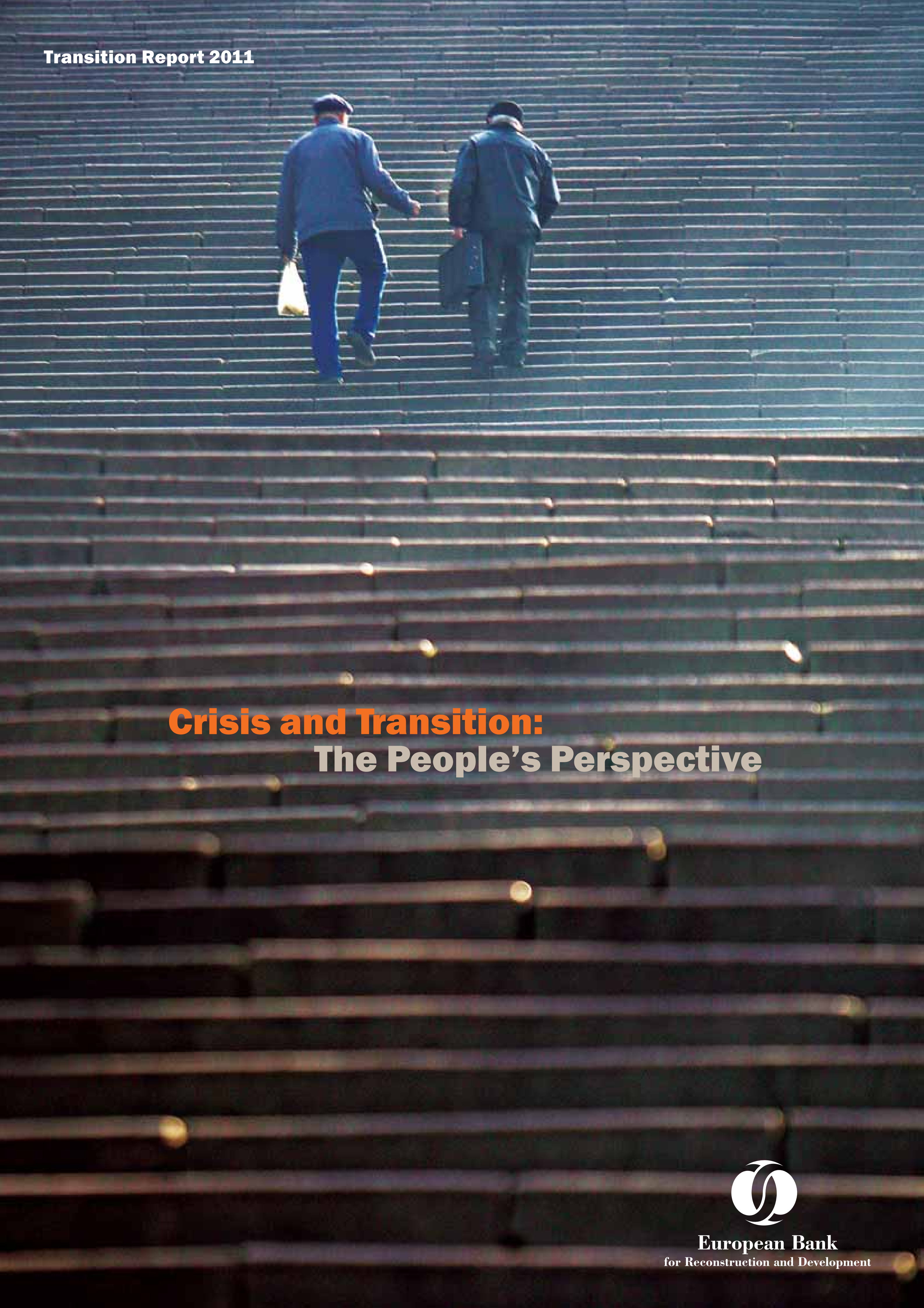


Transition Report 2011

# Crisis and Transition: The People's Perspective

European Bank
for Reconstruction and Development

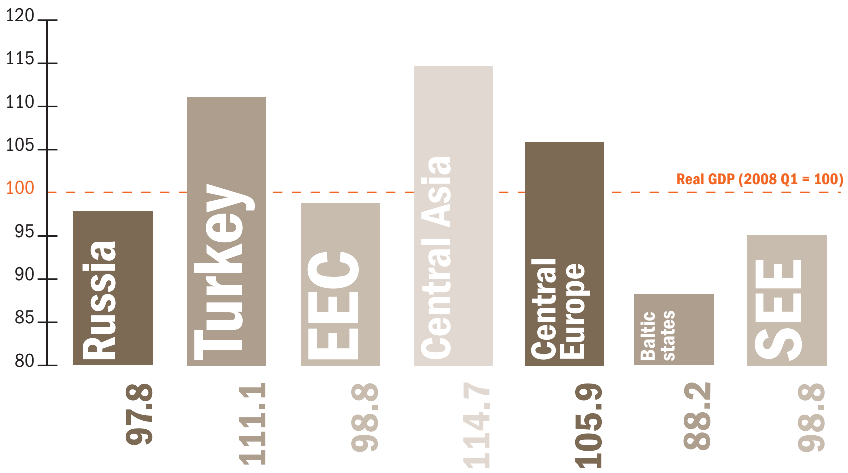
# Around the region

**The impact of the global crisis is still present in many transition economies, even as a recovery took hold – a recovery now under threat from a much less benign external environment.**

**The 2010 Life in Transition Survey reveals that the crisis hit many people in the region hard at an individual level. Crisis impact has in turn lowered people's support for democracy and markets, but also induced a change in attitudes against the system in place in 2009, on balance resulting in higher support levels in many CIS countries.**

## Lasting crisis impact

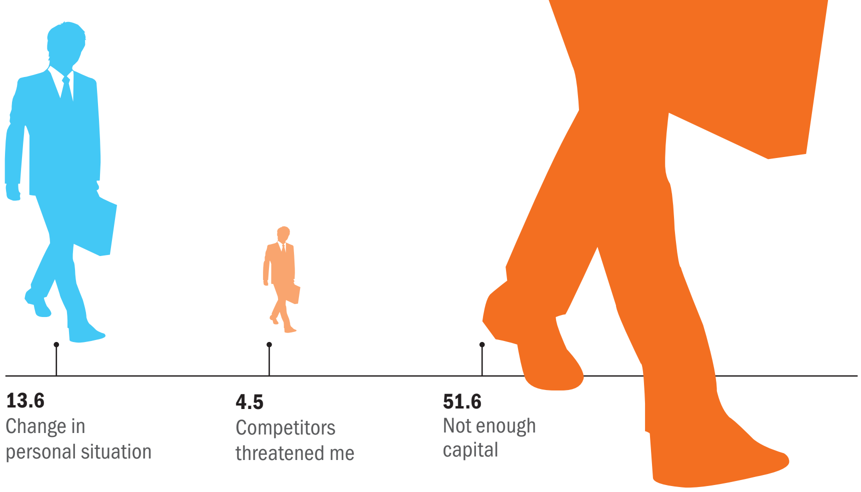
Baltic countries still about 10% below pre-crisis output levels




**EEC**- Eastern Europe and the Caucasus
**SEE**- South-eastern Europe

## Obstacles to healthy post-crisis growth

Business start-ups fail due to lack of capital



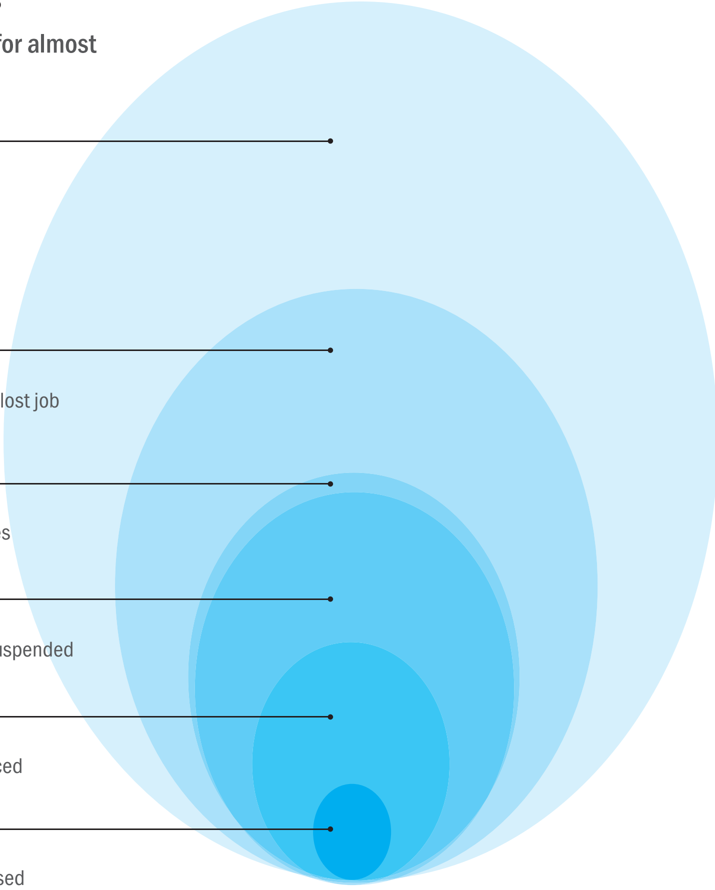

Percentage of failed entrepreneurs, by reason for failure

## Country abbreviations

| | | | |
|---|---|---|---|
| Albania | ALB | Poland | POL |
| Armenia | ARM | Romania | ROM |
| Azerbaijan | AZE | Russia | RUS |
| Belarus | BEL | Serbia | SER |
| Bosnia and Herz. | BOS | Slovak Republic | SVK |
| Bulgaria | BUL | Slovenia | SLO |
| Croatia | CRO | Tajikistan | TJK |
| Estonia | EST | Turkey | TUR |
| FYR Macedonia | FYR | Turkmenistan | TKM |
| Georgia | GEO | Ukraine | UKR |
| Hungary | HUN | Uzbekistan | UZB |
| Kazakhstan | KAZ | | |
| Kyrgyz Republic | KGZ | France | FRA |
| Latvia | LAT | Germany | GER |
| Lithuania | LIT | Italy | ITA |
| Moldova | MDA | Sweden | SWE |
| Mongolia | MON | United Kingdom | UK |
| Montenegro | MNG | | |

## Households hit hard in the crisis

Wages reduced for almost a third of them



**29.3%**
Wages reduced

**19.8%**
Household member lost job

**13.6%**
Reduced remittances

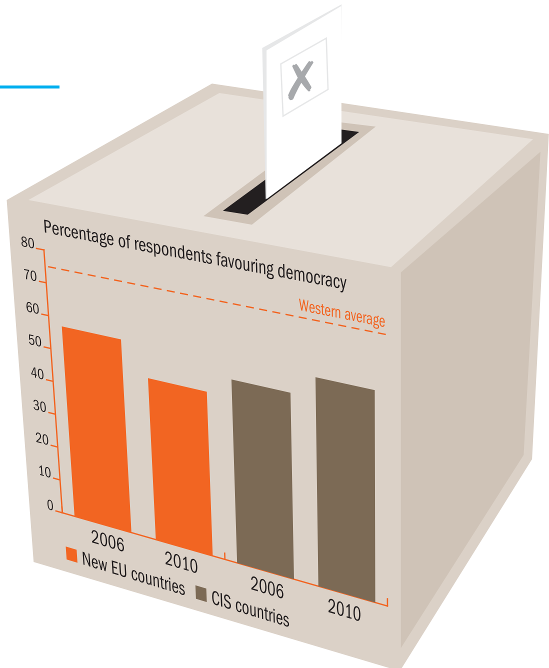
**13.1%**
Wages delayed or suspended

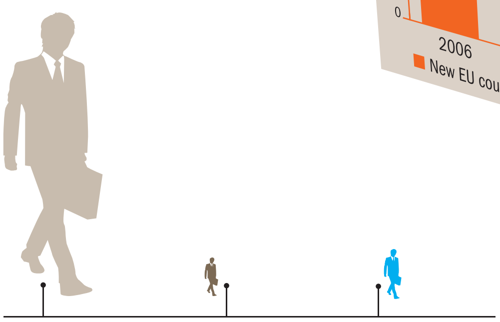
**8.1%**
Working hours reduced

**3.2%**
Family business closed

## Crisis impact on democracy support

Increased in the CIS but dropped in the new EU countries



**12.0**
Too much bureaucracy

**1.6**
Couldn't afford the protection payments

**2.1**
Couldn't afford the bribes

## The region in numbers

**8**

**the number of countries** where improvements in competition policy warranted a transition indicator upgrade

**14%**

**University graduates are** 14% more likely to support democracy than those with a primary education

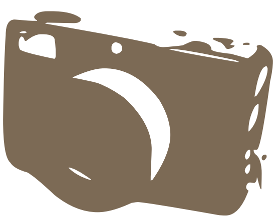
**38%**

**of the households in** the transition region had to reduce staple food consumption as a result of the crisis, compared with only 11 per cent in western Europe

**13%**

**of people in the** transition region have tried to set up a business

**Go to page 96 to see images from around the region**



**The EBRD is changing people's lives and environments from central Europe to central Asia. Working together with the private sector, we invest in projects, engage in policy dialogue and provide technical advice that builds sustainable and open-market economies.**

## About this report

The EBRD seeks to foster the transition to an open market-oriented economy and to promote entrepreneurship in countries from central Europe to central Asia. To perform this task effectively, the Bank needs to analyse and understand the process of transition. The purpose of the Transition Report is to advance this understanding and to share our analysis with our partners.

The responsibility for the content of the Transition Report is taken by the Office of the Chief Economist. The assessments and views expressed in the Transition Report are not necessarily those of the EBRD. All assessments and data in the Transition Report are based on information as of early October 2011.

www.ebrd.com/transitionreport

# Contents

# 1 A fragile recovery

Structural reforms have again had a mixed year in the transition region. At the sector level, there has been progress in infrastructure in countries such as Kazakhstan, Russia, Turkey and in the Western Balkans, and a mixture of progress and backtracking in the energy and financial sectors. At the country level, the enforcement of competition policy improved in several of the central and south-eastern European countries as well as in Russia and Turkey.

Governance and enterprise restructuring in Croatia and Montenegro were boosted as these countries reached milestones in their EU accession processes. Several European countries have also initiated or continued fiscal-structural reforms including: fiscal rules, public employment cuts and the elimination of tax exemptions and subsidies. In other countries backtracking has occurred. For example, in Armenia, Belarus and Kazakhstan controls on some prices were imposed, in part as a reaction to commodity price pressures. Belarus and Uzbekistan tightened exchange controls.

By the second quarter of 2011 virtually all transition countries had returned to positive growth. This was led increasingly by domestic demand on the back of easy monetary conditions and a gradual resumption in credit growth and despite continued fiscal consolidation in many countries. Unemployment, however, remains stubbornly high, and the recovery of capital inflows tailed off as a result of increased risk perceptions globally and especially in Europe. The economic outlook for the region deteriorated sharply towards the middle of the year, as a result of a slow-down in growth in some countries, weak leading indicator data, and especially the much less benign external environment resulting from the ongoing sovereign debt crisis in the eurozone. The latter is particularly expected to affect central and south-eastern Europe due to its strong financial and trade linkages to the euro area.

Compared with 2008, economic fundamentals in the region have strengthened in several respects. The region is less dependent on external financing, and bank balance sheets are generally stronger as a result of recapitalisation and de-leveraging. However, public debt levels and financing requirements have gone up, notwithstanding significant fiscal consolidation. A particular concern for the coming year is the large exposure of the region to the eurozone, and particularly the dominant position of eurozone banks in many of the region's economies.

# 2 The crisis from the household perspective

Data from the 2010 EBRD – World Bank Life in Transition Survey (LiTS) show that households in the transition region typically had to reduce their consumption much more than their western European counterparts during the 2008-10 recession. This held true in particular for essentials such as staple foods and health care, where 38 per cent of households in the transition region reported declines, compared with only 11 per cent in western Europe. There were also large differences in the reduction of consumption across transition countries.

Statistical analysis points to a number of reasons for these differences. First, households in the transition region suffered more crisis-related "shocks" such as job losses, wage reductions and declines in remittances. For example, the proportion of households that reported a job loss was twice as high as in western Europe. Second, in comparison to western Europe, official safety nets were much less effective in most of the transition countries. For the transition region as a whole, the analysis shows that unemployment and housing benefits did not significantly dampen the fall in consumption. The lack of effective formal safety nets was only partly offset by borrowing from friends or family (an informal safety net which did not play a significant role in the West).

The third reason has to do with the role of borrowing from banks and other formal sources. While formal borrowing during the crisis helped offset consumption declines in both the transition region and western Europe, it had stronger effects in the West. Moreover, *pre-crisis* borrowing may have left some households across the transition region vulnerable. While mortgages supported consumption during the crisis in the West (presumably because households used them to withdraw equity), they had the opposite effect in the transition region. This is due to the FX-denominated mortgages in countries that experienced a large currency depreciation. However, this does not appear to have made FX borrowers worse credit risks: arrears on FX mortgages were generally lower, even in countries that experienced high depreciation. FX mortgage borrowers in these countries appear to have continued to service their debt at the expense of consumption.

# 3 The intangible transition: support for markets and democracy after the crisis

The LiTS indicates that support for markets and democracy has fallen significantly in most of the more advanced transition countries since 2006, but has increased in many of the less-developed CIS countries. This chapter investigates several hypotheses to explain these changes.

One group of explanations has to do with crisis experiences. The LiTS data reveal that the more people were personally hit by the crisis, the more they turned away from democracy and the free market. Moreover, it seems that it is the impact of the crisis compared with preceding crisis experiences that matters. People became less supportive of democracy if the recent crisis hit them hard relative to their memories of past crises. Since the more advanced transition countries experienced deeper downturns in this crisis but milder ones in the early and mid 1990s, this could go some way to explain why markets and democracy lost support, particularly in the new EU Member States.

However, this does not explain why support for markets and democracy actually *rose* in many of the CIS countries. To address this the analysis tests and finds support for the theory that the crisis made people "turn against what they had". Those who lived in more market-oriented and democratic societies and were affected by the crisis became less likely to choose democracy and markets over other systems. In contrast, people in less democratic and market-oriented countries increased their support for markets and democracy. This is particularly true of crisis-hit people in the CIS countries who perceived a high degree of corruption. It may be that for those individuals, the crisis diminished any sympathy they may have had for state-led systems.

Access to mechanisms that smoothed consumption in the face of crisis-induced income shocks reduced the degree to which households reacted against markets and democracy. In addition, government aid limited the crisis-induced backlash of public opinion against the system in place. In the EU countries, merely *receiving* social assistance (over and above the effect of social assistance on consumption) helped maintain support for democracy and markets. At the same time, receiving unemployment benefits made it less likely that people increased their support for markets in the more state-led CIS countries.

# 4 Entrepreneurship in the transition region: an analysis based on the Life in Transition Survey

Entrepreneurial activity is a key contributor to private sector development and economic growth in transition countries. This chapter analyses the determinants of entrepreneurship in the region using data from the second round of the LiTS. In line with previous research, the results confirm that development of the financial sector and access to credit are important determinants of entrepreneurial success. At the individual level, the analysis suggests that exposure to education is associated with a higher propensity to start a business, although not with a higher likelihood of success. The chapter also finds that entrepreneurship is linked to individual attitudes, such as a willingness to take risks, and that women, although less likely to attempt to set up a business, are no less likely to succeed than men when they try to do so. This may argue for policies targeted at encouraging potential female entrepreneurs.

The evidence in this chapter also supports the theory that entrepreneurial activity develops in clusters. In regions where such activity is more prevalent, individuals appear more likely to try to set up a business and to succeed in doing so. Whether this reflects a positive "spillover" from existing entrepreneurial activity or simply the fact that some regions provide a better environment for entrepreneurs requires further research. Either way, the results suggest that it may be worth creating good conditions for entrepreneurship at the regional level rather than just the national level.

One important feature of the LiTS data is that they allow the distinction between "necessity entrepreneurship", in which individuals are forced to create small businesses due to a lack of formal employment and "opportunity entrepreneurship", where they instead act on ideas and profit opportunities. "Necessity entrepreneurs" will be less likely to innovate, limiting their potential positive impact on economic growth. However, the LiTS data show that similar individual, regional and country-wide features contribute to the likelihood of trying and being successful in starting a business among opportunity entrepreneurs and the wider population. Based on this analysis, policy-makers should not be concerned about the possibility of encouraging the wrong kind of entrepreneurship – in other words, supporting all business starters should translate into increased numbers of opportunity entrepreneurs.

# Foreword

For the second time in only three years, the global economy and the transition region are facing a situation of exceptional uncertainty and potential crisis. In 2008-09 the transition region was one of the areas most deeply affected by the global crisis. Since then it has also been the region slowest to recover. With few exceptions the European transition region never reached the buoyant growth levels of other emerging market countries, and in many countries output is still below 2008 levels. Before the eurozone crisis intensified growth prospects looked encouraging; but unfortunately the region again has reasons to prepare itself for another crisis.

This time the circumstances are different. The transition region is in some ways better prepared for a reversal of capital flows than it was in 2008. Financial sectors have generally been strengthened. At the same time, fiscal positions, notwithstanding significant adjustments in the last two years, remain fragile. So does the fledgling economic recovery in the region. Most significantly, the main source of the instability – the debt crisis in the eurozone – is hitting even closer to home this time. If the crisis spins out of control, the financial integration model across advanced and emerging Europe and beyond may be in jeopardy. The model was defended against the odds in the last crisis, but will it survive intact this time?

This *Transition Report* is once again concerned with the themes of crisis and transition. Like its two predecessors, the *Transition in Crisis?* (2009) and *Recovery and Reform* (2010), this report focuses on understanding both the 2008-10 crisis and its longer-term implications. It looks beyond the crisis for sources of growth that are less sensitive to changes in the external environment than the capital-inflow driven boom of the pre-crisis years. But it does so from a fresh perspective: that of households and individuals, based on a new round of the EBRD – World Bank Life in Transition Survey (LiTS), conducted in late 2010.

The LiTS survey allows us to obtain a much better picture of how the crisis played out at the level that really matters for welfare: people. A far larger proportion of households were hit hard by the crisis, in the sense of having to reduce even basic consumption such as staple foods and visits to the doctor when ill, than their counterparts in western Europe. The report also shows very large variations within the transition region, with households in countries such as Bulgaria, FYR Macedonia, Hungary, Latvia and several other south-eastern European countries among the hardest hit, while households in Belarus, Poland, Russia and the Slovak Republic seem to have been much less affected (about in line with France or the UK in terms of reported consumption declines).

The differences across countries are somewhat, but not very closely, correlated with aggregate measures of the crisis impact such as GDP decline or increases in unemployment. This demonstrates that macroeconomic measures alone do not give the full picture. The report goes on to explore in detail why households in some countries suffered much more than in others, and why the transition region as a whole suffered more severe consumption adjustments than western Europe – with important new findings about the role of social safety nets and foreign currency borrowing, to name a few.

A critical – perhaps the most critical – question concerns the potential long-run implications of the crisis: did the crisis undermine support for democracy and markets in the transition region? The 2010 LiTS suggests that in the new EU Member States, which have market-based and democratic systems and were also generally hit hard by the crisis, unequivocal support for markets and democracy, respectively, dropped sharply by about 10 percentage points compared with the first round of the survey

> **"If the crisis spins out of control, the financial integration model across advanced and emerging Europe and beyond may be in jeopardy. The model was defended against the odds in the last crisis, but will it survive intact this time?"**

in 2006. At the same time, the LiTS reveals an extraordinary development in the opposite direction in countries further east. Excluding Russia – where unequivocal support for democracy and markets was and remains low – support for democracy and markets increased in eastern Europe, the Caucasus countries and Central Asia, overtaking support levels in the new EU member countries by a wide margin. Households seem to have turned particularly against the systems that they perceived to prevail in their own countries.

Lastly, this report also explores a wealth of available data in LiTS on a subject that is likely to be key to sustainable long-run growth in the region: entrepreneurship. The last chapter confirms some insights from the previous literature, in particular the paramount importance of access to finance, quality education and some degree of entrepreneurial risk-taking. It also shows that women are less likely to try to set up businesses than men, but that once they try, they are no less likely to succeed. Lastly, it finds that regions within countries which already harbour many entrepreneurs are both more likely to see new attempts to set up businesses and to see them succeed conditional on trying. This suggests either that there are genuine geographic spillovers of entrepreneurship, or that local business environment conditions matter a lot, or both. Disentangling these factors is a matter for future research.

In the end this report offers limited comfort to a region that once again is looking into the abyss, at the mercy of a global financial crisis not of its own making. On balance the region may be more resilient than in 2008, but the storm potentially hitting the region may be even stronger. It is also unclear whether the international policy response will be as supportive as last time. The impact on households may be even stronger as their balance sheets have not been fully repaired and social safety nets have not been reinforced. Yet these generalisations mask tremendous diversity in resilience and overlook remarkable pockets of entrepreneurship. In their search for how to better protect households and harness entrepreneurial talent, policy-makers should look at the experience within the region, as well as outside.

A remarkable fact, particularly against the background of the Arab Spring, is the coincidence of a rising sentiment for democracy and markets in many of the more state-dominated transition countries with a hardening of policies – including in the economic sphere, as shown in the report. How this tension is resolved will shape the future of these countries, but may also have an impact far beyond the region. Possibly for the first time the experience from 20 years of hard-fought economic and political transition, particularly that of central and eastern Europe, is serving as an inspiration to other regions in the world, including North Africa and the Middle East. At the same time, developments in the latter region are influencing events in less-advanced transition countries in Europe and Asia. This transfer of transition experience across regions promises to spark new hope in societies that find themselves stuck in their economic and political transformation.

**Erik Berglof**
Chief Economist
EBRD

# Chapter 1
# A fragile recovery

**Reforms have advanced in the region in 2011 in some difficult areas including: enforcement of competition policy, commercialisation of infrastructure and development of capital and private equity markets. However, there have also been reversals, including in some more basic reforms. The economic recovery that began in 2010 consolidated in the first half of 2011, as growth has continued or restarted almost everywhere in the transition region. More recently, outlook has worsened and risks to the recovery have significantly increased as a result of the region's high exposure to the troubled eurozone.**

## Reforms, economic development and outlook in the transition region

8

**The number of countries** where improvements in competition policy warranted a transition indicator upgrade

12%

**The average non-**performing loans level in the first half of 2011

3.2%

projected growth rate for the region in 2012, down from 4.5% in 2011

# A fragile recovery

The past year has seen a consolidation of the economic recovery that began in 2010. Growth has resumed in almost the entire transition region, driven by a benign external environment until the first half of this year. However, the outlook for growth has worsened and risks to its continuation have increased significantly, mainly due to persisting financial market volatility and weaker growth in the eurozone, the region's key economic partner. While some market reforms have continued to progress – notably in difficult areas such as enforcement of competition policy, commercialisation of infrastructure and development of capital and private equity markets – there have also been reversals in a number of countries in more basic, first-stage transition, such as price and trade liberalisation. Most of these setbacks have occurred in less-developed countries, risking even wider divisions between the relatively advanced states of central Europe and the Baltic states (CEB) and, to a lesser extent, south-eastern Europe (SEE) on the one hand, and those transition countries further east on the other.

The first part of this chapter assesses the progress and reversals in reform that have occurred over the past year. Two broad measures of reform are used to allow cross-country comparisons and to show how transition challenges have evolved. The first is an assessment covering 16 sectors grouped within four main categories – corporate, energy, infrastructure and financial – in each economy. The second is broader and country-based, and relates to issues such as privatisation, liberalisation and governance. Both measures are based on a similar numerical scale and together provide a useful complementary snapshot of where each country stands in the transition process.

The chapter then provides an overview of macroeconomic developments since mid-2010. The region has continued to recover from the deep impact of the crisis over the past year, and by the summer of 2011 virtually all countries were experiencing growth again. The expansion was driven by strong performance in core eurozone countries, as well as by high commodity prices. In many countries this growth has not yet translated into lower unemployment; however, it appears to have helped fuel an increase in core inflation. This may be partly due to rather loose monetary policies across the region, which have attempted to soften the negative impact on growth of the fiscal tightening that took place in many transition economies.

The region's exposure to the eurozone is the main factor behind its worsened growth outlook and probably the main vulnerability that could derail its continued recovery. A prolonged weakness in western European economies would likely result in lower exports from transition countries, as well as depressed foreign direct investment (FDI) and other inward financing flows. Perhaps most importantly, an adverse shock to bank inflows from the eurozone, which is now quite likely, would lower the availability of private credit extended by eurozone bank subsidiaries in the region. The central and south-eastern European countries, and especially the latter, are the most exposed to a slow-down in eurozone activity in general as well as to a bank financing shock in particular. Projections for their growth have been therefore lowered significantly as a result of the ongoing eurozone debt turmoil, which affects economic performance further east much less.

## Progress in transition

### Sectoral transition indicators

In recent years the EBRD's Office of the Chief Economist has developed a new methodology for assessing progress in transition at the sectoral level. This involves examining 16 sectors in four categories – covering the corporate, energy, infrastructure and financial areas – in each country and, based on a wealth of data and other information, evaluating the size of the remaining transition "gaps", or challenges. An assessment can then be made about what needs to be done, in terms of changing the market structure and developing market-supporting institutions, to bring the standards up to those of a hypothetical well-functioning market economy. The information used in this assessment includes analysis not only of laws and regulations "on the books", but also of how well they are being implemented.

The methodology underlying these assessments was explained in Chapter 1 of the *Transition Report 2010* (see also the Methodological Notes on page 168). In summary: for each sector, the EBRD's economists select subcategories of the market structure and institution components for which public data and other information are available. This information is then "scored" and, based on these scores, the transition gaps for both market structure and market-supporting institutions are classified as "negligible", "small", "medium" or "large". These gap scores are then combined to give an overall numerical score for the sector, on a scale of 1 to 4+. The final score involves a strong element of judgment on the part of the EBRD's economists, as well as rigorous analysis of the data and information.

Table 1.1 shows the transition scores for all sectors and countries. Annex 1.1 contains the component ratings for market structure and market-supporting institutions and policies, respectively. Those instances where an upgrade (higher score) has occurred are marked with an upward arrow, while downgrades are marked with a downward arrow.[1]

Most scores are the same as those reported last year, and therefore the broad differences across regions and sectors revealed by last year's analysis remain unchanged. The highest scores are typically in the CEB countries, followed by SEE and Turkey; the lowest scores are in Central Asia. At the sectoral level,

[1] It should be noted that some sector scores differ from those reported last year, not because of upgrades or downgrades but because of historical revisions to reflect information that was either not available or not fully taken into account last year.

Table 1.1
## Sector transition indicators 2011: overall scores

| | Corporate sectors | | | | Energy | | | Infrastructure | | | | Financial institutions | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Agribusiness | General industry | Real estate | Telecommunications | Natural resources | Sustainable energy | Electric power | Water and wastewater | Urban transport | Roads | Railways | Banking | Insurance and other financial services | MSME finance | Private equity | Capital markets |
| **Central Europe and the Baltic states** | | | | | | | | | | | | | | | | |
| Croatia | 3 | 3+ | 3+ | 4 | 4- | 3- | 3 | 3+ | 3+ | 3 | 3- | 3+ | 3 | 3- | 2+ | 3 |
| Estonia | 3+ | 4+ | 4+ | 4 | 4 | 3- | 4 | 4 | 4- | 3 | 4 | 4- | 3+ | 3 | 3- | 3↑ |
| Hungary | 4 | 4- | 4- | 4 | 4 | 3 | 4- | 4 | 3+ | 4- | 3+↓ | 3+ | 3↓ | 3 | 3 | 3+ |
| Latvia | 3 | 4- | 4- | 3+ | 3+ | 3+ | 3+ | 3+ | 4- | 3 | 4- | 3+ | 3+ | 3 | 3-↑ | 3 |
| Lithuania | 3+ | 4- | 4- | 4- | 3+ | 3+ | 3+ | 3+ | 4- | 3 | 3 | 3+ | 3+ | 3 | 2+ | 3 |
| Poland | 3+ | 4- | 4- | 4 | 3 | 3 | 3+ | 4- | 4- | 4- | 4 | 3+ | 4- | 3 | 3+ | 4- |
| Slovak Republic | 3+ | 4+ | 4 | 4- | 3+ | 3 | 4 | 3+ | 3+ | 3- | 3+↑ | 4- | 3+ | 3+ | 2+ | 3 |
| Slovenia | 4- | 3+ | 4 | 3+ | 3+ | 3+ | 3 | 3+ | 3+ | 3 | 3 | 3 | 3 | 3 | 2+ | 3 |
| **South-eastern Europe** | | | | | | | | | | | | | | | | |
| Albania | 3- | 2+ | 3- | 3+ | 3- | 3+ | 3 | 2+↑ | 3- | 3-↑ | 2 | 3- | 2 | 2+ | 1 | 2- |
| Bosnia and Herz. | 3- | 2 | 2- | 2+ | 2 | 2 | 2+ | 2 | 2+ | 3↑ | 3+ | 3- | 2+ | 2+ | 2-↑ | 2- |
| Bulgaria | 3 | 3+ | 3+ | 4- | 3+ | 3- | 4- | 3 | 3+ | 3- | 3+ | 3 | 3+ | 3- | 3- | 3 |
| FYR Macedonia | 3- | 3 | 3- | 4- | 2+↑ | 2+ | 3 | 2+ | 3- | 3- | 3- | 3- | 2+ | 2+ | 1 | 2- |
| Montenegro | 2+ | 2+ | 2+ | 3+ | 3+ | 2 | 2+↓ | 2 | 3 | 2+ | 2 | 3- | 2+ | 2+ | 1 | 2 |
| Romania | 3- | 3+ | 3+ | 3+ | 4- | 3+ | 4- | 3+ | 3+ | 3 | 4 | 3 | 3+ | 3- | 2+ | 3 |
| Serbia | 3- | 3- | 3- | 3 | 2 | 2 | 2+ | 2+↑ | 3- | 3- | 3 | 3- | 3 | 3- | 2- | 3- |
| Turkey | 3- | 3 | 3+ | 3+ | 3+ | 3+ | 3+ | 3 | 3+ | 3-↑ | 3- | 3 | 3+ | 3- | 2+ | 4- |
| **Eastern Europe and Caucasus** | | | | | | | | | | | | | | | | |
| Armenia | 3- | 3 | 3- | 3 | 3- | 3- | 3+ | 3- | 2+ | 3- | 2+ | 2+ | 2 | 2+ | 1 | 2 |
| Azerbaijan | 2+ | 2 | 2 | 2- | 2+ | 2 | 2+ | 2- | 2 | 2+ | 2+ | 2 | 2 | 2 | 1 | 2- |
| Belarus | 3- | 2↓ | 2 | 2 | 1 | 2 | 1 | 2- | 2 | 2 | 1 | 2 | 2 | 2 | 1 | 2- |
| Georgia | 3- | 3- | 3- | 3- | 2 | 3- | 3+ | 2 | 2+ | 2+ | 3 | 3- | 2 | 2+ | 1 | 2- |
| Moldova | 3- | 2- | 2+ | 3 | 3 | 2+ | 3 | 2 | 3- | 3- | 2 | 2+ | 2 | 2 | 2- | 2+ |
| Ukraine | 3- | 2+ | 3- | 3- | 2- | 2+ | 3 | 2+↑ | 3- | 3- | 2 | 3- | 3- | 2 | 2- | 3- |
| Russia | 3- | 3- | 3- | 3+ | 2 | 2 | 3+ | 3- | 3 | 3-↑ | 3+↑ | 3- | 3- | 2 | 2+ | 4- |
| **Central Asia** | | | | | | | | | | | | | | | | |
| Kazakhstan | 3- | 2 | 3 | 3 | 2- | 2 | 3+ | 2+↑ | 2+↑ | 2+ | 3 | 3- | 2+ | 2 | 2- | 3 |
| Kyrgyz Republic | 2+ | 2 | 2+ | 3 | 2+ | 2 | 2+ | 2- | 2 | 2- | 1 | 2 | 2- | 2- | 1 | 2- |
| Mongolia | 3- | 2+ | 2 | 3 | 2 | 2 | 2+ | 2 | 2 | 2- | 3- | 2+ | 2 | 2 | 2- | 2+ |
| Tajikistan | 2 | 2- | 2- | 2+ | 1 | 2+ | 2 | 2↑ | 2 | 2- | 1 | 2 | 2 | 1 | 1 | 1 |
| Turkmenistan | 1 | 1 | 1 | 2- | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 2- | 1 | 1 | 1 |
| Uzbekistan | 2 | 1 | 2 | 2 | 1 | 2- | 2+ | 2- | 2 | 1 | 3- | 1 | 2 | 1 | 1 | 1 |

Source: EBRD.
Note: There were one-notch upgrades this year in 16 cases: natural resources (FYR Macedonia), water and wastewater (Albania, Serbia, Ukraine, Kazakhstan and Tajikistan), urban transport (Kazakhstan), roads (Albania, Bosnia and Herzegovina, Turkey and Russia), railways (Slovak Republic and Russia), private equity (Latvia and Bosnia and Herzegovina) and capital markets (Estonia). There were four downgrades - general industry (Belarus), electric power (Montenegro), railways (Hungary), insurance and other financial services (Hungary). In addition, there were historical revisions in the following cases to take account of new data and information and to achieve greater cross-sector consistency: roads (Estonia, Latvia and Lithuania), banking (Mongolia and Slovenia), water and wastewater (Georgia), insurance and other financial services (Croatia, Poland and Slovenia), private equity (Croatia) and capital markets (Mongolia and Slovenia), and urban transport (Mongolia).

Box 1.1

## Reform progress and sector-level challenges in Egypt, Morocco and Tunisia

The "Arab Spring" revolutions have sparked a process of transition towards a new democratic order in the countries of the southern and eastern Mediterranean (SEMED). Accompanying these democratic reforms are plans for economic reform focused on private sector-led growth, as described in the countries' submissions to the "Deauville partnership" proposed by the G-8 in May 2011.[2] At the same time the EBRD was asked by its shareholders to undertake a series of technical assessments, carried out in the spring and summer of 2011, that could serve to underpin a private-sector led, socially inclusive transition agenda. While these assessments do not yet apply the full EBRD transition indicator methodology to these countries, they give a flavour of where these countries stand in terms of market structures and market-supporting institutions, particularly at the sector level. This box summarises the results for three countries: Egypt, Morocco and Tunisia.

The economic history of the three countries contains some important parallels. From the 1950s until the 1970s, all countries pursued state-led policies, involving the nationalisation of industrial plants, banks and insurance companies in Egypt and the enforcement of "Moroccanisation" in Morocco. Protectionist trade policies were gradually relaxed during the 1970s.

Market-oriented reforms generally began in the mid-1980s. In Morocco an initial round of liberalisation and privatisation in the financial sector was followed by a more comprehensive reform push from 2000 which included large-scale privatisation (such as telecommunications); an in-depth public finance reform; external liberalisation; and stronger financial sector regulation. Egypt liberalised trade, dismantled some state monopolies along with investment and production controls, and privatised one-third of its state-owned companies in the early and mid 1990s. A second reform round during 2004-08 brought about further price liberalisation and privatisations, tariff reductions and the removal of foreign direct investment (FDI) restrictions, improvements in the business environment, the creation of a competition agency, and financial sector reform.

Tunisia's path differs in so far as its production and export industries were already developed and sufficiently diversified during the protectionist period. Trade and the exchange rate system were gradually liberalised, culminating in full current account convertibility by 1993. Subsequent reform efforts focused on improving competitiveness and boosting foreign participation, albeit with a focus almost entirely on creating an offshore sector within special industrial zones located along the coastline.

While many of these reforms moved in the right direction and were partly successful, they left some important gaps. All three countries, particularly Egypt and Morocco, suffer from high subsidies in the energy and food sectors; a poorly targeted and expensive form of social protection. In Tunisia the banking system remains vulnerable, with under-performing state-banks, borrower concentration and high non-performing loans. Government control was largely retained not only in banking but also in key sectors including energy and telecommunications. In Morocco there is an unfinished reform agenda concerning the energy sector and infrastructure, as well as the business environment, which suffers from low minority interest protection and cumbersome property registration procedures. The business environment also remains a problem in Egypt, particularly when it comes to closing a business and enforcing contracts. In addition, fiscal-structural reforms remain incomplete, regulatory institutions are often weak, and there is scope for further privatisation.

Sector-level analyses add granularity to this general picture of unfinished transition:

In **manufacturing and services**, Tunisia stands out with a relatively competitive offshore sector that hosts many private and international companies, the result of well-sequenced privatisations paralleled by the liberalisation of prices and trade. Morocco has undergone rapid trade integration and its manufacturing sector is largely privately owned, but generally lacks competitiveness. In Egypt the privatisation process has stalled, leaving the petrochemical, pharmaceuticals and textile sectors under public control. Energy subsidies encourage high energy intensity, partly offsetting the positive effects of price liberalisation. With respect to the institutional framework, Tunisia is the most advanced, with an independent competition authority that is in line with international standards. Morocco is catching up in this area, most recently by submitting a draft law that would strengthen the competition authority. Egypt's competition authority is not yet fully independent.

Egypt's **agricultural sector** faces high obstacles. Small and fragmented land holdings, a lack of training and inefficient irrigation systems contribute to overall low productivity. Morocco also lacks adequate infrastructure and suffers from inefficient water and fertilisation management. Its food processing industry also needs development. However, Morocco has started a pilot project on warehouse receipt finance and plans to move away from water-intensive grain crops supported by the government's *Plan Maroc Vert* (Green Morocco Plan). Access to rural credit remains limited and agricultural insurance products such as weather-indexed insurance are yet to be developed. In Tunisia rural financing is dominated by the activities of state-owned agricultural banks, alongside government subsidies and company-retained earnings. Shortcomings persist along the whole food value chain, particularly

[2] For example, the Egyptian and Tunisian documents emphasise governance and transparency of public institutions, job creation and social reforms. Morocco's submission emphasises human capital formation, greater independence of regulatory bodies such as the Competition Authority, and unbundling in the energy sector.

with regard to logistics and the implementation of international standards as well as product tracking. Modern retailers are present in all three countries, but mainly in urban areas. Egypt has reduced its tariffs on agricultural products to below 30 per cent, while most favoured nation-applied tariffs remain high at over 40 per cent in Morocco and Tunisia. Significant untargeted consumer and producer subsidies remain in place in all three countries.

The **municipal infrastructure** in the region is generally hampered by low private sector participation, weak regulatory frameworks and limited fiscal autonomy and administrative capacity. Only Morocco's water administration is relatively decentralised. Egypt partly unbundled the water supply, but did not dissolve its centralised structure. Inadequate solid waste management, poor access to sanitation and low efficiency in the use of water constitute a significant social and environmental problem. Excluding sanitation, where the private sector share covers about 20 per cent, Tunisia has very limited private sector participation in municipal infrastructure. This differs from Morocco, where private sector firms operate in waste management and water supply, albeit with low competition, and also have an increasing role in urban transport. Neither Morocco nor Tunisia has an independent water regulator and Egypt's regulator is not fully operational.

**Transport** networks have been extended over the past years but are dominated by state-owned companies that usually combine infrastructure provision and operations. Private sector participation is extremely limited and confined to public-private partnerships (which are currently not to international standards). One exception is the ports, which are open to private sector operations in Morocco and Tunisia. Morocco also has plans to corporatise the vertically integrated national rail agency and separate operations from infrastructure. In all three countries, the transport sector lacks an independent regulator.

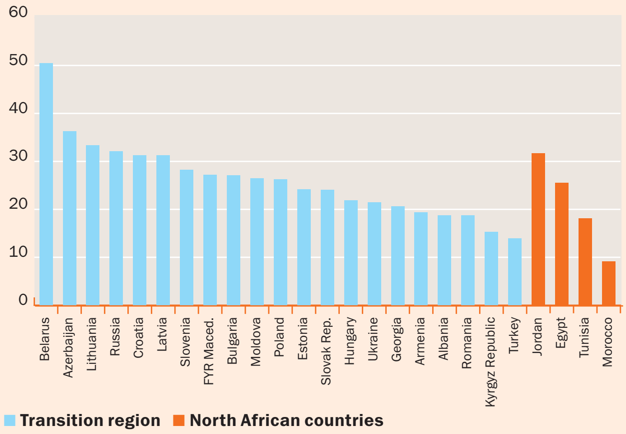
In the **energy sector**, markets continue to be dominated by vertically integrated state monopolies, while legislative and regulatory frameworks lack transparency. Morocco and, to a lesser extent, Tunisia depend on energy imports (mostly crude oil and petroleum products). Although the downstream petrol distribution sector has been liberalised in all three countries and opened to foreign entry, state-owned incumbents continue to manage a large sector share and there is lack of competition. However, the private sector and international oil and gas companies play an important role in hydrocarbon extraction. Plans to establish an independent oil and gas regulator in Egypt and new allocation of exploration permits in Egypt and Tunisia point to renewed efforts to attract much-needed investment in the sector. Fuel and electricity are subsidised in all three countries, contributing to wasteful consumption and poor energy efficiency. Although targets have been set to meet energy demand with renewable energy technologies, the sustainable energy sector is still in its infancy.

In the **financial sector**, Morocco has the highest degree of financial intermediation and the largest share of private ownership among the three countries. State-owned banks represent 25 per cent of the banking sector, compared with 33 per cent in Tunisia and 45 per cent in Egypt. Half of the population in Morocco has a bank account, but only 10 per cent does so in Egypt, where there are only 4.5 bank branches per 100,000 inhabitants, compared with 13 in Tunisia and 14 in Morocco. Small and medium-sized enterprises generally find it hard to access bank borrowing, in part because banks typically require collateral.

Structural weaknesses in the banking sector typically involve low capitalisation and insufficient competitiveness. Insurance and non-banking financial services are still relatively small and concentrated on few participants in all three countries. Over the past years, both Egypt and Morocco have initiated steps to strengthen the regulation and supervision of the financial sector. The domestic capital markets are generally underdeveloped, although building blocks for a government securities market have been established. While Tunisia's secondary market offers long maturities but is lacking in liquidity, Egypt does not have a reliable local currency yield curve. By contrast, Morocco has a relatively liquid and operationally efficient debt secondary market and an inter-bank repurchase agreement (repo) market. However liquidity only exists in the overnight market, and collateral valuation and use still need to be developed.

Chart 1.1.1
**Similar share of public sector employment in southern, eastern Mediterranean countries and transition region**

**Public sector employment in percentage of total employment**




Source: International Labour Organization, Tunisian National Institute of Statistics.
Note: Most recent available data. Data for Tunisia uses the 2007 Tunisian National Institute of Statistics Labor Force Survey (LFS). Note that the public sector employment shares are substantially higher for university graduates (for example, 55 per cent in Tunisia).

the sector with the highest average score is telecommunications, with 3.08, while the least-developed sector is private equity, with an average of 1.78. The rest of this section looks more closely at these changes relative to last year.

Of the four broad sector categories – corporate, energy, infrastructure and financial – the one with the highest number of upgrades is infrastructure, where there has been significant progress in the roads and water and wastewater sectors. Elsewhere, there have been only isolated changes.

Box 1.1 gives a sense of the sector transition gaps (without for now including a numerical rating) in three North African countries that have recently expressed an interest in becoming EBRD countries of operations. Future *Transition Reports* will extend these sector assessments and calculate transition indicators at both the sector and country level for these and other countries of the southern and eastern Mediterranean (SEMED).

### Infrastructure

In Russia and Turkey, the two largest countries, the score for roads has increased from 2+ to 3-, reflecting sustained improvement in commercialisation and private sector involvement. In Russia the concession law was amended in July 2010 and two major road concession projects have since been signed and are under construction. In Turkey several public-private partnership (PPP) projects have been launched, with contracts awarded in the past year. Upgrades in Albania and Bosnia and Herzegovina reflect reform momentum over several years. In Albania a road agency was established in July 2011 and private sector involvement in maintenance has increased significantly, while in Bosnia and Herzegovina all maintenance companies have been privatised and a PPP tender has been launched on a competitive basis. In the water and wastewater sector five countries – Albania, Kazakhstan, Serbia, Tajikistan and Ukraine – have been upgraded, although from a relatively modest level (2 to 2+, except in Tajikistan where it was 2- to 2), due to tariff increases and/or methodological reforms with the aim of achieving cost-reflective pricing.

In the urban transport sector the only upgrade has been in Kazakhstan. A public service contract was signed in the second half of 2010 in the largest city, Almaty, and masterplans have been formulated for several major cities. The upgrade also reflects significant efforts to introduce greater energy efficiency into urban transport – for example, through the introduction of buses fuelled by compressed natural gas. In Hungary increased central government influence and control over the Budapest municipal transport company, BKV, was not sufficiently retrogressive to warrant a downgrade. However, the railways sector score was marked down to reflect the establishment of a National Transport Holding Company, which is expected to weaken intermodal competition, and an increase in subsidies and proposed debt write-off. On the positive side, there were upgrades for railways in Russia, where infrastructure has been separated from operations and there has been progress in divesting non-core assets and in privatisation, and also in the Slovak Republic as a result of advances in labour restructuring and the reduction of state subsidies.

### Financial sectors

As financial sectors continue to recover from the effects of the crisis, the number of upgrades has been limited to two in the private equity market and one in capital markets. Bosnia and Herzegovina and Latvia each received a private equity upgrade to reflect substantial increases in the amount of active capital invested and capital available for investment, respectively. Estonia's capital market score was raised from 3- to 3 as a result of the country's accession to the eurozone in January 2011, which allows it to benefit from the eurozone money market. However, Hungary received a downgrade in the insurance and other financial services sector as a result of significant reversals in the pension system in autumn 2010 entailing the virtual abolition of the second pillar (II) system.

Despite their declining role, state banks in the EBRD region proved to be a relatively stable source of credit during the recent crisis. Some governments in the Commonwealth of Independent States (CIS) and SEE countries have used state banks to fill the funding gaps left by private institutions, turning state banks into a countercyclical credit source. The weakness of the private banking sector has led some state banks to expand their domestic operations and also increase their international subsidiary networks. It remains to be seen whether the conduct of their lending operations abroad will prevent the build-up of bad loan portfolios that have plagued many state banks in their domestic markets (see Box 1.2).

### Corporate sectors

There has been little tangible reform progress or regression across the three corporate sectors – agribusiness, general industry and real estate. Agribusiness in Bosnia and Herzegovina and Turkey has shown a significant increase in ISO (International Organization for Standardization) certifications, warranting a reduction in the market institutions transition gap for both countries, but the overall sector score has remained the same. The only score change was a downgrade from 2+ to 2 for general industry in Belarus. This reflects an increase in the market institutions transition gap from "medium" to "large", which was mainly due to a presidential decree in 2010 that allows the state to take control of private companies. This decree has been used in the case of a major industrial company following an accident at its plant which led to a number of deaths.

### Energy

Progress in the sustainable energy sector over the past year has been limited across the whole region. Nevertheless, the general trend has been towards greater use of sustainable methods and processes, and scores are likely to increase in future years if this momentum is maintained. In the natural resources sector,

Table 1.2
## Transition indicator scores, 2011

| | Enterprises | | | Markets and trade | | |
|---|---|---|---|---|---|---|
| | Large-scale privatisation | Small-scale privatisation | Governance and enterprise restructuring | Price liberalisation | Trade and foreign exchange system | Competition policy |
| Albania | 4- | 4 | 2+ | 4+ | 4+ | 2+ |
| Armenia | 4- | 4 | 2+ | 4 ↓ | 4+ | 2+ |
| Azerbaijan | 2 | 4- | 2 | 4 | 4 | 2- |
| Belarus | 2- | 2+ | 2- | 3 ↓ | 2 ↓ | 2 |
| Bosnia and Herzegovina | 3 | 3 | 2 | 4 | 4 | 2+ |
| Bulgaria | 4 | 4 | 3- | 4+ | 4+ | 3 |
| Croatia | 3+ | 4+ | 3+↑ | 4 | 4+ | 3 |
| Estonia | 4 | 4+ | 4- | 4+ | 4+ | 4- |
| FYR Macedonia | 3+ | 4 | 3- | 4+ | 4+ | 3- ↑ |
| Georgia | 4 | 4 | 2+ | 4+ | 4+ | 2 |
| Hungary | 4 | 4+ | 4- | 4+ | 4+ | 4- |
| Kazakhstan | 3 | 4 | 2 | 4- ↓ | 4- | 2 |
| Kyrgyz Republic | 4- | 4 | 2 | 4+ | 4+ | 2 |
| Latvia | 4- | 4+ | 3 | 4+ | 4+ | 4- ↑ |
| Lithuania | 4 | 4+ | 3 | 4+ | 4+ | 4- ↑ |
| Moldova | 3 | 4 | 2 | 4 | 4+ | 2+ |
| Mongolia | 3+ | 4 | 2 | 4+ | 4+ | 3- |
| Montenegro | 3+ | 4- | 2+↑ | 4 | 4 | 2 |
| Poland | 4- | 4+ | 4- | 4+ | 4+ | 4- |
| Romania | 4- | 4- | 3- | 4+ | 4+ | 3+↑ |
| Russia | 3 | 4 | 2+ | 4 | 3+ | 3- ↑ |
| Serbia | 3- | 4- | 2+ | 4 | 4 | 2+ |
| Slovak Republic | 4 | 4+ | 4- | 4+ | 4+ | 4- ↑ |
| Slovenia | 3 | 4+ | 3 | 4 | 4+ | 3 |
| Tajikistan | 2+ | 4 | 2 | 4 | 3+ | 2- |
| Turkey | 3+ | 4 | 3- | 4 | 4+ | 3 ↑ |
| Turkmenistan | 1 | 2+ | 1 | 3- | 2 | 1 |
| Ukraine | 3 | 4 | 2+ | 4 | 4 | 2+ |
| Uzbekistan | 3- | 3+ | 2- | 3- | 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 168. ↑ and ↓ arrows indicate one-notch upgrades or downgrades from the previous year. Some of the competition policy scores differ from those reported last year because of retroactive changes to the scores to reflect new information not available in previous years.

Box 1.2

## State banks: confidently crossing borders

The role of state-owned banks has declined over the past two decades, most notably in central and eastern Europe, where many have been privatised and subsequently sold to foreign investors.[3] State banks nevertheless remain integral to banking sectors across the world, and the global crisis has boosted their economic importance (although whether this is temporary or not remains to be seen). While private banks struggled – and in some cases continue to struggle – with liquidity and solvency problems, government-owned banks could rely on the certainty of state support and a stable deposit base. Some governments also actively used state banks to fill the funding gap left by private institutions, turning state banks into a countercyclical credit source.

Some state banks not only consolidated their position at home but also announced ambitious expansion plans abroad, often profiting from the weakness of their private competitors. For instance, the foreign subsidiaries of Russia's Sberbank in Belarus, Kazakhstan and Ukraine jointly amount to about 2 per cent of the bank's total group assets after having doubled in size between 2004 and 2010. More significantly, Sberbank recently signed an agreement to acquire 100 per cent of Austrian Volksbank International, including its subsidiary network across the transition region, except for its Romanian division. According to its development strategy up to 2014, Sberbank aims to expand mainly into the CIS countries, but will also consider acquisitions and greenfield investments outside that region. Likewise, the subsidiaries of Russia's VTB Bank in Armenia, Belarus, Georgia and Ukraine account for 3.4 per cent of the bank's total assets. The bank intends further expansion abroad and plans to become one of the top five banks in Ukraine by 2013.

Chart 1.2.1 shows that Chinese, Indian, Libyan and Russian state banks are relatively active abroad. Within the transition region, foreign state banks operate predominantly in Belarus, Kazakhstan, Russia, Ukraine and a number of the Western Balkans countries. For example, Bosnia and Herzegovina hosts five subsidiaries of foreign state banks (including banks from Slovenia and Turkey), which accounted for 8.5 per cent of total banking sector assets in the country at end-2009.

Overall, it is possible to distinguish four broad geographical patterns of foreign state bank activity, each with its own economic rationale.

- First, foreign state banks in the transition region are often subsidiaries of Russian banks, most notably VTB and Sberbank, and of the Slovenian bank Nova Ljubljanska Banka (NLB – which is 48.6 per cent government-controlled). Roughly 18 per cent of NLB's assets derive from its subsidiaries in Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Montenegro and Serbia (up from only 7 per cent in 2004). These foreign state banks lend to local borrowers as well as home-country firms in an effort to geographically diversify their business – which raises an as-yet unanswered question about the extent to which they distort the market because of their access to abundant government funding at home. What is clear is that they aim to expand rapidly to take advantage of the prevailing weakness of private banks.

- Second, state banks from the Middle East and North Africa (MENA) mainly operate in other MENA countries. This is particularly the case

an upgrade occurred in FYR Macedonia, where a new energy law, approved by parliament in February 2011, complies with EU requirements. In the power sector, the only change was a downgrade for Montenegro because of a decision by the regulator in early 2011 to reduce tariffs, particularly for residential users.

## Country transition indicators

Since 1994, when the *Transition Report* was first published, the EBRD has been tracking progress in transition through a set of country-level transition indicators. The evolution of this methodology, and its relative merits and drawbacks, were discussed at length in last year's report. The main weakness of these indicators was that they failed to take sufficient account of the institutional framework surrounding private-sector development and the creation of markets. That was one of the reasons why a more rigorous, sector-based methodology was developed and why these sector scores have superseded the traditional transition indicators. However, most of the latter indicators still capture relevant aspects of transition and it was therefore decided that six should be retained and updated for this year. The six indicators are: small-scale privatisation; large-scale privatisation; price liberalisation; trade and foreign exchange system; governance and enterprise restructuring; and competition policy. The scoring scale is the same as for the sector indicators, with 1 representing little or no progress in transition and 4+ representing the standards of an industrialised market economy.

Table 1.2 shows this year's scores, with upgrades and downgrades indicated by an upward or downward pointing arrow. There are two striking results to be noted: a significant number of countries have been upgraded for competition policy, while a few have shown a reversal in price liberalisation.

For several years, the EBRD has monitored developments in the implementation of anti-monopoly laws across the

[3] A foreign state bank is defined as being at least 30 per cent-owned by a government or state/public authority of a country other than that where the bank is registered. State banks here do not include those taken temporarily under state control during the financial crisis.

in the state-dominated banking sectors of Algeria, Libya and Syria. State banks are typically involved in supporting rural and agricultural development – for example, the Egyptian Arab Land Bank, which is present in Jordan – while some specialise in housing.

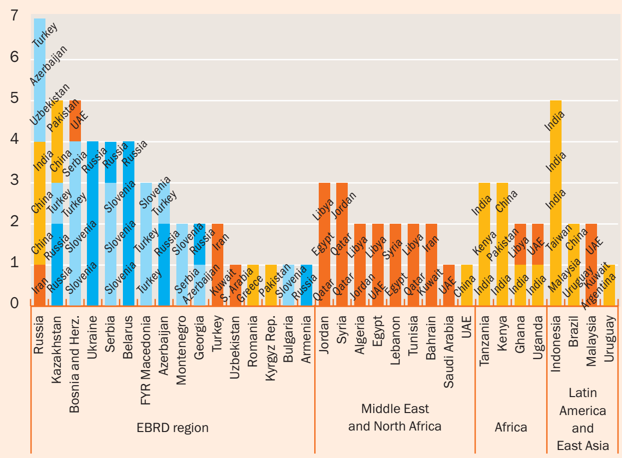
- Third, banks from the Gulf countries – where state and family ownership structures go hand-in-hand and the distinction between public and private ownership is less obvious – operate mainly in countries with a significant Muslim population, such as the MENA region, Malaysia and Uzbekistan. Government-owned Islamic banks provide Sharia law-compliant financing to Muslims abroad, and aim to facilitate cross-border trade and payments in the absence of interest.

- Lastly, Chinese and Indian state banks have established offshore units throughout the world, mostly in developed countries but increasingly in other emerging markets. Notably, sub-Saharan Africa hosts a number of Indian and Chinese banks, reflecting the commodity trade between the two continents.

In conclusion, while state ownership of banks has generally been declining, a few large state-owned banks with international aspirations have bucked the trend. The weakness of the private banking sector has offered a unique opportunity for state banks to expand their international subsidiary networks. It remains unclear how this will impact on local banking sectors. Whereas governments may sometimes manipulate domestic state banks for social or political purposes, banks operating from abroad may face less pressure to deviate from commercial practices. It also remains to be seen whether this will prevent the build-up of bad loans that have undermined many state banks in their domestic markets. However, just like at home, access to funding from home-country governments and depositors may give state banks a competitive advantage that could distort the local market.

Chart 1.2.1
**Crossing borders: foreign state banks across the world**

**Number of foreign state banks, by country**




**Home country or region of the banks**

**EBRD region** **MENA** **Russia** **Other**

Source: Bankscope, internet.

region, assisted by national competition authorities which have responded to a questionnaire and provided detailed information on their activities. The findings from this year's survey have revealed a significant increase in enforcement activity, particularly in CEB and SEE countries, Russia and Turkey. All CEB countries except Croatia and Slovenia have achieved a rating of 4- as a result their strong track records of enforcement and the imposition of fines in cases of violation of the law. In Albania and FYR Macedonia, the evident improvements in enforcement have come from a much lower base, while in Romania the upgrade is warranted by a particularly effective record on fighting cartels (taking the score to 3+). In Turkey efforts have been made to further coordinate competition policies with public procurement practices and sector regulators in the network industries. In Russia the Federal Anti-Monopoly Service was particularly active in 2010, and its authority was further strengthened in May that year when the Supreme Commercial Court upheld a fine levied on the TNK-BP oil company in a landmark case.

In contrast, there have been negative developments in several countries with regard to price liberalisation. In Belarus, where progress in previous years had given hope of more comprehensive reforms to follow, a macroeconomic crisis developed in the spring of 2011, and the government responded by reintroducing a range of price controls to offset the high inflation that resulted in part from a currency devaluation. Rising prices, particularly for food and fuel, also lay behind the decision of the authorities in Armenia and Kazakhstan to impose administrative controls on basic goods.

There were trade and foreign exchange system downgrades for Belarus and Uzbekistan, which had already scored poorly in respect of this indicator. In both cases it reflected important foreign exchange restrictions and a significant spread between the official and black market exchange rates. Belarus also introduced bans on the export of various goods, as did

Moldova on wheat, although in the latter case it has since been removed.

Elsewhere, the only significant changes were in Croatia and Montenegro, with both countries upgraded in the governance and enterprise reform category. Croatia achieved a major success this year by completing accession negotiations with the European Union, which necessitated a commitment to restructuring key state-owned industries. Montenegro acquired EU candidate status at the end of 2010, and has implemented a new bankruptcy law.

## Macroeconomic developments and outlook

### Recovery in domestic demand

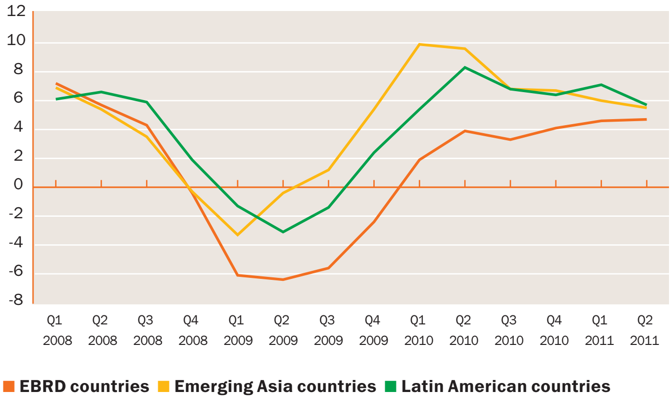
Recovery was under way in virtually all countries of the EBRD region by the summer of 2011. Although its pace has continued to lag behind that of other emerging markets, by the second quarter of this year growth in the average transition country was almost as high as in Latin America or emerging Asia (see Chart 1.1). After strong economic rebounds by early 2010 in countries such as Georgia, Kazakhstan, Russia, the Slovak Republic, Turkey and Ukraine, growth also gathered momentum in most countries with initially weaker recoveries (especially in the Baltic states). The recovery was founded on strong growth in the core eurozone countries (as major trading partners) and rapidly rising commodity prices, mitigated by region-specific factors such as fiscal tightening and scarce new lending. By now many transition countries have reached, or surpassed, their pre-crisis output levels, even though the Baltic countries are on average still more than 10 per cent below them. On average, real GDP in the transition region is just barely higher than it was in early 2008, while output in Latin America and emerging Asia has by now significantly exceeded its pre-crisis level ( see Chart 1.2).

The recovery has mostly followed a typical post-crisis pattern. Following a period of net export-led growth in 2009 and early 2010, growth has since been driven increasingly by domestic demand (see Chart 1.3). The sharp falls in inventories and investment that had characterised the immediate aftermath of the crisis in Armenia, the CEB countries, Moldova, Russia and Ukraine began to reverse in the first half of 2010, and by the second half of the year consumption growth had resumed in these countries.

Recovery in the larger south-eastern European countries, Belarus and Turkey has followed different trajectories for idiosyncratic reasons. In Bulgaria, Croatia and Romania growth was slack or negative well into 2011, as fiscal consolidation (especially in Bulgaria and Romania) combined with weak capital inflows and the unwinding of a pre-crisis construction boom (in Croatia) dampened domestic demand throughout 2010. Turkey, in contrast, continued to experience a boom in domestic

Chart 1.1
**Growth in EBRD countries started to approach other emerging markets by Q2 2011...**

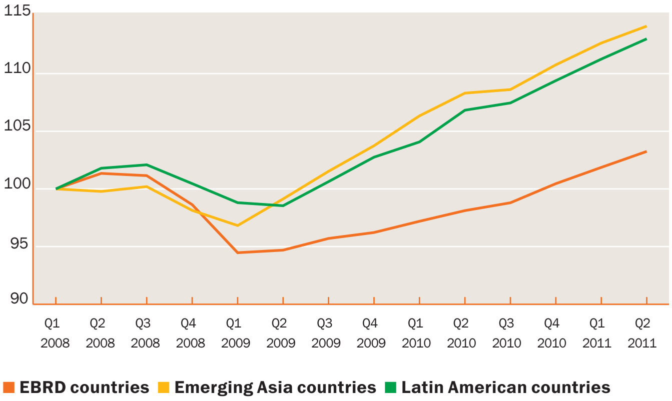
**Quarterly real GDP growth, year-on-year, per cent**




Source: CEIC Data Company (CEIC) and International Monetary Fund *International Financial Statistics* (IMF IFS).
Note: Growth rates for each group of countries are simple averages of individual countries' growth rates. Latin America includes Argentina, Brazil, Chile, Colombia, Mexico and Peru. Emerging Asia includes Hong Kong, India, Indonesia, Korea, Malaysia, Singapore and Thailand. The EBRD region includes all transition countries except Albania, Bosnia and Herzegovina, FYR Macedonia, Mongolia, Montenegro and Turkmenistan.

Chart 1.2
**... but their post-crisis GDP levels remain far below those of other emerging markets**

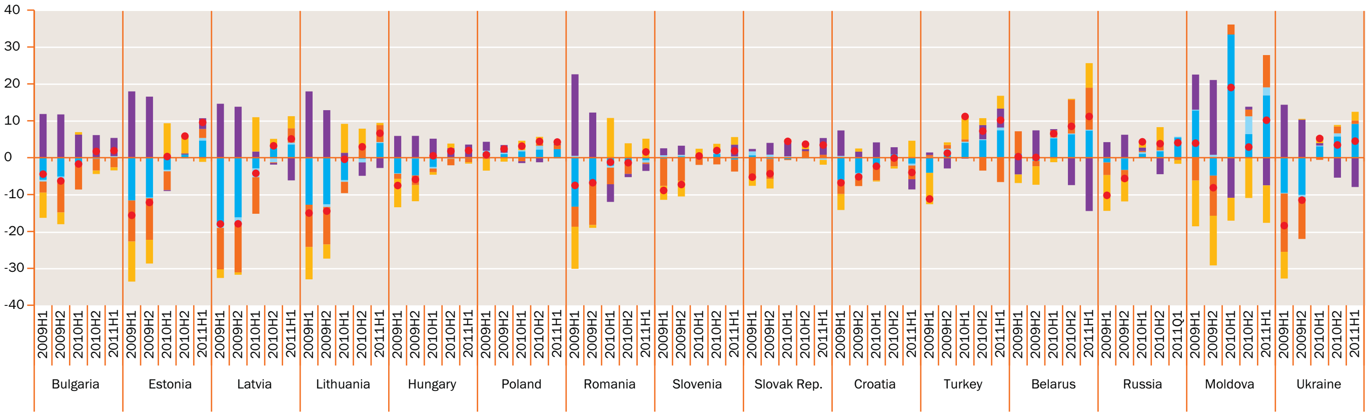
**Real GDP levels, Q1 2008 = 100**




Source: CEIC Data Company (CEIC) and International Monetary Fund *International Financial Statistics* (IMF IFS).
Note: GDP levels for each group of countries are simple averages of individual countries' GDP levels. Latin America includes Argentina, Brazil, Chile, Colombia, Mexico and Peru. Emerging Asia includes Hong Kong, India, Indonesia, Korea, Malaysia, Singapore and Thailand. The EBRD region includes all transition countries except Albania, Bosnia and Herzegovina, FYR Macedonia, Mongolia, Montenegro and Turkmenistan.

Chart 1.3
**Domestic demand and investments are the main driving forces of the recovery in 2011**

**Contributions to real GDP growth (per cent)**



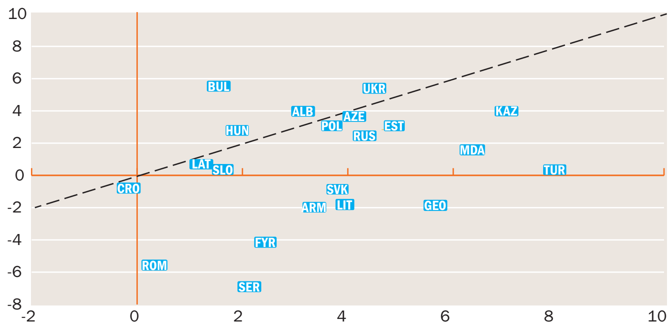

Source: CEIC database and National Statistical Offices.
Note: "Other" component includes changes in inventories and statistical discrepancy.

demand fuelled by capital inflows, strong credit growth and loose macroeconomic policies. Belarus enjoyed strong, but ultimately unsustainable, GDP growth in 2009 and 2010, driven by loose monetary policy and fiscal stimulus, which ended in a severe balance-of-payments crisis. Following a large devaluation in May 2011, the authorities introduced administrative controls in the currency and consumer goods markets. This sharply reduced access to imports and weakened exports, and will likely have a depressive impact on growth in the remainder of 2011.

A return to growth has yet to be felt in the labour markets of many of the transition economies. During 2009 employment contracted sharply (by 2-14 per cent) in most non-oil exporting countries.[4] By the first half of 2010 it had begun to recover in most countries (with a few exceptions in south-eastern Europe), and reached or exceeded pre-crisis levels in six countries (Georgia, FYR Macedonia, Mongolia, Poland, Russia and Turkey) by the end of the year. Only in Bulgaria, Croatia, Moldova, Serbia and Slovenia was employment continuing to decline by the first quarter of 2011. There is some evidence that labour market rigidities – in particular, notice periods – cushioned the fall in employment during the crisis, but they have since delayed the recovery in employment growth (see Table 1.3). Unemployment rates began to decline in 2010, reflecting shrinking labour forces as a result of emigration and informal employment and also rising formal employment. However, they remain near, or at, double-digit levels in most countries in central Europe and the Baltic states (CEB) and south-eastern Europe (SEE) regions (except Romania, where low pre-crisis rates and high public sector employment have limited the rise). With labour market recovery still at an

Chart 1.4
**Real wage growth is slower than real output growth in most countries**

**Real wage growth, May 2011 or later, per cent**




**Average real GDP growth, 2010-11, per cent**

Source: CEIC database and National Statistical Offices.

early stage, real wage growth remains static or negative in many countries. Where real wage growth has turned positive, it remains largely below real GDP growth (see Chart 1.4) except in Albania, Hungary and Ukraine, as well as Bulgaria, where it significantly exceeds output growth.

Non-FDI capital inflows have typically been slow to recover. Following their "sudden stop" in late 2008 and early 2009, the EBRD region experienced only outflows or weak inflows of non-FDI capital until mid-2010.[5] In the second half of 2010 through

[4] There were, of course, exceptions: countries with heavy state intervention (such as Belarus), Poland (which avoided recession in 2009) and Romania (where a large package of IFI support helped the authorities cope with the worst effects of the crisis) largely escaped widespread job losses, although employment stagnated. Mongolia, which enjoyed a boom related to its new copper mine, and the Kyrgyz Republic, which benefited during the crisis from high gold prices, saw employment rise even during 2009.

[5] Exceptions were Poland and Turkey (both attractive emerging markets for international investors).

the first half of 2011, however, non-FDI inflows became positive or strengthened (see Chart 1.5) in an increasing number of countries, including Albania, Armenia, Bosnia and Herzegovina, Belarus, Georgia, Moldova and the Slovak Republic. More recent higher-frequency data suggest that the newest bout of market instability that started in August 2011 may have caused non-FDI capital outflows from the region (see Chart 1.6).

With the exception of Armenia, Estonia, Mongolia and Serbia, FDI flows remain well below pre-crisis levels. With financial sectors and profits under strain, post-crisis FDI inflows have been particularly weak in countries where pre-crisis FDI had predominantly targeted financial intermediation (see Chart 1.7) and had taken the form of retained earnings rather than new investments.

Private-sector credit growth has also been slow to recover in most transition countries (see Box 1.3). This is especially true relative to other emerging markets, where credit growth has largely returned to pre-crisis levels (see Chart 1.8). Over the past two years there has been continued deleveraging in some countries, as well as credit growth below pre-crisis levels in others and potentially overheating credit growth in a few more (see Chart 1.9). Credit to the private sector has continued to contract in nominal terms in the Baltic states, Hungary and Montenegro, and in real terms in Bosnia and Herzegovina, Bulgaria, Kazakhstan, Romania, Serbia and Slovenia. In contrast, real credit growth in Albania, Georgia, Moldova, Russia and the Slovak Republic is well above 5 per cent and in Armenia, Mongolia and Turkey it is at double-digit levels. In these countries, recovery in the growth of domestic demand since mid-2010 has coincided with FDI or non-FDI capital inflows, facilitating credit growth which, to date, has been mostly broad-based across sectors. In some countries, foreign currency credit rebounded and was the main source of credit growth to the private sector (Armenia, Albania, Bulgaria, Georgia, Romania; see Chart 1.10), while local currency credit drove lending growth in others such as Belarus, Poland, Russia, Serbia, Turkey and Ukraine, reflecting regulatory measures favouring local currency or government subsidy schemes.[6]

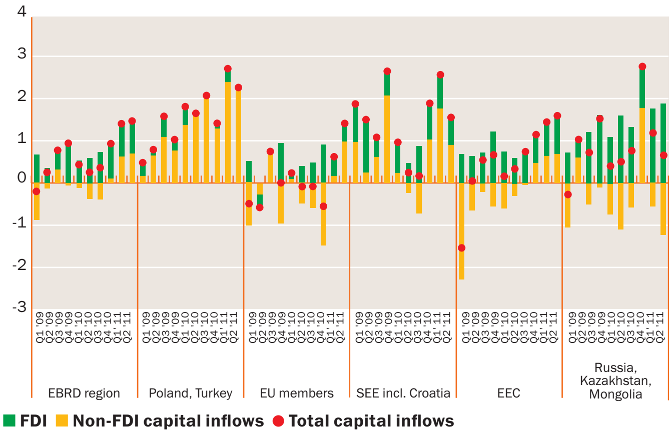
## Table 1.3
## Employment growth and labour market rigidities

| OLS regression: employment growth | | |
|---|---|---|
| | During crisis | Post-crisis |
| Employment growth during crisis | | -0.12 |
| | | (0.94) |
| Real GDP growth | 0.30** | 0.58** |
| | (0.02) | (0.02) |
| Notice period for 1-year employees | 0.48* | -0.53* |
| | (0.12) | (0.08) |
| Constant | -3.90** | 0.97 |
| | (0.05) | (0.50) |
| Number of observations | 24 | 27 |
| R2 | 0.27 | 0.29 |

Note: p-value in brackets. Cross-country OLS regression including the EBRD's countries of operations (except Azerbaijan, Bosnia and Herzegovina, Georgia, the Kyrgyz Republic, Mongolia, Montenegro, Serbia, Turkmenistan and Uzbekistan), Greece, Ireland, Portugal and Spain. Employment growth during crisis defined as employment growth during December 2008-December 2009. Post-crisis employment growth defined as employment growth during December 2009-December 2010. Taking into account that employment tends to lag growth in economic activity, real GDP growth defined as real GDP growth during Q2 2008-Q2 2009 for the regression of employment growth during the crisis. Real GDP growth defined as real GDP growth during Q2 2009-Q2 2010 for the regression of post-crisis employment growth.

## Chart 1.5
## Increase in capital inflows mostly non-FDI-driven

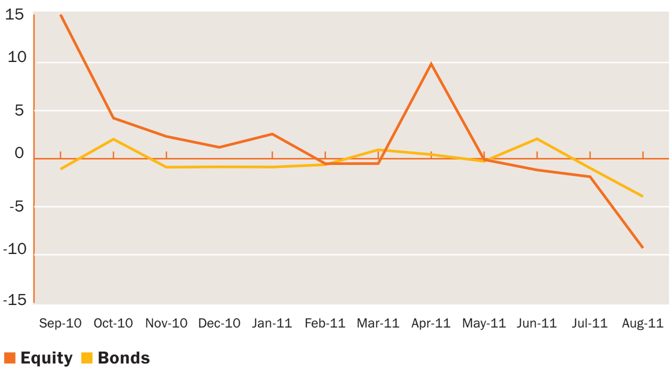
**Capital inflows, per cent of GDP**




Source: CEIC database and national authorities.
Note: "SEE incl. Croatia" refers to south-eastern Europe including Croatia; "EEC" stands for eastern Europe and the Caucasus region.

## Chart 1.6
## Both equity and debt flows into the region down in August 2011

**Monthly fund flows, per cent of total allocation**




Source: Emerging Portfolio Fund Research (EPFR).

[6] See EBRD *Transition Report 2010*, Chapter 3.

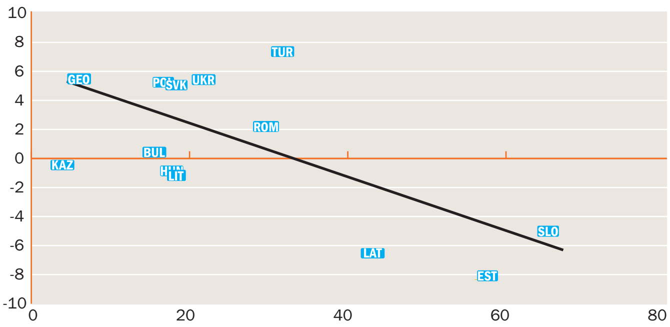
## Loose monetary policies

Central banks have generally tightened monetary policy across the transition region in 2010-11, except in SEE countries with slow recoveries or still-unwinding credit booms and Turkey. Nevertheless, real interest rates remain very low, or negative, in real terms in most countries (see Chart 1.11).

Policy rate increases in order to tighten monetary conditions have typically been accompanied by changes in reserve requirements or prudential measures. Such prudential measures have often been directed at reducing risks associated with foreign currency lending (see Chart 1.12). The most sweeping measures have been taken by Hungary, which capped loan-to-value ratios, administratively fixed rates and prohibited collateral registration for foreign currency housing loans.[7] In an attempt to tighten credit conditions while reducing capital inflows, the Central Bank of Turkey lowered monetary policy rates twice and

Chart 1.7
**FDI inflows are weak where pre-crisis FDI was directed at financial intermediation**

**FDI inflows, 2010, per cent of GDP**

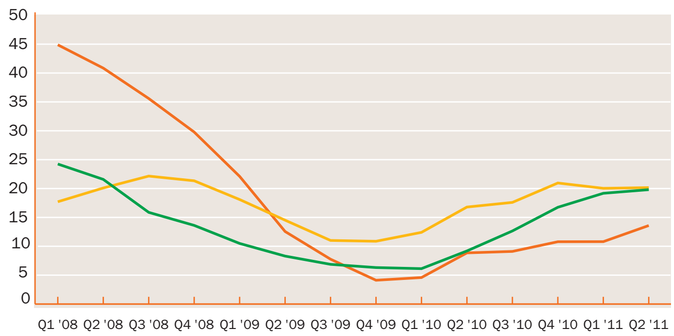



**Share of FDI directed at financial intermediation, average 2004-07, per cent of total**

Source: Eurostat.

Chart 1.8
**Credit growth is slow relative to other emerging markets**

**Private sector credit growth, year-on-year, per cent**

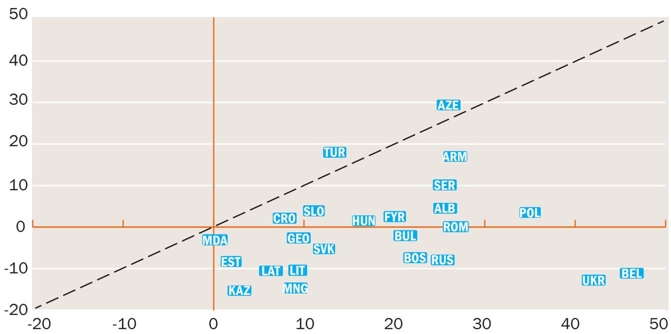



■ **EBRD countries** ■ **Emerging Asia countries** ■ **Latin American countries**

Source: CEIC Data Company (CEIC) and International Monetary Fund *International Financial Statistics* (IMF IFS).
Note: Latin America includes Brazil, Colombia and Mexico; emerging Asia includes India, Indonesia and Thailand.

Chart 1.9
**Credit growth is significantly below pre-crisis levels**

**Real credit growth, Dec 2010-May/June 2011, per cent**

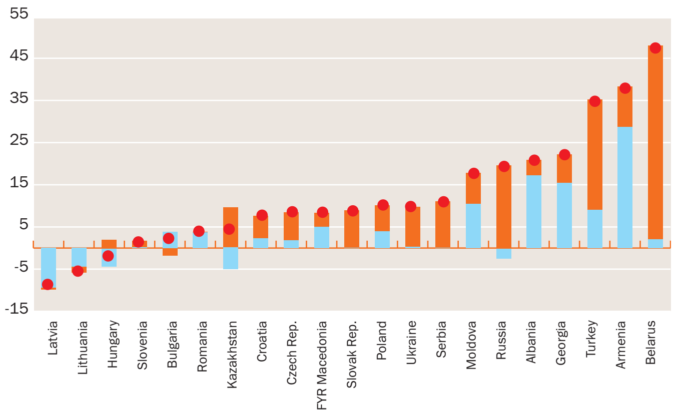



**Real credit growth, Dec 2007-Mar/Apr 2008, per cent**

Source: CEIC database.

Chart 1.10
**Strong local currency credit growth in Belarus, Russia and Turkey**

**Contribution to credit growth, June 2011, year-on-year, per cent**




■ **Local currency contribution** ■ **Foreign currency contribution**
● **Total credit growth**

Source: CEIC database.

[7] The last measure had to be subsequently lifted.

## Box 1.3

### Recovery of credit growth

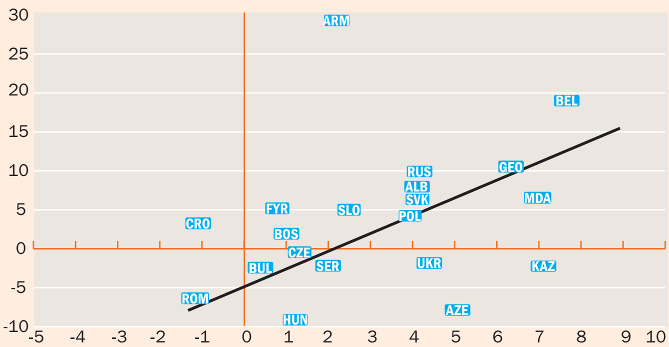
Credit growth has largely resumed in the transition region. As of end-June 2011 credit to the private sector had been steadily increasing in most countries in nominal terms. Underlying factors include: stronger recoveries in GDP (see Chart 1.3.1); better bank capitalisation; more vigorous deposit growth following withdrawals during the crisis (as in Georgia, FYR Macedonia, Moldova and Serbia); stronger capital inflows since 2010; and in some cases (for example: Belarus, Russia and Serbia) state-supported lending.

An update of the analysis in the *Transition Report 2010* suggests a subtle change in the nature of the credit recovery (see Table 1.3.1). Column I restates the results in the 2010 report. In 2010 the recovery in credit growth mainly reflected the unwinding of pre-crisis credit booms and capital adequacy of the banking system, regardless of the quality of the loan portfolio (see Box 2.2, *Transition Report 2010*). Column II shows the same regression for year-on-year credit growth to June 2011. The size of the pre-crisis credit boom in itself is no longer a significant determinant of credit growth; however, its legacy – the non-performing loan (NPL) ratio – is. The rate of credit growth has become more dependent on whether banking systems can clean up their balance sheets.

As scarce credit may itself prevent the rollover of old loans and therefore trigger non-performing loans, columns III and IV show the results of a simultaneous equations model that estimates credit growth and NPL ratios jointly. In addition to being higher where pre-crisis credit booms were greater, NPL ratios are also higher where more of this pre-crisis credit was denominated in foreign currency.

Chart 1.3.1
**Real output and real credit growth are positively correlated**

**Real credit growth, end of June 2011, year-on-year, per cent**




**Real GDP growth, 2010, year-on-year, per cent**

Source: CEIC database.

Table 1.3.1
**Determinants of credit growth: December 2009-June 2010 and June 2010-June 2011**

| Variables | Credit growth Dec 2009 to June 2010 | Credit growth June 2010 to June 2011 | Credit growth June 2010 to June 2011 | Change in NPLs levels 2007-10 | Real credit growth June 2010 to June 2011 | Change in NPLs levels 2007-10 |
|---|---|---|---|---|---|---|
| | I | II | III | IV | V | VI |
| Capital adequacy ratio end-2007 | 0.462* | 0.452** | 1.227** | | 0.479* | |
| | (0.0557) | (0.0469) | (0.0163) | | (0.0990) | |
| Number of branches per person per square km, 2007 | 0.0804* | 0.0619* | 0.0194 | | 0.0214 | |
| | (0.0989) | (0.0998) | (0.486) | | (0.196) | |
| Change in credit-to-GDP ratio 2001-07 | -0.131** | 0.0410 | 0.333 | 0.108* | 0.333 | 0.108* |
| | (0.0116) | (0.608) | (0.223) | (0.0649) | (0.223) | (0.0649) |
| Change in NPLs levels 2007-10 | 0.0247 | -0.735*** | -2.479** | | -2.909** | |
| | (0.720) | (0.0000) | (0.09) | | (0.0356) | |
| Dummy on capital inflows | 5.114*** | 5.884** | 10.33* | | 15.26*** | |
| | (0.012) | (0.0157) | (0.0873) | | (0.0000) | |
| Dummy on state lending | 5.530* | 0.381 | | | | |
| | (0.0698) | (0.960) | | | | |
| Percentage of FX credit in total lending end 2007 | | | | 0.0769* | | 0.0769* |
| | | | | (0.0528) | | (0.0528) |
| Constant | -2.125 | 0.715 | 3.886 | 0.0900 | 2.115 | 0.0900 |
| | (0.465) | (0.849) | (0.668) | (0.962) | (0.753) | (0.962) |
| Observations | 23 | 23 | 25 | 25 | 25 | 25 |

Source: EBRD staff analysis using official authorities data and EBRD Banking System Survey.
Note: Robust p-values in parentheses. *** p<0.01, ** p<0.05, * p<0.1. In column I credit growth in 2010 measured as FX-adjusted total private credit stock at end-Jun 2010 divided by the end-Dec 2009 stock of credit. In columns II and III credit growth in 2011 measured as FX-adjusted total private credit stock at end-June 2011 divided by the end-June 2010 stock of credit. In column V nominal credit growth over the June-2011 to June-2010 period is deflated by the annual average inflation. Cross-country OLS regression including the EBRD's countries of operations (except Bulgaria, Mongolia, Montenegro, Russia, Tajikistan, Turkmenistan and Uzbekistan in columns I and II and excluding Mongolia, Montenegro, Tajikistan, Turkmenistan and Uzbekistan in columns III-VI). Columns III, IV and columns V and VI show the results of the simultaneous equations regression models.

raised reserve requirements on various liabilities in the first half of 2011. Since August, however, the Central Bank of Turkey has loosened its monetary policy stance again amid concerns about rapidly deteriorating conditions in the external markets.

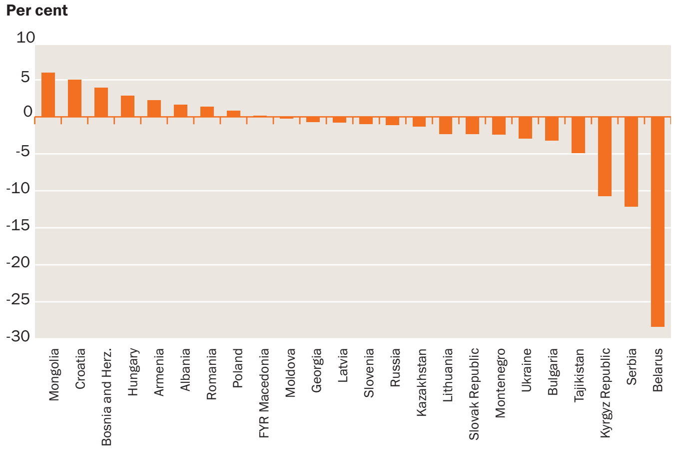
Generally loose monetary policy across much of the region in 2010 to the beginning of 2011, as well as increasing global commodity prices, have contributed to high inflation in 2011 (see Chart 1.13). Inflation remained low, however, in countries where the recovery has been particularly weak (Croatia and Slovenia). The recent contribution of non-core inflation was limited where new harvest showed a rich crop (Russia), local food price inflation slowed as imports expanded (Turkey), or where energy price inflation dropped as regulated price increases slowed (Georgia and Moldova). By August 2011 inflation remained in double-digits only in Belarus, the Kyrgyz Republic and Tajikistan. In Belarus in particular a sharp devaluation of the currency in May 2011 raised inflation above 60 per cent. High food prices and imported fuel prices explain accelerated inflation in the Kyrgyz Republic and Tajikistan.

In contrast to 2010, with the exception of a few countries, core inflation (excluding food and energy prices) has increasingly driven the headline rate in 2011. Non-core inflation began to recede as global energy and food prices declined and the 2011 harvest promised to be a significant improvement on the drought-damaged 2010 crop. Rising core inflation partly reflects the second-round pass-through of 2010's global commodity price increases. It also suggests that the deep output gaps exacerbated by post-crisis recessions may be closing; indeed, the countries where real GDP had recovered by 2010 to nearer pre-crisis levels have been those with higher core inflation by August 2011 (see Chart 1.14). In Serbia and Ukraine inflation has, in addition, been fuelled by exceptionally high industry-specific price hikes (by a processed food oligopoly in Serbia and administered transport and utilities prices in Ukraine).

The experience of the past year has shown that central banks may not have the appropriate tools to rein in inflation episodes driven by food price increases, such as those in 2010 and early 2011. Such events call for measures targeted at improving supply chains, particularly in the large grain exporters of the CIS (see Box 1.4). More recently, the greater prominence of core inflation (for example, in Poland and Turkey) has created a more conventional challenge for monetary policy-makers. If core inflation continues on its rising trend, monetary policy could face a more difficult trade-off between maintaining price stability and supporting economic growth.

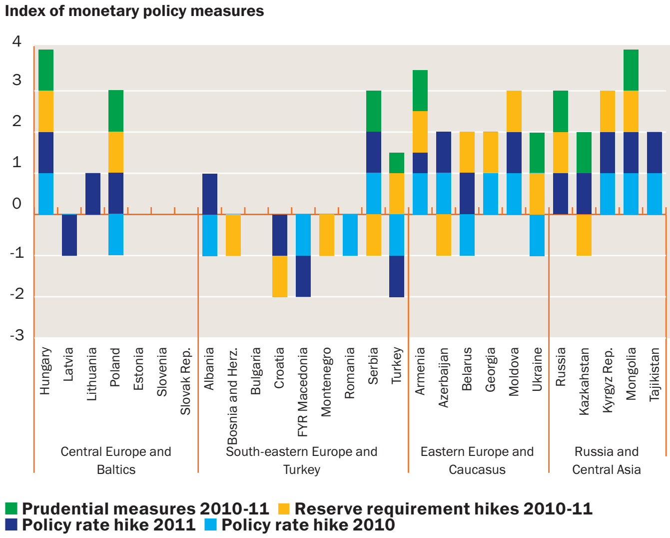
Despite loose monetary conditions and volatility in the European sovereign debt markets, transition currencies strengthened or remained stable over their anchor currency during 2010 – although by less against the trading partner currencies. However, intensifying financial market volatility has

Chart 1.11
**As of August 2011 real interest rates were negative or very low in many of the EBRD's countries of operations**




Source: CEIC database.
Note: Central banks' policy rates adjusted by the concurrent annual inflation rate.

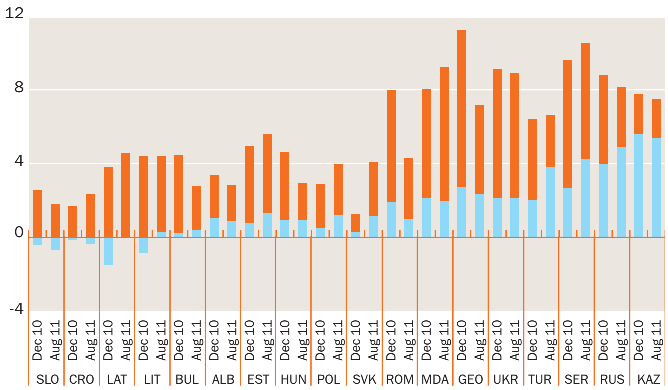
Chart 1.12
**Several countries have implemented monetary tightening measures**




Source: EBRD estimates.
Note: If country used at least one of the named measures, it will be granted a value of "1" if a measure meant to tighten the monetary policy, and "-1" if it supposed to have a loosening impact. In the cases, where countries in the same year were using mixed policy measured (for example, increase and decrease their policy rates), only net effect will be shown on the chart with value of "1/2" if the net effect had tightening impact.

Chart 1.13
**Inflation is especially high where non-core price rises remain significant**

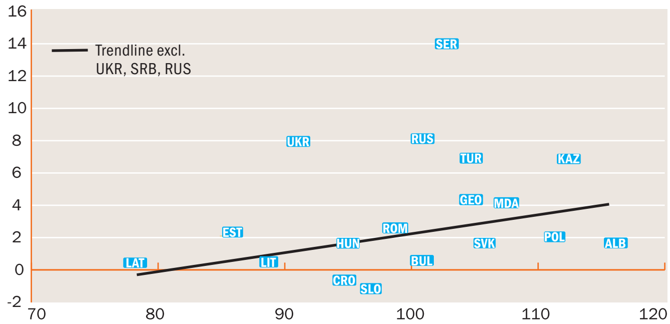
**Contribution to inflation, per cent**




Source: CEIC database and EBRD staff calculations.

Chart 1.14
**Core inflation is rising in countries with growing economies**

**Core inflation, August 2011, year-on-year, per cent**

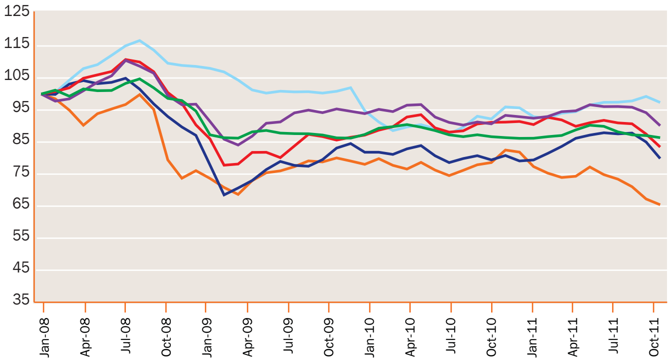



**Real GDP, 2010, per cent of real GDP in 2007**

Source: EBRD estimates.

Chart 1.15
**After some appreciation in 2009-10, exchange rates have recently faced downward pressure**

**Index, January 2008=100**




Source: CEIC database and IMF IFS.
Note: An increase represents an appreciation.

recently put pressure on several currencies in the region (see Chart 1.15). In real effective terms, most currencies in flexible exchange rate regimes remain about 10 per cent weaker than before the crisis.

## Fiscal consolidation

Significant fiscal consolidation has delayed recovery in the CEB and SEE regions. Fiscal consolidation began early in these countries and was front-loaded and expenditure-based (see Charts 1.16 and 1.17). Assuming standard multipliers, this hindered growth, particularly in 2010 when its cumulative effect during 2009-10 began to impact fully on economic activity (see Charts 1.18 and 1.19) and, in some countries, was compounded by expectations of further consolidation in 2011.

Initial consolidation efforts in the EBRD region focused on measures that generated immediate deficit reductions, including large cuts in civil service wages and public pensions, reductions in pillar II pension contributions, cuts in public investment, and hikes in indirect taxes such as value-added tax (VAT) and excise rises on “vice goods” (such as alcohol or tobacco; see Table 1.4). Some countries also cut tax exemptions, revised government subsidies and initiated other structural fiscal reforms, including reducing the size of the civil service and improving the solvency of the pension system. While the latter group of measures is likely to have benefits beyond the short term, this is not true of some of the other measures undertaken during the crisis. Wage and pension cuts of the order of 25 per cent may prove not to be sustainable (and in Estonia were temporary by design), while cuts in pillar II pension contributions impede the development of an important institutional investor base and weaken the long-term sustainability of the pension system.

From 2010 fiscal consolidation has increasingly been accompanied by structural reforms within the context of an EU-wide overhaul of fiscal frameworks. In March 2011 the eurozone heads of state and government adopted the “Pact for the Euro”, and in June the European Parliament voted in favour of a new EU Directive on Requirements for Budgetary Frameworks of Member States. The Directive envisages the passage of national legislation by end-2013 to improve: the transparency and comprehensiveness of reporting on government finances;

Box 1.4

## Global food crisis: challenges and opportunities for the transition region

In early 2011 world food prices breached their previous peaks and the volatility of staple food prices in developing countries also increased dramatically. Higher and more volatile price increases reflected long-term food demand trends, supply shocks and *ad hoc* government interventions in key producing regions, as well as increasing demand for bio-fuels in response to rising oil prices. The price increases have not only hit poorer people who spend a large share of their income on food and stirred social tensions in low- and middle-income countries, but also resulted in trade restrictions and renewed emphasis on national self-sufficiency programmes that in turn are likely to exacerbate global food price volatility. Although food prices have begun to ease as output has increased, they are likely to remain volatile for the foreseeable future.

Like other developing and emerging market countries, the transition region has been disproportionately affected by food price increases, (see Chart 1.4.1) and the problem has been aggravated in some areas by local agricultural supply shocks due to extreme weather. In the two most affected countries (Armenia and Russia), agricultural value-added declined by 18 per cent and 11 per cent, respectively, in the first three quarters of 2010 (compared with the same period in 2009). Trade integration has led to an increase of high value-added food stuff as a share of agricultural imports, which in turn has contributed to rising food price inflation pass-through in emerging markets.

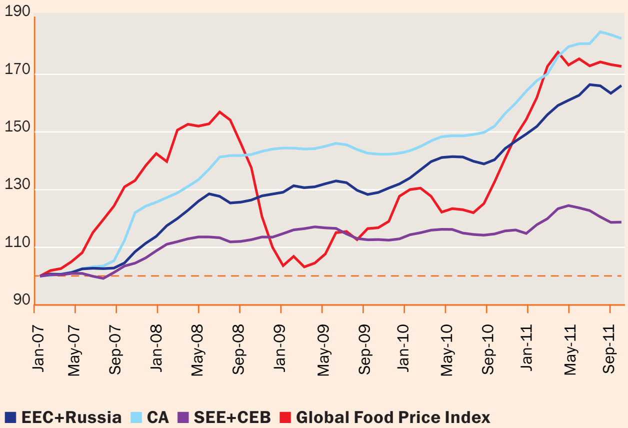
Policy responses to the latest bout of food price inflation in the EBRD region have also exacerbated global food price volatility. Over the last two decades, the region has become one of the leading players in the global grain markets. In 2010 Kazakhstan, Russia and Ukraine produced around 10 per cent of wheat and coarse grains, and contributed around 20 per cent of the global trade in these products. In response to rising grain prices, they and other neighbouring countries introduced a range of policies aimed at containing domestic price increases by curtailing exports. Russia introduced a temporary grain export ban and Ukraine imposed export quotas. A number of countries increased purchases by state-owned grain companies to replenish domestic food stocks, and food price ceilings, particularly in some less advanced transition countries, have become more binding. From a regional and global standpoint, most of these measures are counterproductive and often unsustainable.

At the same time, high agricultural commodity prices have offered an opportunity to several countries in the transition region to help alleviate the global food crisis while benefiting from what seems to be a permanent rise in the level of global food demand. Some of these countries – previously viewed as international breadbaskets – have suffered a fall in agricultural sector productivity over the past two decades. It is estimated that the CIS agricultural producers alone should be able to double their grain output by restoring productivity, and contribute up to 50 per cent of the global grain trade.

In order to achieve this, these countries need to adopt transparent and predictable policies that create conditions for increasing investment along the whole value chain. Public-private forums, such as a working group on the grain sector established in Ukraine in 2011, should provide mechanisms to help improve policy frameworks in the sector. Instead of trade restrictions and price controls, policy-makers need to make sure that supply responds to higher prices, and at the same time provide targeted support for the most vulnerable consumers. International coordination to manage emergency global or regional food reserves (including through pooling of reserves, virtual buffer stocks and reciprocal trade agreements) would help moderate price volatility and reduce fiscal costs of *ad hoc* interventions. Competition in retail and distribution sectors needs to be fostered in order to reduce mark-ups and ease price pressures over time. This would allow the market to develop and investors to take part in an agricultural renaissance in this potentially key agricultural region.

Chart 1.4.1
**Central Asia and eastern Europe inflation rose as food prices spiked**

**Price Index, January 2007=100**




Source: Food and Agriculture Organization and CEIC.
Note: Global Food Price Index is constructed using FAO data for global price index.

fiscal rules consistent with the Maastricht Treaty criteria, encompassing not only central governments but also subnational levels of government; and medium-term budgetary frameworks that ensure that expenditure budgeting is based on realistic revenue assumptions and insulated against the business cycle. Most recently, pressures related to the eurozone sovereign debt crisis have prompted a debate on whether some of these fiscal rules should be given constitutional status.

EU countries in the EBRD region have drafted or passed legislation to comply with the Directive, and several non-EU countries are also undertaking similar structural reforms. Montenegro recently introduced a medium-term budgetary framework, and Georgia introduced a numerical fiscal rule in July 2011, which stipulates upper limits for budget deficit, expenditure and public debt as shares of GDP. In June 2010 a new Fiscal Stability Law was adopted in Mongolia that envisages introduction of a 40 per cent of GDP net present value cap on public debt from 2014, and a 2 per cent of GDP ceiling on the structural deficit from 2013.

In many countries outside the CEB and SEE regions, fiscal policy remains loose despite the strengthening recovery. Stimulus packages in Armenia, Kazakhstan and Russia that were implemented in 2008-09 have not yet been phased out. Some measures within Turkey's stimulus programme – which added a fiscal boost of 2 per cent of GDP in 2009 – were allowed to expire in late 2009, cutting the annual fiscal cost of the original package by about 50 per cent. No further fiscal tightening, however, has since been undertaken. In Ukraine ambitious consolidation plans within the context of an 2008 IMF programme were repeatedly delayed and, as a result, fiscal policy remained broadly neutral throughout 2010-11.

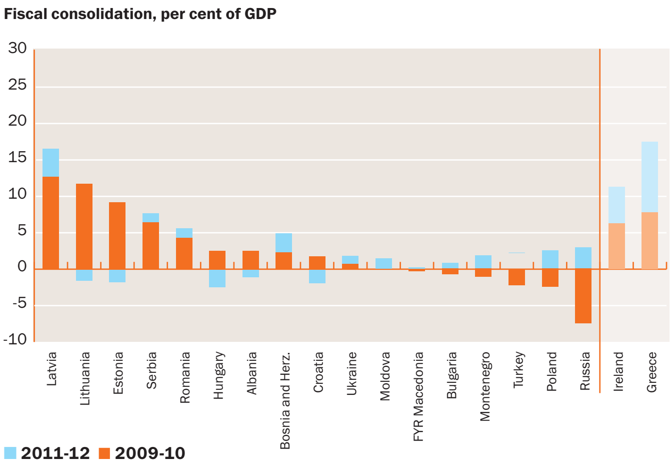
## Regional vulnerabilities

As this *Transition Report* went to press, financial turmoil and slowing growth in advanced financial markets were once again casting a shadow over emerging Europe. When the crisis hit the region in 2008, the consequences were disastrous (see EBRD *Transition Report 2009* and Chapter 2 of this report). How vulnerable would countries be today to a similar shock? This question is addressed in the following section from three perspectives: private-sector vulnerability to a sudden stop in capital inflows; public-sector vulnerability to a sudden increase in the cost of borrowing; and the extent to which countries in the region are integrated with the increasingly beleaguered eurozone.

### External and financial vulnerabilities

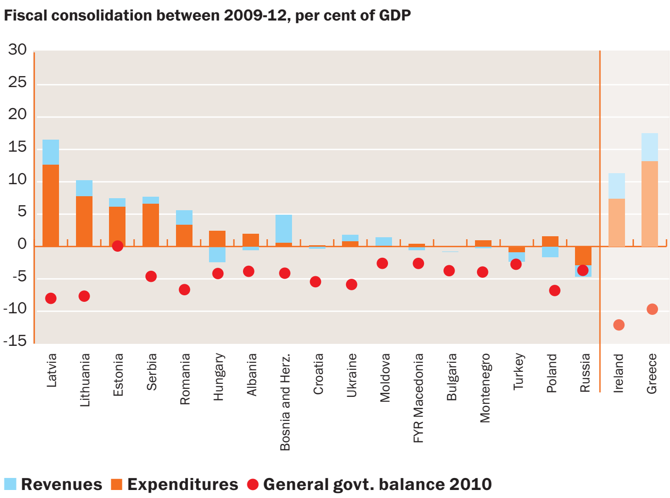
The slow recovery in the transition region has helped reduce macroeconomic and financial vulnerabilities in the private sector, which is better placed to weather external shocks than in 2007. Current account deficits in most countries (except Belarus, Turkey and the commodity producers) have shrunk significantly compared with the pre-crisis period (see Chart 1.20), reducing the need for external financing and exposure to any volatility in

Chart 1.16
**Fiscal consolidation has been front-loaded in most countries...**




Source: CEIC database and IMF IFS.
Note: Chart depicts implemented and planned fiscal consolidation (budget deficit reduction) totals over given periods.

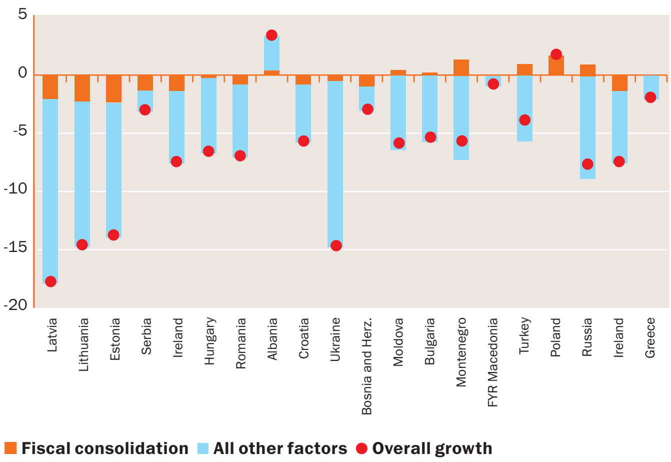
Chart 1.17
**... and largely expenditure-based**




Source: OECD *Restoring Public Finances* (2011), IMF *Regional Economic Outlook* (April 2011), EBRD estimates.
Note: Chart depicts the breakdown of fiscal consolidation measures over 2009-2012 into expenditures and revenues, and compares them to actual general government balance in 2010.

## Chart 1.18
**Drag on growth in 2009 from fiscal consolidation was small relative to other factors…**

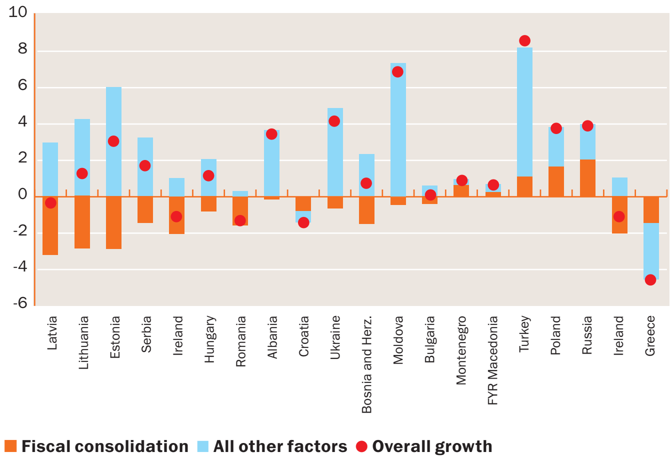
**Contribution to GDP growth, per cent**




Source: OECD *Restoring Public Finances* (2011), IMF *Regional Economic Outlook* (April 2011), EBRD staff estimates.
Note: In line with IMF *World Economic Outlook* (October 2010), this chart assumes for expenditure-based consolidation a multiplier of 0.3 and for tax-based consolidation a multiplier of 1.3 to calculate the contributions of fiscal consolidation to GDP growth. Contribution of all other factors is the residual growth after accounting for the contribution of fiscal consolidation.

## Chart 1.19
**… but grew larger in 2010, especially in the Baltic states**

**Contribution to GDP growth, per cent**




Source: OECD *Restoring Public Finances* (2011), IMF *Regional Economic Outlook* (April 2011), EBRD estimates.
Note: In line with IMF *World Economic Outlook* (October 2010), this chart assumes for expenditure-based consolidation a multiplier of 0.3 and for tax-based consolidation a multiplier of 1.3 to calculate the contributions of fiscal consolidation to GDP growth. Contribution of all other factors is the residual growth after accounting for the contribution of fiscal consolidation.

## Table 1.4
**Fiscal austerity measures 2010-11**

| Revenue measures | Expenditure measures |
|---|---|
| VAT hikes | Public sector salaries/employment cuts |
| Baltic states, Bulgaria, Croatia, Greece, Hungary 5%, Ireland, Poland, Romania, Slovak Republic, Serbia | **Salary cuts** Bosnia and Herzegovina 15%; Greece, Ireland 14%; Latvia 15%-20%; Lithuania 10%-12%; Romania 25%; Serbia 10% |
| | **Wage bill cuts** Bulgaria 3%; Croatia, Estonia 15%; Hungary, Montenegro 8%; Poland, Slovak Republic 10%; Slovenia 14%; Serbia 10% |
| Excise tax hikes | Pension cuts |
| EU members, Montenegro, Russia, Serbia and Ukraine | Estonia, Greece, Hungary, Latvia 15% (overturned); Lithuania, Romania 15% |
| Pillar II pension contributions cuts | Welfare payment cuts |
| Albania, Baltic states, Bulgaria, Hungary [diversion of funds], Poland, Romania, Slovak Republic | Hungary, Ireland, Lithuania, Romania, Slovak Republic |
| Cuts in tax exemptions/expenditures | Public investment programme |
| Albania, Baltic states, Greece, Hungary, Ireland, Romania, Slovak Republic | Estonia, Slovak Republic |

Source: EBRD and public news sources.

capital inflows. Real credit growth has, in most countries, slowed sharply. In almost all banking systems, capital adequacy ratios have improved as a result of recapitalisations and the slow-down in lending (see Chart 1.21). At the same time, more capital may be necessary to merely deal with the high levels of non-performing loans, which may not have yet reached their post-crisis peak. Moreover, the legacy of past credit and import booms is still evident; private external debt has continued to rise, except in Kazakhstan where heavy deleveraging coincided with an oil-based recovery (see Chart 1.22). Stocks of private external debt are thus often high and its relatively short-term nature in some countries is a potential source of vulnerability.

### Public-sector vulnerabilities
Although public debt and financing needs in the transition region are, for the most part, lower than in western Europe, fiscal vulnerability has increased compared with the pre-crisis period because the deep recession of 2009 led to large fiscal deficits and raised the stock of public debt (see Chart 1.23). This in turn increased governments' gross financing needs in the short term, which, despite ambitious consolidation programmes, have remained significantly above pre-crisis levels (see Chart 1.24).

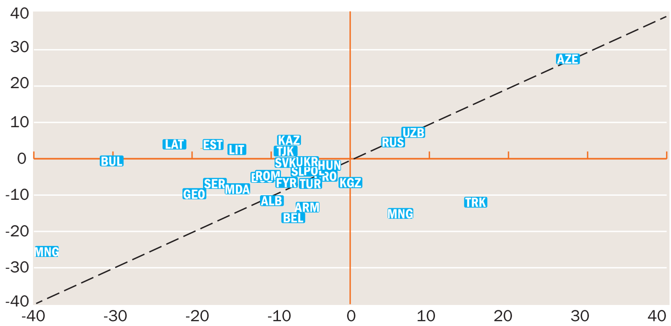
From a long-term sustainability perspective, this is not a reason for concern. Chart 1.25 shows that only Latvia, Lithuania, Poland, the Slovak Republic and Slovenia need to reduce their spending or increase their revenues by around 5 per cent of GDP or more (and even those countries are in better shape in 2011 than they were in 2010). Quite a few countries do not need to consolidate any further (see Table 1.7). Perhaps more importantly, only six countries will need to consolidate beyond what their current fiscal plans can achieve through 2016 (as forecast by the IMF). Albania, Armenia, Croatia, the Kyrgyz Republic, Russia[8] and Slovenia should increase their fiscal revenues or lower expenditure more than currently planned (or achieve real growth rates above recent projections) in order to ensure fiscal sustainability.[9] However, all of these observations are conditional on the prevailing exchange rates and interest rates facing public borrowers. This renders them vulnerable to either internally or externally induced interest rate shocks – an issue confronting quite a few eurozone countries at this time – as well as exchange rate depreciations in the case of countries with significant amounts of foreign currency-denominated debt.

## Exposure to the eurozone

The principal vulnerability of the transition region is its exposure to, and dependence on, the eurozone economy. The single

### Chart 1.20
### Current account deficits have reduced

**Current account, 2010, per cent of GDP**

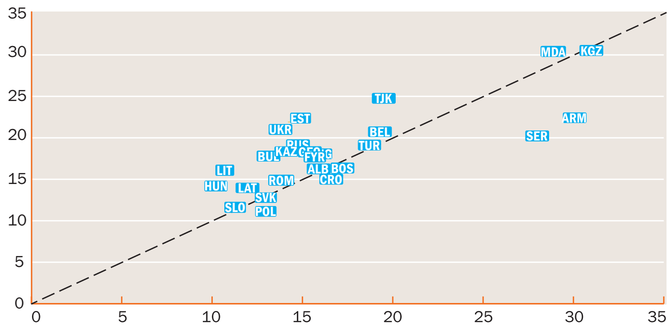



**Current account, 2008, in per cent of GDP**

Source: IMF *World Economic Outlook* (April 2011) and CEIC database.

### Chart 1.21
### Bank capitalisation has improved

**Capital adequacy, 2010, per cent of risk-weighted assets**

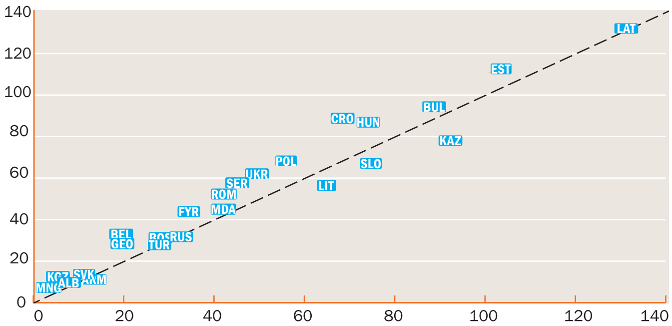



**Capital adequacy, 2007, per cent of risk-weighted assets**

Source: IMF *World Economic Outlook* (April 2011) and CEIC database.

### Chart 1.22
### Private external debt is generally higher

**Private external debt, 2010, per cent of GDP**

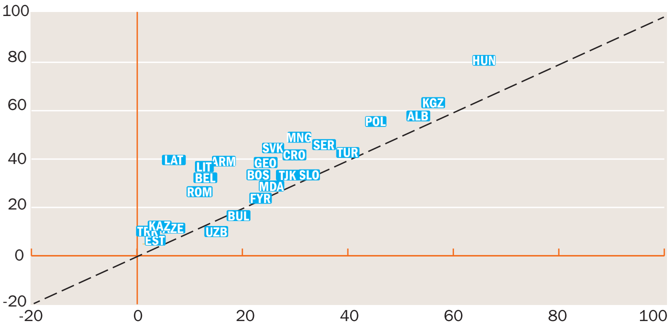



**Private external debt, 2007, per cent of GDP**

Source: IMF *World Economic Outlook* (April 2011) and CEIC database.

### Chart 1.23
### Public debt is up in virtually all countries

**Public debt, 2010, per cent of GDP**




**Public debt, 2007, per cent of GDP**

Source: IMF *World Economic Outlook* (October 2011), EBRD calculations and *Transition Report 2010*.

[8] The analysis presented here assumes that a country achieves fiscal sustainability when its debt levels have become stable. Since Russia's public debt is particularly low, it can likely afford lower fiscal balances than those seen as sustainable by this analysis. At the same time, the IMF projections used here assume a relatively high price of oil. Should it decline, Russia would have to consolidate substantially more than suggested in Table 1.7.

[9] Long-run fiscal sustainability may be an issue in many CEB and SEE countries, as shown in the European Commission 2009 Ageing Report. These countries will face future increases in pensions and health spending due to ageing.

currency area is a significant export market for many transition economies and an important source of FDI. Private investors and banks in the eurozone provide portfolio and debt financing to the region. Eurozone-based banks represent large shares of banking systems in emerging Europe and therefore may be responsible for transmitting funding shocks to households and firms in the EBRD's countries of operations.[10]

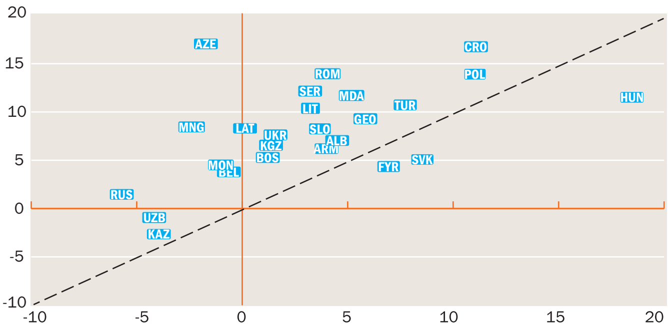
If the economic slow-down and financial market turmoil in the eurozone continues for a prolonged period of time, it will affect the transition region through all of these channels and linkages. Table 1.5 below summarises the vulnerability of each country in the EBRD region to shocks generated in the eurozone using an "exposure index"; this is calculated as the sum of three components, each of which is expressed as a share of GDP. These are: exports to the eurozone; FDI from the eurozone; and an approximation of the share of short-term external debt financing by the eurozone. The index therefore measures the maximum "hit" that a transition economy would suffer, as a share of its GDP, if these flows were to collapse.

The table reveals that Hungary, the Slovak Republic and Bulgaria, are most vulnerable to the turmoil and slow-down in the eurozone, followed by Croatia, Slovenia, Romania and Poland. The most exposed country in the CIS region is Ukraine.

Table 1.6 presents a similar index which measures exposure to five "peripheral" eurozone economies (Greece, Ireland, Italy, Portugal and Spain) rather than the eurozone as a whole. This shows that Bulgaria and FYR Macedonia, followed by Romania, are the most vulnerable countries in the EBRD region to the shocks originated in the "peripheral" eurozone economies.[11]

Chart 1.24
**Virtually all countries require more fiscal financing than in 2007**

**Gross fiscal financing needs, 2011, per cent of GDP**

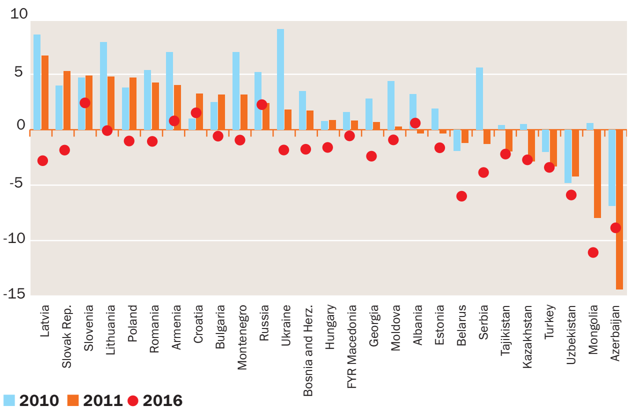



**Gross fiscal financing needs, 2007, per cent of GDP**

Source: Most recent IMF Country Reports, EBRD calculations and *Transition Report 2010*.

Chart 1.25
**Most countries will not need to consolidate beyond their current plans through 2016**

**Fiscal consolidation need, per cent of GDP**




Source: IMF *World Economic Outlook* (October 2011), EBRD calculations and *Transition Report 2010*.
Note: Consolidation need is the difference between the fiscal balance necessary to achieve a constant level of public debt, given the real interest rates and growth rates projected for the medium term by the IMF, and either the actual fiscal balance (for the 2010 consolidation need) or the fiscal balance projected by the IMF for 2011 and 2016 based on the current consolidation plans of each country.

## Outlook and risks

A recent slow-down in some countries in the region, weak leading indicator data, and especially the much less benign external environment resulting from the ongoing sovereign debt crisis in the eurozone all point to weaker growth rates for the transition region. Lower growth in the eurozone, a key export market, and continued market turmoil, which will imply reduced capital inflows and slower credit growth, all bear on the outlook, especially for the CEB and SEE regions. As of mid-October 2011, the EBRD predicts that the transition region as a whole will expand by about 4.5 per cent in 2011 and 3.2 per cent in 2012, a marked decline compared with earlier projections and recent actual growth rates.

Developments in the advanced economies of western Europe will significantly affect the region as a whole and those transition countries that are most strongly integrated with the eurozone in particular. As Table 1.5 suggests, especially the countries of the CEB and SEE regions depend on the eurozone as the destination of their exports and source of both longer-term FDI inflows and shorter-term external debt funding. As the outlook for the eurozone worsens, each of these channels will contribute to weaker growth in the transition region. Moreover, large shares of the banking systems in CEB, SEE and some other countries (for example, Ukraine) are comprised of subsidiaries of eurozone banks. As these face more difficult funding conditions due to the

[10] See De Haas et al. (2011).
[11] Table 1.6 excludes exposures to Cyprus, although a downgrade rating at end-July 2011 suggests market concerns over banking system exposure to Greek sovereign debt. Turmoil in the Cypriot financial system could potentially significantly impact FDI flows outside the EU. For example, in 2007 Cyprus accounted for just under one-third of FDI inflows into Russia, four-fifths of FDI inflows into Ukraine and two-fifths of FDI into Tajikistan. However, it is unclear to what extent Cyprus was merely the conduit for these flows or their source.

## Table 1.5
## Exposure of transition countries to the eurozone

| | Exposure to eurozone (% of GDP) | | | |
|---|---|---|---|---|
| | Exports | External debt | FDI | INDEX |
| | I | II | III | |
| Hungary | 34 | 34 | 50 | 117 |
| Slovak Republic | 33 | 45 | 35 | 113 |
| Bulgaria | 18 | 36 | 58 | 112 |
| Croatia | 9 | 31 | 42 | 82 |
| Slovenia | 33 | 22 | 21 | 76 |
| Romania | 16 | 21 | 21 | 58 |
| Poland | 17 | 15 | 25 | 57 |
| Estonia | 25 | 3 | 22 | 51 |
| Ukraine | 5 | 25 | 8 | 38 |
| Kazakhstan | 15 | 5 | 16 | 36 |
| Lithuania | 14 | 3 | 10 | 27 |
| Turkey | 7 | 10 | 9 | 25 |
| Russia | 9 | 5 | 10 | 24 |
| Latvia | 8 | 8 | 6 | 22 |
| Armenia | 4 | 0 | 9 | 13 |
| Georgia | 2 | 2 | 7 | 11 |
| Kyrgyz Republic | 1 | 7 | 0 | 7 |
| FYR Macedonia | 18 | 25 | … | 43 |
| Serbia | 8 | 18 | … | 25 |
| Belarus | 7 | 8 | … | 15 |
| Moldova | 5 | 10 | … | 15 |
| Albania | 8 | 5 | … | 13 |
| Bosnia and Herzegovina | 8 | 3 | … | 11 |
| Tajikistan | 7 | 1 | … | 8 |
| Uzbekistan | 1 | 0 | … | 1 |
| Azerbaijan | 19 | … | … | 19 |
| Mongolia | 2 | … | … | 2 |

Source: Eurostat, Direction of Trade Statistics IMF, Bank for International Settlements (BIS).
Note: The index is calculated as the sum of the share of eurozone countries in exports from each country weighted by the share of exports in GDP (column I), the share of eurozone in cross-border claims on the country weighted by the short-term external debt of each country as a share of GDP (column II), the share of eurozone countries in FDI weighted by the share of FDI inflows to each country in GDP (column III).

## Table 1.6
## Exposure of transition countries to Greece, Ireland, Italy, Portugal and Spain

| | Exposure to Greece, Ireland, Italy, Portugal and Spain (% of GDP) | | | |
|---|---|---|---|---|
| | Exports | External debt | FDI | INDEX |
| | I | II | III | |
| Bulgaria | 9 | 15 | 17 | 40 |
| FYR Macedonia | 8 | 19 | 6 | 33 |
| Romania | 6 | 4 | 4 | 14 |
| Slovak Republic | 6 | 0 | 5 | 11 |
| Poland | 4 | 1 | 4 | 9 |
| Croatia | 4 | 0 | 5 | 9 |
| Slovenia | 9 | 0 | 0 | 9 |
| Kazakhstan | 7 | 0 | 2 | 9 |
| Hungary | 7 | 0 | 0 | 7 |
| Turkey | 2 | 3 | 2 | 6 |
| Ukraine | 2 | 1 | 0 | 4 |
| Russia | 2 | 0 | 0 | 3 |
| Armenia | 0 | 0 | 2 | 3 |
| Estonia | 2 | 0 | 2 | 3 |
| Georgia | 1 | 0 | 2 | 3 |
| Lithuania | 2 | 0 | 0 | 2 |
| Latvia | 1 | 0 | 1 | 2 |
| Kyrgyz Republic | 0 | 0 | 0 | 0 |
| Albania | 7 | 2 | … | 9 |
| Serbia | 3 | 5 | … | 8 |
| Bosnia and Herzegovina | 3 | 3 | … | 6 |
| Moldova | 3 | 0 | … | 3 |
| Tajikistan | 1 | 0 | … | 1 |
| Belarus | 0 | 0 | … | 0 |
| Uzbekistan | 0 | 0 | … | 0 |
| Azerbaijan | 15 | … | … | 14 |
| Mongolia | 1 | … | … | 0 |

Source: Eurostat, Direction of Trade Statistics IMF, Bank for International Settlements (BIS).
Note: The index is calculated as the sum of the share of these five countries in exports from each country weighted by the share of exports in GDP (column I), the share of five countries in cross-border claims on the country weighted by the short-term external debt of each country as a share of GDP (column II), the share of these five countries in FDI inflows to each country weighted by the share of FDI in GDP (column III).

sovereign debt crisis, their subsidiaries are likely to receive less funding support and therefore extend less private credit in the transition countries, bearing on credit growth.

The EBRD baseline forecast for 2011 and 2012 assumes an eventual, but not immediate, containment of the current eurozone problems. While growth in the euro area is expected to grind to a near standstill, the currency union is expected to avoid a full recession. It is also assumed that as in 2008-09, eurozone government support to their large cross-border bank groups will be available for their subsidiaries in emerging Europe. Under these circumstances, countries in central Europe are expected to see low, but positive average growth rates of 3.1 and 1.7 per cent in 2011 and 2012, respectively, as their strong linkages to the stressed eurozone translate into substantially weaker performance in 2012. Currently subdued growth in south-eastern Europe is unlikely to take off significantly during the forecast period, and is expected to remain at 1.7 and 1.6 per cent in 2011 and 2012, respectively, as it will not receive the necessary boost from the external environment. Turkey is expected to slow down very rapidly from its current boom, with its growth rate falling from 7.5 per cent to 2.5 per cent between 2011 and 2012.

Recovery further east will be much less impacted by the eurozone troubles, as economies of countries there are much less intertwined with those of western Europe. Commodity exporters will continue to enjoy reasonably strong growth rates, as demand from growing emerging markets will sustain commodity prices at levels only slightly lower than in early 2011. Russia in particular is projected to grow at 4.2 per cent in 2012, slightly below earlier projections.

The current situation in advanced Europe poses significant risks even to the already worsened outlook for the transition region. While in some important respects the region is better prepared for a new crisis than in 2008 – with less dependence on external financing, and generally stronger financial sectors – it is not inconceivable that the region might suffer an even worse external shock than the one experienced in 2008-09. As documented in *Transition Report 2009*, the reversal of financial flows during the last crisis was surprisingly mild, given the continued commitment of EU banking groups to the region, the success of financial stabilisation efforts in the home countries of these groups and the European Bank Coordination ("Vienna") Initiative. However, EU banking groups may well be more severely affected in any new crisis that may result from eurozone sovereign debt issues than they were in 2008-09. Indeed, it seems well within the realms of possibility that the current eurozone crisis will take longer to resolve than assumed in the baseline, with severe consequences for the health of some sovereigns as well as systemically important banks. In addition to the negative impact of a new eurozone recession, this could result in a substantial reversal of bank debt flows and a large contraction of credit in the region, with severe consequences for output.

## References

**R. De Haas, Y. Korniyenko, E. Loukoianova and A. Pivovarsky (2011)**
"Foreign banks during the crisis: sinners or saints?", available at SSRN: http://ssrn.com/abstract=1799181

Table 1.7
## Underlying data and assumptions for the debt sustainability analysis

| | Debt to GDP ratio (per cent) | GDP growth rates (per cent) | | Real interest rate (per cent) | | | | |
|---|---|---|---|---|---|---|---|---|
| Source | 2010 | 2016, LC | 2016, USD nominal | Nominal interest rate, IMF/WB sustainability framework | 5-year bond yield or (bund yield+CDS spread) LC | WEO, long-term GDP inflation | LC real interest rate | US$ interest rate |
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| EBRD region | | | | | | | | |
| Albania | 58.2 | 4.0 | 6.2 | 5.9 | NA | 3.9 | 1.9 | 3.3 |
| Armenia | 39.2 | 4.0 | 6.1 | 10.6 | NA | 6.3 | 4.1 | 1.7 |
| Azerbaijan | 10.8 | 2.3 | 5.6 | 4.2 | NA | 9.4 | -4.8 | 2.6 |
| Belarus | 26.5 | 5.0 | 8.7 | 5.9 | NA | 10.8 | -4.4 | 4.9 |
| Bosnia and Herzegovina | 39.7 | 4.5 | 7.0 | 2.2 | NA | 3.4 | -1.2 | 2.0 |
| Bulgaria | 17.4 | 4.0 | 5.8 | 4.8 | 4.6 | 3.4 | 1.2 | 4.6 |
| Croatia | 40.6 | 3.0 | 5.3 | 5.8 | 6.8 | 3.2 | 3.4 | 6.8 |
| Czech Republic | 38.5 | 3.2 | 3.5 | 3.4 | 2.5 | 2.0 | 0.5 | 1.5 |
| Estonia | 6.6 | 3.8 | 4.5 | 6.3 | 5.8 | 1.6 | 4.1 | 4.8 |
| FYR Macedonia | 24.6 | 4.0 | 6.3 | 4.0 | NA | 3.7 | 0.3 | 3.9 |
| Georgia | 39.1 | 5.0 | 7.2 | 3.8 | NA | 7.4 | -3.4 | 5.6 |
| Hungary | 80.2 | 3.2 | 5.3 | 5.7 | 7.1 | 3.3 | 3.7 | 6.1 |
| Kazakhstan | 10.7 | 6.4 | 14.6 | 5.4 | 3.7 | 8.1 | -4.1 | 3.7 |
| Kyrgyz Republic | 62.6 | 5.0 | 7.4 | 11.6 | NA | 8.0 | 3.4 | 0.8 |
| Latvia | 39.9 | 4.1 | 5.5 | 5.6 | 6.0 | 1.2 | 4.7 | 6.0 |
| Lithuania | 38.7 | 3.8 | 5.9 | 5.9 | 5.1 | 3.1 | 2.0 | 5.1 |
| Moldova | 26.6 | 5.0 | 9.8 | 9.8 | 7.0 | 7.8 | -0.7 | 12.1 |
| Mongolia | 53.4 | 15.6 | 20.7 | 13.2 | NA | 10.9 | 2.0 | 2.4 |
| Poland | 55.0 | 3.6 | 5.7 | 5.5 | 5.6 | 2.8 | 2.8 | 4.6 |
| Romania | 31.7 | 4.1 | 9.1 | 5.1 | 6.7 | 5.5 | 1.1 | 6.7 |
| Russia | 11.7 | 3.8 | 9.9 | 8.9 | 6.9 | 10.3 | -3.1 | 7.6 |
| Serbia | 44.9 | 5.0 | 9.0 | 3.6 | 2.0 | 6.0 | -3.8 | 3.0 |
| Slovak Republic | 41.8 | 4.2 | 5.5 | NA | 2.6 | 2.0 | 0.6 | 1.6 |
| Slovenia | 37.3 | 0.0 | 3.5 | NA | 4.5 | 2.2 | 2.2 | 4.5 |
| Tajikistan | 36.7 | 4.8 | 12.1 | 6.5 | NA | 15.7 | -7.9 | 2.0 |
| Ukraine | 40.1 | 4.0 | 8.1 | 5.7 | 7.5 | 9.6 | -1.9 | 7.5 |
| Uzbekistan | 10.0 | 6.0 | 8.4 | 2.8 | NA | 14.2 | -9.9 | 4.3 |
| Turkey | 42.2 | 4.3 | 9.4 | 10.9 | 4.9 | 6.9 | -1.9 | 5.9 |
| Montenegro | 44.1 | 3.8 | 5.9 | 5.6 | NA | 1.6 | 4.0 | 7.0 |
| Advanced | | | | | | | | |
| Austria | 72.2 | 1.8 | 2.8 | 2.8 | 2.0 | 1.9 | -0.1 | -0.1 |
| Belgium | 96.7 | 1.8 | 3.1 | 3.6 | 3.3 | 1.9 | 1.0 | 1.0 |
| Cyprus | 60.8 | 2.7 | 4.1 | 4.6 | 5.2 | 2.5 | 2.2 | 2.2 |
| Denmark | 43.7 | 1.9 | 2.6 | 2.4 | 2.6 | 1.8 | 0.0 | 0.0 |
| Finland | 48.4 | 2.0 | 3.4 | 2.5 | 1.7 | 1.9 | -0.7 | -0.7 |
| France | 82.4 | 2.1 | 3.4 | 2.6 | 1.9 | 2.0 | 0.0 | 0.0 |
| Germany | 84.0 | 1.3 | 1.4 | 2.3 | 2.2 | 1.5 | 0.9 | 0.9 |
| Greece | 142.8 | 3.3 | 3.1 | 15.9 | 18.2 | 1.2 | 16.5 | 16.5 |
| Iceland | 92.4 | 3.0 | 5.3 | 6.2 | 6.0 | 2.4 | 2.2 | 2.2 |
| Ireland | 94.9 | 3.3 | 4.2 | 5.2 | 8.0 | 1.6 | 7.1 | 7.1 |
| Italy | 119.0 | 1.2 | 2.4 | 4.1 | 4.3 | 2.0 | 2.2 | 2.2 |
| Luxembourg | 18.4 | 3.1 | 3.6 | 3.3 | 3.3 | 1.5 | 0.2 | 0.2 |
| Malta | 67.2 | 2.3 | 4.4 | 6.1 | 6.1 | 2.6 | 3.0 | 3.0 |
| Netherlands | 63.7 | 1.8 | 2.4 | 2.4 | 2.9 | 1.4 | 1.3 | 1.3 |
| Norway | 55.4 | 2.1 | 2.4 | 3.0 | 2.8 | 2.3 | -1.0 | -1.0 |
| Portugal | 92.9 | 2.0 | 2.6 | 10.4 | 11.6 | 1.6 | 9.6 | 9.6 |
| Spain | 60.1 | 1.8 | 3.0 | 4.7 | 4.2 | 1.7 | 2.4 | 2.4 |
| Sweden | 39.7 | 2.5 | 5.0 | 2.8 | 1.8 | 2.0 | -0.3 | -0.3 |
| Switzerland | 54.5 | 1.8 | 1.3 | 1.1 | 0.5 | 1.0 | -0.4 | -0.4 |
| United Kingdom | 75.5 | 2.7 | 5.6 | 2.2 | 1.3 | 2.7 | -2.0 | -2.0 |
| United States | 94.4 | 3.4 | 4.9 | 1.9 | 1.0 | 1.5 | -0.6 | -0.6 |

Source: IMF *World Economic Outlook* (October 2011), EBRD calculations and *Transition Report 2010*.
Notes: 1/NA: Historical values of actual primary fiscal balance were already significantly positive in 2010, which implies that countries can sustain their current level of debt at any market rate.

| Primary balance (per cent of GDP) | | | | | Consolidation need | | | Debt stabilising interest rate, (per cent)/1 | |
|---|---|---|---|---|---|---|---|---|---|
| Debt stabilising, 2011 LC | Debt stabilising, 2011 FX | Debt stabilising, 2016 LC | Actual 2010 | Actual 2016 | 2011 LC | 2011 FX | 2016 LC | 2016 LC | 2016 FX |
| 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 |
| | | | | | | | | | |
| -1.1 | 3.3 | -1.3 | -0.8 | -1.9 | -0.3 | 4.1 | 0.7 | 0.9 | 3.0 |
| 0.0 | -2.4 | 0.0 | -4.1 | -0.8 | 4.1 | 1.7 | 0.9 | 1.7 | 3.7 |
| -0.7 | -2.0 | -0.9 | 13.7 | 8.2 | -14.4 | -15.7 | -9.1 | NA | NA |
| -2.4 | -1.5 | -5.0 | -1.2 | 1.1 | -1.2 | -0.3 | -6.1 | 7.1 | 10.9 |
| -2.2 | 2.0 | -1.5 | -3.9 | 0.2 | 1.7 | 6.0 | -1.8 | 5.4 | 7.9 |
| -0.5 | 1.1 | -0.5 | -3.7 | 0.0 | 3.2 | 4.8 | -0.6 | 4.2 | 6.0 |
| 0.2 | 4.6 | 0.2 | -3.1 | -1.4 | 3.3 | 7.7 | 1.6 | 0.5 | 2.6 |
| -1.0 | 0.2 | -1.2 | -3.5 | -1.5 | 2.5 | 3.7 | 0.3 | 0.0 | 0.2 |
| 0.0 | 0.3 | 0.0 | 0.4 | 1.6 | -0.4 | 0.0 | -1.6 | NA | NA |
| -0.9 | 1.3 | -1.0 | -1.7 | -0.4 | 0.8 | 3.0 | -0.5 | 2.4 | 4.6 |
| -3.1 | -1.0 | -2.8 | -3.8 | -0.3 | 0.7 | 2.8 | -2.4 | 4.0 | 6.1 |
| 0.4 | 3.8 | 0.4 | -0.5 | 2.0 | 0.9 | 4.3 | -1.6 | 6.0 | 8.2 |
| -1.1 | -2.1 | -1.4 | 1.8 | 1.4 | -2.9 | -3.9 | -2.7 | NA | NA |
| -0.9 | 1.4 | -0.8 | -5.2 | -1.9 | 4.3 | 6.6 | 1.1 | 1.3 | 3.6 |
| 0.3 | 5.7 | 0.3 | -6.4 | 3.1 | 6.7 | 12.1 | -2.8 | 12.1 | 13.7 |
| -0.7 | 2.6 | -0.8 | -5.5 | -0.8 | 4.8 | 8.0 | 0.0 | 2.1 | 4.1 |
| -1.4 | 1.3 | -1.0 | -1.7 | 0.0 | 0.3 | 3.0 | -0.9 | 4.7 | 9.5 |
| -6.3 | -13.3 | -7.1 | 1.7 | 4.3 | -8.0 | -15.0 | -11.3 | NA | NA |
| -0.4 | -2.2 | -0.4 | -5.2 | 0.6 | 4.7 | 2.9 | -1.0 | 4.7 | 6.8 |
| -0.9 | 2.5 | -0.9 | -5.1 | 0.2 | 4.2 | 7.6 | -1.0 | 4.6 | 9.6 |
| -0.8 | -1.3 | -1.3 | -3.2 | -3.7 | 2.4 | 1.9 | 2.4 | 0.0 | 0.0 |
| -3.8 | 3.9 | -3.0 | -2.5 | 0.9 | -1.3 | 6.4 | -3.9 | 7.8 | 11.9 |
| -1.4 | 0.9 | -1.6 | -6.8 | 0.3 | 5.3 | 7.6 | -1.8 | 4.9 | 6.1 |
| 0.8 | 2.9 | 1.2 | -4.1 | -1.3 | 4.9 | 6.9 | 2.5 | 0.0 | 0.9 |
| -4.5 | -3.7 | -4.6 | -2.5 | -2.4 | -2.0 | -1.2 | -2.2 | 0.0 | 5.0 |
| -2.3 | -3.5 | -2.0 | -4.1 | -0.2 | 1.8 | 0.6 | -1.8 | 3.5 | 7.6 |
| -1.5 | -1.0 | -3.0 | 2.7 | 3.0 | -4.2 | -3.8 | -6.0 | NA | NA |
| -2.5 | -4.9 | -2.0 | 0.8 | 1.5 | -3.3 | -5.7 | -3.4 | NA | NA |
| 0.1 | 4.7 | 0.1 | -3.1 | 1.0 | 3.2 | 7.8 | -0.9 | 6.5 | 8.6 |
| | | | | | | | | | |
| -1.3 | 0.8 | -1.4 | -2.5 | 0.5 | 1.2 | 3.3 | -1.9 | 2.5 | 3.5 |
| -0.8 | 1.8 | -0.8 | -0.9 | 0.2 | 0.1 | 2.7 | -1.0 | 2.1 | 3.3 |
| -0.3 | 2.5 | -0.4 | -0.1 | -0.1 | -0.2 | 2.5 | -0.3 | 2.6 | 4.0 |
| -0.8 | -0.1 | -0.9 | -2.4 | -1.3 | 1.6 | 2.3 | 0.4 | 0.0 | 0.0 |
| -1.3 | 0.1 | -1.4 | -3.2 | 0.3 | 1.9 | 3.3 | -1.7 | 2.6 | 4.0 |
| -1.7 | 2.2 | -1.8 | -4.9 | 1.5 | 3.2 | 7.1 | -3.3 | 3.9 | 5.2 |
| -0.3 | 1.3 | -0.3 | -1.2 | 2.1 | 0.8 | 2.5 | -2.4 | 4.2 | 4.3 |
| 18.3 | 35.5 | 20.8 | -4.9 | 4.4 | 23.2 | 40.5 | 16.4 | 6.1 | 5.9 |
| -0.7 | -1.7 | -0.6 | -2.5 | 5.0 | 1.8 | 0.8 | -5.6 | 9.3 | 11.7 |
| 3.5 | 15.0 | 4.2 | -28.9 | 2.2 | 32.4 | 43.8 | 2.0 | 5.3 | 6.2 |
| 1.1 | 6.2 | 1.0 | -0.3 | 4.6 | 1.4 | 6.5 | -3.5 | 5.3 | 6.6 |
| -0.5 | -0.7 | -0.9 | -1.9 | -3.2 | 1.4 | 1.3 | 2.3 | 0.0 | 0.0 |
| 0.4 | 1.2 | 0.4 | -0.1 | -0.1 | 0.5 | 1.3 | 0.5 | 2.3 | 4.3 |
| -0.3 | 2.1 | -0.3 | -3.9 | 1.8 | 3.5 | 5.9 | -2.2 | 4.7 | 5.3 |
| -1.7 | -6.2 | -1.7 | 8.4 | 6.5 | -10.0 | -14.5 | -8.2 | NA | NA |
| 6.9 | 11.4 | 8.2 | -6.3 | 3.2 | 13.2 | 17.7 | 5.0 | 5.0 | 5.6 |
| 0.3 | 4.0 | 0.4 | -7.8 | -0.9 | 8.2 | 11.8 | 1.3 | 0.7 | 1.8 |
| -1.1 | -4.9 | -0.5 | -1.1 | 1.3 | 0.1 | -3.7 | -1.8 | NA | NA |
| -1.2 | -3.9 | -1.0 | 1.0 | 1.4 | -2.1 | -4.8 | -2.4 | NA | NA |
| -3.5 | -3.7 | -3.7 | -7.7 | 1.2 | 4.2 | 4.0 | -4.9 | 4.3 | 7.2 |
| -3.7 | -4.4 | -4.5 | -8.4 | -2.8 | 4.7 | 4.0 | -1.7 | 0.9 | 2.3 |

Table A.1.1.1
## Sector transition indicators 2011: market structure

| | Corporate sectors | | | | Energy | | | Infrastructure | | | | Financial institutions | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Agribusiness | General industry | Real estate | Telecommunications | Natural resources | Sustainable energy | Electric power | Water and wastewater | Urban transport | Roads | Railways | Banking | Insurance and other financial services | MSME finance | Private equity | Capital markets |
| **Central Europe and the Baltic states** | | | | | | | | | | | | | | | | |
| Croatia | Small | Small | Medium | Small | Small | Medium | Large | Medium | Medium | Medium | Medium | Small | Small | Medium | Medium | Medium |
| Estonia | Small | Negligible | Negligible | Small | Small | Medium | Small | Negligible | Small | Medium | Small | Small | Small | Medium | Medium | Medium |
| Hungary | Small | Small | Small | Small | Small | Medium | Medium | Small | Medium | Small | Medium | Small | Small | Medium | Medium | Small |
| Latvia | Small | Negligible | Small | Small | Medium | Small | Medium | Small | Small | Medium | Small | Medium | Small | Medium | Medium | Medium |
| Lithuania | Small | Small | Small | Small | Medium | Medium | Medium | Medium | Small | Medium | Medium | Small | Small | Medium | Medium | Medium |
| Poland | Small | Small | Small | Small | Medium | Medium | Medium | Small | Small | Small | Small | Small | Small | Medium | Small | Small |
| Slovak Republic | Small | Negligible | Small | Small | Small | Medium | Small | Medium | Medium | Medium | Small | Small | Small | Medium | Large | Medium |
| Slovenia | Small | Small | Negligible | Small | Medium | Small | Medium | Small | Small | Medium | Medium | Medium | Small | Medium | Large | Medium |
| **South-eastern Europe** | | | | | | | | | | | | | | | | |
| Albania | Medium | Medium | Large | Medium | Medium | Small | Medium | Large | Medium | Medium | Large | Medium | Large | Medium | Large | Large |
| Bosnia and Herzegovina | Medium | Large | Large | Medium | Large | Large | Large | Large | Medium | Medium | Medium | Medium | Medium | Medium | Large | Large |
| Bulgaria | Medium | Small | Medium | Small | Small | Large | Medium | Medium | Small | Medium | Medium | Small | Small | Medium | Medium | Medium |
| FYR Macedonia | Medium | Medium | Large | Medium | Medium | Large | Medium | Large | Medium | Medium | Medium | Medium | Large | Medium | Large | Large |
| Montenegro | Medium | Large | Medium | Small | Small | Large | Large | Large | Small | Medium | Medium | Medium | Medium | Medium | Large | Large |
| Romania | Medium | Small | Medium | Small | Small | Medium | Medium | Medium | Small | Small | Small | Small | Small | Medium | Large | Medium |
| Serbia | Medium | Medium | Large | Medium | Medium | Large | Large | Large | Medium | Medium | Medium | Medium | Medium | Medium | Large | Large |
| **Turkey** | Medium | Small | Small | Medium | Medium | Medium | Medium | Medium | Medium | Medium | Medium | Medium | Medium | Medium | Large | Small |
| **Eastern Europe and Caucasus** | | | | | | | | | | | | | | | | |
| Armenia | Medium | Medium | Large | Medium | Medium | Medium | Medium | Medium | Large | Medium | Medium | Large | Large | Medium | Large | Large |
| Azerbaijan | Medium | Large | Large | Large | Large | Large | Large | Large | Large | Medium | Medium | Large | Large | Large | Large | Large |
| Belarus | Medium | Large | Large | Medium | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large |
| Georgia | Medium | Medium | Large | Medium | Large | Medium | Small | Large | Large | Large | Medium | Medium | Large | Medium | Large | Large |
| Moldova | Medium | Large | Large | Medium | Medium | Large | Medium | Large | Medium | Medium | Large | Large | Large | Large | Large | Large |
| Ukraine | Medium | Medium | Large | Medium | Large | Large | Medium | Large | Medium | Medium | Large | Medium | Medium | Medium | Large | Large |
| **Russia** | Medium | Medium | Medium | Medium | Large | Large | Medium | Medium | Small | Medium | Small | Medium | Medium | Large | Medium | Small |
| **Central Asia** | | | | | | | | | | | | | | | | |
| Kazakhstan | Medium | Large | Medium | Medium | Medium | Large | Medium | Large | Medium | Medium | Medium | Medium | Medium | Large | Large | Medium |
| Kyrgyz Republic | Medium | Large | Large | Large | Large | Large | Large | Large | Medium | Large | Large | Large | Large | Large | Large | Large |
| Mongolia | Medium | Large | Large | Large | Medium | Large | Large | Large | Medium | Large | Medium | Large | Large | Large | Large | Large |
| Tajikistan | Medium | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large |
| Turkmenistan | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large |
| Uzbekistan | Medium | Large | Large | Large | Large | Large | Large | Large | Large | Large | Medium | Large | Large | Large | Large | Large |

Source: EBRD Note: Large equals a major transition gap. Negligible equals standards and performance typical of advanced industrial economies.

Table A.1.1.2

## Sector transition indicators 2011: market-supporting institutions

| | Corporate sectors | | | | Energy | | | Infrastructure | | | | Financial institutions | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Agribusiness | General industry | Real estate | Telecommunications | Natural resources | Sustainable energy | Electric power | Water and wastewater | Urban transport | Roads | Railways | Banking | Insurance and other financial services | MSME finance | Private equity | Capital markets |
| **Central Europe and the Baltic states** | | | | | | | | | | | | | | | | |
| Croatia | Medium | Small | Small | Small | Small | Medium | Medium | Small | Small | Medium | Medium | Small | Small | Medium | Medium | Small |
| Estonia | Medium | Negligible | Negligible | Negligible | Negligible | Medium | Negligible | Small | Small | Medium | Negligible | Small | Small | Small | Medium | Small |
| Hungary | Small | Small | Negligible | Negligible | Negligible | Small | Negligible | Small | Small | Negligible | Small | Medium | Small | Small | Small | Small |
| Latvia | Medium | Small | Negligible | Negligible | Negligible | Small | Negligible | Small | Small | Medium | Negligible | Small | Small | Small | Medium | Small |
| Lithuania | Medium | Small | Negligible | Negligible | Negligible | Small | Small | Small | Small | Medium | Small | Small | Small | Small | Medium | Small |
| Poland | Small | Small | Small | Small | Medium | Small | Negligible | Small | Small | Small | Negligible | Small | Small | Small | Small | Negligible |
| Slovak Republic | Medium | Negligible | Negligible | Small | Small | Small | Small | Small | Small | Medium | Medium | Small | Small | Negligible | Small | Small |
| Slovenia | Medium | Negligible | Negligible | Negligible | Small | Small | Small | Small | Small | Medium | Small | Small | Small | Small | Medium | Small |
| **South-eastern Europe** | | | | | | | | | | | | | | | | |
| Albania | Medium | Medium | Medium | Medium | Medium | Medium | Medium | Large | Large | Medium | Large | Medium | Medium | Medium | Large | Large |
| Bosnia and Herzegovina | Medium | Medium | Large | Medium | Large | Large | Large | Large | Large | Medium | Small | Medium | Medium | Medium | Large | Large |
| Bulgaria | Medium | Small | Small | Medium | Medium | Negligible | Small | Small | Small | Medium | Small | Medium | Small | Medium | Small | Small |
| FYR Macedonia | Medium | Medium | Medium | Small | Medium | Medium | Medium | Large | Large | Medium | Medium | Medium | Medium | Medium | Large | Large |
| Montenegro | Medium | Medium | Large | Medium | Medium | Medium | Medium | Large | Large | Large | Large | Medium | Medium | Medium | Large | Large |
| Romania | Medium | Small | Small | Small | Small | Small | Small | Small | Small | Medium | Negligible | Medium | Small | Medium | Small | Small |
| Serbia | Medium | Medium | Medium | Large | Large | Medium | Large | Large | Large | Medium | Small | Medium | Small | Medium | Medium | Medium |
| **Turkey** | Small | Medium | Medium | Small | Small | Medium | Medium | Medium | Small | Medium | Medium | Medium | Small | Medium | Small | Small |
| **Eastern Europe and Caucasus** | | | | | | | | | | | | | | | | |
| Armenia | Medium | Small | Medium | Medium | Medium | Medium | Medium | Medium | Medium | Medium | Medium | Medium | Large | Medium | Large | Large |
| Azerbaijan | Medium | Large | Large | Large | Medium | Large | Large | Large | Large | Medium | Large | Large | Medium | Large | Large | Large |
| Belarus | Medium | Large | Large | Large | Large | Medium | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large |
| Georgia | Medium | Medium | Small | Medium | Large | Large | Medium | Large | Large | Medium | Medium | Medium | Medium | Medium | Large | Large |
| Moldova | Medium | Large | Medium | Medium | Medium | Medium | Large | Large | Large | Medium | Large | Medium | Large | Medium | Medium | Medium |
| Ukraine | Medium | Large | Medium | Medium | Large | Small | Large | Large | Large | Medium | Large | Medium | Medium | Large | Large | Medium |
| **Russia** | Medium | Medium | Medium | Medium | Large | Medium | Medium | Medium | Medium | Medium | Medium | Medium | Medium | Large | Medium | Medium |
| **Central Asia** | | | | | | | | | | | | | | | | |
| Kazakhstan | Medium | Large | Small | Medium | Large | Large | Medium | Large | Large | Medium | Medium | Medium | Medium | Large | Medium | Medium |
| Kyrgyz Republic | Medium | Medium | Medium | Medium | Medium | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large |
| Mongolia | Medium | Medium | Large | Medium | Large | Large | Large | Large | Large | Large | Medium | Medium | Large | Large | Medium | Medium |
| Tajikistan | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large |
| Turkmenistan | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large |
| Uzbekistan | Large | Large | Large | Large | Large | Large | Large | Large | Large | Large | Medium | Large | Large | Large | Large | Large |

Source: EBRD
Note: Large equals a major transition gap.
Negligible equals standards and performance typical of advanced industrial economies.

# Credit information reporting systems in the transition region

The global economic crisis of 2008-09 has highlighted the importance of an effective institutional environment within which credit decisions can be made judiciously. A key element is an efficient credit information reporting system (also known as a "credit bureau"; a glossary of the terms used in this annex appears in Table A.1.2.4), governed by appropriate legislation and often under the auspices of a regulator, that allows lenders to appraise the characteristics and credit history of potential borrowers, and therefore to discern good and bad credit risks. This annex reports on a survey-based assessment of credit information reporting systems in the transition region, which was undertaken in late 2010 and the first quarter of 2011.

Interest in the workings of credit bureaus goes back at least a decade. The International Finance Corporation (IFC)'s 2006 *Credit Bureau Knowledge Guide* made detailed recommendations on how such institutions should be established, and in 2009 the World Bank and the Bank for International Settlements set up a task force which prepared international standards on credit reporting systems.[1]

Mindful of these principles, this study considers the nature of credit reporting systems in the transition region – ownership, oversight, data/consumer protection issues, usage and constraints – and goes significantly beyond the scope of annual World Bank *Doing Business* reports (currently the most comprehensive source of such information), which rate the depth of credit information reporting systems according to some basic criteria, as well as their coverage.

The survey has two main objectives. First, it describes the institutional structure of credit information reporting systems in the transition region. Second, it considers their legal efficiency. Legal efficiency is measured through 10 criteria, grouped under two headings: *basic legal function* and *maximising economic benefits*. The basic legal function of a credit reporting system is to allow for the sharing of accurate and sufficient credit information to support credit providers in assessing the creditworthiness of a potential borrower/debtor, while respecting the sensitive and confidential nature of such information. Maximising economic benefits of the system broadly consists of allowing for all functions of the system to be fulfilled simply, within an appropriate time and cost, while providing the different users with certainty as to how the system and its safeguards are to operate. There should also be evidence that the system fits in the context (social, economic, and so on) of the country, present and foreseeable.

## Methodology

The analysis in this annex was conducted through a combination of survey and desk research. A questionnaire was sent to a number of relevant parties in the transition region to seek their views, perceptions and experience on a number of key questions:[2]

- *Operators* of credit information reporting system(s) in each country were asked how the system is operated and used.
- *Regulators* of the credit information reporting system(s) were asked about their role, responsibilities and experience in regulating and sometimes disciplining such system(s).
- *Data providers and users* of the systems – in other words, those institutions that feed credit information and also retrieve information on data subjects when required.

The study has also reviewed relevant laws and regulations and related publicly available material in order to augment the questionnaire responses.

Basic information was gathered on each of the 29 transition countries in which the EBRD operates. In addition, detailed surveys were undertaken in 16 of those countries (which were deemed to allow for a fairly representative overview of the region):

Table A.1.2.1
**Credit information reporting systems in transition countries: basic classification**

| | Availability of credit information reporting system | Countries |
|---|---|---|
| **No system** | No system of credit information reporting which allows the assessment of creditworthiness of potential borrowers. | Moldova; Tajikistan; Turkmenistan |
| **Limited system** | System in place but too limited in terms of data, data providers, and potential users to serve its function. | Belarus; Croatia; Estonia; Montenegro; Slovenia; Uzbekistan |
| **System in place** | System is in place, which may in some cases have inefficiencies in terms of processes, data quality and consumer protection, is deemed generally fit-for-purpose. | Albania; Armenia; Azerbaijan; Bosnia and Herzegovina; Bulgaria; FYR Macedonia; Georgia; Hungary; Kazakhstan; Kyrgyz Republic; Latvia; Lithuania; Mongolia; Poland; Romania; Russia; Serbia*; Slovak Republic; Turkey; Ukraine |

Source: EBRD survey of credit information systems.
Note: Serbia excludes Kosovo.

[1] See World Bank, *General Principles for Credit Reporting*, Consultative Report (2011), http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/GeneralPrinciplesforCreditReporting(final).pdf).

[2] For the full survey questionnaire, see Dahan and Kirk (2011).

Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Mongolia, Poland, Romania, Russia, Serbia (excluding Kosovo), Slovak Republic and Turkey.

Table A.1.2.1 provides a summary classification based on the basic information collected for all 29 countries. Moldova, Tajikistan and Turkmenistan have no credit information reporting system. In Belarus, Croatia, Estonia, Montenegro, Slovenia and Uzbekistan there is a system in place; however, it is either highly restrictive (whereby it only serves banks or financial institutions and excludes other institutions such as utilities – for example, in Croatia) or only collects negative information such as payment delays or defaults (as in Estonia). In all other countries (20 out of 29), a credit information reporting system exists, although many systems suffer from inefficiencies in terms of processes, data quality and consumer protection. These are captured by the main survey.

There follows an overview of the institutional and market structure found in the region, and the main results of the survey with regard to legal efficiency.

Table A.1.2.2
**Transition countries: main institutional form of credit information reporting systems, early 2011**

| | Public registry dominant | Public registry and private bureau coexisting | Single private bureau only | Multiple private bureaus/registry – competitive environment |
|---|---|---|---|---|
| Bosnia and Herzegovina | | ● | | |
| Bulgaria | ● | | | |
| Croatia | | | ● | |
| FYR Macedonia | ● | | | |
| Georgia | | | ● | |
| Hungary | | | ● | |
| Kazakhstan | | | ● | |
| Kyrgyz Republic | | | ● | |
| Latvia | | ● | | ● |
| Mongolia* | | | ● | |
| Poland | | | | ● |
| Romania | | ● | | ● |
| Russia | | | | ● |
| Serbia | | | ● | |
| Slovak Republic | | ● | | |
| Turkey | | ● | | |

Source: EBRD survey of credit information systems.
Note: For Mongolia the characterised system, noted in the table, is under development.
Serbia excludes Kosovo.

## Institutional and market structure

### Institutional structure of the credit information reporting service providers

There is no consensus on whether credit information reporting systems should best be run by public agencies, private companies or some hybrid model and, to some extent, this will be determined by the size of the market. Credit information reporting entities in the transition region have a wide diversity of ownership structures which have evolved over time. Private ownership predominates, as Table A.1.2.2 illustrates.

None of the 16 countries surveyed has a structure which solely comprises a public registry. In Mongolia, where the Credit Information Bureau which operated out of the Bank of Mongolia from the mid-1990s is undergoing privatisation, it seems likely that a joint venture company will be formed with the US-based commercial information company Dun & Bradstreet.

Bulgaria and FYR Macedonia both have a private credit bureau and a public credit registry, but the latter dominates the market at present, although this may change. The public credit registry in FYR Macedonia was established in 1998 and the private bureau became operational this year. Seven of the surveyed countries – Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Latvia, Romania, the Slovak Republic and Turkey – have a private credit bureau and a public credit registry. In Latvia the public registry (operated by the Bank of Latvia) is the main credit information reporting system, but some private companies offer reporting services alongside their primary business of debt recovery. In the Slovak Republic the private bureau covers only individuals, while the public registry applies only to firms. In Bosnia and Herzegovina the private bureau was formed in 2000 and the public registry in 2006; the coverage of the latter has since increased greatly, while that of the private bureau has dropped significantly. The public registry in Bulgaria and Romania, which was formed in 2000 and 1999, respectively, was joined by a private credit bureau in both countries from 2004. Despite these similar formation timelines, it should be noted that in Romania the private credit bureau has larger coverage, while the financial institutions in Bulgaria that responded to the survey indicated that they only used reports from the public registry. Lastly, Turkey has a significantly longer track record in providing credit information services; the central bank has owned and operated a credit registry since 1951, and a private credit bureau has been operational since 1997.

The other nine countries rely on private credit bureaus to provide credit information services, but with significant differences in the number of operating bureaus. In Serbia there is one private bureau, which was established by the Association of Serbian Banks. In Russia, as of January 2011, there were 32 registered bureaus throughout the country, many of which were affiliated directly with various financial institutions.

### Legal framework

Among the countries surveyed, there is a fairly even split between those with specific laws or regulations relating to credit information reporting and those which rely on other general legislation (typically banking law and data protection law) to control the operations of credit bureaus and registries. Nevertheless, there seems to be a trend towards developing specific laws on credit reporting, for example in Croatia, the Kyrgyz Republic and Mongolia. In Croatia HROK credit bureau was founded by 20 Croatian banks under the auspices of the country's banking association. There is no legal framework other than the 2003 Act on Personal Data Protection, and participation in the system is determined by the internal regulations of the bureau.

Public registries are all based on laws and/or regulations governing banking or financial services. Some private credit bureaus have been set up by experienced international firms (such as Experian) using existing data protection law on which to base their operations. The Kyrgyz Republic is a special case in that the credit bureau was developed without any legal framework; a draft law which reflects the current system is being developed.

### Competition among service providers

A number of jurisdictions in the transition region have competitive markets for credit reporting service providers, whether operating as a private bureau providing services alongside a public registry (for example, in Bosnia and Herzegovina), a public registry coexisting with multiple credit bureaus (as in Latvia and Romania) or in an entirely private bureau environment (as in Poland, and Russia, where the sheer size of these markets can accommodate a number of competing organisations). See Table A.1.2.2. Hungary is unique among countries in the region insofar as it permits only one credit bureau at a time to operate.

In Russia the competitive environment is enabled by the Central Catalogue of Credit Histories (CCCH), a database run by the central bank containing information about where a data subject's credit history is stored. The role of the CCCH is to direct a lender (or an individual) to all the credit bureaus that keep records of that individual's (as a potential borrower) credit history. This should reduce the possibility of getting a blank report when a potential borrower has an existing credit history. The catalogue database receives information identifying data subjects from all of the existing credit bureaus, so data can be sourced from a single reference point.

### Stress resistance and system integrity

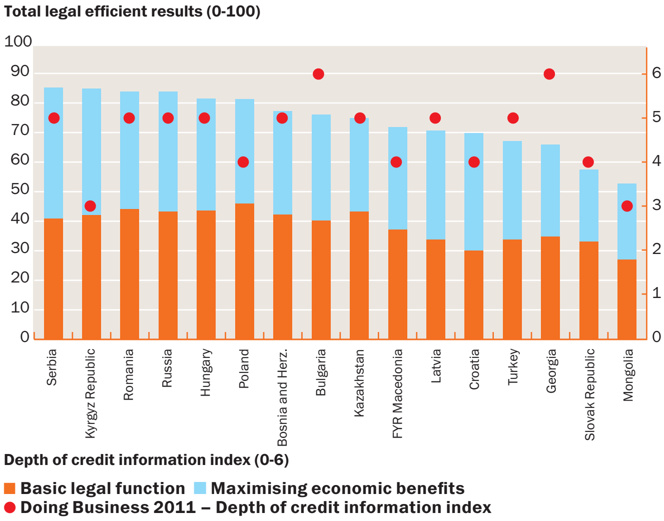
Defining the rights of credit information operators over data in cases of cessation of trading, transfer of a business to a third party or insolvency of a credit registry is an essential part of ensuring data protection. In Russia the Federal Law on Credit Histories dictates that, in the event of a credit bureau's insolvency, the credit histories owned by the insolvent bureau should be sold in an auction involving only other state-registered credit bureaus. The CCCH would temporarily store databases of liquidated, re-organised or excluded credit bureaus. In Hungary, in the event of the Central Credit Information System becoming insolvent, the data would reportedly be transferred to the replacement institution designated by the Supervisory Authority. Other countries do not seem to have procedures in place to respond to such a situation and surveyed parties were uncertain as to what the outcome of such a scenario would be.

## Legal efficiency of credit information reporting systems

The main purpose of the study was indeed to provide a view on how effective the system in place is. For that purpose, the questions in the main survey of 16 countries were grouped into two main categories: those referring to the basic legal function of credit information reporting systems, and those describing how economic benefits have been maximised. These main categories in turn consist of five subcategories, each comprising between two and five questions. For each of these, survey answers were coded from 0 (categorical negative answer) to 6 (unqualified positive answer), yielding a theoretical maximum of 114 points for the basic legal function and 108 for maximising economic benefits. The maxima actually attained in each category were 105 for the basic legal function (in Poland) and 97 for maximising economic benefits (in Serbia). To allow for a better visual presentation, the results were adjusted on a scale of 100, where each main category carries a maximum of 50.

Chart A.1.2.1 shows the results for the two main categories

Chart A.1.2.1
**Legal efficiency of credit information reporting systems**



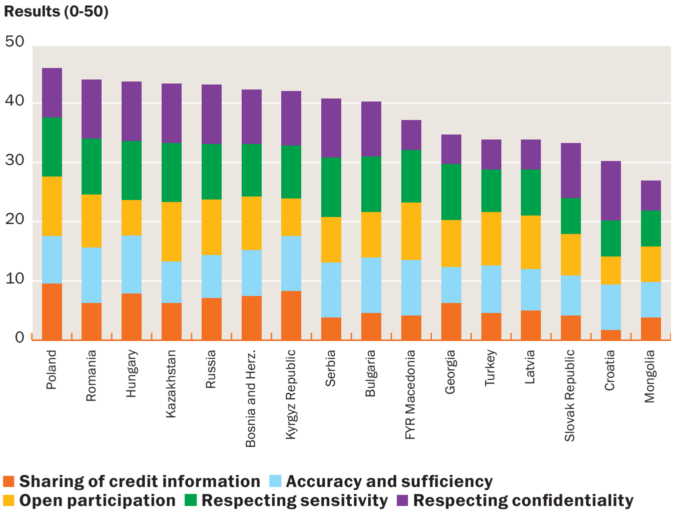

Source: Dahan and Kirk (2011) and Doing Business Report (2011).
Note: Serbia excludes Kosovo.

and the total score by country. The best results were recorded in Hungary, the Kyrgyz Republic, Poland, Romania, Russia and Serbia, all of which achieved total scores above 80. This reflected good performance in both of the main categories, although the Kyrgyz Republic and Serbia scored a little lower than the other countries on the basic legal function while doing particularly well on maximising economic benefits. The worst-performing countries were Mongolia and, perhaps surprisingly, the Slovak Republic. Although reform was under way at the time of the survey, Mongolia had not yet enacted a specific legal framework for credit information systems, and access to its existing system was limited to financial institutions. The Slovak Republic did not score well due to the very fragmented structure of the system in place, in which different databases serve different users and data subjects (something unique in the transition region).

Croatia is an interesting case insofar as it received a high score on maximising economic benefits, but the lowest score among all 16 countries with regard to the basic legal function. As in the case of Mongolia, this was due to the lack of a specific legal framework and the restriction of access to information under its prevailing system to financial institutions. In Table A.1.2.1, Croatia is in fact classified as having a "limited system" of credit information reporting in place.

The chart also shows how the legal efficiency scores from the survey compare with the depth of credit information index compiled by the World Bank and IFC as part of its *Doing Business* project (the right axis). This is calculated as the sum of six binary checks, which award a point if: the credit history information gives positive aspects (for example, a track record of regular payment)

Chart A.1.2.2
**Basic legal function: subscores**




Source: Dahan and Kirk (2011).
Note: Serbia excludes Kosovo.

and also negative ones; individuals and firms are covered; data from retailers, trade creditors and utilities are collected in addition to data from financial institutions; more than two years of data are distributed; small loans are included; and borrowers have a legal right to access their data. The point is granted if either of the private bureau or public registry scores positively on the question.

As one would expect, there is a positive correlation in the chart between the World Bank index and the legal efficiency index, but it is low (0.2). Also as expected, the correlation is determined mostly by the basic legal function subcomponent (0.3), whereas the correlation with the maximising economic benefits subcomponent is near zero. The dimensions checked by the *Doing Business* index overlap only partly with the 10 subcategories covered by the legal efficiency survey, primarily under the basic legal function. Therefore, the main cause of discrepancies between the World Bank index and the legal efficiency results is that the latter takes a much broader view of what defines the quality of a credit information system – via its "maximising economic benefits" category. Another reason could be that the *Doing Business* index, having to design simple measures that can be applied to 100+ countries, is based on binary (yes/no) information, whereas the present survey uses a six-point scale which tries to capture the quality of implementation, based on the views of not just the systems operators but also the users and regulators.

## Basic legal function

Chart A.1.2.2 plots the subcategories that constitute the basic legal function as defined in the survey, that is to say, how widely information is shared within a system (or whether the system creates "silos" of information that cannot be accessed), whether information is sufficient and accurate, whether the system is open to broad participation, and whether it respects information sensitivity and protects confidentiality. The following analysis describes some of the main factors that determine cross-country differences in these categories.

### *Sharing of information*

Sharing of information concerns the various credit reporting information systems. If only one credit reporting system (either a public registry or a private bureau) exists in a country, the sharing of information is impossible. Nevertheless, in six countries in the survey where several systems exist, this opportunity for cross-checking has been missed. Only in Bosnia and Herzegovina, Poland and Russia does such sharing take place. Moreover, a diversity of credit information reporting systems should not promote a "silo" mentality where data providers or data subjects are assigned exclusively to one system (such as in the Slovak Republic).

It is perhaps less surprising that cross-border links have not yet been developed between institutions from different countries, given that the process has barely started in the European Union (although Hungary, Poland and Romania – all new EU members – have taken a lead). Since many private bureaus are owned or operated by large international organisations, there would be a great advantage in establishing such links, especially in countries which have close commercial connections with their neighbours. The Kyrgyz Republic seems to have recognised this opportunity.

### *Accuracy and sufficiency of information*

A critical factor in assessing information gathered by a credit bureau is whether both positive and negative credit data are collected and distributed. Most transition countries which have a credit information system in place have chosen to include positive and negative data in either a public registry or private bureau. One notable exception is Poland, where it appears that the main database – Biuro Informacji Gospodarczej InfoMonitor (BIG InfoMonitor) – contains only negative economic entries, although this is supplemented by positive information from the Biuro Informacji Kredytowej (BIK) credit bureau. In Latvia the private credit bureaus that operate beside the Credit Register of the Bank of Latvia also collect only negative information, while the Central Credit Information System (CCIS) in Hungary contains only negative data about debtors, based on legal provisions. Hungary's Credit Reference service (CR), on the other hand, contains positive information about debtors but is not supported by a legal framework.

While it is important that sufficient data are collected to give an accurate borrower profile, there is a risk that collecting excessive information may actually be detrimental. An important issue is the length of time that data – in particular negative data – are retained and distributed by a credit reporting system. In general, negative data should be retained by credit bureaus and registries for up to five years, while positive data are often retained longer. The Kyrgyz credit bureau, for example, has a policy of retaining positive data for 10 years, and removes negative information after three. The absence of legislation in Mongolia means there is no legal limit on how long data are retained and included on credit reports. In Russia credit bureaus may retain all data for 15 years (far exceeding what is permitted in most other jurisdictions) but there is not yet evidence that credit bureaus will choose to do so. In Georgia, two concerns emerge on this subcategory: first, there seems to be no system or legal requirement for ensuring data accuracy. CreditInfo expects data providers to be responsible for the correctness of the data they collect. Second, the collection of data is not limited to credit reporting purposes.

### *Open participation*

An important characteristic of credit information systems is the extent to which they are open to a range of market participants. A system should not be exclusive, where small market players are denied vital information. This does not seem to be the pattern in the transition region. However, there is still a bias in favour of financial institutions: in the majority of the countries surveyed, only financial institutions can receive data from at least one of the existing reporting systems. Interestingly, this situation prevails when a central bank operates the credit information reporting system but also when the system has been privately developed (for example, by banking associations). In FYR Macedonia, the Credit Registry of the National Bank, which was the only system in operation until 2011, includes only data on financial institutions (domestic banks, savings houses and branches of foreign banks), while the private credit bureau (MKB) similarly includes data from financial institutions but also other credit providers, service providers and government entities (such as the tax authority and pension fund). The MKB was founded in December 2008 and started operations in January 2011.

In Hungary the private credit bureau BISZ Zrt operates the Central Credit Information System (CCIS), the Credit Reference service (CR) and Credit Bureau services. Initially restricted to banks, savings cooperatives and credit unions, its remit was then widened to include all financial institutions and those investment companies engaged in investment lending. Enterprises engaged in commercial lending have become eligible to subscribe to the CCIS since 2010. Institutions such as tax authorities, ministries, municipalities, public utility and telecommunications providers and non-governmental organisations (NGOs) are not allowed to subscribe to the service.

The Credit Reporting Agency in Serbia is a private credit bureau established in 2004 by the Association of Serbian Banks. Only financial institutions are required to provide data. Government entities and other credit providers are excluded although some, such as telecommunications companies, may access credit histories as users.

Data protection requires that information is collected and distributed solely for assessing the creditworthiness of potential borrowers. In most countries permissible purposes are specified in legislation or regulations. Where a country does not have a credit information reporting law in place, there may be concern that data can be requested for purposes other than assessing a subject's creditworthiness. In Mongolia, for example, there is no law explicitly restricting data usage to permissible purposes, although the data providers and users who were surveyed maintained that the aim of data requests was solely to assess the credit history of existing or prospective borrowers. Croatia is a similar case. Georgia also provides no specific legal restriction.

### *Respecting the sensitivity of information*

This refers to subjects' right of access to their own data and the right to challenge incorrect information and have it corrected promptly. They should be able to request corrections through an internal mechanism at the credit bureau and to have those requests recorded, investigated and acted upon. Such a right is evident in all the countries surveyed. The usual practice is for credit bureaus and registries to allow data subjects to access their credit report once a year for free and then to charge small fees for additional access. In some countries, such as

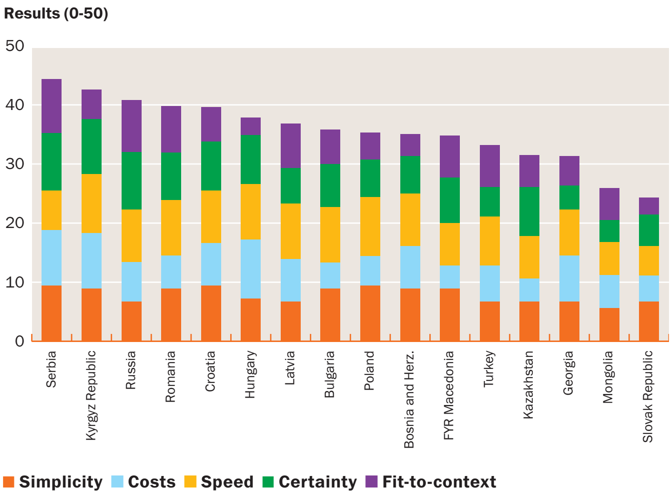
Bulgaria and the Kyrgyz Republic, there are procedures in place for the correction of erroneous credit data although there is little evidence regarding their effectiveness. In contrast, the Serbian Credit Reporting Agency reported approximately 8,000 corrections taking place in 2009, and the public registry in Turkey indicated that an average of 80 corrections take place each month.

### *Respecting the confidentiality of information*
The consent of data subjects for their personal data to be collected and used in credit reporting systems is a generally accepted data protection principle. Borrower written consent is required before credit information may be reported in the majority of transition countries. The most common approach is to obtain consent as part of a loan application. In Kazakhstan a loan agreement cannot be signed, and credit cannot be advanced, if there is no written authorisation from the client to report credit information to the credit bureau. There are, however, some countries that do not require consent. In addition to Mongolia, where there is no law or practice requiring consent, survey respondents in FYR Macedonia and Turkey all indicated that consent is not required. In Latvia too, respondents were conflicted as to whether or not consent was required.

In summary, it is encouraging to note that, with exceptions, most of the surveyed countries have achieved a credit information reporting system which, by and large, fulfils its basic legal function.

Chart A.1.2.3 shows the scores of the subcategories that together evidence how the system is maximising economic benefits as defined in the survey. They refer to simplicity, speed,

Chart A.1.2.3
**Maximising economic benefits: subscores**




Source: Dahan and Kirk (2011).
Note: Serbia excludes Kosovo.

costs, certainty and fit-to-context. As the Mongolian system is under development, many scores were marked as unclear, which led to an overall poor grading on these subcategories.

### *Simplicity*
Credit reports are available online to users in all of the 16 surveyed countries. Data subjects, however, find it harder to access their own credit histories. In some countries they have to make a request through their bank, which will pass the query on to the credit information reporting system. In Georgia the data subject must present his or her identification in person at CreditInfo's office, although once verification has been completed the subject may access a service which allows the monitoring of credit information online. Similarly, in Latvia data subjects have to present themselves at the Credit Register in person and prove their identity (or, in the case of a subject's representative, produce a document certifying that person's legal right to represent the subject). Furthermore, a credit history cannot be sent electronically to individuals for security reasons, although the Bank of Latvia is working to amend this. Simplifying a data subject's access to his or her credit history is very important, since accuracy depends very much on the subject's opportunity to review, and if necessary challenge, the data.

### *Speed*
The speed of processes depends to a large extent on how simple they are to use. Speed is also essential in ensuring the accuracy of data subject credit histories when they are affected by changes. It is important that users are made aware of any such changes as quickly as possible. In six of the surveyed countries (Bosnia and Herzegovina, Georgia, Hungary, the Kyrgyz Republic, Serbia and Turkey) significant changes are reported immediately, or within a week, and this prompts user notification. However, users in all the other countries must update their records on their own initiative (through regular monitoring of the reporting system) or changes will not be recorded before the next reporting cycle (which may undermine the validity of the credit information).

### *Costs*
As evidenced in Chart A.1.2.3, the costs of obtaining a credit report are low in all of the surveyed countries. In the majority of countries, members of the credit registry or bureau can obtain a report for free or for less than €1, or alternatively through an annual or monthly membership fee. In all cases, data subjects have the right to one free report of their own credit history each year (with additional reports often costing under €10).

### *Certainty*
Certainty about credit reporting is an issue in just under half of the countries surveyed and revolves around two key questions. First, what are the requirements for obtaining consent from data subjects? Respondents in Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Latvia, Mongolia, Poland and Turkey were

confused by, or gave contradictory answers to, this question. Clarity regarding consent of the data subject is essential for public confidence in the credit reporting system. Second, is existing credit data in dispute? Most of the surveyed countries do not record ongoing disputes initiated by data subjects over their credit histories in the information supplied to lenders. Notable exceptions include FYR Macedonia, the Kyrgyz Republic, Russia and Serbia. In the Slovak Republic, it seems that data subjects (which are firms exclusively) are not allowed to access their credit history in the public registry.

### *Fit-to-context*

Fit-to-context refers to market coverage (which shows whether the use of the credit reporting system is sufficiently broad to serve the market) and also the perceived effectiveness of the system from the perspective of users in predicting the repayment behaviour of data subjects. Based on the *Doing Business* coverage data, it is clear that the region has still some way to go in this respect (Croatia, Poland, Serbia and Turkey are notable exceptions).

Most of the users of credit information in the survey felt that the system in place was reasonably effective in determining the creditworthiness of data subjects. Only the private credit bureaus in Bosnia and Herzegovina and Hungary were rated negatively, although in each case only one or two financial institutions had provided a response. In Latvia (the country with the highest number of user responses at 14), none of the financial institutions gave the registry a negative rating, while 9 of the 14 rated it as "effective" or "very effective".

In summary, the credit reporting systems in place in the 16 surveyed countries score well in terms of the user-friendliness of their processes (and perhaps even higher than some of the more established systems in the world). However, the relative immaturity of systems in the transition region is evident in relation to certainty and fit-to-context. Since most of these systems are not yet 10 years old, what they have already achieved is nevertheless impressive.

## Conclusion and policy implications

Credit information systems that fulfil their basic legal function operate in all but a handful of transition economies. Nevertheless, the survey shows that there are large, and sometimes surprising, differences in the quality of these systems across countries. These differences relate not only to basic aspects, such as data coverage, accuracy, protection and access, but also to economic benefits that should be derived from the

Table A.1.2.3
**Priority areas for reform of credit information reporting systems**

| | Basic legal function | Maximising economic benefits | | | | |
|---|---|---|---|---|---|---|
| | | Simplicity | Speed | Costs | Certainty | Fit-to-context |
| Bosnia and Herzegovina | Efficient | Efficient | Some inefficiency | Some inefficiency | Some inefficiency | Inefficient |
| Bulgaria | Efficient | Efficient | Inefficient | Some inefficiency | Some inefficiency | Some inefficiency |
| Croatia | Inefficient | Efficient | Efficient | Efficient | Efficient | Some inefficiency |
| FYR Macedonia | Efficient | Efficient | Inefficient | Efficient | Some inefficiency | Some inefficiency |
| Georgia | Inefficient | Some inefficiency | Efficient | Efficient | Inefficient | Some inefficiency |
| Hungary | Some inefficiency | Some inefficiency | Very efficient | Efficient | Efficient | Inefficient |
| Kazakhstan | Some inefficiency | Some inefficiency | Inefficient | Some inefficiency | Efficient | Some inefficiency |
| Kyrgyz Republic | Some inefficiency | Efficient | Efficient | Very efficient | Efficient | Some inefficiency |
| Latvia | Some inefficiency | Some inefficiency | Some inefficiency | Efficient | Inefficient | Efficient |
| Mongolia | Inefficient | Unclear | Unclear | Unclear | Inefficient | Inefficient |
| Poland | Efficient | Efficient | Some inefficiency | Very efficient | Some inefficiency | Some inefficiency |
| Romania | Very efficient | Efficient | Unclear | Efficient | Efficient | Some inefficiency |
| Russia | Efficient | Some inefficiency | Some inefficiency | Efficient | Efficient | Some inefficiency |
| Serbia | Efficient | Efficient | Efficient | Some inefficiency | Efficient | Efficient |
| Slovak Republic | Inefficient | Efficient | Some inefficiency | Unclear | Efficient | Unclear |
| Turkey | Some inefficiency | Some inefficiency | Some inefficiency | Efficient | Inefficient | Some inefficiency |

**Very efficient** **Efficient** **Some inefficiency** **Inefficient** **Unclear**

Source: Dahan and Kirk (2011).
Note: Serbia excludes Kosovo.

system, including speed and costs. Some countries score highly in some respects but poorly in others.

Accordingly, priorities for reform vary markedly from country to country. Table A.1.2.3 maps these priorities based on the limitations identified in the survey, using a "traffic light" colour code. A diverse picture emerges not only across countries, but also across the areas where reform should be focused first. Nevertheless, the mapping also shows that all these areas have been successfully tackled by at least one existing system, which should encourage countries to learn from each other.

Lastly, the survey may be able to shed some light on the question which has perhaps been the thorniest and most controversial in the development of credit information reporting systems in the last decade or so – that of the most efficient model between a public registry and a private bureau. It has shown that, despite a trend towards the "privatisation" of reporting systems, the transition region has evolved a diversity of models where the share of private-sector involvement varies. Is there a correlation between the structural features of these systems, on the one hand, and their performance (as measured by total legal efficiency), on the other?

To answer this question, a value based on the extent of private-sector involvement in credit information systems was given to each country in the survey, as per Table A.1.2.2 ranging from 1 (only public registry) to 5 (private provision in a competitive environment). Chart A.1.2.4 plots these values (on the horizontal axis) against the total legal efficiency results (on the vertical axis).

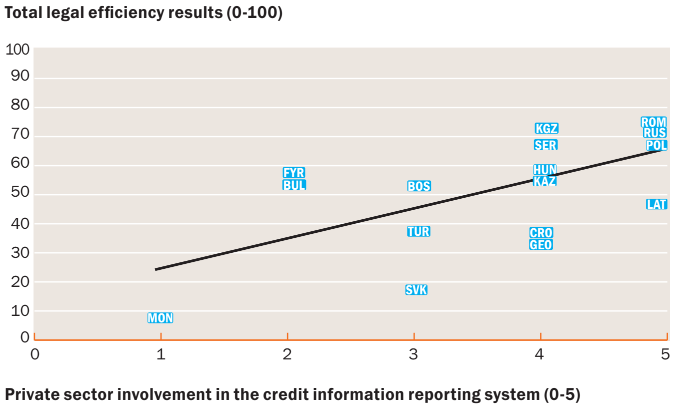
There is a clear positive correlation in the chart (with a coefficient of 0.61), suggesting that private-sector provision of credit information, particularly in a competitive environment, benefits the overall quality of the system. However, there are also some counter-examples, such as in Croatia, Georgia, Latvia and the Slovak Republic, which show that private bureaus do not automatically result in an efficient system. Nevertheless, the positive correlation is noteworthy, especially for those transition countries which do not yet have, and may be planning to establish, a credit information reporting system.

## References

**F. Dahan and E. Kirk (2011)**
"Credit Information Reporting Systems: perspective on the progress made in Transition Economies", forthcoming Working Paper, EBRD.
See also: www.ebrd.com/pages/sector/legal/flu.shtml

**Doing Business Report (2011)**
*Doing Business* database, available online at http://www.doingbusiness.org/

Chart A.1.2.4
**Legal efficiency results and private-sector involvement in credit information reporting systems**




Source: Dahan and Kirk (2011).
Note: Serbia excludes Kosovo.

Table A.1.2.4
**Glossary of relevant legal terms**

| | |
|---|---|
| **Credit history** | A borrower's past payment history, including credit applications and payment history. |
| **Credit information reporting system** | Overall term encompassing credit bureaus and credit registries. Refers to the database that contains information on data subjects and the processes for accessing information on subjects to support users in their analysis of creditworthiness. |
| **Credit bureau** | Privately owned entity that processes information on data subjects to support users. Can be operated by banks (which are then considered non-neutral, since banks are also users) or neutral data processing companies. |
| **Credit registry** | Public entity operated by central banks or other agencies collecting information from data providers about the indebtedness of data subjects. |
| **Credit report** | Document produced by credit bureaus or registries for users about the credit history of data subjects. May include a credit score. |
| **Credit information** | Core information on data subjects, which may include borrowers' identity details, past and present payment history and updated basic credit risk information. *Positive credit information* is a record of good repayment behaviour, such as on-time payments. *Negative credit information* describes missed payments, tax arrears, and so on. |
| **Data provider** | An institution which has disclosed information about a data subject and a payment history to the credit information reporting system. In most cases, data providers are government agencies and financial institutions with which the data subject has credit relationships. |
| **Data subject** | Individual or legal person (a company, for example) whose data are subject to processing. |
| **User** | Individual/company who asks the credit information reporting system for credit reports and other information about data subjects for permissible purposes. |

Table A.1.2.5
## Credit information reporting systems assessment

| I Basic legal function | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **1 Sharing of credit information** | Bosnia and Herz. | Bulgaria | Croatia | FYR Macedonia | Georgia | Hungary | Kazakhstan | Kyrgyz Republic | Latvia | Mongolia | Poland | Romania | Russia | Serbia | Slovak Republic | Turkey |
| 1.1 Does the system allow data providers to share credit information with all credit reporting organisations? | ✔✔✔ | ✔✔ | ✘✘ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✘✘ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔ |
| 1.2 Does the system allow all credit information reporting organisations to share credit information with users who enquire for that information? | ✔✔✔ | ✔✔✔ | ✘✘ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✘✘ | ✔✔ | ✔✔✔ |
| 1.3 Is there sharing of information between the different credit reporting organisations? | ✔✔✔ | ✘✘✘ | ? | ✘✘✘ | N/A | N/A | N/A | N/A | ✘✘✘ | N/A | ✔✔✔ | ✘✘✘ | ✔✔ | N/A | ✘✘✘ | ✘✘✘ |
| 1.4 Is there sharing of information between credit reporting organisations from different countries? | ✘✘✘ | ✘✘✘ | ✘✘✘ | ✘✘✘ | ✘✘✘ | ✔✔✔ | ✘✘✘ | ✔✔ | ✘✘ | ✘✘✘ | ✔✔ | ✔✔ | ✘✘✘ | ✘✘✘ | ✘✘✘ | ✘✘✘ |
| **2 Accuracy and suficiency of credit information** | | | | | | | | | | | | | | | | |
| 2.1 Is credit information collected in such a way as to ensure accuracy? | ✔✔✔ | ✔✔ | ✔✔ | ✔✔ | ✘✘✘ | ✔✔✔ | ? | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔ | ✘✘ | ? |
| 2.2 Is the amount of collected data adequate (completeness, including positive data, etc)? | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✘✘ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ |
| 2.3 Are the collected data necessary for credit reporting purposes (for a clearly defined permissible purpose, etc)? | ✔✔ | ✔✔✔ | ✘✘ | ✔✔ | ✘✘✘ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✘✘ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔ |
| 2.4 Is the credit information kept up to date (data should be regularly updated)? | ✘✘ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ? | ✔✔✔ |
| 2.5 Is the credit information not excessive (time-limited data retention, etc)? | ✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✘✘ | ✔✔ | ✘✘✘ | ✘✘✘ | ✔✔✔ | ✔✔ | ✘✘ | ✔✔ | ✔✔✔ | ✔✔ |
| **3 All credit providers and data subjects as potential borrowers** | | | | | | | | | | | | | | | | |
| 3.1 Does the legal framework take an open approach to participation in the system? | ✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✘✘✘ | ✔✔✔ | ✘✘ | ✔✔ | ✘✘ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔ |
| 3.2 Are users not excluded from participating in the system because of their type of organisation? | ✔✔✔ | ✔✔ | ✘✘ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔ |
| 3.3 Does the system promote a broad understanding of credit? | ✔✔ | ✘✘ | ✘✘ | ✔✔✔ | ✔✔✔ | ✘✘ | ✔✔✔ | ✘✘ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✘✘ | ✘✘ | ✔✔ |
| 3.4 Does the legal framework clearly define circumstances under which a user can request a credit report? | ✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✘✘ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✘✘ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ |
| 3.5 Does the system take an open approach to which entities can be a data subject? | ✔✔✔ | ✔✔✔ | ✘✘ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ |
| **4 Respecting sensitive nature of information** | | | | | | | | | | | | | | | | |
| 4.1 Can data subjects access their own credit information? | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ |
| 4.2 Can data subjects request the rectification of their credit information and credit history, if inaccurate or processed unlawfully? | ✔✔ | ✔✔ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✘✘ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ |
| 4.3 Does the legal framework provide for liability resulting from inaccurate information or other unlawful wrongdoing? | ✔✔ | ✔✔✔ | ✘✘ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ? | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✘✘ | ✘✘ |

| 5 Respecting confidential nature of information | Bosnia and Herz. | Bulgaria | Croatia | FYR Macedonia | Georgia | Hungary | Kazakhstan | Kyrgyz Republic | Latvia | Mongolia | Poland | Romania | Russia | Serbia | Slovak Republic | Turkey |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 5.1 Does the legal framework require consent of the data subject for credit information to be shared? | ✔✔✔ | ✔✔ | ✔✔✔ | ✘✘✘ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✘✘ | ✘✘✘ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✘✘✘ |
| 5.2 Is access to credit histories limited to permissible purposes? | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✘✘ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ |
| **II Maximising economic benefits** | | | | | | | | | | | | | | | | |
| **6 Simplicity** | | | | | | | | | | | | | | | | |
| 6.1 Is it simple for users to obtain credit reports? | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔ |
| 6.2 Is it simple for data subjects to access their credit histories? | ✔✔ | ✔✔ | ✔✔ | ✔✔ | ✘✘ | ✘✘ | ✘✘ | ✔✔ | ✘✘ | ? | ✔✔✔ | ✔✔ | ✘✘ | ✔✔ | ? | ✘✘ |
| 6.3 Is making a correction in a credit report simple? | ✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔ | ? | ✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ |
| **7 Speed** | | | | | | | | | | | | | | | | |
| 7.1 Is accessing a credit report fast? | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✘✘ |
| 7.2 Is correcting a credit report fast? | ✘✘ | ✘✘ | ✔✔ | ✘✘ | ? | ✔✔✔ | ✘✘ | ✔✔✔ | ✔✔✔ | ? | ✘✘ | ? | ✔✔✔ | ✔✔✔ | ✘✘ | ✔✔ |
| 7.3 Can users be made aware of sudden changes in the credit history of data subjects quickly? | ✔✔✔ | ✘✘ | ? | ✘✘✘ | ✔✔✔ | ✔✔✔ | ✘✘✘ | ✔✔✔ | ✘✘ | ? | ? | ? | ✘✘ | ✔✔ | ? | ✔✔ |
| **8 Costs** | | | | | | | | | | | | | | | | |
| 8.1 Is getting a credit report inexpensive for users? | ✔✔ | ✔✔ | ✔✔ | ? | ? | ✔✔ | ✘✘ | ✔✔✔ | ✔✔ | ? | ✔✔✔ | ✔✔ | ✔✔ | ✘✘ | ✔✔ | ✔✔ |
| 8.2 Is accessing their credit report inexpensive for data subjects? | ✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ? | ✔✔ |
| 8.3 Is correcting a credit report inexpensive? | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ? | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ? | ✔✔ |
| **9 Certainty** | | | | | | | | | | | | | | | | |
| 9.1 Is the permissible purpose for issuing a credit report sufficiently certain? | ✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✘✘✘ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ |
| 9.2 Is the access by data subjects to their credit history clear and certain? | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✘✘✘ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✘✘ | ✔✔✔ |
| 9.3 Are the requirements for obtaining consent from data subjects clearly defined and understood? | ✘✘ | ✘✘ | ✔✔✔ | ✘✘ | ✔✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ✘✘ | ✘✘✘ | ✘✘✘ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✘✘✘ |
| 9.4 Are there clear data quality standards? | ✔✔ | ✔✔ | ✔✔ | ✔✔ | ✘✘✘ | ✔✔ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ✔✔ | ? | ✘✘ |
| 9.5 Are ongoing disputes on data subjects regarding the data subject's credit history noted? | ? | ✔✔ | ? | ✔✔✔ | ✘✘✘ | ? | ? | ✔✔✔ | ✘✘✘ | ✘✘ | ? | ? | ✔✔✔ | ✔✔✔ | ? | ? |
| **10 Fit to context** | | | | | | | | | | | | | | | | |
| 10.1 Is the system sufficiently broad to serve the market's needs? | ✘✘ | ✘✘ | ✔✔✔ | ✘✘ | ✘✘✘ | ✘✘✘ | ✘✘ | ✘✘✘ | ✔✔ | ✘✘✘ | ✔✔✔ | ✘✘ | ✔✔ | ✔✔✔ | ✘✘ | ✔✔ |
| 10.2 Is there an effective regulatory system with enforcement powers in place? | ✔✔ | ✔✔ | ✘✘ | ✔✔ | ✔✔ | ✘✘ | ✔✔ | ✔✔ | ✔✔ | ✔✔✔ | ✘✘ | ✔✔✔ | ✔✔ | ✔✔ | ? | ✔✔ |
| 10.3 Do users find the system effective in predicting the creditworthiness of data subjects? | ✘✘ | ✔✔✔ | ✔✔ | ✔✔ | ✔✔ | ✘✘✘ | ✔✔ | ✔✔ | ✔✔✔ | ✔✔✔ | ? | ✔✔✔ | ✔✔ | ✔✔ | ? | ✔✔ |
| 10.4 Are data subjects aware of their rights under the system? | ? | ? | ? | ✔✔✔ | ? | ✔✔✔ | ? | ? | ? | ✘✘ | ? | ✔✔✔ | ✔✔✔ | ✔✔✔ | ? | ? |

Key ✔✔✔ **Yes** ✔✔ **Yes, but with some reservations** ✘✘ **Response is negative, but there are some mitigating factors in law or practice** ✘✘✘ **Categorical no** ? **Uncertain** N/A **Not applicable**
Note: Serbia excludes Kosovo.

# Chapter 2
# The crisis from the household perspective

**This chapter analyses the impact of the global crisis on the economic well-being of households across the transition region. It shows that these households had to reduce consumption more than families in western Europe and offers three explanations for this difference. First, households in the transition region suffered more job losses, wage reductions, and declines in remittances. Second, social safety nets were less effective in absorbing shocks compared with western Europe. Third, pre-crisis borrowing had left some households vulnerable. In particular, this chapter shows that in countries with large currency depreciations, FX-denominated mortgage debt aggravated the consumption compression for households that also experienced income shocks during the crisis.**

**The crisis and households' economic well-being**

38%

**of the households in** the transition region had to reduce staple food consumption as a result of the crisis, compared with only 11 per cent in western Europe

29%

**of transition households** saw their wages reduced during the crisis, compared with 16 per cent in western Europe

49%

**of the households in** Germany that lost a job successfully applied for unemployment benefits, in contrast to households in Central Asia and the Caucasus where the success rate was on average only 2 per cent

# The crisis from the household perspective

The 2009 and 2010 EBRD *Transition Reports* analysed the causes and implications of the crisis in the transition region mainly from the perspective of the aggregate economy – gross domestic product (GDP), unemployment, aggregate credit, capital flows, trade and asset prices – and particular economic sectors. Based on the 2010 EBRD – World Bank *Life in Transition Survey II* (LiTS), this report complements that analysis from the perspective of households. This chapter examines how the crisis affected the economic well-being of households, while the next chapter analyses its impact on household attitudes towards democracy and market economies.[1]

The LiTS is a combined household and values survey which was undertaken for the first time in 2006. [2] A second round was conducted in the last quarter of 2010 on a face-to-face basis with at least 1,000 randomly chosen households in each of the 29 transition countries and five comparator countries in western Europe (France, Germany, Italy, Sweden and the United Kingdom).[3] The survey collected a host of socio-economic data about respondent households, concerning expenses, housing, education level, age, gender and marital status, labour market status and access to finance. In addition, there are survey modules about the impact of the crisis, attitudes and values, and entrepreneurial activity.[4]

The 2010 LiTS assessed each household's experience of the crisis based on three sets of questions. First, households were asked whether the crisis affected them a great deal, a fair amount, just a little or not at all. Second, all households, except those which said that the crisis did not affect them at all, were asked *how* they were affected. Possible responses included job loss by the head of the household or another household member, closure of the family business, reduction in working hours, delay or suspension of wage payments, reduction in wages and a reduced flow of remittances from abroad. Lastly, households were asked whether they changed their behaviour as a result of a decline in income or other economic difficulty in the past two years – and specifically whether they reduced their consumption, deferred further education plans or medical treatment, or tried to work longer hours. Questions about reductions in consumption applied to a range of items from staple foods to luxury goods.

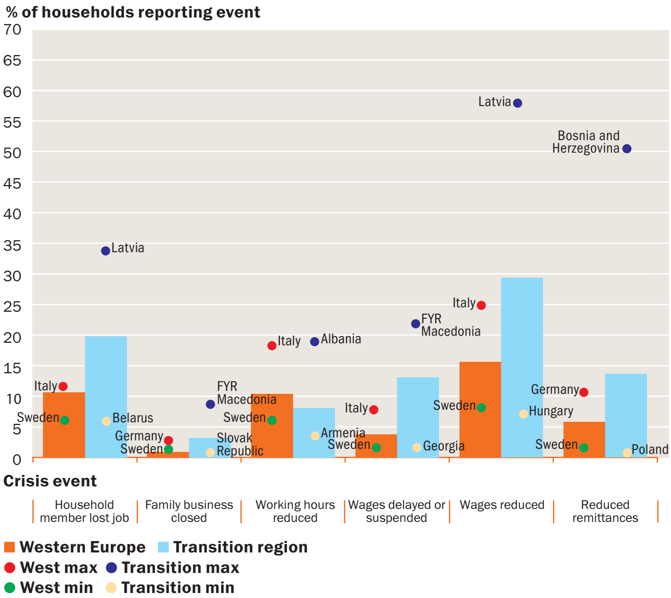
In addition, the crisis impact module of the LiTS also contained questions about household coping mechanisms, particularly access to government-provided social safety nets (such as unemployment insurance or housing benefits), and borrowing money from banks or informal sources (relatives and friends).

These data, as well as the socio-economic information available about each survey participant, offer considerable insight into how the crisis affected households, and why they responded in the way that they did. Households were indeed affected severely, although large variations are discernible. This chapter looks to address the reasons for these variations and, in particular, to ascertain why households in the transition region appear to have reduced their consumption, on average, much more than their western European counterparts. In addition, the role of finance is examined more closely, and especially whether mortgage borrowing before the crisis made households better or worse off when the crisis hit, and whether the currency denomination of mortgages played a significant role.

## How households experienced the crisis: the main facts

Chart 2.1 shows the main "shocks" through which the crisis impacted households. The most common experience by far, both in the transition region and in the western European comparators, was a reduction of wages (reported by almost 30 per cent of transition households), followed by the job loss of a household member or a reduction in remittances (reported by about 20 per cent and almost 15 percent of transition respondents, respectively). The chart also shows that, as a whole, the transition region was hit harder than the Western comparators across all impact categories except reduction in working hours. This was somewhat higher in the Western countries, in part

Chart 2.1
**Wages reduced for almost one-third of transition region households**




Source: LiTS
Note: This graph shows the severity of various household crisis events in the transition region and western Europe.
Maxima and minima refer to the countries reporting the highest and lowest proportion of the crisis event in the transition region and in the western European comparator countries, respectively.

[1] For a description and initial analysis of the LiTS data in relation to these topics, see EBRD (2011), *Life in Transition: After the Crisis*, Chapters 1 and 2.
[2] See EBRD (2007a,b).
[3] The 29 transition countries included the former communist countries of central and eastern Europe and Central Asia (except for Turkmenistan) and also Turkey. In addition, Kosovo was surveyed separately from Serbia, with a sample of 1,000. A larger sample of 1,500 was used in Poland, Russia, Ukraine and Uzbekistan to provide a sufficiently large comparison for a follow-up survey of the same households being held in late 2011. For the sampling methodology, see EBRD (2011), *Life in Transition: After the Crisis*, annex.
[4] For the questionnaire, go to: www.ebrd.com/pages/research/publications/special/transitionII.shtml. For a detailed descriptive presentation of the main result of the survey, see EBRD (2011), *Life in Transition: After the Crisis*.

reflecting labour market policies designed to prevent a rise in unemployment.

As is clear from the maximum and minimum country averages shown in the chart for each crisis event, the reported averages mask a large cross-country variation within both regions, and particularly the transition countries. To further demonstrate this heterogeneity and to show how the reported impact at the household level relates to commonly used economy-wide measures of the depth of the crisis, Chart 2.2a plots the country-level average of an index of crisis impact against the change in GDP experienced by the country in 2009. Chart 2.2b does the same for the change in unemployment. In both cases, the impact index measures the average number of crisis events reported by households in that country.[5]

According to the impact index, the hardest-hit transition countries during the financial crisis were in the Baltic region and in south-eastern Europe (FYR Macedonia, Latvia, Lithuania, Moldova, Montenegro, Romania and Serbia). Tajikistan, which saw a sharp decline in remittances due to a return of migrant workers, is also in this group. At the other end of the spectrum, countries where the crisis impact appears to have been relatively mild included the Czech Republic, Georgia, the Kyrgyz Republic and Poland.

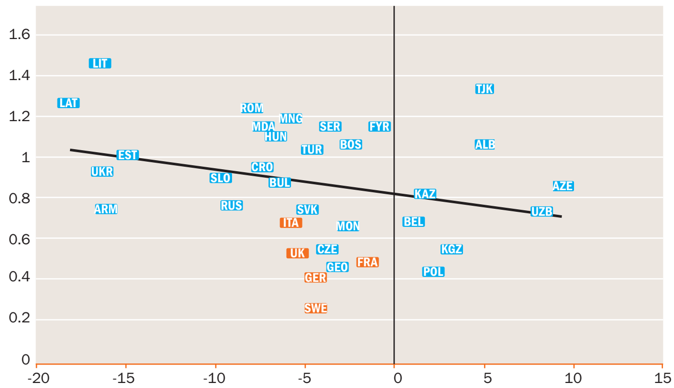
Charts 2.2a and 2.2b show the expected correlations between the crisis event impact index and the change in real GDP and in unemployment: the higher the unemployment increase and/or the decline in GDP, the larger the crisis impact on households. Some of the hardest-hit countries in terms of household-level measures were also among those with the largest falls in aggregate output and the largest increases in unemployment (Latvia and Lithuania, and to a lesser extent Moldova and Serbia). At the other end of the spectrum, the Kyrgyz Republic and Poland suffered no output declines in 2009 and only slight increases in unemployment. These countries also registered only a small crisis impact from the household perspective.

At the same time, the correlations are not very high. This is partly due to the presence of the five Western countries, in which households on average appear to have suffered fewer crisis events for given falls in aggregate output or increases in unemployment.[6] However, even in the transition region there are examples of collapses in output and increases in unemployment that do not register highly on the household crisis impact scale (as in Estonia). Conversely, there are countries with high crisis impact values from the household perspective that do not register exceptionally in terms of unemployment or output collapse (as in FYR Macedonia and Tajikistan).

These discrepancies are partly to do with measurement: for example, the macroeconomic variables capture collapses in aggregate output and employment in 2009, while the household responses to the crisis period could include experiences

Chart 2.2a
**Crisis impact on households related to economy-wide contractions**

**Crisis event impact index**

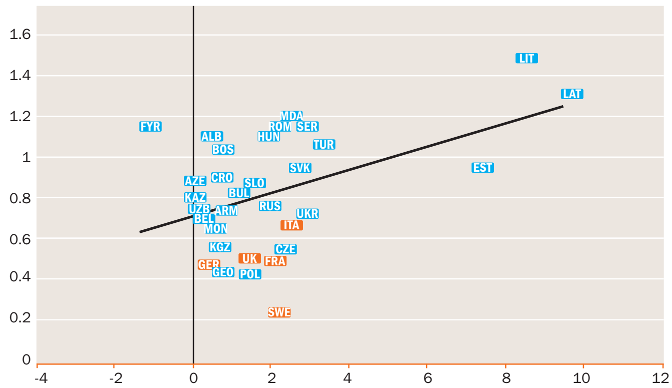



**Change in GDP in 2009 (in per cent)**

Source: National Statistical Offices, Eurostat and LiTS.
Note: This chart shows the crisis impact on households in relation to the change in GDP in 2009.
GDP growth information missing for the Czech Republic.
Western European countries are marked in orange.

Chart 2.2b
**Crisis impact on households and rise in unemployment strongly correlated**

**Crisis event impact index**




**Change in unemployment in 2009 (in percentage points)**

Source: IMF, International Financial Statistics (IFS) and LiTS.
Note: This chart shows the crisis impact on households in relation to the change in unemployment in 2009.
Unemployment information missing for Montenegro and Tajikistan.
Western European countries are marked in orange.

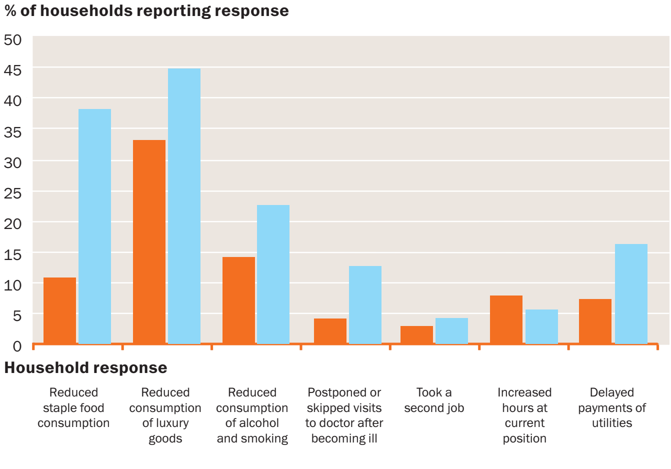
[5] The crisis events included in the impact index are: (1) head of household lost job; (2) other member of household lost job; (3) family business closed; (4) working hours reduced; (5) wages delayed or suspended; (6) wages reduced; (7) reduced flow of remittances. For each household, the index is equal to the number of events reported. This is then averaged over all households in a particular country.

[6] If the western European countries are excluded from the charts, the correlation coefficient in Chart 2.2a changes from -0.23 to about -0.35. In Chart 2.2b it moves from 0.46 to 0.50.

before or after that time. Mainly, however, they are likely to reflect differences in the concepts that are being measured. In particular, GDP excludes much informal economic activity (which is considerable in many transition countries) as well as remittance inflows, both of which would register in household responses; and it includes profits and government income that may not directly affect households. Perhaps for this reason, the correlation between unemployment changes and the crisis event impact index is tighter than between the index and changes in GDP. However, even unemployment is only a rough measure of what may happen to households in a recession: household members may stay employed and still suffer through wage income and remittance receipt channels (which are captured in the LiTS crisis impact index). For example, the sharp decline in remittance flows may help explain why countries such as Albania, FYR Macedonia and Tajikistan were hit much harder than their changes in output and unemployment would suggest. Conversely, a country can experience a sharp spike in unemployment while wage levels and remittance inflows are not much affected. The LiTS crisis impact index is therefore likely to be a more comprehensive measure of the effect on the general population than any single macroeconomic variable.

Chart 2.3 shows how household consumption and labour supply decisions were influenced by the crisis and gives a more detailed picture of the likely welfare effects than the previous charts. Like Chart 2.1, this chart suggests that the crisis was on average much harder for households in the transition region than those in the western European countries. This is particularly the case for some consumption categories essential to well-being: only 11 per cent of households in the Western comparators reported reducing staple food consumption as a result of the crisis, as opposed to 38 per cent in the transition region. In the Western countries, only 4 per cent reported postponing or skipping medical treatment; in the transition region, almost 13 per cent did so. The percentage of households reporting delays in paying utility bills was also more than twice as high in the transition region.

Chart 2.3
**Well over one-third of transition region households cut staple food consumption**




Source: LiTS.
Note: This chart shows the household response to the crisis in the transition region and western Europe.

Chart 2.4 shows the cross-country variation in the typical consumption response to the crisis and how it relates to crisis events. The horizontal axis of the chart represents the same crisis event index shown in Charts 2.2a and 2.2b. The vertical axis shows the number of consumption responses reported by households, on average, in each country.[7] The chart includes transition and Western comparator countries.

The chart confirms that Poland was the only country in which the crisis affected households comparably with those in the Western countries, regardless of whether this is measured in terms of crisis events (the horizontal axis) or consumption response (the vertical axis). More generally, the chart shows a close correlation (with a coefficient of 0.72) between crisis impact and consumption response. In some countries, particularly Bulgaria and FYR Macedonia, the compression of consumption reported by households was higher than would have been predicted based on the reported crisis impact; in others, including Bosnia and Herzegovina, Germany, Russia, the Slovak Republic, Sweden and Tajikistan, it was lower. This raises the question as to whether safety nets of some form in these countries softened the blow of the crisis. The fact that this group of countries is so diverse suggests that not only formal safety nets, such as unemployment insurance, but also informal mechanisms, such as borrowing from friends or relatives, may have played a part.

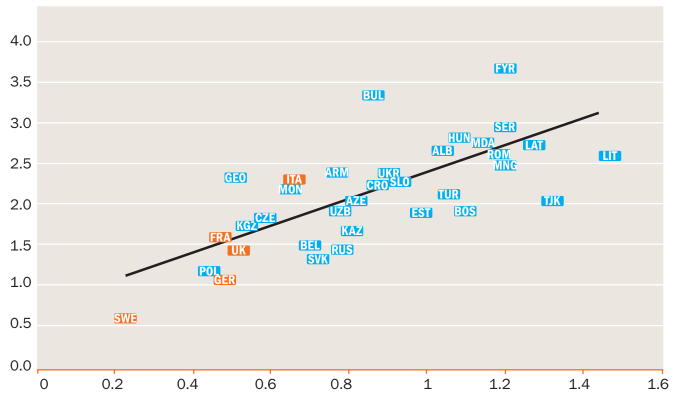
Chart 2.5 shows how households subjectively perceived the impact of the crisis, and compares this to the reported compressions of consumption. The horizontal axis measures country averages of the general consumption response index, while the vertical axis measures the proportion of households in each country which stated that the crisis had affected them "a great deal" or "a fair amount". There is a close correlation between the subjective crisis measure and the consumption response (of 0.81), which is higher than that between the subjective measure and the index of crisis impact (0.65, not shown). This suggests that what mattered most for households were the consequences of the crisis for consumption, health, education and so on, rather than crisis events such as job loss or wage reduction *per se*. Again, this points to the potential importance of formal or informal safety nets in shielding households from the impact of certain crisis-related events.

Charts 2.6, 2.7a and 2.7b indicate the extent to which various safety nets were used by crisis-affected households according to the LiTS. In the survey, households were asked whether they applied for various forms of social assistance, and whether they tried to borrow from formal sources (such as banks) or informally (from friends, relatives or private money lenders). If the

[7] The index includes all adjustment responses undertaken by the household that are listed in question 8.04 of the 2010 LiTS, except for 8.04 h ("Enrolled in further education because of lack of job opportunities"); see LiTS questionnaire (available on the EBRD web site, go to: www.ebrd.com/pages/research/publications/special/transitionII.shtml). The economy-wide index is the average of the index values of all households in a particular country.

Chart 2.4
**Household crisis events closely correlated with subsequent consumption response**

**Overall consumption response index**

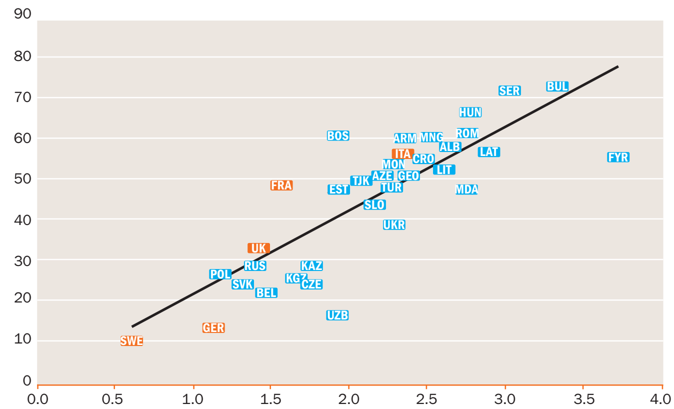



**Crisis event impact index**

Source: LiTS.
Note: This chart shows the household consumption response in relation to crisis events, by country. See text for an explanation of the two indices that are being compared. Western European countries are marked in orange.

Chart 2.5
**Households in Bulgaria, Hungary and Serbia felt hardest hit by the crisis**

**% of households "affected a fair amount or a great deal"**




**Overall consumption response index**

Source: LiTS.
Note: This chart shows the subjective crisis intensity in relation to household consumption response, by country. Western European countries are marked in orange.

respondents answered any of these questions affirmatively, they were then asked if they were successful, and – in the case of social assistance – whether it was helpful.

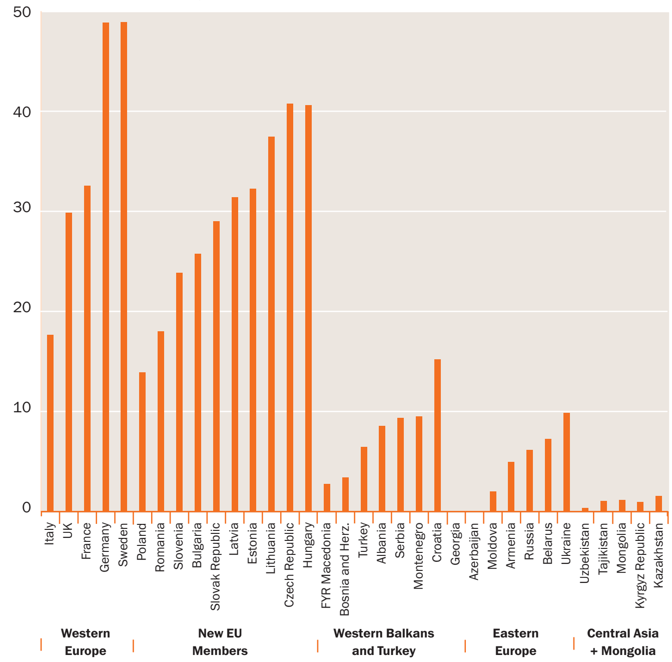
One way to ascertain the availability of safety nets during the crisis might be to compare the number of households that attempted to borrow with the number that actually succeeded in doing so. However, this measure could be misleading, since even crisis-affected individuals might not have applied for a benefit or loan if they did not expect to receive it. A better way of comparing coverage across countries might therefore be to focus on the extent to which "needy" individuals, based on information that they reported in the LiTS, actually received a benefit or loan.

In Chart 2.6 each bar shows the percentage of households that succeeded in obtaining unemployment benefits among those reporting a job loss during the crisis in a particular country.[8] Among the Western comparator countries, almost one-half of households in Germany or Sweden made successful applications, although in Italy the proportion was much lower (about 18 per cent). In the transition region, unemployment protection was more prevalent among the new European Union (EU) members than the Central Asian and Caucasus countries, where generally fewer than 5 per cent of households obtained benefits.

Charts 2.7a and 2.7b indicate the frequency of formal and

Chart 2.6
**Unemployment protection better in West and among the new EU members relative to rest of transition region**

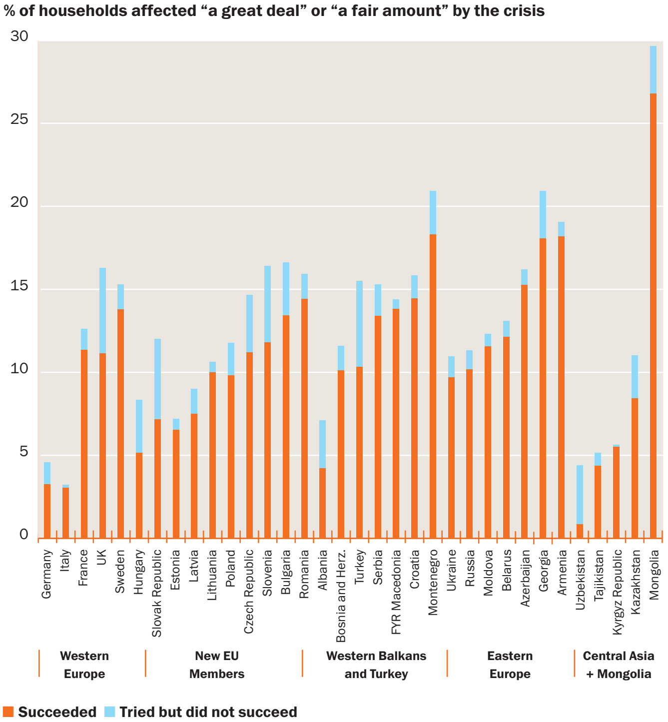
**% of households reporting a job loss**




Source: IMF, International Financial Statistics (IFS) and LiTS.
Note: This chart shows the successful applications for unemployment benefits as a percentage of households reporting a job loss, by country.

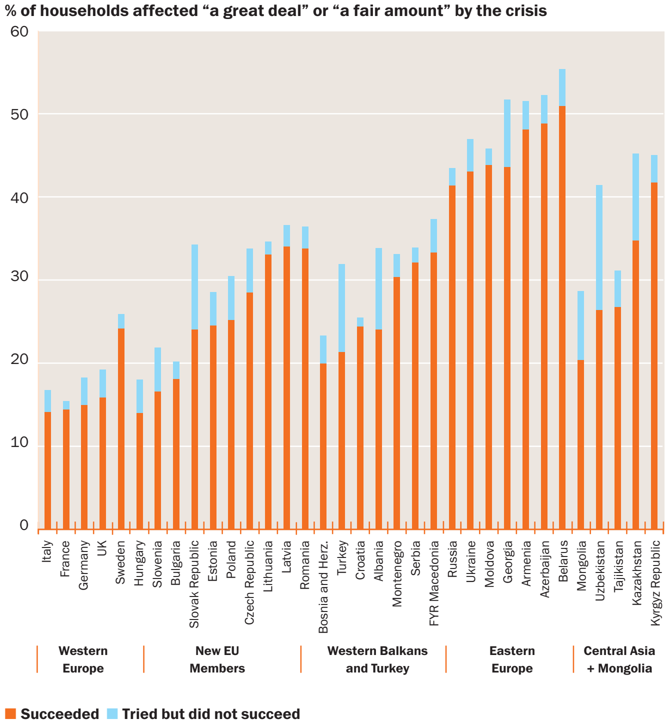
[8] This measure may understate the coverage of unemployment benefits as LiTS asked respondents about job losses over the past two years, whereas the unemployment benefit question only refers to the past 12 months.

Chart 2.7a
**Large variation within regions in households' use of formal borrowing**




Source: LiTS.
Note: This chart shows borrowing from formal sources as a percentage of households affected "a great deal" or "a fair amount" by the crisis, by country.

Chart 2.7b
**Many crisis-hit households in transition countries borrowed informally, especially relative to the West**




Source: LiTS.
Note: This chart shows borrowing from informal sources as a percentage of households affected "a great deal" or "a fair amount" by the crisis, by country.

informal household borrowing. They focus on those households affected "a great deal" or "a fair amount" by the crisis, and show the percentage of these households which tried to borrow and also succeeded in doing so. Regarding formal borrowing, Chart 2.7a implies no clear pattern across regions. The striking factor apparent in Chart 2.7b is the much higher use of informal borrowing among crisis-affected households in the transition region compared with western Europe – and particularly in the less advanced and harder-hit countries.

## Understanding the impact of the crisis on household consumption

The preceding section has shown that households in the transition region were hit much harder by the crisis than those in the western European countries, and that there were also large differences in its impact across the region. It is also apparent that simple indices of crisis events and consumption responses are correlated across countries. However, this correlation is imperfect: in particular, in some countries households report relatively few falls in consumption compared with their reported exposure to crisis events. In addition, there appears to be considerable variation in the extent to which households tried, successfully or not, to borrow from formal and informal sources and to access social safety nets.

These findings raise three main questions.

First, how have crisis events – the loss of jobs, reduced wages and hours worked and so on – affected household consumption? We know that there is a correlation, but did the type of event matter to a greater or lesser extent? This is a question with direct relevance for policy-makers. For example, if a reduction in working hours to the degree that typically occurred in this crisis affected households less than job losses, this would strengthen the argument for labour market frameworks that encourage employers to adjust to changes in demand through changes in working hours, rather than the retrenchment or hire of employees.

Second, to what extent have government-provided social safety nets, such as unemployment and housing benefits, been able to soften the blow of the crisis? Chart 2.3 makes plain that households in the transition region suffered more than their Western counterparts – particularly when measured in terms of basic consumption. Was this because they were exposed to more crisis events, because they were poorer and more vulnerable to begin with, or because they lacked the access to quality official safety nets that Western households had?

Lastly, what was the role of finance in the crisis? On the one hand, access to formal financial services – such as bank accounts, debit and credit cards and mortgages – and informal means of borrowing may have helped households to maintain a more stable level of consumption over time. Such households may therefore have been more resilient and coped better with unexpected income shocks. On the other hand, there are indications that the rapid increase in household debt before the crisis may have left many financially more vulnerable. Should the rapid financial deepening in the decade before the crisis be viewed mainly as a positive structural development, or did it encourage at least some households to saddle themselves with too much debt?

The following section answers these questions using multiple regression techniques, which allow the joint analysis of many potential factors that might have affected the decline in consumption. It also examines the role of finance – and in particular of mortgages denominated in foreign currency (FX) – in more detail.

### Crisis events, crisis borrowing and official safety nets

Table 2.1 presents the results of a regression analysis that examines how household consumption was affected by crisis events and by household attempts to mitigate them through credit (formal or informal) or social protection mechanisms. The household response is measured in two ways:

- first, through the "overall response" index (as in Charts 2.4 and 2.5), which includes the impact on all consumption categories as well as stress responses such as loan defaulting, selling an asset, and relocating
- second, through a narrower concept that looks only at the reduction of basic goods and services consumption, including essential services such as medical care, but excluding luxury goods, car use, vacations or training. This is referred to as the "base consumption" response.

The analysis takes account of household characteristics, such as size, age, gender, income (proxied by annual expenses), wealth, housing expenses, education level, employment and location (urban or rural), that may also have played a role in the extent to which households had to adjust during the crisis.[9] Omitting such characteristics from the analysis could lead to a biased view of how shocks and mitigation strategies affected consumption and spending. To save space in the table, the impact of these "control variables" is not shown, but in all cases their influence is as expected. For instance, highly educated and wealthier people had to reduce consumption less, as did those with formal, and hence relatively secure, employment. Households that had locked themselves into paying a high proportion of their income towards housing had to adjust their consumption by more compared with those with lower fixed housing costs.

The upper section of Table 2.1 compares the impact of various crisis events (either jointly through the crisis event impact index or separately) on *base* consumption (see columns [1], [2], [5] and [6]) and on the *overall* household response (columns [3], [4], [7] and [8]). The left-hand side of the table shows results for the transition region and the right-hand side for the five western European comparator countries. The table shows that crisis impact on *base* consumption was higher in the transition region than in western Europe. Even when correcting for household characteristics and for the use of credit and social safety nets, transition households had to reduce their base consumption by about 20 per cent more compared with their western European counterparts (see columns [1] and [5]). This is true for all types of shocks with the exception of the forced closure of a business, perhaps because in the transition region an (informal) business is often not the only source of income whereas it is in western Europe. As will be explained later in this chapter, one difference between the transition region and western Europe that may explain the higher impact on basic consumption in the former is the role of pre-crisis mortgage debt.

In contrast, for a given severity of shocks, similar household characteristics and access to social safety nets and borrowing, the *overall* response in consumption, beyond the essential items, appears to have been higher in the Western comparator countries. This is probably because a larger proportion of the population owns a car, goes on vacation and consumes other luxury items. If such consumption was not prevalent in the transition region in the first place, it could not have been lowered during the crisis.

The most severe shocks were job loss and reduced wage income in the transition region and, similarly, job loss but also the closure of a family business in the Western comparators. Interestingly, households which saw their working hours reduced during the crisis had to adjust their consumption pattern considerably less than those which suffered job loss. This may be because the typical reduction in working hours suffered by respondents was relatively small. However, it could also suggest that reducing working hours is an effective way to spread the pain of (temporary) reductions in working potential more evenly across households. Indeed, countries such as Germany and Italy introduced, or expanded, short-time work schemes during the crisis to preserve jobs in firms that experienced a temporary reduction in the demand for their products or services.[10]

The lower section of Table 2.1 provides some insight into the role that social safety nets and formal and informal borrowing

[9] Wealth is measured by the ownership of a personal computer, car and/or second home. Housing expenses refer to either rent or debt servicing and are expressed as a percentage of household income.

[10] See Boeri and Brücker (2011). According to the regression coefficients in the first column of Table 2.1, for example, these schemes would be appropriate in the transition region as long as the positive consumption impact of avoiding a layoff in one household is not more than offset by the typical negative impact of reducing working hours in two other households.

Table 2.1
## Household consumption response, crisis impact and access to credit and safety nets

| Country sample | Transition region | | | | Western Europe | | | |
|---|---|---|---|---|---|---|---|---|
| Dependent variable | Base response | Base response | Overall response | Overall response | Base response | Base response | Overall response | Overall response |
| | [1] | [2] | [3] | [4] | [5] | [6] | [7] | [8] |
| Crisis event impact index 1/ | 0.349*** | | 0.681*** | | 0.291*** | | 0.794*** | |
| | (0.014) | | (0.023) | | (0.043) | | (0.051) | |
| *Job loss* | | 0.487*** | | 0.897*** | | 0.399*** | | 1.032*** |
| | | (0.028) | | (0.046) | | (0.081) | | (0.155) |
| *Close business* | | 0.243*** | | 0.753*** | | 0.413** | | 1.033*** |
| | | (0.044) | | (0.089) | | (0.186) | | (0.347) |
| *Less wage income* | | 0.446*** | | 0.876*** | | 0.319*** | | 0.868*** |
| | | (0.030) | | (0.041) | | (0.072) | | (0.081) |
| *Less remittances* | | 0.335*** | | 0.678*** | | 0.197*** | | 0.727*** |
| | | (0.032) | | (0.065) | | (0.034) | | (0.047) |
| *Reduced hours* | | 0.276*** | | 0.526*** | | 0.225*** | | 0.653*** |
| | | (0.036) | | (0.073) | | (0.072) | | (0.096) |
| Tried informal borrowing | 0.678*** | 0.683*** | 1.024*** | 1.031*** | 0.768*** | 0.767*** | 1.203*** | 1.195*** |
| | (0.090) | (0.090) | (0.161) | (0.163) | (0.227) | (0.209) | (0.278) | (0.249) |
| Tried formal borrowing | 0.583*** | 0.585*** | 1.108*** | 1.114*** | 0.796*** | 0.795*** | 1.791*** | 1.796*** |
| | (0.090) | (0.094) | (0.129) | (0.137) | (0.237) | (0.238) | (0.475) | (0.481) |
| Applied for housing support | 0.251*** | 0.258*** | 0.293** | 0.304** | 0.527*** | 0.530*** | 0.774*** | 0.785*** |
| | (0.073) | (0.073) | (0.118) | (0.121) | (0.133) | (0.131) | (0.113) | (0.112) |
| Applied for unemployment benefit | 0.241*** | 0.231*** | 0.415*** | 0.403*** | 0.574*** | 0.539*** | 0.775*** | 0.703*** |
| | (0.075) | (0.074) | (0.119) | (0.118) | (0.086) | (0.117) | (0.110) | (0.168) |
| Succeeded informal borrowing | -0.183* | -0.183* | -0.321* | -0.319* | -0.133 | -0.132 | 0.099 | 0.104 |
| | (0.104) | (0.104) | (0.180) | (0.182) | (0.235) | (0.221) | (0.197) | (0.170) |
| Succeeded formal borrowing | -0.365*** | -0.365*** | -0.582*** | -0.587*** | -0.620*** | -0.616*** | -1.400*** | -1.402*** |
| | (0.086) | (0.088) | (0.144) | (0.147) | (0.202) | (0.205) | (0.316) | (0.327) |
| Received housing support | 0.079 | 0.070 | 0.157 | 0.145 | -0.272** | -0.279** | -0.338** | -0.359** |
| | (0.119) | (0.123) | (0.146) | (0.154) | (0.121) | (0.119) | (0.163) | (0.167) |
| Received unemployment benefit | -0.011 | -0.038 | -0.020 | -0.054 | -0.460*** | -0.457*** | -0.532*** | -0.518*** |
| | (0.098) | (0.097) | (0.172) | (0.169) | (0.159) | (0.163) | (0.188) | (0.194) |
| Observations | 30,469 | 30,469 | 30,469 | 30,469 | 5,278 | 5,278 | 5,278 | 5,278 |
| R-squared | 0.217 | 0.213 | 0.250 | 0.244 | 0.242 | 0.239 | 0.330 | 0.327 |
| Socio-economic controls 2/ | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| Country fixed-effects | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |

Source: LiTS.
Note: The table shows OLS regression coefficients. Standard errors in parentheses. The dependent variable is either an index of *base consumption response*, constructed by giving one "point" for each type of consumption reduction response that the household names among the possibilities named in LiTS question 8.02a, c, f, j, l, n, o or p; or an index of *overall consumption response*, in which a "point" is given for each type of response that the household names among all possibilities named in LiTS question 8.02, except for 8.02h.
1/ The crisis event impact summarises the crisis impacts, job loss, business closure, reduced wages, reduced hours and fewer remittances.
2/ Includes household size, income and wealth (the latter is measured by the ownership of a personal computer, car, and/or second home); urban versus rural location of the household; age, gender, education level, and type of employment of the household head; and housing expenses (either rent or debt servicing) as a percentage of income.

may have played in helping households to weather the crisis and maintain consumption.[11] All regressions include variables that indicate whether a household *tried* to borrow formally (from a bank) or informally (from a friend or family member) during the crisis. Two other variables indicate whether a household *applied* for housing support or unemployment benefits (that is, safety mechanisms provided by the state). Separately, the regressions analyse the effect of actually *succeeding* in accessing credit or social safety nets. It is important to distinguish the effects of *applying* and *succeeding*, because the former may contain otherwise unobservable information about why a household might need to access safety nets or credit, while the latter reflects the pure effect of the borrowing or the social benefit.

The results reveal that households which *applied* for any form of credit or state support reduced their consumption significantly more (even when controlling for the severity of the income shocks) than those which did not. This is probably because households which found themselves in particularly dire straits were most likely to apply for help. In contrast, successful *access* to credit or social safety nets tended to help households, but did not affect consumption in the same way in the Western comparators and the transition region.

One difference relates to the roles of formal and informal borrowing. While access to formal borrowing from a bank reduced the compression of consumption in both regions, only in the transition countries did successful informal borrowing from friends or family mitigate the consumption response. This may reflect the fact that in western European societies, where formal channels of finance are more developed, informal borrowing has become relatively less important.

However, even in the transition region successful informal borrowing only protected consumers to a limited extent. It reduced the difference in consumption responses between those needing, and those not needing, to apply for such finance by about one-third. In contrast, formal borrowing had a larger impact: access to formal finance allowed borrowers to reduce the gap between themselves and those not needing to apply for loans by almost two-thirds (and by 80 per cent in western Europe). Therefore, even when informal mechanisms are active, as in transition countries, access to formal credit seems to be a more effective way to maintain consumption. This is perhaps unsurprising, given that loans from friends and family will tend to be significantly smaller than bank loans. Furthermore, when many households are hit hard by a negative income shock at the same time, informal borrowing from friends and family may work less well.[12]

The regressions also reveal significant differences in the ability of social safety nets to help households through difficult times across the two regions. In the Western comparator countries, households which succeeded in claiming housing support and unemployment benefits during the crisis were significantly better off compared with rejected applicants. In contrast, in the transition region as a whole, neither of these government supports seems to have had a statistically significant effect in offsetting the crisis impact among applicants. Further analysis (not shown in the table) indicates that this is also true for most individual transition countries, but there are exceptions. In Hungary, Kazakhstan and Latvia unemployment benefits seem to have had a significant impact in dampening the fall in consumption as reported by households. In Poland and Russia, housing benefits seem to have had a similar effect.

It is not clear why formal safety nets were not more successful in the transition region. However, the LiTS data provide some clues. Recipients in the Western comparators received their first housing and unemployment benefit payments almost eight and three days earlier, respectively, than those in the transition region. Western recipients also rated their satisfaction with these government supports about 16 and 11 per cent higher, respectively, than their transition counterparts.[13] Therefore, differences in effectiveness may have had to do with the size of benefits and the speed with which they were actually delivered.

What does the analysis in Table 2.1 suggest about the relative importance of all factors considered so far in influencing the consumption response across transition and western European households? One way of answering this question is to sequentially exclude various groups of variables from the analysis, and record the difference which this makes to the overall explanatory power of the regression. The results (based on regressions [1] and [5], but which are also very similar for the other regressions) are shown in Chart 2.8. The main result is that the variables which most affected household responses in the transition region were differences in exposure to crisis events, and that unexplained country-level differences also played a major role. In contrast, differences in socio-economic characteristics of households and access to safety nets and credit were less important. The western European experience was very different: variations in socio-economic characteristics mattered much more (about twice as much as differences in exposure to crisis events). Success in accessing unemployment and housing benefits was more important in the comparator countries than in the transition region, and unexplained country-level differences mattered relatively little.

### Did pre-crisis access to finance help or hinder?

Access to emergency borrowing, either from banks or from friends and family, appears to have cushioned households substantially during the crisis. However, to what extent did debt accumulated *before* the crisis actually make households more vulnerable in the first place? The pre-crisis boom period, and the associated optimistic assumptions about future incomes, may have enticed banks and households to ramp up household debt too fast. While this allowed households to increase current spending against potential future earnings, it may also have made them more vulnerable to unexpected income shocks. Consequently, highly leveraged households, with high debt-servicing burdens, may have had to cut back their consumption the most.[14]

[11] This analysis does not take targeted social assistance (TSA) and guaranteed minimum income (GMI) programmes into account, which in some transition countries were used or significantly adjusted during the crisis.

[12] Further analysis shows that the mitigating effect of informal borrowing was particularly high for those households in the transition region that were hit relatively hard. A similar interaction effect was found for western European households which applied for formal finance.

[13] These differences are statistically significant at the 1 per cent (satisfaction) or 5 per cent (delivery speed) levels, with the exception of the three-day difference for unemployment benefits.

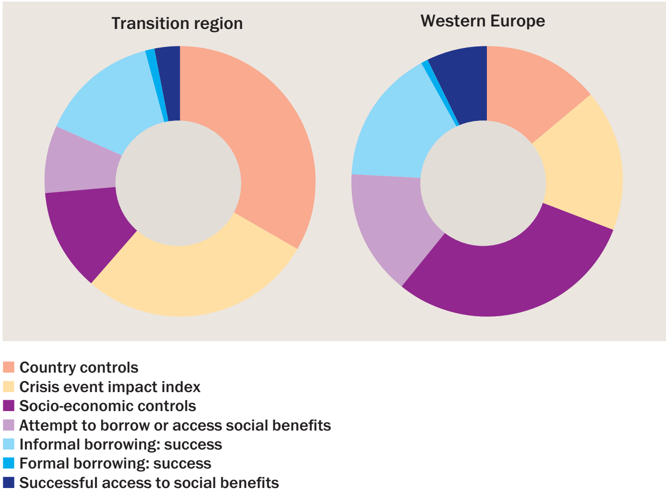
[14] For more details, see Brown, De Haas and Grosjean (2011).

Table 2.2
## Mortgage debt, crisis impact and household response

| Country sample | Transition region | | | | | | | | Western Europe | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Dependent variable** | **Base consumption response** | | | | **Overall response** | | | | **Base response** | | **Overall response** | |
| | **[1]** | **[2]** | **[3]** | **[4]** | **[5]** | **[6]** | **[7]** | **[8]** | **[9]** | **[10]** | **[11]** | **[12]** |
| Mortgage | 0.128** | 0.067 | | | 0.268** | -0.053 | | | -0.116*** | -0.101*** | -0.216*** | -0.194*** |
| | (0.053) | (0.075) | | | (0.107) | (0.144) | | | (0.026) | (0.032) | (0.045) | (0.044) |
| *Local currency mortgage* | | | 0.085 | 0.103 | | | 0.193** | 0.031 | | | | |
| | | | (0.054) | (0.097) | | | (0.096) | (0.159) | | | | |
| *FX mortgage* | | | 0.203** | 0.007 | | | 0.402** | -0.188 | | | | |
| | | | (0.084) | (0.107) | | | (0.159) | (0.202) | | | | |
| *Bank account* | -0.081*** | -0.081** | -0.081*** | -0.081** | -0.045 | -0.111** | -0.045 | -0.110* | -0.145*** | -0.134 | -0.101 | -0.021 |
| | (0.026) | (0.034) | (0.026) | (0.034) | (0.048) | (0.056) | (0.048) | (0.057) | (0.055) | (0.081) | (0.115) | (0.186) |
| *Credit card* | 0.001 | -0.020 | 0.001 | -0.019 | 0.112** | 0.031 | 0.111** | 0.032 | -0.143** | -0.066 | -0.227** | -0.152*** |
| | (0.024) | (0.021) | (0.024) | (0.021) | (0.053) | (0.069) | (0.053) | (0.069) | (0.067) | (0.046) | (0.099) | (0.044) |
| Crisis event impact | 0.348*** | 0.342*** | 0.348*** | 0.342*** | 0.681*** | 0.628*** | 0.681*** | 0.629*** | 0.290*** | 0.391** | 0.792*** | 1.021*** |
| | (0.014) | (0.017) | (0.014) | (0.017) | (0.023) | (0.024) | (0.023) | (0.024) | (0.041) | (0.193) | (0.048) | (0.292) |
| *Crisis event impact * mortgage* | | 0.050 | | | | 0.258*** | | | | -0.027 | | -0.042 |
| | | (0.051) | | | | (0.085) | | | | (0.043) | | (0.073) |
| Crisis event impact * Local currency mortgage | | | | -0.016 | | | | 0.134 | | | | |
| | | | | (0.075) | | | | (0.114) | | | | |
| Crisis event impact * Foreign currency mortgage | | | | 0.149** | | | | 0.443*** | | | | |
| | | | | (0.063) | | | | (0.097) | | | | |
| *Crisis event impact * Bank account* | | -0.000 | | -0.000 | | 0.066* | | 0.065* | | -0.013 | | -0.143 |
| | | (0.025) | | (0.025) | | (0.037) | | (0.037) | | (0.163) | | (0.300) |
| *Crisis event impact * Credit card* | | 0.021 | | 0.021 | | 0.079* | | 0.077* | | -0.153** | | -0.149 |
| | | (0.019) | | (0.019) | | (0.041) | | (0.040) | | (0.076) | | (0.102) |
| Observations | 30,465 | 30,465 | 30,465 | 30,465 | 30,465 | 30,465 | 30,465 | 30,465 | 5,278 | 5,278 | 5,278 | 5,278 |
| R-squared | 0.22 | 0.22 | 0.22 | 0.22 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.33 | 0.34 |
| Socio-economic controls | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| Social assistance controls | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| Borrowing controls | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| Country-fixed effects | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |

Source: LiTS.
Note: See note for Table 2.1.

Chart 2.8
**Crisis events were a key driver of consumption responses in transition region**




Source: LiTS and Table 2.1.
Note: This chart shows the relative importance of factors explaining differences in the consumption response across households.

Can such effects be detected in the LiTS, and if so, how damaging was pre-crisis debt in exacerbating the household consumption compression during the crisis? Table 2.2 presents regression results that analyse the impact of the use of credit services on the consumption shock. A distinction is made between having a bank account, using a credit card, and having mortgage debt.[15] For the transition region, regressions are also run to separate the impact of FX-denominated and local-currency denominated mortgages (this distinction is not meaningful for the western European countries where only a handful of LiTS respondents had an FX mortgage). Columns [1] to [8] in the table show results for the transition region, while columns 9 to 12 deal with the Western comparators. The analysis controls for a comprehensive set of socio-economic household characteristics, making it less likely that the financial service variables proxy for something else (such as household income).

The right-hand side of the table shows how the presence of a mortgage, bank account or credit card influenced household responses in the western European countries. Households with access to these financial products reduced consumption to a lesser extent than comparable households without such access. Credit cards and savings in bank accounts appear to have been used to smooth over temporary reductions in income. Having a bank account mitigated the compression of base consumption, but had no statistically significant effect on the overall consumption response. This may be because (limited) savings allowed a household to continue its base consumption pattern, but were insufficient to also sustain holidays or car use, for example. The same "protective" use of bank accounts to maintain basic, but not necessarily overall, consumption was also evident in the transition region (see left-hand side of the table).

The table also shows that in western Europe, households with mortgage debt reduced their consumption *less* than households without mortgages. This effect is statistically highly significant and works for base consumption and the overall consumption response. There are several possible interpretations. The negative coefficient might reflect unobserved differences between mortgagors and non-mortgagors that are not picked up by the control variables. It is also possible that developed western European mortgage systems enabled households to use their mortgages to withdraw equity from their property during the crisis, making them less financially constrained.[16]

However, as Table 2.2 shows, mortgages did not have such a protective effect in the transition region. Indeed, mortgage debtors were hit harder than households without a mortgage. Why this difference? First, mortgage markets across the transition region are structurally less developed and equity withdrawal is uncommon, therefore limiting a potential source of additional finance. Instead, having a mortgage could only be a constraint, as households had pre-committed themselves before the crisis to a fixed and inflexible debt-servicing schedule.

In addition, the average mortgagor in the transition region may differ from the average borrower in western European countries in ways that may not be fully captured by control variables. For instance, it is likely that mortgagors in western Europe have typically had loans for a longer period of time. Indeed, LiTS statistics show that the average age of mortgage holders in eastern Europe was 39 years compared with 46 years in western Europe. Moreover, the average time since a mortgage was taken out was eight years in western Europe and four in eastern Europe. As a result, western European mortgagors will have had a chance to build up more home equity and would therefore have had a larger pot of "savings" that they could in principle draw on when the crisis hit. In contrast, mortgagors in eastern Europe are on average younger and have taken out mortgages relatively recently. As a result, the ability to draw on home equity would have been more constrained (and the less-developed mortgage system would have made it difficult to liquidate these savings in any case).

Table 2.2 also analyses whether the contrasting impact of mortgage debt in the western European countries and in the transition region was stronger for those households that were hit hardest during the crisis (see coefficients below the solid line). The results on the right-hand side of the table show that all mortgage debtors in western Europe, whether hit hard by the crisis or not, fared better than non-mortgagors. In contrast, the left-hand side shows that the exacerbating impact of having a mortgage in the transition region was driven by those households which scored relatively highly on the "*crisis event impact*"

[15] The pair-wise correlations between mortgage, bank account, and credit card are all smaller than 0.4. Note that across much of the transition region household debt also included consumption and car loans, while in a few specific cases -most notably Hungary- home equity loans were important debt instruments too. LiTS did not ask households about such debt categories.

[16] While tighter credit conditions (and lower house prices) may have limited the ability of homeowners to realise part of the value of their property through taking on additional mortgage debt, many households may still have done so when they experienced a fall in their income during the crisis. Data for the United Kingdom show that while households drew less on their housing equity than before the crisis, this was not the main reason for the sharp decline in overall equity withdrawal (see Reinold, 2011). The main driver was a sharp reduction in the number of housing transactions.

Box 2.1

## Foreign-currency mortgages and the crisis

Table 2.2 shows that in the transition region, in contrast to western Europe, households with a mortgage were worse off during the crisis than those without one. This effect was caused by households that experienced one or several negative income shocks (such as a reduced flow of remittances or losing a job) and seems to have been particularly strong for households with FX-denominated mortgages.

This section examines the role of different types of mortgages in more detail. The analysis is limited to emerging Europe, which is here defined as central and eastern Europe, south-eastern Europe and Ukraine. In 2010 only 5 per cent of emerging Europe's population reported having a mortgage, compared with 26 per cent in the five western European comparator countries. Forty-two per cent of these mortgages were denominated in a foreign currency and 13 per cent were in arrears at the end of that year.[17] In contrast, in the Western comparators FX mortgages were virtually absent and the level of (self-reported) arrears was significantly lower at only 2 per cent.

Table 2.1.1 analyses the effects of two mortgage characteristics that may have influenced the severity of the impact of the crisis: first, the relative size of the mortgage debt, captured by the variable *debt-service burden*, which measures expenditure on mortgage payments as a percentage of household income; and second, the currency denomination of the mortgage (local or foreign). Both of these variables might have influenced consumption during the crisis through channels that worked in opposite directions.

In both emerging and western Europe the debt-service burden was about 30 per cent in 2010, although with substantial variation across households. A debt-service burden that exceeds 30 per cent is often considered to indicate that a household is financially vulnerable. One would therefore expect households that locked themselves into high mortgage debt before the outbreak of the crisis to have to reduce their consumption more during the crisis (and particularly if they were also hit by negative income shocks). However, some selection effect may be apparent as well, as banks will only give large mortgages (relative to household income) to particularly creditworthy clients, who may also be in a stronger position to maintain consumption during a crisis.

As regards currency denomination, two effects might have played a role too. First, banks and households would be aware that FX-denominated mortgages might be riskier than local currency loans, as they lead to higher monthly mortgage repayments if the local currency depreciates. Banks might therefore advance FX mortgage loans only to relatively creditworthy households, particularly in countries where the risk of a substantial devaluation or depreciation was high. In some countries, such as Poland, bank regulators explicitly demanded stricter screening procedures in the case of FX loans. While the regressions in Table 2.1.1 control for various household characteristics, and therefore for borrower quality in a rough fashion, it is possible that banks had access to better information about borrower quality than is apparent from the LiTS data. As a result, households with FX mortgages might have been stronger financially and therefore less likely to reduce their consumption during the crisis. However, in countries where a large depreciation occurred, any such effect may have been outweighed by the large increases in the local currency value of mortgage payments faced by FX borrowers. In these circumstances, FX borrowers may have been forced to adjust their consumption more, particularly when they were hit by income shocks as well.

To test whether these potentially opposing effects are indeed present, Table 2.1.1 splits the household sample into two groups: mortgage debtors who lived in a country that experienced a large currency depreciation or devaluation during the crisis (right-hand side of the table) and those who lived in a country with a more stable exchange rate (left-hand side). A currency depreciation of 30 per cent is taken as a cut-off point. Three countries: Hungary, Poland and Ukraine fell into this category.

Columns [1] and [2] show that in countries with a stable exchange rate, the currency denomination of mortgages did not significantly affect the base consumption response of mortgage holders. In sharp contrast, households with an FX mortgage in countries with a large depreciation had to reduce consumption significantly more. The difference is large: column [3] shows that, compared with local currency mortgagors, FX mortgagors had to adjust their base consumption by almost twice as much.

Column [4] shows that this exacerbating effect of an FX mortgage is completely driven by households that experienced an income shock during the crisis. As the negative coefficient on the FX mortgage variable in that column shows, in countries that went through a currency crisis, households with an FX mortgage which did *not* experience an income shock reduced consumption by *less* than mortgage debtors holding local currency mortgages. Similarly, the

[17] See Beck and Brown (2011) and Brown and De Haas (2011).

Table 2.1.1
**Households with an FX mortgage in countries with a currency crisis reduced their consumption more**

| Exchange rate development | Small depreciation | | Large depreciation | |
|---|---|---|---|---|
| Dependent variable | Base consumption | | Base consumption | |
| | [1] | [2] | [3] | [4] |
| FX mortgage | 0.045 | -0.118 | 0.240*** | -0.340*** |
| | (0.171) | (0.188) | (0.061) | (0.093) |
| Debt-service burden | 0.309 | 0.620 | 0.266 | -1.227 |
| | (0.455) | (0.492) | (0.410) | (0.952) |
| Crisis event impact | 0.522*** | 0.548*** | 0.260* | -0.342*** |
| | (0.076) | (0.150) | (0.134) | (0.053) |
| *Crisis event impact * FX mortgage* | | 0.123 | | 0.422*** |
| | | (0.090) | | (0.048) |
| *Crisis event impact * Debt service burden* | | -0.230 | | 1.154*** |
| | | (0.372) | | (0.430) |
| Observations | 702 | 702 | 174 | 174 |
| R-squared | 0.237 | 0.238 | 0.225 | 0.262 |
| Socio-economic controls | Yes | Yes | Yes | Yes |
| Country fixed-effects | Yes | Yes | Yes | Yes |

Source: LiTS.
Note: The table shows OLS regression coefficients with standard errors in parentheses. The regressions explain a household's consumption response through various mortgage characteristics while controlling for household characteristics. The sample only includes households that held mortgages. For the definition of crisis event impact, see note to Table 2.1.

table indicates that households (in the same countries) which were highly leveraged and hit by a negative income shock compressed their base consumption the most.

Next, Table 2.1.2 investigates whether the differentiated impact of crisis shocks on FX (as opposed to local currency) mortgagors also influenced (self-reported) arrears on mortgage payments. Again, there are possible conflicting effects. If FX households had a better repayment propensity (something which bankers may have detected during the loan application) they might be better risks even if they had to reduce their consumption by more in order to continue to service their mortgage debt. However, it is possible that this effect would be outweighed by the higher debt service burden triggered by a large depreciation.

As expected, the table shows that households that were impacted more by the crisis were more likely to be in arrears on their mortgage (see "crisis event impact" line). This effect is about three times as strong in countries that experienced a large depreciation. However, the results also indicate that, across the entire sample, FX mortgagors tended to be better credit risks compared with local currency borrowers (see negative coefficients in first row of columns [1] and [2]). As shown in columns [3] and [4], this result was driven by countries with no (or only a limited) depreciation during the crisis. However, even in countries that experienced a sharp depreciation, there was no general increase of mortgage-payment arrears associated with FX denomination. Moreover, the interaction terms below the dotted line between crisis impact and FX denomination show that FX households which were hit

Table 2.1.2
## No evidence for higher credit risk on FX mortgages

| Dependent variable | Mortgage arrears | | | | | |
|---|---|---|---|---|---|---|
| **Exchange rate development** | **All countries** | | **Small depreciation** | | **Large depreciation** | |
| | **[1]** | **[2]** | **[3]** | **[4]** | **[5]** | **[6]** |
| FX mortgage | -0.094*** | -0.105** | -0.122** | -0.129* | -0.037 | 0.032 |
| | (0.037) | (0.049) | (0.053) | (0.069) | (0.065) | (0.033) |
| Debt-service burden | 0.077 | 0.113 | 0.004 | 0.080 | 0.185 | 0.036 |
| | (0.090) | (0.092) | (0.081) | (0.096) | (0.182) | (0.085) |
| Crisis event impact | 0.035** | 0.040** | 0.022* | 0.039** | 0.076*** | 0.071*** |
| | (0.014) | (0.017) | (0.011) | (0.019) | (0.012) | (0.020) |
| *Crisis event impact * FX mortgage* | | 0.008 | | 0.005 | | -0.065** |
| | | (0.020) | | (0.023) | | (0.026) |
| *Crisis event impact * Debt service burden* | | -0.030 | | -0.060** | | 0.155*** |
| | | (0.032) | | (0.029) | | (0.038) |
| Observations | 864 | 864 | 691 | 691 | 173 | 173 |
| R-squared | 0.136 | 0.135 | 0.147 | 0.146 | 0.110 | 0.109 |
| Socio-economic controls | Yes | Yes | Yes | Yes | Yes | Yes |
| Country fixed-effects | Yes | Yes | Yes | Yes | Yes | Yes |

Source: LiTS.
Note: The table shows OLS regression coefficients with standard errors in parentheses. The regressions explain a household's consumption response through various mortgage characteristics while controlling for household characteristics. The sample only includes households that held mortgages. For the definition of crisis event impact, see note to Table 2.1.

by an income shock in countries which experienced a large depreciation were generally *better*, not *worse* credit risks than crisis-hit households holding local currency mortgages. In contrast, crisis-hit households with high leverage levels in countries which experienced a large depreciation were more likely to go into arrears than low leverage households (but not in countries with more stable nominal exchange rates).

These results show that the currency composition of mortgage borrowing mattered, although not in a straightforward manner. In countries which experienced a sharp exchange rate depreciation, households which both took out an FX mortgage *and* were hit by one or more negative income shocks had to cut a larger number of expenditure items than similar households with a mortgage in the local currency. Interestingly, however, this does *not* appear to have made these borrowers worse credit risks: arrears on FX mortgages were in general lower, even in high depreciation cases. On the one hand, this is reassuring, as it suggests that banks generally seem to have done a good job in selecting the appropriate households for FX mortgages. However, the efforts of these households to repay in the face of a crisis and depreciation meant a significant sacrifice in terms of consumption. In this sense, FX mortgages did indeed prove costly in countries that suffered large depreciations.

index. This confirms that, in transition countries, it was those households which experienced the worst shocks that felt the constraint of existing mortgage debt the most.

Columns [3]-[4] and [7]-[8] also show that the negative impact of having a mortgage on consumption in the transition region was mainly driven by FX-denominated mortgages. In particular, FX mortgages led to a sharp consumption response of households which were hit relatively hard by the crisis. Box 2.1 examines the impact of FX mortgages on household vulnerability during the crisis in more detail.

## Conclusion

Households in the transition region suffered much more as a result of the 2008-10 financial crisis than those in western European comparator countries. The crisis led to larger reductions across virtually all consumption categories, particularly in essentials such as staple foods and health expenditures.

The analysis in this chapter points to four main reasons for these differences.

- First, compared with their Western comparator counterparts, transition region households suffered far more job losses, wage reductions and reductions in remittances. For example, the proportion of households which reported a job loss between late 2008 and late 2010 was twice as high (20 per cent) as in western Europe. Cross-country comparisons based on macroeconomic measures (such as the fall in GDP in 2009) tend to underestimate these differences, particularly for countries that are dependent on remittances.

- Second, official social safety nets were weaker in most countries in the transition region. For the transition region as a whole, the analysis shows no statistically significant mitigating effects from unemployment or housing benefits on the fall in consumption. In contrast, these safety nets are shown to have had a strong influence in western Europe.

- Third, while access to formal sources of borrowing helped offset consumption declines in both the transition region and western Europe, the mitigating effects in the latter were stronger.

- Lastly, unlike in the Western comparator countries, pre-crisis borrowing may have left some households across the transition region in a vulnerable state. The analysis shows that mortgage debt did not help transition households to maintain consumption when they were hit by negative income shocks (for instance, by increasing the mortgage to withdraw equity). Furthermore, in countries in which there were substantial currency depreciations, FX-denominated mortgage debt made the compression of consumption worse. In contrast, the repayment record of FX mortgage borrowers tended to be better than that of local currency borrowers, even in countries that suffered large depreciations. This suggests that banks generally had been careful to select especially creditworthy households for FX lending.

In conclusion, much like earlier *Transition Reports* that have analysed the crisis from a macroeconomic and financial sector perspective,[18] this chapter points to the ambivalent role of finance in shaping the response of the transition region to the crisis. On the one hand, finance helped buffer the impact of the crisis. On the other, it created vulnerabilities – down to the household level – that exacerbated the fall in consumption.

Lastly, this chapter suggests that in many transition countries, official safety nets were not very effective when the crisis struck. Developing and extending social security should be high on the post-crisis policy agenda if support for open and potentially vulnerable economic systems is to be maintained.

## References

**T. Beck and M. Brown (2011)**
"Which households use banks? The impact of bank ownership, deposit insurance, and creditor protection", Discussion Paper No. 2011-24, European Banking Center, Tilburg.

**T. Boeri and H. Brücker (2011)**
"Short-time work benefits revisited: Some lessons from the Great Recession", http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1812480&download=yes" \l "%23%23%23", IZA Discussion Paper No. 5635, Institute for the Study of Labor (IZA), Bonn.

**M. Brown and R. De Haas (2011)**
"Foreign currency lending in Emerging Europe: Bank-level evidence", *Economic Policy*, forthcoming.

**M. Brown, R. De Haas and P. Grosjean (2011)**
"Mortgage debt and household vulnerability. Micro-evidence from Emerging Europe", EBRD Working Paper, forthcoming.

**EBRD (2007a)**
*Life in Transition. A survey of people's experiences and attitudes*, London.

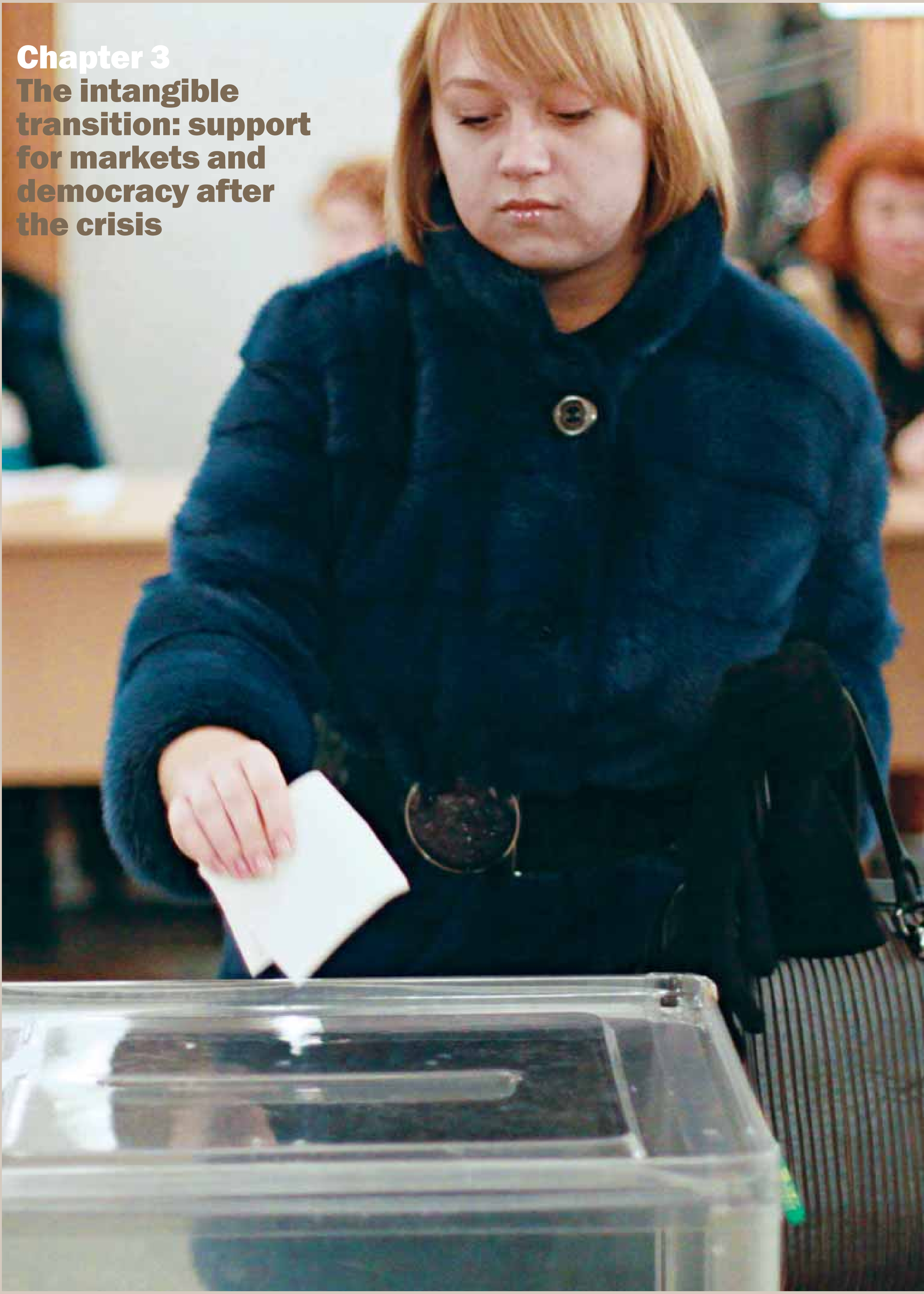
**EBRD (2007b)**
*Transition Report 2007: People in transition*, London.

**EBRD (2011)**
*Life in Transition: After the Crisis*, London.

**K. Reinold (2011)**
*Housing equity withdrawal since the financial crisis*, Bank of England Quarterly Bulletin, Q2, Bank of England, London.

[18] See, in particular, the 2009 *Transition Report, Transition in Crisis?*, Chapters 2 and 3.

# Chapter 3
# The intangible transition: support for markets and democracy after the crisis



**Support for democracy and free markets decreased over the past four years in the new EU countries, whereas it rose in many CIS countries. Why? Analysis shows that the more people were hit by the crisis, especially compared with what they experienced in previous crises, the more they turned away from democracy and markets. In addition, the crisis seems to have made people "turn against what they had". Those who lived in freer societies turned against democracy and markets, while people living in more state-dominated and authoritarian systems turned towards them.**

### Support for democracy in the transition region

10%

**fewer people support** democracy in the new EU countries compared with before the crisis

6%

**more people support** democracy in the CIS countries compared with before the crisis

14%

**University graduates are** 14% more likely to support democracy than those with a primary education

# The intangible transition: support for markets and democracy after the crisis

The previous chapter showed that the recent financial crisis significantly affected the material well-being and consumption of households in the transition region. But did it also impact them in less tangible ways? Did it bring about a change in their political and economic system attitudes? In particular, has it changed their support for democracy and the market economy, the very political and economic systems to which the transition process is supposed to lead?

The short answer to these questions is yes. Results from the 2010 Life in Transition Survey (LiTS) suggest that support for democracy and markets has changed significantly since the first round of the survey in 2006. It has declined in many of the more advanced transition countries, including all the new EU members except Bulgaria. On the other hand, it has increased in quite a few of the countries of the Commonwealth of Independent States (CIS), which are not as far along the path of transition. The changes have been significant enough so that in 2010, as opposed to 2006, almost all the strongest supporters of democracy and free markets were to be found in the CIS or other less advanced transition countries. How has the crisis led or contributed to the opposite movements in attitudes and the resulting re-alignment of democracy and markets support levels across the region?

This chapter shows that the more people were personally hit by the crisis, the more they turned away from democracy and free markets. The fact that many of the more developed transition countries experienced more severe downturns than their less advanced counterparts helps to explain the drop in support for democracy and markets among the former. Moreover, it seems that it was the *relative* impact of the crisis that mattered in changing attitudes, especially towards political systems. People became less supportive of democracy if the crisis hit them harder relative to their previous crisis experience. In many of the CIS countries, which endured much deeper downturns early in the transition process, the relative effect of the recent crisis was diminished by their previous experience. This reduced the negative impact of the more recent turmoil on attitudes towards democracy and markets.

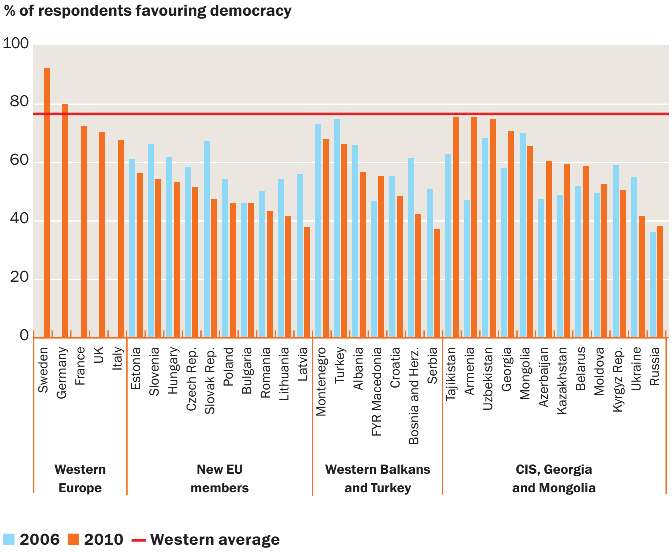
However, except for a few CIS countries whose economies actually grew through the crisis, these findings do not explain why democracy and markets became *more* popular in many CIS countries. This phenomenon could be explained by another relationship, for which the analysis in this chapter finds empirical support. The crisis appears to have made people "turn against what they had". Those who lived in freer societies and were impacted by the crisis turned against their current system and became less likely to choose democracy and markets over other systems. Those in more authoritarian environments, however, became stronger supporters of freer systems after the crisis had hit them. Many of the CIS countries score lower on various external and LiTS-based measures of freedom, democracy and market development, and are therefore in the latter category.

This chapter lastly considers the impact of economic policy on changes in attitudes. It concludes that the availability of mechanisms to protect consumption – such as personal savings, the ability to borrow formally or informally or government-provided social safety nets – in the wake of a crisis-induced income shock reduces a negative attitudinal response. In addition, merely receiving government assistance seemed to diminish the extent to which people living in freer countries turned away from democracy and markets after the crisis impacted them, and *vice versa*.

## Changes in support for markets and democracy: an initial look at the data

The LiTS contains two analogous questions to gauge the strength of household support for markets and democracy, respectively. To assess market support, respondents were asked which of the following three statements they agreed with the most: (i) a market economy is preferable to any other form of economic system; (ii) under some circumstances, a planned economy may be preferable to a market economy; and (iii) for people like me, it does not matter whether the economic system is organised as

Chart 3.1
**Transition region support for democracy is below the Western average**



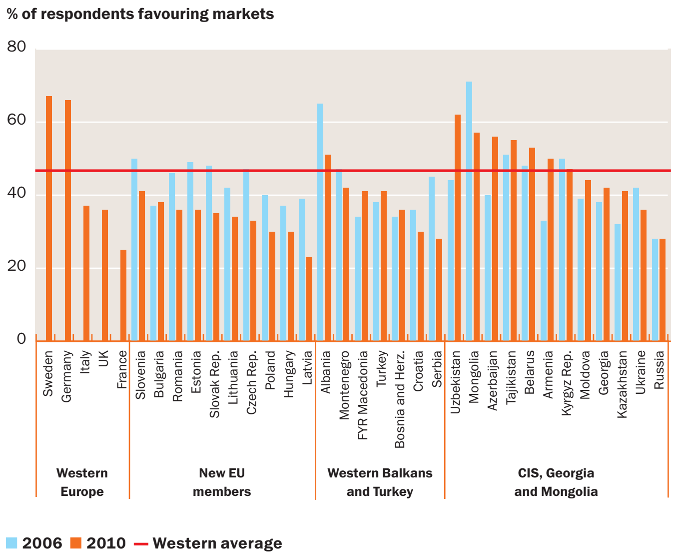

Source: LiTS, 2006 and 2010.
Note: For each country, this graph plots the share of the population that unequivocally supports democracy. The horizontal line indicates the 2010 average for the Western comparator countries (France, Germany, Italy, Sweden and the UK).

a market economy or as a planned economy. The corresponding question on support for democracy similarly asks whether it is preferable to any other political system, whether in some circumstances authoritarian government may be preferable, or whether it does not matter what system is in place.

The data from the 2010 LiTS show that the levels of self-reported support for markets and democracy have undergone significant changes in many of the countries of the transition region since the 2006 round. Charts 3.1 and 3.2 plot the proportions of each country's populations who unequivocally preferred democracy and markets to any other political and economic system, respectively. They reveal large swings between the two survey rounds.

Turkey, Montenegro, Mongolia, Uzbekistan, Albania and Tajikistan have remained among the countries with the highest levels of support for democracy in the transition region. In 2010 they were joined by Georgia, Kazakhstan, Belarus as well as Armenia. The latter saw the biggest change in the level of democracy support since 2006. A 28 percentage point increase raised it from 26th place in the region to second. It is now only marginally behind Tajikistan, the 2010 regional leader, and at a level comparable to most of the Western comparator countries, where support for democracy ranged from 92 per cent in Sweden to 68 per cent in Italy. There were no new EU members among the top 10 supporters of democracy in 2010, which comprised only the CIS countries, Mongolia and Turkey.

Chart 3.2
**Support for markets is down among new EU members**




Source: LiTS, 2006 and 2010.
Note: For each country, this graph plots the share of the population that unequivocally supports the free market. The horizontal line indicates the 2010 average for the Western comparator countries (France, Germany, Italy, Sweden and the UK).

Conversely, Hungary, the Slovak Republic and Slovenia, which had previously been among the top 10 supporters of democracy, all recorded significant falls – and by over 20 percentage points in the case of the Slovak Republic. In fact, the proportion of people who preferred democracy to any other political system was lower in 2010 than in 2006 in all of the new EU member countries except for Bulgaria, where it was already low in 2006. Apart from FYR Macedonia, support for democracy only increased in CIS countries. Ukraine was the most notable exception in the CIS, with a drop of almost 13 percentage points. Bulgaria, Russia and Serbia, which were among the least supportive of democracy in the 2006 survey, have been joined in this category in 2010 by, among others, no less than another five new EU members.

Support for markets has seen similarly significant changes since 2006. Mongolia, Albania, Tajikistan and the Kyrgyz Republic have remained among the strongest proponents of free markets in the transition region, while support in Uzbekistan has risen almost 20 percentage points to head the list. Azerbaijan and Armenia saw similarly strong increases. Apart from Albania and Mongolia, the 10 countries with the highest proportion of people who preferred markets to any other economic system were all in the CIS. Their support often surpassed that in the Western comparators, where it ranged from over two-thirds in Germany and Sweden to only one-quarter in France.

Once again, all those new EU members from among the top 10 supporters of markets in 2006 experienced a decline in their preference for a market system. The Czech Republic, Estonia, the Slovak Republic and Slovenia all saw their populations' support for markets shrink by at least 10 percentage points. With the exception of Slovenia, this placed them in the bottom 10 in 2010 (in a group comprising Croatia, Russia, Serbia and seven of the new EU members).

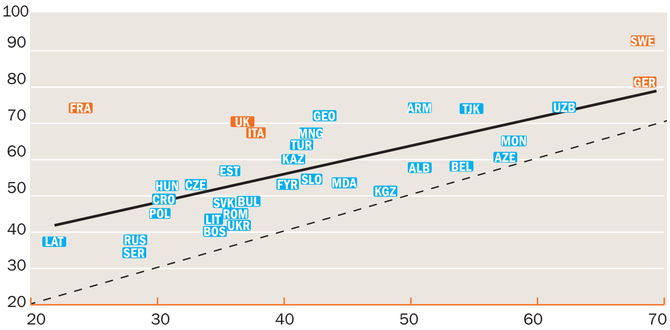
Chart 3.3 confirms what the preceding analysis suggests – that there is a strong correlation between the proportion of people who supported markets and those who supported democracy. A simple linear regression line shows that support for democracy was generally higher than that for markets in the countries surveyed in the 2010 LiTS. This was especially true in the Western comparator countries (apparent in Charts 3.1 and 3.2).

Do people who prefer democracy over other political systems participate more in the democratic process than others? Chart 3.4 suggests so, as it shows a positive correlation between the proportions of people in each country who supported democracy and who voted in at least one of the most recent elections. No transition countries matched the political involvement of the Swedes, where almost everyone seems to exercise their right to vote. Nevertheless, in all transition countries except Kazakhstan, at least two-thirds of people had voted in a recent election.

Interestingly, democracy enjoys stronger support wherever people have more trust in their government institutions. Chart 3.5 plots support for democracy against an index of trust in the presidency, the central government, regional government, local

## Chart 3.3
### Support for democracy and markets is strongly correlated

% of respondents favouring democracy

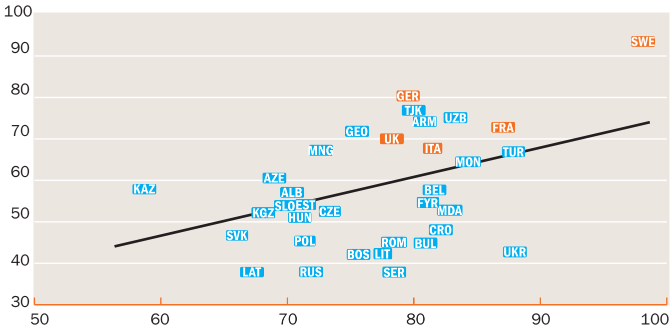



% of respondents favouring markets

Source: LiTS, 2010.
Note: For each country, this graph plots the share of the population that unequivocally supports democracy against the share of the population that unequivocally supports the free market. The line represents the best linear approximation of the relationship between the two variables, as determined by an OLS regression model.

## Chart 3.4
### Democracy supporters are more inclined to vote

% of respondents favouring democracy

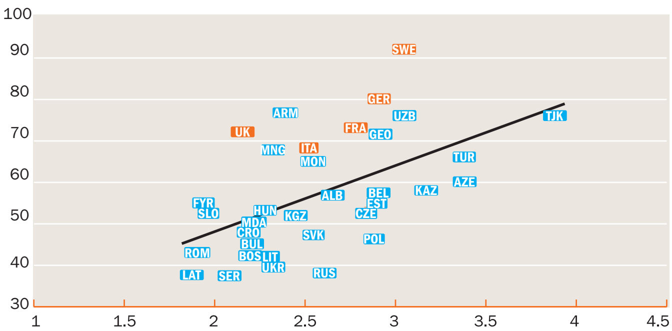



% of people who voted in recent elections

Source: LiTS, 2010.
Note: For each country, this graph plots the share of the population that unequivocally supports democracy against the share of the population that voted in the most recent local, national or presidential elections. The line represents the best linear approximation of the relationship between the two variables, as determined by an OLS regression model.

## Chart 3.5
### Democracy is more popular where trust in government is stronger

% of respondents favouring democracy

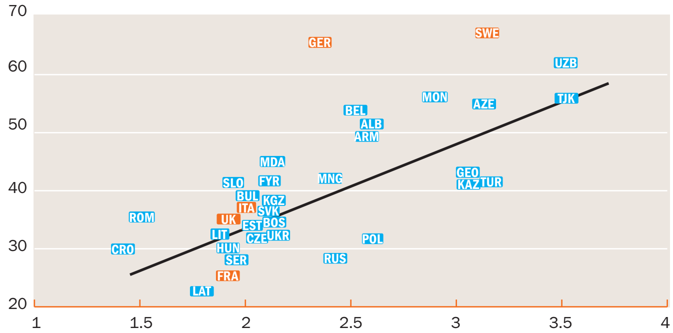



Average trust in government institutions

Source: LiTS, 2010.
Note: For each country, this graph plots the share of the population that unequivocally supports democracy against the average trust among the population in the presidency, the government, regional government, local government and the parliament, on a scale from 1 to 5. The line represents the best linear approximation of the relationship between the two variables, as determined by an OLS regression model.

## Chart 3.6
### Support for markets is higher where economy is seen as improving

% of respondents favouring markets




Average perception of improvement of the state of the economy

Source: LiTS, 2010.
Note: For each country, this graph plots the share of the population that unequivocally supports the free market against the average response among the population to the question whether they agree that the economic situation in their country is better today than around 4 years ago, on a scale from 1 to 5 (individuals could strongly disagree (1), disagree (2), neither disagree nor agree (3), agree (4) or strongly agree (5)). The line represents the best linear approximation of the relationship between the two variables, as determined by an OLS regression model.

government and parliament. Respondents rated their trust in each public institution on a scale of 1 to 5. These ratings were averaged across the five institutions to create the trust index. The chart shows significant variation between countries, with the Tajiks trusting their government institutions particularly strongly. On the other hand, those in Latvia, FYR Macedonia, Romania and Slovenia did not express much faith in their elected representatives. Clearly, as some of these countries were hit hard by the financial crisis, the economic fall-out impacted on both the level of trust in elected officials and support for democracy.

Chart 3.6 echoes this conjecture as it depicts a strong correlation between support for markets and the perceived change in the economic situation in each country. Respondents in the 2010 LiTS were asked to state whether they agreed with the statement that "the economic situation in our country is better today than around four years ago", on a scale of 1 to 5. Not surprisingly, people in very few countries (only in Tajikistan and Uzbekistan) believed that their countries' economic situation had improved during the turbulent crisis years. While households in a few countries neither agreed nor disagreed with the statement, most on average disagreed. These were led by Croatia and Romania, whose populations were the least satisfied with the recent developments on the economic front in their countries, followed by Latvia and Lithuania.

A similar correlation is also present in the corresponding data for support for democracy and perceived change in the political situation (see Chart 3.7). Again, respondents were asked whether they agreed that "the political situation in our country is better today than around four years ago". As with the question regarding the economic situation, only in Tajikistan and Uzbekistan did people think that the political climate had improved during the crisis years. In most transition countries, respondents believed that their political situation had worsened, particularly in Croatia and Romania. Households in these two countries were even more disappointed with the changes in their political situation than those in the Kyrgyz Republic, which experienced major political and social upheaval just months before the 2010 LiTS was conducted. This suggests that attitudes towards the political climate may be strongly related to a country's economic performance.

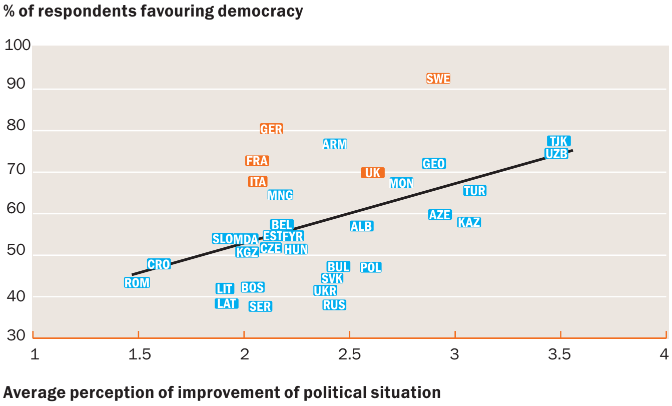
Based on this initial analysis of the data, what might be plausible hypotheses to explain why markets and democracies have lost support in the EU countries but gained support in the CIS? The above charts suggest that there is a relationship between individuals' perceptions of how well the economy has been doing and their support for both free markets and democracy. One reason may therefore be that the impact of the crisis was generally higher in the EU countries (see Chapter 2). Furthermore, while many CIS countries also suffered, the crisis may have appeared relatively minor to people who witnessed the post-communist collapse in output, which was particularly large and prolonged in the CIS. Perhaps it was the economic crisis as viewed through the lens of past crisis experiences, rather than just its absolute size, that influenced shifts in attitudes towards markets and democracy. Lastly, it is possible that people in each country associated the crisis that hit them with the system that they lived under at the time, and consequently turned against it. If they were living under democratic and free market systems and yet were hurt by the economic downturn, as would tended to have been the case among the new EU members, their support for the two systems may have wavered. On the other hand, those who experienced the crisis under the more authoritarian or less market-oriented systems prevalent in several CIS countries may have reacted against those systems, resulting in greater support for democracy and markets.

The next three sections of this chapter explore each of the three hypotheses in turn and confirm that all three may be part of the story behind the changes in political and economic system preferences in the transition region.

## Negative impact of the crisis on support for markets and democracy

Charts 3.8 and 3.9 show a positive correlation between output growth in 2009 and the change in support for democracy and markets between 2006 and 2010. Many countries that experienced a comparatively mild crisis or even grew in 2009, such as Azerbaijan and Uzbekistan, saw an increase in both democracy and markets support, while harder-hit countries, such as Estonia, Latvia and Lithuania, experienced a decline. That said, there are some significant outliers in the two charts, such as Armenia, where support for markets and democracy grew in spite of a large output decline in 2009.

Chart 3.7
**Support for democracy is higher where political improvement is perceived**




Source: LiTS, 2010.
Note: For each country, this graph plots the share of the population that unequivocally supports democracy against the average response among the population to the question whether they agree that the political situation in their country is better today than around 4 years ago, on a scale from 1 to 5 (individuals could strongly disagree (1), disagree (2), neither disagree nor agree (3), agree (4) or strongly agree (5)). The line represents the best linear approximation of the relationship between the two variables, as determined by an OLS regression model.

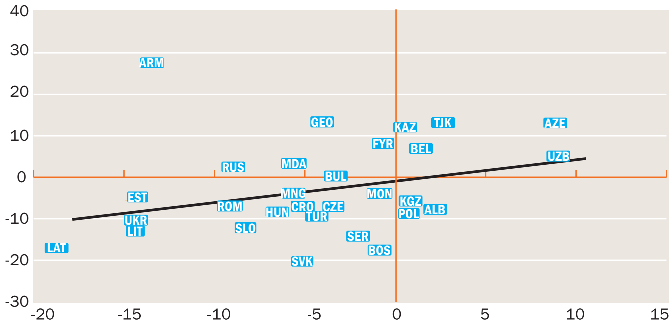
Why would households in countries with more severe economic downturns turn away from democracy and free markets? It may be that people associated these systems with the crisis itself. Between 30 per cent and 70 per cent of households in nearly all transition countries blamed the West[1] for the crisis (see Chart 3.10). In the new EU member countries at least 45 per cent of people held that view. People who were affected in a negative way by the crisis may therefore have been inclined to turn away from values and systems associated with the West. Or they may simply have held free markets (and perhaps democracy, by association) responsible, without explicitly blaming the West.

To further investigate the relationship between the crisis and support for democracy and markets, this analysis turns to multivariate regressions, which take full advantage of the individual-level data from the 2010 LiTS. This approach enables an assessment of the impact of various individual characteristics, perceptions and external factors on attitudes towards political and economic systems at the same time. This is crucial to isolate the effect of, for example, the impact of the crisis on attitudes in a heterogeneous population that varies by gender, age, education, wealth and other attributes, which are also likely to affect individuals' attitudes.

The variables to be explained in these and all further regressions are dummy variables. The democracy variable takes on the value of 1 if the respondent expressed an unequivocal preference for democracy over any other political system. It equals 0 where the respondent thought that under some circumstances an authoritarian regime might be preferable or that it did not matter whether the system was democratic or authoritarian. Similarly, the free market variable takes on the value of 1 if the respondent expressed an unequivocal preference for markets over any other form of economic system. It equals 0 when he or she thought that under some circumstances a planned economy may be preferable or that it did not matter

Chart 3.8
## Support for democracy decreased more where the crisis hit harder

**Change in share of supporters of democracy, 2006–10 (%)**

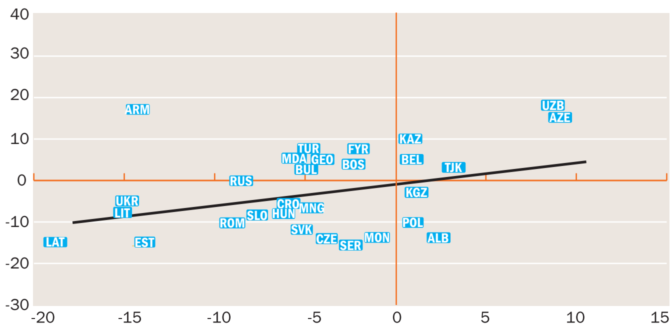



**Real GDP growth, 2009 (%)**

Source: LiTS, 2006 and 2010, World Development Indicators.
Note: For each country, this graph plots the change in the share of the population that unequivocally supports democracy between 2006 and 2010 against the country's real GDP growth rate in 2009. The line represents the best linear approximation of the relationship between the two variables, as determined by an OLS regression model.

Chart 3.9
## Markets support declined steeply where the crisis hit more

**Change in share of supporters of markets, 2006–10 (%)**

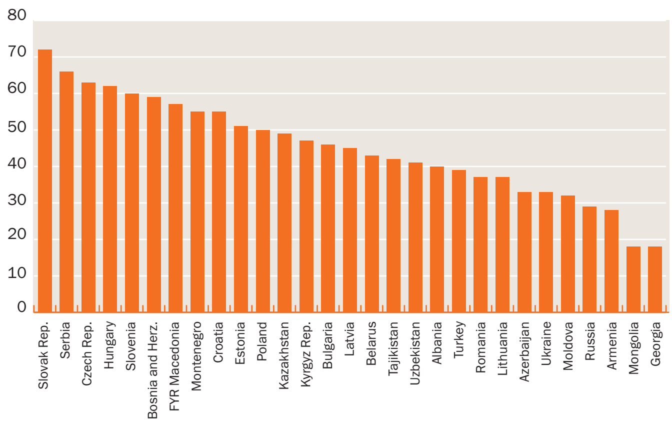



**Real GDP growth, 2009 (%)**

Source: LiTS, 2006 and 2010, World Development Indicators.
Note: For each country, this graph plots the change in the share of the population that unequivocally supports the free market between 2006 and 2010 against the country's real GDP growth rate in 2009. The line represents the best linear approximation of the relationship between the two variables, as determined by an OLS regression model.

Chart 3.10
## At least a third in most transition countries blame the West for the crisis

**% of respondents who blame the West**




Source: LiTS, 2010.
Note: For each country, this graph plots the share of the population that blames the West (the US, the EU or the West in general) for the crisis.

[1] The United States, the European Union or the West in general.

whether the system was organised as a market economy or as a planned economy. The coefficients on the two variables express the effect of a one unit increase in the factors that potentially shape attitudes on the likelihood that a person will support markets or democracy.

As described in Chapter 2, the 2010 LiTS includes several potential measures of the impact of the crisis on respondents and their households. The measure used throughout this chapter is a version of the base consumption response index defined in Chapter 2. It awards one point for each positive response to questions of whether the households had to reduce consumption of staple foods, reduce tobacco smoking, postpone or skip medical treatment, stop buying regular medications or had utilities cut off because of delayed payment.

This measure captures the way that a household had to adjust its most basic consumption in response to changed circumstances (such as unemployment, reduced wages, and so on) and how it felt the impact of the crisis after any mitigating effect of actions it may have taken in response to crisis-related shocks – for instance, attempting to find a new job, drawing on household savings, borrowing from friends or applying for, and receiving, government benefits. It is this extent to which the household felt the crisis that is most likely to have had an impact on a respondent's attitudes, rather than the primary events triggered by the crisis such as reduced working hours or wages.

Table 3.1 presents the results of the basic regression of individual support for markets and democracy on this crisis-response measure and other individual-level control variables. The results are presented for the transition region as a whole, for the subsets of the CIS and new EU member countries and for the five Western comparator countries. They confirm that people who were hit harder by the crisis were less likely to support markets or democracy. More specifically, one additional point on the consumption response index makes it 2 to 3 per cent less likely

Table 3.1
**Impact of the crisis on support for democracy and free markets**

| Region | Transition | | CIS | | New EU | | West | |
|---|---|---|---|---|---|---|---|---|
| **Dependent variable** | **Democracy [1]** | **Free market [2]** | **Democracy [3]** | **Free market [4]** | **Democracy [5]** | **Free market [6]** | **Democracy [7]** | **Free market [8]** |
| Crisis consumption response | -0.0212*** | -0.0259*** | -0.0168* | -0.0319** | -0.0260*** | -0.0302*** | -0.0446*** | -0.0459** |
| | (0.00437) | (0.00637) | (0.00830) | (0.0118) | (0.00373) | (0.00518) | (0.00595) | (0.0152) |
| Wealth | 0.00912*** | 0.00855*** | 0.00641 | 0.00363 | 0.0123*** | 0.0158*** | 0.00560 | 0.0186** |
| | (0.00230) | (0.00236) | (0.00512) | (0.00453) | (0.00322) | (0.00411) | (0.00481) | (0.00474) |
| Woman | -0.0240*** | -0.0280*** | -0.0291** | -0.0501*** | -0.0128 | -0.0295* | 0.00114 | -0.0120 |
| | (0.00722) | (0.00826) | (0.0121) | (0.00957) | (0.0116) | (0.0158) | (0.0145) | (0.0151) |
| Married | 0.0149* | 0.0223*** | 0.0197 | 0.0269** | 0.0106 | 0.0163* | 0.0254** | 0.0206 |
| | (0.00728) | (0.00560) | (0.0112) | (0.0106) | (0.0137) | (0.00796) | (0.00619) | (0.0125) |
| High school | 0.0764*** | 0.0369*** | 0.0545 | 0.0685** | 0.113*** | 0.0446*** | 0.0499 | -0.0135 |
| | (0.0162) | (0.0129) | (0.0324) | (0.0228) | (0.0144) | (0.00996) | (0.0512) | (0.0327) |
| University | 0.144*** | 0.0896*** | 0.103** | 0.104*** | 0.229*** | 0.133*** | 0.167* | 0.00546 |
| | (0.0207) | (0.0151) | (0.0335) | (0.0274) | (0.0224) | (0.0196) | (0.0757) | (0.0228) |
| Age | 0.000872 | 0.00121 | 0.0000533 | 0.000533 | -0.0000899 | 0.00171 | 0.00350** | -0.00198 |
| | (0.000898) | (0.000791) | (0.00146) | (0.00126) | (0.00189) | (0.00149) | (0.00113) | (0.00178) |
| Age^2 | -0.0000311** | -0.0000459*** | -0.0000127 | -0.0000393** | -0.0000142 | -0.0000530** | -0.0000390** | 0.0000273 |
| | (0.0000143) | (0.0000126) | (0.0000209) | (0.0000159) | (0.0000274) | (0.0000222) | (0.0000108) | (0.0000302) |
| Health | -0.0473*** | -0.0596*** | -0.0520** | -0.0539** | -0.0561*** | -0.0683*** | -0.0367 | -0.0555* |
| | (0.00981) | (0.00997) | (0.0188) | (0.0206) | (0.0146) | (0.0129) | (0.0214) | (0.0243) |
| Urban | 0.00606 | -0.0103 | -0.0238 | -0.0210 | 0.0267 | -0.00404 | -0.0304 | -0.0334 |
| | (0.0136) | (0.0129) | (0.0214) | (0.0268) | (0.0197) | (0.0171) | (0.0273) | (0.0316) |
| Constant | 0.651*** | 0.443*** | 0.687*** | 0.451*** | 0.302*** | 0.267*** | 0.842*** | 0.282*** |
| | (0.0301) | (0.0262) | (0.0520) | (0.0446) | (0.0613) | (0.0472) | (0.0812) | (0.0358) |
| Observations | 28312 | 27457 | 10382 | 10117 | 9428 | 9164 | 5248 | 4864 |
| Adj. R-squared | 0.082 | 0.068 | 0.083 | 0.057 | 0.062 | 0.065 | 0.078 | 0.146 |
| Country fixed effects | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |

Sources: LiTS 2010.
Notes: Standard errors in parentheses are clustered at the country level. Estimation is done by OLS. The dependent variables are as follows: in regressions (1), (3), (5) and (7) Democracy, which is a dummy variable equal to 1 if respondent unequivocally prefers democracy to any other political system; in regressions (2), (4), (6) and (8) Free Market, which is a dummy variable equal to 1 if respondent unequivocally prefers the free market to any other economic system. Sample: all respondents within region listed for a particular regression. *** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

[2] The value of the consumption response index for the average household in the transition region is just below 1.

that a person would prefer democracy or markets.[2] This means that members of a household hit particularly hard by the crisis could be more than 10 per cent less likely to favour democracy or markets over any other political and economic systems, respectively. This is true in the transition region as a whole and in the new EU members. The relationship is rather weaker in the CIS countries regarding attitudes to democracy – support for which, at whatever level it may be, seems to be less responsive to the impact of the crisis.

Interestingly, people in the Western comparator countries seem to have responded to the same crisis-induced consumption adjustment twice as intensely as those in the transition region in respect of their preferences for democracy and markets. While country-level support for democracy in particular was initially much higher in the Western comparators than in most transition countries, the attitudes of western Europeans appear to have changed to a greater extent in response to a crisis shock of a similar magnitude. This suggests a greater resilience of transition region attitudes to a given reduction in consumption, even though these countries still have a long way to go to reach Western levels of support for democracy in particular. The greater sensitivity of Western households may reflect the fact that they were far less likely to experience a one unit compression in base consumption than their transition counterparts, and hence would have suffered a more extreme event relative to other households in their country.[3]

The results also suggest that the impact of the crisis on attitudes may be less than that of education. More educated people were stronger supporters of both democracy and markets. This may be because education has enabled them to take better advantage of the free market system and to understand why and how democracy gives them a bigger say in political decisions. In the transition region as a whole, someone with a high school education was almost 8 per cent more likely to support democracy than someone with no, or only primary education, and almost 4 per cent more likely to favour a market economy. The effect of a university education was even stronger, making preferences for democracy and markets 14 per cent and 9 per cent more likely, respectively.

While this effect is also discernible in the CIS region, it is particularly pronounced among the new EU members, especially with regard to democracy. People with a high school education in the new EU countries were over 11 per cent more likely to prefer democracy to any other political system, and those with a university degree almost 22 per cent more likely. On the other hand, the level of education appears to have had little or no effect on support for democracy and markets in the Western comparators. This does not necessarily mean that such support was lower among the more educated – rather, it may imply that a larger proportion of people, even at lower education levels, appreciated, and could take advantage of, markets and democracy.

Women were less likely to support democracy and free markets in the transition region. This was particularly so in the CIS countries, where a woman was 5 per cent less likely to prefer markets than a man. Wealthier households were more likely to prefer democracy and markets. Especially with regard to markets, the richer were likely to have already benefited, and would perhaps benefit more in the future, from a market system, and would therefore favour it more strongly. This result is driven by the new EU countries within the transition region and is also present in the West. Older people in the transition region were rather less enamoured of markets and democracy, while in the Western countries they were particularly supportive of democracy. In addition, married people were more likely to prefer markets and democracy, while those with health concerns were less inclined.

## The role of crisis impact relative to past crisis experiences

As suggested in the first section of this chapter, it is possible that the impact of the crisis on people's attitudes towards political or economic systems depends on their past crisis experiences. If they had experienced a much larger crisis in the past, then they might be less likely to view a more recent, but less significant episode as severe enough to change their attitudes towards political and economic systems or other issues.

How can previous crisis experiences be measured? The biggest economic contraction in recent history for transition countries occurred right after the fall of communism. Therefore, a reasonable country-level proxy may be the amount of output lost in the early 1990s relative to the pre-1990 peak: specifically, the real output drop in percentage points between 1990 and the year with the lowest real output following the start of the transition period. For some countries, such as Poland or Slovenia, output and growth recovered early in the post-communist era (1991 or 1992). For others, including Russia, recovery did not occur until the late 1990s, and five of the transition countries have yet to fully restore their pre-transition output levels according to official data.[4]

Chart 3.11 shows that support for democracy declined less between 2006 and 2010 in countries that had experienced a deeper crisis at the start of the transition process. Indeed, support increased in several countries that went through particularly deep downturns in the early to mid-1990s, such as Georgia, Moldova and Tajikistan. A similar pattern is apparent in support for markets. This chart of course does not account for the size of the recent crisis and other factors, therefore the analysis again turns to individual-level regressions based on the 2010 LiTS data.

On an individual level, past crisis experience can be captured in two ways using the data from the LiTS and from external sources. First, the approach of measuring the depth of the post-1990 crisis using the total drop in real output can be "individualised", based on the age of a LiTS respondent. Only people above a certain age will have experienced an economic downturn in their own country. If one assumes that people

[3] The average value of the consumption response index in the Western countries is below one-third, therefore the average impact of the crisis on support for democracy and markets is smaller than in the transition countries (see Chapter 2).

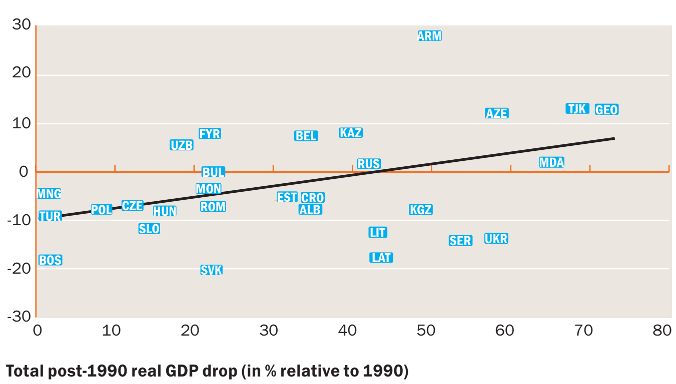
[4] Georgia, Moldova, Serbia, Tajikistan and Ukraine.

remember crisis experiences that occurred when they were at least 15 years old, then the total real fall in output relevant to an individual is equal to the one used in Chart 3.11 if a particular respondent was at least 15 years old in 1990 (born in 1975 or before). For individuals born after 1975, it is assumed to be equal to the largest total output decrease experienced by the respondent's national economy after his or her 15th birthday – which will necessarily be smaller or equal to the decline seen by their older compatriots.

This approach does not, however, take into account the fact that people of different ages when the downturn occurred would have experienced it to varying degrees. During the transition recession of the early 1990s, an 18-year-old might have had a harder time finding a job, or might have had to reduce his or her consumption of certain goods. However, a 40- to 50-year-old employee who lost a supposedly secure job after many years of service might have had trouble providing for his or her family in the absence of a previously strong social safety net. To account for the potentially greater impact of previous crises on older people, the regressions include not only the "individualised" output drop measure attributable to the post-1990 crisis, but also an interaction term between the output drop and the individual's age.[5]

A second approach focuses on a LiTS question which asked respondents about their level of satisfaction with the state of their country's economy. The answer would, of course, reflect many factors – including individual characteristics, such as wealth, education, gender and, importantly, life satisfaction – as well as the impact of the crisis on the respondent's household. A relationship between the answer to this question and these

Chart 3.11
**Recent decline in support for democracy was greater in countries with smaller post-1990 recessions**




Source: LiTS, 2006 and 2010, World Development Indicators.
Note: For each country, this graph plots the change in the share of the population that unequivocally supports the free market between 2006 and 2010 against the total percentage drop in the country's real GDP after 1990, relative to the 1990 GDP level. The line represents the best linear approximation of the relationship between the two variables, as determined by an OLS regression model.

factors can be estimated using the LiTS II data and a linear regression model. This reveals how an average person, with given individual characteristics, who has been hit by the crisis to a certain degree would feel about the country's economy. The difference between the stance regarding the economy of a particular person and the stance that a person with his or her characteristics should have according to the regression model is the *residual* attitude towards the state of the economy, unexplained by the characteristics of the individual that are accounted for in the regression.

This *residual* can help to identify the extent to which people have had to face economic adversity in the past. If they expressed optimism about their country's economy beyond what would be expected of people with the same individual characteristics, life satisfaction and recent crisis experience, it may be because of their different *relative* perspectives. For example, respondents may think that their country's economy is not performing particularly well but, if they were strongly affected personally by a previous crisis (in the early 1990s or otherwise), the response would likely be more upbeat than that of respondents with similar individual characteristics but with no such experience. The *residual* should therefore have a positive relationship with support for markets and democracy, mitigating the direct negative effect of the most recent downturn.

Table 3.2 confirms the importance of past crisis experience for people's attitudes towards democracy. It presents the results of linear regressions that account for the post-1990 output decline that a respondent experienced in adult life or use the individual's "unexplainable optimism about the economy" (the above-described residual) as an indirect measure of previous crisis exposure. The regressions control for the same individual characteristics as those in Table 3.1, but as the coefficients on those variables remain qualitatively the same, they are not presented here.

In all regressions the crisis consumption response remains a strong predictor of reduced support for markets and democracy. In addition, the first two columns of Table 3.2 confirm that witnessing a larger output decline in the early transition years implies a stronger level of support for markets and democracy. The interaction term between the recent and past crisis is not statistically significant, implying that merely experiencing a crisis at an age of 15 or over did not make an individual more resilient to events in 2008-09 as far as attitudes towards markets and democracy were concerned. The interaction term between exposure to past crisis, recent crisis consumption response and age in the first column, however, is positive and significant. This means that older people who were more strongly impacted by the recent crisis and also lived through a previous significant downturn were more likely to prefer democracy to authoritarian political systems. As mentioned earlier, these people were likely more severely affected by the crisis that followed the fall of communism. Consequently, the recent crisis was not sufficient to make them turn against democracy, at least not by as much as

[5] This term is the product of the individualised output drop measure and the individual's age and therefore increases in either variable.

their younger compatriots. This result does not appear to apply in respect of support for markets.

The third column of Table 3.2 supports the above finding using the economy residual measure. It appears that people who are "unexplainably optimistic" about the state of the economy (their residual value is high) are more supportive of markets. More interestingly, respondents who were hit by the recent crisis *and* have a particularly sanguine outlook on the economy are more likely to support democracy than those similarly hurt by the crisis, but who are not "unexplainably optimistic".

Both approaches to measuring previous crisis experience therefore suggest that, at least for preferences with respect to democracy, it is to some extent the *relative* crisis that matters. If people had experienced a worse economic event in the past that had impacted on them deeply, they would probably view the effects of the most recent crisis less gravely – and therefore it would be less likely to sway their attitudes away from democracy.

Table 3.2
**Impact of past crises on support for democracy and free markets**

| Region | Transition | | Transition | |
|---|---|---|---|---|
| **Dependent variable** | **Democracy [1]** | **Free market [2]** | **Democracy [3]** | **Free market [4]** |
| Crisis consumption response | -0.0271*** | -0.0315*** | -0.0217*** | -0.0267*** |
| | (0.00460) | (0.00644) | (0.00400) | (0.00638) |
| Post-1990 output drop | 0.000583* | 0.000659* | | |
| | (0.000304) | (0.000376) | | |
| Crisis consumption response * post-1990 output drop | 0.000211 | 0.000219 | | |
| | (0.000153) | (0.000250) | | |
| Crisis consumption response * post-1990 output drop * age | 0.0000258** | 0.0000139 | | |
| | (0.0000102) | (0.0000120) | | |
| Economy view residual | | | -0.00506 | 0.0184** |
| | | | (0.00623) | (0.00730) |
| Crisis consumption response * economy view residual | | | 0.00835** | 0.00380 |
| | | | (0.00348) | (0.00492) |
| Constant | 0.580*** | 0.363*** | 0.621*** | 0.404*** |
| | (0.0242) | (0.0193) | (0.0246) | (0.0169) |
| Observations | 25632 | 24958 | 25605 | 24943 |
| Adj. R-squared | 0.080 | 0.070 | 0.081 | 0.071 |
| Individual controls | Yes | Yes | Yes | Yes |
| Country fixed effects | Yes | Yes | Yes | Yes |

Sources: LiTS 2010, World Development Indicators.
Notes: Standard errors in parentheses are clustered at the country level. Estimation is done by OLS. The dependent variables are as follows: in regressions (1) and (3) Democracy, which is a dummy variable equal to 1 if respondent unequivocally prefers democracy to any other political system; in regressions (2) and (4) Free Market, which is a dummy variable equal to 1 if respondent unequivocally prefers the free market to any other economic system. Sample: all respondents within region listed for a particular regression. *** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

## The crisis and turning against the existing system

While the tough experience of the early transition years may have made the attitudes of people in the CIS region more resilient in the recent downturn, it does not explain the increase in support for democracy and markets in some CIS countries. Many people in the transition region blamed the West or markets and democracy more generally for causing the crisis, irrespective of the system in place in their own countries (see Chart 3.10). On the other hand, others blamed their own governments or may have believed that their authorities could have responded more effectively to the downturn. This would imply a belief that the economic and political systems in place in their own countries somehow contributed to the crisis, even if it originated abroad.

Some initial evidence that people "turned against what they had" when hit by the crisis, or blamed the system in place at home, has already been suggested in Table 3.1. The crisis had the strongest negative impact on preferences for democracy and markets in the Western comparator countries, which have the strongest democratic and market institutions in the LiTS sample. The impact was weakest in the CIS, with some of the least democratic countries. When the CIS sample is further restricted to the six countries with the lowest 2010 World Bank governance score – Uzbekistan, Tajikistan, Kyrgyz Republic, Belarus, Azerbaijan and Russia – the negative coefficient on the crisis variable loses its statistical significance. Within that group, the crisis did not turn people against democracy and free markets – systems that, according to external measures such as the World Bank score, were less developed there than in other countries of the region.

How can the hypothesis that citizens of transition countries who are particularly affected by the crisis changed their political and economic system preferences against "their" systems be tested at the individual level? According to the hypothesis, respondents would not turn against the systems that they objectively had in their countries according to external measures, but rather against the systems that they thought they enjoyed. The LiTS does not provide such an individual-level measure for the perceived economic system, but it is available for the perceived political system (which can then feed into perceptions regarding the economic system as well). Specifically, respondents were asked to what extent they agreed that (i) free and fair elections, (ii) freedom of speech and (iii) freedom to travel abroad existed in their countries. The responses can be used to define a subjective liberties index for each individual respondent, which is the simple average of the response to these three questions, on a scale from 1 to 5.

If people who were affected by the crisis turned against the system that they perceived as having been in place, the coefficient on the interaction term between the crisis consumption response and the liberties index should be negative. In other words, if people living under a democracy were hit by the crisis, they would support that system less. If, on the other hand, they were similarly impacted by the crisis in a non-democratic regime, they would favour democracy more.

Table 3.3 shows that this is indeed the case. The first line of the table confirms that, even when accounting for the liberties index, the crisis consumption response retains its negative direct effect on attitudes towards democracy and free markets. The line below, as a baseline, shows that respondents were more likely to support democracy and free markets if they felt that they were already enjoying basic freedoms. This effect is stronger for democracy than for markets. The last line of the table shows the main result – the negative coefficient on the interaction term between the crisis consumption response and the liberties index. While those who felt that they had more liberties generally preferred democracy and markets, the same people responded *negatively* in their preferences for the two systems if they were hit by the crisis.

In other words, people did indeed turn against the systems they believed functioned in their country when they were affected by economic turmoil. Those who enjoyed more freedoms wanted less democracy and markets when they were hurt by the crisis, while those who felt that their liberties were more limited became more likely to support these systems. This effect is magnified in countries with limited freedoms *and* higher levels of corruption, where people seem to have increased their support for democracy and free markets more strongly (see Box 3.1).

Table 3.3
**Impact of perceived level of freedom on support for democracy and free markets**

| Region | Transition | |
|---|---|---|
| **Dependent variable** | **Democracy [1]** | **Free market [2]** |
| Crisis consumption response | -0.0253*** | -0.0323*** |
| | (0.00441) | (0.00641) |
| Liberties index | 0.0633*** | 0.0439*** |
| | (0.00968) | (0.00951) |
| Crisis consumption response * liberties index | -0.0148*** | -0.0173*** |
| | (0.00410) | (0.00564) |
| Constant | 0.680*** | 0.442*** |
| | (0.0232) | (0.0215) |
| Observations | 28075 | 27247 |
| Adj. R-squared | 0.092 | 0.073 |
| Individual controls | Yes | Yes |
| Country fixed effects | Yes | Yes |

Sources: LiTS 2010.
Notes: Standard errors in parentheses are clustered at the country level. Estimation is done by OLS. The dependent variables are as follows: in regression (1) Democracy, which is a dummy variable equal to 1 if respondent unequivocally prefers democracy to any other political system; in regression (2) Free Market, which is a dummy variable equal to 1 if respondent unequivocally prefers the free market to any other economic system. Sample: all respondents within region listed for a particular regression. *** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

## The mitigating effect of government aid on attitude changes

Chapter 2 shows that a variety of mechanisms – personal savings, family aid, bank borrowing or possibly government assistance – allowed households to cushion the impact of crisis events on their actual consumption. Many households were therefore able to mitigate a decline in consumption despite crisis-induced falls in their income levels. Did such mechanisms also attenuate the change in their preferences towards democracy and markets? In other words, would access to safety nets limit the impact of the crisis on people's attitudes? If this is the case, policy-makers attempting to help households through the crisis would be also limiting the attitudinal consequences of the downturn.

To some extent the results presented in the preceding tables already suggest that this must be the case, since they show a strong impact of the consumption response to the crisis on preferences towards markets and democracy. Therefore, anything that mitigates the impact of the crisis on consumption should also have an effect on attitudes. However, it is possible to test the role of safety nets more directly. The two measures of the crisis in the 2010 LiTS – actual crisis events, such as job loss, on the one hand and the ensuing consumption response on the other – enable the creation of a measure of each household's mitigation mechanisms. A linear regression model can predict the household consumption response expected for a given set of individual characteristics and the value of the index of crisis events introduced in Chapter 2. The crisis event index awards one point for each possible event, including job loss by a household member, reduced working hours, reduced wages and so on. The difference between a household's actual crisis consumption response and the response predicted by the regression in light of the crisis events experienced by the household is taken to be a measure of the mitigation mechanism available to the household. If the mechanism is strong, the residual is negative – the household had to reduce its consumption by less than would be expected given what happened to it during the crisis. On the other hand, if it is weak – meaning a relatively large reduction in consumption – the residual will be positive.

Table 3.4 presents the results of a linear regression of support for markets and democracy on the crisis events index as well as on the households' smoothing mechanism measure. The first line of the table shows that a weaker mitigation mechanism (positive residual) led people to turn more against democracy and markets. This result holds for the transition region as a whole, new EU countries as well as the CIS sample in the case of support for markets. Only the preference for democracy in the CIS appears to be solely driven by the extent to which a household is impacted by exogenous crisis events, rather than by its capacity to shield its consumption as well.

Based on these results, government-provided safety nets would be expected to cushion the effect of the crisis on attitudes towards democracy and markets to the extent that they helped

Box 3.1

## Political development in corrupt countries: the crisis as a chance for democracy and markets?

In 2006 support for markets and democracy was lower in countries with the weakest institutions, which, then and now, also experience the highest levels of corruption and are lagging behind in terms of liberal reforms. However, in 2010 the picture was reversed and support for democracy and markets had increased a great deal in such countries, in contrast with limited progress on the path of reform. Turning against existing institutions when hit by the crisis only partly explains the increase of support for democracy and markets by respondents in these countries and particularly in the CIS. This box illustrates another phenomenon. The increase in support for democracy and markets has been particularly strong in the countries with the highest perceived levels of corruption, and among segments of the population that were most excluded from the political-economic system in place, namely the young and unemployed.

Previous research has found that corruption affects attitudes towards free markets. Even though "capitalism" is the system most conducive to growth, there are persistent negative attitudes towards it in developing countries. There is also evidence that high levels of corruption are associated with support for left-leaning policies. According to Di Tella and MacCulloch,[6] a reason for this is that when people perceive capitalists as being corrupt, they are more inclined to favour policies that limit their activities. In countries with weak institutions and limited checks and balances on politicians, anti-market policies appear as the solution to limit the freedom of capitalists and, in turn, political capture. In such countries, people who believe that there are high levels of corruption are less likely to support free markets in order to constrain capitalism. However, an unintended consequence of anti-market policies is that they may ultimately hurt the economic interests of the majority and in particular of those most excluded from the political-economic system: the young and unemployed, as well as those who would most benefit from more open societies and freer markets, such as mobile individuals.

An economic crisis may lead people to realise that such a system is not optimal and generate a strong reaction against statist policies and in favour of free markets and, possibly, democracy. On this basis, one would expect people who perceive high levels of corruption and live in countries with weak institutions to become more supportive of the market as they are hit by the crisis,

Table 3.1.1
**Impact of corruption on support for democracy and free markets**

| Region | Transition | | | | CIS | | | | New EU | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Dependent variable | Democracy | | Free market | | Democracy | | Free market | | Democracy | | Free market | |
| Group | All [1] | Young [2] | All [3] | Young [4] | All [5] | Young [6] | All [7] | Young [8] | All [9] | Young [10] | All [11] | Young [12] |
| Crisis consumption response | -0.0219*** | -0.0147* | -0.0265*** | -0.0284*** | -0.0204** | -0.0138 | -0.0373** | -0.0299 | -0.0242*** | -0.00839 | -0.0297*** | -0.0449*** |
| | (0.00412) | (0.00792) | (0.00668) | (0.0102) | (0.00722) | (0.0116) | (0.0121) | (0.0169) | (0.00414) | (0.0141) | (0.00509) | (0.0123) |
| Corruption | -0.0132* | -0.0254** | -0.00748 | -0.0124 | -0.0128 | -0.0143 | 0.00174 | 0.0118 | -0.0123 | -0.0531* | -0.00854 | -0.0468 |
| | (0.00769) | (0.0105) | (0.00820) | (0.0131) | (0.0133) | (0.0159) | (0.00957) | (0.0160) | (0.0157) | (0.0278) | (0.0143) | (0.0263) |
| Crisis consumption response* corruption | 0.00641 | 0.0137** | 0.00575 | 0.0184** | 0.0152** | 0.0247*** | 0.0159** | 0.0335*** | -0.00783 | -0.0129 | 0.00170 | 0.0223 |
| | (0.00449) | (0.00532) | (0.00484) | (0.00817) | (0.00607) | (0.00455) | (0.00616) | (0.00839) | (0.0102) | (0.0254) | (0.00823) | (0.0174) |
| Constant | 0.632*** | 0.657*** | 0.410*** | 0.310*** | 0.676*** | 0.559*** | 0.442*** | 0.250*** | 0.288*** | 0.604*** | 0.193*** | 0.401*** |
| | (0.0226) | (0.0309) | (0.0215) | (0.0382) | (0.0530) | (0.0725) | (0.0452) | (0.0649) | (0.0234) | (0.0504) | (0.00789) | (0.0590) |
| Observations | 27664 | 7101 | 26840 | 6886 | 10097 | 2779 | 9855 | 2719 | 9248 | 1815 | 8989 | 1742 |
| Adj. R-squared | 0.082 | 0.053 | 0.068 | 0.042 | 0.084 | 0.056 | 0.057 | 0.038 | 0.062 | 0.051 | 0.065 | 0.040 |
| Individual controls | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| Country fixed effects | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |

Sources: LiTS 2010.
Notes: Standard errors in parentheses are clustered at the country level. Estimation is done by OLS. The dependent variables are as follows: in regressions (1), (2), (5), (6), (9) and (10) Democracy, which is a dummy variable equal to 1 if respondent unequivocally prefers democracy to any other political system; in regressions (3), (4), (7), (8), (11) and (12) Free Market, which is a dummy variable equal to 1 if respondent unequivocally prefers the free market to any other economic system. Sample: all respondents within region listed for a particular regression. *** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

[6] R. Di Tella, and R. MacCulloch, "Why Doesn't Capitalism Flow to Poor Countries?", Brookings Papers on Economic Activity (Spring 2009), pp. 285-321.

compared with people who have been spared by the crisis. Such a reaction should be stronger for individuals who benefit less from the capitalist-constraining environment, either because the lack of free markets limits their own options – for instance, the young or the more geographically mobile – or because the system has failed them – such as the unemployed.

Table 3.1.1 presents results from multivariate linear regressions that confirm these expectations. The explanatory variables used in these regressions include, apart from the usual individual characteristics including the consumption-based crisis measure used in the earlier regression tables, a measure of corruption perceptions from the 2010 LiTS. Each respondent was asked how frequently, in their opinion, unofficial payments were made across a wide range of public services that are meant to be free – including traffic policing, public education and health care. The response scores from these categories (from 1 for "never" to 5 for "always") are averaged to produce a single measure of corruption perception for every individual.[7] In addition to the crisis and corruption measures, the regression also includes an interaction of the two. This reflects the combined effect of the perception of corruption and of being personally hit by the crisis.

The first four columns of the table summarise the models for the transition region as a whole. Regression results are presented in turn for the entire population and for those younger than 35 only. In additional specifications (not shown), the analysis proceeds in the same way, by considering the subsamples of the unemployed and of those who are geographically mobile.

Results in the first and third columns suggest that, for the entire population of the region, corruption tends to be negatively correlated with support for democracy. This is a weak confirmation of the hypothesis that corruption drives people to desire more restrictive economic and political systems so as to constrain capitalists. More importantly, the coefficients on the interaction term between the crisis impact and corruption is positive and significant in the second and fourth columns (but not in the first and third), where only the subsample of young people (younger than 35 years old) is considered. In other words, the young have significantly increased their support for democracy and markets as a response to the combined effect of high levels of corruption and being personally hit by the crisis. Similar results were obtained for the unemployed and for those who are geographically mobile (results not displayed here).

Columns [5] to [12] repeat these regressions in subsamples comprising countries of different levels of institutional quality, namely the CIS countries on the one hand and the new EU countries on the other. The mechanism described above is only expected to work in countries with low institutional quality, which leads to insufficient checks and balances to prevent capitalists from exerting political capture (this is what leads the majority to support state-oriented policies in the first place). Again, the results are in line with this expectation: as columns [5] and [6] show, the interaction term between crisis impact and corruption perceptions is positive and significant for entire populations only in the CIS countries. This is driven particularly by a very strong interaction effect for the young in the CIS (columns 7 and 8),[8] which also drives the impact among the young in the transition region as a whole. By contrast, the effect is never observed in countries with better quality institutions, such as the new EU members (see columns [9] to [12]).

[7] Some readers may be worried that perceptions of corruption are heavily correlated with respondents' attitudes to the political-economic system in general, and support for democracy and markets in particular. To address this issue, the regressions were also run using the number of times that respondents used public services as an instrumental variable for the perception of corruption. The validity of this instrument rests on the assumption that the use of public services is a good, and more objective (that is, uncorrelated with political attitudes), predictor of perceived corruption. All the results discussed above are robust to this alternative estimation method.

[8] Similarly, the effect is particularly strong for the other categories of people mentioned above, that is, the unemployed and the more geographically mobile (not shown in Table 3.1.1).

Table 3.4
## Impact of smoothing mechanisms on support for democracy and free markets

| Region | Transition | | New EU | | CIS | |
|---|---|---|---|---|---|---|
| **Dependent variable** | **Democracy [1]** | **Free market [2]** | **Democracy [3]** | **Free market [4]** | **Democracy [5]** | **Free market [6]** |
| Smoothing mechanism | -0.0190*** | -0.0245*** | -0.0236*** | -0.0254*** | -0.0144 | -0.0291** |
| | (0.00465) | (0.00601) | (0.00409) | (0.00539) | (0.00880) | (0.0115) |
| Crisis events | -0.0118** | -0.0101 | -0.0147*** | -0.0217** | -0.0120** | -0.0159* |
| | (0.00429) | (0.00611) | (0.00425) | (0.00723) | (0.00481) | (0.00835) |
| Constant | 0.629*** | 0.411*** | 0.319*** | 0.317*** | 0.686*** | 0.439*** |
| | (0.0234) | (0.0200) | (0.0219) | (0.0124) | (0.0565) | (0.0450) |
| Observations | 28312 | 27457 | 9428 | 9164 | 10382 | 10117 |
| Adj. R-squared | 0.082 | 0.068 | 0.063 | 0.066 | 0.083 | 0.058 |
| Individual controls | Yes | Yes | Yes | Yes | Yes | Yes |
| Country fixed effects | Yes | Yes | Yes | Yes | Yes | Yes |

Sources: LiTS 2010.
Notes: Standard errors in parentheses are clustered at the country level. Estimation is done by OLS. The dependent variables are as follows: in regressions (1), (3) and (5) Democracy which is a dummy variable equal to 1 if respondent unequivocally prefers democracy to any other political system; in regressions (2), (4) and (6) Free Market, which is a dummy variable equal to 1 if respondent unequivocally prefers the free market to any other economic system. Sample: all respondents within region listed for a particular regression. *** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

Table 3.5
## Impact of government programmes on support for democracy and free markets

| Region | Transition | | New EU | | CIS | |
|---|---|---|---|---|---|---|
| **Dependent variable** | **Democracy [1]** | **Free market [2]** | **Democracy [3]** | **Free market [4]** | **Democracy [5]** | **Free market [6]** |
| Crisis consumption response | -0.0207*** | -0.0255*** | -0.0240*** | -0.0279*** | -0.0164* | -0.0321** |
| | (0.00457) | (0.00635) | (0.00401) | (0.00467) | (0.00869) | (0.0118) |
| Apply for social assistance | 0.00000488 | 0.0242 | -0.0517 | -0.0117 | -0.0173 | 0.000550 |
| | (0.0168) | (0.0253) | (0.0336) | (0.0308) | (0.0218) | (0.0371) |
| Receive social assistance | 0.0110 | -0.0112 | 0.0810* | 0.0465* | -0.00551 | -0.0411 |
| | (0.0250) | (0.0262) | (0.0393) | (0.0219) | (0.0326) | (0.0390) |
| Apply for unemployment benefits | -0.0206 | -0.0144 | -0.0193 | -0.0399 | 0.00115 | 0.0310 |
| | (0.0181) | (0.0205) | (0.0417) | (0.0449) | (0.0355) | (0.0226) |
| Receive unemployment benefits | -0.0272 | -0.0376 | -0.0288 | -0.0189 | -0.0318 | -0.133* |
| | (0.0290) | (0.0261) | (0.0508) | (0.0511) | (0.0723) | (0.0617) |
| Constant | 0.653*** | 0.431*** | 0.349*** | 0.346*** | 0.704*** | 0.468*** |
| | (0.0244) | (0.0201) | (0.0199) | (0.0149) | (0.0593) | (0.0410) |
| Observations | 27861 | 27014 | 9255 | 8999 | 10201 | 9936 |
| Adj. R-squared | 0.083 | 0.068 | 0.064 | 0.068 | 0.083 | 0.058 |
| Individual controls | Yes | Yes | Yes | Yes | Yes | Yes |
| Country fixed effects | Yes | Yes | Yes | Yes | Yes | Yes |

Sources: LiTS 2010.
Notes: Standard errors in parentheses are clustered at the country level. Estimation is done by OLS. The dependent variables are as follows: in regressions (1), (3) and (5) Democracy, which is a dummy variable equal to 1 if respondent unequivocally prefers democracy to any other political system; in regressions (2), (4) and (6) Free Market, which is a dummy variable equal to 1 if respondent unequivocally prefers the free market to any other economic system. Sample: all respondents within region listed for a particular regression. *** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

households maintain their consumption in the face of crisis events. However, Chapter 2 finds that these safety nets were generally not very effective in the transition region. Did receiving these forms of assistance have an impact on peoples' attitudes to markets and democracy even when they did not make a material difference on the consumption response to the crisis reported by households? Table 3.5 presents the results of linear regressions that investigate the direct impact of such government programmes on political and economic system preferences, while controlling for the consumption response of these households. The LiTS asked respondents whether they sought unemployment, social assistance, child and housing benefits during the crisis and whether they were successful. The set of regressions in Table 3.5 controls for eight relevant variables – for each of the four benefit programmes it includes a dummy variable that equals 1 when the household applied for it and another dummy equalling 1 if the household was successful. In addition, it uses the same index of consumption crisis response that was included in Tables 3.1, 3.2 and 3.3. For conciseness, only results for unemployment and social assistance benefits are presented.[9]

No benefit programme had a significant direct impact on attitudes to political and economic systems in the transition region as a whole.[10] Among the new EU members, however, receiving social assistance did increase respondents' preferences for markets and democracy. The fact that these countries have high levels of democracy and free market development suggests that safety nets can help governments maintain support for the political and economic systems in place, at least to some extent.

Interestingly, within the CIS region, receiving unemployment benefits reduced support for free markets. While this coefficient has the opposite sign to the coefficient for social benefits in the new EU members, its interpretation may be very similar. CIS countries generally have rather undeveloped free markets. Here, it seems, the government can then also buy support for the system in place – by providing unemployment benefits. Their recipients are less likely to support free markets, that is, they are happier with the system in place.

Overall, these results suggest a general role for mitigation mechanisms in reducing the attitudinal crisis impact. They also confirm the direct role that governments can play in lessening the effect of economic downturns on people's preferences regarding political and economic systems. On a positive note, democracies and free market economies can bolster citizen support for the systems in place. Perhaps more negatively, people in countries with limited, or no, free markets can also be influenced to desire less change in their country's economic system as a result of a crisis.

## Conclusion

The 2010 LiTS reveals that preferences for political and economic systems in transition countries have changed significantly since the first round. Support for democracy and markets has dropped in many of the more advanced transition countries, but increased in some of the less-developed ones. The analysis in this chapter finds two main drivers for these diverging developments, and both relate to the recent crisis.

First, a higher crisis-induced reduction of consumption, especially relative to any past crisis experience, has driven people away from supporting markets and democracy. This may have occurred for a variety of reasons, including that they blamed these systems (or Western countries with these systems) for causing the crisis in the first place.

Second, people impacted by the crisis turned against the political and economic systems that they perceived to be in place in their own countries. Individuals who had been enjoying fuller freedoms at the time of the crisis tempered their preference for democracy and markets, while the popularity of markets and democracy rose in countries where such systems were less established.

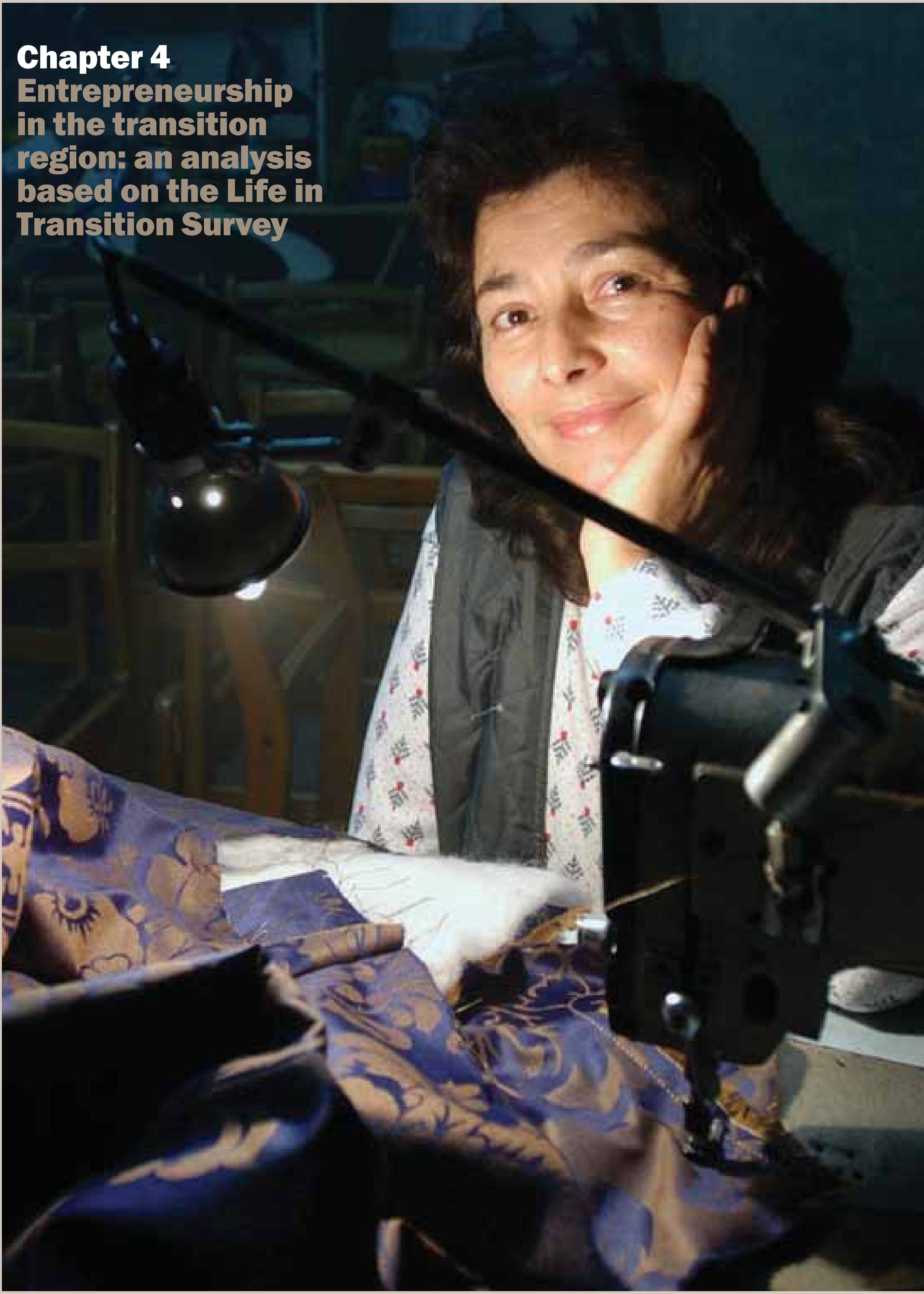
Governments can, to some extent, mitigate the effects of the above mechanisms on people's attitudes and help maintain support for prevailing political and economic systems. Social safety nets can limit a crisis-induced decrease in support for democracy and markets in freer countries. Perhaps less fortunately, however, they can also induce a drop in support for free markets in countries with constrained freedoms, thereby to some extent counteracting the crisis-induced increase.

## References

**R. Di Tella and R. MacCulloch (Spring 2009)**
"Why Doesn't Capitalism Flow to Poor Countries?", Brookings Papers on Economic Activity, pp. 285-321.

[9] Child and housing benefit variables are not statistically significant in these regressions. This is not entirely surprising, as they are the least likely to be applied for as a result of a crisis event.
[10] The actual importance, quality and efficiency of the four benefit programmes varies considerably across the transition subregions, which may contribute to this finding.

# Chapter 4
# Entrepreneurship in the transition region: an analysis based on the Life in Transition Survey



**Entrepreneurial activity is a key contributor to economic growth, innovation and the development of a market economy in transition countries. LiTS data reveal that financial sector development and access to credit are the most important drivers of entrepreneurship. Education is associated with a higher probability of trying to set up a business, but not with more entrepreneurial success. Women are less likely to attempt to set up a venture but no less likely to succeed than men once they try. Furthermore, entrepreneurial activity develops in clusters. An individual is more likely to try – and succeed – in setting up a business in a region that is already home to many entrepreneurs.**

**Entrepreneurial attempts and success in the transition region**

13%

**of people have** tried to set up a business

65%

**of people have succeeded** in setting it up once they tried – 20 percentage points below the West

51%

**of people failed to set** up a business because of insufficient capital

# Entrepreneurship in the transition region: an analysis based on the Life in Transition Survey

The success of a transition economy is linked closely to entrepreneurial activity. In economies in the early stages of transition, entrepreneurship is an important ingredient of structural change, since new domestic business (in addition to foreign direct investment) is essential to create industries that did not exist, or to revitalise those that were stagnant, under socialism.[1] Research also shows that sales and employment grow faster in entrepreneurial ventures than in state or privatised firms and that new businesses are more efficient.[2] In more advanced countries, including the new EU members,[3] entrepreneurship is likely to be an indispensable ingredient of a sustainable growth model that emphasises innovation rather than booms in consumption and investment in non-tradeable sectors fuelled by debt inflows. Also, entrepreneurial ventures may be an effective way to mitigate income shocks associated with economic crises, by providing households with an alternative source of employment.

This chapter analyses the determinants of entrepreneurship in the EBRD's countries of operations using data from the 2010 round of the Life in Transition Survey (LiTS). Its conclusions are partly in line with previous cross-country research, but also provide some surprises and new findings. In particular, the results confirm that development of the financial sector and access to credit are important determinants of entrepreneurial success. At the individual level, the analysis suggests that more education is associated with a higher propensity to start a business, although not with a higher likelihood of success. The chapter also finds that entrepreneurship is linked to individual attitudes, such as a willingness to take risks, and that women, although less likely to attempt to set up a business, are no less likely to succeed than men when they try to be entrepreneurs. This may argue for policies targeted at encouraging potential female entrepreneurs.

The evidence in this chapter also supports the theory that entrepreneurial activity develops in clusters. In regions where such activity is more prevalent, individuals appear more likely to try to set up a business and to succeed in doing so. Whether this reflects a positive "spillover" effect from existing entrepreneurial activity or simply the fact that some regions provide a better environment for entrepreneurs cannot be conclusively answered in this chapter, although the analysis suggests that the former impact may be present, at least to some degree.

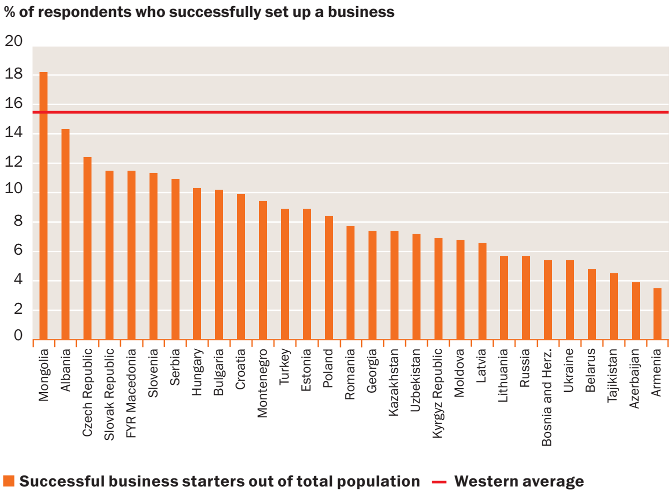
The chapter also examines *necessity* entrepreneurship, in which individuals are forced to create small businesses because of the lack of formal employment, and *opportunity* entrepreneurship, where they instead act on ideas and profit opportunities. Businesses in the former category will be less likely to innovate, thus having a limited positive impact on economic growth (although evidence shows they are not detrimental to it). The LiTS data demonstrate that similar individual, regional and country-wide features contribute to the likelihood of trying and being successful in starting a business among opportunity entrepreneurs and the wider entrepreneurial population. Based on this analysis, policy-makers should not worry about the possibility of encouraging the *wrong* kind of entrepreneurship: supporting all business starters should translate into higher activity among opportunity entrepreneurs.

Lastly, the chapter cautions that certain policies which are found to positively affect entrepreneurship across the transition region as a whole may in fact have the opposite, or a weaker, impact in individual countries. For example, in the countries that are part of the Commonwealth of Independent States (CIS),[4] increasing the proportion of the population that has completed secondary and tertiary education may actually have a detrimental effect on entrepreneurial success among those respondents who tried to start a business. The chapter argues that in the CIS, increasing the quality, rather than quantity, of education, may be relevant.

## An initial examination of the data

The main data source for this chapter is the 2010 LiTS, in which individuals were asked if they had ever tried to start a business. If so, they were also asked when they last tried and whether they

Chart 4.1
**Mongolia is the only transition country with more successful business start-ups than the Western average**




Source: LiTS.
Note: For each country, this graph plots the proportion of the population who successfully set up a business. The horizontal red line indicates the average of the Western comparator countries (France, Germany, Italy, Sweden and the United Kingdom).

[1] See Berkowitz and DeJong (2004).
[2] See McMillan and Woodruff (2002).
[3] The new EU members are Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.
[4] The CIS group includes Armenia, Azerbaijan, Belarus, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

succeeded, and if not, why not. These data are complemented by information on characteristics ranging from respondents' wealth and education levels to their perceptions of corruption and trust in others and in their countries' institutions.[5]

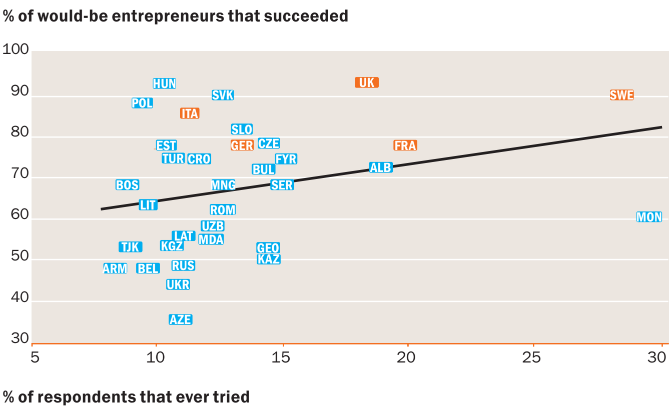
Chart 4.1 shows that the proportion of successful business starters is much lower in the transition region than in the Western comparator countries included in the LiTS.[6] In most transition countries this proportion is less than the Western average of 16 per cent (ranging from just over 3.5 per cent in Armenia to more than 14 per cent in Albania). The only exception is Mongolia, where the figure is slightly over 18 per cent, for reasons that are explored in detail in Box 4.1.

The proportion of successful entrepreneurs shown in Chart 4.1 is the product of two components: the rate at which a respondent tries to start a business, and the rate at which he or she succeeds, conditional on trying.[7] Chart 4.2 shows that there is a positive correlation between the proportion of respondents who ever tried to start a business and those who succeeded once they tried. Countries with frequent entrepreneurial start-up attempts also tend to be countries in which would-be entrepreneurs are more likely to be successful. The chart also demonstrates that the trial rate does not vary widely across Western and transition countries, with the exception of Sweden and Mongolia. However, the entrepreneurial success rate varies considerably between the Western comparator countries and the transition region, as well as within the region. While approximately 13 per cent of would-be entrepreneurs tried to start a business in Germany and the Kyrgyz Republic, the German success rate was almost 78 per cent compared with only 53 per cent in the Kyrgyz Republic. Similarly, although respondents in Kazakhstan and Slovenia were equally likely to try to start a business, Slovenians were nearly 30 percentage points more likely to succeed.

Are these differences related to cross-country variation in the level of economic development? Charts 4.3a and 4.3b plot the country-level entrepreneurial trial and success rates, respectively, against GDP per capita. While the proportion of people who attempted to start a business is not correlated with per capita income, economic development seems to be associated with a higher likelihood that would-be entrepreneurs will succeed. This may mean that richer countries provide a better environment for successful entrepreneurship, or, alternatively, that countries that foster successful entrepreneurship stand a better chance of becoming wealthy. Country wealth is probably correlated with other country-level characteristics that may have an impact on entrepreneurship, such as financial development and the quality of institutions. In addition, the individual characteristics of respondents may matter, as well as regional-level controls. The next section shows that when all these factors are taken into account, there is no longer a positive effect of GDP per capita on entrepreneurship.

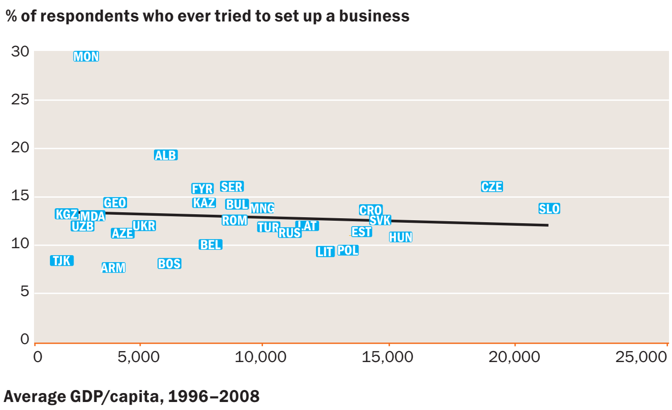
Chart 4.4 indicates that insufficient capital was the most frequently cited reason for entrepreneurial failure in both the transition region and the Western comparators, and even more so in the transition countries. This could either be because individuals and their families did not have enough funds to successfully start a business, or because respondents lived in

Chart 4.2
**Business start-up trial and success rates are correlated**




Source: LiTS.
Note: For each country, this graph plots the proportion of respondents who ever tried to set up a business against the proportion of those who were successful starters.

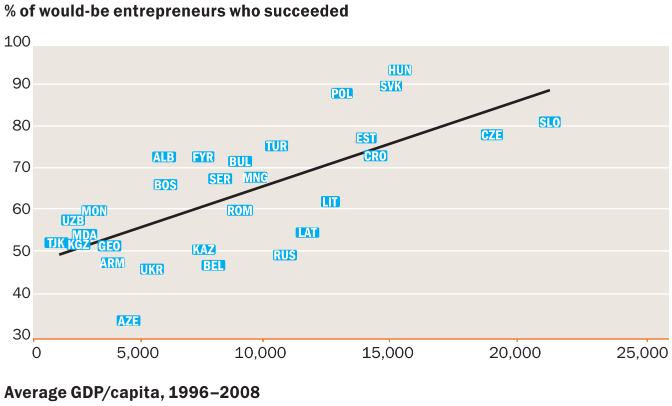
Chart 4.3a
**Entrepreneurial trial rate is largely unrelated to income per capita**




Source: LiTS.
Note: For each country, this graph plots the proportion of the population that has ever tried to set up a business against the 1996-2008 average of GDP per capita, and includes a trend line.

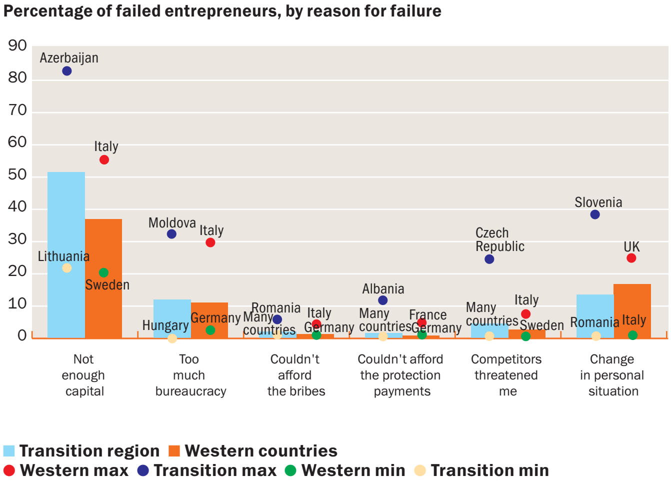
[5] Some of these data have already been used in previous chapters of this report. See Annex 4.1 for a full list and definitions of individual, country and regional variables, both from the LiTS and from other sources.
[6] These are France, Germany, Italy, Sweden and the United Kingdom.
[7] In other words, the share of successful business starters out of the whole population is a simple product of the share of people who try to set up a business out of the whole population and the share of those who succeed in setting it up out of the subset of people who have tried.

## Chart 4.3b
### The success rate of business start-ups is strongly correlated with income per capita



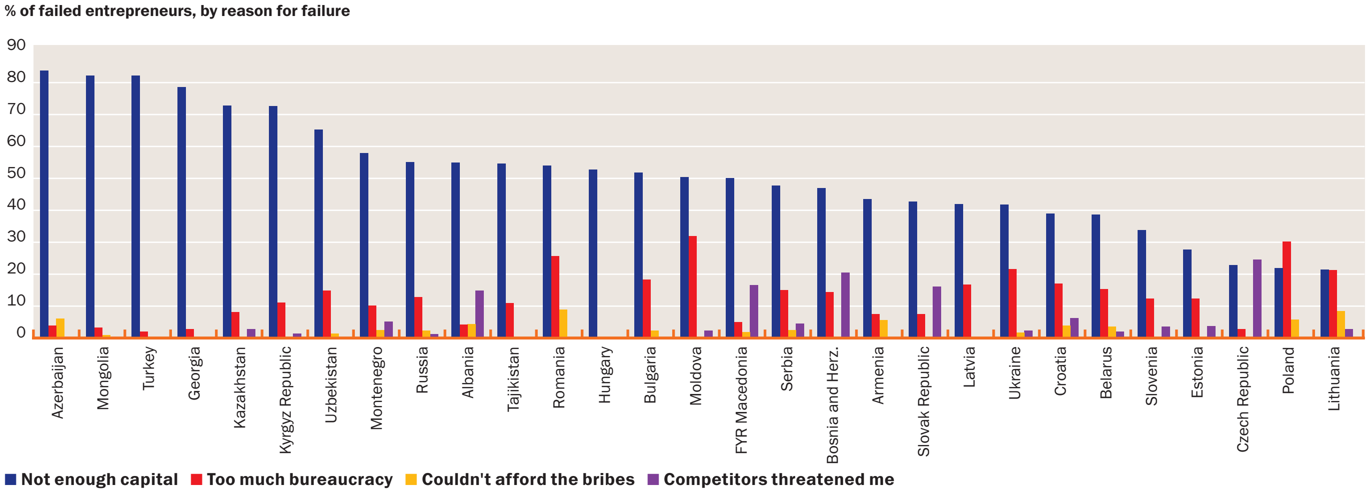

Source: LiTS.
Note: For each country, this graph plots the proportion of successful business starters out of those who tried against the 1996-2008 average of GDP per capita, and includes a trend line.

## Chart 4.4
### Insufficient capital is the most frequently cited reason for failing to set up a business




Source: LiTS.
Note: This graph compares the transition region with the five Western comparator countries. For each cited reason, the proportion of respondents who listed that specific reason for not managing to set up a business is calculated against all respondents who tried to set up a business and failed.

## Chart 4.5
### Insufficient capital is a problem for over 80 per cent in Azerbaijan, Mongolia and Turkey




Source: LiTS.
Note: For each country, this graph plots the proportion of respondents who listed a specific reason for not managing to set up a business, calculated against all respondents who tried to set up a business and failed.

regions or countries with underdeveloped financial systems, making it harder for would-be entrepreneurs to borrow. Bureaucratic impediments were the next most commonly cited reason for failing to set up a business. The relative importance of these constraints differs across transition countries (see Chart 4.5). While the threat from competition was reported as the principal reason for business failure in the Czech Republic, over 80 per cent of unsuccessful entrepreneurs in Azerbaijan, Mongolia and Turkey cited capital constraints.

## Main regression analysis

The remainder of this chapter employs multivariate regression techniques to jointly analyse the impact of individual, regional and country-level characteristics on entrepreneurship (see Annex 4.1 for a summary of the techniques used). The focus is on what determines the likelihood that a household will report a successful attempt to start a business – and on the two steps that lead to this outcome: (i) why respondents try to start a business; and (ii) why they are successful in the venture, compared with others who try but fail. The results for (i) and (ii) can help identify relevant policies that may encourage either more start-up attempts or make it easier for would-be entrepreneurs to succeed. At the same time, studying the determinants of overall entrepreneurial success can be useful for policy-makers who want to know the combined impact of a factor that may affect both the propensity to try to start a business and the probability of success.

The results presented in Table 4.1 point to a number of drivers of entrepreneurial activity. Interestingly, factors that contribute to a higher likelihood of an individual trying to set up a business do not necessarily increase his or her chances of success, and vice versa. It seems that there is no single factor that increases both the entrepreneurial trial and success rates in the transition region, and that multiple approaches are necessary to help raise the number of successful start-ups. The policy implications are discussed in the conclusion of this chapter.

The first three columns in Table 4.1 present results from regressions including only country-level and individual variables. In columns [4], [5] and [6] the analysis is augmented with regional-level variables. There is a strong *a priori* case for having regional variables in the regression: for example, institutional quality varies across regions rather than just at the country level, and regional clusters of entrepreneurs may make it easier for new entrepreneurial activity to develop. However, for many of these regional variables – particularly variables capturing institutions – there are no reliable data sources. The only means of measuring these factors is by aggregating the views of LiTS respondents located in a particular region. This in turn could be a source of error, because the LiTS was designed to be representative at the country rather than the regional level.[8] Each of these two approaches – a regression model that includes possibly mismeasured regional variables, and one that ignores the regional dimension altogether – is imperfect, but considering both allows for a comparison of the results and their robustness.

### Individual-level characteristics

Some of the most interesting results in Table 4.1 relate to the determinants of entrepreneurship measured at the individual level by the LiTS, including: the ability to access capital; income; education; gender; perceptions about the institutional environment; demographic variables; and individual attitudes. These results are largely consistent across the two types of regressions considered in the table, in that they are not significantly affected by the presence of regional variables. These findings are summarised below.

#### *Access to capital, income and wealth*

The LiTS asked all individuals who tried to set up a business whether they had attempted to borrow money for the venture, and if so, whether they had obtained a loan. Access to capital emerged as the single strongest predictor of an entrepreneur's success. Individuals who tried to start a business and were able to borrow from a bank, non-governmental organisation (NGO), microfinance institution or from informal sources were 14-15 percentage points more likely to be successful, compared with those who did not try to borrow. In contrast, respondents who were unable to borrow from any of these sources were 30-36 percentage points more likely to experience business failure, relative to the same reference group. The success rate was therefore highest among those who sought, and managed, to borrow during their start-up attempt, followed by those business starters who did not try to borrow (presumably because their own savings or income were deemed sufficient to finance their plans), and lowest for those who attempted to borrow and failed.

Importantly, the large variations in the probability of business success across these groups are likely to reflect the effect of access to borrowing *per se* as well as the fact that individuals who tried to borrow but were rejected may have had a less worthy business idea than those who were granted a loan. The analysis cannot distinguish between these two effects, although country-level results on financial development (see below) suggest that the access to finance effect must have been present.

Household income and wealth also appear to be important determinants of entrepreneurial activity. However, they are difficult to measure and their effect appears to be weaker than that of access to finance. Income and wealth at the time of the survey likely do not represent well those variables measured at the time of the business attempt. Therefore, the father's education level and the respondent's membership of the Communist Party[9] are used as proxies for individual income at the time of the entrepreneurial attempt (the latter may also capture the importance of social networks in addition to income).[10] Table 4.1 shows that individuals who were richer and better socially connected at the time of their last start-up attempt were more likely to pursue an entrepreneurial activity, but the effects are not estimated precisely. In particular, a respondent who was a member of the Communist Party was about 3.0 percentage points more likely to try to start a business, and about

[8] Comparable regional data for all of the EBRD's countries of operations included in the survey are unavailable from any other sources. In addition, regional LiTS data have been used in other published studies (see Grosjean, 2011).

[9] Both of these measures are very likely to be correlated with the income and wealth of a respondent at any point in his or her life, including at the time when he or she may have tried to start a business.

[10] Djankov et al. (2005, 2007 and 2008) use both of these measures in analyses of entrepreneurship in Russia, China and Brazil.

Table 4.1
## Entrepreneurial trial and success rates

| | With individual and country controls | | | With individual, country and regional controls | | |
|---|---|---|---|---|---|---|
| **Dependent variable** | **Trial [1]** | **Success \| Trial [2]** | **Success [3]** | **Trial [4]** | **Success \| Trial [5]** | **Success [6]** |
| **Individual variables** | | | | | | |
| Borrowed successfully | | 0.147*** | | | 0.140*** | |
| | | (0.018) | | | (0.017) | |
| Borrowed unsuccessfully | | -0.363*** | | | -0.302*** | |
| | | (0.031) | | | (0.027) | |
| Father's education | 0.001 | 0.004 | 0.002 | 0.002** | 0.004 | 0.002** |
| | (0.001) | (0.003) | (0.001) | (0.001) | (0.003) | (0.001) |
| Member Communist Party | 0.031* | 0.038 | 0.022* | 0.032** | 0.058* | 0.025** |
| | (0.016) | (0.033) | (0.011) | (0.015) | (0.031) | (0.011) |
| Secondary education | 0.030*** | -0.004 | 0.022*** | 0.025** | 0.017 | 0.020** |
| | (0.009) | (0.040) | (0.008) | (0.010) | (0.033) | (0.008) |
| Bachelor or Master's education | 0.066*** | 0.017 | 0.048*** | 0.053*** | 0.050 | 0.043*** |
| | (0.012) | (0.046) | (0.010) | (0.013) | (0.037) | (0.010) |
| Good health | -0.002 | 0.103*** | 0.013* | -0.004 | 0.080** | 0.009 |
| | (0.008) | (0.038) | (0.007) | (0.006) | (0.035) | (0.006) |
| Male | 0.064*** | -0.012 | 0.040*** | 0.065*** | -0.009 | 0.039*** |
| | (0.009) | (0.016) | (0.008) | (0.008) | (0.019) | (0.007) |
| Age | 0.009*** | | 0.006*** | 0.009*** | | 0.006*** |
| | (0.001) | | (0.001) | (0.001) | | (0.001) |
| Age^2 | -0.000*** | | -0.000*** | -0.000*** | | -0.000*** |
| | (0.000) | | (0.000) | (0.000) | | (0.000) |
| Age at trial | | 0.001 | | | 0.001 | |
| | | (0.002) | | | (0.002) | |
| Age at trial^2 | | -0.000 | | | -0.000 | |
| | | (0.000) | | | (0.000) | |
| Vote | 0.017* | 0.041* | 0.015** | 0.017** | 0.022 | 0.015** |
| | (0.009) | (0.021) | (0.007) | (0.008) | (0.020) | (0.006) |
| Urban | 0.005 | -0.013 | 0.001 | 0.000 | -0.006 | 0.001 |
| | (0.009) | (0.017) | (0.008) | (0.007) | (0.015) | (0.006) |
| Willingness to move | 0.057*** | -0.076*** | 0.020** | 0.051*** | -0.068*** | 0.015* |
| | (0.010) | (0.020) | (0.009) | (0.009) | (0.016) | (0.009) |
| Risk score | 0.020*** | 0.019*** | 0.017*** | 0.021*** | 0.020*** | 0.017*** |
| | (0.002) | (0.006) | (0.002) | (0.002) | (0.005) | (0.002) |
| Trust score | -0.001 | 0.001 | -0.000 | -0.002 | -0.000 | -0.001 |
| | (0.003) | (0.010) | (0.002) | (0.002) | (0.009) | (0.002) |

| | | | | | | |
|---|---|---|---|---|---|---|
| **Country variables** | | | | | | |
| # Bank branches / 1,000 pop, 1996-2008 | 0.293* | 0.191 | 0.206* | -0.044 | 0.017 | -0.052 |
| | (0.168) | (0.202) | (0.122) | (0.047) | (0.069) | (0.045) |
| ln(GDP/capita), 1996-2008 | -0.029* | 0.011 | -0.017 | -0.015* | -0.012 | -0.011* |
| | (0.015) | (0.034) | (0.011) | (0.008) | (0.013) | (0.006) |
| Procedures start business, 2004-11 | -0.010*** | -0.011 | -0.007*** | -0.002 | -0.000 | -0.000 |
| | (0.004) | (0.009) | (0.003) | (0.002) | (0.002) | (0.002) |
| National average corruption | -0.005 | -0.058 | -0.010 | -0.007 | -0.022** | -0.007 |
| | (0.014) | (0.069) | (0.016) | (0.009) | (0.009) | (0.007) |
| National average liberties | 0.001 | 0.024*** | 0.004*** | 0.002** | 0.005** | 0.003*** |
| | (0.002) | (0.005) | (0.001) | (0.001) | (0.002) | (0.001) |
| Standard deviation of inflation, 1996-2008 | 0.013** | 0.017 | 0.012** | -0.007* | 0.002 | -0.003 |
| | (0.005) | (0.022) | (0.005) | (0.004) | (0.006) | (0.003) |
| Exports, 1996-2008 | 0.067 | -0.002 | 0.031 | 0.058*** | 0.041 | 0.022 |
| | (0.083) | (0.169) | (0.068) | (0.020) | (0.041) | (0.017) |
| Trademarks, 1996-2008 | -0.018 | 0.023 | -0.006 | -0.003 | -0.005 | 0.002 |
| | (0.016) | (0.038) | (0.013) | (0.005) | (0.011) | (0.004) |
| **Regional variables** | | | | | | |
| Regional average trial | | | | 0.988*** | 0.040 | 0.664*** |
| | | | | (0.044) | (0.046) | (0.069) |
| Regional average success | | | | -0.006 | 0.946*** | 0.114*** |
| | | | | (0.009) | (0.036) | (0.018) |
| Regional demeaned corruption | | | | -0.014** | -0.010 | -0.010** |
| | | | | (0.006) | (0.014) | (0.005) |
| Regional demeaned liberties | | | | 0.000 | 0.002 | 0.001 |
| | | | | (0.001) | (0.002) | (0.001) |
| Regional average relative wealth | | | | -0.015*** | -0.007 | -0.009** |
| | | | | (0.004) | (0.007) | (0.004) |
| **Respondents completing interview** | 19,650 | 2,784 | 19,650 | 19,541 | 2,784 | 19,541 |
| **R squared** | 0.074 | 0.161 | 0.059 | 0.101 | 0.253 | 0.082 |

Source: LiTS, World Development Indicators, Doing Business, EBRD Banking Survey.
Note: Standard errors in parentheses are clustered at the country level. Estimation is done by OLS. The dependent variables are as follows: in regressions (1) and (4) Trial, which is a dummy variable equal to 1 if the respondent has ever tried to set up a business; in regressions (2) and (5) Success | Trial, which is a dummy variable equal to 1 if the respondent has tried and succeeded in setting up a business; in regressions (3) and (6) Success, which is a dummy variable equal to 1 if the respondent has succeeded in setting up a business, regardless if he or she has tried or not.
Sample: respondents from all transition countries. *** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

2.5 percentage points more likely to be successful, relative to the total population (see columns [1], [3], [4] and [6]).

Taken together, these results highlight the importance of financial development, economic development and social capital in encouraging entrepreneurial activities. The three processes are intertwined, as financial development has been shown to lead to growth, while social capital is related to differences in economic development.[11]

### *Education and health*

Table 4.1 shows that education positively affects the probability of trying to be an entrepreneur, but does not have a significant effect on the likelihood that a business start-up will be successful. Respondents who completed secondary school were about 2.2 to 3.0 percentage points more likely to try to set up a business than those with only primary or no education. A completed university education (Bachelor or Master's degree) raised this probability to between 5.3 and 6.6 percentage points (columns [1] and [4]). These effects feed through to the overall rate of successful business start-ups (columns [3] and [6]), raising it by about 2.0 and 4.8 percentage points, respectively.

Education is likely to be a proxy for other individual characteristics that encourage entrepreneurial attempts, such as greater self-confidence or perceived ability. Formal education may be less important when it comes to success. In itself, it may not teach people the business acumen necessary for success, and may not be necessary for the particular types of businesses that LiTS respondents operate. For example, an entrepreneur wishing to establish a beauty salon may not require secondary or university education in order to successfully set up the business.

The results also indicate a fairly prominent role for health. According to the analysis, respondents who consider themselves to be in good health are 8.0 to 10.3 percentage points more likely to be successful, conditional on trying. The effect on overall entrepreneurial success (taking into account trying) is smaller however, and only marginally statistically significant.

### *Demographic and social variables*

The analysis also considers the impact of gender, age, whether a respondent voted in the previous election, and urban residence. The likelihood of voting is included as it may be correlated with several omitted individual characteristics relevant to entrepreneurship.[12]

Men are more likely to try to start a business, but female entrepreneurs are equally likely to succeed. Table 4.1 shows that when it comes to the trial rate, the gender difference is 6.5 percentage points, but there is no significant difference when success, conditional on trying, is considered. There could be several reasons why women might be less willing to try entrepreneurial activities: they may have alternative working preferences (due to child care considerations, for example), or they may anticipate discrimination when it comes to taking out a loan. Even though men are no more likely to succeed in business than women who try, the higher trial rate among men translates to a higher proportion (by about 4 percentage points) of successful male business starters in the population as a whole.

At the individual level, the analysis reveals that age has an inverted U-shape effect on the likelihood of having ever tried to start up a business. The likelihood increases until about the age of 50 and drops off after that. Since the cumulative probability of having tried to start a business increases over time, this suggests that relatively younger individuals are more likely to attempt an entrepreneurial venture. Also, respondents who voted in the previous election are around 2 percentage points more likely to attempt to start a business, and 2.2 to 4.1 percentage points more likely to succeed, although the effects are not estimated precisely.

### *Individual attitudes*

Risk-tolerant respondents are more likely to both try and succeed at starting a business. The correlation is quite large and highly statistically significant. For example, the 5 per cent of LiTS respondents who reported a maximum willingness to take risks (on a 1 to 10-point scale) tended to be around 10 percentage points more likely to both try and succeed in starting a business than those who reported only an average willingness (just under 5 on the scale).

Willingness to relocate also has a positive effect on trying to start a business (despite a negative effect on success), raising the probability of successful entrepreneurship by about 2 percentage points. People who are willing to make sacrifices for their business idea may be more likely to try to start a business but, once they have successfully launched it, they may be less inclined than others to move from their current location. This would explain the lack of a positive correlation between the willingness to move and success, conditional on trying.

Lastly, trusting other people does not seem to have an independent impact on entrepreneurial activities in the transition region.

## Country-level variables

Many of the individual-level characteristics discussed above also reflect country-level factors, such as the level of financial development, the quality of institutions, the quality of the educational system, or the general wealth of the country. As a result, these factors are influenced by country-level policies.

There are, nonetheless, two reasons why including additional direct measures of country-level variables may contribute to the analysis. First, individual perceptions and experiences are not the only, and not necessarily the best, measures of country-level factors that influence entrepreneurship. For example, if a would-be entrepreneur cannot obtain financing, this could either reflect a poorly developed financial system or a weak business idea, or both. Second, several aspects of the national business environment that might affect entrepreneurship may not have been captured by any of the individual characteristics considered

[11] See Arcand, Berkes and Panizza (2011) and Putnam (1993).
[12] Research has shown that voting is correlated with a multitude of individual-level characteristics that are not fully captured by the LiTS survey, including race, class, and ability.

thus far. This includes some institutional factors for which there is perception-based data in the LiTS itself, such as corruption, but also aspects of the business environment for which there is data from other sources (including the World Development Indicators, the Doing Business database and the EBRD Banking Survey), such as macroeconomic stability, the size of export markets, the degree of technological development within a country and the bureaucratic obstacles in setting up a new business.

Accordingly, the following country-level variables are considered: (i) the number of bank branches relative to the population as a country-level proxy of financial development;[13] (ii) macroeconomic variables, such as the standard deviation of inflation, exports as a share of GDP, and the number of trademarks per 10,000 people; and (iii) institutional measures, including corruption and civil liberties (both measured by individual perceptions from the LiTS itself),[14] and the number of administrative procedures necessary to start a business. In addition, per capita income is included as a general control. With the exception of the variables that are derived from LiTS responses, all variables are included in the form of long-run (1996-2008) averages, in line with the fact that the entrepreneurial experiences of LiTS respondents may stretch well back in time (given that they were asked whether they had *ever* tried to set up a business).[15]

The main outcome is that few of these country-level variables appear to have statistically significant effects that are consistent across specifications. The main exceptions are institutional variables. A 10-percentage point rise in the civil liberties index has a significant impact on the probability of business success ranging between 0.5 and 2.4 percentage points, while the effect of this variable on the entrepreneurial trial rate is smaller but still positive. Most other institutional variables, such as the number of procedures required to start a business and average corruption perceptions, also work in the expected direction, although they are statistically significant only in some regressions.

Financial development, as proxied by the penetration of bank branches, appears to have a large influence in the expected direction in regressions [1] and [3], but this is only marginally statistically significant and disappears when regional controls are included. Among the macroeconomic controls, only the coefficient on the share of exports out of GDP has the expected positive sign across most specifications, but the magnitude of the effect is small and statistically significant only in regression [4]. Lastly, GDP per capita appears to have a negative effect on the rate at which entrepreneurs try to start a business. However, this is only marginally statistically significant in regressions [1], [4] and [6] and not significant in the remaining specifications.

The results for GDP per capita are not necessarily surprising. Many of the variables that might generate the positive correlation between per capita income and entrepreneurship in the raw data – such as financial development, institutional quality, education and health – are already taken into account in the regression. The fact that the coefficient on per capita GDP turns negative in the presence of these variables may be because richer countries have fewer necessity entrepreneurs (see below). Similarly, the statistically weak effect of bank penetration may be because access to finance is already measured at the individual level in the regression. Lastly, the weak effect of macroeconomic variables could be due to the fact that, as long-run averages, they are poor proxies for the environment prevailing at the time of a particular start-up attempt. Alternatively, these factors might be of secondary importance for new businesses, at least for the range of average values prevailing in transition countries during the 1996-2008 period, which was characterised by stability and steady growth in many countries.

### Regional-level variables

At the regional level, the analysis presented in Table 4.1 focuses on two main questions. First, does a larger presence of entrepreneurs in a specific region induce more would-be entrepreneurs to attempt to set up businesses in that region, and does it increase their likelihood of success? This is referred to as regional *cluster effects*.[16] Second, is there institutional variation at the regional level which affects entrepreneurship in the direction suggested by the country-level variables? Both of these effects appear to be present, with sometimes surprising strength.

To check for regional cluster effects, regional average success and trial rates were calculated from the individual LiTS responses and added to the list of explanatory variables. Table 4.1 shows that respondents are more likely to try setting up a business in regions that have a higher average trial rate, and are also more likely to succeed in regions that have a higher average success rate. The magnitude of these effects is large: a 10 percentage point rise in the regional trial rate makes respondents 9.9 percentage points more likely to try to start a business, and there is a nearly identical effect of the regional success rate on the individual likelihood of success, conditional on trying (columns [4] and [5]). This could suggest either that there are positive spillovers from existing entrepreneurial activity, or that cluster effects may be indicative of other regional-level factors that encourage entrepreneurship but are not explicitly measured in the analysis.

To study the potential effects of regional institutions, the analysis includes two variables capturing the differences in average perceptions of corruption and civil liberties, respectively, between LiTS respondents living in a particular region and the country as a whole. The results suggest that corruption perceptions at the regional level have a significant effect on discouraging would-be entrepreneurs: a 10 percentage point rise in regional corruption, relative to the country average, decreases the probability of an entrepreneurial attempt by 1.4 percentage points and that of a successful venture by 1.0 percentage point (columns [4] and [6]). In contrast, deviations (from the country mean) in the perception of civil liberties at the regional level do not seem to have an impact. This is perhaps because there is not much variation in these liberties at the regional level, and

[13] This variable is averaged over the period 1996-2008 and is from the EBRD Banking Survey.
[14] Since the LiTS is representative at the country level, individual perceptions of corruption and the extent to which formal institutions exist can be aggregated at the country level and included in the regressions.
[15] Due to data availability, the variable measuring the average number of procedures required to start a business is averaged over the period 2004-11.
[16] See Giannetti and Simonov (2009), and Chen et al. (2010).

because their influence is already largely captured by the (highly statistically significant) national-level variable.

In addition, the results show that regional income, measured using aggregated individual measures of relative wealth,[17] is again inversely related to entrepreneurial outcomes. As before, the interpretation for this may be that richer regions have fewer necessity entrepreneurs.

The contribution of regional variables to the explanatory capacity of the analysis can be gauged by comparing the *R squared*, which expresses the proportion of the overall variation in entrepreneurship that is attributable to the explanatory variables, in the regressions with and without the relevant variables. Without regional variables, this share is low (as is typical for household data): for example, only about 7.4 per cent in the trial regression (column [1]) and 16.1 per cent in the success regression (column [3]). With regional variables, these shares increase to 10.1 and 25.3 per cent, respectively. This suggests that understanding the regional drivers of entrepreneurship in the transition region – and particularly, what is behind regional cluster effects – may be key in future research.

## Entrepreneurship: necessity or opportunity?

Before discussing the policy implications of the analysis presented thus far, it is necessary to confirm that the factors identified in Table 4.1 do in fact drive socially desirable forms of entrepreneurial activity – that is, promoting businesses with opportunities to grow or to support growth elsewhere in the economy – rather than just necessity entrepreneurship, in which individuals pursue self-employment due to the lack of other alternatives. While previous evidence suggests that necessity entrepreneurship is not detrimental to economic development and growth, and may in fact have benefits by increasing employment, its growth benefits are limited – because, for example, it is not based on new ideas and does not generate knowledge transfers.[18] As a result, if the policies required for promoting opportunity entrepreneurship are at odds with those encouraging business starters in general (including necessity ones), policy-makers may wish to focus solely on the former category.

To ascertain whether this is the case, the regression analysis of the previous section was repeated on a subsample of respondents who declared that they *preferred* to be self-employed, and was compared with the results obtained from the entire sample. If an individual who has tried to start a business prefers self-employment to other types of work, he or she is more likely to be an opportunity entrepreneur.[19] Conversely, a respondent who favours formal employment is more likely to become a business starter out of necessity.

The results of this analysis are shown in Table 4.2. Although there are differences in the magnitudes of some of the coefficients when the sample is restricted only to respondents preferring self-employment, the coefficient signs almost always agree across samples. One of the exceptions is GDP per capita, which has a positive coefficient (significantly so in regressions [4] and [6]). This is encouraging, as the negative coefficient in the previous regression was interpreted as reflecting the presence of necessity entrepreneurs, which should no longer be the case in the smaller sample. These results suggest that any policy conclusions based on the analysis in the previous section should apply also to opportunity entrepreneurs.

Certain individual characteristics appear to have a stronger effect in the restricted sample. In particular, the impact of education on the propensity of individuals to start a business nearly doubles in the sample of respondents who prefer to be self-employed. The coefficients on the individual income variables, father's education and individual membership of the Communist Party, are also nearly three times higher in the regressions explaining the entrepreneurial trial rate, and double in the regressions explaining business success. The reason for this could be that opportunity entrepreneurs are more likely to establish bigger and more sophisticated enterprises, requiring a higher degree of education and investment, relative to necessity business starters. A formerly unemployed respondent is unlikely to have decided to run his or her own enterprise, for example, if it involves high start-up costs as well as specialised knowledge acquired through formal education.

Some of the regional variables also appear to have stronger effects in the restricted sample. A 10 percentage point rise in regional corruption, relative to the country average, decreases the probability of an entrepreneurial start-up attempt by 4.4 percentage points and of overall business success by close to 5 percentage points (the latter figure is just 1 percentage point in the full sample). Similarly, regional cluster effects appear to be even more important: the propensity of individuals to start a business out of opportunity rather than necessity in regions with high trial rates increases by 35 per cent (compare column [4] in Tables 4.1 and 4.2), and the coefficient on the average regional success rate more than doubles in the regression exploring the determinants of a successful business starter out of the total population (similarly compare column [6]). These results are intuitive: opportunity entrepreneurs are more likely to attract the attention of corrupt officials since they are more worthwhile targets for extracting bribes. And, as argued above, businesses that are created out of opportunity rather than necessity would be expected to generate higher knowledge spillovers, which could explain the increase in cluster effects.

[17] This variable was not used at the individual level because of its volatility and concerns about its measurement. At the level of regional aggregates, these issues are less of a concern.
[18] See Acs and Varga (2005).
[19] Although the survey only provides information about a respondent's *current* preference for self-employment, such a measure may actually be more appropriate than using preferences for self-employment at the time when a business started. The measure used in this chapter captures respondents who like self-employment *ex post*, which may be more accurate than the *ex ante* measure since it is based on individuals' actual entrepreneurship experiences.

## Differences in the determinants of entrepreneurship across the transition region

An important question for policy-makers is whether the findings in Tables 4.1 and 4.2 are applicable to different geographical groupings within the transition region. Table 4.3 replicates the analysis in Table 4.1 but breaks down the sample into those countries belonging to the CIS and the new EU Member States. Because of limited variation at the country and regional levels, these disaggregated regressions are run without regional and country controls.[20]

While most of the signs and magnitudes are consistent – for example, the analysis confirms the importance of individual borrowing constraints across both regions – some significant differences emerge. The most notable concerns the impact of higher education: secondary education does not seem to have an effect on the entrepreneurial trial rate in the CIS region, while the coefficient on CIS university education in the trial regressions is just two-thirds of the estimate for the overall sample. Secondary and higher education even appear to have a negative impact on entrepreneurial success in the CIS region. This finding is puzzling, and could point to problems with the quality of post-primary education in the CIS countries.

Other interesting differences relate to membership of the Communist Party, which has a stronger effect on the probability that an entrepreneur will be successful in the former CIS region than in the new EU region (perhaps reflecting a more pronounced impact of communism on individual income and social networks in the past). A respondent's willingness to relocate decreases the likelihood of entrepreneurial success by 4.6 percentage points in the new EU countries, and by almost double that in the CIS region and in the overall sample. Willingness to take risks appears to be more important for entrepreneurial success, conditional on trying, in the CIS countries than in the new EU members.

## Conclusion

What are the characteristics of successful business starters in the transition region? And what can policy-makers do to encourage more entrepreneurial activity? This chapter finds a number of drivers of business start-up attempts and success at the individual, regional and country levels, many of which suggest ample opportunities for policy-makers to get involved.

Expanding the availability of credit appears to be the most important factor in increasing the entrepreneurial success rate and should rank highly on the policy agenda. The results also show that women are less likely to try to start a business, even though they are no less successful than their male counterparts when they try. This may argue for greater support, including lending, to encourage potential female entrepreneurs. Such a policy will likely increase not only their own welfare, but also that of other family members and could be a source of economic growth.

The chapter also finds that more educated respondents are more likely to try entrepreneurial activities. Interestingly, however, such individuals appear no more likely to succeed, conditional on trying, perhaps because the quality or relevance of post-secondary education in the transition region is not sufficient to affect business success, especially in CIS countries. While the findings of this chapter therefore support the general case for more and better education, it is important to understand why higher education does not seem to promote entrepreneurial success in the region, and what can be done about it. This poses a challenge to both researchers and policy-makers.

Lastly, the results lend strong support to the theory that entrepreneurship is shaped by regional factors, including regional institutions that benefit entrepreneurial activity (by reducing corruption, for example). This is an encouraging finding, since regional institutions may be easier to reform or incentivise than those at the national level. In addition, higher levels of entrepreneurship in a region seem to encourage even more start-up activity. This result requires further research, as it is not completely clear from the analysis whether a higher presence of entrepreneurs reflects genuine spillover effects or merely better business conditions that are not directly measurable. If it is the former, then policy-makers may be advised to encourage entrepreneurial activity in regions that already exhibit higher rates of enterprise start-ups. This is an uncomfortable conclusion, insofar as it implies that differences in living standards across regions could be exacerbated. However, entrepreneurial success in some regions is likely to raise growth and employment for a country as a whole.

[20] Instead, a full set of country "dummy variables" are included. Each assigns a value of 1 to observations belonging to a particular country and 0 otherwise.

Table 4.2
## Entrepreneurial trial and success rates for those who prefer to be self-employed

| | With individual and country controls | | | With individual, country and regional controls | | |
|---|---|---|---|---|---|---|
| **Dependent variable** | **Trial [1]** | **Success \| Trial [2]** | **Success [3]** | **Trial [4]** | **Success \| Trial [5]** | **Success [6]** |
| **Individual variables** | | | | | | |
| Borrowed successfully | | 0.092*** | | | 0.086*** | |
| | | (0.025) | | | (0.025) | |
| Borrowed unsuccessfully | | -0.409*** | | | -0.364*** | |
| | | (0.056) | | | (0.052) | |
| Father's education | 0.005* | 0.005* | 0.006*** | 0.007*** | 0.004* | 0.007*** |
| | (0.003) | (0.003) | (0.002) | (0.002) | (0.003) | (0.002) |
| Member Communist Party | 0.102*** | 0.082 | 0.102*** | 0.106*** | 0.097* | 0.107*** |
| | (0.033) | (0.055) | (0.039) | (0.034) | (0.054) | (0.038) |
| Secondary education | 0.060*** | 0.017 | 0.058*** | 0.053*** | 0.020 | 0.049*** |
| | (0.020) | (0.049) | (0.021) | (0.018) | (0.035) | (0.015) |
| Bachelor or Master's education | 0.103*** | -0.017 | 0.078*** | 0.092*** | 0.007 | 0.067*** |
| | (0.021) | (0.061) | (0.024) | (0.024) | (0.049) | (0.022) |
| Good health | 0.011 | 0.061 | 0.031* | 0.006 | 0.060 | 0.021 |
| | (0.020) | (0.047) | (0.018) | (0.019) | (0.045) | (0.018) |
| Male | 0.072*** | -0.025 | 0.050*** | 0.073*** | -0.019 | 0.051*** |
| | (0.022) | (0.023) | (0.019) | (0.020) | (0.024) | (0.018) |
| Age | 0.015*** | | 0.012*** | 0.014*** | | 0.012*** |
| | (0.002) | | (0.002) | (0.002) | | (0.002) |
| Age^2 | -0.000*** | | -0.000*** | -0.000*** | | -0.000*** |
| | (0.000) | | (0.000) | (0.000) | | (0.000) |
| Age at trial | | 0.002 | | | 0.001 | |
| | | (0.003) | | | (0.003) | |
| Age at trial^2 | | -0.000 | | | -0.000 | |
| | | (0.000) | | | (0.000) | |
| Good health | 0.011 | 0.061 | 0.031* | 0.006 | 0.060 | 0.021 |
| | (0.020) | (0.047) | (0.018) | (0.019) | (0.045) | (0.018) |
| Vote | 0.022 | 0.078*** | 0.035* | 0.028 | 0.049* | 0.038** |
| | (0.022) | (0.028) | (0.018) | (0.019) | (0.029) | (0.015) |
| Urban | 0.003 | -0.023 | -0.010 | 0.001 | -0.008 | -0.001 |
| | (0.018) | (0.029) | (0.017) | (0.017) | (0.028) | (0.018) |
| Willingness to move | 0.025* | -0.098*** | -0.019 | 0.020 | -0.086*** | -0.021 |
| | (0.014) | (0.025) | (0.015) | (0.013) | (0.023) | (0.013) |
| Risk score | 0.029*** | 0.021*** | 0.029*** | 0.031*** | 0.020*** | 0.029*** |
| | (0.005) | (0.006) | (0.005) | (0.005) | (0.006) | (0.005) |
| Trust score | 0.002 | -0.014 | 0.000 | -0.000 | -0.018 | -0.002 |
| | (0.008) | (0.012) | (0.007) | (0.006) | (0.012) | (0.006) |

| | | | | | | |
|---|---|---|---|---|---|---|
| **Country variables** | | | | | | |
| # Bank branches / 1,000 pop, 1996-2008 | 0.460 | -0.065 | 0.230 | -0.012 | -0.055 | -0.124 |
| | (0.299) | (0.188) | (0.263) | (0.149) | (0.103) | (0.163) |
| ln(GDP/capita), 1996-2008 | 0.030 | 0.051 | 0.035 | 0.036** | 0.012 | 0.032** |
| | (0.024) | (0.035) | (0.025) | (0.015) | (0.019) | (0.015) |
| Procedures start business, 2004-11 | -0.014* | -0.010 | -0.011 | -0.002 | 0.004 | -0.000 |
| | (0.008) | (0.010) | (0.009) | (0.005) | (0.005) | (0.006) |
| National average corruption | 0.030 | 0.012 | 0.031 | 0.012 | -0.015 | 0.009 |
| | (0.042) | (0.079) | (0.046) | (0.015) | (0.019) | (0.017) |
| National average liberties | -0.001 | 0.019*** | 0.005 | -0.000 | -0.001 | 0.001 |
| | (0.004) | (0.005) | (0.004) | (0.003) | (0.003) | (0.002) |
| Standard deviation of inflation, 1996-2008 | 0.033 | 0.038* | 0.036 | 0.009 | 0.030*** | 0.018 |
| | (0.021) | (0.021) | (0.027) | (0.017) | (0.008) | (0.019) |
| Exports, 1996-2008 | 0.114 | -0.121 | 0.058 | 0.200* | 0.013 | 0.161 |
| | (0.205) | (0.142) | (0.203) | (0.104) | (0.064) | (0.106) |
| Trademarks, 1996-2008 | -0.014 | 0.034 | 0.008 | -0.004 | -0.005 | 0.002 |
| | (0.039) | (0.032) | (0.039) | (0.019) | (0.013) | (0.020) |
| **Regional variables** | | | | | | |
| Regional average trial | | | | 1.376*** | -0.027 | 0.981*** |
| | | | | (0.078) | (0.076) | (0.087) |
| Regional average success | | | | 0.100* | 0.874*** | 0.290*** |
| | | | | (0.054) | (0.059) | (0.061) |
| Regional demeaned corruption | | | | -0.044*** | -0.012 | -0.048*** |
| | | | | (0.014) | (0.017) | (0.011) |
| Regional demeaned liberties | | | | 0.001 | 0.010*** | 0.004** |
| | | | | (0.002) | (0.003) | (0.002) |
| Regional average relative wealth | | | | -0.014 | 0.004 | -0.005 |
| | | | | (0.018) | (0.014) | (0.015) |
| **Respondents completing interview** | 4,447 | 1,226 | 4,447 | 4,419 | 1,226 | 4,419 |
| **R squared** | 0.102 | 0.179 | 0.105 | 0.148 | 0.274 | 0.150 |

Source: LiTS, World Development Indicators, Doing Business, EBRD Banking Survey.
Note: Standard errors in parentheses are clustered at the country level. Estimation is done by OLS. The dependent variables are as follows: in regressions (1) and (4) Trial, which is a dummy variable equal to 1 if the respondent has ever tried to set up a business; in regressions (2) and (5) Success | Trial, which is a dummy variable equal to 1 if the respondent has tried and succeeded in setting up a business; in regressions (3) and (6) Success, which is a dummy variable equal to 1 if the respondent has succeeded in setting up a business, regardless if he or she has tried or not. Sample: respondents from all transition countries who prefer to be self-employed. *** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

Table 4.3
## Entrepreneurial trial and success rates, by geographic region

| Country sample | All countries | | | CIS | | | New EU | | |
|---|---|---|---|---|---|---|---|---|---|
| **Dependent variable** | **Trial [1]** | **Success \| Trial [2]** | **Success [3]** | **Trial [4]** | **Success \| Trial [5]** | **Success [6]** | **Trial [7]** | **Success \| Trial [8]** | **Success [9]** |
| **Individual variables** | | | | | | | | | |
| Borrowed successfully | | 0.147*** | | | 0.109*** | | | 0.154*** | |
| | | (0.018) | | | (0.039) | | | (0.044) | |
| Borrowed unsuccessfully | | -0.356*** | | | -0.437*** | | | -0.330*** | |
| | | (0.036) | | | (0.066) | | | (0.062) | |
| Father's education | 0.003*** | 0.003 | 0.003*** | 0.003 | 0.000 | 0.002 | 0.003 | 0.010* | 0.004** |
| | (0.001) | (0.003) | (0.001) | (0.002) | (0.004) | (0.001) | (0.002) | (0.005) | (0.002) |
| Member Communist Party | 0.037** | 0.062** | 0.030*** | 0.041 | 0.085* | 0.024* | 0.021 | 0.071 | 0.021 |
| | (0.015) | (0.030) | (0.011) | (0.031) | (0.049) | (0.014) | (0.022) | (0.049) | (0.020) |
| Secondary education | 0.031*** | 0.029 | 0.025*** | -0.007 | -0.307*** | -0.025* | 0.046*** | 0.018 | 0.029** |
| | (0.009) | (0.036) | (0.008) | (0.015) | (0.099) | (0.015) | (0.015) | (0.069) | (0.014) |
| Bachelor or Master's education | 0.059*** | 0.055 | 0.047*** | 0.038** | -0.257** | 0.008 | 0.081*** | 0.030 | 0.062*** |
| | (0.012) | (0.042) | (0.010) | (0.019) | (0.117) | (0.020) | (0.021) | (0.091) | (0.018) |
| Good health | -0.006 | 0.080** | 0.007 | -0.016 | 0.086* | 0.005 | -0.001 | 0.082 | 0.003 |
| | (0.007) | (0.034) | (0.006) | (0.011) | (0.047) | (0.010) | (0.013) | (0.069) | (0.012) |
| Male | 0.064*** | -0.015 | 0.038*** | 0.055*** | 0.009 | 0.029*** | 0.063*** | 0.002 | 0.045*** |
| | (0.008) | (0.015) | (0.007) | (0.014) | (0.034) | (0.009) | (0.010) | (0.025) | (0.006) |
| Age | 0.009*** | | 0.006*** | 0.007*** | | 0.004*** | 0.011*** | | 0.009*** |
| | (0.001) | | (0.001) | (0.001) | | (0.001) | (0.002) | | (0.001) |
| Age^2 | -0.000*** | | -0.000*** | -0.000*** | | -0.000*** | -0.000*** | | -0.000*** |
| | (0.000) | | (0.000) | (0.000) | | (0.000) | (0.000) | | (0.000) |
| Age at trial | | 0.001 | | | 0.002 | | | 0.001 | |
| | | (0.002) | | | (0.004) | | | (0.002) | |
| Age at trial^2 | | -0.000 | | | -0.000 | | | 0.000 | |
| | | (0.000) | | | (0.000) | | | (0.000) | |
| Vote | 0.014 | 0.034* | 0.012* | 0.019* | -0.000 | 0.007 | 0.030 | 0.081*** | 0.033** |
| | (0.009) | (0.020) | (0.007) | (0.011) | (0.044) | (0.008) | (0.020) | (0.025) | (0.015) |
| Urban | 0.004 | -0.002 | 0.002 | 0.007 | 0.017 | 0.009 | 0.009 | -0.057* | 0.001 |
| | (0.007) | (0.017) | (0.006) | (0.014) | (0.037) | (0.011) | (0.010) | (0.034) | (0.010) |
| Willingness to move | 0.054*** | -0.085*** | 0.016** | 0.063*** | -0.084** | 0.009* | 0.059*** | -0.046*** | 0.035*** |
| | (0.009) | (0.017) | (0.008) | (0.014) | (0.040) | (0.006) | (0.010) | (0.016) | (0.010) |
| Risk score | 0.020*** | 0.021*** | 0.017*** | 0.021*** | 0.027** | 0.015*** | 0.021*** | 0.016** | 0.020*** |
| | (0.002) | (0.005) | (0.002) | (0.003) | (0.012) | (0.003) | (0.004) | (0.007) | (0.004) |
| Trust score | -0.004** | 0.002 | -0.002 | -0.005** | -0.006 | -0.002 | -0.002 | 0.004 | -0.001 |
| | (0.002) | (0.009) | (0.002) | (0.002) | (0.016) | (0.002) | (0.002) | (0.025) | (0.004) |
| Country fixed effects | YES | YES | YES | YES | YES | YES | YES | YES | YES |
| **Respondents completing interview** | 22,051 | 3,060 | 22,051 | 6,684 | 799 | 6,684 | 5,797 | 824 | 5,797 |
| **R squared** | 0.083 | 0.204 | 0.067 | 0.072 | 0.182 | 0.051 | 0.084 | 0.202 | 0.074 |

Source: LiTS.
Note: Standard errors in parentheses are clustered at the country level. Estimation is done by OLS. The dependent variables are as follows: in regressions (1), (4) and (7) Trial, which is a dummy variable equal to 1 if the respondent has ever tried to set up a business; in regressions (2), (5) and (8) Success | Trial, which is a dummy variable equal to 1 if the respondent has tried and succeeded in setting up a business; in regressions (3), (6) and (9) Success, which is a dummy variable equal to 1 if the respondent has succeeded in setting up a business, regardless if he or she has tried or not. All regressions include country dummies. Sample: All transition countries (regressions 1-3); CIS countries (regressions 4-6); New members of the EU (regressions 7-9). *** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

## References

**D. Acemoglu, S. Johnson, J. A. Robinson and Pierre Yared (2008)**
"Income and democracy", *American Economic Review*, Vol. 98, No. 3, pp. 808-842.

**Z. Acs and A. Varga (2005)**
"Entrepreneurship, agglomeration and technological change", *Small Business Economics*, Vol. 24, pp. 323-34.

**J. L. Arcand, E. Berkes and U. Panizza (2011)**
"Too much finance?", Working Paper.

**D. Berkowitz and D. DeJong (2004)**
"Entrepreneurship and post-socialist growth", *Oxford Bulletin of Economics and Statistics*, Vol. 67, No. 1, pp. 25–46.

**D. Chen, P. Gompers, A. Kovner and J. Lerner (2010)**
"Buy local? The geography of venture capital", *Journal of Urban Economics*, Vol. 67, No. 1, pp. 90-102.

**CHF International (2009)**
"GER Initiative final report".

**Development Solutions web site**
go to: www.dsmongolia.org/intro.html

**S. Djankov, E. Miguel, Y. Qian, G. Roland and E. Zhuravskaya (2005)**
"Who are Russia's entrepreneurs", *Journal of the European Economic Association*, Papers and Proceedings, Vol. 3, No. 2, pp. 587-97.

**S. Djankov, Y. Qian, G. Roland and E. Zhuravskaya (2007)**
"What makes a successful entrepreneur: evidence from Brazil", Working Paper.

**S. Djankov, Y. Qian, G. Roland and E. Zhuravskaya (2008)**
"Entrepreneurship in Brazil, China and Russia", Working Paper.

**M. Giannetti and A. Simonov (2009)**
"Social interactions and entrepreneurial activity", *Journal of Economics and Management Strategy*, Vol. 18, No. 3, pp. 665-709.

**P. Grosjean (2011)**
"The institutional legacy of the Ottoman Empire: Islamic rule and financial development in south eastern Europe", *Journal of Comparative Economics*, Vol. 39, pp. 1-16.

**G. S. Maddala (1985)**
"A survey of the literature on selectivity bias as it pertains to health care markets", *Advances in Health Economics and Health Services Research*, Vol. 6, pp. 3-18.

**J. McMillan and C. Woodruff (2002)**
"The central role of entrepreneurs in transition economies", *Journal of Economic Perspectives*, Vol. 16, No. 3, pp. 153-70.

**National Statistical Office of Mongolia, *Yearbook 2008*.**

**P. A. Puhani (2000)**
"The Heckman correction for sample selection and its critique", *Journal of Economic Surveys*, Vol. 14, No. 1, pp. 54-68.

**R. Putnam (1993)**
"Making democracy work", Princeton University Press.

**UN Habitat web site**
http://www.unhabitat.org/bestpractices/2006/mainview.asp?BPID=1680

**World Bank (2010)**
"Enhancing policies & practices for ger area development in Ulaanbaatar".

**World Bank *Doing Business* databases, 2004-11.**

**World Development Indicators, 1996-2008.**

Box 4.1

## Why do so many Mongolians try to be entrepreneurs?

As shown in Chart 4.1, Mongolia recorded a higher rate of successful business starters, according to the LiTS, than any other transition country. This reflects the fact that 30 per cent of the population have tried to start a business at some point in the past.[21] This figure is more than double the 12 per cent average trial rate of all the other transition countries, and higher even than Sweden's 28 per cent rate. It is also much higher than the rate that would be expected, given the country, regional and individual characteristics prevailing in Mongolia, based on the regression analyses presented in Table 4.1.[22]

What could explain the large discrepancy between the actual rate of entrepreneurial attempts in Mongolia and the rate that one would expect based on its general characteristics? This case study explores the role of an externally funded entrepreneurship development programme, which was in place for several years before the 2010 LiTS. It concludes that this may have had a strong impact on Mongolia's entrepreneurial trial rate, given the country's relatively small population and some distinctive geographic and socio-economic characteristics. In addition, it is possible that the programme also had a positive effect on the success of Mongolia's entrepreneurs, although other factors, such as remittances, are likely to have been important too.

Mongolia is the most sparsely populated country in the world, with little arable land and a great area covered by steppes. Approximately 30 per cent of Mongolians are nomadic or semi-nomadic, making a living mainly from breeding livestock. The majority of the population lives in cities, with 40 per cent of the total living in Ulaanbaatar, the capital, and another 20 per cent living in the three other biggest cities.[23] The past 20 years have seen high rural-to-urban migration, with former nomads settling into informal tent-dwelling *ger* districts surrounding the largest cities. For example, in Ulaanbaatar 60 per cent of the population lives in *ger* districts, which are much poorer than areas dominated by apartment buildings. Unemployment in *ger* districts is also higher, with an unemployment rate of half of the working-age population, compared with the national average of 36.4 per cent.[24]

Between 2002 and 2009, the population of these districts was targeted by the Growing Entrepreneurship Rapidly (GER) Initiative, a development project run by CHF International (a non-governmental development organisation) and funded by the US Agency for International Development and the US Department of Agriculture.[25] The GER Initiative focused on recent migrants to the *ger* districts in the four largest cities and provided them with fee-based services related to business consulting and training, financial services, employment training and matching, association development and business and legal information. In addition, it helped individuals liaise with large corporations and financial institutions that could either support entrepreneurial activity or provide access to finance. For example, in July 2004 GER negotiated for Darkhan Nekii, a large sheepskin manufacturer and programme client, to buy stitched garments from small entrepreneurs.[26]

As a result of these activities, the programme is likely to have made it more attractive for necessity entrepreneurs to try to start a business. More importantly, by networking with companies and financial institutions, the GER initiative also created market possibilities for opportunity business starters. Three factors suggest that the GER programme may have had a significant impact on increasing the rate at which potential entrepreneurs tried to start businesses in Mongolia.

- It had a wide coverage, reaching more than 20 per cent of the population and working with roughly one-half of officially registered formal enterprises.[27] Since many of the Mongolian entrepreneurs interviewed in the LiTS likely operate informally, the overall effect of the programme may have been even larger.
- Although the programme officially started in 2002, its activities intensified in 2004-05;[28] LiTS data show that close to 60 per cent of all respondents who tried to start a business did so in 2004 or later (the rest having made attempts between 1990 and 2003).
- The types of business that GER financed appeared to match the industries in which LiTS respondents were active.[29] The LiTS data suggest that Mongolians tried to start a business in urban and semi-urban areas, as 22 per cent of potential entrepreneurs were in services (other than tourism and financial intermediation); 15 per cent in trade (wholesale and retail) and vehicle repair; and 8 per cent in education. Moreover, 46 per cent of potential entrepreneurs who have tried to set up a business are located in, or around, Ulaanbaatar. This sectoral distribution of would-be entrepreneurs broadly corresponds to the employment profile of GER clients, who were also primarily engaged in non-agricultural businesses, such as services, trade and manufacturing.[30]

In summary, this evidence suggests that the GER programme could have been an important factor in explaining the extraordinary propensity of Mongolians to attempt entrepreneurial activities. Furthermore, it may also have raised the success rate of entrepreneurs. Nevertheless, the impact of the programme may to some extent be specific to Mongolia's distinctive geographic, social and economic characteristics: namely, a large proportion of the population with low formal employment living within relatively concentrated urban and semi-urban areas. These caveats need to be taken into account by policy-makers considering similar entrepreneurship programmes elsewhere.

[21] In contrast, the business success rate among Mongolians, conditional on trying, was about average for the transition region (around 60 per cent; see Chart 4.2).

[22] Two related techniques are used to estimate the extent to which the regression analysis underestimates the entrepreneurial trial and success rates, conditional on trying, in Mongolia. An analysis of the prediction errors from the regressions shows that while these figures are high for both entrepreneurial outcomes, the predicted trial rate is the most imprecisely estimated, relative to all countries included in the sample. Similarly, including a variable in the statistical analysis that is 1 for all observations from Mongolia, and 0 otherwise, demonstrates that the Mongolian success and trial rates are underestimated.

[23] These are Darkhan, Erdenet and Choibalsan. See National Statistical Office of Mongolia, *Yearbook 2008*.

[24] World Bank, "Enhancing policies & practices for *ger* area development in Ulaanbaatar" (2010); CHF

# Regression techniques and robustness checks used in the analysis

In each household interviewed in the LiTS, a randomly chosen adult respondent was asked two separate questions related to entrepreneurship: if he or she had ever tried to set up a business; and if he or she had actually succeeded in doing so at some point in the past. Based on these two questions, the LiTS data allow for the separate analysis of (i) what affects the individual probabilities of becoming a *would-be* entrepreneur (that is, a respondent who has tried to set up a business); (ii) what affects the individual probabilities of becoming an *actual* entrepreneur *conditional* on trying; and (iii) the determinants of both trying and succeeding, that is, of the *unconditional* probability of entrepreneurial success. In Tables 4.1, 4.2 and 4.3, the results of these three analyses are shown for a variety of samples and potential determinants.

All regressions underlying these tables assume a *linear probability model*, which is estimated using ordinary least squares (OLS). In addition, three checks are conducted to verify that the main results are robust to the technique used:

- estimation of all specifications assuming a probit model, using maximum likelihood
- estimation of all specifications assuming a linear probability model calculated using two-stage least squares, treating GDP per capita as endogenous
- estimation of the probability of success conditional on trying using a Heckman selection model.

The estimation models and assumptions underlying the main regression and robustness checks are described briefly below.

## Regression techniques

The following linear probability models are estimated. These regressions provide results that are similar to, but easier to interpret than, a probit model, as in the OLS model each coefficient can be interpreted as a constant marginal effect of a determinant on the probability of the outcome shown on the left hand side of the equations that follow:

$$(1)\ Trial_{i,r,k} = \delta_0 + \mathbf{X}_{i,r,k}\ \delta_1 + \mathbf{Y}_{r,k}\ \delta_2 + \mathbf{Z}_k\ \delta_3 + \varepsilon_{i,r,k}$$

$$(2)\ Success_{i,r,k} \mid Trial_{i,r,k} = \gamma_0 + \mathbf{X^*}_{i,r,k}\ \gamma_1 + \mathbf{Y}_{r,k}\ \gamma_2 + \mathbf{Z}_k\ \gamma_3 + \eta_{i,r,k}$$

$$(3)\ Success_{i,r,k} = \rho_0 + \mathbf{X}_{i,r,k}\ \rho_1 + \mathbf{Y}_{r,k}\ \rho_2 + \mathbf{Z}_k\ \rho_3 + \xi_{i,r,k},$$

where $Trial_{i,r,k}$ is a dummy variable equal to 1 if individual $i$ from region $r$ in country $k$ has tried to set up a business, and $Success_{i,r,k}$ is a dummy variable equal to 1 if the individual has succeeded in setting up a business. To allow for possible correlations among the answers of individuals living in the same country, all standard errors $\varepsilon_{i,r,k}$, $\eta_{i,r,k}$, $\xi_{i,r,k}$ are clustered at the country level.

$\mathbf{X}_{i,r,k}$ and $\mathbf{X^*}_{i,r,k}$ are vectors of individual level variables (such as age, gender, education; see Table A.4.1). As respondents who tried to set up a business were asked additional questions, $\mathbf{X^*}_{i,r,k}$ contains additional variables to $\mathbf{X}_{i,r,k}$: age at time of trial instead of age at the time of interview, and dummy variables set to unity if the potential entrepreneur tried to borrow money successfully or not.

$\mathbf{Y}_{r,k}$ is a vector of regional level variables (see Table A.4.1), obtained by calculating the regional averages or the regional deviations from country averages of variables contained in the LiTS. Although the survey is not representative at the regional level, the averages can nevertheless be useful proxies, for example, the average trial and success rates proxy for how entrepreneurial a region is.

$\mathbf{Z}_k$ is a vector of country level variables (see Table A.4.1) that capture the macroeconomic and country-wide environment that entrepreneurs likely faced at the time of their trial and potential success.

## Robustness checks

In addition to re-estimating the main regressions using the probit model, two alternative estimation techniques are used.

### *Instrumental variables approach*

GDP per capita is a potentially endogenous variable as it can be correlated with omitted variables that are not captured by the LiTS. In addition, there may be reverse causality between GDP per capita and entrepreneurship, as high rates of entrepreneurship may increase a country's income.

In order to isolate the exogenous variation in GDP per capita, the results from Table 4.1 are re-estimated using two-stage least squares. In the first stage, the average GDP per capita of neighbouring countries, weighted by their respective border length, is included as an instrument for a country's GDP per capita (in the spirit of Acemoglu et al. 2008). This instrument is a strong predictor of a country's own GDP per capita. In the second stage the regression results turn out broadly similar to those in Table 4.1.

### *Heckman correction*

Regressions (1) and (2) constitute a two-part model (TPM). The estimates of the TPM can be used to disentangle the independent effects that the explanatory variables have on the two parts of the entrepreneurship process (trial and success). In contrast,

International, "GER Initiative final report" (2009).

[25] The programme ran officially from 2002 until March 2009. From October 2008 onward, CHF transferred its management to Development Solutions, a Mongolian NGO that it helped to establish. While Development Solutions is still administering the programme, it has significantly cut down its coverage and activities (Development Solutions web site: www.dsmongolia.org/intro.html).

[26] UN Habitat web site: unhabitat.org/bestpractices/2006/mainview.asp?BPID=1680.

[27] The 2009 GER report lists 14,712 business owners among its clients, and 7,211 future businesses, making a total of 21,923. This data covers the period 2002-09. Although a comparable figure for total business owners during the entire period is unavailable, one can use the average number of officially registered enterprises over the period 2002-08, which is 42,438 (Mongolian Business Register).

[28] UN Habitat web site: unhabitat.org/bestpractices/2006/mainview.asp?BPID=1680.

[29] The LiTS does not record the sector in which businesses have been set up, only the sector in which the respondent is currently occupied.

[30] UN Habitat web site: www.unhabitat.org/bestpractices/2006/mainview.asp?BPID=1680.

regression (3) combines the two outcomes and looks at overall success by considering *Success*$_{i,r,k}$ to be 0 for those individuals who have never tried to set up a business.

From a policy point of view, all three regression specifications are of interest. However, OLS estimates of (2) are likely subject to selection bias: since regression (2) provides the conditional estimate of the probability of being an actual entrepreneur, relative only to those respondents who have chosen to try to start a business, its results may not be valid for all respondents. For example, the positive impact of a father's education in the regression estimating success, conditional on trial, may simply reflect the fact that richer and more socially connected respondents are more likely to *try* to start a business. Moreover, the results in regression (2) may be biased due to the impact of individual characteristics that are not captured by the survey. For example, Table 4.1 shows that risk-tolerant respondents are more likely to try to start a business and to succeed at doing so. However, these two samples may also include successful entrepreneurs who are both less risk-loving and more intelligent. As a result, the coefficient on a respondent's propensity to take risks in regression (2) will be underestimated.

In order to correct for this selection bias, a Heckman correction is applied to regression (2), taking into account that trying to set up a business is not independent of, but rather a necessary condition for, succeeding in setting up a business. As it was impossible to a *priori* identify a variable affecting only the first-stage (trying) from the second stage (succeeding) (the exclusion restriction approach to the Heckman correction), the correction rests solely on the assumption of a specific joint distribution of the residuals in the two stages (a bivariate normal distribution). This approach is generally not considered desirable, since it produces unbiased but inefficient and imprecise estimates in the success regression. However, these issues may be less of a concern in the present analysis, as the LiTS has a sample size of more than 33,000 observations.[31] Moreover, the Heckman maximum likelihood estimation is used instead of the Heckman two-stage estimation, as it is more robust to the lack of a credible exclusion restriction.[32]

This exercise produces results that are very similar to those of regression (2) above. Therefore, it is reasonable to assume that, even with all the caveats in mind, the results of regression (2) can be used for policy recommendations.

[31] See Maddala (1985) and Puhani (2000).
[32] See Puhani (2000).

Table A.4.1
## Variable definitions and sources

| Variable name | Description | Source |
|---|---|---|
| **Dependent variables** | | |
| Trial | Dummy variable equal to 1 if respondent has ever tried to set up a business, zero otherwise | LiTS 2010, q530 |
| Success \| Trial | Dummy variable equal to 1 if respondent has tried and succeeded to set up a business, zero if he or she tried but failed | LiTS 2010, q532 |
| Success | Dummy variable equal to 1 if respondent has succeeded in setting up a business, zero otherwise (whether he or she tried and failed, or never tried) | LiTS 2010, q532 |
| **Individual level controls** | | |
| Borrowed successfully | Dummy variable equal to 1 if respondent attempted to and was successful in borrowing money for the business (from relatives, friends, private money lenders, banks, NGOs, microfinance institutions or other sources) | LiTS 2010, q534, q535 |
| Borrowed unsuccessfully | Dummy variable equal to 1 if respondent attempted to but was not successful in borrowing money for the business (from relatives, friends, private money lenders, banks, NGOs, microfinance institutions or other sources) | LiTS 2010, q534, q535 |
| Father's education | Years of respondent's father's full-time education | LiTS 2010, q718 |
| Member Communist Party | Dummy variable equal to 1 if respondent has been a  member of the Communist Party | LiTS 2010, q714 |
| Secondary education | Dummy variable equal to 1 if respondent completed lower secondary, upper secondary or post secondary education | LiTS 2010, q515 |
| Bachelor or Master's education | Dummy variable equal to 1 if respondent completed Bachelor or Master's education | LiTS 2010, q515 |
| Male | Dummy variable equal to 1 if respondent is male | LiTS 2010, q102 |
| Age | Age of respondent | LiTS 2010, q104 |
| Age at trial | Respondent's age when trying to set up a business | LiTS 2010, q104, q531 |
| Good health | Dummy variable equal to 1 if respondent's health is good or medium | LiTS 2010, q704 |
| Vote | Dummy variable equal to 1 if respondent has voted in local elections, parliamentary elections, or presidential elections | LiTS 2010, q319 |
| Urban | Dummy variable equal to 1 if respondent lives in an urban setting | LiTS 2010, qtablec |
| Willingness to move | Dummy variable equal to 1 if respondent is willing to move for a job | LiTS 2010, q528 |
| Risk score | Score of respondent's willingness to take risks in general on a scale from 1 to 10 | LiTS 2010, q537 |
| Trust score | Score of respondent's trust in other people on a scale from 1 to 5 | LiTS 2010, q302 |
| Prefer to be self-employed | Dummy variable equal to 1 if respondent's ideal job is self-employment | LiTS 2010, q526 |
| **Country level controls** | | |
| # Bank branches / 1,000 pop, 1996-2008 | 1996-2008 average of number of bank branches per 1,000 inhabitants | EBRD Banking Survey |
| ln(GDP/capita), 1996-2008 | 1998-2008 average of log of GDP per capita | World Development Indicators |
| Procedures start business, 2004-11 | 2004-11 average number of procedures to start a business | World Bank Doing Business |
| National average corruption | Average number of respondents in a country that believe that people like them have to make unofficial payments or gifts when requesting official documents or when going to courts for a civil matter. Variable is weighted using national survey weights | LiTS 2010, q601 |
| National average liberties | National average of the rights existence score (calculated for each respondent as the average of scores on a scale of 1 to 5 of existence of free elections, law and order, freedom of speech, peace and stability, independent press, political opposition, free and fair courts, minority rights and freedom to travel). Variable is weighted using national survey weights. | LiTS 2010, q312 |
| SD of inflation, 1996-2008 | 1996-2008 average of standard deviation of inflation in the past six years | World Development Indicators |
| Exports, 1996-2008 | 1996-2008 average of exports of goods and services (as a share of GDP) | World Development Indicators |
| Trademarks, 1996-2008 | 1996-2008 average number of trademark applications per 10,000 inhabitants | World Development Indicators |
| **Regional level controls** | | |
| Regional average trial | Regional average of number of respondents who tried to set up a business | LiTS 2010, q530 |
| Regional average success | Regional average of number of respondents who tried and succeeded to set up a business | LiTS 2010, q532 |
| Regional demeaned corruption | Difference between regional and national average corruption (calculated as the number of respondents who believe that people like them have to make unofficial payments or gifts when requesting official documents or when going to courts for a civil matter). The national average is obtained using national survey weights, while the regional average is unweighted. | LiTS 2010, q601 |
| Regional demeaned liberties | Difference between regional and national liberties (calculated for each respondent as an average of scores on a scale of 1 to 5 of existence of free elections, law and order, freedom of speech, peace and stability, independent press, political opposition, free and fair courts, minority rights and freedom to travel). The national average is obtained using national survey weights, while the regional average is unweighted. | LiTS 2010, q312 |
| Regional average relative wealth | Regional average of respondent's perceived place on a 10-step income ladder | LiTS 2010, q227 |

**“This report shows a region that has been hard hit by the crisis, is internally highly diverse, and shows remarkable pockets of entrepreneurship. The crisis has been accompanied by large and sometimes disconcerting shifts in political and economic preferences. A remarkable fact, particularly amid the background of the “Arab Spring”, is the coincidence of a rising sentiment for democracy and markets in many of the more state-dominated countries in the transition region with a hardening of policies in several of these countries – including in the economic sphere.”**

**Erik Berglof**
Chief Economist
EBRD

# In focus
## Selected images from around the region

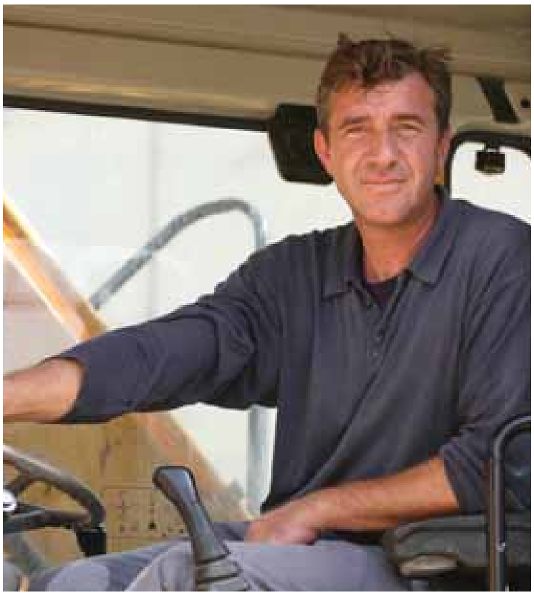
**Below:** Herding goats, Central Asia

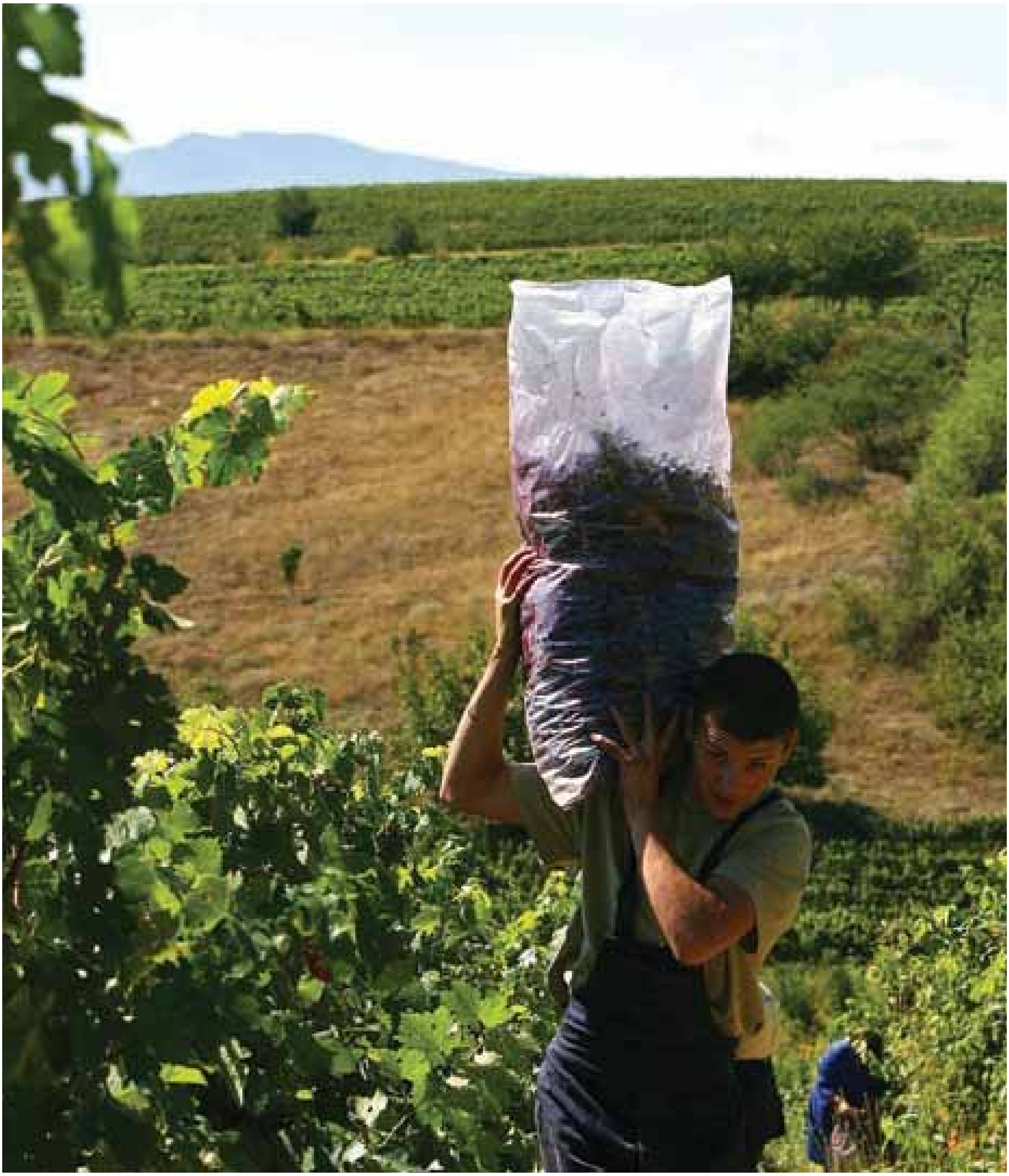
# In focus

**Below:** Enjoying the sunset, Serbia

**Bottom left:** Nurturing the younger generation, Azerbaijan

**Bottom right:** Working on site, Bosnia and Herzegovina





**Below:** Picking fruit,
FYR Macedonia

# In focus

**Below:** Helping schools to save energy, Kazakhstan

**Bottom:** Producing corn oil, Russia

**Left:** Re-stocking supermarket shelves, Bulgaria

**Below:** Manufacturing cement, Albania

# In focus

**Left:** Repairing machinery, Bosnia and Herzegovina

**Below:** Processing the grape harvest, FYR Macedonia

# In focus

**Below left:**
Observing the crisis from a household perspective, Russia

**Below right:**
Maintaining factory standards, Russia

**Bottom right:**
Voting, Georgia

**Below:** Promoting small business, Moldova

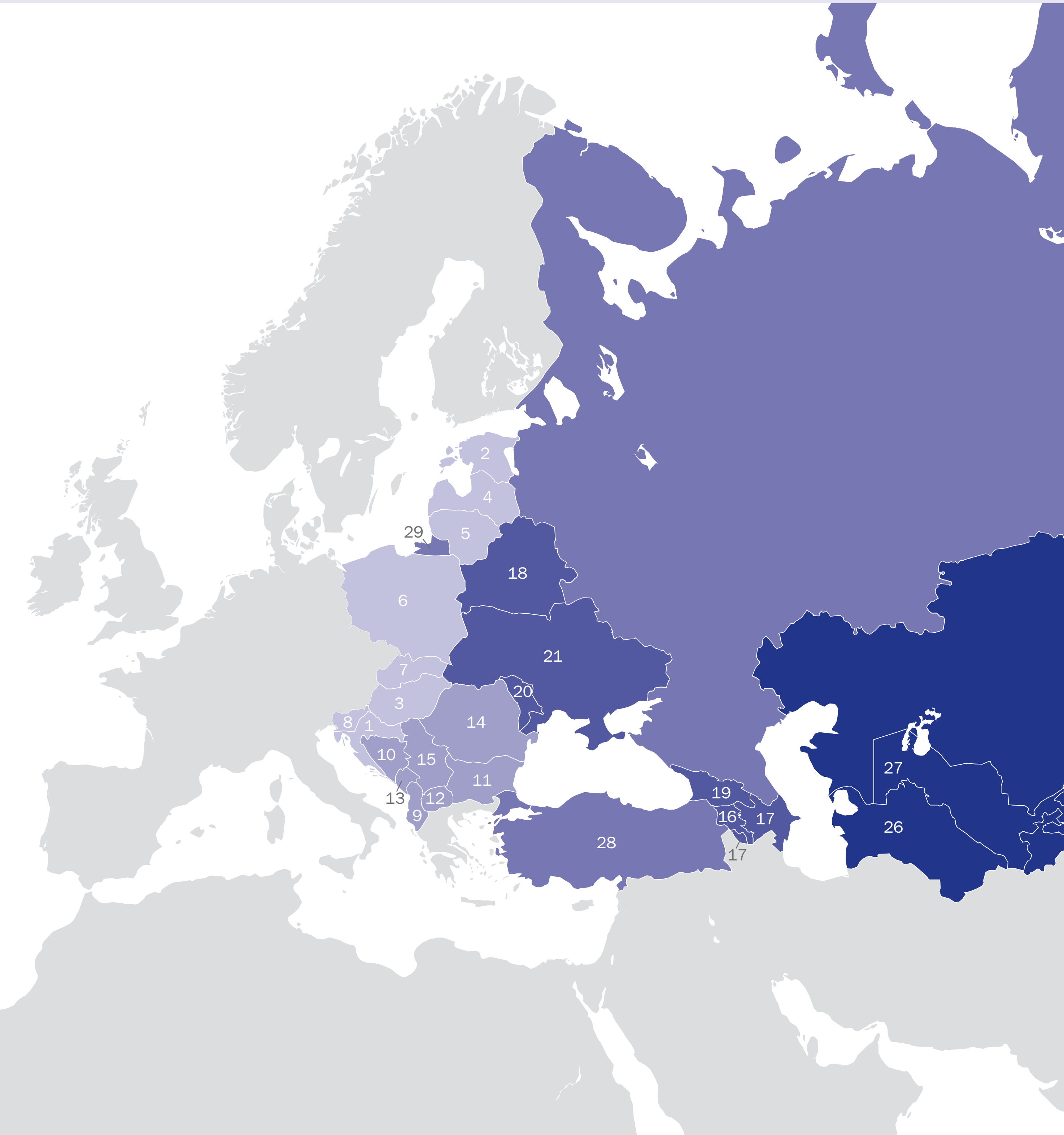
**Bottom:** Socialising with friends, FYR Macedonia

# In focus

**Below:** Delivering baked goods, Moldova

# Country Assessments

This part of the Transition Report contains a country-by-country review of reform progress and macroeconomic developments in the transition region from mid-2010 to the third quarter of 2011. It also includes a brief table of key macroeconomic indicators, including forecasts for 2011. The "cut-off" date for data and other information was early October 2011. More detailed data, both historical and current, covering structural, institutional and macroeconomic developments are available at the EBRD web site, at www.ebrd.com/economics


2
4
29
5
18
6
21
7
20
3
14
8
1
10
15
11
13
12
9
19
16
17
28
17
27
26


29
22
24
23
25

# Albania

## Highlights of the past year

- **The economy is still coping with the effects of the crisis.** Growth rates continue to exceed those of regional peers, but a slow-down is evident in 2011, reflecting contagion effects from key eurozone partners.
- **Progress in European Union approximation has slowed down.** Internal political infighting has prevented the passage of important laws and reforms and has not allowed the country to gain candidate status.
- **Road sector reforms have advanced.** International financial institutions (IFIs) are providing important support to the building of new roads and upgrading infrastructure, while substantive progress has been made in commercialising the sector.

## Key priorities for 2012

- **Further fiscal measures are needed for macroeconomic stabilisation.** It is important for Albania to keep public debt below 60 per cent of gross domestic product (GDP), and the sluggish economy may require further spending cuts to keep borrowing down.
- **Progress on EU approximation is a vital objective.** It is essential for the political classes to work together to advance the necessary reforms, especially in the areas of governance and the rule of law, in order to gain EU candidate status.
- **Sales of state-owned assets should be concluded.** The completion of planned privatisations would not only bring much-needed revenue to the government, but would also signal its commitment to market-oriented reforms. This could trigger substantial foreign direct investment (FDI) inflows in the coming years.

## Macroeconomic performance

**The Albanian economy continues to grow but the pace of growth has slowed.** Real GDP is estimated to have expanded in 2010 by 3.8 per cent, the highest growth rate in south-eastern Europe for the second consecutive year. The largest contributor to growth was the strong export performance, in particular in the energy sector. In addition, Albania has attracted substantive inflows of FDI, which grew by around 17 per cent on an annual basis in 2010 to around €800 million. The current account deficit narrowed to around 12 per cent of GDP in 2010. More recent macroeconomic figures in the first half of 2011 point to a deceleration in economic activity, in particular in light of a weakening performance in some key EU markets, such as Greece and Italy. Trade activity continues to remain strong but remittances, a vital source of income for many Albanians, have dropped, and this is expected to weaken domestic demand in the coming year. The inflation rate, in line with regional trends, accelerated throughout 2010 and peaked in early 2011, but had fallen by the middle of the year.

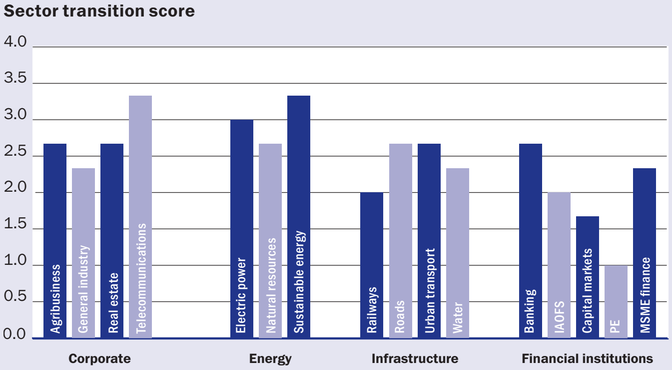
**Fiscal policies have become more prudent in recent years.** The 2010 budgetary deficit reached 4.2 per cent of GDP and was partly financed by a debut €300 million eurobond that the authorities successfully placed in October 2010. However, in light of local elections in spring 2011, the government significantly increased capital expenditures and was forced to revise the budget in July 2011 in order to meet the target deficit of 3.5 per cent of projected GDP in 2011. The Bank of Albania (BoA) has pursued loosening monetary policy since the onset of the global financial crisis, but it reversed the trend in March 2011 when it increased its key policy rate by 25 basis points to 5.25 per cent, as annual inflation reached the upper ceiling of the BoA's target range of 2 to 4 per cent. The rate was lowered again to 5 per cent in early October 2011.

**The economy is expected to slow further in 2011 and 2012, as the debt crisis in the key European markets unfolds.** Negative contagion effects have so far been limited, but Albania's close trading and investment ties to neighbouring Greece and Italy may affect the real economy in the short term. The banking sector has so far remained resilient to the crisis and private sector credit growth has resumed in the past year. However, with Greek banks accounting for more than 35 per cent of total banking assets, and a high level of euroisation in the economy, strong policy actions are required to support the banking sector.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 7.5 | 3.6 | 3.8 | 1.9 |
| Inflation (end-year) | 2.2 | 3.7 | 3.3 | 3.2 |
| Government balance/GDP | -5.5 | -7.0 | -4.2 | -3.7 |
| Current account balance/GDP | -15.6 | -15.2 | -11.8 | -10.9 |
| Net FDI (in million US$) | 874 | 924 | 1098 | 914 |
| External debt/GDP | 32.6 | 41.1 | 36.6 | na |
| Gross reserves/GDP | 17.5 | 19.8 | 22.7 | na |
| Credit to private sector/GDP | 35.2 | 36.7 | 38.0 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Albania's progress towards integration into the European Union has been halted in the past year.** In November 2010 the European Commission (EC) published its Opinion on Albania's application for membership of the European Union. The Opinion did not recommend that Albania be granted candidate status. It noted the need for further progress towards meeting the membership criteria and particularly the Copenhagen political criteria concerning governance and the rule of law. The October 2011 report noted the need to make considerable and sustained efforts in all areas identified in last year's Opinion. However, in December 2010 Albania (along with Bosnia and Herzegovina) was granted visa-free access for its citizens to the Schengen Zone.

**Further privatisations are envisaged and implementation of competition laws has been strengthened, but the sale of some key companies remains stalled.** In early 2011 the government announced its intention to privatise nearly 1,300 remaining (mostly small) state-owned enterprises. The main large assets for sale included Albpetrol, the country's sole oil extraction company, which the government attempted, but failed, to sell last year. In July 2011 the selected adviser for the privatisation advised a further delay in the sell-off because of unfavourable market conditions. The Canadian company, Bankers Petroleum, reached an agreement with Albpetrol in March 2011 to take over production and royalty payments for all active well production undertaken by Albpetrol. In addition, the government is trying once again to sell its stake in the insurance company INSIG, for which two previous tenders had failed. In preparation for a new privatisation attempt, the Albanian authorities removed the minimum bid requirements for INSIG at the end of June 2011, and are expected to call a new tender in the coming months. INSIG's share of the insurance market has dropped significantly in recent years to below 10 per cent. Meanwhile, the powers of the national competition authority have been strengthened over the past year.

**Reforms have advanced in the road sector.** A road agency was established in July 2011. The implementation of pilot performance-based maintenance contracts is ongoing. Two World Bank-funded pilot contracts have been implemented in two regions (Tirana and Kukës) and contracting of all periodic and routine maintenance on national and regional roads to the private sector is in progress. In 2010 the General Roads Directorate contracted out 100 per cent of periodic maintenance works. Significant improvements have also been made in road sector financing.

**The development of road infrastructure remains a priority.** The government has secured the support of IFIs for several loans to construct new roads and motorways in the coming years. For 2011 alone, the government has planned to invest up to €500 million in the local transport infrastructure. In April 2011 the Albanian authorities signed a loan agreement of US$ 223 million with the Islamic Development Bank to finance the construction of the highway connecting Tirana and Elbasan in central Albania as part of the pan-European Corridor VIII project. In addition it plans to construct 500 km of secondary roads in 2011.

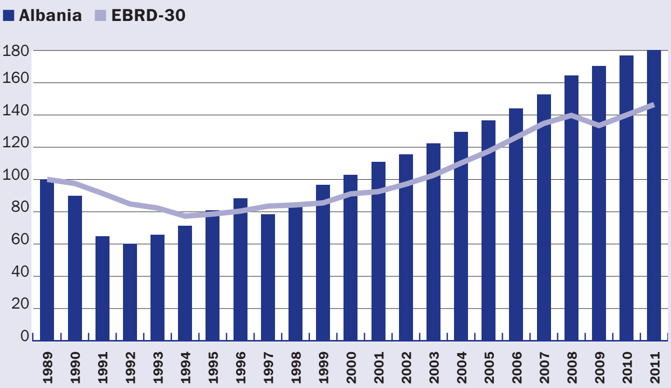
**The government has launched a number of concessions aimed at expanding the country's hydropower plants.** These plants generate around 98 per cent of Albania's electricity output. In recent years the government has awarded more than 200 concessions for hydropower plants and a second round of concessions is announced for the coming months. However, to date only a small number of concessions have developed into concrete projects. Further, the government plans to privatise some of its remaining assets in the hydropower sector and launched a concession of three state-owned utilities currently incorporated into the state-run power plant KESH in early August 2011. The three utilities will be merged into one company, of which the government is hoping to sell at least 51 per cent.

**The first 3G licence was awarded last year.** In November 2010 Vodafone Albania won the first 15-year 3G licence for the price of €31.4 million, a bid much higher than the initial asking price of €12.5 million. Vodafone launched operations of its 3G service in January 2011 and has expanded it since. This step is an important development in enhancing Albania's telecommunications sector, but other telecommunications providers, as well as the Consumer Protection Office, have complained about abuse of market power. In October 2011, a second 3G licence was awarded to Albania Mobile Communications.

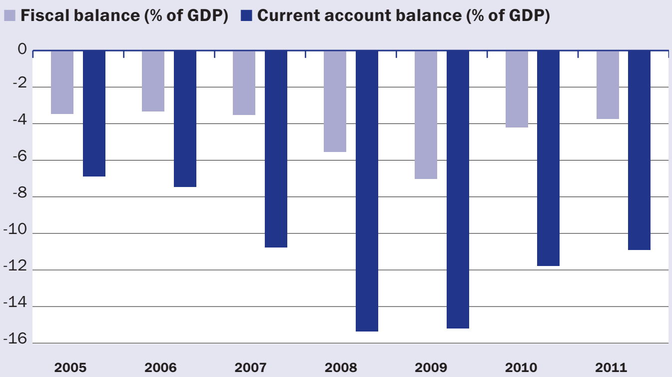
**Management of the water and wastewater sector has improved.** The Albanian water sector has undertaken some core sector reforms in the past such as decentralisation and corporatisation of its water utilities. Recently, further initiatives towards effective tariff reforms have taken place, with tariff increases and some improvement in collection rates in the capital, Tirana, but effective implementation remains a critical issue.

**Albanian banks remain profitable but there are concerns about consumer rights.** In February 2011 the Albanian Competition Authority (ACA) issued a report showing that banks in Albania charge higher service tariffs than regional peers. It recommended an improved legislative framework of the banking sector to increase transparency and the establishment of an ombudsman to protect consumers' rights.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Armenia

## Highlights of the past year

- **The post-crisis recovery has been slow.** Exports and remittances have helped to stabilise output and the agricultural sector is recovering from last year's drought while the construction sector remains depressed. Food prices surged, bringing overall inflation into double digits in early 2011, but have declined recently due to the rebound in agriculture and favourable base effects.
- **The authorities have embarked on an ambitious deregulation programme.** Various measures have been introduced, including a reduction in the required number of licences and the establishment of "one-stop shops" for business registration, the use of risk-based oversight systems, and the "regulatory guillotine" initiative aimed at eliminating excessive regulation.
- **The central bank has pursued policies to contain dollarisation.** These include changes in the denomination of foreign currency reserve requirements and risk weights for foreign currency assets in the capital adequacy calculation and increased exchange rate flexibility.

## Key priorities for 2012

- **Further improvement of the business environment is a top priority.** It is important to strengthen competition, to consistently apply the recently adopted legislation on conflicts of interest in the public sector and further professionalise the tax administration. The expected approval of a new mining code consistent with international best practices should help attract further investment in this sector.
- **The internal transportation and communications infrastructure needs to be upgraded.** Given the country's land-locked status, it is important to reduce internal and international transport costs, including those of air travel, by liberalising access of international airlines to the local market.
- **More action should be taken to further develop local capital markets and reduce dollarisation.** The authorities should finance a greater share of public debt domestically and ensure that financial regulations continue to support the development of local currency lending.

## Macroeconomic performance

**Economic recovery has been slow.** Real gross domestic product (GDP) increased by 2.1 per cent in 2010 and 3 per cent year-on-year in the first half of 2011. Mining and manufacturing have been the main drivers of growth, largely due to higher global prices for metals. The largely unreformed agricultural sector, which suffered from drought and disruption of remittances in 2010, has also recovered. The construction sector, an important engine of growth before the crisis, remains subdued. The authorities continue to reduce the government deficit in order to maintain public debt at a sustainable level. The current account deficit has narrowed due to recovering remittances and increasing mining exports, although it remained high in 2010 at about 14 per cent of GDP.

**Inflation has been an important policy challenge.** In spring 2011 annual consumer price inflation rose into the double digits as a result of increasing global food and energy prices, significantly exceeding the central bank's target range of 4 +/-1.5 per cent. However, inflation moderated by mid-2011 as the central bank increased policy rates, fiscal spending moderated and food price pressures receded. The central bank reduced its policy rate in September as inflation fell within the target band. In March 2011 the government introduced targeted subsidies to mitigate the impact of inflation on vulnerable social groups and provided support to the agricultural sector.

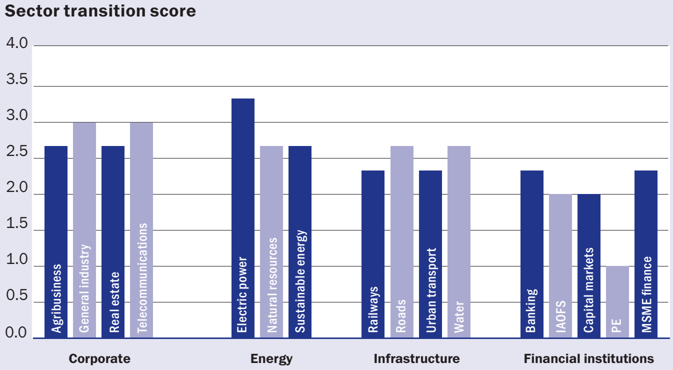
**The economic recovery is expected to continue with inflation moderating.** Output growth is projected to be 4.5 per cent in 2011, largely due to the ongoing recovery in the agricultural sector, which will also help inflation remain close to the target level. However, Armenia's relatively monopolised economy remains largely dependent on the external sector which makes it vulnerable to negative shocks suffered by its trading partners. Immediate risks are related to the uncertain external environment, in light of the country's dependence on remittances and the export of few commodities. The medium-term prospects depend to a large extent on the authorities' ability to create conditions for investment, productivity improvements and diversification.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 6.9 | -14.1 | 2.1 | 4.5 |
| Inflation (end-year) | 5.2 | 6.5 | 9.3 | 4.2 |
| Government balance/GDP[1] | -1.8 | -7.7 | -4.9 | -3.8 |
| Current account balance/GDP | -11.8 | -15.8 | -13.9 | -11.5 |
| Net FDI (in million US$) | 940 | 725 | 569 | 600 |
| External debt/GDP | 16.7 | 41.5 | 45.0 | na |
| Gross reserves/GDP | 12.1 | 23.2 | 19.9 | na |
| Credit to private sector/GDP | 17.8 | 23.6 | 26.8 | na |

Note: [1] Government balance covers central government only.

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Throughout the second half of 2010 and into 2011, the authorities have undertaken various measures to improve the business environment.** A new electronic business registration system and single window registration procedures were introduced in 2010, aimed at reducing the cost of business registration. The number of licences required for various business activities has been reduced substantially, and the time of obtaining construction permits declined from an average of 137 days to 27 days. Risk-based approaches to selecting enterprises for audit are being introduced in the tax and customs bodies and the labour inspectorate. In October 2010 the authorities eased the certification of origin requirements and simplified import procedures, measures that should reduce the cost of cross-border trade. A small and medium-sized enterprises (SME) council was established in July 2011 to address policy issues pertaining to this sector. In cooperation with the European Union (EU), the authorities are working to reform customs and are targeting better governance, compliance, and speeding up clearance.

**The amendments to the Law on Protection of Economic Competition introduced in April 2011 should help strengthen the Competition Commission (CC), through improved methodologies, increased penalties for monopolistic behaviours and strengthened inspections.** However, excessive regulations remain a difficult obstacle to investment with over 25,000 legal norms in effect at the national level. Although many of these legal norms are well designed, there are inconsistencies, contradictions and complexities in the legal framework that are burdensome for citizens and businesses. A regulatory guillotine, announced by the government in June 2011, should help reduce obstacles to doing business and further improve the business environment.

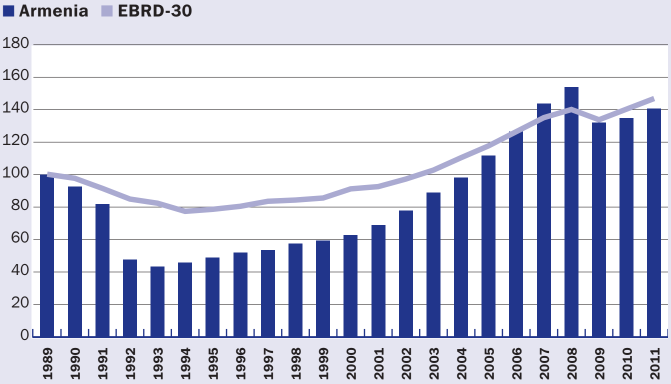
**A mandatory funded pension system is expected to come into force in 2014.** According to new legislation, adopted by the parliament in December 2010, the existing "pay-as-you-go" system will be replaced by a multi-pillar system, including a state pillar and a private pillar, with a fully funded second pension pillar available on a voluntary basis from 2011. The funded system would require that employees transfer 5 per cent of their salaries into the fund until they reach retirement age, and that this will be matched by an equal government contribution (capped at 25,000 drams per year). These funds will be invested predominantly in locally traded securities. The reform should help contribute to the development of long-term investments and a local capital market. The motor liability insurance introduced in January 2011 has boosted development of the insurance sector and is expected to strengthen the local securities market.

**The government continues to make progress in reforming tax administration.** Tax reporting procedures have been made less onerous and payments less frequent. By mid-2011, the e-filing system was extended to over 4,000 taxpayers, and electronic processing of tax returns and automated invoice processing are expected to become operational by the end of 2011. In addition, actions have been undertaken to develop and improve risk management of VAT refunds, audit manuals, large taxpayer auditing and cash register surveillance. To date, however, broad tax reform efforts have brought less revenue to the government than expected.

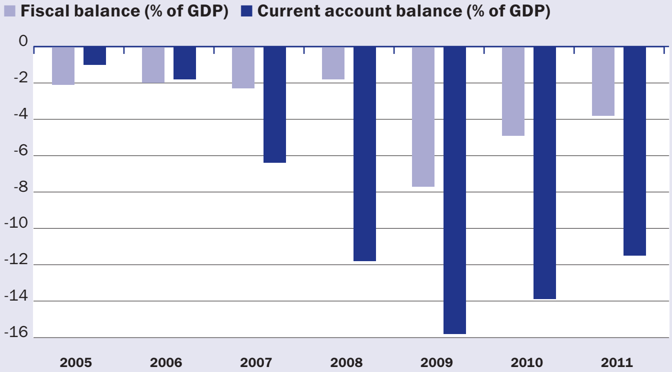
**The authorities are pursuing policies to promote exports.** Armenia is expected to receive €32 million assistance from the EU in 2011-13 to help prepare for the introduction of a free trade regime with the EU and harmonisation of Armenia's laws and regulations with EU standards. The government is also creating export-oriented, free-economic zones to help develop the agricultural sector, high-tech industry and trade. One of these zones will be opened in Zvartnots airport in cooperation with Argentine Corporation America, which will facilitate the export of fresh fruits and vegetables. Another zone, to be based at the Mars plant, is expected to develop industry using innovative technologies. However, the preferential tax treatments offered by these zones may pose risks to the government's tax base.

**The Central Bank of Armenia (CBA) continues to reduce incentives for dollarisation and strengthen the monetary transmission mechanism.** The CBA has continued to raise the proportion of dram-denominated reserves required to support foreign currency liabilities, in order to enlarge the spread in interest rates between local and foreign currency deposits. Although this has helped to decrease deposit dollarisation, foreign currency loans continue to expand. In July 2011 the Armenian authorities signed a Memorandum of Understanding (MoU) with the EBRD to support local currency financing and the development of local capital markets.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Azerbaijan

## Highlights of the past year

- **Economic growth slowed as oil output peaked.** While the recent oil output decline is partly related to extensive maintenance works, it has once again highlighted the country's vulnerability to the swings in energy output and prices. Benefiting from high oil prices, the authorities responded to the slow-down by revising the budget with a view to boosting the non-oil sector, which may lead to an overheating economy.
- **Preparations for restructuring and privatisation of the International Bank of Azerbaijan (IBA) commenced.** A privatisation adviser was selected in June 2011 to help prepare the bank for privatisation.
- **Some anti-corruption measures have been introduced.** These include the launch of a formal anti-corruption campaign and strengthening of the anti-corruption committee. However, corruption remains a serious problem, according to surveys.

## Key priorities for 2012

- **Diversification of the economy remains a priority.** The development of non-oil sectors would make the economy less vulnerable to commodity price volatility. Completing accession to the World Trade Organization (WTO) and simplifying cross-border trading should help achieve this objective.
- **Steps should be taken to improve the business environment and promote competition.** Measures to improve public sector governance should focus on fighting corruption in tax and customs administrations and making their operations more rules-based. Sector regulators should encourage greater competition (especially in telecommunications, transport and the financial sector) and stimulate the entry of foreign strategic investors.
- **The financial sector requires significant reform.** The banking system continues to be dominated by the state-owned IBA, and some of the smaller private banks remain non-transparent and inefficient. Reforms should involve privatisation of the state incumbent and encourage greater competition and consolidation in the sector.

## Macroeconomic performance

**After successfully weathering the financial crisis, Azerbaijan's economy has slowed down recently as the pace of oil extraction decelerated.** In 2010 output grew by 5 per cent, largely due to rising non-oil output which was fuelled by public investment spending. Oil output declined in 2011 leading to further deceleration of the overall growth rate. The policy of maintaining a stable exchange rate of the manat in relation to the US dollar has complicated the central bank's ability to contain inflation, which remains high at around 8.3 per cent in August 2011, largely due to the past year's global food price increases and rising public sector spending. External debt is low, and the public sector balance sheet is supported by a large oil fund. In May 2011 the government amended its 2011 budget by further increasing the non-oil deficit and the pace of transfers from the national oil fund to the budget. This raised concerns about the long-term sustainability of the government's fiscal policy.

**Economic growth is expected to decline in the short term as oil output contracts further.** Oil and gas production growth is expected to remain subdued for the rest of 2011 and remain below the pre-crisis level in 2012. With a mere 2 per cent oil production increase projected by the State Oil Company of Azerbaijan (SOCAR) last year, there will be little to drive growth in an economy that has so far failed to develop viable alternatives to the hydrocarbon sector. Non-oil sector growth is expected to reach around 6 per cent, as the government continues to support the construction sector. Nevertheless, exports of oil and gas will continue to ensure that the current account remains in surplus and the exchange rate remains stable.

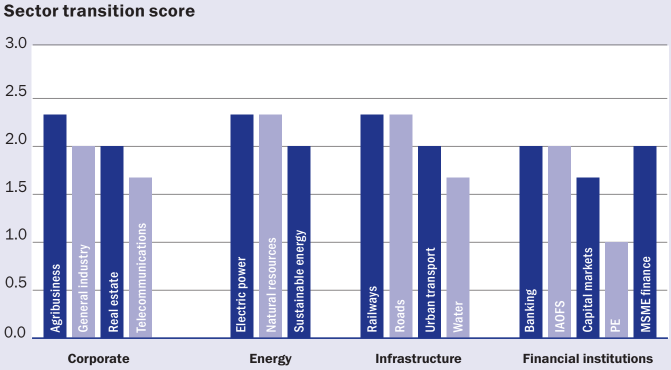
**Longer-term growth will depend on the country's ability to diversify the economy.** Output growth will be boosted temporarily after the Shah Deniz II gas field comes into operation in 2016-17. At that time, the energy sector is expected to begin to stabilise and the importance of the non-oil sector to increase. Profound reforms of the institutional environment and gaining access to the international markets will be needed to attract investment into the non-oil sectors in the coming years.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 10.9 | 9.3 | 5.0 | 0.5 |
| Inflation (end-year) | 15.5 | 0.7 | 7.8 | 7.2 |
| Government balance/GDP[1] | 20.0 | 6.8 | 13.6 | 9.8 |
| Current account balance/GDP | 35.5 | 23.6 | 27.7 | 23 |
| Net FDI (in million US$) | -541 | 147 | 326 | -500 |
| External debt/GDP | 19.1 | 19.9 | 20 | na |
| Gross reserves/GDP[2] | 13.9 | 12.5 | 12.7 | na |
| Credit to private sector/GDP | 16.5 | 19.6 | 18.5 | na |

Note: [1]Government balance excludes municipalities.
[2]Gross reserves do not include the sovereign wealth fund

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**The authorities initiated reforms to improve the judicial system and reduce pervasive corruption.** Administrative courts were established, and the administration of justice was decentralised in late 2010. In early 2011 the President launched an anti-corruption campaign and strengthened the anti-corruption committee. In January 2011 Azerbaijan and the European Union (EU) signed a Memorandum of Understanding (MoU) on a framework document for a comprehensive institution-building programme to help make public institutions more compatible with EU standards. The authorities continue to participate in the Extractive Industries Transparency Initiative (EITI). Despite these recent efforts, corruption remains a serious problem. The recent EBRD-World Bank Life in Transition II survey shows that the level of perceived corruption in Azerbaijan is one of the highest among the transition countries.

**Preparations have begun for privatisation of the dominant state bank.** In June 2011 the government selected an international consortium of companies to advise the state property fund on privatisation of the International Bank of Azerbaijan (IBA). In addition to preparing the bank for privatisation, the advisers are expected to review the legal and regulatory frameworks with a view to strengthening competition in the financial sector and improving the privatisation procedures.

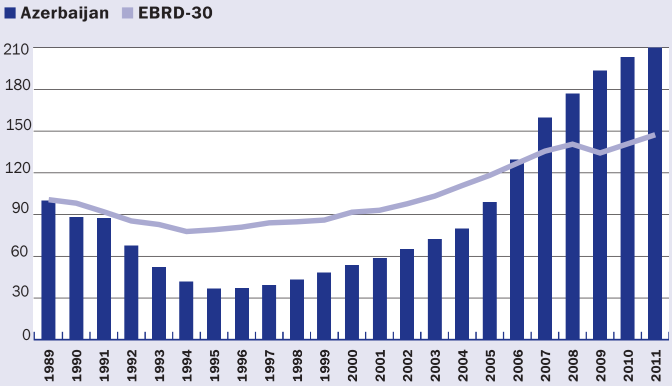
**The authorities have continued to diversify access to hydrocarbon markets.** A feasibility study for a project to export liquefied gas from Azerbaijan to Romania is ongoing. In January 2011 in a joint Azerbaijan-EU declaration on gas delivery to Europe, the authorities expressed their commitment to the development of the Southern Corridor, which should help strengthen energy security in the region. In the meantime, in 2011 the national energy company SOCAR agreed to double gas exports to Russia.

**Large infrastructure projects intended to connect Azerbaijan to its main trading partners are progressing.** Modernisation of the Baku-Tbilisi-Kars railway as well as the north-south rail corridor is expected to be completed in 2012. The government made further allocations to the former project in its 2011 supplementary budget. The construction of a new International Sea Trade Port Complex is also ongoing.

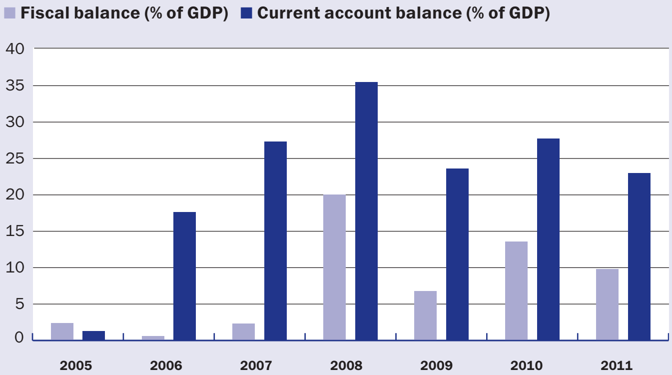
**The National Bank of Azerbaijan (NBA) continues to strengthen the supervisory framework, build capacity for inflation targeting and liberalise the financial market.** In January 2011 the central bank officially announced it would target a dollar-manat exchange rate as a monetary regime. At the same time, the bank's new strategic plan for 2011-14, adopted in July 2011, includes strengthening macroeconomic analysis and forecasting and developing a risk-based supervisory framework among its top priorities. The new law on investment funds, approved in November 2010 and modelled on international best practice, should stimulate greater innovation in this under-developed sector. New private credit bureaus, expected to be established by 2013 based on a new bill currently in the parliament, should help financial institutions to share information on the quality of borrowers.

**Azerbaijan's authorities continue negotiations on the country's access to the WTO.** In October 2010 at the eighth meeting of the accession working party, members noted recent progress on the legislative front and stressed the importance of further intensifying market access negotiations. Bilateral discussions on market access are under way on the basis of revised offers of goods and services.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Belarus

## Highlights of the past year

- **Belarus has suffered from a severe balance-of-payments crisis.** Unsustainable public wage and directed lending policies have caused large current account deficits and loss of central bank reserves. The central bank has devalued the rouble, tightened monetary policy and introduced various controls in the foreign exchange market. After the currency market migrated off-shore, the central bank allowed trading of foreign exchange at a market-determined rate.
- **The government has struggled to balance economic reforms with administrative measures to support the economy.** It has reversed some of the earlier price liberalisation measures, introduced export controls and rationed foreign exchange. At the same time, business licensing and reporting requirements were further simplified.
- **Belarus largely completed its integration into the Customs Union with Kazakhstan and Russia.** A common external tariff is now in place and internal customs borders were eliminated.

## Key priorities for 2012

- **Stabilising the economy is a key priority.** The authorities should permit normal functioning of the foreign exchange market, set policy rates at positive real levels, continue to liberalise prices and contain the growth of directed lending and public sector wages. This should help reduce the large external imbalances.
- **Privatisation and structural reforms should be accelerated.** Commercialisation and privatisation of large enterprises should help modernise the country's industrial base, increase efficiency and make available some of the labour force to work in the nascent private sector. Obstacles for entry and operation of private sector firms should be further reduced.
- **The authorities should promote commercialisation and modernisation of municipal services.** There is clear scope to make tariff policies more cost-reflective and to gradually increase private sector participation, which is currently confined to urban transport.

## Macroeconomic performance

**The macroeconomic situation in Belarus deteriorated sharply in 2011.** Following the expiration of the International Monetary Fund (IMF)-supported programme in 2010, the authorities increased public sector wages and pensions and expanded directed lending and subsidy programmes. These policies eroded competitiveness gains from the devaluation of early 2009, contributed to a further increase of the current account deficit to 15.5 per cent of gross domestic product (GDP) in 2010, and led to the erosion of central bank reserves to less than 1.5 months of imports. The authorities have pursued administrative foreign exchange control measures and tapped commercial banks' external assets via currency swaps with the central bank. Loose monetary and fiscal policies have enabled the government to maintain a high but unsustainable rate of growth. A quick intervention by the IMF, as requested by the government, is unlikely given the disagreement between the government and the IMF on macroeconomic and structural priorities and the need to generate broad support for the programme among IMF membership. The first tranche disbursement provided in June under a three-year US$ 3 billion loan from the Commonwealth of Independent States (CIS) regional stabilisation fund will only provide a few months' reprieve.

**Over the past year, Belarus has experienced a severe balance-of-payments crisis.** In May 2011 the central bank devalued the rouble exchange rate in relation to the dollar by 56 per cent; established a new official exchange rate which it has been unable to support with interventions due to the low level of international reserves; and increased the refinancing rate by 16 percentage points to 30 per cent in September, with a further rise to 35 per cent in October. At the same time, the authorities have resorted to old-fashioned administrative measures in the currency and consumer markets. Multiple exchange rates have emerged in the retail and wholesale markets. Inflation soared to 61 per cent year-on-year in August 2011, and is likely to rise further as most imports are re-priced at depreciating unofficial exchange rates. Although the latest data continue to record robust growth, output is likely to slow as the central bank withdraws the stimulus and the government cuts back on its enormous directed lending programme. The true quality of assets in the state-dominated banking system is highly uncertain given the history of directed lending. In September 2011, the central bank introduced a special session at the Belarus Stock and Currency Exchange where foreign currency may be traded at market exchange rates.

**Immediate and longer-term growth prospects depend on the authorities' ability to pursue a credible stabilisation programme and structural reforms.** As the government's ability to stimulate domestic

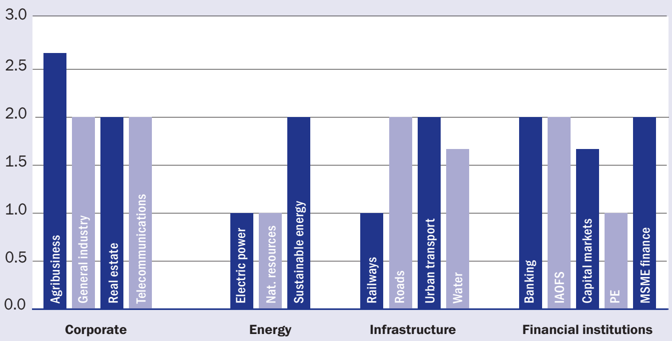
### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 10.2 | 0.2 | 7.6 | 4.5 |
| Inflation (end-year) | 13.3 | 10.1 | 10.0 | 100 |
| Government balance/GDP[1] | -3.5 | -0.7 | -4.3 | -3.3 |
| Current account balance/GDP | -8.6 | -13.0 | -15.5 | -13.4 |
| Net FDI (in million US$) | 2150 | 1782.2 | 1307 | 1800 |
| External debt/GDP | 25.0 | 44.8 | 52.1 | na |
| Gross reserves/GDP | 5.0 | 11.5 | 9.2 | na |
| Credit to private sector/GDP | 28.6 | 37.2 | 44.8 | na |

Note: [1]Augmented balance.

### 2011 sector transition indicators

Sector transition score




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

consumption and investment is diminished, output growth is expected to decelerate sharply. Credit growth is also expected to decline as the government curtails the directed lending programmes. Medium-term growth prospects hinge on the authorities' ability to rebalance the economy without destabilising the financial sector and, at the same time, to implement structural reforms needed to increase productivity in the existing industries and support labour migration to new sectors. Uncertain future energy prices remain a source of macroeconomic risk, as Belarus is one of the most energy-intensive and import-dependent economies in the region.

## Major structural reform developments

**The government took steps to stimulate private sector development and competition.** In January 2011 the number of economic activities subject to licensing requirements was further reduced by one-third. This measure was expected to eliminate the need to renew 60 per cent of licences in effect at that time. In the same month the number of required tax and various other reports to be filed by companies was significantly decreased. A new five-year plan and the President's Directive No. 4, approved in December 2010, envisage further significant reforms intended to stimulate high value-added and export-oriented sectors via further liberalisation of private sector activities, strengthening protection of property rights, modernisation of the financial sector and privatisation to attract foreign direct investment (FDI). The reforms are intended to create one million private sector jobs by 2015. However, their implementation has been hampered by the crisis.

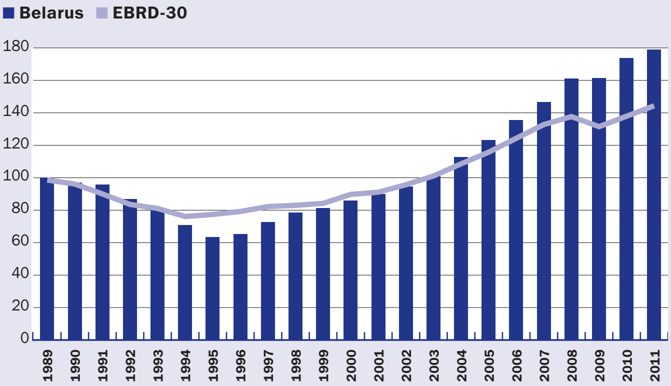
**Enterprise privatisation has made slow progress.** In March 2011 the Cabinet of Ministers approved plans for the privatisation of 245 state-owned enterprises and corporatisation of 134 companies. The privatisation list includes enterprises in the machine building, chemical, energy, textile, transport, food-processing and forestry sectors. However, this list does not include the main blue chip companies in the petrochemical and machine-building sectors. The agency for privatisation and investment became operational in June 2011. Privatisation suffered a reversal in January 2011, as the government re-nationalised Pinskdrev, a furniture manufacturer, after an industrial accident.

**The government reintroduced some price controls and curbed exports during the crisis.** Before the crisis broke out in spring 2011, the government had prepared a new draft decree on further price liberalisation. However, as pressure on prices increased after the May devaluation, the government reintroduced and expanded price controls. Motivated by the low production volumes of rapeseed last year, in March 2011 the government decreed a ban on the export of various seeds and oils. In addition, a temporary ban on the export of some agricultural products and white goods was also introduced. These measures led to temporary shortages of some products and hampered the economy's capacity to adjust from a growth model based on domestic consumption to one based on exports.

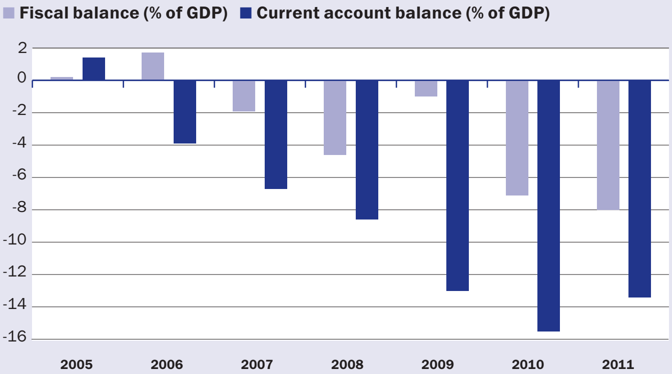
**The government has started to reform the state-owned financial sector.** In July 2011 the central bank stopped direct lending operations to banks. In June 2011 President Lukashenka signed a decree mandating the creation of a state-owned Development Bank of the Republic of Belarus. Over time, the new bank will take over financing of projects under the state-directed lending programmes currently undertaken primarily through the state-owned banks, Belarusbank and Belagroprombank. This should introduce greater transparency to the directed lending programmes, help account for their fiscal costs and strengthen competition in the banking sector as a whole, provided access to the directed lending programmes is competitively rationed. However, an orderly transfer of directed loans from commercial banks to the new bank will be necessary to ensure that it improves banks' balance sheets and does not disrupt their operations.

**Belarus has pursued deeper integration in the Customs Union with Kazakhstan and Russia.** After a transition period, in July 2011 the authorities adopted the new common tariff on all products, including cars. In April 2011 internal borders were eliminated and in July 2011 Belarusian citizens were allowed to work in Russia without permits and special registration. In December 2010 the three nations' chief executives signed a Declaration on the establishment of the Single Economic Space to commence on 1 January 2012. Since the beginning of 2011, Russia has not applied export duties on crude oil exported to Belarus while the latter has been transferring revenues from export taxes on petroleum products sold outside the Customs Union to the Russian budget. In August 2011 Prime Minister Putin of Russia announced that Belarus will receive a gas price discount, to be linked to the depth of its integration with the Customs Union.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Bosnia and Herzegovina

## Highlights of the past year

- **No progress has been made towards European Union (EU) approximation.** The situation has been additionally complicated by the long delay in forming a government at state level. Some EU funding has also been held back.
- **Roads are being improved and some reforms are occurring.** The quality of the road network continues to be improved gradually, along with some important commercially-oriented reforms such as the establishment of a motorway agency.
- **The economy has stabilised but business environment conditions are still dificult.** Economic growth was marginally positive last year but further stabilisation measures were hampered by slow progress in implementing the International Monetary Fund (IMF) programme and the still burdensome administrative procedures for enterprises.

## Key priorities for 2012

- **Advancing the EU process is vital.** Bosnia and Herzegovina risks being left behind unless progress is made in preparing the country for a possible application for EU membership. This will require stabilisation of the political situation and agreement on constitutional reforms aimed towards more efficient institutions.
- **Privatisation needs to be accelerated.** A speeding-up of the process would bring much-needed investment, along with new skills and technology, and could provide a boost to growth rates but will require some politically difficult decisions by the authorities.
- **The Stand-By Arrangement (SBA) with the IMF should be completed.** This would be a positive signal of the authorities commitment to prudent macroeconomic policies and it would help unlock significant support from international financial institutions (IFIs) and other countries.

## Macroeconomic performance

**Macroeconomic performance improved slightly in 2010.** Real GDP growth is estimated to have reached 0.7 per cent last year. Trading activity has resumed as exports increased by double-digit levels and imports only marginally. However, domestic consumption has remained somewhat subdued, largely owing to both the austerity measures which have been implemented by the authorities in the past two years and to falling remittances. Private investment, especially from foreign sources, declined substantially in 2009-10 but has since started to recover. Annual inflation has increased since early 2011 and peaked at 4.2 per cent year-on-year in May this year. The banking system remains liquid and well capitalised but the ratio of non-performing loans (NPLs) to total loans is still rising.

**The government's fiscal policies are anchored by the 36-month SBA with the IMF.** Within this framework, the authorities committed to implement comprehensive fiscal austerity measures and structural reforms and to focus on enterprise restructuring. Following significant expenditure cuts in 2009, in particular in the Federation of Bosnia and Herzegovina (FBiH), progress stalled since the run-up to the national elections in autumn 2010, but further fiscal consolidation will be necessary in the coming months. The consolidated budgetary deficit in 2010 is estimated at 4.5 per cent of GDP, and the authorities are planning a deficit amounting to 3 per cent of projected GDP in 2011, as envisaged by the IMF programme. However, the central government's draft budget for 2011 was rejected in parliament in June 2011. The Central Bank of Bosnia and Herzegovina (CBBH) decided in January 2011 to lower commercial banks' minimum reserve requirements on short-term deposits by four percentage points to 10 per cent.

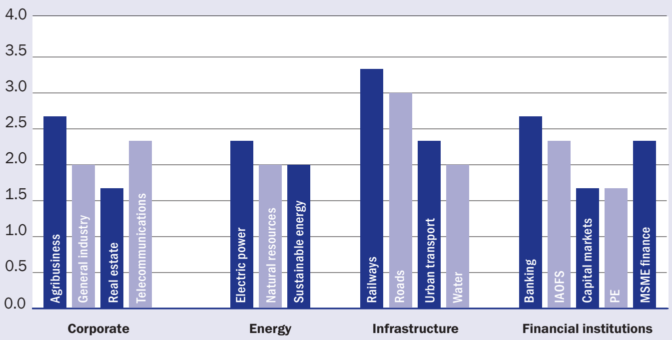
**The economy is expected to continue the export-driven recovery.** However, the complex constitutional structures continue to prevent the implementation of a comprehensive and much-needed reform agenda. Further risks stem from a deteriorating fiscal stance if governments in both entities fail to maintain their commitment to fiscal consolidation. This could severely delay the full implementation of the SBA and jeopardise additional and necessary funding from both the European Union and the World Bank.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 5.7 | -2.8 | 0.7 | 2.1 |
| Inflation (end-year) | 7.4 | -0.1 | 3.1 | 3.5 |
| Government balance/GDP | -3.6 | -5.7 | -4.5 | -3.5 |
| Current account balance/GDP | -14.2 | -6.3 | -5.6 | 6.2 |
| Net FDI (in million US$) | 908 | 245 | 17 | 226 |
| External debt/GDP | 49.0 | 54.1 | 56.9 | na |
| Gross reserves/GDP | 25.4 | 25.9 | 20.5 | na |
| Credit to private sector/GDP | 58.9 | 58.7 | 56.6 | na |

### 2011 sector transition indicators

**Sector transition score**




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**No progress has been made in EU approximation in the past year.** In its 2010 and 2011 Progress Reports, the European Commission underlined the only limited progress the country has made with regard to structural and economic reform. Bosnia and Herzegovina is the only country in south-eastern Europe that has not yet even applied for EU membership. However, in December 2010, its citizens (along with those in Albania) were granted visa-free travel to the Schengen Zone.

**The privatisation process continues to be stalled.** A significant number of companies, in particular in the FBiH, continue to remain under state control. Many companies are in principle up for sale but, in general, no credible plan to implement this programme exists. In August 2011 the government of the FBiH approved the privatisation of construction company Hidogradnja, the wood-processing firm Šipad Export-Import, metal industry UNIS and fuel retailer Energopetrol. No minimum asking prices have been set, although the government is apparently hoping to raise around €8.5 million for Energopetrol. Additional companies, including the aluminium smelter Aluminij, engineering company Energoinvest and the insurer Sarajevo Osiguranje are supposed to be put up for sale in 2012. No new details have emerged on the sale of the national flag carrier BH Airlines and the telecommunications operator HP Mostar, whose privatisation failed in 2010. In the Republika Srpska, the 2011 privatisation plan envisages the sale of majority shares in 14 strategic companies, but progress remains limited.

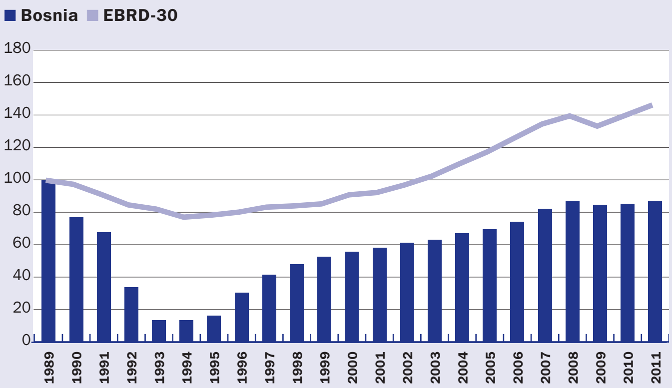
**Private sector development continues to be hampered by the unfavourable business environment.** In the World Bank *Doing Business 2011* survey, Bosnia and Herzegovina is ranked at the bottom of the south-eastern European region and among the lowest economies in the transition region at 110th position out of 183 surveyed countries. Progress, however, has been made with regard to registering property. The authorities further simplified the labour tax process and reduced employer contribution rates to social security. Despite the weaknesses in the investment climate, a private equity market is starting to develop, with active capital in the market reaching 0.8 per cent of GDP in 2010, up from 0.3 per cent in 2009, on the back of a large transaction.

**Motorway construction is advancing.** Progress has been made with regard to the construction of the motorway between Banja Luka and Gradiška. After further delays, the motorway is expected to be completed in autumn 2011. A new concession was also launched in June 2011 for the construction of the motorway linking Banja Luka to Doboj, which had been cancelled last year as the selected construction company, Strabag, had difficulties in securing finance.

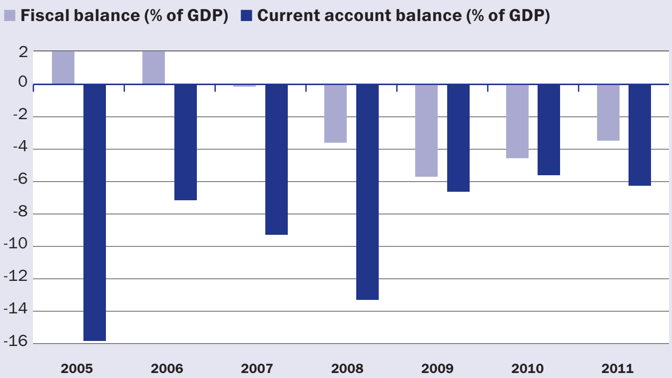
**Reforms have progressed in the road sector.** All maintenance companies have been privatised and performance-based contracts have been introduced in a number of pilot areas. Motorways agencies have been established and the authorities in both entities are keen to advance public-private partnerships (PPPs.)

**New employment strategies have been adopted.** Both the Federation of Bosnia and Herzegovina and the Republika Srpska have adopted Employment Strategies in the past year outlining their objectives in reforming the labour market. The RS Employment Strategy 2011-15 in particular envisages a reform of the education system, and aims to encourage female participation in the labour force. In addition, both strategies aim to improve employment protection legislation.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Bulgaria

## Highlights of the past year

- **Growth has returned to the economy, combined with improved fiscal discipline.** After barely positive growth in 2010, the outlook for 2011 is improved. In parallel, the government has made important spending cuts in the public sector and has introduced new rules, endorsed by parliament, to limit spending and deficit levels in the future.
- **Progress is being made in using European Union (EU) funds.** The rate of absorption of EU structural and cohesion funds accelerated from a low level, and measures are being implemented to further increase technical and administrative capacities.
- **A more commercial approach to some transport infrastructure is being introduced.** Concessions have been developed in the port and aviation sectors. Their successful implementation would help to bring much-needed finance to further upgrade these sectors, but will depend on signing term agreements with high-quality owner/operators.

## Key priorities for 2012

- **Fiscal discipline should be maintained.** Successive governments have pursued over the years strong fiscal discipline and it is vital that this is maintained, particularly given the strong commitment to maintaining the currency board. A timely implementation of the Fiscal Stability Pact (FSP) and further progress on key structural reforms to the healthcare and pension systems would further support this.
- **Further progress is needed towards increasing energy tariffs and improving predictability of tariff setting processes.** Regulated prices have been used to cross-subsidise certain groups (primarily retail buyers) and to keep prices below long-term sustainable levels; reversing this practice would lead to higher investment and a more effective operation of the market.
- **Business environment improvements are needed.** Surveys show that problems persist with regard to obtaining construction permits and trading across borders, two areas where the authorities should push reforms and align legislation with EU standards.

## Macroeconomic performance

**As a small open economy, Bulgaria has been hit hard by the global economic crisis but a modest turnaround took place in 2010.** The economy grew last year by 0.2 per cent. Export activity gained momentum and increased by more than 30 per cent on an annual basis, while imports improved only slightly, reflecting weak domestic demand. The level of unemployment remained relatively high at 10.2 per cent in 2010. There has been a significant decline in inflows of foreign direct investment (FDI), which accounted for only 4.1 per cent of gross domestic product (GDP) in 2010 and a negligible amount in the first half of 2011. Meanwhile, the current account deficit narrowed significantly to around 1 per cent of GDP. In 2011 the recovery is continuing. Exports have increased strongly (as have imports). Inflationary pressures have risen throughout 2010 and the rate of consumer price inflation peaked in early 2011 at 5.6 per cent year-on-year in March. Annual private sector credit growth remains limited and the ratio of non-performing loans (NPLs) to total gross loans has deteriorated to 13.5 per cent by June 2011, but the banking sector remains sound and bank deposits have grown substantially, underlining confidence in the sector.

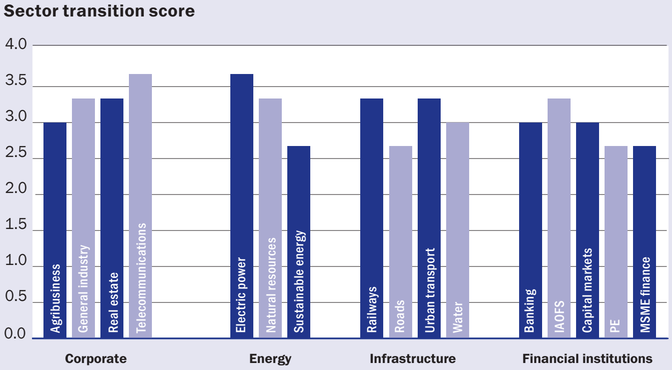
**The authorities are tightening fiscal policy in 2011.** The budget deficit stood at nearly 4 per cent of GDP in 2010 (or 3.2 per cent on an accrual basis according to Eurostat methodology). However, the government is targeting a deficit of 2.5 per cent of projected GDP in 2011. In addition, the authorities initiated the adoption of an FSP in mid-2011. The organic budget law limits the budget deficit and the level of overall budget spending through the introduction of ceilings of 2 per cent and 40 per cent of GDP, respectively. The FSP would further introduce a required constitutional majority vote in order to change direct taxes, but this remains on hold. The Bulgarian National Bank's (BNB) policy tools remain limited by the currency board arrangement, but it has implemented prudent regulatory policies to help weather the worst effects of the global financial crisis.

**The authorities remain committed to the currency board and entry into the Exchange Rate Mechanism-II in the coming years.** Despite the reduction in external imbalances and improved risk profile (Moody's ratings agency upgraded Bulgaria's sovereign rating by one notch in August 2011), vulnerabilities continue to stem from Bulgaria's high level of private external, mostly inter-company, debt. In addition, uncertainties surrounding the prospects for foreign bank subsidiaries, which account for the great majority of total assets in the Bulgarian banking sector, may further weaken credit growth.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 6.2 | -5.5 | 0.2 | 1.6 |
| Inflation (end-year) | 7.2 | 1.6 | 4.4 | 2.7 |
| Government balance/GDP | 2.9 | -0.9 | -3.9 | -2.5 |
| Current account balance/GDP | -22.9 | -8.8 | -1.0 | -1.6 |
| Net FDI (in million US$) | 9187 | 3525 | 1936 | 807 |
| External debt/GDP | 96.9 | 113.2 | 101.6 | na |
| Gross reserves/GDP | 33.1 | 38.8 | 35.0 | na |
| Credit to private sector/GDP | 69.8 | 73.3 | 74.6 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Bulgaria continues to stress the need to fight organised crime and corruption, and has demonstrated commitment to the reform of the judiciary.** These were among the main conclusions of the European Commission's (EC) Annual Report, issued in July 2011, on Bulgaria's progress made under the Cooperation and Verification Mechanism (CVM). However, the EC also urged the authorities to take further steps to complete a fundamental judiciary reform. At a meeting of the EU justice and interior ministers in June 2011, it was decided to further postpone Bulgaria's entry into the Schengen Zone, linked in parts to the still insufficient progress with regard to strengthening the judiciary.

**Some progress has been made recently in absorbing EU structural and cohesion funds.** By the end of 2010, only around 10 per cent of available funding for the period 2007-13 had been disbursed. However, the authorities have implemented a number of reforms aimed at increasing absorption, and a special EU Funds Minister was appointed to improve coordination. Consequently, the rate of absorption accelerated in the second half of 2010, and the government is aiming to increase the absorption in 2011 to €770 million, equivalent to the total amount disbursed between 2007 and 2010. Further reforms, in particular with regard to the Public Procurement Law, are under consideration.

**Privatisation of Bulgartabac has been completed.** This formerly state-owned company owns about half of the local tobacco market. A tender for the sale of the 79.8 per cent state assets in Bulgartabac was launched in April 2011 without a minimum asking price. In late August, the Bulgarian privatisation agency accepted an offer of €100.1 million offer by the sole bidder, the Austrian firm BT Invest GmbH, who pledged an additional BGN 7 million (approximately €3.5 million) investment in the coming years. In addition, the BPA announced plans in May 2011 to privatise the state's minority stakes in majority foreign-owned power distribution utilities CEZ, EVN and E.ON.

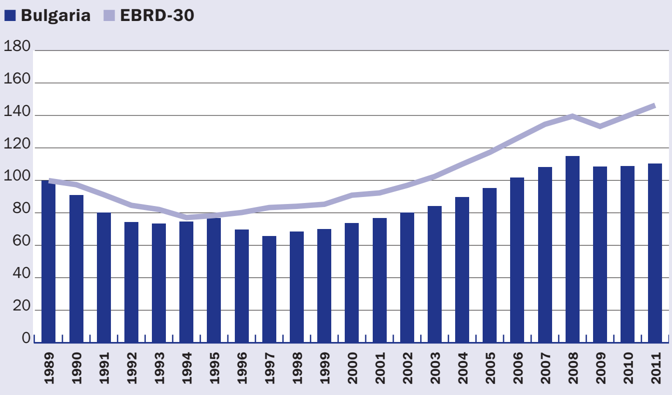
**Bulgaria's eligibility to trade $CO_2$ emissions has been restored.** The decision was taken by the United Nations Compliance Committee of the Kyoto Protocol in February 2011. It followed a temporary annulment in summer 2010 of Bulgaria's accreditation to participate in the international carbon quota trading scheme after the country had failed to set up a well-functioning system to measure and report emissions. The decision also allows Bulgaria to return to the European Union emission trading scheme (ETS) , therefore allowing it to take advantage of trading its surplus carbon credits and raising much-needed revenue.

**The government has decided to offer a number of concessions in 2011 to upgrade the country's port and aviation infrastructure.** In July 2011 the Lukoil Neftochim (a joint venture of Russia's Lukoil and the Bulgarian state) was granted permission to run the Rosenetz terminal in Bourgas under concession. A concession on Bourgas-East 2 Port Terminal was awarded to BMF port Bourgas FAD. Concession tender procedures were launched for regional airports in Gorna, Plovdiv and Rousse. Further, the government indicated its intention to start concession procedures for a number of assets in the public transport sector. The government may require additional management/advisory resources to implement this programme.

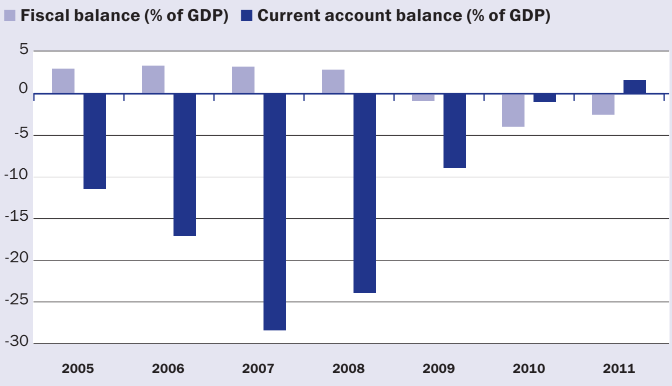
**The banking sector has remained profitable despite the crisis.** As of the end of 2010 there were 30 banks, with foreign-owned banks (22 in total) holding 81 per cent of total bank assets. Parent banks abroad have shown commitment during the height of the crisis, especially in relation to any adverse effects from developments in Greece. Competition is strong, and financial intermediation has remained stable with an assets-to-GDP ratio of 1.05 in 2010 and deposits-to-GDP of 0.8, with 55 per cent of the deposits denominated in foreign currency (mostly the euro).

**A comprehensive pension reform has been approved.** In November 2010 the Bulgarian parliament approved a comprehensive pension reform, envisaging an increase in the contribution rate by 1.8 percentage points as of 2011 and a gradual rise in the retirement age to 63 for women and to 65 for men from 60 and 63 years, respectively, from 2021 to 2026 for women and by 2024 for men. The Bulgarian pension system currently accounts for approximately 10 per cent of annual GDP, and further adjustments are likely to become necessary in the coming years as the contribution-benefit gap will widen. In addition, the government has reduced the public sector workforce by more than 12 per cent since the onset of the global crisis. In spring 2011 the government announced plans to further reduce the public work force by approximately 4 per cent.

**Real GDP (1989 = 100)**




**Fiscal balance and current account balance**



# Croatia

## Highlights of the past year

- **EU accession negotiations have successfully been completed.** The EU accession treaty is expected to be signed before the end of this year, and will be followed by the ratification process. Croatia is most likely to join the European Union in July 2013.
- **The Economic Recovery Programme (ERP) is gradually being implemented.** Some reforms have been made to the pension system and to tackle long-term unemployment, but other measures envisaged by the programme to increase the long-term competitiveness of the Croatian economy have yet to be adopted.
- **Macroeconomic performance remains weak.** The economy recorded negative growth in 2010 and only marginally positive growth is expected this year. While inflation is low, the level of foreign exchange reserves is relatively low compared to regional peers and the banking system remains heavily dependent on external financing.

## Key priorities for 2012

- **Restoring robust growth is the main challenge.** The completion of EU accession negotiations is a boost, but needs to be accompanied by comprehensive reforms to reduce the size of the state, further increase labour market flexibility and promote a more business-friendly environment.
- **Privatisation needs to be accelerated.** A relatively large number of companies remain under state control and progress in divesting these stakes has been limited in recent years. It is important to pursue further enterprise restructuring in order to reduce the relatively high level of state subsidies.
- **Further commercialisation of infrastructure should be advanced.** Implementation of the energy development strategy and the national renewable energy action plan, both adopted in recent years, would help make prices more cost reflective and would boost energy efficiency.

## Macroeconomic performance

**Croatia is struggling to recover from the global economic and financial crisis.** Real gross domestic product (GDP) decreased further in 2010 by 1.2 per cent. Foreign direct investment (FDI) more than halved and trading activity remained subdued throughout much of 2010. Exports have accelerated more recently, suggesting that the main driver of growth is shifting from the domestic to the external sector. As a result, the current account deficit narrowed substantially from almost 10 per cent of GDP during the initial pre-crisis period to just 1.1 per cent of GDP in 2010. Industrial output remains weak and (ILO-defined) unemployment was still rising (year-on-year) in the first half of 2011. Reflecting weak domestic consumption, inflation has remained relatively modest at 2 per cent in August 2011. The banking sector remains sound and liquid and annual private credit growth resumed in mid-2010, partially attributed to state-funded credit support schemes and higher lending to the corporate sector. However, the level of non-performing loans (NPLs) is still increasing, reaching 11.5 per cent of total loans in the first quarter of 2011.

**In 2010, the Croatian government adopted a comprehensive Economic Recovery Programme.** This is aimed at increasing Croatia's long-term competitiveness and sustaining public finances. Fiscal consolidation, however, has been limited so far and the 2010 general budgetary deficit increased to 5 per cent of GDP. In November 2010 the parliament adopted a Fiscal Responsibility Law, which aims to reduce government spending by 1 percentage point of projected annual GDP, starting in 2012, until the primary fiscal deficit has been eliminated. In 2011 the government has planned a general government deficit of 5.4 per cent of GDP, including some one-off revenue reduction measures, part of which is being financed by a US$ 1.5 billion Eurobond issued in March 2011. The Croatian National Bank's (HNB) priority continues to be the preservation of Kuna stability and it has occasionally intervened on the foreign exchange market. In order to boost banking sector liquidity, the HNB reduced the minimum foreign exchange liquidity requirement from 20 to 17 per cent. It also lowered the interest rate of commercial banks' overnight deposit from 0.5 to 0.25 per cent in March 2011 in order to stimulate lending. However, it increased the reserve requirement in September 2011 from 13 to 14 per cent.

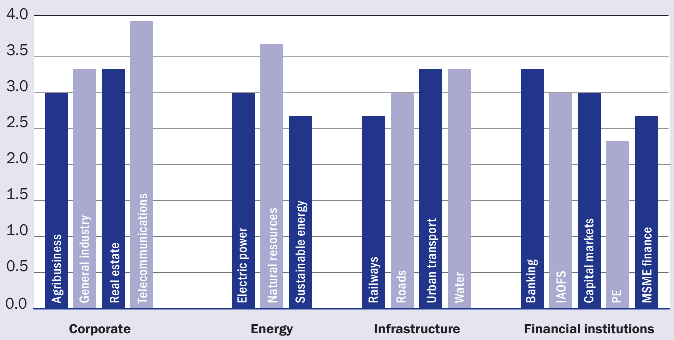
**The economy is projected to recover very slowly.** An EU pre-accession boost is likely to support economic growth in 2012 and 2013. However, significant vulnerabilities persist, in particular if the government fails to fully implement the ERP and if the recovery of the eurozone continues to remain sluggish. The economy is facing serious competitiveness problems unless deep structural reforms are implemented.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 2.2 | -6.0 | -1.2 | 0.5 |
| Inflation (end-year) | 6.1 | 1.9 | 1.9 | 2.4 |
| Government balance/GDP | -1.3 | -4.1 | -5.0 | -5.7 |
| Current account balance/GDP | -8.6 | -5.0 | -1.1 | -1.8 |
| Net FDI (in million US$) | 4706 | 1617 | 452 | 990 |
| External debt/GDP | 82.5 | 102.4 | 102.1 | na |
| Gross reserves/GDP | 18.5 | 23.5 | 24.7 | na |
| Credit to private sector/GDP | 64.4 | 65.9 | 70.1 | na |

### 2011 sector transition indicators

Sector transition score




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**EU accession negotiations have been successfully completed.** In the first half of the year, Croatia and the European Commission successfully concluded the last four chapters of the EU accession negotiation process, on Competition Policy, Judiciary and Fundamental Rights, Financial and Budgetary Provisions, and Other Issues. EU member states decided on 30 June to close negotiations, and the accession treaty is expected to be signed before the end of 2011. The treaty will then face ratification in all member states and Croatia, and accession is now expected on 1 July 2013.

**The privatisation agenda remains unfinished and a large number of state-owned assets continue to await sell-off.** The Croatian Privatisation Fund (HFP) has resumed its privatisation efforts and in early 2011 it offered minority stakes in more than 150 companies. Efforts to sell these stakes are proceeding slowly. Between September 2010 and March 2011, a total of four companies in which the state holds a majority stake were privatised, along with 68 minority shares, generating around €11 million. Some 600, mostly indebted, companies currently remain under state control.

**Further progress has been made in privatising the remaining six state-owned shipyards.** This was a key requirement for closing the Competition Chapter in the EU accession negotiations. The shipyards receive subsidies amounting to approximately 0.25 per cent of GDP according to IMF estimates, while financial and performance guarantees generate additional liabilities to the government accounting for 3.3 per cent of GDP at the end of 2010. In November 2010 the HFP received three bids for a 99.5 per cent stake in the Brodogradiliste Kraljevica shipyard for the symbolic price of 1 Kuna and negotiations commenced with the Croatian investment company Jadranska Ulaganja. The same investors bid for a 95.2 per cent stake in Brodotrogir shipyard and a 83.3 per cent stake in the 3.Maj shipyard when a new tender was launched for the shipyard, after the government had rejected an offer by the German company Crown Investment. The restructuring programmes for the three shipyards are currently pending EU approval. In February 2011 the European Commission approved the restructuring programme of Brodosplit and the affiliated Brodogradiliste Specijalnih Objekata by the local coil company DIV, for which a 100 per cent stake for the price of Kuna 18.16 million was offered. DIV's restructuring plan envisages investments of Kuna 1.5 billion.

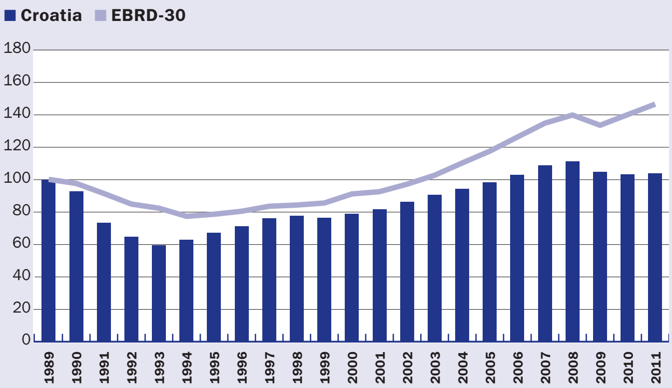
**Some reforms to the business environment have been implemented.** These include measures to strengthen bankruptcy procedures and harmonise business registration. As a result, Croatia's ranking climbed 44 places (to 56th) in the World Bank's *2011 Doing Business* survey with regard to starting a business. The number of income tax rate bands was reduced, income taxes were lowered, and the so-called crisis tax introduced in 2009 was abolished in autumn 2010.

**Private sector investment in Zagreb airport is invited.** In February 2011 the Ministry for Transport published a tender for a 30-year concession of Zagreb airport, envisaging the construction of a new passenger terminal and upgrading the infrastructure of the existing airport. In late July 2011 the government asked those bidders who successfully completed the pre-qualification round to submit a final offer by the end of October 2011. The deadline for the pre-qualification round had been delayed several times and construction at the airport is now expected to start in mid-2012.

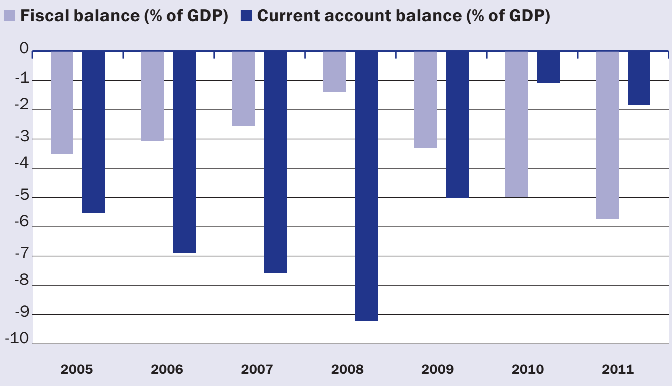
**The financial sector has coped well with the crisis.** Foreign-owned banks continue to dominate the market with more than 90 per cent of market share (in terms of assets), and the banking system as a whole remains well capitalised and profitable, although non-performing loans (NPLs) have risen significantly in the crisis. Pension funds have also managed to avoid the worst effects of the crisis.

**Implementation of the ERP, introduced by the government in April 2010, is advancing slowly.** Among other measures, the pension law was amended in October 2010 with the aim of harmonising the retirement age of men and women to 65 by 2030. In addition, policies for early retirement were revisited and the government adopted new measures in February 2011 under the National Plan for Encouraging Employment to tackle long-term and youth unemployment. In addition, the Labour Law was amended, envisaging unemployment benefits to be lowered from 50 per cent to 35 per cent of the previous wage after the first 90 days. However, reforms are lagging behind in a number of areas envisaged by the ERP, such as more flexible wage setting and the reduction of the large public sector.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Estonia

## Highlights of the past year

- **Euro adoption in January 2011 has boosted investor and consumer confidence.** Strong economic growth in 2011 is being boosted by an exceptional export performance in the technology-intensive sector.
- **The fiscal consolidation programme following the financial crisis allowed for a better-than-expected deficit.** In addition, gross public debt remains at the lowest level in the European Union.
- **Further progress has been made in the energy sector.** Plans have been announced to unbundle natural gas sales and transmission. If implemented, this should lead to greater transparency and competition in the gas sector.

## Key priorities for 2012

- **Sustaining a good fiscal position is crucial.** Estonia is well placed to continue strong growth provided that fiscal discipline is maintained.
- **Securing sustainable energy and the development of nuclear energy are vital priorities.** These objectives continue to be particularly important following the closure of the Ignalina nuclear power plant in Lithuania.
- **The authorities should continue to enhance the knowledge-based economy.** Estonia is leading the way in the region through specialising in the production of high-technology goods, but there is scope to develop these further, which underlines the need for an ongoing upgrade in the education system.

### Macroeconomic performance

**Estonia was severely impacted by the crisis but the economy has been on a solid recovery path, recording the strongest growth of any EU country in the first half of 2011.** Estonia is now projected to grow by 7.5 per cent in 2011, growth that has been primarily driven by exports and the inventory cycle. Exports grew by 35.2 per cent in real terms in the first half of 2011 compared with a year ago. They were driven, in particular, by strong demand from Sweden (where Estonian exports have increased by 92 per cent in the first six months of the year), Finland and Russia, which make up Estonia's three most important export markets. Technology-intensive products such as electrical equipment continue to take the lead. The country is capitalising on sound competitiveness indicators following the internal devaluation throughout the crisis, a good position in key technology-intensive product groups, and good growth in partner countries, such as Sweden and Germany.

**In line with the improving growth momentum, the labour market is also recovering and driving the increase in private consumption.** A much sharper than anticipated drop in unemployment (to 12.8 per cent in mid-2011 from 17.9 per cent a year earlier) has already lifted private consumption, as underlined by positive consumer sentiment data, which stands higher than all other countries in the region. Credit continues to contract (down 5.2 per cent in June on an annual basis) as the largely foreign-owned banks continue to normalise their loan-to-deposit ratios from still very high levels. Despite the rapid credit boom in the years leading up to the crisis, fairly sound regulation appears to have contained a deterioration in bank asset quality, with non-performing loans (NPLs) remaining the lowest of the three Baltic states at only 6.2 per cent in July 2011.

**Over the course of the 2009 recession and leading up to euro adoption fiscal policy, nominal wages within Estonia showed exceptional flexibility.** While average nominal wages fell by 20 per cent between June 2008 and August 2009, they were once again up by 8.7 per cent in May compared with a year earlier. Inflation continues to be well contained, although it picked up slightly in early 2011, largely due to import prices. This flexibility was essential in maintaining competitiveness within the constraints of its rigid currency board and will now remain so within the eurozone.

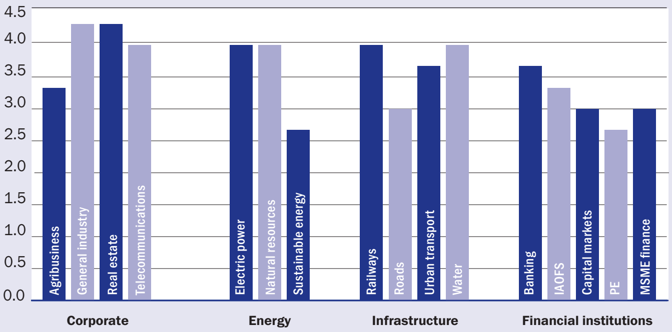
**Despite the massive output contraction Estonia managed to contain the fiscal deficit in advance of euro adoption.** The general government surplus at 0.1 per cent of gross domestic product (GDP) in 2010 was better than expected and the outcome of a swift recovery and sizeable

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| **GDP growth** | -3.7 | -14.3 | 2.3 | 7.5 |
| **Inflation (end-year)** | 7.5 | -1.9 | 5.4 | 2.7 |
| **Government balance/GDP** | -2.8 | -1.7 | 0.1 | 0.0 |
| **Current account balance/GDP** | -9.7 | 3.7 | 3.6 | 3.0 |
| **Net FDI (in million US$)** | 598 | 202 | 991 | 1071 |
| **External debt/GDP** | 118.5 | 125.8 | 117.6 | na |
| **Gross reserves/GDP** | 16.7 | 20.6 | 13.9 | na |
| **Credit to private sector/GDP** | 93.1 | 105.4 | 97.1 | na |

### 2011 sector transition indicators

**Sector transition score**




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

sales of carbon credits which amounted to about 1 per cent of GDP. For 2012 a modest widening is expected to a deficit of about 2 per cent of GDP, and the government is also considering another reduction in personal taxation. Such fiscal stimulus could help to protect growth against the slow-down in export markets expected for next year. Estonia's gross public debt still remains the lowest in the entire European Union at only 6.6 per cent of GDP in 2010. Given these very sound fiscal indicators but also due to the exceptional policy record over the course of the recession and leading up to euro accession, rating agency Standard & Poor's awarded a two-notch upgrade to AA- in August 2011.

## Major structural reform developments

**Given the authorities' priority of joining the eurozone, less emphasis was given to structural reforms which are already well advanced.** The business environment in Estonia continues to be one of the best in the EBRD region and the country is ranked second highest among the transition countries in the World Bank's *Doing Business 2011* survey, in 17th place. Despite the high overall score, Estonia scores considerably lower with regard to the conditions for closing a business or investor protection. According to the survey, dealing with construction permits has been made harder in the last year whereas access to credit has improved.

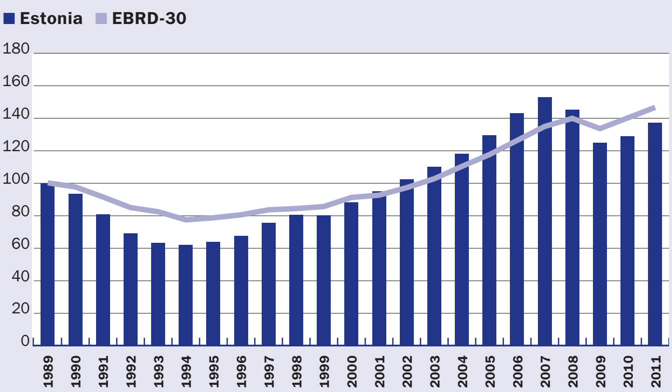
**In line with developments elsewhere in the transition region, the Estonian authorities have adopted reforms to enable household debt restructuring.** In April 2011 a Debt Restructuring and Debt Protection Act came into force which allows households with debt servicing problems to restructure their debts while avoiding bankruptcy procedure. The new law foresees a case-by-case restructuring of all liabilities without the use of public funds and aims to address increasing household debt. Household NPLs peaked in August 2010 and have since decreased to about 4.5 per cent as of mid-2011.

**Some progress was made in the energy sector.** In May 2011 a draft bill published by the Ministry of Economy stipulated plans to separate AS Eesti Gaas's natural gas sales and transmission division by 2015. This move would achieve greater transparency and increase competition by allowing biogas to enter the market and establish the legal basis to build a liquefied natural gas terminal. Further investment in capacity, in particular for renewable energy, is needed, ideally in coordination with neighbours in the region. Improving energy efficiency in residential properties and transport remains a priority.

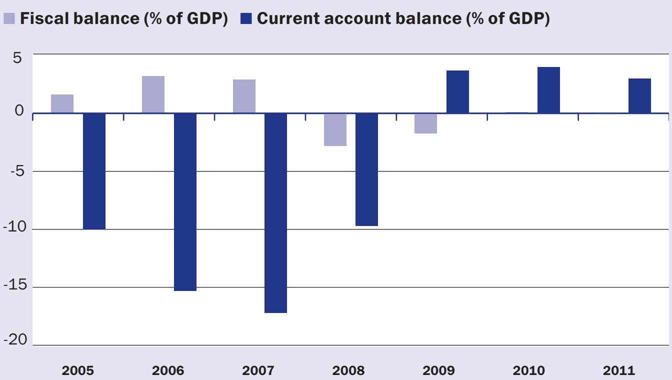
**Estonia remains the most knowledge-intensive economy in the transition region with high-technology goods accounting for about one-third of total exports to other EU countries.** The country's labour force is highly skilled and research and development holds an important role in the economy. As pointed out by the European Commission, however, cooperation between academia and industry could be further strengthened to foster the continued development of the technology-intensive sector. (Further reforms of the education system are currently under way.)

**The government is undertaking a four-year programme aimed at further boosting the country's competitiveness.** This will be achieved through lowering the tax burden, spurring job creation while preserving the current conservative fiscal approach. More specifically, a reduction in personal income tax from 21 per cent to 20 per cent has been agreed for 2015, and the land tax for homeowners will be withdrawn by 2013.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# FYR Macedonia

## Highlights of the past year

- **The economy has weathered the crisis reasonably well.** Growth has resumed, inflation and the government deficit are low and debt levels remain manageable. The International Monetary Fund's (IMF) Precautionary Credit Line (PCL) is an extra source of support.
- **A new energy law has been adopted.** The new law is fully compliant with European Union directives, and should facilitate greater competition in the market, as well as improved energy efficiency.
- **Further improvements to the business climate have been implemented.** The government has maintained its commitment to creating a favourable business environment and has adopted a number of new measures, including to facilitate business registration and broaden the tax base, while also abolishing certain customs tariffs.

## Key priorities for 2012

- **Maintaining fiscal discipline is a key requirement for further growth.** In this regard, it will be important to repay in a timely manner the amount drawn down from the IMF's PCL, as a signal of commitment to prudent macroeconomic policies and the credibility of the government.
- **Privatisation should be advanced.** Once market conditions improve, the sale of several large companies, facilitated by realistic tender conditions, should be brought to completion, in order to bring fresh capital and skills to these enterprises.
- **Further efforts are needed to attract investment.** As a small, land-locked country, FYR Macedonia needs to redouble its efforts to attract investors. Despite significant success in recent years, further improvements to the investment climate and tackling issues such as construction permits and bankruptcy procedures are required.

## Macroeconomic performance

**The economy has been less affected by the global economic and financial crisis than some regional peers.** Gross domestic product (GDP) has recovered from a modest downturn in 2009 to an estimated 1.8 per cent growth in 2010, largely attributed to a substantial increase in exports and global demand for commodities. Net foreign direct investment (FDI) has resumed significantly and increased by around 60 per cent year-on-year. Economic performance continued to be relatively strong in the first half of 2011, though industrial production remained somewhat volatile. In addition, unemployment is still very high at over 30 per cent in early 2011, therefore subduing domestic consumption. Inflation accelerated considerably in the first half of 2011 to above 5 per cent on an annual basis, but has begun moderating again more recently. The banking sector remains liquid, owing mostly to stable internal funding sources and conservative asset portfolios. Annual private sector credit growth has remained positive throughout the crisis and the level of non-performing loans (NPLs) has levelled off to 8.9 per cent of total loans in the second quarter of 2011.

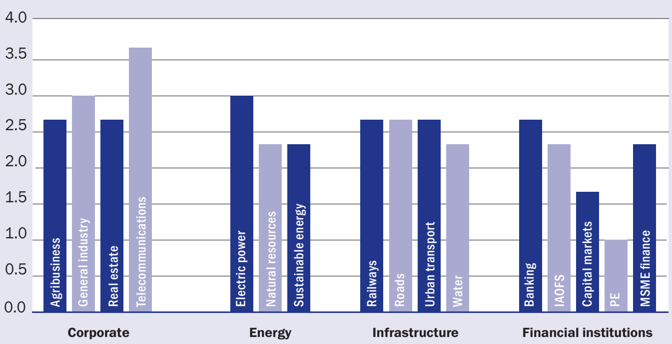
**Fiscal policy has been prudent throughout the crisis.** Despite several anti-crisis measures implemented during the crisis, the government has maintained a budget deficit of 2.5 per cent in 2010, relatively low by regional standards. Spending on capital investments has increased in recent months, though the government is planning to maintain the budget deficit at the same level in 2011. In addition, in January 2011, FYR Macedonia was the first country to receive support from the IMF in the form of a 24 month Precautionary Credit Line (PCL) in the amount of €396 million. The PCL is a new IMF product, designed to support countries with otherwise sound fiscal and policy fundamentals in effective crisis prevention. Despite the initial plan not to draw funds from the facility, in March 2011 the authorities unexpectedly decided to draw €220 million in advance of general elections, but they stated their intention to repay the disbursement ahead of schedule, provided financing conditions are favourable. On the monetary side, the central bank is committed to the exchange rate pegged to the euro. In light of recovering international reserves and in order to encourage economic activity, it gradually lowered its key policy rate to 4 per cent in December 2010 but has kept it unchanged since then.

**The economy will continue to benefit from global demand for commodities and growth is projected to continue in the coming years.** However, the economy remains particularly vulnerable to the broader crisis in the eurozone, with which it enjoys close trading and investment ties.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 5.0 | -1.0 | 1.8 | 3.0 |
| Inflation (end-year) | 4.1 | -1.6 | 3.0 | 3.5 |
| Government balance/GDP | -0.9 | -2.7 | -2.5 | -2.5 |
| Current account balance/GDP | -12.6 | -6.4 | -2.8 | -5.5 |
| Net FDI (in million US$) | 601 | 186 | 292 | 509 |
| External debt/GDP | 44.2 | 59.9 | 59.0 | na |
| Gross reserves/GDP | 21.4 | 24.6 | 21.0 | na |
| Credit to private sector/GDP | 42.4 | 43.9 | 45.6 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**The privatisation process of remaining state assets remains somewhat stalled.** Several attempted privatisations have failed over the past year because of a lack of investor interest. These include a fifth privatisation round for a 65 per cent stake in one of the leading electrical engineering companies in the region, EMO, an 84.4 per cent stake in tobacco producing company Tutunski Kombinat, and a 100 per cent stake in the military equipment producer 11 Oktomvri-Eurokompozit. A sixth tender for the sale of EMO was launched in April 2011 and remains ongoing. No progress has been made in the sell-off of a 75.6 per cent stake in the chemical manufacturer Ohis.

**FYR Macedonia has made progress regarding the implementation of the Energy Community Treaty.** In February 2011 the parliament approved a new Energy Law that provides the basic legislative and regulatory framework for the energy sector, covering electricity, gas, renewable energy and energy efficiency, as well as oil and security of energy supply. The new law is fully compliant with the relevant EU laws. In addition, the government awarded concessions in February 2011 to five companies for the construction of over 50 new hydropower plants.

**Transport is being upgraded through concession contracts.** The modernisation of Ohrid Airport was completed in April 2011, a year after the concessionaire TAV started construction. TAV has further committed to upgrade Skopje Airport, envisaging the construction of a new passenger terminal building (which opened in September 2011) and extending the airport's infrastructure. Furthermore, five consortia have passed the pre-qualification round in November 2010 of a 35-year concession for two road sections along the pan-European Corridor VIII. The final deadline for the concession has been delayed a number of times.

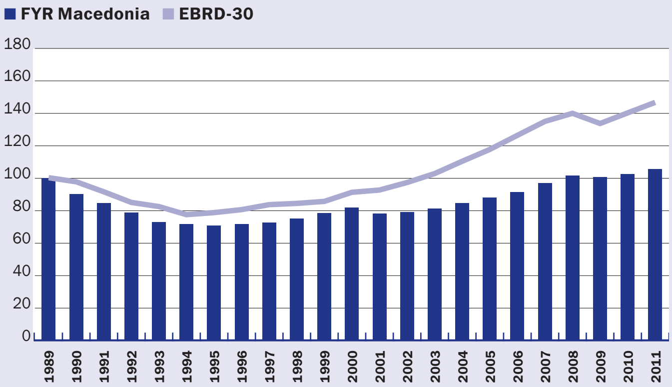
**Foreign investments are being attracted to economic zones.** The development of the technological and industrial zone in Bunardzik that opened in April 2010 is well advanced. Two additional foreign investments were made in May and June 2011 for approximately €27 million. After large-scale investments made in 2010, there are now two foreign companies operating at Bunardzik and another two that are constructing facilities. Three more companies have recently started investments there and the construction of additional economic zones is currently under way.

**FYR Macedonia has taken further steps to improve its business environment.** According to the World Bank's *2011 Doing Business* survey, the business climate in FYR Macedonia remains among the best in the transition region, and the country ranks 38th out of 183 countries in terms of ease of doing business. The powers and resources of the competition authority have been strengthened in the past year, albeit from a low base. In 2011 the authorities introduced further measures to aid business operations and to bring the country's legislation in line with the EU *acquis*. In February 2011 they abolished some custom tariffs in line with the ongoing implementation of the Stabilisation and Association Agreement (SAA) and introduced amendments to the Profit Tax Law in April 2011 in order to clarify the definition of a permanently established business, a measure designed to reduce tax evasion and broaden the tax base.

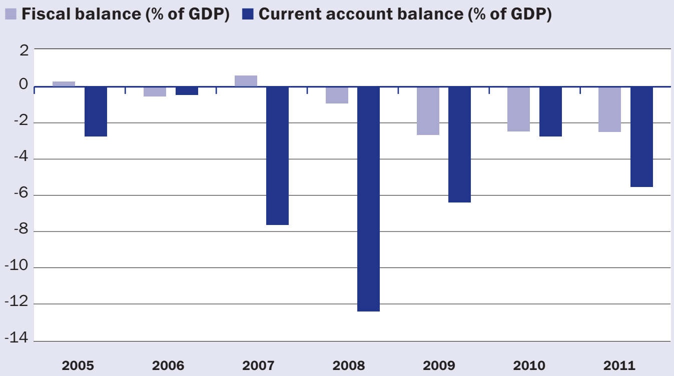
**A new law on the central bank was approved by parliament in October 2010.** It aims to increase the transparency of operations and strengthen the independence of the institution, as well as to adjust practices in line with EU directives. The banking system has coped well in the crisis and remains profitable and liquid, although banking assets remain low (as a percentage of GDP) compared with other countries in the region.

**The first private credit bureau launched operations in January 2011.** The bureau has received support from USAID and the World Bank, and will help to improve credit risk management practices and access to credit in the medium term.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Georgia

## Highlights of the past year

- **The economy has stabilised and grown.** As domestic credit and external demand recovered, output increased in most sectors above the pre-crisis level, with the notable exceptions of agriculture and construction. The government has pursued its fiscal consolidation efforts, introduced fiscal rules and rolled over a large eurobond on favourable terms.
- **The central bank is moving towards inflation targeting and has strengthened the financial stability framework.** The central bank has allowed the lari to float more freely. It has also strengthened prudential regulations and the consumer protection framework, and improved the analytical capacity to support inflation targeting.
- **The government has shifted to a more proactive growth strategy, targeting the energy, tourism and agricultural sectors.** The capacity to support EU food safety standards is being established and should boost agricultural exports.

## Key priorities for 2012

- **Reviving private investment is a key priority.** The authorities' efforts to encourage foreign direct investment (FDI) should be broadened to stimulate domestic savings and investment. Financial sector policies should focus on completing the transition to inflation targeting and further strengthening of prudential supervision.
- **Municipal and other infrastructure should be strengthened.** Major challenges include rehabilitation of physical infrastructure and restructuring of municipal enterprises to improve efficiency. In the natural resources sector, the role of the dominant state-owned player, the Georgian Gas and Oil Corporation (GOGC), should be reduced through break-up or sale of parts of the company to increase competition.
- **The authorities should improve the trade and investment climate.** Pursuing negotiations on access to the European markets should support the revival of the agricultural sector as well as FDI-supported manufacturing of tradeable goods.

## Macroeconomic performance

**The economy has recovered from the dual shock of the armed conflict with Russia in 2008 and the global economic crisis.** Output is estimated to have grown by 6.4 per cent in 2010 and another 5 per cent in the first half of 2011 as private sector credit and exports rebounded. The recovery was led by manufacturing, with most other sectors also contributing. Although agriculture has recovered from last year's drought, it remains depressed. FDI inflows, an important engine of growth before the crisis, remain well below their pre-crisis levels. A large package of support from international financial institutions (IFIs) is being drawn down, while the level of foreign reserves remains reasonable at around four months of imports. The share of non-performing loans (NPLs) in the financial sector has been steadily declining, although it remains high, at 9.9 per cent of total loans as of July 2011.

**Public sector consolidation has continued although inflation increased.** The authorities have been able to substantially lower the fiscal deficit in 2010 by reducing expenditures, and they have adopted some fiscal rules that should help support fiscal sustainability over the medium term. In April 2011 the Ministry of Finance placed a US$ 500 million eurobond at very favourable terms that reduced medium-term rollover risk. Inflation pressures re-emerged in the middle of 2010 in response to further devaluation and global food price increases, although core inflation has remained low. The government partially compensated vulnerable households for food and energy price increases. Inflation declined considerably, from 14.3 per cent year-on-year in May to 7.2 per cent in August 2011 mainly due to falling food prices and subdued demand-side pressures, and the central bank was able to loosen monetary policy by decreasing the refinancing rate to 7.5 per cent

**The medium-term challenge for the government is to create conditions for sustainable economic growth while completing the post-crisis external and fiscal adjustment.** Despite recent progress toward bringing the external current account to a sustainable level, the deficit remains very high. The adjustment is all the more necessary as donor support and fiscal stimulus are expected to be wound down and debt rollover requirements remain large over the medium term. To maintain growth over the longer term, the authorities would need to supplement their proactive growth strategy for agriculture, tourism and energy with building of the necessary regulatory capacity, deepening institutional reforms to further strengthen investor confidence, and opening additional export markets (in the EU and more broadly).

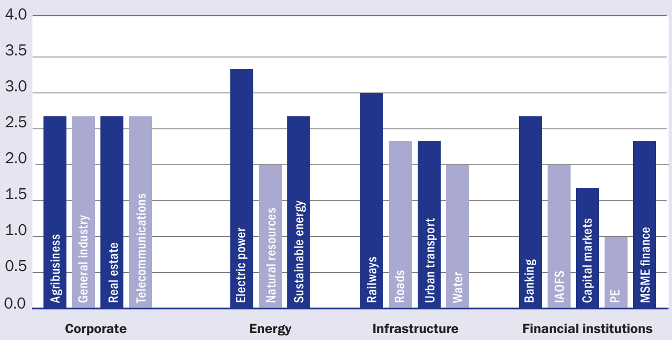
### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 2.3 | -3.8 | 6.4 | 5.0 |
| Inflation (end-year) | 5.5 | 3.0 | 11.2 | 4.6 |
| Government balance/GDP 1/ | -6.3 | -9.2 | -6.6 | -3.9 |
| Current account balance/GDP | -22.6 | -11.2 | -9.8 | -10.8 |
| Net FDI (in million US$) | 1494 | 659 | 493 | 750 |
| External debt/GDP | 44.0 | 58.0 | 61.6 | na |
| Gross reserves/GDP | 11.5 | 19.6 | 20.5 | na |
| Credit to private sector/GDP | 33.2 | 31.1 | 32.4 | na |

Note: 1/ Consolidated government balance.

### 2011 sector transition indicators

Sector transition score




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Georgia's investment environment remains among the best in the region.** According to EBRD-World Bank Life in Transition survey II, carried out in 2010, perceptions of corruption are as low as in western European countries. The World Bank's *Doing Business 2011* survey continues to rank Georgia among the best in its composite ease-of-doing-business measure. The authorities have started to address concerns about the politicisation of the tax administration that emerged during the past year.

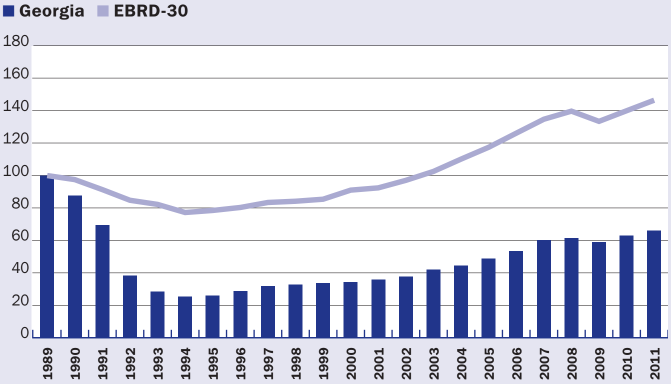
**The government has strengthened the credibility of its commitment to fiscal sustainability and further simplified revenue administration.** The Economic Liberty Act, adopted in July 2011 and scheduled to come into force in 2014, caps budget expenditure at 30 per cent of gross domestic product (GDP), limits the budget deficit to 3 per cent of GDP and public debt to 60 per cent of GDP. Also, it alleviates the constraints to fiscal policy created by the referendum requirement on new taxes adopted in 2011. The new tax code, approved in September 2010, simplified the taxation regime for small and medium-sized enterprises (SMEs) and introduced a new category of micro businesses which will not be subject to income tax. The code foresees a widening of the tax base by increasing some excises, applying VAT to entities with an annual turnover of over 100,000 lari and introducing a moderate income tax on small businesses. The authorities have also strengthened the e-filing system that now integrates all taxes and other web-based revenue services, although rising pressures to generate revenues have increased the perception in the business community of arbitrariness in the application of rules by the revenue service.

**The National Bank of Georgia (NBG) has continued to strengthen its monetary policy and financial stability frameworks.** The reforms included activation of central bank standing facilities and active use of refinancing instruments, reduced frequency of foreign exchange interventions and greater exchange rate flexibility. Since April 2010 the NBG has been offering commercial banks guaranteed access to refinancing loans against collateral at an interest rate linked to the NBG's key policy rate. The collateral base for refinancing loans has also been extended to include international bank guarantees and long-term local currency loans. The central bank has continued to strengthen its capacity to forecast and model inflation. To limit financial sector vulnerability, the NBG tightened prudential regulations in December 2010 by strengthening capital requirements on foreign currency loans, initiating the transition to risk-based supervision and introducing policies for consumer financial protection.

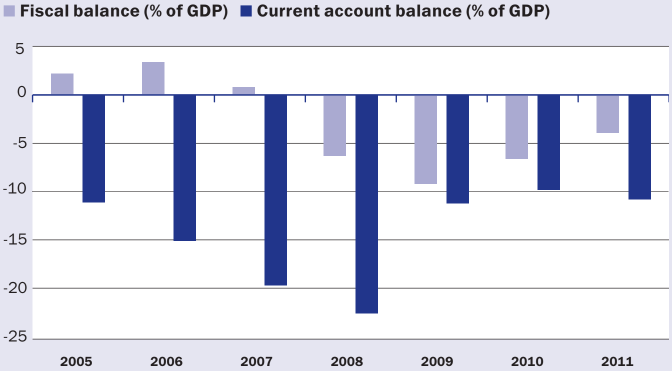
**The authorities are working on further improvement of the country's infrastructure and identifying mechanisms for addressing market failures.** The ongoing construction of the Black Sea Energy Transmission System should integrate Georgia in the regional energy market, improve the regulatory framework and set standards for corporate governance and business conduct. The construction of a new hydropower plant will lead to greater cross-border energy flows via a transmission line from Georgia to Turkey. The purchase of the Poti Port by the subsidiary of the Danish Maersk company from RAKIA should further integrate Georgia into the global shipping networks over time. The authorities' efforts to encourage recovery in the agricultural sector and their targeted support to the infrastructure should boost growth.

**Proposals for establishing a new state bank are being pursued.** With international assistance, the government is preparing a feasibility study for setting up a development bank that would identify projects in promising sectors that require public action to overcome market failures. The bank could be beneficial for stimulating growth, provided it has a strong governance framework and its activities are complementary to those of commercial banks.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Hungary

## Highlights of the past year

- **The recovery in domestic demand remains very weak.** However, the economy has benefited this year from stronger demand for its exports in the eurozone.
- **Until the summer of 2011 the announced fiscal consolidation measures had reassured investors in Hungary's debt securities.** These measures have also contributed to a number of successful foreign bond issues early in 2011. Increased efficiencies are targeted through a significant investment programme, EU grant funds and closer investment ties with China.
- **The rise in the bilateral exchange rate to the Swiss franc has become a major concern.** About two-thirds of mortgages are still denominated in this currency. A mortgage payment relief plan was announced in the summer of 2011 following consultation with the industry. However, this was overtaken by a law that allowed certain mortgage borrowers to pre-pay their liabilities at a substantially discounted foreign currency rate. This raises a number of concerns over sanctity of contracts and the outlook for financial stability.

## Key priorities for 2012

- **Implementation of the fiscal consolidation plan is critical to maintain investor confidence.** The government's various announced measures envisage considerable savings, of over 4 per cent of gross domestic product (GDP), which are necessary for medium-term fiscal sustainability despite the current budget surplus, and improved debt ratios resulting from the government's acquisition of mandatory pension funds.
- **Hungary needs to preserve an open and even-handed approach to foreign investment.** Early and credible measures are needed to bring to an end the "crisis taxes" imposed on four sectors, and to reassure banks that loan contracts will not be subject to regulatory interference which would erode bank equity.
- **Independence of the central bank and the fiscal council are essential for sound economic governance.** These institutions should be strengthened in the interests of credible and sustainable macroeconomic and fiscal policy-making.

## Macroeconomic performance

**Hungary's recovery remained weak by regional standards.** The economy grew by 1.1 per cent in 2010, with domestic demand continuing to stagnate well below pre-crisis levels. Recent indicators point to the strength of industrial production and exports, both of which continued to benefit from the recovery in the core eurozone economies in early 2011. Weakness in domestic demand is persisting, as it is held back by high unemployment levels (over 12 per cent in mid-2011), and the continued contraction in credit to both households and the corporate sector. This may explain why the economy saw a 0 per cent quarterly GDP growth in the second quarter of 2011 when export demand slowed down.

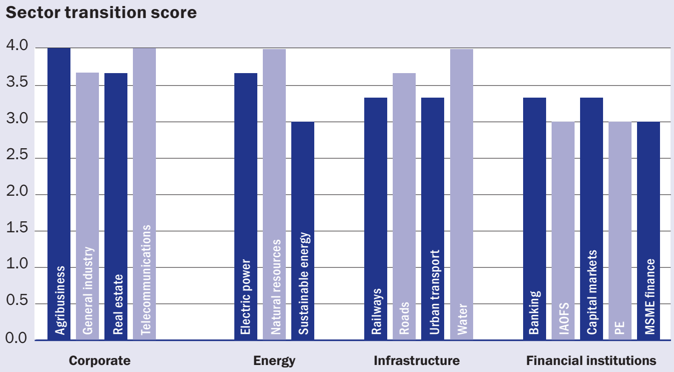
**A new fiscal reform programme is addressing some long-standing vulnerabilities.** The substantial financial sector levy, first imposed in the summer of 2010 was extended for another two years and supplemented by taxes on a number of other sectors (telecommunications, energy and retail services). These "crisis taxes" have been criticised by investors as discriminatory in targeting industries with significant sunk costs, and the levy on the telecommunications sector was found by the European Commission to be contravening Community law. The government also reduced the tax burden on small and medium-sized enterprises (SMEs) and introduced a flat-rate personal income tax. The target for the 2010 deficit under the European Union/International Monetary Fund (EU/IMF) programme was narrowly missed, with the deficit reaching 4.2 per cent of GDP.

**In 2011 the budget targeted a surplus of about 2 per cent GDP.** This may be achieved as the shift of private pension assets into the state system is recorded as one-off revenue (amounting to about 9.5 per cent of GDP). While the surplus will therefore be temporary, the government's most recent convergence programme update aims to reduce the budget deficit to below 2 per cent of GDP by 2015, largely through expenditure reductions in areas such as social and health care benefits. To this end, the Szell Kalman Plan was announced in the spring although it will, for the most part, take effect in 2012 and 2013 and important implementation details will need to be finalised. In view of the deterioration in the economic outlook, in September the government announced a large additional consolidation package of 2.5 per cent of GDP in order to achieve the 2012 deficit target that meets the Maastricht threshold. On the external side, the country is now running a current account surplus, which has reduced pressures on the currency. International bond investors have also been encouraged by the government's fiscal strategy, as underlined by several successful international bond issues in the first half of 2011. However, gross foreign direct investment (FDI) inflows slowed to about 1 per cent of GDP last year.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 0.6 | -6.5 | 1.1 | 1.0 |
| Inflation (end-year) | 3.4 | 5.4 | 4.6 | 3.0 |
| Government balance/GDP | -3.6 | -4.4 | -4.2 | 1.0 |
| Current account balance/GDP | -7.3 | 0.2 | 1.1 | 1.8 |
| Net FDI (in million US$) | 1726 | 656 | 934 | -1600 |
| External debt/GDP | 104.6 | 157.0 | 143.3 | na |
| Gross reserves/GDP | 21.8 | 34.3 | 34.5 | na |
| Credit to private sector/GDP | 58.8 | 59.5 | 59.6 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

**Hungary remains vulnerable to external shocks, such as loss of capital market access due to investor risk aversion, or from exchange rate depreciation, in particular in relation to the Swiss franc.** If the country can address macroeconomic vulnerabilities, in particular through implementation of its fiscal reform programme, trend growth of between 2 and 3 per cent could be achieved.

## Major structural reform developments

**Hungary is still attractive for certain export-oriented investors.** However, surveys show that there remain a number of important impediments to investment, and overall FDI flows have subsided. The World Bank's *Doing Business 2011* survey ranks Hungary at 46th out of 183 countries, a slight improvement compared with a year earlier, with notable progress in tax administration and in registering property. Investor protection remains a considerable problem, according to this survey.

**Ambitious government attempts to address the legacy of foreign exchange-based lending may undermine broader investor confidence.** The stock of household foreign exchange borrowing has become more burdensome as the widely-used Swiss franc continued to appreciate amidst a broader flight to safety. Previous restrictions on foreign currency lending were at first considerably tightened (through a ban on registering collateral), but then had to be partially lifted, due to concerns over compliance with EU legislation. In May 2011 the government announced an agreement with the banking association to shield mortgage borrowers from exchange rate fluctuations, while at the same time lifting a long-running ban on foreclosures of delinquent mortgage loans. Given the very low take-up of this scheme, a further initiative was announced in September 2011 which would allow borrowers to pre-pay FX mortgages at a heavily discounted rate. This initiative has raised concerns over the sanctity of private contracts and compliance with EU law, and unsettled investors in a broader range of sectors. It risks undermining bank capital positions, raising funding costs and setting back a recovery in credit growth.

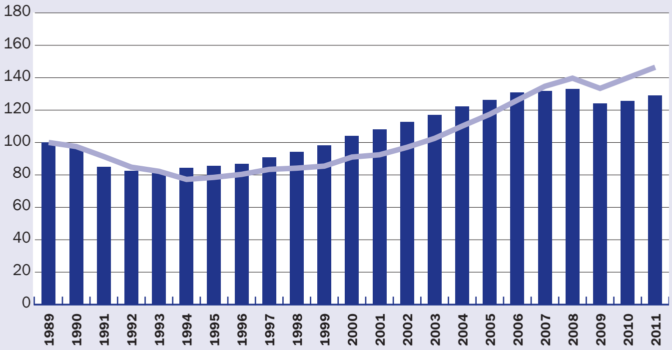
**Reversals in pension reform put at risk plans to develop a local bond market.** In autumn 2010 the government decided to offer strong incentives for shifting assets held in private pension funds back into the state system, which nearly all beneficiaries did. This measure was in part motivated by a better appreciation of the fiscal costs associated with the transition to a partially funded pension system while continuing to finance a state-run pay-as-you-go system, and by the fact that European fiscal accounting rules offer very limited recognition of such costs. Through this near-complete abolition of the second pillar pension system the government again assumes future liabilities for retirement payments and has put in doubt private property rights over financial assets. The government's acquisition of significant equity stakes in important Hungarian companies is problematic for corporate governance. The measure is also likely to set back the growth of local institutional investors that could underpin the development of local capital markets. Reforms to allow a broader set of financial institutions to issue forint-denominated mortgage-backed securities also remain on hold.

**Full unbundling of the power sector and curtailing the dominant position of the state-owned supplier, MVM, are pending.** Competition in transmission services is still restricted. In July 2011 the Hungarian power exchange initiated trade in futures contracts up to one year ahead, and a gas exchange market will be in operation from 2013. In May 2011 the government sought to clarify the ownership of the refinery company MOL and announced the acquisition of a minority stake, purchased from the Russian company Surgutneftegas for about €1.9 billion (about 2 per cent of GDP). However, the government's intentions regarding this ownership, with what amounts to a controlling minority stake, remains uncertain.

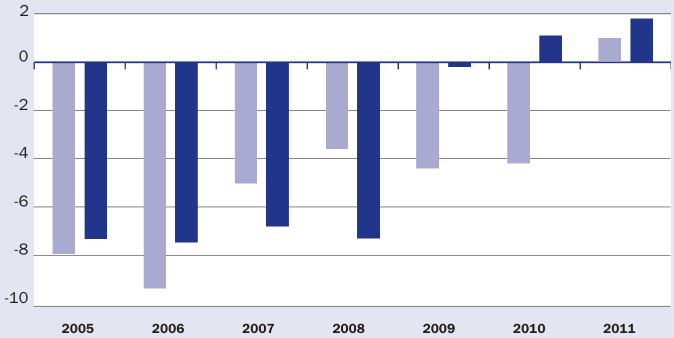
**The railway company and several municipal transport companies remain heavily loss-making.** The financial performance of MAV, the state-run company operating the rail network, remains poor. The government is considering consolidating, within the general government budget, the €1.2 billion debt the company owes relating to operating expenses and equipment purchases, although this debt assumption appears to be delayed compared to the original plans. The government is also seeking efficiencies through a substantial investment programme including the utilisation of EU grant funds and possibly Chinese investment.

**The government has introduced governance changes to important state institutions.** It has curtailed the rights of the Constitutional Court to review tax legislation and other fiscal measures, and it has changed the appointment procedures of members of the central bank's monetary policy committee. A new Fiscal Council established under the revised Constitution has a narrower mandate in assessing the medium-term fiscal outlook, even though a new debt limit has been set, and the Council will have a veto right over the budget.

**Real GDP (1989 = 100)**




**Fiscal balance and current account balance**



# Kazakhstan

## Highlights of the past year

- **Economic activity rebounded from the crisis on the back of higher oil prices.** GDP growth shot up to 7.3 per cent in 2010, from 1.2 per cent in 2009, and continued to grow at 7 per cent during the first half of 2011. However, this growth has thus far mostly been driven by oil-related production, exports and services.
- **Inflation accelerated despite administrative price controls.** Year-on-year inflation rose to 9.0 per cent in August 2011, the highest rate since late 2008, driven by a combination of external and domestic factors. In response, the authorities imposed numerous formal and informal administrative price controls.
- **While credit growth picked up, asset quality continued to worsen.** Bank credit growth, which had remained flat until early 2011, increased to 10 per cent year-on-year in July, but this was driven mostly by state-sponsored subsidised loan programmes. At the same time, total non-performing loans (NPLs) continued to rise to nearly 30 per cent of total loans (on a 90-day basis), while provisioning for NPLs continued to fall.

## Key priorities for 2012

- **The health of the banking system needs to be restored.** To structurally reduce the high level of NPLs, the authorities need to conduct a thorough assessment of asset quality, ensure proper valuation and accounting of restructured loans and remove the current tax disincentives for NPL write-offs.
- **State ownership and excessive state interference need to be reduced.** To attract private investors, the authorities should reduce excessive state interference in business processes, phase out price controls, and reform tariff-setting and corporate governance in state-owned enterprises.
- **Reducing energy intensity constitutes another key priority.** This requires technological modernisation, appropriate tariff policies and further commercialisation of utilities. To enable investment in renewable energy, a comprehensive legislative and regulatory framework needs to be developed that includes feed-in tariffs and connection charges.

## Macroeconomic performance

**Kazakhstan's economy is on a steady recovery path, with real GDP continuing to grow in excess of 7 per cent.** Following a large recovery from 1.2 per cent in 2009 to 7.3 per cent in 2010, GDP growth remained strong at 7 per cent during the first half of 2011. This was driven by increased oil and gas production and rising wholesale and retail trade, helped by a recovery in commodity prices and strong public sector support.

**Both current account and fiscal balances returned to positive territory in 2010 after having deteriorated in 2009.** Exports have continued to recover during the first half of 2011 and the current account has remained positive. The fiscal balance turned into surplus in 2010, and the authorities are planning further fiscal consolidation during 2011 and over the medium term.

**Rising inflation led to increased price controls.** While at the end of 2010 inflation, at 7.8 per cent, remained within the National Bank of Kazakhstan (NBK)'s target range of 6.0 to 8.0 per cent, it accelerated to 9.1 per cent in August 2011, driven by rising international commodity prices and public sector wage increases. In response, the authorities imposed a number of formal and informal administrative price controls, some of which led to fuel shortages. Inflation began to decelerate in September and is expected to average 8.7 per cent during 2011.

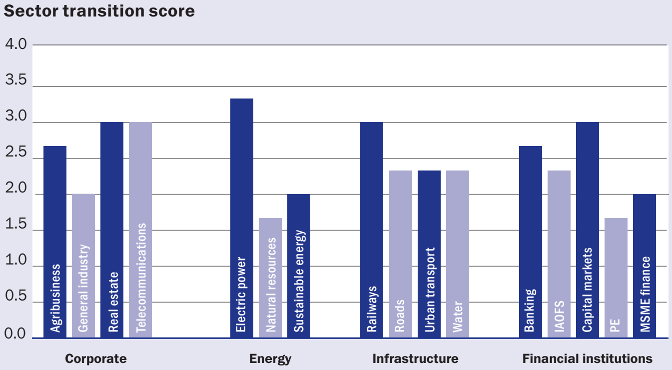
**Despite abandoning the previous exchange rate corridor and notwithstanding large capital flow volatility, the exchange rate has remained broadly stable.** The NBK formally abandoned its exchange rate corridor on 28 February 2011. Nevertheless, it has since continued to heavily intervene in the foreign exchange market to smooth exchange rate volatility.

**GDP growth is forecasted to remain at 7 per cent in 2011 but slow down to 6 per cent in 2012, reflecting the deteriorated oil price outlook.** The outlook is subject to significant downside risks associated with further deteriorations in external conditions and in the banking sector.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 3.2 | 1.2 | 7.3 | 7.0 |
| Inflation (end-year) | 9.5 | 6.2 | 7.8 | 8.8 |
| Government balance/GDP | 1.2 | -1.3 | 1.5 | 1.8 |
| Current account balance/GDP | 4.7 | -3.8 | 2.9 | 5.9 |
| Net FDI (in million US$) | 13118 | 10653 | 2155 | 8123 |
| External debt/GDP | 79.8 | 98.2 | 85.5 | na |
| Gross reserves/GDP | 13.3 | 18.1 | 17.3 | na |
| Credit to private sector/GDP | 46.0 | 49.0 | 37.2 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**State ownership increased in recent years, but the authorities envisage massive privatisation during the years to come.** Assets under the control of the National Welfare Fund, Samruk-Kazyna (SK) rose to around 50 per cent of GDP in the aftermath of the crisis, but the authorities envisage large-scale privatisation within the next five years. Privatisation will be conducted in two stages. The first stage is the partial privatisation of state-owned enterprises through a so-called "People's IPO" which is expected to begin in the second quarter of 2012 and finish in 2015, when state assets of US$ 500 million are expected to be acquired by pension funds and Kazakhstani citizens. During the second stage, which will be initiated after 2015, the national holdings will aim to attract strategic global investors.

**Related to these privatisation plans, the authorities are developing plans to accelerate tariff reform in regulated industries.** Improving tariff methodologies and regulation is crucial for attracting new investment in energy, infrastructure and utilities, possibly through public-private partnerships (PPPs). Promoting the efficient use of energy will also be easier when tariffs are cost-reflective and environmental costs are included in the tariff rates.

**The authorities started developing a new strategy to recognise and restructure NPLs but implementation remains to be seen.** The Council for Financial Stability approved a preliminary plan to improve the quality of banks' assets, through a new Distressed Asset Fund, but the plan presents only a partial solution to the problem and details are still to be worked out. Legislation to remove some of the tax disincentives for NPL write-offs was approved by the lower chamber of parliament in September 2011.

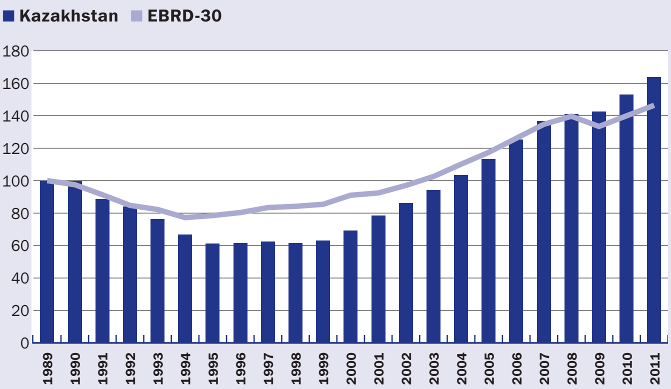
**Financial system regulation was strengthened through the integration of the Financial Supervisory Agency (FSA) into the NBK in April 2011.** The acquisition of financial supervision responsibilities by the NBK may involve some transition costs, but could make it easier for the NBK to enforce painful regulatory measures, including the current plans to transfer their bad loans to a new distressed asset fund.

**The business environment has improved but challenges remain.** According to the World Bank *Doing Business 2011* survey, Kazakhstan improved its ranking from 74th to 59th place. Major improvements were made in easing the procedures to start a business, protecting investors and paying taxes. The country's rank in terms of trade across the border is very poor (181st place out of 183 countries) and there is significant room to improve the quality of trade-related institutions. Investor confidence has likely deteriorated following a recent incident related to the London-listed Eurasian Natural Resources Corp (ENRC) that raised corporate governance concerns.

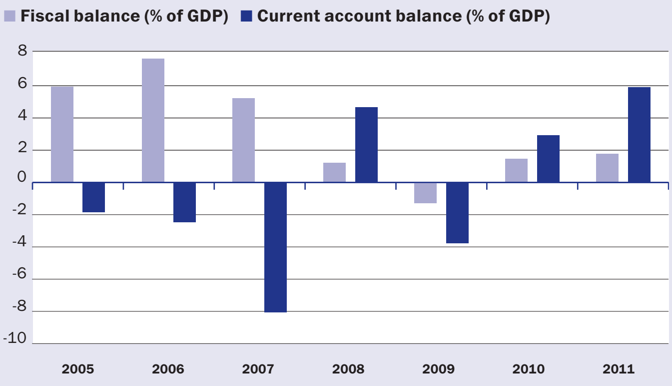
**The authorities have announced plans to diversify the economy away from hydrocarbons and raise productivity.** In 2010 the hydrocarbon sector accounted for almost 30 per cent of GDP, contributed to roughly half of GDP growth, and hydrocarbon exports amounted to over 60 per cent of total exports. Under the country's Strategic Development Plan to 2020 and the State Programme of Forced Industrial-Innovation Development for 2010-2014, the authorities will pursue an increase in the share of non-oil exports and higher productivity in the manufacturing and agricultural sectors. The "2020 Plan" envisages improvements in the business environment, modernising enterprises, creating new high value-added export-oriented sectors and providing selective support to key industries.

**Kazakhstan and Russia abolished their internal customs borders on 1 July 2011 as part of the tripartite Customs Union with Belarus.** In addition, the average tariff rate in Kazakhstan increased from about 6 to about 10 per cent, as it had to be equalised with the Russian rate. The Kazakhstani authorities continue to pursue accession negotiations to the World Trade Organization (WTO) and expect to conclude bilateral talks with most partners by the end of 2011. The Customs Union will impose growing competition on a number of food products from Russian producers.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Kyrgyz Republic

## Highlights of the past year

- **The economy has recovered faster than expected from the 2010 socio-political crisis.** Real gross domestic product (GDP) fell by 1.4 per cent in 2010 but rose by 5.5 per cent during the first half of 2011, partly reflecting a one-off base effect.
- **A new International Monetary Fund (IMF) programme was signed in June 2011.** By signing up to this programme, the authorities have committed to a series of major reforms, including strengthening the transparency of public finances, improving tax administration, resolving the major remaining problems in the banking sector and strengthening the supervisory independence of the central bank.
- **The Kyrgyz Republic submitted an application to join the Belarus-Kazakhstan-Russia Customs Union (CU).** However, several issues remain to be resolved prior to accession, including compatibility with the country's existing membership in the World Trade Organization (WTO).

## Key priorities for 2012

- **The new government should continue its efforts to improve the business climate and restore investor confidence.** Key priorities include strengthening governance and protecting private property rights after the 2010 socio-political crisis revealed the problems of deep-rooted corruption and nepotism.
- **The financial sector should be further strengthened and deepened.** The main challenges for 2012 are (i) to increase confidence in the banking system through successfully resolving the remaining problem banks; (ii) to increase competition in the banking system so as to improve financial services and increase access to finance, and (iii) to reduce dollarisation and develop local currency capital markets.
- **Basic infrastructure is in need of massive modernisation, which requires significant reforms and investment, especially in the power sector.** Key challenges are to re-establish access to basic public services (such as water supply, solid waste management and city transport) and to improve energy supply and efficiency.

## Macroeconomic performance

**Socio-political instability in 2010 led to a temporary drop in GDP, but the economy is recovering.** The political turmoil in April 2010 and subsequent inter-ethnic violence in June 2010 resulted in a temporary sharp drop in economic activity by over 10 per cent during the second quarter of 2010 (seasonally adjusted), particularly in agriculture, construction, trade and other services. The economy started recovering in the second half of 2010, driven by improved security and stability, higher gold prices and fiscal stimulus, limiting the overall GDP decline in 2010 to 1.4 per cent. GDP continued to grow in the first half of 2011, increasing by 5.5 per cent compared to a year earlier.

**Inflation rose temporarily to over 20 per cent in 2011.** Domestic prices accelerated sharply during the second half of 2010, on the back of rapidly rising international food and fuel prices and large increases in public sector wages, implying an annual inflation rate of over 20 per cent year-on-year during the first half of 2011. However, the subsequent stabilisation of international commodity prices should bring annual inflation back down to around 13 per cent by the end of 2011. The fiscal deficit remained limited to around 6 per cent of GDP in 2010, but is expected to increase to 8 per cent in 2011, in part because of the large public sector wage increases that were considered necessary for maintaining social stability.

**The financial system was seriously affected by the 2010 crisis.** Seven banks were placed under temporary administration following large non-resident deposit outflows at Asia Universal Bank (AUB). Two banks were released from administration, while four were placed under conservatorship. In October 2010, AUB was split into "good" and "bad" part, and a new bank, "Zalkar," was created out of the "good" parts. Despite the negative effect of the crisis, financial sector stability has been maintained. Non-performing loans (NPLs) have decreased from 17 per cent in September 2010 to around 12 per cent in June 2011, with a capital adequacy ratio at around 28 per cent. However, while overall system stability indicators are favourable, a few problem banks remain and vulnerabilities are building up in the systemically important state-owned bank.

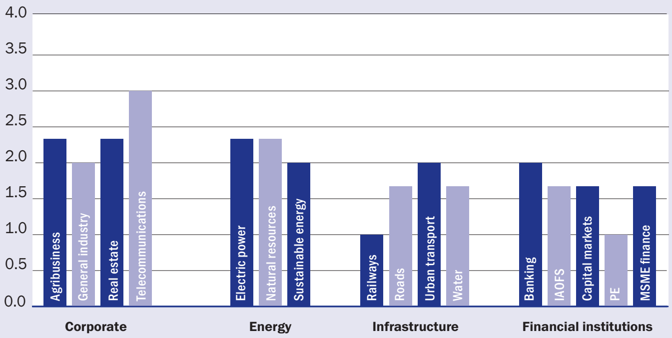
**The economy is expected to continue its recovery but annual GDP growth is expected to slow down from 6 per cent in 2011 to 4 per cent in 2012.** Maintaining higher growth in 2012 will be difficult given that 2011 growth is largely due to a one-off base effect, while the global economy is again slowing down. Additional risk factors are political stability and the ability of the new government to implement prudent economic policies and reforms.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 7.6 | 2.9 | -1.4 | 6.0 |
| Inflation (end-year) | 20.1 | -0.1 | 19.3 | 13.1 |
| Government balance/GDP | 1.0 | -1.3 | -6.1 | -8.0 |
| Current account balance/GDP | -8.1 | 0.7 | -7.2 | -7.7 |
| Net FDI (in million US$) | 265 | 190 | 438 | 249 |
| External debt/GDP | 45.1 | 58.2 | 84.8 | na |
| Gross reserves/GDP | 22.5 | 32.0 | 35.0 | na |
| Credit to private sector/GDP | 13.6 | 12.5 | 12.4 | na |

### 2011 sector transition indicators

**Sector transition score**




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Progress in privatisation has been mixed.** The new authorities that came to power after the April 2010 events re-nationalised two regional electricity distribution companies and KyrgyzTelecom because of widespread allegations of non-transparent privatisation processes. At the same time, the mobile operator Alfa Telecom (brand name Megacom) was partially nationalised, with the state acquiring a 49 per cent stake. On the positive side, in July 2011 the government announced a list of enterprises prepared for privatisation, and shortly afterwards an agreement was reached with the Russian research and production association, ELSIB, to privatise one of the small hydropower plants.

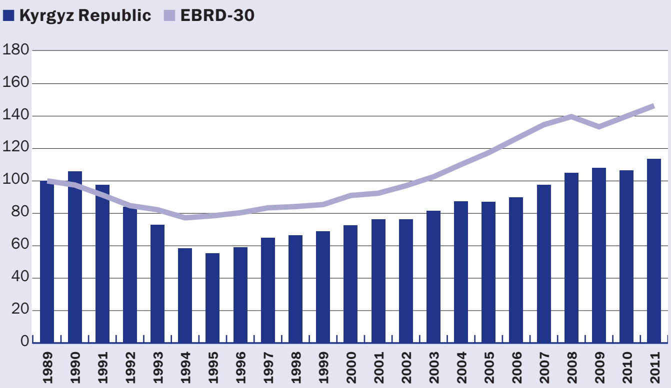
**Substantial progress was made with regard to strengthening governance in the mining sector.** Following the formal launch of the Extractive Industries Transparency Initiative (EITI) in June 2004, the Kyrgyz Republic has gradually strengthened governance by improving transparency and accountability of its mining assets, which include substantial deposits of gold, coal and uranium. This gradual progress has culminated in the acceptance of the Kyrgyz Republic by the EITI Board as being EITI Compliant as of 1 March 2011.

**The business climate has improved somewhat while weak law enforcement and regulation continue to constrain businesses.** Business climate reforms have recently advanced as evidenced by the Kyrgyz Republic's favourable rankings in the World Bank *Doing Business 2011* survey where the country's ranking improved from 47th to 44th place out of 183 countries, reflecting improvements in the ease of starting a business. However, poor governance and corruption continue to prevent economic agents from fully benefiting from this improved regulatory environment.

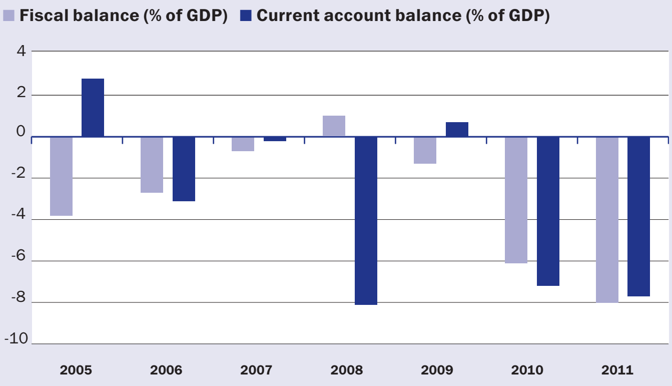
**Some progress was made with strengthening the microfinance sector.** Bai Tushum & Partners became the first microfinance institution (MFI) in the country to be able to conduct deposit taking operations, following the approval by the National Bank of the Kyrgyz Republic (NBKR) of the company's application for a deposit license. At least one other MFI is planning to apply for a banking license by the end of 2011. Allowing MFIs to take deposits will strengthen the micro-finance sector, by increasing their local currency funding sources, although some supervision issues have not yet been fully resolved.

**Energy sector reforms are lagging behind.** The sector remains in a poor condition with unreliable supplies, especially during the winter. Tariffs are below cost-recovery levels, and the sector is characterised by extremely high technical and commercial losses, as well as poor governance. There have been efforts to increase transparency and efficiency at the largest energy companies. For example, following the April 2010 events, the new government introduced a Fuel and Energy Sector Transparency Initiative (FESTI), aimed at improving management and governance within the sector by increasing public participation and transparency. This is a modest step forward but the sector continues to be in need of major investment and modernisation.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Latvia

## Highlights of the past year

- **Latvia's recovery from the dramatic contraction of 2009 has continued.** The country has gained market share in fast-growing export markets, and exports were up 37 per cent in the first half of 2011.
- **Latvia has continued to perform well in the final year of the European Union/International Monteary Fund (EU/IMF) programme.** This may allow the country to meet the fiscal criteria for euro adoption within two years, although inflation remains a concern. The improved outlook on public finances has allowed the government to regain access to the international bond markets.
- **Reforms are beginning to re-establish a fully functioning banking sector.** The division of assets in Parex (Latvia's third-largest bank) has progressed. The performing assets, managed within Citadele Bank, are about to be put back into private hands. Transformation of Mortgage and Land Bank, the other important state-owned bank, is in progress.

## Key priorities for 2012

- **To make growth more sustainable the government will need to persevere with its competitiveness agenda.** The programme appropriately emphasises education, skills and an improved investment environment. This agenda is particularly important given the mobility of Latvia's skilled labour force within the integrated European labour market.
- **Non-bank finance, such as private equity and mezzanine capital is needed.** The development of these products would encourage growth of the small and medium-sized enterprise (SME) sector.
- **Support to energy security and eficiency is critical.** Further energy market integration within the Baltic region and with other neighbours is needed. Investment into private energy generation could facilitate the production of electricity from renewable sources.

## Macroeconomic performance

**The economy has emerged from recession.** Latvia suffered one of the sharpest economic downturns of any emerging market in 2009. However, the country showed steady growth quarter-on-quarter throughout 2010, though for the year as a whole, the economy still showed a slight contraction, as a strong rebound in exports was more than off-set by weakness in government consumption and investment. In the first half of 2011 exports of goods grew by 37 per cent in value terms compared to the first half of 2010, and growth in the export market share confirms Latvia's continued potential. The economy is likely to grow at around 3.9 per cent in 2011.

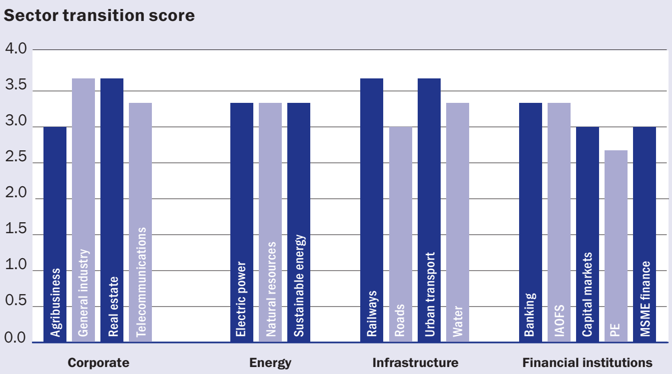
**Fiscal performance has strengthened in the final year of the EU/IMF programme.** A further stage in the programme was completed in spring 2011 based on additional fiscal measures in the 2011 budget, which brought the overall sum of fiscal adjustment to 16.6 per cent of gross domestic product (GDP) over the period 2008-11. Following these further fiscal corrections, the authorities will seek to comply with the Maastricht criteria for euro adoption, although inflation, which reached 4.7 per cent in August 2011, remains a key risk. These fiscal developments underpinned a more positive assessment by sovereign rating agencies and, in June 2011, Latvia returned to the international bond markets with the issuance of a US dollar bond.

**The recovery remains fragile, with export demand still having to stimulate more broad-based growth.** The initial recovery was largely based on inventories and exports to dynamic markets such as Germany and Sweden. A more durable growth in productive capacity and, subsequently, in domestic demand is yet to come. The lack of business investment is a concern, given that a number of manufacturing sectors, in particular wood-processing, clothing and metals, have now reached capacity utilisation levels close to those seen before the crisis, thus limiting their future growth potential. Hence, the inability to revive credit to the corporate sector represents the key threat to sustaining growth. The stock of bank loans to the private sector contracted by 6.7 per cent in 2010, with all banks continuing to tighten lending standards and primarily focusing on a small subset of customers with very safe cash flows. Credit growth is also being hampered by the still very high levels of debt of key enterprises as well as a high level of non-performing loans (NPLs), about 18.2 per cent in August 2011.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | -2.9 | -17.1 | -1.2 | 3.9 |
| Inflation (end-year) | 10.6 | -1.2 | 2.5 | 3.5 |
| Government balance/GDP | -4.2 | -9.7 | -7.7 | -6.5 |
| Current account balance/GDP | -13.2 | 8.7 | 3.0 | -1.5 |
| Net FDI (in million US$) | 699 | 113 | 271 | 823 |
| External debt/GDP | 121.0 | 164.0 | 165.0 | na |
| Gross reserves/GDP | 15.0 | 26.7 | 31.7 | na |
| Credit to private sector/GDP | 93.4 | 108.8 | 104.5 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Latvia has completed a substantial range of structural reforms under the EU/IMF programme.** The deep recession of 2008-09 stimulated some wide-ranging reforms in the tax system, large expenditure cuts and a streamlining of public administration. In the education and health care sectors, savings were achieved through layoffs and closing under-used facilities. While these reforms were painful and motivated by the immediate need to contain public sector financing requirements, many were needed to put public finances back on a sustainable footing. Recent revenue measures have helped, but the overall tax burden remains relatively high, particularly on labour.

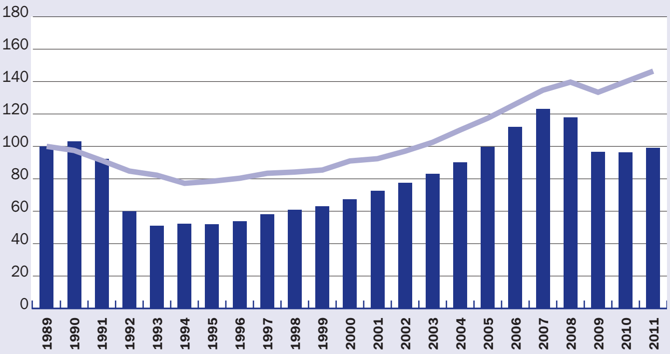
**Reforms in the financial sector will further bolster a well-functioning banking sector, though weaknesses of certain banks still need to be fully addressed.** The government has already significantly strengthened the powers of the Financial and Capital Market Commission, primarily through seeking stronger coordination with other authorities in the home countries of foreign bank subsidiaries, (Latvia is a signatory of the joint banking sector crisis resolution framework for the Nordic region introduced in August 2010). A core element in returning the financial sector to health was the restructuring of Parex Bank, and the subsequent creation of a recapitalised "good" bank (Citadele) that now has the capacity to generate fresh lending, and for which the return into full private ownership is progressing as planned. The government indicated that Citadele is to be sold at auction. With regard to the Mortgage and Land Bank, Latvia's eighth-largest bank, which is also in state ownership, a transformation plan was submitted to the European Commission in April 2011, though this plan still needs to be implemented.

**The authorities have undertaken wide-ranging reforms to facilitate market-based household and corporate debt restructuring.** These reforms reduce the likely need for injection of public funds into distressed institutions, and they should free up lending capacity. Incentives for debt relief or speedy out-of-court restructuring were strengthened in July 2010, through tax benefits, and the corporate and personal insolvency regimes were reformed. To address mounting debt to utility companies the authorities have submitted amendments to the Civil Procedures Law, which in particular seeks to safeguard the status of secured creditors.

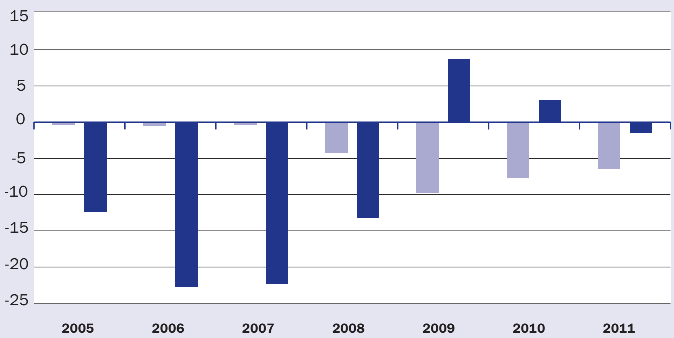
**Reforms in the power market have advanced significantly.** In part this was motivated by the closure of the Ignalina nuclear power plant in Lithuania in 2009, which underlined the need to develop alternative and more secure energy sources. There is still a relatively limited private sector participation, mainly in the generation segment of the market where state-owned companies are still dominant. The legal and functional unbundling of the vertically integrated state-owned power utility Latvenergo is currently under way with both the distribution and transmission assets being transferred to a fully owned subsidiary. Latvenergo's privatisation, however, is not being contemplated, as private ownership is prohibited by legislation. Efforts to upgrade the existing power facilities, such as the recent modernisation of Latvenergo's plant in Riga, are improving generation efficiency. The feed-in-tariff mechanism introduced in 2009 is valid for 10 years, following which there will be a reduced rate. Companies are only eligible for the tariff if they sell their energy to the public electricity supplier, Latvenergo. This framework is, however, being revised and a support scheme for renewable energy is expected to be in place by the end of 2011.

**A programme for competitiveness is being implemented.** Recent government announcements underline the clear intention to restructure the economy in support of a more sustainable growth model. The government is pursuing a "competitiveness agenda" through a study that will make specific recommendations on appropriate workforce skills, and will seek to improve the business environment by targeting a number of indicators. Priority sectors are export-oriented manufacturing, logistics and infrastructure and energy efficiency investments.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Lithuania

## Highlights of the past year

- **Following a determined policy response the Lithuanian economy is now recovering rapidly.** The upturn was initially driven by exports but then rapidly broadened to investment and household consumption, as well as a strong export performance.
- **Anti-monopoly enforcement has been strengthened.** The Competition Authority has increased its activities in terms of cases opened and decisions reached, in particular against restrictive agreements between companies and against restrictive activities by public administrative authorities.
- **A new strategy for energy independence has been adopted.** It aims to expand generation capacity, raise energy efficiency and secure supplies by connecting to markets in continental Europe.

## Key priorities for 2012

- **The government should stop the rise in public debt ratios to safeguard Lithuania's low risk premia and put the country on a path towards euro adoption.** A comprehensive reform of the pension system, including the second pillar funds, and efficiency improvements in education and health could supplement other consolidation efforts.
- **Encouraging research and development activities and upgrading the technological content of exports are needed.** Policies to help develop sources of funding outside the banking sector, such as the venture capital industry, in particular aimed at technology intensive enterprises, should contribute to this objective.
- **Implementation of power sector reform remains essential, including in the area of sustainable energy.** The government's strategy to connect the country to the European grid, and stimulate other sources of power (including through an LNG terminal), is well designed in this regard.

## Macroeconomic performance

**Following the drastic output contraction in 2009, Lithuania has experienced a steady recovery since early 2010.** Despite a relatively weak second quarter in 2011, growth in the first half of the year showed an average of 6.5 per cent compared with the same period last year. Lithuania has seen a revival in domestic demand, in particular of investment, earlier than other countries in the region, helped by a fall in the unemployment rate and a resumption of real wage growth. Unemployment, however (at 15.6 per cent in June 2011), still remains Lithuania's major weak spot, and will restrain private demand. Growth remains export-dependent, with much of the revival in industrial production (annual growth of 9.1 per cent in June 2011) geared towards exports. In that context, the slowdown in the eurozone since mid-2011, and in particular in Germany to which 9.5 per cent of exports are directed, is a concern. Over the course of the financial crisis Lithuania allowed its fiscal deficit to widen rapidly to over 9.5 per cent in 2009, despite a substantial consolidation effort. Having remained outside an International Monetary Fund (IMF)/EU programme, the government borrowed substantially in European bond markets. Gross debt rose rapidly from about 17 per cent of gross domestic product (GDP) in 2007 to over 40 per cent in 2011.

**The government adopted a consolidation package that is designed to improve fiscal performance, largely based on improved tax compliance and administration.** Nevertheless, the general government deficit has remained precariously high (at over 7 per cent of GDP last year), and the country has witnessed a rapid deterioration in its public debt indicators. Given its strong position in a number of export markets, and given strengthened competitiveness (through sharp drops in average gross earnings), real GDP is expected to grow by over 6 per cent this year, led by export growth. Unlike other economies in the region, domestic demand will also contribute measurably.

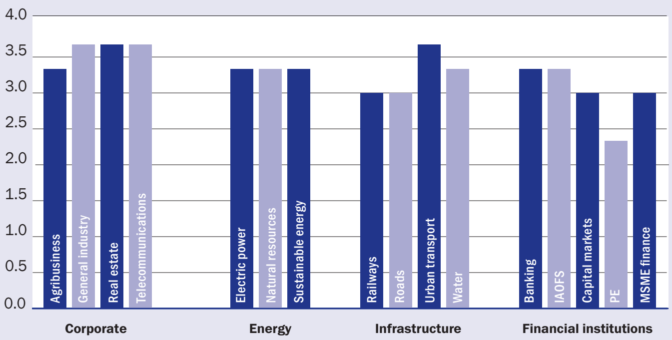
**The authorities seek to comply with Maastricht criteria from next year, to pave the way for euro adoption.** This would require considerable further fiscal adjustment next year. Sharp increases in the price of food and other consumer items in early 2011 also translated into broader inflation pressures and underline further risks to this scenario.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| **GDP growth** | 2.8 | -14.7 | 1.3 | 6.1 |
| **Inflation (end-year)** | 8.5 | 1.2 | 3.6 | 2.7 |
| **Government balance/GDP** | -3.3 | -9.5 | -5.5 | -5.5 |
| **Current account balance/GDP** | -13.0 | 4.5 | 6.0 | -1.43 |
| **Net FDI (in million US$)** | 1113 | -74.6 | 509 | 697 |
| **External debt/GDP** | 68.6 | 90.4 | 85.7 | na |
| **Gross reserves/GDP** | 13.3 | 17.5 | 19.7 | na |
| **Credit to private sector/GDP** | 59.1 | 66.9 | 59.7 | na |

### 2011 sector transition indicators

**Sector transition score**




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

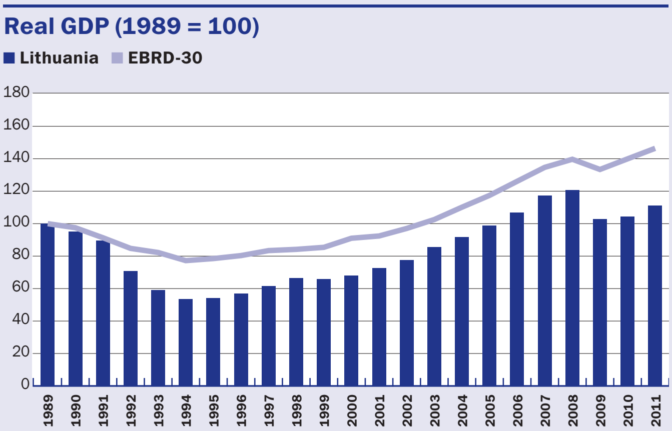
**Some progress in business environment reforms has been made.** The country ranks relatively highly in international comparisons of the business environment (at 23rd place in the World Bank's *Doing Business 2011* survey), and over the past year company registrations were further accelerated and credit bureaus were allowed to collect and disseminate positive information on borrower credit histories. The country further tightened compliance with EU rules by allowing electronic submission of customs declarations, and in transposing the EU's Services Directive into local legislation.

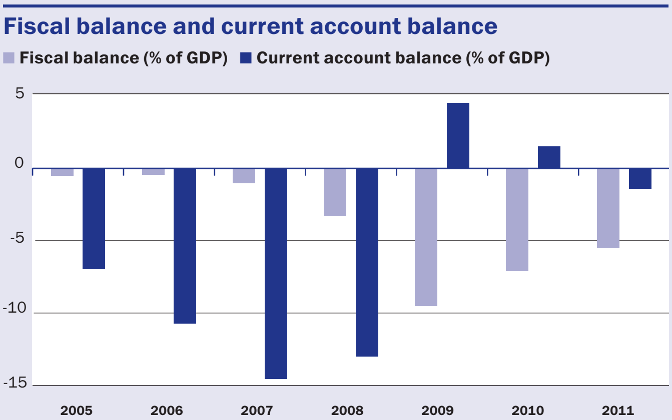
**Private investors continue to list governance issues and competition from the informal sector as key obstacles.** Tax incentives and loopholes used to be widespread, though more recently the government has sought to ensure a more level playing field. The reduction in the flat rate corporate tax from 20 to 15 per cent in 2010 should further support this. The share of the private sector in the economy is already relatively high, though the state retains important stakes in a number of sectors, including energy, transportation and postal services, with assets estimated at 18 per cent of GDP by the European Commission. There has been some progress in enhancing transparency on the activities of these companies, though a full separation of regulatory functions from the ministries that also manage the ownership stakes in these enterprises remains outstanding.

**Sources of energy supply are being diversified.** Uncertainty over the reliability of gas supplies from Russia is an important motivation. In October 2010 the government adopted the Energy Independence Strategy, which is aimed at expanding generation capacity, raising energy efficiency and securing supplies through the connection to markets in continental Europe. Following the closure of the Ignalina nuclear power plant in December 2009, all main electricity generation assets have been grouped under a separate company. In December 2010 the public network companies in the eastern and western parts of the country also merged into a new state-owned entity, which has assumed all financial obligations and was listed on the stock exchange. In June 2011 the Lithuanian parliament adopted amendments to the law on natural gas so as to implement the EU's Third Energy Package and allow full ownership unbundling. The bill aims to separate the country's gas transportation and supply assets and would limit the potential of Gazprom, the most important foreign investor in the sector, to acquire other assets.

**Efforts are under way to improve supervision and coordination in the financial sector.** The legacy of Lithuania's boom in retail credit continues to weigh on consumption and growth. Experience in other countries underlines the risk that a large stock of non-performing loans, which remained at 19.1 per cent of total loans in Lithuania in the first quarter of 2011, may induce banks to tighten credit standards, may impede fresh lending, and could further depress property values. The government therefore introduced a law to parliament that could facilitate the declaration of bankruptcy where personal debts exceed a certain limit. In each case a plan for the return to solvency is to be developed in cooperation between the borrower, a court and the creditor. The Lithuanian credit bureau estimates that this could ultimately benefit about 5 per cent of household borrowers. In September 2011 The Bank of Lithuania adopted a regulation for responsible lending which aims at preventing the re-emergence of unsustainable credit and house price developments. In particular, it sets a limit of 85 per cent for the loan-to-value ratio in mortgage lending.

**A national reform programme to enhance competitiveness has been developed.** The programme targets technology intensive production through stimulating research and development. This programme may face obstacles as public funds will be constrained amid further fiscal consolidation, and the commercial private equity funds remain relatively under-developed. Moreover, many of the objectives listed in the programme will require lengthy implementation, such as improving education and training or the development of clusters of innovative technologies. Nevertheless, the relatively sound skills base in the country should provide a good basis to develop these industries further.



# Moldova

## Highlights of the past year

- **Moldova's economy has rebounded after the financial crisis.** By the end of 2010 output surpassed the pre-crisis level, with growth being driven last year by remittance-based consumption and credit expansion, and underpinned by strong support from the International Monetary Fund (IMF) for the macroeconomic policy framework.
- **The authorities have worked to improve the business environment and stabilise the financial and energy sectors.** Important reforms include simplification of business regulations and liberalisation of trade, including the reversal of the temporary wheat export ban, strengthened supervision of banks and a rise in heating tariffs towards cost recovery.
- **Some planned structural reforms have been delayed.** These include procedures for simplifying the collection of non-performing loans (NPLs) by banks and measures to further strengthen the quality of banks' governance and ownership transparency, as well as resolution of energy sector arrears.

## Key priorities for 2012

- **Commercialisation of the transportation and communication infrastructure should be promoted.** The authorities should proceed with privatising the public telecommunications and airline incumbents and consider divesting the railways.
- **The governance of locally-owned banks should be strengthened further.** It is important to identify all the main beneficiary owners and ensure that they meet the fit-and-proper criteria. Reliable channels of communication with home-country supervisors of foreign-owned banks should be established, while privatisation of Banca de Economii to a quality investor would benefit the sector.
- **Moldova's dependence on energy imports highlights the need to focus on energy security.** More investment in this sector is required to integrate Moldova into the EU energy market and reduce technical losses. This should be combined with regulations and tax policies to increase energy efficiency of end users.

## Macroeconomic performance

**The economy has recovered from the deep recession of 2008-09.** Industrial output and trade turnover has increased, enterprises have pursued investments and restocked their inventories and households have increased consumption, supported by remittances (13 per cent of gross domestic product [GDP] in 2010). GDP growth in 2010 is estimated at 6.9 per cent. After registering a fall of 2.3 per cent in September 2009, consumer price inflation increased to 8.8 per cent in September 2011 as higher electricity and gas costs were passed on to consumers and global food prices increased. In response, the central bank has tightened monetary policy by raising the policy rate by 3 per cent since September 2010 and the reserve requirement ratios in the national and foreign currencies by 6 percentage points since 2010.

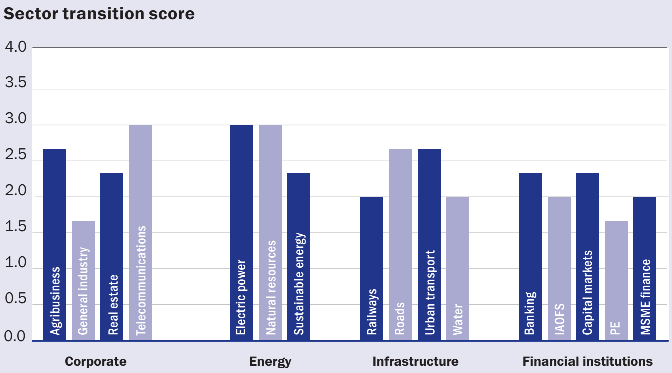
**The authorities' prudent fiscal and monetary policies have continued to be supported by a medium-term IMF arrangement.** Budget sector consolidation remains on track, although revenue performance lags behind the economic recovery. The central bank is successfully implementing the transition to inflation targeting and a flexible exchange rate regime. The level of NPLs has been decreasing due to write-offs and credit growth. Bank capitalisation and liquidity are at high levels. However, the economy remains vulnerable to external shocks, and the current account deficit remains high. Since January 2011 the country has been paying European prices for natural gas supplies by Gazprom, with a resulting net impact of 1.5 per cent of GDP on the balance of payments. Private external debt remains elevated and contingent liabilities related to gas payment arrears in Transnistria are large.

**Future economic prospects are very dependent on structural reforms.** GDP growth is expected to reach 6 per cent in 2011 but decelerate to 4 per cent in 2012. However, the authorities' efforts to improve the business environment and promote exports, including to the European Union, should raise potential growth over the medium term and make it more sustainable. The still high current account deficit, the economy's dependence on volatile remittance inflows and foreign aid, and volatile commodity prices remain among the key sources of macroeconomic risk.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 7.8 | -6.0 | 6.9 | 6.0 |
| Inflation (end-year) | 7.3 | 0.4 | 8.1 | 5.9 |
| Government balance/GDP | -1.0 | -6.3 | -2.5 | -1.9 |
| Current account balance/GDP | -16.3 | -8.5 | -8.3 | -9.9 |
| Net FDI (in million US$) | 697 | 121 | 191 | 250 |
| External debt/GDP | 55.2 | 65.5 | 68.1 | na |
| Gross reserves/GDP | 27.6 | 27.4 | 31.0 | na |
| Credit to private sector/GDP | 36.5 | 36.0 | 33.3 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**The authorities have made efforts to improve the business climate and promote exports.** Laws and regulations are being reviewed with a view to streamlining permit requirements and decreasing the constraints on doing business. A law on state inspection of entrepreneurial activities, which is intended to further simplify the regulatory regime, is expected to be adopted by the end of 2011. The authorities recently embarked on an education sector reform that should help improve labour force quality while reducing fiscal outlays. The export ban on wheat, introduced in early 2011, was short-lived, and the authorities have committed to avoiding export controls in the future. Meanwhile, the government is working on measures to strengthen food safety standards to increase agricultural exports to the European Union.

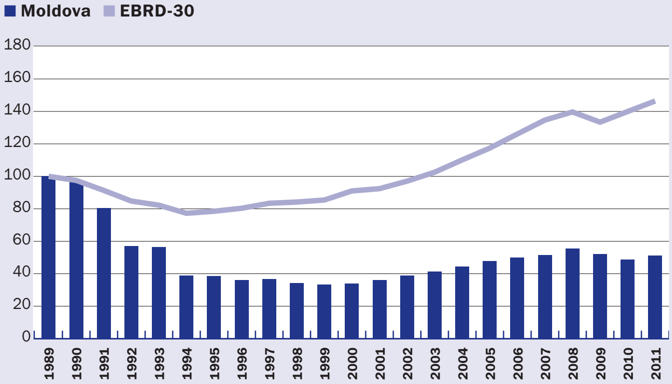
**Reform of the loss-making energy sector is ongoing.** The energy regulator ANRE has continued to maintain retail energy tariffs in line with costs. A new policy on bill collection was introduced in September 2011. The authorities and the energy companies have agreed a schedule for reducing the post-2008 stock of arrears. A new Memorandum of Understanding (MoU) agreed by the key consumers and suppliers should help improve payment discipline in the sector.

**The privatisation of public entities is on the short-term agenda.** Over the past year, the authorities privatised a number of small companies and land plots. However, the public sector continues to play a dominant role in telecommunications and air and rail transport and, to a more limited extent, the financial sector through its controlling majority ownership of Banca de Economii. The International Finance Corporation (IFC) has been contracted to prepare Moldtelecom for privatisation, and the list of state assets subject to privatisation via tenders was extended to large public companies. In addition, the government is in discussions with international financial institutions about options for the privatisation of Air Moldova in the near future. In September 2011 the Ministry of Economy approved a roadmap for the privatisation of Banca de Economii.

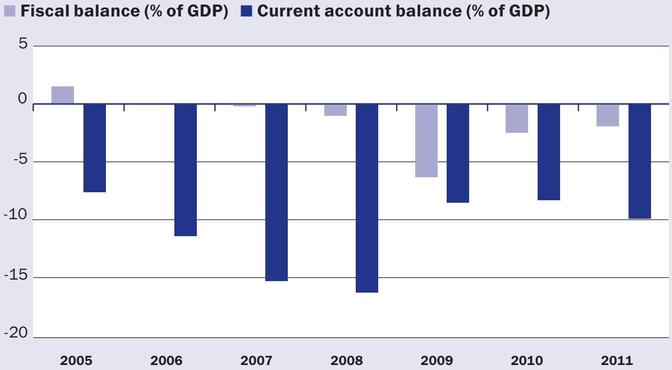
**The central bank has continued its efforts to maintain price stability and strengthen the banking sector.** Since the 2008-09 crisis the central bank has maintained greater exchange rate flexibility and has built the capacity to implement inflation targeting. The newly established financial crisis/stability committee should help strengthen the crisis management framework, and successful completion of bankruptcy procedures involving the failed Investprivatbank has raised confidence in the banking system. The central bank changed regulations on the execution of collateral, allowing creditors to execute collateral without going through the courts, thus creating incentives to restructure NPLs. Recent raider attacks on commercial banks have demonstrated weaknesses in the legal and judicial frameworks governing the financial sector.

**The government adopted policies to revitalise the construction sector.** The government resolved to nationalise a number of unfinished construction projects, primarily in the capital, Chisinau, in a two-year scheme. Projects are to be completed at the expense of the budget and various donor funds. There will also be a subsidised mortgage lending programme and a risk guarantee fund. While these policies should revitalise the sector, public support may undermine lending standards and burden the public balance sheet over the longer term.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Mongolia

## Highlights of the past year

- **Mongolia is benefiting from a mining boom.** The economy grew by 6.4 per cent in 2010, despite widespread damage to agriculture, as foreign direct investment (FDI) reached a record 26 per cent of gross domestic product (GDP), most of it mining-related. Negotiations on a concession to develop Tavan Tolgoi, a major coal deposit, are ongoing.
- **The government has created the Development Bank of Mongolia (DBM).** The newly created state entity will focus on financing infrastructure, social housing and other development projects.
- **In October 2010 Mongolia achieved compliance with the Extractive Industries Transparency Initiative (EITI).** The initiative is the global standard for improved transparency in the oil, gas and mining sectors.

## Key priorities for 2012

- **The macroeconomic framework for dealing with volatile commodity revenues needs to be developed further.** A stabilisation fund, envisaged in principle in the Fiscal Stability Law passed in 2010, could be used to save revenues during times of high commodity prices. They could then be deployed to offset the adverse impact of future sharp declines in commodity revenues.
- **The banking system needs a deposit insurance scheme.** The blanket guarantee introduced in the early days of the crisis is due to expire in November 2012 and needs to be replaced with a proper deposit insurance mechanism.
- **Significant infrastructure development related to large-scale mining projects calls for private sector participation.** The involvement of the private sector in the construction and operation of infrastructure assets would allow essential infrastructure requirements to be met within the limited fiscal space available.

### Macroeconomic performance

**Economic growth of 6.4 per cent in 2010 and 14.3 per cent year-on-year in the first half of 2011 attests to a robust economic recovery.** Growth has been driven by a rebound in the price of copper and other commodities and expansionary fiscal policy, and has been supported by a policy programme agreed with the International Monetary Fund (IMF) in 2009 and successfully completed in 2010. Foreign direct investment (FDI) reached a record high level of 26 per cent of GDP in 2010, which was sustained in the first half of 2011. FDI more than offset the rising current account deficit, which surpassed 15 per cent of GDP in 2010. Higher commodity revenues also led to a strengthening of the togrog and enabled the central bank to build up reserves of around US$ 2.5 billion (around eight months of imports).

**Inflation remains highly volatile.** The rate of inflation accelerated from under 6 per cent year-on-year at the beginning of 2010 to almost 14 per cent at the beginning of 2011. It then decelerated sharply to 4.2 per cent in May 2011 as the impact of the exceptionally cold winter of 2009-10 on food prices subsided, before picking up again, to 10.1 per cent at the end of July 2011. Inflation is likely to remain at elevated levels as the fiscal stance remains expansionary.

**Against the background of high commodity prices fiscal policy remains highly procyclical.** The government achieved a balanced budget in 2010 following deficits of around 5 per cent of GDP in the previous two years. A deficit of around 2 per cent of GDP is expected in 2011 in the light of increased spending on wages, social transfers and infrastructure. The authorities also indicated their readiness to guarantee debt issuance by the newly created state Development Bank of Mongolia. At the same time, completion of negotiations on the development of the Tavan Tolgoi coal deposit may generate additional government revenue, including prepayments by the winning parties.

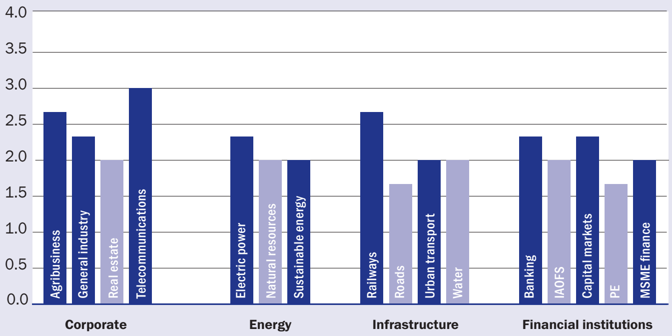
**Output growth is expected to reach 11 per cent in 2011.** It is forecast to accelerate to 12 per cent in 2012 and further in the medium term, supported by a rebound in commodity prices and major forthcoming investments in the mining sector to develop Oyu Tolgoi, Tavan Tolgoi and other deposits. The key risk is a possible renewed downturn in global commodity prices, which would weaken investment and economic activity and could lead to substantial delays in the implementation of the large mining projects. A further risk comes from a possible rapid increase in government contingent liabilities from the new state-owned DBM.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 8.9 | -1.3 | 6.4 | 11.0 |
| Inflation (end-year) | 22.1 | 4.1 | 13.0 | 8.2 |
| Government balance/GDP | -4.5 | -5.0 | 0.0 | -3.5 |
| Current account balance/GDP | -13.2 | -7.5 | -15.3 | -21.6 |
| Net FDI (in million US$) | 586 | 570 | 1574 | 2731 |
| External debt/GDP | 29.3 | 46.0 | 65.8 | na |
| Gross reserves/GDP | 10.3 | 28.2 | 37.3 | na |
| Credit to private sector/GDP | 43.5 | 43.9 | 44.0 | na |

### 2011 sector transition indicators

Sector transition score




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**In October 2010 Mongolia achieved compliance with the Extractive Industries Transparency Initiative (EITI),** the global standard for improved transparency in the oil, gas and mining sectors. Mongolia and Ghana join Azerbaijan, Liberia and Timor-Leste as countries with this status.

**Progress has been made in tendering the development of a major coal deposit, Tavan Tolgoi.** The Tavan Tolgoi mining deposit is estimated to hold reserves of over 6 billion tonnes and its development envisages near-term investment of around 100 per cent of Mongolia's GDP. A large number of bidders from all over the world applied, and negotiations with the shortlisted consortia are ongoing. The government is expected to retain a majority stake in part of the development and is considering an initial public offering (IPO) in domestic and international markets, with a possibility of distributing some of the shares among the population. To improve the attractiveness of mining projects to foreign investors, the Windfall Profit Tax on mining profits was abolished from January 2011. At the same time, the royalty rates on unprocessed minerals, including copper, were raised to partly offset the impact on government revenues.

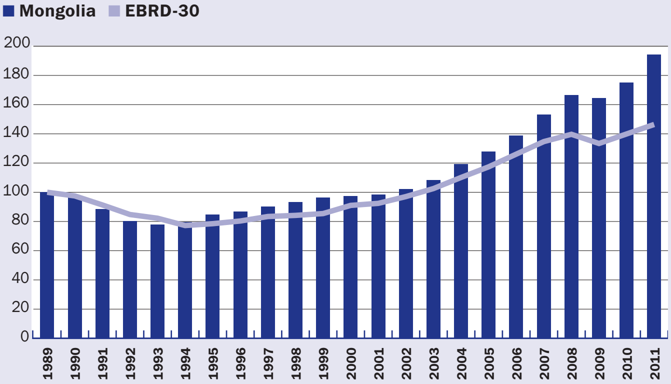
**To facilitate much-needed investment in infrastructure and other development projects the government set up the Development Bank of Mongolia.** The DBM, which officially opened in May 2011, is a state institution with a broad development mandate, which is expected to focus on infrastructure and social housing projects. Its Board of Directors is currently chaired by the head of the National Development and Innovation Committee. The bank will benefit from the support of senior management assigned by the Korean Development Bank. The financing model for the bank is yet to be fully worked out but it will likely involve a combination of earmarked revenues from mining royalties and bond issuance. The government indicated its readiness to provide a state guarantee for the first issues of DBM debt. The bank will complement the Human Development Fund created in 2009 mainly as a vehicle for handing out cash transfers and tuition fees subsidies to the population.

**The authorities approved in principle the construction of a new railway across the country.** The first phase envisages a 1,100 km link, which will connect Tavan Tolgoi, the coal mining area in South Gobi, with the trans-Mongolian railway crossing it at Sainshand, and continue to Choibalsan in the east of the country, with a potential extension linking it with the Russian railway network. The construction is estimated to cost US$ 3 billion (around 40 per cent of GDP) and will take up to five years to complete. A preliminary agreement with a consortium of South Korean construction and manufacturing companies has been reached but sources of funding remain to be clarified. The second phase of the Railway Policy adopted in July 2010 would allow private operators in the South Gobi to build railway lines to the border with China under concession agreements with the government. Sainshand, where the new line intersects the existing railway, may become home to an industrial park specialising in the processing of natural resources.

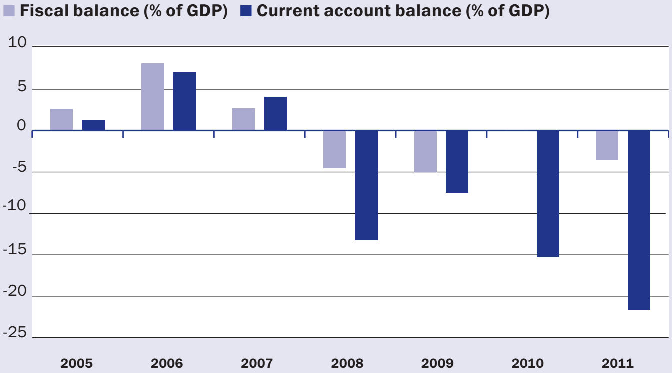
**The Mongolia Stock Exchange (MSE) reached an agreement on a partnership with the London Stock Exchange (LSE).** Under the Master Service Agreement signed in April 2011, the LSE is expected to help the MSE to upgrade its trading platform and build up capacity in anticipation of the forthcoming IPOs related to the mining boom under way. The LSE will also advise the MSE on changes to listing and trading rules. The authorities remain committed to privatising the stock exchange over the medium term. In the banking sector proposals are being considered to replace the blanket deposit guarantee introduced in November 2008 with a proper deposit insurance scheme. The current guarantee expires in November 2012.

**A law on air pollution in Ulaanbaatar was passed in December 2010.** It provides a general framework for tackling air pollution in the capital city and envisages a combination of tax incentives and fines.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Montenegro

## Highlights of the past year

- **Montenegro has become an official European Union (EU) candidate.** The decision by the European Council was made in December 2010 and reflects the reform progress over recent years. In October 2011, the European Commission (EC) recommended that accession negotiations be opened.
- **Economic stability has been preserved.** Signs of modest economic growth have emerged in the past year, but annual credit growth was still negative by mid-2011, reflecting the unwinding of bank balances after an excessive pre-crisis credit boom.
- **A major road project has been stalled.** Negotiations have failed with the selected bidder for the Bar-Boljare motorway, a key road in the country that would significantly upgrade Montenegro's transport infrastructure.

## Key priorities for 2012

- **Achieving a start date for EU accession talks is a priority.** The authorities need to continue progress on issues such as judicial reform and the fight against organised crime and corruption.
- **Fiscal discipline is crucial for maintaining growth.** Further reforms are needed to broaden the tax base and reduce overall government spending. This would also reduce public debt and make prospects for further foreign investment more attractive.
- **Weaknesses in the banking sector should be addressed.** Confidence in the sector is gradually returning and foreign parent banks have maintained their commitment. The comprehensive set of financial sector laws introduced recently should further support financial stability. However, the sector remains volatile and exposed to non-performing loans (NPLs), and higher levels of liquidity and solvency are required.

## Macroeconomic performance

**Montenegro has emerged from a deep recession in 2009.** Real gross domestic product (GDP) is estimated to have grown by 2.5 per cent in 2010. Foreign direct investment (FDI) almost halved in 2010, after a record inflow of FDI in 2009 close to €1 billion. Export activity increased significantly in 2010 by almost 20 per cent on an annual basis, while imports have been stagnant. This trend has so far continued in 2011. Notwithstanding these developments, the current account deficit remains high at around 25 per cent of GDP, according to International Monetary Fund (IMF) estimates. Inflation has increased in 2011 but remains modest by regional standards at around 3 per cent on an annual basis. Following a relatively strong performance in 2010, industrial production decreased significantly in March 2011 and remained negative until July. Annual private sector credit growth is also in negative territory, and although confidence is slowly returning, the soundness of the banking sector has not yet been fully restored.

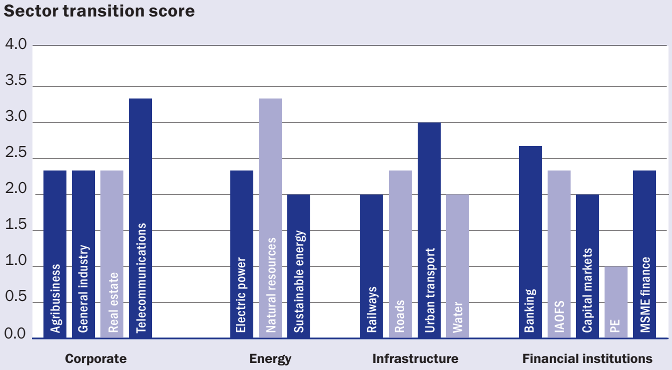
**Fiscal policies have become more prudent in the past couple of years.** The budget deficit has been kept under control partly through significant cuts in capital expenditure. The result was a general budget deficit amounting to 3.8 per cent of GDP in 2010. For 2011 the government plans to further reduce the deficit further, with the intention of reaching a balanced budget in 2012. In September 2010 the authorities successfully placed a €200 million eurobond issue, followed by another issue in early April 2011 of €180 million. The monetary policy tools of the Central Bank of Montenegro (CBCG) are limited due to the unilateral adoption of the euro.

**Exports and a good tourism season are expected to further support the economic recovery in 2011 and 2012.** However, financial sector stability is a concern as the effects of the massive pre-crisis credit boom continue to be felt. In addition, the economy still lacks diversity, with its reliance on a few key sectors such as electricity generation (where new investments are under way), metals and tourism.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 6.9 | -5.7 | 2.5 | 2.0 |
| Inflation (end-year) | 7.2 | 1.5 | 0.7 | 2.9 |
| Government balance/GDP | -0.3 | -5.3 | -3.8 | -3.4 |
| Current account balance/GDP | -51.3 | -30.1 | -25.6 | -24.5 |
| Net FDI (in million US$) | 852 | 1482 | 721 | 645 |
| External debt/GDP | 95.5 | 93.3 | 100.2 | na |
| Gross reserves/GDP | 9.6 | 13.8 | 14.8 | na |
| Credit to private sector/GDP | 88.5 | 77.7 | 68.8 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Montenegro has become an EU candidate.** Official EU candidacy status was granted by the European Council in December 2010. In October 2011, the EC recommended that accession negotiations be opened, noting that the country had successfully addressed the key priorities set out in the 2010 report. The authorities have adopted amendments to the Judicial Council, the law on public prosecution and the law on courts, but failed to adopt amendments to the labour law.

**The privatisation process has made limited progress in the past year.** Only one significant privatisation was completed in 2010, when the maritime company Pomorski Poslovi was sold in October 2010. In December 2010 the tender for the sale of a 30 per cent stake in the national flag carrier Montenegro Airlines failed due to a lack of interested investors. In addition, the privatisation council annulled the privatisation tender for the railway cargo operator MonteCargo in March 2011, despite ongoing negotiations with GFR, the Romanian rail freight operator. GFR was the sole interested bidder in the 87.6 per cent share in MonteCargo and had offered €2 million and an additional €5 million investment. After several delays, in October 2010, the government regained ownership of a 29 per cent share in the country's aluminium conglomerate KAP from the Russian majority owner Central European Aluminium Company.

**Some measures have been taken to improve the business environment.** Montenegro has made significant progress relative to regional peers in improving the business environment according to the World Bank's *Doing Business 2011* survey, which places the country in 66th position out of 183 economies surveyed. Important advances have been made with regard to starting a business and trading across borders. In March 2011 amendments to the Law on Administrative Fees were adopted in order to reduce or completely abolish payments for a number of administrative and custom documents. In addition, in May 2011 the government announced that a new one-stop shop registration procedure would soon be available at regional offices of the tax administration, in order to facilitate court and tax registration.

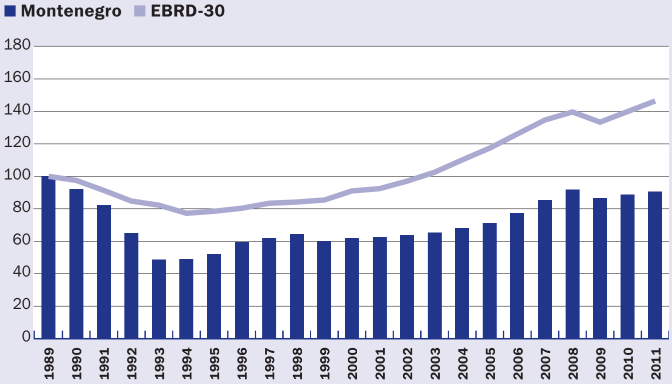
**A major motorway project has been stalled.** After the concession of the Bar-Boljare motorway to the tender winner was annulled in March 2010, the second-ranked bidder, the Israeli-Greek consortium Housing & Construction Holding and Aktor, was awarded the project. However, the authorities did not reach an agreement with the consortium as it failed to provide the required bank guarantees, and the agreement was cancelled in early 2011. A new tender for the motorway, which would link the Montenegrin coastline with the pan-European Corridor X, is expected to be called in 2012.

**New power transmission lines are being built, but energy tariffs have been reduced.** In November 2010 the Montenegrin Transmission System (CGES) signed an agreement with the Italian electricity transmission operator Terna on the construction of a 540 km interconnection cable, which is expected to cost up to €760 million. Terna will also build additional grid infrastructure to connect Montenegro with Bosnia and Herzegovina and Serbia. However, a setback to reform occurred in 2011 when tariffs were reduced by the regulator, particularly in the residential sector, which may jeopardise future investment in the sector. Another setback was the political decision not to allow the private sector to obtain a majority stake in the incumbent power company (EPCG).

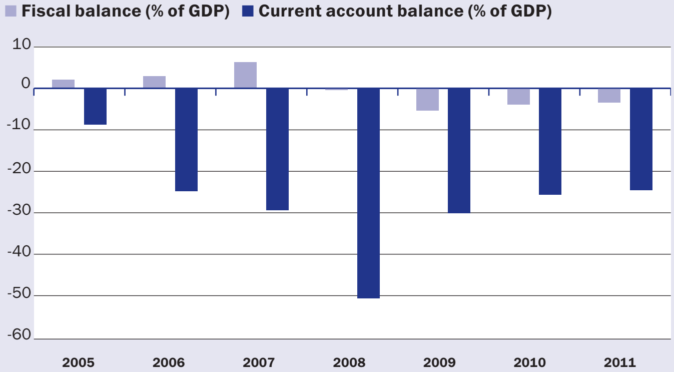
**The banking sector is recovering slowly from the global financial crisis.** Annual private sector growth remains negative. The CBCG has responded to the crisis with a comprehensive set of anti-crisis measures, including the provision of direct liquidity to the banking sector. In March 2011 it implemented further measures to alleviate the risk of a liquidity crisis and activated its function as a lender of last resort, and it redefined conditions for granting loans to banks through daily, overnight and short-term loans. In March 2011 all remaining restrictions on the lending activity of the largest domestically owned lender Prva Banka, which had received a €44 million loan from the government to help tackle its liquidity problems in late 2008, were removed.

**Pension reforms have advanced.** A recent set of reforms increased the retirement age from 65 for men and 60 years for women to 67 years in 2025 and 2041, respectively, and introduced a re-indexation of pension benefits to 75 per cent of the living cost index and 25 per cent of the general wage level, compared with the previous 50 per cent for both indices.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Poland

## Highlights of the past year

- **Poland continues to weather the European financial crisis well.** Growth remains supported by domestic consumption, positive labour market trends, and public investment fuelled largely by EU grants. The budget deficit has widened but an ambitious consolidation programme is being implemented.
- **The privatisation process has advanced.** Sales of government stakes accelerated last year, including significant deals in the power and insurance sectors, as well as a majority stake in the Warsaw Stock Exchange.
- **Profitability in the banking sector has increased and credit to households and corporates is again expanding.** The equity market has further solidified its role as a regional platform for issuance and trading.

## Key priorities for 2012

- **Implementation of the announced fiscal consolidation strategy is vital.** This is key to sustaining investor confidence amid broader concerns over sovereign exposures. It will require difficult choices in restraining social expenditures.
- **Reducing the influence of the state remains an overriding priority.** Continuation of the privatisation programme, in particular in key sectors such as energy and mining, is essential, even in less propitious market conditions. Full unbundling of the energy sector also remains a priority.
- **Completion of the pension reform process could help the development of local capital markets.** Corporate bond markets or mortgage-backed bonds could play an important role in bridging maturity mismatches on bank balance sheets and in making long-term funds available for private and public investment.

## Macroeconomic performance

**Poland remains on an impressive growth path.** Gross domestic product (GDP) growth accelerated to 3.8 per cent in 2010, and even picked up momentum in the first half of 2011. This is supported by growth in wages and disposable income and a slight drop in unemployment, which underpinned consumption, as well as the government's capacity to absorb EU grant funds, which boosted public investment. Poland's exports have benefited from the strong recovery in industrial production in Germany up to the second quarter of 2011. In the context of favourable growth the banking sector has remained profitable and well-capitalised, with private sector credit recently growing by about 9 per cent in annual terms, primarily due to renewed mortgage lending.

**The underlying deficit was allowed to further widen last year to 7.9 per cent of GDP.** The government has targeted a reduction in the deficit in 2011 to 5.6 per cent of GDP, which will stem partly from a reduction in contributions to mandatory pension funds, as well as a freeze in the public sector wage bill and cuts in certain social security expenditures. Accomplishing the targeted reduction in the government deficit to under 3 per cent next year (which would allow Poland to exit the EU's Excessive Deficit Procedure), will depend on more broad-ranging reforms in social expenditures, especially early retirement benefits to farmers and uniformed personnel such as the military and police. One symptom of the so far loose fiscal policies has been the slight widening in the current account deficit, and market concerns over external vulnerabilities were further fuelled by a statistical correction of recent balance-of-payments data. Hence the central bank engaged in some rate tightening in early 2011. Amid rapid outflows of portfolio capital from emerging markets the zloty weakened in September 2011, prompting an unusual intervention by the national bank in the foreign exchange markets.

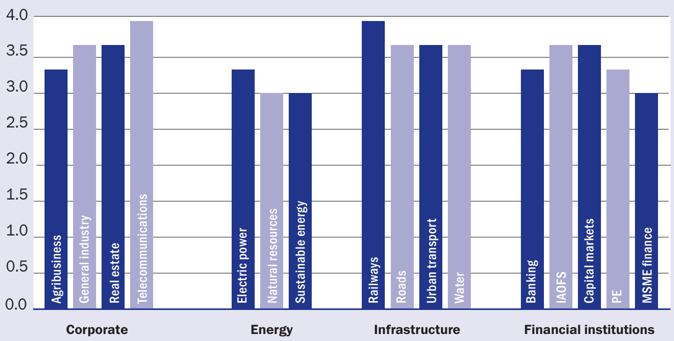
**Trend growth of between 3 to 4 per cent over the medium term is feasible.** However, this depends on whether capacity constraints can be overcome through stronger renewed bank lending to the corporate sector, and whether the necessary structural reforms are carried out. A key risk is that debt limits under national legislation (the 55 per cent of GDP legal limit and the constitutional threshold of 60 per cent of GDP) are reached, imposing the need for a sudden fiscal correction. Moreover, in 2011 Poland received substantial inflows into its government bond markets (about 4.5 per cent of GDP) where about 27 per cent of capitalisation is now owned by non-resident investors. This funding window would be susceptible to a further resurgence of risk aversion.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 5.1 | 1.6 | 3.8 | 3.7 |
| Inflation (end-year) | 4.2 | 4.0 | 2.7 | 4.0 |
| Government balance/GDP | -3.7 | -7.3 | -7.9 | -5.7 |
| Current account balance/GDP | -6.6 | -3.8 | -4.5 | -4.8 |
| Net FDI (in million US$) | 7055 | 6057 | 2502 | 1700 |
| External debt/GDP | 46.3 | 65.0 | 73.0 | na |
| Gross reserves/GDP | 14.4 | 16.9 | 19.6 | na |
| Credit to private sector/GDP | 46.2 | 46.6 | 48.2 | na |

### 2011 sector transition indicators

Sector transition score




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**State involvement in the Polish economy remains extensive.** This is especially the case in the power, natural resources and banking sectors. The country ranks 70th out of 183 countries in the World Bank's *Doing Business 2011* survey, which represents a slight improvement over the previous year. Rankings in dealing with construction permits, paying taxes and starting and closing a business all improved slightly. The government is seeking to address these bottlenecks and a deregulation package which aims to ease business activity and lower administrative costs of doing business was submitted to parliament in July 2011.

**Poland has nevertheless remained attractive to foreign direct and portfolio investors.** Notwithstanding the continued barriers in the investment environment, foreign direct investment (FDI) inflows have risen in the first half of 2011 relative to a year earlier, with notable foreign investment projects in particular in the BPO (Business Process Outsourcing) and research and development sectors. The 21 initial public offerings (IPOs) floated on the Warsaw Exchange in 2010 also attracted significant interest from portfolio investors, and the Warsaw Stock Exchange has further solidified its position as a regional equity platform.

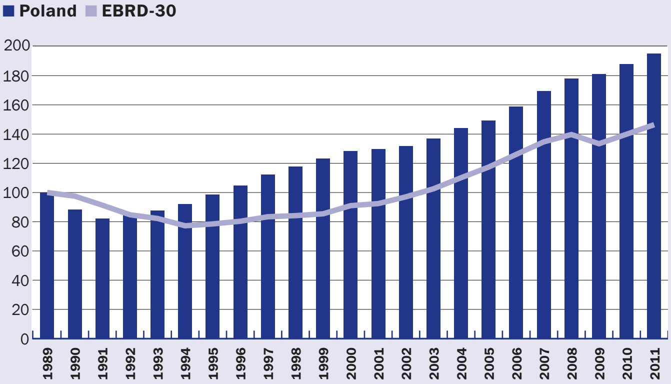
**The privatisation process has continued to accelerate.** Following the streamlining of privatisation procedures in 2008, sales accelerated notably last year in favourable market conditions, and a number of significant deals went ahead, representing in total 1.6 per cent of GDP. Sales of minority stakes in power company PGE and the insurance company PZU, as well as a 64 per cent stake in the Warsaw Stock Exchange, underlined strong investor interest. With this volume the government has nearly met its target of a PLN 25 billion privatisation volume for the year. While the target for 2011 is again ambitious (standing at PLN 15 billion), market conditions became less propitious in the middle of the year. A number of examples highlighted the government's reluctance to sell full majority stakes in particular in the energy and financial sectors. The sale of energy firm Energa to PGE, which remains state-owned, was blocked by the competition authority in January 2011 and this decision has now been taken to court. In the power sector the government's policies, in particular with regard to full unbundling in the sector, remain unclear.

**Infrastructure is being upgraded through the rapid absorption of EU structural funds.** The total allocation to Poland under the 2007-13 EU budget plan is substantial, amounting to 22 per cent of Poland's 2008 GDP. The availability of these grant funds may have constrained the involvement of other creditors. Since a law on public-private partnerships (PPPs) was passed in 2009, a substantial number of PPPs have been announced, although to date only 12 deals have been signed, amounting to less than €100 million.

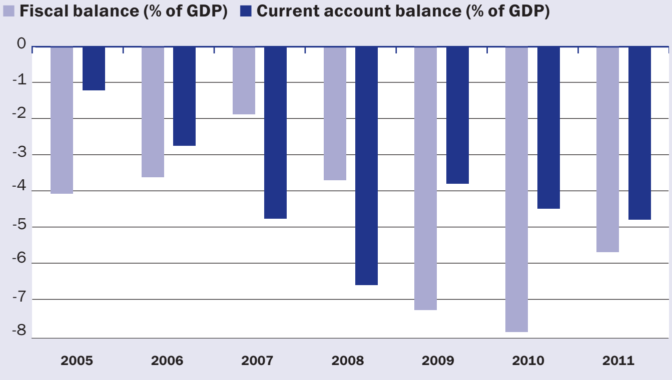
**Poland's pension system has been curtailed.** The initial pension reform in 1999 had a positive impact on capital market development, on easing future liabilities of the state pension system and building a savings culture among the workforce. However, at the end of 2010 it was announced that the contributions to open pension funds were to be reduced from 7.3 per cent of gross salaries to 2.3 per cent from May 2011, (rising to 3.5 per cent by 2017). This partial reversal of the earlier reforms was motivated by the substantial fiscal costs of moving from an unfunded to a partially funded pension system. The government was also concerned that an estimated 70 per cent of fund contributions were effectively returned to government accounts through either government bonds or privatised state-owned companies and that fee income of the industry appeared substantial. A broader redesign of benchmarks, of permissible investment portfolios and of the fee structure remains outstanding, although with over 15 per cent of GDP in invested assets, the sector will likely remain an important institutional investor.

**Polish private bond markets remain underdeveloped.** Poland has a highly liquid government bond market, which extends to very long maturities. However, the revision in the investment allocation of the open pension funds again highlights the opportunity from corporate bond markets. Capitalisation of the market remains negligible, even compared with other countries in the central Europe region. Bank issuance of bonds could help bridge maturity mismatches on balance sheets. Given the considerable investment need in both the public and the private sectors, bond markets could open an important source of more long-term funding.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Romania

## Highlights of the past year

- **The deep recession has ended and modest growth has returned.** The return to growth has been aided by prudent macroeconomic policies and successful cooperation with the International Monetary Fund (IMF) and the European Union (EU). However, short-term growth rates are likely to be low.
- **Absorption of EU funds remains inadequate.** Only a small percentage of available structural and cohesion funds have been used so far. The authorities have recently stepped up efforts to improve the utilisation rate.
- **New privatisations have been launched.** Offers of minority stakes in a number of energy companies are being prepared in line with the government's commitment to the new precautionary Stand-By Arrangement (SBA) with the IMF. However, an attempted sale of a minority stake in the major oil and gas company Petrom failed because of insufficient interest at the minimum price.

## Key priorities for 2012

- **Further fiscal reforms are needed.** These include the clearing of public arrears and ongoing reforms to the social security, pension and health care system.
- **Road commercialisation measures should be advanced.** Private finance should be attracted into the road sector, where major investments are greatly needed, either under the Concession Law, or under the new Public-Private Partnership (PPP) Law once it is approved by the European Union.
- **The government's energy sector strategy should be clarified.** The uncertainty over whether two national champions will be created should be resolved by the end of the year, by which time the government's plans and timings for further privatisations of energy companies should be clarified, thus providing opportunities to attract fresh investment into the sector.

### Macroeconomic performance

**Following a deep recession in 2009, the economy has struggled to recover in 2010.** Real gross domestic product (GDP) decreased further in 2010 by 1.3 per cent despite a strong performance in exports, which increased substantially by more than 20 per cent year-on-year. Foreign direct investment (FDI) also fell by approximately 26 per cent in 2010 after an already sharp drop in 2009. The recovery has consolidated somewhat in 2011, as exports continue to grow. Imports are also rising. Industrial production performed strongly in early 2011 but has slowed in mid-2011. Inflation peaked in May 2011 at 8.4 per cent on an annual basis, but has dropped significantly since then, partly because of base effects. Despite an increase in the ratio of non-performing loans (NPLs), the banking sector remains liquid and well capitalised, while private sector credit growth has gradually returned. In July 2011 the international ratings agency Fitch Ratings improved Romania's sovereign rating to "investment grade".

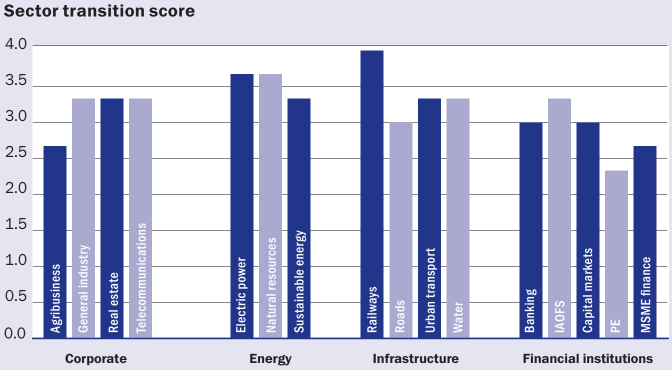
**Fiscal performance has been quite disciplined in the past two years.** Fiscal policies are anchored by a 24-month precautionary IMF Stand-By Arrangement (SBA) of €3.5 billion approved in March 2011, together with an EU precautionary Balance of Payments assistance programme of €1.4 billion in force since June 2011. These programmes follow the successful completion of the joint IMF/EU assistance programmes initiated in 2009. The 2010 budget deficit stood at 6.5 per cent of GDP, which was partly achieved by major cuts to social benefits and public wages reform, as well as an increase in the VAT rate. The 2011 budget deficit is targeted at 4.4 per cent of GDP (on a cash basis). The National Bank of Romania (BNR) has kept its key policy rate unchanged since May 2010 at 6.25 per cent. It further implemented measures to align with standards of the European Central Bank and introduced a number of amendments to the minimum reserve requirements.

**The economy is expected to remain stable but grow slowly.** Full commitment by the government to the IMF/EU programmes will help maintain macroeconomic stability, though risks continue to stem from the still high level of accumulated domestic arrears. In addition, the Romanian banking system remains exposed to subsidiaries of foreign parent banks, and could suffer significant setbacks if the eurozone debt crisis were to further deteriorate.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 7.4 | -7.1 | -1.3 | 1.5 |
| Inflation (end-year) | 6.3 | 4.7 | 8.0 | 4.0 |
| Government balance/GDP | -4.8 | -7.3 | -6.5 | -4.4 |
| Current account balance/GDP | -11.6 | -4.3 | -4.3 | -4.5 |
| Net FDI (in million US$) | 13606 | 4934 | 3583 | 4107 |
| External debt/GDP | 46.6 | 73.4 | 76.4 | na |
| Gross reserves/GDP | 13.8 | 18.9 | 28.1 | na |
| Credit to private sector/GDP | 37.7 | 39.5 | 46.1 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Absorption of EU structural and cohesion funds remains at a low level.** According to recent figures, Romania has absorbed only about 4 per cent of the €20 million allocated to the country for the period 2007-13. To increase the absorption rate, a new ministry to coordinate implementation of EU programmes is being established, and public procurement legislation is being amended.

**Romania has made progress in judicial and integrity reforms, but more work is needed.** In its annual progress report on Romania under the Cooperation and Verification Mechanism, the European Commission (EC) welcomed continued improvements in the efficiency of judicial procedures and the fact that the National Integrity Authority has started operating under an amended legal framework, as recommended in last year's report. However, the EC urged the authorities to further enhance the fight against corruption and to swiftly complete the reform of the judiciary system. At a meeting of the EU justice and interior ministers in June 2011, Romania's planned access to the Schengen Zone was postponed, with the delay linked to insufficient progress in the fight against corruption. Meanwhile, implementation of anti-monopoly laws has been strengthened over the past year.

**The government has committed to divest remaining state assets in a variety of companies, mostly in energy and transport.** In November 2010 the authorities offered the state's 46 per cent stake in the land-line operator Romtelecom to the majority shareholder, Greece's OTE, which holds the remaining 54 per cent. However, OTE turned down the authorities offer in May 2011, citing mainly external economic difficulties. In July 2011 the government and OTE agreed to sell some or all state-owned shares through an initial public offering on the local stock exchange in the coming year. In February 2011 the government launched an international tender for the sale of a 9.84 per cent share in the oil and gas company OMV Petrom, in which it currently holds 20.58 per cent, hoping to raise up to €500 million through a secondary public offer (SPO) on the Bucharest stock exchange. The minimum asking price was set at €485 million, but the SPO failed at the end of July 2011 after offers were below the floor price. Plans to restructure and sell stakes in other state companies are being agreed with the IMF.

**Shares are being offered in a number of energy companies.** Two 15 per cent SPOs are planned for the electricity transporter Transelectrica and the natural gas transporter Transgaz. The government is also considering an issue of 10 per cent shares in the country's two main electricity producers, the hydro power system operator, Hidroelectrica, and the nuclear plant operator, Nuclearelectrica. Both companies were involved in plans to restructure 21 state-owned power utilities and merge them into two "national champions". However, these plans have faced opposition and may be cancelled if nothing happens by the end of 2011.

**New energy sources are being developed.** The government's revised energy strategy 2011-35 aims to increase the share of renewable energy sources to 16.3 per cent in 2011, and envisages the creation of two additional nuclear power plants, which are to replace fossil-fuelled capacities. In July 2011 the European Commission approved the green certificates renewable energy support scheme, which is expected to significantly increase investments in the renewable generation sector in the short to medium term.

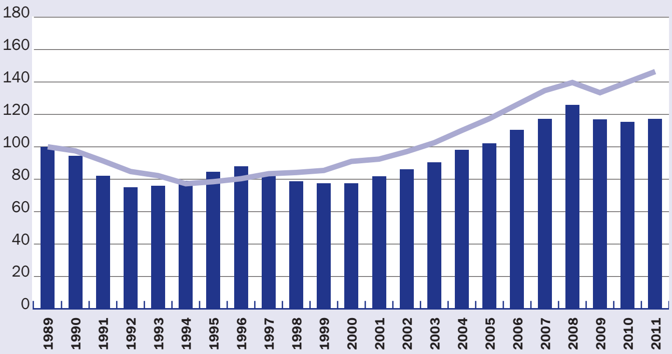
**The development of public-private partnerships (PPPs) in the roads sector is still lagging behind.** A new PPP law entered into force in October 2010, but it faced significant national and international opposition on the grounds that it breached EU legislation on public procurement and the Romanian constitution. In April 2011 the law was amended to harmonise it with EU standards, primarily by increasing transparency on PPP projects. It currently awaits approval from the European Union, but in the meantime new motorways can still be developed with private sector financing, under the existing Concession Law. In August 2011 the government renegotiated and scaled down the contract with the US company Bechtel on the construction of the 415 km Transylvania motorway project signed in 2004. There were issues with Bechtel's performance and the payment from the state budget. The construction of the remaining planned motorway sections may be carried out under concession or PPP contracts.

**The banking system has remained well capitalised and profitable.** The Vienna Initiative, under which the main foreign banks committed to maintain their exposures to their subsidiaries in Romania through the crisis, formally expired in early 2011. However, in March 2011 the parent banks of the nine largest foreign-owned bank subsidiaries further affirmed their long-term support to the Romanian banking sector. Preparations have begun to introduce International Financial Reporting Standards (IFRS) for the banking sector in 2012.

**Important social reforms have been implemented or are under way.** These include pension reforms, increasing the retirement age to 63 for women and 65 for men, harmonisation of public wages, reform of social benefits (including employment insurance, maternity benefits and social assistance programmes), and health care reform.

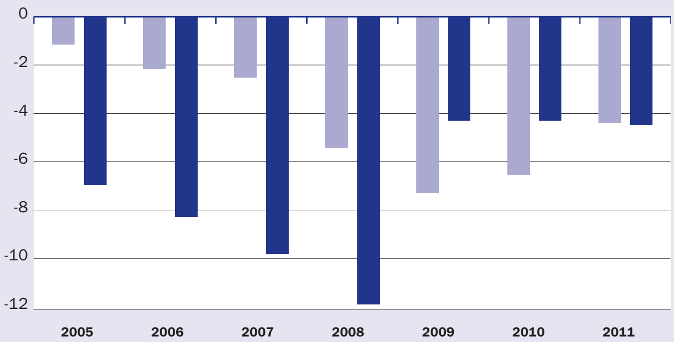
### Real GDP (1989 = 100)

■ Romania ■ EBRD-30




### Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



# Russia

## Highlights of the past year

- **Economic recovery has been sustained.** Economic growth in the past year has been robust, reaching 4 per cent in 2010 and 3.7 per cent in the first half of 2011. Net capital outflows have persisted but were more than offset by the current account surplus.
- **The privatisation programme has been revived.** In February 2011 the government sold a minority stake in VTB, the second largest bank, in a landmark deal, which was well subscribed by a broad range of investors.
- **A new direct investment fund has been set up to attract foreign investment.** The fund will be managed by a subsidiary of Vnesheconombank (VEB), the state development bank, and will benefit from a government contribution of over US$ 2 billion. It will seek to finance hi-tech and modernisation projects.

## Key priorities for 2012

- **Diversification of the economy away from growing dependence on oil revenues remains the key long-term priority.** Progress in this area requires further improvements in the business environment throughout the regions, stronger enforcement of competition laws and supporting investment in infrastructure.
- **As economic recovery gains momentum, fiscal discipline should be strengthened.** The implicit oil price needed to balance the budget has been rising steadily and appears to have exceeded US$ 110 per barrel. Arresting and reversing this trend will position the economy to better withstand an adverse shock to the external environment.
- **The financial system needs further improvements in legal framework and banking sector regulation and supervision.** This will support domestic capital market development and make progress towards the objective of positioning Moscow as an international financial centre.

## Macroeconomic performance

**The economy remains on a recovery path.** Output expanded by 4 per cent in 2010 and 3.7 per cent year-on-year in the first half of 2011. Growth has been supported by higher oil prices (Urals brand averaged US$ 108 per barrel in the first half of 2011 compared with US$ 78 in 2010), a sustained fiscal stimulus extended with further pension increases and ample liquidity in the banking system. Other economic indicators also reflect a broad recovery: the non-performing loans ratio has been falling since mid-2010, and the unemployment rate declined to around 6.5 per cent in seasonally adjusted terms by mid-2011. Real incomes posted a sizeable increase of 4.3 per cent year-on-year in 2010, in part due to increases in pensions. At the same time, investment activity has remained subdued with a year-on-year growth of 2.7 per cent in the first half of 2011, and the stock market has been affected by the global turbulence in August 2011.

**Net capital outflows have persisted.** They accelerated somewhat in the first half of 2011 compared with 2010 reaching an estimated US$ 31 billion in six months. However, they were more than offset last year by the current account surplus (US$ 72 billion in 2010). Inflation picked up to almost 10 per cent by January 2011 due to higher food prices following widespread damage to crops caused by forest fires in August 2010. In response, the central bank raised the refinancing rate by 25 basis points twice, reaching 8.25 per cent in May 2011. Inflation has since fallen to 7.2 per cent in September 2011.

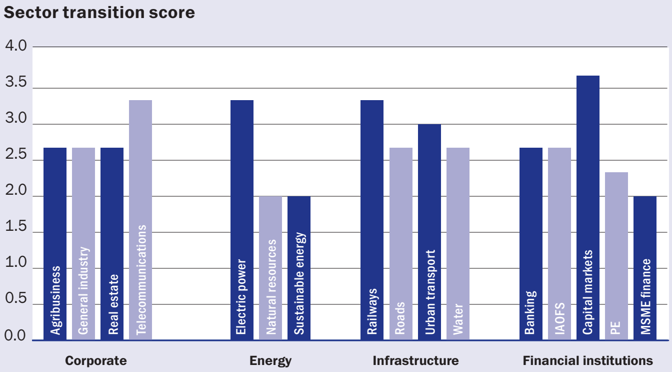
**Fiscal policy remains accommodating, backed up by fiscal reserves.** The revised 2011 budget foresees a decline in the deficit from 3.6 per cent of gross domestic product (GDP) in 2010 to 1.3 per cent of GDP in 2011, rising to 2.7 per cent of GDP in 2012 and declining again over the medium term. This path of deficits combined with further debt issuance in international markets will delay depletion of fiscal reserves (which are approximately US$ 120 billion as of mid-2011) beyond 2013 provided that high commodity prices persist. In the medium term, the hosting of the 2018 football World Cup will necessitate substantial investment in transport, hotel and sports infrastructure.

**Economic growth is expected to reach 4 per cent in 2011 and accelerate slightly to 4.2 per cent in 2012.** The key risks are a deterioration in the external environment and a new drop in the oil price.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 5.2 | -7.8 | 4.0 | 4.0 |
| Inflation (end-year) | 13.3 | 8.8 | 8.8 | 7.3 |
| Government balance/GDP | 4.9 | -6.3 | -3.6 | -1.2 |
| Current account balance/GDP | 6.2 | 4.0 | 4.9 | 4.6 |
| Net FDI (in million US$) | 20425 | -7335 | -10502 | -12078 |
| External debt/GDP | 28.9 | 38.2 | 33.3 | na |
| Gross reserves/GDP | 24.5 | 32.6 | 30.3 | na |
| Credit to private sector/GDP | 40.9 | 42.4 | 41.8 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Further progress has been made with the formation of a full Customs Union of Belarus, Kazakhstan and Russia.** Following the adoption of a common external tariff structure and a common Customs Code in 2010, customs checks were removed from the border between Belarus and Russia from April 2011. From July 2011 customs checks were also removed from the border between Kazakhstan and Russia. Integration is expected to be completed with the introduction of the common economic area, the modalities of which are yet to be fully agreed.

**World Trade Organization (WTO) and Organisation for Economic Cooperation and Development (OECD) accession remains on the agenda.** Towards the end of 2010 Russia, the United States and the European Union announced that respective bilateral negotiations were completed, with consensus achieved regarding the most important issues. The temporary ban on wheat exports, introduced following widespread damage to crops caused by a drought and forest fires in August 2010, was lifted from July 2011. A number of issues related to WTO accession are yet to be fully resolved, however, and multilateral negotiations continue. The Russian authorities also reiterated their commitment to subsequently joining the OECD, and they appointed an accession negotiations team.

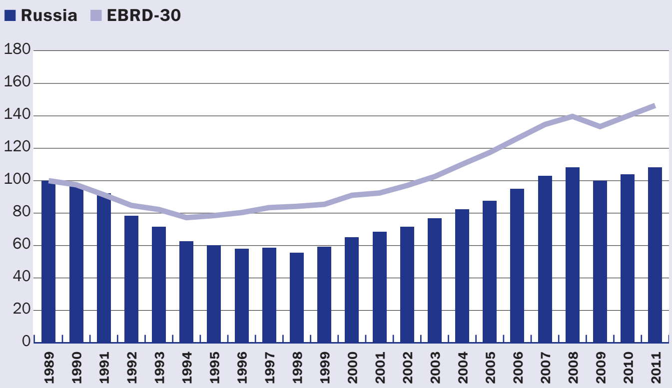
**Implementation of the privatisation programme has started, albeit slowly.** The programme for 2011-15, announced in 2010 and subsequently revised, foresees sales or initial public offerings of shares in state-controlled companies in various sectors including transport, power generation, pipelines, banking and insurance. Mostly these are minority stakes, although selected majority privatisations are being considered. In February 2011 VTB, the second largest state-owned bank, successfully placed a 10 per cent stake through a public offering, reaching a diverse investor base and exceeding the earlier announced revenue target of US$ 3 billion. Other landmark deals anticipated in the near future include minority stakes in Sberbank, the largest bank, and Sovcomflot, a maritime company specialising in oil and gas shipment. The privatisation programme also includes around 1,000 other items, mostly stand-alone minor assets in the regions. To reduce the deficit of the pension fund, the social security tax was increased from 15 per cent for SMEs (small and medium-sized enterprises) and 26 per cent for large firms to 34 per cent in 2011. Following repeated complaints from the business community, the government indicated a partial reversal of the increase from 2012, to 30 per cent, with a special rate of 20 per cent for SMEs in manufacturing and social services.

**Regulation and supervision have been strengthened in the banking sector but significant challenges remain.** In July 2011 the Deposit Insurance Agency (ASV) committed to extend emergency funding of 295 billion roubles (US$ 10.6 billion) to the Bank of Moscow, the sixth largest bank formerly controlled by the city government of Moscow. The funding was provided in the form of a 10-year loan at a fixed rate of 0.51 per cent on the condition that VTB, the new controlling shareholder, increased its stake to 75 per cent and provided extra funds of around US$ 4 billion. The asset problems of the bank, which led to the largest bailout in Russia so far, appear to stem from connected lending, asset concentration and poor risk management. While it is likely to be an isolated episode, it underscores the need to make further progress in strengthening banking supervision, particularly with respect to monitoring concentration of exposure, related-party lending limits and the reporting of the quality of assets. Higher minimum capital requirements for banks (180 million roubles from 2012) may lead to some consolidation among smaller regional players.

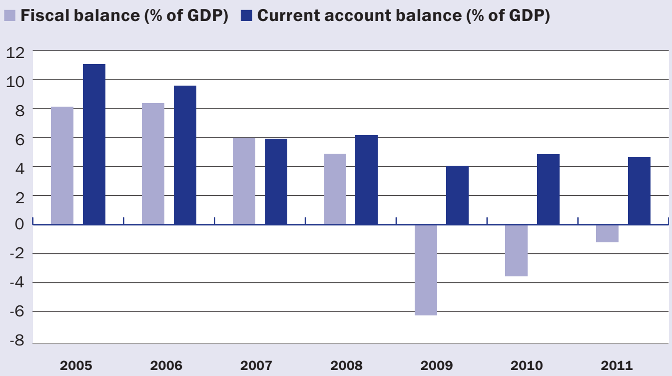
**To promote innovation and modernisation of the economy the government set up a direct investment fund.** The fund anchored by the Russian government contribution of around US$ 2.2 billion, potentially rising to US$ 10 billion, is expected to leverage private co-investment in individual projects, in particular from foreign investors. The fund will be managed by a fully-owned subsidiary of VEB, the state development bank, and will invest in hi-tech and modernisation projects in various sectors of the economy. It will thus join other government-sponsored vehicles with the mandate of supporting innovation and diversification of the economy, such as RusNano, which was created in 2007 and reorganised from a state corporation into a joint stock company in March 2011, and the Russian Venture Company established in 2006. An important distinction is that the new fund specifically seeks to attract foreign investors.

**The competition authority further stepped up its activities.** In 2010 the Federal Anti-Monopoly Service (FAS) initiated over 11,000 cases and levied a number of large fines for collusion in the domestic petrol market. The authority of FAS had been further strengthened in May 2010 when the Supreme Commercial Court upheld the fine levied on TNK-BP, an oil company, in a landmark case which set an important precedent. In the infrastructure sector, restructuring of the Russian Railways continued with unbundling and divestment of a number of non-core assets.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Serbia

## Highlights of the past year

- **Serbia has made major progress in the EU approximation process.** An Opinion on Serbia's application for EU membership, issued by the European Commission (EC) in October 2011, recommended that Serbia be granted formal candidate status. Ratification by the member states of the existing Stabilisation and Association Agreement (SAA) is advancing.
- **Investments in infrastructure are ongoing but privatisation is lagging behind.** Major projects are under way or in preparation in the roads and railways sectors, but several large-scale privatisations have either failed or are behind schedule.
- **Macroeconomic stability has been preserved.** The Serbian economy has shown some signs of recovery from the crisis and the economy is expected to grow in 2011. However, inflation remains significantly above that of regional peers.

## Key priorities for 2012

- **Preparing for EU accession talks is the main priority.** Acquiring official EU candidate status and the challenges stemming from the accession talks, once they start, would give a further push to implementing EU-compatible reforms.
- **Further fiscal reforms are needed.** A new programme with the International Monetary Fund (IMF) will help safeguard macroeconomic stability, but further efforts are required to reduce public spending and start to put pension commitments on a more sustainable footing.
- **Policies to encourage local currency use should be intensified.** Recent efforts by the National Bank of Serbia (NBS) to encourage greater use of the dinar are already having positive results and should be advanced further, particularly in light of the volatility of foreign exchange markets.

## Macroeconomic performance

**The economy has recovered slowly from the crisis.** Real gross domestic product (GDP) grew by 1 per cent in 2010, following a drop of 3.5 per cent in 2009. Exports have gained momentum and increased by 13 per cent, while imports rose by just 4 per cent in 2010, reflecting a modest rise in domestic demand. Foreign direct investment (FDI) fell by more than 30 per cent in 2010, while the current account deficit remained constant at 7.2 per cent of GDP. Unemployment remains a major problem and increased to 19.2 per cent at the end of 2010. Inflationary pressures have increased significantly amid rising food and energy prices and exchange rate depreciation, and the rate of inflation reached 14.7 per cent on an annual basis in April 2011. It declined in the second half of 2011, reaching 9.3 per cent in September. The banking sector remains liquid and annual private sector credit growth began to pick up slowly, supported by the government's loan subsidies programme. However, the ratio of non-performing loans (NPLs) in total loans continued to deteriorate in the first half of 2011 and stood at around 17.4 per cent in April 2011.

**The government's fiscal policies were anchored by a Stand-By Arrangement (SBA) with the IMF, which expired in April 2011.** In September 2011, the IMF Board approved an 18-month €1.1 billion successor agreement, which is precautionary. In 2010 the general government deficit stood at 4.6 per cent of GDP (on a cash basis), and the government is targeting a similar deficit in 2011. Under the proposed new SBA, the authorities have committed to cut spending by between RSD 15 billion and RSD 20 billion in order to cover the deficit that has been created partly by an economic slowdown but also by a new decentralisation law, passed in June 2011, which envisages major transfers from central government to local municipalities. The NBS has pursued tightening monetary policies since August 2010, and gradually increased the key policy rate to 12.5 per cent. However, in June 2011 the trend was reversed and the NBS has since then reduced its policy rate to 10.75 per cent (as of early October 2011). In addition, it has intervened occasionally on the foreign exchange market to smooth out currency fluctuations.

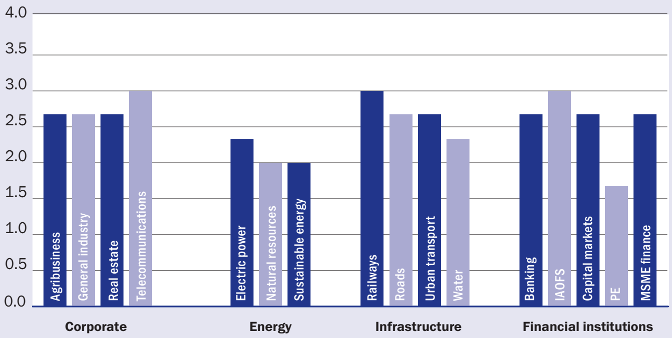
**Serbia's ongoing recovery is supported by the strong performance in the external sector.** A slow-down in the pace of reform may become evident in the short term in light of upcoming elections, but the successful adoption of a new IMF programme and a possible move to the next stage of the EU accession process would support further progress. However, potential contagion effects from the eurozone and reduced FDI flows could endanger the economic recovery.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 3.8 | -3.5 | 1.0 | 2.1 |
| Inflation (end-year) | 7.9 | 6.6 | 10.4 | 7.9 |
| Government balance/GDP | -2.6 | -4.3 | -4.6 | -4.6 |
| Current account balance/GDP | -20.9 | -6.9 | -7.2 | -7.7 |
| Net FDI (in million US$) | 2714 | 1881 | 1141 | 2146 |
| External debt/GDP | 65.2 | 76.5 | 83.1 | na |
| Gross reserves/GDP | 25.0 | 42.5 | 35.7 | na |
| Credit to private sector/GDP | 40.3 | 45.2 | 50.6 | na |

### 2011 sector transition indicators

Sector transition score




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Serbia has taken decisive steps in the EU approximation process.** The ratification process of the SAA, which started in June 2010, is advancing. With the arrest in May and July 2011 of the last two remaining fugitives wanted by the International Criminal Tribunal for the Former Yugoslavia (ICTY) in The Hague, the country has overcome a major political obstacle for gaining EU candidate status. An Opinion by the European Commission on Serbia's application for EU membership, published in October 2011, recommended that Serbia be awarded candidate status, and will be followed before the end of the year by a decision from the European Council.

**Large-scale privatisation is making little progress.** Two planned flagship sales – Telekom Srbija and JAT Airways – did not materialise in the past year. In late-2010, the government announced it would sell a 51 per cent share in Telekom Srbija, which remains 80 per cent state-owned, for a minimum asking price of €1.4 billion. The process failed in May 2011 when the government rejected the sole offer, from Telekom Austria, as the bid was significantly below the asking price. The privatisation of JAT Airways resumed in late 2010 when the government established a new company to take over JAT's operations and some assets, which became active in April 2011. A public tender was announced in early August 2011, requiring potential investors to have at least 5 per cent of their investments directly linked to an airline, to have transported at least 1.5 million passengers and to hold a minimum of €200 million in assets.

**A new energy law has been approved.** The new law, approved by parliament in July 2011, aligns Serbian legislation with the EU *acquis communautaire* and will immediately lead to a complete opening of the gas and electricity market for all consumers except households, for whom the market will be opened in January 2015. It further envisages strengthening the role of the energy regulator, who will have the power to set regulated tariffs from October 2012. The law will also facilitate investments in energy efficiency and encourage the use of renewables.

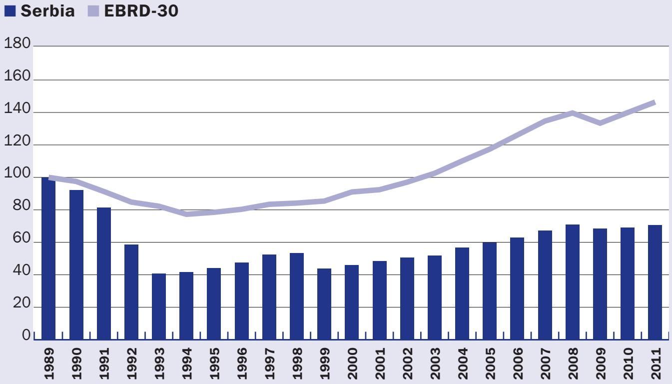
**Significant investments are being made in the roads and railways sectors.** In January 2011 a Spanish consortium, together with an Italian company, won the public tender to reconstruct the Zezlje Bridge in Novi Sad. In addition, a tender for the completion of the pan-European Corridor X was called in June 2011. Lastly, in March 2011 the authorities agreed with Russia a US$ 800 million loan to modernise Serbia's railway sector, the details of which remain to be negotiated.

**Operations in the water and wastewater sector are becoming more efficient.** Continued operational improvements from investments and corporate strengthening, together with improved bill collection and minor tariff increases, are moving the sector towards more cost-reflective pricing and a better managed water sector overall. There have also been initial attempts of signing better contractual arrangements in the form of public service contracts between municipalities and water utilities in at least one city.

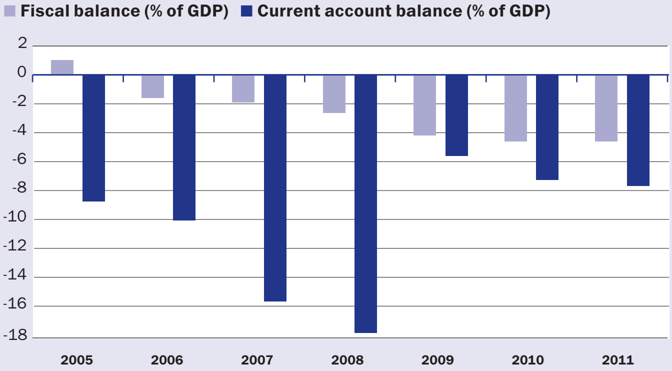
**Implementation of the competition law is proceeding.** There have been two reported cases of direct fines imposed by the Serbian Competition Commission (CC) in the retail and dairy sectors in 2010 and 2011, but the fines are currently being appealed.

**Various measures to promote use of the dinar are being implemented.** The NBS has introduced a variety of policy tools to provide incentives for local currency lending as part of its "dinarisation" strategy. In the past year, the NBS has abolished mandatory collateral deposits for household loans by raising the borrowing limit from 30 per cent to 40 per cent of personal income if a minimum of 80 per cent of the debt is denominated in local currency. In addition, the ratio of dinar reserve requirements was gradually abandoned and reserve requirements for foreign exchange increased. In June 2011 the NBS further imposed a compulsory 30 per cent deposit for corporate loans denominated in, or indexed to, the euro, and it increased the required downpayment rate from 10 per cent to 20 per cent for foreign exchange-denominated household loans. It has also prohibited loans indexed to foreign currencies other than the euro.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Slovak Republic

## Highlights of the past year

- **The Slovak Republic has shown one of the most dynamic recoveries of any EU country.** However, growth is dependent on export demand in a small number of cyclical industries, and high structural unemployment, in particular in certain regions and among the young, remains a major problem.
- **The government has put in place an ambitious fiscal consolidation plan that will seek to arrest the rapid rise in public debt.** Plans for strict rules on public debt and monitoring by an independent fiscal council should keep public finances on a sustainable footing.
- **The government has revived the programme of motorway construction.** This is essential to help bridge income disparities between the country's regions. While EU structural funds will account for most of the funding, public-private partnerships (PPPs) continue to provide some financing.

## Key priorities for 2012

- **Further efforts are needed to keep administrative costs for businesses low and the labour market flexible.** The restrictions of EMU membership and the rapid gains in competitiveness among regional peers underline the urgency of such efforts. The recent drop in foreign direct investment (FDI) inflows is also a concern in this regard.
- **The government should implement the ambitious new privatisation strategy that deals with the remaining state-held stakes.** This programme should be advanced even though financial market conditions have become less propitious in mid-2011.
- **Making the pension system sustainable is essential.** Reform of performance criteria and the liberalisation of allocation limits should allow operators of the mandatory pension funds, which are important for establishing a sustainable pension system, to diversify and increase retirement savings.

### Macroeconomic performance

**The Slovak Republic continues to show a strong recovery from the severe recession of 2009.** Growth in 2010 of 4 per cent was primarily driven by net exports (which grew at 39.4 per cent over the previous year), and which are in turn closely tied to export-oriented production in Germany and other eurozone economies. Manufacturing accounts for about 35 per cent of gross domestic product (GDP), and this sector is concentrated in a few important product groups, namely vehicles, machinery and electrical equipment. With these products the Slovak Republic has continued to gain export market share, although a slow-down in the second quarter of 2011 underlined the risks from the highly concentrated production structure.

**By contrast, domestic demand grew only modestly.** Gross investment remained the most dynamic component (growth of nearly 13 per cent in 2010), although the recovery in inventories was an important factor. The Slovak Republic remains an attractive destination for FDI and important projects were again announced in the transport sector. Household consumption stagnated in 2010 at a level unchanged from that of mid-2008. At 14 per cent the unemployment rate is among the five highest in the European Union and unemployment is particularly high among the under 25 year old age group, and in a number of regions.

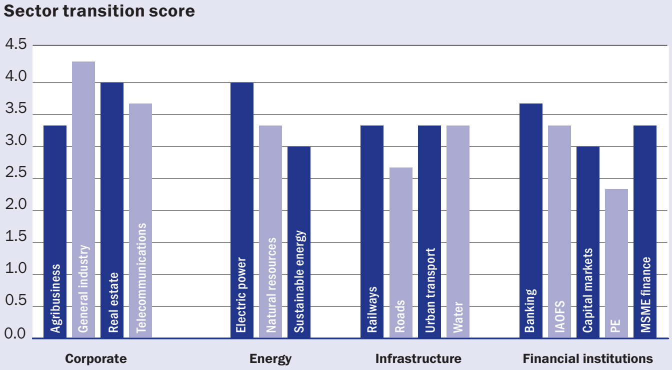
**The government has made rapid progress in lowering the fiscal deficit.** The various stimulus measures introduced by the previous government in response to the crisis led to a general government deficit of nearly 8 per cent of GDP in 2010, roughly unchanged from the previous year, and coming in spite of the strong pick-up in growth in 2010. Public debt as a percentage of GDP was the seventh-lowest within the European Union by the end of last year (41 per cent of GDP), but had risen rapidly following the recession. The government has implemented a substantial consolidation effort, which amounts to 2.5 per cent of GDP in 2011 alone, which includes drastic salary cuts to the civil service wage bill and a temporary VAT increase. In addition, the government plans new fiscal rules that would roll out strong incentives to contain public debt and manage public finances on a sustainable basis.

**The economy is well placed to enjoy trend growth of 3-4 per cent.** Fiscal and financial sector vulnerabilities are well controlled, but the economy will remain highly susceptible to external shocks, because it is potentially exposed to cyclical swings in production in a small number of industries.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| **GDP growth** | 5.8 | -4.8 | 4.0 | 3.1 |
| **Inflation (end-year)** | 3.5 | 0.0 | 1.3 | 2.7 |
| **Government balance/GDP** | -2.1 | -8.0 | -7.9 | -5.5 |
| **Current account balance/GDP** | -6.5 | -3.2 | -3.0 | -1.5 |
| **Net FDI (in million US$)** | 3168 | -483 | 198 | 400 |
| **External debt/GDP** | 55.6 | 74.5 | 75.4 | na |
| **Gross reserves/GDP** | 18.9 | 0.8 | 0.9 | na |
| **Credit to private sector/GDP** | 38.8 | 43.9 | 44.5 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Various labour market initiatives are under way.** A number of the government's announced initiatives should help to make growth more inclusive and address the problem of high unemployment. For example, the government is encouraging training and more active search efforts by those who are unemployed, as well as greater labour market flexibility, for example by restricting the activities of small unions within the workplace. The government also announced reforms of public sector governance, for example, in procurement, and plans a further simplification in administrative procedures affecting businesses such as electronic filing.

**The government has adopted a major new initiative on privatisation.** According to this plan, announced in March 2011, six regional heating companies are to be privatised (with only 5 per cent of the equity transferred to the local city government). This process may be concluded by early 2012 and could unlock the considerable investment and modernisation programmes that will need to be undertaken within these companies. Also the privatisation agency has announced the sale on the capital markets of the 49 per cent stake in Slovak Telekom. Bratislava airport, which has increasingly lost traffic to regional competitors, and will be leased under a 30-year contract. In March 2011 the government also approved a restructuring plan for the three state-owned railway companies to re-establish their financial viability by 2013. Under the plan, the government will reduce subsidies, lay off one-sixth of the employees and offer a majority stake in the cargo company to a strategic investor. If implemented, these measures will not only reduce budgetary transfers and gross public debt, but also allow greater private sector involvement in the restructuring of transport and utility companies.

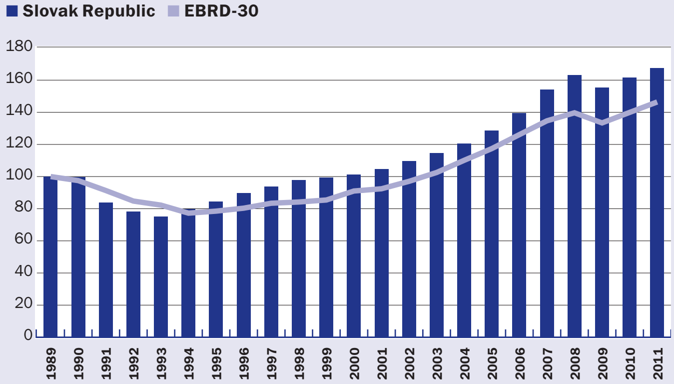
**Competition enforcement has improved.** Over the past year, some improvements have been observed with regard to speeding up final court decisions in anti-monopoly cases. The competition authority continues to show solid and aggressive law enforcement.

**The financing concept for the central D1 motorway has been clarified.** This motorway is of critical importance in connecting the eastern parts of the country. In 2010 the first phase of the PPP for the D1 motorway between Martin and Presov had been cancelled, postponing the construction of the motorway by over a year. In July 2011 the government approved a four-year motorway and dual carriageway programme with the aim of completing nine stretches of the main D1 motorway. The considerable project costs (estimated at €5 billion) will now be financed primarily by EU cohesion funds, with co-financing coming from EIB loans, state funds and tolls collected. However, the authorities continue to see a supplementary role for PPPs in financing infrastructure, as is the case in phase II of the D1 motorway and the R1 motorway that is already under construction.

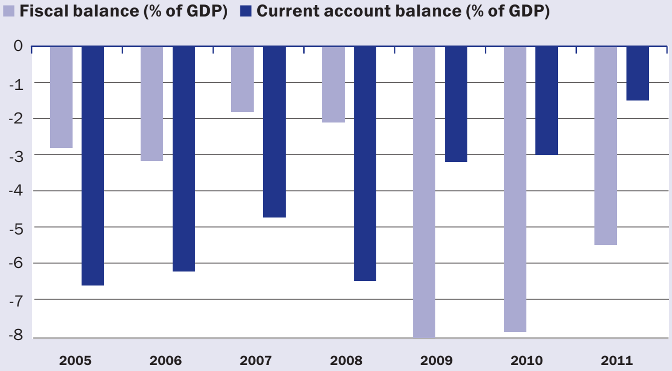
**The financial system remains dominated by foreign-owned bank subsidiaries, which have proven resilient to the crisis.** Non-performing loans (NPLs) have begun to decline (to 5.4 per cent for households and 7.9 per cent for corporate loans at the end of 2010) and the capital and liquidity ratios of the system have improved in line with the strong recovery over the past two years. In addition, credit to the corporate sector has expanded and credit to households has increased by 12.3 per cent in the year to mid-2011. Given the traditionally conservative bank funding model, with an aggregate loan-to-deposit ratio of about 89 per cent at the end of 2010 and limited reliance on parent bank funding, the system appears well prepared to meet future liquidity standards. A bank tax remains under consideration, although the government intends to coordinate with important home countries of bank subsidiaries. The government has launched some efforts to improve the functioning and liquidity of the government bond market, although a private bond market is virtually absent.

**The government is attempting to revive the second pillar pension system.** Several reversals to this system took place in 2009, motivated in part by the considerable transition costs for the budget from retaining an unfunded pension system while the funded system is being established, but also by concerns over the returns achieved. The changes, which include a reduction in management fees for pension fund operators and a liability for losses accrued on portfolios in any six-month period, have given every incentive to fund managers to shift allocations into defensive low return portfolios, irrespective of the risk preferences indicated by beneficiaries. This has undermined the potential benefits of pension funds such as diversification and potentially higher returns, and the growth of a local, long-term investor base. Therefore, in May 2011 the new government introduced to parliament draft legislation that would abolish performance guarantees for most beneficiaries, thereby allowing a more growth-oriented investment allocation by fund managers.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Slovenia

## Highlights of the past year

- **The economy is slowly recovering from the deep recession of 2009.** The recovery is being driven by exports but domestic demand remains exceptionally weak.
- **The two main state-owned banks, NLB and NKBM, have passed the EU-wide bank stress tests.** This outcome of July 2011 has reassured creditors somewhat. The largest bank, NLB, will nevertheless need to raise additional capital by the spring of 2012, and the overall outlook for banking sector asset quality remains a concern.
- **Two important food and beverage companies have been acquired by foreign strategic investors from the region.** This is a positive signal of Slovenia's openness to foreign direct investment (FDI), which could help to stimulate productivity growth, attract new skills and further integrate the economy within the region.

## Key priorities for 2012

- **The government should seek to establish a broader domestic consensus around pension reform.** This issue remains an essential component of fiscal reform in a rapidly ageing society.
- **Restructuring and eventual privatisation of state-controlled enterprises is essential.** The central ownership agency needs to be tasked through an act of parliament to enforce better governance practices and sell a wide range of assets, and should also consider bids from strategic investors from all countries of origin.
- **The government should seek to restore the health of bank balance sheets which would allow the flow of credit to resume.** This sector remains a key risk amid low growth and an unpredictable funding environment in the European banking markets. Ultimately, the government should reduce its direct involvement in bank decision-making, withdraw guarantees and plan for the privatisation of state-owned banks.

## Macroeconomic performance

**Slovenia's economic recovery remains slow by regional standards.** The country has close links to other eurozone economies with an export share of about 64 per cent of gross domestic product (GDP), and about 56 per cent of total exports directed to other eurozone members. Slovenia was therefore severely affected by the recession of 2009, when GDP experienced one of the sharpest contractions (a drop of 8 per cent) within the European Union. In 2010 growth reached just 1.3 per cent. Domestic demand remains exceptionally weak, with household consumption nearly 10 per cent below its pre-crisis peak in mid-2008, and gross fixed capital formation over 40 per cent below that peak (largely due to the depressed construction sector, which was down 17 per cent in 2010).

**Exports over the past six quarters have grown by 14 per cent.** Other eurozone economies, in particular Germany, are gaining importance over other trade partners in south-eastern Europe. However, this momentum has slowed in 2011, and growth in industrial production has fallen to about 6 per cent (mid-2011) in annual terms. While a number of fiscal stimulus measures were implemented over the course, and in the immediate aftermath, of the 2009 crisis, the government seeks to consolidate expenditures in the upcoming budgets.

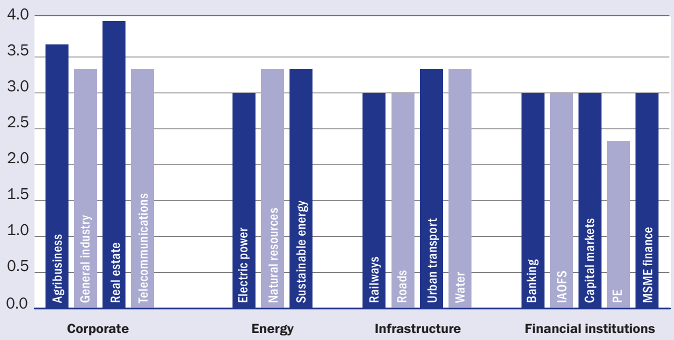
**The country is vulnerable to renewed external shocks.** The corporate sector remains over-indebted and some banks are under-capitalised. The ongoing contraction in credit and the collapse in investment have already led to a rapid rise in corporate bankruptcies and bank non-performing loans (NPLs) which in mid-2011 were estimated at more than 15 per cent for the two-largest banks. These NPLs are expected to rise further. In the short term the recovery will be constrained by the continued weakness in demand, the de-leveraging by firms and tight credit conditions. Slovenia's medium-term growth potential is unlikely to exceed 2 per cent and a return to more robust growth over the medium term remains doubtful given the lack of structural reforms at present. Demographic ageing dynamics and unreformed expenditure policies in the pension field are further risks.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 3.1 | -8.1 | 1.3 | 0.9 |
| Inflation (end-year) | 1.7 | 2.1 | 2.2 | 2.0 |
| Government balance/GDP | -1.8 | -6.0 | -5.6 | -6.0 |
| Current account balance/GDP | -6.9 | -1.3 | -0.8 | 1.0 |
| Net FDI (in million US$) | 234 | 25 | 47 | 30 |
| External debt/GDP | 96.5 | 119.1 | 115.2 | na |
| Gross reserves/GDP | 1.7 | 2.2 | 2.3 | na |
| Credit to private sector/GDP | 76.2 | 82.7 | 85.0 | na |

### 2011 sector transition indicators

Sector transition score




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Slovenia remains an economy with numerous impediments to investment and relatively low productivity levels.** The country's tradition of consensus-based and gradual policy-making has meant that progress with structural reforms has been slower than in other central European countries. The enterprise sector continues to suffer from a high level of direct and indirect government involvement and many enterprises require far-reaching restructuring to make them internationally competitive. In the World Bank's *Doing Business 2011* survey, for example, the country remains at the lower end of the European Union's new Member States, at 42nd, one rank higher than the previous year. Progress was made in particular in registering property, largely through the computerisation of the registry of land and other property. According to an Organisation for Economic Co-operation and Development (OECD) assessment published in February 2011, Slovenia's productivity levels in a range of manufacturing sectors remain well below those seen in comparable economies. In part this is due to a history of exceptionally low FDI which impedes the transfer of technology and skills.

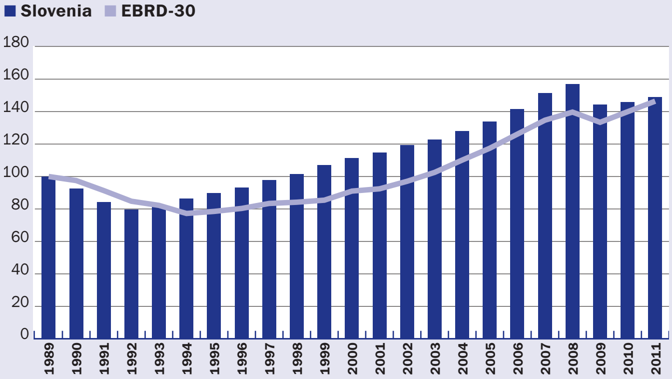
**Proposed pension reforms have recently been rejected.** The government's proposal for a reform of the pension system was defeated in a referendum in June 2011. Given the present system, European Commission projections indicate that Slovenia will have one of the highest relative pension expenditures of any EU country within 30 years. Rapid ageing, early retirement rights and the design of benefits will impose substantial additional expenditures. The proposed reforms therefore envisaged a gradual increase in the retirement age, restricting early retirement, and closing the gap between the retirement rights of men and women. Apart from the adverse impact on the medium-term path for fiscal policy, the defeat will also discourage greater labour force participation, and the set-up of alternative pension saving schemes. An earlier reform bill on certain aspects of labour market regulation, aimed at reducing the segmentation in the labour market while increasing the social protection of young workers, was also rejected.

**The government, which faces elections in December 2011, was moving slowly towards a restructuring of its extensive ownership stakes.** Before accession to the OECD in July 2010 the government committed to a range of structural reforms. It adopted legislation to improve the corporate governance framework for state-owned enterprises, minority shareholder protection and securities regulation. The Capital Assets Management Agency was established as a holding agency for the state's extensive interests in banks and enterprises, including those held indirectly through the pension fund (KAD) and restitution fund (SOD). The agency's brief included drawing up corporate governance principles and proposing a strategy for the sale of all assets not considered to be of strategic interest. In June 2011 the agency proposed to the government a strategy for the reduction in state ownership in most companies, including the state insurance company, and the two largest banks, NLB and NKBM, although the state would in all cases retain a controlling stake. According to this draft strategy which remains to be implemented, outright majority stakes were to be retained in the power sector, the postal operator, and the motorway company, with the railways company to be restructured into a holding company.

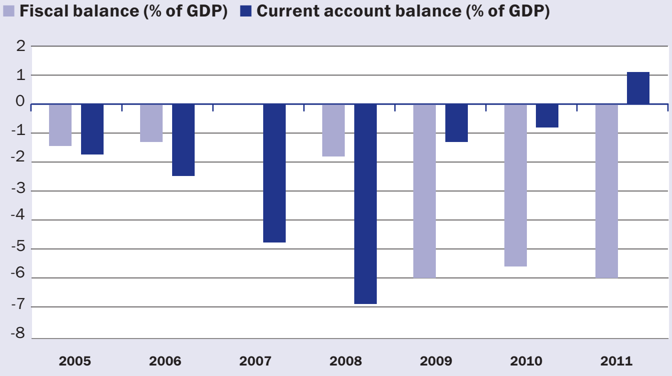
**A National Reform Programme envisages wide-ranging reforms to ease impediments to business.** The programme was announced in April 2011 and covers the next three years. However, in its assessment in June 2011, the EU Commission found little progress in implementing previously envisaged reforms in terms of services liberalisation, in particular with regard to the regulated professions, and land registration. In February 2011 the government drafted legislation to make the Competition Protection Office independent, although as yet staffing and resourcing of the Office remain inadequate. The agency recently initiated proceedings in the drugs and construction industry, and imposed a fine for price collusion on a number of ski-lift operators.

**Slovenia's banking sector continues to be dominated by the two large state-controlled banks, NLB and NKBM.** The two banks have a combined market share of about 40 per cent. The sector has suffered from low efficiency and is now experiencing a severe shortage of wholesale funding and a rapid deterioration in asset quality, which has already led to a number of downgrades in bank credit quality. A restructuring of bank balance sheets and improvements in governance are needed to advance the sector's efficiency and enable it to resume lending to enterprises. While both banks passed the second set of EU-wide stress tests, NLB did so only with a small margin which will require the bank to raise additional capital by April 2012. The central bank has repeatedly flagged the risks from deteriorating bank asset quality in the context of low growth and high corporate debt levels.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Tajikistan

## Highlights of the past year

- **Economic activity is recovering.** Real gross domestic product (GDP) growth reached 6.5 per cent in 2010 and 6.9 per cent during the first half of 2011, driven by agriculture, trade and services, on the back of growing remittances and recovering economic activity in the region.
- **Rising inflation became a policy challenge in 2011.** The annual inflation rate rose from around 5 per cent in mid-2010 to almost 15 per cent in mid-2011. In response to these inflation pressures, the authorities took various administrative measures to contain "artificial" price hikes and increase strategic food and fuel imports.
- **The banking sector remains very fragile and financial intermediation very shallow.** This reflects continued directed lending practices and other forms of excessive state interference, which have negatively affected capitalisation and the ability of banks to lend to the real sector.

## Key priorities for 2012

- **State control over the banking system needs to be reduced.** In particular, the authorities should refrain from providing any further directed credit through commercial banks to "strategic" sectors or imports. Once excessive intervention is phased out, there is significant potential to deepen financial intermediation by increasing deposits, capturing a larger portion of remittances, strengthening microfinance institutions and developing a non-bank financial sector.
- **Access to basic public goods and services needs to improve further.** In particular, there is an urgent need to improve the availability, reliability and quality of water supply, solid waste and urban transport. Improving these basic services by rehabilitating physical infrastructure is a precondition for improving tariff levels and collection rates, and achieving operational and financial sustainability of these utilities.
- **Developing the agricultural sector remains a key priority.** Increasing productivity and restoring and building new value chains require more access to finance and technology, less state interference and more reliable electricity provision.

## Macroeconomic performance

**Economic production and trade have largely recovered from the crisis.** GDP growth picked up from 3.9 per cent in 2009 to 6.5 per cent in 2010, driven by stronger hydroelectricity production, construction and a recovery of remittance inflows, which supported growth in services. The current account balance also changed significantly during 2010, turning from a 6 per cent deficit in 2009 to a surplus of 2.2 per cent in 2010, driven by the lagged impact of the 2008-09 exchange rate depreciation, disruptions to rail transit in early 2010 (constraining imports), and a slow-down in external loan disbursements for public investments. Gross reserves remain very low at around 1.4 months of imports of goods and services at the end of 2010, but are projected to gradually increase under the International Monetary Fund (IMF) programme.

**Rising inflation became a concern in 2011.** Year-on-year inflation accelerated rapidly from around 5 per cent in mid-2010 to nearly 15 per cent in mid-2011, driven by rising international fuel and good prices. The sharp rise in Russian export taxes on refined fuel products since May 2011 exacerbated these pressures. However, given the stabilisation of international commodity prices, inflation is expected to gradually decelerate to around 8 per cent by the end of 2012.

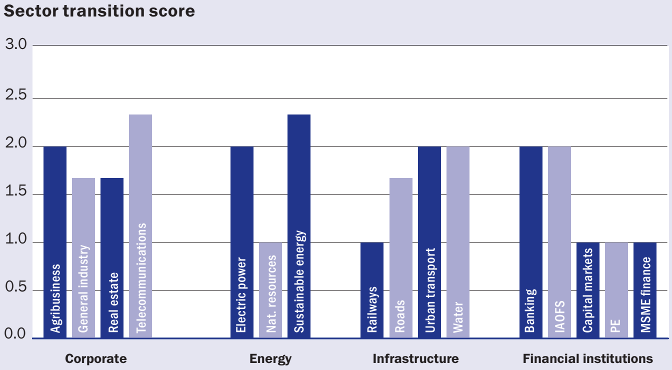
**Banks are continuing to suffer from excessive state intervention.** They have been hit in recent years by a series of events involving government-induced accumulation of non-performing cotton debt, a liquidity squeeze from the forced Roghun share sales and more recent state-directed lending to "strategic" sectors and for imports of "strategic" food and fuel products. These events have led to a substantial increase in classified loans and a reduction in profitability and capitalisation.

**GDP growth is expected to remain strong, but there are important downside risks.** GDP is expected to grow by 6.5 per cent in 2011 and by 5 per cent in 2012. The main downside risk to these projections is a renewed slow-down in global economic growth and associated commodity prices, which could negatively affect trade, foreign direct investment (FDI) and remittances. Moreover, the ability of the authorities to address major vulnerabilities, ensure macroeconomic stability and refrain from unnecessary state intervention will be crucial to support sustainable economic growth.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 7.9 | 3.9 | 6.5 | 6.5 |
| Inflation (end-year) | 11.9 | 4.9 | 9.8 | 11.9 |
| Government balance/GDP | -5.0 | -5.2 | -2.9 | -4.9 |
| Current account balance/GDP | -7.6 | -5.8 | 2.1 | -3.6 |
| Net FDI (in million US$) | 300 | 15.8 | 15.8 | 110 |
| External debt/GDP | 26.7 | 34.0 | 34.4 | na |
| Gross reserves/GDP | 4.2 | 6.9 | 9.1 | na |
| Credit to private sector/GDP | 26.4 | 25.5 | 14.3 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**There has been some progress with agricultural reform.** Progress in recent years includes liberalisation of cotton sector prices and production under the “freedom to farm” decree, cotton debt resolution, and the drafting (but not yet adoption) of a new land code that makes land tradeable. However, productivity remains low and the sector is still highly dependent on cotton production. This lack of diversification makes incomes and employment vulnerable to international price shocks and is a threat to food security, particularly in light of recent food price hikes and food shortages. One of the main constraints to agricultural diversification is the lack of access to finance, which the EBRD is helping to address through its Tajikistan Agricultural Financing Facility (TAFF).

**There has been progress in improving governance and transparency of large state-owned enterprises (SOEs).** The state aluminium company, TALCO, published audited financial statements in 2010, while the hydropower plant Roghun published its audited 2008-09 financial statements in June 2011. Tajik SOEs still face the pervasive problem of inter-enterprise and tax arrears that affect their profitability and undermine fiscal discipline. In mid-2011 the government approved a programme aimed at restructuring the state-owned electricity company, Barki Tajik, to be completed by 2015, which also involves breaking down the company into three entities with separation of power generation, transmission and distribution.

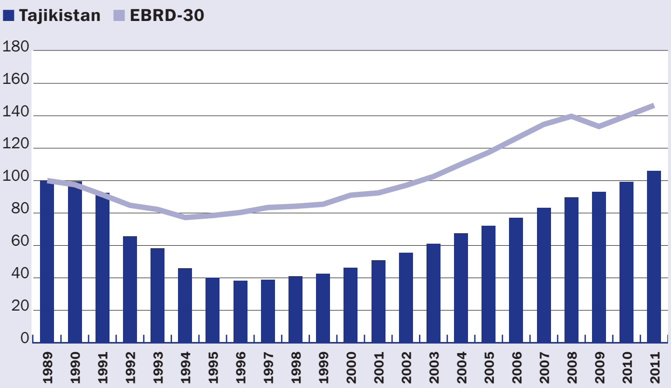
**With IMF support, the National Bank of Tajikistan (NBT) made significant improvements in governance and transparency.** Audited NBT financial statements through December 2009 were published on the NBT’s web site in September 2010. A revised NBT law was adopted by parliament in June 2011. However, the capacity of the NBT’s regulatory function is limited and state-directed liquidity lending still takes place.

**The business environment remains weak.** In the World Bank *Doing Business 2011* survey, Tajikistan gained 10 places from 149th in 2010 to 139th in 2011, putting it among the top 10 most improved countries. However, this improved score was mainly due to changes in legislation, simplified procedures to start up a business, simplified operation requirements and greater investor protection, while implementation remains weak. Areas where Tajikistan continues to score poorly include paying taxes (reflecting overly complex tax laws and weak tax administration), trading across borders, construction permits and access to finance. Overall, the business environment remains difficult with excessive state intervention in the corporate and banking sectors, a lack of competition and many formal and informal administrative barriers.

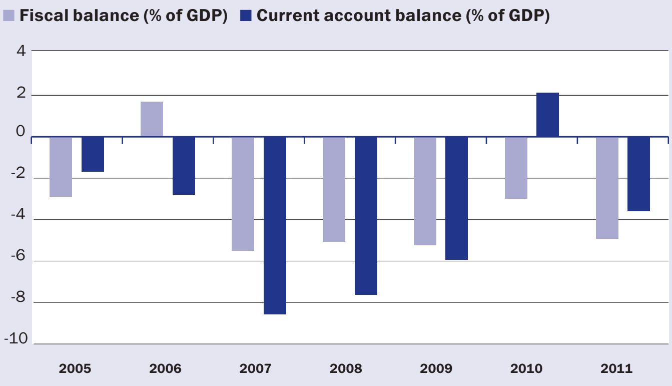
**Progress with infrastructure and municipal reforms has been uneven.** While the first road concession was signed in April 2010, the transparency of this process was questionable. Nevertheless, tolls were installed and collected funds seem to meet operational funding needs for the roads. The reform process in the municipal sector has started but progress has been slow, and the sector remains at a very early stage of development. On the positive side, progress was made with tariff reforms for water and wastewater. Since July 2011 tariffs for private enterprises approximately doubled in most regions in comparison to the end of 2010. Particularly good progress was made in the Khujand area, where water tariffs reached cost recovery for commercial business consumers and a service level agreement was developed, leading to significant improvements in water supply and water quality. However, other small cities lack institutional capacity. One other positive step was that the Anti-Monopoly Agency of Tajikistan obtained a more independent status from the Ministry of Economy in the beginning of 2010, and the tariff regulation responsibility for water utilities was given to this agency.

**Financial sector reform has progressed but the banking system remains fragile.** Asset quality remains poor reflecting exposure to the cotton sector and lending to state enterprises. Risk management and accounting standards are inadequate and some banks continue to depend on liquidity support from the NBT. Dollarisation levels in the banking system remain high while financial intermediation and capital markets development are poor. There has been some progress in the area of banking supervision, as banks that did not meet prudential criteria submitted time-bound action plans in early 2011 to become compliant with these standards, in line with the IMF programme. In addition to the adoption of the revised NBT law, during the first half of 2011 the parliament adopted a bankruptcy law for credit institutions and a new law on anti-money laundering and combating the financing of terrorism (AML/CFT).

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Turkey

## Highlights of the past year

- **Economic growth has been rapid, but vulnerabilities are increasing.** High growth rates in 2010 and the first half of 2011 have been fuelled by strong capital inflows, while measures to tighten macroeconomic policy have so far been limited.
- **Structural reforms in 2010-11 have been concentrated in the energy sector.** Recent reforms include the introduction of a new renewable energy law and preparations to sell a number of power distribution companies, with two deals already finalised.
- **Efforts to enforce competition laws have been strengthened.** In the past year the track record of law enforcement has shown a substantial increase, with significant fines being issued in a number of cases where the law has been violated.

## Key priorities for 2012

- **Further reforms in the energy sector are needed.** Progress should be made in unbundling the state-owned transmission company and improving its operational efficiency.
- **A more commercial approach to municipal financing should be developed.** The introduction of service contracts and, more generally, commercialisation, particularly in smaller operators, would improve operational and financial performance.
- **Credit growth should be curtailed, but longer-term sources of funding should be developed.** Continued rapid credit growth could pose risks for financial stability, especially as the economy is exposed to further shocks in the eurozone. However, the corporate bond market and institutional investors who could provide long-term local currency funding are small and need further development.

## Macroeconomic performance

**The economy is increasingly showing signs of overheating.** Economic activity has rebounded strongly from the crisis, with growth estimated at 8.9 per cent in 2010 and 10.2 per cent in the first half of 2011. Confidence, production and order indicators have reached pre-crisis levels or beyond, although some of them showed a modest cooling in the middle of 2011. The capacity utilisation rate still remains below the pre-crisis level. Growth is driven by domestic demand, fuelled by capital inflows and loose fiscal and monetary policy stances. Private sector credit has expanded rapidly, by about 40 per cent year-on-year in August 2011, despite government policies aimed at restraining the booming domestic demand. Import growth has outpaced export growth by a factor of 2.5, as a result of rapid domestic demand growth and increased energy prices. The current account deficit widened to 9 per cent of gross domestic product (GDP), on an annualised basis, in the first half of 2011. Although foreign direct investment (FDI) is also growing, the deficit is increasingly financed by portfolio investment and public and private sector short-term borrowing. Formal and informal repatriation of assets held abroad by the Turkish private sector also appears to have been an important form of financing in the first half of 2011.

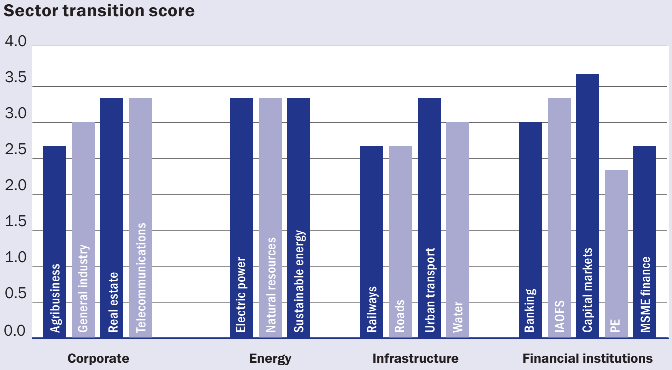
**Fiscal and monetary policies have been loose.** Concerned about the potential impact of rapidly deteriorating global economic conditions and of the widening euro area sovereign debt crisis, the Central Bank of the Republic of Turkey (CBRT) unexpectedly loosened monetary policy at the beginning of August 2011 by cutting the weekly repurchase agreement lending rate from 6.25 to 5.75 per cent. At the same time, it raised its main overnight borrowing rate from 1.5 per cent to 5.0 per cent, gradually narrowing the interest corridor. The CBRT has also acted to ease depreciation pressures by suspending daily foreign-exchange buying auctions and reducing reserve requirements for foreign-exchange deposits. Despite loose monetary policy and current devaluation of the lira, inflation of 6.3 per cent in July 2011, remains within the official target of 5.5 per cent ±2 percentage points for the end of 2011. Citing worsening external conditions in September 2011, the Central Bank announced a number of measures aimed at boosting banks' liquidity, including lower reserve requirements for banks' FX and lira liabilities and renewed FX interventions. Nevertheless, the lira has continued to depreciate, and as of 5 October 2011 has lost about 20 per cent of its value since the beginning of the year. Fiscal policy, if implemented as announced, will be broadly neutral in 2011.

**Risks of overheating and an abrupt reversal of capital flows are rising.** At the same time, fiscal tightening has not yet been mooted in the public debate. The government has also shown its readiness to act promptly if

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 0.7 | -4.8 | 8.9 | 7.5 |
| Inflation (end-year) | 10.4 | 6.3 | 8.6 | 6.2 |
| Government balance/GDP | -2.4 | -5.6 | -2.9 | -0.9 |
| Current account balance/GDP | -5.7 | -2.3 | -6.6 | -9.8 |
| Net FDI (in million US$) | 16955 | 6858 | 7816 | 9000 |
| External debt/GDP | 38.3 | 39.1 | 35.3 | na |
| Gross reserves/GDP | 6.72 | 8.5 | 6.6 | na |
| Credit to private sector/GDP | 28.5 | 6.8 | 33.8 | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

needed to smooth the possible adverse impact of the new global financial turmoil and economic slow-down by the means of monetary and fiscal policies.

## Major structural reform developments

**Structural reforms are ongoing in several areas, with current reform priorities being to raise labour market eficiency and reduce energy dependence.** Excessive labour market regulation discourages both the formal labour market and the formal economy in general. The widening current account deficit has raised policy-makers' concerns about competitiveness and Turkey's energy dependence. The latter has resulted in an increasing policy interest in energy efficiency and the renewable energy sector.

**The renewable energy sector and the ongoing privatisation of electricity distribution grids are attracting investor interest.** A generous endowment in reliable wind and hydropower resources, supporting measures introduced by the 2005 law, as well as high wholesale electricity prices have made significant renewable energy investments profitable, notwithstanding the fact that the feed-in-tariff price floor for renewables is relatively low by international standards. A new law passed in December 2010 introduced feed-in tariffs differentiated by technology, with subsidies for firms using components "made in Turkey". This will further improve the return to investors. In 2011 Enel Green Power (EGP), the renewable subsidiary of the Italian company Enel, reached an agreement with the Turkish industrial group Uzun to develop geothermal plants in Turkey. The non-renewable electricity generation system, however, remains mostly in state-owned hands although the government is in the process of privatising parts of it, with mixed success so far. Turkey's Privatisation Administration (ÖİB) announced that 2011 "will be the year of the privatisation of power plants", with 16,000 MW of power plants to be privatised. The last round of electricity distribution assets privatisations, however, stalled as the five awarded companies failed to secure the necessary financing worth US$ 9 billion.

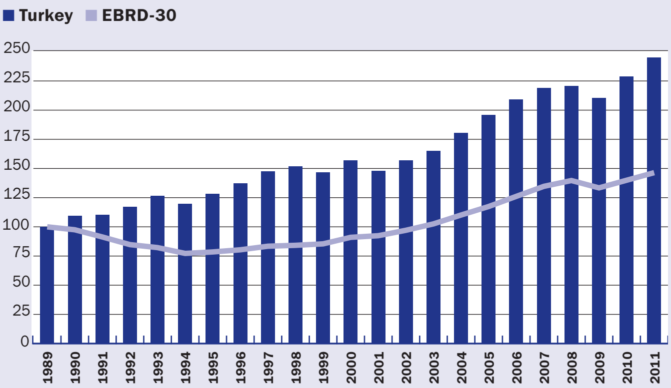
**Privatisation of Ankara's natural gas distributor, Başkent Doğalgaz, Turkey's second-largest gas distribution company, has been postponed until the end of October 2011.** In March 2008 a consortium led by Turkey's Global Yatırım Holding submitted a bid of US$ 1.61 billion for the gas distribution grid. The offer from the second-highest bidder, Elektromed, was US$ 1.55 billion. After several legal problems which occurred during the transfer of Başkent Doğalgaz to Global Yatırım Holding, the auction was awarded to the runner-up, Elektromed. However, the Ankara Municipality then cancelled the tender because Elektromed failed to meet its responsibilities.

**Large public infrastructure companies continue to be privatised and new projects are being implemented.** To improve logistics and increase passenger turnover the government is planning to build seven new airports by 2013. The privatisation process for the motorways and bridges by the method of "Transfer of Operation Rights" started in 2011. A deadline of 15 December 2011 has been set for applications. The whole network of existing motorways and bridges will be privatised as a single package. Also, the tender for the Northern Marmara Highway "build, operate, transfer" (BOT) concession, which will also include the construction and operation of the third Bosporus bridge, is planned for the end of 2011. With an estimated cost of US$ 6.5 billion it will be the second-largest infrastructure project in Turkey after the Izmit Bay Crossing. Construction of Çandarlı Port is on schedule, and the facility is due to accept its first vessel in 2013. The port is intended to cater for Turkey's growing maritime trade and also to function as a regional hub port, offering connections to the Middle East and the Black Sea states, and potentially competing with the Greek port of Piraeus.

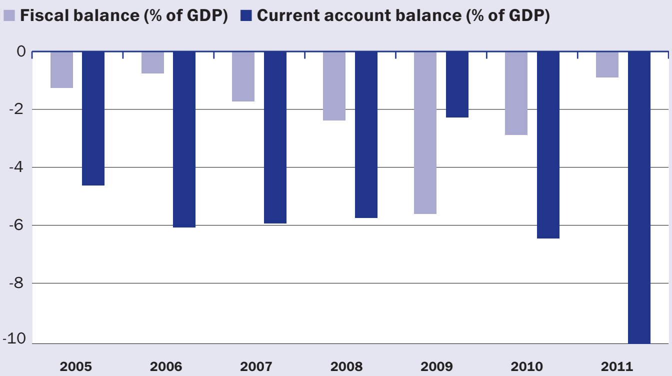
**Inefficiencies and protectionism remain significant in the agricultural sector, but there is growing investor interest in primary agriculture.** Ziraat Bank intensified its subsidised agricultural lending in the run-up to the 2011 parliamentary elections. Nevertheless, large corporates are increasingly showing interest in entering primary agriculture and engaging with the fragmented universe of small, informal and inefficient family farms, for example, through longer-term off-take relationships. The large corporates (and their banks) are also beginning to see investment opportunities in improving health standards in dairy and meat farming.

**The Government's 2011 Annual Programme targets an improved investment climate.** The new programme, announced in July 2011 by Prime Minister Recep Tayyip Erdogan focuses on the development of an enterprise-friendly system, in which efficiency is increased and bureaucracy reduced. To achieve these goals the National Competition Authority continues to strengthen its anti-trust regulation and competition advocacy activities. Recently, effort has been made to further coordinate competition policies with public procurement practices and sector regulators in the network industries. The government is already focusing on employment and education reforms. A new draft of the national employment strategy, prepared in 2011, focuses on severance payments. If implemented, this will make Turkey's labour market more competitive and will reduce the large burden on firms.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Turkmenistan

## Highlights of the past year

- **The Turkmen economy is continuing to grow robustly.** The country's gross domestic product (GDP) grew by over 9 per cent in 2010 and surged to 14 per cent year-on-year during the first half of 2011. These high growth rates have been mainly driven by the growing production and export of gas, following the construction of new pipelines to China and Iran.
- **The authorities have announced plans to reduce the dominance of the state and speed up the transition to a market economy.** They have already announced the list of companies for potential privatisation and have made progress with drafting a privatisation law.
- **Some progress has been made with financial sector reform.** New central bank and banking laws were adopted in 2011 and banks started introducing international financial reporting standards (IFRS) from January 2011.

## Key priorities for 2012

- **The share of the private sector should be increased and government intervention gradually phased out.** In conjunction with the announced privatisation plans, the authorities should begin to gradually remove price, interest rate and exchange controls, reduce subsidies on inputs and abolish production targets, particularly in the agriculture and textile sectors.
- **The new banking law is welcomed, but further financial sector liberalisation is needed to improve the depth and efficiency of financial intermediation.** The authorities should reduce controls on interest rates, phase out subsidised and policy-directed lending, eliminate payment and cash holding restrictions and increase the share of private banks.
- **Governance and the business climate need to be further improved to attract private investment.** In the hydrocarbon sector, improving governance and transparency of financial flows is key. In the non-hydrocarbon sector, the authorities should lower barriers to entry for new private businesses, reduce the regulatory burden on existing businesses, establish independent competition authorities and improve transaction legislation.

## Macroeconomic performance

**The Turkmen economy has continued to grow strongly by 9.2 per cent in 2010, and over 14 per cent year-on-year in the first half of 2011.** Economic growth in 2010 and well into 2011 was mainly driven by recovering gas exports, owing to alternative gas export routes to China and Iran, as well as by government-led investment. Natural gas production increased by over 40 per cent in the first half of 2011 compared with the same period last year. New on-shore gas discoveries and changes in the foreign investment law have led to a significant increase in foreign direct investment (FDI) since 2009, mainly into the hydrocarbon sector. Inflation increased from around 0 per cent at the end of 2009 to 4.8 per cent at the end of 2010, mostly reflecting higher international commodity and food prices.

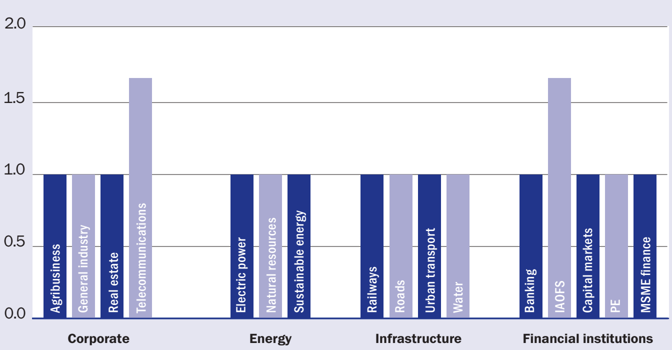
**The external balance has improved while fiscal indicators have worsened.** Despite the increase in construction-related imports, the current account deficit narrowed from 16 per cent in 2009 to about 12 per cent in 2010, while the general government's fiscal surplus appears to have fallen. External public debt is estimated to have increased from 2.6 per cent of GDP in 2009 to 11.8 per cent in 2010, mostly due to increased borrowing for the development of gas fields.

**GDP growth prospects are good.** In the short term, GDP growth will continue to be driven by increasing gas exports to China and public investment. The downside risks are related to the global slow-down, over-reliance on gas production and exports, excessive state intervention and slow progress with market-oriented reforms.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| **GDP growth** | 14.7 | 6.1 | 9.2 | 9.9 |
| **Inflation (end-year)** | 8.9 | 0.1 | 4.8 | 7.5 |
| **Government balance/GDP** | 10.0 | 7.6 | 2.3 | 0.5 |
| **Current account balance/GDP** | 16.5 | -16.0 | -11.7 | -2.9 |
| **Net FDI (in million US$)** | 1277 | 4553 | 3631 | 3186 |
| **External debt/GDP** | 2.8 | 2.6 | 11.8 | na |
| **Gross reserves/GDP** | na | na | na | na |
| **Credit to private sector/GDP** | 15.0 | 16.7 | na | na |

### 2011 sector transition indicators




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Turkmenistan remains the least reformed of all transition countries, but the authorities have expressed commitment to begin a serious privatisation process.** Although small-scale privatisation has proceeded since the start of transition, an estimated 75 per cent of the national economy is still under the control of the state and large-scale privatisation still needs to be started in a significant way. The authorities have begun drafting a privatisation law and have stated their aim to develop a privatisation strategy in accordance with international best practice, ensuring a fair, competitive and transparent privatisation process, as well as enforcement of good corporate governance post-privatisation.

**Transparency of financial flows remains limited in the natural resource sector.** Since establishing a stabilisation fund in 2008, the authorities have further improved budget transparency by consolidating some extrabudgetary funds under the state budget. However, most hydrocarbon revenues continue to be accumulated in the Foreign Exchange Reserve Fund (FERF), an off-shore, off-budget account that was created and controlled by the former President, and which continues to be spent in a highly non-transparent way.

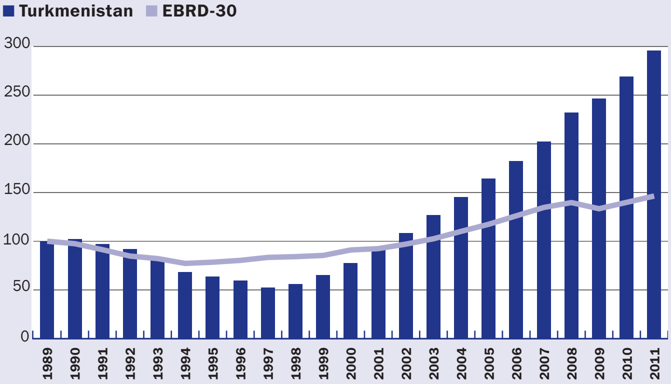
**Some progress has been made with financial sector reform.** After a new law on anti-money laundering and counter-terrorism financing (AML/CTF) came into force in August 2009, a Financial Intelligence Unit under the Ministry of Finance was established in January 2010. New central bank and banking laws were adopted in 2011, while a new draft law on foreign exchange regulation that was submitted to parliament in August 2010 has not yet been passed. Another important reform is that international financial reporting standards have started to be introduced into banks from 2011 and are on track to be introduced into the corporate sector as well from 2013.

**Some progress has been made with developing the small and medium-sized enterprises (SME) sector.** Following the adoption of an SME development law in 2009, the President approved a state programme for 2011-15 to support SMEs, which included state-directed loans to SMEs at preferential rates. While this has contributed to rapid growth in private sector credit, it has not been market driven and therefore is not sustainable. Access to commercial finance for the SME sector remains constrained by limited competition in the banking sector, state interference and lack of availability of a wide array of financial products, including leasing and equity finance. Management skills in the SME sector are below the standards of the rest of the transition region, which limits the potential growth of the private sector, a key government priority.

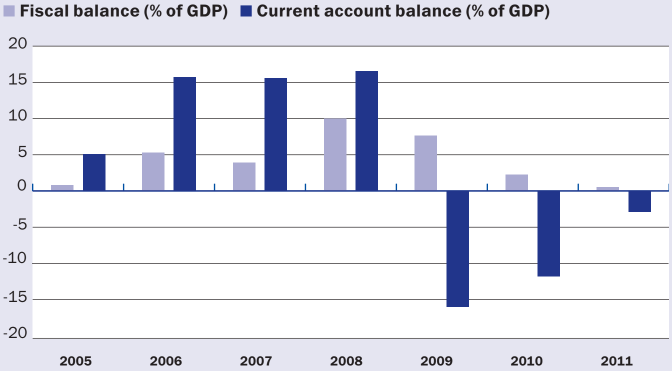
**Transport infrastructure remains largely unreformed.** The investment needed in the country to modernise transport infrastructure is enormous. Most transport infrastructure in Turkmenistan is owned and operated by the state. Investment decisions have often been arbitrary and there has been slow progress with reforms to improve commercial orientation, increase the efficiency of services and create space for the private sector. The willingness of the government to introduce such reforms is as yet untested, although discussions are taking place regarding improvements in tariff methodologies, financial reporting standards and corporate governance in the transport sector.

**The economy remains undiversified and highly dependent on its hydrocarbon wealth.** The economy is largely dependent on hydrocarbon exports: oil and gas accounted for nearly 94 per cent of total goods exported in 2009. The new north-south railway link, construction of which is under way, could help diversification by facilitating transport flows between the Persian Gulf, Turkmenistan and Kazakhstan.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Ukraine

## Highlights of the past year

- **Ukraine's economy continued to recover from the deep crisis, but better performance is hindered by uneven policy implementation and an uncertain external environment.** Output growth has benefited from rising external demand, improved real incomes and tentative recovery of bank credit. However, inflation has risen somewhat as higher food, gas and electricity prices were passed on to consumers.
- **Some progress has been made with institutional and structural reforms.** Among other measures, the anti-corruption law became effective in July 2011 and should reduce red tape and increase the effectiveness of public institutions, if fully implemented. Pension legislation enacted in September 2011 will help improve medium-term fiscal sustainability.
- **Reform of the critical gas sector has proven difficult.** To ensure Ukraine's role as a gas transit country, the authorities started rehabilitation of the ailing gas transport system. However, households continue to pay a fraction of international prices for natural gas and Naftogaz continues to run significant deficits.

## Key priorities for 2012

- **Further improvements to the difficult business environment are required.** Reforms should aim to introduce broad political checks and balances, de-politicise the commercial courts and establish fair conflict resolution procedures, as well as resolve long-standing problems with land ownership and use rights without compromising social justice.
- **The authorities should reform the gas sector.** The energy regulator should be allowed to raise domestic gas prices towards import parity levels while the state-owned energy company, Naftogaz, should be restructured and corporatised.
- **Post-crisis stabilisation in the financial sector should be completed.** The government should develop and implement a strategy for reducing the role of state financial institutions, so as to improve management and ultimately to divest nationalised banks and develop local capital markets.

## Macroeconomic performance

**The economy has continued to recover from the deep crisis, but slower global growth and financial sector instability could weigh on the recovery.** Growth in 2010 of 4.2 per cent was supported by the resumption of exports, while more recently output growth has benefited from rising real incomes and consumption. The authorities have pursued an ambitious investment programme in anticipation of the 2012 European football championship, and investment confidence has been maintained, though signs of strain have emerged since late summer 2011, with rising risk perceptions and slower trading partner growth. The agricultural sector benefited from the more benign weather conditions. However, inflation has remained high throughout much of the year due to higher energy and food prices and as the National Bank of Ukraine (NBU) has continued to peg the hryvnia to the US dollar, but declined to 5.9 per cent in September 2011.

**The economy remains vulnerable to external shocks.** Although Ukraine's exports are less energy and resource-dependent than those of neighbouring countries, the share of low value-added steel and chemicals remains very high. External private and public debt is also high, most of it with relatively short maturities and denominated in foreign currencies, and gross external financing requirements remain large. Public debt has increased rapidly during the crisis. The authorities' International Monetary Fund (IMF)-supported programme has been delayed since February 2011, pending completion of difficult energy sector reforms and other measures.

**Deep structural reforms are needed to increase and sustain economic growth over the long term.** Output is expected to recover to the pre-crisis level by the end of 2012. As productivity of Ukraine's economy remains very low, it has a strong long-term growth potential in traditional areas such as agriculture (where yields are a fraction of those in western Europe) and in relatively untapped export sectors. However, policy reforms are needed to attract supporting domestic and foreign investment. Over the past year, the authorities have made some progress in important structural reforms, including strengthening corporate governance, stimulating greater energy efficiency and strengthening sustainability in the fiscal and financial sectors. However, reforms to strengthen administration of justice and reduce corruption in the public sector remain in an embryonic state. Further decisive steps in all these areas will be needed. In addition, serious fiscal risks stem from the large and unsustainable pay-as-you-go pension system, the loss-making natural gas monopoly Naftogaz and the highly dollarised financial sector.

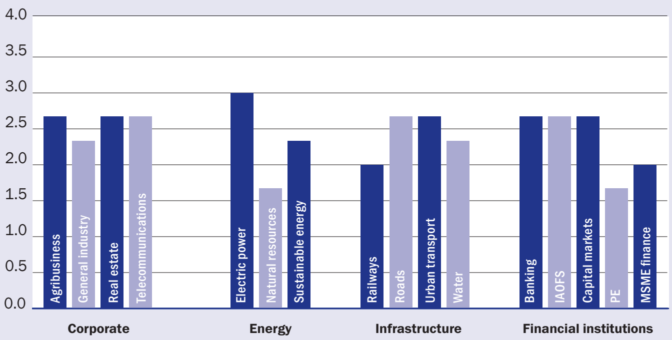
### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 2.3 | -14.8 | 4.2 | 4.5 |
| Inflation (end-year) | 22.3 | 12.3 | 9.1 | 7.9 |
| Government balance/GDP[1,2] | -3.2 | -11.3 | -9.9 | -4.0 |
| Current account balance/GDP | -7.1 | -1.5 | -2.9 | -3.9 |
| Net FDI (in million US$) | 9903 | 4654 | 5759 | 6300 |
| External debt/GDP | 56.4 | 88.2 | 85.1 | na |
| Gross reserves/GDP | 17.1 | 21.8 | 25.0 | na |
| Credit to private sector/GDP | 73.7 | 73.4 | 61.7 | na |

Note: [1]Augmented general government balance
[2]Overall government balance includes Naftogaz and other debt-creating flows.

### 2011 sector transition indicators

Sector transition score




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**The authorities have started to improve Ukraine's dificult business climate.** In July 2011 a new law on corruption prevention came into effect, intended to systematise and strengthen existing legislation in this area. The number of economic activities requiring licensing was further reduced. A new Law on State Regulation of Construction Activities, approved in January 2011, is expected to decrease significantly the number of required planning permissions (from 93 to 23), reduce the waiting period and increase the transparency of urban development plans. VAT refund arrears were substantially decreased and the tax administration has been increasing the list of companies eligible for automatic refunds. Grain export quotas introduced in October 2010, perceived to be discriminatory and non-transparent by traders, were replaced with export duties in May 2011. In October 2011, parliament approved a bill eliminating export duties on wheat and maize. However, uncertainty over regulation of external grain trade remains.

**Administrative and pension reforms have been initiated.** In December 2010 President Yanukovych signed a decree on streamlining the executive branch by halving the number of central executive bodies, reducing the number of ministries from 20 to 12, and cutting by half the Cabinet of Ministers' staff. In September 2011, the pension reform legislation was enacted. It includes raising the minimum retirement age requirement for women from 55 to 60 years, capping the maximum pension at 10 times the minimum wage and extending the required length of employment by 10 years.

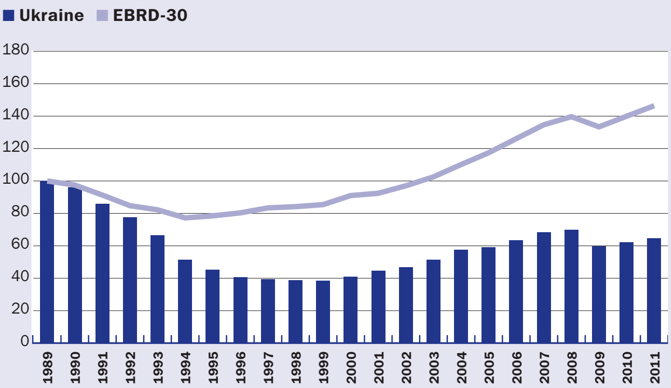
**A new tax code has been introduced.** The new code, implemented in January 2011, is intended to streamline the complex tax system and includes a reduction of the corporate income tax rate from 25 per cent to 23 per cent in 2011 and then further to 16 per cent by 2014. At the same time, the personal income tax rate will increase to 17 per cent in 2011, and new taxes on interest income and real estate are to be introduced in 2015. However, it also introduced further tax exemptions. Moreover, the perceived distributional impact of the original draft tax code generated significant controversy among small traders since the tax burden on small and medium-sized enterprises (SMEs) working under the simplified tax regime would have increased. In response, the government decided to keep the regime unchanged for the time being.

**Mixed results have been achieved in the gas sector.** The authorities have backtracked on their commitment to bring household gas tariffs towards import parity levels. As a result, Naftogaz has continued to cross-subsidise domestic consumption and accumulate net losses that are expected to reach around 1.5 per cent of GDP in 2011. At the same time, the government, with support of the EBRD and other international financial institutions (IFIs), initiated a technical audit of the gas transportation system with a view to identifying modernisation needs, and it embarked on the first stage of repairing the Ukrengoy-Pomary-Uzhgorod line. However, some of the reforms agreed with the European Union when Ukraine joined the European Energy Community (EEC) remain unfinished, including the unbundling of Naftogaz into separate legal entities by key business segment (production, transmission and distribution) with separate managements and financial accounts.

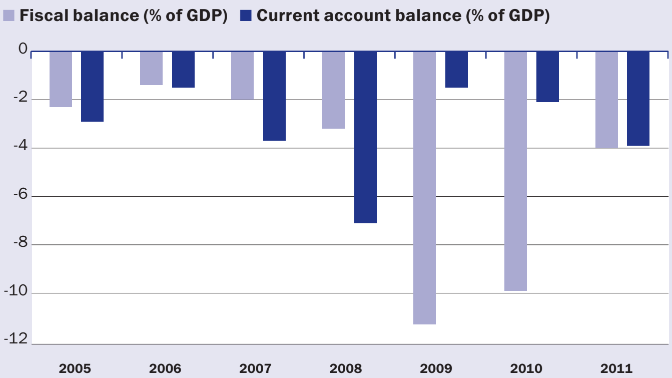
**The NBU has continued to normalise its policies after the crisis.** In May 2011 it reversed some foreign exchange controls imposed during 2008-09 by permitting banks to place both bid and ask quotes in the foreign exchange market within a given day. It also allowed foreign currency swaps between commercial banks, as well as with non-resident banks. However, non-conventional measures forcing banks to take long positions in the local currency, adopted during the crisis, remain in place. In addition, in June 2011, the NBU reduced the limit on banks' total long open foreign currency positions from 20 to 5 per cent of regulatory capital and initiated their daily monitoring. The narrowing of these limits helps to reduce speculative exchange rate pressures, and is believed to be a better way to do so than through the current unorthodox requirement to provision for foreign currency loans in local currency. However, unless the latter is reversed soon, the new policy may lead to financial sector de-leveraging.

**Some progress has been made in resolving state-intervened banks.** Nadra Bank was recapitalised with private funds and is now fully under private management. Other nationalised banks are hiring advisers and new management, or are being unwound.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Uzbekistan

## Highlights of the past year

- **Uzbekistan's economy appears to have been relatively unaffected by the crisis and the authorities reported strong growth of over 8 per cent in both 2009 and 2010.** This surprising resilience could be as a result of favourable commodity prices, the country's relative autarky and a large fiscal stimulus package.
- **Inflation pressures have built up.** In 2010 Uzbekistan had the highest average inflation rate in Central Asia, despite the fact that the share of imported food is significantly lower than in other countries in the region. Inflation has therefore been driven mostly by domestic factors, although exchange rate depreciation and the widening spread between "street" and official rates have also pushed up inflation.
- **The role of the state is increasing.** The government is embarking on a very large industrial policy programme that risks crowding out private sector development. In addition, recapitalisation of banks has been coupled with further market-distorting state-directed lending practices. Moreover, continued foreign exchange restrictions deter foreign investment.

## Key priorities for 2012

- **The economy needs to be further liberalised and government intervention needs to be reduced.** Priority measures include reducing discriminatory barriers against imports and eliminating state procurement quotas in agriculture.
- **To reinvigorate trade and private investment, the authorities should facilitate access to foreign currency by the private sector.** This should be combined with increased exchange rate flexibility and fewer controls, to decrease the wedge between the official and black market rates.
- **Financial sector development will require reducing the dominance of state-owned banks and other forms of state interference in the banking system.** While some foreign banks are operating in the country, the state still owns about 70 per cent of the banking sector. Increasing the share of the private sector and phasing out interest rate controls and policy-directed lending would improve the efficiency of credit allocation.

## Macroeconomic performance

**Uzbekistan's economy continues to grow at above 8 per cent according to official statistics.** The country's gross domestic product (GDP) officially grew by 8.5 per cent in 2010, driven by favourable external conditions and rising commodity prices as well as by the lagged effect of the large 2009 fiscal stimulus, which was equivalent to around 4 per cent of GDP. Average annual inflation remained high and while it fell from about 14 per cent in 2009 to below 10 per cent in 2010, it picked up again during the first half of 2011. This reflected increases in administrative prices and international food prices and the lagged effect of fiscal and monetary stimulus (large increases in credit and broad money). The government balance and current account remained in surplus and both surpluses increased in 2010.

**Despite substantial banking sector recapitalisation, asset quality has deteriorated considerably.** Continued directed lending practices by the government distort competition in the banking sector and lead to an inefficient allocation of financial resources and undiversified loan portfolios of banks. Credit provided by banks to the real sector increased by almost 36 per cent in the first quarter of 2011 compared with the same period in 2010, but this was mostly driven by state policy lending. Banks have continued to lend in foreign exchange to unhedged borrowers, creating substantial risks.

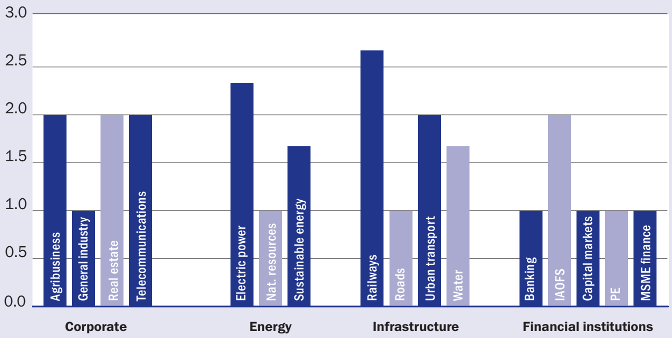
**Economic growth is expected to be between 7 and 8 per cent in 2011 and slow down to 6 per cent in 2012.** According to official statistics, GDP growth thus far grew by 7.6 per cent year-on-year during the first quarter of 2011. What could underpin such strong growth is successful implementation of the authorities' medium-term growth strategy, which is based on a sizeable Industrial Modernisation and Infrastructure Development Programme, amounting to nearly US$ 43 billion over six years. However, there are also serious downside risks to growth, stemming from the risk of a global slow-down that would affect Uzbek exports and remittances, the overall weak business environment, the continuation of excessive state intervention and restrictions on foreign currency conversion that limit trade and private sector development.

### Main macroeconomic indicators (% – unless indicated)

| | 2008 | 2009 | 2010 estimated | 2011 projected |
|---|---|---|---|---|
| GDP growth | 9.0 | 8.1 | 8.5 | 7.5 |
| Inflation (end-year) | 14.4 | 10.6 | 12.1 | 12.0 |
| Government balance/GDP | 10.7 | 3.1 | 4.6 | 7.0 |
| Current account balance/GDP | 8.7 | 2.2 | 6.7 | 10.0 |
| Net FDI (in million US$) | 711 | 842 | 1628 | 1403 |
| External debt/GDP | 13.1 | 15.0 | 14.7 | na |
| Gross reserves/GDP | 29.2 | 30.5 | 28.8 | na |
| Credit to private sector/GDP | 15.0 | 16.7 | na | na |

### 2011 sector transition indicators

**Sector transition score**




Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

## Major structural reform developments

**Uzbekistan remains at an early stage in its transition towards a market economy and still has a substantial structural reform agenda.** State ownership in the economy remains dominant and has recently increased as the authorities undertook a large fiscal stimulus programme to support economic activity during and after the crisis.

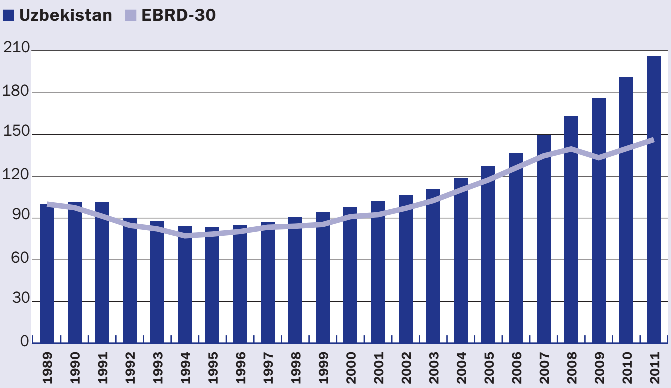
**The business climate remains very weak.** According to the World Bank *Doing Business 2011* survey, Uzbekistan continued to be among the worst places in the world to do business, with a rank of 150 out of 183 countries. The country scored poorly in every component of the ranking. Foreign exchange restrictions remain a major concern, as delays with currency conversion and restrictions on foreign exchange availability are hampering international trade and foreign investment.

**Several positive measures in the banking sector are counter-balanced by continued directed lending practices.** The authorities took steps to recapitalise commercial banks to mitigate the consequences of the crisis, and to increase the investment base, in particular for small and medium-sized enterprises (SMEs). While capital adequacy of the banking system in terms of risk-weighted assets is now about 23 per cent, the recapitalisation was coupled with a directive to increase lending to exporters and preferred projects, thus continuing market-distorting direct lending practices. In mid-2011 Fitch downgraded four Uzbek state-owned banks on their long-term foreign-currency issuer default ratings (IDR) to 'B-' from 'B', reflecting Fitch's concerns over the close integration of these banks with the state, in particular the direct and indirect control of majority stakes in the banks by the authorities.

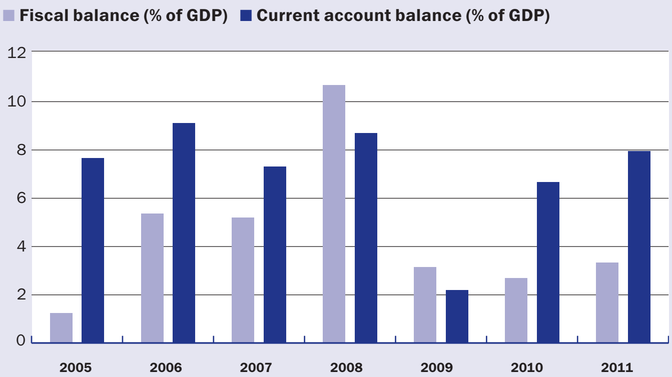
**Despite some progress with governance reform, public accountability and transparency are lacking.** According to the authorities, progress has been made with treasury modernisation, public financial management, anti-money laundering and counter-terrorism financing and transparency. However, concrete improvements in governance remain to be seen, particularly regarding the public accountability of state agents, the transparency and accessibility of public socio-economic data, and independent verification of information.

**Although there has been some progress with energy tariff reforms, the energy sector remains largely unreformed.** The country suffers from insufficient and unreliable electricity supply, while the economy's energy intensity is the highest in Europe and Central Asia. Energy efficiency and proper collection mechanisms and discipline are lacking. One positive step towards environmental management is that the state-owned oil company, Uzbekneftegaz, has confirmed its participation in the Global Gas Flaring Reduction (GGFR) Partnership for 2010-12, aiming to reduce gas flaring from its oil production.

### Real GDP (1989 = 100)




### Fiscal balance and current account balance



# Sectoral transition scores

The sectoral transition scores reflect the judgements of the EBRD's Office of the Chief Economist about progress in transition by sector and the size of the remaining transition "gap" or challenges ahead. The scores range from 1 to 4+ and are based on an assessment of the size of the challenges in two components: market structure and market-supporting institutions and policies. The scoring for the components is based on either publicly available data or observable characteristics of market structure and institutions. Based on the results of this scoring exercise, remaining transition gaps for market structure and institutions were classified as either "negligible", "small", "medium" or "large". The final numerical score is based on these gap ratings as well as the underlying information, guided by the ranges defined in the table below for those cases where the two component assessments are the same (see the discussion on page 8 in Chapter 1 for more details).

Table M.1.1.1
**Transition cut-off points**

| Cut-off points | |
|---|---|
| **Transition gaps (MS/MI)** | **Potential scores** |
| Large/Large | from 1 to 2+ |
| Medium/Medium | from 2+ to 3+ |
| Small/Small | from 3+ to 4 |
| Negligible/Negligible | 4+ |

The following tables show for each sector the weighting attached to the two components (market structure and market-supporting institutions and policies), the criteria used in each case (and the associated weights), and the indicators and data sources that fed into the final assessments. For the corporate and financial sectors, the exact sources are listed in the tables. The assessment of remaining transition challenges in the energy sectors is based on cross-country factual data and information on the energy sector (oil, gas, mining, electric power) in the EBRD's countries of operations, including from external agencies (International Energy Agency, EC Progress Reports on accession countries, Business Monitor International sector reports, Energy Regulators Regional Association, and so on). For infrastructure sectors, the assessment relied both on quantitative indicators (for example, cost recovery tariffs based on information from EBRD projects) and qualitative assessments of the less quantifiable measures, such as the relations between municipalities and their utilities. Sources encompassed in-house information from investment projects and cross-country data and assessments from several external agencies (including the World Bank, the European Commission and the OECD).

## Corporates

Table M.1.2.1
**Rating transition challenges in the agribusiness sector**

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [50%] | Liberalisation of prices and trade [15%] | Wheat: producer price to world price ratio (FAO GIEWS and PriceSTAT, 2008)<br>MFN applied tariff, simple average, agricultural products (WTO, 2009)<br>NRA to agriculture (World Bank Distortions, 2004-07)<br>WTO membership (WTO) |
| | Development of private and competitive agribusiness [40%] | Wheat: yields per ha (FAO ProdSTAT, 2009)<br>Wheat: average change in yields per ha (FAO ProdSTAT, 2006-09)<br>Mass grocery retail sales in per cent of total grocery retail (BMI, latest available data)<br>Processing mark-up in agriculture (EBRD calculation based on UNIDO, 2008) |
| | Development of related infrastructure [25%] | EBRD railways infrastructure (EBRD Transition Report, 2010)<br>EBRD road infrastructure (EBRD Transition Report, 2010)<br>Tractors per 100 ha arable land (World Bank, 2008)<br>Pump price for gasoline (World Bank Development Indicators, 2010) |
| | Development of skills [20%] | Ratio of a percentage of tertiary graduates in agriculture over a percentage of agricultural share in GDP (EBRD calculations based on UNESCO and CEIC, 2009/2010)<br>Value-added per worker in agriculture (World Bank World Development Indicators, 2009) |
| Market-supporting institutions and policies [50%] | Legal framework for land ownership, exchanges and pledges [40%] | Tradeability of land (EBRD Transition Report, 2009)<br>Warehouse Receipt Programmes (FAO Investment Centre WP, 2009)<br>Building a warehouse: Dealing with construction permits (World Bank Doing Business, 2011)<br>Registering property (World Bank Doing Business, 2011) |
| | Enforcement of traceability of produce, quality control and hygiene standards [40%] | Overall TC 34 (ISO, 2009)<br>Hygiene standard implementation (EBRD assessment) |
| | Creation of functioning rural financing systems [20%] | Ratio of percentage of lending to agriculture relative to percentage of agricultural share in GDP (EBRD calculations) |

Source: EBRD.

## Table M.1.2.2
### Rating transition challenges in the general industry sector

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [60%] | Market determined prices [20%] | Subsidies in % of GDP (CEIC, latest available data)<br>Energy intensity (World Bank Development Indicators, 2008) |
| | Competitive business environment [40%] | MFN applied tariff, simple average, non-agricultural products (WTO, 2009)<br>Lerner index (EBRD calculation based on UNIDO, 2008)<br>Large scale privatisation (EBRD Transition Report, 2010) |
| | Productivity and efficiency [40%] | Expenditures on R&D in % of GDP (UNESCO, 2009)<br>R&D effectiveness (EBRD calculation based on WIPO and UNESCO, 2004-09)<br>Value-added, manufacturing, per employee (UNIDO, 2008)<br>Knowledge Index (World Bank, 2009) |
| Market-supporting institutions and policies [40%] | Facilitation of market entry and exit [40%] | Starting a business (World Bank Doing Business, 2011)<br>Closing a business (World Bank Doing Business, 2011)<br>Percentage of firms identifying permits and licenses as major constraint (EBRD and World Bank, 2005-09) |
| | Enforcement of competition policy [30%] | Competition index (EBRD Transition Report, 2010) |
| | Corporate governance and business standards [30%] | Composite country law index (EBRD Legal Transition Team 2010)<br>ISO certification (EBRD calculation based on ISO and World Bank data, 2009) |

Source: EBRD.

## Table M.1.2.3
### Rating transition challenges in the real estate sector

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [40%] | Sufficient supply of quality assets in all sub-segments (warehouse/office/retail/hotels) [60%] | Class A industry supply per capita (Colliers, DTZ, King Sturge, CB Richards Ellis, Jones Lang LaSalle)<br>Modern office space per capita (Colliers, DTZ, King Sturge, CB Richards Ellis, Jones Lang LaSalle)<br>Prime retail space per capita (Colliers, DTZ, King Sturge, CB Richards Ellis, Jones Lang LaSalle)<br>Hotel room supply per capita (WEF Tourism Competitiveness Index, 2009) |
| | Market saturation and penetration of innovative construction technologies [40%] | Market saturation index (EBRD, 2010)<br>Index on penetration of innovative construction technologies (EBRD, 2010) |
| | Tradeability and accessibility of land [20%] | Accessing industrial land: Lease rights (World Bank, 2010)<br>Accessing industrial land: Ownership rights (World Bank, 2010)<br>Access to land (BEEPS, 2008) |
| Market-supporting institutions and policies [40%] | Development of an adequate legal framework for property development [30%] | Quality of primary legislation in the property sector (EBRD, 2010)<br>Quality of secondary legislation in the property sector (EBRD, 2010)<br>Mortgage market legal efficiency indicators (EBRD Legal Transition Team) |
| | Presence and effectiveness of energy efficiency support mechanisms [10%] | Sustainability of government support mechanisms (EBRD, 2010) |
| | Adequacy of property-related business environment [40%] | Registering property (World Bank Doing Business, 2011)<br>Dealing with construction permits (World Bank Doing Business, 2011)<br>Property rights (WEF Tourism Competitiveness Index, 2009)<br>Level of corruption for construction related permits (BEEPS, 2008) |

Source: EBRD.

# Energy

## Table M.1.3.1
### Rating transition challenges in the electric power sector

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [40%] | Restructuring through institutional separation, unbundling and corporatisation [33%] | Extent of corporatisation (setting up of joint stock companies, improved operational and financial performance)<br>Extent of legal unbundling of generation, transmission, distribution and supply/retail<br>Extent of financial unbundling of generation, transmission, distribution and supply/retail<br>Extent of operational unbundling of generation, transmission, distribution and supply/retail |
| | Private sector participation [33%] | Degree of private sector participation in generation and/or distribution |
| | Competition and liberalisation [33%] | Degree of liberalisation of the sector (third party access to network on transparent and non-discriminatory grounds)<br>Ability of end-consumers to freely choose their provider<br>Degree of effective competition in generation and distribution |
| Market-supporting institutions and policies [60%] | Tariff reform [40%] | Presence of cost-reflective domestic tariffs<br>Existence of cross-subsidisation among consumers<br>Degree of payment discipline as measured by collection rates and payment arrears |
| | Development of an adequate legal framework [20%] | Energy law in place to support full-scale restructuring of the sector and setting up of a regulator<br>Quality of taxation and licensing regime<br>Existence and relative strength of the regulatory framework for renewables |
| | Establishment of an independent energy regulator [40%] | Degree of financial and operational independence of the regulator<br>Level of standards of accountability and transparency |

Source: EBRD.

Table M.1.3.2
## Rating transition challenges in the natural resources sector

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [40%] | Restructuring through institutional separation and corporatisation [40%] | Degree of unbundling of different business lines into separate legal entities (joint-stock companies)<br>Existence of separate financial accounts for different lines of businesses<br>Extent of unbundling of different business lines into separate legal entities<br>Extent of measures adopted to improve operational and financial performance<br>Degree of transparency and corporate governance |
| | Private sector participation [20%] | Degree of private sector participation in upstream and/or downstream/supply |
| | Competition and liberalisation [40%] | Degree of liberalisation of the sector (third party access to network)<br>Ability of end-consumers to freely choose their provider<br>Degree of effective competition in upstream/extraction, supply and retail |
| Market-supporting institutions and policies [60%] | Tariff reform [40%] | Presence of cost-reflective domestic tariffs<br>Existence of cross-subsidisation among consumers<br>Degree of payment discipline as measured by collection rates and payment arrears |
| | Development of an adequate legal framework [40%] | Energy law in place to support full-scale restructuring of the sector and setting up of a regulator<br>Quality of taxation and licensing regime<br>Extent of transparency and accountability on revenues from extractive industries and management of the oil stabilisation fund, EITI/PWYP compliance |
| | Establishment of an independent energy regulator [20%] | Degree of financial and operational independence of the regulator<br>Level of standards of accountability and transparency |

Source: EBRD.

Table M.1.3.3
## Rating transition challenges in the sustainable energy sector: energy efficiency (EE), renewable energy (RE) and climate change (CC)

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [67%] | Market determined prices [50%] | Quality of energy pricing: end-user cost-reflective electricity tariffs<br>Level of enforcement of pricing policies: collection rates and electricity bills<br>Amount of wastage: transmission and distribution losses<br>Quality of tariff support mechanisms for renewables (tradeable green certificate schemes / feed-in tariffs/no support)<br>Presence of carbon taxes or emissions trading mechanisms |
| | Outcomes [50%] | Level of energy intensity<br>Level of carbon intensity<br>Share of electricity generated from renewable sources |
| Market-supporting institutions and policies [33%] | Laws [25%] | Index on laws on the books related to EE and RE (such as those that support renewable technologies, compel minimum standards in various areas of energy use, provide guidance for sectoral targets in terms of energy savings and provide incentives and penalties for achieving desirable targets)<br>Stage of institutional development in implementing the Kyoto Protocol |
| | Agencies [25%] | Existence of EE agencies or RE associations (autonomous/departments within government)<br>Index on employment, budget and project implementation capacity of agencies<br>Index on functions of agencies: adviser to government, policy drafting, policy implementation and funding for projects |
| | Policies [25%] | Sustainable energy index: existence, comprehensiveness and specific targets of policies on SE<br>Renewable energy index: existence of specific sectoral regulations for RE (renewables obligation, licensing for green generators, priority access to the grid)<br>Climate Change Index: existence of policies (emissions targets and allocation plans) |
| | Projects [25%] | Index on project implementation capacity in EE, RE and CC<br>Number of projects in EE, RE and CC<br>Expenditure data on projects in EE, RE and CC |

Source: EBRD.

# Infrastructure

Table M.1.4.1
## Rating transition challenges in the railways sector

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [55%] | Restructuring through institutional separation and unbundling [40%] | Extent of corporatisation of railways<br>Extent of unbundling of different business lines (freight and passenger operations)<br>Extent of divestment of ancillary activities |
| | Private sector participation [40%] | Number of new private operators<br>Extent of privatisation of freight operations and ancillary services |
| | Competition and liberalisation of network access [20%] | Extent of liberalisation of network access according to non-discriminatory principles<br>Number of awards of licences to the private sector to operate services |
| Market-supporting institutions and policies [45%] | Tariff reform [50%] | Extent of freight tariff liberalisation<br>Extent of introduction of public services obligations (PSO) |
| | Development of an adequate legal framework [25%] | Presence of railways strategy and railways act |
| | Development of the regulatory framework [25%] | Establishment of a railway regulator to regulate the network access according to non-discriminatory principles<br>Degree of independence of the regulator and level of accountability and transparency standards<br>Level of technical capacity of the regulator to set retail tariffs and regulate access to the track |

Source: EBRD.

## Table M.1.4.2
## Rating transition challenges in the roads sector

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [55%] | Restructuring through institutional separation and unbundling [40%] | Degree of independence of the road management from the Ministry<br>Extent of divestment of construction from road maintenance, engineering and design activities |
| | Private sector participation [40%] | Extent of private sector companies in construction and maintenance (BOT-type concessions, management or service contracts, other types of public-private partnerships (PPPs)) |
| | Competition and liberalisation of network access [20%] | Index on rules for open tendering of construction and maintenance contracts<br>Index on practices for open tendering of construction and maintenance contracts |
| Market-supporting institutions and policies [45%] | Tariff reform [50%] | Level of road maintenance expenditures (that is, it should be sufficient to maintain the quality of state roads and motorways)<br>Introduction of road user charges based on vehicles and fuel taxes<br>Level of road user charges (that is, it should be sufficient to cover both operational and capital costs in full)<br>Comprehensiveness index of road user charges (extent of accordance with road use, extent of incorporation of negative externalities, and so on) |
| | Development of an adequate legal framework [25%] | Extent and quality of PPP legislation<br>Existence of road act |
| | Development of the regulatory framework [25%] | Creation of a road agency<br>Index of road agency effectiveness (decision making power, resource allocation, management capacity across road networks) |

Source: EBRD.

## Table M.1.4.3
## Rating transition challenges in the urban transport sector

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [50%] | Decentralisation and corporatisation [33%] | Extent of decentralisation (that is, transfer of control from the national to the municipal or regional level)<br>Degree of corporatisation of local utilities to ensure financial discipline and improve service levels, including in smaller municipalities |
| | Commercialisation [33%] | Level of financial performance (no concern for financials/a few financially sound utilities in the country/solid financial performance is widespread)<br>Level of investment financing (only through grants/selective access to commercial finance/widespread access to commercial finance)<br>Level of operational performance: progress in tackling cost control (labour restructuring, energy cost control, reduction of network losses), demand side measures (metering and meter-based billing, e-ticketing), focus on quality of service |
| | Private sector participation and competition [33%] | Extent of legal framework and institutional capacity for PPP and competition<br>Extent and form of private sector participation |
| Market-supporting institutions and policies [50%] | Tariff reform [50%] | Degree of tariff levels and setting (cost recovery, tariff methodologies)<br>Existence of cross-subsidisation among consumers |
| | Contractual, institutional and regulatory development [50%] | Quality of the contractual relations between municipalities and utility operators<br>Degree of regulatory authority capacity and risks of political interference in tariff setting |

Source: EBRD.

## Table M.1.4.4
## Rating transition challenges in the water and wastewater sector

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [50%] | Decentralisation and corporatisation [33%] | Extent of decentralisation (that is, transfer of control from the national to the municipal or regional level)<br>Degree of corporatisation of local utilities to ensure financial discipline and improve service levels, including in smaller municipalities |
| | Commercialisation [33%] | Level of financial performance (no concern for financials/a few financially sound utilities in the country/solid financial performance is widespread)<br>Level of investment financing (only through grants/selective access to commercial finance/widespread access to commercial finance)<br>Level of operational performance: progress in tackling cost control (labour restructuring, energy cost control, reduction of network losses), demand-side measures (metering and meter-based billing, e-ticketing), focus on quality of service |
| | Private sector participation and competition [33%] | Extent of legal framework and institutional capacity for PPP and competition<br>Extent and form of private sector participation |
| Market-supporting institutions and policies [50%] | Tariff reform [50%] | Degree of tariff levels and setting (cost recovery, tariff methodologies)<br>Existence of cross-subsidisation among consumers |
| | Contractual, institutional and regulatory development [50%] | Quality of the contractual relations between municipalities and utility operators<br>Degree of regulatory authority capacity and risks of political interference in tariff-setting |

Source: EBRD.

Table M.1.4.5
**Rating transition challenges in the telecommunications sector**

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [50%] | Competition and private sector involvement: mobile telephony [40%] | Expansion of services to rural areas, proxied by % of population covered by mobile signal (World Bank, 2008)<br>Mobile penetration rate (International Telecommunications Union, 2010)<br>Percentage of private ownership in the incumbent mobile operator (Global Insight, BuddeCom, 2011)<br>Market share of the largest mobile operator (Business Monitor International, Global Insight, BuddeCom, 2011)<br>Mobile number portability (Business Monitor International, Global Insight, BuddeCom, 2011)<br>Level of competition for mobile telephone services (World Bank, 2008) |
| | Competition and private sector involvement: fixed telephony [20%] | Fixed-line teledensity (International Telecommunications Union, 2010)<br>Percentage of private ownership in fixed telephony incumbent (Business Monitor International, Global Insight, 2011)<br>Market share of the largest fixed telephony provider (Global Insight, BuddeCom, 2011)<br>Fixed number portability (Business Monitor International, Global Insight, 2011)<br>Level of competition for international long distance services (World Bank, 2008)<br>Mobile and fixed line subscribers per employee (World Bank, 2008) |
| | IT and high-tech markets [40%] | Internet users penetration rates (International Telecommunications Union, 2010)<br>Broadband subscribers penetration rate (International Telecommunications Union, 2010)<br>International internet bandwidth (World Bank, 2008)<br>Level of competition for internet services (World Bank, 2008)<br>Piracy rates (Business Software Alliance, 2010) |
| Market-supporting institutions and policies [50%] | Institutional framework assessment [25%] | Regulatory independence (EBRD, Legal Transition Team, 2011)<br>Dispute resolution and appeal (EBRD, Legal Transition Team, 2011) |
| | Development of the regulatory framework aimed at promoting the emergence of competition within the sector [45%] | Market access assessment (for non-scarce resources) (EBRD, Legal Transition Team, 2011)<br>Operational environment assessment: SMP and safeguards (EBRD, Legal Transition Team, 2011)<br>Operational environment assessment: interconnection and special access (EBRD, Legal Transition Team, 2011) |
| | Preparedness of the country to develop a knowledge economy [25%] | Knowledge Economy Index: Economic incentives (World Bank, 2009)<br>Knowledge Economy Index: Innovation (World Bank, 2009)<br>Knowledge Economy Index: Education (World Bank, 2009) |
| | Freedom of media [5%] | Freedom of press (Reporters without borders, Freedom House, 2010 / 2011) |

Source: EBRD.

# Financial institutions

Table M.1.5.1
**Rating transition challenges in the banking sector**

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [35%] | Degree of competition [43%] | Asset share of five largest banks (EBRD Banking Survey 2011)<br>Net interest margin, (EBRD Banking Survey 2011)<br>Overhead cost to assets (EBRD Banking Survey 2011, official statistical sources) |
| | Ownership [29%] | Asset share of private banks (EBRD Banking Survey 2011, official statistical sources)<br>Asset share of foreign banks (subjective discount relative to home/host coordination) (EBRD Banking Survey 2011 and latest EBRD assessment) |
| | Market penetration [14%] | Assets/GDP (EBRD Banking Survey 2011, official statistical sources) |
| | Resource mobilisation [14%] | Domestic credit to private sector/ total banking system's assets ( EBRD Banking Survey 2011, official statistical sources) |
| Market-supporting institutions and policies [65%] | Development of adequate legal and regulatory framework [40%] | Existence of entry and exit restrictions (EBRD assessment, latest estimates)<br>Adequate liquidity requirements (EBRD assessment, latest estimates)<br>Other macro prudential measures (EBRD assessment, latest estimates)<br>Supervisory coordination (home-host country) (EBRD assessment, latest estimates)<br>Dynamic counter cyclical provisioning (EBRD assessment, latest estimates)<br>Deposit insurance scheme with elements of private funding (EBRD assessment, latest estimates) |
| | Enforcement of regulatory measures [50%] | Compliance with Basel Core principles ( EBRD assessment, latest estimates)<br>Unhedged FX lending to the private sector / total lending to the private sector (EBRD Banking Survey 2011, national statistical sources via CEIC, latest estimates)<br>Banking strength – actual risk weighted capital to assets ratio (IMF Global Financial Stability Report 2010, National Sources, latest estimates)<br>Actual risk-weighted capital adequacy ratio (IMF, official statistical sources)<br>Sophistication of banking activities and instruments (EBRD assessment, latest estimates)<br>Deposits to GDP (EBRD Banking Survey, 2011, official statistical sources)<br>Non-performing loans (IMF, EBRD Banking Survey 2011, official statistical sources) |
| | Corporate governance and business standards [10%] | Proportion of banks which have good corporate governance practices (EBRD assessment, latest estimates) |

Source: EBRD.

## Table M.1.5.2
## Rating transition challenges in the insurance and other financial services sector

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [45%] | Market penetration [60%] | Insurance premia (% of GDP) (National Insurance Associations, UBS, World Bank, EBRD, latest information)<br>Life insurance premia (% of GDP) (National Insurance Associations, UBS, World Bank, EBRD, latest information)<br>Non- life insurance premia (% of GDP) (National Insurance Associations, UBS, World Bank, EBRD, latest information)<br>Leasing portfolio (% of GDP) (Leaseurope, national statistical sources, latest information)<br>Availability of insurance products (UBS and own EBRD assessments, latest estimates)<br>Mortgage debt/GDP (EBRD Banking Survey 2011)<br>Type of pension system (Pillar I, II, III) (Axco)<br>Pension fund assets/GDP (Axco, Renaissance Capital, latest information) |
| | Competition [10%] | Market share of top 3 insurance companies (Axco, EBRD, latest information) |
| | Private sector involvement [10%] | Share of private insurance funds in total insurance premia (UBS, national authorities, EBRD, latest information) |
| | Development of skills [20%] | Skills in the insurance industry (UBS and own EBRD assessments, latest estimates) |
| Market-supporting institutions and policies [55%] | Development of adequate legal and regulatory framework [88%] | Existence of private pension funds (Social Security Administration - ISSA)<br>Pillar II legislation (Organisation of Economic Co-operation and Development, World Bank, national official sources, EBRD, latest information)<br>Quality of insurance supervision assessment (UBS, EBRD, latest estimates)<br>Legislation leasing (National authorities, International Finance Corporation, EBRD, latest information) |
| | Business standards [12%] | AIS member (International Association of Insurance Supervisors- IAIS) |

Source: EBRD.

## Table M.1.5.3
## Rating transition challenges in the capital markets sector

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [50%] | Market penetration [50%] | Stock market capitalisation/GDP (FESE, FEAS, S&P Global Stock Markets Factbook 2010, official; statistical sources, 2010)<br>Number of listed companies (FESE, FEAS, official statistical sources, 2010)<br>Securities (bonds and stocks) traded as % of GDP (FESE, FEAS, official statistical sources, 2010) |
| | Market infrastructure and liquidity (50%) | Money Market Index (EBRD 2010 Survey)<br>Government Bond Index (EBRD 2010 Survey) |
| Market-supporting institutions and policies [50%] | Development of adequate legal and regulatory framework (100%) | Quality of securities market legislation (EBRD Legal Transition Survey, 2007)<br>Effectiveness of securities market legislation (EBRD Legal Transition Survey, 2007) |

Source: EBRD.

## Table M.1.5.4
## Rating transition challenges in the private equity sector

| Components | Criteria | Indicators |
|---|---|---|
| Market structure [50%] | Competition [35%] | Effective number of fund managers per thousand companies (Company websites, Prequin, EMPEA, latest available) |
| | Market penetration [65%] | Scope of fund type/strategy (EMPEA, Prequin, Mergermarket and EVCA, EBRD estimates, latest available)<br>PE capital available for investment as % of GDP (EMPEA, Prequin, Mergermarket and EVCA, EBRD estimates, latest available) |
| Market-supporting institutions and policies [50%] | Development of adequate legal and regulatory framework [70%] | Barriers to institutional investor participation (EBRD, latest estimates)<br>Quality of securities market legislation (EBRD Legal Transition Survey, 2007)<br>Effectiveness of securities market legislation (EBRD Legal Transition Survey, 2007) |
| | Corporate governance [30%] | Effective framework (EBRD Corporate Governance Legislation Assessment, 2007)<br>Rights and role of shareholders (EBRD Corporate Governance Legislation Assessment, 2007)<br>Equitable treatment of shareholders (EBRD Corporate Governance Legislation Assessment, 2007)<br>Responsibilities of board (EBRD Corporate Governance Legislation Assessment, 2007)<br>Disclosure and transparency (EBRD Corporate Governance Legislation Assessment, 2007) |

Source: EBRD.

## Table M.1.5.5
## Rating transition challenges in the MSME finance sector

| Components | Criteria | | Indicators |
|---|---|---|---|
| Market structure [50%] | Non-banking financing [10%] | | Leasing (respective ATC score)<br>Private equity (respective ATC score)<br>Capital Markets (respective ATC score) |
| | Banking financing [90%] | Competition | Competition in banking ( respective ATC score)<br>Interest margin between bank lending to SMEs and large corporates (short-term and long-term) |
| | | Access to bank lending | Share of SME lending to total lending/ weighted by distance of domestic credit to GDP to that in EU area<br>Outreach of commercial banks (branches per 100,000 adults) |
| | | Skills | Existence of Specialised SME department in banks (Internal EBRD survey 2011)<br>Extent of use of SME lending methodologies (Internal EBRD survey 2011)<br>Presence of trained loan officers in SME lending (Internal EBRD survey 2011) |
| Market-supporting institutions and policies [50%] | Development of adequate legal framework [50%] | | Ability to offer and take security over immovable property (cadastre)<br>Credit information services<br>Registration system for movable assets - Ability to offer and take non-possessory security over movable property<br>Collateral and provisioning regulatory requirements<br>Enforcing secured creditor rights |

Source: EBRD.

# Country transition indicators

(see Table 1.2 on page 13)

The country 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 range from 1 to 4+ and are based on a classification system that was originally developed in the 1994 *Transition Report*, but has been refined and amended in subsequent Reports. In calculating averages, "+" and "–" ratings are treated by adding 0.33 and subtracting 0.33 from the full value. Two financial sector indicators – banking reform and interest rate liberalisation, and securities markets and non-bank financial institutions – have been discontinued this year, as they have been superseded by the more refined sector-level methodology, as explained above.

## 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 almost completed.
**4** Complete privatisation of small companies with tradeable ownership rights.
**4+** Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradeability of land.

## Governance and enterprise restructuring

**1** Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.
**2** Moderately tight credit and subsidy policy, but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
**3** Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (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 and current account convertibility.
**4+** Standards and performance norms of advanced industrial economies: removal of most tariff barriers; membership in WTO.

## Competition policy

**1** No competition legislation and institutions.
**2** Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms.
**3** Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.
**4** Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.
**4+** Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.

# Acknowledgements

This *Transition Report* was prepared by the Office of the Chief Economist (OCE) of the EBRD, under the general direction of Erik Berglof. It also includes a contribution from the Office of the General Counsel (Annex 1.2).

This year's editors were Jeromin Zettelmeyer, Franto Ricka and Peter Sanfey.

The writing teams for the chapters, boxes and annexes comprised:

**Chapter 1**
Yevgeniya Korniyenko, Franziska Ohnsorge, Franto Ricka and Peter Sanfey, with contributions from Marina Kaloumenou.
**Box 1.1** was prepared by Hannah Levinger and Elisabetta Falcetti; **Box 1.2** by Ralph de Haas and Hannah Levinger, **Box 1.3** by Yevgeniya Korniyenko, and **Box 1.4** by Heike Harmgart and Alexander Pivovarsky, with contributions from Asset Irgaliev.
**Annex 1.1** was prepared by Katrin Weissenberg, based on assessments prepared by OCE sector economists. **Annex 1.2** was prepared by Frédérique Dahan, Elizabeth Kirk and Alexander Plekhanov, with contributions from Andrew Rundus, Katrin Weissenberg and Veronika Zavacka.

**Chapter 2**
Ralph de Haas, Carly Petracco and Jeromin Zettelmeyer, with contributions from Martin Brown and Pauline Grosjean.
**Box 2.1** was prepared by Ralph de Haas, Martin Brown and Pauline Grosjean.

**Chapter 3**
Pauline Grosjean, Franto Ricka and Claudia Senik, with contributions from Dora Simroth.
**Box 3.1** was prepared by Pauline Grosjean and Franto Ricka.

**Chapter 4**
Elena Nikolova, Franto Ricka and Dora Simroth, with contributions from Givi Melkadze.
**Box 4.1** was prepared by Elena Nikolova and Dora Simroth.

The country assessments were prepared by the regional economists of the Office of the Chief Economist and edited by Peter Sanfey. Piroska M. Nagy provided comments and general guidance and Marina Kaloumenou data support. The main authors were:

- Central Europe and the Baltic states (excluding Croatia): Alexander Lehmann, assisted by Marilyn Polena.
- South-eastern Europe and Croatia: Peter Sanfey, assisted by Simone Zeh.
- Eastern Europe and Caucasus: Alexander Pivovarsky, assisted by Asset Irgaliev.
- Russia: Alexander Plekhanov, assisted by Asel Isakova.
- Turkey: Franziska Ohnsorge, Yevgeniya Korniyenko and Heike Harmgart.
- Central Asia: Nienke Oomes (all countries except Mongolia) and Alexander Plekhanov (Mongolia), assisted by Asel Isakova.

Editorial and production guidance was provided by Dan Kelly, Amanda Railson, Jane Ross, Natasha Treloar and Bryan Whitford in the EBRD Communications department and by Richard German and Carole Ray.

The Report was designed and print managed by Andy Ritchie and Terry Hawes, with project management by Clare Ritchie from bn1creative.

The editors are indebted to Benu Bidani, Mame Fatou Diagne, Christoph Rosenberg and Geoff Gottlieb for comments on Chapter 2. The Report benefited from comments and feedback from the EBRD Board of Directors and their authorities, the EBRD Executive Committee, the EBRD's Resident Offices and Country Teams, and staff from the European Commission, International Monetary Fund and the World Bank.

Much of the material in this Transition Report is based on the second round of the EBRD/World Bank Life in Transition Survey, which was funded by the Canadian International Development Agency (CIDA), the Central European Initiative (CEI), the UK Department for International Development (DfID), the World Bank and the EBRD Shareholder Special Fund. This funding is gratefully acknowledged.

# Notes

Both Satimat Silk and Edixion Offset are FSC certified and manufactured using EFC (Elemental Chlorine Free) pulp.

The mills for both are accredited with ISO 9001 & ISO 14001 and are FSC certified.

Fulmar Colour are ISO 14001 certified, CarbonNeutral, Alcohol Free and FSC Chain Of Custody certified.

The inks used are vegetable oil based.



Designed and produced by bn1creative and the EBRD

7886 Transition Report 2011 (E/3,500)

Printed in England by Fulmar which operates an environmental waste and paper recycling programme.

**Photography**
EBRD/John McConnico (Cover), EBRD/Simon Crofts (p6, 105, 106), EBRD/ Gjorgji Licovski (p44), OSCE (p60), Yevgeni Kondakov (p76, 104), Jan Maas (p97), Jim Hodson (p98), Susie Scannelli Cook (p98), Gjorgji Licovski (p99, 102, 105), Bryan Whitford (p100), Mike Ellis (p100, 104), Arnhel de Serra (p101), Aleksandar Andjic (p101), Sue Cunningham (p103), OSCE (p104).



FSC
www.fsc.org
MIX
Paper from responsible sources
FSC® C016486

**European Bank for Reconstruction and Development**
One Exchange Square
London
EC2A 2JN
United Kingdom

**Switchboard/central contact**
Tel: +44 20 7338 6000
Fax: +44 20 7338 6100

**Information requests**
For information requests
and general enquiries,
please use the information
request form at
www.ebrd.com/inforequest

**Project enquiries**
Tel: +44 20 7338 7168
Fax: +44 20 7338 7380
Email: projectenquiries@ebrd.com

**EBRD publications**
Tel: +44 20 7338 7553
Fax: +44 20 7338 6102
Email: pubsdesk@ebrd.com

**Web site**
www.ebrd.com
www.ebrd.com/transitionreport

**ISBN 978-1-898802-36-5**
**ISSN 1356-3424**