

# Transition report 2004

Infrastructure



European Bank  
for Reconstruction and Development

# About this Report

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



## Central eastern Europe and the Baltic states (CEB) ▲

- 01 Czech Republic
- 02 Estonia
- 03 Hungary
- 04 Latvia
- 05 Lithuania
- 06 Poland
- 07 Slovak Republic
- 08 Slovenia

## South-eastern Europe (SEE)

- 09 Albania
- 10 Bosnia and Herzegovina
- 11 Bulgaria ♦
- 12 Croatia ♦
- 13 FYR Macedonia
- 14 Romania ♦
- 15 Serbia and Montenegro

♦ European Union candidate country.

## Commonwealth of Independent States (CIS)

- 16 Armenia
- 17 Azerbaijan
- 18 Belarus
- 19 Georgia
- 20 Kazakhstan
- 21 Kyrgyz Republic
- 22 Moldova
- 23 Russia
- 24 Tajikistan
- 25 Turkmenistan
- 26 Ukraine
- 27 Uzbekistan

▲ European Union member states.

# Transition report 2004

## Infrastructure

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# Abbreviations

The Bank,	The European Bank for	MTEF	medium-term expenditure framework
EBRD	Reconstruction and Development	na	not available
BEEPS	Business Environment and Enterprise Performance Survey	NATO	North Atlantic Treaty Organisation
BOT	build-operate-transfer	NGO	non-governmental organisation
CEB	central eastern Europe and the Baltic states (see map inside front cover)	OECD	Organisation for Economic Cooperation and Development
CEFTA	Central European Free Trade Agreement	PCA	Partnership and Cooperation Agreement
CIS	Commonwealth of Independent States (see map inside front cover)	PPP	purchasing power parity
CMEA	Council for Mutual Economic Assistance	PRGF	Poverty Reduction and Growth Facility
CPI	consumer price index	PRSP	Poverty Reduction Strategy Paper
DH	district heating	PSA	production sharing agreement
EC	European Commission	PSP	private sector participation
ECSEE	Energy Community of South-Eastern Europe	SAA	Stabilisation and Association Agreement
EMU	Economic and monetary union	SAC	structural adjustment credit
ERM	Exchange Rate Mechanism	SAL	structural adjustment loan
EU	European Union	SAP	Stabilisation and Association Process
FDI	foreign direct investment	SBA	Stand-By Arrangement
FESAL	Financial and Enterprise Sector Adjustment Program	SEE	south-eastern Europe (see map inside front cover)
FSA	Financial Supervision Authority	SGP	Stability and Growth Pact
FYR	Former Yugoslav Republic	SMEs	small and medium-sized enterprises
GDP	gross domestic product	SMP	Staff Monitored Programme
IFC	International Finance Corporation	SOE	state-owned enterprise
IFI	international financial institution	TACIS	Technical assistance for CIS countries (EU)
ILO	International Labour Organization	UN	United Nations
IMF	International Monetary Fund	USAID	United States Agency for International Development
ISPA	Instrument of Structural Policies for Pre-Accession	VAT	value added tax
LIS	Legal Indicator Survey	WTO	World Trade Organization

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# Executive summary

- Progress in reform during 2003-04 was most pronounced in south-eastern Europe. Elsewhere the pace of transition was uneven. Sustained structural reforms will stimulate growth in the longer term.
- The transition countries are expected to grow by 6.1 per cent in 2004, helped by a positive international trade environment. Rapid credit growth is boosting domestic consumption and investment.
- In the infrastructure sector, many countries have found it difficult to establish independent, accountable and credible regulatory agencies.
- Private sector participation is increasingly taking the form of concessions and management contracts rather than asset sales. Local investors are becoming more important.

## 1

### Chapter 1: Progress in transition and the link to growth

Although 2003-04 was a positive year for market reform in the transition countries, progress across the region was uneven. Reform accelerated in south-eastern Europe (SEE), especially in the EU candidate countries – Bulgaria, Croatia and Romania. Following EU accession, reform in central eastern Europe and the Baltic states (CEB) has slowed although countries continue to improve the business environment. In the Commonwealth of Independent States (CIS) 2003-04 was another year of only modest progress in transition. Reform may have been hindered by government caution during a year of elections in many countries.

Most progress was made in the difficult task of building market-supporting institutions. Financial services continued to develop and bank lending to the private sector accelerated. This was complemented by improvements in regulation and further banking consolidation. Progress in infrastructure and large-scale privatisation was also significant.

A sustained commitment to reform and sound fiscal policies has been associated with substantial benefits in macro-economic performance over the longer term. Higher growth can in turn spur further reform efforts, potentially leading to a “virtuous circle” of reform. However, the link between reform and growth is complex, and other factors need to be taken into account. They include an allowance for the catch-up and recovery process, external demand and terms of trade (especially in relation to oil prices).

## 2

## Chapter 2: The macroeconomic environment for transition

Most transition countries enjoyed strong economic growth in 2003-04. Growth in CEB is expected to increase to 4.9 per cent in 2004, driven primarily by domestic demand but also increasingly by an expansion of exports.

In SEE continued political stability, although still fragile in some places, and the prospect of EU membership for Bulgaria, Croatia and Romania have underpinned economic progress. Growth is expected to rise to 5 per cent in 2004, stimulated in part by a credit-driven boom in demand. This expansion in domestic credit has helped to deepen financial systems but has also raised concerns about the quality of rapidly expanding loan portfolios.

In the CIS high commodity prices have continued to underpin economic growth, which is forecast at 7.4 per cent for 2004. Although inflationary pressures are currently subdued, the rapid growth in base money associated with strong export growth and the expansion of bank credit bring the risk of higher inflation in the future.

Several transition countries have capitalised on the period of strong growth and consolidated their public finances. For others, particularly in CEB, consolidation remains elusive. Reform of the rules and institutions that govern fiscal policy needs to complement macroeconomic stabilisation.

## 3

## Chapter 3: Regulation of infrastructure services

This chapter presents evidence from a survey of regulators in the telecommunications, electricity and railways sectors on regulatory effectiveness. The results show that experience in establishing modern regulatory regimes for network utilities has been mixed. Many of the advanced countries in the region have succeeded in establishing independent and accountable authorities. Other countries have struggled to put credible arrangements in place. This is due in part to the weak institutional environment in which regulatory reform is taking place in many transition countries and to the ability of vested interests to seize control of or hinder the reform agenda.

Despite limited data, results from extensive surveys of industrial consumers of infrastructure services suggest that effective regulation helps to improve service delivery. Specifically, where regulators have taken steps to encourage more commercial discipline in infrastructure services (through tariff reform, improved collection rates and private sector investment) there has been less interruption in services.

Better regulation promotes private investment, and private operators have stronger incentives to raise collection rates, prevent arrears and ensure adequate revenue flows. However, the impact of private ownership on performance depends on the extent of competition.

## 4

## Chapter 4: Private sector participation in infrastructure

This chapter looks at the development and extent of private sector participation (PSP) in telecommunications, energy, water and transport services across the transition countries. The telecommunications sector has attracted most private sector interest, followed by urban transport and, to a lesser extent, the power sector. PSP has been most evident in CEB and the EU candidate countries of SEE.

The bulk of investment has come from Western – mostly European – utilities. However, utilities from within the transition region and small local investors are becoming increasingly important.

Governments have promoted PSP for a number of reasons – to raise fiscal resources, to improve the operating performance of utilities and to ensure adequate funds to meet future investment needs. Conclusive analysis of the consequences of PSP is still limited by the lack of data. Nevertheless, it is clear that PSP has helped to commercialise services, increase productivity and, in some cases, improve access to finance. At the same time, investors' expectations have not always been met. Returns in many privatised businesses appear modest relative to the cost of capital.

In the future, local investors are likely to play an increasing role in PSP. There is also likely to be a move away from outright asset sales to concessions and management contracts, which harness the expertise of the private sector but limit its financial exposure.

## Foreword by the Chief Economist



### Sustained progress in transition requires strong political will.

The publication of this *Transition Report* coincides with the 15th anniversary of the fall of the Berlin Wall. Much has been achieved since then, even if transition has proved a long and sometimes painful process. In most of the 27 transition countries, the transformation of the state from sole producer of the vast majority of goods and services to regulator of economic activity, financier (but not necessarily supplier) of public goods and provider of a social safety net is advancing rapidly. However, the limited experience of the state in its new roles is still apparent.

Most countries have successfully redirected their trade towards the global economy and have moved away from the old trade patterns of the Council for Mutual Economic Assistance. They have achieved moderate to high rates of growth for several years and have attracted an increased level of foreign investment, admittedly from a low starting point and concentrated in a few sectors and countries – predominantly the natural resources sector and central eastern Europe and the Baltic states.

Chapter 1 shows that, despite initial hardships, the liberalisation of markets and the introduction of structural reforms are rewarded by better economic

performance in the longer term. Macroeconomic policy is another important factor that determines the pattern of growth across the region. Over the past few years, growth in the transition countries has consistently exceeded the world average, and is expected to do so again in 2004, reaching just over 6 per cent. Since 1999, regional output has increased by more than 25 per cent. Chapter 2 looks at macroeconomic performance in more detail.

Of course, not everything is working well in the transition countries. The Commonwealth of Independent States (CIS) continues to rely too heavily on high but volatile prices for oil and other commodities. Diversification into other sectors remains a challenge for all countries that export natural resources. Macroeconomic vulnerabilities remain even in the most advanced countries. For example, persistent and unsustainable fiscal imbalances are still a cause for concern in the larger countries of central Europe. Unemployment continues to be high, particularly in central Europe and the EU candidates of south-eastern Europe. In the CIS and the western Balkans, poverty levels have started to decline but still remain high.



Enterprise surveys continue to identify serious shortcomings in the business environment. They include barriers to business expansion, market entry and exit, weak judicial and regulatory systems, and widespread corruption. Much of the region's infrastructure needs to be upgraded. Many of the networks have been under-funded, badly maintained or poorly managed. And despite several years of rapid growth in credit, access to finance remains inadequate. It is easy to find evidence of market, regulatory and government failure even in the most advanced economies of the region. The transition process still continues.

With so much still to be done, it is important that governments maintain or renew their commitment to reform and to sound and sustainable macroeconomic policies. This will not be easy, especially as most countries have now entered a phase of complex and controversial institutional reforms.

Sustained progress in transition will require strong leadership, a willingness to take on vested interests and the readiness to endure periods of political unpopularity. In some central eastern European and Baltic countries, public willingness to accept the immediate hardships of further reform may diminish now that EU membership has been achieved. In their first European Parliament elections, for example, voters in the new EU member states abstained in large numbers. Maintaining support for fiscal restraint or even retrenchment represents a significant challenge in the four largest central European countries.

The experience of the transition countries since the fall of the Berlin Wall underlines the importance of the political aspect of the EBRD's mandate. Economic reforms have been successful only where they were accompanied by a commitment to democratic principles and political freedoms. Adherence to the rule of law, control of corruption, respect for human rights and the protection of civil and political liberties are key factors in the transition process. They are also at the core of the EBRD's mandate. These principles are well entrenched in central eastern Europe and the Baltic states but progress elsewhere is mixed. For example, independent monitors have indicated failures across the CIS to meet international standards for free and fair democratic elections. Assessments in the past year by the Organisation for Security and Cooperation

in Europe, the Council of Europe and human rights organisations such as Freedom House have also expressed concern about abuses of power and the curtailing of media freedom in many transition countries.

Sustained progress in reform will continue to require commitment from the donor community. Without ongoing international assistance, the poorer countries in the CIS and south-eastern Europe in particular will struggle to establish functioning market economies and to win the fight against poverty. However, even maintaining existing aid levels cannot be taken for granted, given competing global needs and, in some donor countries, shrinking aid budgets. South-eastern Europe, where many countries still rely heavily on donor assistance, will be particularly affected by this. The prospect of closer ties with the EU has helped to encourage reform in south-eastern Europe over the past year but the western Balkans, at least, have still not attracted sizeable private investment.

One area where much remains to be done is infrastructure, as shown in Chapters 3 and 4 of this Report. For many years international financial institutions and development organisations sought to gradually reduce their involvement in the core infrastructure services of power, telecommunications, transport and water. This was on the assumption that with proper regulation the private sector could finance and operate these services.

Two factors changed this perception. First, discussions leading to the development of the Millennium Development Goals led to a renewed realisation of the importance of good infrastructure for economic development and the alleviation of poverty. They also underlined the continuing need for public financing (both domestic and from official sources) alongside private investment in infrastructure services. Secondly, the global economic slowdown from the beginning of 2000, which coincided with crises in the international telecommunications and electricity markets, led many international operators to scale back their engagement in the emerging markets.

These developments were felt in the transition countries, even though their infrastructure challenges differ in some ways from those in other emerging markets. The main issue for transition countries is to maintain and upgrade service networks – which are

often too extensive for current needs and in a poor state of repair – rather than extend networks, as is the case in developing countries. The transition countries also need to develop the rules and regulations that encourage efficient, cost-effective, environmentally sustainable and affordable services.

Infrastructure services in the transition countries need to be redesigned to improve regional and global integration and trade expansion. Since the publication of Adam Smith's *Wealth of Nations* back in 1776, economists have known that the division of labour (and the associated gains in efficiency and productivity) may be limited by the extent of the market. In other words, transaction and transportation costs restrict competition and limit the benefits of economies of scale and scope. Transaction costs can be reduced by eliminating administrative barriers to trade, by implementing transparent regulation and by investing in new technologies. Transportation costs can be minimised by cost-effective investment in infrastructure networks.

Transition countries have sought private sector assistance both in financing the upgrade and maintenance of infrastructure services and in improving the management of networks. Notable successes have been recorded, in particular in reducing losses and improving the collection of payments. There have also been some high-profile failures. With hindsight, we know that expectations about the potential impact of private sector participation were often unrealistically high. Private sector participation is not a panacea.

Nevertheless, private entrepreneurs are involved successfully in providing a large and growing number of infrastructure services throughout the region. However, as lessons from past projects are absorbed, the shape of private sector participation is changing. Increasingly, the private sector is invited to provide management skills rather than to finance capital investment. This makes the arrangements less risky for both partners but no less difficult to structure.

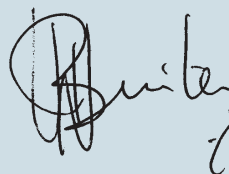
One reason why private sector participation in infrastructure has not been as successful as hoped is the existence of institutional weakness and political constraints. The private sector can perform effectively only if it is allowed to do so. The commercialisation

and privatisation of infrastructure services vastly increase the need for regulation, and experience has shown that regulatory requirements do not necessarily diminish as services become more competitive. This is clearly the case in mobile telecommunications, which is highly competitive but subject to licensing and regulated arrangements regarding interconnection.

Throughout the region, progress in infrastructure reform has been hindered by a lack of efficient regulatory institutions and by vested interests seeking to protect their position of strength. This is particularly evident in the area of tariff reform, where well-connected interest groups have often succeeded in blocking the tariff adjustments needed to put infrastructure services on a sound and sustainable financial footing.

There are justifiable concerns about the impact of tariff reform on poor consumers, who may not be able to afford steep price rises. However, there are a number of ways to address these concerns, such as "lifeline" tariffs that allow a certain level of services to be provided free of charge. Organisations such as the EBRD are now paying more attention to this issue. Infrastructure reform may be difficult but it is not impossible.

As a transition bank, the EBRD needs to understand the complex processes of transition. The *Transition Report* is a contribution to this learning curve. It is also a way for the EBRD to share its analysis and findings with other investors, policy-makers, the research community and the public at large.



**Willem Buiter**

Chief Economist  
and Special Counsellor to the President

1 October 2004

# Part I: Progress in transition and macroeconomic performance

Part I of the *Transition Report* focuses on progress in transition and macroeconomic performance over the past year. Chapter 1 presents updated transition indicator scores for 2004, tracking each country's progress from a centrally planned to a market economy. The nine indicator scores cover four broad areas of structural and institutional reform, including enterprises, markets and trade, financial institutions and infrastructure.

Chapter 1 also examines the complex relationship between reform and economic growth. Many factors affect growth, including macroeconomic policies, initial conditions and the terms of trade (for example, favourable commodity prices). This chapter provides some new evidence on the importance of both initial-phase "liberalising" reforms and institutional reforms for long-term growth.

Chapter 2 reviews macroeconomic performance in 2003-04 in output and inflation, monetary policy, government and external balances and foreign direct investment. The chapter also examines reforms of institutions and rules that govern management of public finances. These can have an important impact on macroeconomic volatility and private sector risk perceptions and growth.

Each chapter in Part I has a separate annex. Annex 1.1 presents the results of this year's annual survey on legal transition. The Legal Indicator Survey in 2004 focuses on insolvency law. Annex 2.1 provides tables on a number of key macroeconomic indicators, including forecasts for growth and inflation for 2005.



# Progress in transition and the link to growth

# 1

The transition countries continued to make progress in structural and institutional reform over the past year, but with different levels of success. The SEE countries made the most significant headway, CEB made only incremental improvements while progress in the CIS countries was modest. In most countries access to finance was improved by a strengthening of local banks and better supervision. There is evidence that a commitment to reform and sound fiscal policies can lead to stronger growth over the longer term, prompting further reform efforts.

Progress in reform in central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) has followed a consistent pattern over the past few years. Starting from a relatively low base, the transition process in SEE is continuing to gather pace and the region is catching up with its CEB neighbours. The prospect of accession to the European Union, which has already accelerated transition in CEB, is now speeding up progress in the accession candidates of Bulgaria, Croatia and Romania. Albania and the Former Yugoslav Republic (FYR) of Macedonia have also made progress.

In the CEB countries there remains considerable room for improvement in institutional reform. There have been some developments in this area, but the formal accession of CEB countries to the EU in May 2004 may have reduced the incentive for reform and contributed to a second year of limited progress, as measured by the EBRD's transition indicators (see page 6).<sup>1</sup> As a group, the CIS countries had another moderate year, with only the Kyrgyz Republic making noticeable progress. The reform process in

the CIS as a whole has for a number of years shown signs of stalling. A particularly active – and in some cases turbulent – year of political transition may have contributed to this.

The first section of this chapter describes the updated EBRD transition indicators and presents the scores for 2004. This is followed by an overview of the year in transition, looking at progress by country and by sector. The second half of the chapter takes a longer-term perspective and examines the relationship between structural reform and growth throughout the transition. It provides an overview of existing evidence on the link between reforms and growth.

Most early analyses considered that reforms had a robust and positive (if delayed) effect on growth. More recently, however, the evidence has been less conclusive. The final section of the chapter presents some new evidence on this issue. It confirms that both “liberalising” and institutional reforms do have a positive impact on growth once other relevant factors are taken into account. These include “catch-up” growth, external growth of the main

trading partners, and the terms of trade (especially with regard to oil prices), the latter being particularly relevant in the CIS.

Annex 1.1 presents the results of the EBRD's annual survey on legal transition. The Legal Indicator Survey (LIS) was implemented by the Bank's Office of the General Counsel. The LIS rates the key areas of the law needed to support market reform. It consists of expert assessments of current laws and case studies of how these laws are being implemented. This year the LIS focuses on insolvency law.

## 1.1 Transition progress in 2004

At the core of the EBRD assessment of progress in transition is a set of transition indicators. These have been used to track reform developments in all 27 countries of the region since the beginning of transition. Progress is measured against the standards of industrialised market economies, while recognising that there is neither a "pure" market economy nor a unique end-point for transition. The measurement scale for the indicators ranges from 1 to 4+, where 1 represents little or no change from a rigid centrally planned economy and 4+ represents the standards of an industrialised market economy. The reform scores reflect the assessments of EBRD country economists using the criteria described in the methodological notes at the back of this Report (see page 199).

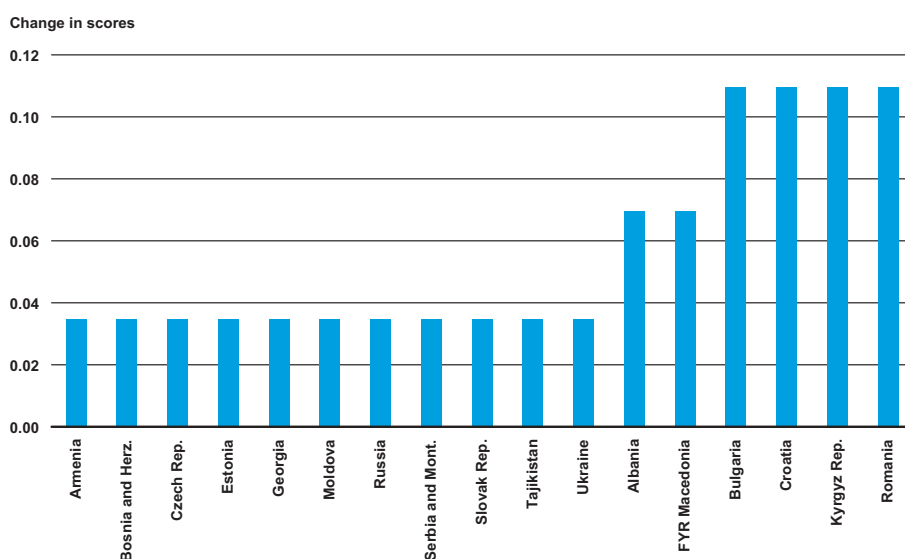
Assessments are made in nine areas which together cover the four main elements of a market economy – enterprises, markets and trade, financial institutions and infrastructure.

■ The reform of enterprises includes two indicators for privatisation and a measure of governance and enterprise restructuring, which indicates progress in cutting production subsidies, introducing effective bankruptcy procedures and applying sound corporate governance practices.

■ The reform of markets and trade is measured by the liberalisation of prices, the liberalisation of trade and access to foreign exchange, and the effectiveness of competition policy in combating the abuses of market dominance and anti-competitive practices.

Chart 1.1

### Change in average transition indicator scores, 2003-04



Source: EBRD.

Note: The chart reports the change in simple unweighted averages in the areas of reform (see Table 1.1). No change was recorded in Azerbaijan, Belarus, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Slovenia, Turkmenistan and Uzbekistan.

■ For financial institutions, the indicators measure reform and development of the banking sector, including the quality of financial regulation as well as the creation of securities markets and non-bank financial institutions.

■ Infrastructure reform is measured as the composite score of progress in five areas – electricity, railways, roads, telecommunications, and water and waste water. For each of these areas, the indicator covers issues such as commercialisation, tariff reform, the quality of the regulatory framework and involvement of the private sector.

Table 1.1 presents the scores for reform progress in these areas for 2004. Table 1.2 provides an explanation of this year's rating changes. Table 1.3 presents the scores for infrastructure reform sector by sector. Past ratings can be found in the country assessments at the back of the Report. These assessments also contain the country-by-country analyses that form the basis of the scores.

### Reform progress by country

Progress in reform along the nine transition indicators presented in Table 1.1 has been steady overall but uneven across countries. A total of 27 upgrades were awarded to 17 countries in 2004 and there were no downgrades. From that perspective, 2004 was a strong year for market reform in the transition countries. However, much of the progress was concentrated in the seven SEE countries,

which received more than half of the upgrades awarded this year. About one-third went to the CIS and the remainder – three upgrades in total – went to CEB. Chart 1.1 shows the change in the average transition scores by country for 2003-04.

While SEE as a whole performed well in the past year, the most striking improvement was in Romania which had not had a transition upgrade for the previous three years. Reforms in Romania accelerated in 2003-04. There was a surge in large-scale privatisation (including several important sales in the energy sector) and significant advances in banking sector and infrastructure reform. This improvement is linked to the country's EU accession ambitions for 2007. In the wake of the acceleration in reform, by September 2004 Romania had provisionally closed 27 out of 31 chapters of the body of EU laws known as the *acquis communautaire*. Nevertheless, it still has a lot of ground to cover in the next two years in the difficult areas of institutional reform and competition policy.

Bulgaria, which also seeks to accede to the EU in 2007, had another good year of transition in 2003-04. Much like Romania, it made progress in large-scale privatisation and in banking and infrastructure reform. Bulgaria has provisionally closed all 31 chapters of the *acquis*. The Bulgarian government expects to sign the accession treaty in 2005 and join the EU by its target date of January 2007. However, questions have arisen



**Box 1.1****Recent developments in Kosovo**

In June 1999 the United Nations Interim Administration Mission in Kosovo (UNMIK) was entrusted with the running of the province. UNMIK is headed by the Special Representative of the Secretary General (SRSG). The current SRSG, Søren Jessen-Petersen (the fifth appointee since 1999), took office in August 2004. The constitutional framework adopted in May 2001 divides powers between the SRSG and the Provisional Institutions of Self Government (the assembly, the president and the government) formed after the elections of 17 November 2001. The current government's term is expiring after general elections in October 2004. The government has delegated powers covering economic and financial policies, trade, industry, investments, transport and telecommunications. Nevertheless, ultimate authority lies with UNMIK. It retains veto powers and controls the customs service, international relations and the administration of public, state and socially owned property.

Economic growth slowed down significantly in 2002. Although in 2003 a sizeable fiscal expansion might have allowed some recovery, only a marginal increase in GDP is expected in 2004 as foreign assistance and private investment continue to decline. At an estimated €930, GDP per capita remains among the lowest in Europe. Owing to good revenue collection and spending constraints, the government has run a budget surplus for three consecutive years. However, exports are negligible and the trade deficit, estimated at above 50 per cent of GDP, is financed mainly by remittances from Kosovans abroad and foreign aid. Poverty and unemployment are widespread and may have contributed to the serious riots in March 2004.

Progress in structural reforms in Kosovo has been very limited. The privatisation of state-owned and socially owned enterprises was stalled for a long time by controversies regarding the approach of the Kosovo Trust

Agency (KTA) to recognising pre-1999 property rights. However, the process was relaunched in July 2004 with a new wave of tenders. The KTA has also sought recently to improve management of public enterprises. The incorporation of Pristina airport is expected to be followed by administrative reforms in the telecommunications operator PTK.

The power utility KEK has benefited from large inflows of donor funds but it still suffers from weak management and lack of transparency. To address these issues, a two-year contract to manage the company was awarded to ESB International of Ireland in June 2004. There has also been some progress in the water sector. A management contract for water supply in the Gjakove-Rahovec area was awarded to Gelsenwasser in 2001. The tender for the much-needed second mobile telecommunications licence ran into problems in mid-2004 after allegations of corruption and lack of transparency. Access to finance has expanded significantly (although from a low base), with a number of local banks offering increasingly accessible, but still expensive, credit to local clients.

The main obstacle to transition and future growth is the lack of a resolution to Kosovo's final status. The international community has insisted that certain, mainly political, standards must be met before the status issue can be resolved. A review has been promised in 2005. The absence of sovereign guarantees has so far prevented international investment in infrastructure and other areas that need capital. It has also hindered the running of publicly owned enterprises and delayed privatisation. In addition, the lack of a clear demarcation of responsibilities between the SRSG and the government impedes efficient decision-making and diverts attention from economic development.

Source: EBRD.

regarding the country's administrative capacity and judicial system, which could affect implementation of the *acquis*. Bulgaria and the EU have negotiated a one-year deferral on formal entry if effective implementation is not assured before 2007. Romania has expressed interest in a similar arrangement once it has fulfilled the initial requirements for EU accession.

Croatia made significant progress in the past year in key areas of governance, banking and infrastructure reform. The country attained EU candidate status in June 2004 and expects to begin membership negotiations in the first half of 2005. Like the other candidate countries, Croatia must maintain its recent reform momentum and make sustained efforts to strengthen the judiciary and public administration.

Elsewhere in SEE, the EU's commitment to the Stabilisation and Association Process, which prepares SEE countries for possible future accession and promotes regional cooperation, may have spurred reform in Albania and FYR Macedonia. Each country received two upgrades this year. Bosnia and Herzegovina was upgraded for banking reform. Serbia and Montenegro received

an upgrade for progress in small-scale privatisation. The pace of reform in Serbia and Montenegro has been modest for the past two years, owing to continued political uncertainties and divisions among the reformers. The election of a pro-reform candidate as President of Serbia in June 2004 has eased fears that the country could return to the damaging nationalist politics of its recent past. However, several key issues remain unresolved. These include the future of the current State Union of Serbia and Montenegro and the final status of Kosovo (see Box 1.1).

Following years of rapid progress needed to complete the EU accession process, many of the CEB countries have experienced a slowdown in the pace of reform. The only upgrades over the past year were in the Czech Republic, Estonia and the Slovak Republic. The Czech Republic improved its capital markets legislation; Estonia and the Slovak Republic saw significant expansion of domestic credit to the private sector and further strengthening of prudential supervision in the banking sector. More remains to be done to bring this region up to the standards of advanced industrial countries; however, institutional reforms are difficult and will take time.

Before accession, the need to satisfy EU membership requirements may have eased the introduction of difficult reforms. However, political differences have since intensified and public support for reform and fiscal prudence has waned. The failure to substantially improve living conditions and to reduce stubborn unemployment has caused many people in the new EU member states to question the economic benefit of accession. It has also encouraged the growth of populist opposition parties that oppose further reform. Consequently, the restructuring and painful fiscal tightening needed to eliminate budget deficits and facilitate entry to the eurozone could be deferred (see Chapter 2).

Within the CIS, the Kyrgyz Republic led the way with upgrades in large-scale privatisation and infrastructure. Reform in other CIS countries was sporadic at best (see Table 1.2). Although reform progress in the region has been patchy for some years, performance in 2003-04 can be explained in part by the election cycle.

Russia, one of the reform leaders in the CIS in recent years, had parliamentary and presidential elections between December 2003 and March 2004, which may have slowed the adoption and implementation

Table 1.1

## Transition indicator scores, 2004

Country	Population mid-2004 (million)	Private sector share of GDP mid-2004 (EBRD estimate in %)	Enterprises			Markets and trade			Financial institutions		Infrastructure
			Large-scale privatisation	Small-scale privatisation	Governance & enterprise restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Infrastructure reform
Albania	3.2	75	2+	4	2	4+	4+	2 ↑	3- ↑	2-	2
Armenia	3.1	75 ↑	3+	4 ↑	2+	4+	4+	2	2+	2	2+
Azerbaijan	8.3	60	2	4-	2+	4	4-	2	2+	2-	2
Belarus	9.9	25	1	2+	1	3-	2+	2	2-	2	1+
Bosnia and Herz.	3.8	50	2+	3	2	4	4-	1	3- ↑	2-	2+
Bulgaria	7.8	75	4 ↑	4-	3-	4+	4+	2+	4- ↑	2+	3 ↑
Croatia	4.4	60	3+	4+	3 ↑	4	4+	2+	4 ↑	3-	3 ↑
Czech Republic	10.3	80	4	4+	3+	4+	4+	3	4-	3+ ↑	3+
Estonia	1.4	80	4	4+	3+	4+	4+	3-	4 ↑	3+	3+
FYR Macedonia	2.0	65 ↑	3+ ↑	4	2+	4	4+	2	3-	2 ↑	2
Georgia	4.6	65	3+	4	2	4+	4+	2	3- ↑	2-	2+
Hungary	10.0	80	4	4+	3+	4+	4+	3	4	4-	4-
Kazakhstan	14.4	65	3	4	2	4	3+	2	3	2+	2+
Kyrgyz Republic	4.8	75 ↑	4- ↑↑	4	2	4+	4+	2	2+	2	2- ↑
Latvia	2.3	70	4-	4+	3	4+	4+	3-	4-	3	3
Lithuania	3.5	75	4-	4+	3	4+	4+	3	3	3	3-
Moldova	4.3	50	3	3+	2-	4-	4+	2	3- ↑	2	2
Poland	38.3	75	3+	4+	3+	4+	4+	3	3+	4-	3+
Romania	21.7	70 ↑	4- ↑	4-	2	4+	4+	2+	3 ↑	2	3+ ↑
Russia	144.9	70	3+	4	2+	4	3+	2+	2	3-	3- ↑
Serbia and Mont.	8.3	50	2+	3+ ↑	2	4	3+	1	2+	2	2
Slovak Republic	5.4	80	4	4+	3	4+	4+	3	4- ↑	3-	3-
Slovenia	2.0	65	3	4+	3	4	4+	3-	3+	3-	3
Tajikistan	6.5	50 ↑	2+	4-	2-	4-	3+	2-	2 ↑	1	1+
Turkmenistan	6.0	25	1	2	1	3-	1	1	1	1	1
Ukraine	48.4	65	3	4	2	4	3	2+	2+	2+ ↑	2
Uzbekistan	26.0	45	3-	3	2-	3-	2-	2-	2-	2	2-

Source: EBRD.

Note: The transition indicators range from 1 to 4+, with 1 representing little or no change from a rigid centrally planned economy and 4+ representing the standards of an industrialised market economy. For a detailed breakdown of each of the areas of reform, see the methodological notes on page 199.

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

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

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

The large-scale privatisation score for Latvia, price liberalisation scores for Albania and Estonia, the trade and foreign exchange score for Romania and the banking reform and interest rate liberalisation score for FYR Macedonia have been revised and backdated this year to reflect historical conditions.

Table 1.2

## Changes in transition scores

Country	Transition indicator	Change in score	Reason for change
Albania	Competition policy	2- to 2	Approval of new competition law and creation of independent competition authority.
	Banking reform and interest rate liberalisation	2+ to 3-	Substantial growth in private sector lending, improvements in supervision and the privatisation of the Savings Bank.
Armenia	Small-scale privatisation	4- to 4	Steady progress in small-scale privatisation, which is now nearly complete.
Bosnia and Herz.	Banking reform and interest rate liberalisation	2+ to 3-	Significant growth in deposits and lending, and a relatively well-functioning supervision framework.
Bulgaria	Large-scale privatisation	4- to 4	Substantial privatisations in energy, telecommunications and shipbuilding.
	Banking reform and interest rate liberalisation	3+ to 4-	Significant growth in lending and deposit taking, and improvements in regulation and supervision.
	Infrastructure	3- to 3	Upgrade of electric power and telecommunications indicators. Electric power was upgraded following privatisations, improvements to the legal framework and tariff reform. Telecommunications was upgraded following the privatisation of the dominant fixed-line operator BTC.
Croatia	Governance and enterprise restructuring	3- to 3	Adoption of a new bankruptcy act, amendments to the law on public companies and the introduction of measures to improve the effectiveness of the judiciary.
	Banking reform and interest rate liberalisation	4- to 4	High level of financial intermediation and well-regulated sector. Croatia has the highest level of private sector lending in the region.
	Infrastructure	3- to 3	Upgrade of railways indicator, following the successful implementation of a restructuring law.
Czech Republic	Securities markets and non-bank financial institutions	3 to 3+	Introduction of a new investment law and the first successful initial public offering by a local company on the Prague stock exchange.
Estonia	Banking reform and interest rate liberalisation	4- to 4	Further financial deepening and the growth of credit to the private sector.
FYR Macedonia	Large-scale privatisation	3 to 3+	Significant progress with the sale or liquidation of around 40 state-owned companies.
	Securities markets and non-bank financial institutions	2- to 2	Steady growth in stock market activity over recent years.
Georgia	Banking reform and interest rate liberalisation	2+ to 3-	Increase in financial intermediation and steady progress in the consolidation of the sector over the past few years.
Kyrgyz Republic	Large-scale privatisation	3 to 4-	Privatisation of the Kumtor gold mine, which accounts for about 10 per cent of Kyrgyz GDP.
	Infrastructure	1+ to 2-	Upgrade of telecommunications indicator, following the successful liberalisation of the sector in 2003.
Moldova	Banking reform and interest rate liberalisation	2+ to 3-	Substantial growth in private sector lending. The sector is relatively well regulated, but concerns remain about state interference.
Romania	Large-scale privatisation	3+ to 4-	Significant privatisations over the past year, including the oil and gas company Petrom and other energy assets.
	Banking reform and interest rate liberalisation	3- to 3	Sharp growth in credit to the private sector and the partial privatisation of Banca Comerciala Romana.
	Infrastructure	3 to 3+	Upgrade of power and water indicators. Regulation has improved in both sectors, and two electricity distribution companies have been privatised.
Russia	Infrastructure	2+ to 3-	Upgrade of railways indicator, following separation of the regulation and management functions and increased private provision of rail services.
Serbia and Mont.	Small-scale privatisation	3 to 3+	Steady progress in privatisation over several years.
Slovak Republic	Banking reform and interest rate liberalisation	3+ to 4-	Growing competition and improved credit quality.
Tajikistan	Banking reform and interest rate liberalisation	2- to 2	Restructuring of the two largest banks and improvements in supervision.
Ukraine	Securities markets and non-bank financial institutions	2 to 2+	Initiation of pensions reform and growth in the bond market.

Source: EBRD.

of reform in the past year. Also, a number of conflicts between the state and private business (both domestic and foreign) have arisen in the past year. The most prominent involves a tax evasion case against the leading oil company Yukos. Such disputes have affected investor sentiment and raised questions about the protection of property rights. Although there have been recent signs of progress in social sector and fiscal reforms, Russia received only one transition indicator upgrade in 2003-04 for infrastructure due to reforms undertaken in the railways sector.

Elections also took place in Armenia, Azerbaijan, Georgia, Kazakhstan and Ukraine in 2003-04. These are likely to have prompted a more cautious attitude towards reform among these countries' leaders. Tajikistan made initial progress in banking reform with the restructuring of the country's two largest banks. There are signs that reforms in Georgia could accelerate following a change in political leadership and installation of a pro-reform government in January 2004.

## Reform progress by sector

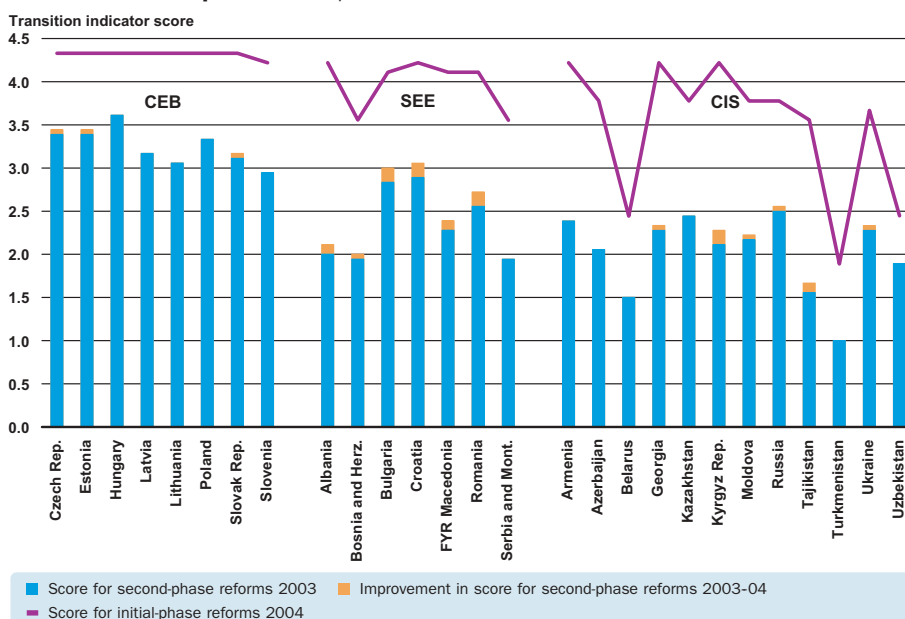
The record of reform since the beginning of transition, as measured by the nine transition indicators, shows that institutions supporting markets and private enterprise tend to develop only after progress has been made in liberalisation and privatisation. This has led to a distinction between initial-phase reforms and second-phase reforms. The former take priority in the early years of transition and focus on the relatively straightforward tasks of price and trade liberalisation and small-scale privatisation. The latter are more difficult comparatively and focus on building market-supporting institutions.

Second-phase reforms include competition policy, enterprise restructuring, the development of financial institutions, and infrastructure reform. Although large-scale privatisation was conducted early in the transition of a few countries, it may also be included in second-phase reforms since it is likely to involve resistance from powerful vested interests. Overall, there was notable progress in second-phase reforms in 2004 across the region.

Second-phase institutional reforms that support markets and private enterprise are central to transition and to the success of initial reforms. As the process of liberalisation, stabilisation and small-scale

Chart 1.2

### Initial and second-phase reform, 2004



Source: EBRD.

Note: The chart reports the average score for all 27 transition countries in the two broad dimensions of reform. Initial-phase reforms include price liberalisation, foreign exchange and trade liberalisation, and small-scale privatisation. Second-phase reforms include large-scale privatisation, governance and enterprise restructuring, competition policy, infrastructure reforms, banking and interest rate liberalisation, and non-bank financial institutions. Reforms are measured using the EBRD transition indicators (see Table 1.1).

privatisation nears completion, there is an increasing need for market-supporting institutions that establish a level playing field and enforce the rules for market participants. As Chart 1.2 shows, initial-phase reform is largely complete for the majority of transition countries. In 2004 progress in initial-phase reform was limited to small-scale privatisation in Armenia and Serbia and Montenegro.

Although there is still a significant gap between initial-phase and second-phase reforms for even the most advanced countries, it has been closing in recent years. The catching-up process in second-phase reforms takes time, however. For most institutional reform indicators, improvements become more difficult at the higher end of the ratings scale. Moreover, the demand for institutional reforms from new market participants may outpace the capacity of governments to introduce them. Some governments may also prefer to retain aspects of a system that allows discretionary state intervention on behalf of favoured enterprises and industries.

In 2003 and 2004 second-phase reform was especially strong in the financial sector, in infrastructure and in large-scale privatisation. Improvements in competition policy and enterprise restructuring were less pronounced. Chart 1.3 shows the number of reform upgrades by sector and region.

In 2004, 10 countries (including five from SEE) received upgraded scores for banking sector reform. There has been a significant increase in bank lending to the private sector over the past year, against a general background of banking consolidation, increased private sector (especially foreign) participation and improvements in supervision and regulation. As Chart 1.3 indicates, banking sector reforms progressed in countries at various stages of transition. Among the advanced countries, domestic credit continued to expand rapidly in Estonia while competition in the banking sector in the Slovak Republic continued to lift the general health and performance of banks. Among the EU candidate countries, domestic credit to the private sector as a percentage of GDP in Croatia rose to 48.5 per cent in 2003 (the highest among the transition countries) and in Bulgaria it grew from 18.5 per cent in 2002 to 26 per cent in 2003. Among the early reformers in the CIS, domestic credit to the private sector in Georgia rose by 24 per cent in real terms in 2003, although the ratio to GDP remains below 10 per cent.

Accelerated credit growth carries obvious risks related to the quality of loan portfolios (see Chapter 2). Nevertheless, it is welcome news for enterprises as access to finance has routinely been identified in company surveys as one of the main obstacles to doing business in

the region.<sup>2</sup> The development of deposit insurance laws, credit bureaux that provide information on borrowers and better laws on secured transactions have facilitated this trend. However, more remains to be done to increase supervisory capacity and central bank independence, to minimise the relaxation of banking procedures following the introduction of deposit insurance and to guard against a potential deterioration in portfolio quality.

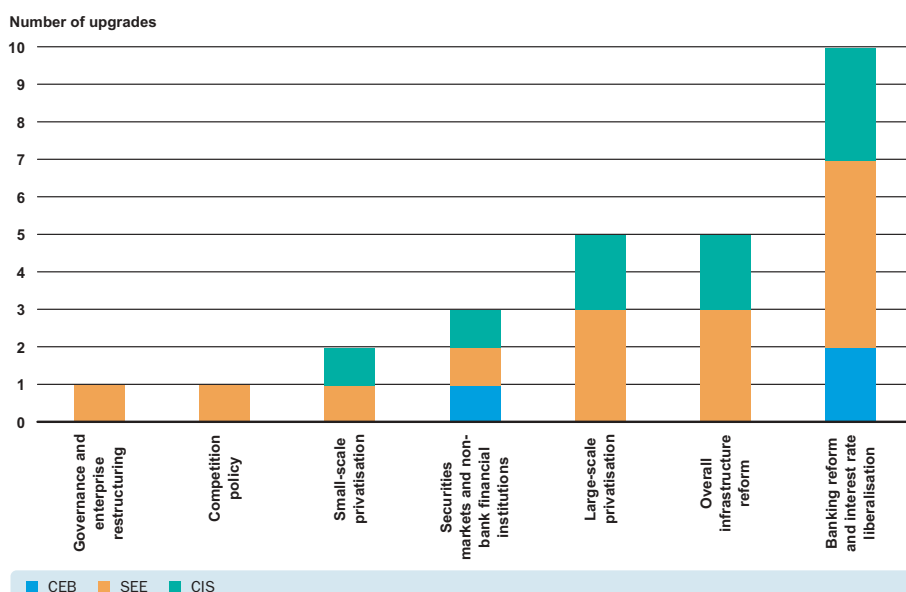
In addition to the reforms in the banking sector, there was progress in the non-bank financial sector, which includes securities markets and pension reform. The Czech Republic, FYR Macedonia and Ukraine were upgraded on this transition indicator. The financial deepening indicated by the upgrades in the scores for banking sector and securities markets reform is positively linked with growth (see Chapter 2). Further progress in improving the business environment and competition – including the ease of market entry and exit – is still needed to make this trend sustainable. In particular, key aspects of public administration and the legal framework, including appropriate laws and even-handed enforcement, need more attention, as does the overall effort to reduce corruption.

The CEB countries have made the most progress in strengthening governance institutions but there remains considerable room for improvement even there. The European Commission's Comprehensive Monitoring Report for the acceding countries, issued in October 2003, called for continued strengthening of the judicial and regulatory frameworks. The Report noted that perceptions of corruption in the CEB countries remains high or very high, which could limit the effective implementation of the *acquis*.<sup>3</sup>

In SEE efforts to meet EU standards of judicial independence and effective legal administration have led to a strengthening of the rule of law in some countries. Tackling corruption also has been high on the political agenda in most SEE countries, and governments in the region have responded with various anti-corruption programmes and laws. However, their impact remains uncertain. Strengthening the rule of law and reducing corruption in the CIS countries remains a key challenge. The level of political independence and the integrity of courts and judges vary by country but are

Chart 1.3

### Transition progress by sector, 2003–04



Source: EBRD.

Note: The chart reports the number of upgrades in each of the areas of reform (see Table 1.1) in CEB, SEE and CIS. Price liberalisation and trade and foreign exchange system are not included as there were no changes recorded for the year.

generally lower than in other transition regions and corruption remains a serious problem.<sup>4</sup>

In 2003–04 only Croatia and Albania received upgrades in governance and enterprise restructuring and competition policy respectively. Croatia improved its bankruptcy legislation and company law and initiated judicial reform. Albania adopted a new competition law and created an independent competition authority.

Over the past year there has been a great deal of activity in reforming various infrastructure sectors, an area where progress was slow at the start of transition. Table 1.3 gives a breakdown of infrastructure scores by sector as well as the overall infrastructure score for the year. Chapters 3 and 4 detail the challenges involved in regulatory reform and private sector participation.

Five countries received upgrades in the transition score for overall infrastructure in 2004, and 16 upgrades in the infrastructure sub-sectors were spread over 13 countries. This reflects a growing recognition that commercialisation, tariff reform and better regulation are essential for the effective provision of infrastructure services and the improvement of long-neglected networks. It also reflects the renewed attention to infrastructure by the international development community, which has created positive incentives for reform.

Most important are the reform incentives contained in the EU accession criteria, which cover energy, telecommunications, transport, and water and waste water. The new EU member states are, accordingly, the most advanced in meeting these criteria although SEE countries are also making progress. Bulgaria, Croatia and Romania received transition score upgrades for overall infrastructure in 2004, bringing them up to a similar level to the reform achievements of CEB countries. The other countries with overall infrastructure upgrades over the past year were the Kyrgyz Republic and Russia. However, they and other countries in the CIS remain behind the more advanced reformers.

The power sector led the way in infrastructure reforms in 2003–04. Seven countries received transition score upgrades. The EU power sector directive of June 2003 is driving reform in the CEB countries. This directive aims to create an internal market for electricity and calls for industry unbundling, non-discriminatory network access and improvements in regulatory frameworks.

In SEE energy reform is motivated by the objective of forming a regional energy market. Supported by the European Commission, the SEE countries have signed up to the creation of the Energy Community of South-Eastern Europe (ECSEE), which commits them to a number of reforms. Over the past year Albania, Bulgaria, Latvia, Lithuania and Romania



Table 1.3

## Infrastructure transition indicators, 2004

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

Source: EBRD.

Note: The transition indicators range from 1 to 4+, with 1 representing little or no change from a rigid centrally planned economy and 4+ representing the standards of an industrialised market economy. The overall indicator reflects the simple average of the five sector indicators. For a detailed breakdown of each of the areas of reform, see the methodological notes on page 200.

↑ and ↓ arrows indicate change from the previous year in that sectoral transition indicator. One arrow indicates a movement of one point (from 4 to 4+, for example), two arrows a movement of two points. Up arrows indicate upgrades, down arrows downgrades. The telecommunications and railways scores for the Slovak Republic and the electric power score for Poland have been revised and backdated this year.

have made progress towards meeting the goals of either the EU directive or the ECSEE, leading to a transition score upgrade for electrical power. In the CIS, Kazakhstan improved its tariff-setting procedures (which have been applied to water as well) while Tajikistan raised electricity prices substantially and improved collection rates. However, tariffs in Tajikistan are still far from reaching cost recovery levels.

Reforms in the railway, telecommunications and water sectors have advanced in SEE and CIS countries in the past year but do not yet match the achievements in CEB. In the telecommunications sector Azerbaijan's transition score was upgraded, recognising private sector participation in the mobile telephone market. Also, Bulgaria privatised its dominant fixed-line operator, and liberalisation in the Kyrgyz Republic (in early 2003) is beginning to show positive results. Croatia and Russia received transition score upgrades for the railway sector. Kazakhstan and Romania

were upgraded for the water sector, based on improvements in the regulatory framework.

The final aspect of second-phase reform that deserves mention is large-scale privatisation. It accelerated in the past year, due in part to renewed interest from potential investors in emerging markets. Three SEE countries – Bulgaria, FYR Macedonia and Romania – achieved higher transition scores for large-scale privatisation in 2003-04. Romania concluded several important privatisations, including the sale of a controlling stake in the Petrom oil and gas company to Austria's OMV, two electricity distribution companies to Italy's Enel, and the sale of two gas distribution companies. The sales of Petrom and the gas distribution companies still require approval from parliament and the Romanian Competition Council.

Bulgaria completed a number of high-profile privatisations, including the sale of a 75 per cent stake in the Varna shipyard and a 65 per cent stake in

the Bulgarian Telecommunications Company (BTC). The sale of a 67 per cent stake in the country's seven electricity distribution companies was nearing completion in September 2004. The tobacco monopoly Bulgartabac is also being prepared for separation and privatisation. FYR Macedonia made important progress in selling or liquidating persistent loss-making companies.

The sale of the Kumtor gold mining company in the Kyrgyz Republic (the largest enterprise in the country whose output accounts for nearly 10 per cent of GDP) was the most notable privatisation of the year in the CIS region. Large-scale privatisation in Ukraine was more quantitative than qualitative. Although the government accelerated its privatisation programme in key areas such as steel and coal mining, sales were marred by accusations of bid-rigging and political interference.



## 1.2 Reforms and growth during transition

It has become increasingly clear in recent years that the link between reforms and growth in transition economies is more complex than many policy-makers and analysts had originally thought. While many countries continue to make advances in market reform, economic growth rates and living standards vary widely across the region.

High growth rates can and do occur in some of the least reform-minded countries. Turkmenistan enjoyed growth of close to 8 per cent in 2003 despite an almost complete lack of commitment to market-oriented reform. At the other end of the reform spectrum, Hungary's growth rate last year fell below 3 per cent for the first time since 1996. Such examples might be dismissed as short-term anomalies that can be explained by other factors. However, it is harder to explain why average growth in the CIS countries, where reforms are typically least advanced, has outpaced the rest of the region for the past few years. It is therefore appropriate to re-examine whether progress in transition enables a country to grow faster, and if so, to what extent and at what speed.

### Stabilisation, initial conditions and reform

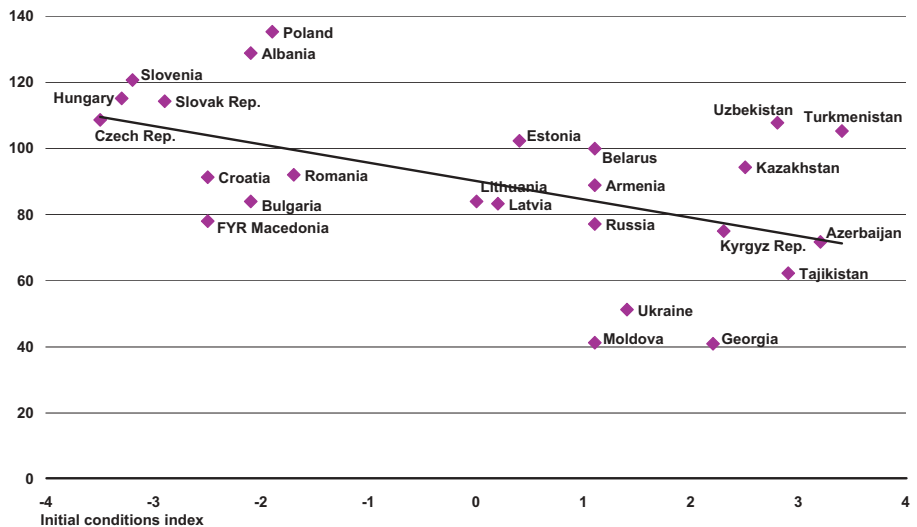
The fundamental argument for transition is that market-oriented institutions and policies create a better climate for innovation and growth in the long term. Sustained progress in transition is closely associated with a better business environment, and hence higher investment and growth. However, transition has been a difficult process for all countries in the region. Falling output, growing unemployment and collapsing institutions have been commonplace. In many cases the negative outcomes of the transition are only recently beginning to be reversed. Once that occurs, the trends have been generally more positive. In particular, robust growth is well established and is continuing strongly in 2004 (see Chapter 2), driven increasingly by enhanced private investment and further integration into world markets.

Three broad factors may explain this improvement in macroeconomic performance and the fact that some countries are performing better

Chart 1.4

### Initial conditions and current GDP

Index of real GDP in 2003 (1989=100)



Sources: de Melo *et al.* (2001) and EBRD staff estimates.

Note: The initial conditions index was calculated using principal components analysis on the following set of variables: GDP per capita in 1989, at PPP exchange rates; pre-transition growth, where pre-transition refers to 1985-89 in CEB and SEE and 1987-91 in the CIS; a dummy for wealth in natural resources (ranging from 0 to 2); the share of the population living in urban areas; the distance between the country's capital and the EU (Brussels); the share of employment in industry, agriculture and services, all relative to market economy benchmarks; the value of trade with the Council for Mutual Economic Assistance over GDP in 1989; a measure of repressed inflation (derived from the difference between wage growth and productivity); the black market exchange rate; the number of years a country lived under central planning; the initial private sector share in GDP; a dummy for state capacity, set equal to 2 in all established nation states, 1 in all dominant states in a federation (Czech Republic and Russia) and the ex-Yugoslav republics, and 0 for all new CIS states and the Slovak Republic. A lower value on this index means better initial conditions. For an explanation of the methodology of principal components, see Falcetti *et al.* (2002) and Box 2.1 of the 1999 *Transition Report*.

than others. These are: initial conditions, including factors that capture the initial level of development and the extent of inherited structural and macroeconomic distortions; the implementation of appropriate monetary and fiscal stabilisation policies, resulting in lower inflation and sustainable fiscal deficits; and progress in market-oriented reforms. In each case there is a positive link with growth.

A country's starting point can help to explain differences in growth performance. Transition countries differ widely in their initial conditions. Such factors may include trade dependence on the Council for Mutual Economic Assistance (CMEA), different levels of macroeconomic distortions (repressed inflation, black market exchange rate premium), administrative capacity, years spent under central planning, and geographical location. Many of these factors are potentially important influences on subsequent growth. To measure their impact, an initial conditions index can be constructed from a series of indicators determined at the start of transition.<sup>5</sup>

Chart 1.4 compares this initial conditions index with another country-specific index representing the level of real GDP reached in 2003 relative to 1989.<sup>6</sup> Countries with

a better starting point, and therefore a lower value in the initial conditions index, should achieve higher cumulative growth than those with a weaker starting point. This is indeed the case, but the link is not particularly strong. This is possibly because the effect of initial conditions declines over time as other factors become more prominent.

Stabilisation policies also played a significant role in reversing the collapse in output that occurred in virtually all countries in the early years of transition. Chart 1.5 divides the region into "early" and "late" stabilising countries and shows the annual average (unweighted) growth rate for each group since 1989. The former group includes those countries that had a comprehensive stabilisation programme in place before 1995 and had reduced annual inflation below 30 per cent by the end of 1995.<sup>7</sup> It includes all CEB countries as well as Croatia and FYR Macedonia in SEE.<sup>8</sup> The chart shows that these countries had shorter and less deep recessions and that they switched to positive growth earlier than the late stabilisers. However, since 1999 average growth in the latter group has been higher than in the former, indicating a sustained catching-up period.

Closer examination shows that the early stabilising countries typically reached the recession trough between 1991 and 1994, while the late stabilisers on average reached it much later. Many of the latter group (but none of the former) saw output fall by more than 50 per cent. Not surprisingly therefore the latter group has since shown much higher average growth rates. When evaluating the effects of policies on growth, it is important to keep this catch-up phenomenon in mind. This is discussed in more detail below.

The link between growth and reforms is of particular interest to researchers and policy-makers. Progress in transition is inherently difficult to measure. However, the EBRD transition indicators described earlier can provide a useful numerical guide to the stage of transition in a country across a variety of dimensions.

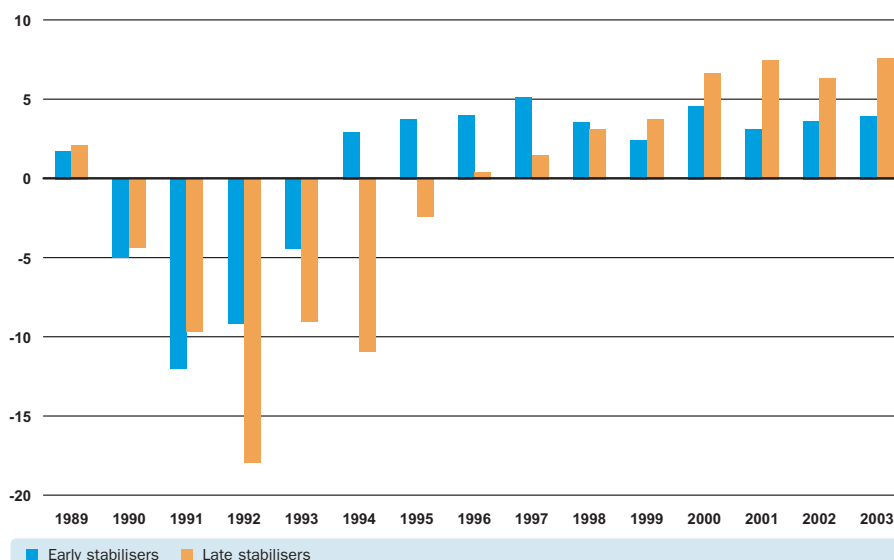
It is difficult to judge which type of reform is the most important. Some analysts have argued that initial-phase reforms, such as price and trade liberalisation and small-scale privatisation, are the key drivers of recovery and growth. Others stress that far-reaching second-phase institutional reforms relating to areas such as governance, enterprise restructuring or the banking sector are critical for long-term growth. The close correlations between the different variables make it difficult to disentangle their individual contributions. Furthermore, countries that have made most progress in reform (as measured by the averages of the EBRD indicators) overlap almost perfectly with the early stabilising countries described above. Therefore, it is equally true to say that early reformers have recorded positive growth earlier and have higher output (relative to 1989 levels) compared with late reformers but the latter are now growing more strongly on average.

In summary, there are clear links over the whole transition period between real GDP growth, good initial conditions, sound macroeconomic policies and progress in structural reforms. However, the simple correlations do not explain the relative importance of, for example, stabilisation policies as opposed to reforms, and are therefore of less use to policy-makers. Disentangling the effects of different variables and policies on growth is a difficult task. Such an analysis can be done only by using econometric methods where the influence of one variable may be identified after controlling for other factors.

Chart 1.5

### Stabilisation and growth, 1989–2003

Real GDP growth in per cent (unweighted average)



Source: EBRD.

Note: Early stabilisers are the countries that had a comprehensive stabilisation programme before 1995 and had reduced inflation below 30 per cent by end-1995. The group includes all CEB countries, Croatia and FYR Macedonia.

### Causes of growth in transition

Many studies have analysed the causes of growth in transition countries but it is fair to say that no consensus has yet been reached. There is broad agreement, however, on the role of stabilisation policies. The early adoption of sound macroeconomic policies is good for growth. Two common ways of measuring stabilisation are the annual inflation rate and the size of the fiscal balance relative to GDP. Most studies have found that lower inflation rates and smaller budget deficits are associated with economic recovery and higher growth rates.<sup>9</sup> Conversely, high inflation appears to be particularly damaging.<sup>10</sup> One study has estimated that a country with 500 per cent inflation in just one year loses about 2 per cent of GDP the following year and 4 per cent of GDP in the longer term.<sup>11</sup> However, there seems to be a threshold inflation level, in the region of 10–20 per cent, below which further improvements in growth resulting from lower inflation are small.<sup>12</sup>

There is also fairly widespread agreement about the importance of initial conditions, especially in the first years of transition, although different interpretations of the evidence exist about how quickly their influence dies out. Several studies show that the effect diminishes quite rapidly and countries with weak initial conditions catch up after a late recovery.<sup>13</sup> Nevertheless,

there remains a link between a good starting point and overall growth in the transition, as Chart 1.4 demonstrates. One explanation is that reform paths have differed across countries, and low starting points have negatively affected growth indirectly through their influence on reform choices.

The area that has generated most debate so far is the influence of reforms on growth. Most of the early studies argued that reforms are beneficial for growth. A common finding was that an increase in a reform indicator has a negative effect on growth at first but after a year has a positive influence that outweighs the initial decline.<sup>14</sup> Some researchers have investigated which reforms were most important, and several concluded that the initial-phase “liberalising” measures have a larger impact on growth than measures to improve the institutional environment.<sup>15</sup> One reason for this result is that institutional reforms are harder to carry out (as shown in Section 1.1). They also bring benefits that are long-term in nature and are not yet visible in the short time-span available for analysis.

However, a number of recent papers cast doubt on the benefits of reform and therefore provide a challenge to those who argue that policy-makers should push ahead with the reform agenda to speed up the transition process. Sometimes the results change when the sample is split into early and later periods of transition.

Although the positive effect of reforms can be detected in the early period, it tends to disappear in later stages.<sup>16</sup> This reflects the fact that there has been a marked acceleration in growth in some of the less-reform minded countries in the last four or five years, in parallel with a slowdown in the most advanced part of the region. The evidence in favour of a robust link between reforms and growth therefore becomes more questionable – although one study provides strong evidence that backtracking in reform (as indicated by a downgrade in the EBRD transition indicators) is bad for growth.<sup>17</sup>

Two points should be borne in mind. First, some studies show that not only are reforms likely to influence growth but the reverse may also be true because higher growth rates give policy-makers more scope to implement often painful reforms. When this effect is taken into account, the estimated influence of reforms on growth can change significantly.<sup>18</sup>

The second point is that empirical research in transition economies is hampered by the poor quality of the data in many countries. It is well known that official estimates of annual growth rates are often rough guesses, especially in the early years of transition. There are several reasons for this: the weaknesses of statistical agencies; the focus of the statistics on existing large industries, many of which reduced output drastically or shut down; the corresponding failure to include new businesses in the formal data; and the emergence of a large informal sector, which sprang up quickly in most cases. As a result, in many cases the severity of the transition recession was exaggerated. Some statistical agencies have begun to incorporate estimates of the informal economy in official statistics. However, it is generally accepted that the data in most countries do not fully reflect the true picture.

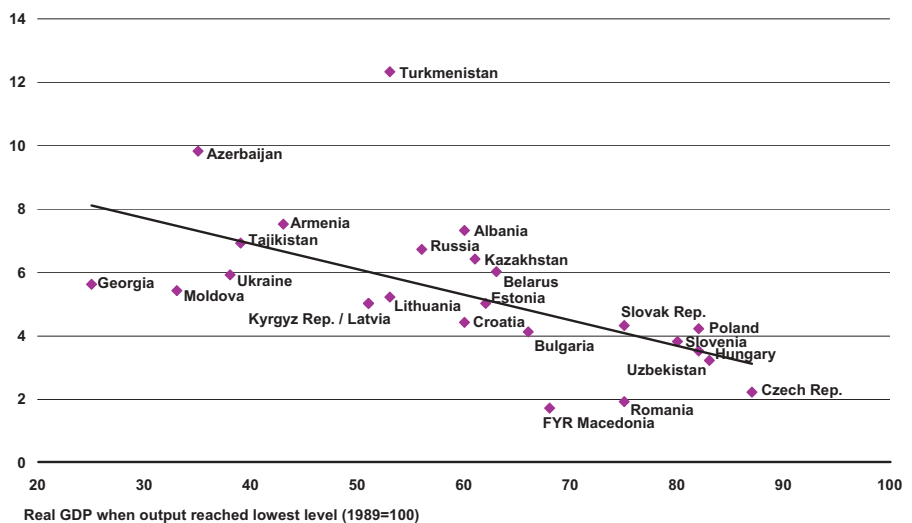
### Reforms and growth: Re-examining the evidence

This section takes a fresh look at the relationships between reforms, growth and other variables. The issue remains a critical one across the region. Reforms in transition countries have usually been associated with short-term costs, especially in countries with weak initial conditions. Pro-reform governments have often paid the penalty at the ballot box for advancing transition. Policy-makers may

Chart 1.6

#### Recovery of output in transition countries

Average real GDP growth since output reached lowest level (in per cent)



Source: EBRD.

need reassurance that the long-term benefits are sufficient to make any short-term pain worthwhile.

As noted earlier, some researchers have failed to find a strong and positive effect of reforms on growth, especially when analysing data from the most recent years. It is possible that previous studies failed to take sufficient account of other relevant factors leading to growth. It may be that once they are included in the equation, the benefits of reforms become apparent again. This section investigates this hypothesis further by focusing on three additional variables: the potential for countries that suffered the deepest recessions to rebound more quickly; changes in terms of trade, particularly in relation to oil prices and dependence on oil imports or exports; and the impact of external growth, by weighting real GDP growth rate in their main trading partner countries by export shares.

Many transition countries have experienced severe falls in output over the past decade. In general, the further the decline, the greater has been the potential for a period of rapid growth once recovery has started. One way to illustrate this is by looking at average growth rates in the years after an economy has suffered a deep, cumulative decline. Chart 1.6 shows for each country the value of real GDP at its lowest point in the transition (relative to the 1989 value) and average annual growth since it recovered above this minimum point. For most countries that had long, deep recessions, average annual

growth rates in the recovery phase were in the range of 6 to 8 per cent and even higher in two cases. For those countries that had relatively mild recessions, subsequent growth was generally more modest.

A second factor affecting growth in some countries, especially in recent years, has been the surge in commodity prices, and in particular the price of oil. For oil-rich countries, this has been a major boon. This factor is especially important in the CIS, where several countries are oil-rich and others can benefit indirectly through trade and other linkages. Chart 1.7 highlights the link between CIS growth rates (weighted by each country's dollar GDP) and the annual average oil price. The strength of this correlation, especially since 1997, suggests strongly that the influence of oil prices on growth is important.

The third factor likely to influence growth in transition countries is the economic performance of their main trading partners. Transition countries have become increasingly integrated into the world economy. This can bring large benefits if the main trading partners have buoyant economies, and it is good for long-term growth. However, if external demand is temporarily weak, this can lead to a short-term slow-down in transition economies and a worsening in their terms of trade.

The prolonged period of modest growth in the EU-15 (the 15 member countries before the latest accessions in May 2004)

in recent years has probably had an adverse effect on some of the new EU members, many of which conduct more than half of their trade with the EU-15. Chart 1.8 illustrates this point. As the share of exports to the EU-15 (as a percentage of GDP) has risen steadily over the past 10 years, growth rates in CEB have moved increasingly in step with the EU (with some divergence in 2003), where average growth has fallen in the past three years to less than 2 per cent. In contrast, the recent boom in Russia has had positive spillover effects for a number of other CIS countries.

Table 1.4 shows what happens if these three factors are incorporated in an econometric analysis.<sup>19</sup> The results in the first column show that reforms have a strong, positive effect on growth rates, with a one-year time lag. The magnitude of this effect depends on the exact specification and technique used in the estimation. Different experiments show that, other factors remaining constant, an increase in the average EBRD transition score by 0.1 – approximately equal to two-and-a-half upgrades – would raise the growth rate the following year (and each subsequent year if the new transition score is maintained) by between 0.3 and 0.7 percentage points. This is not a trivial effect, especially when cumulated over several years. These results suggest that a sustained commitment to reforms is associated with substantial benefits over the long term.

Other results also match expectations. The catching-up process, oil balances and weighted external growth all play a role in explaining differences in growth over the transition period (although the oil balance variable falls marginally short of statistical significance in this general specification). Stabilisation is also relevant, as shown by the positive and significant link between growth and the fiscal balance. The effect of initial conditions appears to tail off over time. The crucial point to note is that when these different influences are taken into account, a steady and important relation of reforms on growth becomes apparent.

The results also throw some light on the causes of reform. Two points are worth noting. First, civil liberties and reforms are strongly linked. Countries that enjoy more freedom – that is, those with a lower index of civil liberties – have recorded higher average growth. Secondly, growth has a positive effect on the level of reforms in the same period. This suggests that

Chart 1.7

## Oil price and average growth in the CIS, 1989–2003

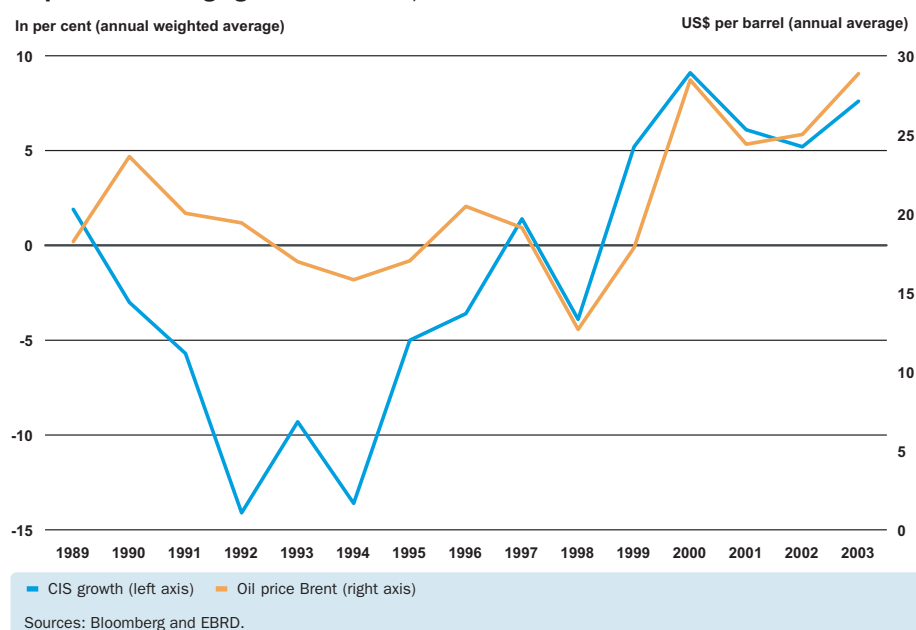
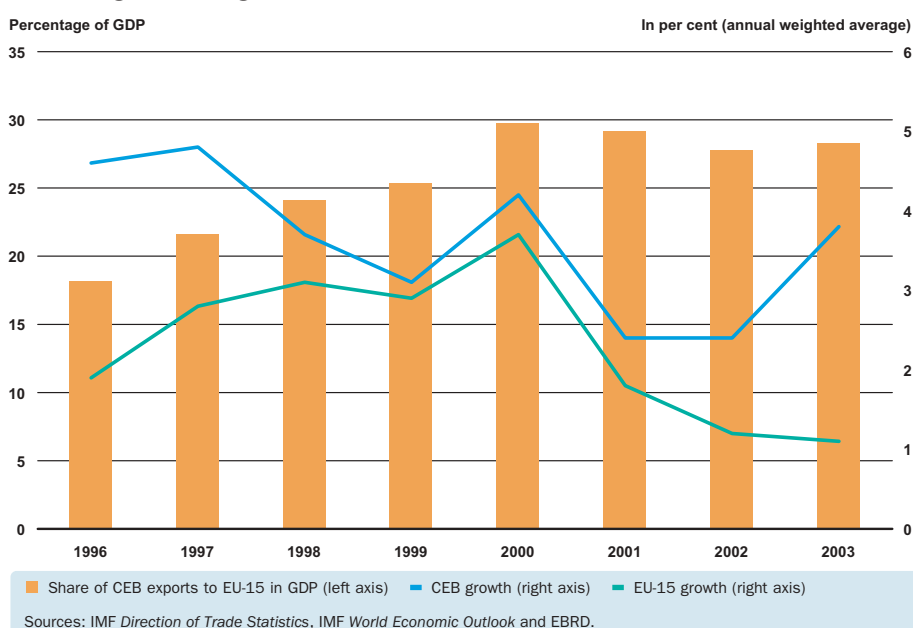


Chart 1.8

## Trade integration and growth in CEB and EU-15



countries may become locked into a “virtuous circle” – an increase in growth has an immediate positive effect on reforms, which in turn benefit growth in the following period, with further knock-on effects on reform and so on. However, countries should not take it for granted that once they enter this positive spiral they will remain there.

Columns 2–6 in Table 1.4 illustrate three further issues: the relative importance of initial- and second-phase reforms on growth; the effects of dropping the early years of transition from the analysis; and differences in regional results. Columns 2

and 3 give results that link growth with initial-phase reforms and second-phase reforms only. As can be seen, the baseline results hold true irrespective of the type of reform.<sup>20</sup> However, the estimated impact of initial-phase reforms on growth is higher than that of second-phase reforms, suggesting that it may take time before the benefits of institutional reforms are translated into higher growth.

Another possibility is that the results are distorted by the early years of transition, when output falls were severe and data limitations most serious. Column 4 tests whether the results hold true when the



Table 1.4

**Determinants of reforms and growth**

Variables	1	2	3	4	5	6
<b>Reforms</b>						
Time trend	***	+	***	-*	**	**
(Time) <sup>2</sup>	-*	-	-**	***	-	-
Initial conditions x time	-**	-	-***	-***	-**	-
Initial conditions x (time) <sup>2</sup>	+	+	***	***	**	+
Growth <sub>t</sub>	***	***	***	***	***	***
Growth <sub>t-1</sub>	-	-	-	-**	-	-
Civil liberties	-***	-***	-***	-	-	-***
<b>Growth</b>						
Time trend	+	+	+	***	-	-
(Time) <sup>2</sup>	-	-	-	-**	-	+
Initial conditions x time	***	***	***	***	+	***
Initial conditions x (time) <sup>2</sup>	-***	-***	-***	-**	-	-*
Reforms <sub>t-1</sub>	***	***	***	***	***	***
Fiscal balance	***	***	***	***	***	***
Catch-up dummy <sub>t-2</sub>	***	**	***	***	**	***
Oil balances	+	+	***	-	+	+
External growth	**	**	**	-	+	+
<b>Number of observations</b>	224	224	224	143	116	132

Source: Falcetti *et al.* (2004).

Note: + or - indicates a positive or negative correlation and \*, \*\*, or \*\*\* show that the regression coefficient is significant at the 10, 5 or 1 per cent level respectively. t indicates the current year. t-1 and t-2 indicate previous year(s).

Column 1: The results are derived by defining reforms as the simple average of all EBRD transition indicators with the exception of infrastructure (for which the transition indicators for each country are not fully backdated to the first five years of transition).

Column 2: The results are derived by using initial-phase reforms, calculated as a simple average of the EBRD transition indicators for price and trade liberalisation and small-scale privatisation.

Column 3: The results are derived by using second-phase reforms, calculated as a simple average of the EBRD transition indicators for large-scale privatisation, governance and enterprise restructuring, competition policy, banking and the non-bank financial sector.

Column 4: The results are derived by dropping the first five years of transition for each country.

Column 5: The results refer to CEB and SEE.

Column 6: The results refer to CIS.

first five years of transition are dropped from the sample. For those countries that started transition in 1989, the sample is restricted to start from 1994; for countries that began transition in 1990, the sample starts from 1995; and so on. This means that for almost all countries in the region the analysis begins at a point when the economy was growing.

Two interesting aspects stand out. First, the effects of fiscal stabilisation come through even more strongly than before.<sup>21</sup> Secondly, the oil balance and external growth variables are no longer significant. The main points from the earlier specifications still apply, in particular the beneficial effect of reforms on growth, although the size of this effect is smaller than when the full sample is used.

Further insights into the relationship between initial conditions, reforms and growth can be derived by splitting the countries according to sub-regions. The last two columns of Table 1.4 compare

the baseline results for the countries of CEB and SEE (column 5) to those of the CIS (column 6). There are important differences between the two sets of results. First, initial conditions in CEB and SEE affect the level of reforms significantly but not growth performance. The opposite is true for the CIS. Secondly, as suggested in Chart 1.7, oil balances help to explain the growth performance in the CIS but not in CEB and SEE countries. Thirdly, political factors (as measured by the extent of civil liberties) tend to have a significant impact on the degree of reforms in the CIS but not in CEB and SEE.

### 1.3 Conclusion

The transition countries have made steady but uneven reform progress in 2003-04. In CEB reforms have long been driven by the prospect of EU membership. Now that this goal has been achieved, the pace of reform seems to have slowed, even though formidable institutional challenges remain.

The disciplining effect of the EU accession process is still being felt in Bulgaria, Croatia and Romania. All three made substantial reform progress in 2003-04, particularly in infrastructure and financial sector reform. The other SEE countries also advanced in transition. However, Bosnia and Herzegovina and Serbia and Montenegro need to accelerate the pace of reforms if they are not to be left further behind.

In the CIS the commitment to reform has been mixed, and may have been further weakened in 2003-04 by a busy electoral schedule. The risk that some CIS countries may become locked into a trap of weak governance, low productivity and high vulnerability – typical of low and middle-income countries – is still very real.

The apparent signs of reform fatigue in some parts of the region are perhaps not surprising, given the economic hardship endured since the beginning of transition. Cross-country surveys of subjective well-being, or “happiness”, regularly put transition countries near the bottom of the list in terms of their citizens’ overall satisfaction with life.<sup>22</sup> Policy-makers need to assess whether a sustained commitment to reform will outweigh these short-term costs and bring lasting benefits to their country.

The link between reform and growth in transition countries is complex. It is clouded by the effect of other factors, such as catch-up and recovery, trade dependency and oil prices. This chapter shows that, after allowing for these factors, there remains a robust, positive influence of reforms on growth. Moreover, higher growth can in turn spur further reform efforts, potentially leading to a “virtuous circle”. Catch-up, oil prices, trade links and initial conditions all influence a country’s growth performance but there is evidence that a sustained commitment to reform and sound fiscal policies will bring substantial benefits over the longer term.

## Endnotes

- 1 Reforms in areas not covered specifically by the EBRD transition indicators, including those measured by the World Bank's annual *Doing Business* surveys, have progressed in some CEB countries. The Slovak Republic, Lithuania and Poland were among the top 10 reformers in the 145-country sample in 2003 due to reforms affecting the *Doing Business* indicators: ease of starting a business, hiring and firing workers, enforcing contracts, getting credit and/or closing a business. See World Bank (2004).
- 2 See the results of the Business Environment and Enterprise Performance Survey (BEEPS) reported in the 2002 *Transition Report*.
- 3 See European Commission (2003).
- 4 See Transparency International, Corruption Perceptions Index 2003.
- 5 See Falcetti *et al.* (2002) and Box 2.1 of the 1999 *Transition Report* for a detailed description of the index and explanation of the methodology used for its construction.
- 6 This chart and all of the subsequent analysis exclude the two countries – Bosnia and Herzegovina and Serbia and Montenegro – that started transition much later than others, mainly because of a lack of comparable data on key variables.
- 7 Countries that experienced inflation reversals – such as Albania, Romania, Russia and some of the Central Asian countries – are excluded from this group.
- 8 A similar division of countries emerges if the reduction in the fiscal deficit is used as a criterion instead of inflation.
- 9 See, for example, Fischer and Sahay (2004), Fischer *et al.* (1996) and Loungani and Sheets (1997).
- 10 Clearly the causation between growth and either inflation or the fiscal balance can run both ways, with higher growth leading to lower inflation and fiscal deficits in percentage of GDP.
- 11 See the empirical evidence presented in Table 6 of Loungani and Sheets (1997). The authors show the results of panel regressions of real GDP growth on lagged growth, inflation, the fiscal balance and other control dummies in a sample of 25 transition countries from 1991 to 1994. Over this time period, 19 countries in their sample experienced average inflation in excess of 100 per cent (over 1,000 per cent for six cases).
- 12 See Christoffersen and Doyle (2000). This study finds evidence in a sample of 22 transition countries between 1990 and 1997 of an inflation-output threshold of 13 per cent. Inflation above that level reduces growth while it does not have a significant effect when it is below the threshold. Ghosh and Phillips (1998) find a much lower inflation threshold, which they estimate in low single digits.
- 13 See Berg *et al.* (1999) and de Melo *et al.* (2001).
- 14 See, for example, de Melo *et al.* (2001) and Merlevede (2003).
- 15 See Fischer and Sahay (2000) and Havrylyshyn and van Rooden (2003).
- 16 See Fidmuc (2003), Lawson and Wang (2004) and Lysenko (2002).
- 17 See Merlevede (2003).
- 18 See Falcetti *et al.* (2002), Merlevede (2003) and Radulescu and Barlow (2002).
- 19 See Falcetti *et al.* (2004) for a detailed description of how the three variables are modelled. The analysis is based on earlier research contained in Falcetti *et al.* (2002) and uses an unbalanced panel of 25 countries in transition time. In line with the earlier work, annual growth and reforms are modelled simultaneously and estimated by three-stage least squares to take account of feedback effects between the two variables. The reform measure is an average of all EBRD transition indicators, mixing initial-phase and second-phase reforms, with the exception of infrastructure (for which the transition indicators are not fully backdated to early years of transition). Both reforms and growth in a given year are assumed to depend on the initial conditions index (interacted with time), a simple time trend and country-specific "fixed" effects to account for unobserved differences between countries. Growth is also a function of the fiscal balance relative to GDP (as a proxy for stabilisation). Reforms are assumed to be influenced by the Freedom House index of civil liberties while the level of reforms depends on current and lagged growth. Growth rates are influenced by lagged reform only.
- 20 This result is not surprising given the high correlation between the two reform indicators.
- 21 That is, the size of the estimated coefficient is larger than before.
- 22 See Inglehart *et al.* (2004).

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## Annex 1.1: Legal Indicator Survey 2004

Progress in legal reform in the transition countries can be measured by assessing both the current laws (“laws in transition”) and how these laws work in practice (“laws in action”). The Legal Indicator Survey (LIS) uses case studies to gauge how a specific area of the law is working.<sup>1</sup> Together with an assessment of laws in transition, the survey provides a broad and reasonably complete picture of a key aspect of the legal framework. This year the LIS focuses on insolvency law.

Bankruptcy and insolvency legal systems are often, incorrectly, thought to be solely about helping creditors recover loans made to debtors. Although that is a principal function of an insolvency law, the ultimate purpose of any insolvency regime is to redistribute the assets of uncompetitive or inefficient entities. This is done in many ways, such as the sale of assets to more efficient entities, distributing assets to constituencies including creditors, governments and employees and turning inefficient entities into more efficient ones through corporate re-organisation. Evidence suggests that countries with insolvency law regimes that operate in a predictable and efficient manner will attract greater investment. Also, the cost of credit will be more affordable as creditors have greater confidence.<sup>2</sup>

### Assessment of insolvency laws, 2003–04

The EBRD’s assessment of insolvency laws (as they relate to corporate entities) is designed to measure their compliance with international standards and best practice.<sup>3</sup> To this end, a list of 97 fields of inquiry – grouped into five “core areas” – has been created, using the most widely accepted international

standards adopted by the World Bank, the Asian Development Bank and the United Nations Commission on International Trade Law (UNCITRAL). The core areas are: commencement of proceedings; treatment of estate assets; treatment and involvement of creditors; terminal/liquidation processes; and reorganisation processes.

An effective insolvency legal regime should:

- allow for relatively easy and predictable access to insolvency proceedings by debtors and creditors
- provide a variety of remedies (for example, liquidation and rehabilitation) for the financial problems of an insolvent debtor
- provide for the efficient and prompt administration of an insolvency case
- generally treat the interests of creditors as paramount.

Experts in the field of insolvency retained by the EBRD studied legislation in all 27 transition countries, analysing laws with regard to the 97 fields of inquiry. Detailed “score sheets” relating to each field were prepared for each country.<sup>4</sup> In nearly every case, practitioners in each country were used to verify the

Table A.1.1.1

## Level of compliance with international insolvency standards

Very low	Low	Medium	High	Very high
Lithuania Tajikistan Turkmenistan Ukraine	Azerbaijan Georgia Hungary Latvia Slovenia Uzbekistan	Armenia Belarus Czech Republic Estonia Kazakhstan Kyrgyz Republic FYR Macedonia Poland Russia Slovak Republic	Albania Bosnia and Herzegovina Bulgaria Croatia Moldova Romania Serbia and Montenegro	-

Source: EBRD Legal Indicator Survey, 2004.

assessments of the EBRD experts. A final numerical score was assigned to each country and the countries were subsequently grouped according to their level of compliance with international standards (ranging from “very low” to “very high”, as shown in Table A.1.1.1).

There was considerable variation across the transition countries. No country was rated as having “very high” compliance. Those countries with the best assessments all come from south-eastern Europe (SEE). The most advanced reformers from central eastern Europe and the Baltic states (CEB) are spread across the “very low”, “low” and “medium” compliance categories. There is plainly room for improvement in the quality of insolvency laws across the whole transition region.

### “High” compliance countries

Countries in the “high” compliance category typically have laws that provide a clear definition of when a debtor can be deemed insolvent. They make an attempt at providing, legislatively, for cross-border insolvencies, give insolvency administrators powers to review suspicious transactions, and are generally compliant with international standards in each of the five core areas. Some countries, such as Bulgaria and Romania, also make provision for priority (or DIP) financing to be obtained by the debtor during a restructuring.<sup>5</sup> This is a rare, but laudable, feature of insolvency laws in the region. The “high” ranking of these countries indicates general compliance but not the absence of deficiencies. Although their insolvency legislation is among the strongest in the region, each country’s laws could certainly be improved.

### “Medium” compliance countries

The “medium” compliance category has the largest number of countries. It also contains countries with the most internally divergent results. Although some (Belarus, for example) have relatively strong provisions dealing with the avoidance of pre-bankruptcy transactions, an initial application to commence proceedings may be delayed for up to seven months before being dealt with by the courts. Similarly, the Slovak law provides for reasonable commencement criteria, interim protection of debtors and requires the delivery of assets by the debtor to the insolvency administrator. However, it does not clearly state how secured creditors are dealt with, does not provide for anticipatory insolvency – when it is known that a debtor is sure to become insolvent in the very near future – and has inadequate provisions to deal with cross-border insolvencies.

### “Low” compliance countries

Six countries are in the “low” compliance category and generally require serious improvement in all of the five core areas. The poor treatment of creditors is often a feature of their laws. In Georgia, for example, creditors are not even directly notified of their responsibility to file claims in bankruptcy cases. “Low” compliance countries often have limited or non-existent provisions for dealing with cross-border insolvencies. Their most significant legal shortcoming, however, is in the area of reorganisation of insolvent debtors. Slovenia (together with many others) requires unrealistic levels of repayment to creditors before a reorganisation plan is approved. Nearly all “low” compliance countries have failed to address the need to help restructuring debtors with additional working capital.

### “Very low” compliance countries

The four countries in the “very low” compliance category have functioning insolvency legislation, but it is rudimentary and severely deficient in all core areas. Their laws complicate the initial filing process, either through unclear and inadequate criteria for the commencement of proceedings or through time-consuming procedural requirements (such as employee consultations in Ukraine). All four countries have inadequate legal provisions regarding the qualifications of insolvency administrators, cross-border insolvencies and the avoidance of pre-bankruptcy transactions.

### Common area of weakness

A common area of weakness shared by most countries, in all of the above categories, relates to cross-border insolvencies. There has been an increase in cross-border trade and economic integration between, and within, the various transition sub-regions. There is likely to be, therefore, a corresponding rise in the number of cases of enterprise insolvency involving assets and business interests in more than one country.

However, only a few of the laws examined in the assessment provide for recognition and assistance in such cases. Of those laws that do, the provisions are often short and unspecific. Lenders whose clients operate in multiple jurisdictions can therefore expect significant difficulties when using insolvency proceedings to enforce their rights across various countries. Similarly, debtors intent on reorganisation should not assume that courts in one jurisdiction will honour the laws and rulings of another.

## Insolvency laws in action

To complement the assessment of laws in transition described above, the EBRD conducted a survey of lawyers working in the region on how those laws are applied in practice. The aim of the survey was to assess how the legislation, together with the local institutional framework in each country – including rules of procedure, courts and judges and insolvency administrators – work to create a functional (or dysfunctional) insolvency legal regime.

## Box A.1.1.1

**Scenario 1 – Use of legal system by creditor to initiate insolvency proceedings**

The client is a local supplier of goods in your country. One of the client's customers, a local, privately owned, limited liability manufacturing company, has failed to pay a debt due to the client in the local currency, equivalent to €10,000, as a result of cash flow problems.

The debt is more than 30 days overdue. There is no dispute regarding the underlying transaction that gave rise to the debt and the debtor has no valid defence for the non-payment of the debt.

The client now asks for your professional advice on:

- any action the client can take under the insolvency law of your country to deal with the apparent insolvency of the debtor
- the process that will be involved in obtaining an effective final order against the debtor.<sup>1</sup>

**Scenario 2 – Use of legal system by debtor to commence insolvency proceedings**

The client is a local, privately owned limited liability manufacturing company in your country. Historically, the client traded successfully for a number of years and presently employs around 100 staff. The client is now experiencing major cash flow difficulties and expects that, within the next month, it will not be able to pay debts owed to a number of its creditors as those debts become due for payment and that its financial position will continue to deteriorate.

The business is basically sound but accounting, financial and other advice is that before the client can return to a profitable position, the client will require:

- a general reduction of debt owed to all non-bank creditors (for example, a 30 per cent reduction)

- an extension of the time for payment of the reduced debts (for example, in 12 months' time)
- a rescheduling of bank financing commitments (for example, deferring repayments of principal for 12 months and a reduction of interest payable).

Some creditors are pressing for payment and are threatening to take enforcement action. In attempting to negotiate an arrangement as indicated above, the client will require protection (for example, a stay or suspension of all legal actions against the client and its assets).

The client now asks for your professional advice on the action it can take under the insolvency/reorganisation laws of your country to get to the stage at which a formal arrangement that embraces the above proposals will take effect.<sup>2</sup>

The following firms participated in the 2004 Legal Indicator Survey: Advokat (Bosnia and Herzegovina); Mr Denes Aparacz (Hungary); Centre for Legal Research under the University of World Economy and Diplomacy (Uzbekistan); Chadbourne & Parke LLP (Azerbaijan, Belarus, Kazakhstan, Kyrgyz Republic, Russia, Ukraine, Uzbekistan); Colja, Rojs & partnerji (Slovenia); Mr Laszlo Csia (Hungary); Grant Thornton Amyot (Armenia); Kalikova Gulnara, Dignitas Law Firm (Kyrgyz Republic); Law Office Polenak (FYR Macedonia); Lideika, Petrauskas, Valiunas & Partners (Lithuania); Linklaters (Czech Republic, Poland, Slovak Republic); Luiga, Mugu & Borenus (Estonia); Mgaloblishvili, Kipiani, Dzidziguri (MKD) Law Firm (Georgia); Nestor Dicuiescu Kingston Petersen (Romania); Sorainen Law Offices (Latvia); Spasov & Bratanov Lawyers' Partnership (Bulgaria); Turcan & Turcan (Moldova); Wolf Theiss (Albania, Croatia, Serbia and Montenegro).

<sup>1</sup> An "effective final order" means the making of an order or the pronouncement of a judgment which has the effect that the affairs of the debtor will be thereafter administered under the insolvency law, whether by way of bankruptcy, liquidation or some other form of insolvency process. It does not mean to the end of such processes.

<sup>2</sup> A formal "arrangement" means a reorganisation/restructuring/composition or similar process and "take effect" means such court or other approval or confirmation as may be required under the country's insolvency law.

Insolvency laws affect a variety of constituents, including banks, employees and governments. Ultimately, however, the users or "clients" of insolvency laws can be divided into two broad groups: debtors and creditors. Consequently, proceedings under most insolvency laws can be commenced by one of these two groups. Although each group is affected by the action of the other, the party commencing the proceeding often dictates, at least at the outset, what type of proceeding will be launched. This year's survey measures how the insolvency regime functions in instances where a creditor commences proceedings under the law (normally seeking liquidation of the relevant debtor) and also when a debtor commences proceedings (which could result in either liquidation or rehabilitation).<sup>6</sup>

Adopting the methodology devised for the 2003 LIS, legal practitioners were presented with a "real-life" case and asked to answer a series of questions relating to how the law might operate in that case (see Box A.1.1.1). The practitioners were asked first to advise a creditor seeking to

apply a relevant insolvency law to a debtor and, secondly, a debtor seeking relief under that law. The EBRD worked with a cross-section of lawyers in the region, ranging from those practising in international firms to sole practitioners.

The questionnaires accompanying the case study scenario, involving about 40 questions, asked lawyers to gauge the degree of effectiveness of the insolvency law according to three principal criteria – speed, efficiency and predictability/ transparency. These three factors together provide insight into the most important aspect of an insolvency law: the ability of either core constituent to initiate insolvency proceedings successfully. The broad purpose of this approach is to test whether, and to what extent, the law may be applied effectively in practice.

Speed is the most straightforward of the criteria, measuring the time that it might take from the initiation of a legal process to its conclusion. In the case of a process initiated by a creditor, speed refers to the time between the initial filing of the

process with the court and the court making a final determination of the result of the application. In the case of a debtor-initiated process, it is from the filing of the process to the confirmation of a reorganisation plan. In this respect, it should be noted that the prospect of, and the time that might be taken with, any appellate process was disregarded for the purposes of the survey.<sup>7</sup>

Efficiency relates to a number of factors involved in legal processes. These include the extent of formalities (for example, excessive documentation and procedural obstacles), cost disincentives (court fees and legal representation), the number of court appearances required and procedural technicalities. Together, they can indicate the extent to which legal processes may hinder access to, and the use of, the law.

The predictability and transparency factor addresses judicial predictability and competence, and also the competence of office-holders appointed to supervise, control or generally administer the affairs of an insolvent debtor. It also reflects the

extent to which outside influences, such as political patronage and corruption, might intrude on the courts and the office-holders.

Based on the three criteria, the survey shows overall effectiveness in terms of access to the insolvency law – either as a creditor’s ultimate means of resolving a debtor’s failure to make payment or as a debtor’s means of initiating a restructuring process. These findings can be used to make a comparison between “laws in transition” and “laws in action”.<sup>8</sup>

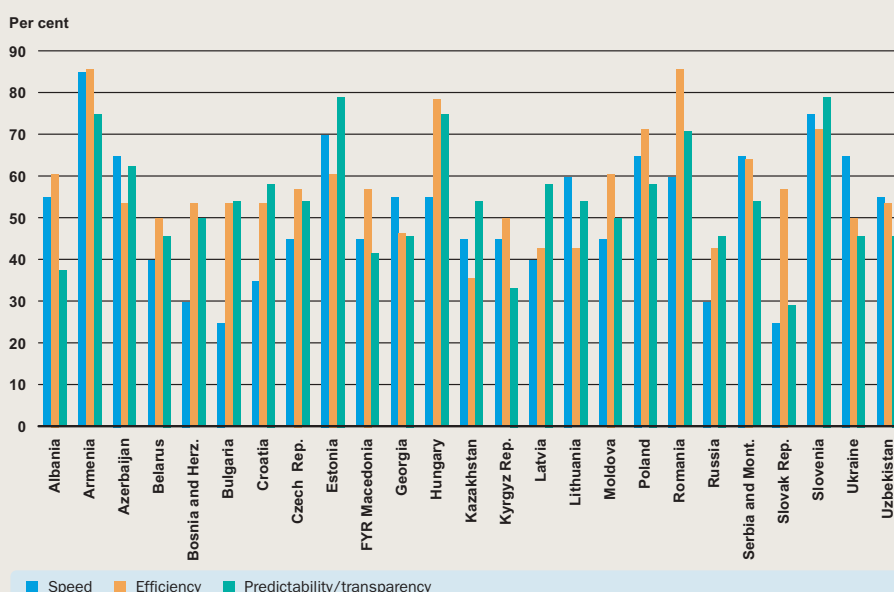
The findings from the survey (presented below) are necessarily limited and must be treated with some caution. First, they reflect the views of only a small number of lawyers. Secondly, the findings exclude consideration of the level of asset recovery in an insolvency case. It is difficult to assess the financial result of insolvency processes (liquidation or rescue). Whether a liquidation is likely to result in a payment to creditors (and, if so, what amount) will depend on a number of variables: the extent, value and realisability of assets; the amount of total liabilities; and the priority afforded to preferred claims, such as those from employees and tax authorities. These are not determined ordinarily by insolvency law, and cannot be taken into account when assessing the effectiveness of that law. Hence, the assessment of insolvency law in action does not address the quantitative result of insolvency processes.

Nevertheless, the survey findings address key questions of concern to investors, lawyers and analysts in this area, such as:

- Can the insolvency law be accessed conveniently, quickly and inexpensively by debtors and creditors?
- Is there an appropriate commercial environment for properly organised “collective” bargaining between the stakeholders in determining the appropriate remedy for a financially troubled enterprise?
- Does recourse to the law (by, for example, the initiation of insolvency proceedings against a financially troubled debtor) produce a real “credible threat” to the debtor (such that the debtor might be prompted to initiate reorganisation proceedings itself)?
- Is there adequate institutional capacity within the courts to apply the law?

Chart A.1.1.1

### Speed, efficiency, predictability/ transparency of creditor-initiated insolvency cases



Source: EBRD Legal Indicator Survey, 2004.

Note: Survey respondents were asked a series of questions about the speed, efficiency and predictability/ transparency of creditor-initiated proceedings. Scores are calculated as a percentage of the maximum score for these criteria. Data for Tajikistan and Turkmenistan were not available.

- Is the rule of law applied (or is the law subject to undue political interference or corruption)?
- Do insolvent debtors have reasonable access to protective rescue processes such that creditors will be induced to work with debtors on an amicable basis?
- Through whatever form of rescue “remedy”, does the insolvency law operate in practice to at least provide the chance of preserving viable businesses and maximise returns to creditors, thereby encouraging and preserving financial investment?
- Does the insolvency law act, in practice, as a “weapon-of-last-resort” for a creditor and, in appropriate cases, does it enable the liquidation of uncompetitive and inefficient enterprises?
- Does the law allow for an enterprise to be reorganised effectively for the commercial benefit of the principal stakeholders?
- Can certain stakeholders block or disrupt collective proceedings under the law?

### Creditor-initiated cases

Chart A.1.1.1 shows the scores for each transition country, split into the principal criteria of speed, efficiency and predictability/ transparency in relation to a creditor-initiated process. Speed is considered “high” in Armenia, Estonia and Slovenia. In Armenia the process may be expected

to be completed within four months whereas in Bulgaria and the Slovak Republic, which are at the low end of the scale, it is estimated that the process could take 12 months or longer. The process is regarded as efficient in five countries: Armenia, Hungary, Poland, Romania and Slovenia. And the process is considered predictable and transparent in five countries: Armenia, Estonia, Hungary, Romania and Slovenia. Across the three criteria, Armenia, Estonia and Slovenia received the highest marks.

Speed, efficiency and predictability/ transparency all affect the degree of overall effectiveness of the insolvency regime for a creditor seeking to launch bankruptcy proceedings against a recalcitrant, insolvent debtor. Chart A.1.1.2 shows the overall effectiveness of the insolvency regime by country, according to the lawyers surveyed. The survey suggests that in only nine countries may the insolvency regime be regarded as relatively effective and that in the majority of countries it is difficult for a creditor to effectively make use of the insolvency laws. The most effective regimes are in countries that scored highly on one or more of the principal criteria: Armenia, Estonia, Hungary, Poland, Romania and Slovenia.

There are a number of factors that undermine effectiveness for the majority of countries. In some countries the insolvency process can take an extraordinarily

long time despite what the legislation may stipulate. In Bulgaria, for example, judges tend to ignore the time limits imposed by the law. Another problem is the deployment of delaying and obstructive tactics by debtors. For instance, in Bosnia and Herzegovina judges tolerate delays for a variety of excuses despite the introduction of timelines in the relevant legislation. This phenomenon was explained as “old habits” dying hard among local judges.

Yet another concern is the overall competency and experience of judges. In the Kyrgyz Republic, for example, it was observed that there are no specialist courts and no specialist judges to hear insolvency matters. The result of this is that the competency of judges in this field is quite low. In Azerbaijan, judicial corruption was cited as a significant negative factor.

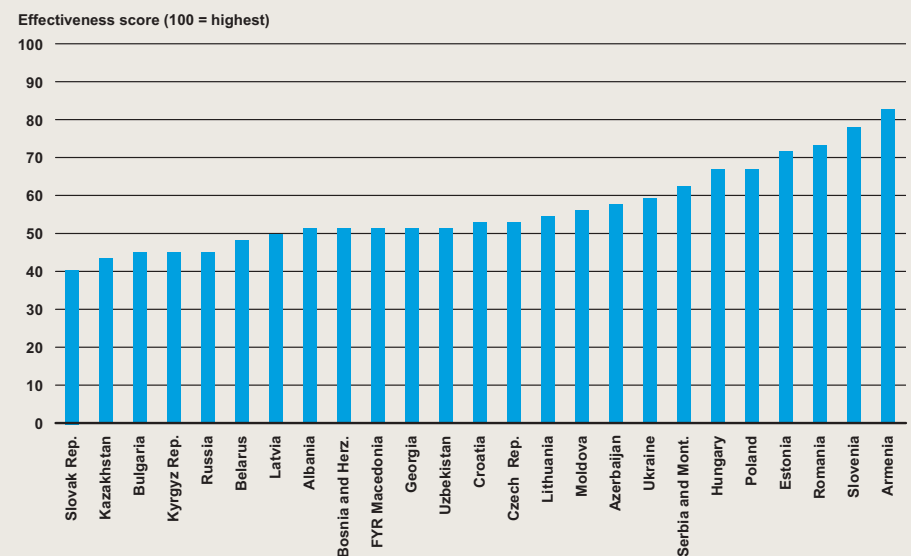
The case of Ukraine shows why the LIS should be read in conjunction with the sector assessment study. According to Ukraine’s procedural rules, if a creditor’s application complies with the prescribed statutory requirements, the judge is obligated to open the case even if the underlying debt is disputed by the debtor. The debtor is forced to argue the issue of the underlying debt at a later date, after insolvency proceedings may have begun. Thus, speedy access to the regime is granted but the regime itself is highly problematic. This can be contrasted with more advanced countries, such as the Slovak Republic, which have more sophisticated laws that may be difficult to implement properly.

### Debtor-initiated cases

Chart A.1.1.3 shows the scores for each country, split into the principal criteria of speed, efficiency and predictability/transparency in relation to the debtor-initiated process. Speed is rated “high” in 12 countries, including Armenia, Azerbaijan and Slovenia (showing a consistency with the speed criteria in the creditor-initiated case). In Poland the average time to complete the formality of an insolvency reorganisation process was estimated at less than four months, compared with Bulgaria where the equivalent time was over 12 months. Ten countries scored relatively highly in terms of efficiency but only two countries – Estonia and Slovenia – obtained a high score in predictability and transparency. Slovenia had the highest scores across the three criteria.

Chart A.1.1.2

#### Effectiveness of insolvency legal regimes in creditor-initiated insolvency cases

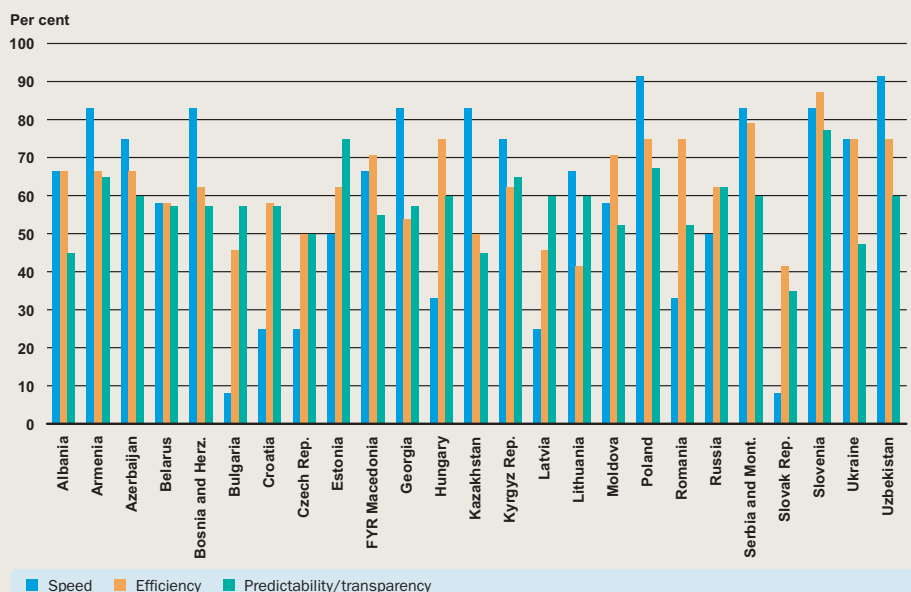


Source: EBRD Legal Indicator Survey, 2004.

Note: Speed, efficiency and predictability scores for each country were combined to provide an overall rating for effectiveness of the insolvency regime. Effectiveness is measured on an ordinal scale from 0 to 100. Data for Tajikistan and Turkmenistan were not available.

Chart A.1.1.3

#### Speed, efficiency, predictability/transparency of debtor-initiated insolvency cases



Source: EBRD Legal Indicator Survey, 2004.

Note: Survey respondents were asked a series of questions about the speed, efficiency and predictability/transparency of debtor-initiated proceedings. Scores are calculated as a percentage of the maximum score for these criteria. Data for Tajikistan and Turkmenistan were not available.

Chart A.1.1.4 shows the degree of overall effectiveness if a debtor is seeking the remedy of reorganisation or rehabilitation under insolvency law. The survey suggests, by comparison with the effectiveness of the remedy available to creditors, that in a clear majority of the countries the relevant process is relatively effective. Only in one country (the Slovak Republic) did it appear that it would be very difficult for a debtor to effectively invoke a rehabilitation process. This result probably represents

a simple neglect of insolvency as a critical area of commercial law reform. This neglect is in the process of being remedied, however, as the Slovak government, recognising the deficiencies in its insolvency legal regime, has drafted new insolvency legislation that has been submitted to parliament. The government has also indicated a desire to devote greater resources towards training judges and insolvency administrators in the new law in order to improve its effectiveness.



In other countries, such as Uzbekistan, access to the reorganisation regime is fairly easy but this needs to be read in the context of the substance of the law which is fairly weak.

### Comparison between cases

A comparison between the creditor-initiated and debtor-initiated cases shows that for speed and efficiency, a greater number of countries score higher in the latter case than the former, indicating that insolvency regimes tend to be more favourable to debtor-initiated processes.

If a debtor is or is likely to become insolvent, time becomes of the essence since the financial position of the debtor will inevitably become more acute and deteriorate over even a short period of time. The greater efficiency is consistent with the fact that debtor-initiated cases are normally voluntary and consensual processes. Creditor-initiated processes, by comparison, are more likely to be contentious. It is more difficult to explain why the predictability of reorganisation processes should be low in debtor-initiated processes compared with creditor-initiated insolvency remedies. That appears to be due to the substance of the law rather than its application. Another contributing factor may be inexperience and lack of commercial understanding of reorganisation processes.

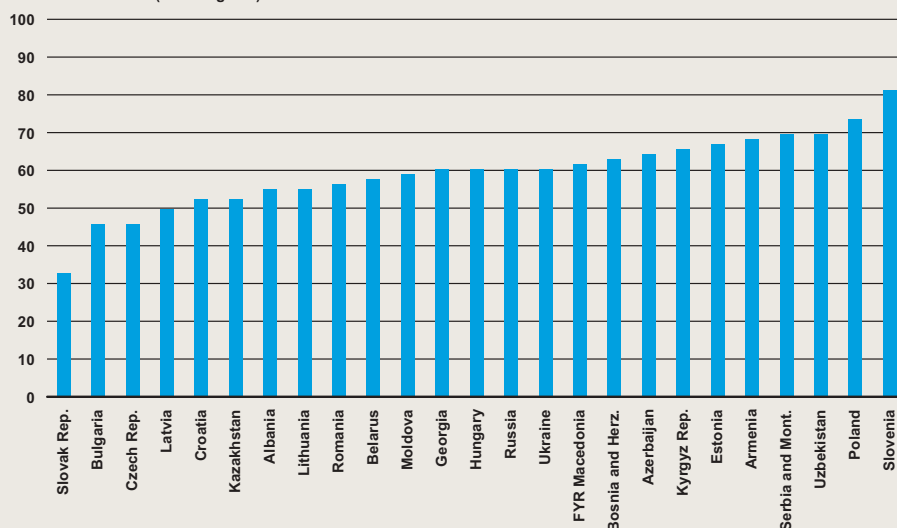
The survey results indicate that the application of insolvency laws in transition countries needs to be improved considerably to increase speed, efficiency and predictability/transparency. Most countries still do not have levels of speed that would be considered acceptable under international standards. The average ratings for efficiency are also low. There are clearly problems to be addressed regarding the burden of formalities, technicalities and costs in the relevant procedures. In the area of predictability/transparency, the scoring indicates a relatively low level of confidence in the majority of countries regarding the experience, competence, reliability and, in some instances, trustworthiness of the judiciary and office-holders.

A comparison of the overall effectiveness of the insolvency regime for creditors and debtors in terms of access to the law shows that for a large number of countries the regime provides more relief and remedies to an insolvent debtor than

Chart A.1.1.4

#### Effectiveness of insolvency legal regimes in debtor-initiated insolvency cases

Effectiveness score (100 = highest)



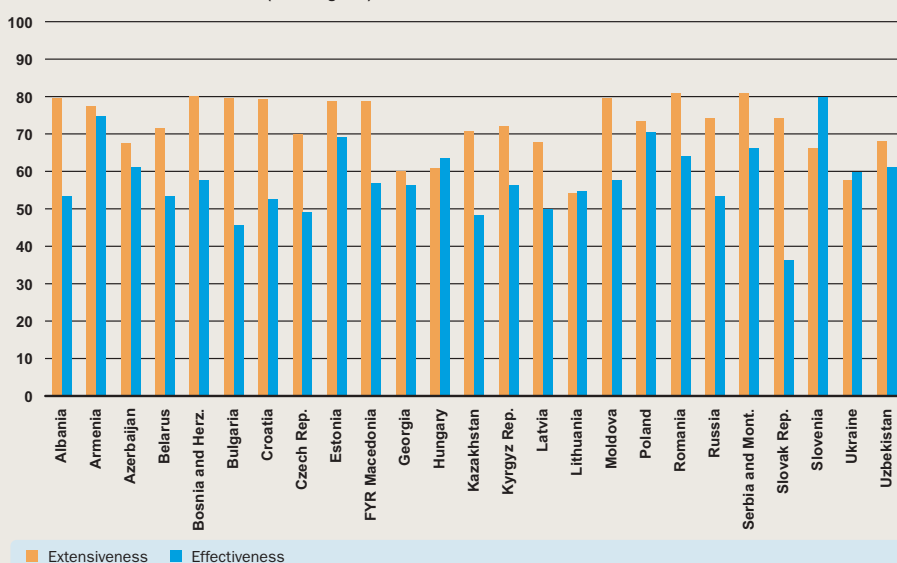
Source: EBRD Legal Indicator Survey, 2004.

Note: Speed, efficiency and predictability scores for each country were combined to provide an overall rating for effectiveness of the insolvency regime. Effectiveness is measured on an ordinal scale from 0 to 100. Data for Tajikistan and Turkmenistan were not available.

Chart A.1.1.5

#### Extensiveness and effectiveness of insolvency legal regimes

Extensiveness / effectiveness score (100 = highest)



Extensiveness Effectiveness

Sources: EBRD Insolvency Sector Assessment Survey, 2003-04 and EBRD Legal Indicator Survey, 2004.

Note: The extensiveness score is based on an expert assessment of the insolvency laws in each country. The effectiveness score refers to the findings of the Legal Indicator Survey. Speed, efficiency and predictability scores for each country were combined to provide an overall effectiveness rating. The extensiveness and effectiveness scores are measured on an ordinal scale from 0 to 100. Data for effectiveness for Tajikistan and Turkmenistan were not available.

to an aggrieved creditor. However, the survey does not purport to measure or assess the quantitative result of any such reorganisation or rehabilitation process. Still, the overall results show that the degree of effectiveness in both cases is not very high and that there is a need for considerable improvement in virtually every country before either procedure can be regarded as truly effective.

### Comparison with insolvency sector assessment

Chart A.1.1.5 shows a comparison of the assessments of the insolvency laws of each country with the results of the survey. The first observation worth noting is the high correlation between the scores obtained on the assessment and the scores obtained under the survey. This appears to demonstrate that the



extensiveness of the law will generally dictate the effectiveness of the application of that law. This is not true for all countries, however. In Bulgaria, for example, the courts appear simply to ignore legislative provisions mandating strict time limits.

Secondly, virtually all countries achieve a higher score on the assessment than on the survey. This suggests that while current laws in many countries are approaching international standards in many respects, legal institutions responsible for their implementation need further reform throughout the region. It also reflects the range of international institutions providing legislative assistance and the relative dearth of those providing help with implementation.

Recognising the importance of having good legislation, many countries may have concentrated resources (with varying degrees of success) on achieving this goal first. However, a highly effective insolvency regime requires much more than good laws and good procedures. In many cases, it is the product of a well-trained and honest judiciary, strong relationships between commercial actors and a healthy regulatory framework with highly qualified insolvency administrators. Simple transplantation of good laws from abroad will not necessarily give rise to an effective regime.

One almost universally consistent finding is that the countries with the best legislation also performed best in the survey – Armenia, Estonia and Poland in particular. Not surprisingly, these tend to be the countries that have identified insolvency law reform as a priority. Poland, for example, which has come under more general criticism for issues such as judicial competence, recently requested the EBRD's technical assistance with the training of its insolvency judges under a project completed in 2003.

## Conclusion

The results of the assessment and the survey suggest that the majority of transition countries have made considerable advances during the past few years in their insolvency law regimes. However, there remains a need for further improvements in the extensiveness and, more urgently, the application of those laws.

A serious concern was raised by the survey. The majority of contributing practitioners stated that it would not be practical to advise their clients (creditors or debtors) to use the insolvency or reorganisation procedures available under their respective laws. Furthermore, few practitioners saw the reorganisation procedures offered within the insolvency laws as a means of resolving the problems of a financially troubled company.

This was due in part to deficiencies in the speed, cost and integrity of the procedures offered. However, it also reflected the lack of effective sanctions against company directors who failed to take timely action to address potential problems.<sup>9</sup> As a result, reorganisation proceedings often were not started until it was too late to rescue the business. In addition, there has been an increase in informal “out-of-court” solutions, which have been devised to make up for deficiencies in formal bankruptcy and reorganisation procedures.

The survey confirms that training, education and institutional development are all necessary if speed, efficiency, predictability/transparency and the overall effectiveness of legal regimes are to improve.

## Endnotes

- <sup>1</sup> In 2003 the survey was introduced as the “New” Legal Indicator Survey (NLIS) in order to distinguish it from previous methodologies. The 2004 LIS uses the same methodology.
- <sup>2</sup> See R. La Porta *et al.* (2000) and A. Ramasastry (2000).
- <sup>3</sup> The assessment is based on laws in transition as at 31 January 2004.
- <sup>4</sup> These score sheets can be found on the EBRD’s web site at [www.ebrd.com/law](http://www.ebrd.com/law).
- <sup>5</sup> “DIP” or Debtor-In-Possession financing is the term generally used to describe funds made available, usually in the form of working capital, to debtors during a restructuring. This financing is usually accorded priority status.
- <sup>6</sup> These scenarios were chosen because terminal proceedings commenced by a debtor are rarely contested and reorganisation proceedings are, for obvious reasons, rarely started by a creditor against the wishes of an insolvent debtor.
- <sup>7</sup> Although questions were asked concerning appellate processes in the survey, the responses were either too general or unspecific to enable a conclusion to be drawn.
- <sup>8</sup> The complete results of the survey are available on the EBRD’s web site at [www.ebrd.com/law](http://www.ebrd.com/law). Results for Turkmenistan could not be used due to the survey respondent’s concern about lack of practical experience with insolvency cases in that country. The survey was not administered in Tajikistan because of the lack of participation by local law firms.
- <sup>9</sup> Consideration of such sanctions is outside the scope of the survey but the absence of provisions to deal with such malfeasance was addressed in the assessment.

## References

- R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. W. Vishny (2000), “Legal determinants of external finance”, *Journal of Finance*, Vol. 52, pp. 1,131–50.
- A. Ramasastry (2000), “Assessing insolvency laws after ten years of transition”, *Law in Transition* (spring 2000), EBRD.

# The macroeconomic environment for transition

## 2

Most transition countries enjoyed strong economic growth in 2003-04, reflecting the positive international trading environment and rising prices for commodity exporters. A rapid expansion in domestic credit in many countries has strengthened local banking and boosted consumption and investment, although it has also raised concerns about the quality of rapidly expanding loan portfolios. Continued growth has helped to improve government finances in some countries and to underpin reforms of fiscal rules and institutions. Net foreign direct investment (FDI) declined sharply in 2003 but should recover during 2004.

The accession of eight countries (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia) to the European Union on 1 May 2004 was an important milestone in the integration process of central eastern Europe and the Baltic states (CEB) with western Europe. In 2003, prior to accession, economic growth rates in the CEB countries averaged 3.8 per cent. This improved economic convergence with the EU as growth in the eurozone remained at 0.5 per cent.<sup>1</sup> In 2004 average CEB growth is expected to increase to 4.9 per cent, driven primarily by domestic demand but also, increasingly, by an expansion of exports.

In south-eastern Europe (SEE) political stability, although fragile in some cases, and the prospects of EU membership for Bulgaria, Croatia and Romania have underpinned economic growth. It is expected to rise to 5 per cent in 2004. Growth has also been stimulated by a credit-driven demand boom. Credit has expanded particularly fast in Bulgaria and Romania. Although the boom in these countries

did not have inflationary consequences in 2003, it did result in sharp increases in imports and current account deficits.

In the Commonwealth of Independent States (CIS) high commodity prices continue to underpin economic growth, which is forecast at 7.4 per cent for 2004. Substantial inflows of foreign currency due to the increase in commodity exports have been associated with loose monetary conditions in many parts of the CIS. Although inflationary pressures are subdued, the rapid growth in base money as well as bank credit carries the risk of higher inflation in the future. Current account developments have been mixed. Oil-exporting countries, such as Kazakhstan and Russia, continue to record current account surpluses. On the other hand, many oil-importing countries have seen their current account deficits rise further.

The remainder of this chapter looks at macroeconomic developments in 2003 and the first half of 2004 in more detail. It also examines progress with

the consolidation and institutional reform of public finances. This complements the analysis of the links between institutional reforms and growth in Chapter 1. The reform of institutions and rules through which fiscal policies are conducted has an important impact on growth of the private sector. Institutions that restrain or guide the future conduct of fiscal policy, and hence make sudden fiscal adjustments less likely, will lower the overall country risk and financing costs and hence support private capital formation. Moreover, the transparency and predictability of public expenditure over the medium term will allow the private sector to adjust its spending plans accordingly.

An annex to this chapter provides tables on a number of key macroeconomic indicators and includes forecasts from a variety of institutions for growth and inflation in 2004 and 2005 (see Annex 2.1).

## 2.1 Macroeconomic performance

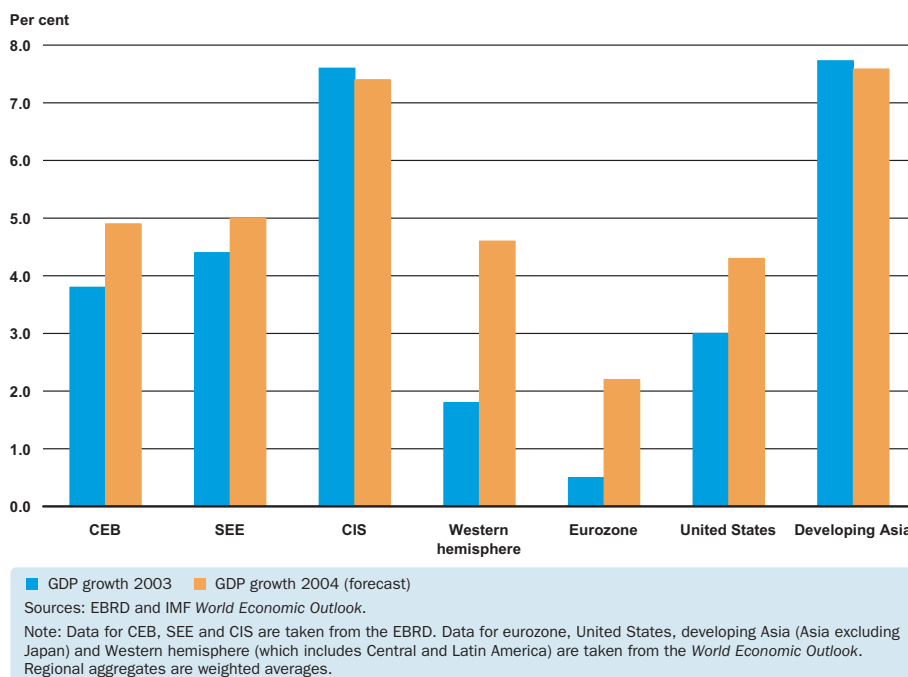
### Overall performance: Continuing strong growth despite a decline in net FDI

During 2003 and the first half of 2004 the transition economies made substantial economic progress. Real GDP grew on average by 5.6 per cent in 2003 and is expected to increase by 6.1 per cent in 2004. The region therefore remains on a path towards higher living standards and eventual convergence with the richer industrial nations (see Chart 2.1). In many instances economic growth has been accompanied by a rapid rise in domestic bank lending. This has stimulated the financial system and boosted investment and consumption. In 2003 total domestic credit increased by 21 per cent on average although there were wide regional variations (see Box 2.1).

In 2003 net inflows of FDI declined sharply to US\$ 19 billion from US\$ 30.3 billion in 2002 (see Chart 2.2). A number of CEB countries (Czech Republic, Hungary, Slovak Republic and Slovenia) attracted only small inflows. This reflects the drying up of major privatisation deals as a source of FDI in these advanced transition countries. Attracting greenfield investments has also become more difficult. Furthermore, several countries recorded substantial repayments of inter-company loans to foreign parents – which the official

Chart 2.1

### International comparison of growth, 2003–04



statistics record as negative inward FDI. Some countries – for example, Hungary and Slovenia – are increasingly investing abroad and therefore becoming important sources of FDI in their own right.

Russia's balance of payments recorded a substantial net FDI outflow in 2003. This reflected the investments by Russian oil companies and financial service providers in a number of CIS and CEB countries. It was also due to uncertainty in the investment climate following the Yukos affair (see Chapter 1), which also manifested itself in other private capital outflows.

Aggregate regional net FDI inflows in 2004 are forecast to return to previous levels if greenfield investments increase as expected. In Hungary and Poland FDI inflows were replaced by less stable portfolio inflows, which have increased their vulnerability to sudden reversals in capital flows.

Favourable economic conditions across the region have also led to a decline in general government budget deficits in some countries. Due in part to fiscal tightening, the rising economic growth in countries as diverse as Bulgaria, Estonia and Russia has not yet led to significant inflationary pressures. Average inflation declined from 8.3 per cent in 2002 to 6.6 per cent in 2003. It is projected to stabilise at around 6.9 per cent in 2004 (see Chart 2.3).

Domestic demand remains the most important driver of the high growth rates in the transition countries. However, a continuing upturn also depends on the further recovery of the world economy. In 2004 GDP growth is expected to reach 4.3 per cent in the United States, 2.2 per cent in the eurozone and 4.4 per cent in Japan.<sup>2</sup> There are substantial risks to the economic outlook in the medium term. In the United States large fiscal and current account deficits may, if uncorrected, lead to a sudden loss of confidence, pressure on the exchange rate and upward pressure on US interest rates. Given the dependence of the global upturn on the US economy, this would have adverse consequences for the transition economies.

Oil prices could also endanger economic prospects. The possibility of disruptions in the oil supply from Iraq and Russia, combined with the continuing high world oil demand (especially from China), has caused oil prices to spiral. This has fuelled levels of growth in oil-exporting countries and their trading partners that may not be sustainable at lower prices. A faltering recovery in the eurozone, which is the main export market for many transition countries, could also have negative effects although in recent years exports to the EU have proven quite resilient.

## Box 2.1

## Credit growth in transition economies

In recent years many transition countries have witnessed substantial increases in domestic bank lending. In 2003 total credit grew by an unweighted average of 24 per cent in CEB, 23 per cent in SEE and 19 per cent in the CIS. The chart below shows credit growth rates for 10 countries of the region since 2001.

In many countries this has resulted from institutional changes, such as the liberalisation of interest rates, the declining role of the state in directing credit, and the increased participation of foreign banks in domestic financial systems. Macroeconomic factors have also played a role – these include fiscal consolidation, low international interest rates and risk premiums, higher expected lifetime incomes in the region and an increasing money demand. This gradual strengthening of domestic financial systems is likely to support higher economic growth over the medium term.<sup>1</sup> Efficient banks attract additional savings and channel these to productive firms in need of external financing. This enhances the economy's growth potential.

However, other factors may pose risks over the medium term. As a number of recent crises have illustrated, excessive credit growth can lead to vulnerabilities in the financial sector with possible repercussions for public and corporate sector creditworthiness and exchange rate stability.<sup>2</sup> For example, more intense competition in the financial sector may prompt commercial banks to relax their loan evaluation standards or to take on excessive maturity or currency mismatches. Rising asset prices may improve the loan eligibility of firms and households, whose borrowing and spending in turn fuels asset valuations beyond realistic levels. Deposit insurance schemes (such as those introduced recently in Albania, Bosnia and Herzegovina, and Russia) need to be carefully designed to provide the appropriate incentives for private sector borrowers.

In times of rapid credit growth, financial regulators may not be able to adequately monitor credit quality, especially if there is a high number of competing banks. The credit boom in transition economies has not as yet put price stability at risk. However, excessive current account deficits make several countries vulnerable to possible external financial shocks. They also underline the importance of fiscal policy in counterbalancing cyclical factors. Furthermore, in countries where the credit booms have fuelled consumption rather than productive investment, households become more vulnerable.

The policy responses of transition countries experiencing rapid credit growth have varied widely. In the three Baltic states, risks still appear manageable. Their banking systems are owned predominantly by foreign banks that are financially strong and have in most cases upgraded the risk management systems of their subsidiaries. Indicators such as non-performing loan or capital adequacy ratios do not give cause for concern. Also, the supervisory agencies in the three countries have sufficient powers and resources according to recent IMF assessments. Central banks have employed "moral suasion" (methods that try to influence the market without mandating action)

to stem credit growth. However, efforts to put a brake on credit growth have proved difficult in the context of open capital accounts and ample credit lines from foreign parent banks.

In a number of SEE countries the authorities have responded more aggressively. In Bulgaria and Romania, financial stability indicators do not give cause for concern. However, a recent IMF sector assessment found that the rapid increase in consumer lending in Romania may have eroded the quality of credit-screening procedures.<sup>3</sup> The authorities have therefore employed monetary policy instruments, including reserve requirements, and also tightened the eligibility criteria for consumer and mortgage loans. Croatia has also imposed several administrative measures, including setting ceilings on bank credit.

In the CIS the initial response to credit growth has focused on supervisory standards, including legal and regulatory frameworks. However, sub-standard accounting and corporate governance standards make screening and monitoring more difficult for banks. Negative real interest rates in several countries, including Russia, have boosted credit demand and have increased the likelihood of banks financing projects with low, or even negative, net present values. State-directed lending in Belarus and Uzbekistan and limited credit portfolio diversification throughout the CIS have further contributed to concerns about credit quality.

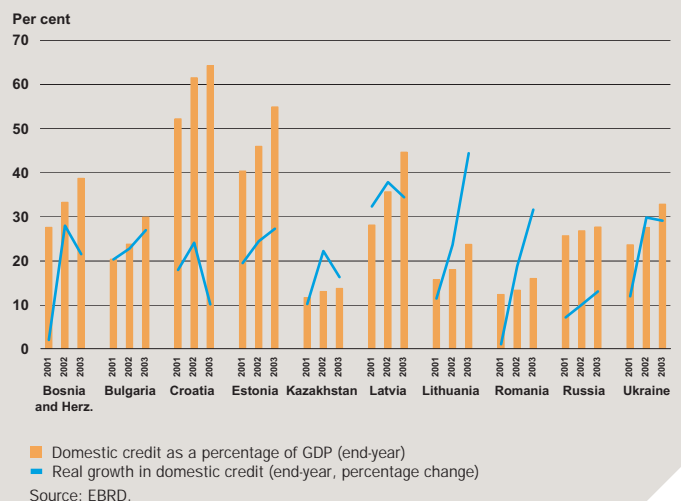
Source: EBRD.

<sup>1</sup> See Levine *et al.* (2000).

<sup>2</sup> See IMF *World Economic Outlook*.

<sup>3</sup> See IMF (2004b).

## Credit growth rates in selected countries, 2001–03



## CEB: Growth accelerates but so does inflation

The first half of 2004 was marked by two significant steps in European integration. As mentioned previously, the eight CEB countries (together with Cyprus and Malta) joined the EU. Accession subjects the new EU members to the budgetary requirements of the Stability and Growth Pact (SGP). However, the Czech Republic, Hungary, Poland and the Slovak Republic (which have excessive deficits) are being allowed a longer period to adjust to the 3 per cent deficit norm.<sup>3</sup> The new member states will also be integrated into the EU's medium-term economic policy coordination

framework, through which they receive country-specific recommendations from the European Commission on issues such as structural imbalances and competitiveness.

A second milestone was the accession of Estonia, Lithuania and Slovenia to the European Exchange Rate Mechanism II (ERM II) in June 2004 (a necessary step towards adoption of the euro). Other accession countries have delayed entry to ERM II as they need more time to reduce budget deficits and inflation. Estonia and Lithuania were allowed to enter ERM II with their currency boards in place. Given the already tight constraints that the currency

boards place on macroeconomic policy, ERM II membership will not lead to much additional loss of economic policy discretion. However, the pegging of the Slovenian tolar within ERM II will restrain Slovenia's exchange rate policy, which has sought to stabilise the real exchange rate through a gradual nominal depreciation.

Real GDP growth in CEB in 2003–04 has been stimulated by continuing high domestic demand and an improving international business climate. The Baltic states, with relatively low per capita GDP levels and a longer remaining path for convergence with other EU members, again outpaced the other countries in the region.



Lithuania increased output by as much as 9 per cent in 2003. In the final quarter of 2003 and the first half of 2004, growth in many other CEB countries also started to accelerate. The Polish economy grew by 6.3 per cent year-on-year during the first half of 2004. Growth of the Hungarian economy also accelerated due to higher investments and export recovery.

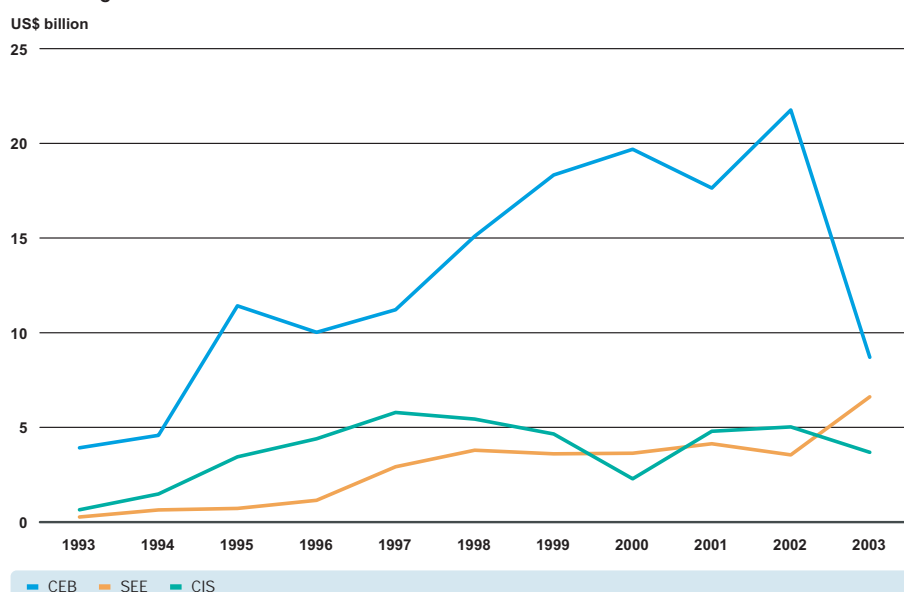
The increase in growth in 2003 was accompanied by a small decline in average inflation. However, EU accession has led in many countries to one-off price increases in the first half of 2004. This has been mainly due to alignments in the excise tax on fuel and alcohol. Average inflation was 2.9 per cent in 2003 but is expected to rise to 4.5 per cent in 2004. Consumer price rises are likely to be higher in all CEB countries except the Slovak Republic and Slovenia. Although this increase in inflation partly reflects the temporary effects of accession, it is not clear what impact other factors (wage indexation, for instance) will have in the future. During the first half of 2004, increased price pressures led to interest rate increases by the central banks of the Czech Republic, Latvia and Poland. They were the first increases for several years in these countries. In the Slovak Republic, however, the central bank cut its repo rate in January 2004, despite significant inflationary pressures, in order to limit the appreciation of the koruna.

The average fiscal deficit remained at 3.6 per cent of GDP in 2003 (about the same level as in 2002). A 0.4 percentage point improvement is expected in 2004. However, fiscal deficits in the Czech Republic, Hungary and Poland are forecast to remain substantial, necessitating further fiscal consolidation. Such consolidation will require strong political will. The best fiscal performers are Estonia, Lithuania and Slovenia (the ERM II members), as well as Latvia, which have all recorded budget deficits under the EU's limit of 3 per cent of GDP.

The average current account deficit in CEB increased slightly to 5.8 per cent of GDP in 2003 and is forecast to remain at that level in 2004 (see Chart 2.4). Deficits are especially high in the Baltic states. High investment and consumption levels, fuelled by a booming credit market (particularly for consumer finance), has led to further increases in imports. Due to a still substantial fiscal imbalance, and a further real appreciation, Hungary's current

Chart 2.2

### Net foreign direct investment flows, 1993–2003

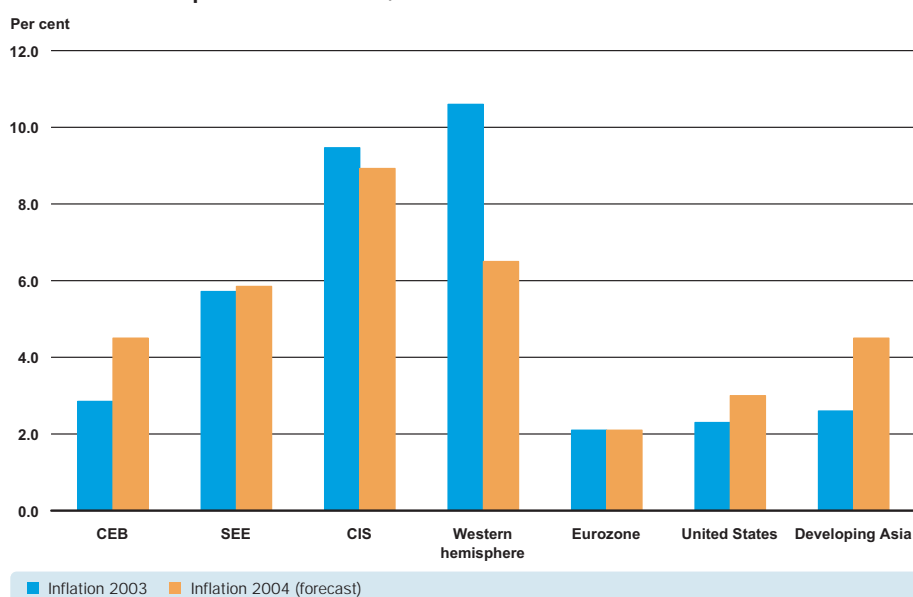


Sources: Central banks, IMF and EBRD estimates.

Note: For most countries, data cover investment in equity capital and contributions in kind. For those countries where investment into equity capital was not easily available (Azerbaijan, Estonia, Kazakhstan and the Slovak Republic), data include reinvested earnings and inter-company debt transactions. Gross inflows of FDI are in some cases considerably higher than net inflows due to increasing intra-regional investment.

Chart 2.3

### International comparison of inflation, 2003–04



Sources: EBRD and IMF *World Economic Outlook*.

Note: Data for CEB, SEE and CIS are taken from the EBRD. Data for eurozone, United States, developing Asia (Asia excluding Japan) and Western hemisphere (which includes Central and Latin America) are taken from the *World Economic Outlook*.

account deficit is expected to reach about 8.6 per cent of GDP this year. By contrast, the Slovak Republic has curbed its consistently high current account deficit through a strong expansion of exports – mainly of motor cars. This has resulted in a deficit of only 0.9 per cent of GDP in 2003.

The substantial cumulative stocks of FDI in the region and their relatively high profitability have led to sizeable deficits in

the income balance of a number of countries. Income deficits make up an increasingly large part of the current account deficits in a number of CEB countries. Chart 2.5 shows that in the Czech Republic and Hungary deficits in the income balance in 2000–03 – primarily caused by FDI income – amounted to more than two-thirds of the current account deficits. At the moment, foreign direct investors appear to reinvest most of their

profits. Nevertheless, a deterioration in the business environment or greater competition from alternative investment locations could lead to larger income repatriations in future years.

### SEE: Continuing growth on the back of political stability

The prospect of EU accession for Bulgaria, Romania and (since June 2004) Croatia continues to support the SEE economic outlook. Average real GDP growth amounted to 4.4 per cent in 2003 and is expected to rise to 5 per cent in 2004. Growth in Albania and Romania has been particularly strong. Only FYR Macedonia is lagging behind in this region, which is partly due to persistently low per capita net FDI inflows.

Average inflation declined to 5.7 per cent in 2003 but is expected to increase again to 5.9 per cent in 2004. This increase mainly stems from an acceleration in the rate in Bulgaria from 2.3 per cent in 2003 to an estimated 6 per cent in 2004. This is largely due to one-off price increases in excise taxes and energy prices, and inflation should ease in 2005. Throughout the region rapid real GDP growth has been associated with the expansion in bank lending, leading to higher consumption levels (see Box 2.1). This has prompted the introduction of tighter regulations on bank lending in SEE countries and, in the case of Romania, a tightening of monetary policy in the second half of 2003.

General government deficits came down in 2003, reaching an average of 2.8 per cent of GDP. They are expected to be only marginally lower in 2004. Albania, Croatia, and Serbia and Montenegro are the only countries with general government fiscal deficits above 3 per cent of GDP. In contrast, FYR Macedonia adopted a significant fiscal consolidation in 2003, leading to a budget deficit of 1.6 per cent of GDP. This should be further reduced to 1.5 per cent of GDP in 2004. Bulgaria reached an almost balanced budget in response to increasing external imbalances.

Current account deficits have remained high, averaging 8.8 per cent of GDP in 2003 and are likely to remain virtually unchanged in 2004. In Bulgaria the current account deficit is expected to stay above 8 per cent of GDP (the level reached in 2003) due to the credit-fuelled consumption boom. In contrast to

Chart 2.4

#### International comparison of current account balances, 2003–04

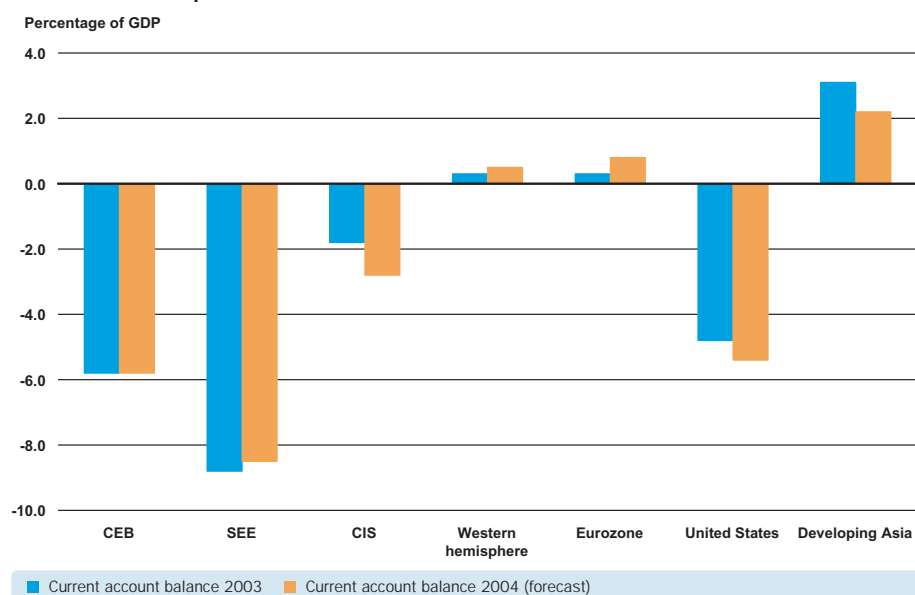
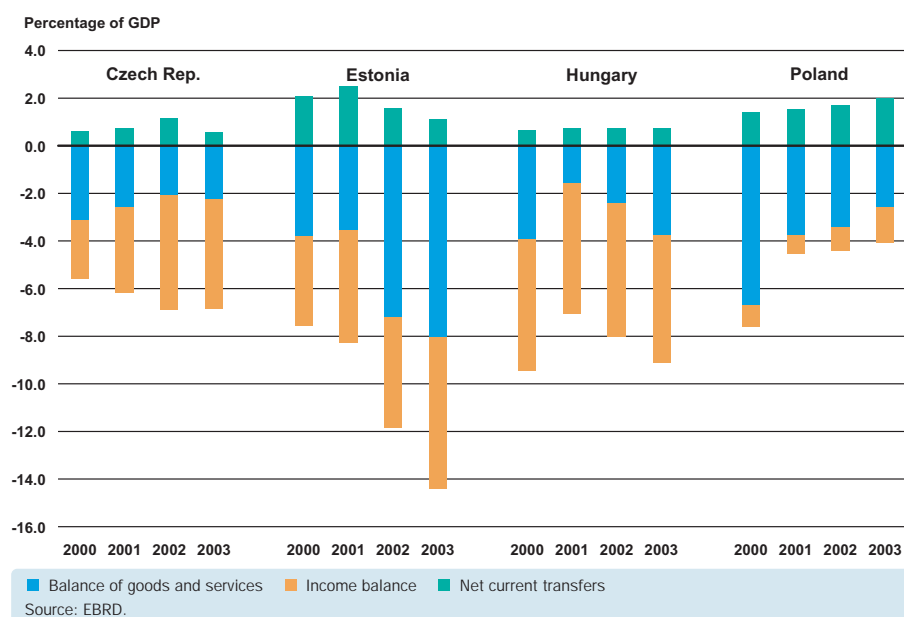


Chart 2.5

#### Components of the current account in selected countries, 2000–03



the situation in CEB, net FDI inflows into SEE increased by 86 per cent in 2003 to US\$ 6.6 billion. Net inflows for 2004 are expected to be of a similar magnitude. FDI has mainly been generated by large privatisation deals.

The increase in net FDI inflows – and the simultaneous decrease of flows into CEB – also partly results from European investors relocating business activities to SEE. The aim has been to take advantage of lower unit labour costs and taxation levels than those in some of the CEB countries.

In 2003 the average cumulative FDI stock per capita, however, amounted to only US\$ 664 in SEE compared with US\$ 2,112 in CEB. In addition to FDI inflows, grants and loans from international financial institutions and other countries, as well as remittances from workers living abroad, remain important sources of foreign funding. Countries such as Albania, Bosnia and Herzegovina, FYR Macedonia and Serbia and Montenegro rely heavily on such finance.

## CIS: Continuing dependence on high commodity prices

Growth in the CIS is expected to reach 7.4 per cent in 2004, only slightly below the figure for 2003. It has been particularly strong in Azerbaijan, Kazakhstan and Ukraine. Russia's strong economic performance has also had a positive knock-on effect on its CIS neighbours. Uzbekistan's development, however, continues to lag behind, pointing to the urgent need for further reforms, especially of the trade regime.

Many CIS countries have benefited from high world commodity prices, particularly for oil and gas, metals and agricultural products. These include Azerbaijan, Kazakhstan, Russia and Turkmenistan for oil and gas, Ukraine for steel, the Kyrgyz Republic and Uzbekistan for gold, Tajikistan for aluminium, Kazakhstan for wheat, and Tajikistan, Turkmenistan and Uzbekistan for cotton. High commodity prices have also had positive indirect effects on other economic sectors, such as services and construction.

Chapter 1 provides evidence of the significant influence that oil price movements have on economic growth in the CIS. Nevertheless, macroeconomic stability and growth in many CIS countries remain dependent on a continuation of high commodity prices. For this reason there is a need for structural diversification in the medium term. Such diversification, however, depends crucially on further progress to strengthen the business environment and improve access to export markets.

High inflows of foreign currency from booming commodity exports have led many central banks in the region to intervene in the foreign exchange markets to prevent their respective currencies from appreciating too rapidly. This has been linked to increases in foreign exchange reserves. The resulting increase in base money has in most cases not been fully sterilised – that is, the monetary effects of the transaction were not offset – as inflationary pressures generally remained subdued and sterilisation was perceived as either expensive or ineffective.

The increased liquidity in the banking system – together with strong growth and increasing confidence – has led to a sharp credit expansion. This averaged about 19 per cent for the CIS as a whole in 2003 and is forecast to reach the same level in 2004. The rapid credit increase has

fuelled both consumption and investment. However, in countries with less open trade regimes – such as Azerbaijan and Belarus – this credit growth could aggravate inflationary pressures or slow down the disinflation process (see also Box 2.1). Inflation in the CIS in 2003 ranged from 3.1 per cent in the Kyrgyz Republic to 28.5 per cent in Belarus. The average CIS rate is expected to fall in 2004 to around 9 per cent.

Fiscal policies have remained tight in almost all CIS countries. Only the Kyrgyz Republic showed a continuing high general government deficit (of 5 per cent of GDP) in 2003. Most countries are at, or close to, fiscal balance and are expected to remain so in the short term. Countries operating resource revenue stabilisation funds saw these absorb significant amounts of liquidity in 2003. During 2003 the Azerbaijan State Oil Fund increased from US\$ 0.7 billion to US\$ 0.8 billion (11.5 per cent of GDP). In Kazakhstan the National Fund increased in the same year from US\$ 1.9 billion to US\$ 3.6 billion (12 per cent of GDP). Russia introduced a stabilisation fund at the beginning of 2004, which held US\$ 9.2 billion (1.7 per cent of GDP) by July.

Current account deficits in the CIS increased in 2003 to an average of around 1.8 per cent of GDP. A further increase to 2.8 per cent of GDP is expected in 2004. In Azerbaijan the high 2003 current account deficit of 27.4 per cent of GDP is expected to increase in 2004 to 35.8 per cent of GDP. This is due in part to capital imports related to the substantial investments in the oil and gas sectors.

In contrast, Russia continued to show a large current account surplus of 8.3 per cent of GDP in 2003 on the back of rising oil exports. However, its high current account surplus also reflects the weaknesses in the Russian investment climate and limited domestic investment opportunities. Growing oil-related exports have also contributed to a projected current account surplus in Kazakhstan for 2004. In Ukraine, meanwhile, the current account surplus is expected to increase further in 2004 because of substantial exports of steel and machinery.

The Russian economy continues to benefit from high oil prices. Nevertheless, the increase in real GDP growth to 7.3 per cent in 2003 and to 7.4 per cent in the first half of 2004 has also been the result of sound macroeconomic policies.

Growth is expected to slow from 2005 due to microeconomic and institutional inefficiencies, capacity constraints in the oil sector and the effects of the real appreciation of the rouble.

Although concerns about aspects of Russia's private banking system in July 2004 were quickly contained, public confidence in private banks has declined. The risk of renewed banking instability could be reduced by further improvements in supervision. Further consolidation would decrease the number of undercapitalised Russian banks and allow supervisors to focus on the stronger ones that remain.

Moreover, the case against the oil company Yukos has heightened uncertainty in the business community. It has already caused substantial volatility in the financial markets, prompted capital outflows and may have a negative effect on inward investment. The impact of recent terrorist outrages on foreign and domestic investor confidence is another concern. Future growth is not only dependent on the continuation of sound macroeconomic policies but also requires greater transparency in business interactions in both the public and private sectors.

## 2.2 Fiscal consolidation and public expenditure rules

In several transition countries strong growth over recent years has contributed to a further fiscal consolidation. By contrast, several large CEB countries have failed to bring their fiscal positions under control. Also, in the early transition countries there are continuing intractable weaknesses, particularly relating to large external debt burdens. While investors may be encouraged where fiscal consolidation has been achieved, two questions remain. First, it is unclear to what extent it reflects an improvement in the underlying structural balance rather than the effects of cyclical factors. Secondly, there is a need to anticipate the response of fiscal policy to the next cyclical downturn. While fiscal prudence is ultimately a reflection of domestic political consensus, the reforms of fiscal rules and institutions that govern fiscal policy may further safeguard fiscal stability.

Table 2.1 provides a number of key fiscal variables in 1998 and 2003. In the SEE and CIS countries (but not in CEB) average fiscal deficits declined markedly.

Table 2.1

**Fiscal indicators (percentage of GDP)**

	Total revenue of the general government		Balance of the general government		Gross total government debt	
	1998	2003	1998	2003	1998	2003
<b>CEB</b>	38.2	37.5	-3.2	-3.6	24.9	31.6
Czech Republic	36.1	38.5	-4.2	-13.0	13.2	37.1
Estonia	37.7	38.5	-0.4	3.1	6.0	5.8
Hungary	44.2	39.5	-8.0	-6.1	61.9	57.3
Latvia	39.5	33.7	-0.7	-1.6	10.6	15.6
Lithuania	31.6	28.2	-3.0	-1.7	16.5	21.9
Poland	39.5	37.9	-2.3	-4.2	39.9	43.1
Slovak Republic	36.8	37.4	-5.0	-3.6	28.6	42.8
Slovenia	40.3	46.2	-2.2	-2.0	22.2	29.3
<b>SEE</b>	na	36.6	na	-2.8	na	35.0
Albania	22.5	22.0	-12.0	-4.5	75.9	56.8
Bosnia and Herzegovina	56.7	46.7	-5.2	-0.2	na	86.3
Bulgaria	38.0	37.9	1.0	-0.4	95.6	47.1
Croatia	45.6	44.2	-1.0	-6.3	38.8	57.5
FYR Macedonia	33.3	33.1	-1.7	-1.6	52.0	47.1
Romania	27.9	30.0	-5.0	-2.4	27.6	27.0
Serbia and Montenegro	na	42.6	na	-4.2	na	79.6
<b>CIS</b>	25.7	28.0	-5.0	-1.2	49.9	41.9
Armenia	20.7	17.8	-4.9	-1.1	41.6	38.0
Azerbaijan	19.6	27.7	-3.9	-2.3	14.9	24.5
Belarus	44.4	44.7	-1.0	-1.4	11.5	10.5
Georgia	13.7	16.4	-5.4	-2.9	58.2	62.0
Kazakhstan	18.0	23.0	-8.0	-1.0	22.4	15.5
Kyrgyz Republic	24.4	22.2	-9.5	-5.0	110.7	102.6
Moldova	33.1	30.4	-6.5	0.1	95.5	62.2
Russia	34.3	36.6	-8.2	1.1	81.9	32.4
Tajikistan	11.2	17.2	-3.8	0.9	62.2	64.8
Turkmenistan	22.0	24.5	-2.6	-1.8	na	na
Ukraine	35.6	36.7	-2.8	-0.7	37.6	29.3
Uzbekistan	31.1	39.3	-3.3	-0.6	12.7	19.1

Source: EBRD.

Note: Due to the adoption of ESA95 methodology, data for 1998 are not directly comparable with those in 2003 in several CEB countries.

While there has been a slight erosion of total revenue to GDP ratios in CEB and SEE, most CIS countries actually increased their revenues. This consolidation reflects cyclical factors and, in some countries, an improvement in the structural deficit. Russia, for instance, implemented wide-ranging tax reforms, with a reduction of statutory rates and the elimination of numerous exemptions.

A recent study of fiscal reforms in CIS countries noted that some statutory tax rates were about the same as, or lower than, those in the advanced transition countries. In addition, these were about the same for corporate taxes and VAT, and lower in the case of payroll and personal income taxes.<sup>4</sup> However, tax revenue from all sources (except corporate taxation) has fallen. This is indicative of continuing problems with tax administration and enforcement.

The CIS countries have also undertaken important adjustments in public expenditure. These measures have brought expenditure levels closer to those in other countries with similar income levels. Policy now focuses on a reduction in quasi-fiscal activities (the deficits in state-owned enterprises) and a reallocation and higher efficiency of public expenditure.<sup>5</sup> Several early transition countries still face unsustainable public debt levels, given their current primary budget balance and prospective aid flows. However, reforms of their tax systems may help them to correct this. In several CEB countries the failure to stabilise public debt levels will endanger the publicly stated ambition of meeting the criteria for accession to the eurozone.

In spite of any initial adverse effect on aggregate demand, fiscal consolidation will ultimately support growth. It will result in a lowering of the costs of funds once the

public borrowing requirements decline. It will also help raise productivity where public sector efficiency is low and resources will be transferred into more productive private sector employment. A number of studies have demonstrated that this spur to growth will be stronger if the fiscal consolidation is sustainable, and the private sector does not expect taxes or borrowing costs to rise in the future.<sup>6</sup>

### Objectives of fiscal reform

Several transition countries have addressed the challenge of medium-term fiscal sustainability by reforming the rules governing fiscal policy. Such rules, in particular relating to the overall fiscal balance, public expenditure and public sector debt, are an important factor in determining private sector expectations and investment and hence may support transition more broadly.

Making present and future public sector borrowing requirements more predictable is desirable because of the link between macroeconomic uncertainty and private investment. Transition economies are subject to a wide range of sudden changes in the global economic environment – for instance, international commodity price movements, export market developments and volatile financial markets. Uncertainty has also often been caused by domestic macroeconomic policy – for example, a failure to adjust the fiscal stance in response to a changing macroeconomic environment or to deal credibly with a large level of public debt. Uncertainty about the fiscal policy stance over the medium term will translate into uncertainty over the marginal tax rate and variables such as the real interest rate, the real exchange rate or growth in domestic sales.

Macroeconomic uncertainty, along with regulatory risks, will depress investment because investors will delay making decisions until uncertainty has resolved itself.<sup>7</sup> It may also divert investment towards sectors that are less capital intensive or less exposed to risk. Small and undiversified enterprises or new market entrants are likely to be particularly exposed to macroeconomic uncertainty. Foreign investors are likely to delay their market entry or target other markets. Domestic investors may do the same, leading to capital flight. Some of the infrastructure investments examined in later parts of this Report have a large sunk cost component, such as assets



## Box 2.2

## Macroeconomic uncertainty and private investment in transition countries

Despite the impressive stabilisation and growth performance in the region since the turmoil of the early transition years, macroeconomic uncertainty remains relatively high in many transition countries. Macroeconomic risk can be measured in three ways: by monitoring variations in inflation, the real exchange rate or growth rates; through forward-looking ratings compiled by commercial providers; and through surveys such as the EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS), which indicate the extent to which macroeconomic instability impedes enterprise growth. The three sets of ratings show relatively strong parallels. A number of countries, including Belarus, Moldova and Turkmenistan, are in the riskiest category in terms of forward-looking ratings and the BEEPS responses.

Others, such as the Kyrgyz Republic and Tajikistan, are assessed as very risky only according to the forward-looking measure.

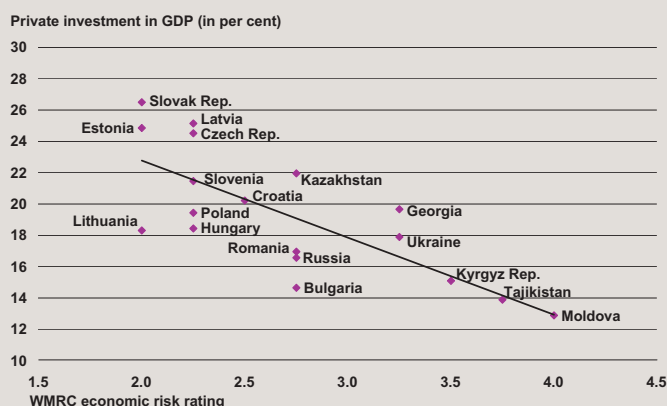
The measurement of gross private capital formation in developing and transition countries is generally poor. Empirical studies therefore often use the difference between total gross capital formation and gross public investment, even though the latter is itself an estimate. As macroeconomic risk is linked to poor budget management systems and large extra-budgetary accounts, the estimates below are likely to understate the true relationship between risk and private investment.

Average private investment rates over a three-year period in 18 transition countries show a negative link with all the above measures of macroeconomic risk. The chart right illustrates this relationship for the forward-looking economic risk rating. A simple model of investment would suggest that lagged growth rates together with a number of control variables should also be included. This would normally include the depth of local financial markets to account for borrowing costs and public investment levels which may pick up any overlap between public and private capital formation.

However, none of these three variables was found to be significant in this cross country regression, and only macroeconomic risk exhibits the expected negative effect.

Source: EBRD.

## Country risk and private investment in selected countries



Source: EBRD staff calculations, based on risk ratings provided by World Markets Research Centre (WMRC).

Note: The WMRC economic risk rating is based on a scale of 1 to 5, with 1 being the lowest risk and 5 being the highest risk.

that cannot be used for other purposes, and will be exposed to domestic macroeconomic risk. Box 2.2 describes the effect of macroeconomic risk on private investment in transition countries.

In addition to safeguarding fiscal sustainability, another objective of fiscal reform has been improvement in the governance of public finances. This tends to be linked to progress in the adoption of a more open and democratic political system generally. Standards among transition countries vary widely on aspects such as participation in budget formulation by official and non-governmental entities, transparency of budget execution, and public accountability of spending authorities.

Countries throughout the region have found that their fiscal policy objectives would be served more efficiently through reforms of public expenditure management. The publication of budget data allows markets to monitor the current and future fiscal policy stance, and will expose unsustainable policies. Given the possibly stronger incentives to maintain lax fiscal policies in the absence of public scrutiny, fiscal transparency may well be a precondition for medium-term sustainability of public finances.<sup>8</sup> Furthermore, transparency and predictability of public expenditure will guide private sector

production and investment decisions and may help coordinate capital spending between the public and private sector. Transparency and predictability of public expenditure are particularly important in the infrastructure sector, in which the public sector still accounts for the largest share of capital spending in transition countries.

As Table 2.2 shows, the extent to which budgets in transition countries are governed by rules and guidelines differs widely. Reforms implemented to date can be grouped into three categories: binding or statutory rules; informal guidelines for public expenditure management; and other measures enhancing fiscal transparency.

## Statutory constraints on expenditure policy

Following the deterioration in their public finances, many industrialised and developing countries have adopted fiscal policy rules.<sup>9</sup> These rules normally set a target for a fiscal variable that is under the direct control of policy-makers, such as the public sector deficit or public debt. They may also prohibit certain sources of public sector funding. They are enforced permanently, on a statutory or perhaps constitutional basis. Infringing them invites judicial sanctions and the associated loss

of credibility with the general public and with financial markets. Such rules help to overcome the “time-inconsistency” problem of fiscal policy whereby public sector agencies cannot commit credibly to a future policy in the face of strong incentives to behave opportunistically, and private sector expectations about future policy will therefore discount any such commitment.

Table 2.2 shows that 17 out of 27 countries have prohibited financing of the public deficit through the central bank – potentially a highly destabilising financing option. Others have also imposed limits in this respect. In several countries, including Turkmenistan, the division between monetary and fiscal means of financing the deficit remains unclear.

Poland is the only transition country to have implemented a debt and deficit rule enforceable under the constitution. The constitution states that the public debt must not exceed 60 per cent of the country’s GDP. The Public Finance Act also stipulates two lower thresholds that will trigger a tightening of the fiscal stance. In May 2004 the Finance Ministry announced that public debt had reached the first such threshold in 2003. As a result, the ratio of budget deficit to budget revenues in 2005 will need to be lower than in 2004.<sup>10</sup>



Table 2.2

**Fiscal rules and institutions**

	Fiscal policy rules <sup>1</sup>	Other medium-term constraints	Central Bank borrowing ruled out?	Other restraints on public borrowing <sup>1</sup>	Published public debt management strategy	Medium-term expenditure framework	Fiscal transparency assessment (latest)
<b>CEB<sup>2</sup></b>							
Czech Republic	-	-	Yes	-	Yes	Yes	Aug 2004
Estonia	ERM II	-	Yes	Yes	Yes	Yes	Jul 2002
Hungary	-	-	Yes	-	Yes	Yes	May 2004
Latvia	-	-	Yes	Yes	Yes	Yes	Mar 2001
Lithuania	ERM II	-	Yes	Yes	Yes	Yes	Nov 2002
Poland	Debt and deficit	-	Yes	-	Yes	Yes	Jul 2004
Slovak Republic	-	-	Yes	-	Yes	Yes	Aug 2003
Slovenia	ERM II	-	Yes	-	Yes	Yes	Jun 2002
<b>SEE</b>							
Albania	-	-	Yes	Yes <sup>3</sup>	-	Yes	Jul 2003
Bulgaria	-	-	Yes	-	Yes	Yes	Mar 2001
Bosnia and Herzegovina	-	-	Yes	Yes <sup>3</sup>	-	Yes	-
Croatia	-	-	Yes	-	Yes	-	-
FYR Macedonia	-	-	Yes	Yes <sup>3</sup>	-	-	-
Romania	-	-	Yes	-	-	Yes	Nov 2002
Serbia and Montenegro	-	-	-	Yes <sup>3</sup>	-	-	-
<b>CIS</b>							
Armenia	-	-	Yes	Yes <sup>3</sup>	-	Yes	Mar 2002
Azerbaijan	-	Stabilisation Fund	-	Yes <sup>3</sup>	-	Yes	Nov 2000
Belarus	-	-	-	-	-	-	-
Georgia	-	-	-	Yes <sup>3</sup>	-	-	Oct 2003
Kazakhstan	-	Stabilisation Fund	Yes	-	-	-	Apr 2003
Kyrgyz Republic	-	-	-	Yes <sup>3</sup>	-	-	Mar 2002
Moldova	-	-	-	Yes <sup>3</sup>	-	Yes	-
Russia	-	Stabilisation Fund	-	-	Yes	Yes	Aug 2004
Tajikistan	-	-	-	Yes <sup>3</sup>	-	Yes	-
Turkmenistan	-	-	-	-	-	-	-
Ukraine	-	-	Yes	-	-	-	Aug 2004
Uzbekistan	-	-	-	-	-	-	-

Source: EBRD.

Note: ERM II signifies participation in the European Exchange Rate Mechanism II; "-" means no.

<sup>1</sup> Rules that have statutory and permanent character, applicable to current and future budgets.<sup>2</sup> All new EU members are subject to the requirements of the Stability and Growth Pact with regard to fiscal deficits.<sup>3</sup> Active or recent coverage through IMF programmes, with limits on non-concessional external borrowing.

Clearly, the effectiveness of fiscal policy rules depends on the institutions tasked with enforcing them. Weak judicial systems or parliamentary control in many transition countries are likely to render strict fiscal rules ineffective. As the Polish budget management system further illustrates, the effectiveness of fiscal policy rules also depends on a medium-term budget framework that facilitates timely policy adjustment and on clear accounting standards.

All new EU members are subject to the EU Stability and Growth Pact. This stipulates a limit on the consolidated government deficit of 3 per cent of GDP (barring exceptional circumstances, such as deep recessions). This deficit target (which is under review) is likely to be a significant constraint on expenditure

in future years. Compliance will be evaluated by the European Council before any decision on admission to the eurozone. The requirements regarding convergence of interest rates and inflation, and exchange rate stability (for two years preceding entry), may be straightforward. However, compliance with the limits on the fiscal deficit (below 3 per cent of GDP) and debt (below 60 per cent of GDP) may pose problems.

In the three ERM II members (Estonia, Lithuania and Slovenia), public sector debt and deficits are at manageable levels and financial markets anticipate their accession to the eurozone in 2007 (see Table 2.1). Latvia could join soon afterwards. However, in the Czech Republic, Hungary, Poland and, to some extent, the Slovak Republic fiscal deficits above the 3 per cent ceiling (coupled with

high debt stocks) suggest that considerable fiscal adjustment will soon be required. Restraining the fiscal balance within the limit will become more difficult as expenditure related to the co-financing requirements of EU structural funds increases. Given the already high levels of taxation, further revenue-raising measures may run into enforcement problems and aggravate price distortions that impede private sector growth. Expenditure cuts will therefore be necessary.

Natural resource funds, such as those established in Azerbaijan, Kazakhstan and Russia, can also play a stabilising role comparable to that of a fiscal policy rule. All three funds aim to stabilise fiscal revenues around a baseline oil price, avoiding the cyclical fiscal expenditure and inflationary developments common to many resource-rich economies.

In Kazakhstan a stabilisation mandate was added to the original savings objective of the fund. In Russia, however, the fund is limited to the stabilisation purpose only. In Azerbaijan the Ministry of Finance created a stabilisation fund in 2003 that is separate from the State Oil Fund. The Kazakhstani and Russian funds have been established by statute, and their governance structures meet basic transparency and accountability criteria. There are few binding rules on the operation of the Azeri stabilisation fund.

In all three countries there is continuing uncertainty about permitted drawings from the funds. In Russia, once the fund reaches RUR 500 billion (€14 billion), expenditure in the current year's budget may be financed from the fund, subject to parliamentary approval. In Kazakhstan such drawings are essentially at the discretion of the President but again subject to parliamentary approval. Nevertheless, as current oil prices and export volumes increase, the stabilisation funds have served their purpose of avoiding large liquidity inflows, which would have put monetary stability and competitiveness at risk.

### Guidelines for public expenditure management

In most transition countries, restraints on public expenditure are not as strictly enforced as statutory debt or deficit limits. Informal guidance or strategy notes for aggregate public expenditure will normally draw on the government's medium-term macroeconomic framework. While governments often overstate prospects for growth and revenues, low-income countries accessing World Bank/IMF concessional lending will typically adopt the more conservative assessments from these organisations. This medium-term framework will target primary fiscal surpluses, revenues and expenditure that safeguard fiscal sustainability.

A public debt law that defines the process through which public debt is contracted and the criteria by which government guarantees are awarded is an institutional prerequisite for debt sustainability. While most countries in transition have such a law in place, very few – principally those with access to international capital markets – have defined specific plans in a published debt management strategy. Such a strategy should contain targets for net issuance in foreign and domestic

markets and for the composition of public liabilities, such as shares of debt in certain currencies or of floating interest debt.

In countries with more developed domestic capital markets, full transparency of the public debt management strategy will be important to avoid sudden adjustments in private sector expectations. In low-income transition countries, a strategy for debt sustainability will be critical in obtaining support from international financial organisations. It may often be imposed as a precondition for such support. The IMF arrangements with low-income countries (under the Poverty Reduction and Growth Facility) normally set strict limits on borrowing under non-concessional terms. All eligible transition countries, except Uzbekistan, have been supported through this facility.

As well as safeguarding fiscal stability, governments aim to deliver more effectively on the policy objectives that they set themselves. Private investors tend to view budgets as a reflection of national policies. In practice, allocations differ from announced policies, and actual spending differs from budget allocations. Expenditure management has therefore emerged as an important area for technical assistance by bilateral donors and international financial institutions in low-income countries. Ongoing reforms are likely to improve the allocation as well as the efficiency of public expenditure.

Public expenditure will be more predictable – and the assumptions for private investment decisions less uncertain – where the public sector compiles a medium-term expenditure framework (MTEF). The MTEF is consistent with the current year's budget and sketches broad expenditure categories over the next two or three years, based on existing and adopted future policies. In preparing it, the authorities need to reconcile spending plans with the medium-term projections for revenues and other public sector financing, based on a macroeconomic framework. Even though MTEFs are typically rolled over every year, this process introduces greater discipline and realism into the spending plans of government ministries. All CEB countries have developed such medium-term strategies but they are still rare or ineffective among CIS and SEE countries (see Table 2.2).

Budget formulation – the process of matching expenditure to policies – is greatly improved where a government adopts a so-called programmatic budget classification. Traditionally, expenditure has been classified along departmental lines, reflecting the organisational structure of the government. By contrast, a programmatic classification matches broad policy objectives to individual budget allocations. Under a broad functional heading – for instance, “expanding rural transport infrastructure” – several programmes (such as road maintenance) and sub-activities (in a particular region) are listed and costed. This aids the monitoring of, and accounting for, major policy initiatives and enhances ownership and decision-making by government ministries.

In 10 of the poorest transition countries medium-term policies, including public investment plans, have mainly been defined through so-called Poverty Reduction Strategy Papers (PRSPs).<sup>11</sup> A range of domestic groups, including from the private sector, participate in the preparation of a PRSP. Also, the World Bank, the IMF, regional development institutions and bilateral donors are committed to incorporating PRSP priorities into their own development strategies.

Among others, the 10 PRSPs propose important policy initiatives in the infrastructure and energy sectors although they lack specific targets and prioritisation. This may be due to the relative inexperience of these countries in preparing such a comprehensive strategy and in incorporating the views of civil society and the private sector. Clearly, preparing a medium-term expenditure plan and tying this in with individual policy initiatives poses new challenges for the analytical and administrative capacity of national governments. However, such reforms are necessary to align expenditure allocations more closely with policy objectives and account for the use of budgetary resources.

A recent World Bank study highlights substantial weaknesses in budget management systems of seven PRSP transition countries.<sup>12</sup> In part, this can be attributed to the institutional history of transition economies. Finance ministries have typically been tasked with executing a central plan rather than translating policies into expenditure allocations and reconciling conflicting demands from other ministries.

Budgets have rarely been used to plan policies over the medium term, and the secrecy surrounding national budget data has been a reflection of broader governance problems.

Among the seven countries, the World Bank study finds little capacity for macro-economic forecasting, costing policy initiatives and budgeting expenditure over the medium term. There has been some progress in restructuring the budget planning process. Nevertheless, there is still little correspondence between policies and spending categories and, with the exception of Albania, extra-budgetary funds account for more than 10 per cent of total expenditure.

The frequent and large adjustments in the seven countries – even over the course of a budget year – add a cautionary note to their ambitions for comprehensive medium-term expenditure frameworks. Deviations from projected revenue performance have resulted in ad hoc expenditure reductions to meet deficit targets and financing. Budget data for the seven early transition countries in the CIS show that during periods of expenditure reductions, there has been little variation in public sector wage bills. A few non-protected budget categories, such as non-wage current expenditure and the public investment programme, have borne the brunt of the adjustment (see Chart 2.6).

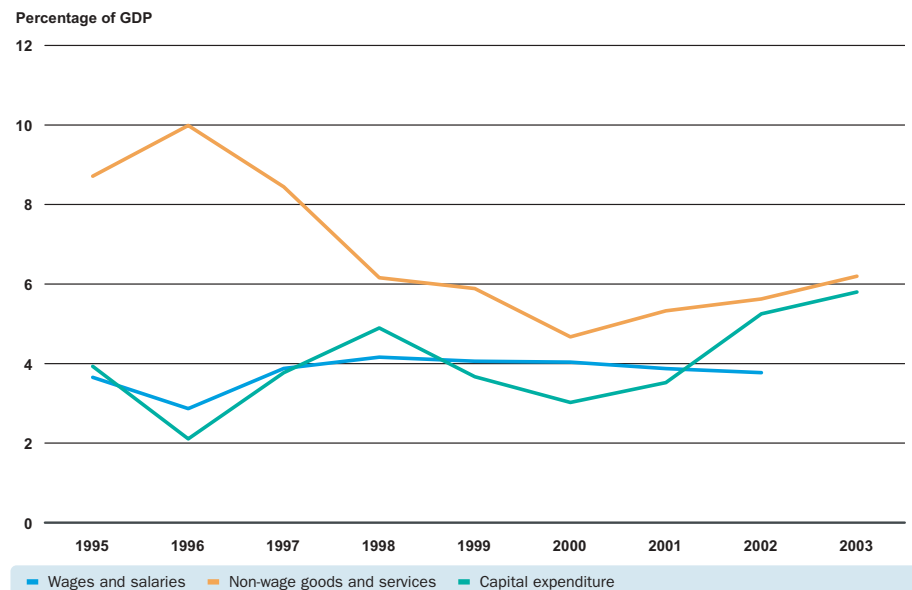
### Fiscal transparency

In the more advanced transition countries the management of public expenditure can be judged against a larger set of fiscal transparency standards. An IMF assessment of adherence to the Code of Good Practices on Fiscal Transparency forms a key part of periodic reports on 12 internationally recognised standards and codes. Countries submit voluntarily to IMF monitoring missions and the publication of their assessments. Private sector investors draw increasingly on such reports in their country risk assessments. International financial institutions also monitor closely adherence to fiscal standards, given the experience of several financial crises that were caused by or instigated severe fiscal imbalances.

The fiscal transparency code sets standards for a range of institutional and administrative features in budget management. These include: the roles and responsibilities of various public

Chart 2.6

#### Government expenditure in early transition countries, 1995–2003



sector bodies; transparency of the annual budget, its history and its medium-term prospects; the process underlying budget preparations, execution and reporting; and the quality and independent audit of reported data. Eighteen transition countries have conducted assessments to date. In many countries, comprehensive early reports have been updated several times.<sup>13</sup>

A review of 11 recent fiscal transparency reports in middle-income transition countries suggests that much progress has been made. Nevertheless, the reports urge the preparation of comprehensive medium-term budget frameworks in Poland and Ukraine and their further refinement in Hungary and Lithuania. Also, unclear public sector delineation hinders the measurement of the fiscal stance in the Czech Republic and Poland.

In CEB countries in particular, the appropriate consolidation of public-private partnerships in infrastructure will be critical for an accurate assessment of fiscal balances and liabilities (see Box 2.3). The comprehensiveness of the general government accounts is also problematic in Kazakhstan, Lithuania and Russia, and audits of the budget in the Slovak Republic are criticised. Despite substantial progress in reforms implemented since 1999, the fiscal transparency report on Russia recommends a more expeditious reduction of quasi-fiscal activities, in particular in the energy sector.

In general, the 11 reports have found few problems with the realism of budgets and the quality of data – only in Latvia and Slovenia have minor technical points been raised. All advanced transition countries are seeking to maintain access to international capital markets and therefore have strong incentives to adhere to and improve on fiscal transparency standards. This contrasts with the assessments in less advanced transition economies. A recent IMF report found that under-funded public utilities, contingent liabilities and substantial quasi-fiscal deficits were common problems. Also, discretionary practices in tax administration were criticised in all reports.<sup>14</sup>

In these less advanced transition countries, engagement with the international financial institutions will normally involve technical assistance to address budget management issues. Adopting fiscal standards certainly entails substantial costs – for instance, in establishing systems for budget forecasting, accounting and maintaining a transparent information system. In several early transition countries the culture of secrecy surrounding the public budget is unlikely to change rapidly. Nevertheless, as the adoption of fiscal transparency standards spreads, the absence of published assessments of such standards may increasingly deter private investors.

### Box 2.3

#### Fiscal transparency and private sector participation in infrastructure

Given the need for large infrastructure investment in many transition countries, and the budget constraints under which many of them operate, there has been a strong incentive to move certain infrastructure operations off the public sector accounts. Certain forms of private sector participation (PSP) essentially transfer investment projects that have traditionally been executed or financed by the public sector to private operators. This can provide much-needed private capital and management expertise, and is increasingly common in transition countries (see Chapter 4). For example, private investors have constructed a number of motorways in Hungary under a contract with the government. Under the concession for the M5 motorway, government payments depend on a number of agreed performance criteria. These contractually agreed payments enter each annual budget but no additional liability for the entire payment stream is included on the government's balance sheet.

A similar approach, but on a municipal level, was taken by the Croatian city of Zagreb in the construction of the Domovinski Bridge across the river Sava. The building of the bridge was incorporated into the PSP contract for

construction and operation of the city's waste-water treatment plant. Once the bridge is completed, its ownership (including maintenance obligations) will be transferred to the city, and the concessionaire's expenses will be repaid through annual payments related to the waste-water concession. Again, although the city will have to repay the concessionaire, the bridge can be built without increasing the reported public debt.

Even though there are strong incentives to move such projects off the public accounts, there is as yet little guidance on whether deals involving PSP should be consolidated. Eurostat recommends that where a private contractor builds an asset and delivers services to a government, the asset need not be shown on the government's accounts if the contractor bears most of the risk involved. However, a stream of contractual payments to the contractor is, in principle, equivalent to debt payments (had the government incurred debt to finance the project) and such liabilities may need to be considered in assessing debt sustainability. Fiscal transparency standards also call for a full disclosure of contingent liabilities that a government incurs in connection with PSP.

Source: EBRD.

## 2.3 Conclusion

Several governments in transition countries have capitalised on the period of strong growth over the past five years and further consolidated their public finances. As yet, this consolidation remains elusive in the four largest CEB countries where, at the prevailing growth and real interest rates, the current fiscal stance will not be sustainable. Given the already high levels of taxation, the objective of accession to the ERM II mechanism will require a credible and sustained programme of expenditure retrenchment. Several of the poorest CIS countries are only beginning to reduce their excessive external debt burdens, and frequent external shocks will continue to disrupt their revenue base.

Where fiscal consolidation has been achieved, its effects on investment and growth will be more powerful if the private sector expects this consolidation to be sustained. Stringent fiscal policy rules are unlikely to be effective in transition countries. Such rules depend on transparent accounting systems that underlie the policy and on credible enforcement through the legislature and judiciary. ERM II is an externally designed mechanism, and may yet provide such enforcement on CEB countries – if only through the sovereign borrower's reputation and credibility in international financial markets.

In the low-income transition countries, reforms of the internal rules and guidelines by which national budgets are governed will be essential. A key element will be more realistic medium-term macroeconomic frameworks that guide expenditure plans and chart the path towards debt sustainability. Restraining spending propositions through realistic revenue projections will require budget management system reforms that are being promoted by international financial institutions.

This agenda is daunting and may strain the administrative capacity of many low-income transition countries. However, the transparency standards that are increasingly adopted by governments – and required by private investors for their risk assessments – are likely to expose governments to more public scrutiny and to further deter unsustainable fiscal policies.

Fiscal transparency is crucial for the effective implementation and monitoring of the poverty reduction strategies that have been adopted by 10 transition economies. In all transition countries, such reforms are likely to introduce greater realism into the assumptions underlying the investment plans of public and private sector agents.

## Endnotes

- <sup>1</sup> Regional real GDP growth rates in this chapter are all calculated as weighted averages. The weights used are EBRD estimates of nominal dollar-GDP lagged by one year.
- <sup>2</sup> See IMF (2004a).
- <sup>3</sup> According to the current SGP, countries should aim for budgetary positions close to balance or in surplus in the medium term. This will enable countries to deal with cyclical fluctuations while at the same time keeping the government deficit within a reference value of 3 per cent of GDP. The extended target dates for bringing the deficits below this reference value have been set at 2007 for Poland and the Slovak Republic and 2008 for the Czech Republic and Hungary.
- <sup>4</sup> See Lorie (2003).
- <sup>5</sup> IMF estimates suggest that in 1997 Russia's quasi-fiscal deficit (losses of public enterprises) in the energy sector alone amounted to about 4 per cent of GDP.
- <sup>6</sup> See Gupta *et al.* (2003).
- <sup>7</sup> The effect of macroeconomic uncertainty in depressing domestic investment has been demonstrated in a number of empirical studies – for instance, in Servén (1998). See EBRD (1995) for transition countries.
- <sup>8</sup> See IMF (1998).
- <sup>9</sup> See Kopits and Symansky (1998).
- <sup>10</sup> The threshold is calculated according to the national statistical recording convention. Public and publicly guaranteed debt according to this definition is somewhat larger than the figure calculated according to the Eurostat methodology (52 per cent compared with 43 per cent) which is included in Table 2.1 and the transition assessment.
- <sup>11</sup> PRSPs or interim PRSPs have been adopted in Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, FYR Macedonia, Georgia, Kyrgyz Republic, Moldova, Serbia and Montenegro, and Tajikistan.
- <sup>12</sup> See World Bank (2004). The study included all PRSP countries (see note 11) except Azerbaijan, FYR Macedonia, and Serbia and Montenegro.
- <sup>13</sup> The published Fiscal Transparency reports are available at [imf.org/external/np/rosc/rosc.asp?sort=topic#FiscalTransparency](http://imf.org/external/np/rosc/rosc.asp?sort=topic#FiscalTransparency).
- <sup>14</sup> See [imf.org/external/np/pdr/sac/2003/030503s2.htm](http://imf.org/external/np/pdr/sac/2003/030503s2.htm).

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## Annex 2.1:

# Macroeconomic performance tables

Table A.2.1

### Growth in real GDP

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Estimated level of real GDP in 2003
	<i>(in per cent)</i>													<i>(1989=100)</i>
Czech Republic	-0.5	0.1	2.2	5.9	4.3	-0.8	-1.0	0.5	3.9	2.6	1.5	3.1	4.0	108
Estonia	-14.2	-8.8	-1.6	4.5	4.5	10.5	5.2	-0.1	7.8	6.4	7.2	5.1	5.5	102
Hungary	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	3.8	3.5	2.9	4.0	115
Latvia	-34.9	-14.9	2.2	-0.9	3.8	8.3	4.7	3.3	6.9	8.0	6.4	7.5	7.5	83
Lithuania	-21.3	-16.2	-9.8	3.3	4.7	7.0	7.3	-1.7	3.9	6.4	6.8	9.0	7.0	84
Poland	2.6	3.8	5.2	7.0	6.0	6.8	4.8	4.1	4.0	1.0	1.4	3.8	5.5	135
Slovak Republic	-6.7	-3.7	6.2	5.8	6.1	4.6	4.2	1.5	2.0	3.8	4.4	4.2	4.8	114
Slovenia	-5.5	1.7	5.8	4.9	3.6	4.8	3.6	5.6	3.9	2.7	3.4	2.3	4.1	120
<i>Central eastern Europe and the Baltic states</i>	-1.7	0.7	3.9	5.4	4.6	4.8	3.7	3.1	4.2	2.4	2.4	3.8	4.9	119
Albania	-7.2	9.6	8.3	13.3	9.1	-7.0	12.7	8.9	7.7	6.8	4.7	6.0	6.2	129
Bosnia and Herzegovina	-80.0	-10.0	0.0	20.8	86.0	37.0	15.6	9.6	5.5	4.4	5.5	3.5	4.0	57
Bulgaria	-7.3	-1.5	1.8	2.9	-9.4	-5.6	4.0	2.3	5.4	4.0	4.8	4.3	5.5	84
Croatia	-11.7	-8.0	5.9	6.8	6.0	6.5	2.5	-0.9	2.9	4.4	5.2	4.3	3.7	91
FYR Macedonia	-8.0	-9.1	-1.8	-1.2	1.2	1.4	3.4	4.3	4.5	-4.5	0.9	3.1	2.5	78
Romania	-8.8	1.5	3.9	7.1	4.0	-6.1	-4.8	-1.2	1.8	5.3	4.9	4.9	5.8	92
Serbia and Montenegro	-27.9	-30.8	2.5	6.1	7.8	10.1	1.9	-18.0	5.0	5.5	4.0	3.0	5.0	52
<i>South-eastern Europe</i>	-10.9	-2.0	3.8	6.4	4.2	1.3	0.6	-2.4	3.6	4.5	4.7	4.4	5.0	86
Armenia	-41.8	-8.8	5.4	6.9	5.9	3.3	7.3	3.3	6.0	9.6	13.2	13.9	8.0	89
Azerbaijan	-22.6	-23.1	-19.7	-11.8	0.8	6.0	10.0	9.5	11.1	9.9	10.6	11.2	10.0	71
Belarus	-9.6	-7.6	-12.6	-10.4	2.8	11.4	8.4	3.4	5.8	4.7	5.0	6.8	6.0	100
Georgia	-44.8	-25.4	-11.4	2.4	10.5	10.6	2.9	3.0	1.9	4.7	5.6	8.6	6.0	41
Kazakhstan	-5.3	-9.3	-12.6	-8.2	0.5	1.7	-1.9	2.7	9.8	13.5	9.8	9.2	9.0	94
Kyrgyz Republic	-19.0	-15.5	-20.1	-5.4	7.1	9.9	2.1	3.7	5.4	5.3	0.0	6.7	6.0	75
Moldova	-29.1	-1.2	-30.9	-1.4	-5.9	1.6	-6.5	-3.4	2.1	6.1	7.2	6.3	7.0	41
Russia	-14.8	-8.7	-12.7	-4.0	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	6.9	77
Tajikistan	-29.0	-11.0	-18.9	-12.5	-4.4	1.7	5.3	3.7	8.3	10.2	9.1	10.2	8.5	62
Turkmenistan	-5.3	-10.0	-17.3	-7.2	-6.7	-11.3	6.7	16.5	18.6	15.9	8.1	7.7	7.5	105
Ukraine	-9.7	-14.2	-22.9	-12.2	-10.0	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.4	12.3	51
Uzbekistan	-11.1	-2.3	-4.2	-0.9	1.6	2.5	4.3	4.3	3.8	4.1	3.1	1.5	2.5	107
<i>Commonwealth of Independent States</i>	-14.1	-9.3	-13.6	-5.0	-3.6	1.4	-3.9	5.2	9.1	6.1	5.2	7.6	7.4	75
<b>All transition countries <sup>1</sup></b>	<b>-9.3</b>	<b>-4.9</b>	<b>-5.5</b>	<b>-0.1</b>	<b>0.2</b>	<b>2.5</b>	<b>-1.0</b>	<b>3.4</b>	<b>6.0</b>	<b>4.3</b>	<b>4.0</b>	<b>5.6</b>	<b>6.1</b>	<b>85</b>

Note: Data for 1992-2002 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2003 are preliminary actuals, mostly official government estimates. Data for 2004 represent EBRD projections.

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

Table A.2.2

**GDP growth by components in selected countries**

(real change, in per cent)

	2000	2001	2002	2003		2000	2001	2002	2003
				<i>Estimate</i>					<i>Estimate</i>
<b>Bulgaria</b>					<b>Lithuania</b>				
Real GDP growth	5.4	4.0	4.8	4.3	Real GDP growth	3.9	6.4	6.8	9.0
Private consumption	4.9	4.5	3.9	6.8	Private consumption	5.9	3.7	5.8	11.1
Public consumption	13.3	4.7	6.2	4.9	Public consumption	3.9	0.3	1.9	5.7
Gross fixed capital formation	15.4	19.9	9.3	13.8	Gross fixed capital formation	-9.0	13.5	8.7	11.4
Exports of goods and services	16.6	8.5	6.2	8.0	Exports of goods and services	9.8	21.2	19.5	6.0
Imports of goods and services	18.6	13.0	4.7	14.8	Imports of goods and services	4.7	17.7	17.6	8.8
<b>Croatia</b>					<b>Poland</b>				
Real GDP growth	2.9	4.4	5.2	4.3	Real GDP growth	4.0	1.0	1.4	3.8
Private consumption	4.2	4.6	7.5	4.1	Private consumption	2.7	2.0	3.3	3.1
Public consumption	-8.9	-4.3	-1.8	-0.3	Public consumption	1.1	2.0	4.0	3.5
Gross fixed capital formation	-3.8	9.7	10.1	16.8	Gross fixed capital formation	2.7	-9.8	-5.8	-0.9
Exports of goods and services	12.0	8.1	1.3	10.1	Exports of goods and services	17.5	8.0	5.0	6.0
Imports of goods and services	3.7	9.3	8.8	10.9	Imports of goods and services	12.0	7.0	3.0	4.0
<b>Czech Republic</b>					<b>Romania</b>				
Real GDP growth	3.9	2.6	1.5	3.1	Real GDP growth	1.8	5.3	4.9	4.9
Private consumption	2.9	2.8	2.7	4.9	Private consumption	0.2	6.4	3.0	7.1
Public consumption	-1.0	5.3	4.5	2.2	Public consumption	20.4	-1.9	2.1	4.6
Gross fixed capital formation	4.9	5.4	3.4	7.4	Gross fixed capital formation	4.6	6.6	8.3	9.2
Exports of goods and services	16.5	11.5	2.3	5.7	Exports of goods and services	23.9	10.6	16.9	11.1
Imports of goods and services	16.0	13.0	4.9	7.9	Imports of goods and services	29.1	17.5	12.1	16.3
<b>Estonia</b>					<b>Russia</b>				
Real GDP growth	7.8	6.4	7.2	5.1	Real GDP growth	10.0	5.1	4.7	7.3
Private consumption	8.6	6.2	10.3	5.7	Private consumption	7.1	9.9	8.7	7.2
Public consumption	1.1	1.8	5.9	5.8	Public consumption	2.1	-0.8	2.6	2.2
Gross fixed capital formation	14.3	13.0	17.2	5.4	Gross fixed capital formation	18.1	10.3	3.0	12.9
Exports of goods and services	28.3	-0.2	0.6	6.0	Exports of goods and services	9.5	4.2	9.6	13.7
Imports of goods and services	28.3	2.1	5.4	9.0	Imports of goods and services	32.4	18.7	14.6	19.5
<b>Hungary</b>					<b>Slovak Republic</b>				
Real GDP growth	5.2	3.8	3.5	2.9	Real GDP growth	2.0	3.8	4.4	4.2
Private consumption	5.0	5.9	9.3	6.5	Private consumption	-0.8	4.7	5.3	-0.4
Public consumption	1.2	5.3	4.8	1.9	Public consumption	1.6	4.6	4.7	2.9
Gross fixed capital formation	7.7	5.0	8.0	3.0	Gross fixed capital formation	-7.2	13.9	-0.9	-1.2
Exports of goods and services	21.0	7.8	3.7	7.2	Exports of goods and services	13.7	6.3	5.5	22.6
Imports of goods and services	19.4	5.1	6.2	10.3	Imports of goods and services	10.5	11.0	5.2	13.8
<b>Latvia</b>					<b>Slovenia</b>				
Real GDP growth	6.9	8.0	6.4	7.5	Real GDP growth	3.9	2.7	3.4	2.3
Private consumption	6.3	7.3	7.4	8.6	Private consumption	0.4	2.3	0.4	2.9
Public consumption	-1.9	0.3	2.4	2.5	Public consumption	2.3	3.9	2.5	1.9
Gross fixed capital formation	10.2	11.4	13.0	7.4	Gross fixed capital formation	0.6	4.1	2.6	5.4
Exports of goods and services	12.0	6.9	6.3	4.3	Exports of goods and services	13.0	6.3	6.8	3.1
Imports of goods and services	4.9	12.6	4.5	13.3	Imports of goods and services	7.6	3.0	4.8	6.4

Source: EBRD.

Note: Data for 2000-02 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2003 are preliminary actuals, mostly official government estimates.

Table A.2.3

**Inflation**

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

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
												<i>Estimate</i>	<i>Projection</i>
<b>Central eastern Europe and the Baltic states</b>													
Czech Republic	11.1	20.8	9.9	9.6	8.9	8.4	10.6	2.1	4.0	4.7	1.8	0.2	3.2
Estonia	1,076.0	89.8	47.7	29.0	23.1	11.2	8.1	3.3	4.0	5.8	3.6	1.3	3.5
Hungary	23.0	22.5	18.8	28.2	23.6	18.3	14.3	10.0	9.8	9.2	4.8	4.7	6.8
Latvia	951.2	109.2	35.9	25.0	17.6	8.4	4.7	2.4	2.6	2.5	1.9	3.0	6.2
Lithuania	1,020.5	410.4	72.1	39.6	24.6	8.9	5.1	0.8	1.0	1.5	0.3	-1.2	1.5
Poland	43.0	35.3	32.2	27.8	19.9	14.9	11.8	7.3	10.1	5.5	1.7	0.7	3.6
Slovak Republic	10.0	23.2	13.4	9.9	5.8	6.1	6.7	10.6	12.0	7.1	3.3	8.5	7.5
Slovenia	207.3	32.9	21.0	12.6	9.7	9.1	7.9	6.1	8.9	8.4	7.5	5.6	3.7
<i>Median</i> <sup>1</sup>	125.2	34.1	26.6	26.4	18.8	9.0	8.0	4.7	6.5	5.7	2.6	2.2	3.7
<i>Mean</i> <sup>1</sup>	417.8	93.0	31.4	22.7	16.7	10.7	8.7	5.3	6.6	5.6	3.1	2.9	4.5
<b>South-eastern Europe</b>													
Albania	226.0	85.0	22.6	7.8	12.7	33.2	20.6	0.4	0.1	3.1	5.2	2.4	3.4
Bulgaria	82.0	73.0	96.3	62.0	123.0	1,082.0	22.2	0.7	9.9	7.4	5.9	2.3	6.0
Croatia	665.5	1,517.5	97.6	2.0	3.5	3.6	5.7	4.2	6.2	4.9	2.2	1.8	2.5
FYR Macedonia	1,664.4	338.4	126.5	16.4	2.5	1.3	0.5	-1.3	6.6	5.2	2.4	1.1	2.8
Romania	210.4	256.1	136.7	32.3	38.8	154.8	59.1	45.8	45.7	34.5	22.5	15.4	11.9
Serbia and Montenegro	9,237.0	116.5x10 <sup>12</sup>	3.3	78.6	94.3	21.3	29.5	37.1	60.4	91.3	21.4	11.3	8.5
<i>Median</i> <sup>1</sup>	445.8	256.1 <sup>2</sup>	97.0	24.4	25.8	27.3	21.4	2.5	8.3	6.3	5.6	2.4	4.7
<i>Mean</i> <sup>1</sup>	2,014.2	454.0 <sup>2</sup>	80.5	33.2	45.8	216.0	22.9	14.5	21.5	24.4	9.9	5.7	5.9
<b>Commonwealth of Independent States</b>													
Armenia	1,346.0	1,822.0	4,962.0	175.8	18.7	14.0	8.7	0.7	-0.8	3.2	1.2	4.7	7.8
Azerbaijan	912.0	1,129.0	1,664.0	412.0	19.7	3.5	-0.8	-8.5	1.8	1.5	2.8	2.2	5.2
Belarus	970.8	1,190.2	2,221.0	709.3	52.7	63.9	72.9	293.7	168.6	61.4	42.6	28.5	19.3
Georgia	887.4	3,125.4	15,606.5	162.7	39.4	7.1	3.6	19.2	4.1	4.6	5.7	4.9	6.0
Kazakhstan	1,381.0	1,662.3	1,892.0	176.3	39.1	17.4	7.1	8.3	13.2	8.4	5.8	6.4	6.7
Kyrgyz Republic	855.0	772.4	180.7	43.5	31.9	23.4	10.5	35.9	18.7	6.9	2.0	3.1	6.2
Moldova	1,276.4	1,184.0	487.0	30.2	23.5	11.8	7.7	39.3	31.1	9.6	5.2	11.8	10.0
Russia	1,526.0	875.0	311.4	197.7	47.8	14.7	27.6	86.1	20.8	21.6	15.7	13.7	10.7
Tajikistan	1,157.0	2,195.0	350.0	609.0	418.0	88.0	43.2	27.6	32.9	38.6	12.2	16.3	6.3
Turkmenistan	493.0	3,102.0	1,748.0	1,005.3	992.4	83.7	16.8	24.2	8.3	11.6	10.6	6.5	8.8
Ukraine	1,210.0	4,734.0	891.0	377.0	80.0	15.9	10.6	22.7	28.2	12.0	0.8	5.2	8.1
Uzbekistan	645.2	534.2	1,568.3	304.6	43.1	70.9	29.0	29.1	25.0	27.2	27.6	10.3	12.0
<i>Median</i> <sup>1</sup>	1,063.9	1,426.3	1,616.2	251.2	41.3	16.7	10.6	25.9	19.8	10.6	5.8	6.5	8.0
<i>Mean</i> <sup>1</sup>	1,055.0	1,860.5	2,656.8	350.3	150.5	34.5	19.7	48.2	29.3	17.2	11.0	9.5	8.9
<b>All transition countries</b>													
<i>Median</i> <sup>1</sup>	899.7	534.2	131.6	41.6	24.1	14.8	10.6	9.2	9.9	7.3	5.0	4.8	6.3
<i>Mean</i> <sup>1</sup>	1,080.3	1,013.6	1,254.5	176.3	85.2	69.1	17.1	27.2	20.5	15.3	8.3	6.6	6.9

Note: Data for 1992-2002 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2003 are preliminary actuals, mostly official government estimates. Data for 2004 represent EBRD projections. The figure for Albania for 1997 is based on the limited country data available. Estimates of inflation from parts of Bosnia and Herzegovina (for the Federation and Republika Srpska separately) are provided in the selected economic indicators at the back of this Report.

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

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

Table A.2.4

## General government balances

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection	Change 2002-03	Change 2003-04
							(in per cent of GDP)					(in percentage points)			
Czech Republic	-3.1	2.6	-1.2	-1.1	-1.7	-2.6	-4.2	-3.4	-4.5	-6.5	-6.4	-13.0	-5.7	-6.6	7.3
Estonia	na	na	1.2	-1.2	-1.4	2.0	-0.4	-4.0	-0.3	0.3	1.8	3.1	0.3	1.3	-2.8
Hungary	-6.1	-6.0	-7.5	-6.7	-5.0	-6.8	-8.0	-5.6	-3.0	-4.4	-9.3	-6.1	-5.0	3.2	1.1
Latvia	na	na	-4.4	-3.6	-1.7	0.7	-0.7	-5.3	-2.7	-1.6	-2.7	-1.6	-2.0	1.1	-0.4
Lithuania	na	-5.3	-4.8	-4.2	-4.4	-1.1	-3.0	-5.6	-2.6	-2.1	-1.6	-1.7	-2.8	-0.1	-1.1
Poland	-4.9	-2.4	-2.2	-3.1	-3.3	-4.5	-2.3	-1.5	-1.8	-3.5	-3.7	-4.2	-5.0	-0.5	-0.8
Slovak Republic	-11.9	-5.7	-1.4	0.4	-1.3	-5.2	-5.0	-6.3	-12.3	-6.0	-5.7	-3.6	-3.9	2.1	-0.3
Slovenia	0.3	0.6	-0.2	-0.2	-0.2	-1.6	-2.2	-2.1	-3.4	-2.8	-2.4	-2.0	-1.9	0.4	0.1
<i>Central eastern Europe and the Baltic states</i> <sup>1</sup>	-5.1	-2.7	-2.6	-2.5	-2.4	-2.4	-3.2	-4.2	-3.8	-3.3	-3.8	-3.6	-3.3	0.1	0.4
Albania	-23.1	-15.5	-12.6	-10.1	-12.1	-13.2	-12.0	-12.2	-9.2	-8.2	-6.7	-4.5	-6.5	2.2	-2.0
Bosnia and Herzegovina	na	na	na	-0.3	-4.4	-0.5	-5.2	-4.8	-3.1	-2.5	-2.4	-0.2	-0.9	2.2	-0.7
Bulgaria	-2.9	-10.9	-5.7	-5.6	-10.3	-2.4	1.0	-0.9	-1.0	-0.9	-0.6	-0.4	-0.4	0.2	0.0
Croatia	-3.9	-0.8	1.2	-1.4	-1.0	-1.9	-1.0	-8.2	-6.5	-6.7	-5.0	-6.3	-4.5	-1.3	1.8
FYR Macedonia	-9.8	-13.4	-2.7	-1.0	-1.4	-0.4	-1.7	0.0	1.8	-7.2	-5.6	-1.6	-1.5	4.0	0.1
Romania	-4.6	-0.4	-2.2	-2.5	-3.9	-4.6	-5.0	-3.5	-4.0	-3.5	-2.6	-2.4	-1.6	0.2	0.8
Serbia and Montenegro	na	na	na	na	na	na	na	na	-0.9	-1.3	-4.5	-4.2	-3.4	0.3	0.8
<i>South-eastern Europe</i> <sup>1</sup>	-8.9	-8.2	-4.4	-3.5	-5.5	-3.8	-4.0	-4.9	-3.3	-4.3	-3.9	-2.8	-2.7	1.1	0.1
Armenia	-13.9	-54.7	-16.5	-9.0	-8.5	-5.8	-4.9	-7.2	-6.4	-3.8	-0.5	-1.1	-1.9	-0.6	-0.8
Azerbaijan	2.7	-15.3	-11.2	-3.1	-2.4	-4.0	-3.9	-4.7	-0.6	0.9	-0.5	-2.3	-0.4	-1.8	1.9
Belarus	-2.0	-5.5	-3.5	-2.7	-1.5	-0.7	-1.0	-2.0	-0.1	-1.9	-1.8	-1.4	-1.8	0.4	-0.4
Georgia	-25.4	-26.2	-7.4	-5.3	-7.3	-6.7	-5.4	-6.7	-4.0	-2.0	-2.0	-2.9	-0.2	-0.9	2.7
Kazakhstan	-7.3	-4.1	-7.4	-3.4	-5.3	-7.0	-8.0	-5.2	-1.0	-0.9	-0.3	-1.0	-2.1	-0.7	-1.1
Kyrgyz Republic	na	-14.4	-11.6	-17.3	-9.5	-9.2	-9.5	-12.7	-9.9	-5.5	-5.3	-5.0	-4.2	0.3	0.8
Moldova	-26.6	-7.5	-10.6	-5.8	-7.0	-9.3	-6.5	-5.5	-1.4	-0.3	-0.9	0.1	-0.7	1.0	-0.8
Russia	-18.9	-7.3	-10.4	-6.6	-9.4	-8.5	-8.2	-3.1	3.1	2.7	0.6	1.1	3.1	0.5	2.0
Tajikistan	-31.2	-22.3	-10.1	-6.1	-5.8	-3.3	-3.8	-3.1	-0.6	-0.1	-0.1	0.9	-0.4	1.0	-1.3
Turkmenistan	-9.4	-3.5	1.7	0.4	0.3	-0.2	-2.6	0.0	-0.4	0.7	0.2	-1.8	-1.0	-2.0	0.8
Ukraine	-25.4	-16.2	-8.7	-6.1	-3.2	-5.4	-2.8	-2.4	-1.3	-1.6	0.5	-0.7	-2.0	-1.2	-1.3
Uzbekistan	-18.5	-18.3	-4.4	-4.1	-7.3	-2.2	-3.3	-2.6	-2.2	-2.1	-1.5	-0.6	-2.2	0.9	-1.6
<i>Commonwealth of Independent States</i> <sup>1</sup>	-16.0	-16.3	-8.3	-5.8	-5.6	-5.2	-5.0	-4.6	-2.1	-1.2	-1.0	-1.2	-1.2	-0.3	0.1
<b>All transition countries</b> <sup>1</sup>	<b>-11.7</b>	<b>-11.0</b>	<b>-5.7</b>	<b>-4.2</b>	<b>-4.6</b>	<b>-4.0</b>	<b>-4.2</b>	<b>-4.6</b>	<b>-2.9</b>	<b>-2.6</b>	<b>-2.6</b>	<b>-2.3</b>	<b>-2.2</b>	<b>0.2</b>	<b>0.2</b>

Note: Data for 1992-2002 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2003 are preliminary actuals, mostly official government estimates. Data for 2004 represent EBRD projections.

<sup>1</sup> Unweighted average for the region.

Table A.2.5

**General government revenue**

(in per cent of GDP)

	1997	1998	1999	2000	2001	2002	2003 <i>Estimate</i>
Czech Republic	39.0	36.1	36.4	36.3	36.8	37.6	38.5
Estonia	37.3	37.7	36.4	35.7	35.4	36.6	38.5
Hungary	47.7	44.2	44.0	43.6	45.4	43.6	39.5
Latvia	37.7	39.5	37.4	34.6	32.8	32.9	33.7
Lithuania	31.7	31.6	31.6	30.1	29.6	29.3	28.2
Poland	42.7	39.5	39.5	38.2	38.1	37.4	37.9
Slovak Republic	39.6	36.8	38.4	39.7	41.6	42.4	37.4
Slovenia	39.3	40.3	41.0	44.7	45.1	45.7	46.2
<i>Central eastern Europe and the Baltic states</i> <sup>1</sup>	39.4	38.2	38.1	37.9	38.1	38.2	37.5
Albania	17.0	22.5	22.7	22.7	22.2	22.2	22.0
Bosnia and Herzegovina	39.2	56.7	60.3	53.7	49.7	48.0	46.7
Bulgaria	30.7	38.0	38.7	38.7	37.7	36.5	37.9
Croatia	42.5	45.6	48.4	46.2	44.0	44.5	44.2
FYR Macedonia	34.8	33.3	35.4	36.2	34.0	34.9	33.1
Romania	27.1	27.9	30.7	31.2	30.1	29.7	30.0
Serbia and Montenegro	na	na	na	36.7	38.9	42.8	42.6
<i>South-eastern Europe</i> <sup>1</sup>	31.9	37.3	39.4	37.9	36.7	36.9	36.6
Armenia	19.7	20.7	22.7	19.6	17.1	18.8	17.8
Azerbaijan	15.2	19.6	17.9	21.2	21.5	28.0	27.7
Belarus	45.5	44.4	45.3	45.8	44.9	42.8	44.7
Georgia	14.3	13.7	15.4	15.2	16.3	15.8	16.4
Kazakhstan	13.5	18.0	18.0	22.2	22.5	21.7	23.0
Kyrgyz Republic	23.9	24.4	21.3	18.5	20.4	22.8	22.2
Moldova	33.9	33.1	27.1	30.7	29.1	30.0	30.4
Russia	37.2	34.3	33.6	36.9	37.3	37.6	36.6
Tajikistan	12.1	11.2	12.5	13.6	15.2	16.7	17.2
Turkmenistan	24.9	22.0	22.7	26.3	23.3	21.3	24.5
Ukraine	38.8	35.6	31.9	33.4	33.5	36.0	36.7
Uzbekistan	30.1	31.1	29.3	28.0	33.9	35.6	39.3
<i>Commonwealth of Independent States</i> <sup>1</sup>	25.8	25.7	24.8	26.0	26.3	27.3	28.0
<b>Comparison countries</b>							
Germany	46.6	46.6	47.3	47.1	45.5	45.0	45.0
Greece	43.7	45.3	45.8	47.8	46.4	45.3	44.2
Japan	31.3	30.6	30.5	30.7	31.6	30.3	29.8
Portugal	41.2	41.0	42.4	42.3	41.8	43.4	45.0
United States	34.2	34.6	34.7	35.3	34.5	32.0	30.9

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

Note: Data for 1997-2002 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2003 are preliminary actuals, mostly official government estimates.

<sup>1</sup> Unweighted average for the region.



Table A.2.6

**General government expenditure**

(in per cent of GDP)

	1997	1998	1999	2000	2001	2002	2003 <i>Estimate</i>
Czech Republic	41.7	38.4	39.0	40.4	41.6	43.9	44.1
Estonia	35.2	38.0	40.4	36.3	35.0	35.5	36.0
Hungary	49.5	50.4	47.4	47.0	51.8	54.2	47.4
Latvia	37.0	40.2	41.0	37.2	34.9	35.7	35.4
Lithuania	32.8	36.9	39.6	33.0	31.1	30.8	31.5
Poland	45.8	42.7	42.8	41.7	43.6	44.1	44.8
Slovak Republic	43.8	41.2	41.8	43.1	45.6	47.4	40.9
Slovenia	43.8	44.4	44.5	48.5	48.1	48.3	48.8
<i>Central eastern Europe and the Baltic states</i> <sup>1</sup>	41.2	41.5	42.1	40.9	41.5	42.5	41.1
Albania	30.2	34.5	34.9	31.9	30.4	28.9	26.5
Bosnia and Herzegovina	39.7	61.8	65.0	56.8	52.2	50.4	46.9
Bulgaria	33.1	37.0	39.6	39.7	38.6	37.2	38.4
Croatia	44.4	46.7	56.6	52.7	50.7	49.2	49.5
FYR Macedonia	35.1	35.0	35.4	34.4	41.1	40.5	34.7
Romania	34.0	34.7	35.2	34.8	33.4	32.3	32.3
Serbia and Montenegro	na	na	na	37.6	40.2	47.3	46.8
<i>South-eastern Europe</i> <sup>1</sup>	36.1	41.6	44.5	41.1	40.9	40.8	39.3
Armenia	25.5	25.6	30.1	25.9	20.9	19.3	18.9
Azerbaijan	19.2	23.7	23.6	20.8	20.3	28.3	30.0
Belarus	46.2	45.4	47.3	45.9	46.8	44.7	46.1
Georgia	21.0	19.1	22.1	19.2	18.3	17.8	18.9
Kazakhstan	20.4	26.1	23.2	23.2	23.4	22.1	24.0
Kyrgyz Republic	33.1	33.9	34.0	28.5	25.9	28.0	27.1
Moldova	43.2	39.5	32.7	33.8	29.3	32.0	30.2
Russia	47.8	42.6	36.7	33.7	34.5	37.0	35.5
Tajikistan	15.5	13.9	14.9	15.2	16.3	16.8	16.3
Turkmenistan	25.0	24.6	22.7	26.7	22.6	21.1	26.3
Ukraine	44.2	38.4	34.2	34.7	35.1	35.5	37.4
Uzbekistan	32.3	34.3	32.0	30.2	36.0	37.2	39.9
<i>Commonwealth of Independent States</i> <sup>1</sup>	31.1	30.6	29.5	28.2	27.5	28.3	29.2
<b>Comparison countries</b>							
Germany	49.3	48.8	48.7	45.7	48.3	48.5	48.9
Greece	47.8	47.8	47.6	49.9	47.8	46.8	47.2
Japan	35.1	36.1	37.7	38.2	37.7	38.2	37.7
Portugal	44.8	44.1	45.3	45.2	46.3	46.1	47.9
United States	34.9	34.2	33.8	33.7	34.6	35.3	35.7

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

Note: Data for 1997-2002 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2003 are preliminary actuals, mostly official government estimates. General government expenditure includes net lending.

<sup>1</sup> Unweighted average for the region.

Table A.2.7

## Current account balance

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection	Change 2002-03	Change 2003-04
						(in per cent of GDP)								(in percentage points)	
Czech Republic	na	1.3	-1.9	-2.6	-7.1	-6.7	-2.1	-2.5	-4.9	-5.4	-5.6	-6.2	-6.2	-0.6	0.0
Estonia	3.3	1.2	-6.9	-4.2	-8.6	-11.4	-8.6	-4.4	-5.4	-5.7	-10.2	-13.2	-11.1	-3.0	2.1
Hungary	0.9	-9.0	-9.4	-5.6	-3.9	-4.5	-7.2	-7.9	-8.7	-6.2	-7.2	-8.9	-8.6	-1.7	0.3
Latvia	na	19.1	5.5	-0.3	-5.0	-5.6	-9.8	-9.1	-6.4	-8.9	-6.5	-8.6	-9.4	-2.1	-0.8
Lithuania	na	-3.2	-2.2	-9.6	-9.0	-10.0	-11.7	-11.0	-5.9	-4.7	-5.2	-6.7	-6.1	-1.5	0.6
Poland	1.1	-0.7	1.0	0.7	-2.4	-4.2	-4.4	-8.1	-6.1	-2.9	-2.7	-2.0	-2.6	0.7	-0.6
Slovak Republic	na	-4.5	4.3	2.0	-10.1	-9.2	-9.3	-5.3	-3.5	-8.4	-8.0	-0.9	-2.0	7.1	-1.1
Slovenia	6.1	1.5	4.0	-0.4	0.3	0.3	-0.6	-3.3	-2.9	0.2	1.7	0.0	0.0	-1.7	0.0
<i>Central eastern Europe and the Baltic states<sup>1</sup></i>	2.9	0.7	-0.7	-2.5	-5.7	-6.4	-6.7	-6.5	-5.5	-5.3	-5.5	-5.8	-5.8	-0.4	0.1
Albania	na	-29.1	-14.3	-7.1	-9.1	-12.4	-6.8	-7.7	-7.9	-6.2	-9.0	-7.6	-7.3	1.4	0.3
Bosnia and Herzegovina	na	na	na	-10.3	-27.3	-30.0	-27.0	-17.9	-13.1	-16.2	-18.4	-17.4	-14.8	1.0	2.6
Bulgaria	-4.2	-10.1	-0.3	-0.2	0.2	4.1	-0.5	-5.3	-5.6	-6.5	-4.4	-8.4	-8.0	-4.0	0.4
Croatia	3.2	5.7	5.9	-7.7	-5.5	-11.6	-6.7	-7.0	-2.5	-3.7	-8.4	-6.1	-5.8	2.3	0.3
FYR Macedonia	-0.8	0.6	-5.3	-5.0	-6.5	-7.8	-7.5	-7.0	-2.1	-6.9	-9.5	-6.0	-6.9	3.5	-0.9
Romania	-8.0	-4.5	-1.4	-5.0	-7.3	-6.1	-6.9	-3.6	-3.6	-5.8	-3.4	-5.8	-5.6	-2.4	0.2
Serbia and Montenegro					-9.8	-6.5	-4.2	-4.4	-4.7	-4.6	-8.8	-10.2	-11.3	-1.4	-1.1
<i>South-eastern Europe<sup>1</sup></i>	-2.5	-7.5	-3.1	-5.9	-9.3	-10.0	-8.5	-6.7	-5.6	-7.1	-8.8	-8.8	-8.5	0.1	0.3
Armenia	na	-14.3	-16.0	-17.0	-18.2	-18.0	-21.3	-16.6	-14.5	-10.0	-6.6	-7.1	-5.6	-0.5	1.5
Azerbaijan	na	-10.2	-10.3	-13.2	-25.8	-23.1	-30.7	-13.1	-3.5	-0.9	-12.6	-27.4	-35.8	-14.8	-8.4
Belarus	na	-11.9	-9.1	-4.4	-3.6	-6.1	-6.7	-1.6	-3.2	-3.2	-2.1	-3.0	-3.2	-0.9	-0.2
Georgia	na	-40.2	-22.3	-7.5	-9.1	-10.6	-8.9	-7.7	-4.5	-6.6	-6.0	-7.9	-8.7	-1.9	-0.8
Kazakhstan	na	-7.8	-7.6	-1.3	-3.6	-3.6	-5.5	-1.4	3.1	-5.4	-3.5	-0.2	1.0	3.3	1.2
Kyrgyz Republic	na	-10.0	-7.6	-15.7	-23.3	-7.8	-22.1	-14.7	-6.6	-3.3	-3.9	-2.8	-3.7	1.1	-0.9
Moldova	na	-14.5	-8.4	-6.8	-9.8	-12.5	-17.3	-3.6	-9.4	-4.9	-3.6	-7.9	-6.4	-4.3	1.5
Russia	na	na	2.8	2.2	2.8	0.0	0.1	12.6	18.0	11.1	8.4	8.3	6.7	-0.1	-1.6
Tajikistan	na	-28.8	-20.1	-14.8	-7.1	-5.4	-9.1	-3.4	-6.4	-7.0	-2.7	-1.3	-1.9	1.4	-0.6
Turkmenistan	na	na	4.0	0.9	0.1	-25.3	-36.7	-28.4	15.2	3.4	15.2	11.6	6.0	-3.6	-5.6
Ukraine	na	na	-3.2	-3.1	-2.7	-2.7	-3.1	5.2	4.7	3.7	7.5	5.8	9.6	-1.7	3.8
Uzbekistan	na	-8.4	2.1	-0.2	-7.8	-5.4	-0.9	-2.0	2.4	-1.5	1.4	10.5	8.7	9.1	-1.8
<i>Commonwealth of Independent States<sup>1</sup></i>	na	-16.2	-8.0	-6.7	-9.0	-10.0	-13.5	-6.2	-0.4	-2.1	-0.7	-1.8	-2.8	-1.1	-1.0
<b>All transition countries<sup>1</sup></b>	<b>0.2</b>	<b>-8.1</b>	<b>-4.7</b>	<b>-5.2</b>	<b>-8.1</b>	<b>-9.0</b>	<b>-10.2</b>	<b>-6.4</b>	<b>-3.3</b>	<b>-4.3</b>	<b>-4.2</b>	<b>-4.8</b>	<b>-5.1</b>	<b>-0.6</b>	<b>-0.4</b>

Note: Data for 1992-2002 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 2003 are preliminary actuals, mostly official government estimates. Data for 2004 represent EBRD projections.

<sup>1</sup> Unweighted average for the region.

Table A.2.8

**Foreign direct investment**

(net inflows recorded in the balance of payments)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Cumulative FDI inflows 1989-2003 (in US\$ mln)	Cumulative FDI inflows per capita 1989-2003 (US\$)	FDI inflows per capita 2002	2003	FDI inflows (in per cent of GDP)	
													Projection						
						(in US\$ million)													
Czech Republic	983	563	749	2,526	1,276	1,275	3,591	6,234	4,943	5,476	8,276	2,351	5,000	38,243	3,710	803	228	11.2	2.6
Estonia	80	156	212	199	111	130	574	222	324	343	153	743	684	3,246	2,402	113	550	2.2	8.2
Hungary	1,471	2,328	1,097	4,410	3,295	3,719	3,065	3,065	2,191	3,580	2,590	874	1,691	33,641	3,364	259	87	4.0	1.1
Latvia	na	50	279	245	379	515	303	331	401	170	374	328	365	3,372	1,454	160	141	4.0	3.0
Lithuania	na	30	31	72	152	328	921	478	375	439	715	142	500	3,683	1,067	207	41	5.1	1.0
Poland	284	580	1,846	3,617	4,445	4,863	6,049	7,239	9,324	5,802	3,901	3,839	5,000	51,906	1,355	102	100	2.0	2.0
Slovak Republic	100	107	236	194	199	84	374	701	2,058	1,460	4,007	549	1,500	10,185	1,894	745	102	16.6	1.7
Slovenia	113	111	129	161	167	303	221	59	71	371	1,748	-118	-32	3,277	1,647	876	-59	7.9	-0.4
Central eastern Europe and the Baltic states	3,031	3,925	4,580	11,422	10,023	11,217	15,098	18,329	19,686	17,640	21,764	8,707	14,708	147,553	2,112	408	149	6.6	2.4
Albania	20	45	65	89	97	42	45	51	143	204	135	178	377	1,114	352	42	56	3.0	3.0
Bosnia and Herzegovina	na	na	0	0	0	0	67	177	150	130	230	320	420	1,073	282	61	84	4.0	5.0
Bulgaria	42	40	105	98	138	507	537	789	1,003	641	876	1,398	2,000	6,235	795	112	178	5.6	7.0
Croatia	13	102	110	109	486	347	835	1,420	1,085	1,407	591	1,700	1,100	8,204	1,857	133	385	2.6	6.0
FYR Macedonia	0	0	24	12	12	18	118	32	176	439	77	94	150	1,002	501	38	47	2.0	2.0
Romania	73	87	341	417	415	1,267	2,079	1,025	1,051	1,154	1,080	1,528	2,100	10,536	486	50	70	2.0	3.0
Serbia and Montenegro	na	na	na	na	0	740	113	112	25	165	562	1,395	600	3,112	374	67	167	4.0	7.0
South-eastern Europe	148	274	646	725	1,148	2,920	3,794	3,606	3,633	4,140	3,552	6,613	6,747	31,276	664	72	141	3.3	4.7
Armenia	0	1	8	25	18	52	221	122	104	70	111	136	98	868	277	37	43	5.0	5.0
Azerbaijan	na	0	22	330	627	1,115	1,023	510	149	299	1,048	2,090	2,673	7,214	873	128	253	17.0	29.0
Belarus	na	18	11	15	105	350	201	443	119	96	453	170	150	1,979	200	46	17	3.1	1.0
Georgia	na	0	8	6	54	236	221	62	153	80	130	306	350	1,257	272	28	66	4.0	8.0
Kazakhstan	100	473	635	964	1,137	1,320	1,143	1,468	1,278	2,861	2,164	2,188	2,500	15,730	1,094	146	152	8.8	7.4
Kyrgyz Republic	na	10	38	96	47	83	87	38	-7	-1	5	17	72	413	85	1	4	0.3	1.0
Moldova	17	14	18	73	23	78	76	154	128	147	117	48	76	893	210	27	11	7.2	2.5
Russia	na	na	408	1,460	1,656	1,681	1,492	1,102	-463	216	-72	-3,002	1,000	4,478	31	0	-21	0.0	-1.0
Tajikistan	9	9	12	10	18	18	25	21	24	9	36	32	20	223	34	6	5	3.0	2.0
Turkmenistan	na	79	103	233	108	108	62	125	131	170	276	218	220	1,613	269	48	36	7.0	5.0
Ukraine	na	na	151	257	516	581	747	489	594	769	698	1,411	1,300	6,213	128	14	29	2.0	3.0
Uzbekistan	9	48	73	-24	90	167	140	121	75	83	65	70	180	917	35	3	3	1.0	1.0
Commonwealth of Independent States	135	652	1,487	3,445	4,399	5,789	5,438	4,656	2,285	4,798	5,030	3,684	8,639	41,797	292	40	50	4.9	5.3
Total	3,314	4,850	6,713	15,593	15,569	19,926	24,329	26,591	25,604	26,578	30,345	19,004	30,094	220,626	928	157	103	5.0	4.3

Sources: IMF, central banks and EBRD estimates.

Note: For most countries, figures cover only investment in equity capital and in some cases contributions-in-kind. For those countries where net investment into equity capital was not easily available (Azerbaijan, Estonia, Kazakhstan and the Slovak Republic), more recent data include reinvested earnings as well as inter-company debt transactions.

Gross inflows of FDI are in some cases considerably higher than net inflows on account of increasing intra-regional investment flows.

Table A.2.9

## GDP growth forecasts for 2004

(in per cent)

	Average <sup>1</sup>	Range <sup>2</sup>	EBRD (Sep 2004)	European Union (Apr 2004)	IMF (Sep 2004)	OECD (May 2004)	United Nations DESA <sup>4</sup> (Sep 2004)	CSFB <sup>5</sup> (Sep 2004)	Dun & Bradstreet (Aug 2004)	Economist Intelligence Unit (Aug 2004)	Global Insight, Inc. <sup>6</sup> (Jul 2004)	IWH <sup>7</sup> (Sep 2004)	JP Morgan (Sep 2004)	Kopint- Datorg <sup>8</sup> (Sep 2004)	Vienna Institute <sup>9</sup> (Jul 2004)
<b>Central eastern Europe and the Baltic states</b>															
Czech Republic	3.5	1.6	4.0	2.9	3.3	3.1	3.5	3.5	3.3	3.5	3.6	4.5	3.7	3.3	3.3
Estonia	5.7	1.3	5.5	5.4	5.8	na	5.2	na	5.2	5.6	6.4	5.5	na	6.5	5.5
Hungary	3.7	0.8	4.0	3.2	3.5	3.3	3.6	3.8	3.8	3.6	3.6	na	3.8	4.0	4.0
Latvia	7.0	1.3	7.5	6.2	6.5	na	6.8	na	7.0	6.8	7.5	7.0	na	7.5	7.5
Lithuania	7.4	2.3	7.0	6.9	7.0	na	7.0	na	8.9	7.0	6.6	6.8	na	7.2	10.0
Poland	5.6	1.9	5.5	4.6	5.8	4.7	5.8	5.9	5.5	5.5	6.0	5.5	6.0	6.5	5.0
Slovak Republic	4.7	1.2	4.8	4.0	4.8	4.3	4.5	4.6	4.8	4.7	4.6	4.8	5.2	5.2	4.5
Slovenia	3.5	0.9	4.1	3.2	3.9	na	3.2	na	3.5	3.5	3.5	3.2	na	3.6	3.4
Average	5.1	1.4	5.3	4.6	5.1	3.9	5.0	4.5	5.3	5.0	5.2	5.3	4.7	5.5	5.4
Weighted average <sup>3</sup>	4.8	1.5	4.9	4.1	4.8	na	4.8	na	4.8	4.7	5.0	na	na	5.3	4.6
<b>South-eastern Europe</b>															
Albania	6.1	0.6	6.2	na	6.2	na	6.0	na	6.5	6.0	5.9	na	na	6.0	6.0
Bosnia and Herzegovina	4.6	1.0	4.0	na	na	na	4.5	na	4.5	5.0	5.0	na	na	4.5	5.0
Bulgaria	4.9	1.5	5.5	5.0	5.2	na	4.0	5.0	4.7	4.2	4.7	na	4.8	5.4	4.5
Croatia	3.8	1.1	3.7	na	3.7	na	3.5	na	3.8	3.7	4.2	na	na	4.3	3.2
FYR Macedonia	2.3	3.0	2.5	na	4.0	na	2.0	na	3.2	2.0	1.4	na	na	1.0	3.0
Romania	5.7	2.0	5.8	5.1	5.0	na	5.8	5.5	5.0	6.0	7.0	na	6.2	5.8	5.0
Serbia and Montenegro	4.7	3.0	5.0	na	4.4	na	4.6	na	3.5	6.0	4.3	na	na	5.2	3.0
Average	4.6	1.7	4.7	5.1	4.8	na	4.3	5.3	4.5	4.7	4.6	na	5.5	4.6	4.2
Weighted average <sup>3</sup>	4.9	1.8	5.0	na	na	na	4.7	na	4.5	5.1	5.4	na	na	5.1	4.3
<b>Commonwealth of Independent States</b>															
Armenia	7.9	2.5	8.0	na	7.0	na	8.0	na	na	7.0	9.5	na	na	na	na
Azerbaijan	9.8	1.3	10.0	na	9.1	na	9.5	na	9.6	10.0	10.4	na	na	na	na
Belarus	7.5	3.4	6.0	na	na	na	6.5	na	7.5	9.0	9.4	na	na	na	8.0
Georgia	7.9	4.0	6.0	na	8.5	na	6.5	na	7.0	10.0	9.1	na	na	na	na
Kazakhstan	8.8	1.1	9.0	na	9.0	na	8.5	na	8.6	9.5	8.4	na	na	na	na
Kyrgyz Republic	5.6	1.7	6.0	na	5.5	na	6.5	na	4.8	6.0	4.8	na	na	na	na
Moldova	6.0	2.0	7.0	na	5.0	na	5.5	na	na	7.0	5.3	na	na	na	na
Russia	7.0	1.2	6.9	6.5	7.3	7.0	7.5	7.0	6.6	7.0	6.8	7.0	7.5	na	6.3
Tajikistan	8.5	3.0	8.5	na	10.0	na	8.0	na	7.0	9.0	8.3	na	na	na	na
Turkmenistan	10.5	13.2	7.5	na	7.5	na	8.0	na	6.5	14.0	19.7	na	na	na	na
Ukraine	10.3	6.5	12.3	6.0	12.5	na	11.5	11.0	10.0	11.0	9.0	na	na	na	9.5
Uzbekistan	3.5	3.5	2.5	na	2.5	na	6.0	na	2.5	3.0	4.6	na	na	na	na
Average	7.8	3.6	7.5	6.3	7.5	7.0	7.7	9.0	7.0	8.6	8.8	7.0	7.5	na	7.9
Weighted average <sup>3</sup>	7.4	1.9	7.4	na	7.8	na	7.9	na	na	7.6	7.3	na	na	na	na
<b>All transition countries</b>															
Average	6.2	2.5	6.1	4.9	6.1	4.5	6.0	5.8	5.7	6.5	6.7	5.5	5.3	5.1	5.4
Weighted average <sup>3</sup>	6.0	1.7	6.1	na	na	na	6.3	na	na	6.1	6.1	na	na	na	na

Note: All forecasts quoted here were published or reported to the EBRD between April and September 2004. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial delays between preparation and publication of forecasts.

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

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

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

<sup>4</sup> United Nations, Department of Economic and Social Affairs (DESA).

<sup>5</sup> Credit Suisse First Boston.

<sup>6</sup> Global Insight Inc. formerly DRI-WEFA.

<sup>7</sup> Institute for Economic Research, Halle, Germany.

<sup>8</sup> Kopint-Datorg is the Institute for Economic and Market Research Information, Hungary.

<sup>9</sup> Vienna Institute for International Economic Studies (WIIW).

Table A.2.10

## GDP growth forecasts for 2005

(in per cent)

	Average <sup>1</sup>	Range <sup>2</sup>	EBRD (Sep 2004)	European Union (Apr 2004)	IMF (Sep 2004)	OECD (May 2004)	United Nations DESA <sup>4</sup> (Sep 2004)	CSFB <sup>5</sup> (Sep 2004)	Dun & Bradstreet (Aug 2004)	Economist Intelligence Unit (Aug 2004)	Global Insight, Inc. <sup>6</sup> (Jul 2004)	IWH <sup>7</sup> (Sep 2004)	JP Morgan (Sep 2004)	Kopit- Datorg <sup>8</sup> (Sep 2004)	Vienna Institute <sup>9</sup> (Jul 2004)
<b>Central eastern Europe and the Baltic states</b>															
Czech Republic	3.7	0.6	4.0	3.4	3.4	3.4	4.0	3.8	3.7	4.0	4.0	3.5	3.7	3.8	3.6
Estonia	5.8	0.6	5.7	5.9	5.4	na	5.5	na	5.8	6.0	5.9	6.0	na	6.0	5.7
Hungary	3.9	1.6	5.0	3.4	3.7	3.8	4.0	3.9	3.7	4.0	3.7	3.8	3.8	4.3	4.3
Latvia	6.5	1.9	6.5	6.2	6.0	na	7.0	na	7.2	5.5	7.4	6.5	na	6.5	7.0
Lithuania	6.6	2.2	6.8	6.6	7.0	na	7.5	na	6.9	6.5	5.3	6.5	na	6.2	8.5
Poland	5.0	1.3	5.0	4.8	5.1	4.5	5.0	5.4	5.0	4.7	5.4	4.5	4.8	5.8	4.5
Slovak Republic	4.8	1.4	5.2	4.1	4.3	4.8	4.8	4.5	4.5	5.0	5.0	4.5	5.0	5.5	5.0
Slovenia	3.7	0.6	3.8	3.6	4.1	na	3.5	na	3.8	3.7	3.7	3.5	na	3.8	3.5
Average	5.0	1.3	5.3	4.8	4.9	4.1	5.2	4.4	5.1	4.9	5.1	4.9	4.3	5.2	5.3
Weighted average <sup>3</sup>	4.6	1.2	4.9	4.3	4.5	na	4.7	na	4.6	4.5	4.8	4.3	na	5.1	4.5
<b>South-eastern Europe</b>															
Albania	6.0	2.0	6.0	na	6.0	na	6.0	na	5.8	7.0	6.5	na	na	5.0	6.0
Bosnia and Herzegovina	4.8	1.5	4.0	na	na	na	4.5	na	4.4	5.3	5.1	na	na	5.5	5.0
Bulgaria	4.9	1.5	5.0	5.5	5.2	na	4.0	5.5	4.5	4.0	4.5	na	5.3	5.5	4.0
Croatia	4.0	0.6	4.0	na	4.1	na	4.0	na	3.7	4.2	4.0	na	na	4.3	3.5
FYR Macedonia	3.7	2.0	3.0	na	4.5	na	3.0	na	3.0	4.0	3.7	na	na	5.0	4.0
Romania	5.3	2.0	5.0	5.3	5.0	na	4.8	5.5	4.5	5.2	6.5	na	5.5	5.5	4.5
Serbia and Montenegro	4.8	1.7	4.0	na	4.5	na	4.8	na	4.0	5.0	5.5	na	na	5.7	4.0
Average	4.8	1.6	4.4	5.4	4.9	na	4.4	5.5	4.3	5.0	5.1	na	5.4	5.2	4.4
Weighted average <sup>3</sup>	4.9	1.6	4.6	na	na	na	4.5	na	4.3	4.9	5.4	na	na	5.3	4.2
<b>Commonwealth of Independent States</b>															
Armenia	6.8	2.9	6.0	na	6.0	na	7.0	na	na	6.0	8.9	na	na	na	na
Azerbaijan	10.6	6.3	12.0	na	11.4	na	8.5	na	7.7	14.0	9.9	na	na	na	na
Belarus	5.6	1.5	5.0	na	5.5	na	5.5	na	6.5	6.0	5.1	na	na	na	7.0
Georgia	7.4	7.0	5.0	na	6.0	na	5.0	na	7.0	12.0	9.4	na	na	na	na
Kazakhstan	8.1	2.8	7.0	na	8.5	na	8.0	na	7.3	8.0	9.8	na	na	na	na
Kyrgyz Republic	4.9	1.7	5.5	na	4.9	na	4.5	na	4.4	6.0	4.3	na	na	na	na
Moldova	5.0	2.0	5.5	na	4.0	na	4.7	na	na	5.0	6.0	na	na	na	na
Russia	6.0	1.2	6.0	5.4	6.6	5.8	6.5	6.0	6.0	5.8	5.6	6.0	6.4	na	5.5
Tajikistan	6.4	3.1	6.0	na	8.0	na	7.5	na	6.0	6.0	4.9	na	na	na	na
Turkmenistan	7.4	8.6	6.8	na	7.0	na	7.5	na	3.5	7.5	12.1	na	na	na	na
Ukraine	7.2	3.0	8.0	6.0	6.0	na	8.5	6.5	9.0	7.0	6.4	na	na	na	7.0
Uzbekistan	2.9	4.0	2.5	na	2.5	na	4.5	na	0.5	3.0	4.1	na	na	na	na
Average	6.5	3.7	6.3	5.7	6.4	5.8	6.5	6.3	5.8	7.2	7.2	6.0	6.4	na	6.5
Weighted average <sup>3</sup>	6.2	1.7	6.2	na	6.6	na	6.7	na	na	6.1	6.0	na	na	na	na
<b>All transition countries</b>															
Average	5.6	2.4	5.5	5.0	5.6	4.5	5.6	5.1	5.1	5.9	6.0	5.0	4.9	5.2	5.1
Weighted average <sup>3</sup>	5.4	1.5	5.5	na	na	na	5.6	na	na	5.3	5.4	na	na	na	na

Note: All forecasts quoted here were published or reported to the EBRD between April and September 2004. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial delays between preparation and publication of forecasts.

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

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

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

<sup>4</sup> United Nations, Department of Economic and Social Affairs (DESA).

<sup>5</sup> Credit Suisse First Boston.

<sup>6</sup> Global Insight Inc, formerly DRI-WEFA.

<sup>7</sup> Institute for Economic Research, Halle, Germany.

<sup>8</sup> Kopit-Datorg is the Institute for Economic and Market Research Information, Hungary.

<sup>9</sup> Vienna Institute for International Economic Studies (WIIW).



Table A.2.11

## Average annual inflation forecasts for 2004

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

Range<sup>2</sup>Average<sup>1</sup>

	EBRD (Sep 2004)	European Union (Apr 2004)	IMF (Sep 2004)	OECD (May 2004)	United Nations DESA <sup>3</sup> (Sep 2003)	CSFB <sup>4</sup> (Sep 2004)	Dun & Bradstreet (Aug 2004)	Economist Intelligence Unit (Aug 2004)	Global Insight, Inc. <sup>5</sup> (Jul 2004)	IWH <sup>6</sup> (Sep 2004)	JP Morgan (Sep 2004)	Kopint- Datorg <sup>7</sup> (Sep 2004)	Vienna Institute <sup>8</sup> (Jul 2004)
<b>Central eastern Europe and the Baltic states</b>													
Czech Republic	3.0	3.2	2.8	3.0	3.0	3.0	3.0	3.2	3.0	3.0	2.8	2.8	3.2
Estonia	2.9	3.5	2.8	na	2.7	na	2.3	3.0	2.3	3.5	na	3.2	2.9
Hungary	6.8	6.8	6.9	6.9	6.8	6.9	6.0	7.0	6.8	7.0	7.0	6.9	6.5
Latvia	4.7	6.2	4.0	na	2.9	na	3.0	5.6	4.7	4.5	na	5.5	4.5
Lithuania	0.8	2.8	1.5	na	1.4	na	-1.3	1.1	0.9	1.0	na	1.2	0.3
Poland	3.2	3.6	2.3	3.2	3.2	3.4	3.2	3.4	3.6	3.5	3.4	3.4	3.0
Slovak Republic	7.8	7.5	8.2	7.6	8.0	7.9	7.5	7.6	7.8	8.0	7.8	7.9	8.0
Slovenia	3.7	3.9	3.6	na	3.5	na	3.5	3.6	3.9	3.5	na	3.6	4.0
<i>Average</i>	<i>4.1</i>	<i>4.5</i>	<i>4.0</i>	<i>4.8</i>	<i>3.9</i>	<i>5.3</i>	<i>3.4</i>	<i>4.3</i>	<i>4.1</i>	<i>4.3</i>	<i>5.3</i>	<i>4.3</i>	<i>4.1</i>
<b>South-eastern Europe</b>													
Albania	3.1	3.4	na	na	3.0	na	2.5	3.0	3.1	na	na	3.0	3.5
Bosnia and Herzegovina	0.8	0.9	na	na	0.4	na	0.6	0.9	0.5	na	na	1.5	0.6
Bulgaria	6.3	6.3	6.0	na	5.8	6.6	5.5	6.1	6.6	na	6.7	6.0	7.0
Croatia	2.3	2.5	na	na	2.5	na	2.0	2.2	2.7	na	na	2.3	2.0
FYR Macedonia	1.8	2.5	na	na	0.5	na	2.8	0.5	1.3	na	na	1.3	3.0
Romania	11.8	11.9	12.0	na	12.0	11.7	12.5	11.8	11.5	na	12.0	12.0	11.0
Serbia and Montenegro	9.1	8.5	na	na	9.0	na	9.5	8.8	9.3	na	na	10.2	10.0
<i>Average</i>	<i>5.0</i>	<i>5.2</i>	<i>9.0</i>	<i>na</i>	<i>4.7</i>	<i>9.2</i>	<i>5.1</i>	<i>4.8</i>	<i>5.0</i>	<i>na</i>	<i>9.4</i>	<i>5.2</i>	<i>5.3</i>
<b>Commonwealth of Independent States</b>													
Armenia	5.9	7.8	na	na	6.5	na	na	5.0	7.1	na	na	na	na
Azerbaijan	4.8	5.2	na	na	5.5	na	2.0	4.1	6.4	na	na	na	na
Belarus	19.6	19.3	na	na	22.0	na	19.0	20.0	17.4	na	na	na	20.0
Georgia	5.2	6.0	na	na	5.0	na	5.0	5.0	4.5	na	na	na	na
Kazakhstan	6.7	6.7	na	na	6.5	na	6.5	6.5	7.0	na	na	na	na
Kyrgyz Republic	4.9	6.2	na	na	4.0	na	5.2	2.7	6.8	na	na	na	na
Moldova	11.0	10.0	na	na	10.5	na	na	11.5	12.1	na	na	na	na
Russia	10.8	10.7	na	14.0	10.0	10.8	10.0	10.6	10.7	na	11.0	na	10.0
Tajikistan	8.2	6.3	na	na	10.0	na	10.0	8.0	7.6	na	na	na	na
Turkmenistan	17.8	8.8	na	na	12.0	na	60.0	9.0	12.2	na	na	na	na
Ukraine	7.5	8.1	na	na	6.5	7.8	6.0	8.1	8.4	na	na	na	7.0
Uzbekistan	18.8	12.0	na	na	19.0	na	64.0	3.0	3.2	na	na	na	na
<i>Average</i>	<i>10.1</i>	<i>8.9</i>	<i>na</i>	<i>14.0</i>	<i>9.8</i>	<i>9.3</i>	<i>18.8</i>	<i>7.8</i>	<i>8.6</i>	<i>na</i>	<i>11.0</i>	<i>na</i>	<i>12.3</i>
<b>All transition countries</b>													
<i>Average</i>	<i>7.0</i>	<i>6.3</i>	<i>5.0</i>	<i>6.7</i>	<i>6.7</i>	<i>7.3</i>	<i>10.0</i>	<i>6.0</i>	<i>6.3</i>	<i>4.3</i>	<i>7.2</i>	<i>4.7</i>	<i>5.9</i>

Note: All forecasts quoted here were published or reported to the EBRD between April and September 2004. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

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

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

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

<sup>4</sup> Credit Suisse First Boston.

<sup>5</sup> Global Insight Inc, formerly DRI-WEFA.

<sup>6</sup> Institute for Economic Research, Halle, Germany.

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

<sup>8</sup> Vienna Institute for International Economic Studies (WIIW).

Table A.2.12

## Average annual inflation forecasts for 2005

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

	Average <sup>1</sup>	Range <sup>2</sup>	EBRD (Sep 2004)	European Union (Apr 2004)	IMF (Sep 2004)	OECD (May 2004)	United Nations DESA <sup>3</sup> (Sep 2004)	CSFB <sup>4</sup> (Sep 2004)	Dun & Bradstreet (Aug 2004)	Economist Intelligence Unit (Aug 2004)	Global Insight, Inc. <sup>5</sup> (Jul 2004)	IWH <sup>6</sup> (Sep 2004)	JP Morgan (Sep 2004)	Kopint- Datorg <sup>7</sup> (Sep 2004)	Vienna Institute <sup>8</sup> (Jul 2004)
<b>Central eastern Europe and the Baltic states</b>															
Czech Republic	2.8	1.5	2.5	2.8	3.0	2.5	2.3	2.8	3.5	2.6	3.1	2.8	3.2	2.9	2.0
Estonia	2.7	2.2	3.3	2.9	2.5	na	1.2	na	2.0	3.2	3.4	3.0	na	2.6	3.1
Hungary	4.6	0.6	4.7	4.6	4.4	4.8	4.5	4.4	5.0	4.7	4.5	4.5	4.5	4.6	4.8
Latvia	3.3	2.3	4.0	3.5	3.5	na	1.7	na	2.5	3.5	3.5	4.0	na	3.1	3.8
Lithuania	1.8	1.8	2.8	2.2	2.5	na	1.0	na	1	1.6	1.1	1.5	na	2.6	1.5
Poland	3.2	1.6	3.0	3.0	3.8	2.4	3.0	3.1	3.5	3.3	3.2	4.0	3.5	3.2	3.0
Slovak Republic	4.4	3.0	4.5	4.5	3.0	3.0	6.0	3.8	5.0	5.1	4.0	5.0	4.0	4.0	5.0
Slovenia	3.2	0.5	3.5	3.2	3.2	na	3.0	na	3.0	3.0	3.5	3.2	na	3.0	3.5
Average	3.3	1.7	3.5	3.3	3.2	3.2	2.8	3.5	3.2	3.4	3.3	3.5	3.8	3.3	3.3
<b>South-eastern Europe</b>															
Albania	3.2	2.6	3.0	na	3.0	na	3.0	na	2.3	3.2	4.9	na	na	3.0	3.5
Bosnia and Herzegovina	1.5	2.3	2.0	na	na	na	0.5	na	0.9	1.3	2.8	na	na	2.2	0.5
Bulgaria	4.2	1.5	4.0	4.5	3.6	na	4.5	4.3	3.5	4.7	5.0	na	4.0	4.2	4.0
Croatia	2.6	2.0	2.9	na	3.5	na	2.5	na	2.0	2.4	3.3	na	na	2.5	1.5
FYR Macedonia	2.3	1.6	2.0	na	3.0	na	2.0	na	2.7	1.4	2.9	na	na	2.5	2.0
Romania	8.3	3.2	8.9	8.5	7.2	na	8.0	8.4	9.0	8.4	6.8	na	10.0	8.5	8.0
Serbia and Montenegro	8.4	4.0	7.0	na	6.9	na	8.0	na	8.5	8.2	10.9	na	na	7.5	10.0
Average	4.4	2.5	4.3	6.5	4.5	na	4.1	6.4	4.1	4.2	5.2	na	7.0	4.3	4.2
<b>Commonwealth of Independent States</b>															
Armenia	3.5	2.5	3.7	na	3.0	na	na	na	na	2.5	5.0	na	na	na	na
Azerbaijan	4.4	2.6	5.0	na	5.0	na	na	na	2.5	4.5	5.1	na	na	na	na
Belarus	19.2	9.0	17.3	na	17.4	na	na	na	16.0	25.0	23.3	na	na	na	16.0
Georgia	4.7	1.8	5.0	na	4.8	na	na	na	4.5	5.6	3.8	na	na	na	na
Kazakhstan	6.2	2.3	4.7	na	6.7	na	na	na	6.0	6.6	7.0	na	na	na	na
Kyrgyz Republic	5.1	5.8	5.2	na	4.6	na	na	na	5.3	2.2	8.0	na	na	na	na
Moldova	8.1	4.2	8.0	na	5.8	na	na	na	na	10.0	8.7	na	na	na	na
Russia	9.7	3.0	9.6	na	8.9	11.0	na	9.8	8.0	9.6	10.3	na	10.7	na	9.0
Tajikistan	7.5	3.3	6.8	na	5.7	na	na	na	9.0	7.5	8.6	na	na	na	na
Turkmenistan	15.8	39.9	9.0	na	5.1	na	na	na	45.0	8.0	12.0	na	na	na	na
Ukraine	7.2	3.6	7.1	na	8.1	na	na	7.7	4.5	8.0	7.0	na	na	na	8.0
Uzbekistan	20.7	65.0	13.0	na	10.5	na	na	na	70.0	5.0	5.1	na	na	na	na
Average	9.3	11.9	7.9	na	7.1	11.0	na	8.8	17.1	7.9	8.7	na	10.7	na	11.0
<b>All transition countries</b>															
Average	6.2	6.4	5.6	4.0	5.3	4.7	3.4	5.5	9.0	5.6	6.2	3.5	5.7	3.8	5.0

Note: All forecasts quoted here were published or reported to the EBRD between April and September 2004. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

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

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

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

<sup>4</sup> Credit Suisse First Boston.

<sup>5</sup> Global Insight Inc, formerly DRI-WEFA.

<sup>6</sup> Institute for Economic Research, Halle, Germany.

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

<sup>8</sup> Vienna Institute for International Economic Studies (WIIW).



## Part II: Infrastructure

Part II of this *Transition Report* is devoted to the special topic of infrastructure. A sound infrastructure – encompassing energy, telecommunications, transport, water supply and municipal services – is an important element of an efficient market economy.

Surveys show that sub-standard infrastructure is a serious impediment to enterprise development. The business community sees unreliable infrastructure services as a significant constraint on the performance and growth of enterprises. By reducing transport and transaction costs, an efficient infrastructure also promotes competition and regional cooperation. As shown in the 2003 *Transition Report*, the poor state of transport and telecommunications in parts of the region creates an important barrier to regional and international trade in many transition countries. Furthermore, efficient and accessible infrastructure services help to promote economic growth and to alleviate poverty.

In the communist era, governments invested heavily in infrastructure. As a consequence, most transition countries have a reasonable level of network coverage compared with other emerging markets. However, as shown in the 1996 *Transition Report*, the systems inherited from communism were badly managed and ill-suited to the demands of a market economy. After decades of under-funding, infrastructure services are in need of upgrading and rehabilitation. The investment needs of the region run into billions of euros.

In response to these shortcomings, the transition countries have embarked on a programme of reform to improve the management of infrastructure services, to shift their operation to a commercial basis and, perhaps most difficult of all, to place them on a sound financial footing. For reform to be successful, the transition countries have to put in place new regulatory systems that encourage investment, promote efficiency and stimulate competition. Many countries are relying on the private sector to provide management skills and capital to improve infrastructure services. The following chapters review progress with regulatory reform and private sector participation.





# Regulation of infrastructure services

# 3

Reforms in infrastructure regulation have occurred as part of the transition process in central eastern Europe and the Baltic states, south-eastern Europe and the Commonwealth of Independent States. However, the experience of the transition countries in setting up modern regulatory regimes for utilities has been mixed. While the more advanced countries in the region have succeeded in constructing stable regulatory arrangements, many others have struggled to establish accountable and credible authorities. Where regulation is more effective, service delivery has generally improved.

Efficient and accessible infrastructure services help to promote economic growth and to alleviate poverty. There is general support for this argument but less evidence on how this should be achieved in practice. Policy-makers around the world continue to debate the best means of promoting restructuring and investment in infrastructure. Nevertheless, there is broad agreement that creating and implementing an effective regulatory regime is an important first step. This is seen as essential to commercialising infrastructure and attracting private investment.

Since the emergence of modern infrastructure services for energy, telecommunications, transport and water, three concerns have been paramount for governments: how to protect consumers against abuse by monopoly suppliers; how to guard investors against direct or implicit expropriation (keeping regulated prices below cost-recovery levels, for example); and how to meet the needs of the population for basic services, such as heat and water.

The typical features of the infrastructure sector – such as high barriers to market entry and natural monopolies – make it difficult for the market to address these three concerns. Historically, the standard solution has been to provide regulated monopoly franchises. In return for building and operating the core networks of rails, pipes or wires, a company would be given the right to supply infrastructure services within a designated area for a given period of time. However, since the 1980s it has become possible, technologically and commercially, to separate networks from service provision and to introduce competition in some segments of the market. This has changed fundamentally the nature of regulation, but has not reduced the need for it. In fact, it is clear that the need for regulation is significantly greater for “unbundled” (or separated) utilities than for traditional monopoly utilities. The expectation is that this increased regulatory effort is rewarded with better and more efficient services.

This chapter addresses the policy challenge of infrastructure regulation. Initially it describes the transition countries' infrastructure inherited from the socialist era and the need for regulatory reform. It then provides an assessment of the quality and effectiveness of regulatory agencies and obstacles to reform. Evidence is drawn from a new EBRD survey of regulators implemented for this *Transition Report*. The third section of the chapter considers some key regulatory challenges, such as setting and adjusting tariffs and promoting competition. This is followed by an examination of how regulatory reform affects infrastructure performance and service quality. The last section offers conclusions and policy recommendations.

### 3.1 Inherited infrastructure and the need for reform

At the start of the transition process, the region inherited extensive infrastructure networks. However, they were in serious disrepair and not necessarily suited to a market economy. Central planning priorities paid little heed to cost, efficiency or environmental considerations. For example, telecommunications systems used outdated technology, with limited access for households and businesses. Energy efficiency was discouraged by low-cost supply. The railways infrastructure was designed to support heavy industrial production and long-range haulage of raw materials. Investment in roads was limited, and use of private cars was discouraged. Water supplies were generally unreliable and of low quality, and waste water was disposed of without regard to the environmental consequences.<sup>1</sup>

There have been efforts to address these problems during transition (see Chapter 1). Nevertheless, the transition countries face, to varying degrees, significant infrastructure challenges. These include: tariffs that do not reflect costs; extensive cross-subsidisation between different types of services and different consumer groups; lack of commercial discipline in the operation of infrastructure industries (particularly in relation to poor revenue collection); and insufficient separation of the different branches of the industry – in particular between operating and regulatory functions and in certain sectors between natural monopoly elements and areas that may be opened to competition.

Without reforms, operating and financial performance will remain poor, service quality will deteriorate further, and adequate investment to resolve these deficiencies will not materialise. This will in turn place an additional strain on state budgets. Effective regulation is an integral part of any strategy to address these challenges, although the requirements and specifications of a regulatory regime will differ for each industry.

#### Infrastructure characteristics and regulation

Although most infrastructure industries share certain features, they also have very different characteristics. Which type of regulatory framework should therefore be applied to each industry? To answer this question, it is helpful to look at the specific features of the infrastructure sectors.<sup>2</sup>

The key considerations in establishing an effective regulatory framework for infrastructure industries include the growth in demand and the rate of technical progress, both of which affect the scope for competition. In principle, industries with a higher growth in demand and a faster rate of technical progress are more attractive to new entrants and may have lower barriers to entry. This, in turn, may reduce the need for regulation. However, this has to be balanced against other factors. Infrastructure networks (such as electricity transmission lines, fixed-line telecommunications networks and railway tracks) require regulation to monitor equal access, in order to prevent an incumbent operator from dominating the market. Also, industries that may have an adverse impact on the environment will require more regulation (see Annex 3.1).

In addition to these generic factors, country characteristics (for example, the size of the country or market) also help to determine the potential for market growth and competition, which in turn affect the sector structure (for example, the degree of unbundling) and the need for regulation.

In the telecommunications sector, there is rapidly growing demand for mobile and other services (for example, internet access and data transmission) but slowing demand for fixed-line services. Rapid technological change has spurred greater competition among providers. Furthermore, cellular telephones have in many cases become substitutes for fixed-line services.

Certain forms of regulation, such as price regulation, therefore become less crucial. However, effective regulation is still important for promoting competition, attracting new investment, governing network access and maintaining the level and quality of supply.

In the water and waste-water sector a lack of growth in demand, slow technological advances, limited potential for competition, and substantial scope for negative impact on the environment suggest that regulation will be crucial for maintaining the volume and quality of supply and investment.

Railways are similar to the water sector in terms of technological innovation, growth in demand and impact on the environment but the potential for competition is higher. Competition between road and rail for freight transport, advances in freight logistics and information technology, and competition with water transport and pipelines have profoundly affected the organisation and practices of transportation markets.<sup>3</sup> There is a strong need for regulation and for non-discriminatory access to the track infrastructure for private carriers as well as for safety regulation.

In the electricity and natural gas sectors, there is some growth in demand. The transmission and distribution networks, system control and dispatch are mostly natural monopolies, but potentially competitive elements exist in generation, bulk power sales and retail supply – provided the market is large enough to support several operators. Furthermore, the introduction of new technologies, such as combined cycle gas turbines, has significantly reduced the minimum size of efficient generating plants, the investment cost of new units, and the time necessary to plan and build new plants. However, problems may arise with “stranded assets” – inefficient existing plants that become uneconomic to run as markets are opened to competition. In practice, it has proved difficult to create and sustain competitive generation markets without some form of regulation.

### 3.2 Regulatory effectiveness

The legal framework for the regulation of infrastructure industries has only recently been created in transition countries. In most countries, new laws and regulators

have been introduced for electricity and telecommunications. For railways, the regulatory and operations functions still lie with the relevant government ministry in most countries. Separation of accounts has been initiated in several countries but actual separation has been achieved in only a few. Regulatory reform in the water sector started with the decentralisation of operations and regulatory functions to municipalities. The majority of countries have either partially or fully implemented this step. The only country that has established a national water regulator so far is Romania, but Bulgaria is also considering this option. More detailed information on progress with infrastructure regulation is provided in Table 3.1.

In practice, formal regulatory autonomy has been compromised frequently, even in some of the more advanced countries of central eastern Europe and the Baltic states (CEB). In Hungary, for example, the authority of the energy regulator has been constrained by unclear criteria for the appointment and dismissal of directors. In the Czech Republic and Croatia, the government has retained the final authority to set prices for gas and electricity. Such evidence suggests a gap between the regulatory arrangements on paper and their application in practice.

### The quality of regulatory agencies

The quality and effectiveness of the newly established regulatory institutions can be assessed using the results of a new EBRD survey of regulators in the electricity, railways and telecommunications sectors. The survey was implemented in summer 2004.<sup>4</sup>

There are six key characteristics of an effective regulatory system: coherence, predictability, capacity, independence, accountability and transparency.<sup>5</sup> The first three criteria depend on each country's wider legal and institutional framework.

Coherence implies that the laws underpinning regulatory policies and their implementation must be consistent. There must be a clear division of responsibilities among national and municipal regulators and government ministries. Ideally, the regulatory agency should have a statutory obligation to publish a formal statement outlining its decision-making remit on entry, pricing and all other elements of industry behaviour that are subject to

**Table 3.1**  
**Progress in infrastructure regulation**

	Electricity (year autonomous regulator established)	Railways (autonomous regulator)	Telecommunications (year autonomous regulator established)	Water (decentralised)
Albania	1996	No	1998	No
Armenia	1997	No	Planned	Partial
Azerbaijan	-	No	Planned	Partial
Belarus	-	No	-	No
Bosnia and Herzegovina	2004	No	2001	No
Bulgaria	1999	No	2002	Partial
Croatia	2002	Planned	2002	Full
Czech Republic	2001	Yes	2000	Full
Estonia	1998	Yes	1998	Full
FYR Macedonia	2003	No	-	Partial
Georgia	1997	No	2000	Partial
Hungary	1994	Planned	1993	Full
Kazakhstan	2002	Yes	2002	Partial
Kyrgyz Republic	1996	No	2001	No
Latvia	1996	Yes	2001	Full
Lithuania	1997	No	2001	Full
Moldova	1998	No	2000	Partial
Poland	1998	Yes	2002	Full
Romania	1999	No	2002	Full
Russia	2004	Planned	2004	Partial
Serbia and Montenegro	Planned	No	-	Partial
Slovenia	2001	No	2001	Partial
Slovak Republic	2001	Yes	2000	Full
Tajikistan	-	No	Planned	No
Turkmenistan	-	No	-	No
Ukraine	2000	No	-	Partial
Uzbekistan	2000	No	-	Partial

Sources: National regulators and EBRD database.

regulatory oversight. However, it is difficult to assess the degree of coherence in a systematic way.

Predictability means that there will not be sudden changes in the overall regulatory framework or in the way regulators make decisions. This is particularly important for investors making long-term decisions. Political commitments, such as EU membership obligations, can help ensure a greater level of predictability in policy. However, in many transition countries (as elsewhere in the world), changes of government have often been associated with major changes in regulatory practice. Even in the new EU member states of CEB, there is some evidence that enterprises still have serious concerns about the lack of predictability of laws and regulation.

Predictability has been a major problem in some of the countries of the Commonwealth of Independent States (CIS). An example has been the uncertainty over frequency rights for two licensed Russian mobile telephone operators, VimpelCom and MTS. In 2000 they were asked by the Ministry of Telecommunications to vacate frequencies that had been designated for alternative use. This led immediately to a

sharp fall in both companies' share price although the issue was subsequently resolved in the companies' favour.<sup>6</sup>

Capacity requires that regulatory agencies are staffed with qualified people and have the authority and appropriate levels of funding to implement their mandate effectively. The budgets available to regulators vary considerably across transition economies, ranging from less than US\$ 100,000 for the Kyrgyz electricity regulator to several million US dollars for the regulators in some CEB countries. Staffing levels also vary widely, from several hundred employees in the Polish and Czech telecommunications regulators to only five professionals in the recently established electricity regulator in FYR Macedonia. While regulatory requirements differ with country size and income levels, this does not fully explain the observed variation in capacity.

Coherence, predictability and capacity are general prerequisites for an effective system of regulation. The other three criteria – independence, accountability and transparency – are more specific to each sector. The EBRD survey provides an indicative ranking of these attributes that

allows for comparisons between countries. Chart 3.1 summarises the findings in the telecommunications and electricity sectors.<sup>7</sup>

Regulatory independence concerns the relationship between regulatory agencies and the government. Regulators were asked in the survey how many agency heads (or commissioners) had served for less than a full term and whether the government could overrule regulatory decisions. They were also asked about aspects of financial independence – for example, whether agency funding came from operational sources (such as user fees or levies on the regulated industry) rather than the state budget.

The results of the survey suggest that interference from government continues to undermine regulatory independence in many transition countries. Governments and especially the ministries with specific infrastructure responsibilities are reluctant to delegate key regulatory functions to independent agencies. Many regulatory agencies continue to report directly to those sectoral ministries. Independence is further undermined by the fact that 70 per cent of the telecommunications regulators and 50 per cent of electricity regulators were not able to serve their full terms.

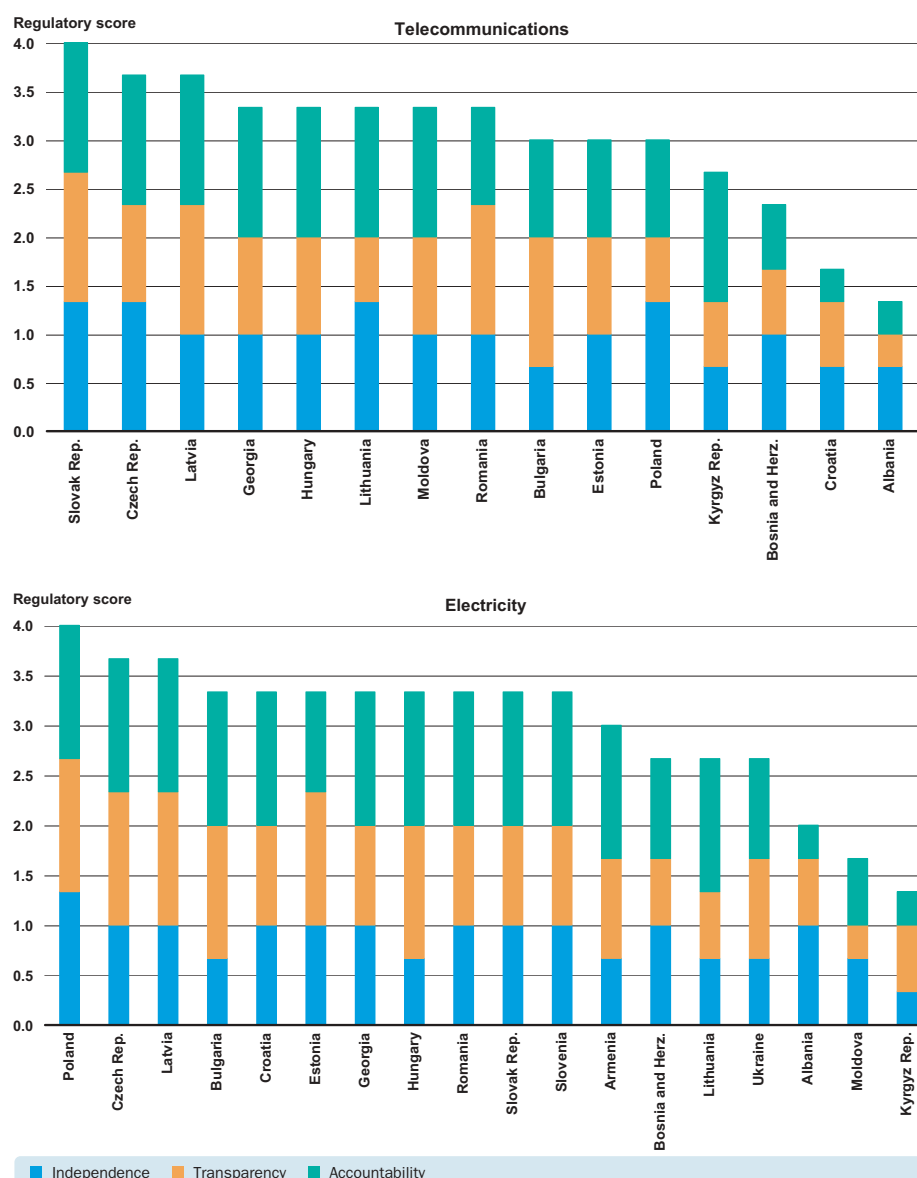
Regulatory behaviour is less predictable where rules can easily be reversed by the government or by presidential decree. The survey shows that regulatory decisions have been overruled in about 30 per cent of cases. However, transition countries scored favourably in terms of the financial independence of the regulator in both telecommunications and electricity – only 20 per cent of the former and 30 per cent of the latter depended on the state budget.

The level of regulatory independence differs by country and sector. Within the telecommunications sector, regulators in much of CEB scored well, indicating a high degree of independence. This was not the case for electricity, however, where only Poland achieved full independence. In south-eastern Europe (SEE) and the CIS far lower levels of independence were attained. Nevertheless, in a number of cases – Bosnia and Herzegovina, Georgia and Moldova, for instance – there was progress in at least one sector.

Accountability ensures that regulators enforce rules fairly while protecting the legal rights and economic interests of the

Chart 3.1

### Regulatory quality in selected transition countries



Source: Vagliasindi and Chirmiciu (2004).

Note: The regulatory score is the average of three dimensions – independence, transparency and accountability – and ranges from 1 (low) to 4 (high). The “independence” score is based on financial independence, decision independence (no government authority can overrule regulatory decisions or dismiss cases without due cause) and management independence (no regulators can be dismissed without due cause). The “transparency” score is based on how often major regulatory decisions are published and disseminated to interested parties. The “accountability” score is based on the requirement for regulators to publish annual reports detailing their activities. Data refer only to transition countries with autonomous regulators.

state, operators and users. Accountability is facilitated by requirements such as the publication of annual reports by the regulatory agency. The survey provided information on which regulatory agencies must publish an annual report and how many annual reports have been published to date. In the telecommunications sector most of the regulators in CEB scored high for accountability, as did those in Georgia and Moldova. However, there was virtually no accountability in Albania and Croatia. For the electricity sector, accountability was high in most CEB and SEE countries but lagged behind in Albania and the Kyrgyz Republic.

Transparency covers several issues.

It involves the right of stakeholders to be informed about decisions affecting them, and also relates to the scope for corruption and secretive decision-making. One way of judging the extent of transparency is the frequency with which existing regulatory decisions, rules and policies as well as the reasoning behind decisions and rules taken by the regulator are published. A regulator’s decisions need to be disseminated to all interested parties effectively. Many infrastructure regulators in transition economies post major decisions on their web sites.



### Box 3.1

#### Russian railways reform

The Russian railways system (MPS) is a huge enterprise, employing over 1.2 million people and operating a network of over 85,000 kilometres. Railways remain the dominant mode of freight transport in most parts of Russia. They carry 80 per cent of domestic and international cargo and account for 90 per cent of the revenues from the domestic freight market. In addition to its core business of freight and passenger traffic, MPS also has stakes in the mining sector, hotels and entertainment, schools and hospitals, publishing houses, and sports teams and stadiums.

The importance of the railways network goes well beyond its core transport functions. The railways are also considered an important means of preserving national unity, implementing industrial policy and regional development priorities, supporting social policies directed at lower-income groups and reinforcing national security.

Since 1990 under-investment in infrastructure and rolling stock, combined with declining traffic volumes and revenues, have undermined the financial performance of the railway network and made reform a necessity. Several decrees were issued, starting in 1997, which laid out the government's reform policy. However, the size and complexity of the railways system had created a level of bureaucracy that provided numerous opportunities for corruption. Those who profited from the existing structure were not eager to promote change.

In 1999 the Russian Audit Chamber, an independent body set up by parliament to provide budgetary oversight, launched an investigation into the conduct of the Railways Ministry. The Audit Chamber investigation reported a range of abuses including: the non-competitive issuing of multi-million dollar contracts to build new rail lines; misuse of funds (including payments to

non-existent companies); and the misuse of a discriminatory tariff regime that resulted in large discounts to several private freight companies owned and operated by relatives of top ministry officials.

In a follow-up report, the Audit Chamber found misappropriations in 1999 and 2000 totalling US\$ 370 million. In October 2001 the General Prosecutor charged the Minister for Railways with abuse of office and in January 2002 he was removed from his position. Subsequently, railways reform has accelerated.

Reform has progressed over four phases. The initial phase, until 2001, was concerned with the separation and privatisation of locomotive and wagon manufacturing facilities. This was followed by the establishment of a new legal framework, including the separation of the rolling stock and infrastructure, which was implemented in 2003. The next phase – the separation of lines of business, including passenger and freight service and repair workshops – is expected to be completed by 2005. The final stage will involve the introduction of competition for passenger and freight services by 2010.

The reform programme has already resulted in the creation of a new national railway joint-stock company, integrating the 17 independent railways. This new company – Russian Railways – is responsible for operating railway services and for maintaining and renewing railway assets. The Transport Ministry, which absorbed the functions of the Railways Ministry in a government restructuring in early 2004, is now responsible for setting strategy and implementing the regulatory regime. However, it took several years to overcome vested interests and reach this stage.

Sources: OECD (2004), Pittman (2004), the Moscow Times (various issues) and EBRD.

The survey asked how often regulators made available their final decisions together with the reasoning behind them. The results showed that telecommunications regulators in Bulgaria, Latvia, Romania and the Slovak Republic had the highest standards of transparency. Most CEB countries as well as Georgia and Moldova achieved reasonable levels of transparency in telecommunications. Electricity regulation appears to be more transparent in the CEB countries and Bulgaria. Regulators in Armenia, Croatia, Georgia, Romania, Slovenia and Ukraine also operated reasonably well according to the survey but there remains room for improvement in Moldova.

The survey highlights the urgent need to strengthen accountability and transparency in order to attract investment and avoid costly and time-consuming regulatory disputes. Progress in these areas can ensure that sufficient information will be available to undertake impact assessments of individual regulatory authorities in line with standard practice in mature market economies.

#### Regulatory capture and obstacles to reform

Even if design problems and capacity limitations can be overcome, the

establishment of an effective regulatory regime, and its subsequent functioning in practice, is often hindered by bureaucratic inertia, corruption and institutional weakness.

The most difficult reforms are those that challenge vested interests and create clear political and/or economic winners and losers. In many countries, infrastructure sectors were dominated by huge organisations with sizeable financial and natural resources as well as political power. Such powerful entrenched interests posed – and, in some cases, continue to pose – a barrier to reform. They also threatened to reduce the effectiveness of reforms once these were put in place.

In some cases, corrupt ties between government officials and service providers emerged, influencing the setting of tariffs, toleration of arrears, financial agreements and contracts, the scope and quality of services, and the use of profits.<sup>8</sup> Those who profited most from these informal ties were not eager to see their above-normal profits curtailed. As a result, reforms to the ownership structure, tariff-setting mechanisms and regulatory framework faced significant obstacles. One example of the power of entrenched interests and institutional impediments to reform has been the railways sector in Russia, where,

until recently, the sector was owned, operated and regulated by a ministry with a questionable commitment to reform (see Box 3.1).

Another problem has been regulatory “capture” or undue influence on regulators. The literature on capture suggests that where interests are concentrated and the costs of organisation are low, industries will have sufficient political power to utilise the state for their narrow purposes.<sup>9</sup> This might include demanding direct or indirect subsidies or blocking market entry by potential rivals. By contrast, ordinary consumers or small firms find it more difficult to organise themselves sufficiently to exert political influence.

The unique circumstances of the transition countries, where a number of highly profitable industrial assets in the mining, metallurgy and rail sectors wound up in the hands of a few well-connected insiders, make regulators susceptible to capture. Where concentration of interests and power in the regulated industries are a problem, formal regulatory independence may be insufficient. Regulators in such environments may be less inclined to serve the public interest when making regulatory decisions.<sup>10</sup>



Direct evidence of capture is difficult to obtain but recent studies indicate that regulators in some countries rule in favour of large operators and industrial consumers who have more influence. For example, in the telecommunications sector there is evidence from the CIS and some SEE countries of discrimination against smaller providers in issuing licences and setting interconnection terms. In the power sector there is evidence of greater tolerance of payment arrears for large industrial users.<sup>11</sup> Surveys also suggest that larger enterprises in transition countries tend to receive more reliable service from network utilities.<sup>12</sup> In SEE and the CIS especially, there is evidence of electricity providers interrupting service and/or changing the terms of a supply contract more frequently for smaller firms, forcing them to stop production temporarily.<sup>13</sup>

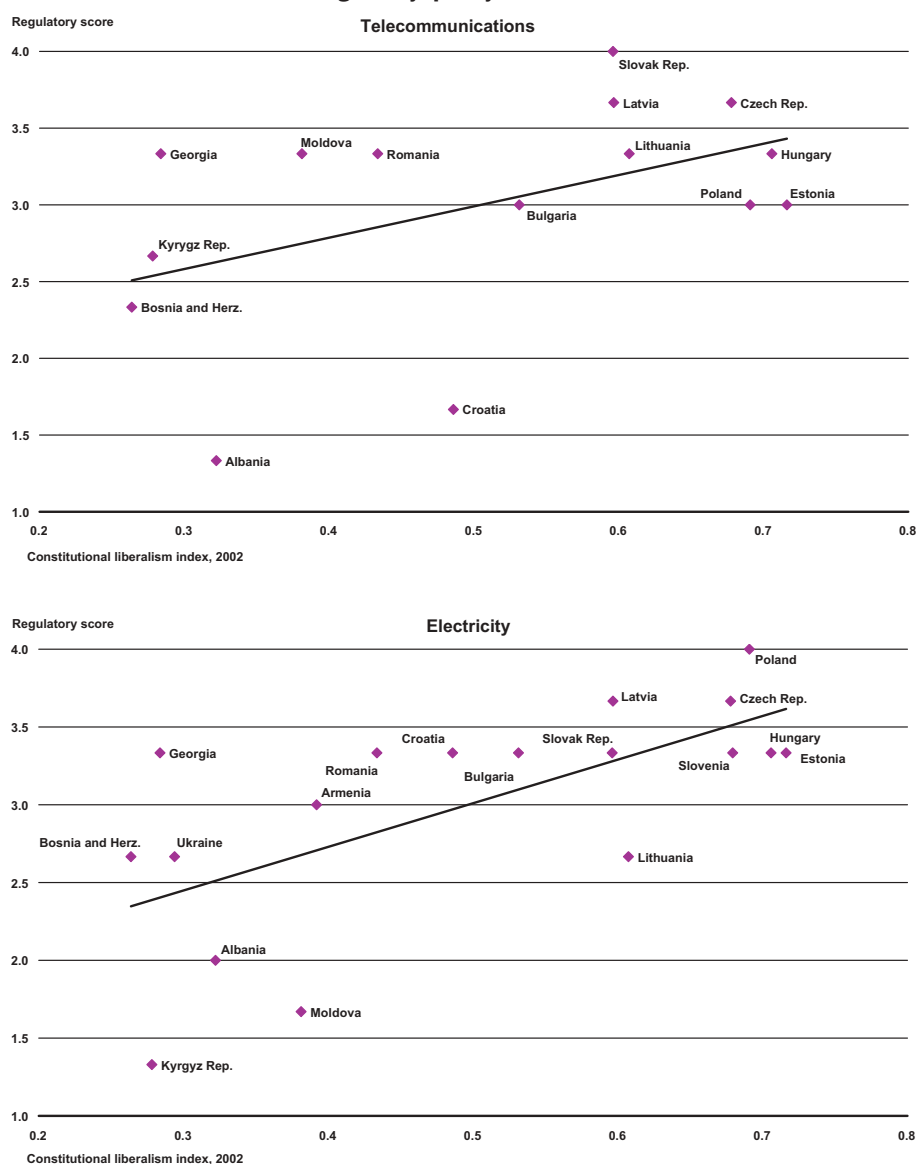
One way to address the problem of capture is to increase transparency and checks and balances through institutional reform. This includes strengthening political competition, encouraging free and independent media, creating effective competition authorities and establishing strong and independent courts. Arbitrary administrative action can be restrained and indiscretions limited by ensuring that regulatory issues and problems are placed prominently in the public arena and debated widely.<sup>14</sup> The result is likely to be greater credibility in regulatory reforms (with more support from investors, operators and consumers) and more policy stability.<sup>15</sup>

Chart 3.2 shows that regulatory quality in telecommunications and electricity tends to be higher in countries where the rule of law is observed, bureaucratic corruption is brought under control, property rights are protected and the media is relatively free.<sup>16</sup> Recent studies also show that investment in the telecommunications and electricity sectors tends to be greater in countries with political institutions that constrain arbitrary behaviour by political actors.<sup>17</sup> Given their high-cost and long-term commitment, investors in infrastructure utilities want assurances against administrative expropriation and legal recourse in cases where it occurs.

Institutional reforms are complex and take time to implement. Although they are progressing in many transition countries, especially in CEB and the EU candidate

Chart 3.2

### Constitutional liberalism and regulatory quality in selected transition countries



Source: EBRD.

Note: The constitutional liberalism index represents the unweighted average of four indicators: the Freedom House Freedom of the Media score; the World Bank's rule of law governance indicator; the World Bank's control of corruption governance indicator; and the protection of property rights score from the Heritage Foundation's Index of Economic Freedom. These indicators have been standardised. In the chart, 0 represents the lowest levels of constitutional liberalism, and 1 represents the highest levels. For an explanation of the regulatory score, see Chart 3.1.

countries in SEE, much remains to be done (see Chapter 1). In the meantime, regulators must address the issues of tariff reform and network access.

## 3.3 Regulatory challenges

The establishment and enforcement of a method for setting tariffs lie at the heart of regulation. Regulators must devise and implement a system that promotes efficiency in production and consumption, guarantees universal access to essential services and encourages investment and modernisation. Where networks have been unbundled, regulators need to promote

competition wherever possible and to ensure that all operators – incumbents and new entrants – have access to infrastructure networks on equal terms.

### Tariff structure

Despite significant adjustments over recent years, infrastructure tariffs still tend to be lower than the full costs of service in many countries and sectors. The resulting shortfall in revenues is at the core of the poor financial and technical performance of energy and water utilities and the lack of new investment.<sup>18</sup> It also means that even infrastructure services that should be commercially viable

## Box 3.2

## Tariff reform and socially vulnerable consumers

Socially vulnerable groups – such as low-income households, pensioners and the unemployed – spend a substantial amount of their income on utility services, even at the current level of tariffs. Further tariff increases may therefore be difficult for these groups to afford, particularly in countries with a lower average income.

The chart below illustrates affordability for consumers in the case of electricity supply. It shows that the poorest 10 per cent of the population typically spend around 8 per cent of their income on electricity at current prices and collection rates – close to the 10 per cent threshold considered by some development agencies to be problematic. The proportion of income spent on electricity is lowest in the CIS despite the widespread poverty in this region. This reflects the current low tariffs and collection rates in the CIS.

The chart also shows the consequences of enforcing payment collection and raising tariffs to full cost-recovery level by 2007. The impact of such a policy would be most heavily felt in the CIS. In CEB the amount of income spent on electricity could actually decrease: the incomes of the poorest households are expected to grow faster than the tariff adjustments required under this scenario. In SEE the increase in utility payments, relative to income, would be small, but the affordability of electricity remains most problematic in this region. SEE has neither the comparatively comfortable income levels of CEB nor the low power generation costs of the energy-rich CIS.

These estimates confirm that the social impact of tariff reform is a justifiable concern for policy-makers. However, a number of policy measures are available to mitigate the social consequences of higher tariffs. They are being introduced in transition countries, although with varying degrees of success.

Block or lifeline tariffs are perhaps the most common schemes to protect low-income consumers. Under a block tariff system, a certain amount of energy or water is provided at a low price or free. Consumption beyond this threshold is charged at full cost. All consumers therefore have access to a minimum level of service but large users are obliged to pay more to reflect the true cost of the service. In the electricity sector, block tariffs of this kind operate in Albania, Bulgaria and Serbia. In Moldova and Romania, electricity consumers have the option to subscribe to either a block system or a uniform pricing system.

Block or lifeline tariffs are relatively simple to operate but they require household consumption to be metered. This is not always the case, particularly in the water and district heating sectors. There have also been cases of fraud through tampering with meters – the same problem that mars efforts to improve collection rates more generally.

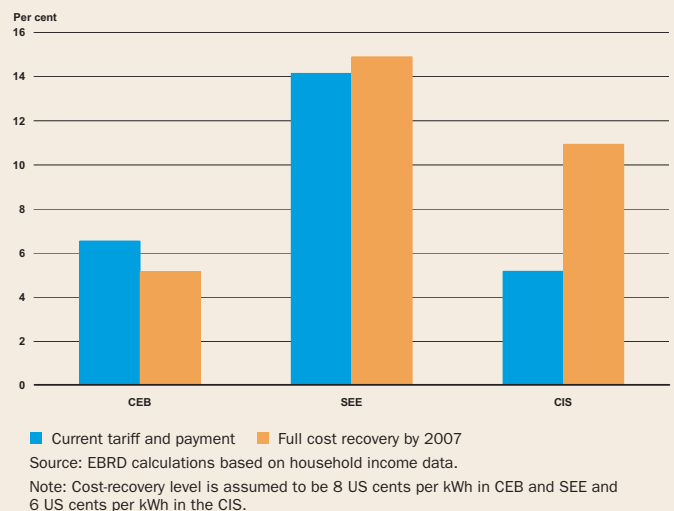
Targeted assistance programmes involve means-tested cash payments or state benefits to vulnerable consumer groups, typically to cover minimum consumption levels. Armenia, Hungary, Kazakhstan and Romania are among the countries that operate dedicated energy assistance programmes.

In Tajikistan the compensation system covers mainly electricity and, to a smaller extent, water consumption. Payments are made either directly to the utilities or to households in cash (usually upon proof that the utility bill has been paid). Programmes are not necessarily permanent. For instance, the precursor to Hungary's current heating assistance programme was a temporary scheme to offset the rapid gas and electricity price increases in 1997–98. Bulgaria and Georgia have seasonal programmes that assist vulnerable consumers during the winter, when energy bills are highest. In Tajikistan the level of support also varies according to the season.

Means-tested assistance programmes have the advantage that tariff policy and social protection are clearly separated. However, the experience with assistance programmes has so far been mixed. The effective targeting of vulnerable households and efficient management of such programmes require substantial administrative support. This is often lacking, particularly in rural areas. In the case of Georgia's winter fuel programme, a new database of eligible households had to be established with donor assistance. Social programmes also depend on a reliable funding source, and hence on good management of fiscal expenditure. This has been a problem, especially in schemes administered and financed at the municipal level. When the government of Kazakhstan withdrew national funding, the Kazakhstani energy assistance programme came to an end in all but four regions.

Sources: The affordability figures are EBRD estimates based on household surveys. The discussion of social safety nets is based on IPA Energy (2003) and Velody *et al.* (2003).

## Proportion of income spent on electricity in low-income households



continue to require government support. The quasi-fiscal deficit of state-owned utilities in the energy sectors in Georgia, the Kyrgyz Republic and Tajikistan, for instance, has been estimated at around 6–7 per cent of GDP.<sup>19</sup>

Despite the urgent need for adjustments, raising the level of tariffs is one of the most politically controversial aspects of infrastructure reform. Independent regulators can help to depoliticise this process but even with regulatory agencies in place, tariff reform remains difficult. One important argument against tariff increases is the impact this would have on low-income consumers. As Box 3.2

shows, the affordability of energy and water services for poor households is an important social concern but it is not a justification to postpone tariff reform. A number of measures can be put in place to mitigate the social consequences of tariff adjustments. These have been introduced in many parts of the region. However, their application in practice is often inadequate and needs to be improved, particularly in the poorer transition countries.

Even in the electricity and telecommunications industries prices are still low, especially in the CIS and the poorer countries of SEE (see Charts 3.3, 3.4 and

3.5). In the Kyrgyz Republic, Turkmenistan and Uzbekistan, for instance, electricity consumers pay less than 2 US cents per kilowatt hour (kWh), compared with a cost-recovery level of two to three times that amount. The problem of low tariffs is made more acute by the existence of payment arrears and low collection rates, particularly in some CIS countries.

There is a widespread need to adjust relative tariffs for different users – so-called rebalancing. An unbalanced structure can impede private investment and hinder competition. Unbalanced tariffs also send a distorted signal about the cost of services to end-users.

Charts 3.3 and 3.4 show the extent of cross-subsidisation in the telecommunications sector. Substantial cross-subsidies are evident between services (for example, local and long-distance calls versus international calls) and between customer groups (business versus residential). In some CIS countries, for instance, international call rates are very high by world standards but local calls are often free. In other countries, tariff rebalancing has been blocked by the incumbent fixed-line operators, which rely heavily on their profits from international and long-distance calls to fend off competition from mobile operators on local calls. Dissatisfied with poor service quality, many customers have switched to mobile phones in place of fixed-line services. As a consequence, subscription rates for fixed-line services have declined significantly in some countries (mainly CEB) and stagnated in others (SEE).<sup>20</sup>

In the electricity sector, about half of the transition countries still have major cross-subsidies between residential and business consumers. As the costs of supplying electricity to industrial customers are typically lower, these consumers should benefit from lower tariffs. However, only in 11 countries are residential tariffs currently higher than industrial tariffs (see Chart 3.5). The difference is still much less than in OECD countries, where residential consumers typically pay more than twice as much as industrial customers for electricity.

In the railways sector, passenger transport tends not to be commercially viable on its own. The survey indicates that in many transition countries losses from passenger traffic are cross-subsidised by profits from freight. However, this is only possible as long as competition in freight services is curtailed. Introducing competition will therefore require a parallel effort to reduce cross-subsidies. This will generally require governments to compensate the operators of passenger services that are loss-making but in the public interest.

## Tariff-setting

The new regulatory authorities need to develop tariff-setting procedures that are transparent and predictable without reducing the incentive of operators to increase efficiency.

The main choice is between imposing limits on price (price cap regulation) and rates of return (also known as cost-plus

Chart 3.3

### Cross-subsidisation between local and international telephone charges

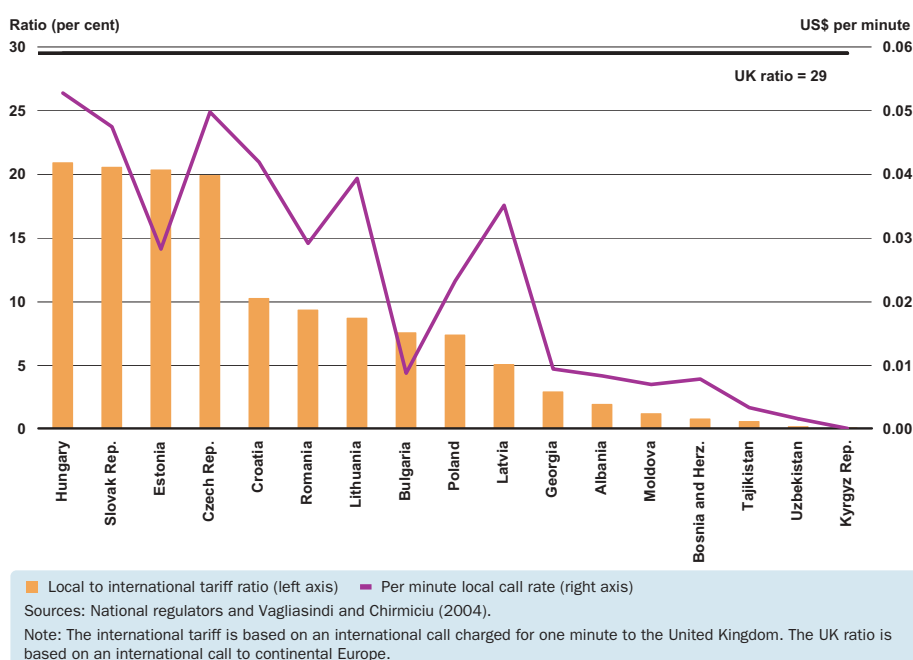
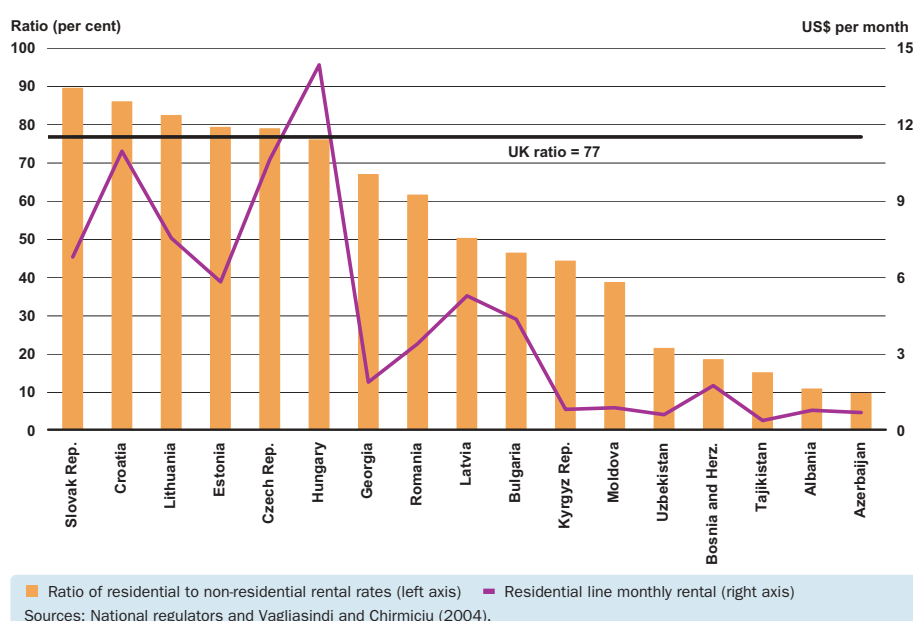


Chart 3.4

### Cross-subsidisation between residential and non-residential telephone charges



regulation). In theory, price caps give operators a strong incentive to control running costs as any reduction in costs turns into increased profits for the operator. Under a rate of return approach, any increase in costs will be passed on to consumers, possibly reducing the incentive for operators to control costs.

In practice, the difference between the two approaches in transition countries is probably small. Incentives for cost reduction crucially depend on the frequency of price reviews, which the regulator can use to adjust utility profits

and capture efficiency gains.<sup>21</sup> The survey shows that most transition countries have an annual price review, which provides few incentives for operators to make efficiency improvements on an ongoing basis. However, this could change in the future. Most CEB countries are planning to introduce multi-year reviews for telecommunications and electricity, as is the standard practice in OECD countries.

Regulatory uncertainty is greatest when the newly established regulatory agencies are granted only limited legal independence or if they are simply too weak to introduce

## Box 3.3

## Regulation by contract in Moldova

Until 1997 Moldenergo was the state-owned, vertically integrated utility responsible for generation, transmission and distribution of power and heat in Moldova. Its financial viability was challenged by declining demand, rising fuel and electricity import prices, high levels of system losses (exacerbated by extensive power theft and corruption) and low levels of revenue collection.

With help from international financial institutions, Moldenergo was restructured into 15 separate companies in 1997 – three for generation, five for distribution, one for transmission and dispatch, and six for heat distribution and construction services. All five distribution companies were offered for privatisation through competitive bidding in 1999. Union Fenosa, a Spanish electricity company, was awarded three distribution companies accounting for over 70 per cent of the total electricity sales in the country. Union Fenosa paid US\$ 25 million, with an obligation to invest US\$ 60 million to upgrade the system.

The National Energy Regulatory Authority (ANRE) was established as an independent body with the power to develop a system for calculating electricity tariff levels. However, tariffs were set initially according to the provisions of the privatisation contract with Union Fenosa. The contract included incentives to reduce technical and commercial losses. It set tariffs on a forward-looking basis for seven years and guaranteed a 23 per cent return on investment. In the event of a dispute over the tariff mechanism, the contract was subject to international arbitration.

The arrangement was intended to reduce regulatory risk for the investor. However, as contracts are often subject to renegotiation, their effectiveness depends on the quality of the institutions – such as courts and the state administration – in place to enforce them. In the case of Moldova and the contract with Union Fenosa, conflicts relating to the tariff formula, the measurement of performance and to the privatisation itself quickly emerged. The tariff reviews in 2002 and 2003 were both delayed by several months and resulted in adjustments that were lower than expected. In 2003 the originally approved adjustment was changed within days of its announcement following pressure on the regulator. In addition, the legality of the privatisation of the electricity distribution companies to Union Fenosa was challenged in court in February 2000 in a dispute that was not resolved until October 2003. The situation has since improved somewhat as ANRE has strengthened its capacity, and some tariff increases have been implemented.

The experience of Union Fenosa in Moldova illustrates how the use of regulation by an explicit contract between an operator and the regulator can facilitate private sector investment in infrastructure in countries with new and/or weak regulatory institutions. It also shows that implementation of these arrangements can be problematic when there is political interference in regulatory decisions. However, the existence of a formal contract provides a stronger legal grounding for defending the rights of the operator in such environments.

Sources: Broadman *et al.* (2004) and EBRD.

controversial pricing changes on a regular basis. One solution is to combine regulation with an explicit contract between the operator and the regulator. This contract, which is typically part of a privatisation or concession agreement, stipulates the tariff-setting formula for the first three to five years of operation.<sup>22</sup> For subsequent periods, detailed tariff-setting processes need to be written into the law. Such arrangements can be useful for the initial period when a new regulator is building up its capacity and reputation. However, their implementation has proved to be problematic, not only in transition countries but also in other emerging markets (see Box 3.3).<sup>23</sup>

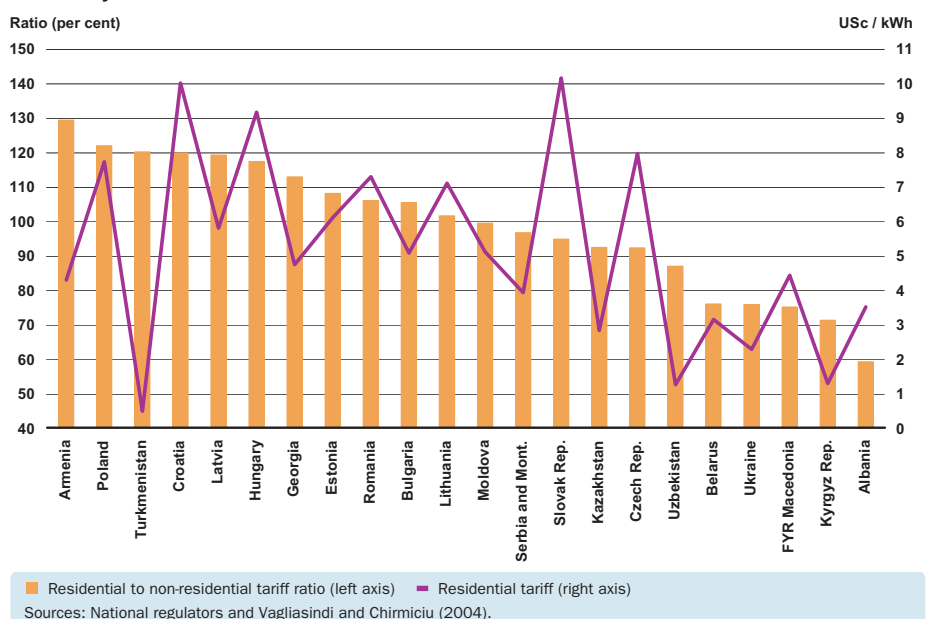
## Network access and competition

Regulators need to design and enforce rules that support competition in those industry segments that can be opened to the market. One key consideration in unbundled systems is access to networks at a cost-reflective price. Without clear rules in this area, competition may be stifled and market entry will be hindered. This will result in lower investment and excessive power for incumbents in controlling prices.

In most transition countries the terms for access to networks are not decided by the regulator. They are determined in negotiations between the operators

Chart 3.5

## Electricity tariffs and cross-subsidisation



(see Table 3.2). As a consequence, too much power might be left in the hands of incumbent operators.

In the telecommunications sector all operators should be obliged to allow interconnection with their networks. Incumbent operators may be subject to special rules to ensure that they do not abuse their market power.

The experience in the Czech Republic and Hungary shows that a reduction by the regulator in interconnection charges can

lead to a significant increase in competition. However, in most other telecommunications sectors, competition has been slow to develop. To boost competition, CEB countries are now developing ways to calculate the full cost of interconnection (the long-run incremental cost). In SEE and CIS – despite some exceptions, such as Bulgaria, Georgia and Romania – the terms of interconnection are still decided through bilateral negotiations. Competition in fixed-line telecommunications is consequently



low and is hindered by the difficulty in reaching interconnection agreements with the incumbent operator.

In the gas and electricity sectors, network access is typically governed by regulated third-party access rules – a legal obligation to provide network access to competing operators at regulated prices in a non-discriminatory way. In networks where electricity transmission is separated from generation, third-party access can encourage new market entrants and lead to greater competition in generation and wider consumer choice.

Under new EU directives, the wholesale electricity and gas markets in CEB have been gradually opened to competition. As of July 2004, all commercial customers have been legally entitled to choose their energy suppliers. However, the CEB markets are still less open than those in the rest of the EU. According to a recent report by the European Commission, the average degree of market openness for the enlarged EU is 56 per cent in electricity and 60 per cent in gas. Prior to enlargement, the figures for the EU-15 were 76 and 82 per cent respectively.<sup>24</sup>

In SEE and the CIS, network access by third parties in these sectors is more limited although Kazakhstan and Russia are beginning to establish a competitive wholesale power market.

Reforms in the railways sector are at an early stage. The new EU member states in CEB have adopted EU standards of open access in principle but implementation in most countries has been slow. Bulgaria, the Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Romania, Russia, the Slovak Republic and Slovenia have started to implement open access rules, allowing private train operators to access their tracks. However, few further changes have been introduced so far.<sup>25</sup>

In the water sector, network access and the promotion of competition in the market is not feasible. However, some benefits can be achieved by introducing competition for the market, for example through competitive tendering for private sector contracts and the use of benchmark or yardstick competition (whereby the individual performance of an operator is measured against an agreed industry reference). The establishment of a national regulator to oversee tariff and quality issues for municipal services can also yield positive results.

**Table 3.2**

**Interconnection and access methodology**

	Electricity	Rail	Telecommunications		
	Generation to transmission	Open access	Incumbent long distance operator	Incumbent mobile operator	Mobile operator
Albania	-	No	Bilateral	Bilateral	Bilateral
Armenia	-	No	Bilateral	Bilateral	Bilateral
Azerbaijan	-	No	Bilateral	Bilateral	Bilateral
Belarus	-	No	Bilateral	Bilateral	Bilateral
Bosnia and Herzegovina	-	No	Bilateral	Bilateral	Bilateral
Bulgaria	Regulator	Yes	Bilateral	Regulator	Bilateral
Croatia	Regulator	No	Bilateral	Bilateral	Bilateral
Czech Republic	Regulator	Yes	Regulator	Regulator	Regulator
Estonia	-	Yes	Bilateral	Regulator	Bilateral
FYR Macedonia	-	No	No rules	Bilateral	Bilateral
Georgia	Regulator	No	Regulator	Regulator	Regulator
Hungary	Regulator	Yes	Regulator	Regulator	Regulator
Kazakhstan	-	Yes	Bilateral	Bilateral	Bilateral
Kyrgyz Republic	Regulator	No	No rules	Bilateral	Bilateral
Latvia	Regulator	Yes	Regulator	Regulator	Regulator
Lithuania	Regulator	Yes	Regulator	Regulator	Bilateral
Moldova	-	No	No rules	Regulator	Bilateral
Poland	Regulator	Yes	Regulator	Bilateral	Bilateral
Romania	Regulator	Yes	Regulator	Regulator	Regulator
Russia	-	Yes	Bilateral	Bilateral	Bilateral
Serbia and Montenegro	Regulator	No	Bilateral	Bilateral	Bilateral
Slovak Republic	Regulator	Yes	Bilateral	Regulator	Bilateral
Slovenia	Regulator	Yes	Regulator	Regulator	Regulator
Tajikistan	-	No	Regulator	Regulator	Bilateral
Turkmenistan	-	No	Bilateral	Bilateral	Bilateral
Ukraine	Regulator	No	Bilateral	Bilateral	Bilateral
Uzbekistan	-	No	Bilateral	Bilateral	Bilateral

Source: EBRD.

Note: For electricity, "regulator" indicates regulated third party access. For rail, "open access" indicates private companies can use the existing rail tracks. For telecommunications, "bilateral" indicates bilateral negotiations between operators; "regulator" indicates regulated tariffs for interconnection.

Romania has taken an initial step in this direction by, first, decentralising the local utility services to municipalities and awarding a series of water concessions to private operators. Then, in 2002 the government established the National Regulator for Municipal Services (ANRSC). ANRSC operates as a government body and is entirely financed by licence fees. It approves and sets utility tariffs, promotes laws and regulations relating to municipal services, and monitors the tenders for municipal service operation throughout the country. At present, there is still considerable variation in drinking water tariffs; in the first half of 2004 tariff levels in the 41 municipalities of Romania ranged from 12.5 US cents to 55 US cents per cubic metre. Such a wide range can only be partially explained by variations in the operating environments. To overcome this, ANRSC could set cost-reflective water tariffs in various municipalities using a benchmark for comparative costs.

Many transition countries are too small to support competitive infrastructure sectors. Greater regional integration can help foster

competition and associated regulatory reforms in these cases. The creation of a regional energy market in SEE – the Energy Community for South East Europe (ECSEE) – is a promising initiative of this type. The ECSEE involves all SEE countries as well as Hungary, Moldova and Slovenia, which have committed to opening their national energy markets to foreign competition and undertaking the reforms necessary for the smooth functioning of a regional market.<sup>26</sup> As well as stimulating competition, regional trade in energy establishes better management of reserve capacity and helps to coordinate investment.<sup>27</sup>

### 3.4 Regulatory reform and service quality

Improvements in the regulatory framework and broader institutional reforms are expected to reduce risks for investors and create a more stable environment for commercial operators. This in turn should lead to better performance in infrastructure. In non-transition countries the combination of privatisation and regulatory



## Box 3.4

## Reversing exclusivity agreements: Armenia and Jamaica

When privatising the state telecommunications company Armentel at the end of 1997, the Armenian government awarded a long period of exclusivity rights in fixed-line (15 years) and mobile telephony (five years) to the new owner – the Greek state-owned telecommunications company OTE. The charts right suggest that exclusivity has had a detrimental effect. Use of mobiles has remained very low relative to other countries in the region. The same is true for fixed-line subscriptions, which have actually declined.

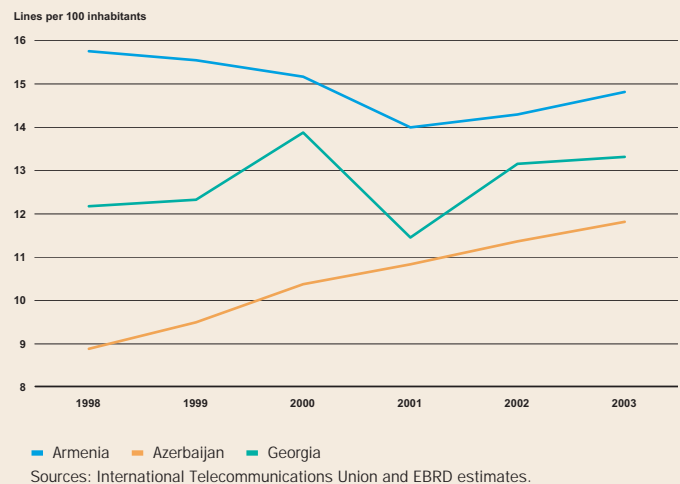
In September 2003 the government attempted to remove the exclusivity rights on mobile and Internet services, amending the terms of the licence in February 2004. Both Armentel and OTE have filed suits in the London Arbitration Court challenging the decision. The exclusivity rights remain in effect as the case is still pending. The ongoing dispute between the Armenian government and Armentel/OTE has not been limited to the issue of exclusivity, however. It includes alleged failure to meet investment obligations and allegations of abuse of market power in setting access charges. Internet service providers that are not controlled by Armentel have faced much higher tariffs than those for Armentel's own service providers. This has led to fines imposed by the Armenian competition authority.

There are examples of other countries breaking exclusivity agreements. In Jamaica the government and a newly empowered multi-sector regulator managed to amend an exclusivity agreement with the existing provider by linking it to an international covenant. At the time, Jamaica was pursuing membership in the World Trade Organization and needed to comply with its Basic Agreement on Telecommunications Services. The 25-year monopoly licence, awarded in May 1987, was consequently brought to an end and a three-year phased liberalisation of the sector was initiated. The final phase, full telecommunications liberalisation, was implemented in March 2003.

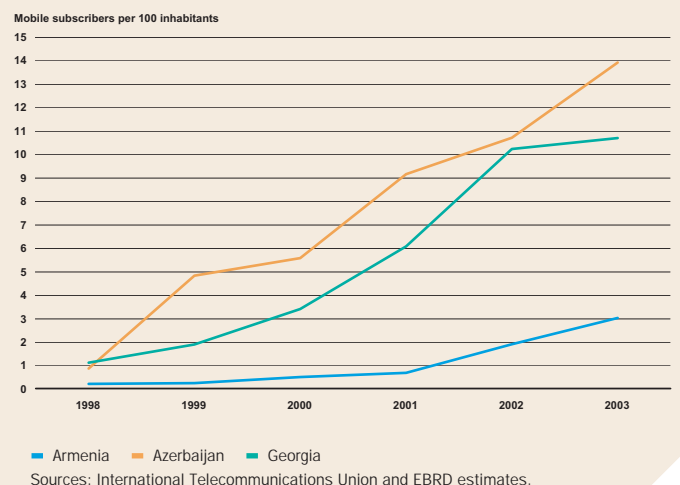
The combination of a strong, independent utilities regulator and a commitment to adhere to international standards embodied in the WTO agreement enabled Jamaican authorities to amend the exclusivity agreement in telecommunications amicably. While Armenia joined the WTO in February 2003, it has so far lacked an independent regulator that can enforce its international commitments and open the market to competition. However, in 2004 the Armenian authorities decided to transfer regulatory authority from the Ministry of Telecommunications to a legally separate, independent utilities regulator.

Sources: State Commission on Protection of Economic Competition (published decisions) and Wallsten (2003).

## Fixed-line telecommunications services in the Caucasus



## Mobile telecommunications services in the Caucasus



reforms has been associated with significant improvements in productivity.<sup>28</sup>

However changes in ownership may not be sufficient to spur service improvements in the absence of reforms. The impact of utility ownership on performance depends on how ownership changes have been implemented and to what extent measures for encouraging competition have been put in place. The privatisation of the dominant operator in Armenia, for example, led simply to the replacement of a state-owned monopoly by a private equivalent. It also provided a long exclusivity period for fixed-line and mobile services. Not surprisingly, Armenia now lags behind most CIS countries on key performance indicators for telecommunications, including countries that have not yet privatised their dominant operator. For Armenia's dominant operator, the exclusivity arrangement for mobile phones has also largely

eliminated the competition that has been influential in other countries (see Box 3.4).

In the transition countries, lack of data and the relatively short time that has elapsed since the beginning of infrastructure reform make it difficult to draw robust conclusions about the impact of reform on performance. Nevertheless, data from enterprise surveys provide some useful indicators of service quality, which can be linked to regulatory reforms. The EBRD's Business Environment and Enterprise Performance Survey (BEEPS) undertaken in 2002 provides information on the average number of days that enterprises experienced power failures or telephone services were unavailable. The results show that many transition economies still face serious problems in the quality of service provision. For energy and telecommunications, service failure is particularly common in both SEE and the CIS.

Evidence from the BEEPS suggests that the establishment of an independent regulator, introduction of tariff reform and increased investment in infrastructure are positively linked to service quality.<sup>29</sup> The BEEPS data also show that strict financial discipline in the infrastructure sector – as indicated by a reduction in payment arrears to utilities – has been associated with lower disruption to power and telecommunications services. Private operators have more incentive to raise tariff collection rates, to be intolerant of arrears, and therefore to ensure adequate revenue flows. For example, in Georgia, Kazakhstan and Moldova privatised distribution utilities have dramatically improved cash collection rates.<sup>30</sup> In Moldova, collection rates improved from below 80 per cent in 2000 to nearly 100 per cent in 2004. System losses decreased from 32 per cent in 2000 to an estimated 22 per cent in 2004.

Lastly, operators and regulators in transition countries face a major challenge in ensuring that service improvements are spread more evenly. Rural areas continue to experience lower levels of service and supply. Evidence from other regions – particularly Latin America – suggests that addressing this challenge requires universal access policies and, where appropriate, the establishment of a universal access fund.

### 3.5 Conclusion

Regulation of infrastructure services has been an essential component of reform during the transition process. Experience shows that it is important to establish a sound regulatory framework before commercialising or privatising utilities, and to deal with issues of market structure from the outset. It is also evident that no single regulatory model can be applied universally. The characteristics of each country and industry, such as ownership structure and potential for competition, have important bearings on how regulation can be implemented.

In telecommunications, technological change has helped to stimulate competition. Even so, there is a clear need for regulation, particularly for ensuring fair access and interconnection charges and for limiting abuse of market power by established, dominant operators. This challenge applies to all transition countries.

In the power sector, low tariff levels and high payment arrears remain a major problem. Changing the level and structure of tariffs needs to be tackled promptly in parallel with the commercialisation of power utilities.

In the water sector, regulatory functions tend to be undertaken at the municipal level. The performance of these municipal regulators is uneven, and tariff levels vary widely. Establishing national regulatory authorities would be one way to benchmark operators against industry leaders at home and abroad and to harmonise service quality, business plans and tariffs.

In the railways sector, the separation of infrastructure from operations is the model either planned or followed by a majority of countries. Under this model, regulatory authorities will be needed increasingly to ensure fair access to networks, to establish cost-reflective tariffs and to tackle cross-subsidies and fair practices for private sector contracts.

Substantial progress has been achieved in establishing independent regulatory authorities and ways of promoting competition. Nevertheless, the EBRD's survey of regulators indicates a need for further strengthening of regulatory independence, accountability and transparency in most transition countries, particularly in SEE and the CIS.

Issues to be addressed include market size, tariff levels, lack of administrative and technical capacity, the power of vested interests and broader political considerations. For the smaller transition countries where market size and capacity are major problems, alternative solutions can be considered, such as the use of multi-sectoral regulators and better regional coordination among national regulators. Latvia has already established a multi-sector regulator, and regional coordination is being pursued in parts of SEE and Central Asia.

## Endnotes

- 1 See EBRD (1996) and Carbajo and Fries (1997).
- 2 For more on the regulation of network utilities, see Armstrong *et al.* (1994) and Newbery (2000).
- 3 See Carbajo and Sakatsume (2004).
- 4 For more details on the survey design and the specific criteria, see Vagliasindi and Chirmiciu (2004). The exclusion of the water sector from the survey was dictated by the over-fragmentation of the sector. For instance, the process of decentralisation generated more than 4,000 municipal water utilities in Russia, about 250 in Ukraine, nearly 100 in Kazakhstan and 52 in Moldova. The EBRD is grateful to all the heads of the regulatory agencies for their cooperation in implementing the survey.
- 5 See Noll (2000) and Stern and Holder (1999) for a discussion of the regulatory criteria.
- 6 See Dutz *et al.* (2002) for more details.
- 7 Only countries with a formally autonomous regulator (see Table 3.1) have been rated.
- 8 See Broadman and Recanatini (2000).
- 9 See Olson (1965), Stigler (1971), Peltzman (1976), and Laffont and Tirole (1991).
- 10 Wallsten (2003) finds that when regulators are independent of political authorities, service quality in telecommunications may suffer.
- 11 See Dutz *et al.* (2002) on Russia.
- 12 See Vagliasindi (2004).
- 13 See Broadman *et al.* (2004) for further details on SEE.
- 14 See Levine and Forrence (1990), Levy and Spiller (1994), and Gutierrez (2003).
- 15 See Henisz (2000), Holburn and Spiller (2003), Tsebelis (2003), and Henisz and Zellner (2004).
- 16 See Levy and Spiller (1994).
- 17 See Henisz (2002) and Henisz and Zellner (2001).
- 18 According to a 2002 World Bank survey of infrastructure investments in emerging market countries, 65 per cent of firms investing in the power sector rated retail pricing and cash flow discipline as the most critical factors in the success of an investment, and 50 per cent of investors said that unfair adjudication of tariff adjustments was a crucial determinant of investment failures. See Lamech and Saeed (2002).
- 19 See Kennedy *et al.* (2004).
- 20 See Rodini *et al.* (2003), Ahn and Lee (1999), Sung *et al.* (2000), and Taubman and Vagliasindi (2004) for evidence of fixed to mobile substitution effects in various countries.
- 21 See Gilbert and Newbery (1994) and Alexander (2003).
- 22 See Bakovic *et al.* (2003).
- 23 A recent cross-country study of concession contracts in Latin America and the Caribbean found that the contract renegotiation rate where a regulatory body was established was only 17 per cent, compared with a renegotiation rate of 61 per cent where no regulatory body existed. See Guasch (2004) and Slattery (2003).
- 24 See European Commission (2004).
- 25 See Pittman (2004) for a discussion of alternative reform paths, including horizontal rather than vertical separation.
- 26 Members from outside the transition region include Austria, Greece, Italy and Turkey. See [www.seenergy.org](http://www.seenergy.org).
- 27 See Broadman *et al.* (2004).
- 28 See Newbery and Pollitt (1997), Ros (1999), Boylaud and Nicoletti (2000), Wallsten (2003) and Gutierrez (2003).
- 29 See Vagliasindi (2004) for detailed results.
- 30 See Kennedy *et al.* (2004).

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## Annex 3.1: Infrastructure, transition and the environment

Infrastructure services can have a substantial impact on the natural environment. The energy and transport sectors are among the main sources of air pollution and greenhouse gas emissions. In the water sector it is the lack of adequate infrastructure – in particular, waste-water treatment facilities – that often leads to significant environmental damage. This annex examines environmental trends associated with infrastructure developments in the energy, transport and water sectors, and considers the regulatory and policy responses.

### Energy

Since the beginning of transition, energy production and domestic consumption in central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) have been declining. There has been a corresponding reduction in the emission of air pollutants and greenhouse gases.<sup>1</sup> However, large variations in production and consumption patterns underlie this general trend.

Before 1989 the region had the world's highest energy intensity, defined as energy consumption per unit of GDP. This arose from an economic structure that was largely based on energy-intensive industries, such as steel, cement and chemicals, and from production processes that used energy very inefficiently.

Overall, energy intensity has decreased in the course of transition but progress has been uneven. Most transition countries still consume several times more energy per unit of GDP than Western countries. One of the key reasons for this is energy tariffs that are well

below world market levels and that do not cover true costs of production and distribution. The low tariffs, combined with poor revenue collection rates, stifle the incentive of consumers to use energy more efficiently. They also hinder efforts to improve the efficiency of supply, as under-funded utilities are unable to finance essential rehabilitation work. In power systems in the early transition countries, transmission losses can be almost 20 per cent.<sup>2</sup>

Electricity production relies predominantly on fossil fuels although nuclear and hydroelectric sources have increased since the late 1980s. Thermal power stations – fired by solid fuels (80 per cent), gas (13 per cent) and oil (7 per cent) – account for around 75 per cent of the electricity generated in the region. The development of renewable energy has been limited to the improvement of existing hydroelectric facilities and small pilot projects for other renewables, such as geothermal and wind power. Hydroelectricity represents a substantial source of power in, for example, Albania, Georgia, the Kyrgyz Republic and Tajikistan but accounts for only about 15 per cent of regional electricity production.<sup>3</sup>



**Box A.3.1.1****Pollution abatement in the Maritza East thermal power stations**

In 1990 the Maritza East region was the largest emitter of SO<sub>2</sub> in Bulgaria and a major industrial polluter in Europe. It accounted for almost 75 per cent of the country's SO<sub>2</sub> emissions. The coal fields of the region supplied low-grade lignite to feed three major power stations (Maritza East 1, 2 and 3), a briquette plant and supporting infrastructure. With a total capacity of 2,490 megawatts (MW), the Maritza power generation complex produced 30 per cent of Bulgaria's annual electricity output.

The Maritza power plants are still important power producers in Bulgaria, but their environmental performance has been improved dramatically due to investments by the government, international financial institutions and the private sector.

Two units of Maritza East 2, the largest of the three generation plants, have been equipped with flue gas desulphurisation technology; other units are to be similarly adapted. The four units at Maritza East 3, the second-largest plant, are undergoing modernisation under a programme that will be completed by 2006. A new 670 MW facility, fitted with state-of-the-art environmental controls, is planned to replace the old units at Maritza East 1.

The investment in the Maritza East 2 and Maritza East 3 thermal power plants is expected to result in a 90 per cent reduction of SO<sub>2</sub> emissions, equivalent to 1.5 million tons a year.

Source: EBRD.

Because of the fall in demand, it has generally been unnecessary to increase generation capacity since the beginning of transition. However, large investments are required to improve the environmental performance (for example, energy efficiency and emissions per unit generated) of old, inefficient and highly polluting industrial plants. This applies particularly to the numerous lignite-fired thermal power plants that use low-quality coal and operate without adequate environmental control equipment. These facilities have contributed to acute local pollution from particulates (dust) and to regional pollution, such as acid rain.

Several countries have made efforts to improve the environmental performance of their coal-fired plants. The emission of air pollutants has been reduced since the early 1990s. Improvements have been achieved mainly by plant refurbishment and the installation of state-of-the-art abatement technology. This includes flue gas desulphurisation (for SO<sub>2</sub> – sulphur dioxide), low NO<sub>x</sub> burners (for nitrogen oxides) and electrostatic precipitators to control dust (see Box A.3.1.1). Facilities have rarely been converted to cleaner fuels (for example, from coal to oil or gas), because replacement fuels are often more expensive or may not be readily available.

Despite improvements, many plants still emit SO<sub>2</sub>, NO<sub>x</sub> and dust in excess of the limits set in most OECD countries. In the case of CO<sub>2</sub> (carbon dioxide), where no abatement technologies are available, the pattern of emissions has largely reflected levels of energy production. CO<sub>2</sub> emissions declined steadily until about 1993. Since then, they have remained relatively stable, in line with gross inland energy consumption. Power generation remains the sector responsible for the highest emissions of CO<sub>2</sub> in the region, and accounts for well over one-third of total greenhouse gas emissions.

**Road and rail transport**

At the start of transition, the transport patterns in eastern Europe and the former Soviet Union were in many ways better environmentally than in Western countries. A very large proportion of the population travelled by train or other forms of public transport, and freight was carried mostly by rail. Most people did not own cars.

However, the situation has since changed. In the last 15 years there has been a shift from public to private transport, and rail freight volume has halved. The rail networks of transition countries were designed to move commodities and equipment over long distances across the Soviet bloc. They were less suited to new trading patterns, and by 1997 more freight was transported by road than by rail. At the same time, car ownership rose sharply, especially in CEB countries (see Chart A.3.1.1). Throughout the region, the adverse environmental impact of transport is increasing.

As road transport has expanded, land development has accelerated, putting pressure on green areas and designated nature conservation sites. Noise pollution and accident rates have also increased.<sup>4</sup> The transport sector has become one of the main sources of acidifying substances, ozone precursors and particulates. Transport fuels in the region are relatively cheap. Few countries, particularly in the CIS, impose significant taxes on petrol or diesel. This does not encourage the use of more fuel-efficient modes of transport.<sup>5</sup>

Across CEB, and to a lesser extent SEE, the pollutant emissions per motor vehicle have decreased due to improvements in emission abatement technology and the use of cleaner fuels. The aggregate emissions from motor vehicles of some harmful substances, such as nitrogen oxides and SO<sub>2</sub>, have also fallen. However,

the emissions of other substances, such as CO<sub>2</sub>, platinum metals and particulates, have again started to rise. This is due to the growing traffic volume and an increase in road transport generally. Improvements in fuel efficiency have not been able to outweigh the growth in volume.

Car ownership in the CIS is still substantially lower than elsewhere in the region (see Chart A.3.1.1). Nevertheless, traffic growth has been equally dramatic, and the technological developments that have reduced emissions per kilometre elsewhere have not yet taken place. Traffic-related air pollution is made worse by an ageing vehicle fleet.<sup>6</sup> There is also a lack of adequate infrastructure for vehicle servicing, traffic management, and vehicle registration, inspection and maintenance. Poor fuel quality aggravates the emissions problems. In the Kyrgyz Republic up to 40 per cent of vehicles apparently exceed the exhaust emission standards. In Kazakhstan the emissions of about 80 per cent of cars are reported to be two to three times higher than the national standard.<sup>7</sup>

At the same time, traffic is burgeoning in the region's cities. This is resulting in very high air pollution levels in urbanised areas. In much of the CIS, transport has become the main source of urban air pollution, and a significant source of greenhouse gas emissions. It is estimated that in the big cities of the CIS about 36,000 people die prematurely and almost 100,000 people fall ill with chronic bronchitis each year as a result of excessive air pollution.<sup>8</sup>

This trend is likely to continue over the next 10 to 15 years. The increase in the number and use of vehicles is expected to lead to a steady rise in the emission of damaging pollutants if there are no changes in policies and practices.



## Water

During the communist era, water and sanitation services were provided by centrally managed public utilities. The level of connection to water supply, and to a lesser extent sanitation, was relatively high but the tariffs charged were notional. As government subsidies were cut sharply after 1989, the shortfall in cash led to a drastic deterioration in the maintenance of the existing water and waste-water infrastructure.

At the same time, water consumption per capita remained high by international standards, with significant levels of wastage by industrial and domestic consumers and losses in the distribution networks. Most countries of the region are opting to build new water treatment plants to provide more water rather than reduce leakages in the existing distribution infrastructure. The main reasons for excessive water consumption are the continuing low water tariffs and the limited use of domestic water meters. This means that water users are not charged for their actual consumption.

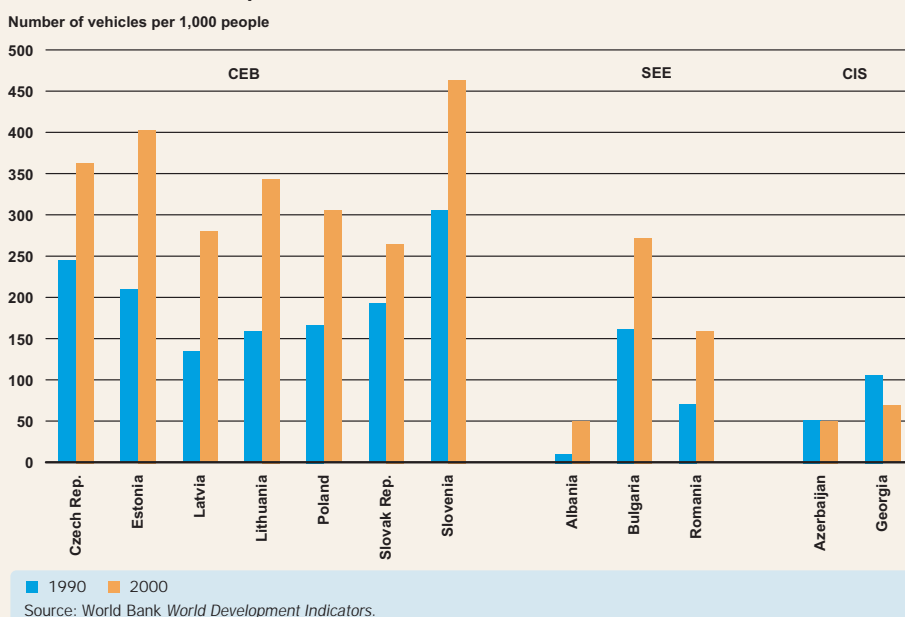
Opposition to water metering among domestic consumers is widespread. This is not only due to financial concerns but also because metering is viewed as an infringement of basic rights. Reducing water wastage is not therefore perceived as a positive step towards sustainable usage and resource conservation. Changing the culture of wasteful consumption among industrial users is proving equally challenging.

Sewerage connection rates and the quality of sewerage collection networks vary greatly among the transition countries. In CEB connection rates are generally higher and most waste water is subject to primary (mechanical) and secondary (biological) treatment. In Estonia, for instance, approximately 70 per cent of the population are connected to sewerage systems. Some progress has been made in SEE, and to a much lesser extent in the CIS. However, there are still many large cities – including Belgrade, Bucharest, Sarajevo, Skopje and Tirana – that discharge a significant amount of largely untreated waste water. Connection rates for rural populations are generally much lower, although there has been some improvement since 1990.

Because of a lack of chemicals and the deterioration of equipment, the treatment rate achieved through existing water

Chart A.3.1.1

### Motor vehicle ownership in selected transition countries, 1990 and 2000



treatment facilities has declined over the course of transition. It has been estimated that less than half of the 560 waste-water treatment facilities in the region are in working condition. Also, the average age of these facilities is over 25 years.<sup>9</sup> There are high leakage levels in the sewerage networks, which lead to direct releases of raw waste water into the environment. In the CIS many of the operating waste-water treatment plants carry out only primary treatment due to technical or financial constraints. In Georgia, for instance, none of the municipal waste water undergoes secondary or higher-level treatment.<sup>10</sup>

As a consequence, the surface and ground water quality has deteriorated in much of the region. This is despite the fact that waste and waste-water discharges fell sharply when industrial production and the use of, for example, pesticides and fertiliser declined. Throughout the region there is still evidence of high biological oxygen demand (BOD)<sup>11</sup> in surface and ground waters. Usually this results from organic pollution caused by discharges of untreated or poorly treated sewage, industrial effluents generated by food processing, and by agricultural run-off.

The level of water-borne diseases in the region is significantly higher than in western Europe. In Central Asia, more than one-third of the population is using water that is not safe to drink. In some rural areas the figure can exceed 50 per cent (see Chart A.3.1.2). The presence of pathogenic micro-organisms in drinking water remains the biggest threat to the

population. Gastro-intestinal diseases are often the main cause of infant morbidity and mortality.<sup>12</sup>

The deterioration in drinking water quality has imposed a significant burden on public health systems in transition economies. In Moldova polluted drinking water is estimated to cause between 950 and 1,850 premature deaths each year, and between 2 million and 4 million lost working days due to illness.<sup>13</sup>

## Challenges and policy response

Policy-makers and regulators tasked with promoting environmental sustainability in infrastructure face huge challenges.<sup>14</sup>

Perhaps the most serious issue is the poor state of existing environmental infrastructure. Decades of chronic under-funding have resulted in outdated, polluting and inefficient facilities. There is an urgent need for new environmental investment. It has been estimated that meeting the Millennium Development Goal on sustainable water supply and sanitation<sup>15</sup> would cost the whole transition region about US\$ 11 billion if the improvements are undertaken swiftly. This figure would rise to about US\$ 40 billion if the systems are allowed to deteriorate further.<sup>16</sup> Furthermore, this would allow countries to meet only the most basic standards on access to safe drinking water.

For the eight new EU member countries from the transition region, compliance with stringent EU environmental directives will

be more costly. Recent national estimates put the total cost of implementing the EU's Urban Waste Water Treatment Plant (UWWTP) Directive in the eight countries at around €22 billion. All the countries have negotiated transition periods ranging until 2015 for full compliance with this directive. In the energy sector, compliance with the Large Combustion Plant Directive and the Directive on National Emission Ceilings for certain atmospheric pollutants also has significant cost implications although lower than for the UWWTP Directive (see Box A.3.1.2).<sup>17</sup>

Concessional funding to finance some of these investments should be available from development organisations and, for EU members and candidate countries, from EU programmes such as Phare, ISPA and the structural and cohesion funds. However, the bulk of the finance will have to come from the countries themselves. It can be raised either through user tariffs, pollution charges and fines, or through general taxation. However, either funding route poses a challenge.

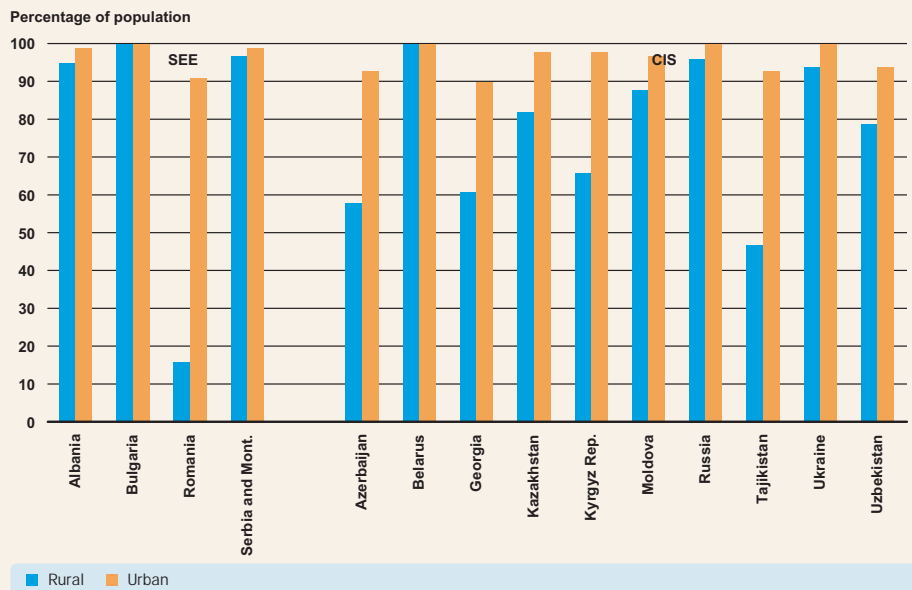
There remains among users a strong expectation that infrastructure services should be available very cheaply. Regulators are finding it difficult to raise energy, water and transport tariffs to a level that would cover financial costs (see Chapter 3), let alone a level that would also compensate for environmental damage.

The introduction of higher tariffs for water and energy use would be an effective way to promote resource efficiency. It would also encourage a shift from a culture of wastage to an appreciation of water and energy as valuable but scarce resources. However, this would need to take into account the affordability constraints on poorer consumers.

Regarding road transport, the main system of user charges is toll roads. Only very few transition countries have experimented with tolls, and the schemes have not generally been successful (see Chapter 4). In Hungary, which used to have one of the most advanced toll systems in the region, most drivers preferred to use smaller roads rather than pay the high charges on the country's M1 and M5 motorways. The result was a significant increase in air pollution in the neighbouring communities and substantial financial losses by the motorway-operating company. Hungary has since changed from a system of selected toll roads to an annual flat fee that is

Chart A.3.1.2

### Percentage of population with access to safe drinking water in selected transition countries, 2000



■ Rural ■ Urban

Source: World Bank World Development Indicators.

Note: Improved access refers to household connection to water supply, public standpipe, protected dug well, protected spring and rainfall collection. In CEB countries almost all the population has access to safe drinking water.

more comprehensive. However, under this scheme drivers are no longer charged for the economic and environmental costs of individual journeys, and have consequently no incentive to reduce their number of journeys.

Many countries in the region have created national environmental funds to stimulate investment in infrastructure and other environmental projects. These funds usually redistribute environmental fees, fines, eco-taxation revenues and other resources, disbursing them in the form of grants and soft loans. National environmental priorities dictate how environmental funds are spent. In the Slovak Republic, for example, 69.3 per cent of environmental expenditure in 2000 went to water protection; Bulgaria similarly spent 48.2 per cent of available funding in this way.

Given fiscal constraints, high inherited debt burdens and under-developed financial markets, environmental funds have been relatively successful in progressing priority environmental investments that might not otherwise have been completed. National environmental funds, if efficiently and transparently managed, should play an important role in financing environmental infrastructure improvements in the future.

Another challenge facing transition countries is the legacy of state environmental regulation and enforcement.

Most regulation was designed to provide a source of revenue for the state rather than to prevent environmental damage. Reform requires an acknowledgement by governments that water and energy are scarce resources that need to be used wisely and protected adequately. Dedicated environmental authorities should therefore be involved in the overall management of these resources.<sup>18</sup> Moreover, environmental standards have to be enforceable, pollution charges and non-compliance fines have to be significantly increased, and enforcement capacity has to be strengthened.

Regulatory reform is most advanced in CEB and the EU candidate countries of SEE, which are all required to implement EU environmental legislation. This includes framework legislation on air quality and water management as well as specific environmental performance standards for power plants, urban waste-water treatment plants and motor vehicles. EU directives not only require changes in technical standards and monitoring methodology but also call for a comprehensive and strategic approach to air quality and river basin management.

EU accession has also been a driving force for the introduction of economic instruments for environmental policy. An important forthcoming instrument in the new EU member states will be the trading of greenhouse gas emissions under the new EU Emission Trading Scheme.

### Box A.3.1.2

#### Compliance with EU directives in the Polish power sector

The Large Combustion Plant Directive (LCPD) is the most important EU directive on the reduction of air pollution from stationary sources. It prescribes the maximum permitted concentrations for key pollutants (particulates, SO<sub>2</sub> and NO<sub>x</sub>) in stack emissions. Initially targeted at large new emission sources, the LCPD has been extended to existing facilities of 50 MW capacity and more. Compliance with set limits is a major challenge for the new EU members from CEB, particularly those depending on coal for power generation and district heating. To achieve compliance with the LCPD, within a technically and economically realistic time-scale, CEB countries have negotiated transition periods of several years.

Poland is one of the transition countries heavily dependent on coal; 97 per cent of electric power generation comes from hard coal and lignite. Given this dependence and the age of existing plants, Poland was given until December

2015 for SO<sub>2</sub> emissions and December 2017 for NO<sub>x</sub> and particulates to comply with the LCPD. It has been estimated that compliance will cost up to €7.8 billion.

The EU's Directive on "National Emission Ceilings (NECs) for Certain Atmospheric Pollutants", in combination with the Accession Treaty, imposes national limits for SO<sub>2</sub> and NO<sub>x</sub> emissions. As these are lower than those forecast during the LCPD transition periods, it is likely that the energy sector will not be able to benefit fully from the transition periods granted under the LCPD. The costs of meeting EU environmental requirements are therefore likely to be higher than the estimated cost of compliance with the LCPD only. However, unlike in other new member countries, energy installations may receive government support for up to 50 per cent of investment costs.

Sources: Farmer *et al.* (2003) and EBRD.

The scheme will cover all combustion installations with a capacity of over 20 megawatts (MW).

In many CIS countries, by contrast, the complex and unrealistic standards inherited from the Soviet system are still in force. Some of the prevailing water quality standards are not technically or economically achievable. There are examples of pollutant concentration limits for waste water that are more stringent than the standards for drinking water. Also, the number of standards often exceeds the administrative capacity of most countries to monitor them. For instance, in 2000 the air management system of Kazakhstan included maximum permissible concentration levels for 1,500 pollutants.<sup>19</sup>

Furthermore, penalties for non-compliance with environmental standards are too low to offset the cost of investment in pollution prevention and control equipment. Obsolete monitoring methods are still widely used and enforcement of the existing regulations remains weak. The fragmentation of public bodies dealing with environmental issues is another obstacle for tackling environmental issues, particularly in the water sector. Significant improvements in environmental quality require institutional, regulatory and tariff reform as well as substantial investment and environmental education.

In CEB and SEE closer links with the EU have encouraged environmental reforms, both in the infrastructure sectors and elsewhere. They have also provided access to significant new funds for environmental infrastructure investment. Improvements in the environmental performance of water and energy utilities have not been matched, however, in the transport sector, where current policy measures remain insufficient to tackle the growing environmental cost associated with ever-increasing road travel.

In the CIS, the reforming and financial influence of the EU has been less immediate and limited to assistance programmes such as the EU Water Initiative. Affordability remains a major constraint to introducing infrastructure tariffs that reflect true economic and environmental costs. An important impetus of change in the CIS has been international programmes such as the Environment for Europe process and more recently the Northern Dimension Environmental Partnership. They have been complemented by the environmental requirements of international institutions investing in the region, and international commitments such as the Millennium Development Goals. However, domestic pressures for a safer environment are also growing.

## Endnotes

- <sup>1</sup> According to the European Commission (2001), energy production decreased by 27 per cent between 1988 and 1997 and gross inland energy consumption fell by 24 per cent.
- <sup>2</sup> See EBRD (2001) and Cornillie and Fankhauser (2004) for a more detailed discussion of energy intensity.
- <sup>3</sup> See Energy Information Administration (2004).
- <sup>4</sup> See Kiss (2002).
- <sup>5</sup> In 2000 diesel fuel was subsidised in Azerbaijan, Turkmenistan and Uzbekistan. The latter two countries also subsidised petrol. See European Environment Agency (2003).
- <sup>6</sup> The average age of the CIS vehicle fleet is over 10 years. See Asian Development Bank (2003).
- <sup>7</sup> See Asian Development Bank (2003).
- <sup>8</sup> See Hughes and Lovei (1999).
- <sup>9</sup> See EBRD (2004).
- <sup>10</sup> See OECD (2003a).
- <sup>11</sup> High organic matter concentration (measured as biological oxygen demand or BOD) has several effects on the aquatic environment. These include a reduction in the chemical and biological quality of river water, the biodiversity of aquatic communities and the microbiological quality of surface and ground waters.
- <sup>12</sup> See OECD (2003b).
- <sup>13</sup> These estimates are from Moldova's National Environmental Action Plan.
- <sup>14</sup> See UNECE (2003) for an overview of environmental policy in transition countries.
- <sup>15</sup> See [www.developmentgoals.org](http://www.developmentgoals.org) for a detailed description of the Millennium Development Goals.
- <sup>16</sup> See OECD (2003b).
- <sup>17</sup> Cost estimates vary considerably. See Farmer *et al.* (2003) for an overview of various estimates.
- <sup>18</sup> For example, in Slovenia and Croatia ministerial responsibility for water management has passed from agriculture to the environmental protection department. In Russia, on the other hand, there is no federal environment ministry, and strategic decisions are made by the ministries of natural resources, construction and industry.
- <sup>19</sup> See Asian Development Bank (2003).

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# Private sector participation in infrastructure

# 4

The transition has occurred at a time of wider experimentation worldwide with ways of financing and operating infrastructure services. The driving forces behind this trend have been dissatisfaction with the performance of incumbent operators and pressure to move away from state funding. This chapter examines the evolution of private sector participation (PSP) in the provision of infrastructure services in transition countries. PSP includes the disposal of assets and operating businesses, lease and management contracts for the operation of assets that continue in public ownership, and other arrangements whereby the private sector provides infrastructure services and takes on some business risks.

Increasing the role of the private sector in infrastructure remains controversial in many countries. There is little dispute that private management brings a more commercial focus. In some cases, private sector involvement improves access to new sources of finance. Better management of existing assets can also reduce the amount of investment required to sustain or extend services. However, it has been argued that such gains can sometimes come at the expense of social goals, such as universal access to services at affordable prices. Furthermore, public assets may be transferred in ways that benefit privileged insiders or foreign interests and provide few guarantees of better performance.

Experience accumulated over the last 15 years permits a more balanced assessment of the potential benefits and difficulties of private sector involvement in infrastructure services. On the negative side, there have been a number of clear failures. Most have been the result of unrealistically high expectations from

private investment, public opposition to tariff increases, and poorly designed contracts combined with unanticipated changes in key economic and financial conditions. While the private sector has certainly contributed to such failures, reversals in government policy have been more to blame.

On the positive side, the majority of contracts have led to substantial improvements in operational efficiency and in the quality or coverage of services.<sup>1</sup> Although improvements have tended to be less rapid than initially expected, services have been upgraded gradually, if partly in ways that may not be visible to many customers. Still, expectations of large investments by private operators have often not been realised, particularly where private operators inherited substantial excess capacity and/or inefficiently configured networks. In such cases, operators have concentrated on using their existing infrastructure assets more effectively.

This chapter begins by examining why governments have promoted PSP in infrastructure and what have been the principal obstacles to engaging the private sector. The next section assesses the extent of PSP across a number of infrastructure sectors in the 27 transition countries. This is followed by information on types of contract and the sources of private investment in the region. The effects of PSP, in terms of sector performance and investor expectations, are then analysed – although evidence is as yet limited. A brief comparison with similar developments in Latin America offers a wider perspective while the final section summarises the main findings and offers some conclusions.

## 4.1 Why have governments promoted PSP?

### Realising asset values

The most obvious financial motive for privatising infrastructure services is that it enables governments to raise funds from selling the assets of the utilities or from payments for concessions or leases. The total proceeds of infrastructure privatisations from 1992 to 2003 amounted to about US\$ 40 billion at 2000 prices (see Table 4.1). Just over 50 per cent of this (US\$ 20.6 billion) came from privatisations in the telecommunications sector.

The peak years for infrastructure privatisation were 2000 and 2002. Over US\$ 7 billion was raised in each year, mainly as a result of the privatisation of telecommunications in Poland in 2000 and gas networks in the Czech Republic and the Slovak Republic in 2002. In 2003 privatisation proceeds fell sharply to only US\$ 1.4 billion. Most desirable assets had by then already been sold but the decline also reflects a general loss of impetus in privatisation programmes.

Chart 4.1 shows average valuations of assets in the fixed-line telecommunications and electricity distribution sectors for the periods 1993-97, 1998-2000 and 2001-04. The chart shows that there was a boom in telecommunications valuations in the middle period with a large decline from 2001 onwards, reflecting the temporary boom in telecommunications assets during the late 1990s. In contrast, the valuation of electricity distribution assets was at its lowest between 1998 and 2000 but has recovered since then. This increase reflects the sale of better quality assets,

Table 4.1

### Proceeds of infrastructure privatisation deals, 1992–2003

(in US\$ million at 2000 prices)

Country / sector	1992-95	1996-99	2000-03	Total
Albania	5	0	93	98
Armenia	0	150	60	210
Azerbaijan	0	0	369	369
Belarus	0	0	0	0
Bosnia and Herzegovina	0	0	0	0
Bulgaria	0	521	194	715
Croatia	0	869	437	1,306
Czech Republic	1,532	166	4,188	5,886
Estonia	14	264	492	770
FYR Macedonia	0	1	316	317
Georgia	0	0	11	11
Hungary	4,501	2,922	9	7,431
Kazakhstan	3	868	343	1,214
Kyrgyz Republic	0	0	0	0
Latvia	177	186	0	363
Lithuania	0	529	371	900
Moldova	0	61	25	86
Poland	115	1,805	7,740	9,660
Romania	0	700	255	955
Russia	1,508	2,483	50	4,041
Serbia and Montenegro	0	951	0	951
Slovak Republic	4	0	4,289	4,293
Slovenia	0	0	2	2
Tajikistan	0	0	0	0
Turkmenistan	0	0	0	0
Ukraine	0	0	283	283
Uzbekistan	0	0	0	0
<b>Total</b>				
CEB	6,344	6,740	17,528	30,611
SEE	5	2,173	859	3,036
CIS	1,511	3,561	1,142	6,215
All transition countries	7,859	12,474	19,529	39,862
<b>Percentage of cumulative general government deficit, excluding privatisation proceeds</b>				
CEB	18%	12%	20%	18%
SEE	0%	17%	10%	11%
CIS	1%	3%	-5%	2%
All transition countries	4%	7%	26%	8%
<b>Sectors</b>				
Electricity	1,894	2,448	3,334	7,676
Gas	3,048	348	6,318	9,714
Telecommunications	2,822	9,371	8,441	20,634
Transport	27	95	594	717
Water	68	210	842	1,120

Source: EBRD estimates, based on the World Bank's PPI database and other sources.

Note: Money values have been converted to US dollars at 2000 prices using current exchange rates and the US GDP price deflator. Negative numbers for privatisation proceeds as a proportion of the general government deficit mean that the government had a surplus (even excluding privatisation proceeds) during the relevant period. Reliable data for Serbia and Montenegro's fiscal deficit prior to 2000 were not available.

principally in central eastern Europe and the Baltic states (CEB) and south-eastern Europe (SEE).

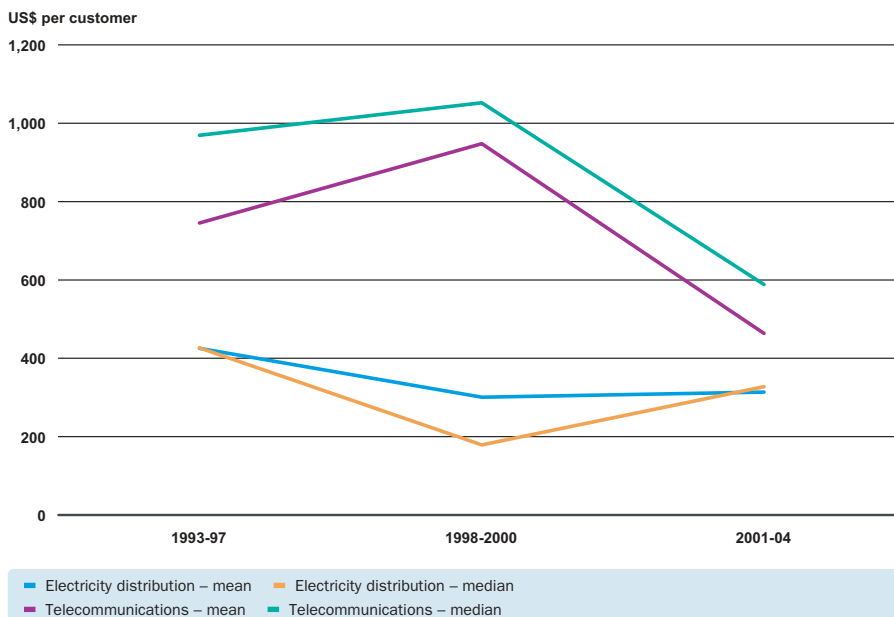
Although infrastructure privatisation has raised large sums in absolute terms, the total was no more than 4.3 per cent of regional GDP in 2002. The sale of infrastructure assets financed just over 8 per cent of the region's cumulative fiscal deficit between 1990 and 2002. Perhaps surprisingly, privatisation transactions did

not make a substantial contribution to the total financing needs of governments in the region.

The proceeds of infrastructure privatisations have financed fiscal deficits to varying degrees. Countries in CEB have financed an average of 17.5 per cent of their accumulated fiscal deficits from privatisations, varying from 11.9 per cent in 1996-99 to 20.4 per cent in 2000-03. At the other end of the scale, the countries

Chart 4.1

### Average valuations of assets in the fixed-line telecommunications and electricity distribution sectors, 1993–2004



of the Commonwealth of Independent States (CIS) have financed only 2.3 per cent of their accumulated fiscal deficits from this source. Analysis of the relationship between privatisation proceeds and fiscal deficits suggests that there is a clear and positive link between them. However, the causal relationship is not obvious. What is plausible is that privatisation revenues have been used as a means to assist fiscal adjustment over several years.

### Fiscal constraints on investment requirements

Although the proceeds from selling assets may not be large in relation to fiscal deficits or GDP, governments may want to reduce future liabilities associated with the upgrading of infrastructure networks.<sup>2</sup> The merits of relying on private sources of finance to fund such investments remain controversial. Publicly owned utilities in transition countries will typically borrow on terms that involve an explicit or implicit state guarantee for loans while relying on public funds for any equity contribution. Governments can borrow on more favourable terms than private utilities operating in the region. Therefore, the overall cost of capital for publicly owned utilities appears to be significantly lower than that for private utilities.

A contrary argument is that the lower cost of capital for publicly owned utilities is an illusion resulting from the implicit transfer of risk to the taxpayer. Public financing may lower the incentive to manage business risks prudently. Furthermore, transferring risk to taxpayers implies insurance benefits only to the extent that taxpayers are better placed than utilities' customers to absorb the risks of running utility businesses. The implication is that the true cost of capital for publicly owned utilities will usually be no less than the equivalent cost for private utilities.

In practice, most governments view this issue mainly in terms of competing claims for public resources. Such claims include programmes of social assistance and other public services. As the capacity and willingness to pay increased taxes are very low, most countries face tight constraints on their ability to borrow. Therefore, using public funds to finance the upgrading of infrastructure services may imply a real cost in terms of other social objectives.

### Improving performance

In many countries there have been repeated attempts to improve the financial and operational performance of publicly owned utilities. However, reforms have often failed to deliver the desired efficiency improvements, even when supported by

financial resources from general taxes to fund new investment. The reasons for this typically lie in an organisational culture and system of governance that resists the adoption of new goals and incentives. In response, some vertically integrated utilities have been divided into separate operating units with more limited goals and access to resources. Others have continued as integrated state-owned utilities but have adopted basic commercial and operational targets.

Where it became apparent that more fundamental changes were needed, the private sector has often been called upon to bring in external management with strong technical skills, frequently backed by additional equity resources. PSP has been considered as a means to commercialise utilities. It has also been argued that private managers seeking to increase profits are generally better placed to improve labour productivity, optimise asset management and provide better services to the local population.

### Obstacles to PSP

Tariffs for most infrastructure services remain well below the levels required to achieve full cost recovery. Private sector operators have been hesitant to invest if a government is unable to provide guarantees for future tariff increases or return on capital invested. With such uncertainty, the main contributions of the private sector are likely to be management skills and operational experience rather than finance.

An alternative form of PSP can be a ring-fenced investment project, such as a build-operate-transfer (BOT) contract, backed by a senior claim on the revenues of the utility. Experience shows, however, that the failure to address the central financial and operational problems of the utility can easily undermine the stability of a PSP contract.

Reluctance to transfer responsibility for infrastructure services to the private sector may be reinforced if publicly owned utilities have privileged access to finance for major investment projects. For instance, several countries in the region have adopted systems of revenue sharing or grants for local government authorities that underpin the deficits or the investments made by municipal companies providing water and other services. Progress of PSP can be held back or limited to management

contracts where national governments continue to offer investment grants or guarantees to municipally owned companies. Certainly, this has been a feature of water and waste-water services.

Grant or loan programmes at international level can have a similar effect on PSP. In practice, current EU rules for grants under the Instrument for Structural Policies for Pre-Accession (ISPA) and similar facilities have tended to favour investments in public enterprises. Because of EU rules on state aid, it is technically difficult to obtain such funds for privatised entities. This is a particularly important issue in environmental services, including the water and waste-water sector, due to the emphasis on using ISPA and cohesion funding to promote compliance with EU environmental directives.

## 4.2 How much PSP?

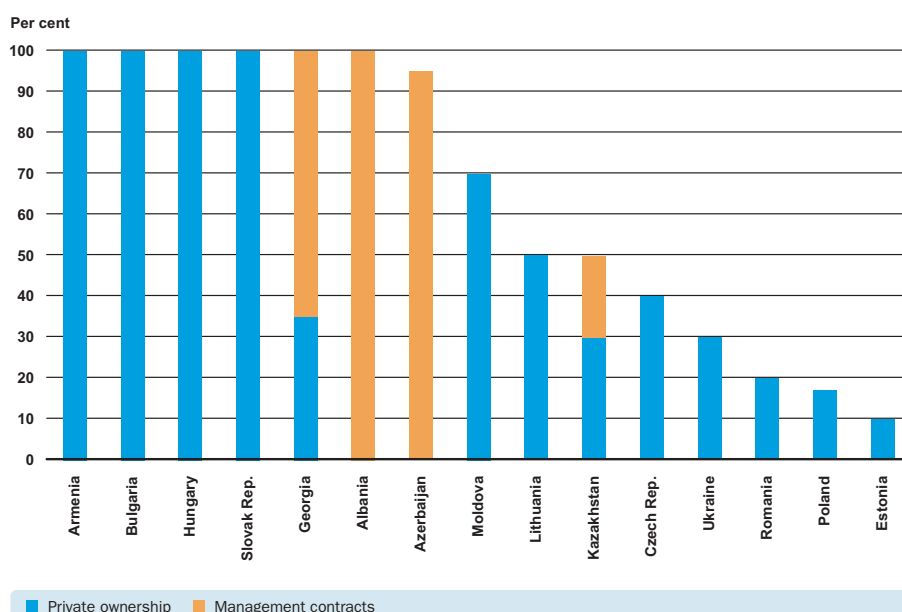
Table 4.2 summarises the extent of PSP in infrastructure. The scales used in the table refer to the share of the relevant national market served by privately controlled firms. Companies are classified as private based on effective management control. Accordingly, PSP comprises any private sector involvement ranging from actual ownership of a controlling stake to simple management contracts although the latter are given reduced weight to reflect the limited nature of such PSP. Throughout, foreign operators or investors are treated as private, irrespective of their actual ownership structure. This approach implies that the foreign activities of, for example, French EdF, German Gelsenwasser or Russian Gazprom are classified as PSP for the purposes of Table 4.2.

PSP is most advanced in the telecommunications sector, followed by urban transport and, to a lesser extent, the power sector. There is also some PSP in gas transmission and distribution, railways, ports and airports, district heating and the water sector, with roads clearly lagging behind. As far as regions are concerned, PSP is most present in CEB countries and the EU candidate countries of SEE. Among the CIS countries, only Armenia, Georgia, Kazakhstan and Russia have noteworthy levels of PSP. In other CIS countries, PSP remains largely confined to mobile telecommunications and urban transport.

Charts 4.2 and 4.3 show the percentage share of customers in each country served by private operators in electricity

Chart 4.2

### Proportion of population served by privately managed electricity distribution companies



Source: EBRD estimates.  
Note: Data relate to 2004. Countries that are not included in the chart do not have private sector participation in electricity distribution.

distribution and water services. By 2004, private electricity distribution companies were serving around 21 per cent of the region's population, while private water operators were serving only about 6 per cent. However, there is considerable variation across countries.

## Energy and water

### Electricity

Throughout the region, governments have generally retained control of electricity transmission systems (as a key strategic sector) – either through a vertically integrated power company, or through a separate, state-owned transmission company after unbundling. Georgia is an exception, in that a management contract to operate its grid was awarded to the Irish power company ESB in 2003.<sup>3</sup> Even so, ownership of the assets remains with the Georgian state.

PSP in Russia has been restricted to minority shareholding in RAO UES, a vertically integrated state-controlled company.<sup>4</sup> However, transmission assets are planned to remain under state control even in the event of further privatisation. There are no concrete plans for PSP in transmission in other countries, even where the national grid is the only major part of the electricity system remaining under state control (as in Hungary).

The private sector has a significant role in electricity generation in Armenia, Hungary

and Kazakhstan – owning and operating at least 50 per cent of the generating industry in each country. PSP in generation is rather less, but still substantial, in the Czech Republic, Georgia and Poland. Other countries have little or no PSP in generation. Albania is a special case in so far as its dominant state-owned power utility is operated by Italian company ENEL through a co-management contract.

PSP is more widespread in electricity distribution. Four countries – Armenia, Bulgaria, Hungary and the Slovak Republic – have fully, or almost fully, privatised their distribution sectors. Several others – Albania, Azerbaijan, Georgia, Kazakhstan, Lithuania, Moldova and to a lesser extent the Czech Republic, Romania and Ukraine – have transferred substantial parts to private ownership and/or operation. Most commonly, these arrangements have taken the form of outright ownership transfer. However, some countries have also used management contracts, either in part (as in Georgia and Kazakhstan) or exclusively (in Albania and Azerbaijan). There is limited PSP in Estonia and Poland as well.

At the other end of the scale, most countries in Central Asia have made little progress towards PSP. Overall, despite recent privatisations in Bulgaria, Lithuania and Romania, the electricity sector lags behind telecommunications in the extent of PSP.

Table 4.2

## Extent of private sector participation in infrastructure, 2004

Country	Energy				Telecommunications		Ports and airports	Transport Railways	Roads	Urban transport	Water	Average
	District heating	Electricity generation	Electricity distribution	Gas transmission and distribution	Fixed-line	Mobile						
Albania	1.0	3.0	3.0	(1.0)	1.0	5.0	1.0	1.0	1.0	3.5	2.0	2.0
Armenia	(1.0)	4.0	5.0	5.0	5.0	5.0	5.0	1.0	1.0	3.0	2.5	3.4
Azerbaijan	1.0	1.0	3.0	1.0	1.0	5.0	1.0	1.0	1.0	3.5	1.0	1.8
Belarus	1.0	1.0	1.0	1.0	1.0	2.0	1.0	1.0	1.0	2.5	1.0	1.2
Bosnia and Herzegovina	1.0	1.0	1.0	(1.0)	1.0	3.0	1.0	1.0	1.0	3.0	1.0	1.4
Bulgaria	2.0	2.5	5.0	(3.0)	5.0	5.0	1.0	1.0	1.0	3.5	2.5	2.9
Croatia	1.0	2.0	1.0	2.0	5.0	5.0	2.0	2.0	2.0	1.0	2.5	2.3
Czech Republic	4.0	3.0	3.0	4.0	2.0	3.5	2.0	2.0	1.0	2.0	4.0	2.8
Estonia	4.0	2.0	2.0	5.0	5.0	5.0	2.0	5.0	1.0	2.5	3.0	3.3
FYR Macedonia	4.0	1.0	1.0	(1.0)	5.0	5.0	1.0	1.0	1.0	2.5	1.0	2.1
Georgia	(1.0)	3.0	4.0	2.0	2.5	5.0	2.0	1.0	1.0	3.0	1.0	2.3
Hungary	2.5	4.0	5.0	4.0	5.0	5.0	2.5	2.0	2.0	2.0	3.0	3.4
Kazakhstan	2.0	4.0	3.0	1.0	2.0	5.0	1.0	2.0	1.0	3.0	2.0	2.4
Kyrgyz Republic	1.0	1.0	1.0	1.0	1.0	5.0	1.0	1.0	1.0	3.5	1.0	1.6
Latvia	2.0	2.0	1.0	5.0	5.0	5.0	2.5	2.0	1.0	2.5	1.0	2.6
Lithuania	3.0	2.0	3.0	5.0	5.0	5.0	2.0	1.0	1.0	2.5	1.0	2.8
Moldova	(1.0)	1.0	4.0	5.0	1.0	5.0	1.0	1.0	1.0	3.0	1.0	2.2
Poland	3.0	3.0	2.5	2.0	5.0	5.0	2.0	2.0	2.0	2.0	2.0	2.8
Romania	2.0	2.0	3.0	3.0	5.0	5.0	2.0	2.0	1.0	2.5	2.5	2.7
Russia	2.0	2.0	1.0	2.0	2.5	5.0	2.5	3.0	1.0	3.0	2.0	2.4
Serbia and Montenegro	1.0	1.0	1.0	1.0	1.0	2.0	1.0	1.0	1.0	2.0	2.0	1.3
Slovak Republic	3.0	2.0	5.0	5.0	5.0	5.0	1.0	1.0	1.0	1.0	2.0	2.8
Slovenia	1.0	2.0	1.0	3.0	1.0	2.5	2.0	1.0	1.0	1.0	2.5	1.6
Tajikistan	1.0	1.0	1.0	1.0	1.0	(4.0)	1.0	1.0	1.0	3.0	1.0	1.5
Turkmenistan	1.0	1.0	1.0	1.0	1.0	(5.0)	1.0	1.0	1.0	2.0	1.0	1.5
Ukraine	1.0	1.0	3.0	1.0	1.0	5.0	1.0	1.0	1.0	2.5	1.0	1.7
Uzbekistan	1.0	1.0	1.0	1.0	1.0	5.0	1.0	1.0	1.0	3.5	1.0	1.6
<b>Population weighted averages</b>												
All countries	1.8	2.0	2.0	2.0	2.6	4.8	1.8	2.0	1.1	2.7	1.8	2.2
CEB	3.0	2.9	3.0	3.1	4.5	4.7	2.0	1.9	1.7	1.9	2.4	2.8
SEE	1.7	1.9	2.6	2.2	3.8	4.4	1.5	1.5	1.1	2.5	2.2	2.3
CIS	1.6	1.7	1.6	1.6	1.9	4.9	1.8	2.1	1.0	2.9	1.6	2.1

Source: EBRD estimates.

Note: Companies are classified as private based on effective management control. The scales adopted in the table thus refer to the share of the relevant national market (in terms of number of customers, capacity etc.) served by privately controlled companies. Actual private ownership of a controlling stake or long-term concessions are treated as a stronger form of private sector participation (PSP) than management contracts. Throughout, foreign operators or investors are treated as private, irrespective of their actual ownership structure. The extent of PSP is measured using the following scale:

1 = No or negligible PSP.

2 = Small PSP (generally no more than 15 per cent of the market served by privately owned companies or a somewhat larger share served by state-owned companies operating under private management contracts).

3 = Noteworthy PSP (generally at least 25 per cent of the market served by privately owned companies or an important share served by state-owned companies operating under private management contracts).

4 = Substantial PSP (generally at least 60 per cent of the market served by privately owned companies).

5 = Sector fully privatised.

Figures in brackets indicate that the sector has a small level of activity. The averages across sectors are unweighted, while averages across countries are weighted by each country's population.



Subsidies have been a major factor influencing both the degree and nature of private sector involvement in the electricity sector. In the early transition period, electricity tariffs were low and many utilities ran large financial deficits that were borne ultimately by the state. The initial emphasis was on improving the commercial and financial performance of distribution companies through higher tariffs as well as more efficient billing and revenue collection.

In some countries, privatisation was seen as a route to better performance. Distribution companies were sold to private operators whose profits would depend on improved commercial performance (as in Armenia, Georgia and Moldova). This route, however, has proved more difficult than anticipated since governments have often been reluctant to sanction tariff levels necessary to generate an adequate return on capital, especially in CIS countries (see Chapter 3). Consequently, the private sector has been more cautious about making a substantial equity commitment to buy distribution companies in less advanced countries.

Reform of tariffs and revenue collection has become a pre-condition for the successful sale of distribution companies. Alternative options are to reduce the level of risk by awarding a management contract or concession, or to structure deals so that payment is linked to the fulfilment of certain financial and other conditions. One exception to the general trend of investor scepticism has been the continued expansion of Russia's RAO UES into many of the more difficult markets in CIS countries. It is not clear, however, to what extent this strategy has actually been driven by commercial considerations.

Monopoly power and vertical integration continue to pose difficulties in some countries with substantial PSP. Even where the intention has been to introduce some form of competition in generation and distribution, it may be undermined by a lack of bidders or sequential sales of different assets to the same investor. In Georgia, for example, the withdrawal of a Western investor has left RAO UES as the sole non-state owner of the country's major power sector assets. In Hungary, RWE and EdF have acquired generation and distribution assets in a series of tenders, raising questions about the capacity of the regulatory regime to

cope with the consequences of vertical re-integration.

In the Czech Republic and Russia the respective incumbent companies – CEZ and RAO UES – dominate generation and distribution. Both companies have been partly privatised, although the two governments have retained majority shareholdings. The Czech government has plans to reduce its shareholding in CEZ but, in the meantime, the company is acquiring assets in neighbouring countries through privatisation deals. RAO UES has been doing the same, both inside and outside Russia.

The Polish government is considering whether to recombine some of the unbundled public companies in order to create stronger vertical units prior to privatisation. In all of these cases, managerial ambitions and the desire to maintain and increase market power seem to run counter to the unbundling of the electricity sector that has been central to reform.

## Gas

Compared with electricity transmission, there have been more diverse arrangements for gas transmission. In six countries – Armenia, Estonia, Latvia, Lithuania, Moldova<sup>5</sup> and the Slovak Republic – control of vertically integrated gas companies that own and operate the entire network has been transferred to the private sector.<sup>6</sup> In the Czech Republic and Hungary, transmission has been separated from distribution, with private companies operating in both segments. Everywhere else, the state has retained control over gas transmission.

In Russia the dominant position of Gazprom remains a contentious issue. The Russian government has recently announced its intention to increase its stake from 38.4 per cent to more than 50 per cent and Gazprom operates as a state-controlled business with near-monopoly rights over gas transmission. Gazprom also invests in international pipelines used to transport Russian gas to western European markets.<sup>7</sup> Private oil companies have been seeking to develop their own gas transmission systems to sell gas to industrial and other major consumers. Gazprom has so far resisted such proposals, allowing it to preserve its dominant position in gas transmission and to maintain a system of price discrimination

between different groups of domestic customers.

The overall level of PSP in gas distribution across the region is similar to that in the electricity distribution sector. However, PSP in gas distribution is more extensive than in electricity distribution among some of the higher-income countries (the Baltic states, Croatia, the Czech Republic and Slovenia) as well as Romania. An increased demand for gas from both companies and households interested in individual heating systems has often resulted in large investment needs. The predominant response has been to privatise existing gas utilities or to award municipal concessions to private operators, usually including domestic and foreign partners. The Overgas concessions in Sofia, Varna and other Bulgarian cities are examples of this.

There is a very low level of PSP in gas distribution among the poorer countries in SEE and the CIS. The exceptions are Armenia and Moldova (where Gazprom holds controlling stakes in vertically integrated gas companies) and Georgia (which has some PSP in distribution). In Kazakhstan the gas distribution network has been renationalised after a private investor (Belgium's Tractebel) withdrew in 2000.

## District heating

Among the legacies of socialism is the presence of large district heating (DH) systems installed in most major and many smaller cities of the region. Poland, for instance, has more than 3,000 heating companies, and the Slovak Republic more than 1,000. However, district heat production has declined substantially since 1989 as a result of neglect and the desire of households to switch to more controllable forms of heating, especially gas. In a few countries – Armenia, Georgia and Moldova – DH systems have largely collapsed in recent years. In other countries, where deterioration has been less severe, PSP offers a potential source of funds to modernise the networks and manage them more efficiently.

However, there are major barriers to PSP. Most DH companies are run by municipalities and are too small to attract the interest of foreign investors. Moreover, although some have improved their performance under private control, investors are rarely willing to bear the initial burden of rescuing a DH system from urgent crisis.

A substantial degree of reform must therefore precede privatisation. Specifically, implementing improvements in consumption metering and raising tariffs towards cost-recovery levels<sup>8</sup> are prerequisites for commercialising the operation of DH systems. Following such reforms, PSP has gradually spread at the municipal level in the Czech Republic, Estonia, Lithuania, Poland, the Slovak Republic and, to a lesser extent, in Hungary (see Table 4.2). FYR Macedonia is an unusual case in that its sole large DH company, based in Skopje, was privatised to its employees. In all other countries, private DH projects are still rare or do not exist.

Much of the private investment has concentrated on heat generation – for example, in the Czech Republic, Hungary and, to a lesser extent, Poland. In such cases, the private operator sells energy to a municipal DH company that, in turn, delivers to final customers. One example is PSEG's ELCHO project near Katowice in Poland. The American investor operates a new co-generation plant and sells its output to Polish electricity company PSE and Katowice's local DH company. However, there have also been arrangements for the private operation of integrated DH companies covering heat generation and distribution.

These contracts often take the form of concessions or leases-to-operate, as, for instance, with French company Dalkia's 30-year concession in Tallinn.

Finally, where private investors actually acquire ownership of DH assets, municipalities often retain a certain share or set up an explicit joint venture. This structure can be observed, for instance, in Poland (MVV/Ruhrgas in Szczecin) and the Slovak Republic (VNG in Prievidza).

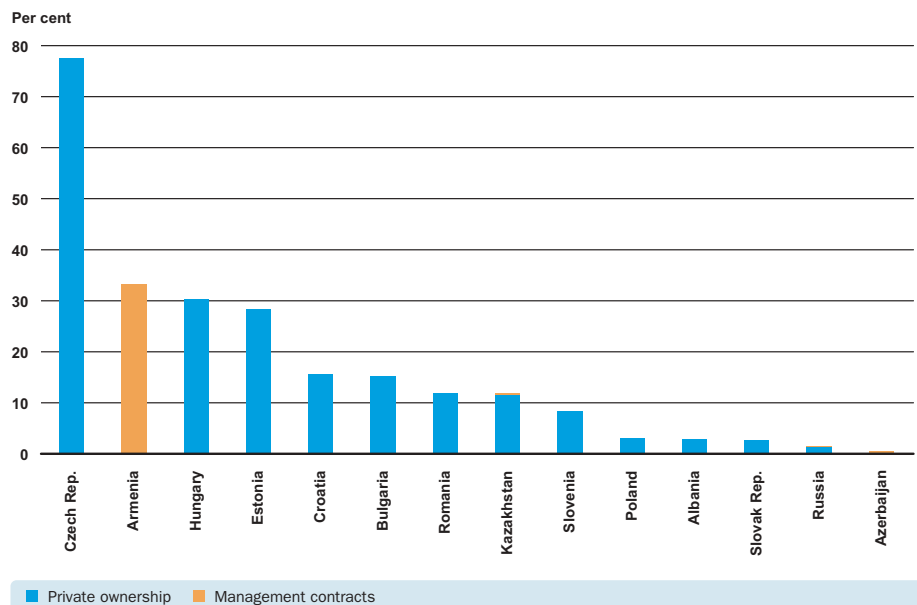
### Water and waste water

Privatisation of water supply and waste-water treatment is most advanced in the Czech Republic. Over 70 per cent of the population is served by private utilities (see Chart 4.3). In other CEE cities, including Budapest (in Hungary), Gdansk (Poland), Maribor (Slovenia), Tallinn (Estonia – see Box 4.1) and Trencin (Slovak Republic) concessions and BOT contracts have been awarded to private operators.

In SEE Romania has emerged as the leader in PSP, with private companies operating in Bucharest, Ploiesti and Timisoara. In Bulgaria a private operator

Chart 4.3

### Proportion of population served by privately managed water companies



Source: EBRD estimates.

Note: Data relate to 2004. Countries that are not included in the chart do not have private sector participation in water and waste-water services.

manages water and waste-water services in Sofia. PSP in other SEE countries is limited to a handful of projects, including a concession in Elbasan (Albania), a private waste-water treatment plant in Zagreb (Croatia) and a management contract in the Gjakove-Rahovec region of Kosovo.

PSP in the CIS countries has been limited to BOT contracts for waste-water treatment plants in Moscow and St Petersburg in Russia. In addition, there are management contracts in some other Russian and Ukrainian cities, and in Almaty in Kazakhstan, Imisli in Azerbaijan and Yerevan in Armenia (see Box 4.1).<sup>9</sup>

The DH and water sectors face many similar problems in promoting PSP. Both are dominated by municipal companies and have a history of charging low tariffs. An additional problem for water utilities in EU member and candidate states is the cost of complying with EU regulations on drinking water quality and waste-water collection and treatment (see Annex 3.1). This means that water bills will have to increase more rapidly than incomes. However, it is uncertain whether consumers will accept the necessity of much higher water tariffs. As a result, PSP has been limited to places with a willingness to pay tariffs at levels broadly equivalent to those charged in western Europe. BOT contracts have been signed with only the most creditworthy municipalities.

Elsewhere, concessions or other PSP contracts have been dominated by a “thin equity” model, under which almost all new investment is funded out of company cash flows and loans provided by international financial institutions or EU grants.

### Telecommunications

The telecommunications sector has the most extensive PSP. In mobile telephone services, there is some degree of PSP in all the transition countries. In fixed-line services PSP has spread more slowly and is lagging behind in some countries, particularly in Central Asia.

The main forms of PSP have involved the sale of strategic stakes in incumbent operators, together with management control. In many cases, governments have retained either a minority shareholding in the incumbent fixed-line operator or some kind of “golden share” designed to prevent hostile take-overs.

A major issue in many PSP transactions has been the balance between the promotion of competition and maximising the revenues from the sale of shares, assets or licences. Governments wishing to maximise the price have had an incentive to grant exclusivity rights or periods of restricted competition to the purchaser. For example, in the privatisation of the Armenian fixed-line operator Armentel to OTE of Greece, Armentel received 15 years exclusivity for the

## Box 4.1

## Private sector participation in water services – a tale of two cities

In 2000, after an open competitive tender, the municipality of Tallinn awarded a private concession for the water and waste-water system to International Water and United Utilities. The new company has a 15-year contract to manage water and waste-water operations serving over 400,000 people. In 2003 the ownership of the company changed, leaving United Utilities, the EBRD and the municipality of Tallinn as the remaining shareholders. Costs have been reduced through efficiency programmes and reductions in the workforce from 564 in 2001 to 351 in 2003. Reduced water leakage and increased compliance with water quality standards have also been achieved (see charts below). At the time of privatisation, the water company was in good financial order, with tariffs set at cost-recovery levels. Recent improvements have been achieved without substantial price increases, being mostly financed through loans and retained earnings. The first substantial price increase did not take place until January 2004.

In May 2000, following an open international tender, a management contract to operate the Yerevan Water and Sewerage Company (YWSC) was awarded to a group of investors led by Rome-based ACEA. During the first two years under private operation, collection rates – although improved – stayed below target, high losses persisted, few new meters were installed and supply did

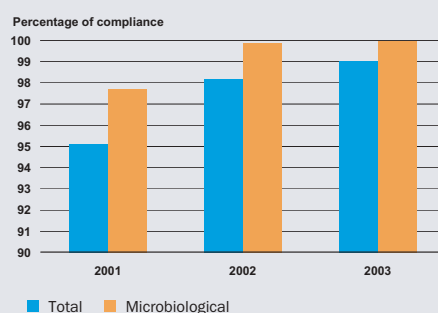
not improve. More recently, however, some improvements have been achieved, including metering of 85 per cent of users, reduction of electricity consumption and better tariff collection (see chart below).

Nevertheless, the general state of the water supply system has remained poor, reflecting a long history of under-investment. Hours of supply have improved but the service is still intermittent in many parts of Yerevan. At the end of 2003, several hundred people were hospitalised after consuming low-quality water. Criticism of the water utility's performance was voiced by a special parliamentary commission which argued against the prolongation of the management contract in 2004. Other stakeholders have taken a more positive view.

The current management contract was extended by a year and a follow-on project scheduled for 2005. However, a number of problems remain. Despite a 61 per cent increase in April 2004, tariffs are clearly below cost levels and this continues to limit new investment. Many pipes are in a state of disrepair, and theft remains widespread, leaving the rate of water losses as high as 70 per cent. Necessary investments to improve the system are estimated at around US\$ 450 million. Without significantly improved collection rates and higher tariffs, it will be difficult to resolve more than the most urgent problems.

Source: EBRD.

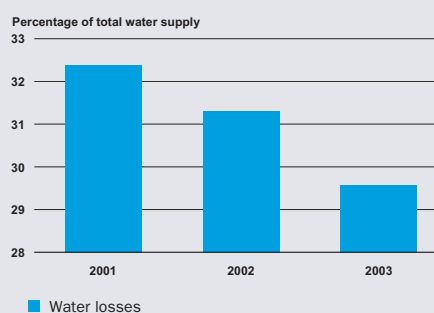
**Tallinn Water: Water quality compliance, 2001–03**



Source: Tallinn Water Annual Reports.

Note: Water quality compliance measures pertain to locally established standards and targets, e.g. with respect to iron content (< 1.0 mg/L).

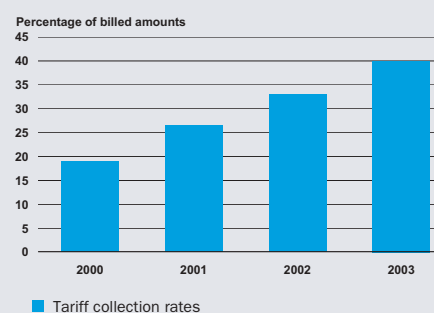
**Tallinn Water: Losses in the distribution system, 2001–03**



Source: Tallinn Water Annual Reports.

Note: Losses in the distribution system refer to leakages or theft (illegal connections), expressed as a percentage of total water supply.

**Yerevan Water: Average tariff collection rates, 2000–03**



Sources: World Bank and local media.

provision of fixed-line and mobile services (see also Chapter 3). In other cases, such as the privatisation of the Bulgarian Telecommunication Company, new mobile phone licences have been awarded free of charge or on favourable terms to an incumbent fixed-line operator as an incentive for potential purchasers of the fixed-line company.

These privileges are sometimes justified on the grounds that they make it possible for the government to impose other more onerous conditions on the purchaser, such as investment in installing new lines. However, enforcing conditions on investment has proved difficult despite such privileges. Furthermore, studies have shown that competition has been a crucial factor in improving the performance of telecommunications operators.<sup>10</sup>

## Transport

### Roads

PSP in the roads sector remains very limited. The only countries that have introduced PSP through toll roads are Croatia, Hungary and Poland. These countries awarded a few concessions attracting investment of approximately US\$ 3 billion. The toll road concessions in Hungary did not meet all their goals, partly due to under-estimation of the extent of traffic diversion to alternative routes and the high risks allocated to private operators. In one case tariffs were also reduced by a court judgment. Hungary has now replaced its toll-based concessions with contracts based on payments for road availability, therefore transferring traffic risk back to the state. Such a model preserves the PSP character of the

transaction as private companies remain responsible for construction, maintenance and related risks. However, they are now paid directly from the state budget rather than through tolls.

Similar problems could affect toll road concessions in Poland while the two private toll roads in Croatia always relied on substantial public support. Several other countries in CEB and SEE have initiated bids for toll road concessions but have failed to bring any to closure.

### Railways

PSP in railways is also limited. Reform has so far focused mainly on the commercialisation and restructuring of public railways. However, even in countries where this process is well advanced, governments have been hesitant to transfer operations

## Box 4.2

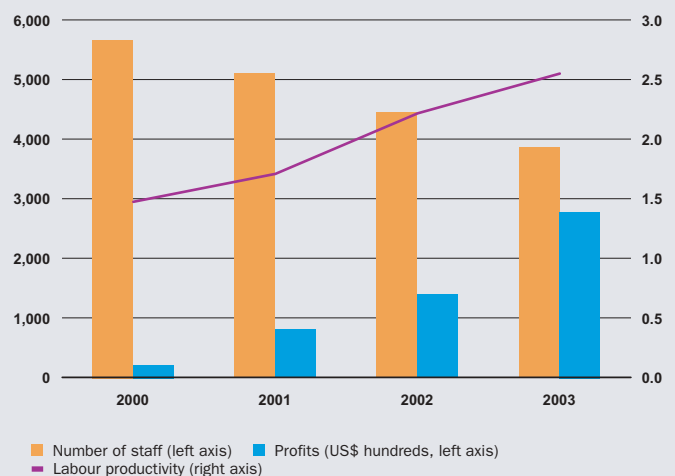
## Privatisation of Estonian Railways

Estonia is the only transition country that has privatised its railways. The regional passenger service (Edelaraudtee) was divested in 1997 and subsequently privatised in 2000 to a consortium of Estonian and British investors. The remaining part of Estonian Railways was privatised in 2001 to a consortium of three foreign strategic investors and an Estonian financial investor, with the government retaining 34 per cent. The new Estonian Railways owns both track and freight operations, while Edelaraudtee operates passenger and freight services and owns some domestic track. In addition, there are two companies operating local commuter services in the Tallinn area and express passenger services to Moscow and St Petersburg. All railway companies can access the rail networks on a non-discriminatory basis following the amendment of the Railway Act in April 2004. Freight operators are free to set tariffs but passenger tariffs are subject to regulatory approval.

Since privatisation, labour productivity in the railway sector has improved significantly, reflecting sales growth and reductions in the workforce. The financial performance has also improved significantly. For example, revenues and profits of Estonian Railways increased by 29 per cent and 73 per cent respectively between 2001 and 2002. This was partly due, however, to state support for loss-making passenger services.

Source: EBRD.

## Productivity and profits following railways privatisation in Estonia, 2000–03



Sources: EBRD railway database and Estonian Railways.

Note: Labour productivity is defined as total passenger traffic (passenger-kilometres, in millions) and freight traffic (freight-tonne-kilometres, in millions) divided by number of staff.

to the private sector. With the exception of Estonia, which has fully privatised its railway system (see Box 4.2), responsibility for the management of infrastructure remains in the public sector. In advanced transition countries the privatisation of ancillary services has largely been completed. Network maintenance is carried out by private companies in Croatia, the Czech Republic, Kazakhstan, Poland and Romania.

In most transition economies, passenger services make a loss and are subsidised. For PSP to be viable under these circumstances, it is necessary to establish explicit arrangements for providing subsidies through Public Service Obligations. The Czech Republic, Latvia and Romania have transferred the operation of some passenger services to private companies. Poland is attempting to do the same for commuter operations in Gdansk and Warsaw.

Many freight services can, however, be profitable. In Russia, energy and industrial companies have owned rolling stock and operated branch lines since well before 1991. The sector is being gradually liberalised by allowing licensed transport and leasing companies to supply wagons to freight users and by granting carrier licences to private companies, allowing them to operate freight services over main

lines as well as branch lines. The first private freight railway companies should start operating before the end of 2004.

Gradual liberalisation is also under way in Kazakhstan, Poland and Romania. In Poland the Rail Regulatory Office has issued over 30 licences to companies that have been “spun off” from the state railway company PKP as well as new private operators. In Kazakhstan there are about 10 private freight companies, and about 40 per cent of rail wagons are owned by private operators or leasing companies. Most of the private activity is linked to the petroleum and mining sectors. The structure is similar in Romania.

## Ports and airports

The earliest PSP arrangements for ports consisted of sales of land, infrastructure and associated port facilities in Russia during the early 1990s. Similar deals were subsequently concluded for the privatisation of a small number of ports or terminals in Estonia, Latvia, Poland and Romania. Most of these ports handle bulk cargo. Other models of PSP in port services have since emerged. These include management or operating contracts (also referred to as “tool ports”), under which the private operator uses the landlord’s equipment and space on a short-term basis. There are also concessions or BOT contracts (also

referred to as “landlord ports”) whereby the private operator has a long-term lease on the land and basic infrastructure and invests in its own equipment and facilities. These are transferred to the landlord at the end of the lease. Riga port in Latvia and a number of ports in the CIS operate under management contracts. However, most ports or terminals with private operators follow the “landlord ports” model.

With changes in the organisation of sea transport and the increasing importance of multi-modal facilities in the major market economies, the challenge faced by ports in the region is how to manage the investments required for the efficient handling of containers as they are transferred between ships and either rail or road. PSP in ports, primarily through concession agreements, is likely to increase as a means of mobilising the investment finance required for modernisation.

PSP arrangements for airports are limited and mainly associated with partial privatisations in Russia and a limited number of BOT type concessions granted during the second half of the 1990s. These projects have been concentrated in a few countries, including Armenia, Hungary, Poland and Russia. A similar arrangement is currently under way in Albania.



Table 4.3

**Distribution of PSP contracts by sector, 1992–2003**

Sector	1992-95			1996-99			2000-03		
	Divestiture	Concession, lease or BOT	Management or operating contract	Divestiture	Concession, lease or BOT	Management or operating contract	Divestiture	Concession, lease or BOT	Management or operating contract
Electricity generation	5	0	0	22	7	1	16	10	2
Electricity transmission and distribution	80	0	0	9	0	2	17	3	5
Gas	27	1	0	4	2	0	5	2	0
Transport	9	3	1	5	9	4	2	4	0
Water	0	10	1	0	18	2	2	17	5

Source: EBRD estimates, based on the World Bank's PPI database, Dealogic's MA Global and the Water and Sanitation Sector PPP database at Cranfield University.

Notes: BOT stands for build-operate-transfer contracts. All telecommunications deals fall into the divestiture category, so this sector is not shown in the table.

## Municipal services

### Urban transport

The primary form of PSP in urban transport has been in the provision of minibus services. These often operate in parallel with existing municipal urban transport, frequently concentrating on the most profitable routes. Most private entry has been in smaller cities, especially those without tram or metro systems. After an initial boom, stricter regulations have since put private minibus operators out of business (as in Poland) or forced them to organise, consolidate and operate pre-determined routes according to agreed timetables (as in Central Asia and the Caucasus). Nevertheless, in many countries (Albania, for instance) the private sector remains largely unregulated and the quality of service is variable or poor.

Another mode of private sector entry is by operating main bus routes in parallel with those offered by publicly owned transportation or by taking on individual routes that have been outsourced by public providers. There are companies operating in this way in Bulgaria (in Sofia), Poland (Gdansk and Warsaw), Russia (Moscow) and Serbia and Montenegro (Belgrade).

The least common form of PSP has been the award of concessions by local authorities for the operation of all municipal transport services to a private operator, usually one with a foreign partner. This has occurred in Tartu (the second-largest city in Estonia) and in Tczew (in northern Poland). Unlike the first two forms of private participation, this mode may not promote competition in service provision but it gives access to the capital necessary for asset renewal and company restructuring.

PSP has tended to be greater in poor countries, particularly those where municipalities face severe fiscal constraints. As a result, the countries with most PSP in urban transport lag behind in many other indicators of transition. The service provided by the private sector is, however, often far below the standards achieved in more developed countries.

### Other municipal services

Other municipal services have also attracted substantial PSP. For example, the private sector is involved increasingly in waste management – as a competitor to municipally owned operators and also through privatisation of incumbent municipal waste management utilities.

In 2002 privately owned firms in Poland collected about 46 per cent of municipal waste and were responsible for about half of all storage and sorting services. Other countries, such as Bulgaria, the Czech Republic, Hungary and the Slovak Republic, also have private involvement in waste collection as well as landfill development and management. In the Hungarian cities of Debrecen and Szolnik, local municipalities have entered into joint ventures with foreign partners for municipal waste management and disposal. The private partners include large international companies, such as Lobbe, Rethmann and Sita as well as locally owned enterprises.

## 4.3 What kinds of PSP?

### Contractual arrangements

PSP has taken a wide range of contractual forms. Table 4.3 gives the distribution of PSP deals in the region by type of contractual arrangement. There are three main types: divestiture, concessions or BOT contracts, and management contracts.

Under a divestiture, all assets, operations and investment obligations are transferred to the private operator. All telecommunications deals fall into this category. Divestiture is also the dominant form of PSP in electricity generation and in electricity and gas distribution. A fundamental condition for the divestiture of assets is consumer willingness to pay for the services provided by the operator, accompanied by levels of tariff revenue that can sustain the investment obligations. This may be achieved through improved commercial performance, in the case of electricity or gas distribution, or as a consequence of expanding the market as in the case of telecommunications.

Under concessions and BOT contracts, the operator has an obligation to invest in new capacity or the replacement of existing infrastructure. The investor is compensated through the tariff charged for the service and/or a payment for the depreciated value of investments at the end of the contract period. With leases, the primary responsibility for financing most investment in infrastructure rests with the owner although the operator may be encouraged to invest in equipment. The overall level of tariffs is not as critical under these contracts as under divestiture because lower tariffs can be offset by lower lease payments for the existing assets. However, concessions or BOT contracts involving substantial investment obligations over 20–30 years will be viable only if the tariff structure ensures that revenues are sufficient to cover the long-term cost of service.

Concessions and similar arrangements are the primary form of PSP in the provision of water and waste-water services and are quite common in transport. The majority of new investment in electricity generation



has been through BOT contracts, sometimes combined with leases for existing plants. The absence of liberalised wholesale power markets means that investors rely on long-term agreements with (usually) state-controlled or guaranteed purchasers. Under these conditions, it is natural to link the purchase agreement to the licence to operate the power plant. From a regulatory point of view, however, long-term power purchase agreements have the disadvantage that they can impede subsequent liberalisation and the introduction of competition.

Management and outsourcing contracts are operating contracts without any investment obligations. These were relatively rare during the early transition phase when most attention was focused on the divestiture of assets. However, they have become more common in recent years as countries have found it harder to attract private operators ready to invest in infrastructure services where there is resistance to cost-reflective tariffs. Management contracts are important for water and waste-water services, especially in the CIS. They have also been awarded in electricity distribution after prior efforts to divest assets have failed to attract bidders, or when bids have been deemed unacceptable. Outsourcing contracts have been awarded in the railway sector as a result of government reluctance to cede control of the basic network infrastructure.

### Main investors in PSP deals

Private participants in the region's infrastructure markets are diverse but may be classified into four main groups. The first comprises foreign utilities that bring management and operational skills, equity investment and access to loans in varying proportions. This group includes (partially) state-owned utilities from western Europe as well as fully private strategic investors from North America and western Europe.

The second group comprises utilities from other transition countries – notably CEZ and RAO UES in electricity, Gazprom in gas transmission and distribution, and some fully private companies (for example, large Russian mobile phone operators). These investors have more limited equity capital but may offer special advantages in relation to key operating issues – such as access to international transmission networks or supplies of fuel – as well as operational experience within the region.

The third group comprises local or regional firms providing a combination of small-scale investment and sector- or country-specific expertise. It includes local firms owning small hydroelectric power plants, as in Albania or Bulgaria, or managing water distribution systems in particular towns (such as in Piaseczno in Poland or Perm in Russia). Local investors also play a role in the Baltic electricity distribution market and in the gas and power distribution sectors of a few other countries.

Lastly, there have been a certain number of international financial investors. One example is Midland Resources, which owns the Armenian electricity distribution network. The actual operation of these Armenian assets is contracted out to South Korea's Daewoo. Other equity investors in the region include the American Crossroads Investment Fund (owners of Hungarian Pannonpower) and the Advent venture capital group, which recently acquired a majority stake in the privatised Bulgarian fixed-line telephone operator.

In terms of relative importance, Western utilities clearly hold the largest stakes. Companies such as AES, Dalkia, EDF, ENEL, E.ON and RWE (in the energy sector), Deutsche Telekom, France Telecom, OTE, Telenor, Telia Sonera and Vodafone (in telecommunications) and Berlinwasser, Gelsenwasser, Ondeo, United Utilities and Veolia (in water services) account for the bulk of private investment in their respective sectors – notably in CEB countries. However, the recent acquisition by Czech group CEZ of three Bulgarian electricity distribution companies (combined with ambitions to expand in Romania and the Slovak Republic) shows that some regional players are increasing their stakes in neighbouring markets as well.

Russia's RAO UES, in particular, has been moving into difficult markets often at the time when Western investors have been pulling out, or as part of debt swap arrangements to clear payment arrears. The company now holds sizeable assets in several CIS countries, especially Armenia, Georgia, Kazakhstan and Ukraine. The large Russian mobile phone operators – MegaFon, MTS and VimpelCom – have similarly expanded into Belarus, Kazakhstan, Tajikistan, Ukraine and

Uzbekistan. Gazprom's reach extends even further, with substantial holdings in the Baltic states, in Bulgaria and in CIS countries (see also footnotes 6 and 7). Compared with these big international groups, the financial influence of local investors is naturally very limited. Nonetheless, their overall importance appears to have increased in recent years.

### Sources of finance

Table 4.4 shows the amounts of new private financing raised from capital markets through loans, bond issues and new equity (excluding privatisation and closed subscriptions) for infrastructure enterprises in the region. The total is just over US\$ 84 billion at 2000 prices, of which loans have accounted for 75 per cent and bonds 22 per cent. New issues of equity represent just under 3 per cent of the total (and have involved almost exclusively telecommunications companies, primarily from the CEB countries). Financial flows to the CEB countries account for 62 per cent of the total. This was equivalent to US\$ 716 per head of population in 2003, compared with US\$ 100 per head for SEE countries and US\$ 94 per head for CIS countries.

The sectoral breakdown shows that the telecommunications and gas sectors raised the largest amounts of money. The water sector, as the smallest recipient of private financing, is much more dependent on official sources of finance from the EU, multilateral financial institutions and bilateral aid programmes.

Foreign direct investment (FDI) was originally expected to play an important role in financing investment in infrastructure services. Initially, foreign investors dominated the telecommunications and electricity sectors but FDI has since decreased due to disappointing returns (see also Section 4.4 below) and problems faced by investors in other markets.

More generally, experience from market economies suggests that most utilities ultimately offer a bond-like return on equity that is attractive to local institutional investors rather than foreign investors expecting higher returns. Thus, it seems likely that investors seeking high returns in the early period of transition will be replaced progressively by local operators expecting lower but more stable returns.

Foreign investment is also likely to fall if and when local capital markets mature to the stage of sustaining long-term financial instruments. Most new finance is likely to be raised predominantly in the form of debt or bonds rather than equity. Where equity is involved, most of it will come from retained earnings rather than new capital.

Major changes within the utilities and the economic environment will be required if this type of financial structure is to be viable. These will include: stable regulatory regimes committed to the principle that efficient operators should earn a reasonable return on capital; competent utility management, focused on improving commercial and operational performance; and economic stability, which also reduces the political conflict over tariff increases.

Some of these conditions have been established in the advanced transition economies but not in many countries of the CIS. Consequently, the CIS countries are likely to remain dependent on external sources – primarily international financial institutions – for many years.

## 4.4 What has PSP achieved?

### Operating performance and standards of service

Systematic evidence on the relative performance of privately controlled utilities in transition countries is limited, due to lack of data. However, there is some anecdotal evidence of utilities increasing productivity substantially after being transferred to a private operator. A distinctive feature of PSP in telecommunications has been the effective implementation of new technologies (such as digital switching and mobile phones) that offer the prospect of improvements in productivity and quality of service. International experience also indicates that PSP in telecommunications is associated with higher levels of service and productivity, with the effects of privatisation being strengthened by market competition.

Consistent with this, the number of customers for both fixed-line and mobile phone services in the region has increased substantially (see Chart 4.4). Access to fixed-line services in the region grew from less than 16 per cent of the population in 1995 to about 23 per cent in 2003 while market penetration of mobile phones

Table 4.4

### Private financing for infrastructure, 1992–2003

(in US\$ million at 2000 prices)

Country group / sector	Source of finance	1992-95	1996-99	2000-03	Total
CEB	Loans	3,577	15,886	21,257	40,720
	Bonds	640	5,814	3,347	9,801
	Equity	0	1,760	146	1,906
	<b>Total</b>	<b>4,217</b>	<b>23,459</b>	<b>24,751</b>	<b>52,427</b>
SEE	Loans	130	1,843	2,802	4,775
	Bonds	0	0	554	554
	Equity	0	0	0	0
	<b>Total</b>	<b>130</b>	<b>1,843</b>	<b>3,356</b>	<b>5,329</b>
CIS	Loans	3,531	11,235	2,809	17,575
	Bonds	0	578	7,617	8,195
	Equity	24	153	371	549
	<b>Total</b>	<b>3,555</b>	<b>11,966</b>	<b>10,797</b>	<b>26,319</b>
All transition countries	Loans	7,238	28,963	26,867	63,069
	Bonds	640	6,391	11,519	18,550
	Equity	24	1,913	518	2,455
	<b>Total</b>	<b>7,903</b>	<b>37,268</b>	<b>38,904</b>	<b>84,074</b>
<b>Sectors</b>					
Electricity	Loans	1,202	5,402	4,931	11,536
	Bonds	588	1,652	1,302	3,542
	Equity	24	4	0	29
	<b>Total</b>	<b>1,814</b>	<b>7,058</b>	<b>6,234</b>	<b>15,106</b>
Gas	Loans	3,615	13,050	4,912	21,577
	Bonds	0	304	5,997	6,301
	Equity	0	0	0	0
	<b>Total</b>	<b>3,615</b>	<b>13,355</b>	<b>10,909</b>	<b>27,878</b>
Telecommunications	Loans	1,186	8,964	13,154	23,304
	Bonds	52	4,361	3,630	8,044
	Equity	0	1,909	518	2,426
	<b>Total</b>	<b>1,238</b>	<b>15,234</b>	<b>17,302</b>	<b>33,774</b>
Transport	Loans	1,235	1,301	3,471	6,007
	Bonds	0	75	589	663
	Equity	0	0	0	0
	<b>Total</b>	<b>1,235</b>	<b>1,376</b>	<b>4,059</b>	<b>6,670</b>
Water	Loans	0	246	399	645
	Bonds	0	0	0	0
	Equity	0	0	0	0
	<b>Total</b>	<b>0</b>	<b>246</b>	<b>399</b>	<b>645</b>

Sources: EBRD staff calculations, based on the World Bank's PPI database, Dealogic's Bondware and Loanware, Bank of New York and other databases.

Note: Money values have been converted to US dollars at 2000 prices using current exchange rates and the US GDP price deflator.

increased from less than 0.2 per cent in 1995 to almost 24 per cent in 2003. In most countries mobile telecommunications infrastructure has been financed by private operators.

The benefits of PSP should be particularly apparent in sectors where entry barriers are low. In urban transport, for instance, private operators can survive only if they provide the service that their customers want, and at a price they are willing to pay. In contrast, the legacy of past investments and mismanagement in the energy, transport and water sectors casts a much longer shadow. PSP can have a quick impact on quality of service where there is apparent excess demand – electricity black-outs, intermittent water

supply – by improving the operation of existing assets or accelerating new investment programmes.<sup>11</sup>

However, most transition countries have been characterised by over-capacity in energy and water networks, with the result that reforms have focused on the commercialisation of utility operations. This has also affected the impact of PSP on sector productivity. Although the correlation between growth in employment in utilities and the extent of PSP across a sample of 17 countries<sup>12</sup> is rather low (about -0.2), a review of the case-by-case evidence indicates that PSP has resulted in higher levels of productivity, at least in some countries (see Boxes 4.1 and 4.2).

Additional evidence for the power sector suggests that the entry of private companies has tended to reduce overall distribution losses. Comparing distribution losses in the year before PSP first occurred in a given country with the losses in 2002, it appears that they decreased by an average of 1.9 percentage points whereas average losses did not change at all in the countries where no PSP has taken place.<sup>13</sup> Albania is a striking example of improved performance. Distribution losses were reduced by more than 16 percentage points between 1999 (the year before Italian ENEL took over control under a co-management contract) and 2002. Overall, even though systematic evidence on efficiency improvements is scarce, these figures indicate some positive effects associated with PSP.<sup>14</sup>

### Prices, tariffs and revenues

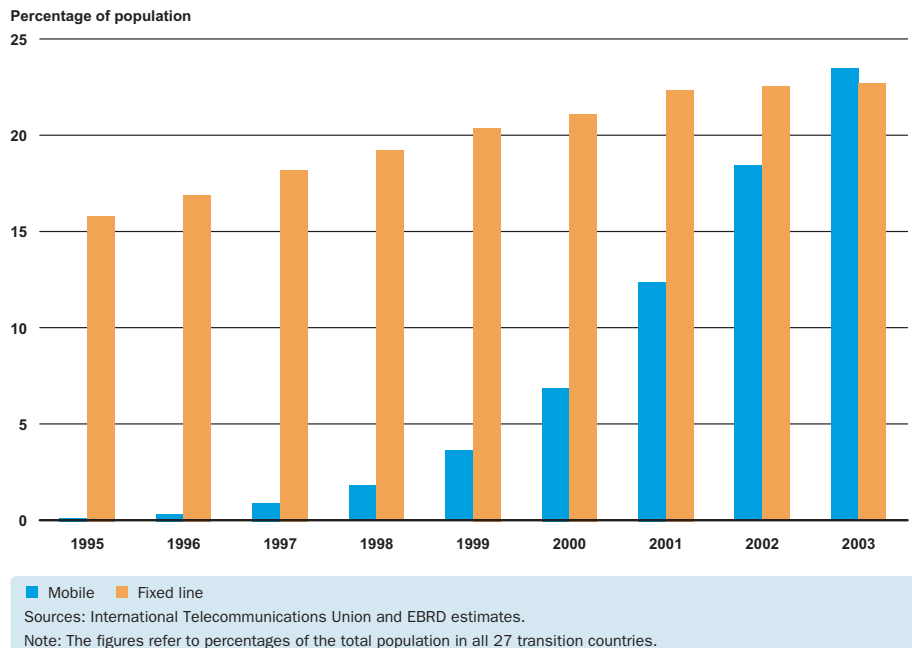
It has been claimed that PSP leads to higher prices for users. However, any impact of PSP on the cost of service provision is confounded by the fact that private involvement usually leads to removal of subsidies. Therefore, the consumer price reflects the full costs of capital as well as the operating and investment expenditure.

The analysis of electricity prices since 2000 reveals two main patterns.<sup>15</sup> First, there is a positive correlation (0.36) between the extent of PSP in electricity generation in 2004 and the prices paid to generators in 2000. This is consistent with the view that it was easier to privatise generation assets in markets where the prices received by generators were relatively high. Secondly, there is a negative correlation (-0.27) between the change in producer prices from early 2000 to the end of 2003 and the extent of PSP in generation in 2004. Accordingly, even though prices may have been relatively high at the time that private operators entered the market, PSP does not mean that prices continued to rise. This supports the view that although price increases might have been necessary to attract private capital, once private investors are in place further price growth can be contained by more efficient operations.

Nevertheless, even with PSP, prices are probably still below cost-recovery levels. The cost of electricity generation is typically about 3–3.5 US cents per kWh for an efficient modern 300–500-MW plant.<sup>16</sup>

Chart 4.4

### Proportion of population with telecommunications services in transition countries, 1995–2003



The median pre-tax producer price of electricity was only 2.5 US cents per kWh at the end of 2003. In all CIS countries the producer price of electricity has been below the level required to ensure the viability of new plants. This can partly be explained by the fact that few countries have had to install new capacity. However, unless producer prices rise above 3.5 US cents per kWh, PSP is likely to be feasible only for the rehabilitation of existing generating plants.

The pattern for gas is very similar. The strongest correlations are between the extent of PSP in 2004 and both wholesale and residential gas prices at the beginning of 2000. There is no correlation between the change in wholesale prices from 2000 to 2003 and the extent of PSP. Although prices are frequently lower than long-term cost-recovery levels, basic price adjustments seem to be an important precondition for PSP. After private entry, the rise in prices usually slows down.

### Rates of return on equity

For private investment in infrastructure services in transition countries to be sustained, it is essential that investors can earn enough to cover their target rate of return on equity. The real equity returns that private investors expect from infrastructure projects in transition countries are difficult to generalise but as a rule of thumb they would generally be in

the following ranges: 10–13 per cent in CEB and 15–19 per cent in SEE in the telecommunications sector; and 6–9 per cent in CEB and 11–15 per cent in SEE in electricity, gas and water.<sup>17</sup>

Table 4.5 shows the actual rates of return on equity for privatised utilities in CEB and SEE, based on a small sample of companies for which accounting data are available for a number of years. Real returns in this sample vary from 6 per cent for gas utilities to 4 per cent for water utilities. Only the average returns on equity for gas companies have been sufficient to meet target returns at the lower end of the range for CEB. Otherwise returns on equity for companies over a five-year period appear to have been too low. The median returns for companies in each sector show that a majority of companies operating in the telecommunications and water sectors failed virtually every year to make a return sufficient to cover their real cost of equity. Companies operating in the electricity and gas sectors fared somewhat better, earning returns that were about equal to, or just above, the bottom of the range of the real cost of equity for investments in CEB countries in two out of five years.<sup>18</sup>

These figures could suggest that the general level of returns has been slowly increasing as investors learn how to manage their operations more effectively. However, this relies on an assumption that the relatively high returns of 2002 were

not exceptions. Overall, the analysis implies that investments in privatised utilities in transition countries have not produced returns sufficient to cover the target rates of return. This could explain the diminishing enthusiasm for investments in PSP in the region. Either returns will have to match or improve on their level in 2002 or private operators will seek arrangements that minimise the amount of equity capital that they are expected to provide.

## Comparison with Latin America

Although evidence on the impact of PSP on sector performance is limited for the transition countries, many studies have examined the effects of PSP in infrastructure services in Latin America, focusing especially on Argentina, Brazil and Chile.<sup>19</sup> While some of the results are specific to particular sectors or countries, others are of wider relevance.

In Latin America, PSP has been associated with an increase in investment in infrastructure assets. The telecommunications sector is the prime example, with waiting lists for connections being eliminated within one to two years. Electricity generation, transmission and distribution, gas distribution and water services have all seen substantial improvements in investment performance and access following PSP. Despite the increase in investment, many private operators have failed to comply with investment targets where these formed a part of the bidding criteria. Following privatisation, operators have had strong incentives to invest only what has been required to meet the growth in actual demand rather than what may have been promised.

The output and quality of infrastructure services have tended to improve rapidly following PSP. Efficiency has improved, as measured by both labour and total factor productivity. Most of the initial efficiency gains have been achieved by reductions in the workforce. In the medium term, efficiency improvements have been associated with a growth in output rather than further reductions in employment. For instance, electricity generation and water services have seen significant advances in capacity utilisation and in the levels of efficiency. Real tariff levels have risen in almost all sectors. The exceptions are mobile telephone services in many

countries and fixed-line services where competition has been introduced (as for long-distance calls in Brazil, Chile and Mexico).

The major difference between Latin America and the transition countries concerns access to network services, apart from telecommunications. Levels of network coverage and consumption of infrastructure services were much higher in transition countries in the early 1990s than in Latin American countries with similar incomes. The weight attached to meeting unsatisfied demand in assessments of PSP in Latin America is therefore less relevant in the transition countries, except for the poorest countries of the Caucasus and Central Asia. Ironically, several of these countries have made the least progress with PSP. This is partly because resistance to the higher tariffs necessary to finance new investments is particularly strong among those who already receive the services. It is interesting to note that PSP has proved particularly difficult to promote in the poorer countries of Central America for similar reasons.

The main challenge for PSP in transition countries is the maintenance and improvement of network infrastructure that was neglected during the final years of the socialist regimes. Even so, by comparison with Latin America, it offers less obvious benefits and poses a more direct challenge to expectations of low tariffs. It is, therefore, not surprising that PSP has generally moved forward more slowly than in Latin America.

Table 4.5

### Returns on equity for privatised utilities, 1998–2002

Year	Median real returns (in per cent)			
	Electricity	Gas	Telecommunications	Water
1998	2.6	4.6	4.5	1.3
1999	3.3	6.7	6.9	3.0
2000	4.4	5.5	2.9	4.5
2001	6.3	5.6	-2.0	7.1
2002	6.5	7.7	13.2	4.4
Average	4.6	6.0	5.1	4.0
Sample size	15	13	10	8

Source: EBRD staff calculations, based on accounting data from the Amadeus database (Bureau van Dijk).

Note: The return on shareholder funds is calculated using end-of-year shareholder funds data. The table includes only companies for which data are available for the full period from 1998 to 2002. The companies in the sample operate in Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Poland, Romania and Slovenia.

As returns in the Amadeus database are expressed in US dollar terms, real returns are obtained by adjusting nominal returns by the US consumer price index rates.

## 4.5 Conclusion – what lies ahead?

There have been significant differences between sectors in the extent of PSP. The telecommunications sector – especially mobile telephone and data transfer services – has attracted large amounts of foreign investment and benefited from the introduction of competition. Some investors have been disappointed in their returns but there is no shortage of new private capital to finance the extension of existing and provision of new services. The sector is, however, a special case. There appears to be a great consumer willingness to pay for telecommunications services. Furthermore, the high rate of technical progress has substantially reduced the cost of upgrading existing services and providing new ones. The key element required to maintain vibrant PSP is an effective regulatory framework focused on promoting competition in the market (see Chapter 3).

The electricity and gas sectors have also attracted substantial private investment, primarily in CEB. Most private capital has been raised through asset sales but there have been some greenfield investments as well, particularly in gas transmission and distribution. The prices obtained for privatised assets declined in the late 1990s although there has been a recent renewal of interest from investors as some countries not involved in the first wave of privatisation have put their companies up for sale. Still, many Western investors are showing less interest in extending their holdings of electricity assets in the region. There has probably been a more realistic



appraisal of the likely return on equity and the scale and speed of reforms that can be implemented in the short term. This has changed the way in which transactions are viewed and financed.

In the poorer countries of the region, particularly where tariffs are far below cost-recovery levels and revenue collections are low, there is a considerable reluctance to make any substantial equity investments. PSP therefore remains largely confined to the provision of operational and management skills. New investment is likely to be financed by loans rather than equity.

In this respect, models of PSP in electricity and gas distribution in the poorer transition countries may be converging with the pattern already apparent in the water sector throughout the region. While there are a variety of concessions, leases and management contracts, the water industry is dominated by a “thin equity” structure of private participation. This means that investors have been very reluctant to provide more than small amounts of equity upfront, hoping to finance investment from loans and company cash flows.

The primary role of the private sector has therefore been to promote the commercialisation of municipal utilities through improved management. Almost all of the external finance raised, except in a few cases in the Czech Republic, has come from loans, sometimes guaranteed by national governments. There have been small equity investments in BOTs and similar projects but these are supported by project finance loans and backed by strong claims on the future revenue of the utility.

PSP in municipal services, including urban transport and waste collection, is dominated by small, locally owned companies. Local companies are also managing district heating and water supply facilities. As they grow in size and expertise, their access to external finance will improve. Given their ability to handle local risks, these companies are likely to become important players in the broader PSP context.

With a variety of participants and contractual arrangements, the impact of PSP on infrastructure services has been threefold. First, private involvement has helped in the commercialisation of many enterprises. Secondly, PSP has introduced a new style of management, combining attention to customer service with stronger financial management. Lastly, in some sectors the entry of private operators has helped to raise finance for upgrading and extending existing assets. The role of private firms in financing mobile telephone networks in the region has been particularly important.

PSP will continue to play an important role in the infrastructure sector of transition economies. Improved regulation and political stability should lower the risks to investors and bring returns on capital (at least in the more advanced countries) to levels comparable with Western economies. Short-term – often speculative – investors have been replaced gradually by companies interested in longer-term strategic involvement in the region.

Another important trend is the emergence of local companies, ranging from “national champions” in sectors requiring high capital outlays to small dynamic companies active in municipal and regional markets.



## Endnotes

- <sup>1</sup> See Harris (2003).
- <sup>2</sup> Fiscal constraints can only be reduced if PSP does not have to be recorded as public expenditure. Box 2.3 in Chapter 2 includes a brief discussion of the relevant Eurostat rules.
- <sup>3</sup> This example illustrates a feature that is common in the electricity sector in the region. ESBi is itself a state-owned company, controlled by the Irish government. Several of the major investors in electricity systems in transition countries are wholly or majority state-owned companies – for example, EDF, Enel, Fortum and RAO UES. However, as mentioned earlier, for the purpose of this analysis state-owned companies have been treated as private operators when they take on PSP contracts outside their home countries.
- <sup>4</sup> The only other company owning some transmission lines is Irkutskenergo, one of the few regional energos in which RAO UES does not hold any stake. Irkutskenergo's main shareholders are the Russian state and the big aluminium companies Rusal and SUAL.
- <sup>5</sup> Throughout this chapter the analysis of PSP in Moldova does not take into account developments in Transnistria.
- <sup>6</sup> In Armenia and Moldova the dominant shareholder is Gazprom, which is effectively controlled by the Russian government. Gazprom also owns shares in the three Baltic gas companies in partnership with E.ON and has an option to buy shares in the Slovak gas company.
- <sup>7</sup> An example is the Yamal-Europe pipeline project, connecting the rich gas deposits on the Yamal peninsula with export markets in western Europe. The section in Poland belongs to a joint venture between Gazprom (with 48 per cent), Polish state company PGNiG (48 per cent) and private Bartimpex (4 per cent).
- <sup>8</sup> Even at current prices, DH payments often represent a substantial share of household income for vulnerable groups of society. Therefore, while cost-recovery tariffs are required to improve efficiency and ensure sufficient funds for maintenance and investment, it is essential to develop appropriate mechanisms to assist poor households.
- <sup>9</sup> In Russia an increasingly important player is Russian Communal Systems (RKS), which has concluded about 50 short-term leasing contracts in 27 Russian regions, providing supplies of water, heat and electric power to over 4.5 million consumers. However, state-controlled RAO UES appears to remain in managerial control of the company. Consequently, RKS is not included within the definition of PSP in this chapter.
- <sup>10</sup> See Ros (1999) and Li and Xu (2002).
- <sup>11</sup> See the selection of studies of the impact of infrastructure privatisation listed on the World Bank web site at <http://rru.worldbank.org/PapersLinks/Impact-Infrastructure-Privatization>.
- <sup>12</sup> Employment data come from the ILO Labour Statistics database for establishments classified under ISIC – Revision 3 Category E.
- <sup>13</sup> A similar result is obtained when considering medians rather than averages. The median improvement in the group of countries with PSP was a reduction of losses by 1.3 percentage points while the median of the control group was again unchanged. The analysis uses annual figures for the 27 transition countries compiled by the International Energy Agency. The average/median changes in distribution losses from the respective pre-privatisation year up to 2002 are compared with changes over the same period for a control group of countries with no PSP. The control group is constructed using the same weight on different base years as in the PSP group.
- <sup>14</sup> For additional evidence regarding the performance of privatised electricity companies in transition countries, see also Lampietti (2004), Chapter 3.
- <sup>15</sup> Quarterly electricity and gas data for 18 transition countries were available from the Energy Regulators Regional Association (ERRA).
- <sup>16</sup> These figures are based on cost estimates assuming modern (EU standard) environmental controls. For small countries, the relevant cost would be 3.5-4 US cents per kWh for a 100 MW plant.
- <sup>17</sup> The real post-tax cost of equity for European utilities operating in market economies falls in the range of 9-11 per cent for telecommunications and 5-7 per cent for electricity, telecommunications and water (see, for example, Civil Aviation Authority, 2002, and Ofgem, 2004). The combination of additional risks associated with country conditions and regulatory policies would imply a risk premium of at least 1-2 per cent for countries in central Europe and at least 6-8 per cent for countries in SEE. See, for example, Durbin and Ng (2004).
- <sup>18</sup> There is one important qualification to these results. Strategic investors in privatised utilities may often have service or technical assistance agreements with the companies in which they have invested. It is impossible to assess whether the payments are really justified or represent an indirect and tax-efficient way of transferring income from the utility to the parent company. Therefore, the reported figures may understate the effective returns earned by certain investors.
- <sup>19</sup> See Ugaz and Waddams Price (2003).

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## Part III: Country assessments

Part III of the *Transition Report* charts the reform progress of the 27 transition countries. The Bank's annual assessments highlight key developments and issues central to transition in a wide range of areas, including liberalisation, privatisation, the business environment, competition, infrastructure, the financial sector and social reform. New to this year's Report is a more detailed discussion of macroeconomic issues, which complements the usual review of reform developments. The key challenges facing each country are summarised at the beginning of the text.

To provide a quantitative foundation for analysing progress in transition, each country assessment includes a set of tables containing structural and institutional indicators, an overview of selected institutional and legal arrangements, as well as macroeconomic indicators.

These data help to describe the process of transition in a particular country, but they are not intended to be comprehensive. Given the inherent difficulties of measuring structural and institutional change, they cannot give a complete account or precise measurement of progress in transition. Moreover, some entries, such as the exchange rate regime and the privatisation methods, are useful only for information and carry no normative content. Other variables may have normative content, but their evaluation may vary depending on the specific country context.

The data should be interpreted with caution also because their quality varies across countries and categories. The data are based on a wide variety of sources, including national authorities, other international organisations and EBRD staff estimates. To strengthen the degree of cross-country comparability, some of the data were collected through standardised EBRD surveys of national authorities. The most recent GDP and fiscal data for the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia have been re-calculated according to Eurostat methodology (ESA95). The source of data and their exact definition are provided in the methodological notes at the end of the Report.

The "cut-off" date for data was mid-September 2004. Data for 2004 are projections.

# Albania

## Key challenges

- Strengthening public administration and law enforcement, combating corruption and reducing the size of the informal economy are essential for private sector development and foreign investment.
- Rehabilitation of the country's infrastructure is important to increase efficiency and stimulate competition.
- High-output growth and successful fiscal consolidation, including a broadening of the revenue base, are critical to sustaining the external debt position and long-term spending plans.

Corruption, weak administration and reported irregularities in tax collection remain serious impediments to competition. These have contributed to Albania's low rating in Transparency International's 2003 Corruptions Perceptions Index, in which it was rated 92nd out of 133 countries. The large informal economy, generating an estimated 30 to 60 per cent of recorded GDP, is another serious concern for local entrepreneurs and potential foreign investors. Companies operating unfairly outside the formal sector have been able to reduce their costs by evading taxes, custom duties and labour laws.

## Infrastructure

There has been further progress in restructuring the electricity sector and implementing a power sector action plan agreed by the government and donors in 2000. Revenue collection targets under the plan have been met and tariffs were raised at the end of 2003. In July 2004 the power utility Albanian Electric Corporation (KESH) established a Transmission System Operator – an important step towards the separation of generation, distribution and transmission activities. Electricity production has increased by 50 per cent since 2002 as investments in new thermal generation and power loss reduction have been implemented.

A 20-year build-own-operate-transfer concession for reconstruction of the international airport in Tirana was granted to a US-German consortium in June 2004. The investment programme envisages a two-stage expansion of the airport's annual capacity from 600,000 passengers in 2004 to 3 million by about 2010. This venture should help promote the viability of private sector partnerships in infrastructure projects in Albania.

Momentum for reform of water supply and related services is growing, partly as a result of the decentralisation of responsibilities to municipalities. By mid-2004 almost half of the 52 water-supply enterprises had been converted into shareholder companies. A World Bank-brokered private management contract for water services in the district of Durrës is expected to be added to the existing private concession in the district of Elbasan. The reforms aim to increase investment, cut illegal connections, and introduce consumption metering and tariff reform.

## Financial sector

The volume of credit to the private sector continued to grow in the first quarter of 2004 at an annualised rate of about 30 per cent. This marked a further advance in the monetisation of the economy. Following the sale of the Savings Bank – the country's largest bank – to the Raiffeisen Group in the first half of the year, the entire banking sector came under private management. The privatisation of the Savings Bank, which had not previously offered credit to private customers, is expected to lead to increased efficiency in the financial sector and to further growth in credit. The government also plans to sell its interest in the state insurance company INSIG and its remaining minority stakes in two commercial banks. Consequently, the ratio of private credit to GDP, estimated at 7 per cent at the end of 2003, should rise.

## Country data

Population (in millions)	<b>3.2</b>
Area ('000 sq. km)	<b>28.7</b>
Official language	<b>Albanian</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 4,830</b>
National currency	<b>Lek</b>

## Progress in structural reform

### Liberalisation and privatisation

Negotiations on the Stabilisation and Association Agreement with the EU have slowed since January 2003. The focus remains on improving standards of governance, strengthening state institutions and the legal framework, and expanding Albania's international economic cooperation. However, in its annual report on the Stabilisation and Association Process (published in April 2004), the European Commission stressed Albania's limited progress in these areas and called for greater commitment in fighting organised crime, human trafficking, money laundering and corruption.

Large-scale privatisation gained impetus when the Ministry of Economy announced that it would launch international tenders in autumn 2004 for the sale of the fixed-line telecommunications operator Albtelcom and the oil processing and distributing company Albanian Refining and Marketing of Oil (ARMO). The government plans to sell between 51 and 76 per cent of its stake in Albtelcom and at least 51 per cent of its shares in ARMO to strategic investors.

### Business environment and competition

The government's efforts to improve the business environment have included a new competition law introducing EU principles, which was approved in mid-2003, and the establishment of an independent Competition Authority in 2004. Legal reform was boosted by the opening of the Serious Crimes Court at the beginning of 2004, and there has since been a reported improvement in the implementation of court sentencing. In addition, an ongoing review of the existing administrative structure is likely to herald important reform of local government.

## Macroeconomic performance

### Real economy

Growth of GDP recovered to about 6 per cent in 2003, after a temporary slowdown to 4.7 per cent in 2002. The trend appears to have continued in 2004, supported by domestic demand and increasing merchandise exports. Strong growth is based primarily on expansion in the services, construction and transport sectors.

### Economic policies

During 2004 annual inflation has been generally within the Bank of Albania's (BOA) 2 to 4 per cent target range, despite a temporary increase in February. The BOA has continued the policy of gradual monetary easing, which began in 2003. By the end of August it had reduced the repo rate to 5.5 per cent, an historically low level, and three percentage points below the 2002 peak.

In spite of monetary easing, the lek appreciated against both the euro and the US dollar. Efforts to improve revenue collection and broaden the tax base are showing positive results, but tax revenues are still only about 22 per cent of GDP. Progress towards improving the sustainability of public finances has continued. The overall fiscal deficit (excluding grants) declined to 4.5 per cent of GDP in 2003 (from 12.0 per cent in 1998) and is projected at 6.5 per cent in 2004.

### External sector

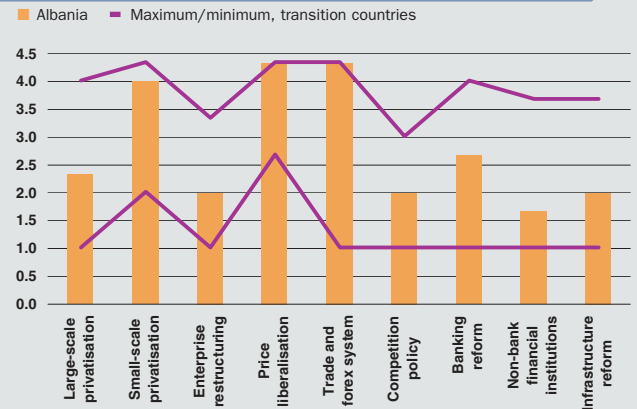
The current account deficit decreased to an estimated 7.6 per cent in 2003. It is expected to stay at a similar level in 2004, supported by exports and private remittances (the latter representing about 12.5 per cent of GDP). In the first quarter of 2004 exports rose reportedly by 26 per cent, appreciably faster than the growth of imports. Foreign reserves, at US\$ 797 million in May 2004, remain at acceptable levels, covering more than four months of imports.

The stock of external debt was US\$ 1.4 billion at the end of 2003, equivalent to about 20 per cent of GDP. It is expected to remain at manageable levels due to improvements in the country's export capacity. Albania has continued to reschedule its external arrears; agreements with creditors from Hungary and FYR Macedonia were ratified by the parliament in March 2004. The fourth review under the Poverty Reduction and Growth Facility (agreed with the IMF in 2002) was completed successfully in July 2004.

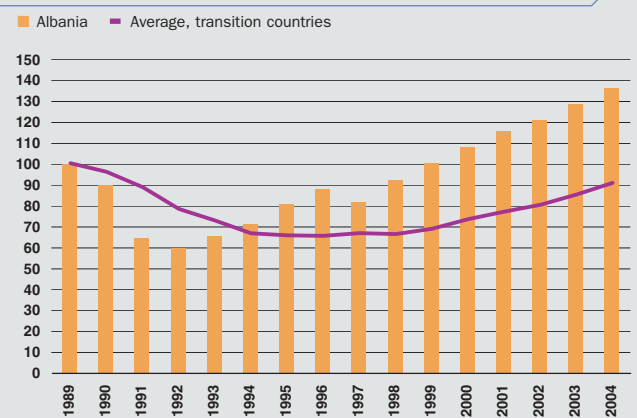
## Outlook and risks

The economy is expected to grow at about 6 per cent in 2004, supported by remittances, private investment and a strengthening of exports. Ongoing measures to improve revenue collection and budget discipline, as well as a broadening of the tax base, should lead to a further lowering of the fiscal deficit and the ratio of debt to GDP (standing at about 57 per cent). However, there are uncertainties relating to political stability, as well as the pace of reforms and the commitment to strengthen administrative capacity, modernise the country's infrastructure and conclude the Stabilisation and Association Agreement with the EU.

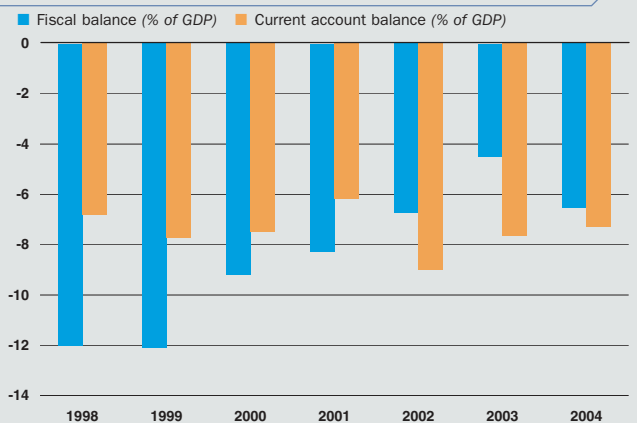
### Transition indicators, 2004



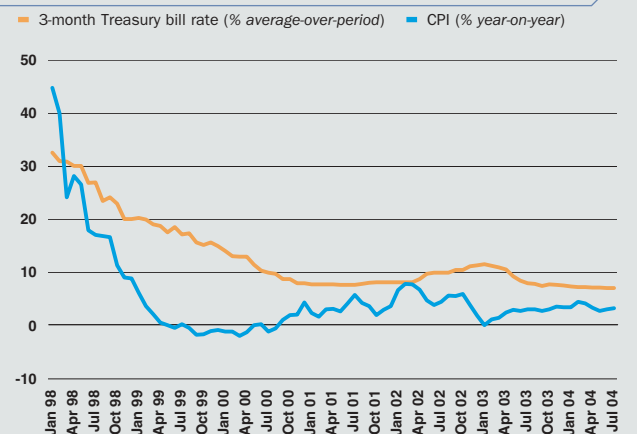
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



<b>Liberalisation</b>	<b>Privatisation</b>	<b>Infrastructure</b>	<b>Social sector</b>
Current account convertibility – full	Primary privatisation method – <b>MEBOs</b>	Independent telecoms regulator – <b>yes</b> <sup>1</sup>	Share of population living in poverty – <b>11.8 per cent</b> <sup>2</sup>
Interest rate liberalisation – full	Secondary privatisation method – <b>vouchers</b>	Separation of railway accounts – <b>no</b>	Private pension funds – <b>yes</b>
Wage regulation – <b>no</b>	Tradability of land – <b>limited de facto</b>	Independent electricity regulator – <b>yes</b> <sup>1</sup>	
<b>Stabilisation</b>	<b>Enterprise and markets</b>	<b>Financial sector</b>	
Share of general government tax revenue in GDP – <b>22.0 per cent</b>	Competition office – <b>yes</b>	Capital adequacy ratio – <b>12 per cent</b>	
Exchange rate regime – <b>managed float</b>		Deposit insurance system – <b>yes</b>	
		Secured transactions law – <b>yes</b>	
		Securities commission – <b>yes</b>	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	95.6	96.3	95.2	91.2	90.6	88.2	na
Share of trade in GDP (in per cent)	37.4	35.3	36.1	38.5	37.6	36.2	na
Tariff revenues (in per cent of imports)	14.3	14.2	14.7	11.7	10.9	12.1	na
<i>EBRD index of price liberalisation</i>	3.7	3.7	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.0	4.0	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	3.6	3.9	7.1	9.2	9.3	9.4	na
Private sector share in GDP (in per cent)	75.0	75.0	75.0	75.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	80.4	81.1	82.2	79.4	79.8	na	na
<i>EBRD index of small-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	2.0	2.0	2.0	2.3	2.3	2.3	2.3
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	0.6	0.4	1.0	1.3	0.9	0.7	na
Share of industry in total employment (in per cent)	7.8	5.8	5.5	6.0	na	na	na
Change in labour productivity in industry (in per cent)	9.0	46.1	9.7	13.0	na	na	na
Investment/GDP (in per cent)	15.9	20.2	23.8	29.5	26.2	25.3	na
<i>EBRD index of enterprise reform</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>EBRD index of competition policy</i>	1.7	1.7	1.7	1.7	1.7	1.7	2.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	3.1 (0.2)	3.7 (0.3)	3.9 (0.8)	6.4 (12.7)	7.1 (27.6)	8.3 (35.8)	na
Internet penetration rate (per 10,000 inhabitants)	0.4	0.6	0.6	0.6	0.6	0.8	na
Railway labour productivity (1989=100)	28.5	32.1	34.9	38.3	39.8	39.4	na
Residential electricity tariffs, USc kWh	na	na	3.3	3.4	4.2	5.1	na
Average collection rate, electricity (in per cent)	70	58	60	76	93	92	na
GDP per unit of energy use (PPP in US dollars per kgoe)	8.2	5.8	6.1	6.4	na	na	na
<i>EBRD index of infrastructure reform</i>	1.3	1.3	2.0	2.0	2.0	2.0	2.0
<i>Electric power</i>	2.0	2.0	2.3	2.3	2.3	2.3	2.7
<i>Railways</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Roads</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Telecommunications</i>	1.0	1.0	3.3	3.3	3.3	3.3	3.3
<i>Water and waste water</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	10 (8)	13 (11)	13 (12)	13 (12)	13 (12)	15 (13)	na
Asset share of state-owned banks (in per cent)	85.6	81.1	64.8	59.2	54.1	51.9	na
Non-performing loans (in per cent of total loans)	35.4	32.7	42.6	6.9	5.6	4.6	na
Domestic credit to private sector (in per cent of GDP)	0.6	2.2	3.0	3.8	4.7	5.1	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na
<i>EBRD index of banking sector reform</i>	2.0	2.0	2.3	2.3	2.3	2.3	2.7
<i>EBRD index of reform of non-bank financial institutions</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	5.2	6.1	5.6	5.2	4.8	5.0	na
Life expectancy at birth, total (years)	na	74.0	74.0	74.0	74.0	na	na
Basic school enrolment ratio (in per cent)	92.6	89.8	105.5	103.1	na	na	na

<sup>1</sup> Although independent telecoms and electricity regulators are in place, many regulatory functions are still carried out by the government.

<sup>2</sup> Data on share of population living in poverty came from 2002.



	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>							
	<i>(Percentage change in real terms)</i>						
GDP	12.7	10.1	7.3	7.6	4.7	6.0	6.2
Private consumption	7.0	2.7	5.3	na	na	na	na
Public consumption	4.7	15.9	7.4	na	na	na	na
Gross fixed capital formation <sup>1</sup>	11.5	14.9	17.9	na	na	na	na
Exports of goods and services	-3.5	47.0	5.8	na	na	na	na
Imports of goods and services	9.3	11.3	6.5	na	na	na	na
Industrial gross output	4.1	6.4	5.0	6.5	1.8	2.7	na
Agricultural gross output	5.0	3.7	4.5	1.4	2.1	3.0	na
<b>Employment<sup>2</sup></b>							
	<i>(Percentage change)</i>						
Labour force (end-year)	1.5	-1.1	-1.8	-2.7	-12.3	-0.2	na
Employment (end-year)	-2.0	-1.8	0.3	-13.8	-0.1	0.9	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	17.8	18.4	16.8	14.5	15.7	15.0	na
<b>Prices and wages</b>							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	20.6	0.4	0.1	3.1	5.2	2.4	3.4
Consumer prices (end-year)	8.7	-1.0	4.2	3.5	1.7	3.3	3.4
Producer prices (annual average)	na	na	na	na	na	na	na
Producer prices (end-year)	na	na	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	26.1	-0.3	14.3	13.0	28.1	na	na
<b>Government sector</b>							
	<i>(In per cent of GDP)</i>						
General government balance	-12.0	-12.2	-9.2	-8.2	-6.7	-4.5	-6.5
General government expenditure	34.5	34.9	31.9	30.4	28.9	26.5	na
General government debt	75.9	72.7	71.3	64.4	60.6	56.8	na
<b>Monetary sector<sup>3</sup></b>							
	<i>(Percentage change)</i>						
Broad money (M2, end-year)	22.8	20.3	10.4	15.4	5.3	9.2	na
Domestic credit (end-year)	20.2	9.8	8.6	4.1	6.7	11.0	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	48.3	50.5	49.8	50.0	47.5	47.1	na
<b>Interest and exchange rates</b>							
	<i>(In per cent per annum, end-year)</i>						
Refinancing rate <sup>4</sup>	22.9	17.8	10.8	7.0	8.5	6.5	na
Treasury bill rate (3-month maturity)	27.5	17.5	10.8	8.0	11.2	7.4	na
Deposit rate (1 year)	16.5	9.1	7.7	7.7	9.3	7.6	na
Lending rate (1 year) <sup>5</sup>	25.0	25.8	23.7	11.9	16.0	10.5	na
	<i>(Leks per US dollar)</i>						
Exchange rate (end-year)	141.4	135.2	142.8	135.9	134.0	106.4	na
Exchange rate (annual average)	151.2	138.1	143.9	143.6	140.2	121.3	na
<b>External sector</b>							
	<i>(In millions of US dollars)</i>						
Current account	-186	-265	-276	-262	-435	-470	-592
Trade balance	-604	-663	-824	-1,027	-1,155	-1,336	-1,601
Merchandise exports	208	275	255	305	330	447	567
Merchandise imports	812	938	1,076	1,332	1,485	1,783	2,168
Foreign direct investment, net	45	51	143	204	135	178	377
Gross reserves, excluding gold (end-year)	384	485	608	737	860	1,026	na
External debt stock	1,007	1,108	1,173	1,198	1,178	1,420	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	4.9	5.3	4.8	4.9	5.0	4.8	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	6.2	3.9	4.0	4.1	6.4	4.7	na
<b>Memorandum items</b>							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	3.1	3.1	3.1	3.1	3.2	3.2	na
GDP (in billions of leks)	412	474	531	610	678	746	837
GDP per capita (in US dollar)	879	1,108	1,185	1,357	1,512	1,942	na
Share of industry in GDP (in per cent)	11.9	11.9	11.5	11.7	11.4	na	na
Share of agriculture in GDP (in per cent)	54.4	52.6	51.0	49.0	48.1	na	na
Current account/GDP (in per cent)	-6.8	-7.7	-7.4	-6.2	-9.0	-7.6	-7.3
External debt - reserves (in US\$ million)	623	624	565	461	318	394	na
External debt/GDP (in per cent)	36.9	32.3	31.8	28.2	24.4	23.1	na
External debt/exports of goods (in per cent)	341.8	204.6	166.2	142.7	128.7	121.7	na

<sup>1</sup> Includes changes in inventories. Disaggregated data on gross fixed capital formation are not available.

<sup>2</sup> Figures do not include emigrant workers abroad who accounted for an estimated 27.4 per cent of the total labour force in 2000.

<sup>3</sup> Data up to and including 2001 are based on the previous reporting standard. The new reporting standard, in accordance with the 2000 Monetary and Financial Statistics Manual, excludes blocked deposits from broad money (ALL 10.7 billion at end-2002).

<sup>4</sup> From 2001 the figures show the repo rate of the Central Bank.

<sup>5</sup> The figures show the weighted average monthly rate for new credit in leks for maturities between 6 months and 1 year in December each year.

# Armenia

## Key challenges

Improvements to the regulatory system, including further simplification and greater transparency, would help to develop the business environment and attract additional foreign investment.

While confidence in the banking sector has been enhanced, the provision of more financial resources to the real sector will depend on strengthening accounting standards and on the enforcement of collateral security.

Although the outlook for further economic growth is positive, weak public finances and the large external imbalances remain serious concerns.

OTE took this case to the International Arbitration Court (IAC) in London in December 2003. Before the IAC could reach a decision, however, the government suspended the decree and agreed to try to negotiate a solution with OTE by the end of September 2004.

The stabilisation of energy supplies has been a major policy issue for Armenia. The privatisation of the power distribution network has yielded some positive results. Revenue collection rates have increased substantially in the household and industrial sectors, resulting in a significant reduction in operational losses.

With regard to power generation, UES has taken control of the Hrazdan thermal power station (with the exception of the fifth block) and has also taken over financial management of the Medzamor nuclear power plant. However, the electricity supplied by the Medzamor power station, which generates about 40 per cent of the country's electricity, is expected to decline over the next few years. The plant may be closed in the medium term. The government is therefore aiming to identify and establish new sources of energy supplies, including the development of small and medium-sized hydro-power stations.

## Financial sector

The Central Bank of Armenia (CBA) continues to strengthen banking regulation and encourage consolidation. Through these measures, the CBA aims to improve public confidence in the banking sector. Consolidation has been promoted by raising the minimum capital requirements to US\$ 2 million from July 2003 (and to US\$ 5 million by 2005). As a result, during 2003 one bank was liquidated while two were merged, leaving 20 commercial banks in operation (of which, one is under temporary administration). In addition, the CBA is establishing a deposit insurance scheme which will become operational in July 2005.

During the first half of 2004 there was a further increase in the growth of domestic credit, partly due to the development of mortgage lending. However, interest rates remain high and loan maturities are relatively short, partly reflecting the difficulties for lenders to realise collateral security.

## Social sector

A Poverty Reduction Strategy Paper (PRSP) was approved by the government in 2003. Owing to continued strong economic growth and the implementation of the PRSP policies, many of the poverty and inequality indicators have improved. Household incomes have continued to increase due to rising foreign remittances and higher wage levels. However, the improvements are uneven across the different regions of the country. The proportion of the population living below the poverty line in urban areas is higher than the national average of 50 per cent. Wages in the public sector are almost half of those in the private sector.

## Country data

Population (in millions)	3.1
Area ('000 sq. km)	29.8
Official language	Armenian
GDP per capita in 2002 at current international US\$ (PPP)	US\$ 3,120
National currency	Dram

## Progress in structural reform

### Business environment and competition

Foreign direct investment (FDI) increased during the first half of 2004, amounting to US\$ 61 million. This was more than double the inflow recorded in the same period in 2003. Higher investment in the food industry and in the communications, transport and construction sectors accounted for most of the increase. A large proportion of the FDI inflows came from investors registered in Russia, Greece, France and the United States.

The increase occurred despite a slowing in the pace of privatisation. The majority of commercially viable state-owned enterprises have already been sold – by July 2004, 7,226 small enterprises and 1,894 medium and large-scale enterprises had been privatised. However, despite the improvements in the business environment in recent years, investors continue to be concerned about the lack of transparency in the regulatory system and the cumbersome administrative procedures.

### Infrastructure

The telecommunications sector (fixed-line, mobile and Internet services) has operated as a monopoly since the privatisation of Armentel in 1997 to the Greek operator OTE. However, the government claims that the quality of the service provided has not improved as expected and that OTE has not delivered the investment commitments made when it purchased a 90 per cent share of Armentel. The government subsequently issued a decree to liberalise the mobile and Internet markets, amending the licence which guaranteed that the sector would be operated as a monopoly.

## Macroeconomic performance

### Real economy

After two consecutive years of exceptionally strong growth, real GDP slowed slightly in the first half of 2004 to 9.2 per cent. Growth in 2003 was led by construction and manufacturing (particularly diamond processing). In 2004 it has reflected strong output from other industries, as well as the construction and agricultural sectors. Although financing from some large diaspora funds has now ended, foreign remittances have continued to flow from other sources, supporting household consumption. These factors have offset the impact on the economy of the disruption of raw diamond supplies from Russia.

### Economic policies

Fiscal policy remained prudent in 2003 and the first half of 2004. After a consolidated fiscal deficit of 1.1 per cent of GDP in 2003 (less than half the official target), there was a fiscal surplus of 1 per cent of GDP at the end of June 2004. However, in 2003 tax revenues as a share of GDP declined to 14.1 per cent, slightly below the budget target of 15 per cent. In order to increase tax revenues, the government has set a minimum corporate tax rate of 1 per cent of companies' turnover. Major enterprises, some of which are believed to have been reporting losses for tax purposes, will now need to pay tax on their turnover even if they continue to report losses.

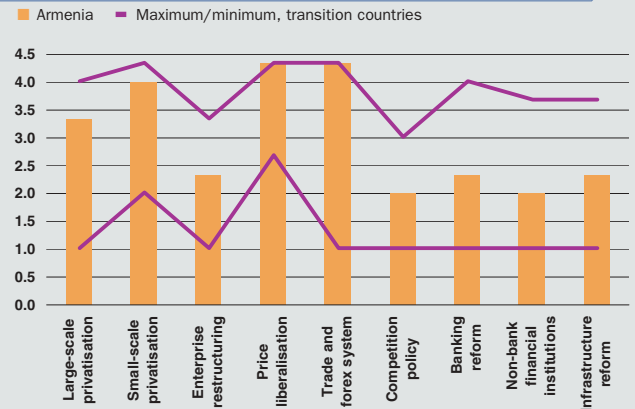
### External sector

Exports continued to grow during the first half of 2004. However, they were affected by the appreciation of the dram during this period (both in nominal and real terms against the euro and US dollar) and by the temporary disruption of the country's main trade route through Georgia. As a result, the trade deficit deteriorated from 15 per cent of GDP in 2003 to over 20 per cent during the first half of 2004. The trade deficit has been partly offset by increased private transfers, but the current account deficit is expected to remain at a high level during 2004. External debt increased slightly to over US\$ 1.1 billion by the end of 2003, but strong economic growth ensured that the ratio of external debt to GDP declined to below 40 per cent.

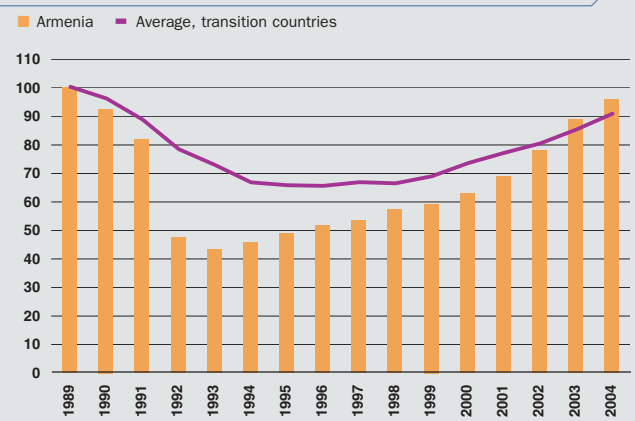
## Outlook and risks

Growth is expected to continue in the medium term, perhaps at a slower but more sustainable pace. In the future, growth will be dependent on factors such as the improvement in the business environment and restructuring of the enterprise sector. It will also depend on external factors such as relations with neighbouring countries and the availability of cheap raw diamonds. Armenia is expected to recover the 1989 real-term GDP level in 2005. The main risks are associated with the government's willingness to implement reform and the phasing out of some of the sources of soft financing.

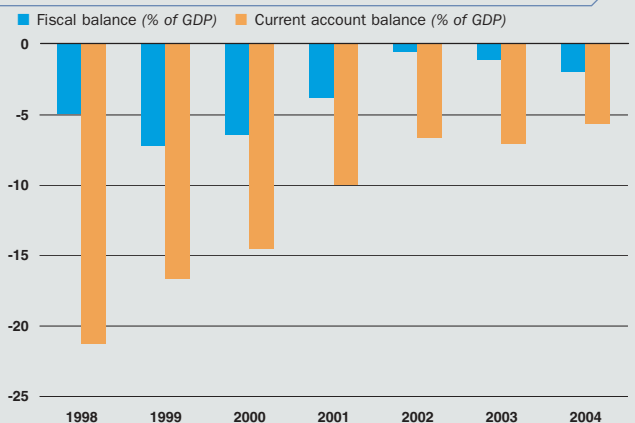
### Transition indicators, 2004



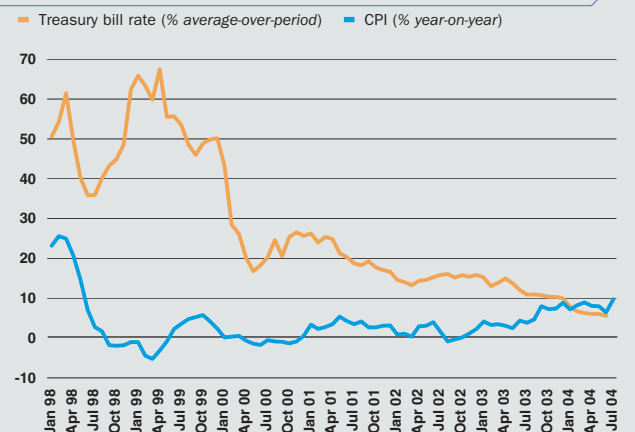
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes	Share of population living in poverty –
Interest rate liberalisation – full	direct sales	Separation of railway accounts – no	49 per cent (1998)
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – no
	MEBOs		
Stabilisation	Tradability of land – full except	Financial sector	
Share of general government tax	foreigners	Capital adequacy ratio – 12 per cent	
revenue in GDP – 14.1 per cent		Deposit insurance system – yes	
Exchange rate regime – floating	Enterprise and markets	Secured transactions law – yes	
	Competition office – yes	Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	8.5	10.6	6.3	6.3	8.1	8.7	8.0
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	60.0	62.0	78.4	79.8	76.4	77.0	na
Share of trade in GDP (in per cent)	54.7	52.5	56.7	52.6	58.4	63.8	na
Tariff revenues (in per cent of imports)	2.8	2.1	2.1	2.3	na	na	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.0	4.0	4.0	4.0	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	5.6	6.7	8.8	9.4	9.7	na	na
Private sector share in GDP (in per cent)	60.0	60.0	60.0	60.0	70.0	70.0	75.0
Private sector share in employment (in per cent)	68.5	71.7	72.9	na	76.9	75.0	na
EBRD index of small-scale privatisation	3.3	3.3	3.3	3.7	3.7	3.7	4.0
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.3	3.3	3.3
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	0.1	1.4	0.8	0.6	0.6	0.9	na
Share of industry in total employment (in per cent)	15.7	15.0	14.4	13.4	13.3	na	na
Change in labour productivity in industry (in per cent)	6.6	12.9	13.2	6.5	13.9	na	na
Investment/GDP (in per cent)	19.1	18.4	18.6	19.8	21.7	24.7	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.3	2.3	2.3
EBRD index of competition policy	1.0	1.0	1.0	2.0	2.0	2.0	2.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	15.7 (0.2)	15.5 (0.2)	15.2 (0.5)	14.0 (0.7)	14.3 (1.9)	14.8 (3.0)	na
Internet penetration rate (per 10,000 inhabitants)	2.5	6.1	7.0	6.2	7.5	5.5	na
Railway labour productivity (1989=100)	20.1	16.2	15.2	17.2	20.6	23.5	na
Residential electricity tariffs, USc kWh	3.8	4.7	4.6	4.4	4.3	4.4	na
Average collection rate, electricity (in per cent)	87	88	80	87	98	95	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.3	3.5	3.0	3.3	na	na	na
EBRD index of infrastructure reform	2.0	2.3	2.3	2.3	2.3	2.3	2.3
Electric power	2.3	3.3	3.3	3.3	3.3	3.3	3.3
Railways	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Water and waste water	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	31 (10)	32 (11)	31 (11)	30 (14)	20 (8)	19 (8)	na
Asset share of state-owned banks (in per cent)	5.7	3.5	3.8	0.0	0.0	0.0	na
Non-performing loans (in per cent of total loans)	10.4	4.7	7.2	6.8	4.9	4.9	na
Domestic credit to private sector (in per cent of GDP)	5.3	5.8	7.1	6.0	4.8	5.8	na
Stock market capitalisation (in per cent of GDP)	1.0	1.3	1.3	1.2	1.0	1.0	na
EBRD index of banking sector reform	2.3	2.3	2.3	2.3	2.3	2.3	2.3
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	4.5	3.7	3.7	3.8	3.4	3.5	na
Life expectancy at birth, total (years)	74.4	73.0	73.6	74.2	74.8	na	na
Basic school enrolment ratio (in per cent)	82.6	80.3	79.5	79.1	88.4	na	na

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>							
	<i>(Percentage change in real terms)</i>						
GDP	7.3	3.3	6.0	9.6	13.2	13.9	8.0
Private consumption	5.3	1.4	5.9	15.2	5.8	8.5	na
Public consumption	-2.2	1.3	-0.3	3.3	-3.2	17.6	na
Gross fixed capital formation	12.0	0.6	8.7	24.8	19.9	31.7	na
Exports of goods and services	8.9	6.5	16.6	20.8	25.0	24.7	na
Imports of goods and services	5.0	-8.1	5.1	1.2	9.4	22.8	na
Industrial gross output	-2.5	5.2	6.4	3.8	14.2	14.9	na
Agricultural gross output	13.1	1.3	-2.3	11.6	4.4	4.3	na
<b>Employment</b>							
	<i>(Percentage change)</i>						
Labour force (end-year)	-4.0	-0.9	-1.0	-2.5	0.3	0.3	na
Employment (end-year)	-2.5	-2.9	-1.6	-1.0	1.4	0.5	na
	<i>(In per cent of labour force)</i>						
Unemployment (annual average) <sup>1</sup>	9.4	11.2	10.6	9.8	10.8	10.1	na
<b>Prices and wages</b>							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	8.7	0.7	-0.8	3.2	1.2	4.7	7.8
Consumer prices (end-year)	-1.3	2.1	0.4	3.0	2.0	8.6	4.7
Producer prices (annual average)	13.4	2.3	0.8	-0.4	2.5	2.9	na
Producer prices (end-year)	8.2	3.8	0.4	-4.3	0.9	21.1	na
Gross average monthly earnings in economy (annual average)	31.0	19.2	22.5	24.6	13.0	11.0	na
<b>Government sector<sup>2</sup></b>							
	<i>(In per cent of GDP)</i>						
General government balance	-4.9	-7.2	-6.4	-3.8	-0.5	-1.1	-1.9
General government expenditure	25.6	30.1	25.9	20.9	19.3	18.9	na
General government debt	41.6	46.3	44.0	41.8	43.2	38.0	na
<b>Monetary sector</b>							
	<i>(Percentage change)</i>						
Broad money (M2, end-year)	36.0	13.6	25.8	15.8	33.9	10.6	na
Domestic credit (end-year)	60.8	3.7	12.3	-9.8	-8.1	-9.6	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	10.0	11.0	13.2	13.5	15.6	14.4	na
<b>Interest and exchange rates</b>							
	<i>(In per cent per annum, end-year)</i>						
Refinancing rate	39.0	43.0	25.0	15.0	13.5	7.0	na
Money market rate <sup>3</sup>	27.8	23.7	18.6	19.4	12.3	7.5	na
Deposit rate <sup>4</sup>	24.9	27.4	18.1	14.9	9.5	6.9	na
Lending rate <sup>4</sup>	48.1	34.5	28.6	27.7	23.4	20.8	na
	<i>(Drams per US dollar)</i>						
Exchange rate (end-year)	522.0	523.8	552.2	561.8	584.9	566.0	na
Exchange rate (annual average)	504.9	535.1	539.5	555.1	573.4	578.8	na
<b>External sector</b>							
	<i>(In millions of US dollars)</i>						
Current account	-403	-307	-278	-211	-157	-198	-185
Trade balance	-577	-474	-464	-431	-378	-434	-434
Merchandise exports	229	247	310	342	505	678	771
Merchandise imports	806	721	773	773	883	1,112	1,205
Foreign direct investment, net	221	122	104	70	111	136	98
Gross reserves, excluding gold (end-year)	298	305	314	329	439	451	na
External debt stock	787	855	862	906	1,026	1,065	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	3.6	4.0	3.9	4.0	4.8	3.9	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	19.0	14.3	10.7	9.7	10.2	11.6	na
<b>Memorandum items</b>							
	<i>(Denominations as indicated)</i>						
Population (end-year, million) <sup>5</sup>	3.1	3.1	3.1	3.1	3.0	3.1	na
GDP (in billions of drams)	955	987	1,031	1,176	1,362	1,623	1,806
GDP per capita (in US dollar)	605	590	614	679	792	896	na
Share of industry in GDP (in per cent)	19.9	21.2	21.9	20.1	20.4	21.5	na
Share of agriculture in GDP (in per cent)	30.8	27.0	23.2	25.5	23.6	21.5	na
Current account/GDP (in per cent)	-21.3	-16.6	-14.5	-10.0	-6.6	-7.1	-5.6
External debt - reserves (in US\$ million)	489	550	548	577	587	614	na
External debt/GDP (in per cent)	41.6	46.3	45.1	42.8	43.2	38.0	na
External debt/exports of goods and services (in per cent)	218.6	223.2	192.9	171.3	148.9	120.5	na

<sup>1</sup> Registered unemployed. Unofficial estimates indicate substantially higher unemployment.<sup>2</sup> Consolidated accounts of the Republican government and the local authorities.<sup>3</sup> Average of one to three-month Treasury bills.<sup>4</sup> Weighted average rate for maturities of 15 days to less than one year.<sup>5</sup> Official figures. Estimates before the 2001 census are known not to reflect fully net emigration.



# Azerbaijan

## Key challenges

Further strengthening and consolidation of the financial sector, including the privatisation of the dominant International Bank of Azerbaijan, is vital for effectively channelling resource revenues to the economy.

Sustained restructuring of the State Oil Company and faster privatisation and reform in the energy sector are important for improving efficiency and productivity and enhancing long-term growth potential.

Prudent and effective use of growing energy resources through transparent operation of the State Oil Fund can contribute to economic diversification, macroeconomic sustainability and poverty reduction.

Although presidential decrees issued in early 2003 called for the reform of the State Oil Company (SOCAR), restructuring and increasing its transparency remain key challenges. Some positive steps have been taken to increase the transparency of resource revenues. Azerbaijan is a pilot country under the Extractive Industry Transparency Initiative (EITI) supported by the G-8 group of industrialised countries. A Commission was established in December 2003 to develop reporting requirements under the initiative.

## Infrastructure

Reform in the energy sector, which dominates Azerbaijan's economy, is slow. Domestic prices of natural gas, oil and oil products were unified with the World Bank's projections of medium-term world oil prices of US\$ 20 per barrel in 2003. However, the design and approval of a mechanism that would automatically align domestic prices of oil and natural gas with current world prices has been delayed.

Cash collection ratios in the energy sector remain low at about 40 to 45 per cent. This is despite the fact that all four main regional energy distribution companies have been operated under concessions for a number of years.

Construction of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline began in early 2003 and by August 2004 approximately 75 per cent of the construction work had been completed. Construction of the South Caucasus Gas pipeline (SCG) is expected to start soon. Oil and gas revenues will increase substantially once the two pipelines are completed – the BTC pipeline is expected to be completed in 2005 and the SCG line in 2006.

## Financial sector

There have been further delays in the privatisation of the International Bank of Azerbaijan (IBA), mainly because of the many differing interests involved. The IBA accounts for about 60 per cent of total bank assets and its privatisation is essential for the development of the banking sector.

A new banking law was enacted in March 2004 and is in line with Basel principles regarding, among other things, capital adequacy regulations and the introduction of international accounting standards. However, the presidential decree that enacted the law also affected the independence of the Central Bank. It removed the Bank's authority over issues such as bank recapitalisation and closure, and gave the ultimate decision-making powers to the President's office. A new Central Bank law that is likely to address this issue is under discussion.

Some positive steps have been taken to strengthen the capital base and consolidate the financial sector. In September 2003 the EBRD acquired a 20 per cent stake in Unibank, which was established from the merger of two banks. In April 2004 the Central Bank announced that minimum capital requirements would increase from US\$ 2.5 million to US\$ 3.5 million by the end of 2004 and to US\$ 5 million by the end of 2005. The non-binding ceiling on the share of foreign banks' capital to 50 per cent of the domestic market has been abolished as part of the new banking law.

## Country data

Population (in millions)	<b>8.3</b>
Area ('000 sq. km)	<b>86.6</b>
Official language	<b>Azeri</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 3,210</b>
National currency	<b>Manat</b>

## Progress in structural reform

### Liberalisation and privatisation

Progress with large-scale privatisation remains slow. However, entities in the telecommunications and transport sectors are being prepared for commercialisation prior to their eventual privatisation. In January 2004 the state sold 49 per cent of the joint-stock mobile communications operator Bakcell to GTIB Motorola of Israel, which owned the balance of the shares.

The privatisation tenders of the two major fixed-line companies – Bakutelecom and Aztelecom – that operate inside and outside Baku respectively are planned to be announced during 2004. This development is part of the new policy for the communications sector, developed with support from the World Bank. The main railway and shipping companies will also be transformed into joint-stock companies in advance of planned privatisation.

### Business environment and competition

The government recognises that improving the investment climate is essential for sustained economic growth. Corruption remains a significant deterrent to investment. In January 2004 the parliament approved an anti-corruption law, which is scheduled to come into effect on 1 January 2005. This law defines corruption and assigns responsibilities to government bodies for tackling it. The current state programme on fighting corruption for the period 2004-06 was amended to conform to the new law. This followed a consultation process with international organisations and NGOs. The amendments were approved by the President in September 2004.

## Macroeconomic performance

### Real economy

GDP rose by 10.6 per cent in the first half of 2004, boosted by high oil prices and investment growth of 63 per cent (mainly energy related). The economy remains dependent on the oil and gas sectors (accounting for about 28 per cent of GDP in 2003). The government has completed a long-term strategy for the management of oil revenues and has submitted it to the President.

To help reduce poverty and promote economic diversification, the government has recently adopted a Regional Social Economic Development Programme for 2004-08. This emphasises the need to improve the investment climate, increase investment in infrastructure, develop the financial sector and expand trade.

### Economic policies

The state budget recorded a surplus of 1.6 per cent of GDP during the first four months of 2004. This reflected an increase in tax revenues resulting from the high oil price. As a result, in June the government amended the 2004 budget, increasing expenditure on investment, wages and pensions. The amendments took place despite the government having established a Stabilisation Fund last year. The Fund is intended to save windfall revenues resulting from above-budget oil prices, and operates independently of the State Oil Fund. Inflation, as measured by the CPI, rose to 6 per cent in July 2004 from 2.1 per cent at the end of 2003. This was due to higher capital flows, a subsequent growth of the money supply and a temporary increase in food prices.

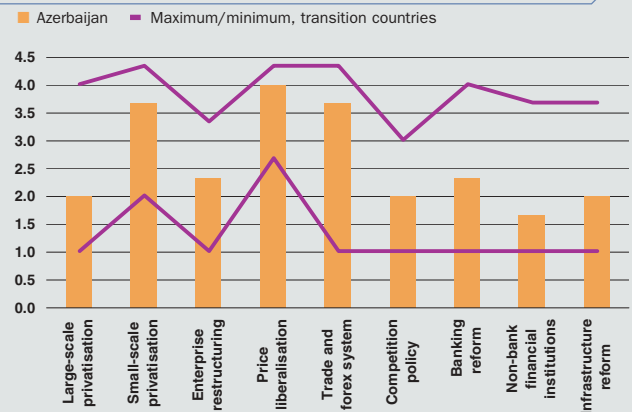
### External sector

High oil prices contributed to an increase in the value of exports by 34 per cent year-on-year at the end of June 2004. Imports also increased, mainly of capital goods related to oil and gas sector development. This resulted in a sharp deterioration in the trade balance to 2.7 per cent of GDP from 1.9 per cent a year earlier. With the development of oil and gas projects, related foreign direct investment (FDI) flows amounted to US\$ 2.2 billion in the first half of 2004. This represents an increase of more than 40 per cent on the same period in 2003. The large capital flows and weakening US dollar have continued to slow the pace of the nominal depreciation of the manat against the US dollar, which is targeted by monetary authorities. The increase in inflation also prevented a real depreciation of the currency during the first half of 2004.

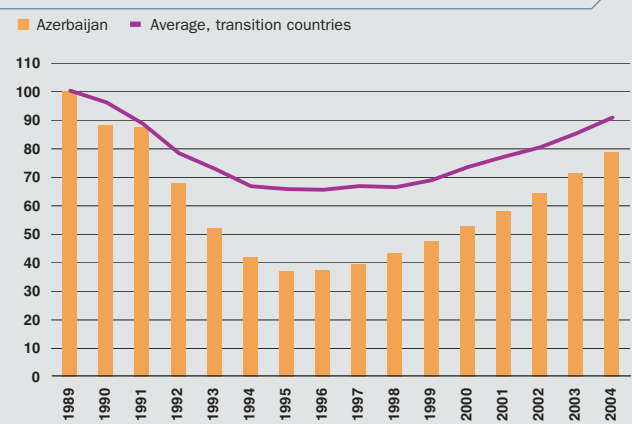
## Outlook and risks

GDP growth is expected to remain at about 10 per cent in 2004. It will be underpinned by capital investments and construction activities linked to the continued development of oil and gas fields, especially while oil prices remain high. The increase in the value of hydrocarbon-related imports will outweigh the increase in export revenues, resulting in a current account deficit in the short term. This in turn should be fully covered by related FDI inflows. However, the high dependence of the economy on the oil and gas sectors continues to be a major risk to sustained growth over the longer term.

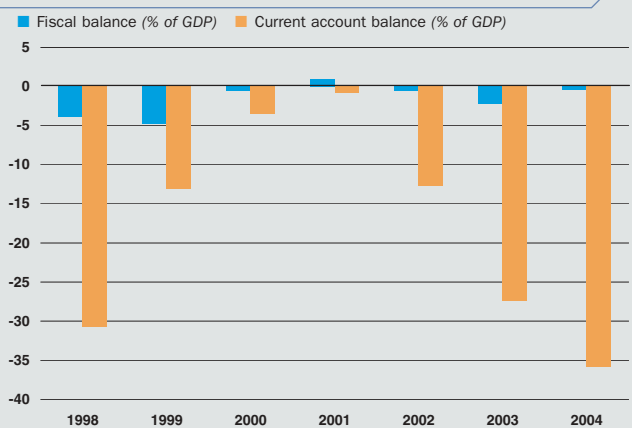
### Transition indicators, 2004



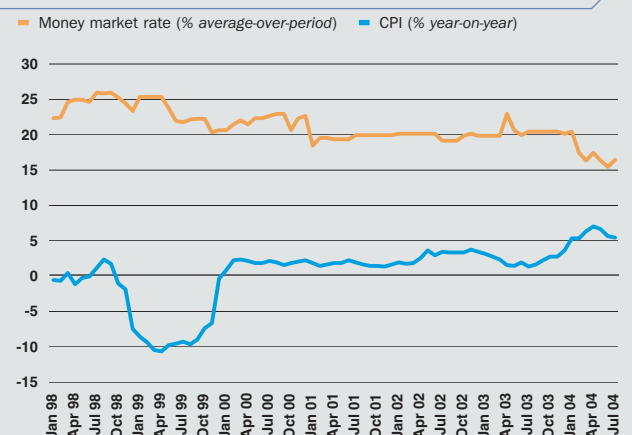
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – no	Share of population living in poverty –
Interest rate liberalisation – full	cash auctions	Separation of railway accounts – no	9.1 per cent (2001) <sup>1</sup>
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – no	Private pension funds – no
	vouchers		
Stabilisation	Tradability of land – limited de jure	Financial sector	
Share of general government tax revenue in GDP – 22 per cent		Capital adequacy ratio – 12 per cent	
Exchange rate regime – managed float	<b>Enterprise and markets</b>	Deposit insurance system – no	
	Competition office – yes	Secured transactions law – restricted	
		Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	6.0	6.0	6.0	6.0	6.0	6.0	7.0
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Share of trade with non-transition countries (in per cent)	43.7	59.2	78.2	79.3	75.0	70.0	na
Share of trade in GDP (in per cent)	54.0	53.7	63.3	61.5	67.8	74.9	80.6
Tariff revenues (in per cent of imports)	5.8	7.3	8.8	12.5	9.1	7.6	6.7
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	3.0	3.3	3.3	3.3	3.7	3.7	3.7
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	0.9	1.5	1.7	2.0	2.4	2.4	2.4
Private sector share in GDP (in per cent)	45.0	45.0	45.0	60.0	60.0	60.0	60.0
Private sector share in employment (in per cent)	57.9	63.7	na	na	na	na	na
EBRD index of small-scale privatisation	3.3	3.3	3.3	3.3	3.7	3.7	3.7
EBRD index of large-scale privatisation	2.0	1.7	1.7	2.0	2.0	2.0	2.0
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	10.4	7.1	6.9	6.6	6.8	6.6	7.0
Share of industry in total employment (in per cent)	6.8	7.0	6.7	6.6	6.8	na	na
Change in labour productivity in industry (in per cent)	-1.5	0.3	10.6	6.5	1.5	na	na
Investment/GDP (in per cent)	33.4	26.5	20.6	17.1	32.8	na	na
EBRD index of enterprise reform	1.7	1.7	2.0	2.0	2.0	2.3	2.3
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	8.9 (0.9)	9.5 (4.8)	10.4 (5.6)	10.8 (9.1)	11.4 (10.7)	11.8 (13.9)	na
Internet penetration rate (per 10,000 inhabitants)	0.5	0.8	1.9	1.6	1.4	0.7	na
Railway labour productivity (1989=100)	16.4	17.5	23.7	25.4	29.4	31.9	na
Residential electricity tariffs, USc kWh	2.5	2.3	2.1	2.1	2.0	2.0 (na)	na
Average collection rate, electricity (in per cent)	na	na	15	30	45	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.3	1.3	1.6	1.7	na	na	na
EBRD index of infrastructure reform	1.3	1.3	1.7	1.7	2.0	2.0	2.0
Electric power	2.0	2.0	2.0	2.0	2.3	2.3	2.3
Railways	2.0	2.0	2.3	2.3	2.3	2.3	2.3
Roads	1.0	1.0	2.3	2.3	2.3	2.3	2.3
Telecommunications	1.0	1.0	1.0	1.0	1.0	1.0	1.7
Water and waste water	1.7	2.0	2.0	2.0	2.0	2.0	2.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	79 (4)	70 (5)	59 (5)	53 (5)	46 (4)	46 (4)	na
Asset share of state-owned banks (in per cent)	65.5	82.5	60.4	na	62.0	55.3	na
Non-performing loans (in per cent of total loans)	19.6	37.2	na	na	19.7	14.6	na
Domestic credit to private sector (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	0.0	na	0.1	0.1	na	na	na
EBRD index of banking sector reform	2.0	2.0	2.0	2.3	2.3	2.3	2.3
EBRD index of reform of non-bank financial institutions	1.7	1.7	1.7	1.7	1.7	1.7	1.7
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	4.2	5.2	4.7	4.3	4.6	4.5	5.1
Life expectancy at birth, total (years)	na	na	65.2	65.2	65.2	na	na
Basic school enrolment ratio (in per cent)	86.7	86.1	90.6	91.4	90.4	na	na

<sup>1</sup> The State Statistics Committee reports 49 per cent of the population were living in poverty in 2001. Poverty is defined by the national authorities as households with a budget of less than AZM 120,000 (US\$ 25) per month.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>							
	<i>(Percentage change in real terms)</i>						
GDP	10.0	9.5	11.1	9.9	10.6	11.2	10.0
Private consumption	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na
Industrial gross output <sup>1</sup>	2.2	3.5	6.8	5.2	3.6	6.1	na
Agricultural gross output	6.2	7.0	12.1	11.1	6.4	na	na
<b>Employment</b>							
	<i>(Percentage change)</i>						
Labour force (end-year)	0.3	0.1	0.0	0.4	0.4	0.6	na
Employment (end-year)	0.2	0.1	-0.1	0.3	0.3	0.5	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	1.1	1.1	1.1	1.3	1.3	1.4	na
<b>Prices and wages</b>							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	-0.8	-8.5	1.8	1.5	2.8	2.2	5.2
Consumer prices (end-year)	-7.6	-0.5	2.2	1.5	3.3	3.5	3.6
Producer prices (annual average)	0.0	-6.1	27.4	na	na	na	na
Producer prices (end-year)	-21.5	17.9	14.5	-4.4	-5.2	11.2	na
Gross average monthly earnings in economy (annual average)	18.9	9.5	20.2	17.3	21.2	21.5	na
<b>Government sector</b>							
	<i>(In per cent of GDP)</i>						
General government balance <sup>2</sup>	-3.9	-4.7	-0.6	0.9	-0.5	-2.3	-0.4
General government expenditure	23.7	23.6	20.8	20.3	28.3	30.0	na
General government debt	14.9	24.2	25.7	25.5	23.5	24.5	na
<b>Monetary sector</b>							
	<i>(Percentage change)</i>						
Broad money (M2, end-year)	-13.3	8.7	27.1	31.8	14.7	30.8	na
Domestic credit (end-year)	8.8	-10.4	13.5	-38.1	84.2	27.1	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	11.0	10.9	11.0	12.9	13.3	14.7	na
<b>Interest and exchange rates</b>							
	<i>(In per cent per annum, end-year)</i>						
Refinance rate (6 months)	14.0	10.0	10.0	10.0	7.0	7.0	na
Interbank interest rate (3 months) <sup>3</sup>	23.2	20.5	22.5	19.8	19.7	20.3	na
Deposit rate	10.9	11.4	12.0	9.0	9.0	9.2	na
Lending rate	27.7	17.9	18.8	19.2	18.0	17.0	na
	<i>(Manats per US dollar)</i>						
Exchange rate (end-year)	3,890.0	4,378.0	4,565.0	4,775.0	4,893.0	4,923.0	na
Exchange rate (annual average)	3,869.0	4,120.2	4,474.2	4,656.6	4,860.8	4,910.7	na
<b>External sector</b>							
	<i>(In millions of US dollars)</i>						
Current account	-1,364	-600	-187	-49	-770	-1,955	-2,645
Trade balance	-1,046	-408	260	581	482	-98	-954
Merchandise exports	678	1,025	1,799	2,046	2,305	2,625	2,500
Merchandise imports	1,724	1,433	1,539	1,465	1,823	2,723	3,454
Foreign direct investment, net	1,023	510	149	299	1,048	2,090	2,673
Gross reserves, excluding gold (end-year) <sup>4</sup>	447	673	680	897	722	821	na
External debt stock	708	870	1,169	1,268	1,384	1,507	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	2.2	4.2	4.0	5.1	2.8	2.1	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	4.7	6.7	8.8	5.7	8.8	8.1	na
<b>Memorandum items</b>							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	8.0	8.0	8.0	8.1	8.2	8.3	na
GDP (in billions of manats)	17,203	18,875	23,591	26,578	29,602	35,053	36,410
GDP per capita (in US dollar) <sup>5</sup>	559	571	659	705	743	864	na
Share of industry in GDP (in per cent)	22.2	22.2	36.0	37.6	34.9	31.9	na
Share of agriculture in GDP (in per cent)	18.0	18.2	15.9	14.8	14.2	12.9	na
Current account/GDP (in per cent)	-30.7	-13.1	-3.5	-0.9	-12.6	-27.4	-35.8
External debt - reserves (in US\$ million)	261	197	489	371	662	686	na
External debt/GDP (in per cent)	15.9	19.0	22.2	22.2	22.7	21.1	na
External debt/exports of goods and services (in per cent)	70.1	67.9	56.8	54.3	51.9	49.7	na

<sup>1</sup> Industrial output excludes crude oil production.

<sup>2</sup> General government consolidates all levels of government, except for municipalities and state-owned enterprises, and includes the State Oil Fund and other extra-budgetary funds.

<sup>3</sup> 90-day interbank offer rate in manats, nominal.

<sup>4</sup> By end-June 2004 there were additional foreign exchange assets of approximately US\$ 839 million in the State Oil Fund.

<sup>5</sup> An improved method of calculating value-added in the oil sector has led to a sharp upward revision in nominal GDP and related variables for 2000 relative to previous estimates.

# Belarus

## Key challenges

A wholehearted commitment to market reform is needed to strengthen the business environment and send a signal to investors that Belarus welcomes more foreign direct investment.

Directed lending by the large state-owned banks, especially to unreformed enterprises, could deteriorate the quality of loan portfolios. All bank lending should be on a commercial basis.

Persistent inflationary pressures could be reduced by limiting the amount of off-budget financing and refraining from further wage increases in excess of productivity.

Furthermore, following a ruling of the Supreme Economic Court, one company was effectively renationalised on the grounds that its original privatisation was illegal. Negotiations with the Russian gas giant Gazprom on the establishment of a joint venture with Beltransgaz, the state-owned gas transit company, have slowed owing to differing valuations by both parties. However, in June there was agreement on the need for an independent valuation of the company.

## Business environment and competition

Output from the small business sector accounted for an estimated 8.2 per cent of GDP in 2003. Some 600,000 people were employed in the sector, representing 13 per cent of total employment in the economy. However, the sector continues to suffer from excessive regulation, arbitrary state interference and a high tax burden. Among the most frequent complaints from the small business associations are the number of licensing requirements, the complex procedures for meeting them and the fact that regulations often conflict with other legislation.

Promoting small business is an important objective of government policy, and the authorities have recently approved a number of decrees intended to address these concerns. A presidential decree in July 2003 (enacted in November) reduced the number of activities subject to licensing. Also, a resolution in December 2003 sought to stimulate business development with tax holidays and lower rent payments for small businesses.

The slow pace of restructuring is reflected in the large proportion of loss-making enterprises. A presidential decree on economic solvency took effect in May 2004 and is intended to address some of the shortcomings of the bankruptcy legislation. However, it appears to restrict the scope for applying bankruptcy procedures to certain companies, including state-owned entities.

In addition, another decree in March 2004 extended the potential application of the “golden share” to any company in which the state at one time held a stake. Although the “golden share” has only been used in a few cases since it took effect at the beginning of 1998, it adds to the uncertainty in the business environment and deters investment. It has also resulted in a modest net inflow of FDI.

## Financial sector

The National Bank of Belarus (NBB) has continued to strengthen its supervisory policies. These include the planned introduction of new national accounting standards from the beginning of 2005. Domestic credit has increased significantly, accompanied by a steady reduction in the NBB's refinancing rate during the first half of 2004. However, concerns in the banking sector remain. The government has announced that four of the main banks – including the renationalised Belpromstroybank – will remain in the public sector until 2010. It has also requested that the main banks continue directed lending in 2004. The NBB has recommended that commercial banks apply interest rate caps on their lending to large enterprises. These policies could lead to serious distortions in the allocation of credit and erode overall credit quality of the main banks' loan portfolios.

### Country data

Population (in millions)	9.9
Area ('000 sq. km)	207.6
Official language	Belarussian, Russian
GDP per capita in 2002 at current international US\$ (PPP)	US\$ 5,520
National currency	Belarussian rouble

## Progress in structural reform

### Liberalisation and privatisation

Negotiations on WTO accession have continued, with some signs of progress. The average import tariff was lowered to 9.5 per cent from the beginning of 2004, in line with WTO requirements. At the fifth round of discussions in January 2004, the WTO Secretariat decided sufficient progress had been made to prepare a summary of the steps needed to harmonise domestic legislation with WTO rules. The main issues to be resolved include the need to strengthen customs procedures and abolish many of the non-tariff barriers. Other factors which could influence the timing of WTO accession include the pace of Russia's negotiations to join the WTO and the progress of negotiations on forming the single economic space (with Russia, Ukraine and Kazakhstan).

State intervention in the economy has continued, including setting wage targets in US dollar terms, pressure on state-owned enterprises to meet production targets and an extension of the number of products subject to administrative price controls.

The emphasis of large-scale privatisation remains limited to corporatisation. There is no specific programme for 2004 and the number of large enterprises which have been sold remains very small. In 2003 privatisation receipts were BYR 36 billion (US\$ 16.5 million), less than 10 per cent of the target. In 2004 the government is aiming to transform over 200 entities and sell stakes in 149 companies, raising BYR 120 billion (US\$ 55 million) for the budget. However, progress remains slow and by July receipts were only 13 per cent of the target.



## Macroeconomic performance

### Real economy

GDP rose by 10.2 per cent in the first seven months of 2004, driven by strong domestic demand and high export growth (especially to Russia). Industrial output has strengthened by 15 per cent during this period. Continued increases in total factor productivity are likely to have contributed to growth. However, doubts over the accuracy of some of the output data persist. Some 30 per cent of all industrial enterprises were reported to be loss-making during the first half of 2004.

### Economic policies

Policies continue to be directed at improving living standards – especially through wage increases, higher pensions, and support for enterprises through the budget and through off-budget financing. The latter, which included directed lending and innovation funds, implies that both government spending and the fiscal deficit are almost certainly higher than reported. The government did, however, lower the rates of VAT and the turnover tax at the beginning of 2004 to reduce the tax burden and to bring tax rates closer to those in Russia. Monetary growth remained strong in the first half of 2004, but greater exchange rate stability contributed to a moderate rate of inflation.

Negotiations on a monetary union with Russia have been hampered by several factors, including the disparities between respective inflation rates, the government's request for compensation from Russia and the dispute over Beltransgaz. These led the two countries to delay the planned introduction of the Russian rouble as the single currency from the beginning of 2005 to the beginning of 2006.

### External sector

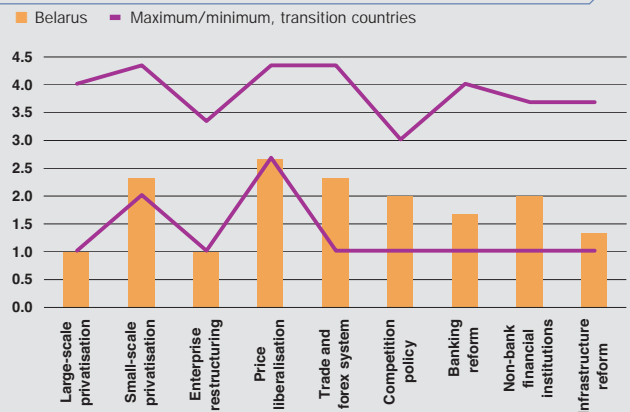
The current account recorded a deficit of 3 per cent of GDP in 2003 and it remained in deficit during the first half of 2004. For a number of years Belarus has benefited from low prices for its gas imports from Gazprom. Following a new agreement with Gazprom, the price of gas has increased by 30 per cent, which is expected to raise import costs by up to 0.5 per cent of GDP. There was a modest increase in external reserves in the first half of 2004 (to US\$ 540 million by end-July), but they cover less than one month's imports.

Access to other sources of external funds remains limited. Disagreements over appropriate policies led the authorities to withdraw their request for an IMF Stand-by Programme. In August it was announced that the Russian government would extend a loan of US\$ 175 million to Belarus, mainly to help the government meet the higher cost of gas imports.

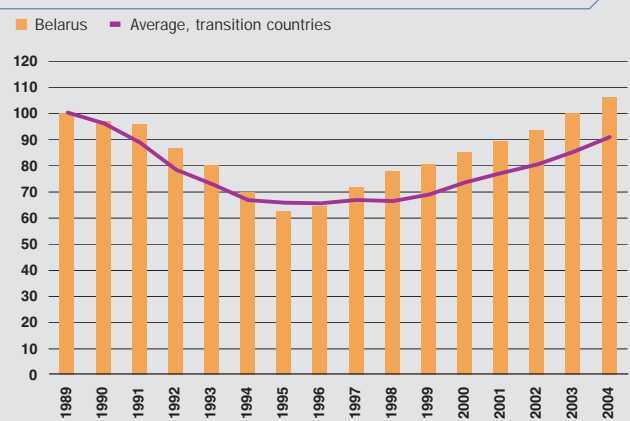
## Outlook and risks

The government is expected to continue its policy of providing financial support to industry and agriculture. As a result, positive growth should be maintained. However, the persistence of soft budget constraints will hinder the adjustment that enterprises and farms need to make in response to higher gas prices, for example. Ultimately, sustained growth will depend on the authorities' willingness to embark on market-oriented reforms.

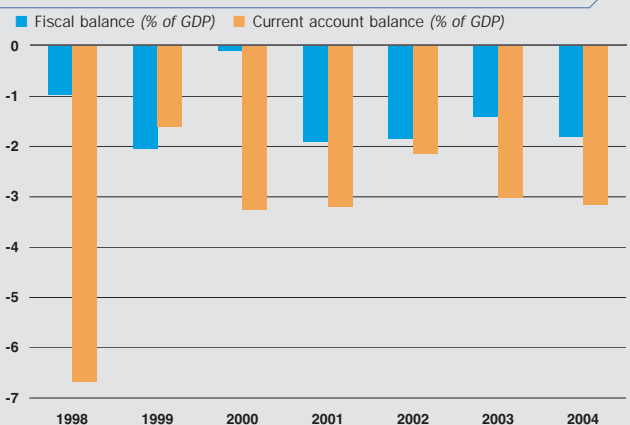
### Transition indicators, 2004



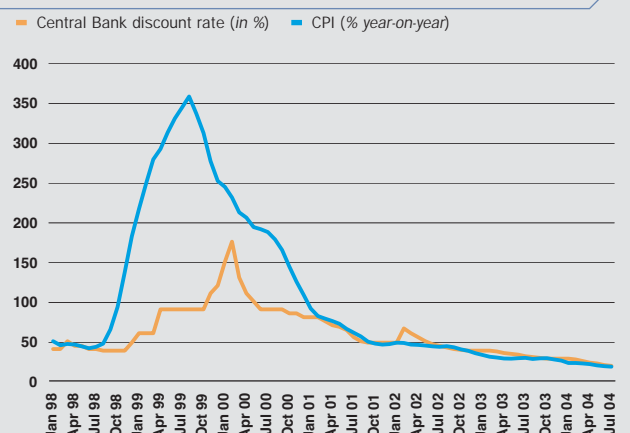
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – <b>limited</b>	Primary privatisation method – <b>MEBOs</b>	Independent telecoms regulator – <b>no</b>	Share of population living in poverty – <b>&lt;2 per cent (2000)</b>
Interest rate liberalisation – <b>limited de facto</b>	Secondary privatisation method – <b>vouchers</b>	Separation of railway accounts – <b>no</b>	Private pension funds – <b>no</b>
Wage regulation – <b>yes</b>	Tradability of land – <b>limited de jure</b>	Independent electricity regulator – <b>no</b>	
Stabilisation	Enterprise and markets	Financial sector	
Share of general government tax revenue in GDP – <b>44.9 per cent</b>	Competition office – <b>no</b>	Capital adequacy ratio – <b>10 per cent</b>	
Exchange rate regime – <b>crawling peg with band to Russian rouble</b>		Deposit insurance system – <b>yes</b>	
		Secured transactions law – <b>restricted</b>	
		Securities commission – <b>no</b>	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	27.0	27.0	27.0	25.0	24.0	21.0	28.0
Number of goods with administered prices in EBRD-15 basket	6.0	6.0	6.0	6.0	6.0	4.0	5.0
Share of trade with non-transition countries (in per cent)	17.3	22.6	22.9	45.7	21.9	22.4	na
Share of trade in GDP (in per cent)	91.0	97.5	136.0	125.3	115.4	122.3	na
Tariff revenues (in per cent of imports) <sup>1</sup>	4.2	3.9	1.7	2.0	2.4	2.6	na
<i>EBRD index of price liberalisation</i>	2.7	2.3	2.3	2.7	2.7	2.7	2.7
<i>EBRD index of forex and trade liberalisation</i>	1.0	1.0	1.7	2.0	2.3	2.3	2.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	1.0	1.1	1.1	1.2	2.8	2.9	na
Private sector share in GDP (in per cent)	20.0	20.0	20.0	20.0	25.0	25.0	25.0
Private sector share in employment (in per cent)	16.4	18.6	na	na	na	na	na
<i>EBRD index of small-scale privatisation</i>	2.0	2.0	2.0	2.0	2.0	2.3	2.3
<i>EBRD index of large-scale privatisation</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	17.2	18.9	18.9	19.8	18.9	18.9	na
Share of industry in total employment (in per cent)	24.3	24.4	24.2	23.7	23.9	23.0	na
Change in labour productivity in industry (in per cent)	12.3	9.2	8.8	8.4	5.6	12.3	na
Investment/GDP (in per cent)	26.7	23.7	25.4	23.8	22.2	na	na
<i>EBRD index of enterprise reform</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>EBRD index of competition policy</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	24.8 (0.1)	25.7 (0.2)	26.9 (0.5)	28.8 (1.4)	29.9 (4.7)	31.1 (11.3)	na
Internet penetration rate (per 10,000 inhabitants)	1.0	0.9	2.0	3.3	4.1	5.0	na
Railway labour productivity (1989=100)	32.2	35.9	37.5	35.1	38.3	40.1	na
Residential electricity tariffs, USc kWh <sup>2</sup>	0.8	0.4	1.4	1.3	3.2	na	na
Average collection rate, electricity (in per cent)	na	na	50	na	98	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.6	1.7	1.8	1.9	na	na	na
<i>EBRD index of infrastructure reform</i>	1.0	1.3	1.3	1.3	1.3	1.3	1.3
<i>Electric power</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Railways</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Roads</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Telecommunications</i>	1.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Water and waste water</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	37 (2)	36 (4)	31 (6)	29 (9)	28 (12)	30 (17)	na
Asset share of state-owned banks (in per cent)	59.5	66.6	66.0	53.2	67.6	63.7	na
Non-performing loans (in per cent of total loans)	16.5	13.1	15.2	11.9	8.3	3.7	na
Domestic credit to private sector (in per cent of GDP)	16.1	9.3	8.9	8.2	8.9	12.0	na
Stock market capitalisation (in per cent of GDP)	3.5	3.4	4.1	2.9	na	na	na
<i>EBRD index of banking sector reform</i>	1.0	1.0	1.0	1.0	1.7	1.7	1.7
<i>EBRD index of reform of non-bank financial institutions</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	11.4	11.1	11.1	11.5	11.5	11.6	na
Life expectancy at birth, total (years)	68.4	67.9	68.0	68.1	68.2	na	na
Basic school enrolment ratio (in per cent)	90.8	91.2	91.8	92.3	93.3	na	na

<sup>1</sup> Refers to taxes on international trade.<sup>2</sup> Refers to average retail tariff.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>							
	<i>(Percentage change in real terms)</i>						
GDP	8.4	3.4	5.8	4.7	5.0	6.8	6.0
Private consumption	14.1	9.5	8.0	17.9	11.4	11.1	na
Public consumption	6.3	5.5	5.8	3.1	0.3	2.5	na
Gross fixed capital formation	6.9	-16.0	14.7	1.9	2.6	12.0	na
Exports	-3.4	-2.3	na	na	na	na	na
Imports	-1.2	-8.6	na	na	na	na	na
Industrial gross output	12.4	10.3	7.8	5.9	4.5	6.8	na
Agricultural gross output	-0.7	-7.0	8.8	1.6	3.1	6.8	na
<b>Employment</b>							
	<i>(Percentage change)</i>						
Labour force (end-year)	0.0	0.3	-0.1	-0.4	-1.3	-1.0	na
Employment (end-year)	1.1	0.6	0.0	-0.5	-1.7	-1.0	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	2.3	2.1	2.1	2.3	3.0	3.1	na
<b>Prices and wages</b>							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	72.9	293.7	168.6	61.4	42.6	28.5	19.3
Consumer prices (end-year)	181.7	251.3	107.5	46.2	34.8	25.4	18.0
Producer prices (annual average)	73.5	355.8	185.6	71.8	40.4	38.0	na
Producer prices (end-year)	200.0	245.0	168.0	39.0	43.0	29.0	na
Gross average monthly earnings in economy (annual average)	104.2	322.4	200.9	108.8	53.8	34.0	na
<b>Government sector</b>							
	<i>(In per cent of GDP)</i>						
General government balance	-1.0	-2.0	-0.1	-1.9	-1.8	-1.4	-1.8
General government expenditure	45.4	47.3	45.9	46.8	44.7	46.1	na
General government debt	11.5	14.7	15.0	11.6	10.6	10.5	na
<b>Monetary sector</b>							
	<i>(Percentage change)</i>						
Broad money (M2, end-year)	275.1	133.2	210.9	66.1	50.3	57.3	na
Domestic credit (end-year)	297.4	143.2	190.8	65.0	54.6	70.7	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	30.9	16.7	17.2	15.2	15.0	17.2	na
<b>Interest and exchange rates</b>							
	<i>(In per cent per annum, end-year)</i>						
Refinancing rate	48.0	120.0	85.0	48.0	38.0	28.0	na
Treasury bill rate (3-month maturity)	na	na	na	na	na	na	na
Deposit rate (1 year) <sup>1</sup>	14.3	23.8	37.6	34.2	26.9	17.4	na
Lending rate (1 year) <sup>2</sup>	27.0	51.0	67.7	47.0	36.9	24.0	na
	<i>(Belarussian roubles per US dollar)</i>						
Official exchange rate (end-year)	106.0	320.0	1,180.0	1,580.0	1,920.0	2,156.0	na
Official exchange rate (annual average)	46.1	248.8	876.8	1,390.0	1,790.9	2,053.6	na
<b>External sector</b>							
	<i>(In millions of US dollars)</i>						
Current account	-1,017	-194	-338	-394	-311	-527	-670
Trade balance	-1,501	-570	-884	-807	-914	-1,256	-1,440
Merchandise exports	6,172	5,646	6,641	7,334	7,965	10,073	12,200
Merchandise imports	7,673	6,216	7,525	8,141	8,879	11,329	13,640
Foreign direct investment, net	201	443	119	96	453	170	150
Gross reserves, excluding gold (end-year)	703	309	357	359	476	496	na
External debt stock <sup>3</sup>	1,011	886	898	1,142	1,439	1,436	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	1.0	0.6	0.5	0.5	0.6	0.5	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	1.9	3.9	4.2	3.4	4.1	4.6	na
<b>Memorandum items</b>							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	10.1	10.1	10.0	10.0	9.9	9.9	na
GDP (in billions of Belarussian roubles)	702	3,026	9,134	17,173	26,138	35,930	46,000
GDP per capita (in US dollar)	1,503	1,207	1,039	1,237	1,468	1,767	na
Share of industry in GDP (in per cent)	33.4	31.9	30.1	29.9	30.1	30.0	na
Share of agriculture in GDP (in per cent)	13.9	14.6	14.2	11.9	10.9	9.5	na
Current account/GDP (in per cent)	-6.7	-1.6	-3.2	-3.2	-2.1	-3.0	-3.2
External debt - reserves (in US\$ million)	308	577	541	783	963	941	na
External debt/GDP (in per cent)	6.6	7.3	8.6	9.2	9.9	8.2	na
External debt/exports of goods and services (in per cent)	14.2	13.8	11.7	13.5	15.5	12.4	na

<sup>1</sup> Data refer to weighted average interest rates on new one-year deposits in commercial banks.<sup>2</sup> Data refer to weighted average interest rates for one-year loans by commercial banks.<sup>3</sup> Total debt including medium and long-term public and publicly guaranteed debt and an estimate of private debt.

# Bosnia and Herzegovina<sup>1</sup>

## Key challenges

As donor assistance is reduced, the current slow pace of privatisation needs to be accelerated and obstacles to business eliminated to promote private capital flows.

To increase much-needed investment in infrastructure, the state government and the governments of the two Entities should press forward with structural and institutional reforms in key sectors, such as transport and telecommunications.

A firm commitment by the authorities to settle domestic debts and to further reduce the size of the public sector is needed for long-term sustainability.

## Business environment and competition

Earlier measures to improve the business environment have yielded positive results. The “Bulldozer Initiative”, launched in November 2002, has made steady progress towards removing obstacles to doing business. The first 50 measures under this initiative were completed by mid-2003 and the second 50 were adopted in the first half of 2004. The third phase, under the slogan “minding our own business”, was launched in August 2004.

In the same month the state parliament adopted a law enabling the creation of a single, state-wide business register. This new law will simplify the registration process significantly. It will also encourage further moves towards a single economic space, since it will enable firms in one Entity to register more easily in the other.

Important amendments to the Federation bankruptcy law were adopted in April 2004. These bring the respective laws in both Entities into line, not only with each other but also with standard international practice. However, implementation will be the key challenge.

## Infrastructure

Energy sector reform advanced in the first quarter of 2004 with the adoption of the Law on the Transmission Company and the Law on the Independent System Operator by both houses of the state parliament. These laws, and the establishment of the independent State Regulatory Commission, are key steps in creating an integrated energy market. They are also important for merging with the wider regional energy market, and for unlocking much-needed investment from international financial institutions and bilateral donors. Bosnia and Herzegovina's infrastructure needs in the areas of roads, railways and telecommunications remain substantial.

## Financial sector

The banking sector has undergone significant consolidation in recent years. The number of banks fell from 56 at the end of 2000 to 37 at the end of 2003 – 27 in the Federation and 10 in the Republika Srpska (RS). Twelve banks in the Federation and seven in the RS are controlled by foreign shareholders. Financial intermediation has expanded rapidly in recent years; domestic credit to non-financial enterprises and cooperatives was around 25 per cent of GDP at the end of 2003. Credit growth to households and enterprises was particularly strong during 2003, at nearly 40 per cent. Minimum reserve requirements rose in September 2004 from 5 to 7.5 per cent, and a further rise to 10 per cent is scheduled for December 2004.

Confidence in the banking system has been enhanced by the introduction in August 2003 of mandatory deposit insurance for all banks in the state. A phase-in period was designated for those banks that could not immediately meet the necessary requirements. By the end of March 2004, 22 banks (accounting for more than 70 per cent of total deposits) were members. The remaining banks (excluding six banks under provisional administration) have submitted action plans to the relevant Entity banking supervision agency to bring them into compliance.

## Country data

Population (in millions)	3.8
Area ('000 sq. km)	51
Official language	Serbian, Croatian, Bosnian
GDP per capita at PPP exchange rates (2001)	US\$ 5,970
National currency	Convertible mark

## Progress in structural reform

### Liberalisation and privatisation

Significant progress is being made in tax reform and in the creation of a single economic space. In April 2004 the Prime Ministers of the two Entities signed an agreement to work towards two broad targets. These were the elimination of all barriers to inter-Entity trade on excisable products and the introduction of new sales and excise tax laws at the state level. In July 2004 a draft law on VAT was adopted by the Council of Ministers. Preparations for the introduction of a state-wide VAT (to replace existing Entity sales taxes) by January 2006 are also on track.

Bosnia and Herzegovina's progress in the Stabilisation and Association Process with the EU has been slow. A feasibility study by the European Commission identified 16 priority reforms where significant progress would be required before negotiations could begin on a Stabilisation and Association Agreement (SAA). While progress has been made in some areas, the process is not yet complete. Negotiations with the EU on an SAA are unlikely to begin before mid-2005.

Many proposed tenders for the privatisation of strategic enterprises have been delayed or postponed repeatedly. Several privatisations have been problematic due to the power of vested interests. The authorities promised to accelerate the privatisation process in 2004, creating a state-wide advisory web site and streamlining administrative procedures in the Federation. Several industrial facilities have since been sold to strategic investors.

<sup>1</sup> The territorial constitutional entities distinguished in this assessment include the State of Bosnia and Herzegovina (BH), the Federation of Bosnia and Herzegovina (FBH), the Republika Srpska (RS) and the cantons of the Federation. The FBH and the RS are referred to as the “Entities”. The District of Brčko enjoys a special status based on an Arbitration Award in accordance with the Dayton Peace Agreement.

## Macroeconomic performance

### Real economy

Growth in the economy in 2003 was sluggish and well below the level recorded in 2002. This reflected declining foreign aid and the effects of drought on the agricultural sector. However, signs of recovery in the industrial sectors of both Entities were apparent in the first months of 2004. The informal sector remains large, with the Central Bank estimating it was 38 per cent of recorded GDP in 2003.

### Economic policies

Economic policy-making has improved in recent years, especially in the fiscal sphere. The IMF Stand-By Arrangement (SBA) was also successfully completed in spring 2004. Fiscal reforms have advanced significantly, notably in tax collection and spending control. As a result, the overall fiscal balance has moved from a deficit of 7 per cent of GDP in 2000 (on a commitment basis) to an estimated small surplus (including grants) in 2003. General government expenditure fell from over 60 per cent of GDP to around 46 per cent over the same period.

Monetary policy continues to be guided by the currency board of the Central Bank. The board was established in 1997 and was fully endorsed by the state presidency and parliament in August 2003, when a new governing board of the Central Bank was appointed. Prices continue to be stable and reserve coverage rose further during 2003.

In late-2003 plans for a comprehensive settlement of domestic public debt claims were approved by governments at all levels. The plan involves the replacement of much of the debt by low-interest, long-term bonds with long grace periods. If the plan is implemented in full, it will result in a reduction of the net present value of domestic debt to around 10 per cent of GDP.

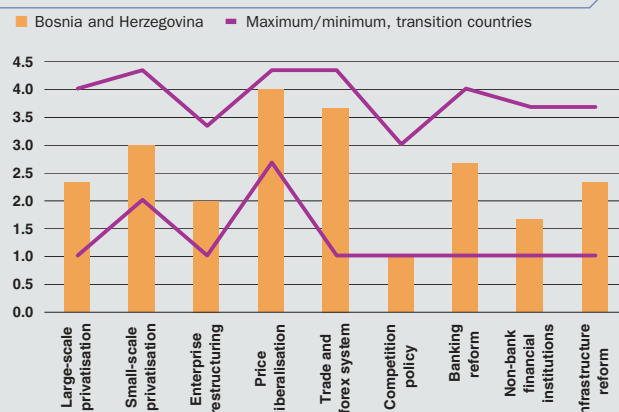
### External sector

The trade and current account deficits remain large, with the latter estimated at around 17.4 per cent of GDP in 2003. Reserve coverage is strong (at about five months of imports) and official and private transfers continue to flow in. However, official aid is on a steady downward trend. Net foreign direct investment inflows in 2003 were around US\$ 300 million, but capital transfers for reconstruction have fallen. In March 2004 the country received its first rating from a major international ratings agency – Moody's assigned a "B3, positive outlook" rating.

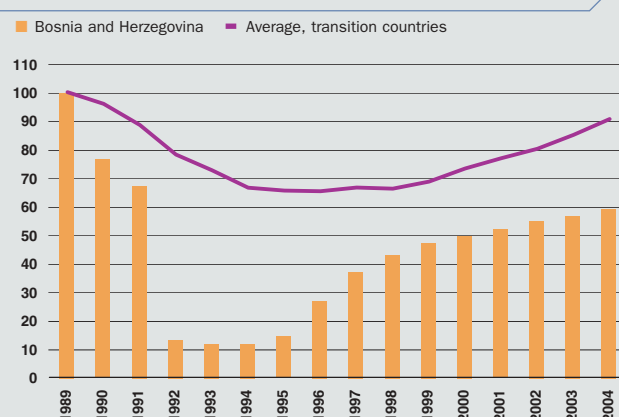
## Outlook and risks

The medium-term economic outlook for Bosnia and Herzegovina is uncertain, notwithstanding recent measures to strengthen the state and enhance cooperation with neighbouring states and the EU. Inflows of foreign aid and assistance are already declining and will fall further over the next few years. Other economic issues facing the country include the future of the currency board when the present Central Bank governor leaves at the end of 2004, the finalisation of the domestic debt resolution plan, and the need for a further reduction in the size of government.

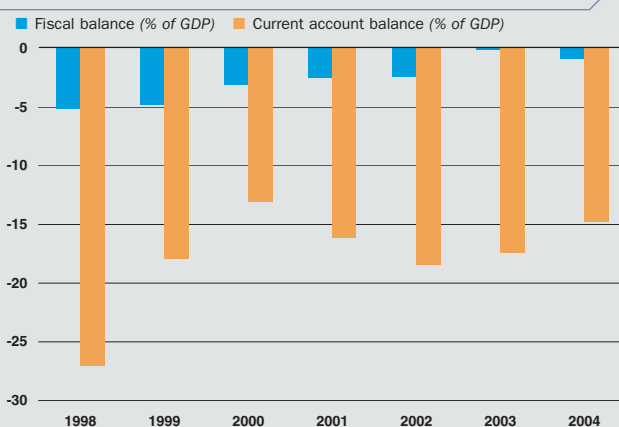
## Transition indicators, 2004



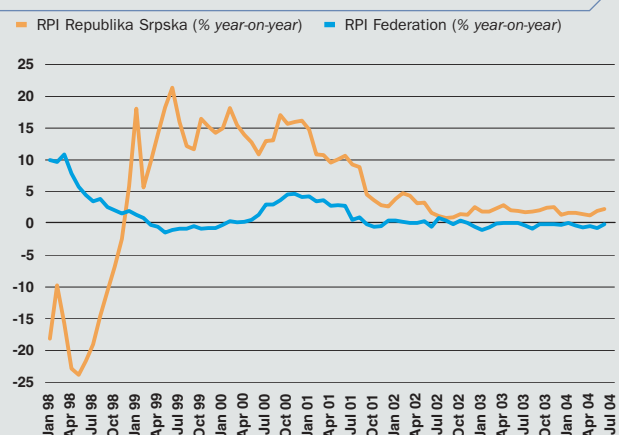
## Real GDP (1989=100)



## Fiscal balance and current account balance



## Interest rates and inflation





<b>Liberalisation</b>	<b>Privatisation</b>	<b>Infrastructure</b>	<b>Social sector</b>
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes	Share of population living in poverty –
Interest rate liberalisation – full	<b>vouchers</b>	Separation of railway accounts – no	<b>na</b>
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – no	Private pension funds – no
	<b>direct sales</b>		
<b>Stabilisation</b>	Tradability of land – limited de jure	<b>Financial sector</b>	
Share of general government tax revenue in GDP – <b>38.8 per cent</b>		Capital adequacy ratio – <b>12 per cent</b>	
Exchange rate regime – <b>currency board pegged to euro</b>	<b>Enterprise and markets</b>	Deposit insurance system – yes	
	Competition office – no	Secured transactions law – no	
		Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket <sup>1</sup>	na	na	5.0	4.0	4.0	3.0	3.0
Share of trade with non-transition countries (in per cent)	59.0	67.4	75.5	52.8	50.8	49.6	na
Share of trade in GDP (in per cent)	102.9	106.0	71.3	71.2	74.3	74.8	na
Tariff revenues (in per cent of imports)	6.1	6.5	11.1	14.2	15.3	10.5	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	3.0	3.0	3.0	3.0	3.0	3.7	3.7
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.7	2.0	2.7	2.8	2.8	na
Private sector share in GDP (in per cent)	35.0	35.0	35.0	40.0	45.0	50.0	50.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
<i>EBRD index of small-scale privatisation</i>	2.0	2.0	2.3	2.7	3.0	3.0	3.0
<i>EBRD index of large-scale privatisation</i>	2.0	2.0	2.0	2.3	2.3	2.3	2.3
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	0.4	0.5	0.8	0.4	na	na	na
Share of industry in total employment (in per cent)	na	na	na	na	na	na	na
Change in labour productivity in industry (in per cent)	na	na	na	na	na	na	na
Investment/GDP (in per cent)	25.9	21.0	21.2	19.4	19.9	20.3	na
<i>EBRD index of enterprise reform</i>	1.7	1.7	1.7	1.7	1.7	2.0	2.0
<i>EBRD index of competition policy</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	9.1 (0.7)	9.6 (1.4)	10.3 (3.0)	22.3 (11.7)	23.7 (19.6)	22.5 (27.4)	na
Internet penetration rate (per 10,000 inhabitants)	1.7	5.2	5.3	8.6	15.0	18.9	na
Railway labour productivity (1989=100)	111.3	153.7	177.2	245.9	267.2	294.7	na
Residential electricity tariffs, USc kWh <sup>2</sup>	3.5	5.1	4.3	5.6	6.2	na	na
Average collection rate, electricity (in per cent)	86	94	75	95	86	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.7	5.4	4.6	4.8	na	na	na
<i>EBRD index of infrastructure reform</i>	1.3	1.3	2.0	2.0	2.3	2.3	2.3
<i>Electric power</i>	2.0	2.0	2.3	2.3	3.0	3.0	3.0
<i>Railways</i>	2.0	2.0	2.0	2.3	3.0	3.0	3.0
<i>Roads</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Telecommunications</i>	1.0	1.0	3.3	3.3	3.3	3.3	3.3
<i>Water and waste water</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	na	61 (9)	56 (14)	49 (20)	40 (21)	37 (19)	na
Asset share of state-owned banks (in per cent)	na	75.9	55.4	17.3	6.3	5.2	na
Non-performing loans (in per cent of total loans)	na	58.7	15.8	20.7	11.4	8.3	na
Domestic credit to private sector (in per cent of GDP)	na	8.9	7.0	9.1	11.2	14.6	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na
<i>EBRD index of banking sector reform</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.7
<i>EBRD index of reform of non-bank financial institutions</i>	1.0	1.0	1.0	1.0	1.7	1.7	1.7
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	na	73.0	73.3	73.6	73.9	na	na
Basic school enrolment ratio (in per cent)	92.4	86.4	84.0	81.1	79.3	na	na

<sup>1</sup> Data based on Republika Srpska only.<sup>2</sup> Refers to average retail tariff.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> <i>(Percentage change in real terms)</i>							
GDP	15.6	9.6	5.5	4.4	5.5	3.5	4.0
Total consumption	7.6	na	na	na	na	na	na
Gross fixed capital formation <sup>1</sup>	5.2	na	na	na	na	na	na
Industrial gross output	23.3	12.1	9.4	-2.0	11.5	3.8	na
Agricultural gross output	8.6	na	na	na	na	na	na
<b>Employment</b> <i>(Percentage change)</i>							
Labour force (end-year)	-2.8	-0.9	2.1	-1.3	3.1	na	na
Employment (end-year)	1.7	-3.1	1.6	-2.3	1.9	na	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	38.0	39.3	39.6	40.3	40.9	42.0	na
<b>Prices and wages</b> <i>(Percentage change)</i>							
Consumer prices (annual average)							
Federation (KM-based)	5.1	-0.9	1.9	1.9	-0.2	-0.5	na
Republika Srpska (KM-based)	-14.0	14.1	14.0	7.0	1.7	1.9	na
Consumer prices (end-year)							
Federation (KM-based)	1.8	-1.0	4.0	2.4	0.7	-0.3	na
Republika Srpska (KM-based)	5.6	14.0	16.0	2.5	2.4	0.2	na
Gross average monthly earnings in economy (annual average)							
Federation	6.3	5.2	8.3	-43.0	na	na	na
Republika Srpska	-24.5	-52.7	-17.0	-25.4	na	na	na
<b>Government sector</b> <i>(In per cent of GDP)</i>							
General government balance (cash basis)	-5.2	-4.8	-3.1	-2.5	-2.4	-0.2	-0.9
General government expenditure	61.8	65.0	56.8	52.2	50.4	46.9	na
<b>Monetary sector</b> <i>(Percentage change)</i>							
Broad money (M2, end-year)	31.3	39.9	13.9	89.3	8.6	9.5	na
Domestic credit (end-year)	16.2	-1.3	10.0	5.2	28.2	21.5	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	20.5	25.2	24.5	42.6	43.5	45.6	na
<b>Exchange rates<sup>2</sup></b> <i>(KM per US dollar)</i>							
Exchange rate (annual average)	1.75	1.84	2.12	2.19	2.08	1.73	na
<b>External sector</b> <i>(In millions of US dollars)</i>							
Current account	-1,167	-837	-621	-811	-1,035	-1,224	-1,200
Trade balance	-3,116	-1,852	-1,715	-1,831	-2,076	-2,438	-2,607
Merchandise exports	664	831	832	870	1,046	1,407	1,715
Merchandise imports	3,780	4,126	2,547	2,701	3,122	3,845	4,322
Foreign direct investment, net <sup>3</sup>	67	177	150	130	230	320	420
Gross reserves, excluding gold (end-year)	175	455	497	1,221	1,279	1,725	na
External debt stock	2,985	3,095	2,969	2,500	2,300	2,450	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	0.5	1.3	2.2	5.1	4.6	5.1	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	13.0	13.8	12.1	6.2	8.5	7.8	na
<b>Memorandum items</b> <i>(Denominations as indicated)</i>							
Population (end-year, million) <sup>4</sup>	3.8	3.8	3.8	3.8	3.8	3.8	na
GDP (in millions of markas)	7,559	8,603	10,054	10,959	11,650	12,170	12,911
GDP per capita (in US dollar)	1,136	1,231	1,247	1,320	1,477	1,849	na
Share of industry in GDP (in per cent)	22.5	na	na	na	na	na	na
Share of agriculture in GDP (in per cent)	16.0	na	na	na	na	na	na
Current account/GDP (in per cent)	-27.0	-17.9	-13.1	-16.2	-18.4	-17.4	-14.8
External debt - reserves (in US\$ million)	2,810	2,640	2,472	1,279	1,021	725	na
External debt/GDP (in per cent)	69.2	66.2	62.7	49.9	41.0	34.9	na
External debt/exports of goods and services (in per cent)	297.0	268.9	230.5	192.8	156.7	129.4	na

<sup>1</sup> Includes changes in inventories. Disaggregated data on gross fixed capital formation are not available.

<sup>2</sup> Since August 1997 Bosnia and Herzegovina has had a common Central Bank. The new currency, the convertible mark (KM), was initially pegged to the Deutschmark at 1:1 under currency board rules. This is equivalent to approximately 1.96 per euro.

<sup>3</sup> Excludes capital transfers for reconstruction.

<sup>4</sup> Excludes refugees abroad.

# Bulgaria

## Key challenges

Completion of the privatisation process and further progress in structural reforms are necessary to sustain large inflows of foreign investment and meet the challenges posed by EU accession.

Although barriers to entry in domestic markets have been eased, the enforcement of property rights depends on the effective implementation of judicial and administrative reforms.

The continuation of prudent fiscal and wage policies is key to sustaining the currency board arrangement and preserving macroeconomic stability, especially as the external imbalances remain large.

In the energy sector the government accepted bids in July 2004 from three strategic investors for the acquisition of 67 per cent stakes in Bulgaria's seven electricity distributors, pooled in three regional packages. Total privatisation revenues from this operation amounted to €693 million, exceeding the government's expectations. Preliminary offers for five of Bulgaria's district heating companies are expected by early October 2004. The government selected a privatisation adviser (CSFB) in July 2004 for the privatisation of the three main thermal power plants.

## Business environment and competition

New legislation has been passed to facilitate market entry. A law on the restriction of administrative regulation and control on business activity entered into force in December 2003. Its main provisions include the establishment of "one-stop shops" for the delivery of administrative services and the principle of silent consent. The latter allows businesses to assume official consent for new permits and certificates if the authorities do not respond within 30 days of the application. A new investment promotion law provides for accelerated licensing and authorisation procedures for new businesses and subsidised infrastructure for selected investments above €50 million. A law for the promotion of entrepreneurship and small and medium-sized enterprises (SMEs) was adopted in early 2004. It aims to improve the coordination of policies on SMEs and facilitate the provision of administrative services to these enterprises.

## Infrastructure

A new energy law and energy efficiency law were approved by the parliament in 2003. They establish a broad regulatory framework for the sector by defining the conditions for third-party access to the energy networks and allowing for direct contracts between large consumers and producers. They also provide for the gradual liberalisation of the sector and facilitate market entry in the field of energy generation. In July 2004 electricity and district heating tariffs for household consumers were increased on average by 10 and 12 per cent, respectively. The aim is to bring these prices to cost recovery levels by the end of 2004.

## Financial sector

With the completion of the privatisation process, confidence in the banking system has strengthened and financial intermediation increased. Over the past two years, the Bulgarian economy has experienced a credit boom. Lending to the private sector has increased at rates above 40 per cent per year in real terms. The amount of domestic credit to the private sector increased to 26 per cent of GDP in 2003 from 15 per cent of GDP at the end of 2001. Deposits as a share of GDP also almost doubled over the same period.

Despite some concerns that the credit boom could affect credit quality, banking performance indicators remain sound. In April 2004 the Bulgarian National Bank (BNB) tightened provisioning requirements on all loan categories. In July 2004 the BNB increased reserve requirements by extending the base and making all loans subject to registration in the credit register. The government also shifted deposits held in commercial banks back to the BNB to reduce liquidity in the system.

### Country data

Population (in millions)	<b>7.8</b>
Area ('000 sq. km)	<b>111</b>
Official language	<b>Bulgarian</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 7,130</b>
National currency	<b>Lev</b>

## Progress in structural reform

### Liberalisation and privatisation

In mid-June 2004 Bulgaria completed EU accession negotiations by provisionally closing all the chapters of the *acquis communautaire*. The country is therefore on track to sign the accession treaty in early 2005 and join the EU on the target date of January 2007. However, progress in the implementation of reform commitments will be monitored closely by the European Commission, which negotiated a safeguard clause that could allow it to defer EU entry by one year.

After long procedural delays, progress has been made in the privatisation of several large enterprises. In October 2003, 75 per cent of the Varna shipyard was sold to the Bulyard shipbuilding company, a consortium of Bulgarian and American investors. In June 2004 the government finalised the sale of its 65 per cent stake in the Bulgarian Telecommunications Company (BTC) to a private equity consortium led by Advent International. The total sale price was €230 million, plus a €50 million capital increase subscribed by Advent and €27.7 million paid for the award of the third GSM licence. The estimated investment commitments for the next five years amount to about €700 million.

At the beginning of July 2004 the Ministry of Economy relaunched the privatisation of the tobacco monopoly Bulgartabac. Under the new privatisation strategy, the company will be broken up into separate units for sale. The tender for the sale of the first four cigarette producers of the holding, grouped into two packages, was opened in July. Binding bids are expected by the end of October 2004.

## Macroeconomic performance

### Real economy

According to preliminary estimates, the economy grew by 5.6 per cent in the first half of 2004 compared with 4.3 per cent in 2003 as a whole. The main drivers of GDP growth on the demand side were private consumption and inventory accumulation. The growth of domestic consumption, which accelerated in 2003 on the back of a lending boom, slowed to below 5 per cent year-on-year in the first half of 2004. The main contributors to growth on the supply side were the industry and services sectors.

The unemployment rate remained high at 11.9 per cent of the active labour force at the end of August 2004, although the rate has gradually fallen in recent years. Despite average GDP growth above 4.5 per cent over the past four years, Bulgaria remains a poor country. According to Eurostat, the average per capita income at purchasing power parity (PPP) was only 28 per cent of the (enlarged 25-member) EU average in 2003.

### Economic policies

Consumer price inflation remained high at 7 per cent in the first half of 2004 due to one-off increases in excise taxes and energy prices. However, the end-year inflation rate is expected to fall to below 4 per cent as these temporary inflationary pressures subside. Fiscal policy remains tight, with the cumulative budget surplus (in cash terms) at 2.6 per cent of GDP in the year to July. As part of a new IMF precautionary Stand-by Agreement, the government is committed to maintaining the budget close to balance in 2004 and saving any extra revenues as a buffer against external shocks.

Strong GDP growth and active debt management policies contributed to a reduction in the ratio of total public debt to GDP to below 50 per cent in 2003. In July 2004 the government retired about US\$ 679 million in Discount Brady bonds and freed collateral worth around US\$ 293 million. The net cost of the buy-back operation was about US\$ 380 million and was financed from the fiscal reserve, which decreased to €2.1 billion as of the end of July 2004.

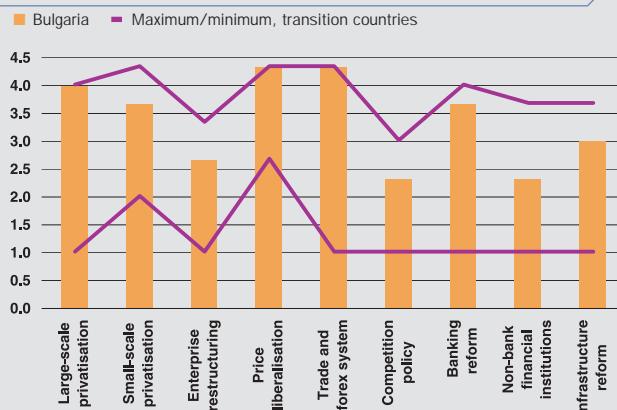
### External sector

The current account deficit is projected to stay above 8 per cent of GDP in 2004. This follows the sharp increase in 2003 as domestic demand rose strongly, fuelled by rapid credit expansion. The financing of these external imbalances is not an issue in the short term. Net foreign direct investment inflows are projected at a record US\$ 2 billion in 2004, reflecting the success of the privatisations in the energy and telecommunications sectors.

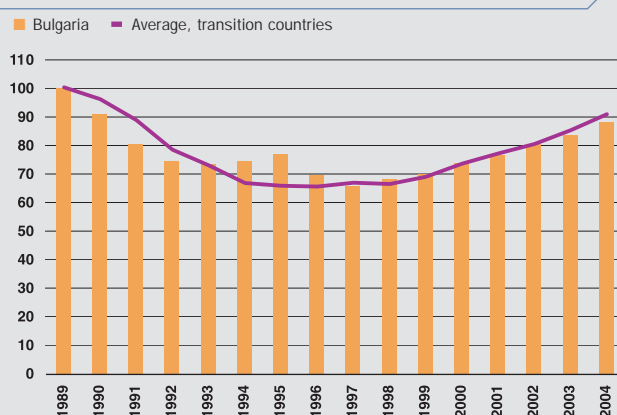
## Outlook and risks

Productivity gains will be necessary to raise the annual rate of GDP growth above the current levels and enable Bulgaria to catch up with the average EU incomes. The external position remains vulnerable to a further acceleration in import growth, continued high oil prices and excessive wage increases which could harm competitiveness. Should there be a need to adjust to unfavourable economic shocks, the government would have to rely on adjustments to fiscal policy because monetary policy is constrained by the currency board regime.

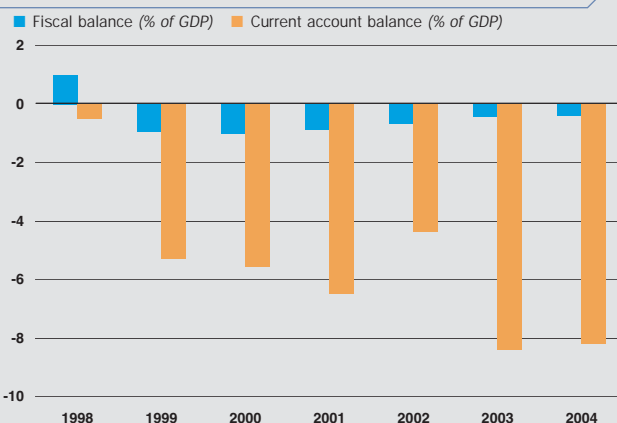
### Transition indicators, 2004



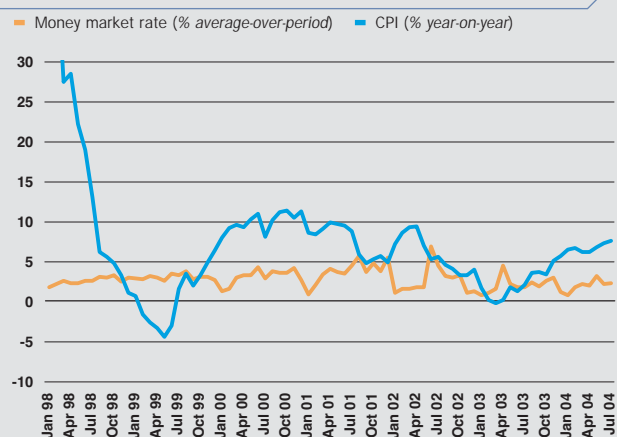
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes	Share of population living in poverty –
Interest rate liberalisation – full	direct sales	Separation of railway accounts – yes	16.2 per cent (2001) <sup>1</sup>
Wage regulation – yes	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – yes
	vouchers		
Stabilisation	Tradability of land – full except	Financial sector	
Share of general government tax	foreigners	Capital adequacy ratio – 12 per cent	
revenue in GDP – 29 per cent		Deposit insurance system – yes	
Exchange rate regime – currency	Enterprise and markets	Secured transactions law – yes	
board	Competition office – yes	Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	15.8	17.2	20.0	20.6	21.3	22.0	24.7
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	1.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	76.9	80.4	76.0	72.1	76.4	77.1	na
Share of trade in GDP (in per cent)	68.8	70.2	85.7	86.8	82.1	87.4	na
Tariff revenues (in per cent of imports)	13.9	10.2	9.9	8.9	10.0	10.3	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	6.2	8.4	9.7	10.3	11.2	12.3	na
Private sector share in GDP (in per cent)	65.0	70.0	70.0	70.0	70.0	75.0	75.0
Private sector share in employment (in per cent)	41.4	45.9	54.9	58.9	60.8	62.1	na
EBRD index of small-scale privatisation	3.0	3.3	3.7	3.7	3.7	3.7	3.7
EBRD index of large-scale privatisation	3.0	3.0	3.7	3.7	3.7	3.7	4.0
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	2.0	1.6	0.9	2.4	2.4	2.6	na
Share of industry in total employment (in per cent)	26.6	27.0	26.2	26.1	24.0	23.5	na
Change in labour productivity in industry (in per cent)	1.4	-1.8	18.7	5.1	8.2	9.6	na
Investment/GDP (in per cent)	16.9	17.9	18.3	20.4	19.7	21.7	na
EBRD index of enterprise reform	2.3	2.3	2.3	2.3	2.3	2.7	2.7
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	33.1 (1.5)	34.2 (4.2)	35.0 (9.0)	35.9 (19.1)	36.8 (33.3)	37.2 (50.0)	na
Internet penetration rate (per 10,000 inhabitants)	12.5	19.4	22.7	33.2	42.3	66.6	na
Railway labour productivity (1989=100)	73.4	65.3	71.2	70.3	65.9	75.2	na
Residential electricity tariffs, USc kWh	na	na	3.5	3.8	5.2	5.2	na
Average collection rate, electricity (in per cent) <sup>2</sup>	110	112	na	85	95	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.2	2.4	2.5	2.5	na	na	na
EBRD index of infrastructure reform	2.0	2.7	2.7	2.7	2.7	2.7	3.0
Electric power	2.0	3.0	3.3	3.3	3.3	3.3	3.7
Railways	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	3.0	3.0	3.0	3.0	3.0	3.0	3.3
Water and waste water	1.0	2.0	3.0	3.0	3.0	3.0	3.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	34 (17)	34 (22)	35 (25)	35 (26)	34 (26)	35 (25)	na
Asset share of state-owned banks (in per cent)	56.4	50.5	19.8	19.9	14.1	0.4	na
Non-performing loans (in per cent of total loans)	11.8	17.5	10.9	7.9	10.4	4.4	na
Domestic credit to private sector (in per cent of GDP)	12.2	14.0	11.6	14.6	18.0	25.8	na
Stock market capitalisation (in per cent of GDP)	7.4	5.8	4.8	3.7	4.3	7.9	na
EBRD index of banking sector reform	2.7	2.7	3.0	3.0	3.3	3.3	3.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.3	2.3	2.3
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	7.1	8.1	7.9	8.0	8.4	na	na
Life expectancy at birth, total (years)	71.1	71.4	71.5	71.7	71.8	na	na
Basic school enrolment ratio (in per cent)	94.3	94.8	95.3	97.1	98.7	na	na

<sup>1</sup> The official 12.8 per cent poverty rate, reported in the Bulgaria 2001 Poverty Assessment published by the World Bank, is based on a different poverty line. The latter was fixed at two-thirds of the 1997 average per capita consumption, deflated by 2001 prices.

<sup>2</sup> Numbers greater than 100 per cent reflect collection of several years worth of payments.



	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> (Percentage change in real terms)							
GDP	4.0	2.3	5.4	4.0	4.8	4.3	5.5
Private consumption	2.6	9.3	4.9	4.5	3.9	6.8	na
Public consumption	23.4	4.1	13.3	4.7	6.2	4.9	na
Gross fixed capital formation	35.2	20.8	15.4	19.9	9.3	13.8	na
Exports of goods and services	-4.7	-5.0	16.6	8.5	6.2	8.0	na
Imports of goods and services	12.1	9.3	18.6	13.0	4.7	14.8	na
Industrial gross output	-5.8	-4.3	12.0	0.7	2.6	12.0	na
Agricultural gross output	-0.6	2.7	-9.1	-0.1	4.2	-1.4	na
<b>Employment</b> (Percentage change)							
Labour force (end-year)	-5.7	-2.7	-3.4	-0.2	-0.5	-0.4	na
Employment (end-year)	-7.4	-3.9	-2.7	-3.9	2.9	4.5	na
(In per cent of labour force)							
Unemployment (end-year)	16.0	17.0	16.4	19.5	16.8	12.7	na
<b>Prices and wages</b> (Percentage change)							
Consumer prices (annual average)	22.2	0.7	9.9	7.4	5.9	2.3	6.0
Consumer prices (end-year)	0.9	6.2	11.4	4.8	3.9	5.6	3.4
Producer prices (annual average)	17.1	4.4	17.3	7.4	3.4	5.0	na
Producer prices (end-year)	0.5	14.0	14.7	-3.3	6.3	4.3	na
Gross average monthly earnings in economy (annual average)	46.5	5.1	15.7	11.9	4.2	6.9	na
<b>Government sector</b> (In per cent of GDP)							
General government balance <sup>1</sup>	1.0	-0.9	-1.0	-0.9	-0.6	-0.4	-0.4
General government expenditure <sup>1</sup>	37.0	39.6	39.7	38.6	37.2	38.4	na
General government debt <sup>2</sup>	95.6	99.1	89.3	70.9	55.1	47.1	na
<b>Monetary sector</b> (Percentage change)							
Broad money (M2, end-year)	11.9	13.0	12.2	49.3	12.2	21.2	na
Domestic credit (end-year)	-3.4	3.9	31.0	26.0	27.4	33.9	na
(In per cent of GDP)							
Broad money (M2, end-year)	28.5	30.3	30.3	40.9	42.0	47.8	na
<b>Interest and exchange rates</b> (In per cent per annum, end-year)							
Base interest rate <sup>3</sup>	5.1	4.5	4.6	4.7	3.3	2.8	na
Interbank interest rate (up to 1 month)	2.5	2.9	3.0	3.7	2.5	1.1	na
Deposit rate (1 month)	3.3	3.3	3.1	2.9	2.8	2.8	na
Lending rate (less than 1 year)	13.3	14.1	11.5	11.1	9.4	9.1	na
(Leva per US dollar)							
Exchange rate (end-year) <sup>4</sup>	1.675	1.947	2.102	2.219	1.885	1.549	na
Exchange rate (annual average) <sup>4</sup>	1.760	1.836	2.123	2.185	2.077	1.733	na
<b>External sector</b> (In millions of US dollars)							
Current account	-62	-685	-701	-878	-679	-1,666	-1,990
Trade balance	-381	-1,081	-1,175	-1,566	-1,619	-2,474	-2,790
Merchandise exports	4,193	4,006	4,812	5,099	5,578	7,439	8,301
Merchandise imports	4,574	5,087	5,988	6,665	7,197	9,912	11,092
Foreign direct investment, net	537	789	1,003	641	876	1,398	2,000
Gross reserves, excluding gold (end-year)	2,679	2,900	3,460	3,591	4,407	6,291	na
External debt stock	10,274	10,204	11,202	10,616	11,245	13,032	na
(In months of imports of goods and services)							
Gross reserves, excluding gold (end-year)	5.4	5.3	5.4	5.0	5.8	6.1	na
(In per cent of exports of goods and services)							
Debt service	20.0	18.0	16.8	20.2	15.8	12.4	na
<b>Memorandum items</b> (Denominations as indicated)							
Population (end-year, million)	8.2	8.2	8.1	8.1	7.8	7.8	na
GDP (in millions of leva) <sup>4</sup>	22,421	23,790	26,753	29,618	32,324	34,410	38,489
GDP per capita (in US dollar)	1,548	1,582	1,551	1,679	1,984	2,531	na
Share of industry in GDP (in per cent)	22.3	25.1	25.8	25.2	24.5	26.2	na
Share of agriculture in GDP (in per cent)	16.8	14.5	12.3	12.1	11.0	10.0	na
Current account/GDP (in per cent)	-0.5	-5.3	-5.6	-6.5	-4.4	-8.4	-8.2
External debt - reserves (in US\$ million)	7,595	7,304	7,742	7,025	6,838	6,741	na
External debt/GDP (in per cent)	80.6	78.7	88.9	78.3	72.3	65.6	na
External debt/exports of goods and services (in per cent)	171.8	176.1	160.3	141.1	137.7	122.9	na

<sup>1</sup> General government includes the state, municipalities and extra-budgetary funds. In 2003 and 2004 general government expenditure includes capital transfers for about 0.4 per cent of GDP, which are classified below the line in the Budget Law. Excluding these extra expenditures, the fiscal balance would be fully balanced.

<sup>2</sup> From April 2001 direct debt to the Bulgarian National Bank (BNB) is excluded from domestic debt to avoid double reporting of IMF credit extended through the BNB.

<sup>3</sup> Effective interest rate at end-month, based on the average annual yield attained at three-month government securities primary actions.

<sup>4</sup> On 5 July 1999 the leva was re-denominated. The post-July rate is equal to 1,000 of the pre-July 1999 leva. All data are expressed in terms of post-5 July 1999 lev.

# Croatia

## Key challenges

Reform of the judiciary and public administration should be accelerated to meet EU standards.

Restructuring and privatisation of the remaining state-owned utilities, as well as the sale of small enterprises in the tourism sector, need to be accelerated.

Tight monetary policy and fiscal consolidation under the new IMF programme should help to lower the persistent external imbalances and create the conditions for sustainable growth.

Other priorities of judicial reform include improving the functioning of the land registry and reducing the backlog of outstanding cases involving land issues. Progress in these areas should be strengthened by the World Bank's Real Property Registration and Cadastre Project. The EU's Community Assistance for Reconstruction, Development and Stabilisation (CARDS) programme for 2004 is also providing €76 million of funding. These programmes are intended to strengthen the rule of law, as well as reform the public administration and the judiciary.

The government will present its EU pre-accession economic programme in December 2004. The programme is likely to include a comprehensive set of reforms intended to improve the business environment, remove administrative barriers, promote SME development and reduce the size of the shadow economy.

## Infrastructure

The sale of the government's remaining 7 per cent share in Croatian Telecom (HT) is expected to be completed by the end of 2005. In July 2003 parliament adopted a new telecommunications bill, which merged the Telecommunications Council and the Telecommunications Institute into a single regulatory agency. The agency was established in September 2004, after parliament nominated its five members. An international tender for a third mobile operator was launched in July 2004, after a delay of more than a year. Given the high mobile penetration rate (close to 60 per cent), this delay could make it increasingly difficult for the existing duopoly in the market to be challenged.

The privatisation of the Croatian Electricity Company (HEP) has been postponed until 2005. This is mainly because the electricity company needs to be unbundled and restructured prior to privatisation. However, HEP has announced a plan to reduce the workforce by 7 per cent by 2008. Electricity prices are expected to be unchanged in 2004. However, in 2005 they will be increased by 10 per cent with plans for a further 5 per cent rise in 2006. Full liberalisation of the electricity market is expected from 2007, assuming that the necessary legislation is adopted by the end of 2004.

## Financial sector

Following a successful round of acquisitions and mergers in 2003 and 2004, the first six banking groups now control over 80 per cent of total banking assets. The Unicredito/Allianz group holds about 26 per cent of the market, followed by Intesa-BCI which controls around 20 per cent through Privredna Banka Zagreb. The government has announced that it will not merge the two remaining state-owned banks – Croatia Banka and Croatian Post Bank – as previously intended. It will instead proceed with the privatisation of one of the two banks on a separate basis by end of June 2005. The Croatian Post Bank is expected to remain in state ownership and to be transformed in the medium term into an SME development bank. The regulatory and supervisory framework for banking supervision has been strengthened by the adoption of several by-laws in 2003 and 2004. The Croatian National Bank (CNB) also reorganised its Banking Supervisory department in early 2004 so that it can conduct on-site supervision. The government has appointed a working group to draft new laws on insurance and on investment funds, which it hopes will be adopted by end-2005.

## Country data

Population (in millions)	4.4
Area ('000 sq. km)	87.6
Official language	Croatian
GDP per capita in 2002 at current international US\$ (PPP)	US\$ 10,240
National currency	Kuna

## Progress in structural reform

### Liberalisation and privatisation

In June 2004 Croatia was given EU candidate status by the European Council in recognition of the political and economic progress made within the Stabilisation and Association Agreement. Negotiations for EU membership should commence in the first half of 2005.

The privatisation programme has had mixed success in 2004. A number of state-owned companies were privatised, while some other tenders were unsuccessful. In September 2004 the Croatian Privatisation Fund (CPF) appointed an adviser to oversee the privatisation of Suncari Hvar, the largest tourism company on the island of Hvar. The CPF received seven bids for the public-private partnership and the final tender decision is expected in November 2004. The first attempt to privatise Suncari Hvar in 2003 led to the dismissal of the CPF's management board, causing a slowdown in tourism privatisations. The CPF intends to complete all small-scale privatisations by June 2005. There are a number of strategic entities and utilities outside CPF's portfolio which are earmarked for privatisation. The government plans to sell at least 15 per cent of the oil company INA by end-2005 and also intends to formulate a plan by June 2005 for the privatisation of the insurance company CO.

### Business environment and competition

The Ministry of Justice has introduced a number of initiatives to improve the effectiveness of the judicial system. These include the establishment of a Judicial Academy, in cooperation with the Law School of Zagreb University and the Supreme Court. The Academy will provide training courses for judges and state attorneys. To reduce the backlog of court cases and to remove some of the burden from judges, the Ministry is also recruiting about 1,000 judicial advisers to prepare judicial decisions and handle the simplest cases.

## Macroeconomic performance

### Real economy

The economy grew by an estimated 4.3 per cent in 2003 and 3.8 per cent in the first half of 2004. Growth was supported by investment associated with ongoing industrial restructuring and by government-initiated projects in the road and housing construction sectors. Although private consumption has also increased, it has weakened over the past year. This reflects the slower growth of bank credit from the third quarter of 2003.

### Economic policies

In 2003 the general government deficit was 6.3 per cent, exceeding the target which had been agreed with the IMF by almost 2 per cent of GDP. The 2004 budget, including the supplementary information approved in mid-2004, targets a general government deficit of 4.5 per cent of GDP. However, during the first five months of the year, the general government deficit failed to reach its target. The IMF Board approved a new Stand-By Arrangement (SBA) in August 2004, which the authorities intend to treat as precautionary, as they are not planning to draw funds under the credit. The programme is intended to help the government with fiscal consolidation and the implementation of structural reforms during negotiations for EU membership.

The growth of domestic credit slowed to an estimated 9.4 per cent in the first quarter of 2004. This compares with 12 per cent at the end of 2003 and 28 per cent at the end of 2002. The slowdown was mainly due to the CNB's imposition of certain administrative measures on commercial banks. (These expired at the end of 2003.) In July 2004 the CNB also adopted measures aimed at curbing the growing foreign indebtedness of the banking sector. In particular, it increased the minimum level of foreign exchange reserves for commercial banks from 19 per cent to 24 per cent of the net increase of their foreign liabilities.

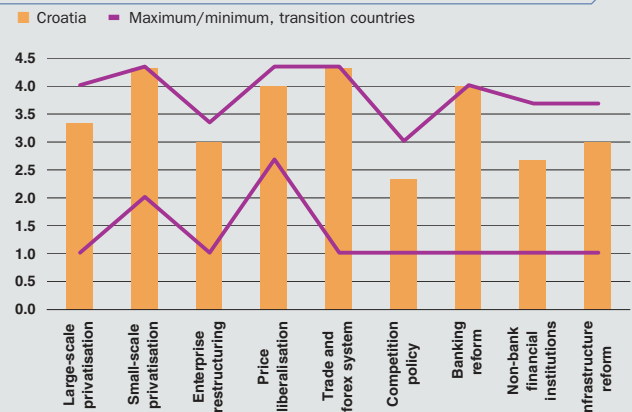
### External sector

The current account deficit was estimated at 6.1 per cent of GDP in 2003, down from 8.4 per cent in 2002. During the first seven months of 2004 there was a further improvement as a result of strong export performance and slower growth of imports. Gross external debt was estimated at US\$ 25.4 billion or 80 per cent of GDP in May 2004. This was just above the level of sustainable debt estimated by the IMF (77 per cent of GDP). The increase in the dollar value of the debt mainly reflects the weakening of the dollar, as most of Croatia's external debt is denominated in euros. However, some of the increase reflects a rise in borrowing abroad by commercial banks.

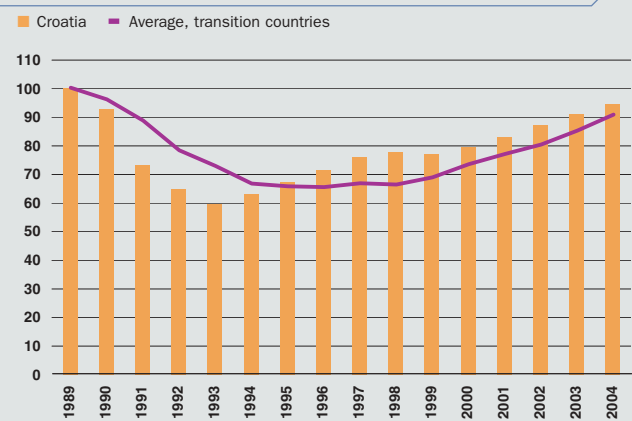
## Outlook and risks

Sustained growth is forecast for the medium term, assuming some improvement in the external environment. Some stimulus to exports is likely to arise following Croatia's entry into the Central Europe Free Trade Area (CEFTA) in March 2003. However, the competitiveness of Croatian export industries is lagging behind that of other countries in the region. The fiscal consolidation programme agreed with the IMF is expected to help the government strengthen fiscal discipline and reduce the external deficit and the level of external indebtedness.

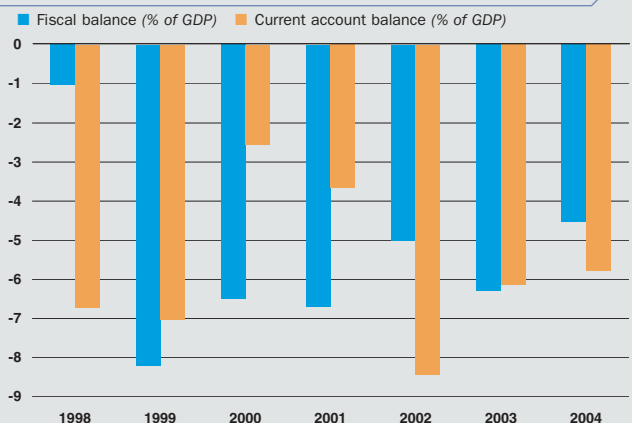
### Transition indicators, 2004



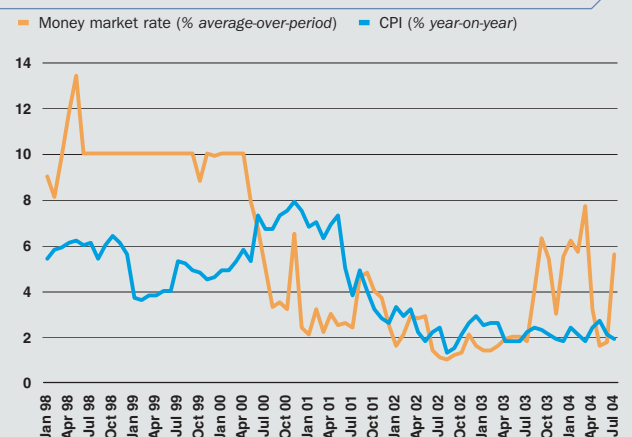
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method – MEBOs	Independent telecoms regulator – yes	Share of population living in poverty –
Interest rate liberalisation – full	Secondary privatisation method –	Separation of railway accounts – yes	<2 per cent (2000)
Wage regulation – no	vouchers	Independent electricity regulator – yes	Private pension funds – yes
	Tradability of land – full <sup>1</sup>		
Stabilisation	Enterprise and markets	Financial sector	
Share of general government tax revenue in GDP – 39.7 per cent	Competition office – yes	Capital adequacy ratio – 10 per cent	
Exchange rate regime – managed float		Deposit insurance system – yes	
		Secured transactions law – yes	
		Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	3.3	3.0	5.6	0.0	0.0	0.0	0.0
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	1.0	1.0	1.0	0.0
Share of trade with non-transition countries (in per cent)	64.9	69.8	68.9	73.0	72.6	74.2	na
Share of trade in GDP (in per cent)	61.2	60.7	67.0	68.6	68.7	71.1	na
Tariff revenues (in per cent of imports) <sup>2</sup>	7.7	7.8	6.1	4.4	2.4	1.9	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	4.0	4.0	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP) <sup>3</sup>	3.6	8.2	10.2	13.5	15.7	17.4	na
Private sector share in GDP (in per cent)	55.0	60.0	60.0	60.0	60.0	60.0	60.0
Private sector share in employment (in per cent)	54.0	58.0	56.0	58.0	58.0	60.0	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.3	3.3
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	7.5	10.1	11.4	16.7	19.0	19.7	na
Share of industry in total employment (in per cent) <sup>4</sup>	28.8	28.3	27.7	27.7	27.1	26.4	na
Change in labour productivity in industry (in per cent)	7.4	1.8	4.3	7.7	7.7	7.8	na
Investment/GDP (in per cent)	24.0	23.0	20.2	21.5	na	na	na
EBRD index of enterprise reform	2.7	2.7	2.7	2.7	2.7	2.7	3.0
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	34.8 (4.1)	36.5 (6.6)	36.5 (23.1)	40.7 (40.1)	41.7 (53.5)	43.3 (58.4)	na
Internet penetration rate (per 10,000 inhabitants)	21.1	31.9	37.9	50.3	67.8	na	na
Railway labour productivity (1989=100)	52.1	52.9	58.2	70.9	78.1	90.4	na
Residential electricity tariffs, USc kWh <sup>5</sup>	7.0	6.8	7.3	9.8	na	na	na
Average collection rate, electricity (in per cent) <sup>6</sup>	na	na	na	101	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.3	4.4	4.6	4.7	na	na	na
EBRD index of infrastructure reform	2.0	2.3	2.3	2.7	2.7	2.7	3.0
Electric power	2.3	2.3	2.3	3.0	3.0	3.0	3.0
Railways	2.3	2.3	2.3	2.3	2.3	2.3	2.7
Roads	2.3	2.3	2.3	2.3	2.3	2.7	2.7
Telecommunications	2.0	3.0	3.0	3.3	3.3	3.3	3.3
Water and waste water	2.3	3.0	3.0	3.3	3.3	3.3	3.3
<b>Financial sector</b>							
Number of banks (foreign-owned)	60 (10)	53 (13)	43 (21)	43 (24)	46 (23)	41 (19)	na
Asset share of state-owned banks (in per cent)	37.5	39.8	5.7	5.0	4.0	3.4	na
Non-performing loans (in per cent of total loans)	12.6	20.6	19.8	15.0	11.6	9.4	na
Domestic credit to private sector (in per cent of GDP)	26.6	22.1	27.8	33.7	44.0	48.5	na
Stock market capitalisation (in per cent of GDP)	14.5	14.0	14.5	16.5	15.8	19.2	na
EBRD index of banking sector reform	2.7	3.0	3.3	3.3	3.7	3.7	4.0
EBRD index of reform of non-bank financial institutions	2.3	2.3	2.3	2.3	2.7	2.7	2.7
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP) <sup>7</sup>	11.2	12.4	14.0	13.0	na	na	na
Life expectancy at birth, total (years)	na	na	73.3	73.5	73.8	na	na
Basic school enrolment ratio (in per cent)	82.8	80.7	82.5	95.2	95.7	na	na

<sup>1</sup> Land is tradable but the right to trade land applies to foreigners only on a reciprocity basis and foreigners cannot acquire certain types of land (including agricultural) from the state.

<sup>2</sup> Refers to all taxes on international trade.

<sup>3</sup> Excludes swaps with frozen currency deposits.

<sup>4</sup> Based on employment service and enterprise data according to NCEA classification standards.

<sup>5</sup> Refers to average retail tariff.

<sup>6</sup> Numbers greater than 100 per cent reflect collection of several years worth of payments.

<sup>7</sup> Refers to expenditures by the health insurance fund and expenditures by the central government on education.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> <i>(Percentage change in real terms)</i>							
GDP	2.5	-0.9	2.9	4.4	5.2	4.3	3.7
Private consumption	-0.6	-2.9	4.2	4.6	7.5	4.1	na
Public consumption	1.6	-1.0	-8.9	-4.3	-1.8	-0.3	na
Gross fixed capital formation	2.5	-3.9	-3.8	9.7	10.1	16.8	na
Exports of goods and services	3.9	0.7	12.0	8.1	1.3	10.1	na
Imports of goods and services	-4.9	-3.5	3.7	9.3	8.8	10.9	na
Industrial gross output	3.7	-1.4	1.7	6.0	5.4	5.0	na
Agricultural gross output	10.2	-3.5	2.8	8.7	na	na	na
<b>Employment</b> <sup>1</sup> <i>(Percentage change)</i>							
Labour force (end-year)	-1.5	-1.0	7.2	-5.6	2.7	-0.1	na
Employment (end-year)	-3.1	-3.4	4.1	-5.4	4.0	0.7	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	11.4	13.6	16.1	15.8	14.8	14.1	na
<b>Prices and wages</b> <i>(Percentage change)</i>							
Retail prices (annual average)	5.7	4.2	6.2	4.9	2.2	1.8	2.5
Retail prices (end-year)	5.4	4.4	7.4	2.6	2.9	2.2	2.2
Producer prices (annual average)	-1.2	2.6	9.7	3.6	-0.4	na	na
Producer prices (end-year)	-2.1	5.9	11.2	-3.1	0.2	na	na
Gross average monthly earnings in economy (annual average)	12.6	10.2	7.0	3.9	6.0	na	na
<b>Government sector</b> <sup>2</sup> <i>(In per cent of GDP)</i>							
General government balance	-1.0	-8.2	-6.5	-6.7	-5.0	-6.3	-4.5
General government expenditure	46.7	56.6	52.7	50.7	51.4	52.7	na
General government debt	38.8	50.1	53.4	54.9	57.5	57.5	na
<b>Monetary sector</b> <i>(Percentage change)</i>							
Broad money (M4, end-year)	13.0	-1.2	28.9	45.2	9.5	11.0	na
Domestic credit (end-year)	19.1	-1.5	8.2	20.9	27.6	12.4	na
<i>(In per cent of GDP)</i>							
Broad money (M4, end-year)	41.7	40.0	47.9	64.0	64.7	66.8	na
<b>Interest and exchange rates</b> <i>(In per cent per annum, end-year)</i>							
Refinancing rate (3 months)	10.5	11.6	7.0	4.3	2.7	1.2	na
Interbank interest rate (daily)	15.8	12.7	4.5	2.2	1.9	6.8	na
Deposit rate <sup>3</sup>	4.1	4.3	3.4	2.8	1.6	1.7	na
Lending rate <sup>3</sup>	16.1	13.5	10.5	9.5	10.9	12.0	na
<i>(Kuna per US dollar)</i>							
Exchange rate (end-year)	6.2	7.6	8.2	8.4	7.1	6.1	na
Exchange rate (annual average)	6.4	7.1	8.3	8.3	7.9	6.7	na
<b>External sector</b> <i>(In millions of US dollars)</i>							
Current account	-1,453	-1,397	-469	-726	-1,920	-2,098	-2,006
Trade balance	-4,071	-3,299	-3,204	-4,101	-5,649	-7,921	-8,317
Merchandise exports	4,581	4,395	4,567	4,759	5,004	6,285	6,599
Merchandise imports	8,652	7,693	7,771	8,860	10,652	14,206	14,917
Foreign direct investment, net	835	1,420	1,085	1,407	591	1,700	1,100
Gross reserves, excluding gold (end-year)	2,816	3,025	3,525	4,704	5,886	8,191	na
External debt stock	9,685	9,978	11,055	11,317	15,426	23,558	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	3.2	3.7	4.4	5.2	5.4	5.7	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	13.6	22.4	22.9	19.6	23.2	13.6	na
<b>Memorandum items</b> <i>(Denominations as indicated)</i>							
Population (end-year, million)	4.5	4.6	4.4	4.5	4.4	4.4	na
GDP (in billions of kuna)	137,604	141,579	152,519	165,639	179,390	193,067	205,747
GDP per capita (in US dollar)	4,805	4,371	4,206	4,458	5,138	6,518	na
Share of industry in GDP (in per cent)	21.1	20.7	20.7	20.7	19.8	na	na
Share of agriculture in GDP (in per cent) <sup>4</sup>	7.9	8.1	7.4	7.1	6.9	na	na
Current account/GDP (in per cent)	-6.7	-7.0	-2.5	-3.7	-8.4	-6.1	-5.8
External debt - reserves (in US\$ million)	6,869	6,953	7,530	6,612	9,540	15,367	na
External debt/GDP (in per cent)	44.8	50.1	60.0	57.0	67.7	81.8	na
External debt/exports of goods and services (in per cent)	113.3	122.9	127.6	117.5	145.9	158.0	na

<sup>1</sup> Based on labour force surveys.<sup>2</sup> Consolidated central government. Government expenditures include net lending.<sup>3</sup> Weighted average over all maturities.<sup>4</sup> Including hunting, forestry and fishing.



# Czech Republic

## Key challenges

Improvements in the relationship between public and private sectors are needed, including more transparency in public procurement and the provision of state aid, a strategy to limit conflicts of interest for public officials and an improved judiciary.

Lending to the enterprise sector remains limited, despite progress in the privatisation and restructuring of financial institutions and a satisfactory legal and regulatory environment.

Comprehensive fiscal reform is needed to bring the record government deficit and the growth in public debt under control.

agency. In February 2004 the authorities launched new investment incentives for the creation of technology centres and business support services aimed at foreign direct investments in high value-added sectors.

The investment promotion agency is being restructured into an economic development agency. It will offer support for large investors as well as small and medium-sized enterprises, for industrial restructuring and for job creation in the private sector. The number of self-employed people declined following the enactment of new legislation on tax and social contributions in January 2004, which increased their payment liabilities.

In November 2003 the parliament revised the legislation on public orders (which was enacted in May 2004). It removed provisions on the preferential treatment of domestic companies and on allowing some orders to be placed without a tender. However, public procurement is still not sufficiently transparent, particularly in smaller municipalities. The authorities in several municipalities are being investigated for their financial management and procurement practices.

The potential for corruption is partly linked to insufficient provisions for conflicts of interest in existing regulations. The lack of transparency and proper governance in the judiciary has also been criticised. This followed an alleged criminal conspiracy relating to a number of bankruptcy cases that involved participants from all levels of the public administration.

## Financial sector

Credit to the enterprise sector has declined over the past few years to below 20 per cent of GDP. In contrast, credit to households has boomed over the same period. This was partly due to banking sector reform and the transfer of non-performing corporate loans to the state. It was also because there has not been significant lending to enterprises. The regulation of the financial sector is in line with EU standards and interest rates have been low. At the same time the largest banks – all owned by foreign strategic investors for several years – have been increasingly able to offer the same range of financial products as those available in other market economies. Therefore, the main constraint on credit growth may not be the financial sector itself, but other factors. These may include the structure of the tax system, inadequate bankruptcy legislation, insufficient protection of creditor rights or crowding out by the high public debt, even though this has not yet led to higher interest rates.

Another reason for the limited credit creation by financial institutions may be the insufficient level of equity in local enterprises. The lack of exit options for private equity investors is one of the factors restricting the provision of equity capital for local companies. In June 2004 Zentiva, a large Czech-Slovak pharmaceutical company, became the first local private company to successfully raise capital on the Prague Stock Exchange. The development of the capital market may be further boosted by a new law on collective investments, enacted in May 2004. This allows the operation of property, hedge, risk-capital and other mutual funds.

## Country data

Population (in millions)	<b>10.3</b>
Area ('000 sq. km)	<b>78.9</b>
Official language	<b>Czech</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 15,780</b>
National currency	<b>Koruna (Crown)</b>

## Progress in structural reform

### Liberalisation and privatisation

The privatisation of significant state holdings in industrial companies progressed in the first half of 2004. In March the government approved the sale of a 46 per cent stake in the coal mining company OKD to its majority owner, Karbon Invest, for €68 million. It also approved the sale of a 50 per cent stake in another coal mining company, Sokolovska Uhelna, to its management for €78 million. In June 2004 the government sold its remaining 63 per cent holding in the petrochemical conglomerate Unipetrol to Poland's PKN for €479 million, subject to approval by the European Commission.

The privatisation of CEZ, the dominant energy company, and Czech Telecom, the main telecommunications operator, is envisaged in the medium term. In December 2003 the former strategic investors in Czech Telecom – Dutch KPN and Swiss Swisscom – sold their 27 per cent stake to private financial investors. In addition, Czech Telecom bought out AT&T and Verizon to take full control over its mobile subsidiary Eurotel. The eventual sale of Czech Telecom is expected to be easier without the need to accommodate several interested parties, as was the case in the past.

### Business environment and competition

The Czech Republic has accumulated more foreign direct investment (FDI) per capita than any other country in the region. This is due to an attractive package of investment incentives, its geographical location, a well educated and relatively cheap workforce, and the focused work of its investment promotion

## Macroeconomic performance

### Real economy

GDP growth was 3.1 per cent in 2003, driven mainly by investments and exports by foreign-owned companies. In the first half of 2004 growth accelerated to 3.7 per cent. Industrial production increased by 10 per cent during that period. Productivity increased more than 11 per cent while real wages grew by only 5 per cent.

Registered unemployment exceeded 10 per cent of the labour force in the first half of 2004. Job creation in competitive and expanding companies did not exceed job losses in old, declining industries. Meanwhile, small and medium-sized enterprises have been affected adversely by tax changes at the beginning of the year.

### Economic policies

The general government deficit increased to 13 per cent of GDP in 2003 from around 6.5 per cent in the previous two years. This increase was mostly due to one-off factors such as banking sector restructuring and the loss of a large arbitration case. The fiscal deficit is expected to decline in 2004.

Public debt more than doubled between 2000 and 2003 and stands at 37 per cent of GDP. To diversify the sources of debt financing, the government issued its first eurobond of €1.5 billion in June 2004. Inflation increased from 1.1 per cent at the end of 2003 to 3.4 per cent year-on-year in August 2004. This was mostly due to tax changes implemented earlier in the year. In June 2004 the Czech National Bank started increasing its interest rate for the first time in three years.

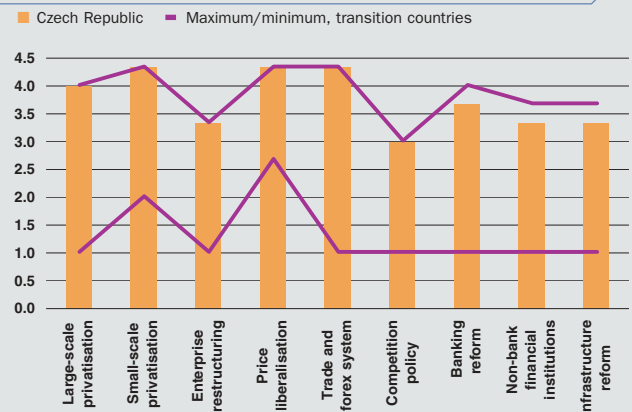
### External sector

The current account deficit increased to 6.2 per cent of GDP in 2003 from 5.6 per cent in 2002. This was despite a decline in the trade deficit to 2.7 per cent of GDP. The deficit on the income balance was mostly the result of high retained earnings and dividends in foreign-owned enterprises. At 4.6 per cent of GDP in 2003, it continued to be the largest component of the current account deficit. Net FDI declined sharply to €2.4 billion in 2003, compared with €8.3 billion the year before. The decline partly reflected the lack of significant privatisation inflows. It was also due to the exit of some foreign investors and a move towards more advanced, higher value-added FDI projects in the service sector, which tend to be less capital intensive.

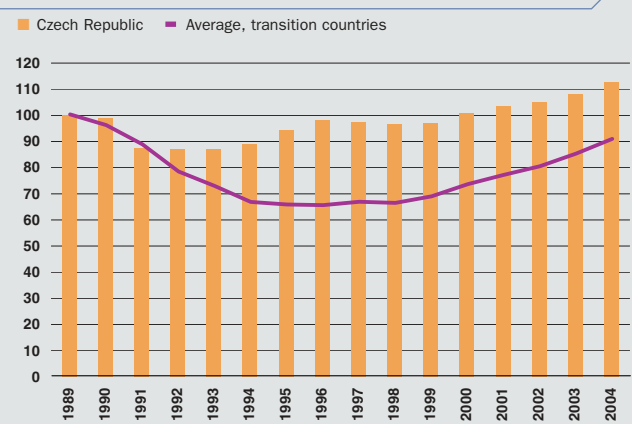
## Outlook and risks

Record FDI inflows in the past should result in higher GDP growth over the medium term, while consumer prices and the exchange rate are expected to remain stable. The slow speed of fiscal consolidation is the main macroeconomic risk factor. However, more determined action would necessitate large fiscal adjustments that would have a negative impact on GDP growth in the short term. The inability of the economy to create sufficient new jobs to lower unemployment is a sign of deeper structural problems. This is a potential risk factor as the Czech economy adjusts to the EU single market.

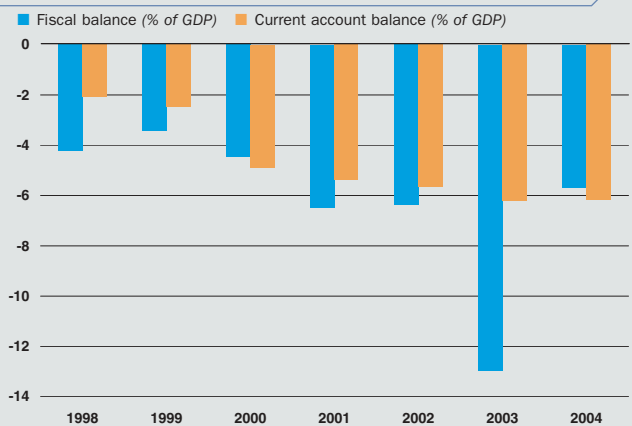
### Transition indicators, 2004



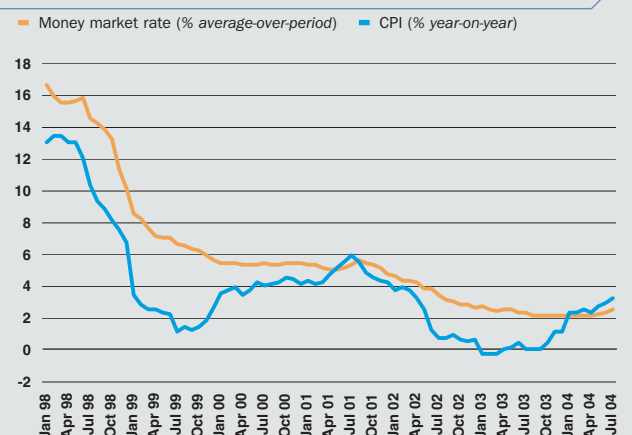
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes	Share of population living in poverty –
Interest rate liberalisation – full	<b>vouchers</b>	Separation of railway accounts – yes	<b>&lt;2 per cent (1996)</b>
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – yes
	<b>direct sales</b>		
Stabilisation	Tradability of land – full except	Financial sector	
Share of general government tax	<b>foreigners</b>	Capital adequacy ratio – <b>8 per cent</b>	
revenue in GDP – <b>38.6 per cent</b>		Deposit insurance system – yes	
Exchange rate regime – <b>managed float</b>	Enterprise and markets	Secured transactions law – yes	
	Competition office – yes	Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	13.3	13.3	13.3	12.4	12.4	10.9	10.9
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	74.3	73.9	76.8	79.9	80.7	80.6	na
Share of trade in GDP (in per cent)	89.3	92.3	110.0	114.7	106.9	111.0	na
Tariff revenues (in per cent of imports)	1.5	1.2	1.1	0.7	0.7	0.5	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	10.5	11.7	12.7	15.3	20.5	21.5	na
Private sector share in GDP (in per cent)	75.0	80.0	80.0	80.0	80.0	80.0	80.0
Private sector share in employment (in per cent)	60.6	65.0	65.0	70.0	70.0	70.0	na
<i>EBRD index of small-scale privatisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of large-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP) <sup>1</sup>	6.2	6.6	6.5	7.0	7.4	5.9	na
Share of industry in total employment (in per cent)	31.2	30.8	30.2	31.0	30.7	29.8	na
Change in labour productivity in industry (in per cent)	4.9	3.1	8.0	4.2	4.9	9.8	na
Investment/GDP (in per cent)	33.6	32.6	33.2	34.2	34.9	35.7	na
<i>EBRD index of enterprise reform</i>	3.0	3.0	3.3	3.3	3.3	3.3	3.3
<i>EBRD index of competition policy</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	36.3 (9.4)	37.1 (19.0)	37.8 (42.4)	37.8 (68.0)	36.2 (84.9)	36.0 (96.5)	na
Internet penetration rate (per 10,000 inhabitants)	84.0	118.6	154.5	210.8	223.2	274.4	na
Railway labour productivity (1989=100)	73.0	69.2	74.1	71.9	68.2	69.9	na
Residential electricity tariffs, USc kWh	5.0	5.1	5.7	7.3	9.0	8.4	na
Average collection rate, electricity (in per cent)	na	na	na	na	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.0	3.3	3.2	3.2	na	na	na
<i>EBRD index of infrastructure reform</i>	2.7	2.7	2.7	3.0	3.0	3.3	3.3
<i>Electric power</i>	2.0	2.0	2.0	3.0	3.0	3.3	3.3
<i>Railways</i>	2.3	2.3	2.3	2.3	2.3	3.0	3.0
<i>Roads</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Telecommunications</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>Water and waste water</i>	3.3	4.0	4.0	4.0	4.0	4.0	4.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	45 (25)	42 (27)	40 (26)	38 (26)	37 (26)	35 (26)	na
Asset share of state-owned banks (in per cent)	53.7	41.2	27.8	3.8	4.6	3.0	na
Non-performing loans (in per cent of total loans) <sup>2</sup>	22.7	24.5	20.4	14.1	8.5	5.0	na
Domestic credit to private sector (in per cent of GDP)	44.0	39.4	27.9	23.8	18.8	17.9	na
Stock market capitalisation (in per cent of GDP)	18.4	20.8	19.3	14.3	19.8	17.9	na
<i>EBRD index of banking sector reform</i>	3.0	3.3	3.3	3.7	3.7	3.7	3.7
<i>EBRD index of reform of non-bank financial institutions</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.3
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	9.0	9.0	8.9	9.2	9.7	10.7	na
Life expectancy at birth, total (years)	74.5	74.7	74.8	74.9	75.0	na	na
Basic school enrolment ratio (in per cent)	97.6	97.7	98.4	98.6	98.7	na	na

<sup>1</sup> Subsidies to enterprises and financial institutions, including the Czech Consolidation Agency.

<sup>2</sup> Excludes loans on the books of the former Konsolidacni Banka, banks in receivership and the loan of CSOB to Slovenska Inkasni.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> (Percentage change in real terms)							
GDP	-1.0	0.5	3.9	2.6	1.5	3.1	4.0
Private consumption	-1.8	1.9	2.9	2.8	2.7	4.9	na
Public consumption	-4.4	2.3	-1.0	5.3	4.5	2.2	na
Gross fixed capital formation	0.7	-1.0	4.9	5.4	3.4	7.4	na
Exports of goods and services	10.0	6.1	16.5	11.5	2.3	5.7	na
Imports of goods and services	6.6	5.4	16.0	13.0	4.9	7.9	na
Industrial gross output	2.8	-0.4	5.1	6.8	4.8	5.8	na
Agricultural gross output	-1.8	2.3	-4.5	2.5	-4.4	0.0	na
<b>Employment</b> (Percentage change)							
Labour force (end-year)	0.5	0.4	0.2	0.0	1.0	0.4	na
Employment (end-year)	-1.4	-2.1	-0.7	-0.1	0.8	-0.7	na
Unemployment (end-year)	6.5	8.7	8.8	8.1	7.3	7.8	na
<b>Prices and wages</b> (Percentage change)							
Consumer prices (annual average)	10.6	2.1	4.0	4.7	1.8	0.2	3.2
Consumer prices (end-year)	6.7	2.6	4.1	4.2	0.6	1.1	4.2
Producer prices (annual average)	4.9	1.0	4.9	2.9	-0.5	-0.3	na
Producer prices (end-year)	2.2	3.4	5.0	0.8	-0.7	0.9	na
Gross average monthly earnings in economy (annual average)	9.4	8.2	7.0	8.6	7.5	7.0	na
<b>Government sector</b> (In per cent of GDP)							
General government balance	-4.2	-3.4	-4.5	-6.5	-6.4	-13.0	-5.7
General government expenditure	38.4	39.0	40.4	41.6	43.9	44.1	na
General government debt	13.2	13.5	18.5	26.9	28.1	37.1	na
<b>Monetary sector</b> (Percentage change)							
Broad money (M2, end-year)	5.2	8.1	6.8	7.9	3.2	7.2	na
Domestic credit (end-year)	-3.6	-2.0	1.0	-5.3	-7.1	21.9	na
Broad money (M2, end-year)	65.3	67.8	68.8	68.9	68.2	69.7	na
<b>Interest and exchange rates</b> (In per cent per annum, end-year)							
2-week repo rate	9.5	5.3	5.3	4.8	2.8	2.0	na
3-month PRIBOR	10.1	5.6	5.4	4.7	2.6	2.1	na
Deposit rate <sup>1</sup>	8.1	4.5	3.4	3.0	2.2	1.5	na
Lending rate <sup>1</sup>	12.9	8.7	7.2	6.6	5.2	4.5	na
Exchange rate (end-year)	30.0	35.7	38.8	36.5	30.7	26.3	na
Exchange rate (annual average)	32.3	34.6	38.6	38.0	32.7	28.2	na
<b>External sector</b> (In millions of US dollars)							
Current account	-1,255	-1,462	-2,718	-3,273	-4,166	-5,570	-6,400
Trade balance	-2,603	-1,903	-3,131	-3,068	-2,179	-2,458	-2,400
Merchandise exports	25,853	26,265	29,052	33,378	38,319	48,599	51,000
Merchandise imports	28,456	28,167	32,183	36,446	40,497	51,058	53,400
Foreign direct investment, net	3,591	6,234	4,943	5,476	8,276	2,351	5,000
Gross reserves, excluding gold (end-year)	12,600	12,894	13,064	14,464	23,709	26,955	na
External debt stock	24,348	22,861	21,608	22,374	26,281	30,000	na
Gross reserves, excluding gold (end-year)	4.4	4.5	4.2	4.1	6.1	5.5	na
Debt service	15.3	15.0	10.1	6.8	6.6	5.3	na
<b>Memorandum items</b> (Denominations as indicated)							
Population (end-year, million)	10.3	10.3	10.3	10.3	10.3	10.3	na
GDP (in billions of korunas)	1,963	2,041	2,150	2,315	2,415	2,532	2,719
GDP per capita (in US dollar)	5,906	5,722	5,399	5,904	7,154	8,708	na
Share of industry in GDP (in per cent)	36.9	35.5	36.0	37.5	38.7	39.7	na
Share of agriculture in GDP (in per cent)	4.8	3.9	3.9	3.9	3.7	3.6	na
Current account/GDP (in per cent)	-2.1	-2.5	-4.9	-5.4	-5.6	-6.2	-6.2
External debt - reserves (in US\$ million)	11,748	9,967	8,544	7,910	2,572	3,045	na
External debt/GDP (in per cent)	40.0	38.7	38.8	36.8	35.6	33.4	na
External debt/current account revenues, excluding transfers (in per cent)	72.7	68.6	60.2	55.3	57.9	53.2	na

<sup>1</sup> Weighted average over all maturities.

# Estonia

## Key challenges

- Further reform of the energy sector is required, including restructuring, the strengthening of the regulatory framework and the opening of the market.
- With privatisation virtually complete, further improvements to the business environment, restructuring of some large-scale enterprises and attracting more foreign investment are needed to sustain productivity increases.
- Following entry into the Exchange Rate Mechanism II, macroeconomic policy should seek ways to reduce external vulnerability from continuing high current account deficits, while at the same time maintaining economic growth.

Within the legal system, amendments to the property law, which came into effect from July 2003, created a more advanced system to take security over intangible properties such as claims, accounts receivables and other rights. However, the scope and effect of these piecemeal reforms have proven limited in practice.

Regarding access to the EU structural funds, it will be necessary to ensure that co-financing is available when needed. Also, the authorities at all levels must be able to cope adequately with the substantial amount of administrative and reporting work required by the European Commission.

## Infrastructure

Following the adoption of the Electricity Market Act in February 2003, the Ministry of Economic Affairs started discussions on the possible unbundling of the vertically integrated Eesti Energia into separate companies. Although several options have been discussed since then, privatisation of parts of the new structure has been ruled out so far. The unbundling process started in April and July 2004 when Eesti Energia set up separate subsidiaries for the transmission network (OU Pohivork) and the distribution network (OU Jaotusvork) based on its existing business units. The Ministry had been considering whether splitting Eesti Energia into fully independent companies would be a feasible next step, but that looks increasingly unlikely. A related effect of the Electricity Market Act has been that Eesti Energia has started to separate its power generation and transmission tariffs and accounts.

At the beginning of 2004 the Ministry presented plans to open up the Estonian electricity market for competition sooner than originally envisaged. It aims to open the market for companies that consume over 20 GWh at the beginning of 2006. After that, the market for smaller consumers will be liberalised step-by-step, with retail clients free to choose from 2016. Meanwhile, Eesti Energia has announced a 15-year investment and renovation plan to ensure that it will be able to supply 85 per cent of the Estonian electricity demand by 2018. About half of the planned EEK 46.1 billion (€3 billion) investment will be spent on further modernisation of the oil shale industry.

## Social sector

Unemployment remains high in Estonia. Nevertheless, the rapid economic growth rates of the past two years reduced it gradually to 10 per cent at the end of 2003. Unemployment at the end of July 2004 was 8.8 per cent and is projected to end the year at 9.8 per cent. Estonia still suffers from a high degree of structural unemployment, especially in the north-eastern part of the country. Future employment growth will depend on sustained labour market flexibility, vocational retraining and other measures to reduce the apparent skills mismatch and the high number of long-term unemployed. Unemployment is especially high in the 15-24 age group, where 20.6 per cent were jobless at the end of 2003. A particular concern is that the proportion of Estonians without secondary education among 15-24 year olds increased from 39 per cent in 1997 to 52 per cent in 2003.

## Country data

Population (in millions)	1.4
Area ('000 sq. km)	45
Official language	Estonian
GDP per capita in 2002 at current international US\$ (PPP)	US\$ 12,260
National currency	Kroon

## Progress in structural reform

### Liberalisation and privatisation

In June 2004 the Estonian government rejected the offer of Finnish-Swedish conglomerate TeliaSonera to buy its remaining 27 per cent stake in Eesti Telekom. (Eesti Telekom is a holding company with two affiliated companies: the fixed-line operator and the mobile operator Eesti Mobiiltelefon – EMT.) The government, advised by McKinsey & Company, considered the offer of €500 million in cash for 51 per cent of Eesti Telekom to be too low and recommended the other shareholders not sell.

For five years until May 2004 the government had retained special “golden shares” in Eesti Telekom. Under an existing agreement, TeliaSonera, as a strategic investor, had preferential rights to buy an additional stake should the government sell more than 10 per cent in the company. TeliaSonera, which also holds strategic stakes in Lattelekom (Latvia) and Lietuvos Telekomas (Lithuania), acquired a 49 per cent stake in Eesti Telekom in 1991-93. It wants to raise this stake to at least 85 per cent, and preferably 100 per cent.

### Business environment and competition

Estonia remains one of the most open and competitive economies in the transition region. It was given high ratings in the World Economic Forum 2003-04 competition report. However, there remains room for further improvements in the business environment. There is a need to further stimulate the creation of small and medium-sized enterprises, to support productivity growth and to attract greenfield foreign direct investment (FDI).



## Macroeconomic performance

### Real economy

Economic growth accelerated towards the end of 2003, leading to an increase in real GDP of 5.1 per cent for the year as a whole. In 2004 internal demand and an accelerating expansion of exports have maintained high growth, which is projected at 5.5 per cent for the year. Employment growth, real wage increases and continuing rapid credit expansion are fuelling investment and private consumption. Domestic credit has risen on average by 27 per cent per year since 2000, resulting in a significant deepening of the banking system. Externally, the improving economic outlook for Estonia's main trading partners – Sweden and Finland – will contribute to the country's positive economic performance.

### Economic policies

Estonia has been showing an increasing surplus on its general government consolidated account since 2001 (ESA95 methodology). In 2003 the positive revenue performance, partly based on high revenues from corporate income taxes and VAT, led to a surplus of 3.1 per cent of GDP. The outlook for 2004 is positive as well, although the surplus is expected to decrease to 0.3 per cent of GDP. The IMF has urged the authorities to address the increased external vulnerability by tightening fiscal policies further.

In June 2004 the Estonian kroon was included in the Exchange Rate Mechanism II (ERM II). Estonia was allowed to join ERM II with its existing currency board arrangement, placing additional obligations on the European Central Bank (ECB). The currency board therefore remains the cornerstone of monetary policy and confidence in the system remains strong. Declining import and food prices brought average inflation in 2003 down to 1.3 per cent. However, inflation picked up significantly during the first half of 2004, mainly due to changes in fuel and sugar prices related to EU accession. For 2004 as a whole, consumer prices are expected to increase by up to 3.5 per cent.

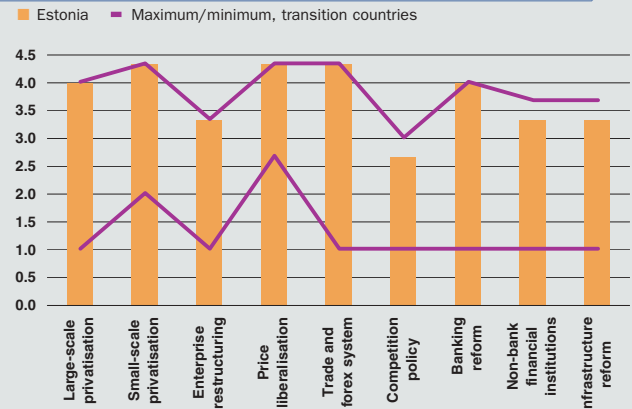
### External sector

The current account deficit increased further in 2003 to 13.2 per cent of GDP from 10.2 per cent in 2002. Moreover, it is forecast to improve only slightly in 2004 (to 11.1 per cent) and is likely to stay above 8 per cent of GDP in the foreseeable future. After a temporary drop in foreign direct investment coverage of the current account deficit in 2002, it improved during 2003 (to 62 per cent) and is expected to stabilise at about 57 per cent in 2004. External debt to GDP seems to have peaked in 2003 at around 70 per cent and, according to projections, will decrease slightly in 2004 to about 65 per cent.

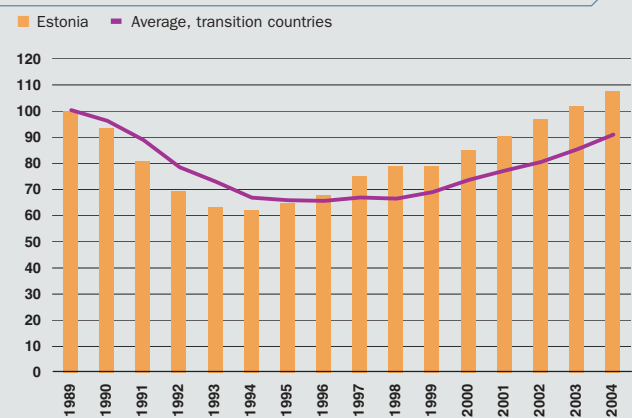
## Outlook and risks

Sustained growth combined with a real appreciation of the kroon is forecast in the coming years. However, the external position remains a considerable source of risk. As Estonia lacks an independent monetary policy, fiscal policy has to play the dominant role in reducing vulnerabilities. Continued fiscal austerity and, if appropriate, increased prudential regulation for sectors experiencing too rapid credit growth may help to restrain future wage and credit growth and keep the current account deficit from deteriorating further.

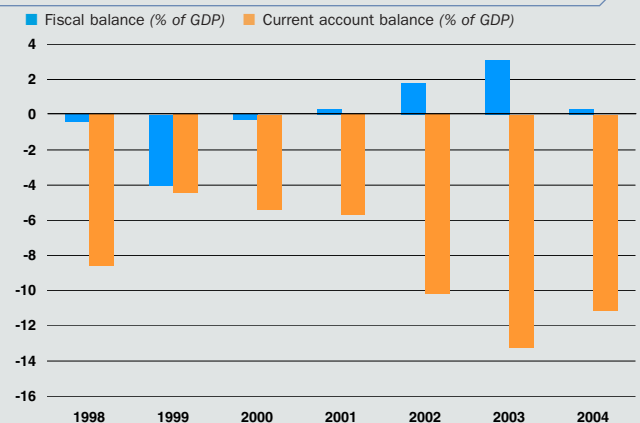
### Transition indicators, 2004



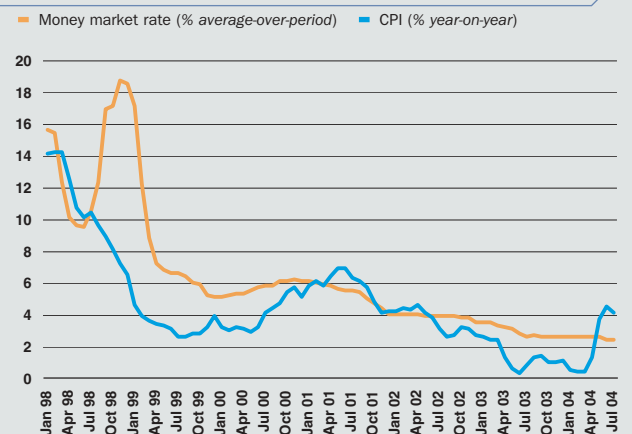
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



<b>Liberalisation</b>	<b>Privatisation</b>	<b>Infrastructure</b>	<b>Social sector</b>
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes	Share of population living in poverty –
Interest rate liberalisation – full	<b>direct sales</b>	Separation of railway accounts – yes	<b>5.2 per cent (1998)</b>
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – yes
	<b>vouchers</b>		
<b>Stabilisation</b>	Tradability of land – full	<b>Financial sector</b>	
Share of general government tax revenue in GDP – <b>32.8 per cent</b>		Capital adequacy ratio – <b>10 per cent</b>	
Exchange rate regime – <b>currency board in ERM II</b>	<b>Enterprise and markets</b>	Deposit insurance system – yes	
	Competition office – yes	Secured transactions law – yes	
		Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent) <sup>1</sup>	25.6	25.6	25.6	28.9	28.5	24.9	26.9
Number of goods with administered prices in EBRD-15 basket <sup>1</sup>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Share of trade with non-transition countries (in per cent)	64.3	76.3	84.7	74.3	71.8	72.0	na
Share of trade in GDP (in per cent)	116.7	105.2	135.2	125.8	115.8	118.8	na
Tariff revenues (in per cent of imports)	0.0	0.0	0.1	0.1	0.0	0.1	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.0	4.0	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	0.3	4.0	4.8	6.7	7.1	7.3	na
Private sector share in GDP (in per cent)	70.0	75.0	75.0	75.0	80.0	80.0	80.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
<i>EBRD index of small-scale privatisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of large-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	0.9	0.8	0.7	0.8	1.0	1.1	na
Share of industry in total employment (in per cent)	25.7	25.3	26.3	26.1	24.7	25.2	na
Change in labour productivity in industry (in per cent)	7.8	1.4	10.8	7.7	19.5	3.9	na
Investment/GDP (in per cent)	30.2	25.0	27.9	29.2	31.8	31.1	na
<i>EBRD index of enterprise reform</i>	3.0	3.0	3.0	3.3	3.3	3.3	3.3
<i>EBRD index of competition policy</i>	2.0	2.7	2.7	2.7	2.7	2.7	2.7
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	34.4 (17.0)	35.7 (26.8)	36.3 (38.7)	35.4 (45.5)	35.1 (65.0)	33.9 (72.3)	na
Internet penetration rate (per 10,000 inhabitants)	175.1	219.7	298.6	356.9	467.6	498.9	na
Railway labour productivity (1989=100)	98.6	129.3	154.5	179.1	232.4	267.3	na
Residential electricity tariffs, USc kWh	na	na	4.3	4.4	5.7	6.5	na
Average collection rate, electricity (in per cent)	99	na	na	97	90	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.3	2.5	2.7	2.8	na	na	na
<i>EBRD index of infrastructure reform</i>	3.0	3.0	3.3	3.3	3.3	3.3	3.3
<i>Electric power</i>	3.0	3.0	3.7	3.7	3.0	3.0	3.0
<i>Railways</i>	4.0	4.0	4.0	4.0	4.3	4.3	4.3
<i>Roads</i>	2.0	2.3	2.3	2.3	2.3	2.3	2.3
<i>Telecommunications</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>Water and waste water</i>	3.0	3.0	4.0	4.0	4.0	4.0	4.0
<b>Financial sector</b>							
Number of banks (foreign-owned) <sup>2</sup>	6 (3)	7 (3)	7 (4)	7 (4)	7 (4)	7 (4)	na
Asset share of state-owned banks (in per cent)	7.8	7.9	0.0	0.0	0.0	0.0	na
Non-performing loans (in per cent of total loans) <sup>3</sup>	4.0	2.9	1.3	1.2	0.8	0.5	na
Domestic credit to private sector (in per cent of GDP)	24.3	24.4	24.0	25.7	27.5	33.7	na
Stock market capitalisation (in per cent of GDP)	8.8	34.2	32.5	25.0	31.1	41.5	na
<i>EBRD index of banking sector reform</i>	3.3	3.7	3.7	3.7	3.7	3.7	4.0
<i>EBRD index of reform of non-bank financial institutions</i>	3.0	3.0	3.0	3.0	3.3	3.3	3.3
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	11.5	na	11.2	11.7	11.7	na	na
Life expectancy at birth, total (years)	69.8	70.6	70.6	70.6	70.6	na	na
Basic school enrolment ratio (in per cent)	99.2	100.9	102.8	103.8	104.4	na	na

<sup>1</sup> The high share can be explained by the inclusion of gasoline (on which there are excise taxes) in the calculations of the Statistical Office.

<sup>2</sup> Includes the Nordea Bank branch and investment banks.

<sup>3</sup> Changes in non-performing loans data compared with previous *Transition Reports* are due to the change of loan categories included in non-performing loans (see methodological notes).

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> (Percentage change in real terms)							
GDP	5.2	-0.1	7.8	6.4	7.2	5.1	5.5
Private consumption	5.2	-2.5	8.6	6.2	10.3	5.7	na
Public consumption	1.7	2.9	1.1	1.8	5.9	5.8	na
Gross fixed capital formation	14.0	-15.6	14.3	13.0	17.2	5.4	na
Exports of goods and services	12.0	0.7	28.3	-0.2	0.6	6.0	na
Imports of goods and services	12.3	-5.2	28.3	2.1	5.4	9.0	na
Industrial gross output	5.3	-4.6	13.9	7.6	14.5	7.9	na
Agricultural gross output	0.1	-2.4	-0.8	-5.4	0.1	-1.5	na
<b>Employment</b> <sup>1</sup> (Percentage change)							
Labour force (annual average)	-1.5	-1.9	0.4	-0.2	-1.2	1.2	na
Employment (annual average)	-1.7	-4.5	-1.2	0.9	1.4	1.5	na
Unemployment (annual average)	9.8	12.2	13.6	12.6	10.3	10.0	na
<b>Prices and wages</b> (Percentage change)							
Consumer prices (annual average)	8.1	3.3	4.0	5.8	3.6	1.3	3.5
Consumer prices (end-year)	4.2	3.8	5.0	4.2	2.6	1.2	5.6
Producer prices (annual average)	4.2	-1.2	4.9	4.4	0.4	0.2	na
Producer prices (end-year)	0.1	2.2	6.0	1.7	1.4	0.3	na
Gross average monthly earnings in economy (annual average)	15.4	7.7	10.6	12.1	11.6	9.4	na
<b>Government sector</b> <sup>2</sup> (In per cent of GDP)							
General government balance	-0.4	-4.0	-0.3	0.3	1.8	3.1	0.3
General government expenditure	38.0	40.4	36.3	35.0	35.5	36.0	na
General government debt	6.0	6.5	5.0	4.7	5.7	5.8	na
<b>Monetary sector</b> (Percentage change)							
Broad money (M2, end-year)	4.2	23.5	25.1	23.8	11.1	10.9	na
Domestic credit (end-year)	16.5	9.6	27.2	24.4	27.6	28.7	na
Broad money (M2, end-year)	27.2	32.3	35.5	39.1	38.8	39.9	na
<b>Interest and exchange rates</b> (In per cent per annum, end-year)							
Interbank interest rate (up to 30 days maturity)	na	na	na	na	na	na	na
Deposit rate (over 12 months) <sup>3</sup>	8.9	8.9	6.8	4.5	3.7	2.4	na
Lending rate (over 12 months) <sup>4</sup>	16.3	8.6	8.9	10.1	6.6	5.1	na
Exchange rate (end-year)	13.4	15.6	16.7	17.6	14.9	12.4	na
Exchange rate (annual average)	14.1	14.7	17.0	17.5	16.6	13.9	na
<b>External sector</b> (In millions of US dollars)							
Current account	-478	-247	-294	-339	-716	-1,199	-1,200
Trade balance	-1,115	-822	-767	-788	-1,089	-1,579	-1,861
Merchandise exports	2,690	2,515	3,309	3,359	3,530	4,602	5,062
Merchandise imports	3,806	3,337	4,076	4,148	4,619	6,181	6,923
Foreign direct investment, net	574	222	324	343	153	743	684
Gross reserves, excluding gold (end-year)	876	944	921	820	1,000	1,373	na
External debt stock <sup>5</sup>	2,924	2,879	3,007	3,279	4,704	6,401	na
Gross reserves, excluding gold (end-year)	2.2	2.7	2.2	1.9	2.1	2.2	na
Debt service	7.7	12.5	8.9	10.7	12.5	11.7	na
<b>Memorandum items</b> (Denominations as indicated)							
Population (end-year, million)	1.4	1.4	1.4	1.4	1.4	1.4	na
GDP (in millions of kroons)	78,341	81,640	92,717	104,338	116,869	125,832	137,399
GDP per capita (in US dollar)	4,036	4,054	3,995	4,384	5,188	6,720	na
Share of industry in gross value added (in per cent)	24.7	22.9	24.1	24.1	24.9	25.2	na
Share of agriculture in gross value added (in per cent)	6.0	5.6	5.1	4.7	4.4	4.0	na
Current account/GDP (in per cent)	-8.6	-4.4	-5.4	-5.7	-10.2	-13.2	-11.1
External debt - reserves (in US\$ million)	2,048	1,935	2,086	2,458	3,703	5,027	na
External debt/GDP (in per cent)	52.5	51.8	55.1	54.9	66.9	70.5	na
External debt/exports of goods and services (in per cent)	70.1	71.9	62.6	65.5	89.7	93.6	na

<sup>1</sup> Based on ILO methodology. Population aged 15-74.<sup>2</sup> General government includes the state, municipalities and extra-budgetary funds.  
General government expenditure includes net lending.<sup>3</sup> Weighted average annual interest rate on time deposits.<sup>4</sup> Weighted average annual interest rate on kroon loans.<sup>5</sup> The debt data are from the Bank of Estonia and include non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

# FYR Macedonia

## Key challenges

A sustained effort to improve the business environment is needed through reduced bureaucracy, faster judicial reform, improved corporate governance standards and better access to finance.

Further regulatory reform and commercialisation in key utilities would help to attract the investment needed to modernise the country's infrastructure.

Growth remains sluggish, especially in the industrial sector, emphasising the need to create more opportunities for entrepreneurship and private sector development.

However, major challenges remain, including the need to reform the judiciary and strengthen the fight against corruption. The independent anti-corruption commission, which was established in October 2002, produced an action plan in June 2003. In August 2004 the commission criticised the government for its lack of cooperation in certain areas of investigation.

## Infrastructure

The law on the transformation of the national electricity company ESM (Electric Power Company of Macedonia) was approved by parliament in March 2004. Restructuring of the company through unbundling, in preparation for eventual privatisation, is under way. The separation of the transmission system operator from the generation/distribution company is scheduled for completion by the end of 2004. Amendments to the energy law are expected to be adopted in the second half of 2004. The government is also considering new social safety measures in the energy sector, based on an expanded study of energy affordability commissioned by the EBRD.

A restructuring programme for the railways was agreed with the World Bank in spring 2003. This included debt rescheduling, labour layoffs and the division and commercialisation of the company. Initial progress was slow, but proposals on debt and on employment levels were put forward in spring 2004. At the municipal level, in line with the Ohrid Framework Agreement, new legislation proposed by the government will allow municipalities from 2005 to substantially increase their local budgets and, eventually, obtain borrowing rights. The government is also preparing new regulations for the water sector and a new law is expected by the end of 2004.

## Financial sector

During the past year banking supervision standards were reinforced. Existing legislation was amended to extend supervisory powers and tighten licensing requirements. However, the banking sector is dominated by the three largest banks and by the low level of financial intermediation and competition. Nevertheless, new products are slowly being developed. The proportion of non-performing loans at the end of 2003 was 15.1 per cent. Foreign ownership accounted for 48.6 per cent of total bank capital at the end of 2003.

The development of non-bank financial institutions is still at an early stage. Although the basic legal foundations are in place, there have been delays in establishing more comprehensive regulatory and supervisory frameworks. The implementation capacity of the supervising authorities is weak, but is nevertheless improving. Activity on the stock market rose significantly in 2003, albeit from a low base. Total turnover and market capitalisation increased by 24 per cent and 22 per cent respectively. Activity on the stock exchange has been strengthened by the introduction of trading in short-term government securities from May 2004. A tender for two second-tier, mandatory, fully funded pension funds was launched in July 2004.

## Country data

Population (in millions)	<b>2.0</b>
Area ('000 sq. km)	<b>26</b>
Official language	<b>Macedonian</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 6,470</b>
National currency	<b>Denar</b>

## Progress in structural reform

### Liberalisation and privatisation

The Stabilisation and Association Agreement with the EU entered into force on 1 April 2004. The European Commission's annual report on the Stabilisation and Association Process noted that EU-oriented reforms in FYR Macedonia had accelerated over the past year. However, it concluded that resources devoted to the process were insufficient. Meanwhile, the government submitted a formal application in March 2004 for membership of the EU. It also applied subsequently for membership of the Central Europe Free Trade Area (CEFTA).

Significant progress has been made in completing the privatisation programme and dealing with loss-making enterprises. The plans for 32 out of the 40 enterprises identified for sale or closure under the World Bank FESAL II programme had been completed by the end of 2003. Further progress was made with the remaining state-owned companies during the first half of 2004. However, the state retains some shares in over 100 companies. The Privatisation Agency, which the government had originally intended to close by the end of March 2004, will remain open until the end of the year and will continue to sell state shares through the stock exchange.

### Business environment and competition

Efforts to improve corporate governance and enhance fiscal discipline in the enterprise sector have advanced over the past year. The sale or closure of persistent loss-making companies has helped to bring the government's fiscal accounts closer to balance. The bankruptcy law was modified in March 2004 and compares well with equivalent legislation in neighbouring countries.

## Macroeconomic performance

### Real economy

Real GDP growth rose by more than 3 per cent in 2003. However, preliminary estimates for the first half of 2004 suggest that the original target for the year of 4 per cent growth will be difficult to achieve. Industrial output was reported to have fallen dramatically in this period, although this was largely attributable to the temporary closure of several large enterprises, including the steel company Balkan Steel. This company has since reopened following its acquisition by the LNM group in July 2004. Other economic indicators are generally positive and point to modest growth this year. Nevertheless, there is little prospect of a significant reduction in the unemployment rate which, at over 30 per cent of the labour force, is one of the highest in the region.

### Economic policies

The macroeconomic framework is one of the most stable among all transition countries. Inflation has been at low levels for many years and inflationary targets are anchored firmly within the Central Bank's exchange rate policy of a de facto near-peg of the denar to the euro. The government has also achieved significant success in its implementation of fiscal policy over the past year. Substantial fiscal consolidation was achieved during 2003, with a major reduction in the general government deficit to 1.6 per cent of GDP (excluding foreign-financed projects). Further cuts in expenditure are expected in 2004, partly through a planned 4 per cent reduction in public sector employment.

### External sector

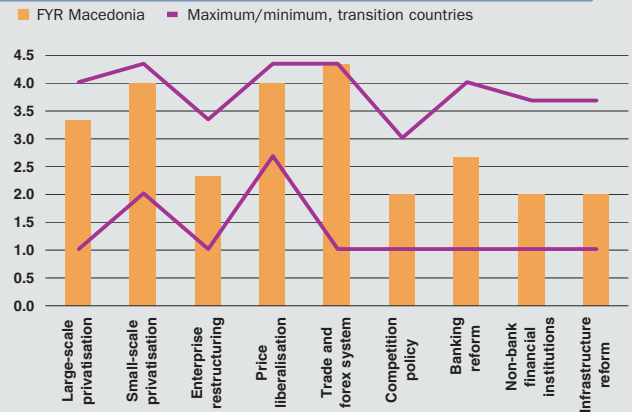
FYR Macedonia continues to run large trade and current account deficits, with the latter close to 6 per cent of GDP in 2003. Exports to some markets were disrupted by the crisis in 2001 and have not yet fully recovered. However, the country's external debt level (public and private) is moderate at less than 40 per cent of GDP. Debt servicing is likely to stay at around 14 to 15 per cent of exports of goods and services in the short term. Foreign direct investment remains at low levels as investors continue to be deterred by the small market size and perceived risk. However, the country received a boost in July 2004 when it was rated BB+/B by Standard and Poor's.

## Outlook and risks

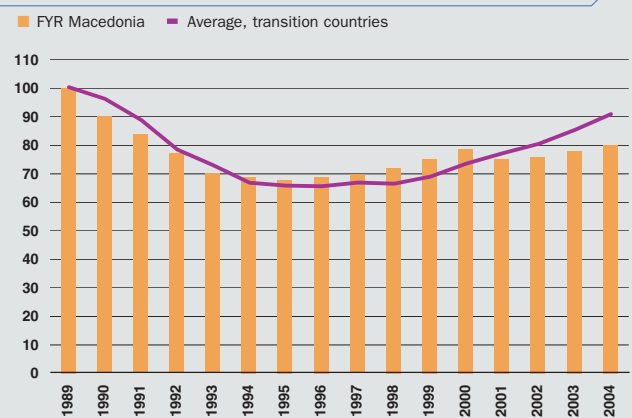
Annual output growth in the medium term is likely to remain positive. However, a sustained period of rapid, robust expansion will only come about if the pace of reform accelerates and regional stability is maintained. FYR Macedonia's application for EU membership is an important step forward. Should a positive response be forthcoming, this could reinforce the commitment to reform, as it has in other applicant countries from the region.

One area to be monitored is the exchange rate peg. This will probably be maintained for the short term, although more flexibility may be permitted over the medium term. The main risk facing the country is the possibility of renewed tensions over the application of the Ohrid Framework Agreement that put an end to the inter-ethnic conflict in 2001.

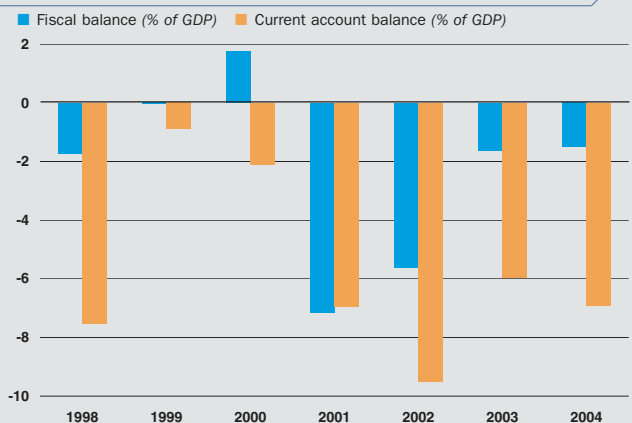
### Transition indicators, 2004



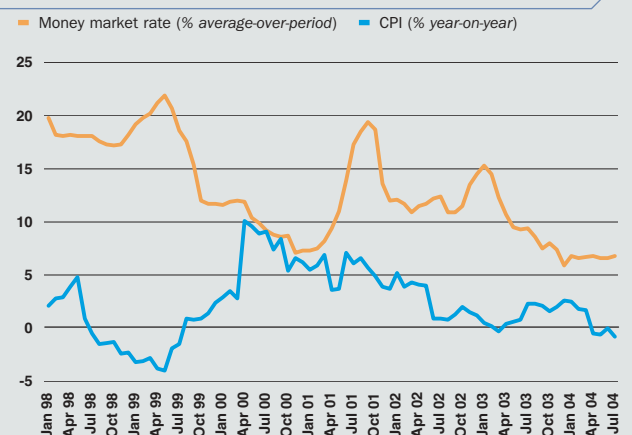
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation





<b>Liberalisation</b>	<b>Privatisation</b>	<b>Infrastructure</b>	<b>Social sector</b>
Current account convertibility – full	Primary privatisation method – <b>MEBOs</b>	Independent telecoms regulator – <b>no</b>	Share of population living in poverty – <b>4 per cent (1998)</b>
Interest rate liberalisation – full	Secondary privatisation method – <b>direct sales</b>	Separation of railway accounts – <b>no</b>	Private pension funds – <b>no</b>
Wage regulation – <b>no</b>	Tradability of land – <b>limited de jure</b>	Independent electricity regulator – <b>yes</b>	
<b>Stabilisation</b>	<b>Enterprise and markets</b>	<b>Financial sector</b>	
Share of general government tax revenue in GDP – <b>31.2 per cent</b>	Competition office – <b>no</b>	Capital adequacy ratio – <b>8 per cent</b>	
Exchange rate regime – <b>de facto fixed to euro</b>		Deposit insurance system – <b>yes</b>	
		Secured transactions law – <b>yes</b>	
		Securities commission – <b>yes</b>	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	19.6	19.5	11.9	8.3	10.9	13.4	1.5
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	1.0	1.0	1.0	1.0	0.0
Share of trade with non-transition countries (in per cent)	83.1	84.7	63.4	57.6	56.6	68.7	na
Share of trade in GDP (in per cent)	86.6	78.3	92.9	82.5	79.9	76.2	na
Tariff revenues (in per cent of imports)	6.9	8.7	5.8	5.3	5.1	5.5	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	4.0	4.0	4.0	4.0	4.0	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	na	na	na	na	na	na	na
Private sector share in GDP (in per cent)	55.0	55.0	55.0	60.0	60.0	60.0	65.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
<i>EBRD index of small-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.3
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	1.3	1.2	1.4	1.4	1.9	na	na
Share of industry in total employment (in per cent)	28.2	27.7	27.1	26.5	24.8	23.2	na
Change in labour productivity in industry (in per cent)	-0.2	0.7	1.3	-12.1	8.3	10.1	na
Investment/GDP (in per cent)	22.3	19.7	21.4	18.3	na	na	na
<i>EBRD index of enterprise reform</i>	2.0	2.0	2.3	2.3	2.3	2.3	2.3
<i>EBRD index of competition policy</i>	1.0	1.0	2.0	2.0	2.0	2.0	2.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	21.9 (1.5)	23.4 (2.4)	25.5 (5.7)	26.4 (10.9)	27.1 (17.7)	27.5 (20.5)	na
Internet penetration rate (per 10,000 inhabitants)	5.6	11.2	7.9	12.7	15.3	17.3	na
Railway labour productivity (1989=100)	68.7	66.7	89.7	78.9	59.2	67.2	na
Residential electricity tariffs, USc kWh <sup>1</sup>	3.7	3.3	3.5	4.1	4.7	na	na
Average collection rate, electricity (in per cent)	89	87	60	80	75	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	na	na	na	na	na	na	na
<i>EBRD index of infrastructure reform</i>	1.7	1.7	2.0	2.0	2.0	2.0	2.0
<i>Electric power</i>	2.0	2.0	2.3	2.3	2.3	2.3	2.3
<i>Railways</i>	2.3	2.0	2.0	2.0	2.0	2.0	2.0
<i>Roads</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Telecommunications</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Water and waste water</i>	1.0	1.0	2.0	2.0	2.0	2.0	2.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	24 (6)	23 (5)	22 (7)	21 (8)	20 (7)	21 (8)	na
Asset share of state-owned banks (in per cent)	1.4	2.5	1.1	1.3	2.0	1.8	na
Non-performing loans (in per cent of total loans) <sup>2</sup>	50.3	62.6	46.5	44.4	35.7	34.9	na
Domestic credit to private sector (in per cent of GDP)	17.7	10.4	10.5	12.8	14.2	14.9	na
Stock market capitalisation (in per cent of GDP)	0.2	0.2	0.2	1.3	4.7	7.6	na
<i>EBRD index of banking sector reform</i>	2.7	2.7	2.7	2.7	2.7	2.7	2.7
<i>EBRD index of reform of non-bank financial institutions</i>	1.7	1.7	1.7	1.7	1.7	1.7	2.0
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	na	72.5	72.8	73.1	73.4	na	na
Basic school enrolment ratio (in per cent)	98.8	99.6	100.1	98.6	97.1	na	na

<sup>1</sup> Refers to average retail tariff.<sup>2</sup> Includes loans of banks under forced administration.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>	<i>(Percentage change in real terms)</i>						
GDP	3.4	4.3	4.5	-4.5	0.9	3.1	2.5
Industrial gross output	4.5	0.0	-0.1	-6.2	-5.3	3.0	na
Agricultural gross output	3.2	0.8	1.0	-11.1	na	na	na
<b>Employment</b>	<i>(Percentage change)</i>						
Labour force (end-year)	2.9	-2.1	0.6	3.9	na	na	na
Employment (end-year)	5.4	1.0	0.9	8.9	-6.3	na	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	34.5	32.4	32.2	28.9	31.9	na	na
<b>Prices and wages</b>	<i>(Percentage change)</i>						
Consumer prices (annual average)	0.5	-1.3	6.6	5.2	2.4	1.1	2.8
Consumer prices (end-year)	-2.4	2.3	6.1	3.6	1.1	2.5	3.3
Producer prices (annual average)	4.0	-0.1	8.9	-1.2	na	na	na
Producer prices (end-year)	-0.2	4.2	7.9	-2.5	1.1	na	na
Gross average monthly earnings in economy (annual average)	3.7	2.9	5.5	3.6	6.9	na	na
<b>Government sector<sup>1</sup></b>	<i>(In per cent of GDP)</i>						
General government balance	-1.7	0.0	1.8	-7.2	-5.6	-1.6	-1.5
General government expenditure	35.0	35.4	34.4	41.1	40.5	34.7	na
<b>Monetary sector</b>	<i>(Percentage change)</i>						
Broad money (M2, end-year)	14.4	29.7	24.4	66.3	-8.0	18.4	na
Domestic credit (end-year)	-31.7	12.8	-10.7	-11.5	28.8	2.7	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	13.3	16.1	17.7	29.8	26.3	29.9	na
<b>Interest and exchange rates</b>	<i>(In per cent per annum, end-year)</i>						
Basic rate of the National Bank <sup>2</sup>	8.9	8.9	8.9	10.7	10.7	7.0	na
Interbank interest rate	18.1	11.6	7.2	11.9	14.4	5.8	na
Deposit rate	11.7	11.3	10.7	10.0	9.2	6.7	na
Lending rate <sup>3</sup>	21.0	20.0	19.0	19.2	17.7	14.5	na
	<i>(Denars per US dollar)</i>						
Exchange rate (end-year)	51.8	60.3	66.3	69.2	58.6	49.1	na
Exchange rate (annual average)	54.5	56.9	65.9	68.0	64.3	54.3	na
<b>External sector</b>	<i>(In millions of US dollars)</i>						
Current account	-269	-33	-75	-239	-360	-279	-356
Trade balance	-515	-496	-690	-527	-803	-852	-860
Merchandise exports	1,292	1,190	1,321	1,155	1,113	1,359	1,489
Merchandise imports	1,807	1,686	2,011	1,682	1,916	2,211	2,349
Foreign direct investment, net <sup>4</sup>	118	32	176	439	77	94	150
Gross reserves, excluding gold (end-year)	304	469	714	775	735	903	na
External debt stock	1,437	1,490	1,488	1,508	1,635	1,813	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	1.8	2.9	3.8	4.8	4.0	4.3	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	10.1	13.7	13.0	19.3	16.4	12.2	na
<b>Memorandum items</b>	<i>(Denominations as indicated)</i>						
Population (end-year, million)	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in billions of denars)	195	209	236	234	244	254	260
GDP per capita (in US dollar)	1,790	1,837	1,793	1,718	1,896	2,341	na
Share of industry in GDP (in per cent)	19.0	18.4	18.1	17.5	na	na	na
Share of agriculture in GDP (in per cent)	11.4	11.0	10.0	9.8	na	na	na
Current account/GDP (in per cent)	-7.5	-0.9	-2.1	-6.9	-9.5	-6.0	-6.9
External debt - reserves (in US\$ million)	1,133	1,021	774	733	900	910	na
External debt/GDP (in per cent)	40.1	40.6	41.5	43.9	43.1	38.7	na
External debt/exports of goods and services (in per cent)	99.7	101.9	91.0	107.9	119.5	108.0	na

<sup>1</sup> General government includes the state, municipalities and extra-budgetary funds, and excludes foreign-financed projects.

<sup>2</sup> Weighted interest rate of credits sold at auction (7-day maturity). The figure for 2000 is from the October auction, the last one of the year.

<sup>3</sup> Mid-point rates for short-term lending to all sectors.

<sup>4</sup> The large increase in 2001 is mainly due to the sale of a majority stake in the fixed-line telephone company.

# Georgia

## Key challenges

- Continued efforts to improve the business environment, including strengthening the state institutions and reducing corruption, are essential but should respect the rule of law.
- To accelerate enterprise restructuring and attract foreign investment, the authorities need to implement the large-scale privatisation programme in a transparent manner.
- The fiscal position could be strengthened by further improvements to the tax administration and the management of public expenditure. These measures, together with bilateral debt restructuring by the Paris Club, would help to ensure debt sustainability over the medium term.

### Country data

Population (in millions)	4.6
Area ('000 sq. km)	70
Official language	Georgian
GDP per capita in 2002 at current international US\$ (PPP)	US\$ 2,260
National currency	Lari

## Progress in structural reform

### Liberalisation and privatisation

Large-scale privatisation has stalled after significant political developments in the country. Attempts to relaunch the privatisation tender of the telecommunications operator, Telecom Georgia, have again been delayed. In June 2004 the Tbilisi municipality cancelled the tender awarding management of Tbilisi water utility – JSC Tbultskalkanali – to Compagnie Generale de Eaux of France. This was due to the lack of legal information about the tender process.

Progress with the privatisation of the remaining large public enterprises depends on resolving issues related to indebtedness, restructuring and the vested interests of the entrenched groups involved. Some positive developments have taken place. These include the establishment of an Enterprise Management Agency, under the auspices of the Ministry of Economy, which will focus on the management of public enterprises. In addition, the government has recently announced a programme for the privatisation of 372 non-strategic companies over the next 18 months.

### Business environment and competition

Positive steps have been taken by the new government to improve the business environment. These include strengthening the fight against corruption, tackling administrative inefficiency, improving the security situation, increasing tax collection rates and preparing a new tax code. Investigations by law enforcement bodies into several cases of large-scale fraud and corruption

have been launched and a government anti-corruption action plan is being prepared. A major reform of the civil service is seen as an important measure to combat corruption. The government's initial proposals include a reduction of up to 40 per cent of the size of the public bureaucracy.

### Infrastructure

The energy sector continues to suffer from chronic illiquidity, caused by theft, corruption and non-payment. Meanwhile under-investment has left the networks in serious need of repair. During the first half of 2004 the government took a number of measures to improve payment discipline, strengthen legislation to reduce the theft of electric power, and to tackle other corrupt practices. These actions had an immediate and significant effect on cash flows within the sector. By the end of June collection rates had increased to an average of 40 per cent, compared with 28 per cent during 2003.

An 18-month action plan for the reform of the power sector, designed with support from the World Bank, was approved by the government in July 2004. The main priorities include infrastructure renovation, improvements in generation and transmission, and reductions of technical loss and theft. A debt resolution agency is being established to resolve the problems of the outstanding indebtedness within the sector.

The government has also appointed new members to the Georgian National Energy Regulatory Commission (GNERC). A number of bilateral donors, as well as the World Bank, are assisting with their training and also with the development and implementation of an improved tariff methodology. The introduction of the new tariff system based on consumption, which was delayed in 2003, is envisaged for November 2004. In addition, the Ministry of Energy is preparing for the privatisation of the electricity generating companies in 2005.

### Financial sector

Financial sector reform and development have significantly progressed during the past two years. The total assets of the banking sector have increased from 13 per cent to 16 per cent of GDP during 2001-03. Financial intermediation to the private sector has increased from 7 per cent to 9.5 per cent of GDP during the same period, and the number of banks had fallen to 23 by June 2004. Despite this progress, many banks lack liquidity and remain undercapitalised.

The National Bank of Georgia (NBG) has taken steps to strengthen banking supervision and regulation, and to promote consolidation. In January 2004 the NBG announced a gradual increase in the capital requirements from the current level of GEL 5 million (€1.9 million) to GEL 12 million (€4.6 million) by 2008. This was followed by the introduction of stricter limits on single party borrowing and connected lending at the beginning of the year.

The development of the non-bank financial sector remains at an early stage. A law on leasing was approved in 2003, but four leasing companies operating in the market have yet to be regulated.

## Macroeconomic performance

### Real economy

GDP rose by an estimated 9.4 per cent in the first half of 2004 after an 8.6 per cent increase during 2003. Industrial activity associated with the construction of the Baku-Tbilisi-Ceyhan (BTC) pipeline continued to boost growth in the construction and communications sectors, where output increased by almost 21 per cent and 38 per cent respectively during the first half of the year. Industrial output rose by 16.4 per cent, reflecting strong growth in the refining, extraction and manufacturing sectors. This increase in output was more than sufficient to offset a fall in agricultural output owing to unfavourable weather conditions.

### Economic policies

The government's efforts to fight corruption and reform tax administration have shown some encouraging results. In the first half of 2004 overall government revenues increased by 56 per cent year-on-year, partly reflecting a 37 per cent rise in tax revenues over the same period. The stronger revenue base allowed the government to reduce wage and pension arrears by about 30 per cent.

The NBG intervened in the foreign exchange market to offset the impact of the increased demand for domestic currency, which was partly caused by the implementation of the government's measures against tax evasion. However, the lari appreciated by 7.5 per cent during the first half of the year. Inflation has remained in the range of 5–6 per cent during this period.

### External sector

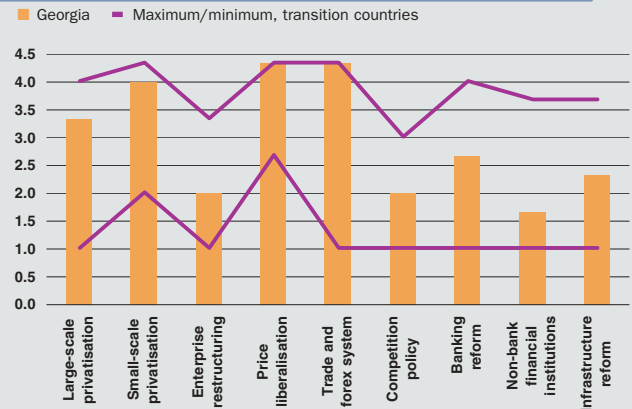
There was a sharp deterioration in the trade account in the first half of 2004, compared with a year earlier. Although exports rose due to strong demand from Turkey and Russia (Georgia's main export partners), there was also a large increase in imports of energy and capital goods. This was mainly related to the construction of the BTC pipeline.

Georgia remains heavily dependent on financing from international financial institutions (IFIs). However, the burden of servicing the large external debt has been lowered in the short term, following the agreement with the Paris Club in July 2004. The Paris Club agreed to reschedule Georgia's bilateral debt due in 2004–06 and the accumulated arrears on Houston terms. As a result, the amount of debt Georgia should pay to Paris Club creditors during 2004–06 is expected to fall from US\$ 169 million to US\$ 46 million.

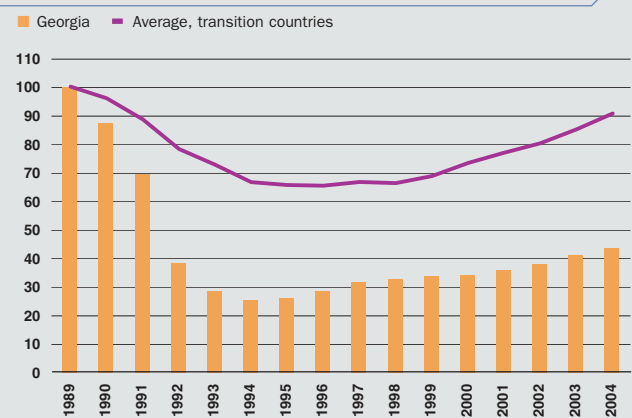
## Outlook and risks

The economy is expected to grow by 5–6 per cent per year in the medium term, supported by activity linked to the construction of the BTC and the South Caucasus Gas pipelines. The consequent increase in imports of capital goods and widening of the current account deficit is expected to be financed by the related flows of foreign direct investment. However, sustained export growth over the longer term requires the development of stronger private sector activity in other areas with good potential, such as agriculture and tourism. The weak fiscal position, large external debt, Georgia's dependence on IFI support and the situation in the energy sector remain the main risks.

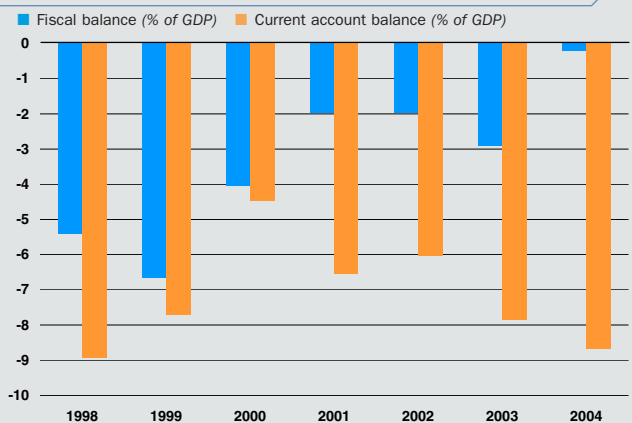
## Transition indicators, 2004



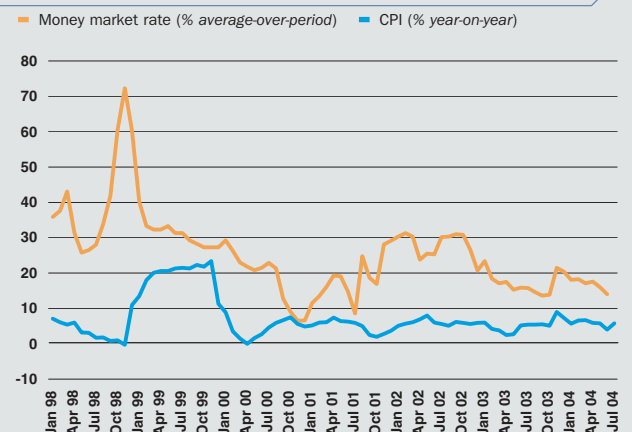
## Real GDP (1989=100)



## Fiscal balance and current account balance



## Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – no	Share of population living in poverty –
Interest rate liberalisation – full	vouchers	Separation of railway accounts – no	15.7 per cent (2001)
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – no <sup>1</sup>
	direct sales		
Stabilisation	Tradability of land – limited for	Financial sector	
Share of general government tax	foreigners	Capital adequacy ratio – 12 per cent	
revenue in GDP – 14.7 per cent		Deposit insurance system – no	
Exchange rate regime – floating	Enterprise and markets	Secured transactions law – restricted	
	Competition office – yes	Securities commission – yes (not independent)	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	58.7	70.0	72.4	68.4	64.5	64.0	na
Share of trade in GDP (in per cent)	39.6	52.9	51.5	44.7	45.5	48.5	na
Tariff revenues (in per cent of imports)	6.6	7.5	7.4	7.3	7.1	7.1	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.0	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	21.8	22.7	23.0	23.1	23.3	23.6	na
Private sector share in GDP (in per cent)	60.0	60.0	60.0	60.0	65.0	65.0	65.0
Private sector share in employment (in per cent)	30.0	40.0	35.0	35.0	35.0	40.0	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	3.3	3.3	3.3	3.3	3.3	3.3	3.3
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	2.1	2.5	2.8	2.1	1.8	1.6	na
Share of industry in total employment (in per cent)	6.1	6.9	7.3	6.4	6.3	5.9	na
Change in labour productivity in industry (in per cent)	16.3	-8.4	-1.4	1.5	11.8	18.0	na
Investment/GDP (in per cent)	na	na	na	na	na	na	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	12.2 (1.1)	12.3 (1.9)	13.9 (3.4)	11.4 (6.1)	13.1 (10.2)	13.3 (10.7)	na
Internet penetration rate (per 10,000 inhabitants)	1.4	1.7	3.2	4.2	6.2	10.1	na
Railway labour productivity (1989=100)	38.9	48.0	59.5	65.1	71.9	72.6	na
Residential electricity tariffs, USc kWh	3.4	4.7	4.6	5.0	5.2	4.5	na
Average collection rate, electricity (in per cent)	na	32	35	32	90	72	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.8	3.0	2.8	4.2	na	na	na
EBRD index of infrastructure reform	2.0	2.3	2.3	2.3	2.3	2.3	2.3
Electric power	3.0	3.3	3.3	3.3	3.3	3.0	3.0
Railways	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Roads	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	2.0	2.0	2.3	2.3	2.3	2.3	2.3
Water and waste water	1.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	42 (9)	36 (9)	30 (8)	27 (7)	25 (5)	24 (6)	na
Asset share of state-owned banks (in per cent)	0.0	0.0	0.0	0.0	0.0	0.0	na
Non-performing loans (in per cent of total loans)	6.5	6.8	7.2	8.6	7.9	7.5	na
Domestic credit to private sector (in per cent of GDP)	3.5	4.7	6.5	7.0	7.7	8.6	na
Stock market capitalisation (in per cent of GDP)	na	na	0.8	2.9	2.9	5.3	na
EBRD index of banking sector reform	2.3	2.3	2.3	2.3	2.3	2.3	2.7
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.7	1.7	1.7	1.7	1.7
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	1.0	0.8	na	1.0	1.6	1.2	na
Life expectancy at birth, total (years)	na	na	73	73.2	73.4	na	na
Basic school enrolment ratio (in per cent)	100.5	100.3	99.2	96.6	97.0	na	na

<sup>1</sup> At early stages of development.



	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> (Percentage change in real terms)							
GDP	2.9	3.0	1.9	4.7	5.6	8.6	6.0
Private consumption	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na
Industrial gross output	-1.8	3.7	5.3	-4.5	7.8	14.0	na
Agricultural gross output	-6.6	6.9	-12.0	8.2	-1.4	7.0	na
<b>Employment</b> <sup>1</sup> (Percentage change)							
Labour force (end-year)	-18.2	0.5	-1.8	8.3	-0.7	1.1	na
Employment (end-year)	-22.5	0.1	0.9	7.4	-2.1	3.1	na
(In per cent of labour force)							
Unemployment (end-year)	12.3	12.7	10.3	11.1	12.3	10.5	na
<b>Prices and wages</b> (Percentage change)							
Consumer prices (annual average)	3.6	19.2	4.1	4.6	5.7	4.9	6.0
Consumer prices (end-year)	10.7	11.0	4.6	3.4	5.6	7.0	5.0
Producer prices (annual average)	2.3	15.7	5.8	3.6	6.0	na	na
Producer prices (end-year)	3.7	15.7	2.4	8.9	1.5	na	na
Gross average monthly earnings in economy (annual average)	30.4	21.8	7.1	30.8	19.1	25.9	na
<b>Government sector</b> <sup>2</sup> (In per cent of GDP)							
General government balance	-5.4	-6.7	-4.0	-2.0	-2.0	-2.9	-0.2
General government expenditure	19.1	22.1	19.2	18.3	17.8	18.9	na
General government debt	58.2	77.0	69.8	68.4	67.4	62.0	na
<b>Monetary sector</b> (Percentage change)							
Broad money (M3, end-year)	-1.1	21.0	39.4	18.5	17.1	22.7	na
Domestic credit (end-year)	39.4	36.7	18.7	1.1	10.1	14.7	na
(In per cent of GDP)							
Broad money (M3, end-year)	6.4	7.9	10.4	11.1	11.6	12.5	na
<b>Interest and exchange rates</b> (In per cent per annum, end-year)							
Money market rate	43.3	34.6	18.2	17.5	27.7	16.9	na
Treasury bill rate (3-month maturity) <sup>3</sup>	43.3	na	26.0	29.9	43.4	44.3	na
Deposit rate (3 months) <sup>4</sup>	17.0	14.6	12.0	7.8	9.8	9.3	na
Lending rate (3 months)	46.0	33.4	32.8	27.0	32.0	32.0	na
(Laris per US dollar)							
Exchange rate (end-year)	1.7	1.9	2.0	2.1	2.1	2.1	na
Exchange rate (annual average)	1.4	2.0	2.0	2.1	2.2	2.1	na
<b>External sector</b> (In millions of US dollars)							
Current account	-370	-217	-136	-210	-205	-310	-418
Trade balance	-685	-536	-398	-486	-439	-615	-770
Merchandise exports	478	477	584	473	553	650	691
Merchandise imports	1,164	1,013	982	959	992	1,265	1,461
Foreign direct investment, net	221	62	153	80	130	306	350
Gross reserves, excluding gold (end-year)	118	132	109	161	198	191	na
External debt stock	1,636	1,722	1,582	1,712	1,858	1,954	na
(In months of imports of goods and services)							
Gross reserves, excluding gold (end-year)	1.0	1.3	0.9	1.4	1.7	1.3	na
(In per cent of current account revenues, excluding transfers)							
Debt service	17.3	20.4	17.0	19.3	21.7	16.6	na
<b>Memorandum items</b> (Denominations as indicated)							
Population (end-year, million)	5.4	5.4	4.6	4.6	4.6	4.6	na
GDP (in millions of laris)	5,741	5,665	6,013	6,638	7,448	8,466	9,422
GDP per capita (in US dollar)	771	524	659	693	734	854	na
Share of industry in GDP (in per cent)	12.3	13.0	13.7	12.2	12.4	13.3	na
Share of agriculture in GDP (in per cent)	26.7	24.7	20.2	20.7	19.3	20.3	na
Current account/GDP (in per cent)	-8.9	-7.7	-4.5	-6.6	-6.0	-7.9	-8.7
External debt - reserves (in US\$ million)	1,518	1,590	1,473	1,551	1,660	1,763	na
External debt/GDP (in per cent)	39.4	61.1	52.0	53.5	54.8	49.5	na
External debt/exports of goods and services (in per cent)	227.1	232.5	143.8	175.6	173.6	161.8	na

<sup>1</sup> Figures consistent with ILO methodology.<sup>2</sup> General government includes the state, municipalities and extra-budgetary funds.<sup>3</sup> The Treasury bills market was suspended from September 1998 to August 1999. The data from 1998 relate to August. The data from 2000 relate to the average auction rates during that year.<sup>4</sup> Data refer to average rates for local currency from international financial statistics.

# Hungary

## Key challenges

Progress with privatisation, health care reorganisation and tax reform, as well as further liberalisation of the energy market, is required to boost investment.

Policies targeted at increasing labour market participation are needed to encourage growth and reduce regional imbalances, including a reduction in labour taxes, reform of disability benefits and appropriate education and training policies.

Fiscal discipline and the coherent implementation of macroeconomic policies will be essential for sustained growth and economic stability in the run-up to the adoption of the euro.

remains attractive to foreign investors. This is due to the low corporate tax rate of 16 per cent, the tax exemption of inbound dividends, tax deductions on interest income and a system of direct budgetary support in favour of certain types of companies.

The support scheme complies with EU requirements on state aid. The provision of state support is not automatic, and the government makes decisions on a case-by-case basis. In June 2004 direct budgetary subsidies were granted to four large foreign companies – Bosch, Electrolux, Exxon Mobil and Denso – that are planning to expand their operations in the country.

To boost tax revenues, the government has decided to introduce a tax on net interest revenue in banks during 2005-06 and to reintroduce capital gains tax on stock exchange transactions from 2005. The latter will mainly affect domestic investors and companies providing investment services to Hungarian clients. As over 80 per cent of the daily turnover on the Budapest Stock Exchange Rt (BSE) is carried out by foreign institutional clients, the reintroduction of the capital gains tax is unlikely to have much effect on the activity of the BSE.

Labour market participation is low but, unlike other central European countries, unemployment is also low. There are several reasons for this level of participation. First, the level of labour taxation is among the highest in the OECD, at 45 per cent of total labour costs for a single worker on an average wage. Even with wage moderation, the high tax wedge impedes employment growth, particularly for minimum wage earners. Secondly, following the introduction of restrictions on early retirement, there has been an increase in the number of people on disability benefits. Thirdly, weaknesses and mismatches in skills, coupled with poor labour mobility, have not been addressed adequately through education and training programmes. At the end of September 2004 the government introduced preferential tax treatment for small companies hiring new staff members aged 25 to 50. These companies will be exempt from paying 50 per cent of social contributions.

## Infrastructure

Hungary's approach to road financing was consolidated with the adoption of a vignette system and the remuneration of private operators based on the availability of roads, rather than toll revenues. These principles were applied in the restructuring of the existing M5 motorway project, the M5 extension, and the ongoing tender for the M6 motorway. Public-private partnerships are also being explored for the construction and operation of student residences and correction facilities.

## Financial sector

In an effort to consolidate central European stock exchanges, investors led by HVB Bank Hungary and including the Vienna Stock Exchange acquired controlling stakes in the Budapest Stock Exchange and in the Budapest Commodity Exchange in May 2004.

In July 2004 the Vienna and Budapest Stock Exchanges announced that they would make a joint bid for the Warsaw Stock Exchange, which is due to be privatised in late 2004. The offer will be the first in a series of bids for other minor stock exchanges in the region. However, the Budapest Stock Exchange will continue to operate as an independent bourse.

## Country data

Population (in millions)	<b>10.0</b>
Area ('000 sq. km)	<b>93.0</b>
Official language	<b>Hungarian</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 13,400</b>
National currency	<b>Forint</b>

## Progress in structural reform

### Liberalisation and privatisation

Controls over the price of pharmaceutical products remain controversial. In March 2004 the government issued a decree to cut and freeze the prices of subsidised drugs. However, the decree was ruled unconstitutional as it did not meet the conditions of the Price Act. Parliament then amended the Act, giving the government the power to freeze the price of subsidised drugs for six to nine months. In subsequent negotiations with drug manufacturers, the government agreed not to invoke its powers until the end of 2006 in return for an agreement on prices. According to this agreement, all prices will remain at their pre-March level until the end of 2004. Afterwards, manufacturers will have the right to adjust them once a year if the euro exchange rate exceeds an agreed level.

The privatisation of remaining state assets is progressing. In December 2003 Postabank was sold to Erste Bank, a transaction that created another nationwide institution and is likely to increase competition in the retail banking sector. A 10.5 per cent stake in the oil and gas company MOL was sold to international and Hungarian institutional investors, reducing the state share in the company to 12.2 per cent. In September 2004 the 25 per cent state holding in Richter, a pharmaceutical producer, was sold via the issue of convertible five-year bonds. Further privatisations are planned, including the sale of 74 per cent stake in the national broadcaster Antenna Hungaria.

### Business environment and competition

Hungary has moved to bring domestic tax legislation into compliance with EU law. This has involved the abolition of the offshore company regime and certain tax holidays, which mostly benefited foreign investors in the past. However, the tax regime

## Macroeconomic performance

### Real economy

Economic growth started to accelerate towards the end of 2003, with a 3.5 per cent increase in the fourth quarter and 4.2 per cent in the first quarter of 2004. The rebound was due to a surge in private investment and the recovery of exports. Industrial output growth was also strong and reached 10.1 per cent in May 2004 year-on-year.

### Economic policies

The fiscal deficit in 2003 was 6.1 per cent of GDP (ESA95 methodology), which was lower than 2002 but higher than originally targeted. Following the appointment of a new Finance Minister in January 2004, the target deficit for 2004 was revised upwards from 3.8 per cent to 4.6 per cent of GDP. Fiscal cuts and a temporary freeze on expenditures were also introduced. However, due to lower-than-expected revenues, the target deficit was again increased to 5–5.3 per cent of GDP in September.

Strong demand, regional increases in food prices and a weak forint led to an increase in inflation to 5.7 per cent at the end of 2003. Moderate wage and consumption growth prompted the Central Bank to restrict its CPI forecast for 2004 to 6 per cent. However, due to the one-off effects of adjustments to the tax system, inflation increased to 7.2 per cent in August 2004 year-on-year.

The significant deterioration in external competitiveness experienced in 2001–02 was reversed in 2003. This was mainly due to the depreciation of the forint, wage moderation and improvements in productivity. The government has moved the target date for accession to the eurozone from 2008 to 2010, allowing more time to implement the economic policies needed to meet the Maastricht criteria.

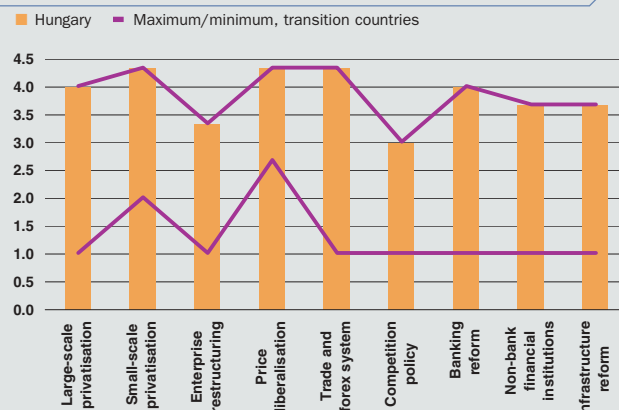
### External sector

Despite accelerating export growth, the current account deficit widened to 8.9 per cent of GDP in 2003. Exports recovered in the first four months of 2004 (particularly in the mobile phone and oil-combustion engine sectors), but the current account deficit grew further. This can be explained by the high import content of Hungarian exports and by the strategy of several companies to bring forward purchases. These companies built up stocks in anticipation of setbacks in customs clearance following the introduction of the new EU trade recording system in May 2004. The external balance is financed by significant but volatile portfolio investments, by foreign direct investment (FDI) and by foreign borrowing. Due to large Hungarian investments abroad and repayment of inter-company loans, net FDI declined to 1.1 per cent of GDP in 2003, even though net equity inflows exceeded the 2002 values.

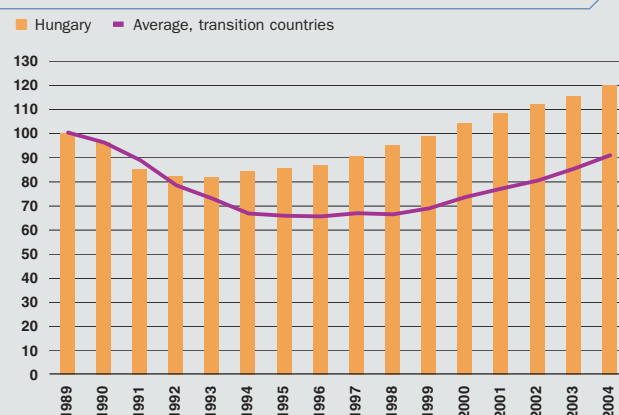
## Outlook and risks

The setting of credible fiscal targets and the rigorous enforcement of the austerity package have restored confidence in government policy. This has helped stabilise the exchange rate, which had weakened in 2003. Also, it has allowed the Central Bank to start lowering interest rates, a trend that is likely to continue. However, potential slippage in the implementation of fiscal policy may cause a reversal in market sentiment.

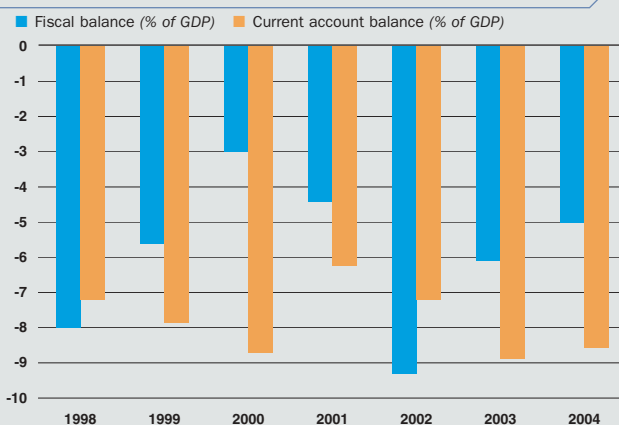
### Transition indicators, 2004



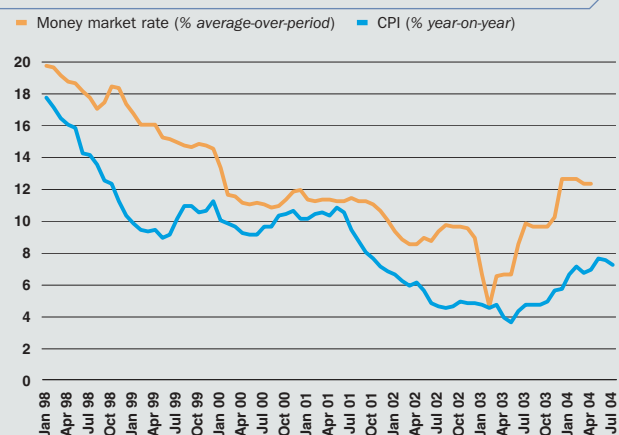
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes	Share of population living in poverty –
Interest rate liberalisation – full	direct sales	Separation of railway accounts – yes	7.3 per cent (1998)
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – yes
	MEBOs		
Stabilisation	Tradability of land – full except	Financial sector	
Share of general government tax	foreigners	Capital adequacy ratio – 8 per cent	
revenue in GDP – 38.3 per cent		Deposit insurance system – yes	
Exchange rate regime – fixed with	Enterprise and markets	Secured transactions law – yes	
band to euro	Competition office – yes	Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	17.0	18.2	18.3	18.5	18.9	19.4	17.9
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Share of trade with non-transition countries (in per cent)	84.3	87.9	87.2	84.4	84.5	84.0	na
Share of trade in GDP (in per cent)	104.8	111.1	129.3	124.2	110.4	108.5	na
Tariff revenues (in per cent of imports)	2.2	1.8	1.5	1.0	1.0	na	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	28.6	29.8	30.2	30.6	30.7	31.1	na
Private sector share in GDP (in per cent)	80.0	80.0	80.0	80.0	80.0	80.0	80.0
Private sector share in employment (in per cent)	81.4	82.1	84.0	84.5	na	na	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	5.2	4.9	na	na	21.5	20.2	na
Share of industry in total employment (in per cent)	33.9	34.0	33.7	34.1	34.1	33.3	na
Change in labour productivity in industry (in per cent)	8.6	7.7	18.5	1.8	2.9	7.6	na
Investment/GDP (in per cent)	23.6	23.9	23.5	23.5	23.4	22.0	na
EBRD index of enterprise reform	3.3	3.3	3.3	3.3	3.3	3.3	3.3
EBRD index of competition policy	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	33.6 (10.5)	37.1 (16.2)	37.3 (30.2)	37.5 (49.8)	36.1 (67.6)	33.4 (78.3)	na
Internet penetration rate (per 10,000 inhabitants)	94.7	118.9	103.6	168.0	191.6	357.8	na
Railway labour productivity (1989=100)	112.9	117.0	122.8	123.3	130.3	133.9	na
Residential electricity tariffs, USc kWh	5.7	5.9	6.2	7.0	8.7	11.4	na
Average collection rate, electricity (in per cent)	na	na	na	na	90	99	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.1	4.3	4.6	4.7	na	na	na
EBRD index of infrastructure reform	3.3	3.7	3.7	3.7	3.7	3.7	3.7
Electric power	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Railways	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Roads	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Telecommunications	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Water and waste water	3.3	4.0	4.0	4.0	4.0	4.0	4.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	44 (28)	43 (29)	42 (33)	41 (31)	38 (27)	38 (29)	na
Asset share of state-owned banks (in per cent)	9.8	7.8	7.7	9.1	10.7	7.4	na
Non-performing loans (in per cent of total loans) <sup>1</sup>	7.9	4.4	3.1	3.0	4.9	3.8	na
Domestic credit to private sector (in per cent of GDP)	24.2	25.8	30.1	31.4	34.5	42.3	na
Stock market capitalisation (in per cent of GDP)	29.9	36.4	25.8	19.2	17.6	18.7	na
EBRD index of banking sector reform	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of reform of non-bank financial institutions	3.3	3.3	3.7	3.7	3.7	3.7	3.7
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	9.3	9.2	9.0	8.5	na	na	na
Life expectancy at birth, total (years)	70.5	70.6	71.2	71.5	72.4	na	na
Basic school enrolment ratio (in per cent)	96.6	97.8	99.2	99.1	99.6	na	na

<sup>1</sup> Changes in non-performing loans data compared with previous *Transition Reports* are due to the change of loan categories included in non-performing loans (see methodological notes).

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> (Percentage change in real terms)							
GDP	4.9	4.2	5.2	3.8	3.5	2.9	4.0
Private consumption	4.7	4.8	5.0	5.9	9.3	6.5	na
Public consumption	-0.3	1.8	1.2	5.3	4.8	1.9	na
Gross fixed capital formation	13.3	5.9	7.7	5.0	8.0	3.0	na
Exports of goods and services	17.6	12.2	21.0	7.8	3.7	7.2	na
Imports of goods and services	23.8	13.3	19.4	5.1	6.2	10.3	na
Industrial gross output	13.7	10.4	18.7	3.6	2.8	6.4	na
Agricultural gross output	0.6	0.4	-6.4	15.8	na	na	na
<b>Employment<sup>1</sup></b> (Percentage change)							
Labour force (annual average)	0.4	2.1	0.6	-0.4	0.2	1.4	na
Employment (annual average)	1.4	3.1	1.2	0.3	0.1	1.3	na
(In per cent of labour force)							
Unemployment (end-year)	7.8	7.0	6.4	5.7	5.8	5.9	na
<b>Prices and wages</b> (Percentage change)							
Consumer prices (annual average)	14.3	10.0	9.8	9.2	4.8	4.7	6.8
Consumer prices (end-year)	10.3	11.2	10.1	6.8	5.3	5.7	6.2
Producer prices (annual average)	11.3	5.1	11.6	5.2	-1.1	2.4	na
Producer prices (end-year)	7.1	8.2	12.4	-0.4	-1.3	6.2	na
Gross average monthly earnings in economy (annual average)	18.3	13.9	13.5	18.2	18.3	12.0	na
<b>Government sector</b> (In per cent of GDP)							
General government balance	-8.0	-5.6	-3.0	-4.4	-9.3	-6.1	-5.0
General government expenditure	50.4	47.4	47.0	51.8	50.7	46.9	na
General government debt	61.9	61.2	55.3	53.5	57.1	57.3	na
<b>Monetary sector</b> (Percentage change)							
Broad money (M2, end-year)	10.1	15.8	12.1	16.8	13.8	13.6	na
Domestic credit (end-year)	19.9	0.4	11.7	5.1	15.1	20.7	na
(In per cent of GDP)							
Broad money (M2, end-year)	43.4	44.5	43.1	44.7	45.1	46.2	na
<b>Interest and exchange rates</b> (In per cent per annum, end-year)							
Refinance rate	17.0	14.5	11.0	9.8	8.5	12.5	na
Interbank interest rate (up to 30-day maturity)	17.3	14.5	11.9	10.0	8.9	10.2	na
Deposit rate weighted average (fixed for less than 1 year)	14.4	11.9	9.9	9.4	7.4	8.7	na
Lending rate weighted average (maturing within 1 year)	18.8	19.4	12.8	12.0	9.7	11.2	na
(Forints per US dollar)							
Exchange rate (end-year)	219.0	252.5	284.7	279.0	225.2	207.9	na
Exchange rate (annual average)	214.5	237.3	282.2	286.5	257.9	224.3	na
<b>External sector</b> (In millions of US dollars)							
Current account <sup>2</sup>	-3,390	-3,773	-4,060	-3,236	-4,675	-7,343	-8,611
Trade balance <sup>2</sup>	-1,885	-2,170	-2,911	-2,235	-2,120	-3,366	-3,735
Merchandise exports <sup>2</sup>	23,696	25,579	28,734	31,068	34,780	43,238	49,093
Merchandise imports <sup>2</sup>	25,580	27,749	31,645	33,303	36,900	46,604	52,829
Foreign direct investment, net	3,065	3,065	2,190	3,579	2,590	874	1,691
Gross reserves, excluding gold (end-year)	9,312	10,948	11,202	10,887	9,314	11,411	na
External debt stock	27,280	29,336	30,287	33,951	36,757	51,569	na
(In months of imports of goods and services)							
Gross reserves, excluding gold (end-year)	3.8	4.1	3.7	3.4	2.6	2.5	na
(In per cent of exports of goods and services)							
Debt service <sup>3</sup>	26.6	17.9	15.5	14.7	13.7	12.9	na
<b>Memorandum items</b> (Denominations as indicated)							
Population (end-year, million)	10.1	10.1	10.0	10.2	10.0	10.0	na
GDP (in billions of forints)	10,087	11,393	13,172	14,850	16,740	18,574	20,630
GDP per capita (in US dollar)	4,641	4,757	4,648	5,092	6,491	8,281	na
Share of industry in GDP (in per cent)	25.9	26.7	27.9	27.2	26.8	na	na
Share of agriculture in GDP (in per cent)	5.4	5.3	4.6	5.5	4.7	na	na
Current account/GDP (in per cent)	-7.2	-7.9	-8.7	-6.2	-7.2	-8.9	-8.6
External debt - reserves (in US\$ million)	17,968	18,388	19,085	23,065	27,443	40,157	na
External debt/GDP (in per cent)	58.0	61.1	64.9	65.5	56.6	62.3	na
External debt/exports of goods and services (in per cent)	93.8	95.3	88.2	90.0	88.2	100.7	na

<sup>1</sup> Data from labour force survey.<sup>2</sup> Data from the balance of payments.<sup>3</sup> Excluding inter-company loans.



# Kazakhstan

## Key challenges

To strengthen competition and diversify the economy, the authorities need to maintain their commitment to financial transparency, good corporate governance and an open market economy.

As infrastructure reform gathers pace, the regulatory framework needs to be further strengthened to ensure non-discriminatory third-party access.

The fiscal prudence of recent years needs to be sustained and money supply growth kept in check to prevent the build-up of inflationary pressure and maintain financial stability.

## Infrastructure

In February 2004 the government agreed on a restructuring programme for the national railway company Kazakhstan Temir Zholy (KTZ). Based on this programme, the railway law of December 2001 was amended in July 2004 and KTZ was split into several joint-stock companies. KTZ itself was turned into an infrastructure company with responsibility for tracks, track maintenance and train movement. Separate companies were created for the operation and maintenance of locomotives (JSC Locomotive) and freight wagons (JSC KazZhelDorTrans). The operation of passenger services had already been unbundled in 2003 with the creation of six regional companies. The ownership of these will be transferred from KTZ to the Ministry of Transport on 1 January 2005. The subsidy regime will also be made more transparent in January 2005.

The current system of discounted infrastructure access charges will be replaced by explicit payments from the state budget to operators of loss-making, but socially important inter-city routes. Non-core companies will be sold through open tenders between 2004 and 2006. Most importantly, the sector is being opened to third-party operators, which should lead to enhanced competition in freight services. Track access charges will be regulated by the Anti-Monopoly Agency (AMA).

A new law on telecommunications was signed in July 2004, and further legislative measures on licensing and regulation are being prepared. Upon their adoption the authorities plan to cancel the exclusivity of Kazakh Telecommunications Company (KTC) over international and inter-city fixed-line services and open these services to competition. However, foreign ownership of new service providers will be restricted to minority stakes.

## Financial sector

The dearth of attractive securities is creating difficulties for pension funds. Since the launch of the mandatory privately managed pension pillar in 1998, pension fund assets have grown to 8 per cent of GDP (by the end of March 2004). Assets are heavily concentrated and not sufficiently diversified from a portfolio management perspective. National Bank bills and corporate bonds each account for 25 per cent of total assets. Government bonds, including municipal bonds, account for another 21 per cent. However, their share is declining as the government seeks to reduce its domestic debt burden.

Investments into domestic equity are less than 5 per cent of total assets. Domestic companies still fear the loss of control that would result from having institutional minority shareholders, while the institutional investors are concerned about the insufficient protection of their minority interests. Local pension funds may have difficulties in finding alternative assets when a sovereign US\$ 300 million eurobond that they predominantly hold matures in October 2004.

## Country data

Population (in millions)	<b>14.4</b>
Area ('000 sq. km)	<b>2,728</b>
Official language	<b>Kazakh</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 5,870</b>
National currency	<b>Tenge</b>

## Progress in structural reform

### Business environment and competition

The state holding company KazMunaiGaz (KMG) was established in 2002 through the consolidation of the state's oil and gas production and distribution businesses. In 2004 it began an asset restructuring programme. The programme calls for the splitting of KMG's 55 subsidiaries into core and non-core assets, a reduction in the number of subsidiaries through mergers, and the privatisation of non-core assets.

It is expected that within two to three years the number of subsidiaries will be reduced to between 20 and 25 companies focused on three major areas of operation – exploration, transportation, and refining and marketing. In line with the programme, two oil and gas production and exploration companies – Uzenmunaigas and Embamunaigas – were merged into a new subsidiary company, KMG Exploration and Production, in April 2004. Similarly, KMG's direct holdings in a pipeline joint venture with a Chinese oil company were reassigned to KazTransGaz (KTO), an oil pipeline subsidiary of KMG.

The restructuring should improve the management of the KMG group, but potential conflicts of interest remain. These relate to KMG's role as the state representative in joint ventures with foreign operators on the one hand and its role as a fully commercial entity on the other. The issue of fair and open access to the transportation infrastructure controlled by KMG – through its subsidiaries and KazTransGaz – also may require more effective regulation.

## Macroeconomic performance

### Real economy

The economy continued to grow strongly by 9.2 per cent in 2003 and by 9.1 in the first half of 2004. Growth was fuelled primarily by high oil and commodity prices, which boosted exports and oil sector-related investments, but was also supported by buoyant domestic consumption.

### Economic policies

The consolidated fiscal surplus, including inflows into the National Fund (which channels foreign currency inflows into overseas investments at times of high oil prices), reached 4.7 per cent of GDP in 2003. The surplus is likely to decline in 2004. This is because the number of companies whose tax payments are earmarked for the National Fund (and hence for saving) has been reduced. Their tax payments will flow into the general budget, where they will support a planned increase in expenditures.

The inflationary pressures that built up towards the end of 2003 have eased. Nevertheless, high foreign currency inflows and the fiscal easing are exerting an increasing strain on monetary policy. The National Bank of Kazakhstan (NBK) changed its focus from maintaining exchange rate stability to price stability at the beginning of 2004. Despite this policy shift, the NBK intervened repeatedly in the market to ease the strong upward pressure on the tenge. The interventions were not fully sterilised and led to a sharp increase in base money. The growth in money supply has not created much inflationary pressure so far, as the demand for money has also risen, but some tightening of liquidity may become necessary to keep inflation in check.

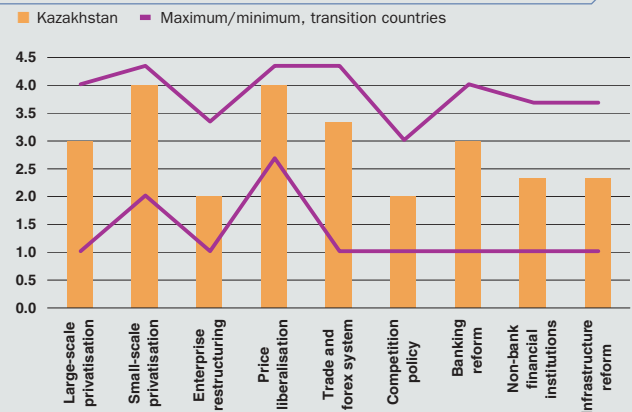
### External sector

The current account deficit narrowed from 3.5 per cent of GDP in 2002 to 0.2 per cent in 2003 owing to the continued surge in oil and commodity prices. The current account was in surplus during the first quarter of 2004. Although there is a surge in demand for imports, a small surplus is likely for the year as a whole should trade continue to improve. The level of external debt remains high and is increasing further. However, most of the debt continues to be inter-company loans associated with foreign direct investment (FDI), and their repayment is linked to the oil price. Net FDI amounted to US\$ 2.2 billion in 2003, a similar level to 2002.

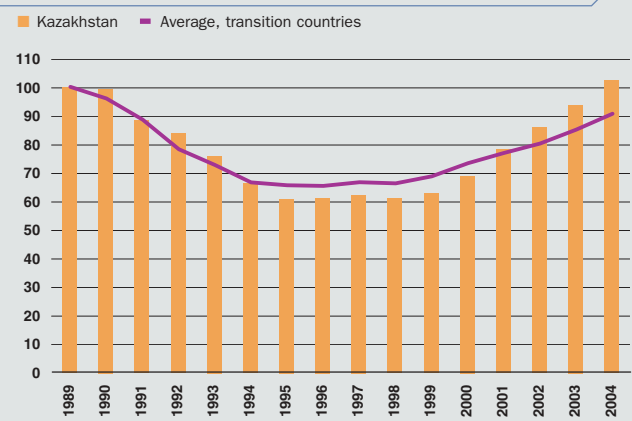
## Outlook and risks

Economic growth is expected to be around 9.0 per cent in 2004, similar to 2003. However, the easing of fiscal policy and strong money supply growth could reignite inflationary pressures. The economy remains heavily resource-based and is vulnerable to fluctuations in commodity prices. In turn, the reserves in the National Fund provide some cushion against a hard landing if oil prices were to fall sharply.

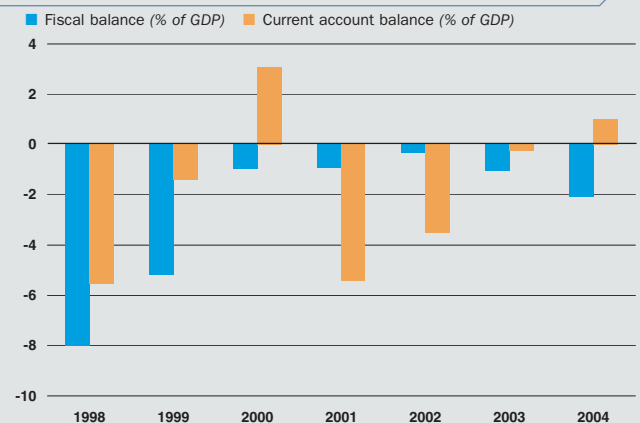
### Transition indicators, 2004



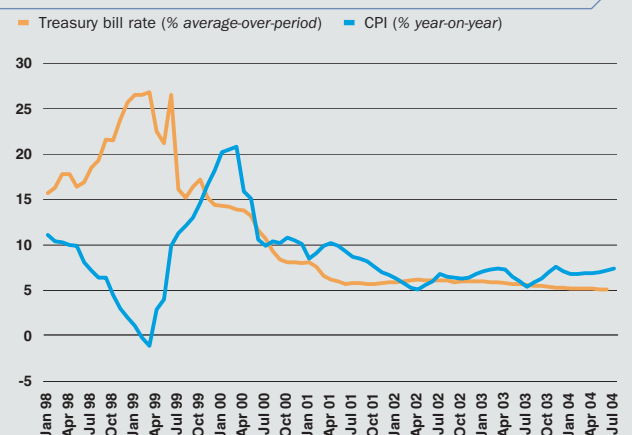
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes <sup>3</sup>	Share of population living in poverty –
Interest rate liberalisation – full	direct sales	Separation of railway accounts – yes	8.5 per cent (2001) <sup>4</sup>
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes <sup>3</sup>	Private pension funds – yes
	vouchers		
Stabilisation	Tradability of land – full except	Financial sector	
Share of general government tax	foreigners <sup>2</sup>	Capital adequacy ratio – 12 per cent	
revenue in GDP – 21.8 per cent <sup>1</sup>		Deposit insurance system – yes	
Exchange rate regime – managed float	Enterprise and markets	Secured transactions law – yes	
	Competition office – yes <sup>3</sup>	Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	47.3	58.7	64.2	57.3	61.8	65.5	na
Share of trade in GDP (in per cent)	56.7	69.0	88.2	74.6	72.1	75.2	na
Tariff revenues (in per cent of imports) <sup>5</sup>	1.9	1.7	1.9	2.2	3.3	3.1	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	4.0	3.0	3.3	3.3	3.3	3.3	3.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	13.0	14.8	15.6	16.1	16.6	18.0	na
Private sector share in GDP (in per cent)	55.0	60.0	60.0	60.0	65.0	65.0	65.0
Private sector share in employment (in per cent)	73.0	77.1	78.8	74.9	75.0	75.0	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP) <sup>6</sup>	na	0.3	0.1	0.1	0.1	na	na
Share of industry in total employment (in per cent)	14.7	14.8	13.8	12.4	12.3	12.2	na
Change in labour productivity in industry (in per cent)	na	2.6	22.2	17.2	11.4	5.8	na
Investment/GDP (in per cent)	15.8	17.8	18.1	26.9	25.5	na	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	10.9 (0.2)	10.8 (0.3)	11.3 (1.2)	12.1 (3.6)	13.0 (6.4)	14.7 (9.4)	na
Internet penetration rate (per 10,000 inhabitants)	1.0	2.5	5.0	6.8	10.4	13.5	na
Railway labour productivity (1989=100)	31.2	27.6	42.5	46.3	51.0	58.5	na
Residential electricity tariffs, US¢ kWh	3.7	0.5	2.8	2.7	3.0	3.1	na
Average collection rate, electricity (in per cent)	na	na	na	na	92	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.4	1.5	1.6	1.7	na	na	na
EBRD index of infrastructure reform	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Electric power	3.3	3.3	3.0	3.0	3.0	3.0	3.3
Railways	2.0	2.0	2.3	2.7	2.7	2.7	2.7
Roads	1.7	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	2.0	2.3	2.3	2.3	2.3	2.3	2.3
Water and waste water	1.0	1.7	1.7	1.7	1.7	1.7	2.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	71 (20)	55 (18)	48 (16)	44 (15)	38 (17)	36 (16)	na
Asset share of state-owned banks (in per cent) <sup>7</sup>	23.0	19.9	1.9	3.5	5.2	5.1	na
Non-performing loans (in per cent of total loans) <sup>8</sup>	na	3.7	5.8	2.1	2.0	2.1	na
Domestic credit to private sector (in per cent of GDP)	5.4	7.4	10.6	15.1	18.6	22.8	na
Stock market capitalisation (in per cent of GDP)	8.2	15.5	7.5	5.6	5.5	8.0	na
EBRD index of banking sector reform	2.3	2.3	2.3	2.7	2.7	3.0	3.0
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.3	2.3	2.3	2.3	2.3
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	6.2	6.1	5.3	5.3	5.3	5.4	na
Life expectancy at birth, total (years)	64.6	65.5	64.2	63.0	61.7	na	na
Basic school enrolment ratio (in per cent)	94.1	94.3	99.7	100.1	100.0	na	na

<sup>1</sup> Excludes revenues into the National Fund.

<sup>2</sup> Ownership of agricultural land is limited to Kazakhstani residents and only applies to one-third of the total land area.

<sup>3</sup> The regulator does not have financial independence.

<sup>4</sup> The percentage of population with incomes below the nationally defined subsistence minimum was 24.2 per cent in 2002.

<sup>5</sup> Refers to taxes on international trade.

<sup>6</sup> Data for 1998 and 1999 refer to expenditures on the economy (fuel and energy, agriculture and mining).

<sup>7</sup> In December 2000 the state reduced its stake in the Savings Bank to less than 50 per cent.

<sup>8</sup> Refers to the loss loans category only. According to the newly introduced definition by the regulator in 2003, the combined share of doubtful and loss loans was 38.9 per cent at end-2003.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> (Percentage change in real terms)							
GDP	-1.9	2.7	9.8	13.5	9.8	9.2	9.0
Private consumption	-0.5	0.1	0.9	7.7	7.2	na	na
Public consumption	-15.2	7.6	15.0	19.2	-4.5	na	na
Gross fixed capital formation	-7.2	0.5	16.1	25.3	3.5	na	na
Exports of goods and services	-11.9	3.0	28.7	-1.1	20.5	na	na
Imports of goods and services	-7.2	0.6	26.1	2.5	2.0	na	na
Industrial gross output	-2.4	2.7	15.5	13.8	10.5	8.8	na
Agricultural gross output	-18.9	28.0	-4.2	17.3	3.4	1.4	na
<b>Employment<sup>1</sup></b> (Percentage change)							
Labour force (end-year)	na	0.0	0.7	5.2	-1.1	3.2	na
Employment (end-year)	na	-0.4	1.6	8.0	0.2	3.9	na
Unemployment (end-year)	13.1	13.5	12.8	10.4	9.3	8.8	na
<b>Prices and wages</b> (Percentage change)							
Consumer prices (annual average)	7.1	8.3	13.2	8.4	5.8	6.4	6.7
Consumer prices (end-year)	1.9	17.8	9.8	6.4	6.6	6.8	4.8
Producer prices (annual average)	0.8	18.8	38.0	0.3	0.4	9.3	na
Producer prices (end-year)	-5.5	57.2	19.4	-14.1	11.9	5.9	na
Gross average monthly earnings in economy (annual average)	13.4	13.4	30.9	20.8	17.0	14.3	na
<b>Government sector<sup>2</sup></b> (In per cent of GDP)							
General government balance <sup>3</sup>	-8.0	-5.2	-1.0	-0.9	-0.3	-1.0	-2.1
General government expenditure <sup>4</sup>	26.1	23.2	23.2	23.4	22.1	24.0	na
General government debt	22.4	31.5	25.5	20.4	17.7	15.5	na
<b>Monetary sector</b> (Percentage change)							
Broad money (M2, end-year) <sup>5</sup>	-14.1	84.4	45.0	40.2	30.1	29.3	na
Domestic credit (end-year) <sup>6</sup>	38.6	35.4	57.3	17.1	30.2	24.1	na
Broad money (M2, end-year)	8.6	13.6	15.3	17.1	19.2	21.0	na
<b>Interest and exchange rates</b> (In per cent per annum, end-year)							
Refinancing rate	25.0	18.0	14.0	9.0	7.5	7.0	na
Treasury bill rate (3-month maturity) <sup>7</sup>	23.6	15.6	6.6	5.3	5.2	5.9	na
Deposit rate <sup>8</sup>	14.5	13.5	15.6	12.8	11.0	10.9	na
Lending rate <sup>9</sup>	17.0	20.8	18.8	15.3	14.1	14.9	na
Exchange rate (end-year)	83.8	138.2	144.5	150.2	154.6	144.2	na
Exchange rate (annual average)	78.3	119.5	142.1	146.7	153.3	149.6	na
<b>External sector</b> (In millions of US dollars)							
Current account	-1,225	-236	563	-1,203	-866	-69	376
Trade balance <sup>10</sup>	-801	340	2,440	1,320	2,301	4,088	6,181
Merchandise exports	5,871	5,989	9,288	8,928	10,027	13,233	18,526
Merchandise imports	6,672	5,648	6,848	7,607	7,726	9,144	12,345
Foreign direct investment, net	1,143	1,468	1,278	2,861	2,163	2,188	2,500
Gross reserves, excluding gold (end-year)	1,461	1,479	1,594	1,997	2,551	4,236	na
External debt stock <sup>11</sup>	9,932	12,081	12,685	15,158	18,201	22,859	na
Gross reserves, excluding gold (end-year) <sup>12</sup>	2.2	2.6	2.2	2.3	2.7	3.9	na
Debt service	22.4	27.3	50.8	37.5	35.2	34.5	na
<b>Memorandum items</b> (Denominations as indicated)							
Population (end-year, million)	15.2	14.9	14.9	14.8	14.9	14.4	na
GDP (in billions of tenges)	1,733	2,016	2,600	3,251	3,776	4,450	5,173
GDP per capita (in US dollar)	1,457	1,132	1,231	1,492	1,658	2,069	na
Share of industry in GDP (in per cent)	23.9	23.9	25.2	25.2	25.3	na	na
Share of agriculture in GDP (in per cent)	9.4	11.1	9.8	10.1	9.5	na	na
Current account/GDP (in per cent)	-5.5	-1.4	3.1	-5.4	-3.5	-0.2	1.0
External debt - reserves (in US\$ million)	8,471	10,602	11,091	13,160	15,650	18,623	na
External debt/GDP (in per cent)	44.9	71.6	69.3	68.4	73.9	76.8	na
External debt/exports of goods and services (in per cent)	146.6	174.7	121.7	148.2	156.8	152.3	na

<sup>1</sup> Employment data are based on labour force surveys.

<sup>2</sup> General government includes the state, municipalities and extra-budgetary funds and is on a cash basis.

<sup>3</sup> Government balance includes quasi-fiscal operations. Balance excludes privatisation revenues and transfers to the National Fund.

<sup>4</sup> Expenditures include extra-budgetary funds.

<sup>5</sup> From international financial statistics.

<sup>6</sup> Domestic credit from international financial statistics. Break in series in 2001.

<sup>7</sup> Three-month Treasury bill rate until 1998, average effective yield of short-term NBK notes thereafter.

<sup>8</sup> Deposit rate refers to the weighted average of interest rates on time deposits of individuals, in tenge by maturity.

<sup>9</sup> Lending rate refers to weighted average of interest rates on credits extended to legal entities, excluding banks in tenge by maturity.

<sup>10</sup> Exports are at declared customs prices and are not corrected for under-invoicing of oil and gas exports.

<sup>11</sup> Includes inter-company debt by branches of non-resident foreign enterprises and short-term debt.

<sup>12</sup> Excluding National Fund.

# Kyrgyz Republic

## Key challenges

New measures to improve governance need to be fully implemented to have a tangible impact on the business environment, and to attract new investment outside the extractive industries.

Renewed efforts to reduce commercial losses and adjust tariffs are necessary in the power sector, but should be complemented by measures to address affordability constraints on low income consumers.

Continued fiscal and monetary prudence is important given the high level of external debt and the vulnerability to shocks.

### Country data

Population (in millions)	<b>4.8</b>
Area ('000 sq. km)	<b>200</b>
Official language	<b>Kyrgyz, Russian</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 1,620</b>
National currency	<b>Som</b>

## Progress in structural reform

### Liberalisation and privatisation

The Kumtor gold mining company was effectively privatised in June 2004, when the government converted its 67 per cent stake into a 28.8 per cent shareholding in Centerra. Centerra is a newly created holding company with gold mining interests in the Kyrgyz Republic, Mongolia and the United States. The government's stake was reduced further to 16.1 per cent when Centerra was listed on the Toronto Stock Exchange. The government sold shares worth US\$ 80 million. The transaction brought the largest company in the country, whose output accounts for around 10 per cent of GDP, into majority private ownership.

### Business environment and competition

The authorities have taken important steps to enhance openness and transparency in business. The government adopted a new anti-corruption law in March 2003 and established a National Council on Good Governance the following month. In February 2004 the government set up a Consultative Council on Good Governance and subsequently ratified the UN Convention against Corruption in June.

These high-profile initiatives were complemented by a number of concrete policies to improve state governance. These included a decree on improved public consultation on new legislation and a new law on the disclosure of incomes of civil servants. One of the first laws to which the revised public consultation procedures applied was the new tax code. This aims to consolidate all provisions on taxes into one code and remove legal inconsistencies.

In mid-2004 the government also adopted the principles of the Extractive Industries Transparency Initiative (EITI). Upon its implementation this will enhance the transparency of revenue flows from the mining sector to the government. Publication of the first EITI report is expected in October 2004.

### Infrastructure

The electric power sector is still characterised by high technical and commercial losses and tariffs that do not cover the full costs of supply. Average residential tariffs increased from 38.3 tyn (0.82 US cents) per kilowatt hour (kWh) in 2002 to 56 tyn (1.28 US cents) per kWh in 2003. Non-residential tariffs rose from 74.4 tyn (1.59 US cents) per kWh to 78.7 tyn (1.8 US cents) per kWh. The adjustments are part of a strategy to raise tariffs to the equivalent of 2.3 US cents per kWh by 2006, a level which the government estimates would cover the short-run costs of supply.

As the tariffs increased, the average revenue collection rate declined from 84 per cent in 2002 to 78 per cent in 2003, further undermining the financial performance of the sector. The decline in payments was particularly noticeable in the residential sector. This deterioration may be connected to the affordability constraints many poorer consumers face in meeting higher utility bills. It also reflects weak management systems and possible corruption within the energy distribution companies. Nevertheless, the tariff adjustments are necessary to finance much-needed investment and perhaps attract financing from the private sector. Donors are prepared to back the government in raising tariffs, by considering support for the poorest segment of the population.

In September, the State Property Agency signed a contract to sell 51 per cent of Kyrgyz Telecom to a consortium of German investors, AREXTECH/Detecom. Approval from the government could occur by the end of 2004.

### Financial sector

Prospects for the banking sector are improving, but the weak legal environment and political interference remain a concern. The sector continued to grow strongly in 2003, with total loans increasing by 44 per cent. At the same time, the ratio of non-performing loans to total loans declined from 13.3 per cent in 2002 to 11.2 per cent in 2003. Nevertheless, the level of financial intermediation is still low.

The sector is attracting considerable interest from banks from Kazakhstan. Following the acquisition of a small bank by Kazkommerts Bank in 2002, Temir Bank took over Ineximbank in July 2003 and Halyk Bank won the privatisation tender for state-owned Kairat Bank in May 2004.

The pledge law of 1997, although in the process of being amended, does not allow for streamlined, out-of-court settlements between borrowers and banks. In mid-2004 parliament passed a bill which, if signed into law, would remove the authority of the regulator – the National Bank of the Kyrgyz Republic – to establish minimum capital requirements for existing banks. The move reflects the influence of vested interests, which could undermine the banking system. The authorities are also in the process of establishing a credit bureau and an effective deposit insurance scheme which may contribute to the further deepening of the financial sector.



## Macroeconomic performance

### Real economy

The economy continued to expand rapidly during the first seven months of 2004, with an estimated growth rate of 8.6 per cent compared with the same period in 2003. This is in part due to the sustained recovery of gold production at the Kumtor mine. The rest of the economy also performed well and grew by a solid 7.6 per cent. There are signs of increased fixed investment.

### Economic policies

The government remains committed to tight fiscal and monetary policies. Macroeconomic performance is monitored by the IMF under a Poverty Reduction and Growth Facility (PRGF). The Kyrgyz Republic must successfully conclude the three-year PRGF, which ends in December 2004, in order to return to the Paris Club for further debt restructuring. The performance criteria for end-March 2004 were met owing to improved tax collection. The higher tax revenues compensated for lower-than-expected spending cuts, as well as delays in the implementation of a new property tax and the extension of VAT to agricultural products.

Monetary policy continued to focus on maintaining inflation within the 4-5 per cent range. Inflationary pressures that arose during the final quarter of 2003 have abated and inflation was below 4 per cent year-on-year in July 2004.

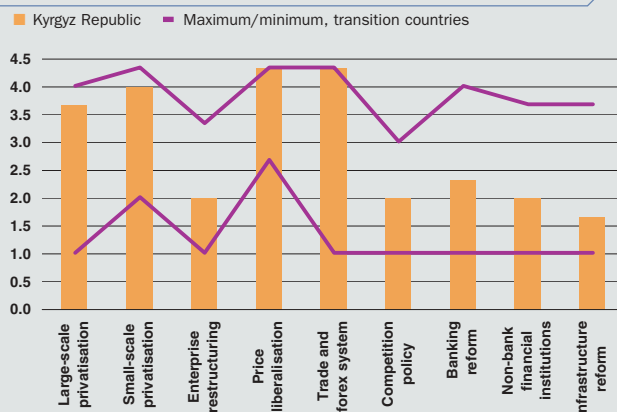
### External sector

The current account deficit narrowed from 3.9 per cent of GDP in 2002 to 2.8 per cent in 2003. This was primarily due to the continued increase in service revenues from Manas airport and the nearby international military base. Imports grew strongly, supported by robust domestic demand. Despite the recovery of gold exports and increased gold prices, the trade deficit increased from 3.4 per cent of GDP in 2002 to 4.3 per cent in 2003. Although total public external debt declined from 97 per cent of GDP in 2002 to 94 per cent in 2003, it remains one of the highest in the region. The flow rescheduling agreement reached with the Paris Club in March 2002 has reduced debt service obligations by about US\$ 111 million in current value terms. However, the programme is coming to an end in December 2004. Without further debt rescheduling, debt service is set to increase from 11 per cent of exports of goods and services in 2004 to 14 per cent in 2005.

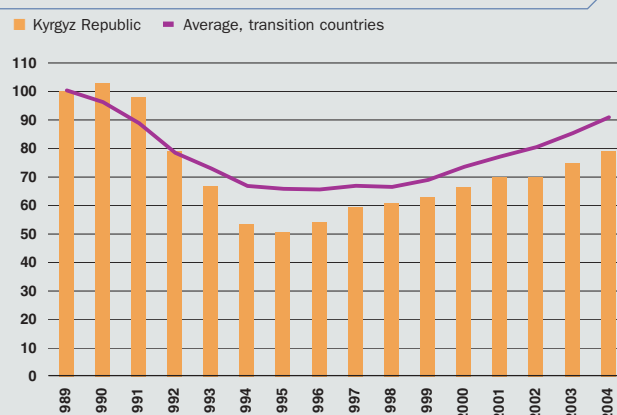
## Outlook and risks

Growth is projected to decelerate slightly to 6 per cent in 2004, although many sectors will remain buoyant in view of the positive external environment. The main macroeconomic challenges remain the high level of public external debt and the concentration of economic activity in a few sectors that are vulnerable to shocks – notably agriculture, gold mining and hydro electric power. Upon the successful completion of the PRGF, the authorities are expected to approach the Paris Club for a stock rescheduling (Naples terms) in 2005. However, even if this is achieved, debt sustainability will depend on further strong and diversified growth.

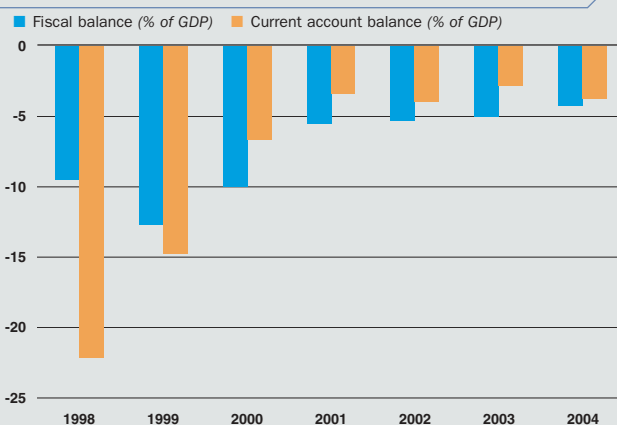
### Transition indicators, 2004



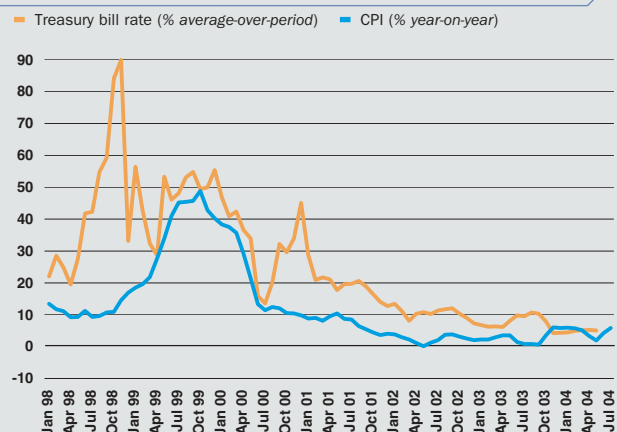
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes <sup>1</sup>	Share of population living in poverty –
Interest rate liberalisation – full	<b>vouchers</b>	Separation of railway accounts – no	<b>27.2 per cent (2001)<sup>2</sup></b>
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes <sup>1</sup>	Private pension funds – yes
	<b>MEBOs</b>		
Stabilisation	Tradability of land – limited de facto	Financial sector	
Share of general government tax revenue in GDP – <b>17.8 per cent</b>		Capital adequacy ratio – <b>12 per cent</b>	
Exchange rate regime – <b>managed float</b>	<b>Enterprise and markets</b>	Deposit insurance system – no	
	Competition office – yes <sup>1</sup>	Secured transactions law – yes	
		Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	12.0
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	57.7	55.7	56.9	52.5	53.8	50.3	na
Share of trade in GDP (in per cent)	78.4	81.1	74.3	60.2	65.4	66.1	na
Tariff revenues (in per cent of imports)	2.4	1.4	1.1	1.4	1.6	1.4	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.0	4.3	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	1.8	2.0	2.3	2.7	2.9	3.2	na
Private sector share in GDP (in per cent)	60.0	60.0	60.0	60.0	65.0	65.0	75.0
Private sector share in employment (in per cent)	76.2	77.7	78.2	79.1	79.7	na	na
<i>EBRD index of small-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.7
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	2.5	2.3	na	3.0	3.4	3.2	na
Share of industry in total employment (in per cent)	10.1	9.0	8.0	7.9	7.6	na	na
Change in labour productivity in industry (in per cent)	5.1	3.6	18.5	5.8	-10.2	na	na
Investment/GDP (in per cent)	15.4	18.0	20.0	18.0	17.6	16.2	na
<i>EBRD index of enterprise reform</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>EBRD index of competition policy</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	7.8 (0.0)	7.6 (0.1)	7.7 (0.2)	7.8 (0.5)	7.8 (1.0)	7.9 (1.2)	na
Internet penetration rate (per 10,000 inhabitants)	0.5	3.2	3.6	9.1	11.6	11.0	na
Railway labour productivity (1989=100)	17.4	15.4	15.3	15.0	16.2	22.0	na
Residential electricity tariffs, USc kWh	na	na	0.6	0.7	0.8	1.3	na
Average collection rate, electricity (in per cent)	na	na	45	na	84	78	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.2	2.6	2.8	3.2	na	na	na
<i>EBRD index of infrastructure reform</i>	1.3	1.3	1.3	1.3	1.3	1.3	1.7
<i>Electric power</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Railways</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Roads</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Telecommunications</i>	2.0	2.0	2.3	2.3	2.3	2.7	3.0
<i>Water and waste water</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	23 (6)	23 (5)	22 (6)	20 (5)	20 (6)	21 (7)	na
Asset share of state-owned banks (in per cent)	10.4	25.8	15.8	16.6	9.7	7.2	na
Non-performing loans (in per cent of total loans) <sup>3</sup>	0.2	6.4	16.3	13.8	13.3	11.2	na
Domestic credit to private sector (in per cent of GDP)	5.0	3.0	2.2	2.0	2.6	na	na
Stock market capitalisation (in per cent of GDP)	0.8	0.4	0.3	0.3	0.5	1.6	na
<i>EBRD index of banking sector reform</i>	2.7	2.3	2.3	2.3	2.3	2.3	2.3
<i>EBRD index of reform of non-bank financial institutions</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	7.7	6.2	5.5	5.7	6.5	6.5	na
Life expectancy at birth, total (years)	67.1	67.0	66.4	65.8	65.2	na	na
Basic school enrolment ratio (in per cent)	90.3	89.8	96.2	95.2	94.8	na	na

<sup>1</sup> The regulator does not have financial independence.

<sup>2</sup> Based on the nationally defined poverty line, the percentage of population living in poverty was 41 per cent in 2003.

<sup>3</sup> In 1998 all bad loans in the banking system were transferred to a special bank managed by NBKR. The data reported by the Central Bank are likely to exclude these bad loans.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>							
	<i>(Percentage change in real terms)</i>						
GDP	2.1	3.7	5.4	5.3	0.0	6.7	6.0
Private consumption	30.3	0.7	-4.2	1.6	4.2	9.7	na
Public consumption	-45.5	3.5	7.5	0.0	-0.2	0.2	na
Gross fixed capital formation	-1.1	27.7	26.4	-1.9	-7.3	-1.4	na
Exports of goods and services	-8.7	-10.4	10.5	-3.2	8.1	2.5	na
Imports of goods and services	1.5	-4.9	0.4	-13.8	13.1	1.8	na
Industrial gross output	5.3	-4.3	6.0	5.4	-10.9	17.0	na
Agricultural gross output	2.9	8.2	2.6	7.3	3.1	3.8	na
<b>Employment</b>							
	<i>(Percentage change)</i>						
Labour force (end-year) <sup>1</sup>	2.2	2.1	1.7	1.8	2.0	na	na
Employment (end-year) <sup>2</sup>	0.9	3.5	0.2	1.1	3.5	na	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year) <sup>1</sup>	5.9	7.4	7.5	7.8	8.6	na	na
<b>Prices and wages</b>							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	10.5	35.9	18.7	6.9	2.0	3.1	6.2
Consumer prices (end-year)	16.8	39.8	9.5	3.7	2.3	5.6	5.0
Producer prices (annual average)	7.9	53.7	30.7	12.0	4.8	4.6	na
Producer prices (end-year)	31.3	43.6	22.9	5.2	6.0	7.8	na
Gross average monthly earnings in economy (annual average)	23.6	24.9	16.9	18.6	15.8	12.9	na
<b>Government sector<sup>3</sup></b>							
	<i>(In per cent of GDP)</i>						
General government balance <sup>4</sup>	-9.5	-12.7	-9.9	-5.5	-5.3	-5.0	-4.2
General government expenditure	33.9	34.0	28.5	25.9	28.0	27.1	na
General government debt	110.7	134.3	113.3	102.1	107.2	102.6	na
<b>Monetary sector</b>							
	<i>(Percentage change)</i>						
Broad money (M2, end-year)	17.5	33.7	11.7	11.3	33.9	33.4	na
Domestic credit (end-year)	22.6	5.0	10.0	-8.1	18.9	10.9	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	14.5	13.6	11.3	11.1	14.6	17.6	na
<b>Interest and exchange rates</b>							
	<i>(In per cent per annum, end-year)</i>						
Official rate <sup>5</sup>	54.0	51.6	32.8	10.7	4.4	4.0	na
Money market rate <sup>6</sup>	43.7	47.2	32.3	19.1	7.0	4.0	na
Deposit rate <sup>7</sup>	35.8	35.6	18.4	12.5	5.9	5.0	na
Lending rate <sup>7</sup>	73.4	60.9	51.9	37.3	24.8	21.7	na
	<i>(Soms per US dollar)</i>						
Exchange rate (end-year)	29.4	45.8	48.3	47.7	46.1	44.2	na
Exchange rate (annual average)	20.8	39.0	47.7	48.3	46.9	43.7	na
<b>External sector</b>							
	<i>(In millions of US dollars)</i>						
Current account	-364	-184	-91	-51	-63	-53	-80
Trade balance	-221	-89	4	40	-54	-83	-120
Merchandise exports	535	463	511	480	498	590	629
Merchandise imports	756	551	507	440	552	673	749
Foreign direct investment, net	87	38	-7	-1	5	17	72
Gross reserves, excluding gold (end-year)	164	230	205	230	290	359	na
External debt stock	1,480	1,647	1,704	1,678	1,785	1,966	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	2.1	3.9	3.8	4.9	5.0	5.3	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	21.8	24.8	24.8	24.3	14.1	17.3	na
<b>Memorandum items</b>							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	4.7	4.7	4.7	4.8	4.8	4.8	na
GDP (in millions of soms)	34,181	48,744	65,358	73,883	75,367	83,421	93,918
GDP per capita (in US dollar)	350	266	289	321	334	395	na
Share of industry in GDP (in per cent)	20.8	24.7	27.2	26.8	21.3	20.9	na
Share of agriculture in GDP (in per cent)	36.1	34.9	34.2	34.5	34.4	35.2	na
Current account/GDP (in per cent)	-22.1	-14.7	-6.6	-3.3	-3.9	-2.8	-3.7
External debt - reserves (in US\$ million)	1,317	1,418	1,499	1,448	1,495	1,607	na
External debt/GDP (in per cent)	89.9	131.8	124.4	109.6	111.1	102.9	na
External debt/exports of goods and services (in per cent)	247.6	312.3	297.5	299.2	280.6	263.4	na

<sup>1</sup> Based on labour force data from World Bank *World Development Indicators*.

<sup>2</sup> The number of people employed in legal entities, which excludes employment in agriculture and forestry. Based on data from the National Statistical Committee (NSC).

<sup>3</sup> General government includes the state, municipalities and extra-budgetary funds. It also includes expenditure under the foreign-financed public investment programme and net lending.

<sup>4</sup> Cash basis in 1998 and accrual basis thereafter.

<sup>5</sup> Lombard rate from international financial statistics.

<sup>6</sup> Weighted average rate on interbank loans in soms with 1-90 days maturity, from international financial statistics.

<sup>7</sup> Weighted average over all maturities from international financial statistics.

# Latvia

## Key challenges

Despite significant progress, additional measures should be taken to reduce corruption and to strengthen the enforcement of anti-money laundering legislation.

In the energy sector challenges remain to reform and unbundle the electricity company Latvenergo and to further liberalise the sector as a whole.

Anticipated accession to the Exchange Rate Mechanism II in January 2005 will place additional importance on fiscal consolidation and control over local government finances. This should prevent further deterioration of the external position in the face of rapid real wage and credit growth.

## Business environment and competition

Reducing corruption and tax fraud and tightening enforcement of anti-money laundering laws are needed to improve the business environment. In July 2004 the Council of Europe's Group of States against Corruption (GRECO) published an evaluation report on Latvia. The report concludes that, although the legal framework concerning freezing and confiscation of proceeds from corruption is adequate, further improvements are needed. These include the strengthening of corruption prevention policies in the public administration by introducing an Ombudsman, and by defining more clearly the legal framework for local-level administration.

Recent measures to combat money laundering still need time to take effect. Another Council of Europe group (Moneyval) was critical of the Latvian law enforcement authorities. It noted that there had been no successful prosecutions in money laundering to date. In March 2004 the Latvian Commercial Banks Association had communicated similar concerns, stressing the lack of enforcement of anti-money laundering laws. In the same month the United States added Latvia to its list of countries of primary concern for money laundering, based largely on the country's poor record of prosecution and convictions.

## Infrastructure

In July 2004 the government announced the opening up of the electricity market, which will also clear the way for transforming the state owned electricity company Latvenergo. A power distribution subsidiary will be established by 1 January 2005, and all power transmission functions will be turned over to another, legally separate, subsidiary by 1 March 2005. In addition, another subsidiary will be established in January 2005 to take responsibility for the distribution of electric power. Latvenergo will remain responsible for electricity generation.

The Ministry of Economics is preparing a final law on the electricity market which will detail the liberalisation of the market. At the same time, this will ensure that Latvenergo – and its subsidiaries – remain in state hands. In July 2004 the electricity market for large customers was liberalised – at least in theory. Once the power bridge between the three Baltic states is fully operational, the market should also be liberalised in practice.

Since the liberalisation of the fixed-line telecommunications market in 2003, a large number of new fixed-line operators have signed interconnection agreements with Lattelekom for using its network. The agreements form a legal base for mutual service provision and for guaranteeing clients of other operators access to the network. As of April 2004 the Public Utilities Regulatory Commission (SPRK) has substantially cut the maximum allowable tariff for new operators. The new operator-specific tariffs are significantly lower than the fixed tariffs that Lattelekom had proposed initially. Consequently, the telecommunications market is beginning to broaden.

### Country data

Population (in millions)	<b>2.3</b>
Area ('000 sq. km)	<b>64.5</b>
Official language	<b>Latvian</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 9,210</b>
National currency	<b>Lat</b>

## Progress in structural reform

### Liberalisation and privatisation

In March 2004, after a three-year arbitration case concerning telecommunications operator Lattelekom, the Latvian government and Finnish-Swedish conglomerate TeliaSonera signed a settlement and cooperation memorandum. The Latvian state owns 51 per cent of Lattelekom and TeliaSonera 49 per cent. The case stemmed from the government's decision to shorten Lattelekom's fixed-line monopoly from 2013 to 2003, in accordance with WTO requirements.

TeliaSonera claimed some LVL 80 million (€119.8 million) in compensation. The government issued a counter-claim of LVL 550 million (€823.4 million) for delayed or unfinished modernisation of the rural telecommunications network and other violations of a framework agreement. The settlement states that both parties will drop their claims. They will also set up a task force to negotiate the sale of the state-held shares in Lattelekom and in mobile phone operator LMT.

The cooperation memorandum states that if the Latvian government and TeliaSonera agree on privatisation before the end of 2004, TeliaSonera will pay LVL 9 million (€13.5 million) to the Latvian government in compensation. TeliaSonera has indicated its intention to acquire 100 per cent of the company. Some disagreements remain, however, and a return to litigation is not ruled out.

## Macroeconomic performance

### Real economy

Real GDP grew by 7.5 per cent in 2003 and by 8.2 per cent in the first half of 2004. Growth for 2004 as a whole is forecast at 7.5 per cent and should, over the medium term, remain at 5.5 to 6 per cent per year. Strong growth in investment and consumption have been the main drivers of this expansion. Investment growth has been stimulated by large, though declining, inflows of foreign direct investment (FDI), low interest rates and longer available maturities (10–12 years) for bank loans. Consumption has been growing as a result of increasing real wages and a boom in mortgage and consumption loans. Domestic credit grew on average by 38 per cent per year during the last three years. External demand strengthened as well in the first half of 2004 and is expected to remain high in the coming years.

### Economic policies

The general government deficit decreased to 1.6 per cent of GDP in 2003. A somewhat higher deficit is expected in 2004. Revenue performance in 2003 and in the first half of 2004 was very strong, despite recent reductions in the corporate and social tax rates. Continuing fiscal consolidation is necessary to prevent difficulties in meeting the spending needs related to EU and NATO membership within the constraints of the Maastricht criteria.

The currency peg to the IMF's Special Drawing Right (SDR) will remain in place until January 2005, when the lat is expected to be re-pegged to the euro within the Exchange Rate Mechanism II. Since inflation has been rising steeply, and is likely to reach more than 6 per cent in 2004, the Bank of Latvia increased reserve requirements and raised its refinancing rate from 3 per cent to 3.5 per cent.

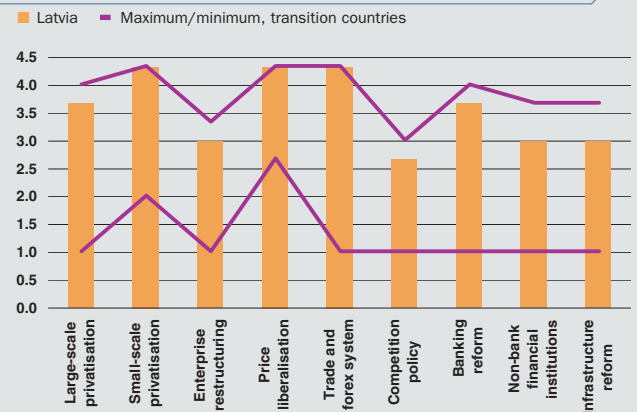
### External sector

The current account deficit grew to 8.6 per cent of GDP in 2003 and is expected to increase to 9.4 per cent in 2004. During the first half of 2004 exports were on average 16 per cent higher than in the first half of 2003, whereas the average level of imports increased by 26 per cent. The current account deficit will remain around 8 per cent over the medium term. Export growth is likely to strengthen, but so is import growth, driven by high investment needs and increasing consumption. In the first half of 2004 net FDI covered 40 per cent of the current account deficit, up from 34 per cent in 2003. The rest of the deficit was covered by other long-term capital.

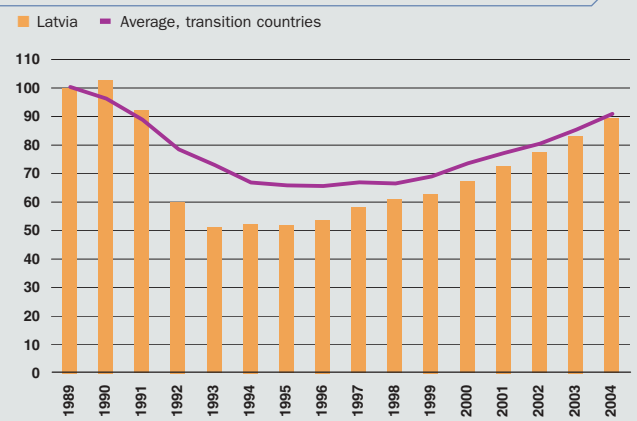
## Outlook and risks

GDP growth will be sustained, but below the current high levels. However, rapidly rising incomes and further credit expansion could endanger the sustainability of the external position. Tight economic policies are essential to restrain wage and credit growth and to prevent the already substantial current account deficit from deteriorating further. In order to fulfil the relevant Maastricht criterion in the medium term, curbing inflation is critical as well.

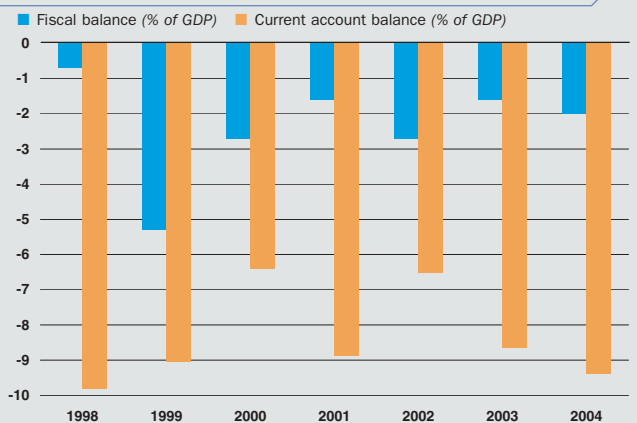
### Transition indicators, 2004



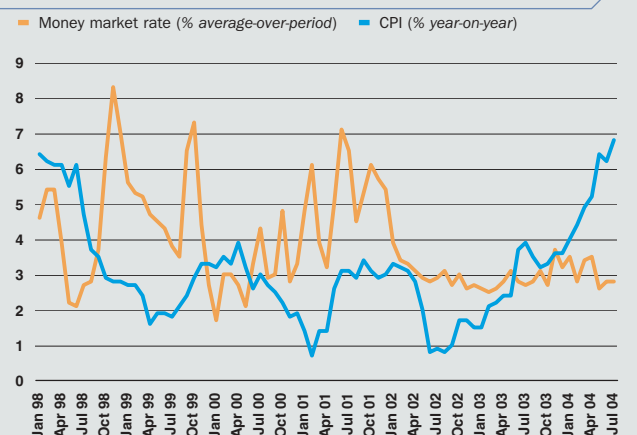
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation





Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes	Share of population living in poverty –
Interest rate liberalisation – full	direct sales	Separation of railway accounts – yes	8.3 per cent (1998)
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – yes
	vouchers		
Stabilisation	Tradability of land – full except	Financial sector	
Share of general government tax	foreigners	Capital adequacy ratio – 10 per cent	
revenue in GDP – 28.2 per cent		Deposit insurance system – yes	
Exchange rate regime – fixed peg	Enterprise and markets	Secured transactions law – restricted	
	Competition office – yes	Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	20.4	22.0	22.3	22.0	20.7	16.3	16.0
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Share of trade with non-transition countries (in per cent)	66.4	72.9	79.8	68.6	67.7	65.5	na
Share of trade in GDP (in per cent)	77.9	66.5	67.0	70.2	71.6	75.4	na
Tariff revenues (in per cent of imports)	1.1	0.9	0.8	0.7	0.6	0.6	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	3.1	3.2	3.8	4.4	5.0	5.2	na
Private sector share in GDP (in per cent)	65.0	65.0	65.0	65.0	70.0	70.0	70.0
Private sector share in employment (in per cent)	68.0	70.0	72.0	73.0	75.0	76.0	na
EBRD index of small-scale privatisation	4.0	4.0	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.3	3.7	3.7
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	4.3	4.8	4.6	4.8	5.5	5.4	na
Share of industry in total employment (in per cent)	21.1	19.9	20.6	19.4	19.5	19.7	na
Change in labour productivity in industry (in per cent)	4.4	5.2	5.4	12.6	5.0	6.7	na
Investment/GDP (in per cent)	24.1	23.2	23.5	26.9	26.8	28.8	na
EBRD index of enterprise reform	2.7	2.7	2.7	2.7	2.7	3.0	3.0
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	2.7	2.7
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	30.2 (6.8)	30.0 (11.3)	30.3 (16.6)	30.7 (27.9)	30.1 (39.4)	28.3 (52.9)	na
Internet penetration rate (per 10,000 inhabitants)	59.7	79.3	110.1	106.4	152.4	178.8	na
Railway labour productivity (1989=100)	72.0	73.6	84.5	90.5	108.6	129.9	na
Residential electricity tariffs, USc kWh	na	na	6.3	6.3	6.5	7.1	na
Average collection rate, electricity (in per cent)	99	na	na	99	99	100	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.5	4.0	4.6	4.1	na	na	na
EBRD index of infrastructure reform	2.7	2.7	2.7	3.0	3.0	3.0	3.0
Electric power	2.3	3.0	3.0	3.0	3.0	3.0	3.3
Railways	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Water and waste water	2.7	3.0	3.0	3.3	3.3	3.3	3.3
<b>Financial sector</b>							
Number of banks (foreign-owned)	27 (15)	23 (12)	21 (12)	23 (10)	23 (9)	23 (10)	na
Asset share of state-owned banks (in per cent)	8.5	2.6	2.9	3.2	4.0	4.1	na
Non-performing loans (in per cent of total loans)	6.8	6.8	5.0	3.1	2.1	1.5	na
Domestic credit to private sector (in per cent of GDP)	13.9	14.8	18.1	24.6	30.5	38.8	na
Stock market capitalisation (in per cent of GDP)	5.6	5.4	7.4	8.5	7.3	9.6	na
EBRD index of banking sector reform	2.7	3.0	3.0	3.3	3.7	3.7	3.7
EBRD index of reform of non-bank financial institutions	2.3	2.3	2.3	2.3	3.0	3.0	3.0
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	10.1	11.4	9.6	9.5	9.8	na	na
Life expectancy at birth, total (years)	69.7	70.4	70.4	70.4	70.4	na	na
Basic school enrolment ratio (in per cent)	92.4	93.3	96.5	99.4	101.0	na	na

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> (Percentage change in real terms)							
GDP	4.7	3.3	6.9	8.0	6.4	7.5	7.5
Private consumption	0.7	4.3	6.3	7.3	7.4	8.6	na
Public consumption	13.0	0.0	-1.9	0.3	2.4	2.5	na
Gross fixed capital formation	61.4	-6.8	10.2	11.4	13.0	7.4	na
Exports of goods and services	4.9	-6.4	12.0	6.9	6.3	4.3	na
Imports of goods and services	19.0	-5.2	4.9	12.6	4.5	13.3	na
Industrial gross output	6.4	-2.4	5.4	8.7	8.8	9.4	na
Agricultural gross output	-3.4	-3.3	11.5	6.4	4.4	1.0	na
<b>Employment</b> (Percentage change)							
Labour force (end-year)	-1.6	-1.6	-2.9	0.9	1.5	0.3	na
Employment (end-year)	-0.4	-1.8	-3.0	2.5	2.8	1.8	na
(In per cent of labour force)							
Unemployment (end-year)	14.1	14.3	14.4	13.1	12.4	10.6	na
<b>Prices and wages</b> (Percentage change)							
Consumer prices (annual average)	4.7	2.4	2.6	2.5	1.9	3.0	6.2
Consumer prices (end-year)	2.8	3.3	1.9	3.0	1.5	3.6	7.0
Producer prices (annual average)	1.9	-4.0	0.6	1.7	1.0	3.2	na
Producer prices (end-year)	-1.9	-1.1	1.0	1.8	0.8	4.1	na
Gross average monthly earnings in economy (annual average)	11.1	5.7	6.1	6.4	8.9	11.1	na
<b>Government sector</b> <sup>1</sup> (In per cent of GDP)							
General government balance	-0.7	-5.3	-2.7	-1.6	-2.7	-1.6	-2.0
General government expenditure	40.2	41.0	37.2	34.9	35.7	35.4	na
General government debt	10.6	13.7	13.9	16.2	15.5	15.6	na
<b>Monetary sector</b> (Percentage change)							
Broad money (M2, end-year)	5.9	8.0	27.9	20.8	21.0	21.1	na
Domestic credit (end-year)	30.6	15.2	44.3	36.2	39.8	39.2	na
(In per cent of GDP)							
Broad money (M2, end-year)	23.6	23.6	27.2	29.8	32.8	35.7	na
<b>Interest and exchange rates</b> (In per cent per annum, end-year)							
Refinancing rate	4.0	4.0	3.5	3.5	3.0	3.0	na
Interbank market rate <sup>2</sup>	7.0	2.7	3.3	5.4	2.7	3.2	na
Deposit rate (short-term, under 1 year)	6.5	4.2	4.2	5.7	5.2	4.6	na
Lending rate (short-term, under 1 year)	16.4	12.5	11.8	9.9	7.4	7.4	na
(Lats per US dollar)							
Exchange rate (end-year)	0.57	0.58	0.61	0.64	0.59	0.54	na
Exchange rate (annual average)	0.59	0.59	0.61	0.63	0.62	0.57	na
<b>External sector</b> (In millions of US dollars)							
Current account	-650	-654	-494	-732	-601	-956	-1,225
Trade balance	-1,130	-1,027	-1,058	-1,351	-1,444	-1,998	-2,491
Merchandise exports	2,011	1,889	2,058	2,216	2,576	3,171	3,755
Merchandise imports	3,141	2,916	3,116	3,567	4,020	5,169	6,246
Foreign direct investment, net	303	331	400	170	374	328	365
Gross reserves, excluding gold (end-year)	728	840	851	1,149	1,241	1,432	na
External debt stock <sup>3</sup>	3,098	3,821	4,702	5,570	6,970	9,140	na
(In months of imports of goods and services)							
Gross reserves, excluding gold (end-year)	2.2	2.8	2.6	3.2	3.2	2.8	na
(In per cent of exports of goods and services)							
Debt service	10.7	14.3	16.5	21.5	15.4	13.8	na
<b>Memorandum items</b> (Denominations as indicated)							
Population (end-year, million)	2.4	2.4	2.4	2.3	2.3	2.3	na
GDP (in millions of lats)	3,903	4,224	4,686	5,168	5,691	6,323	7,113
GDP per capita (in US dollar)	2,757	3,032	3,268	3,511	3,949	4,771	na
Share of industry in GDP (in per cent)	24.0	21.8	20.7	20.4	20.3	20.3	na
Share of agriculture in GDP (in per cent)	4.4	4.3	4.9	4.7	4.5	4.3	na
Current account/GDP (in per cent)	-9.8	-9.1	-6.4	-8.9	-6.5	-8.6	-9.4
External debt - reserves (in US\$ million)	2,370	2,981	3,851	4,421	5,729	7,708	na
External debt/GDP (in per cent)	46.8	52.9	60.9	67.6	75.7	82.6	na
External debt/exports of goods and services (in per cent)	99.3	131.1	143.7	163.6	182.1	194.5	na

<sup>1</sup> General government includes the state, municipalities and extra-budgetary funds. Privatisation revenues are not included in revenues. General government expenditure includes net lending.

<sup>2</sup> Weighted average interest rates in the interbank market.

<sup>3</sup> Includes non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

# Lithuania

## Key challenges

- The electricity market would benefit from a clearer legal and regulatory framework concerning future electricity prices and the underlying tariff-setting methodology.
- Additional reforms to raise the contribution rate are needed to ensure a well-capitalised and sustainable second pension pillar.
- In order to keep the current account deficit at a sustainable level and to enable fulfilment of the Maastricht criteria in the medium term, the track record of fiscal caution that has been built up in recent years should not be put at risk.

The German energy group E.ON Energie, which already holds a 20.3 per cent stake in RST, did not submit an offer for the government stake. It argued that it was unable to adequately value the shares due to uncertainty about future electricity prices. However, this issue should be resolved when parliament adopts a new law on electric energy and the Lithuanian authorities clarify electricity price regulation rules.

In March 2004 the sale of a second 34 per cent stake in the gas transmission and distribution monopoly Lietuvos Dujos (Lithuanian Gas) to Russia's Gazprom was finalised after two years of negotiations. This transaction immediately followed a deal on long-term gas supplies between Gazprom and Lithuanian Gas.

In June 2004 the Lithuanian government took further steps in liberalising the gas market. Following amendment of the law on natural gas, all non-household consumers have been able to choose their gas supplier since July. Companies using more than 1 million cubic metres of gas a year were already free to choose. Domestic consumers will be allowed to pick a gas supplier of their own choice from July 2007. However, competition will be limited as long as Gazprom remains the sole provider of gas to Lithuania and an important shareholder in Lithuanian Gas and the other wholesale companies.

## Social sector

A recent UN report on reaching the Millennium Development Goals shows that Lithuania has made substantial socio-economic progress in recent years. Net secondary school enrolment rates have been increasing steadily and full enrolment should be achievable in the next few years. However, the report also points out that after an initial decline, the overall poverty level has been increasing slowly since 1999. In rural Lithuania, where unemployment is highest, poverty has been rising steadily since 1996. This calls for more active regional employment initiatives, targeted at creating the right incentives for recipients in the social assistance system.

The UN report also urged Lithuania to promote sustainable development by introducing cleaner production principles in industry. The country's rapid economic development has been accompanied by increasing amounts of waste water being discharged into surface waters without treatment.

The introduction of a second pillar in the pension system is making progress. During the second half of 2003, nearly 442,000 Lithuanians signed agreements with second-pillar pension funds. Since January 2004 individuals have been able to voluntarily arrange for a part of the state social insurance contributions to be accumulated in private pension funds. Despite initial success, however, doubts remain as to whether the current voluntary contribution system is sustainable over the long term. If the contribution rate cannot be raised through the voluntary system, it could lead to the introduction of some form of mandatory participation.

## Country data

Population (in millions)	<b>3.5</b>
Area ('000 sq. km)	<b>67</b>
Official language	<b>Lithuanian</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 10,320</b>
National currency	<b>Lita</b>

## Progress in structural reform

### Liberalisation and privatisation

During the second half of 2003 and the first half of 2004 further progress was made with privatisation. Important privatisations in the first half of 2004 include the sale of 44.3 per cent of the National Stock Exchange of Lithuania (NSEL), 32 per cent of the Central Securities Depository of Lithuania (CSDL), 83.8 per cent of the beverage company Alita, and 100 per cent of the Lithuanian Film Studio.

During 2003 total privatisation proceeds amounted to LTL 910 million (€263.8 million). In the first seven months of 2004 the sale of state-owned and municipal assets raised LTL 368 million (€106.7 million). Privatisation opportunities remain in a number of majority stakes in medium-sized companies, some minority stakes in the utilities sector and a portfolio of real estate properties.

### Infrastructure

In July 2003 the privatisation of the two regional electricity distribution companies – VST (Vakaru Skirstomieji Tinklai) and RST (Rytu Skirstomieji Tinklai) – commenced. In December the government approved the sale of 77 per cent of VST to NDX Energy, a Lithuanian concern, for LTL 539.85 million (€156 million). However, the government then postponed the sale of its 71.8 per cent stake in RST due to concerns that the sole qualified bidder, state-owned Estonian Energy, had not been restructured.

## Macroeconomic performance

### Real economy

Real GDP grew by 9 per cent in 2003 and by an estimated 7.3 per cent in the first half of 2004. It has been backed by strong growth in investments and consumption, in turn fuelled by higher employment and low interest rates. Export growth was less impressive in 2003 than in previous years, but is expected to pick up again in 2004. The unemployment rate continued to decline to 12.4 per cent by the end of 2003 and is projected to fall to 11.3 per cent at the end of 2004.

### Economic policies

The general government budget deficit in 2003 amounted to 1.7 per cent of GDP. In 2004 a widening of the deficit to 2.8 per cent of GDP is envisaged. This deficit increase is primarily due to higher expenditures, mainly on public investment, pension reform and public sector salaries. In June 2004 the Lithuanian lita was included in the Exchange Rate Mechanism II (ERM II). The country was allowed to join ERM II with its existing currency board arrangement, placing no additional obligations on the European Central Bank (ECB).

Lithuania recorded deflation of 1.3 per cent at the end of 2003. This reflected the nominal effective appreciation of the lita, strong productivity gains, and low food prices. However, during the first half of 2004 price increases related to EU accession (mainly tax alignments) reversed the deflationary trend. An average inflation rate of 1.5 per cent is forecast for the year.

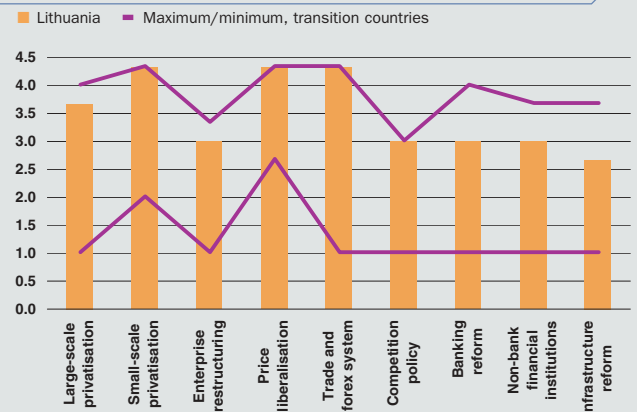
### External sector

The current account deficit widened to 6.7 per cent of GDP in 2003 and continued to rise in the first half of 2004. It is expected to remain above 6 per cent in the foreseeable future. The increase is partly due to the strength of private consumption, the rapid credit growth to households, and the high import content of EU-related investment. Net foreign direct investment (FDI) fell to around US\$ 142 million for 2003, down from US\$ 714 million in 2002. This steep decline was caused, in part, by the reclassification of an existing loan by a foreign investor from "FDI" to "other foreign investment". At the same time, new FDI inflows related to the privatisation process declined by almost 90 per cent when compared with 2002. However, greenfield FDI is expected to pick up in the coming years.

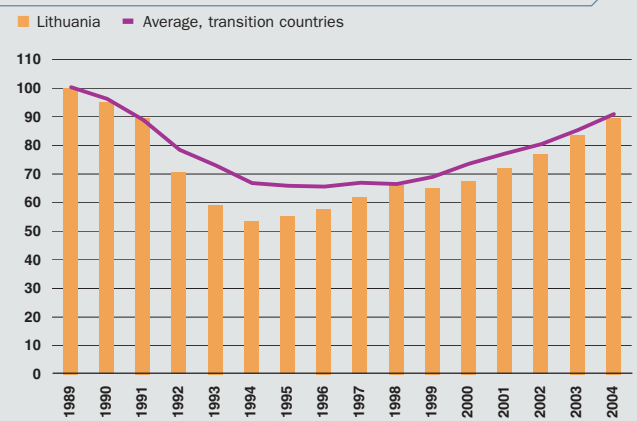
## Outlook and risks

Real GDP is expected to grow by 7 per cent in 2004 and by 5 to 6 per cent per year over the medium term. Although consumption and investment-related imports will increase, EU accession and economic recovery in the eurozone should also boost exports. The current account deficit could widen further in 2004 due to imports fuelled by EU-related investment and rapid credit growth.

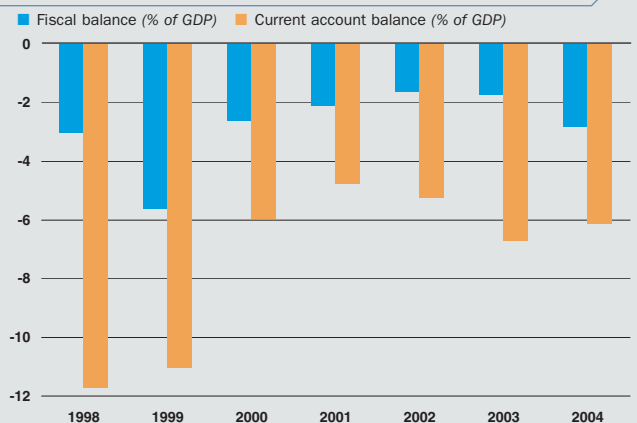
### Transition indicators, 2004



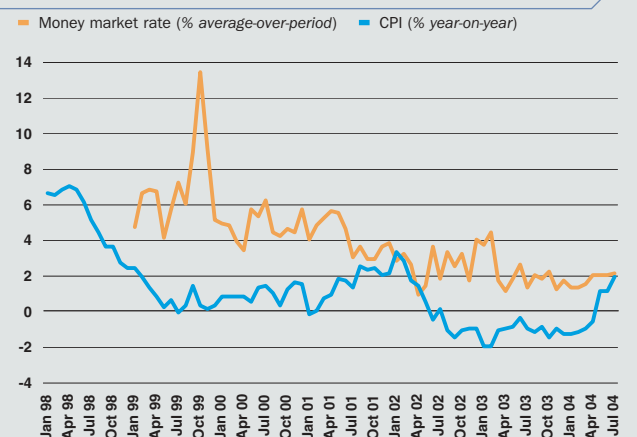
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes	Share of population living in poverty –
Interest rate liberalisation – full	<b>vouchers</b>	Separation of railway accounts – yes	<b>13.7 per cent (2000)</b>
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – yes
	<b>direct sales</b>		
Stabilisation	Tradability of land – full <sup>1</sup>	Financial sector	
Share of general government tax revenue in GDP – <b>27 per cent</b>	<b>Enterprise and markets</b>	Capital adequacy ratio – <b>10 per cent</b>	
Exchange rate regime – <b>currency board in ERM II</b>	Competition office – yes	Deposit insurance system – yes	
		Secured transactions law – yes	
		Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	16.9	16.2	18.1	20.4	21.5	23.5	19.8
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	46.6	50.9	65.9	59.9	61.5	63.6	na
Share of trade in GDP (in per cent)	85.1	71.0	81.0	90.1	95.3	92.8	na
Tariff revenues (in per cent of imports) <sup>2</sup>	1.1	1.1	0.7	0.6	0.5	0.5	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.0	4.0	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.0	4.0	4.0	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	6.7	7.8	9.6	10.6	11.1	12.7	na
Private sector share in GDP (in per cent)	70.0	70.0	70.0	70.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
<i>EBRD index of small-scale privatisation</i>	4.0	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of large-scale privatisation</i>	3.0	3.0	3.0	3.3	3.7	3.7	3.7
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	0.5	0.3	0.2	0.2	0.2	0.3	na
Share of industry in total employment (in per cent)	22.1	21.0	20.8	20.8	20.9	20.7	na
Change in labour productivity in industry (in per cent) <sup>3</sup>	11.6	-4.7	10.9	19.9	0.6	14.1	na
Investment/GDP (in per cent)	25.6	22.5	19.6	20.5	21.7	21.9	na
<i>EBRD index of enterprise reform</i>	2.7	2.7	2.7	2.7	3.0	3.0	3.0
<i>EBRD index of competition policy</i>	2.3	2.3	2.7	3.0	3.0	3.0	3.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	30.1 (7.2)	31.2 (9.0)	32.1 (14.7)	31.3 (27.7)	27.0 (47.5)	25.3 (66.6)	na
Internet penetration rate (per 10,000 inhabitants)	26.5	38.4	48.2	95.5	157.7	203.8	na
Railway labour productivity (1989=100)	36.3	34.9	41.3	39.1	54.4	67.8	na
Residential electricity tariffs, USc kWh	na	na	6.3	6.3	7.9	9.4	na
Average collection rate, electricity (in per cent)	90	90	na	91	90	91	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.9	3.4	3.9	3.7	na	na	na
<i>EBRD index of infrastructure reform</i>	2.3	2.3	2.7	2.7	2.7	2.7	2.7
<i>Electric power</i>	2.3	2.3	3.0	3.0	3.0	3.0	3.3
<i>Railways</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Roads</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Telecommunications</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3
<i>Water and waste water</i>	2.3	2.7	3.0	3.3	3.3	3.3	3.3
<b>Financial sector</b>							
Number of banks (foreign-owned)	12 (5)	13 (4)	13 (6)	13 (6)	14 (7)	13 (7)	na
Asset share of state-owned banks (in per cent)	44.4	41.9	38.9	12.2	0.0	0.0	na
Non-performing loans (in per cent of total loans)	12.5	11.9	10.8	7.4	5.8	2.6	na
Domestic credit to private sector (in per cent of GDP)	9.3	10.9	10.0	11.4	13.9	19.9	na
Stock market capitalisation (in per cent of GDP)	9.7	10.5	13.9	9.9	9.3	17.2	na
<i>EBRD index of banking sector reform</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>EBRD index of reform of non-bank financial institutions</i>	2.3	2.7	3.0	3.0	3.0	3.0	3.0
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	10.9	11.0	10.3	10.3	na	na	na
Life expectancy at birth, total (years)	71.6	72.1	72.6	72.7	72.7	na	na
Basic school enrolment ratio (in per cent)	99.8	99.2	101.5	102.4	103.0	na	na

<sup>1</sup> Full for non-agricultural land, but ownership of agricultural land is constitutionally prohibited for foreigners and partially restricted for Lithuanian legal persons.

<sup>2</sup> Refers to all taxes on foreign trade.

<sup>3</sup> There is a break in the series. Data from 2000 are based on the population census and previous data have not been recalculated.



	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> (Percentage change in real terms)							
GDP	7.3	-1.7	3.9	6.4	6.8	9.0	7.0
Private consumption	4.8	4.0	5.9	3.7	5.8	11.1	na
Public consumption	6.0	-8.1	3.9	0.3	1.9	5.7	na
Gross fixed capital formation	21.8	-6.1	-9.0	13.5	8.7	11.4	na
Exports of goods and services	4.6	-16.8	9.8	21.2	19.5	6.0	na
Imports of goods and services	6.2	-12.4	4.7	17.7	17.6	8.8	na
Industrial gross output	8.2	-11.2	5.3	15.9	5.0	15.8	na
Agricultural gross output	1.1	-2.6	0.9	-4.6	6.1	2.2	na
<b>Employment<sup>1</sup></b> (Percentage change)							
Labour force (end-year)	-6.1	-0.6	-2.0	-2.1	-0.3	0.7	na
Employment (end-year)	-5.2	-2.2	-4.0	-3.3	4.0	2.3	na
Unemployment (end-year)	13.2	14.6	16.4	17.4	13.8	12.4	na
<b>Prices and wages</b> (Percentage change)							
Consumer prices (annual average)	5.1	0.8	1.0	1.5	0.3	-1.2	1.5
Consumer prices (end-year)	2.4	0.3	1.5	2.1	-1.0	-1.3	3.5
Producer prices (annual average)	-3.9	1.7	16.0	-3.0	-2.8	-0.5	na
Producer prices (end-year)	-8.3	23.3	-7.8	1.9	2.1	-0.5	na
Gross average monthly earnings in economy (annual average)	19.5	5.9	-1.5	1.4	3.2	4.2	na
<b>Government sector<sup>2</sup></b> (In per cent of GDP)							
General government balance	-3.0	-5.6	-2.6	-2.1	-1.6	-1.7	-2.8
General government expenditure	36.9	39.6	33.0	31.1	30.8	31.5	na
General government debt	16.5	23.0	24.3	23.4	22.8	21.9	na
<b>Monetary sector</b> (Percentage change)							
Broad money (M2, end-year)	14.5	7.7	16.5	21.4	16.9	18.2	na
Domestic credit (end-year)	16.8	24.5	1.7	13.7	22.3	42.4	na
Broad money (M2, end-year)	18.8	20.7	23.0	26.2	28.7	31.5	na
<b>Interest and exchange rates</b> (In per cent per annum, end-year)							
Interbank interest rate	na	7.7	10.4	5.5	10.0	4.3	na
Treasury bill rate (3-month maturity)	11.5	12.3	5.9	4.8	3.3	2.5	na
Deposit rate <sup>3</sup>	2.4	1.6	1.0	0.8	0.3	0.2	na
Lending rate <sup>4</sup>	9.5	10.1	10.7	8.1	6.1	5.1	na
Exchange rate (end-year)	4.0	4.0	4.0	4.0	3.3	2.7	na
Exchange rate (annual average)	4.0	4.0	4.0	4.0	3.7	3.1	na
<b>External sector</b> (In millions of US dollars)							
Current account	-1,298	-1,194	-675	-574	-734	-1,218	-1,311
Trade balance	-1,518	-1,405	-1,104	-1,108	-1,337	-1,629	-1,240
Merchandise exports	3,962	3,147	4,050	4,889	6,031	7,642	8,865
Merchandise imports	5,480	4,551	5,154	5,997	7,368	9,271	10,105
Foreign direct investment, net <sup>5</sup>	921	478	375	439	714	142	500
Gross reserves, excluding gold (end-year)	1,409	1,195	1,312	1,618	2,349	3,372	na
External debt stock <sup>6</sup>	3,795	4,540	4,884	5,268	6,199	7,400	na
Gross reserves, excluding gold (end-year)	2.7	2.7	2.7	2.9	3.4	3.9	na
Debt service	18.2	20.5	20.5	15.5	15.0	13.3	na
<b>Memorandum items</b> (Denominations as indicated)							
Population (end-year, million)	3.5	3.5	3.5	3.5	3.5	3.5	na
GDP (in millions of litai)	44,377	43,359	45,526	48,379	51,633	55,737	60,224
GDP per capita (in US dollar)	3,137	3,086	3,260	3,477	4,066	5,281	na
Share of industry in GDP (in per cent)	27.9	27.2	26.9	27.8	27.2	28.9	na
Share of agriculture in GDP (in per cent)	8.7	7.4	7.0	6.3	6.2	5.6	na
Current account/GDP (in per cent)	-11.7	-11.0	-5.9	-4.7	-5.2	-6.7	-6.1
External debt - reserves (in US\$ million)	2,386	3,345	3,573	3,650	3,849	4,028	na
External debt/GDP (in per cent)	34.2	41.9	43.0	43.6	44.1	40.6	na
External debt/exports of goods and services (in per cent)	74.8	107.1	95.6	87.1	82.5	78.3	na

<sup>1</sup> There is a break in the series. Data from 2000 are based on the population census. Previous data from the labour force survey have not been recalculated.

<sup>2</sup> General government includes the state, municipalities and extra-budgetary funds. General government expenditure includes net lending.

<sup>3</sup> Average interest rate on demand deposits in litai.

<sup>4</sup> Average interest rate on loans in litai.

<sup>5</sup> Covers equity capital and reinvested earnings.

<sup>6</sup> Includes non-resident currency and deposits and loans to foreign subsidiaries.

# Moldova

## Key challenges

- Widespread state interference needs to be curtailed to restore investor confidence and take advantage of Moldova's position at the border of the enlarged EU.
- The timely implementation of the new Economic Growth and Poverty Reduction Strategy would boost economic development and help to secure access to official finance.
- Moldova's standing as a creditor is threatened by substantial debt-service arrears, while debt sustainability in the longer term depends on an agreement with the Paris Club.

### Country data

Population (in millions)	<b>4.3</b>
Area ('000 sq. km)	<b>33.8</b>
Official language	<b>Moldovan</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 1,470</b>
National currency	<b>Leu</b>

## Progress in structural reform

### Business environment and competition

Moldovan entrepreneurs remain concerned over the extent of state intervention. This is despite the resolution of some high-profile disputes, including those with two prominent foreign investors – French cement producer Lafarge, and Spanish company Union Fenosa.

In a long-awaited ruling in October 2003, the Court of Accounts upheld the legality of the privatisation of three electricity distribution companies to Union Fenosa. This dispute had not only affected operations in the power sector, but had also soured the relationship between the authorities and international investors.

However, there have since been other cases of alleged government intervention. Government influence is also increasing in the financial sector, where the state-owned savings bank is expanding on the back of government and government-supported business.

The difficult business environment continues to hold back investment. Despite lower taxes and some improvements in licensing and business registration, gross capital formation remains low at around 15 per cent of GDP. Foreign direct investment is stagnating. As a result, there has been little enterprise restructuring, either in industry or in agriculture. The privatisation of winery and tobacco assets remains a government priority under the 2003-05 privatisation programme. However, to date there have only been a limited number of sales, mostly to local and Russian investors.

A new investment law was passed in April 2004, which unifies the treatment of foreign and domestic investors, calls for a reduction in administrative barriers and promises further tax cuts. The government is also working with the EU on a joint action plan under the European Neighbourhood Policy, which sets out ambitious reform measures.

The recent EU enlargement is seen by Moldova as an opportunity to attract additional investment, increase trade and deepen the country's relationship with the West. However, cumbersome customs procedures, weak transport infrastructure and informal export restrictions are holding back trade.

### Infrastructure

The clarification of Union Fenosa's ownership rights has helped to normalise operations in the power sector. The strong leu has improved Union Fenosa's cost structure and, despite increased capital expenditures, no tariff review is therefore anticipated for 2004. The 2003 review had been controversial, since the agreed new tariffs were changed within a few days of their publication.

No progress has been made on the sale of the remaining two state-owned power distribution companies located in the north of the country. A tender was launched in December 2003, but was cancelled when only one bid (from Russia's RAO UES) was received.

Two other infrastructure companies – Moldtelecom, the dominant telecommunications operator, and Thermocom, the Chisinau district heating company – also remain on the privatisation list. No further attempt has been made to sell Moldtelecom since a failed bid at the end of 2002. However, the regulatory authorities have made progress with tariff rebalancing and full sector liberalisation, which are seen as prerequisites for a successful privatisation. Thermocom will have to undergo financial restructuring before it can be offered for sale. The company has accumulated substantial arrears on gas, electricity and water payments. This has affected the ability of suppliers to pay their own bills. The Chisinau water company was further affected by a politically motivated dispute over water tariffs, which began last year and has not yet been resolved.

### Social sector

In mid-2004 the government approved a new Economic Growth and Poverty Reduction Strategy (EGPRS). The strategy sets out a blueprint for further reform and economic development. It identifies a sound business environment, prudent macro-economic management and better infrastructure as the main determinants for sustainable growth. It also highlights improved human development and social protection as key conditions for reducing poverty. The strategy is expected to be endorsed by the World Bank and the IMF later this year. Both organisations will make the consistent implementation of the EGPRS a condition of their future involvement in the country.

Although the incidence of poverty has fallen, Moldova remains the poorest country in Europe. According to the EGPRS, 40 per cent of the population are classified as poor, with a monthly income of less than US\$ 20. In response to the economic situation, an estimated 600,000 Moldovans have so far sought employment abroad. The remittances that they send home have become an important income supplement for their families.

## Macroeconomic performance

### Real economy

The Moldovan economy grew by 6.5 per cent, year-on-year, in the first half of 2004. As in previous years, a strong industrial sector and a boom in construction were behind the rapid expansion. However, much of the industrial growth is due to improved capacity utilisation rather than investment. Although investment has risen, growth is predominantly led by consumption and fuelled by higher wages, strong remittances and increased bank lending.

### Economic policies

Price stability has again become a concern after the consumer price index rose by 16 per cent in 2003, mainly because of exceptionally high food prices. However, the National Bank of Moldova (NBM) is confident that its policies will bring inflation down to less than 10 per cent in 2004. Inflationary pressures have been eased by the strong appreciation of the leu since the end of 2003. The NBM has been concerned, however, about the impact of the stronger currency on exports and intervened repeatedly towards the middle of 2004 to slow the appreciation.

The government appears on track to meet its budget deficit target of 0.7 per cent of GDP for 2004. Despite lower tax rates, fiscal revenues in the first half of the year were higher than in the same period of 2003. This is mainly due to higher-than-expected growth and strong VAT receipts. However, recent decisions on public wages and the high debt service burden mean expenditures may also be higher than expected.

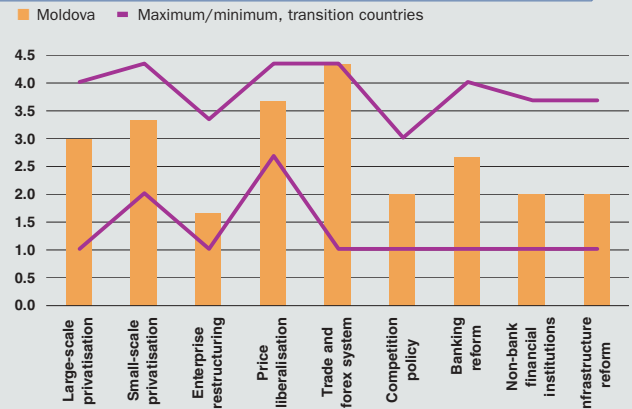
### External sector

Moldova's current account deficit has widened to around 8 per cent of GDP as a consequence of strong import growth, which was only partly offset by higher exports. However, official figures overstate the size of the deficit as they do not fully account for the substantial flow of remittances. The latter, estimated to be between US\$ 600 million to US\$ 1 billion per year, is of a similar magnitude to export revenues. External debt has stabilised at around US\$ 1.7 billion, but since mid-2003 the servicing of this debt has been irregular and the government has accumulated substantial arrears. Agreements on the rescheduling and buy-back of some debt were reached in mid-2004. This should ease debt-service obligations in the short term. However, an agreement with the Paris Club of bilateral creditors is not expected before 2006 and will depend on an agreement with the IMF on a new Fund programme.

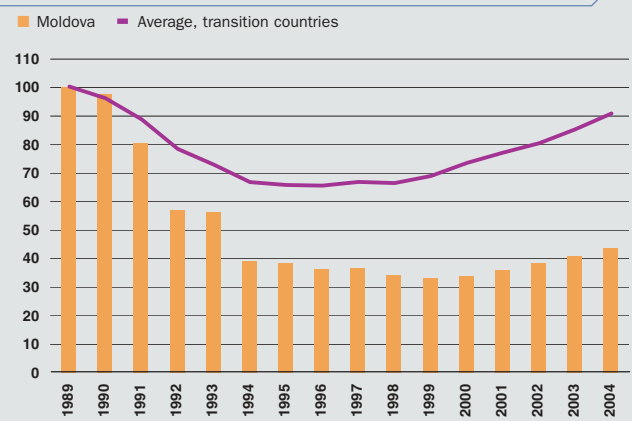
## Outlook and risks

Since 2000 Moldovan GDP has increased by almost 30 per cent. The period of strong growth is likely to continue, but the foundation of this recovery is weak. Growth has not been underpinned sufficiently by structural reforms. Also, the confidence of the business community has been undermined by a series of disputes between the government and prominent investors. Consequently, the flow of private and official capital has dried up and the country depends heavily on remittances from abroad. The EGPRS provides a blueprint for sustainable growth, but potential investors are likely to look for signs that the strategy is being implemented successfully before deciding to invest.

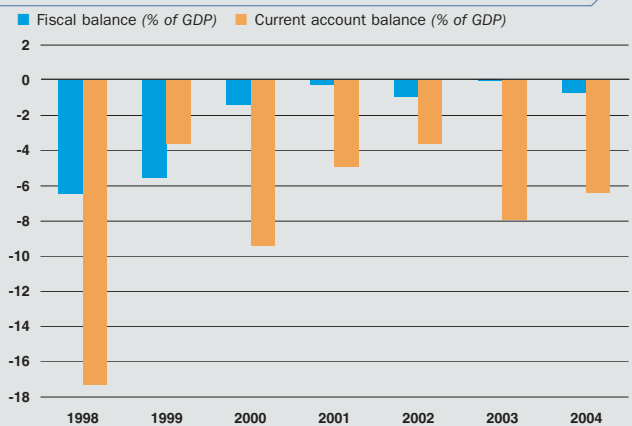
### Transition indicators, 2004



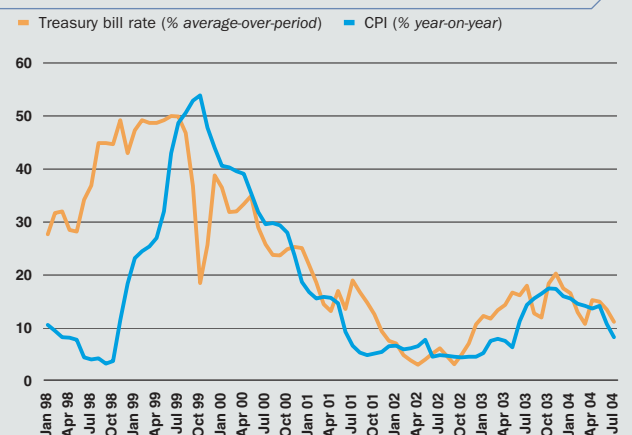
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



<b>Liberalisation</b>	<b>Privatisation</b>	<b>Infrastructure</b>	<b>Social sector</b>
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes	Share of population living in poverty –
Interest rate liberalisation – full	<b>vouchers</b>	Separation of railway accounts – no	<b>63.7 per cent (2001)</b>
Wage regulation – yes	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – no
	<b>direct sales</b>		
<b>Stabilisation</b>		<b>Financial sector</b>	
Share of general government tax revenue in GDP – <b>27 per cent</b>	Tradability of land – full	Capital adequacy ratio – <b>12 per cent</b>	
Exchange rate regime – <b>floating</b>	<b>Enterprise and markets</b>	Deposit insurance system – yes	
	Competition office – yes	Secured transactions law – <b>restricted</b>	
		Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	10.0	10.0	10.0	8.0	7.0	7.0	7.0
Share of trade with non-transition countries (in per cent)	29.2	40.3	44.0	42.9	43.4	37.0	na
Share of trade in GDP (in per cent)	86.8	82.7	97.8	97.7	104.5	106.3	na
Tariff revenues (in per cent of imports) <sup>1</sup>	2.0	3.6	2.4	2.1	2.4	2.6	na
EBRD index of price liberalisation	3.7	3.7	3.7	3.7	3.7	3.7	3.7
EBRD index of forex and trade liberalisation	4.0	4.0	4.0	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	4.4	5.4	11.8	12.2	12.9	13.2	na
Private sector share in GDP (in per cent)	50.0	45.0	50.0	50.0	50.0	50.0	50.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	3.3	3.3	3.3	3.3	3.3	3.3	3.3
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	na	na	na	na	na	na	na
Share of industry in total employment (in per cent)	15.3	16.2	16.4	18.2	18.1	18.9	na
Change in labour productivity in industry (in per cent)	-7.0	-0.7	22.9	3.6	12.7	9.4	na
Investment/GDP (in per cent)	22.8	20.4	23.9	23.3	22.7	na	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	1.7	1.7
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	15.0 (0.2)	12.7 (0.4)	13.3 (3.2)	14.6 (5.1)	16.1 (7.7)	16.3 (8.2)	na
Internet penetration rate (per 10,000 inhabitants)	3.2	3.0	4.9	4.0	5.0	27.2	na
Railway labour productivity (1989=100)	25.2	15.6	18.7	23.3	27.5	29.5	na
Residential electricity tariffs, USc kWh	na	na	4.6	5.2	6.0	5.6	na
Average collection rate, electricity (in per cent)	na	na	55	na	99	100	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.3	1.6	1.8	1.7	na	na	na
EBRD index of infrastructure reform	2.0	2.0	2.3	2.3	2.3	2.0	2.0
Electric power	3.0	3.0	3.3	3.3	3.3	3.0	3.0
Railways	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Roads	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Water and waste water	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	23 (7)	20 (10)	20 (11)	19 (10)	16 (10)	16 (9)	na
Asset share of state-owned banks (in per cent)	0.3	7.9	9.8	10.2	13.4	15.5	na
Non-performing loans (in per cent of total loans)	32.0	29.3	20.6	10.4	7.6	6.4	na
Domestic credit to private sector (in per cent of GDP)	15.8	11.1	14.0	16.0	18.7	22.4	na
Stock market capitalisation (in per cent of GDP) <sup>2</sup>	na	32.3	30.3	24.0	24.9	25.2	na
EBRD index of banking sector reform	2.3	2.3	2.3	2.3	2.3	2.3	2.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	9.9	6.6	7.4	7.7	9.2	8.7	na
Life expectancy at birth, total (years)	66.5	67.8	67.5	67.2	67.0	na	na
Basic school enrolment ratio (in per cent)	92.5	94.1	93.5	94.0	94.7	na	na

<sup>1</sup> Refers to all taxes on foreign trade.

<sup>2</sup> Data from survey of Moldovan Stock Exchange, including government securities.

	1998	1999	2000	2001	2002	2003	2004
						Estimate	Projection
Output and expenditure	(Percentage change in real terms)						
GDP	-6.5	-3.4	2.1	6.1	7.2	6.3	7.0
Private consumption	5.1	-13.8	27.6	na	na	na	na
Public consumption	-18.9	-28.1	-17.9	na	na	na	na
Gross fixed capital formation <sup>1</sup>	1.5	-14.7	-0.7	na	na	na	na
Exports of goods and services	-22.1	-22.7	6.8	15.7	14.5	12.2	na
Imports of goods and services	-11.0	-36.4	29.8	9.3	16.1	20.5	na
Industrial gross output	-15.0	-11.6	7.7	13.7	10.8	13.6	na
Agricultural gross output	-11.6	-8.4	-3.3	6.4	3.4	2.0	na
Employment	(Percentage change)						
Labour force (end-year)	-42.4	-16.4	-13.5	-0.7	-1.0	-1.0	na
Employment (end-year)	-0.2	-9.0	1.3	-1.1	0.4	-9.9	na
Unemployment (end-year) <sup>2</sup>	9.2	11.1	(In per cent of labour force)		8.5	7.3	6.8
			8.5	7.3	6.8	7.9	na
Prices and wages	(Percentage change)						
Consumer prices (annual average)	7.7	39.3	31.1	9.6	5.2	11.8	10.0
Consumer prices (end-year)	18.3	43.7	18.4	6.3	4.4	15.8	8.0
Producer prices (annual average)	9.7	44.0	28.5	5.7	na	na	na
Producer prices (end-year)	13.6	58.6	24.2	5.9	5.2	8.9	na
Gross average monthly earnings in economy (annual average)	13.9	21.6	33.9	33.3	27.2	29.0	na
Government sector <sup>3</sup>	(In per cent of GDP)						
General government balance	-6.5	-5.5	-1.4	-0.3	-0.9	0.1	-0.7
General government expenditure	39.5	32.7	33.8	29.3	31.5	31.0	na
General government debt <sup>4</sup>	95.5	92.2	93.3	79.9	75.3	65.0	na
Monetary sector	(Percentage change)						
Broad money (M2, end-year)	-22.0	33.3	39.0	37.8	30.4	24.4	na
Domestic credit (end-year)	29.2	18.1	14.4	29.6	25.2	23.6	na
Broad money (M2, end-year)	13.1	13.1	(In per cent of GDP)		15.7	18.2	20.5
			15.7	18.2	20.5	21.0	na
Interest and exchange rates	(In per cent per annum, end-year)						
Refinancing rate	32.7	31.0	27.0	13.0	9.5	14.0	na
Interbank interest rate (up to 30-days maturity)	30.9	32.6	20.8	11.0	4.8	16.3	na
Deposit rate (1 year)	21.7	27.5	24.9	20.9	12.6	14.2	na
Lending rate (1 year)	30.8	35.5	33.8	28.7	19.3	19.4	na
Exchange rate (end-year)	8.3	11.6	(Lei per US dollar)		12.4	13.1	13.8
			12.4	13.1	13.8	13.2	na
Exchange rate (annual average)	5.4	10.5	12.4	12.9	13.6	13.9	na
External sector	(In millions of US dollars)						
Current account	-334	-47	-121	-72	-60	-155	-160
Trade balance	-388	-135	-307	-313	-378	-622	-595
Merchandise exports	644	475	477	567	660	806	825
Merchandise imports	1,032	610	783	880	1,038	1,429	1,420
Foreign direct investment, net	76	154	128	147	117	48	76
Gross reserves, excluding gold (end-year)	144	186	230	229	269	259	na
External debt stock	1,451	1,495	1,623	1,577	1,687	1,709	na
Gross reserves, excluding gold (end-year)	1.4	2.9	(In months of imports of goods and services)		2.8	2.5	1.9
			2.8	2.5	1.9	1.7	na
Debt service	25.1	32.4	(In per cent of exports of goods and services)		16.4	16.8	14.1
			16.4	16.8	14.1	13.9	0.0
Memorandum items	(Denominations as indicated)						
Population (end-year, million)	4.3	4.3	4.3	4.3	4.3	4.3	na
GDP (in millions of lei)	10,370	13,800	16,020	19,052	22,040	26,720	31,449
GDP per capita (in US dollar)	449	306	301	347	381	451	na
Share of industry in GDP (in per cent)	19.5	18.8	18.5	20.5	na	na	na
Share of agriculture in GDP (in per cent)	30.5	27.9	29.0	26.0	na	na	na
Current account/GDP (in per cent)	-17.3	-3.6	-9.4	-4.9	-3.6	-7.9	-6.4
External debt - reserves (in US\$ million)	1,307	1,309	1,393	1,349	1,418	1,450	na
External debt/GDP (in per cent)	75.1	114.0	126.0	106.5	103.9	89.2	na
External debt/exports of goods and services (in per cent)	182.8	244.4	253.5	214.4	193.8	171.7	na

<sup>1</sup> Includes changes in inventories.<sup>2</sup> Unemployment rate according to the International Bureau of Labour.<sup>3</sup> General government includes the state, local government and extra-budgetary funds.<sup>4</sup> Including publicly guaranteed debt, but excluding energy arrears.



# Poland

## Key challenges

To improve the business environment and encourage private investment in non-agricultural sectors, it is necessary to build on recent regulatory reforms and strengthen implementing institutions, such as the judiciary and public administration.

Labour market rigidities need to be addressed to reduce unemployment and increase participation in the labour market.

Macroeconomic stability is threatened by the loose fiscal policy, with public debt exceeding 50 per cent of GDP.

also been less successful than other central European countries in attracting foreign direct investment (FDI). The framework for state support for foreign investments is being restructured to make it more effective. Corruption also remains a serious issue. There have been several cases of alleged corruption, which in some instances have resulted in the resignation of senior officials.

Little progress has been made on the restructuring of the agricultural sector. It continues to employ between 15 and 20 per cent of the total labour force, yet contributes only about 3 per cent to GDP. The rigid structure of the sector reflects a generous social safety net for small farmers and restrictions on the sale of agricultural land. For instance, small farmers obtain a 95 per cent discount on social insurance contributions and enjoy free unemployment insurance. As a result, the number of small, inefficient farms has increased over the past few years. However, the number of farms with land in excess of 15 hectares has also risen.

The implementation of the EU Common Agricultural Policy and the removal of agricultural trade restrictions following EU accession are expected to result in some restructuring of the sector. The impact that this will have on productivity is as yet unclear. Exports of dairy and meat products to EU-15 countries have increased substantially since May 2004. Farmers have also reportedly started to claim EU funds and there are signs of increased investment in equipment and machinery.

## Financial sector

In January 2004 banking regulation was brought into line with prevailing practice in most EU member states. The main changes include a revised definition of substandard loans (from 30 days overdue to 90 days), in line with EU standards, and the different treatment of collateral in provisioning. Also introduced was a simplified classification system for housing loans and stricter rules on the valuation of collateral. In addition, lending to small and medium-sized enterprises will be analysed annually instead of quarterly, and the classification of all exposures to a single client will be unified.

## Social sector

Only approximately 50 per cent of the working age population in Poland is in active employment. This reflects a low rate of participation in the labour market (13 per cent of the working age population claim disability pension benefits) and a high unemployment rate (around 20 per cent). There is also large hidden unemployment in rural areas and a large unofficial economy. The statistical office made significant revisions to the unemployment rate in 2003. The revised estimate is approximately 2 percentage points higher than the original figure, due to a downward correction in the estimate of the agricultural labour force.

The high unemployment rate reflects significant structural deficiencies in the labour market. These include a relatively high minimum wage compared with the average salary, high payroll taxes, strict rules on job termination (particularly in privatised companies) and low labour mobility. The partial opening of the EU labour market to Polish workers since May 2004 has so far not resulted in any significant labour migration to other EU member states.

## Country data

Population (in millions)	<b>38.3</b>
Area ('000 sq. km)	<b>313.9</b>
Official language	<b>Polish</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 10,560</b>
National currency	<b>Zloty</b>

## Progress in structural reform

### Liberalisation and privatisation

Privatisation proceeds for 2003 amounted to PLN 4.1 billion (€890 million), much lower than the government target of PLN 9.1 billion (around €2 billion). The revenue generated through privatisation did not increase substantially in the first half of 2004, reaching only about PLN 1 billion (€220 million). To cover the shortfall, the authorities have initiated the sale of a minority stake in the country's largest bank, PKO BP. The expected sale proceeds are PLN 6 billion (€1.5 billion). The government is also expected to give up its majority in BGZ, a bank with a strong market position in rural areas and in the agricultural sector. Both transactions are expected to be completed in late 2004. The government has also used some of its shares in listed companies, such as the dominant fixed-line telecommunications operator TPSA, to support struggling sectors such as mining and shipbuilding.

Notable progress was made in the privatisation of the steel sector. In October 2003 the government reached an agreement on the sale of PHS, which accounts for 70 per cent of Polish steel production, to the international group LNM Holding. The privatisation of another large steel mill, Huta Czerwona, is in progress. The sale is pending a decision by the European Commission on the legality of the state aid that the mill receives. The restructuring of other ailing steel companies has also moved ahead. In September 2003 Huta Ostrowiec was acquired out of bankruptcy by the Spanish Celsa Group.

### Business environment and competition

Growth and entrepreneurship continue to be hindered by discrepancies between the content of new regulations, which often represent good practice, and their arbitrary and inefficient application by the administration and the judiciary. Poland has

## Macroeconomic performance

### Real economy

The economy is recovering from weak performance in 2001 and 2002. GDP grew by 3.8 per cent in 2003 and by a further 6.4 per cent in the first half of 2004. The recovery has been driven so far primarily by exports and private consumption. An increase in inventories, triggered by the expectation of price changes following EU accession, also contributed to strong output growth in the first quarter of 2004. Registered unemployment peaked in February 2004, but then started to decline (mostly due to seasonal factors). There is little evidence of significant job creation in the private sector.

### Economic policies

The general government deficit exceeded 4 per cent of GDP in 2003. A further increase is expected in 2004. EU-compatible public debt reached about 43 per cent of GDP at the end of 2003. At the same time, public and publicly guaranteed debt (according to the national definition) exceeded 50 per cent of GDP. This is the first prudential threshold defined by the Public Finance Act which triggers restrictions on fiscal policy. Debt levels are now approaching the second threshold of 55 per cent.

In response, the government has submitted to parliament a number of proposals critical for implementation of the so-called Hausner plan. This plan aims to stabilise public finances and contains a combination of expenditure cuts and revenue increases. However, the measures are heavily back-loaded and their impact will not be felt until 2005 at the earliest. Furthermore, only some of the proposals have so far been approved by parliament. Consumer price inflation reached 1.7 per cent at the end of 2003. However, it rose to over 4 per cent in June 2004, compared with the target range of 1.5 to 3.5 per cent. Much of this increase can be attributed to rising oil and food prices and factors related to EU accession (increases in indirect taxes). In response, the Monetary Policy Committee started to increase interest rates in June 2004. This was the first increase in four years.

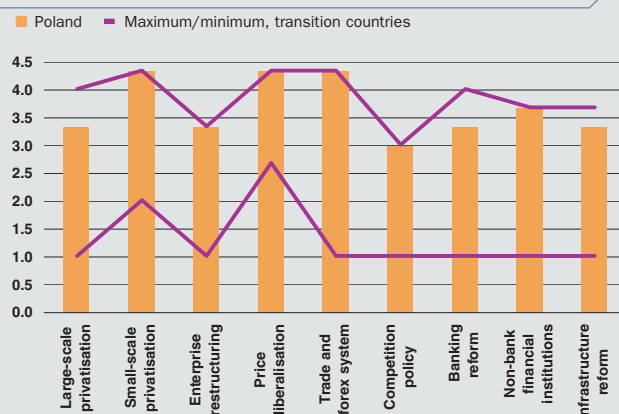
### External sector

The current account deficit was a modest 2 per cent of GDP in 2003. It declined further in the first half of 2004 as external trade continued to expand strongly, partly due to EU accession. The inflow of FDI has remained below US\$ 4 billion in each of the last two years. No major privatisations have taken place and foreign investors have shunned Poland in favour of other countries in the region. Inflows of portfolio investment, mostly into government bonds, continued to increase. Foreign investment in debt securities increased in 2003 and a further US\$ 6.1 billion was attracted in the first half of 2004.

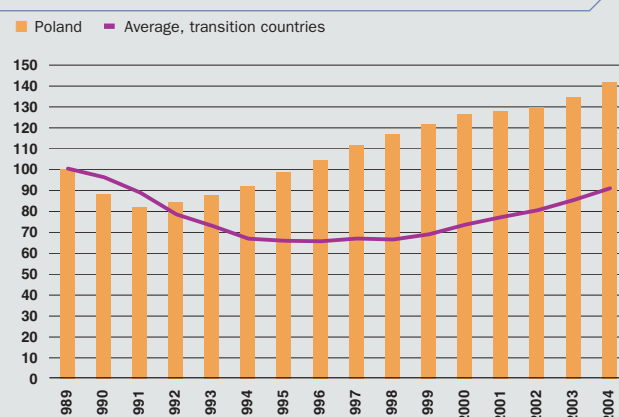
## Outlook and risks

Strong growth in the first half of the year is expected to be sustained in the short term, although at a decelerating pace. The need to tighten fiscal and monetary policy in order to reverse increases in the public debt and to control inflation may restrict growth. The new government appointed in June 2004 may find it hard to initiate the difficult reforms needed to lower unemployment and provide new jobs for workers in declining industries and the agricultural sector.

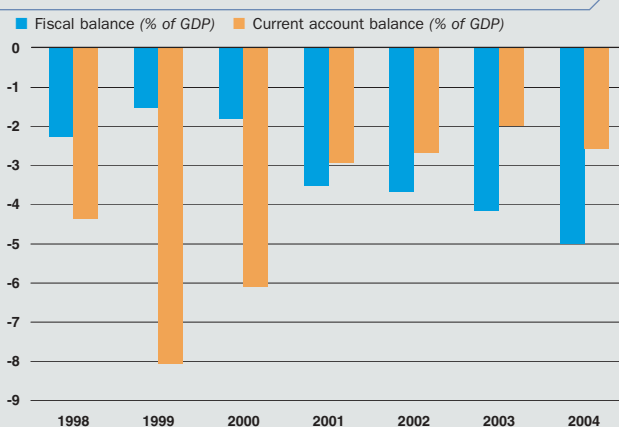
### Transition indicators, 2004



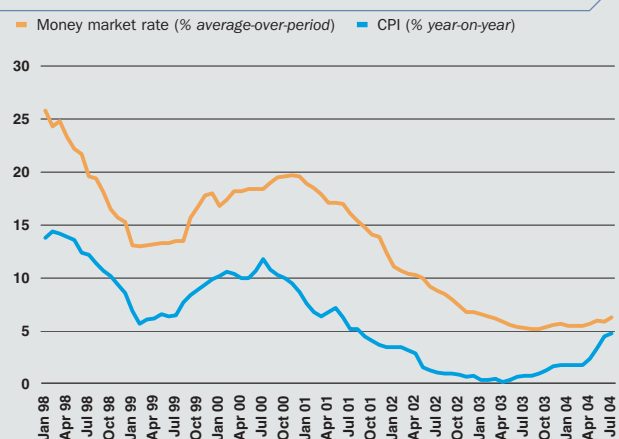
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes	Share of population living in poverty –
Interest rate liberalisation – full	direct sales	Separation of railway accounts – yes	<2 per cent (1999)
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – yes
	MEBOs		
Stabilisation	Tradability of land – full except	Financial sector	
Share of general government tax	foreigners	Capital adequacy ratio – 8 per cent	
revenue in GDP – 37.9 per cent		Deposit insurance system – yes	
Exchange rate regime – floating	Enterprise and markets	Secured transactions law – yes	
	Competition office – yes	Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	10.6	9.0	2.6	1.2	1.0	1.0	1.0
Number of goods with administered prices in EBRD-15 basket	1.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	77.4	79.3	81.1	80.9	81.3	81.7	na
Share of trade in GDP (in per cent)	49.1	48.5	51.3	49.7	53.4	61.7	na
Tariff revenues (in per cent of imports)	3.8	3.1	2.4	2.0	1.7	1.5	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	6.6	7.9	11.6	12.5	12.8	13.3	na
Private sector share in GDP (in per cent)	65.0	65.0	70.0	75.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	69.2	70.9	72.0	72.0	72.0	72.0	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.3	3.3	3.3	3.3	3.3	3.3	3.3
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	2.9	2.7	2.2	2.3	2.5	2.5	na
Share of industry in total employment (in per cent)	21.4	21.7	23.3	22.3	23.0	22.4	na
Change in labour productivity in industry (in per cent)	4.3	9.1	10.4	4.4	3.7	12.4	na
Investment/GDP (in per cent)	25.2	25.4	25.0	21.0	19.2	20.3	na
EBRD index of enterprise reform	3.0	3.0	3.0	3.3	3.3	3.3	3.3
EBRD index of competition policy	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	22.8 (5.0)	26.3 (10.2)	28.2 (17.4)	29.5 (25.9)	30.1 (36.0)	31.9 (45.1)	na
Internet penetration rate (per 10,000 inhabitants)	33.9	44.2	87.9	126.8	170.3	203.8	na
Railway labour productivity (1989=100)	78.2	78.4	84.3	86.7	93.1	106.0	na
Residential electricity tariffs, USc kWh	5.3	5.5	7.0	8.3	8.8	9.8	na
Average collection rate, electricity (in per cent)	na	na	na	na	90	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.3	3.6	3.9	3.9	na	na	na
EBRD index of infrastructure reform	3.0	3.0	3.3	3.3	3.3	3.3	3.3
Electric power	3.0	3.0	3.0	3.0	3.3	3.3	3.3
Railways	3.3	3.3	4.0	4.0	4.0	4.0	4.0
Roads	3.0	3.3	3.3	3.3	3.3	3.0	3.0
Telecommunications	3.3	3.3	4.0	4.0	4.0	4.0	4.0
Water and waste water	3.0	3.0	3.0	3.3	3.3	3.3	3.3
<b>Financial sector</b>							
Number of banks (foreign-owned) <sup>1</sup>	83 (31)	77 (39)	73 (46)	69 (46)	59 (45)	58 (46)	na
Asset share of state-owned banks (in per cent)	48.0	24.9	23.9	24.4	26.6	25.7	na
Non-performing loans (in per cent of total loans)	11.8	14.9	16.8	20.5	24.7	25.1	na
Domestic credit to private sector (in per cent of GDP)	17.5	18.7	18.1	18.0	17.6	17.8	na
Stock market capitalisation (in per cent of GDP)	13.0	19.9	18.1	13.7	14.3	17.3	na
EBRD index of banking sector reform	3.3	3.3	3.3	3.3	3.3	3.3	3.3
EBRD index of reform of non-bank financial institutions	3.3	3.3	3.7	3.7	3.7	3.7	3.7
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	9.3	9.4	10.5	10.6	11.0	10.9	na
Life expectancy at birth, total (years)	73.0	73.0	73.3	73.5	73.8	na	na
Basic school enrolment ratio (in per cent)	100.1	100.2	100.5	99.8	100.3	na	na

<sup>1</sup> Data for 2000 include Slaski Bank Hipoteczny SA, a banking organisation that previously did not file reports on ownership.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>	<i>(Percentage change in real terms)</i>						
GDP	4.8	4.1	4.0	1.0	1.4	3.8	5.5
Private consumption	4.8	5.2	2.7	2.0	3.3	3.1	na
Public consumption	1.4	1.0	1.1	2.0	4.0	3.5	na
Gross fixed capital formation	14.2	6.8	2.7	-9.8	-5.8	-0.9	na
Exports of goods and services	11.0	1.0	17.5	8.0	5.0	6.0	na
Imports of goods and services	14.0	6.0	12.0	7.0	3.0	4.0	na
Industrial gross output	4.8	4.4	7.1	-0.5	2.0	8.7	na
Agricultural gross output	5.9	-5.2	-5.6	5.8	-1.9	-1.4	na
<b>Employment</b>	<i>(Percentage change)</i>						
Labour force (end-year)	3.4	-2.3	-6.1	1.8	-2.9	-3.4	na
Employment (end-year)	2.8	-5.8	-9.4	-0.8	-4.5	-4.5	na
Unemployment (end-year)	10.2	13.4	16.4	18.5	19.8	19.2	na
<b>Prices and wages</b>	<i>(Percentage change)</i>						
Consumer prices (annual average)	11.8	7.3	10.1	5.5	1.7	0.7	3.6
Consumer prices (end-year)	8.6	9.8	8.6	3.4	0.7	1.7	4.5
Producer prices (annual average)	7.3	5.7	7.9	5.5	1.0	2.6	na
Producer prices (end-year)	4.9	8.1	5.7	5.0	2.2	3.7	na
Gross average monthly earnings in economy (annual average)	16.7	10.6	11.4	8.0	3.5	2.9	na
<b>Government sector</b>	<i>(In per cent of GDP)</i>						
General government balance	-2.3	-1.5	-1.8	-3.5	-3.7	-4.2	-5.0
General government expenditure	42.7	42.8	41.7	43.6	44.1	44.8	na
General government debt	39.9	43.4	38.8	39.1	40.0	43.1	na
<b>Monetary sector</b>	<i>(Percentage change)</i>						
Broad money (M2, end-year)	24.7	20.1	11.8	9.2	-2.6	5.6	na
Domestic credit (end-year)	27.4	27.2	13.6	9.2	5.3	8.9	na
Broad money (M2, end-year)	40.4	43.7	42.2	43.8	41.6	42.0	na
<b>Interest and exchange rates</b>	<i>(In per cent per annum, end-year)</i>						
Rate on 28-day open market operations	15.5	16.5	19.0	11.5	6.8	5.3	na
3-months WIBOR	15.2	17.9	19.5	12.3	6.7	5.6	na
Deposit rate <sup>1</sup>	12.8	12.9	14.3	7.9	4.2	2.9	na
Lending rate <sup>2</sup>	20.4	20.3	21.5	16.2	12.8	10.6	na
Exchange rate (end-year)	3.5	4.2	4.3	4.0	3.9	3.8	na
Exchange rate (annual average)	3.5	4.0	4.3	4.1	4.1	3.9	na
<b>External sector</b>	<i>(In millions of US dollars)</i>						
Current account	-6,901	-12,487	-9,998	-5,357	-5,007	-4,085	-6,000
Trade balance	-12,836	-15,072	-12,308	-7,660	-7,249	-5,725	-8,000
Merchandise exports	32,467	30,060	35,902	41,664	46,742	61,007	65,000
Merchandise imports	45,303	45,132	48,210	49,324	53,991	66,732	73,000
Foreign direct investment, net	6,049	7,239	9,324	5,802	3,901	3,839	5,000
Gross reserves, excluding gold (end-year)	27,325	26,354	26,564	25,649	28,660	31,725	na
External debt stock	59,135	65,365	69,465	71,900	84,305	103,806	na
Gross reserves, excluding gold (end-year)	6.3	6.1	5.6	5.3	5.4	4.9	na
Debt service	10.9	12.9	13.6	13.0	11.7	8.9	na
<b>Memorandum items</b>	<i>(Denominations as indicated)</i>						
Population (end-year, million)	38.7	38.7	38.6	38.6	38.3	38.3	na
GDP (in billions of zlotys)	554	615	712	749	769	805	880
GDP per capita (in US dollar)	4,096	4,011	4,241	4,739	4,924	5,402	na
Share of industry in GDP (in per cent)	28.1	28.2	29.0	28.6	28.8	30.1	na
Share of agriculture in GDP (in per cent)	3.8	3.4	3.1	3.2	3.1	3.0	na
Current account/GDP (in per cent)	-4.4	-8.1	-6.1	-2.9	-2.7	-2.0	-2.6
External debt - reserves (in US\$ million)	31,810	39,011	42,901	46,251	55,645	72,081	na
External debt/GDP (in per cent)	37.3	42.2	42.4	39.3	44.7	50.2	na
External debt/exports of goods and services (in per cent)	136.5	170.1	150.1	139.8	148.5	143.8	na

<sup>1</sup> The lowest rate offered on six-month time deposits.

<sup>2</sup> The lowest rate charged by commercial banks to prime borrowers.

# Romania

## Key challenges

The legal framework has been strengthened, but further improvements in the business environment will depend on the successful implementation of institutional reforms and the enforcement of financial discipline in the enterprise sector.

The momentum in large-scale privatisation should be maintained and structural reforms accelerated to sustain the growth of productivity and output over the longer term.

Implementation of tight fiscal and wage policies is necessary to support the authorities' aim of lowering inflation and reducing the current account deficit.

August 2004 the government selected Gaz de France and Ruhrgas (Germany) as the preferred buyers for two natural gas distribution companies – Distrigaz Sud and Distrigaz Nord.

## Business environment and competition

The authorities have intensified their efforts to improve governance and strengthen the weak business environment. In October 2003 constitutional amendments were introduced to secure the independence of the judiciary from political influence. In June 2004 the Romanian parliament passed a series of laws to implement the long-awaited reform of the judiciary, strengthening the role of the Superior Council of the Magistrates. In addition, amendments to the bankruptcy law were approved in May 2004, while a new fiscal code came into force in January. The code consolidates previous tax legislation and harmonises Romanian legislation with that of the EU. Amendments to the competition law, which took effect in December 2003, strengthen the role of the Competition Council by giving it exclusive administrative authority over competition issues.

## Infrastructure

Following a series of adjustments, electricity prices were increased towards cost-recovery levels in September 2003. They were further increased by 7.8 per cent in July 2004 to enable the distribution companies to secure a return on equity – an important prerequisite for their commercialisation and privatisation. In March 2004 the Romanian gas regulator announced a schedule for future price increases. This envisages domestic prices reaching import-parity levels by January 2007.

However, despite the steps that have been taken to improve financial discipline in the enterprise sector, total tax and other payment arrears remain high and account for almost 40 per cent of GDP. In the past, the problem was particularly severe among utilities in the energy sector, mainly reflecting weak payment discipline by large state-owned enterprises. While collection rates of electricity and gas utilities have improved, problems remain in the district heating sector.

## Financial sector

Following the sale of a 25 per cent stake plus 2 shares in Banca Comerciala Romana (BCR) to the EBRD and the International Finance Corporation in November 2003, the Savings Bank (CEC) and Eximbank are the only remaining majority state-owned banks in Romania. They account for about 8 per cent of total bank assets. The government has announced plans to privatise CEC by the end of 2005.

In February 2004 the National Bank of Romania (NBR) tightened some of the provisions relating to consumer and mortgage credit. This was in response to a sharp increase in lending to the non-government sector (up by 55 per cent in real terms in 2003). The eligibility criteria for consumer and mortgage credit were tightened by limiting the ratio of monthly payments to net-income to 30 and 35 per cent for consumer and mortgage lending respectively. In addition, mortgages cannot exceed 75 per cent of the value of the property. In August 2004, commercial banks established a credit bureau to monitor the credit risk of consumer loans. The NBR has also strengthened its supervisory role by extending the scope of its own credit bureau, particularly with respect to delinquent loans and credit and debit card fraud.

### Country data

Population (in millions)	<b>21.7</b>
Area ('000 sq. km)	<b>238</b>
Official language	<b>Romanian</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 6,560</b>
National currency	<b>Romanian leu</b>

## Progress in structural reform

### Liberalisation and privatisation

Romania's reform and liberalisation process has been underpinned by the prospect of accession to the EU and by increasing integration with European markets. At the end of September 2004 Romania had provisionally closed 27 of the 31 chapters of the EU's *acquis communautaire*.

The privatisation of large state-owned enterprises accelerated in the first half of 2004, with several important sales in the energy sector. The Authority for the Privatisation and Management of State Ownership sold about 190 companies (one-third of which were large enterprises) between September 2003 and May 2004. During April it was merged with AVAB, the authority responsible for the recovery of banking assets. (The new entity is named AVAS.)

In July 2004 the Romanian authorities and Austria's OMV AG signed the country's single-largest privatisation transaction to date. OMV agreed to pay €669 million for the purchase of a 33.3 per cent stake in the national oil and gas company SNP Petrom SA. In addition, OMV agreed to subscribe to a capital increase estimated at between €723 million and €855 million to gain majority control. The exact amount will be confirmed following the conclusion of the pre-emption rights period in November.

Progress was also made with the privatisation of electricity and gas distribution companies. In July 2004 the government finalised the sale of a 51 per cent stake in Electrica Banat and Electrica Dobrogea (two of the eight electricity distribution companies) to Enel (Italy) for a total of €112 million. The privatisation of two more power companies was announced in April 2004. Also in



## Macroeconomic performance

### Real economy

The economy grew by 6.6 per cent in the first half of 2004, following a 4.9 per cent increase in real GDP in 2003. Domestic consumption and investment have been the major drivers of growth on the demand side. The construction industry and the services sector have been the major contributors on the supply side. The registered unemployment rate was about 7 per cent of the active population in 2003, reflecting in part the slow pace of economic restructuring.

### Economic policies

The NBR is reducing the depreciation rate of the leu in line with its inflation rate target. This target is 9 per cent by the end of 2004 (compared with 14.1 per cent at the end of 2003 and 12.3 per cent in August 2004). Strong capital inflows, attracted by high interest rates and the prospect of EU accession, have forced the NBR to buy excess foreign reserves to prevent a sharp appreciation of the currency. By August 2004 the reserve cover ratio had reached just over four months of imports.

However, the NBR had to undertake sterilisation operations to neutralise the effect of monetary creation on inflation. At the end of August 2004 the NBR cut the reference interest rate by 50 basis points, to 18.25 per cent. This was the latest in a series of interest rate cuts since June 2004. It reversed the trend in the second half of 2003 when the NBR increased rates in response to rapid growth in bank lending.

Following revisions to the budget, the authorities lowered the target for the end-2004 consolidated general government fiscal deficit to 1.6 per cent of GDP from the original 3 per cent. Higher-than-expected fiscal revenues should help the authorities meet this target, providing there is no increase in discretionary spending ahead of the November 2004 parliamentary elections.

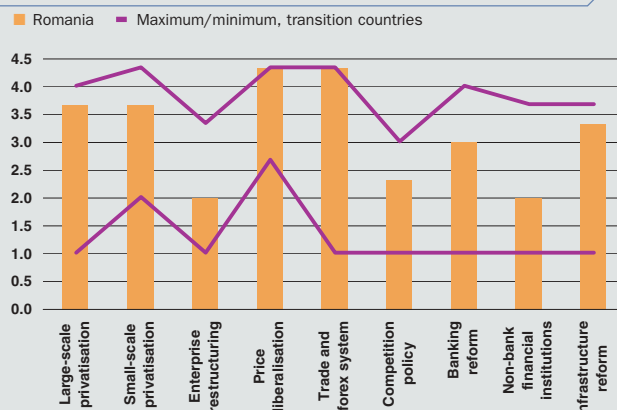
### External sector

The current account deficit is expected to remain at over 5 per cent of GDP, owing to strong import growth (reflecting strong domestic demand) and higher interest payments. The flow of private remittances from Romanians working abroad, estimated to be between €1.5 billion and €2 billion per year, is increasing. This should help mitigate the impact of the higher trade deficit on the current account. Financing is unlikely to be a problem in the short term owing to large inflows of foreign direct investment, reflecting both privatisation deals and greenfield investments, as well as increasing amounts of EU pre-accession funds.

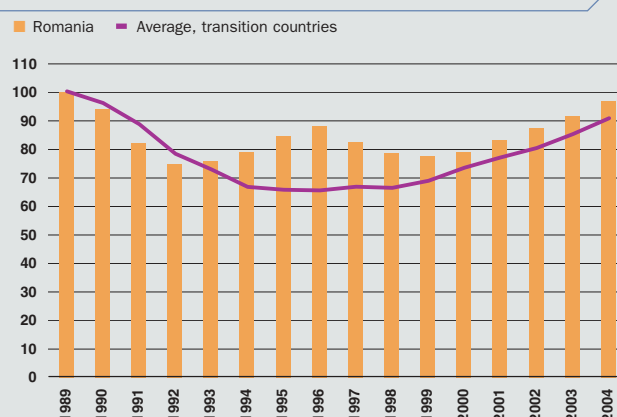
## Outlook and risks

The major short-term risk to macroeconomic stabilisation is the possibility of fiscal and income policies being loosened ahead of the November elections. The government's plan to reduce tax rates in 2005 could threaten fiscal consolidation if it is not matched by a reduction in state subsidies and a cut in arrears. In order to sustain growth over the longer term, the authorities will need to accelerate enterprise restructuring to increase productivity, improve labour market flexibility and deepen financial intermediation.

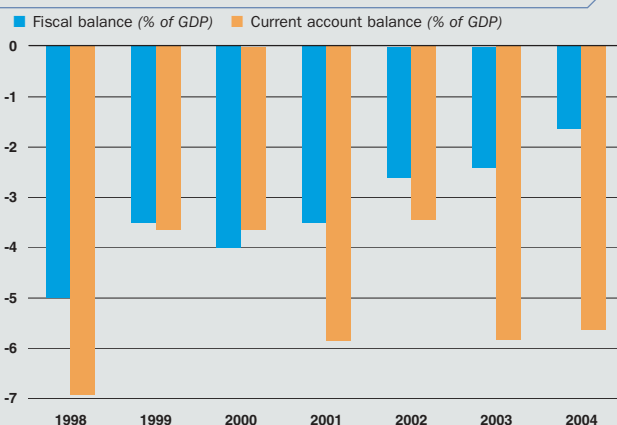
## Transition indicators, 2004



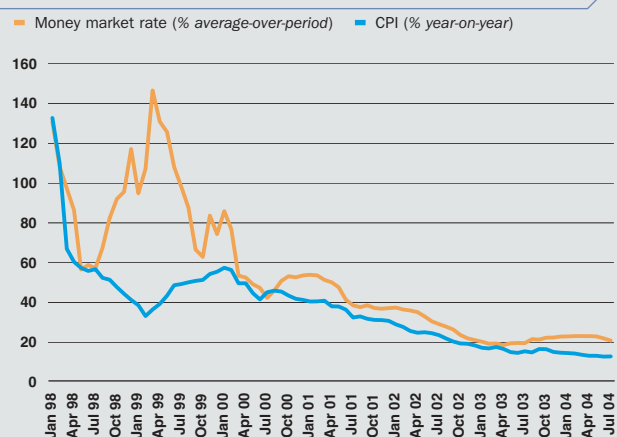
## Real GDP (1989=100)



## Fiscal balance and current account balance



## Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method – MEBOs	Independent telecoms regulator – yes	Share of population living in poverty – 20.5 per cent (2000)
Interest rate liberalisation – full	Secondary privatisation method – direct sales	Separation of railway accounts – yes	Private pension funds – yes
Wage regulation – yes	Tradability of land – limited de facto	Independent electricity regulator – yes	
Stabilisation	Enterprise and markets	Financial sector	
Share of general government tax revenue in GDP – 28 per cent	Competition office – yes	Capital adequacy ratio – 12 per cent	
Exchange rate regime – managed float		Deposit insurance system – yes	
		Secured transactions law – yes	
		Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	7.0	8.5	10.5	13.0	20.4	21.5	22.5
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	88.0	89.5	87.5	83.2	84.0	83.9	na
Share of trade in GDP (in per cent)	45.7	50.8	60.5	64.1	66.3	70.2	na
Tariff revenues (in per cent of imports)	5.9	5.5	3.3	2.2	1.7	1.7	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	6.4	7.6	8.2	8.5	8.9	9.1	na
Private sector share in GDP (in per cent)	60.0	60.0	60.0	65.0	65.0	65.0	70.0
Private sector share in employment (in per cent)	62.0	72.0	75.0	75.0	na	na	na
EBRD index of small-scale privatisation	3.3	3.7	3.7	3.7	3.7	3.7	3.7
EBRD index of large-scale privatisation	2.7	2.7	3.0	3.3	3.3	3.3	3.7
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	14.8	14.7	14.4	14.4	14.0	14.1	na
Share of industry in total employment (in per cent)	26.3	24.4	23.2	23.6	22.8	21.9	na
Change in labour productivity in industry (in per cent)	-12.6	2.9	10.9	7.5	13.4	15.5	na
Investment/GDP (in per cent)	17.7	16.1	19.5	22.6	23.5	24.6	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	16.0 (2.9)	16.7 (6.1)	17.5 (11.2)	18.4 (17.2)	19.4 (23.6)	20.5 (32.9)	na
Internet penetration rate (per 10,000 inhabitants)	10.4	16.2	18.5	20.7	18.9	22.6	na
Railway labour productivity (1989=100)	54.2	46.0	48.9	48.7	50.4	58.3	na
Residential electricity tariffs, USc kWh	3.2	4.1	5.5	5.7	7.0	8.1	na
Average collection rate, electricity (in per cent)	na	na	45	62	96	98	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.9	3.2	3.2	3.4	na	na	na
EBRD index of infrastructure reform	2.7	2.7	3.0	3.0	3.0	3.0	3.3
Electric power	2.3	2.7	3.0	3.0	3.0	3.0	3.3
Railways	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Roads	2.3	2.3	3.0	3.0	3.0	3.0	3.0
Telecommunications	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Water and waste water	2.0	2.3	3.0	3.0	3.0	3.0	3.3
<b>Financial sector</b>							
Number of banks (foreign-owned)	36 (16)	34 (19)	33 (21)	33 (24)	31 (24)	30 (21)	na
Asset share of state-owned banks (in per cent)	75.3	50.3	50.0	45.4	43.6	40.6	na
Non-performing loans (in per cent of total loans) <sup>1</sup>	58.5	35.4	3.8	3.4	2.3	1.6	na
Domestic credit to private sector (in per cent of GDP)	11.6	8.1	7.2	7.7	8.3	9.5	na
Stock market capitalisation (in per cent of GDP) <sup>2</sup>	3.0	2.9	3.4	5.8	10.1	9.6	na
EBRD index of banking sector reform	2.3	2.7	2.7	2.7	2.7	2.7	3.0
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	6.2	6.5	3.9	4.0	3.9	na	na
Life expectancy at birth, total (years)	69.3	69.8	69.9	69.9	70.0	na	na
Basic school enrolment ratio (in per cent)	97.8	98.5	98.9	100.0	100.9	na	na

<sup>1</sup> The large decrease in non-performing loans in 2000 is due to the imposition of NBR regulations on loan classification and the transfer of non-performing loans of Bancorex and Banca Agricola to the Banking Assets Recovering Agency. Changes in non-performing loans data compared with previous *Transition Reports* are due to the change of loan categories included in non-performing loans (see methodological notes).

<sup>2</sup> Includes listings on the Bucharest Stock Exchange and RASDAQ over-the-counter market.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>							
	<i>(Percentage change in real terms)</i>						
GDP <sup>1</sup>	-4.8	-1.2	1.8	5.3	4.9	4.9	5.8
Private consumption	1.4	-1.1	0.2	6.4	3.0	7.1	na
Public consumption	1.8	-19.1	20.4	-1.9	2.1	4.6	na
Gross fixed capital formation	-5.7	-4.8	4.6	6.6	8.3	9.2	na
Exports of goods and services	-1.7	9.7	23.9	10.6	16.9	11.1	na
Imports of goods and services	11.4	-5.1	29.1	17.5	12.1	16.3	na
Industrial gross output, unadjusted series	-17.3	-8.8	8.2	8.2	6.0	3.2	na
Agricultural gross output	-7.6	5.5	-14.1	22.7	-3.5	3.0	na
<b>Employment</b>							
	<i>(Percentage change)</i>						
Labour force (end-year)	-0.7	-2.9	0.9	-2.6	-3.7	1.2	na
Employment (end-year)	-2.3	-4.5	2.5	-0.8	-3.2	2.5	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year) <sup>2</sup>	10.4	11.8	10.5	8.8	8.4	7.2	na
<b>Prices and wages</b>							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	59.1	45.8	45.7	34.5	22.5	15.4	11.9
Consumer prices (end-year)	40.6	54.8	40.7	30.2	17.9	14.2	9.5
Producer prices (annual average)	33.2	42.2	51.5	40.9	24.6	20.7	na
Producer prices (end-year)	19.8	62.9	48.6	29.9	21.9	19.3	na
Gross average monthly earnings in economy (annual average)	60.3	44.3	46.9	48.9	27.3	23.6	na
<b>Government sector</b>							
	<i>(In per cent of GDP)</i>						
General government balance	-5.0	-3.5	-4.0	-3.5	-2.6	-2.4	-1.6
General government expenditure	34.7	35.2	34.8	33.4	32.3	32.3	na
General government debt	27.6	33.2	31.3	28.6	28.3	27.0	na
<b>Monetary sector</b>							
	<i>(Percentage change)</i>						
Broad money (M2, end-year)	48.9	45.0	38.0	46.2	38.1	23.3	na
Domestic credit (end-year)	95.2	26.8	7.5	31.5	39.9	50.2	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	24.8	24.6	23.0	23.2	24.7	24.4	na
<b>Interest and exchange rates</b>							
	<i>(In per cent per annum, end-year)</i>						
Discount rate	35.0	35.0	35.0	35.0	29.0	20.4	na
1-week BUBOR	159.0	68.9	47.3	39.3	20.0	21.4	na
Deposit rate (average)	38.3	45.4	32.4	26.2	18.4	10.8	na
Lending rate (average)	56.9	65.9	53.2	45.7	36.7	26.2	na
	<i>(Lei per US dollar)</i>						
Exchange rate (end-year)	10,951	18,255	25,926	31,597	33,500	32,595	na
Exchange rate (annual average)	8,875	15,333	21,693	29,061	33,055	33,200	na
<b>External sector</b>							
	<i>(In millions of US dollars)</i>						
Current account	-2,917	-1,296	-1,347	-2,349	-1,573	-3,318	-3,764
Trade balance	-2,625	-1,092	-1,684	-2,969	-2,613	-4,494	-4,814
Merchandise exports	8,302	8,503	10,366	11,385	13,869	17,743	20,760
Merchandise imports	10,927	9,595	12,050	14,354	16,482	22,238	25,573
Foreign direct investment, net	2,079	1,025	1,051	1,154	1,080	1,528	2,100
Gross reserves, excluding gold (end-year)	1,375	1,526	2,497	3,960	6,145	8,106	na
External debt stock	9,935	9,215	10,271	12,470	15,227	19,694	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	1.3	1.6	2.1	2.9	3.9	3.9	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service <sup>3</sup>	24.1	29.0	25.9	21.1	18.9	17.7	na
<b>Memorandum items</b>							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	22.5	22.5	22.4	22.3	21.7	21.7	na
GDP (in billions of lei)	373,779	545,730	803,773	1,167,243	1,512,617	1,890,778	2,239,873
GDP per capita (in US dollar)	1,872	1,585	1,651	1,804	2,109	2,624	na
Share of industry in GDP (in per cent)	26.3	24.8	27.3	28.2	28.4	28.4	na
Share of agriculture in GDP (in per cent)	14.4	13.3	11.1	13.3	11.3	11.7	na
Current account/GDP (in per cent)	-6.9	-3.6	-3.6	-5.8	-3.4	-5.8	-5.6
External debt - reserves (in US\$ million)	8,560	7,689	7,774	8,510	9,083	11,588	na
External debt/GDP (in per cent)	23.6	25.9	27.7	31.0	33.3	34.6	na
External debt/exports of goods and services (in per cent)	104.4	93.4	84.7	93.5	94.0	94.9	na

<sup>1</sup> From 2001 growth rates are calculated by the National Statistical Institute using a new methodology that complies with European standards of national accounting.

<sup>2</sup> Officially registered unemployed. According to the ILO methodology, the rate of unemployment in Romania is lower than the official one.

<sup>3</sup> Debt service payments on private and public external debt.

# Russia

## Key challenges

Economic diversification, supported by an acceleration in foreign investment, is an important precondition for sustaining economic growth and reducing vulnerability to fluctuations in commodity prices.

Further improvements in the quality and efficiency of state institutions, including the judiciary and public administration, are required to effectively implement structural reform and strengthen the property rights regime.

Sound macroeconomic management will require continued fiscal prudence against growing pressures to loosen budgetary policies in an already buoyant economic environment.

A new telecommunications law was enacted on 1 January 2004. This introduced rules for universal service obligations, provided for an economically justified tariff and aims to ensure that all market players have equal network interconnection rights. The successful implementation of the law will, however, require the adoption of several supporting pieces of legislation. Regarding other infrastructure industries, power sector reform has been delayed and the government plans to remove the ring fence on the domestic Gazprom shares.

## Financial sector

The law on deposit insurance was signed in December 2003. However, Sberbank will only formally join the planned new deposit insurance system in 2007, unless its share of retail deposits falls below 50 per cent. The Central Bank of Russia (CBR) received applications from 1,140 banks for participation in the new system and has until the end of March 2005 to screen the applications for eligibility. At the same time, the CBR will withdraw licences from weak and unviable banks. In January 2004 new tighter rules and procedures for banking supervision were introduced. These included a shift from supervision based only on formal compliance to a risk-oriented approach.

In mid-2004 the banking sector suffered liquidity pressures and falling confidence among depositors. The closure of Sodbusiness Bank triggered depositor nervousness and culminated in runs on two major private banks in July. Measures by the Central Bank, including large liquidity injections and the introduction of an interim deposit guarantee for all banks, calmed the market.

In July and August further reform steps were taken. These included improvements in bankruptcy legislation, restricting Sberbank's full state guarantees to deposits prior to the creation of the new deposit insurance scheme, and adopting laws on mortgage securities.

## Social sector

During 2004 the government reform agenda has focused increasingly on social issues. Priority targets include halving the level of poverty within three years, restructuring the health and education sectors, making housing more accessible and the housing market more competitive, and reforming social benefits financing.

There has been some early progress in the last two areas. A package of 27 housing-related bills were passed by the Duma on first reading in June. Of these bills, eight (relating to the development of the residential mortgage and real estate markets) had been adopted by both houses of parliament by the end of the spring/summer session. In August 2004 the President signed into law a bill that replaces most non-monetary social benefits with cash payments starting from 1 January 2005. For now, the reforms exclude, among others, subsidised housing and utilities payments and all benefits to civil servants and the military. Opposition to the monetisation of benefits has been strong. This is partly due to expectations that the overall level of benefits will be eroded by inflation.

## Country data

Population (in millions)	<b>144.9</b>
Area ('000 sq. km)	<b>17,075</b>
Official language	<b>Russian</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 8,230</b>
National currency	<b>Rouble</b>

## Progress in structural reform

### Business environment and competition

The business environment has continued to benefit from general political stability and sound macroeconomic policy. However, events surrounding the legal case against the Yukos oil company and its principals, combined with the authorities' ambiguous attitude to previous privatisations, have increased uncertainties about property rights and the overall rules for the private sector, especially for large businesses.

State interference in the economy has increased despite continued progress in deregulation and some initial steps in administrative reform. Positive changes have included a reduced tax burden on businesses, streamlined regulations for small business and improvements in corporate governance. However, these have been constrained by uneven implementation and remaining weaknesses in state institutions, notably the public administration and the judiciary.

### Infrastructure

Reforms in the railway and telecommunications sectors have accelerated since mid-2003. Railway reforms entered their second phase in the autumn of 2003. The Transport Ministry took over the former Railway Ministry's regulatory functions and Russian Railway (RR) was established. RR, a state-owned, joint-stock company, has inherited most of the former ministry's commercial operations, railway infrastructure and rolling stock. The institutional and legal separation of the different business areas of RR is under way. Private sector participation in the provision of railway services is also increasing. A decree of November 2003 provides for non-discriminatory access to the infrastructure for all carriers.

## Macroeconomic performance

### Real economy

Supported by higher oil prices, Russia has maintained its growth momentum. GDP and industrial output have increased by 7.4 per cent and investment in fixed capital rose by over 12 per cent in the first half of 2004. Growth and investment activity is broadly based. Output of the machine-building and metal working industries and the construction sector has expanded strongly. This sign of diversification is primarily due to spillovers from the natural resources sectors. However, continued high investment activity does reflect an acceleration of the restructuring and modernisation process in some segments of the economy.

### Economic policies

Fiscal policies have remained prudent, resulting in a federal budget surplus of 3.2 per cent of GDP in the first half of 2004. The stabilisation fund created at the beginning of 2004 accumulated over US\$ 9.2 billion by the end of July. However, a significant relaxation of the authorities' fiscal stance has been built into the draft 2005 budget. Monetary policy continues to be guided by the dual target of reducing inflation and limiting real appreciation. With exceptionally large current account surpluses and rapid growth, tension is growing between these two objectives. Inflation slowed to 10.2 per cent in the first half of 2004 but subsequently picked up again. This has been due partly to sizeable liquidity injections into the banking system. The rouble appreciated by 5 per cent in real terms between January and July 2004 against a 7 per cent Central Bank target for the year.

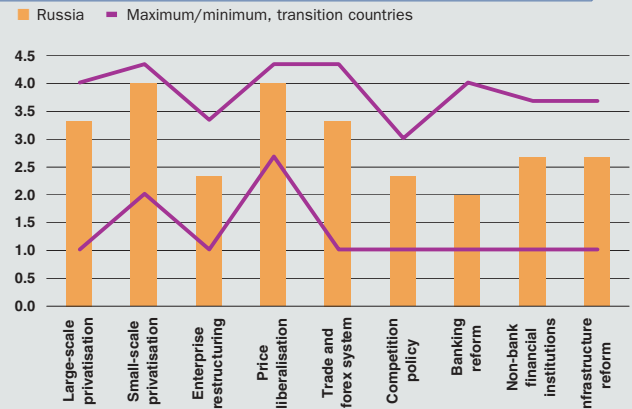
### External sector

The trade and current account balances remain strong. High oil prices and a 10 per cent growth in the volume of exports have offset the impact of increased imports. International reserves have continued to increase sharply in 2004, reaching a record high of US\$ 89.2 billion in mid-July. Net private capital outflows, though declining steadily in previous years, were more volatile in the past year. A net inflow of US\$ 3.9 billion in the first half of 2003 was reversed to an outflow of US\$ 2.3 billion by the end of the year. In the first half of 2004 there was a net outflow of US\$ 5.5 billion. Gross inflows of foreign direct investment (FDI), driven mainly by large deals in the fuel sector, rose sharply to US\$ 6.7 billion in 2003. FDI inflows in the first half of 2004 remained strong, but continue to be concentrated in the natural resources sector and a few regions.

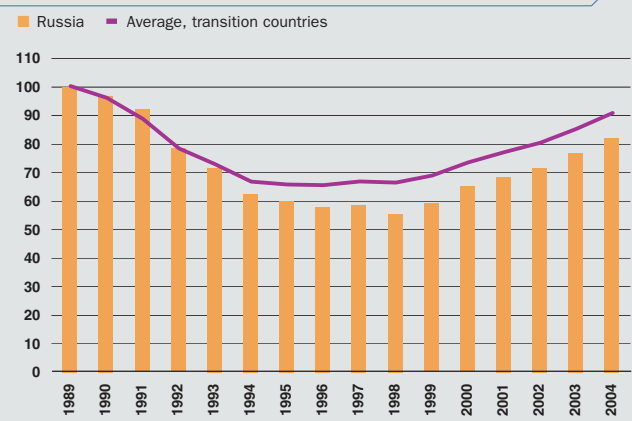
## Outlook and risks

Continued high oil prices will support Russia's GDP growth in the short to medium term. After 2004 some deceleration could occur as a result of increasing capacity constraints, strong real appreciation of the currency and inadequate progress in structural and institutional reforms. Macroeconomic performance could be affected adversely if uncertainty over the protection of property rights and the independence of the judiciary continues. The planned fiscal relaxation may also have negative repercussions, given its potential impact on inflation and exchange rate developments at a time when inflationary pressures are already growing. In the longer term the pace of growth will depend primarily upon successful diversification and modernisation of the economy.

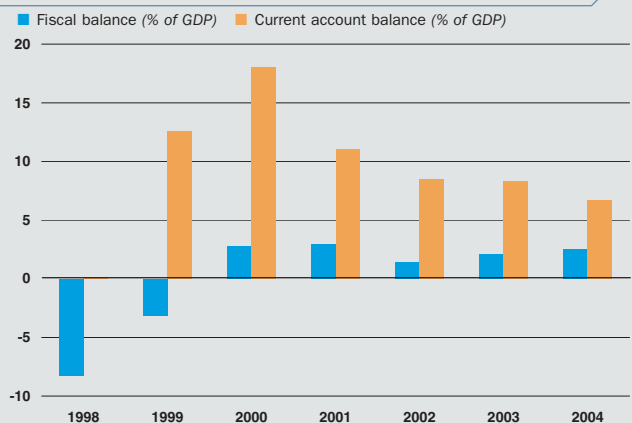
### Transition indicators, 2004



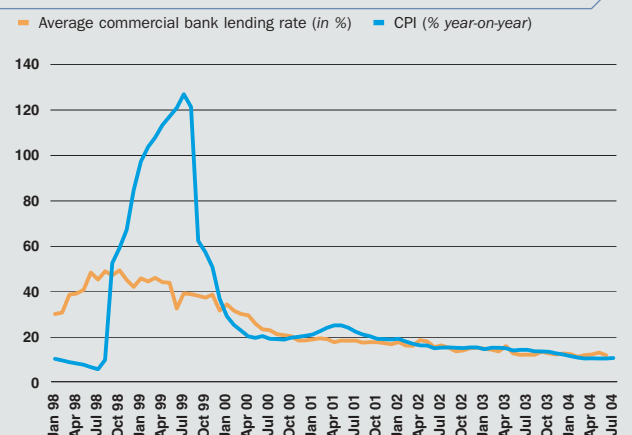
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation





Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – no	Share of population living in poverty –
Interest rate liberalisation – full	<b>vouchers</b>	Separation of railway accounts – no	<b>23.8 per cent (2000)</b>
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – yes
	<b>direct sales</b>		
Stabilisation	Tradability of land – limited de facto	Financial sector	
Share of general government tax revenue in GDP – <b>38 per cent</b>	<b>Enterprise and markets</b>	Capital adequacy ratio – <b>8 per cent</b>	
Exchange rate regime – <b>managed float</b>	Competition office – yes	Deposit insurance system – <b>yes</b> <sup>1</sup>	
		Secured transactions law – <b>yes</b>	
		Securities commission – <b>yes</b>	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	13.0	9.0
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	2.0	1.0
Share of trade with non-transition countries (in per cent)	66.9	70.5	68.5	71.4	71.6	na	na
Share of trade in GDP (in per cent)	50.2	58.7	57.7	50.8	48.7	48.8	na
Tariff revenues (in per cent of imports) <sup>2</sup>	7.1	8.9	18.5	21.1	16.9	na	na
<i>EBRD index of price liberalisation</i>	3.3	3.3	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	2.3	2.3	2.3	2.7	3.0	3.3	3.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	3.5	3.6	3.9	4.3	4.7	5.4	na
Private sector share in GDP (in per cent)	70.0	70.0	70.0	70.0	70.0	70.0	70.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
<i>EBRD index of small-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP) <sup>3</sup>	6.0	5.3	na	na	na	na	na
Share of industry in total employment (in per cent)	20.7	22.4	22.7	20.5	19.6	na	na
Change in labour productivity in industry (in per cent)	0.8	10.2	10.1	5.0	6.8	na	na
Investment/GDP (in per cent)	16.0	15.0	19.0	22.0	21.0	na	na
<i>EBRD index of enterprise reform</i>	2.0	1.7	2.0	2.3	2.3	2.3	2.3
<i>EBRD index of competition policy</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	19.9 (0.5)	21.0 (0.9)	21.8 (2.2)	22.7 (5.3)	24.2 (12.0)	26.0 (25.0)	na
Internet penetration rate (per 10,000 inhabitants)	12.5	6.3	22.5	24.1	27.9	42.2	na
Railway labour productivity (1989=100)	60.9	72.1	78.8	85.0	90.1	101.6	na
Residential electricity tariffs, USc kWh <sup>4</sup>	2.7	1.1	0.9	na	2.4	na	na
Average collection rate, electricity (in per cent) <sup>5</sup>	87	na	85	na	102	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.4	1.5	1.6	1.6	na	na	na
<i>EBRD index of infrastructure reform</i>	2.0	2.3	2.3	2.3	2.3	2.3	2.7
<i>Electric power</i>	2.0	2.0	2.0	2.0	2.3	3.0	3.0
<i>Railways</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.7
<i>Roads</i>	2.0	2.0	2.0	2.0	2.3	2.3	2.3
<i>Telecommunications</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>Water and waste water</i>	2.0	2.3	2.3	2.3	2.3	2.3	2.3
<b>Financial sector</b>							
Number of banks (foreign-owned)	1476 (30)	1349 (32)	1311 (33)	1319 (35)	1329 (37)	1329 (41)	na
Asset share of state-owned banks (in per cent)	41.9	na	na	na	na	na	na
Non-performing loans (in per cent of total loans)	30.9	28.1	16.1	12.2	11.4	10.4	na
Domestic credit to private sector (in per cent of GDP)	13.2	10.8	11.9	15.5	17.3	20.9	na
Stock market capitalisation (in per cent of GDP) <sup>6</sup>	16.9	41.2	15.3	26.0	36.6	50.8	na
<i>EBRD index of banking sector reform</i>	2.0	1.7	1.7	1.7	2.0	2.0	2.0
<i>EBRD index of reform of non-bank financial institutions</i>	1.7	1.7	1.7	1.7	2.3	2.7	2.7
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	7.4	6.6	6.3	6.4	6.6	na	na
Life expectancy at birth, total (years)	67.0	66.0	65.3	65.6	65.9	na	na
Basic school enrolment ratio (in per cent)	88.5	88.8	89.4	90.1	90.0	na	na

<sup>1</sup> The Central Bank of Russia has until April 2005 to determine which banks are eligible to join the deposit insurance scheme.

<sup>2</sup> Refers to all taxes on international trade.

<sup>3</sup> Expenditures on national economy of the consolidated budget (including industry, agriculture, the energy sector and housing subsidies of regional budgets).

<sup>4</sup> Refers to average retail tariff. Figures are averages of the Siberian, Northern, Southern, Volga, Far East and Ural regions and the Federation.

<sup>5</sup> Numbers greater than 100 per cent reflect collection of several years worth of payments.

<sup>6</sup> Includes listings on the Moscow Interbank Currency Exchange, Moscow Stock Exchange and RTS Stock Exchange.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> (Percentage change in real terms)							
GDP	-5.3	6.4	10.0	5.1	4.7	7.3	6.9
Private consumption	-3.3	-2.9	7.1	9.9	8.7	7.2	na
Public consumption	1.0	3.1	2.1	-0.8	2.6	2.2	na
Gross fixed capital formation	-12.4	6.3	18.1	10.3	3.0	12.9	na
Exports of goods and services	1.9	11.2	9.5	4.2	9.6	13.7	na
Imports of goods and services	-17.4	-17.0	32.4	18.7	14.6	19.5	na
Industrial gross output	-5.2	11.0	11.9	4.9	3.7	7.0	na
Agricultural gross output	-13.2	4.1	7.7	7.5	1.7	na	na
<b>Employment</b> (Percentage change)							
Labour force (end-year)	-0.3	-0.5	-1.0	-0.7	1.3	0.3	na
Employment (end-year)	-1.6	-0.9	2.2	0.3	1.7	-0.1	na
(In per cent of labour force)							
Unemployment (end-year)	12.3	12.6	9.8	8.9	8.6	8.5	na
<b>Prices and wages</b> (Percentage change)							
Consumer prices (annual average)	27.6	86.1	20.8	21.6	15.7	13.7	10.7
Consumer prices (end-year)	84.5	36.8	20.1	18.6	15.0	12.0	10.0
Producer prices (annual average)	7.1	58.9	46.6	19.2	14.0	15.6	na
Producer prices (end-year)	23.2	67.3	31.6	10.7	17.1	13.1	na
Gross average monthly earnings in economy (annual average)	10.7	47.7	43.2	45.8	36.2	24.6	na
<b>Government sector</b> <sup>1</sup> (In per cent of GDP)							
General government balance	-8.2	-3.1	3.1	2.7	0.6	1.1	3.1
General government expenditure	42.6	36.7	33.7	34.5	37.0	35.5	na
General government debt	81.9	90.0	62.5	48.2	41.4	32.4	na
<b>Monetary sector</b> (Percentage change)							
Broad money (M2, end-year)	19.8	57.2	62.4	40.9	32.4	50.5	na
Domestic credit (end-year)	71.0	36.1	12.1	27.0	26.5	26.5	na
(In per cent of GDP)							
Broad money (M2, end-year)	17.0	14.6	15.7	18.0	19.7	24.2	na
<b>Interest and exchange rates</b> (In per cent per annum, end-year)							
Central Bank refinancing rate (uncompounded)	60.0	55.0	25.0	25.0	21.0	16.0	na
Treasury bill rate (all maturities) <sup>2</sup>	56.4	25.5	12.8	14.7	12.7	4.5	na
Deposit rate	17.1	13.7	6.5	4.9	5.0	4.5	na
Lending rate	41.8	39.7	24.4	17.9	15.6	13.0	na
(Roubles per US dollar)							
Exchange rate (end-year) <sup>3</sup>	20.7	26.8	28.2	30.1	31.8	29.5	na
Exchange rate (annual average) <sup>3</sup>	10.0	24.6	28.1	29.2	31.3	30.7	na
<b>External sector</b> (In millions of US dollars)							
Current account	218	24,615	46,839	33,934	29,116	35,845	36,500
Trade balance	16,429	36,014	60,171	48,120	46,335	60,493	70,000
Merchandise exports	74,444	75,551	105,033	101,884	107,301	135,929	163,000
Merchandise imports	58,015	39,537	44,862	53,764	60,966	75,436	93,000
Foreign direct investment, net	1,492	1,102	-463	216	-72	-3,002	1,000
International reserves, excluding gold (end-year)	7,801	8,457	24,264	32,542	44,054	73,175	na
External debt stock	185,700	177,100	158,300	150,400	153,200	182,100	na
(In months of imports of goods and services)							
International reserves, excluding gold (end-year)	1.3	1.9	4.8	5.3	6.3	8.6	na
(In per cent of exports of goods and services)							
Public debt service due <sup>4</sup>	15.1	17.5	10.4	15.2	11.8	10.1	na
Public debt service paid <sup>4</sup>	12.6	14.2	10.3	14.4	11.7	10.1	na
<b>Memorandum items</b> (Denominations as indicated)							
Population (end-year, million)	146.4	145.6	145.2	144.4	145.2	144.9	na
GDP (in billions of roubles)	2,630	4,823	7,306	8,944	10,834	13,285	15,716
GDP per capita (in US dollar)	1,802	1,347	1,789	2,123	2,381	2,987	na
Share of industry in GDP (in per cent)	29.9	30.8	31.4	28.1	26.5	na	na
Share of agriculture in GDP (in per cent)	5.7	7.7	6.7	6.8	6.1	5.2	na
Current account/GDP (in per cent)	0.1	12.6	18.0	11.1	8.4	8.3	6.7
External debt - reserves (in US\$ million)	177,899	168,643	134,036	117,858	109,146	108,925	na
External debt/GDP (in per cent)	70.4	90.3	61.0	49.1	44.3	42.1	na
External debt/exports of goods and services (in per cent)	213.9	209.3	138.1	132.7	126.7	119.8	na

<sup>1</sup> General consolidated government includes the federal, regional and local budgets and extra-budgetary funds, and excludes transfers.

<sup>2</sup> The 1998 figure is the yield on obligations of the Central Bank of Russia.

<sup>3</sup> Exchange rate data are in new (denominated) roubles per dollar. From 1 January 1998, one new rouble = 1,000 old roubles.

<sup>4</sup> Difference between due and paid arises from accumulation of arrears on debt servicing.

# Serbia and Montenegro

## Key challenges

Privatisation and restructuring of large-scale enterprises is needed to attract investment and boost enterprise profitability and performance.

While financial intermediation is increasing, more needs to be done to ensure further consolidation in the banking sector and smooth, transparent privatisation of the majority state-owned banks.

Public expenditure is still very high as a percentage of GDP. A reduction in spending is needed to release resources for private sector development and to ensure that government liabilities remain at manageable levels.

## Business environment and competition

A number of new business-enabling laws were passed by the Serbian parliament in July 2004. These include a new bankruptcy law that simplifies the process significantly and improves the rights of creditors. However, strong opposition to some closures, and weaknesses in the court system, will remain serious obstacles to its implementation.

The corporate tax rate in Serbia has been reduced from 14 to 10 per cent, one of the lowest rates among all transition countries. However, surveys reveal that the business environment in both republics remains weak. Serious concerns about political instability, pervasive corruption and the poor functioning of the judicial system continue.

## Infrastructure

After lengthy delays, the Serbian parliament approved a new law on energy in July 2004. It sets out the framework for the eventual privatisation of the power company EPS and establishes an independent energy regulator. In the past two years average electricity prices in both republics have risen steadily towards cost-recovery levels and both state-owned power companies are undergoing restructuring.

Major reforms in other infrastructure sectors such as roads, railways and telecommunications have been delayed. This is due to parliament's failure to pass key laws and, in the case of the mobile telecommunications company Mobtel, to a dispute between the government and the private shareholder over the ownership structure. A government-appointed commission determined in June 2004 that the state owns more than 58 per cent of Mobtel. However, the other shareholder disputes this finding and is threatening legal action, which could further delay any potential sale.

## Financial sector

Confidence is returning to the banking sector. Financial intermediation continues to increase in both republics, although from a very low base. Domestic credit to the private sector grew by more than 20 per cent in real terms in 2003. However, much of the increase was accounted for by new lending to the household sector. Access to capital for the private corporate sector remains limited.

The banking sectors in both republics are arguably still "over-banked" with 47 banks in Serbia and 10 in Montenegro at the end of 2003. Although bank privatisation is well advanced in Montenegro, in Serbia the state still has significant or majority shareholdings in 16 banks. Most of these are being prepared for privatisation over the next two or three years. A tender for Yubanka was offered in the first half of 2004 and a short list of eight foreign banks was chosen in June. Two further banks – Continental Banka and Novosadska Banka – are expected to be offered for sale in the autumn.

## Country data

Population (in millions)	10.6 (including Kosovo)
Area ('000 sq. km)	102
Official language	Serbian
GDP per capita in 2002 at current international US\$ (PPP)	na
National currency	Dinar (Serbia); euro (Montenegro)

## Progress in structural reform

### Liberalisation and privatisation

Little progress has been made with negotiations on the EU's Stabilisation and Association Agreement (SAA). Among other things, the EU had been insisting the two republics harmonise their tariffs on 56 agricultural products. However, it has recently proposed a more flexible approach whereby Serbia and Montenegro would continue to approach the EU as a joint state, but where economic policies are involved, the framework could diverge.

Trade relations with the EU worsened in 2003 when exports of sugar to the region were suspended. This followed allegations that much of the sugar had in fact originated elsewhere. The ban was lifted in August 2004 after the introduction of new controls.

Small-scale privatisation of enterprises through auctions in Serbia proceeded steadily during the past year. By mid-2004, over 1,000 companies had been sold (out of a total of around 2,500) since a comprehensive new programme was adopted in 2001. However, the large-scale privatisation programme has been affected by political uncertainty. Revenue targets from privatisation for 2004 are unlikely to be met as the programme has slowed markedly. Around 60 large industrial conglomerates are undergoing major restructuring, with the help of international donors to prepare them for eventual sale.

In Montenegro privatisation in the important hotel industry is well advanced. The Niksic steel mill was privatised in the first half of 2004. The sale of the giant aluminium conglomerate KAP is progressing, following the preparation of a pre-privatisation feasibility study by BNP-Paribas. A tender for a 65.5 per cent stake in the company was launched in August 2004.

## Macroeconomic performance

### Real economy

Output growth in 2003 slowed to 3 per cent. However, prospects for 2004 appear more favourable. The official projected growth rate is in the range of 4.5 to 5.5 per cent. Indications from the first half of 2004 suggest that the economy is on track to achieve or even exceed this target. Industrial production rose by nearly 8 per cent during the first half of 2004 (year-on-year). Output from the agricultural sector, which accounts for about 25 per cent of GDP, could grow in excess of 10 per cent in 2004.

### Economic policies

Economic policies in both republics are characterised by tight monetary policies but more relaxed fiscal policies. In Serbia annual inflation fell to single figures by the end of 2003. However, it has since increased due to higher oil prices and relatively strong wage growth. The end-2004 inflation target of 8.5 per cent will be difficult to achieve. The exchange rate remains relatively stable, with a regular slight depreciation against the euro. Monetary policies continue to be underpinned by comfortable levels of foreign reserves. Budget constraints for public enterprises in both republics have been hardened. However, the size of government spending in both republics is still very large relative to GDP (at close to 50 per cent), and further fiscal streamlining is necessary. The IMF's three-year Extended Arrangement remains on track.

### External sector

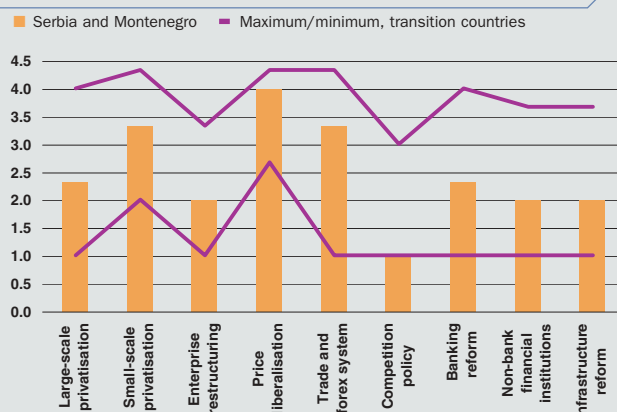
There are large trade and current account deficits. The latter is running at more than 10 per cent of GDP (before grants) and is mainly a reflection of the structural problems in the economy and the competitive pressures faced by exporters.

The current account deficit continues to be covered by capital inflows and substantial foreign direct investment (FDI). Capital inflows mainly comprise grants and loans from bilateral donors and international financial institutions. Total net FDI in 2003 was nearly US\$ 1.4 billion, generated mostly by a few large transactions in the tobacco and oil sectors. Following a Paris Club rescheduling agreement in November 2001, current debt service is manageable. However, it will rise significantly after 2005. In July 2004 the authorities finally reached a settlement of outstanding debts with the London Club of commercial creditors, reducing the present value of the debt by 62 per cent.

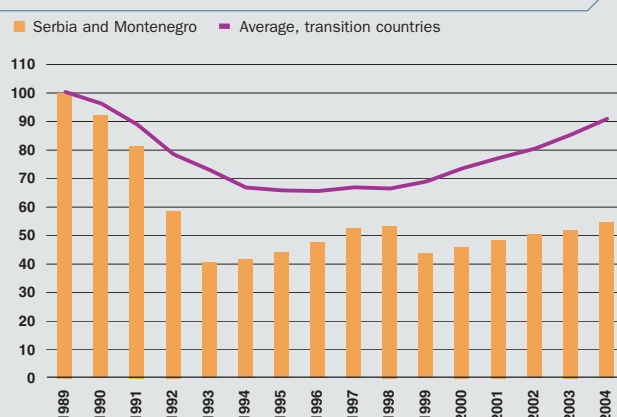
## Outlook and risks

After many years of stagnation and decline in the 1990s, the economy of Serbia and Montenegro has the potential to grow robustly in the medium term. However, prospects depend crucially on political stability and a favourable business environment. There must also be a sustained commitment to reform by the governments of both republics. Key restructuring challenges remain, especially in the enterprise sector. Many large conglomerates may have to undergo significant rationalisation before being sold – or be closed down. Despite major progress in restoring solvency, the country's ability to service its debts over the medium term depends on continued growth and significant improvements in export-earning capacity.

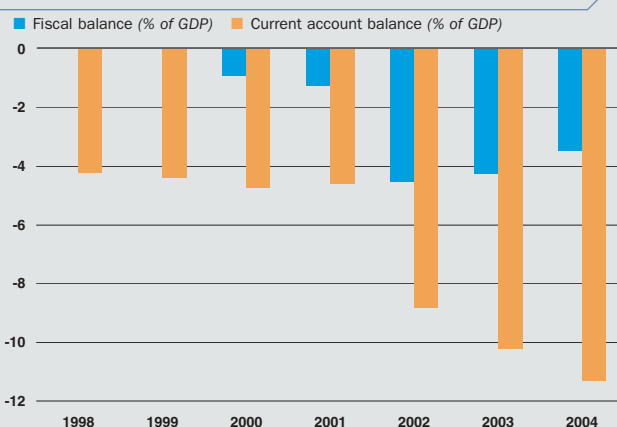
### Transition indicators, 2004



### Real GDP (1989=100)

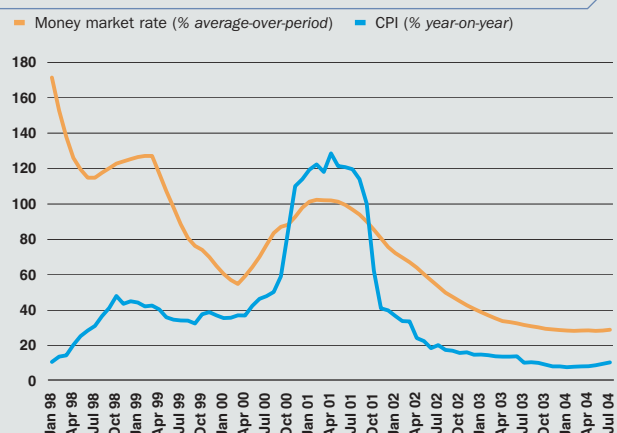


### Fiscal balance and current account balance



Fiscal balance data for 1998–99 not available

### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – no	Share of population living in poverty –
Interest rate liberalisation – full	<b>auctions (Serbia); vouchers</b>	Separation of railway accounts – yes	<b>na</b>
Wage regulation – no	<b>(Montenegro)</b>	Independent electricity regulator – yes	Private pension funds – no
Stabilisation	Secondary privatisation method –	Financial sector	
Share of general government tax	<b>direct sales</b>	Capital adequacy ratio – 8 per cent	
revenue in GDP – 38.7 per cent	Tradability of land – limited de jure	Deposit insurance system – no	
Exchange rate regime – managed float	Enterprise and markets	Secured transactions law – yes	
<b>(Serbia); euro (Montenegro)</b>	Competition office – no	Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	25.4	25.6	10.3	11.0	11.0	11.2	11.2
Number of goods with administered prices in EBRD-15 basket	12.0	13.0	1.0	2.0	3.0	4.0	3.0
Share of trade with non-transition countries (in per cent) <sup>1</sup>	80.7	80.0	73.2	78.1	82.9	79.3	na
Share of trade in GDP (in per cent)	50.3	28.6	81.0	59.2	55.7	52.4	na
Tariff revenues (in per cent of imports)	9.9	na	5.1	4.9	6.7	na	na
EBRD index of price liberalisation	2.3	2.3	2.3	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	1.0	1.0	1.0	3.0	3.3	3.3	3.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.0	0.0	0.0	2.6	6.9	na
Private sector share in GDP (in per cent)	na	na	40.0	40.0	45.0	45.0	50.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.3
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	2.0	2.3	2.3
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	na	na	2.1	3.1	4.4	3.5	na
Share of industry in total employment (in per cent)	36.5	35.1	na	na	na	na	na
Change in labour productivity in industry (in per cent)	2.4	-16.4	na	na	na	na	na
Investment/GDP (in per cent)	na	na	na	na	na	na	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	2.0	2.0	2.0
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	21.8 (2.3)	21.4 (5.7)	22.6 (12.3)	22.9 (18.7)	23.3 (25.7)	24.3 (33.8)	na
Internet penetration rate (per 10,000 inhabitants)	7.3	12.6	17.5	14.7	15.8	18.4	na
Railway labour productivity (1989=100)	45.9	25.1	39.9	41.2	45.1	50.3	na
Residential electricity tariffs, USc kWh	3.7	4.0	1.1	2.0	3.6	5.2	na
Average collection rate, electricity (in per cent)	na	na	na	74	84	87	na
GDP per unit of energy use (PPP in US dollars per kgoe)	na	na	na	na	na	na	na
EBRD index of infrastructure reform	1.7	1.7	2.0	2.0	2.0	2.0	2.0
Electric power	2.0	2.0	2.0	2.0	2.0	2.3	2.3
Railways	na	na	na	2.0	2.3	2.3	2.3
Roads	1.7	1.7	2.0	2.0	2.3	2.3	2.3
Telecommunications	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Water and waste water	1.7	1.7	2.0	2.0	2.0	2.0	2.0
<b>Financial sector</b>							
Number of banks (foreign-owned) <sup>2</sup>	104 (3)	75 (3)	81 (3)	54 (8)	50 (12)	47 (16)	na
Asset share of state-owned banks (in per cent) <sup>2</sup>	90.0	89.0	90.9	68.0	35.6	34.1	na
Non-performing loans (in per cent of total loans) <sup>2</sup>	13.1	10.2	27.8	24.4	28.5	23.8	na
Domestic credit to private sector (in per cent of GDP) <sup>2</sup>	11.2	9.8	7.6	5.6	na	na	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	2.3	2.3	2.3
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.0	1.7	2.0	2.0
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	72.2	na	72.5	72.6	72.7	na	na
Basic school enrolment ratio (in per cent)	69.9	67.0	66.1	65.9	na	na	na

<sup>1</sup> For some years data were unavailable for some important trading partner countries, such as Bosnia and Herzegovina and FYR Macedonia.

<sup>2</sup> Data refer to Serbia only.



	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> (Percentage change in real terms)							
GDP	1.9	-18.0	5.0	5.5	4.0	3.0	5.0
Industrial gross output	4.4	-24.4	11.1	0.0	1.7	-2.7	na
Agricultural gross output	-3.2	-2.0	-13.7	23.2	3.0	-6.0	na
<b>Employment</b> (Percentage change)							
Labour force (end-year)	-0.6	-7.6	-2.4	1.8	-6.2	0.7	na
Employment (end-year)	-1.8	-6.0	-2.6	0.2	-11.9	-4.4	na
(In per cent of labour force)							
Unemployment (end-year)	26.8	25.5	25.6	26.8	28.9	na	na
<b>Prices and wages</b> (Percentage change)							
Consumer prices (annual average)	29.5	37.1	60.4	91.3	21.4	11.3	8.5
Consumer prices (end-year)	44.5	36.5	113.5	39.3	14.3	7.8	10.0
Producer prices (annual average)	25.5	44.2	44.5	na	na	na	na
Gross average monthly earnings in economy (annual average) <sup>1</sup>	117.7	18.2	83.3	129.6	51.7	25.5	na
<b>Government sector</b> (In per cent of GDP)							
General government balance	na	na	-0.9	-1.3	-4.5	-4.2	-3.4
General government expenditure	na	na	37.6	40.2	47.3	46.8	na
<b>Monetary sector<sup>2</sup></b> (Percentage change)							
Broad money (M2, end-year)	na	67.6	58.5	67.6	73.4	28.6	na
Domestic credit (end-year)	na	130.1	58.2	10.0	-38.2	27.3	na
(In per cent of GDP)							
Broad money (M2, end-year)	16.6	21.0	16.9	14.0	18.6	20.2	na
<b>Interest and exchange rates</b> (In per cent per annum, end-year)							
Discount rate	33.7	26.3	26.3	16.4	9.5	9.0	na
Deposit rate	16.2	13.1	8.3	4.1	2.6	na	na
Lending rate (long-term)	60.3	45.4	77.9	32.5	19.2	na	na
(Dinars per US dollar)							
Exchange rate (official, end-year) <sup>3</sup>	10.0	11.7	66.5	67.7	59.0	54.6	na
Exchange rate (official, annual average)	9.3	11.1	54.9	66.8	64.2	57.5	na
<b>External sector</b> (In millions of US dollars)							
Current account	-660	-764	-327	-528	-1,384	-2,121	-2,577
Trade balance	-1,816	-1,619	-1,788	-2,834	-3,908	-5,040	-5,322
Merchandise exports	3,033	1,676	1,923	2,003	2,412	2,917	3,483
Merchandise imports	4,849	3,295	3,711	4,837	6,320	7,957	8,805
Foreign direct investment, net	113	112	25	165	562	1,395	600
Gross reserves, excluding gold (end-year)	na	289	516	1,169	2,280	3,550	na
External debt stock	10,539	10,744	11,403	11,948	11,839	14,303	na
(In months of imports of goods and services)							
Gross reserves, excluding gold (end-year)	na	1.0	1.5	2.7	4.0	4.9	na
(In per cent of exports of goods and services)							
Debt service <sup>4</sup>	1.9	4.7	2.2	3.9	5.6	11.0	na
<b>Memorandum items</b> (Denominations as indicated)							
Population (end-year, million) <sup>5</sup>	10.6	8.4	8.3	8.3	8.3	8.3	na
GDP (in billions of dinars)	146	193	382	772	1,007	1,193	1,354
GDP per capita (in US dollar)	1,475	2,071	834	1,386	1,884	2,492	na
Share of industry in GDP (in per cent)	26.1	25.5	na	na	na	na	na
Share of agriculture in GDP (in per cent)	19.0	25.1	na	na	na	na	na
Current account/GDP (in per cent)	-4.2	-4.4	-4.7	-4.6	-8.8	-10.2	-11.3
External debt - reserves (in US\$ million)	na	10,455	10,887	10,779	9,559	10,753	na
External debt/GDP (in per cent)	67.3	61.8	164.0	103.5	75.5	68.9	na
External debt/exports of goods and services (in per cent)	267.0	500.4	447.7	435.6	365.3	360.3	na

Note: Data from 1999 onwards exclude Kosovo.

<sup>1</sup> Data from 1999 refer to net wages.

<sup>2</sup> Data refer to Serbia only.

<sup>3</sup> The exchange rate regime was unified in December 2000. The unofficial rate in October 2000 was 30 dinars: 1 Deutschmark (DM), compared with an official rate of 6 dinars: 1 DM.

<sup>4</sup> Serbia and Montenegro was in default on virtually all of its external debt between 1998 and 2001.

<sup>5</sup> Population decrease in 1999 is the result of excluding Kosovo population from the total.

# Slovak Republic

## Key challenges

Consolidating recent improvements in the business environment and further development of transport infrastructure will be critical to sustaining strong growth and attracting foreign investment.

The successful introduction of mandatory pension funds will depend on the local financial market's ability to offer appropriate investment opportunities and adequate supervision.

While pension and health care reforms remain critical to a successful fiscal adjustment, the effectiveness of monetary policy could be improved by a clearer focus on disinflation.

Measures have been taken to adapt the law on bankruptcy and to modernise the judiciary. More transparency has been introduced in the legal system with the establishment of an electronic commercial registry. The tax system has also been simplified with the introduction of a flat tax rate of 19 per cent on personal and corporate incomes and the unification of the VAT rate at 19 per cent.

## Infrastructure

The next phase of railway sector reform was initiated in June 2004. The government announced the division of the operating company Železnica Spolocnost (ZSSK) into two entities in charge of passenger and freight transport respectively. The latter is earmarked for privatisation to a strategic investor at the beginning of 2005. In preparation for this, the state assumed debts worth SKK 21 billion (€500 million) from ZSSK and the public railway network operator Železnice Slovenskej Republiky (ZSR) in July 2003. Both companies have been loss-making in recent years. They are in the process of reducing their workforces by 10 per cent, which is likely to result in 4,750 redundancies.

Progress has been made in liberalising the energy sector. More than a third of the electricity and gas markets were opened to competition in 2003. Medium-sized electricity consumers were allowed to select their suppliers in January 2004. The electricity market was liberalised for all industrial customers in July 2004. Market liberalisation for residential consumers is planned for July 2007. Electricity and gas prices have been increased by between 30 and 60 per cent over the past two years. They are now considered to have reached (or nearly reached) full cost-recovery levels for every category of consumer. Cross-subsidies have been eliminated.

## Social sector

In January 2004 parliament adopted a new pension law that introduces a second pillar consisting of mandatory privately managed pension funds. The new funds will be operative from January 2005 and will complement the existing pension system, which comprises a pay-as-you-go component and voluntary private pension funds. In June 2004 amendments to the law reduced the minimum share of the funds' capital that can be invested in domestically traded assets from 50 to 30 per cent. However, it remains unclear whether the thin local capital market will be able to offer sufficient investment opportunities for an estimated annual inflow of 1 per cent of GDP. Another challenge will be the supervision of the newly created pension funds in a period of institutional change. Supervision of the financial sector is to be unified under the auspices of the National Bank of Slovakia by 2006.

A series of measures have been initiated to stave off a financial crisis in the health care sector, which has accumulated debts and arrears amounting to around 2.5 per cent of GDP. Patients' co-payments were introduced in 2003 to create additional resources and reduce abuses of the system. These initial steps have helped to slow the expansion of health sector debt. Further rationalisation of health services (including the introduction of market incentives), along with the planned extension of co-payments, is intended to stop the accumulation of new debt altogether. The objective of the government is to limit total health expenditures to the current 6.5 per cent of GDP.

## Country data

Population (in millions)	<b>5.4</b>
Area ('000 sq. km)	<b>49.0</b>
Official language	<b>Slovak</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 12,840</b>
National currency	<b>Koruna</b>

## Progress in structural reform

### Liberalisation and privatisation

The law preventing the state from lowering its stake in strategic enterprises to below 51 per cent was amended in late 2003. This was done to allow for the full privatisation of most of these firms. The exceptions are postal services, the railway companies and the national forests. Only a few large state-owned companies have yet to be fully privatised. In the energy sector these include the dominant electricity generator Slovenske Elektrarne, for which a strategic investor is expected to be chosen before the end of the year, and the regional distribution companies. In the telecommunications sector the government still holds a 49 per cent stake in Slovak Telekom. In the transport sector regional bus companies, Slovak Airlines, and the country's airports are still to be privatised.

### Business environment and competition

Several foreign investors, including automobile manufacturers Peugeot-Citroën and Hyundai-Kia, have initiated large investment projects in 2003 and 2004, underlining substantial improvements in the country's business environment. In its survey "Doing Business", the World Bank ranked the Slovak Republic as the world's best reformer and one of the top 20 most business-friendly countries in 2004. However, obstacles remain, particularly for small businesses. These relate mainly to the legal environment, the uneven implementation of rules and regulations, and corruption.

## Macroeconomic performance

### Real economy

GDP growth increased to 5.4 per cent year-on-year in the first half of 2004, compared with 4.2 per cent for 2003 as a whole. Growth was primarily sustained by internal demand. After a year of stagnation due to a surge in inflation that squeezed real income in 2003, household spending increased by 2.9 per cent in the first half of 2004. A significant rise in inventories accounted for most of this investment, while government consumption remained flat. Net exports contributed only one-third of total growth. However, growth in total exports remained strong at 16.1 per cent.

### Economic policies

In 2003 the general government deficit was reduced to 3.6 per cent of GDP. This represented the first successful step in a fiscal adjustment strategy aimed at reaching compliance with the Maastricht criteria by 2007. In the first half of 2004 the state deficit reached 3.1 per cent of GDP while the general government deficit for the year is officially projected at 3.9 per cent of GDP. Inflation declined slightly to 8.1 per cent annually in the first eight months of 2004. Despite sustained inflationary pressure, the two-week repo rate has been cut by 150 basis points since January 2004 to 4.5 per cent. The reduction was motivated by a desire to contain appreciation pressures on the koruna, which the National Bank of Slovakia regarded as excessive.

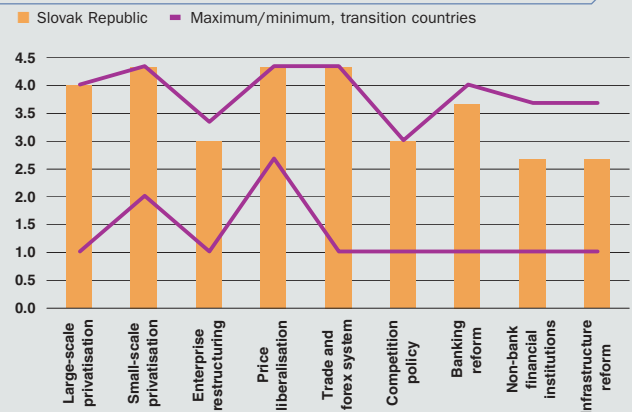
### External sector

Owing to dynamic export growth, particularly by the motor industry, the trade deficit was reduced to 1.9 per cent of GDP in 2003, down from 8.8 per cent in 2002. The current account deficit declined from 8 per cent in 2002 to 0.9 per cent last year. Due to the resumption of internal demand in the first half of 2004 the trade deficit rose to just over 2 per cent of GDP. The current account deficit is expected to reach a similar level. Net foreign direct investment declined to 1.8 per cent of GDP in 2003, from a record 17 per cent of GDP in 2002. It bounced back to 4.4 per cent of GDP in the first quarter of 2004.

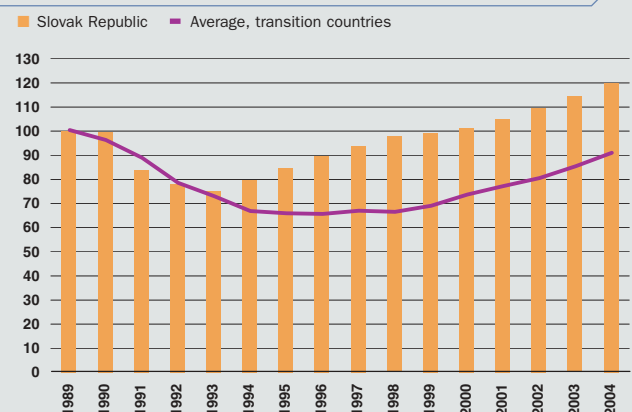
## Outlook and risks

Household consumption and investment have replaced net exports as the main drivers of growth. Activity for 2004 is expected to expand in line with the half-year results, but should slow in the medium term. The external accounts and public finances are likely to remain on a sustainable path, as the government seeks to complete its ambitious programme of structural reforms and fiscal adjustment. The effectiveness of monetary policy will be affected by the pursuit of conflicting objectives. Reducing inflation further from its current high level may deserve renewed attention, while the trend appreciation of the koruna might simply reflect a natural evolution.

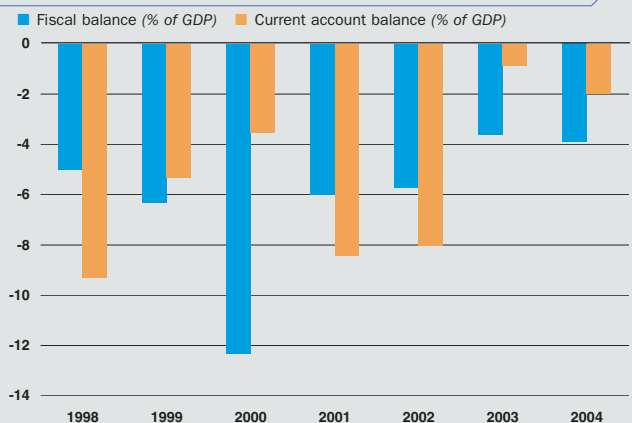
### Transition indicators, 2004



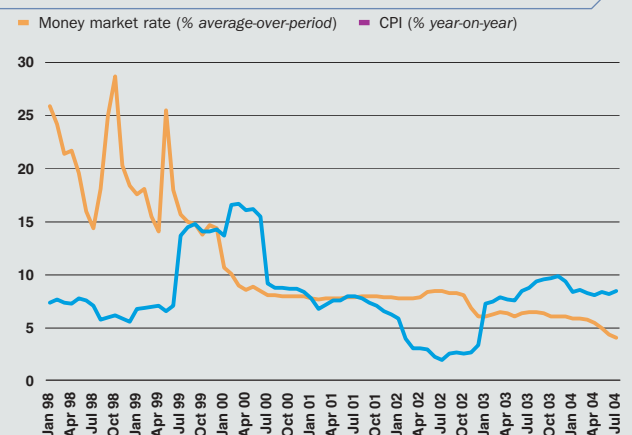
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – yes	Share of population living in poverty –
Interest rate liberalisation – full	direct sales	Separation of railway accounts – yes	2.4 per cent (1996)
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – yes
	vouchers		
Stabilisation	Tradability of land – full except	Financial sector	
Share of general government tax	non EU foreigners	Capital adequacy ratio – 8 per cent	
revenue in GDP – 30.4 per cent		Deposit insurance system – yes	
Exchange rate regime – managed	Enterprise and markets	Secured transactions law – yes	
floating	Competition office – yes	Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	17.8	17.8	17.8	17.8	21.1	20.7	19.9
Number of goods with administered prices in EBRD-15 basket	4.0	4.0	3.0	3.0	3.0	3.0	2.0
Share of trade with non-transition countries (in per cent)	62.0	62.0	64.0	62.0	63.5	66.1	na
Share of trade in GDP (in per cent)	106.5	105.3	122.0	131.2	127.6	136.3	na
Tariff revenues (in per cent of imports) <sup>1</sup>	2.6	2.7	2.2	0.5	0.5	0.5	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	11.1	11.4	15.7	19.3	34.0	35.0	na
Private sector share in GDP (in per cent)	75.0	75.0	80.0	80.0	80.0	80.0	80.0
Private sector share in employment (in per cent)	68.9	70.0	75.0	75.0	na	na	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	1.9	1.8	3.8	2.6	1.6	1.8	na
Share of industry in total employment (in per cent)	26.6	24.4	25.3	27.7	29.6	29.2	na
Change in labour productivity in industry (in per cent)	7.8	2.6	-2.5	3.6	4.8	6.8	na
Investment/GDP (in per cent)	na	na	na	na	na	na	na
EBRD index of enterprise reform	2.7	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of competition policy	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	28.5 (8.8)	30.7 (12.3)	31.4 (20.5)	28.9 (39.9)	26.8 (54.4)	24.1 (68.4)	na
Internet penetration rate (per 10,000 inhabitants)	41.2	55.2	70.2	134.9	159.9	212.2	na
Railway labour productivity (1989=100)	60.8	53.0	61.0	62.4	61.7	60.5	na
Residential electricity tariffs, USc kWh	2.8	3.5	4.9	5.7	7.1	10.9	na
Average collection rate, electricity (in per cent) <sup>2</sup>	na	na	na	102	95	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.1	3.1	3.2	3.1	na	na	na
EBRD index of infrastructure reform	1.7	2.0	2.0	2.3	2.7	2.7	2.7
Electric power	2.0	2.0	2.0	3.0	4.0	4.0	4.0
Railways	2.0	2.0	2.3	2.3	2.7	2.7	2.7
Roads	2.0	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	2.3	2.3	2.3	3.0	3.3	3.3	3.3
Water and waste water	1.0	2.3	2.3	2.3	2.3	2.3	2.3
<b>Financial sector</b>							
Number of banks (foreign-owned)	27 (11)	25 (11)	23 (14)	21 (13)	20 (15)	21 (16)	na
Asset share of state-owned banks (in per cent)	50.0	50.7	49.1	4.9	2.9	1.5	na
Non-performing loans (in per cent of total loans)	44.3	32.9	26.2	24.3	11.2	9.1	na
Domestic credit to private sector (in per cent of GDP)	42.1	39.1	35.7	26.3	24.6	25.0	na
Stock market capitalisation (in per cent of GDP) <sup>3</sup>	4.5	3.6	3.7	3.2	6.9	7.6	na
EBRD index of banking sector reform	2.7	2.7	3.0	3.3	3.3	3.3	3.7
EBRD index of reform of non-bank financial institutions	2.3	2.3	2.3	2.3	2.3	2.7	2.7
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	9.8	9.6	9.2	9.1	9.6	na	na
Life expectancy at birth, total (years)	72.6	72.9	73.1	73.2	73.3	na	na
Basic school enrolment ratio (in per cent)	101.3	107.5	107.4	106.2	107.0	na	na

<sup>1</sup> Refers to import tariffs, customs duties and import surcharge.<sup>2</sup> Numbers greater than 100 per cent reflect collection of several years worth of payments.<sup>3</sup> Data from the Bratislava Stock Exchange.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>							
	<i>(Percentage change in real terms)</i>						
GDP	4.2	1.5	2.0	3.8	4.4	4.2	4.8
Private consumption	6.5	3.2	-0.8	4.7	5.3	-0.4	na
Public consumption	12.5	-7.1	1.6	4.6	4.7	2.9	na
Gross fixed capital formation	11.0	-19.6	-7.2	13.9	-0.9	-1.2	na
Exports of goods and services	12.8	5.0	13.7	6.3	5.5	22.6	na
Imports of goods and services	16.5	-6.7	10.5	11.0	5.2	13.8	na
Industrial gross output	3.4	-3.4	9.1	4.6	6.8	5.7	na
Agricultural gross output	-5.9	1.0	3.2	-4.0	10.9	na	na
<b>Employment</b>							
	<i>(Percentage change)</i>						
Labour force (end-year)	0.9	0.9	2.0	2.0	0.3	0.4	na
Employment (end-year)	-1.0	-1.8	-1.4	-1.0	0.5	0.9	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	15.6	19.2	17.9	19.8	17.9	17.4	na
<b>Prices and wages</b>							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	6.7	10.6	12.0	7.1	3.3	8.5	7.5
Consumer prices (end-year)	5.6	14.2	8.3	6.2	3.3	9.3	6.0
Producer prices (annual average)	3.3	3.8	9.8	6.6	2.1	8.3	na
Producer prices (end-year)	1.6	7.7	9.1	3.4	2.3	8.7	na
Gross average monthly earnings in economy (annual average)	8.4	7.2	6.5	8.2	9.3	6.3	na
<b>Government sector<sup>1</sup></b>							
	<i>(In per cent of GDP)</i>						
General government balance	-5.0	-6.3	-12.3	-6.0	-5.7	-3.6	-3.9
General government expenditure	41.2	41.8	59.9	51.5	50.9	39.2	na
General government debt	28.6	43.8	49.9	48.7	43.3	42.8	na
<b>Monetary sector</b>							
	<i>(Percentage change)</i>						
Broad money (M2, end-year)	2.7	13.0	15.4	11.9	3.4	5.6	na
Domestic credit (end-year)	11.2	7.5	9.1	13.3	-12.7	15.0	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	59.7	62.4	65.1	67.3	64.1	62.1	na
<b>Interest and exchange rates</b>							
	<i>(In per cent per annum, end-year)</i>						
Refinancing rate	11.3	8.7	8.0	7.8	6.5	6.0	na
3-month BRIBOR	18.3	14.3	7.9	7.8	6.0	6.0	na
Deposit rate <sup>2</sup>	10.4	9.9	5.6	4.8	3.5	3.0	na
Lending rate <sup>2</sup>	16.2	13.5	10.8	9.8	8.8	7.7	na
	<i>(Korunas per US dollar)</i>						
Exchange rate (end-year)	36.9	42.1	48.6	48.2	41.1	33.6	na
Exchange rate (annual average)	35.2	41.4	46.2	48.4	45.3	36.8	na
<b>External sector</b>							
	<i>(In millions of US dollars)</i>						
Current account	-2,059	-1,083	-713	-1,756	-1,939	-280	-816
Trade balance	-2,293	-1,103	-917	-2,135	-2,131	-641	-1,219
Merchandise exports	10,667	10,197	11,870	12,632	14,365	21,838	26,205
Merchandise imports	12,959	11,301	12,786	14,766	16,497	22,479	27,425
Foreign direct investment, net	374	701	2,058	1,460	4,007	549	1,500
Gross reserves, excluding gold (end-year)	2,867	3,366	4,077	4,189	9,196	12,149	na
External debt stock	11,902	10,518	10,804	11,269	13,188	18,322	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	2.3	3.1	3.4	3.0	5.9	5.7	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service due	11.6	16.8	17.4	19.5	11.7	11.6	na
<b>Memorandum items</b>							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	5.4	5.4	5.4	5.4	5.4	5.4	na
GDP (in billions of korunas)	781	844	934	1,010	1,096	1,196	1,347
GDP per capita (in US dollar)	4,112	3,780	3,742	3,869	4,497	6,045	na
Share of industry in GDP (in per cent)	25.5	24.3	25.9	26.0	25.9	na	na
Share of agriculture in GDP (in per cent)	4.0	4.0	5.2	4.8	5.1	na	na
Current account/GDP (in per cent)	-9.3	-5.3	-3.5	-8.4	-8.0	-0.9	-2.0
External debt - reserves (in US\$ million)	9,035	7,152	6,727	7,080	3,993	6,173	na
External debt/GDP (in per cent)	53.7	51.5	53.4	54.0	54.5	56.3	na
External debt/exports of goods and services (in per cent)	91.8	86.3	76.5	74.5	76.9	72.9	na

<sup>1</sup> General government includes the state, municipalities and extra-budgetary funds.  
General government balance and debt calculated according to Eurostat methodology (ESA95) from 1999 inclusive.

<sup>2</sup> Weighted average over all maturities.



# Slovenia

## Key challenges

- Improvements in competition policy, regulation and the efficiency of the judiciary are needed for the economy to achieve greater integration and competitiveness in the enlarged EU.
- Delays in the full privatisation of large companies could hold back efficiency improvements in the financial sector and other key industries.
- Following swift accession to Exchange Rate Mechanism II, continued disinflation and increased flexibility in fiscal policy are necessary to preserve exchange rate stability.

### Country data

Population (in millions)	<b>2.0</b>
Area ('000 sq. km)	<b>20.51</b>
Official language	<b>Slovenian</b>
GDP per capita in 2002 at current international US\$ (PPP)	<b>US\$ 18,540</b>
National currency	<b>Tolar</b>

## Progress in structural reform

### Liberalisation and privatisation

Privatisation needs to be accelerated. Parliament adopted a new privatisation programme for 2004-05 in October 2003. However, this was later suspended by the government, which did not consider the political and market conditions to be right for its successful implementation. The privatisations of the Slovenian Steelworks and the aluminium producer Talum were suspended in August and December 2003. The government is in the process of merging Nova Kreditna Banka Maribor, the second largest bank, and Postna Banka Slovenije before the new entity is privatised. The legal structure of Triglav, the leading insurance company, still has to be changed before it can be sold. The privatisation of a further stake in the telecommunications operator Telekom Slovenije has also been delayed.

Fuel and energy prices were among a number of items that were added to the list of prices administered by the government in March 2004. The list already includes oil, gas and utility services. The measure, which is intended to be temporary, brought the share of regulated prices in the CPI basket to 18 per cent and is intended by the government to contribute to its disinflation strategy.

### Business environment and competition

In the spring of 2004 a comprehensive tax reform was approved by parliament. The number of personal income tax brackets was reduced and the tax rate for the lowest bracket cut. At the same time, the tax base was extended to encompass additional sources of income. The effective corporate income tax was increased following a reduction in allowances (except on

investment). The higher corporate income tax burden was partly offset by an increase in payroll tax exemptions for low wages. The wage-setting mechanism for the private sector was amended. Wage increases will now lag productivity gains by one percentage point. In addition, the dismantling of the Slovene Development Corporation (SRD) was completed in April 2004, in accordance with commitments made to the EU.

A World Bank study on the business environment shows that there is potential for further improvement. Starting and closing a business takes longer in Slovenia and is more expensive than the OECD average (a natural reference point). Also, hiring and firing workers remains more complex, and contracts still take much longer to be enforced. Despite new measures, the backlog in the courts was not significantly reduced, according to the European Commission's Comprehensive Monitoring Report of 2003. In May 2004 the government announced the introduction of the "All-in-one" programme for the licensing of new businesses.

Entry into the single European market in May 2004 underlines the importance of creating a more credible and transparent competition culture in a number of sectors. The Competition Protection Office (CPO) lacks the legal powers to issue fines for anti-competitive behaviour and is inadequately staffed in view of its long-term needs.

### Infrastructure

The liberalisation of the electricity and gas markets has proceeded gradually over recent years. Both markets were fully liberalised nominally in July 2004 for industrial customers, and the liberalisation of the residential market is planned for 2007. The electricity market has been open to foreign suppliers since January 2003, although with a cap on imports set at 25 per cent of total consumption. The gas market was also partially opened to supply from abroad and a grid code and commercial rules for the gas network were introduced in May 2003. Some price distortions, benefiting large energy-intensive state-owned industrial companies, remain but are being removed progressively.

In the telecommunications sector a new law on electronic communications was adopted in March 2004 in accordance with the EU's *acquis communautaire*. Despite progress in the liberalisation of the sector, competition remains limited, in particular for fixed-line services. Also, prices are not yet determined on the basis of costs.

### Social sector

The reform of the health care system was launched in mid-2003. It aims to eliminate a deficit that reached 0.3 per cent of GDP in 2003 and to stabilise total expenditure at around 9 per cent of GDP. The reform is to introduce some differentiation in the personal contributions to the voluntary health insurance scheme, with differing payment levels for 10 income groups. To contain spending, the payment system for hospitals was changed from a day-system (payment per number of treatment days) to a system of diagnosis-related groups (fixed payments for each type of treatment). General practitioners are now paid according to the number of registered patients (capitation system).

## Macroeconomic performance

### Real economy

Economic activity accelerated significantly during the first half of 2004. GDP growth reached 4.2 per cent year-on-year, compared with 2.3 per cent for 2003 as a whole. Total domestic expenditure remained the main growth engine, contributing 5.3 percentage points. Gross fixed capital formation increased by 7.3 per cent compared with the same period in 2003. A substantial increase in inventories explains most of the acceleration observed in the second quarter. Household expenditure grew by 3.5 per cent, while government consumption remained almost flat. The contribution of net exports to growth improved during the year, owing to the strong recovery of export growth. Exports increased by 11.5 per cent, while import growth reached 12.9 per cent.

### Economic policies

In 2003 fiscal policy remained tight. The budget deficit was kept at a low level of 2 per cent of GDP (ESA95 methodology), despite increasing pressure from EU and NATO accession. Disinflation progressed further in 2003 and the first half of 2004, with average inflation rates of 5.6 per cent and 3.7 per cent year-on-year respectively. The good performance was attributable to a negative output gap recorded in 2003 and the slower depreciation of the tolar. Price controls and wage de-indexation contributed less. Since January 2003 the Bank of Slovenia has cut its key interest rates by between 425 and 550 basis points. In June 2004 Slovenia joined the Exchange Rate Mechanism II with a central parity of SIT/€239.64.

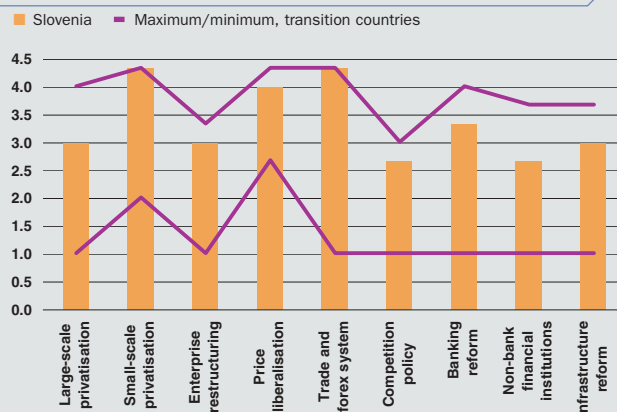
### External sector

In 2003 the current account was practically balanced, with a slight surplus of less than 0.1 per cent of GDP. The current account remained close to balance in the first quarter of 2004, with a small surplus of 0.7 per cent of GDP. In 2003 the absence of large privatisation deals and increasing investments abroad by Slovenian companies resulted in the first-ever net outflow of foreign direct investment (FDI) amounting to 0.5 per cent of GDP. This trend continued in the first quarter of 2004 with a net outflow of 0.4 per cent of GDP.

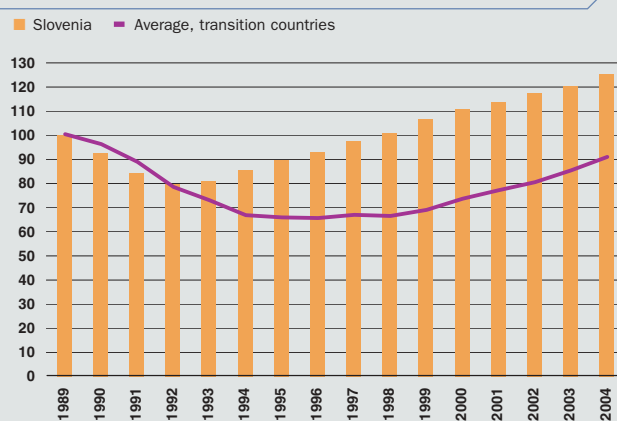
## Outlook and risks

Economic recovery in Slovenia has so far mainly depended on accelerating investment (inventories, in particular) and sustained household consumption. In the medium term, growth is expected to accelerate somewhat. Over the past year inflation expectations have been lowered through further wage de-indexation and the gradual phase out of the crawling peg to the euro. However, further disinflation is needed in ERM II. Given rapid growth, high oil prices and the stabilisation of the exchange rate under ERM II, this might require tighter monetary conditions. Containing public expenditure will also be important in limiting the structural deficit and inflationary pressure.

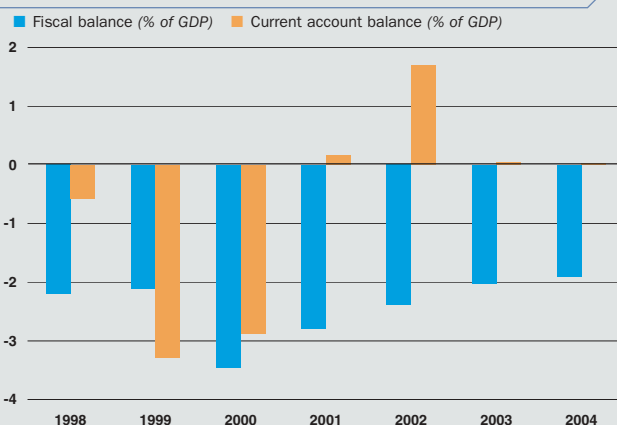
### Transition indicators, 2004



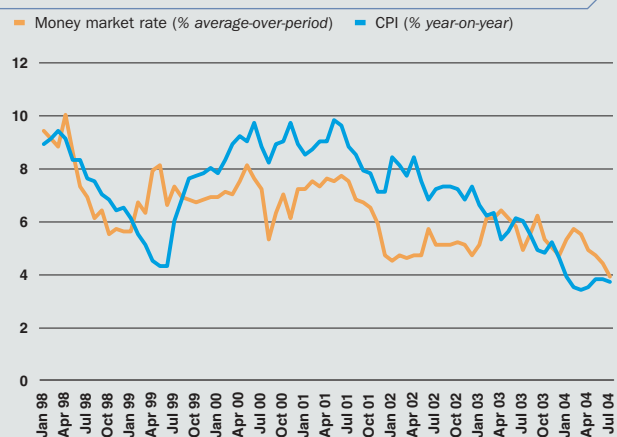
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



<b>Liberalisation</b>	<b>Privatisation</b>	<b>Infrastructure</b>	<b>Social sector</b>
Current account convertibility – full	Primary privatisation method – <b>MEBOs</b>	Independent telecoms regulator – <b>yes</b>	Share of population living in poverty –
Interest rate liberalisation – full	Secondary privatisation method –	Separation of railway accounts – <b>yes</b>	<b>&lt;2 per cent (1998)</b>
Wage regulation – <b>yes</b>	<b>vouchers</b>	Independent electricity regulator – <b>yes</b>	Private pension funds – <b>yes</b>
<b>Stabilisation</b>	Tradability of land – full except	<b>Financial sector</b>	
Share of general government tax	<b>no EU foreigners</b>	Capital adequacy ratio – <b>8 per cent</b>	
revenue in GDP – <b>40.9 per cent</b>	<b>Enterprise and markets</b>	Deposit insurance system – <b>yes</b>	
Exchange rate regime – <b>managed</b>	Competition office – <b>yes</b>	Secured transactions law – <b>restricted</b>	
<b>float, ERM II membership since</b>		Securities commission – <b>yes</b>	
<b>July 2004</b>			

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	17.0	14.3	13.7	13.2	14.0	15.4	16.1
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	1.0	1.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	74.1	75.5	73.1	76.7	77.6	77.7	na
Share of trade in GDP (in per cent)	91.0	86.7	98.2	98.5	95.8	95.8	na
Tariff revenues (in per cent of imports)	2.9	2.5	1.7	1.2	1.2	1.2	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	2.0	2.2	2.3	2.4	4.6	4.7	na
Private sector share in GDP (in per cent)	60.0	60.0	65.0	65.0	65.0	65.0	65.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
<i>EBRD index of small-scale privatisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of large-scale privatisation</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	1.4	1.6	1.5	1.4	1.2	1.5	na
Share of industry in total employment (in per cent)	39.5	37.8	37.4	38.2	38.5	36.3	na
Change in labour productivity in industry (in per cent)	5.7	5.7	7.3	-1.3	0.8	8.8	na
Investment/GDP (in per cent)	24.7	27.3	26.7	23.9	23.6	24.8	na
<i>EBRD index of enterprise reform</i>	2.7	2.7	2.7	2.7	3.0	3.0	3.0
<i>EBRD index of competition policy</i>	2.3	2.3	2.7	2.7	2.7	2.7	2.7
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	36.3 (8.1)	37.3 (31.8)	38.6 (61.2)	40.2 (73.7)	40.5 (83.5)	40.7 (87.1)	na
Internet penetration rate (per 10,000 inhabitants)	114.5	118.0	109.5	148.2	179.3	214.8	na
Railway labour productivity (1989=100)	120.2	118.4	123.0	122.7	133.6	150.3	na
Residential electricity tariffs, USc kWh	9.7	10.0	8.9	8.6	9.2	na	na
Average collection rate, electricity (in per cent)	99	99	na	na	97	93	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.2	4.5	4.6	4.5	na	na	na
<i>EBRD index of infrastructure reform</i>	2.7	3.0	3.0	3.0	3.0	3.0	3.0
<i>Electric power</i>	2.3	3.0	3.0	3.0	3.0	3.0	3.0
<i>Railways</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>Roads</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>Telecommunications</i>	2.3	2.3	2.3	3.0	3.0	3.0	3.0
<i>Water and waste water</i>	3.3	3.7	3.7	4.0	4.0	4.0	4.0
<b>Financial sector</b>							
Number of banks (foreign-owned) <sup>1</sup>	30 (3)	31 (5)	28 (6)	24 (5)	22 (6)	22 (6)	na
Asset share of state-owned banks (in per cent)	41.3	42.2	42.5	48.9	13.3	12.8	na
Non-performing loans (in per cent of total loans) <sup>2</sup>	9.5	9.3	9.3	10.0	10.0	9.4	na
Domestic credit to private sector (in per cent of GDP)	30.6	35.8	38.5	40.2	40.3	43.3	na
Stock market capitalisation (in per cent of GDP)	11.4	11.1	13.6	14.6	19.0	17.1	na
<i>EBRD index of banking sector reform</i>	3.0	3.3	3.3	3.3	3.3	3.3	3.3
<i>EBRD index of reform of non-bank financial institutions</i>	2.7	2.7	2.7	2.7	2.7	2.7	2.7
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	74.8	74.9	75.3	75.6	75.9	na	na
Basic school enrolment ratio (in per cent)	98.7	99.5	100.1	101.1	na	na	na

<sup>1</sup> The first foreign branch in Slovenia, established in 1999, is included in this figure.

<sup>2</sup> Changes in non-performing loans data compared with previous *Transition Reports* are due to the change of loan categories included in non-performing loans (see methodological notes).

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>							
	<i>(Percentage change in real terms)</i>						
GDP	3.6	5.6	3.9	2.7	3.4	2.3	4.1
Private consumption	3.0	5.9	0.4	2.3	0.4	2.9	na
Public consumption	5.4	2.9	2.3	3.9	2.5	1.9	na
Gross fixed capital formation	9.9	21.0	0.6	4.1	2.6	5.4	na
Exports of goods and services	7.4	1.6	13.0	6.3	6.8	3.1	na
Imports of goods and services	10.3	8.0	7.6	3.0	4.8	6.4	na
Industrial gross output	4.0	-0.5	6.3	3.1	2.5	1.4	na
Agricultural gross output <sup>1</sup>	3.1	-2.1	-1.0	-2.5	1.1	-6.2	na
<b>Employment<sup>2</sup></b>							
	<i>(Percentage change)</i>						
Labour force (mid-year)	1.8	-2.0	0.0	0.9	0.9	-0.3	na
Employment (mid-year)	1.0	-1.7	0.2	2.2	0.9	-1.1	na
	<i>(In per cent of labour force)</i>						
Unemployment (mid-year)	7.6	7.4	7.2	5.9	5.9	6.7	na
<b>Prices and wages</b>							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	7.9	6.1	8.9	8.4	7.5	5.6	3.7
Consumer prices (end-year)	6.5	8.0	8.9	7.0	7.2	4.7	3.6
Producer prices (annual average)	6.0	2.1	7.6	9.0	5.1	2.5	na
Producer prices (end-year)	3.6	3.5	9.2	7.5	3.7	2.1	na
Gross average monthly earnings in economy (annual average)	9.6	9.6	10.6	11.9	9.7	7.5	na
<b>Government sector<sup>3</sup></b>							
	<i>(In per cent of GDP)</i>						
General government balance	-2.2	-2.1	-3.4	-2.8	-2.4	-2.0	-1.9
General government expenditure	41.7	41.9	48.2	47.9	48.1	48.2	na
General government debt	22.2	23.4	27.4	28.1	29.5	29.3	na
<b>Monetary sector</b>							
	<i>(Percentage change)</i>						
Broad money (M2, end-year)	24.5	11.8	9.7	27.4	25.1	5.2	na
Domestic credit (end-year)	22.4	19.3	16.7	16.9	13.9	14.7	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	38.1	38.1	38.0	43.3	48.5	47.3	na
<b>Interest and exchange rates</b>							
	<i>(In per cent per annum, end-year)</i>						
Discount rate	10.0	8.0	10.0	11.0	10.0	7.3	na
Interbank market rate (average)	5.6	6.9	7.2	4.7	4.7	4.7	na
Deposit rate (31-90 days)	7.0	9.6	10.9	8.5	7.6	4.8	na
Lending rate (short-term working capital)	12.3	15.2	16.3	13.7	11.8	9.9	na
	<i>(Tolars per US dollar)</i>						
Exchange rate (end-year)	161.2	196.8	235.6	250.9	226.2	193.0	na
Exchange rate (annual average)	166.1	181.8	222.7	243.0	240.2	207.1	na
<b>External sector</b>							
	<i>(In millions of US dollars)</i>						
Current account	-118	-698	-548	31	375	10	5
Trade balance	-792	-1,235	-1,139	-620	-243	-627	-715
Merchandise exports	9,091	8,623	8,808	9,343	10,473	12,929	14,739
Merchandise imports	9,883	9,858	9,947	9,962	10,716	13,556	15,454
Foreign direct investment, net	221	59	71	371	1,748	-118	-32
Gross reserves, excluding gold (end-year)	3,639	3,168	3,196	4,330	6,980	8,352	na
External debt stock	7,245	8,532	8,736	9,310	10,813	14,664	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	3.8	3.3	3.4	4.5	6.7	6.4	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service <sup>4</sup>	13.5	8.0	9.5	14.6	14.3	12.7	na
<b>Memorandum items</b>							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in billions of tolar)	3,465	3,875	4,252	4,762	5,314	5,726	6,182
GDP per capita (in US dollar)	10,542	10,724	9,595	9,905	11,088	13,894	na
Share of industry in GDP (in per cent)	28.1	27.3	27.7	27.4	27.7	27.6	na
Share of agriculture in GDP (in per cent)	3.6	3.2	2.9	2.7	2.8	2.6	na
Current account/GDP (in per cent)	-0.6	-3.3	-2.9	0.2	1.7	0.0	0.0
External debt - reserves (in US\$ million)	3,932	4,932	5,320	4,953	4,711	7,614	na
External debt/GDP (in per cent)	34.7	40.0	45.7	47.5	48.9	53.0	na
External debt/exports of goods and services (in per cent)	68.1	77.2	79.6	82.1	91.6	101.6	na

<sup>1</sup> Agricultural value-added.<sup>2</sup> Based on labour force survey. These figures have been consistently lower than those calculated as officially registered unemployed.<sup>3</sup> General government includes the state, municipalities, social security and extra-budgetary funds. Figures are calculated according to the Eurostat methodology (ESA95) except for 1998-99, where revenue and expenditure are calculated according to the methodology of the Ministry of Finance. Using this methodology, privatisation revenues from state and socially owned enterprises are placed below the line.<sup>4</sup> Long-term debt only.

# Tajikistan

## Key challenges

- Further progress in poverty alleviation is crucial and will require more private investment and the removal of regional trade barriers.
- The timely implementation of the privatisation programme is important to advance enterprise restructuring, increase productivity and promote investment.
- While significant progress towards reducing the external debt has been made, the government needs to strengthen tax collection and prioritise public investments to maintain long-term debt sustainability.

## Infrastructure

The government is finalising its energy sector strategy. Under the restructuring plan, the vertically integrated power provider BarkiTajik is likely to be unbundled, with the creation of individual power generation and distribution companies and the sale of more than 500 subsidiary companies. The restructuring of 37 larger subsidiaries is also envisaged.

Both Russia and Iran have expressed their willingness to invest in the generation sector. They are likely to take equity stakes in the Sangtuda hydro power station, which requires an additional US\$ 400 million for completion. Russia's RAO UES also expressed interest in Rogun, another unfinished large-scale hydro power station.

In addition, the Pamir Energy project, a 25-year concession for the supply and distribution of energy in the Gorno-Badakhshan Oblast (in the eastern part of Tajikistan), was signed in 2003. The project is sponsored by the Aga Khan Fund for Economic Development, with the participation of the International Finance Corporation and the World Bank.

## Financial sector

The banking sector has been strengthened following further consolidation and the completion of restructuring programmes in the largest banks. During 2004 the National Bank of Tajikistan (NBT) revoked four banking licences, leaving 11 domestic banks and one foreign affiliate bank in operation. All banks meet the current minimum capital requirement of US\$ 1.5 million and should be able to accommodate the rise to US\$ 2 million planned for the end of 2004.

The restructuring of Agroinvest Bank, the largest commercial bank, was completed in the first quarter of 2004. It has been separated into two entities – a credit union specialising in cotton financing, and a commercial bank dealing with non-cotton financing. A deposit insurance scheme was approved in late 2003 and should be operational in 2005. This should boost public confidence in the banking sector.

## Social sector

Two years after the approval of the Poverty Reduction Strategy Paper (PRSP), the government published its progress report in June 2004. According to the report, the number of people living in poverty (defined as an income of less than US\$ 2.15 per day in PPP terms) declined from 83 per cent of the population in 1999 to 68 per cent in 2003. Other indicators, such as basic education coverage, access to health services and infant mortality, have also improved. However, there are large variations across regions. Although poverty levels have fallen significantly in the major cities, those in rural areas have barely changed.

## Country data

Population (in millions)	6.5
Area ('000 sq. km)	143.1
Official language	Tajik
GDP per capita in 2002 at current international US\$ (PPP)	US\$ 980
National currency	Somoni

## Progress in structural reform

### Liberalisation and privatisation

A new privatisation strategy for 2003-07 was approved in November 2003. All state-owned enterprises, with a few exceptions, will either be privatised, restructured (if direct privatisation is not feasible) or liquidated. Three groups of enterprises are distinguished.

The companies in the first group (422 small enterprises) will be privatised through auctions. Those in the second group (104 medium-sized enterprises) will be sold through competitive tender. The third group of 37 large and strategic enterprises will be dealt with individually, with specific privatisation and restructuring programmes to be developed for each. This group includes the aluminium smelter Tadaz, the electric power monopoly BarkiTajik, TajikTelecom, Tajikistan State Air Company, TajikRail and the state television companies.

A total of 71 enterprises have already been privatised during the first half of 2004. However, many were only sold after several auctions and for below the original minimum prices. Few foreign investors were involved in the process and 90 per cent of the assets went to domestic investors.

Progress in farm privatisation has been hindered by the debt of state-owned farms. According to the government, state farms have accumulated US\$ 255 million in debt, of which 66 per cent is owed to private foreign creditors. The private debt burden alone is equivalent to 130 per cent of cotton exports. The government agreed to write off US\$ 80 million in state debt in January 2004, but the issue of the private debt is unresolved. One option under consideration is to swap the existing external debt for temporary cotton marketing rights.



## Macroeconomic performance

### Real economy

The Tajik economy has enjoyed four years of rapid expansion, with an average growth rate of 9.5 per cent per annum between 1999 and 2003. The trend continued in the first half of 2004, when GDP grew by 11.1 per cent year-on-year. Although growth in the important aluminium and cotton sectors decelerated, other sectors such as mining, chemicals, non-cotton agriculture and services expanded at an increasing pace. Growth is driven by strong domestic demand. Private consumption is being fuelled by higher incomes and increased foreign remittances. Public consumption is being stimulated by donor-funded programmes.

### Economic policies

Consumer prices rose by 13.7 per cent in 2003. Inflationary pressure was due to a sharp increase in food prices and the National Bank's unsterilised purchase of foreign exchange from Tadaz. However, inflation slowed during the first half of 2004 to 6.2 per cent. The unsterilised purchase of foreign exchange was stopped in June 2004. Also, monetary policy (conducted by the Monetary Policy Committee) has become more focused on liquidity management and price stability.

The fiscal performance remains strong. There was an overall fiscal surplus of 0.9 per cent of GDP in 2003 and 1.0 per cent during the first half of 2004 (excluding public investment programmes). The good result is due to increased tax collection, strong economic growth and tight expenditure management. Further improvements in tax and customs administration should help the authorities to maintain fiscal responsibility.

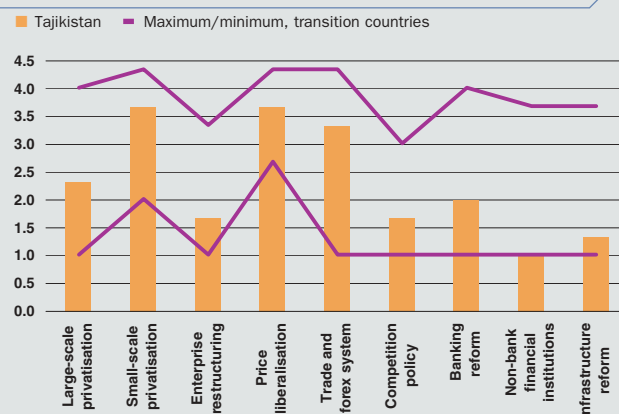
### External sector

The external debt position has improved significantly. The total external debt in absolute terms increased slightly to approximately US\$ 1 billion by the end of 2003. Meanwhile, the ratio of debt to GDP fell from 72 per cent in 2002 to 65 per cent in 2003, due to the high economic growth. In June 2004 Russia, the largest bilateral creditor, agreed in principle to write off debt of US\$ 300 million in exchange for the ownership rights over a hydro power station and military facilities. The external debt burden will be reduced below 40 per cent of GDP once the swap arrangement is formally signed.

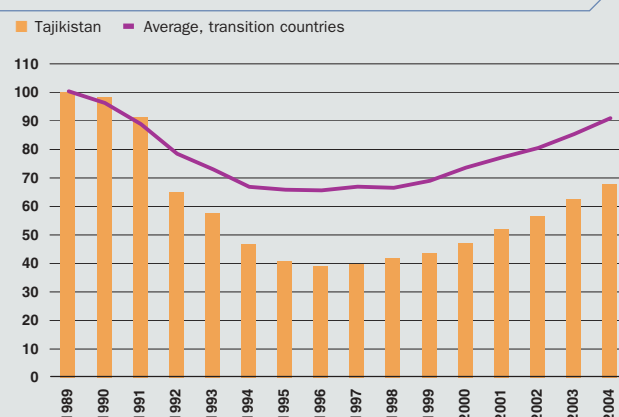
## Outlook and risks

Economic growth is expected to level off at around 6 per cent over the medium term. Domestic demand is set to increase further. However, the traditional sources of growth on the production side – aluminium and cotton – may face capacity constraints and could be affected by financial problems in key enterprises. Investment commitments by Iran and Russia and improved economic relationships with China and South Asia provide opportunities for closer trade and business links with these countries. Unless the trade restrictions imposed by neighbouring Central Asian countries are reduced, however, it will be hard to increase exports significantly, particularly through the northern corridors.

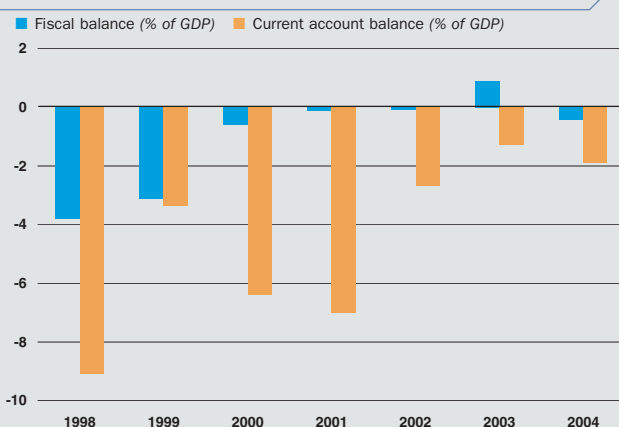
### Transition indicators, 2004



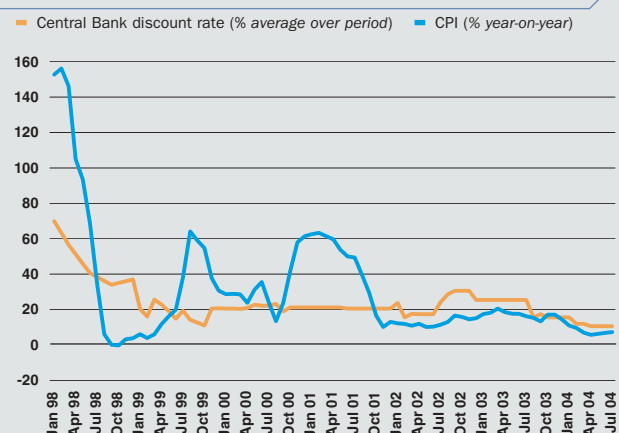
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator –	Share of population living in poverty –
Interest rate liberalisation – full	direct sales	yes, limited	50.8 per cent (1998)
Wage regulation – yes	Secondary privatisation method –	Separation of railway accounts – no	Private pension funds – no
	MEBOs	Independent electricity regulator – no	
Stabilisation	Enterprise and markets	Financial sector	
Share of general government tax revenue in GDP – 17.2 per cent	Tradability of land – limited de facto	Capital adequacy ratio – 12 per cent	
Exchange rate regime – managed floating	Competition office – yes	Deposit insurance system – no	
		Secured transactions law – yes	
		Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	47.9	36.2	33.4	38.3	32.7	46.3	na
Share of trade in GDP (in per cent)	99.4	125.1	164.7	135.2	126.6	116.0	na
Tariff revenues (in per cent of imports)	2.2	2.1	1.8	2.8	2.6	2.4	na
EBRD index of price liberalisation	3.7	3.7	3.7	3.7	3.7	3.7	3.7
EBRD index of forex and trade liberalisation	2.7	2.7	3.3	3.3	3.3	3.3	3.3
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	2.8	3.6	4.6	4.9	5.8	6.1	na
Private sector share in GDP (in per cent)	30.0	40.0	40.0	45.0	50.0	50.0	50.0
Private sector share in employment (in per cent)	57.0	63.0	60.0	62.8	65.3	na	na
EBRD index of small-scale privatisation	3.0	3.0	3.3	3.7	3.7	3.7	3.7
EBRD index of large-scale privatisation	2.0	2.3	2.3	2.3	2.3	2.3	2.3
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	0.6	0.8	0.7	0.5	0.5	0.8	na
Share of industry in total employment (in per cent)	8.2	7.7	6.9	7.2	6.4	5.7	na
Change in labour productivity in industry (in per cent)	19.8	16.8	21.2	5.7	15.5	18.2	na
Investment/GDP (in per cent)	15.4	19.1	21.7	15.8	15.5	na	na
EBRD index of enterprise reform	1.7	1.7	1.7	1.7	1.7	1.7	1.7
EBRD index of competition policy	2.0	2.0	2.0	1.7	1.7	1.7	1.7
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	3.7 (0.0)	3.5 (0.0)	3.6 (0.0)	3.7 (0.0)	3.7 (0.2)	3.7 (0.7)	na
Internet penetration rate (per 10,000 inhabitants)	0.1	0.4	0.4	0.5	0.5	0.1	na
Railway labour productivity (1989=100)	75.5	62.9	62.9	57.2	50.3	47.3	na
Residential electricity tariffs, USc kWh	0.1	0.4	0.4	0.5	0.5	0.7	na
Average collection rate, electricity (in per cent)	na	na	na	na	65	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.3	1.3	1.6	1.7	na	na	na
EBRD index of infrastructure reform	1.0	1.0	1.0	1.0	1.0	1.0	1.3
Electric power	1.0	1.0	1.0	1.0	1.0	1.0	1.7
Railways	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Roads	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Telecommunications	1.0	1.0	1.0	2.3	2.3	2.3	2.3
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	20 (5)	20 (3)	17 (4)	17 (3)	17 (2)	11 (1)	na
Asset share of state-owned banks (in per cent)	29.2	6.9	6.8	4.8	4.5	6.1	na
Non-performing loans (in per cent of total loans)	3.2	15.8	10.8	12.5	84.2	73.6	na
Domestic credit to private sector (in per cent of GDP)	na	4.6	11.3	13.6	11.5	10.5	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	1.7	1.7	2.0
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	3.3	3.1	2.9	3.5	3.5	3.5	na
Life expectancy at birth, total (years)	na	na	67.3	66.9	66.6	na	na
Basic school enrolment ratio (in per cent)	89.7	89.1	88.5	91.1	94.4	na	na

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>	(Percentage change in real terms)						
GDP	5.3	3.7	8.3	10.2	9.1	10.2	8.5
Industrial gross output	8.1	5.0	10.3	14.4	8.2	10.2	na
Agricultural gross output	6.3	3.8	12.4	11.0	15.0	9.6	na
<b>Employment</b>	(Percentage change)						
Labour force (end-year)	0.8	-3.5	0.2	4.3	5.0	4.8	na
Employment (end-year)	0.3	-3.3	0.5	4.8	5.0	4.8	na
	(In per cent of labour force)						
Unemployment (end-year) <sup>1</sup>	3.2	3.0	2.7	2.3	2.4	2.0	na
<b>Prices and wages</b>	(Percentage change)						
Consumer prices (annual average)	43.2	27.6	32.9	38.6	12.2	16.3	6.3
Consumer prices (end-year)	2.7	30.1	60.8	12.5	14.5	13.7	5.0
Producer prices (annual average)	27.8	41.2	43.5	28.7	10.1	15.4	na
Producer prices (end-year)	5.9	64.0	33.9	9.4	19.0	14.5	na
Gross average monthly earnings in economy (annual average)	84.8	35.2	30.6	50.7	33.8	44.0	na
<b>Government sector<sup>2</sup></b>	(In per cent of GDP)						
General government balance	-3.8	-3.1	-0.6	-0.1	-0.1	0.9	-0.4
General government expenditure	13.9	14.9	15.2	16.3	16.8	16.3	na
General government debt	62.2	79.8	90.9	85.9	72.1	64.8	na
<b>Monetary sector</b>	(Percentage change)						
Broad money (M2, end-year)	34.1	24.5	63.3	35.0	37.5	48.5	na
Domestic credit (end-year)	179.7	23.4	14.5	94.9	14.0	-6.4	na
	(In per cent of GDP)						
Broad money (M2, end-year)	7.1	6.7	8.2	7.9	8.2	8.6	na
<b>Interest and exchange rates</b>	(In per cent per annum, end-year)						
Monetary policy rate	36.4	20.1	20.6	23.4	21.0	15.0	na
Deposit rate (up to 3 months)	15.7	11.4	41.3	25.5	12.1	14.6	na
Lending rate (up to 3 months)	49.7	30.6	18.3	21.3	12.1	15.6	na
	(Tajik somoni per US dollar)						
Exchange rate (end-year) <sup>3</sup>	1.0	1.4	2.2	2.6	3.0	3.0	na
Exchange rate (annual average) <sup>3</sup>	0.8	1.2	1.8	2.4	2.8	3.1	na
<b>External sector</b>	(In millions of US dollars)						
Current account	-120	-36	-63	-74	-32	-20	-37
Trade balance	-139	-27	-46	-121	-124	-205	-226
Merchandise exports	586	666	788	652	699	799	869
Merchandise imports	725	693	834	773	823	1,004	1,095
Foreign direct investment, net	25	21	24	9	36	32	20
Gross reserves, excluding gold (end-year)	65	58	87	96	96	123	na
External debt stock	1,179	1,233	1,226	1,024	982	1,007	na
	(In months of imports of goods and services)						
Gross reserves, excluding gold (end-year)	1.0	0.9	1.2	1.4	1.2	1.3	na
	(In per cent of exports of goods and services)						
Debt service	8.7	6.6	9.2	16.6	14.7	12.7	na
<b>Memorandum items</b>	(Denominations as indicated)						
Population (end-year, million)	6.1	6.2	6.2	6.3	6.4	6.5	na
GDP (in millions of somoni)	1,025	1,345	1,807	2,512	3,345	4,758	5,750
GDP per capita (in US dollar)	216	174	160	168	187	239	na
Share of industry in GDP (in per cent) <sup>4</sup>	18.1	21.3	22.6	22.9	23.2	23.8	na
Share of agriculture in GDP (in per cent) <sup>4</sup>	19.8	18.7	19.4	20.5	21.5	21.0	na
Current account/GDP (in per cent)	-9.1	-3.4	-6.4	-7.0	-2.7	-1.3	-1.9
External debt - reserves (in US\$ million)	1,114	1,175	1,139	928	886	884	na
External debt/GDP (in per cent)	89.4	113.5	124.5	97.2	81.7	64.8	na
External debt/exports of goods and services (in per cent)	183.0	170.4	143.4	142.8	127.7	115.1	na

<sup>1</sup> Officially registered unemployed. The World Bank estimates the true unemployment rate in 2000 was more than 30 per cent of the labour force.

<sup>2</sup> Excludes transfers from the state budget to the pension fund and employment funds, and externally financed public investment programmes.

<sup>3</sup> Tajik roubles (until October 2000) are converted to somoni.

<sup>4</sup> Figures are based on current prices. Variations in the shares reflect changes in relative prices.

# Turkmenistan

## Key challenges

Continued state-directed investment and state-controlled prices, as well as the dual exchange rate regime, are preventing efficient resource allocation and stunting private sector activity.

The management of energy revenues must become more transparent and accountable to increase the benefits from increased hydrocarbon exports to the population.

Despite strong output performance, the heavily energy export-oriented economy is vulnerable to interruptions in pipeline access and external shocks.

## Business environment and competition

The low level of foreign direct investment (FDI) underlines the poor business environment in the country. According to an official report on capital investment, the proportion of foreign investment in total investment in 2003 was just 5 per cent.

Although the attraction of more FDI to the energy sector is an official target, the government has an ambivalent attitude towards foreign investors. The dual exchange rate system, lack of an established rule of law, complex and arbitrary regulatory framework, and unfamiliarity with international business practices further deter investment. Private enterprises also have only limited access to bank loans under the tightly government-controlled banking system.

## Infrastructure

To fulfil its export commitments, Turkmenistan needs to secure reliable access to gas pipelines with a capacity of around 100 billion cubic metres (bcm) per year by 2007. To achieve this goal, the Central Asia Centre (CAC) pipeline – the main export route available – is being upgraded and its capacity expanded from 40-50 bcm to 80-90 bcm. The authorities are also seeking to build a new 30 bcm pipeline to southern Russia.

The project is facing difficulties, however, because of competing interests with Kazakhstan and Uzbekistan, through which the pipeline will pass. The two countries plan to export their own gas through these routes, and are only willing to offer Turkmenistan the leftover capacity. All three countries will face tough negotiations with Russia's Gazprom, which enjoys considerable market power, to secure their supply. An alternative route would be through the 30 bcm Trans-Afghan Pipeline (TAP), but the political and economic viability of this project remains in question.

The government has decided to introduce a new state-run mobile telephone operator. This follows the expiry of the exclusivity period granted to the incumbent operator, US-based Barash Communications Technologies, in April 2004. Meanwhile, the Turkmenbashi Port is being rehabilitated to diversify and improve the country's access to world markets.

## Social sector

The level of education continues to deteriorate. The period of compulsory public education has been reduced from 10 to 9 years. The study of the *Ruhnama*, President Niyazov's moral code, has become a central part of the curriculum. There are only 3,000-4,000 university places each year. Higher education consists of two years of classroom study and two years of internship training. A presidential decree issued in June 2004 invalidates all higher education degrees received abroad, and prevents holders of such degrees from seeking or keeping state jobs. The deteriorating quality of education is restricting the development of a workforce capable of supporting advanced industrial projects. It also contributes to the high level of youth unemployment.

## Country data

Population (in millions)	6.0
Area ('000 sq. km)	488
Official language	Turkmen
GDP per capita in 2002 at current international US\$ (PPP)	US\$ 4,250
National currency	Manat

## Progress in structural reform

### Liberalisation and privatisation

The government's preference for state-led economic development was reconfirmed when it adopted a new long-term national programme in August 2003. This Soviet-style strategy features pervasive controls over prices and resources, and includes specific (and not always realistic) production targets for all sectors. There are no plans to liberalise the exchange rate and extensive restrictions on foreign trade, including non-tariff barriers, persist.

The prices of basic services, such as housing, transport and telecommunications, are to remain at the present low levels. The continuing free provision of gas, electricity and water, together with low tariffs for petrol and diesel, are major costs for the budget and also encourage overuse. On a per capita basis, domestic gas consumption in Turkmenistan is estimated to be the same as in the United States and more than in western Europe.

Privatisation remains confined to small retail and service businesses. Strategic enterprises in the energy, transport and telecommunications sectors are formally excluded from privatisation. Although the need for exit visas was lifted in January 2004, there are still many practical restrictions on travel. The government has promised to transfer land ownership to farmers within 5 to 10 years, but the implementation of this policy remains uncertain.

## Macroeconomic performance

### Real economy

According to official statistics the economy grew by 23.1 per cent in 2003, fuelled primarily by energy sector growth. However, estimates of the performance in key sub-sectors do not support the official figures. Gas and oil production rose by 11 per cent, while the electricity sector grew by only 2 per cent. The cotton harvest was estimated to be around 0.7 million tonnes, far below the official 2 million tonne target. The IMF puts output growth in 2003 at 7.7 per cent. Official figures for the first half of 2004 again indicate growth of more than 20 per cent, but this may be exaggerated.

### Economic policies

Average inflation has been moderate at 6.5 per cent in 2003. This is due to continued subsidising of basic goods and services and the administrative control over the financial system. Both the official and the parallel market exchange rates are stable. The market rate is more than four times higher than the official rate.

Opaque fiscal management remains a serious problem. The IMF estimates that extra-budgetary operations carried out through state funds and self-financing ministries are four times bigger than the activities recorded in the state budget. The tax collection system has practically collapsed because of widespread tax exemptions for public enterprises. As a consequence, public payment arrears are mounting and the state system is increasingly starved of cash.

To cut public expenditure, the government has announced plans to lay off 15,000 medical workers and abolish most forms of free medical service. Civil unrest was reportedly triggered in April 2004 due to several months' worth of wage arrears to budget-paid employees.

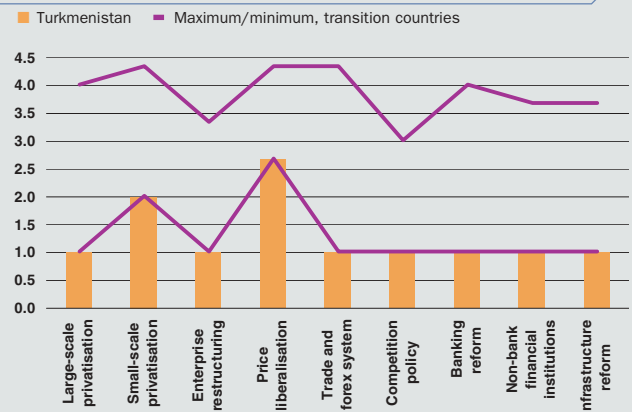
### External sector

The external balance has been boosted by an increase in hydrocarbon exports, combined with ongoing policies to restrain imports. The current account surplus in 2003 was 11.6 per cent of GDP, despite massive prestige construction and industrial projects. Foreign reserves reached the equivalent of 10 months of imports by the end of 2003, and the outstanding external debt fell to US\$ 1.5 billion (or 35 per cent of GDP). Turkmenistan is in ongoing talks with other CIS countries on the restructuring of their overdue energy payments. If successful, this will further strengthen its comfortable external position.

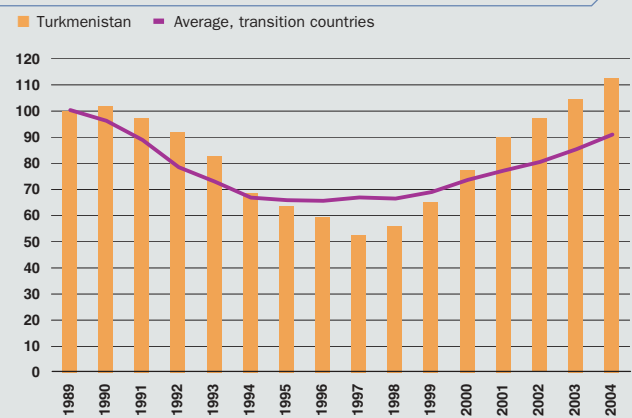
## Outlook and risks

The economic outlook continues to depend heavily on developments in the gas export market. The existing gas export agreements may allow stable growth of 5-7 per cent over the medium term. However, the unbalanced and largely unstructured economy is vulnerable to external fluctuations and pipeline constraints. To fulfil its gas sale commitments, Turkmenistan needs continued pipeline access, and hence the cooperation of its neighbours and Gazprom. Substantial financial resources to expand production capacity are also critical, but their availability is uncertain in the prevailing business environment.

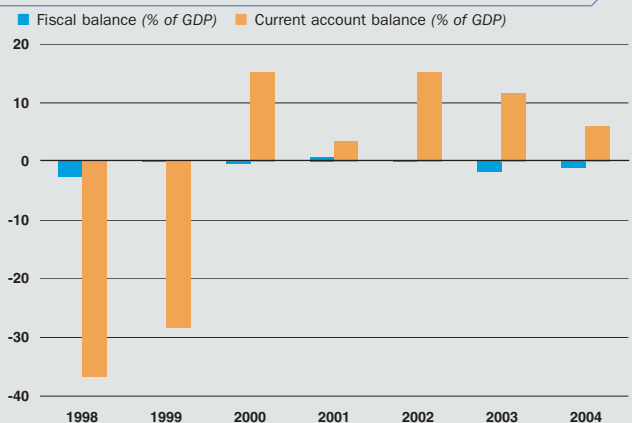
### Transition indicators, 2004



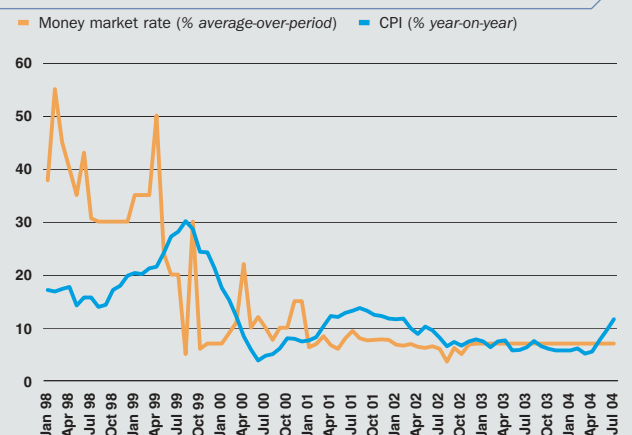
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation





<b>Liberalisation</b>	<b>Privatisation</b>	<b>Infrastructure</b>	<b>Social sector</b>
Current account convertibility – <b>limited</b>	Primary privatisation method – <b>MEBOs</b>	Independent telecoms regulator – <b>no</b>	Share of population living in poverty – <b>44 per cent (1998)</b>
Interest rate liberalisation – <b>limited de jure</b>	Secondary privatisation method – <b>direct sales</b>	Separation of railway accounts – <b>no</b>	Private pension funds – <b>no</b>
Wage regulation – <b>yes</b>	Tradability of land – <b>limited de jure</b>	Independent electricity regulator – <b>no</b>	
<b>Stabilisation</b>	<b>Enterprise and markets</b>	<b>Financial sector</b>	
Share of general government tax revenue in GDP – <b>24.5 per cent</b>	Competition office – <b>no</b>	Capital adequacy ratio – <b>10 per cent<sup>1</sup></b>	
Exchange rate regime – <b>fixed</b>		Deposit insurance system – <b>no</b>	
		Secured transactions law – <b>restricted</b>	
		Securities commission – <b>no</b>	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	6.8	6.8	6.8	6.8	6.8	6.7	6.7
Number of goods with administered prices in EBRD-15 basket	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Share of trade with non-transition countries (in per cent)	72.6	61.0	51.3	59.5	56.8	54.3	na
Share of trade in GDP (in per cent)	68.8	126.1	157.4	138.3	122.8	136.8	na
Tariff revenues (in per cent of imports) <sup>2</sup>	0.3	0.5	na	na	na	na	na
EBRD index of price liberalisation	2.7	2.7	2.7	2.7	2.7	2.7	2.7
EBRD index of forex and trade liberalisation	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	0.2	0.3	0.6	0.6	0.6	0.6	na
Private sector share in GDP (in per cent)	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of large-scale privatisation	1.7	1.7	1.7	1.0	1.0	1.0	1.0
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	1.6	na	na	na	na	na	na
Share of industry in total employment (in per cent)	12.5	12.6	na	na	na	na	na
Change in labour productivity in industry (in per cent)	11.4	11.0	33.0	na	na	na	na
Investment/GDP (in per cent)	46.5	40.7	36.4	33.5	28.2	27.3	na
EBRD index of enterprise reform	1.7	1.7	1.0	1.0	1.0	1.0	1.0
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	8.2 (0.1)	8.2 (0.1)	8.2 (0.2)	8.0 (0.2)	7.7 (0.2)	7.7 (0.2)	na
Internet penetration rate (per 10,000 inhabitants)	0.5	0.9	2.3	3.4	4.2	1.1	na
Railway labour productivity (1989=100)	27.8	26.9	27.3	26.9	32.7	34.3	na
Residential electricity tariffs, USc kWh <sup>3</sup>	0.8	0.5	0.5	0.5	0.5	na	na
Average collection rate, electricity (in per cent)	na	na	30	na	63	85	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.1	1.0	1.2	1.3	na	na	na
EBRD index of infrastructure reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Electric power	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Railways	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Roads	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Telecommunications	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Financial sector</b>							
Number of banks (foreign-owned)	13 (4)	13 (4)	13 (4)	13 (4)	13 (4)	na	na
Asset share of state-owned banks (in per cent)	77.8	96.9	97.1	96.5	95.7	na	na
Non-performing loans (in per cent of total loans)	2.2	0.5	0.2	0.3	0.3	na	na
Domestic credit to private sector (in per cent of GDP) <sup>4</sup>	2.0	1.7	2.4	2.1	2.2	na	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	9.8	8.1	11.1	9.1	8.5	11.3	na
Life expectancy at birth, total (years)	na	na	65.1	64.8	64.6	na	na
Basic school enrolment ratio (in per cent)	80.5	79.5	80.2	80.4	80.8	na	na

<sup>1</sup> Calculated with a risk weight of zero for all loans to state-owned enterprises. These are assumed to be implicitly guaranteed by the state.

<sup>2</sup> Refers to differential excise taxes on imports; Turkmenistan does not levy import tariffs.

<sup>3</sup> Refers to average retail tariff.

<sup>4</sup> Manat credit to state-owned and private firms.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>							
	<i>(Percentage change in real terms)</i>						
GDP	6.7	16.5	18.6	15.9	8.1	7.7	7.5
Private consumption	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na
Exports of goods and services	-18.6	61.7	101.6	na	na	na	na
Imports of goods and services	9.9	10.9	14.9	20.1	na	na	na
Industrial gross output	25.8	13.0	29.0	13.6	5.1	7.6	na
Agricultural gross output	8.7	35.0	17.0	8.0	-6.6	11.8	na
<b>Employment</b>							
	<i>(Percentage change)</i>						
Labour force (end-year)	5.5	-1.6	3.1	5.0	2.6	3.7	na
Employment (end-year)	1.3	0.7	na	na	na	na	na
	<i>(In per cent of labour force)</i>						
Unemployment	na	na	na	na	na	na	na
<b>Prices and wages</b>							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	16.8	24.2	8.3	11.6	10.6	6.5	8.8
Consumer prices (end-year)	19.8	21.2	7.4	11.7	7.8	5.7	10.0
Producer prices (annual average)	na	na	na	na	na	na	na
Producer prices (end-year)	10.3	na	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	46.1	22.1	80.4	47.1	8.2	84.2	na
<b>Government sector<sup>1</sup></b>							
	<i>(In per cent of GDP)</i>						
General government balance	-2.6	0.0	-0.4	0.7	0.2	-1.8	-1.0
General government expenditure	24.6	22.7	26.7	22.6	21.1	26.3	na
General government debt	na	na	na	na	na	na	na
<b>Monetary sector</b>							
	<i>(Percentage change)</i>						
Broad money (M3, end-year)	na	na	na	na	na	na	na
Domestic credit (end-year)	74.6	26.9	24.4	7.7	-2.9	-0.6	na
	<i>(In per cent of GDP)</i>						
Broad money (M3, end-year)	na	na	na	na	na	na	na
<b>Interest and exchange rates</b>							
	<i>(In per cent per annum, end-year)</i>						
Refinance rate	30.0	27.0	20.0	12.0	12.0	10.0	na
Interbank market rate	30.0	27.0	15.0	7.7	7.0	7.0	na
Deposit rate (1 year)	24.2	27.1	na	na	na	na	na
Lending rate (1 year)	58.6	41.8	11.3	na	na	na	na
	<i>(Manats per US dollar)</i>						
Exchange rate (end-year) <sup>2</sup>	8,148.4	8,200.0	9,790.0	10,060.0	10,150.0	10,390.0	na
Exchange rate (annual average)	5,500.4	8,523.9	8,478.6	9,827.9	10,097.5	10,033.5	na
<b>External sector</b>							
	<i>(In millions of US dollars)</i>						
Current account	-934	-571	411	116	583	507	318
Trade balance	-523	-210	766	515	1,030	966	938
Merchandise exports	614	1,164	2,508	2,623	2,862	3,468	3,815
Merchandise imports	1,137	1,374	1,742	2,108	1,832	2,502	2,877
Foreign direct investment, net	62	125	131	170	276	218	220
Gross reserves, excluding gold (end-year) <sup>3</sup>	1,379	1,555	1,808	2,055	2,346	2,673	na
External debt stock	1,842	2,026	2,184	1,865	1,660	1,519	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	9.0	9.1	9.2	9.1	11.8	10.0	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	35.3	28.5	14.2	17.3	14.3	11.6	na
<b>Memorandum items</b>							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	5.0	5.2	5.4	5.6	5.8	6.0	na
GDP (in billions of manats)	13,995	17,158	22,900	33,623	38,611	43,775	53,759
GDP per capita (in US dollar)	510	387	503	607	661	727	na
Share of industry in GDP (in per cent)	29.0	33.6	37.2	38.0	38.0	38.5	na
Share of agriculture in GDP (in per cent)	26.5	27.8	27.3	26.0	21.0	18.0	na
Current account/GDP (in per cent)	-36.7	-28.4	15.2	3.4	15.2	11.6	6.0
External debt - reserves (in US\$ million)	463	471	376	-190	-686	-1,154	na
External debt/GDP (in per cent)	72.4	100.7	80.9	54.5	43.4	34.8	na
External debt/exports of goods and services (in per cent)	216.5	147.2	78.7	64.8	53.9	40.8	na

<sup>1</sup> Significant off-budget expenditures occur through extra-budgetary funds and direct lending.

<sup>2</sup> Turkmenistan operates a dual exchange rate system. The series refers to a weighted average between the official exchange rate and the commercial rate, given as the buying rate offered at commercial banks until September 1998 and the black market rate thereafter. Weights are variable depending on the relative size of official and shuttle trade.

<sup>3</sup> Foreign exchange reserves of the Central Bank plus the foreign exchange reserve fund.

# Ukraine

## Key challenges

- To attract more foreign investment, the institutional environment and the legal framework for corporate governance must be strengthened and the rights of shareholders protected.
- Continued efforts to improve the regulatory framework for banks are necessary to encourage consolidation, ensure greater transparency of ownership and strengthen the banks' capital base.
- Fiscal policy should be tightened to reduce inflationary pressures. Despite strong GDP growth and further increases in bank credit, the government eased fiscal policy in mid-2004.

business. This was confirmed by an International Finance Corporation report on the business environment issued in autumn 2003. The report also found that taxation, inspections and customs procedures posed the most significant obstacles to business.

Property rights protection has been uneven. This is in part due to weaknesses in the legal system, but also to the absence of a joint-stock company law that adequately protects minority shareholder rights. Although the new Civil Code and Commercial Code, which took effect at the beginning of 2004, should clarify basic property rights, inconsistencies between the two codes remain.

The reduction in income tax and corporate tax rates from the beginning of 2004 should improve incentives. There has also been progress with VAT reform as a result of the introduction of a new VAT regime for agriculture (from 2005) and the abolition of the exemptions for new housing construction. However, in February the President vetoed a bill to lower the VAT rate (from the beginning of 2005). This was partly because it reinstated some VAT exemptions which had been abolished in the 2004 budget. The government has started to issue bonds to exporters as a means of resolving the repayment of outstanding VAT arrears. However, at mid-year, delays in repayments persisted and the amount of arrears had grown.

## Infrastructure

A new law on telecommunications took effect in November 2003, although one of its key provisions – the establishment of a regulatory commission – does not come into force until 2005. The government also announced its intention to proceed with the long-awaited sale of a 42.8 per cent stake in Ukrtelecom in late 2004.

There has been no further progress with privatisation in the power sector, in part because of the failure of parliament to approve the debt restructuring law. In June 2004 the government approved the establishment of a state-owned power company to enhance energy security. It is likely to be a holding company comprising many of the remaining state-owned assets in the sector. However, it will exclude Ukrenergo and the nuclear power plants.

## Financial sector

The banking sector has continued to expand, with further increases in both deposits and credit, especially to the private sector. The National Bank of Ukraine (NBU) has strengthened the supervisory framework, notably by increasing the minimum capital adequacy ratio to 10 per cent from March 2004. However, the rapid growth of credit has raised some concerns over credit risk should macroeconomic conditions deteriorate.

There are still over 150 operating banks, many of which are small and weakly capitalised. The IMF has drawn attention to the need for greater transparency in bank ownership. Without that, a number of banks could face difficulties in raising additional capital. In February 2004 progress with the implementation of new anti-money laundering legislation led to Ukraine's removal from the Financial Action Task Force (FATF) list of non-cooperating countries.

### Country data

Population (in millions)	48.4
Area ('000 sq. km)	603.7
Official language	Ukrainian
GDP per capita in 2002 at current international US\$ (PPP)	US\$ 4,870
National currency	Hryvnia

## Progress in structural reform

### Liberalisation and privatisation

By the end of August 2004 Ukraine had signed 25 of the bilateral protocols necessary for WTO accession (although an agreement with the United States remains to be concluded). Negotiations focused on harmonising the relevant trade legislation with WTO standards and on multilateral issues, including technical trade barriers. In May 2004 the European Commission concluded that Ukraine did not yet meet the criteria for market economy status with regards to anti-dumping investigation. This was due to concerns over state interference in pricing and certain aspects of the bankruptcy law and its application.

The State Property Fund (SPF) slightly exceeded the target of UAH 2.15 billion (US\$ 400 million) for revenues from large-scale privatisation in 2003. It is also set to exceed a similar initial target for 2004 by a substantial margin. By August 2004 revenues amounted to UAH 8.2 billion (US\$ 1.5 billion). This progress reflects the government's decision to accelerate the privatisation of a number of key industrial enterprises. These included Krivoriizhstal, Ukraine's largest steel plant, and Pavlogradugol, a major coal producer.

The terms of some of these sales have been controversial. The 93 per cent stake in Krivoriizhstal was sold to a consortium representing two major domestic industrial groups. However, the terms effectively limited the tender to domestic enterprises and higher bids from foreign strategic buyers were rejected.

### Business environment and competition

The majority of enterprises in Ukraine view the cumbersome regulatory framework, unstable legislation, anti-competitive practices and widespread corruption as serious barriers to doing

## Macroeconomic performance

### Real economy

GDP rose by 13.6 per cent during the first eight months of 2004 (year-on-year), boosted by increases in consumption, exports and investment. Consumer spending was driven by real wage growth. Exports benefited from continued strong demand and firm commodity prices, especially for metals. Investment spending also strengthened, with purchases of machinery and equipment. Industrial production remained buoyant, increasing by almost 15 per cent during this period, and was accompanied by rapid growth in the construction sector and a recovery in agricultural output. However, the economy has remained largely dependent on its major exporting industries.

### Economic policies

The impact of lower tax rates on total revenues was partly offset by the effect of higher-than-expected growth. In June 2004 the budget law was amended to increase spending on social payments and wages, doubling the projected fiscal deficit to 2.4 per cent of GDP, and to allow the government to spend excess privatisation proceeds.

The NBU took a number of steps to slow the growth of the money supply, including an increase in the discount rate to 7.5 per cent in mid-June, reflecting concerns over inflation. In addition, the NBU allowed the currency to appreciate slightly in nominal terms against the US dollar – the first such change in policy in over two years. Despite these measures, CPI inflation could exceed the government's revised target of 7 to 7.6 per cent.

The IMF approved a one-year Stand-By Arrangement (SBA) in March 2004, which the authorities intend to treat as precautionary in view of the strength of the external position. The IMF was unable to complete its review of the SBA in August, however, due to fiscal easing and slow progress in certain structural reforms, including in the banking sector.

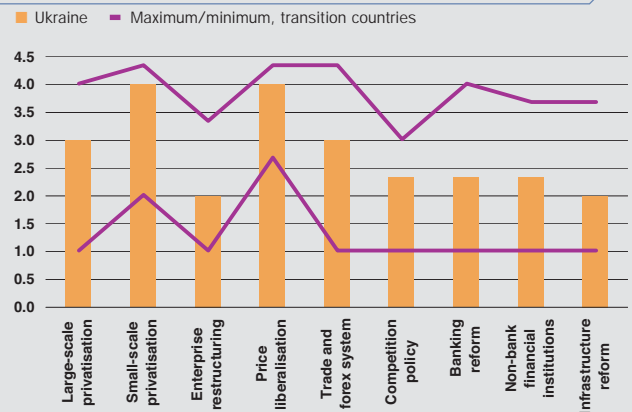
### External sector

A substantial current account surplus – US\$ 4 billion – was recorded during the first half of 2004, as demand for Ukraine's exports strengthened and prices for export metals remained firm. The receipts from the export of services and strong net transfers (including workers' remittances) also contributed to the surplus on the current account. Gross reserves amounted to US\$ 12.2 billion by the beginning of September. These were boosted by the proceeds from eurobond issues in February and July, which amounted to US\$ 1.1 billion. Net inflows of foreign direct investment (FDI) were estimated at US\$ 884 million during the first half of 2004, following net FDI of US\$ 1.4 billion in 2003.

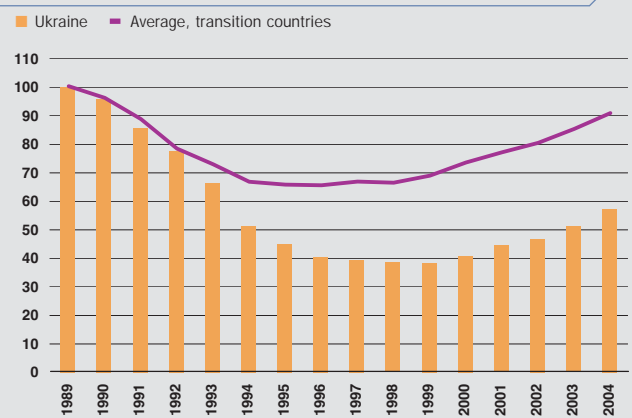
## Outlook and risks

Despite slow progress in reform, growth is expected to remain strong during the remainder of 2004. The effects of the fiscal stimulus should largely offset any weakening in external conditions. GDP growth is estimated at 12.25 per cent in 2004, slowing to 8 per cent in 2005, assuming a tightening of fiscal policy. The government will face important decisions on the future development of the single economic space (with Belarus, Kazakhstan and Russia), and its impact on negotiations with the WTO and EU.

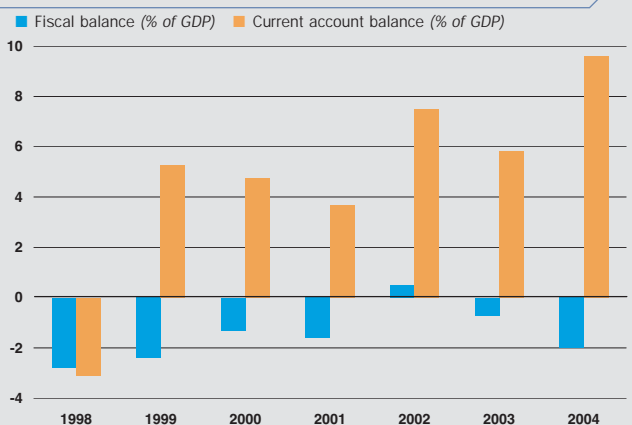
### Transition indicators, 2004



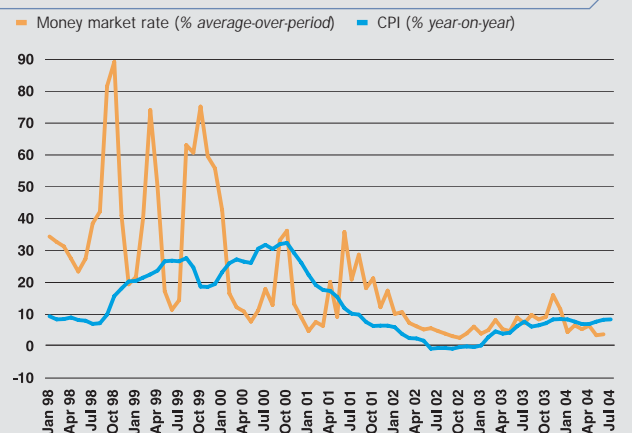
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



Liberalisation	Privatisation	Infrastructure	Social sector
Current account convertibility – full	Primary privatisation method –	Independent telecoms regulator – no	Share of population living in poverty –
Interest rate liberalisation – full	<b>vouchers</b>	Separation of railway accounts – no	<b>45.7 per cent (1999)<sup>1</sup></b>
Wage regulation – no	Secondary privatisation method –	Independent electricity regulator – yes	Private pension funds – yes
	<b>MEBOs</b>		
Stabilisation	Tradability of land – limited de facto	Financial sector	
Share of general government tax revenue in GDP – <b>37.7 per cent</b>	<b>Enterprise and markets</b>	Capital adequacy ratio – <b>10 per cent</b>	
Exchange rate regime – <b>managed float</b>	Competition office – yes	Deposit insurance system – yes	
		Secured transactions law – yes	
		Securities commission – yes	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	3.0	3.0	3.0	6.0	6.0
Share of trade with non-transition countries (in per cent)	53.6	57.4	52.0	49.6	47.5	52.9	na
Share of trade in GDP (in per cent)	71.7	82.7	98.1	89.3	86.4	96.3	na
Tariff revenues (in per cent of imports) <sup>2</sup>	2.4	2.3	1.9	2.1	2.5	3.0	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	2.7	3.0	3.0	3.0	3.0	3.0	3.0
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	2.3	2.9	4.3	5.5	6.0	6.8	na
Private sector share in GDP (in per cent)	55.0	55.0	60.0	60.0	65.0	65.0	65.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
<i>EBRD index of small-scale privatisation</i>	3.3	3.3	3.3	3.3	3.7	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	2.3	2.3	2.7	3.0	3.0	3.0	3.0
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP) <sup>3</sup>	na	na	1.4	na	na	na	na
Share of industry in total employment (in per cent)	21.2	19.9	19.3	18.6	na	na	na
Change in labour productivity in industry (in per cent)	2.1	13.4	19.9	20.0	na	na	na
Investment/GDP (in per cent)	20.8	17.5	19.8	21.8	20.2	20.3	na
<i>EBRD index of enterprise reform</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>EBRD index of competition policy</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	19.1 (0.2)	19.9 (0.4)	20.7 (1.6)	21.2 (4.4)	21.6 (8.4)	22.4 (13.4)	na
Internet penetration rate (per 10,000 inhabitants)	3.9	5.8	7.3	11.6	14.3	18.3	na
Railway labour productivity (1989=100)	42.2	41.7	44.9	46.5	49.9	56.5	na
Residential electricity tariffs, USc kWh	na	na	2.7	2.6	2.7	2.7	na
Average collection rate, electricity (in per cent)	79	84	na	78	83	94	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.2	1.2	1.3	1.4	na	na	na
<i>EBRD index of infrastructure reform</i>	1.7	1.7	2.0	2.0	2.0	2.0	2.0
<i>Electric power</i>	2.3	2.3	3.0	3.3	3.3	3.3	3.3
<i>Railways</i>	1.0	1.0	2.0	2.0	2.0	2.0	2.0
<i>Roads</i>	1.0	1.0	2.0	2.0	2.0	2.0	2.0
<i>Telecommunications</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Water and waste water</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
<b>Financial sector</b>							
Number of banks (foreign-owned)	175 (12)	161 (15)	154 (14)	152 (16)	157 (15)	158 (19)	na
Asset share of state-owned banks (in per cent)	13.7	12.5	11.9	11.8	12.0	9.8	na
Non-performing loans (in per cent of total loans)	34.6	34.2	32.5	na	na	32.7	na
Domestic credit to private sector (in per cent of GDP)	7.8	8.6	11.2	13.0	17.6	24.6	na
Stock market capitalisation (in per cent of GDP)	1.9	4.5	6.0	3.6	7.4	8.7	na
<i>EBRD index of banking sector reform</i>	2.0	2.0	2.0	2.0	2.3	2.3	2.3
<i>EBRD index of reform of non-bank financial institutions</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.3
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	6.5	5.3	5.9	6.5	8.0	8.6	na
Life expectancy at birth, total (years)	68.2	68.2	68.2	68.2	68.2	na	na
Basic school enrolment ratio (in per cent)	89.9	89.9	91.7	93.7	94.7	na	na

<sup>1</sup> Based on international poverty line. The poverty rate based on the national poverty line in 2002 was 28.1 per cent.

<sup>2</sup> Refers to taxes on international trade and transactions.

<sup>3</sup> Refers to consumer and producer subsidies.



	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b> (Percentage change in real terms)							
GDP	-1.9	-0.2	5.9	9.2	5.2	9.4	12.3
Private consumption	1.3	-2.2	2.3	9.0	9.0	12.1	na
Public consumption	-3.5	-7.9	1.0	10.4	-6.7	14.8	na
Gross fixed capital formation <sup>1</sup>	2.6	0.1	12.4	6.2	3.4	15.8	na
Exports of goods and services	1.2	-2.2	21.5	3.5	9.1	9.4	na
Imports of goods and services	2.0	-16.7	23.8	6.0	3.7	19.8	na
Industrial gross output	-1.0	4.0	13.2	14.2	7.0	15.7	na
Agricultural gross output	-9.6	-6.9	9.8	10.2	1.2	-10.2	na
<b>Employment</b> (Percentage change)							
Labour force (end-year)	-5.3	-0.9	-1.9	-2.3	-1.3	-1.5	na
Employment (end-year)	-1.1	-2.3	-2.5	-1.2	1.7	na	na
(In per cent of labour force)							
Unemployment (end-year)	3.7	4.3	4.2	3.7	3.8	3.6	na
<b>Prices and wages</b> (Percentage change)							
Consumer prices (annual average)	10.6	22.7	28.2	12.0	0.8	5.2	8.1
Consumer prices (end-year)	20.0	19.2	25.8	6.1	-0.6	8.2	7.7
Producer prices (annual average)	13.2	31.1	20.9	8.6	3.1	7.9	na
Producer prices (end-year)	35.1	15.7	20.6	0.9	5.7	11.1	na
Gross average monthly earnings in economy (annual average)	7.2	19.4	34.5	30.1	17.7	24.5	na
<b>Government sector<sup>2</sup></b> (In per cent of GDP)							
General government balance	-2.8	-2.4	-1.3	-1.6	0.5	-0.7	-2.0
General government expenditure	38.4	34.2	34.7	35.1	36.3	37.7	na
General government debt	37.6	50.7	45.1	37.5	33.5	29.3	na
<b>Monetary sector</b> (Percentage change)							
Broad money (M2, end-year)	24.0	40.7	45.3	43.2	42.3	46.9	na
Domestic credit (end-year)	58.0	30.5	23.1	18.7	28.9	39.6	na
(In per cent of GDP)							
Broad money (M2, end-year)	15.0	16.6	18.5	22.1	28.5	35.8	na
<b>Interest and exchange rates</b> (In per cent per annum, end-year)							
Refinancing rate	60.0	45.0	27.0	12.5	7.0	7.0	na
Treasury bill rate (3-month maturity)	na	na	na	na	na	na	na
Deposit rate <sup>3</sup>	22.3	20.7	13.7	11.0	7.9	7.0	na
Lending rate <sup>3</sup>	54.5	55.0	41.5	32.3	25.4	17.9	na
(Hryvnias per US dollar)							
Exchange rate (end-year)	3.4	5.2	5.4	5.3	5.3	5.3	na
Exchange rate (annual average)	2.5	4.1	5.4	5.4	5.3	5.3	na
<b>External sector</b> (In millions of US dollars)							
Current account	-1,296	1,658	1,481	1,402	3,173	2,891	5,850
Trade balance	-2,584	244	779	198	710	-269	2,290
Merchandise exports	13,699	13,189	15,722	17,091	18,669	23,739	30,600
Merchandise imports	16,283	12,945	14,943	16,893	17,959	24,008	28,310
Foreign direct investment, net	747	489	594	769	698	1,411	1,300
Gross reserves, excluding gold (end-year)	761	1,046	1,353	2,955	4,241	6,731	na
External debt stock <sup>4</sup>	11,973	13,532	11,819	12,098	12,774	14,733	na
(In months of imports of goods and services)							
Gross reserves, excluding gold (end-year)	0.5	0.8	0.9	1.7	2.4	2.9	na
(In per cent of exports of goods and services)							
Debt service <sup>5</sup>	11.2	15.9	10.4	8.7	5.7	6.3	na
<b>Memorandum items</b> (Denominations as indicated)							
Population (end-year, million)	50.5	50.1	49.3	49.0	48.7	48.4	na
GDP (in billions of hryvnias)	103	130	170	204	226	264	325
GDP per capita (in US dollar)	828	631	634	777	870	1,024	na
Share of industry in GDP (in per cent)	25.2	27.2	26.7	27.1	30.5	31.0	na
Share of agriculture in GDP (in per cent)	11.9	11.7	14.4	14.4	13.4	13.0	na
Current account/GDP (in per cent)	-3.1	5.2	4.7	3.7	7.5	5.8	9.6
External debt - reserves (in US\$ million)	11,212	12,486	10,466	9,143	8,533	8,002	na
External debt/GDP (in per cent)	28.6	42.8	37.8	31.8	30.1	29.7	na
External debt/exports of goods and services (in per cent)	67.9	79.3	60.5	57.4	54.7	50.9	na

<sup>1</sup> Includes changes in inventories.<sup>2</sup> General government includes the state, municipalities and extra-budgetary funds.<sup>3</sup> Weighted average over all maturities.<sup>4</sup> Public and publicly guaranteed debt and an estimate of the stock of private debt.<sup>5</sup> Refers to payments on public debt only.

# Uzbekistan

## Key challenges

Restrictions on external trade and access to foreign currency are undermining the new current account convertibility and impeding regional cooperation. Also, limitations on the circulation of domestic currency, coupled with recurring wage and pension arrears, are restraining growth.

State intervention and the uncertain enforcement of tax and other regulations, particularly in the retail and wholesale sectors, continue to deter private domestic investment.

Uncertain access to bank deposits, and other state interference in the operation of the banking sector, will depress financial intermediation.

Domestic trade has suffered from a number of reforms in the wholesale and retail sectors, aimed at curbing cash transactions. A government resolution in January 2004 refined the so-called "localisation" programme for the purpose of modernising Uzbek industry. Under this initiative, selected enterprises will be eligible for tax exemptions as well as preferential access to bank credit. Despite the intention to modernise, privatisation has made limited progress, with only 1,000 mainly small enterprises privatised in 2003, including a number of minority stakes in commercial banks. Privatisation accounted for only 0.5 per cent of GDP in revenues in 2003.

## Business environment and competition

In early 2004 the authorities again lowered the profit tax base rate to 18 per cent, and further narrowed the range of activities subject to VAT. This reform has been complemented by a widening of exemptions from customs duties and profit taxes under the localisation programme. Despite the objective of simplifying the tax structure for the corporate sector, domestic and foreign investors have reported a further deterioration in the business environment. Lack of transparency and discretion granted to tax and other law enforcement agencies have facilitated increasingly arbitrary enforcement of regulations by the authorities.

The agricultural sector suffers acutely from the absence of competition, particularly in the wholly state-owned cotton processing sector. Prices on mandatory procurement by state processors, although more responsive to trends in world markets, are still well below the levels in neighbouring countries. This explains the increasingly widespread smuggling of raw cotton to those countries.

## Financial Institutions

Reform of the financial sector slowed over the past year. In February 2003 the Central Bank abolished the plans under which legal entities were obliged to coordinate their projected cash deposits and withdrawals with commercial banks. However, given tight cash balances, banks still need to apply to the monetary authorities for cash supplements when large withdrawals are needed. In addition, cash can only be disbursed to enterprises for certain uses. This attempt to curtail the use of cash in the economy has severely damaged confidence in the financial system and has depressed financial intermediation. The right of tax authorities to debit individual accounts without the account holder's prior permission has had a similar effect.

## Infrastructure

As part of the convergence towards cost recovery that was initiated in 2002, further increases in gas and electricity prices were implemented in 2003. In the electricity sector pre-payment of bills and disconnection of clients in arrears have become more widespread, although the metering of household consumption is minimal. Nevertheless, electricity tariffs are still very low. Large gaps in revenue collection, together with technical losses in the network, have contributed to a fiscal deficit in the energy sector that was estimated at US\$ 2.2 billion in 2002. Even though Russian investors have purchased a number of assets, lack of transparent financial accounting and the absence of majority stakes still deter strategic investors.

### Country data

Population (in millions)	26.0
Area ('000 sq. km)	448.9
Official language	Uzbek
GDP per capita in 2002 at current international US\$ (PPP)	US\$ 1,670
National currency	Sum

## Progress in structural reform

### Liberalisation and privatisation

In October 2003 the government introduced domestic currency convertibility for current account transactions. To meet the obligations of Article VIII of the IMF Agreement, several restrictions on access to foreign currency were abolished. These included pre-registration of imports, requirements to clear applications to purchase foreign exchange for imports with a monetary commission, and restrictions on the purchase of foreign exchange with loaned funds. There were, however, reports from private sector representatives that the authorities limited access to foreign exchange for the purpose of consumer goods imports in the first few months after introducing convertibility.

The government has repeatedly stated its intention to reform the trade regime, including advancing accession to the WTO. Following a meeting of the Central Asia Economic Cooperation Forum in November 2003, working groups on trade facilitation and transport were established. However, restrictive trade barriers have persisted throughout 2003 and into 2004. Tariff barriers have severely disrupted international trade for the private sector. These tariffs reach up to 70 per cent on imports of non-food products by individual traders. There are also restrictive non-tariff barriers, such as health and safety standards. Intermittent border closures compound the problems.

## Macroeconomic performance

### Real economy

Official data reported a GDP growth rate of 4.4 per cent in 2003 and just over 6 per cent in the first half of 2004. Estimates by the IMF and World Bank are considerably lower. In the first six months of 2004, growth was driven by a recovery in industrial output – primarily from state-owned enterprises – and more modest growth in agriculture. However, as the authorities are continuing their restrictive monetary and trade policies, a substantial acceleration of growth appears unlikely.

### Economic policies

In 2003 the government managed to contain spending and kept the budget in balance, even though there was a substantial build-up of wage and pension arrears. There should be a loosening of fiscal policy during 2004. This follows the announcement of a number of tax cuts and exemptions from taxes and tariffs, under the localisation programme, which will support domestic industry.

Current account convertibility was introduced in October 2003. However, monetary policy has been tightened excessively through restrictions on domestic currency circulation and denial of access to bank deposits. This has been in an effort to appreciate the black market exchange rate to the official rate. Unification of the exchange rates and conversion for current account transactions present important opportunities for export-led growth. The tight monetary policy explains the slowdown in inflation to about 8 per cent in 2003, although increases in administered prices should bring about a higher level in 2004.

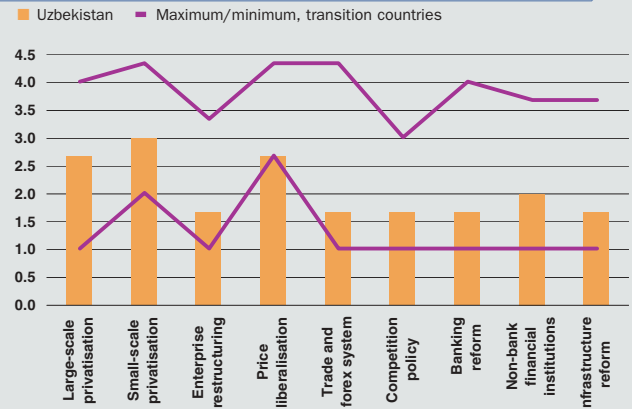
### External sector

Favourable world prices for cotton and gold, and a revival of exports in state-owned industries, contributed to a higher current account surplus (about 9 per cent of GDP) in 2003. Figures for the first half of 2004 indicate that this trend has continued, further contributing to the comfortable level of international reserves. In the capital account there has been a net repayment of external public debt. However, foreign direct investment (FDI) inflows in 2003 were among the lowest in the region, at just over US\$ 60 million. Greater interest by Russian investors in Uzbekistan's telecommunications and hydrocarbon sectors may, however, lead to higher FDI inflows in the future.

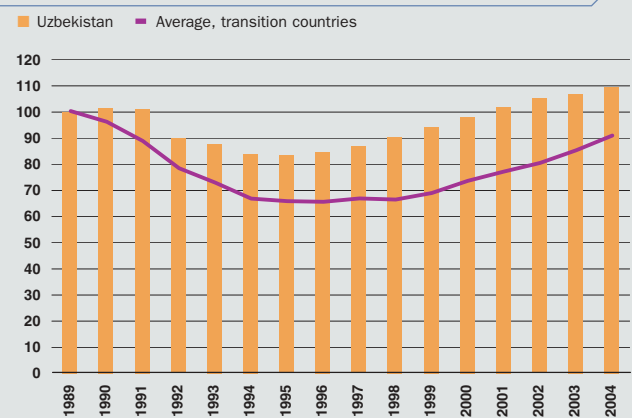
## Outlook and risks

The economic outlook depends critically on easing tight restrictions on the availability of cash and liberalising trade. These restrictions ostensibly support the present level of the exchange rate. However, this policy is likely to depress growth, aggravate corruption and relegate an increasing share of economic activity to the informal sector. There are risks to public debt sustainability from a substantial exchange rate depreciation, although the level of international reserves makes a rapid correction unlikely. The strength of the balance of payments, coupled with the favourable regional environment, present an opportunity to implement a comprehensive liberalisation of external trade.

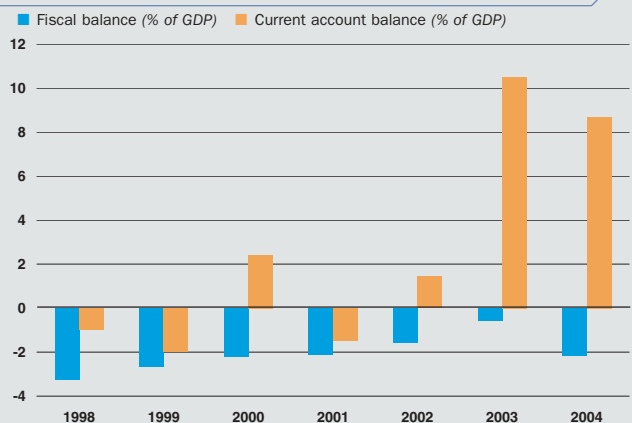
### Transition indicators, 2004



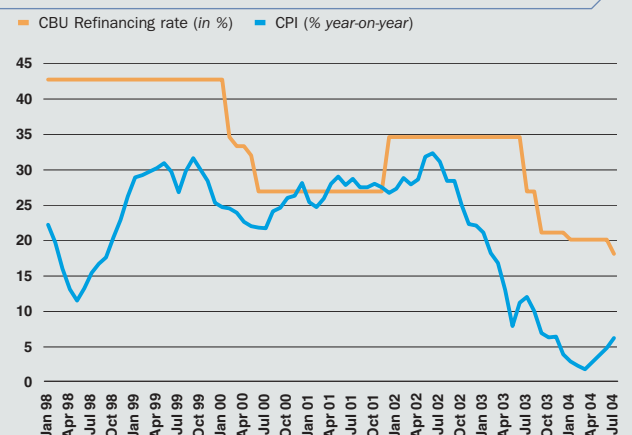
### Real GDP (1989=100)



### Fiscal balance and current account balance



### Interest rates and inflation



<b>Liberalisation</b>	<b>Privatisation</b>	<b>Infrastructure</b>	<b>Social sector</b>
Current account convertibility – <b>limited</b>	Primary privatisation method – <b>MEBOs</b>	Independent telecoms regulator – <b>no</b>	Share of population living in poverty – <b>28 per cent (2002)</b>
Interest rate liberalisation – <b>limited de jure</b>	Secondary privatisation method – <b>direct sales</b>	Separation of railway accounts – <b>yes</b>	Private pension funds – <b>no</b>
Wage regulation – <b>yes</b>	Tradability of land – <b>limited de jure</b>	Independent electricity regulator – <b>no</b>	
<b>Stabilisation</b>	<b>Enterprise and markets</b>	<b>Financial sector</b>	
Share of general government tax revenue in GDP – <b>23 per cent<sup>1</sup></b>	Competition office – <b>yes</b>	Capital adequacy ratio – <b>8 per cent</b>	
Exchange rate regime – <b>managed float<sup>2</sup></b>		Deposit insurance system – <b>yes</b>	
		Secured transactions law – <b>yes</b>	
		Securities commission – <b>yes</b>	

	1998	1999	2000	2001	2002	2003	2004
<b>Liberalisation</b>							
Share of administered prices in CPI (in per cent)	53.0	60.0	53.0	53.0	53.0	53.0	53.0
Number of goods with administered prices in EBRD-15 basket	8.0	9.0	8.0	8.0	8.0	8.0	8.0
Share of trade with non-transition countries (in per cent)	47.4	53.5	45.3	48.4	48.6	na	na
Share of trade in GDP (in per cent)	55.7	65.0	59.6	69.5	55.6	67.2	na
Tariff revenues (in per cent of imports) <sup>3</sup>	2.3	1.3	2.6	1.9	2.8	3.6	na
<i>EBRD index of price liberalisation</i>	2.7	2.7	2.7	2.7	2.7	2.7	2.7
<i>EBRD index of forex and trade liberalisation</i>	1.7	1.0	1.0	1.7	1.7	1.7	1.7
<b>Privatisation</b>							
Privatisation revenues (cumulative, in per cent of GDP)	2.6	2.6	2.8	2.9	3.5	4.1	na
Private sector share in GDP (in per cent)	45.0	45.0	45.0	45.0	45.0	45.0	45.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
<i>EBRD index of small-scale privatisation</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>EBRD index of large-scale privatisation</i>	2.7	2.7	2.7	2.7	2.7	2.7	2.7
<b>Enterprise and markets</b>							
Budgetary subsidies and current transfers (in per cent of GDP)	3.2	2.9	2.2	2.1	1.9	na	na
Share of industry in total employment (in per cent)	12.7	12.7	12.7	12.7	12.7	12.7	na
Change in labour productivity in industry (in per cent)	5.3	5.2	1.6	7.2	5.7	5.8	na
Investment/GDP (in per cent)	20.9	17.1	19.6	20.0	na	na	na
<i>EBRD index of enterprise reform</i>	2.0	2.0	1.7	1.7	1.7	1.7	1.7
<i>EBRD index of competition policy</i>	2.0	2.0	2.0	2.0	2.0	1.7	1.7
<b>Infrastructure</b>							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	6.4 (0.1)	6.6 (0.2)	6.7 (0.2)	6.7 (0.5)	6.7 (0.7)	6.7 (1.3)	na
Internet penetration rate (per 10,000 inhabitants)	0.1	0.1	0.1	0.1	0.1	0.4	na
Railway labour productivity (1989=100)	27.1	26.6	34.2	35.5	51.1	51.8	na
Residential electricity tariffs, USc kWh <sup>4</sup>	1.9	1.2	0.7	na	1.4	na	na
Average collection rate, electricity (in per cent)	80	90	na	na	72	95	na
GDP per unit of energy use (PPP in US dollars per kgoe)	0.6	0.6	0.7	0.7	na	na	na
<i>EBRD index of infrastructure reform</i>	1.3	1.3	1.3	1.7	1.7	1.7	1.7
<i>Electric power</i>	1.0	1.0	1.0	2.0	2.0	2.0	2.0
<i>Railways</i>	2.0	2.0	2.3	2.7	2.7	2.7	2.7
<i>Roads</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Telecommunications</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Water and waste water</i>	1.0	1.0	1.0	1.0	1.7	1.7	1.7
<b>Financial sector</b>							
Number of banks (foreign-owned) <sup>5</sup>	33 (4)	35 (5)	34 (6)	na	na	28 (5)	na
Asset share of state-owned banks (in per cent) <sup>5</sup>	67.3	65.8	77.5	na	na	91.0	na
Non-performing loans (in per cent of total loans) <sup>5</sup>	0.1	0.1	0.0	1.0	2.0	1.0	na
Domestic credit to private sector (in per cent of GDP) <sup>5</sup>	na	na	na	na	33	26	na
Stock market capitalisation (in per cent of GDP)	2.1	1.9	1	0.6	0.4	0.2	na
<i>EBRD index of banking sector reform</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
<i>EBRD index of reform of non-bank financial institutions</i>	2	2	2	2	2	2	2
<b>Social sector</b>							
Expenditures on health and education (in per cent of GDP)	10.7	10.4	9.3	9.2	9.2	9.2	na
Life expectancy at birth, total (years)	na	na	67.9	67.4	67	na	na
Basic school enrolment ratio (in per cent)	89.2	88.9	97	97.8	97.5	na	na

<sup>1</sup> Including tax revenues of extra-budgetary funds would raise the ratio to 30 per cent of GDP.

<sup>2</sup> Following the unification of the "over the counter" and official exchange rates in June 2003, only one exchange rate exists.

<sup>3</sup> Refers to custom duties and export taxes.

<sup>4</sup> Refers to average retail tariff.

<sup>5</sup> Data from IMF.

	1998	1999	2000	2001	2002	2003 Estimate	2004 Projection
<b>Output and expenditure</b>							
	<i>(Percentage change in real terms)</i>						
GDP <sup>1</sup>	4.3	4.3	3.8	4.1	3.1	1.5	2.5
Private consumption	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na
Industrial gross output	5.8	6.1	3.5	8.1	8.5	6.2	na
Agricultural gross output	4.0	5.9	3.2	4.5	6.1	4.7	na
<b>Employment</b>							
	<i>(Percentage change)</i>						
Labour force (end-year)	1.4	1.0	1.1	1.5	2.4	na	na
Employment (end-year)	1.4	1.0	1.1	1.5	2.4	na	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year) <sup>2</sup>	0.4	0.4	0.4	0.4	0.4	0.3	na
<b>Prices and wages</b>							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	29.0	29.1	25.0	27.2	27.6	10.3	12.0
Consumer prices (end-year)	26.1	26.0	28.2	26.4	21.6	7.7	14.0
Producer prices (annual average)	48.4	38.0	61.1	42.2	46.0	na	na
Producer prices (end-year)	48.4	34.5	70.2	44.0	36.7	na	na
Gross average monthly earnings in economy (annual average)	49.0	33.4	47.4	58.2	32.9	na	na
<b>Government sector<sup>3</sup></b>							
	<i>(In per cent of GDP)</i>						
General government balance	-3.3	-2.6	-2.2	-2.1	-1.5	-0.6	-2.2
General government expenditure	34.3	32.0	30.2	36.0	37.2	39.9	na
General government debt	12.7	11.8	16.6	24.3	22.4	19.1	na
<b>Monetary sector</b>							
	<i>(Percentage change)</i>						
Broad money (M3, end-year)	28.1	32.1	37.1	54.3	29.7	27.2	na
Domestic credit (end-year)	79.5	34.5	88.8	90.8	41.1	3.8	na
	<i>(In per cent of GDP)</i>						
Broad money (M3, end-year)	15.4	13.6	12.2	12.4	10.6	12.1	na
<b>Interest and exchange rates</b>							
	<i>(In per cent per annum, end-year)</i>						
Refinancing rate	48.0	42.6	26.8	26.8	34.5	20.0	na
Treasury bill rate (3-month maturity)	20.4	16.5	17.1	17.1	17.1	na	na
Deposit rate (1 year)	13.1	13.5	18.8	21.2	26.0	na	na
Lending rate (1 year)	33.1	32.7	27.6	27.6	33.4	na	na
	<i>(Sums per US dollar)</i>						
Exchange rate (end-year)	178.7	348.4	631.3	937.6	1,068.3	979.2	na
Exchange rate (annual average) <sup>4</sup>	131.8	257.2	360.7	646.3	885.0	995.6	na
<b>External sector</b>							
	<i>(In millions of US dollars)</i>						
Current account	-102	-164	218	-113	122	883	846
Trade balance	111	203	494	186	324	836	954
Merchandise exports	3,049	2,790	2,935	2,740	2,510	3,240	3,830
Merchandise imports	2,938	2,587	2,441	2,554	2,186	2,404	2,876
Foreign direct investment, net	140	121	75	83	65	70	180
Gross reserves, excluding gold (end-year)	533	763	684	1,212	1,215	1,659	na
External debt stock	3,230	4,805	4,418	4,279	4,260	4,149	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	1.9	2.9	2.8	4.6	5.4	6.7	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	10.5	17.8	25.5	26.2	24.6	22.2	na
<b>Memorandum items</b>							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	24.0	24.3	24.7	24.9	25.6	26.0	na
GDP (in billions of sums)	1,416	2,129	3,256	4,925	7,469	8,362	9,600
GDP per capita (in US dollar) <sup>5</sup>	449	340	366	306	330	323	na
Share of industry in GDP (in per cent)	14.9	14.3	14.2	14.1	14.1	na	na
Share of agriculture in GDP (in per cent)	26.8	29.0	30.1	30.0	30.6	na	na
Current account/GDP (in per cent)	-0.9	-2.0	2.4	-1.5	1.4	10.5	8.7
External debt - reserves (in US\$ million)	2,697	4,042	3,734	3,067	3,045	2,490	na
External debt/GDP (in per cent)	30.1	58.1	48.9	56.2	50.5	49.4	na
External debt/exports of goods and services (in per cent)	96.6	155.4	131.4	133.7	142.7	110.9	na

<sup>1</sup> EBRD estimate. Official figures are considerably higher, at 4.2 per cent in 2001 and 2002, and 4.3 per cent in 2003.

<sup>2</sup> Officially registered unemployed. No labour force survey estimates available.

<sup>3</sup> Includes extra-budgetary funds, but excludes local government.

<sup>4</sup> Dual exchange rates were in operation until October 2003. From 1998-2000 data show the weighted average of the official exchange rate (40 per cent), the bank rate (30 per cent) and the parallel market rate (30 per cent). From 2001 the weights changed to the official rate (20 per cent), the so-called "over the counter" (OTC) rate (50 per cent) and the black market rate (30 per cent).

<sup>5</sup> Calculated at the weighted exchange rate.





# Methodological notes

## Transition indicators

The transition indicator scores in Chapter 1 reflect the judgment of the EBRD's Office of the Chief Economist about country-specific progress in transition. The scores are based on the following classification system, which was originally developed in the 1994 *Transition Report*, but has been refined and amended in subsequent Reports.

"+" and "-" ratings are treated by adding 0.33 and subtracting 0.33 from the full value. The average is obtained by rounding down, e.g. a score of 2.6 is treated as 2+, but a score of 2.8 is treated as 3-.

## Overall transition indicators

### Large-scale privatisation

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

### Small-scale privatisation

- 1 Little progress.
- 2 Substantial share privatised.
- 3 Comprehensive programme almost ready for implementation.

- 4 Complete privatisation of small companies with tradable ownership rights.
- 4+ Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.

### Governance and enterprise restructuring

- 1 Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.
- 2 Moderately tight credit and subsidy policy, but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
- 3 Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (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.
- 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.

### Banking reform and interest rate liberalisation

- 1 Little progress beyond establishment of a two-tier system.
- 2 Significant liberalisation of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.
- 3 Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalisation with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.
- 4 Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.
- 4+ Standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services.

### Securities markets and non-bank financial institutions

- 1 Little progress.
- 2 Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities.
- 3 Substantial issuance of securities by private enterprises; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of non-bank financial institutions (for example, investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework.
- 4 Securities laws and regulations approaching IOSCO standards; substantial market liquidity and capitalisation; well-functioning non-bank financial institutions and effective regulation.
- 4+ Standards and performance norms of advanced industrial economies: full convergence of securities laws and regulations with IOSCO standards; fully developed non-bank intermediation.

### Infrastructure reform

The ratings are calculated as the average of five infrastructure reform indicators covering electric power, roads, railways, telecommunications, water and waste water. The classification system used for these five indicators is detailed below.

## Infrastructure transition indicators

### Electric power

- 1 Power sector operates as government department with few commercial freedoms or pressures. Average prices well below costs, with extensive cross-subsidies. Monolithic structure, with no separation of different parts of the business.
- 2 Power company distanced from government, but there is still political interference. Some attempt to harden budget constraints, but effective tariffs are low. Weak management incentives for efficient performance. Little institutional reform and minimal, if any, private sector involvement.
- 3 Law passed providing for full-scale restructuring of industry, including vertical unbundling through account separation and set-up of regulator. Some tariff reform and improvements in revenue collection. Some private sector involvement.
- 4 Separation of generation, transmission and distribution. Independent regulator set up. Rules for cost-reflective tariff-setting formulated and implemented. Substantial private sector involvement in distribution and/or generation. Some degree of liberalisation.
- 4+ Tariffs cost-reflective and provide adequate incentives for efficiency improvements. Large-scale private sector involvement in the unbundled and well-regulated sector. Fully liberalised sector with well-functioning arrangements for network access and full competition in generation.

### Railways

- 1 Monolithic structure operated as government department, with few commercial freedoms. No private sector involvement and extensive cross-subsidisation.
- 2 Rail operations distanced from state, but weak commercial objectives. Some business planning, but targets are general and tentative. No budgetary funding of public service obligations. Ancillary businesses separated, but little divestment. Minimal private sector involvement.
- 3 Commercial orientation in rail operations. Freight and passenger services separated and some ancillary businesses divested. Some budgetary compensation available for passenger services. Improved business planning with clear investment and rehabilitation targets, but funding unsecured. Some private sector involvement in rehabilitation and/or maintenance.
- 4 Railways fully commercialised, with separate internal profit centres for passenger and freight. Extensive market freedoms to set tariffs and investments. Implementation of medium-term business plans. Ancillary industries divested. Private sector participation in freight operation, ancillary services and track maintenance.
- 4+ Separation of infrastructure from operations and freight from passenger operations. Full divestment and transfer of asset ownership implemented or planned, including infrastructure and rolling stock. Rail regulator established and access pricing implemented.

### Roads

- 1 Minimal degree of decentralisation and no commercialisation. All regulatory, road management and resource allocation functions centralised at ministerial level. New investments and road maintenance financing dependent on central budget allocations. Road user charges not based on the cost of road use. Road construction and maintenance undertaken by public construction units. No public consultation in the preparation of road projects.
- 2 Moderate degree of decentralisation and initial steps in commercialisation. Road/highway agency created. Improvements in resource allocation and public procurement. Road user charges based on vehicle and fuel taxes, but not linked to road use. Road fund established, but dependent on central budget. Road construction and maintenance undertaken primarily by corporatised public entities, with some private sector participation. Minimal public consultation/participation on road projects.
- 3 Fair degree of decentralisation and commercialisation. Regulation and resource allocation functions separated from road maintenance and operations. Level of vehicle and fuel taxes related to road use. Private companies able to provide and operate roads under negotiated commercial contracts. Private sector participation in road maintenance and/or through concessions to finance, operate and maintain parts of highway network. Limited public consultation/participation and accountability on road projects.
- 4 Large degree of decentralisation. Transparent methodology used to allocate road expenditures. Track record in competitive procurement for road design, construction, maintenance and operations. Large-scale private sector participation in construction, operations and maintenance directly and through public-private partnerships. Substantial public consultation/participation and accountability on road projects.
- 4+ Fully decentralised road administration. Commercialised road maintenance operations competitively awarded to private companies. Road user charges reflect the full costs of road use and associated factors, such as congestion, accidents and pollution. Widespread private sector participation in all aspects of road provision. Full public consultation on new road projects.

### Telecommunications

- 1 Little progress in commercialisation and regulation. Minimal private sector involvement and strong political interference in management decisions. Low tariffs, with extensive cross-subsidisation. Liberalisation not envisaged, even for mobile telephony and value-added services.
- 2 Modest progress in commercialisation. Corporatisation of dominant operator and some separation from public sector governance, but tariffs are still politically set.
- 3 Substantial progress in commercialisation and regulation. Telecommunications and postal services fully separated, and cross-subsidies reduced. Considerable liberalisation in the mobile segment and in value-added services.
- 4 Complete commercialisation, including privatisation of the dominant operator, and comprehensive regulatory and institutional reforms. Extensive liberalisation of entry.
- 4+ Effective regulation through an independent entity. Coherent regulatory and institutional framework to deal with tariffs, interconnection rules, licensing, concession fees and spectrum allocation. Consumer ombudsman function.

### Water and waste water

- 1 Minimal degree of decentralisation; no commercialisation. Services operated as vertically integrated natural monopolies by a government ministry or municipal departments. No financial autonomy and/or management capacity at municipal level. Low tariffs, low cash collection rates and high cross-subsidies.
- 2 Moderate degree of decentralisation; initial steps towards commercialisation. Services provided by municipally owned companies. Partial cost recovery through tariffs, and initial steps to reduce cross-subsidies. General public guidelines exist regarding tariff-setting and service quality but both under ministerial control. Some private sector participation through service or management contracts, or competition to provide ancillary services.
- 3 Fair degree of decentralisation and commercialisation. Water utilities operate with managerial and accounting independence from municipalities, using international accounting standards and management information systems. Operating costs recovered through tariffs, with a minimum level of cross-subsidies. More detailed rules drawn up in contract documents, specifying tariff review formulae and performance standards. Private sector participation through the full concession of a major service in at least one city.
- 4 Large degree of decentralisation and commercialisation. Water utilities managerially independent, with cash flows – net of municipal budget transfers – that ensure financial viability. No cross-subsidies. Semi-autonomous regulatory agency has power to advise and enforce tariffs and service quality. Substantial private sector participation through build-operator-transfer concessions, management contacts or asset sales in several cities.
- 4+ Water utilities fully decentralised and commercialised. Fully autonomous regulator exists with complete authority to review and enforce tariff levels and quality standards. Widespread private sector participation via service/ management/lease contracts. High-powered incentives, full concessions and/or divestiture of water and waste-water services in major urban areas.

## Definitions and data sources for structural indicators box

### Liberalisation

#### Current account convertibility

Options: full (full compliance with Article VIII of IMF Agreement); limited (restrictions on payments or transfers for current account transactions).

Source: *International Monetary Fund, Annual report on exchange arrangements and exchange restrictions.*

#### Interest rate liberalisation

Options: full (banks free to set deposit and lending rates); limited de facto (no legal restrictions on banks to set deposit and lending rates, but limitations arise from substantial market distortions, such as directed credits or poorly functioning or high illiquid money or credit markets); limited de jure (restrictions on the setting of interest rates by banks through law, decree or central bank regulation).

Source: *EBRD staff assessments.*

#### Wage regulation

Restrictions or substantial taxes on the ability of some enterprises to adjust the average wage or wage bill upward. Options: yes; no.

Source: *EBRD staff assessments.*

### Stabilisation

#### Share of general government tax revenue in GDP

General government includes central government, extra-budgetary funds and local government.

Source: *See the macroeconomic indicators tables.*

#### Exchange rate regime

Options: currency board; fixed; fixed with band; crawling peg; crawling peg with band; managed float; floating.

Source: *International Monetary Fund, Annual report on exchange arrangements and exchange restrictions.*

### Privatisation

#### Primary privatisation method since the start of transition

Options: vouchers (distribution of investment coupons at a symbolic price); direct sales (sales to outsiders); MEBOs (management/employee buy-outs); liquidations.

Source: *EBRD staff assessments.*

#### Secondary privatisation method since the start of transition

Options and definitions as above.

Source: *EBRD staff assessments.*

#### Tradability of land

Options: full (no substantial restrictions on the tradability of land rights beyond administrative requirements; no discrimination between domestic and foreign subjects); full except foreigners (as “full”, but with some differential treatment of foreigners); limited de facto (substantial de facto limitations on the tradability of land, for example, the lack of enforceability of land rights, a non-existent land market, or significant obstruction by government officials); limited de jure (legal restrictions on the tradability of land rights); no (land trade prohibited).

Source: *EBRD staff assessments.*

### Enterprise and markets

#### Competition Office

Competition or anti-monopoly office exists separately from any ministry, though it may not be fully independent. Options: yes; no.

Source: *EBRD staff assessments.*

### Infrastructure

#### Independent telecommunications regulator

Independent body, but the scope of power may differ across countries. Options: yes; no.

Source: *EBRD staff assessments.*

#### Separation of railway accounts

Accounts for freight and passenger operations separated. Options: yes; no.

Source: *EBRD staff assessments.*

#### Independent electricity regulator

Independent body, but the scope of power may differ across countries. Options: yes; no.

Source: *EBRD staff assessments.*

### Financial sector

#### Capital adequacy ratio

Ratio of bank regulatory capital to risk-weighted assets; regulatory capital includes paid-in capital, retentions and some forms of subordinated debt.

Source: *EBRD staff assessments.*

#### Deposit insurance system

Deposits in all banks covered by a formal deposit insurance scheme. Options: yes; no.

Source: *EBRD staff assessments.*

#### Secured transactions law

Non-possessory security over movable assets permitted. Options: yes; restricted; no.

Source: *EBRD regional survey of secured transactions laws.*

#### Securities commission

Securities and exchange commission exists separately from any ministry, although it may not be fully independent. Options: yes; no.

Source: *EBRD staff assessments.*

### Social sector

#### Share of the population living in poverty

Percentage of population living on less than US\$ 2 (in 1985 US\$ at purchasing power parity) a day per person. Selected years 1995-99.

Source: *World Bank, World Development Indicators.*

#### Private pension funds

Options: yes; no.

Source: *EBRD staff assessments.*



## Definitions and data sources for structural indicators table

### Liberalisation

#### Share of administered prices in CPI (in per cent)

Administered prices are those prices subject to regulation by the state.

Sources: EBRD survey of national authorities and IMF country reports.

#### Number of goods with administered prices in EBRD-15 basket

EBRD-15 basket consists of flour/bread, meat, milk, gasoline/petrol, cotton textiles, shoes, paper, cars, television sets, cement, steel, coal, wood, rents, intercity bus service.

Source: EBRD survey of national authorities.

#### Share of trade with non-transition economies (in per cent)

Ratio of merchandise exports and imports with non-transition economies to total trade (exports plus imports).

Source: IMF, *Directions of Trade Statistics*.

#### Share of trade in GDP (in per cent)

Ratio of exports plus imports to GDP.

Source: See the macroeconomic indicators tables.

#### Tariff revenues (in per cent of imports)

Tariff revenues include all revenues from international trade. Imports are those of merchandise goods.

Sources: National authorities and IMF country reports.

### Privatisation

#### Privatisation revenues (cumulative, in per cent of GDP)

Government revenues from cash sales of enterprises, not including investment commitments.

Sources: National authorities and IMF country reports.

#### Private sector share in GDP (in per cent)

“Private sector share” in GDP represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies, as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available.

Source: EBRD staff estimates.

#### Private sector share in employment (in per cent)

“Private sector share” in employment represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector employment includes employment in private registered companies, as well as in private entities engaged in informal activity in those cases where reliable information on informal activity is available.

Source: EBRD staff estimates.

### Enterprise and markets

#### Budgetary subsidies and current transfers (in per cent of GDP)

Budgetary transfers to enterprises and households, excluding social transfers.

Sources: National authorities and IMF country reports.

#### Share of industry in total employment (in per cent)

Industry includes electricity, power, manufacturing, mining and water.

Sources: ILO, *Labour Statistics Yearbook*, UN, *National Account Statistics*, national statistical publications and IMF country reports.

#### Change in labour productivity in industry (in per cent)

Labour productivity is calculated as the ratio of industrial production to industrial employment. Changes in productivity are calculated on the basis of annual averages.

Sources: National statistical publications and IMF country reports.

#### Investment rate/GDP (in per cent)

Gross domestic investment consists of additional outlays to the economy's fixed assets, plus net changes in inventory levels. Fixed assets include: land improvements (fences, ditches, drains, etc.); plant, machinery and equipment purchases; and the construction of roads, railways, schools, offices, hospitals, private residential dwellings, commercial and industrial buildings etc. Inventories are stocks of goods held by firms to meet temporary or unexpected fluctuations in production or sales and “work in progress”. Net acquisitions of valuables are also considered capital formation.

Source: See the macroeconomic indicators tables.

### Infrastructure

#### Fixed-line (mobile) penetration rate (per 100 inhabitants)

Fixed line refers to the number of telephone lines connecting a customer to the Public Switched Telephone Network (PSTN). Mobiles refer to the number of cellular mobile telephone subscribers.

Source: International Telecommunications Union.

#### Internet penetration rate (per 10,000 inhabitants)

Internet penetration rate is calculated as the number of Internet hosts (number of computers directly linked to the worldwide Internet network) per 10,000 inhabitants.

Source: International Telecommunications Union.

#### Railway labour productivity (1989=100)

Productivity measured as the ratio of the number of traffic units (passenger-kilometres plus freight tonne-kilometres) and the total number of railway employees.

Sources: National authorities and World Bank.

#### Residential electricity tariff, US cents per kilowatt-hour

Average tariff paid by residential consumers; where data on residential tariffs is not available, average retail tariff.

Sources: International Energy Agency, Energy Regulators Association and EBRD survey of national authorities.

#### Average collection rates, electricity (in per cent)

Collection rate is defined as the ratio of total electricity payments received in cash and total electricity charges.

Source: EBRD survey of national authorities.

#### GDP per unit of energy use (PPP in US dollars per kgoe)

The PPP GDP per kilogram of oil equivalent of commercial energy use. GDP is converted to international US dollars using purchasing power parity exchange rates.

Source: World Bank, *World Development Indicators*.

## Financial sector

### Number of banks (foreign-owned)

Number of commercial and savings banks, excluding cooperative banks. Foreign-owned banks are defined as those with foreign ownership exceeding a 50 per cent share, end-of-year.

Source: EBRD survey of central banks.

### Asset share of state-owned banks (in per cent)

Share of total bank assets of majority state-owned banks in total bank sector assets. The state includes the federal, regional and municipal levels, as well as the state property fund and the state pension fund. State-owned banks are defined as banks with state ownership exceeding 50 per cent, end-of-year.

Source: EBRD survey of central banks.

### Non-performing loans (in per cent of total loans)

Ratio of non-performing loans to total loans. Non-performing loans include sub-standard, doubtful and loss classification categories for loans, but excludes loans transferred to a state rehabilitation agency or consolidation bank, end-of-year.

Source: EBRD survey of central banks.

### Domestic credit to private sector (in per cent of GDP)

Ratio of total outstanding bank credit to the private sector at end-of-year, including households and enterprises, to GDP.

Source: EBRD survey of central banks.

### Stock market capitalisation (in per cent of GDP)

Market value of all shares listed on the stock market as a percentage of GDP, end-of-year.

Source: EBRD survey of national stock markets. In some cases, the data differ notably from capitalisation as reported by the Standard & Poor's/IFC Handbook of Emerging Markets. The difference is due to the exclusion in the Standard & Poor's/IFC data of companies listed on the third tier.

## Social sector

### Expenditures on health and education (in per cent of GDP)

Expenditures of general government, excluding those by state-owned enterprises.

Sources: Ministries of finance, IMF country reports, World Bank, World Development Indicators.

### Life expectancy at birth, total (years)

Life expectancy is defined as the average age reached by an individual after the first day of life, excluding deaths at birth.

Source: World Bank, World Development Indicators.

### Basic school enrolment ratio (in per cent)

Gross rates of school enrolment in per cent of the relevant population between 7 and 15 years old. Basic school includes eight years of schooling from the age of 7/8 to 14/15.

Sources: UNICEF, International Child Development Centre, TransMONEE Database.

## Definitions and data sources for macroeconomic indicators table

Data represent official estimates of out-turns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank and other sources. Data for the current year are EBRD staff estimates.

### Output and expenditure

Official estimates of GDP, industrial and agricultural production. Growth rates can lack precision in the context of transition due to large shifts in relative prices, the failure to account for quality improvements and the substantial size and change in the informal sector. Some countries have started to incorporate the informal sector into their estimates of GDP.

### Employment

For most countries, data reflect official employment records from the labour registries. In many countries, small enterprises are not recorded by official data. A number of countries have moved towards ILO-consistent labour force surveys in recording changes in labour force, employment and unemployment. Where available these data are presented.

### Prices and wages

Data from the statistical offices or IMF. In some countries, notably Belarus, Turkmenistan and Uzbekistan, official CPI data may underestimate underlying inflation because of price controls and inadequate measurement of price increases in informal markets. Wage data are from national authorities and often exclude small enterprises as well as the informal sector.

### Government sector

Data for the general government, including local government and extra-budgetary funds, where available. Data for most countries are from IMF country reports. Budget balance data can differ from official estimates due to different budgetary accounting, in particular with respect to privatisation revenues and foreign lending.

### Monetary sector

Broad money is the sum of money in circulation outside banks and demand deposits other than those of the central government. It also includes quasi-money (time, savings and foreign currency deposits of the resident sectors other than the central government). Data from IMF, International Financial Statistics, IMF country reports and monetary authorities.

### Interest and exchange rates

Deposit and lending rates from most countries are weighted averages across maturities. For some countries, weighted averages are not available and rates are quoted for the most frequently used instruments. Data from the IMF, International Financial Statistics, IMF country reports and monetary authorities.

### External sector

Trade data in many countries can differ between balance of payments and customs statistics, because of differences in recording and of informal border trade, which is typically not recorded by customs statistics. Trade data are on a balance of payments basis as published by the monetary authorities and in IMF country reports.

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# Transition report 2004

The *Transition Report* offers an in-depth analysis of economic progress in 27 countries from central Europe to central Asia. Drawing on the EBRD's extensive experience as one of the largest investors in the region, the Report offers comprehensive analysis of the transition from central planning to market economies.

Over the past year the transition countries have made steady, if uneven, progress in structural reform. But do reforming countries get rewarded with high rates of growth? And why are some countries with low levels of reform currently achieving some of the highest growth rates? Is this simply because they are recovering from a long recession or benefiting from high oil prices? The *Transition Report* seeks to answer these questions.

The special topic of this year's Report is infrastructure, covering energy, telecommunications, transport and water supply. After decades of neglect in infrastructure services, many transition countries have turned to the private sector both for managerial know-how and to finance essential upgrading. But has the private sector delivered? And can regulatory frameworks support commercial infrastructure industries and, ultimately, competition? The Report looks at the track record of the private sector and reviews the regulatory environment.

Country-by-country assessments focus on both structural and macroeconomic developments. Extensive tables and charts provide the latest data on output, fiscal and monetary policy, the external sector and many other indicators.