant on external finance show the largest potential gains in terms of growth.

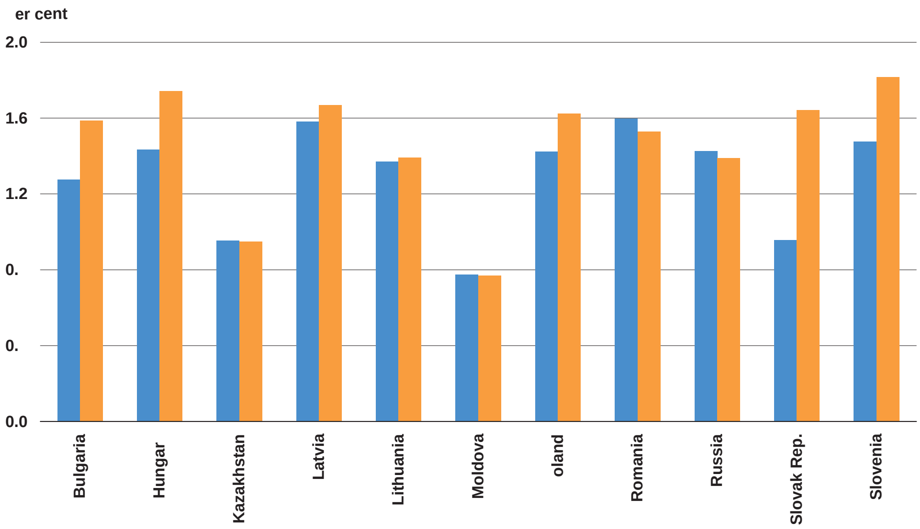
In the first scenario, the gains in growth are very large, averaging 1.2 per cent improvement in annual rates of growth (see Chart 3.3) and ranging from 1 per cent for the CIS to 1.3 per cent for CEB. Similar results are obtained for the broader measure that also includes stock market capitalisation. On average, transition countries would experience an increase of 1.4 per cent per year in the growth rates of industrial output by raising their overall financial development to the target level (see Chart 3.3).

If the variations in financial development across the transition countries are taken into account, greater gains for CIS countries with lower levels of development could be expected. Countries with lower levels of financial development tend to have an industrial structure based on sectors that rely less on external finance. This partly softens the adverse effects on growth of underdevelopment in the financial sector. Nevertheless, the growth dividend also appears considerable for these countries.

In line with changes in the industrial structure between 1994 and 2003, there has been a small increase in sectors with a higher reliance on external finance in CEB

Chart 3.3

Growth dividend from increase in credit and stock market capitalisation



■ Growth dividend from increase in bank credit
■ Growth dividend from increase in bank credit and stock market capitalisation

Sources: World Bank Database on Financial Development and Structure (1960-2004), UNIDO Industrial Statistics Database at the three-digit level of ISIC Rev. 2 (2006), Rajan and Zingales (1998).

Note: The chart shows the increase in growth resulting from an increase in the credit-to-GDP ratio and in the ratio of stock market capitalisation and bank credit over GDP of transition countries to the levels in the top 25 per cent of countries in the sample in terms of financial development. The growth dividend is computed as follows: the coefficient in the interaction term of the benchmark regression is multiplied by the level of dependence on external finance. These coefficients are multiplied by the difference between the target credit-to-GDP ratio and its average value in the sample period. Finally a weighted average of these sectoral variables is taken, with weights given by the share in total manufacturing output of each sector in 1993.

Table 3.6

Loans received by firms

(in sample means)

	2001	2004
Number of loans per firm in a given year	1.2	1.4
Loan size in US dollars	19,826	26,070
Interest rate charged on loan (in real terms, in per cent)	20.4	17.9
Maturity of loan (months)	13.9	20.1
Percentage of loan requested as collateral	209	162
Number of working days taken to obtain loan	16.1	11.0
Number of firms that received bank loans	334	626

Source: EBRD survey of micro, small and medium-sized enterprises in Bulgaria, Georgia, Russia and Ukraine.

countries. This suggests a loosening of the constraints on industrial specialisation exerted by lack of financial development, especially in the more advanced transition countries.

Another relevant issue is whether the effects of finance depend on the stage of development of financial markets. It could be argued that the more backward a country's financial sector, the greater the liquidity constraints for firms and households. As a result, an improvement in financial development could be expected to have a greater impact as new households and firms enter credit markets.

However, if the main link between financial market development and growth operates through the funding of innovative activities, development of the financial sector could be expected to be stronger in countries with developed financial markets. For transition countries, it seems likely that constraints on the financing of innovation are less relevant, as most economic activities in these countries are concentrated in traditional sectors. Furthermore, sectors relying on more innovative technologies are usually dominated by foreign firms that do not generally suffer from financing constraints.

Table 3.7

Financing sources for working capital and fixed assets

(as sample means of the percentage of total needs of firms)

	Working capital		Fixed assets	
	Loan recipients	Control group	Loan recipients	Control group
Firm's internal funds, retained earnings	45.9	74.7	47.4	84.1
Loans from family, friends	5.2	11.8	2.6	9.0
Loans from money lenders or other informal sources	1.9	1.4	0.8	1.0
Loans from banks	37.7	0.0	42.4	0.0
Equity	0.7	0.7	0.9	0.1
Trade credit from suppliers	6.6	7.9	1.8	1.9
Trade credit from customers	0.7	1.9	0.2	0.6
Credit cards	0.2	0.0	0.0	0.1
Leasing arrangement	0.6	0.8	3.1	3.3
Government	0.0	0.1	0.1	0.0
Other	0.5	0.7	0.7	0.0
Total	**100.0**	**100.0**	**100.0**	**100.0**
Number of firms	929	295	725	190

Source: EBRD survey of micro, small and medium-sized enterprises in Bulgaria, Georgia, Russia and Ukraine.

Results appear to confirm that the benefits are greater for the more backward countries. Indeed, they indicate the presence of two thresholds in terms of the initial level of private sector credit to GDP – one at 18 per cent, the other at 81 per cent. The effect of financial development declines if credit to GDP is initially larger than 18 per cent and drops substantially for initial values above 81 per cent (a level that is common in most advanced market economies). The fact that the effect diminishes for very high credit-to-GDP levels could be expected. The more interesting finding is the significant difference in the effects between low and intermediate levels of financial development.

The effect of finance on growth is much higher for countries with low initial levels of financial development. For the transition countries, all those in the CIS fall into the low development category, as their private credit-to-GDP ratio in 1994 was below the 18 per cent threshold. Most CEB countries fall into the intermediate group with ratios between 18 and 81 per cent. It is evident that finance has a positive impact on growth whatever the level of initial financial market development. However, it has the greatest effect on growth in countries at lower initial levels of financial development. This indicates that reducing severe liquidity constraints is the principal means by which financial development can improve growth.

In principle, trade credit can compensate for the lack of access to bank financing. As with the need for external finance, trade credit will vary across economic sectors because of structural differences. Reliance on supplier credit tends to be higher in sectors that require goods and services from a variety of sources.

Using the US sample of companies as a benchmark, reliance on trade credit was included in an analysis of the impact of financial development on growth.[18] It was assumed that sectors that rely on trade credit to offset the lack of other sources of finance tend to grow faster in countries with lower levels of financial development.[19] This assumption was confirmed by the analysis. However, as in the banking sector, factors such as creditor protection and registries are also important for the efficient functioning of a trade credit system. As is generally the case in advanced market economies, trade credit tends to complement bank credit in enterprise financing.

3.5 Finance and enterprise performance

The following analysis examines whether access to bank credit helps firms to grow faster. The analysis draws on information from an EBRD survey in 2005 of 1,272 micro, small and medium-sized enterprises in the trade and manufacturing sectors in four countries – Bulgaria, Georgia, Russia and Ukraine.[20] Within the sample, 54 per cent were micro enterprises, 36 per cent were small, and 10 per cent were medium-sized. Overall, 76 per cent had received bank credit.

The survey results indicate that firms' financial constraints between 2001 and 2004 became less binding. The number of firms in receipt of bank loans almost doubled and the number of loans per firm also increased (see Table 3.6). Over this period the average loan size increased by more than 30 per cent, the average real interest rate fell by 12 per cent and the maturity of loans increased from 14 to 20 months. These findings suggest that banks have become more efficient in processing loans, and that firms which repaid their first bank loan obtained better terms on their next credit application.

Table 3.7 shows the average proportion of funds drawn from each source of finance as a percentage of total needs for working capital and investment in 2003–04. This is broken down by firms that had access to bank loans and those that did not. Access to a bank loan drastically reduced the use of internal funds or loans from family and friends but had only a marginal effect on the use of suppliers' credit.

Within the survey sample, bank credit proved the second most expensive source of finance in terms of interest rate costs (after money lenders) for both working capital and investment purposes. Leasing finance appears to be a cheaper alternative to bank credit for investment purposes but this was only used by 10 per cent of firms that had access to bank credit. The low usage is explained by the fact that leasing finance is more difficult to access than bank credit.

Data from this survey have been used to evaluate the impact of bank credit on the enterprises which benefited from it.[20] The analysis shows that bank credit has an independent and significant impact on firms' performance once factors such as different forms of management, firm structure, previous performance as well as differences in the level of development, business environment, country-wide economic performance and industry characteristics are taken into account. Access to bank credit increases the scale of a firm's activity – as measured in terms of growth of fixed assets and revenues – by 22 and 75 per cent respectively, regardless of the size of loan received. The data show that smaller firms grow faster than larger firms but this is not related to the receipt of loans.

Data from this survey were also used to look at how firms use bank credit. It appears that firms make use of loans in different ways according to their size and age. The effect of bank credit on the growth of the firm's scale of activity is strongest for larger firms in the sample and weakest for micro enterprises. This finding about the ability of firms of different size to process credit differently for productive purposes is also supported by the information provided by the entrepreneurs on the activity financed by the loans they were granted.

For example, about 24 per cent of micro entrepreneurs indicated that they used bank loans to finance personal purchases compared with an average of 11 per cent for small and medium-sized entrepreneurs. These answers showed little variance over time but vary with the age of the enterprise, with "young" firms (that is, under five years of age) more likely than "old" firms to use bank loans for personal purchases. Of all "young" micro firms, 27 per cent used part of the bank loans received to make personal purchases versus 23 per cent of "old" micro firms. For small and medium-sized enterprises (SMEs), the age effect is stronger: of all "young" SMEs, 23 per cent made personal purchases with bank loan funds versus 8 per cent of "old" SMEs.

In summary, bank credit can have a positive effect on firm performance. Older and larger firms tend to benefit more from bank loans than smaller firms.

3.6 Conclusion

Despite increasing access to bank finance in the transition countries, the region still trails behind other countries with comparable levels of income. Further development of the financial sector would significantly help the transition countries to increase output and to catch up with more advanced market economies. An underdeveloped financial sector penalises in particular the activities and sectors that require external finance to operate efficiently. This has led to particular forms of industrial specialisation in the transition countries as resources have been directed to sectors that do not rely on external finance. However, this may not be efficient in the long term.

Development of the financial sector can have a particularly big impact on growth in countries that currently suffer from very low levels of financial development. There is clear evidence that both creditor rights and registries are key factors in determining the effectiveness of credit markets. The transition countries need to give priority to the implementation of reforms that would improve these areas. This includes effective systems for valuing collateral, enforcing repayment and allowing creditors to gain possession of collateral. These changes are beginning to take place in many of the more advanced transition countries. However, in other transition economies progress has been slow.

The entry of foreign banks into the market helps to develop skills in the transition countries and to increase the range of financial services available to customers. However, foreign banks are geared mainly towards household financing and may have a limited impact on reducing financing constraints for businesses. Moreover, while international integration allows firms to borrow directly from abroad, it does not fully compensate for the failings of domestic markets. Furthermore, cross-border loans tend to involve lending from foreign banks to branches of foreign firms in the receiving country. In short, institutional reforms will continue to play a fundamental role in the development of the financial sector.

Finally, firm-level analysis shows that bank credit appears to have an independent, strong and positive effect on firm performance. This effect tends to vary with firms' age and size, with smaller and younger firms being less able to channel bank credit towards productive uses than older and larger firms.

Endnotes

1 See Levine (2005) for a comprehensive survey.

2 See Cetorelli (2004).

3 See Beck *et al*. (2006).

4 See Demirguc-Kunt (2006).

5 See Levine (2002).

6 Corporate bond markets do not exist in most transition countries or are very small in those where they do exist.

7 The increase in commodity prices has certainly boosted valuation of listed firms in the Russian market, dominated by companies in the energy sector.

8 See Coricelli *et al*. (2006).

9 This effect has been found for three transition countries by Duenwald *et al*. (2005).

10 Both credit and consumption boom are defined as large (greater than 1.75 standard deviations) deviations from the trend of the variables. These booms represent exceptional realisation of both consumption and credit (see Coricelli *et al*. 2006).

11 See Djankov *et al*. (2005).

12 Detragiache *et al*. (2005) find that foreign bank penetration reduces financial development in low-income countries.

13 Financial integration may be a powerful force increasing competition in local financial markets and limiting the role of connected lending related to loans allocated because of political influence and monopolistic positions of firms (Giannetti and Ongena, 2005).

14 However, openness to international capital flows does not imply that national measures of financial development are irrelevant. In fact, market segmentation has been found even at the regional level within advanced market economies (Guiso *et al*. 2002).

15 This approach has been pioneered by Rajan and Zingales (1998). In the benchmark regression the dependent variable is the average annual growth of real output of industry *j* in country *k* over the sample period. The interaction of an industry's dependence on external finance with a measure of financial sector development in country *k* provides the main coefficient of interest. The regression controls for the industry's *j* nominal share of output in total manufacturing in the initial year. It also controls for country characteristics through country indicators. The original Rajan and Zingales framework is then extended to allow for differences in the impact of financial sector development on industry growth. The hypothesis is that the initial size of the financial sector is a threshold variable, according to which the individual countries' observations are split into different classes and examined through a two-step procedure. In the first step, the thresholds are identified. In the second step, the estimated thresholds are employed to split the sample into different classes and the model is estimated allowing for different coefficients for the different potential classes of the sample. The data on output come from the UNIDO Industrial Statistics Database at the three-digit level for 29 manufacturing sectors.

16 Other definitions were tried, such as the accounting standards in the countries. Using these alternatives, the sample gets smaller, as these indicators are not available for several countries. However, results do not significantly change.

17 Guiso *et al*. (2004) carry out a similar analysis for European countries.

18 A term was added, given by the interaction between the reliance on trade credit in the various sectors in the United States and the level of financial development of each country. The coefficient of this term is, as expected, negative and statistically significant.

19 A similar analysis has been carried out by Fisman and Love (2003) for a sample of countries that did not contain transition economies. Their results are similar to the EBRD's.

20 See Joeveer, Pissarides and Svejnar (2006). Micro enterprises were defined as having 0–9 employees, small firms 10–49, and medium-sized businesses 50–249. The survey included questions relating to financial and operational performance between 2001 and 2004, access to different sources of finance, and perception of obstacles to doing business. The sample was not randomly selected. The larger proportion of enterprises had benefited from bank credit. The majority of sampled firms had to be micro enterprises, and the rest small and medium-sized enterprises. Loan recipients and non-loan recipients had to be based in the same locations within the four countries. Enterprises may have received one or more loans from the same bank or from different banks at different points in time.

21 In this type of analysis, results may be distorted by "selection bias". First, any positive impact on firms' performance may not necessarily derive from having received a bank loan, but from the possibility that those firms applying for bank finance are inherently more growth-oriented. Secondly, banks lend to those relatively more able to repay. The analysis aims to control for selection bias by using a control sample which matches by categories of size, location and sector, the sample of firms receiving a loan, and also uses appropriate econometric techniques.

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Annex 3.1: Banking and sustainable development

Corporate responsibility and sustainable development have become key aspects of good business practice in the financial sectors of mature market economies. Responding to increasing pressure from customers, shareholders, non-governmental organisations and the media, financial institutions have realised that it is important for their good reputation to address environmental and social issues. They have also recognised that borrowers' non-compliance with national regulations and standards can translate into real financial risk for banks. This has prompted many to integrate environmental and social considerations into their credit assessment processes.

In addition, many banks have come to recognise the business potential of sustainable development in areas such as energy efficiency and carbon finance. Over 65 per cent of respondents to a recent survey by the International Finance Corporation (IFC) indicated that following training, they experienced "tangible benefits" from developing new business in these areas.[1]

To what extent the concepts of corporate responsibility and sustainable development have become key considerations in the financial sector in the transition region is analysed below. First, the analysis examines the participation of banks in three major international initiatives that aim to promote environmental and social standards in the financial sector – the Equator Principles, the United Nations Environment Programme Finance Initiative (UNEP FI) and the United Nations Global Compact. Secondly, the analysis looks at the degree to which environmental and social issues are reported in the official publications of leading banks.

The findings show that banks in the transition region consistently lag behind in terms of adopting environmental and social policies, compared with three benchmark countries – Greece, Spain and Portugal.

Participation in international initiatives

Equator Principles

The "Equator Principles" were agreed by a group of leading commercial banks in 2003.[2] Based on environmental, health and safety guidelines and the IFC's environmental and social safeguard policies, the principles set out a framework for socially responsible and environmentally sound lending practices. They focus exclusively on project finance – bank lending against the cash flow of a specific investment project without recourse to the sponsors of the project. Originally, they only applied to loans of more than US$ 50 million but in 2006 this threshold was lowered to US$10 million. At the same time, the principles were updated to include new IFC Performance Standards on Social and Environmental Sustainability, and their scope was expanded to include advisory services. Signatories are also required to report publicly on their performance in meeting the principles. As at September 2006, 41 banks had signed up to the revised principles.

The Equator Principles are relatively stringent and require a serious institutional commitment in terms of environmental and social assessment and performance standards for borrowers. However, by focusing on project finance they are also quite narrow.

Project finance is rather specialised and usually reserved for large and complex transactions like extractive industries or big infrastructure investments. As such, it is not a typical banking activity in the transition region and made up only 9 per cent of total lending (or about US$8.5 billion)[3] between January 2005 and July 2006. About two-thirds of the projects (accounting for more than 90 per cent of this amount) were for loans above US$50 million. (If the US$10 million threshold had been in place for the whole of this period, practically all projects would have fallen within the scope of the Equator Principles.)

Although there are no banks from the transition region among the 41 signatories of the Equator Principles (see Table A.3.1.1), most project finance activities in transition countries are covered. This is because most project finance transactions are processed by specialised teams in international banks, whose central office has signed up to the principles. Many deals also involve international financial institutions, such as the EBRD and IFC, which have stringent environmental and social requirements.

The only commercial banks involved in project financing in the region that are not signatories of the Equator Principles are BayernLB, BNP Paribas and Raiffeisen Zentralbank (RZB). However, all of these banks have some level of commitment to environmental and social assessment in lending, and BayernLB requires its projects to meet World Bank environmental and social standards.[4]

Table A.3.1.1

Participation in sustainability indicators and guidelines

	Equator Principles	UNEP FI	UN Global Compact
Description	Strict guidelines for project finance only, for financial sector, narrow and specific	General guidelines, only for financial sector, broad and general	General principles, not specifically for financial sector, broad and general
Membership fee?	No	Yes	No
Monitoring	Signatories required to report publicly on implementation	Internal reports, publication encouraged	Required to report publicly on progress to meet the ten principles
Total number of participants	41	161	284[1]
Participants from transition countries	0	4	29[1]

Source: EBRD.

[1] Finance and insurance only.

UNEP Finance Initiative

The UNEP FI is a partnership arrangement between the public and private sector, which offers training and best practice advice to its members.[5] Unlike the Equator Principles, it has very general objectives.

Participating banks must embrace sustainable development as a fundamental aspect of sound business management in both lending and internal operations. They are also encouraged to report publicly on the implementation of their environmental policies although they are not obliged to apply any measurable performance standards to either themselves or their borrowers. The only membership obligation is the submission of an annual report outlining the steps taken to comply with UNEP FI principles. These reports are for internal UNEP FI use only and are not made public.

As at September 2006, the UNEP FI had 161 members worldwide, with some 75 per cent based in western Europe or North America. The number of signatories has dropped from 289 members in 2002, when a compulsory membership fee was introduced. Those leaving included banks from the transition countries, which are now represented by only four signatories – the American Bank of Albania (a commercial bank), HBOR (the state development bank of Croatia), Banca Commerciala Romana (a leading Romanian bank) and Econatsbank (a Russian niche bank).

UN Global Compact

Launched in 1999, the UN Global Compact brings together companies, UN agencies and others, such as NGOs, to support ten universal environmental and social principles.[6] These principles cover human rights, labour standards, the environment and fighting corruption. The operational phase was launched in 2000. Participants are asked to report on their progress in following the principles but do not assume any more detailed commitments. The Compact is open to participants from all areas of the economy, with only one in eight members coming from the financial sector. The 282 participants from transition countries account for about 8 per cent of all members. In the financial sector, transition country participants number 29 (out of 284) or about 10 per cent of signatories (see Table A.3.1.1).

Reporting on social and environmental policy

Transparency and accountability are considered important elements of corporate responsibility. Therefore, an important way to gauge commitment to sustainable development is to examine how leading banks cover this commitment in their official reports. Publications from the three largest banks (by assets) in 20 transition countries were screened for information about the banks' external and internal policies on the environment and social issues and their sponsorship activities in local communities.[7]

External policies cover the integration of environmental and social considerations in the credit appraisal process and the standards expected from borrowers. Internal policies concern a bank's own rules and procedures covering, for example, energy efficiency, recycling or human resource management. Development initiatives aimed purely at improving the financial performance of the bank are not considered. Local sponsorship activities are of interest because in western Europe they have often been the first steps that companies have taken to demonstrate good corporate citizenship. Their adoption in transition countries might therefore imply a similar advance.

Such a survey may not describe accurately the efforts made by a bank in its actual operations. The subsidiaries of Western banks, for instance, typically apply the environmental and social policies of their parent companies, which are reported on a group-wide basis.[8] In some cases, policy statements may not be fully implemented. Moreover, the efforts of the three largest banks are not necessarily representative of a country's financial sector as a whole. Nevertheless, scrutiny of public reports can give a good indication of the importance of environmental and social policies.

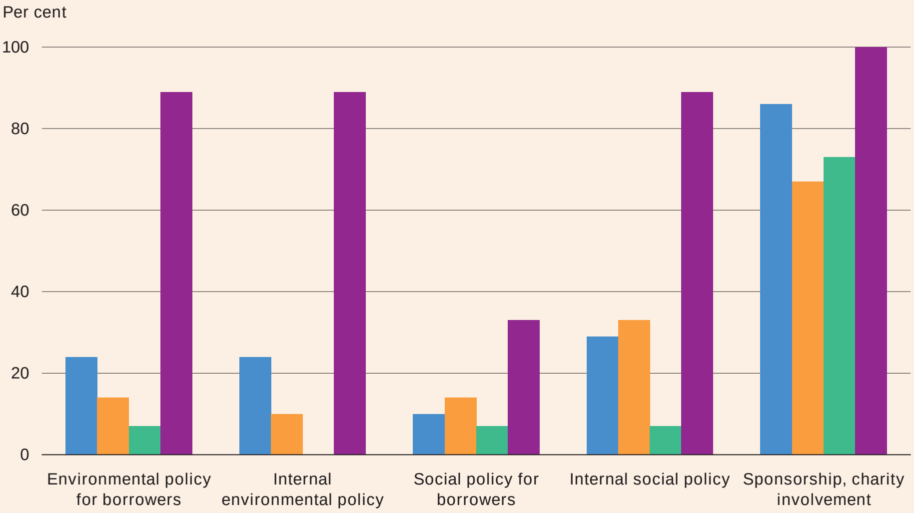
The results of the survey are shown in Chart A.3.1.1 along with the results from these benchmark countries (Greece, Portugal and Spain).

Banks in the transition region show a far lower level of environmental and social awareness than those in the benchmark countries. Only one-sixth of the banks surveyed took environmental factors into account in their lending decisions, and even fewer were concerned about social factors. Internal measures to improve the environment were also rare. Regarding internal social policies, only one in four banks in the transition countries reported programmes to improve working conditions and staff welfare. More positively, three out of four had a local community sponsorship or charity programme. It is the only area where the level of activity approaches that of the benchmark countries.

Chart A.3.1.1 shows banks in central eastern Europe and the Baltic states (CEB) out-performing their counterparts in south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) regarding environmental criteria.

Chart A.3.1.1

Sustainability reporting



Source: EBRD.

Note: Based on latest English annual reports published on the web sites of the largest banks (in terms of assets).
CEB: Czech Republic, Estonia, Hungary, Latvia, Poland, Slovak Republic and Slovenia.
SEE: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Montenegro, Romania and Serbia.
CIS: Georgia, Kazakhstan, Moldova, Russia and Ukraine.
Benchmark countries: Greece, Portugal and Spain.
For Ukraine and Georgia, one of the top three banks did not supply an online English Annual Report; the next largest bank was therefore included.

Social indicators are similar for SEE and CEB, with the CIS again recording a lower score. Sponsorship and philanthropy is the only area where CIS banks do not lag behind. This could be because company involvement in activities benefiting the community was already a well-established practice during the Soviet era.

Factors affecting sustainable banking

Both the depth of environmental and social reporting and the level of participation in international initiatives suggest that sustainable development is not a major issue for banks in transition countries. There are a number of factors that explain this low level of concern.

Perhaps the most important factor is inadequate labour and environmental, health and safety regulation. As long as standards are ineffective or not properly enforced, non-compliance by borrowers only poses a minor credit risk. Once non-compliance has financial implications for borrowers, banks will have a much stronger incentive to integrate environmental and social considerations into their risk management processes. In this respect, the eastern expansion of the European Union has helped to promote sustainable development in finance through the promotion of harmonised and comparatively stringent environmental regulations.

The risk of liability regarding soil and groundwater contamination has similarly played a role in advancing the business case for environmental risk management. How to address past environmental contamination was a key issue during the 1990s in many CEB and some SEE countries, although less so in the CIS. Banks began to realise the need for environmental due diligence to understand the clean-up responsibilities that their clients or they themselves might face – for example, when taking possession of a secured asset.

A second important factor is the low awareness of environmental and social issues in local communities and the media. The environmental and social performance of companies is scrutinised increasingly by non-governmental organisations and the public. Campaigners are also starting to trace the funds received by companies with a bad sustainability record back to their lenders. Pressure on banks to consider the environmental and social impact of their core business is consequently rising. However, this type of public scrutiny, primarily targeting international financial institutions (IFIs) and foreign-owned banks, is relatively new in the transition region and the risk to domestic banks is still comparatively low.

Similarly, the pressure on banks in the transition countries to disclose environmental and social information remains much lower than in western Europe. Foreign-owned banks in the region will probably rely on group-wide reports published by the foreign owner. However, what is often lacking in this case is a reference in the subsidiary's report to sustainability information provided by the group. Conversely, only a few international banks provide disaggregated data for their eastern European subsidiaries in their sustainability reports or supply information on how they ensure effective implementation of their policies in subsidiaries.

In addition to environmental law enforcement and public scrutiny, the desire to access funding from IFIs is one of the main incentives for adopting environmental and social risk management practices. For example, the EBRD and the IFC have extended finance to almost 80 per cent of the leading banks surveyed above and the two institutions have, between them, an equity stake in over 50 per cent of these. Their technical assistance programmes are helping to develop a deeper understanding of corporate responsibility, the effect of environmental regulations on financial services, and environmental and social risks in project financing. In parallel, initiatives such as the UNEP FI's Central and Eastern European Task Force are raising awareness at the level of senior management.

Modern environmental and social practices are being adopted at a slow rate, however. Typically they are introduced initially for products (such as credit lines) supported by an IFI. With adequate technical support, they may be extended subsequently to cover other lines of business and incorporated into the company's general business practices. Only a few banks in the transition region have so far reached this stage.

Conclusion

Environmental and social awareness has not yet become a significant feature of the financial sector in the transition region. Transition countries are clearly under-represented in international initiatives such as the Equator Principles, UNEP FI and the UN Global Compact. For all three initiatives, the number of participants is lower than the combined total for Portugal and Spain. Compliance with the Equator Principles is highest, helped by the fact that most transactions covered under this initiative are undertaken by institutions outside the region. A low level of environmental and social reporting by leading banks is also evident, particularly in the CIS.

However, increased environmental awareness, improvements in the application of environmental, health and safety standards and the continuing influence of IFIs should gradually encourage change. A small UNEP FI survey conducted in 2004 in 12 transition countries found that more than 75 per cent of the responding banks expected that sustainable development issues, particularly environmental risk management, would increase in importance in the financial sector in the coming years.[9]

Endnotes

1 See IFC (2006).

2 For more information, see www.equator-principles.com.

3 Source: Loanware.

4 See 2005 annual reports by BayernLB, BNPP and RZB Group.

5 For more information on the UNEP FI, see www.unepfi.org.

6 For more information, see www.unglobalcompact.org.

7 Information was gleaned from annual reports, sustainability or corporate responsibility reports (where available) and English-language web sites. This approach builds on a similar exercise by the Partners for Financial Stability Program sponsored by USAID and the East-West Management Institute. See PFS Program (2006).

8 For the purposes of this survey, a policy was acknowledged whenever global reports or policies were referenced on the local web pages or in the local annual reports.

9 See UNEP FI (2004).

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Banking in transition

4

The banking sector across the transition region has made remarkable progress since the early 1990s, with important changes in ownership structure and the institutional environment. The most significant progress has been in central eastern Europe and the Baltic states, where banks have reached an advanced level of development. In some countries in south-eastern Europe and the Commonwealth of Independent States, however, modern banking is still in its infancy.

Foreign banking groups have made significant inroads into the region, leading to unprecedented integration between the banking systems of mature (mainly western European) market economies and those in the transition region. In central eastern Europe and the Baltic states (CEB) and parts of south-eastern Europe (SEE), foreign banks dominate the market, and their local affiliates are the main source of external finance for many households and firms. The transition from centrally planned to market economies has also gradually, yet substantially, changed the working environment for banks. Most important in this respect is the improvement in the legal protection for banks, the enforcement of legislation through the courts and more effective supervision and regulation of the banking industry.

Changes in ownership structure and the institutional environment have influenced banks' activities, their performance and, in turn, their role in financing business activity. While it has been possible to track the growth of loans in transition countries, little is known about the composition of bank lending. Do foreign banks, for example, differ from domestic banks in the composition of their loan portfolio? Do they allocate a higher or lower proportion of their customer portfolio to small and medium-sized enterprises (SMEs) and to subsidiaries of foreign firms? Furthermore, has the banking sector increased the range of services that it provides to clients? And what is the effect of a changing legal environment on banks? Is a bank's loan portfolio influenced by the quality of creditor protection and does a better institutional environment prompt banks to diversify their activities?

The following analysis seeks to answer these questions, drawing on a new EBRD survey covering bank activities and the influence of the institutional environment. The Banking Environment and Performance Survey (BEPS) was conducted in 2005 with a random sample of 220 banks in 20 transition countries.[1] In each case the questionnaire was answered by a senior bank officer during an interview. The survey covered the banks' credit and deposit activities and other business activities. In addition, the bank officer was asked about risk management techniques, the security rights of lenders, bankruptcy law and the effectiveness of regulatory policy.

Chapter 4 at a glance

- The banking sector in most transition countries has become more efficient, more competitive and better regulated. The ratio of non-performing loans has declined substantially.
- The share of loans to households has increased sharply, particularly in central and south-eastern Europe. Much of this has been due to mortgage lending.
- The entry of foreign banks has had a positive influence on the efficiency and stability of the banking systems but their presence should not be seen as a way of avoiding institutional reforms.
- Institutional reforms have allowed banks to reduce costs, to broaden their customer base, especially to small businesses and retail clients, and to make more effective use of collateral. However, further reforms are needed.
- Smaller banks are more inclined than larger banks to provide loans to small businesses. Foreign banks have been particularly active in household lending but their focus is gradually shifting to the small business sector.

4.1 The legacy of central planning

Since the end of central planning, when the financial sector was almost entirely controlled by the state, transition banking has evolved in four stages.[2] The first involved the establishment of banks in the early 1990s. The second witnessed bank failures and systemic crises that affected almost all transition countries in the mid-1990s. The third stage involved lengthy restructuring through privatisation and the entry of foreign banks. By the end of the century, most banks were privately owned, and foreign banks dominated the sector in many transition countries.[3] In the fourth and current stage, banks in most transition countries have established sound balance sheets, and the industry has become well regulated and broadly competitive. By 2005 the foreign bank asset share was over 70 per cent in most CEB and SEE countries (with the exception of the Former Yugoslav Republic of Macedonia, Latvia, Serbia and Slovenia).

Changes have often been dramatic – for example, foreign ownership in Croatia and the Slovak Republic has risen from about 10 per cent of assets to more than 90 per cent since 1998. The bank ownership structure in the Commonwealth of Independent States (CIS) is rather different. While there is substantial foreign ownership in Armenia and the Kyrgyz Republic (although mainly from Russian banks), state ownership is still considerable in Azerbaijan, Belarus, Turkmenistan and Uzbekistan. Elsewhere in the CIS, domestic private banks prevail. In the larger economies of Kazakhstan and Russia, foreign ownership was about 10 per cent of assets in 2005 while in Ukraine it was about 20 per cent. In many CIS countries an uncertain economic environment and the threat of asset appropriation continue to pose significant risks to foreign banks.

Parent banks may influence the operations of their foreign subsidiaries in several ways. Many parent banks have, for example, introduced advanced risk management techniques, information technology systems, screening methods and monitoring systems in their subsidiaries.[4] Whereas many newly created foreign subsidiaries have been equipped with relatively sophisticated technology from the outset, subsidiaries resulting from take-overs have had to go through a restructuring process during which the new ownership has updated the technology. New technology has also gradually been adopted by domestically owned banks.

Parent banks have helped to set growth targets for their subsidiaries and have provided financial support where necessary.[5] Evidence suggests that the entry of foreign banks has had a positive influence on the efficiency and stability of the banking systems in transition.[6] Nevertheless, concerns have been raised in many countries about the potentially negative effect of large-scale foreign bank entry on the availability of bank loans to local SMEs.

4.2 Bank performance

Bank performance may be affected by changes in market power, ownership structure, technology or any combination of these factors. Banking in most transition countries is highly concentrated. In 2002-05 the five largest banks in all but three transition countries accounted for more than 50 per cent of total bank assets. The exceptions were Montenegro (at 45 per cent), Russia (44 per cent) and Ukraine (36 per cent) as of the end of 2005. In Belarus, Estonia, Lithuania, Turkmenistan and Uzbekistan, the ratio was over 80 per cent.

Bank profitability has been strong. Since the late 1990s, standard accounting measures – such as return on assets (ROA), the ratio of profit before tax to total assets, and the return on equity (ROE) – have allowed comparison across countries. Across the transition region, ROA and ROE have increased or remained at a relatively high level since the Russian financial crisis of 1998. They are well above the average level prevailing in three benchmark EU countries (Greece, Portugal and Spain – see Chart 4.1).

Banks operating in countries with lower income per capita enjoy higher ROA. In the CIS countries, for instance, ROA has been consistently higher than in other transition countries. This may reflect higher interest margins associated with unstable macroeconomic conditions as well as a larger proportion of profitable fee and commission income in banks' total income (see below). Nevertheless, in CEB, where inflation rates have fallen substantially, banks have still gradually increased their ROA.

Non-performing loans (NPL) were a hallmark of the early transition banking systems. However, as Chart 4.2 shows, the ratio of NPL to total loans has declined substantially in CEB and SEE. In CEB the ratio is approaching the eurozone average of 3.4 per cent. In SEE the decline has been particularly dramatic since 1999 but the ratio remains high (9.5 per cent in 2005). In the CIS non-performing loans still accounted for about 15 per cent of total loans in 2004.

Aggregate data on national banking systems mask differences in bank performance within each country. Some banks perform better than others due to the quality of the bank management, the size of the institution or its ownership structure. BEPS distinguishes between four bank ownership categories: private banks with majority domestic ownership, newly created foreign banks, privatised banks with majority foreign ownership and state-owned banks.

A detailed analysis shows that bank ownership does not have a strong influence on a bank's performance. Return on assets and net interest margins are, for instance, largely similar across the ownership categories. The exception to this finding is that newly created foreign banks have significantly lower cost-to-asset ratios than domestic private and other banks. This is probably because they have more efficient technologies and risk management techniques (leading to a more efficient labour force) and a less extensive branch network.

Bank size seems to have a more important effect on performance, as smaller banks have significantly higher net interest margins compared with larger banks.[7] Several factors may account for this. First, smaller banks mainly serve smaller companies. This is because they do not generally have the capacity to serve larger companies and, being based mainly outside the capital city, they are likely to have a comparative advantage from understanding the local business sector (see below). Also, SMEs have limited access to external finance compared with larger firms. With less competition in the SME lending sector, small banks may charge higher interest rates.

Secondly, higher margins may also reflect greater risk-taking by smaller banks. Indeed, smaller banks have a higher percentage of non-performing loans compared with larger banks. Equity and inter-bank deposits constitute the main source of funds for smaller banks. While the ratio of customer deposits to total assets is lower for smaller banks compared with larger banks, their share of inter-bank deposits as a percentage of total assets is greater. Smaller banks also have larger equity-to-asset ratios. With relatively expensive sources of funding, smaller banks may try to compensate when possible by taking more risk and charging higher interest rates. Lastly, smaller banks have a relatively high ratio of net commission income to total income compared with larger banks. This may partly account for their higher return on assets.

Besides bank ownership and size, the institutional environment is likely to play an important part in influencing a bank's

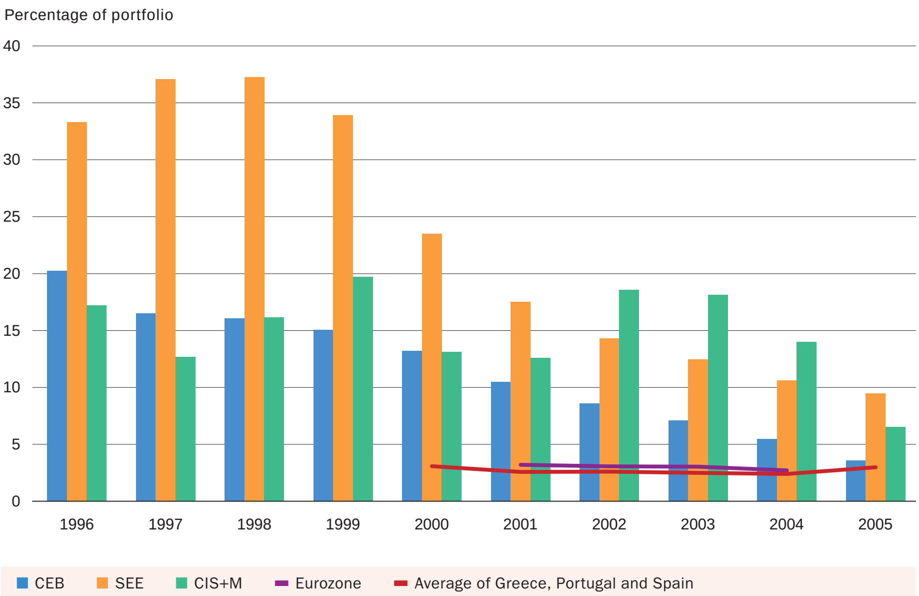
Chart 4.1

Banks' return on assets

Sources: EBRD and IMF.

Chart 4.2

Non-performing loans



Sources: EBRD and IMF.

performance.[8] Significant factors include the protection of banks through legislation and the court system, the regulatory framework and banking supervision. For example, an institutional framework that is effective in securing creditor rights can affect the asset composition of banks and the services that they offer. The institutional environment may also affect banking costs, particularly those associated with risk management and the evaluation of credit information. In addition, effective protection of creditor rights can strengthen competition among banks and increase access to finance.[9]

The BEPS provides measures of the quality of the institutional environment, as perceived by banks (see Annex 4.1). These measures are used in a regression analysis to explain bank performance. Bank size – in terms of scale of operations and market position – needs to be taken into account as one of the factors determining bank performance. Larger banks that dominate the local deposit market may use their market position to introduce higher interest margins (over their cheap deposits) while economies of scale may reduce their costs. The economic development of the country, measured as income per capita, also needs to be taken into account.

The analysis of the survey data reveals that the institutional environment has not significantly affected the profitability of banks, as measured by the return on assets. Banks operating in a poor institutional environment may in fact have higher returns that compensate for greater risk. However, the institutional environment has had a negative effect on banks' cost-to-asset ratios. Costs associated with risk management and the evaluation of credit information may be higher due to greater uncertainty and risk. Banks operating in lower-income countries have enjoyed higher returns on assets, as higher interest rates associated with unstable macroeconomic conditions have been an important source of profit for banks.

In summary, the performance of banks is influenced by ownership structure, bank size and the institutional environment. However, the institutional environment and ownership have only affected the cost efficiency of banks. In countries with a weak institutional framework, banks have incurred more costs when providing services to clients. Regarding ownership, the greater cost efficiency of newly created foreign banks has been connected with their higher level of skills and technology and a smaller branch network. Privatised and domestic banks have had to upgrade their technologies, resulting in higher costs.

Nevertheless, the superior cost performance of newly created foreign banks has not allowed them to attain a significantly higher profitability. This may be due to the lower interest margins for banks operating in more developed countries and/or because newly created foreign banks have a more conservative provisioning policy. Only bank size and the level of economic development of the country appear to affect the profitability of banks. Small banks have been able to generate higher net interest margins, probably because they focus on riskier and more profitable market segments.

4.3 Availability of finance

As discussed in Chapter 3, the level of finance provided by banks can be measured by the ratio of domestic credit to the private sector in relation to GDP. This has been rising slowly in most CEB countries but remains under 50 per cent across the region overall (which is low by international standards). The ratio for Portugal and Spain in 2005 was over 150 per cent and for Greece it was 86 per cent. More rapid development of the financial sector has occurred in some CEB countries, notably Estonia, Hungary and Latvia.

In the CIS countries the ratios average only 13 per cent. They are increasing, particularly in Russia and Kazakhstan, but even in Russia the ratio had only reached 25 per cent of GDP by 2005. The only SEE country with a wider availability of bank finance is Croatia, which has a ratio of 56 per cent. The average ratio in the rest of SEE in 2005 was around 18 per cent.

Much of the increase in lending by the financial sector that has taken place is in the form of household credit. The share of loans to households as opposed to enterprises has increased particularly sharply in CEB and SEE (see Chart 4.3). By 2005 it accounted for between 45 and 60 per cent of total credit to the private sector in these regions compared with 10 to 15 per cent in 1996. Moreover, in many countries much of this has been mortgage lending.

While financial deepening has been modest at the national level, certain types of banks may have expanded their lending more rapidly than others. Analysis of the BEPS data shows that the average loan growth in 2003–04 was strongest in newly created foreign banks, irrespective of their size. These banks appear to have the skills and financial resources to respond to customer demand more rapidly than other types of banks. Loan growth was weakest in state-owned banks.

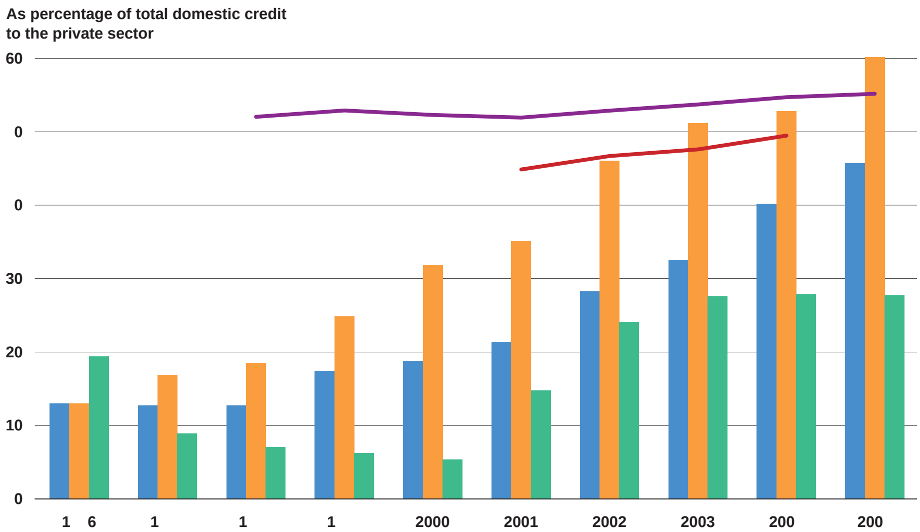
Although growth in bank lending is desirable in the transition process, there is a danger that it may lead to greater risk-taking by banks. It is necessary to ask, therefore, whether banks that grow faster employ better risk management techniques and practices and whether the quality of their portfolio is better or worse than other banks. To this end, the ratio of loan loss provisions to net interest revenue has been used as a measure of loan quality since it captures the ability of the bank to recover its loan loss provisions from net interest revenue. A higher ratio generally indicates a lower loan quality, assuming that all banks provision properly.

Chart 4.4 shows that in 2004 smaller banks have on average a worse loan quality than larger banks while foreign banks tend to have better loan quality than other types of banks. The same is observed from analysing the ratio of non-performing loans to total loans. Although newly created foreign banks have been growing relatively fast, they have been able to do so without a deterioration in their asset quality.

The BEPS indicates that larger banks and newly created foreign banks tend to have more experience in risk management

Chart 4.3

Share of household credit



CEB SEE CIS+M Eurozone Average of Greece, Portugal and Spain

Sources: EBRD and ECB.

Note: Eurozone data are calculated as a ratio of household loans to the sum of loans to households and non-financial corporations.

practices, as measured by the number of years that a separate risk management department and an internal rating-based approach for credit risk have been in place. This suggests that there is scope for smaller, domestic banks to strengthen their risk management practices since they are the banks with the worst loan quality.

Loan growth has differed significantly between countries at different levels of development. It has been highest in the countries with least economic development but this growth is associated with high rates of inflation in many of these countries. Also, loan growth in less developed countries is from a very low base and may merely be a sign that they are beginning to catch up with more developed countries. The institutional environment, as perceived by banks, does not seem to have played a significant role in average real loan growth in 2003–04.

4.4 Composition of bank lending

The size and ownership of a bank are likely to affect not only the growth of its portfolio but also its loan composition. The banking environment may also have an impact. The BEPS is the first source of detailed data on both bank-client relationships and the composition of loan portfolios in transition countries. It identifies the types of banks that are lending to particular groups of customers and their reasons for lending.

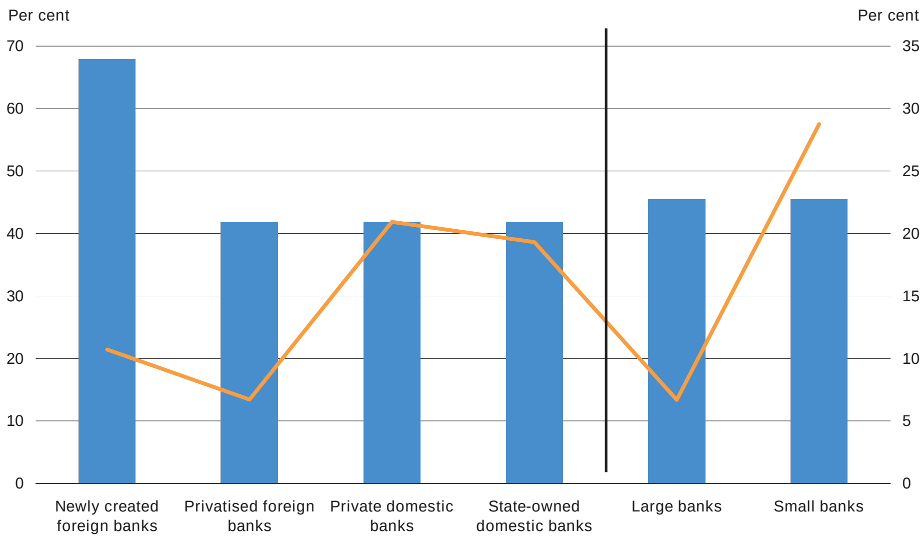
Bank size and ownership

The ownership structure and size of a bank partly determine its ability and willingness to lend to particular types of customers. Foreign banks with a limited knowledge of local markets may prefer to limit credit to companies that they consider to be the most transparent and least risky (such as large and foreign-owned firms). Domestic banks, on the other hand, can base their credit decisions on a deeper knowledge of the local business environment using information that is not readily available on local and smaller firms. Nevertheless, such differences may have receded over the years as many foreign banks have acquired domestic banks.

The size of a bank may also influence its customer profile. Larger banks may prefer to lend to larger clients in order to exploit economies of scale in evaluating the "hard" information that tends to be available on such customers. On the other hand,

Chart 4.4

Loan growth and loan quality



Sources: BEPS and Bankscope.

Note: The loan growth data reported are the fitted values from a two-stage regression analysis. The average real loan growth for 2003–04 was regressed on bank ownership dummies, bank size measured by the logarithm of bank assets, the perceived quality of the institutional environment index, the level of country development measured by the GDP per capita ratio and country dummies. Majority private-owned domestic banks were used as the control group for bank ownership. In the first stage, the perceived quality of the institutional environment index was explained (instrumented) by country-level institutional indicators, such as the EBRD legal indicator on the enforcement of charged assets, or the World Bank's Doing Business indicator on "depth of credit information". See De Haas *et al.* (2006) for more details.

because of size limitations, smaller banks may not be able to lend to larger companies and may instead have a comparative advantage in serving SMEs.

Table 4.1 illustrates the relationship between bank type and portfolio composition in 2004. Foreign banks were more actively involved than domestic banks in lending to households (comprising on average 30 and 18 per cent respectively of the loan portfolio). SMEs were the most important customer category for almost all types of banks, as indicated by the share of SME lending in their loan portfolio. Dealings between private banks and state-owned enterprises were very limited (only 3 per cent on average) while state-owned banks allocated a considerable share of their loan portfolios to state-owned enterprises (14 per cent) and other state agencies (27 per cent).

Large banks lent more to large companies, state-owned enterprises and governments and devoted markedly less to small businesses and household lending not involving mortgages. Small banks lent on average 57 per cent of their portfolio to SMEs whereas the largest banks allocated only 28 per cent. Differences between regions were also quite substantial. In CEB, mortgage financing constituted 51 per cent of all lending to households compared with 26 and 17 per cent in SEE and the CIS respectively.

Further analysis has been undertaken to explore the association between loan portfolio composition and bank types in more depth (see Table 4.2).[10] This confirms that household lending forms a much higher share of the loan portfolio for foreign banks than it does for domestic banks. Large banks tend to finance fewer SMEs as a proportion of their loan portfolio while loans to state-owned enterprises are provided by government-owned banks more than private banks.

The BEPS shows that both foreign and domestic banks denominated about 37 per cent of all household lending in foreign currencies. Foreign-currency household lending was more prevalent in the CIS (45 per cent) than in SEE (37 per cent) and CEB (30 per cent). Foreign banks in general tended to denominate a larger proportion (48 per cent) of such lending in foreign currencies than domestic banks (38 per cent). The share of foreign-currency denominated corporate lending was similar across all three regions (at about 43 per cent).

Foreign currency lending is increasing because borrowers are attracted by the lower interest rates on these loans and by the expectation that local currencies may appreciate. At the same time, banks lend in foreign currency because they would like to avoid foreign currency risk and are constrained by the currency mismatches

Table 4.1

Composition of the loan portfolio by bank type

(in per cent of total lending)

	Newly created foreign banks	Privatised foreign banks	Private domestic banks	State-owned domestic banks	Small banks	Large banks	CEB	SEE	CIS+M
Mortgages	12.1	11.7	5.8	1.6	7.7	14.7	17.5	6.8	2.5
Other consumer lending	18.3	18.1	14.0	16.4	15.4	15.4	16.5	19.1	12.0
SMEs	41.1	27.0	47.0	31.3	56.9	28.4	31.7	45.3	46.6
Large enterprises	15.0	23.7	27.4	9.0	12.5	26.3	13.4	16.9	28.8
State-owned enterprises	3.6	3.8	2.4	14.2	4.3	3.4	3.9	3.8	3.6
Other	9.9	15.6	3.5	27.4	3.2	11.8	17.0	8.1	6.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: BEPS and Bankscope.

Note: A bank is classified as "small" when its total assets are less than US$ 200 million; "medium" signifies assets of US$ 200 million to US$ 1 billion. "Large" indicates above US$1 billion. This classification follows Haselmann and Wachtel (2006a).

Table 4.2

Factors that affect loan portfolio composition

	All household lending	Mortgage lending	SMEs	Large enterprises	Foreign subsidiaries	State-owned enterprises
Newly created foreign banks	+**	+*	+	-**	-	-
Privatised foreign banks	+**	+	-	-	+	+
State-owned banks	-	+	-	-**	+	+**
Bank size	-	+	-**	+	+	+
GDP per capita	+	+*	+	-	-**	+*
(I) Perceived institutional quality	+**	-	+**	-**	-**	-
(II) Perceived legal quality	+*	+**	-**	-**	-**	+
(III) Perceived quality of banking regulation	+	+	+**	-**	-**	-*

Sources: BEPS and Bankscope.

Note: The table details the final results of a two-stage regression analysis. In the first stage, each of the three indicators measuring a bank's perception about the quality of its institutional environment (measures I, II, and III) were explained (instrumented) by country-level institutional indicators, such as the EBRD legal indicator on the enforcement of charged assets or the World Bank Doing Business indicator on "depth of credit information". Majority private-owned domestic banks were used as the control group. Bank size is measured by bank assets. For each dependent variable (proportion of a particular customer type in total bank lending) three regressions were run, including institutional measures I, II or III. + or - indicates a positive or negative effect. * and ** denote a 10 per cent and 5 per cent significance level, respectively. Institutional measures are explained in Annex 4.1.

in their balance sheet. To the extent that corporate borrowers and households earn their income in local currencies, foreign currency lending may lead to significant currency mismatches in these areas of the private sector.

Even if banks adequately match the currency exposures on their own balance sheets, they are still exposed to credit risks associated with unhedged customers who may not be able to service their foreign currency debt in the event of unfavourable exchange rate movements. Such indirect risks appear to vary between regions. In CEB 45 per cent of all foreign currency lending went to corporate customers with some hedging against currency risk – for example, to companies with revenue in foreign currency or to enterprises (such as hotels and other forms of tourism) that link their prices to the foreign exchange value of the local currency. In contrast, the percentage of hedged corporate customers in both SEE and CIS was much lower at 28 per cent.

The banking environment

Table 4.2 shows how bank lending is influenced by the institutional environment, as perceived by banks. A better institutional environment generally encourages banks to move from lending to large enterprises and subsidiaries of foreign companies to lending to SMEs and households. The relative importance of credit to foreign subsidiaries further declines as income per capita increases. In richer and institutionally more developed countries, banks no longer target only large and foreign companies but are able to shift their activities partly towards SMEs and households.

Table 4.2 shows that improvements in the quality of the legal system and in banking regulation lead to a smaller share of credit being allocated to large and foreign firms. When pledge and mortgage law improve and courts become more effective, households receive a larger proportion of all bank loans. Because mortgage lending is intrinsically related to the use of collateral, an adequate legal framework is a necessary pre-condition for banks to shift towards this type of business. A better institutional environment may not be as necessary for developing consumer credit when starting from a low base. On average, households received 33 per cent of bank lending in CEB, 26 per cent in SEE and only 15 per cent in the CIS.

In contrast, improved bank regulation increases the proportion of bank lending to SMEs. In summary, the BEPS data

Table 4.3

Proportion of banks reporting an increase in lending share

(in per cent)

	Newly created foreign banks	Privatised foreign banks	Private domestic banks	State-owned domestic banks	Small banks	Large banks	CEB	SEE	CIS+M
Households	76.4	95.0	77.6	100.0	80.0	85.1	69.1	89.6	82.5
SMEs	77.1	66.7	92.3	57.1	85.0	82.6	63.6	81.1	91.9
Large enterprises	50.0	66.7	47.4	100.0	62.9	47.6	45.0	71.1	35.1
State-owned enterprises	38.1	46.2	26.5	25.0	24.1	45.5	20.0	45.2	33.3
Other	84.6	71.4	67.6	85.7	76.0	77.1	82.2	81.1	70.0

Sources: BEPS and Bankscope.

Note: See note to Table 4.1.

indicate that an improved institutional environment tends to allow domestic and foreign banks to focus less on large and foreign-owned corporations and to start lending more to households and SMEs.

Changes in lending patterns

The BEPS asked banks to what extent they had altered the share of lending to each customer category from 2001 to 2004. More than three-quarters of banks increased household lending over this period (see Table 4.3). Most banks – in particular, domestic private banks and newly created foreign banks – also increased lending to SMEs. Although foreign banks lent less to SMEs during the earlier transition years, this difference seems to have disappeared over time.

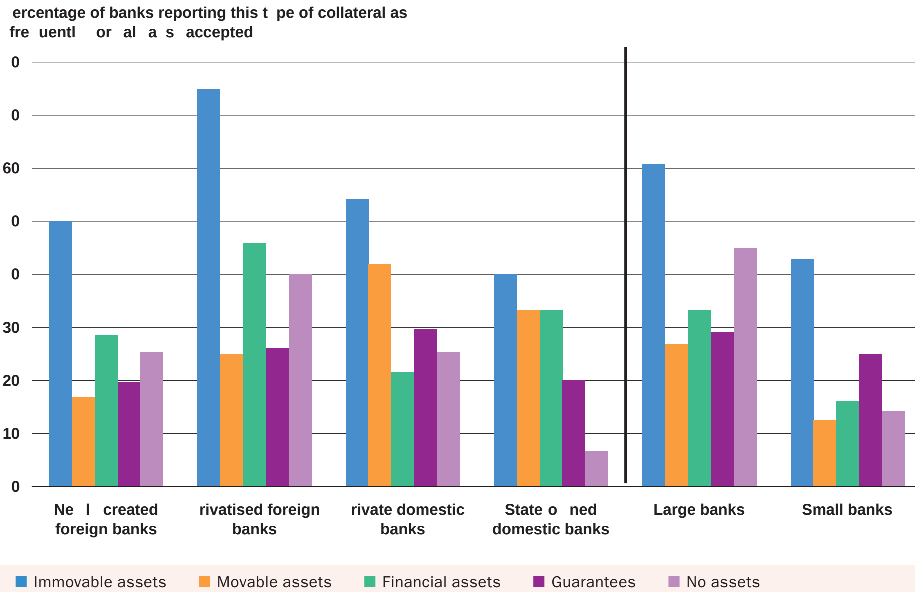
The BEPS indicates a declining focus on large enterprises. Most private domestic banks and newly created foreign banks have either maintained or decreased the proportion of their lending to large corporate customers. Partly due to the increasing attractiveness of lending to households and SMEs, this development also reflects greater competition – and therefore lower interest rate margins – in lending to large, foreign-owned firms. Moreover, many large domestic and foreign firms have gradually gained access to alternative credit sources. For foreign firms, these include finance from banks in their own country, international financial markets and funding from the parent company.

4.5 Collateral use and constraints to bank lending

The BEPS provides information on the extent of collateral use by lenders, the reasons why banks reject loan applications, and the factors that constrain bank lending. This information contributes to a more complete understanding of how banks respond to the growing demand for bank loans.

Chart 4.5

Collateral accepted by banks



Sources: BEPS and Bankscope.

Note: See note to Table 4.1.

Collateral use

Chart 4.5 summarises the use of collateral by type of bank ownership in 2004. In all instances the use of collateral increased between 2001 and 2004. However, privatised foreign banks used financial assets more frequently than other banks to secure a loan. This may be simply because this type of bank has a substantial number of foreign clients that are able to supply such collateral.

The analysis shows that collateral in the form of land and buildings (immovables), vehicles, business equipment and inventory (movables) and guarantees tends to be used mostly by larger banks to secure a loan. Banks operating in lower-income countries use movables and financial assets more frequently as collateral than banks in more developed countries. How banks perceive the institutional environment also has a significant influence on the ability and willingness of banks to accept collateral for securing a loan.[11]

A better institutional environment encourages banks to use a wider range of collateral to secure a loan due to the existence, for example, of property and land registries and reliable financial statements. The existence of this institutional framework and the quality of court procedures make it easier for banks to recover collateral in the event of default.

Rejecting loan applications

All types of banks reported that the main reason for rejecting a loan application was lack of cash flow or profitability of the borrower. Lack of acceptable collateral and an inadequate credit history were the second and third most important reasons given. More detailed analysis shows that foreign privatised banks reject fewer loans than other banks on the grounds of a borrower's lack of collateral, cash flow or inadequate credit history. Large banks tend to reject more applications than smaller banks for lack of cash flow and for credit history reasons. This is because large banks operate more standardised loan approval processes whereas smaller banks rely more on the analysis of less readily available information.

Banks operating in a relatively good institutional environment, with better creditor protection rights, are more likely to reject a loan application on collateral grounds. In a poor environment, a borrower's collateral will be unreliable anyway and so less important. Lack of an adequate credit history is a more frequent reason for rejecting a loan for a bank operating in a less developed country. This may be related to the lack of a credit registry in such countries or the lack of actual credit history for many firms.

The institutional environment, as viewed by banks, determines to a great extent their response to the demand for loans. It influences the range of collateral accepted by banks to secure a loan and consequently affects the number of loan applications that they reject. Larger banks demand collateral for making loans more frequently than smaller banks, which have adapted to institutional constraints while lending to smaller firms. Smaller banks also reject fewer loan applications for cash flow or credit history reasons, enabling them to expand their loan portfolios relatively fast.

Constraints to making loans

BEPS respondents were asked to rate the major constraints on their ability to make loans. These included a lack of creditworthy customers, low interest rate margins, bank officers not having the necessary skills to evaluate loans, insufficient information to evaluate loan risks, a lack of bank liquidity and a lack of bank equity.

The survey results were used to explore the relationship between banks' perceived constraints to making loans and their perception of the institutional environment. It transpired that there were no significant differences among different types of banks regarding the major constraints to making loans. However, the way that banks judge the quality of their institutional environment significantly affects which type of lending constraint they perceive as most binding.

Banks operating in a poor institutional environment as well as larger banks saw the lack of creditworthy borrowers as a major constraint. This indicates that larger banks in particular tend to be more cautious about lending in an environment where creditor protection rights are not secured. In better institutional environments, banks viewed low interest margins as a bigger constraint to making loans. Moreover, where competition has driven down interest margins, smaller banks tend to find it more difficult to make loans. Due in part to their funding structure (mainly equity and inter-bank loans), smaller banks also find lack of liquidity to be a significant constraint. Privatised foreign banks and state-owned banks saw lack of bank equity as a less significant constraint than other types of banks.

4.6 Diversification of bank activities

Although deposit taking and lending are their principal activities, many banks in the transition countries have also started to provide other services. Some fee and income-generating activities, such as payment and settlement, are directly related to more traditional banking tasks. Others, such as corporate finance, asset management and the trading and sales of securities, constitute new ventures.

Table 4.4 shows that banks operating in transition countries have, on average, only slightly lower ratios of net commission income to total income compared with banks operating in the eurozone countries (where the ratio was 33.2 per cent in 2004). Smaller banks and state-owned banks had a relatively high ratio of net commission income compared with other banks. Banks in SEE and the CIS also have a larger ratio of net commission

Table 4.4

Fee and commission income from financial services

(as a percentage of income)

	Newly created foreign banks	Privatised foreign banks	Private domestic banks	State-owned domestic banks	Small banks	Large banks	CEB	SEE	CIS
Corporate finance	12.4	9.9	13.9	13.8	21.6	7.8	6.4	22.6	8.2
Retail brokerage	0.6	1.7	1.6	0.3	1.1	1.4	0.7	0.9	1.7
Asset management	3.6	2.2	2.8	0.9	2.9	2.9	4.8	0.5	3.5
Trading and sales	7.1	7.0	10.1	15.2	8.7	8.6	9.0	5.2	13.2
Retail banking	24.0	34.1	19.6	10.9	22.5	29.2	29.6	21.2	15.8
Commercial banking	23.6	18.4	20.2	26.3	19.5	20.1	18.1	19.6	27.4
Payment and settlement	26.5	24.6	28.8	32.3	21.6	27.8	29.2	28.7	26.3
Agency services and custody	2.5	1.8	2.8	0.3	2.1	1.8	2.0	1.4	3.5
Net commission income to net interest revenue	48.6	53.9	51.1	54.1	60.4	41.4	42.7	50.4	55.3
Net commission income to total revenue	24.8	26.8	25.2	30.1	30.1	24.3	22.7	27.1	27.2

Sources: BEPS and Bankscope.

Note: See note to Table 4.1.

income to total income compared with banks in CEB. In more developed countries, banks tend to lend more, as reflected by bank loan to assets ratio.

Banks' fee and commission income still derives to a large extent from traditional retail and commercial banking and from payment and settlement. More than 80 per cent of all banks reported that they earned some fee and commission income through these activities. The number of banks receiving income from retail brokerage, asset management and custody services was considerably lower. The most important activities comprised payment and settlement (28 per cent) and services directly related to commercial banking (22 per cent) and retail banking (22 per cent). A much lower proportion of all fee and commission income was earned through asset management (3 per cent), agency services and custody (2 per cent) and retail brokerage (1 per cent).

Further analysis of the data shows that the composition of banks' fee and commission activities were affected by the institutional environment. In a better environment, the proportion of fee and commission income increased in relation to retail banking and to payment and settlements but decreased in relation to commercial banking, reflecting a shift away from serving large and foreign companies.

4.7 Conclusion

Banks in the transition countries have significantly improved their performance, particularly since the Russian financial crisis of 1998. Foreign ownership continues to be associated with greater cost efficiency. Banks have also diversified their activities so that a significant part of their income now comes from fees and commissions. However, the improvements in performance stand in contrast with the relatively low levels of finance provided by banks despite recent rapid credit growth. Credit-to-asset ratios are still well below levels in comparable non-transition countries (as discussed in Chapter 3).

The BEPS results show that loan growth was fastest among newly created foreign banks. Much of the loan growth by foreign banks was in the form of greater household lending. Loan growth in smaller banks, although similar to the growth of larger banks, has led to some deterioration in the quality of their loan portfolios. It is smaller, domestic banks, therefore, that need to strengthen their risk management practices. Small banks also tend to allocate a substantially higher share of lending to SMEs. More generally, banks have reduced their emphasis on serving large and/or foreign-owned enterprises and have started to lend more to retail clients.

The quality of the institutional environment, as perceived by banks, also affects bank behaviour. Although it does not affect performance measures, such as net interest margins or return on assets, the legal environment does have an impact on bank costs. A weak environment leads to higher costs – especially costs associated with evaluation of credit information and risk management – which tend to inhibit credit expansion. More importantly, a better environment is associated with relatively more lending to households and SMEs. When the institutional framework improves, banks are no longer confined to lending to large, mainly foreign companies and can diversify their customer base. For example, foreign banks have shifted their focus away from large and foreign-owned firms and lend increasingly to SMEs.

In a better institutional environment with protection from the legal system, banks can focus more on SMEs and retail customers. For example, once a legal framework for mortgage lending is in place, collateralised mortgage loans become more attractive to banks. A better institutional environment also broadens the range of collateral that can be accepted by banks.

Banks in transition countries are gradually reaching the levels of their counterparts elsewhere and this process is expected to continue in the future. They are increasing their lending to households and SMEs although larger banks are still more likely to lend to large firms. However, there is considerable scope for further growth in lending.

The survey analysis suggests that there are existing barriers to growth. The institutional environment plays a big part in determining lending decisions. The quality of banking regulation and creditor protection remains a major constraint to the expansion of bank activities. Since banks' views of their institutional environment affect their choices, this framework needs to be improved. Properly managed institutional change can have a significant impact on banking evolution.

Endnotes

1 The sample does not include banks in Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan.

2 For more detail, see Bonin and Wachtel (2005).

3 See Berglöf and Bolton (2002).

4 See De Haas and Naaborg (2006).

5 Ibid.

6 Bonin *et al.* (2005) and Fries and Taci (2005) find that foreign-owned banks tend to be more cost-efficient than domestic banks. Fries *et al.* (2006) show that foreign-owned banks maintained their lower marginal costs whereas state banks persistently underperformed in controlling costs. See also Box 2.1 in Chapter 2 of this *Transition Report* on the macroeconomic implications of foreign bank entry.

7 Bank size is measured by the logarithm of a bank's assets. Although newly created foreign banks and domestic private banks tend to be smaller in size, there is no strong correlation between bank size and its ownership.

8 See La Porta *et al.* (1997).

9 See Hainz (2003).

10 More details are provided in De Haas *et al.* (2006). For a similar analysis, see Haselmann and Wachtel (2006a).

11 Larger banks are more willing to take both movable and immovable assets as collateral. The type of bank ownership is not particularly important, except that state-owned banks are less willing to accept immovable assets than other banks, which probably reflects the fact that they have not entered the mortgage business. Importantly, objective measures of the quality of the legal environment and the bankers' own perceptions of collateral law have statistically significant effects on the probability of accepting collateral. See also Haselmann and Wachtel (2006b).

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Annex 4.1: The Banking Environment and Performance Survey

Respondents to the Banking Environment and Performance Survey were asked about their view of the legal environment. Answers to questions on the protection of creditor rights and bank regulation were graded on a six-point scale (with a higher number reflecting a more positive view). Three indices were subsequently created.

The perceived legal system quality index is an average of three indices, which measure banks' views of pledge laws, mortgage laws and the quality of the court system. For pledge laws and mortgage laws, respondents were asked to rate from 1 (strongly disagree) to 6 (strongly agree) whether these laws:

- provide adequate scope for security
- enable efficient creation and perfection of security rights
- enable efficient enforcement of security rights
- adequately protect secured creditor rights.

The index for the assessment of the court system measures banks' views of the courts' ability to resolve business disputes. Bankers were asked how often from 1 (seldom) to 6 (always) they associate the court system with being:

- fair and impartial
- honest and uncorrupted
- quick and efficient
- affordable
- able to enforce its decisions.

The perceived banking regulation quality index is an average of indices on the views of regulation laws and banking regulators. For the laws index, respondents were asked:

- whether information on the banking laws and regulations were easy to obtain in 2001-04
- if interpretations of the laws and regulations were consistent and predictable.

For the regulators index, respondents were asked whether the banking regulator is:

- fair and impartial
- honest and uncorrupted
- quick and efficient
- able to enforce its decisions.

Finally, an overall perceived institutional environment quality index was created as an average of the two main indices. Responses, broken down by ownership, size and region, are given in Chart A.4.1.1.

Chart A.4.1.1

Banks' perception of the quality of their institutional environment

Sources: BEPS and Bankscope.

Note: The index ranges from one to six where one indicates a poor perception of the institutional environment and six indicates a very good perception.

Chart A.4.1.1 shows that bank managers across different countries have different perceptions of the quality of their legal and regulatory environment, with bankers in central eastern Europe and the Baltic states (CEB) having the most positive views on average. However, there are also substantial differences between countries within a region. For example, while indices of the overall perception of the quality of the institutional environment in Russia and Ukraine are the lowest among all transition countries, the perceptions of the quality of the banking environment in Belarus, Kazakhstan and Moldova are comparable with some countries in CEB.

Similarly, banks' perceptions about the quality of the legal and regulatory environment in Bulgaria, FYR Macedonia and Romania are similar to those in CEB countries, such as the Czech Republic, Poland and Slovenia. This indicates that a country's level of development and banks' average perception of the quality of the institutional environment in that country are not necessarily closely related.

The perception of the quality of banking regulation varies less across countries. Banking regulation is perceived as at least "frequently" fair and efficient in all countries. However, laws and the court system tend to be seen as weaker throughout the Commonwealth of Independent States (CIS) and south-eastern Europe (SEE). In CEB the legal environment is rated as weak among bankers in the Czech Republic, Lithuania, Poland and Slovenia.

Banks' perception of the quality of the legal system is strongest in CEB across all bank ownership types. However, CEB managers in privatised foreign banks have a relatively low opinion of the legal system. In the CIS, domestic banks tend to be more positive about the legal environment than either the newly created or privatised foreign banks. In contrast, in SEE privatised foreign banks evaluate the legal environment more positively than other types of banks. While state-owned domestic banks in CEB have a positive view of the legal environment, in SEE these banks have the worst view of the legal system.

Private equity

5

Although banks continue to dominate the financial sectors of the transition countries, there has been growth in other types of financial services. The size of public equity markets has expanded substantially across the transition region. There has also been an increase – although from a very low base – in other forms of financing, including investing in private companies through equity funds. The following analysis focuses on the role that private equity funds have played as part of the diversification of finance in the transition region.

Private equity has been crucial in stimulating growth in the advanced market economies of North America and western Europe. For example, venture capital investments have helped to finance the development of innovation and high-tech projects. These transactions tend to be very risky in the early stages and require large injections of cash from sophisticated investors that are able to assess the potential of an investment. Venture capital funds have proven useful in this respect. In addition to investment, they have provided expertise to help entrepreneurs turn their innovative ideas into well-managed operations. It is widely accepted, for example, that venture capital financing played a big part in the technological boom of the United States.

Another form of private equity – buy-out funds – has helped to turn around large companies that have been under-performing. These funds specialise in acquiring and restructuring companies. This might entail the sale of some of the company's assets or a change in its corporate governance or pay structure. Once the company has improved its performance, buy-out funds tend to sell the company and reap the rewards.

Private equity has the potential to be particularly important in the transition countries for two reasons. First, it provides companies with an additional source of financing. As indicated in earlier chapters, the banking sector in transition countries may often be underdeveloped and stock markets may be relatively small and lacking liquidity. Firms may consequently have difficulty in raising sufficient finance from these sources. Lack of personal wealth can also hinder access to finance, as borrowers may be unable to provide the collateral required by banks. Secondly, private equity substantially supports the development of know-how and expertise. The experience provided by private equity funds can prove crucial to the development and success of the companies that they support (see Box 5.1).

To stimulate growth in the transition countries, several international institutions, including the EBRD, the International Finance Corporation (IFC) and the European Investment Bank (EIB), have invested in private equity funds operating in the transition region. This chapter assesses the role and performance of private equity

Chapter 5 at a glance

- Private equity in transition countries is gradually becoming an established element of enterprise financing, in line with more advanced market economies. However, legal and regulatory barriers still need to be overcome.
- Returns on investment are comparable to those in western Europe. Larger equity funds tend to perform better than smaller funds.
- Private equity funds play an important role in restructuring companies and promoting entrepreneurial skills.
- Most funding for private equity in the transition countries has been provided by foreign institutions. Domestic sources of finance are still very limited.
- Further improvements in the business environment and the development of the banking sector and public equity markets will help to support the expansion of private equity.

in the transition countries. Private equity investment in central eastern Europe and the Baltic states (CEB) has been available for nearly 15 years. During that time, a number of constraints and several financial crises have impaired the performance of private equity funds (see Box 5.2). These have hampered the growth of the sector and have led to some disappointing results, particularly in the early years of transition.[1] However, 2004 and 2005 were very successful years that saw the completion of several projects, improving the general performance of these funds.

The following analysis examines how equity funds have been performing and what criteria have been used in selecting projects for investment. The types of projects that have been particularly suitable for financing in these economies are identified and the impact of private equity expertise on a company's fortunes is assessed.

5.1 Evolution of private equity

Private equity in the transition countries started in 1990 with funds supported by government agencies, such as the early Enterprise Funds supported by the US government. This was followed by private equity investments by major international financial institutions, such as the EBRD, IFC and the EIB. The inflow of funds supported by government agencies peaked in 1995 and 1996 with the development of several Regional Venture Funds (RVFs) in Russia and Post Privatisation Funds (PPFs) in central Europe. Donor-supported funding subsequently declined and by 2006 had nearly disappeared.

Chart 5.1 shows that commercial funds began to flow into the transition region around 1992 and reached a first peak in 1998. The flow declined thereafter, in the wake of the Russian financial crisis of 1998 and the general decline of stock markets in 2001. However, there was an upsurge from 2004, which has continued into 2005 and 2006. In 2005 finance committed to new private equity funds in the transition countries exceeded US$1.6 billion.[2]

The accession of CEB countries to the European Union in May 2004 has contributed to the development of private equity in these countries. Harmonisation of legal and regulatory policies and deeper integration with established EU markets has led many international investors to view the new EU member states as less risky investment opportunities. A number of profitable exits from private companies have boosted investor confidence. The private equity market has also been growing in Russia, where many foreign investors have been attracted by macroeconomic stability, strong growth and booming consumption. There are also signs that domestic investors are increasingly interested in channelling their funds into private equity.

5.2 Fund performance

The following analysis is based on data from 44 equity funds in which the EBRD invested between 1992 and 2005.[3] In the early 1990s equity funds supported by the EBRD were practically the only funds investing in the region. Other funds, without EBRD backing, have since started operating but often have too short a history to be included in this performance analysis. The total volume of capital committed to the 44 funds analysed in this chapter has amounted to around US$4.6 billion. Operating in CEB, the Commonwealth of Independent States (CIS) and south-eastern Europe (SEE), the funds have made around 450 investments worth almost US$2.7 billion.

Fund performance is measured by examining the cash flows between a fund and a limited partner and calculating the internal rate of return (IRR) of these cash flows. The IRR is defined as the discount rate that would make the present value of all cash flows equal to zero. The IRR takes into account the timing of the various cash flows. It represents the return to an investor from investing in a private equity fund, net of fees.

Aggregate results are presented using both value-weighted IRR and pooled IRR based on US$ cash flows. Value-weighted IRR is a weighted average of the IRRs of individual funds, where the weights are given by the amount of money invested in the fund (company). Pooled IRR, used as an industry standard by private equity professionals, is based on the sum of cash flows from all relevant transactions. It is calculated on the basis of an aggregate cash flow that would be received by a hypothetical fund that holds all relevant companies or funds.

While pooled IRR is generally used in the private equity industry to measure returns, value-weighted IRR is more standard in research and policy analysis. Pooled IRR can produce substantially different results from value-weighted IRR. For example, if a US$1 investment in one company resulted in a complete write-off (IRR of -100 per cent) and a US$1 investment in another company resulted in a pay-off of US$5 four years after the original investment (IRR of 50 per cent), the value-weighted IRR would be equal to -25 per cent while the pooled IRR, representing aggregate cash flows from both investments, would be 26 per cent.

The funds in the sample are at different stages of their lives and most have not yet returned all cash to investors. If a fund has not been fully liquidated, some of the money is still invested in projects. For those projects, the final cash flow is not an actual cash flow but simply an estimate of the value of the assets that the fund still owns, and against which investors have a claim. This is termed the net asset value (NAV). This estimate is made by the fund managers and can therefore reflect their bias. In the following analysis, the IRRs are presented with NAV and without (cash only). Returns in cash only will be artificially lower since they ignore any future cash flows that the fund may be able to return to investors. Nevertheless, this measure is used as a way of checking the robustness of the results against any bias originating from the fund managers' estimates.

Table 5.1 presents the returns of EBRD funds using different methodologies. As expected, returns based on cash flows and NAV are higher than returns based on cash flows only. Furthermore, returns of funds that have been operating for longer than five years are generally higher than the returns of the entire sample. This is mainly because older funds had more time to exit their investments and return money to limited partners. Although the results in Table 5.1 seem lower than some of the data reported for private equity funds in the United States, they compare favourably with the 10.3 per cent pooled IRR reported by the European Private Equity and Venture Capital Association for net returns to investors on all European private equity funds formed between 1980 and 2005.

Chart 5.2 shows the time profile of returns, illustrated by the length of time taken for the cash flows generated by private equity funds to turn positive. It shows that, in the 1990s in particular, it took longer to exit in transition countries than in the United States, where private equity funds exit on average after seven years, or in Europe, where the exit takes place after 7.5 years.[4] However, there has been an improvement in recent years and the time to return cash to investors appears to have shortened.

There are several reasons why the early funds took longer to return cash to investors. Initially, the supply of attractive projects was limited. As a result, early funds took longer than more recently established funds to invest in their portfolio companies.[5] There have also been economic crises (such as in Russia in 1998) that have impeded the progress of investments and there have been persistent difficulties in exiting investments. In turn, this has extended the time between investment and exit and consequently reduced returns.

Box 5.1

How does private equity work?

What do private equity funds do?

The purpose of private equity financing is to fill the gap between internally generated financing and conventional market sources, such as bank loans and public equity. There are two main types of private equity funds. Buy-out funds specialise in acquiring large public companies, restructuring them and reselling them in a relatively short time. Venture capital funds specialise in start-up companies, which do not have sufficient track records to receive bank financing and are too immature to be listed on the stock market. An important feature of these funds is their active involvement in the companies they finance. For instance, they support expansion, help to implement management, labour and financial restructuring and assist in divestments, mergers and acquisitions.

How do private equity funds work?

Generally, private equity funds operate as limited partnerships, which are controlled by the private equity firm (general partner) that manages the fund. The fund obtains commitments from a number of investors, such as pension funds, financial institutions and wealthy individuals, who invest a specified amount. Usually these investors (the limited partners) commit their financial contributions to the fund during several "closings" or rounds. A private equity firm will invest in several companies, each of which is known as a portfolio company. A fund will typically make between 15 and 25 separate investments over its lifetime, which usually lasts up to ten years.

How do private equity funds make money?

An exit is the means by which a fund is able to realise or "cash" its investment. This can take place after the portfolio company has grown or once it has been restructured or made financially sound and consequently has become of greater interest to the market. There are several exit strategies, including an initial public offering (IPO), a trade sale, selling to another private equity firm or a company buy-back. Since private equity funds deal with high-risk projects, they should gain sufficiently large returns on some investments to compensate for losses on others.

How important are private equity funds in financing enterprises?

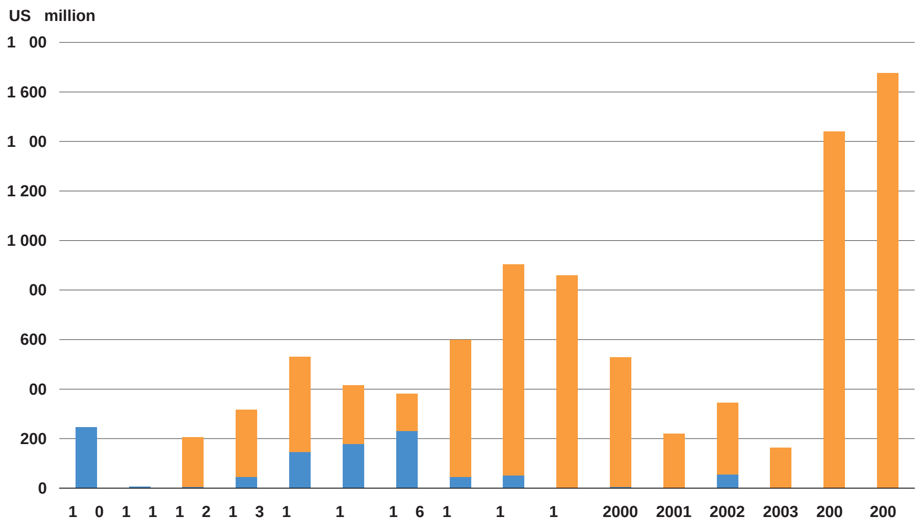
Private equity funds are often credited with the growth of the most innovative and successful companies. Some of the legendary high-growth enterprises in the United States – including Apple Computers, Federal Express, Intel, Oracle and Starbucks – were financed initially by private equity. According to some estimates, companies in the United States backed by private equity funds employ about 6 per cent of the country's workforce and account for around 13 per cent of GDP.[1] Within Europe, the United Kingdom traditionally attracts most private equity investment, accounting in 2005 for 1.3 per cent of GDP. This is about 20 times more than in Poland, which is the leader in private equity investments among the transition countries.[2]

[1] See Bartlett (2002).

[2] See EVCA (2006).

Chart 5.1

Total capital raised by private equity funds in transition countries



Donor-supported funds   Commercial funds

Sources: EBRD, Factiva and ISI Emerging Markets.

Note: The chart shows capital committed to the funds.

Another interesting issue is the link between the fund's characteristics and its performance. The analysed sample shows that larger funds tend to perform better than smaller funds. To show this, funds that have been operating for more than five years were categorised according to their size. Twenty funds received less than US$80 million in committed capital and 14 funds received more than this. The weighted average of returns by 2005 was 3.3 per cent (cash plus NAV) for the smaller funds and 15.7 per cent for the larger funds.[6]

To rule out the possibility that the difference in returns reflected the length of time that the funds had been operating, the average returns for the first five years since the establishment of the funds were also calculated. On this basis, value-weighted average return amounted to 8.8 per cent for large funds and -3.0 per cent for small funds, confirming that large funds perform much better. This trend is mirrored by an increase in the average size of a fund in transition economies. Funds established in recent years tend to be larger which may contribute to a further improvement in performance.

Performance may also be affected by whether a fund concentrates on a particular industry. In the United States, some venture capital funds have chosen to focus on a single industry. The advantage of this strategy is that the fund can hire people with specialist knowledge who can help to evaluate potential investments and monitor their subsequent performance. However, some funds prefer to invest in any projects that appear to be attractive.

In the sample, 44 per cent of funds have at least 40 per cent of their investments in one industry only. If funds created after 2002 are excluded (since these started investing relatively recently and their portfolio composition may not be representative), this percentage rises to 50 per cent. Most of these investments have occurred in manufacturing or telecommunications and information technologies (IT). Early funds tended to be concentrated in manufacturing but those established between 1995 and 1999 mainly concentrated on the telecommunications and IT sectors.[7]

Judging by returns, the strategy of focusing on one industry has not been very successful so far. The value-weighted average IRR of the concentrated funds was 9.7 per cent whereas the average for non-concentrated funds was 15.5 per cent.[8] This was not

Box 5.2

Constraints on private equity funds

The volume of private equity investment in transition countries is lower than in developed market economies. To some extent, this reflects a number of constraints specific to the transition countries, particularly a lack of local investors, high risk perceived by foreign investors and insufficient loan finance for private equity transactions. The shortage of experienced local management teams is also an obstacle.

Legal, regulatory and tax issues pose further difficulties. Investors often complain about slow legal and regulatory processes, an inexperienced and understaffed judiciary and excessive bureaucracy. Barriers that prevent domestic capital from investing in private equity funds remain a problem. Weak protection of minority equity investors and the inability to purchase significant stakes in various strategic industries are other obstacles.

The magnitude of these constraints varies across the transition countries. In central eastern Europe and the Baltic states (CEB) the situation has improved over the years but in other regions, private equity investors have faced persistent barriers, such as bureaucratic hurdles and corruption. A ranking of the attractiveness of the business environment for private equity in the accompanying table illustrates this.[1]

The most common impediments in CEB are bureaucracy, lack of market opportunities, a weak bankruptcy framework and obstacles to starting a business. In Russia this list also includes predatory officials, shareholder abuse, weak licensing and uncertain law enforcement. Policy-makers across the region still need to pay more attention to the specific needs of the private equity industry and to address barriers to its further development.

Attractiveness of private equity investment in selected countries

Country	Rank	Score	Country	Rank	Score
United States	1	5.8	Slovak Republic	25	-2.1
United Kingdom	2	4.6	Czech Republic	26	-2.2
Australia	3	3.7	Greece	27	-2.3
Poland	19	-0.4	Russia	30	-4.0
Spain	21	-0.8	India	32	-4.3
Hungary	22	-0.9	China	33	-5.3

Source: Apax Partners/Economist Intelligence Unit (2005).

Note: The scores in the ranking are based on a range of macroeconomic variables and indicators of the business environment such as access to finance, legal and policy environment etc. The scores are z-scores, a statistical device used to measure the distance from the mean. A country with a positive score is above the mean; a negative scoring country is below the mean.

[1] See Apax Partners/Economist Intelligence Unit (2005).

Table 5.1

Returns on private equity funds in transition countries

(in per cent)

	Cash + net asset value	Cash only
All funds		
Median IRR	5.2	-2.5
Value-weighted average IRR	11.9	-16.1
Pooled IRR	13.5	2.2
Funds operating for more than five years		
Median IRR	6.0	-0.4
Value-weighted average IRR	13.3	-2.3
Pooled IRR	13.0	5.5

Source: EBRD.

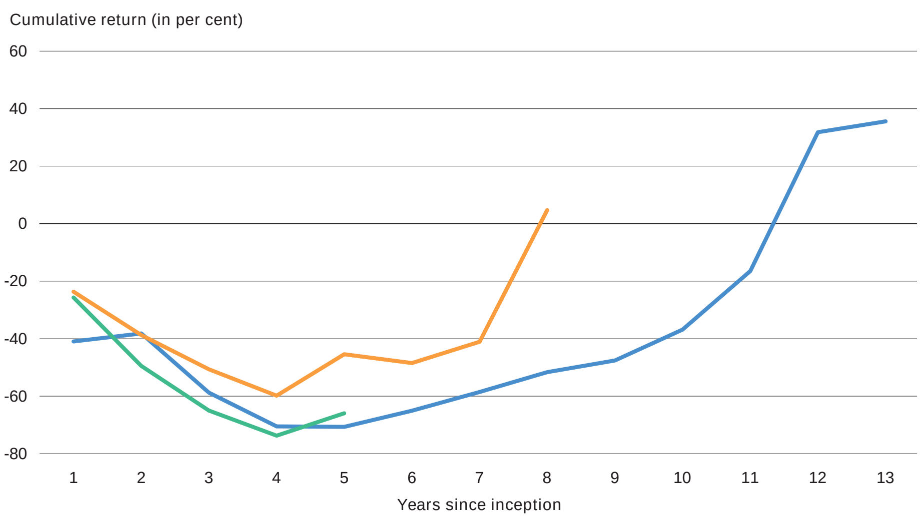
Note: All returns are in per cent and net of fees. Value-weighted averages are weighted by cumulative disbursements made by all limited partners to the fund. Pooled IRRs are based on the sum of cash flows from all relevant funds. There are 44 funds, of which 34 have been operating for more than five years.

due to the weakness of a particular industry.[9] In fact, the telecommunications and IT sectors have not performed any worse than any other industries.

There are several reasons why funds focusing on only one sector may have, to this point, had lower returns. First, a fund's main contribution to helping a company grow may be the development of managerial expertise. This does not require any specialist knowledge of the sector. Secondly, the supply of attractive investments might have been limited and a narrow focus on one industry could have curtailed the choice of projects. Finally, concentration in one "fashionable" or rising industry may draw in other investors, creating competition for projects and worsening terms for the funds.

Chart 5.2

Time profile of returns from private equity funds



Source: EBRD.

Note: The chart shows the net distribution ratios without net asset value. The net distribution ratio in a year is calculated by taking cumulative cash flows for a fund up to that year – the money returned by the fund to the investors less the money received – and dividing it by the total amount invested in the fund over its lifetime. If the net distribution ratio exceeds zero, it means that all disbursed funds have been recovered and that the fund is realising positive returns.

5.3 Characteristics of portfolio companies

To understand what drives the performance of private equity funds, this section looks at the companies that the funds have invested in and how these portfolio companies have performed over time. Company expansions and start-ups have been the most common type of investments undertaken by private equity funds (see Chart 5.3). Privatisations were mainly in the early transition years while buy-outs are largely associated with the later years when the transition economies had become more developed.

The average amount invested in a single project has changed over the years. There is a clear trend towards larger projects, possibly reflecting the greater ability of equity funds to commit money to one large project. The trend may also reflect the wider development of the economy, which in turn generates more ambitious projects.

The 44 funds in the sample have undertaken 450 investments in 399 companies, suggesting that most companies received finance from a single fund. This differs from the pattern in North America and western Europe, where syndication is more common.[10] The difference may be due to the relatively small size of the investments in the transition countries, the small number of funds present in the region or the relative absence until recently of large buy-out transactions.

Chart 5.3 highlights the absence of co-investors in private equity deals. In almost 70 per cent of the investments, the fund was the only investor. Of the projects with a co-investor, approximately 34 per cent had a financial co-investor, either domestic or foreign. The low percentage (8.5 per cent) of domestic co-investors, either financial or industrial, suggests that companies are still finding it difficult to raise equity capital domestically.

Chart 5.3 also shows that private equity was mainly focused on manufacturing, retail, telecommunications and IT. Chart 5.4 gives the share of investments approved in any given year by sector.[11] The boom in telecommunications and IT that started in 1998 took the place of financing traditional sectors, such as manufacturing, retail and construction. After 2002 this process was reversed. This implies that an increase in investment in one sector tends to come at the expense of other sectors. It also appears that existing funds tend not to switch sectors according to fashion whereas new funds created in particular years have tended to focus on the rising sector at that time. This has been confirmed by replicating Chart 5.4 using start years of funds (vintage years) instead of start years of individual investments.

An important factor affecting fund returns has been the average time to exit or how quickly a fund can realise its investments. This depends not only on the success of the investment but also on the opportunities to exit. This can take place in various ways – for example, through an initial public offering (IPO) or a private disposal. IPOs are the most visible and often the most profitable way to exit.

For example, Enterprise Investors, a Warsaw-based private equity fund, has established a reputation for this. One of the IPOs facilitated by this fund was Eldorado, a Polish food retailer. Enterprise Investors invested in the company in 1999. The private equity investment allowed Eldorado to grow from a local wholesaler into one of the largest food distribution companies in south-east Poland. The fund took steps to improve corporate governance and developed the company's expertise through the appointment of foreign consultants. This led to Eldorado's management decision to raise additional capital on the Warsaw Stock Exchange. The IPO, which occurred in January 2002, raised US$5 million for further development and facilitated the subsequent exit of Enterprise Investors.[12]

The viability of IPOs depends on the size of the public equity market in the country. Early in transition, most markets were relatively small and lacked liquidity so a private equity fund trying to exit would not find it profitable. More recently, the IPO exit has become a more attractive option for two main reasons. First, some domestic stock exchanges (particularly Warsaw) have grown considerably so more companies are trading on them and there is more liquidity.

Secondly, companies from transition countries have found it easier to gain access to foreign stock exchanges.

Chart 5.5 shows the evolution of IPOs and their distribution across stock exchanges. There have been two IPO waves. The first took place between 1996 and 1997. This was followed by a sharp reduction due to the Russian financial crisis of 1998 and the 2000–01 global stock market decline. From 2004 a new wave appeared. While this seems smaller in terms of the number of companies going public, the proceeds raised in these IPOs have actually increased. In addition, in the early 1990s there were hardly any IPOs on foreign stock exchanges but the number rose to 34 per cent in 1996 and 31 per cent in 2005.

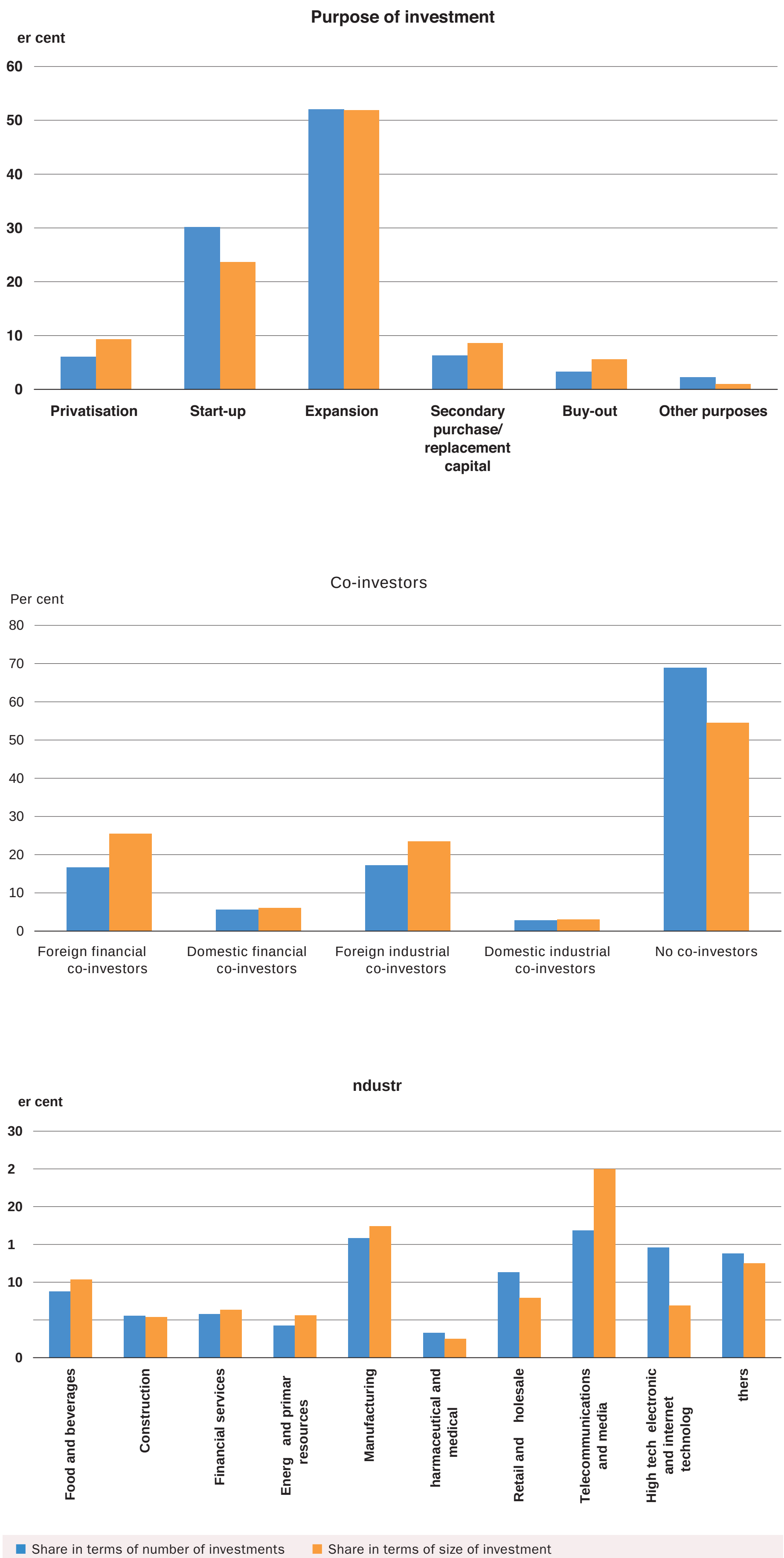
Within the sample, there were 21 IPOs between 1992 and 2005, accounting for approximately 10 per cent of all exits, excluding write-offs. This is comparable with the rest of Europe, where the percentage of divestments by IPOs was 8 per cent in 2004 and 10 per cent in 2005. IPOs appear to be an increasingly popular way to exit by private equity funds in transition economies. Some 62 per cent of exits through IPOs in the sample occurred in 2004 and 2005.

Exit opportunities are crucial if private equity funds are to realise their investments in a sufficiently short space of time. The average time to exit in the analysed sample has been approximately 4.6 years. However, funds started in recent years have so far exited only the most successful investments and so their average is artificially low. Therefore, the average time to exit investments undertaken by funds in a given year has been calculated. For funds started between 1992 and 1994 the average time to exit was 5.5 years. The percentage of investments not exited was 5.8 per cent in 1992, 0 per cent in 1993 and 18 per cent in 1994. Between 1995 and 1999 the average time to exit was 3.9 years and the percentage of projects not exited rose from a minimum of 13 per cent in 1995 to a maximum of 50 per cent in 1999.

Recent evidence indicates that private equity funds in the United States and Europe hold their investments for an average of 3.6–3.7 years.[13] Although the average time to exit in the transition countries is longer, it has nevertheless declined. Not only have exits through IPOs become more likely but overall opportunities to exit have improved.

Chart 5.3

Types of investments by private equity funds



Source: EBRD.

5.4 Investment returns

To assess the sources of a fund's success or failure, it is necessary to analyse the return on each investment in a portfolio company that a fund has undertaken. As on the fund level, the analysis here is based on the internal rate of return (IRR) to each investment. The returns are calculated by assessing the cash flows between the fund and the company (defined as "raw IRRs"). When using this measure, however, a number of points have to be taken into account.

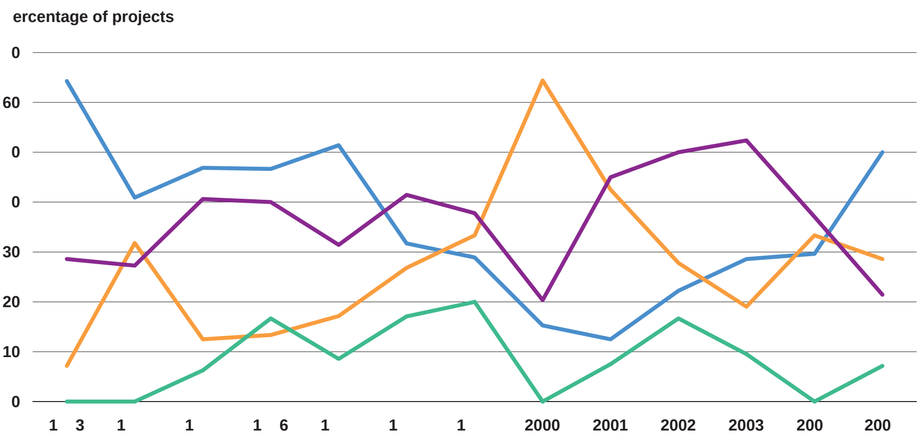
The first is whether all investments should be included or only those fully exited (or written off). The IRRs of the exited projects are the so-called "cash-on-cash IRRs" – since the investment has been liquidated, all cash flows are actual money flows. When a project has not been fully exited, the final cash flow reported by the fund is the NAV, or an estimate of the value of the assets made by the fund manager. The analysis is conducted both for all portfolio companies and for those which are fully exited and written off (that is, those which have no remaining NAV).

A second issue concerns the means of comparison. In the analysis, the benchmarked return is calculated by subtracting from the raw IRR the return that an investor would have made by investing in public equity over the same period. Benchmarked IRRs therefore measure the additional return that a fund made in a particular investment over the amount it would have made by investing in the stock market over the same period. In developed countries there is disagreement whether the returns from private equity outperform stock market returns. One study has found private equity exceeding by 5 to 8 per cent per year the returns from the Standard and Poor's (S&P) index of 500 publicly listed companies. Another study has found that the average returns of private equity funds have been similar to the S&P 500.[14]

For an advanced market economy, the natural comparison for private equity would be with the domestic stock market in that country. In transition countries, however, the domestic stock market often lacks liquidity and is not a good reference point. Several possible alternatives, including the London Stock Exchange (FTSE index) and the Datastream Emerging Europe (DSEE) index, are considered instead.[15] For the DSEE, industry indices also exist and the return to each project

Chart 5.4

Target industry by year of investment

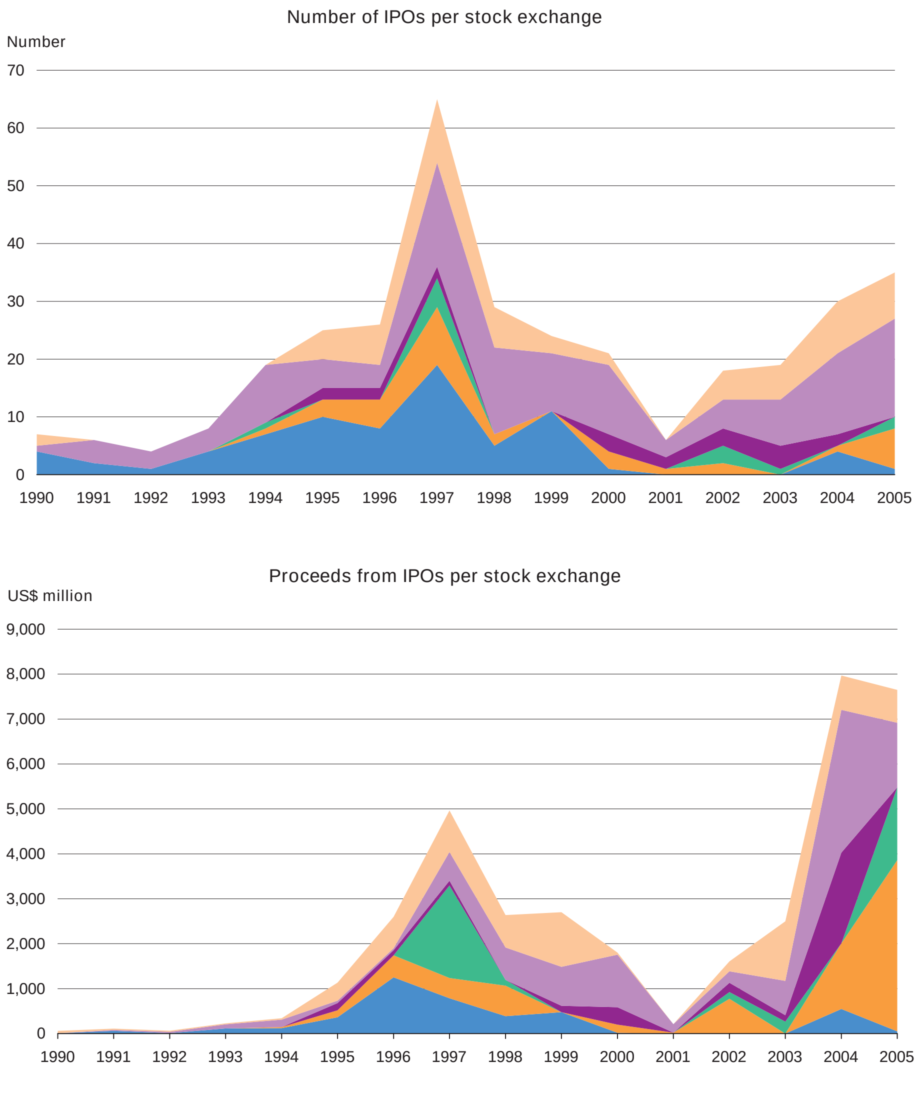


Manufacturing, construction and retail; Telecommunications/media and high-tech, electronic and internet technology; Food and beverages; Others

Source: EBRD.

Chart 5.5

IPOs in transition countries



Budapest; London; Moscow; New York; Warsaw; Others

Source: Datastream.

can be benchmarked to the return of the relevant industry. Finally, pooled IRRs are also reported.

The pooled IRR for all investments by the analysed private equity funds was 19.7 per cent and for fully exited and written-off investment it was 20.5 per cent. The value-weighted average IRR (weighted by investment size) for all investments was 11.1 per cent while for projects fully exited and written off it was 7.7 per cent. The average IRR relative to an equivalent investment in the FTSE was 5.7 per cent and 3.8 per cent respectively. For an equivalent investment in the DSEE it was -17.5 per cent and -9.8 per cent. The returns from private equity were therefore superior to the FTSE but significantly below the DSEE benchmark. However, the DSEE index might not be a reliable benchmark as it was made up of relatively few firms in the early years. Moreover, there is a great variation in returns, significantly higher than, for example, in the United States.[16]

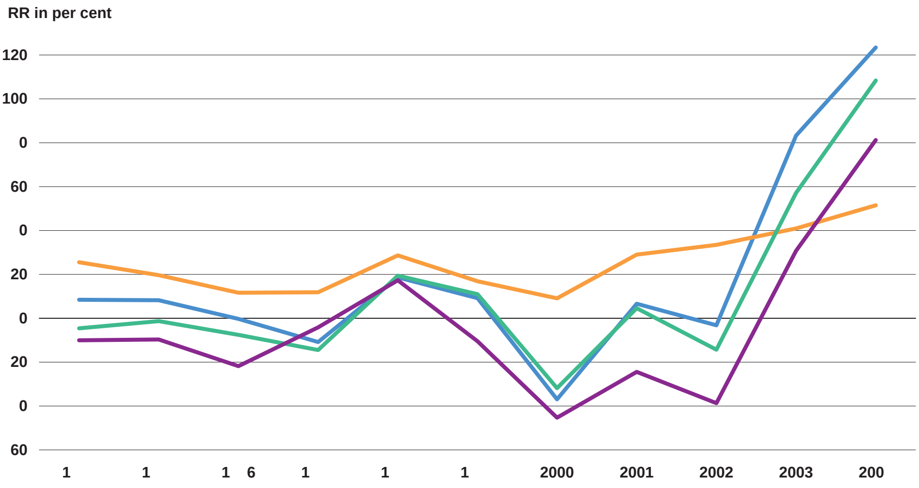
Chart 5.6 shows how these returns have evolved by calculating the returns of all investments started in a given year.[17] It shows that returns have increased dramatically in recent years.[18] This may be partly due to the easier opportunities to exit and to better investment opportunities. If investments are grouped by the year of exit from a project, the same trend of returns increasing over time is apparent. In addition, investments that started in years in which it was difficult to exit at a high profit tend to have larger returns on average (and vice versa).

This suggests that when there is a lot of competition for business (for example, following a period of successful exits) funds may pay too much for their investments. By contrast, in 1998 – the year of the Russian financial crisis – few investors were willing to come to the region and this was reflected in the valuations of private equity transactions. Investments that started just after the Russian crisis have generated higher returns than those started in any other year before 2003.

Chart 5.7 reports value-weighted returns by sector for fully exited projects only. The most profitable sectors have been financial services, telecommunications and high technology. The “others” category (covering services, hotels and restaurants, and other miscellaneous groups) and the retail and wholesale sector show lower results.[19] Investments in high-tech sectors tend to

Chart 5.6

Investment returns by year of initial investment



Value-weighted raw IRR   Pooled raw IRR   IRR benchmarked to London Stock Exchange (FTSE index)
IRR benchmarked to Datastream Emerging Europe index

Source: EBRD.

Note: Only investments that are either fully realised or written off are included. The raw IRR and IRR benchmarked to the FTSE and DSEE are value-weighted.

be riskier so higher returns compensate for the higher risk. The superior performance of investments in more complex and technologically intensive sectors suggests that private equity in the transition countries may be as successful in financing these types of projects as it has been in western Europe and in the United States.

In the advanced market economies, private equity funds have invested in traditional sectors of the economy through buy-outs predominantly whereas these have not been common until recently in the transition countries. The fact that private equity has mostly financed traditional projects in the transition countries suggests that it has filled a gap created by insufficient bank lending and a general shortage of external finance.

However, private equity tends to be a very expensive way of financing an investment that might have been financed with a bank loan. Returns may have been lower in traditional sectors for this reason. It remains to be seen whether private equity funds in the transition countries will move away from more traditional sectors and focus on those where their expertise can prove crucial and where they can reap higher returns or successfully implement more efficient methods of financing, such as buy-outs.

Another factor that influences differences in returns is the type of company restructuring that is undertaken. Operational restructuring signifies changes in the strategy or organisation of a company, labour restructuring involves lay-offs or retraining, and financial restructuring indicates changes in the debt structure of the company. The most common form of restructuring by private equity funds is operational restructuring, which occurred in 36 per cent of investments. Some 20 per cent of investments were subject to mergers or acquisitions, 14 per cent pursued labour restructuring, 9 per cent undertook substantial divestments and 8 per cent underwent financial restructuring. Private equity funds are most successful when they redirect the strategy of a company, helping it to reorganise, expand or merge with another enterprise. Returns after financial or labour restructuring have been much weaker.[20] This suggests that private equity funds can be most successful in supporting management improvements.

There is no clear pattern when considering differences in returns between countries. The Czech Republic, the Slovak Republic and SEE in general show relatively good performance when measured by value-weighted IRRs but the differences to the rest of the transition region are not statistically significant. In fact, the better performance of these countries appears to have been driven by a handful of large successful deals in the telecommunications sector where exit has taken place over the last two years. The Baltic states have also recorded above-average value-weighted IRR due mainly to a number of successful transactions in Estonia. The pooled IRR results confirm the good performance of these countries but also show high returns in Russia and the CIS in general, where a number of highly successful transactions have produced cash flows and net asset values that have far exceeded losses on less successful deals.

Table 5.2 relates the IRR of an investment to a variety of factors. The analysis uses different benchmarks and looks at exited and written-off projects only. Account is taken of industry and country effects, the size of investment and the type of restructuring. The determining factors include whether the investment has been a privatisation or a start-up, and whether the project has had a co-investor. The analysis also considers the importance of the quality of management. This is particularly relevant because one of the problems hindering growth in the transition countries has been a lack of managerial and entrepreneurial skills. Helping managers or entrepreneurs with no previous management experience to cope with the difficulties of running a business is one of the major contributions of private equity funds.

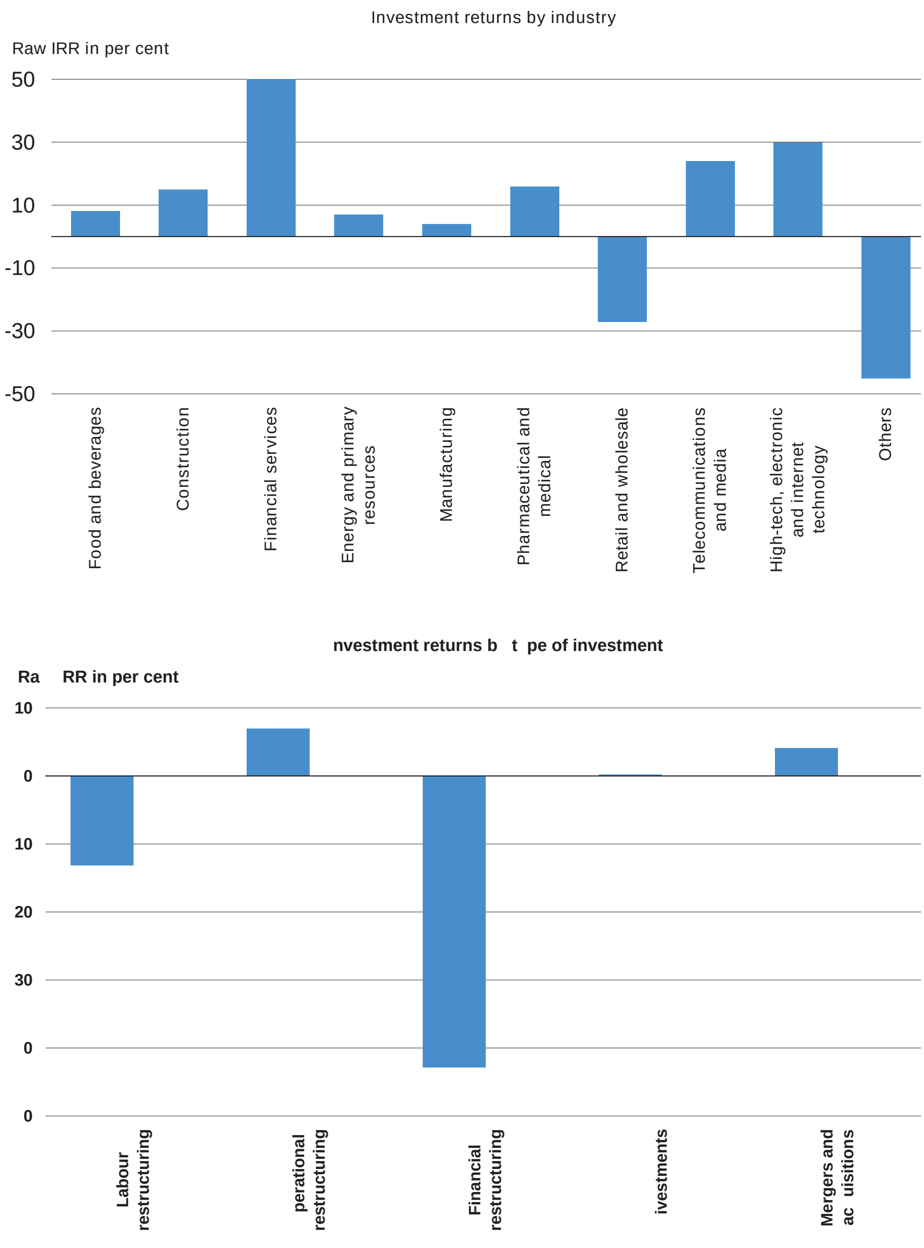
Internal EBRD assessments prepared over a number of years have provided detailed information about how each investment is developing. They have also recorded whether there has been a problem with the quality of management and have indicated whether a fund intended to implement management training, hire additional people or replace managers. In other words, they have recorded instances of when a fund can take an active role in improving a company's operations. This allows controlling for funds' intervention when management was deemed of poor quality.[21]

Table 5.2 shows that start-up investments have a lower return than other projects while privatisations tend to have a higher return.[22] In particular, the analysis shows lower returns for start-ups in the high-tech sector, where write-offs have been more common.[23] Projects with a co-investor have higher returns but whether the co-investor was a strategic or a financial partner makes no significant difference. If the co-investor was foreign, the returns are only slightly higher. If only fully exited projects (not those written off) are considered, the presence of a co-investor does not improve the return of the investment.

The analysis reveals that returns were lower when management was problematic. In cases where the fund took steps to improve the management, there is some

Chart 5.7

Investment returns



Source: EBRD.

Note: The chart presents value-weighted raw IRRs. If the returns are benchmarked against FTSE and DSEE indices, the same trend emerges. Only fully exited projects have been included.

statistically significant evidence that a fund's mentoring and supervisory role has been helpful. Funds may intervene to improve the company's management in many different ways. For instance, in the case of Eldorado (see above), it was sufficient to bring in experienced consultants to provide guidance on business development and expansion. In other cases, more intervention was required.

For example, to revitalise @Entertainment, a Polish cable TV operator, private equity investors, including Advent International equity fund, brought in a new chief executive and finance officer, relocated the company headquarters and revamped the sales team. When an exit opportunity arose, the funds realised substantial financial returns as reward for the successful managerial changes.[24] However, such intervention may not be enough in some cases to compensate for the damage done by low-quality management.

Table 5.2 also considers how the type of exit influences the returns on an investment. Exit through an IPO does not seem to have an impact on returns in the transition

Table 5.2

Factors determining investment results

	Raw IRR	FTSE	DSEE	IRR [1]
Returns by type of investment				
Constant	–	+	– **	–
Privatisation	+ **	+ **	+	+ *
Start-up	– ***	– ***	– **	– ***
Co-investor	+ **	+ *	+ ***	+ **
Bad management	– ***	– ***	– **	– ***
Bad management x intervention	+ **	+ **	+	+

	Raw IRR	FTSE	DSEE
Returns by type of exit			
Constant	+ ***	+ ***	+ ***
Privatisation	+ ***	+ ***	+ **
Start-up	+	+	+
Exit with IPO	+	–	–
Exit to a co-investor	– **	– **	– *
Exit to a foreign investor	+ *	+ *	+ *

Source: EBRD.

Note: *, ** and *** show that the regression coefficient is significant at the 10, 5 or 1 per cent level respectively. Results only include companies that have been fully exited. All regressions include industry and country fixed effects. Regressions explaining returns by type of investment also include control variables for different types of restructuring.

[1] Results in this column include companies that have either been fully exited or written off.

countries. This may appear surprising given the fact that this form of exit is by far the most successful outcome in the United States. Its lack of impact in the transition countries may be at least partly due to the fact that few, if any, of the IPOs in the sample involved start-ups that were nurtured by private equity funds, as is more often the case for successful IPO exits in the United States. Instead, the most common candidate for an IPO in the transition countries appears to have been a rapidly expanding company in need of additional expansion capital (for example, @Entertainment described above). Another factor might be the limited role of domestic stock exchanges in the region.

A further interesting finding shown in Table 5.2 is that an exit to a co-investor has a negative effect on returns. This suggests that this form of exit has been used when the project has not been particularly successful and when an alternative exit strategy has not been available. Exit to a foreign investor has a generally positive effect, reflecting the fact that only the best projects attract the attention of foreign investors.

5.5 Conclusion

Private equity had a difficult beginning in the transition countries but has experienced considerable improvement in recent years. In addition to institutional constraints, funds have had to contend with a banking system that is still developing and with immature stock markets. The lack of a sufficiently developed financial system has made exiting from investments particularly difficult. In addition, there have not been enough attractive investment opportunities. This was especially true in the early years of transition.

Aggregate returns on private equity funds in the transition countries appear comparable with returns on private equity investments in western Europe over a similar period. Nevertheless, returns on individual investments have been affected by the choices made by private equity funds. In some cases, funds have invested in projects that do not necessarily require private equity expertise. Consequently, these investments have not provided high enough returns to compensate for the risk. Moreover, funds have at times concentrated excessively on “fashionable” sectors instead of looking for the best possible projects.

Returns have improved in recent years because of a better range of investment projects and greater access to stock markets. Moreover, the private equity industry seems to be moving in the direction of larger funds, which have been shown to realise higher returns. Investments have continued to increase in size and the possibility to leverage (for example, by raising debt to finance buy-outs) should boost returns. Further development of the banking sector and public equity markets will allow private equity funds to focus on projects needing expertise as well as financial support.

Private equity funds have financed both traditional and newer high-tech sectors. Evidence shows that focusing on one particular sector, however, has led so far to lower returns on average. This is probably because there were not enough attractive investment projects in any one sector to justify specialisation.

The active involvement of private equity funds in their portfolio of companies tends to have a positive effect on the performance of these firms. Funds have been particularly successful in projects where they redirect the company’s strategy or assist in reorganisation. When the quality of the company’s management has been poor, this has had a negative impact on the performance of the investment but intervention by the equity fund can help to mitigate this. This means that private equity funds are helping to develop managerial skills in the transition countries.

The volume of finance committed to private equity in the transition countries in 2005 exceeded US$1.6 billion. Most of this came from foreign institutions, and the domestic base of private equity investors in the region remains thin. Lack of domestic investment remains a crucial obstacle to the development of a sustainable, mature private equity market in the region. This may change if private pension funds and insurance companies begin to engage in private equity investment and if regulatory constraints are relaxed.

There is a growing willingness among wealthy individuals and companies to channel their funds into private equity. In Poland and Russia local experts are increasingly available to offer their expertise on private equity investment. As the average size of an IPO increases and the banking sector across the transition region develops, the target market for private equity may become increasingly clear. In the medium term, the main focus is likely to be on buy-outs, start-ups and medium-sized companies that are either too small to attract equity capital through stock markets or too risky to qualify for loans from banks.

Endnotes

1 See, for example, Leeds and Sutherland (2003) and Bartlett (2002).

2 This is equivalent to at least 25 per cent of the finance raised by firms from the region on international stock markets in the same year.

3 There are other funds in which the EBRD invested but only institutional funds dominated by private investors were considered, on the grounds that only those funds are expected to follow exclusively commercial principles.

4 See Ljungqvist and Richardson (2003a) for the United States and Kaserer and Diller (2004) for Europe.

5 The negative relationship between vintage year of the fund and the length of investment period is robust but is not statistically significant when funds that have not finished their investment period are excluded from the sample.

6 This difference is statistically significant. If the average of cash-only returns is measured, the difference between averages remains substantial (9.4 per cent) but is not statistically significant.

7 For example, 60 per cent of funds established in 1997 invested at least 50 per cent of their capital in high-tech projects.

8 Only funds that have been operating for more than five years and that have invested in at least five companies are considered; otherwise, concentration may be driven by two investments only. They are split between those that have at least 40 per cent invested in one industry (the concentrated ones) and those that have less than 40 per cent invested in one industry (the non-concentrated ones). The difference, although substantial in economic terms, is not statistically significant.

9 For example, although many funds are concentrated in telecommunications and IT, returns on all funds for which the dominant industry was telecommunications and IT are not significantly different from returns on other funds.

10 See EVCA (2006).

11 Looking at percentage of amount invested instead of comparing the number of investments does not change the picture.

12 See Enterprise Investors (2006).

13 See Ljungqvist and Richardson (2003b) for the United States and Schwienbacher (2002) for Europe.

14 See Ljungqvist and Richardson (2003a) and Kaplan and Schoar (2005).

15 The Alternative Investment Market (AIM) in London, a mixture of the Moscow and Warsaw stock exchange indices and the Nomura Emerging Europe index, was also considered. The results were qualitatively similar no matter which index is used for benchmarking.

16 The standard deviation of the IRRs for all projects is 226 per cent. For only the fully realised and written off projects, it is 275 per cent. Cochrane (2005) estimates standard deviation of return on private equity investments in the United States at 10.7 per cent.

17 The start year of an investment is the year in which the investment was approved by the fund and the money was committed.

18 Investments undertaken in 2003 and 2004 and already fully exited are the very successful ones since they were exited quickly and therefore the returns were high. By the time the fund is liquidated, returns will not look so high. However, the increase is so dramatic that even when corrected for that bias, an upward trend in the returns is evident.

19 The superior performance of financial services and the poor performance of retail and "others" are statistically significant. The magnitude of the difference between sectors prevails when analysis is conducted on the basis of pooled IRR although the pooled IRRs for each sector are usually higher than value-weighted IRRs.

20 The poor performance of financial restructuring is statistically significant while the poor performance of labour restructuring is less obvious. The magnitude of the difference between various types of restructuring prevails when analysis is conducted on the basis of pooled IRR although the pooled IRRs for each type of restructuring are usually higher than value-weighted IRRs.

21 The variable in the regression is the product of a dummy controlling for bad management and a dummy accounting for intervention by the fund. Therefore, it captures situations where the management was of low quality and where the fund took steps to improve it.

22 The coefficient of privatisation becomes insignificant when IRRs are benchmarked to the DSEE. However, as mentioned before, care is needed in interpreting this result since most privatisations took place in the early years, when the index probably did not include many firms.

23 To confirm this, four variables are introduced. Start-ups are interacted with four different sectors: retail, telecommunications, high technology and "others". It is found that start-ups lose significance while the interaction of start-up and high technology is strongly negative and significant.

24 See EVCA (2004) for more details on this case study.

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Country assessments

The following section contains a country-by-country review of reform progress and macroeconomic developments in the transition region from mid-2005 to mid-2006.

It includes for the first time an assessment of economic developments in Mongolia, which became an EBRD country of operations in October 2006. Following the independence of Montenegro in June 2006, Serbia and Montenegro are considered separately. A retrospective assessment of developments in these three countries is provided to chart their reform path since the beginning of transition.

The country assessments highlight key developments in liberalisation and privatisation, business environment and competition, infrastructure, the financial sector and social reform. They also include data tables of structural, institutional and macroeconomic indicators. However, in view of the inherent difficulties in measuring structural and institutional change, the data cannot give a complete account or precise measurement of progress in transition.

There is still considerable variation in data quality across countries and categories. The data are based on a wide variety of sources, including national authorities, other international organisations and EBRD estimates. To strengthen the degree of comparison between countries, some of the data were collected through standardised EBRD surveys of national authorities. The source of data and exact definitions are provided in the methodological notes at the end of the Report. The “cut-off” date for data was end-September 2006. Data for 2006 are projections.

Albania

Key challenges

- Effective and systematic action against corruption and organised crime, as well as measures to increase the efficiency and impartiality of the judiciary and public administration, are needed to improve business confidence in the public sector.
- Better transport infrastructure and greater progress in the restructuring and privatisation of utilities are needed to promote more reliable services, enhanced environmental standards and stronger economic growth.
- Increased export competitiveness, through more investment and better labour training, is necessary to lower the trade deficit and reduce the country's excessive reliance on remittances from Albanian workers abroad.

Country data

Population (in millions)	**3.2**
Area ('000 sq km)	**28.7**
GDP (in billion US$, 2005)	**8.7**
GDP per capita in 2005 at current international US$ (PPP)	**5,201**
National currency	**Lek**

Progress in structural reform

Liberalisation and privatisation

Negotiations with the European Union (EU) on a Stabilisation and Association Agreement (SAA) were concluded in February 2006 and the accord was signed in June. Although the SAA has still to be ratified by all the EU member states, the Interim Agreement on Trade will come into force immediately after its official publication by Albanian authorities. Albania will have to lower or abolish its customs duties on most EU imports, but will have improved access to EU markets. The SAA will also help Albania to harmonise its legal system with that of the EU, thereby improving the business environment for local companies.

In August 2006 a review instigated by the government ruled that the sale in 2005 of a 76 per cent stake in Albtelecom, the dominant fixed-line telecommunications operator, to the Turkish consortium of Calik and Turk Telecom had a number of important shortcomings. Although the privatisation contract had been signed in June 2005, the new parliament elected in July that year did not ratify it.

Business environment and competition

The new government, elected in 2005, has made tackling corruption and organised crime a key priority. It has already taken some measures, including amending the law on conflict of interest, reviewing administrative procedures to increase their transparency, and strengthening the judiciary. The government has also replaced many personnel in the customs and tax offices. A new law on state aid was enacted in January 2006, and the State Aid Commission was established in March 2006.

The Millennium Challenge Account (MCA), a US initiative to help the authorities in partner countries address corruption in tax administration, public procurement and business registration, was approved by the US administration in January 2006. In Albania, specific MCA objectives include increasing the tax collection rate from 30.4 per cent to 50.0 per cent, reducing the cost of public procurement by 20 per cent, and increasing the number of new businesses registered monthly from 625 to 1,000. The programme also sets targets for the reduction of bribery in tax collection, business registration and procurement of government contracts.

The time-scale for registering an enterprise declined from an average of about 30 days to eight in the first half of 2006 following measures to simplify and decentralise the commercial register. In addition, foreign investors are now charged the same fee for registering a new company as local enterprises (having previously paid twice as much). However, the business environment continues to be hampered by unclear property rights. This hinders the use of property as collateral in the main urban and coastal areas where only a small share of real estate is properly registered. Law enforcement, particularly relating to commercial litigation and bankruptcy, remains weak.

Infrastructure

Between September and December 2005 the combination of a summer drought, a fire at one of the main hydroelectric generators and inadequate forward planning on electricity imports resulted in blackouts of up to 20 hours a day throughout the country. The situation subsequently improved as new power import contracts were signed and water levels at the main hydroelectric plants increased. However, the reliability of the supply network remains well below international standards and localised blackouts are still common. Investment in power sector upgrades is also endangered by low tariff collection rates.

The authorities have adopted a new electricity tariff structure, applied from July 2006, which removes cross-subsidies from businesses to household users. The average tariffs for households have increased by 11 per cent, while electricity prices for businesses have decreased on average by 28 per cent. The authorities have also expanded the social transfer scheme to compensate approximately 270,000 low income households. Since the tariff increase does not apply to customers without electricity meters, the power utility company KESH plans to install 25,000 meters, covering 10 per cent of its customers in Tirana, by the end of 2006.

Financial sector

A new law on the banking sector, aimed at consolidating the legal framework for bank supervision and strengthening existing regulation, was approved by the government in July 2006. In the first half of the year credit growth, driven by both consumer and corporate loans, reached 60 per cent year-on-year, while the ratio of credit to GDP increased to approximately 18 per cent. As of mid-2006, about 90 per cent of credit was secured by collateral and about 70 per cent of loans were denominated in foreign currencies. The share of non-performing loans was low at about 4 per cent of the total.

Macroeconomic performance

Real economy

Real GDP increased by 5.5 per cent in 2005. The impact of the power crisis in the second half of the year lowered growth by an estimated half a percentage point. Economic expansion has continued to be driven by private consumption and investment, financed by strong remittance inflows and rapidly increasing household credit. However, rising net imports and weakening of economic activity in the construction sector have also had a significant downward effect on growth.

Economic policies

Inflation over the past year has generally been within the Bank of Albania's target range of 2 per cent to 4 per cent. In July and August 2006 it exceeded 3 per cent year-on-year, up from a low of 1.3 per cent in February. Also in July the Bank increased its key interest rate by 25 basis points to 5.25 per cent to dampen inflationary pressures and the strong credit growth. Meanwhile, the conduct of fiscal policy has continued to improve. In 2005 the fiscal deficit was 3.6 per cent of GDP compared with 5.1 per cent in 2004. Tax revenues increased more than 10 per cent year-on-year in the first half of 2006. In July 2006 the authorities passed a supplementary budget due to higher than expected revenues, and approved increased expenditures of 2.2 per cent of GDP in the second half of the year.

In the second half of 2005 the new government cut the income tax rate for small businesses from 3 per cent to 1.5 per cent, and reduced fees for registering small businesses. Furthermore, in July 2006 social security contributions were reduced from 29 per cent to 20 per cent (due to a cut in employers' contributions by 9 per cent), customs tariffs on machinery and equipment were eliminated, and excise taxes on alcohol and cigarettes were raised from 20 per cent to 30 per cent.

External sector

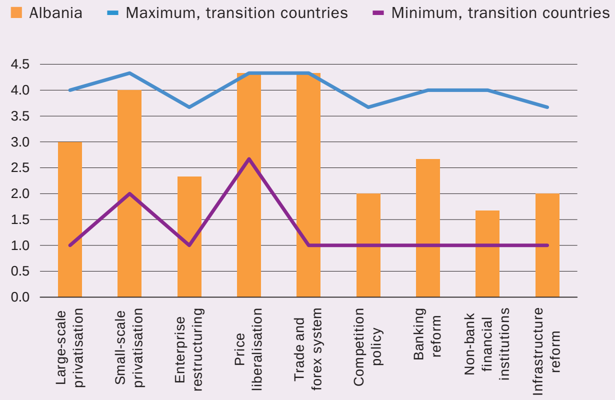
The current account deficit increased substantially in 2005 as the growth of imports, mainly of consumer and investment goods and electricity, outstripped that of exports. The latter weakened from 25 per cent in 2004 to 13 per cent in 2005 owing to strong competition in the textile sector from China and weak demand in Italy (the main export market).

The trade and current account deficits increased further in the first quarter of 2006 and there was also a marked rise in deposits abroad. However, workers' remittances continued to grow strongly, and tourism revenues, which are about 40 per cent higher than the export value of goods, increased 30 per cent year-on-year. As a result the overall balance of payments recorded a surplus in the first quarter of 2006.

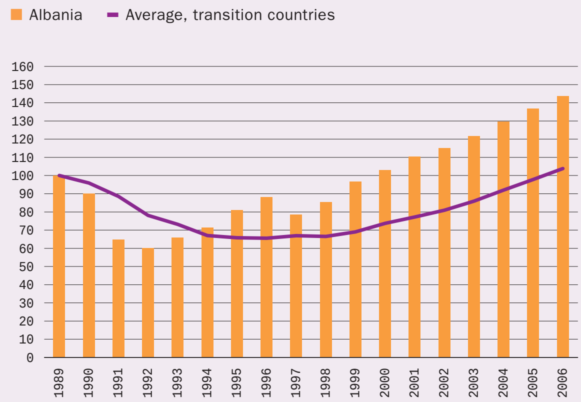
Outlook and risks

Strong economic growth, low inflation and a stable exchange rate are expected to be maintained in the medium term, provided there is a steady improvement in infrastructure deficiencies, including the poor state of the road network and the inadequate power system. The key risk factors are possible instability from high credit growth and the continuing reliance on remittances from abroad to cover the large trade deficit.

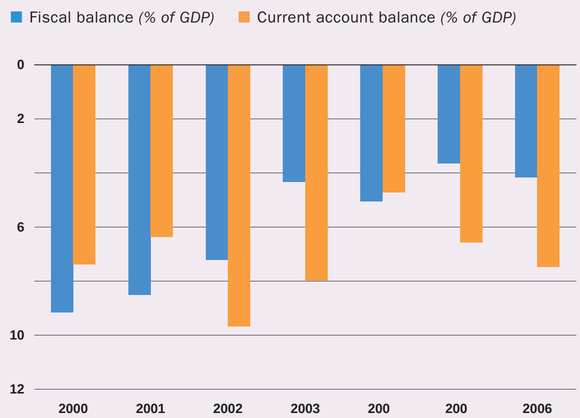
Transition indicators, 2006



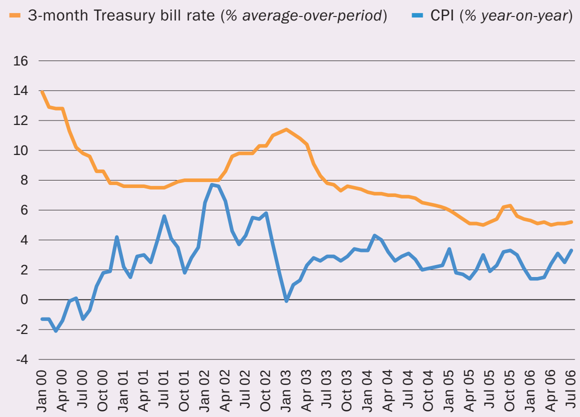
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradability of land – **limited de facto**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **high**

Secured transactions law – **advanced**

Quality of corporate governance law – **medium**

Infrastructure

Independent telecoms regulator – **partially**

Independent electricity regulator – **partially**

Separation of railway infrastructure from operations – **no**

Independence of the road directorate – **partially**

Quality of concession laws – **low**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **low**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **11.8 per cent** (2002)

Government expenditure on health – **2.6 per cent of GDP**

Government expenditure on education – **3 per cent of GDP**

Household expenditure on power and water – **5 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)	0	2			2		a
r a e e r are (per e)	0	0	0	0	0	0	0
r a e e r are e pl y e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
u ge ary u e a urre ra er (per e)	0		0	0	0	0	a
S are u ry al e pl y e (per e)		6 0		2	2		a
a ge la ur pr u y u ry (per e)	0	6					a
e e (per e)	2	2 2	26 2	2 0	2	26 6	a
EBRD index of small-scale privatisation	0	0	0	0	0	0	0
EBRD index of large-scale privatisation	2	0	0	0	0	0	0
EBRD index of enterprise reform	2 0	2 0	2 0	2 0	2 0	2 0	2
S are a ere pr e (per e)	a	a	a	a	a	a	a
u er g a ere pr e a e	0 0	0 0	0 0	0 0	0 0	0 0	a
S are ra e ra u re (per e)	2	2	0 6	2	6		a
S are ra e (per e)	6 0		0		0	6	a
ar re e ue (per e p r)		6	6	6	6 0	6	a
EBRD index of price liberalisation							
EBRD index of forex and trade liberalisation							
EBRD index of competition policy					2 0	2 0	2 0
u er a (re g e)	(2)	(2)	(2)	( )	6 ( )	6 ( )	a
A e are a e e a (per e)	6	2			6		a
A e are re g e a (per e)	2	0				2	a
per r g l a (per e al l a)	2 6	6	6	6	2	2	a
e re pr a e e r (per e)	0	0	0		6 2	0	a
e re u e l (per e)	a	a	a	a	2	6	a
r gage le g (per e)	a	a	a	a			a
S ar e ap al a (per e)	a	a	a	a	a	a	a
S ra g lu e (per e ar e ap al a)	a	a	a	a	a	a	a
ur ua e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
EBRD index of banking sector reform	2	2	2	2	2	2	2
EBRD index of reform of non-bank financial institutions							
e l e (le) pe e ra ra e (per 00 a a)	(0)	6 (2)	(2 6)	( )	6 ( )	6 ( )	a
er e pe e ra ra e (per 0 000 a a)	0	0 6	0 6	0			a
a l ay la ur pr u y (00)					0	2 6	a
e e al ele r y ar (S)			2		6 2	6	a
A erage lle ra e ele r y (per e)	60	6		2	6		a
per u e ergy u e (S llar per g e)	6		6	6	a	a	a
EBRD index of infrastructure reform	2 0	2 0	2 0	2 0	2 0	2 0	2 0
Electric power	2	2	2	2	2	2	2
Railways	2 0	2 0	2 0	2 0	2 0	2 0	2 0
Roads	2 0	2 0	2 0	2 0	2 0	2 0	2 0
Telecommunications	0	0	0	0	0	0	0
Water and waste water	0	0	0	0			

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	6.5	7.1	4.3	5.7	6.7	5.5	5.0
Private consumption	5.3	na	na	na	na	na	na
Public consumption	7.4	na	na	na	na	na	na
Gross fixed capital formation [1]	17.9	na	na	na	na	na	na
Exports of goods and services	5.8	na	na	na	na	na	na
Imports of goods and services	6.5	na	na	na	na	na	na
Industrial gross output	0.5	7.1	-7.9	2.7	3.1	4.0	na
Agricultural gross output	4.5	2.2	2.1	3.0	3.8	3.0	na
Employment [2]			(Percentage change)				
Labour force (end-year)	-1.8	-3.0	-12.2	-0.3	-0.8	0.9	na
Employment (end-year)	0.2	-13.8	0.0	0.7	-0.4	0.9	na
			(In per cent of labour force)				
Unemployment (end-year)	16.8	14.5	15.8	15.0	14.5	14.7	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	0.1	3.1	5.2	2.4	2.9	2.3	2.3
Consumer prices (end-year)	4.2	3.5	1.7	3.3	2.2	2.0	2.1
Producer prices (annual average)	5.0	-5.8	6.5	6.7	12.4	2.5	na
Producer prices (end-year)	na	-4.0	11.2	5.0	12.3	2.4	na
Gross average monthly earnings in economy (annual average)	19.7	24.7	11.7	10.0	6.0	7.3	na
Government sector			(In per cent of GDP)				
General government balance	-9.2	-8.5	-7.2	-4.3	-5.1	-3.6	-4.1
General government expenditure	31.8	31.5	31.0	27.7	28.8	26.7	na
General government debt	71.1	66.6	64.7	59.1	55.9	54.8	na
Monetary sector [3]			(Percentage change)				
Broad money (M2, end-year)	10.4	15.4	5.3	9.2	10.8	8.4	na
Domestic credit (end-year)	8.6	4.1	6.7	11.0	7.7	13.2	na
			(In per cent of GDP)				
Broad money (M2, end-year)	49.6	51.7	50.9	49.2	50.2	49.2	na
Interest and exchange rates			(In per cent per annum, end-year)				
Refinancing rate [4]	10.8	7.0	8.5	6.5	5.3	5.0	na
Treasury bill rate (3-month maturity)	10.8	8.0	11.2	7.4	6.2	5.5	na
Deposit rate (1 year)	6.9	6.9	8.0	5.5	4.5	3.0	na
Lending rate (1 year) [5]	21.2	15.3	14.6	11.8	11.0	12.0	na
			(Leks per US dollar)				
Exchange rate (end-year)	142.8	135.9	134.0	106.4	92.6	98.1	na
Exchange rate (annual average)	143.9	143.6	140.2	121.3	102.8	98.1	na
External sector			(In millions of US dollars)				
Current account	-273	-261	-435	-470	-355	-574	-710
Trade balance	-821	-1,027	-1,155	-1,336	-1,586	-1,868	-2,160
Merchandise exports	255	305	330	447	603	671	740
Merchandise imports	1,076	1,332	1,485	1,783	2,189	2,539	2,900
Foreign direct investment, net	143	204	135	178	332	265	350
Gross reserves, excluding gold (end-year)	608	737	860	1,026	1,374	1,459	na
External debt stock	1,640	1,200	1,180	1,420	1,673	1,747	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.8	4.9	5.0	4.8	5.1	4.5	na
			(In per cent of exports of goods and services)				
Debt service	4.0	4.1	6.8	5.0	4.1	4.3	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	3.1	3.1	3.2	3.2	3.2	3.2	na
GDP (in billions of leks)	533	590	631	714	776	857	937
GDP per capita (in US dollars)	1,190	1,312	1,409	1,858	2,359	2,730	na
Share of industry in GDP (in per cent)	8.2	7.8	7.7	7.5	7.3	7.1	na
Share of agriculture in GDP (in per cent)	32.2	32.2	28.4	27.6	26.7	26.3	na
Current account/GDP (in per cent)	-7.4	-6.3	-9.7	-8.0	-4.7	-6.6	-7.5
External debt - reserves (in US$ million)	1,032	463	320	394	299	288	na
External debt/GDP (in per cent)	44.3	29.2	26.2	24.1	22.2	20.0	na
External debt/exports of goods (in per cent)	232.4	142.9	128.9	121.7	104.1	94.5	na

Armenia

Key challenges

- Consistent improvements in the business environment, particularly relating to the establishment of a level playing field for market entry and tax collection, should encourage diversification in the economy and foster sustainable growth.
- Improvements in corporate governance, transparency and enhanced competition in the banking sector are needed to promote access to finance and investment.
- In the absence of faster productivity gains, continuing appreciation of the Armenian dram threatens the competitiveness of the economy.

Country data	
Population (in millions)	**3.2**
Area ('000 sq km)	**29.8**
GDP (in billion US$, 2005)	**4.9**
GDP per capita in 2005 at current international US$ (PPP)	**4,658**
National currency	**Armenian dram**

Progress in structural reform

Liberalisation and privatisation

The privatisation of state-owned assets continued in 2005, but at a slower pace. Sixty-four companies were privatised, 27 by tender or auction, and total privatisation receipts amounted to US$ 3 million. Only eight enterprises were sold in the first half of 2006, netting US$ 0.6 million. However, in June 2006 parliament approved the privatisation programme for 2006–07, targeting some 45 medium and large-sized enterprises. This could accelerate the pace of asset transfers, including land and unfinished buildings.

Business environment and competition

Enterprise surveys rank Armenia among the top CIS countries in terms of business environment. The country also holds the best ranking among CIS countries in Transparency International's 2005 Corruption Perceptions Index. Nevertheless, a recent EBRD survey of enterprises, as well as the World Bank's Doing Business report, highlight only modest improvements in the business environment over the past year. These were largely confined to the elimination of some business registration and licensing procedures. Moreover, implementation of the anti-corruption programme has been uneven and the level of corruption remains high compared with more advanced transition countries.

Barriers to market entry, particularly informal obstacles, for both foreign and new domestic firms are considerable and the application of competition policy is inconsistent. For example, in accordance with a practice of publishing information on tax payers in the country introduced at the beginning of 2005, foreign-owned firms and joint ventures consistently top the list of Armenia's largest tax payers. By contrast, many of the largest domestically owned firms pay little or no tax at all. Many domestic enterprises remain outside the taxation system, while others hold lucrative de facto monopolies on the import of basic commodities. Tax exemptions for certain sectors, such as the booming construction industry, remain widespread. This situation undermines the competitiveness of the Armenian economy, weakens entrepreneurial initiative, distorts the allocation of resources in the economy and therefore constrains growth.

Infrastructure

The telecommunications industry developed rapidly in 2005–06. Although the fairness of the award in 2005 of the second mobile licence was questioned, greater competition quickly led to a decrease in tariffs and a genuine boom in the telecommunications sector. The number of mobile subscribers increased in 2005 by almost 60 per cent. Although Armentel still enjoys a monopoly on fixed lines and remains the leader in the mobile market, its owner – OTE of Greece – has announced its intention to sell the assets. As of September 2006 it was in advanced negotiations with a number of interested operators.

From 1 April 2006 the price of gas supplied by Russia's Gazprom to Armenia was increased to US$ 110 per 1,000 cubic metres (mcm) from US$ 56 per mcm. The government decided to cushion the impact on the economy by subsidising end-users. To finance the subsidies until 2008, the fifth block of the Hrazdan power station (under construction) was sold to Gazprom for an estimated US$ 188 million, giving the company an even larger presence in the Armenian energy market. The first section of a new gas pipeline between Iran and Armenia, which could provide a viable alternative gas source for the country if issues of ownership, access and pricing are regulated effectively, is due for completion at the end of 2006. The sale of Armenia's electricity distribution networks by British Midland Resources to an affiliate of Russia's RAO UES in September 2005 has led to concerns about the extent of vertical integration in the power sector. RAO UES already owns most of the Hrazdan thermal power plant, as well as hydroelectric capacity, and also manages the financial flows of the Medzamor nuclear power plant.

Financial sector

Regulation and supervision of the entire financial sector was unified under the Central Bank of Armenia (CBA) in 2005. Recent measures adopted in late 2005 and 2006, such as strengthened creditor rights, clearer procedures for collateral registration and foreclosure, and guidelines for monitoring beneficiary owners beyond the licensing stage, have improved the lending environment. Nevertheless, weaknesses in corporate governance and ownership transparency persist, lending is insufficiently monitored, and competition in the banking sector remains weak. Although lending to the private sector increased by 33 per cent in nominal terms in 2005, the level of access to finance remains among the lowest in the region (with an 8.2 per cent ratio of domestic credit to GDP).

Macroeconomic performance

Real economy

The economy grew by a remarkable 14.0 per cent in real terms in 2005, and exceeded the 1989 output level for the first time. The construction sector continued to drive GDP growth (with construction output rising by 35 per cent) and has become the largest sector of the Armenian economy. On the demand side, investment grew by 26.7 per cent, largely on the back of the construction sector, while remittances from Armenian workers abroad and increased government spending on social programmes boosted consumption, which rose by 10.8 per cent. Despite a 1 per cent decline in industrial production in the first half of 2006, GDP grew by 11.9 per cent.

Economic policies

The state budget deficit was estimated at 2.6 per cent of GDP in 2005. Fiscal policy is set to loosen further in 2006, mainly because of substantial rises in expenditure on social and infrastructure programmes to meet poverty reduction targets. Despite significant nominal increases in tax revenues in 2005, the high incidence of tax evasion and exemptions are reflected in the persistently low ratio of tax revenue to GDP (14.4 per cent). The CBA is shifting its main policy objective from monetary targeting to inflation targeting in 2006. Annual average inflation for 2005 was only 0.6 per cent, well within the CBA target of 3 per cent. However, high energy costs have strengthened inflationary pressures in 2006, with year-on-year inflation of 7.2 per cent recorded in August.

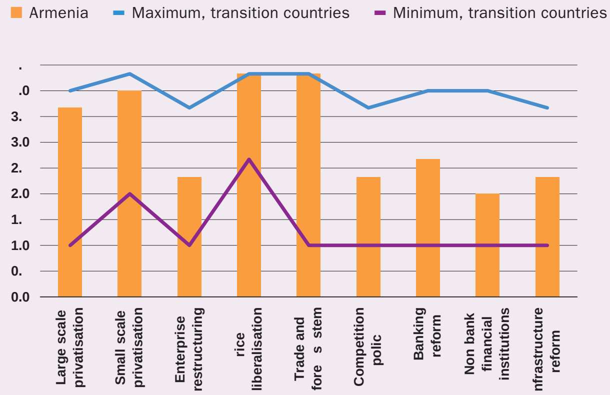
External sector

While exports in US dollar terms increased faster than imports in 2005, the reverse occurred during January to July 2006. This was largely due to higher energy costs, demand for consumer goods and a decline in precious stone exports. The large trade deficit has continued to be offset by substantial flows of remittances. According to a CBA study, total private transfers (mainly remittances from Russia), including those cash transfers not captured by the balance of payments statistics, amounted to US$940 million in 2005, or 19 per cent of GDP. The capital account recorded a modest increase in foreign direct investment in 2005, sufficient to cover the 4.2 per cent current account deficit. Strong foreign currency inflows in 2005 and early 2006 have led to both nominal and real appreciation of the dram against the US dollar and other currencies. Public external debt declined to US$1.1 billion, leading to a further decline in the ratio of external debt to GDP to 22.8 per cent by the end of 2005.

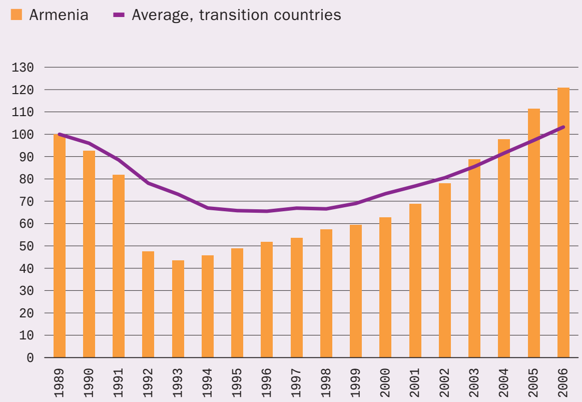
Outlook and risks

Strong economic growth is expected to continue in the short term, particularly in construction and services, driven by remittances and supported by large bilateral grant flows. Nevertheless, continued currency appreciation, vulnerability to commodity prices, and dependence on soft finance from donors and multilateral institutions pose significant risks in the medium term. Furthermore, the political situation in the region remains volatile, and the restrictions on intra-regional trade threaten access to key markets and impose higher transport costs. Substantial progress in structural reforms to diversify investment and expand the productive base of the economy is required to generate sustainable growth over the medium and long term.

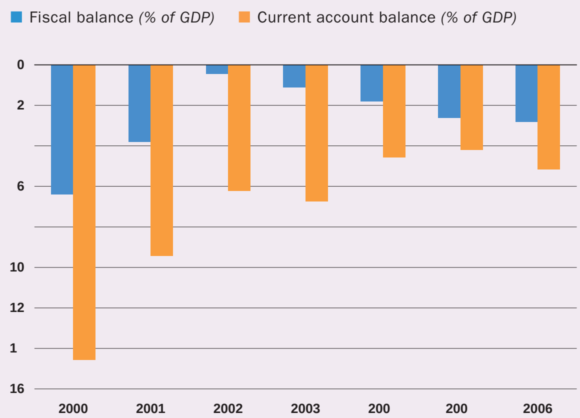
Transition indicators, 2006



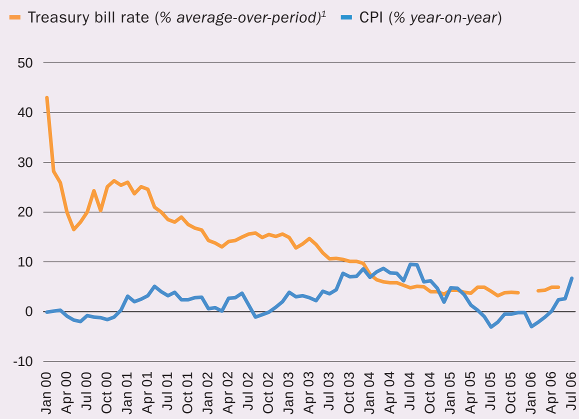
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



[1] No data available for January 2006.

Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full** Controls on inward direct investment – **no** Interest rate liberalisation – **full** Exchange rate regime – **floating** Wage regulation – **no** Tradability of land – **full except foreigners**	Competition office – **yes** Quality of insolvency law – **medium** Secured transactions law – **malfunctioning** Quality of corporate governance law – **high**	Independent telecoms regulator – **partially** Independent electricity regulator – **partially** Separation of railway infrastructure from operations – **no** Independence of the road directorate – **no** Quality of concession laws – **na** [1]	Capital adequacy ratio – **12 per cent** Deposit insurance system – **yes** Quality of securities market laws – **high** Private pension funds – **no**	Share of population living in poverty – **31.1 per cent** (2003) Government expenditure on health – **1.3 per cent of GDP** Government expenditure on education – **2.4 per cent of GDP** Household expenditure on power and water – **6.8 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)				0 2	0 2	a	a
r a e e r are (per e)	60 0	60 0	0 0	0 0	0	0	0
r a e e r are e pl y e (per e)	0	0	0	6 0	a	a	a
u ge ary u e a urre ra er (per e)	0	0 6	0 6	0	0	0 6	a
S are u ry al e pl y e (per e)			2	a	a	a	a
a ge la ur pr u y u ry (per e)		2 0	6 0	a	a	a	a
e e (per e)	6		2	2 2	22 0	2 2	a
EBRD index of small-scale privatisation					0	0	0
EBRD index of large-scale privatisation	0	0					
EBRD index of enterprise reform	2 0	2 0	2	2	2	2	2
S are a ere pr e (per e)	6	6			0	0	a
u er g a ere pr e a e	0	0	0	0	0	0	a
S are ra e ra u re (per e)			6	0	6	6 2	a
S are ra e (per e)	6	2		6		2	a
ar re e ue (per e p r)	2	2		6	2 0	2	a
EBRD index of price liberalisation							
EBRD index of forex and trade liberalisation	0	0	0				
EBRD index of competition policy	0	2 0	2 0	2 0	2 0	2	2
u er a (re g e)	( )	0 ( )	20 ( )	( )	20 ( )	2 (0)	a
A e are a e e a (per e)		0 0	0 0	0 0	0 0	0 0	a
A e are re g e a (per e)		6	2		6		a
per r g l a (per e al l a)	2	6			2	2	a
e re pr a e e r (per e)		6 0			6	0	a
e re u e l (per e)	a	a			2 6		a
r gage le g (per e)	a	a	a	a	a	0	a
S ar e ap al a (per e)		2	0	0	0	0	a
S ra g lu e (per e ar e ap al a)	0 0	6	6		0	6	a
ur ua e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
EBRD index of banking sector reform	2	2	2	2	2	2	2
EBRD index of reform of non-bank financial institutions	2 0	2 0	2 0	2 0	2 0	2 0	2 0
e l e (le) pe e ra ra e (per 00 a a)	(0 6)	(0)	(2)	6 ( )	(6)	(0 6)	a
er e pe e ra ra e (per 0 000 a a)	6			6	6	6	a
a l ay la ur pr u y (00)	2		20 6	2	2	26	a
e e al ele r y ar (S)	6						a
A erage lle ra e ele r y (per e) [2]	0					0	a
per u e ergy u e (S llar per g e)	6		0	2	a	a	a
EBRD index of infrastructure reform	2	2	2	2	2	2	2
Electric power							
Railways	2 0	2 0	2 0	2 0	2 0	2 0	2 0
Roads	2	2	2	2	2	2	2
Telecommunications	2	2	2	2	2	2	2
Water and waste water	2 0	2 0	2 0	2 0	2 0	2 0	2 0

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	5.9	9.6	13.2	13.9	10.1	14.0	8.5
Private consumption	8.3	7.5	9.0	6.9	10.2	na	na
Public consumption	2.8	4.3	2.2	14.1	16.1	na	na
Gross fixed capital formation	16.2	5.3	33.1	33.7	12.4	na	na
Exports of goods and services	16.6	20.8	26.3	23.2	3.7	na	na
Imports of goods and services	5.1	1.2	9.0	31.0	3.0	na	na
Industrial gross output	6.5	3.8	14.4	15.3	2.1	7.5	na
Agricultural gross output	-2.4	11.6	4.5	4.0	14.5	11.2	na
Employment			(Percentage change)				
Labour force (end-year)	-1.0	-2.5	-12.2	-0.6	-0.5	-2.6	na
Employment (end-year)	-1.6	-1.0	-12.5	0.5	-0.1	-0.5	na
			(In per cent of labour force)				
Unemployment (annual average) [1]	11.7	10.4	10.8	10.1	9.4	7.4	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	-0.8	3.1	1.1	4.7	7.0	0.6	3.2
Consumer prices (end-year)	0.4	2.9	2.0	8.6	1.9	-0.2	6.5
Producer prices (annual average)	0.8	-0.4	2.5	5.9	21.7	7.9	na
Producer prices (end-year)	0.4	-3.6	0.9	21.1	25.3	-4.0	na
Gross average monthly earnings in economy (annual average)	15.0	10.7	12.2	21.7	22.8	29.5	na
Government sector [2]			(In per cent of GDP)				
General government balance	-6.4	-3.8	-0.4	-1.1	-1.8	-2.6	-2.8
General government expenditure	25.9	20.9	19.3	18.9	17.2	17.7	na
General government debt	46.8	45.3	46.6	40.9	32.6	24.3	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	39.7	4.3	34.0	10.4	22.3	27.8	na
Domestic credit (end-year)	12.3	-9.8	-8.1	-9.6	41.1	54.4	na
			(In per cent of GDP)				
Broad money (M2, end-year)	14.7	13.4	15.6	14.4	15.1	16.4	na
Interest and exchange rates			(In per cent per annum, end-year)				
Refinancing rate	25.0	15.0	13.5	7.0	3.8	3.5	na
Money market rate [3]	18.6	19.4	12.3	7.5	3.1	4.3	na
Deposit rate [4]	18.1	14.9	9.5	6.9	4.4	6.5	na
Lending rate [4]	28.6	27.7	23.4	20.8	18.2	17.3	na
			(Drams per US dollar)				
Exchange rate (end-year)	552.2	561.8	584.9	566.0	486.3	450.2	na
Exchange rate (annual average)	539.5	555.1	573.4	578.8	533.5	457.8	na
External sector			(In millions of US dollars)				
Current account	-278	-200	-148	-189	-162	-204	-290
Trade balance	-463	-420	-369	-434	-458	-585	-771
Merchandise exports	310	353	514	696	738	981	1,030
Merchandise imports	773	773	883	1,130	1,196	1,566	1,801
Foreign direct investment, net	104	70	111	121	217	255	220
Gross reserves, excluding gold (end-year)	318	321	425	510	576	755	na
External debt stock	860	906	1,026	1,098	1,183	1,099	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.0	3.9	4.6	4.4	4.6	4.6	na
			(In per cent of exports of goods and services)				
Debt service	10.7	9.5	10.1	11.4	7.2	4.4	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	3.3	3.2	3.2	3.2	3.2	3.2	3.2
GDP (in billions of drams)	1,031	1,176	1,362	1,625	1,896	2,228	2,401
GDP per capita (in US dollars)	582	659	740	874	1,106	1,499	na
Share of industry in GDP (in per cent)	21.9	20.5	18.9	19.9	19.7	na	na
Share of agriculture in GDP (in per cent)	27.0	24.9	23.4	21.3	22.5	na	na
Current account/GDP (in per cent)	-14.6	-9.4	-6.2	-6.7	-4.5	-4.2	-5.1
External debt - reserves (in US$ million)	542	585	601	588	607	344	na
External debt/GDP (in per cent)	45.0	42.8	43.2	39.1	33.3	22.6	na
External debt/exports of goods and services (in per cent)	192.5	167.9	147.1	121.5	120.1	83.0	na

1 Registered unemployed. Unofficial estimates indicate substantially higher unemployment.

2 Central government account only.

3 Average of one to three-month Treasury bills.

4 Weighted average rate for maturities of 15 days to less than one year.

Azerbaijan

Key challenges

- To improve the business climate and attract investment in the non-oil sector, the government needs to strengthen the legal and regulatory framework for competition and implement anti-corruption legislation effectively.
- Encouraging greater private sector participation would help to advance the development of the financial sector and strengthen competition among banks.
- With sizeable oil revenues likely to continue, growing inflationary pressures need to be contained through prudent monetary and fiscal expenditure policies as infrastructure modernisation and the high incidence of poverty are addressed.

Country data

Population (in millions)	**8.4**
Area ('000 sq km)	**86.6**
GDP (in billion US$, 2005)	**12.8**
GDP per capita in 2005 at current international US$ (PPP)	**5,600**
National currency	**Manat**

Progress in structural reform

Business environment and competition

The complex tax and customs system, bureaucratic delays and the high level of corruption continue to be major obstacles to private enterprise, particularly in the non-oil sector. Government expropriation of investments in the non-oil sector has also undermined investor confidence. Although the anti-corruption law became effective in January 2005, implementation has been slow. Two state-owned banks – International Bank of Azerbaijan (IBA) and Kapital Bank – continue to dominate the banking sector. Despite some efforts to revive their privatisation, no significant progress had been made as of September 2006. The state-owned banks benefit from credit lines for subsidised funding to enterprises through the National Fund for the Support of Entrepreneurship. As a result, several private commercial banks have seen their lending activities decrease.

Reforms to improve the business environment have gathered pace, including efforts to simplify registration procedures for businesses. New investment and competition laws are also under consideration. The government has made some progress with the implementation of International Financial Reporting Standards (IFRS) and National Accounting Standards, following the adoption of the accounting law in February 2005. A new decree from the Finance Ministry requires that 20 "public interest" entities, including state-owned enterprises, adopt IFRS by July 2007 (six months earlier than envisaged by the law).

Infrastructure

The government has taken initial steps towards improving the regulatory framework. In December 2005 a presidential decree established the Tariff Council as a separate budgetary agency responsible for the regulation of prices and tariffs for about 35 goods and services. These goods and services, currently regulated by the state, include gas, electricity and oil products. This is considered an intermediary step before establishing separate regulating bodies in the different sectors. One of the first acts of the Tariff Council was to double the retail prices of diesel, kerosene and domestic boiler fuel in January 2006, continuing the government's policy of bringing domestic energy prices closer into line with world market levels.

The Baku-Tbilisi-Ceyhan (BTC) oil pipeline was formally inaugurated on 13 July 2006, following the completion of its construction in April 2005. The construction of the South Caucasus (SC) gas pipeline is expected to be completed by the end of 2006.

A new law on telecommunications came into force in August 2005, setting out rules for licensing and tariff implementation in the sector. The law does not, however, define the policy for market liberalisation or the procedure for setting up an independent regulatory body. Competition in the sector is still limited, as the state-owned company Aztelecom has a monopoly on fixed lines and a range of other services. Mobile telecommunications are, however, developing rapidly, with an estimated 280 mobile phones per 1,000 inhabitants at the end of March 2006. The government has announced its intention to sell its 35.7 per cent stake in Azercell, the country's largest mobile phone company. Licences granted at the end of 2005 to foreign mobile operators Catel and Azerfon were expected to increase competition. However, the transparency of the licensing process has been subject to criticism, with the telecommunications ministry holding significant interests in both operators. Regulatory uncertainty also persists as the process of separation of the regulatory and commercial functions of the ministry has been delayed.

Social sector

The proportion of the population below the extreme poverty line (equivalent to about US$43 per capita a month) fell to 29.3 per cent in 2005 from about 45 per cent in 2003, according to a Household Budget Survey. The government is in the process of preparing the new State Programme on Poverty Reduction and Sustainable Development, intended to halve poverty by 2015. To mitigate the effects of higher utility tariffs on those with low incomes, the government is establishing a system of targeted social assistance. Based on eligibility criteria, it is consolidating various existing payments into a single targeted family poverty benefit. The system became operational on a pilot basis in July 2006.

A law increasing the minimum monthly pension benefit over the next few years was passed by parliament in March 2006. The minimum monthly pension is set at US$45 for 2006, rising to about US$65 in 2007. Also in early 2006, the government started a registration process for workers and employers as part of ongoing reform envisaging the introduction of a mandatory two-tier pension system based on individual accounts from January 2007.

Macroeconomic performance

Real economy

Following real GDP growth of 26.4 per cent in 2005, the economy grew by 36.3 per cent year-on-year in the first half of 2006. GDP growth was led by the oil sector, the output of which rose by over 52 per cent during the first seven months of the year. The oil sector accounts for about 42 per cent of GDP. The non-oil sector increased by 10 per cent in the January-June period, partly reflecting the spill-over effect of rising oil income on the transport, construction and telecommunications sectors. However, agriculture grew by only 3.6 per cent over the same period.

Economic policies

Budget revenues grew by 76.2 per cent in the first six months of 2006 as a result of surging oil revenue, leading to a fiscal surplus of 2.6 per cent of GDP despite increases in infrastructure spending. In May the government revised the budget for 2006 – 90 per cent larger than in 2005 – allocating significantly more funding for infrastructure development and military spending. The large increase in oil exports, growth in domestic demand and continued wage increases have exerted upward pressure on monetary growth. The result has been an increase in inflation, which rose to about 10 per cent in July 2006 from 5.5 per cent at the end of 2005. In response, the National Bank raised its refinancing rate from 9 per cent to 9.5 per cent in July 2006. The real exchange rate appreciated by about 10.9 per cent year-on-year in July 2006.

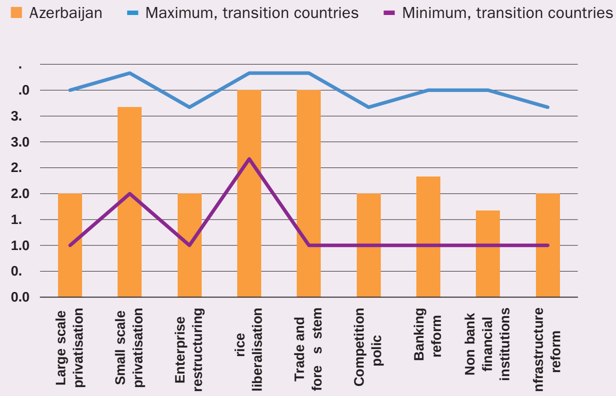
External sector

As oil exports surged in the first half of 2006 (with total exports more than doubling), import growth (associated mostly with oil and gas development projects) decreased by 5.8 per cent as major capital investments were completed. This situation led to a large trade surplus of about 4 per cent of estimated annual GDP during the same period compared with a deficit of 6 per cent a year earlier. The government has continued to pursue its strategy of reducing external debt. The ratio of gross public external debt to GDP had declined to 13.1 per cent at the end of 2005 compared with 18.6 per cent in 2004.

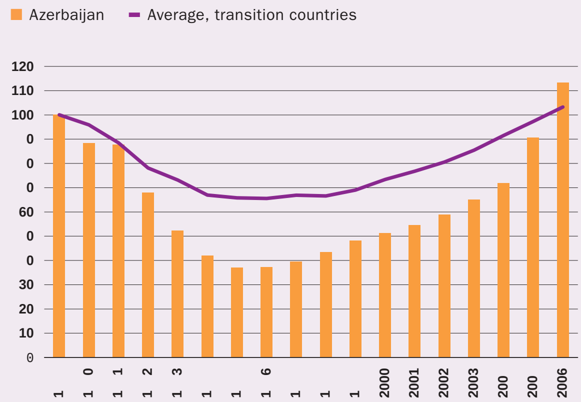
Outlook and risks

With the inauguration of the BTC oil pipeline and the imminent opening of the South Caucasus gas pipeline, increased oil and gas export capacity is expected to result in a large current account surplus in the medium term. GDP growth of more than 20 per cent per year is forecasted. However, the economy remains highly dependent on the energy sector and diversification is a priority for long-term sustainability. Given the spiralling oil export revenues and the limited monetary policy instruments available to the authorities, controlling inflation and protecting the currency against excessive real appreciation pose major challenges. At the same time, the government needs to address infrastructure modernisation and the high levels of poverty.

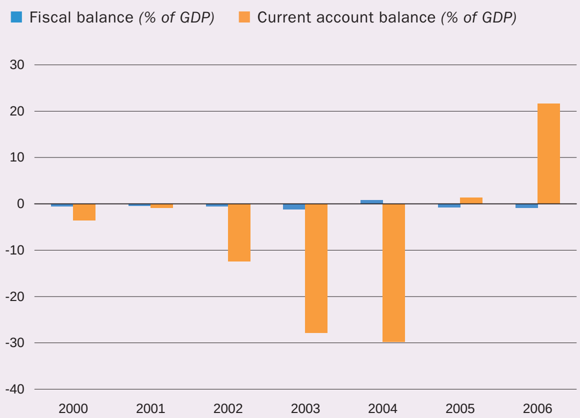
Transition indicators, 2006



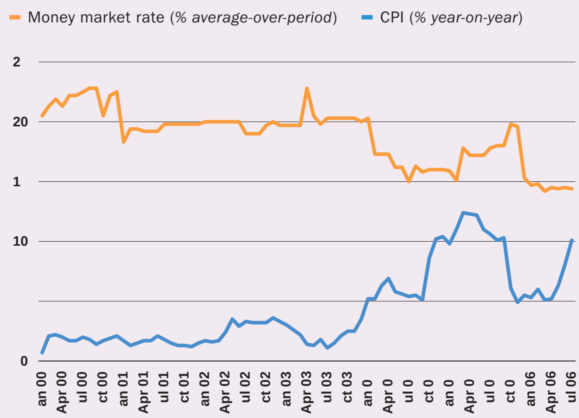
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **yes**

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradability of land – **limited de jure**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **malfunctioning**

Quality of corporate governance law – **very low**

Infrastructure

Independent telecoms regulator – **no**

Independent electricity regulator – **no**

Separation of railway infrastructure from operations – **no**

Independence of the road directorate – **partially**

Quality of concession laws – **na** [1]

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **no**

Quality of securities market laws – **low**

Private pension funds – **no**

Social reform

Share of population living in poverty – **<2 per cent** (2002) [2]

Government expenditure on health – **1.6 per cent of GDP**

Government expenditure on education – **4.9 per cent of GDP**

Household expenditure on power and water – **3.5 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)		2 0	2	2 6	0	2	a
r a e e r are (per e)	0	60 0	60 0	60 0	60 0	60 0	60 0
r a e e r are e pl y e (per e)	6	66 6	6 0	6	6	6	a
u ge ary u e a urre ra er (per e)	6	6 6			0		a
S are u ry al e pl y e (per e)	6	6 6	6	6	0	0	a
a ge la ur pr u y u ry (per e)	0	6				2	a
e e (per e)	20 6	20	6	6	2	6	a
EBRD index of small-scale privatisation							
EBRD index of large-scale privatisation		2 0	2 0	2 0	2 0	2 0	2 0
EBRD index of enterprise reform				2 0	2 0	2 0	2 0
S are a ere pr e (per e)	6 0	6 0	6 0	6 0	0	a	a
u er g a ere pr e a e	0	0	0	0	0	0	a
S are ra e ra u re (per e)	2		0	0 0	6	6	a
S are ra e (per e)	6	6	66 2			0	a
ar re e ue (per e p r)		2		6 0			a
EBRD index of price liberalisation	0	0	0	0	0	0	0
EBRD index of forex and trade liberalisation						0	0
EBRD index of competition policy	2 0	2 0	2 0	2 0	2 0	2 0	2 0
u er a (re g e)	( )	( )	6 ( )	6 ( )	( )	( )	a
A e are a e e a (per e)	60		62 0		6	2	a
A e are re g e a (per e)		6		2		6 6	a
per r g l a (per e al l a)		20		6			a
e re pr a e e r (per e)	a	a	6			6 2	a
e re u e l (per e)	a	0		2 0	0		a
r gage le g (per e)	a	a	a	a	a	a	a
S ar e ap al a (per e)	0	6	a	a	a	a	a
S ra g lu e (per e ar e ap al a)	a	a	a	a	a	a	a
ur ua e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
EBRD index of banking sector reform	2 0	2	2	2	2	2	2
EBRD index of reform of non-bank financial institutions							
e l e (le) pe e ra ra e (per 00 a a)	(2)	0 6 ( )	2 (6)	(2)	2 ( )	0 (26)	a
er e pe e ra ra e (per 0 000 a a)		6		0	0	0	a
a l ay la ur pr u y (00)	2	2	2			2	a
e e al ele r y ar (S)	2	2	2 0	2 0	2 0	2 2	a
A erage lle ra e ele r y (per e)		0		2	2	26	a
per u e ergy u e (S llar per g e)		2 0	2 2	2	a	a	a
EBRD index of infrastructure reform					2 0	2 0	2 0
Electric power	2 0	2 0	2	2	2	2	2
Railways	2	2	2	2	2	2	2
Roads	2	2	2	2	2	2	2
Telecommunications	0	0	0	0			
Water and waste water							

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	6.2	6.5	8.1	10.4	10.2	26.4	25.0
Private consumption	12.1	9.9	13.1	6.0	6.9	21.7	na
Public consumption	2.2	4.9	0.5	11.1	4.6	19.7	na
Gross fixed capital formation	2.6	20.6	64.8	72.6	13.0	14.6	na
Exports of goods and services	na	34.1	14.0	9.2	-9.0	70.9	na
Imports of goods and services	na	33.0	48.4	45.6	-9.5	21.9	na
Industrial gross output	6.9	5.1	3.6	6.1	5.7	33.5	na
Agricultural gross output	12.1	11.1	6.4	5.6	7.6	7.1	na
Employment			(Percentage change)				
Labour force (end-year)	0.0	0.4	0.4	0.6	0.5	2.3	na
Employment (end-year)	-0.1	0.3	0.3	0.5	0.5	2.3	na
			(In per cent of labour force)				
Unemployment (end-year)	1.1	1.3	1.3	1.4	1.5	1.4	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	1.8	1.5	2.8	2.2	6.7	9.6	8.5
Consumer prices (end-year)	2.2	1.5	3.3	3.6	10.4	5.5	11.0
Producer prices (annual average)	27.4	1.8	-2.3	16.1	12.9	10.6	na
Producer prices (end-year)	14.5	-4.4	-5.2	11.2	21.9	10.8	na
Gross average monthly earnings in economy (annual average)	20.2	17.3	21.3	21.4	26.2	41.7	na
Government sector			(In per cent of GDP)				
General government balance [1]	-0.6	-0.4	-0.5	-1.2	0.8	-0.7	-0.9
General government expenditure	20.8	18.7	27.7	28.3	26.0	23.5	na
General government debt	20.3	20.9	20.5	20.0	18.6	13.3	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	15.9	7.7	15.6	27.9	31.9	15.8	na
Domestic credit (end-year)	13.5	-38.1	85.9	26.1	39.5	50.2	na
			(In per cent of GDP)				
Broad money (M2, end-year)	6.9	6.6	6.7	7.3	8.0	6.6	na
Interest and exchange rates			(In per cent per annum, end-year)				
Refinance rate (6 months)	10.0	10.0	7.0	7.0	7.0	7.0	na
Interbank interest rate (3 months) [2]	22.5	19.8	19.7	20.3	16.6	na	na
Deposit rate	12.9	8.5	8.7	9.5	9.2	na	na
Lending rate	19.7	19.7	17.4	15.5	15.7	na	na
			(Manats per US dollar)				
Exchange rate (end-year) [3]	0.91	0.96	0.98	0.98	0.98	0.92	na
Exchange rate (annual average) [3]	0.89	0.93	0.97	0.98	0.98	0.95	na
External sector			(In millions of US dollars)				
Current account	-187	-49	-770	-2,020	-2,586	167	4,197
Trade balance	260	581	482	-98	162	3,309	6,717
Merchandise exports	1,799	2,046	2,305	2,625	3,743	7,659	11,826
Merchandise imports	1,539	1,465	1,823	2,723	3,581	4,350	5,109
Foreign direct investment, net	149	299	1,048	2,353	2,351	458	-2,124
Gross reserves, excluding gold (end-year) [4]	680	725	721	803	1,075	1,181	na
External debt stock	1,044	1,154	2,603	3,064	3,808	6,720	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.0	4.1	2.8	2.0	2.0	2.1	na
			(In per cent of exports of goods and services)				
Debt service	4.6	4.9	4.4	5.2	3.6	1.3	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	8.0	8.1	8.2	8.3	8.3	8.4	na
GDP (in millions of manats)	4,718	5,316	6,062	7,147	8,530	12,076	17,594
GDP per capita (in US dollars)	659	705	760	881	1,051	1,521	na
Share of industry in GDP (in per cent)	36.0	37.6	37.4	37.3	37.8	43.0	na
Share of agriculture in GDP (in per cent)	15.9	14.8	13.8	12.2	11.3	9.0	na
Current account/GDP (in per cent)	-3.5	-0.9	-12.3	-27.8	-29.8	1.3	21.6
External debt - reserves (in US$ million)	364	429	1,882	2,261	2,733	5,539	na
External debt/GDP (in per cent)	19.8	20.2	41.7	42.1	43.9	52.6	na
External debt/exports of goods and services (in per cent)	50.7	49.4	97.6	100.3	89.9	81.1	na

1 General government consolidates all levels of government, except for municipalities and state-owned enterprises, and includes the State Oil Fund and other extra-budgetary funds.

2 90-day interbank offer rate in manats, nominal.

3 In January 2006 Azerbaijan introduced a new currency denomination. One new manat is equal to 5,000 old manat. All data are retrospectively converted into new manat.

4 By end-December 2005 there were additional foreign exchange assets of approximately US$1.4 billion in the State Oil Fund.

Belarus

Key challenges

- To enhance the role of the private sector, it is necessary to facilitate the entry of new businesses and accelerate both the corporatisation and privatisation of existing enterprises.
- Efficient financial intermediation requires the phasing out of support to state-owned banks, the elimination of directed lending and the creation of a level playing field for state-owned and private banks.
- Monetary policy should remain cautious, to maintain the exchange rate and price stability. Greater exchange rate flexibility may be needed in the future to counter energy price fluctuations and other external shocks.

Country data	
Population (in millions)	**9.8**
Area ('000 sq km)	**207.6**
GDP (in billion US$, 2005)	**29.6**
GDP per capita in 2005 at current international US$ (PPP)	**7,903**
National currency	**Belarussian rouble**

Progress in structural reform

Liberalisation and privatisation

The privatisation process remains stalled. Although corporatisation has continued, the majority of incorporated enterprises remain state-owned. Shares in nine enterprises were sold in 2005, out of 203 prepared for privatisation. Another 30 enterprises have been prepared for sale in 2006, but none were sold by September. At the same time, a presidential decree to re-nationalise 82 formerly privatised loss-making enterprises was signed in August 2006.

In early 2006 Russia's Gazprom announced that it would increase gas charges to Belarus from 2007, bringing them in line with European price levels. This would represent an almost five-fold increase over the current price of US$47 per 1,000 cubic metres of gas. It is believed this increase may be linked with ongoing negotiations regarding the shared ownership of gas transportation networks between Gazprom and the Belarussian government. As of September 2006, the parties had not been able to reach an agreement on several long-standing issues, including the value of the state-owned gas transmission company Beltransgaz. The Dutch bank ABN Amro was appointed in September 2006 to value Beltransgaz and other Belarussian assets of potential interest to Gazprom.

Business environment and competition

The economy remains heavily regulated. The government imposes various targets on enterprises, relating for example to wage growth, production and exports. Regulation often takes the form of "recommendations", such as recommended lending rates for banks (including those under private ownership) or recommended price increases.

The authorities have taken steps to improve the business environment. A presidential decree on business registration issued in April 2006 provides for the simplification of the procedure and is perceived by the business community as an improvement. The government also intends to accelerate the development of the small and medium-sized enterprise (SME) sector by minimising administrative restrictions and improving access to funding, including microfinance. The country's social and economic development programme for 2006-10 sets targets for SME growth (of between 44,000 and 46,000 enterprises), an increase in their share in total sales to 30 per cent, and a rise in their contribution to total employment to around 25 per cent by the end of the period. However, monitoring progress in this area is not straightforward. The concept of a medium-sized enterprise is not clearly defined in Belarus and official statistics cover only small businesses.

Amendments to the Investment Code, adopted in July 2006, abolished some preferential treatment for foreign investors, including the freedom to set prices and a moratorium on legislative changes affecting businesses with foreign capital during five years following their registration. Foreign direct investment remains low, with inflows of only US$303 million in 2005 (equivalent to about 1 per cent of GDP).

Financial sector

Private participation in the financial sector is limited. Priorbank remains the largest privately owned bank in Belarus in terms of capital and assets. There are signs of increasing competition, however, especially in the areas of advanced consumer products and SME lending. Some state-owned banks have been expanding into new sectors and products. However, loans to priority enterprises and sectors under government direction continue to account for a large share of their portfolios.

Although Belarus does not yet have a sovereign rating, major state-owned Belarussian banks (Belarusbank, Belagroprombank and Belpromstroibank) and Belgazprombank (majority owned by Gazprom) are rated by Fitch. In February 2006 all of the foreign currency issuer default ratings for these banks were upgraded from CCC+ to B-. These ratings reflect the government support that the state-owned banks are likely to receive in case of financial difficulties (or in the case of Belgazprombank, from its majority owner).

A series of amendments to the Banking Code were adopted in July 2006, strengthening the supervisory role of the National Bank and streamlining licensing procedures. The amended Code bans direct financing of the budget by the National Bank. However, in exceptional cases the Budget Law or the president may sanction deficit financing.

In August 2006 the president approved amendments abolishing the "golden share" in the banking sector, thereby preventing the government from interfering in the management decisions of privatised banks. There are also plans to remove the current 25 per cent limit on the proportion of foreign capital in the banking system.

Macroeconomic performance

Real economy

Real GDP grew by 9.2 per cent in 2005, reflecting high prices for commodity exports and booming domestic demand. The economy continued to grow strongly at an estimated 9.8 per cent year-on-year in the first eight months of 2006. Investment increased markedly, growing at about 35 per cent over the period, supported by a surge in lending. Private consumption also expanded in line with the continued growth in household incomes. Industrial output rose by 12.7 per cent year-on-year in the first eight months of 2006, surpassing the 10.5 per cent rise registered in 2005, while growth in the agricultural sector decelerated slightly.

Economic policies

The consolidated budget recorded a surplus of 2.2 per cent of GDP in the first half of 2006. Revenues remained buoyant, supported by the favourable external environment. The turnover tax was reduced from 3.9 per cent to 3 per cent of enterprise revenue in 2006, and a new method of value added tax (VAT) distribution between the regions, proportional to population, was introduced. Budgetary expenditures stood at around 48.2 per cent of GDP, slightly below 2005. However, quasi-fiscal activities in the banking sector have increased. Inflation remained moderate at 6.3 per cent year-on-year in August 2006, reflecting not only the stability of the nominal exchange rate and the ongoing remonetisation of the economy, but also the increasing use of administrative price controls.

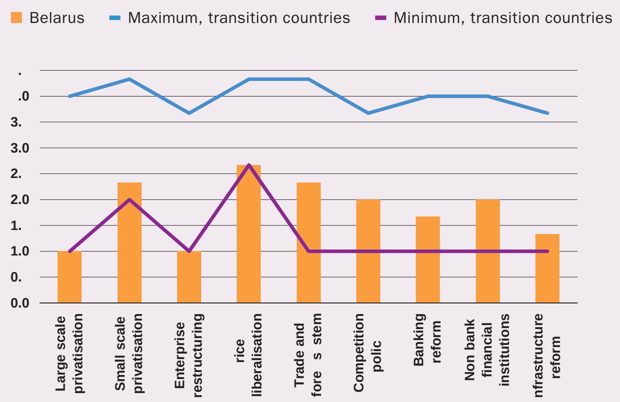
External sector

In 2005 the current account recorded a surplus, for the first time, of 1.5 per cent of GDP. The trade deficit fell to 1.7 per cent of GDP, but widened significantly in the first half of 2006 to an estimated 5.1 per cent. Exports remained buoyant on the back of high commodity prices and strong demand from Russia. However, imports expanded at a much faster rate than exports, reflecting fast growth in real income and an appreciating real exchange rate. The current account is expected to record a deficit for 2006 as a whole, as the projected surplus in services is unlikely to offset the widening trade deficit. Official reserves (excluding gold) fell in the first eight months of 2006 to US$ 910 million, in contrast to 2005 when they registered a sharp 60 per cent increase to US$ 1.1 billion by year-end.

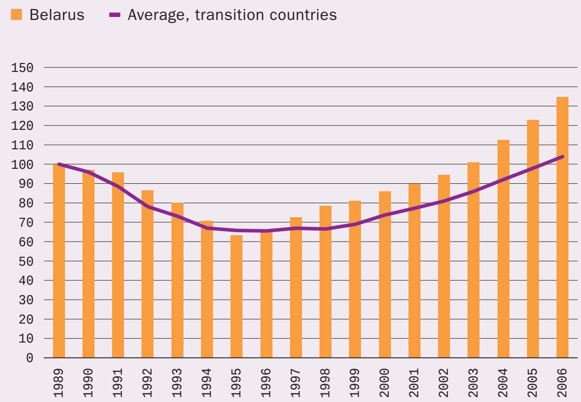
Outlook and risks

Government policies stimulating demand coupled with the favourable external environment should continue to support strong growth in the short term. The long-term outlook depends on progress in market-oriented reforms and further improvements in the business environment. Although macroeconomic stabilisation has advanced in recent years, the economy remains vulnerable to external shocks, such as increases in the price of imported energy or a fall in world commodities prices. With limited capital flows, the widening current account deficit may put further pressure on official reserves (which cover less than one month of imports), jeopardising exchange rate and price stability.

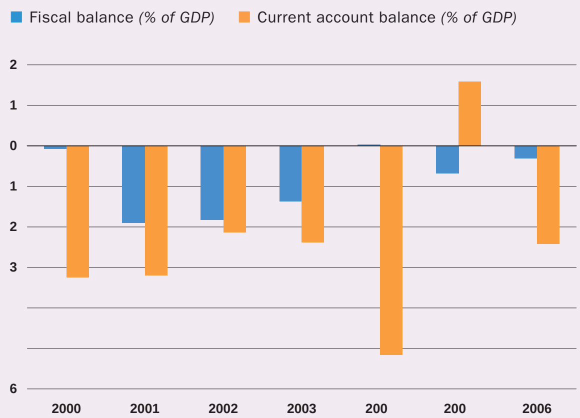
Transition indicators, 2006



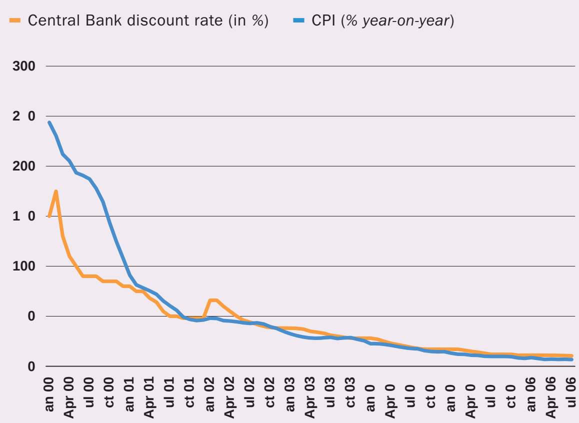
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	**Business environment and competition**	**Infrastructure**	**Financial sector**	**Social reform**
Current account convertibility – **limited** Controls on inward direct investment – **yes** Interest rate liberalisation – **limited de facto** Exchange rate regime – **crawling peg** Wage regulation – **yes** Tradability of land – **limited de jure**	Competition office – **no** Quality of insolvency law – **medium** Secured transactions law – **malfunctioning** Quality of corporate governance law – **very low**	Independent telecoms regulator – **no** Independent electricity regulator – **no** Separation of railway infrastructure from operations – **no** Independence of the road directorate – **no** Quality of concession laws – **very low**	Capital adequacy ratio – **8 per cent**[1] Deposit insurance system – **yes** Quality of securities market laws – **low** Private pension funds – **no**	Share of population living in poverty – **<2 per cent** (2002) Government expenditure on health – **5 per cent of GDP** Government expenditure on education – **6.4 per cent of GDP** Household expenditure on power and water – **4 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)		2	2	2	0		a
r a e e r are (per e)	20 0	20 0	2 0	2 0	2 0	2 0	2 0
r a e e r are e pl y e (per e)	a	a	a	a	a	a	a
u ge ary u e a urre ra er (per e)				6	0		a
S are u ry al e pl y e (per e)	2 2	2	2	22	22 6	22	a
a ge la ur pr u y u ry (per e)			6	2 6	2	0	a
e e (per e)	2	2	22 2	26 6	0	a	a
EBRD index of small-scale privatisation	2 0	2 0	2 0	2	2	2	2
EBRD index of large-scale privatisation	0	0	0	0	0	0	0
EBRD index of enterprise reform	0	0	0	0	0	0	0
S are a ere pr e (per e)	2 0	2 0	2 0	2 0	2 0	2 0	a
u er g a ere pr e a e	6 0	6 0	6 0	0	0	6 0	6 0
S are ra e ra u re (per e)	22	22	26	2	2 0	2	a
S are ra e (per e)	6 0	2		20	2	0	a
ar re e ue (per e p r)[2]		2					0
EBRD index of price liberalisation	2	2	2	2	2	2	2
EBRD index of forex and trade liberalisation		2 0	2	2	2	2	2
EBRD index of competition policy	2 0	2 0	2 0	2 0	2 0	2 0	2 0
u er a (re g e)	(6)	2 ( )	2 (2)	0 ( )	2 ( )	0 ( )	a
A e are a e e a (per e)	66 0	2	6	6 6	0 2	2	a
A e are re g e a (per e)				20	20 0	6 2	a
per r g l a (per e al l a)	2				2		a
e re pr a e e r (per e)		6 0	6	6			a
e re u e l (per e)	a	a	a	a	a	a	a
r gage le g (per e)	a	a	a	a	a	a	a
S ar e ap al a (per e)		2	a	a	a	a	a
S ra g lu e (per e ar e ap al a)	a	a	a	a	a	a	a
ur ua e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
EBRD index of banking sector reform	0	0					
EBRD index of reform of non-bank financial institutions	2 0	2 0	2 0	2 0	2 0	2 0	2 0
e l e (le) pe e ra ra e (per 00 a a)	2 (0)	2 ( )	2 ( )	( )	2 (22)	(2 0)	a
er e pe e ra ra e (per 0 000 a a)	2 0			0	0	0	a
a l ay la ur pr u y (00)				0		0	a
e e al ele r y ar (S)			2	2			a
A erage lle ra e ele r y (per e)	0	a		a	a	a	a
per u e ergy u e (S llar per g e)	2 0	2	2 2	2 2	a	a	a
EBRD index of infrastructure reform							
Electric power	0	0	0	0	0	0	0
Railways	0	0	0	0	0	0	0
Roads	2 0	2 0	2 0	2 0	2 0	2 0	2 0
Telecommunications	2 0	2 0	2 0	2 0	2 0	2 0	2 0
Water and waste water	0	0	0	0	0	0	0

	2000	2001	2002	2003	2004	2005	2006
						Estimate	Projection
Output and expenditure				*ercentage c ange in real terms*			
GDP	5.8	4.7	5.0	7.0	11.4	9.2	9.5
Private consumption	8.0	17.9	11.4	7.4	9.6	14.8	na
Public consumption	5.8	3.1	0.3	0.3	-0.2	0.4	na
Gross fixed capital formation	2.3	-2.3	6.7	22.0	19.7	20.4	na
Exports	na	na	na	na	na	na	na
Imports	na	na	na	na	na	na	na
Industrial gross output	7.8	5.9	4.5	7.1	15.9	10.5	na
Agricultural gross output	9.3	1.8	0.7	6.6	12.6	1.7	na
Employment				*ercentage c ange*			
Labour force (end-year)	-0.1	-0.4	-0.4	-0.5	-1.2	0.0	na
Employment (end-year)	-0.1	-0.6	-0.8	-1.0	-0.5	0.8	na
				n per cent of labour force			
Unemployment (end-year)	2.1	2.3	3.0	3.1	1.9	1.5	na
Prices and wages				*ercentage c ange*			
Consumer prices (annual average)	168.6	61.1	42.5	28.4	18.1	10.3	7.0
Consumer prices (end-year)	107.5	46.1	34.8	25.4	14.4	8.0	6.7
Producer prices (annual average)	185.6	71.8	40.4	37.5	24.1	12.1	na
Producer prices (end-year)	168.0	39.1	42.6	28.1	18.8	10.2	na
Gross average monthly earnings in economy (annual average)	200.9	108.8	53.8	32.5	38.6	33.4	na
Government sector				*n per cent of D*			
General government balance	-0.1	-1.9	-2.1	-1.7	0.0	-0.7	-0.3
General government expenditure	45.9	46.8	46.6	47.7	46.0	49.1	na
General government debt	16.5	13.2	11.0	10.4	8.9	8.4	na
Monetary sector				*ercentage c ange*			
Broad money (M3, end-year)	216.3	66.1	50.3	56.3	44.1	42.2	na
Domestic credit (end-year)	190.8	72.9	55.6	72.2	30.8	33.5	na
				n per cent of D			
Broad money (M3, end-year)	17.2	15.2	15.0	16.8	17.7	19.7	na
Interest and exchange rates				*n per cent per annum end-year*			
Refinancing rate	80.0	48.0	38.0	28.0	17.0	11.0	na
Treasury bill rate (3-month maturity)	na	na	na	na	na	na	na
Deposit rate (1 year) [1]	37.6	34.2	26.9	17.4	12.7	9.2	na
Lending rate (1 year) [2]	67.7	47.0	36.9	24.0	16.9	11.4	na
				Belarussian roubles per dollar			
Official exchange rate (end-year)	1,180.0	1,580.0	1,920.0	2,156.0	2,170.0	2,152.0	na
Official exchange rate (annual average)	876.8	1,390.0	1,790.9	2,051.3	2,160.3	2,153.8	na
External sector				*n millions of dollars*			
Current account	-338	-411	-326	-434	-1,194	434	-860
Trade balance	-884	-807	-914	-1,247	-2,184	-501	-2,000
Merchandise exports	6,641	7,334	7,965	10,076	13,942	16,109	20,500
Merchandise imports	7,525	8,141	8,879	11,324	16,126	16,610	22,500
Foreign direct investment, net	119	96	453	170	163	303	300
Gross reserves, excluding gold (end-year)	350	391	417	462	691	1,107	na
External debt stock [3]	1,265	1,381	1,655	1,615	1,351	1,366	na
				n mont s of imports of goods and services			
Gross reserves, excluding gold (end-year)	0.5	0.5	0.5	0.5	0.5	0.7	na
				n per cent of exports of goods and services			
Debt service	4.2	3.4	4.1	4.6	4.0	4.0	na
Memorandum items				*Denominations as indicated*			
Population (end-year, million)	10.0	10.0	9.9	9.8	9.8	9.8	na
GDP (in billions of Belarussian roubles)	9,134	17,173	26,138	36,565	49,992	63,679	76,701
GDP per capita (in US dollars)	1,043	1,242	1,474	1,810	2,361	3,032	na
Share of industry in GDP (in per cent)	31.0	29.9	29.6	30.8	32.7	32.3	na
Share of agriculture in GDP (in per cent)	14.2	11.9	11.8	10.2	10.3	9.5	na
Current account/GDP (in per cent)	-3.2	-3.3	-2.2	-2.4	-5.2	1.5	-2.4
External debt - reserves (in US$ million)	914	991	1,238	1,154	660	259	na
External debt/GDP (in per cent)	12.1	11.2	11.3	9.1	5.8	4.6	na
External debt/exports of goods and services (in per cent)	16.6	16.4	17.8	14.0	8.6	7.5	na

commercial banks.

Bosnia and Herzegovina[1]

Key challenges

- Renewed momentum in privatisation and enterprise restructuring is needed to ensure an increase in private sector profitability and maintenance of output and export growth.
- While the reform of the financial sector has generally been successful, further strengthening of supervisory standards is necessary to help improve efficiency in the banking and leasing sectors.
- The public sector is too large and effective fiscal coordination is required to streamline the budgetary process at Entity and state levels and to improve the medium-term budget planning framework.

Country data	
Population (in millions)	**3.8**
Area ('000 sq km)	**51.0**
GDP (in billion US$, 2005)	**9.2**
GDP per capita in 2005 at current international US$ (PPP)	**7,844**
National currency	**Convertible mark**

Progress in structural reform

Liberalisation and privatisation

Following a long preparatory period, and the establishment of the Indirect Tax Authority in 2005, a state-wide value added tax (VAT) was introduced in January 2006, replacing the Entity-level sales taxes. The new tax marks a significant step in state-building. It provides, for the first time, a reliable and substantial direct source of revenue to the state, and replaces the previous almost total dependence on transfers from the Entities.

Bosnia and Herzegovina has made progress during 2006 on a Stabilisation and Association Agreement (SAA) with the European Union (EU). By July 2006, two official and three technical rounds of talks had taken place. However, the closure of negotiations depends on the implementation of a number of key reforms, including police reform, in which delays have occurred. Bosnia and Herzegovina will be part of a new initiative to promote regional free trade, but trade relations with neighbouring Croatia and Serbia remain complicated by disputes over the free trade agreements signed some years ago.

Privatisation has proceeded at a slow pace, especially in the Federation where only 14 companies were sold in 2005. More progress was made in the Republika Srpska (RS), including the sale of a 54 per cent stake in Banja Luka Brewery to Altima Partners of London in December 2005. This was a notable transaction given that several previous attempts to sell this asset had failed in controversial circumstances. By mid-2006 the amount of capital remaining to be privatised in the RS was estimated to be close to 50 per cent, while in the Federation it was around 60 per cent.

Business environment and competition

Since the enactment of a new law on competition in July 2005, a number of cases have come before the Competition Council (established in 2004 to oversee implementation of previous legislation). The first case that the Council cleared was the purchase in early 2006 by Bank Austria Creditanstalt of shares in Nova Banjalučka Banka. Meanwhile, new bankruptcy laws introduced in 2003 are being implemented slowly, and by March 2006, about 400 cases were under consideration by the courts.

Infrastructure

A major privatisation in the telecommunications sector was launched in August 2006 with the announcement by the RS government of a tender for 65 per cent of the state-owned operator Telekom Srpske. The sale, expected to be completed by the end of the year, should yield substantial revenues to the RS government, and may encourage similar privatisations of the two companies operating in the Federation – BH Telekom and HT Mostar.

In the power sector, the establishment of regulatory commissions, a single transmission company, and an independent system operator have enabled Bosnia and Herzegovina to participate in the initiative to establish a functioning electricity market in south-eastern Europe (the Energy Community Treaty). There is also increasing private sector interest in generation projects. As of September 2006, however, the Entity governments had not yet developed a fully transparent, coordinated and competitive approach to identifying priority projects and selecting suitable investors.

Financial sector

Strong credit growth continued in 2005. Total credit increased by 27 per cent over the previous year, which was channelled mostly to the private sector. In an effort to curb this expansion, the Central Bank raised required reserves in December 2005 from 10 per cent to 15 per cent. There were no moves towards consolidation of the banking sector during 2005, the number of banks remaining unchanged at 33. An IMF Financial Sector Assessment Programme Mission meanwhile noted significant weaknesses in the supervision of the banking sector and of leasing and insurance companies. In addition, a proposal to bring the banking supervision agencies of the two Entities under the umbrella of the Central Bank has yet to be implemented, despite strong pressure from the international community.

[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.

Macroeconomic performance

Real economy

The economy grew at about 5.8 per cent in 2005, similar to the growth rate of the previous year. Export growth was particularly strong, reflecting increasing access by Bosnian producers to regional and EU markets. Industrial production also rose moderately, helped by substantial investments in key industries, and this trend continued in the first quarter of 2006 with strong year-on-year growth. The construction sector also recorded double-digit growth in 2005.

Economic policies

The introduction of VAT in January 2006, together with higher oil prices, have given some upward impetus to inflation, which stood at over 4.0 per cent at the end of 2005. However, it is projected to remain at single-digit levels in 2006. The increase in reserve requirements in late 2005 has helped to keep credit growth in check although it remains strong. Preliminary estimates from the first half of 2006 show buoyant VAT revenues, although much of this increase (relative to the previous sales taxes) is temporary and unlikely to be repeated in future years. Overall, the consolidated government budget was slightly in surplus in 2005 and is expected to remain close to balance in 2006. Nevertheless, fiscal deficits may emerge next year because governments in both Entities have made pre-election commitments on wage and pension increases. Meanwhile, the problem of potentially large domestic liabilities (some arising from war claims) facing governments at all levels remains to be fully resolved. However, progress has been made in putting in place the necessary laws to deal with the issue.

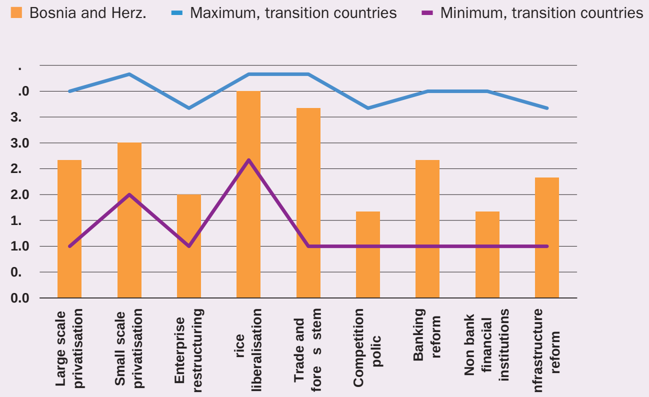
External sector

Notwithstanding the strong growth in exports in 2005, Bosnia and Herzegovina continued to record very high trade and current account deficits. The latter was estimated at about 17 per cent of GDP in 2005, although this estimate was subject to considerable uncertainty. The size of the deficit may also have been slightly inflated by the strong demand for imports in late 2005 from those wishing to avoid the effects of the VAT introduction. The deficit is covered fully by a combination of capital transfers, foreign direct investment (FDI) and other capital inflows. Foreign reserves rose steadily to €2.14 billion by the end of 2005. FDI in 2005 fell to US$300 million, compared with US$490 million in 2004, reflecting the limited privatisation and greenfield investment opportunities.

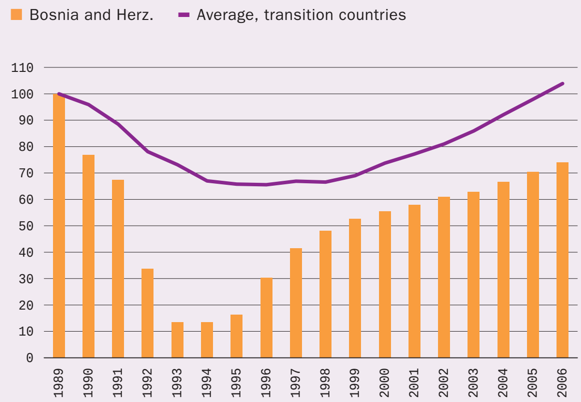
Outlook and risks

In recent years, Bosnia and Herzegovina has managed quite successfully to move away from dependence on aid and growth rates have held up well. The outlook is for continued growth in the region of 5 to 6 per cent per year, allied to low inflation. Also, the EU is expected to provide strong support for reform, particularly after the Office of High Representative closes in 2007. The main risk to this generally positive outlook lies in the negative approach of some public officials to serious reform. While the small and medium-sized enterprise sector is quite dynamic, only limited restructuring has occurred in larger companies and this is reflected in low corporate profitability and high unemployment.

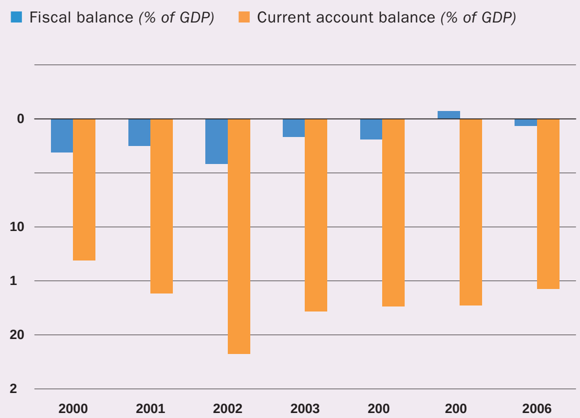
Transition indicators, 2006



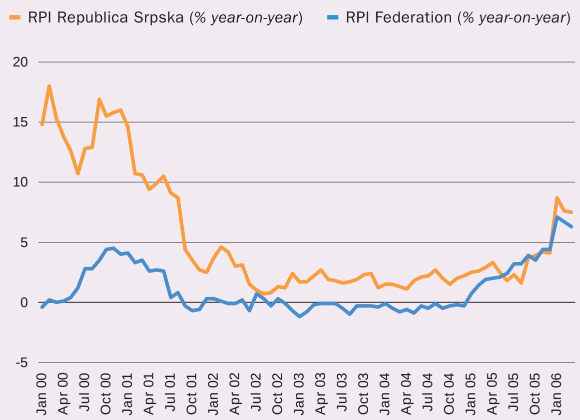
Real GDP (1989=100)



Fiscal balance and current account balance



Inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **yes** [1]

Interest rate liberalisation – **full**

Exchange rate regime – **currency board pegged to euro**

Wage regulation – **no**

Tradability of land – **limited de jure**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **high**

Secured transactions law – **some defects**

Quality of corporate governance law – **low**

Infrastructure

Independent telecoms regulator – **partially**

Independent electricity regulator – **partially**

Separation of railway infrastructure from operations – **partially**

Independence of the road directorate – **fully**

Quality of concession laws – **medium**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **high**

Private pension funds – **no**

Social reform

Share of population living in poverty – **na**

Government expenditure on health – **na**

Government expenditure on education – **na**

Household expenditure on power and water – **4.9 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)	2 0	2	2	2	2	a	a
r a e e r are (per e)	0	0 0	0	0 0	0 0	0	0
r a e e r are e pl y e (per e)	a	a	a	a	a	a	a
u ge ary u e a urre ra er (per e)	0	0	a	a	a	a	a
S are u ry al e pl y e (per e)	a	a	a	a	a	a	a
a ge la ur pr u y u ry (per e)	a	a	a	a	a	a	a
e e (per e)	20 6		20		20	a	a
EBRD index of small-scale privatisation	2	2	0	0	0	0	0
EBRD index of large-scale privatisation	2 0	2	2	2	2	2	2
EBRD index of enterprise reform				2 0	2 0	2 0	2 0
S are a ere pr e (per e)	a	a	a	a	a	a	a
u er g a ere pr e a e [2]	0	0	0	0	0	0	a
S are ra e ra u r e (per e)		2	0	6	a		a
S are ra e (per e)		0		2 2	6		a
ar re e ue (per e p r)		2				a	a
EBRD index of price liberalisation	0	0	0	0	0	0	0
EBRD index of forex and trade liberalisation	0	0	0				
EBRD index of competition policy	0	0	0	0	0	0	
u er a (re g e)	6 ( )	(20)	0 (2)	( )	( )	(20)	a
A e are a e e a (per e)			6 2		0	6	a
A e are re g e a (per e)	2 6	6	6		0	0	a
per r g l a (per e al l a)		20			6		a
e re pr a e e r (per e)	0	0	2			22 6	a
e re u e l (per e)	6		0	2	2		a
r gage le g (per e)	a	a	a	a	a	a	a
S ar e ap al a (per e)	a	a	a	a	a	a	a
S ra g lu e (per e ar e ap al a)	a	a	a	a	a	a	a
ur ua e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
EBRD index of banking sector reform	2	2	2	2	2	2	2
EBRD index of reform of non-bank financial institutions	0	0					
e l e (le) pe e ra ra e (per 00 a a)	20 6 (2)	22 ( )	2 (6)	2 (2)	2 6 (6)	2 (0)	a
er e pe e ra ra e (per 0 000 a a)	6 0	6	0		2	2	a
a l ay la ur pr u y (2000 00)	00 0	2		6	2 6 0	0	a
e e al ele r y ar (S)			6 0		6	6	a
A erage lle ra e ele r y (per e)			6	a	a	6	a
per u e ergy u e (S llar per g e)					a	a	a
EBRD index of infrastructure reform	2 0	2 0	2	2	2	2	2
Electric power	2	2	0	0	0	0	0
Railways	2 0	2	0	0	0	0	0
Roads	2 0	2 0	2 0	2 0	2 0	2 0	2 0
Telecommunications	2	2	2	2	2	2	2
Water and waste water	2 0	2 0	2 0	2 0	2 0	2 0	2 0

1 There are restrictions on the production and sale of arms, ammunition, military equipment and public information.

2 Goods have administered prices in either the Federation or Republika Srpska or both Entities.

3 For some years data were unavailable for important trading partners, such as Croatia, FYR Macedonia, Montenegro and Serbia. As a result, the share of trade with non-transition countries for these years has been over-estimated.

	2000	2001	2002	2003	2004	2005	2006
						Estimate	*ro ection*
ercentage c ange in real terms							
				0	6 0		0
u r al gr u pu		2 0			2 0		a
Agr ul ural gr u pu	a	a	a	a	a	a	a
ercentage c ange							
a ur r e (e year)	2			2	0 6		a
pl y e (e year)	6	2		0 6	0 2	2	a
n per cent of labour force							
e pl y e (e year)	6	0	0	2 0	0		a
ercentage c ange							
u er pr e (a ual a erage)							
e era (M a e)			0 2	0 2	0	2	
epu l a Srp a (M a e)	0	0			2 2	2	0
u er pr e (e year)							
e era (M a e)	0	0	0	0	0		6
epu l a Srp a (M a e)	6	2 2	2		2 2		6
r a erage ly ear g e y (a ual a erage)							
e era	0 0	6	2			a	a
epu l a Srp a	2 2					a	a
n per cent of D							
e eral g er e ala e		2				0	0 6
e eral g er e e pe ure	6 6	2			0		a
ercentage c ange							
r a ey (M2 e year)			6		2	2	a
e re (e year)	0 0	2	2 2		0	2	a
n per cent of D							
r a ey (M2 e year)	2	2	6		2 6	6	a
per dollar							
a ge ra e (a ual a erage)	2 2	2	2 0				a
n millions of dollars							
urre a u	62		2	2		2	2
ra e ala e			2 2	2 20	2 2	2	0
Mer a e e p r	2	0	2	2 6	66	2 0 2	2
Mer a e p r	2	2 0	2	6	6		
re g re e e e	0	0	266	2	0	00	0
r re er e e lu g g l (e year)		22	2	6	2	2 0	a
er al e	2	2 2	2	2 6	2 0	2 6	a
n mont s of imports of goods and services							
r re er e e lu g g l (e year)	2 2				6	6	a
n per cent of exports of goods and services							
e er e	2	6 2	2	2	6	6	a
Denominations as indicated							
pula (e year ll) 2							a
(ll ar a)	0 0 6	0 6	6 6	2 26	2	2 0	00
per ap a (S llar)	2	2		62	2 2	2 2	a
S are u ry (per e)	a	a	a	a	a	a	a
S are agr ul ure (per e)	a	a	a	a	a	a	a
urre a u (per e)		6	2				
er al e re er e (S ll)	2	6				6	a
er al e (per e)	2					2	a
er al e e p r g a er e (per e)	2		6	0	2	6	a

Bulgaria

Key challenges

- Completion of the legal and administrative framework and stronger enforcement of legislation combating crime, corruption and fraud would bring about significant improvements in the business environment. Labour market flexibility should also be improved.
- The government should establish transparent procedures and fast review mechanisms for the appeals of past privatisations and the awarding of concession agreements, where delays in court have occurred, to help improve growth prospects.
- Tight fiscal and wage policies are essential to preserve macroeconomic stability and support the currency board regime.

Country data	
Population (in millions)	**7.7**
Area ('000 sq km)	**111.0**
GDP (in billion US$, 2005)	**26.6**
GDP per capita in 2005 at current international US$ (PPP)	**8,820**
National currency	**Lev**

Progress in structural reform

Business environment and competition

Some progress has been made in introducing reforms to strengthen the judiciary. These include a new code for penal procedure and an infrastructure for legal aid. In addition, the prosecution service has been put in charge of investigations and a disciplinary commission under the Supreme Judicial Council is in charge of tackling corruption within the judiciary. The government has also introduced an anti-corruption strategy for 2006-08.

As a consequence of these changes, the immunity of members of parliament has been curbed, which has allowed some investigations to be carried out. A special code of ethics for top government officials was adopted at the end of 2005. However, there is still a need to increase the efficiency and accountability of the judicial system.

Important measures to improve the business environment are still to be adopted (the commercial procedure code) or fully implemented (a new administrative procedure code, the law on private bailiffs). Other steps undertaken have had mixed results. The May 2006 amendments to the Labour Code which allow for greater flexibility in the labour market have not yet been broadly implemented. A significant new law transforming business registration from a judicial to a purely administrative procedure, which was approved in March 2006, has not yet been implemented. The need to further alleviate the regulatory burden and to improve the functioning of the administration remains a challenge.

Infrastructure

Significant progress has been made in privatising infrastructure. In May 2006 the government signed an agreement with the Czech energy company, CEZ, for the sale of the 1,260 megawatt Varna power plant for €306 million. CEZ has also pledged a further €40 million for additional investment. Two smaller hydropower plants – Hubcha and Yakoruda – have been sold to local investors. In June 2006 the government approved the sale of 70 per cent of Rousse-based Bulgarian River Shipping Corporation (BRSC) to Chimimport for €11.2 million. In the same month the government launched a tender for the purchase of Bulgaria Air.

In July 2006 Greece's Public Power Corporation won a tender to buy the 630-MW Bobov Dol power plant for €70.9 million. The Privatisation Agency opened a sell-off procedure for the thermal power plant Toplofikatsiya Russe (TPP) Rousse-West in July 2006, and the heating utilities in Plovdiv, Sliven and Varna are also under offer. According to current rules only foreign bidders will be able to participate in the privatisation of the Plovdiv, Varna, Russe Sliven and Shumen district heating utilities, as no Bulgarian firms have the minimum rating required of potential buyers.

The Road Executive Agency has been transformed into a fund under the Ministry of Finance. This change is expected to promote better coordination of the various road projects and increase the efficiency of investment in the national road network. The government, within its recently launched National Strategy for Integrated Development of Infrastructure, plans to initiate a more transparent and competitive procedure for awarding motorway concessions.

The telecommunications law was amended in October 2005 to reinforce the powers of the Communications Regulation Commission (CRC) in dealing with operators with significant market share. The CRC auctioned three national licences for fast data transfer for US$3.8 million in October 2005. The third GSM mobile operator started providing services in November 2005.

Financial sector

Policies to curb the rapid growth of bank lending have been partially successful, with credit growth slowing from 50 per cent in 2004 to 32 per cent in 2005. These policies, however, have also had the effect of boosting the provision of finance from non-bank sources. The authorities have consequently taken measures to strengthen the supervision of this sector, especially with respect to leasing companies, which are now required to report regularly to the Central Bank. Leasing companies which are bank subsidiaries have always been indirectly supervised owing to the requirement for banks to be supervised on a consolidated basis. From January 2007 a new law will result in the direct supervision of leasing companies owned by financial conglomerates.

Risk management in the non-bank financial sector has been greatly enhanced by the introduction of a new insurance law facilitating supervision and by amendments in February 2006 to the pension law. Pension funds are no longer obliged to invest a part of their assets in government securities.

Macroeconomic performance

Real economy

The economy grew by 5.5 per cent in 2005 and by 6.1 per cent in the first half of 2006, driven by sustained investment and private consumption. Investment and consumption were in turn fuelled by rapid growth of credit to the private sector, rising incomes and employment. In 2005 agricultural production contracted by about 8.6 per cent as a consequence of flooding. Industrial production increased on a year-on-year basis by 6.3 per cent in 2005 and by 5 per cent in June 2006.

Economic policies

The annual inflation rate rose to 6.5 per cent in December 2005, due to higher fuel and food prices and the depreciation of the lev against the US dollar. By February 2006 it had risen to 8.8 per cent as a consequence in part of higher excise taxes, but fell to 6.8 per cent by August due to a decline in food prices. Income policies in 2005–06 have helped to maintain moderate wage growth. The consolidated general government balance recorded a surplus of 3.1 per cent of GDP in 2005. After initial disagreement, the authorities and the IMF have agreed (within the framework of the Fund's precautionary Stand-By Arrangement) on a target surplus of at least 3 per cent for 2006. In August 2006 the government also agreed to target a fiscal surplus of at least 2 per cent of GDP for 2007. In July 2006 the Fiscal Reserve Account stood at €2.8 billion (about 11.7 per cent of GDP), even after debt buy-backs in 2005–06. The National Revenue Agency started operating in January 2006 with the aim of improving the tax collection rate.

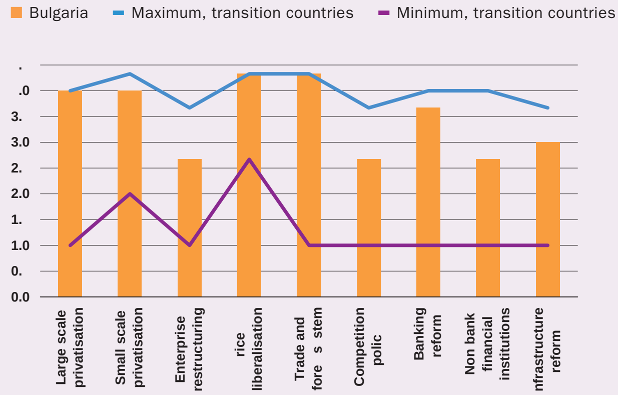
External sector

The current account deficit widened to 11.3 per cent of GDP in 2005, from 5.8 per cent in 2004, and to 14.6 per cent of GDP in June 2006, on a 12-month rolling basis. This mainly reflected the large and increasing deficit on the trade account (21.5 per cent of GDP in June 2006). The financing of the current account deficit has been supported in the short-term by strong flows of net foreign direct investment (which covered 73 per cent of the deficit in 2005 and 75 per cent in June 2006) and other inflows, including bank lending. The overall balance of payments is in surplus due to large inflows recorded as "net errors and omissions" which amounted to around €658 million in the 12-month period ending in June 2006.

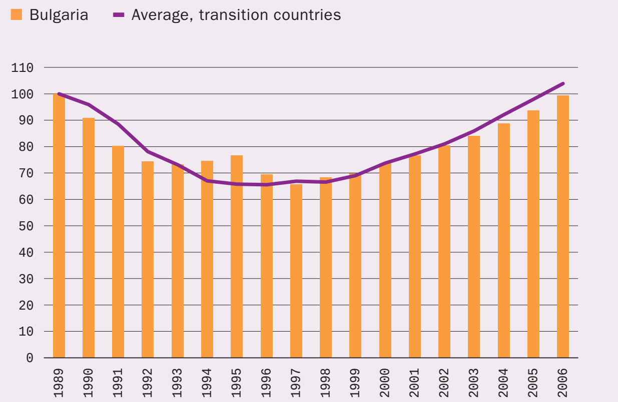
Outlook and risks

Bulgaria's medium-term economic prospects remain favourable, especially in view of the country's accession to the EU in January 2007. The currency board regime is well established and is expected to contribute to a tight monetary policy in the run-up to eventual adoption of the euro. The main vulnerability is the external position, with persistently high current account deficits giving some cause for concern. Continued high oil prices may exacerbate this situation in the short-run. Looking ahead, the government must maintain a tight fiscal policy. In addition, further fiscal tightening may be necessary to help offset the excessive buoyancy of domestic demand and enable the government to manage the consequences of an unexpected external shock. Continued progress in structural reforms is also critical to the achievement of the country's growth potential.

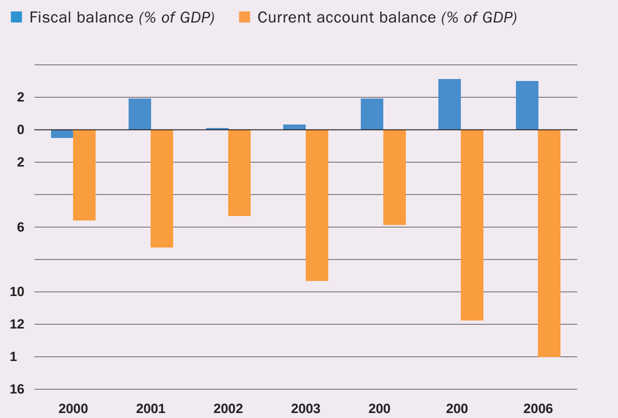
Transition indicators, 2006



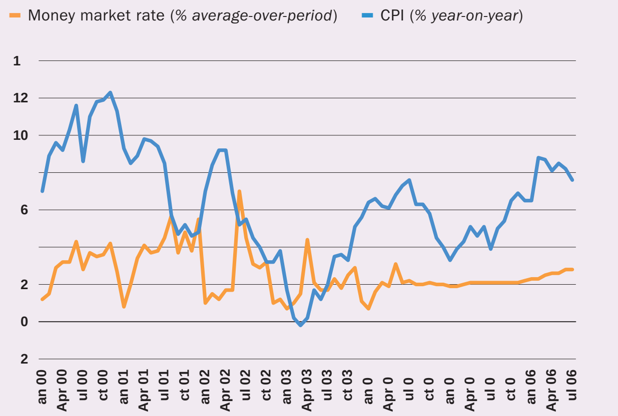
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **12 per cent**	Share of population living in poverty – **6.1 per cent** (2003)[1]
Controls on inward direct investment – **no**	Quality of insolvency law – **high**	Independent electricity regulator – **fully**	Deposit insurance system – **yes**	Government expenditure on health – **2.7 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **advanced**	Separation of railway infrastructure from operations – **fully**	Quality of securities market laws – **high**	Government expenditure on education – **4.1 per cent of GDP**
Exchange rate regime – **currency board**	Quality of corporate governance law – **medium**	Independence of the road directorate – **fully**	Private pension funds – **yes**	Household expenditure on power and water – **11.2 per cent**
Wage regulation – **yes**		Quality of concession laws – **high**		
Tradability of land – **full except foreigners**				

	2000	2001	2002	2003	2004	2005	2006
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	9.7	12.6	13.8	15.0	18.1	21.5	na
Private sector share in GDP (in per cent)	70.0	70.0	70.0	75.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	54.9	58.9	60.8	62.1	65.9	71.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.9	2.7	2.6	3.0	2.5	2.2	na
Share of industry in total employment (in per cent)	26.2	26.1	24.0	23.5	23.4	24.1	na
Change in labour productivity in industry (in per cent)	18.7	-0.6	9.7	15.8	17.8	1.1	na
Investment/GDP (in per cent)	18.3	20.7	19.8	21.7	23.5	28.0	na
EBRD index of small-scale privatisation	3.7	3.7	3.7	3.7	3.7	3.7	4.0
EBRD index of large-scale privatisation	3.7	3.7	3.7	3.7	4.0	4.0	4.0
EBRD index of enterprise reform	2.3	2.3	2.3	2.7	2.7	2.7	2.7
Markets and trade							
Share of administered prices in CPI (in per cent)	20.0	20.6	21.3	22.0	24.7	21.3	na
Number of goods with administered prices in EBRD-15 basket	1.0	0.0	0.0	0.0	0.0	0.0	na
Share of trade with non-transition countries (in per cent)	76.0	72.1	76.4	77.1	78.0	75.0	na
Share of trade in GDP (in per cent)	85.9	86.8	83.4	88.3	96.7	108.4	na
Tariff revenues (in per cent of imports)	9.9	8.9	9.9	10.2	9.2	8.0	na
EBRD index of price liberalisation	4.0	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
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	2.7	2.7
Financial sector							
Number of banks (foreign-owned)	35 (25)	35 (26)	34 (26)	35 (25)	35 (24)	34 (23)	na
Asset share of state-owned banks (in per cent)	19.8	19.9	14.1	2.5	2.3	1.7	na
Asset share of foreign-owned banks (in per cent)	75.3	72.7	75.2	82.7	81.6	74.5	na
Non-performing loans (in per cent of total loans)[2]	10.9	7.9	5.6	4.4	3.7	3.8	na
Domestic credit to private sector (in per cent of GDP)	11.7	14.5	18.0	18.4	23.2	26.0	na
Domestic credit to households (in per cent of GDP)	2.1	2.8	3.7	7.1	10.0	14.7	na
Of which mortgage lending (in per cent of GDP)	na	na	na	1.2	2.7	4.8	na
Stock market capitalisation (in per cent of GDP)	4.8	3.7	4.3	7.9	10.6	20.1	na
Stock trading volume (in per cent of market capitalisation)	9.2	12.9	13.9	16.3	22.8	35.2	na
Eurobond issuance (in per cent of GDP)	0.0	2.0	6.6	0.0	1.1	1.4	na
EBRD index of banking sector reform	3.0	3.0	3.3	3.3	3.7	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	2.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	35.4 (9.1)	36.6 (19.6)	36.6 (33.1)	36.1 (44.9)	35.1 (60.9)	32.1 (80.8)	na
Internet penetration rate (per 10,000 inhabitants)	22.6	34.1	42.0	64.1	84.7	84.7	na
Railway labour productivity (1989=100)	71.2	70.3	65.9	75.2	78.4	73.7	na
Residential electricity tariffs (in USc kWh)	3.5	3.8	5.2	5.2	6.0	8.4	na
Average collection rate, electricity (in per cent)	na	85	95	na	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.7	2.7	3.0	2.8	na	na	na
EBRD index of infrastructure reform	2.7	3.0	3.0	3.0	3.0	3.0	3.0
Electric power	3.3	3.3	3.3	3.3	3.7	3.7	3.7
Railways	3.0	3.3	3.3	3.3	3.3	3.3	3.3
Roads	2.3	2.3	2.3	2.3	2.3	2.7	2.7
Telecommunications	3.0	3.0	3.0	3.0	3.3	3.3	3.3
Water and waste water	3.0	3.0	3.0	3.0	3.0	3.0	3.0

[1] The official 12.8 per cent poverty rate, reported in the World Bank's 2001 Poverty Assessment, 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] The ratio is calculated in per cent of total net loans excluding loans to financial institutions.

	2000	2001	2002	2003	2004	2005 Estimate	2006 ro ection
			ercentage c ange in real terms				
							6 0
r a e u p							a
u l u p			6 2	0	6	2 2	a
r e ap al r a						0	a
p r g a er e	6 6		6 2	0	0	2	a
p r g a er e	6	0				6	a
u r al gr u pu	2 0		0		2		a
Agr ul ural gr u pu		0	2		6	0	a
			ercentage c ange				
a ur r e (e year)		0 2	0		2	0 2	a
pl y e (e year)	2		2			2 0	a
			n per cent of labour force				
e pl y e (e year)	6		6		2 0	0	a
			ercentage c ange				
u er pr e (a ual a erage)				2	6	0	0
u er pr e (e year)				6	0	6	0
r u er pr e (a ual a erage)		6			6 0	6	a
r u er pr e (e year)			6		2		a
r a erage ly ear g e y (a ual a erage)	2	6		2			a
			n per cent of D				
e eral g er e ala e	0		0	0			0
e eral g er e e pe ure			2	2			a
e eral g er e e [2]	6	6	6	2	0		a
			ercentage c ange				
r a ey (M2 e year)		0			2	2	a
e re (e year)	0	26 0	2			2	a
			n per cent of D				
r a ey (M2 e year)	0		2			60 2	a
			n per cent per annum end-year				
a e ere ra e	6			2	2	2	a
er a ere ra e (up)	0		2		2 0	2 2	a
ep ra e ( )		2	2	2	0	0	a
e g ra e (le a year)							a
			eva per dollar				
a ge ra e (e year)	2	2 2					a
a ge ra e (a ual a erage)	2	2 2	2		6	6	a
			n millions of dollars				
urre a u	0		2	6	6		000
ra e ala e	6			2	6		6 0
Mer a e e p r	2		6 2			0	262
Mer a e p r	6 000	6 6	2	0 0			2 66
re g re e e e		0	6	2 0 0	2	2 2	000
r re er e e lu g g l (e year)	60		0	6 2	6	2	a
er al e	6	0 626	2	0	0 0		a
			n mont s of imports of goods and services				
r re er e e lu g g l (e year)				6 0	6		a
			n per cent of exports of goods and services				
e er e	6	20	6	0	2	6	a
			Denominations as indicated				
pula (e year ll)							a
(ll le a)	26	2 0	2		00		
per ap a (S llar)	6	2		2 6	0		a
S are u ry (per e)	2	2 2	2 6	20 6	26 0	26	a
S are agr ul ure (per e)	2	2	0	0		0	a
urre a u (per e)	6	2					
er al e re er e (S ll)	0	0	6 0			6	a
er al e (per e)	6		2	6	0	6 2	a
er al e e p r g a er e (per e)		6	0	2	2	2 0	a

Croatia

Key challenges

- Privatisation and restructuring of the remaining state-owned assets is a priority and needs to regain momentum.
- Despite some reform of the pension and health care systems, comprehensive changes need to be implemented to restore fiscal sustainability.
- Careful management of budgetary spending and a continuation of tight monetary policies are necessary to consolidate improvements in the fiscal accounts and to control the expansion of credit.

Country data	
Population (in millions)	4.4
Area ('000 sq km)	87.6
GDP (in billion US$, 2005)	38.5
GDP per capita in 2005 at current international US$ (PPP)	13,185
National currency	Kuna

Progress in structural reform

Liberalisation and privatisation

After regaining some momentum in early 2005, the privatisation process slowed and fell short of the authorities' policy objective. Reconfirmed in August 2005, the objective was to sell 50 per cent of companies with minority state ownership and a third of companies with majority state ownership by June 2006 (almost 500 firms). However, only 55 companies were sold. Factors delaying the privatisation process have included legal problems, a lack of investor interest and unrealistic sale conditions. The authorities also intend to adopt a new Act on Privatisation, the draft of which was made public at the end of June 2006.

In September 2006 the government announced its decision to offer between 15 and 17 per cent of shares in the oil company INA, and at least 20 per cent of shares in Croatia Telekom for sale on the Zagreb and London stock markets. The government's announcement envisages the INA IPO in November 2006. In March 2006 the government established a working group to prepare a strategy for the sale of some of the remaining entities under state ownership in the tourism sector. It also submitted a programme for the restructuring and privatisation of the steel industry to the European Commission in May 2006.

Accession negotiations with the European Union (EU) opened in October 2005. The chapter on science and research has already been closed, the customs and competition chapters are open and the screening of other chapters has either finished or is scheduled to be finished shortly.

Business environment and competition

The simplification of company registration procedures started in early 2005 with the opening of a network of "one-stop shops". This resulted in a 15.3 per cent increase year-on-year in the number of newly established companies in the Croatian Register of Business Entities (contributing to a 5 per cent increase in the overall number of registered businesses in 2005). However, starting up and running a business is still hampered by inefficiencies in public administration and the courts.

An inefficient judicial system has continued to undermine the enforcement of property and creditor rights. Furthermore, a new digitalised land registry will not be finalised before the end of 2006. Recent amendments to the Bankruptcy Law, which came into force in July 2006, aim to end prolonged bankruptcy procedures (sometimes taking several years) and boost protection of employee rights. Implementing rules for the Competition Act have been adopted in the areas of anti-trust and merger control.

State intervention remains significant and damaging. State aid, mostly to specific sectors such as shipbuilding, railways and tourism, represented 2.8 per cent of GDP in 2005. (As of 2006, tourism no longer receives aid.)

Infrastructure

The liberalisation of the telecommunications industry has advanced. The fixed-line market was liberalised in 2004 and there are now five new operators with a combined market share of about 7 per cent. Competition has increased further in the mobile sector with the entry of a third operator – Tele2 – in October 2005. Increased competition in both markets has led to lower prices and a larger number of subscribers.

Restructuring of the state railway company (Croatian Railways – HZ) has continued, resulting in staff reductions and productivity improvements. The separation of freight and passenger services and infrastructure was supposed to have been implemented by the end of June 2006. However, due to delays, the government approved a new restructuring programme in July 2006. This envisages splitting HZ into four smaller companies running different areas of HZ's existing activities.

Social sector

Reform of the pension and health care systems is behind schedule and more needs to be done. In July 2005 the government approved the introduction (from February 2006) of a new formula for pension indexation to restore fiscal sustainability of the system. The new formula adjusts pensions twice a year to a figure calculated as half of the sum of the growth of salaries and living costs.

Administrative fees for medical services were introduced in July 2005 followed by the adoption of a more comprehensive health care reform in July 2006. However, the latter is unlikely to be fully implemented before 2007.

Macroeconomic performance

Real economy

Real GDP growth increased in 2005 to 4.3 per cent, compared with 3.8 per cent in 2004. Industrial output rose by about 6.5 per cent, while investment and exports also grew strongly. The important tourism sector continues to develop, with the number of overnight stays in 2005 up 8 per cent on 2004. Preliminary figures for the first quarter of 2006 suggest a similar rate of real GDP growth is likely for 2006 as a whole.

Economic policies

Fiscal performance improved in 2005 with the general government budget deficit reduced to 4.1 per cent of GDP, compared with 4.9 per cent in 2004. The government is targeting a further reduction in 2006 to 3 per cent of GDP. In addition, the authorities managed to contain inflation to 3.3 per cent in 2005, despite rising energy and food costs as well as higher excise taxes. The Croatian National Bank (CNB) remains committed to tight monetary policies, mainly aimed at exchange rate stability and the containment of credit expansion.

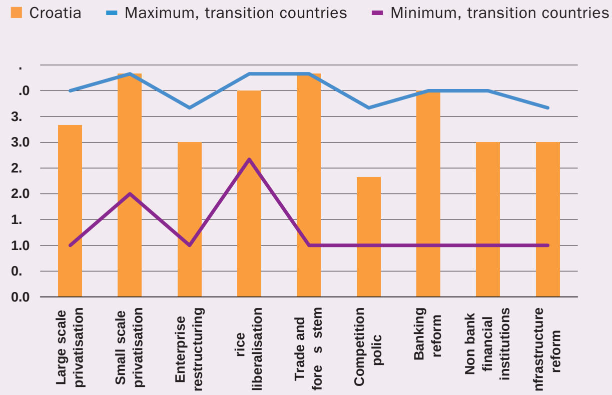
External sector

The current account deficit increased to 6.3 per cent of GDP in 2005, owing to the impact of higher international energy prices, which are pushing the current account deficit higher in 2006 as well. The deficit continues to be a source of concern for policymakers. There was strong growth in foreign direct investment in 2005, which reached €1.2 billion. This reflected significant investment in the banking sector (which grew by 51.1 per cent on the back of increasing shares and the recapitalisation of foreign-owned banks), oil and gas extraction, and other investments in non-specialised sectors. Gross external debt exceeded €25 billion, or 82.5 per cent of GDP, by the end of 2005. Domestic banks and other private entities increased their share of total external debt, while the government's share fell substantially. The CNB took a number of measures to curb the rise in external indebtedness among commercial banks. These included three increases in reserve requirements on banks' new foreign liabilities in 2005 (the latest, in December, from 40 per cent to 55 per cent). In addition, a 55 per cent mandatory reserve to be paid by commercial banks as a share of issued securities was introduced in February 2006.

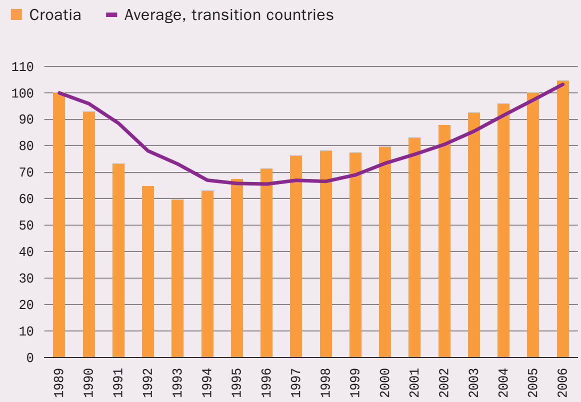
Outlook and risks

The economy is on course for moderately strong growth over the short to medium term, and Croatia's aspiration to EU membership should provide a strong impetus for further reforms. Nevertheless, the authorities face a number of significant macroeconomic challenges in particular with respect to fiscal stance and external indebtedness. Further progress in fiscal consolidation is essential for stability, although this will be increasingly difficult to achieve given the pressures for higher government spending. The strong expansion in recent years in domestic credit and the growing external indebtedness of commercial banks will require careful monitoring.

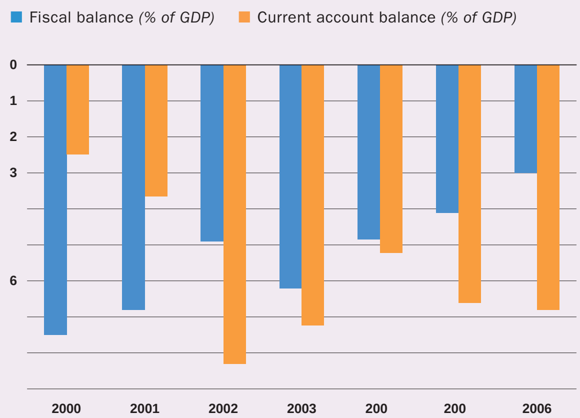
Transition indicators, 2006



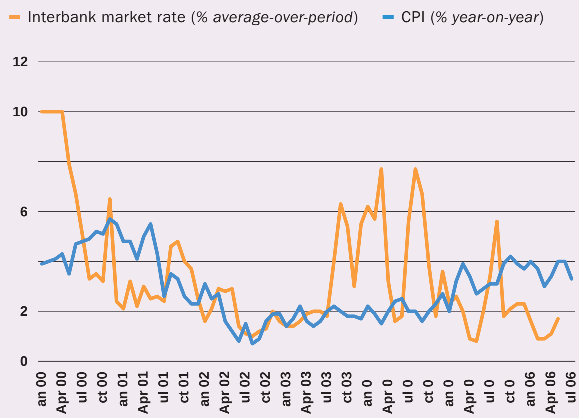
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no** [1]

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradability of land – **full** [2]

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **high**

Secured transactions law – **inefficient**

Quality of corporate governance law – **medium**

Infrastructure

Independent telecoms regulator – **partially**

Independent electricity regulator – **partially**

Separation of railway infrastructure from operations – **partially**

Independence of the road directorate – **fully**

Quality of concession laws – **low**

Financial sector

Capital adequacy ratio – **15.06 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **very high**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2 per cent** (2001)

Government expenditure on health – **8.5 per cent of GDP**

Government expenditure on education – **4.8 per cent of GDP**

Household expenditure on power and water – **13.1 per cent**

	2000	2001	2002	2003	2004	2005	2006
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP) [3]	10.2	13.5	14.9	16.6	16.8	17.0	na
Private sector share in GDP (in per cent)	60.0	60.0	60.0	60.0	60.0	60.0	60.0
Private sector share in employment (in per cent)	56.0	58.0	58.0	60.0	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	11.4	16.7	18.8	19.2	19.3	18.7	na
Share of industry in total employment (in per cent) [4]	22.7	23.4	22.8	21.6	21.7	20.5	na
Change in labour productivity in industry (in per cent)	na	9.6	4.2	9.8	2.5	10.3	na
Investment/GDP (in per cent)	20.2	23.9	29.1	31.1	30.9	31.3	na
EBRD index of small-scale privatisation	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	3.3	3.3	3.3	3.3
EBRD index of enterprise reform	2.7	2.7	2.7	2.7	3.0	3.0	3.0
Markets and trade							
Share of administered prices in CPI (in per cent)	5.6	0.0	0.0	0.0	0.0	0.0	na
Number of goods with administered prices in EBRD-15 basket	2.0	1.0	1.0	1.0	0.0	0.0	na
Share of trade with non-transition countries (in per cent)	68.9	73.0	72.6	74.2	72.3	69.5	na
Share of trade in GDP (in per cent)	67.0	68.6	67.9	69.3	70.2	70.8	na
Tariff revenues (in per cent of imports) [5]	6.1	4.4	2.4	1.9	1.6	1.4	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Financial sector							
Number of banks (foreign-owned)	43 (21)	43 (24)	46 (23)	41 (19)	37 (15)	34 (13)	na
Asset share of state-owned banks (in per cent)	5.7	5.0	4.0	3.4	3.3	3.4	na
Asset share of foreign-owned banks (in per cent)	84.1	89.3	90.2	91.0	91.2	91.2	na
Non-performing loans (in per cent of total loans)	19.8	15.1	11.0	9.7	8.6	7.2	na
Domestic credit to private sector (in per cent of GDP)	36.0	41.3	49.7	52.6	55.8	55.6	na
Domestic credit to households (in per cent of GDP)	15.3	18.2	23.8	27.7	30.7	34.3	na
Of which mortgage lending (in per cent of GDP)	5.4	5.7	6.9	8.5	10.1	12.0	na
Stock market capitalisation (in per cent of GDP)	14.5	16.5	15.6	18.7	29.0	35.2	na
Stock trading volume (in per cent of market capitalisation)	7.4	4.0	3.8	4.8	6.0	6.7	na
Eurobond issuance (in per cent of GDP)	5.2	6.3	13.3	3.2	4.4	0.0	na
EBRD index of banking sector reform	3.3	3.3	3.7	3.7	4.0	4.0	4.0
EBRD index of reform of non-bank financial institutions	2.3	2.3	2.7	2.7	2.7	2.7	3.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	38.5 (23.1)	40.7 (40.1)	41.7 (53.5)	42.8 (58.0)	42.7 (64.2)	41.5 (65.6)	na
Internet penetration rate (per 10,000 inhabitants)	37.1	50.3	67.8	67.8	78.6	78.6	na
Railway labour productivity (1989=100)	55.4	67.3	78.1	90.4	92.7	107.0	na
Residential electricity tariffs (in USc kWh)	5.1	6.1	6.5	8.2	11.1	11.4	na
Average collection rate, electricity (in per cent)	93	95	94	95	96	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	5.1	5.4	5.5	5.6	na	na	na
EBRD index of infrastructure reform	2.3	2.7	2.7	3.0	3.0	3.0	3.0
Electric power	2.3	3.0	3.0	3.0	3.0	3.0	3.0
Railways	2.3	2.3	2.3	2.3	2.7	2.7	2.7
Roads	2.3	2.3	2.3	3.0	3.0	3.0	3.0
Telecommunications	3.0	3.3	3.3	3.3	3.3	3.3	3.7
Water and waste water	3.0	3.3	3.3	3.3	3.3	3.3	3.3

1

	2000	2001	2002	2003	2004	2005 Estimate	2006 ro ection
				ercentage c ange in real terms			
	2		6				6
r a e u p	2			6			a
u l u p		6 2			0	0	a
r e ap al r a				2			a
p r g a er e	2 0		2			6	a
p r g a er e				2			a
u r al gr u pu		6 0				6	a
Agr ul ural gr u pu	0 0						a
[1]				ercentage c ange			
a ur r e (e year)		6		0	0 2	0	a
pl y e (e year)	a	6 0		0	0	2	a
				n per cent of labour force			
e pl y e (e year)		6				2	a
				ercentage c ange			
u er pr e (a ual a erage)	6				2		
u er pr e (e year)		2			2	6	
r u er pr e (a ual a erage)		6	0			0	a
r u er pr e (e year)	2		2			2	a
r a erage ly ear g e y (a ual a erage)	0		6 0		6		a
[2]				n per cent of D			
e eral g er e ala e		6		6 2			0
e eral g er e e pe ure	6 6	2	0		0 0		a
e eral g er e e		0 6	0 0	0	6	2	a
				ercentage c ange			
r a ey (M e year)	2	2		0	6	0	a
e re (e year)		2 6	2	2		2	a
				n per cent of D			
r a ey (M e year)		6 0	6	6 0	6	6	a
				n per cent per annum end-year			
u ra e							a
er a ar e ra e (a erage)		2 2		0	6 0	0	a
ep ra e		2	6			6	a
e g ra e	0		0				a
				una per dollar			
a ge ra e (e year)	2			6	6	6 2	a
a ge ra e (a ual a erage)				6	6 0		a
				n millions of dollars			
urre a u		2		2 2	2	2	2
ra e ala e	20	0	6	0	0	2 6	a
Mer a e e p r	6		00	6 0	2 0	2	a
Mer a e p r	0	60	0 6 2	2 6	6 60	2	a
re g re e e e	0		6	2		0	a
r re er e e lu g g l (e year)	2	0	6			0	a
er al e	2 2	0	6 0	2	002	0 220	a
				n mont s of imports of goods and services			
r re er e e lu g g l (e year)		2			2		a
				n per cent of exports of goods and services			
e er e	2 0		2 2	6	22 6	2	a
				Denominations as indicated			
pula (e year ll)							a
(ll u a)		66			2	22	2
per ap a (S llar)	206			6 666		6	a
S are u ry (per e)	20	20					a
S are agr ul ure (per e)				6 0			a
urre a u (per e)	2	6		2	2	6 6	6
er al e re er e (S ll)		66		6 6	22 2	2	a
er al e (per e) [6]	6 2		6 0	6			a
er al e e p r g a er e (per e)	0 6	2		66	6		a

[1] Data based on labour force surveys.
[2] Consolidated general government from 2002 onwards.
[3] Weighted average over all maturities.
[4] Agriculture includes hunting, forestry and fishing.
[5] Ratio calculated in US dollars.
[6] Ratio calculated in US dollars.

Czech Republic

Key challenges

- Further reforms of the judicial system and a reduction in the overall level of bureaucracy are needed to make significant improvements to the business environment.
- The new government must complete the programme of privatisations of state-owned assets.
- The absence of structural fiscal reforms in the pension and health care systems and rising inflationary pressures pose significant risks to the economic outlook over the medium term. A delay in the euro adoption date beyond 2010 is inevitable.

Country data

Population (in millions)	**10.3**
Area ('000 sq km)	**78.9**
GDP (in billion US$, 2005)	**124.6**
GDP per capita in 2005 at current international US$ (PPP)	**21,203**
National currency	**Czech Koruna (Crown)**

Progress in structural reforms

Liberalisation and privatisation

Progress in liberalisation and privatisation has slowed markedly, largely due to the general elections held in June 2006. Before the elections, the previous government was hesitant to push ahead with privatisation as it lacked the necessary backing in parliament. Also, the sale of a majority stake in Cesky Telecom to Telefonica of Spain for CZK 83 billion (€2.8 billion) in June 2005 provided a substantial revenue inflow and reduced the fiscal incentive for further privatisations during the year.

The elections in June 2006 resulted in a hung parliament and a continuing political impasse, which has thrown future privatisations into question – especially high profile cases such as Ceske Energeticke Zavody (CEZ), the sale of which was expected to generate CZK 200 billion (€6.7 billion). However, only a limited number of state assets in major companies remain to be privatised, including stakes in the brewery Budvar (owner of the Budweiser brand name in many countries), Czech Airlines (CSA), Ceska Posta (the postal service), and the railway company Ceske Drahy.

Business environment and competition

One of the main impediments to the creation of an efficient business environment is the weak condition of the Czech judicial system, particularly bankruptcy administration. According to the World Bank's 2006 Doing Business report, it takes on average about nine years to liquidate a bankrupt firm; this compares with an average of 3.5 years in neighbouring countries. A new bill on bankruptcy was passed in the lower house of parliament in February 2006. Taking effect in mid-2007, the legislation should increase the pace and efficiency of existing procedures. Substantial reforms, however, are still required to fundamentally improve the country's entire judicial system.

The government has taken some measures to reduce the time it takes to set up a company. For example, "one-stop shops" have been established to enable entrepreneurs to easily register their businesses or make changes to their registration. These measures, however, only address the final step of incorporation (cutting this process to five days) and fail to reduce the onerous bureaucratic and licensing requirements for establishing a new business. Fulfilling these requirements represent the bulk of the delay in starting an enterprise, especially for local entrepreneurs. According to the World Bank's Doing Business report, entrepreneurs can expect to go through 10 steps to launch a business over 24 days on average. Lengthy tax compliance procedures are also an obstacle for businesses. It takes 930 hours per year for a medium-sized business to comply fully with tax requirements.

The Czech Republic remains an attractive destination for foreign direct investment (FDI). At the end of 2005 net FDI inflows were around US$ 10 billion, up from about US$ 4 billion in 2004. The increase was mainly due to privatisations, including that of Cesky Telecom (as mentioned above) and the sale of 63 per cent of the chemical company Unipetrol to PKN Orlen of Poland for CZK 13 billion (€0.4 billion) in May 2005. Hyundai has more recently made a commitment to invest €1 billion in a new car factory in the country, with construction starting in late 2006 and production commencing a year later.

Social sector

Reform of social security, pensions, health care and education systems remain pressing policy challenges. According to projections by the European Commission and the Economic Policy Committee released in 2006, the Czech Republic will face one of the highest increases in age-related public expenditure in the European Union over the next few years. This is due to the country's rapidly ageing population and the largely unreformed public pension and health care systems. Despite earlier commitments to reform, little progress was achieved in the year to mid-2006. In the health sector, the re-nationalisation of regional hospitals was in part overruled by the constitutional court at the end of September 2006.

In May 2006 parliament enacted a controversial law on non-profit hospitals, partially reversing earlier measures to prepare these hospitals for privatisation. The law reflected the previous government's desire to provide access to cheap health care and avoid additional payments by patients and a reduction in services. The law establishes 146 public and non-profit institutional health care facilities, whose ownership is being returned to the Ministry of Health from the country's 14 regional governments and whose services will be fully covered by health insurers. Hospitals outside this system, however, will not be covered by insurers. In the meantime the constitutional court has cancelled the list of hospitals. It remains to be seen what will happen to other parts of the law.

Macroeconomic performance

Real economy

Annual real GDP growth in 2005 was 6.1 per cent, up from 4.2 per cent in 2004. The increase was driven by exports and investment, although private consumption was also an important factor. The latter reflected higher household income, owing to strong growth in real wages and falling unemployment. GDP growth accelerated to 7.1 per cent in the first quarter of 2006, the highest recorded quarterly year-on-year growth rate since the last quarter of 1994. In the second quarter growth slowed down to 6.2 per cent year-on-year. Higher private consumption was again likely to have made a significant contribution to the increase, as personal income tax rates were reduced at the beginning of the year.

Economic policies

According to data notified to Eurostat in April 2006, the general government budget deficit narrowed to 2.6 per cent of GDP in 2005 from 2.9 per cent the previous year, mainly due to deferred spending and higher-than-expected revenues on the back of strong economic growth. The 2005 deficit is likely to be revised significantly upwards in October. The deficit for 2006 is expected to be lower than the official target of 3.8 per cent of GDP, but higher than the Maastricht criterion of 3.0 per cent of GDP, due mainly to electoral factors. The outturn of the budget for the first seven months of 2006 suggests that some of the decisions taken before the June elections will have had some negative impact on the budget. In the face of increasing demand pressures and higher energy prices, the Czech National Bank (CNB) raised its main policy interest rate by 25 basis points to 2.25 per cent at the end of July, having kept rates constant for nine months.

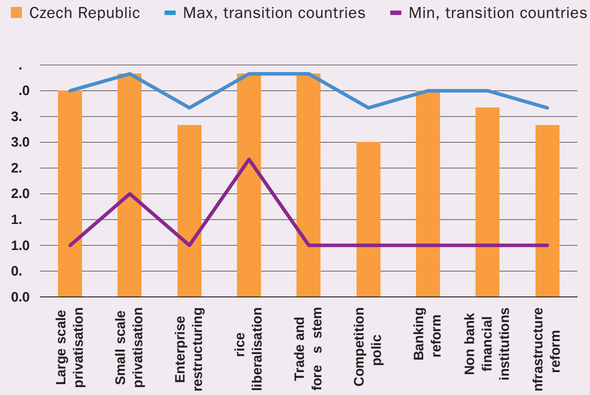
External sector

The Czech Republic recorded a current account deficit of US$2.6 billion in 2005, down from US$6.5 billion in 2004. As a share of GDP, the deficit fell from 6.0 per cent in 2004 to 2.1 per cent in 2005. The narrowing of the external imbalance was driven primarily by the shift in the foreign trade balance from a deficit to a surplus during 2005, reflecting strong exports of cars and electrical machinery.

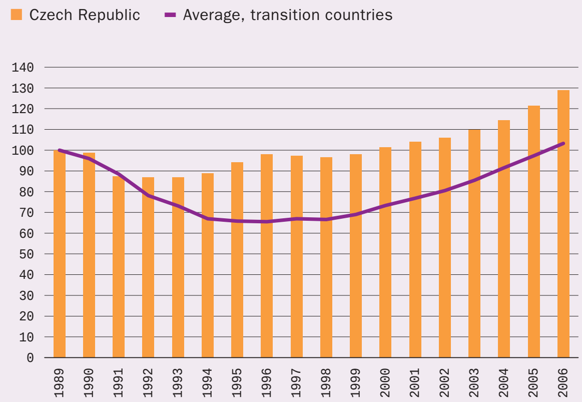
Outlook and risks

Economic growth in 2006 should be similar to that in 2005, driven mainly by domestic demand as well as net exports. Thereafter, the slowdown in eurozone growth should lead to a deceleration in economic growth. Strong private demand and higher energy prices are expected to increase inflationary pressures over the medium term. The prevailing political stalemate makes the timely implementation of structural fiscal reforms unlikely. The new 2007 draft budget proposes a deficit of 3.8 per cent of GDP, 0.5 percentage points higher than the deficit target published in the November 2005 convergence programme. The Czech Republic was expected to join the European Union's Exchange Rate Mechanism II (ERM II) in mid-2007 and to adopt the euro in 2010, but lack of political will and delays in fiscal consolidation have led to a delay of these dates. Reform of both the pension and health care systems will be necessary to ensure fiscal sustainability over the medium term.

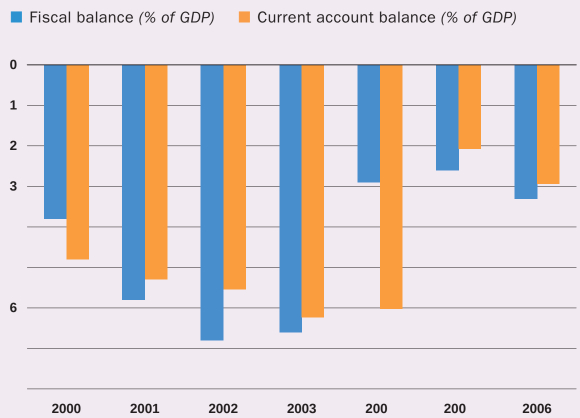
Transition indicators, 2006



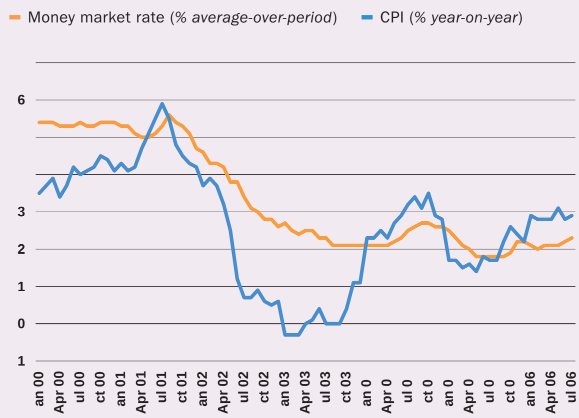
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **yes** [1]

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradability of land – **full except foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **inefficient**

Quality of corporate governance law – **medium**

Infrastructure

Independent telecoms regulator – **fully**

Independent electricity regulator – **fully**

Separation of railway infrastructure from operations – **fully**

Independence of the road directorate – **fully**

Quality of concession laws – **na** [2]

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **high**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2 per cent** (1996)

Government expenditure on health – **6.3 per cent of GDP**

Government expenditure on education – **5.0 per cent of GDP**

Household expenditure on power and water – **5.8 per cent**

	2000	2001	2002	2003	2004	2005	2006
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	12.3	14.8	20.0	21.0	21.6	25.1	na
Private sector share in GDP (in per cent)	80.0	80.0	80.0	80.0	80.0	80.0	80.0
Private sector share in employment (in per cent)	65.0	70.0	70.0	70.0	70.0	70.0	na
Budgetary subsidies and current transfers (in per cent of GDP) [3]	7.2	8.8	9.6	9.5	8.6	9.4	na
Share of industry in total employment (in per cent)	28.7	29.5	29.7	29.3	28.9	28.9	na
Change in labour productivity in industry (in per cent)	4.3	4.1	2.0	8.3	10.8	5.7	na
Investment/GDP (in per cent)	29.5	29.5	28.6	27.2	27.5	26.5	na
EBRD index of small-scale *privatisation*							
EBRD index of large-scale privatisation	0	0	0	0	0	0	0
EBRD index of enterprise reform							
S are a ere pr e (per e)		2	2	0	0	0	a
u er g a ere pr e a e	2 0	2 0	2 0	0	0	0	a
S are ra e ra u r e (per e)	6		0	0 6		a	a
S are ra e (per e)	0 0	2	0	0 0	2	2	a
ar re e ue (per e p r)		0	0	0	0 2	0 2	a
EBRD index of price liberalisation							
EBRD index of forex and trade liberalisation							
EBRD index of competition policy	2	2	0	0	0	0	0
u er a (re g e)	0 (26)	(26)	(26)	(26)	(26)	6 (2)	a
A e are a e e a (per e)	2		6	0	2	2	a
A e are re g e a (per e)	6			6			a
per r g l a (per e al l a)				0		0	a
e re pr a e e r(per e)		26	2	2	6	6	a
e re u e l (per e)	6				2		a
r gage le g(per e)	2 0	2	0	2			a
S ar e ap al a (per e)				6	2		a
S ra g lu e(per e ar e ap al a)	60 0	0	0	2 0	0	6	a
ur ua e(per e)	0 0	0	0	0	2		a
EBRD index of banking sector reform						0	0
EBRD index of reform of non-bank financial institutions	0	0	0	0			
e l e(le) pe e ra ra e (per 00 a a)	(2)	(6 0)	6 0 ( )	6 (2)	6 (0 6)	(2)	a
er e pe e ra ra e (per 0 000 a a)		2 0	222 0	2 0	6	6	a
a l ay la ur pr u y (00)	2 2		6 0	0	2		a
e e al ele r y ar (S)			0		0		a
A erage lle ra e ele r y (per e)	00	00	00	00	00	00	a
per u e ergy u e (S llar per g e)	6				a	a	a
EBRD index of infrastructure reform	0	0	0				
Electric power	2 0	0	0				
Railways	2	2	2	0	0	0	0
Roads	2	0	0	0	0	0	0
Telecommunications	0	0	0	0	0		
Water and waste water	0	0	0	0	0	0	0

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	3.6	2.5	1.9	3.6	4.2	6.1	6.2
Private consumption	1.3	2.3	2.2	6.0	2.5	2.4	na
Public consumption	0.7	3.6	6.7	7.1	-3.2	0.7	na
Gross fixed capital formation	5.1	6.6	5.1	0.4	4.7	3.6	na
Exports of goods and services	16.5	11.2	2.1	7.2	21.1	10.6	na
Imports of goods and services	16.3	12.8	5.0	8.0	18.2	4.9	na
Industrial gross output	1.5	6.7	1.9	5.5	9.6	6.7	na
Agricultural gross output	-3.0	-1.6	2.5	-5.5	0.0	8.0	na
Employment			(Percentage change)				
Labour force (end-year)	0.2	0.0	1.0	0.4	0.3	0.8	na
Employment (end-year)	1.7	-0.1	-0.9	-1.3	0.2	1.2	na
			(In per cent of labour force)				
Unemployment (end-year)	8.3	8.0	7.5	8.3	8.4	7.9	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	4.0	4.7	1.8	0.2	2.8	1.9	2.9
Consumer prices (end-year)	4.1	4.2	0.6	1.1	2.8	2.2	3.1
Producer prices (annual average)	4.9	2.9	-0.5	-0.3	5.7	3.0	na
Producer prices (end-year)	5.0	0.8	-0.7	0.9	7.7	-0.3	na
Gross average monthly earnings in economy (annual average)	6.4	8.7	7.3	6.6	6.6	5.4	na
Government sector [1]			(In per cent of GDP)				
General government balance	-3.8	-5.8	-6.8	-6.6	-2.9	-2.6	-3.3
General government expenditure	42.6	45.2	47.3	47.7	44.6	44.1	na
General government debt	18.2	25.9	28.5	30.1	30.7	30.3	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	5.6	13.0	3.5	6.9	4.4	8.0	na
Domestic credit (end-year)	1.0	-5.3	-7.1	21.9	0.1	1.7	na
			(In per cent of GDP)				
Broad money (M2, end-year)	64.5	67.9	67.0	68.5	66.3	66.9	na
Interest and exchange rates			(In per cent per annum, end-year)				
2-week repo rate	5.3	4.8	2.8	2.0	2.5	2.0	na
3-month PRIBOR	5.4	4.7	2.6	2.1	2.6	2.2	na
Deposit rate	3.4	2.6	1.7	1.3	1.4	1.2	na
Lending rate	7.2	8.7	8.8	8.2	8.0	7.2	na
			(Korunas per US dollar)				
Exchange rate (end-year)	37.8	36.3	30.1	25.7	22.4	24.6	na
Exchange rate (annual average)	38.6	38.0	32.7	28.2	25.7	23.9	na
External sector			(In millions of US dollars)				
Current account	-2,718	-3,273	-4,166	-5,690	-6,511	-2,575	-4,100
Trade balance	-3,131	-3,068	-2,179	-2,473	-1,029	1,685	1,700
Merchandise exports	29,052	33,378	38,319	48,568	67,027	78,307	91,500
Merchandise imports	32,183	36,446	40,497	51,041	68,056	76,622	89,800
Foreign direct investment, net	4,943	5,476	8,276	1,895	3,960	10,135	4,500
Gross reserves, excluding gold (end-year)	13,019	14,341	23,556	26,771	28,259	29,330	na
External debt stock	21,608	22,374	26,983	34,893	45,241	45,791	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.2	4.1	6.0	5.5	4.4	4.1	na
			(In per cent of exports of goods and services)				
Debt service	9.6	8.3	6.8	7.6	5.8	7.5	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	10.3	10.2	10.2	10.2	10.2	10.3	na
GDP (in billions of korunas)	2,189	2,352	2,464	2,577	2,781	2,978	3,255
GDP per capita (in US dollars)	5,520	6,059	7,378	8,947	10,588	12,151	na
Share of industry in GDP (in per cent)	36.0	37.5	37.5	38.2	40.2	40.4	na
Share of agriculture in GDP (in per cent)	3.9	3.7	3.8	3.4	3.3	3.4	na
Current account/GDP (in per cent)	-4.8	-5.3	-5.5	-6.2	-6.0	-2.1	-2.9
External debt - reserves (in US$ million)	8,589	8,033	3,428	8,122	16,981	16,461	na
External debt/GDP (in per cent)	38.1	36.2	35.8	38.2	41.8	36.8	na
External debt/current account revenues, excluding transfers (in per cent)	60.2	55.3	59.5	61.9	59.0	51.4	na

[1] Calculated according to Eurostat methodology (ESA95).

Estonia

Key challenges

- Despite rapid economic growth, income inequality has increased and needs to be addressed, especially the disparity between rural and urban areas.
- Labour market policies should aim to counter the effects of unfavourable demographic trends, migration outflows and a shrinking workforce.
- The external position remains weak with a large current account deficit and growing net external debt. In the absence of a tight fiscal policy, inflationary pressure may lead to further delays in the adoption of the euro.

Country data	
Population (in millions)	1.3
Area ('000 sq km)	45.0
GDP (in billion US$, 2005)	13.3
GDP per capita in 2005 at current international US$ (PPP)	16,203
National currency	Kroon

Progress in structural reform

Business environment and competition

The business environment in Estonia, already one of the best in the transition countries, continued to improve in 2005-06. According to Transparency International's 2005 Corruption Perceptions Index, the level of perceived corruption declined between 2004 and 2005, and Estonia moved from 21st to 17th position in the global corruption rankings. In addition, the government adopted amendments to the Competition Act in May 2006 which simplified the exemption notification system, bringing this aspect of Estonia's competition policy in line with European Union (EU) norms. These amendments to the Act also clarified the criteria for defining the limitations of ownership concentration.

Regulatory burdens on firms in Estonia also fell in 2005-06. The World Bank's 2006 Doing Business report found that the cost and minimum capital required to start a business in the country has fallen by around 20 per cent, while the time required to start up a business has halved to 35 days (although this remains above the average for central eastern Europe and the Baltic states – CEB). Licensing regulations are generally efficient and inexpensive, but the costs and regulatory burden surrounding the hiring and firing of workers is higher than the CEB average. Flexibility in the labour market is becoming increasingly important as the government tries to tackle Estonia's serious labour shortage.

Financial sector

Financial services have continued to develop, with domestic credit around 70 per cent of GDP in 2005. The small non-banking sector has started to grow on the back of the credit expansion. The Central Bank reported in 2005 that securities market capitalisation was 46 per cent of GDP in 2005 (up from 36 per cent in 2002 but below the peak of 58 per cent in 2004), one of the highest rates among transition countries. The total volume of capital invested in pension and investment funds increased from 3.4 per cent to 10.9 per cent of GDP between 2002 and 2005. In the insurance market, gross premiums (both life and non-life) collected by insurance companies increased from 1.8 per cent to 2.4 per cent of GDP over the same period.

The banking sector continues to be one of the mainstays of the Estonian economy. International Financial Reporting Standards (IFRS), first introduced in 2003, have become mandatory for compliance with European Union (EU) regulations. From July 2005, Estonian companies listed in EU securities markets – including banks and insurance companies – have had to prepare their consolidated financial statements in accordance with IFRS requirements.

Social sector

Income inequality in Estonia is among the highest in the transition countries, according to the United Nations Development Programme's Human Development Report. Poverty rates are also significantly higher than those in most EU countries, despite Estonia's strong economic growth over recent years.

According to the latest data available from Statistics Estonia, 20.2 per cent of the population is classified as "at risk of poverty" (defined as having an income of 60 per cent or less of the median equalised disposable income after social transfers). This compares with an average of 15 per cent in the wealthier EU member countries. Furthermore, poverty in Estonia is concentrated in rural areas and is particularly acute among the young and the elderly. The growth of income inequality and the urban/rural divide remains a concern, with the government implementing measures to stimulate real income growth in the countryside.

Unemployment fell to 7.9 per cent in 2005, continuing the gradual decline from 13.6 per cent in 2000, following Estonia's rapid economic growth. However, the labour market is beginning to suffer from structural imbalances, with shortages in key, high value-added sectors of the economy. Labour shortages have arisen in part from a decline of 14.5 per cent in Estonia's population between 1991 and 2006. This has reflected a combination of natural decrease, net migration outflows in the early 1990s (primarily of ethnic Russians), and more recent outflows following the opening up of labour markets in a number of other EU countries. The government has responded with measures encouraging larger families, including the introduction of earnings-linked child benefits targeted at young professionals.

The high incidence of HIV/AIDS – 460 new infections per million of population in 2005 – is also a cause for concern. The government is actively engaged in HIV/AIDS prevention, primarily through public awareness campaigns.

Macroeconomic performance

Real economy

Real GDP growth accelerated to 10.5 per cent in 2005 and to 12.0 per cent in the second quarter of 2006. Net exports and domestic demand remained the main drivers. Stronger growth was recorded across the economy, most notably in construction, financial services, manufacturing and the hotel industry. Higher employment, real wage increases in line with productivity, and rapid credit expansion fuelled the growth of investment and private consumption without undermining the economy's competitiveness. The housing market was overheating in 2005, but has shown signs of slowing down.

Economic policies

The general government balance was in surplus by 1.6 per cent of GDP in 2005 on the back of increased tax revenues. While keeping the budget in surplus, the government decided late in the year to adopt a supplementary budget to increase spending by some 1 per cent of GDP, mostly for basic pensions and higher maternity benefits. The long track record of fiscal discipline has meant that Estonia recorded a low public debt ratio of only 4.8 per cent of GDP in 2005.

Annual average consumer prices rose by 4.1 per cent in 2005 and 4.3 per cent (year-on-year) in June 2006. This was driven largely by supply side factors, notably oil and EU accession-related price increases. However, core inflation also accelerated, mainly through the indirect effects of higher oil prices on transport costs. These developments led the authorities to postpone the target date for joining the European Economic and Monetary Union (EMU), initially scheduled for January 2007. Markets have not been perturbed by the delay and confidence in the currency board remains strong, as indicated by decreasing short-term interest rate differentials with the euro.

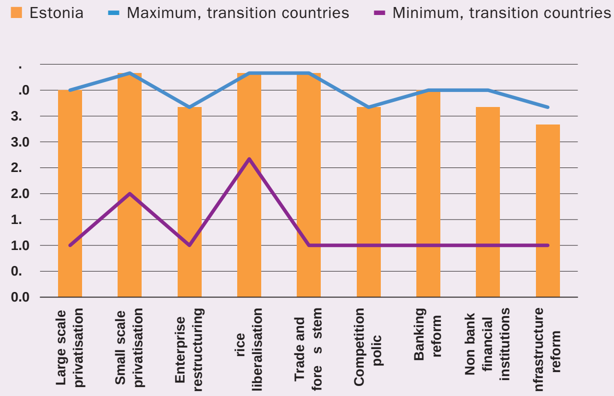
External sector

The current account deficit decreased to about 10 per cent of GDP in 2005, mainly as a result of strong export growth. The deficit on the income account continued, reflecting the repatriation of profits earned on existing foreign direct investment (FDI). The current account deficit was financed by a combination of FDI inflows, bank borrowing from foreign parents and growing EU funding. Net external debt grew to an estimated 44 per cent of GDP at the end of 2005. Much of this is private inter-company debt that is unlikely to be withdrawn abruptly.

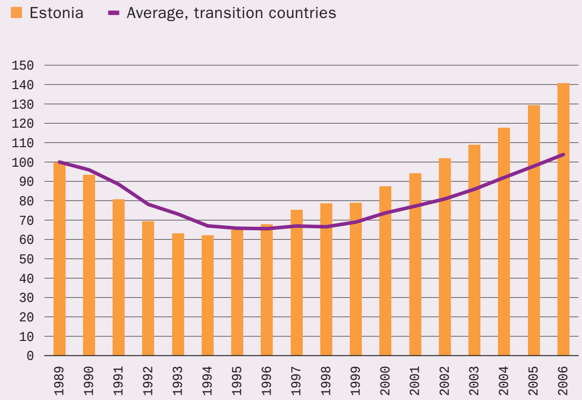
Outlook and risks

The outlook for the economy, with continuing robust growth, remains positive. However, unfavourable demographics and migration make labour shortages an increasing concern. Inflation forecasts remain dependent on oil price developments, although fast credit growth and real wage increases are adding to inflationary pressures on the demand side. Unless external economic conditions worsen, the delay in EMU membership should not have major consequences for the currency regime or the credibility of the government's economic policy.

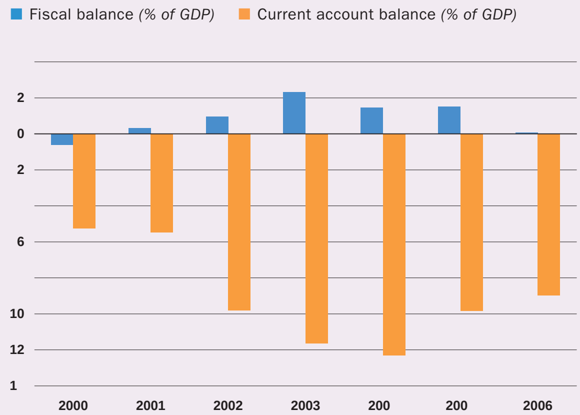
Transition indicators, 2006



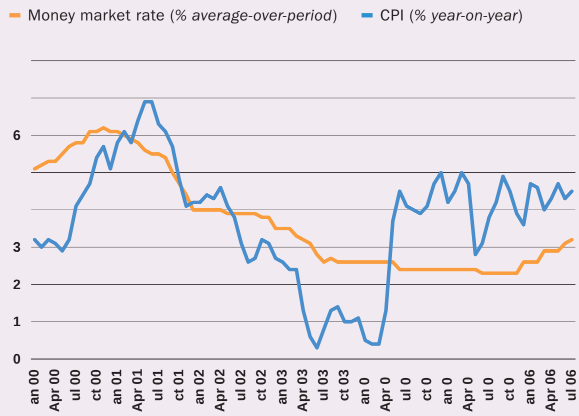
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **currency board in ERM II**

Wage regulation – **no**

Tradability of land – **full**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **inefficient**

Quality of corporate governance law – **medium**

Infrastructure

Independent telecoms regulator – **fully**

Independent electricity regulator – **fully**

Separation of railway infrastructure from operations – **fully**

Independence of the road directorate – **partially**

Quality of concession laws – **na** [1]

Financial sector

Capital adequacy ratio – **10 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **very high**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **7.5 per cent** (2003)

Government expenditure on health – **4.1 per cent of GDP**

Government expenditure on education – **6.6 per cent of GDP**

Household expenditure on power and water – **6.1 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)		6 6	0	2		a	a
r a e e r are (per e)	0	0	0 0	0 0	0 0	0 0	0 0
r a e e r are e pl y e (per e)						6	a
u ge ary u e a urre ra er (per e)	0	0	0				a
S are u ry al e pl y e (per e)	26	26	2	2 2	2 0	26 0	a
a ge la ur pr u y u ry (per e)	0						a
e e (per e)	2 0	2 2	0 6	2	2 6	0	a
EBRD index of small-scale privatisation							
EBRD index of large-scale privatisation	0	0	0	0	0	0	0
EBRD index of enterprise reform	0						
S are a ere pr e (per e) [2]	2 6	2	2	2	26	26	a
u er g a ere pr e a e	0	0	0	0	0	2 0	a
S are ra e ra u re (per e)				2 0	2 0	2	a
S are ra e (per e)		2		2		2	a
ar re e ue (per e p r)	0	0	0 0	0	0 2	a	a
EBRD index of price liberalisation							
EBRD index of forex and trade liberalisation							
EBRD index of competition policy	2	0	0	0			
u er a (re g e)	( )	( )	( )	( )	(6)	(0)	a
A e are a e e a (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
A e are re g e a (per e)		6			0		a
per r g l a (per e al l a)		2	0	0	0	0 2	a
e re pr a e e r (per e)	2	2	26				a
e re u e l (per e)			0 6			2	a
r gage le g (per e)		6	6	2		2	a
S ar e ap al a (per e)		2	2			2	a
S ra g lu e (per e ar e ap al a)		6					a
ur ua e (per e)	6					2	a
EBRD index of banking sector reform					0	0	0
EBRD index of reform of non-bank financial institutions	0	0					
e l e (le) pe e ra ra e (per 00 a a)	6 ( )	( )	(6 0)	( )	( )	(0)	a
er e pe e ra ra e (per 0 000 a a)	2	6	6 6		6	6	a
a l ay la ur pr u y (00)		2 2	22	2 6	2		a
e e al ele r y ar (S)				6		2	a
A erage lle ra e ele r y (per e)	a		0	a	a	a	a
per u e ergy u e (S llar per g e)					a	a	a
EBRD index of infrastructure reform							
Electric power			0	0	0	0	
Railways	0	0					
Roads	2	2	2	2	2	2	2
Telecommunications	0	0	0	0	0	0	0
Water and waste water	0	0	0	0	0	0	0

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	10.8	7.7	8.0	7.1	8.1	10.5	8.9
Private consumption	8.6	6.2	10.3	5.7	4.4	9.2	na
Public consumption	1.1	1.8	5.9	5.8	9.1	7.5	na
Gross fixed capital formation	14.3	13.0	17.2	5.4	9.1	13.9	na
Exports of goods and services	28.3	-0.2	0.6	6.0	16.5	21.3	na
Imports of goods and services	28.3	2.1	5.4	9.0	14.7	17.4	na
Industrial gross output	13.9	7.6	14.5	7.9	8.5	11.6	na
Agricultural gross output	-0.8	-5.4	0.1	-1.5	-8.0	0.1	na
Employment			(Percentage change)				
Labour force (annual average)	0.4	-0.2	-1.2	1.2	-0.2	0.1	na
Employment (annual average)	-1.2	0.9	1.4	1.5	0.2	2.0	na
			(In per cent of labour force)				
Unemployment (annual average)	13.6	12.6	10.3	10.0	9.6	7.9	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	4.0	5.8	3.6	1.3	3.0	4.1	3.6
Consumer prices (end-year)	5.0	4.2	2.6	1.2	5.0	3.6	5.0
Producer prices (annual average)	4.9	4.4	0.4	0.2	2.9	2.1	na
Producer prices (end-year)	6.0	1.7	1.4	0.3	3.9	2.2	na
Gross average monthly earnings in economy (annual average)	10.4	12.3	11.5	9.4	8.4	10.8	na
Government sector			(In per cent of GDP)				
General government balance	-0.6	0.3	0.9	2.3	1.4	1.6	0.1
General government expenditure	35.3	33.5	34.3	34.1	35.9	38.5	na
General government debt	4.7	4.7	5.8	6.0	5.5	4.8	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	25.1	23.8	11.1	10.9	15.8	42.0	na
Domestic credit (end-year)	27.2	24.4	27.6	28.7	29.2	32.1	na
			(In per cent of GDP)				
Broad money (M2, end-year)	34.5	37.7	37.3	37.8	39.7	47.7	na
Interest and exchange rates			(In per cent per annum, end-year)				
Deposit rate (over 12 months)	6.8	4.5	3.7	2.4	2.1	3.0	na
Lending rate (over 12 months)	8.9	10.1	6.6	5.1	6.2	6.3	na
			(Kroons per US dollar)				
Exchange rate (end-year)	16.7	17.6	14.9	12.4	11.5	12.5	na
Exchange rate (annual average)	17.0	17.5	16.6	13.9	12.6	12.4	na
External sector			(In millions of US dollars)				
Current account	-294	-339	-716	-1,116	-1,432	-1,446	-1,390
Trade balance	-767	-788	-1,089	-1,553	-1,966	-1,845	-1,800
Merchandise exports	3,309	3,359	3,530	4,607	5,971	7,785	9,700
Merchandise imports	4,076	4,148	4,619	6,161	7,937	9,631	11,500
Foreign direct investment, net	324	343	153	763	781	2,250	540
Gross reserves, excluding gold (end-year)	921	820	1,000	1,373	1,790	2,407	na
External debt stock [1]	3,007	3,279	4,704	7,054	10,012	12,130	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.2	1.9	2.1	2.2	2.2	2.5	na
			(In per cent of exports of goods and services)				
Debt service	8.9	11.7	15.1	15.9	17.8	14.6	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	1.4	1.4	1.4	1.4	1.4	1.3	na
GDP (in billions of kroons)	95	108	121	133	147	173	195
GDP per capita (in US dollars)	4,099	4,528	5,369	7,072	8,619	10,386	na
Share of industry in gross value added (in per cent)	23.4	23.3	23.9	23.8	23.4	24.5	na
Share of agriculture in gross value added (in per cent)	5.0	4.6	4.2	3.8	3.4	3.3	na
Current account/GDP (in per cent)	-5.2	-5.5	-9.8	-11.6	-12.3	-10.3	-9.0
External debt - reserves (in US$ million)	2,086	2,458	3,703	5,680	8,222	9,723	na
External debt/GDP (in per cent)	53.5	53.0	64.4	73.6	86.0	86.7	na
External debt/exports of goods and services (in per cent)	62.6	65.5	89.7	103.1	113.8	110.9	na

[1] Data from the Bank of Estonia include non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

FYR Macedonia

Key challenges

- Faster implementation of judiciary reforms, more effective action against corruption, and the removal of ambiguities over property rights should improve the business environment.
- Completion of the privatisation and commercialisation of utility companies is necessary to modernise the infrastructure and attract further investment.
- Measures to encourage job creation are needed to lower the persistently high rate of unemployment, improve living standards and strengthen public support for economic reforms.

Country data	
Population (in millions)	2.0
Area ('000 sq km)	26.0
GDP (in billion US$, 2005)	5.7
GDP per capita in 2005 at current international US$ (PPP)	7,268
National currency	Denar

Progress in structural reform

Liberalisation and privatisation

FYR Macedonia officially joined the Central-European Free Trade Agreement (CEFTA) in February 2006 and new trading arrangements took effect from July. Trade in industrial products with other CEFTA countries is now almost tariff-free, with the exception of a limited number of goods where a gradual tariff withdrawal has been agreed. In January 2006 parliament ratified a free trade agreement with Kosovo, resulting in a significant reduction of trade barriers.

Business environment and competition

In December 2005 parliament approved a series of constitutional amendments aimed at making the judiciary more efficient and reducing the extent of political influence. In particular, parliamentary powers over the election and composition of the Judicial Council were reduced, with the Council electing judges rather than nominating them for parliamentary consideration. The judiciary, however, still faces a backlog of about 1.2 million cases.

A "one-stop shop" for the registration of businesses came into force in January 2006, reducing the time taken to establish a business from 48 days to five days. In the first six months of 2006 the new system facilitated 5,400 new registrations. In March 2006 parliament approved new bankruptcy legislation, aiming to streamline and shorten proceedings and reduce costs. In April 2006 new legislation to simplify tax procedures took effect to help improve the business environment for small enterprises and encourage better tax compliance.

The process of registering real estate is improving due to a new real estate cadastre and registration project. This project will make it possible to register real estate transactions within a day, instead of several weeks. However, only about half of real estate assets are properly registered as the process for resolving land ownership disputes is slow. The new cadastre system will be completed in 2009.

Infrastructure

In March 2006 a majority state holding in ESM, a monopoly power distribution company established during the unbundling process in 2005, was sold to EVN AG, an Austrian power distribution utility. EVN AG paid €225 million and made a commitment to invest a further €96 million in ESM over the following three years. Completion of the privatisation of the Negotino thermo-power plant, the second-largest power generator in the country, was delayed due to parliamentary elections in July 2006 and a final decision on the sale is expected later in 2006.

The government is selling most of its 47.1 per cent stake in MakTel, the dominant telecommunications company (majority owned by Magyar Telekom), in small lots through the stock exchange. By the end of June 2006 the government had sold more than 10 per cent of the 45.1 per cent stake on sale for about €63 million. In April 2006 the state competition agency ruled that MakTel has been abusing its dominant position in the sector and prohibited the operator from charging its clients a handling fee of 2 per cent. However, MakTel continued to impose the charge and the competition agency announced that it would seek a judgement against the company from the Skopje district court.

While municipal utility companies have been corporatised, their decision-making is still controlled by the authorities both at the central and local level. Although the utility companies are required by law to sign contracts with customers, there has been little progress in implementing such contracts. Despite recent improvements, including the adoption of a new tariff methodology, utility companies still face significant problems in bill collection. Less than half of billed amounts are collected during the specified time period.

Financial sector

Following the approval of a new pension law, which took effect in September 2005, contributions started to be transferred to private pension funds in January 2006. More than 100,000 employees had joined the two largest private pension funds by mid-2006, twice the number expected by the authorities. More than half of participants have joined the second pillar voluntarily. However, as a result of the large number of new participants, the costs of reform for the state pension fund have led to a €26 million deficit. To cover this deficit, the government has authorised the fund to sell its minority stakes in around half of its 200 or so enterprise holdings (a measure designed to raise €36 million).

In June 2006 the National Bank amended the methodology for classifying risk related to bank balance sheet and off-balance sheet assets. This was intended to further strengthen banks' credit policies and procedures related to credit risk management. Banks are required to allocate at least 1 per cent of all loans to a special reserve for loan losses arising from high-risk credit exposures.

Macroeconomic performance

Real economy

Real GDP grew by 4 per cent in 2005, down from 4.1 per cent in 2004. The economy was driven by exports, especially of metal and textile products, while private consumption and investment increased by 0.8 per cent and 1.5 per cent respectively. In the first half of 2006 industrial production rose by less than 2 per cent year-on-year, following strong growth in 2005.

Unemployment remained high at 36.5 per cent of the labour force at the end of 2005. In the first quarter of 2006 the unemployment rate declined by 2.4 percentage points as employment increased 10.3 per cent and the labour force rose 6.1 per cent. However, the unemployment figures may be inflated by the inclusion of people registered as unemployed to qualify for benefits such as health insurance. The level of informal activity in the labour market is also very high.

Economic policies

Following deflation in 2004 and subdued consumer prices in 2005, inflation increased in the first half of 2006 reaching 4 per cent in August. This rise was mainly due to tax increases and high energy prices. The exchange rate against the euro remained stable at around 61 denar, in line with the Central Bank's exchange rate policy of a de facto near-peg to the euro.

The government's target (agreed with the IMF) of a fiscal deficit of 0.8 per cent of GDP in 2005 was exceeded comfortably as the general government budget recorded a surplus of 0.3 per cent of GDP. Most of the municipalities operate with a balanced budget and are not allowed to borrow until mid-2007, with the exception of loans from international financial institutions without guarantees.

External sector

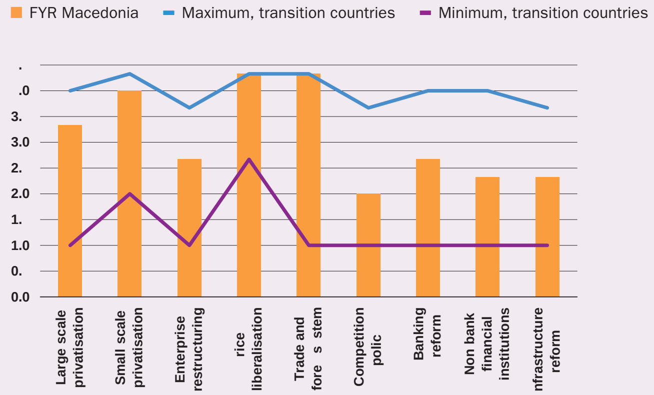
The current account deficit declined from 7.8 per cent of GDP in 2004 to 1.3 per cent in 2005, driven by a substantial increase in net current transfers as well as a decline in the trade deficit. The positive trend in the external sector was sustained in the first half of 2006. Foreign direct investment (FDI) is expected to increase substantially in 2006 as a result of energy sector privatisation, but new FDI inflows remain low.

The external debt to GDP ratio increased temporarily from 38 per cent of GDP at the end of 2004 to 40 per cent of GDP at the end of 2005. This was due to the issue of a €150 million eurobond in December 2005. However, the proceeds from the eurobond issue were used to retire debt owed to London Club creditors and the external debt subsequently declined to 35 per cent of GDP by the end of May 2006.

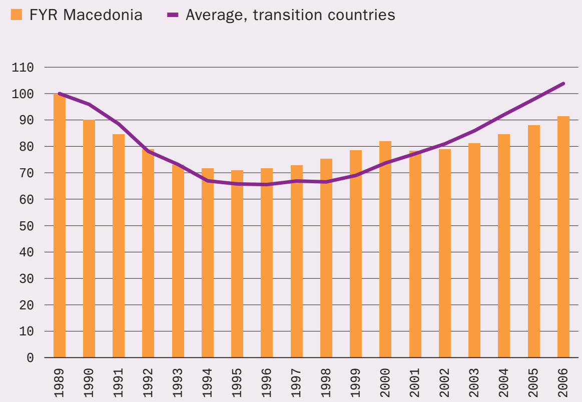
Outlook and risks

Economic stability should be maintained in the medium term. However, growth is likely to remain below the regional average due to very low levels of new FDI inflows, infrastructure deficiencies, and insufficient institutional capacity to implement the necessary reforms. Political developments, both internal and those related to the status of Kosovo, are the key risks to macroeconomic performance.

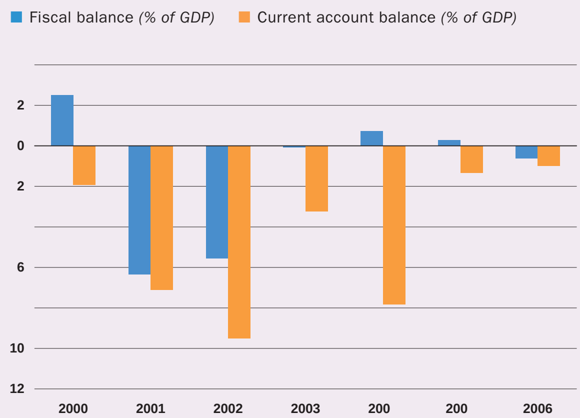
Transition indicators, 2006



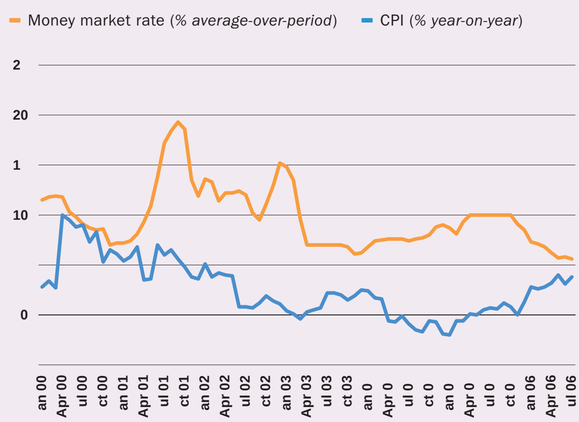
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **yes**

Interest rate liberalisation – **full**

Exchange rate regime – **de facto fixed to euro**

Wage regulation – **no**

Tradability of land – **limited de jure**

Business environment and competition

Competition office – **no**

Quality of insolvency law – **medium**

Secured transactions law – **some defects**

Quality of corporate governance law – **high**

Infrastructure

Independent telecoms regulator – **partially**

Independent electricity regulator – **partially**

Separation of railway infrastructure from operations – **no**

Independence of the road directorate – **partially**

Quality of concession laws – **medium**

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **high**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2 per cent** (2003)

Government expenditure on health – **5.2 per cent of GDP**

Government expenditure on education – **4.2 per cent of GDP**

Household expenditure on power and water – **21.6 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)	2	2 6		6		0	a
r ae e r are (per e)	0	60 0	60 0	60 0	6 0	6 0	6 0
r ae e r are e pl y e (per e)	0	0 0	0 0	0 0	0	0	a
u ge ary u e a urre ra er (per e)			0				a
S are u ry al e pl y e (per e)	2	26	2	2	2 2		a
a ge la ur pr u y u ry (per e)	0	0 6		2			a
e e (per e)	2		6 6	6		20 0	a
EBRD index of small-scale privatisation	0	0	0	0	0	0	0
EBRD index of large-scale privatisation	0	0	0	0			
EBRD index of enterprise reform	2	2	2	2	2	2	2
S are a ere pr e (per e)			0			2	a
u er g a ere pr e a e	0	0	0	0	0 0	0 0	a
S are ra e ra u re (per e)	6	6	6 6	6		0	a
S are ra e (per e)	2	2 6	0	2	0	0 0	a
ar re e ue (per e p r)					2	2	a
EBRD index of price liberalisation	0	0	0	0			
EBRD index of forex and trade liberalisation	0	0	0				
EBRD index of competition policy	2 0	2 0	2 0	2 0	2 0	2 0	2 0
u er a (re g e)	22 ( )	2 ( )	20 ( )	2 ( )	2 ( )	20 ( )	a
A e are a e e a (per e)			2 0			6	a
A e are re g e a (per e)			0	0			a
per r g l a (per e al l a)	6				2	22 2	a
e re pr a e e r (per e)	0	2	6	6 0		2	a
e re u e l (per e)	6		2	0	6		a
r gage le g (per e)	a	a	a	a	a	a	a
S ar e ap al a (per e)	0 2	0					a
S ra g lu e (per e ar e ap al a)	a	6 6			6		a
ur ua e (per e)	0 0	0 0	0 0	0 0	0 0		a
EBRD index of banking sector reform	2	2	2	2	2	2	2
EBRD index of reform of non-bank financial institutions					2 0	2 0	2
e l e (le) pe e ra ra e (per 00 a a)	2 ( )	26 ( )	2 ( )	2 ( )	26 ( )	26 2 (62 0)	a
er e pe e ra ra e (per 0 000 a a)		2					a
a l ay la ur pr u y (00)			2	6 2	6 2	0 0	a
e e al ele r y ar (S)	a	a					a
A erage lle ra e ele r y (per e)	60	0		a	a	a	a
per u e ergy u e (S llar per g e)	a	a	a	a	a	a	a
EBRD index of infrastructure reform	2 0	2 0	2 0	2 0	2	2	2
Electric power	2	2	2	2	2	2	0
Railways	2 0	2 0	2 0	2 0	2 0	2 0	2 0
Roads	2	2	2	2	2	2	2
Telecommunications	2 0	2	2	2	0	0	0
Water and waste water	2 0	2 0	2 0	2 0	2 0	2 0	2

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	4.5	-4.5	0.9	2.8	4.1	4.0	4.0
Industrial gross output	9.4	-4.6	-0.8	5.1	-2.1	6.9	na
Agricultural gross output	1.0	-10.8	-2.0	4.8	4.9	3.0	na
Employment			(Percentage change)				
Labour force (end-year)	0.6	6.3	-4.4	4.4	-3.3	6.9	na
Employment (end-year)	0.8	9.0	-6.3	-2.9	3.0	8.0	na
			(In per cent of labour force)				
Unemployment (end-year)	32.1	30.5	31.9	36.7	37.2	36.5	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	5.8	5.3	2.4	1.1	-0.3	0.1	3.4
Consumer prices (end-year)	6.1	3.7	1.0	2.5	-1.9	1.3	3.3
Producer prices (annual average)	8.9	2.0	-0.9	-0.3	0.9	3.0	na
Producer prices (end-year)	7.9	-2.5	1.1	-0.2	1.3	2.9	na
Gross average monthly earnings in economy (annual average)	5.5	3.6	6.9	4.8	3.5	3.8	na
Government sector			(In per cent of GDP)				
General government balance	2.5	-6.3	-5.6	-0.1	0.7	0.3	-0.6
General government expenditure	33.7	40.3	40.5	38.5	35.8	37.8	na
General government debt	53.2	51.6	49.6	45.7	44.3	47.6	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	24.4	66.3	-8.0	18.4	16.1	17.7	na
Domestic credit (end-year)	-10.7	-11.5	28.8	14.1	20.0	16.7	na
			(In per cent of GDP)				
Broad money (M2, end-year)	17.7	29.8	26.3	30.2	33.3	37.6	na
Interest and exchange rates			(In per cent per annum, end-year)				
Basic rate of the National Bank	8.9	10.7	10.7	7.0	6.5	6.5	na
Interbank interest rate	7.2	11.9	14.4	5.8	7.9	8.5	na
Deposit rate	10.7	10.0	9.2	6.7	6.5	5.2	na
Lending rate	19.0	19.2	17.7	14.5	12.0	12.1	na
			(Denars per US dollar)				
Exchange rate (end-year)	65.3	69.2	58.6	49.9	49.4	48.9	na
Exchange rate (annual average)	65.9	68.1	64.7	54.3	50.0	48.5	na
External sector			(In millions of US dollars)				
Current account	-69	-244	-358	-149	-415	-76	-60
Trade balance	-690	-526	-804	-848	-1,112	-1,052	-1,100
Merchandise exports	1,321	1,155	1,112	1,363	1,672	2,040	2,300
Merchandise imports	2,011	1,682	1,916	2,211	2,785	3,092	3,400
Foreign direct investment, net	175	441	78	96	156	97	300
Gross reserves, excluding gold (end-year)	700	760	730	890	980	1,401	na
External debt stock	1,548	1,494	1,641	1,831	2,034	2,253	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.5	4.8	4.1	4.2	3.8	4.9	na
			(In per cent of exports of goods and services)				
Debt service	11.5	14.7	17.2	14.8	12.2	8.9	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in billions of denars)	236	234	244	251	265	276	297
GDP per capita (in US dollars)	1,793	1,717	1,885	2,316	2,653	2,850	na
Share of industry in GDP (in per cent)	18.1	17.5	17.2	17.6	16.5	17.0	na
Share of agriculture in GDP (in per cent)	10.0	9.8	9.5	9.7	9.8	9.7	na
Current account/GDP (in per cent)	-1.9	-7.1	-9.5	-3.2	-7.8	-1.3	-1.0
External debt - reserves (in US$ million)	848	734	911	941	1,054	852	na
External debt/GDP (in per cent)	43.2	43.5	43.5	39.5	38.3	39.5	na
External debt/exports of goods and services (in per cent)	94.6	106.9	120.0	108.8	100.6	93.1	na

Georgia

Key challenges

- Despite significant progress, infrastructure deficiencies remain major obstacles to doing business. Privatisations in the energy and telecommunications sectors should promote greater investment and improve performance.
- Further improvements in the business environment depend on sustained implementation of anti-corruption measures, strengthening of administrative capacity and greater independence of the judiciary.
- In the face of high energy prices, strong domestic demand and capital inflows, containing inflationary pressures is a major challenge necessitating better public expenditure management.

Country data	
Population (in millions)	**4.6**
Area ('000 sq km)	**70.0**
GDP (in billion US$, 2005)	**6.4**
GDP per capita in 2005 at current international US$ (PPP)	**3,078**
National currency	**Lari**

Progress in structural reform

Liberalisation and privatisation

The government has continued to liberalise external trade in line with World Trade Organization requirements. A new Customs Code, reducing the number of tariffs on imported goods from 16 to three, was approved in July 2006. Custom duties and taxes will not be applied to raw materials, machinery and equipment, all of which are major imports. At the same time, to protect the agricultural and construction sectors, a maximum tariff of 12 per cent will be applied to imports of those agricultural products and building materials competing with domestically produced items.

Significant progress has been made in the ongoing large-scale privatisation programme. Since August 2005, 243 companies have been privatised, with another 137 up for sale. In November 2005 Stanton Equities Corporation (BVI) bought the metallurgical plant JSC Madneuli for US$35.1 million. In May 2006 the Danish Greenoak Group, which already owns Batumi Oil Terminal, won a management contract to lease and operate the Batumi seaport for 49 years for US$92 million.

Infrastructure

The energy sector has suffered badly from lack of investment, resulting in infrastructure deterioration, energy wastage and theft. The implementation of the government's Energy Action Plan increased average collection rates in the power sector to 78 per cent by the end of 2005 (up from 12 per cent in 2003). In June 2006 two major regional distribution companies – the United Distribution Company and JSC Adjara Energy Company – and six power stations were sold to the Czech company ENERGO-PRO.

To strengthen security of gas supply, a project supported by the Millennium Challenge Account has been launched to rehabilitate sections of the main gas transit pipeline from Russia. In addition, in May 2006 KazTransGas (Kazkahstan's national gas transmission company) purchased TbilGaz, the gas distribution company for Tbilisi, for US$12.5 million. KazTransGas is expected to undertake essential rehabilitation work on the distribution network.

The telecommunications sector in Georgia remains underdeveloped, with fixed-line penetration at about 15 per cent. Rural areas are particularly poorly served. Since the sale of Georgia Telecom to a US company at the beginning of 2005, another major fixed-line operator, Georgian United Telecommunications Company (GUTC), has been privatised. In May 2006 GUTC was sold to Kazakhstan's Black Sea Telecom Holding BV for US$90 million.

These sales should bring much-needed investment for network upgrading and expansion. Furthermore, the law on electronic communications, enacted in July 2006, brings the country's legislation into line with best practice in the sector.

Financial sector

Domestic credit to the private sector rose by more than 70 per cent in real terms during 2005 and by another 30 per cent in the first six months of 2006. The legal framework for secured transactions was improved when amendments to provisions in the Civil Code regarding the pledge of movable property came into force in March 2006. However, the establishment of a centralised pledge registry for movable property, which is necessary for the implementation of the law, has been delayed. A proper implementation of the secured transactions law would further promote the provision of credit to the private sector.

Mortgage lending has also started to develop. However, the provisions in the Civil Code applying to mortgage lending have not yet been amended and are constraining the development of an active mortgage market.

The National Bank of Georgia (NBG) has improved the legal framework and further strengthened requirements for financial reporting by commercial banks. The law on commercial bank activities has been amended to improve the transparency of ownership and corporate governance of banks. In March 2006 the restriction under which one shareholder (or a group of joint shareholders) could hold no more than 25 per cent of voting shares in a bank was abolished. The rules governing the proportion of shares that can be acquired in a bank with or without consent from the NBG are under review.

A new law regulating the activity of microfinance organisations came into force in August 2006. A proposed law for a deposit insurance scheme, covering primarily deposits under 1,500 lari (US$840), should also improve confidence in the banking system.

Macroeconomic performance

Real economy

The economy grew by 9.3 per cent in 2005 and by 8.4 per cent in the first quarter of 2006. Growth was particularly strong in the industrial and construction sectors, where output rose by about 26 per cent in both cases. Growth was also strong in the services sector (especially financial services), which grew by almost 57 per cent during the period. However, agricultural production fell by 8.3 per cent, partly because of unfavourable weather conditions.

Economic policies

Improved tax collection and progress in tackling corruption, as well as growing privatisation revenues, helped to raise budget revenues during 2005 and allowed the government to increase fiscal spending. Consolidated budget revenues increased by nearly 37 per cent year-on-year in the first seven months of 2006 and tax receipts rose by 34 per cent. High oil prices, extra government spending and strong capital inflows have meanwhile increased inflationary pressures. The inflation rate reached 14.5 per cent in July 2006, well above the NBG's target of 6 per cent. To help lower inflation, the NBG allowed the lari to appreciate in nominal terms against the US dollar during the first half of 2006, reflecting foreign currency inflows, and also plans to issue treasury bills to reduce the money supply.

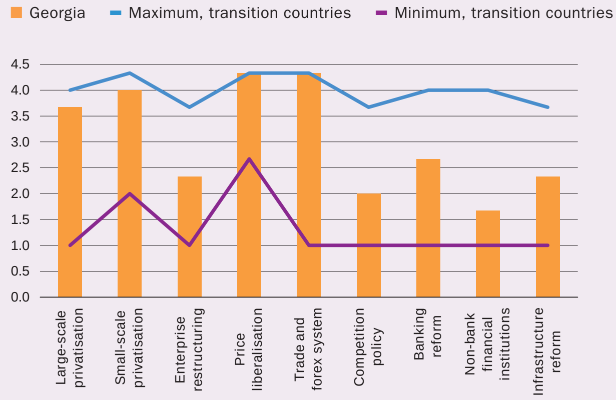
External sector

The trade deficit widened dramatically by 82 per cent in the first half of 2006 compared with the same period in 2005. While exports grew by 26 per cent, imports (mainly of investment goods related to pipeline construction) grew by about 61 per cent. Export growth was also negatively affected by a Russian trade embargo on Georgian wine and mineral water which took effect in March 2006. Wine was Georgia's second most important export in 2005, and the wine ban is estimated to have resulted in a loss of between US$35 million and US$40 million in export revenue by June. The external debt position has improved significantly, supported by debt relief agreements with a number of bilateral creditors. The ratio of public external debt to GDP fell to 27 per cent in 2005 from 36 per cent in 2004.

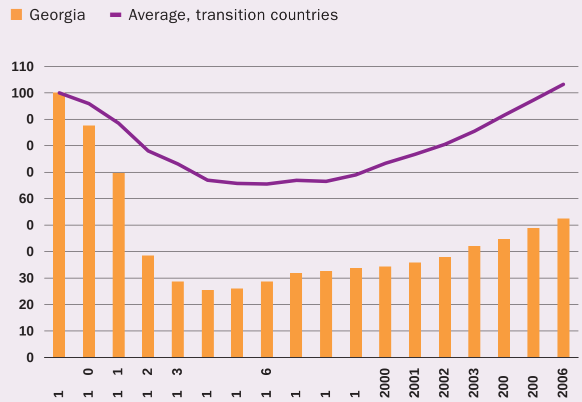
Outlook and risks

GDP growth is expected to remain in the range of 6 per cent to 8 per cent per year in the short term, driven mainly by industrial output, construction and investment activities related to the South Caucasus gas pipeline. Exports of services associated with the Baku-Tbilisi-Ceyhan pipeline should lessen the negative effect of the continuing trade deficit on the current account. However, a combination of strong domestic demand, high government spending and price increases (due to deregulation of state-controlled prices) means that inflationary pressures pose a significant risk.

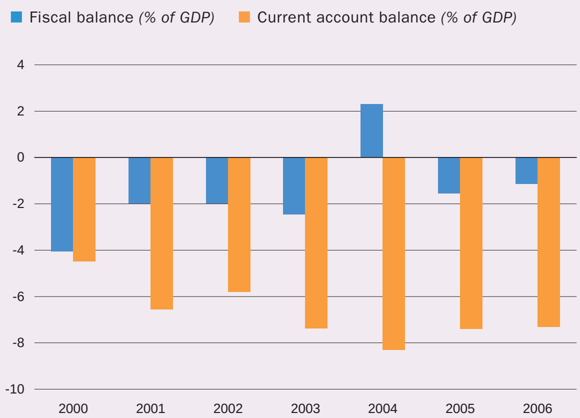
Transition indicators, 2006



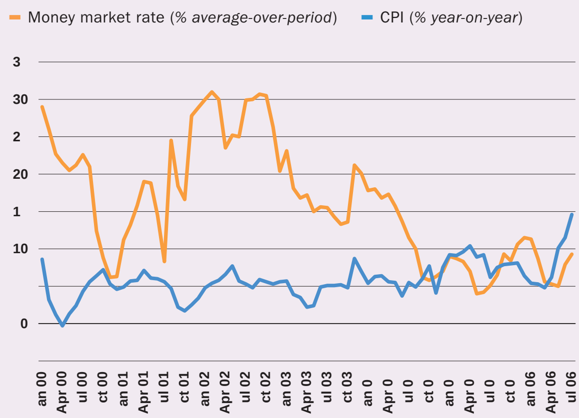
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **floating**

Wage regulation – **no**

Tradability of land – **limited for foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **malfunctioning** [1]

Quality of corporate governance law – **low**

Infrastructure

Independent telecoms regulator – **fully**

Independent electricity regulator – **partially**

Separation of railway infrastructure from operation – **no**

Independence of the road directorate – **partially**

Quality of concession laws – **very low**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **no**

Quality of securities market laws – **medium**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **25.3 per cent** (2003)

Government expenditure on health – **0.55 per cent of GDP**

Government expenditure on education – **0.66 per cent of GDP**

Household expenditure on power and water – **11 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)	2 0	2	2	2 6	2	2	a
r a e e r are (per e)	60 0	60 0	6 0	6 0	6 0	6 0	0 0
r a e e r are e pl y e (per e)			6				a
u ge ary u e a urre ra er (per e)	2	2		6	2	2	a
S are u ry al e pl y e (per e)		6	6		6	6	a
a ge la ur pr u y u ry (per e)					0		a
e e (per e)	2 6	2	22 0	2	26 6	26	a
EBRD index of small-scale privatisation	0	0	0	0	0	0	0
EBRD index of large-scale privatisation							
EBRD index of enterprise reform	2 0	2 0	2 0	2 0	2 0	2	2
S are a ere pr e (per e)							a
u er g a ere pr e a e	0 0	0 0	0 0	0 0	0 0	0 0	a
S are ra e ra u re (per e)	2	6	6	6 0		2	a
S are ra e (per e)				6	62	0	a
ar re e ue (per e p r)				6	0		a
EBRD index of price liberalisation							
EBRD index of forex and trade liberalisation							
EBRD index of competition policy	2 0	2 0	2 0	2 0	2 0	2 0	2 0
u er a (re g e)	2 ( )	2 ( )	2 ( )	2 (6)	2 ( )	(0)	a
A e are a e e a (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
A e are re g e a (per e)	6		2 2			a	a
per r g l a (per e al l a)	2				6 2		a
e re pr a e e r (per e)	6	6					a
e re u e l (per e)	0 6	2 6	2	2	2 6		a
r gage le g (per e)	0	0	0	0	0	2	a
S ar e ap al a (per e)	0	2	2				a
S ra g lu e (per e ar e ap al a)	a			0	6	6	a
ur ua e (per e)	0		0 0	0 0	0 0	0 0	a
EBRD index of banking sector reform	2	2	2	2	2	2	2
EBRD index of reform of non-bank financial institutions							
e l e (le) pe e ra ra e (per 00 a a)	0 ( )	2 2 (6)	(0)	6 (6)	(6)	(2 6)	a
er e pe e ra ra e (per 0 000 a a)			6 6	0	0	0	a
a l ay la ur pr u y (00)		6 2		2 6	6 6		a
e e al ele r y ar (S)	6	0	2			2	a
A erage lle ra e ele r y (per e)		2	0	2	a	a	a
per u e ergy u e (S llar per g e)		2	6		a	a	a
EBRD index of infrastructure reform	2	2	2	2	2	2	2
Electric power				0	0	0	0
Railways	0	0	0	0	0	0	0
Roads	2 0	2 0	2 0	2 0	2 0	2 0	2 0
Telecommunications	2	2	2	2	2	2	2
Water and waste water	2 0	2 0	2 0	2 0	2 0	2 0	2 0

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	1.9	4.7	5.5	11.1	6.2	9.3	7.5
Private consumption	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na
Industrial gross output	5.3	-4.5	7.8	14.0	12.2	13.0	na
Agricultural gross output	-12.0	8.2	-1.4	7.0	-6.7	na	na
Employment [1]			(Percentage change)				
Labour force (end-year)	9.3	-2.2	-5.0	8.1	-4.4	0.7	na
Employment (end-year)	15.0	-2.1	-6.8	9.6	-6.3	-0.8	na
			(In per cent of labour force)				
Unemployment (end-year)	10.4	10.3	11.9	10.7	12.5	13.8	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	4.1	4.6	5.7	4.9	5.7	8.4	9.0
Consumer prices (end-year)	4.6	3.4	5.6	7.0	7.5	6.4	8.0
Producer prices (annual average)	5.8	3.6	6.0	2.3	3.8	7.2	na
Producer prices (end-year)	2.4	8.9	1.5	5.4	0.7	8.2	na
Gross average monthly earnings in economy (annual average)	7.1	30.8	20.5	10.4	19.9	22.5	na
Government sector [2]			(In per cent of GDP)				
General government balance	-4.0	-2.0	-2.0	-2.5	2.3	-1.5	-1.1
General government expenditure	19.2	18.3	17.8	18.7	19.5	24.9	na
General government debt	69.8	68.4	67.4	61.5	47.0	35.8	na
Monetary sector			(Percentage change)				
Broad money (M3, end-year)	39.4	18.5	17.1	22.7	43.6	26.4	na
Domestic credit (end-year)	17.5	2.3	9.5	14.7	7.4	39.8	na
			(In per cent of GDP)				
Broad money (M3, end-year)	10.4	11.1	11.6	12.4	15.3	16.6	na
Interest and exchange rates			(In per cent per annum, end-year)				
Money market rate	18.2	17.5	27.7	16.9	11.9	7.7	na
Treasury bill rate (3-month maturity) [3]	26.0	29.9	43.4	44.3	19.2	na	na
Deposit rate (3-month) [4]	12.0	7.8	9.8	9.3	7.2	7.6	na
Lending rate (3-month)	32.8	27.0	31.8	32.3	31.2	21.6	na
			(Laris per US dollar)				
Exchange rate (end-year)	2.0	2.1	2.1	2.1	1.8	1.8	na
Exchange rate (annual average)	2.0	2.1	2.2	2.1	1.9	1.8	na
External sector			(In millions of US dollars)				
Current account	-136	-210	-196	-294	-430	-473	-537
Trade balance	-398	-486	-439	-598	-719	-907	-1,048
Merchandise exports	584	473	553	730	1,272	1,403	1,522
Merchandise imports	982	959	992	1,328	1,991	2,310	2,570
Foreign direct investment, net	153	80	122	335	503	415	390
Gross reserves, excluding gold (end-year)	109	161	198	191	383	493	na
External debt stock	1,582	1,712	1,858	1,954	2,039	2,137	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	0.9	1.4	1.6	1.3	1.8	2.1	na
			(In per cent of current account revenues, excluding transfers)				
Debt service	16.7	19.3	7.4	10.0	10.2	9.8	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	4.6	4.6	4.6	4.6	4.6	4.6	na
GDP (in millions of laris)	6,013	6,638	7,448	8,565	9,951	11,600	13,080
GDP per capita (in US dollars)	659	693	734	864	1,124	1,385	na
Share of industry in GDP (in per cent)	17.3	16.6	17.6	17.7	16.1	15.6	na
Share of agriculture in GDP (in per cent)	20.2	20.7	19.3	19.3	16.4	14.8	na
Current account/GDP (in per cent)	-4.5	-6.6	-5.8	-7.4	-8.3	-7.4	-7.3
External debt - reserves (in US$ million)	1,473	1,551	1,660	1,763	1,656	1,644	na
External debt/GDP (in per cent)	52.0	53.5	54.8	49.0	39.3	33.4	na
External debt/exports of goods and services (in per cent)	143.8	175.6	167.2	151.7	111.4	110.7	na

1 Data consistent with ILO methodology.

2 General government includes the state, municipalities and extra-budgetary funds.

3 Data relate to the average auction rates during the year.

4 Data refer to average rates for local currency from international financial statistics.

Hungary

Key challenges

- Restoring balance in government finances and providing an effective austerity package are crucial to rebuilding investor confidence.
- Swift implementation of reforms in the administration, health care and education sectors is essential for the long-term international competitiveness of Hungary.
- Extending the share of services and high value-added products in the national economy, increasing labour participation, and ensuring efficient spending of EU funds are key to facilitating long-term growth.

Country data	
Population (in millions)	**10.1**
Area ('000 sq km)	**93.0**
GDP (in billion US$, 2005)	**109.2**
GDP per capita in 2005 at current international US$ (PPP)	**18,100**
National currency	**Forint**

Progress in structural reform

Business environment and competition

The government's fiscal difficulties and the large deficit in public finances have contributed to currency depreciation, increased exchange rate volatility and a widening of spreads on forint-denominated financial instruments. Following its re-election the government announced in June 2006 a fiscal consolidation plan based mainly on tax increases. While considered to be the first step in reducing the deficit, there is concern that this plan may have a negative effect on international competitiveness. Even before the new tax rises, Hungary had the second highest labour tax level in the OECD. The government also outlined a number of potential medium-term structural reforms, including partial centralisation of local administration responsibilities, cuts in subsidies for prescription medicines, and a tightening of eligibility criteria for disability benefits. Other measures expected to be implemented in the near future include the introduction of tuition fees for higher education and co-financing of services by patients as part of health care reform. Nevertheless, public opposition to the reforms, expressed by demonstrations and riots in autumn 2006, has increased the risk of the government postponing some measures.

Infrastructure

Divestment from the remaining state controlled infrastructure assets has dominated the privatisation agenda. The sale of the rights to operate Budapest Airport to the UK operator BAA for US$2.2 billion was the single largest privatisation transaction in 2005. The sale of the state-owned airline Malev, regional coach company Volan and partial privatisation of the state-owned motorway management company are also planned.

In the energy sector, an international share swap resulted in Russia's Gazprom taking a 50 per cent-minus-one-share stake in E.ON's gas storage and wholesale business in Hungary in mid-2006. The deal, although accepted by the authorities, has raised some concerns about the effects of concentrated ownership of gas production and distribution on competition in the sector. In August 2006 the government cut subsidies on gas supplies to residential consumers. As a result, the retail price of natural gas increased by an average of 27 per cent and electricity prices rose by 14.5 per cent.

In the railway sector, MAV Cargo was separated from MAV as a fully owned subsidiary and its privatisation is planned for 2007–08. Restructuring plans for MAV also envisage the closure of 28 rural railway routes, a significant reduction in administrative staffing, and the unbundling of infrastructure maintenance and passenger services.

Financial sector

Bank profitability remained strong in 2005, based on expanding foreign-currency lending, and high margins and fees, especially in the retail segment. Foreign-currency lending, mainly in Swiss francs and euros, has developed rapidly since the end of 2003 owing to the relatively high level of domestic interest rates. Such lending now accounts for two-thirds of all new consumer loans, a quarter of new housing loans and over 60 per cent of outstanding corporate debt. The limited hedging possibilities available to bank clients, however, particularly in the case of consumer loans, pose some danger to the stability of smaller non-banking financial institutions should the currency depreciate suddenly.

Yields on pension funds rose by 10.6 per cent in 2005, compared with an average 2.1 per cent between 1998 and 2004. However, the pension system has continued to suffer from weak competition, inadequate operational arrangements of funds linked to banks and insurance companies, and low transparency of costs. Concerns about the sustainability of the system have also increased. A study published by the Central Bank in December 2005 estimated that unfunded liabilities of the state pension system amounted to about 240 per cent of GDP. The relatively weak return performance of pension funds has been attributed to the undiversified portfolios. According to the Central Bank, at the end of 2005 some 75 per cent of pension fund assets were directed into Hungarian government bonds and a further 15 per cent to stocks.

Social sector

The employment rate, at around 57 per cent in 2005 (according to Eurostat), is well below the European Union (EU) average of around 64 per cent. This largely reflects a generous benefit system, low labour mobility and weak incentives to seek employment. Although the government has adopted some measures aimed at increasing labour participation, including tougher eligibility rules for some social and health benefits, their results are unlikely to have an impact in the immediate future. Unemployment was 7.6 per cent in July 2006, lower than in many other EU countries.

Macroeconomic performance

Real economy

Real GDP growth slipped from 4.6 per cent in the first quarter of 2006 to 3.8 per cent in the second quarter of the year. This unexpected slowdown was due primarily to a decline in investments and weak domestic consumption, which increased by only 2.5 per cent despite substantial growth in real wages since the end of 2005. The growth rate in the second quarter of 2006 was below both the 4.1 per cent achieved in 2005 and the 5.2 per cent recorded in 2004. Weaker growth is likely to continue into 2007 when the government's fiscal tightening measures are expected to have their full impact on domestic demand.

Economic policies

The general government deficit in 2005 was an estimated 6.1 per cent of GDP (according to ESA95 methodology, excluding costs of pension reform). The 2006 fiscal deficit is expected to reach around 8.6 per cent of GDP (according to the same methodology), the highest level among all transition countries. The persistent fiscal difficulties have led to declining investor confidence and downgrades by the main rating agencies. They have also contributed to the depreciation of the Hungarian forint. The currency had weakened against the euro by more than 8 per cent between January and September 2006. Inflation was at 3.5 per cent in August 2006, but is expected to increase in 2007 as the planned tax increases and price subsidy cuts take effect. As a result of inflationary pressures and weakening investor confidence, the Central Bank had increased the reference rate to 7.75 per cent by September 2006, up from 6 per cent in June.

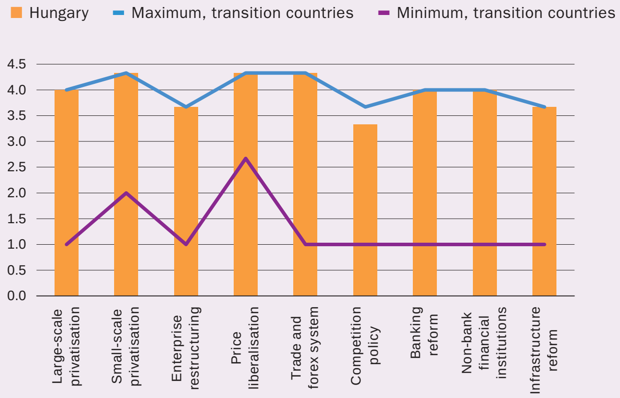
External sector

The current account deficit was around 7.4 per cent of GDP in 2005, compared with 8.6 per cent in 2004. During the year exports increased by 10.5 per cent, imports rose by 8.2 per cent, and the trade deficit shrank to around US$2 billion. The trend continued in the first half of 2006 when export growth outstripped the increase in imports. In 2005 the trade deficit continued to be financed by government and corporate borrowing, significant (but volatile) portfolio investments and foreign direct investment (FDI). Net FDI benefited from a substantial volume of reinvested profits by foreign companies, and was equivalent to 4.9 per cent of GDP in 2005.

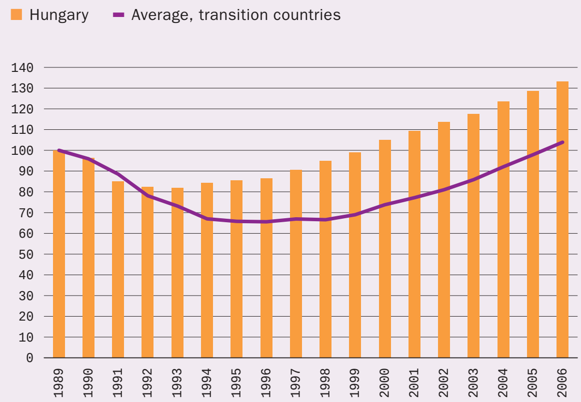
Outlook and risks

Although the economy has benefited from a sound banking sector, sustained market-oriented reforms and extensive foreign investments, the medium-term outlook will be affected by the scale of the fiscal difficulties, the impact of the government's austerity measures and structural reforms. In the long-term such reforms, particularly in the health care, education and administration sectors, are likely to improve Hungary's international competitiveness. Nevertheless, the short-term effects of the measures will reduce the purchasing power of consumers and increase costs for enterprises. Furthermore, any unexpected fiscal slippage is likely to have negative consequences for overall economic performance. According to the government, adoption of the euro is expected between 2011-13.

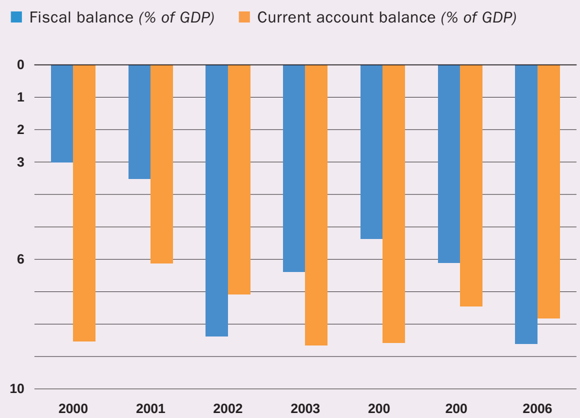
Transition indicators, 2006



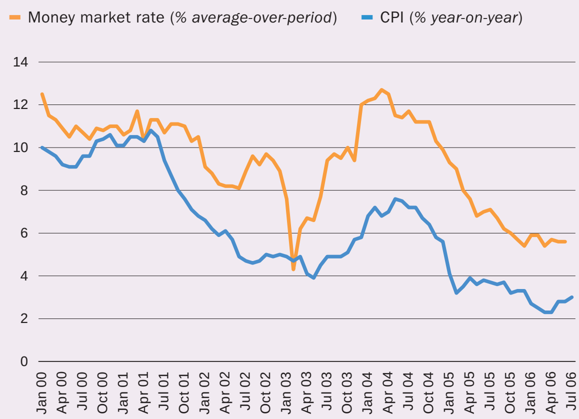
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full** Controls on inward direct investment – **no** Interest rate liberalisation – **full** Exchange rate regime – **fixed with band to euro** Wage regulation – **no** Tradability of land – **full except foreigners**	Competition office – **yes** Quality of insolvency law – **low** Secured transactions law – **advanced** Quality of corporate governance law – **high**	Independent telecoms regulator – **fully** Independent electricity regulator – **fully** Separation of railway infrastructure from operations – **partially** Independence of the road directorate – **fully** Quality of concession laws – **low**	Capital adequacy ratio – **8 per cent** Deposit insurance system – **yes** Quality of securities market laws – **not available** Private pension funds – **yes**	Share of population living in poverty – **<2 per cent** (2002) Government expenditure on health – **5.4 per cent of GDP** Government expenditure on education – **5.8 per cent of GDP** Household expenditure on power and water – **10.9 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)	0 2	0 6	0	6		2	a
r a e e r are (per e)	0 0	0 0	0 0	0 0	0 0	0 0	0 0
r a e e r are e pl y e (per e)	0	6					a
u ge ary u e a urre ra er (per e)	2	2	2	2		2	a
S are u ry al e pl y e (per e)					2	2	a
a ge la ur pr u y u ry (per e)		2		6	6	6	a
e e (per e)	2	2	2	22	22	20	a
EBRD index of small-scale privatisation							
EBRD index of large-scale privatisation	0	0	0	0	0	0	0
EBRD index of enterprise reform							
S are a ere pr e (per e)	6	6	6		6 0		a
u er g a ere pr e a e	2 0	2 0	2 0	2 0	2 0	2 0	a
S are ra e ra u re (per e)	2			0		0 2	a
S are ra e (per e)	2	2 0	0	0			a
ar re e ue (per e p r)					0	0	a
EBRD index of price liberalisation							
EBRD index of forex and trade liberalisation							
EBRD index of competition policy	0	0	0	0			
u er a (re g e)	2 ( )	(2)	(2)	(2)	(2)	(2)	a
A e are a e e a (per e)			0		6 6	0	a
A e are re g e a (per e)	6	66	0		6 0	2 6	a
per r g l a (per e al l a)		0					a
e re pr a e e r (per e)	0			2			a
e re u e l (per e)					0		a
r gage le g (per e)			2	0		6	a
S ar e ap al a (per e)	2 6	0		6	2		a
S ra g lu e (per e ar e ap al a)		0		6	6	0	a
ur ua e (per e)	2	2	0 0	0	2	6	a
EBRD index of banking sector reform	0	0	0	0	0	0	0
EBRD index of reform of non-bank financial institutions						0	0
e l e (le) pe e ra ra e (per 00 a a)	(0 2)	6 ( )	6 2 (6)	6 ( )	(6)	2 (2)	a
er e pe e ra ra e (per 0 000 a a)	02	6		6	2	2	a
a l ay la ur pr u y (00)	22	2	0			0	a
e e al ele r y ar (S)	6 2	0					a
A erage lle ra e ele r y (per e)	a	a	0			a	a
per u e ergy u e (S llar per g e)			6	6	a	a	a
EBRD index of infrastructure reform							
Electric power	0	0	0	0	0	0	0
Railways							
Roads							
Telecommunications	0	0	0	0	0	0	0
Water and waste water	0	0	0	0	0	0	0

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	6.0	4.3	3.8	3.4	5.2	4.1	3.5
Private consumption	5.0	5.8	9.7	7.8	3.1	2.1	na
Public consumption	1.2	1.2	6.6	7.9	0.9	-1.4	na
Gross fixed capital formation	7.7	5.9	9.3	2.5	8.4	6.6	na
Exports of goods and services	21.0	8.0	3.9	7.8	16.4	10.6	na
Imports of goods and services	19.4	5.2	6.6	11.1	13.2	5.8	na
Industrial gross output	9.6	0.5	1.4	5.3	4.9	5.4	na
Agricultural gross output	-7.9	24.6	-12.9	-4.2	37.9	-11.8	na
Employment			(Percentage change)				
Labour force (annual average)	0.6	-0.4	0.2	1.4	0.1	1.3	na
Employment (annual average) [1]	1.2	0.3	0.1	1.3	-0.3	0.2	na
			(In per cent of labour force)				
Unemployment (end-year)	6.4	5.7	5.8	5.9	6.3	7.3	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	9.8	9.2	5.3	4.7	6.8	3.6	4.0
Consumer prices (end-year)	10.1	6.8	4.8	5.7	5.5	3.3	6.0
Producer prices (annual average)	11.7	5.2	-1.8	2.4	3.5	4.3	na
Producer prices (end-year)	12.4	-0.4	-1.3	6.2	1.6	4.7	na
Gross average monthly earnings in economy (annual average)	13.5	18.2	18.3	12.0	6.2	7.3	na
Government sector			(In per cent of GDP)				
General government balance [2]	-3.0	-3.5	-8.4	-6.4	-5.4	-6.1	-8.6
General government expenditure	47.4	48.0	52.1	49.8	49.5	50.6	na
General government debt	54.9	51.7	55.0	56.7	57.1	58.4	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	12.1	16.8	13.8	13.6	9.9	13.0	na
Domestic credit (end-year)	11.8	4.7	15.3	19.8	11.9	23.3	na
			(In per cent of GDP)				
Broad money (M2, end-year)	42.8	44.3	44.6	46.0	46.2	48.9	na
Interest and exchange rates			(In per cent per annum, end-year)				
Refinance rate	11.0	9.8	8.5	12.5	9.5	6.0	na
Interbank interest rate (up to 30-day maturity)	11.9	10.0	8.9	12.2	9.7	6.1	na
Deposit rate weighted average (fixed for less than 1 year)	9.9	9.4	7.4	8.7	9.1	5.2	na
Lending rate weighted average (maturing within 1 year)	12.8	12.0	9.7	11.2	11.0	7.4	na
			(Forints per US dollar)				
Exchange rate (end-year)	284.7	279.0	225.2	207.9	180.3	213.6	na
Exchange rate (annual average)	282.2	286.5	257.9	224.3	202.7	199.6	na
External sector			(In millions of US dollars)				
Current account [3]	-4,011	-3,201	-4,643	-7,198	-8,641	-8,253	-8,600
Trade balance [3]	-2,930	-2,234	-2,076	-3,271	-3,037	-2,036	-4,500
Merchandise exports [3]	28,822	31,054	34,684	43,325	55,902	62,996	68,300
Merchandise imports [3]	31,752	33,288	36,760	46,596	58,939	65,032	72,800
Foreign direct investment, net [3]	2,151	3,573	2,722	479	3,542	5,353	3,500
Gross reserves, excluding gold (end-year)	11,229	10,766	10,394	12,791	15,963	18,603	na
External debt stock	30,287	33,951	36,883	53,761	75,149	82,423	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.7	3.3	2.9	2.8	2.8	2.9	na
			(In per cent of exports of goods and services)				
Debt service [4]	15.3	14.5	13.7	14.2	15.1	na	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	10.0	10.2	10.1	10.1	10.1	10.1	na
GDP (in billions of forints)	13,272	14,990	16,915	18,651	20,413	21,785	23,412
GDP per capita (in US dollars)	4,683	5,140	6,467	8,219	9,971	10,829	na
Share of industry in GDP (in per cent)	27.9	27.2	26.8	27.5	28.3	na	na
Share of agriculture in GDP (in per cent)	4.6	5.5	4.7	4.4	4.6	na	na
Current account/GDP (in per cent)	-8.5	-6.1	-7.1	-8.7	-8.6	-7.4	-7.8
External debt - reserves (in US$ million)	19,058	23,185	26,490	40,970	59,186	63,820	na
External debt/GDP (in per cent)	64.4	64.9	56.2	64.7	74.6	75.5	na
External debt/exports of goods and services (in per cent)	87.2	89.1	87.7	103.3	112.8	109.1	na

Kazakhstan

Key challenges

- Minority shareholder rights need to be enhanced as more companies and banks seek equity investments from third-party sources.
- Business entry and entrepreneurship should be facilitated, including through the adoption of a modern competition policy.
- High oil prices have resulted in strong growth rates and ample international reserves. However, banking regulation and supervision should be strengthened as the sector is increasingly vulnerable to shocks, and fiscal policy may need to be tightened to stem further inflationary pressures.

Country data

Population (in millions)	**15.1**
Area ('000 sq km)	**2,728.0**
GDP (in billion US$, 2005)	**56.1**
GDP per capita in 2005 at current international US$ (PPP)	**8,536**
National currency	**Tenge**

Progress in structural reform

Business environment and competition

Several private Kazakh companies raised capital through overseas listings during 2005. Kazakhmys, a copper mining company, raised £600 million through an initial public offering (IPO) on the London Stock Exchange (LSE) in October. The company has subsequently been included in the FTSE 100 index of leading shares. In November, KazakhGold, a gold mining company, raised US$196.5 million through an IPO of global depositary receipts, also on the LSE. Other Kazakh companies and banks have made IPO plans to boost their equity base. However, their success will depend on improvements protecting minority shareholder rights, including consistent enforcement of corporate governance legislation and greater transparency.

In early 2006 a presidential decree was issued establishing the state holding company Samruk, which will be responsible for improving corporate governance in large state-owned firms. Stakes in several major companies in the telecommunications, postal service, electricity transmission, railways and oil and gas sectors have subsequently been transferred to Samruk. In March 2006 Kazyna, the Sustainable Development Fund, was established to manage existing state-owned development institutions such as the Development Bank of Kazakhstan.

In June 2005 Kazakhstan officially endorsed the principles of the Extractive Industries Transparency Initiative (EITI), which aims to increase the transparency of revenue flows from the extractive sectors. A memorandum of understanding was signed by various stakeholders, including the government and 28 companies, in October 2005. Under this initiative, all revenue flows from oil, gas and mining companies to the government will be disclosed to the public.

A new competition law, which raises the threshold of asset and share acquisitions requiring approval from the competition authorities, came into effect in July 2006. This law also defines a dominant position – a company with a share in the relevant market exceeding 35 per cent. While the new law relieves small and medium-sized enterprises from regulatory approval, further changes in the legal framework may be required to promote new business entry and ease exit.

Infrastructure

The legal framework for private sector participation in infrastructure was strengthened in July 2006 with the adoption of a new law on concessions and by amendments to existing legislation. The new law defines the concept of concession, and determines the obligations of contracting parties and the contents, terms and procedures of a concession agreement.

The regulatory environment for natural monopolies has improved, with companies no longer required to seek approval for various cost components from designated ministries and agencies. Companies have also been permitted greater flexibility in applying for tariff increases.

The telecommunications market was fully liberalised from January 2006 when the provisions on the law on communications lifting the exclusivity of Kazakhtelecom, the dominant majority state-owned operator, came into effect. Mobile and fixed-line service providers are now free to choose any operator for interconnection arrangements to carry all types of calls, including international traffic.

Financial sector

At the end of 2005, the government lifted a restriction limiting foreign ownership of banks in Kazakhstan to 50 per cent. However, the opening of branches of foreign banks remains prohibited by law and is one of the remaining issues for Kazakhstan's accession to the World Trade Organization.

Robust credit growth has continued despite the adoption of measures to restrain externally financed credit in 2005. The authorities have therefore taken steps to tighten banking regulations and improve supervision. Minimum reserve requirements were further extended to cover all liabilities from July 2006. Higher reserve requirements for foreign liabilities compared with domestic liabilities were also introduced in order to stem the growth of external borrowing by commercial banks. This amounted to US$15 billion at the end of 2005, almost double the volume recorded in 2004, and accounted for around 50 per cent of banks' total liabilities. Consolidated supervision of banking-industrial conglomerates was introduced in late 2005, which should improve the reporting of related-party lending and mitigate associated risks.

Buoyed by increased liquidity in the economy and the build-up of contributions to privately-managed pension funds, market capitalisation of the Kazakh Stock Exchange (KASE) increased sharply in 2005. Pension fund assets rose by 34 per cent in 2005 to reach KZT 649 billion, a large proportion of which was invested in domestic corporate bonds, national bank notes and domestic shares.

Macroeconomic performance

Real economy

Real GDP grew by 9.4 per cent in 2005. This reflected higher oil prices and strong domestic demand resulting from higher government spending and a further easing of credit conditions. The economy grew at a similar rate during the first half of 2006, although it was mainly driven by activity in the non-oil sectors.

Economic policies

The general government surplus widened to 6 per cent of GDP in 2005 from 2.6 per cent in 2004, accommodating an increase in expenditures of over 20 per cent in real terms. The rapid growth in spending reflected the buoyancy of tax revenues as oil income nearly doubled (primarily due to high oil prices). Non-oil revenues also rose sharply because of improved tax collection. The budget for 2006 forecast a similar overall fiscal position as a percentage of GDP to that of 2005. In July 2006 the National Fund (NFRK) was fully integrated with the budget. Under this new arrangement, all oil revenues will accrue to the NFRK, which will then transfer part of the funds to finance investment and programmes for human capital development.

Inflation remained on an upward trend during the first half of 2006. The consumer price index increased from 7.5 per cent year-on-year in December 2005 to 8.7 per cent in July 2006. In order to stem inflationary pressures and dampen credit growth, the National Bank of Kazakhstan (NBK) raised the refinancing rate by a cumulative 1 percentage point during the first seven months of 2006. It also broadened reserve requirements (see above) and allowed the local currency to appreciate against the US dollar in nominal terms.

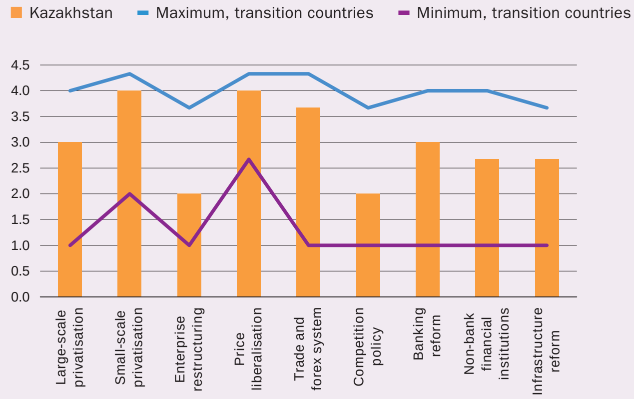
External sector

The current account recorded a small deficit of nearly 1 per cent of GDP in 2005, while high commodity prices resulted in a record trade balance surplus of 18 per cent of GDP. This was more than offset, however, by a sharp increase in income payments associated with foreign direct investment (FDI) in the hydrocarbon sector and an increase in imports of services, also linked to investments in that sector. The current account returned to surplus during the first quarter of 2006. International reserves and NFRK assets amounted to US$23 billion (around ten months of import cover) at the end of the first half of 2006. Total external debt as a percentage of GDP remained constant at 74 per cent in 2005. While the repayment of inter-company loans associated with FDI in the hydrocarbons sector accelerated, the external liabilities of Kazakh banks increased.

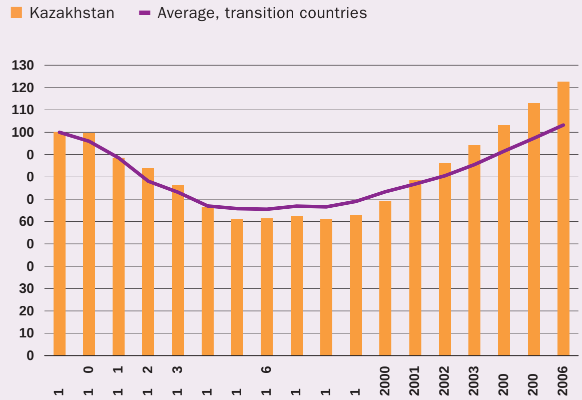
Outlook and risks

Short-term prospects remain favourable as oil prices are likely to stay high. A slight deceleration of growth to 8.5 per cent is expected in 2006, reflecting constraints on hydrocarbon production and a tightening of monetary policy which is expected to dampen domestic demand. However, given the accumulation of external liabilities of Kazakh banks and the risk of rapid credit growth over the medium term, further monetary and regulatory tightening may be required. Fiscal policy may also have to be tightened should inflationary pressures persist.

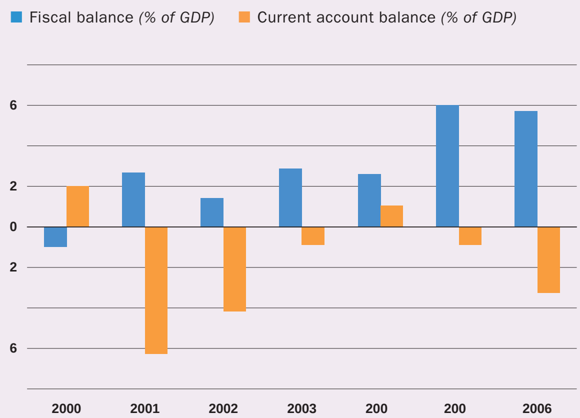
Transition indicators, 2006



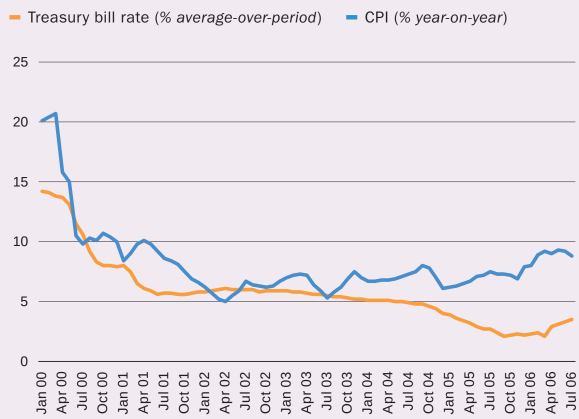
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **partially**	Capital adequacy ratio – **12 per cent**	Share of population living in poverty – **16 per cent** (2003)
Controls on inward direct investment – **yes**	Quality of insolvency law – **medium**	Independent electricity regulator – **partially**	Deposit insurance system – **yes**	Government expenditure on health – **2.6 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **inefficient**	Separation of railway infrastructure from operations – **partially**	Quality of securities market laws – **high**	Government expenditure on education – **3.5 per cent of GDP**
Exchange rate regime – **managed float**	Quality of corporate governance law – **high**	Independence of the road directorate – **no**	Private pension funds – **yes**	Household expenditure on power and water – **3.7 per cent**
Wage regulation – **no**		Quality of concession laws – **na** [2]		
Tradability of land – **full except foreigners** [1]				

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)	2 6	2	2 6	2 0	2	2	a
r a e e r are (per e)	60 0	60 0	6 0	6 0	6 0	6 0	6 0
r a e e r are e pl y e (per e)			0				a
u ge ary u e a urre ra er (per e)	0	0	0	0	0	a	a
S are u ry al e pl y e (per e)		2	2	2 2	2	2	a
a ge la ur pr u y u ry (per e)	22 2	2				2 0	a
e e (per e)		26	2	2	22	a	a
EBRD index of small-scale privatisation	0	0	0	0	0	0	0
EBRD index of large-scale privatisation	0	0	0	0	0	0	0
EBRD index of enterprise reform	2 0	2 0	2 0	2 0	2 0	2 0	2 0
S are a ere pr e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	0 0
u er g a ere pr e a e	0 0	0 0	0 0	0 0	0 0	0 0	0 0
S are ra e ra u r e (per e)	6 2		6	6	6	6	a
S are ra e (per e)		6 2				2	a
ar re e ue (per e p r)		2		0	2	2 6	a
EBRD index of price liberalisation	0	0	0	0	0	0	0
EBRD index of forex and trade liberalisation							
EBRD index of competition policy	2 0	2 0	2 0	2 0	2 0	2 0	2 0
u er a (re g e)	(6)	( )	( )	6 (6)	( )	( )	a
A e are a e e a (per e)			2				a
A e are re g e a (per e)				6			a
per r g l a (per e al l a)	a	a				6	a
e re pr a e e r (per e)	0 6			2	2		a
e re u e l (per e)	0 6	0	6	2	2		a
r gage le g (per e)	a	a	a				a
S ar e ap al a (per e)		6					a
S ra g lu e (per e ar e ap al a)	0	2	26	22 0	0		a
ur ua e (per e)							a
EBRD index of banking sector reform	2	2	2	0	0	0	0
EBRD index of reform of non-bank financial institutions	2	2	2	2	2	2	2
e l e (le) pe e ra ra e (per 00 a a)	2 2 ( )	0 ( )	0 (6)	0 (0)	6 (6)	6 ( )	a
er e pe e ra ra e (per 0 000 a a)							a
a l ay la ur pr u y (00)	2	6	0		62 6	02	a
e e al ele r y ar (S)	2	2	0		0		a
A erage lle ra e ele r y (per e)	a	a	2	a	a	a	a
per u e ergy u e (S llar per g e)					a	a	a
EBRD index of infrastructure reform	2 0	2	2	2	2	2	2
Electric power	0	0	0	0			
Railways	2	2	2	2	2	0	0
Roads	2 0	2 0	2 0	2 0	2 0	2 0	2 0
Telecommunications	2	2	2	2	2	2	0
Water and waste water					2 0	2 0	2 0

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	9.8	13.5	9.8	9.3	9.6	9.4	8.5
Private consumption	1.2	7.8	2.7	11.8	13.9	11.4	na
Public consumption	15.0	19.2	-7.5	8.9	10.6	11.8	na
Gross fixed capital formation	16.1	25.3	10.0	8.0	22.5	11.9	na
Exports of goods and services	28.7	-1.8	16.6	7.5	10.9	1.4	na
Imports of goods and services	26.1	0.3	3.1	-7.6	14.8	13.3	na
Industrial gross output	15.5	13.8	10.5	9.1	10.1	4.6	na
Agricultural gross output	-4.2	17.3	3.4	1.6	1.0	6.7	na
Employment			(Percentage change)				
Labour force (annual average)	0.7	5.2	-1.1	3.5	2.4	0.8	na
Employment (annual average)	1.6	8.0	0.2	4.1	2.8	1.1	na
			(In per cent of labour force)				
Unemployment (annual average)	12.8	10.4	9.3	8.8	8.4	8.1	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	13.2	8.4	5.9	6.4	6.9	7.6	8.7
Consumer prices (end-year)	9.8	6.4	6.6	6.8	6.7	7.5	8.4
Producer prices (annual average)	38.0	0.3	0.3	9.3	16.7	23.7	na
Producer prices (end-year)	19.4	-14.1	11.9	5.9	23.8	20.3	na
Gross average monthly earnings in economy (annual average)	21.2	20.4	17.5	13.8	22.5	20.3	na
Government sector [1]			(In per cent of GDP)				
General government balance [2]	-1.0	2.7	1.4	2.9	2.6	6.0	5.7
General government expenditure [3]	23.2	23.0	21.0	22.5	22.0	22.6	na
General government debt	25.5	20.4	17.7	15.0	11.4	10.0	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	45.0	40.2	30.1	29.5	69.3	24.8	na
Domestic credit (end-year) [4]	57.3	17.1	30.2	24.1	69.6	82.5	na
			(In per cent of GDP)				
Broad money (M2, end-year)	15.3	17.1	19.2	20.3	27.1	26.6	na
Interest and exchange rates			(In per cent per annum, end-year)				
Refinancing rate	14.0	9.0	7.5	7.0	7.0	8.0	na
Treasury bill rate (3-month maturity) [5]	6.6	5.3	5.2	5.9	3.3	3.3	na
Deposit rate [6]	15.6	12.8	11.0	10.9	9.3	9.1	na
Lending rate [7]	18.8	15.3	14.1	14.9	13.7	13.0	na
			(Tenges per US dollar)				
Exchange rate (end-year)	144.5	150.2	155.6	144.2	130.0	134.0	na
Exchange rate (annual average)	142.1	146.7	153.3	149.6	136.0	132.9	na
External sector			(In millions of US dollars)				
Current account	366	-1,390	-1,024	-273	455	-486	-2,341
Trade balance [8]	2,168	983	1,987	3,679	6,785	10,322	11,714
Merchandise exports	9,288	8,928	10,027	13,233	20,603	28,301	31,131
Merchandise imports	7,120	7,944	8,040	9,554	13,818	17,979	19,417
Foreign direct investment, net	1,278	2,861	2,164	2,213	5,392	1,721	2,500
Gross reserves, excluding gold (end-year)	1,594	1,997	2,555	4,236	8,473	6,084	na
External debt stock [9]	12,685	15,158	18,252	22,920	31,941	41,516	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year) [10]	2.1	2.3	2.6	3.8	5.4	2.9	na
			(In per cent of exports of goods and services)				
Debt service	31.7	37.6	35.4	35.2	35.9	35.5	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	14.9	14.9	14.9	15.0	15.1	15.1	na
GDP (in billions of tenges)	2,600	3,251	3,776	4,612	5,870	7,457	8,798
GDP per capita (in US dollars)	1,231	1,492	1,657	2,062	2,863	3,714	na
Share of industry in GDP (in per cent)	25.2	25.2	25.3	25.3	25.5	24.3	na
Share of agriculture in GDP (in per cent)	9.8	10.1	9.5	8.9	8.1	7.9	na
Current account/GDP (in per cent)	2.0	-6.3	-4.2	-0.9	1.1	-0.9	-3.3
External debt - reserves (in US$ million)	11,090	13,160	15,696	18,684	23,468	35,432	na
External debt/GDP (in per cent)	69.3	68.4	74.1	74.3	74.0	74.0	na
External debt/exports of goods and services (in per cent)	122.7	148.8	157.8	153.4	141.3	135.9	na

[1] General government includes the state, municipalities and extra-budgetary funds and is on a cash basis.

[2] Government balance includes quasi-fiscal operations and transfers to the National Fund. Balance excludes privatisation revenues.

[3] Expenditures include extra-budgetary funds.

[4] Domestic credit data from International Financial Statistics. Break in series in 2001. From 2001, data include National Fund.

[5] Average effective yield of short-term NBK notes.

[6] Deposit rate refers to the weighted average of interest rates on time deposits of individuals, in tenge by maturity.

[7] Lending rate refers to weighted average of interest rates on credits extended to legal entities, excluding banks in tenge by maturity.

[8] Trade balance includes exports at declared customs prices. These are not corrected for under-invoicing of oil and gas exports.

[9] Data includes inter-company debt by branches of non-resident foreign enterprises and short-term debt.

[10] Reserves exclude National Fund.

Kyrgyz Republic

Key challenges

- Tax cuts have been welcomed by the business community, but corruption in public administration and the judiciary remains a key concern.
- Reforms in the power sector need to be reinvigorated to attract new investment and promote modernisation of the network.
- Further debt relief should reinforce macroeconomic stability, but sustained growth requires greater improvement in the business environment and in the quality of public institutions.

Country data

Population (in millions)	**5.1**
Area ('000 sq km)	**200.0**
GDP (in billion US$, 2005)	**2.4**
GDP per capita in 2005 at current international US$ (PPP)	**1,944**
National currency	**Som**

Progress in structural reform

Business environment and competition

Measures to simplify the tax system, broaden the tax base and reduce corruption came into effect from January 2006. Income tax was set at a uniform rate of 10 per cent, profit tax was reduced from 20 per cent to 10 per cent, value added tax (VAT) on farm output was temporarily suspended, and payroll tax was reduced from 31 per cent to 29 per cent.

According to a survey on the business environment conducted by the EBRD in early 2006, businesses perceived high tax rates as one of the main factors driving firms into the informal sector and feeding corruption. The frequency of inspections of enterprises by public officials has also been cited as a cause of corruption, and is under review by the authorities.

Infrastructure

The privatisation of Kyrgyz Telecom, the main telecommunications service operator, remains on hold, although the government has restated its intention to resume the process. The sale of privately owned BiTel, the largest mobile operator, to a Kazakh investor in April 2005 has been contested by a Russian investor. The legality of this transaction was challenged by a Kyrgyz court in December 2005 following the sale of the Kazakh investor's stake to a different Russian group. In June 2006 the regulator, the National Agency for Communications, warned BiTel that it could lose its licence unless there were improvements in service quality.

A combination of the BiTel ownership dispute and the delays in the privatisation of Kyrgyz Telecom could affect the prospects for further investment in the sector as a whole. The Kyrgyz Republic has low fixed-line telephone density and mobile penetration.

The electricity sector's quasi-fiscal deficit (defined as the cost of production minus cash revenues) declined to 7.6 per cent of GDP in 2005. The deficit was in line with targets agreed with the IMF and mainly reflected improved cash collection. Based on an updated methodology agreed with the World Bank, however, the 2005 deficit has been revised upwards to 8.8 per cent of GDP.

Electricity tariffs for households were unified in April 2006 at som 0.62 or 1.5 US cents per kWh, abolishing the lifeline tariff system that had been subject to billing abuses. However, the prevailing average tariff level is just over half the short-term cost recovery level of som 1.115 or 2.66 US cents per kWh and continues to undermine the financial viability of the sector. The authorities are working closely with the World Bank on a tariff schedule to reach full-cost recovery levels by 2010.

Financial sector

In November 2005 further revisions to the law regulating the banking sector not only introduced improved principles of corporate governance, but also enhanced the remit of the banking regulator, the National Bank of the Kyrgyz Republic (NBKR). The amendments to the law extended the regulator's authority over banking groups on a consolidated basis and also gave it rights to request additional information from the bank auditors. A new anti-money laundering law entered into force in August 2006.

However, the prevailing legislative framework does not provide either for the NBKR's legal independence or for the protection of its employees in performing official duties. A new law to strengthen the bank's independence was submitted to parliament in September 2005 but has yet to be approved.

Social sector

According to an IRI/USAID Kyrgyzstan National Opinion Poll conducted in March 2006, the most pressing issues for individuals are unemployment and poverty. Preliminary data suggest that while the poverty rate (based on consumption measures) declined from 50 per cent in 2003 to 44 per cent in 2005, the level of unemployment (labour force survey data) increased from 8.9 per cent to 10 per cent of the labour force.

A draft development strategy for 2006-10 emphasises the importance of countering unemployment, underemployment and rural poverty. The authorities have assigned the State Committee on Migration and Employment as a key coordinating agency for implementing labour market policies.

Macroeconomic performance

Real economy

In 2005 real output contracted by 0.6 per cent due to disruptions caused by the political events in March/April that year and a scheduled sharp decline in production from the Kumtor gold mine (accounting for 6 per cent of GDP). However, the economy rebounded in the first half of 2006 with year-on-year growth of 2.5 per cent, which partly reflected stronger investment.

Economic policies

The general government fiscal deficit (cash basis) narrowed to 4.0 per cent of GDP in 2005, mainly due to a larger-than-expected increase in tax revenues. The budget for 2006 has set expenditure (excluding net lending) at 27.5 per cent of GDP, 1.25 percentage points lower than 2005. This is mainly due to the impact of lower interest payments in the wake of the 2005 Paris Club debt rescheduling. Inflationary pressures rose at the end of 2005, mainly because of the shortfall in farm output and fuel price increases. A surge in the money supply around the third quarter of 2005, linked to sizable unsterilised intervention in the foreign exchange market by the NBKR, may also have been a factor. During the first half of 2006 the NBKR has adopted a more flexible exchange rate policy to allow the local currency to appreciate nominally against the US dollar.

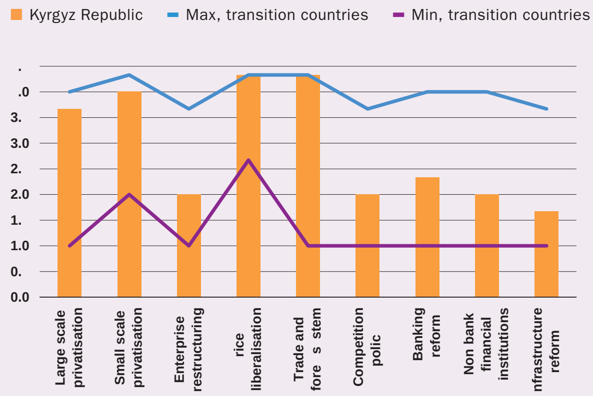
External sector

The current account deficit widened sharply to 8 per cent of GDP in 2005. A record trade deficit, reflecting a decline in gold exports and a surge in imports, was only partly offset by strong inflows of remittances from workers living abroad. Foreign direct investment in 2005 was not seriously affected by the political events in March as net inflows amounted to US$ 101 million, a slight decline from the record US$ 131 million recorded in 2004. Total public external debt amounted to 83 per cent of GDP at the end of 2005, following the rescheduling of bilateral debt by the Paris Club of creditors in March that year. On the basis of end-2004 data, the Kyrgyz Republic was found in April 2006 to be eligible for debt relief under the enhanced heavily indebted poor countries (HIPC) initiative, according to the IMF and World Bank. Under this initiative, the Kyrgyz Republic could apply for further debt relief.

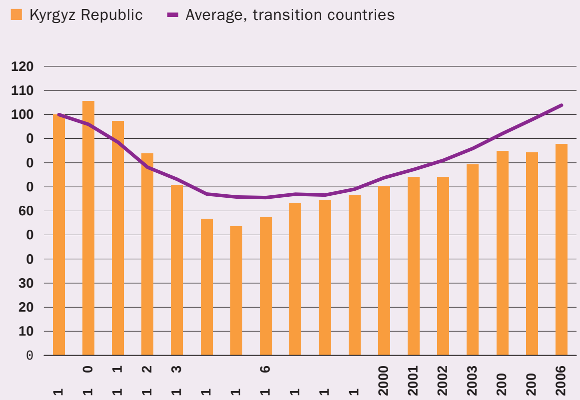
Outlook and risks

An economic recovery is expected for 2006 as a whole, despite a further drop in gold output due to an accident at the Kumtor mine in July. Real GDP is projected to grow by around 4 per cent. Encouraging exploration results from the Kumtor mine should reverse the decline in gold output in the medium term and provide additional impetus for growth in 2007–09. If the country initiates a HIPC debt relief process by the end of 2006 and completes the process successfully, this would improve the fiscal position and allow the government to reallocate spending to pressing social needs and essential infrastructure investment. The main risks are that resources may be misallocated due to pressures from vested interests and political groups and that the business environment remains unfavourable for private sector development.

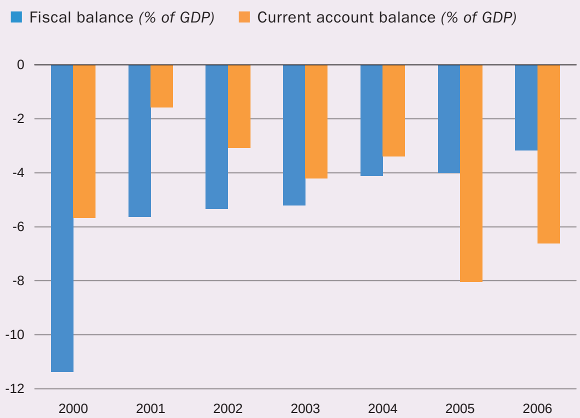
Transition indicators, 2006



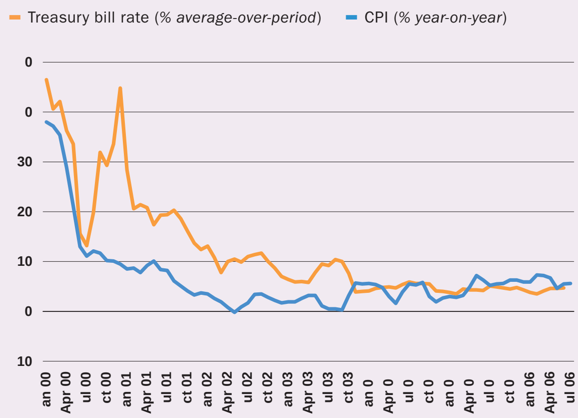
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no** [1]

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradability of land – **limited de facto**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **some defects**

Quality of corporate governance law – **medium**

Infrastructure

Independent telecoms regulator – **partially**

Independent electricity regulator – **partially**

Separation of railway infrastructure from operations – **no**

Independence of the road directorate – **no**

Quality of concession laws – **low**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **no**

Quality of securities market laws – **medium**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **21.4 per cent** (2003) [2]

Government expenditure on health – **2.5 per cent of GDP**

Government expenditure on education – **5 per cent of GDP**

Household expenditure on power and water – **4.4 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)	2	2	2	2	2		a
r a e e r are (per e)	60 0	60 0	6 0	6 0	0	0	0
r a e e r are e pl y e (per e)	2			0	0	a	a
u ge ary u e a urre ra er (per e)	a	0		2			a
S are u ry al e pl y e (per e)	0					a	a
a ge la ur pr u y u ry (per e)			0 2			a	a
e e (per e)	20 0			6			a
EBRD index of small-scale privatisation	0	0	0	0	0	0	0
EBRD index of large-scale privatisation	0	0	0	0			
EBRD index of enterprise reform	2 0	2 0	2 0	2 0	2 0	2 0	2 0
S are a ere pr e (per e)	a	a	a	a	2 0	2	a
u er g a ere pr e a e	0	0	0	0	0	2 0	a
S are ra e ra u re (per e)	6	2		0		6 2	a
S are ra e (per e)		60	66 6	6	0	0	a
ar re e ue (per e p r)			6		2	6	a
EBRD index of price liberalisation							
EBRD index of forex and trade liberalisation							
EBRD index of competition policy	2 0	2 0	2 0	2 0	2 0	2 0	2 0
u er a (re g e)	22 (6)	20 ( )	20 (6)	2 ( )	(0)	(0)	a
A e are a e e a (per e)		6 6		2			a
A e are re g e a (per e)	2 6	2	0	6 2	0	6	a
per r g l a (per e al l a)	6		6	2	6		a
e re pr a e e r (per e)	2 2	2 0	2 6	a	a	a	a
e re u e l (per e)	a	0	0	0	0	2	a
r gage le g (per e)	a	0 0	0 0	0	0	0	a
S ar e ap al a (per e)	0	0	0	6			a
S ra g lu e (per e ar e ap al a)	a	a	a	a	a	a	a
ur ua e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
EBRD index of banking sector reform	2 0	2 0	2 0	2	2	2	2
EBRD index of reform of non-bank financial institutions	2 0	2 0	2 0	2 0	2 0	2 0	2 0
e l e (le) pe e ra ra e (per 00 a a)	(0 2)	(0 6)	( )	(2)	2 (2)	(0)	a
er e pe e ra ra e (per 0 000 a a)		2			0	0	a
a l ay la ur pr u y (0 00)			6 2	22 0	2	2 0	a
e e al ele r y ar (S)	0 6	0	0	0	0	2	a
A erage lle ra e ele r y (per e)		a			a		a
per u e ergy u e (S llar per g e)		6	2	2	a	a	a
EBRD index of infrastructure reform							
Electric power	2	2	2	2	2	2	2
Railways	0	0	0	0	0	0	0
Roads	0	0	0	0	0	0	0
Telecommunications	2	2	2	2	0	0	0
Water and waste water	0	0					

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			ercentage c ange in real terms				
GDP	5.4	5.3	0.0	7.0	7.0	-0.6	4.0
Private consumption	-4.2	1.6	4.2	22.1	7.5	3.2	na
Public consumption	7.5	0.0	-0.2	-2.0	2.5	-1.0	na
Gross fixed capital formation	26.4	-3.2	-7.4	-6.4	7.4	10.2	na
Exports of goods and services	10.5	-3.2	8.1	5.3	12.8	-9.8	na
Imports of goods and services	0.4	-13.8	13.1	16.0	16.3	1.0	na
Industrial gross output	6.0	5.4	-10.9	17.0	3.7	-12.1	na
Agricultural gross output	2.6	7.3	3.1	3.2	4.1	-4.2	na
Employment			ercentage c ange				
Labour force (annual average)[1]	1.6	1.4	1.2	2.3	1.9	na	na
Employment (annual average)	0.2	1.1	1.1	1.7	2.3	na	na
			n per cent of labour force				
Unemployment (annual average)	7.5	7.8	8.6	8.9	9.0	9.7	na
Prices and wages			ercentage c ange				
Consumer prices (annual average)	18.7	6.9	2.0	3.1	4.1	4.3	5.5
Consumer prices (end-year)	9.5	3.7	2.3	5.6	2.8	4.9	4.3
Producer prices (annual average)	30.7	12.0	4.8	4.6	5.9	9.0	na
Producer prices (end-year)	22.9	11.2	7.5	13.5	4.3	2.8	na
Gross average monthly earnings in economy (annual average)	16.9	18.6	15.8	13.7	16.9	14.5	na
Government sector[2]			n per cent of D				
General government balance	-11.4	-5.6	-5.3	-5.2	-4.1	-4.0	-3.1
General government expenditure	29.9	26.0	28.1	27.4	27.2	28.3	na
General government debt	113.3	107.3	107.3	104.9	94.3	90.1	na
Monetary sector			ercentage c ange				
Broad money (M2, end-year)	11.7	11.3	33.9	33.4	32.1	10.0	na
Domestic credit (end-year)	10.0	-8.1	21.6	11.3	-18.8	19.6	na
			n per cent of D				
Broad money (M2, end-year)	11.3	11.1	14.6	17.5	20.6	21.3	na
Interest and exchange rates			n per cent per annum end-year				
Official rate	32.8	10.7	4.4	4.0	4.0	4.1	na
Money market rate[3]	32.3	19.1	7.0	4.0	4.0	4.3	na
Deposit rate[4]	18.4	12.5	5.9	5.0	6.7	5.8	na
Lending rate[4]	51.9	37.3	24.8	21.7	29.3	26.6	na
			oms per dollar				
Exchange rate (end-year)	48.3	47.7	46.1	44.2	41.6	41.3	na
Exchange rate (annual average)	47.7	48.3	46.9	43.7	42.6	41.0	na
External sector			n millions of dollars				
Current account	-78	-24	-49	-81	-75	-196	-179
Trade balance	4	31	-74	-133	-171	-435	-474
Merchandise exports	511	480	498	590	733	686	786
Merchandise imports	507	450	572	724	904	1,121	1,260
Foreign direct investment, net	-7	-1	5	46	131	101	89
Gross reserves, excluding gold (end-year)	205	230	289	365	549	570	na
External debt stock	1,704	1,678	1,785	1,978	2,104	2,154	na
			n mont s of imports of goods and services				
Gross reserves, excluding gold (end-year)	3.8	4.8	4.8	5.0	5.8	4.8	na
			n per cent of exports of goods and services				
Debt service[5]	28.1	30.8	21.0	22.3	19.1	15.0	na
Memorandum items			Denominations as indicated				
Population (end-year, million)	4.9	4.9	5.0	5.0	5.1	5.1	na
GDP (in millions of soms)	65,358	73,883	75,367	83,872	94,351	100,116	110,719
GDP per capita (in US dollars)	279	309	322	381	435	476	na
Share of industry in GDP (in per cent)	27.2	26.8	21.3	20.2	21.7	18.7	na
Share of agriculture in GDP (in per cent)	34.2	34.5	34.4	33.6	29.9	30.5	na
Current account/GDP (in per cent)	-5.7	-1.6	-3.1	-4.2	-3.4	-8.0	-6.6
External debt - reserves (in US$ million)	1,499	1,448	1,496	1,614	1,555	1,584	na
External debt/GDP (in per cent)	124.4	109.6	111.1	103.0	95.1	88.2	na
External debt/exports of goods and services (in per cent)	297.5	299.3	278.8	265.5	223.3	228.6	na

1 Based on labour force data from World Bank *e e me t i at s*

2 General government includes the state, municipalities and extra-budgetary funds. It also includes expenditure under the foreign-financed public investment programme and net lending.

Latvia

Key challenges

- Despite substantial progress in tackling money laundering, further measures are required to combat corruption and so improve Latvia's business environment.
- Although unemployment is decreasing, policy measures are needed to improve human capital. This would enable the economy to move up the technology ladder and address waning competitiveness.
- While catch-up opportunities continue, macroeconomic policy needs to address overheating and curb rising inflation.

Country data

Population (in millions)	**2.3**
Area ('000 sq km)	**64.5**
GDP (in billion US$, 2005)	**15.8**
GDP per capita in 2005 at current international US$ (PPP)	**13,595**
National currency	**Lat**

Progress in structural reform

Business environment and competition

The business environment in Latvia is among the best in the transition region. However, obstacles to the efficient functioning of the private sector remain, particularly in business licensing, labour markets and some types of business regulation. These administrative barriers create opportunities for rent-seeking among public officials. As a result, and despite improvements recorded by Transparency International's 2005 Corruption Perceptions Index, corruption among both public officials and politicians remains an obstacle to the efficient functioning of the business environment.

Moreover, serious cases of high-level political corruption have continued to affect the government. The investigation of electoral fraud in the 2005 Jūrmala mayoral election by the Corruption Prevention and Combating Bureau led to the resignation of a government minister in March 2006. This was followed by an investigation by the Interior Ministry's economic crimes unit into the allocation of European Union (EU) structural funds by a former minister.

The financial sector regulator is making considerable progress in reducing money laundering risks in the banking sector. Legislation in 2005 strengthening banks' responsibilities included amendments to the law on credit institutions, permitting fines of up to €140,000 if anti-money laundering procedures are found to be inadequate. Also, a law instituting a cross-border currency declaration was adopted in October 2005 and came into effect in July 2006.

Significant improvements have been made in bringing the "know your customer" initiative and related procedures into line with international best practice. As a result, no banks are now under the regulator's "close watch" compared with 13 in mid-2005. In addition, the number of unreported suspicious transactions discovered by the regulator fell sharply from 103 in 2004 to 23 in 2005.

Infrastructure

Railway restructuring progressed significantly in 2005-06. Towards the end of 2005, the board of state-owned Latvijas Dzelzcels (Latvian Railway) approved plans to establish three subsidiaries: LDz Infrastruktura (LDz Infrastructure), LDz Kravu Parvadajumi (LDz Cargo Shipments) and LDz Ritosa Sastava Serviss (LDz Rolling Stock Service). In addition, in May 2006 Latvia acceded to the European Agreement on Main International Railway Lines (AGC), which provides the legal framework for the construction and development of a coherent international rail network under the auspices of the United Nations Economic Commission for Europe.

Due to a series of reforms in recent years, the railways sector is well regulated and private sector participation has increased. There are two key rail authorities: the State Railway Administration and State Railway Technical Inspectorate. The Public Utility Commission issues passenger operator licences and deals with track access charging.

Since 2002 some passenger services have been provided by a private company, Gulbenes-Aluksnes Banitis, while freight transportation has also been provided by private operators Baltijas Ekspresis and Baltijas Tranzita Serviss since 2003. However, Latvijas Dzelzcels remains a fully state-owned joint-stock company, with ownership rights exercised through the Ministry of Transport.

The deterioration of infrastructure continues to be a major issue, with an estimated 30 per cent of main track needing renovation and over 25 per cent of the rail network lacking traffic control systems that comply with EU safety standards.

Social sector

Unemployment has declined steadily since 2000 as economic growth accelerated and other EU countries opened their labour markets. The unemployment rate was below 9 per cent by the end of 2005, with less than half of the jobless total being long-term unemployed. However, regional differences in unemployment and shortages of skilled labour remain.

Long-term unemployment is concentrated among older and low-skilled workers, made redundant by enterprise restructuring or without qualifications. Vocational education and training systems have been insufficient to equip the workforce with skills relevant to the needs of the private sector. To maintain competitiveness, the government has started to pursue active labour market policies that address the mismatch of skills and a large share of EU financing is earmarked for human capital development.

Macroeconomic performance

Real economy

Real GDP growth accelerated to 10.2 per cent in 2005 and reached 13.1 per cent in the first quarter of 2006, the fastest rate since independence. Growth is broad-based, but strongest in wholesale and retail trade and construction, followed by manufacturing and transport, storage and communications. The main driver continues to be domestic demand, fuelled by low interest rates and longer maturities on local bank loans. The increased availability of credit, as well as speculative activity, have resulted in accelerating housing prices.

Economic policies

In 2005 the general government budget recorded a small surplus of 0.2 per cent of GDP, reflecting strong growth and improved tax revenues. As a result of increased collection of the social tax, value added tax and excise tax, the first half of 2006 has seen a similarly positive return. While comfortably within Maastricht requirements, Latvia's fiscal position features significant EU-funded demand injections.

Consumer prices rose by 7 per cent year-on-year in July 2006, following a 6.7 per cent average annual increase in 2005. The main determinants of inflation have been higher oil prices and faster-than-expected growth. In response, the Central Bank has continued to pursue a tight monetary policy. In July 2006 it increased the refinancing rate to 4.5 per cent, although the open capital markets and exchange regime limit the effectiveness of such a measure. Much of the uncertainty about the timing of the adoption of the euro will depend on the government's ability to maintain fiscal discipline.

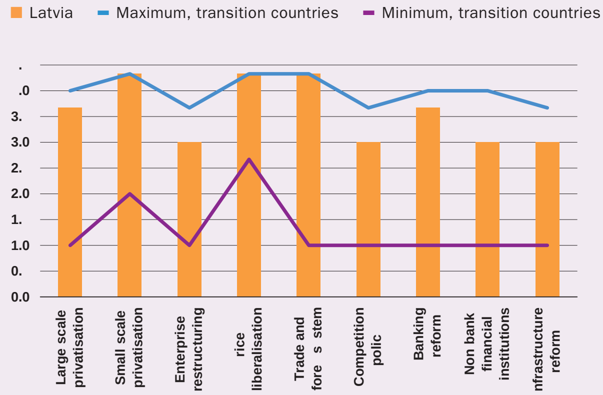
External sector

Following a slight improvement in 2005, Latvia's external position deteriorated in the early months of 2006. The strong growth of consumption, fuelled by the ready availability of credit, contributed to the decline in the trade balance. In addition, export growth slowed due to a weakening of competitiveness (as the economic strategy has continued to favour cheap, unskilled labour over added value). This has been coupled with a worsening of the income balance, as foreign investors' earnings have increased. In 2005 the financing of the current account deficit relied on intra-company loans and foreign direct investment flows, although the latter have started to decline. In 2006 the deficit has not moderated, adding to the economy's already high external debt burden. The value of gross external debt exceeded that of GDP in 2005 as bank borrowing abroad and non-resident deposits increased. Net external debt is also high at about 40 per cent of GDP.

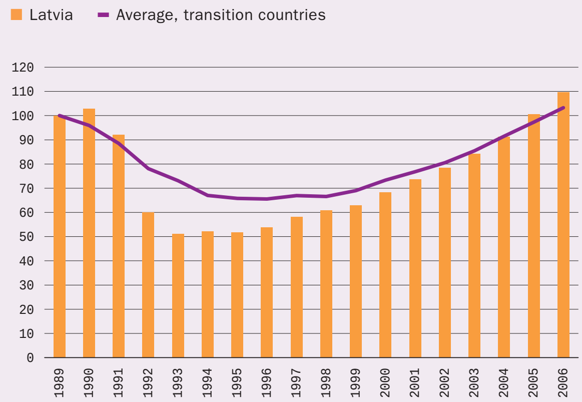
Outlook and risks

Annual real GDP growth for 2006 is forecast at 9 per cent. Strong domestic demand will continue on the back of credit expansion, real wage growth and increasing EU funding. Labour migration, declining unemployment and higher income expectations are likely to generate inflation pressures and real wage growth. In addition, the prevalence of euro-denominated loans is a source of vulnerability should membership of the European Economic and Monetary Union be delayed.

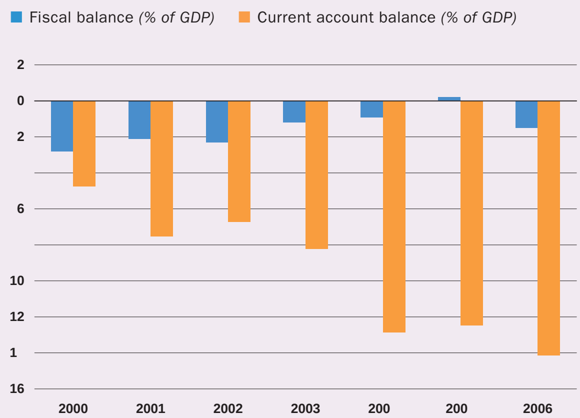
Transition indicators, 2006



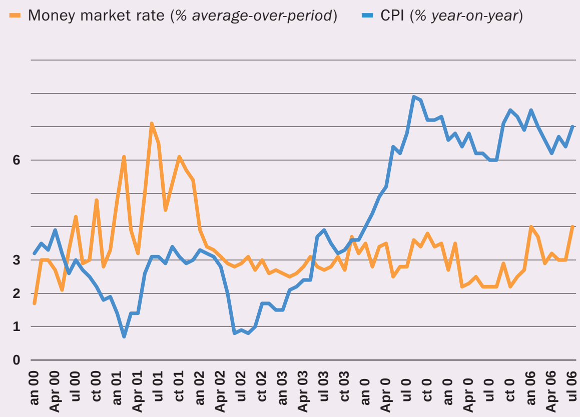
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	**Business environment and competition**	**Infrastructure**	**Financial sector**	**Social reform**
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **8 per cent**	Share of population living in poverty – **4.7 per cent** (2003)
Controls on inward direct investment – **no** [1]	Quality of insolvency law – **low**	Independent electricity regulator – **fully**	Deposit insurance system – **yes**	Government expenditure on health – **3.4 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **advanced**	Separation of railway infrastructure from operations – **fully**	Quality of securities market laws – **high**	Government expenditure on education – **5.7 per cent of GDP**
Exchange rate regime – **fixed peg in ERM II**	Quality of corporate governance law – **high**	Independence of the road directorate – **partially**	Private pension funds – **yes**	Household expenditure on power and water – **3.8 per cent** [2]
Wage regulation – **no**		Quality of concession laws – **low**		
Tradability of land – **full except foreigners**				

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)			0				a
r a e e r are (per e)	6 0	6 0	0 0	0 0	0 0	0 0	0 0
r a e e r are e pl y e (per e)	2 0	0	0	6 0	6 0	6 0	a
u ge ary u e a urre ra er (per e)					0		a
S are u ry al e pl y e (per e)	20					a	a
a ge la ur pr u y u ry (per e)		2	0	6		a	a
e e (per e)	2	26 6	26	2		2	a
EBRD index of small-scale privatisation							
EBRD index of large-scale privatisation	0	0					
EBRD index of enterprise reform	2	2	2	0	0	0	0
S are a ere pr e (per e)	22	22 0	20	6	6 0		a
u er g a ere pr e a e	2 0	2 0	2 0	2 0	2 0	2 0	a
S are ra e ra u r e (per e)		6 6	6	6	6		a
S are ra e (per e)	66	0 0	0				a
ar re e ue (per e p r)	0	0	0 6	0 6	0	0	a
EBRD index of price liberalisation							
EBRD index of forex and trade liberalisation							
EBRD index of competition policy	2	2	2	2	2	0	0
u er a (re g e)	22 (2)	2 (0)	2 ( )	2 (0)	2 ( )	2 (0)	a
A e are a e e a (per e)	2	2	0		0		a
A e are re g e a (per e)		6 2	2	0	6		a
per r g l a (per e al l a)		2	2 0			0	a
e re pr a e e r (per e)		2	0			6	a
e re u e l (per e)		6		6		2 2	a
r gage le g (per e)	6	2		6	2	6	a
S ar e ap al a (per e)						6	a
S ra g lu e (per e ar e ap al a)	6	26	2 0			6	a
ur ua e (per e)	0 0	2	0 0	0 0	0 0	0 0	a
EBRD index of banking sector reform	0						
EBRD index of reform of non-bank financial institutions	2	2	0	0	0	0	0
e l e (le) pe e ra ra e (per 00 a a)	0 (6 6)	0 (2)	0 ( )	2 2 (2 6)	2 (6 2)	( )	a
er e pe e ra ra e (per 0 000 a a)	0 2	06	2		2	2	a
a l ay la ur pr u y (00)		0	0	2	0	6	a
e e al ele r y ar (S)	6	6	6		2		a
A erage lle ra e ele r y (per e)	a		00	00	a	a	a
per u e ergy u e (S llar per g e)	0	6			a	a	a
EBRD index of infrastructure reform	2	0	0	0	0	0	0
Electric power	0	0	0	0			
Railways							
Roads	2	2	2	2	2	2	2
Telecommunications	0	0	0	0	0	0	0
Water and waste water	0						

[1] There are controls on raffles and gambling for certain nationals.
[2] Estimates based on the poorest 20 per cent of households (lowest income quintile).

	2000	2001	2002	2003	2004	2005 Estimate	2006 ro ection
			ercentage c ange in real terms				
		0	6	2		0 2	0
r a e u p	6 2			6			a
u l u p		0	2	2		2	a
r e ap al r a	0 2		0		2	6	a
p r g a er e	2 0	6	6			20	a
p r g a er e		2 6			6 0		a
u r al gr u pu					0	6	a
Agr ul ural gr u pu		6		0	0 2		a
			ercentage c ange				
a ur r e (e year)	2	0		0	0	a	a
pl y e (e year)	2	2 2	2				a
			n per cent of labour force				
e pl y e (e year)			2	0 6	0		a
			ercentage c ange				
u er pr e (a ual a erage)	2 6	2		2	6 2	6	6 2
u er pr e (e year)		0		6		0	2
r u er pr e (a ual a erage)	0 6		0	2	6		a
r u er pr e (e year)	0		0			6	a
r a erage ly ear g e y (a ual a erage)	6 2	6		2	6	6 6	a
			n per cent of D				
e eral g er e ala e	2	2	2	2	0	0 2	
e eral g er e e pe ure	6	6		6	6	0	a
e eral g er e e	2	0			6		a
			ercentage c ange				
r a ey (M2 e year)	2	20	2 0	2	2 0	6	a
e re (e year)		6 2		2	0 2	6 2	a
			n per cent of D				
r a ey (M2 e year)	26	2	2				a
			n per cent per annum end-year				
e a g ra e			0	0	0	0	a
er a ar e ra e [2]			2	2		2	a
ep ra e (r er u er year)			2	0		2	a
e g ra e (r er u er year)	2	0					a
			ats per dollar				
a ge ra e (e year)	0 6	0 6	0 6	0	0	0 6	a
a ge ra e (a ual a erage)	0 6	0 6	0 6	0 6	0	0 6	a
			n millions of dollars				
urre a u	2	626	62	20	66		2 6
ra e ala e	0			2 0	2	2 6	
Mer a e e p r	2 0 0	2 2	2	6	22	06	6
Mer a e p r	2		02		002	2	0
re g re e e e	00		2 0	2 6	6		0
r re er e e lu g g l (e year)			2	2	0	2	a
er al e	02		0		2 6	6 000	a
			n mont s of imports of goods and services				
r re er e e lu g g l (e year)	2 6	2		2	2		a
			n per cent of exports of goods and services				
e er e		20				6	a
			Denominations as indicated				
pula (e year ll)	2	2	2	2	2	2	a
(ll la)		220		6	2		0 6
per ap a (S llar)	2				2	6 60	a
S are u ry (per e)	20	20 2	20	20	20 0	6	a
S are agr ul ure (per e)						6	a
urre a u (per e)			6	2	2	2	
er al e re er e (S ll)		22	02		0 0	2	a
er al e (per e)	60 0	6 0	6		2	0	a
er al e e p r g a er e (per e)	2	62			2	2	a

Lithuania

Key challenges

- Tackling corruption, including the effective enforcement of Lithuania's conflict of interest and anti-bribery legislation, is essential to enhance foreign investor confidence.
- The curriculum in the education system needs to be adjusted to match the demands of the labour market and address growing structural imbalances in the workforce.
- Fiscal discipline needs to be maintained to contain the growth of domestic demand, lower inflationary pressures and avoid further postponement of EMU membership.

Country data	
Population (in millions)	**3.4**
Area ('000 sq km)	**67.0**
GDP (in billion US$, 2005)	**26.0**
GDP per capita in 2005 at current international US$ (PPP)	**14,340**
National currency	**Litas**

Progress in structural reform

Business environment and competition

Lithuania's business environment continues to suffer from administrative and political corruption, reflected in the slippage of the country's ranking in Transparency International's Corruption Perceptions Index from 28th in 2004 to 31st in 2005. Although Lithuania was the top ranked transition country in the World Bank's 2006 Doing Business report and has a regulatory burden for firms which is in many respects comparable with (or better than) established market economies, rent-seeking opportunities among state institutions remain. The time and minimal capital requirements for starting a business in Lithuania are high, the hiring and firing of workers is overly bureaucratic, and the tax system is complex and time-consuming.

Lithuanian firms have reported levels and frequency of administrative corruption higher than the advanced transition country average. Moreover, administrative corruption in Lithuania has been increasing. In addition to widespread administrative corruption, a series of high-level political scandals in 2005–06 eventually led to the collapse of the coalition government. The apparent inability of the government to significantly reduce corruption threatens to undermine Lithuania's reputation among international investors.

Infrastructure

The energy and industrial sectors remain heavily dependent on imports of crude oil and gas from Russia. The Mazeikiu Nafta (MN) refinery – the only refinery in the Baltic states – and associated Butinge export terminal together account for approximately 30 per cent of Lithuania's export earnings and 2-3 per cent of GDP. Recent disruptions caused by technical problems with the supply pipeline from Russia have had serious consequences for export revenues. Although MN has been able to secure some replacement crude oil supplies by tanker in the short term, the Russian state-owned pipeline operator Transneft estimates that pipeline repairs will take 21 months. This problem highlights the need for Lithuania to diversify and secure oil supplies for the country's vital refinery sector.

Financial sector

Low interest rates and robust economic growth resulted in a significant expansion of domestic credit in 2005, most of it to the private household and enterprise sector. Credit to households expanded at an especially fast pace, notably for real estate purchases. Mortgage lending is increasingly common, although consumer finance is at an early stage of development. Foreign currency lending has expanded rapidly and banks rely increasingly on foreign credit sources as their lending outstrips their deposit base.

Competition in the banking sector has led to aggressive lending practices, resulting in the deterioration of some asset quality and capital adequacy indicators in 2005. Provisioning against non-performing loans remains low by international standards, and loans to large borrowers as a ratio of bank capital have increased. The sector is highly concentrated, with the top three banks – SEB Vilniaus Bankas, Hansabankas and Nord/LB – accounting for 68 per cent of banking assets. Foreign ownership, mostly from Nordic countries, is widespread and accounts for 87 per cent of the capital of commercial banks.

Social sector

Unemployment fell to 8.3 per cent in 2005 from approximately 11 per cent in 2004, after a post-independence high of over 17 per cent in 2001. This steady decline has been attributed to increasing employment opportunities generated by rapid growth and the high level of emigration among unemployed younger members of the workforce, particularly following Lithuania's accession to the European Union (EU). Unemployment among those aged 15-24 was running at 20.6 per cent in 2005.

The labour market continues to suffer from structural imbalances, with falling demand for unskilled workers and increasing demand for the highly skilled and professionals. Concerns remain about the ability of the education system to provide younger people with the skills required by the labour market. Vocational education and training systems are in need of updating in order to equip the workforce with skills relevant to the private sector's needs. Despite increasing employment in the services sector, a disproportionally high percentage of the workforce (12.7 per cent in 2005) is still engaged in the agricultural sector; the proportion of those employed in the industrial sector has remained constant at around 26 per cent.

Macroeconomic performance

Real economy

Real GDP grew by 7.5 per cent in 2005 and by 8.5 per cent in the first quarter of 2006 due to strong growth in domestic consumption. In the first half of 2006, growth was fastest in the manufacturing and construction sectors, followed by market services, transport, communications and trade. However, several indicators, including declining unemployment, high capacity utilisation, and buoyant asset prices, point to a tightening of resource use.

Economic policies

Although methodological changes to fiscal statistics have resulted in a downward revision of the government deficit figures since 2000, the fiscal stance is set to loosen in 2006 following a neutral stance in 2005. Despite better than expected revenues, Lithuania's fiscal policy has loosened due to public salary increases, higher pension benefits and rising investment. The general government deficit is expected to account for 1.8 per cent of GDP in 2006, up from 0.5 per cent in 2005. Public debt has fallen below 20 per cent of GDP since 2004 and is expected to decline to 18.5 per cent in 2006.

After several years of low inflation, the annual inflation rate increased to 3.1 per cent by end-2005 and to 4.4 per cent by July 2006 due to rising excise taxes, administered prices and oil and gas price increases. As a result, Lithuania failed to meet the relevant Maastricht criterion in May 2006 and had to postpone accession to the European Economic and Monetary Union (EMU), initially planned for January 2007. This postponement has not, however, had negative repercussions on the markets and confidence in the currency board remains strong.

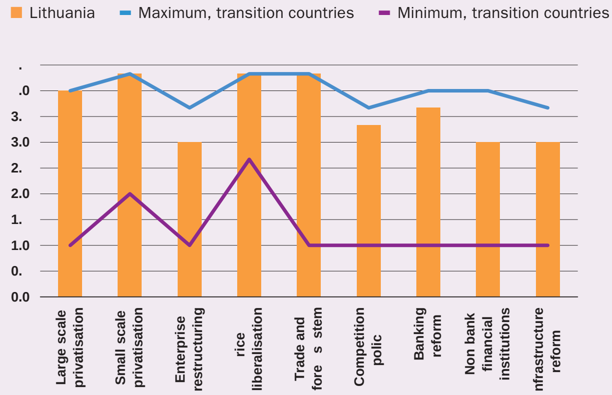
External sector

The current account deficit decreased to 7.0 per cent of GDP in 2005 as the trade balance improved. This was linked to fast import growth in some of Lithuania's main trading partners, notably neighbouring EU countries and the Commonwealth of Independent States. However, the strong growth of domestic consumption is expected to lead to a deterioration of the trade and services balances in 2006. As a result, the current account deficit is expected to widen to 7.9 per cent of GDP in 2006. Foreign direct investment (FDI) and EU financing are expected to finance only 50 per cent of the 2006 deficit. Gross external debt is relatively small at 48 per cent of GDP and short-term debt includes mainly lending from parent banks to their Lithuanian subsidiaries.

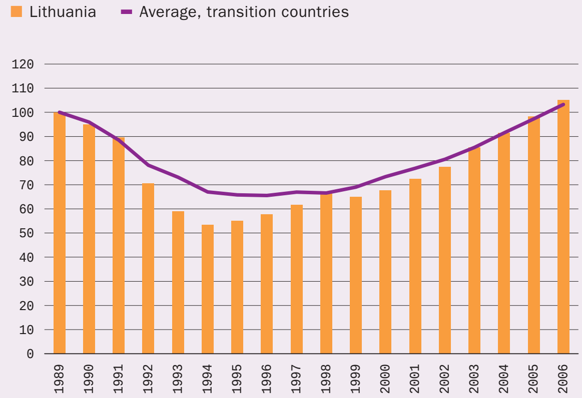
Outlook and risks

Domestic demand remains strong, especially among consumers, and the flow of EU funds is increasing production and strengthening competitiveness. As a result, growth is expected to remain robust in the short term. However, a disciplined fiscal policy is essential to contain expanding domestic demand, deter overheating, curb inflationary pressures, and avoid further postponements to EMU membership.

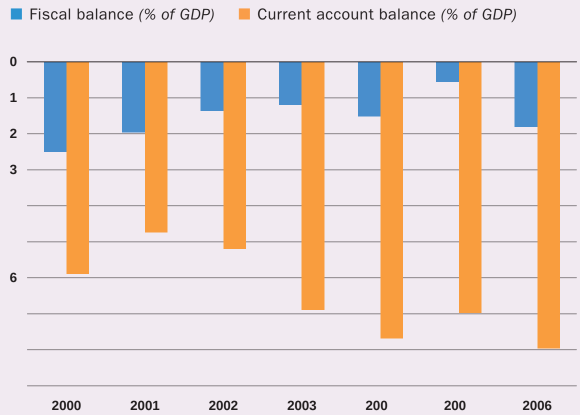
Transition indicators, 2006



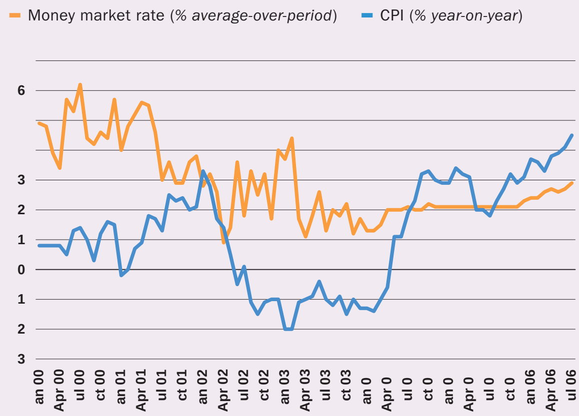
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**[1]

Interest rate liberalisation – **full**

Exchange rate regime – **currency board in ERM II**

Wage regulation – **no**

Tradability of land – **full**[2]

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **very low**

Secured transactions law – **advanced**

Quality of corporate governance law – **high**

Infrastructure

Independent telecoms regulator – **fully**

Independent electricity regulator – **fully**

Separation of railway infrastructure from operations – **partially**

Independence of the road directorate – **partially**

Quality of concession laws – **very high**

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **high**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **7.8 per cent** (2003)

Government expenditure on health – **4.1 per cent of GDP**

Government expenditure on education – **5.9 per cent of GDP**

Household expenditure on power and water – **3.8 per cent**

	2000	2001	2002	2003	2004	2005	2006
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	9.6	10.6	11.1	12.7	13.3	13.7	na
Private sector share in GDP (in per cent)	70.0	70.0	75.0	75.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.2	0.2	0.2	0.3	0.7	0.8	na
Share of industry in total employment (in per cent)	20.8	20.8	20.9	20.7	20.1	20.1	na
Change in labour productivity in industry (in per cent) [3]	10.9	19.9	0.2	14.1	12.6	4.9	na
Investment/GDP (in per cent)	19.8	20.6	22.0	22.9	24.2	25.0	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.0	3.3	3.7	3.7	3.7	4.0	4.0
EBRD index of enterprise reform	2.7	2.7	3.0	3.0	3.0	3.0	3.0
Markets and trade							
Share of administered prices in CPI (in per cent)	18.1	20.4	21.5	23.5	19.8	18.2	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
Share of trade with non-transition countries (in per cent)	65.9	59.9	61.5	63.6	58.2	54.2	na
Share of trade in GDP (in per cent)	80.4	89.7	94.8	91.7	93.5	101.5	na
Tariff revenues (in per cent of imports) [4]	0.7	0.6	0.5	0.5	0.5	0.4	na
EBRD index of price liberalisation	4.0	4.0	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
EBRD index of competition policy	2.7	3.0	3.0	3.0	3.0	3.3	3.3
Financial sector							
Number of banks (foreign-owned)	13 (6)	13 (6)	14 (7)	13 (7)	12 (6)	12 (6)	na
Asset share of state-owned banks (in per cent)	38.9	12.2	0.0	0.0	0.0	0.0	na
Asset share of foreign-owned banks (in per cent)	54.7	78.2	96.1	95.6	90.8	91.7	na
Non-performing loans (in per cent of total loans)	10.8	7.4	5.8	2.6	2.4	0.7	na
Domestic credit to private sector (in per cent of GDP)	10.0	11.4	13.8	19.6	24.8	34.0	na
Domestic credit to households (in per cent of GDP)	1.3	1.5	2.4	4.2	7.1	12.0	na
Of which mortgage lending (in per cent of GDP)	na	na	1.9	3.4	5.5	9.0	na
Stock market capitalisation (in per cent of GDP)	13.8	9.9	9.3	16.9	26.2	31.8	na
Stock trading volume (in per cent of market capitalisation)	48.5	14.8	15.1	17.5	8.2	10.1	na
Eurobond issuance (in per cent of GDP)	5.6	1.8	0.7	0.1	5.0	3.0	na
EBRD index of banking sector reform	3.0	3.0	3.0	3.3	3.3	3.7	3.7
EBRD index of reform of non-bank financial institutions	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	32.2 (14.2)	33.0 (29.2)	26.9 (47.4)	23.9 (62.8)	23.8 (99.3)	23.4 (127.1)	na
Internet penetration rate (per 10,000 inhabitants)	48.2	100.8	157.1	192.2	274.3	274.3	na
Railway labour productivity (1989=100)	41.3	39.1	54.4	67.8	71.0	77.1	na
Residential electricity tariffs (in USc kWh)	6.3	6.3	7.9	9.4	9.7	10.2	na
Average collection rate, electricity (in per cent)	na	91	90	91	97	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.3	4.1	4.2	4.3	na	na	na
EBRD index of infrastructure reform	2.7	2.7	2.7	2.7	2.7	2.7	3.0
Electric power	3.0	3.0	3.0	3.0	3.3	3.3	3.3
Railways	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	3.3	3.3	3.3	3.3	3.3	3.3	3.7
Water and waste water	3.0	3.3	3.3	3.3	3.3	3.3	3.3

1 There are controls for national security, defence and lotteries.

2 Non-agricultural land is fully tradable. However, ownership of agricultural land is constitutionally prohibited for foreigners and partially restricted for Lithuanian legal persons.

3 Data based on the population census.

4 Tariff revenues refer to all taxes on foreign trade.

	2000	2001	2002	2003	2004	2005 Estimate	2006 ro ection
			ercentage c ange in real terms				
		2	6	0	0		0
r a e u p						0	a
u l u p		0				6	a
r e ap al r a	0				2	2	a
p r g a er e		2 2		6	2		a
p r g a er e		6		0			a
u r al gr u pu			6			6	a
Agr ul ural gr u pu	0	0			0		a
[1]			*ercentage c ange*				
a ur r e (e year)	2 0	2	0	0		0	a
pl y e (e year)	0		0	2	0	2 6	a
			n per cent of labour force				
e pl y e (e year)	6			2			a
			ercentage c ange				
u er pr e (a ual a erage)	0		0	2	2	2	
u er pr e (e year)		2	0		2		
r u er pr e (a ual a erage)	6 0	0	2	0	6 0		a
r u er pr e (e year)	2 6			0 2	6		a
r a erage ly ear g e y (a ual a erage)			2			0	a
			n per cent of D				
e eral g er e ala e	2	2 0		2		0	
e eral g er e e pe ure[2]	2	0	0 6	0		2	a
e eral g er e e	2	22	22	2 2			a
			ercentage c ange				
r a ey (M2 e year)	6	2	6	2	2	2	a
e re (e year)		2 6	22		2 0	6	a
			n per cent of D				
r a ey (M2 e year)	22	26	2 6	0		0	a
			n per cent per annum end-year				
er a ere ra e	0		0 0		0		a
rea ury ll ra e (a ur y)				2	2	2	a
ep ra e	0	0	0	0 2	0 2	a	a
e g ra e	0		6		6		a
			itai per dollar				
a ge ra e (e year)	0	0		2	2	2	a
a ge ra e (a ual a erage)	0	0			2	2	a
			n millions of dollars				
urre a u	6			2	2		2 2
ra e ala e	0	0		0	2 2	2	600
Mer a e e p r	0 0		6 0	6	0		06
Mer a e p r			6	6	6	6	06
re g re e e e				2	0	6 0	0
r re er e e lu g g l (e year)		66	2	0		6	a
er al e [6]		26	6		0 2	2	a
			n mont s of imports of goods and services				
r re er e e lu g g l (e year)	2	0			2	2	a
			n per cent of exports of goods and services				
e er e	20			6 6		6 6	a
			Denominations as indicated				
pula (e year ll)							a
(ll l a)		6		6 2	62 0	0	
per ap a (S llar)	260		06	60	6	60	a
S are u ry (per e)	26	2	26	2	2	0 2	a
S are agr ul ure (per e)	0	6	6			2	a
urre a u (per e)			2	6		0	
er al e re er e (S ll)			6		6		a
er al e (per e)	2				6 6		a
er al e e p r g a er e (per e)			2				a

Moldova

Key challenges

- Reform momentum linked to the EU-Moldova Action Plan needs to be maintained to improve the business environment, attract investment and enhance competitiveness.
- Improvements in corporate governance and greater transparency in the banking sector are required to attract strategic investors, increase competition among banks and improve access to capital.
- Growing imbalances in the external account and rising inflation emphasise the need for continued prudent fiscal and tight monetary policies, as well as exchange rate flexibility.

Country data	
Population (in millions)	3.4
Area ('000 sq km)	33.8
GDP (in billion US$, 2005)	2.9
GDP per capita in 2005 at current international US$ (PPP)	1,903
National currency	Leu

Progress in structural reform

Liberalisation and privatisation

An economic review of state-owned assets, completed in 2005, concluded that performance under state ownership was unsatisfactory and proposed privatisation, primarily through the stock exchange. Accordingly, parliament amended the privatisation law to include an updated list of 333 enterprises to be sold in 2006–07. The list includes strategic assets such as Moldtelecom (see below), wine and tobacco companies and Banca de Economii (the only remaining large state-owned bank).

The effective sale of state assets in 2006, however, has been slow and lacked transparency. A new privatisation strategy for 2007 is currently being prepared and envisages only a negative list of firms that cannot be sold. The government plans to complement the privatisation strategy with a new law aiming to promote further commercialisation and private sector participation in the management of state assets by introducing public-private partnerships and concessions into the legal framework.

Business environment and competition

In May 2006 the authorities signed a three-year IMF Poverty Reduction and Growth Facility Programme, committing to reforms in public administration and finance, corporate governance, regulation and enterprise restructuring. The programme calls for a revision of Moldova's bankruptcy regulations and abolishment of the Council of Creditors, a state body providing debt and tax relief to state-owned enterprises. The EU-Moldova Action Plan, signed in February 2005, called for the establishment of an independent competition authority to ensure fair trading in the economy and to improve the business environment. Actual establishment and operation of the competition commission, however, have been delayed.

Regulatory reform is progressing. Implementation of the first stage of the Guillotine Law, approved in 2005, has been completed. This has resulted in the streamlining of licensing and business registration procedures, and also a substantial reduction in the number of permits, licences, authorisations and certificates required for business activities. In July 2006 parliament adopted a bill requiring all regulatory authorities to undertake a regulatory impact assessment of existing laws and regulations (over two years) and future legislation.

Infrastructure

Gas import prices doubled in the first half of 2006 and the regulator (ANRE) has raised industry and household prices proportionally. This is in line with the government's commitment to pass energy costs on to the final consumer (excluding low-income families on state support). Restructuring in the energy sector remains a key challenge. The two northern electricity distribution companies need reorganisation and investment to improve their financial performance, while key power generating assets require funding to improve technical efficiency.

Progress in municipal infrastructure reform has been mostly confined to improvements in the collection of tariffs. In Chisinau collection of water bills was close to 100 per cent in 2005 and some historic debts were also recovered. Nevertheless, municipal utility operators remain inefficient and tariff setting is often politicised. Accordingly, tariffs remain substantially below cost-recovery levels, threatening the financial viability of water, transport and district heating operators.

Although the telecommunications industry has been fully liberalised, enforcement powers and mechanisms available to the regulator (ANRTI) are hampered by weaknesses in the legal framework, such as ANRTI's inability to designate operators with significant market power. Following a process that lacked transparency, the third licence for mobile communications was awarded to the incumbent fixed-line operator Moldtelecom in June 2006.

Financial sector

Despite improvements in the legal framework, the ability of the National Bank of Moldova (NBM) to implement effective banking supervision remains untested. As a result, structural weaknesses in the banking sector persist. These include continued shortcomings in corporate governance and transparency (particularly relating to the ownership of banks and corporate clients), as well as insufficient competition.

The privatisation of Banca de Economii to a strategic banking investor is expected to reduce the risk of state interference in financial sector development and enhance competition. However, the privatisation remains just a medium-term objective of the government and has no specific timeline. The acquisition of Eximbank, a small Moldovan bank, by Veneto Banca of Italy in May 2006 represented the first entry of a foreign bank into the Moldovan banking system. Meanwhile, Raiffeisen Bank has opened a representative office in Chisinau and other foreign banks have expressed interest in the Moldovan market.

Macroeconomic performance

Real economy

The economy grew by 7.1 per cent in 2005, but slowed to 5 per cent year-on-year in the first half of 2006. A further slowdown is expected during the remainder of 2006 following a ban on Moldovan wine and agricultural produce exports to Russia. The negative impact of this ban led to a decline in industrial production of 6.9 per cent year-on-year in the first half of 2006, compared with a 6.3 per cent increase in 2005. Domestic demand has grown, with private consumption – buoyed by remittances from workers abroad and public sector wage growth – the main driver. Capital formation has also accelerated.

Economic policies

The Central Bank law has been amended to make price stability the sole policy objective of the National Bank of Moldova (NBM). However, the sharp increase in gas import prices is posing a substantial challenge to the NBM's single-digit inflation objective. Inflation was 14.5 per cent in August 2006 (year-on-year). Despite repeated NBM intervention, the deterioration of the external account during 2006 has led to volatility on the foreign exchange market and nominal depreciation of the leu. Fiscal policy is set to loosen, with a target for the public budget deficit of 1.7 per cent in 2006, following a 1.6 per cent surplus recorded in 2005. Reductions in direct tax rates are likely to be offset by higher indirect taxes on imports and consumption, but social expenditure is expected to grow.

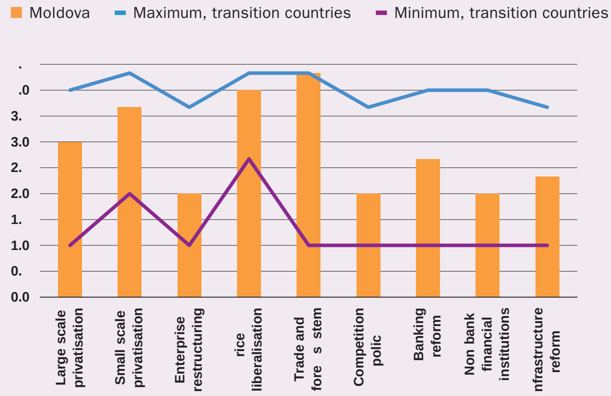
External sector

External imbalances in the economy are increasing. During the first half of 2006, the growth of imports considerably outpaced that of exports. This was partly due to the trade restrictions imposed by Russia, resulting in an 8.5 per cent decline in exports in US dollar terms over the period. Meanwhile, the sharp rise in energy import costs has led to a 15 per cent rise in imports in US dollar terms. The trade deficit reached 40 per cent of GDP in 2005 and is expected to increase further in 2006. Remittances continue to provide major support for the current account, but their growth declined in 2005 compared with previous years. Foreign direct investment in Moldova reached US$225 million in 2005, the highest level ever recorded. Following the agreement on a new IMF programme, Moldova reached a restructuring deal with the Paris Club of creditors in May 2006, which will ease the debt service burden on external public debt.

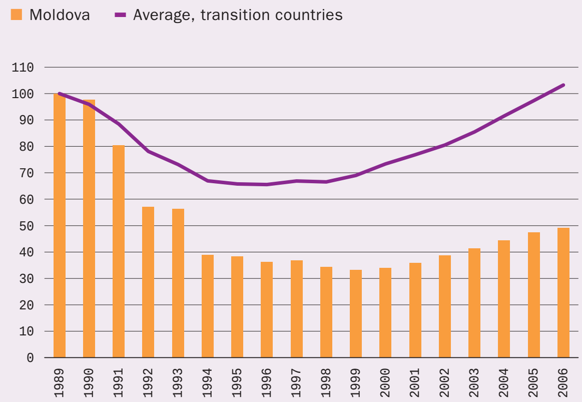
Outlook and risks

The sharp increase in gas import prices and the ban on alcohol exports to Russia have had a negative impact on the economy. This has highlighted Moldova's heavy reliance on workers' remittances and agriculture, as well as the country's vulnerability to external shocks. High energy costs and the difficulty of diversifying export markets will continue to hinder growth in the short term. Long-term prospects, however, will depend on productivity gains and the further expansion of export-oriented capacity. This in turn requires effective implementation of the reform agenda in the EU-Moldova Action Plan, supported by improvements in the business environment to facilitate investment and the transfer of know-how.

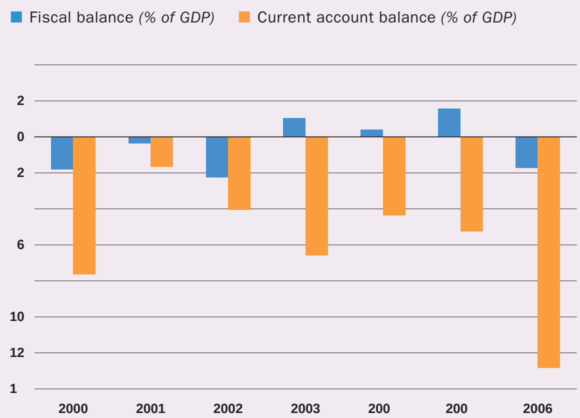
Transition indicators, 2006



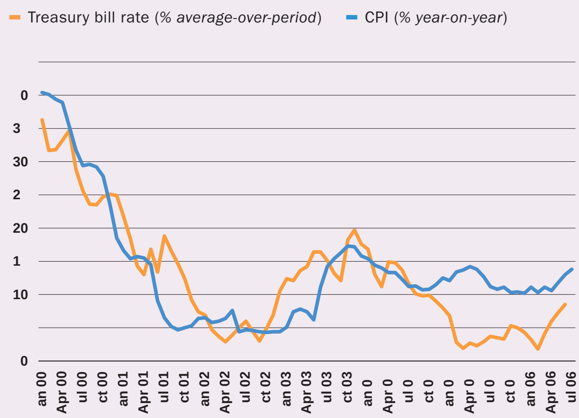
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **no**	Independent telecoms regulator – **partially**	Capital adequacy ratio – **12 per cent**	Share of population living in poverty – **63.7 per cent** (2001)
Controls on inward direct investment – **no**	Quality of insolvency law – **high**	Independent electricity regulator – **partially**	Deposit insurance system – **yes**	Government expenditure on health – **4.7 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **some defects**	Separation of railway infrastructure from operations – **no**	Quality of securities market laws – **low**	Government expenditure on education – **6.8 per cent of GDP**
Exchange rate regime – **floating**	Quality of corporate governance law – **high**	Independence of the road directorate – **no**	Private pension funds – **yes**	Household expenditure on power and water – **9.6 per cent**
Wage regulation – **yes**		Quality of concession laws – **medium**		
Tradability of land – **full**				

	2000	2001	2002	2003	2004	2005	2006
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	12.4	12.9	13.5	13.9	14.2	14.7	na
Private sector share in GDP (in per cent)	50.0	50.0	55.0	55.0	55.0	60.0	65.0
Private sector share in employment (in per cent)	na	na	na	60.0	60.0	60.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	na	na	na	na	na	na	na
Share of industry in total employment (in per cent)	11.0	11.0	11.4	12.1	12.4	12.0	na
Change in labour productivity in industry (in per cent)	3.8	14.3	6.8	20.4	8.5	10.0	na
Investment/GDP (in per cent)	23.9	23.3	21.7	23.2	25.3	29.8	na
EBRD index of small-scale privatisation	3.7	3.7	3.7	3.7	3.7	3.7	3.7
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of enterprise reform	2.0	2.0	2.0	1.7	1.7	2.0	2.0
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	10.0	8.0	7.0	7.0	7.0	4.0	5.0
Share of trade with non-transition countries (in per cent)	44.0	42.9	43.4	37.0	37.3	37.7	na
Share of trade in GDP (in per cent)	96.8	97.7	102.1	112.8	105.9	114.8	na
Tariff revenues (in per cent of imports)	2.4	2.1	2.4	2.4	2.3	2.4	na
EBRD index of price liberalisation	3.7	3.7	3.7	3.7	3.7	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
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	20 (11)	19 (10)	16 (10)	16 (9)	16 (9)	16(7)	na
Asset share of state-owned banks (in per cent)	9.8	10.2	13.4	15.5	17.6	19.3	na
Asset share of foreign-owned banks (in per cent)	39.8	34.9	36.7	35.2	33.6	19.6	na
Non-performing loans (in per cent of total loans)	20.6	10.4	7.6	6.4	6.9	5.3	na
Domestic credit to private sector (in per cent of GDP)	13.3	15.3	17.3	20.3	21.2	25.4	na
Domestic credit to households (in per cent of GDP)	0.5	0.5	0.5	0.6	0.9	2.1	na
Of which mortgage lending (in per cent of GDP)	0.6	0.7	0.9	1.0	1.1	1.5	na
Stock market capitalisation (in per cent of GDP)	30.3	24.1	24.4	24.4	22.4	na	na
Stock trading volume (in per cent of market capitalisation)	6.8	5.8	5.2	7.7	9.7	5.9	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	2.3	2.3	2.3	2.3	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
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants) [1]	13.7 (3.3)	15.0 (5.3)	16.9 (10.0)	18.7 (11.3)	20.3 (18.5)	22.1 (25.9)	na
Internet penetration rate (per 10,000 inhabitants)	4.1	4.1	5.2	28.3	31.2	31.2	na
Railway labour productivity (1989=100)	18.7	23.3	28.2	29.5	31.0	31.4	na
Residential electricity tariffs (in USc kWh)	4.6	5.2	6.0	5.6	5.8	6.0	na
Average collection rate, electricity (in per cent)	55	na	99	100	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.9	1.9	2.1	1.9	na	na	na
EBRD index of infrastructure reform	2.3	2.3	2.3	2.0	2.0	2.3	2.3
Electric power	3.3	3.3	3.3	3.0	3.0	3.0	3.0
Railways	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Roads	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	2.3	2.3	2.3	2.3	2.3	2.7	3.0
Water and waste water	2.0	2.0	2.0	2.0	2.0	2.0	2.0

1

	2000	2001	2002	2003	2004	2005 Estimate	2006 ro ection
			ercentage c ange in real terms				
	2	6		6 6			
r a e u p	2 6	6			6 2	0	a
u l u p				2	6 2	6	a
r e ap al r a	0	2			0	0	a
p r g a er e	6			2	0		a
p r g a er e	2			2	6		a
u r al gr u pu			0	6	6	6	a
Agr ul ural gr u pu		6		6	20	0	a
			ercentage c ange				
a ur r e (e year)		2	0			2 2	a
pl y e (e year)		0	0			0 6	a
			n per cent of labour force				
e pl y e (e year)			6		0	6	a
			ercentage c ange				
u er pr e (a ual a erage)		6	2	6	2	2 0	2
u er pr e (e year)		6			2	0 2	
r u er pr e (a ual a erage)	2	2			6		a
r u er pr e (e year)	2		6	2		0	a
r a erage ly ear g e y (a ual a erage)			2 2	2	2		a
			n per cent of D				
e eral g er e ala e[2]		0	2 2	0	0	6	
e eral g er e e pe ure[2]		2			2	0	a
e eral g er e e					6 0		a
			ercentage c ange				
r a ey (M2 e year)	0		0	2		6	a
e re (e year)		2 6	2 2	2	2	20	a
			n per cent of D				
r a ey (M2 e year)		2	20 0	20	2	0	a
			n per cent per annum end-year				
e a g ra e	2 0	0		0		2	a
er a ere ra e (up 0 ay a ur y)	20	0		0			a
ep ra e (year)	2 6	20 6		2	2	2	a
e g ra e (year)		2	2	2	2 0		a
			ei per dollar				
a ge ra e (e year)	2			2	2	2	a
a ge ra e (a ual a erage)	2	2	6		2	2 6	a
			n millions of dollars				
urre a u		2	6	0			
ra e ala e	2			62		62	6
Mer a e e p r		6	660	0		0	
Mer a e p r	0	0	0	2		2 2 6	2 6
re g re e e e	2	02	2			22	0
r re er e e lu g g l (e year)	222	22	26	02	0		a
er al e	2	6		2	2		a
			n mont s of imports of goods and services				
r re er e e lu g g l (e year)	2	2	2	2	2 6	2	a
			n per cent of exports of goods and services				
e er e	6			2 2	2	6	
			Denominations as indicated				
pula (e year ll)	6	6	6	6			a
(ll le)	6 020	0 2	22 6	2 6	2	6	2
per ap a (S llar)		0			66	62	a
S are u ry (per e)	0	2	20 2	20	20	0	a
S are agr ul ure (per e)	2	22	2 0		2	2	a
urre a u (per e)	6		0	6 6		2	2
er al e re er e (S ll)			6	622			a
er al e (per e)	6		0 2	2	2	6 2	a
er al e e p r g a er e (per e)	26	226	20		6	2	a

1 Unemployment determined according to ILO methodology.

2 General government includes the state, local government, social security and health care.

3 Government debt includes public and publicly guaranteed debt.

4 Population excludes Transnistria.

Mongolia

Key challenges

- To maintain an internationally competitive business environment for mining and other sectors, the government should ensure a level playing field for foreign investments and strengthen dialogue between the government and the business community.
- Regulatory agencies in the financial sector need to ensure that asset quality is maintained and that lending practices are improved.
- Mongolia needs to reduce its vulnerability to global commodity price fluctuations, building on recent progress with the creation of the Development Fund.

Country data

Population (in millions)	**2.6**
Area ('000 sq km)	**1,567.0**
GDP (in billion US$, 2005)	**1.9**
GDP per capita in 2005 at current international US$ (PPP)	**2,169**
National currency	**Togrog**

Progress in structural reform

Business environment and competition

Mongolia has received relatively favourable ratings in business environment surveys, such as the World Bank's Doing Business report, particularly relating to starting a business, licensing, hiring and firing and registering property. Amendments to the tax laws in 2006 lowered corporate taxes from 30 per cent to 25 per cent and value added tax (VAT) from 15 per cent to 10 per cent.

Mongolia ranked higher than all the CIS countries on Transparency International's 2005 Corruption Perceptions Index. Nevertheless, corruption is perceived as a major problem by foreign investors and domestic enterprises. Lack of transparency and accountability in government-business interactions is also an impediment to the development of the private sector.

A new windfall tax adopted in 2006, together with amendments to the minerals law, seems to have substantially increased the cost of doing business in the mining sector. Mining companies must pay a 68 per cent tax on profits from the sale of copper and gold (when prices move above certain levels). In addition, mining companies must list 10 per cent of their shares on the Mongolian Stock Exchange. Royalty rates have also been increased. Moreover, the state will have the right to acquire up to 50 per cent (or 34 per cent if exploration is privately funded) of any strategic asset discovered in Mongolia. Accordingly gold sales to the Central Bank declined by 24 per cent during the first eight months of 2006.

A Development Fund has been established to soften commodity price fluctuations and set aside revenues. However, contrary to the recommendations by the IMF, the use of proceeds is partly linked to social and capital investment programmes.

An independent competition authority was established in 2005. The new body has already addressed two cases of anti-competitive behaviour during 2006 involving a state-run stamp company and a school textbook printing and publishing operation.

Infrastructure

In the telecommunications sector new privatisation guidelines were approved by parliament in July 2005 and a resolution to implement them was signed by the government in July 2006. These instruments define the restructuring strategy for the telecommunications sector. The network assets will be transferred to an independent, stand-alone network company (NETCO) and there will be open access to the network. Moreover, the government intends to fully privatise Mongolian Telecom, the incumbent fixed-line operator, in which Korean Telecom holds a 40 per cent stake. Whether these measures will increase competition in fixed-line services remains to be seen.

Until 2005 there were only two operating companies (both foreign-sponsored) in the mobile phone sector, with Mobicom holding the majority share of the market. A third mobile licence has since been awarded to Cityphone, and it is likely that more licences will be tendered in the future. Although the Communications Regulatory Commission has been established as an independent regulator for the sector, certain regulatory decisions continue to be taken by the Information and Communication Technologies Authority, which was established in 2004 with responsibility for policy making.

Financial sector

The banking sector's capital base has increased significantly, partly as a result of the rise in minimum capital requirements to 8 billion togrog (US$6.6 million) in March 2006. There are 17 banks, some of which have been sold to foreign investors during the privatisation process. The only remaining state-owned bank – the Savings Bank – is due to be privatised by the end of 2006. Financial service development has advanced rapidly, as illustrated by the increase in the domestic credit-to-GDP ratio from 20 per cent in 2002 to 40 per cent in 2005. However, as credit to the private sector has grown, the stock of non-performing loans has increased (at an annual rate of 25 per cent nominally by early 2006).

The average lending rate remains at over 20 per cent. There is no deposit insurance scheme, but legislation is being drafted. There are also some concerns over the large off-balance-sheet activities of commercial banks. Non-bank financial institutions have been small and fragmented in Mongolia, but in 2006 the Financial Regulatory Authority was established to independently regulate the sector (including insurance companies, stock markets and non-bank lending institutions).

Macroeconomic performance

Real economy

Real GDP increased by 6.2 per cent in 2005. This is regarded as strong growth for Mongolia, even though it is lower than the record rate of 10.6 per cent achieved in 2004. Economic performance was supported by rapid export growth (owing to high commodity prices and increased gold production) and increased foreign direct investment. Domestic demand was fuelled by higher incomes and growing remittances from workers abroad. However, textile output dropped significantly as quotas were phased out with the expiry in January 2005 of the Multi Fibre Arrangement governing international textile trade.

Economic policies

During 2005 there were strong inflationary pressures, partly due to robust growth of the money supply, but also because of higher prices for oil, agricultural products and utilities. The year-on-year inflation rate peaked at 18 per cent in mid-2005. However, cheaper imports from China and the deceleration in food prices resulted in a slowdown in the 12-month rate to about 2 per cent in June 2006.

The 2005 budget ended with a surplus of 3 per cent of GDP, the first time a surplus had been recorded since 1992. Fiscal revenues were boosted by strong economic growth, while the management of expenditure improved under a new financial information system. For 2006, the authorities have increased public wages by 30 per cent and social benefits by 32 per cent. In addition, as part of a policy of tax reform, new tax legislation was approved by parliament in July 2006 (effective from January 2007) reducing a number of tax rates including those for VAT and income tax.

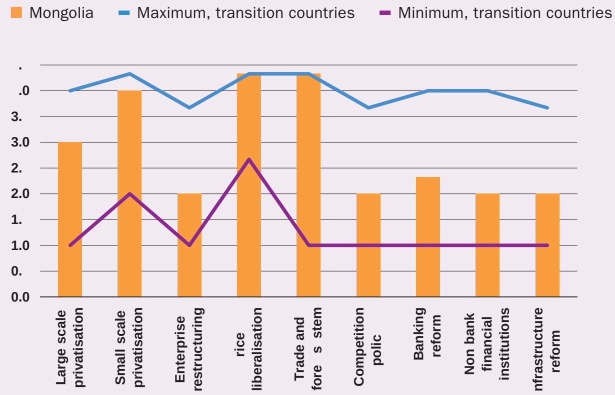
External sector

External performance improved substantially in 2005 as the current account recorded a surplus. This was in part due to higher mineral prices and growing remittances. The external debt stock has risen gradually from US$837 million in 2000 to US$1,307 million in 2005. However, owing to rapid growth over this period, the ratio of external debt to GDP declined after 2003 to stand at about 70 per cent by the end of 2005. The authorities are keen to undertake further borrowing to finance much-needed investment in infrastructure and to expand trade with China. The majority of Mongolia's external debt is comprised of multilateral loans, repayable at low interest rates over long periods.

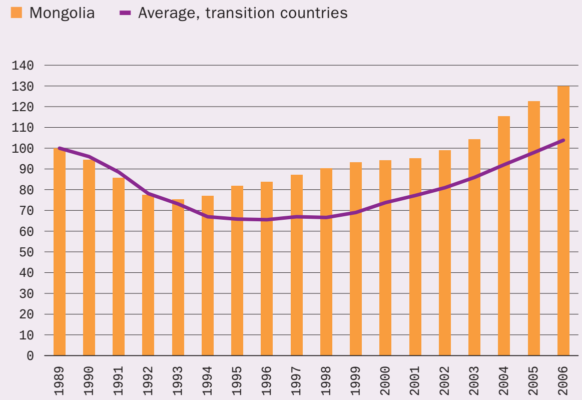
Outlook and risks

Despite solid growth in recent years, poverty remains widespread and the economy remains vulnerable to variations in weather conditions, as well as fluctuations in global commodity prices (especially for oil, metals and textiles). Moreover, there is uncertainty over the impact of government changes to taxation and mineral laws. The outlook also depends on progress in structural reform and Mongolia's economic interaction with the international community. If these factors remain relatively stable, growth is expected to stay strong at around 5 to 7 per cent per year over the medium term.

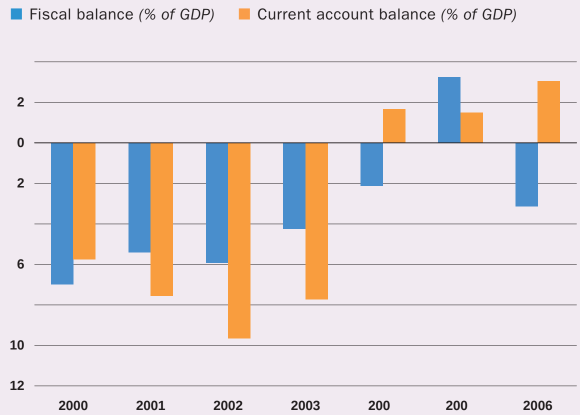
Transition indicators, 2006



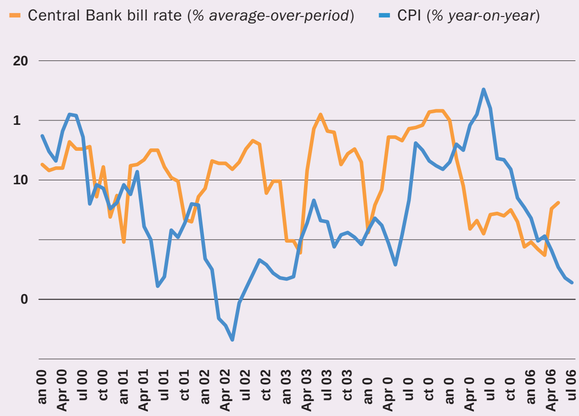
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradability of land – **limited de facto**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **malfunctioning**

Quality of corporate governance law – **high**

Infrastructure

Independent telecoms regulator – **partially**

Independent electricity regulator – **partially**

Separation of railway infrastructure from operations – **no**

Independence of the road directorate – **no**

Quality of concession laws – **not available**

Financial sector

Capital adequacy ratio – **17.4 per cent** (2004)

Deposit insurance system – **no**

Quality of securities market laws – **not available**

Private pension funds – **no**

Social reform

Share of population living in poverty – **74.9 per cent** (1998)

Government expenditure on health – **3.8 per cent of GDP**

Government expenditure on education – **7.4 per cent of GDP**

Household expenditure on power and water – **9.4 per cent** [1]

	2000	2001	2002	2003	2004	2005	2006
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	7.8	8.3	8.7	9.4	10.3	10.5	na
Private sector share in GDP (in per cent)	60.0	60.0	65.0	70.0	70.0	70.0	70.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	8.4	8.6	8.9	8.6	8.4	8.6	na
Share of industry in total employment (in per cent)	14.1	13.7	14.3	15.6	16.1	na	na
Change in labour productivity in industry (in per cent)	11.7	1.2	-7.5	-11.2	8.4	-2.2	na
Investment/GDP (in per cent)	36.2	36.1	32.2	29.0	36.5	35.5	na
EBRD index of small-scale *privatisation*				0	0	0	0
EBRD index of large-scale privatisation	2 0	2 0	2	2	0	0	0
EBRD index of enterprise reform	2 0	2 0	2 0	2 0	2 0	2 0	2 0
S are a ere pr e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	0 0
u er g a ere pr e a e	0 0	0 0	0 0	0 0	0 0	0 0	0 0
S are ra e ra u re (per e)		2 0			6	2	a
S are ra e (per e)	2		0			2	a
ar re e ue (per e p r)			2				a
EBRD index of price liberalisation							
EBRD index of forex and trade liberalisation							
EBRD index of competition policy						2 0	2 0
u er a (re g e)	2 (0)	(0)	6 (2)	( )	( )	( )	a
A e are a e e a (per e)	a	a	a	a	a	a	a
A e are re g e a (per e)	a	a	a	a	a	a	a
per r g l a (per e al l a)	2 6	6	0		6 0	a	a
e re pr a e e r (per e)	6		0			a	a
e re u e l (per e)	a	a	a	a	a	a	a
r gage le g (per e)	a	a	a	a	a	a	a
S ar e ap al a (per e)	0		2		6	2	a
S ra g lu e (per e ar e ap al a)	a			2 2	2	6	a
ur ua e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
EBRD index of banking sector reform		2 0	2 0	2	2	2	2
EBRD index of reform of non-bank financial institutions	2 0	2 0	2 0	2 0	2 0	2 0	2 0
e l e (le) pe e ra ra e (per 00 a a)	0 (6)	2 ( )	( )	6 (0)	6 (6)	(2)	a
er e pe e ra ra e (per 0 000 a a)	0	0 6	0	0 2	0 6	0 6	a
a l ay la ur pr u y (0 00)	2	2			2	202 6	a
e e al ele r y ar (S)			2			0	a
A erage lle ra e ele r y (per e)	a	a	a	a	a	a	a
per u e ergy u e (S llar per g e)	a	a	a	a	a	a	a
EBRD index of infrastructure reform		2 0	2 0	2 0	2 0	2 0	2 0
Electric power	0		2	2	2	2	2
Railways	2 0	2 0	2 0	2 0	2	2	2
Roads							
Telecommunications	2	2	2	2	2	2	2
Water and waste water	2 0	2 0	2 0	2 0	2 0	2 0	2 0

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	1.1	1.0	4.0	5.5	10.6	6.2	6.0
Industrial gross output	1.1	0.6	1.5	3.0	15.0	-0.9	na
Agricultural gross output	1.6	1.0	5.0	3.7	17.7	7.7	na
Employment			(Percentage change)				
Labour force (end-year) [1]	-0.7	2.9	3.3	6.4	2.7	1.4	na
Employment (end-year)	-0.6	2.9	4.6	6.4	2.6	1.7	na
			(In per cent of labour force)				
Unemployment (end-year) [2]	4.6	4.6	3.4	3.5	3.6	3.5	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	11.6	8.0	0.3	5.1	8.3	12.5	4.1
Consumer prices (end-year)	8.1	8.0	1.7	4.7	11.0	9.2	6.6
Producer prices (annual average)	na	na	na	na	na	na	na
Producer prices (end-year)	na	na	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	33.5	4.7	9.4	22.0	16.0	23.5	na
Government sector			(In per cent of GDP)				
General government balance [3]	-7.0	-5.4	-5.9	-4.2	-2.1	3.2	-3.1
General government expenditure [3]	41.5	43.9	44.4	42.1	39.4	33.7	na
General government debt [4]	97.3	90.1	100.3	121.2	100.7	83.5	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	17.6	27.9	42.0	49.6	20.5	37.1	na
Domestic credit (end-year)	6.5	6.1	42.9	147.3	23.1	22.2	na
			(In per cent of GDP)				
Broad money (M2, end-year)	25.4	29.7	37.9	48.1	44.3	51.2	na
Interest and exchange rates			(In per cent per annum, end-year)				
Central bank bills rate	8.7	8.6	9.9	11.5	15.8	4.4	na
Deposit rate [5]	16.8	14.3	13.2	14.0	14.2	13.0	na
Lending rate [5]	32.8	30.2	28.4	26.3	25.4	23.6	na
			(Togrog per US dollar)				
Exchange rate (end-year)	1,097.0	1,101.3	1,122.2	1,168.3	1,211.8	1,221.0	na
Exchange rate (annual average)	1,076.7	1,097.6	1,108.5	1,142.7	1,185.2	1,205.2	na
External sector			(In millions of US dollars)				
Current account	-54	-77	-108	-99	27	28	70
Trade balance	-140	-170	-229	-199	-149	-155	-72
Merchandise exports	536	523	524	627	872	1,069	1,295
Merchandise imports	676	693	753	827	1,021	1,224	1,367
Foreign direct investment, net	40	43	78	132	129	258	215
Gross reserves, excluding gold (end-year)	191	207	271	178	208	333	na
External debt stock	837	854	978	1,287	1,360	1,307	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.9	3.0	3.4	2.0	1.8	2.5	na
			(In per cent of exports of goods and services)				
Debt service	3.8	5.3	4.5	34.0	7.4	2.5	2.6
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	2.5	2.5	2.6	2.6	2.6	2.7	na
GDP (in billions of togrog)	1,019	1,116	1,241	1,461	1,911	2,267	2,737
GDP per capita (in US dollars)	379	402	437	494	617	710	na
Share of industry in GDP (in per cent)	na	22.0	22.5	25.3	29.9	30.2	na
Share of agriculture in GDP (in per cent)	na	24.9	20.7	20.1	20.9	21.7	na
Current account/GDP (in per cent)	-5.8	-7.6	-9.6	-7.7	1.6	1.5	3.1
External debt - reserves (in US$ million)	646	647	707	1,109	1,152	974	na
External debt/GDP (in per cent)	88.4	84.0	87.4	100.7	84.3	69.5	na
External debt/exports of goods and services (in per cent)	130.8	134.1	138.0	154.1	112.5	88.1	na

1 Labour force includes economically active population registered at the employment registration office.

2 Officially registered unemployed. According to the 2003 population census, the real unemployment rate was 17 per cent.

3 General government revenue and expenditure includes grants and net lending.

4 General government debt includes direct and assumed debt of the central government and loans guaranteed by the government.

5 Weighted average over all maturities.

Montenegro

Key challenges

- The government should withdraw from the remaining state-owned enterprises to entrench the development of a favourable private sector business environment.
- Infrastructure reform is at an early stage and the need for modernisation is substantial. Planned investment in the road, railway and energy sectors requires complementary improvement in the commercial orientation and efficiency of companies.
- The government has made progress in reducing deficits, but future plans for tax reform and infrastructure spending must be costed carefully to ensure long-term fiscal and debt sustainability.

Country data	
Population (in millions)	0.7
Area (‘000 sq km)	13.8
GDP (in billion US$, 2005)	2.1
GDP per capita in 2005 at current international US$ (PPP)	na
National currency	Euro

Progress in structural reform

Liberalisation and privatisation

Privatisation is well advanced in Montenegro, most recently focusing on the sale of the remaining large companies in state hands. In July 2006 a tender was launched to find a new buyer for the Niksic steel mill (which had been effectively renationalised by the government earlier in the year). Four companies made bids for the 67 per cent stake on offer, and in September, the Tender Commission announced that it ranked the bid of UK-based MN Speciality Steels above the others. In the hotel sector, several tenders have been announced since the start of 2006.

In May 2006 negotiations between the State Union of Serbia and Montenegro and the European Union (EU) on a Stabilisation and Association Agreement (SAA) were called off due to the failure of the Serbian authorities to comply fully with the requirements of the International Criminal Tribunal for the former Yugoslavia. Montenegro has since achieved its independence and resumed negotiations with the EU in September. The new state already has a relatively open trade regime with low tariff barriers and has applied to join the World Trade Organization.

Business environment and competition

Montenegro has liberal, business-friendly laws, although there are some impediments. The corporate tax rate, at 9 per cent, is among the lowest in Europe, and the introduction of a flat income tax is under active consideration. In principle, new businesses can be registered in four days at a nominal cost of €1. However, the procedures for obtaining the necessary licences and other permits are sometimes cumbersome and provide scope for petty corruption.

A new competition law, generally in line with European standards, was adopted in 2005, and preparations for a draft competition strategy are in hand. In March 2006 the government agreed to set up an independent competition authority, although by mid-year only one merger case and no cartel or abuse of market dominance cases had been opened.

Infrastructure

Infrastructure reform varies widely across sectors. Privatisation of the telecommunications sector is complete and the government is planning a new licence tender in the mobile sector. Power sector privatisation is still at an early stage, with preparations under way to unbundle the state-owned power company, Elektroprivreda Crne Gore. Montenegro has considerable, but relatively undeveloped, hydroelectric potential, and two new hydropower plants are under reconstruction.

Infrastructure reforms in the road and railway sectors have also advanced. Three different government bodies that had previously been responsible for the roads programme were amalgamated in 2005. As a result, a more transparent financing mechanism has been introduced. In the railway sector, the majority state-owned company ZCG (established in 2005) was restructured in January 2006 as a holding company with two wholly owned subsidiaries for infrastructure and operations. Each of these is a separate incorporated entity. The government is also aiming to establish a regulatory authority for railways during 2006.

Financial sector

The performance and supervision of the banking sector has improved significantly in recent years. As of end-2005, there were 10 banks operating in Montenegro, with total assets of 42 per cent of GDP. The year 2005 saw a rapid increase in assets, lending activities and total deposits. Also, most banks were transferred to private hands. By the end of 2005, following the sale of Podgorička Banka to Société Générale in October 2005, the state’s share of banking sector capital had fallen to about 13 per cent. A decision was taken by the Privatisation Council in October 2005 to privatise the two remaining banks with majority state capital, Pljevaljska Banka and Niksička Banka.

Domestic credit to the private sector grew by 33 per cent in 2005, and confidence in the banking sector has been enhanced by the establishment of a Deposit Protection Fund in January 2006. The Fund protects depositors (up to €5,000) in the event of a bank failure or bankruptcy.

Macroeconomic performance

Real economy

While in union with Serbia, Montenegro generally enjoyed more stable, if lower, economic growth on average than its partner republic. In terms of the main macroeconomic indicators, 2005 was its best year since the start of transition. Real GDP growth was above 4 per cent for the first time since serious reforms began, inflation was less than 3 per cent and the main fiscal and external indicators were relatively positive. Early indications have suggested that growth may exceed 5 per cent in 2006. However, there was virtually no growth during 2005 in the industrial sector, labour market participation rates are low and poverty remains a serious problem in much of the country.

Economic policies

Montenegro has no currency of its own, having adopted the German deutschmark as sole legal tender from 2000 and the euro from 2002. The policy has been successful at delivering low inflation and there are no plans to introduce a domestic currency. Reserve requirements for banks were lowered in April 2006, with the standard rate for short-term deposits falling from 23 per cent to 19 per cent. The conduct of fiscal policy has meanwhile improved significantly. While total revenue has remained steady at around 40 per cent of GDP, expenditure has been reduced gradually to about 42 per cent of GDP, resulting in a fiscal deficit in 2005 (after grants) of 1.7 per cent of GDP. Strong revenue collection (especially from value added tax) has put the fiscal accounts on course for near balance in 2006.

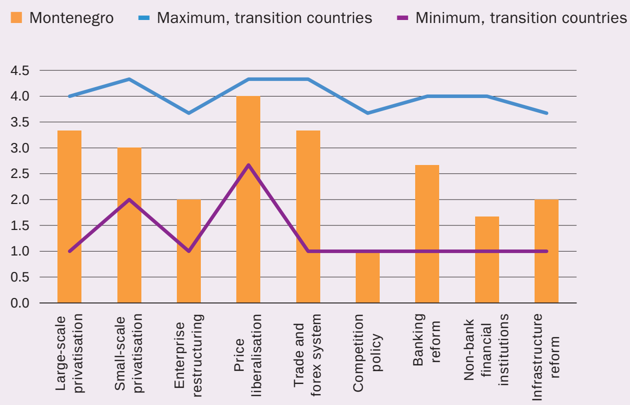
External sector

According to Central Bank data, the current account recorded a deficit of 8.6 per cent of GDP in 2005. The deficit is likely to decline gradually. Montenegro has a relatively liberal trade regime and exports and services (mostly related to tourism) are forecast to rise sharply over the medium term. On the capital account, a huge influx of foreign direct investment – €375 million or nearly 20 per cent of GDP – took place in 2005, mainly as a result of several large privatisations. The level of external debt is moderate at about 42 per cent of GDP, of which less than 25 per cent is private. The debt service profile is also relatively favourable – mostly on a long-term basis from international financial institutions and bilateral creditors.

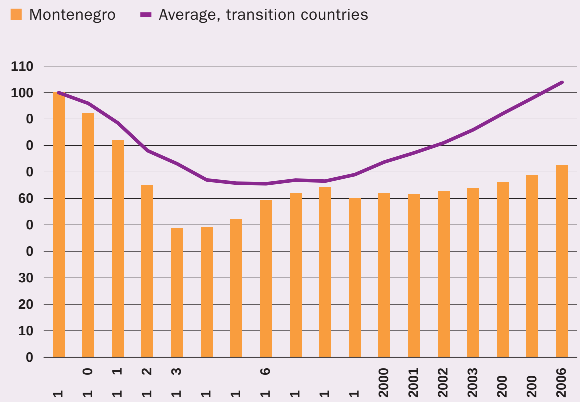
Outlook and risks

As a newly independent country, Montenegro has the potential to grow rapidly over the medium term. It has already had some success in attracting foreign funding, which should not only boost future expansion but also signal its worth as an investment destination. However, the country's administrative capacity to implement a comprehensive reform programme may be insufficient to fulfil that potential.

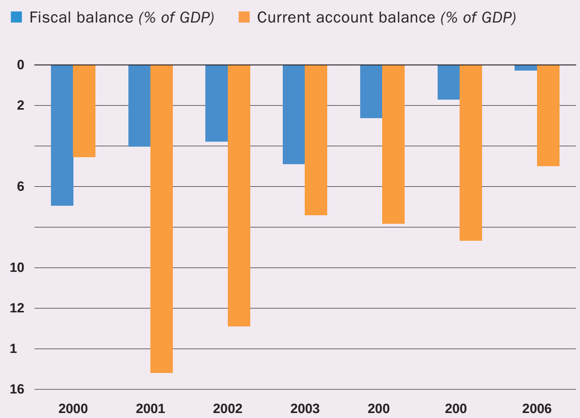
Transition indicators, 2006



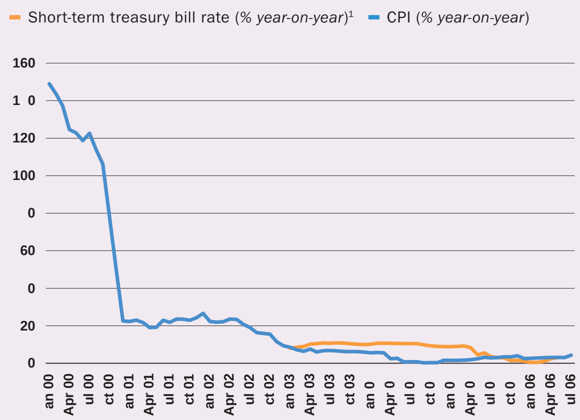
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



[1] Short-term treasury bill rate data were not available for 2000-02.

Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **unilateral euroisation**

Wage regulation – **no**

Tradability of land – **limited de jure**

Business environment and competition

Competition office – **na** [1]

Quality of insolvency law – **na**

Secured transactions law – **na**

Quality of corporate governance law – **na**

Infrastructure

Independent telecoms regulator – **partially**

Independent electricity regulator – **partially**

Separation of railway infrastructure from operations – **fully**

Independence of the road directorate – **partially**

Quality of concession laws – **medium**

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **medium**

Private pension funds – **no**

Social reform

Share of population living in poverty – **na**

Government expenditure on health – **na**

Government expenditure on education – **na**

Household expenditure on power and water – **na**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)	a	a	a	a	a	a	a
r a e e r are (per e)	0	0 0	0	0	0	6 0	6 0
r a e e r are e pl y e (per e)	a	a	a	a	a	a	a
u ge ary u e a urre ra er (per e)	a	a	a	a	a	a	a
S are u ry al e pl y e (per e)	a	a	a	a	a	a	a
a ge la ur pr u y u ry (per e)	a	a	a	a	a	a	a
e e (per e)	a	a	a	a	a	a	a
EBRD index of small-scale privatisation	2 0	2 0	0	0	0	0	0
EBRD index of large-scale privatisation			2	2	2		
EBRD index of enterprise reform	0	0			2 0	2 0	2 0
S are a ere pr e (per e)	a	a	a	a	a	a	a
u er g a ere pr e a e	a	a	a	a	a	a	a
S are ra e ra u re (per e)	a	a	a	a	a	a	a
S are ra e (per e)		0	2	6	6		a
ar re e ue (per e p r)	a	a	a	a	a	a	a
EBRD index of price liberalisation		0	0	0	0	0	0
EBRD index of forex and trade liberalisation	2	2	0	0	0		
EBRD index of competition policy	0	0	0	0	0	0	0
u er a (re g e)	a	a	0 ( )	0 ( )	0 ( )	0 ( )	a
A e are a e e a (per e)	a	a	2	2	6		a
A e are re g e a (per e)	a	a	6	2	0		a
per r g l a (per e al l a)	a	a	a	a	a	a	a
e re pr a e e r (per e)	a	a	a	a	a	a	a
e re u e l (per e)	a	a	a	a	a	a	a
r gage le g (per e)	a	a	a	a	a	a	a
S ar e ap al a (per e)	a	a	a	a	a	a	a
S ra g lu e (per e ar e ap al a)	a	a	a	a	a	a	a
ur ua e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
EBRD index of banking sector reform			2 0	2 0	2	2	2
EBRD index of reform of non-bank financial institutions	0	0					
e l e (le) pe e ra ra e (per 00 a a)	a	a	a	a	a	a	a
er e pe e ra ra e (per 0 000 a a)	a	a	a	a	a	a	a
a l ay la ur pr u y (00)	a	a	a	a	a	a	a
e e al ele r y ar (S)	a	a	a	a	6 0		a
A erage lle ra e ele r y (per e)	a	a	a	a	a	a	a
per u e ergy u e (S llar per g e)	a	a	a	a	a	a	a
EBRD index of infrastructure reform						2 0	2 0
Electric power	0	0	0		2 0	2	2
Railways	0	0	0	0	0	0	0
Roads					2 0	2 0	2 0
Telecommunications		2	2	2	2	0	0
Water and waste water	2 0	2 0	2 0	2 0	2 0	2 0	2 0

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	3.1	-0.2	1.7	1.5	3.7	4.1	5.5
Industrial gross output	3.3	-2.0	0.7	2.2	13.8	-1.9	na
Employment			(Percentage change)				
Labour force (end-year)	1.8	-1.3	-0.5	-2.7	-3.3	-4.8	na
Employment (end-year)	-3.4	0.0	-0.7	2.1	0.0	0.7	na
			(In per cent of labour force)				
Unemployment (end-year)	37.3	36.5	36.7	33.5	31.3	27.3	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	97.1	22.6	18.2	6.7	2.2	2.6	3.5
Consumer prices (end-year)	22.5	26.6	9.3	6.0	1.6	2.5	3.6
Producer prices (annual average)	16.5	14.5	4.6	2.9	5.8	2.1	na
Gross average monthly earnings in economy (annual average)	-96.0	16.8	30.5	17.8	12.2	7.6	na
Government sector			(In per cent of GDP)				
General government balance	-6.9	-4.0	-3.8	-4.9	-2.6	-1.7	-0.3
General government expenditure	36.5	39.9	37.3	45.6	43.3	42.0	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	na	na	na	na	16.3	49.6	na
Domestic credit (end-year)	na	na	na	na	37.8	42.1	na
			(In per cent of GDP)				
Broad money (M2, end-year)	na	na	na	33.1	34.9	48.8	na
Interest and exchange rates			(In per cent per annum, end-year)				
Discount rate	na	na	na	na	na	na	na
Money market rate	na	na	na	na	na	na	na
Deposit rate	na	na	na	na	na	na	na
Lending rate (long-term)	na	na	na	na	na	12.1	na
			(Euros per US dollar)				
Exchange rate (official, end-year) [1]	1.1	1.1	1.0	0.8	0.7	0.8	na
Exchange rate (official, annual average) [1]	1.1	1.1	1.1	0.9	0.8	0.8	na
External sector			(In millions of US dollars)				
Current account	-43	-169	-158	-116	-149	-180	-112
Trade balance	-193	-436	-402	-405	-518	-640	-645
Merchandise exports	161	211	305	306	561	549	596
Merchandise imports	354	647	707	711	1,079	1,189	1,241
Foreign direct investment, net	na	10	84	44	63	474	149
Gross reserves, excluding gold (end-year)	na	na	na	56	75	219	na
External debt stock	na	na	700	na	na	822	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	na	na	na	0.8	0.7	1.9	na
			(In per cent of exports of goods and services)				
Debt service	na	na	4.2	4.8	3.4	2.9	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	0.7	0.7	0.7	0.7	0.7	0.7	na
GDP (in billions of euros)	1.02	1.24	1.30	1.39	1.54	1.64	1.80
GDP per capita (in US dollar)	1,432	1,688	1,857	2,381	2,889	3,147	na
Share of industry in GDP (in per cent)	na	na	na	na	na	na	na
Share of agriculture in GDP (in per cent)	na	na	na	na	na	na	na
Current account/GDP (in per cent)	-4.5	-15.2	-12.9	-7.4	-7.8	-8.6	-5.0
External debt - reserves (in US$ million)	na	na	na	na	na	603	na
External debt/GDP (in per cent)	na	na	57.1	na	na	39.6	na
External debt/exports of goods and services (in per cent)	na	na	148.6	na	na	86.7	na

[1] Montenegro unilaterally adopted the deutschmark in 2000 as sole legal tender, and replaced it with the euro in 2002.

Poland

Key challenges

- Clear, market-oriented restructuring plans for sectors which remain under state influence are needed to improve enterprise performance and ensure continuing economic growth.
- Reversing the rise in state interference, lowering administrative barriers, tackling corruption and ensuring effective allocation of EU funds are necessary to maintain Poland's attractiveness to foreign and domestic investors.
- To support growth with low inflation, the government must sustain budgetary discipline, promote fiscal reforms and maintain the independence of the Central Bank and financial regulatory authorities.

Country data	
Population (in millions)	**38.1**
Area ('000 sq km)	**313.9**
GDP (in billion US$, 2005)	**302.8**
GDP per capita in 2005 at current international US$ (PPP)	**13,996**
National currency	**Zloty**

Progress in structural reform

Liberalisation and privatisation

The reform process has slowed since Poland's accession to the European Union (EU) and was brought to a near standstill following the presidential and parliamentary elections in autumn 2005. Gross privatisation revenues in 2005 were around €1 billion, well below the €2.3 billion raised in 2004. The only major privatisation undertaken in 2006 has been the sale of the chemical companies Zachem and Sarzyna. Privatisation revenues in 2006 are expected to total around €0.3 billion, compared with the €1.4 billion envisaged in the budget. The new government's policies towards key economic sectors remain unclear, and there has been a series of personnel changes at the largest state-controlled enterprises, adding to the uncertainty. The coal industry has gained a temporary respite as a result of the sharp rise in world energy prices, but remains in need of deep restructuring.

Business environment and competition

Administrative barriers remain high in comparison to the rest of central eastern Europe and the Baltic states (CEB). According to the World Bank's 2006 Doing Business report, the minimum capital requirements for starting a business in Poland are 204 per cent of the average per capita income, compared with just 54 per cent in the rest of the CEB region. Similarly, it takes much longer to obtain licences, register property or enforce a contract in Poland than elsewhere in the CEB region.

According to Transparency International's 2005 Corruption Perceptions Index, Poland has the highest level of corruption among the CEB countries. The Law and Justice (PiS) party won the parliamentary elections in September 2005 on an anti-corruption platform. The three-party coalition government formed in May 2006 adopted important elements of this agenda, including the formation of the Central Anti-corruption Bureau.

Nevertheless, further reform measures essential to improve the business environment have stalled, and government interference in the private sector has increased. The inclusion in the government of populist parties that have historically opposed market reform has heightened concerns about the government's commitment to eurozone convergence and the broader EU agenda.

Infrastructure

The coalition government has signalled that involvement of the state in the infrastructure sector is likely to increase, particularly with regard to motorway construction (one of the investment priorities). Elsewhere, steps have been taken to commercialise rail passenger services and involve local authorities in financing regional transport. After several months of uncertainty, the government announced plans in August 2006 to restructure the power sector and create two large and two smaller energy groups controlling both production and distribution. There are concerns that such ownership concentration is likely to be detrimental to competition and consumer interests. In 2005 the "green certificates" system was introduced to support investment in renewable energy. In 2006 the Office of Electronic Communications (UKE) was created to replace the old telecommunications regulator and take on some of the technical responsibilities of the Radio and TV Council (KRRiT). The creation of UKE was nevertheless marred by delays in the appointment of its president.

Financial sector

Credit to households, driven by strong demand for housing and consumer loans, grew by around 26 per cent in 2005 and contributed to the deepening of financial markets. The capitalisation of the Warsaw Stock Exchange grew by around 46 per cent in 2005. Thirty-five new companies entered the market and 23 listed companies made public issues, raising a total of about €1.3 billion in capital increases. The conflict between the government and Dutch insurer Eureko over the privatisation of the country's largest insurance company, PZU, remains unresolved. The merger of banks Pekao SA and BPH SA, both controlled by the Italian Unicredito, has been approved but marred by delays and sharp rhetoric from government officials.

The state has also reasserted control over the BOS Bank from the Swedish banking group SEB. The coalition agreement included a proposal to broaden the mandate of the National Bank (NBP) to include growth targets in addition to inflation-targeting, which could threaten the bank's independence. Moves are also under way to shift banking supervision from the NBP to a new centralised financial sector regulatory body, the Financial Supervision Commission (KNF). This has raised concerns that appointments to the new authority might become politicised.

Macroeconomic performance

Real economy

Real GDP growth in 2005 was relatively disappointing at 3.4 per cent. However, it recovered to around 5.5 per cent year-on-year in the second quarter of 2006, supported by steady growth in domestic demand. Despite this resurgence, strong regional disparities persist. The five poorest regions of the EU are all located in Poland. According to Eurostat, the rate of unemployment declined to 15 per cent in July 2006, but remains the highest in the EU.

Economic policies

The general government deficit fell to an estimated 2.4 per cent of GDP in 2005 from 3.9 per cent in 2004 (according to ESA methodology, excluding costs of pension reform). Public debt was around 42.0 per cent of GDP in 2005 (according to the same methodology). This is expected to increase in 2006, reflecting lower privatisation receipts and higher state contributions to the pension system. Annual consumer price inflation was at around 1.6 per cent in August 2006, well below the NBP's 2.5 per cent target rate. Inflation appears, nevertheless, to be on an upward trend, suggesting possible future interest rate increases. Between March 2005 and February 2006 the Monetary Policy Council reduced the policy rate in seven steps from 6.5 per cent to 4 per cent, an historic low.

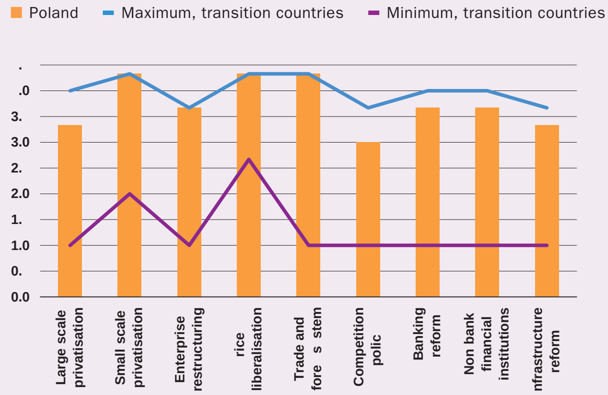
External sector

Strong export growth (particularly in services) and a stable inflow of transfers kept the current account deficit at around 1.4 per cent of GDP in 2005, compared with 4.2 per cent in 2004. According to customs-based methodology, exports rose by just over 16 per cent year-on-year in the first half of 2006, outpacing imports which rose by almost 14 per cent. Portfolio inflows continued to dominate the capital account. Net foreign direct investment (FDI), at US$ 6.7 billion, was some 2.2 per cent of GDP in 2005, supported by stronger economic growth and EU membership. External debt declined to 43.3 per cent of GDP at the end of 2005 and international reserves remained above 4.5 months of imports of goods and services. The current account deficit was covered comfortably by inflows of FDI, complemented by sizeable portfolio inflows.

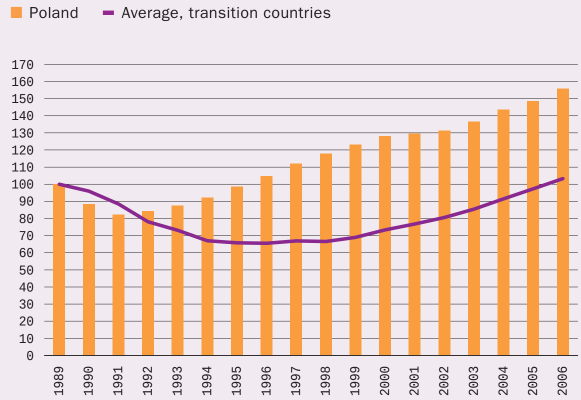
Outlook and risks

Given renewed economic growth and expected improvements in infrastructure, the outlook remains positive. The political situation is likely to be the main source of uncertainty for the continuation of structural reforms and restoration of fiscal balances. More populist government policies could encourage greater interventionism and state control in the economy, and also weaken the position of the Central Bank. Fiscal reforms will become increasingly urgent as the costs of pension reform are likely to be included in the headline general government deficit. Entry to the eurozone does not appear to be an immediate government priority.

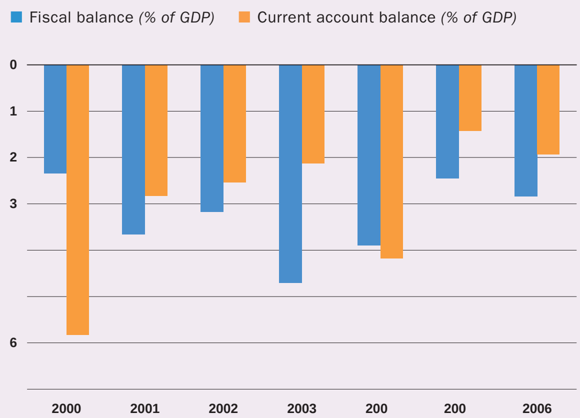
Transition indicators, 2006



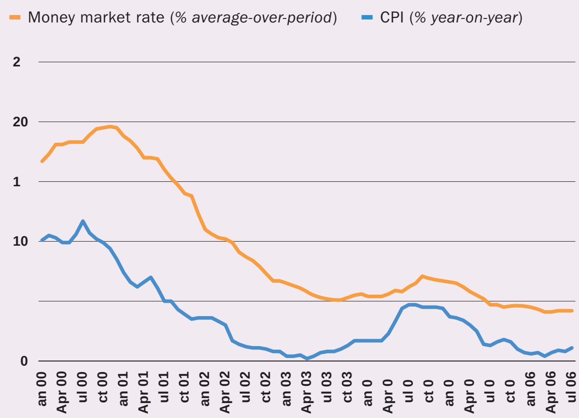
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **floating**

Wage regulation – **no**

Tradability of land – **full except foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **some defects**

Quality of corporate governance law – **high**

Infrastructure

Independent telecoms regulator – **fully**

Independent electricity regulator – **fully**

Separation of railway infrastructure from operations – **fully**

Independence of the road directorate – **partially**

Quality of concession laws – **na** [1]

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **high**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2 per cent** (2002)

Government expenditure on health – **4.3 per cent of GDP**

Government expenditure on education – **6.0 per cent of GDP**

Household expenditure on power and water – **6.8 per cent** [2]

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)	0	6		2			a
r a e e r are (per e)	0 0	0	0	0	0	0	0
r a e e r are e pl y e (per e)	2		6	0 2	0	0	a
u ge ary u e a urre ra er (per e)	2	2	2	2		a	a
S are u ry al e pl y e (per e)	2	20	2	2 6	22	2 2	a
a ge la ur pr u y u ry (per e)	0		2	2			a
e e (per e)	2	20			20 0	20 2	a
EBRD index of small-scale privatisation							
EBRD index of large-scale privatisation							
EBRD index of enterprise reform	0						
S are a ere pr e (per e)	2 6	2	0	0	0	2	0
u er g a ere pr e a e	0	0	0	0	0	0	0
S are ra e ra u re (per e)		0					a
S are ra e (per e)			0	0	6	6 2	a
ar re e ue (per e p r)	2	2			0	0	a
EBRD index of price liberalisation							
EBRD index of forex and trade liberalisation							
EBRD index of competition policy	2	0	0	0	0	0	0
u er a (re g e)	(6)	6 (6)	( )	(6)	( )	6 (0)	a
A e are a e e a (per e)	2	2	26 6	2	2	2	a
A e are re g e a (per e)	2 6	2 2	0			2	a
per r g l a (per e al l a)	6	20	2	2	6	2	a
e re pr a e e r (per e)	20	2	2 6	22 6	2	2	a
e re u e l (per e)	a	a		0	0	2 6	a
r gage le g (per e)	a	a	2				a
S ar e ap al a (per e)		2		6	2		a
S ra g lu e (per e ar e ap al a)		26	2	26 6		6	a
ur ua e (per e)	0		2	0		0	a
EBRD index of banking sector reform							
EBRD index of reform of non-bank financial institutions							
e l e (le) pe e ra ra e (per 00 a a)	2 ( )	2 (2)	0 (6 0)	( )	2 6 ( )	0 6 ( )	a
er e pe e ra ra e (per 0 000 a a)		26	0	20	0	0	a
a l ay la ur pr u y (00)		6		0	0		a
e e al ele r y ar (S)	0					2	a
A erage lle ra e ele r y (per e)	a	a	0	a	a	a	a
per u e ergy u e (S llar per g e)			6	6	a	a	a
EBRD index of infrastructure reform							
Electric power	0	0					
Railways	0	0	0	0	0	0	0
Roads				0	0	0	0
Telecommunications	0	0	0	0	0	0	0
Water and waste water	0						

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	4.2	1.1	1.4	3.8	5.3	3.4	5.0
Private consumption	3.0	2.2	3.3	1.9	4.0	2.0	na
Public consumption	2.4	2.5	1.5	4.7	3.9	2.7	na
Gross fixed capital formation	2.7	-9.7	-6.3	-0.1	6.3	6.5	na
Exports of goods and services	23.2	3.1	4.8	14.2	14.0	7.1	na
Imports of goods and services	15.5	-5.3	2.7	9.3	15.2	3.4	na
Industrial gross output	7.1	0.0	1.5	8.7	12.3	4.0	na
Agricultural gross output	-4.1	6.6	1.0	2.7	6.0	0.0	na
Employment			(Percentage change)				
Labour force (end-year)	-0.3	-0.9	-9.1	-3.4	2.6	-0.2	na
Employment (end-year)	-2.6	-3.7	-11.9	-4.5	3.9	1.5	na
			(In per cent of labour force)				
Unemployment (end-year) [1]	15.1	17.5	20.0	20.0	19.0	17.6	na
Prices and wages [2]			(Percentage change)				
Consumer prices (annual average)	10.1	5.5	1.9	0.8	3.5	2.1	1.6
Consumer prices (end-year)	8.5	3.6	0.8	1.7	4.4	0.7	2.7
Producer prices (annual average)	7.7	1.7	1.2	2.7	7.1	0.8	na
Producer prices (end-year)	5.5	-0.3	2.3	3.7	5.4	0.5	na
Gross average monthly earnings in economy (annual average)	12.7	7.2	3.5	3.2	4.0	3.5	na
Government sector [3]			(In per cent of GDP)				
General government balance	-2.3	-3.7	-3.2	-4.7	-3.9	-2.4	-2.8
General government expenditure	43.6	43.6	44.2	44.6	42.5	43.2	na
General government debt	36.8	36.7	39.8	43.9	41.9	42.0	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	11.8	9.2	-2.4	5.5	7.3	11.0	na
Domestic credit (end-year) [4]	8.7	10.6	3.2	8.8	3.3	8.7	na
			(In per cent of GDP)				
Broad money (M2, end-year)	40.3	42.1	39.6	40.1	39.3	41.1	na
Interest and exchange rates			(In per cent per annum, end-year)				
Rate on 28-day open market operations [5]	19.0	11.5	6.8	5.3	6.5	4.5	na
3-months WIBOR	19.5	12.3	6.7	5.6	6.7	4.6	na
Deposit rate [6]	14.3	8.0	4.2	2.9	3.7	2.7	na
Lending rate [6]	21.5	16.8	11.6	9.6	10.4	8.6	na
			(Zlotys per US dollar)				
Exchange rate (end-year)	4.3	4.0	3.9	3.8	3.0	3.3	na
Exchange rate (annual average)	4.3	4.1	4.1	3.9	3.7	3.2	na
External sector			(In millions of US dollars)				
Current account	-9,981	-5,376	-5,009	-4,599	-10,522	-4,314	-6,400
Trade balance	-12,307	-7,661	-7,249	-5,725	-5,622	-2,694	-5,000
Merchandise exports	35,902	41,663	46,742	61,007	81,862	95,846	110,000
Merchandise imports	48,209	49,324	53,991	66,732	87,484	98,540	115,000
Foreign direct investment, net	9,327	5,804	3,901	4,284	12,079	6,716	8,400
Gross reserves, excluding gold (end-year)	27,466	26,564	29,794	34,168	36,783	42,571	na
External debt stock	69,463	71,971	84,875	106,961	128,658	131,102	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	5.8	5.5	5.7	5.3	4.4	4.5	na
			(In per cent of exports of goods and services)				
Debt service	13.6	13.0	11.7	8.9	8.3	9.2	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	38.6	38.6	38.2	38.2	38.2	38.1	na
GDP (in billions of zlotys)	745	779	808	842	922	979	1,042
GDP per capita (in US dollars)	4,433	4,928	5,181	5,670	6,609	7,943	na
Share of industry in GDP (in per cent)	29.5	27.0	26.5	26.6	28.0	28.2	na
Share of agriculture in GDP (in per cent)	3.0	3.2	2.7	2.6	2.5	2.5	na
Current account/GDP (in per cent)	-5.8	-2.8	-2.5	-2.1	-4.2	-1.5	-2.0
External debt - reserves (in US$ million)	41,997	45,407	55,081	72,793	91,875	88,531	na
External debt/GDP (in per cent)	40.5	37.8	42.9	49.4	51.0	43.3	na
External debt/exports of goods and services (in per cent)	150.0	140.0	149.5	148.2	135.0	117.0	na

[1] Unemployment as reported by the Central Statistical Office. The methodology was revised in 2002, resulting in a 2 per cent increase.

[2] Prices and wages as reported by the Central Statistical Office.

[3] Calculated according to Eurostat methodology (ESA95), including private pension funds in the general government.

[4] Domestic credit to non-financial sector and general government included.

[5] In 2003 and 2004 the rate refers to 14-day open market operations. From January 2005 it refers to 7-day open market operations.

[6] Weighted average as reported by the National Bank of Poland.

Romania

Key challenges

- To boost the business environment, efforts to reform the judiciary and fight corruption should be intensified, including a stronger stance against petty corruption.
- Road and railway infrastructure must continue to be upgraded to attract significant flows of investment.
- More consistent economic policies and a better balance between monetary and fiscal objectives are required to reduce inflation and address the widening current account deficit and the loss of competitiveness.

Country data

Population (in millions)	**21.7**
Area ('000 sq km)	**238.0**
GDP (in billion US$, 2005)	**98.6**
GDP per capita in 2005 at current international US$ (PPP)	**9,165**
National currency	**Romanian leu (RON)**

Progress in structural reform

Liberalisation and privatisation

While the sale of state assets is almost complete, the remaining privatisations of relatively low quality assets are proceeding at a slower pace than planned. As of July 2006 the National Authority for State Assets Realization (AVAS) owned 620 companies, amounting to 90 per cent of remaining state-owned enterprises. Having sold 41 companies in the first half of 2006, AVAS plans to liquidate 43 companies and sell 31 companies from its portfolio during the remainder of the year.

Priority privatisations include Antibiotice, one of the largest domestic pharmaceutical producers and the most valuable company in the AVAS portfolio, the electrical equipment manufacturer Electroputere, and the five companies of Nitramonia Fagaras. Most of these companies are being restructured in preparation for their sale. AVAS also plans to sell the 17 research institutes in its portfolio by the end of 2007.

On 1 September 2006 the Romanian currency became fully convertible. As a result, offshore investors will be allowed to trade financial assets with a maturity of under one year.

Business environment and competition

Since the European Commission's report in October 2005 on Romania's readiness to join the European Union (EU), Romania has made significant progress in the reform of the judiciary, especially strengthening the impartiality of the justice system. The government has intensified the fight against corruption by initiating investigations and issuing indictments in several prominent cases, although these have not yet resulted in convictions.

However, further efforts are still required to coordinate the work carried out by the National Anti-Corruption Directorate with that of other public institutions. Public administration reform has been advanced through the adoption of legislation in the first half of 2006 to promote decentralisation.

Infrastructure

The government has started to implement an ambitious programme to increase the modern motorway network from 200 km to 1,300 km, supported by about €630 million of EU finance. Upgrading the country's road infrastructure will require further funding from both the budget and private investment. The government has reviewed a number of contracts for motorway construction which were awarded by the former administration to foreign investors. The most prominent is the contract for the motorway between central Romania (Brasov-Bors) and Hungary, the largest ongoing infrastructure project in Europe. This contract was allocated, without a tender process, in 2003 to a consortium headed by US-based Bechtel. The contract was renegotiated in 2005 allowing the government to review and control construction costs. Also, plans for the Bucharest-Brasov motorway have been cancelled.

Privatisation in the energy sector is progressing, with five of the eight power distribution companies in private hands. The Italian company Enel, which already owns two power distribution companies, won the tender in June 2006 to acquire 67.5 per cent of Electrica Muntenia Sud (the power distribution company serving Bucharest and surrounding regions) for €820 million. However, plans to sell a 15 per cent stake of the natural gas producer Romgaz to a strategic investor have been shelved.

Since 2001, 75 per cent of the gas market has been opened to competition, with eligible industrial consumers able to choose their supplier. The number of eligible consumers rose from 75 in 2004 to 154 by mid-2006. The market is scheduled to be completely open for all non-household consumers by January 2007 and for all consumers by July that year. Domestic gas prices have not yet been brought in line with international prices. The deadline for bringing domestic gas prices in line with the import parity has been postponed to December 2008.

Financial sector

Privatisation in the banking sector is nearing completion. In December 2005 Austrian Erste Bank AG signed the contract for the purchase of a 62 per cent stake (comprising a 37 per cent stake from the government and two 12.5 per cent stakes from the EBRD and Intenational Finance Corporation) in Banca Comerciala Romana (BCR), for €3.75 billion. BCR is the country's largest bank with 26 per cent of overall market share as measured by assets. Closing of the deal is expected in October 2006. Hungarian OTP (which in 2004 took over former Robank, now OTP Bank Romania) and the National Bank of Greece (which already owns 88 per cent of Banca Romaneasca) are the final bidders for the sale of CEC Savings Bank, the fifth-largest bank in the country. The government is postponing the final phase of bidding in order to structure the deal so that the resulting ownership structure will maintain a 30 per cent state stake in the final entity.

Macroeconomic performance

Real economy

Real growth slowed to 4.1 per cent in 2005 from a record rate of 8.4 per cent in 2004, but accelerated again to 7.4 per cent in the first half of 2006, showing signs of overheating. The recovery in 2006 reflected stronger growth of private consumption and investment, both of which rose by some 12 per cent in the first half on a year-on-year basis. On the supply side, services increased by 7.2 per cent, agriculture contracted by 0.4 per cent and industrial production grew by 6.5 per cent during the first half of 2006. A slowdown in productivity growth in 2005, coupled with strong wage growth and an appreciating currency, has caused a decline in competitiveness margins.

Economic policies

The rate of inflation has gradually fallen from 9.3 per cent in 2004 to 8.6 per cent in 2005 and 6 per cent in August 2006. This fall has been aided by the significant currency appreciation, the postponement of administered price increases and decreasing agricultural prices. However, the Central Bank remains concerned about inflationary pressures, given the buoyant domestic demand fuelled by rapid domestic credit growth. The bank's inflation forecast for 2006 was revised downward in August from 6.8 per cent to 6.1 per cent, while the official inflation target for 2007 is set at 4 per cent. On the fiscal side, the government decided to increase the budget deficit target for 2006 from 0.5 per cent to 0.9 per cent of GDP in April and to 2.5 per cent in June 2006. These increases were mainly to address investment needs in infrastructure and a rise in public sector wages. Other current expenditures also rose substantially, namely for transfers and goods and services.

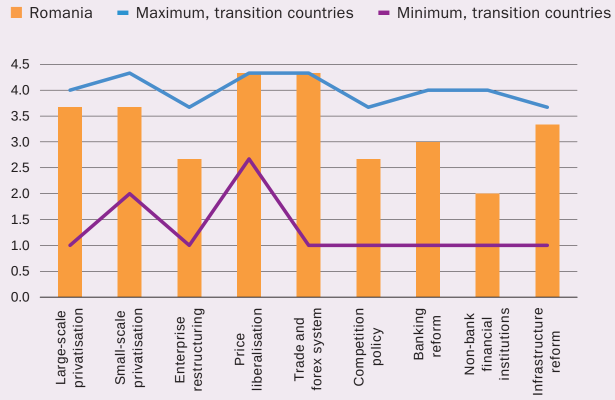
External sector

The trade deficit contributed to a current account deficit of €6.9 billion in 2005, representing 8.7 per cent of GDP. Flows of foreign direct investment (FDI) covered 75.6 per cent of the current account deficit. Foreign exchange reserves reached record levels of €16.8 billion by the end of 2005, the Central Bank having made significant interventions in the foreign exchange market during the year. By June 2006 the current account deficit reached €8.4 billion (9.7 per cent of GDP) on a 12-month rolling basis, partly reflecting the nominal appreciation of the RON against the euro. However, higher FDI flows financed 84 per cent of the current account deficit during the 12 months to May 2006. By the end of June 2006 foreign exchange reserves amounted to €18.2 billion.

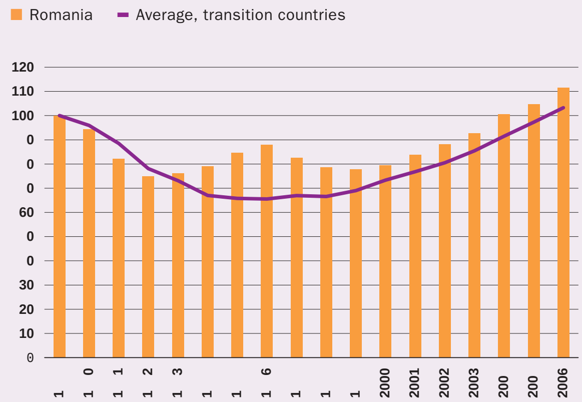
Outlook and risks

Romania will join the EU in January 2007. Increased investment stimulated by EU accession requirements and the completion of privatisation and enterprise restructuring should help to maintain strong economic growth. However, consistent monetary and fiscal policies are required to deter inflationary pressures and address the loss of competitiveness. The latter reflects the appreciation of the currency, slower productivity growth and strong wage growth. Real appreciation of the currency is expected to continue over the medium term, and a sustained commitment to structural reforms will be needed to improve productivity.

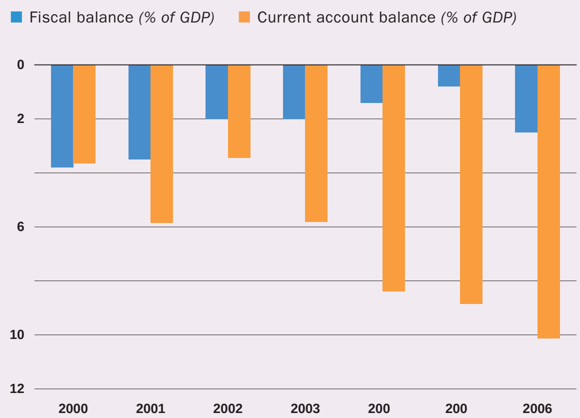
Transition indicators, 2006



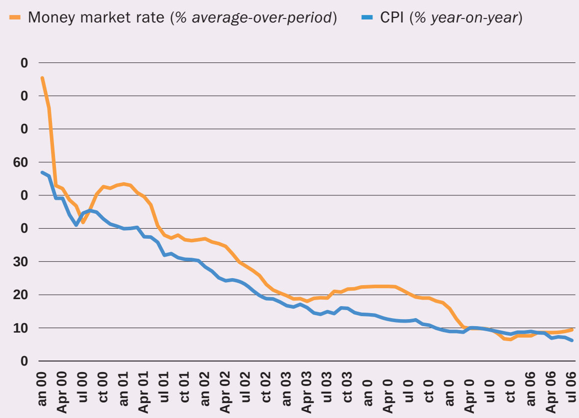
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	**Business environment and competition**	**Infrastructure**	**Financial sector**	**Social reform**
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **12 per cent**	Share of population living in poverty – **12.9 per cent** (2003)
Controls on inward direct investment – **no**	Quality of insolvency law – **high**	Independent electricity regulator – **fully**	Deposit insurance system – **yes**	Government expenditure on health – **3.3 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **advanced**	Separation of railway infrastructure from operations – **fully**	Quality of securities market laws – **medium**	Government expenditure on education – **2.9 per cent of GDP**
Exchange rate regime – **managed float**	Quality of corporate governance law – **low**	Independence of the road directorate – **fully**	Private pension funds – **yes**	Household expenditure on power and water – **3.7 per cent**
Wage regulation – **yes**		Quality of concession laws – **medium**		
Tradability of land – **limited de facto**				

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)					2		a
r a e e r are (per e)	60 0	6 0	6 0	6 0	0 0	0 0	0 0
r a e e r are e pl y e (per e)	0		2	6	0	a	a
u ge ary u e a urre ra er (per e)			0		6	2	a
S are u ry al e pl y e (per e)	6		20	2 2		6	a
a ge la ur pr u y u ry (per e)	0	6	6	6	2		a
e e (per e)		22	2	2	22	22	a
EBRD index of small-scale privatisation							
EBRD index of large-scale privatisation	0						
EBRD index of enterprise reform	2 0	2 0	2 0	2 0	2 0	2	2
S are a ere pr e (per e)		6	20	2	22	2	2
u er g a ere pr e a e	0 0	0 0	0 0	0 0	0 0	0 0	0 0
S are ra e ra u re (per e)		2	0		0		a
S are ra e (per e)	60	6	66 2	66		6	a
ar re e ue (per e p r)		2 2				a	a
EBRD index of price liberalisation							
EBRD index of forex and trade liberalisation							
EBRD index of competition policy	2	2	2	2	2	2	2
u er a (re g e)	(2)	(2)	(2)	0 (2)	2 (2)	(2)	a
A e are a e e a (per e)	0 0		6	0 6		6	a
A e are re g e a (per e)	6		2			2	a
per r g l a (per e al l a)	6		2		6	6	a
e re pr a e e r (per e)	2					0 2	a
e re u e l (per e)	a	a	a				a
r gage le g (per e)	a	a	a	0	0	0 6	a
S ar e ap al a (per e)			0	2		22	a
S ra g lu e (per e ar e ap al a)	2		2 0		6	2 0	a
ur ua e (per e)	0	2 2		0	0 0	2	a
EBRD index of banking sector reform	2	2	2	2	0	0	0
EBRD index of reform of non-bank financial institutions	2 0	2 0	2 0	2 0	2 0	2 0	2 0
e l e (le) pe e ra ra e (per 00 a a)	( )	(2)	(2)	20 0 (2)	20 ( )	20 2 (6)	a
er e pe e ra ra e (per 0 000 a a)		20		2	22 6	22 6	a
a l ay la ur pr u y (00)			0		60 0		a
e e al ele r y ar (S)			0		6		a
A erage lle ra e ele r y (per e)		62	6		a	a	a
per u e ergy u e (S llar per g e)			0	0	a	a	a
EBRD index of infrastructure reform	0	0	0	0			
Electric power	0	0	0	0			
Railways	0	0	0	0	0	0	0
Roads	0	0	0	0	0	0	0
Telecommunications	0	0	0	0	0	0	
Water and waste water	0	0	0	0			

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			*ercentage c ange in real terms*				
GDP [1]	2.1	5.7	5.1	5.2	8.4	4.1	6.5
Private consumption	-0.8	6.9	5.3	8.5	14.1	9.8	na
Public consumption	12.3	3.6	3.0	7.5	5.0	4.4	na
Gross fixed capital formation	5.5	10.1	8.2	8.6	10.8	13.0	na
Exports of goods and services	23.4	12.1	17.5	8.4	13.9	7.6	na
Imports of goods and services	27.1	18.4	12.0	16.0	22.1	17.2	na
Industrial gross output, unadjusted series	8.2	8.3	4.3	3.1	5.3	2.1	na
Agricultural gross output	-14.8	22.7	-3.5	5.2	18.9	-13.9	na
Employment			*ercentage c ange*				
Labour force (end-year)	0.2	-1.2	-12.0	-1.6	-10.7	0.1	na
Employment (end-year)	-0.1	-0.6	-13.7	-0.1	-52.3	2.3	na
			n per cent of labour force				
Unemployment (end-year) [2]	7.1	6.6	8.4	7.0	6.3	5.9	na
Prices and wages			*ercentage c ange*				
Consumer prices (annual average)	45.7	34.5	22.5	15.3	11.9	9.5	6.5
Consumer prices (end-year)	40.7	30.3	17.8	14.1	9.3	8.6	6.0
Producer prices (annual average)	53.4	40.3	24.5	19.6	18.6	12.3	na
Producer prices (end-year)	50.3	32.6	20.1	20.0	16.3	10.4	na
Gross average monthly earnings in economy (annual average)	46.9	48.9	27.3	23.6	22.5	17.0	na
Government sector			*n per cent of D*				
General government balance [3]	-3.8	-3.5	-2.0	-2.0	-1.4	-0.8	-2.5
General government expenditure	35.3	33.3	32.3	30.9	31.1	31.1	na
General government debt [3]	22.7	23.2	23.3	21.3	18.5	19.0	na
Monetary sector			*ercentage c ange*				
Broad money (M2, end-year)	38.0	46.2	38.1	23.3	39.9	33.9	na
Domestic credit (end-year)	11.4	26.9	39.8	50.4	21.2	49.5	na
			n per cent of D				
Broad money (M2, end-year)	23.0	23.2	24.7	23.3	26.2	30.1	na
Interest and exchange rates			*n per cent per annum end-year*				
Discount rate	35.0	35.0	29.0	20.4	18.0	7.5	na
1-week BUBOR	53.0	36.6	20.5	22.3	17.6	7.6	na
Deposit rate (average)	32.4	26.2	18.4	10.8	11.3	4.2	na
Lending rate (average)	53.2	45.7	36.7	26.2	25.8	15.7	na
			ei per dollar				
Exchange rate (end-year) [4]	2.6	3.2	3.4	3.3	2.9	3.1	na
Exchange rate (annual average) [4]	2.2	2.9	3.3	3.3	3.3	2.9	na
External sector			*n millions of dollars*				
Current account	-1,347	-2,349	-1,573	-3,455	-6,333	-8,716	-11,500
Trade balance	-1,684	-2,969	-2,613	-4,465	-6,611	-9,873	-13,125
Merchandise exports	10,366	11,385	13,869	17,627	23,518	28,149	35,468
Merchandise imports	12,050	14,354	16,482	22,092	30,130	38,022	48,592
Foreign direct investment, net	1,051	1,154	1,080	2,156	6,368	6,587	8,652
Gross reserves, excluding gold (end-year)	2,497	3,960	6,145	8,050	14,806	20,995	na
External debt stock	10,673	12,399	16,021	20,621	26,500	32,510	na
			n mont s of imports of goods and services				
Gross reserves, excluding gold (end-year)	2.1	2.9	3.9	3.9	5.2	5.8	na
			n per cent of exports of goods and services				
Debt service [5]	25.9	21.1	18.9	16.3	18.6	18.2	na
Memorandum items			*Denominations as indicated*				
Population (end-year, million)	22.4	22.4	21.8	21.7	21.7	21.7	na
GDP (in billions of lei) [4]	80	117	151	198	246	287	326
GDP per capita (in US dollars)	1,652	1,793	2,103	2,738	3,483	4,535	na
Share of industry in GDP (in per cent)	27.3	28.2	28.4	25.0	25.2	24.4	na
Share of agriculture in GDP (in per cent)	11.1	13.3	11.3	11.6	12.8	8.9	na
Current account/GDP (in per cent)	-3.6	-5.8	-3.4	-5.8	-8.4	-8.8	-10.1
External debt - reserves (in US$ million)	8,176	8,439	9,877	12,571	11,694	11,515	na
External debt/GDP (in per cent)	28.8	30.9	35.0	34.7	35.1	33.0	na
External debt/exports of goods and services (in per cent)	88.1	93.0	98.9	99.9	97.7	98.2	na

of unemployment in Romania is lower than the official rate.

Russia

Key challenges

- To improve the investment climate, the government should increase the pace of reform of public institutions, step up the fight against corruption, further reduce bureaucracy and administrative barriers, and clarify its position on foreign investment in strategic sectors.
- The process of industry consolidation and the role of state-owned entities should be balanced against the need to maintain an open and rule-based regime for trade and foreign investment that will ensure competitive domestic markets.
- Containing the expansion of fiscal expenditures and allowing the Central Bank to focus on lowering inflation through a more flexible exchange rate policy are the central macroeconomic challenges over the medium term.

Country data	
Population (in millions)	**144.1**
Area ('000 sq km)	**17,075.0**
GDP (in billion US$, 2005)	**765.5**
GDP per capita in 2005 at current international US$ (PPP)	**10,825**
National currency	**Rouble**

Progress in structural reform

Liberalisation and privatisation

Russia has been continuing to integrate into the global economy. From July 2006 the government abolished the remaining controls on capital account transactions and established full convertibility. Non-residents in Russia and Russian residents abroad are now permitted to hold rouble accounts. This measure will support the development of the domestic bond market, in which foreign participation has been relatively low. The government also announced a strategy to swap part of its foreign debt into long-dated domestic debt, thereby stimulating liquidity and defining a benchmark for interest rates.

Russia made significant progress in 2005-06 in its negotiations on accession to the World Trade Organization. Agreement was reached with all the working party members except the United States, with which a number of issues (including agricultural trade, the aircraft industry, financial markets, protection of intellectual property rights and energy pricing) still need to be resolved. There were also some adverse trade policy developments, including a ban on wine and other imports from Georgia and Moldova and disputes with Ukraine regarding the pricing of natural gas.

Business environment and competition

The investment climate has continued to benefit from general political stability, sound macroeconomic policy and abundant liquidity. Domestic and foreign investment have grown dynamically. More than 90 per cent of investors are planning to expand their business operations over the next three years, according to a survey conducted by the Foreign Investment Advisory Council. However, the business environment still has major weaknesses. Administrative obstacles remain pervasive, especially at the regional and local level. Obtaining construction permits and approvals is cumbersome, land allocation lacks transparency and connection to utilities is slow and expensive, resulting in frequent delays to project implementation and cost overruns. The practice of hostile take-overs is still widespread, including by state-controlled business entities. Foreign investors face a range of additional restrictions. In March 2006 the government released a preliminary list of 39 strategic sectors in which foreign investment will be restricted. A new law being drafted will also contain major limitations on foreign ownership of strategic assets in the natural resources sector.

Infrastructure

Although infrastructure investment and modernisation is a government priority, reform in most sectors has been slow. Most progress has been made in the power sector where all the key regulatory and market institutions have been created. The unbundling of the original 72 regional power companies in the RAO group is set to be completed by the end of 2006. Seven new wholesale generation companies (OGKs), six thermal and one hydro OGK, as well as most of the planned 14 regional generation companies, have been established and are managed as fully independent entities. The development of a market system for electric power, capacity and ancillary services is at an advanced stage of preparation, although the actual transition to a liberalised market is much slower than originally planned. The increasing presence of Gazprom and large financial industrial groups in the ownership of the new generation companies may have an adverse impact on competition in the market.

Financial sector

The banking sector continued its rapid expansion in 2005. Consumer credit and mortgages grew particularly rapidly, although from a very low base, and most financial retail products became available throughout Russia's regions. The share of banking assets controlled by foreign investors has risen to 12 per cent following a number of acquisitions. Nevertheless, the reform momentum in this sector has not been maintained compared with previous years. Only a small number of bank licences have been withdrawn, and a requirement on minimum capitalisation from January 2007 will be effectively waived for existing banks.

Russian private enterprises have extended their access to funding on the capital markets considerably. A number of listings in both foreign and Russian equity markets demonstrate that many Russian entities are adhering to higher corporate governance standards. The bond market is also very dynamic, with a wider set of borrowers issuing and longer maturities becoming available. Russian banks conducted a number of securitisations, which could become an important instrument for recapitalisation.

Macroeconomic performance

Real economy

Real GDP grew by 6.4 per cent in 2005, only slightly below the levels of the previous two years, and growth accelerated to an annualised 7.4 per cent by mid-2006. Growth depends increasingly on domestic sources of demand rather than the external sector. Output from mineral extraction and manufacturing has decelerated markedly.

Economic policies

The consolidated fiscal surplus was 7.5 per cent of GDP in 2005, and a similar surplus is expected in 2006. Even though oil prices are higher than those included in the federal budget assumptions, the government has shown restraint in its approach to expenditure. The Oil Stabilisation Fund (OSF) has proved a valuable instrument in managing budgetary surpluses, thereby underpinning price stability. Assets in the fund would be sufficient to cover moderate budgetary shortfalls during a cyclical downturn. The improvement in public finances has been further underlined by repayments of liabilities owed to the Paris Club of creditors. While the main aim of monetary policy is to limit inflation, the Central Bank also seeks to limit the appreciation of the real effective exchange rate. Official foreign exchange reserves rose substantially to US$260 billion by late September 2006, resulting in strong growth in broad money. The first half of 2006 has nevertheless seen a remarkable reduction in inflation to less than 10 per cent, due to the ongoing remonetisation of the economy and also informal administrative price controls.

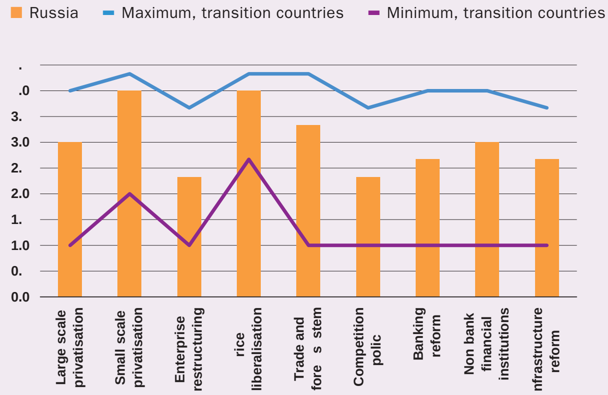
External sector

Record current account surpluses (around 11 per cent of GDP in 2005) are a reflection of substantial increases in the prices for Russian exports, principally mineral and metal products. Investor confidence in Russia and buoyant domestic demand have fuelled inward foreign direct investment (FDI). Gross FDI inflows in 2005 were equivalent to about 1.9 per cent of GDP and just over 10 per cent of gross fixed capital formation. More sectors are attracting FDI inflows, particularly those responding primarily to domestic demand such as financial services. The positive net balance in private transactions is a notable change in Russia's capital account.

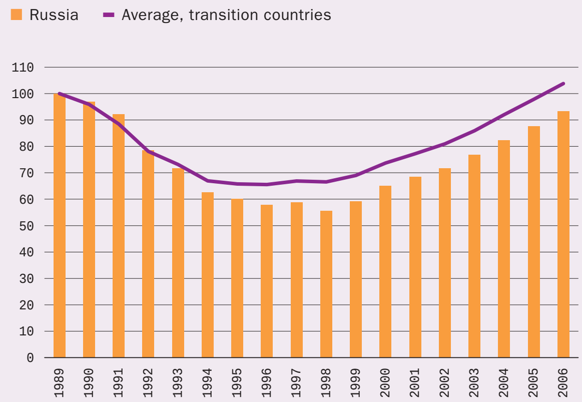
Outlook and risks

GDP growth of around 6.5 per cent is expected in 2006, due in part to the increase in budget expenditures. Further expansion of fiscal expenditures could unsettle hard-won price stability. Monetary policy will need to be adapted to the ongoing pressures on the exchange rate through the judicious adoption of an inflation targeting regime. Progress in opening the capital account may also expose financial markets to greater volatility and put at risk the achievement of the inflation target in the context of a managed exchange rate regime. This emphasises the need for further reform in the banking system and greater trade liberalisation. Despite the current favourable growth environment, faster structural reform is required to stimulate the productivity increases that can counter the inevitable appreciation of the real exchange rate.

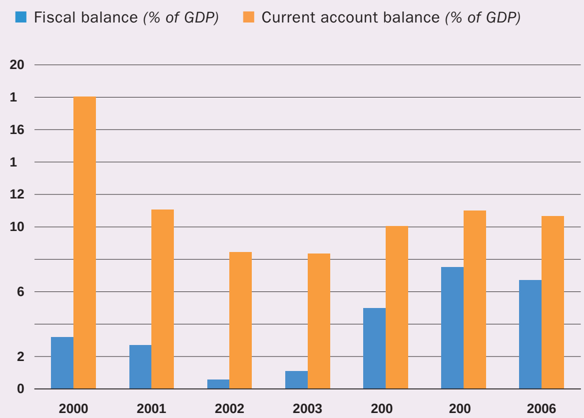
Transition indicators, 2006



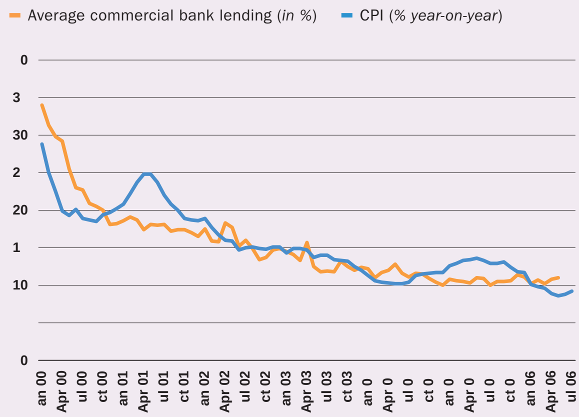
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **no**	Capital adequacy ratio – **10-11 per cent**	Share of population living in poverty – **12.1 per cent** (2002)
Controls on inward direct investment – **yes**	Quality of insolvency law – **medium**	Independent electricity regulator – **no**	Deposit insurance system – **yes**	Government expenditure on health – **3.4 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **malfunctioning**	Separation of railway infrastructure from operations – **partially**	Quality of securities market laws – **medium**	Government expenditure on education – **3.4 per cent of GDP**
Exchange rate regime – **managed float**	Quality of corporate governance law – **high**	Independence of the road directorate – **partially**	Private pension funds – **yes**	Household expenditure on power and water – **6.6 per cent**
Wage regulation – **no**		Quality of concession laws – **medium**		
Tradability of land – **limited de facto**				

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)					a	a	a
r a e e r are (per e)	0 0	0 0	0 0	0 0	0 0	6 0	6 0
r a e e r are e pl y e (per e)	a	a	a	a	a	a	a
u ge ary u e a urre ra er (per e)	a	a	a	a	a		a
S are u ry al e pl y e (per e)	22	20 6		a	a	a	a
a ge la ur pr u y u ry (per e)	0	0	6	a	a	a	a
e e (per e)		2	20 0	20	20	20	a
EBRD index of small-scale privatisation	0	0	0	0	0	0	0
EBRD index of large-scale privatisation						0	0
EBRD index of enterprise reform	2 0	2	2	2	2	2	2
S are a ere pr e (per e)	0	0	0	0	0	0	a
u er g a ere pr e a e	2 0	2 0	2 0	2 0	2 0	2 0	0
S are ra e ra u r e (per e)	66 6	6	0	6	6	2	a
S are ra e (per e)		0			2	2	a
ar re e ue (per e p r)[2]		2	6		2	2	a
EBRD index of price liberalisation	0	0	0	0	0	0	0
EBRD index of forex and trade liberalisation	2	2	0				
EBRD index of competition policy	2	2	2	2	2	2	2
u er a (re g e)	( )	( )	2 ( )	2 ( )	2 (2)	2 (2)	a
A e are a e e a (per e)	a	a	a	a	a	a	a
A e are re g e a (per e)					a	a	a
per r g l a (per e al l a)	6		6	6	6	2	a
e re pr a e e r (per e)		6		2 0	2	2	a
e re u e l (per e)	0	0	0		2		a
r gage le g (per e)	a	a	a	a	0	0 2	a
S ar e ap al a (per e)		26 0	6		6		a
S ra g lu e (per e ar e ap al a)	6		0	6 0	0	0	a
ur ua e (per e)		0	0	2	2	2	a
EBRD index of banking sector reform			2 0	2 0	2 0	2	2
EBRD index of reform of non-bank financial institutions			2	2	2	2	0
e l e (le) pe e ra ra e (per 00 a a)	2 (2 2)	22 ( )	2 (2)	2 0 (2 0)	26 (2)	2 (6)	a
er e pe e ra ra e (per 0 000 a a)	22	2	2 2	2			a
a l ay la ur pr u y (00)		0	0	0 6	0		a
e e al ele r y ar (S)	a	a	a	2	2		a
A erage lle ra e ele r y (per e)		a	02	a	a	a	a
per u e ergy u e (S llar per g e)					a	a	a
EBRD index of infrastructure reform	2	2	2	2	2	2	2
Electric power	2 0	2 0	2	0	0	0	0
Railways	2	2	2	2	2	2	2
Roads	2 0	2 0	2	2	2	2	2
Telecommunications	0	0	0	0	0	0	0
Water and waste water	2	2	2	2	2	2	2

[1] Data show expenditures on the consolidated budget, including industry, agriculture, the energy sector and housing subsidies from regional budgets.

[2] Tariff revenues refer to all taxes on international trade.

[3] Numbers greater than 100 per cent reflect collection of several years worth of payments.

	2000	2001	2002	2003	2004	2005 Estimate	2006 ro ection
			ercentage c ange in real terms				
	0 0					6	6
r a e u p		0			6		a
u l u p		0	2 6	2 2	2		a
r e ap al r a	2	0	2	2		0	a
p r g a er e		2	0	2		6	a
p r g a er e			6		22	6 2	a
u r al gr u pu				0		0	a
Agr ul ural gr u pu					0		a
			ercentage c ange				
a ur r e (e year)	0			2 2	0	a	a
pl y e (e year)	2	0	2	0 2	2 0	a	a
			n per cent of labour force				
e pl y e (e year)	0 2			6		6	a
			ercentage c ange				
u er pr e (a ual a erage)	20	2 6			0		
u er pr e (e year)	20	6	0	2 0		0	
r u er pr e (a ual a erage)	6 6	2	0	6	2 0	2	a
r u er pr e (e year)	6	0			2		a
r a erage ly ear g e y (a ual a erage)	2			2	2 0	2	a
[1]			n per cent of D				
e eral g er e ala e	2	2	0 6		0		6
e eral g er e e pe ure		6			6	6 0	a
e eral g er e e	62	2		2	2	6	a
			ercentage c ange				
r a ey (M2 e year)	62	0	2	0		6	a
e re (e year)	2	2 0	26	26		2	a
			n per cent of D				
r a ey (M2 e year)		0		2	26 0	2	a
			n per cent per annum end-year				
e ral a re a e ra e (u p u e)	2 0	2 0	2 0	6 0	0	2	a
rea ury ll ra e (all a ur e)	2		0				a
ep ra e	2	2				6	a
e g ra e	2	6	0	2	0 0		a
			Roubles per dollar				
a ge ra e (e year)	2 2	0		2	2	2	a
a ge ra e (a ual a erage)	2	2 2		0	2	2	a
			n millions of dollars				
urre a u	6		2 6		2	2	0 2
ra e ala e	60	20	6	60	2	266	
Mer a e e p r	0 0	0	0 0	2	20	2 6	2
Mer a e p r	62	6	60 66	6	2	2 0	6
re g re e e e	6	2 6	2	6	662		2 00
er a al re er e e lu g g l (e year)	2 26	2 2	0		20 0	00	a
er al e	60 02	22	6 00	00	22 000	26 600	a
			n mont s of imports of goods and services				
er a al re er e e lu g g l (e year)			6	6		2	a
			n per cent of exports of goods and services				
u l e er e ue	0	2	6	20	22 2	26 0	a
u l e er e pa	0	2	6	20	22 2	26 0	a
			Denominations as indicated				
pula (e year ll)	2		2				a
(ll r u le)	06		0	20	6	2 66	2 2
per ap a (S llar)		2 2	2	2 6	0	2	a
S are u ry (per e)	6	6			6 0	0	a
S are agr ul ure (per e)	6	6			0	0	a
urre a u (per e)	0				0	0	0
er al e re er e (S ll)	6	0	2 6	26 22	0	00	a
er al e (per e)	6 6		2	6	6	0	a
er al e e p r g a er e (per e)	6		0	2	0 6		a

Serbia

Key challenges

- Speeding up the privatisation and restructuring programme for large companies should attract much-needed investment and boost industrial competitiveness.
- There must be effective implementation of important new legislation to promote enterprise performance, including laws on competition policy and bankruptcy.
- High inflation and current account deficits need to be brought under control without damaging the real economy through a careful balance of fiscal and monetary policies.

Country data	
Population (in millions)	**10.4 (including Kosovo)**
Area ('000 sq km)	**88.4**
GDP (in billion US$, 2005)	**24.3**
GDP per capita in 2005 at current international US$ (PPP)	**na**
National currency	**Dinar**

Progress in structural reform

Liberalisation and privatisation

Serbia's integration into European structures stalled in May 2006 when negotiations on a Stabilisation and Association Agreement were called off by the European Union (EU). This was due to the failure of the Serbian authorities to comply in full with the requirements of the International Criminal Tribunal for the former Yugoslavia (ICTY). Until then, negotiations had proceeded well; two official rounds of negotiations had been completed and progress made on a number of issues. The European Commission has stated its readiness to resume negotiations as soon as Serbia achieves full cooperation with ICTY.

More than 200 companies were privatised through auctions in 2005, with a similar pace being maintained in the first half of 2006. Small-scale privatisation is on course for completion in 2007.

Several large industrial enterprises have been prepared for privatisation, notably the oil and gas company Naftna Industrija Srbija (NIS). A proposal for the sale (through tender) of a minority stake of 25 per cent in the company (with the option to increase the holding to 37.5 per cent) was approved by the government in August 2006. A second stage in 2009 would allow the buyer to increase its share to 49 per cent. In addition, a tender for the mining and smelting complex RTB Bor was launched in September 2006. However, overall progress with the sale of other large industrial enterprises has been slower than planned.

Business environment and competition

A new competition law took effect in September 2005. While it is generally in line with EU standards, much remains to be done to implement it. The law envisaged the establishment of an independent Competition Protection Commission by the end of 2005. However, by mid-2006 competition responsibilities still rested with the Ministry of Trade, Tourism and Services. The implementation of new laws on bankruptcy and company legislation has also been slow in 2005-06. More than 1,000 bankruptcy cases were registered by March 2006, but only a small number had been processed, reflecting both slow progress in training new licensed bankruptcy administrators and a lack of political will to use this instrument.

Infrastructure

In a major privatisation in August 2006, the mobile telecommunications company Mobi63 was sold to Telenor of Norway for over €1.5 billion. Mobi63 is a new company, created in early 2006 when the state took effective control of its predecessor Mobtel. Competition in the mobile sector is expected to increase, following the announcement in September 2006 of a tender for a new 3G licence. The winner of the tender will be announced in November.

There has been little progress in effective market liberalisation of the fixed-line sector. Although a new regulator – the Telecommunications Agency – was established in December 2005, it has yet to establish its independence. The majority state-owned Telekom Srbija retains a dominant market share.

Further reforms have occurred in the roads sector, with 20 out of 25 maintenance companies being privatised during 2005. In addition, Serbian Roads has become a separate public enterprise from the Ministry of Transport. Consolidated road user charges are above cost recovery levels.

Reforms in the railways sector are progressing, with the state-owned company, ZTP, being separated into infrastructure and operating companies. A programme of labour restructuring is also proceeding well.

Financial sector

A number of significant privatisations have occurred over the past year in the banking sector, including those of Niška Banka, Panonska Banka and Vojvodjanska Banka, as well as a minority stake in Nacionalna Stedionica Banka. As a result, the state's share of banking capital shrunk to 21 per cent by mid-2006, down from 32 per cent a year earlier. In addition, a significant recapitalisation took place in the first half of 2006 of one of the largest state-owned banks – Komercialjna Banka – in preparation for its privatisation in 2009.

In the insurance sector, the National Bank of Serbia (NBS) has withdrawn the licences of companies not satisfying required standards. Meanwhile, the Deposit Insurance Agency has put a number of other insurance companies up for sale (including DDOR osiguranje, the second-largest company, in May 2006).

Macroeconomic performance

Real economy

Real GDP growth was around 6.3 per cent in 2005 and a similar rate is forecast for 2006. Industrial output in the first seven months of 2006 rose by nearly 8 per cent. Several industries that have benefited from substantial foreign investment, such as tobacco and base metals, have performed particularly well. On the demand side, rapid credit expansion is fuelling domestic consumption. Export growth has also been strong, reaching nearly 30 per cent in 2005 and more than 20 per cent year-on-year in the first half of 2006.

Economic policies

Government success in boosting fiscal revenues contributed to an overall fiscal surplus in 2005 of nearly 1 per cent of GDP. Nevertheless, government spending remained high at around 40 per cent of GDP. Also, although subsidies to state and socially owned companies are on a downward trend, the government's plan for a programme of major capital investment of about €1.7 billion over the next few years may put pressure on prices and the current account deficit. Meanwhile, inflation has eased during 2006, falling from 17.5 per cent at the end of 2005 to 12.8 per cent by August. The nominal exchange rate has appreciated slightly over the period, following reduced foreign exchange interventions by the NBS. However, the continued strong growth of both wages and credit may add to inflationary pressures. The NBS's main tools to combat inflation are the two-week repo rate and reserve requirements, with the latter raised several times during 2006.

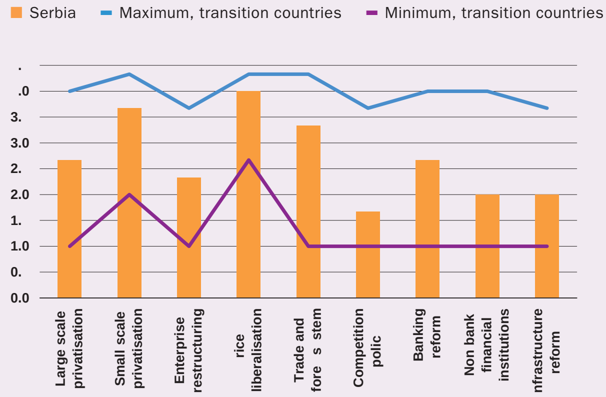
External sector

Export growth and robust inflows of remittances have contributed to a decline in the current account deficit from nearly 15 per cent in 2004 to 10 per cent of GDP in 2005. Foreign direct investment inflows remain very strong and are projected to exceed €3 billion in 2006 (about half of which reflects the sale of Mobi63 to Telenor of Norway – see 'infrastructure' section). Overall debt levels are moderate, although private debt is rising rapidly. Servicing external public debt will remain a challenge over the next few years, with debt service requirements for 2006 estimated at almost US$2 billion, compared with less than US$1 billion in 2004.

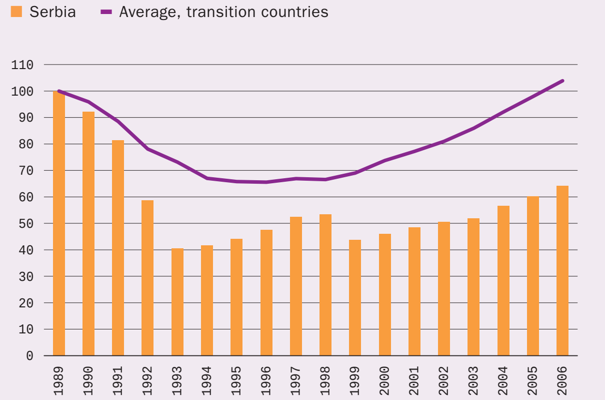
Outlook and risks

The overall economic outlook for Serbia is favourable, but significant short-term downside risks remain. Although the economy has strong growth potential, unresolved issues about the country's political future, notably concerning the status of Kosovo, are likely to distract attention from urgent economic reforms and progress towards EU integration. Furthermore, an escalation of tensions would deter foreign investment. Meanwhile, credit to the private sector could be squeezed by a combination of higher public investment demands and the ongoing efforts by the Central Bank to dampen inflation.

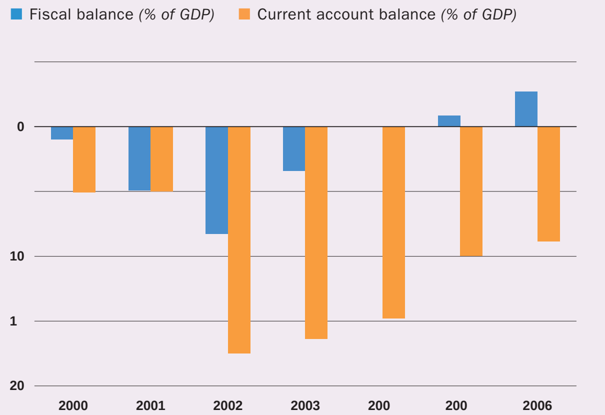
Transition indicators, 2006



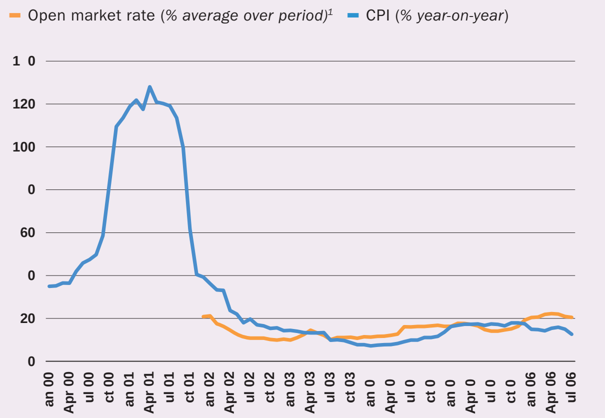
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



¹ Open market rate data were not available for 2000-01.

Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **no**	Capital adequacy ratio – **8 per cent**	Share of population living in poverty – **na**
Controls on inward direct investment – **no**	Quality of insolvency law – **high**	Independent electricity regulator – **partially**	Deposit insurance system – **yes**	Government expenditure on health – **na**
Interest rate liberalisation – **full**	Secured transactions law – **some defects**	Separation of railway infrastructure from operations – **no**	Quality of securities market laws – **medium**	Government expenditure on education – **na**
Exchange rate regime – **managed float**	Quality of corporate governance law – **medium**	Independence of the road directorate – **no**	Private pension funds – **no**	Household expenditure on power and water – **9.3 per cent**
Wage regulation – **no**		Quality of concession laws – **medium**		
Tradability of land – **limited de jure**				

	2000	2001	2002	2003	2004	2005	2006
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.0	2.4	7.0	7.6	na	na
Private sector share in GDP (in per cent)	40.0	40.0	45.0	45.0	50.0	55.0	55.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.3	3.4	4.8	3.8	3.3	2.6	na
Share of industry in total employment (in per cent)	38.7	37.9	35.4	33.9	na	na	na
Change in labour productivity in industry (in per cent)	18.5	2.0	10.4	3.1	na	na	na
Investment/GDP (in per cent)	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	3.0	3.0	3.0	3.0	3.3	3.3	3.7
EBRD index of large-scale privatisation	1.0	1.0	2.0	2.3	2.3	2.7	2.7
EBRD index of enterprise reform	1.0	1.0	2.0	2.0	2.0	2.3	2.3
Markets and trade							
Share of administered prices in CPI (in per cent)	10.3	11.0	11.0	11.2	11.2	9.2	na
Number of goods with administered prices in EBRD-15 basket	1.0	2.0	2.0	3.0	3.0	2.0	na
Share of trade with non-transition countries (in per cent)	73.2	78.1	82.9	79.3	na	na	na
Share of trade in GDP (in per cent)	87.1	64.5	57.7	55.2	63.1	61.3	na
Tariff revenues (in per cent of imports)	5.1	4.9	6.8	6.8	6.1	na	na
EBRD index of price liberalisation	2.3	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	1.0	2.7	3.0	3.0	3.0	3.3	3.3
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.7
Financial sector							
Number of banks (foreign-owned)	81 (3)	54 (8)	50 (12)	47 (16)	43 (11)	40 (17)	na
Asset share of state-owned banks (in per cent)	90.9	68.0	35.6	34.1	23.4	23.9	na
Asset share of foreign-owned banks (in per cent)	0.5	13.2	27.0	38.4	37.7	66.0	na
Non-performing loans (in per cent of total loans)	24.9	24.4	28.5	23.8	22.4	23.8	na
Domestic credit to private sector (in per cent of GDP)	8.2	6.1	na	na	na	na	na
Domestic credit to households (in per cent of GDP)	na	na	na	2.6	4.9	7.6	na
Of which mortgage lending (in per cent of GDP)	na	na	na	0.4	0.7	1.4	na
Stock market capitalisation (in per cent of GDP)	na	na	4.7	7.1	14.5	24.0	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	1.0	1.0	2.3	2.3	2.3	2.7	2.7
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.7	2.0	2.0	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants) [1]	22.6 (12.3)	22.9 (18.7)	30.7 (33.9)	32.1 (44.7)	32.9 (58.0)	32.9 (64.0)	na
Internet penetration rate (per 10,000 inhabitants) [1]	14.1	14.7	20.9	24.4	33.8	33.8	na
Railway labour productivity (1989=100)	na	na	na	na	na	na	na
Residential electricity tariffs (in USc kWh)	na	na	na	na	na	na	na
Average collection rate, electricity (in per cent)	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
EBRD index of infrastructure reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Electric power	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Railways	na	2.0	2.3	2.3	2.3	2.3	2.3
Roads	2.0	2.0	2.3	2.3	2.3	2.3	2.7
Telecommunications	2.0	2.0	2.0	2.0	2.0	2.0	2.3
Water and waste water	2.0	2.0	2.0	2.0	2.0	2.0	1.7

[1] Data for Serbia and Montenegro.

	2000	2001	2002	2003	2004	2005	2006
						Estimate	ro ection
ercentage c ange in real terms							
	2			2		6	6
u r al gr u pu		0 0		2		0 0	a
Agr ul ural gr u pu		2 2	0	6 0		2	a
ercentage c ange							
a ur r e (e year)	2			2		a	a
pl y e (e year)	2 6	0 2	6		6	a	a
n per cent of labour force							
e pl y e (e year)	2	2	2 6	0		a	a
ercentage c ange							
u er pr e (a ual a erage)	60		2 2			2	0
u er pr e (e year)		0	2	6			0
r u er pr e (a ual a erage)		a	a	a	a	a	a
r a erage ly ear g e y (a ual a erage)		2 6		2	2	2	a
n per cent of D							
e eral g er e ala e	0				0 0	0	2
e eral g er e e pe ure	0			6			a
ercentage c ange							
r a ey (M2 e year)		6 6		26	0	2	a
e re (e year)	2		6	6	6		a
n per cent of D							
r a ey (M2 e year)		2	20	2 6	2 6	2 2	a
n per cent per annum end-year							
u ra e	26	6		0			a
M ey ar e ra e			2 2	2	6	2	a
ep ra e		6		2	2 0		a
e g ra e (l g er)						6	a
Dinars per dollar							
a ge ra e (al e year)	66	6	0	6		2 2	a
a ge ra e (al a ual a erage)		66	6 2			6 2	a
n millions of dollars							
urre a u	2	2	2 02	22	02	2	2 0
ra e ala e		2		6	6 6	6	6 000
Mer a e e p r	2	2 00	2 0	2	26	6	6 000
Mer a e p r			6 6	0 2	0 6	0 2 0	2 000
re g re e e e	2	6		60	66		00
r re er e e lu g g l (e year)	6	6	2 2 0	0	2		a
er al e	0 0	2	2 0		0	6	a
n mont s of imports of goods and services							
r re er e e lu g g l (e year)		2	0				a
n per cent of exports of goods and services							
e er e	2 2		6	2		2	a
Denominations as indicated							
pula (e year ll)							a
(ll ar)		0		0	0	6 0	26
per ap a (S llar)	6		0	2 2	2	2	a
S are u ry (per e)	26 0	2 2		a	a	a	a
S are agr ul ure (per e)	6	2		a	a	a	a
urre a u (per e)		0		6		0 0	
er al e re er e (S ll)	0	6	0	0 02		62	a
er al e (per e)	6	0 0		2	6	6	a
er al e e p r g a er e (per e)	2 2	0 6		6	2 2	2 6	a

[1] The exchange rate regime was unified in December 2000. The unofficial rate in October 2000 was 30 dinars: 1 deutschmark (DM), compared with an official rate of 6 dinars: 1DM.

Note: Data exclude Kosovo.

Slovak Republic

Key challenges

- The government's decision not to pursue further privatisations is deterring foreign investors and poses a risk to the funding of pension reform over the medium term.
- Inefficiency and corruption in the judiciary remain major impediments in the business environment.
- The authorities need to reduce inflation and maintain sound public finances to meet the government’s goal of adopting the euro in 2009, especially in view of plans for higher spending and lower tax revenues.

Country data	
Population (in millions)	**5.4**
Area (‘000 sq km)	**49.0**
GDP (in billion US$, 2005)	**47.5**
GDP per capita in 2005 at current international US$ (PPP)	**16,483**
National currency	**Slovak Koruna**

Progress in structural reform

Liberalisation and privatisation

The pace of privatisation slowed in the lead up to the general elections in June 2006. Before the elections, the government put all privatisations on hold, fearing insufficient backing from parliament. After the poll, the new government decided to stop the sale of state firms (with the exception of two imminent deals) and retain ownership in strategic companies. The halt on privatisation implies that all sales that were suspended by the previous government will not be completed. This decision has angered those foreign investors who had submitted bids, especially those which had offers approved. The suspension is likely to incur lost revenue of at least SKK 50 billion (3.5 per cent of GDP).

The deals affected by the privatisation suspension include: a 100 per cent stake in ZSKK Cargo, the freight arm of the state-owned Slovak railway company; a 51 per cent stake in each of the six state-owned district heating plants in the largest cities; and the remaining 51 per cent state-owned holding in each of the three regional energy distributors. Other privatisations that the previous government had announced but are now under review include the sales of the Bratislava stock exchange, several hospitals, an arms producer and the completion of several public bus transport privatisations.

Among the deals concluded prior to the privatisation suspension was the sale of a 66 per cent stake in the main electricity generator Slovenske Elektrarne to ENEL (the Italian electricity company) for €840 million. This was finalised in April 2006, although the privatisation was signed in February 2005.

Among the privatisations close to completion is the sale of a 66 per cent stake in the Kosice international airport. (Bratislava international airport had also been up for privatisation, but this has now been cancelled.) The Austrian TwoOne consortium (led by the operators of Vienna airport) was selected as the preferred bidder for both airport privatisations. The previous government had approved both sales in February 2006, on the understanding that they would be cleared by the Slovak anti-monopoly office by mid-August. However, the anti-monopoly office only approved the sale of the smaller Kosice airport on time. It rejected the merger between the Bratislava and Vienna airports in September 2006. The government has subsequently cancelled the Bratislava deal.

Business environment and competition

At the beginning of 2006 a new Bankruptcy Act came into force, providing for the complete reform of the Slovak bankruptcy regime. The new law envisages a fast, creditor-oriented procedure and emphasises the restructuring process for insolvent debtors. Several of the amendments passed are designed to reform and strengthen the status of courts. The main aim of the changes is to speed up the system before cases are heard in the civil courts. Institutional weaknesses, in particular an inefficient and corrupt bureaucracy, hamper the implementation of further judicial reforms.

According to the World Bank’s Doing Business report, the Slovak Republic is ranked fifth among all transition countries, after the Baltic states and Armenia, in terms of business environment. However, while the Slovak Republic is above average in most categories (for example, starting a business, dealing with licences, employing workers), investor protection and the enforcement of contracts are still below the region’s average.

Social sector

The introduction of mandatory pension funds in 2005 has proved relatively costly as more people than expected have joined the scheme. The deficit of the public pension system reached 2.2 per cent of GDP in 2005, compared with the initial projection of 1.6 per cent. Under European Union (EU) accounting standards, privatisation receipts cannot directly increase public revenues, but can be used either to reduce public debt or to finance the deficit in the public social security system. For the next two or three years, the deficits of the public pension system can be covered by the proceeds from earlier privatisations. After that, the lack of privatisation revenues could pose a sizeable funding problem. Six private pension funds had SKK 20 billion (€0.5 billion) in net assets under management by the end of July 2006 (and are growing rapidly).

The domestic capital market has not yet benefited from the pension reform as much as hoped, mainly because investment opportunities in the Slovak Republic are still limited given the small size of the domestic capital market. In addition, pension funds are allowed to invest anywhere in the EU according to EU legislation.

Macroeconomic performance

Real economy

Overall GDP growth averaged 6.1 per cent in 2005, although there was a record high of 7.4 per cent in the fourth quarter of the year. It slowed to 6.3 per cent in the first quarter of 2006 but accelerated to 6.7 per cent year-on-year in the second. Investment spending and private consumption were the main drivers of growth both in 2005 and in early 2006. Exports and imports grew strongly in 2005, but on balance had a small negative effect on growth.

Economic policies

Year-on-year inflation reached 5.0 per cent in July 2006, driven by high oil prices and by the lingering effects of utility price increases in late 2005. This rate exceeded the end-year inflation forecast of 3.9 per cent set by the National Bank of Slovakia (NBS). As growth, especially in domestic demand, and inflation were both higher than expected, the NBS has increased its policy interest rate since January 2006 from 3.0 per cent to 4.5 per cent.

Since November 2005 the Slovak koruna has participated in the Exchange Rate Mechanism II (ERM II) with a central parity of 38.4550 koruna per euro. It has a standard fluctuation band of plus or minus 15 per cent. In practice, however, the NBS has allowed the currency to weaken only marginally. Following a shift in market sentiment, the NBS intervened in the foreign exchange market to prevent a weakening of the koruna below the central ERM II rate in June and July 2006.

In 2005 the general government deficit was 2.9 per cent of GDP, half a percentage point below the deficit target presented in the 2005 budget. On the back of continued strong revenue growth, the state budget figures have been better than forecast for the first seven months of 2006.

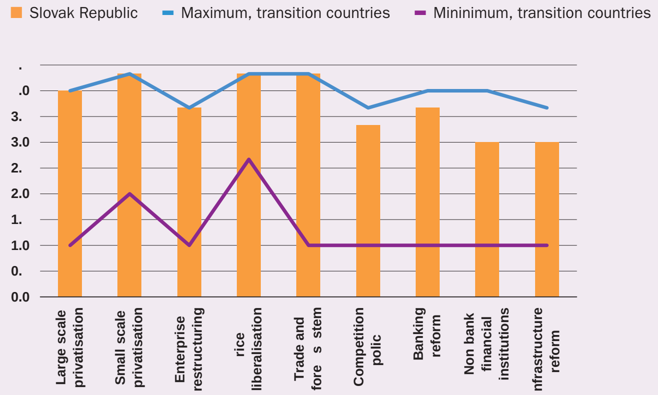
External sector

The current account deficit more than doubled as a percentage of GDP in 2005 because of a sharp rise in investment-related imports and a change in accounting methodology. Net foreign direct investment (FDI) increased markedly to US$1.9 billion from US$1.4 billion in 2004, due in part to the privatisation of the electricity generator Slovenske Elektrarne. The current account deficit deteriorated in the first four months of 2006, but was covered by net FDI inflows during the period.

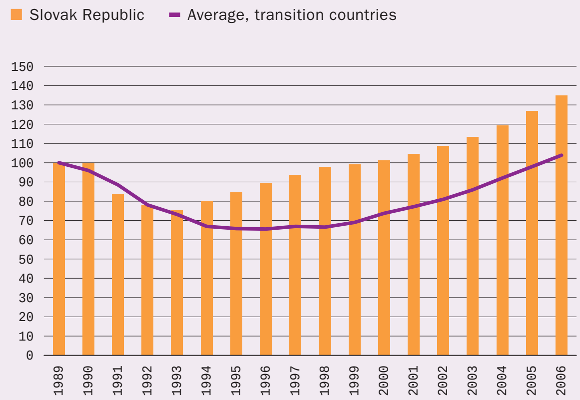
Outlook and risks

The new government has underlined its commitment to the adoption of the euro in 2009, although convergence with the Maastricht criteria may be jeopardised if inflation continues to rise. Plans for higher public spending (on social transfers and farm subsidies) and revenue cuts (through higher tax allowances for the poor and the re-introduction of the lower value added tax rate) could also put the attainment of the Maastricht fiscal deficit target at risk. In addition, Eurostat accounting rules, which prescribe that the deficit of the funded pension pillar be included in the general government deficit, will have to be implemented from Spring 2007. This means that the deficit figures would be significantly higher from 2007 without compensatory measures.

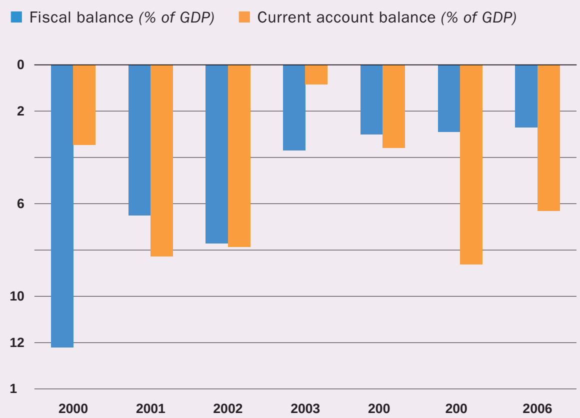
Transition indicators, 2006



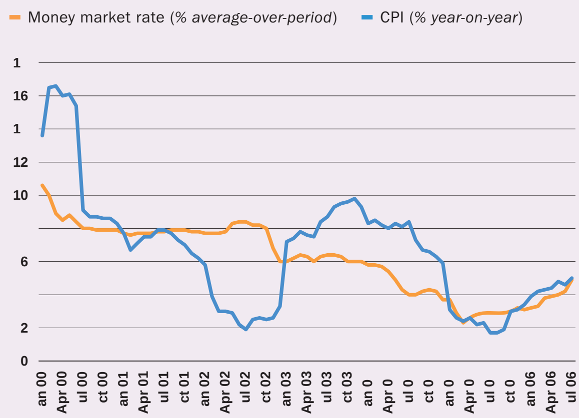
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **8 per cent**	Share of population living in poverty – **2.9 per cent** (1996)
Controls on inward direct investment – **no**	Quality of insolvency law – **medium**	Independent electricity regulator – **fully**	Deposit insurance system – **yes**	Government expenditure on health – **4.1 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **advanced**	Separation of railway infrastructure from operations – **fully**	Quality of securities market laws – **high**	Government expenditure on education – **3.6 per cent of GDP**
Exchange rate regime – **managed float in ERM II**	Quality of corporate governance law – **medium**	Independence of the road directorate – **fully**	Private pension funds – **yes**	Household expenditure on power and water – **9.5 per cent** [1]
Wage regulation – **no**		Quality of concession laws – **medium**		
Tradability of land – **full except non-EU foreigners**				

	2000	2001	2002	2003	2004	2005	2006
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	15.7	19.2	33.7	34.7	35.1	35.1	na
Private sector share in GDP (in per cent)	80.0	80.0	80.0	80.0	80.0	80.0	80.0
Private sector share in employment (in per cent)	75.0	75.0	75.0	75.0	75.0	75.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.5	2.2	1.5	1.7	2.2	1.3	na
Share of industry in total employment (in per cent)	29.0	29.4	29.8	29.2	29.2	28.8	na
Change in labour productivity in industry (in per cent)	10.9	5.9	4.3	6.2	2.7	2.7	na
Investment/GDP (in per cent)	25.9	29.6	29.0	24.6	26.0	28.4	na
EBRD index of small-scale *privatisation*							
EBRD index of large-scale privatisation	0	0	0	0	0	0	0
EBRD index of enterprise reform	0	0					
S are a ere pr e (per e)			2	20		2	a
u er g a ere pr e a e	0	0	0	0	2 0	2 0	a
S are ra e ra u r e (per e)	6 0	62 0	6	66	62 6	a	a
S are ra e (per e)	2 0	2	2			0	a
ar re e ue (per e p r)[2]	0 6	0	0	0	0 2	0	a
EBRD index of price liberalisation	0	0					
EBRD index of forex and trade liberalisation							
EBRD index of competition policy	0	0	0	0			
u er a (re g e)	2 ( )	2 (2)	20 ( )	2 (6)	2 (6)	2 (6)	a
A e are a e e a (per e)							a
A e are re g e a (per e)	2			6	6		a
per r g l a (per e al l a)	26 2	2	2		2		a
e re pr a e e r (per e)		26	2	2	2 2	26	a
e re u e l (per e)				0	6	0	a
r gage le g (per e)	0	0	0	2 2	2	6	a
S ar e ap al a (per e)	6		6				a
S ra g lu e (per e ar e ap al a)	2	0		2		6	a
ur ua e (per e)			0 0	0	2	0 0	a
EBRD index of banking sector reform	0						
EBRD index of reform of non-bank financial institutions	2	2	2	2	2	2	0
e l e (le) pe e ra ra e (per 00 a a)	(2 0)	2 ( )	26 ( )	2 (6)	2 2 ( )	22 2 ( )	a
er e pe e ra ra e (per 0 000 a a)	0 2			2 2	22	22	a
a l ay la ur pr u y (00)	6 0	62	60 6	60	6	6	a
e e al ele r y ar (S)				0			a
A erage lle ra e ele r y (per e)	a	02		a	a	a	a
per u e ergy u e (S llar per g e)					a	a	a
EBRD index of infrastructure reform	2 0	2	2	0	0	0	0
Electric power	2 0	0	0	0	0	0	0
Railways	2	2	2	2	2	0	0
Roads	2	2	2	2	2	2	2
Telecommunications	2	0					
Water and waste water	2	2	2	2	0	0	

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure [1]			(Percentage change in real terms)				
GDP	2.0	3.2	4.1	4.2	5.4	6.1	6.4
Private consumption	na	5.2	5.2	0.2	4.2	7.0	na
Public consumption	na	5.2	5.2	3.9	2.0	0.5	na
Gross fixed capital formation	na	12.9	0.3	-2.3	5.0	13.8	na
Exports of goods and services	na	6.8	4.7	15.9	7.9	13.5	na
Imports of goods and services	na	13.5	4.6	7.6	8.8	15.5	na
Industrial gross output	8.3	7.0	6.3	5.1	3.9	3.9	na
Agricultural gross output	3.2	-4.0	10.9	4.4	1.2	na	na
Employment			(Percentage change)				
Labour force (end-year)	1.3	1.4	-0.5	0.1	0.8	0.1	na
Employment (end-year)	0.2	0.8	0.5	0.9	1.3	2.5	na
			(In per cent of labour force)				
Unemployment (end-year)	18.0	18.7	17.9	17.4	17.1	15.3	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	12.0	7.3	3.3	8.5	7.5	2.7	4.5
Consumer prices (end-year)	8.4	6.5	3.4	9.3	5.9	3.7	4.2
Producer prices (annual average)	9.8	6.6	2.2	8.9	3.4	3.9	na
Producer prices (end-year)	8.9	3.8	2.1	9.6	3.4	5.9	na
Gross average monthly earnings in economy (annual average)	6.5	8.2	9.3	6.3	10.2	9.2	na
Government sector [2]			(In per cent of GDP)				
General government balance [3]	-12.2	-6.5	-7.7	-3.7	-3.0	-2.9	-2.7
General government expenditure	63.1	43.8	43.3	39.4	38.9	36.8	na
General government debt	49.9	49.2	43.3	42.7	41.6	34.5	na
Monetary sector [4]			(Percentage change)				
Broad money (M2, end-year)	15.4	11.9	3.4	-4.9	9.5	7.3	na
Domestic credit (end-year)	9.1	13.3	-12.7	9.3	6.9	12.0	na
			(In per cent of GDP)				
Broad money (M2, end-year)	64.6	66.6	63.2	55.1	54.0	53.3	na
Interest and exchange rates			(In per cent per annum, end-year)				
Refinancing rate	8.0	7.8	6.5	6.0	4.0	3.0	na
3-month BRIBOR	7.9	7.8	6.0	6.0	3.7	3.1	na
Deposit rate [5]	5.6	4.8	3.5	3.0	2.0	1.4	na
Lending rate [5]	10.1	9.8	8.8	7.7	6.4	5.9	na
			(Korunas per US dollar)				
Exchange rate (end-year)	48.6	48.2	41.1	33.6	29.1	31.9	na
Exchange rate (annual average)	46.2	48.4	45.3	36.8	32.3	31.0	na
External sector			(In millions of US dollars)				
Current account	-702	-1,746	-1,924	-276	-1,507	-4,090	-3,400
Trade balance	-904	-2,125	-2,117	-637	-1,536	-2,450	-2,200
Merchandise exports	11,872	12,645	14,382	21,843	27,621	32,026	39,700
Merchandise imports	12,777	14,770	16,499	22,480	29,157	34,476	41,900
Foreign direct investment, net	1,897	1,520	4,130	737	1,403	1,951	3,400
Gross reserves, excluding gold (end-year)	4,022	4,141	8,809	11,678	14,418	14,901	na
External debt stock	10,804	11,269	13,188	18,090	23,764	27,053	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.3	3.0	5.6	5.5	5.3	4.6	na
			(In per cent of exports of goods and services)				
Debt service due	17.4	19.5	11.7	11.6	2.9	3.4	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	5.4	5.4	5.4	5.4	5.4	5.4	na
GDP (in billions of korunas)	941	1,021	1,111	1,213	1,355	1,472	1,637
GDP per capita (in US dollars)	3,771	3,910	4,559	6,131	7,811	8,823	na
Share of industry in GDP (in per cent)	25.5	25.2	23.5	24.3	24.5	23.9	na
Share of agriculture in GDP (in per cent)	4.2	4.5	4.0	3.6	3.6	3.5	na
Current account/GDP (in per cent)	-3.4	-8.3	-7.8	-0.8	-3.6	-8.6	-6.3
External debt - reserves (in US$ million)	6,782	7,128	4,379	6,412	9,346	12,152	na
External debt/GDP (in per cent)	53.0	53.4	53.8	54.9	56.6	57.0	na
External debt/exports of goods and services (in per cent)	76.5	74.5	76.8	72.0	75.8	74.3	na

1 Due to a revision of GDP data for 2000-05, consistent growth rates are not available for private and public consumption, gross fixed capital formation and exports and imports of goods and services in 2000.

2 General government includes central government, municipalities and extra-budgetary funds.

3 The general government balance excludes privatisation revenues and is calculated according to Eurostat methodology (ESA95). In line with the Eurostat derogation, the second pillar pension funds are included from 2005.

4 Until 2002 monetary data are compiled using national methodology. From 2003 data are compiled according to harmonised European Central Bank methodology.

5 Weighted average over all maturities.

Slovenia

Key challenges

- The pace of large-scale privatisation in Slovenia continues to lag behind other CEB countries. The government's privatisation agenda must be implemented without further delay.
- Improvements in corporate governance, in addition to the implementation of the new Companies Act, are needed to attract additional domestic and foreign investment.
- While the current macroeconomic situation is relatively positive, proposed reforms to the tax system will need to be accompanied by reforms on the expenditure side to ensure the sustainability of public finances over the longer term.

Country data

Population (in millions)	**2.0**
Area ('000 sq km)	**20.5**
GDP (in billion US$, 2005)	**34.0**
GDP per capita in 2005 at current international US$ (PPP)	**22,384**
National currency	**Slovenian Tolar**

Progress in structural reform

Liberalisation and privatisation

Limited progress has been made in privatising large companies during 2005-06. However, a consensus has been reached among the government coalition parties on a privatisation formula. This envisages the state keeping a 25 per cent-plus-one-share stake in a company, with a percentage being sold on the stock exchange and the balance sold to a strategic partner. This arrangement will still allow the state to retain an influence in some strategic decisions, but limit its involvement in day-to-day business administration. The government's privatisation agenda, approved in July 2006, groups companies into categories based on the time period in which they are to be privatised (24 months, 30 months or not specified). The privatisation of Telekom Slovenije will follow this model, with its listing on the Ljubljana Stock Exchange planned for October 2006.

The partial privatisation of dominant insurance company Triglav, which was suspended in late February 2005, has been further delayed in the courts. The timing of the company's privatisation is not yet known.

Business environment and competition

The procedure for registering as an individual private entrepreneur has improved significantly since July 2005, when single access points – via the internet or dedicated offices – were established. The entire process can be done at one site, takes about one hour, is free of charge and, in the case of the internet portal, can be done at any time of the day. In the year to June 2006, the number of registrations increased by 14.3 per cent. The service is expected to be extended to limited liability companies and general partnerships in 2007.

Full harmonisation with the European Union's *acquis communautaire* was achieved in the area of company law following the introduction of the new Companies Act in May 2006. The legislation aims to improve corporate governance and minority shareholder protection. From January 2007 minimum initial share capital requirements will be reduced from €8,750 to €7,500.

Infrastructure

In September 2005 Telekom Slovenije complied with a request from the Agency for Post and Electronic Communication (APEK) to untie its ISDN (Integrated Services Digital Network) and ADSL (Asymmetric Digital Subscriber Line) products. In February 2006 the European Commission again criticised the telecommunications regulator for delays in implementing the *acquis communautaire*. The portability of mobile numbers was introduced in January and fixed numbers in May 2006.

In December 2005 Slovenia's competition authority rejected a claim by Western Wireless International (WWI) that mobile operator Mobitel was obstructing competition. WWI subsequently filed a damages suit against both Mobitel and the state, but in April 2006 withdrew the action and sold the network of its Slovenian subsidiary, Vega, to Mobitel and Simobil. The Slovenian Competition Office required Mobitel to phase out the locking of mobile phones and the imposition of long-term obligations on its subscribers. In February 2006 APEK designated Mobitel and Simobil (and Vega at that time) as having significant market power and obliged them to allow other mobile operators to access their networks. Two new mobile phone services providers, Izimobil and M mobil, began operating in November 2005 and August 2006 respectively. Another provider, Tusmobil, is expected to commence operations by the end of 2006. Mobitel's market share has decreased to 72 per cent of all active users.

The liberalisation of the energy market is ongoing and, according to a commitment with the European Union (EU), the government plans to fully open it to competition by July 2007.

Financial sector

Increased demand from companies and households for loans has resulted in fiercer competition among banks and low interest rates. In 2005 corporate loans (mainly denominated in foreign currency at cheaper rates) grew by 22 per cent in nominal terms. Lending to households increased by 26.6 per cent by the end of 2005, with housing loans accounting for 60 per cent of the net rise. International Financial Reporting Standards (IFRS) were introduced for banks in January 2006.

The Ljubljana Stock Exchange introduced new rules in October 2005, establishing a prime market for elite shares where listed companies must follow international reporting standards. Amendments to the Securities Market Act, intended to improve the transparency of trading, came into force in March 2006. However, companies still finance themselves predominantly with bank loans, closed recapitalisations and the private placement of securities.

Macroeconomic performance

Real economy

Real GDP grew by 4 per cent in 2005, compared with 4.4 per cent in 2004. Preliminary figures for the first half of 2006 suggest a year-end rate above this level. The main drivers of growth in 2005 were financial services and transport. Export performance was also robust. Industrial production growth continued in the first half of 2006 after a slowdown in the third quarter of 2005.

Economic policies

In November 2005 Slovenia became the first of the EU members admitted in 2004 to satisfy all the Maastricht criteria for the adoption of the euro. In June 2006, the EU finance ministers formally confirmed the country's entry into the European Economic and Monetary Union. The rate at which the tolar will be converted was fixed in June 2006 at SIT 239.64 per euro. The euro will become the official currency in January 2007. The low level of inflation (2.3 per cent at the end of 2005) should be maintained in the short term as a social consensus among employers and employees is limiting wage increases to 2 per cent per year on average. The fiscal deficit was 1.1 per cent of GDP in 2005 (GFS methodology) and general government debt at the end of the year was 28.8 per cent of GDP. However, the tax burden, among the highest in the new EU member states, is a disincentive to job creation. The government proposed a tax reform in August 2006, reducing the number of income tax brackets from five to three, curbing the corporate income tax by two percentage points in 2007 and then gradually reducing it to 20 per cent by 2010. The reform also plans to gradually eliminate payroll tax by 2009.

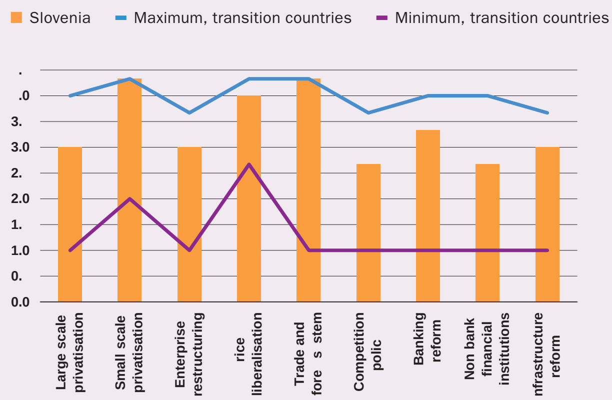
External sector

Despite weak growth in the eurozone in 2005, Slovenia's merchandise exports grew by about 10.3 per cent in real terms. However, import growth was also strong, resulting in a current account deficit of about 1 per cent of GDP. Outflows of foreign direct investment (FDI) meanwhile exceeded inflows. Bank borrowing from abroad increased sharply and was one of the main contributors to the 28 per cent rise (in euro terms) in gross external debt in 2005. However, while the ratio of external debt to GDP is relatively high, other indicators, such as the net debt position and debt maturity ratios, suggest that this level remains manageable.

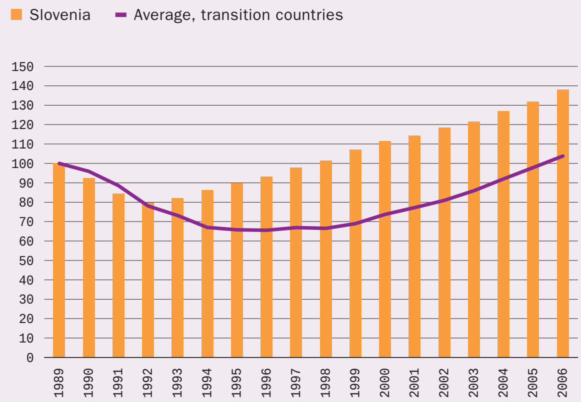
Outlook and risks

The short-term economic outlook is positive, with growth likely to reach 4.5 per cent on the year and inflation and the fiscal deficit expected to stay low. However, with the output gap almost closed, risks for demand-led inflationary pressures have increased, requiring a tighter fiscal stance than envisaged in the two-year rolling budget (in the absence of monetary policy). The proposed (and necessary) tax reforms will need to be accompanied by reforms on the expenditure side (in pensions and health care, for example) since the impact of Slovenia's ageing population on public finances is a major concern over the longer term. In addition, further progress in structural reform is necessary to increase the potential growth rate and assure Slovenia's long-term competitiveness.

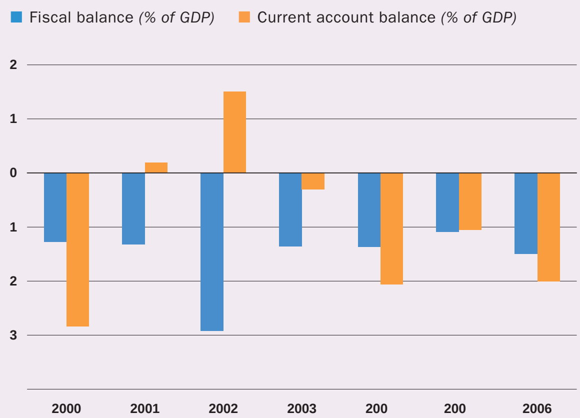
Transition indicators, 2006



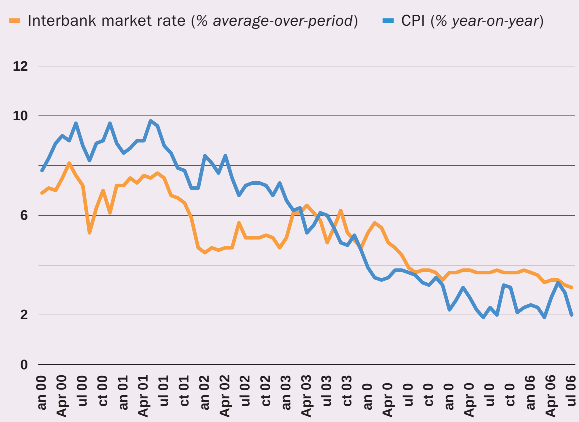
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no** [1]

Interest rate liberalisation – **full**

Exchange rate regime – **managed float in ERM II**

Wage regulation – **yes**

Tradability of land – **full except non-EU foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **inefficient**

Quality of corporate governance law – **medium**

Infrastructure

Independent telecoms regulator – **fully**

Independent electricity regulator – **fully**

Separation of railway infrastructure from operations – **fully**

Independence of the road directorate – **partially**

Quality of concession laws – **na** [2]

Financial sector

Capital adequacy ratio – **10.6 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **high**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2 per cent** (1998)

Government expenditure on health – **6.7 per cent of GDP**

Government expenditure on education – **5.8 per cent of GDP**

Household expenditure on power and water – **9.1 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)	2	2					a
r a e e r are (per e)	6 0	6 0	6 0	6 0	6 0	6 0	6 0
r a e e r are e pl y e (per e)	a	a	a	a	a	a	a
u ge ary u e a urre ra er (per e)						20	a
S are u ry al e pl y e (per e)	2 2	2	2		0	0	a
a ge la ur pr u y u ry (per e)	6 2		2	0	0	2	a
e e (per e)	26	2	2	2	26	26 0	a
EBRD index of small-scale privatisation							
EBRD index of large-scale privatisation	0	0	0	0	0	0	0
EBRD index of enterprise reform	2	2	0	0	0	0	0
S are a ere pr e (per e)		2	0		6	6	a
u er g a ere pr e a e	0	0	0	0	0	0	0
S are ra e ra u re (per e)		6	6			6	a
S are ra e (per e)				2	02	0	a
ar re e ue (per e p r)		2	2	2	0 6	0	a
EBRD index of price liberalisation	0	0	0	0	0	0	0
EBRD index of forex and trade liberalisation							
EBRD index of competition policy	2	2	2	2	2	2	2
u er a (re g e)	2 (6)	2 ( )	22 (6)	22 (6)	22 ( )	2 ( )	a
A e are a e e a (per e)	2			2	2 6	2 0	a
A e are re g e a (per e)		2	6		20	22 6	a
per r g l a (per e al l a)		0 0	0 0			6	a
e re pr a e e r (per e)		0	0 0	2		6	a
e re u e l (per e)		0	0	0	2 2		a
r gage le g (per e)			2 0	2	2	6	a
S ar e ap al a (per e)				2 2	2 2	2	a
S ra g lu e (per e ar e ap al a)	20	0	2	2		0	a
ur ua e (per e)	2 0	0	0 0	0 0	0	0 0	a
EBRD index of banking sector reform							
EBRD index of reform of non-bank financial institutions	2	2	2	2	2	2	2
e l e (le) pe e ra ra e (per 00 a a)	(6)	0 2 ( )	0 ( )	0 ( )	( )	( )	a
er e pe e ra ra e (per 0 000 a a)	0	2		2	26	26	a
a l ay la ur pr u y (00)	2 0	22		0	6 2		a
e e al ele r y ar (S)					2		a
A erage lle ra e ele r y (per e)	a	a			a	0	a
per u e ergy u e (S llar per g e)				2	a	a	a
EBRD index of infrastructure reform	2	0	0	0	0	0	0
Electric power	0	0	0	0	0	0	0
Railways	0	0	0	0	0	0	0
Roads	0	0	0	0	0	0	0
Telecommunications	2	0	0	0	0	0	0
Water and waste water							

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	4.1	2.7	3.5	2.7	4.4	4.0	4.5
Private consumption	0.7	2.3	1.3	3.5	2.6	3.4	na
Public consumption	2.6	3.9	3.2	1.6	3.4	2.2	na
Gross fixed capital formation	1.8	0.4	0.9	7.1	7.9	1.5	na
Exports of goods and services	13.2	6.3	6.7	3.1	12.5	10.5	na
Imports of goods and services	7.3	3.0	4.8	6.7	13.4	7.0	na
Industrial gross output	6.3	3.1	2.5	1.4	2.3	3.4	na
Agricultural gross output [1]	0.6	-4.0	13.2	-15.7	16.9	-5.1	na
Employment [2]			(Percentage change)				
Labour force (end-year)	1.4	1.0	-3.2	3.2	2.6	2.4	na
Employment (end-year)	2.6	0.6	-2.6	2.9	2.9	1.7	na
			(In per cent of labour force)				
Unemployment (end-year)	6.6	7.0	6.5	6.7	6.5	7.2	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	8.9	8.4	7.5	5.6	3.6	2.5	2.5
Consumer prices (end-year)	8.9	7.0	7.2	4.6	3.2	2.3	2.6
Producer prices (annual average)	7.6	9.0	5.2	2.6	4.3	2.7	na
Producer prices (end-year)	9.2	7.5	3.7	2.1	4.9	1.8	na
Gross average monthly earnings in economy (annual average) [3]	10.6	11.9	9.8	7.5	4.4	4.9	na
Government sector [4]			(In per cent of GDP)				
General government balance	-1.3	-1.3	-2.9	-1.3	-1.4	-1.1	-1.5
General government expenditure	43.0	44.0	43.6	44.0	44.1	44.4	na
General government debt	27.1	28.2	29.7	29.1	29.4	28.8	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	17.1	29.9	11.0	6.2	8.0	8.3	na
Domestic credit (end-year)	16.7	16.9	14.1	14.4	24.1	20.1	na
			(In per cent of GDP)				
Broad money (M2, end-year)	46.1	53.7	53.4	52.3	52.3	53.7	na
Interest and exchange rates			(In per cent per annum, end-year)				
Discount rate	8.2	7.8	7.3	5.0	3.3	3.8	na
Interbank market rate (average)	7.0	6.9	4.9	5.6	4.4	3.7	na
Deposit rate (31-90 days)	10.0	9.8	8.2	6.0	3.8	3.2	na
Lending rate (short-term consumer loans)	13.6	13.5	12.3	10.4	8.6	7.7	na
			(Tolars per US dollar)				
Exchange rate (end-year)	227.4	250.9	221.1	189.4	176.2	202.4	na
Exchange rate (annual average)	222.7	242.7	240.2	207.1	192.4	192.7	na
External sector			(In millions of US dollars)				
Current account	-548	37	335	-85	-670	-362	-673
Trade balance	-1,139	-615	-248	-622	-1,258	-1,270	-1,616
Merchandise exports	8,808	9,348	10,471	12,916	16,065	18,043	19,279
Merchandise imports	9,947	9,963	10,719	13,539	17,322	19,313	20,894
Foreign direct investment, net	71	226	1,489	-139	277	-72	88
Gross reserves, excluding gold (end-year)	3,196	4,330	6,980	8,497	8,793	8,076	na
External debt stock	8,830	9,168	12,043	16,746	20,801	23,082	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.4	4.5	6.7	6.5	5.3	4.4	na
			(In per cent of exports of goods and services)				
Debt service	9.6	14.6	14.6	16.6	16.9	16.6	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in billions of tolars)	4,300	4,800	5,355	5,814	6,272	6,620	6,987
GDP per capita (in US dollars)	9,704	9,995	11,174	14,105	16,382	17,263	na
Share of industry in GDP (in per cent)	30.0	30.1	29.6	29.8	29.3	na	na
Share of agriculture in GDP (in per cent)	3.2	3.0	3.2	2.6	2.7	na	na
Current account/GDP (in per cent) [5]	-2.8	0.2	1.5	-0.3	-2.1	-1.1	-2.0
External debt - reserves (in US$ million)	5,634	4,838	5,063	8,249	12,008	15,006	na
External debt/GDP (in per cent) [6]	45.7	46.4	54.0	59.7	63.8	67.2	na
External debt/exports of goods and services (in per cent)	82.6	81.2	94.2	106.6	106.6	104.7	na

[1] Agricultural value-added.

[2] Data based on labour force survey.

[3] Data for enterprises employing three or more persons until 2004. From 2005 onwards, data for legal persons with one or two employees in the private sector also taken into account.

[4] General government includes central government, municipalities and extra-budgetary funds. Data calculated according to GFS methodology from 2000.

[5] Ratio calculated in US dollars.

[6] Ratio calculated in US dollars.

Tajikistan

Key challenges

- Consolidation of the banking sector has progressed, but further financial reforms are required to meet the needs of domestic enterprises and individual customers.
- The government should continue the restructuring and privatisation of strategically important enterprises, as well as establishing sound regulatory frameworks.
- Although medium-term growth prospects are positive, the country remains dependent on a few sectors and further diversification of the economy is needed.

Country data

Population (in millions)	**6.5**
Area ('000 sq km)	**143.1**
GDP (in billion US$, 2005)	**2.3**
GDP per capita in 2005 at current international US$ (PPP)	**1,314**
National currency	**Somoni**

Progress in structural reform

Liberalisation and privatisation

By the end of 2005 around 8,700 entities had been privatised out of a total of 9,271 subject to sale. During 2005, 670 enterprises were sold, enabling the authorities to announce in January 2006 that the small-scale privatisation programme had been completed. The privatisation of large-scale enterprises has been less conclusive.

To meet the conditions of a World Bank loan, the authorities prepared individual plans for the restructuring of all strategically important enterprises by the end of 2005. However, there has since been limited progress in the implementation of these plans. The sale of Tadaz, the sole aluminium smelter accounting for half of the country's industrial output, had been expected by 2007, but the government announced in May 2006 that privatisation was no longer an option.

The business environment has been improving but is still perceived as difficult by foreign investors. The present limited ability for international investors to resolve disputes fairly outside of Tajikistan could be addressed through accession to the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

Infrastructure

There have been significant foreign investment commitments in infrastructure projects in recent years, mainly from Russia, China and Iran. The most advanced projects are the construction, with Iranian support, of the Anzob tunnel linking north and south Tajikistan, and the building of the Sangtuda hydropower plants, with funding from Iran and Russia's RAO UES.

Rusal, the major Russian aluminium producer, has agreed to invest over US$1 billion to complete the Rogun hydropower station. This power station will provide electricity to a planned smelter in the south of the country which will produce 200,000 tonnes of aluminium per year. The Tajik authorities are keen to diversify their sources of supply of alumina and they envisage signing a new contract with Kazakhstan for direct supply.

The Tajik authorities also reached an agreement in June 2006 with China on a US$600 million loan. The proceeds of this loan will be used to construct a 350km north-south power transmission line and a motorway linking the centre of Tajikistan to the Uzbek border in the north.

In March 2006 the state electricity company Barqi Tojik became a joint-stock company and is likely to be restructured as several separate entities. Nevertheless, electricity tariffs remain below cost-recovery levels and the regulatory framework is not independent. Restructuring and commercialisation of Tajikgas is also under way.

Financial sector

Good progress has been made in the consolidation of the banking sector, the number of commercial banks having fallen. To further strengthen the sector, all banks were required from January 2006 to meet the minimum capital requirement of US$5 million (more than double the previous requirement of US$2 million).

The banking sector was opened up to foreign investment in 2005, allowing foreign banks to establish subsidiaries. However, commercial banks have been cautious about expanding their lending activities. They have tended to focus on low-risk, short-term lending and on the recovery of existing loans. The main sources of profit remain money transfers and foreign exchange operations, rather than lending activities, and the volume of credit to the private sector consequently remains low.

Social sector

The proportion of the population living below the poverty line (defined as those living on less than US$2.15 per day at purchasing power parity) declined to 64 per cent in 2003, from 81 per cent in 1999, according to a poverty reduction strategy paper published in January 2006. Consumption levels have improved for the entire population, mainly due to strong economic growth and continued foreign remittance inflows. The improvements are larger in rural areas, although the situation in the countryside is generally more dire than in urban areas. Despite recent progress in poverty reduction, Tajikistan remains the poorest transition country. To continue its efforts to reduce poverty and achieve Millennium Development Goals, the government has drawn up a national development strategy covering 2007-15 to meet international targets on poverty reduction. The second Poverty Reduction Strategy (2007-09) is also under development.

Macroeconomic performance

Real economy

Real GDP grew by 6.9 per cent in 2005 and by 7.5 per cent in the first eight months of 2006 – below the average 10 per cent recorded annually over the previous five years. The slowdown reflected a fall in cotton production (which declined by 20 per cent in 2005) as well as lower electricity production. Farm incomes were affected adversely by high fuel and low cotton prices. Nevertheless, domestic demand generally remained strong, fuelled by wage growth and an increasing flow of remittances from workers abroad.

Economic policies

There was an overall fiscal surplus of 0.5 per cent of GDP in 2005 (excluding public investment programmes). Revenues were boosted by higher income tax receipts as household incomes rose, as well as by improved tax collection. A new tax code in 2005 has simplified the tax structure and eliminated a number of distortions. Government expenditure was lower than expected in 2005, partly due to the introduction of new management systems, but also to spending shortfalls. There was an increase in inflationary pressure in the first half of 2006 due to higher prices for food and services. The monetary authorities aim to develop marketable government securities to broaden the range of monetary policy instruments.

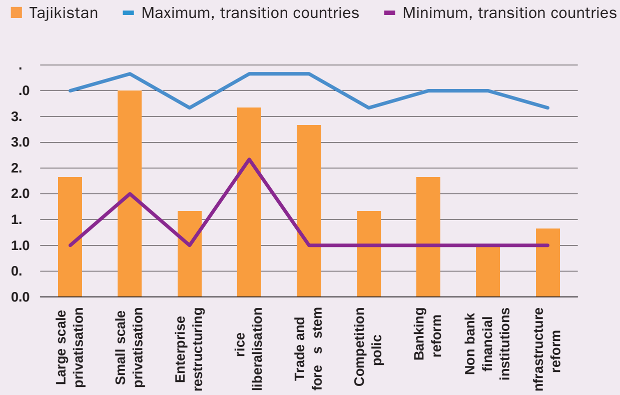
External sector

Following a series of debt reduction agreements, the level of public external debt declined to US$828 million by mid-2006, equivalent to about 32 per cent of GDP (down from more than 80 per cent in 2002). These agreements include Russia's cancellation in 2005 of US$306 million of debt as part of a debt-equity swap, and the IMF's debt relief of US$99 million under the Multilateral Debt Relief Initiative in early 2006. However, debt ratios are set to increase when new loans from China are received (see 'Infrastructure' section). Moreover, there is a growing concern over the level of debt among farmers in the cotton sector. Cotton farmers have accumulated approximately US$280 million in debt, of which the majority was owed to foreign creditors through domestic intermediaries. This amount increased to over US$300 million by mid-2006 (representing over 200 per cent of cotton exports).

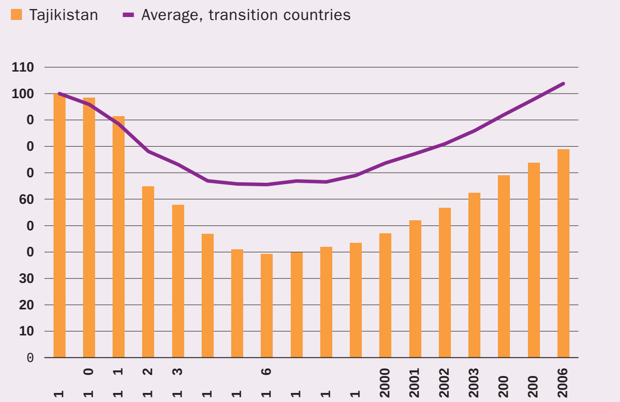
Outlook and risks

The economy is expected to return to high growth in the medium term, reflecting higher incomes and growing remittances. The large investment commitments from China, Russia and Iran should meanwhile result in higher production, and also provide opportunities for closer bilateral trade and business links. However, Tajikistan's economy remains dependent on a few key sectors – aluminium, cotton and power – which are vulnerable to large fluctuations in prices and demand.

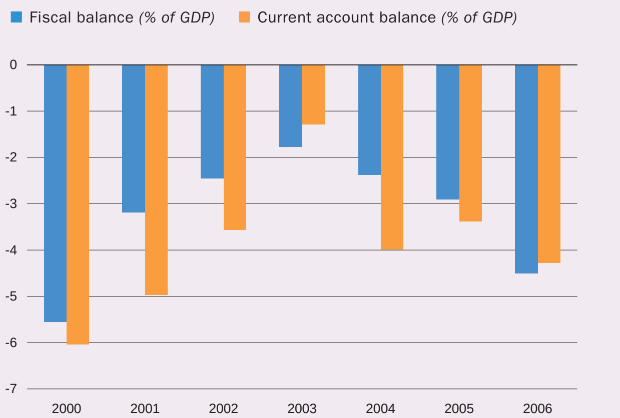
Transition indicators, 2006



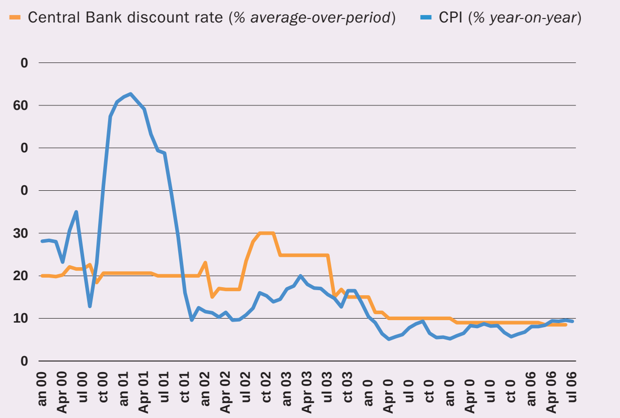
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no** [1]

Interest rate liberalisation – **full**

Exchange rate regime – **managed floating**

Wage regulation – **yes**

Tradability of land – **limited de jure**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **very low**

Secured transactions law – **malfunctioning**

Quality of corporate governance law – **very low**

Infrastructure

Independent telecoms regulator – **no**

Independent electricity regulator – **no**

Separation of railway infrastructure from operations – **no**

Independence of the road directorate – **no**

Quality of concession laws – **very low**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **low**

Private pension funds – **no**

Social reform

Share of population living in poverty – **42.8 per cent** (2003) [2]

Government expenditure on health – **1.3 per cent of GDP**

Government expenditure on education – **3.5 per cent of GDP**

Household expenditure on power and water – **6.0 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)	6			6	6	2	a
r a e e r are (per e)	0 0	0	0 0	0 0	0 0	0	0
r a e e r are e pl y e (per e)	60 0	62	6	6 0	6 0	a	a
u ge ary u e a urre ra er (per e)	0	0	0	0	0	0	a
S are u ry al e pl y e (per e)	6	6	6 6	6	6	a	a
a ge la ur pr u y u ry (per e)	2 2	2	2	6 6	0		a
e e (per e)	2					6	a
EBRD index of small-scale privatisation						0	0
EBRD index of large-scale privatisation	2	2	2	2	2	2	2
EBRD index of enterprise reform							
S are a ere pr e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	0 0
u er g a ere pr e a e	0 0	0 0	0 0	0 0	0 0	0 0	0 0
S are ra e ra u r e (per e)			2	6			a
S are ra e (per e)	6 0		2	22	2	0 6	a
ar re e ue (per e p r)		2	2 6	2	2	2 2	a
EBRD index of price liberalisation							
EBRD index of forex and trade liberalisation							
EBRD index of competition policy	2 0						
u er a (re g e)	6 ( )	( )	( )	( )	2 ( )	2 ( )	a
A e are a e e a (per e)	6			6	2 2		a
A e are re g e a (per e)		0		6	6 2		a
per r g l a (per e al l a)	0	2	2	6			a
e re pr a e e r (per e)		6		0	a	6 2	a
e re u e l (per e)	a	a	a	0			a
r gage le g (per e)	a	a	a	a	a	a	a
S ar e ap al a (per e)	a	a	a	a	a	a	a
S ra g lu e (per e ar e ap al a)	a	a	a	a	a	a	a
ur ua e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
EBRD index of banking sector reform	0	0			2 0	2 0	2
EBRD index of reform of non-bank financial institutions	0	0	0	0	0	0	0
e l e (le) pe e ra ra e (per 00 a a)	6 (a)	(a)	(0 2)	(0)	(2)	( )	a
er e pe e ra ra e (per 0 000 a a)	0	0	0	0	0 2	0 2	a
a l ay la ur pr u y (00)	62	2	0		0		a
e e al ele r y ar (S)	0	0	0	0	0 6	a	a
A erage lle ra e ele r y (per e)	a	a	6				a
per u e ergy u e (S llar per g e)				2	a	a	a
EBRD index of infrastructure reform	0	0	0	0			
Electric power	0	0	0	0			2 0
Railways	0	0	0	0	0	0	0
Roads	0	0	0	0	0	0	0
Telecommunications	0	2	2	2	2	2	2
Water and waste water	0	0	0	0	0	0	0

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	8.3	10.2	9.1	10.2	10.6	6.9	7.0
Industrial gross output	10.3	14.4	6.3	9.9	13.8	8.5	na
Agricultural gross output	12.4	11.0	14.0	9.1	11.3	3.1	na
Employment			(Percentage change)				
Labour force (end-year)	0.2	4.3	1.7	1.5	-0.7	1.0	na
Employment (end-year)	0.4	4.8	1.5	1.7	-0.7	0.9	na
			(In per cent of labour force)				
Unemployment (end-year) [1]	2.7	2.3	2.5	2.2	2.2	2.3	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	32.9	38.6	12.2	16.3	7.1	7.0	9.2
Consumer prices (end-year)	60.8	12.5	14.5	13.7	5.6	6.8	9.8
Producer prices (annual average)	43.5	28.7	10.1	15.0	17.1	10.7	na
Producer prices (end-year)	33.9	9.4	19.0	14.1	15.1	5.6	na
Gross average monthly earnings in economy (annual average)	25.8	50.6	38.6	36.9	36.3	43.1	na
Government sector [2]			(In per cent of GDP)				
General government balance	-5.6	-3.2	-2.5	-1.8	-2.4	-2.9	-4.5
General government expenditure	19.2	18.4	19.2	19.1	20.3	23.0	na
General government debt	124.5	97.0	78.8	63.0	39.4	38.4	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	70.1	40.0	39.7	29.3	14.3	25.8	na
Domestic credit (end-year)	14.5	95.0	14.0	-6.5	24.3	7.6	na
			(In per cent of GDP)				
Broad money (M2, end-year)	8.5	8.6	9.0	8.2	7.2	7.8	na
Interest and exchange rates			(In per cent per annum, end-year)				
Monetary policy rate	20.6	23.4	21.0	15.0	10.0	9.0	na
Deposit rate (up to 3 months)	41.3	25.5	12.1	14.6	8.6	7.3	na
Lending rate (up to 3 months)	18.3	21.3	12.1	15.6	21.3	18.7	na
			(Somoni per US dollar)				
Exchange rate (end-year) [3]	2.2	2.5	3.0	2.9	3.0	3.2	na
Exchange rate (annual average) [3]	1.8	2.4	2.8	3.1	3.0	3.1	na
External sector			(In millions of US dollars)				
Current account	-60	-52	-43	-20	-82	-78	-110
Trade balance	-43	-104	-94	-103	-151	-319	-372
Merchandise exports	791	673	730	900	1,088	1,107	1,336
Merchandise imports	834	777	824	1,003	1,239	1,426	1,708
Foreign direct investment, net	24	9	36	32	272	36	60
Gross reserves, excluding gold (end-year)	87	96	96	135	189	235	na
External debt stock	1,226	1,022	1,010	1,031	822	872	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	1.2	1.4	1.2	1.4	1.6	1.7	na
			(In per cent of exports of goods and services)				
Debt service	9.2	16.1	14.1	6.0	6.1	5.9	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	6.2	6.3	6.4	6.5	6.5	6.5	na
GDP (in millions of somoni)	1,810	2,510	3,340	4,760	6,160	7,200	8,400
GDP per capita (in US dollars)	160	168	187	239	319	356	na
Share of industry in GDP (in per cent) [4]	23.9	22.7	22.1	20.9	19.6	21.3	na
Share of agriculture in GDP (in per cent) [4]	27.0	26.5	26.3	25.2	21.6	17.2	na
Current account/GDP (in per cent)	-6.0	-5.0	-3.6	-1.3	-4.0	-3.4	-4.3
External debt - reserves (in US$ million)	1,139	926	914	896	633	637	na
External debt/GDP (in per cent)	124.5	97.0	84.0	66.3	39.7	37.7	na
External debt/exports of goods and services (in per cent)	142.9	138.6	126.2	105.6	70.9	73.5	na

[1] Officially registered unemployed. The World Bank estimates the true unemployment rate in 2000 was more than 30 per cent of the labour force.

[2] Government sector includes externally financed public investment programmes.

[3] Tajik roubles (until October 2000) have been converted to somoni.

[4] Figures are based on current prices. Variations in the shares reflect changes in relative prices.

Turkmenistan

Key challenges

- The government must reduce its dominant influence in all spheres of economic activity, particularly trade, banking and the foreign exchange system, to stimulate entrepreneurship and competition.
- Improvements in the management and transparency of extra-budgetary funds, including oil and gas revenues, are urgently needed.
- High hydrocarbon prices should continue to generate strong growth, but more investment in the country's gas pipeline capacity is necessary and the economy remains vulnerable to external shocks.

Country data	
Population (in millions)	**6.5**
Area ('000 sq km)	**488.0**
GDP (in billion US$, 2005)	**8.3**
GDP per capita in 2004 at current international US$ (PPP)	**5,326**
National currency	**Manat**

Progress in structural reform

Liberalisation and privatisation

Virtually no progress has been made relating to enterprise privatisation or liberalisation of the restrictive trade and foreign exchange regime in 2005–06. Enterprise privatisation has been limited, particularly for large-scale enterprises. Entities in the energy, transport and telecommunications sectors have been formally excluded from privatisation until at least 2020. Approval from the State Commodity Exchange is required for all trade transactions, and access to foreign exchange auctions is restricted to those with official sanction.

In March 2006 the Foreign Affairs Committee of the European Parliament approved a proposal (initiated in 1997) for an interim trade agreement with Turkmenistan, with a view to strengthening cooperation in the energy sector. However, full parliamentary approval, which was scheduled in April 2006, has been delayed due in part to concerns about Turkmenistan's human rights record.

Business environment and competition

Further to the introduction of a new tax code in October 2004, the authorities simplified the tax system for domestic private companies in December 2005. Five different taxes on domestic private companies, including the profit tax of 8 per cent and value added tax (VAT) of 15 per cent, were unified into a single tax of 2 per cent on total turnover. The authorities stressed that the changes were mainly to improve the business environment rather than to increase tax revenue.

The business environment in Turkmenistan nevertheless remains among the most difficult in the region. There are severe impediments, including pervasive administrative interventions, widespread corruption, substantial restrictions on trade, the dual exchange rate system and limited access to finance. Foreign investors are also concerned about frequent changes of government officials and policies. Foreign direct investment (FDI) is restricted to only a few sectors, mainly oil and gas and textiles. All foreign investments must be approved by the Ministry of Economy and Finance. (The State Agency for Foreign Investment, which had been responsible for the approval and registration of all foreign investments, was abolished in September 2006.) In addition, major projects and contracts must receive presidential approval. In April 2006 the president reiterated that foreign investors will not be allowed to own a controlling stake in any onshore oil or gas developments in the country.

Infrastructure

Turkmenistan has been keen to expand and diversify its gas transport capability, as the main Central Asia Centre pipeline (controlled by Russia) reaches the limits of its capacity. In May 2006 India joined the Turkmenistan-Afghanistan-Pakistan (TAP) pipeline project, the protocol for which had been signed by the three original members in April 2005. However, the feasibility of the venture depends critically on the establishment of political stability in Afghanistan, as well as the financing of the project costs estimated at US$3.5 billion. In April 2006 Turkmenistan and China agreed to build a gas pipeline capable of supplying 30 billion cubic metres (bcm) of gas annually to China for 30 years from January 2009. Moreover, five European countries (Austria, Turkey, Bulgaria, Romania and Hungary) have signed an agreement for the construction of a 3,300 km gas pipeline (the Nabucco project) to transport around 30 bcm of gas a year from the energy-rich Central Asian states, including Turkmenistan, to Turkey and the EU countries.

The oil and gas sector was restructured in December 2005 to limit the controlling power of state oil and gas companies. However, the role of the president in this sector has been increased through the establishment of a new government body responsible for hydrocarbon resources and oil field development.

Social sector

Over the past year there has been a deterioration in the social sector in Turkmenistan, including the closure of a number of libraries and health care centres, particularly in rural areas. In January 2006 the authorities adopted a new pension law, reducing state support in areas such as maternity and sick leave payments and cancelling state pensions for 100,000 senior citizens. Pension payments for those still eligible were reduced by more than 30 per cent. The law also raised the retirement age from 60 to 62 years for men and from 55 to 57 years for women. While the authorities claim that the new law was introduced to switch the state-funded pension system to a "voluntary" contribution programme, other reports indicate that the measures were aimed at reducing state spending.

Macroeconomic performance

Real economy

Real production growth was 20.7 per cent in 2005, according to official statistics, although the IMF estimates a lower real GDP growth rate of about 9.5 per cent. Even at the lower estimate, growth was impressive, due largely to high hydrocarbon exports from increased oil and gas prices and public investment programmes. There was little growth in the agriculture sector in 2005, with no increase in the production of cotton, a key agricultural product.

Economic policies

According to official figures, a budget surplus of 0.9 per cent of GDP was recorded in 2005. Although further details are not known, this was most likely attributable to expenditure cuts. The state budget for 2006 was approved without a deficit, although reductions in funding for health, education and pensions suggest that public finances may be less positive than official data indicate. Much of the country's financial assets, especially derived from its oil and gas revenues, continue to be kept in extra-budgetary state funds that are separate from the official budget. Moreover, the spending and investment operations of these funds are predominantly under the control of the president and without proper regulation and transparency. Monetary policy is inflexible. The official exchange rate remains fixed, even though the parallel market rates are approximately five times the official rate. Inflation was at 10.4 per cent at the end of 2005, slightly up from 9 per cent in 2004 due to higher food prices.

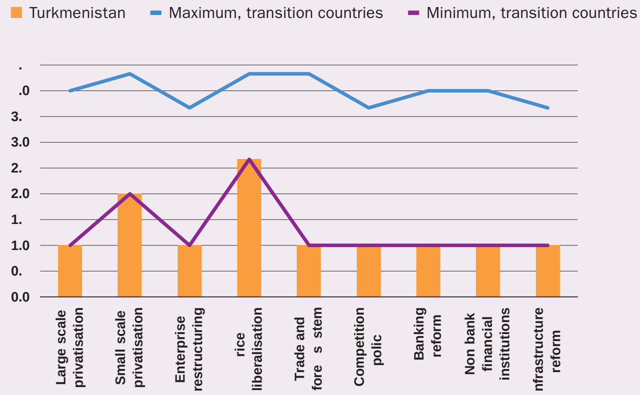
External sector

Due to strong export performance on the back of higher international energy prices, the trade surplus in 2005 reached approximately US$1.3 billion (15.6 per cent of GDP), the highest level since independence. Accordingly, the current account surplus surged to an estimated 7.4 per cent of GDP, up from 1.2 per cent in 2004. In December 2005 Turkmenistan reached agreement with Russia to raise gas export prices from US$44 to US$65 per thousand cubic metres (tcm) and annual export volumes from about 4 bcm to 30 bcm for 2006. In September 2006 the price was raised further to US$100 per tcm for the additional export of 12 bcm in 2006 and 50 bcm annually from 2007-09. In February 2006 Turkmenistan also reached agreement with Iran to increase gas export prices (from US$42 to US$65 per tcm) and export volumes (from around 6 bcm to 14 bcm per year) from 2007.

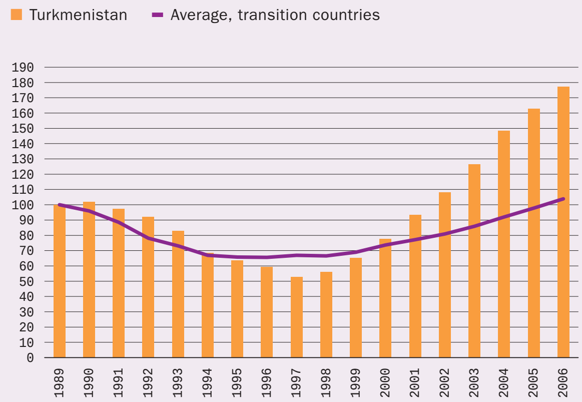
Outlook and risks

The economic outlook remains heavily dependent on developments in the hydrocarbon sector. While the long-term gas supply deal with Russia concluded in 2003, the September 2006 agreement on export prices and the development of offshore oil production and the oil refining industry may support real GDP growth of around 7 per cent per year over the medium term. However, the over-dependency on hydrocarbons and the failure to reform the economic system leave the economy vulnerable to external shocks. There are also constraints relating to gas production and pipeline capacity. The mismanagement of public resources and the continued deterioration in social services may also undermine economic sustainability and political stability.

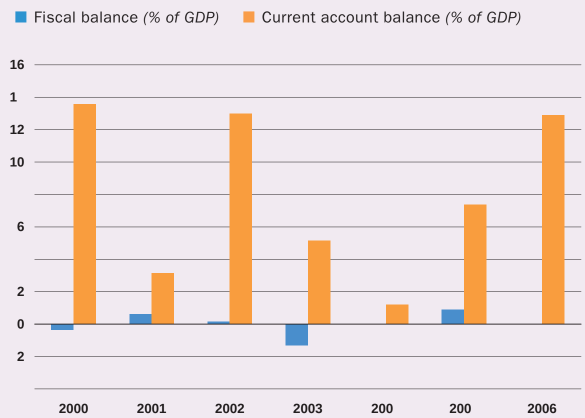
Transition indicators, 2006



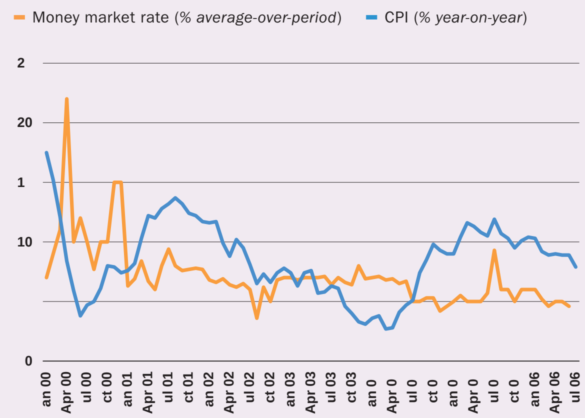
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **limited**	Competition office – **no**	Independent telecoms regulator – **no**	Capital adequacy ratio – **10 per cent**[2]	Share of population living in poverty – **44 per cent** (1998)
Controls on inward direct investment – **no**[1]	Quality of insolvency law – **very low**	Independent electricity regulator – **no**	Deposit insurance system – **no**	Government expenditure on health – **2 per cent of GDP**
Interest rate liberalisation – **limited de jure**	Secured transactions law – **malfunctioning**	Separation of railway infrastructure from operations – **no**	Quality of securities market laws – **very low**	Government expenditure on education – **5.4 per cent of GDP**
Exchange rate regime – **fixed**	Quality of corporate governance law – **low**	Independence of the road directorate – **no**	Private pension funds – **no**	Household expenditure on power and water – **0.3 per cent**
Wage regulation – **yes**		Quality of concession laws – **low**		
Tradability of land – **limited de jure**				

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)	0 6	0 6	0 6	0 6	0 6	0 6	a
r a e e r are (per e)	2 0	2 0	2 0	2 0	2 0	2 0	2 0
r a e e r are e pl y e (per e)	a	a	a	a	a	a	a
u ge ary u e a urre ra er (per e)	a	a	a	a	a	a	a
S are u ry al e pl y e (per e)	0				0	a	a
a ge la ur pr u y u ry (per e)	2	0 6		0	2 0	a	a
e e (per e)	6		2 6	2	2	a	a
EBRD index of small-scale privatisation	2 0	2 0	2 0	2 0	2 0	2 0	2 0
EBRD index of large-scale privatisation		0	0	0	0	0	0
EBRD index of enterprise reform	0	0	0	0	0	0	0
S are a ere pr e (per e)	6	6	6	6	6	a	a
u er g a ere pr e a e	0	0	0	0	0	0	a
S are ra e ra u re (per e)		0			2	6 0	a
S are ra e (per e)	0	2 0	0	02		02	a
ar re e ue (per e p r)	a	a	a	a	a	a	a
EBRD index of price liberalisation	2	2	2	2	2	2	2
EBRD index of forex and trade liberalisation	0	0	0	0	0	0	0
EBRD index of competition policy	0	0	0	0	0	0	0
u er a (re g e)	( )	( )	( )	2 ( )	( )	( )	a
A e are a e e a (per e)		6		6	a	a	a
A e are re g e a (per e)				6	a	a	a
per r g l a (per e al l a)	0 2	0	0	0	a	a	a
e re pr a e e r (per e)	2 2	2 0			a	a	a
e re u e l (per e)	a	a	a	a	a	a	a
r gage le g (per e)	a	a	a	a	a	a	a
S ar e ap al a (per e)	a	a	a	a	a	a	a
S ra g lu e (per e ar e ap al a)	a	a	a	a	a	a	a
ur ua e (per e)	0 0	0 0	0 0	0 0	0 0	0 0	a
EBRD index of banking sector reform	0	0	0	0	0	0	0
EBRD index of reform of non-bank financial institutions	0	0	0	0	0	0	0
e l e (le) pe e ra ra e (per 00 a a)	2 (0 2)	0 (0 2)	(0 2)	(0 2)	(0)	(0)	a
er e pe e ra ra e (per 0 000 a a)	2		2		2	2	a
a l ay la ur pr u y (00)	2	26	2		0		a
e e al ele r y ar (S)	0	0	0	0	0	0	a
A erage lle ra e ele r y (per e)	0	a	6	a	a	a	a
per u e ergy u e (S llar per g e)	2				a	a	a
EBRD index of infrastructure reform	0	0	0	0	0	0	0
Electric power	0	0	0	0	0	0	0
Railways	0	0	0	0	0	0	0
Roads	0	0	0	0	0	0	0
Telecommunications	0	0	0	0	0	0	0
Water and waste water	0	0	0	0	0	0	0

	2000	2001	2002	2003	2004	2005 Estimate	2006 Projection
Output and expenditure			(Percentage change in real terms)				
GDP [1]	18.6	20.4	15.8	17.1	17.2	9.6	9.0
Private consumption	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na
Exports of goods and services	92.6	4.8	13.0	4.0	na	na	na
Imports of goods and services	14.9	20.1	-3.7	4.3	na	na	na
Industrial gross output	21.0	16.8	12.8	13.5	16.4	8.5	na
Agricultural gross output	17.0	23.0	9.5	9.5	13.0	4.0	na
Employment			(Percentage change)				
Labour force (end-year)	3.1	3.2	3.2	3.0	3.0	0.0	na
Employment (end-year)	3.0	2.0	2.5	2.2	na	na	na
			(In per cent of labour force)				
Unemployment [2]	27.9	28.8	29.3	29.8	30.2	na	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	8.3	11.6	8.8	5.6	5.9	10.7	9.0
Consumer prices (end-year)	7.4	11.7	7.8	3.1	9.0	10.4	8.0
Producer prices (annual average)	na	na	na	na	na	na	na
Producer prices (end-year)	na	na	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	80.4	47.1	8.2	84.2	5.7	21.6	na
Government sector [3]			(In per cent of GDP)				
General government balance	-0.3	0.6	0.2	-1.3	0.0	0.9	0.0
General government expenditure	23.9	21.1	18.1	19.4	19.6	18.8	na
General government debt	na	na	na	na	na	na	na
Monetary sector			(Percentage change)				
Broad money (M3, end-year)	94.6	16.7	1.5	40.9	13.4	27.2	na
Domestic credit (end-year)	24.4	7.7	-2.9	-0.6	3.6	0.6	na
			(In per cent of GDP)				
Broad money (M3, end-year)	19.4	16.1	13.0	13.9	12.9	13.0	na
Interest and exchange rates			(In per cent per annum, end-year)				
Refinance rate	20.0	12.0	12.0	10.0	5.0	5.0	na
Interbank market rate	15.0	7.7	7.0	6.9	4.6	6.0	na
Deposit rate (up to 1 year) [4]	22.8	16.9	17.8	15.4	11.3	8.6	na
Lending rate (up to 1 year) [4]	27.9	26.7	21.9	20.4	17.3	17.3	na
			anats per dollar				
Exchange rate (end-year) [5]	9,790.0	10,060.0	10,150.0	10,390.0	10,540.0	10,870.0	na
Exchange rate (annual average)	8,478.6	9,827.9	10,097.5	10,033.5	10,375.0	11,015.2	na
External sector			(In millions of US dollars)				
Current account	411	116	583	305	84	616	1,295
Trade balance	766	515	1,030	886	706	1,302	1,963
Merchandise exports	2,508	2,623	2,862	3,465	3,854	4,939	5,935
Merchandise imports	1,742	2,108	1,832	2,579	3,148	3,637	3,972
Foreign direct investment, net	131	170	276	226	354	320	300
Gross reserves, excluding gold (end-year) [6]	1,808	2,055	2,346	2,673	2,714	3,442	na
External debt stock	2,184	1,865	1,660	1,519	1,273	1,007	na
			n mont s of imports of goods and services				
Gross reserves, excluding gold (end-year)	9.2	9.1	11.8	9.5	8.0	8.9	na
			n per cent of exports of goods and services				
Debt service [7]	14.2	17.3	14.3	11.6	9.6	5.6	na
Memorandum items			*Denominations as indicated*				
Population (end-year, million)	5.4	5.6	5.8	6.2	6.5	6.5	na
GDP (in billions of manats)	25,648	36,052	45,240	59,405	72,706	91,863	109,143
GDP per capita (in US dollars)	563	650	774	955	1,078	1,283	na
Share of industry in GDP (in per cent)	45.8	39.8	40.9	39.7	38.6	na	na
Share of agriculture in GDP (in per cent)	24.5	23.0	21.8	19.6	18.4	na	na
Current account/GDP (in per cent)	13.6	3.2	13.0	5.2	1.2	7.4	12.9
External debt - reserves (in US$ million)	376	-190	-686	-1,154	-1,441	-2,435	na
External debt/GDP (in per cent)	72.2	50.8	37.1	25.7	18.2	12.1	na
External debt/exports of goods and services (in per cent)	78.7	64.8	53.9	40.8	30.2	18.9	na

2

Ukraine

Key challenges

- Good governance and transparency should be top priorities. This includes improving company law, combating corruption at all levels, advancing judicial reform, and maintaining a level playing field for all private enterprises.
- In light of rising gas import prices, the authorities must continue to promote investment in energy-saving technologies and increase private sector participation in Ukraine's energy sector.
- To better withstand adverse external shocks, fiscal discipline should be maintained and the National Bank should be given full independence to target price stability while allowing greater exchange rate flexibility.

Country data	
Population (in millions)	**47.1**
Area ('000 sq km)	**603.7**
GDP (in billion US$, 2005)	**78.7**
GDP per capita in 2005 at current international US$ (PPP)	**6,810**
National currency	**Hryvnia**

Progress in structural reform

Liberalisation and privatisation

Net privatisation receipts peaked at US$4.1 billion in 2005, mainly due to the resale of Kryvorizhstal, Ukraine's largest steel mill, to Mittal Steel for UAH 24.2 billion (US$4.8 billion) in October. However, privatisation slowed in 2006. As of September, privatisation revenues totalled only UAH 0.3 billion (US$60 million), well below the UAH 2.1 billion (US$416 million) budgeted for the year. In an attempt to meet the 2006 privatisation target, 48 additional companies have been planned for sale, including the state insurance company Oranta and some ore mines.

Progress towards World Trade Organization (WTO) membership has been made with bilateral accession protocols with the United States and Australia being signed in March and May 2006 respectively. As of mid-September 2006, only the Kyrgyz Republic and Taipei China still had to endorse Ukraine's bid for WTO accession. However, in the multilateral negotiations Ukraine has yet to finalise a number of outstanding issues that require approval by the parliament, such as export tariffs on scrap metals and state support for agriculture.

Infrastructure

A dispute over gas supplies between Ukraine and Russia in January 2006 led to a disruption in supply to Western Europe at the beginning of the year. Under an agreement reached on 4 January, RosUkrEnergo (an intermediary owned by Gazprombank and two Ukrainian businessmen) will deliver gas at the Ukrainian border at a fixed price of US$95 per thousand cubic metres (tcm). While this price (almost double what Ukraine paid in 2005) has been fixed until the end of 2006, it is likely to be renegotiated in the future as Turkmenistan, a main supplier of the gas Gazprom sells to RosUkrEnergo, has increased its own gas export prices. Given the uncertainty regarding future gas import prices, diversification of energy suppliers and fuel mix have become key priorities for Ukraine. In this context, there have been safety upgrades at the nuclear power generating facilities at Khmelnitsky and Rivne, but much remains to be done to improve nuclear safety, including at the Chernobyl plant.

Only part of the increase in gas import prices was passed on to end-consumers. This caused a rapid deterioration in the financial position of Naftogaz Ukrainy, the state-owned gas trading monopoly, during the first half of 2006. While the average tariff for industrial users was raised to US$100 per tcm in January, residential tariffs were raised only after the March parliamentary elections. The cost of gas and electricity increased by 25 per cent in May to UAH 0.22 (3.4 euro cents) per tcm and UAH 0.195 (3.1 euro cents) per kWh respectively. Residential gas tariffs were further increased by 85 per cent in July, leaving the monthly bill for utilities about 12 per cent higher on average. In September 2006 the power sector regulator approved a timetable for semi-annual increases in electricity prices until 2008, starting with a 25 per cent increase. If implemented, these measures would help reduce the degree of cross-subsidisation in the economy and avert the accumulation of quasi-fiscal losses.

Tariffs for public railway transportation were increased by 26.6 per cent in June 2006, while tariffs on telecommunications have been rebalanced (up by 25 per cent on average, with the cost of local calls increasing faster than that for long-distance). Plans to sell shares in the incumbent fixed-line telecommunications operator Ukrtelecom have been delayed repeatedly, but there has been substantial foreign investment in the mobile telecommunications market. With five GSM operators in Ukraine, competition is increasing and mobile penetration rates are rising, although from a low base.

Financial sector

Foreign participation in the banking sector has increased further since the acquisition of Aval Bank by Raiffeisen International in October 2005. In February 2006 Italy's Banca Intesa reached an agreement to buy an 85 per cent stake in Ukrsotsbank, the sixth-largest bank, for US$1.3 billion. In April 2006 BNP Paribas acquired a 51 per cent stake in UkrSibbank, the fourth-largest Ukrainian bank by size of assets. Foreign investors have also acquired a number of other smaller banks, bringing the share of foreign capital in the Ukrainian banking sector to about 24 per cent by mid-2006.

Bank lending continued to expand in 2006, due in part to increased liquidity in the money market and a further loosening in monetary policy. By June 2006, bank loans had increased by almost 55 per cent year-on-year in real terms to 40 per cent of GDP, while real deposits rose more slowly by 33 per cent. Consumer loans and mortgages in foreign currency have been among the fastest growing categories, raising concerns about asset quality and risk management in under-capitalised banks. A number of Ukrainian banks and corporates tapped the local and international capital markets. Municipal bonds were issued by the cities of Kharkiv, Donetsk, Zaporizhzhya and Odessa in 2005, while the city of Kiev issued a 10-year eurobond of US$250 million in October that year.

Macroeconomic performance

Real economy

The economy showed resilience despite higher energy prices in the first half of 2006. According to preliminary estimates, GDP growth accelerated to 5.7 per cent in the year to end-August, from 2.6 per cent at the end of 2005. On the supply side, retail trade, transport and communications were the fastest growing sectors, while higher international prices for steel and other metals fuelled the recovery in industry. A boom in private consumption and an upturn in fixed capital investment boosted growth on the demand side.

Economic policies

Despite higher gas import prices, the rate of inflation slowed to 6.8 per cent in June 2006 from 10.3 per cent at the end of 2005. This was due largely to lower food prices (accounting for about 65 per cent of the consumer price index) and tighter budgetary management. The National Bank of Ukraine (NBU) in June 2006 cut its reference rate by one percentage point to 8.5 per cent. It also announced further cuts in mandatory reserve requirements for commercial banks following an initial cut of 200 basis points in May.

Revenue collection was on target in the first half of 2006, due to growing value added tax (VAT) and personal income tax receipts which counterbalanced a fall in corporate income tax payments. Although expenditure was less than projected, there was a state deficit of about 0.5 per cent of GDP in the first half of the year. However in September the new government approved a draft budget for 2007, which envisages an increase in state budget deficit to 2.6 per cent of GDP. It also announced further cuts in corporate tax and VAT from 2008 to reduce the tax burden and stimulate long-term growth.

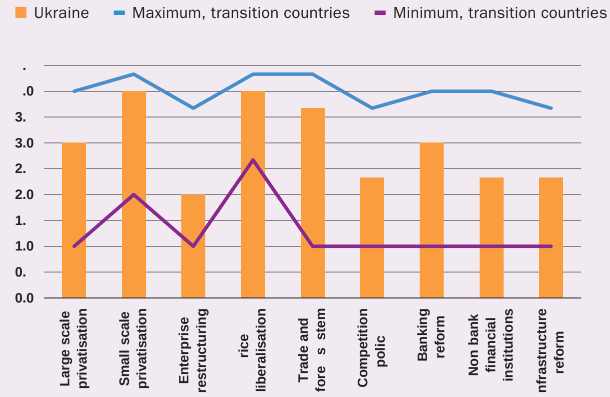
External sector

A deceleration in export growth and a surge in imports, inflated by the increase in energy import prices at the beginning of 2006, caused the rapid weakening of Ukraine's current account balance in the first half of the year. Net FDI inflows of US$ 2.1 billion have largely offset the flight of short-term capital recorded during that period. Gross international reserves recovered to US$ 18.7 billion in August 2006 after falling earlier in the year. The government is planning to issue up to US$ 1 billion in eurobonds in the second half of 2006.

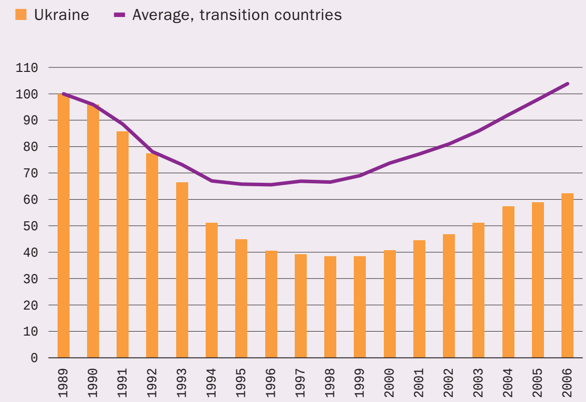
Outlook and risks

Although growth has accelerated during 2006, short-term economic risks remain. The economy is highly vulnerable to further increases in energy import prices and to swings in metal prices, the main export commodity. The declining trend in inflation may reverse in the second half of 2006 owing to the impact of higher utility tariffs, especially for energy. Higher energy prices could also have adverse effects on companies' performance and, ultimately, on the state budget. In the long term, gradual convergence of domestic energy prices to international levels will be key to stimulating investment, not only in the energy sector but also in energy-saving technology throughout the economy. Ukraine remains one of the most energy intensive and inefficient countries in the region.

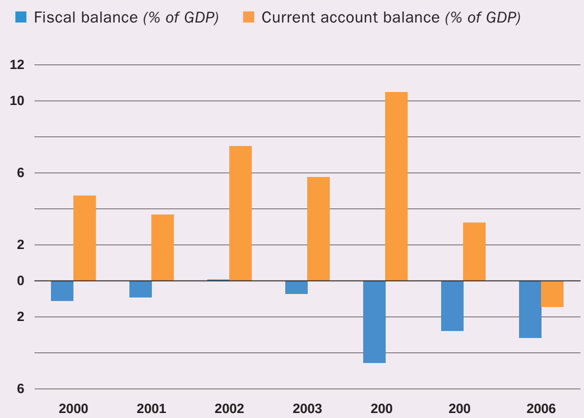
Transition indicators, 2006



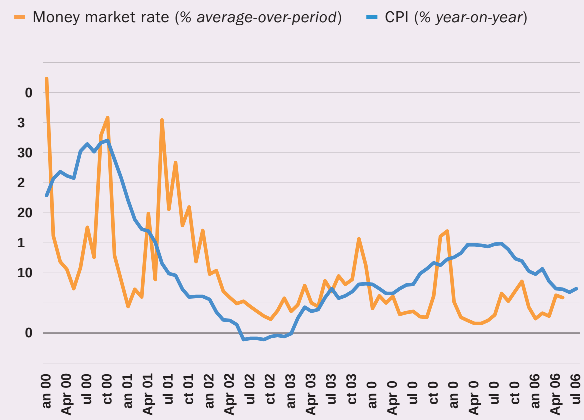
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no** [1]

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradability of land – **limited de facto**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **very low**

Secured transactions law – **modern/some defects**

Quality of corporate governance law – **very low**

Infrastructure

Independent telecoms regulator – **partially**

Independent electricity regulator – **partially**

Separation of railway infrastructure from operations – **no**

Independence of the road directorate – **partially**

Quality of concession laws – **medium**

Financial sector

Capital adequacy ratio – **10 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **high**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **4.9 per cent** (2003) [2]

Government expenditure on health – **3.5 per cent of GDP**

Government expenditure on education – **5.1 per cent of GDP**

Household expenditure on power and water – **3.2 per cent**

	2000	2001	2002	2003	2004	2005	2006
r a a re e ue (u ula e per e)			6 0				a
r a e e r are (per e)	60 0	60 0	6 0	6 0	6 0	6 0	6 0
r a e e r are e pl y e (per e)	2	0	6		a	a	a
u ge ary u e a urre ra er (per e)			2	2 2	2 2	2 0	a
S are u ry al e pl y e (per e)		2 0	20	20	20	a	a
a ge la ur pr u y u ry (per e)				2 2		a	a
e e (per e)		2	20 2	20	2 2	22 2	a
EBRD index of small-scale privatisation				0	0	0	0
EBRD index of large-scale privatisation	2	0	0	0	0	0	0
EBRD index of enterprise reform	2 0	2 0	2 0	2 0	2 0	2 0	2 0
S are a ere pr e (per e)	a	a	a	a	a	a	a
u er g a ere pr e a e	0	0	0	6 0	6 0	a	a
S are ra e ra u re (per e)	2 0	6		2		6	a
S are ra e (per e)			6	2		0	a
ar re e ue (per e p r)	2	2	0	0			a
EBRD index of price liberalisation	0	0	0	0	0	0	0
EBRD index of forex and trade liberalisation	0	0					
EBRD index of competition policy	2	2	2	2	2	2	2
u er a (re g e)	( )	2 (6)	( )	( )	60 ( )	6 (2)	a
A e are a e e a (per e)			2 0		0		a
A e are re g e a (per e)		2	2	2	2	2	a
per r g l a (per e al l a)	2 6	2 6	2	2	0 0	0	a
e re pr a e e r (per e)	2	0	6	2	2	2	a
e re u e l (per e)	0 6	0			2		a
r gage le g (per e)	a	a	a	a	a	a	a
S ar e ap al a (per e)	6 0	6		6			a
S ra g lu e (per e ar e ap al a)	20 0			2	2	6	a
ur ua e (per e)	0 0	0 0		6	6	2	a
EBRD index of banking sector reform	2 0	2 0	2	2	2	2	0
EBRD index of reform of non-bank financial institutions	2 0	2 0	2 0	2 0	2	2	2
e l e (le) pe e ra ra e (per 00 a a)	2 2 ( )	22 0 (6)	22 6 ( )	2 ( )	2 (2 2)	2 (0)	a
er e pe e ra ra e (per 0 000 a a)		2 0		2	2	2	a
a l ay la ur pr u y (00)		6		6	60	6	a
e e al ele r y ar (S)	2	2 6	2	2	2	2	a
A erage lle ra e ele r y (per e)	a				a		a
per u e ergy u e (S llar per g e)	6				a	a	a
EBRD index of infrastructure reform	2 0	2 0	2 0	2 0	2 0	2 0	2
Electric power	0						
Railways	2 0	2 0	2 0	2 0	2 0	2 0	2 0
Roads	2 0	2 0	2 0	2 0	2 0	2 0	2 0
Telecommunications	2	2	2	2	2	2	2
Water and waste water							

[1] Registration of foreign investment is required.

[2] Income based.

[3] Tariff revenues refer to taxes on international trade and transactions.

[4] Data from the International Monetary Fund.

	2000	2001	2002	2003	2004	2005 Estimate	2006 ro ection
					ercentage c ange in real terms		
		2	2		2	2 6	6 0
r a e u p	2	0	0	2		0	a
u l u p	0	0	6			0	a
r e ap al r a	2	6 2			0 0	2 0	a
p r g a er e	2			0	0 0	0	a
p r g a er e	2	6 0		6		0	a
u r al gr u pu	2	2	0		2		a
Agr ul ural gr u pu		0 2	2			0	a
					ercentage c ange		
a ur r e (e year)	0	0	0	0	0 0	0	a
pl y e (e year)	2		0	6 0	0		a
					n per cent of labour force		
e pl y e (e year)	2			6			a
					ercentage c ange		
u er pr e (a ual a erage)	2 2	2 0	0	2	0		
u er pr e (e year)	2	6	0 6	2	2	0	
r u er pr e (a ual a erage)	20		0	6	20	6	a
r u er pr e (e year)	20 6	0			2		a
r a erage ly ear g e y (a ual a erage)	2 2	2	20	22	2	6	a
[1]					*n per cent of D*		
e eral g er e ala e		0	0	0		2	2
e eral g er e e pe ure			6	2	0 0	2	a
e eral g er e e		6		2 0	2	22	a
					ercentage c ange		
r a ey (M2 e year)		2	2	6	2		a
e re (e year)	2	2	2 0		2		a
					n per cent of D		
r a ey (M2 e year)		22	2		6		a
					n per cent per annum end-year		
e a g ra e	2 0	2	0	0	0		a
ep ra e[2]		0		0			a
e g ra e[2]		2	2			6 2	a
					ryvnias per dollar		
a ge ra e (e year)							a
a ge ra e (a ual a erage)							a
					n millions of dollars		
urre a u		02		2	6 0	2	2
ra e ala e			0	26			6 2
Mer a e e p r	22	0	66	2	2	02	26
Mer a e p r		6		2 00	2 6	6	
re g re e e e		6	6				000
r re er e e lu g g l (e year)		2	2	6	02		a
er al e		2 0	2		20	2 2	a
					n mont s of imports of goods and services		
r re er e e lu g g l (e year)	0		2	2	2		a
					n per cent of exports of goods and services		
e er e	0			6			a
					Denominations as indicated		
pula (e year ll)			0	6			a
(ll ry a)	0	20	226	26	6	0	6
per ap a (S llar)	6			0		6	a
S are u ry (per e)	26	2	0	0	0 0	a	a
S are agr ul ure (per e)				0		a	a
urre a u (per e)					0	2	
er al e re er e (S ll)	0 66		0		0		a
er al e (per e)			0	2	0	2 6	a
er al e e p r g a er e (per e)	60			0	0	2	a

Uzbekistan

Key challenges

- The authorities must reduce trade restrictions, increase access to foreign exchange and cash, and accelerate reform of the financial sector and customs administration to strengthen private sector growth.
- The agricultural sector needs to diversify and decrease its overdependence on cotton production. To this end, the state needs to reduce its role in the supply of agricultural inputs and remove administrative barriers.
- Fiscal discipline must be maintained and the rapid expansion of broad money should be constrained to stem inflationary pressures.

Country data	
Population (in millions)	**26.0**
Area ('000 sq km)	**448.9**
GDP (in billion US$, 2005)	**13.7**
GDP per capita in 2005 at current international US$ (PPP)	**2,074**
National currency	**Sum**

Progress in structural reform

Liberalisation and privatisation

Tariff and non-tariff barriers to trade remain high. Although current account convertibility was adopted in October 2003, many entrepreneurs are still confronted with limited, or severely delayed, access to foreign exchange. This applies particularly to the import of consumer goods, where importers often have to wait up to two months or more for foreign exchange. Since May 2006, importers have also been hindered increasingly by delays in customs procedures. In many cases, goods have to be stored for long periods at border warehouses before they are finally cleared for collection.

The restructuring of shirkats (collective farms) into private leaseholds has continued. By mid-2006 around 80 per cent of all shirkats had been restructured; the remaining 20 per cent are expected to be privatised by 2007. Although agricultural input markets are still state-controlled, the restructuring of the shirkats seems to have had a positive influence on efficiency in the agriculture sector.

Business environment and competition

The business environment has improved to some extent for small and medium-sized enterprises (SMEs), but deteriorated for some of the larger and foreign-owned companies. For SMEs, reporting requirements and the burden of inspections have been reduced and tax payments unified. According to the International Finance Corporation, these reforms have had a positive impact on entrepreneurs' plans to invest in fixed assets. However, many SMEs still struggle with other institutional constraints, such as lengthy business start-up and exit procedures and an overlap in the tasks of several of the inspectorates. The high cost associated with doing business in the formal sector has caused the growth of the large informal economy in Uzbekistan. In addition, competition in many sectors remains hindered by powerful industrial associations which limit business opportunities for non-members.

Although foreign direct investment (FDI) increased during 2005, many foreign companies have closed their representative offices, citing the unpredictability of government policy. (This unpredictability is reflected in the large number of decrees issued each year.) In addition, the introduction of a number of ad hoc measures, such as the retroactive imposition of import duties and the revocation of earlier decisions on tax-breaks for joint ventures, have heightened business uncertainty.

Bankruptcy proceedings against the Zarafshan-Newmont gold mining joint venture, revocation of the licence of Oxus Gold (UK) to develop a precious metal deposit, and the reining in of Uzmetal Technology, an Uzbek-Israeli joint venture, exemplify the increasing difficulties experienced by foreign investors.

Financial sector

The banking sector is dominated by two state-owned banks, the National Bank for Foreign Economic Activity (NBU) and Asaka Bank, which are responsible for some 75 per cent of all loans. A small number of other banks are also effectively owned by the state. In 2005 UzJilSberbank and Zaminbank merged to create Ipotekabank and in 2006 UzPromstroybank absorbed UzPrivatbank. However, no progress has been made in restructuring and privatising some of the larger banks, and the sale of the NBU has been postponed until 2009. This is hampering the growth of domestic credit to the private sector, which has declined as a share of GDP from 25 per cent at the end of 2004 to 20 per cent at the end of 2005. There remains a significant and unfulfilled demand for credit, especially from SMEs.

Cash rationing remains a problem. Although firms have been able to access more cash for payroll purposes, it remains difficult for them to acquire sufficient cash for working capital. Banks still come under informal pressure to discriminate against the use of cash. Bank customers are required to surrender cash on a regular basis, as banks are still used by the tax authorities for collection purposes. This further undermines trust in the banking system and impedes financial sector development.

A new anti-money laundering law came into force in January 2006, and a presidential decree, issued in April, obliges banks to report all financial transactions exceeding a certain threshold to the General Prosecutor's Office. There are concerns that the decree has been misused in some cases to gather financial information on banks' clients.

Macroeconomic performance

Real economy

Real GDP grew by 7 per cent in 2005 and by 6.6 per cent year-on-year in the first half of 2006. This growth reflects strong gold and cotton prices and also higher production and exports of building materials, fruit and vegetables. Growth was also supported by a substantial inflow of remittances, mainly from migrant workers in Russia and Kazakhstan. With limited job opportunities in the Uzbek private sector, private consumption remains depressed and has even decreased on a per capita basis in real terms.

Economic policies

Official reserves increased by 33 per cent during 2005, fuelling strong monetary expansion. Broad money grew by more than 50 per cent. Loose monetary policy has increased pressure on inflation, which was estimated by international financial institutions at around 20 per cent by the end of the year (considerably above official figures). The Central Bank has nevertheless continued to pursue a policy of nominal depreciation, further undermining monetary discipline. On the fiscal side, the state budget recorded a surplus of 1.2 per cent of GDP in 2005. The IMF expects a broadly balanced government budget in 2006.

In May 2006 the government announced the creation of the Uzbekistan Reconstruction and Development Fund. With US$ 1 billion worth of funding from tax resources, foreign exchange reserves and privatisation revenues, the Fund will finance major projects in the energy and other high priority economic sectors. It will also support social programmes and strategically important enterprises. While the Fund may help the government rein in the rapid monetary expansion, there is also the risk that it may further increase the role of the state in the economy at the expense of private sector initiative. Moreover, there are concerns about the revenues and expenditures of this Fund not being consolidated within the government budget.

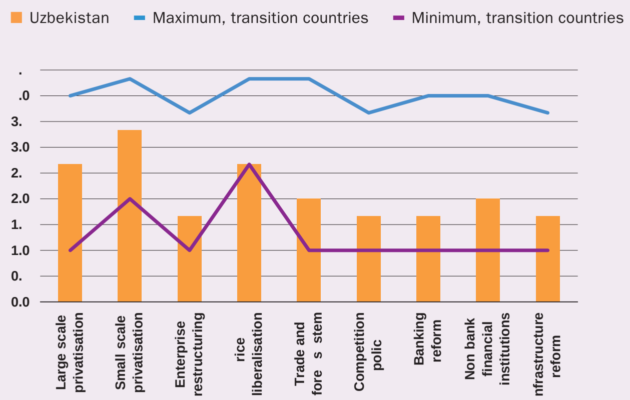
External sector

In 2005 the current account surplus increased to just over 13 per cent of GDP, reflecting a US$ 1.4 billion trade surplus based on exports of cotton, gold, textiles, machinery and chemicals. External debt declined further to 33 per cent of GDP as the policy of zero net public borrowing continued. Net FDI increased to US$ 211 million, although this only represented 1.5 per cent of GDP. Foreign investment is coming increasingly from Russia, Turkey and Asia, while investment from the US and Western European countries has declined.

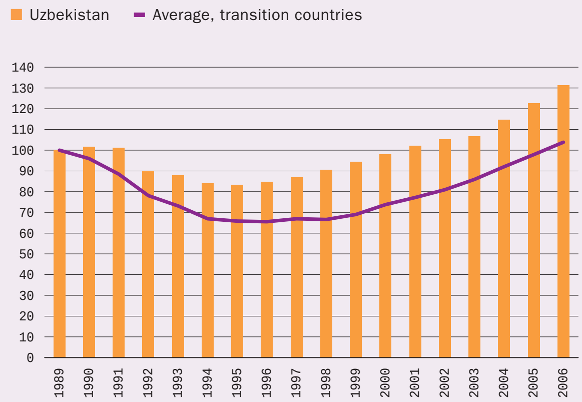
Outlook and risks

Although workers' remittances and high commodity prices have helped to sustain strong economic growth, they also make the economy vulnerable to external shocks, such as a possible slowdown in Russian and Kazakh growth. To make the economy structurally more resilient, the authorities need to diversify the agricultural sector and stimulate private enterprise in order to boost employment and domestic demand.

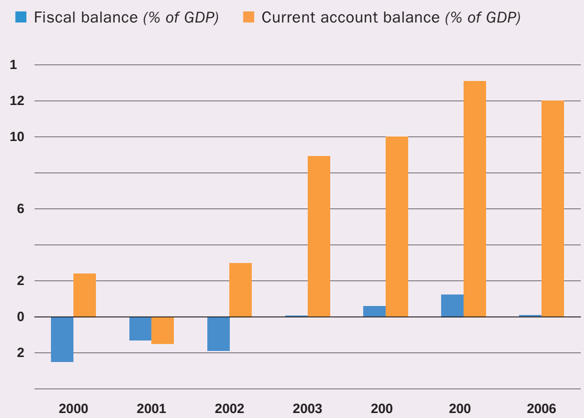
Transition indicators, 2006



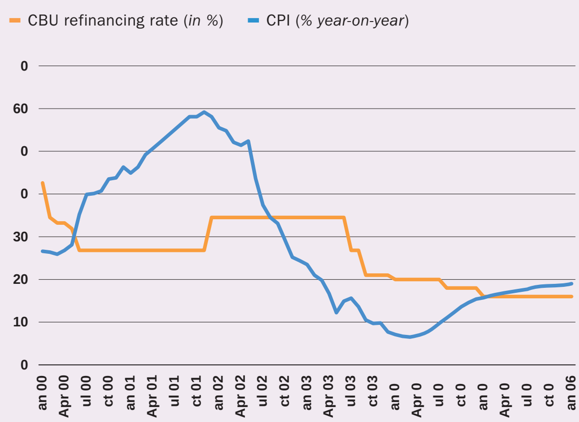
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full (sometimes limited de facto)**	Competition office – **yes**	Independent telecoms regulator – **no**	Capital adequacy ratio – **8 per cent**	Share of population living in poverty – **26 per cent** (2003)
Controls on inward direct investment – **yes**	Quality of insolvency law – **low**	Independent electricity regulator – **no**	Deposit insurance system – **yes**	Government expenditure on health – **2.6 per cent of GDP**
Interest rate liberalisation – **limited de jure**	Secured transactions law – **malfunctioning**	Separation of railway infrastructure from operation – **partially**	Quality of securities market laws – **high**	Government expenditure on education – **8.7 per cent of GDP**
Exchange rate regime – **managed float**	Quality of corporate governance law – **medium**	Independence of the road directorate – **no**	Private pension funds – **no**	Household expenditure on power and water – **5.2 per cent**
Wage regulation – **yes**		Quality of concession laws – **low**		
Tradability of land – **limited de jure**				

	2000	2001	2002	2003	2004	2005	2006
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.8	2.9	3.5	4.0	4.7	5.2	na
Private sector share in GDP (in per cent)	45.0	45.0	45.0	45.0	45.0	45.0	45.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.2	2.1	1.9	2.1	2.2	na	na
Share of industry in total employment (in per cent)	12.7	12.7	12.7	12.4	13.0	13.2	na
Change in labour productivity in industry (in per cent)	-0.6	1.8	0.7	2.5	-2.3	-0.7	na
Investment/GDP (in per cent)	19.6	21.1	21.2	20.7	22.5	23.0	na
EBRD index of small-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.3
EBRD index of large-scale privatisation	2.7	2.7	2.7	2.7	2.7	2.7	2.7
EBRD index of enterprise reform	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Markets and trade							
Share of administered prices in CPI (in per cent)	53.0	53.0	53.0	53.0	53.0	na	na
Number of goods with administered prices in EBRD-15 basket	8.0	8.0	8.0	8.0	8.0	4.0	na
Share of trade with non-transition countries (in per cent)	45.3	48.4	48.6	57.2	54.1	50.8	na
Share of trade in GDP (in per cent)	59.6	69.5	55.8	57.1	59.7	57.1	na
Tariff revenues (in per cent of imports) [1]	2.6	1.9	2.8	3.8	3.1	3.1	na
EBRD index of price liberalisation	2.7	2.7	2.7	2.7	2.7	2.7	2.7
EBRD index of forex and trade liberalisation	1.0	1.7	1.7	1.7	1.7	2.0	2.0
EBRD index of competition policy	2.0	2.0	2.0	1.7	1.7	1.7	1.7
Financial sector							
Number of banks (foreign-owned)	34 (6)	38 (6)	35 (6)	33 (5)	31 (5)	na	na
Asset share of state-owned banks (in per cent)	77.5	80.4	73.7	70.0	67.6	na	na
Asset share of foreign-owned banks (in per cent)	2.2	2.4	3.2	4.3	4.4	na	na
Non-performing loans (in per cent of total loans)	0.0	na	na	na	na	na	na
Domestic credit to private sector (in per cent of GDP)	27.9	36.9	34.0	27.5	24.5	20.4	na
Domestic credit to households (in per cent of GDP)	na	na	na	na	na	na	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	0.6	0.6	0.4	0.1	0.0	0.3	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	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
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	6.7 (0.2)	6.7 (0.5)	6.7 (0.7)	6.7 (1.3)	6.7 (2.1)	6.7 (2.7)	na
Internet penetration rate (per 10,000 inhabitants)	0.1	0.1	0.1	0.4	1.1	1.1	na
Railway labour productivity (1989=100)	33.7	35.6	51.1	51.8	47.9	45.6	na
Residential electricity tariffs (in USc kWh)	1.0	1.0	1.2	1.7	na	2.6	na
Average collection rate, electricity (in per cent)	na	na	72	95	na	60	na
GDP per unit of energy use (PPP in US dollars per kgoe)	0.7	0.8	0.8	0.8	na	na	na
EBRD index of infrastructure reform	1.3	1.7	1.7	1.7	1.7	1.7	1.7
Electric power	1.0	2.0	2.0	2.0	2.0	2.3	2.3
Railways	2.3	2.7	2.7	2.7	2.7	2.7	2.7
Roads	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	2.0	2.0
Water and waste water	1.0	1.0	1.7	1.7	1.7	1.7	1.7

[1] Tariff revenues refer to custom duties and export taxes.

	2000	2001	2002	2003	2004	2005 Estimate	2006 ro ection
			ercentage c ange in real terms				
						0	0
u r al gr u pu		2		2		2	a
Agr ul ural gr u pu	2		6 0		0	0	a
			ercentage c ange				
a ur r e (e year)			2	2		2	a
pl y e (e year)			2	2		2	a
			n per cent of labour force				
e pl y e (e year) [2]	0	0	0	0	0	0	a
			ercentage c ange				
u er pr e (a ual a erage)						2 0	
u er pr e (e year)	6 2	2	2				
r u er pr e (a ual a erage)	6	2 2	a	a	a	a	a
r u er pr e (e year)	0 2	0	2 2	0	6	2	a
r a erage ly ear g e y (a ual a erage)		2		2 2		22 0	a
4			n per cent of D				
e eral g er e ala e	2			0	0 6	2	0
e eral g er e e pe ure		6 0	2		2	2 6	a
e eral g er e e	2		6		6	2	a
			ercentage c ange				
r a ey (M e year)			2	2			a
e re (e year)		0	0		6	0	a
			n per cent of D				
r a ey (M e year)	2 2	2	0 6	0	2 2		a
			n per cent per annum end-year				
e a g ra e	26	26		20 0	20 0	6 0	a
rea ury ll ra e (a ur y)				a	a	a	a
ep ra e (year)		2 2	26 0	20	6		a
e g ra e (year)	2 6	2 6		2	2 2		a
			ums per dollar				
a ge ra e (e year)	6	6	06	0	0 6 6	0 0	a
a ge ra e (a ual a erage)	60	6 6	0		2	0 2	a
			n millions of dollars				
urre a u	2		2 2	2			00
ra e ala e		6	2	6	202	00	26
Mer a e e p r	2	2 0	2 0	2 0	26	0	
Mer a e p r	2	2	2 6	2 0	06	0	
re g re e e e			6	0		2	2 0
r re er e e lu g g l (e year)	6	2 2	2	6	2 00	600	a
er al e		2	260	26		606	a
			n mont s of imports of goods and services				
r re er e e lu g g l (e year)	2	6		6	2	0 0	a
			n per cent of exports of goods and services				
e er e	2	26 2	2	22			a
			Denominations as indicated				
pula (e year ll)	2	2	2 6	26 0	26 0	26 0	a
(ll u)	2 6	2	0		2 26	2 0	2 2
per ap a (S llar) [6]	66	06	2	0	2	6	a
S are u ry (per e)	2					20	a
S are agr ul ure (per e)	0	0 2	0	2 6	26	2 0	a
urre a u (per e)	2		0		0 0		2 0
er al e re er e (S ll)		06	0	2 6		006	a
er al e (per e)		6 2	0 6		6	2	a
er al e e p r g a er e (per e)			2	2	0		a

Methodological notes

Transition indicators

The transition indicator scores in Chapter 1 reflect the judgement of the EBRD's Office of the Chief Economist about country-specific progress in transition. The scores are based on the following classification system, which was originally developed in the 1994 *Transition Report*, but has been refined and amended in subsequent Reports.

"+" and "-" ratings are treated by adding 0.33 and subtracting 0.33 from the full value. Averages are obtained by rounding down. For example, a score of 2.6 is treated as 2+, but a score of 2.8 is treated as 3-.

Overall transition indicators

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 with 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 under 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; little action taken to strengthen competition and corporate governance.

3 Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (for example, privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).

4 Substantial improvement in corporate governance and significant new investment at the enterprise level, including minority holdings by financial investors.

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, but 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 current account convertibility.

4+ Standards and performance norms of advanced industrial economies: removal of most tariff barriers; membership of 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 (for example, 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 reform

Infrastructure reform ratings are calculated as the average of five indicators covering electric power, railways, roads, telecommunications, water and waste water. The classification system used for these five indicators is detailed below.

Infrastructure transition indicators

Electric power

1 Power sector operates as government department with few commercial freedoms or pressures. Average prices well below costs, with extensive cross-subsidies. Monolithic structure, with no separation of different parts of the business.

2 Power company distanced from government, but there is still political interference. Some attempt to harden budget constraints, but effective tariffs are low. Weak management incentives for efficient performance. Little institutional reform and minimal, if any, private sector involvement.

3 Law passed providing for full-scale restructuring of industry, including vertical unbundling through account separation and set-up of regulator. Some tariff reform and improvements in revenue collection. Some private sector involvement.

4 Separation of generation, transmission and distribution. Independent regulator set up. Rules for cost-reflective tariff-setting formulated and implemented. Substantial private sector involvement in distribution and/or generation. Some degree of liberalisation.

4+ Tariffs cost-reflective and provide adequate incentives for efficiency improvements. Large-scale private sector involvement in the unbundled and well-regulated sector. Fully liberalised sector with well-functioning arrangements for network access and full competition in generation.

Railways

1 Monolithic structure operated as government department, with few commercial freedoms. No private sector involvement and extensive cross-subsidisation.

2 Rail operations distanced from state, but weak commercial objectives. Some business planning, but targets are general and tentative. No budgetary funding of public service obligations. Ancillary businesses separated, but little divestment. Minimal private sector involvement.

3 Commercial orientation in rail operations. Freight and passenger services separated and some ancillary businesses divested. Some budgetary compensation available for passenger services. Improved business planning with clear investment and rehabilitation targets, but funding unsecured. Some private sector involvement in rehabilitation and/or maintenance.

4 Railways fully commercialised, with separate internal profit centres for freight and passenger services. Extensive market freedoms to set tariffs and investments. Implementation of medium-term business plans. Ancillary industries divested. Private sector participation in freight operation, ancillary services and track maintenance.

4+ Separation of infrastructure freight and passenger operations. Full divestment and transfer of asset ownership implemented or planned, including infrastructure and rolling stock. Rail regulator established and access pricing implemented.

Roads

1 Minimal degree of decentralisation and no commercialisation. All regulatory, road management and resource allocation functions centralised at ministerial level. New investments and road maintenance financing dependent on central budget allocations. Road user charges not based on the cost of road use. Road construction and maintenance undertaken by public construction units. No public consultation in the preparation of road projects.

2 Moderate degree of decentralisation and initial steps in commercialisation. Road/highway agency created. Improvements in resource allocation and public procurement. Road user charges based on vehicle and fuel taxes, but not linked to road use. Road fund established, but dependent on central budget. Road construction and maintenance undertaken primarily by corporatised public entities, with some private sector participation. Minimal public consultation/participation on road projects.

3 Fair degree of decentralisation and commercialisation. Regulation and resource allocation functions separated from road maintenance and operations. Level of vehicle and fuel taxes related to road use. Private companies able to provide and operate roads under negotiated commercial contracts. Private sector participation in road maintenance and/or through concessions to finance, operate and maintain parts of highway network. Limited public consultation/participation and accountability on road projects.

4 Large degree of decentralisation. Transparent methodology used to allocate road expenditures. Track record in competitive procurement of road design, construction, maintenance and operations. Large-scale private sector participation in construction, operations and maintenance directly and through public-private partnerships. Substantial public consultation/participation and accountability on road projects.

4+ Fully decentralised road administration. Commercialised road maintenance operations competitively awarded to private companies. Road user charges reflect the full costs of road use and associated factors, such as congestion, accidents and pollution. Widespread private sector participation in all aspects of road provision. Full public consultation on new road projects.

Telecommunications

1 Little progress in commercialisation and regulation. Minimal private sector involvement and strong political interference in management decisions. Low tariffs, with extensive cross-subsidisation. Liberalisation not envisaged, even for mobile telephony and value-added services.

2 Modest progress in commercialisation. Corporatisation of dominant operator and some separation from public sector governance, but tariffs are still politically set.

3 Substantial progress in commercialisation and regulation. Telecommunications and postal services fully separated; cross-subsidies reduced. Considerable liberalisation in the mobile segment and in value-added services.

4 Complete commercialisation, including privatisation of the dominant operator; comprehensive regulatory and institutional reforms. Extensive liberalisation of entry.

4+ Effective regulation through an independent entity. Coherent regulatory and institutional framework to deal with tariffs, interconnection rules, licensing, concession fees and spectrum allocation. Consumer ombudsman function.

Water and waste water

1 Minimal degree of decentralisation; no commercialisation. Services operated as vertically integrated natural monopolies by government ministry or municipal departments. No financial autonomy and/or management capacity at municipal level. Low tariffs, low cash collection rates and high cross-subsidies.

2 Moderate degree of decentralisation; initial steps towards commercialisation. Services provided by municipally owned companies. Partial cost recovery through tariffs; initial steps to reduce cross-subsidies. General public guidelines exist regarding tariff-setting and service quality, but both under ministerial control. Some private sector participation through service or management contacts, or competition to provide ancillary services.

3 Fair degree of decentralisation and commercialisation. Water utilities operate with managerial and accounting independence from municipalities, using international accounting standards and management information systems. Operating costs recovered through tariffs, with a minimum level of cross-subsidies. More detailed rules drawn up in contract documents, specifying tariff review formulae and performance standards. Private sector participation through the full concession of a major service in at least one city.

4 Large degree of decentralisation and commercialisation. Water utilities managerially independent, with cash flows – net of municipal budget transfers – that ensure financial

viability. No cross-subsidies. Semi-autonomous regulatory agency able to advise and enforce tariffs and service quality. Substantial private sector participation through build-operator-transfer concessions, management contacts or asset sales in several cities.

4+ Water utilities fully decentralised and commercialised. Fully autonomous regulator exists with complete authority to review and enforce tariff levels and quality standards. Widespread private sector participation via service/management/lease contracts. High-powered incentives, full concessions and/or divestiture of water and waste-water services in major urban areas.

Definitions and data sources for structural indicators box

Liberalisation and privatisation

Current account convertibility

Options: full (full compliance with Article VIII of the IMF Agreement); limited (restrictions on payments or transfers for current account transactions).

Source: IMF Annual Report on exchange arrangements and exchange restrictions.

Controls on inward direct investment

Options: yes (controls on foreign ownership, and/or minimum capital requirements); no (no restrictions on inward foreign direct investment, except in some cases on arms production and military equipment).

Source: IMF Annual Report on exchange arrangements and exchange restrictions.

Interest rate liberalisation

Options: full (banks 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 highly illiquid money or credit markets); limited de jure (restrictions on banks to set interest rates through law, decree or central bank regulation).

Source: EBRD staff assessments.

Exchange rate regime

Options: currency board; fixed; fixed with band; crawling peg; crawling peg with band; managed float; managed float in ERM II; floating.

Source: IMF Annual Report on exchange arrangements and exchange restrictions.

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.

Tradability of land

Options: full (no substantial restrictions on 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 tradability of land, for example, limited enforceability of land rights, a non-existent land market, or significant obstruction by government officials); limited de jure (legal restrictions on tradability of land rights); no (land trade prohibited).

Source: EBRD staff assessments.

Business environment and competition

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.

Quality of insolvency law

Level of compliance of insolvency laws with international standards, such as the World Bank's Principles and guidelines for effective insolvency and creditor rights systems, the UNCITRAL working group on legislative guidelines for insolvency law, and others. Options: very high; high; medium; low; very low.

Source: EBRD Legal Sector Assessment 2004.

Secured transactions law

Level of reform assessed in relation to the EBRD model law on secured transactions and the EBRD ten core principles of secured transactions laws. Options: advanced; some defects; inefficient; malfunctioning.

Source: EBRD Regional Survey of Secured Transactions 2005.

Quality of corporate governance law

Level of compliance of corporate governance laws with international standards, such as the OECD principles of corporate governance. Options: very high; high; medium; low; very low.

Source: EBRD Legal Sector Assessment 2005.

Infrastructure

Independent telecommunications regulator

Options: fully (institutional, financial, managerial and decision making independence granted); partially (some elements of independence, but not all four dimensions); no (no regulator with institutional independence).

Source: EBRD staff assessments.

Independent electricity regulator

Options: fully (institutional, financial, managerial and decision making independence granted); partially (some elements of independence, but not all four dimensions); no (no regulator with institutional independence).

Source: EBRD staff assessments.

Separation of railway infrastructure from operations

Separate entities responsible for track infrastructure and for freight and passenger operations. Options: fully (institutional separation); partially (accounting only); no.

Source: EBRD staff assessments.

Independence of road directorate

Separate road management agency from government. Options: fully (institutional, managerial and decision making independence and independent account); partially (some elements of independence, but not all four dimensions); no (part of a government body).

Source: EBRD staff assessments.

Quality of concession laws

Level of compliance of concession laws with international standards, in particular the UNCITRAL Legislative guide on privately financed infrastructure projects. Options: very high; high; medium; low; very low.

Source: EBRD Legal Sector Assessment 2005.

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 covered by formal deposit insurance scheme. Options: yes; no.

Source: EBRD staff assessments.

Quality of securities market laws

Level of compliance of securities market laws with international standards, mainly the objectives and principles of securities regulation issued by the International Organization of Securities Commissions (IOSCO). Options: very high; high; medium; low; very low.

Source: EBRD Legal Sector Assessment 2004.

Private pension funds

Options: yes; no.

Source: EBRD staff assessments.

Social reform

Share of population living in poverty

Percentage of population living on less than US$2 a day per person (in 1993 US$ at purchasing power parity). Selected years.

Source: World Bank World Development Indicators.

Government expenditure on health

Expenditures by general government, excluding state-owned enterprises, on health services including hospitals, clinics, public health, medicaments, medical equipment and applied research related to the sector. Expenditures are expressed as percentage of GDP. Latest available year.

Source: National statistics.

Government expenditure on education

Expenditures by general government, excluding state-owned enterprises, on education services including pre-primary and primary education, secondary and tertiary education, and subsidiary services to education. Expenditures are expressed as percentage of GDP. Latest available year.

Source: National statistics.

Household expenditure on power and water

Share of total household expenditures used on electric power and water/waste-water services. Estimate based on the poorest 10 per cent of households (lowest income decile). Latest available year.

Source: EBRD staff estimates, based on household survey data.

Definitions and data sources for structural indicators table

Enterprises

Privatisation revenues (cumulative, in per cent of GDP)

Government revenues from cash sales of enterprises, not including investment commitments.

Sources: National authorities and IMF country reports.

Private sector share in GDP (in per cent)

Private sector share in GDP represents rough EBRD estimates, based on available statistics from both official (government) 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.

Source: EBRD staff estimates.

Private sector share in employment (in per cent)

Private sector share in employment represents rough EBRD estimates, based on available statistics from both official (government) 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.

Source: EBRD staff estimates.

Budgetary subsidies and current transfers (in per cent of GDP)

Budgetary transfers to enterprises and households, excluding social transfers.

Sources: National authorities and IMF country reports.

Share of industry in total employment (in per cent)

Industry includes electricity, power, manufacturing, mining and water.

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. Changes in productivity are calculated on the basis of annual averages.

Sources: National statistical publications and IMF country reports.

Investment/GDP (in per cent)

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: See the macroeconomic indicators tables.

Markets and trade

Share of administered prices in CPI (in per cent)

Administered prices include directly regulated prices (prices set up directly by the state); partly regulated prices (state has co-determination right in setting prices); quasi-regulated prices (for goods which are subject to specific customer taxes); indirectly regulated prices (for goods which the state guarantees a purchase quote).

Sources: EBRD survey of national authorities and IMF country reports.

Number of goods with administered prices in EBRD-15 basket

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 countries (in per cent)

Ratio of merchandise exports and imports with non-transition economies (including, until 2004, Mongolia) to total trade (exports plus imports).

Source: IMF Directions of Trade Statistics.

Share of trade in GDP (in per cent)

Ratio of exports plus imports to GDP.

Source: See the macroeconomic indicators tables.

Tariff revenues (in per cent of imports)

Tariff revenues include all revenues from international trade. Imports are those of merchandise goods.

Sources: National authorities and IMF country reports.

Financial sector

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 50 per cent, end-of-year.

Source: EBRD survey of central banks.

Asset share of state-owned banks (in per cent)

Share of majority state-owned banks' assets in total bank sector assets. The state includes 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.

Asset share of foreign-owned banks (in per cent)

Share of total bank sector assets in banks with foreign 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 sub-standard, doubtful and loss classification categories of 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 private sector at end-of-year, including households and enterprises, to GDP.

Source: EBRD survey of central banks.

Domestic credit to households (in per cent of GDP)

Ratio of total outstanding bank credit to households, at end-of-year, to GDP.

Source: EBRD survey of central banks.

Mortgage lending (in per cent of GDP)

Ratio of mortgage lending to households, at end-of-year, to GDP.

Source: EBRD survey of central banks.

Stock market capitalisation (in per cent of GDP)

Market value of all shares listed on the stock market, calculated by multiplying the share price by the number of shares outstanding; presented as a percentage of GDP, end-of-year. Listed domestic companies are the domestically incorporated companies listed on the country's stock exchanges at end-of-year.

Source: Standard & Poor's/IFC Emerging Stock Markets Factbook, Federation of Euro-Asian Stock Exchanges and local stock exchanges.

Stock trading volume (in per cent of market capitalisation)

Total value of shares traded during the period, divided by the average market capitalisation for the period.

Source: World Bank World Development Indicators, Standard & Poor's/IFC Emerging Stock Markets Factbook and local stock exchanges.

Eurobond issuance (in per cent of GDP)

Total value of the bond issuance (including sovereign, municipality and corporate issuance) denominated in a currency different to that of the country in which the bond was issued.

Source: JP Morgan.

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) and refers to the lines which have a dedicated port on a telephone exchange. Mobile refers to users of portable telephones subscribing to an automatic public mobile service using cellular technology that provides access to the PSTN.

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.

Residential electricity tariffs, US cents per kilowatt-hour

Average tariff paid by residential consumers; where data on residential tariffs are not available, average retail tariff.
Sources: International Energy Agency, Energy Regulators Association and EBRD survey of national authorities.

Average collection rate, electricity (in per cent)

Collection rate is defined as the ratio of total electricity payments received in cash and total electricity charges.
Source: EBRD survey of national authorities.

GDP per unit of energy use (PPP in US dollars per kgoe)

PPP of GDP per kilogram of oil equivalent for commercial energy use. GDP is converted to international US dollars using purchasing power parity exchange rates.
Source: World Bank World Development Indicators.

Definitions and data sources for macroeconomic indicators table

Data represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank and other sources. Data for the current year are EBRD staff estimates.

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. Some countries 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 sourced from statistical offices or the IMF. In some countries, notably Belarus, Turkmenistan and Uzbekistan, 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, incorporated 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 sourced from the IMF, International Financial Statistics 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. Data sourced from the IMF, International Financial Statistics 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. Trade data are on a balance of payments basis as published by the monetary authorities and in IMF country reports.

Abbreviations

The Bank, EBRD	European Bank for Reconstruction and Development
BEEPS	Business Environment and Enterprise Performance Survey
BEPS	Banking Environment and Performance Survey
BTC	Baku-Tbilisi-Ceyhan pipeline
CEB	central eastern Europe and the Baltic states (see map on p. ii)
CIS+M	Commonwealth of Independent States and Mongolia (see map on p. ii)
CPI	consumer price index
DSEE	Datastream Emerging Europe
ECB	European Central Bank
EIB	European Investment Bank
EITI	Extractive Industries Transparency Initiative
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
EU	European Union
FDI	foreign direct investment
FYR	Former Yugoslav Republic
GDP	gross domestic product
IFRS	International Financial Reporting Standards
ILO	International Labour Organization
IMF	International Monetary Fund
IPO	initial public offering
IRR	internal rate of return
LIS	Legal Indicator Survey
na	not available
NAV	net asset value
NGOs	non-governmental organisations
NPL	non-performing loan
OECD	Organisation for Economic Cooperation and Development
PAYG	Pay-as-you-go
PPP	purchasing power parity
PPPs	public-private partnerships
ROA	return on assets
ROE	return on equity
SAA	Stabilisation and Association Agreement
SEE	south-eastern Europe (see map on p. ii)
SEE-3	Bulgaria, Croatia, Romania
SEE-5	Albania, Bosnia and Herzegovina, FYR Macedonia, Montenegro, Serbia
SMEs	small and medium-sized enterprises
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
VAT	value added tax
WTO	World Trade Organization

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Transition report 2006

The *Transition Report* offers an in-depth analysis of economic progress in 29 countries from central Europe to central Asia, including, for the first time, Mongolia. Drawing on the EBRD’s experience as one of the largest investors in the transition region, the Report provides comprehensive analysis of the transition from central planning to market economies.

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In particular, the Report looks at the performance of banks, the types of customers they lend to and how this is affected by changes in the legal and institutional framework. It also investigates why financial systems in the transition countries remain underdeveloped in comparison with advanced market economies and how this affects overall growth and enterprise performance. The role that private equity funds have begun to play in the region is also examined.

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