TRANSITION REPORT 2009

Transition in crisis?



European Bank
for Reconstruction and Development

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About this report

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

The responsibility for the content of the *Transition Report* is taken by the Office of the Chief Economist. The assessments and views expressed in the *Transition Report* are not necessarily those of the EBRD. All assessments and data in the *Transition Report* are based on information as of early October 2009.

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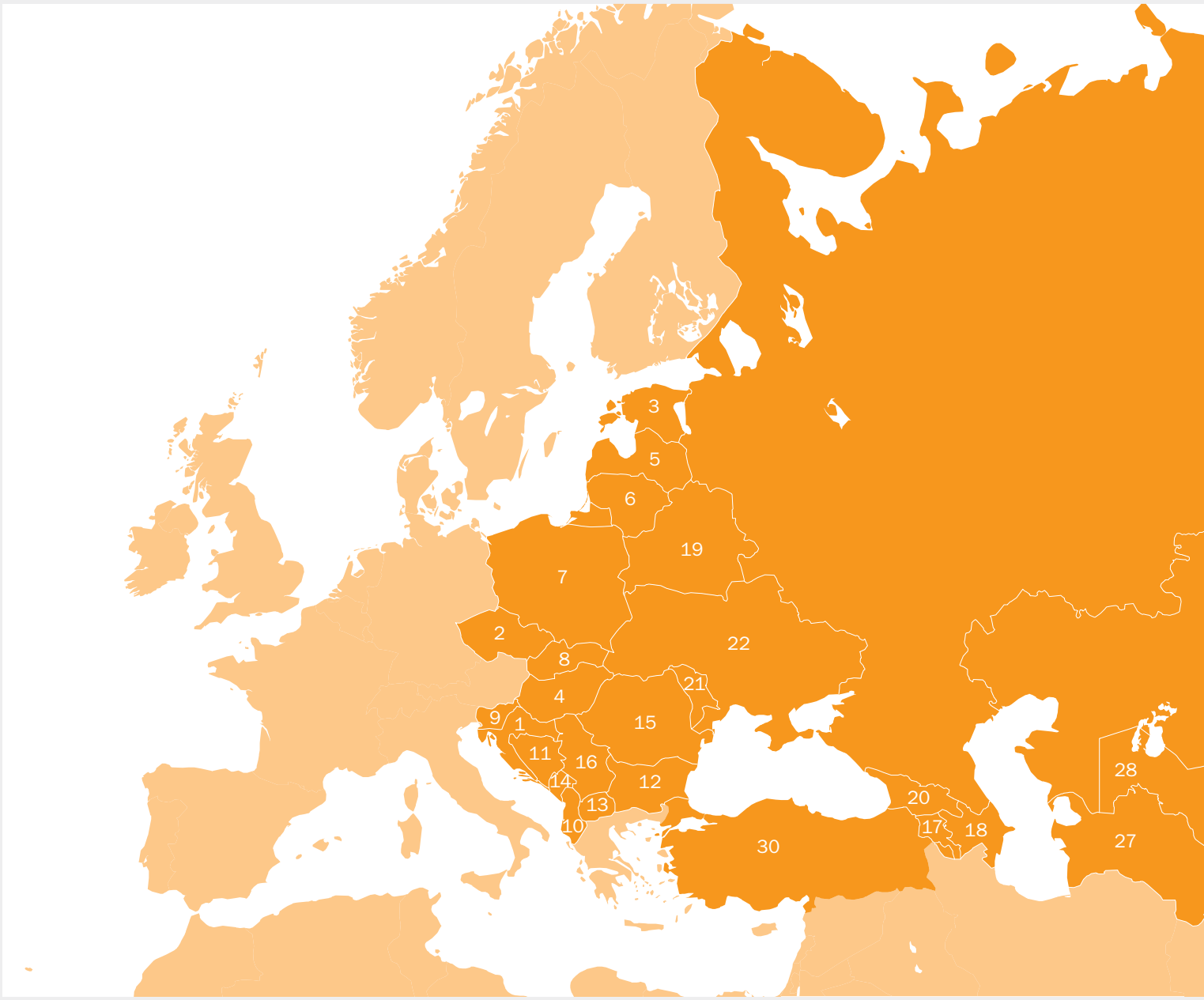
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Transition countries



GDP (in billion US$, 2008)

Central Europe and the Baltic states		
1	Croatia	69.4
2	Czech Republic*	216.4
3	Estonia	23.5
4	Hungary	155.9
5	Latvia	34.0
6	Lithuania	47.3
7	Poland	527.9
8	Slovak Republic	95.4
9	Slovenia	54.6

South-eastern Europe		
10	Albania	13.0
11	Bosnia and Herzegovina	18.5
12	Bulgaria	49.9
13	FYR Macedonia	9.6
14	Montenegro	4.8
15	Romania	200.1
16	Serbia	50.1

Eastern Europe and the Caucasus		
17	Armenia	11.9
18	Azerbaijan	46.4
19	Belarus	60.3
20	Georgia	12.9
21	Moldova	6.0
22	Ukraine	179.6

* From 2008 the EBRD no longer makes new investments in the Czech Republic nor provides a country assessment in the *Transition Report*. However, parts of the Report refer to the Czech Republic for analytical and comparative purposes.



Central Asia	
23 Kazakhstan	135.6
24 Kyrgyz Republic	5.0
25 Mongolia	5.2
26 Tajikistan	5.1
27 Turkmenistan	19.0
28 Uzbekistan	27.9

29 **Russia**	1,676.6

30 **Turkey**	730.0

Executive summary

Chapter 1
Structural and macroeconomic impact of the crisis: an overview

The past year of financial and economic crisis has proved exceptionally difficult for policy-makers across the transition region. There have been few new reforms, as reflected in the lowest number of upgrades to the EBRD transition scores since the start of transition. More encouraging, however, has been a near absence, so far, of reversals in transition, with only four downgrades.

The emerging global crisis left most transition economies largely unaffected until mid-2008, after which it hit hard as commodity prices collapsed, exports contracted and capital inflows stopped. This led to extraordinarily sharp output declines later in the year and in the first quarter of 2009. By the third quarter of 2009 there were signs that the downturn was bottoming out. However, unemployment and the volume of non-performing loans are expected to rise for several quarters to come, complicating and slowing the recovery in many countries.

Although there have been dramatic declines in national outputs, collapses of banking systems and currencies have to date been largely avoided (unlike the experiences in previous emerging market crises), for three reasons. First: although the region approached the crisis with large macroeconomic imbalances in many countries, financial sectors were relatively sound (compared with the Asian countries in the 1990s, for example). Second: except in a few countries, such as Latvia, Russia and Ukraine, reversals in net capital flows were mild across the transition region compared with the experience in previous crises. Lastly: there was an effective coordinated policy response to maintain financial stability, involving national authorities, international organisations and regional banking groups.

Chapter 2
Understanding the crisis in the transition region

Although net capital outflows from the transition region in late 2008 and the first quarter of 2009 were generally more moderate than expected, output declines were unexpectedly sharp. These sudden declines can be attributed to: the collapse of exports in the fourth quarter of 2008; the fact that the boom was coming to an end in several transition countries even before the eruption of the crisis; and to the macroeconomic imbalances that had accumulated during the boom. Because of these imbalances, financing needs in the region were much larger than in other emerging market countries, implying that even relatively moderate net capital outflows would have a significant impact.

Differing macroeconomic imbalances also help to explain the large cross-country variations in the depth of output declines within the transition region. Countries with larger pre-crisis credit booms and higher levels of private external debt at the end of 2007 have tended to suffer larger declines. In contrast, foreign bank ownership seems to have helped to stabilise output. The likely reason for this is that foreign bank presence mitigated the capital outflow, as parent banks continued to refinance their subsidiaries and branches. This mitigating effect can be confirmed using statistical analysis both for the transition countries and a larger sample that includes many non-transition developing and emerging market countries.

Chapter 3
Development based on financial integration?

Financial integration – in the form of large debt flows and foreign direct investment, and an increasing presence of foreign banks – has been an integral part of the "development model" of transition countries (particularly in Europe) over the last decade. The region's slide into deep recession has raised questions about whether the growth benefits associated with this model may have been short-lived and whether the model created vulnerabilities that have been a contributing cause of the crisis.

Macroeconomic and sector-level analysis shows that financial integration did in fact boost long-term growth in the transition region (unlike other emerging market regions, where the evidence is not so clear). At the same time, there is evidence that the process of financial integration – particularly large inflows of foreign financing – has indeed contributed to credit booms and foreign currency lending. These, in turn, made the crisis deeper and complicated its management.

While financial integration cannot and should not be reversed, its risks must be better managed. This means addressing the bias toward foreign currency lending through macroeconomic policies, regulation, and the creation of legal frameworks and market infrastructures supporting local currency finance. It also requires countercyclical financial sector policies that mitigate credit booms, regardless of whether they originate from capital inflows or domestic sources. To be effective, these policies need to be consistent across jurisdictions, or formulated at a regional level.

Chapter 4
Development based on commodity revenues?

Commodity-rich transition countries, such as Azerbaijan, Kazakhstan, Russia and Turkmenistan, have been on an exceptionally fast-growth trajectory since the late 1990s. In the long term, however, these countries tend to grow more slowly than their resource-poor peers because they have higher macroeconomic volatility and because commodity "rents" undermine incentives to improve economic institutions (since good institutions, by definition, make it more difficult for elites to appropriate these rents).

To avoid this "resource trap", resource-rich economies can attempt to: diversify, mainly by improving the business environment; build stabilisation buffers and deepen financial sectors to reduce the impact of commodity price volatility; and reduce inequality as a way of distributing rents more widely (including through higher public spending on education).

Resource-rich transition economies have embraced these strategies to varying degrees. In some respects – particularly in financial development and in building and managing stabilisation funds – they have been fairly successful. Partly for this reason, the impact of the crisis on resource-rich transition countries does not appear to have been worse than elsewhere. However, raising the share of non-commodity tradeable sectors in GDP or exports has so far proved elusive, perhaps because success in diversification, as empirical analysis shows, itself depends on institutional quality. Escaping from this conundrum – namely, low diversification inhibiting institutional development, and vice versa – is difficult but not impossible. One approach is to deepen reforms in areas such as macroeconomic, financial sector and competition frameworks where resource-rich transition countries have already demonstrated their ability to make progress.

Chapter 5
Transition: where does it stand and where should it go?

There has been increasing recognition that successful transition involves not only market mechanisms and private economic activity, but also effective interaction between the state and private sectors and high-quality state institutions. Analysis of the business environment, level of competition by sector and managerial practices shows the heterogeneity of the transition region, while an assessment of remaining transition "gaps" exposes the size of the challenges still facing some countries.

Firms in central Europe and the Baltic states (CEB) tend to rate their business environment better than most other emerging market regions, while firms in Central Asia, eastern Europe and the Caucasus (EEC), Russia and Central Asia view it less favourably. With respect to managerial practices, the Central Asian countries and Russia lag behind not only Western benchmark countries but also China, while the CEB countries rate about the same as Greece, Ireland and Portugal. Firm-level data for three countries in south-eastern Europe (SEE) suggest that their levels of competition lagged behind CEB and other developing country benchmarks.

Sector-level analysis shows that the remaining transition gaps are mostly small in EU member countries, with medium gaps remaining in energy efficiency, transport infrastructure and in the financial sector. Gaps are typically medium in Armenia, Georgia, Kazakhstan, Russia and most SEE countries, and predominantly large elsewhere. These results imply that those countries which are least advanced in terms of reform will be left further behind once economic recovery takes root.

Chapter 6
Transition in crisis? The impact of the crisis on reform

Economic crises have sometimes led to major reactions against the status quo. On other occasions they have left prevailing political and economic regimes in place but triggered policy reforms within those regimes. How crises turn out depends on a variety of factors, including their scale, the maturity of pre-crisis institutions, social cohesion, pre-crisis political regimes, external anchors, and which (if any) aspects of the pre-crisis status quo were viewed as responsible for the crisis.

The 2008-09 crisis has led to a slow-down in reform. However, unlike the 1998 crisis in Russia, it has not triggered a major reversal. An analysis of government changes since early 2008 suggests that the political and reform orientation of governments has generally been preserved and, if anything, favoured pro-reform parties. The lack of an anti-reform backlash reflects more mature economic institutions and political systems compared with 1998, better integration into regional and global institutions, and a more successful crisis response which has prevented high inflation and banking system collapses.

However, a major round of new reforms also appears unlikely. This is true for EU member countries, in which the distance from the transition frontier is moderate and the reform effort needed to reach the frontier is typically greater, and for countries further east, where reform progress has been less consistent and support for market institutions weaker. The scope for new reforms is greatest in the Western Balkans and some eastern European and Caucasus countries and in the financial sector, where initiatives are under way across a diverse range of countries.

Foreword

This year has witnessed the worst output collapse since the great "transitional recession" that followed the end of communism. Five countries are expected to suffer double-digit declines. On average, GDP will shrink by about 6 per cent. Non-performing loans and unemployment are rising, extending the crisis and complicating recovery in many countries.

So there is no doubt that the transition region is in deep crisis. But is transition itself in crisis? How have the institutions and policy frameworks that were the outcome of the transition process coped? Are the ideas that drove transition, which in addition to market reforms and trade integration also encompassed financial liberalisation and integration, still attractive? Lastly, is the future of transition in doubt? Will the crisis lead to a backlash against market-oriented reforms?

These are the main questions addressed by the *Transition Report* 2009, which also happens to coincide with the 20th anniversary of the fall of communism in several eastern European countries. A crisis is a strange way to celebrate an anniversary. At the same time, it puts the structural transformation of the last 20 years to the test. What does this test reveal?

While the transition region was the emerging market region to suffer the most in the crisis, it has generally avoided the currency collapses, systemic banking crises and spikes in inflation that were the staple of previous crises. This is less contradictory than it seems initially. It relates to the special role of integration with advanced countries – economically, financially and even politically – in the region's development model. This has cut both ways. On the one hand it has created economic ties and financial dependence that have made many transition countries highly susceptible to the crisis in the West. On the other hand, it has mitigated the large capital outflows that were a destructive force in past crises, it has contributed to more mature institutions and domestic policy responses, and it has mobilised vigorous international support. The latter included an unprecedented effort to coordinate public and private financial sector crisis responses of which the EBRD is proud to have been a part. For all these reasons, this crisis has not spiralled out of control.



Erik Berglöf
Chief Economist

The global recession has plunged the transition region into crisis, but at the same time demonstrated the resilience of reforms and economic integration achieved over the last 15 to 20 years.

The two faces of integration have been particularly visible in the financial arena. Aside from fuelling the boom years, financial integration has been an important force for long-term growth in the transition region, as shown in Chapter 3. At the same time, it has no doubt contributed to excessively fast expansions in private sector credit, and excessively high levels of private sector debt. It is also likely to have encouraged indebtedness in foreign currency, which has complicated the crisis in many countries. The lesson from this experience is not to attempt to reverse financial integration – that would be both unfeasible and unwise – but to mitigate its risks, particularly through policy frameworks and institutional development that address the problem of foreign currency lending and that lead to a better management of future booms.

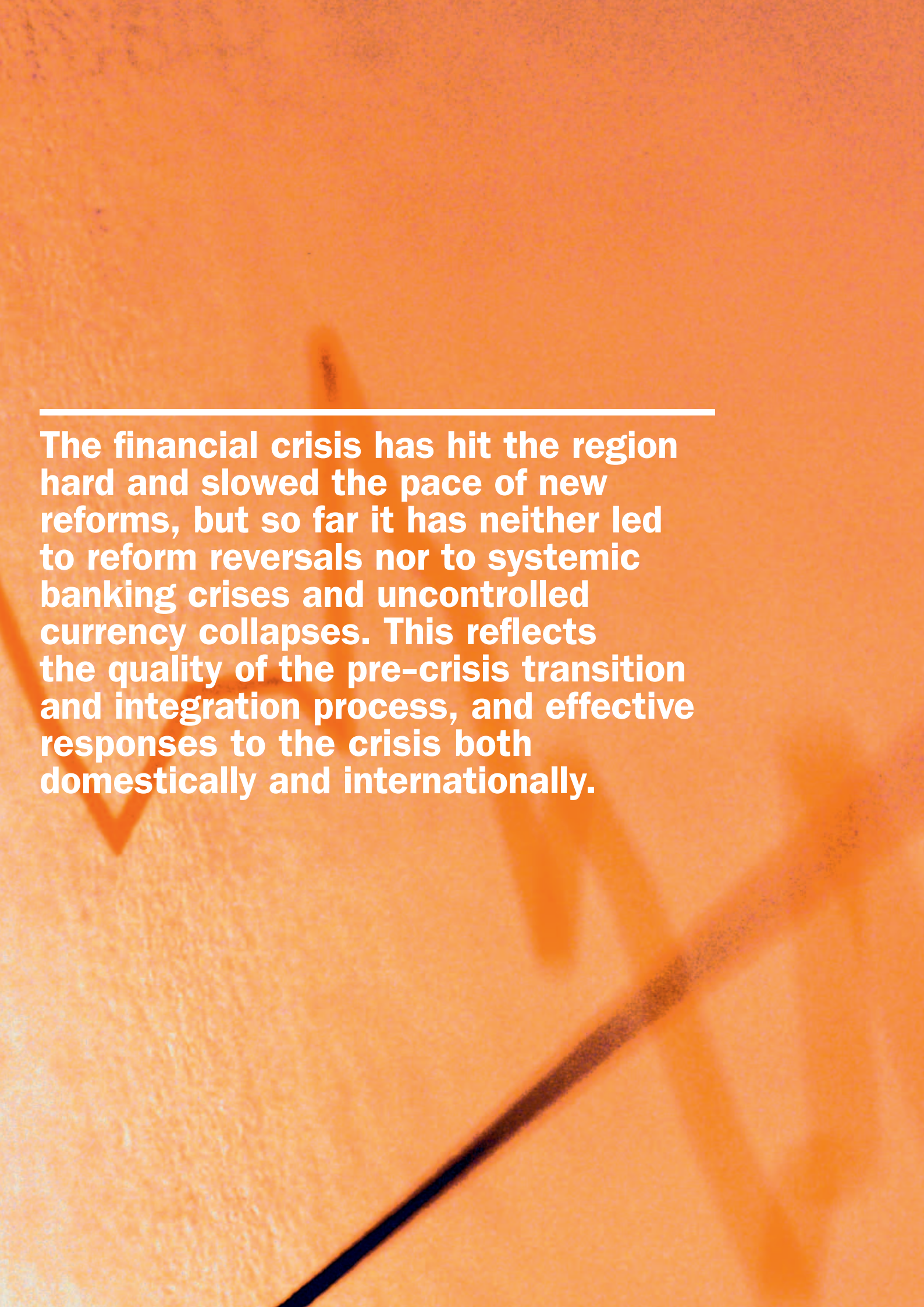
Further east, the resource-rich transition economies are facing what is arguably an even bigger challenge. Like the financially integrated economies of central and south-eastern Europe, the commodity-rich countries have had to manage the complications of rapid inflows of foreign currency. In some countries this has lead to similar problems, such as credit booms and private sector debt. But unlike some forms of financial integration, commodity inflows are not necessarily conducive to the financial and institutional development that would mitigate the risks of sudden reversals. This creates an even more difficult problem for domestic policy-makers. In some areas, particularly macroeconomic management involving the accumulation and use of stabilisation funds, resource-rich transition countries have performed fairly well. But the ultimate goal – diversification and associated improvements in economic (and political?) institutions and the business climate – has mostly proved elusive.

The crisis has also tested ideas about the ultimate aims of transition. It has confirmed a view which has been gaining traction over the last decade, namely that transition to a market economy is about much more than building markets and shifting economic responsibilities from the state to the private sector. It also involves developing certain state functions, and improving how the state interacts with the private sector. The crisis has brought home the importance of market-supporting policy institutions and policies, particularly in the financial sector. This does not necessarily mean more regulation, but it certainly means better regulation, focused on improving incentives.

Based on this extended concept of institutional change, Chapter 5 attempts to gauge the remaining reform needs in the transition region, including through the use of an exhaustive study at the sector level. Not surprisingly, the largest scope for reforms is found to be in countries with low transition indicator scores, particularly in Central Asia and some eastern European and Western Balkans countries. However, significant reform needs remain in specific sectors even in some central European and Baltic countries, particularly in sustainable energy and energy efficiency; transport; and in the financial sector, where regulatory and supervisory regimes require strengthening, finance to small and medium-sized firms needs to be further improved, and local capital markets need to be developed.

However, in light of the crisis, what is the likelihood of such reforms actually being implemented? Will this crisis act as a catalyst for reforms, or will it lead to a backlash against the market model? One year into the crisis in the transition region, we can almost rule out the latter. While the crisis has clearly slowed the pace of new reforms, it has led to far fewer reform reversals than in 1998-99, for example, following the crisis in Russia. Furthermore, government changes since early 2008 have either led to no change with respect to the reform stance, or indeed favoured pro-reform parties (see Chapter 6). However, a significant acceleration of reforms also appears unlikely. The main exception could be the financial sector, where the crisis appears to be stimulating political will for reforms in a number of countries, reinforced by the movement towards reform in the advanced market economies.

To conclude, the answer to the title question of this Report “Transition in crisis?” is a qualified “no”. The global recession has plunged the transition region into crisis, but at the same time demonstrated the resilience of reforms and economic integration achieved over the last 15 to 20 years. It has also highlighted some pitfalls of the development models that countries in the transition region have pursued. However, it is clear that the way to address these pitfalls is to extend the transition agenda, not to replace it. It would be a shame if, after all the hardship, the region did not seize the opportunity for transition in the crisis.



The financial crisis has hit the region hard and slowed the pace of new reforms, but so far it has neither led to reform reversals nor to systemic banking crises and uncontrolled currency collapses. This reflects the quality of the pre-crisis transition and integration process, and effective responses to the crisis both domestically and internationally.

Chapter 1
Structural and macroeconomic impact of the crisis: an overview

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3 Macroeconomic and financial developments

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17 Outlook and risks

18 Box 1.4 The Vienna Initiative

The past year has witnessed the worst crisis in the transition region since the output collapse that followed the end of central planning in the early 1990s. Chapter 1 undertakes a preliminary assessment of the crisis impact. As is customary in the *Transition Report*, it begins with an overview of reform progress (as well as reform reversals) in transition economies, before discussing macroeconomic and financial developments and policy responses.

This chapter also serves as a guide to some of the analytical content of the Report. The crisis has raised many questions – not just about the crisis itself but also about the development models that were pursued in the region before the crisis and the future of reform and the transition process. The chapter raises some of these questions and suggests answers that are elaborated on in subsequent chapters.

Progress in transition

The past year has been exceptionally difficult for policy-makers across the region. The economic crisis has dominated the agenda almost everywhere, especially in those countries where output contractions have been the most severe. But one of the most encouraging features of the period has been the near-absence, thus far, of reversals in transition. This section will show that there has indeed been a marked slow-down in reforms relative to previous years but that the number of instances of previous reforms being dismantled is well below that of the last big crisis that affected the region in 1998.

There are at least three reasons why one would expect to see a slow-down in reforms during an economic downturn. First, most governments and central banks in the region have been engaged in a "fire-fighting" exercise to mitigate the worst effects of the crisis and have therefore had little or no time or energy to devote to the implementation of structural reforms. Second, many reforms involve the imposition of short-term pain for long-term benefit. In times of economic hardship, people are already suffering and it often becomes politically impossible to gain acceptance of the need for further changes that will initially increase hardship. Third, some reforms – privatisation being an obvious example – require not only a commitment from policy-makers but also investor community interest. In many cases, key privatisations are on hold because the likelihood of finding a buyer – at an acceptable price – is low in the current environment.

Once the crisis in the region took hold there were concerns that policy-makers would roll back some of the key reforms introduced over the past two decades. One possibility was that they would decide that the market-driven "development model", which relied on strong inflows of foreign investment (see Chapter 3) and which had appeared to serve the region well in the previous decade, was no longer the right approach. Instead (it was feared) the state might decide to play a much more active role in managing the economy, as indeed has been the case in many advanced Western economies. Related to this was the risk that vested interests would try to insulate themselves from the global downturn by extracting concessions and "gifts" from policy-makers in the form of tariff barriers, price controls or restrictions on capital inflows from abroad.

As an aid to examining what actually happened, and to justify the assertion that there has been a significant slow-down in transition but no widespread return to the past, one can draw on the EBRD's transition indicators. These numerical scores attempt to measure each year – for a range of indicators – how far each country has travelled on its transition journey towards the standards of a well-functioning market economy. The indicators cover early, "first-phase" reforms, such as price and trade liberalisation and small-scale privatisation; and more advanced reforms that relate to large-scale privatisation competition policy and governance, and reforms to financial and infrastructure institutions. In each case, the scale goes from 1 to 4+, where 1 indicates little or no progress and 4+ represents the standards of a hypothetical, advanced, industrialised market economy.

It is worth emphasising, as have previous *Transition Reports*, that the transition scores do not capture all aspects of a country's transition, particularly those that pertain to the business environment and the quality and effectiveness of public institutions. Further, the scoring involves an inevitable degree of subjectivity, although every effort is made to ensure consistency across countries and time. Indeed, it is for these reasons that this year's *Transition Report* attempts to go beyond the usual analysis of the transition indicators by enhancing the use of survey data and other quantitative information to assess where large transition gaps remain (see Chapter 5). Nevertheless, this year's scores tell an interesting story about the path of reforms over the past year.

The scores are presented in Table 1.1, with upgrades and downgrades identified by upward and downward arrows, respectively. The reasons for the changes are explained briefly in Table 1.2 (see also the country assessments from page 130). One of the nine transition indicators is a composite infrastructure score, consisting of five subcomponents. These scores are presented in Table 1.3, with accompanying explanations for any changes (relative to last year) in Table 1.4. Table 1.1 shows that there have been 14 upgrades this year and four downgrades. Table 1.3 identifies seven cases where an upgrade was warranted for one of the infrastructure components.

The most striking feature of Table 1.1 is the low number of upgrades compared with previous years. Chart 1.1 shows the number of upgrades and downgrades this year and the average transition score. The previous record low for progress was in 2007, when there were no downgrades and 21 upgrades (see Chapter 6). The only countries to receive more than one upgrade this year were Belarus, FYR Macedonia and Montenegro, with two each. FYR Macedonia and Montenegro received upgrades for infrastructure, as well as securities markets and non-bank financial institutions (FYR Macedonia) and competition policy (Montenegro). In the case of Belarus, the past year has seen welcome progress in price liberalisation, where requirements on firms to register price increases above certain thresholds have been relaxed; and in the banking sector, where several important steps towards liberalisation have been introduced. Nevertheless, the average transition score in Belarus is still one of the lowest in the entire region (only Turkmenistan scores worse) and the state continues to dominate decision-making in many important sectors of the economy.

One region where progress remains evident and several upgrades have occurred is the Western Balkans. All countries in this region are either candidate or potential candidate countries for membership of the European Union and, as the experience of previous candidates (and now members) has shown, this provides an important motivation to reform. Two examples from the past year make this point. In Montenegro, the government has, in line with EU directives, made progress in the difficult area of restructuring the railways. In Serbia, the government signed a major trade agreement with the European Union and decided to implement it unilaterally, even though implementation remains blocked on the EU side (because of a lack of full Serbian cooperation with the International Criminal Tribunal for the former Yugoslavia). Albania also made important advances in large-scale privatisation and in reforming its road and energy sectors.

Elsewhere, the only upgrades in central Europe and the Baltic states (CEB) were in Croatia and Latvia for continued improvement in enforcing competition laws, and in the Slovak Republic, where progress in implementing public-private partnerships (PPPs) warranted an upgrade in the road sector and in the overall infrastructure score. In eastern Europe and the Caucasus (EEC), Georgia received an upgrade for infrastructure, reflecting major improvements in the water and wastewater sector, while Ukraine introduced an important joint-stock law that should lead to significant improvements in corporate governance. There were no upgrades in Russia, where progress in improving the business environment and completing a landmark PPP tender (Pulkovo airport in St Petersburg) was balanced by protectionist measures in certain industries and an increasing role of state corporations in the enterprise sector. In Central Asia, only Tajikistan merited an upgrade – for improvements in transparency and corporate governance, and progress in the resolution of cotton debt.

This year's *Transition Report* for the first time provides transition scores for Turkey, which became an EBRD country of operations in November 2008. Turkey scores highly in the categories of small-scale privatisation, price liberalisation, and trade and foreign exchange liberalisation, achieving 4+ in the latter. However, the remaining scores are between 3- and 3+, and its average transition score of 3.26 is identical to that of another EU candidate country, FYR Macedonia.

In recent years, downgrades became increasingly rare; no downgrades were recorded in the past three *Transition Reports* and only one since 2003. This year, however, has seen four downgrades – for the banking reform and interest rate liberalisation indicator in Kazakhstan and Latvia, for the large-scale privatisation indicator in Montenegro, and for the trade and foreign exchange liberalisation indicator in Ukraine. It is important to stress that these scoring decisions do not necessarily imply a criticism of the authorities. In each case, these actions by the authorities can be justified as crisis responses that are likely to be reversed in the future. However, the fact remains that the distance to the transition "frontier" that the transition indicators are intended to measure has increased, even if the authorities have adopted the correct short-term policy response.

Specifically, in the case of Kazakhstan and Latvia, the actions of the state in effectively nationalising systemically important banks were arguably the best responses by the authorities to extremely difficult circumstances. If a pure "market" solution had been adopted and these banks had been allowed to fail, then the consequences for the real economy could have been devastating. Likewise, in Ukraine the introduction of currency controls may well have played a role in stabilising the currency and preventing an even greater contraction in the real economy. In Montenegro the state has reacquired a major share in the country's largest company (and main export revenue earner), the aluminium complex KAP, which had been sold in 2005 but was in deep financial difficulty. The government recognises that an extensive restructuring of the company, involving major retrenchments, is needed. This balances the twin aims of making the company less inefficient and loss-making and avoiding a sudden collapse of KAP, which could have had deep economic and social consequences.

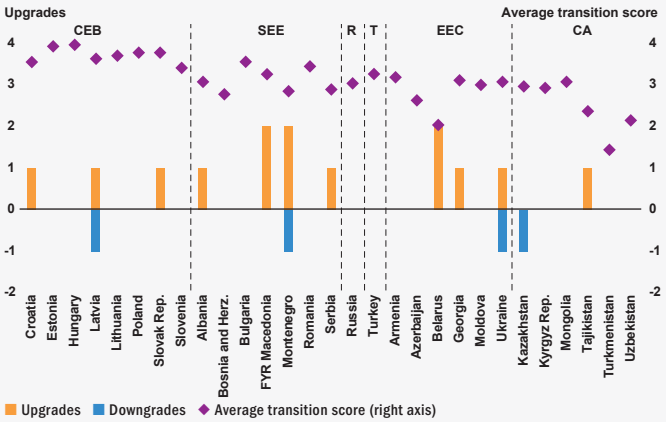
Macroeconomic and financial developments

Crisis in the transition region: a synopsis

In July and August of 2007, the crisis in the US mortgage sector spilled over to asset-backed securities, such as collateralised debt obligations. With confidence in the balance sheets of those financial institutions holding such assets badly shaken, money markets dried up, both in the United States and in Europe. Risk premiums rose sharply, affecting corporate borrowing. The US high-yield bond spread, traditionally a bell-wether for global risk aversion and a reliable predictor of financing conditions in emerging markets, quickly doubled, from around 250 to about 500 basis points by September 2007.

In light of large macrofinancial vulnerabilities in most emerging European countries (see Chapter 2 of this Report), a shock of this size at the international financial system's centre may have been expected to quickly spill over to the transition region. Yet this did not occur. Instead, the crisis unfolded in three phases (see Box 1.1 on page 6).

Chart 1.1
Transition scores, upgrades and downgrades, 2009



Source: EBRD.

Note: The chart shows the total number of upgrades and downgrades in the nine areas of reform covered by the transition indicators (see Table 1.1), as well as each country's average transition indicator on a scale from 1 to 4.33 (which is represented in Tables 1.1 and 1.3 as "4+"). No bars at all means that there were no upgrades or downgrades for that particular country. CEB (central Europe and the Baltic states); SEE (south-eastern Europe), R (Russia), T (Turkey), EEC (eastern Europe and the Caucasus), CA (Central Asia).

Table 1.1
Transition indicator scores, 2009

			Enterprises			Markets and trade			Financial institutions		Infrastructure
Country	Population mid-2009 (million)	Private sector share of GDP mid-2009 (EBRD estimate in per cent)	Large-scale privatisation	Small-scale privatisation	Governance and enterprise restructuring	Price liberalisation	Trade and foreign exchange system	Competition policy	Banking reform and interest rate liberalisation	Securities markets and non-bank financial institutions	Overall infrastructure reform
Albania	3.2	75	4-↑	4	2+	4+	4+	2	3	2-	2+
Armenia	3.2	75	4-	4	2+	4+	4+	2+	3-	2+	3-
Azerbaijan	8.4	75	2	4-	2	4	4	2	2+	2-	2
Belarus	9.7	30	2-	2+	2-	3↑	2+	2	2+↑	2	1
Bosnia and Herzegovina	3.8	60	3	3	2	4	4	2	3	2-	2+
Bulgaria	7.6	75	4	4	3-	4+	4+	3	4-	3	3
Croatia	4.4	70	3+	4+	3	4	4+	3↑	4	3	3
Estonia	1.3	80	4	4+	4-	4+	4+	4-	4	4-	3+
FYR Macedonia	2.0	70	3+	4	3-	4+	4+	2+	3	3-↑	3-↑
Georgia	4.5	75	4	4	2+	4+	4+	2	3 -	2-	3-↑
Hungary	10.0	80	4	4+	4-	4+	4+	3+	4	4	4-
Kazakhstan	15.7	65↓	3	4	2	4	4-	2	3-↓	3-	3-
Kyrgyz Republic	5.1	75	4-	4	2	4+	4+	2	2+	2	2-
Latvia	2.3	70	4-	4+	3	4+	4+	3+↑	4-↓	3	3
Lithuania	3.4	75	4	4+	3	4+	4+	3+	4-	3+	3
Moldova	3.4	65	3	4	2	4	4+	2+	3	2	2+
Mongolia	2.8	75	3+	4	2	4+	4+	2+	3-	2+	2+
Montenegro	0.7	65	3↓	4-	2	4	4	2↑	3	2-	2+↑
Poland	38.0	75	3+	4+	4-	4+	4+	3+	4-	4-	3+
Romania	21.7	70	4-	4-	3-	4+	4+	3-	3+	3	3+
Russia	142.2	65	3	4	2+	4	3+	2+	3-	3	3-
Serbia	9.9	60	3-	4-	2+	4	4↑	2	3	2	2+
Slovak Republic	5.4	80	4	4+	4-	4+	4+	3+	4-	3	3+↑
Slovenia	2.0	70	3	4+	3	4	4+	3-	3+	3	3
Tajikistan	6.8	55	2+	4	2↑	4-	3+	2-	2+	1	1
Turkey	69.7	70	3+	4	3-	4	4+	3-	3	3-	3-
Turkmenistan	6.5	25	1	2+	1	3-	2	1	1	1	1
Ukraine	46.6	65	3	4	2+↑	4	4↓	2+	3	3-	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 248. 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". ↑ and ↓ arrows indicate a change from the previous year. One arrow indicates a movement of one point (from 4 to 4+, for example). Up arrows indicate upgrades, down arrows indicate downgrades. Population data for Serbia include Kosovo.

Table 1.2
Changes in non-infrastructure transition scores

Country	Transition indicator	Change in score	Reason for change
Albania	Large-scale privatisation	3+ to 4-	Important privatisations in power, telecommunications and banking sectors.
Belarus	Price liberalisation	3- to 3	Abolition of requirement to register price increases for various goods.
	Banking reform and interest rate liberalisation	2 to 2+	Suspension of lending caps on interest rates, introduction of universal deposit guarantees and improved supervision of banking sector.
Croatia	Competition policy	3- to 3	Continued improvement of the law enforcement track record and further strengthening of the competition law.
FYR Macedonia	Securities markets and non-bank financial institutions	2+ to 3-	Significant pension reforms with introduction of voluntary pension funds.
Kazakhstan	Banking reform and interest rate liberalisation	3 to 3-	Significant deterioration in credit portfolios, sharp drop in lending to private sector and expansion of state role in major banks.
Latvia	Competition policy	3 to 3+	Continued improvement of the law enforcement track record and further strengthening of the competition law.
	Banking reform and interest rate liberalisation	4 to 4-	Nationalisation of a majority stake in the largest banking group.
Montenegro	Large-scale privatisation	3+ to 3	Re-acquisition by the state of a significant stake in the country's largest exporter.
	Competition policy	2- to 2	An independent directorate for protection of competition was established in 2007 and became operational in 2008 following amendments to the Law of Competition Protection.
Serbia	Trade and foreign exchange system	4- to 4	Unilateral implementation of major trade agreement with the European Union.
Tajikistan	Governance and enterprise restructuring	2- to 2	Significant improvements in governance and transparency of large enterprises, progress in resolution of cotton debt.
Ukraine	Governance and enterprise restructuring	2 to 2+	Introduction of joint-stock company law designed to strengthen property and minority shareholders' rights.
	Trade and foreign exchange system	4+ to 4	Introduction of foreign exchange controls as a response to pressures in the currency markets.

Source: EBRD

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

Table 1.3
Infrastructure transition scores, 2009

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

Source: EBRD.
Note: An arrow indicates a change from the previous year. One arrow indicates a movement of one point (from 4 to 4+, for example). Up arrows indicate upgrades from the previous year.

Table 1.4
Changes in infrastructure transition scores

Country	Transition indicator	Change in score	Reason for upgrade
Albania	Electric power	3– to 3	Significant progress in unbundling, commercialisation and privatisation.
	Roads	2 to 2+	Cumulative improvements over several years in road sector financing and in open tendering of maintenance contracts.
FYR Macedonia	Telecommunications	3+ to 4–	Introduction of fixed and mobile number portability and greater competition in the market.
Georgia	Water and wastewater	2 to 2+	Introduction of an independent regulator and consolidation of water companies.
Montenegro	Railways	2– to 2	Adoption of a restructuring plan in line with EU directives.
	Roads	2 to 2+	Signing of the first public–private partnership (PPP) in the roads sector (a 30–year concession for maintenance and management of the motorway).
Slovak Republic	Roads	2+ to 3–	Signing of a number of PPP projects for the first time in the country.

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

Box 1.1
The spread of the crisis across the transition region

To track the severity of the crisis throughout the transition region, a "crisis index" was constructed for each country and three points in time: March 2008, December 2008 and March 2009 (see Map 1.1.1). The index ranges between 1 and 4 and is a sum of four subindices that measure whether a country experienced:

— a 25 per cent (or more) depreciation of the nominal exchange rate in relation to the US dollar

— a nominal house-price decline of 20 per cent or more since the pre-crisis peak

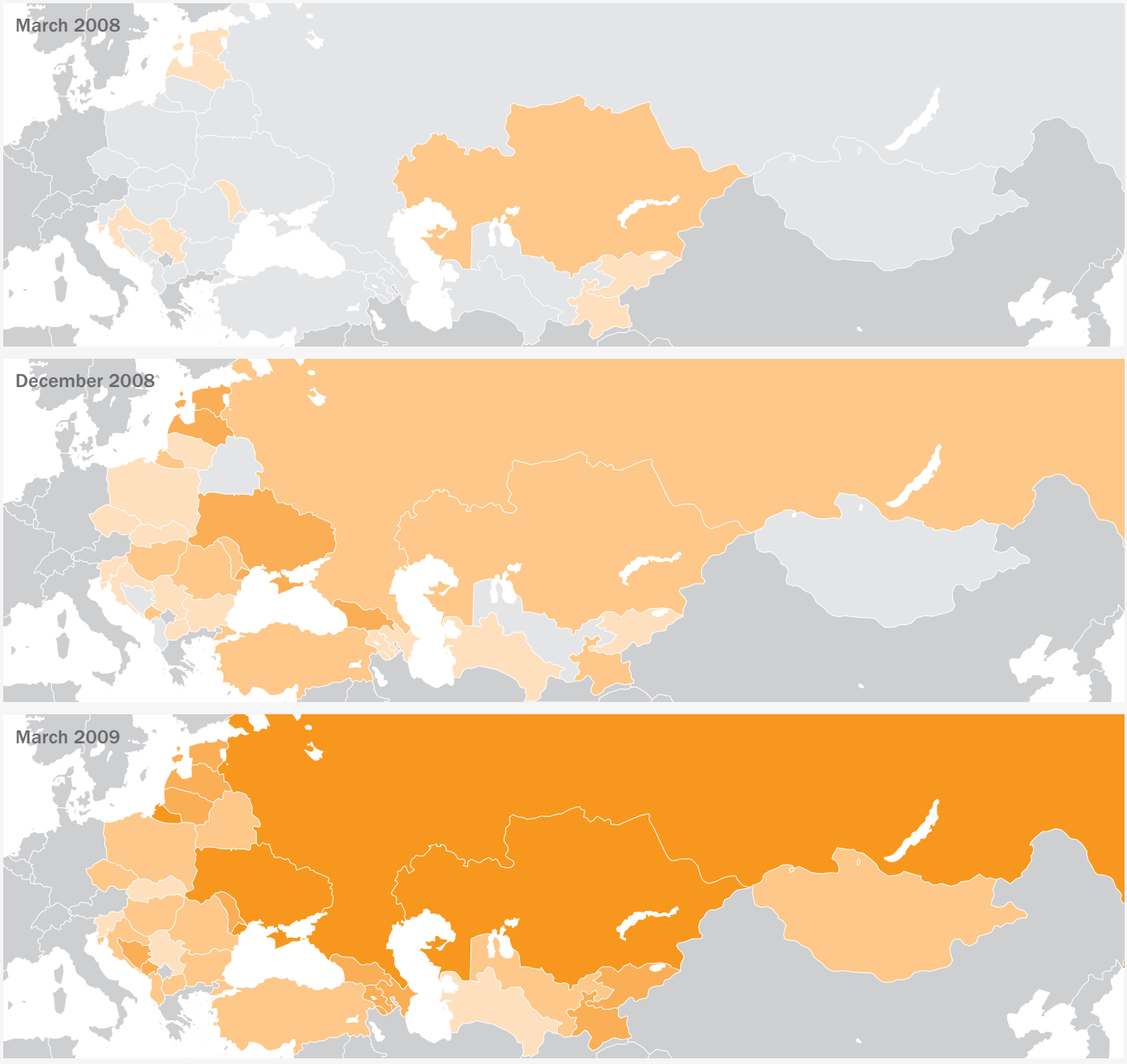
— two (or more) months of declining industrial production within the previous six months

— two (or more) consecutive months of declining net credit within the previous six months.

The subindices take the values of 1 if a particular condition is met and zero otherwise.

The maps confirm that there were signs of crisis by the first quarter of 2008 but only in a few countries, including Kazakhstan, the Baltic states and some SEE countries. By the end of 2008 most countries were affected to some extent and by the first quarter of 2009 the crisis had spread across the whole region, albeit with different speed and intensity, affecting Kazakhstan, Russia and Ukraine

Map 1.1.1
How the crisis spread across the transition region

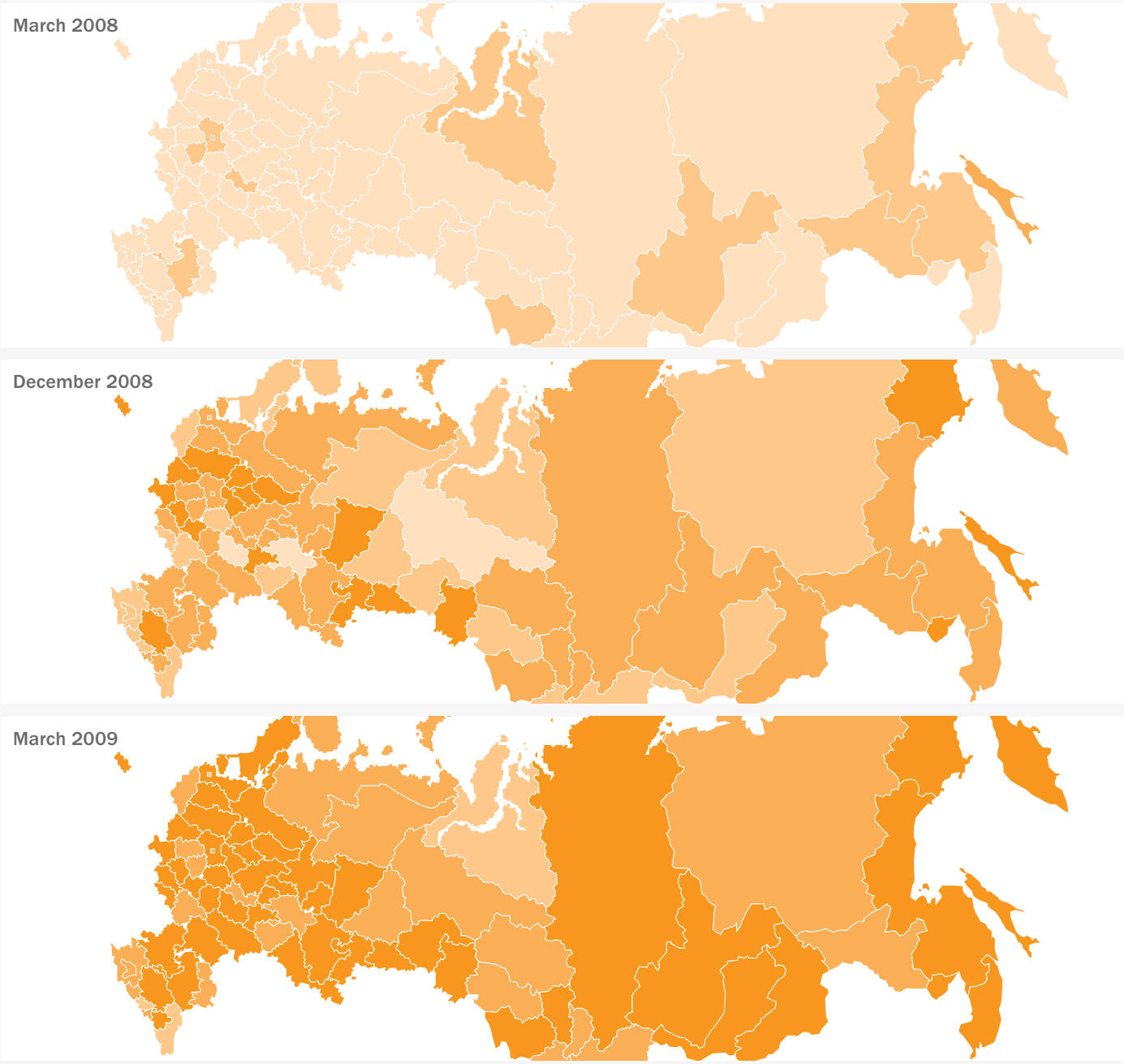


Sources: IMF *International Financial Statistics*, CEIC Database, national authorities and EBRD staff calculations.

particularly heavily (the Baltic states were also heavily affected in terms of declines in house prices, credit and industrial production, but miss the top score because the index uses nominal currency depreciations as one of its components).

Although in Russia as a whole the full impact of the crisis was felt later than in the CEB countries, some of its regions were affected sooner and more severely than others. To show this, a similar crisis intensity index was constructed for each of the 83 Russian regions (see Map 1.1.2).[1] A visual inspection of the spread of the crisis throughout the Russian regions, as well as additional empirical work, suggest that richer regions were on average hit harder, as were regions specialising in manufacturing. Interestingly, the share of construction in gross regional product (GRP) is negatively associated with the crisis severity, probably due to the fact that implementation of many large construction projects, especially public ones, continued during the crisis. The share of mining and natural resources in GRP does not appear to have had a significant impact on the depth of the crisis. Regions with more developed banking sectors, as measured by the corporate credit to GRP ratio, and those regions less reliant on federal transfers, also appear to have been more resilient.

Map 1.1.2
How the crisis spread across Russia



Sources: RosStat, Central Bank of Russia and EBRD staff calculations.

July 2007 to September 2008: boom as usual?

During its first four quarters the crisis left most transition economies largely unaffected. With the exception of Kazakhstan and the three Baltic states, where extreme credit booms had peaked and begun to reverse even before the onset of the global crisis, credit growth continued unabated. Domestic demand generally remained buoyant and high commodity prices supported growth in Russia and other resource-rich countries (see Chart 1.2). The proximate cause for this was continued abundant foreign financing, notwithstanding the credit crunch at the centre of the financial system (see Chart 1.2a, showing bank lending flows to the region).

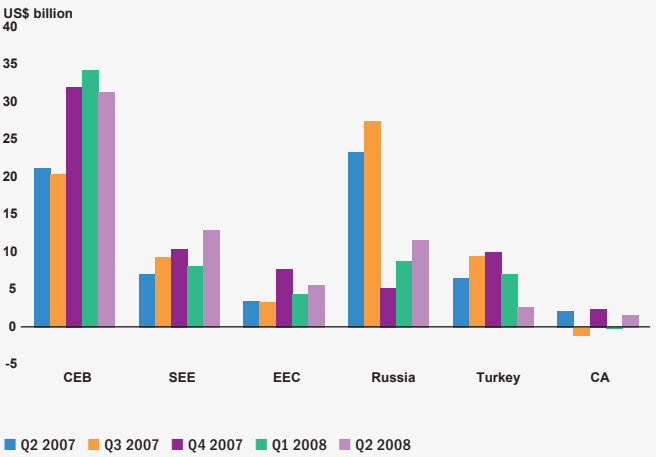
The lack of an initial "sudden stop" in capital flows to the transition region was part of a general decoupling of emerging market finance from the crisis in the advanced world during its first year. This phenomenon is sometimes attributed to the fact that the crisis originated in US mortgage and other asset markets – to which emerging market countries were not directly exposed. However, this misses the point that historically, financial crises in the United States have almost always spilled over to emerging markets, as investors withdrew from all types of risky assets. Box 1.2 documents this fact and shows that the current crisis was initially different in this respect.

What caused the difference? One possibility is that emerging market fundamentals improved since the last round of crises at the end of the 1990s and so were less prone to contagion. This is certainly true for Latin America, which narrowed its external deficit, greatly improved its public finances and sharply reduced its foreign currency borrowing. But is it also true for emerging Europe, where expansion was financed by high external borrowing, much of it in foreign currency?

Chart 1.2

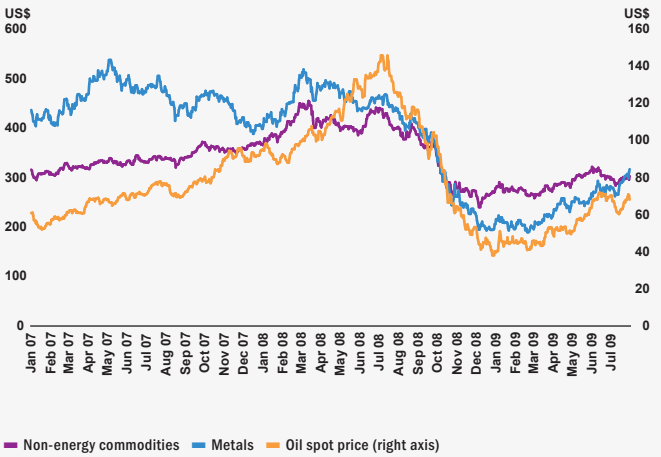
Key economic indicators during the period of decoupling, 2007-Q2 2008

1.2a Cross-border bank lending



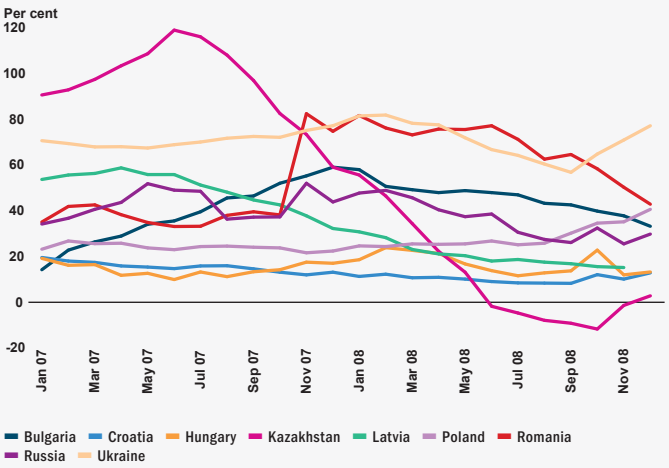
Source: Bank of International Settlements (BIS) and EBRD calculations.

1.2b Commodity prices (indices)



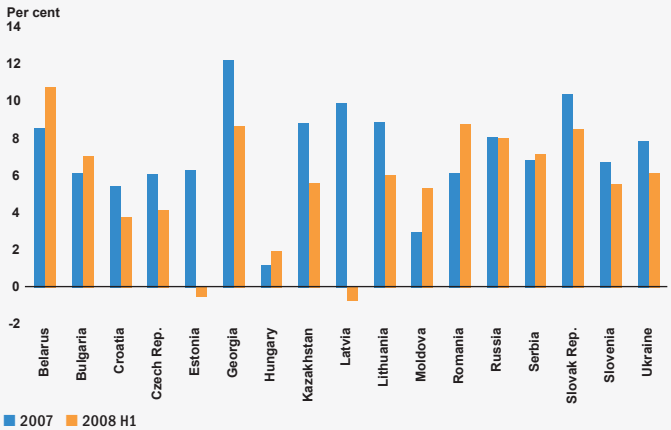
Source: Bloomberg.

1.2c Credit growth, year-on-year in per cent



Source: IMF.

1.2d Real GDP growth in per cent



Source: CEIC and EBRD calculations.

Note: BIS locational dataset 6A, exchange rate-adjusted changes in external assets of BIS-reporting banks.
CEB (central Europe and the Baltic states) SEE (south-eastern Europe), EEC (eastern Europe and the Caucasus) and CA (Central Asia).

Box 1.2

Financial "decoupling" during the first phase of the crisis

Ever since the first era of financial globalisation in the 19th century, crises at the centre of the world financial system have regularly spilled over to emerging market countries. In addition to trade and commodity price channels, this has happened through the reversal of financial flows, as investors in advanced countries needed liquidity, or as part of a general retreat from risky assets. As a result, the prices of risky assets in advanced countries and emerging markets have typically moved in tandem during periods of crisis. However, this was not the case – or only to a much more limited extent – in the first phase of the financial crisis (July 2007 to September 2008).

This fact can be documented by examining the relationship between the VIX (a widely used measure of US stock market risk) and the emerging market bond spread index (EMBI) published by J.P. Morgan, which measures emerging market risk during episodes of US financial market volatility. The episodes were identified based on the level of VIX during the first phase of the most recent crisis, from late July 2007 to 12 September 2008. During this period, the VIX consistently exceeded 20 percentage points (except for a few weeks in May and early June of 2008), and stood at about 23 points on average (this means that financial markets expected a change in US stock prices of 23 per cent on an annualised basis, in either direction, over the next 30 days). A search of similar periods since the late 1980s resulted in four episodes: one in the early 1990s, two during 1997-99 and a longer period from September 2000 until May 2003. The episodes during 1997-99 were excluded because they were related in part to turmoil in the emerging markets (the Asian and Russian crises, respectively). The other two episodes were driven by events in the United States: the 1991 recession; the recession of 2001; the terrorist attacks of September 2001; and hopes of a market recovery in the second half of 2002.

Table 1.2.1 shows the average relationship between the VIX and the EMBI during these episodes as well as the first two phases of the 2007-09 crisis, estimated by running a simple linear regression of the EMBI on the VIX during these periods. The lower part of the table shows the results from a similar regression using the EMBI subindex for emerging Europe, rather than the full EMBI, as the dependent variable.

The table shows that emerging market risk premiums were highly correlated with the VIX during the US recession and volatility periods in 1991 and 2000-03.[2] In contrast, the average response of the EMBI to the VIX during the first phase of the crisis was much lower and it can explain only 9 per cent of the variation in emerging market risk spreads during this period (compared with 43 to 50 per cent during the two earlier US recessions).

In the second phase of the crisis (September 2008 to March 2009) there was some "recoupling" but the average response of the EMBI to the VIX and the proportion in its variation that can be explained by the VIX remained relatively low, at only about half the levels observed during past US recessions.

Table 1.2.1

Average response of emerging market risk premiums to US stock market risk

(Regression coefficients, standard errors in parentheses)

Variable	Sample period[1]			
	1991	2000–03	2007–08	2008–09
Dependent variable: emerging market bond spread index (EMBI, JPEIDISP)[2]				
Regression coefficient on VIX	11.6	8.7	3.4	5.4
	(1.43)	(0.33)	(0.65)	(0.80)
R squared	0.43	0.50	0.09	0.30
Dependent variable: bond spread subindex for emerging Europe (JPSSGEUR)				
Regression coefficient on VIX	na	–0.9	2.6	5.6
		(1.16)	(0.68)	(0.93)
Regression R squared	na	0.00	0.05	0.24

Sources: Bloomberg (VIX, JPEIDISP, JPSSGEUR) and J.P. Morgan (EMBI during 1991).

Note: [1] The sample period comprises 31 December 1990 to 11 March 1991 (constrained by EMBI data availability); 18 September 2000 to 8 May 2003; 26 July 2007 to 12 September 2008; 15 September 2009 to 31 March 2009. Regressions use daily data. [2] EMBI for 1991; EMBI Global (JPEIDISP) for remainder.

Chapter 2 shows that the boom period indeed created some of the macroeconomic vulnerabilities that have typically preceded emerging market currency collapses and banking crises. However, it also avoided several of the problems associated with past emerging market booms. Fiscal positions were generally sound, and public debt remained low. Unlike the Asian crisis, financial sectors were mostly healthy (see Box 1.3 on page 12). Furthermore, the structure of foreign capital was better – in the sense of being less prone to sudden reversal – than had been typical for emerging market finance. Much of it came in the form of foreign direct investment (FDI) and although private debt flows also played an important role, they were often intermediated by the local subsidiaries of foreign banks with long-term interests in the region. The role of these banking groups both in shaping the impact of the crisis on the transition region and in the longer term will be a recurrent theme of this *Transition Report* (see Chapters 2 and 3).

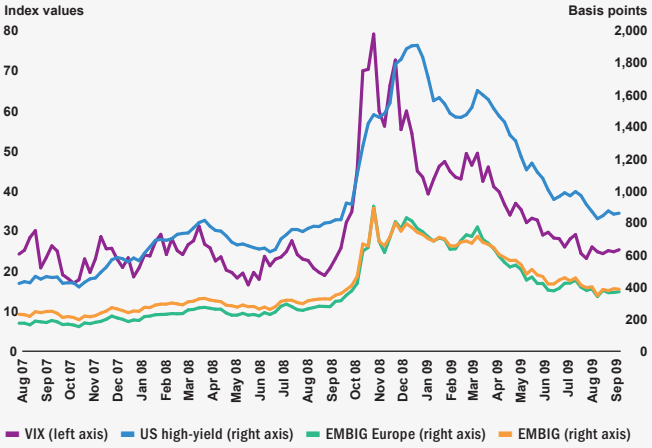
The crisis hits (September 2008 to March 2009)

The crisis finally arrived, with successive blows, in the third quarter of 2008. Commodity prices collapsed in July; the reserves accumulation in Russia and Ukraine reversed; and the conflict between Russia and Georgia in August 2008 began to undermine confidence. Most importantly, following the collapses of Lehman Brothers and Washington Mutual in the United States in mid-September, financial contagion finally occurred. Emerging market risk premiums shot up, new loan syndications dropped sharply and cross-border net lending turned negative. At the same time, export volumes contracted by 5-15 per cent in the fourth quarter of 2008 relative to the same quarter of the previous year, and by 10-25 per cent in the first quarter of 2009 (see Chart 1.3). FDI flows also declined, although net inflows remained positive.

Chart 1.3

The crisis hits: financial and export shocks

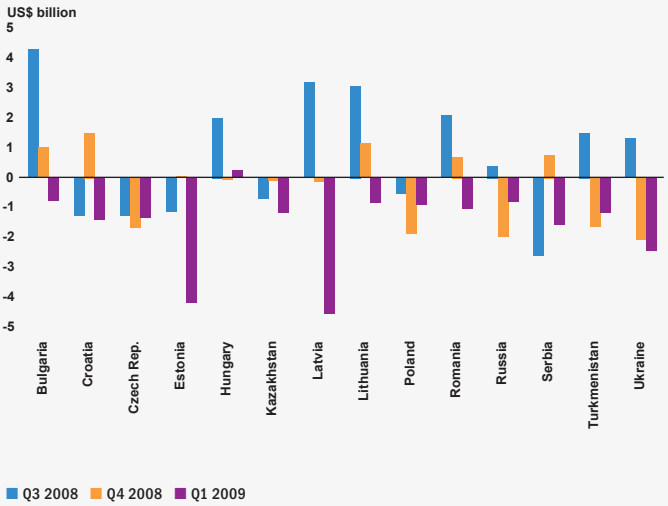
1.3a Risk spreads in the United States and emerging markets



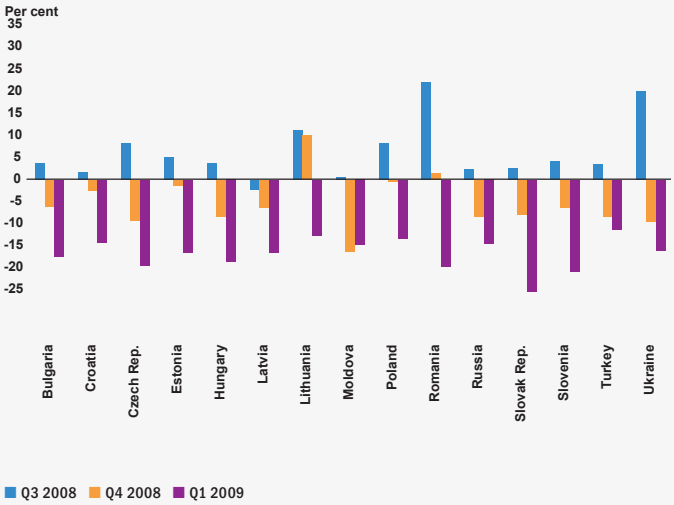
1.3b Syndicated lending to private borrowers in the transition region



1.3c Cross-border bank lending



1.3d Export volumes



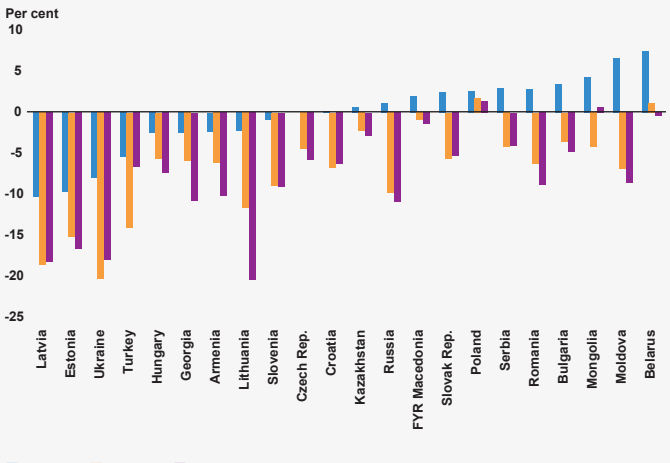
Sources: Bloomberg, Dealogic Loan Analytics, BIS, national statistical offices via CEIC.
Note: For a full explanation of VIX, EMBIG and EMBIG Europe please refer to Box 1.2.

Economic activity contracted rapidly, with almost no lag. By November 2008 many countries were experiencing large declines in industrial production and the stock of outstanding bank credit began to contract for the first time in years. By February 2009 the crisis was spilling back over from the real to the financial sector, as fears of bank credit losses triggered a new wave of currency pressures. First quarter output growth was sharply negative even in countries that had remained relatively resilient in the fourth quarter of 2008, such as Bulgaria, Moldova, Mongolia, Romania, Russia and the Slovak Republic. The output collapse was almost universal, albeit with large, and sometimes puzzling, cross-country differences (see Chart 1.4). For example, Bulgaria, Romania and Serbia were much harder hit than Poland, which managed to escape any output decline, notwithstanding large declines among all the major trading partners.

What explains the speed and virulence of output contractions in most of the EBRD's countries of operations? Based on the experiences in other emerging market crises, such as the Asian crisis in 1997 and the downturn that followed the Russian default in 1998, the lead suspect is the sudden stop in capital inflows in the fourth quarter of the year. However, except in a few countries – notably Estonia, Latvia, Russia and Ukraine, which suffered very large outflows as a share of GDP in either the fourth quarter of 2008, the first quarter of 2009, or both – the reversal in bank lending to the region was surprisingly mild.[3] This is true both compared with the sharp rise in country risk that preceded it (see Chapter 2), and compared with other regions (see Chart 1.5). Using a broader measure of capital flows – the financial account of the balance of payments, which includes FDI and portfolio investment – net capital flows were still slightly positive in the fourth quarter in the transition region, if Russia, which suffered a US$ 136 billion outflow, is excluded.

Chapter 2 examines the dynamic of output in the transition region in detail and finds that in most countries, contractions in trading partner growth appear to have been a more important cause of the output decline than capital outflows. Further, export and financial shocks magnified the reversal of credit booms that had already been under way in many countries before the September shock. Chapter 2 also analyses the determinants of debt outflows from the region as well as from emerging markets more broadly, and concludes that the presence of foreign banks is likely to have played a mitigating role in limiting the outflow of capital from financially integrated transition countries.

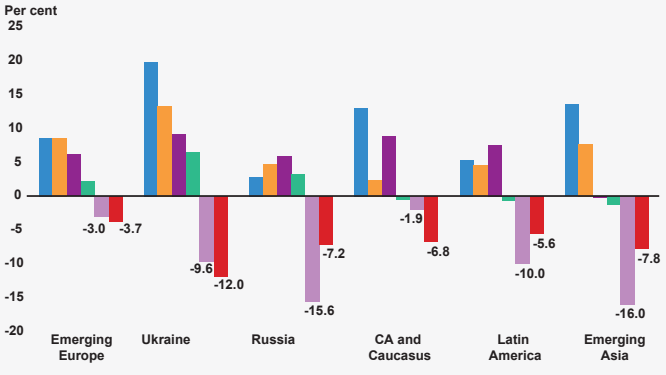
Chart 1.4
Real GDP growth, Q4 2008 to Q2 2009



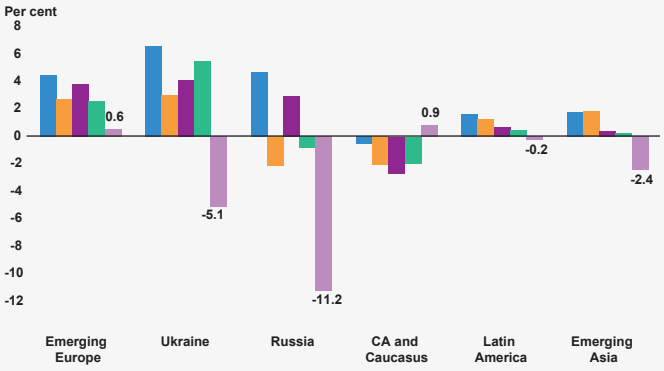
Sources: Eurostat, CEIC and national statistical offices.
Note: For Armenia, Kazakhstan and Serbia, Q2 2009 numbers are EBRD estimates.

Chart 1.5
Financial flows to developing and emerging market countries, Q4 2007 to Q1 2009

1.5a Percentage changes in external assets of BIS-reporting banks



1.5b Financial account flows in percentage of previous year's total external liabilities[1]



Sources: BIS locational dataset 6A; IMF *International Financial Statistics* and gross external liability data from Lane and Milesi-Ferretti (2006), updated by Abiad et al (2009).
Note: [1] Changes in aggregate financial account balances (balance of payments) for the countries in the groups expressed in percentage of gross external liabilities at the end of 2007. Emerging Europe excludes Russia and Ukraine. Emerging Asia excludes China, Central Asia and Caucasus. Central Asia and Caucasus excludes Mongolia, Turkmenistan and Uzbekistan.

Box 1.3

Comparing the 1997–98 Asian crisis with the 2008–09 crisis in emerging Europe

Of all of the previous major emerging market crises, the 1997–98 Asian crisis arguably shares the most similarities with the present crisis in the transition region. Both crises ended a period of large capital inflows that fuelled domestic demand and asset price booms, and led to large current account deficits. In many countries, perceived exchange rate stability and low foreign exchange (FX) interest rates encouraged corporations and households to borrow in foreign currency. In both cases, vulnerabilities were concentrated in the private sector, while public sector balance sheets remained broadly sound and public debt low. Both crises were accompanied by large output declines and sharp reversals of capital flows in most of the crisis-hit countries. However, there are also some interesting differences between the two crises.

The present crisis occurred in a much less benign global environment

The current external macroeconomic environment is substantially more difficult than that which prevailed during the 1997 Asian crisis (see Chart 1.3.1). The current distress of eastern European economies exists amid the sharpest and most coordinated downturn in post-war history. For 2009, the IMF's *World Economic Outlook* projects a contraction in the global trade volume of almost 12 per cent. This compares with positive trade growth in 1997 of more than 10 per cent. Similarly, in 1997 despite the Asian crisis, capital inflows into all emerging markets still grew at 1.5 per cent. In contrast, the IMF projects a generalised retrenchment of capital inflows into emerging markets to almost 0 in 2009.

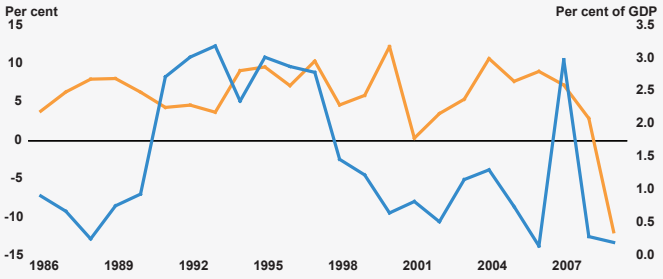
While output declines have been comparable across the crises, financial distress has been thus far more contained in the present crisis

At the height of the current crisis, cumulatively during the fourth quarter of 2008 and the first quarter of 2009, output contracted on average by some 6.5 per cent in the transition region (and 12.5 per cent in the Baltic states), broadly comparable to output declines during the Asian crisis (see Chart 1.3.2). However, with the exception of a few countries – particularly Latvia, Russia and Ukraine, see Chart 1.3.3 – capital outflows from emerging Europe were milder, with average outflows of 1 per cent of GDP across the region in the fourth quarter of 2008 and the first quarter of 2009, as against average outflows of 4.5 per cent during the worst two quarters in 1997 in East Asia. With the exception of Ukraine, exchange rate depreciations were milder and far more controlled (see Chart 1.3.4). Unlike currencies during the Asian crisis, eastern European currencies did not go into freefall for extended periods of time.

The financial systems in eastern Europe have also held up better. According to the IMF, the worst-hit banking systems – Latvia and Ukraine – have required liquidity support of 6.75 and 7.50 per cent of GDP, respectively. This is comparable with the support given to banks in Malaysia and Korea (5 and 7 per cent, respectively), but remains far below liquidity injections in Indonesia (17 per cent) and Thailand (22 per cent). With the exception of Kazakhstan, non-performing loans in emerging Europe have so far remained far beyond the levels

Chart 1.3.1

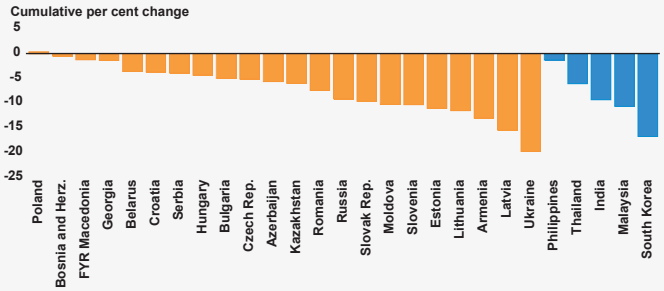
External shocks



Source: IMF (2009), *World Economic Outlook*, Washington D.C.

Chart 1.3.2

Real GDP two quarters following onset of the crisis[1]

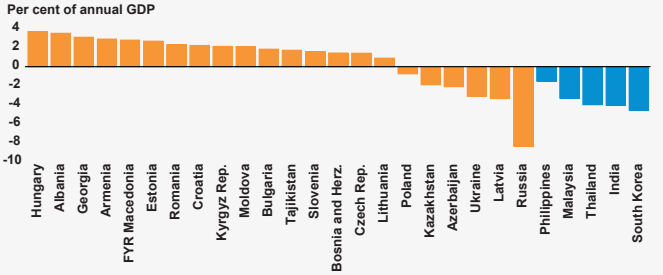


Source: IMF *International Financial Statistics* and country authorities.

Notes: [1] Q1 2009 over Q3 2008 for transition region, Q1 1998 over Q3 1997 for East Asia (except for Q2 1998 over Q4 1997 for Korea).

Chart 1.3.3

Capital, financial account, and error and omissions

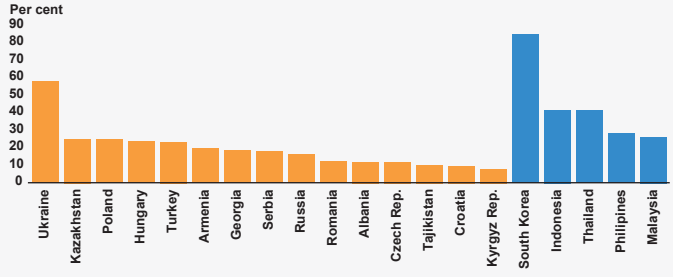


Source: IMF *International Financial Statistics*.

Note: Q4 2008 for transition economies and Q4 1997 for East Asian crisis countries.

Chart 1.3.4

Maximum depreciation during crisis or the following quarter[1]



Source: IMF *International Financial Statistics*.

Notes: [1] Q1 2009 over Q3 2008 for transition region, Q1 1998 over Q3 1997 for East Asia (except for Q2 1998 over Q4 1997 for Korea). Exchange rate defined as local currency against the US dollar.

of 30 to 35 per cent of total loans estimated for the four worst crisis-hit countries in Asia, although they are still rising, and likely to be underestimated by the official data.

The nature of pre-crisis vulnerabilities was different, with financial sector problems more extensive in Asia and macroeconomic imbalances more prominent in the present crisis

Many transition countries entered the crisis with larger macroeconomic vulnerabilities than their East Asian counterparts. In the Balkan countries, the Baltic states and the Caucasus, as well as Tajikistan, credit-fuelled domestic demand booms led to large current account deficits. Despite similar real GDP growth rates, current account deficits were smaller in East Asia due to less pronounced credit booms and stronger real exports. By 2007 several years of current account deficits in eastern Europe had culminated in stocks of gross external debt well in excess of those in the Asian crisis countries in 1996 (see Chart 1.3.5). While, by 1996, the Asian crisis countries had accumulated fiscal surpluses for three years or more, only Bulgaria, Estonia and the commodity-exporting countries had similarly strong fiscal positions by 2007.

By contrast, financial sector vulnerabilities were generally smaller in the transition region, which entered the crisis with smaller and more foreign-owned banking systems than those of East Asia in the mid-1990s (see Table 1.3.1). While financial system assets in the East Asian economies ranged from 90 to 300 per cent of GDP in the mid-1990s, those in eastern Europe ranged from 70 to 150 per cent of GDP by 2008. With the exceptions of Azerbaijan, Kazakhstan and Russia, banking systems in the European transition region are generally majority foreign-owned, while in East Asia foreign ownership was very low. Capital inflows into East Asian countries in the first half of the 1990s were largely intermediated through capital markets rather than subsidiaries and branches of foreign banks.

International financial support has been much greater in the current crisis

Support from international financial institutions and bilateral donors to East Asia amounted to at most 2.25 per cent of GDP, while IMF and EU support in eastern Europe has ranged between 4 and 6 per cent of GDP or more for the four eastern European countries that have accepted IMF programmes (see Chart 1.3.6). Together with the difference in the nature of pre-crisis vulnerabilities, this may explain why the crisis outcomes have so far been no worse in the transition countries compared with Asia, despite the far larger shocks at the global economic level experienced in this crisis.

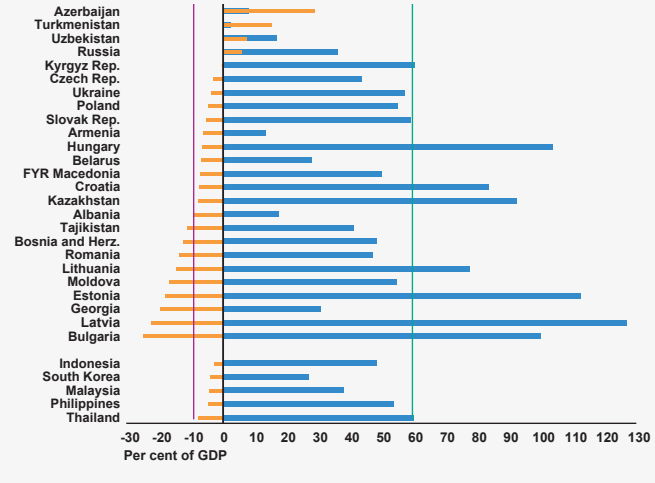
Table 1.3.1
Characteristics of financial systems, most recent data available (2005–08)

	Total assets of financial system (per cent of GDP)	Share of banks	Share of non-banks	Share of foreign-owned banks (per cent of banking system assets)[1]
Indonesia	90	86	14	4
Korea	300	70	30	2
Philippines	115	92	8	2
Thailand	190	74	26	9
Croatia	116	74	26	85
Czech Republic	146	75	25	84
Estonia	141	89	11	99
Kazakhstan	74	82	18	16
Latvia	154	92	8	60
Lithuania	80	95	5	75
Poland	97	75	25	70
Romania	74	83	17	88
Russia[2]	158	33	67	17
Slovak Republic	95	89	11	96
Ukraine	na	na	na	50

Sources: Claessens et al (2008) and Lindgren et al (1999); Financial Sector Assessment Programmes for the Baltics and the Slovak Republic; IMF Nordic–Baltic Seminar; IMF Staff Reports and Financial Stability Reports of Austria, Croatia, the Czech Republic, Kazakhstan, Poland, Romania and Russia; and staff calculations.

Note: [1] 1996 for East Asian countries, most recent available for transition economies.
[2] Financial system assets defined as the sum of banking sector assets, stock market and bond market capitalisation.

Chart 1.3.5
Current account balance and gross external debt

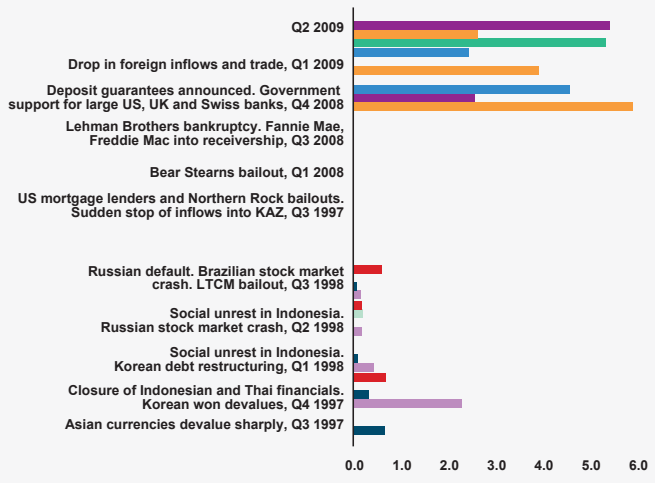


Gross external debt Current account balance

Source: IMF, *International Financial Statistics*.

Note: Data for eastern Europe and Central Asia are from 2007. Data for East Asia are from 1996. The purple and green lines show the maximum reached in the Asia crisis for current account balances and gross external debt, respectively.

Chart 1.3.6
Official support (per cent of GDP)



Korea Thailand Philippines Indonesia Hungary Latvia Romania Ukraine

Sources: IMF Finances by Country and IMF Staff Reports.

Tentative stabilisation with rising crisis costs (April 2009–present)

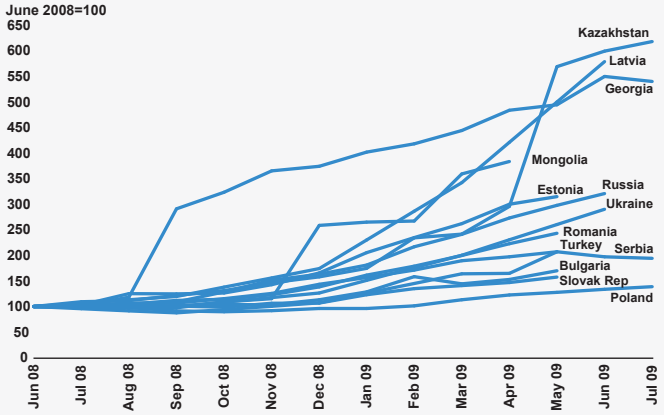
In line with the general recovery in international financial markets, regional financial indicators began to point upwards in March 2009. Industrial output declines slowed or reversed in a number of countries and confidence indicators stabilised. In the second quarter, output growth turned positive on a quarter-by-quarter basis in a number of countries, including Croatia, Kazakhstan, Poland, Russia, Serbia, the Slovak Republic, Slovenia, Turkey and Ukraine. In other countries the contraction continued but the pace of decline slowed relative to the first quarter.

At the same time, the ripple effects of the financial and real shocks began to be felt in the corporate, household and banking sectors, with rises in unemployment, corporate insolvencies and non-performing loans. Excluding Central Asian countries, where the rise in recorded unemployment has so far been negligible, average unemployment rose by about 2.3 percentage points on average between September 2008 and June 2009.[4] Over the same period, officially reported non-performing loans rose dramatically, sometimes by several hundred per cent (see Chart 1.6). As a percentage of total loans, they rose from the low single digits to about 7 per cent on average in central and south-eastern European countries, 10 per cent in Ukraine, 12 per cent in Latvia and over 30 per cent in Kazakhstan.

Notwithstanding these stresses, a remarkable feature of the crisis has been the fact that uncontrolled currency collapses and systemic banking crises have largely been avoided so far, in spite of the vulnerabilities accumulated during the boom years and the magnitude of the external shocks and output declines. That said, there were episodes of intense deposit withdrawals, particularly in October and November of 2008, as well as heavy pressure on currencies. Some currencies in the region depreciated by as much as 25 per cent in real terms between September and March, and several countries, including Bulgaria, Latvia, Russia and Ukraine, suffered heavy reserve losses (see Chart 1.7). Only in Ukraine, however, did the currency declines resemble currency collapses typical of past emerging market crises, such as the Asian crisis (see Box 1.3). And even in Ukraine, the banking crisis has so far been contained.

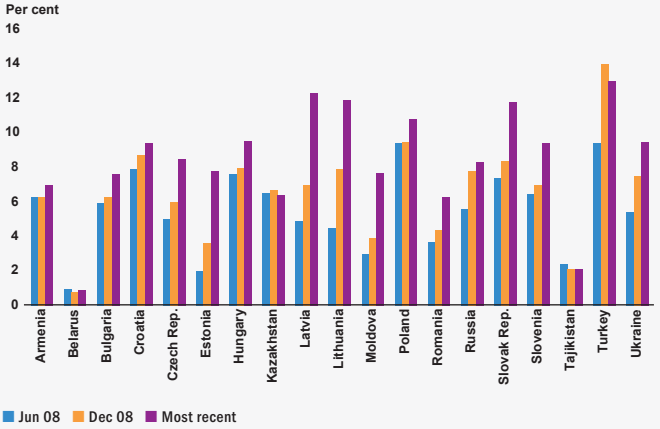
Chart 1.6
The rising costs of the crisis

1.6a Growth of non-performing loans (index)



Sources: CEIC Data Company and EBRD calculations.
Note: As defined by national authorities.

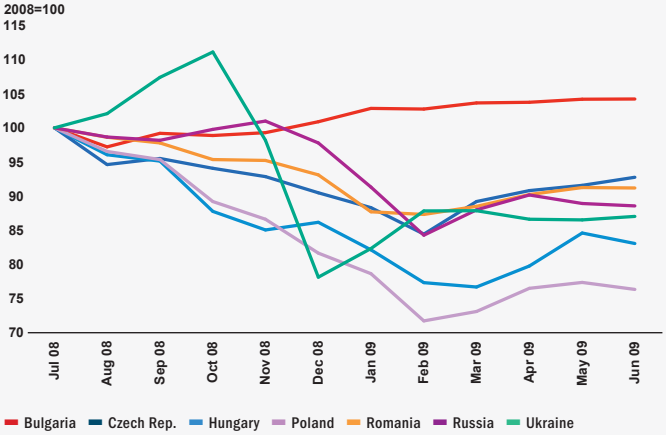
1.6b Unemployment



Sources: CEIC Data Company and IMF.
Note: Most recent data represent March 2009 for Croatia, Lithuania, Moldova and Ukraine; June 2009 for Armenia, Belarus, Estonia, Hungary, Slovak Rep., Tajikistan and Turkey; July 2009 for Bulgaria, Romania, Russia and Slovenia; and August 2009 for other countries.

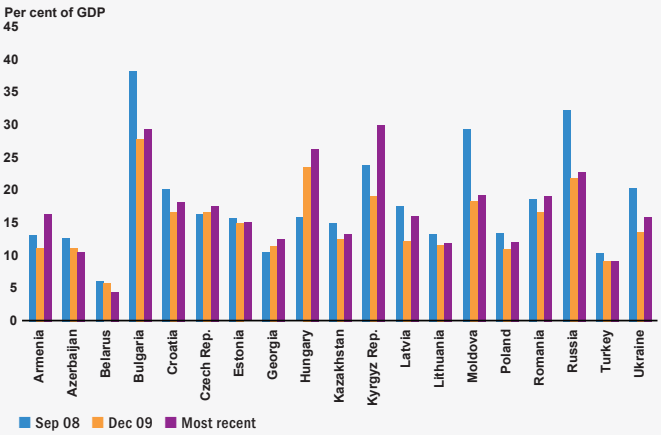
Chart 1.7
Real exchange rates and reserves in the crisis period

1.7a Real exchange rates



Source: IMF.
Note: In Chart 1.7b the most recent data represent May 2009 for Moldova; June 2009 for Poland; and July 2009 for all other countries.

1.7b Reserves



The region's resilience to the threat of uncontrolled collapse is related to three factors. First, except in Latvia, Russia and Ukraine, the capital reversal in the fourth quarter of 2008 and the first quarter of this year was generally moderate – not just compared with other regions but also compared with previous emerging market crises, such as the Asian crisis (see Box 1.3). This limited the pressure on currencies and banking systems, which in turn limited the losses in confidence which could have led to runs on deposits. Second, while the region shared some of the vulnerabilities associated with emerging market boom periods in the past – particularly large external imbalances and large private sector liabilities denominated in foreign currency – its financial systems were smaller and much more sound in terms of their underlying credit quality and ability to absorb shocks (see again Box 1.3 for a comparison with emerging Asia in 1997). Third, the domestic and international policy responses were consistent, fast and vigorous, as described below.

Domestic policy responses to the crisis

Following the intensification of the crisis in September 2008, financial sector stability became a priority in almost all countries in the region. Other than that, economic policies have been heterogeneous, ranging from expansionary to highly contractionary.

Governments attempted to safeguard *financial sector stability* through a range of instruments, including deposit guarantees, liquidity injections and the recapitalisation of banks (see Table 1.5). In October and November 2008 most governments in the region reacted quickly to counter the growing threat of large deposit withdrawals by expanding their deposit insurance schemes, even though such initiatives were only poorly coordinated between countries. Russia and Ukraine increased their guarantees for individual deposits to around €20,000. Other governments extended their protection to around €50,000 (the EU norm) or €100,000 (Lithuania), and Montenegro, the Slovak Republic and Slovenia even committed to unlimited coverage.

Central banks and supervisors also took measures to expand banking system liquidity. A first plank of this policy was to reverse the liquidity-draining measures of the previous credit boom. Central banks in Belarus, Croatia, Poland, Romania, Russia and Serbia reduced reserve requirements in October 2008. The previous boom in foreign currency credit had created large refinancing requirements in many countries, and the central banks of Hungary and Serbia provided foreign currency swap facilities. The European Central Bank (ECB) assisted such initiatives through offering repurchase (repo) facilities for euro-denominated assets offered by the Polish and Hungarian central banks. As in the advanced financial markets, these measures helped to ease liquidity pressures on banks, although at the risk of displacing private interbank markets. In the face of sharp economic contractions and currency depreciations, several governments, notably in Kazakhstan, Latvia and Ukraine, were forced to recapitalise failing banks. In Kazakhstan, the government took a majority stake in the country's largest bank and a minority stake in two other major banks.

Table 1.5
Financial sector anti-crisis measures

	Deposit insurance expanded	Additional liquidity measures	Guarantees, capital injections
Hungary	■	■	■
Slovenia	■	■	■
Serbia	■	■	■
Russia	■	■	■
Romania	■	■	■
Belarus	■	■	■
Poland	■	■	■
Lithuania	■	■	■
Ukraine	■	■	■
Czech Republic	■	■	■
Bulgaria	■	■	
Croatia	■	■	
Bosnia and Herzegovina	■	■	
Slovak Republic	■	■	
Albania	■	■	
Latvia		■	■
Kazakhstan	■		■
Turkey		■	■
Estonia		■	

Source: EBRD.

Monetary policy has been generally eased, although a few countries were forced to maintain tight policies as they sought to defend currency pegs or lean against depreciations (see Chart 1.8a). In Hungary, where 70 per cent of credit to the household sector is denominated in foreign currency, policy interest rates were raised by 3 percentage points in October 2008 to prevent an overshooting of the forint. Only when investor risk aversion abated from May 2009 did the national bank begin to ease. Russia initially maintained low real interest rates but tightened monetary policy in late January to defend its currency peg, before reversing course in late April 2009.

Mirroring the differences in pre-existing currency regimes, *exchange rate policies* have been diverse. Bulgaria, Estonia, FYR Macedonia, Latvia and Lithuania have maintained their hard pegs, in some cases in the face of rapid reserve losses and resulting contractions in money supply. Armenia, Belarus, Georgia, Kazakhstan and Russia undertook step devaluations (in the case of Russia, in a series of small steps over several months), followed in most cases by increased flexibility. Albania, the Czech Republic, Hungary and Poland continued to let their currencies float (except for Hungary's interest rate defence in October). Mongolia, Romania, Serbia and Ukraine initially allowed depreciations, followed by managed floats, which in the case of Ukraine were supported by currency controls. Most currencies in the region have been stable since May or even saw appreciations as investor risk appetite revived. Only Ukraine has recently been subject to continued depreciation pressure, in the face of still-weak domestic confidence.

With the exception of a few commodity-exporting countries benefiting from accumulated fiscal reserves (see Chapter 4), lack of external financing and fears about crowding out private sector credit have limited the scope for expansionary fiscal policy. Most countries have pursued mildly contractionary policies, allowing "automatic stabilisers" to work to some extent but limiting the rise in the budget deficit through expenditure cuts.

In a few cases, automatic stabilisers were allowed to play out more fully, as for instance in Poland, where the deficit is expected to widen to 6 per cent of GDP in 2009. Large stimulus packages were implemented in only two countries: Kazakhstan and Russia. Excluding support to the banking system, Russia's fiscal stimulus amounts to about 5 per cent of GDP, focused on social benefits and support for local governments but also some subsidies to industry. Kazakhstan implemented a discretionary fiscal stimulus of about 9.5 per cent of GDP mainly to support industry and invest in infrastructure. These packages may help explain why commodity exporters, on average, do not appear to have suffered larger output declines than their commodity-importing peers, notwithstanding large negative shocks to commodity prices (see Chapters 2 and 4).

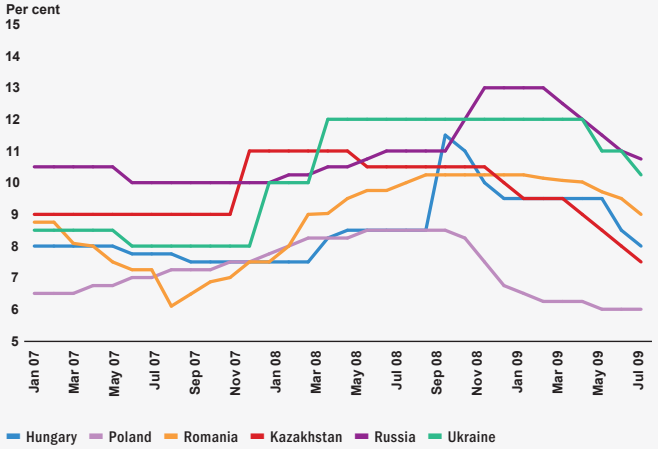
To summarise, macroeconomic and financial sector policy responses to the crisis have generally operated along similar principles to those in advanced countries. Populist and confiscatory policy reactions, a hallmark of emerging market crises in the past, were avoided. To the extent that there have been differences – particularly in the area of fiscal policy, which has generally been tighter than in advanced countries – these reflected greater difficulties in accessing capital markets during the crisis period. At the same time, however, the region has also avoided recourse to extremely tight monetary and fiscal policies which were often viewed as the price of restoring confidence in past crises, in light of heavy pressures on the balance of payments and unsustainable fiscal positions. As argued above, a plausible interpretation is both that capital outflows were generally milder, and fundamentals in the public and financial sectors generally stronger than in past emerging market crises.

International policy response

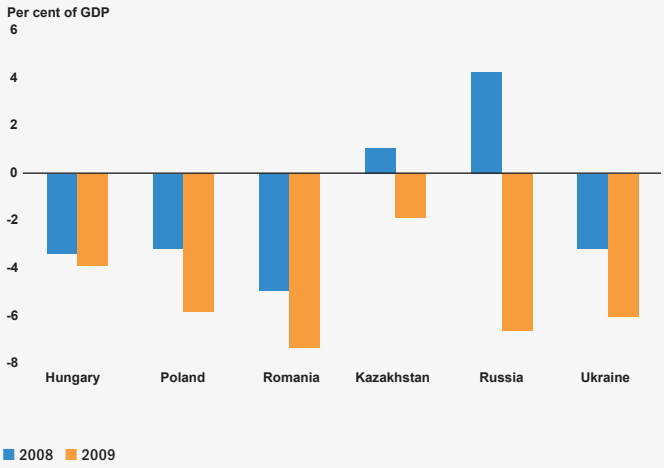
The international policy response has been coordinated, timely and involved large-scale balance of payments support. The International Monetary Fund (IMF)'s resources were tripled to US$ 750 billion, in part with a view to the emerging needs in the transition region, and the European Commission's resources for balance of payments support quadrupled to €50 billion. The two institutions jointly agreed stabilisation programmes with Hungary, Latvia and Romania, to which a number of other EU countries and international financial institutions (IFIs) also contributed. The IMF also agreed

Chart 1.8
Policy interest rates and general government deficits in selected transition countries

1.8a Policy interest rates



1.8b General government balance



Sources: IMF *World Economic Outlook* (Chart 1.8a), CEIC Data Company (Chart 1.8b).

programmes with Armenia, Belarus, Bosnia and Herzegovina, Georgia, Serbia and Ukraine. The IMF gave Poland access to €20 billion under a new flexible credit line designed for countries with sound macroeconomic fundamentals. Conditionality has been lighter than in previous crises and focused on securing financial sector stability. In total, official commitments of balance of payments support under these programmes ranged from 4 to 30 per cent of the respective country's GDP, distributed over several years (see Chart 1.9).

A significant element in the international policy response in this crisis has been conditional multinational development bank (MDB) support to the private financial sector. Under the Joint IFI Initiative, the EBRD, the European Investment Bank (EIB) and the World Bank coordinated the provision of up to €25 billion of financing to financial institutions operating in the transition region. Under the broader "Vienna Initiative", key public and private sector stakeholders have been working together to establish burden-sharing arrangements between IFIs, home countries of international banking groups and host country authorities in emerging Europe (see Box 1.4). Under this process, national authorities committed not to discriminate in the allocation of liquidity support on the basis of bank ownership, while regionally active bank groups committed to maintain exposures where possible, and provide adequate capitalisation. Specific measures were agreed under the IMF programmes for Bosnia and Herzegovina, Hungary, Latvia, Romania and Serbia. Although the ECB was not a formal partner in the Initiative, the process has benefited from the ECB's quantitative easing programme through liquidity made available to eurozone-based parent banks, which was in part passed on to subsidiaries in the region.

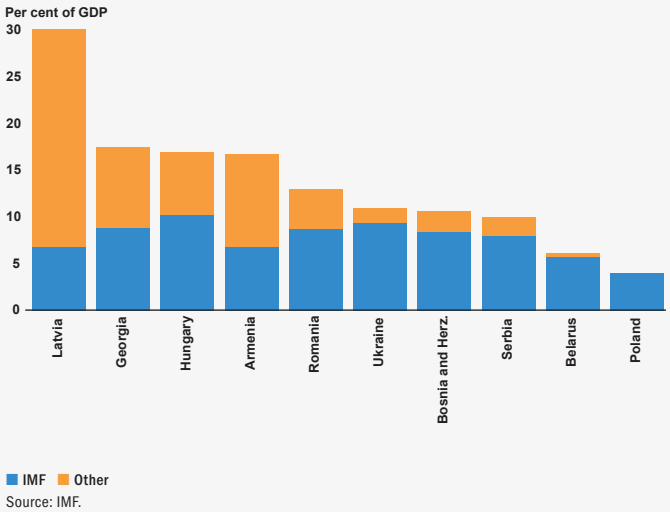
Outlook and risks

Looking ahead, the future of the transition region is driven by two main factors:

— in the short term, the prospects of recovery from the present crisis

— in the longer term, the future of reforms and the success of the European integration process.

Chart 1.9
Official balance of payments support commitments



Source: IMF.

Short-term macroeconomic outlook

As of late September 2009, there were signs of positive quarter-on-quarter growth in most of the EBRD's countries of operations. Based on this and the recovery of the international financial markets, as well as signs of a rebound in the advanced countries, it appears likely that the transition region has started on the road to recovery. The main questions now are how vigorous the recovery is likely to be and whether it might yet be interrupted.

With the stabilisation of international banking groups on track and asset values rising, risks that the recovery could be punctured by new crises will mostly come from within the region. Non-performing loans and unemployment are still on the rise. As a result, banking systems will remain under threat for some time and will continue to rely on support from parent banks and from domestic and international policies. The situation will remain particularly difficult in countries where pre-crisis credit booms were larger and more focused on construction; where confidence is still fragile (including for reasons relating to domestic political uncertainty); and where fiscal positions are weaker. A systemic banking and currency crisis in one of these countries remains a possibility. However, in light of the more favourable external environment, the chances that such a crisis would have regional spill-overs are lower than they were six months ago.

The EBRD's baseline projection envisages a bottoming out or even rebound in most countries in late 2009, followed by modest growth in 2010. Average growth for the region as a whole is expected to be -6.2 per cent in 2009, reflecting the large output declines recorded in the first half of the year, followed by 2.5 per cent growth in 2010 (see Table A.1.1.9). However, average year-on-year growth in 2010 is in part driven by rebounds in late 2009. Cumulative quarterly growth in 2010 itself is likely to be lower, in the order of 1-2 per cent. Growth in 2010 is expected to be subdued due to the slow projected recovery of export markets (with the IMF expecting less than 1 per cent growth in the eurozone, for example) and a continuing credit crunch. The latter, in turn, reflects the expectation that: international banking groups will continue to gradually shrink their assets in the region as they write down and provide for loan losses, particularly in Europe (see IMF, 2009); syndicated loan markets will remain slow, prolonging the difficulties of large corporate borrowers seeking to roll over loans; and bank lending to households and small firms will remain constrained by rising non-performing loans.

This said, there are likely to be significant cross-country differences regarding the speed and shape of recovery. The fastest growth can be expected in internationally competitive economies with relatively sound pre-crisis banking systems, as well as in some commodity producing countries, whose financial systems are smaller and were less affected by the crisis. The continuing credit crunch is likely to put the biggest brakes on growth in countries with high non-performing loans and weaker institutional frameworks for debt restructuring. In countries with hard currency pegs, the need to adjust real exchange rates through prices and wages could also hold back growth in 2010, and possibly over the medium term. Finally, fiscal adjustment will weigh on aggregate demand in some countries.

Box 1.4
The Vienna Initiative

The Vienna Initiative is a forum that was created in early 2009 to coordinate the responses of major public and private stakeholders to the financial crisis in the European transition countries. It brings together home and host country authorities of the major EU-based bank groups; the bank groups themselves; the International Monetary Fund (IMF); the EBRD; the European Investment Bank (EIB); the World Bank Group; and the European Commission (EC). The Initiative's objectives were to determine the respective responsibilities of national home and host authorities in crisis management; avoid uncoordinated national crisis responses; and keep key international bank groups engaged – all under the auspices of, and with financial backing from, international financial institutions (IFIs).

The Initiative has established a consensus on responsibilities and burden-sharing.

— Host governments have given assurances to provide deposit insurance and liquidity support for banks regardless of ownership, as well as supportive macroeconomic policies (sometimes in the context of IMF programmes).

— EU-based parent banks pledged to recapitalise and refinance their subsidiaries in transition countries. In countries with IMF-supported programmes (co-financed, in the case of EU members, by the EC), this has taken the form of letters by the major banks which commit to maintaining exposures as long as IMF-backed programmes remain on track.[5]

— Home governments have allowed bank groups to access national packages for their whole operations, that is, without restrictions on funding their subsidiaries. An important milestone in this regard was the 1 March 2009 Emergency Summit of EU leaders, which confirmed that national government support packages for parent banks would not contain restrictions affecting the activities of subsidiaries in EU host countries.

— IFIs announced financing packages within the mandate of their respective institutions. In late February the EBRD, the EIB and the private sector arms of the World Bank Group (IFC and MIGA) launched the Joint IFI Action Plan to support banking sector stability and lending in the real economy with a budget of €25 billion for 2009-10.

So far, the Initiative appears to have been a success in the sense that, by and large, the various parties have met these commitments. Most importantly, it has achieved its aim in avoiding a financial collapse in emerging Europe, notwithstanding the large shocks and output declines experienced in late 2008 and the first half of 2009. Agreements under the Initiative have also had some unexpected positive consequences. In several countries, non-systemic banks have asked to be signatories of commitment letters similar to those provided by major parent banks. Private-public sector coordination has allowed for concerted shifts towards monetary easing. For example, reserve requirements could be reduced in some countries following private bank assurances that this would not lead to capital "flight", with the associated exchange rate pressures.

The Vienna Initiative compares favourably with initiatives for "private sector involvement" in the 1990s, which were generally short lived, relied on heavy moral suasion and sometimes on administrative instruments, and were not always successful in preventing large capital flow reversals.[6] Possible reasons for the greater success of the Vienna Initiative include the role of IFIs in providing conditional support to the private financial sector in the crisis (which was largely absent in previous efforts to "bail in" the private sector); the broader definition of the Initiative, which created a forum for home and host authority cooperation in Europe for the first time; and the much higher degree of political and economic integration in Europe, which creates incentives both for home and host country cooperation and long-term commitments of parent banks to subsidiaries in the region.

Countries where the recovery is expected to be delayed as a result of one or several of these factors include Bulgaria, Hungary, Latvia, Lithuania and Ukraine. The recovery is also likely to be slow and uncertain in Kazakhstan and Russia, which benefit from stronger fiscal positions, but at the same time suffer from weak banking systems and a high share of non-performing loans. The short-term growth prospects for these countries will depend on the success of the authorities in cleaning up banking systems, as well as the strength of the international recovery, particularly through its impact on commodity prices.

The future of reforms

This chapter has argued that the crisis has led to a major slow-down in reforms in the past year and points to the absence in most countries of discernible progress – as measured by the EBRD transition indicators – as evidence. But what about next year and beyond? Will the reform process gain fresh momentum once the global economy starts to recover, or will the legacy of the crisis be an "anti-market" bias that will see authorities undoing the good work of the past?

These questions are examined in some detail in Chapter 6 of this Report, which concludes that the current crisis is unlikely to either trigger major reform reversal or significantly re-invigorate the reform process with a few years' lag, as occurred, for example, after the 1998 Russian crisis. Several factors support this prediction.

Major reform reversals remain unlikely based on the fact that the reform orientation of most governments has not changed since the intensification of the crisis in the second half of 2008. Indeed, several pro-reform governments have come to office in the meantime. The lack of a generalised anti-reform backlash may be attributable to the fact that economic institutions and political systems are generally more mature in this crisis than in 1998; that the region is better integrated into regional and global institutions; and that the crisis response was more successful, preventing high inflation and banking system collapses notwithstanding large declines in output.

However, a major burst in new reforms, as happened during the early years of this decade, is also unlikely. This is true both for EU member countries in which the distance from the transition frontier is moderate at this point, and where the reform effort needed to make further advances in transition is typically higher; and for countries further east, where reforms have been less consistent in recent years and support for market institutions is weaker (see Chapter 6). Chapter 4 shows how difficult it can be to develop strong constituencies for institutional reform in resource-dependent countries. In addition, the political systems in this part of the region have not yet developed mature institutions of interest intermediation and accountability, suggesting that incumbent governments and conservative policies are likely to remain in place despite pressures for change.

While this crisis will therefore probably not be a boon to the reform process in the medium term, reforms are likely to pick up again, particularly as economic growth returns to the region, providing policy-makers with some leeway to implement measures that might initially be unpopular. There is also widespread support for financial sector reforms that address some of the regulatory and structural weaknesses that have contributed to the crisis. The EU anchor will continue to be important for those countries that aspire either to EU membership (in the Western Balkans) or to closer economic and cultural ties with the European Union (including under the framework of the Eastern Partnership).

Perhaps most encouragingly, there have been welcome signs of progress in some of the smaller, less-reformed countries in the EEC and Central Asia regions in recent years, including in areas not specifically covered by the transition indicators. For example, the World Bank's *Doing Business 2010* survey included several of these countries among its top reformers. It will be important to build on this momentum in the coming years to prevent less-advanced countries from falling further behind the rest of the region.

Endnotes

1 As the rouble exchange rate is common for all regions, this index has only three components measuring: (i) industrial production contraction (year-on-year) for at least three consecutive months; (ii) reduction in the nominal stock of private sector credit granted by bank branches in a given region; and (iii) decline in house prices by at least 5 per cent from the peak. Given the rouble depreciation, a 5 per cent price decline in rouble terms typically corresponds to a more than 20 per cent decline in US dollar or euro terms by March 2009.

2 The lack of a correlation between the subindex for emerging Europe and the VIX during 2000–03 was driven by the crisis in Turkey in 2000–01, which dominated the behaviour of European risk premiums.

3 In the fourth quarter of 2008 the largest outflows of bank lending were in Russia and Ukraine, in the order of 2.5 per cent of GDP. In the first quarter, the largest outflows were in Latvia, Estonia and Ukraine (5.4, 4.6 and 3.0 per cent, respectively). A large outflow was also reported for the Slovak Republic in the first quarter, but this was driven by the move of banking system reserves to the European Central Bank and not the crisis.

4 This estimate is based on data for 14 countries in the region.

5 As of late September 2009 countries for which such commitments have been made included Bosnia and Herzegovina, Hungary, Latvia, Romania and Serbia.

6 See Roubini and Setser (2004), for an overview.

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Annex 1.1

Macroeconomic performance tables

The tables in this annex provide the most up-to-date information available at the time of publication. The cut-off date was early October 2009. There is still considerable variation in data quality across countries, and between different economic indicators. The data are based on a wide variety of sources, including national authorities, other international organisations and EBRD staff estimates. Data for 2009 are projections.

Table A.1.1.1 Growth in real GDP
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Table A.1.1.1
Growth in real GDP (in per cent)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 Estimate	2009 Projection	Estimated level of real GDP in 2008
Central Europe and the Baltic states														*(1989=100)*
Croatia	6.8	2.1	-1.5	3.0	3.8	5.4	5.0	4.2	4.2	4.7	5.5	2.4	-5.4	**111**
Czech Republic	-0.7	-0.8	1.3	3.6	2.5	1.9	3.6	4.5	6.3	6.8	6.1	2.7	-4.3 [2]	**142**
Estonia	11.7	6.7	-0.3	10.0	7.5	7.9	7.6	7.2	9.4	10.0	7.2	-3.6	-13.2	**147**
Hungary	4.6	4.8	4.2	5.2	4.1	4.4	4.3	4.7	3.9	4.0	1.2	0.6	-6.5	**136**
Latvia	8.4	4.7	3.3	6.9	8.0	6.5	7.2	8.7	10.6	12.2	10.0	-4.6	-16.0	**118**
Lithuania	8.5	7.5	-1.5	4.2	6.7	6.9	10.2	7.4	7.8	7.8	9.8	2.8	-18.4	**120**
Poland	7.1	5.0	4.5	4.3	1.2	1.4	3.9	5.3	3.6	6.2	6.8	4.9	1.3	**178**
Slovak Republic	4.6	4.2	1.5	2.0	3.4	4.8	4.7	5.2	6.5	8.5	10.4	6.4	-6.0	**164**
Slovenia	4.8	3.9	5.4	4.1	3.1	4.0	2.8	4.3	4.5	5.8	6.8	3.5	-7.8	**156**
Average [1]	*5.2*	*3.8*	*3.1*	*4.2*	*2.6*	*2.9*	*4.3*	*5.1*	*4.9*	*6.3*	*6.3*	*3.3*	*-3.6*	***156***
South-eastern Europe														
Albania	-10.9	8.6	13.2	6.5	7.9	4.2	5.8	5.7	5.7	5.4	6.0	6.8	3.0	**163**
Bosnia and Herzegovina	37.0	15.6	9.6	5.5	4.3	5.5	3.0	6.3	3.9	6.7	6.8	5.4	-3.1	**84**
Bulgaria	-5.6	4.0	2.3	5.4	4.1	4.5	5.0	6.6	6.2	6.3	6.2	6.0	-6.0	**114**
FYR Macedonia	1.4	3.4	4.3	4.5	-4.5	0.9	2.8	4.1	4.1	4.0	5.9	4.9	-1.6	**102**
Montenegro	4.2	4.0	-6.7	3.1	1.1	1.9	2.5	4.4	4.2	8.6	10.7	7.5	-4.1	**92**
Romania	-6.1	-4.8	-1.1	2.1	5.7	5.1	5.2	8.5	4.2	7.9	6.0	7.1	-8.0	**128**
Serbia	10.1	1.9	-18.0	5.2	5.1	4.5	2.4	9.3	6.3	5.5	6.9	5.4	-4.0	**72**
Average [1]	*-0.2*	*0.1*	*-2.5*	*3.9*	*4.8*	*4.7*	*4.5*	*7.8*	*4.9*	*7.0*	*6.3*	*6.5*	*-6.2*	***114***
Eastern Europe and the Caucasus														
Armenia	3.3	7.3	3.3	5.9	9.6	13.2	13.9	10.1	14.0	13.2	13.8	6.8	-14.3	**153**
Azerbaijan	6.0	10.0	11.0	11.1	9.9	10.6	11.2	10.2	24.3	30.5	23.4	10.8	5.0	**177**
Belarus	11.4	8.4	3.3	5.8	4.7	5.0	7.0	11.4	9.4	9.9	8.2	10.0	-3.0	**161**
Georgia	10.6	2.9	3.0	1.9	4.7	5.5	11.1	5.9	9.6	9.4	12.4	2.1	-5.5	**61**
Moldova	1.6	-6.5	-3.4	2.1	6.1	7.8	6.6	7.4	7.5	4.8	3.0	7.2	-8.5	**55**
Ukraine	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.6	12.1	2.7	7.3	7.9	2.1	-14.0	**70**
Average [1]	*1.3*	*1.0*	*1.5*	*6.0*	*8.1*	*6.0*	*9.4*	*11.3*	*6.7*	*10.2*	*10.0*	*5.0*	*-8.7*	***100***
Turkey	7.5	3.1	-3.4	6.8	-5.7	6.2	5.3	9.4	8.4	6.9	4.7	1.1	-6.0	**221**
Russia	1.4	-5.3	6.4	10.0	5.1	4.7	7.4	7.1	6.4	7.4	8.1	5.6	-8.5	**108**
Central Asia														
Kazakhstan	1.7	-1.9	2.7	9.8	13.5	9.8	9.3	9.6	9.7	10.7	8.9	3.2	-1.3	**141**
Kyrgyz Republic	9.9	2.1	3.7	5.4	5.3	0.0	7.0	7.0	-0.2	3.1	8.2	7.6	1.5	**102**
Mongolia	4.0	3.5	3.2	1.1	1.0	4.0	5.9	10.1	7.3	8.6	10.2	8.9	1.0	**167**
Tajikistan	1.7	5.3	3.7	8.3	10.2	9.1	10.2	10.6	6.7	7.0	7.8	7.9	2.0	**61**
Turkmenistan	-11.3	6.7	16.5	18.6	20.4	15.8	17.1	14.7	13.0	11.4	11.6	10.5	6.0	**226**
Uzbekistan	2.5	4.3	4.3	3.8	4.1	4.0	4.2	7.7	7.0	7.3	9.5	9.0	7.0	**163**
Average [1]	*1.7*	*0.9*	*4.2*	*8.4*	*10.8*	*8.6*	*8.9*	*9.8*	*9.1*	*9.8*	*9.2*	*5.0*	*0.8*	***149***
All transition countries														
Average [1]	***3.5***	***-0.1***	***1.8***	***6.3***	***1.8***	***4.5***	***5.8***	***7.2***	***6.3***	***7.2***	***7.0***	***4.2***	***-6.2***	***140***

Note: Data for 1997-2007 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2008 are preliminary actuals, mostly official government estimates. Data for 2009 represent EBRD projections, except for the Czech Republic (IMF, World Economic Outlook, October 2009).

[1] Weighted averages. The weights used for the growth rates are EBRD estimates of nominal dollar-GDP lagged by one year; those used for the index in the last column are EBRD estimates of GDP converted at PPP US$ exchange rates in 2005.

[2] IMF forecast (World Economic Outlook, October 2009).

Table A.1.1.2

GDP growth by components in selected countries (real change, in per cent)

	2005	2006	2007	2008 *Estimate*
Bulgaria				
Real GDP growth	6.2	6.3	6.2	6.0
Private consumption	5.5	8.5	5.1	4.5
Public consumption	4.1	-2.5	3.4	-1.4
Gross fixed capital formation	23.3	14.7	21.7	20.4
Exports of goods and services	8.5	8.7	5.2	2.9
Imports of goods and services	13.1	14.0	9.9	4.9
Croatia				
Real GDP growth	4.2	4.7	5.5	2.4
Private consumption	4.4	3.6	6.2	0.8
Public consumption	1.2	2.2	3.4	1.9
Gross fixed capital formation	4.9	10.9	6.5	8.2
Exports of goods and services	3.7	6.5	4.3	1.7
Imports of goods and services	3.9	7.4	6.5	3.6
Czech Republic				
Real GDP growth	6.3	6.8	6.1	2.7
Private consumption	2.5	5.1	4.9	3.4
Public consumption	2.9	1.2	0.7	1.6
Gross fixed capital formation	1.8	6.0	10.8	-1.1
Exports of goods and services	12.1	15.9	15.2	6.5
Imports of goods and services	5.0	14.2	14.2	4.6
Estonia				
Real GDP growth	9.4	10.0	7.2	-3.6
Private consumption	9.9	13.0	9.1	-4.8
Public consumption	-0.2	3.5	3.7	4.1
Gross fixed capital formation	15.4	18.5	9.0	-12.1
Exports of goods and services	18.6	14.0	0.0	-0.7
Imports of goods and services	17.5	22.9	4.7	-8.7
Hungary				
Real GDP growth	3.9	4.0	1.2	0.6
Private consumption	3.4	1.7	0.6	-0.5
Public consumption	2.1	3.8	-7.5	0.7
Gross fixed capital formation	5.8	-3.7	1.8	-2.6
Exports of goods and services	11.3	18.6	16.4	4.8
Imports of goods and services	7.0	14.8	13.4	4.7
Latvia				
Real GDP growth	10.6	12.2	10.0	-4.6
Private consumption	11.2	21.2	14.8	-5.4
Public consumption	2.7	4.9	3.7	1.5
Gross fixed capital formation	23.6	16.4	7.5	-13.2
Exports of goods and services	20.2	6.5	10.0	-1.3
Imports of goods and services	14.8	19.4	14.7	-13.6

	2005	2006	2007	2008 *Estimate*
Lithuania				
Real GDP growth	7.8	7.8	9.8	2.8
Private consumption	12.2	10.6	12.1	3.6
Public consumption	3.5	3.7	3.2	7.9
Gross fixed capital formation	11.2	19.4	23.0	-6.5
Exports of goods and services	17.7	12.0	5.3	9.7
Imports of goods and services	16.4	13.7	10.7	10.5
Poland				
Real GDP growth	3.6	6.2	6.8	4.9
Private consumption	2.1	5.0	5.0	5.4
Public consumption	5.2	6.1	3.7	7.6
Gross fixed capital formation	6.5	14.9	17.6	8.1
Exports of goods and services	8.0	14.6	9.1	7.2
Imports of goods and services	4.7	17.3	13.6	8.3
Romania				
Real GDP growth	4.2	7.9	6.0	7.1
Private consumption	9.9	12.4	11.0	10.8
Public consumption	8.5	-3.1	5.6	5.2
Gross fixed capital formation	12.7	19.3	28.9	8.3
Exports of goods and services	7.7	10.6	8.8	8.0
Imports of goods and services	16.0	22.4	26.1	20.9
Russia				
Real GDP growth	6.4	7.4	8.1	5.6
Private consumption	11.8	11.4	13.7	11.3
Public consumption	1.3	2.4	3.4	2.5
Gross fixed capital formation	10.6	18.0	21.1	10.0
Exports of goods and services	6.5	7.3	6.3	0.5
Imports of goods and services	16.6	21.3	26.5	15.0
Slovak Republic				
Real GDP growth	6.5	8.5	10.4	6.4
Private consumption	6.5	5.8	7.0	6.1
Public consumption	3.3	10.2	-1.4	4.3
Gross fixed capital formation	17.6	9.3	8.7	6.8
Exports of goods and services	10.0	21.0	13.8	3.2
Imports of goods and services	12.4	17.7	8.9	3.3
Slovenia				
Real GDP growth	4.5	5.8	6.8	3.5
Private consumption	2.6	2.9	6.7	2.0
Public consumption	3.4	4.0	0.7	6.2
Gross fixed capital formation	3.7	9.9	11.7	7.7
Exports of goods and services	10.6	12.5	13.7	2.9
Imports of goods and services	6.6	12.2	16.3	2.9

Source: EBRD.

Note: Data for 2005-07 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2008 are preliminary actuals, mostly official government estimates.

Table A.1.1.3

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

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 Estimate	2009 Projection
Central Europe and the Baltic states													
Croatia	3.6	5.7	4.0	4.6	3.8	1.7	1.8	2.1	3.3	3.2	2.9	6.1	2.5
Czech Republic	8.4	10.6	2.1	4.0	4.7	1.8	0.2	2.8	1.9	2.6	3.0	6.3	1.0
Estonia	11.2	8.1	3.3	4.0	5.8	3.6	1.3	3.0	4.1	4.4	6.6	10.4	0.3
Hungary	18.3	14.3	10.0	9.8	9.2	5.3	4.7	6.8	3.6	3.9	8.0	6.1	4.5
Latvia	17.6	8.4	4.7	2.6	2.5	1.9	2.9	6.2	6.7	6.5	10.1	15.4	3.6
Lithuania	8.9	5.1	0.8	1.0	1.5	0.3	-1.1	1.2	2.7	3.8	5.7	11.0	4.2
Poland	14.9	11.8	7.3	10.1	5.5	1.9	0.8	3.5	2.2	1.2	2.5	4.2	3.4
Slovak Republic	6.1	6.7	10.6	12.0	7.3	3.0	8.5	7.5	2.5	4.5	2.8	4.6	2.6
Slovenia	8.4	8.0	6.2	8.9	8.4	7.5	5.6	3.6	2.5	2.5	3.6	5.7	1.8
Median[1]	*8.9*	*8.1*	*4.7*	*4.6*	*5.5*	*1.9*	*1.8*	*3.5*	*2.7*	*3.8*	*3.6*	*6.1*	*2.6*
Mean[1]	*10.8*	*8.7*	*5.4*	*6.3*	*5.4*	*3.0*	*2.7*	*4.1*	*3.3*	*3.6*	*5.0*	*7.8*	*2.7*
South-eastern Europe													
Albania	33.2	20.6	0.4	0.1	3.1	5.2	2.3	2.9	2.4	2.4	2.9	3.4	1.7
Bosnia and Herzegovina	na	-0.3	3.4	5.0	3.2	0.4	0.6	0.4	3.8	6.1	4.9	6.5	3.0
Bulgaria	1,082.0	22.2	0.7	9.9	7.4	5.9	2.3	6.1	5.0	7.3	8.4	12.3	2.6
FYR Macedonia	2.6	-0.1	-0.7	5.8	5.5	1.8	1.2	-0.4	0.5	3.2	2.3	8.3	-0.4
Montenegro	23.4	32.4	67.6	97.1	22.6	16.0	6.7	2.4	2.3	3.0	4.2	7.4	1.8
Romania	154.8	59.1	45.8	45.7	34.5	22.5	15.4	12.0	9.5	6.9	4.8	7.9	5.3
Serbia	18.3	30.0	41.1	70.0	91.8	19.5	11.7	10.1	16.5	12.7	6.7	11.7	8.3
Median[1]	*28.3*	*22.2*	*3.4*	*9.9*	*7.4*	*5.9*	*2.3*	*2.9*	*3.8*	*6.1*	*4.8*	*7.9*	*2.6*
Mean[1]	*219.0*	*23.4*	*22.6*	*33.4*	*24.0*	*10.2*	*5.7*	*4.8*	*5.7*	*5.9*	*4.9*	*8.2*	*3.2*
Eastern Europe and the Caucasus													
Armenia	14.0	8.7	0.7	-0.8	3.1	1.1	4.7	7.0	0.6	2.9	4.4	9.0	3.0
Azerbaijan	3.5	-0.8	-8.5	1.8	1.5	2.8	2.2	6.7	9.6	8.3	16.7	20.8	2.5
Belarus	63.9	72.9	293.7	168.6	61.1	42.5	28.4	18.1	10.3	7.0	8.4	14.9	13.2
Georgia	7.1	3.6	19.2	4.1	4.6	5.7	4.9	5.7	8.4	9.2	9.3	10.0	1.2
Moldova	11.8	7.7	39.3	31.1	9.6	5.2	11.6	12.5	12.0	12.8	12.4	12.8	0.0
Ukraine	15.9	10.6	22.7	28.2	12.0	0.8	5.2	9.0	13.5	9.1	12.8	25.2	16.0
Median[1]	*12.9*	*8.2*	*21.0*	*16.2*	*7.1*	*4.0*	*5.0*	*8.0*	*10.0*	*8.7*	*10.8*	*13.8*	*2.8*
Mean[1]	*19.4*	*17.1*	*61.2*	*38.8*	*15.3*	*9.7*	*9.5*	*9.8*	*9.1*	*8.2*	*10.7*	*15.4*	*6.0*
Turkey	85.7	84.7	64.9	55.0	54.2	45.1	25.3	8.6	8.2	9.6	8.8	10.4	5.9
Russia	14.7	27.8	85.7	20.8	21.6	16.0	13.6	11.0	12.5	9.8	9.1	14.1	12.3
Central Asia													
Kazakhstan	17.4	7.1	8.3	13.2	8.4	5.9	6.4	6.9	7.6	8.6	10.8	17.2	7.2
Kyrgyz Republic	23.4	10.5	35.9	18.7	6.9	2.0	3.1	4.1	4.3	5.6	10.2	24.5	7.6
Mongolia	36.6	9.4	7.6	11.6	8.0	0.3	5.1	8.3	12.7	5.1	9.0	26.7	8.1
Tajikistan	88.0	43.2	27.5	32.9	38.6	12.2	16.4	7.2	7.3	10.0	13.2	20.4	8.6
Turkmenistan	83.7	16.8	24.2	8.3	11.6	8.8	5.6	5.9	10.7	10.5	8.6	12.0	5.5
Uzbekistan	70.9	29.0	29.1	25.0	27.3	27.3	11.6	6.6	10.0	14.2	12.3	12.7	14.5
Median[1]	*53.7*	*13.6*	*25.8*	*15.9*	*10.0*	*7.4*	*6.0*	*6.7*	*8.8*	*9.3*	*10.5*	*18.8*	*7.9*
Mean[1]	*53.3*	*19.3*	*22.1*	*18.3*	*16.8*	*9.4*	*8.0*	*6.5*	*8.8*	*9.0*	*10.7*	*18.9*	*8.6*
All transition countries													
Median[1]	***17.4***	***10.5***	***9.2***	***10.0***	***7.7***	***5.2***	***5.0***	***6.4***	***5.9***	***6.3***	***8.2***	***10.7***	***3.5***
Mean[1]	***67.2***	***19.1***	***28.6***	***23.6***	***16.2***	***9.1***	***7.0***	***6.3***	***6.6***	***6.6***	***7.5***	***11.9***	***5.1***

Note: Data for 1997-2007 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2008 are preliminary actuals, mostly official government estimates. Data for 2009 represent EBRD projections,except for the Czech Republic (*IMF, World Economic Outlook*, October 2009). Estimates of inflation from parts of Bosnia and Herzegovina (for the Federation and Republika Srpska separately) are provided in the selected economic indicators at the back of this Report.

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

Table A.1.1.4
General government balances (in per cent of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 Estimate	2009 Projection
Central Europe and the Baltic states													
Croatia	-1.1	-3.0	-8.2	-7.5	-6.8	-4.9	-4.8	-4.0	-3.5	-3.1	-2.5	-1.4	-3.3
Czech Republic	-3.8	-5.0	-3.7	-3.7	-5.7	-6.8	-6.6	-2.9	-3.6	-2.6	-0.6	-1.4	-2.5
Estonia	1.9	-0.3	-3.7	-0.6	0.3	0.3	1.7	1.6	1.6	2.3	2.6	-2.7	-3.0
Hungary	-6.2	-8.2	-5.5	-3.0	-4.0	-9.0	-7.2	-6.4	-7.8	-9.3	-4.9	-3.4	-3.9
Latvia	1.4	0.0	-3.9	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.5	-0.4	-4.0	-10.0
Lithuania	-11.9	-3.1	-2.8	-3.2	-3.6	-1.9	-1.3	-1.5	-0.5	-0.4	-1.0	-3.2	-9.0
Poland	-4.6	-4.3	-2.3	-3.0	-5.1	-5.0	-6.3	-5.7	-4.3	-3.9	-1.9	-3.9	-6.0
Slovak Republic	-5.2	-5.0	-7.1	-12.3	-6.5	-8.2	-2.8	-2.4	-2.8	-3.5	-1.9	-2.2	-5.5
Slovenia	-1.1	-0.7	-0.6	-3.7	-4.0	-2.5	-2.7	-2.2	-1.4	-1.3	0.5	-0.9	-5.5
Average [1]	*-3.4*	*-3.3*	*-4.2*	*-4.4*	*-4.2*	*-4.5*	*-3.5*	*-2.7*	*-2.5*	*-2.5*	*-1.1*	*-2.6*	*-5.4*
South-eastern Europe													
Albania	-12.7	-12.1	-12.3	-7.6	-6.9	-6.1	-4.9	-5.1	-3.5	-3.3	-3.5	-5.7	-6.3
Bosnia and Herzegovina	-0.4	-0.1	-4.0	-4.7	2.2	-4.2	2.3	1.6	2.2	2.2	-0.1	-3.0	-4.0
Bulgaria	-0.3	1.7	0.4	-0.5	1.9	0.1	-0.9	2.2	1.9	3.3	3.5	3.0	-0.1
FYR Macedonia	-0.4	-1.7	0.0	2.5	-6.3	-5.7	-0.6	0.4	0.3	-0.5	0.6	-1.0	-2.8
Montenegro	na	na	na	-4.0	-2.0	-1.9	-3.1	-1.9	2.1	4.2	6.4	1.5	-3.0
Romania	-4.5	-3.2	-4.5	-4.6	-2.1	-2.0	-1.5	-1.2	-0.8	-1.6	-3.1	-4.9	-7.3
Serbia	na	na	na	-0.9	-6.3	-3.2	-1.1	0.9	1.0	-1.6	-1.9	-2.4	-4.5
Average [1]	*-3.7*	*-3.1*	*-4.1*	*-2.8*	*-2.8*	*-3.3*	*-1.4*	*-0.4*	*0.5*	*0.4*	*0.3*	*-1.8*	*-4.0*
Eastern Europe and the Caucasus													
Armenia	-5.8	-4.9	-7.2	-6.4	-3.8	-0.4	-1.1	-1.8	-2.6	-2.8	-2.3	-1.4	-1.5
Azerbaijan	-4.0	-3.9	-4.7	-0.6	-0.4	-0.5	-0.8	1.0	2.6	-0.2	2.4	25.5	9.2
Belarus	-0.7	-1.0	-2.0	-0.1	-1.9	-2.1	-1.7	0.0	-0.7	1.4	0.4	1.4	0.0
Georgia	-6.7	-5.4	-6.7	-4.0	-1.9	-2.0	-2.5	2.3	-1.5	-3.0	-4.2	-6.4	-9.4
Moldova	-10.5	-7.4	-6.2	-1.8	-0.3	-2.2	1.0	0.4	1.5	-0.3	-0.3	-1.0	-7.0
Ukraine	-5.4	-2.5	-2.3	-1.1	-0.9	0.1	-0.7	-4.4	-2.3	-1.3	-2.0	-3.2	-11.4
Average [1]	*-5.5*	*-4.2*	*-4.8*	*-2.3*	*-1.6*	*-1.2*	*-1.0*	*-0.4*	*-0.5*	*-1.0*	*-1.0*	*2.5*	*-3.4*
Turkey	-7.8	-5.4	-8.7	-8.0	-12.1	-11.4	-8.8	-5.4	-1.3	-0.8	-1.7	-1.9	-7.0
Russia	-6.5	-5.9	-0.9	1.9	3.0	0.9	1.3	4.5	8.1	8.4	6.0	4.8	-8.8
Central Asia													
Kazakhstan	-7.0	-8.0	-5.2	-1.0	2.7	1.4	3.0	2.5	5.8	7.2	4.7	1.1	-2.0
Kyrgyz Republic	-9.2	-9.5	-13.1	-10.4	-5.6	-5.3	-4.7	-4.4	-3.4	-2.5	-0.3	-0.1	-3.8
Mongolia	-7.9	-12.4	-10.6	-6.1	-4.7	-5.2	-3.7	-1.9	2.6	3.3	2.8	-5.0	-6.0
Tajikistan	-3.3	-3.8	-3.1	-5.6	-3.2	-2.4	-1.8	-2.4	-2.9	1.7	-6.2	-6.1	-8.9
Turkmenistan	-0.2	-2.6	0.0	-0.3	0.6	0.2	-1.3	1.4	0.8	5.3	4.0	11.3	5.3
Uzbekistan	-2.2	-3.8	-3.0	-2.5	-1.3	-1.9	0.1	1.2	2.8	6.8	5.7	10.5	2.0
Average [1]	*-5.0*	*-6.7*	*-5.8*	*-4.3*	*-1.9*	*-2.2*	*-1.4*	*-0.6*	*0.9*	*3.6*	*1.8*	*1.9*	*-2.2*
All transition countries													
Average [1]	***-4.5***	***-4.3***	***-4.7***	***-3.5***	***-2.9***	***-3.1***	***-2.1***	***-1.2***	***-0.3***	***0.1***	***0.0***	***-0.2***	***-4.2***

Note: Data for 1997-2007 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2008 are preliminary actuals, mostly official government estimates. Data for 2009 represent EBRD projections, except for the Czech Republic (IMF, *World Economic Outlook* , October 2009).

[1] Unweighted average for the region.

Table A.1.1.5
General government expenditure (in per cent of GDP)

	2002	2003	2004	2005	2006	2007	2008 Estimate
Central Europe and the Baltic states							
Croatia	39.8	39.4	39.3	38.9	39.2	40.3	39.4
Czech Republic	39.5	40.7	42.2	41.4	41.2	42.0	40.9
Estonia	36.0	36.5	35.6	35.2	36.3	37.4	37.1
Hungary	42.4	42.0	42.6	42.3	42.7	44.7	46.2
Latvia	33.4	33.2	34.7	35.2	37.7	35.5	35.4
Lithuania	32.9	31.9	31.8	32.8	33.1	33.8	34.2
Poland	39.2	38.4	36.9	39.1	39.9	40.2	39.2
Slovak Republic	36.8	37.4	35.3	35.4	33.5	32.5	32.7
Slovenia	43.9	43.7	43.6	43.8	43.2	42.8	42.6
Average [1]	*38.2*	*38.1*	*38.0*	*38.2*	*38.5*	*38.8*	*38.6*
South-eastern Europe							
Albania	24.8	24.1	24.6	25.1	25.8	25.7	27.4
Bosnia and Herzegovina	44.6	41.5	40.4	42.1	47.4	47.4	47.9
Bulgaria	36.3	37.7	38.4	39.8	38.8	40.7	39.5
FYR Macedonia	34.9	33.4	33.2	35.2	33.5	33.8	34.2
Montenegro	43.6	43.5	38.6	41.2	46.7	45.4	44.4
Romania	37.6	32.1	32.4	30.4	31.0	31.4	32.7
Serbia	41.8	41.7	42.6	42.9	43.8	42.4	40.5
Average [1]	*37.7*	*36.3*	*35.7*	*36.7*	*38.1*	*38.1*	*38.1*
Eastern Europe and the Caucasus							
Armenia	18.8	17.8	15.5	16.6	18.0	20.1	20.0
Azerbaijan	27.3	26.8	26.8	25.1	28.0	29.6	49.3
Belarus	44.5	45.9	46.0	47.4	48.4	49.5	51.0
Georgia	15.8	16.2	21.7	23.4	26.3	29.2	30.7
Moldova	29.3	34.1	35.5	38.6	39.9	41.6	40.6
Ukraine	35.6	36.5	37.1	41.8	43.7	41.8	44.2
Average [1]	*28.6*	*29.6*	*30.4*	*32.1*	*34.0*	*35.3*	*39.3*
Turkey	21.6	22.0	19.8	21.3	22.3	22.0	21.5
Russia	32.5	31.3	31.9	39.7	39.5	40.4	38.4
Central Asia							
Kazakhstan	22.5	25.4	24.6	28.1	27.5	28.8	27.8
Kyrgyz Republic	22.8	22.5	23.3	24.7	26.4	30.3	30.3
Mongolia	33.8	33.4	33.1	30.1	36.6	40.9	35.2
Tajikistan	16.7	17.3	17.9	20.1	23.6	22.5	22.1
Turkmenistan	18.2	18.0	20.3	20.5	20.2	17.4	na
Uzbekistan	35.7	33.4	32.2	30.8	34.4	35.6	41.7
Average [1]	*25.0*	*25.0*	*25.2*	*25.7*	*28.1*	*29.2*	*31.4*
All transition countries							
Average [1]	***32.8***	***32.6***	***32.6***	***33.6***	***35.0***	***35.5***	***36.8***

Note: Data for 2002-07 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2008 are preliminary actuals, mostly official government estimates. General government expenditure includes net lending.

[1] Unweighted average for the region.

Table A.1.1.6
Current account balances (in per cent of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 Estimate	2009 Projection
Central Europe and the Baltic states													
Croatia	-10.7	-5.8	-6.6	-2.5	-3.2	-7.5	-6.3	-4.4	-5.5	-6.9	-7.5	-9.4	-8.5
Czech Republic	-6.3	-2.1	-2.4	-4.7	-5.3	-5.7	-6.3	-5.2	-1.3	-2.7	-3.1	-3.1	-2.1
Estonia	-11.1	-8.6	-4.3	-5.3	-5.2	-10.6	-11.3	-11.4	-9.8	-17.0	-17.8	-9.5	2.7
Hungary	-4.5	-7.2	-7.8	-8.4	-6.0	-7.0	-7.9	-8.6	-7.6	-7.6	-6.4	-8.4	-3.0
Latvia	-5.5	-9.7	-9.0	-4.7	-7.5	-6.7	-8.2	-12.8	-12.4	-22.7	-22.3	-13.2	5.4
Lithuania	-9.8	-11.6	-10.9	-5.9	-4.7	-5.2	-6.9	-7.6	-6.9	-10.7	-14.5	-12.3	1.2
Poland	-3.7	-4.0	-7.4	-6.0	-3.1	-2.8	-2.5	-4.0	-1.2	-2.8	-4.8	-4.4	-1.8
Slovak Republic	-9.1	-9.2	-5.3	-2.4	-5.8	-5.5	-4.3	-5.9	-6.5	-6.2	-4.8	-6.3	-5.5
Slovenia	0.3	-0.7	-4.0	-3.2	0.2	1.1	-0.8	-2.7	-1.7	-2.5	-4.8	-6.2	-2.4
Average [1]	*-6.7*	*-6.5*	*-6.4*	*-4.8*	*-4.5*	*-5.5*	*-6.1*	*-6.9*	*-5.9*	*-8.8*	*-9.6*	*-8.1*	*-1.5*
South-eastern Europe													
Albania	-11.7	-6.9	-7.8	-4.7	-7.4	-9.5	-7.0	-5.8	-8.7	-11.3	-10.6	-15.1	-14.5
Bosnia and Herzegovina	-26.6	-8.5	-9.8	-16.4	-18.8	-19.3	-19.5	-16.4	-16.8	-8.0	-12.2	-14.7	-9.6
Bulgaria	10.0	-0.5	-5.0	-5.6	-5.9	-2.0	-5.1	-6.8	-12.2	-17.9	-25.4	-25.2	-12.6
FYR Macedonia	-7.7	-7.5	-0.9	-1.9	-7.1	-9.5	-4.0	-8.4	-2.7	-0.9	-7.5	-12.7	-11.9
Montenegro	na	na	na	-4.5	-14.6	-12.3	-6.8	-7.2	-8.6	-24.7	-29.4	-33.6	-22.8
Romania	-6.1	-6.9	-3.6	-3.6	-5.8	-3.4	-5.8	-8.4	-10.2	-11.8	-14.4	-12.3	-6.0
Serbia	-6.5	-4.2	-4.1	-2.2	2.5	-4.3	-7.8	-13.9	-8.7	-10.1	-15.7	-17.2	-12.9
Average [1]	*-8.1*	*-5.7*	*-5.2*	*-5.6*	*-8.2*	*-8.6*	*-8.0*	*-9.6*	*-9.7*	*-12.1*	*-16.4*	*-18.7*	*-12.9*
Eastern Europe and the Caucasus													
Armenia	-18.0	-22.1	-16.6	-14.6	-9.4	-6.2	-6.7	-4.5	-3.9	-1.8	-6.4	-12.5	-12.4
Azerbaijan	-23.1	-30.7	-13.1	-3.5	-0.9	-12.3	-27.8	-29.8	1.3	17.7	28.8	35.5	4.9
Belarus	-6.1	-6.7	-1.6	-3.2	-3.3	-2.2	-2.4	-5.2	1.4	-3.9	-6.7	-8.4	-12.1
Georgia	-10.6	-8.9	-7.7	-4.4	-6.5	-5.8	-7.4	-8.3	-9.8	-13.7	-19.7	-22.7	-16.1
Moldova	-14.2	-19.7	-5.8	-7.6	-1.7	-4.0	-6.6	-2.2	-8.1	-11.7	-15.2	-16.7	-9.0
Ukraine	-2.7	-3.1	5.3	4.7	3.7	7.5	5.8	10.5	2.9	-1.5	-4.1	-7.2	-0.8
Average [1]	*-12.5*	*-15.2*	*-6.6*	*-4.8*	*-3.0*	*-3.9*	*-7.5*	*-6.6*	*-2.7*	*-2.5*	*-3.9*	*-5.3*	*-7.6*
Turkey	-1.4	0.7	-0.4	-3.7	1.9	-0.3	-2.5	-3.7	-4.6	-6.0	-5.9	-5.7	-3.0
Russia	0.0	0.1	12.6	18.0	11.1	8.5	8.2	10.1	11.1	9.6	5.9	6.1	3.1
Central Asia													
Kazakhstan	-3.6	-5.5	-1.4	2.0	-6.3	-4.2	-0.9	1.1	-1.8	-2.3	-7.8	5.2	-2.1
Kyrgyz Republic	-7.8	-22.2	-14.7	-4.3	-1.5	-4.0	1.7	4.9	2.8	-3.1	-0.2	-8.2	-7.9
Mongolia	4.7	-6.7	-5.8	-5.0	-6.6	-8.5	-6.8	1.5	1.3	7.0	6.7	-13.7	-6.0
Tajikistan	-4.0	-7.3	-0.9	-1.6	-5.0	-3.6	-1.3	-3.9	-2.7	-2.8	-8.6	-7.9	-11.2
Turkmenistan	-24.8	-34.3	-23.3	13.6	3.2	13.0	5.2	1.2	10.5	32.2	31.7	18.8	21.2
Uzbekistan	-5.4	-0.9	-2.0	2.7	-1.5	1.4	5.9	7.0	7.4	9.1	7.3	12.8	7.8
Average [1]	*-6.8*	*-12.8*	*-8.0*	*1.2*	*-2.9*	*-1.0*	*0.6*	*1.9*	*2.9*	*6.7*	*4.9*	*1.2*	*0.3*
All transition countries													
Average [1]	***-7.8***	***-9.0***	***-5.7***	***-3.0***	***-4.0***	***-4.4***	***-4.9***	***-5.0***	***-3.8***	***-4.5***	***-6.5***	***-7.6***	***-4.9***

Note: Data for 1997-2007 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2008 are preliminary actuals, mostly official government estimates. Data for 2009 represent EBRD projections, except for the Czech Republic (IMF, *World Economic Outlook* , October 2009).

[1] Unweighted average for the region.

Table A.1.1.7

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

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 Estimate	2009 Projection	Cumulative FDI inflows 1989-2008	Cumulative FDI inflows per capita 1989-2008	FDI inflows per capita 2007	FDI inflows per capita 2008	FDI inflows 2007	FDI inflows 2008
Central Europe and the Baltic states							(in US$ million)								(in US$ mln)	(US$)	(US$)		(in per cent of GDP)	
Croatia	466	348	842	1,392	1,105	1,398	552	1,927	732	1,551	3,194	4,736	4,576	2,731	23,164	5,215	1,066	1,030	8.0	6.6
Czech Republic	1,280	1,259	3,575	6,220	4,942	5,474	8,282	1,814	3,941	11,630	4,043	8,955	8,972	na	75,226	7,287	868	869	5.1	4.2
Estonia	111	130	574	222	324	342	153	763	698	2,255	676	1,000	876	-50	8,770	6,530	745	652	4.7	3.7
Hungary	3,335	3,715	3,070	3,060	2,151	3,573	2,722	479	3,405	5,586	3,640	2,197	4,685	2,400	53,242	5,295	218	466	1.6	3.0
Latvia	379	515	303	331	400	114	250	254	528	585	1,491	1,945	1,092	300	8,759	3,857	853	481	6.8	3.2
Lithuania	152	328	921	478	375	439	714	142	510	689	1,551	1,409	1,490	980	9,331	2,779	417	444	3.6	3.2
Poland	4,445	4,863	6,049	7,239	9,327	5,804	3,901	4,284	11,761	6,951	10,727	17,987	11,747	4,134	111,529	2,927	472	308	4.2	2.2
Slovak Republic	199	84	374	701	1,897	1,520	4,130	1,913	3,052	2,279	4,178	2,881	3,156	2,000	27,115	5,011	532	583	3.4	3.2
Slovenia	167	303	221	59	71	226	1,508	-174	281	-67	-215	-273	519	-250	3,081	1,531	-136	258	-0.6	0.9
Total	*10,534*	*11,544*	*15,928*	*19,702*	*20,590*	*18,890*	*22,212*	*11,401*	*24,907*	*31,459*	*29,284*	*40,836*	*37,112*	*12,245*	*320,216*	*4,492*	*559*	*566*	*4.1*	*3.4*
South-eastern Europe																				
Albania	97	42	45	51	143	207	135	178	324	258	315	647	844	650	3,505	1,101	204	265	6.0	6.6
Bosnia and Herzegovina	0	0	100	90	146	119	266	382	708	608	718	2,088	1,003	600	6,228	1,639	549	264	13.8	5.3
Bulgaria	138	507	537	802	998	803	876	2,070	2,879	4,005	7,583	11,433	8,472	5,775	41,448	5,454	1,504	1,115	28.9	17.0
FYR Macedonia	11	30	128	32	175	441	105	117	322	94	424	700	612	300	3,226	1,570	342	298	8.8	6.4
Montenegro	na	na	na	na	na	10	84	44	63	482	585	717	805	638	2,791	4,229	1,087	1,220	18.7	16.7
Romania	415	1,267	2,079	1,025	1,051	1,154	1,080	2,156	6,368	6,587	10,957	9,629	13,519	4,900	58,224	2,683	444	623	5.8	6.8
Serbia	0	740	113	112	50	165	475	1,365	966	1,550	4,264	2,523	2,717	1,400	15,040	2,005	336	362	6.2	5.3
Total	*661*	*2,586*	*3,002*	*2,112*	*2,564*	*2,899*	*3,022*	*6,313*	*11,631*	*13,584*	*24,846*	*27,737*	*27,972*	*14,263*	*130,462*	*2,669*	*638*	*592*	*12.6*	*9.2*
Eastern Europe and the Caucasus																				
Armenia	18	52	221	122	104	70	111	121	217	252	450	701	784	488	3,257	1,006	217	242	7.6	6.5
Azerbaijan	627	1,115	1,023	510	149	299	1,048	2,353	2,351	458	-1,301	-5,201	-555	-871	3,229	384	-619	-66	-16.6	-1.2
Belarus	105	350	201	443	119	96	453	170	163	303	351	1,770	2,143	1,326	6,708	694	183	222	3.9	3.6
Georgia	54	236	221	62	153	80	122	335	420	529	1,115	1,740	1,561	887	6,643	1,510	395	355	17.1	12.2
Moldova	23	78	75	38	127	102	132	71	146	199	223	481	679	75	2,442	713	140	198	10.9	11.2
Ukraine	516	581	747	489	594	769	698	1,411	1,711	7,533	5,737	9,218	9,683	4,000	40,753	889	200	211	6.5	5.4
Total	*1,343*	*2,412*	*2,488*	*1,664*	*1,245*	*1,415*	*2,564*	*4,461*	*5,007*	*9,273*	*6,575*	*8,710*	*14,296*	*5,905*	*63,032*	*866*	*86*	*194*	*4.9*	*6.3*
Turkey	612	554	573	138	112	2,854	957	1,252	2,005	8,967	19,065	19,940	15,633	7,000	77,540	1,113	289	224	3.1	2.1
Russia	1,657	1,680	1,492	1,102	-463	216	-588	-1,769	1,662	118	6,550	9,158	20,425	708	43,108	304	64	144	0.7	1.2
Central Asia																				
Kazakhstan	1,137	1,320	1,143	1,468	1,278	2,861	2,164	2,213	5,436	2,123	6,663	8,000	10,700	8,200	49,501	3,183	515	688	7.6	7.9
Kyrgyz Republic	31	83	87	38	-7	-1	5	46	132	43	182	208	265	60	1,226	231	40	50	5.5	5.2
Mongolia	16	20	19	34	40	43	78	132	129	258	290	360	586	410	2,030	761	136	219	9.2	11.1
Tajikistan	18	18	25	21	24	9	36	32	272	55	66	160	300	100	1,075	166	25	46	4.3	5.8
Turkmenistan	108	108	62	125	131	170	276	226	354	418	731	804	820	1,355	4,748	730	124	126	6.3	4.3
Uzbekistan	90	167	140	121	75	83	65	83	177	192	174	705	711	711	2,858	103	26	26	3.2	2.5
Total	*1,399*	*1,716*	*1,476*	*1,808*	*1,541*	*3,165*	*2,624*	*2,731*	*6,499*	*3,088*	*8,106*	*10,237*	*13,382*	*10,836*	*61,438*	*862*	*144*	*193*	*6.0*	*6.2*
All transition countries Total	**14,548**	**18,811**	**23,466**	**25,424**	**26,052**	**29,223**	**31,379**	**26,158**	**50,049**	**66,372**	**87,875**	**107,461**	**108,394**	**50,249**	**652,688**	**2,363**	**375**	**397**	**6.5**	**5.8**

Sources: IMF, central banks and EBRD estimates.

Note: Regional FDI inflows per capita are weighted averages (by population). Regional FDI in per cent of GDP is an unweighted average.

Table A.1.1.8
GDP growth forecasts for 2009 (in per cent)

	Average[1]	Range[2]	EBRD (Oct 2009)	European Union (May 2009)	IMF (Oct 2009)	OECD (June 2009)	United Nations (Oct 2009)	Credit Suisse (Sep 2009)	Dun & Bradstreet (Sep 2009)	Economist Intelligence Unit (Sep 2009)	Global Insight, Inc.[4] (Aug-Sep 2009)	IWH[5] (Sep 2009)	JP Morgan (Sep 2009)	Kopint-Tárki[6] (Sep 2009)	Vienna Institute[7] (July 2009)	Business Monitor Online[8] (May-Sep 2009)
Central Europe and the Baltic states																
Croatia	-4.8	2.5	-5.4	-3.0	-5.2	na	-5.0	na	-4.0	-5.4	-4.9	-5.5	na	-5.4	-4.0	-5.1
Czech Republic	-3.5	3.0	na	-2.7	-4.3	-4.2	-4.0	-4.5	-2.5	-4.3	-3.5	-3.8	-4.0	-2.8	-1.5	-3.1
Estonia	-12.9	6.0	-13.2	-10.3	-14.0	-13.9	-12.0	na	-10.0	-13.0	-13.1	-13.8	na	-12.0	-16.0	-13.2
Hungary	-6.4	1.6	-6.5	-6.3	-6.7	-6.1	-6.5	-5.5	-7.1	-7.0	-6.5	-6.3	-6.2	-6.0	-6.5	-6.4
Latvia	-16.7	6.9	-16.0	-13.1	-18.0	na	-17.5	na	-15.0	-17.0	-17.4	-16.0	na	-15.0	-20.0	-18.4
Lithuania	-15.8	7.8	-18.4	-11.0	-18.5	na	-16.0	na	-15.0	-15.0	-18.8	-15.5	na	-14.0	-16.0	-15.9
Poland	0.6	2.7	1.3	-1.4	1.0	-0.4	1.1	1.0	0.4	0.7	-0.4	0.9	1.2	0.8	0.8	1.0
Slovak Republic	-4.6	3.4	-6.0	-2.6	-4.7	-5.0	-4.0	na	-4.5	-5.5	-4.8	-4.6	na	-3.8	-5.0	-4.2
Slovenia	-5.7	4.6	-7.8	-3.4	-4.7	-5.8	-5.5	na	-7.0	-7.0	-4.9	-8.0	na	-4.5	-4.0	-5.9
Average	*-7.8*	*4.3*	*-8.5*	*-6.0*	*-8.3*	*-5.9*	*-7.7*	*-3.0*	*-7.2*	*-8.2*	*-8.3*	*-8.1*	*-3.0*	*-7.0*	*-8.0*	*-7.9*
Weighted average[3]	*-3.4*	*3.1*	*-3.6*	*-3.4*	*-3.5*	*na*	*-3.2*	*na*	*-3.2*	*-3.7*	*-4.0*	*-3.4*	*na*	*-2.9*	*-3.0*	*-3.2*
South-eastern Europe																
Albania	1.5	6.7	3.0	na	0.7	na	4.0	na	1.5	1.0	4.7	na	na	na	-1.0	-2.0
Bosnia and Herzegovina	-3.1	1.0	-3.1	na	-3.0	na	-3.5	na	-2.5	-3.0	-3.5	na	na	na	-3.0	-3.0
Bulgaria	-4.6	4.9	-6.0	-1.6	-6.5	na	-5.7	na	-6.0	-5.3	-4.0	-4.0	-5.0	-3.0	-3.0	-5.3
FYR Macedonia	-2.3	2.7	-1.6	-0.3	-2.5	na	-3.0	na	-3.0	-3.0	-2.8	na	na	na	-2.0	-2.5
Montenegro	-4.8	3.0	-4.1	na	-4.0	na	-6.0	na	na	-5.0	-5.6	na	na	na	-3.0	-5.8
Romania	-6.6	4.5	-8.0	-4.0	-8.5	na	-7.6	na	-7.5	-7.5	-5.6	-6.6	-6.0	-6.2	-6.0	-5.7
Serbia	-4.3	1.5	-4.0	na	-4.0	na	-4.0	na	-4.0	-4.0	-4.8	na	-4.0	-5.5	-4.0	-5.1
Average	*-3.5*	*3.5*	*-3.4*	*-2.0*	*-4.0*	*na*	*-3.7*	*na*	*-3.6*	*-3.8*	*-3.1*	*-5.3*	*-5.0*	*-4.9*	*-3.1*	*-4.2*
Weighted average[3]	*-5.3*	*3.9*	*-6.2*	*na*	*-6.7*	*na*	*-6.0*	*na*	*na*	*-6.0*	*-4.7*	*na*	*na*	*na*	*-4.8*	*-5.2*
Eastern Europe and the Caucasus																
Armenia	-10.8	9.2	-14.3	na	-15.6	na	-9.0	na	na	-9.0	-10.7	na	na	na	na	-6.4
Azerbaijan	3.7	6.0	5.0	na	7.5	na	3.0	na	1.5	3.0	1.8	na	na	na	na	3.8
Belarus	-2.6	3.4	-3.0	na	-1.2	na	-3.5	na	-2.0	-2.0	-4.6	na	na	na	na	-1.9
Georgia	-4.2	4.0	-5.5	na	-4.0	na	-4.0	na	-5.0	-3.0	-5.8	na	na	na	na	-1.8
Moldova	-8.6	3.1	-8.5	na	-9.0	na	-10.0	na	na	-9.0	-8.2	na	na	na	na	-6.9
Ukraine	-14.2	6.0	-14.0	na	-14.0	na	-13.2	-13.0	-15.0	-17.0	-16.1	na	-13.7	-15.0	-11.0	-14.7
Average	*-6.1*	*5.3*	*-6.7*	*na*	*-6.1*	*na*	*-6.1*	*-13.0*	*-5.1*	*-6.2*	*-7.3*	*na*	*-13.7*	*-15.0*	*-11.0*	*-4.7*
Weighted average[3]	*-8.8*	*5.5*	*-8.7*	*na*	*-8.0*	*na*	*-8.4*	*na*	*na*	*-10.2*	*-10.5*	*na*	*na*	*na*	*na*	*-8.6*
Turkey	-5.9	3.4	-6.0	-3.7	-6.5	-5.9	na	-5.4	-5.5	-5.4	-7.1	na	-4.7	-7.0	-7.0	-6.2
Russia	-7.6	6.7	-8.5	-3.8	-7.5	-6.8	na	-8.4	-10.0	-7.4	-7.5	-10.5	-8.5	-7.0	-4.7	-7.8
Central Asia																
Kazakhstan	-1.6	3.3	-1.3	na	-2.0	na	-2.0	-0.2	-3.0	-2.0	-1.4	na	0.3	na	-2.0	-1.9
Kyrgyz Republic	0.1	3.1	1.5	na	1.5	na	-1.0	na	0.0	1.0	-0.5	na	na	na	na	-1.6
Mongolia	0.2	4.4	1.0	na	0.5	na	na	na	na	na	1.9	na	na	na	na	-2.5
Tajikistan	1.3	4.0	2.0	na	2.0	na	1.0	na	1.5	1.0	2.8	na	na	na	na	-1.2
Turkmenistan	2.5	11.0	6.0	na	4.0	na	-5.0	na	6.0	-5.0	5.9	na	na	na	na	5.4
Uzbekistan	6.3	6.8	7.0	na	7.0	na	2.5	na	5.0	6.0	9.3	na	na	na	na	7.6
Average	*1.5*	*5.4*	*2.7*	*na*	*2.2*	*na*	*-0.9*	*-0.2*	*1.9*	*0.2*	*3.0*	*na*	*0.3*	*na*	*-2.0*	*1.0*
Weighted average[3]	*0.1*	*4.6*	*0.8*	*na*	*0.1*	*na*	*na*	*na*	*na*	*na*	*1.1*	*na*	*na*	*na*	*na*	*0.2*
All transition countries																
Average	*-4.5*	*4.6*	*-4.6*	*-4.8*	*-4.7*	*-6.0*	*-5.1*	*-5.1*	*-4.3*	*-5.1*	*-4.5*	*-7.8*	*-5.1*	*-7.1*	*-5.9*	*-4.6*
Weighted average[3]	*-5.7*	*4.8*	*-6.0*	*na*	*-5.9*	*na*	*na*	*na*	*na*	*na*	*-6.1*	*na*	*na*	*na*	*na*	*-5.8*

Note: All forecasts quoted here were published or reported to the EBRD between April and September 2009. 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 2008. Weighted averages of EBRD forecasts for CEB and for all transition countries use IMF October forecast for the Czech Republic.

[4] Global Insight Inc. was formerly DRI-WEFA.

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

[6] Institute for Economic Research, Hungary.

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

[8] Forecasts for Kazakhstan and Tajikistan are as of April 2009. Forecast for Turkmenistan was revised prior to January 2009.

Table A.1.1.9

GDP growth forecasts for 2010 (in per cent)

	Average[1]	Range[2]	EBRD (Oct 2009)	European Union (May 2009)	IMF (Oct 2009)	OECD (June 2009)	United Nations (Oct 2009)	Credit Suisse (Sep 2009)	Dun & Bradstreet (Sep 2009)	Economist Intelligence Unit (Sep 2009)	Global Insight, Inc.[4] (Aug-Sep 2009)	IWH[5] (Sep 2009)	JP Morgan (Sep 2009)	Kopint-Tárki[6] (Sep 2009)	Vienna Institute[7] (July 2009)	Business Monitor Online[8] (May-Sep 2009)
Central Europe and the Baltic states																
Croatia	0.5	2.5	1.5	1.5	0.4	na	0.1	na	0.3	0.3	0.1	-1.0	na	0.5	0.5	1.1
Czech Republic	1.2	2.8	na	0.3	1.3	1.4	1.0	2.0	1.0	1.0	1.1	0.2	3.0	1.8	1.0	1.1
Estonia	-2.4	10.1	0.1	-0.8	-2.6	-0.7	-3.5	na	-2.0	-3.0	-0.9	-3.8	na	0.0	-10.0	-1.2
Hungary	-0.6	3.2	-0.9	-0.3	-0.9	-2.2	0.2	0.0	-1.2	-1.0	-1.3	-1.7	1.0	1.0	-1.5	0.1
Latvia	-4.2	10.8	-1.2	-3.2	-4.0	na	-4.0	na	-3.5	-4.0	-3.6	-5.8	na	-2.5	-12.0	-2.3
Lithuania	-4.2	13.0	-3.0	-4.7	-4.0	na	-3.8	na	-2.5	-4.5	-2.7	-4.8	na	-3.0	-13.0	0.0
Poland	1.8	2.8	1.8	0.8	2.2	0.6	2.9	2.0	1.7	1.5	1.1	1.7	3.0	1.1	1.5	3.4
Slovak Republic	1.5	5.1	3.5	0.7	3.7	3.1	1.2	na	1.2	1.0	1.2	-1.4	na	2.0	0.0	1.3
Slovenia	0.7	3.9	2.6	0.7	0.6	0.7	1.5	na	0.5	0.0	-0.5	-1.3	na	1.0	1.0	1.0
Average	*-0.6*	*6.0*	*0.6*	*-0.6*	*-0.4*	*0.5*	*-0.5*	*1.3*	*-0.5*	*-1.0*	*-0.6*	*-2.0*	*2.3*	*0.2*	*-3.6*	*0.5*
Weighted average [3]	*0.8*	*3.8*	*1.2*	*0.2*	*1.1*	*na*	*1.3*	*na*	*0.7*	*0.5*	*0.4*	*-0.1*	*na*	*1.0*	*-0.3*	*1.8*
South-eastern Europe																
Albania	2.4	4.0	1.6	na	2.2	na	2.5	na	1.8	3.0	5.0	na	na	na	1.0	2.0
Bosnia and Herzegovina	0.9	3.5	0.8	na	0.5	na	1.0	na	2.5	0.5	1.0	na	na	na	-1.0	1.5
Bulgaria	0.1	4.5	-1.5	-0.1	-2.5	na	2.0	na	0.5	0.8	1.4	0.2	-1.5	1.0	0.0	0.4
FYR Macedonia	1.2	2.5	2.0	1.5	2.0	na	1.0	na	0.0	0.5	2.5	na	na	na	0.0	1.2
Montenegro	-0.3	3.0	0.1	na	-2.0	na	1.0	na	na	0.5	-0.8	na	na	na	-1.0	0.0
Romania	0.4	2.3	1.0	0.0	0.5	na	0.1	na	1.0	1.0	1.0	-1.3	na	0.8	0.0	0.3
Serbia	0.5	2.4	1.0	na	1.5	na	0.8	na	0.5	1.0	-0.9	na	1.0	0.3	0.0	0.2
Average	*0.7*	*3.2*	*0.7*	*0.5*	*0.3*	*na*	*1.2*	*na*	*1.1*	*1.0*	*1.3*	*-0.6*	*-0.3*	*0.7*	*-0.1*	*0.8*
Weighted average [3]	*0.5*	*2.8*	*0.7*	*na*	*0.3*	*na*	*0.7*	*na*	*na*	*1.0*	*1.0*	*na*	*na*	*na*	*0.0*	*0.4*
Eastern Europe and the Caucasus																
Armenia	1.8	2.6	1.3	na	1.2	na	1.0	na	na	1.0	3.6	na	na	na	na	2.5
Azerbaijan	5.4	6.5	7.1	na	7.4	na	4.5	na	3.0	4.5	2.5	na	na	na	na	9.0
Belarus	0.4	4.0	0.9	na	1.8	na	-2.0	na	1.0	2.0	-1.9	na	na	na	na	0.9
Georgia	1.5	1.0	2.0	na	2.0	na	1.5	na	1.0	1.0	1.4	na	na	na	na	1.5
Moldova	0.5	2.4	1.5	na	0.0	na	1.0	na	na	0.0	-0.9	na	na	na	na	1.2
Ukraine	1.4	3.5	3.0	na	2.7	na	0.4	1.7	0.0	0.0	-0.5	na	3.0	2.0	1.5	1.3
Average	*1.8*	*3.3*	*2.6*	*na*	*2.5*	*na*	*1.1*	*1.7*	*1.3*	*1.4*	*0.7*	*na*	*3.0*	*2.0*	*1.5*	*2.7*
Weighted average [3]	*1.8*	*3.9*	*3.1*	*na*	*3.1*	*na*	*0.6*	*na*	*na*	*1.1*	*-0.1*	*na*	*na*	*na*	*na*	*2.4*
Turkey	2.4	2.7	3.0	2.2	3.7	2.6	na	3.3	1.0	3.0	1.8	na	3.0	1.2	1.0	3.4
Russia	1.9	10.5	3.1	1.5	1.5	3.7	na	3.6	0.0	2.5	1.5	-5.5	5.0	2.0	4.0	2.0
Central Asia																
Kazakhstan	2.0	1.0	1.6	na	2.0	na	2.0	2.5	1.5	2.0	1.8	na	2.0	na	2.0	2.4
Kyrgyz Republic	1.7	4.0	3.0	na	3.0	na	-1.0	na	1.5	2.0	0.1	na	na	na	na	3.0
Mongolia	5.2	6.5	5.0	na	3.0	na	na	na	na	na	3.4	na	na	na	na	9.5
Tajikistan	3.1	0.7	3.0	na	3.0	na	3.0	na	2.8	3.0	3.2	na	na	na	na	3.5
Turkmenistan	9.3	10.3	13.0	na	15.3	na	8.0	na	7.5	8.0	5.0	na	na	na	na	8.5
Uzbekistan	6.6	4.5	7.0	na	7.0	na	3.5	na	7.0	6.0	8.0	na	na	na	na	8.0
Average	*4.7*	*4.5*	*5.4*	*na*	*5.6*	*na*	*3.1*	*2.5*	*4.1*	*4.2*	*3.6*	*na*	*2.0*	*na*	*2.0*	*5.8*
Weighted average [3]	*3.5*	*2.6*	*3.6*	*na*	*4.1*	*na*	*na*	*na*	*na*	*na*	*3.0*	*na*	*na*	*na*	*na*	*4.0*
All transition countries																
Average	*1.4*	*4.6*	*2.2*	*0.0*	*1.8*	*1.2*	*1.0*	*2.2*	*1.1*	*1.2*	*1.1*	*-2.0*	*2.2*	*0.6*	*-1.3*	*2.2*
Weighted average [3]	*1.6*	*6.0*	*2.3*	*na*	*1.9*	*na*	*na*	*na*	*na*	*na*	*1.1*	*na*	*na*	*na*	*na*	*2.2*

Note: All forecasts quoted here were published or reported to the EBRD between April and October 2009. 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 2008. Weighted averages of EBRD forecasts for CEB and for all transition countries use IMF October forecast for the Czech Republic.

[4] Global Insight Inc. was formerly DRI-WEFA.

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

[6] Institute for Economic Research, Hungary.

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

[8] Forecasts for Kazakhstan and Tajikistan are as of April 2009. Forecast for Turkmenistan was revised prior to January 2009.

Table A.1.1.10

Average annual inflation forecasts for 2009 (change in the average consumer price level, in per cent)

	Average[1]	Range[2]	EBRD (Oct 2009)	European Union (May 2009)	IMF (Oct 2009)	OECD (June 2009)	United Nations (Oct 2009)	Credit Suisse (Sep 2009)	Dun & Bradstreet (Sep 2009)	Economist Intelligence Unit (Sep 2009)	Global Insight, Inc.[3] (Aug-Sep 2009)	IWH[4] (Sep 2009)	JP Morgan (Sep 2009)	Kopint-Tárki[5] (Sep 2009)	Vienna Institute[6] (July 2009)	Business Monitor Online[7] (May-Sep 2009)
Central Europe and the Baltic states																
Croatia	2.8	0.6	2.5	3.1	2.8	na	3.0	na	2.7	2.5	3.0	3.0	na	2.9	3.0	2.8
Czech Republic	1.2	1.5	na	1.1	1.0	1.6	1.0	1.1	1.8	1.1	1.1	1.2	1.2	0.7	1.0	2.2
Estonia	0.0	1.8	0.3	0.6	0.0	-0.5	-0.5	na	0.3	-0.8	-1.1	0.7	na	0.2	0.0	0.5
Hungary	4.4	2.7	4.5	4.4	4.5	4.5	4.5	4.2	5.5	4.8	4.3	3.8	4.3	4.5	4.7	2.8
Latvia	3.5	3.0	3.6	4.6	3.1	na	3.0	na	2.0	3.3	4.0	4.0	na	3.4	3.0	5.0
Lithuania	4.2	1.5	4.2	3.6	3.5	na	5.0	na	3.5	4.6	4.5	4.3	na	3.7	4.5	4.4
Poland	3.3	1.5	3.4	2.6	3.4	3.5	3.8	3.4	2.3	3.3	3.8	3.5	3.6	3.8	3.3	3.0
Slovak Republic	1.8	1.5	2.6	2.0	1.5	1.8	1.6	na	1.8	2.1	1.1	2.0	na	1.3	2.0	2.3
Slovenia	0.8	1.6	1.8	0.7	0.5	0.8	0.2	na	0.5	0.8	1.0	0.9	na	0.3	1.5	0.2
Average	*2.5*	*1.7*	*2.7*	*2.5*	*2.3*	*2.0*	*2.4*	*2.9*	*2.3*	*2.4*	*2.4*	*2.6*	*3.0*	*2.3*	*2.6*	*2.6*
South-eastern Europe																
Albania	1.9	0.9	1.7	na	1.7	na	2.5	na	2.0	2.1	2.0	na	na	na	2.0	1.6
Bosnia and Herzegovina	1.0	3.5	3.0	na	0.9	na	0.5	na	2.0	0.5	-0.4	na	na	na	-0.5	2.1
Bulgaria	3.0	2.2	2.6	3.9	2.7	na	3.2	na	3.5	2.8	4.2	2.7	3.9	2.2	2.0	2.5
FYR Macedonia	1.3	4.0	-0.4	0.8	-0.5	na	1.5	na	3.5	0.5	3.4	na	na	na	3.0	0.2
Montenegro	3.4	2.2	1.8	na	3.4	na	3.9	na	na	3.6	3.9	na	na	na	3.0	4.0
Romania	5.5	1.5	5.3	5.8	5.5	na	5.5	na	5.5	5.0	5.7	5.5	5.9	5.2	6.0	4.5
Serbia	8.6	4.8	8.3	na	9.9	na	10.5	na	7.5	9.9	9.4	na	9.0	8.2	8.0	5.7
Average	*3.5*	*2.7*	*3.2*	*3.5*	*3.4*	*na*	*3.9*	*na*	*4.0*	*3.5*	*4.0*	*4.1*	*6.3*	*5.2*	*3.4*	*2.9*
Eastern Europe and the Caucasus																
Armenia	3.4	2.1	3.0	na	3.0	na	4.2	na	na	4.2	2.1	na	na	na	na	3.6
Azerbaijan	3.3	3.8	2.5	na	2.2	na	2.5	na	6.0	2.8	2.4	na	na	na	na	5.0
Belarus	12.8	5.8	13.2	na	13.0	na	12.5	na	9.5	12.5	15.3	na	na	na	na	13.5
Georgia	1.9	3.2	1.2	na	1.2	na	1.0	na	4.0	0.8	1.8	na	na	na	na	3.0
Moldova	1.4	4.4	0.0	na	1.4	na	1.0	na	na	1.0	0.8	na	na	na	na	4.4
Ukraine	16.6	3.7	16.0	na	16.3	na	17.2	16.3	15.0	16.5	17.2	na	17.3	16.0	16.0	18.7
Average	*6.6*	*3.8*	*6.0*	*na*	*6.2*	*na*	*6.4*	*16.3*	*8.6*	*6.3*	*6.6*	*na*	*17.3*	*16.0*	*16.0*	*8.0*
Turkey	6.1	2.3	5.9	7.3	6.2	6.3	na	6.2	5.0	5.9	6.1	na	6.1	6.0	6.0	6.7
Russia	11.9	5.3	12.3	13.3	12.3	8.0	12.7	12.2	12.0	12.2	12.4	12.0	12.1	10.8	12.0	11.7
Central Asia																
Kazakhstan	8.0	2.3	7.2	na	7.5	na	8.2	7.7	7.5	7.5	7.5	na	na	na	9.5	9.3
Kyrgyz Republic	10.9	11.1	7.6	na	8.0	na	7.9	na	18.0	7.9	8.0	na	na	na	na	18.7
Mongolia	8.4	1.1	8.1	na	8.5	na	na	na	na	na	9.1	na	na	na	na	8.0
Tajikistan	7.8	4.5	8.6	na	8.0	na	6.6	na	7.0	6.6	6.9	na	na	na	na	11.1
Turkmenistan	8.8	14.6	5.5	na	0.4	na	15.0	na	6.5	15.0	8.0	na	na	na	na	11.5
Uzbekistan	11.6	9.5	14.5	na	12.5	na	8.6	na	12.0	8.6	7.7	na	na	na	na	17.2
Average	*9.3*	*7.2*	*8.6*	*na*	*7.5*	*na*	*9.3*	*7.7*	*10.2*	*9.1*	*7.9*	*na*	*na*	*na*	*9.5*	*12.6*
All transition countries																
Average	*5.3*	*3.6*	*5.2*	*3.8*	*4.8*	*3.3*	*5.2*	*7.3*	*5.7*	*5.1*	*5.2*	*3.6*	*7.0*	*4.6*	*4.5*	*6.2*

Note: All forecasts quoted here were published or reported to the EBRD between April and September 2009. 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. The EBRD no longer produces forecasts for the Czech Republic, and instead uses IMF projections (*World Economic Outlook*, October 2009) for the purposes of computing regional weighted averages.

[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] Global Insight Inc. was formerly DRI-WEFA.

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

[5] Institute for Economic Research, Hungary.

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

[7] Forecasts for Kazakhstan and Tajikistan are as of April 2009. Forecast for Turkmenistan was revised prior to January 2009.

Table A.1.1.11

Average annual inflation forecasts for 2010 (change in the average consumer price level, in per cent)

	Average[1]	Range[2]	EBRD (Oct 2009)	European Union (May 2009)	IMF (Oct 2009)	OECD (June 2009)	United Nations (Oct 2009)	Credit Suisse (Sep 2009)	Dun & Bradstreet (Sep 2009)	Economist Intelligence Unit (Sep 2009)	Global Insight, Inc.[3] (Aug-Sep 2009)	IWH[4] (Sep 2009)	JP Morgan (Sep 2009)	Kopint-Tárki[5] (Sep 2009)	Vienna Institute[6] (July 2009)	Business Monitor Online[7] (May-Sep 2009)
Central Europe and the Baltic states																
Croatia	2.9	1.7	3.5	3.7	2.8	na	3.0	na	2.6	2.6	2.9	3.5	na	3.1	2.5	2.0
Czech Republic	1.7	2.7	na	1.6	1.1	0.3	2.0	1.1	2.0	1.9	1.6	1.4	3.0	2.2	2.0	1.7
Estonia	0.1	5.5	-0.3	0.5	-0.2	-0.5	1.0	na	1.3	0.2	0.1	1.5	na	0.3	-4.0	0.8
Hungary	3.7	2.0	3.0	4.1	4.1	4.1	4.0	2.8	4.0	4.2	3.6	3.2	3.5	4.5	4.3	2.5
Latvia	-1.3	6.5	-2.8	-0.7	-3.5	na	1.0	na	0.0	-1.7	0.4	1.5	na	-3.0	-5.0	0.0
Lithuania	0.5	6.9	-2.0	-0.4	-2.9	na	2.5	2.7	4.0	1.5	0.4	1.5	na	-1.5	-2.0	1.9
Poland	2.5	1.2	2.7	1.9	2.6	1.8	3.0	na	2.5	2.6	2.6	2.3	2.7	2.7	2.6	2.6
Slovak Republic	2.1	1.7	3.0	2.4	2.3	1.8	1.3	na	2.7	2.4	2.2	1.8	na	2.2	2.0	1.5
Slovenia	1.8	2.5	2.0	2.0	1.5	1.6	1.7	na	2.0	1.7	3.0	1.4	na	1.8	2.0	0.5
Average	*1.6*	*3.4*	*1.1*	*1.7*	*0.9*	*1.5*	*2.2*	*2.2*	*2.3*	*1.7*	*1.9*	*2.0*	*3.1*	*1.4*	*0.5*	*1.5*
South-eastern Europe																
Albania	2.4	1.1	2.5	na	2.0	na	3.0	na	2.5	2.9	2.0	na	na	na	2.0	1.9
Bosnia and Herzegovina	2.2	4.0	3.0	na	1.6	na	2.0	na	4.0	1.5	3.4	na	na	na	0.0	1.9
Bulgaria	2.5	5.1	-0.1	3.6	1.6	na	3.0	na	5.0	2.4	3.3	2.3	na	2.0	2.0	2.1
FYR Macedonia	2.1	1.6	2.0	1.7	2.0	na	2.0	na	3.0	1.6	2.6	na	na	na	3.0	1.4
Montenegro	2.3	1.9	2.0	na	2.1	na	2.0	na	na	2.2	3.2	na	na	na	3.0	1.3
Romania	3.9	3.5	4.0	3.5	3.6	na	3.6	na	4.5	3.3	3.8	2.5	6.0	3.5	4.0	4.0
Serbia	5.9	3.0	5.0	na	7.3	na	6.0	na	5.5	6.4	6.3	na	6.5	6.0	6.0	4.3
Average	*3.0*	*2.9*	*2.6*	*2.9*	*2.9*	*na*	*3.1*	*na*	*4.1*	*2.9*	*3.5*	*2.4*	*6.3*	*3.8*	*2.9*	*2.4*
Eastern Europe and the Caucasus																
Armenia	4.3	2.8	3.5	na	3.2	na	6.0	na	na	6.0	3.6	na	na	na	na	3.2
Azerbaijan	7.4	4.5	5.0	na	5.3	na	9.2	na	8.0	9.5	6.9	na	na	na	na	8.0
Belarus	8.4	3.8	8.5	na	8.3	na	8.0	na	10.0	8.0	6.2	na	na	na	na	9.5
Georgia	3.3	3.3	3.2	na	3.0	na	4.3	na	5.0	4.0	1.7	na	na	na	na	1.8
Moldova	4.3	4.9	4.8	na	7.7	na	3.0	na	na	3.0	4.3	na	na	na	na	2.8
Ukraine	11.7	5.5	10.0	na	10.3	na	12.0	12.8	10.0	12.2	10.4	na	12.1	11.0	12.0	15.5
Average	*6.5*	*4.1*	*5.8*	*na*	*6.3*	*na*	*7.1*	*12.8*	*8.3*	*7.1*	*5.5*	*na*	*12.1*	*11.0*	*12.0*	*6.8*
Turkey	5.9	3.0	7.0	6.3	6.8	5.9	na	6.4	4.0	7.0	6.3	na	5.7	5.8	5.0	4.8
Russia	9.4	4.7	11.2	9.1	9.9	6.5	7.3	8.8	11.0	9.4	10.6	10.0	9.3	9.2	10.0	10.0
Central Asia																
Kazakhstan	7.7	2.9	7.0	na	6.6	na	7.3	8.0	9.0	6.4	8.1	na	na	na	8.0	9.3
Kyrgyz Republic	7.3	8.5	6.7	na	6.7	na	5.2	na	12.0	5.2	3.5	na	na	na	na	11.8
Mongolia	7.4	2.6	8.6	na	7.9	na	na	na	na	na	7.1	na	na	na	na	6.0
Tajikistan	8.8	4.5	10.8	na	10.9	na	7.9	na	8.5	8.0	6.4	na	na	na	na	9.3
Turkmenistan	7.9	8.5	4.5	na	3.5	na	12.0	na	5.0	12.0	8.2	na	na	na	na	10.0
Uzbekistan	10.5	5.9	11.4	na	9.5	na	8.7	na	14.0	8.7	8.1	na	na	na	na	12.8
Average	*8.3*	*5.5*	*8.2*	*na*	*7.5*	*na*	*8.2*	*8.0*	*9.7*	*8.1*	*6.9*	*na*	*na*	*na*	*8.0*	*9.9*
All transition countries																
Average	*4.6*	*3.9*	*4.5*	*2.8*	*4.3*	*2.7*	*4.7*	*6.1*	*5.5*	*4.7*	*4.4*	*2.7*	*6.1*	*3.3*	*3.0*	*4.8*

Note: All forecasts quoted here were published or reported to the EBRD between April and September 2009. 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. The EBRD no longer produces forecasts for the Czech Republic, and instead uses IMF projections (*World Economic Outlook*, October 2009) for the purposes of computing regional weighted averages.

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

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[5] Institute for Economic Research, Hungary.

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

[7] Forecasts for Kazakhstan and Tajikistan are as of April 2009. Forecast for Turkmenistan was revised prior to January 2009.

Annex 1.2

Energy sector assessment

The authorities in the EBRD transition region are increasingly taking steps to open up their electricity and gas sectors to competition and trade, promote new renewable energy sources and implement measures to improve efficiency. These sectors are transforming in response to concerns about supply and demand, but energy security, environmental sustainability policies and regulatory frameworks in the region are evolving at different speeds and with varying success.

The EBRD conducted its first in-depth assessment of the electricity and gas sectors in its countries of operations[1] in mid-2009. This annex summarises the findings.[2] The broad objective of the assessment is to help the private and public sectors measure regulatory and legal risk, so as to facilitate energy-targeted investment and development throughout the region. Additional, more specific objectives encourage continued reform and liberalisation of the electricity and gas sectors, improvements in security of supply, and the use of renewable energy sources and energy efficiency in the participant countries.

The following analysis is based on international best practices, drawing particularly on experience across Europe and North America, along with guidance from international financial institutions (IFIs) and other energy sector authorities.

The assessment reveals that the EBRD countries of operations that are members of the European Union have already embraced international best practices and the principles embodied in the EU legal framework, and are steadily implementing broad-based reform of their energy sectors. In the "Energy Community" region – the area bordering the European Union to the south-east which has been brought together with the European Community under the Energy Community Treaty – institutional reforms pre-date (to greater and lesser degrees) actual changes in market operation. Beyond the European Union and the Energy Community regions, policy and regulatory development is inconsistent; the energy sectors of these countries, and indeed the overall economic and political structures, vary greatly from state to state. As a general rule, regulation and policy in these countries are driven less by independent authority and open competition, and their energy sectors are more centralised than in the European Union and the Energy Community. Overall, however, regulatory risk is diminishing across the EBRD countries of operations and investment opportunities in this sector are increasing.

Assessment model and methodology

The assessment was conducted through questionnaires and responses, together with supplementary research and analysis. While efforts have been made to get verification from all participants of the data collected, in a few instances the assessment team did not receive data directly from countries (although all had repeated opportunities to provide material).

When assessing the energy sector in the EBRD transition region, the assessment model takes into account the differences in the countries' political, economic and infrastructure environments. It uses best practices that have broad international recognition. The model is adaptable, however, to the regional differences wherever possible, and offers a quantitative analysis that accommodates developing frameworks.

Internationally, no multilateral standard embodying generally accepted best practices exists in the energy sector (unlike, for example, telecommunications).[3] The EBRD has therefore encouraged public comment and consultation and high-level negotiation among stakeholders to elaborate and promote detailed, sound standards. This assessment is based on those best practices that have achieved a high degree of consensus over the years. These are drawn from international[4] and regional agreements,[5] treatises and papers by IFIs,[6] aid organisations,[7] leading sector experts[8] and regional regulatory groups.[9] These general principles form the benchmarks by which to measure energy regulatory development.

The benchmarks are:

— clear, coherent and targeted policy, supported by primary legislation that sets out the rights and obligations of different sector participants and supplemented by consistent secondary legislation (all publicly accessible)

— a solid institutional framework of regulation in the form of an energy regulator, ideally independent but at least sufficiently separated from industry and from policy-making

— a liberalised electricity market, or a framework that supports steady movement towards such a market, and a framework in the gas sector that supports a wholesale market

— non-discriminatory, third-party access to the existing network

— the effective separation of the network business from (commercial) generation and supply activities

— the elimination of cross-subsidies and promotion of cost-reflective tariffs

— a fair, equitable and transparent licensing procedure

— a dispute resolution and appeal process that is efficient and accessible

— a transparent framework that holds the regulatory authority accountable

— public service obligations that are carefully targeted to support vulnerable customers, rural or outlying customers, environmental protection and security of supply, while not impeding liberalisation.

Indicators[10]

Eight indicators are each assigned a points value and the composite score from all indicators is used to assess each sector participant (to a maximum of 100). The most fundamental criteria (regulatory authority and independence) receive the greatest weightings.

1. **Regulatory independence – maximum score 15 points**
   This indicator assesses the institutional framework in order to measure a regulatory authority's level of freedom from industry, government and other interests.

2. **Regulatory authority – maximum score 15 points**
   The more independent the regulatory authority, and the more autonomy it has to decide the framework tariffs, the more likely is the development of a market economy that supports competition and cost-reflective prices.

3. **Market framework – maximum score 14 points**
   This indicator assesses the degree to which competition is possible, as well as the actual degree of competition in the market.

4. **Network access – maximum score 12 points**
   This assesses the network options available to new market entrants. Without access to a stable network that is able to handle increases in capacity, new producers cannot sell their product (within or beyond a country's borders) and new customers may be restricted.

5. **Tariff structure – maximum score 12 points**
   A liberalised market requires that energy enterprises receive a fair price for the energy produced, distributed and supplied.

6. **Public service obligations – maximum score 10 points**
   It is widely accepted that some energy services (particularly transmission) are monopolies and therefore require regulation that includes public service and public protection components.

7. **Transparency and accountability – maximum score 12 points:**
   Without transparency and accountability, any regulatory and policy framework can be subject to abuse, misinterpretation or disregard.

8. **Private sector participation – maximum score 10 points**
   This indicator is mostly concerned with the viability of the existing framework for bringing in new investment.

Although the indicators are the same for electricity and gas, several subcomponents vary in order to accurately reflect the differences between the two sectors. These differences are small and, where applicable, elaborated on in the EBRD Energy Sector Assessment report.

Country/regional groupings

The assessment divides the EBRD countries of operations into three separate groups:

Group A – the EU member states.[11]

Group B – the Energy Community signatories, which include, the south-eastern European (SEE) countries (with the exception of Bulgaria and Romania which are included in Group A), along with the observers to the Energy Community Treaty (Georgia, Moldova, Turkey and Ukraine). These countries are grouped together to reflect the common rules under which each of the signatories to the Energy Community Treaty is bound and the common objectives to which each of the observers have committed.

Group C – Armenia, Azerbaijan, Belarus, Kazakhstan, the Kyrgyz Republic, Mongolia, Russia, Tajikistan, Turkmenistan and Uzbekistan.

Results

Indicators

For each transition country, a "spider" diagram reflects the quality (that is, the score) of the regulatory framework and market structure for electricity. Each diagram includes the indicators (numbered 1 to 8). For each indicator, the diagram presents the scores as fractions of the maximum achievable rating. The scores begin at zero at the centre of the chart and reach 1.0 at the outside so that, in the overall chart, the wider the coloured "web" the better the scores in the assessment (and the level of performance within the defined benchmarks.)

1 = Regulatory independence

2 = Regulatory authority

3 = Market framework

4 = Network access

5 = Tariff structure

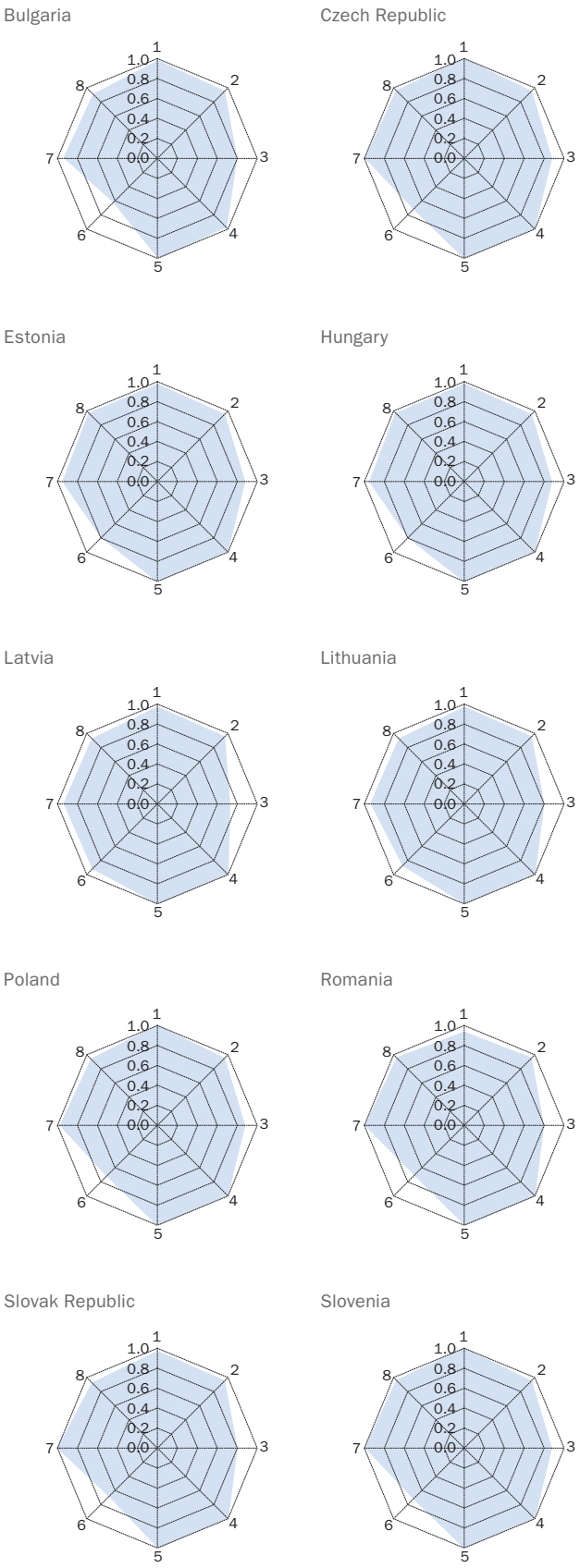
6 = Public service obligations

7 = Transparency

8 = Private sector investment

Chart A.1.2.1
Quality of energy sector regulatory frameworks in transition countries

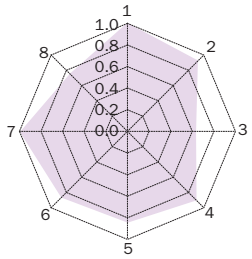
EBRD EU member states
(Group A)



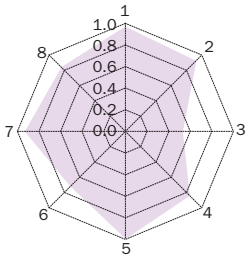
Source: EBRD, Energy sector assessment, 2009.

Energy Community Treaty signatories and observers (Group B)

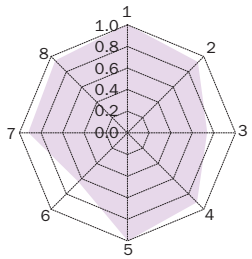
Albania



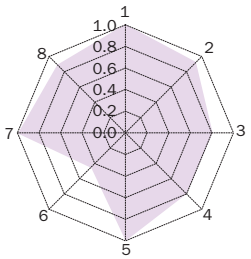
Bosnia and Herzegovina



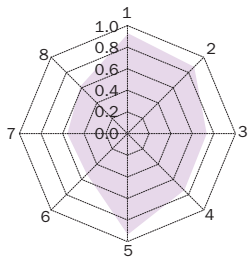
Croatia



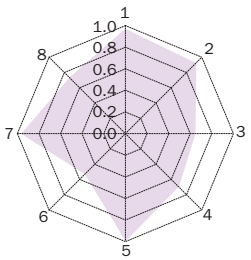
FYR Macedonia



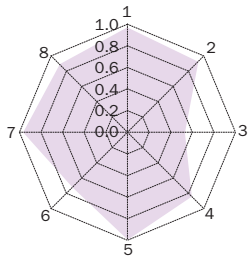
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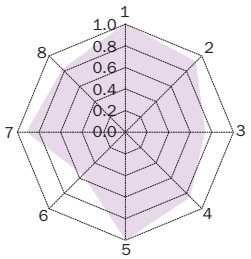
Moldova



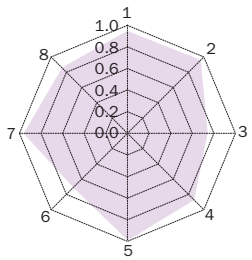
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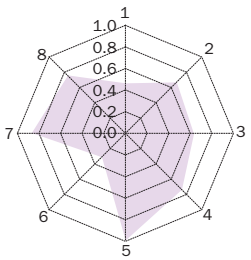
Serbia



Turkey

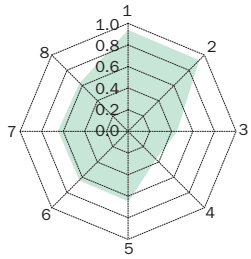


Ukraine

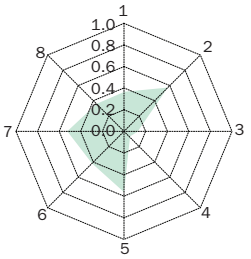


Armenia, Azerbaijan, Belarus, Russia and Central Asian republics (Group C)

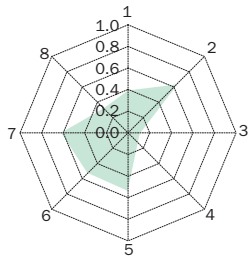
Armenia



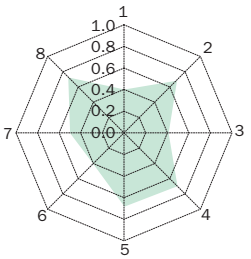
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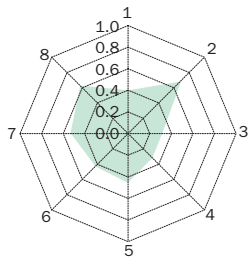
Belarus



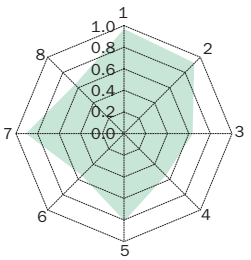
Kazakhstan



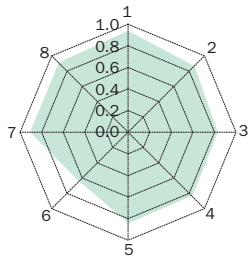
Kyrgyz Republic



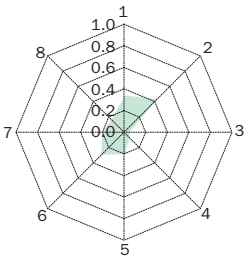
Mongolia



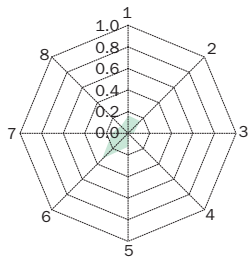
Russia



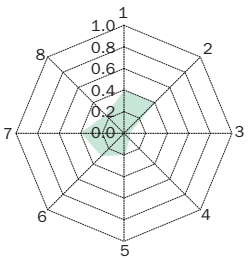
Tajikistan



Turkmenistan



Uzbekistan



Regional comparison

For the purposes of the charts that follow in this annex: (i) "institutional framework", constituted by indicators 1 and 2 comprises 30 per cent of the point-scoring potential; (ii) "market structure and access", constituted by indicators 3 and 4, comprises 26 per cent; (iii) "tariffs and public service obligations", constituted by indicators 5 and 6, comprise 22 per cent; (iv) and "transparency and private sector participation", constituted by indicators 7 and 8, comprise 22 per cent.

Group A

For those EBRD countries of operations that are EU member states, compliance with energy market liberalisation requirements and the EU *acquis communautaire* has been mandatory for many years. As expected, they achieve a score above 90 per cent with respect to all the indicators, although there is still room for further improvement (see Chart A.1.2.2).

Group B

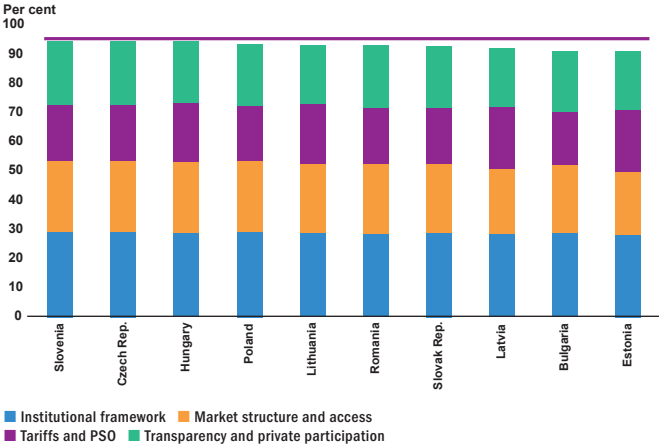
Obligations on the Energy Community Treaty signatories are less demanding than those on EU members (for example, environmental and competition requirements), and for observer countries such commitment is entirely voluntary. Nonetheless, the Energy Community Treaty draws on the principles embodied in the EU legal framework which therefore means that scores for the contracting parties should be at least 80 per cent (see Chart A.1.2.3 for confirmation). Observer countries, which are not so bound but are voluntarily moving towards implementation, fall closer to the 70 per cent+ range. (Ukraine is the only country that falls below this mark, due largely to the reduced independence of its regulatory framework and the limited opening of the market.)

Group C

The three highest-performing countries – Armenia, Mongolia and Russia – have made significant efforts over the last five to 10 years to reform their energy markets and regulatory frameworks. Russia is the best-performing in this group by a considerable margin (see Chart A.1.2.4).

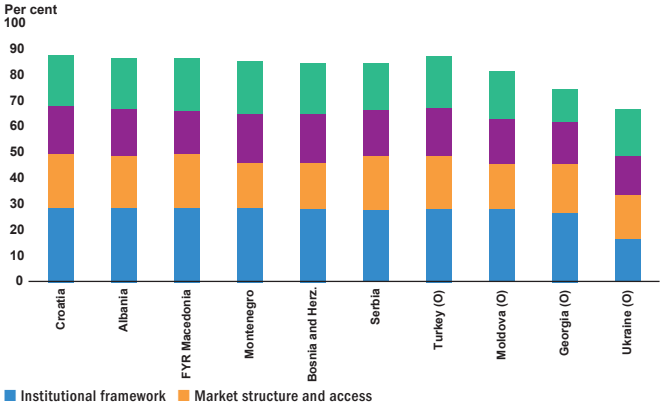
In the six least-performing countries, the absence (or low level) of a wholesale market contributed to the low scores, while limited independence of the regulator and transparency are other critical factors. In the case of Kazakhstan, a wholesale market has been active since 1996. An electric power exchange has been in place since 2001 and a grid code was adopted in the same year. In addition, wholesale market participants have established the Pool of Electric Capacity Reserves (Pool ECR), which supports a reservation mechanism in order to cover emergency deficiencies in contributors' contractual obligations.

Chart A.1.2.2
Quality of energy regulatory frameworks, by indicator
EBRD EU member states (Group A)



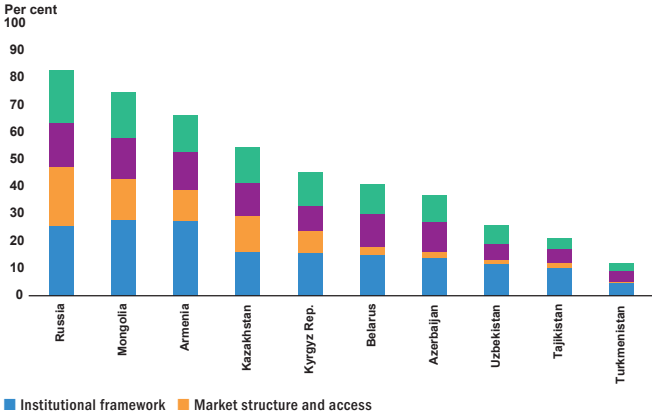
Source: EBRD, Energy sector assessment, 2009.
Note: PSO is public service obligations.

Chart A.1.2.3
Quality of energy regulatory frameworks, by indicator
Energy Community Treaty signatories and observers (Group B)



Source: EBRD, Energy sector assessment, 2009.
Notes: PSO is public service obligations; O is Observers.

Chart A.1.2.4
Quality of energy regulatory frameworks, by indicator
Armenia, Azerbaijan, Belarus, Russia and Central Asian republics (Group C)



Source: EBRD, Energy sector assessment, 2009
Note: PSO is public service obligations.

The institutional frameworks are weaker in this region, with lower levels of independence and scope of authority among regulators (or their Ministry equivalents) than in Groups A and B. Armenia and Mongolia do have strong institutional frameworks, but with limitations to market access and transparency. Azerbaijan's sector is heavily dominated by the government, with minimal market access. The absence of public consultation also results in low transparency scores, as is the case for Tajikistan and Uzbekistan. In Mongolia the regulator launched an operational model for the national power grid starting from September 2002, whereby the generation companies sell electricity at regulated prices to a single buyer. To complement the single-buyer model, a spot market was introduced in 2006 and an auction market has been operating since 2007. The Mongolian electricity industry has been unbundled since 2001, and comprises five generation, one transmission and eight distribution companies. With the exception of one private distribution company, all are state joint-stock companies.

Box A.1.2.1
Case study: FYR Macedonia

FYR Macedonia was part of the former Yugoslav energy system until 1991. Since then, it has worked steadily to develop a national energy policy and regulatory framework and to liberalise its sector, including the privatisation of distribution companies. The country suffers from limited energy resources; only about 75 per cent of its electricity consumption is produced domestically (the majority from inefficient low-caloric lignite resources and the remainder from hydropower) and all its gas supply is imported from Russia. Demand and import prices are increasing while domestic supply is not.

FYR Macedonia has therefore taken steps to reform its institutional, market and investment environment, unbundling its electricity sector and privatising distribution in 2005. It has a regulated market and a wholesale market for eligible customers, with a phased market liberalisation plan (with 30.47 per cent opening up on 1 January 2008 and staggered thereafter until full liberalisation in 2015). A gas law was passed in 2006, introducing a similar timetable for market opening. There has been some political pressure with regard to end-user pricing over the years, and investors have balked at inadequate tariff levels and the absence of institutional policing and legal assistance to address commercial losses. However, a credible regulator has been in place since 2004, with an independent structure and financing.

Recognising the importance of regional energy market trade to its security of supply, FYR Macedonia has taken an active position in the Energy Community. In 2009 the country signed a Memorandum of Understanding on the establishment of the Coordinated Auction Office, initiated by the Energy Community, which is intended to function as a supranational auction office for capacity allocation on interconnections in the south-east European region.

Additional institutional reform, particularly on the policy side, is still needed. This includes the creation of a separate Ministry in charge of energy (rather than – as is the case in much of SEE– diluted responsibility within the Ministry of Economy). A dedicated Ministry could direct its attention to developing greater domestic resources, including improvements to the gas infrastructure (and particularly the development of gas-fired power plants).

Box A.1.2.2
Case study: Russia

The strides that Russia has made over the last decade to reform its electricity market offer a useful model for its neighbours. The monopoly RAO UES (Unified Energy System of Russia) has been unbundled, and 20 of the resulting companies were privatised in 2008. The reforms created six wholesale thermal power-generating companies (OGKs – which remain separate from hydro and nuclear assets) and 14 territorial generating companies (TGKs – which provide district heating as well as power). Foreign investors include E.ON and RWE of Germany (in OGK 4 and TGK 2, respectively), ENEL of Italy (in OGK 5) and Fortum of Finland (in TGK 10, plus a minority share in TGK 1). The (60 per cent) state-owned RusHydro JSC manages the vast majority of the Russian hydropower plants (HPPs). The operation of the country's transmission grid remains under state control through the Federal Grid Company.

At the wholesale level, a power exchange was established in 2006. The share of electricity that is sold at non-regulated prices is increasing in stages, from 5 per cent of the forecast balance prepared by the Federal Tariffs Service of Russia for 1 January 2007 to full liberalisation of the wholesale electricity (capacity) market in 2011. In the interim phase, the majority of traded volumes is still exchanged and paid for at regulated prices pursuant to regulated bilateral contracts.

The power exchange is made up of:

— the day-ahead market (DAM) – based on the mechanism of competitive price formulation or auction of electricity buyers' and sellers' bids. Auctioning is conducted daily, one day ahead of real time, and simultaneously for each hour of the day in question. Based on its results, balanced planned hourly output/consumption volumes are formed and equilibrium prices are determined, taking into account system constraints and electricity transmission losses. A major bid selection criterion is the maximisation of total benefit to DAM participants.

— free bilateral contracts – the execution of free bilateral electricity contracts by market participants, offering a complementary trade mechanism (in addition to the auction) by which contractual prices and supply volumes are defined by the parties. For the preservation of the day-ahead market financial balance, the parties to the contract pay the cost of electricity load losses and system constraints associated with the corresponding contract.

The power exchange is complemented by a balancing market. Volumes of actual output/consumption deviation from planned amounts for each participant are sold/purchased in the balancing market. The balancing market calculations are performed one hour ahead.

Conclusions

The assessment model implies that the transition countries are moving towards an internationally agreed set of principles, and provides an overview of sector compliance from this perspective. Concerns over security of energy supply, together with economic pressures, have led various countries to look towards regional market frameworks. Such markets require that regulatory environments are reasonably harmonised and that market participants can operate within predictable, transparent and non-discriminatory frameworks.

Across the EBRD's countries of operations, regulatory progress is visible, although the degree differs greatly from region to region and intra-regionally as well. The EU members have achieved a high threshold of compliance. The Energy Community countries (the signatories in particular, but increasingly the observers too) are catching up steadily; the adoption of the EU framework and the implementation of acknowledged best practices are viewed as a defining step toward EU integration and the greater economic security that comes with EU membership.

In general, the remaining countries have been slower to implement reforms, which largely reflects political, economic and infrastructure limitations (although Russia stands out for its noteworthy reform efforts).

The EBRD is continuing to support regulatory reforms in countries where they are most needed. The target for these countries should be the achievement of greater regulatory independence (or even just the setting up of a regulator in some Central Asian republics) and competition safeguards, supported by transparency, non-discrimination and accountability. The implementation of best practices in these countries should inevitably lead to greater energy security, energy access and public confidence in the sector, promoting in turn economic development and growth.

Endnotes

1 The Czech Republic has been included in this assessment for comparison purposes, although it graduated from EBRD operations as of December 2007.

2 A detailed report will be published in late 2009.

3 World Trade Organization Reference Paper on Basic Telecommunications Services.

4 One important example is the Energy Charter Treaty. Its fundamental aim is to strengthen the rule of law on energy issues by creating fair and transparent rules to be observed by all participating governments, thereby mitigating risks associated with energy-related investment and trade. Signed in 1994, the Treaty entered into force in 1998. Belarus and Russia have signed but not ratified it, while both Serbia and Montenegro are yet to sign.

5 These include, among other things, the following EU Directives and Regulations in the energy sector, which are accompanied by Interpretive Notes: Directive 2003/54/EC (Electricity Directive); Directive 2003/55/EC (Gas Directive); Regulation (EC) No. 1228/2003 and the Revised Guidelines on Congestion Management (CMG); Regulation (EC) No. 1775/2005 (access to the gas network); Council Directive 2004/67/EC (security of gas supply); Directive 2005/89/EC (security of electricity supply); Note of the Directorate-General for Energy and Transport of the European Commission on Unbundling; Note of the Directorate-General for Energy and Transport of the European Commission on Distribution; Note of the Directorate-General for Energy and Transport of the European Commission on Exemptions. Explanations for the rationale behind these rules provide helpful insight into the core principles underlying them, and can be found in Jones and Webster (2006), Albers et al (2005) and Bertoldi et al (2006).

6 For example, Haralampieva and Moffatt (2008) and the World Bank's *Handbook for Evaluating Infrastructure Regulatory Systems* (2006).

7 See Archer (2007).

8 World Resource Institute, National Institute of Public Finance and Policy, and Prayas Energy Group (2004) *Electricity Governance Toolkit*, DC, WRI; see Cubbin and Stern (2005).

9 NARUC Principles (1991); CEER Regulatory Benchmarking Standards for South East Europe Regional Electricity Market (2003) WG SEEER Discussion Paper, Brussels; ERGEG Good Practice Guidelines in the electricity and gas sectors, issued periodically and updated, see http://www.energy-regulators.eu/portal/page/portal/EER_HOME/EER_PUBLICATIONS; G-8 Meeting of Energy Ministers; Round Table of Energy Regulators; G-8 Summit (2009).

10 A detailed description of the indicators (including all indicator subcomponents) and their respective weightings will be provided in the final assessment, to be issued in late 2009.

11 Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia.

12 A number of countries of operations do not have gas sectors, so a homogenised evaluation of all participants can be done only for electricity. In Groups A and B, market liberalisation of the gas sector has advanced at a comparable speed (but at different times because only in the last few years have Group B countries entered into commitments regarding market opening and unbundling as envisaged by the EU Electricity and Gas Directives, whereas in the European Union the process has been ongoing for over a decade). The only group with notable differences between electricity and gas markets, in terms of market structure, network access and tariffs, is Group C, which will be comprehensively discussed in the final report.

References

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R. Archer (2007), "Autonomy-authority-accountability-ability: key characteristics of regulatory authorities", USAID.

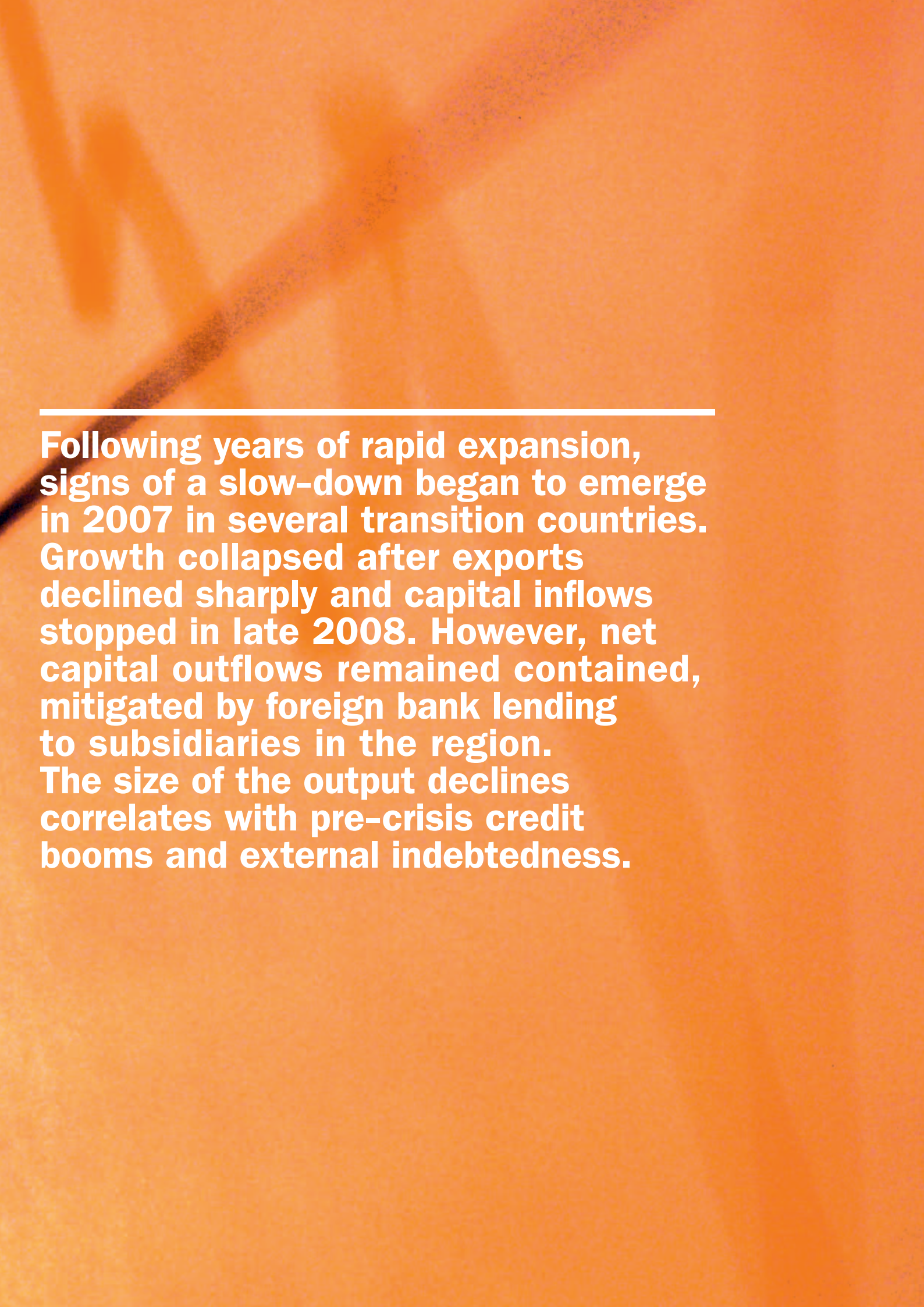
P. Bertoldi, R. Bowie and P. Hodson (2006), "EU environmental law, Vol. III", Claeys & Casteels.

J. Cubbin and J. Stern (2005), "Regulatory Effectiveness and the Empirical Impact of Variations in Regulatory Governance", World Bank Policy Research Working Paper No. 3535

V. Haralampieva and P. Moffatt (2008), "Core principles for effective power sector reform", Law in transition online, EBRD.

C. Jones and W. Webster (2006), "EU energy law, Vol. I", 2nd edition, Claeys & Casteels.

World Bank (2006), *Handbook for Evaluating Infrastructure Regulatory Systems*.



Following years of rapid expansion, signs of a slow-down began to emerge in 2007 in several transition countries. Growth collapsed after exports declined sharply and capital inflows stopped in late 2008. However, net capital outflows remained contained, mitigated by foreign bank lending to subsidiaries in the region. The size of the output declines correlates with pre-crisis credit booms and external indebtedness.

Chapter 2
Understanding the crisis in the transition region

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46 Transmission of the crisis

48 Box 2.2: What caused the "sudden stop" in international bank lending to emerging markets?

51 Box 2.3: The transmission of the financial crisis: econometric methodology and results

54 Why was the "sudden stop" contained?

55 What explains cross-country differences in output declines?

56 Conclusion

58 Box 2.4: Explaining cross-country variance in cumulative output declines in the transition region, Q4 2008 to Q1 2009

Chapter 1 has identified three critical areas of analysis for understanding the crisis in the transition region and drawing policy conclusions from it.

— First, what caused the sudden large output declines in the fourth quarter of 2008 and first quarter of 2009 in a region that seemed to have been booming only a few months before? The answer must surely involve the crisis in advanced countries, which intensified sharply in September and October 2008, but what were the transmission mechanisms? Is it plausible that financial market turmoil in the West could trigger a large output decline in many transition countries within barely a month, particularly since private capital outflows – the most obvious channel of contagion – were moderate by international comparison?

— Second, what accounts for the differences in the extent of capital outflows across countries? Why was the reversal in net capital flows to the transition region in the fourth quarter relatively mild in most countries, both compared to the extreme turmoil at the centre of the world financial system, and compared to other regions?

— Lastly, what explains the large cross-country differences in output declines? While the declines were generally abrupt and large on average, they were also extraordinarily heterogeneous – some countries suffered huge falls while others maintained positive growth. Can these anomalies be linked to specific differences in pre-crisis vulnerabilities?

This chapter begins by reviewing the genesis of macro-financial vulnerabilities in the run-up to the crisis. It then addresses the questions posed above in turn.

Before the crisis: integration and vulnerabilities

Beginning in the mid-1990s, many transition countries experienced a rapid process of integration into the global economy and income convergence with more advanced economies (see Chart 2.1). By 2008 average per capita incomes in central Europe and the Baltic states (CEB) had surpassed 50 per cent of the average in the EU-15 (the 15 member states of the European Union prior to the 2004 expansion). In most other transition countries living standards also increased rapidly but from lower starting points.

Economic integration occurred at three levels – trade, finance and labour.

— Trade volumes between the CEB and south-eastern Europe (SEE) countries on the one hand and the EU-15 on the other expanded particularly rapidly. For these transition countries, the sum of exports and imports exceeded 100 per cent of gross domestic product (GDP) by 2007. Further eastwards in the transition region, trade integration did not progress so quickly, although between 2001 and 2008 several countries – particularly Azerbaijan, Kazakhstan and Russia – experienced sharply increasing hydrocarbon exports as a result of growing production capacity and steep rises in commodity prices (see Chapter 4).

— Financial integration proceeded at an even faster pace than did trade, linked in part to political integration (see Box 2.1 on page 44). Most countries reduced barriers to capital account transactions, particularly those joining the European Union where free movement of capital is a legal requirement. The presence of foreign-owned bank groups grew dramatically, especially in CEB and SEE, therefore linking many banks in the transition region both organisationally and financially to parent institutions abroad. Foreign direct investment (FDI) in the corporate sectors also increased, supporting productivity growth through the transfer of technology and fostering local skills.

— Labour migration meanwhile generated considerable remittance flows. A number of the EU-15 member states opened their labour markets, attracting significant numbers of workers from the candidate countries.[1] Although regional trade integration within the Commonwealth of Independent States (CIS) developed only slowly, Russia and, to a lesser extent, Kazakhstan drew large labour flows from poorer countries in the CIS. As a result, cross-border remittances developed into one of the main sources of household income in countries such as Armenia, the Kyrgyz Republic, Moldova and Tajikistan. Gross remittances and other current transfers sent by migrant workers to their families in the transition region reached around US$ 50 billion by 2007. Through this channel, oil-driven growth in Kazakhstan and Russia, particularly in the booming construction sector, spilled over to the rest of the CIS.

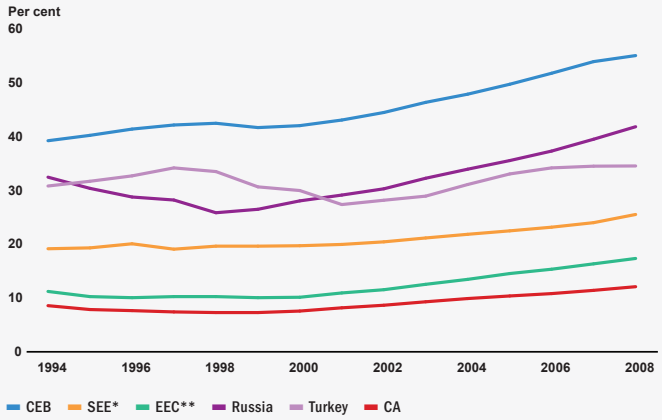
While economic integration was a powerful driver of growth, it also set up the transition region for the crisis of 2008-09: first, by creating potential channels for contagion in the event that exports, remittances and other financial inflows declined; and second, by contributing to macroeconomic and financial vulnerabilities, particularly between 2005 and 2007, which coincided with a period of high global output growth, soaring commodity prices and abundant liquidity.

Cross-border inflows of bank lending acquired boom proportions during this period. While a portion of these debt flows went directly to end-borrowers, a substantial part was intermediated by local banks. Subsidiaries of European banking groups had access to ample funding from parent banks eager to expand their market shares across the transition region. In contrast, domestically-owned banks relied on borrowing in the international bond and syndicated loan markets. Such "wholesale" borrowing became a particularly important source of banking system funding in Kazakhstan, Russia and, to a lesser extent, Ukraine. The availability of foreign finance in turn allowed banks to rapidly expand their loan portfolios (see Chart 2.2 on page 45).

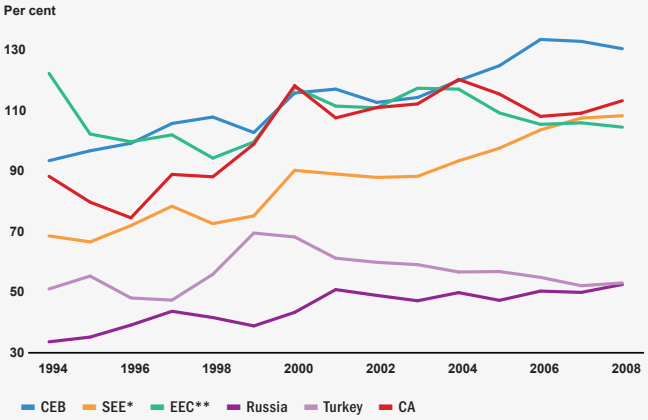
Chart 2.1

Transition economies: integration and convergence

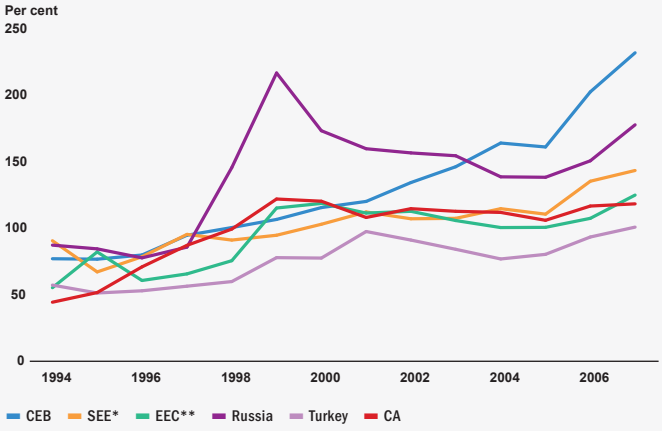
2.1a Income convergence[1]



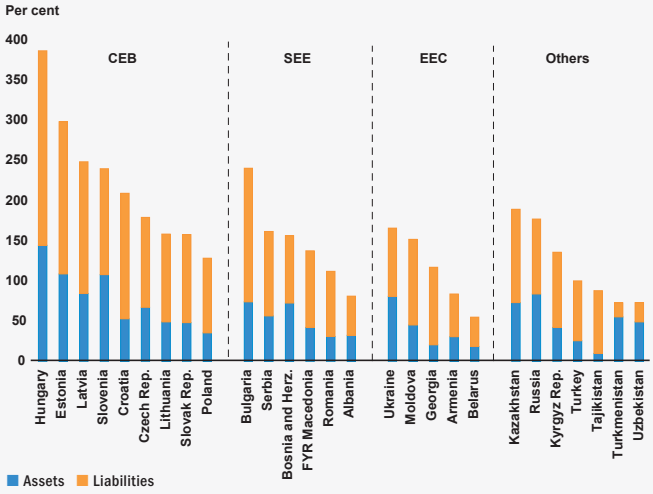
2.1b Trade openness[2]



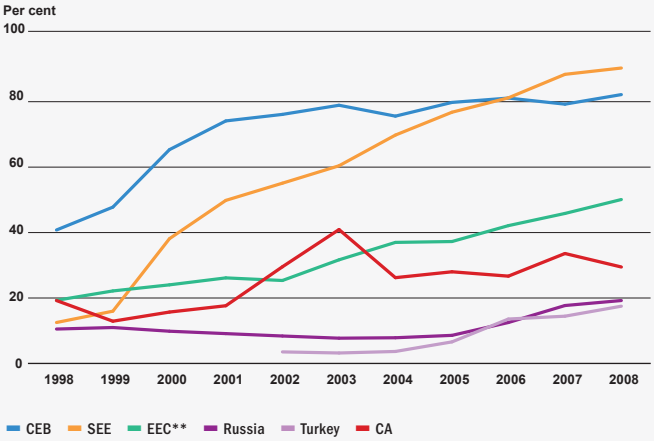
2.1c Financial integration,[3] 1994–2007



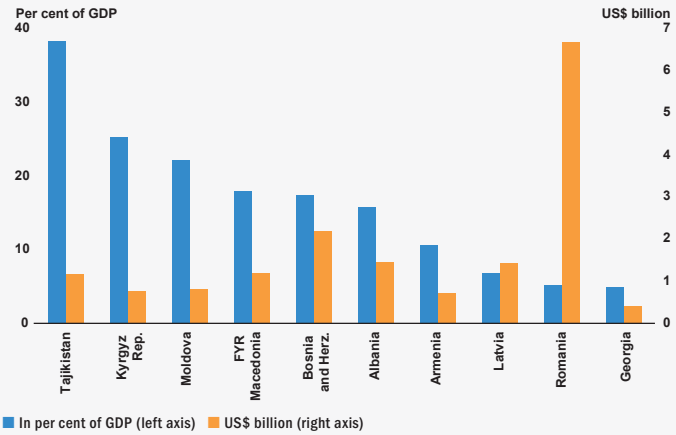
2.1d Financial integration,[3] 2007



2.1e Foreign-owned bank assets, 1998–2008[4]



2.1f Workers' remittances, 2005–07 averages[5]



Sources: International Monetary Fund (IMF) *World Economic Outlook*, Penn World Tables, Lane and Milesi–Ferretti (2006), IMF Balance of Payments Statistics, national statistical agencies and the EBRD.

Note: [1] Per capita GDP, in per cent of EU–15 average. Purchasing power–adjusted; unweighted averages across countries for each subregion. [2] Exports plus imports in per cent of GDP, unweighted averages across countries. [3] External assets plus external liabilities in per cent of GDP. [4] In per cent of total banking system assets (unweighted averages). [5] Includes other current transfers. * SEE excludes Serbia and Montenegro. **EEC excludes Azerbaijan. In Chart b, SEE excludes Bosnia and Herzegovina. EEC excludes Georgia. CA includes Kazakhstan and Mongolia only. In Chart c, CEB excludes Croatia. SEE excludes Bosnia and Herzegovina. EEC excludes Armenia and Georgia. CA excludes Mongolia and Tajikistan. In Chart e, SEE excludes Montenegro and Romania. CA excludes Mongolia and Uzbekistan.

In many cases, the credit boom allowed households and corporations to access credit markets for the first time. For example, foreign bank subsidiaries contributed to the rapid deepening of local mortgage markets in CEB and SEE, building on the mortgage lending experience in their home countries.[2] Microfinance institutions across the Balkan region and Central Asia gained access to foreign finance, either from commercial banks or from not-for-profit lenders. Therefore, abundant global liquidity gradually reached the periphery of the transition region.

The macroeconomic counterpart to this capital inflow and credit boom was a sharp increase in current account deficits in many transition countries and a related increase in private sector external indebtedness. Debt rose rapidly between 2002 and 2007, particularly in the Baltic states and some SEE countries, but also in Kazakhstan, Russia and Ukraine. This contrasts with the experience of other major emerging market economies during the same period, suggesting that the accumulation of private external debt during this period was not an inevitable by-product of the global boom (see Chart 2.3).

Aside from its magnitude and the fact that it was partly funded from abroad (and therefore vulnerable to a sudden reversal in lending flows), credit growth during 2004–07 was problematic for two reasons.

– First, in many countries a large share of domestic credit was denominated in (or indexed to) foreign currency (FX) – such as euros, US dollars, Swiss francs or Japanese yen – as borrowers sought to take advantage of lower FX interest rates and local currency appreciation. Many borrowers were households or firms without foreign exchange income. These borrowers – and, indirectly, the banks that had extended the loans – therefore became vulnerable to exchange rate depreciations. Chart 2.4 shows that in some countries, such as Estonia, Latvia and particularly Hungary, the share of FX loans in the banking system increased further during the boom years. However, it fell in other countries that also received large capital inflows, including Kazakhstan and Russia, suggesting that foreign financing was not the only factor contributing to FX-denominated lending (see Chapter 3).

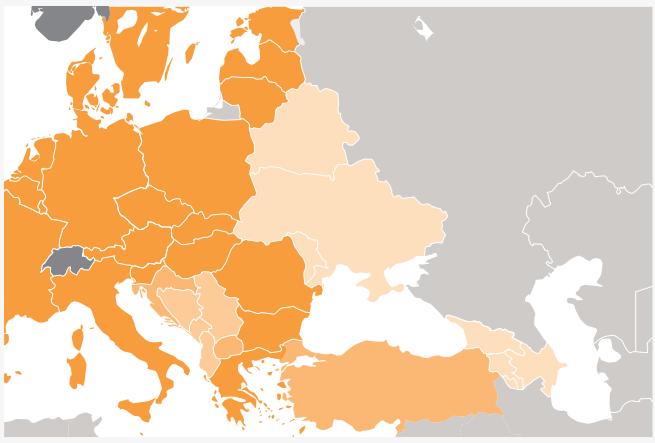
Box 2.1
Political and economic integration with the European Union

Economic integration in the European transition region[3] has gone hand-in-hand with increasing political integration with the European Union. In May 2004, following a decade-long process of negotiation and preparation, eight transition countries (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia and the Slovak Republic) joined the Union in its biggest enlargement to date. Bulgaria and Romania followed in 2007. Turkey has been a formal EU candidate since 1999, and Croatia and FYR Macedonia since 2005. The remaining Western Balkan countries have signed Stabilisation and Association Agreements with the European Union, as part of an association process, and have been recognised by the Union as potential candidate countries.

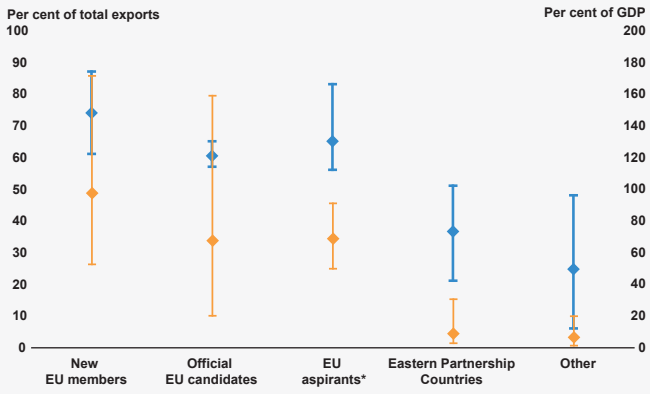
In May 2009 the European Union established an Eastern Partnership Framework with Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. Although the Framework involves a lower degree of commitment by the European Union than the Stabilisation and Association Agreements signed with the potential candidate countries, it is expected to help deepen political and economic relations and to support the institutional development of the participating countries.

The high level of economic integration between large parts of the transition region and western Europe has therefore been embedded in a simultaneous process of political and institutional integration (see Chart 2.1.1).

Chart 2.1.1
Political and economic integration with the European Union



EU member countries Formal EU candidates EU aspirant countries (SAP)
Eastern partnership countries Norway and Switzerland
Source: Eurostat Country Profiles, EBRD



Sources: BIS and UN Comtrade database.
Note: * Excluding Montenegro and Kosovo. For trade, data are for 2007; for bank assets, data are as at the end of 2007. The diamond shapes are at the average values and ranges are at the minimum and maximum values for each group.

– Second, credit was increasingly directed to the real estate and construction sectors, which became important drivers of economic growth in many countries. For example, the share of construction in total value added in the Baltic states increased from 5.7 per cent in 2000 to 8.8 per cent in 2007 (see Table 2.1). As a result, house prices increased rapidly (see Chart 2.5 on page 46). In some countries the rise of real estate prices in urban centres was exacerbated by speculation, as the newly-emerged middle class engaged in real estate transactions as a regular source of income. Some construction companies added to this speculative dynamic by using proceeds from pre-sold apartments to buy new plots of land rather than completing existing projects. These schemes frequently went undetected, as fast lending growth overwhelmed the risk management capacity of banks.

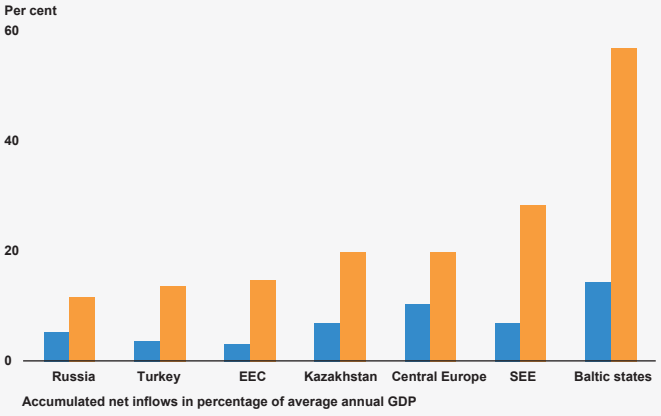
Table 2.1
Construction share in gross value added

		2000	2004	2007
		In per cent of the total		
CEB	Czech Republic	6.5	6.5	4.8
	Estonia	5.6	6.5	9.1
	Hungary	4.3	4.3	3.8
	Latvia	5.5	6.2	7.4
	Lithuania	5.9	7.2	9.8
	Poland	7.7	5.8	6.6
SEE	Bulgaria	4.6	4.9	5.7
	Croatia	4.8	6.8	6.7
	Romania	5.5	6.7	9.7
EEC	Kazakhstan	5.5	6.4	10.2
	Russia	5.2	5.7	7.4
	Ukraine	4.0	4.2	5.0

Sources: National statistical agencies, CEIC Data Company and news reports.

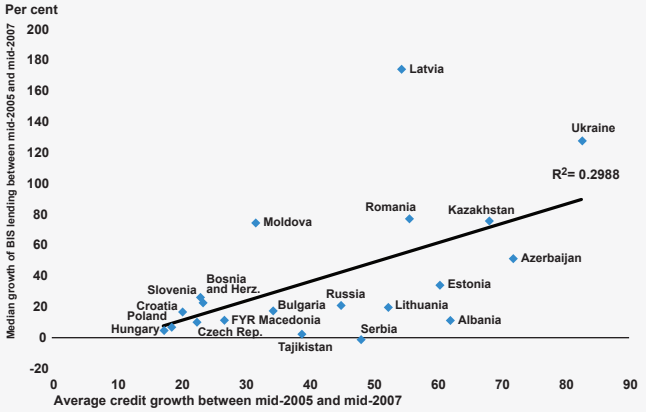
Chart 2.2
Cross-border bank lending and domestic credit growth

2.2a Cross-border bank lending to transition countries, 2002-07



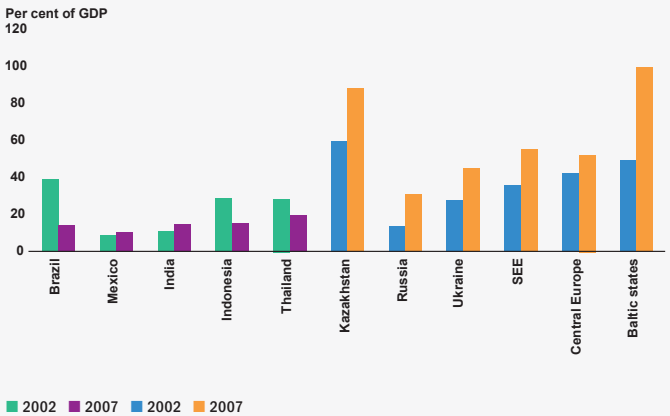
Sources: Bank of International Settlements (BIS) locational dataset 6A and IMF, *International Financial Statistics*.

2.2b Correlation between cross-border lending and domestic credit growth, 2005-07



Note: Total exchange rate-adjusted changes in external assets of BIS-reporting banks.

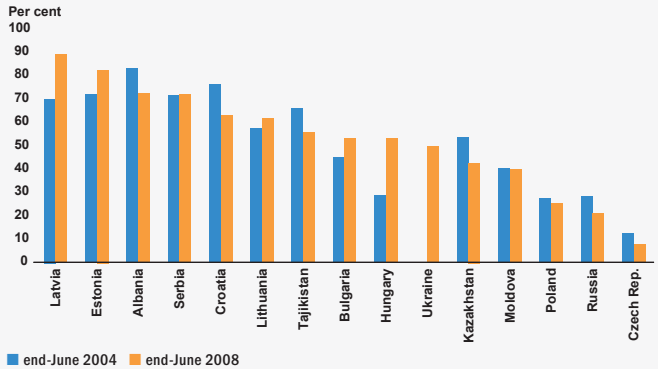
Chart 2.3
Private external debt in selected emerging market countries, 2002 and 2007



Source: IMF *International Financial Statistics*.

Note: Debt outstanding to commercial banks at year-end plus debt outstanding to other private creditors at year-end as a percentage of GDP. For Kazakhstan, includes intra-company debt within the extractive sector.

Chart 2.4
Foreign currency lending in per cent of total lending



Sources: ISI Emerging Markets, CEIC Data Company.

Note: Includes exchange rate indexed local currency lending. Assumptions on exchange rate indexed lending: Serbia: 57 per cent of total local currency lending in 2004, 70 per cent in 2008. Croatia: 74 per cent in 2004 and 61 per cent in 2008. Sources underlying these assumptions are annual reports and information directly provided by the respective central banks. For all other countries, exchange rate indexed lending is assumed to be insubstantial. Foreign currency lending is not adjusted for valuation effects. There were no comparable data available for Ukraine for end-June 2004.

In summary, by 2007 transition economies had become vulnerable to external and domestic shocks through several channels. High current account deficits and rising private external debt had created large external financing needs; greater trade integration had made transition countries vulnerable to a reduction in export demand; and real estate booms and FX lending had exposed many banking systems to asset price declines and currency depreciations.

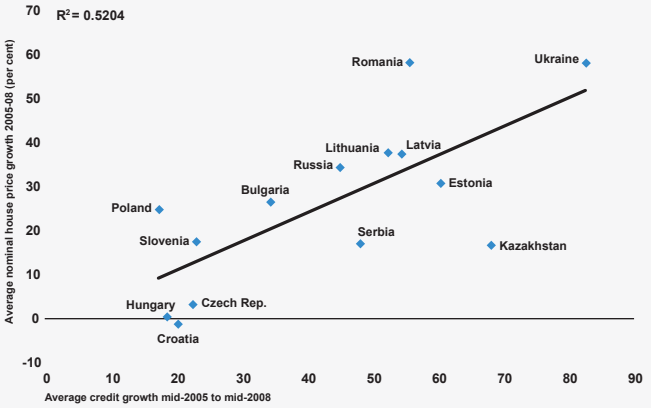
Transmission of the crisis

Despite the macroeconomic and financial vulnerabilities described in the previous section, the financial crisis took some time to arrive in the transition region, as capital inflows, modest borrowing costs, and buoyant credit and output growth continued in most countries in the first year after the initial disruptions in advanced markets. Once it did arrive, however, collapses in output were sudden and massive, and followed the intensification of the crisis in the United States and western Europe in September 2008 almost immediately. How can this be explained? The analysis that follows points to three main factors.

- Despite the initial absence of a "sudden stop" in capital flows and continued high growth in most countries, there were already signs of a downturn in the economic cycle in many transition countries prior to September 2008, and in some cases as early as 2007. As lending standards tightened – either on the initiative of regulators or banks themselves – credit growth began to retreat from unsustainable rates. Tighter monetary policy also played a role in some countries. Less accommodating international financing conditions and slower inflows compounded these effects.
- The main reason why these signs did not manifest themselves in declining output in most countries before the second half of 2008 was the continued expansion of exports. At the same time commodity prices remained high, supporting growth in countries such as Azerbaijan, Kazakhstan and Russia. When commodity prices declined in the third quarter and export demand contracted sharply in the fourth quarter, this had immediate consequences.
- The effects of the export decline were compounded by additional financial shocks, including the "sudden stop" in bank lending flows in the fourth quarter of 2008, a sharp drop in trade credit and a fall in remittances. Although Chapter 1 showed that this "sudden stop" was mild compared with the experience of other regions, the transition countries were much more sensitive to it as a result of their large external financing needs.

The remainder of this section traces developments through 2007 and the first three quarters of 2008, and then analyses the impact of the external shocks in late 2008 and early 2009.

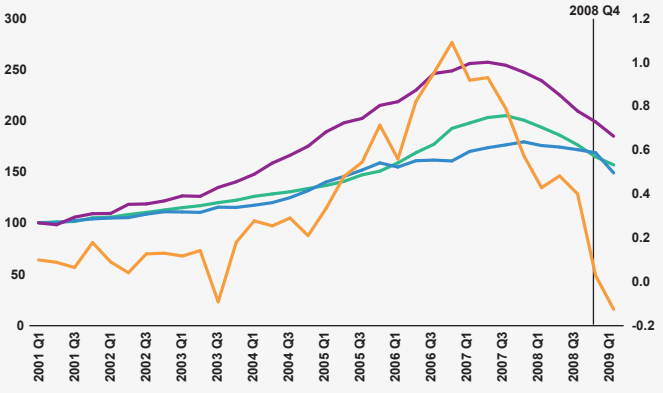
Chart 2.5
House price and credit growth, 2005–08



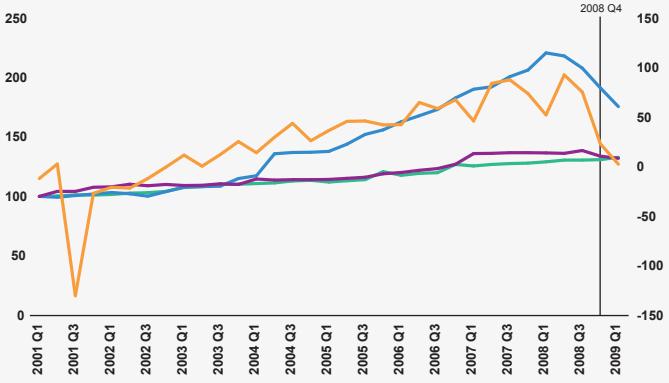
Sources: IMF *International Financial Statistics* and national statistical agencies.
Note: R^2 describes the fit of a univariate regression of average nominal house price growth on average credit growth.

Chart 2.6
Credit-driven versus export-driven contraction

2.6a Latvia



2.6b Czech Republic



Real consumption (2001 Q1=100), sa
Real investment (2001 Q1=100), sa
Real exports (2001 Q1=100), sa
Net credit to private sector (in billions of local currency units, right axis)
Sources: Eurostat and Global Insight.
Note: Sa means seasonally adjusted.

From boom to downturn, 2007–08

Beginning in 2007, signs emerged throughout the transition region that, following a phase of economic overheating and inflationary pressures, the growth period was coming to an end. Not surprisingly, the first countries to register these signs were the Baltic states, which had experienced the most extreme boom. Domestic credit growth began to slow in the first quarter of 2007, partly because concerns about the boom led to tighter financial supervision, including by the Swedish home authorities of banking groups operating in the Baltic states. This dampened investment and consumption and began to slow real GDP growth (see Chart 2.6 for the experience of Latvia compared to the Czech Republic). Following the onset of the crisis in advanced financial markets, foreign inflows to the Baltic states and Croatia declined in the second half of 2007 and credit growth slowed further. Within six months the fall in investment and consumption accelerated and real GDP began to contract in the second quarter of 2008.

Kazakhstan, because of the reliance of its banks on funding from international capital markets, was initially the only transition economy to be directly affected by the crisis. As early as August 2007 cross-border credit flows plummeted and domestic credit growth contracted sharply. With exports faltering, real GDP growth began to flatten out in the second half of 2007. It resumed briefly following a renewed increase in exports in the first half of 2008 on the back of sharply rising oil prices, but then stalled when oil prices began to fall from the third quarter of 2008.

By the end of 2007 credit growth and domestic demand were beginning to subside across the transition region (often before foreign funding inflows slowed). Domestic lending levelled off in Bulgaria, Romania, Russia and Slovenia as foreign inflows stalled or fell in the fourth quarter of 2007. Investment also slowed, beginning in the first quarter of 2008 in Russia and Slovenia and in the second quarter in Bulgaria and Romania. In Turkey and Ukraine tighter monetary policy in the first quarter of 2008 began to dampen inflationary domestic demand. Nevertheless, a contraction was initially delayed as expanding exports continued to support real GDP growth in all these countries.

This changed once the financial crisis developed into a global economic slowdown. Although US growth was still positive in the second quarter of 2008, output declined in the European Union – the main trading partner of many transition countries. Trade credit began to shrink and global trade levelled off (see Chart 2.7). Exports slowed in the second and third quarters of 2008, in turn slowing growth in the most export-dependent countries, such as the Czech Republic, Hungary and the Slovak Republic. At about the same time, the decline in oil and other commodity prices transmitted the crisis to the commodity exporters further to the east. From the third quarter of the year, growth slowed in Kazakhstan, Russia, Ukraine and even Azerbaijan, which had until then been largely insulated from the crisis due to its lower exposure to global financial markets.

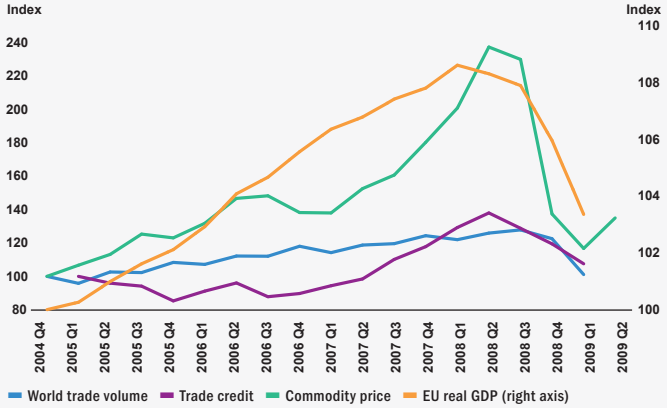
By September 2008 most transition economies that were dependent on export demand from the West, international financing or commodity prices were either slowing or contracting. The turmoil in financial markets following the failure of the US investment bank Lehman Brothers exacerbated this slow-down by finally bringing about a "sudden stop" in lending flows to emerging markets (see Box 2.2 on page 48) and by pushing advanced countries into a much deeper recession. The three hardest hit transition countries were initially Hungary, Russia and Ukraine. In addition to the impact of commodity price and demand shocks (which affected Ukraine's steel exports, for example), this reflected higher financial vulnerability compared to other countries in the region. Hungary and Russia were among the few transition countries with significant foreign investor participation in domestic securities markets. Russia and Ukraine's banking systems were relatively weak and fragmented (below the level of top-tier foreign-owned banks in Ukraine and the state banks in Russia), while Hungary had a high level of public debt which became difficult to roll over during that period.

In Russia capital flows began to reverse in the summer of 2008, following a number of incidents that seemed to raise questions about shareholder rights and depressed investor confidence. The conflict with Georgia in August further undermined sentiment. This was subsequently aggravated by a flight from the rouble by Russian enterprises as domestic confidence began to wane. Financial system liquidity tightened, despite central bank injections, as deposits were withdrawn on a large scale. With high currency reserves, the Russian authorities decided to accommodate the outflow rather than raise interest rates sharply or devalue abruptly, and opted for a sequence of small (1 per cent) devaluations. As a result, Russia's central bank lost over US$ 200 billion in reserves between September 2008 and January 2009. The private capital outflow in the fourth quarter (US$ 130 billion) was the largest of any transition country, even as a share of GDP, reversing the entire stock of accumulated inflows over the previous two years. In late January the central bank changed policy, announcing a new exchange rate ceiling and raising repurchase rates by 100 basis points, leading to a stabilisation of the currency.

Chart 2.7

Development of real GDP and world trade volume

EU real GDP, trade credit, commodity prices and world trade volume



Sources: IMF *World Economic Outlook*, World Bank Joint External Debt Hub (JEDH) and EBRD calculations.

Note: Trade credit (to the EBRD transition region). Lines show Index values with Q4 2004=100, except for trade credit where, due to data availability, Q1 2005=100.

Box 2.2

What caused the "sudden stop" in international bank lending to emerging markets?

The mechanics of the spillover of the financial crisis to emerging markets in October 2008 remains subject to debate. US and European financial markets had suffered several bouts of turbulence from August 2007 but emerging market finance was largely unaffected until the collapse of the US banks Washington Mutual and Lehman Brothers in mid-September 2008, after which net capital flows turned negative (see Chapter 1).

Why did this happen? In principle, two factors could have played a role.

- Events in September 2008 could have triggered a change in the distribution of global capital flows to the detriment of emerging markets. This could have reflected a "safe haven" effect, benefiting advanced countries as a group, as investors feared that a world recession would hurt emerging markets disproportionately or viewed the impact of the shock on emerging markets as more uncertain. Alternatively, the propensity to invest at home could have increased.[4] One possible trigger for such a homeward-bound shift could have been the announcement of large-scale support packages for US and EU banks. If banks benefiting from these packages were expected to focus their lending on domestic firms, this may have led them to "deleverage" (shrink their loan positions) mainly abroad, to the detriment of emerging markets.[5]
- Alternatively (or in addition), retrenchment from emerging markets could simply have been a manifestation of a worldwide decline in loan volumes as the global credit crunch intensified – without a particular bias against emerging markets.

Data on syndicated lending can help to assess these explanations and, more generally, to obtain a better sense of financial flows after the shock of the Lehman bank collapse. Bank syndicates have been an important source of loan flows to emerging markets and specifically the transition region, where loans to private borrowers peaked at US$ 51 billion in the second half of 2007 (US$ 93 billion for the whole year) but fell sharply in 2008, particularly after the Lehman collapse (Chart 2.2.1). Unlike aggregate data on cross-border bank assets or the balance of payments, syndicated lending data identify not only the destination country of financial flows but also the source country. They can therefore be used to distinguish whether outflows from emerging markets benefited mainly home markets (in relative terms) or advanced countries more generally. In addition, because such data are available for each participating bank in a loan syndicate, they can reveal whether banks receiving government support packages directed a larger share of their lending to home markets after the shock.

Chart 2.2.2 shows the distribution of all syndicated loans by the 156 largest international lenders in the syndications market during three periods in time: the pre-crisis period (August 2006 to July 2007), the build-up to the Lehman collapse (August 2007 to 15 September 2008) and the aftermath of the Lehman demise (16 September 2008 to April 2009).[6] Following the collapse, banks from advanced countries increased the proportion of their loans to borrowers in those countries. At the same time they halved the proportion of loans to borrowers in emerging markets (from 18 per cent to 9 per cent of all loans). This applied to international banks based in the European Union, Japan, the United States and various other advanced countries. A similar picture emerges when one analyses loan amounts rather than the number of loans. What is not clear from the chart, however, is whether the retrenchment from emerging markets reflected a general "flight to quality" reaction or whether banks specifically increased lending to their home markets. In addition, the chart says nothing about changes in overall loan volumes.

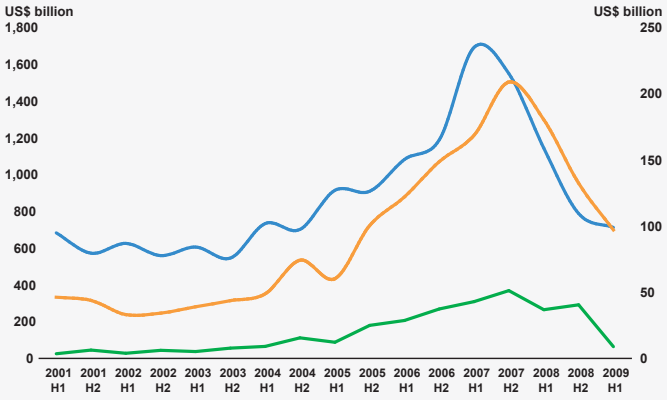
Chart 2.2.3 provides this information by showing how both the volume and geographical distribution of new syndicated lending by large European and US banks changed as a result of the crisis. After September 2008 the loan distribution shifted, with home country lending increasing from 29 per cent of the total to almost 34 per cent. This came mostly at the expense of lending to emerging markets, which fell from 8 to 4 per cent. However, this shift occurred in the context of sharply reduced loan volumes worldwide. While emerging market lending experienced a particularly steep fall – by 75 per cent – home country lending also fell by more than 50 per cent. Hence, the main driver of the sudden stop of syndicated loan flows to emerging markets appears to have been global deleveraging. An increase in the propensity to lend at home also played a role, but was less important.[7] Furthermore, it is an average effect that conceals some important cross-country differences (which are not shown). On average, British and French banks actually reduced their focus on domestic customers during the crisis, while Italian, German and Dutch banks increased it.

Chart 2.2.4 compares shifts in the destination of syndicated lending by those US and European banks that received government support (including capital injections and loan guarantees) with those that did not. The chart shows that although lending to emerging markets by supported and unsupported banks fell after the Lehman shock (particularly the proportion of loan numbers), the drop was somewhat higher among supported banks. Furthermore, unsupported banks saw virtually no increase in the proportion of lending to home-country borrowers, whereas supported banks increased home-country lending from 27 per cent to 32 per cent in terms of number of loans and from 33 per cent to 40 per cent in terms of loan amounts.

In summary, there is some evidence that both a shift in the distribution of lending towards home markets contributed to the sudden stop of syndicated loan flows to emerging markets, and that banks receiving government support packages in the wake of the September 2008 shock were more likely to raise the proportion of their lending to home-country borrowers. For the most part, however, the sharp drop in new lending to emerging markets seems to have been part of a global deleveraging process that hit all regions of the world, although to varying degrees.

Chart 2.2.1

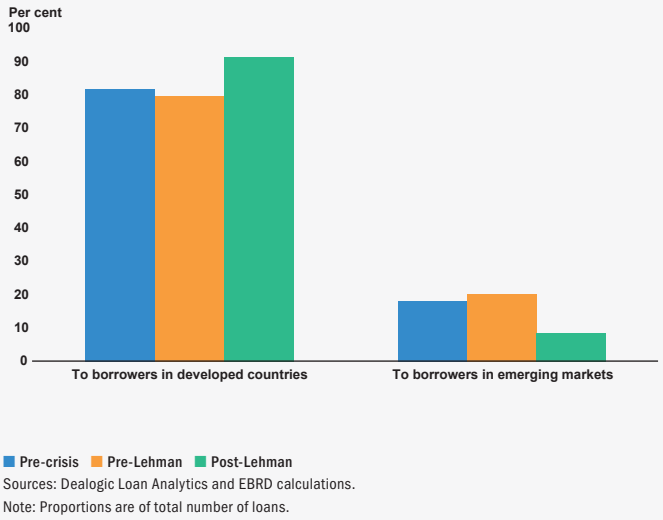
Syndicated loan flows to private sector borrowers (loan volumes per half-year)



Sources: Dealogic Loan Analytics and EBRD calculations.

Chart 2.2.2

Distribution of syndicated bank loan flows from advanced countries

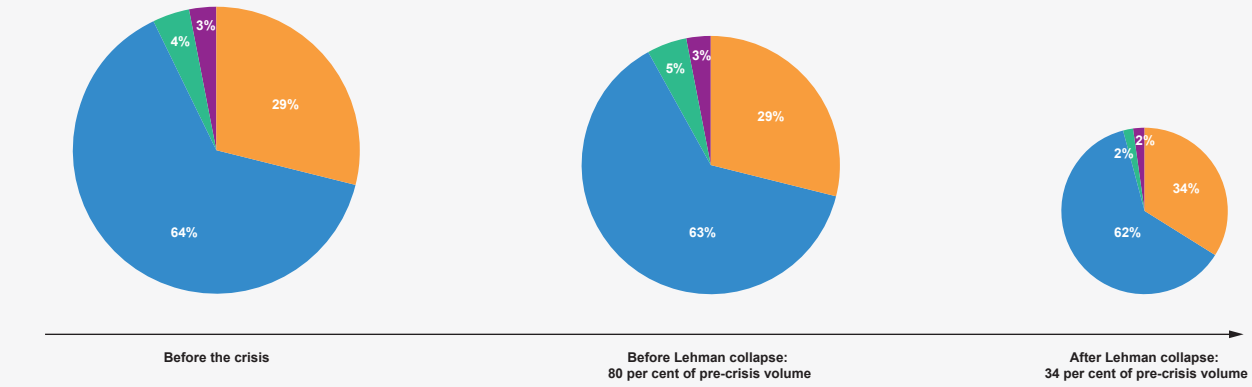


Sources: Dealogic Loan Analytics and EBRD calculations.

Note: Proportions are of total number of loans.

Chart 2.2.3

Distribution of syndicated loan flows from European and US banks (loan volumes)



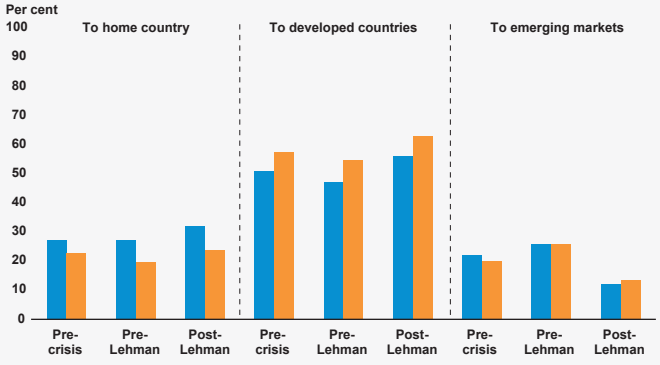
Sources: Dealogic Loan Analytics and EBRD calculations.

Note: The size of the pie charts reflects average monthly volumes in each period.

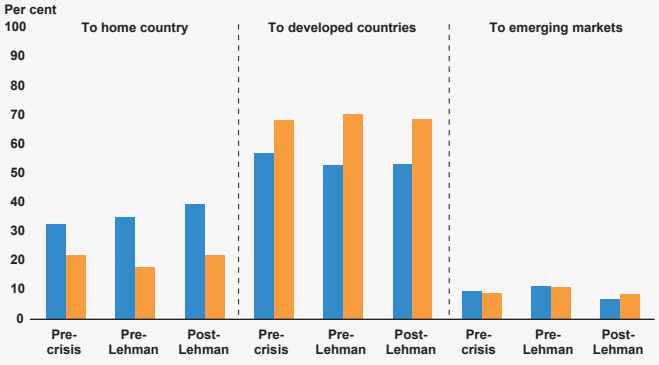
Chart 2.2.4

Comparative shifts in distribution of syndicated loan flows by supported and unsupported European and US banks

2.2.4a Proportion of number of loans



2.2.4b Proportion of loan volumes



Supported Unsupported

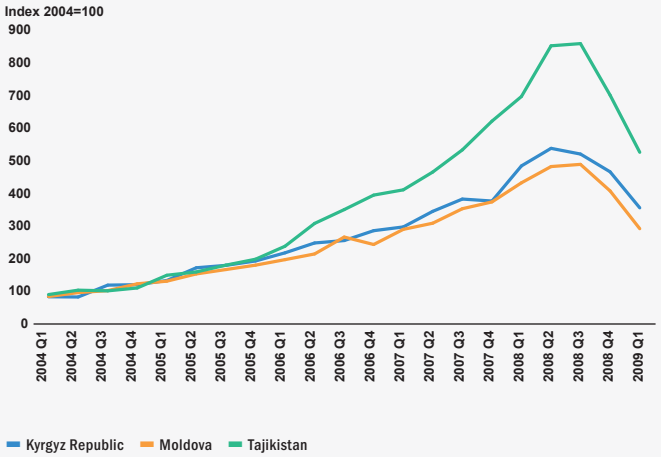
Sources: Dealogic Loan Analytics and EBRD calculations.

Debilitated by financial, commodity price and export demand shocks, and with mounting political uncertainty, Ukraine was effectively shut out of international capital markets in September 2008, although credit lines were initially rolled over. Domestic credit froze, and the failure of a large bank and restrictions on deposit withdrawals undermined confidence in the banking system. Households started to convert cash holdings into FX. Imports fell, leading to a rapid improvement in the trade balance. Despite initial central bank intervention, the currency had depreciated by more than 25 per cent by December.

By the first quarter of 2009 the collapse in global trade had also transmitted the crisis to the previously insulated Balkan and Caucasus regions. As in the Baltic states nine months earlier, external shocks compounded the correction of overheating domestic demand and rapid credit growth. In some countries, including Bosnia and Herzegovina and Montenegro, banking systems came under pressure from large deposit outflows amid mounting concerns about sector stability. Having pursued broadly sound macroeconomic policies before the crisis, Albania turned out to be something of an exception in the SEE region (much like Poland among the central European countries), as its real GDP fell much less than elsewhere.

The last stage in the transmission of the crisis was a sharp contraction of remittances, beginning in the fourth quarter of 2008. This had an impact on some CIS and SEE countries that had initially been relatively shielded from other aspects of the downturn (see Chart 2.8). Economic retrenchment in the European Union, Kazakhstan and Russia – important source countries for remittances – led to falling migrant labour incomes (particularly in the construction sector, which was disproportionately affected by the credit crunch) and a return of some migrants to their home countries. With remittances no longer supporting domestic demand, growth in the Kyrgyz Republic and Tajikistan declined sharply in the first quarter of 2009.

Chart 2.8
Evolution of remittances in the Kyrgyz Republic, Moldova and Tajikistan



Sources: IMF Balance of Payments Statistics and national statistical agencies.
Note: Data are seasonally adjusted.

The impact of crisis-related shocks: statistical analysis

The previous section suggests that the transition economies imported the crisis through three main channels.

— *Finance* – foreign inflows into financially integrated countries contracted as global risk aversion increased. This in turn affected domestic credit conditions, reducing demand.

— *Trade and remittances* – as global trade collapsed and GDP contracted in major markets (the European Union and Russia), external demand for the region's exports declined. Domestic demand was also affected by the decline of remittance flows to some countries. The fall in global energy prices in late 2008 may have supported domestic demand to some extent but exacerbated its decline in the commodity-exporting countries.

— *Country-specific policies and initial conditions* – including: vulnerabilities (that may have interacted with financial and trading shocks to varying degrees); policy changes (for example, tighter monetary policy in the first half of 2008 and subsequent loosening in the latter); and the effect of domestic credit cycles (some of which had peaked even before the crisis).

To gauge the relative importance of these three elements in generating the output declines of the last quarter of 2008 and the first quarter of 2009, a panel regression analysis was conducted focusing on the effects of cross-border bank lending flows reported to the BIS (Bank for International Settlements), energy prices and external demand on output growth (see Box 2.3 for details). The analysis focused on a group of 12 countries from the CEB and SEE regions that are all commodity importers and roughly comparable in terms of financial and trade integration. The regression takes account of country-specific features only through the inclusion of country-specific constants ("fixed effects") which allow for differences in average growth; therefore, country-specific features affecting the dynamic of growth over the period will be reflected in the regression residual.

The statistical model is estimated using data from the late 1990s until the second quarter of 2008 – that is, before the financial and trade shocks of the third and fourth quarters. It is then applied to predict the growth path for each country in the group for the fourth quarter of 2008 and the first of 2009, using the actual realised values of exports, bank inflows and commodity price inflation. This helps determine the relative significance of export and capital flow shocks. Comparing the predicted and actual growth paths for these two quarters also reveals whether the reaction of growth to the shocks of late 2008 and early 2009 should be viewed as surprising or not, given the typical reaction of growth in the CEB and SEE countries to external demand and capital flows before the crisis.

Box 2.3

The transmission of the financial crisis: econometric methodology and results

The relationship between GDP growth in transition countries and external factors (export demand, external financing and energy prices) was estimated using a panel regression model based on quarterly data for a group of 12 countries – the 10 new EU member states, Croatia and Turkey (which are reasonably similar in terms of financial and trade integration and are not commodity exporters). Since one of the objectives is to determine whether the falls in output recorded in late 2008 and early 2009 were in line with what would have been expected given actual export demand declines and financing reversals, the model is estimated for a sample that starts in the second quarter of 1999 and ends in the second quarter of 2008, thus excluding the crisis period.

Export demand was captured using EU and Russian GDP growth (separately). Cross-border bank lending flows were used as a measure of external financing. This variable was chosen because, as a major funding source of domestic credit, it is likely to be most closely related to domestic demand conditions.

From an econometric perspective, the main difficulty is the potential reverse causality of bank inflows with respect to quarterly GDP – that is, the possibility that a regression of GDP growth on bank inflows may reflect the effect of GDP in attracting inflows, rather than the effect of bank inflows on growth. To address this problem, a second equation was simultaneously estimated, in which bank inflows were regressed on GDP growth and squared GDP growth, as well as measures of global risk aversion or liquidity (the VIX and the EMBI – see Box 1.2 in Chapter 1 and notes to Table 2.3.1). This approach relies on the assumption that the VIX and the EMBI do not impact on growth in transition economies other than through their effect on bank inflows. Part of the underestimation of growth declines reported in the text may be because there are, in fact, additional channels, such as trade finance, through which changes in these variables affected growth.

The results are shown in Table 2.3.1. With one exception, the coefficients are significant at the 10 per cent level or lower with the expected signs. Global financial factors were an important driver of growth in banking inflows. In addition, the model confirms that domestic demand, proxied by GDP, attracted banking inflows. Real GDP growth in turn was driven by growth in banking inflows as well as real GDP growth in emerging Europe's main trading partners – the European Union and Russia. Energy price rises had a dampening effect on growth. The results are broadly similar if any one country is excluded from the regression and if the time horizon is extended to cover the crisis period (as expected, this strengthens the coefficient estimates).

Table 2.3.1

Simultaneous equations regression model

(Coefficient estimates; p-values in parentheses. Dependent variable: quarter-on-quarter real GDP growth, Q4 1999–Q2 2008, seasonally adjusted)

Variables	Real GDP growth	Growth in BIS inflows
Growth in banking inflows	0.1610 (0.0000)	
EU real GDP growth	0.3540 (0.0856)	
Russia real GDP growth	0.2220 (0.0371)	
Energy price growth	–0.0128 (0.0887)	
Real GDP growth		–2.398 (0.405)
Real GDP growth squared		0.8910 (0.0514)
VIX		–0.196 (0.0301)
EMBI Global Europe		–0.00379 (0.00123)
Constant	–0.282 (0.479)	11.3600 (0.00589)
Observations	435	435

Sources: Bloomberg, BIS, IMF *International Financial Statistics* and the EBRD.

Note: The VIX refers to the implied volatility of the Standard and Poor's 500 Stock Index (see Box 1.2); the EMBI to JP Morgan's index of emerging market bond spreads. Growth in banking inflows refers to the quarterly growth rate of exchange-rate-adjusted net bank inflows. Quarterly real GDP growth and energy price growth were taken from the IMF's *International Financial Statistics*. The model was estimated using country fixed effects (not reported).

The results (see also Chart 2.9) can be summarised as follows.

— On average, the model predicts much smaller output declines than actually occurred. This could reflect: asymmetric or non-linear effects of shocks on output – that is, a larger impact of large adverse export and financial shocks (perhaps in light of accumulated vulnerabilities) than was typical for the shocks during the estimation period; or the downturn of the economic cycle that was already under way, as previously argued; or additional shocks, such as declines in trade credit or confidence, that are not accounted for in the model.

— Except in the Czech Republic, Poland and Turkey, which suffered sizeable outflows of cross-border lending in the fourth quarter of 2008, the collapse in external demand appears to have been a much more important factor in the output decline than the reversal of capital flows. Falls in external demand are estimated to have reduced real GDP growth in the CEB and SEE countries by about 1 percentage point in the fourth quarter of 2008 and almost 3 percentage points in the first quarter of 2009. In comparison, the drop in banking inflows reduced real GDP declines by less than 1 percentage point in either quarter on average.[8] For the most part, this reflects a limited decline in inflows compared to the decline in trade partners' GDP.[9]

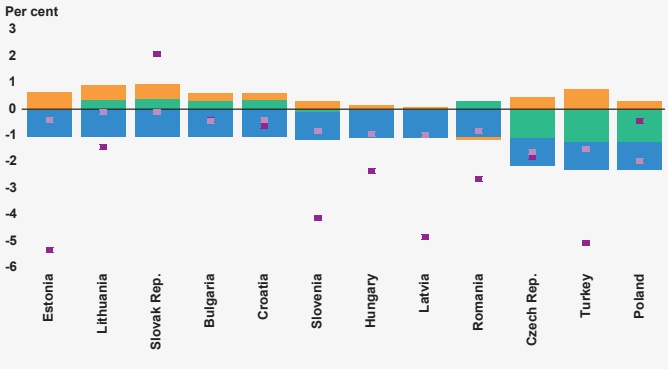
— The extent to which output declines are underpredicted varies greatly across countries. Two countries suffered smaller declines than the model predicts: the Slovak Republic in the fourth quarter of 2008 and Poland in both the fourth quarter of 2008 and the first of 2009. Growth in Bulgaria, Croatia and the Czech Republic in the fourth quarter of 2008 and in the Czech Republic and Hungary in the first quarter of 2009 is reasonably well matched by the model forecasts. However, the large contractions in the Baltic states, Slovenia and (in the fourth quarter of 2008) Turkey are mostly not matched.

What variables could help to account for both the size and the cross-country variation in differences between actual and predicted values? The most obvious candidates are country vulnerabilities, as well as shocks such as changes in trade credit, which could not be reflected in the regression model because of data limitations. Chart 2.10 shows some correlations between regression residuals and these variables. They suggest that a greater stock of external debt at the end of 2007 was associated with a steeper decline in real GDP, both in the fourth quarter of 2008 and the first of 2009, and that real GDP dropped more in the first quarter of 2009 in countries that were more open to trade. Furthermore, real GDP contracted more in countries where trade credit also contracted more – especially in the first quarter of 2009 (although this could of course reflect the effect of output declines on trade credit, rather than the reverse). While these are merely bivariate correlations, they do suggest that country vulnerabilities may have magnified the impact of external shocks and that understanding the cross-sectional variation in the output decline necessitates taking account of country-specifics to a much greater degree than in the panel regression used in this section. This is the subject of the last section of this chapter.

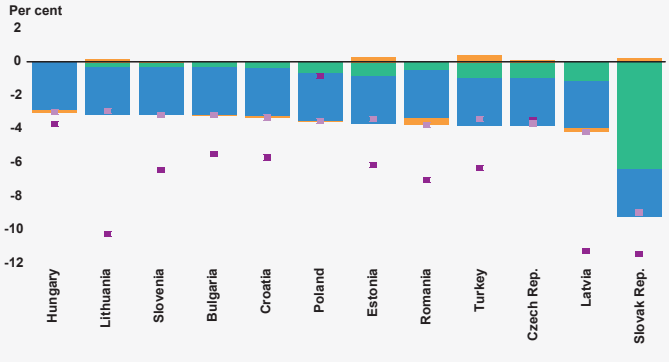
In addition to comparing the impact of demand and cross-border lending shocks on output, the analysis underlying Chart 2.10 can also be used to compare the reversal in cross-border lending in the CEB and SEE countries to what would have been expected based on the shock to the international financial system in September 2008. This is possible because the regression model described in Box 2.3 not only estimates the impact of cross-border lending flows on output growth, but also the influence of international risk aversion measures on cross-border flows themselves. The results suggest that the sharp rise in international risk aversion at the end of the third quarter of 2008 should have triggered a significantly stronger contraction in foreign banking inflows than actually took place (see Chart 2.11). The extent to which actual capital outflows fell short of their predicted values is, however, very heterogeneous. Capital outflows from Hungary and Lithuania, for example, were much smaller than predicted by the model, while outflows from the Czech Republic and Turkey were only moderately smaller. This confirms that the pattern of outflows in the fourth quarter was unusual – not just across subregions but also within the transition region as a whole.

Chart 2.9
Predicted impact of crisis-related shocks on output growth in CEB and SEE
Actual and predicted real GDP growth, contributions to predicted real GDP growth (quarter-on-quarter, in per cent)

2.9a 2008 Q4



2.9b 2009 Q1



Percentage change in BIS asset flows | External demand growth | Other | Actual | Predicted

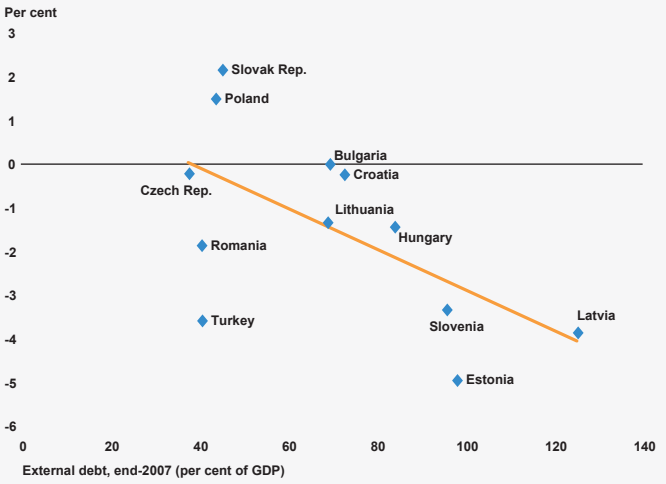
Sources: BIS, IMF *International Financial Statistics*, Bloomberg and authors' estimates.

Note: 2009 BIS asset flow data for the Slovak Republic are distorted by accounting changes related to the adoption of the euro.

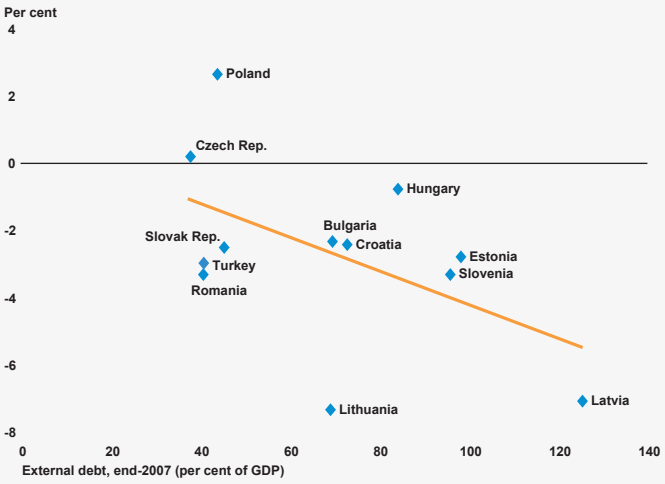
Chart 2.10

Correlates of regression residuals

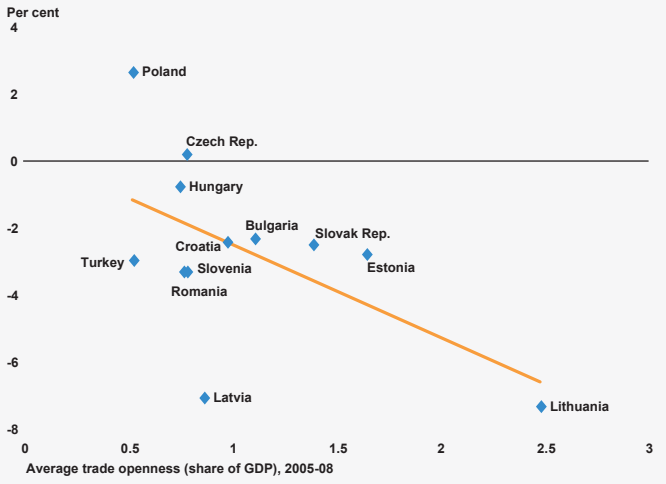
2.10a 2008 Q4



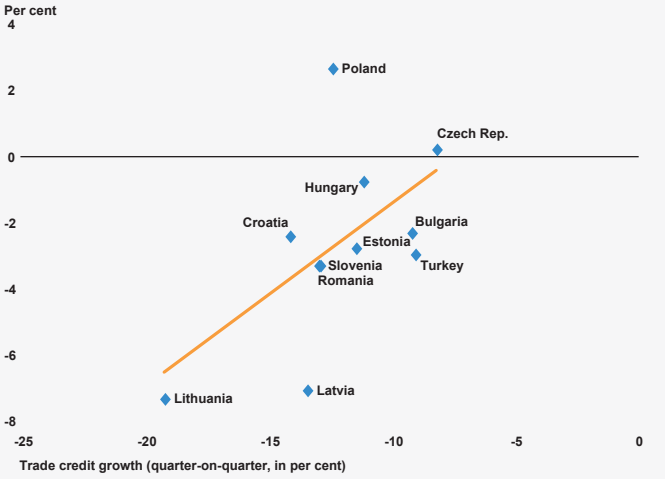
2.10b 2009 Q1



2.10c 2009 Q1



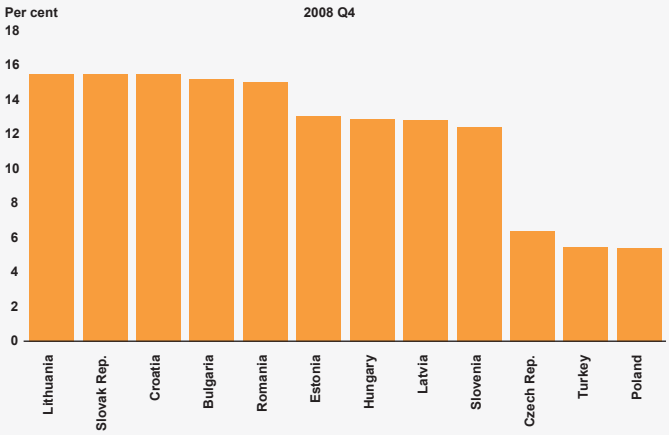
2.10d 2009 Q1

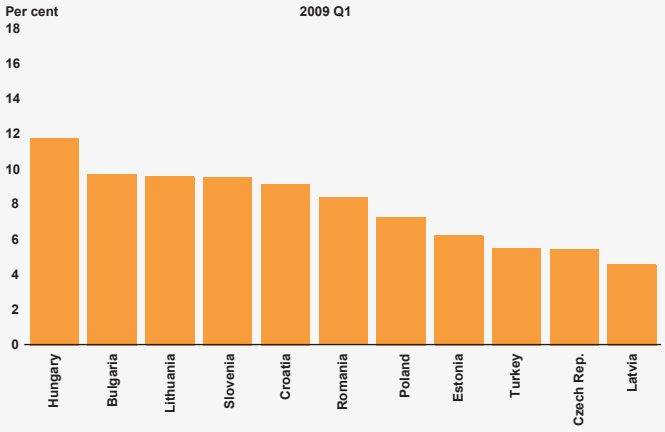


Sources: BIS, IMF *International Financial Statistics*, Bloomberg and authors' estimates.

Chart 2.11

Difference between actual and predicted changes in cross-border bank lending





Sources: BIS, IMF *International Financial Statistics*, Bloomberg and authors' estimates.

Note: Difference between actual and predicted growth in foreign bank inflows as predicted by VIX and EMBIG Europe (see Box 2.3). 2009 Q1 data for the Slovak Republic are distorted by accounting changes related to the adoption of the euro and are therefore not shown.

Why was the "sudden stop" contained?

Chapter 1 showed that the "sudden stop" in net capital flows suffered by the transition region in the fourth quarter of 2008 and the first quarter of 2009 was moderate on average compared to other regions and that it varied greatly across countries. Latvia, Russia and Ukraine, for example, suffered much larger outflows. This impression is corroborated by the analysis in the previous section, which showed that the reversal in bank lending experienced in CEB and SEE countries was much smaller than would have been predicted based on the historic relationship between lending flows to these countries and measures of international risk aversion.

This section investigates whether the behaviour of cross-border flows in the crisis has been related to the presence of foreign banks, which tends to be strong in the transition region as a whole but variable across countries (see Chart 2.12). Evidence suggests that foreign bank lending through a network of local branches and subsidiaries tends to be more stable than direct cross-border lending.[10] Furthermore, foreign bank subsidiaries often reduce their lending during financial crises to a lesser extent than domestic banks, provided that parent banks are in good financial health.[11] While the crisis obviously affected the financial strength of the western European banking groups that dominate banking sectors in the European transition region, no parent bank as of the end of September 2009 had liquidated or sold any subsidiary.[12]

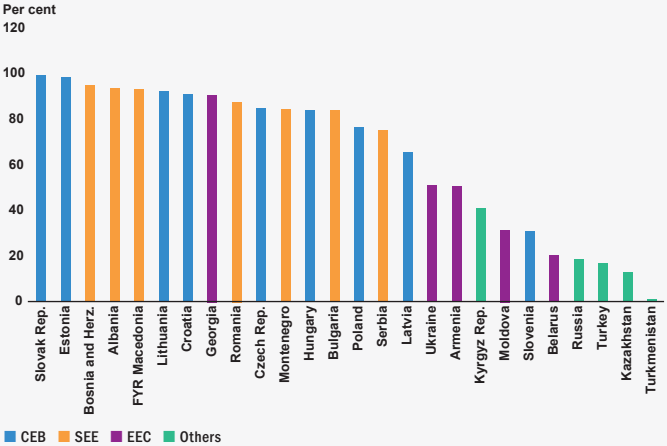
Cross-border bank lending flows during the "sudden stop" in the fourth quarter of 2008 and foreign bank ownership are indeed positively correlated both in the transition region and in a larger sample of about 100 countries, although the correlation is statistically significant only in the broader sample (see Chart 2.13). The question is whether these correlations can be given a causal interpretation or whether they reflect other factors – for example, that foreign banks tend to have a greater presence in countries with stronger fundamentals, which in turn suffer smaller outflows.

To address this question, a cross-sectional regression analysis was conducted for the transition region and for the broader country sample, respectively. This relates net cross-border lending flows in the fourth quarter of 2008 to the asset share of foreign bank ownership in the host country banking system, the 2007 credit rating as a measure of fundamentals, and the logarithm of purchasing power-adjusted GDP per capita to control for the level of development (see Table 2.2). To ensure that the results are not sensitive to the inclusion of other variables in the regression, a large number of additional fundamentals that might possibly have affected the propensity of banks to reduce their exposures were sequentially included in the regression. These included various measures of macroeconomic and financial fundamentals – such as pre-crisis domestic credit growth, pre-crisis external debt, financial development and liquidity measures – as well as a number of measures of institutional quality. Columns 2 and 4 in Table 2.2 show the upper and lower bounds of the coefficient estimates obtained for the three core variables in these additional regressions.

The results indicate that foreign bank ownership is a highly significant predictor of smaller net outflows in the baseline regression, both in the broad sample (column 1) and the transition-only sample (column 3). The coefficient estimate is virtually identical in both samples, with a 10 percentage point increase in foreign ownership reducing the net outflow of cross-border loans by 1.4 percentage points.[13] The credit rating also has the expected negative sign, with a better (that is, lower) credit rating indicating a larger net inflow, while the coefficient on per capita GDP suggests that richer countries suffered larger outflows.

Columns 2 and 4 in the table indicate that the basic result – a positive effect of foreign bank presence on net capital flows in both samples – is robust, although the coefficient estimates lose statistical significance in some cases. Having said that, the coefficient on bank asset shares was significant in 95 out of 98 regressions performed in the broad sample of countries (97 per cent) and 61 out of 102 regressions in the transition sample (60 per cent). Therefore, the presence of foreign banks does seem to have had a stabilising effect on the transition region in this crisis by helping to mitigate the "sudden stop" in capital flows.[14]

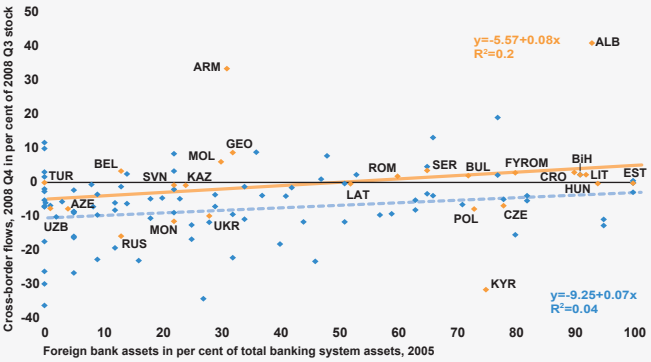
Chart 2.12
Foreign bank asset shares in the transition region



Source: EBRD.

Note: The chart shows the share of banking system assets owned by foreign bank branches or subsidiaries. "Others" includes Russia, Turkey and Central Asia (excluding Uzbekistan). EEC excludes Azerbaijan. Data are for 2008.

Chart 2.13
Cross-border lending flows and bank ownership (Q4 2008)



Sources: Bank for International Settlements and Claessens et al (2008).

Note: Equations refer to a linear regression of cross-border flows in Q4 2008 (shown on y-axis) on foreign bank asset share (shown on x-axis). Blue equation based on sample of all countries; orange equation based on sample of transition countries only. The countries shown are Albania (ALB), Armenia (ARM), Azerbaijan (AZE), Belarus (BEL), Bosnia and Herzegovina (BiH), Bulgaria (BUL), Croatia (CRO), Czech Republic (CZE), Estonia (EST), Georgia (GEO), Hungary (HUN), Kazakhstan (KAZ), Latvia (LAT), Lithuania (LIT), FYR Macedonia (FYROM), Moldova (MOL), Mongolia (MON), Poland (POL), Romania (ROM), Russia (RUS), Serbia (SER), Slovenia (SVN), Turkey (TUR), Ukraine (UKR) and Uzbekistan (UZB).

What explains cross-country differences in output declines?

As shown in Chapter 1, the cross-country variation in crisis-related declines in output is very large. Chart 2.14 illustrates this variation using three different measures (from left to right) explained below.

— First, year-on-year output growth in the first quarter of 2009 (compared to the first quarter of 2008). This measure has the advantage of being widely available and does not require any manipulation.[15] Its disadvantage is that it reflects the cumulative effect of still positive quarter-on-quarter growth in the second and third quarters of 2008 and the generally negative growth of the fourth quarter and first quarter of 2009. Strong growth at the beginning of the period may therefore obscure sharp declines at the end.

— Second, the sum of seasonally-adjusted quarter-on-quarter declines in the fourth quarter of 2008 and the first of 2009. This is the best measure insofar as it captures the effect of the shocks suffered by the European transition region in terms of output in the two main crisis quarters. The main disadvantage is that official seasonally adjusted quarter-on-quarter data are not available for most countries in the sample, so it is necessary to apply an alternative seasonal adjustment in these cases.[16]

— Finally, year-on-year growth in the first quarter of 2009 compared to trend – that is, subtracting average first quarter year-on-year growth over the seven-year period ending in the first quarter of 2009. This measure is preferable if one believes that the effect of the crisis is to slow GDP down from a country-specific trend (or potential) growth rate.

In Chart 2.14 countries are ranked in a decreasing sequence of output growth according to the first measure. It is clear that there is a large variation across countries no matter which measure is used. The correlation coefficient between the first and each of the other two measures is 0.84; and between the second and third 0.88.

Table 2.2
Bank lending flows, Q4 2008, and foreign bank ownership (coefficient estimates, p-values in parentheses)

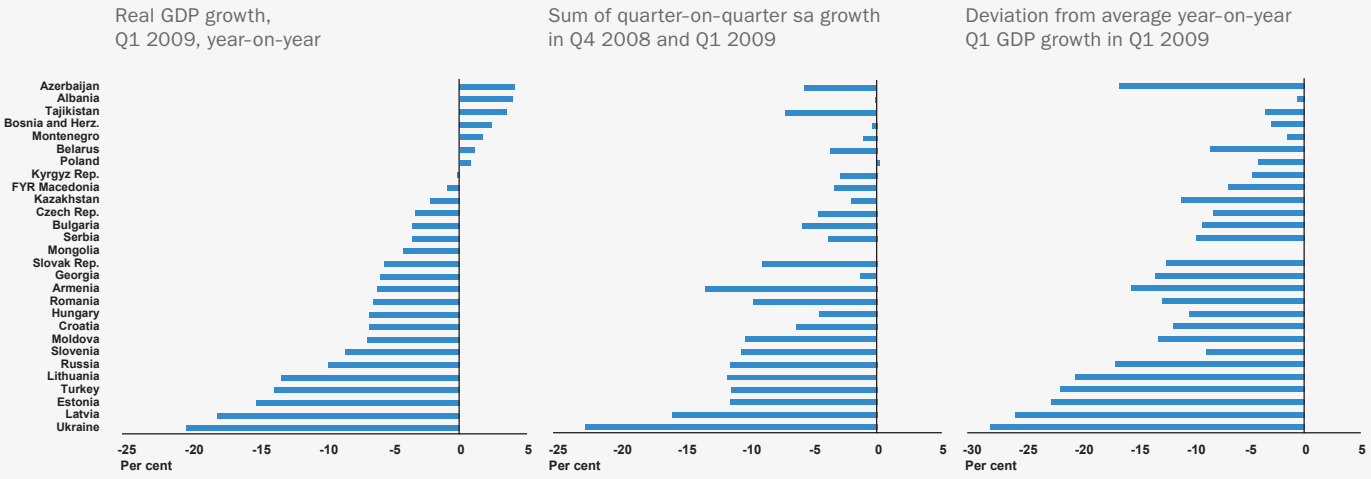
	Dependent variable: change in cross-border lending, Q4 2008[1]			
	Broad sample		Transition countries	
	(1)	(2)[2]	(3)	(4)[2]
Foreign bank ownership	0.14 *(0.008)*	[0.06, 0.17] *[0.295, 0.000]*	0.14 *(0.053)*	[0.04, 0.20] *[0.602, 0.002]*
Rating	-1.52 *(0.038)*	[-2.88, -0.84] *[0.001, 0.284]*	-1.87 *(0.158)*	[-3.86, 0.21] *[0.000, 0.759]*
GDP per capita PPP, log	-6.76 *(0.082)*	[-12.96, -5.13] *[0.003, 0.206]*	-15.62 *(0.061)*	[-35.16, -6.14] *[0.000, 0.31]*
Number of countries	64	[42, 64]	25	[18, 25]
R-squared	0.20	[0.20, 0.42]	0.38	[0.31, 0.77]

Source: EBRD staff analysis using the data sources listed below.

Note: For a definition of foreign bank ownership, see Chart 2.12. GDP per capita PPP, log refers to the logarithm of purchasing power adjusted GDP per capita. Rating refers to the Standard & Poor's (S&P) sovereign credit rating (Moody's has been used when the S&P rating was unavailable). [1] In per cent of 2008 Q3 stock; [2] Ranges refer to coefficients from a total of 98 (102 for transition countries) regressions in which 98 potential covariates (see list of variables below) were "rotated through" the baseline specification presented in columns 1 and 3. These included variables from three groups: (i) *Macroeconomic indicators* were taken from the IMF's *International Financial Statistics* and *World Economic Outlook* (current account, GDP per capita PPP-adjusted, openness, fiscal sector measures, inflation, domestic and external total and private debt); the *World Bank Development Indicators 2008* (reserves to GDP, external debt and (in month of imports) M2 or M3 in per cent of GDP and reserves, real interest rates and real effective exchange rates); and the CEIC database for transition countries. (ii) *Financial variables* were sourced from Beck et al (2009) (variables relating to financial development and liquidity); Claessens et al (2008) (foreign bank ownership); Lane and Milesi-Ferretti (2006) and Abiad et al (2009) (external financial assets and liabilities); the BIS (cross-border flows and stocks); the IMF's *Global Financial Stability Report* (bank capital to assets, non-performing loans); the *World Bank Development Indicators 2008* (short-term debt as a share of reserves); and Rose and Spiegel (2009) (liquid assets to total assets, countries ratings). (iii) Institutional variables were taken from the Economic Freedom of the World 2008 Project; the World Bank *Doing Business 2009* report; Rose and Spiegel (2009); the EBRD/World Bank Business Environment and Enterprise Performance Survey (2008/09); and the Polity IV database.

A full list of variable definitions is available upon request.

Chart 2.14
Real GDP growth in Q4 2008 and Q1 2009



Sources: CEIC Data Company and national sources.

Note: No data available for Turkmenistan. For Mongolia, only year-on-year data were available. Sa means seasonally adjusted.

As shown in the second section of this chapter, differences in shocks to exports or private capital flows are insufficient to fully explain the variation in output decline. The question is whether the remaining variation can be related to cross-country differences in pre-crisis vulnerabilities and, if so, which vulnerabilities seem most relevant. Chart 2.15 shows bivariate correlations between the output decline, using the second measure (cumulative output drop in the fourth and first quarters), and six measures of macro-financial fundamentals on the eve of the crisis (as follows):

— external debt as a share of GDP

— the share of foreign banks' assets in total banking system assets

— the loan-to-deposit ratio of the banking system as a measure of foreign financing

— the level of financial development at the end of 2007

— the change in the ratio of credit to GDP between the end of 2004 and the end of 2008 as a measure of the pre-crisis credit boom

— the share of foreign currency debt in total liabilities of the banking system.

As expected, the correlations tend to be negative (as higher vulnerabilities are associated with larger cumulative output drops) except for foreign bank ownership, which is positively correlated with growth.

Box 2.4 explores the relationship between pre-crisis macro-financial fundamentals and the cumulative output decline in the crisis, taking account of differences in export demand shocks and institutional quality across countries. As expected, the stock of external debt at the end of 2007 helps predict the decline of output, even in the presence of these controls. In addition, the size of the domestic credit boom, hard currency pegs, the stock of FDI liabilities and the share of foreign bank assets have statistically significant coefficients with the expected signs (that is, negative except for FDI and the share of foreign banks) when added to a baseline regression that controls for exports, institutional quality and external debt. The most robust predictors of the size of the output decline turn out to be the domestic credit boom (negatively) and the share of foreign banks in total banking system assets (positively). They remain statistically significant even when added jointly to the regression and even if cross-border bank flows and changes in trade credit during the crisis are also controlled for.

In contrast, the loan-to-deposit ratio, openness to trade, the current account deficit, the share of foreign currency debt in total liabilities of the banking system, the level of financial development and integration, and reserves as a share of GDP were not significantly associated with the output decline (when already accounting for external debt, institutional quality and export shocks), although their coefficients usually had the expected signs. For some variables, such as the average current account deficit, this may be due to a high correlation with external debt. The lack of significant correlation between the share of foreign currency debt and the output decline may be attributable to the fact that only a few economies with high foreign currency shares (primarily, Hungary and Ukraine) experienced large depreciations during this crisis.

Conclusion

During the boom years of 2005–07, many countries in the region developed significant macroeconomic vulnerabilities. Foreign inflows intermediated by local subsidiaries and branches of foreign banks fuelled credit expansion in many countries in the European transition region. Export receipts and domestic bank borrowing on international capital markets played a similar role in commodity-exporting countries. The result was fast growth but also unsustainable investment and consumption booms. Some countries, however, managed to bypass this trend, particularly the Czech Republic, Poland, the Slovak Republic and Slovenia. With slower and more export-driven development during the boom years, they never accumulated the imbalances of the countries with more domestically-driven growth.

Even before the global financial shock of September 2008 hit the transition region, the economic cycle had started to turn down in many countries. With the exception of Kazakhstan, which was an early victim of the crisis due to its reliance on bank borrowing in international capital markets, this reversal was mostly a consequence of overheating, tighter lending standards and tighter monetary policy, rather than the credit crunch and slowing growth of advanced economies from mid-2007. This deceleration was reinforced by the onset of the recession in the European Union in the second quarter of 2008, the sharp drop of commodity prices in the third quarter and, lastly, the collapse of emerging market capital flows and world trade in the fourth quarter.

Having said that, the reversal in net capital flows that confronted most transition countries in late 2008 was relatively modest (except in Russia, Ukraine and some Baltic states). There is strong empirical support for the hypothesis that foreign bank ownership played a role in mitigating the reversal in bank lending flows, as parent banks continued to refinance their subsidiaries and branches. The main cause of the sharp output declines in the fourth quarter of 2008 and the first quarter of 2009 is likely to have been the collapse in exports and trade credit, although the reversal in bank lending flows also played a role, particularly in countries with high external financing needs.

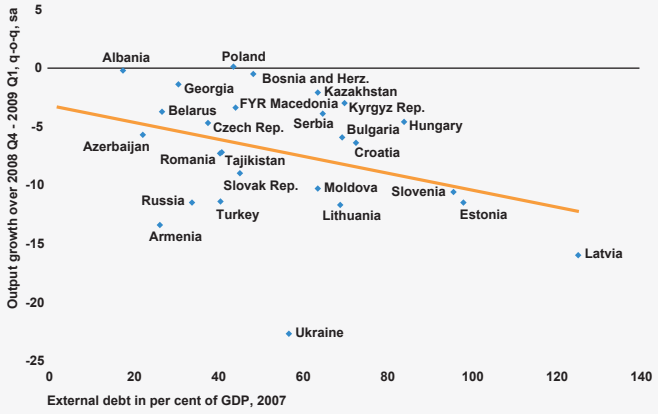
While output declines in the fourth quarter of 2008 and the first of 2009 were large on average in nearly the entire region, there were also significant cross-country differences in the magnitude of the falls. These are related to differences in export declines across countries and to variances in pre-crisis vulnerabilities. A particularly robust predictor in this respect is the size of pre-crisis credit booms. Other relevant variables are hard currency pegs and the level of private external debt at the end of 2007, both of which can be linked to larger output declines. Foreign bank ownership (consistent with the finding that it was a factor in stabilising the reversal of capital flows) appears to be associated with smaller output declines.

The results of the analysis in this chapter raise further questions. On the one hand, foreign banks are found to have been a stabilising force in this crisis; on the other, output losses during the crisis are clearly linked to vulnerabilities such as pre-crisis external debt and the size of pre-crisis credit booms. If foreign banks contributed to the credit booms and facilitated private indebtedness, how should their overall role, and the desirability of financial integration more generally, now be judged? This is addressed in Chapter 3.

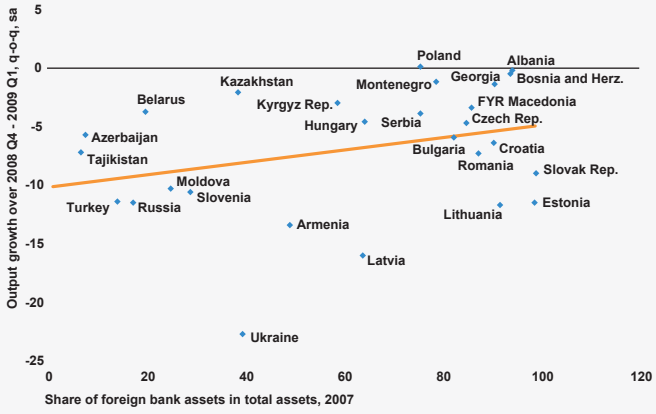
Chart 2.15

Cumulative output decline and macro-financial fundamentals

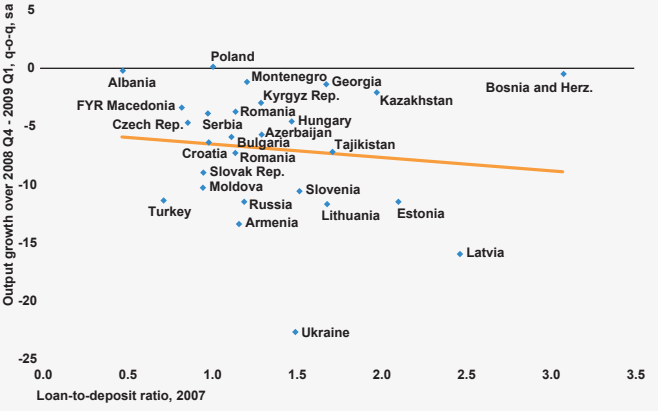
2.15a Correlation with external debt, 2007



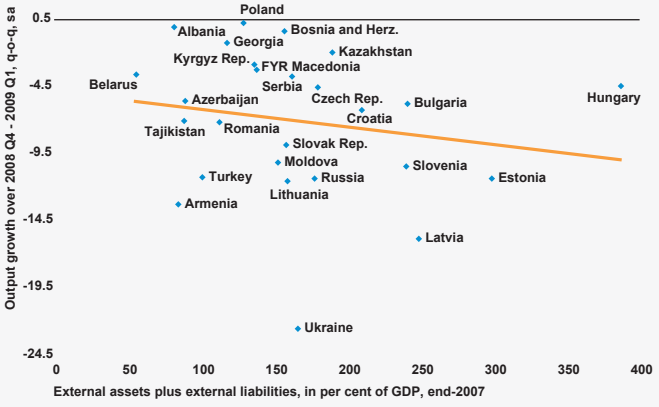
2.15b Correlation with foreign bank ownership, 2007



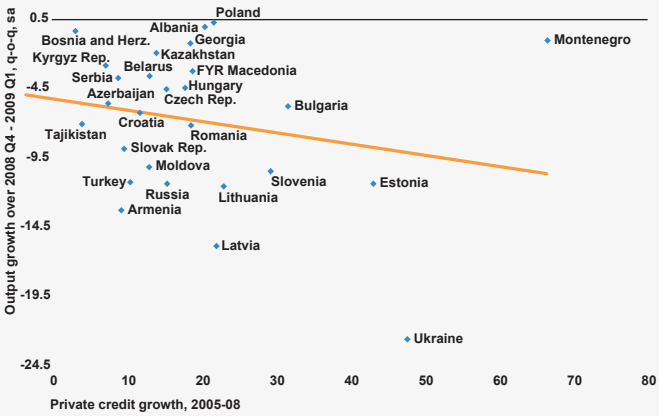
2.15c Correlation with loan-to-deposit ratio, 2007



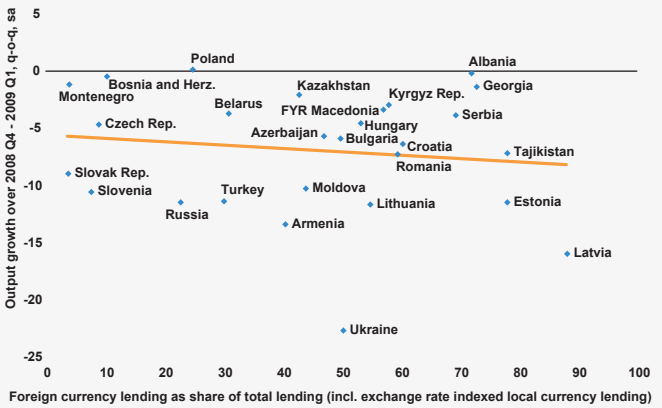
2.15d Correlation with financial integration, 2007



2.15e Correlation with private credit growth, 2005-08



2.15f Correlation with share of FX lending, 2007



Sources: BIS, IMF *International Financial Statistics*, Abiad et al (2009), Lane and Milesi-Ferretti (2006), Claessens et al (2008) and official sources.

Box 2.4

Explaining cross-country variance in cumulative output declines in the transition region, Q4 2008 to Q1 2009

Establishing the statistical relationship of pre-crisis fundamentals to cumulative output declines in the crisis is difficult for two reasons:

— many potential fundamentals could matter. In the context of a cross-sectional regression with fewer than 30 observations, it is impossible to analyse them all at the same time

— it is important to take into account that countries suffered shocks of different magnitudes and to control for the effect of export shocks in particular. One would ideally also want to control for financial shocks, but this is complicated by the fact that they cannot be measured directly. Changes in bank debt inflows or trade credit, for example, are not a satisfactory measure of financial shocks in a cross-sectional regression, as they could be responding to differences in output declines rather than the other way around.

To address these problems (although imperfectly), potential determinants of the output decline are divided into two groups. The first group contains export growth, external debt at the end of 2007 as a core potential vulnerability, and a measure of institutional quality (corruption perceptions). The second group contains an additional set of pre-crisis fundamentals: the credit-to-GDP ratio as a measure of financial development; changes in this ratio during 2005-08 as a measure of the pre-crisis credit boom; the loan-to-deposit ratio as a measure of foreign financing; openness to trade; reserves as a share of short-term debt; the asset share of foreign banks in the banking system; the stock of foreign direct investment liabilities; the current account deficit in 2007; the share of foreign currency debt in total liabilities of the banking system; and a dummy variable for currency pegs. The potential relevance of these variables is then investigated sequentially, by adding them to the first group containing the three basic controls. In addition, the robustness of the results is checked by additionally controlling for debt inflows and trade finance.

Table 2.4.1 contains the results which appear to be statistically significant. Column 1 shows the result of the three core control variables (export growth in the fourth quarter of 2008 and first of 2009, private external debt and the BEEPS corruption variables as a measure of the institutional environment) on their own. In columns 2 to 5, four additional financial fundamentals are added individually to the regression. Column 6 considers all variables together. Columns 7 and 8 add additional controls for the percentage change in trade credit and cross-border bank flows. The main result in the last three regressions is that the size of pre-crises credit booms and the share of foreign banks remain statistically significant even in the presence of the additional controls but the stock of external debt does not.

In addition to the variables shown, the loan-to-deposit ratio, openness to trade, current account deficit, share of foreign currency debt in total liabilities of the banking system, level of financial development and financial integration, and reserves as a share of GDP were also individually added to the regression model, but were not significantly associated with the output decline when controlling for external debt and export shocks.

The pre-crisis correlates of the cross-sectional output decline were also explored using a much larger sample, which, in addition to transition countries, included non-transition developing and emerging market countries and advanced countries (see Berglöf et al (2009) for details). Regressions using that sample confirm the role of pre-crisis credit growth as a robust predictor of output decline. At the same time, however, the levels of credit as a share of GDP – a commonly used measure of financial development – are shown to have had a mitigating effect. This result is driven by the presence of advanced countries in the sample; however, it is robust to the inclusion of both per capita GDP and a variable reflecting institutional quality (rule of law). Controlling for these factors, commodity exports, on average, are shown to have mitigated the output declines, a result explored further in Chapter 4. The asset share of foreign banks also seems to have had a mitigating effect, as within the transition region, but the result is not statistically significant in the broader sample.

Table 2.4.1

Determinants of cumulative Q4 2008 and Q1 2009 output declines across transition countries

(Dependent variable: real GDP growth, measured as sum of Q4 2008 and Q1 2009 growth, seasonally adjusted)

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Size of pre-crisis credit boom[1]		-0.20 (0.090)				-0.21 (0.095)	-0.19 (0.010)	-0.20 (0.088)
FDI to GDP[2]			0.04 (0.029)			0.02 (0.444)		
Foreign bank ownership[2]				0.04 (0.079)		0.06 (0.028)	0.09 (0.000)	0.06 (0.008)
Dummy variable for "hard peg"					-4.42 (0.011)	-2.66 (0.373)	-3.04 (0.117)	-2.94 (0.265)
Cross-border lending, Q4 2008 - Q1 2009[3]								0.05 (0.678)
Trade credit growth, Q4 2008 - Q1 2009[3]							0.26 (0.000)	
Exports, Q4 2008 - Q1 2009[4]	0.16 (0.123)	0.10 (0.273)	0.15 (0.168)	0.12 (0.259)	0.20 (0.059)	0.04 (0.711)		0.04 (0.777)
External debt to GDP[2]	-0.10 (0.013)	-0.07 (0.122)	-0.11 (0.006)	-0.10 (0.014)	-0.07 (0.095)	-0.07 (0.135)	-0.03 (0.394)	-0.06 (0.208)
Corruption perceptions[5]	-2.62 (0.349)	-3.59 (0.089)	-1.95 (0.495)	-2.26 (0.435)	-3.42 (0.183)	-4.56 (0.029)	-4.20 (0.012)	-4.71 (0.014)
Observations	25	25	25	25	25	24	24	24
R-squared	0.31	0.42	0.34	0.35	0.38	0.58	0.78	0.58

Source: BEEPS IV.

Note: Coefficient estimates, robust p-values in parentheses. Constant is included but not shown.
[1] Change in the ratio of private sector domestic credit to GDP between end-2004 and end-2008 (in percentage points of GDP). [2] As of end-2007. For a definition of foreign bank ownership, see Chart 2.12.
[3] In per cent of Q3 2008 stock. [4] Measured as a sum of Q4 2008 and Q1 2009 export growth rates, seasonally adjusted quarter-on-quarter, per cent. [5] Corruption measure is taken from the 2008/09 BEEPS IV (see Chapter 5).

Endnotes

1 For example, the Polish population in the United Kingdom increased almost seventeen-fold from 24,000 to 406,000 between 2002 and 2007. During the same period, the combined number of Latvian, Lithuanian and Polish migrants in Ireland increased about sixteen-fold from 6,000 to over 100,000 (OECD, International Migration Data, 2009).

2 See De Haas, Ferreira and Taci (2009).

3 In this chapter and elsewhere in this report, the term "European transition region" is used to denote all transition countries whose territory is in Europe in whole or in part, as well as Turkey.

4 See García-Herrero and Vazquez (2007) and Buch, Driscoll and Ostergaard (2005) on the determinants of a "home bias" in bank lending.

5 Fears that this might be occurring were widely voiced during the most turbulent period of the crisis. For example, Indian premier Manmohan Singh observed that: "The phenomenon of industrialised countries pressurising their banks to give preference to lending at home does present a problem. It is a form of financial protectionism which should be avoided." (see *Financial Times*, 1 April 2009).

6 The analysis in this box is based on data on 134,946 syndicated loans to private borrowers in the United States, western Europe, Japan and various transition and emerging market countries. The source is Dealogic Loan Analytics database. See De Haas, Van Horen and Zettelmeyer (2009) for details.

7 More precisely, between 46 and 78 per cent of the reduction in emerging market lending can be attributed to the reduction in global lending volumes, depending on whether the post-Lehman or pre-Lehman distribution of lending is assumed, with the remainder explained by the change in the distribution of lending.

8 This average excludes the large outflow that the BIS statistics show from the Slovak Republic in the first quarter of 2009, which was related to euro adoption and not a consequence of the crisis.

9 In addition, real GDP growth is estimated to be somewhat less sensitive to such declines compared with a contraction in trade: a 1 per cent contraction in EU or Russian markets reduces real GDP growth by some 0.2–0.4 of a percentage point while a 1 per cent contraction in banking inflows reduces it by less than 0.2 percentage points.

10 See García-Herrero and Martínez Pería (2007).

11 See De Haas and Van Lelyveld (2006, 2009).

12 Some groups have indicated their intention to sell some subsidiaries over time in order to restructure their presence in the region. This is expected to occur in an orderly way.

13 The standard deviation in the broad sample and transition-only sample is 0.5 and 0.6 percentage points, respectively.

14 The results were similar when using different bank flow measures (as per cent of GDP or per cent deviation from trend rather than as per cent of 2008 third quarter asset stocks) and when performing the analysis for the combined cross-border lending flows in the fourth quarter of 2008 and first of 2009. The latter leads to slightly weaker results in terms of statistical significance but the estimated coefficient on bank asset shares remained positive in all regressions.

15 As of beginning of September there were still some countries that had not released official first quarter GDP growth data. EBRD projections for Q1 GDP were therefore used for these countries.

16 Quarterly data are adjusted using five-year moving averages.

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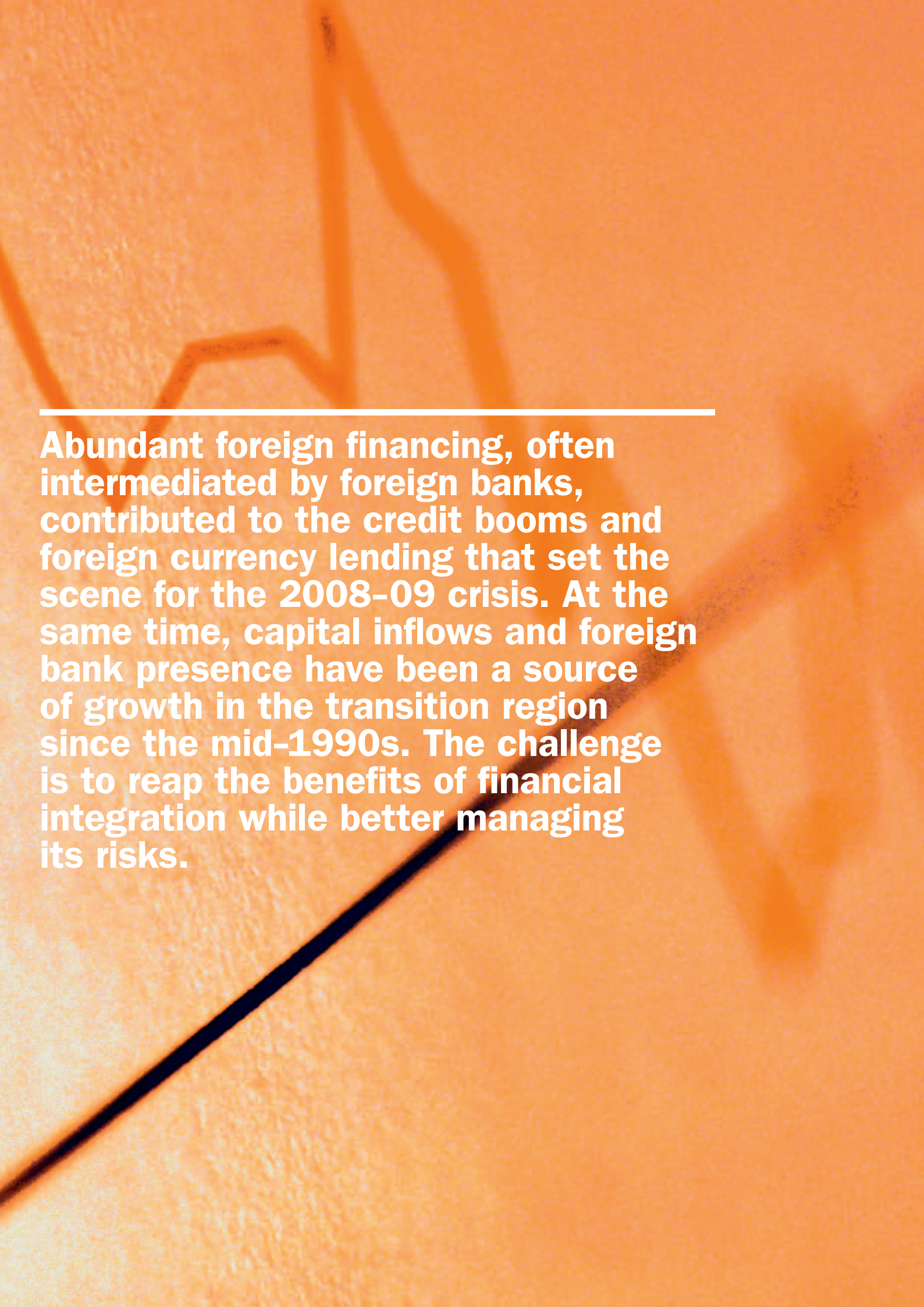
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Abundant foreign financing, often intermediated by foreign banks, contributed to the credit booms and foreign currency lending that set the scene for the 2008–09 crisis. At the same time, capital inflows and foreign bank presence have been a source of growth in the transition region since the mid-1990s. The challenge is to reap the benefits of financial integration while better managing its risks.

Chapter 3
Development based on financial integration?

Featured

62 Has financial integration benefited the transition region?
63 Box 3.1 Sustained growth episodes with large current account deficits
66 Box 3.2 Applying the Rajan-Zingales methodology to financial integration
68 The costs of financial integration in the transition region
73 Policy implications

As discussed in Chapter 2, political, trade and financial integration with western Europe have been the defining pillars of the "development model" that most of the European transition countries,[1] particularly in central Europe and the Baltic states (CEB) and south-eastern Europe (SEE), have pursued since the mid-1990s. Because of its perceived success in raising living standards – and also in allowing migration and reviving longstanding cultural and historical ties across Europe which had been disrupted by the Cold War – this model continues to enjoy widespread support.[2] However, the catastrophic impact of the financial crisis on the European transition countries – five of which (Estonia, Latvia, Lithuania, Ukraine and, possibly, Moldova) – are expected to suffer 10-20 per cent falls in gross domestic product (GDP) in 2009 – has cast a shadow over the model. As shown in Chapter 2, economic integration with the West is perhaps the main reason why the region has been hit so hard, particularly through trade and financial channels. This raises questions about whether the model should be changed or adjusted.

Even after the worst crisis in Europe in 60 years, reversing trade integration is not under consideration in European transition countries. This is partly because, in the European context, trade and political integration are inextricably linked. There is also solid evidence that trade integration increases choice and affordability of goods and helps countries grow faster[3] and, based on the experience of the CEB countries, boosts product quality.[4] Furthermore, while export shocks have been an important channel through which the European transition region imported the crisis, the relationship between trade openness, volatility and growth is complex and not necessarily negative. While trade openness tends to increase growth volatility, particularly in developing countries, it has also been shown to reduce the harmful effects of such volatility on long-term growth.[5]

In the case of financial integration, there is little robust evidence that it benefits long-term growth in emerging market countries.[6] Indeed, countries that have relied on foreign financing have tended on average to grow more slowly than those reliant on domestic savings.[7] There is also a widespread view that financial integration has contributed to the credit booms, large private debt stocks and lending in foreign currency that made the transition region vulnerable to external shocks. Furthermore, countries generally have policy instruments at their disposal that can restrict the reliance on debt inflows, or at least modulate their consequences, even while maintaining a high degree of trade and political integration. Apart from capital controls (prohibited in the European Union but, in principle, deployable elsewhere), these include macroeconomic policies and attempts to regulate financial exposures at either the national or supranational level.

The question of whether the financial integration pillar of the model needs to be recast is hence a critical policy issue confronting the European transition countries as they begin to emerge from the 2008–09 crisis, and forms the core of the following analysis. Most of the chapter will focus on the CEB and SEE countries, as they share a particular form of financial integration in which foreign banking groups have a dominant presence. However, some of the analysis and many of the policy implications will apply to transition countries more generally – and to non-transition countries with advanced economies pursuing similar integration models.

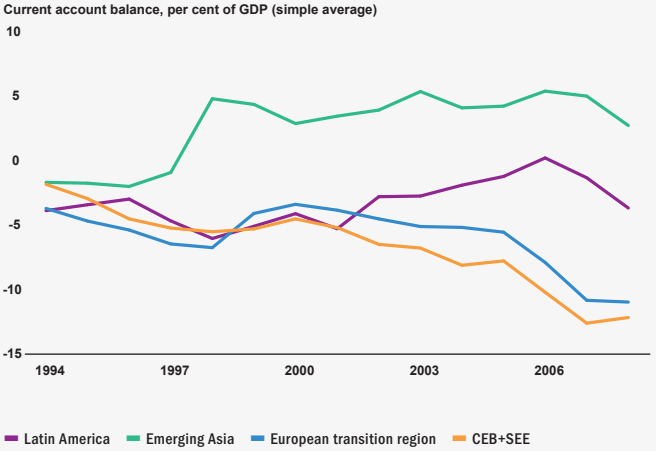
The chapter begins by examining the potential benefits of financial integration in the transition region – in particular, whether financial integration was an independent source of economic growth (over and above trade integration and other factors). It then examines the possible costs of financial integration in terms of encouraging the use of foreign currency debt, fuelling credit booms and facilitating excessive debt accumulation. The final section explores policy implications.

Has financial integration benefited the transition region?[8]

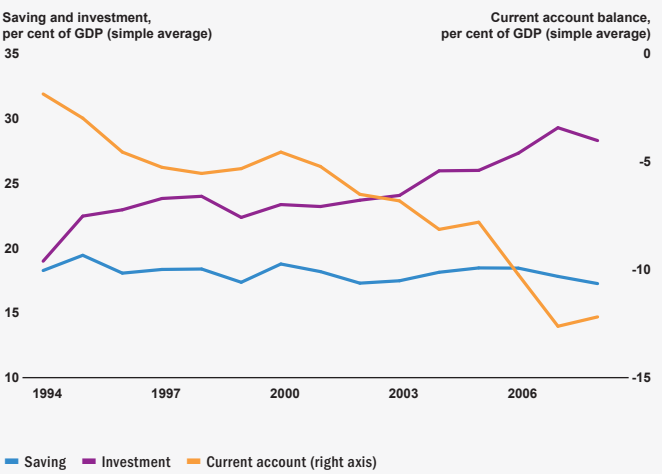
Capital inflows and growth: the transition experience in context

The "growth model" pursued by the European transition countries since the mid-1990s has some unique features, contrasting sharply with emerging Asian and Latin American economies that have had extended periods of high growth during the same period. Following the financial crises of the late 1990s, all three regions enjoyed high per capita growth, with the European transition countries growing fastest on an unweighted average basis (6.8 per cent per year, against 5.2 per cent in emerging Asia and 3.7 per cent in Latin America).[9] Only in the European countries, however, was this growth period accompanied by large and widening current account deficits, together with a sharp rise in investment (see Chart 3.1).

Chart 3.1
Current account balances in emerging market regions, 1994–2008
3.1a Current account balance



3.1b CEB and SEE countries



Source: International Monetary Fund (IMF), *World Economic Outlook*, 2008.

To find growth periods resembling the European transition experience, one has to delve much deeper into history (see Box 3.1). In the post-war period, there are three main episodes of growth accompanied by large capital inflows: post-war "catch-up" in western Europe (particularly in France, Germany, Italy, Portugal, Spain and the United Kingdom); in Latin America and a handful of Asian countries during the 1970s and early 1980s; and in a few emerging Asian countries (Thailand, Malaysia and Vietnam) in the decade prior to the 1997–98 crisis.

The comparative paucity of instances of catch-up growth financed by foreign capital relates to two well-known "puzzles" in international economics:

— the "Lucas puzzle" (named after Nobel Prize-winning economist Robert Lucas): contrary to economic theory, private capital does not tend to flow from rich to poor countries but rather, for the most part, in the other direction

Box 3.1
Sustained growth episodes with large current account deficits

Chart 3.1 shows that the transition country experience of sustained high growth accompanied by large current account deficits contrasts with that of other emerging market regions in the last decade. But what if the comparison is extended to other time periods? To answer this question, purchasing power-adjusted GDP-per-capita and current account data were collected for a broad group of countries from the Americas, the Asia-Pacific region and Europe from 1850 to 2008.[10] A two-stage selection was then made:

— all episodes with an average annual growth rate above 2.5 per cent over a time span between 10 and 20 years – comparable to the recent growth phase in the European transition region – were identified.[11] This led to 296 episodes, of which 26 correspond to the transition region.

— from that group, all episodes where average current account deficit exceeded 4.2 per cent of GDP (the average value for central and eastern Europe between 1995 and 2008, based on the regional definition used in the IMF's World Economic Outlook database) were selected.

The resulting set contains 14 growth episodes with high current account deficits for the transition region (with an average growth rate of 5.9 per cent and an average current account deficit of 7.8 per cent) against 39 episodes from other regions, out of a total of 272 that satisfied the average growth criterion (see Table 3.1.1). Therefore, growth episodes accompanied by large capital inflows do indeed seem much less frequent, in relative terms, in the broad non-transition sample.

Table 3.1.1 shows that there are three historic periods that contain more than five such episodes. The post-war catch-up experience in western Europe comes closest to the transition experience with seven episodes, an average growth rate of 5 per cent and an average current account deficit of 10 per cent over all identified episodes. Other historical precedents include south-east Asian growth from the 1970s until the Asian crisis, and a handful of Latin American growth experiences between the mid-1960s and the early 1980s. In summary, the recent experience of the European transition region is exceptional but not unique.

Table 3.1.1
Growth episodes with high capital inflows in non-transition countries

Period	Country	Start	End	Duration (years)	Growth (in per cent)	Current account (in per cent of GDP)
Pre-World War I	Finland	1868	1877	10	3.13	-6.29
	Canada	1879	1888	10	3.17	-6.11
	Canada	1897	1906	10	5.19	-4.41
	Finland	1903	1913	11	2.57	-6.71
1920s	Norway	1919	1930	12	4.01	-5.12
	Portugal	1920	1929	10	3.17	-15.62
	Spain	1920	1929	10	2.93	-4.24
Post-war catch-up	Portugal	1953	1962	10	4.32	-7.90
	Germany	1957	1966	10	4.19	-21.22
	Korea	1957	1966	10	3.12	-9.25
	Italy	1959	1968	10	5.30	-11.87
	France	1960	1970	11	4.47	-7.91
	Spain	1961	1970	10	7.21	-6.59
	United Kingdom	1963	1973	11	2.77	-5.04
	Portugal	1964	1973	10	7.01	-9.03
Emerging Asia, 1970s until 1997-98 Asian crisis	Korea	1968	1977	10	8.31	-7.37
	Malaysia	1971	1980	10	5.65	-5.34
	Thailand	1973	1982	10	4.51	-5.84
	Sri Lanka	1977	1986	10	3.81	-8.97
	Pakistan	1978	1987	10	3.71	-4.50
	Nepal	1984	1994	11	2.93	-6.24
	Thailand	1987	1996	10	7.75	-5.44
	Vietnam	1988	1997	10	5.24	-5.56
Latin America, 1960s until 1980s debt crisis	Costa Rica	1965	1974	10	4.03	-7.71
	Honduras	1970	1979	10	3.11	-11.54
	Haiti	1971	1980	10	3.21	-11.32
	Uruguay	1972	1981	10	2.93	-9.36
	Paraguay	1972	1981	10	6.08	-6.85
Other	Ireland	1971	1980	10	3.20	-8.91
	Spain	1971	1980	10	3.76	-5.84
	Portugal	1976	1991	16	3.44	-6.16
	Jamaica	1986	1995	10	2.57	-4.30
	Sri Lanka	1990	2000	11	4.04	-4.79
	New Zealand	1993	2002	10	2.52	-4.68
	Nicaragua	1995	2004	10	3.95	-20.64
	Costa Rica	1998	2007	10	3.65	-4.50
	Greece	1998	2007	10	4.04	-7.73
	Lao PDR	1999	2008	10	4.10	-12.52
	Panama	1999	2008	10	3.63	-5.80

Note: For sources and methodology, see endnote 10 of this chapter.

— the "allocation puzzle": when private capital *does* flow to developing countries, it tends to flow to low-growth rather than high-growth countries. Developing and emerging market countries that have grown rapidly have typically relied mainly on domestic savings rather than capital imports.[12]

Neither of these puzzles applies in the transition region.[13] Chart 3.2a shows the allocation puzzle for a sample of emerging market countries that excludes large aid recipients, so that the current account reflects primarily private financing.[14] The vertical axis records average real per capita growth, while the horizontal axis shows the current account balance as a percentage of GDP. Economic reasoning would suggest a negative correlation, with capital flowing to the fastest growing countries, but this is not the case. In contrast, in the transition sample (Chart 3.2b) fast growth and capital inflows (that is, negative current account balances) are indeed correlated.

However, correlation does not necessarily imply that capital inflows have had a causal impact on growth in transition economies. Indeed, a plausible interpretation of Chart 3.2b is that high growth – perhaps generated by structural and institutional reforms, stabilisation or trade integration – *attracted* capital flows and led to financial integration. The key question is whether financial integration had positive growth effects beyond those of reforms and trade integration.

Growth effects of financial integration

Disentangling cause and effect in the relationship between capital flows and growth requires statistical analysis. This can be done using a growth regressions approach, based on country-level data (which is standard in the research literature but does not conclusively prove causality) and a less common, but more powerful, technique based on sector data.

Growth regressions approach

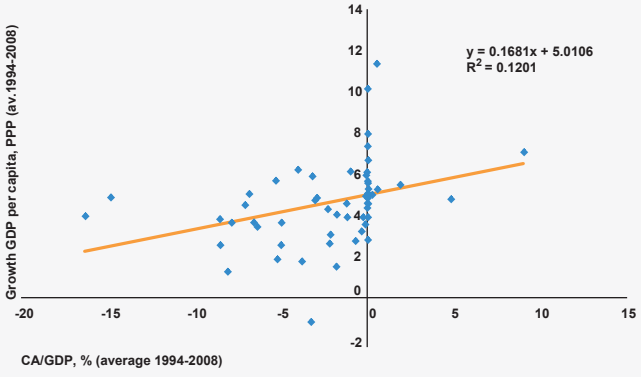
This approach considers the effect of capital inflows (or more generally, financial integration) on growth, together with that of trade openness, institutional quality, education and life expectancy (which have been shown to be determinants of growth in research literature). The problem of "reverse causality" – that the correlation between growth and financial integration may arise on account of growth attracting finance, rather than the other way round – remains present but can be mitigated by techniques that exploit the time variation in the data in addition to the cross-country variation. In Table 3.1 these techniques are used in the set of columns to the right, while the columns to the left reflect simple cross-sectional regressions based on period averages between 1994 and 2008.

The analysis focuses on a group of countries that are sometimes referred to as emerging Europe, comprising the CEB and SEE countries, Turkey and Ukraine. For the purposes of this chapter, the term "CESE+" is used to refer to this group. Table 3.1 compares the relationship between financial integration and growth in this group with that in a broad set of non-transition emerging market countries. Several alternative measures of financial integration are considered in addition to the current account (as a measure of capital inflows), including changes in net foreign assets of the country over the estimation period,[15] the level of gross foreign assets and liabilities as a share of GDP, and the presence of foreign banks. All statistical models include an "interaction term" which measures how the effect of financial integration differs for the CESE+ group compared to the remaining countries. The models also control for a set of other variables that are standard in growth regressions (see Note 1 in the table). However, in this instance, the table shows only the growth effect of the financial integration variables in the non-CESE+ group, the differential effect in the CESE+ group, and the total effect in that group.

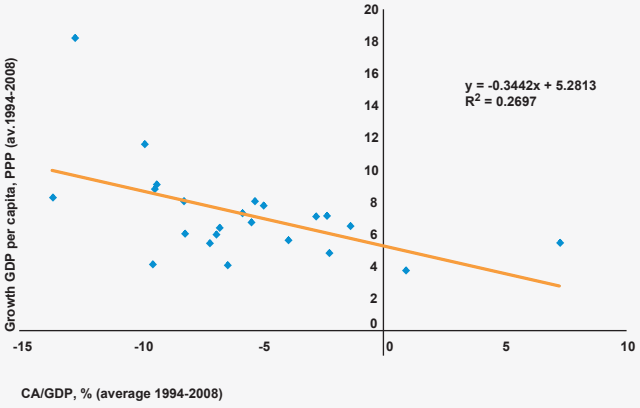
If financial integration has growth benefits, there should be statistically significant negative coefficients on the average current account and change in net foreign assets and positive coefficients on the remaining integration measures. However, for the non-CESE+ countries, this is generally not found to be the case. In particular, current account surpluses and increases in net foreign assets – that is, net capital outflows – are associated with higher growth, while higher levels of gross financial integration (GFI) are associated with lower growth. In the panel regressions, three out of five coefficients have the expected sign, but none is statistically significant.

The results are quite different in the CESE+ group, as suggested by the differential growth effect data line of the table, which is large and often statistically significant. That is followed by the total growth effect for the CESE+ group.[16] All but two coefficients have the expected signs, suggesting a beneficial effect of financial integration on growth. The net

Chart 3.2
Current account balances and growth
3.2a Developing countries (excluding transition countries)



3.2b European transition region



◆ Country

Source: IMF, *World Economic Outlook*, 2008.

Note: CA/GDP, % means current account balance in per cent of GDP.
X and y axes are expressed in per cent.

capital inflow measures (current account and change in net foreign assets) have statistically significant growth effects in the cross-country regression, while gross financial integration and presence of foreign banks are statistically significant in the panel regression.

Sector approach

Some industries depend on external finance – as opposed to internal finance, such as retained earnings – more than others (for example, because they often need to make large investments that require external capital). Therefore, if financial integration "works" in the sense that it facilitates access to financing and ultimately investment and growth, it should have a more marked effect in industries that depend strongly on external financing. This implication can be tested by estimating an econometric model in which the growth effect of financial integration is allowed to depend on the external finance dependence of an industry (see Box 3.2 on page 66 for details on methodology and data).

The analysis is carried out for a sample of low and middle-income countries selected on the same basis as in Table 3.1. Due to limited sector data availability, the sample shrinks to 26 countries, 12 of which are transition countries. In addition to a term capturing the interaction of external dependence and financial integration, another interaction term is added to the statistical model to see whether there is an additional growth effect in CESE+ economies (see Note in Table 3.2). The expected signs are as in the previous analysis: if financial integration fosters growth in the non-transition sample, then the interaction of external dependence and financial integration should have a negative and significant coefficient on the current account and change in net foreign assets, and positive coefficients on the remaining integration measures. If the effect of financial integration is different in the transition sample compared to the non-transition sample, then the coefficient on the second interaction term should be significantly different from zero.

Table 3.2 on page 66 shows that the estimated growth effects of financial integration in the non-transition sample are always statistically insignificant and sometimes have the "wrong" sign (first data line of the table). There is little evidence that financial integration has boosted growth in non-transition economies. As in Table 3.1, however, the second data line suggests that the experience in financially integrated transition countries has generally been different. Industries depending on external finance show a significantly stronger growth effect of financial integration in the transition region than elsewhere.

The total growth effect of financial integration in transition countries is given in the third data line. As in the country-level analysis, current account deficits are shown to have been associated with higher growth (significant at the 5 per cent level). The other measures of financial integration are also statistically significant with expected signs, with the exception of debt flows. However, the effect of average debt levels is significant and positive as expected, suggesting perhaps that additional inflows may have helped only in countries that had a minimum level of financial development to begin with.

The second memorandum item in Table 3.2 gives a sense of the magnitude of the impact of financial integration on growth in CESE+ countries. For example, the value of 1.613 in the regression using the current account balance as a measure of financial integration has been calculated as follows: an industry that does not depend strongly on external finance (25th percentile of external dependence) grows by 0.37 percentage points faster in a country with a relatively small current account (25th percentile) than in a country with a relatively high current account (75th percentile). For an industry that depends strongly on external finance (75th percentile of external dependence), this growth difference amounts to 1.98 percentage points. The difference between these two numbers is 1.61. The benefits of financial integration for industries depending on external finance are therefore substantial in CESE+ countries.

Table 3.1

Country-level evidence on growth effects of financial integration

(Regression coefficients; p-values in parentheses; dependent variable: average growth in country GDP, 1994-2008)[1]

	Cross-country regression[2]					Panel regression[3]				
	Financial integration (FI) measure[4]					Financial integration (FI) measure[4]				
	CA	ΔNFA	GFI	Banks (a)	Banks (b)	CA	ΔNFA	GFI	Banks (a)	Banks (b)
Growth effect of financial integration (non-CESE+ countries)[5]	0.231 (0.00)	0.221 (0.031)	-0.008 (0.067)	0.001 (0.955)	-0.001 (0.96)	0.121 (0.44)	0.269 (0.001)	0.001 (0.822)	0.010 (0.572)	0.006 (0.823)
Differential growth effect in CESE+ countries[6]	-0.379 (0.00)	-0.505 (0.002)	0.006 (0.279)	0.017 (0.347)	0.011 (0.518)	-0.544 (0.078)	-0.014 (0.955)	0.029 (0.008)	0.028 (0.243)	0.045 (0.125)
***Memorandum item*: total growth effect in CESE+ countries**	-0.147 (0.003)	-0.284 (0.031)	-0.002 (0.826)	0.018 (0.259)	0.010 (0.491)	-0.422 (0.110)	0.255 (0.234)	0.031 (0.025)	0.039 (0.019)	0.051 (0.018)
Observations	55	54	54	50	50	213	209	209	194	194
Number of instruments	–	–	–	–	–	39	39	39	39	39
Hansen test p-value	–	–	–	–	–	0.13	0.22	0.11	0.14	0.14
Number of countries	55	54	54	50	50	56	55	55	51	51

Sources: IMF *World Economic Outlook* (current account, initial PPP-GDP per capita and fiscal balance); Claessens et al (2008) (foreign bank asset shares); Lane and Milesi-Ferretti (2006) and Abiad et al (2009) (other financial integration measures); World Bank World Development Indicators (life expectancy); Wacziarg and Welch (2003) (initial trade regime); International Country Risk Guide (ICRG – institutional quality).

Note: [1] The table shows results from two data samples and five statistical models for each sample. The models differ in terms of the financial integration measure used, but are otherwise identical. Following Prasad et al (2007), the following control variables were included (not shown in the table): initial GDP per capita, life expectancy, initial trade policy, fiscal balance to GDP ratio, as well as a measure for institutional quality (ICRG). The magnitude, sign and significance of the additional control variables are similar to the ones obtained by Prasad et al (2007) and related studies. [2] Cross-sectional regression on country averages, 1994-2008. [3] Panel estimation using five, three-year, non-overlapping averages, 1994-2008. Estimated using Generalised Method of Moments, using past values of the measures for financial integration, log of the initial GDP per capita, life expectancy, fiscal balance, trade openness and institutional quality as instruments. [4] CA: average current account over period (share of GDP, in per cent); ΔNFA: change in net foreign asset position over period (as share of GDP, in per cent); GFI: level of gross financial integration (foreign assets+foreign liabilities, in per cent of GDP); Banks (a): share of foreign bank assets in total assets of banking system; Banks (b): proportion (number) of foreign banks in banking system. [5] Non-transition country sample obtained by starting with all countries and eliminating countries with (i) 1994-2008 average of purchasing power adjusted GDP per capita higher than US$ 20,000; (ii) area smaller than 30,000 sq. km and island economy; (iii) average value of oil exports in per cent of GDP from 1994 to 2008 higher than 10 per cent of GDP; and (iv) average developmental aid from 1994 to 2008 higher than 15 per cent of GDP. [6] The CESE+ group is composed of the CEB and SEE countries, Turkey and Ukraine.

Box 3.2

Applying the Rajan–Zingales methodology to financial integration

A cross-country regression of economic growth on macroeconomic variables such as financial development or financial integration (as in Table 3.1) can suffer from reverse causality, as current or anticipated growth in a country may be the driver of financial integration. In a seminal paper, Rajan and Zingales (1998) suggested a new approach for dealing with this problem by running a sector-level regression to test whether sectors of the economy that should benefit disproportionately from access to credit do in fact grow faster in countries with more developed financial systems. Country- and industry-specific constants are used to capture the effect of other factors that affect growth in a particular country and sector.

Following this approach, the estimation equation underlying Table 3.2 is:

$$Growth_{j,k}=\alpha_k + \beta_j + \gamma \times industry\ share_{j,k} + \delta_0 \times (ext.\ dependence_j \times fin.\ integration_k) + \delta_1 \times (ext.\ dependence_j \times fin.\ integration_k \times Dummy\ CESE+_k)+\varepsilon_{jk},$$

where j denotes the industry and k the country. α_k is a country fixed effect and β_j is an industry fixed effect. The industry share is included in order to control for the maturity of an industry in a given country. External dependence measures the degree to which firms of industry j are dependent on external finance. This is interacted with various *de facto* measures of financial integration at the country level.

The main coefficients of interest are δ_0 and δ_1. δ_0 captures the impact of financial integration on external finance-dependent sectors in non-CESE+ countries. If industries that rely strongly on outside financing benefit more from financial integration in this group of countries, this coefficient should be positive. δ_1 captures the differential effect of financial integration in CESE+ countries. A significant coefficient implies that the growth effects of financial integration are different in CESE+ countries. The sum of δ_0 and δ_1 captures the effect of financial integration (again depending on external dependence) in the CESE+ countries.

The analysis is based on 4-digit-level industry data from the third revision of the Industrial Statistics Databases provided by the United Nations Industrial Development Organization (UNIDO). It includes data for the CESE+ group as well as Armenia, Botswana, Brazil, Georgia, Indonesia, Jordan, Korea, Madagascar, Moldova, Panama, Philippines, Portugal, South Africa and Uruguay. (The main results are preserved if Armenia, Georgia and Moldova switch groups.) The dependent variable is industry-level average real output growth between 1998 and 2005 (the longest time span for which data for a sufficiently large number of countries can be obtained). Because of the relatively short time span, the effects of financial integration may be underestimated, since many benefits only materialise over longer time intervals. The results may therefore understate the benefits of financial integration. The values for external dependence of sectors are taken from Rajan and Zingales (1998). Industry shares are calculated using 1998 data. Financial integration variables are from the sources described in Table 3.1 and are measured as an average over the time period.

Table 3.2

Sector-level evidence on growth effects of financial integration

(Regression coefficients; p-values in parentheses; dependent variable: average growth in sectoral output, 1998-2005)

	Financial integration (FI) measure								
	CA	ΔNFA	ΔFDI	ΔD	GFI	FDI	D	Banks (a)	Banks (b)
Growth effect of financial integration interacted with external dependence (non-CESE+ countries)	0.377 (0.20)	-0.153 (0.61)	0.126 (0.73)	0.210 (0.34)	0.013 (0.27)	-0.010 (0.89)	0.008 (0.75)	0.008 (0.90)	-0.004 (0.94)
Differential growth effect in CESE+ countries	-1.047 (0.01)	-1.030 (0.07)	1.269 (0.02)	-0.511 (0.29)	0.044 (0)	0.152 (0.01)	0.113 (0.01)	0.072 (0.19)	0.093 (0.05)
Memorandum items:									
Total growth effect of financial integration interacted with external dependence (CESE+)	-0.669 (0.03)	-1.184 (0.02)	1.394 (0.01)	-0.301 (0.47)	0.057 (0.01)	0.141 (0.04)	0.121 (0.03)	0.080 (0.01)	0.089 (0.03)
Difference in sectoral growth rates in CESE+ countries	1.613	1.925	1.364	-0.481	1.363	0.730	2.146	1.412	1.313
Observations	1,041	1,041	1,041	1,041	1,041	1,041	1,041	1,041	1,041
Number of countries	26	26	26	26	26	26	26	26	26

Sources: UNIDO (sectoral output data, see Box 3.2); source of FI measures as in Table 3.1.

Note: The table shows results from nine regressions that differ with respect to the financial integration measure used. Each regression includes country and industry fixed effects and sector shares (results not shown), as well as two interaction terms: financial integration interacted with industry dependence on external finance; and this term in turn interacted with a dummy variable denoting whether the country belongs to the CESE+ group. The memorandum items show: (1) the total sectoral growth effect in CESE+, computed as the sum of the previous two coefficients; (2) the differences in sectoral growth rates between sectors at the 75- and 25-percentiles of external dependence in the countries at the 75- and 25-percentiles of the respective financial integration measure for the group of CESE+ countries. The financial integration measures are (see Box 3.2 for details on data and methodology): CA: average current account over period (share of GDP, in per cent); ΔNFA: change in net foreign asset position over period (share of GDP, in per cent); ΔFDI: change in gross foreign direct investment liabilities over the period (share of GDP, in per cent); ΔD: change in gross foreign debt liabilities over the period (share of GDP, in per cent); GFI: level of gross financial integration (foreign assets+foreign liabilities as share of GDP, in per cent); FDI: level of gross foreign direct investment liabilities, period average (share of GDP, in per cent); D: level of gross foreign debt liabilities, period average (share of GDP, in per cent). Banks (a): share of foreign bank assets in total assets of banking system; Banks (b): share of foreign bank number in total bank number.

What makes the transition region different?

Why has foreign capital – and financial integration more generally – stimulated growth in the European transition region, when this has not been the typical experience of other emerging market countries? Three potential explanations have been suggested:

— higher initial levels of financial development, which imply a higher capacity of financial sectors to absorb and effectively intermediate capital inflows

— better institutions compared to other developing and emerging market countries (perhaps reflecting the incentive to reform by states aspiring to EU membership)

— higher levels of financial integration itself – the notion being that the benefits of integration can be reaped only when the level of that integration is high to begin with.[17]

To investigate these explanations, the techniques underlying Table 3.2 can again be deployed, adding a further interaction term to the statistical analysis that shows how the effects of financial integration are modified either by financial development (see the third data line in the first panel of Table 3.3), institutional quality (third line in second panel) or the level of integration (third line in third panel).[18] The additional terms capture threshold effects associated with these variables. A significant coefficient implies that a country with financial development, institutional quality or financial integration above the sample median can reap additional benefits from financial integration. The key question is whether the CESE+ interaction term (see the second line in each panel) maintains its statistical significance even after the new terms are added. If not, the additional variable can be considered an important driver of the difference between the CESE+ group and other countries. If the CESE+ interaction term remains significant, there must be other factors that are responsible for the differential effect in transition economies.

Table 3.3 shows that the coefficient of the CESE+ interaction is largely unaffected and remains statistically significant when controlling for financial development or institutional quality (or both, for which the results are not shown). Differences in these variables cannot therefore explain the unusually strong growth effect of financial integration in transition countries. However, the third panel suggests that a large part of this differential growth effect could be driven by financial integration itself. When adding an interaction with the foreign bank number share, the coefficient of the CESE+ interaction term decreases in size and becomes insignificant in many cases.[19]

There are two non-exclusive explanations for this result. First, foreign bank presence may have improved the allocation of funds entering the country. Second, foreign bank presence may be correlated with conditions that make foreign investments growth-enhancing but could not be captured by the standard measures of financial development or institutional quality used in the regressions. An example would be the policy commitment that accompanies actual or envisaged EU membership.

Table 3.3
Sector-level evidence on threshold effects
(Regression coefficients; p-values in parentheses; dependent variable: average growth in sectoral output, 1998-2005)

	Financial integration (FI) measure								
	CA	ΔNFA	ΔFDI	ΔD	GFI	FDI	D	Banks (a)	Banks (b)
Threshold effects in financial development:									
Basic growth effect in non-CESE+ countries with below-median financial development[1]	0.492 (0.18)	-0.333 (0.64)	-0.371 (0.67)	1.407 (0.04)	0.001 (0.96)	-0.064 (0.54)	-0.029 (0.54)	-0.004 (0.96)	-0.036 (0.61)
Differential sectoral growth effect in CESE+ countries	-1.058 (0.01)	-0.932 (0.16)	1.374 (0.02)	-1.407 (0.03)	0.047 (0.00)	0.168 (0.02)	0.131 (0.01)	0.076 (0.18)	0.114 (0.04)
Differential sectoral growth effect in countries with above-median financial development	-0.291 (0.41)	0.194 (0.78)	0.518 (0.49)	-1.252 (0.06)	0.01 (0.56)	0.061 (0.37)	0.043 (0.28)	0.021 (0.56)	0.049 (0.31)
Threshold effects in institutional quality:									
Basic growth effect in non-CESE+ countries with below-median institutional quality[1]	0.382 (0.29)	-0.191 (0.60)	-0.487 (0.51)	0.413 (0.24)	-0.003 (0.90)	-0.089 (0.47)	-0.026 (0.57)	0.007 (0.93)	-0.022 (0.75)
Differential sectoral growth effect in CESE+ countries	-1.04 (0.01)	-1.087 (0.06)	1.446 (0.02)	-0.423 (0.37)	0.042 (0.00)	0.139 (0.02)	0.104 (0.01)	0.072 (0.20)	0.09 (0.06)
Differential sectoral growth effect in countries with above-median institutional quality	-0.014 (0.97)	0.167 (0.76)	0.743 (0.28)	-0.463 (0.23)	0.013 (0.46)	0.081 (0.35)	0.039 (0.26)	0.002 (0.96)	0.027 (0.56)
Threshold effects in foreign bank number shares:									
Basic growth effect in non-CESE+ countries with below-median foreign bank presence[1]	0.384 (0.20)	-0.146 (0.63)	0.101 (0.78)	0.240 (0.29)	0.006 (0.65)	-0.053 (0.58)	-0.006 (0.83)	-0.044 (0.63)	-0.198 (0.14)
Differential sectoral growth effect in CESE+ countries	-0.699 (0.15)	-0.773 (0.33)	0.124 (0.95)	-0.315 (0.52)	0.032 (0.05)	0.095 (0.20)	0.083 (0.05)	0.047 (0.41)	0.047 (0.33)
Differential sectoral growth effect in countries with above-median foreign bank presence	-0.472 (0.32)	-0.369 (0.65)	1.213 (0.50)	-0.546 (0.30)	0.018 (0.15)	0.087 (0.30)	0.049 (0.09)	0.067 (0.34)	0.169 (0.08)
Observations	1,041	1,041	1,041	1,041	1,041	1,041	1,041	1,041	1,041
Number of countries	26	26	26	26	26	26	26	26	26

Sources and abbreviations: see Tables 3.1 and 3.2 and Box 3.2.

Note: The table shows the results from 27 (= 3·9) regressions that differ with respect to the financial integration measures and to the types of threshold effects. Each regression includes country and industry fixed effects and sector shares (results not shown), as well as three interaction terms: (i) industry external dependence interacted with financial integration; (ii) this first term interacted with a dummy variable denoting whether the country belongs to the CESE+ group and (iii) the first term interacted with either the ratio of private credit over GDP as a measure of financial development (first panel), the variable regulatory quality by the World Bank as a measure of institutional quality (second panel), or the foreign bank number share as a measure of financial integration (third panel). [1] Basic growth effect refers to interaction of financial integration with industry dependence on external finance.

To summarise, the analysis indicates a robust positive effect of financial integration on economic growth in the European transition region, unlike other emerging market regions. A possible reason for the difference could be threshold effects with respect to financial integration, in particular regarding the presence of foreign banks.

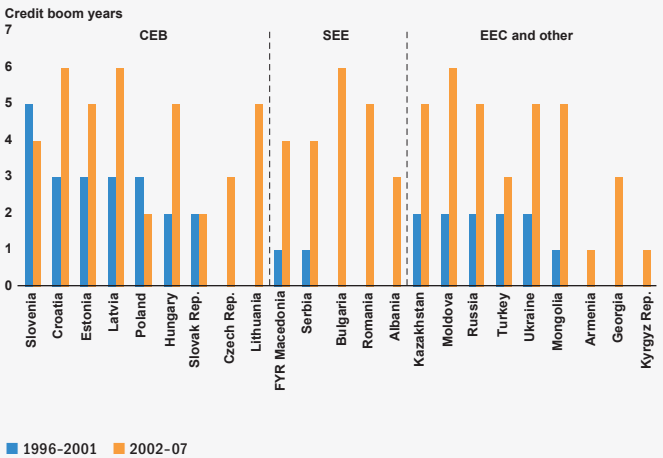
The costs of financial integration in the transition region

As shown in Chapter 2, the relationship between financial integration and the degree to which transition countries suffered in the crisis is not straightforward. On the one hand, the presence of foreign banks seems to have mitigated the sudden stop in capital flows suffered by the transition region. On the other, both credit booms and external indebtedness – a direct consequence of financial integration – are associated with higher output declines during the crisis. This raises the question of whether foreign banks facilitated credit booms and over-borrowing. If so, they may have been mitigating a problem of their own making.

High private debt levels and past credit booms could also impose a burden that stretches beyond their impact during the crisis. Rapid credit expansion is likely to have strained the capacity of banks to properly evaluate credit applications and monitor existing exposures without eroding risk standards. Moreover, as argued in Chapter 2, rapid credit growth in the property sector may have fuelled house price rises. However, with house prices declining, banks may not be able to recover their principal, leading to an erosion in capital, a more protracted credit crunch and a slower recovery.[20] Excessive debt could also constrain new investment, depressing growth over the longer term. Did financial integration contribute to these problems?

Similar issues arise with respect to the potential impact of financial integration on the currency composition of debt. Foreign currency-denominated debt has been a complicating factor in the crisis. Aside from contributing to insolvencies of firms in countries with large currency depreciations, it restricted policy options in others, forcing some countries to turn to highly contractionary measures in order to defend their currency pegs. Was the sharp rise of foreign currency lending in transition countries an inevitable by-product of foreign financing and can it be specifically linked to the entry of foreign banks?

Chart 3.3
Frequency of credit boom years in transition countries, 1996–2007



Source: EBRD staff calculations based on World Bank and EBRD data.

The remainder of the chapter attempts to address these questions, drawing on macroeconomic and microeconomic evidence.

Did financial integration fuel credit booms?

Chapter 2 showed that flows in cross-border bank lending to the transition region are correlated with credit expansions. From a policy perspective, however, this is not a very helpful insight: credit expansions are desirable and to be expected, in the context of financial development, which is one of the purposes of financial integration. The critical question is whether financial integration encouraged excessive credit growth – that is, credit growth that is likely to have exceeded the capacity of bank risk management systems and supervisory institutions, as argued above.

To answer this question, one must first define when credit growth becomes "excessive". Empirical studies typically identify credit booms as sharp deviations from the historic rate of expansion.[21] However, in the transition region it is difficult to apply this definition because there is no historic rate of credit expansion that could be used as a baseline. In line with other empirical studies,[22] the analysis that follows therefore defines a credit boom as a period during which credit was growing by more than two percentage points of GDP per year.

Chart 3.3 shows the distribution of credit boom years across 23 transition countries based on this simple criterion during the 12-year period 1996-2007. This is divided into two six-year sub-periods – 1996-2001 and 2002-07 – the second of which is the period of fast growth, integration and accumulation of financial vulnerabilities described at the beginning of Chapter 2 and in the first half of this chapter. Out of 276 (23 x 12) country-years overall, 128 are classified as credit boom years. Not surprisingly, the large majority – 94 boom years, or 73 per cent of the total – are located in the second sub-period.

The chart shows that many transition countries did not have a boom year in the first sub-period. Those which had three or more tend to be geographically close to the European Union and were early reforming countries, such as Slovenia (five boom years out of six) and Croatia, Estonia, Latvia and Poland (all with three boom years). In contrast, in the second sub-period, all countries had at least one boom year, and Bulgaria, Croatia, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, FYR Macedonia, Moldova, Mongolia, Romania, Russia, Serbia, Slovenia and Ukraine had four or more. This group is highly heterogeneous with respect to the degree and structure of financial integration (in particular, the role of foreign banks), as are those countries that had two or fewer boom years (Poland and the Slovak Republic with two, and Armenia and the Kyrgyz Republic with one). This suggests that the relationship between credit booms and financial integration is not straightforward and/or that booms were heavily influenced by additional factors.

This is confirmed in Table 3.4. The upper rows contain the relative frequency of boom years, stratified according to the level of gross financial integration and the share of foreign-owned bank assets in the total assets of the banking system. The sample is split according to whether countries were below or above the median of these variables. This is done for both the initial level of integration at the beginning of the period and the change in the variables over the period. For example, for countries with *below median* initial levels of capital account openness, 15.2 per cent of country-years during 1996–2001 were boom years, while for countries with *at or above median* initial financial integration, only 9.4 per cent were boom years.

Three main observations emerge.

— With few exceptions, the difference in relative frequencies between the *below median* and *at or above median* groups is small relative to the difference across time periods. The average difference across time periods is 22 percentage points, while the average difference between countries with financial integration values at or above the median and below the median is only three percentage points. This suggests that global factors – the period between 2002 and 2007 was characterised by abundant liquidity in international credit markets – dominated the effects of policy-related cross-country differences.

— Differences in *changes in financial integration* seem to influence the propensity to experience a credit boom more than differences in levels. During 2002–07 the probability of experiencing a credit boom was 16 percentage points higher in countries with *at or above median* rises in gross financial integration (in practice, countries experiencing rapid debt inflows) compared to countries with *below median* rises.

— The share of domestic banking sector assets controlled by foreign institutions appears to play no role in determining the likelihood of credit booms. This applies to levels of, and changes in, foreign bank asset shares.

These observations are broadly confirmed by cross-country correlations between the number of credit boom years and financial integration measures, reproduced in the last two data rows of the table. With only one exception, all correlations are small and statistically insignificant. The exception is the correlation with changes in gross financial integration, which is large in the 2002–07 period (0.52) and statistically significant at the 1 per cent level.

Did financial integration induce excessive debt accumulation?[23]

An alternative to focusing on the speed of credit growth is to ask whether financial integration contributed to excessive stocks of private debt. As in the previous section, this requires a definition of "excessive". A macroeconomic approach is to define "excessive" as a higher level of aggregate private sector credit than would be commensurate with economic fundamentals.[24] The present analysis follows an alternative approach, namely, to define excessive debt accumulation at the microeconomic (firm) level. Recent research based on a large sample of firms from 12 transition economies suggests that debt in excess of about 40 per cent of assets no longer benefits productivity growth.[25] The question is whether financial integration is a contributory factor in pushing firm debt above that threshold.

A statistical analysis was undertaken which relates the probability of exceeding the 40 per cent threshold to the same measures of financial integration used in Table 3.1. Other explanatory variables included a set of firm-level variables and a measure of financial development – private credit in per cent of GDP – as a proxy of firm access to credit. Also included was an interaction term between financial integration and financial development to capture the possibility that the effect of financial integration differs depending on the depth of the financial system (see Table 3.5 on page 70).

Table 3.4
Financial integration and credit booms

	1996–2001		2002–07	
	GFI	Foreign bank asset share	GFI	Foreign bank asset share
Relative frequency of credit boom years (%)[1]				
Initial levels of financial integration[2]				
below median	10.9	10.1	29.0	36.2
at or above median	13.8	14.5	39.1	31.9
Change in financial integration[3]				
below median	10.9	14.5	26.1	34.1
at or above median	13.8	10.1	42.0	34.1
Cross-country correlations between number of credit boom years and financial integration measures				
Initial levels of financial integration[2]	–0.03	0.08	0.04	0.01
Change in financial integration[3]	0.14	0.09	0.52	–0.10

Sources: Lane and Milesi-Ferretti (2006) and Abiad et al (2009) for GFI (gross financial integration) measure (that is, sum of external assets and liabilities in per cent of GDP); and EBRD for foreign bank asset share.

Note: [1] Per cent of years in which ratio of private credit to GDP grew by more than two percentage points. [2] Refers to first year of each period. [3] Differences in level of GFI and foreign bank asset share, respectively, between first and last year of each period.

As expected, financial development is generally associated positively with excess leverage (it is easier for firms to borrow in excess of the threshold in deeper financial systems). The results for financial integration are more difficult to interpret because they depend on the level of financial development. To understand the overall effect, it is best to focus on the memorandum item in the table, which gives the threshold level of financial development below which (<) or above which (>) the total effect of financial integration decreases the probability of excess leverage.

The results turn out to depend on the form of financial integration – in particular, whether it is driven by debt or foreign direct investment (FDI).

— Not surprisingly, the probability of excess firm leverage rises with higher aggregate levels of external debt – but only in relatively developed financial systems (the threshold level in this regard is a ratio of domestic credit to GDP of 40 per cent). A possible interpretation is that the scope for intermediating foreign debt is more limited in undeveloped financial systems.

— In contrast, FDI is associated with a lower probability of excess leverage at higher levels of financial development.

There is also mixed evidence on the role of foreign banks.

— A higher foreign bank asset share is associated with a higher probability of excess leverage. However, the estimated direct effect is statistically insignificant and the effect works entirely through the interaction with financial development. Since the direct effect of financial development also becomes insignificant when the foreign bank asset share is included in the model, a plausible interpretation is that excess leverage was associated with higher levels of both foreign bank asset shares and financial development, and that the effects of the two cannot easily be disentangled.[26]

— In contrast, measuring foreign bank presence through the proportion of foreign banks suggests a more benign effect, namely, a reduction of the probability of excess leverage once financial development exceeds a certain threshold. In essence, this implies that, in countries with high credit-to-GDP ratios, excess leverage was more likely if banking systems were either predominantly domestically owned or if foreign bank ownership was more concentrated, than if there were many foreign banks present in the system.

Did financial integration encourage foreign currency borrowing?

Foreign currency/exchange (FX) borrowing has been a recurring source of vulnerability in emerging markets. When financial liabilities are in foreign currency but assets are denominated in domestic units, a real depreciation of the exchange rate can make an exposed household, firm, bank or government insolvent, triggering corporate, banking and even sovereign debt crises. This mechanism has played a role in most modern emerging market traumas, including the debt crisis of the 1980s, the Mexican peso crisis of 1994–95, the Asian crisis of 1997–98 (see Box 1.3) and the Argentina crisis of 2001–02. As discussed earlier in this chapter and in Chapter 2, it has also aggravated the present difficulties in the transition region, although its effects have so far been mitigated by large-scale international lending to both the public and private sectors of the affected countries and by foreign bank support of local subsidiaries.

If FX borrowing is so risky – both individually and collectively – why is it so prevalent in emerging markets? There is a rich economic literature on this question, written mainly in the last 10 years.[27] There are two broad explanations.

— While FX debt exposes borrowers to currency shocks, it may shield borrowers and lenders from others, particularly domestic shocks that affect the inflation rate. Therefore, although risky, it might be less so than local currency debt in environments with weak macroeconomic institutions (especially in terms of fiscal capacity and monetary policy credibility).[28]

Table 3.5
Financial integration and excess leverage
(Regression coefficients; p-values in parentheses; dependent variable: dummy variable that takes value 1 if firm debt/assets > 0.4 and 0 otherwise)

	Financial integration (FI) measure						
	GFI	FDI	D	ΔFDI	ΔD	Banks (a)	Banks (b)
Financial development (FD)	18.806	8.666	–4.199	2.304	1.561	0.260	6.518
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.586)	(0.000)
FI measure	4.033	7.494	–5.020	0.283	0.453	0.086	2.127
	(0.000)	(0.000)	(0.000)	(0.267)	(0.278)	(0.675)	(0.000)
Interaction term	–11.516	–21.072	12.648	–0.819	1.134	1.397	–7.763
(FIxFD)	(0.000)	(0.000)	(0.000)	(0.175)	(0.231)	(0.018)	(0.000)
***Memorandum item:* Threshold of FD[1]**	0.350 (>)	0.356 (>)	0.397 (<)	0.346 (>)	effect always positive	effect always positive	0.274 (>)
Observations	6,382	6,382	6,382	6,382	6,382	6,382	6,382

Sources: see Table 3.1 and Orbis database for firm–level data.

Note: FD is measured as a ratio of domestic credit to GDP. Regressions also control for dummy variables for small and medium–sized enterprises, young firms (set up after 1995) and foreign ownership; and a measure of profitability. Firms are from Bulgaria, Croatia, Czech Republic, Hungary, Latvia, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia and Ukraine; the sample period is 2001–05. FD and all FI stock (level) variables are measured in the first year of the sample. [1] Threshold of FD indicates the level of financial development below which (<) or above which (>) the total effect of financial integration is to decrease the probability of excess leverage.

— The risks and costs of FX borrowing may seem smaller from the perspective of individual borrowers than from the perspective of society as a whole. This could be, for example, because borrowers expect to be bailed out in the event of a devaluation ("moral hazard") or because they do not fully take account of the repercussions of an insolvency for firm employees, other firms or the financial system.[29] In this case, rational decisions at the firm or household level may lead to too much FX debt from an economy-wide perspective.

Both explanations are supported by evidence, mainly from Latin America and emerging Asia. However, they may not fully capture the transition experience of the last decade. Notwithstanding institutional improvements and lower inflation volatility, there has been a steady increase in the share of FX liabilities in many countries, including new EU member states. It is possible that this reflects a variant of the second explanation – that government commitments to keep the exchange rate stable ahead of adoption of the euro or ERM2 (Exchange Rate Mechanism) membership may have led firms and households to underestimate the risks of a devaluation. However, it is also possible that there is a direct link between foreign financing or foreign bank presence and FX lending, as suggested by the fact that these are correlated in the transition region (see Chart 3.4).

Several research papers explain why such a link might exist and offer supporting evidence.[30] The simplest explanation has to do with the availability of funding in foreign currency. If banks have cheap access to such funding – either through their foreign parents or the syndicated lending market during times of abundant world liquidity – they may be tempted to also lend in foreign currency in order to avoid having a mismatch (an open FX position) on their own balance sheets. This may lead them to price FX loans relatively cheaply, which in turn expands the share of FX lending in the economy relative to domestic currency lending.

The remainder of this section tests the proposition that financial integration, and particularly foreign funding of banking systems or the presence of foreign banks, has contributed to FX lending in transition economies.[31] Two main questions are addressed: first, whether financial integration measures have played a role, taking into account the determinants that have been emphasised in the previous empirical literature; and second, whether foreign-owned banks have played a special role, or whether it is foreign *funding* that matters, regardless of whether it comes from a parent bank or from the international capital market.

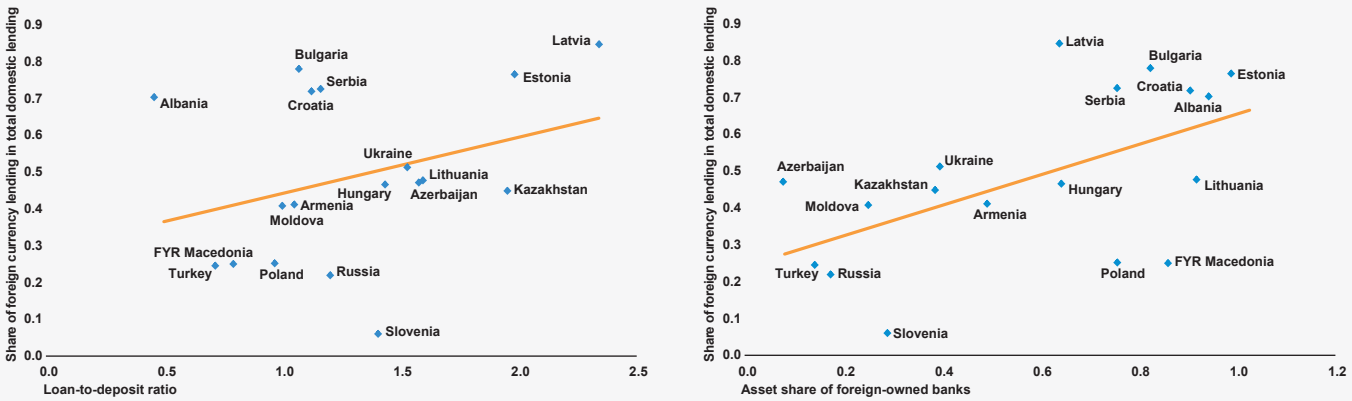
To ensure that the answers are not driven by a particular methodology, these questions are addressed in the context of three analyses based on different datasets:

— a firm-level dataset based on the third (2005) EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS), which contains a question about the currency denomination of the last loan taken out by the firms participating in the survey. The answer to this question – whether the loan was in domestic or foreign currency – is represented using a dummy variable, which is regressed on a set of firm variables and country variables, including several measures of financial integration

— a quarterly macroeconomic dataset with the same country-level variables and the same sample period (2002-05). The dependent variable in this analysis is the FX share in banking system liabilities for each country

— an annual macroeconomic dataset with similar variables, but comprising a longer period (2000-08).

Chart 3.4
FX lending share and foreign financing



Sources: IMF, *International Financial Statistics*, CEIC Data Company and EBRD calculations.

Note: Loan-to-deposit ratio based on IFS dataseries 22S, 24 and 25; these are not adjusted for valuation effects. Foreign currency lending based on CEIC data; also not adjusted for valuation effects. Asset share of foreign-owned banks is based on EBRD survey of central banks, end of 2007.

Table 3.6 summarises the results. For each of the three datasets used, it shows the results of three statistical models. All models comprise a number of potential country-level determinants of FX liabilities, including inflation volatility, a proxy for institutional quality (the EBRD governance and enterprise reform index), a dummy variable that takes the value of 1 if the country had a hard peg and 0 otherwise, the asset share of foreign banks, and an additional financial integration variable. There are also a number of additional country-level control variables for which the results are not shown, as well as firm-level controls in the first group of regressions based on BEEPS data (see table notes). The difference between the models used for each dataset is in the financial integration variable, namely: gross financial integration, cross-border bank lending (using data from the Bank for International Settlements – BIS) and the loan-to-deposit ratio of the banking system. The latter two are used as alternative measures of foreign financing.

The table shows that the governance indicator is a significant and robust determinant of the FX lending share, confirming the finding of earlier studies that FX lending is more prevalent in countries with weak institutions. The economic magnitude is large, with a 1-point improvement on the EBRD transition indicator scale (which runs from 1 to 4.3) associated with a reduction in the probability of FX borrowing by 14–33 percentage points (firm-level regressions) and a reduction in the share of FX lending of 12–22 percentage points (country-level regressions). Inflation volatility also matters in two out of the three datasets but its effects are less robust (controlling for the governance indicator). Also, the association between hard pegs and FX borrowing seems to be strong in the macroeconomic data.

Regarding the role of foreign financing and foreign banks, there is some disagreement between the firm-level and the macroeconomic regressions.

— In the firm-level regression, the presence of foreign banks appears to make FX borrowing more likely, and significantly so in two out of the four specifications shown. Additional regressions using a broader set of financial inflow and integration controls (as used in Table 3.2, for example) reveal a statistically significant impact in 10 out of 14 specifications. In contrast, the other FI measures do not seem to have this effect.

— In contrast, in the macroeconomic regressions bank lending inflows, but not foreign banks, appear to be associated with FX borrowing. According to these regressions, what mattered is bank lending to transition countries – regardless of whether this took the form of parent bank lending to a subsidiary, direct cross-border lending or syndicated lending.

— The level of gross financial integration does not seem to be associated with higher liabilities in FX.

In summary, there is some evidence that foreign financing and/or the presence of foreign banks played a role, on top of the usual determinants, in encouraging FX lending in transition economies. However, the results are not conclusive on whether foreign banks contributed to the FX lending bias beyond their role as a conduit for foreign financing. Furthermore, they imply that if there was such an effect, it was economically small, with a 10 per cent increase in the share of foreign bank assets increasing the probability of FX denomination of lending and the share of FX lending by at most 3 percentage points. (See the second column of firm-level regressions in Table 3.6.)

Table 3.6
The effect of financial integration on foreign currency liabilities
(Regression coefficients; p-values in parentheses)[1]

	Firm regression, 2002–05[2]			Quarterly dataset, 2002–05[3]			Annual dataset, 2000–08[4]		
	Financial integration (FI) measure[5]			Financial integration (FI) measure[5]			Financial integration (FI) measure[5]		
	GFI	BIS	L/D	GFI	BIS	L/D	GFI	BIS	L/D
Inflation volatility	0.035 (0.010)	0.026 (0.049)	0.012 (0.418)	5.986 (0.308)	5.499 (0.363)	11.040 (0.009)	-1.823 (0.204)	-4.648 (0.072)	-1.510 (0.270)
Governance[6]	-0.321 (0.000)	-0.228 (0.001)	-0.209 (0.004)	-15.800 (0.010)	-13.780 (0.030)	-17.070 (0.010)	-20.070 (0.006)	-17.070 (0.020)	-22.120 (0.001)
Hard peg[7]	0.013 (0.786)	0.001 (0.972)	0.075 (0.280)	32.220 (0.001)	33.300 (0.002)	23.350 (0.000)	23.020 (0.021)	24.040 (0.018)	19.500 (0.057)
FI measure	0.060 (0.360)	0.000 (0.540)	-0.185 (0.057)	4.625 (0.628)	0.068 (0.047)	12.940 (0.390)	2.564 (0.821)	0.016 (0.088)	3.048 (0.842)
Foreign banks	0.003 (0.000)	0.001 (0.001)	0.001 (0.166)	0.122 (0.243)	0.067 (0.473)	0.131 (0.321)	-0.049 (0.775)	0.024 (0.888)	-0.095 (0.587)
Observations	1,574	1,452	1,541	223	212	196	74	74	59
Number of countries	21	19	19	21	20	20	15	15	15

Sources: Brown et al (2009); Claessens and Van Horen (2007); Lane and Milesi-Ferretti (2006); Abiad et al (2009); EBRD; BIS; IMF IFS; BEEPS III; Basso et al (2007).

Note: [1] The table shows results from three statistical models using three datasets. See notes 2–4 for the dependent variable in each model. For each dataset, the models differ only in terms of the financial integration measure used. The table shows only five variables of interest; additional controls are listed in the following. [2] Firm-level quarterly data, Q1 2002 to Q2 2005, probit estimation, marginal effects reported. The dependent variable is a dummy for whether the last loan of the firm was in a foreign currency. Following Brown et al (2009), additional controls used include inflation, depreciation and depreciation volatility, firm-level controls (exporter dummy, sales to multinationals, international accounting, dummy for firm size, age of firm), loan characteristics (duration, collateral) and banking sector and institutional controls (interest rate differential), foreign exchange deposits, CIS dummy, dummy for forward FX exchange market, capital controls and foreign exchange). [3] Panel estimation, Q1 2002 to Q2 2005. The dependent variable is the share of FX loans to total loans, in per cent. Estimated using Generalised Method of Moments, using past values as instruments. Additional controls include inflation, depreciation, depreciation volatility, interest differential and foreign exchange deposits. [4] Panel estimation, 2000–08. The dependent variable is the share of FX loans to total loans, in per cent. Estimated using Generalised Method of Moments, using past values as instruments. Additional controls include inflation, depreciation, depreciation volatility and interest differential. [5] GFI: level of gross financial integration (external assets+external liabilities in per cent of GDP); BIS: cross-border bank lending, year-on-year change in per cent; L/D: loan-to-deposit ratio. [6] EBRD governance and enterprise restructuring indicator (defined from 1 to 4.3). [7] Dummy variable taking the value 1 for Bosnia and Herzegovina, Bulgaria, Estonia, Latvia and Lithuania, and 0 otherwise.

Policy implications

The analysis of this chapter leads to two main conclusions.

— First, financial integration has significantly benefited the transition region by contributing to high economic growth over at least a decade. This contrasts with the experience of non-transition lower- and middle-income countries. The difference may reflect the fact that the CEB and SEE countries have achieved a much higher degree of financial integration with advanced economies than is typically the case in emerging market countries, and also the role of foreign-owned banks.

— Second, financial integration may also have had significant costs, in terms of encouraging credit booms and over-borrowing, and possibly in biasing the denomination of borrowing towards foreign currency. However, some of these costs seem related to the process of financial integration (particularly cross-border financing of rapid domestic credit expansion) rather than the level of integration – that is, the structure of financial systems and the level of foreign assets and liabilities. Furthermore, foreign bank presence and deeper financial systems (the end result of the expansion of intermediation, driven in part by financial integration) have also played a stabilising role in this crisis, as shown in Chapter 2 (see, in particular, Box 2.4).

Based on these findings, it is clear that attempting to reverse financial integration would be the wrong conclusion to draw from the crisis. The region would deprive itself of a source of growth. Furthermore, some of the costs of financial integration were the by-product of a process of extraordinarily fast-paced private capital inflows which is unlikely to repeat itself for years to come. The region is suffering the consequences in the present crisis. Calling for an end to financial integration at this stage will not reverse these costs. Also, in many, if not most, transition countries, a reversal of financial integration would be exceedingly difficult to achieve, given the already high level of political and trade integration.

This conclusion should not be seen as justifying complacency. There is a critical need for policy action on two main fronts. First, the transition region must deal with the bias toward FX lending, which could continue to pose a threat to stability. Second, it must develop instruments to mitigate and better manage fast credit growth episodes in the future, whether this comes from foreign or domestic sources. The second issue is not unique to the transition region, however, as many advanced countries and other emerging market economies share the same problem.

Reducing currency mismatches

The evidence presented in this chapter and the experience from other emerging market regions – particularly Latin America (which has made significant progress in de-dollarising its financial systems since the late 1990s) – suggest the adoption of a three-pronged strategy to rid the transition region of its addiction to foreign currency debt:[32]

— building credible macroeconomic frameworks and institutions that focus on stable inflation and allow exchange rate flexibility (unless precluded by international commitments – for example, in the context of the adoption of the euro)

— developing local currency money and bond markets in order to extend the sources of domestic funding and make it easier to price domestic currency loans at longer maturities

— imposing regulation that limits foreign currency exposure in the banking, corporate and household sectors.

There are important interdependencies between these three elements. Regulation can be used as an instrument to encourage local currency market development. However, credible macroeconomic frameworks and low inflation volatility (though not necessarily exchange rate flexibility) are preconditions for local currency market development. If they are not present, issuing domestic bonds at longer maturities will be prohibitively expensive. Furthermore, regulation that limits foreign currency exposures does not make economic sense if foreign currency lending is primarily a response to a volatile inflation environment.

As a result, the optimal combination of the three elements varies greatly across countries. Less advanced transition countries in which macroeconomic institutions are relatively weak need to focus above all on strengthening their fiscal frameworks and enhancing the credibility of their monetary policy institutions. The experience of other emerging market countries has shown that the adoption of formal inflation targeting regimes with floating exchange rates can be helpful in this respect.[33] More advanced transition countries outside the European Union should focus on strengthening monetary policy credibility and on developing local currency bond markets. Regulation can also play a role in these countries. In countries within the European Union where local currency markets are either already developed or difficult to develop (in light of their small size or a perception that euro adoption will happen soon), the main strategy is regulation, possibly at the EU level in order to avoid cross-border regulatory competition for bank funding.

Regulation can play a role at several levels. First, it can require banks to disclose the risks of FX borrowing to potential borrowers as clearly as possible.[34] Second, it can correct potential under-pricing of FX loans by imposing higher reserve requirements, higher capital requirements or more demanding provisioning rules. Third, banks could be given incentives to be more careful about FX-related credit risks by requiring automatic restructuring of FX loans beyond a certain threshold of devaluation (for example, an automatic extension of loan maturity that keeps monthly debt service constant for the borrower). Lastly, regulators could place limits on the FX risks taken by borrowers or make some types of borrowers ineligible for FX loans altogether.

Of the above approaches, the last is the least applied and most difficult to implement. From a practical perspective, the main difficulty is that although countries have institutions for monitoring and supervising the balance sheet risks of banks, there are no equivalent institutions for supervising similar risks in the more populous and fragmented corporate and household sectors. One way to address this problem could be to strengthen banks' loan assessments of borrowers. For example, when households ask for a mortgage, they typically need to disclose not only their income but also their assets and liabilities. Banks could be required to take account of currency risks in the balance sheet of a potential borrower in the same way. FX lending would be allowed only if it did not push foreign currency exposure beyond a pre-determined limit. Alternatively (or in addition), lower loan-to-value (LTV) ratios could be applied for FX borrowers that offer domestic collateral (for example, mortgage borrowers).

Mitigating credit booms

Bank lending standards (the requirements imposed on the solvency of potential borrowers and the extent and quality of collateral) tend to erode in boom times.[35] This erosion has been evident in the transition region during the last credit boom, based on collateral ratios reported by banks for new mortgage lending and also on responses by senior lending officers who were surveyed about how their lending practices had changed. In Hungary, for instance, collateralisation of mortgage loans deteriorated up until the third quarter of 2008.

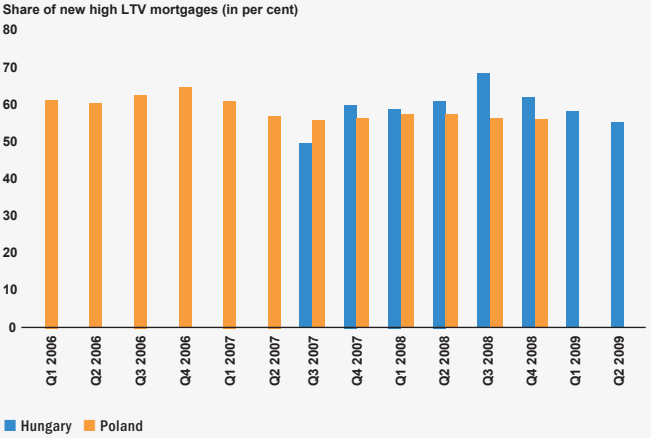
However, the experience in the transition region (and elsewhere) shows that lending standards are amenable to regulation or stricter supervision, and that regulators have it in their power to mitigate credit booms, at least to some extent. For example, mortgage lending policies in Poland were tightened in the first half of 2007, leading to more contained LTV ratios (see Chart 3.5). In Romania average and maximum LTV ratios in mortgage lending both fell from about mid-2008. In Croatia, in 2005, supervisors started imposing stringent reserve requirements and the requirement to hold a significant share of banks' foreign currency liabilities in liquid instruments; both measures were later redesigned to limit the annual credit expansion of individual banks to 12 per cent and, despite some evasion of these restrictions, credit growth slowed markedly from about 2006. In the Baltic states the principal Swedish bank subsidiaries imposed a substantial tightening in lending standards from early 2007, in part at the insistence of the Swedish banking supervisor.

As in the advanced countries, institutional and regulatory frameworks in the transition countries need to be reformed to introduce such "macro-prudential" elements more systematically and effectively. These could include higher capital or provisioning requirements in good times to cushion banks in bad times, and higher levels of capital and/or special resolution regimes for large (or otherwise systemically important) institutions.[36] Explicit liquidity standards will also be needed.

Regardless of whether its objective is to address currency mismatches or strengthen macro-prudential frameworks, new regulation will only be effective in a financially integrated Europe if similar reforms are undertaken across jurisdictions. International solutions, and particularly coordination between home and host countries of international banking groups, are critical to prevent cross-border "regulatory arbitrage"– for example, the circumvention of host country regulation by borrowing directly from the parent bank.

One good thing to emerge from the crisis is that it has effectively established – and tested – this cross-country coordination principle. Parent banks have stood by their subsidiaries and national home country support packages have been allowed to benefit subsidiaries of supported parent banks operating in European transition economies, even outside the European Union. This international dimension will need to be maintained and developed beyond the crisis-management level. As the crisis has tested the strength of European financial integration, it has also generated solutions that, if applied beyond the crisis, can put recovery on a safer and more sustainable footing.

Chart 3.5
Mortgage lending standards in Hungary and Poland, 2006–09



Sources: Central banks for Hungary and Poland.

Note: Chart shows the share of new mortgages approved in each quarter with LTV ratios exceeding 70 per cent.

Endnotes

1 The term "European transition countries" is used in this chapter to denote all transition countries whose territory is in Europe in whole or in part, as well as Turkey. The analysis concentrates on non-resource-rich European transition countries with tighter economic and financial links to the European Union. Resource-rich Azerbaijan, Kazakhstan, Russia and Turkmenistan are the focus of Chapter 4.

2 This is particularly true for the SEE countries, and for Lithuania and Poland but less so for other CEB countries such as Hungary or Latvia (according to *Eurobarometer* surveys).

3 See Alesina, Spolaore and Wacziarg (2005).

4 See Fabrizio, Igan and Mody (2007).

5 See Kose, Prasad and Terrones (2006).

6 See Kose et al (2009a).

7 See Aizenman, Pinto and Radziwill (2004) and Prasad, Rajan and Subramanian (2007).

8 This section draws on Abiad, Leigh and Mody (2009), Prasad, Rajan and Subramanian (2007) and Friedrich, Schnabel and Zettelmeyer (2009). See also Lane and Milesi-Ferretti (2007) and Lane (2008).

9 Average is computed for 1999-2007 for emerging Asia (excluding Pacific islands) and European transition countries, and for 2002-07 for Latin America where the recovery from the 1998-99 crisis was delayed as a result of the crisis in Argentina.

10 Sources included – for GDP data: *Historical Statistics of the World Economy: 1-2006 AD* by Angus Maddison, updated to 2008 using real GDP growth rates from the IMF's World Economic Outlook (WEO) database; for current accounts and trade balances, 1950-2008: WEO database; for pre-1945: Jones and Obstfeld (2001). For seven countries not covered by Jones and Obstfeld, Michael Bordo and Christopher Meissner's Financial Crisis Database was used, available at http://michael.bordo.googlepages.com/home3.

11 In case growth episodes fulfilling the above depicted criteria overlap, the one with the highest average growth rate was chosen.

12 The two puzzles were pointed out by Lucas (1990) and Gourinchas and Jeanne (2007), respectively.

13 For the 1994-2008 period, the Lucas puzzle is mainly attributable to the United States and China, which were large capital importers and exporters, respectively, during that time. It does not generally hold for samples that exclude these two countries, particularly a Europe-only sample (see Abiad, Leigh and Mody, 2009). The allocation puzzle is more robust and tends to hold for most developing country samples that exclude oil-exporting countries, but not for the transition region, as shown in Chart 3.2.

14 Large oil exporters and small island countries are also excluded.

15 The variable measuring changes in net foreign assets is conceptually similar to the current account variable, except that it ignores the portion of the current account that is financed by transfers and that it controls for valuation effects driven by exchange rates and prices. See Lane and Milesi-Ferretti (2006).

16 Growth is measured in per cent while the financial integration measures are measured in per cent or percentage points of GDP. Hence, a coefficient of -0.15 means that a one percentage point reduction in the current account balance (that is, increase in net capital inflows) was associated with higher average growth of 0.15 percentage points.

17 For the first of these explanations see Prasad, Rajan and Subramanian (2007). For the second and the third see Abiad, Leigh and Mody (2009).

18 The additional interaction term is defined as "external dependence x financial integration x threshold dummy", where the threshold dummy is equal to 1 if the threshold variable is above the sample median. Three threshold variables are used: the ratio of private credit to GDP as a measure of financial development; the World Bank variable "regulatory quality" as a measure of institutional quality; and the proportion of foreign banks as a measure of financial integration. These variables can be also be used directly in the interaction term rather than through a threshold dummy. The qualitative results are unchanged in this case.

19 This is in line with Abiad, Leigh and Mody (2009), who found threshold effects with respect to financial integration in cross-country regressions explaining international capital flows. However, note that the threshold interaction is insignificant in most regressions. Institutional thresholds are sometimes significant when the thresholds are defined at higher levels, such as the 75th percentile.

20 See Laeven and Valencia (2008).

21 See Mendoza and Terrones (2008).

22 See, for example, Cottarelli et al (2003).

23 This subsection is based entirely on work in progress by Coricelli et al (2009).

24 See Cottarelli et al (2003).

25 The 12 countries are Bulgaria, Croatia, Czech Republic, Hungary, Latvia, Poland, Romania, Russia, Serbia, the Slovak Republic, Slovenia and Ukraine. Firm-level data are from the Orbis database. The sample period is 2001-05. The 40 per cent level is determined by running a threshold regression of growth in total factor productivity on firm leverage, threshold indicator variables and a number of controls. See Coricelli et al (2009) and Hansen (2000).

26 That foreign bank presence may have facilitated excess leverage (whether directly or through its effect on financial development) is not necessarily inconsistent with the finding in the first section of this chapter, as giving access to credit to firms that were not excessively leveraged should have had a positive impact on growth.

27 See Jeffrey and Zettelmeyer (2009) for a survey.

28 See Jeanne (2003) and Rajan and Tokatlidis (2005).

29 See Burnside, Eichenbaum and Rebelo (2001), Schneider and Tornell (2004) and Korinek (2009), among others.

30 See Basso, Calvo-Gonzalez and Jurgilas (2007), Luca and Petrova (2008), Rosenberg and Tirpák (2008), Brown, Ongena and Yeşin (2009) and Haiss et al (2009).

31 The empirical results that follow extend analysis undertaken in Brown, Ongena and Yeşin (2009) and Rosenberg and Tirpák (2009).

32 For a more detailed discussion, see Jeffrey and Zettelmeyer (2009).

33 See Kamil (2008).

34 Regulations of this type were introduced by several transition countries, including Hungary and Poland, in recent years. For example, Poland's "Recommendation S" requires banks to show a customer wishing to borrow in FX a simulation of loan instalments assuming a depreciation of the zloty.

35 See Igan and Tamirisa (2008). Similarly, in the field of syndicated lending – a key component of bank credit flows to the transition region – De Haas and Van Horen (2009) find that banks stepped up screening and monitoring efforts considerably only after the onset of the current financial crisis.

36 See Brunnermeier et al (2009) and Čihák and Nier (2009).

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Commodity resources offer significant opportunities for development. In the long run, however, the performance of commodity-rich countries tends to fall short of expectations, as commodity rents induce macroeconomic volatility and undermine incentives to improve institutions. The resource-rich countries have embraced a range of diversification strategies to avoid the "resource trap", to varying degrees and with varying success. Improving institutions remains the key challenge.

Chapter 4
Development based on commodity revenues?

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91 Box 4.4 How Mongolia is fighting the resource curse

Modern oil drilling started in Bibi-Aybat outside Baku, then part of the Russian Empire, in 1846, a decade before extraction began in Pennsylvania in the United States. More than a century and a half later, Baku has once again been at the centre of an oil boom underpinning Azerbaijan's astonishing average economic growth rate of over 20 per cent annually in real terms in 2005-08. While most countries in the transition region experienced strong growth until 2008 (see Chapter 2), the performance of major oil and gas producers – Azerbaijan, Kazakhstan, Russia and Turkmenistan – stands out (see Chart 4.1). The performance differential is even more striking if growth is measured in US dollars rather than real terms (see Chart 4.2). By this measure Russian GDP grew almost six-fold over the period 1999-2008, compared with the real GDP growth of 93 per cent, and Azerbaijan's growth was faster still.

Reaping the rewards and managing the problems of natural resource wealth have been the defining characteristics of the development experience of commodity-rich countries, particularly in the last decade. On the upside, commodity revenues have put enormous fiscal resources at the disposal of governments and fuelled an unparalleled economic boom. On the downside, commodity exports and commodity-related foreign direct investment (FDI) have led to large foreign exchange inflows that have complicated macroeconomic management and made countries vulnerable to sudden swings in commodity prices. Partly as a consequence of the collapse of oil prices in the summer of 2008, growth in Azerbaijan declined dramatically from 16.5 per cent in the first half of 2008 to 3.6 per cent in the first half of 2009. In Russia the decline was even greater, from 8 per cent growth in the first half of 2008 to -10.4 per cent in the first half of 2009.

Even more challenging than managing short-run volatility is the problem of maintaining high growth rates in the long term. Past experiences of resource-rich economies worldwide tell a cautionary tale in this respect. Over the long term, resource-rich countries tend to underperform compared to their resource-poor peers with the same initial level of per capita income (see Chart 4.3). This observation gave rise to the concept of a "resource curse", meaning that resource abundance may undermine rather than foster economic development over a longer period of time.[1]

This chapter looks at the policy problems faced by major commodity exporters in the EBRD region, focusing on Azerbaijan, Kazakhstan and Russia, which enjoy relatively high oil revenues (see Chart 4.4), and also Turkmenistan, the world's sixth largest natural gas exporter. The analysis is also applicable to some degree to two other transition countries which exhibit a high share of non-fuel commodity exports – in Mongolia copper receipts accounted for over 50 per cent of merchandise exports in 2007, while in the Kyrgyz Republic gold, mercury and other metals accounted for approximately half of exports.

This chapter interprets some of the key policies and reforms undertaken in commodity-exporting countries over the last decade – particularly Azerbaijan, Kazakhstan and Russia – in terms of a development strategy based on:

— commodity exports and investment in further natural resource production

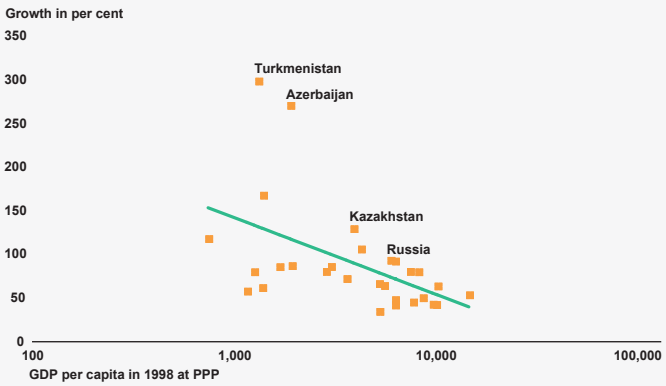
— the creation of macroeconomic buffers in the form of sovereign wealth funds, to allow countercyclical fiscal policy and mitigate upward pressures on the real exchange rate

— diversification based in part on public investment and state-led industrial policy, and also on financial development to direct natural resource income to productive uses outside the natural resource sector.

The question is to what extent this "model" has been successful in laying the basis for sustainable long-term growth and avoiding the short and long-term problems associated with commodity exports.

In the light of the previous chapter's emphasis on policies to manage foreign exchange inflows – a problem that carries over to the resource-rich economies, as do some of the solutions – most of the following analysis will focus on issues unique to the commodity-led development model, particularly the channels through which natural resource wealth can undermine long-term growth and the policies that can help avoid this outcome. The chapter then provides evidence on the actual policies of the resource-rich transition countries in recent years and assesses the success of such policies, particularly with regard to diversification.

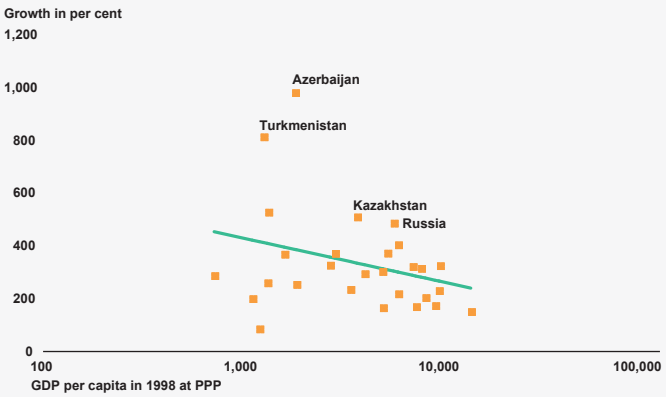
Chart 4.1
Cumulative real GDP growth, 1999-2008



Sources: International Monetary Fund (IMF), EBRD and authors' calculations.

Note: Fitted line is based on the OLS regression of growth on logarithm of GDP per capita at purchasing power parity (PPP).

Chart 4.2
Cumulative nominal US$ GDP growth, 1999-2008



Sources: IMF, EBRD and authors' calculations.

Note: Fitted line is based on the OLS regression of growth on logarithm of GDP per capita. Data for Turkmenistan are from 2007. Data for Montenegro were not available.

Economic growth in resource-rich countries

How does natural resource abundance affect long-term economic growth and development? Economics has traditionally viewed growth as determined by the rate of capital accumulation, labour force growth and technological progress. Natural resource wealth can spur growth by financing capital accumulation and creating incentives for private investment, particularly in the natural resources sector. In addition, commodity resources can help developing countries escape from an "underdevelopment trap". If there are fixed costs of investing in a new technology, and investment in one sector influences demand for another sector's products, an economy may be stuck in a state of chronic low investment and low growth.[2] Commodity resources could give the economy the impetus that it needs to finance a coordinated investment effort and break out of the trap.

However, the presence of commodity resources may also create disincentives to investment in ways that could offset the beneficial effects on long-term growth. These disincentives create the potential resource curse. They fall into two categories: disincentives for physical and human capital accumulation (particularly in the non-resource sectors) and disincentives for improving political and economic institutions.

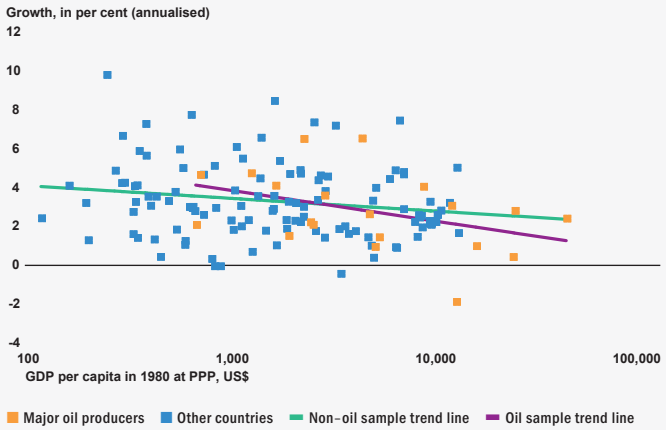
Macroeconomic volatility and the "Dutch Disease"

Commodity dependence is an obvious source of macroeconomic volatility, with explosive booms when commodity prices are high and excruciating busts when they collapse (see Chart 4.5 setting the volatile oil price against the very low terms of trade volatility of a large diversified country – the United States). This need not be a big problem if these risks can be insured via the financial system (for example, by making debt payments contingent on oil prices). When financial markets are not developed, however, investors may find it hard to fully hedge. As a result, terms of trade volatility could have a negative effect on growth, as economic agents may find it too risky to undertake irreversible investments in projects that may turn out unprofitable in an economic downturn.[3]

Human capital accumulation particularly can suffer as a result of this problem. Investments in education are long-term and irreversible, and will therefore be rationally scaled down in a volatile environment in which demand for qualified labour is more uncertain. There is evidence that this mechanism is indeed at work in resource-rich countries.[4] As education cycles stretch over years and sometimes decades, underinvestment in this area may be even more difficult to reverse than underinvestment in physical capital.

A related problem is the "Dutch Disease", which refers to the idea that natural resource exports may come at the expense of the manufacturing sector.[5] Investment and consumption related to commodity revenues raise the cost of labour and the relative prices of non-tradeable goods (services). Labour and capital inputs shift towards the booming resource sector, services and residential construction, while inhibiting the development of manufacturing.[6] If manufacturing production is more responsive to "learning by doing", product quality improvements and the discovery of new products, this could depress long-term growth.[7] Growth could also suffer because commodity rents are distributed less equally than manufacturing revenues, which may weaken constituencies for institutional reform (see next section).

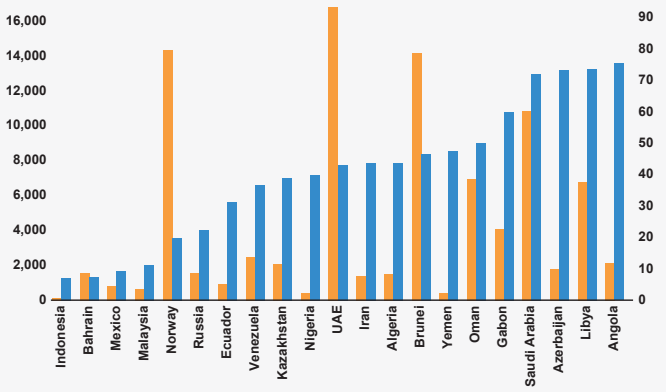
Chart 4.3
Average real GDP growth in selected oil-rich countries, 1981-2000



Sources: IMF, Energy Information Administration (EIA) and EBRD calculations.

Note: Trend lines are fitted based on regressions for a broad sample of 138 countries. Major oil producers are defined as countries where oil production valued at international prices exceeded 10 per cent of GDP in 1980.

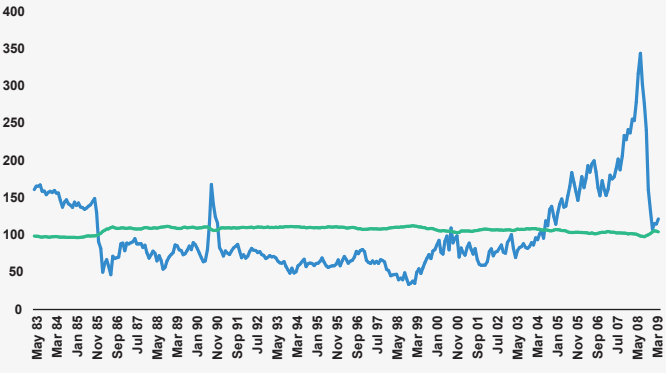
Chart 4.4
Value of produced oil, 2006



Sources: EIA, IMF and authors' calculations.

Note: Oil is valued at international prices.

Chart 4.5
Oil price in real terms



Sources: Bloomberg, IMF and EBRD calculations.

Note: Based on oil price in US$ per barrel of Brent Crude, in 2008 prices, adjusted using US consumer price index.

In addition, the Dutch Disease may exacerbate the problem of macroeconomic volatility. If there are dynamic economies of scale in the manufacturing sector (from learning by doing), manufacturing will suffer when resource prices increase. However, when resource prices fall, there is no symmetric boost; there has been a period of low manufacturing output, and productivity in this sector has fallen behind its foreign peers, so manufacturing has become non-competitive. As a result, nominal exchange depreciation may depress the domestic economy to a much greater extent than would otherwise have happened (a prospect that will discourage investment). Countries that switch from manufacturing to oil exports during a resource boom may lose their technological edge and then struggle to recover after the boom ends.[8]

Institutions and inequality

Political and economic institutions are vital to economic development. In a weak institutional environment, with a lack of protection for property rights, investors fear expropriation by the state and will underinvest. In an environment with strong institutions, where laws governing financial markets reflect best practice, courts are independent and the police enforce the law equitably, private returns to investment are higher. Institutions therefore provide incentives for investment and innovation which are critical to long-term growth.

To understand the effect of resource rents (revenues net of extraction costs) on institutions, one needs to analyse the incentives of those individuals who may be in a position to shape institutional development. Politicians or other policy-makers who are able to influence institutions may genuinely care about economic growth and development, but at the same time may also be concerned about their own rents. While strong institutions promote growth, they do so by constraining politicians' ability to extract those rents. For example, if courts and regulatory bodies are independent from political authorities, this limits the ability of those authorities to use these institutions to further their private interests. Natural resources provide revenues that politicians can potentially extract – but only if institutions allow them to do so. Higher resource revenues will therefore increase the preference of politicians for weak institutions.[9]

Whether this preference can be realised may depend critically on the initial quality of political and economic institutions. In countries with strong institutions, politicians' ability to extract rents will be low to begin with – hence they will prefer to promote economic growth, including through sustaining those institutions. In countries with weak initial institutions, attempts to extract rents are likely to be more successful. In such countries, resource abundance slows down or even reverses the development of institutions, which in turn slows economic growth. This results in an "institutional trap" in resource-rich countries, meaning a vicious circle of underdeveloped institutions and a lack of incentive to improve them.

This vicious circle may be exacerbated by high income inequality, which typically accompanies natural resource wealth (see Chart 4.6 for the Gini coefficients – a statistical measure of inequality – of selected commodity exporters).[10] High inequality can be harmful for growth for several reasons. In an unequal society with imperfect capital markets, many talented people will have no access to capital or education, resulting in individual poverty traps. High inequality may also bias government policies towards redistribution policies that hurt growth, as the relatively poor median voter would prefer to have more redistribution.[11]

Inequality and resource wealth may interact in nefarious ways. When resource rents are large, it is easier to buy off the median voter without achieving real redistribution or implementing development-friendly policies. (This logic applies regardless of the presence of elections, as most modern dictators are arguably in even greater need of popular consent.) Conversely, when total rents are appropriated by fewer individuals, rent-seeking (and weak institutions that make rent-seeking possible) become even more attractive to the members of the elite. In this way, weak institutions and high inequality can feed off each other in an economy with large natural resources.

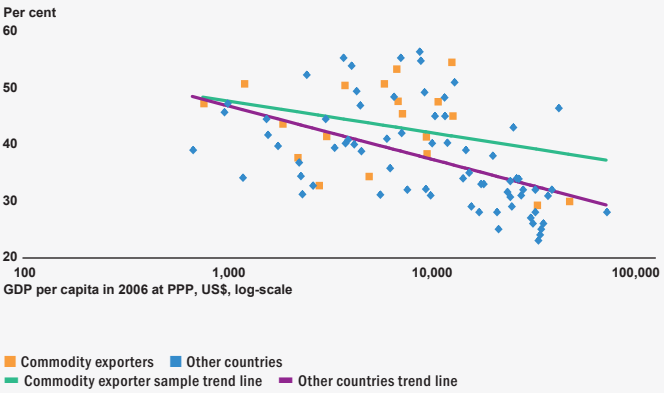
Empirical evidence on resource curse or resource blessing

Is there a resource curse or a resource blessing? While the empirical debate is far from settled, there is an emerging consensus based on a number of cross-country growth studies[12] that resource-rich countries perform less successfully than resource-poor ones. Furthermore, the literature has found that the effect of resource abundance does indeed depend (as discussed above) on the initial quality of political and economic institutions.[13] If this is low, resource abundance slows down or even reverses the development of institutions, which in turn slows down economic growth. In contrast, in countries with developed institutions, resource abundance does not seem to have a consequent negative effect on growth. In particular, a number of studies found no evidence of Dutch Disease in Norway, the Netherlands, the United Kingdom, or in Russia until 2006.[14]

There is extensive literature on the interaction between resource rents and institutions. Oil revenues have been shown to have adverse effects on property rights, corporate governance, media freedom, institutions of democracy, and reforms that improve the operating environment for medium-sized businesses in non-resource sectors.[15] In unstable societies resource revenues may substantially undermine social cohesion, increasing the likelihood of civil unrest and armed conflict.[16] As those institutions listed above have a positive effect on long-term growth, the negative impact of resource wealth suggests an explanation of the resource curse phenomenon.

The empirical debate is far from complete. Many of the cross-country results are not robust in respect of the sample countries and time period. Moreover, cross-country growth regressions suffer from well-known methodological problems.[17] Recent studies on the effect of resource abundance on institutions use techniques that avoid these problems, but do not focus on the causal effect of resource abundance on growth and development.

Chart 4.6
Gini coefficients of selected commodity exporters



Sources: World Institute for Development Economics Research of the United Nations University, IMF, World Trade Organization (WTO) and EBRD calculations.

Note: Higher values of Gini coefficients correspond to higher income inequality. Trend lines are fitted based on regressions for a broad sample of countries, where Gini coefficients are available for 2002–06, taking the latest observation available. Commodity exporters are defined as countries where mining and fuel exports accounted for more than half of total merchandise exports.

Policy goals and tools

Resource-rich economies face a number of difficult policy problems. These include problems with respect to the natural resource sector itself – in particular, how fast to develop the sector and whether to front-load extraction as much as possible or delay it over time (see Box 4.1). Beyond this question, the main challenge is to develop policies that will allow the economy to benefit from resource revenues while mitigating the associated resource curse. The arguments made in the previous section suggest that such policies should include: economic diversification; reducing macroeconomic volatility; financial development; and reducing inequality.

— Diversification addresses the root cause of the resource curse – the bias generated by resource rents. By doing so, it creates an environment that is more conducive to productive investment and to better institutions. In a sense, diversification acts like a commitment device; even if it is costly in the short term (by channelling public investment away from the resource sector, for example), it increases investment and growth in the long term. At the same time, it makes a resource-rich economy less vulnerable to external shocks and therefore less volatile.

— Policies that reduce volatility lower risk in the economy and so weaken one of the links through which commodity dependence can depress investment and long-term growth. The reduction of risk is also desirable in itself.

— Promoting financial development acts as a horizontal diversification policy, as it provides disproportionate support to financially dependent industries in non-resource sectors.

— In addition to its direct benefits for growth (particularly by allowing a wider group to access investment and education opportunities), reducing inequality can weaken an important incentive that stands in the way of institutional development in resource-rich countries – namely rent-seeking that is relatively more attractive if its fruits do not have to be shared widely.

The remainder of this section briefly discusses the policy tools that can be employed to advance these objectives.

Vertical versus horizontal diversification policies

Diversification is often pursued through vertical industrial policies. These involve "picking winners", through preferential treatment of specific non-resource industries (for example, particular manufacturing activities). This may take the form of lower taxes, subsidies, protection from foreign competitors, or direct government investment.

The alternative horizontal approach provides incentives for diversification without targeting specific sectors, by raising private returns to investment in physical and human capital across the board. Policies include improvements in property rights protection, contract enforcement and financial regulation, as well as investment in education and infrastructure and broad support for financial development.

Chapter 5 of the 2008 *Transition Report* surveys the experience with vertical and horizontal industrial policies and argues that the former have rarely been successful, particularly in weak institutional environments. This is because they give discretion to government officials who may not have the technical capacity or the incentives to use it well and also provide additional opportunities for rent-seeking. For this reason, vertical diversification policies are not advisable for most resource-rich emerging market countries.

Box 4.1
The optimal rate of resource extraction

Should countries front-load resource extraction as much as technically feasible or should they try to spread extraction over a long period? On the one hand, immediately extracting as much resource as possible could help avoid an under-development trap by financing a "big push". On the other hand, it might be rational to save non-renewable resources for future generations when they could be extracted using more efficient technologies. In addition, the rate of resource extraction could affect international commodity prices. Governments of oil-rich countries could seek to slow down oil extraction to raise the world oil price and maximise revenue. However, this may be risky if high oil prices encourage investment in alternative technologies that over time challenge the dominance of oil.

Assuming that no single producer enjoys enough market power to "play" the market and that resource demand is constant over time, the present value-maximising extraction path is one that keeps the resource price (net of unit extraction costs) increasing at the rate of interest (and thus the present value of a unit extracted remains unchanged over time).[18] This implies that output will decline monotonically. A critical assumption is obviously the profile of demand. If demand is assumed to rise – for example, because of world economic growth – it may well be optimal to have a rising extraction path. If demand is expected to fall – say, because of alternative technologies – more front-loading extraction could be the best option.

Models based on the level of proven reserves in the oil-rich countries and assumptions about future demand, future technologies and extraction costs suggest that, on balance, hydrocarbon-rich transition countries undertake too little – rather than too much – extraction at present, and should invest more in future extraction capacity.[19] These countries possess substantial oil and gas reserves (equivalent to more than 50 years of production) implying that the risk of unjustly expropriating the wealth of future generations is low. That said, the models typically do not take into account institutional development. If institutions are expected to improve over time, there could be a case for back-loading extraction, as future revenues would then be used with higher social returns and the negative effects of resource rents on institutions would be reduced.

In practice, increasing investment in long-term extraction capacity is difficult, even during times of high oil prices, due to high investor uncertainty. In addition, a project that is too risky for private investors should arguably also be considered too risky for the state, although in some cases governments may use additional tax incentives to attract private investors to long-term projects.

At the same time, many aspects of horizontal policies will also be hard to implement for a government operating in a resource-rich environment with weak institutions. Indeed, better contract enforcement or better regulatory institutions, for example, constitute the ultimate aim of diversification (as this is supposed to lead to better incentives for institutional reform). For many resource-rich emerging market governments, diversification policies will therefore need to concentrate on public investment, and particularly investments in infrastructure and education, which may be feasible even with weaker institutions.

Macroeconomic policies and sovereign wealth funds

In the late 1970s many major oil exporters ran budget deficits, borrowing against future revenues and paving the way to a disaster when oil prices eventually dropped. In the early 21st century most governments have pursued macroeconomic policies that took these lessons into account. Most governments extensively taxed resource revenues, paid off sovereign debt (ahead of schedule in many cases) and accumulated international reserves or other foreign assets.

Building up reserves and externally held sovereign wealth serves multiple purposes (see also sovereign wealth fund section on page 84). In the short term it reduces pressures for real appreciation and preserves competitiveness of the domestic sector. In addition, state wealth funds enable governments to diversify risk away from commodity risk or domestic shocks, to smooth budget expenditures over time and to build a reserve that can support a fiscal stimulus in a downturn. As a result, they help reduce macroeconomic volatility and improve the investment climate.[20]

Aside from stabilising the economy, state wealth funds can also support diversification by limiting rent-seeking. By channelling resources to pre-defined and transparent uses – for example, spending in a downturn, specific forms of public investment or saving funds for future generations – sovereign wealth funds make it more difficult to divert resource rents for private gain. This, in turn, can begin to change the incentives of economic and political elites in the direction of policies and institutions that support growth. Whether wealth funds are successful in this respect will depend on whether they are strong enough to resist "raiding" for extraneous purposes, and also on the transparency of the spending that they are meant to finance.

Financial development

Financial development can support diversification in resource-rich economies through several channels. First, as already discussed, it mitigates the effect of resource price volatility and so increases incentives to invest. Second, functioning financial markets should, in principle, disproportionately benefit investors in non-resource industries as those industries are more dependent on external finance than the resource sector.[21] Lastly, a developed financial system reduces inequality by giving more people access to credit and so to opportunities to invest, including in their own education.

Financial development policies are well-known and include improved regulation of banks and security markets, the introduction of deposit insurance and credit history bureaux and the establishment of effective court systems. However, the fundamental problem is that it may be particularly difficult to undertake such reforms in weak institutional environments that need them the most. Nonetheless, most emerging market countries have taken initial steps in this regard.

Reducing inequality

Redistributing resource rents to the broader public reduces the ruling elite's interest in rent-seeking and therefore promotes development of institutions. In developed countries, such redistribution can be carried out directly through progressive taxation. In developing countries with weak government, progressive taxation does not work as the rich can avoid paying taxes. Most redistribution policies in these circumstances take the form of public projects financed by the resource rents accumulated by governments or free provision of public goods, such as education and health care, which disproportionately benefit the poor.

Ideally, policies aimed at combating inequality should include improving financial institutions, reforming education systems and facilitating labour mobility. In practice, resources are often channelled to existing inefficient structures rather than to emerging or reforming ones.

Diversification policies in resource-rich countries

International experience suggests that economic diversification away from oil and gas is a very challenging task. As discussed in Chapter 4 of the 2008 *Transition Report*, the oil sector is poorly "connected" to other exports in terms of the required production capabilities and inputs.[22] This implies that launching the production and exports of new goods may require substantial investment in capacity building and technological transfer. In contrast, products in higher-value-added manufacturing (for instance, in the automotive or electronics sectors) tend to be relatively well connected to other potential exports, making it easier to diversify further.

Nonetheless, a number of oil-rich countries have managed to achieve a substantial degree of diversification: copper-rich Chile developed competitive agriculture and fishing industries, including salmon farming and wine production; Malaysia built up technologically advanced manufacturing industries integrated into the Asian and global production chains; Indonesia developed a medium-to-high technology manufacturing base while significantly improving the international competitiveness of its agricultural sector; and Mexico established a high-tech manufacturing sector based primarily on FDI from US firms.

Overall, the international experience backs the view that resource-rich countries can promote economic diversification by: investing in human capital and infrastructure; developing financial institutions with a view to effectively intermediating commodity-related and other financial inflows throughout the economy; and building stabilisation or sovereign wealth funds. Hydrocarbon-rich transition countries have embraced all these policies to varying degrees.

Public investment

Diversification away from excessive dependence on oil and gas is a cornerstone of Russia's long-term development concept and underpins the establishment of the Russian Venture Corporation, the Russian Nanotechnology Corporation and the Russian Technologies Corporation. These public vehicles were created in recent years to promote innovation and diversification. Similarly, Kazakhstan embraced economic diversification as a "national idea" and created two development funds in 2002-03, followed by a larger one – Kazyna – in 2006. These aim to co-finance a wide range of development projects from small businesses support to infrastructure, with a particular focus on local content in the oil and gas sector, high-tech industries and agriculture.

According to International Monetary Fund (IMF) estimates, public investment as a proportion of GDP increased over the commodity-boom period from around 3 per cent to 4.5 per cent in Russia, from 3 per cent to 6 per cent in Kazakhstan, and from around 2 per cent to 10 per cent in Azerbaijan. Public spending on education increased from 2.9 per cent to 4 per cent of GDP in Russia and from 3.3 per cent to 4.2 per cent in Kazakhstan, but declined in Azerbaijan from around 3.9 per cent in 2000 to 2.6 per cent in 2008.

Financial development

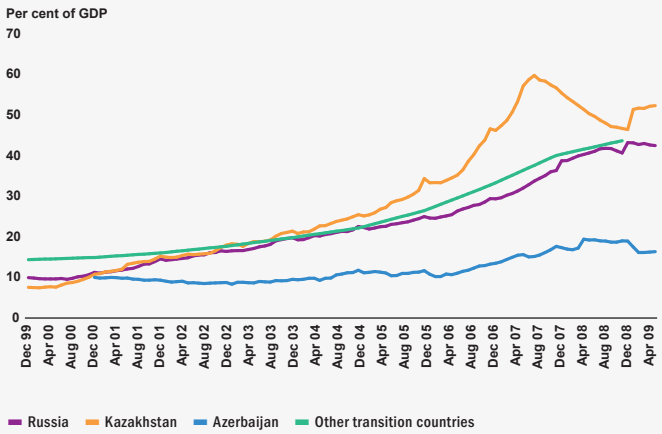
An important development of the 2000s in hydrocarbon-rich transition economies (with the probable exception of Turkmenistan) has been very rapid financial development. Even though nominal GDP in Russia grew eight-fold between 1999 and 2008, bank credit to the private sector not only kept pace but increased from under 10 per cent of GDP in 1999 to over 40 per cent by the end of 2008 (see Chart 4.7). Kazakhstan saw an even faster growth of its banking system, with the credit-to-GDP ratio peaking at 60 per cent in mid-2007 compared to 7 per cent at the end of 1999. In Azerbaijan the stock of bank sector credit increased from 10 per cent of GDP in mid-2005 to 19 per cent in mid-2009, with year-on-year growth of aggregate loan portfolio exceeding 100 per cent.

The rapid growth of bank loans was made possible through the abolition of capital controls, the active use of wholesale funding markets (particularly in the form of international syndicated loans) and the entry of foreign banks (except in Azerbaijan). As a result, the loan-to-deposit ratio in Kazakhstan peaked at almost 200 per cent and approached 160 per cent in Russia (see Chart 4.8). In Azerbaijan the ratio exceeded 150 per cent by mid-2008, and increased to 200 per cent in 2009 as a result of a net deposit outflow coupled with liquidity support to the banking system. Although the speed of financial deepening (relative to GDP) was generally in line with recent experiences of other transition countries, the loan-to-deposit ratios in these three resource-rich countries stayed well above the regional average.

Financial sector growth was assisted by a number of structural reforms, including the introduction and expansion of deposit insurance (from November 1999 in Kazakhstan, 2004 in Russia and 2005 in Azerbaijan), improved disclosure of effective interest rates to customers, and revisions to collateral and bankruptcy legislation. All three countries upgraded their frameworks for credit history bureaux and score highly on the World Bank's Doing Business Credit Information Index. However, credit bureau coverage remains limited (estimated at 25 per cent of the adult population in Kazakhstan, 10 per cent in Russia and nil in Azerbaijan). Furthermore, only in Russia did structural reforms in the financial sector outpace the average of non-oil-rich transition countries, as reflected in the EBRD's financial sector transition indicators (see Chart 4.9). The lower score in Azerbaijan in part reflects stringent restrictions on the entry of foreign banks.

Non-bank finance has also been growing, although at a slower pace. While stock markets in Russia experienced rapid growth before mid-2008, listings remained confined to a relatively small number of very large companies. (The Russian stock market had the largest average company capitalisation of all markets surveyed by Standard and Poor's in 2008.) As part of a diversification agenda (and encouraged by the earlier successes of oil-rich Bahrain and Dubai), the Russian authorities launched an initiative in 2007-08 to develop Moscow into an international financial centre. Some important steps undertaken to date include changes in legislation that exempt derivatives and term contracts from restrictions on gambling. However, the implementation of the reform agenda remains in its early stages – for example, Russia has yet to

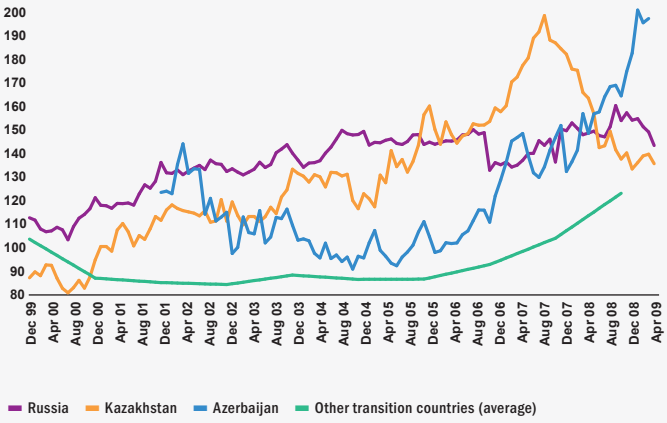
Chart 4.7
Credit to the private sector



Sources: Central banks of Azerbaijan, Kazakhstan and Russia, EBRD Banking Survey and EBRD calculations.

Note: Monthly data for Azerbaijan not available before December 2000.

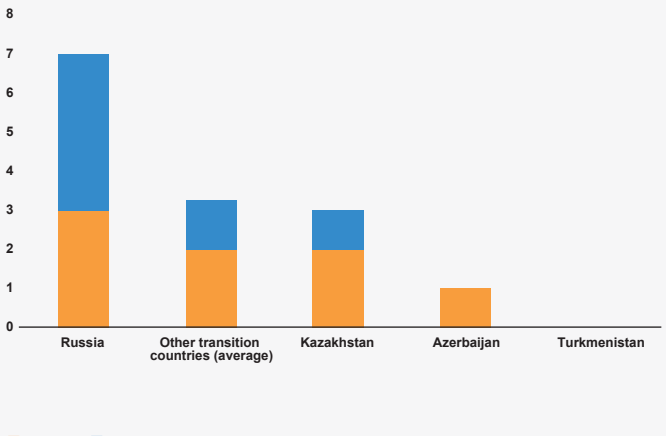
Chart 4.8
Loans-to-deposits ratio (in per cent)



Sources: Central banks of Azerbaijan, Kazakhstan and Russia, EBRD Banking Survey and EBRD calculations.

Note: Simple average for other transition countries. Monthly data for Azerbaijan not available before December 2001.

Chart 4.9
Number of financial sector transition indicator upgrades, 2000-08



Source: EBRD.

Note: Based on transition indicators for banking sector and non-bank financial institutions (NBFIs).

pass a law on insider trading – and the ultimate success of the initiative will depend on the establishment of an effective and independent judiciary and on less corrupt law enforcement.

Sovereign wealth funds

To accumulate "excess" government revenues stemming from oil and gas during the years of high oil prices, hydrocarbon-rich transition countries have established sovereign wealth funds. Azerbaijan set up the State Oil Fund in 1999, Kazakhstan followed suit with its National Fund in 2000 and Russia created the Stabilisation Fund in 2004 (later subdivided into the Reserve Fund and the National Welfare Fund in 2006 – see Box 4.2). Turkmenistan is in the process of setting up a similar fund. By the second half of 2008 these funds had accumulated substantial reserves. The largest of them in absolute terms (Russia's) peaked at US$ 225 billion and the largest in relative terms (Kazakhstan's) reached almost 30 per cent of GDP. Despite their rapid growth, transition countries' sovereign wealth funds remain much smaller as a percentage of GDP than those of some other major oil exporters, such as Kuwait, the United Arab Emirates (Abu Dhabi) and Norway, which established funds years earlier (see Chart 4.10).

Assessment

While it may be too early to assess the success of development policies in hydrocarbon-rich countries in the region, the course of the commodity price cycle can nonetheless provide a few early insights.

Diversification

Measuring diversification away from oil and gas accurately is a challenging task, because empirical measures of production or export shares tend to be affected by commodity prices. Higher commodity prices increase the nominal value of production and exports of primary natural resources. They may also induce temporary relocation of resources towards extraction and related sectors. Therefore, measures of economic diversification in oil-rich countries tend to decrease naturally with increases in the oil price, even in countries perceived to have relatively well-diversified economies such as Malaysia and Mexico. For instance, as commodity prices increased between 2000 and 2005, the share of medium- and high-value-added manufacturing in total exports declined in commodity exporting countries such as Australia, Chile and Norway (see Chart 4.11).

To isolate commodity cycle effects as far as possible, one should analyse the export structures at similar points in the oil price cycle – that is, during periods when oil prices were almost identical in real terms (using the US consumer price index as a deflator). Such an approach is particularly useful for detecting signs of persistent structural changes once oil price increases have been reversed – since most of the resource curse channels involve such changes.

By looking at production as well as merchandise exports, it is possible to track the degree of economic diversification. Exports provide more consistent data coverage and may be a better measure of competitiveness. This is because countries tend to export goods where they have comparative advantage, prices of exports are set in international markets and are less subject to distortions, and exports cannot be easily influenced by domestic protectionist policies. The downside of this approach is the potential exclusion of internationally competitive non-exporting industries (particularly in large economies such as Russia's), as well as tradeable services such as finance and tourism. As a result, it is important to consider both export and production structures.

Box 4.2

Russia's reserves and national wealth funds

The Russian Stabilisation Fund was established on 1 January 2004 and took its revenue from oil export duties and extraction taxes when the Urals brand oil price exceeded a certain threshold (initially set at US$ 27 per barrel). Export duties are, in turn, set by the government and reviewed regularly, depending on oil price movements. The Fund was set up to finance budget deficits when the oil price fell below that same threshold. The Fund could also be used for other purposes, provided that its total assets exceeded 500 billion roubles (US$ 17 billion at the time). When this target was first surpassed in 2005, some of the savings were used to prepay federal external debt and finance the deficit of the State Pension Fund. The Stabilisation Fund is managed by the Ministry of Finance and is invested in highly rated securities issued by foreign governments. Fund accounts are published monthly.

Then in 2006 the Fund's framework underwent reform. Sources of revenue were augmented to include gas export duties (in addition to oil export duties) and the Fund was subdivided into the Reserve Fund and the National Welfare Fund. The former is capped at 10 per cent of forecast GDP, to be invested into highly rated liquid securities issued by foreign governments or international organisations. Its assets can be used to prepay federal debt or finance spending if oil and gas revenues fall short of a target predefined in the budget.

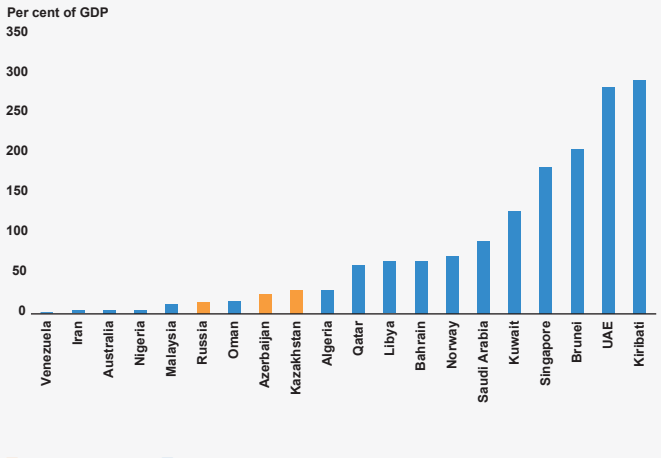
When the Reserve Fund reaches 10 per cent of GDP, oil and gas revenues in excess of the target are channelled to the National Welfare Fund, whose investment criteria for the latter are similar to those of the Reserve Fund, except that part of the National Welfare Fund assets can be invested in equity and bonds of domestic and foreign enterprises or placed with the state development bank, Vnesheconombank (including in rouble-denominated deposits, up to a certain limit). The uses of the National Welfare Fund are exclusively to co-finance voluntary pension contributions and finance State Pension Fund deficits, complementing or replacing federal budget transfers to the Pension Fund.

Overall, this framework has proved to be useful for accumulating fiscal reserves during the commodity boom and aiding macroeconomic management. It could also serve as a commitment device to ring-fence resource revenues and redistribute them broadly. That said, current rules leave room for substantial discretion regarding the proportion of oil rents deposited to the sovereign wealth funds and how they can be spent. The current commodity boom-bust cycle – the first since the establishment of the Stabilisation Fund – will be an important test of the strength and resilience of the Fund's institutional framework.

Chart 4.12a shows the structure of Russian merchandise exports in December 2004 to April 2005, when Urals brand oil price averaged US$ 42 per barrel (US$ 46 in 2008 prices), and in December 2008 to April 2009, when the oil price returned to the level of early 2005, averaging US$ 43 per barrel. For comparison, the period December 2007 to April 2008 is also shown (during which time Urals oil averaged US$ 95 a barrel). Chart 4.12b shows GDP structures based on national accounts for the first quarters of 2005, 2008 and 2009, respectively. Overall, headline figures suggesting an increase in Russia's dependence on oil and gas revenues in recent years appear to largely reflect higher oil prices. The share of crude oil and gas in total merchandise exports in 2009 fell back to approximately the levels of early 2005 as price increases of previous years were undone. In fact, the demand for higher-value-added manufacturing exports seems to have held up slightly better during the global economic crisis than the demand for fuel exports, particularly gas.

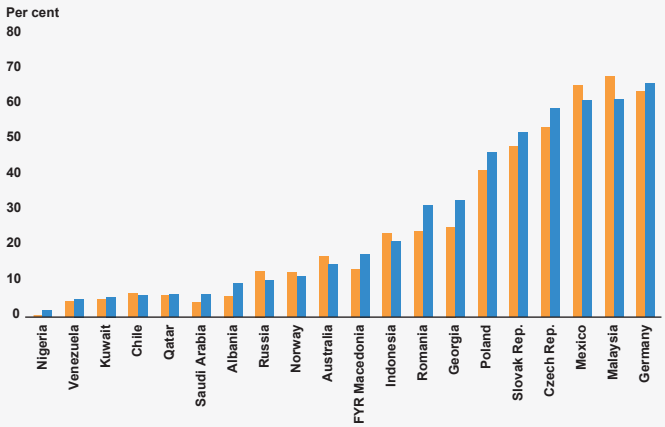
However, the share of manufacturing and agriculture in total output continued to shrink, mirrored by expansion of non-tradeables (services and construction). These data may partly reflect the temporary impact of the economic crisis, which induced contracting trade volumes and industrial production across the world (which may explain the observed drop in the share of extraction industries in the total value added in the first quarter of 2009). Nonetheless, the breakdowns of GDP and exports at comparable points in the oil price cycle suggest that the Russian economy has not made significant progress in diversification towards non-resource tradeable sectors in recent years.

Chart 4.10
Sovereign wealth fund assets



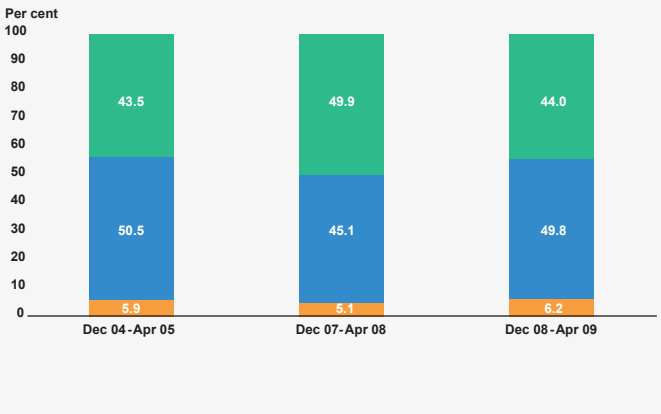
Sources: Sovereign Wealth Fund (SWF) Institute and IMF.
Note: Data for 2008 or latest estimate available.

Chart 4.11
Share of higher-value-added manufacturing in exports



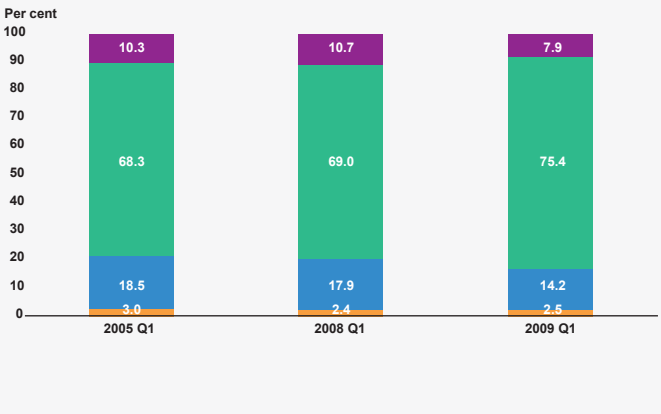
Source: United Nations Industrial Development Organization (UNIDO).
Note: Selected countries.

Chart 4.12a
Russia: Structure of merchandise exports



Sources: Rosstat and EBRD calculations.
Note: Higher-value-added manufacturing goods include machinery, equipment and vehicles. Other goods include refined oil and petrochemicals.

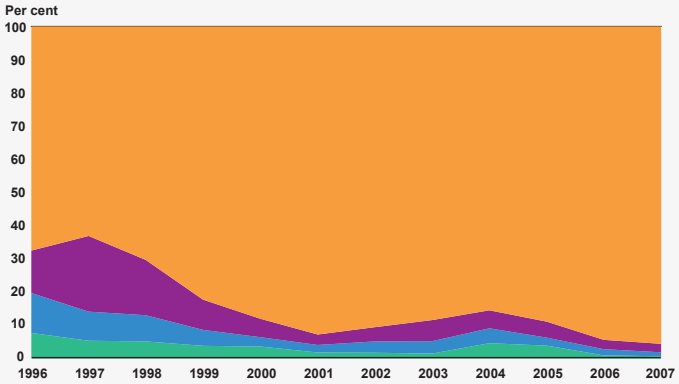
Chart 4.12b
Russia: Structure of GDP



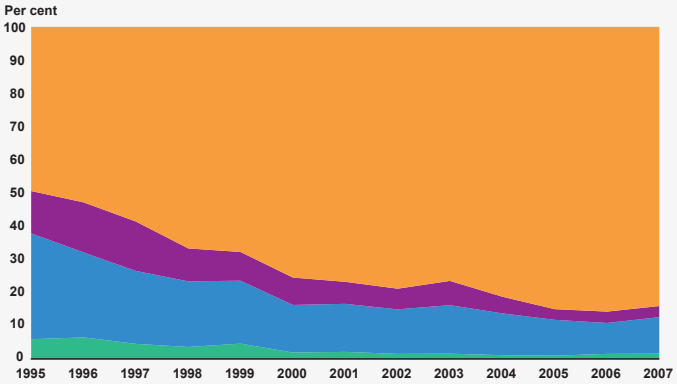
Sources: Rosstat and EBRD calculations.
Note: Based on quarterly data. Excluding net taxes. Agriculture includes fishing. "Other" includes services and construction.

Chart 4.13
Structure of merchandise exports

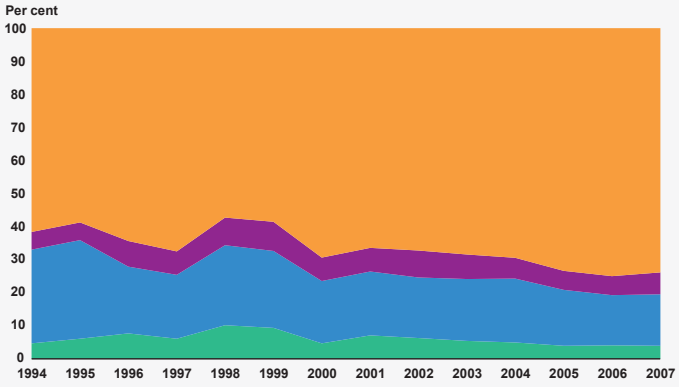
4.13a Azerbaijan



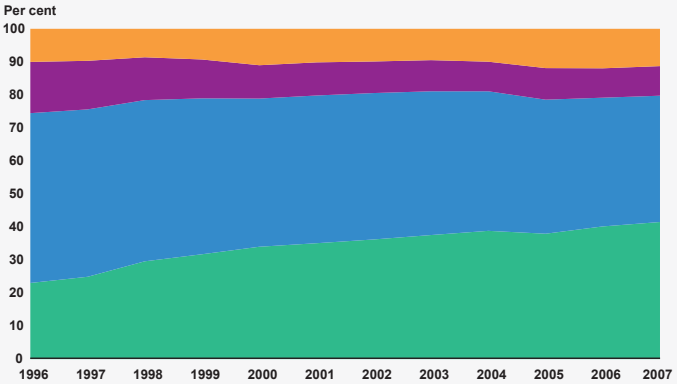
4.13b Kazakhstan



4.13c Russia



4.13d Other transition countries



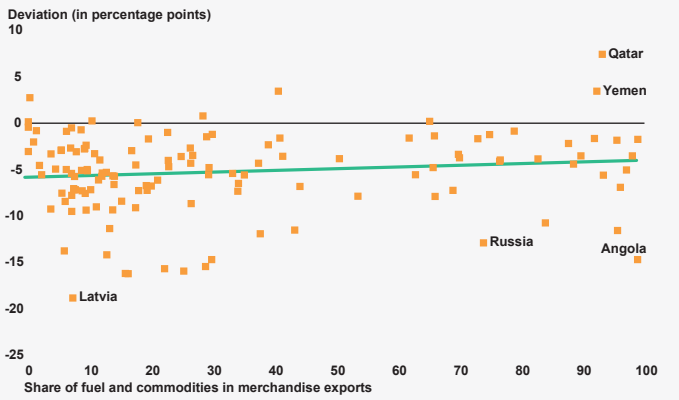
Higher-tech manufacturing Other manufacturing Agriculture Mining and fuels

Sources: WTO and authors' calculations.

Note: Authors' calculations based on export-weighted average of Armenia, Belarus, Bulgaria, Czech Republic, Estonia, FYR Macedonia, Georgia, Hungary, Kyrgyz Republic, Latvia, Lithuania, Moldova, Mongolia, Poland, Romania, Slovak Republic, Slovenia, Turkey and Ukraine. Comparable points: 1996 (oil at US$ 28 in 2008 prices) and 2002 (oil at US$ 30 in 2008 prices).

Chart 4.14
Commodity dependence and crisis impact

4.14a Broad sample of countries

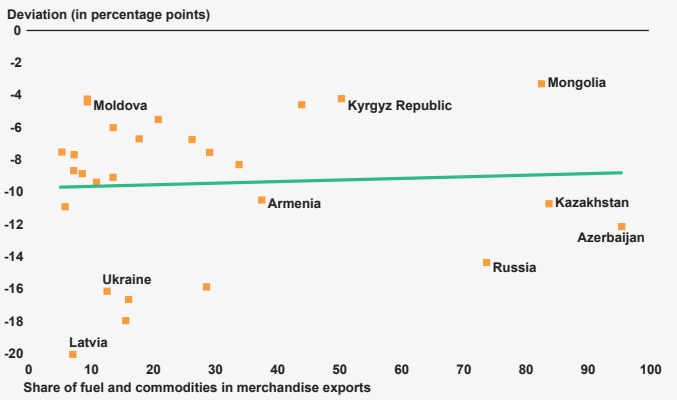


Fitted line Selected countries

Sources: WTO, IMF and authors' calculations.

Note: Based on World Economic Outlook April 2009 forecasts, 129 countries.

4.14b Transition countries



Sources: WTO, EBRD and authors' calculations.

Note: Based on May 2009 EBRD forecasts. Data for Tajikistan, Turkmenistan and Uzbekistan are not available.

Chart 4.13 shows the evolution of the structure of merchandise exports over a longer period for Azerbaijan, Kazakhstan, Russia and other transition countries, highlighting points in time when oil prices were comparable in real terms. In Russia the structure of exports was similar at corresponding points in the oil price cycle, but Azerbaijan and Kazakhstan saw a gradual yet sustained decline in the export shares of agricultural produce and manufacturing (both in the lower-value-added and higher-value-added segments). Growing dependence on oil and gas exports over time partly reflects the successful development of new oil and gas fields based on production sharing agreements with international oil companies. However, it also suggests very limited progress, if any, in diversification efforts to date.

Macroeconomic policies

A steep drop in commodity prices in late 2008 was one of the key channels of transmission of the global economic and financial crisis, alongside a sharp reduction in financial flows and a fall in demand for manufactured goods and tradeable services. However, it is not obvious whether commodity exporters have been hit harder than other countries, as world prices for investment goods may have decreased more steeply than, for example, oil prices. The analysis in Chapter 2 of factors explaining cross-country differences in output declines in the transition region did not point to commodity dependence as a significant determinant.

Indeed, if anything, commodity-rich countries seem to have been affected less severely than other countries. Chart 4.14 shows the relationship between the share of natural resources in countries' total exports and the deviation of the 2009 output growth forecast from the 1999-2008 average. (The forecasts are from the April 2009 IMF World Economic Outlook for a broad sample of countries and from the May 2009 EBRD press release for a subsample of the Bank's countries of operations.) The correlation is positive but weak. When differences in other key indicators, such as per capita GDP, are taken into account, commodity resources appear as a significant mitigating factor of the output decline in the broad sample.

The lack of a negative relationship may be due to the fact that other countries, including those specialising in manufacturing, have been severely affected by capital flow reversals and lower global demand. Importantly, however, a number of commodity exporters have been able to soften the impact of the downturn by using accumulated sovereign reserves to deploy forceful fiscal and monetary stimuli.

Indeed, fiscal and foreign currency reserves accumulated by major oil and gas producers have substantially widened the policy options available during the downturn. International reserves helped Azerbaijan to defend its currency and Russia and Kazakhstan to manage orderly currency depreciations in the face of lower oil receipts and capital outflows, while preserving financial stability through the provision of large-scale liquidity support to the banking system. In all three countries, governments drew on the reserves of sovereign wealth funds to provide a fiscal stimulus, boosting social transfers, targeting particular industries and earmarking funds for the recapitalisation of banks. While the targeting of some of these expenditures is debatable, the presence of sovereign wealth funds clearly expanded the ability of these governments to pursue countercyclical policy.

Financial development

Earlier analysis has emphasised the potential benefits of financial development in reducing macroeconomic volatility and alleviating credit constraints of companies operating in the agribusiness and non-oil-related manufacturing sectors (which tend to be particularly dependent on external finance). At the same time, however, financial flows in hydrocarbon-dependent economies tend to be closely correlated with oil price movements. Financial development can therefore also exacerbate the commodity price cycles and increase leverage – and vulnerabilities – in the banking system. Moreover, credit-fuelled consumption booms may shift demand and production structure further towards services, so magnifying the Dutch Disease symptoms. Perhaps unsurprisingly, empirical evidence on the role of financial development in resource-rich countries worldwide has been scarce and inconclusive.[23]

It appears that both effects have been at play in the oil-rich transition countries. Financial deepening supported enterprise growth across various sectors of the economy but a significant proportion of credit was channelled to trade, other services, residential construction and personal consumption. In Kazakhstan consumer credit grew at explosive rates of up to 150 per cent a year and peaked at over 21 per cent of GDP. In Russia household credit growth has been more modest but total consumer credit nonetheless increased from 0.5 per cent of GDP in 1999 to 10 per cent in 2008, and many real estate developers and construction firms opted for very high levels of leverage. In Azerbaijan almost 40 per cent of outstanding credit by mid-2008 comprised lending to consumers.

In addition, high loan-to-deposit ratios have made banks more vulnerable to reversals of financial flows. While the negative impact of the global crisis on economic growth in countries with deeper financial systems appears to be less severe, it has been more pronounced in countries with higher loan-to-deposit ratios (see Chapter 2). Furthermore, credit growth rates of over 50 per cent per year have strained banks' risk management systems. Similarly, regulation and supervision, while substantially improved in recent years, have not always kept pace with a rapid growth of financial assets. The sharp economic downturn has highlighted the need to strengthen the standards of asset quality disclosure by banks (see Chapter 3).

Institutions

As discussed in Chapter 5 of the 2008 *Transition Report*, diversification policies are difficult to get right in practice and their success largely depends on the quality of institutions. This claim is consistent with the results of a cross-country study of diversification experiences, which show that the quality of institutions is a powerful predictor of shifts towards export structures based on higher-value-added manufacturing and food exports (see Box 4.3 on page 88). Oil rents are negatively associated with diversification outcomes but this association disappears when the quality of institutions is controlled for, suggesting that oil rents influence diversification outcomes primarily through their impact on the institutional environment.

This leads to the question of how institutions have been affected by natural resource abundance and whether the oil-rich countries in the region have succeeded in improving the quality of institutions. Chart 4.15 plots the evolution of World Bank Governance Indicators since 1996 (when the first set of indicators was published) for hydrocarbon-rich transition countries, as well as for a simple average of other transition countries. The overall index takes into account the rule of law, voter accountability, effectiveness of government, regulatory quality, control of corruption, political stability and the absence of violence.

From the start, the perceived quality of institutions in the hydrocarbon-rich countries was substantially below the transition country average. Furthermore, while the transition average has been steadily improving over time, the perceived quality of institutions in most oil-rich countries "peaked" in 1998-2000, at the bottom of the oil price cycle, and declined as oil prices started recovering. For Kazakhstan, even though in recent years this perceived quality improved and exceeded the peak of 1998, the gap in relation to the non-oil-rich transition country average remained greater than in 1996. For all hydrocarbon-rich countries the gap widened more significantly for the indicators tracking rule of law and voice and accountability, while the effectiveness of government is perceived to have improved.

Box 4.3
Diversification and institutions: cross-country evidence

Examining export structures during periods when oil prices were comparable in real terms is useful when considering the long-term outcomes of diversification. The analysis below compares average export structures of 96 countries (where data are available) in 1991-92, when oil averaged US$ 30.3 per barrel in 2008 prices (adjusted using US consumer price index), and in 2001-03, when oil averaged US$ 31 per barrel in 2008 prices. The dependent variable, interpreted as a measure of diversification away from commodities, is the share of higher-value-added manufacturing (transport, machinery, equipment, electronics) and food in merchandise exports, as reported by the World Trade Organization.

These export items are technologically distanced from commodities – unlike, for example, petrochemicals or semi-finished steel. Furthermore, they constitute the bulk of advanced countries' exports (around 70 per cent in the case of Germany and Japan, 60 per cent in the case of France and the United States, around half for Canada and the United Kingdom and around 30 per cent for Australia – compared with less than 10 per cent in Azerbaijan, Kazakhstan and Russia).

Table 4.3.1 shows the results of simple regressions of export structure in 2001-03 on the structure in 1991-92 and a number of controls. They indicate that export structures change slowly – structures in 1991-92 explain almost three-quarters of the variation in structures in 2001-03. Higher oil rents (as a share of GDP) at the start of the period are associated with a decline in the share of higher-value-added manufacturing and food exports, and this effect appears to be statistically and economically significant, controlling for the initial level of income at purchasing power parity prices (see column A).

However, when a measure of the quality of institution is included, oil rents lose their significance (and the corresponding coefficient even becomes positive, although very small – see column B).[24] The estimates suggest that a one-standard deviation improvement in the quality of institutions is associated with a 4-6 percentage point increase in the share of higher-value-added manufacturing and food in merchandise exports. Column D shows that this relationship is even stronger in a subsample of countries with weaker institutions (with values below the sample median). It also holds in a subsample of 25 countries where commodities accounted for over 40 per cent of merchandise exports at the start of the period (see column E).

The coefficient on financial development (measured by the average private sector credit-to-GDP ratio – columns C and D) is positive but small and statistically insignificant. This is consistent with the view that financial deepening in itself may, but need not always, be supportive of export sophistication and diversification, and its impact ultimately depends on the structural characteristics of credit and the financial system. The presence of a sovereign wealth fund did not seem to be associated with positive diversification outcomes in oil-rich countries: the coefficient on the interaction term between oil rents and the dummy variable indicating existence of the sovereign wealth fund at the start of the period is small and statistically insignificant.

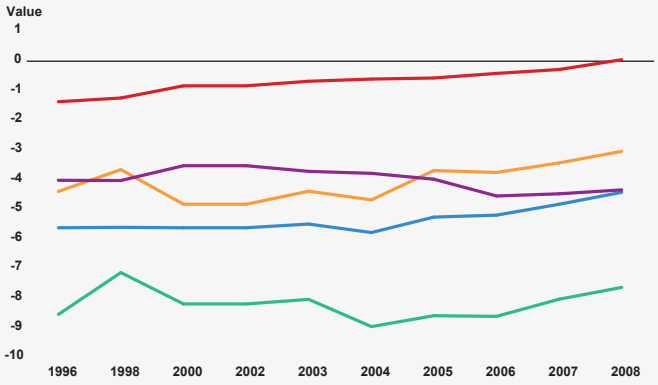
Table 4.3.1
Determinants of export structure

Model	A	B	C	D	E
Method	OLS				
Dependent variable	*Share of higher-value-added manufacturing and food in exports, 2001-03*				
Exports structure in 1991–92	0.784 (0.061)***	0.806 (0.059)***	0.803 (0.058)***	0.815 (0.073)***	0.756 (0.067)***
GDP per capita, log, PPP	1.779 (0.935)*	-2.874 (1.769)	-2.472 (1.818)	-3.664 (2.057)	-5.608 (2.094)**
Oil rents (in per cent of GDP)	-0.230 (0.114)**	0.013 (0.127)	-0.051 (0.150)	0.027 (0.151)	0.159 (0.144)
Oil rents* SWF dummy	-	-	-0.045 (0.103)	-	-
Quality of institutions, index	-	1.222 (0.549)**	1.074 (0.620)*	3.779 (0.943)***	1.130 (0.484)**
Private sector credit-to-GDP (period average)	-	-	0.009 (0.041)	0.012 (0.093)	-
Constant	-5.487 (7.724)	30.282 (14.615)**	26.709 (14.824)*	39.716 (16.101)**	51.026 (18.151)**
R^2	0.72	0.75	0.76	0.79	0.79
Number of observations	96	89	86	43	25

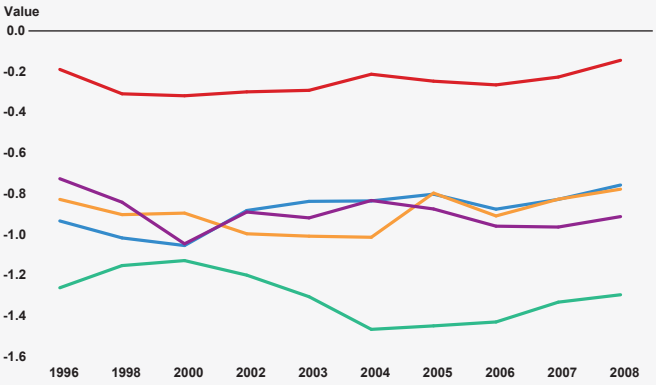
Source: Authors' calculations.
Note: Robust standard errors in parentheses. Values significant at the 10 per cent level are marked with *; at the 5 per cent level, with **; at the 1 per cent level, with ***. In column D only countries with the value of index of institutions below the median are included. In column E only countries where commodities accounted for more than 40 per cent of merchandise exports at the start of the period are included.

Chart 4.15
World Bank Governance Indicators 1996-2008

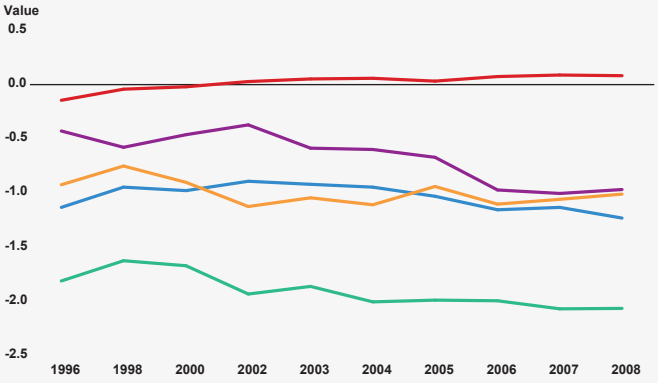
4.15a Overall



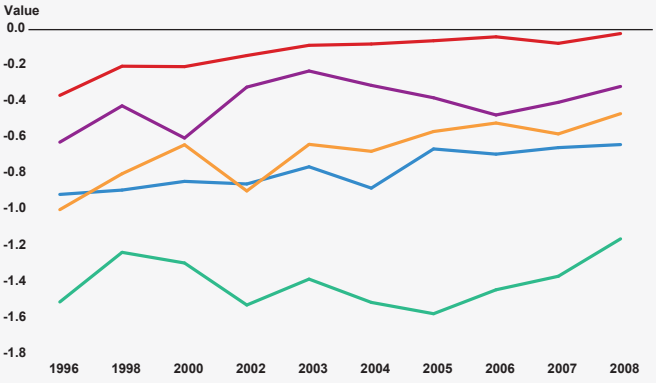
4.15b Rule of law



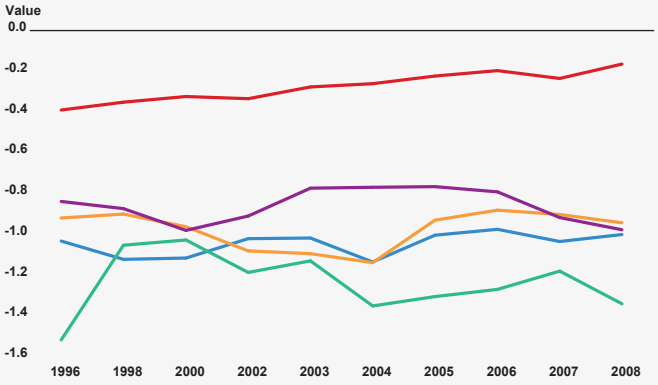
4.15c Voice and accountability



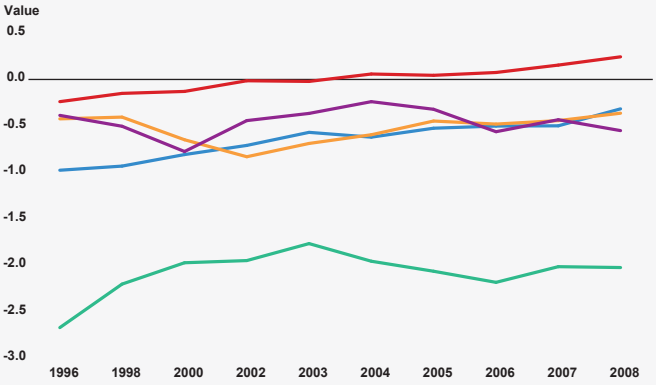
4.15d Government effectiveness



4.15e Control of corruption



4.15f Quality of regulation



Azerbaijan Kazakhstan Russia Turkmenistan Other transition countries (average)

Sources: World Bank and Kaufmann et al (2009).
Note: Higher values correspond to better institutions.

Conclusion

Commodity resources create huge opportunities for financing investment, education and, ultimately, growth. At the same time, there are channels through which they can depress a country's long-term growth potential. Unstable resource prices can generate macroeconomic volatility which discourages investment, especially in countries with underdeveloped financial institutions. Shifts in physical and human capital investment away from non-resource sectors during commodity booms are hard to reverse once those booms subside. Most importantly, high resource rents provide incentives for powerful elites to engage in rent-seeking rather than building growth-promoting institutions.

To address these challenges, resource-rich economies can pursue diversification through a variety of strategies: direct investment in non-resource sectors; investments in infrastructure and education that benefit all sectors; fiscal redistribution to spread resource wealth more widely and fairly; and financial sector development to effectively intermediate commodity-related and other financial inflows throughout the economy. In addition, they can build institutions such as sovereign wealth funds that save a portion of high hydrocarbon revenues in order to reduce macroeconomic volatility, protect resource rents and make their use more transparent.

The post-communist oil-rich countries have done fairly well in terms of prudent macroeconomic policies and financial sector development. Reserves accumulated during the boom helped maintain financial stability when commodity prices collapsed and the financial crisis hit in the second half of 2008, and have since been underpinning stimulus packages in crisis-hit economies. Also, while booms in financial services fuelled by external borrowing have amplified the effects of the commodity cycle and generated vulnerabilities in the banking system (particularly in Kazakhstan), greater financial sophistication is playing an important role in supporting the real sector, including agribusiness and non-oil manufacturing. In addition, public investment as a share of GDP has increased significantly in the oil-rich countries and for the most part so has spending on education.

However, these policies have not so far been successful in achieving diversification. A comparison of export and output structure over time shows a decline in non-oil export shares in Azerbaijan and Kazakhstan, a roughly constant share in Russia, and a decline in manufacturing as a share of Russian GDP. This is not entirely surprising in the light of international evidence suggesting that the success of diversification policies in resource-rich countries depends critically on the quality of institutions. According to standard measures, the resource-rich post-communist countries entered the resource boom with weaker institutions than many other transition economies; and, unlike in other transition economies, institutions in resource-rich countries do not seem to have improved significantly over time.

This points to a conundrum. Institutions are important for successful diversification but, at the same time, resource wealth and lack of diversification are an obstacle to improving institutions. How can oil-rich economies break free from what appears to be a "weak institutions trap"? The analysis in this chapter suggests that doing so is difficult but also identifies some "escape routes". Diversification policies, broadly defined, include not just industrial policies but also financial development and countercyclical macroeconomic policies. The latter have been broadly successful in oil-rich transition countries but may not have gone far enough (or been in place for long enough) to have an impact on the production structure. Financial development, in particular, has a long way to go.

Finally, the experience with sovereign wealth funds demonstrates that even in environments with strong incentives for rent-seeking, it is possible to create new institutions that protect these rents and channel them towards more transparent uses. While rent-seeking is a powerful obstacle to better institutions, it is not the only incentive that matters. For example, as large business groups in Russia seek to attract international capital, they are becoming more interested in improving their corporate governance. Growing middle classes and global economic competition among large emerging markets may also trigger institutional reform. Meanwhile, pressure for improvement may come from exterior sources (see also Box 4.4). These include, for example: the Extractive Industries Transparency Initiative (which classifies Azerbaijan as the only compliant transition country, and Kazakhstan, the Kyrgyz Republic and Mongolia – but not Russia – as candidates); and anti-corruption legislation in home countries of foreign firms, which has been shown to affect their behaviour in the FDI-recipient countries.[25] Institution building in resource-rich countries is likely to be difficult and protracted, but by no means hopeless.

Box 4.4

How Mongolia is fighting the resource curse

With mining accounting for roughly 25 per cent of GDP and 70 per cent of total exports, Mongolia fits well into the group of resource-rich transition countries studied in this chapter. However, three features set it aside. First, it is much poorer and smaller, with per capita GDP at about 20 per cent of Russia's, 30 per cent of Kazakhstan's and 60 per cent of Turkmenistan's. Second, its political institutions are ranked much higher, in line with advanced democracies. Third, it is at an earlier stage of resource sector development, with a number of multi-billion investment projects under preparation, whose total exploration and investment costs are expected to exceed 200 per cent of 2008 GDP and lead to annual revenue of about 100 per cent of 2008 GDP after they start production. Hence, Mongolia's current resource streams are a small fraction of what is expected in the future.

Together, these features create extraordinary challenges and opportunities. This box focuses on two. First, how can a small country that depends on foreign capital develop its resource sector in a way that makes it both attractive to foreign investment and allows it to keep most of its resource rents? Second, is there an opportunity to forestall the "resource curse" before the full brunt of revenue income materialises (particularly when political institutions are good)?

In the 1990s Mongolia's resource regime was highly favourable to foreign investors, with licences often granted on a first-come, first-served basis and tax and royalty rates low by international standards. As a number of mining projects were successfully implemented and commodity prices rose sharply, the government – and public opinion – became increasingly concerned with capturing a larger share of resource rents. In 2006 the government introduced a 68 per cent surtax on corporate revenues once commodity prices exceeded pre-set thresholds, and announced its intention to obtain majority control over strategic mining assets (or at least 34 per cent if mines were developed privately).[26]

While Mongolia was not very different from other developing country resource exporters in this respect (particularly in Latin America, where several countries introduced similar windfall taxes at about the same time, or even nationalised their mining industries),[27] these decisions had costly repercussions. Mongolia's attractiveness for minerals exploration, as published by the Fraser Institute, dropped from 3rd place out of 64 countries in 2005/06 to 57th out of 71 countries in 2008/09. Non-transparent gold sales have substantially increased in recent years. Most importantly, negotiations between the government and foreign mining companies relating to the large Oyu Tolgoi copper and gold mining project have been delayed. A number of foreign investors perceived policy uncertainty to be excessive and decided to leave the country. The Mongolian example therefore raises the question of whether it is possible to write international resource contracts that are more robust to large commodity price changes – a question that has attracted much recent interest.[28]

The second challenge is whether a country can forestall a resource curse by taking appropriate action before resource rents start arriving (or while they are comparatively modest). Based on the economic models surveyed in the chapter, there is reason to be sceptical: it is expectations of future rents, together with pre-existing institutional constraints, that determine institutional development. With regard to pre-existing institutions, Mongolia is something of a mix (see Table 4.4.1). On the one hand it has a multi-party democracy, a free press and a vibrant network of non-governmental organisations, but on the other hand it tends to score worse than the transition economy average (but better than the average of resource-rich transition economies) on rule of law, regulatory quality and corruption perceptions. So Mongolia could be a test case on whether good political institutions can eventually lead to improvements in economic institutions, even in the presence of resource wealth, or whether the resource curse will begin to undermine political institutions as well.

One channel through which Mongolia is attempting to forestall the resource curse is by using the international community as a commitment device. In 2007 Mongolia agreed with the Asian Development Bank, the EBRD and World Bank to establish a platform for sustainable mining sector development. The government joined the Extractive Industries Transparency Initiative (EITI) and developed a set of fiscal rules for the use of proceeds of the Development Fund – a ring-fenced fund generated by the windfall profit tax. Multilateral development banks (MDBs) have financed a number of mining sector projects, in which companies were required to meet EITI accounting and publication standards, and undertake environmental and social action plans and public consultations in the project regions. More recently, the government has established a modern PPP framework to develop infrastructure for mining sector development, supported by MDBs. It remains to be seen whether the potential discipline that these initiatives provide can help offset incentives for rent-seeking and contribute to the improvement of economic institutions more broadly.

Table 4.4.1

Mongolia and comparator countries: resources, per capita income and institutions

	Resource exports (per cent of GDP)	PPP GDP per capita (US$)	Democracy (-10 to 10)	Rule of law (-2.5 to +2.5)	Regulatory quality (-2.5 to +2.5)	Corruption perceptions index (0 to 10)
Mongolia	70.0	3,541	10.0	-0.5	-0.3	3.0
Resource-rich transition countries[1]	76.0	8,770	-2.8	-1.0	-0.7	2.0
All transition countries	28.5	11,937	4.9	-0.3	0.1	3.6
Non-transition OECD countries	18.5	37,398	9.1	1.5	1.4	7.6

Sources: WTO; IMF World Economic Outlook (PPP GDP per capita); Polity IV database (Democracy); World Bank World Governance Indicators (Rule of law, Regulatory quality); Transparency International (Corruption perceptions index, with 10 meaning the least corrupt).

Note: Data are based on the latest available (2007 or 2008). [1] Azerbaijan, Kazakhstan, Kyrgyz Republic, Russia and Turkmenistan. Resource export averages exclude Tajikistan, Turkmenistan and Uzbekistan.

Endnotes

1 The term was first coined by Auty (1993).

2 See Rosenstein-Rodan (1943) and Murphy, Shleifer and Vishny (1989).

3 See Aghion, Bacchetta, Ranciere and Rogoff (2006) for empirical evidence on this point.

4 See Gylfason (2001), Stijns (2006) and Suslova and Volchkova (2007).

5 The term was coined by *The Economist* magazine to refer to the Netherlands' experience following the discovery of hydrocarbons in the North Sea in 1959.

6 See, for example, Corden and Neary (1982).

7 There is evidence that the "sophistication" of export products predicts higher future growth. See Hausmann, Hwang and Rodrik (2007) and EBRD, *Transition Report* (2008), Chapter 4.

8 See Krugman (1987).

9 See Tornell and Lane (1999) and Sonin (2003).

10 This relationship is still under-researched compared to other dimensions of the resource curse. As correctly argued by Ross (2007), the quality of data on inequality is relatively low in general and is especially low in resource-rich countries.

11 See Persson and Tabellini (2000) and Acemoglu, Robinson, and Verdier (2004). The concept of the "median voter" refers to a representative individual whose vote on a certain issue (for example redistribution) will be deciding, giving a candidate or proposal a majority of 50 per cent plus one. If each voter had a preferred degree of redistribution in society and these preferences were ranked, the winning proposal would be the degree of redistribution at the median of the distribution of preferences.

12 See Sachs and Warner (1997a,b; 2001), Auty (1993, 2001) and Gylfason, Herbertsson and Zoega (1999).

13 See Mehlum, Moene and Torvik (2006).

14 See Hutchison (1994), Volchkova (2005) and Ahrend, de Rosa and Tompson (2007).

15 See Guriev, Kolotilin and Sonin (2009), Blanchard et al (1994), Durnev and Guriev (2007), Egorov, Guriev and Sonin (2009), Ross (2001) and Amin and Djankov (2009), respectively. See also Esanov, Raiser and Buiter (2001) for early evidence of the adverse impact of oil revenues on reform progress in Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan.

16 See Ross (2006).

17 Chiefly, difficulties in establishing causality in light of possible reverse causality and omitted variables in the regression. In a cross-section of countries, it is impossible to control for all the factors that may influence growth; and there may be feedback effects from growth to its supposed determinants.

18 See Hotelling (1931).

19 Based on the standard Hotelling analysis, Heal (2007) arrives at the opposite result. However, this analysis does not account for the market power of the major oil producers or for the risk of arrival of alternative technologies in the foreseeable future.

20 Note that taxation of resource exports cannot play a significant role in redirecting investment towards the non-resource sectors. In an open economy, when the government increases taxes (that is, decreases returns on investment) in one sector, capital will flow to other countries, with negligible impact on domestic investment.

21 See Rajan and Zingales (1998).

22 See also Hausmann and Klinger (2007) and Hidalgo et al (2007).

23 See Nili and Rastad (2007), Chapter 3 of this report, and Berglof and Lehmann (2009).

24 The quality of institutions is measured by the World Bank's Governance Index, which takes into account voter accountability, political stability, effectiveness of government, quality of regulations, rule of law and control of corruption. The first available observation is for 1996.

25 See Javorcik and Wei (2009).

26 A repeal of the windfall tax was announced in August 2009.

27 See Box 5 in IMF (2006). On the topic of natural resources populism, see Hogan and Sturzenegger (2009).

28 See Aghion and Quesada (2009).

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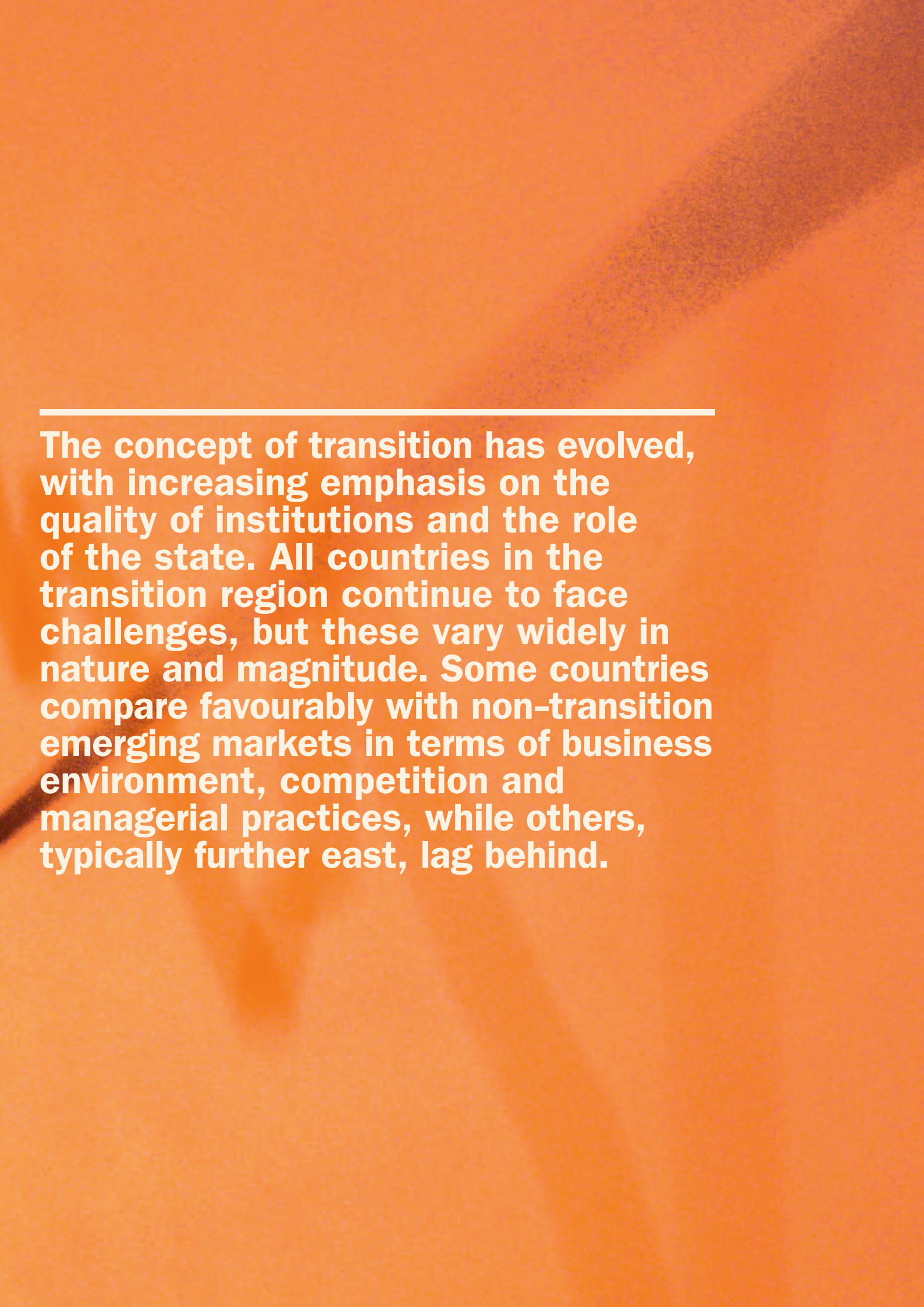
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The concept of transition has evolved, with increasing emphasis on the quality of institutions and the role of the state. All countries in the transition region continue to face challenges, but these vary widely in nature and magnitude. Some countries compare favourably with non-transition emerging markets in terms of business environment, competition and managerial practices, while others, typically further east, lag behind.

Chapter 5
Transition: where does it stand and where should it go?

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114 Annex 5.1 Management, Organisation and Innovation (MOI) survey

Chapters 3 and 4 have analysed the key problems of economic development in the transition region in the last decade – managing economic integration, particularly financial integration, and maximising the benefits of commodity resources. Following the initial wave of privatisation, liberalisation and opening up that began the process of transition to market economies in the first half of the 1990s, development "models" based on these policies have transformed the economic structures of countries in the region.[1] This prompts several questions. How different is the transition region to other countries at comparable levels of economic prosperity? Are there major differences within the transition region in this regard? In which countries and sectors does the transition agenda remain incomplete? Most importantly, what should be the main priorities for future reforms?

An initial appraisal was given in Chapter 1, using the EBRD transition indicators. This chapter provides a more complete analysis in three particular respects. First, it takes a broad view of transition objectives that emphasises not only market mechanisms and private sector development, but also the interaction between the state and the private sectors and the role and quality of state institutions. Second, as far as the data allow, the analysis focuses on comparisons with countries outside the transition region. Lastly, and most importantly, the chapter draws on several new data sources and studies at the sector and firm levels.

The analysis begins with a summary of how the concept of transition has evolved since the mid-1990s and what this implies for transition measurement. It then reviews transition through four perspectives:

— the latest (2008/09) Business Environment and Enterprise Performance Survey (BEEPS IV), which the EBRD and World Bank jointly undertake every three to four years

– a new EBRD/World Bank survey of management practices

– a sector-level comparison of competition across countries

– a comprehensive analysis of remaining transition challenges across 13 specific sectors.

The concluding section considers whether the transition region is still different to other countries at comparable stages of development and indicates priorities for future reform.

Transition to where?

Since the early 1990s, the word "transition" has been used to describe the evolution from a planned economy to a well-functioning market economy. In the light of the overwhelming role of the state at the start of the process, the questions of what exactly constitutes a well-functioning market economy and what part the state should play in it were initially given less attention. The imperatives were to reduce state ownership and direct state intervention and to build market mechanisms.

However, as the transition process and economic thought evolved, it became increasingly clear that this approach was too simplistic – to the point where it could be misleading as a yardstick for reforms – for two reasons.

First, moving from central planning to an "optimal" role of the state is not just a matter of reducing state interference and control but also involves *developing* certain state activities. Transition is not just (and perhaps not even primarily) about the size of the state's "footprint" in the economy but also about where and how the state treads – that is, what the state does to affect economic outcomes and how it attempts to do so. The consensus in the early 1990s was that it was not the business of the state to set prices or directly control or interfere with production and allocation decisions. That remains the overwhelming view. However, in order to function properly, the private sector needs market-supporting public institutions and policies.[2] These include: a functioning legal system to enforce contractual obligations; regulation to deal with external effects and incentive problems; safety nets to allay concerns about social cohesion; physical and intellectual property rights protection; and competition policy.

Second, the quality of institutions emerged as a critical dimension of transition. State institutions with similar objectives – for example, enforcing laws, collecting taxes or supervising the financial sector – can have vastly different impacts in terms of their effectiveness (whether laws are actually enforced and taxes collected) and the burden that state activities impose on the private sector. The effectiveness of institutions depends on two factors: technical capacity, which is related to information and human capital, and incentives. The latter will depend not only on the design of economic institutions but also on the political structure and on complementary civil society institutions that promote transparency and accountability.

The quality dimension is also important with respect to non-state institutions. Markets do not function well if they are not competitive or there are barriers to entry. Corporations do not function well if corporate governance is poor and minority investors are not protected. In large part, these quality differences are driven by the presence (or absence) and effectiveness of supporting state institutions, such as legal frameworks and competition authorities. However, the functioning of market institutions may also depend on such factors as values, attitudes and practices. Unwritten rules – for example, on what constitutes acceptable behaviour within a firm or in the political arena by government officials – may be as important in practice as explicit rules.

Transition should therefore be about redefining the state as opposed to simply minimising it, and about improving the quality of state and private institutions and ensuring that they work well together. Defining transition in this way poses significant challenges – or rather it makes challenges that are hidden in simpler definitions of transition explicit.

– If the objective is to redefine the role of the state rather than simply maximise the scope of private activity, there must be a clear idea of what that role should be. Beyond some general principles (identified previously), this is likely to be possible mainly at the level of specific sectors.

— Even at the sector level, it will rarely be possible to define a uniquely "optimal" role of the state. This is due partly to differences in political cultures and traditions. In addition, the desirable role of the state could depend on the quality of state and market institutions. For example, poor state performance in the provision of certain public goods could be an argument for a greater private sector input. Conversely, lack of competition or high barriers to entry could justify a temporarily greater or more heavy-handed role of the state in certain markets.

These challenges both confront a policy-maker who is weighing reforms and complicate any attempt to take stock of transition. The following analysis tries to address them in three ways: by characterising two critical dimensions of institutional quality – the business environment and the quality of managerial practices – that cut across sectors; by taking the analysis to the sector level, focusing on competition, market structure and institutions; and by accommodating a range of visions of what the sector-level goal of transition should be. Together, these building blocks give a reasonably complete and consistent picture of the status of transition and the challenges ahead.

Business environment

One way in which the state can enable markets to function properly is by creating a favourable business environment. To understand how far the transition region has come in this respect, and where it stands compared to other countries, this section presents the main results of the BEEPS IV – a survey of perceptions and enterprise operations based on face-to-face interviews with the owners or senior managers of randomly chosen companies.[3] Comparisons are drawn with earlier rounds of the survey and with similar recent surveys carried out elsewhere.

Main obstacles

The main purpose of the BEEPS is to identify problems that affect the operations of enterprises. Many questions in the survey asked respondents to rate the severity of different obstacles to doing business on a five-point scale – 0 (no obstacle), 1 (minor obstacle), 2 (moderate obstacle), 3 (major obstacle) or 4 (very severe obstacle) – thereby allowing the construction of simple averages across firms for each obstacle.

In addition, owners or managers were given a list of 15 different obstacles in the business environment and asked to identify the biggest one faced by their firm.

Table 5.1 presents the average score for the 15 obstacles for the whole transition region, as well as for the subregions (including Russia and Turkey). It also shows the percentage of firms that considered a given obstacle as the "most serious" facing their operations (using the same regional breakdown). Three obstacles stand out for the region as a whole and across almost all subregions. *Tax rates* is the only obstacle with an average score above 2.0, and also ranks highest among the "most serious" obstacles. While it is not surprising that businesses complain about taxes being too high, it is striking that this outweighs any other obstacle in importance. *Political instability* is the next highest ranked obstacle according to average score. Unsurprisingly, this features in countries such as Bosnia and Herzegovina, Georgia, Serbia, Turkey and Ukraine, but also in some less likely countries such as Hungary and Lithuania. The subregion that emphasises political instability the least is Central Asia, which perhaps reflects the authoritarian nature of the prevailing regimes. *Access to finance* is also a significant obstacle, with almost 15 per cent of firms identifying it as their biggest problem – even though most firms were surveyed before the full effects of the global financial crisis were felt.

In other cases, there are larger differences in obstacle ratings across countries and subregions. For the transition region as a whole, *corruption* is viewed as fairly serious (1.8), but more so in Russia (2.2) than in CEB (central Europe and the Baltic states – 1.4). Only in Russia did more than 10 per cent of respondents regard corruption as the "most serious" obstacle.[4]

Table 5.1
BEEPS IV (2008/09) summary results, by region

	Average obstacle score							Per cent identifying constraint as "most serious"						
	All transition countries	CEB	SEE	EEC	Russia	Central Asia	Turkey	All transition countries	CEB	SEE	EEC	Russia	Central Asia	Turkey
Access to finance	1.5	1.3	1.6	1.7	1.9	1.7	1.0	14.7	11.2	18.5	10.1	16.9	17.6	25.9
Access to land	1.2	0.9	1.0	1.7	2.0	1.3	0.4	2.5	1.7	2.1	4.0	5.7	1.7	0.4
Business licensing and permits	1.3	1.1	1.2	1.3	1.5	1.3	1.4	4.7	3.3	3.4	8.0	8.0	6.7	2.5
Corruption	1.8	1.4	1.8	1.9	2.2	1.8	2.0	6.6	4.6	7.1	8.9	11.2	9.9	2.0
Crime, theft and disorder	1.4	1.3	1.2	1.7	1.9	1.7	0.7	2.8	3.3	3.0	3.7	1.7	1.6	1.0
Customs and trade regulations	0.9	0.6	0.9	1.2	1.0	1.1	0.8	1.9	1.7	1.1	4.5	0.9	2.2	2.0
Electricity	1.6	1.4	1.3	1.7	2.0	1.9	1.1	2.9	3.5	1.6	2.1	2.0	6.7	3.0
Functioning of the judiciary	1.3	1.2	1.4	1.3	1.3	1.2	1.1	2.1	3.7	1.3	1.9	0.2	0.6	0.2
Inadequately educated workforce	1.7	1.5	1.3	1.7	2.4	1.8	1.5	12.0	12.3	14.0	8.0	15.4	9.1	9.1
Labour regulations	0.9	1.2	1.0	0.8	0.9	0.6	0.9	4.2	6.0	4.1	0.9	4.4	1.4	2.0
Political instability	1.9	1.8	1.9	2.0	2.0	1.6	2.5	10.7	9.8	10.0	15.7	8.1	3.0	17.5
Practices of competitors (informal sector)	1.6	1.4	1.6	1.7	1.3	1.5	1.7	10.5	12.5	8.6	9.2	6.1	9.1	14.7
Tax administration	1.5	1.5	1.5	1.5	1.5	1.4	1.4	4.2	5.8	4.3	3.0	2.2	6.0	0.3
Tax rates	2.2	2.2	1.9	2.2	2.4	2.1	2.4	19.1	19.3	19.3	19.2	17.2	23.3	18.2
Transport	1.2	1.0	0.9	1.3	1.6	1.3	0.9	1.2	1.3	1.7	1.0	0.1	1.2	1.1

Source: BEEPS IV.

In contrast, *competition from the informal sector* is viewed as a relatively minor problem in Russia but as more serious in most other regions. An *inadequately educated workforce* is perceived as a major problem in countries that have grown rapidly in recent years, such as Estonia, Romania and Russia.[5]

For most obstacles – access to finance, access to land, business licensing and permits, corruption, crime, theft and disorder, electricity, functioning of the judiciary, workforce education and transport infrastructure – Russia, eastern Europe and the Caucasus (EEC) and Central Asia tend to have higher average obstacle scores than CEB and south-eastern Europe (SEE). This finding is likely to reflect broad differences in the quality of infrastructure and institutions rather than differences in the importance that firms attach to particular obstacles. This is confirmed by more objective measures of business obstacles, based on the BEEPS itself[6] and on the World Bank's *Doing Business* survey (some of the indicators in which overlap conceptually with the BEEPS).[7]

Comparison over time

How have perceptions of obstacles to doing business changed over time? Chart 5.1 shows how responses to 11 business environment elements have changed on average since 1999 by plotting the percentage of firms in the latest and previous BEEPS rounds that reported a non-zero score for each obstacle – that is, those seeing the problem as being of at least minor importance for their operations.[8] Three interesting findings emerge.

First, there are several categories – access to finance, customs and trade regulations and tax administration – where there appears to be an improvement between 1999 and now. Second, some obstacles such as corruption, functioning of the judiciary and labour regulations are still more or less at the level of 1999. Lastly, perceived obstacles related to infrastructure – transport, telecommunications and electricity – significantly increased in the latest round compared to the previous two rounds.[9]

The infrastructure findings may seem surprising, as the EBRD infrastructure reform indicators suggest that there has been continued progress in these areas in recent years (see the transition scores in the country assessments from page 130). However, a heightened perception of problems could be an indication of a growing economy where firms wishing to expand their operations have run into difficulties that were not binding constraints beforehand. Given the strong growth that the transition region experienced between 2005 and early 2009, it is likely that the demands on infrastructure services grew more rapidly than the supply (even when improving) could cope with.[10] This demonstrates the need for continued investment and upgrading of these services across the board.

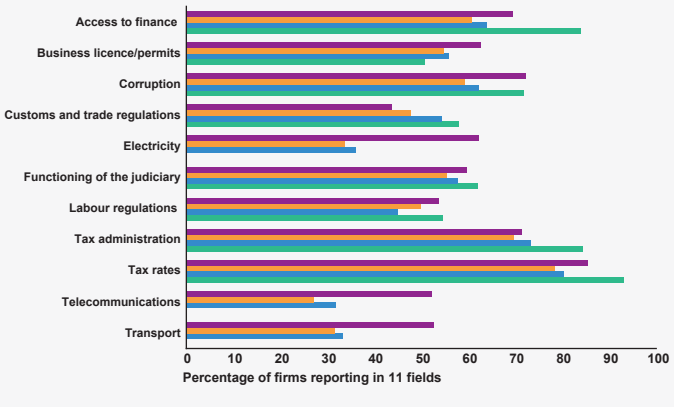
Comparison across countries

In recent years the World Bank (sometimes in collaboration with other international organisations) has sponsored a wide range of Enterprise Surveys around the world. These differ to some extent from the BEEPS, and the timing also varies across countries. However, there is sufficient overlap to allow some comparison to be made about how perceptions of the business climate differ between the transition region and other emerging markets.

Is the business environment worse in the transition region than in other regions of similar gross domestic product (GDP) per capita? Indicators based on subjective perceptions are not well suited to answer this question, as there may be systematic differences in the propensity of firms to report obstacles across countries.[11] Nonetheless, it is possible to come up with a worldwide ranking by constructing an average obstacle score for each country. This suggests that the transition group is not very different, on average, from non-transition developing countries. However, the variation within the transition group is very wide.[12] If the transition countries are separated along geographical lines into CEB, SEE and Turkey on one hand and EEC, Russia and Central Asia (EEC+R+CA) on the other, it turns out that there are statistically significant differences across these two groups. On average, business obstacles in the former are as low as, or lower than, in any other developing country region, while in the latter they are higher than in most regions (see Table 5.2).

Aside from the overall rankings, does the nature of perceived business obstacles still differ between the transition region and non-transition countries? Charts 5.2a and 5.2b plot country mean obstacle scores against purchasing power-adjusted per capita income for eight selected obstacle categories. Transition and non-transition countries are coloured differently and each group is fitted with a line which shows the

Chart 5.1
Perceptions of selected business obstacles



Sources: BEEPS I, II, III and IV.

Note: BEEPS I, which was administered in 1999, did not include separate questions on electricity, telecommunications and transport, but rather a single question on infrastructure as a business obstacle. Sample average for firms reporting minor to major obstacles for infrastructure was 60 per cent in this round of the survey.

Table 5.2
BEEPS rankings and mean obstacle score, by country group

Group	Number of countries	Mean rank	Mean score
CEB + SEE + Turkey	17	33	1.27
EEC + Russia + Central Asia	12	49	1.50
Latin America	14	50	1.50
Africa	27	33	1.29
Other	8	44	1.47

Source: BEEPS IV survey.

Note: "Other" consists of a group of Asian and Middle Eastern countries.

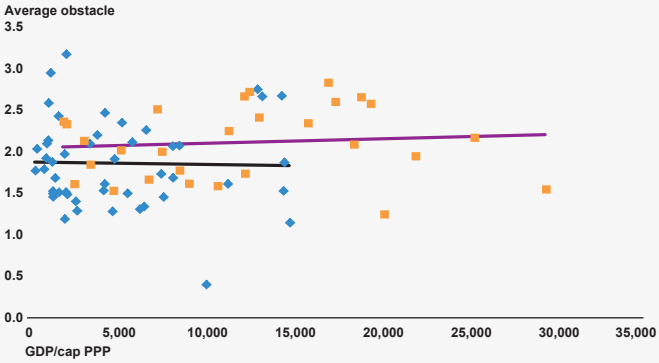
Chart 5.2a

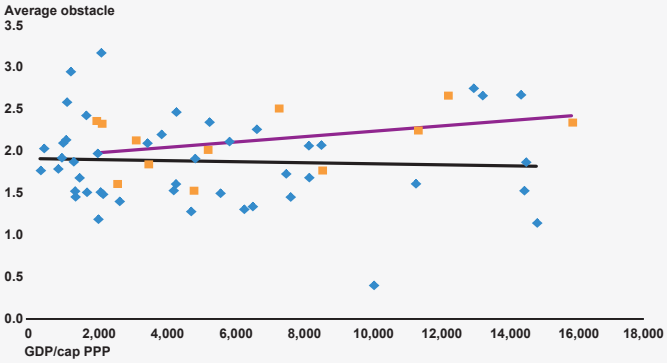
Business obstacles: comparison between transition and non-transition countries

Comparison with all transition countries

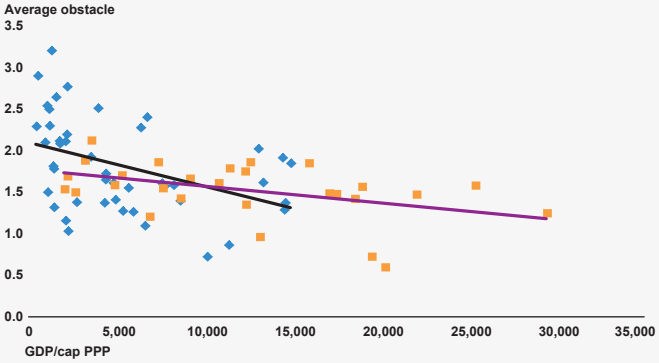
Comparison with EEC+R+CA

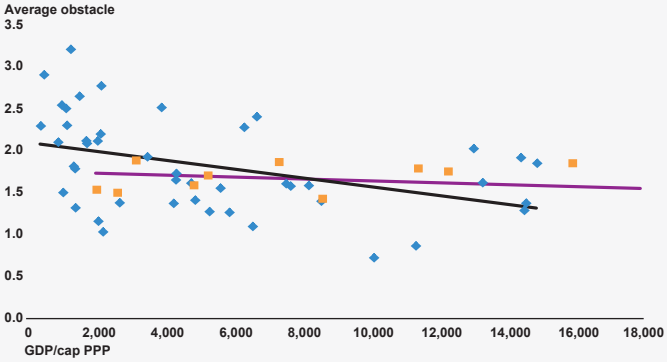
1. Tax rates



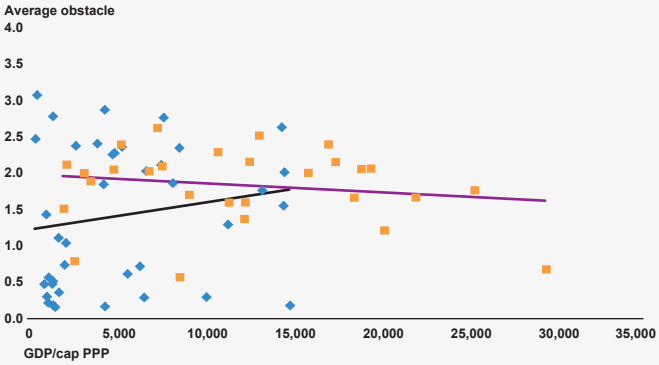


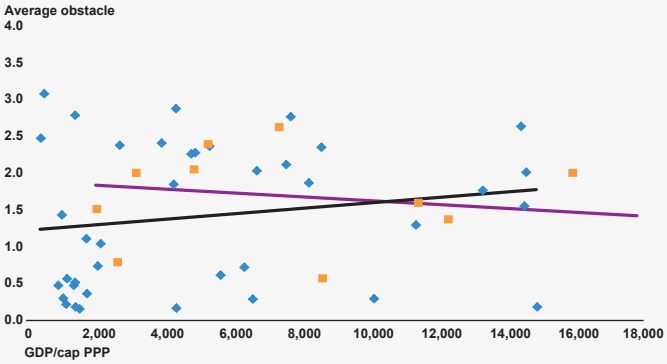
2. Access to finance



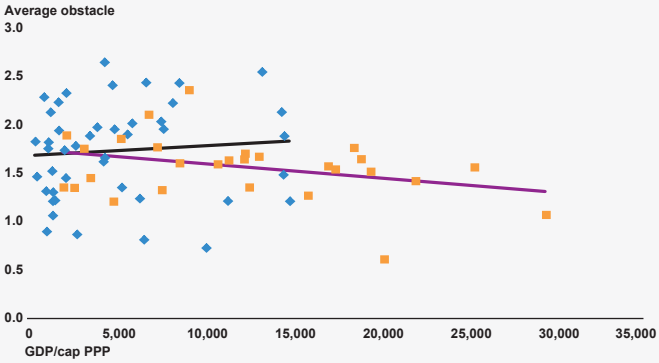


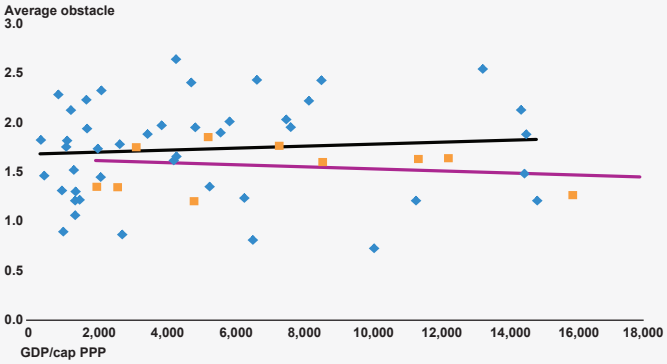
3. Political instability





4. Competitors in the informal sector





Non-transition countries Transition countries
Linear (Non-transition countries) Linear (Transition countries)

Sources: BEEPS IV and Enterprise Surveys.

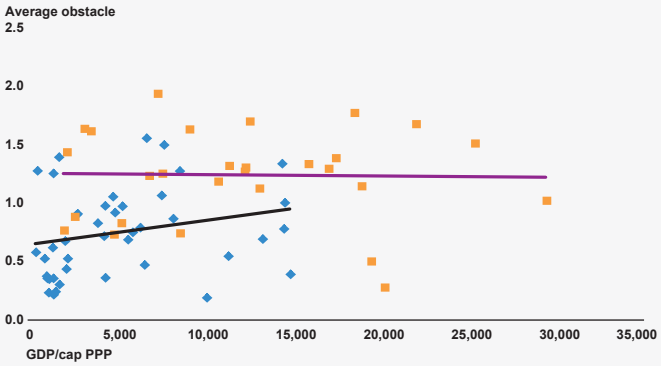
Non-transition countries EEC+R+CA
Linear (Non-transition countries) Linear (EEC+R+CA)

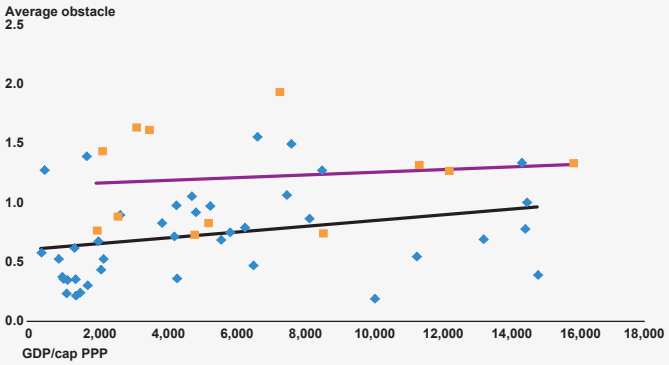
Chart 5.2b

Business obstacles: comparison between transition and non-transition countries

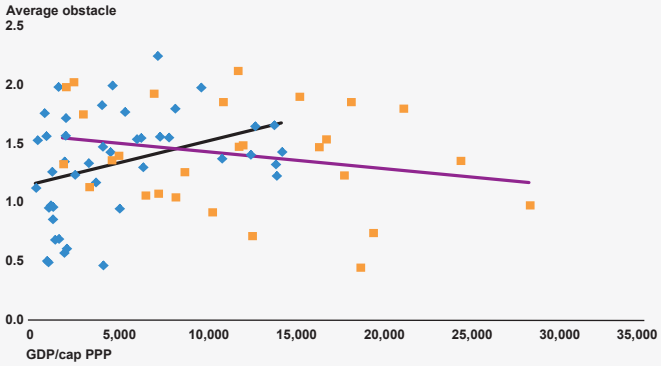
Comparison with all transition countries | Comparison with EEC+R+CA

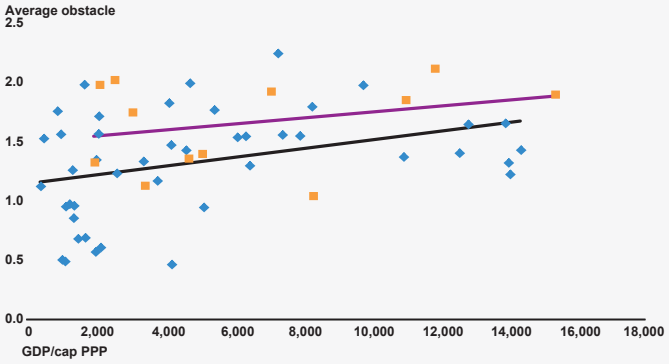
1. Functioning of the judiciary



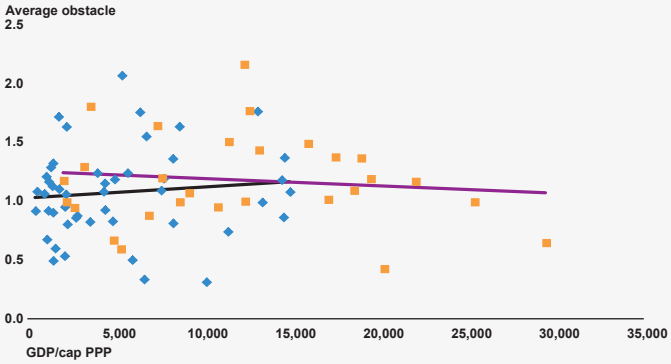


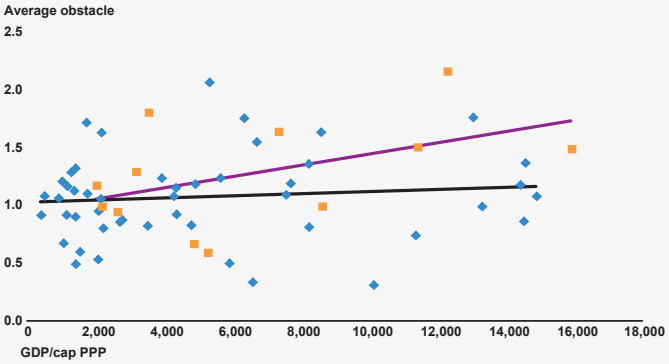
2. Crime



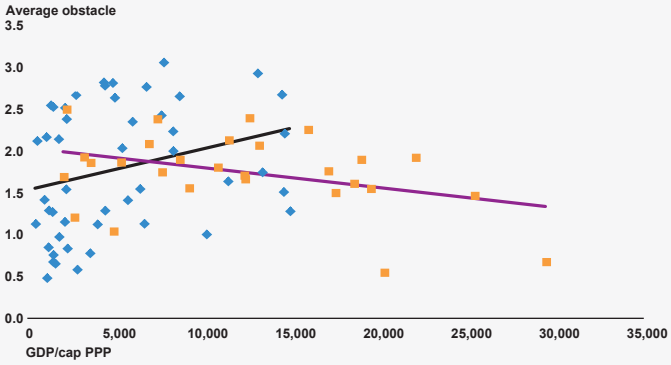


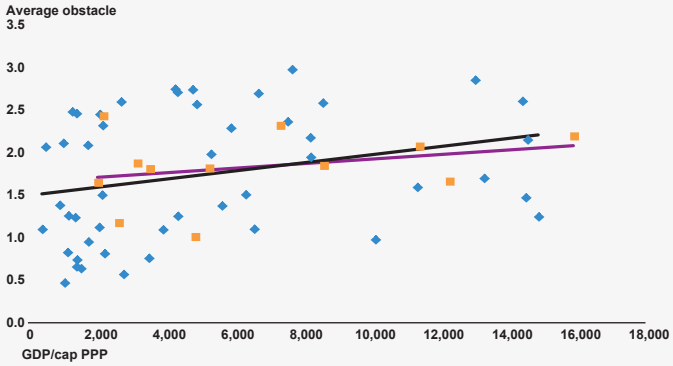
3. Business licences and permits





4. Corruption





Non-transition countries | Transition countries
Linear (Non-transition countries) | Linear (Transition countries)

Non-transition countries | EEC+R+CA
Linear (Non-transition countries) | Linear (EEC+R+CA)

Sources: BEEPS IV and Enterprise Surveys.

relationship between the obstacle score and per capita income. If the obstacle plays a bigger role in the transition region, the line fitted to the transition group will be shifted up from the non-transition line. In the light of the results in Tables 5.1 and 5.2, comparisons with non-transition countries are shown for the entire transition group in BEEPS IV – left-hand column – and for EEC+R+CA only – right-hand column.

Two facts are worth noting at the outset. First, as expected, the dispersion within the transition economy group is generally quite high – for the most part as high as, or higher than, the dispersion within the 45 non-transition developing countries in the sample. Second, in the transition group as a whole the average obstacle scores are generally negatively correlated with per capita income, although this relationship is reversed in the EEC+R+CA group. Richer countries in this group tend to have higher perceived business obstacles. One possible interpretation for this is that the richer EEC+R+CA countries are large commodity exporters, which tend to have weaker institutions (see Chapter 4).

Chart 5.2a plots four categories of business obstacles scores – tax rates, access to finance, political instability and competitors in the informal sector – for which there is no statistically significant difference between the non-transition and transition groups (either as a whole or just EEC+R+CA). (The same is true for the categories of transport, customs and trade regulations and tax administration, which are not shown in the chart.) This suggests that in some areas that reflected high state interference – particularly tax rates, tax administration and customs and trade regulations – the transition region has indeed converged. Tax rates continue to receive a higher average obstacle score in the transition region, particularly in EEC+R+CA, but the difference is no longer statistically significant.

Chart 5.2b shows four categories for which there are statistically significant differences with respect to non-transition countries. In the functioning of the judiciary and crime categories this is true for the comparison with the transition group as a whole, but the chart indicates that the differences are driven by higher obstacles in the poorer transition countries, and particularly in EEC+R+CA. (The same pattern arises for the telecommunications, access to land and workforce education categories, which are not shown on the chart.) In the case of business licences and permits, only the EEC+R+CA group does significantly worse, on average, than non-transition economies. Lastly, the transition region overall scores significantly better than the non-transition sample on corruption but there is no statistical difference between the non-transition group and EEC+R+CA. The same is true for electricity as an obstacle (not shown on the chart).

To conclude, for the transition region as a whole, the business environment appears to be no worse than in other developing countries. However, there is large heterogeneity within the region. CEB countries tend to have a better business environment than other emerging market regions, while Russia and countries in EEC and Central Asia tend to have weaker environments (despite their lower per capita incomes). In some categories – such as access to land, some infrastructure constraints and workforce education – comparatively high average obstacle scores are a new phenomenon and are likely to reflect fast recent growth rather than the legacy of central planning. For the most part, however, the weaknesses are in areas in which the transition economies have traditionally lagged, and in which the EEC+R+CA countries continue to lag.

Management practices

The previous section has focused on the environment that firms face in their daily operations – but how well are firms managed and organised in the transition region and how do they compare in this respect to firms in non-transition countries? Recent research suggests that management practices are strongly associated with firm performance. A study of 7,000 medium-sized manufacturing firms across Asia, Europe, North and South America found that there are large differences in management practices across firms as well as countries, and that these practices are strongly associated with firm-level productivity and other performance measures such as profitability and survival rates.[13] The United States had the best overall management practices, although Germany, Japan and Sweden did better in operations management. Multinational firms tended to be run well everywhere, even in developing countries. Importantly, differences in management practices were found to be larger between firms in the same country than across countries, suggesting that firm- and sector-specific factors are at least as important as the general business environment in shaping managerial performance. Differences in management practices were found to be related to competition, labour market flexibility, education and also ownership structure (with dispersed ownership being associated with better performance than state- or family-run firms).

This section reports on the results of a new Management, Organisation and Innovation (MOI) survey that applies this line of research to transition economies for the first time. The survey focused on practices in four core management areas – operations, monitoring, targets and incentives (see Annex 5.1) – conducting 1,669 face-to-face interviews with factory managers in 10 transition countries (Belarus, Bulgaria, Kazakhstan, Lithuania, Poland, Romania, Russia, Serbia, Ukraine and Uzbekistan) as well as Germany as an advanced country benchmark. It therefore covered a geographically diverse sample that includes the largest transition countries, with a wide variation in transition progress.

Box 5.1

Management practices in eastern Europe and Central Asia

To estimate how firm management practices relate to performance in the MOI survey sample, the following firm-level production function has been estimated:

$$y_{itc} = \alpha_l l_{itc} + \alpha_k k_{itc} + \alpha_n n_{itc} + \beta M_i + \gamma Z_{itc} + u_{itc}$$

where y is the natural logarithm of sales, l the natural logarithm of labour, k the natural logarithm of capital, and n the natural logarithm of intermediate inputs (materials) of firm i in country c at time t. The Zs are a number of other controls that will affect productivity, such as workforce characteristics (employees with a completed university degree and the average weekly hours worked), firm characteristics (firm age and whether it is listed on the stock market), a set of three-digit industry dummies and country-year (or only country) dummies.

M is the variable of interest and represents average management quality. It is calculated based on a scoring of each of 13 individual management practices, averaged over the variables included in each of the four core areas of management practices, and finally averaged over these four areas (see Annex 5.1 for details).

Table 5.1.1 summarises the findings. Column 1 reports an OLS specification with only labour, three-digit industry and country*time dummies as controls. The management score is strongly and statistically significantly associated with higher labour productivity. The magnitude of the effect is comparable with the one reported in previous research.[14] Adding further controls, such as workforce and firm and interviewer characteristics, reduces the coefficient only slightly (column 2). Adding a measure of materials in column 4 almost halves the management coefficient, along with reducing the sample size, but it remains statistically and economically significant. An improvement in an average firm's management practices from the mid-point (or median) to the top 10 per cent is associated with an increase in productivity of between 6.9 per cent (column 4) and 18.3 per cent (column 1).[15]

Better management practices are also positively and significantly associated with the likelihood both of introducing new products or services (column 6) and of incidence of spending on research and development (R&D – column 7). Nonetheless, little or no evidence was found of a link between management practices and either the percentage of annual sales accounted for by new products and services, or the amount of R&D spending (results not shown). This could possibly reflect greater measurement error in these variables, which are harder for the manager to estimate than incidence.

Table 5.1.1

Firm performance and management practices

	1	2	3	4	5	6	7
Estimation method	OLS	OLS	OLS	OLS	OLS	Probit	Probit
Firms	All	All	All	All	All	All	All
Dependent variable	Ln(Y) Labour Productivity	Ln(Y) Labour Productivity	Ln(Y) Labour Productivity	Ln(Y) Labour Productivity	Ln(Y) Sales	New products in last three years?	Research and development activities in 2007?
Management score	0.1831*** (0.0338)	0.1400*** (0.0362)	0.1263*** (0.0355)	0.0688** (0.0281)	0.1383*** (0.0384)	0.0462*** (0.0112)	0.0709*** (0.0123)
Ln(L) Labour	0.0999*** (0.0385)	0.1571*** (0.0400)	-0.0004 (0.0466)	-0.2916*** (0.0440)	0.9623*** (0.0524)	0.0379** (0.0152)	0.0783*** (0.0146)
Ln(K) Capital			0.1524*** (0.0244)	-0.0583** (0.0236)			
Ln(N) Materials				0.4939*** (0.0271)			
Country*time effects	Yes	Yes	Yes	Yes	Yes	No	No
Country effects	No	No	No	No	No	Yes	Yes
Industry effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Firm controls	No	Yes	Yes	Yes	Yes	Yes	Yes
Firms	834	763	761	627	776	1,458	1,405
Observations	3,469	3,193	3,179	2,590	3,321	1,458	1,405

Source: Estimations based on MOI survey.

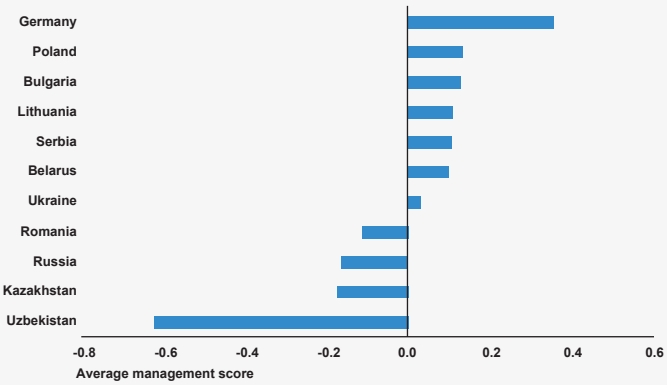
Note: *** – significant at 1 per cent level, ** – significant at 5 per cent level, * – significant at 10 per cent level. In all columns, standard errors are in parentheses beside coefficient estimates and allow for heteroscedasticity and serial correlation. Firm controls include natural logs of firm age, average hours worked by production/non-production workers, share of production/non-production workers with a university degree; a dummy variable for stock exchange listing; and a series of "noise controls" that capture differences across managers who responded to the interview and the interview setting. All regressions include a full set of three-digit industry dummies and country dummies interacted with a full set of time dummies (except columns 6 and 7 which use cross sectional data). The dependent variables in columns 6 and 7 are dummy variables that take the value 1 if the firm answers yes to the relevant question, and 0 otherwise. Average marginal effects are reported in columns 6 and 7. For a full explanation of management scores, refer to Annex 5.1 on page 114.

Main findings

Like previous studies performed in non-transition countries, the MOI survey suggests a strong positive link between management scores and firm performance, as measured by labour productivity, size, sales growth and innovation (for example the introduction of new products). The magnitude of the link can be estimated with econometric techniques: an improvement in an average firm's management practices from the mid-point (or median) to the top 10 per cent is associated with an 18.3 per cent increase in labour productivity when differences in the country where the firm is located, the firm's sector and the size of the firm are controlled for.[16] The effect is smaller, but still significant, when a range of other factors are accounted for (see Box 5.1).

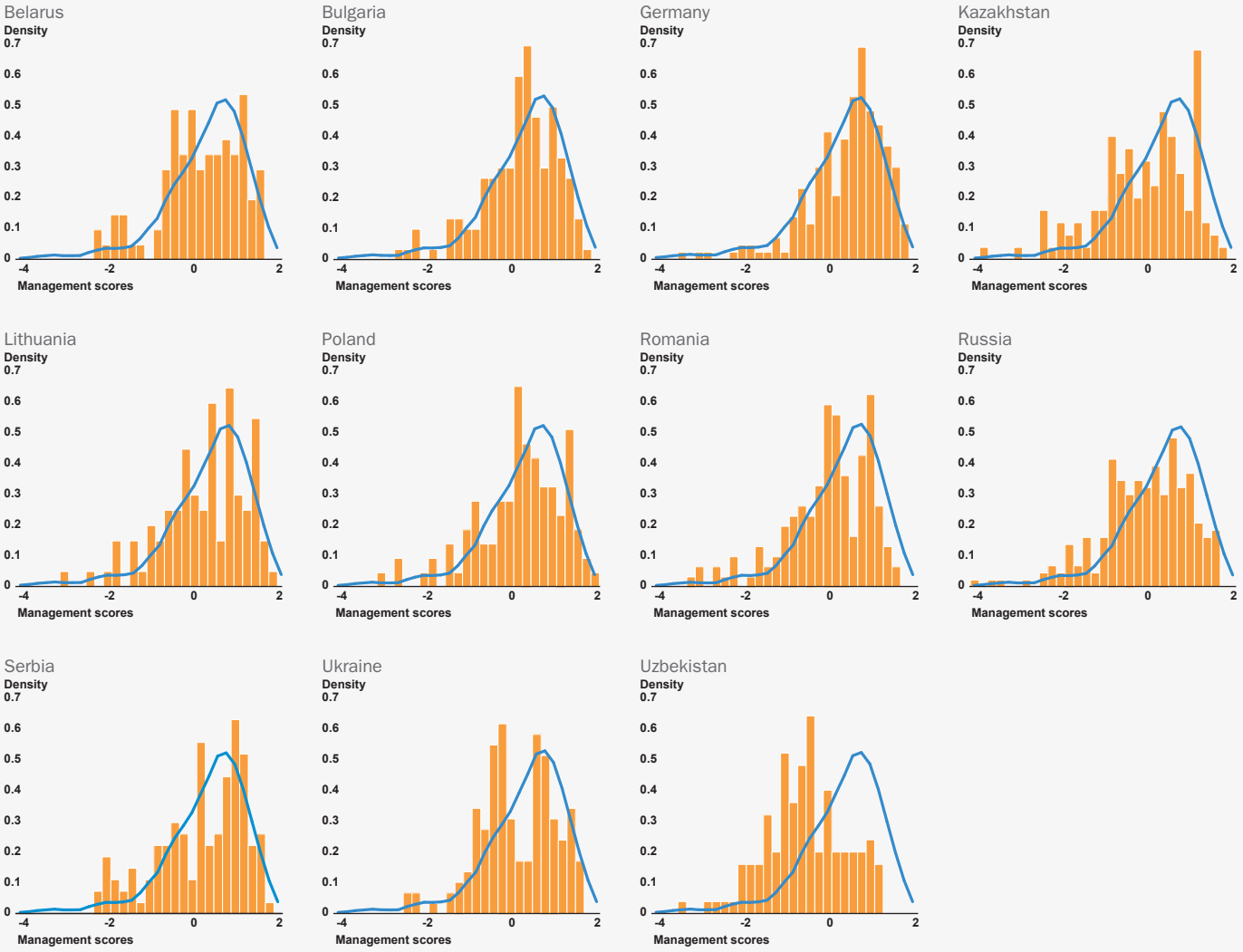
The ranking in Chart 5.3 of surveyed countries in terms of average management practices shows Germany on top and Uzbekistan at the bottom (although this does not mean that Germany has no firms with bad management practices or that Uzbekistan has no good ones). Chart 5.4 shows that there is a wide spread of management scores in every country.

Chart 5.3
Average management scores across countries



Source: MOI survey.
Note: For a full explanation on management scores please refer to Annex 5.1.

Chart 5.4
Distribution of firm-level management scores

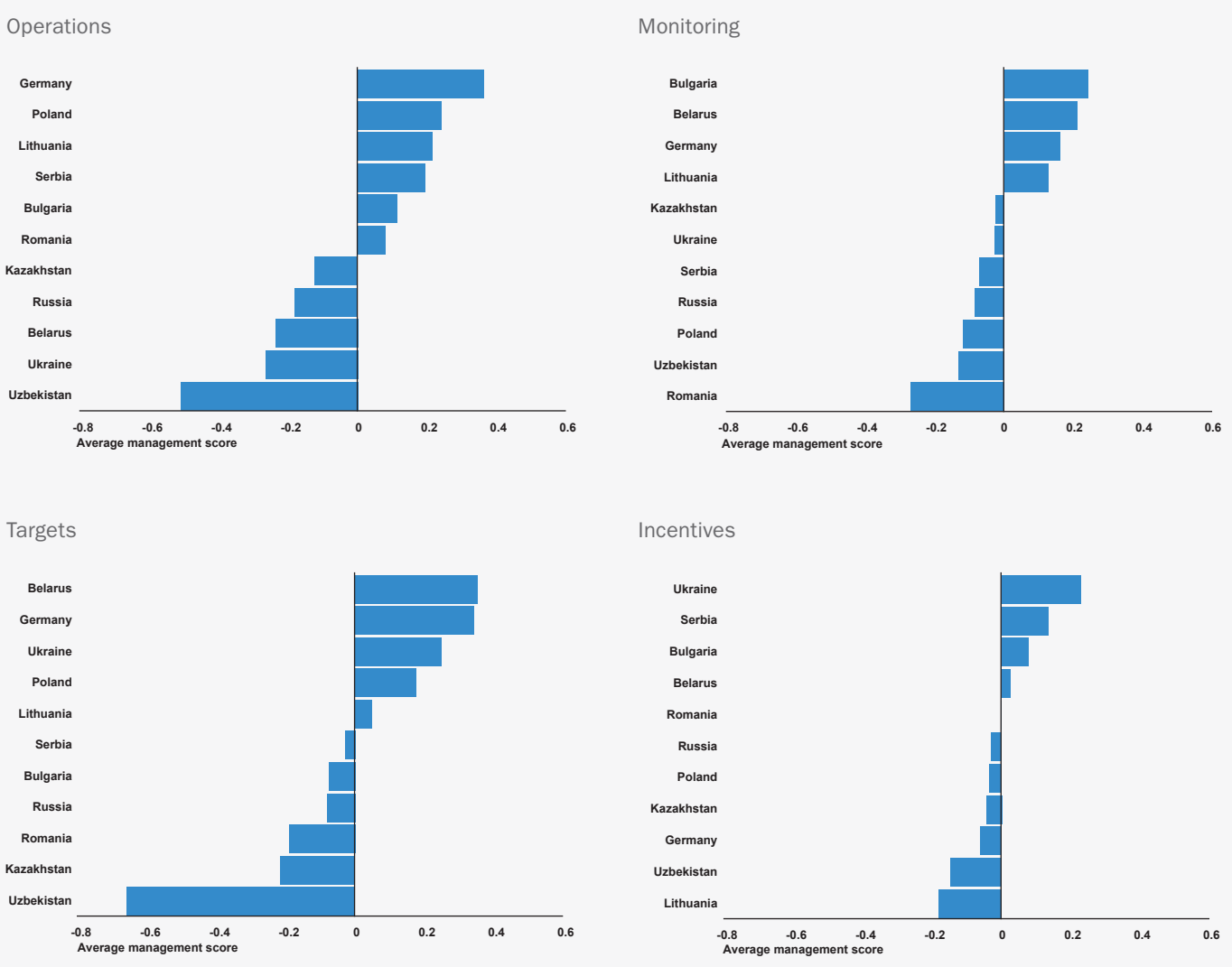


Source: MOI survey.
Note: Fitted distribution for Germany. The density is calculated by dividing the relative frequency (number of values that fall into each class divided by the number of observations in the set) by the class width. For a full explanation of management scores, refer to Annex 5.1 on page 114.

Because of the overlaps in the distribution of management scores across countries, the differences in average scores shown in Chart 5.3 are often small. Indeed, the average scores of Belarus, Bulgaria, Lithuania, Poland, Serbia and Ukraine are not statistically significantly different from each other; nor are there statistically significant differences between the average scores of Kazakhstan, Romania, Russia and Ukraine.

Chart 5.5 shows country rankings for each of the four subcomponents of management practices (operations, monitoring, targets and incentives). In line with the overall rankings, Germany is in the top three in three out of the four categories, while Uzbekistan is consistently in the bottom two. However, there are also some interesting differences across categories. While many firms interviewed in Belarus and Bulgaria, for example, excel at monitoring – that is, frequently collecting data on several production performance indicators, showing it to factory managers and workers, and regularly reviewing the production performance indicators – they are less adept at translating monitoring into operations. Firms in Belarus also tend to be good at targets management (which is perhaps a legacy of meeting planned production targets). However, this is not the case in Kazakhstan and Uzbekistan. The most eclectic ranking emerges on incentives management, although differences across countries are smaller in this category than in others and often not statistically significant. It is nevertheless striking that Germany and Lithuania join Uzbekistan in the bottom three, perhaps reflecting a continental European management culture that de-emphasises high-powered incentives.

Chart 5.5
Average management scores by subcomponent



Source: MOI survey.
Note: For a full explanation of management scores, refer to Annex 5.1 on page 114.

How different is the transition region?

Although the MOI survey did not include non-transition countries (except for Germany), a broader international comparison is possible using average management scores from related studies of non-transition countries (see Chart 5.6).[17] Two facts are striking. First, six out of the 10 transition economies studied in the MOI – Belarus, Bulgaria, Lithuania, Poland, Serbia and Ukraine – are statistically indistinguishable in terms of average scores from more advanced EU countries such as Greece, Ireland and Portugal. Second, the remaining transition countries – Kazakhstan, Romania, Russia and Uzbekistan – are at the bottom of the ranking (and below China).

Like the transition economies, China was a centrally planned economy during most of its post-war history. However, it started the process of transition to a market-based system at least 10 years earlier than those countries in the MOI sample (beginning with an initial set of economic reforms in 1978, followed by a second phase in 1982 aiming to introduce market institutions). China's better management practices could also be related to foreign direct investment (FDI) and foreign ownership. Previous research[18] shows that foreign-owned firms tend to have better management practices than domestically-owned enterprises. While Kazakhstan and Russia (but not Uzbekistan) enjoy considerable FDI, it is mostly concentrated in the natural resources sector rather than in manufacturing. In contrast, FDI in China has targeted the manufacturing industry, potentially benefiting the management practices of a larger set of firms.

Explaining differences across firms

Three factors may help to explain the differences in firm-level management scores.[19] First, managers' self-reported measure of the number of competitors is positively and significantly related to management practices. The importance of competitive intensity in improving productivity and management is a robust finding from a wide range of economic studies. Stronger competition can drive out poorly managed firms but can also change the behaviour of incumbent managers who have to lift their performance in order to survive and prosper. (Lack of competition may partly explain the relative scarcity of well-managed firms in Uzbekistan.)

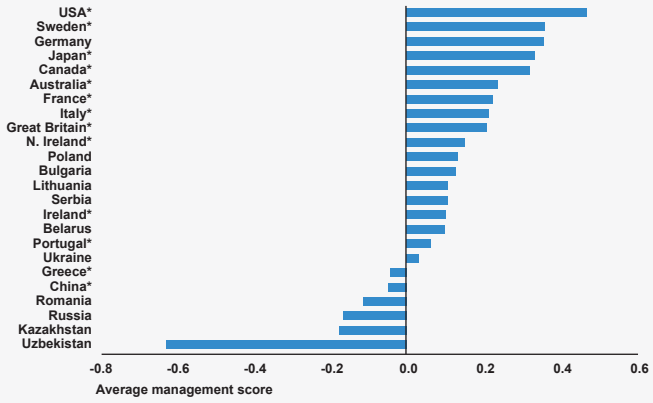
Second, ownership matters. Firms with foreign owners from non-transition countries have the best management practices (suggesting that openness to foreign investment is key to spreading best practice) while state-owned firms tend to have the worst. There are at least two possible explanations for this: managers of state-owned firms might have been selected because of political or bureaucratic connections rather than managerial ability; and state-owned firms need to worry less about surviving in the market.[20]

Lastly, privatised (formerly state-owned) firms have similar management practices to enterprises that were privately owned from the beginning, suggesting that privatisation is an effective medium-term means of improvement. Given the importance of privatisation in transition countries, this is an encouraging result. Furthermore, the quality of management practices is not significantly associated with the number of years since privatisation. This suggests that, while privatisation does tend to improve management, the magnitude of improvement over the years probably depends on the new owners.

Competition

Having highlighted cross-country differences in the business environment and managerial practices, both within the transition region and compared to benchmarks outside, the remainder of this chapter focuses on cross-country differences at the sector level, beginning with competition. Previous EBRD research has shown that levels of product market competition in transition economies (measured in terms of average profit mark-ups) have increased substantially since the beginning of the 1990s. However, they remain below the Organisation for Economic Co-operation and Development (OECD) average, and there is generally less competition in the EEC+R+CA and SEE countries than in the CEB region.[21] These cross-country differences cannot necessarily be interpreted in terms of product market regulation or barriers to entry. Some sectors, such as commodities or pharmaceuticals, tend to have intrinsically higher profit mark-ups, and so a proportion of the differences in observed average mark-ups could reflect differences in sector composition. It is therefore important to compare competition measures at the sector level.

Chart 5.6
Average management scores across the world



Sources: Bloom and Van Reenen (2009) and MOI survey.

Note: * indicates that the management scores are from the Bloom and Van Reenen (2009) management practices survey. For a full explanation of management scores, refer to Annex 5.1 on page 114.

Table 5.3 gives a comparison of mark-ups across defined manufacturing sectors based on data from 2005-07 for 25,000 firms in 10 transition countries as well as Germany, India, Indonesia and the United Kingdom.[22] The table shows that manufacturing firms in transition economies – even in CEB countries – generally have rather higher profit margins, indicating a lower degree of competition than for firms in Germany or the United Kingdom. However, the differences between the CEB countries (and Ukraine) on the one hand and non-transition countries on the other disappear when the comparison is extended to emerging markets such as India. In contrast, profit margins in the three SEE countries (Bosnia and Herzegovina, Romania and Serbia) are generally higher. There is significant heterogeneity in this comparison: in some sectors, such as pharmaceuticals or rubber and plastics, profit margins are substantially higher in transition countries, while in other sectors, such as food, they are in line with Germany or the United Kingdom (except in the case of Bosnia and Herzegovina).

Apart from cross-country differences in average profit margins, Table 5.3 also shows substantial variation in the degree of competition between manufacturing sectors within a country. Companies operating in Poland face tougher competition if they operate in the food industry than if they produce refined petroleum products. This may reflect differences in barriers to entry, the degree of specialisation or research and development (R&D) intensity between these sectors. There are also significant differences in mark-ups in the same sector across countries – from very low in basic metals manufacturing to large in beverage production – suggesting that incumbent market power may play a role in this respect.

Table 5.3
Competition in the manufacturing sector

			Central Europe and the Baltic states					SEE			Other		Comparator countries			
		Sector average	Estonia	Hungary	Latvia	Poland	Slovenia	Bosnia and Herz.	Romania	Serbia	Turkey	Ukraine	India	Indonesia	Germany	UK
Food		0.08	0.09	0.08	0.07	0.08	0.08	0.18	0.09	0.09	0.09	0.07	0.09	0.08	0.07	0.08
Beverages		0.12	0.15	0.14	na	0.11	na	0.20	0.12	0.14	na	0.09	0.09	n.a.	0.14	0.15
Tobacco		0.10	na	na	na	0.08	na	na	0.10	0.13	na	0.13	0.10	0.07	0.02	0.10
Textiles		0.12	0.11	0.11	na	0.11	0.07	0.19	0.14	0.13	na	0.09	0.13	0.10	0.08	0.08
Wearing apparel		0.11	0.10	0.09	na	0.08	0.08	0.29	0.14	0.12	na	0.08	0.10	0.07	0.06	0.06
Leather		0.11	0.08	0.10	na	0.10	0.06	0.24	0.13	0.11	na	0.06	0.11	0.06	0.07	0.08
Wood		0.11	0.11	0.13	0.10	0.10	0.10	0.15	0.13	0.10	na	0.08	0.11	0.06	0.08	0.07
Paper		0.10	0.11	0.09	na	0.10	0.10	0.20	0.11	0.11	na	0.10	0.11	0.15	0.09	0.09
Printing		0.13	0.15	0.13	0.16	0.13	0.12	0.24	0.18	0.14	na	0.10	0.17	na	0.12	0.10
Petroleum refineries		0.10	na	na	na	0.14	na	0.08	0.09	0.11	na	0.05	0.09	na	0.07	0.14
Chemicals		0.11	0.11	0.09	na	0.11	0.10	0.13	0.15	0.11	na	0.06	0.12	0.05	0.09	0.11
Pharmaceutical products		0.14	0.30	0.16	na	0.14	na	0.24	0.17	0.16	na	0.12	0.13	0.06	0.12	0.14
Rubber and plastic		0.11	0.10	0.10	na	0.11	0.14	0.21	0.12	0.11	na	0.08	0.12	0.11	0.08	0.09
Other minerals		0.13	0.16	0.12	na	0.15	0.10	0.22	0.14	0.12	0.15	0.10	0.14	0.19	0.10	0.13
Basic metals		0.09	na	0.09	na	0.08	na	0.13	0.10	0.10	na	0.07	0.10	0.04	0.08	0.09
Fabricated metal		0.11	0.11	0.11	na	0.10	0.14	0.23	0.13	0.13	na	0.08	0.12	0.09	0.09	0.10
Furniture		0.10	0.11	0.08	0.10	0.08	0.15	0.21	0.11	0.11	na	0.08	na	0.09	0.07	0.07
Other manufacturing		0.12	0.17	0.08	na	0.13	0.11	0.30	0.17	0.15	na	0.12	0.11	na	0.10	0.11
All manufacturing	**mean**	0.11	0.11	0.10	0.10	0.10	0.11	0.19	0.12	0.11	0.12	0.08	0.11	0.09	0.09	0.10
	s.d.	*0.10*	*0.09*	*0.09*	*0.06*	*0.08*	*0.09*	*0.18*	*0.10*	*0.10*	*0.08*	*0.07*	*0.11*	*0.07*	*0.08*	*0.09*

Source: EBRD staff calculations based on Orbis data.

Note: Sector average indicates the difference between value added and the total wage bill expressed as a share of gross output. The index varies between 0 and 1 with higher values indicating less competition.

Research shows that cross-country differences in mark-ups reflect a variety of factors,[23] including stages of development of certain industries. The relatively lower degree of competition in the pharmaceutical industry, for example, might be explained by the comparatively low level of development of this high-technology sector in transition countries (as also evidenced by the low number of registered patents or R&D investments). Differences in tariffs and trade regimes (including World Trade Organization (WTO) pre-accession reforms) and changes in corporate tax levels also matter, as they influence barriers to entry and therefore competitive pressure on incumbents. A further important determinant of actual product market competition is the efficiency and effectiveness of competition policy. Analysis shows that countries that rank higher on the EBRD competition policy indicator do indeed seem to have lower firm mark-ups. This relationship holds true across virtually all manufacturing sectors in the transition region (with the exception of pharmaceuticals, which is not very competitive even if the overall policy environment is conducive to competition).

Remaining transition challenges: a sector approach

This section moves from cross-country comparisons to perhaps the most important question posed at the beginning of this chapter – what are the principal reform and institutional development challenges that remain in transition countries? This can be considered at the sector level using the summary findings of a forthcoming EBRD study, the *2009 Assessment of Remaining Transition Challenges*, encompassing 13 specific sectors in 29 countries.[24] The study defines a set of transition benchmarks and measures the gap between where countries stand to date and the "end-zone" of transition in terms of two components:

— market structure – the balance between the private sector and the state and the extent of competition

— market-supporting institutions and policies – the regulatory and policy framework underpinning the functioning of the market in a given sector.

Report methodology

For every country, each of the 13 sectors was rated on a four-point scale (negligible, small, medium or large remaining transition challenges) for the two components, and also given an overall rating. Rating the transition challenge in each sector and country involved a four-step process.

— First, for each sector, EBRD economists defined a broad vision of what constitutes good market structure and strong market-supporting institutions. Each was typically defined in terms of three or four criteria related to principles such as efficiency, competition, accountability, transparency and competence.

— Second, a set of indicators was identified to help rate countries on each of these criteria (typically on a 10-point scale), based where possible on data from publicly available sources.

— Third, a scoring and weighting scheme was applied at three levels in order to: generate scores for each of the main three to four criteria underlying the market structure and market-supporting institutions categories; weight these criteria to establish overall market structure and market-supporting institutions ratings; and average these two main components (usually applying 50-50 weights, but with variations – for example, 45-55 or 60-40 – in some cases).

— Fourth, a judgemental check was applied to ensure that the interaction between market structure and institutions was appropriately reflected. In some cases this led to modifications in the final rating, particularly where there was a large discrepancy between the two component ratings. When the institutions rating was below the market structure rating, the final score was usually adjusted downward on the presumption that a good supporting institutional framework is critical for the proper functioning of markets.

Table 5.4 shows an example of the full methodology (except for the judgemental step) in the *general industry* sector. The weights assigned to the components and criteria are indicated in square brackets.

Table 5.4
Rating transition challenges in the general industry sector

Components	Criteria	Data
Market structure [60%]	Market-determined prices [20%]	– Price liberalisation (EBRD *Transition Report*, 2008) – Subsidies in per cent of GDP (CEIC database, 2007) – Energy intensity (Enerdata, 2007)
	Competitive business environment [40%]	– MFN trade weighted tariff (World Bank, 2008) – Lerner index (EBRD calculation from UNIDO dataset, 2006) – Large-scale privatisation (EBRD *Transition Report*, 2008)
	Productivity and efficiency [40%]	– R&D in per cent of GDP (UNESCO, 2007, 2006) – Value added per employee (UNIDO, 2006 and CEIC database, 2007) – Knowledge Index on knowledge economy (World Bank, 2008)
Market-supporting institutions and policies [40%]	Facilitation of market entry and exit [40%]	– *Doing Business – starting a business* (World Bank, 2008) – *Doing Business – closing a business* (World Bank, 2008) – Enterprise Surveys – percentage of firms identifying permits and licences as major constraint (EBRD and World Bank, 2009)
	Enforcement of competition policy [30%]	– Competition index (EBRD *Transition Report*, 2008)
	Corporate governance and business standards [30%]	– Quality of legislation in corporate governance (EBRD Legal Transition Team survey, 2007) – ISO 9001 and ISO 14001 (ISO survey, 2007)

Source: *Assessment of remaining transition challenges*, EBRD.

Table 5.5

Assessment of transition challenges by country and sector: summary of results

	Corporate				Energy and infrastructure					Financial institutions			
	Agribusiness	General industry	Property and tourism	Telecoms	Municipal and environmental infrastructure	Natural resources	Power	Sustainable energy	Transport	Banking	Non-bank financial institutions	MSMEs	Private equity and capital markets
Central Europe and the Baltic states	2.00	1.63	2.13	2.00	2.13	2.13	2.13	2.50	2.63	2.13	2.13	2.88	2.75
Croatia	2	2	3	2	3	2	3	3	3	2	2	3	3
Estonia	2	1	2	2	2	2	2	3	2	2	2	3	3
Hungary	2	1	2	2	2	2	2	2	2	2	2	3	2
Latvia	2	2	2	2	2	2	2	3	3	3	2	3	3
Lithuania	2	2	2	2	2	2	2	2	3	2	2	3	3
Poland	2	2	2	2	2	3	2	2	2	2	2	3	2
Slovak Republic	2	1	2	2	2	2	2	3	3	2	2	2	3
Slovenia	2	2	2	2	2	2	2	2	3	2	3	3	3
South-eastern Europe	3.00	3.00	3.29	2.71	3.00	2.71	3.14	3.14	3.14	2.86	3.00	3.00	3.57
Albania	3	3	3	3	4	3	3	3	4	3	4	3	4
Bosnia and Herzegovina	3	4	4	3	4	3	4	4	3	3	3	3	4
Bulgaria	3	2	3	2	2	2	2	2	3	2	2	3	3
FYR Macedonia	3	3	3	3	3	3	3	3	3	3	3	3	4
Montenegro	3	4	4	3	3	3	4	4	3	3	4	3	4
Romania	3	2	3	2	2	2	2	2	3	3	2	3	3
Serbia	3	3	3	3	3	3	4	4	3	3	3	3	3
Turkey	3	3	2	3	3	3	3	3	3	3	3	3	2
Eastern Europe and the Caucasus	3.17	3.50	3.67	3.33	3.83	3.50	3.50	3.67	3.50	3.50	3.83	3.50	4.00
Armenia	3	3	3	3	3	3	3	3	3	3	4	3	4
Azerbaijan	3	4	4	4	4	3	4	4	3	4	4	4	4
Belarus	4	4	4	4	4	4	4	4	4	4	4	4	4
Georgia	3	3	3	3	4	4	3	3	3	3	4	3	4
Moldova	3	4	4	3	4	3	3	4	4	4	4	3	4
Ukraine	3	3	4	3	4	4	4	4	4	3	3	4	4
Russia	3	3	3	3	3	4	3	4	3	3	3	4	3
Central Asia	3.50	4.00	3.83	3.50	4.00	3.83	3.83	4.00	3.83	3.83	3.83	4.00	3.83
Kazakhstan	3	4	3	3	4	4	3	4	3	3	3	4	3
Kyrgyz Republic	3	4	4	3	4	3	4	4	4	4	4	4	4
Mongolia	3	4	4	3	4	4	4	4	4	4	4	4	4
Tajikistan	4	4	4	4	4	4	4	4	4	4	4	4	4
Turkmenistan	4	4	4	4	4	4	4	4	4	4	4	4	4
Uzbekistan	4	4	4	4	4	4	4	4	4	4	4	4	4
EBRD region	2.96	3.04	3.21	2.93	3.25	3.11	3.18	3.39	3.32	3.11	3.21	3.43	3.54

1 = negligible challenge 2 = small challenge 3 = medium challenge 4 = large challenge

Source: *Assessment of remaining transition challenges*, EBRD.

A consequence of this approach is that two countries may have similar gaps or challenges, as measured by the value of the overall index, as a result of very different combinations of strengths and weaknesses in market structure and market-supporting institutions and policies. This supports the perception that there is not a unique transition path and that countries can embrace different market models and institutions that deliver outcomes of comparable quality.

Results

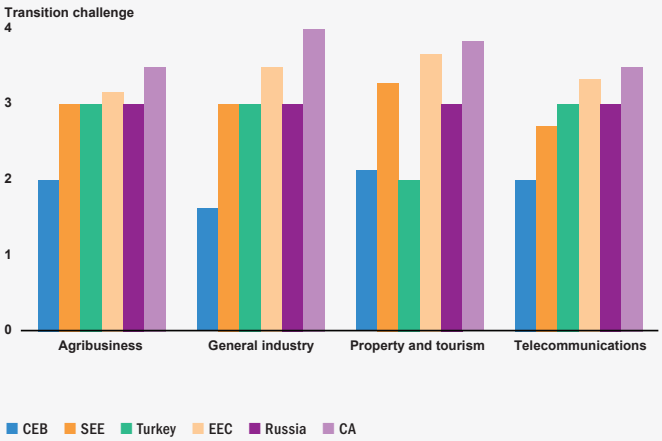
Table 5.5 shows the assessments made for transition gaps for all sectors and countries. Out of a total of 377 sector/country ratings, there are 284 medium or large challenges as against 93 small or negligible ones. There are just three negligible ratings overall (in general industry in CEB).

— In Central Asia there are large transition gaps in nearly all sectors, while large or medium gaps dominate in EEC, Russia and Turkey. Market development in these countries is seriously hampered by state interference in various sectors, the lack of an adequate legal framework (or its effective implementation) and an unfavourable business environment.

— In SEE there is a mix of small, medium and large challenges (with small challenges prevalent in the two EU countries of Bulgaria and Romania). Despite a gradual alignment of regulation with EU standards, further work is needed in most countries to implement international best practice and strengthen the implementation capacity of regulatory authorities.

— In CEB transition gaps are mainly small, with the exceptions of sustainable energy, transport and financial institutions where medium challenges remain. All countries have aligned their institutional frameworks with EU norms, and the remaining challenges relate mainly to improving efficiency, productivity and competition.

Chart 5.7
Transition challenges in the corporate sector



Source: EBRD.
Note: 1 = negligible challenge, 2 = small challenge, 3 = medium challenge, 4 = large challenge.

At the sector level, transition gaps are smallest in the corporate group of sectors, with agribusiness, general industry and telecommunications having the highest concentration of small and/or negligible ratings. Within the energy and infrastructure group, the challenges are greatest in sustainable energy and in transport, where 23 and 26 countries face medium and large challenges, respectively. In the financial institutions group 28 and 26 countries have medium and large challenges in the small business finance and private equity and capital markets sectors, respectively. The sections below summarise the results for each of the three broad groups of sectors.

Corporate sectors

The remaining transition challenges in the corporate group of sectors – agribusiness, general industry, telecommunications and property and tourism – are smaller than in the other groups, but medium and large transition gaps remain in all subregions other than CEB (see Chart 5.7).

General industry still faces issues related to the restructuring of sensitive industries (such as shipbuilding in Croatia and chemicals in Poland) and a continued high level of state involvement, which have hampered improvements in efficiency and competition. Hurdles remain particularly in business start-up and bankruptcy procedures, and corporate governance and business standards remain weak. Ukraine's accession to the WTO should give further impetus to enterprise reform, although close links between business and politics, weak governance and transparency, and significant barriers to market entry and exit remain key challenges for the country.

In the telecommunications sector, lack of competition and inadequate tariffs (pricing) in many countries have led to an investment backlog and, in many cases, a deterioration in infrastructure. In the CEB countries the main outstanding challenges relate to the legal framework (for example, intellectual property rights), regulatory capacity and infrastructure. In Central Asia and most EEC countries, challenges are much larger. Many countries still need to liberalise their markets, and penetration rates are generally low. In some cases, state-owned incumbents hamper competition and commercial incentives and regulation suffers from strong political influence.

In the agribusiness sector the development of efficient private farms remains a challenge, particularly in Central Asia and EEC, due to unclear property rights, land fragmentation and the lack of active land markets. State support measures in the meat, dairy products, sugar and tobacco segments distort the market while lack of infrastructure contributes to lower yields and prevents countries from realising their full agricultural potential. Quality and hygiene standards also need to be improved.

Clearer ownership rights and simpler procedures for land registration and building permits are critical for a balanced longer-term development of the property and tourism sector. Although this sector has witnessed rapid growth in recent years in many countries, investments have been concentrated in the capital cities, leaving regional centres underfunded. With the exception of Georgia, the property sectors of nearly all Central Asian and EEC countries remain underdeveloped, endure a difficult business environment and need further regulatory reform.

Energy and infrastructure sectors

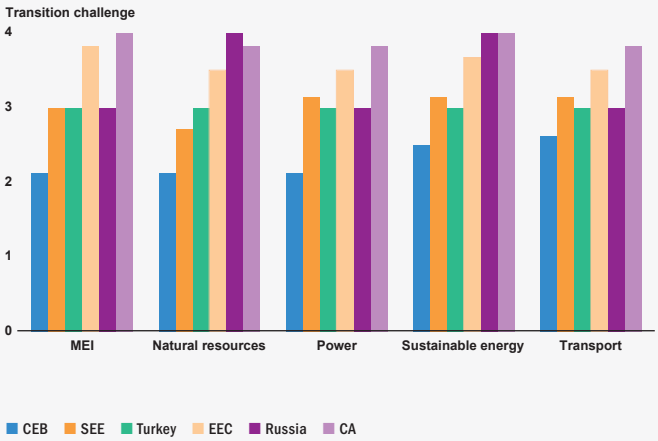
Remaining transition challenges are concentrated in Central Asia and EEC and particularly in the infrastructure sectors. In CEB and SEE regions the process (or prospect) of EU accession (involving the harmonisation of legislation and regulations) has been a key driver of reforms in these countries, leading to greater market conformity and stronger institutions. In Russia large challenges remain in the natural resources and sustainable energy sectors, which are increasingly dominated by state-owned, energy-intensive enterprises (see Chart 5.8).

Key challenges in municipal and environmental infrastructure include improving tariff systems, promoting contractual arrangements that foster commercialisation and widening regulatory autonomy. This is applicable particularly to non-EU countries in SEE, where municipal services have been decentralised and corporatised but financial performance is still generally weak and private sector participation limited. In Central Asia and EEC financial and operational performance remains poor. There needs to be tariff reform (as water and district heating tariffs barely cover operating costs) and improvements in governance, regulation and transparency of contractual arrangements.

In the transport sector the implementation of successful public-private partnerships remains a challenge in CEB, although new efforts are under way in Latvia and the Slovak Republic. Transport operation and policy functions have been separated in the CEB and SEE regions, and road construction and maintenance have generally been contracted out. However, full commercialisation of the railways has yet to be achieved and road concession policies and financing arrangements generally remain below EU standards. In Russia the private sector has played an increasing role in transport services, accounting for a major part of port terminal expansion and rail fleet renewal, but the restructuring and commercialisation of state-owned entities needs to be addressed. In the Central Asian countries, core railway businesses continue to operate under state control (except in Kazakhstan) and the road sector remains largely unreformed, with no private sector participation, limited commercial financing and a rudimentary institutional framework.

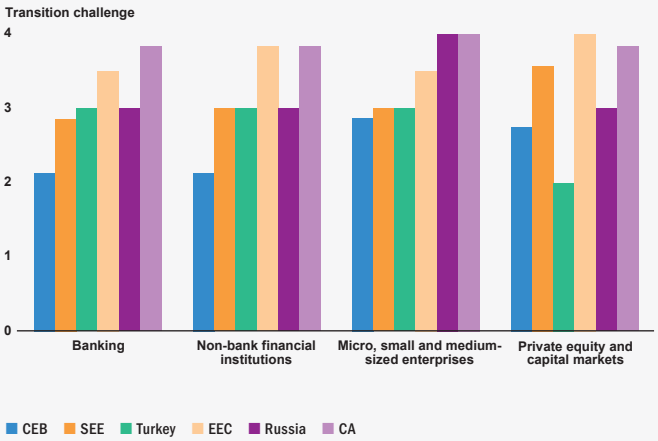
In the natural resources sector, breaking the monopoly of largely unreformed and non-transparent state-owned oil and gas companies and improving corporate governance and environmental conduct are key challenges in countries such as Azerbaijan, Kazakhstan, Russia, Turkmenistan and Uzbekistan. In the CEB, SEE and resource-importing EEC countries, remaining challenges include diversifying energy sources and suppliers, granting third-party access to transmission networks, and promoting greater competition and entry into the downstream power supply industry. Coal sector reform is an important outstanding issue in those countries with substantial reserves, such as Poland where a medium transition gap remains.

Chart 5.8
Transition challenges in the energy and infrastructure sectors



Source: EBRD.
Note: 1 = negligible challenge, 2 = small challenge, 3 = medium challenge, 4 = large challenge.

Chart 5.9
Transition challenges in the financial institution sectors



Source: EBRD.
Note: 1 = negligible challenge, 2 = small challenge, 3 = medium challenge, 4 = large challenge.

In the power sector, low energy tariffs and slow progress in enterprise restructuring have hampered progress towards energy efficiency across the transition region. In many countries, domestic gas and electricity prices are not cost-reflective and do not provide incentives to use energy efficiently and invest in renewable sources. With the exception of the new EU member states (where liberalisation, private sector participation and regulation have advanced), transition challenges in the rest of the EBRD countries of operations remain formidable. Power sectors are still vertically integrated, state-owned and only partially unbundled. Transmission and distribution losses are high, regulators are not fully independent, there are affordability constraints on tariff reform, and the legal and institutional capacity for implementing sustainable energy initiatives is low.

In the light of the implications of global climate change, measuring progress towards meeting energy efficiency targets for countries in the transition region (in terms of institutions, policies and outputs) is increasingly important. The EBRD's Index of Sustainable Energy (ISE) suggests that 23 transition countries still face medium or large challenges in this area.[25] The legacy of central planning in terms of inefficient use of resources is still prevalent and much remains to be done to improve market structures and supporting institutions to secure energy sustainability.

Financial institution sectors

Transition challenges in these sectors reflect unfinished financial deepening and capital market development reforms, particularly in Central Asia and EEC (see Chart 5.9). In addition, shortcomings in supervisory and regulatory institutions have been exposed by the global financial crisis, even in CEB countries.

In the banking sector, the credit boom over the period 2004-08 widened access to finance for many borrowers and broadened the range of available products and services. However, the crisis that engulfed the region from late 2008 revealed the full extent of the remaining transition challenges in terms of supervision, internal bank governance and risk management. With a few exceptions, such as in Poland and the Slovak Republic, bank supervision generally did not effectively address excessive credit growth or foreign currency exposures by unhedged borrowers. In addition, the crisis exposed an excessive concentration of bank assets in a limited number of areas (for example, construction, real estate and mortgage lending), suggesting that the risk management of banks was less sophisticated than previously thought. In some countries, notably Kazakhstan, the crisis highlighted an over-reliance on wholesale funding. Russia's fragmented banking sector (with its underdeveloped segments such as mortgages and lending in the more remote regions) was also exposed – although the authorities have initiated a number of regulatory reforms to facilitate mergers and raise capital requirements.

For the micro, small, and medium enterprises (MSME) sector, the crisis has shown that the improved access to funding was to some extent the product of the credit boom and it remains to be seen how the sector recovers after the crisis recedes. In many Central Asian and EEC countries and in Russia, small business lending continues to be hampered by structural impediments. Improved credit information services, better enforcement of bankruptcy laws and the establishment of a central collateral registry are necessary to strengthen lending on a sustainable basis.

The non-bank financial institutions sector (incorporating services such as leasing, insurance and asset management) remains underdeveloped. Given the demographic make-up of the transition region, the establishment of privately funded and managed pension systems based on capital accumulation is a central challenge. The problems arising both from cross-border wholesale lending and foreign exchange bank funding (see Chapters 2 and 3) have underlined the importance of developing local currency money and bond markets. Only Hungary, Poland, Russia and Turkey have such markets, but there remains scope for making these deeper and more liquid, particularly at longer maturities.

Regarding the private equity and capital markets sector, domestic equity markets are generally small and relatively illiquid (with the exception of Hungary, Poland, Russia and Turkey). In many Central Asian, EEC and some smaller SEE countries, regional financial integration may make more sense than building domestic securities markets – a strategy already adopted by some of the smaller CEB countries. Private equity has played an important role in firm restructuring and as a source of risk-oriented capital in more advanced transition countries. It could also be an important substitute for public equity markets in less advanced transition countries but this will require stronger shareholder rights and better corporate governance and accounting practices.

Conclusion

This chapter has analysed the status of transition from four perspectives: the business environment, competition, managerial practices, and an examination of 13 specific sectors. Although quite different in emphasis, they give rise to a consistent picture. The most striking finding, in all four analyses, is the heterogeneity of the transition region. This impression arises not only when the region is considered on its own, as in the sector assessment of transition challenges, but also in comparison with other regions. In terms of business environment, competition and managerial practices, countries in the CEB region appear at about the same level as – or indeed ahead of – large emerging market countries. However, this is not true for transition countries in other regions.

— On average, firms in EEC+R+CA rate their business environment as worse than in other emerging market regions (or about the same as that reported by Latin American firms).

— The nature of the main reported obstacles in the EEC+R+CA region is also different, with more complaints about the judiciary, crime, business permits and workforce education compared to the CEB, SEE and non-transition developing countries. In contrast, the only obstacle that is rated higher in CEB compared to other regions is labour regulations.

— With respect to managerial practices, the Central Asian countries and Russia lag behind not only Western benchmarks but also China, while the CEB countries rate similarly with countries such as Greece, Ireland and Portugal.

— Regarding competition, lack of data precludes sector-level comparisons that include most EEC+R+CA countries. However, data for three SEE countries for the 2001–04 period suggest that these countries lagged behind CEB, Ukraine and other developing country benchmarks.

— Sector-level analyses show small transition gaps in a majority of sectors in CEB countries, medium gaps in Armenia, Georgia, Kazakhstan, Russia and most SEE countries (except Bulgaria and Romania) and predominantly large gaps elsewhere.

In light of these results, the question at the start of this chapter of how different the transition region still is to other countries has no clear-cut answer. It may be more useful to ask how large the group of transition countries still is. The answer will depend on the sector and the aspect of transition that is emphasised. In general, the analysis of this chapter indicates that most countries in Central Asia, EEC and SEE still face challenges that distinguish them from other countries at comparable income levels. In contrast, most new EU member states now appear to have more in common with non-transition emerging market countries (or even other EU countries) than with the less advanced transition economies. Even within the group of new EU member states, however, significant transition challenges remain in some sectors. This is particularly so in respect of sustainable energy and energy efficiency, and also the financial sector where regulatory and supervisory regimes require strengthening, small business finance needs to be further improved and local capital markets need to be developed.

The large transition gaps in most Central Asian and EEC countries lead to the question of why these countries have failed to catch up. Chapters 3 and 4 have suggested partial answers. Integration into the European Union – a powerful motor of reform – has not been an option for some more distant countries. In addition, institutional reform (which facilitates reform more generally) is much more difficult in resource-rich countries. These points may help to explain why the Central Asia-EEC group as a whole has reformed less vigorously and why some countries within the group – such as Armenia or Georgia – have done better. Nonetheless, it remains a puzzle as to why progress in reform in some other countries that do not suffer from a resource curse has remained slow and why some resource-rich countries have advanced much less than other equally resource-rich peers. A better understanding of these questions will be critical in determining how countries can avoid the “low reform trap” that may compromise their prospects for development far into the future.

Endnotes

1 See EBRD *Transition Report* 1999 for an overview of the initial reforms and transition in its first decade.

2 See Besley et al (2009).

3 Earlier rounds of the BEEPS were conducted in 1999, 2002 and 2005, and have been analysed in the EBRD *Transition Reports* published in those years. BEEPS IV is the most ambitious round to date, covering nearly 12,000 firms in 29 countries of the transition region (compared to around 9,000 firms in 27 countries in 2005). The interviews were carried out in 2008 and early 2009. Unlike in previous survey rounds, which concentrated mainly on small and medium-sized enterprises, the aim has been to construct a representative sample of all types of companies. About 25 per cent of the enterprises in BEEPS IV are large. Virtually all firms in the sample are privately owned (and mostly private from their inception rather than privatised), with only just over 1 per cent still majority state-owned. 100 per cent state-owned firms were not eligible for inclusion in the survey.

4 The ranking of countries on the corruption score is fairly similar to that of Transparency International (rank correlation coefficient: 0.65).

5 The average scores reported in Table 5.1 are not adjusted for firm or country characteristics; in particular, whether or not firms or countries have been growing in recent years. As a result, differences in reported obstacles could reflect differences in demand for certain public goods, such as education, in addition to a lack of supply of such goods. See Carlin, Schaffer and Seabright (2007).

6 Within the BEEPS, there are a number of questions about infrastructure services. For example, respondents are asked about the number of power outages they experienced, and their severity in terms of length and extent of losses caused by them. These answers can then be related to the subjective perceptions as a cross-check on the validity of the latter.

7 This statement applies to the comparison of EEC, Russia and Central Asia on the one hand and CEB and SEE on the other. The correlation of corresponding BEEPS and *Doing Business* indicators on a country-by-country basis is lower, albeit positive (depending on the indicator, between 0 and 0.5). For the relative merits of objective and subjective indicators of the business environment see Bertrand and Mullainathan (2001), Gelb, Ramachandran, Kedia-Shah and Turner (2007) and Gaelle and Scarpetta (2004).

8 Focusing on the percentage of firms reporting a non-zero score avoids having to rescale the scores of surveys to achieve comparability over time, in the light of changes in the scale. A rescaled average score would give broadly similar results. The main exception is the variable "functioning of the judiciary" which rises, rather than falls, in the 2008/09 BEEPS round if an average score is used.

9 Questions about perceived obstacles to infrastructure were not asked in the 1999 BEEPS round.

10 This conclusion is supported by a detailed analysis by the World Bank (2009).

11 In particular, firms in a generally bad business environment may take a more restrictive view on when to call an obstacle "very serious" compared to those in a generally good environment, so that average obstacle scores may understate differences across countries.

12 This ranges from Estonia (ranked 3rd worldwide) to Ukraine (ranked 73rd out of 76).

13 See Bloom and Van Reenen (2007, 2009).

14 Bloom and Van Reenen (2007).

15 The performance of firms is also positively and significantly associated with most of the underlying 13 management practices as well as all of the four subcomponents of management practices (operations, monitoring, targets and incentives). See Bloom, Schweiger and Van Reenen (2009).

16 An increase of this magnitude represents approximately one standard deviation in the estimated sample.

17 See Bloom and Van Reenen (2009). This is a rough and ready comparison as there are methodological differences between the Bloom and Van Reenen (2007, 2009) studies and the MOI survey (see Annex 5.1). The comparison exploits the fact that some of the firms in Germany and Poland participated in both surveys, with relatively high and statistically significant correlations between the management scores across both. The scores from the surveys in non-transition countries were benchmarked to these firms.

18 See Bloom and Van Reenen (2007, 2009).

19 See Bloom, Schweiger and Van Reenen (2009).

20 Previous research found that family-owned firms with non-professional managers were the most poorly managed on average. Interestingly, this does not appear to be the case for family-owned firms in transition countries, perhaps because family-owned firms tend to be relatively young and do not carry the legacy of central planning.

21 See Chapter 3, EBRD (2008a).

22 Unfortunately, data coverage precludes most CIS countries – either firm-level data are not available or information on sales and costs is missing.

23 See Chapter 3, EBRD (2008a) and Aghion, Harmgart and Weisshaar (2009).

24 See Table 5.5 for a full list of countries and sectors.

25 See EBRD (2008b).

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Annex 5.1

Management, Organisation and Innovation (MOI) survey

From October 2008 to March 2009 the EBRD conducted the first MOI survey in collaboration with the World Bank. The survey covered almost 1,700 manufacturing firms with between 50 and 5,000 employees in 10 transition countries – Belarus, Bulgaria, Kazakhstan, Lithuania, Poland, Romania, Russia, Serbia, Ukraine and Uzbekistan – and Germany (see Table 5.1.1). The sampling frame, from which these firms were picked randomly with equal probability, was based on Bureau Van Dijk's Orbis database (as available in August 2008) with the exception of Kazakhstan and Uzbekistan, which Orbis does not cover. The sampling frame in Kazakhstan was the official list of establishments obtained from the Agency of Statistics of the Republic of Kazakhstan, and in Uzbekistan the Uniform State Register of Enterprises and Organisations published by the State Department of Statistics of the Republic of Uzbekistan. In Poland and Germany several establishments that participated in a previous survey on management practices[1] were re-interviewed as well. All regions within a country had to be covered (with the exception of the Far East in Russia) and the percentage of the sample in each region was required to be equal to at least one half of the percentage of the sample frame population in each region. The types of firms taking part in the survey are described in detail in Table A.5.1.2.

The survey was targeted at factory, production or operations managers, who are close to the day-to-day operations of the firm but are at the same time senior enough to have an overview of management practices.[2] Interviews were conducted face-to-face in the manager's native language by interviewers employed by the market research companies hired to implement the MOI survey. Each interview took on average 50 minutes.

The average response rate to the survey was 44 per cent and this appeared to be uncorrelated with productivity or profitability. There was some evidence that larger firms were more likely to respond, which is why the regressions typically control for this variable to offset any potential sample selection bias. In the initial contact with the firm, the interview was introduced as part of a study that would not discuss the firm's financial position or its accounts, making it relatively non-controversial for managers to participate.

The questionnaire comprised seven sections organised by topic. The first asked questions about the characteristics of the firm, such as legal status, ownership and number of years in operation. This was followed by sections on management practices, organisation of the firm, innovation and R&D, degree of competition, and also labour. Data on the location and size of the firm, interview start and end times, and interviewer and interviewee characteristics were also collected. The MOI questionnaire was developed and tested in two pilot surveys prior to its implementation in the field.

The concept of "good" or "bad" management needs to be translated into a measure applicable to different firms across the manufacturing sector. In contrast to previous questionnaires on management practices, the MOI survey consisted mostly of closed-ended questions,[3] in which the options offered to interviewees were based on the most common responses from previous surveys. Management practices were grouped into four areas: operations (one question), monitoring (seven questions), targets (two questions) and incentives (three questions). The operations question focused on how the establishment handled a process problem, such as machinery breakdown. The monitoring questions covered collection, monitoring, revision and use of production performance indicators. The targets questions focused on the time-scale and realism of production targets, and the incentives questions covered promotion criteria, practices for addressing poor employee performance, and rewarding production target achievement.

As the scaling varied across management practices, the scores were converted to z-scores by normalising each practice (that is, question) to mean zero and standard deviation 1. To avoid putting the most emphasis on the monitoring aspect of management practices, the unweighted average was first calculated across z-scores for a particular area of the four management practices. An unweighted average was then taken across the scores for the four practices, and finally a z-score of the measure obtained was calculated.[4] This means that the average management practices across all firms in all countries in the sample are equal to zero, and the actual management practices of the firm deviate from zero either to the left ("bad" practices) or to the right ("good" practices).

Firm-level performance data – balance sheets and income and loss statements – were obtained from Bureau Van Dijk's Orbis database for the countries covered and matched to the sample of completed interviews.

The MOI questionnaire and full dataset are published on the EBRD's web site www.ebrd.com.

Table A.5.1.1
MOI firms by country

Country	Total number of firms participating in survey	Panel firms participating in MOI and previous management practices survey
Belarus	102	–
Bulgaria	154	–
Germany	219	97
Kazakhstan	125	–
Lithuania	101	–
Poland	190	108
Romania	154	–
Russia	216	–
Serbia	135	–
Ukraine	148	–
Uzbekistan	125	–
Total	1,669	205

Source: MOI survey.

Table A.5.1.2
Firms participating in the MOI survey

Characteristics		Percentage
Establishment size (number of employees)	Small and medium (under 249)	72.0
	Large (249 to 5,000)	28.0
Largest owner	Multiple owners	17.4
	Foreign	14.8
	Domestic private – individual	42.0
	Domestic private – family	11.0
	State	11.1
	Other	3.7
Privatisation status	State-owned	8.7
	Privatised	30.8
	Always private	60.6
Location	Capital city	26.5
	Large cities (excluding the capital)	35.1
	Small cities	26.0
	Rural areas	12.3

Source: MOI survey.

Note: Largest owner is defined as owner of the highest share of the firm but owning at least 25 per cent. Privatised firms are formerly state-controlled firms whose largest owner is no longer the state.

Endnotes

1 See Bloom and Van Reenen (2009).

2 Factory managers are usually responsible for the efficient operation, maintenance and budgetary control of production. Production/operations managers ensure that goods are produced efficiently, at the right quality, quantity and cost, and that they are produced on time.

3 Closed-ended questions have a finite number of answers – for example: "Are employees promoted on merit?" [Yes/No] – while an open-ended question has no set of pre-defined answers (for example: "How are employees promoted?").

4 This is an accepted way of calculating index numbers – see Bresnahan, Brynjolfsson and Hitt (2002).

Major economic crises have the potential to destabilise political regimes and can either hinder or propel structural reforms. The political and policy impact of the current crisis, however, has thus far been muted. Despite political turnover, there have been few significant changes in policy direction. The post-crisis period is likely to be characterised by only modest political or institutional changes.

Chapter 6
Transition in crisis? The impact of the crisis on reform

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As Chapter 5 has shown, there remains a sizeable unfinished reform agenda in the transition region. Enhancing the quality of market-supporting institutions will be particularly critical. However, in light of the current crisis, what is the likelihood of such reforms actually being implemented? Will the crisis tip certain crisis-hit countries over the threshold, which might generate pressure for large-scale changes to political or economic institutions? If so, what would be the likely nature of such changes? Will the crisis encourage further market-supporting reforms or will it trigger a wave of transition reversals? As this episode is sometimes viewed as a "crisis of capitalism", could it trigger a backlash against reforms?

This chapter addresses these questions by drawing on the literature on the political economy of reform, the experience in previous crises of comparable magnitude and the effects that the current crisis appears to have had on reforms and political systems in the transition region so far. The institutional and policy changes assessed in this chapter include changes *of* system – changes to the constitutional order and system of government – as well as changes *within* system – turnover in political leadership, adjustments to the legal and regulatory framework, the financial system, or revisions to property and contract rights. The latter result in changes to the level and nature of the state's involvement in the economy, but do not threaten the fundamental basis of the political order.

The first section of the chapter briefly reviews the literature on crises and institutional and policy change. The second section examines the 1997-98 Asian crisis and the 1998 Russian financial crisis and their effects on the institutional and policy environment. The third applies the lessons of these illustrative cases to the current crisis and the likely impact on reform in the transition countries. The last section concludes.

Crisis, institutions and policy change

Institutions – broadly defined as "the rules of the game" – are resistant to change.[1] Vested interests make it difficult to push through reforms that will inevitably erode their privileged position.[2] Even when reforms would benefit large segments of society in the long term, they tend to impose short-term costs on well-organised opponents, making them difficult to implement for political reasons.[3]

How, then, does institutional change take place? Research on the political economy of institutions and reform suggests that institutional change takes place incrementally as interests shift over time and new constituencies supporting reform (for example, a growing middle class) become better organised and positioned to advance their policy preferences.[4] However, a large shock, such as a sharp economic contraction, national emergency or political crisis, can accelerate the process of change.[5]

If a crisis does trigger major institutional change, what direction will it take? For the purposes of this chapter, two forms of change that are sometimes observed after crises are of particular interest: large reactions against the status quo leading to regime change (as distinct from government turnover) or an economic paradigm shift; and policy adjustments to address institutional deficiencies revealed by a crisis.

A deep economic crisis will sometimes generate a reaction against a regime, ideology or institutions that either gave rise to it (if its source was internal) or made a country more vulnerable to it (if its source was external). A crisis can weaken interest groups benefiting from an inefficient status quo, either directly or through the loss of public support. It can also make the public more willing to tolerate painful institutional reform.

Reactions against the status quo can involve revolutions and political regime shifts: the First World War contributed to the revolution in Russia, the Great Depression facilitated Hitler's rise to power and the Asian economic crisis led to the collapse of the Suharto regime in Indonesia. Crises can also trigger major changes in economic paradigms and institutions: the Great Depression led to the New Deal in the United States (see Box 6.1), the Second World War to the Bretton Woods institutions and the United Nations, and the Latin American debt crisis of the 1980s to a new economic paradigm that became known as the Washington Consensus. Hence, reactions against the status quo can, but often do not, lead to welfare-improving outcomes.

The second type of change triggered by crisis includes policy improvements and institutional reform within the broad framework of existing political regimes and institutions. Crises make past policy failures visible, encourage learning from experience and can serve as a wake-up call to introduce changes in policy stance, regulatory framework or institutional structure.[6] A crisis can also loosen the constraints faced by a reform-oriented government (such as the need to preserve a governing coalition) and so give it greater scope to pursue reforms.

Examples of policy adjustments of this type include: economic reforms that were introduced in Chile in the mid-1980s in the wake of a major balance of payments and banking crisis; reforms of monetary and fiscal institutions undertaken by many Latin American countries after the crises in the late 1990s; and the regulatory reforms under consideration in Europe and the United States in reaction to the current crisis. The common thread of such reforms is that they constitute an attempt to improve existing policies and institutions, rather than overthrowing them and replacing them with an alternative paradigm.

Based on this distinction, two main areas for analysis are considered over the remainder of this chapter.

— Will the present crisis reach the level that could trigger a large reaction against the status quo in the transition region and, if it does, what elements of that status quo are likely to become the target? Will it be the paradigm of market reform which many countries have embraced in the last decade or will it be the (often authoritarian) regimes and institutions that have sometimes stood in the way of change?

— Where countries do not experience a significant reaction against the status quo, will the crisis trigger policy improvements and institutional reforms?

Box 6.1

The Great Depression and the New Deal

The Great Depression was the most severe economic crisis of the 20th century. Triggered by the US stock market crash in 1929, it lasted for nearly a decade and had economic and political repercussions around the world. Although the current crisis has not resulted in as severe a global downturn, and both faster and more effective policy action by the most affected countries appears to have put countries back on a growth path far more quickly this time around, the global nature of the Great Depression nonetheless evokes several parallels with the current economic crisis.

Like the current crisis, the Great Depression started in the United States and followed a period of robust growth in the preceding decade that was prone to a series of speculative bubbles, including in real estate. As in the 1920s, the near decade-long boom in the transition region after 2000 created a large middle class whose increasing consumption levels and investment in the stock market helped to drive growth. The response to the sudden economic collapse, and to the counterproductive policy reactions of the governments in place at the time, was a strong anti-status quo reaction in countries where the crisis hit the hardest.

In political terms this led to electoral victories for opposition forces in the United States (where Franklin D. Roosevelt was elected for the first time in 1932), Canada (where the Liberals were replaced by the "Imperial protectionist" Conservatives), France (which turned to the left-wing Popular Front movement), Germany (where the National Socialist Party gained ground and helped elect Adolf Hitler as chancellor in 1933) and Latin America (which turned to populist leaders who rejected global free trade). Europe's most fragile democracies – Germany, Italy and Spain – all turned towards authoritarian forms of government in the wake of the sharp economic decline and high rates of unemployment that attended the global downturn. Meanwhile, governments across Europe and North America adopted protectionist trade and exchange rate policies, slowing or reversing the process of global integration and stoking continental rivalries.

In the United States the strong anti-status quo reaction manifested itself in the rejection of the *laissez faire* orientation of the outgoing Republican Party and President Herbert Hoover. Following Roosevelt's inauguration in 1933, his new Democratic Party administration took immediate steps to restore solvency to banks and set about a complete overhaul of the regulatory framework in the financial system through the Glass Steagall Act of 1933 (separating investment banking from commercial banking), the creation of the Federal Deposit Insurance Corporation, and the Securities and Exchange Act of 1934, which for the first time established independent regulation of the stock market and its participants.

These steps to rescue banks and restore stability to the financial system were set within the broader context of Roosevelt's New Deal, which saw the introduction of a set of economic policies and institutions governing industry, the labour market, agriculture and infrastructure. The new administration also pushed through Congress an assertive fiscal stimulus package to boost employment and output through public works. In the social sphere, the Social Security Act of 1935 laid the foundations for the modern US welfare state with the first-ever provision for a national pension system, unemployment insurance and a social safety net for the poor and disabled.

The Great Depression sparked a crisis of capitalism that in turn brought about a paradigm shift in thinking about the role of the state in economic affairs. In the United States, the New Deal amounted to a fundamental overhaul of institutions of governance. The previously unquestioned belief in the efficiency of markets and a minimal role of the state in delivering a socially optimal return was dismantled. In its place the Roosevelt administration put the Keynesian belief in activist government and fiscal policy to manage the national economy and boost both aggregate demand and employment.

The answers will depend on the prevailing political and social conditions in the transition countries and on the role of the international community. Research on the political economy of reforms suggests that the following factors may play a role.

— The degree of social cohesion (or social disaffection) and publicly perceived policy success before the crisis: countries in which policies enjoyed strong public support just prior to the downturn are less likely to experience an anti-status quo reaction. Similarly, systems viewed by their citizens as illegitimate are more likely to collapse under the stress of crisis.

— Conditional international support: where the international community subscribes to a core set of reform principles (for example, during the time of the Washington Consensus) and makes aid conditional on the enforcement of those principles, a crisis may present the opportunity to press for reforms that have previously been blocked.[7]

— Regime type: a crisis is generally less likely to lead to a regime shift in democracies than in authoritarian government structures. However, this may not be the case in countries with short democratic traditions or low social cohesion, whose leaders (or elites, such as the military) may justify a shift towards authoritarian rule as necessary to combat a crisis. Furthermore, it is not clear whether democratic regimes are necessarily superior in implementing good policy adjustments. Constitutional checks and balances can provide an institutional mechanism for peaceful conflict resolution, increase accountability of rulers and encourage credible commitments by political leaders.[8] However, the dispersed decision-making authority in democracies can also make it more difficult to take decisive political action.[9]

The next section examines how these factors have shaped institutional arrangements and policy reactions in two emerging market crises (the Asian crisis of 1997-98 and the Russian financial crisis of 1998) that had several elements in common with the current crisis in the transition region.

Impact of the Asian and Russian crises on reforms and institutions

The Asian crisis was similar to the current crisis in that it was the consequence of financial and macroeconomic imbalances that developed from an era of fast, market-based growth and increased openness. It is therefore instructive to examine the extent to which the crisis triggered policy reforms or a larger reaction, and what elements of the status quo in particular came under attack. The Russian financial crisis is particularly relevant because it was the first major crisis in the transition region after the recessions that followed the collapse of central planning. The question in this case is, what impact did it have on the trajectory of structural and institutional reforms?

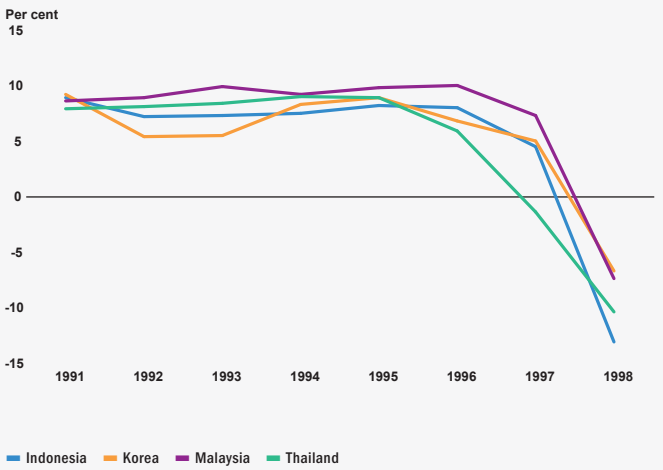
Asian crisis of 1997–98

The Asian crisis hit the region unexpectedly after a decade of strong economic performance. Annual GDP growth in the ASEAN-5 countries (Indonesia, Malaysia, the Philippines, Singapore and Thailand – often referred to as the "Asian tigers") had averaged about 8 per cent during the 1990s. As in the transition region a decade later, this growth process also resulted in the gradual accumulation of economic vulnerabilities, particularly in the financial sector (see Box 1.3 in Chapter 1). The crisis across the region was triggered by a sudden shift in investor sentiment towards emerging market risk and an ensuing large private capital outflow, reversing the trend of the previous decade.[10] The result was a balance of payments crisis, unprecedented financial turmoil and dramatic economic decline (see Chart 6.1).

What makes this crisis an instructive test case for the political economy of reform is that developments leading up to it could be (and were) interpreted in quite different ways.

From one perspective, the Asia region went too far in opening itself to international capital flows and became the largely innocent victim of a sudden loss of investor confidence.[11] On this basis, an anti-status quo reaction could have manifested itself in an attempt to reintroduce capital controls and reverse financial integration.

Chart 6.1
Real GDP growth: selected East Asian countries (per cent year-on-year)



Source: International Monetary Fund (IMF).

Another interpretation was that the region, while pursuing a successful growth model, made mistakes by ignoring growing vulnerabilities in the financial sector, allowing excessive private debt accumulation and foreign currency-denominated borrowing, and engaging in distortive fiscal and trade policies (including preferential finance and subsidies to export-oriented industries and protectionist tariffs to help import-competing producers).[12] This interpretation, favoured by international financial institutions (IFIs) and particularly the International Monetary Fund (IMF), would suggest policy adjustments to result from the crisis.

A further view agreed that policy mistakes had been made but saw them as the manifestation of weak governance and deficiencies in the political system (or "crony capitalism").[13] From this perspective, an anti-status quo reaction should have forced a change in the political regimes of the crisis economies.

In the event, the changes brought about by the crisis reflected both a massive anti-status quo reaction triggering political change (more so in some countries than others) and policy or institutional adjustments.

Following the outbreak of the crisis, most incumbent political systems were undermined with consequent changes in regimes and/or governments.

The most pronounced change occurred in Indonesia, which had been ruled by Suharto's authoritarian regime for more than three decades. The regime could not mount a coherent crisis response, in part because the IMF's conditionality was in direct conflict with the economic interests of the Suharto family. After deepening economic chaos and weeks of riots in the first part of 1998, Suharto was forced to resign. This triggered a process of democratisation that culminated in the country's first free elections in June 1999. Subsequently, stronger checks and balances in the political system, including greater authority for parliament and term limits for the president, were adopted.

In Korea and Thailand (both classified as democracies) the crisis prompted a change of political administration but not a shift to a new system of government. If anything, it appeared to accelerate the trend in both countries towards further consolidation of democratic rule and institutions. In Korea the crisis discredited the government of Kim Young-sam and its ties to the major business conglomerates *(chaebols)*. The victory of the opposition in presidential elections in 1997 marked the first true break from the era of military dictatorship. In Thailand the new government ushered in changes to the constitution, enhancing the impact of the crisis on fundamental institutions of governance.

In Malaysia, although equally affected by the crisis, the political repercussions and anti-status quo sentiment were less dramatic. A broad reform movement, inspired by popular protests in Indonesia and fuelled by widespread dissatisfaction with the Mahathir government, gained strength but failed to oust the incumbent government coalition in the hotly contested parliamentary elections in November 1999.

The degree of social cohesion and underlying democratic values within these countries helps to explain these differences.[14] In Indonesia support for a more democratic political regime among students and the middle class, together with a generalised lack of trust in the existing institutions, had grown progressively. In Korea and Thailand popular support for democracy was widespread, preventing any potential reversals towards authoritarian rule in the wake of the crisis and propelling further democratic reforms. In Malaysia, by contrast, support for democracy was weaker and more diffuse and there was less pressure for new leadership.[15]

The Asian crisis was followed by a wave of market-supporting economic reform in all four of the above countries, coupled with a stronger institutional role for the state.[16]

— Financial regulation was strengthened and financial sector reforms were introduced. Insolvent financial institutions were closed and distressed assets transferred to government agencies for restructuring (except in Malaysia). Viable financial entities were recapitalised through public funds. All countries introduced measures to significantly strengthen prudential regulation of the banking system, including loan classification and tightening of provisioning requirements, stronger capital adequacy standards and higher minimum capital requirements.

— Outside the financial sector, incentives to improve corporate governance were introduced. Measures were taken to strengthen disclosure, accounting and auditing standards, as well as the legal and supervisory frameworks for markets. Bankruptcy laws were strengthened in Indonesia, Korea and Thailand.

— Steps were taken to better separate private and public sectors and to promote competition. Restrictions on the use of public funds to bail out private sector corporations and liberalisation of foreign investment in ownership and management were introduced in all four countries. Competitive procedures for privatisation of government assets and for procurement were introduced in Indonesia, Malaysia and Thailand. Competition laws were strengthened in Indonesia, Malaysia and Thailand and price controls were removed in Indonesia and Thailand.

— The crisis also led to further trade liberalisation. Indonesia reduced import tariffs and export taxes and eased quantitative restrictions on imports and exports. Korea also eased quantitative restrictions on imports. However, in response to capital outflows and speculative pressures on the domestic currency, Malaysia introduced short-term capital controls and restrictions on foreign exchange transactions.

The crisis therefore appears to have triggered a similar impetus to reform in the four countries, although the effects may have been less extensive in Malaysia – which, unlike Indonesia, Korea and Thailand, did not manage the crisis within the context of an IMF-supported programme (although it consulted with the IMF and other IFIs during the crisis).

1998 Russian financial crisis

The financial meltdown in Russia in August 1998 was a home-grown crisis that severely affected the real economy, the financial sector and government finances. Although Russia had just started to grow year-on-year in 1997, led by the economy in and around Moscow, output was estimated to have contracted in 43 out of 79 regions in the rest of the country in that year. The economy continued to struggle in 1998, aggravated by a sharp drop in oil prices that also made a large dent in public finances. This was temporarily filled by issuing short-term debt (GKOs) at very high interest rates, which became difficult to roll over in June and July. Following a failed IMF-backed rescue attempt, the Russian government on 17 August 1998 announced a simultaneous devaluation of the rouble, its intention to default on most of its outstanding debt and a moratorium on the repayment of principal on foreign debt owed by Russian banks and firms. This sparked a run on the currency and on the banks, and a sudden spike in inflation to levels not seen since the stabilisation programme of 1995.

The crisis had immediate spill-over effects in the Commonwealth of Independent States (CIS) and other transition countries with close trade and financial links to Russia. Five countries, including Russia itself, experienced crisis-induced economic contractions in 1998 or 1999: Russia by -5.8 per cent, Moldova by -6.5 per cent and Kazakhstan by -1.9 per cent in 1998; and Estonia by -0.3 per cent and Lithuania by -1.5 per cent in 1999. The economies of other CIS countries were also weakened but did not experience a fall in real GDP growth.

Like the Asian crisis, the 1998 Russian crisis combined all the ingredients that could have justified policy adjustments, a major reaction against the status quo, or a combination of the two. Political conditions ranged from fairly new and sometimes fragile democracies in central Europe, the Baltic states, Russia and Ukraine, to authoritarian regimes elsewhere in the CIS (except Armenia). Policy failures by the Russian government – particularly the inability of the Yeltsin administration to place the public finances on a sustainable path by broadening the non-oil revenue base – were arguably an important cause of the crisis. However, unlike the weak policies of the Asian governments before 1997, these failures had occurred during a period of robust market-oriented reforms. As a result, any anti-status quo reaction to the crisis was likely to be directed against the reforms themselves, making it more difficult to undertake corrections within the broader reform strategy.

In the event, the anti-status quo reaction was muted in the political arena.

— In Russia the crisis further weakened the Yeltsin presidency and led to a new government under conservative Prime Minister Primakov. However, both the president and the political system survived.

— In Moldova, one of the hardest-hit countries, the crisis destabilised the Alliance for Democracy and Reforms coalition that had been voted into power just before the crisis in early 1998, leading to several changes in leadership.

— In Ukraine, where anti-status quo sentiment would have been weaker due to the lack of reform before the crisis, incumbent president Leonid Kuchma was returned to office in elections in late 1999, although he did install a leading reformer, National Bank of Ukraine chairman Viktor Yushchenko, as his prime minister.

— Elsewhere, the political consequences of the crisis were negligible, although for different reasons. In the CIS, there was no backlash against the prevailing authoritarian regimes, while crisis-hit countries in central Europe and the Baltic states (CEB) and south-eastern Europe (SEE) had the anchor of the EU and Euro-Atlantic integration process to keep them on the democratic path.

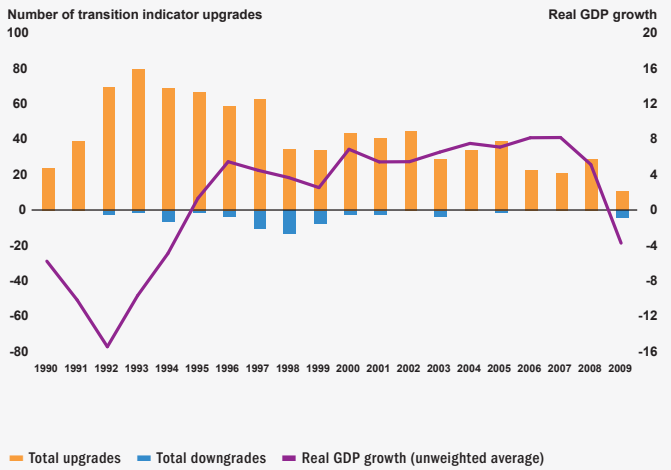
The short-term impact of the Russian crisis on market reforms was more profound, as can be seen in the EBRD transition indicator scores for 1998 and 1999. After five years of rapid progress, averaging 66 transition indicator upgrades per year from 1992 to 1997, the region stalled and to some extent went into reverse. In 1998 only 35 transition indicator upgrades were awarded and 13 downgrades were issued in nine countries (Belarus, Latvia, Romania, Russia, Serbia, Turkmenistan, Ukraine, Uzbekistan and the then Federal Republic of Yugoslavia). In 1999 there were 34 upgrades and seven downgrades (see Chart 6.2). In no other period during the 20 years of transition were transition reversals so pronounced.[17] The reversals came mainly in the areas of price liberalisation (due to the imposition of price controls in four countries) and the banking sector (due to sharp reductions in lending to the private sector, state intervention and weak regulation in four countries). In Russia, where the impact was most direct, there were downgrades in the financial sector (both banking and non-bank financial institutions), price liberalisation, enterprise reform, and trade and foreign exchange liberalisation.

Although the anti-market impact of the crisis was sharp, it was not lasting. By 2000, after positive GDP growth had returned to Russia and other crisis-affected countries, the backtracking on reform had ceased and support for market solutions had returned.[18] In 2000-02 an average of 42 net transition indicator upgrades (upgrades less the number of downgrades) were recorded, nearly a 100 per cent increase from the low of 22 in 1998. This "V-shaped" recovery in reform momentum may partly reflect the fact that the required market economy and democratic thresholds for countries seeking entry into important multilateral bodies, such as the European Union (for CEB) and the World Trade Organization (for SEE and the CIS), had not yet been reached. The crisis therefore interrupted, but did not derail, the transition process.

Russia's reform trajectory also conforms to this pattern. Following the election of Vladimir Putin as president in March 2000, his new administration introduced a number of important structural and institutional changes relating to tax policy, legal reform, labour and land market issues, deregulation, corporate governance, banking sector supervision, pensions and electrical power. By 2002 Russia had made up much of the ground lost during the crisis and was awarded upgrades on three separate transition indicators, making it a leading reformer in that year (see Chart 6.3). However, concurrent political developments moved in the opposite direction, strengthening the influence of the state and curbing some of the freedoms introduced in the Yeltsin era.

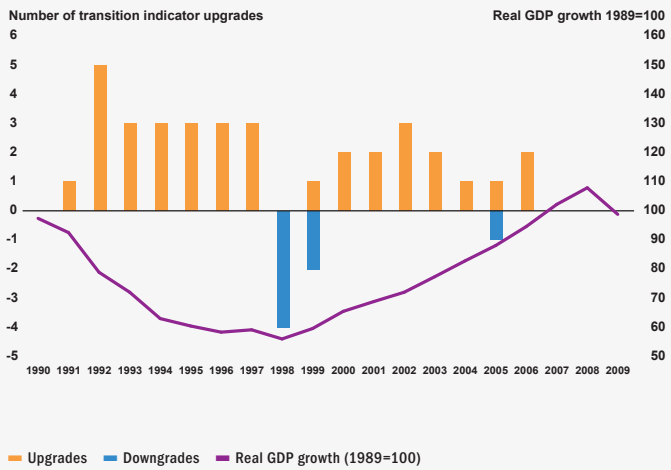
The Russian crisis also produced a shift in values among the population that has endured through the present decade. Before the crisis, most Russians had been strongly in favour of democratic change and moderately supportive of integration with the West. Afterwards, however, there was far greater scepticism. The perception that many of the reforms were rushed or reckless, and had made Russia weaker as a nation, led to a suspicion of imported ideology, including liberal democracy. This is clear from the results of the 2006 EBRD/World Bank Life in Transition Survey (LiTS), which are examined in the next section.

Chart 6.2
Transition and economic growth



Source: EBRD.

Chart 6.3
Russia: transition and economic growth



Source: EBRD.

Institutional and political change in the current crisis

The preceding section has shown that the impact of crises on political institutions and economic reform was quite different in the Asian and Russia crises, notwithstanding some similarities in initial conditions. In Asia the crisis transformed the political landscape, particularly in Indonesia, and led to market reform. In contrast, in Russia and the transition region, incumbent regimes (though not necessarily incumbent governments) were largely unaffected and there was more of a backlash against reforms. The analysis suggested that this difference can be attributed to four main factors:

— institutional development and social cohesion before the crisis

— the extent to which market reforms were associated with the status quo

— the degree of economic collapse, as well as the capacity of incumbent regimes to respond

— the role of external anchors and institutions, such as the European Union, which probably muted the political impact of the 1998 Russian crisis in CEB and encouraged the post-crisis return of reform momentum in prospective member countries; and IFIs, which had an impact on post-crisis reforms in Asia (but were absent from the policy response in Russia).

The following analysis summarises changes to those institutions and to policies over the previous year, and then assesses the medium-term implications of the crisis for democratic and market transition.

Short-term crisis impact

It is still too early to assess even the short-term impact of the crisis on political systems and market reforms. However, the evidence so far suggests that it has been limited:

— in the political arena, there has been an anti-status quo reaction directed at some incumbent governments, particularly in the more seriously hit CEB countries (such as Croatia, Hungary, Latvia and Lithuania) and in Moldova. Nowhere, however, has the crisis triggered a change in political system. In Central Asia, eastern Europe and the Caucasus (EEC) and Russia, the status quo has been largely reinforced, even in the countries most affected by the crisis

— as far as economic reforms are concerned, the crisis has clearly slowed momentum (as identified in Chapter 1). However, it has triggered far fewer reform reversals than the 1998 Russian crisis. The EBRD transition indicators record only four downgrades during 2009, compared with 13 in 1998. Furthermore, these downgrades are mostly justifiable in the context of crisis management strategies and are not indicative of a generalised anti-reform shift in the four countries involved (Kazakhstan, Latvia, Montenegro and Ukraine)

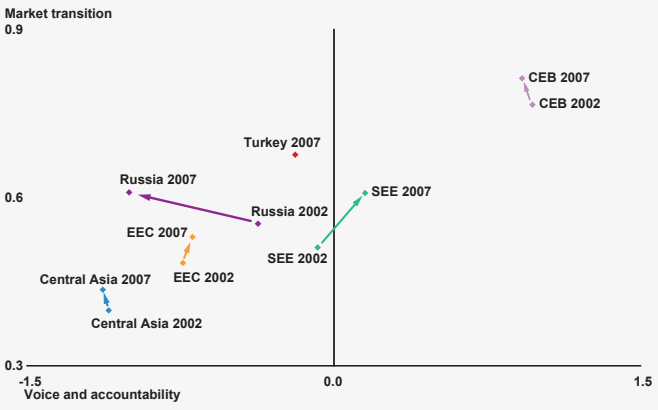
— most importantly, elections and political turnover during 2008-09 have not produced any evidence of a political shift against market reforms (see Box 6.2). Indeed, the declared policy stance of governments has either remained the same or (in seven out of the 29 EBRD countries of operations) become more reform-friendly. On this basis, it is unlikely that the region will witness an intensification of the backlash against reforms over the next year.

What explains these outcomes? While it is too early for a firm analysis, the factors already identified as relevant in the Asian and Russian crises offer some clues.

First, while events in the transition region could have been, and in some cases were, blamed on pre-crisis market reforms, pre-crisis institutional arrangements were much more mature than in the crises of the late 1990s. This applies both to economic institutions, which benefited from the wave of reforms at the beginning of this decade (see Chart 6.2), and to political systems. As shown in Chart 6.4, reforms progressed in all regions – most vigorously in SEE – while Russia made gradual progress in economic reform from 2002-07 but saw a deterioration in the quality of democratic institutions. The institutional starting points at the time the crisis hit the region were nonetheless varied, with countries in CEB most advanced, followed by countries in SEE and eastern Europe, and countries in Central Asia lagging behind in terms of both market-supporting economic institutions and democratic institutions. However, even the less democratic regimes benefit from popular support and there seems to be little appetite for more democratic alternatives (see next section).

Second, external anchors played an even more important role in this crisis than in 1998, with more than half of the transition countries being members of the European Union, formal EU candidates or EU aspirant countries. The prospect of long-term EU accession may have played a role in moderating policy reactions to the crisis even in some EU neighbourhood countries that do not fall into any of these categories.

Chart 6.4
Pre-crisis economic and political institutions



Sources: EBRD and World Bank.

Note: Voice and accountability reports the World Bank's Worldwide Governance Indicators, which estimate the deviation from the global mean across a large number of sector-specific country reports. Market transition reports the average EBRD transition indicator score.

Box 6.2

Short-term impact of the crisis: political turnover and policy changes

The current crisis has generated an expected, albeit contained, anti-incumbent reaction in many of the hardest-hit countries. Governments have fallen in several countries in central Europe and the Baltic states (CEB), including Croatia, Hungary, Latvia and Lithuania. The fragile minority coalition government in equally hard-hit Estonia remains in place but has undergone a significant reshuffle. In the less crisis-prone CEB countries of Poland, the Slovak Republic and Slovenia, the current leadership has been retained.

Although voters in the countries where leadership changes have occurred were clearly dissatisfied with the incumbents, the new governments did not necessarily receive a mandate to shift away from democratic and market-oriented policies. Thus far, the results of these changes have been market-conforming, unlike with the immediate impact of the Russia crisis in 1998. There was only one transition indicator upgrade (in the Slovak Republic) and one downgrade (in Latvia), suggesting that the impact of these changes on reforms will be modest.

In south-eastern Europe government changes through scheduled elections in Bulgaria and Romania, both recent entrants to the European Union, have boosted reform in areas where the European Commission had been most critical of previous administrations – corruption, the rule of law and organised crime. It is still too early to say how far the new governments will go in implementing these reforms. In the Western Balkans, where the impact of the crisis has been less severe, the existing governing coalitions have remained in power in all countries. The governments in FYR Macedonia, Montenegro and Serbia have managed the economic crisis with relatively high levels of popular support. The ruling parties in Albania, FYR Macedonia and Montenegro have all won national elections during 2009. In the Federation of Bosnia and Herzegovina the prime minister resigned and was replaced but this was not followed by a major change in the composition of the government, nor has it led to dramatic policy changes.

Further east, very limited political or policy change has been introduced in the partial democracies in the countries in the Commonwealth of Independent States. A protracted election process in Moldova has resulted in a change in leadership, with the liberal democratic opposition replacing the outgoing Communist Party. Elsewhere in eastern Europe and the Caucasus, Russia and Central Asia, the status quo has been largely reinforced, even in the countries most affected by the crisis.

— The downturn in Russia produced signs of tension in vulnerable regions, but the authorities' use of the huge build-up of financial reserves to cushion the impact on households and prop up consumption has maintained public support for the current leadership and blunted calls for a change in direction.

— Belarus has shown some signs of a positive policy shift, partly linked to the International Monetary Fund programme currently in force, but the conservative leadership remains firmly in place.

— Ukraine remains mired in a political stalemate that has seen the fragmentation of the governing coalition and a sharp decline in popular support for the democratically elected president, but any substantive policy changes will depend on the presidential elections scheduled for January 2010.

— Kazakhstan was one of the first countries to be affected by the global crisis and one of the hardest hit but, with weak institutions of political accountability and interest intermediation, this has not produced any noticeable change in policy direction.

Table 6.2.1 notes all instances of elections and leadership changes in transition countries between January 2008 and September 2009 and summarises their implications for the government's stance toward reforms. Elections or leadership changes have occurred in 25 out of 29 countries considered. However, in only eight out of these 25 cases did this lead to a switch in power to the opposition, and in no cases to an anti-reform shift in the government. Indeed, in seven cases the leaderships resulting from these changes appear *more* reform-minded than their predecessors.

Table 6.2.1

Leadership changes and policy implications, January 2008 to September 2009

	Opportunity for change in leadership through:			Implications for policy
	Parliamentary elections	Presidential elections	Change in leadership outside electoral process (that is, due to resignation of PM or exit of coalition party)	Declared policy stance of the government
CEB				
Croatia			I	=
Czech Republic			0	=[1]
Estonia			I	=
Hungary			I[2]	+
Latvia			0[3]	+
Lithuania		0		+
Slovak Republic		I		=
Slovenia	0			=
SEE				
Albania	I			=
Bosnia and Herzegovina			=[4]	=
Bulgaria	0			+
FYR Macedonia		I		=
Montenegro	I*			=
Romania	0			+
Serbia	I			=
EEC				
Armenia		I		=
Azerbaijan		I		=
Belarus	I			+
Georgia	I			=
Moldova	0			+[5]
Russia	I			=
Central Asia				
Kazakhstan	I			=
Kyrgyz Republic		I		=
Mongolia		0		=
Turkmenistan	I			=

Source: EBRD.

Note: The following countries did not have elections in this period: Poland, Turkey, Ukraine, Tajikistan and Uzbekistan. Incumbent party (I), Opposition party (O). Less reform-minded (–), same (=), pro reforms (+). * snap parliamentary elections. [1] In the Czech Republic, the interim government that took office in May 2009 is unlikely to make much reform progress. Moreover, the Constitutional Court's decision to postpone the new elections scheduled for October adds to the uncertainty regarding reforms. [2] Hungary's ruling party has been diluted by a considerable number of technocrats (including the new prime minister) as a direct result of crisis. [3] Latvia has a new prime minister. However, the new coalition still includes two main parties from the previous government. [4] In Bosnia and Herzegovina, the change is only at entity level. [5] In Moldova, a delay in policy reform is expected due to political uncertainties.

Lastly, even though the crisis led to large output declines in many countries, it was far better managed than in previous episodes. Unlike the crises of the 1990s, systemic banking and currency collapses as well as spikes in inflation were generally avoided. In part, this was attributable to better domestic policy responses, related to more mature pre-crisis institutions; but it was also due to a much stronger international policy response (see Chapter 1, particularly Boxes 1.3 and 1.4). Some countries, such as Kazakhstan and Russia, managed the crisis without significant outside official support but with the benefit of accumulated fiscal reserves (which were absent in 1998).

Medium-term impact on reforms

While the short-term impact on political regimes and reforms has been modest, the question remains whether the crisis will produce either a major deterioration in, or provide a boost to, reforms in the transition region over the medium term. Will there be any shift in constitutional arrangements or even in regimes – from authoritarianism to democracy, for example, or the other way around? What might be the sources of such a shift and how likely might it be?

The remainder of this section focuses on three possible determining factors:

— a major global rethink on the role of the state in the economy, on the appropriate degree of regulatory oversight and on the place of industrial policy in national development strategies (that might deter some countries from quickening reform and retard the transition prospects of others)

— an adverse distributional impact of the crisis that weakens large, pro-reform constituencies in the region, such as the middle class

— a lack of social cohesion in some countries, including in advanced countries, that would raise the potential for political destabilisation and feed the anti-reform and anti-market sentiment that has been evident in recent years.

As in the Great Depression in the 1930s, the current crisis has led to a change in views on the role of the state and focused attention on the importance of market-supporting institutions, such as effective financial sector regulation. In many advanced countries, it has also involved large-scale state intervention (particularly in, but not limited to, the financial sector) and large increases in government spending. The proposition that fiscal policy plays an important role in stabilising the economy, which contrasts with pre-crisis market orthodoxy in some advanced countries, seems to have been implicitly accepted.

However, while the consensus seems to have shifted to support for a somewhat greater role for the state and efforts to strengthen the regulatory framework for capital markets are under way, there is no talk of replacing the market system with anything else. This is likely to be relevant for many countries in the transition region which have crossed a threshold in terms of integration in regional and global institutions – such as the European Union, World Trade Organization and the Organisation for Economic Co-operation and Development – that help to align their policies with those of the advanced industrialised economies. For countries that are not as integrated into these rule-bound structures, future policies towards institutional reform are more likely to be determined by domestic factors than by a global paradigm shift.

The distributional consequences of the crisis could have more significant policy implications in the medium term. Sharp economic contractions in many countries have raised unemployment and pushed millions of people back below the poverty line. In the Baltic states and Moldova, in particular, unemployment rates have soared. In Estonia, unemployment more than quadrupled from 2.0 per cent in June 2008 to 8.9 per cent in September 2009. In Latvia, Lithuania and Moldova it increased by over 150 per cent, from 4.9 to 13.2 per cent (September 2009) in Latvia, 4.5 to 13.6 per cent (July 2009) in Lithuania and 3.0 to 7.7 per cent (March 2009) in Moldova. Higher unemployment tends to produce greater inequality and lower incomes and a larger share of the population living in poverty, leading to a greater risk of political instability.[19]

Progress in building up the ranks of the middle class as a bulwark of democracy and free markets has also been set back by the crisis. One important way in which the crisis has affected the middle class in the advanced transition countries has been the mortgage market. Many homeowners held mortgages denominated in foreign currency (or indexed to a foreign currency), leading to much higher debt burdens in countries suffering sharp exchange rate depreciations.[20] Expenditure cuts, forced on governments by crisis-driven collapses in revenue and lack of external financing, have resulted in lower wages and a reduction in public sector payrolls, affecting middle class professionals such as teachers, health care workers and civil servants. Remittance flows, which fuelled consumption patterns that swelled the ranks of the middle class in some of the less developed transition countries, have dried up. In the Kyrgyz Republic, Moldova and Tajikistan remittance flows started decreasing in September 2008 and have since declined by approximately one-third – back to January 2007 levels.

The toll that the crisis is taking on the middle class could undermine future reforms by weakening pro-reform support and increasing populist pressure for a more interventionist government role and administrative redistribution of wealth. However, assuming that the stabilisation seemingly taking hold in the third quarter of 2009 persists, the costs of the crisis in terms of weakening the middle class are unlikely to fully reverse the gains made during the 2004-07 boom years. In many transition countries, particularly the more advanced ones, middle class groups whose interests are more aligned with defenders of open markets than with populist nationalist parties are likely to remain politically and socially powerful.[21] As a result, the risk of medium-term reform reversals driven by a shrinking middle class appears limited.

This leaves one main factor that could potentially undermine medium-term reforms: the interaction of the economic impact of the crisis with greater social fragmentation and weaker support for market institutions than would be found in more mature market economies. The 2006 Life in Transition Survey (LiTS), conducted at a time when economies across the region were still growing steadily, showed that views on the economic and political situation even in the most advanced countries were often quite negative (see Box 6.3). In Hungary, for example, more than 70 per cent of people said they felt that the situation in the country in 2006 was worse than at the start of transition in 1989. Disaffection was highest in more dynamic EEC and SEE countries, perhaps reflecting the fact that expectations tend to rise during periods of rapid growth and social change.

The survey also showed robust support for a “strong” state and government intervention, particularly in Central Asia (notably Kazakhstan and Uzbekistan), Russia and Turkey, but also in some CEB countries such as Croatia and Lithuania. However, greater support for intervention did not correlate strongly with backing for a planned economy, according to the survey. This could imply that, while people in most transition

Box 6.3

Economic crisis, social cohesion and support for market institutions

The 2006 Life in Transition Survey (LiTS), undertaken at a time when economies across the region were still growing steadily, contained a range of survey questions that can be used to gauge social cohesion and support for market reforms. Chart 6.3.1 presents an index for "disaffection" based on answers to questions on perceived changes in households' relative income from 1989 to 2006, on whether the economic and political situation was worse or better in 2006 than in 1989, and on the level of general life satisfaction.

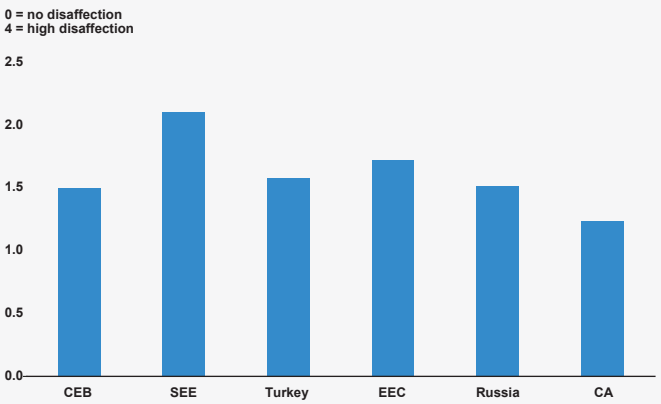
Disaffection was highest in south-eastern Europe (SEE) and eastern Europe and the Caucasus (EEC), the most dynamic subregions in recent years where economic and political transition progress has been most consistent. At first glance, this seems surprising, as people in those countries might have been expected to be more satisfied in light of improving conditions. However, it is also consistent with the notion that expectations rise during periods of rapid growth and change. Disaffection was comparatively lower in the more "stable" regimes in Central Asia (CA) and in Russia.

Alongside disaffection with living conditions and political and economic direction, support for government intervention in the economy is also an important indicator of popular support for economic reform. Again, a simple index based on the LiTS responses is constructed (see Chart 6.3.2). The index captures the public's sympathy for government intervention, as opposed to preferences for market discipline, on a score ranging from 0 to 5, with five indicating the most support for government involvement in the economy.

For the region as a whole, the average value of the index is 2.9, suggesting that in 2006 there was fairly robust support for a "strong" state and government intervention. The index is lower in central Europe and the Baltic states (CEB – an average of 2.40) than in other regions but this still suggests considerable support for government as opposed to market solutions. The chart also reveals a significant divide among countries within the CEB region: households in Croatia (2.76), Lithuania (2.61) and Hungary (2.55) showed the most support for strong state intervention, while calls for state support were comparatively moderate in the Czech Republic, Estonia and Slovenia.[22] Support for state involvement was highest in Turkey, Central Asia (notably Kazakhstan and Uzbekistan) and Russia. Albania, Belarus and Mongolia all tended to favour less state involvement, with rankings close to or even below the CEB average. However, support for state involvement may not necessarily imply opposition to a market-based economic system.

Chart 6.3.1

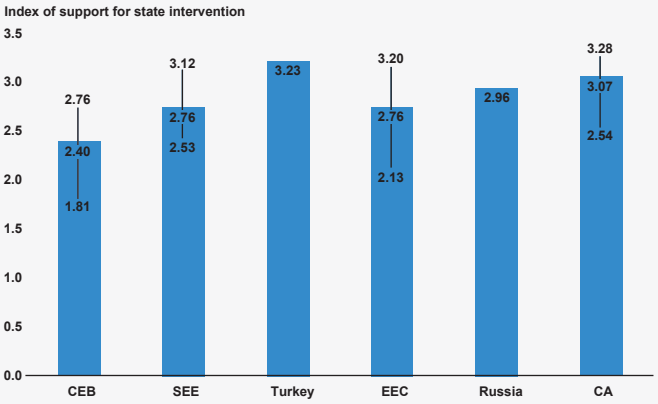
Disaffection in the transition region



Source: EBRD calculations based on Life in Transition Survey, EBRD/World Bank, 2006.

Chart 6.3.2

Support for government intervention in the economy



Source: EBRD calculations based on Life in Transition Survey, EBRD/World Bank 2006.

Note: The black vertical lines indicate the countries with the lowest and highest percentage in each subregion.

countries want governments to provide better public goods and services and guarantee a fairer distribution of income, they do not wish for a return to communism. This view is consistent with the emerging global consensus on the role of the state relative to the market. Widespread support for government intervention need not therefore signal a preference for reversing market-oriented reforms in the medium term.

It is conceivable that the combination of existing discontent in many countries and a penchant for government rather than market solutions could make the crisis a trigger for political destabilisation, a rise in populist nationalist sentiment and weakening commitment to further liberal reforms. The improving fortunes of illiberal political parties in local and European elections over the past year could be viewed as an indication that the transition region is moving in that direction. However, several factors mitigate against a significant anti-market or anti-democratic policy shift:

— first, the recent history of populist parties in power or serving in coalition governments in the transition region has not resulted in a sharp anti-market backlash. In a broadly democratic setting, where the constraints of either the European Union or an active civil society, or both, impose strict discipline on leaders, populist parties in countries such as Bulgaria, Poland, Romania and the Slovak Republic have not pressed extreme policy positions

— second, popular support for truly illiberal populist nationalist parties has not reached alarming proportions. On the contrary, reform-oriented parties have continued to do well in elections, even in the midst of economic downturn. This suggests that most voters still view improved market-supporting institutions as the best way to emerge from the crisis

— lastly, the process of economic convergence has had positive results. People in almost all countries in the region live better than they did under communism and this is mainly due to the policies that governments in power have put in place over the past two decades with the help and encouragement of the IFIs and the European Union. This has put a floor under transition achievements that has prevented serious reversals.

Conclusion

The crisis in the transition region is not yet over and its impact on medium-term reform prospects depends on factors that are difficult to predict. Nonetheless, developments so far, and the comparison with previous emerging market experiences, suggest that the current crisis is unlikely to prompt wide swings in reform orientations or political systems.

Reform reversals have been limited and are likely to remain so. The European transition countries are integrated into regional or global institutions that have prevented a serious downward slide. Harder-hit countries further east, such as Kazakhstan and Russia, have had sufficient fiscal reserves to cushion the social impact of the crisis and have adopted reasonable response measures to minimise the economic fall-out. Furthermore, although the crisis has led to greater state intervention (particularly in the financial sector), it has not resulted in a rejection of market-based economic systems or global integration.

However, the potential for the crisis to act as a catalyst for a major resurgence in reform momentum also appears limited. In the EU member countries, this is unlikely because the distance from the transition frontier is moderate at this point and the reform effort needed to make further advances in transition is typically greater. Moreover, in many countries, there is little social support for further market-oriented reform. The highest rate of reform progress is expected in EEC countries, Turkey and the Western Balkans, encouraged by the prospect of closer integration with, or aspiring membership of, the European Union and backed by Stabilisation and Association Agreements. Countries such as Belarus and Moldova, which have been stepping up the pace of reforms in recent years, may get a further pro-market boost from the crisis.

Further eastwards, the impetus for reforms will have to come from within rather than from any external influence. This suggests a gradual rather than radical reform path. Many countries in the CIS have not experienced a growing social consensus in favour of democracy and market reforms. Oil exporters, such as Azerbaijan, Kazakhstan and Russia, have learned a hard lesson about the importance of economic diversification. However, while market-friendly policies may yet emerge, state-centred remedies have so far been the norm, as discussed in Chapter 5 of the 2008 *Transition Report* and Chapter 4 of this Report. With commodity prices stabilising at a reasonable level, major institutional reform also remains unlikely.

This suggests that the post-crisis transition path will differ from that following the 1998 Russian financial crisis. Rather than a sharp decline in reforms followed by a steep recovery, the transition experience following the 2008–09 crisis is likely to involve a more moderate decline in the pace of reforms, followed by a modest recovery driven mainly by countries in the Western Balkans and EEC. The main exception could be institutional change and policy adjustments in the financial sector, where initiatives to increase both the quality and the extent of government regulation appear to be taking hold in quite diverse countries (such as Hungary and Kazakhstan, for example).

There could yet be some surprising developments – positive and negative. On the downside, a second wave of the crisis, related to the rise in non-performing loans and destabilisation of banks in some countries, might invigorate the populist nationalist trend which has so far been muted. Political destabilisation could then follow, triggering a reform backlash. On the upside, Russia has a government with many committed reformers in key positions of influence, who have stated their support for a new wave of modernising reforms and privatisation. Should that come to pass, it would be a powerful incentive for reform in several countries in the eastern transition region.

Endnotes

1 See North (1990).

2 See Olson (1982).

3 See Olson (1965).

4 See North (1990).

5 The creation of the transition region provides a compelling example of how a large shock – the collapse of communism and the dissolution of the Soviet Union – led to rapid widespread change in fundamental institutions across much of the region. However, this did not result in a uniform institutional overhaul across the board. Rather, the crisis removed an obstacle to reform in countries where the domestic debate had already been shifting for many years and the upward push for change was already fairly developed, while it did little to change the governance institutions in countries where the status quo was not being actively challenged at home – hence the heterogeneity in transition progress that is evident to this day.

6 See Drazen and Grilli (1993), Krueger (1993) and Ptilik and Wirth (2003).

7 See Fernandez-Arias and Montiel (1997) and Drazen (1999).

8 See Rodrik (1999).

9 See Haggard (2000), Haggard and Kaufmann (1992) and Tsebelis (2002).

10 See Berg (1999), Kochhar et al (1998), IMF (1998) and Fischer (1998) for a detailed discussion on the origins of the Asian crisis.

11 See Furman and Stiglitz (1998) and Radelet and Sachs (1998).

12 This was essentially the interpretation taken by the IMF. See Lane et al (1999) and Kochhar et al (1998).

13 See Corsetti, Pesenti and Roubini (1999) and Johnson et al (2000).

14 This assessment is based on the World Values Survey (1995, 2000) and the Asian Barometer Survey (2002).

15 See Welsh (1996).

16 See Kochhar et al (1998), IMF (1998) and Asian Development Bank (1998, 1999, 2000) for a detailed description of the measures implemented.

17 Ten downgrades were given in 1997 but this was due to a change in the transition indicator methodology.

18 On the relationship between reforms and growth see Falcetti et al (2006).

19 See Furman and Stiglitz (1999)

20 In Hungary, Poland and the Baltic states household lending in foreign currency increased sharply in the last few years. By July 2009, over one-third of total household lending was in foreign currency, compared to one-sixth in 2004.

21 See EBRD *Transition Report* 2007, Chapter 3, Box 3.1, for a discussion of middle class values.

22 See EBRD *Transition Report* 2007, Chapter 3.

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Country assessments

This part of the *Transition Report* contains a country-by-country review of reform progress and macroeconomic developments in the transition region from mid-2008 to the third quarter of 2009.

The data tables include indicators of structural, institutional and macroeconomic developments that help to describe transition in a particular country. However, they are not intended to be comprehensive. Given the inherent difficulties of measuring structural and institutional change, the data cannot give a complete account or precise measurement of progress in transition.

The data are based on a wide variety of sources, including national authorities, other international organisations and EBRD staff estimates. The source of data and the exact definition of variables are provided in the methodological notes at the end of the Report. The "cut-off" date for data and other information was early October 2009.

Albania

Key developments and challenges

The government has made progress in improving the business environment, including simplifying procedures for issuing licences and permits. However, weak law enforcement remains a significant impediment to business development, while property rights need to be developed further.

The completion of the Durres-Kukes highway has created new transit opportunities for regional exports. This potential could be increased through further upgrades of the road networks and modernisation of seaports, especially through public-private partnerships (PPPs).

The financial sector has developed strongly in recent years and adequate regulation and timely monetary interventions helped to limit the impact of the global financial crisis. However, improving access to finance – especially for micro, small and medium-sized enterprises (MSMEs) – remains a serious challenge.

Country data

Population (in millions)	**3.2**
Area ('000 sq km)	**28.7**
GDP (in billion US$, 2008)	**13.0**
Average transition score (scale: 1 to 4.33)	**3.07**

Progress in structural reform

Liberalisation and privatisation

The Stabilisation and Association Agreement signed with the European Union in June 2006, has been ratified by all member states and consequently came into force in April 2009. In the same month, Albania submitted its formal application for EU membership. However, the country (with Bosnia and Herzegovina) was not included among those Western Balkans countries recommended by the European Commission to the Council of the European Union for visa-free access to the Schengen area.

Business environment and competition

The government has continued to improve the business climate. Following the establishment of a national business registration centre, the number of newly registered businesses in 2008 increased by 29 per cent compared with 2007. A one-stop shop for licences and permits was opened in June 2009 and legal amendments to reduce the time for issuing construction permits from 60 to 45 days were also adopted. However, in the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), companies continue to report practices of unregistered firms operating in the informal economy as one of the most serious obstacles affecting their operations. Bottlenecks in the bankruptcy process were addressed by introducing further amendments to the bankruptcy law, although it remains largely untested. Only limited progress has been made towards the establishment of secure property rights, and weak law enforcement and the perceived high levels of corruption remain significant impediments to business development.

Infrastructure

Progress has been made in the power sector by upgrading generation capacities and expanding market structures following the completion of the sector's unbundling. Power supply has become more reliable and in spring 2009 the state-owned power company, KESH, started exporting electricity to Greece. In April 2009 the parliament approved the sale of a 76 per cent stake in the electricity distribution company, OSSH, to the Czech power group, CEZ. However, electricity tariffs do not yet fully reflect costs, while the level of technical and commercial losses continues to be high owing to the low quality of the electricity grid. By mid-2009 there had been a further increase in private sector participation in power generation following the government's award of 50 out of a planned 130 concessions for private companies to operate both small and large hydropower plants. Market rules have been approved to provide the necessary framework for the opening and functioning of the wholesale and retail market for electricity. However, competition has been limited so far and the Energy Regulatory Authority has only just begun to establish itself as an effective, independent regulator.

In the transport sector, significant progress was made in rebuilding road networks although the sector requires further investment. Major improvements include the main road from Tirana International Airport into the city, as well as the north-bound highways (to Shkoder) and south-bound (to Vlore and Saranda) and east-west highways (to Korca and Pogradec). The government has also invested more than €1 billion in the new highway to Kosovo, which opened in June 2009, with plans to develop new export routes for the entire Balkan region via the Durres and Shenjin ports. In September 2009 the second phase of the rehabilitation of the Tirana International Airport was completed, successfully demonstrating the benefits of involving the private sector in public infrastructure projects.

Financial sector

The banking sector developed strongly in recent years from a low base, up until the onset of the global financial crisis. Following the privatisation of the government's 40 per cent equity stake in the United Bank of Albania in March 2009, the banking sector is now fully privatised. The global financial crisis is affecting the sector, although to a lesser extent than in other countries of the region, mainly because of Albania's lower level of integration in the global financial markets. Lending conditions have become more restricted, in particular for MSMEs, and businesses in BEEPS IV reported access to finance as the single most important obstacle affecting their operations. Deposits fell by around 10 per cent between September 2008 and April 2009. In response, the government increased the deposit insurance ceiling from Lk 700,000 to Lk 25,000,000 (around €20,000) in March 2009 and the level of deposits has stabilised since May. The Bank of Albania strengthened banking supervision and further developed its credit registry, which is vital for risk management as the sector's level of non-performing loans doubled in the past 12 months, reaching 8.7 per cent in June 2009. The capital adequacy ratio remained stable at around 17 per cent.

Macroeconomic performance

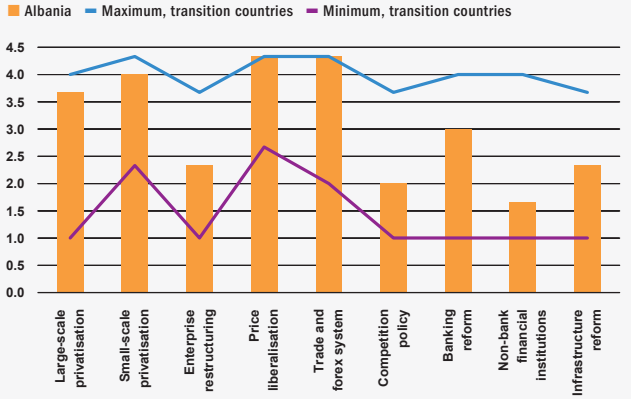
The global economic crisis has had less effect on Albania so far than on most other countries in the region. The economy grew by around 7 per cent in 2008 and 6 per cent in the first quarter of 2009, driven by public infrastructure investments and activity in the services and telecommunications sectors. The 2008 budget deficit increased to 5.7 per cent, up from 3.5 per cent in 2007, mainly due to an increase in the number and size of infrastructure projects. Revenue administration and public debt management were strengthened, leading to increasing tax revenues in 2008 despite a reduction of corporate and personal income tax rates to 10 per cent. The government debt burden remains high at above 50 per cent of GDP, while external debt is manageable at around 20 per cent of GDP.

The biggest impact of the crisis was felt in the real economy due to lower remittances (a fall of 18 per cent in the first half of 2009 compared with a year earlier) and lower exports (down 17 per cent year on year in the first half of 2009) while imports decreased by less than 2 per cent. As a result, the current account deficit continues to remain high at around 15 per cent of GDP. In response to falling foreign currency inflows and tighter lending conditions, the Bank of Albania (BoA) lowered its policy rate from 6.25 to 5.75 per cent in January 2009. Inflation has remained well within the BoA's 2 to 4 per cent target range, and continued its downward trend in 2009, reaching 2.2 per cent year on year in July. International reserves have remained broadly stable at around four months of imports as a result of prudent monetary policy and the flexible exchange rate regime.

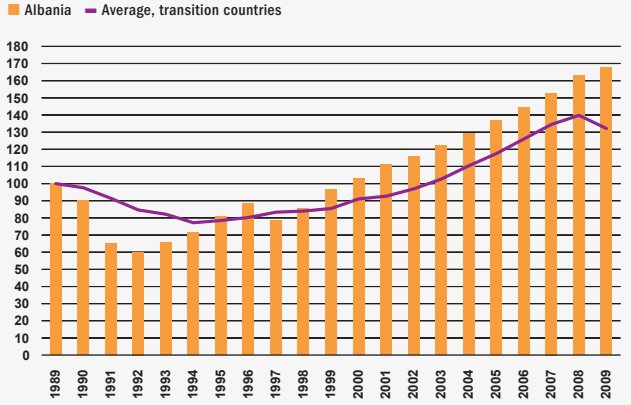
Outlook and risks

Albania's less-advanced financial sector and limited exposure to international goods and capital markets provide buffers against the crisis, and local banks seem well placed to overcome the current crisis due to strong capitalisation, limited reliance on wholesale funding and still-low loan-to-deposit ratios. However, export growth is expected to decline further and the global recession will continue to affect remittances. As a result, it is likely that Albania will achieve a significantly lower, but still positive growth in 2009. Key macroeconomic challenges include financing the large trade and current account deficits. Fiscal risks remain as the government continues to subsidise underperforming state-owned utilities, especially water, power generation and transmission, where revenues do not cover necessary maintenance and investment. Continuing EU approximation, which culminated with the recent formal bid for EU membership, as well as membership of North Atlantic Treaty Organization (NATO), has improved Albania's image as an investment destination and should contribute to a rebound in growth in the second half of 2010 and further catch-up growth over the medium term.

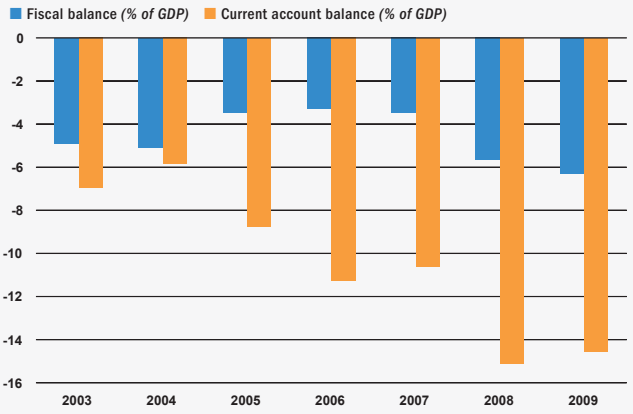
Transition indicators 2009



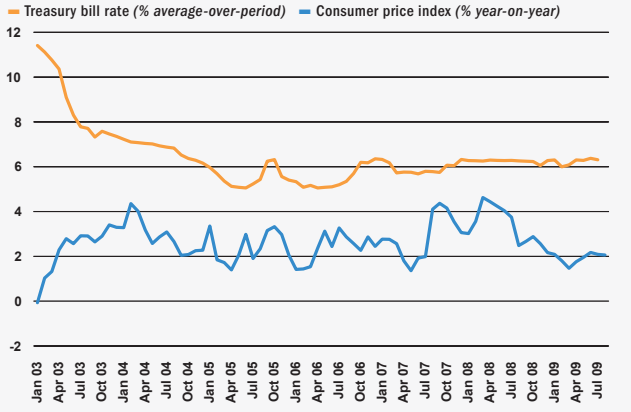
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Telecoms regulatory assessment compliance – **high**	Capital adequacy ratio – **12 per cent**	Share of population living in poverty – **7.8 per cent** (2005)
Controls on inward direct investment – **no**	Quality of insolvency law – **high**	Independence of the electricity regulator – **partial**	Deposit insurance system – **yes**	Government expenditure on health – **2.7 per cent** (2008)
Interest rate liberalisation – **full**	Secured transactions law – **advanced**	Separation of railway infrastructure from operations – **no**	Private pension funds – **yes**	Government expenditure on education – **3.8 per cent** (2008)
Exchange rate regime – **floating**		Independence of the road directorate – **partial**		Household expenditure on power and water – **5.0 per cent**
Wage regulation – **no**				
Tradeability of land – **limited de facto**				

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	9.5	11.4	11.5	11.7	13.1	**13.6**	**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)	80.0	80.0	80.0	80.0	80.0	**83.0**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	0.7	0.7	0.4	0.4	0.4	**0.2**	**na**
Share of industry in total employment (in per cent)	7.3	8.2	8.0	7.9	7.6	**na**	**na**
Change in labour productivity in industry (in per cent)	33.0	2.1	15.9	13.6	10.1	**na**	**na**
Investment/GDP (in per cent)	25.4	26.3	28.9	29.1	29.9	**32.0**	**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	**3.3**	**3.7**
EBRD index of enterprise reform	2.0	2.0	2.0	2.3	2.3	**2.3**	**2.3**
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	**na**	**na**
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Share of trade with non-transition countries (in per cent)	81.6	81.5	78.5	75.9	77.4	**74.7**	**na**
Share of trade in GDP (in per cent)	39.0	38.1	37.7	40.5	46.7	**49.1**	**na**
Tariff revenues (in per cent of imports)	6.4	6.2	5.6	4.9	2.7	**2.1**	**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	4.3	4.3	4.3	4.3	4.3	**4.3**	**4.3**
EBRD index of competition policy	1.7	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Financial sector							
Number of banks (foreign-owned)	15 (13)	16 (14)	16 (14)	17 (14)	17 (15)	**16 (14)**	**na**
Asset share of state-owned banks (in per cent)	51.9	6.7	7.7	0.0	0.0	**0.0**	**na**
Asset share of foreign-owned banks (in per cent)	47.1	93.3	92.3	90.5	94.2	**93.6**	**na**
Non-performing loans (in per cent of total loans)	4.6	4.2	2.3	3.1	3.4	**6.6**	**na**
Domestic credit to private sector (in per cent of GDP)	7.3	9.2	14.9	21.5	28.9	**35.3**	**na**
Domestic credit to households (in per cent of GDP)	na	2.8	4.6	7.3	10.6	**13.2**	**na**
– Of which mortgage lending (in per cent of GDP)	na	1.4	1.9	4.3	na	**8.3**	**na**
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	**na**	**na**
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	**na**	**na**
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
EBRD index of banking sector reform	2.3	2.7	2.7	2.7	2.7	**3.0**	**3.0**
EBRD index of reform of non-bank financial institutions	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	8.3 (35.6)	8.9 (40.7)	9.0 (49.2)	9.1 (60.9)	9.6 (73.4)	**10.1 (99.9)**	**na**
Internet users (per 100 inhabitants)	1.0	2.4	6.0	15.1	15.1	**15.1**	**na**
Railway labour productivity (1989=100)	39.4	35.0	28.6	35.5	34.5	**33.3**	**na**
Residential electricity tariffs (USc kWh)	4.1	5.3	5.9	6.6	7.7	**9.6**	**na**
Average collection rate, electricity (in per cent)	92	76	74	68	76	**76**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	6.8	7.6	7.2	na	na	**na**	**na**
EBRD index of infrastructure reform	2.0	2.0	2.0	2.0	2.3	**2.3**	**2.3**
– Electric power	2.3	2.7	2.7	2.7	2.7	**2.7**	**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**	**2.3**
– Telecommunications	3.0	3.0	3.0	3.0	3.3	**3.3**	**3.3**
– Water and wastewater	1.0	1.7	1.7	1.7	1.7	**1.7**	**1.7**

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	5.8	5.7	5.7	5.4	6.0	**6.8**	**3.0**
– Private consumption	11.1	9.4	6.0	7.2	11.5	**na**	**na**
– Public consumption	-1.9	7.4	2.6	1.4	7.2	**na**	**na**
– Gross fixed capital formation	18.0	2.7	4.9	9.3	6.5	**na**	**na**
– Exports of goods and services	19.5	16.6	18.1	14.9	15.8	**na**	**na**
– Imports of goods and services	12.7	6.4	14.0	7.0	18.5	**na**	**na**
Industrial gross output	29.0	14.1	14.4	12.1	8.6	**3.8**	**na**
Agricultural gross output	2.9	6.3	0.9	3.0	-1.9	**2.5**	**na**
Employment[1]			*(Percentage change)*				
Labour force (end-year)	-0.3	-0.1	-0.3	0.0	-0.2	**3.1**	**na**
Employment (end-year)	0.7	0.5	0.1	0.3	3.3	**0.9**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	15.0	14.4	14.1	13.8	13.2	**12.7**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	2.3	2.9	2.4	2.4	2.9	**3.4**	**1.7**
Consumer prices (end-year)	3.3	2.2	2.0	2.5	3.1	**2.2**	**1.8**
Producer prices (annual average)	6.2	10.8	5.1	0.1	4.1	**6.5**	**na**
Producer prices (end-year)	4.4	12.3	1.5	0.2	6.6	**4.3**	**na**
Gross average monthly earnings in economy (annual average)	12.0	2.8	5.0	9.2	25.2	**12.0**	**na**
Government sector *(In per cent of GDP)*			*(In per cent of GDP)*				
General government balance	-4.9	-5.1	-3.5	-3.3	-3.5	**-5.7**	**-6.3**
General government expenditure	29.0	29.6	28.5	29.0	29.1	**33.0**	**na**
General government debt	60.7	57.7	58.2	56.1	53.2	**55.9**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	7.6	12.0	8.9	12.1	5.3	**10.3**	**na**
Domestic credit (end-year)	8.7	8.8	16.1	19.6	24.1	**18.0**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	50.4	52.1	52.3	53.6	51.3	**52.2**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate[2]	6.5	5.3	5.0	5.5	6.3	**6.3**	**na**
Treasury bill rate (3-month maturity)	7.3	6.2	5.4	6.4	6.3	**6.3**	**na**
Deposit rate (1 year)	7.6	6.0	5.6	5.5	6.0	**6.9**	**na**
Lending rate (1 year)[3]	10.5	13.7	12.2	11.2	13.6	**11.1**	**na**
			(Leks per US dollar)				
Exchange rate (end-year)	106.4	92.6	98.1	94.1	82.9	**87.9**	**na**
Exchange rate (annual average)	121.3	102.8	98.1	98.1	90.4	**83.5**	**na**
External sector			*(In millions of US dollars)*				
Current account	-398.0	-427.0	-726.0	-1,024.4	-1,147.8	**-1,923.8**	**-1,679.7**
Trade balance	-1,336.0	-1,583.0	-1,821.0	-2,089.5	-2,899.6	**-3,551.9**	**-3,537.0**
– Merchandise exports	447.0	601.0	656.0	792.9	1,078.7	**1,355.6**	**1,125.2**
– Merchandise imports	1,783.0	2,184.0	2,477.0	2,882.3	3,978.3	**4,907.5**	**4,662.1**
Foreign direct investment, net	178.0	324.0	258.0	314.7	647.4	**843.7**	**650.0**
Gross reserves, excluding gold (end-year)	1,009.4	1,357.6	1,404.1	1,768.8	2,104.2	**2,319.8**	**na**
External debt stock	1,253.5	1,519.4	1,752.1	1,807.6	1,950.8	**2,600.6**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.7	5.0	4.4	4.4	4.3	**3.8**	**na**
			(In per cent of exports of goods and services)				
Debt service	3.1	3.1	2.8	3.1	2.4	**4.2**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	3.1	3.1	3.1	3.2	3.2	**3.2**	**na**
GDP (in billions of leks)	694.1	750.8	814.8	891.0	980.1	**1,064.0**	**1,110.0**
GDP per capita (in US dollars)	1,844.7	2,341.7	2,648.7	2,883.0	3,422.8	**4,005.9**	**na**
Share of industry in GDP (in per cent)	8.7	10.0	10.6	11.0	10.3	**10.4**	**na**
Share of agriculture in GDP (in per cent)	23.5	22.3	20.7	19.8	21.0	**21.5**	**na**
Current account/GDP (in per cent)	-7.0	-5.8	-8.7	-11.3	-10.6	**-15.1**	**-14.5**
External debt - reserves (in US$ million)	244.0	161.8	348.0	38.8	-153.4	**280.8**	**na**
External debt/GDP (in per cent)	21.9	20.8	21.1	19.9	18.0	**20.4**	**na**
External debt/exports of goods and services (in per cent)	107.4	95.0	94.7	80.4	64.5	**67.8**	**na**

[1] Figures do not include emigrant workers abroad.

[2] The figures show the repo rate of the central bank.

[3] 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 developments and challenges

The global financial crisis has underlined Armenia's economic dependence on the remittance-financed construction sector. To channel remittances and foreign direct investment (FDI) into a broader group of industries, the business environment needs to be improved through better enforcement of anti-competitive measures and a reduction in the administrative burden on small and medium-sized enterprises (SMEs).

High transportation costs and closed borders with Turkey and Azerbaijan emphasise the need to improve the competitiveness of the tradeable sector and to diversify and upgrade regional transport infrastructure.

The switch to a floating exchange rate and subsequent depreciation of the dram has eliminated the exchange rate misalignment and helped to improve export competitiveness. To further contribute to macroeconomic stabilisation the central bank needs to continue providing the banking system with sufficient liquidity support, including through repo instruments with longer maturities.

Country data

Population (in millions)	**3.2**
Area ('000 sq km)	**29.8**
GDP (in billion US$, 2008)	**11.9**
Average transition score (scale: 1 to 4.33)	**3.18**

Progress in structural reform

Business environment and competition

Remittances from Russia, previously accounting for about 80 per cent of overall remittance inflows, have declined significantly. The construction sector – the main pillar of economic growth – has suffered the most as a consequence and the need for diversification has become even more pressing. Improving the overall business climate can be an effective means of fostering diversification. The 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV) identified anti-competitive practices, particularly in the informal sector, and taxes as key impediments to the development of SMEs. While competition policy has limited impact on the informal sector, the government has made some progress in 2009 with simplifying the tax code for SMEs. Tax policy changes include the introduction of a threshold below which enterprises need not register for VAT and ongoing administrative reform to reduce delays in VAT refunds.

Infrastructure

In 2009 Armenia made significant progress in expanding and diversifying its energy infrastructure. In May the Iran-Armenia gas pipeline became operational, allowing both countries to start implementing their substantially increased gas-for-electricity swap programme in which Armenia will import Iranian gas and use it to generate electricity and export part of it back to Iran. This is the first of a number of planned joint Iran-Armenian infrastructure projects forming part of a broader diversification strategy to reduce Armenia's dependency on energy and goods transit through Georgia. An agreement was reached with Turkey in March 2009 that provides for Armenia to export 1.5 billion kWh per year once the electricity grid in eastern Turkey has been upgraded.

The inadequate irrigation network has been one of the most acute problems facing Armenian agriculture since the break-up of the Soviet Union, compounded by under-investment in rural infrastructure. With funding from the Millennium Challenge Account and the World Bank, a large-scale reconstruction project of the canal network started in September 2008. Many rural farmers in the intensively cultivated Ararat valley nevertheless remain without access to an efficient irrigation system.

Financial sector

Although the direct impact of the global financial crisis on Armenian banks has been limited to date, greater economic uncertainty has resulted in banks slowing their lending to the private sector. Annual credit growth slowed to 25 per cent in the first quarter of 2009 from 67 per cent a year earlier. New consumer loans in particular have fallen sharply – by more than 40 per cent year on year by the end of the first quarter 2009 – and mortgage lending has come to a near standstill. The government has reacted by establishing a state mortgage fund, which offers funding to commercial banks at an annual interest rate of 9 per cent for on-lending to households.

The switch to a free-floating exchange rate regime in March 2009 went relatively smoothly and did not adversely affect banking sector stability. After a rapid increase in the volume of US dollar deposits in anticipation of the depreciation, this trend levelled off later in 2009 (at around 65 per cent from only 35 per cent in November 2008) partially undermining the authorities' efforts to increase confidence in the Armenian dram. The depreciation, however, did not trigger a significant outflow of deposits. Non-performing loans as a percentage of gross loans increased from 4.4 per cent at the end of 2008 to 7.6 per cent in March 2009 and to 10.2 per cent in June 2009.

Social sector

The sharp slow-down in economic growth has led to a substantial decline in tax revenues, putting pressure on the government's expenditure plans. The government has ring-fenced part of the 2009 budget to keep the existing social safety net in place and to ensure that progress with poverty alleviation will not be reversed. The government has also signed several multilateral and bilateral agreements (including an International Monetary Fund stand-by facility, additional World Bank funding and a large bilateral loan from Russia) that will enable it to spend more on capital investment. This will target new housing projects (especially in the 1988 earthquake zone) and infrastructure, particularly the rehabilitation of rural roads.

Macroeconomic performance

After several years of double-digit economic growth, the global financial crisis hit Armenia in the final quarter of 2008, moderating real GDP growth to 6.8 per cent for 2008 as a whole. Since then, a significant reduction in external demand and dwindling remittances have further constrained growth, with GDP contracting 16.3 per cent (year on year) in the first half of 2009. The non-tradeable sector – particularly services (diamond processing), retail trade and construction – which has been the main driver of growth, was seriously affected by the crisis, with output declining by over 40 per cent in the first five months of 2009. At the same time, the tradeable sector, particularly manufacturing and agriculture, continues to lag behind in terms of productivity levels.

While trade with Iran has intensified in 2009, the continuing closure of the Turkish and Azerbaijani borders remains a major impediment to Armenian trade flows. Falling prices for base metals over the past year have put additional pressure on Armenia's external position. The move towards a flexible exchange rate and the subsequent 22 per cent depreciation in relation to the US dollar by the end of March have boosted the competitiveness of Armenia's exporters.

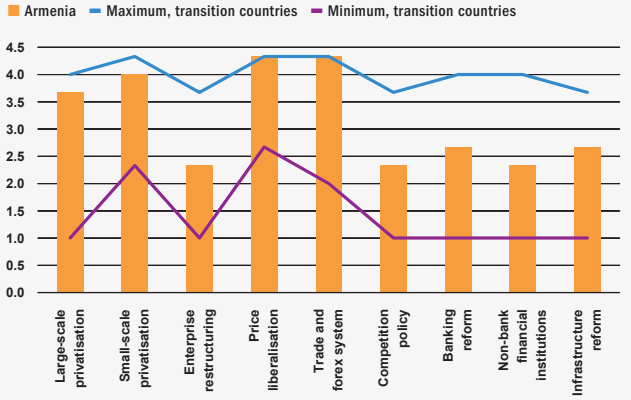
Despite the depreciation, inflation amounted to only 3.5 per cent in August compared with a year earlier and is expected to remain within the central bank's inflation target of 4 per cent (+/- 1.5 per cent) for 2009. Although prices for a number of other imported commodities have fallen, limited competition among commodity importers has meant that only part of these price declines has been passed on to consumers.

Slower growth has resulted in a substantial decline in tax revenues to the government since the beginning of 2009. As a result, the government's expenditure plans have come under pressure and, with the exception of certain categories of social spending, have been either scaled back or postponed. The government was forced to raise the legally allowed maximum budget deficit from 5.0 to 7.5 per cent of GDP for 2009. However, low debt levels and concessional financing terms are helping the country to achieve sustainable medium-term fiscal and external debt.

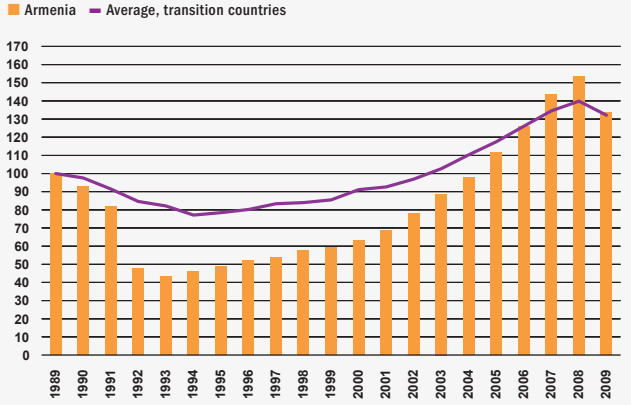
Outlook and risks

Armenia's economy is expected to contract by about 12 per cent in 2009 in the wake of the global economic downturn. However, it is expected to record positive growth in 2010, partly as a result of the significant concessional finance packages from the International Monetary Fund (IMF), the World Bank and Russia. The main risk stems from the possibility of an even more dramatic decline in remittances than already envisaged, combined with a more severe decline in base metal prices and a significant slow-down of FDI. Further improvements in relations with Turkey could, on the other hand, make a significant positive contribution to Armenia's trade balance. Continuing the ambitious pension reform agenda and safeguarding key social expenditure will be the main fiscal challenges in 2010.

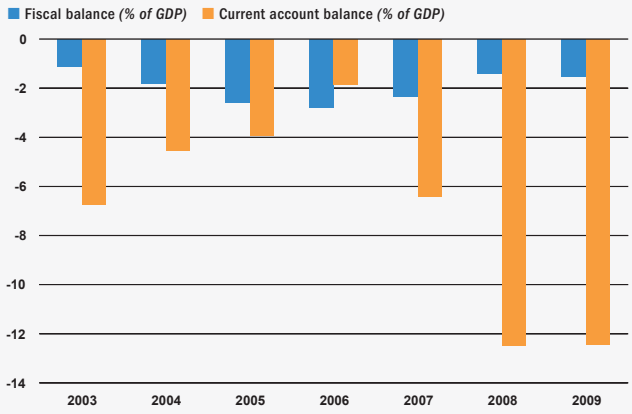
Transition indicators 2009



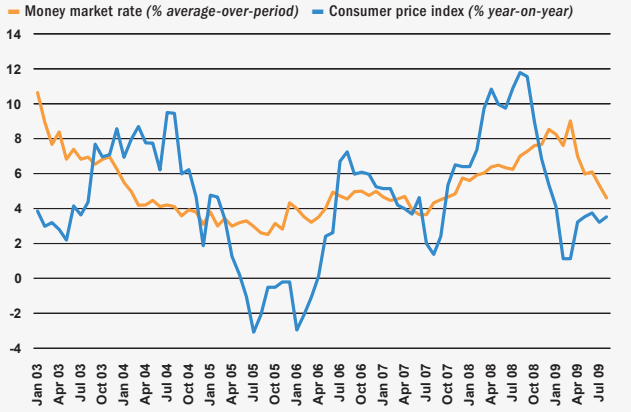
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **floating**

Wage regulation – **no**

Tradeability of land – **full except foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **under development**

Infrastructure

Telecoms regulatory assessment compliance – **medium**

Independence of the electricity regulator – **partial**

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

Independence of the road directorate – **no**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Private pension funds – **no**

Social reform

Share of population living in poverty – **43.4 per cent** (2003)

Government expenditure on health – **1.5 per cent** (2006)

Government expenditure on education – **2.7 per cent** (2006)

Household expenditure on power and water – **6.8 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)[1]	10.2	10.2	na	na	na	**na**	**na**
Private sector share in GDP (in per cent)	70.0	75.0	75.0	75.0	75.0	**75.0**	**75.0**
Private sector share in employment (in per cent)	76.0	na	na	na	na	**na**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	0.9	1.0	0.6	na	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)	24.2	22.0	23.2	na	na	**na**	**na**
EBRD index of small-scale privatisation	3.7	4.0	4.0	4.0	4.0	**4.0**	**4.0**
EBRD index of large-scale privatisation	3.3	3.3	3.7	3.7	3.7	**3.7**	**3.7**
EBRD index of enterprise reform	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
Markets and trade							
Share of administered prices in CPI (in per cent)	8.7	8.0	8.0	8.1	8.1	**8.1**	**na**
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	1.0	1.0	1.0	**1.0**	**na**
Share of trade with non-transition countries (in per cent)	77.0	73.6	69.3	59.5	58.2	**na**	**na**
Share of trade in GDP (in per cent)	65.1	54.1	53.0	46.1	43.4	**40.7**	**na**
Tariff revenues (in per cent of imports)	1.6	2.0	2.3	na	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	4.3	4.3	4.3	4.3	4.3	**4.3**	**4.3**
EBRD index of competition policy	2.0	2.0	2.3	2.3	2.3	**2.3**	**2.3**
Financial sector							
Number of banks (foreign-owned)	19 (9)	20 (9)	21 (9)	21 (10)	22 (12)	**22 (12)**	**na**
Asset share of state-owned banks (in per cent)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Asset share of foreign-owned banks (in per cent)	51.3	56.7	48.7	45.8	49.0	**50.5**	**na**
Non-performing loans (in per cent of total loans)	4.9	2.1	2.1	2.6	2.5	**4.4**	**na**
Domestic credit to private sector (in per cent of GDP)	6.0	7.2	8.1	8.7	na	**na**	**na**
Domestic credit to households (in per cent of GDP)	2.1	2.9	3.6	4.5	7.1	**9.1**	**na**
– Of which mortgage lending (in per cent of GDP)	na	na	0.5	0.9	1.7	**2.3**	**na**
Stock market capitalisation (in per cent of GDP)	1.0	0.5	0.9	0.8	1.0	**1.4**	**na**
Stock trading volume (in per cent of market capitalisation)	2.9	7.0	3.6	9.4	5.5	**0.6**	**na**
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
EBRD index of banking sector reform	2.3	2.3	2.7	2.7	2.7	**2.7**	**2.7**
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	**2.3**	**2.3**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	18.4 (3.7)	18.9 (6.6)	19.4 (10.4)	19.4 (41.1)	19.4 (61.1)	**19.4 (61.1)**	**na**
Internet users (per 100 inhabitants)	4.6	4.9	5.3	5.6	5.6	**5.6**	**na**
Railway labour productivity (1989=100)	23.5	29.1	26.9	27.6	34.6	**31.5**	**na**
Residential electricity tariffs (USc kWh)	4.3	4.6	5.4	5.9	7.1	**7.9**	**na**
Average collection rate, electricity (in per cent)	96	96	102	99	99	**101**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	4.7	5.0	4.9	na	na	**na**	**na**
EBRD index of infrastructure reform	2.3	2.3	2.3	2.3	2.3	**2.7**	**2.7**
– Electric power	3.3	3.3	3.3	3.3	3.3	**3.3**	**3.3**
– Railways	2.0	2.0	2.0	2.0	2.0	**2.3**	**2.3**
– Roads	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Telecommunications	2.3	2.3	2.3	2.7	2.7	**3.0**	**3.0**
– Water and wastewater	2.0	2.0	2.0	2.0	2.3	**2.3**	**2.3**

[1] Privatisation proceeds are in principle to finance fiscal deficits only. The part saved in the Special Privatisation Accounts is not included.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	13.9	10.1	14.0	13.2	13.8	**6.8**	**-12.9**
Private consumption	11.5	16.3	7.6	13.3	16.1	**10.6**	**na**
– Public consumption	21.9	17.0	21.9	13.3	24.2	**13.7**	**na**
– Gross fixed capital formation	30.0	21.9	46.8	41.2	21.3	**na**	**na**
– Exports of goods and services	30.6	0.0	23.7	6.7	17.6	**-3.0**	**na**
– Imports of goods and services	28.1	-1.1	20.6	19.4	41.5	**30.3**	**na**
Industrial gross output	15.3	2.1	7.5	-0.9	2.6	**2.0**	**na**
Agricultural gross output	4.0	14.5	11.2	0.4	9.6	**1.3**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	-0.6	-0.5	0.6	0.5	-8.8	**na**	**na**
Employment (end-year)	0.5	-4.6	2.6	-0.3	0.1	**na**	**na**
			(In per cent of labour force)				
Unemployment (annual average)[1]	10.1	9.7	7.9	7.2	7.1	**6.3**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	4.7	7.0	0.6	2.9	4.4	**9.0**	**3.0**
Consumer prices (end-year)	8.6	1.9	-0.2	5.2	6.6	**5.2**	**3.7**
Producer prices (annual average)	8.9	-13.3	7.7	0.9	0.6	**2.2**	**na**
Producer prices (end-year)	21.1	25.3	-4.0	na	na	**na**	**na**
Gross average monthly earnings in economy (annual average)	26.7	23.7	23.9	22.9	20.9	**17.6**	**na**
Government sector[2]			*(In per cent of GDP)*				
General government balance	-1.1	-1.8	-2.6	-2.8	-2.3	**-1.4**	**-1.5**
General government expenditure	18.9	17.1	17.6	20.0	22.4	**21.7**	**na**
General government debt	40.9	51.5	39.7	34.3	20.5	**20.0**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	10.4	22.3	27.8	32.9	42.3	**-1.2**	**na**
Domestic credit (end-year)	-10.1	41.2	54.6	8.7	78.4	**na**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	14.4	15.0	16.3	18.3	22.0	**18.7**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	7.0	3.8	3.5	4.1	4.8	**4.5**	**na**
Money market rate	7.5	4.2	3.2	na	5.1	**na**	**na**
Deposit rate	6.9	4.9	5.8	na	6.2	**na**	**na**
Lending rate	20.8	18.6	18.0	16.5	17.5	**16.5**	**na**
			(Drams per US dollar)				
Exchange rate (end-year)	566.0	486.3	450.2	363.5	304.2	**299.1**	**na**
Exchange rate (annual average)	578.8	533.5	457.8	416.0	342.1	**304.1**	**na**
External sector			*(In millions of US dollars)*				
Current account	-189.4	-161.7	-193.1	-117.0	-589.0	**-1,499.0**	**-1,229.0**
Trade balance	-434.1	-457.9	-588.0	-896.0	-1,600.0	**-2,649.0**	**-2,160.0**
– Merchandise exports	696.1	738.3	1,005.0	1,025.0	1,197.0	**1,118.0**	**815.0**
– Merchandise imports	1,130.2	1,196.3	1,593.0	1,921.0	2,797.0	**3,767.0**	**2,975.0**
Foreign direct investment, net	121.0	217.0	252.0	450.0	701.0	**784.0**	**488.0**
Gross reserves, excluding gold (end-year)	502.0	547.8	669.5	1,071.9	1,659.0	**1,405.0**	**na**
External debt stock	1,788.1	1,868.0	1,860.2	2,052.7	2,200.0	**na**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.3	4.3	4.0	5.1	5.5	**3.6**	**na**
			(In per cent of exports of goods and services)				
Debt service	15.6	9.7	4.6	3.9	2.9	**na**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	3.2	3.2	3.2	3.2	3.2	**3.2**	**na**
GDP (in billions of drams)	1,624.6	1,907.9	2,244.0	2,656.0	3,149.0	**3,650.0**	**3,757.0**
GDP per capita (in US dollars)	873.9	1,112.8	1,510.0	1,982.6	2,850.0	**3,707.9**	**na**
Share of industry in GDP (in per cent)	19.9	19.7	na	na	na	**na**	**na**
Share of agriculture in GDP (in per cent)	21.3	22.5	na	na	na	**na**	**na**
Current account/GDP (in per cent)	-6.7	-4.5	-3.9	-1.8	-6.4	**-12.5**	**-12.4**
External debt – reserves (in US$ million)	1,286.1	1,320.2	1,190.7	980.7	541.0	**na**	**na**
External debt/GDP (in per cent)	63.7	52.2	38.0	32.2	23.9	**na**	**na**
External debt/exports of goods and services (in per cent)	197.9	189.7	139.1	135.9	123.8	**na**	**na**

[1] Registered unemployed only.

[2] Central government account only.

Azerbaijan

Key developments and challenges

The global financial crisis and the resulting sharp drop in oil prices have emphasised the need for greater economic diversification. Measures to improve the business environment through fighting corruption and breaking up monopolies are essential for the sustained development of the non-oil sector.

The National Bank of Azerbaijan has tightened banks' regulatory requirements and undertaken timely measures to provide liquidity. In addition, improvements in the portfolio and risk management skills of banks are needed to ensure financial sector stability in the long run.

Lower oil prices and the ensuing fall in fiscal revenues have further underlined the need to improve investment efficiency in the public sector. This requires the successful implementation of the recently established rules for the selection, execution, monitoring and auditing of public investment projects.

Country data

Population (in millions)	**8.4**
Area ('000 sq km)	**86.6**
GDP (in billion US$, 2008)	**46.4**
Average transition score (scale: 1 to 4.33)	**2.63**

Progress in structural reform

Business environment and competition

Azerbaijan's participation in programmes related to the European Neighbourhood Policy (ENP) and Eastern Partnership will gradually bring its laws and regulations more in line with European standards and encourage stricter implementation. Nevertheless, the effectiveness of government institutions and the quality of regulation remain below the standards of the transition region. According to the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), firms cite state inspections and certification as particular obstacles to their development. Significant challenges also remain in the enforcement of competition policy and ensuring a level playing field for all businesses.

Corruption continues to be a major issue and 87 per cent of the firms included in BEEPS IV reported it as an obstacle. In Transparency International's 2008 Corruption Perception Index, Azerbaijan scored well below others in the transition region and was ranked 158th out of 180 countries globally. In June 2009 the President issued a decree on strengthening the fight against corruption. The administration is working on defining rules for inspections, regulations and legal Acts related to corruption. In addition, a Corruption Fight Department was established in July 2009 under the Ministry of Taxes to deal with corruption by the tax administration.

In July, the President signed into law 46 amendments to the tax code that are expected to help small and medium-sized enterprises (SME) development. The changes, taking effect from January 2010, include a reduction in the maximum rate of personal income tax from 35 to 30 per cent. The corporate profit tax will also be reduced from 22 to 20 per cent and the income tax for individual entrepreneurs will be 20 per cent.

Infrastructure

The state-owned power company, Azerenerji, remains the dominant utility in the power sector and continues to be subsidised by the government owing to high technical and financial losses and low collection rates. Work has started on the rehabilitation of the power sector infrastructure as well as on plans to increase electricity production. However, the plans to introduce Independent Power Producers (IPPs) and increase competition in the sector have been abandoned so that little progress has been made with unbundling the sector over the past year.

Improving road infrastructure remains an important priority for the government and public investment in the sector has increased significantly over the past years. However, a key pre-requisite is the further strengthening of the quality and efficiency of the procedures for public investment, including better procurement rules. At the end of 2008 the President issued a decree to establish clear rules for the selection, execution, monitoring and auditing of public investment projects.

In July 2009 the President issued a decree to transform the state-owned railway monopoly, Azerbaijan Dovlet Demir Yolu (ADDY), into a joint-stock company, Azerbaijan Railway (ADY). This new wholly state-owned joint-stock company intends to commercialise its activities and will prepare the future privatisation of a number of railway services.

While the fixed-line telecommunication market continues to be dominated by state-owned company, Aztelecom, competition has intensified in the mobile telephone market after the privatisation of Azercell in February 2008. The penetration rate of mobile phones increased significantly during the first half of 2009, reaching more than 80 per cent.

Financial sector

The direct impact of the global financial crisis on the Azerbaijani banking sector has been relatively modest because of its limited integration with international financial markets. Measures taken by the National Bank of Azerbaijan (NBA) to contain rapid credit growth in the first half of 2008 have also contributed to banks' resilience. Since the deepening of the financial crisis in October 2008, the NBA repeatedly reduced its reserve requirements: to 0.5 per cent as of August 2009. The NBA also reduced its policy rate from 15 per cent in mid-October 2008 to 3 per cent in March 2009 and provided liquidity support to solvent banks. However, banks' loan portfolios have been shrinking month on month since the beginning of 2009, although a reversal has been seen since June. Bank lending grew by little over 13 per cent in annual terms as of July 2009 (compared with 86 per cent a year earlier). Banks' non-performing loans have started to increase in the wake of slower economic growth, and the reduced value of collateral, amounting to more than 4.5 per cent in June 2009 compared with 2 per cent at the end of 2008. Nevertheless, in general, banking sector liquidity and capital ratios remain sound.

Macroeconomic performance

Signs of economic recovery are emerging as the annual GDP growth for the first eight months of 2009 reached 5 per cent, an increase from 3.6 per cent during the first half of the year, reflecting a recovery in oil prices and an improved global economic outlook. Although this is a relatively strong growth performance regionally or even globally, it reflects a marked slow-down when compared with growth rates of over 20 per cent annually during the past three years. This slow-down mainly reflects sharply lower oil prices compared with a year ago. Industrial output, dominated by oil production that accounted for 60 per cent of GDP in 2008, grew by only 3.9 per cent in the first eight months of 2009. Inflation has slowed due to lower demand and the annual inflation rate was negative from May, reaching -0.4 per cent in August 2009 compared with 22 per cent at the end of 2008. Lower oil prices have also affected budgetary revenues. Tax revenues had fallen by about 20 per cent by the end of June 2009 compared with a year earlier, implying an annual increase in total budget revenue of little over 1 per cent during the same period. Despite some recent cuts, overall budget expenditures – in particular for infrastructure investments and social spending – have increased as part of the government's crisis response, resulting in an estimated budget deficit of about 2 per cent of GDP in the first half of 2009.

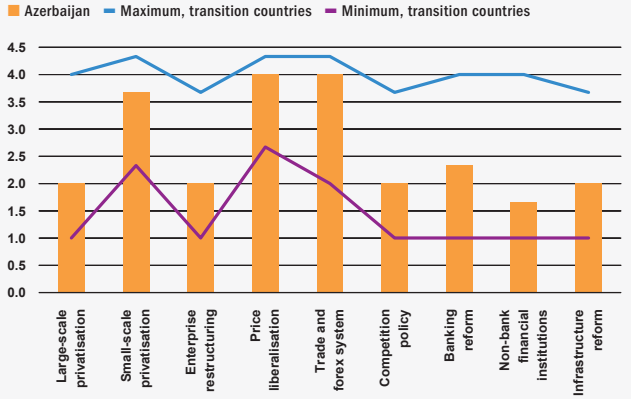
Lower oil prices and weaker demand for hydrocarbons has also significantly affected exports, which had dropped by 77 per cent by the end of August 2009 compared with a year earlier. As imports dropped by only 15 per cent over the same period, the trade surplus narrowed by almost 78 per cent compared with the same period in 2008, although it still amounted to 7.8 per cent of GDP in August 2009.

Lower foreign exchange inflows following the large decline in exports outstripping the decline in imports has put pressure on the currency. The NBA has so far supported the currency and lost about 19 per cent of its foreign exchange reserves during the first three months of 2009. Consequently, the exchange rate has remained relatively stable and reserves have gradually increased again since March to US$ 4.8 billion in August although they remain about 22 per cent lower than at the end of 2008.

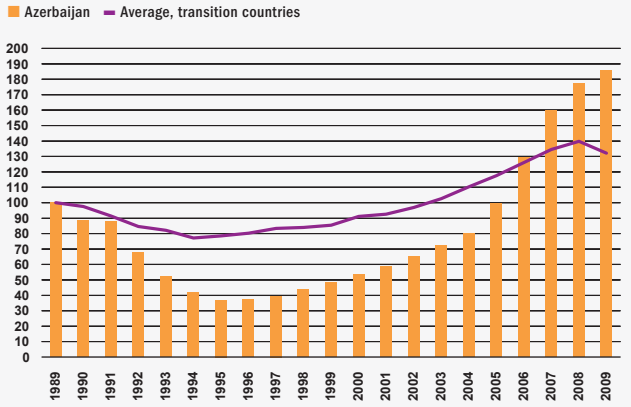
Outlook and risks

For 2009 moderate economic growth of around 3 per cent is expected, with a likely increase in 2010. Higher oil and gas production will underpin further investments in the sector. Notwithstanding the significant drop in hydrocarbon exports expected this year, the current account balance will remain in surplus. The NBA will focus its policy on ensuring adequate liquidity. Risks to the economic outlook continue to reflect Azerbaijan's dependence on the hydrocarbon sector. Another sharp drop in oil prices would have significant knock-on effects, particularly on real estate prices. Lower collateral values and a worsening of the portfolio quality of banks could thus undermine the latter's lending capacity, affecting growth prospects for the non-oil sector.

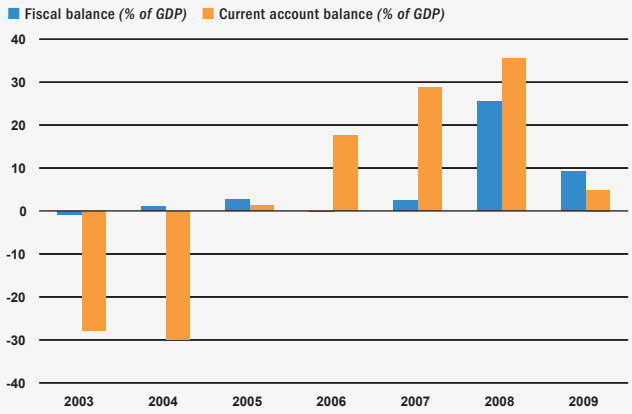
Transition indicators 2009



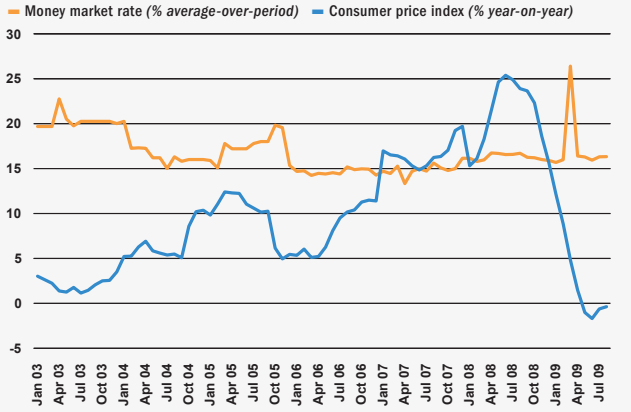
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradeability of land – **limited de jure**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **under development**

Infrastructure

Telecoms regulatory assessment compliance – **low**

Independence of the electricity regulator – **no**

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

Independence of the road directorate – **full**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Private pension funds – **no**

Social reform

Share of population living in poverty – **<2.0 per cent** (2005)

Government expenditure on health – **1.0 per cent** (2008)

Government expenditure on education – **2.6 per cent** (2008)

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

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.6	3.0	3.2	na	na	**na**	**na**
Private sector share in GDP (in per cent)	60.0	60.0	60.0	60.0	75.0	**75.0**	**75.0**
Private sector share in employment (in per cent)	68.5	68.4	68.1	68.0	67.5	**67.0**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	12.1	10.7	7.7	7.1	6.5	**na**	**na**
Share of industry in total employment (in per cent)	6.7	6.9	7.0	7.1	7.1	**4.8**	**na**
Change in labour productivity in industry (in per cent)	5.9	1.3	29.7	31.9	23.5	**55.4**	**na**
Investment/GDP (in per cent)	53.2	58.0	41.5	29.9	20.1	**na**	**na**
EBRD index of small-scale privatisation	3.7	3.7	3.7	3.7	3.7	**3.7**	**3.7**
EBRD index of large-scale privatisation	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	6.0	7.0	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	**3.0**	**na**
Share of trade with non-transition countries (in per cent)	70.0	67.4	66.9	71.9	76.5	**na**	**na**
Share of trade in GDP (in per cent)	73.5	84.4	90.6	87.1	87.2	**82.5**	**na**
Tariff revenues (in per cent of imports)	6.0	4.9	8.4	9.0	13.5	**na**	**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	3.7	3.7	4.0	4.0	4.0	**4.0**	**4.0**
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Financial sector							
Number of banks (foreign-owned)	46 (4)	44 (5)	44 (5)	44 (5)	44 (6)	**46 (9)**	**na**
Asset share of state-owned banks (in per cent)	55.3	56.1	55.2	51.0	42.4	**42.5**	**na**
Asset share of foreign-owned banks (in per cent)	5.2	5.8	6.6	6.1	7.5	**9.1**	**na**
Non-performing loans (in per cent of total loans)	14.6	14.5	14.9	12.0	8.1	**5.2**	**na**
Domestic credit to private sector (in per cent of GDP)	7.0	9.3	9.5	11.7	15.2	**16.5**	**na**
Domestic credit to households (in per cent of GDP)	2.0	3.0	3.1	4.1	5.8	**3.6**	**na**
– Of which mortgage lending (in per cent of GDP)	na	na	na	0.3	0.7	**1.9**	**na**
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	**na**	**na**
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	**na**	**na**
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	**0.2**	**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	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	11.3 (12.7)	12.1 (17.4)	12.9 (26.5)	13.8 (37.9)	14.5 (52.4)	**15.1 (75.0)**	**na**
Internet users (per 100 inhabitants)	4.2	4.9	8.0	9.7	10.7	**10.7**	**na**
Railway labour productivity (1989=100)	31.9	32.0	39.9	45.0	41.6	**40.2**	**na**
Residential electricity tariffs (USc kWh)	2.0	2.0	2.1	2.2	7.0	**7.3**	**na**
Average collection rate, electricity (in per cent)	21	27	26	na	55	**64**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	2.1	2.3	2.8	na	na	**na**	**na**
EBRD index of infrastructure reform	1.7	2.0	2.0	2.0	2.0	**2.0**	**2.0**
– Electric power	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Railways	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Roads	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Telecommunications	1.0	1.7	1.7	1.7	1.7	**1.7**	**1.7**
– Water and wastewater	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	11.2	10.2	24.3	30.5	23.4	**10.8**	**5.0**
– Private consumption	6.0	6.9	6.3	18.9	3.8	**10.0**	**na**
– Public consumption	11.1	4.6	1.9	16.9	27.0	**18.0**	**na**
– Gross fixed capital formation	72.6	13.0	-0.5	15.2	3.5	**17.0**	**na**
– Exports of goods and services	9.2	-9.0	52.7	73.7	66.6	**25.8**	**na**
– Imports of goods and services	45.6	-9.5	-1.9	20.1	11.5	**4.8**	**na**
Industrial gross output	6.1	5.7	33.5	36.6	25.0	**6.0**	**na**
Agricultural gross output	5.6	4.6	7.5	0.9	4.0	**6.1**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	0.6	1.7	1.1	9.2	0.7	**-2.1**	**na**
Employment (end-year)	0.6	1.7	1.1	3.2	1.0	**0.2**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	1.4	1.4	1.4	6.8	6.5	**4.3**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	2.2	6.7	9.6	8.3	16.7	**20.8**	**2.5**
Consumer prices (end-year)	3.6	10.4	5.5	11.4	19.7	**22.0**	**5.0**
Producer prices (annual average)	16.1	12.9	10.6	17.7	12.8	**15.1**	**na**
Producer prices (end-year)	11.2	21.9	10.8	17.1	11.3	**11.6**	**na**
Gross average monthly earnings in economy (annual average)	21.4	26.2	21.9	19.8	51.5	**25.2**	**na**
Government sector			*(In per cent of GDP)*				
General government balance[1]	-0.8	1.0	2.6	-0.2	2.4	**25.5**	**9.2**
General government expenditure	28.5	25.9	22.7	27.4	27.4	**27.6**	**na**
General government debt	20.0	18.6	14.2	10.8	9.4	**9.7**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	28.3	31.9	16.2	128.5	141.8	**38.2**	**na**
Domestic credit (end-year)	26.1	39.4	50.0	75.4	98.5	**33.7**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	7.3	8.0	6.4	9.7	16.4	**16.0**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinance rate (6 months)	7.0	7.0	9.0	9.5	13.0	**8.0**	**na**
Interbank interest rate (3 months)[2]	20.3	16.6	15.3	14.3	16.1	**16.6**	**na**
Deposit rate	9.5	9.2	8.5	10.6	11.6	**12.2**	**na**
Lending rate	15.5	15.7	17.0	17.7	19.1	**19.8**	**na**
			(Manats per US dollar)				
Exchange rate (end-year)[3]	1.0	1.0	0.9	0.9	0.8	**0.8**	**na**
Exchange rate (annual average)[3]	1.0	1.0	0.9	0.9	0.9	**0.8**	**na**
External sector			*(In millions of US dollars)*				
Current account	-2,020.7	-2,588.0	167.0	3,707.0	9,013.0	**16,425.6**	**2,024.2**
Trade balance	-97.7	162.0	3,299.0	7,745.0	15,224.0	**23,010.4**	**7,956.6**
– Merchandise exports	2,625.0	3,743.0	7,649.0	13,014.0	21,269.0	**30,584.8**	**15,690.0**
– Merchandise imports	2,722.7	3,581.0	4,350.0	5,269.0	6,045.0	**7,574.4**	**7,733.4**
Foreign direct investment, net	2,353.0	2,351.0	458.0	-1,300.9	-5,200.6	**-555.2**	**-870.8**
Gross reserves, excluding gold (end-year)[4]	803.0	1,075.0	1,178.0	2,500.0	4,273.0	**6,467.0**	**na**
External debt stock	2,744.3	3,488.8	4,345.3	4,865.9	5,835.1	**6,400.0**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.0	2.0	2.0	3.8	5.8	**7.7**	**na**
			(In per cent of exports of goods and services)				
Debt service	5.2	3.6	1.3	1.1	0.8	**1.1**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	8.3	8.3	8.4	8.4	8.4	**8.4**	**na**
GDP (in billions of manats)	7.1	8.5	12.5	18.7	26.9	**38.0**	**35.5**
GDP per capita (in US dollars)	880.9	1,050.9	1,576.8	2,497.9	3,729.6	**5,508.2**	**na**
Share of industry in GDP (in per cent)	37.2	38.3	47.5	57.3	59.1	**55.6**	**na**
Share of agriculture in GDP (in per cent)	12.2	10.8	9.0	6.7	5.9	**5.6**	**na**
Current account/GDP (in per cent)	-27.8	-29.8	1.3	17.7	28.8	**35.5**	**4.9**
External debt - reserves (in US$ million)	1,941.3	2,413.8	3,167.3	2,365.9	1,562.1	**-67.0**	**na**
External debt/GDP (in per cent)	37.7	40.2	32.8	23.2	18.6	**13.8**	**na**
External debt/exports of goods and services (in per cent)	89.8	82.4	52.2	35.5	26.3	**20.2**	**na**

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

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

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

[4] By end-December 2008 there were additional foreign exchange assets of approximately US$ 11.2 billion in the State Oil Fund.

Belarus

Key developments and challenges

In the medium term, economic competitiveness will depend on efforts to modernise industry and increase its efficiency, not least energy efficiency. Achieving these goals would require further liberalisation and commercialisation of the financial sector operations in order to optimise allocation of scarce capital resources.

Some recent reforms have contributed to deregulation and have improved the business environment. The further simplification of the taxation regime and enhanced protection of property rights would help to sustain this reform momentum and encourage entrepreneurship and greater private investment.

A continuation of the strong commitment to implement prudent fiscal and monetary policies, including a moderation of directed lending, will be crucial to preserving macroeconomic stability in the wake of the global economic crisis and, in particular, weak external demand.

Country data

Population (in millions)	9.7
Area ('000 sq km)	207.6
GDP (in billion US$, 2008)	60.3
Average transition score (scale: 1 to 4.33)	2.04

Progress in structural reform

Liberalisation and privatisation

Privatisation and the further liberalisation of prices and wages are among the key structural policy commitments of the authorities under the International Monetary Fund (IMF) stand-by agreement which was signed in January 2009. A first step in this direction was taken in March 2009, when requirements to register prices of new goods and services, as well as price increases above certain thresholds, were abolished for a wide range of goods. However, restrictions on wholesale and retail margins remain in place.

The process of corporatisation of state-owned enterprises has continued, but the implementation of the 2008-10 privatisation programme stalled somewhat in 2009, partly reflecting subdued asset valuations in emerging markets. Gazprom made the third tranche of its payment for the 50 per cent stake in Beltransgaz, the pipeline operator, under the terms of its 2007 joint venture agreement. Gazprom now owns 37.5 per cent of the company, with the last tranche scheduled to be paid during the first quarter of 2010.

Business environment and competition

Notable progress has been made in the area of deregulation, including the streamlining of registration rules for real estate transactions in 2008; the introduction of a one-day registration policy for enterprises and individual entrepreneurs from February 2009; and simplification of liquidation procedures. In fiscal year 2009, the authorities continued their policy of lowering the rate of turnover tax by reducing it to 1 per cent, and consideration is also being given to a further streamlining of indirect taxes. As a result of the deregulation reforms, in the World Bank *Doing Business 2010* survey, Belarus improved its ranking, moving from 82nd to 58th place. In addition, consultations between the authorities and the business community, while still limited in scope, have become more common.

However, firms continue to experience a number of significant problems, including excessive and arbitrary regulation and a complicated tax system. Price controls, production targets and wage restrictions are common. Almost 43 per cent of the respondents in the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV) identified taxation and the need to obtain various business licences and permits as the main obstacles to doing business. An inadequately educated workforce was also among commonly cited problems, revealed as the key obstacle by 15 per cent of survey participants. Net foreign direct investment (FDI) amounted to 3.6 per cent of GDP in 2008, slightly below the record of 3.9 per cent of GDP reached in 2007.

Financial sector

Despite the difficult external environment, credit to enterprises and consumers continued to grow, and amounted to some 32 per cent of GDP by May 2009. However, small and medium-sized enterprises appear to have been hit disproportionately hard in terms of their ability to access credit.

In response to the turbulence in the banking sectors of neighbouring countries in late 2008, the authorities introduced universal deposit insurance coverage regardless of the currency denomination or residency of the depositor. This contributed to levelling the playing field between Belarusbank, the largest state-owned bank, and other banks. In addition, the interest rate caps on loans have been suspended and the ceiling on foreign ownership in the banking sector was increased from 25 to 50 per cent. The National Bank of Belarus (NBB) continued strengthening the quality of bank supervision and imposed a ban on foreign currency lending to households until the end of 2010. However, the sector remains dominated by large state-owned banks; Prior Bank, the third-largest bank majority-owned by the Raiffeisen Group, remains the only private bank among the top five.

Macroeconomic performance

The Belarusian economy has been growing rapidly in recent years and real GDP increased by 10 per cent in 2008. However, the openness of the economy means that Belarus has been severely affected by the global economic crisis, not so much through financial channels as through the fall in external demand. Merchandise sales to Russia, Ukraine and other CIS countries have dropped sharply since September 2008. The economy has also suffered from negative terms of trade shocks on its main imports and exports of commodities. The price of Russian gas has continued to increase, while the price of its key commodity export – potassium – fell sharply from its summer 2008 peak. As a result of these trends, economic growth slowed to 0.3 per cent in the first half of 2009 (year on year), despite the rapid accumulation of stocks of unsold industrial goods.

Declining export revenues led to pressures on the currency and forced the NBB to limit liquidity injections into the banking system and raise the policy interest rate from 10 to 14 per cent. On 2 January 2009 the NBB devalued the currency, which had been de facto pegged to the US dollar, by 20.5 per cent and re-pegged it to a basket consisting of the US dollar, the euro and the Russian rouble in equal proportions, while the target band was subsequently widened. In January 2009 the authorities agreed a US$ 2.5 billion stand-by arrangement with the IMF, which was increased to US$ 3.5 billion in June 2009. The package of measures agreed includes strengthening fiscal discipline, in particular through public sector wage restraint, and moderating the growth of directed lending through state-owned banks.

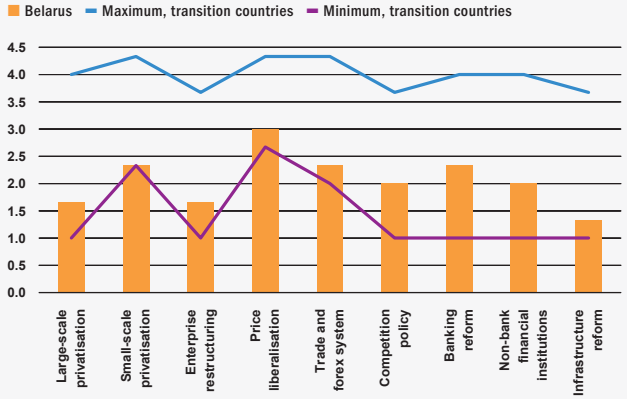
Financing for the rising current account deficit, which reached 8.4 per cent of GDP in 2008, will depend on the government's ability to borrow from international financial institutions (IFIs), Russia and China, given that international markets have been effectively closed for Belarusian borrowers since the onset of the financial crisis. China has granted Belarus a three-year currency swap line of US$ 2.9 billion equivalent, while the Russian government has disbursed a total of US$ 3 billion in loans.

Outlook and risks

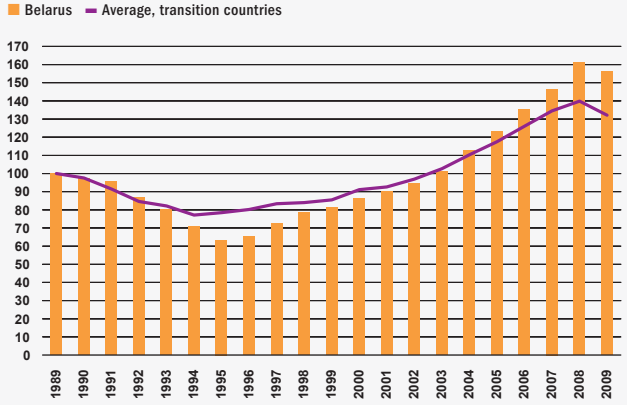
In the short term, economic growth is expected to be negative in 2009, reflecting the difficult external environment. In addition, the combination of significant current account deficits, mainly due to weak external demand, and subdued investor interest in emerging markets are likely to result in sizeable external funding requirements. Recognising this, the authorities appear to be committed to tight fiscal and monetary policies under the IMF stand-by agreement.

In the medium term, economic competitiveness will depend on efforts to restructure and modernise the industrial base. The success of these efforts will depend on the efficient allocation of capital and other resources, which in turn depends on further reforms to liberalise prices, the commercialisation of operations in the financial sector, streamlining taxation and the introduction of other measures to improve the business environment.

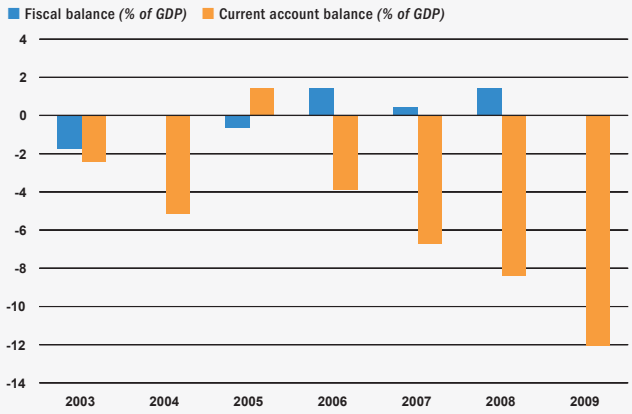
Transition indicators 2009



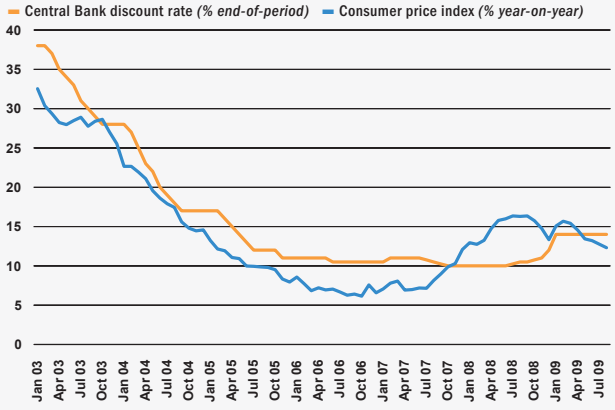
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **limited**

Controls on inward direct investment – **yes**

Interest rate liberalisation – **limited de facto**

Exchange rate regime – **managed float**

Wage regulation – **yes**

Tradeability of land – **limited de jure**

Business environment and competition

Competition office – **no**

Quality of insolvency law – **medium**

Secured transactions law – **under development**

Infrastructure

Telecoms regulatory assessment compliance – **low**

Independence of the electricity regulator – **no**

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

Independence of the road directorate – **no**

Financial sector

Capital adequacy ratio – **8 per cent**[1]

Deposit insurance system – **yes**

Private pension funds – **no**

Social reform

Share of population living in poverty – **<2.0 per cent** (2005)

Government expenditure on health – **4.5 per cent** (2007)

Government expenditure on education – **5.8 per cent** (2007)

Household expenditure on power and water – **4 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.9	3.0	3.1	2.9	5.5	**6.3**	**na**
Private sector share in GDP (in per cent)	25.0	25.0	25.0	25.0	25.0	**30.0**	**30.0**
Private sector share in employment (in per cent)	na	na	na	na	na	**na**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	18.6	18.0	19.4	19.1	20.9	**20.9**	**na**
Share of industry in total employment (in per cent)	24.4	24.5	24.4	24.3	24.2	**24.0**	**na**
Change in labour productivity in industry (in per cent)	9.2	15.9	10.0	10.8	7.1	**9.5**	**na**
Investment/GDP (in per cent)	20.7	30.5	28.5	30.4	32.8	**36.4**	**na**
EBRD index of small-scale privatisation	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	1.0	**1.7**	**1.7**
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	1.0	**1.7**	**1.7**
Markets and trade							
Share of administered prices in CPI (in per cent)	21.0	24.0	27.0	27.0	30.0	**30.0**	**na**
Number of goods with administered prices in EBRD-15 basket	4.0	5.0	6.0	6.0	7.0	**7.0**	**na**
Share of trade with non-transition countries (in per cent)	27.1	26.8	34.3	35.3	32.6	**32.2**	**na**
Share of trade in GDP (in per cent)	120.1	130.3	108.8	113.5	116.5	**119.7**	**na**
Tariff revenues (in per cent of imports)[2]	4.1	3.1	4.7	4.4	10.3	**12.7**	**na**
EBRD index of price liberalisation	2.7	2.7	2.7	2.7	2.7	**2.7**	**3.0**
EBRD index of forex and trade liberalisation	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Financial sector							
Number of banks (foreign-owned)	30 (17)	32 (19)	30 (18)	30 (18)	27 (16)	**31 (20)**	**na**
Asset share of state-owned banks (in per cent)	61.6	70.2	75.2	79.0	76.5	**77.9**	**na**
Asset share of foreign-owned banks (in per cent)	20.4	20.0	16.2	14.7	19.7	**20.6**	**na**
Non-performing loans (in per cent of total loans)[3]	5.8	4.7	3.4	2.9	2.0	**1.7**	**na**
Domestic credit to private sector (in per cent of GDP)	11.7	14.0	15.9	20.2	24.8	**28.8**	**na**
Domestic credit to households (in per cent of GDP)	2.8	3.9	5.0	6.9	8.2	**9.8**	**na**
– Of which mortgage lending (in per cent of GDP)	2.1	2.5	3.1	3.8	4.5	**5.2**	**na**
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	**na**	**na**
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	**na**	**na**
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.5	**0.0**	**na**
EBRD index of banking sector reform	1.7	1.7	1.7	1.7	2.0	**2.0**	**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**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	31.0 (11.3)	32.2 (22.7)	33.5 (41.8)	34.5 (61.0)	37.8 (71.6)	**37.8 (71.6)**	**na**
Internet users (per 100 inhabitants)	16.2	25.0	25.0	25.0	28.9	**28.9**	**na**
Railway labour productivity (1989=100)	40.1	41.5	40.9	42.5	43.9	**42.8**	**na**
Residential electricity tariffs (USc kWh)	3.1	3.3	3.6	4.1	5.0	**6.1**	**na**
Average collection rate, electricity (in per cent)[4]	91	95	101	100	100	**100**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	2.5	2.8	3.1	na	na	**na**	**na**
EBRD index of infrastructure reform	1.3	1.3	1.3	1.3	1.3	**1.3**	**1.3**
– *Electric power*	1.0	1.0	1.0	1.0	1.0	**1.0**	**1.0**
– *Railways*	1.0	1.0	1.0	1.0	1.0	**1.0**	**1.0**
– *Roads*	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
– *Telecommunications*	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
– *Water and wastewater*	1.0	1.0	1.0	1.0	1.0	**1.0**	**1.0**

[1] Ratio is 12 per cent for the first two years of bank's operation.

[2] Refers to taxes on international trade.

[3] Change in methodology of definition of non-performing loans from 1 January 2007.

[4] The collection rates are for residential electricity and heating combined. Numbers higher than 100 reflect collection of arrears.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	7.0	11.4	9.4	9.9	8.2	**10.0**	**-3.0**
– Private consumption	7.4	9.6	15.0	14.6	11.3	**16.2**	**na**
– Public consumption	0.3	-0.2	0.6	0.2	0.5	**0.3**	**na**
– Gross fixed capital formation	20.8	20.9	20.0	32.2	16.2	**23.5**	**na**
– Exports	na	na	na	na	na	**na**	**na**
– Imports	na	na	na	na	na	**na**	**na**
Industrial gross output	7.1	15.9	10.5	11.4	8.7	**11.5**	**na**
Agricultural gross output	6.6	12.6	1.7	6.0	4.4	**8.6**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	-0.5	-1.2	0.0	0.9	1.3	**2.5**	**na**
Employment (end-year)	-1.0	-0.5	0.8	1.2	1.7	**2.6**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	3.0	1.9	1.5	1.2	1.0	**0.8**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	28.4	18.1	10.3	7.0	8.4	**14.9**	**13.2**
Consumer prices (end-year)	25.4	14.4	8.0	6.6	12.1	**13.3**	**11.8**
Producer prices (annual average)	37.5	24.1	12.1	8.3	16.4	**15.0**	**na**
Producer prices (end-year)	28.1	18.8	10.0	9.0	16.8	**16.4**	**na**
Gross average monthly earnings in economy (annual average)	32.5	38.6	33.4	25.5	19.2	**25.1**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	-1.7	0.0	-0.7	1.4	0.4	**1.4**	**0.0**
General government expenditure	47.7	46.0	48.0	48.0	49.0	**49.5**	**na**
General government debt	10.4	8.9	8.3	8.8	11.5	**13.0**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M3, end-year)	56.3	44.1	42.2	39.3	40.0	**26.3**	**na**
Domestic credit (end-year)	64.7	39.1	34.8	53.2	22.2	**51.7**	**na**
			(In per cent of GDP)				
Broad money (M3, end-year)	16.8	17.7	19.3	22.1	25.2	**24.0**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	28.0	17.0	11.0	10.5	10.0	**12.0**	**na**
Treasury bill rate (3-month maturity)	na	na	na	na	na	**na**	**na**
Deposit rate (1 year)[1]	17.4	12.7	9.2	7.7	8.1	**10.3**	**na**
Lending rate (1 year)[2]	24.0	16.9	11.4	8.8	8.5	**9.5**	**na**
			(Belarusian roubles per US dollar)				
Official exchange rate (end-year)	2,156.0	2,170.0	2,152.0	2,140.0	2,150.0	**2,200.0**	**na**
Official exchange rate (annual average)	2,051.3	2,160.3	2,153.8	2,144.6	2,146.0	**2,136.7**	**na**
External sector			*(In millions of US dollars)*				
Current account	-434.4	-1,193.3	435.5	-1,431.2	-3,037.6	**-5,048.8**	**-5,929.5**
Trade balance	-1,255.6	-2,271.8	-637.6	-2,269.0	-4,071.0	**-6,111.2**	**-6,285.3**
– Merchandise exports	10,072.9	13,942.2	16,108.8	19,834.7	24,328.9	**33,043.3**	**19,165.1**
– Merchandise imports	11,328.5	16,214.0	16,746.4	22,103.7	28,399.9	**39,154.5**	**25,450.4**
Foreign direct investment, net	170.3	162.5	302.5	351.0	1,770.0	**2,143.4**	**1,325.7**
Gross reserves, excluding gold (end-year)	461.5	690.8	1,106.5	1,067.2	4,182.0	**3,061.1**	**na**
External debt stock	4,174.9	4,935.4	5,168.4	6,785.7	12,719.2	**14,817.9**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	0.5	0.5	0.7	0.5	1.6	**0.9**	**na**
			(In per cent of exports of goods and services)				
Debt service	13.7	11.7	12.4	16.6	14.4	**17.3**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	9.8	9.8	9.8	9.7	9.7	**9.7**	**na**
GDP (in billions of Belarusian roubles)	36,564.8	49,991.8	65,067.0	79,267.0	97,165.0	**128,828.8**	**137,460.3**
GDP per capita (in US dollars)	1,809.9	2,361.4	3,096.9	3,810.2	4,672.5	**6,234.2**	**na**
Share of industry in GDP (in per cent)	30.8	32.7	33.1	32.2	31.6	**28.1**	**na**
Share of agriculture in GDP (in per cent)	10.2	10.3	9.8	9.3	8.8	**8.4**	**na**
Current account/GDP (in per cent)	-2.4	-5.2	1.4	-3.9	-6.7	**-8.4**	**-12.1**
External debt - reserves (in US$ million)	3,713.4	4,244.6	4,061.9	5,718.5	8,537.2	**11,756.8**	**na**
External debt/GDP (in per cent)	23.4	21.3	17.1	18.4	28.1	**24.6**	**na**
External debt/exports of goods and services (in per cent)	36.1	31.5	28.4	30.5	46.1	**39.7**	**na**

[1] Data refer to weighted average interest rates on new one-year deposits in commercial banks.

[2] Data refer to weighted average interest rates for one-year loans by commercial banks.

Bosnia and Herzegovina

Key developments and challenges

The past year has, once again, seen little progress in privatisation, especially in the FBH.[1] Although the global environment is more challenging, it is important to restore momentum to the process so that stakes can be offered when conditions improve.

Prudent regulation by the central bank and strong coordination among the domestic authorities, foreign-owned commercial banks and international financial institutions enabled the banking sector to weather the financial crisis. Further efforts are needed to maintain confidence, including through an expansion of deposit insurance coverage towards EU levels.

Bosnia and Herzegovina has embarked on a three-year programme with the International Monetary Fund (IMF) that will support the authorities' efforts to safeguard the currency board. In this context, the authorities need to adhere to commitments to reduce public sector spending, including in the area of social transfers.

Country data

Population (in millions)	**3.8**
Area ('000 sq km)	**51.0**
GDP (in billion US$, 2008)	**18.5**
Average transition score (scale: 1 to 4.33)	**2.78**

Progress in structural reform

Liberalisation and privatisation

Since the Stabilisation and Association Agreement was signed and the Interim Trade Agreement with the European Union came into force in the summer of 2008, there has been little further progress in EU integration. Bosnia and Herzegovina was (like Albania) excluded from a European Commission recommendation in July 2009 to the Council of the European Union to extend visa-free access to the Schengen area for citizens of the Western Balkans.

Regional trade liberalisation suffered a set-back when parliament passed a law in June 2009, contrary to the regional Central European Free Trade Agreement (CEFTA), to reintroduce customs tariffs on meat and dairy products from Croatia and Serbia. However, the Constitutional Court suspended the law in July 2009.

Slow progress in privatisation in the FBH in recent years has meant that proceeds from sales have been negligible. In February 2009 the FBH government adopted a new privatisation programme, with the aim of raising KM 1 billion (around €515 million) over the following 15 months. Under the plan, 11 companies would be sold through direct tender, including some of the Entity's biggest companies in aluminium, construction and telecommunications. However, given previous failures, there are doubts that the plan's targets will be met.

For example, the privatisation of the Mostar-based aluminium smelter, the largest exporter in the country, failed even though it had received the interest of strategic sponsors. The proposed privatisation of the two telecommunications companies in the FBH – BH Telekom and HT Mostar – remains on hold, as global conditions have made the prospects less attractive to potential investors. One important deal over the past year was the partial privatisation in December 2008, through the sale of 49 per cent, of BH Airlines to Turkish Airlines; the government retains a majority stake.

Business environment and competition

The quality of the business environment in Bosnia and Herzegovina continues to lag behind other countries in south-eastern Europe, according to the World Bank's *Doing Business 2010* survey scores. In the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), more than one-quarter of the enterprises surveyed identified political instability as the main problem affecting their operations. Tax rates were also considered a serious obstacle by many respondents. The Foreign Investor Council White Paper, published in December 2008, highlights business registration as a particular problem for foreign investors. The introduction of a new Companies Law in the RS, effective from July 2009, aims to simplify the registration of new companies and bring companies law closer to EU standards.

Infrastructure

In the roads sector, several projects have been signed in the past year with international financial institutions for building parts of the 330 km Corridor Vc (a branch of the fifth pan-European corridor), as well as strengthening the institutional development of the Motorway Directorate in both Entities. In May 2009 the RS government and Austrian construction company, Strabag, signed a contract to establish a joint venture company to construct highways in the RS. Strabag will build, operate and maintain major roads in the Entity. The first project will be the proposed highway from Banja Luka to Doboj, for which Strabag will have a 30-year concession. However, raising financing is likely to be difficult, as this was a directly negotiated concession. In the railways sector, various projects to upgrade and modernise services are ongoing, with the support of bilateral donors and international institutions.

Financial institutions

The banking system has remained sound, despite the global crisis. There was a significant outflow of deposits of around KM 800 million (about €410 million) in the fourth quarter of 2008, but the central bank reacted promptly and effectively to stem the outflow and restore confidence. Bank reserve requirements were lowered, credit lines from abroad were excluded from the base used in calculating mandatory reserve requirements, and deposit insurance was raised from KM 7,500 to KM 20,000. A further increase in the level of deposit insurance is being prepared, depending on the swift adoption of amendments to the state law on debt, debt issuance and guarantees. In addition, within the context of the new IMF programme, the main foreign-owned banks have made a commitment to maintain their exposure to the country at the same level as, or higher than, that prevailing at the end of 2008.

Macroeconomic performance

After several years of strong growth, the economy began to suffer in late 2008, with GDP growth estimated at 5.4 per cent for the year as a whole. However, the full effects of the global financial crisis were not felt until the first half of 2009 when various factors contributed to a dramatic slow-down, including the drying-up of bank credit, a severe contraction in foreign direct investment (FDI), lower demand from the European Union for exports and a fall in remittances from workers abroad. Construction activity in particular has suffered and unemployment is rising.

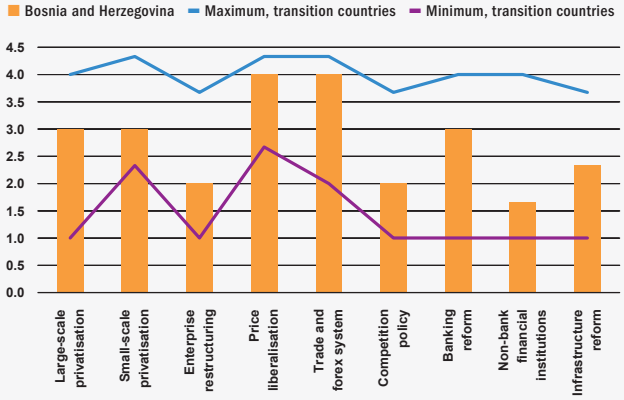
The authorities' problems have been compounded by major fiscal pressures. The signing of the SAA in June 2008 meant that VAT refunds accelerated and custom duties on EU imports decreased, contributing to lower revenues, while the failure of the authorities to adjust their spending behaviour accordingly, as witnessed by increases in wages and social benefits, put upward pressure on expenditures. As a result, the general government balance deteriorated from approximately zero in 2007 to a deficit of 4 per cent of GDP in 2008. The authorities responded by curbing non-mandatory expenditures in the first quarter of 2009. In addition, the Fiscal Council has begun to contribute to better coordination of fiscal policies among the state, entities and cantons. The currency board remains the key anchor for monetary policy, and by August 2009 inflation had fallen to below zero, reflecting not only currency stability but also weak domestic demand. The decline in domestic demand has contributed to a significant drop in the current account deficit, which is expected to fall from nearly 15 per cent of GDP in 2008 to less than 10 per cent in 2009. In July 2009 following important fiscal measures at state and entity level, the IMF approved a 36-month stand-by arrangement of US$ 1.57 billion.

Outlook and risks

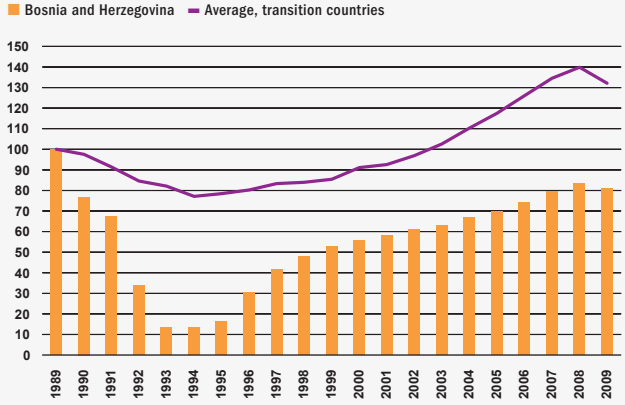
In the short term, the economy will remain weak. GDP is expected to decline by around 3 per cent in 2009, with the likelihood of at best a very modest recovery in 2010. The authorities have very little room for manoeuvre to alleviate the effects of the crisis, especially in the FBH where (unlike in the RS) there are virtually no funds from past privatisation receipts. However, the economy is likely to remain stable, aided by low inflation, continued strong support from parent banks abroad and IMF support under the new programme. Over the medium term, there is no reason why growth should not improve, aided by the resumption of strong inflows of FDI, provided that the authorities implement reform-oriented policies and that the country remains on the path to EU integration. The main risks to this scenario are political and economic; the issues of constitutional reform, the creation of a genuine single economic space and the need to reduce the size of the public sector remain the key challenges to achieving long-term prosperity.

[1] The territorial constitutional entities distinguished in this assessment include the State of Bosnia and Herzegovina (BH), the Federation of Bosnia and Herzegovina (FBH), the Republika Srpska (RS) and the cantons of the Federation. The FBH and the RS are referred to as the "Entities". The District of Brčko enjoys a special status based on an Arbitration Award in accordance with the Dayton Peace Agreement.

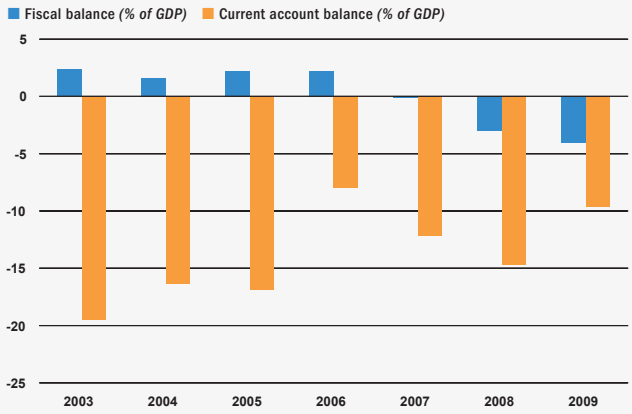
Transition indicators 2009



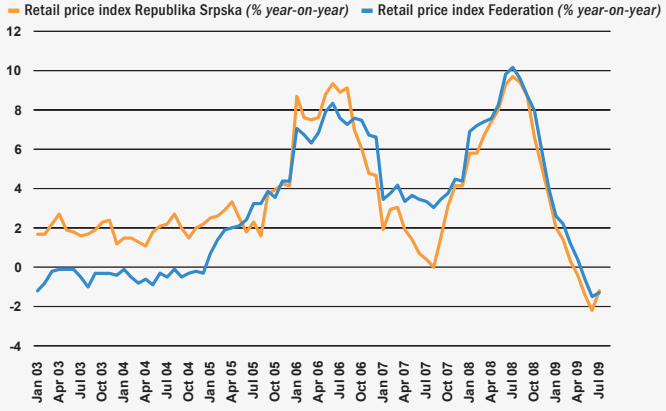
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

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

Interest rate liberalisation – **full**

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

Wage regulation – **no**

Tradeability of land – **limited de jure**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **high**

Secured transactions law – **modern/some defects**

Infrastructure

Telecoms regulatory assessment compliance – **high**

Independence of the electricity regulator – **partial**

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

Independence of the road directorate – **full**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Private pension funds – **no**

Social reform

Share of population living in poverty – **<2 per cent** (2004)

Government expenditure on health – **9.5 per cent of GDP** (2006)

Government expenditure on education – **na**

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

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.6	2.6	na	na	na	**na**	**na**
Private sector share in GDP (in per cent)	50.0	50.0	55.0	55.0	60.0	**60.0**	**60.0**
Private sector share in employment (in per cent)	na	na	na	na	na	**na**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	5.9	5.4	5.4	5.5	5.1	**4.6**	**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)	19.9	27.1	27.0	21.6	28.1	**21.3**	**na**
EBRD index of small-scale privatisation	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
EBRD index of large-scale privatisation	2.3	2.3	2.7	2.7	3.0	**3.0**	**3.0**
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	**na**	**na**
Number of goods with administered prices in EBRD-15 basket[2]	5.0	5.0	5.0	4.0	6.0	**na**	**na**
Share of trade with non-transition countries (in per cent)[3]	48.5	47.9	45.4	43.7	42.8	**42.4**	**na**
Share of trade in GDP (in per cent)	85.0	87.2	91.4	90.2	95.3	**93.1**	**na**
Tariff revenues (in per cent of imports)	6.4	5.1	na	na	na	**na**	**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	3.7	3.7	3.7	3.7	3.7	**4.0**	**4.0**
EBRD index of competition policy	1.0	1.0	1.0	1.7	2.0	**2.0**	**2.0**
Financial sector							
Number of banks (foreign-owned)	37 (19)	33 (17)	33 (20)	32 (22)	32 (21)	**30 (21)**	**na**
Asset share of state-owned banks (in per cent)	5.3	4.0	3.6	3.2	1.9	**0.9**	**na**
Asset share of foreign-owned banks (in per cent)	79.7	80.9	90.9	94.0	93.8	**95.0**	**na**
Non-performing loans (in per cent of total loans)	8.4	6.1	5.4	4.1	3.0	**3.1**	**na**
Domestic credit to private sector (in per cent of GDP)	31.0	32.3	39.6	44.2	50.6	**53.5**	**na**
Domestic credit to households (in per cent of GDP)	11.6	13.6	17.6	19.6	26.2	**27.2**	**na**
– Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	**na**	**na**
Stock market capitalisation (in per cent of GDP)	na	23.7	36.2	59.8	71.8	**31.3**	**na**
Stock trading volume (in per cent of market capitalisation)	na	5.0	10.7	7.4	9.2	**3.2**	**na**
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
EBRD index of banking sector reform	2.3	2.7	2.7	2.7	2.7	**3.0**	**3.0**
EBRD index of reform of non-bank financial institutions	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	24.8 (28.4)	25.2 (37.2)	25.6 (42.2)	26.2 (49.9)	28.2 (64.9)	**27.3 (84.3)**	**na**
Internet users (per 100 inhabitants)	4.0	15.5	21.3	25.1	27.9	**34.7**	**na**
Railway labour productivity (2000=100)	136.3	256.0	480.7	481.4	447.3	**448.0**	**na**
Residential electricity tariffs (USc kWh)	7.1	7.3	6.4	7.4	8.6	**9.1**	**na**
Average collection rate, electricity (in per cent)	90	93	96	98	98	**98**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	4.5	4.7	4.7	na	na	**na**	**na**
EBRD index of infrastructure reform	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Electric power	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Railways	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Roads	2.0	2.0	2.3	2.3	2.7	**2.7**	**2.7**
– Telecommunications	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Water and wastewater	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**

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

[2] Administered prices in either the Federation or Republika Srpska or both entities.

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

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	3.0	6.3	3.9	6.7	6.8	**5.4**	**-3.1**
Industrial gross output	3.8	7.2	6.4	5.5	8.2	**8.0**	**na**
Agricultural gross output	na	13.3	5.8	6.1	-0.3	**3.0**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	0.8	1.6	0.5	9.6	1.6	**-0.6**	**na**
Employment (end-year)	-1.0	0.2	2.1	4.3	4.5	**4.0**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	42.1	42.9	42.0	44.8	43.2	**40.6**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)							
– Federation (KM based)	0.1	-0.3	3.0	6.0	1.9	**7.7**	**3.6**
– Republika Srpska (KM based)	1.8	1.9	5.2	6.4	1.1	**6.9**	**2.5**
Consumer prices (end-year)							
– Federation (KM based)	0.3	-0.3	4.4	4.5	5.5	**4.0**	**1.5**
– Republika Srpska (KM based)	1.3	2.2	3.7	4.6	4.3	**3.6**	**0.7**
Gross average monthly earnings in economy (annual average)							
– Federation	8.6	1.9	4.6	8.0	9.8	**13.4**	**na**
– Republika Srpska	9.3	11.6	10.0	12.2	10.3	**29.4**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	2.3	1.6	2.2	2.2	-0.1	**-3.0**	**-4.0**
General government expenditure	39.2	38.8	39.9	45.2	47.6	**50.9**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	8.4	24.3	18.2	24.7	21.6	**4.3**	**na**
Domestic credit (end-year)	20.7	16.3	27.6	22.3	29.5	**22.3**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	37.9	43.3	47.7	52.7	56.6	**50.9**	**na**
Exchange rates			*(KM per US dollar)*				
Exchange rate (end-year)	1.5	1.4	1.6	1.5	1.3	**1.4**	**na**
Exchange rate (annual average)	1.7	1.6	1.5	1.6	1.4	**1.3**	**na**
External sector			*(In millions of US dollars)*				
Current account	-1,631.0	-1,639.3	-1,844.5	-981.0	-1,848.5	**-2,764.4**	**-1,630.0**
Trade balance	-4,159.3	-4,569.7	-4,898.9	-4,298.1	-5,956.7	**-7,092.4**	**-5,900.0**
– Merchandise exports	1,477.5	2,086.7	2,555.3	3,381.4	4,243.3	**5,194.0**	**4,600.0**
– Merchandise imports	5,636.8	6,656.4	7,454.2	7,679.5	10,200.0	**12,286.4**	**10,500.0**
Foreign direct investment, net	381.8	708.3	607.8	718.4	2,087.5	**1,002.8**	**600.0**
Gross reserves, excluding gold (end-year)	1,611.0	2,208.0	2,530.0	3,371.0	4,524.0	**3,515.0**	**na**
External debt stock	4,475.9	5,139.2	5,400.2	6,025.6	7,342.5	**7,981.3**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.2	3.7	3.8	5.0	5.0	**4.2**	**na**
			(In per cent of exports of goods and services)				
Debt service	4.0	3.1	4.2	4.0	3.2	**2.8**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)[1]	3.8	3.8	3.8	3.8	3.8	**3.8**	**na**
GDP (in millions of markas)	14,505.0	15,786.0	16,928.0	19,121.0	21,647.0	**25,100.0**	**24,298.0**
GDP per capita (in US dollars)	2,203.2	2,638.1	2,880.9	3,227.0	3,986.4	**4,942.8**	**na**
Share of industry in GDP (in per cent)	16.1	16.4	16.3	16.0	21.0	**20.0**	**na**
Share of agriculture in GDP (in per cent)	8.1	8.9	8.7	8.5	7.9	**8.0**	**na**
Current account/GDP (in per cent)	-19.5	-16.4	-16.8	-8.0	-12.2	**-14.7**	**-9.6**
External debt - reserves (in US$ million)	2,864.9	2,931.2	2,870.2	2,654.6	0.0	**3,457.3**	**na**
External debt/GDP (in per cent)	53.5	51.3	49.3	49.1	48.5	**42.5**	**na**
External debt/exports of goods and services (in per cent)	183.0	136.9	122.6	90.2	69.6	**61.2**	**na**

[1] Excludes refugees abroad.

Bulgaria

Key developments and challenges

The financial sector has coped well with the crisis, although many small and medium-sized enterprises (SMEs) have experienced difficulties in accessing finance and the provisioning for non-performing loans has risen considerably. A continued close coordination among foreign banks and their local subsidiaries, regulators, and international institutions is important to ensure that financial intermediation increases once the crisis subsides.

Infrastructure quality has improved, but key challenges remain, including: further liberalisation of the electricity market; new water sector reforms; improved waste management; and further road sector development.

The full force of the global economic crisis has meant falling exports, reduced capital inflows and a sharp decline in domestic demand. An important challenge for the government is to balance the need for a sound fiscal policy to provide comfort to the markets, with the need for sufficient economic stimulus to prevent a prolonged recession.

Country data

Population (in millions)	**7.6**
Area ('000 sq km)	**111.0**
GDP (in billion US$, 2008)	**49.9**
Average transition score (scale: 1 to 4.33)	**3.56**

Progress in structural reform

Business environment and competition

The conditions for doing business in Bulgaria have improved in recent years. According to the World Bank's *Doing Business 2010* survey, Bulgaria is ranked 44 out of 183 countries. However, in the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV) Bulgarian companies identified an inadequately educated workforce, difficulties in accessing finance and competition from the informal sector as the main obstacles to their development.

The European Commission (EC) in its annual report on progress under the Co-operation and Verification Mechanism of July 2009 noted that there was a new momentum in Bulgaria in terms of improving the judiciary and combating corruption and organised crime. However, the Commission also noted that the steps taken so far to address these issues have had only a limited impact, and that many shortcomings still needed to be addressed. The situation will be reassessed by the EC in the summer of 2010.

Infrastructure

The development of the first Energy Efficiency Action Plan for 2008-10, and the introduction of new legislation for renewable energy in November 2008 are expected to add to the substantial investments in energy efficiency and renewable energy sources that have occurred over recent years. Some initial problems with the Renewable Energy Act, such as an unbalanced allocation of the green premiums that form the subsidies for renewable energy, were addressed by the regulator in June this year. Also, better coordination of the country's environmental strategy and national energy policies is expected to promote further investments in energy efficiency and renewable energy sources in the country. Effective liberalisation of the electricity market has not yet taken place despite a legal framework that provides for a full market opening. This lack of market development in the electricity sector has prevented a flexible price mechanism from providing an adequate anti-crisis response at a time when the economic slow-down has pushed unregulated market prices below the regulated electricity tariffs.

As a result of the immediate shortage in gas supply that followed the dispute between Russia and Ukraine at the beginning of 2009, a number of new policies and projects have been initiated to promote energy security in the country. Bulgaria signed the Nabucco gas pipeline project in July 2009 with three other EU countries and Turkey. Steps have also been taken to increase gas interconnectivity with Greece and Romania and to enhance gas storage facilities.

A new Water Act was approved in June this year and, if implemented successfully, will allow for more local control and new contractual arrangements for the operating water utilities. In the roads sector, further clarification of responsibilities for investments, maintenance and use of structural funds is needed, and delays in bringing the country's waste management in line with best standards is also expected to be addressed following increased pressure from the EC.

Financial sector

Existing regulations ensure that the banks are well capitalised and have a high level of provisioning and thus the financial sector was well placed to weather the international financial and economic crisis. The authorities have also introduced measures to support the sector in response to the crisis. In line with other EU countries the state guarantee on bank deposits was increased from Lv 40,000 (€20,000) to Lv 100,000 (€50,000) and the Bulgarian Development Bank will grant Lv 500 million to the commercial banks in the country in 2009 to fund small and medium-sized enterprises. At the beginning of 2009 the central bank requested banks to maintain their Tier I capital adequacy ratio at a minimum of 10 per cent. Also, most major banks have committed themselves to capitalise their profit and to ensure that their funds remain in the country.

The majority of banks are now focusing on sustainable and prudent lending rather than competing for market share, as seen in previous years. There has also been renewed competition for local deposits as funding from abroad has been limited or expensive. As a consequence, credit growth during the first half of 2009 was very low, and interest rates on deposits have remained high so far this year.

Macroeconomic performance

After several years of strong economic growth, Bulgaria has experienced a sharp slow-down that began in the fourth quarter of 2008 and has continued throughout the first half of 2009. The weakness in economic activity has come through two channels. First, a reduction in external demand, with exports down as much as 30 per cent over the first six months of 2009 year on year. Second, domestic demand has contracted as private capital inflows have dried up significantly and consumer and investor sentiment have worsened. Industrial output, construction, tourism and other services are all down sharply.

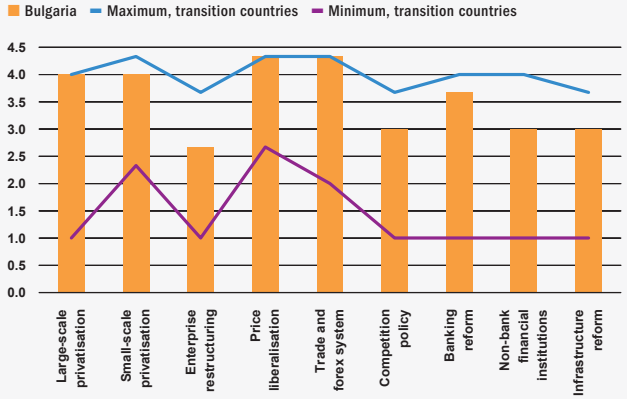
The internal and external imbalances associated with the years of strong growth have mostly been reduced. The rate of inflation fell to below 1.5 per cent in August 2009 (from 12 per cent in 2008) because of the reduced domestic demand, as well as lower world prices for some food and commodity imports. The declines in consumer and investment spending have also led to a further slow-down in imports during the first half of 2009. Thus, despite the fall in exports, the trade deficit has dropped and the current account deficit narrowed to 18.1 per cent of GDP in annualised terms at the end of the first half of 2009, down from 24.6 per cent of GDP at the end of 2008. Fiscal policy has remained prudent (with the exception of pre-election months in the second quarter of 2009). In 2008 the general government surplus was 3 per cent of GDP and the new government is planning for a balanced budget for 2009 and 2010 mainly by improving tax compliance and cutting expenditures sharply.

Outlook and risks

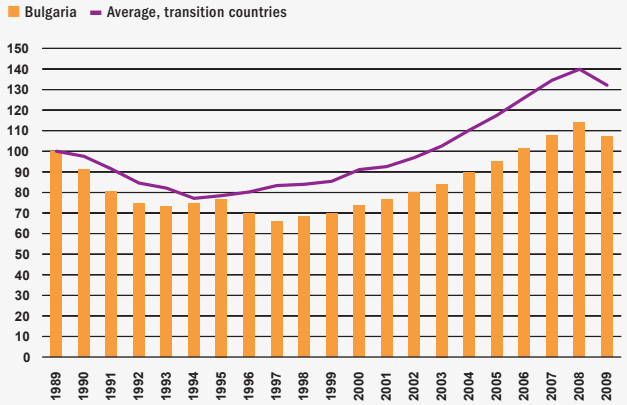
As an open economy increasingly integrated into the European Union's internal market, with a banking sector primarily owned by international banking groups with head offices in other EU countries, Bulgaria's economic recovery is very much dependent on developments in the European Union as well as other neighbouring countries. The Bulgarian economy is forecasted to shrink by 6 per cent in 2009, with only a modest recovery starting in 2010.

There is a risk that the asset quality of banks could deteriorate significantly if the economic slow-down is deeper or longer than expected. There are also some vulnerabilities linked to Bulgaria's large external financing needs arising from current account deficits and the fact that one-third of the external debt is short term. At the same time, medium-term prospects for growth remain favourable and Bulgaria has a well capitalised and well regulated banking sector while the central bank holds a large amount of foreign reserves. The overall fiscal position is also sound with fiscal reserves in excess of the low level of gross public debt, and Bulgaria's history of fiscal surpluses reflects an understanding across the political spectrum of the importance of fiscal prudence in the context of the currency board arrangement.

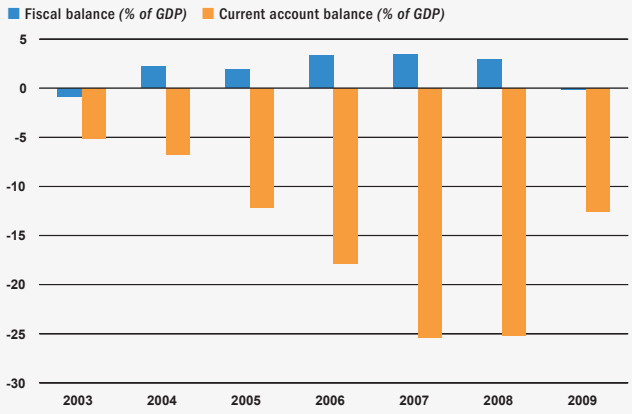
Transition indicators 2009



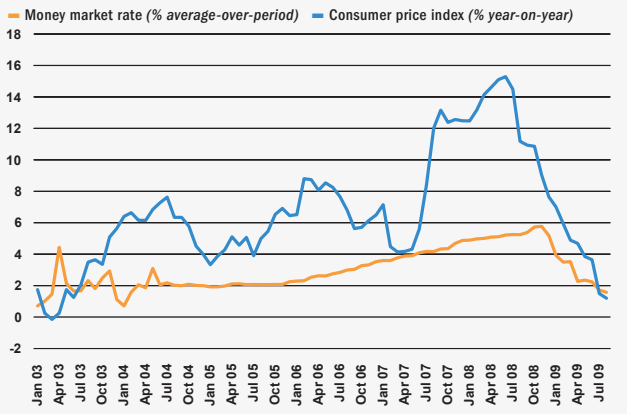
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **currency board**

Wage regulation – **yes**

Tradeability of land – **full within EU**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **high**

Secured transactions law – **advanced**

Infrastructure

Telecoms regulatory assessment compliance – **full**

Independence of the electricity regulator – **full**

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

Independence of the road directorate – **full**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2 per cent** (2003)[1]

Government expenditure on health – **4.3 per cent** (2007)

Government expenditure on education – **4.2 per cent** (2007)

Household expenditure on power and water – **11.2 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	15.0	18.0	21.4	22.8	23.3	**na**	**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)	65.0	69.0	71.0	71.0	73.0	**74.0**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	3.0	2.4	2.1	1.5	1.5	**na**	**na**
Share of industry in total employment (in per cent)	23.5	23.5	23.2	22.5	22.1	**21.1**	**na**
Change in labour productivity in industry (in per cent)	9.2	10.0	11.7	11.2	10.5	**9.5**	**na**
Investment/GDP (in per cent)	21.7	23.5	28.0	na	na	**na**	**na**
EBRD index of small-scale privatisation	3.7	3.7	3.7	4.0	4.0	**4.0**	**4.0**
EBRD index of large-scale privatisation	3.7	4.0	4.0	4.0	4.0	**4.0**	**4.0**
EBRD index of enterprise reform	2.7	2.7	2.7	2.7	2.7	**2.7**	**2.7**
Markets and trade							
Share of administered prices in CPI (in per cent)	22.0	24.7	21.3	21.3	22.1	**18.6**	**na**
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	1.0	**1.0**	**na**
Share of trade with non-transition countries (in per cent)	77.1	78.0	73.8	71.8	na	**na**	**na**
Share of trade in GDP (in per cent)	83.8	95.5	106.8	117.6	119.2	**116.4**	**na**
Tariff revenues (in per cent of imports)	10.6	9.1	8.0	na	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	4.3	4.3	4.3	4.3	4.3	**4.3**	**4.3**
EBRD index of competition policy	2.3	2.3	2.7	2.7	2.7	**3.0**	**3.0**
Financial sector							
Number of banks (foreign-owned)	35 (25)	35 (24)	34 (23)	32 (23)	29 (21)	**30 (22)**	**na**
Asset share of state-owned banks (in per cent)	2.5	2.3	1.7	1.8	2.1	**2.0**	**na**
Asset share of foreign-owned banks (in per cent)	82.7	81.6	74.5	80.1	82.3	**83.9**	**na**
Non-performing loans (in per cent of total loans)	4.4	3.7	3.8	3.2	2.5	**3.2**	**na**
Domestic credit to private sector (in per cent of GDP)	26.7	35.2	42.9	47.1	66.8	**74.5**	**na**
Domestic credit to households (in per cent of GDP)	7.1	10.0	14.4	16.6	23.0	**26.0**	**na**
– Of which mortgage lending (in per cent of GDP)	1.2	2.7	4.8	7.2	10.4	**12.4**	**na**
Stock market capitalisation (in per cent of GDP)	7.9	10.4	19.7	31.1	51.3	**18.5**	**na**
Stock trading volume (in per cent of market capitalisation)	16.3	22.8	35.2	19.6	34.2	**10.8**	**na**
Eurobond issuance (in per cent of GDP)	0.0	1.1	1.4	2.0	0.0	**0.0**	**na**
EBRD index of banking sector reform	3.3	3.7	3.7	3.7	3.7	**3.7**	**3.7**
EBRD index of reform of non-bank financial institutions	2.3	2.3	2.3	2.7	2.7	**3.0**	**3.0**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	35.9 (44.7)	35.0 (60.7)	32.2 (80.7)	31.2 (107.3)	30.1 (129.5)	**29.7 (140.1)**	**na**
Internet users (per 100 inhabitants)	12.0	16.0	20.0	23.9	31.0	**31.0**	**na**
Railway labour productivity (1989=100)	75.2	78.4	73.7	76.3	74.5	**70.0**	**na**
Residential electricity tariffs (USc kWh)	5.2	6.0	8.4	8.8	9.1	**10.9**	**na**
Average collection rate, electricity (in per cent)	92	92	93	93	93	**na**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	3.1	3.5	3.6	na	na	**na**	**na**
EBRD index of infrastructure reform	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Electric power	3.3	3.7	3.7	3.7	3.7	**3.7**	**3.7**
– Railways	3.3	3.3	3.3	3.3	3.3	**3.3**	**3.3**
– Roads	2.3	2.3	2.7	2.7	2.7	**2.7**	**2.7**
– Telecommunications	3.0	3.3	3.3	3.7	3.7	**3.7**	**3.7**
– Water and wastewater	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**

[1] The official 12.8 per cent poverty rate, reported in the 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.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	5.0	6.6	6.2	6.3	6.2	**6.0**	**-6.0**
– Private consumption	6.3	5.3	5.5	8.5	5.1	**4.5**	**na**
– Public consumption	3.1	6.8	4.1	-2.5	3.4	**-1.4**	**na**
– Gross fixed capital formation	13.9	13.5	23.3	14.7	21.7	**20.4**	**na**
– Exports of goods and services	10.7	12.7	8.5	8.7	5.2	**2.9**	**na**
– Imports of goods and services	16.4	14.5	13.1	14.0	9.9	**4.9**	**na**
Industrial gross output	11.6	13.5	13.0	14.3	11.9	**6.0**	**na**
Agricultural gross output	-0.2	3.4	-4.4	0.9	-18.3	**19.4**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	-0.4	2.0	0.2	4.1	0.7	**0.4**	**na**
Employment (end-year)	4.5	3.1	2.4	5.9	3.1	**1.6**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	12.7	11.8	9.9	8.4	6.2	**5.1**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	2.3	6.1	5.0	7.3	8.4	**12.3**	**2.6**
Consumer prices (end-year)	5.6	4.0	6.5	6.5	12.5	**7.6**	**0.2**
Producer prices (annual average)	2.8	5.4	7.2	8.7	8.0	**13.3**	**na**
Producer prices (end-year)	2.5	5.4	9.6	6.8	11.2	**4.7**	**na**
Gross average monthly earnings in economy (annual average)	6.1	7.0	10.7	11.3	19.5	**21.7**	**na**
Government sector			*(In per cent of GDP)*				
General government balance[1]	-0.9	2.2	1.9	3.3	3.5	**3.0**	**-0.1**
General government expenditure[1]	38.1	36.7	37.5	35.3	37.2	**36.5**	**na**
General government debt	45.9	40.1	31.3	24.6	19.8	**19.6**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	18.8	23.3	24.3	26.9	31.3	**8.7**	**na**
Domestic credit (end-year)	33.9	34.2	33.0	15.3	58.8	**33.0**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	47.5	52.3	59.0	64.9	74.4	**68.5**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Base interest rate[2]	2.8	2.4	2.1	3.3	4.6	**5.8**	**na**
Interbank interest rate (up to 1 month)	1.1	2.0	2.2	3.5	4.9	**5.3**	**na**
Deposit rate (1 month)	2.8	2.6	3.1	3.1	4.0	**6.7**	**na**
Lending rate (less than 1 year)	9.2	8.4	8.6	9.0	8.9	**11.2**	**na**
			(Leva per US dollar)				
Exchange rate (end-year)	1.5	1.4	1.7	1.5	1.3	**1.4**	**na**
Exchange rate (annual average)	1.7	1.6	1.6	1.6	1.4	**1.3**	**na**
External sector			*(In millions of US dollars)*				
Current account	-1,022.2	-1,671.1	-3,304.6	-5,658.7	-10,039.4	**-12,577.4**	**-5,648.7**
Trade balance	-2,575.9	-3,687.9	-5,490.8	-7,028.1	-9,991.4	**-12,864.8**	**-7,232.8**
– Merchandise exports	7,081.4	9,931.2	11,776.4	15,101.4	18,575.3	**22,585.5**	**15,809.9**
– Merchandise imports	9,657.3	13,619.1	17,267.2	22,129.5	28,566.7	**35,450.3**	**23,042.7**
Foreign direct investment, net	2,070.3	2,879.2	4,004.8	7,582.8	11,432.5	**8,472.2**	**5,775.1**
Gross reserves, excluding gold (end-year)	6,291.0	8,776.3	8,519.7	10,941.3	16,487.9	**17,871.9**	**na**
External debt stock	13,439.1	17,276.3	19,383.6	27,223.9	42,563.4	**51,634.7**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	6.2	6.2	4.9	5.0	5.8	**5.1**	**na**
			(In per cent of exports of goods and services)				
Debt service	14.9	25.5	46.6	30.2	36.7	**33.8**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	7.8	7.8	7.7	7.7	7.6	**7.6**	**na**
GDP (in millions of leva)	34,627.5	38,822.6	42,797.4	49,361.0	56,519.8	**66,728.1**	**64,378.1**
GDP per capita (in US dollars)	2,561.8	3,175.8	3,522.7	4,111.2	5,204.1	**6,561.1**	**na**
Share of industry in GDP (in per cent)	24.9	24.4	26.1	na	na	**na**	**na**
Share of agriculture in GDP (in per cent)	10.0	9.2	8.0	na	na	**na**	**na**
Current account/GDP (in per cent)	-5.1	-6.8	-12.2	-17.9	-25.4	**-25.2**	**-12.6**
External debt - reserves (in US$ million)	7,148.1	8,500.1	10,864.0	16,282.6	26,075.5	**33,762.8**	**na**
External debt/GDP (in per cent)	67.2	70.1	71.3	86.0	107.6	**103.5**	**na**
External debt/exports of goods and services (in per cent)	133.8	123.8	119.8	133.5	169.7	**168.8**	**na**

[1] In 2003 and 2004 general government expenditure includes capital transfers for about 0.4 per cent of GDP, which were classified below the line in the Budget Law.

[2] Until 2005, effective interest rate at end-month, based on the average annual yield attained at three-month government securities primary auctions. Since 1 February 2005, the simple average of the daily values of LEONIA (Lev Overnight Index Average), for the business days of the preceding month.

Croatia

Key developments and challenges

Little progress with large-scale privatisation has been made over the past year, partly because of the challenging global environment. A successful restructuring and privatisation of the shipyards, for which tenders were announced in mid-2009, would be an important sign of the government's commitment to the process.

Businesses face a number of obstacles, with slow progress to date in judicial and administrative reform, and a labour market characterised by rigidity. Further improvements are needed to enable companies to cope with the competitive pressures they will face once Croatia joins the European Union.

The economy has suffered significantly from the global downturn. Given the large external indebtedness and tightly managed exchange rate policy, it is essential to maintain fiscal discipline.

Country data

Population (in millions)	**4.4**
Area ('000 sq km)	**87.7**
GDP (in billion US$, 2008)	**69.3**
Average transition score (scale: 1 to 4.33)	**3.55**

Progress in structural reform

Liberalisation and privatisation

Over the past year, progress towards eventual EU accession has been slower than planned. As of September 2009, Croatia had opened negotiations on 22 of the 35 chapters of the *acquis communautaire*[1] (and had provisionally closed talks on seven). The European Commission had proposed a roadmap indicating that it would be possible to reach the final stage of negotiations on all of the chapters by the end of 2009. However, the opening and closing of some chapters was delayed in the first half of the year because of a border dispute with neighbouring Slovenia.

Some progress has been made in the privatisation of the main shipyards. This is a key issue in the country's EU accession negotiations and for the economy more generally, given that the shipyards account for 15 per cent of total annual exports and employ around 11,500 staff. In July 2009 the government announced tenders for the six state-owned shipyards. Four of the six shipyards were offered for a nominal price of one kuna, a fifth – Brodosplit Naval and Special Vessels Shipyard – was offered for Kuna 18.16 million (around €2.5 million). In the case of the sixth shipyard, Uljanik in Pula, which is generally regarded as the most profitable, a stake of nearly 60 per cent is on offer for Kuna 398 million (€54.2 million), with 25 per cent reserved for sale to employees. The deadline for submitting bids was 30 September 2009 but the results were disappointing, as only two bids were received.

The privatisation of oil company, INA, has progressed over the past year. In October 2008 the Hungarian oil company, MOL, increased its stake to 46.7 per cent through a public tender. In May 2009 the European Commission gave its formal approval for MOL's takeover of INA, while in June the anti-monopoly commission also gave its approval although it required INA to reduce its domination of the retail market by selling off some retail sites. Elsewhere, progress with privatisation remains slow; by mid-2009 the State Privatisation Fund still had a portfolio of more than 800 companies.

Business environment and competition

Croatia continues to score poorly on some cross-country surveys of the business environment. It was ranked 103rd (out of 183 countries) in the World Bank's *Doing Business 2010* survey while the country's ranking for starting a business is 101st. Difficulties with construction permits and the employment of workers are the most serious constraints, with the latter reflecting more general, deep-seated problems with labour market rigidities. The 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV) shows that businesses regard tax rates and administration, as well as competition from the informal sector, as the main obstacles to doing business.

From February 2009 foreign investors in real estate have been able to purchase property in their own name. However, there has been little progress over the past year in the government's programme to reduce regulatory obstacles to doing business. The implementation of the Hitrorez guillotine project, introduced by the government in 2007 to simplify regulations, slowed significantly and was replaced in 2009 by the Office for Control of Efficiency of Regulations. A new competition law was presented to parliament in mid-2009, building on the significant progress in recent years in law enforcement in this area.

Infrastructure

A number of large public infrastructure enterprises continue to receive significant state subsidies, putting a strain on public finances during the recession. One of the main beneficiaries of these subsidies continues to be the national railway company, Hrvatske Zeljeznice (HZ). The company announced in mid-2009 that it planned to reduce its workforce this year by 240 people, but this represents less than 2 per cent of the workforce and the company continues to make significant losses.

Financial sector

The financial sector has managed to weather the global financial crisis fairly well. The banking system is well-capitalised and liquid, and foreign banks have remained strongly committed to supporting their subsidiaries. The authorities responded promptly to the crisis in the fourth quarter of 2008 by reducing reserve requirements, eliminating the marginal reserve requirement on banks' foreign borrowing and increasing the guarantee on bank deposits from €14,000 to €56,000. Nevertheless, the number of banks – 32 at the end of 2008 – remains large for the size of the country. Some consolidation in the sector is likely over the medium term.

Macroeconomic performance

The crisis has had a major effect on the Croatian economy, with early signs of a downturn apparent in the fourth quarter of 2008 and a deep recession taking root in the first half of 2009. Economic growth slowed significantly to 2.4 per cent in 2008 and the economy declined by 6.7 and 6.3 per cent year on year in the first and second quarters, respectively, of 2009. Industrial production fell by 10.2 per cent in the first half over the same period last year, accompanied by sharp falls in construction activity and exports.

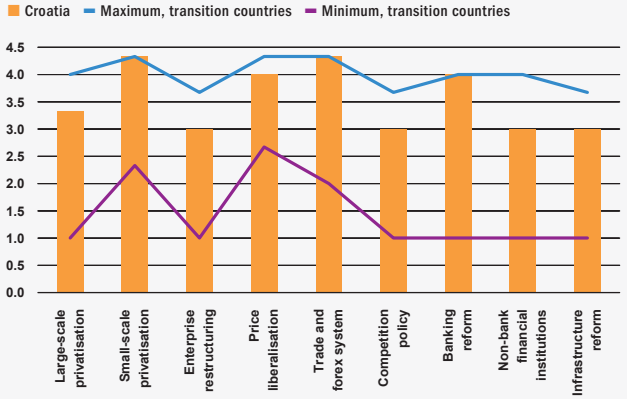
The authorities have responded in various ways to try to minimise the effects of the crisis. However, the room for fiscal manoeuvre is limited as weaker economic activity has contributed to a significant drop in revenues. As a consequence, the government has had to make three revisions to the 2009 budget. The first major revision was adopted in April 2009 when the target for the general government deficit was set at 1.6 per cent of GDP, based on an assumption that GDP would fall by 2 per cent this year. The government introduced measures to try to alleviate the worst effects of the recession, including selected support for small and medium-sized enterprises (SMEs) and tourism-related sectors, but also cancelled a previously agreed 6 per cent increase in public sector salaries. Further cuts to public spending were announced in budget revisions in July. Meanwhile, the authorities raised €750 million in the eurobond market in May 2009, with 5.7 years maturity and a coupon rate of 6.5 per cent. The central bank has continued to adhere to its tightly managed exchange rate policy, and inflation has remained moderate at 2.1 per cent in June 2009. Although measures have been brought in to encourage lending, the level of credit growth remained modest at 2.5 per cent in the year to June.

Outlook and risks

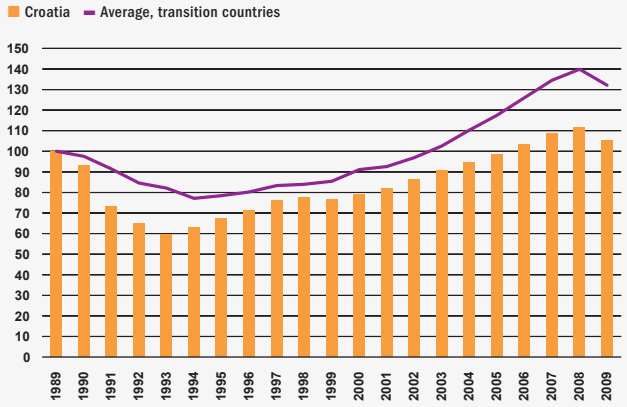
There is considerable uncertainty over short-term economic prospects. Much depends on the 2009 tourism season, which was struggling as of mid-year although performing better than feared. The likelihood is that GDP will fall in real terms by at least 5 per cent in 2009, before recovering somewhat in 2010. Inflation is likely to remain low, although some upward pressure will be exerted by expected increases (of about 20 per cent) in natural gas prices for households. The main short-term risk lies externally as the relatively high current account deficit (9.4 per cent of GDP in 2008) is normally financed primarily by foreign direct investment, which is likely to drop sharply this year. Given the extent of euroisation in the economy, the policy of tightly managing the exchange rate within a very narrow band is expected to continue. Over the medium term, prospects for a return to growth are favourable, provided that the government remains committed to macroeconomic stability and to the implementation of remaining reforms in the areas of business regulation, privatisation and the public sector.

[1] The *acquis communautaire* is the body of European law that countries must adopt to become EU members.

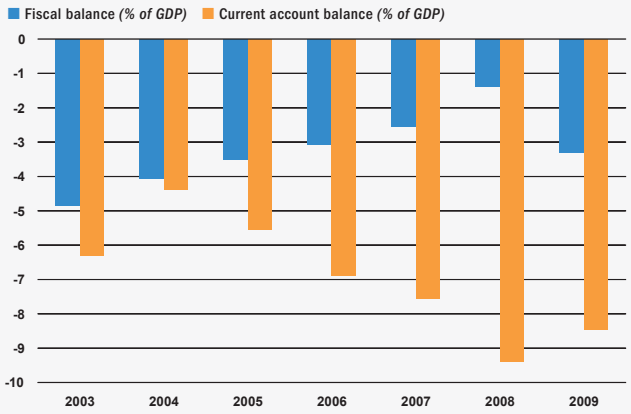
Transition indicators 2009



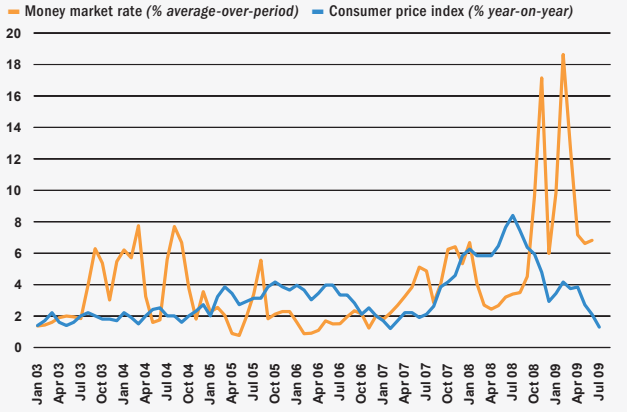
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**[1]

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**[2]

Tradeability of land – **full**[3]

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **high**

Secured transactions law – **inefficient**

Infrastructure

Telecoms regulatory assessment compliance – **full**

Independence of the electricity regulator – **full**

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

Independence of the road directorate – **full**

Financial sector

Capital adequacy ratio – **10 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2.0 per cent** (2005)

Government expenditure on health – **6.1 per cent of GDP** (2005)

Government expenditure on education – **4.7 per cent of GDP** (2005)

Household expenditure on power and water – **13.1 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	14.4	14.6	14.7	15.7	16.7	**17.0**	**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)	65.0	66.0	68.0	68.0	70.0	**70.0**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	2.2	2.3	2.3	2.3	2.4	**na**	**na**
Share of industry in total employment (in per cent)	21.6	21.7	20.5	21.0	21.6	**21.7**	**na**
Change in labour productivity in industry (in per cent)	9.8	2.5	8.8	-1.0	2.6	**0.7**	**na**
Investment/GDP (in per cent)	26.4	26.0	26.3	28.1	28.9	**30.7**	**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**
EBRD index of enterprise reform	2.7	3.0	3.0	3.0	3.0	**3.0**	**3.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Number of goods with administered prices in EBRD-15 basket	1.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Share of trade with non-transition countries (in per cent)	73.5	71.3	68.5	68.3	65.2	**64.7**	**na**
Share of trade in GDP (in per cent)	60.4	60.9	61.5	64.6	64.9	**59.6**	**na**
Tariff revenues (in per cent of imports)	2.1	1.6	1.5	1.3	1.2	**1.3**	**na**
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	**4.0**	**4.0**
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	**4.3**	**4.3**
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.7	**2.7**	**3.0**
Financial sector							
Number of banks (foreign-owned)	42 (19)	39 (15)	36 (13)	35 (15)	35 (16)	**36 (16)**	**na**
Asset share of state-owned banks (in per cent)	3.4	3.1	3.4	4.2	4.7	**4.4**	**na**
Asset share of foreign-owned banks (in per cent)	91.0	91.3	91.3	90.8	90.4	**90.8**	**na**
Non-performing loans (in per cent of total loans)	13.1	7.5	6.2	5.2	4.8	**4.8**	**na**
Domestic credit to private sector (in per cent of GDP)	49.2	51.8	56.4	64.0	67.1	**68.1**	**na**
Domestic credit to households (in per cent of GDP)	27.7	30.4	34.0	38.2	41.1	**37.1**	**na**
– Of which mortgage lending (in per cent of GDP)	8.5	10.1	12.0	14.7	16.4	**15.3**	**na**
Stock market capitalisation (in per cent of GDP)	16.4	25.2	30.5	56.5	104.7	**40.4**	**na**
Stock trading volume (in per cent of market capitalisation)	4.8	6.0	6.7	8.7	8.6	**7.4**	**na**
Eurobond issuance (in per cent of GDP)	2.9	4.3	0.0	0.9	1.3	**0.0**	**na**
EBRD index of banking sector reform	3.7	4.0	4.0	4.0	4.0	**4.0**	**4.0**
EBRD index of reform of non-bank financial institutions	2.7	2.7	2.7	3.0	3.0	**3.0**	**3.0**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	42.0 (56.9)	42.4 (63.7)	42.4 (82.2)	41.3 (99.1)	41.7 (113.7)	**41.9 (134.0)**	**na**
Internet users (per 100 inhabitants)	22.8	30.9	33.1	38.0	44.8	**50.8**	**na**
Railway labour productivity (1989=100)	90.4	92.7	107.0	125.3	141.7	**145.4**	**na**
Residential electricity tariffs (USc kWh)	8.2	9.1	9.4	10.0	10.9	**12.4**	**na**
Average collection rate, electricity (in per cent)	95	96	98	100	100	**100**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	5.8	6.2	6.6	na	na	**na**	**na**
EBRD index of infrastructure reform	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Electric power	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Railways	2.3	2.7	2.7	2.7	2.7	**2.7**	**2.7**
– Roads	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Telecommunications	3.3	3.3	3.3	3.7	3.7	**4.0**	**4.0**
– Water and wastewater	3.3	3.3	3.3	3.3	3.3	**3.3**	**3.3**

[1] Registration is required with commercial courts and National Bank of Croatia.

[2] But there is a minimum wage regulation.

[3] Land is tradeable 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. The Croatian property market was liberalised for EU citizens on 1 February 2009, as part of the harmonisation with EU legislation on free movement of capital. An adjustment period limiting the sale of agricultural land, forests and parks was requested.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	5.0	4.2	4.2	4.7	5.5	**2.4**	**-5.4**
– Private consumption	4.8	4.3	4.4	3.6	6.2	**0.8**	**na**
– Public consumption	1.3	2.6	1.2	2.2	3.4	**1.9**	**na**
– Gross fixed capital formation	24.7	5.0	4.9	10.9	6.5	**8.2**	**na**
– Exports of goods and services	11.6	5.4	3.7	6.5	4.3	**1.7**	**na**
– Imports of goods and services	11.9	4.7	3.9	7.4	6.5	**3.6**	**na**
Industrial gross output	4.1	3.7	5.1	4.5	5.6	**1.6**	**na**
Agricultural gross output	-15.9	11.9	-8.7	4.4	-3.9	**8.0**	**na**
Employment[1]			*(Percentage change)*				
Labour force (end-year)	0.1	-0.2	0.7	0.7	-0.9	**-0.6**	**na**
Employment (end-year)	0.1	0.5	2.5	2.8	0.1	**0.5**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	14.4	13.8	12.3	10.5	9.7	**8.7**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	1.8	2.1	3.3	3.2	2.9	**6.1**	**2.5**
Consumer prices (end-year)	1.7	2.7	3.6	2.0	5.8	**2.9**	**2.0**
Producer prices (annual average)	1.9	3.5	3.0	2.9	3.4	**8.4**	**na**
Producer prices (end-year)	1.1	4.8	2.7	1.9	5.8	**4.7**	**na**
Gross average monthly earnings in economy (annual average)	4.8	6.4	4.4	6.2	6.2	**7.1**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	-4.8	-4.0	-3.5	-3.1	-2.5	**-1.4**	**-3.3**
General government expenditure	44.3	43.4	42.3	42.3	42.8	**40.8**	**na**
General government debt	35.8	37.8	38.3	35.7	33.1	**33.6**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M4, end-year)	11.0	8.6	10.5	18.0	18.3	**4.3**	**na**
Domestic credit (end-year)	12.3	11.8	19.2	18.9	12.9	**12.6**	**na**
			(In per cent of GDP)				
Broad money (M4, end-year)	56.8	57.0	58.5	63.7	68.7	**65.8**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Domestic rate	4.5	4.5	4.5	4.5	9.0	**9.0**	**na**
Money market interest rate (daily)	7.0	6.0	4.0	3.5	6.7	**7.6**	**na**
Deposit rate[2]	1.7	1.8	1.6	1.9	2.7	**2.9**	**na**
Lending rate[2]	11.5	11.4	9.9	9.1	9.3	**10.7**	**na**
			(Kuna per US dollar)				
Exchange rate (end-year)	6.1	5.6	6.2	5.6	5.0	**5.2**	**na**
Exchange rate (annual average)	6.7	6.0	5.9	5.8	5.4	**4.9**	**na**
External sector			*(In millions of US dollars)*				
Current account	-2,162.3	-1,874.7	-2,555.0	-3,287.1	-4,436.8	**-6,338.1**	**-5,189.4**
Trade balance	-7,904.6	-8,345.8	-9,341.5	-10,486.5	-12,933.4	**-16,060.0**	**-13,994.1**
– Merchandise exports	6,311.4	8,214.5	8,959.8	10,644.4	12,622.7	**14,358.0**	**10,580.9**
– Merchandise imports	14,216.0	16,560.3	18,301.3	21,130.9	25,556.1	**30,419.0**	**24,575.1**
Foreign direct investment, net	1,927.3	732.3	1,551.0	3,193.7	4,735.8	**4,575.9**	**2,730.6**
Gross reserves, excluding gold (end-year)	8,191.3	8,759.0	8,801.1	11,488.6	13,675.3	**12,958.1**	**na**
External debt stock[3]	24,850.7	31,209.5	30,464.7	38,544.9	48,859.0	**55,469.2**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)[4]	5.2	4.8	5.1	5.3	5.2	**4.6**	**na**
			(In per cent of exports of goods and services)				
Debt service[4]	-20.2	-24.2	-26.9	-36.8	-44.0	**-28.0**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	4.4	4.4	4.4	4.4	4.4	**4.4**	**na**
GDP (in billions of kuna)	227.0	245.6	264.4	286.3	314.2	**342.2**	**332.2**
GDP per capita (in US dollars)	7,625.5	9,167.0	10,003.9	11,040.9	13,196.5	**15,608.4**	**na**
Share of industry in GDP (in per cent)	18.0	18.5	17.9	17.7	17.6	**17.5**	**na**
Share of agriculture in GDP (in per cent)[5]	5.7	6.1	5.6	5.4	5.2	**5.6**	**na**
Current account/GDP (in per cent)[4]	-6.3	-4.4	-5.5	-6.9	-7.5	**-9.4**	**-8.5**
External debt – reserves (in US$ million)	16,659.4	22,450.5	21,663.6	27,056.3	35,183.7	**42,511.1**	**na**
External debt/GDP (in per cent)[4]	66.3	70.0	72.1	74.9	77.6	**82.4**	**na**
External debt/exports of goods and services (in per cent)[4]	151.3	161.0	168.6	172.2	181.2	**197.2**	**na**

[1] Data based on labour force surveys.

[2] Weighted average over all maturities.

[3] Change in reporting methodology from 2007 onwards.

[4] Ratio calculated in euros.

[5] Agriculture includes hunting, forestry and fishing.

Estonia

Key developments and challenges

The scale of the economic recession has resulted in a rapid increase in the fiscal deficit, unemployment and deterioration in credit quality. Further efforts are required to ensure fiscal sustainability, while financial stability can be improved by intensifying cooperation with foreign financial regulatory authorities.

Progress has been made in securing future energy supply with the agreement between the Baltic states on the creation of a common electricity market by 2013. Decisive steps to carry out these plans will be needed, while there also needs to be more emphasis on developing renewables and improving energy efficiency.

Measures to increase innovation, develop human capital and support investor confidence will be crucial to Estonia's effort to promote the tradeable sector in the coming years when domestic demand is expected to be more subdued.

Country data

Population (in millions)	**1.3**
Area ('000 sq km)	**45.2**
GDP (in billion US$, 2008)	**23.5**
Average transition score (scale: 1 to 4.33)	**3.93**

Progress in structural reform

Business environment and competition

The Estonian economy's flexibility and resilience are being tested by the rapid change in economic conditions. The business environment in Estonia has long been considered to be well advanced, with low levels of corruption. Estonia was ranked 24th globally in the World Bank's *Doing Business 2010* survey, the highest ranking among all the central Europe and the Baltic states countries. However, on a few indicators, relating to employing workers, protecting investors and closing a business, Estonia ranks relatively low. In addition, persistent regional differences in employment and skill mismatches also point to barriers to mobility, which are of concern at a time of rising unemployment. The new Employment Act, which took effect on 1 July 2009, aims to make hiring and firing easier and cheaper for employers, while also increasing unemployment benefits.

Infrastructure

Securing sustainable supplies of energy and developing sources of renewable energy are becoming increasingly pressing in Estonia. This reflects the growing reliance on fossil fuels (and the costs linked to buying carbon dioxide emission allowances), the high energy intensity of production and the closure of the Ignalina nuclear power plant in Lithuania at the end of 2009. Eesti Energia's Aulepa wind park development began operations in 2009 and is expected to supply 1.3 per cent of Estonia's electricity consumption. This development is part of Eesti Energia's long-term strategy of decreasing carbon dioxide emissions, while increasing generation capacity by 2016 when the oil shale-fired power plants of AS Narva Elektrijaamad will be closed or reconstructed. In April 2009 the prime ministers of the three Baltic states agreed on the creation of a common electricity market by 2013, guided by the Scandinavian Nord Pool market, and to build power interconnections under the Baltic Sea to Sweden and Finland. For Estonia, the implementation of the Estlink-2 project, a 800 MW interconnection to Finland, is of particular importance. In addition, Estonia remains favourable to the idea of building a nuclear power plant in Lithuania, although delays have put it off until 2018 at the earliest.

Unbundling of Eesti Energia remains a challenge and Estonia has decided to open 35 per cent of the market by the end of 2009, with full liberalisation by 2013, although restrictions may be lifted earlier. Private sector participation in generation and distribution is growing, but effective competition is limited by the dominant position of Eesti Energia and the small size of the market.

Financial sector

As the recession has deepened, there has been a rapid deterioration in credit quality, forcing a number of the main Nordic parent banks to raise provisioning and new capital. Non-performing loans (defined as loans overdue by over 60 days) have increased from 2 per cent of the total loan portfolio in August 2008 to 6.1 per cent in August 2009. Credit growth to the private sector has continued to decelerate, from an annual rate of over 60 per cent in early 2007 to -1.3 per cent in July 2009. The presence of foreign banks continues to be a positive factor, in particular as government support measures to the banking sectors in home countries have not carried any restrictions in access to capital for foreign subsidiaries and branches and all major parent banks have confirmed their commitment to remaining in the Baltic region. In recent years, banks have built up sizeable capital buffers, also by retaining profits, and in April 2009 the capital adequacy ratio stood at over two times the 10 per cent minimum required in Estonia. Bank of Estonia has assessed that up to 6 per cent of the total portfolio could be written off while still remaining within the regulatory requirement. As the global financial crisis deepened in late 2008 and early 2009, a precautionary swap arrangement to provide foreign exchange liquidity was made with the Swedish central bank in February 2009 (allowing for access to Sk 10 billion (€0.92 billion) in exchange for Estonian kroons) in order to secure financial stability and promote confidence in financial markets. In Estonia, over 80 per cent of all loans are in foreign currency, mainly in euro.

Macroeconomic performance

GDP growth fell by 3.6 per cent in 2008 following an eight-year period when growth averaged 8.4 per cent per year. The slow-down had begun in the domestic sector in 2007 and was further aggravated by the global financial turmoil in late 2008. Real GDP declined by nearly 16 per cent in the first half of 2009 (year on year) with the construction and real estate sectors particularly affected. From a record low of 4 per cent in the second quarter of 2008, unemployment has risen rapidly to 13.3 per cent in the second quarter of 2009.

In response, inflation has decelerated rapidly since the end of 2008. From an average of 10.4 per cent in 2008, the annual inflation rate fell to -0.9 per cent in August 2009. Annual wage growth has also slowed, from over 20 per cent in 2007, to -4.4 per cent in the second quarter of 2009.

The economic slow-down has led to a rapid external adjustment, with the current account turning into a surplus of 4.9 per cent of GDP in the second quarter of 2009, compared with a deficit of close to 18 per cent in 2007.

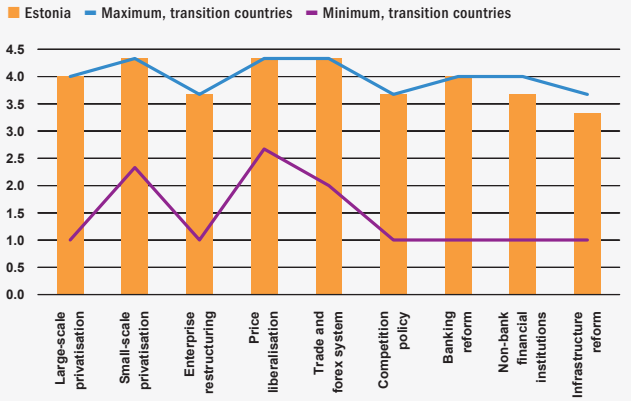
From a surplus in 2007, the general government balance moved into a deficit of 2.7 per cent of GDP in 2008. The weak economy has resulted in a rapid deterioration in budget revenues, forcing the government to implement emergency spending cuts and additional expenditure adjustments to halt the increase in the deficit. The past years of prudent fiscal policy have provided Estonia with a buffer of fiscal reserves, which have been helpful during the financial crisis.

Outlook and risks

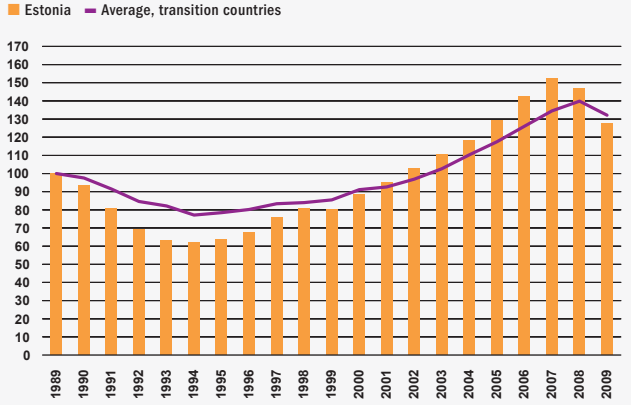
Real GDP is expected to contract by 13.2 per cent in 2009, with any recovery beyond that largely dependent on external demand conditions as domestic demand is likely to take longer to recover. So far, the flexibility of the Estonian economy has been impressive – a key condition for maintaining competitiveness and a successful currency peg. With a strong fiscal position at the outset of the crisis, no International Monetary Fund (IMF) support package has been required. The main challenges in the short term include addressing the rapid increase in unemployment and the deterioration in non-performing loans, while easing financing constraints to avoid any further weakening of growth.

It will be necessary to further expand the tradeable sector and increase exports of higher value-added products. Measures to control the deterioration in public finances, improve innovation and human capital, as well as developing key sectors for future growth will be important for investor confidence and for attracting foreign investment. Moreover, finding sustainable solutions in the energy sector will be a key challenge. With macroeconomic imbalances being reduced, Estonia is again approaching a situation where adoption of the euro may be possible. Focus on fiscal sustainability will, in this regard, be crucial for a successful participation in the euro.

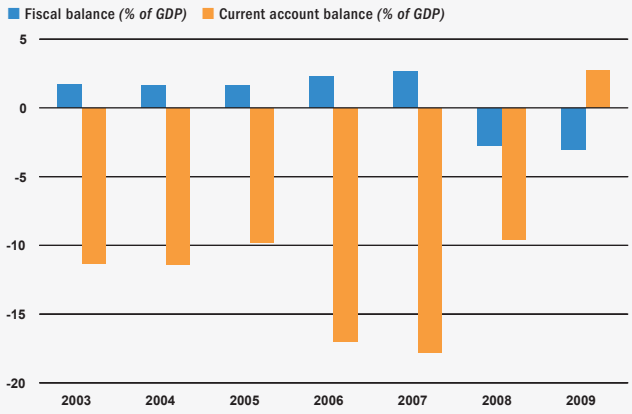
Transition indicators 2009



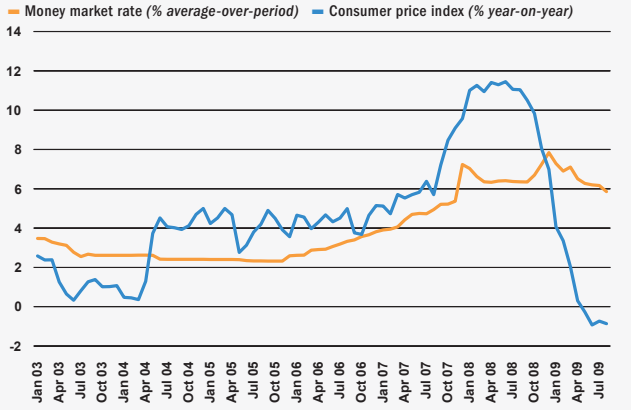
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **currency board in ERM II**

Wage regulation – **no**

Tradeability of land – **full except foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **high**

Secured transactions law – **inefficient**

Infrastructure

Telecoms regulatory assessment compliance – **full**

Independence of the electricity regulator – **full**

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

Independence of the road directorate – **partial**

Financial sector

Capital adequacy ratio – **10 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2.0 per cent** (2004)

Government expenditure on health – **4.0 per cent of GDP** (2005)

Government expenditure on education – **6.0 per cent of GDP** (2005)

Household expenditure on power and water – **6.1 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	7.1	7.2	na	na	na	**na**	**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)	73.7	74.5	75.5	74.8	75.9	**76.3**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	1.6	2.1	2.3	2.2	2.4	**2.6**	**na**
Share of industry in total employment (in per cent)	25.2	27.0	26.0	23.8	22.9	**23.4**	**na**
Change in labour productivity in industry (in per cent)	4.3	1.5	14.6	14.2	11.1	**-7.1**	**na**
Investment/GDP (in per cent)	33.1	33.1	33.8	38.7	40.2	**29.7**	**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**
EBRD index of enterprise reform	3.3	3.3	3.7	3.7	3.7	**3.7**	**3.7**
Markets and trade							
Share of administered prices in CPI (in per cent)[1]	24.9	26.9	26.7	24.7	23.3	**21.6**	**na**
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	2.0	2.0	2.0	**2.0**	**na**
Share of trade with non-transition countries (in per cent)	71.6	72.4	71.8	67.5	65.9	**64.1**	**na**
Share of trade in GDP (in per cent)	109.2	114.8	125.0	135.7	121.6	**118.6**	**na**
Tariff revenues (in per cent of imports)	0.1	0.2	0.3	0.3	0.3	**0.3**	**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**
EBRD index of competition policy	3.0	3.3	3.3	3.7	3.7	**3.7**	**3.7**
Financial sector							
Number of banks (foreign-owned)	7 (4)	9 (6)	13 (10)	14 (12)	15 (13)	**17 (15)**	**na**
Asset share of state-owned banks (in per cent)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Asset share of foreign-owned banks (in per cent)	97.5	98.0	99.4	99.1	98.8	**98.2**	**na**
Non-performing loans (in per cent of total loans)	0.5	0.3	0.2	0.2	0.5	**1.9**	**na**
Domestic credit to private sector (in per cent of GDP)	30.6	39.6	56.6	77.5	87.2	**91.9**	**na**
Domestic credit to households (in per cent of GDP)	14.3	19.7	28.1	38.2	43.3	**46.9**	**na**
– Of which mortgage lending (in per cent of GDP)	9.5	14.6	22.6	33.0	37.7	**41.0**	**na**
Stock market capitalisation (in per cent of GDP)	38.3	46.9	25.0	34.2	26.3	**8.6**	**na**
Stock trading volume (in per cent of market capitalisation)	18.3	17.5	51.1	20.5	34.9	**25.4**	**na**
Eurobond issuance (in per cent of GDP)	5.8	8.1	2.5	0.0	0.2	**0.0**	**na**
EBRD index of banking sector reform	3.7	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	3.3	3.7	3.7	**3.7**	**3.7**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	34.1 (77.6)	32.9 (93.1)	32.8 (107.3)	33.6 (123.4)	36.9 (147.6)	**37.1 (188.2)**	**na**
Internet users (per 100 inhabitants)	45.3	49.5	58.3	60.1	63.6	**63.6**	**na**
Railway labour productivity (1989=100)	256.5	294.4	359.7	348.0	285.2	**208.2**	**na**
Residential electricity tariffs (USc kWh)	6.5	8.1	9.2	10.1	10.2	**11.5**	**na**
Average collection rate, electricity (in per cent)	99	99	99	99	99	**99**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	3.6	3.8	4.4	na	na	**na**	**na**
EBRD index of infrastructure reform	3.3	3.3	3.3	3.3	3.3	**3.3**	**3.3**
– Electric power	3.0	3.0	3.0	3.3	3.3	**3.3**	**3.3**
– Railways	4.3	4.3	4.3	4.3	4.0	**4.0**	**4.0**
– Roads	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Telecommunications	4.0	4.0	4.0	4.0	4.0	**4.0**	**4.0**
– Water and wastewater	4.0	4.0	4.0	4.0	4.0	**4.0**	**4.0**

[1] The high share is explained by the inclusion of gasoline (on which there are excise taxes) in the calculations of the Statistical Office.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	7.6	7.2	9.4	10.0	7.2	**-3.6**	**-13.2**
– Private consumption	8.6	9.6	9.9	13.0	9.1	**-4.8**	**na**
– Public consumption	0.8	2.0	-0.2	3.5	3.7	**4.1**	**na**
– Gross fixed capital formation	18.6	5.2	15.4	18.5	9.0	**-12.1**	**na**
– Exports of goods and services	7.4	14.6	18.6	14.0	0.0	**-0.7**	**na**
– Imports of goods and services	10.1	14.4	17.5	22.9	4.7	**-8.7**	**na**
Industrial gross output	8.4	8.9	12.5	11.4	8.1	**-4.8**	**na**
Agricultural gross output	3.7	-9.3	-3.2	-4.0	6.5	**0.2**	**na**
Employment			*(Percentage change)*				
Labour force (annual average)	1.2	-0.2	0.1	4.1	0.1	**1.1**	**na**
Employment (annual average)	1.5	0.2	2.0	6.4	1.4	**0.2**	**na**
			(In per cent of labour force)				
Unemployment (annual average)	10.0	9.6	7.9	5.9	4.7	**5.5**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	1.3	3.0	4.1	4.4	6.6	**10.4**	**0.3**
Consumer prices (end-year)	1.1	5.0	3.6	5.1	9.6	**7.0**	**-0.8**
Producer prices (annual average)	0.2	2.9	2.1	4.5	8.3	**7.1**	**na**
Producer prices (end-year)	0.3	3.9	2.2	5.9	8.7	**5.2**	**na**
Gross average monthly earnings in economy (annual average)	9.4	8.4	10.8	16.5	20.5	**13.9**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	1.7	1.6	1.6	2.3	2.6	**-2.7**	**-3.0**
General government expenditure	34.8	34.0	33.6	34.0	34.8	**39.9**	**na**
General government debt	5.6	5.0	4.6	4.5	3.8	**4.6**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	10.9	15.8	42.0	28.2	13.4	**5.5**	**na**
Domestic credit (end-year)	28.7	29.2	32.1	41.9	34.2	**8.1**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	36.8	38.4	47.2	51.2	49.1	**50.4**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Deposit rate (over 12 months)	2.4	2.1	3.0	4.1	5.6	**6.0**	**na**
Lending rate (over 12 months)	5.1	6.2	9.2	7.7	9.7	**11.1**	**na**
			(Kroons per US dollar)				
Exchange rate (end-year)	12.4	11.5	12.5	11.9	10.6	**11.1**	**na**
Exchange rate (annual average)	13.9	12.6	12.4	12.5	11.4	**10.7**	**na**
External sector			*(In millions of US dollars)*				
Current account	-1,116.3	-1,369.5	-1,386.8	-2,816.0	-3,803.8	**-2,245.4**	**517.9**
Trade balance	-1,556.7	-1,947.7	-1,920.4	-3,010.9	-3,816.0	**-2,763.8**	**-750.1**
– Merchandise exports	4,595.8	5,929.5	7,879.1	9,755.6	11,089.4	**12,568.4**	**8,939.9**
– Merchandise imports	6,152.5	7,877.2	9,799.5	12,766.5	14,905.4	**15,332.2**	**9,690.0**
Foreign direct investment, net	762.7	697.8	2,255.1	675.8	999.5	**875.8**	**-50.0**
Gross reserves, excluding gold (end-year)	1,373.4	1,792.5	1,945.1	2,855.9	3,330.0	**3,913.0**	**na**
External debt stock[1]	7,064.7	10,173.6	11,446.7	16,992.4	25,502.8	**26,843.3**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.2	2.2	1.9	2.2	2.2	**2.5**	**na**
			(In per cent of exports of goods and services)				
Debt service	20.5	26.2	27.0	30.4	38.1	**39.0**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	1.4	1.4	1.3	1.3	1.3	**1.3**	**na**
GDP (in billions of kroons)	136.4	151.5	175.0	207.0	244.5	**251.5**	**219.0**
GDP per capita (in US dollars)	7,258.5	8,903.8	10,495.7	12,340.5	15,930.7	**16,686.9**	**na**
Share of industry in gross value added (in per cent)	25.4	24.7	25.3	25.7	26.2	**25.9**	**na**
Share of agriculture in gross value added (in per cent)	3.6	3.4	3.1	2.8	2.9	**2.5**	**na**
Current account/GDP (in per cent)	-11.3	-11.4	-9.8	-17.0	-17.8	**-9.5**	**2.7**
External debt – reserves (in US$ million)	5,691.3	8,381.1	9,501.6	14,136.5	22,172.8	**22,930.3**	**na**
External debt/GDP (in per cent)	71.8	84.6	80.9	102.4	119.3	**114.1**	**na**
External debt/exports of goods and services (in per cent)	103.6	115.9	102.9	128.1	164.7	**151.2**	**na**

[1] Data from the Bank of Estonia and include non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

FYR Macedonia

Key developments and challenges

There were further improvements in the Former Yugoslav Republic (FYR) of Macedonia's business climate over the past year, with greater labour market flexibility and an improved land cadastre. However, cumbersome court procedures and administrative bottlenecks in the bankruptcy process continue to cause difficulties for businesses and investors.

Continued modernisation of the power infrastructure, effective tariff reforms and a further opening up of the market are needed to increase competition in the sector and provide incentives to end-users for more efficient use of electricity.

The impact of the crisis on the financial sector has been relatively modest so far. However, external imbalances have increased due to a drop in exports and capital inflows. Maintaining fiscal discipline over the medium term and avoiding accumulation of external debt are therefore essential for overall macroeconomic stability.

Country data

Population (in millions)	**2.1**
Area ('000 sq km)	**26.0**
GDP (in billion US$, 2008)	**9.6**
Average transition score (scale: 1 to 4.33)	**3.26**

Progress in structural reform

Liberalisation and privatisation

FYR Macedonia became a formal EU candidate country in December 2005 but, as of early October 2009 no date had been set for starting accession talks. However, the European Commission has recommended to the Council of the European Union that the country (with Montenegro and Serbia) be given visa-free access to the Schengen area.

Business environment and competition

The business environment improved further over the past year. Significant progress was made in establishing the real estate cadastre, which by mid-2009 covered more than 90 per cent of the country. Property registration was eased by reducing the average time to register a title deed by eight days. Amendments to the labour law introduced in January 2009 led to a reduction in minimum social contributions and made hiring of workers more flexible. The authorities also harmonised the bases for social security contributions and personal income tax and made these dependent on gross rather than net wages. These improvements are reflected in the World Bank's *Doing Business 2010* survey, which ranks FYR Macedonia 32nd out of 183 countries (up from 69th) and also places it among the top 10 reformers globally with regard to business environment reforms implemented over the past year.

Further improvements to the judicial system and the functioning of courts are required to bring the country to EU standards as well as to increase the country's attractiveness as an investment destination. The 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV) found that dealing with courts is a severe constraint on businesses. Despite ongoing reforms to speed up court procedures, legal procedures are still slow, hampering contract enforcement. For example, while the average duration of bankruptcy procedures has fallen slightly, it still takes around two years on average to close a business.

Infrastructure

The unbundling of the energy sector has been completed, but the generation segment is still dominated by the state-owned ELEM. The government increased electricity tariffs for households by 13 per cent in November 2008, in line with its policy of gradually increasing electricity prices to market levels. A further opening up of the market in line with the provisions of the Energy Community Treaty is needed to encourage competition and provide incentives for more efficient use of electricity to end-users.

In the road sector, the government, supported by the EBRD, is implementing a programme to upgrade more than 400 km of regional and local roads. The aim is to improve key regional transport links and provide connections to international road corridors. The planned modernisation of the airport system on the basis of a 20-year concession won by the Turkish company, TAV, has been postponed to 2010 due to pressure resulting from the global economic crisis.

Financial sector

The impact of the crisis on the financial sector has been relatively modest to date, mainly because banks rely primarily on domestic deposits to fund lending and deposit withdrawals have been limited. Strengthened banking supervision and adequate regulation have helped maintain the stability of the sector. However, lending has become more restricted and growth in bank lending to the private sector slowed significantly to 11.2 per cent year on year by the end of July 2009, compared with 34 per cent at the end of 2008. At the same time, the annual growth of deposits came to a virtual standstill in July 2009, compared with a 12.4 per cent growth at the end of 2008. Overall, banks remain well capitalised, including through continued support by overseas parent banks, and the capital adequacy ratio remained stable at 16.5 per cent after the first quarter of 2009, double the minimum that is required by law. At the same time, the number of non-performing loans increased to 8.4 per cent at the end of June from 6.8 per cent at the end of 2008. The public credit bureau increased its coverage and at the end of 2008 the first privately owned credit bureau was established. In July 2009 the voluntary pension insurance system ("third pillar") became operational, completing a seven-year pension reform intended to harmonise FYR Macedonia's social insurance legislation with that of the European Union.

Macroeconomic performance

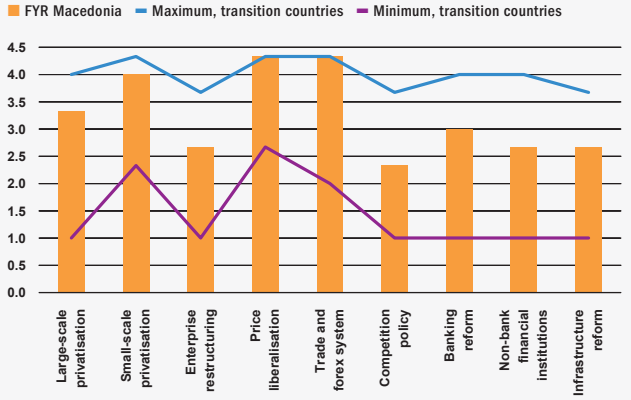
After several strong years, GDP growth declined from 5.9 per cent in 2007 to 4.9 per cent in 2008. The global financial crisis started affecting the economy in the fourth quarter of 2008, led by a decline in the output of the metal and textile sectors. The situation deteriorated in the first half of 2009 as industrial production contracted by 11 per cent compared with a year earlier, while foreign trade dropped sharply and foreign direct investment (FDI) roughly halved. The growth of GDP was -1.4 per cent in the second quarter of 2009 (compared with -0.9 per cent in the first quarter and 2 per cent growth in the fourth quarter of 2008) and unemployment remains high at about one-third of the workforce. At the same time, external imbalances increased, forcing the central bank to increase the reference interest rate from 7 to 9 per cent in March 2009 and repeatedly intervene on the foreign exchange market. As a result, foreign exchange reserves fell to 3.4 months of imports in May 2009, but have stabilised somewhat since then at a level of above 4 months of imports, supported by the issuing of a eurobond as well as inflows based on special drawing right allocations. Gross external debt remained at around 50 per cent of GDP, partly reflecting increased public borrowing. Inflation remained subdued at around 0.1 per cent in the first half of the year.

In response to the crisis, in November 2008 the authorities adopted an economic stimulus plan, which includes a number of fiscal measures such as rebates and write-offs of unpaid social security contributions, a further lowering of taxes on profits and agricultural incomes and a reduction of some import tariffs. As a result, fiscal policy has become more expansionary and after being in surplus during most of 2008, intensive spending in the last months of the year resulted in a budget deficit of 0.9 per cent of GDP for 2008. In March 2009 the government presented a €8 billion investment programme for the next seven years, focusing on large infrastructure projects in energy, transport, environment protection, education and culture. In June 2009 in order to preserve the projected 2009 budget deficit at -2.8 per cent of GDP and following lower-than-projected revenue performance in the first months of 2009, the parliament adopted a revised budget which included a cut in public expenditures of 9 per cent, mainly through a hiring freeze and a suspension of public wage increases.

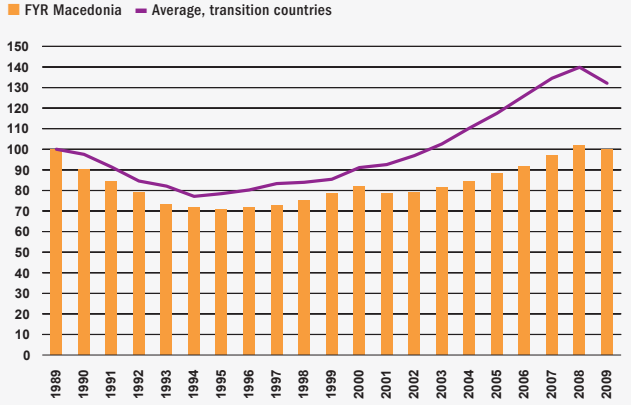
Outlook and risks

The economy is likely to fall into recession this year as a result of a sharp drop in industrial output and exports. A more expansionary policy stance, reflecting the government's anti-crisis measures and the need to modernise the country's infrastructure, will result in a shift from modest fiscal deficits or surpluses of earlier years to higher deficits in the near future. The combination of lower exports, falling capital inflows (including FDI) and an expansionary fiscal policy have increased external risks, especially given the drop in reserves and relatively modest reserve coverage. These pressures, with weaker remittances, could necessitate a sharp contraction in imports, triggering a deeper and more prolonged recession. However, the recent rise in reserve coverage, as well as the government's commitment to fiscal discipline should help to mitigate these risks. Continued progress in the EU accession process is an important condition for the realisation of FYR Macedonia's medium-term growth potential.

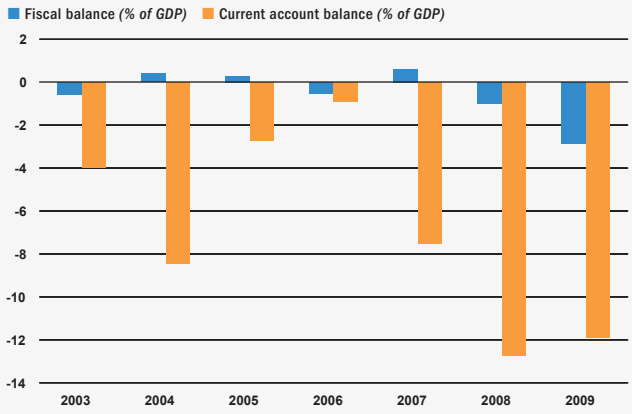
Transition indicators 2009



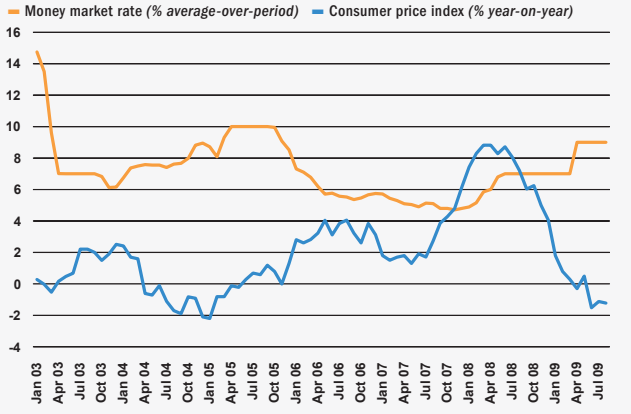
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Telecoms regulatory assessment compliance – **high**	Capital adequacy ratio – **8 per cent**	Share of population living in poverty – **3.2 per cent** (2003)
Controls on inward direct investment – **yes**[1]	Quality of insolvency law – **high**	Independence of the electricity regulator – **partial**	Deposit insurance system – **yes**	Government expenditure on health – **4.8 per cent** (2008)
Interest rate liberalisation – **full**	Secured transactions law – **modern/some defects**	Separation of railway infrastructure from operations – **yes**	Private pension funds – **yes**	Government expenditure on education – **5.1 per cent** (2008)
Exchange rate regime – **de facto fixed to euro**		Independence of the road directorate – **partial**		Household expenditure on power and water – **6.6 per cent**
Wage regulation – **no**				
Tradeability of land – **limited de jure**				

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	13.6	13.8	14.3	20.0	20.2	**20.6**	na
Private sector share in GDP (in per cent)	60.0	65.0	65.0	65.0	65.0	**70.0**	**70.0**
Private sector share in employment (in per cent)	50.0	55.0	55.0	60.0	60.0	**60.0**	na
Budgetary subsidies and current transfers (in per cent of GDP)	1.1	1.1	1.3	2.3	3.3	**4.6**	na
Share of industry in total employment (in per cent)	23.8	25.8	25.8	25.0	24.9	**24.8**	na
Change in labour productivity in industry (in per cent)	14.0	-5.7	2.7	1.9	0.9	**2.5**	na
Investment/GDP (in per cent)	20.0	21.4	20.7	21.9	24.2	**na**	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	3.3	3.3	3.3	3.3	**3.3**	**3.3**
EBRD index of enterprise reform	2.3	2.3	2.3	2.7	2.7	**2.7**	**2.7**
Markets and trade							
Share of administered prices in CPI (in per cent)	13.4	1.5	1.2	1.2	1.2	**0.7**	na
Number of goods with administered prices in EBRD-15 basket	1.0	0.0	0.0	0.0	0.0	**0.0**	na
Share of trade with non-transition countries (in per cent)[2]	58.8	55.9	54.1	51.6	53.4	**51.3**	na
Share of trade in GDP (in per cent)	77.2	83.6	88.5	95.4	105.1	**110.2**	na
Tariff revenues (in per cent of imports)	5.1	4.2	3.4	4.3	2.8	**2.3**	na
EBRD index of price liberalisation	4.0	4.3	4.3	4.3	4.3	**4.3**	**4.3**
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	**4.3**	**4.3**
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.3	**2.3**	**2.3**
Financial sector							
Number of banks (foreign-owned)	21 (8)	21 (8)	20 (8)	19 (8)	18 (11)	**18 (14)**	na
Asset share of state-owned banks (in per cent)	1.8	1.9	1.6	1.6	1.4	**1.2**	na
Asset share of foreign-owned banks (in per cent)	47.0	47.3	51.3	53.2	85.9	**93.1**	na
Non-performing loans (in per cent of total loans)	34.9	27.5	22.2	15.1	10.9	**10.1**	na
Domestic credit to private sector (in per cent of GDP)	18.8	22.1	25.1	30.2	36.8	**43.9**	na
Domestic credit to households (in per cent of GDP)	3.7	5.6	7.5	9.6	13.5	**15.5**	na
– Of which mortgage lending (in per cent of GDP)	na	na	na	na	2.6	**3.3**	na
Stock market capitalisation (in per cent of GDP)	7.7	7.7	11.0	16.5	31.8	**9.0**	na
Stock trading volume (in per cent of market capitalisation)	8.1	8.6	18.3	22.4	26.5	**8.9**	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	3.0	0.0	0.0	**0.0**	na
EBRD index of banking sector reform	2.7	2.7	2.7	2.7	2.7	**3.0**	**3.0**
EBRD index of reform of non-bank financial institutions	1.7	2.0	2.0	2.3	2.3	**2.3**	**2.7**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	25.9 (38.3)	26.4 (48.5)	26.2 (62.0)	24.1 (69.5)	22.7 (95.4)	**22.4 (122.6)**	na
Internet users (per 100 inhabitants)	19.1	21.0	23.0	25.0	27.3	**42.9**	na
Railway labour productivity (1989=100)	67.2	76.2	112.9	132.0	161.0	**162.4**	na
Residential electricity tariffs (USc kWh)	4.7	5.1	4.4	5.1	5.7	**6.1**	na
Average collection rate, electricity (in per cent)	77	82	88	85	86	**87**	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.9	5.2	5.5	na	na	**na**	na
EBRD index of infrastructure reform	2.0	2.3	2.3	2.3	2.3	**2.3**	**2.7**
– Electric power	2.3	2.3	2.7	3.0	3.0	**3.0**	**3.0**
– Railways	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
– Roads	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Telecommunications	2.7	3.0	3.0	3.0	3.3	**3.3**	**3.7**
– Water and wastewater	2.0	2.0	2.0	2.3	2.3	**2.3**	**2.3**

[1] There are controls on arms production, trade in narcotics, historical and cultural heritage.

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

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	2.8	4.1	4.1	4.0	5.9	**4.9**	**-1.6**
Industrial gross output	6.6	-2.1	7.0	3.6	3.7	**5.5**	**na**
Agricultural gross output	4.8	6.2	0.2	4.6	-2.0	**3.5**	**na**
Employment[1]			*(Percentage change)*				
Labour force (end-year)	4.4	-3.3	4.4	2.6	1.7	**1.4**	**na**
Employment (end-year)	-2.8	-4.1	4.3	4.6	3.5	**3.2**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	36.7	37.2	37.3	36.0	34.9	**33.8**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	1.2	-0.4	0.5	3.2	2.3	**8.3**	**-0.4**
Consumer prices (end-year)	2.6	-1.9	1.2	2.9	6.1	**4.1**	**-1.0**
Producer prices (annual average)	-0.3	0.9	3.2	4.5	2.5	**10.3**	**na**
Producer prices (end-year)	-0.2	1.3	4.0	3.2	4.2	**-1.8**	**na**
Gross average monthly earnings in economy (annual average)	4.9	4.1	2.7	8.0	4.8	**8.7**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	-0.6	0.4	0.3	-0.5	0.6	**-1.0**	**-2.8**
General government expenditure	34.5	33.2	34.9	34.0	33.1	**35.2**	**na**
General government debt	39.0	36.6	39.5	32.9	24.7	**21.3**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	18.1	17.1	15.5	24.8	28.1	**7.1**	**na**
Domestic credit (end-year)	7.0	27.5	3.7	27.4	67.1	**39.4**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	30.7	34.1	36.5	41.9	47.1	**44.9**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Basic rate of the National Bank	7.0	6.5	6.5	6.5	6.5	**6.5**	**na**
Interbank interest rate	6.2	10.0	8.5	5.7	4.8	**6.5**	**na**
Deposit rate	6.7	6.5	5.6	4.4	5.3	**5.7**	**na**
Lending rate	14.5	12.0	12.1	10.7	9.9	**9.7**	**na**
			(Denars per US dollar)				
Exchange rate (end-year)	49.1	45.1	51.7	46.5	41.7	**43.7**	**na**
Exchange rate (annual average)	54.3	49.4	49.3	48.8	44.7	**41.9**	**na**
External sector			*(In millions of US dollars)*				
Current account	-184.1	-452.8	-157.9	-56.4	-596.8	**-1,209.6**	**-1,155.0**
Trade balance	-851.0	-1,139.0	-1,063.0	-1,285.0	-1,629.8	**-2,551.8**	**-2,000.0**
– Merchandise exports	1,362.7	1,674.9	2,040.6	2,396.3	3,349.5	**3,970.9**	**2,300.0**
– Merchandise imports	2,213.7	2,813.8	3,103.6	3,681.2	4,979.2	**6,522.7**	**4,300.0**
Foreign direct investment, net	117.5	321.9	94.2	424.0	700.2	**612.0**	**300.0**
Gross reserves, excluding gold (end-year)	897.7	905.0	1,228.5	1,750.6	2,082.3	**1,920.3**	**na**
External debt stock	1,840.5	2,816.9	2,970.6	3,284.4	4,160.8	**4,678.3**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.1	3.3	4.0	4.9	4.5	**3.2**	**na**
			(In per cent of exports of goods and services)				
Debt service	19.7	12.4	10.2	18.8	15.5	**na**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	2.0	2.0	2.0	2.0	2.0	**2.1**	**na**
GDP (in billions of denars)	251.5	265.3	286.6	310.9	354.3	**398.6**	**407.0**
GDP per capita (in US dollars)	2,285.6	2,645.2	2,854.0	3,119.4	3,868.1	**4,633.1**	**na**
Share of industry in GDP (in per cent)	20.8	19.5	19.6	20.2	21.9	**22.3**	**na**
Share of agriculture in GDP (in per cent)	11.4	11.3	10.8	10.8	9.4	**9.4**	**na**
Current account/GDP (in per cent)	-4.0	-8.4	-2.7	-0.9	-7.5	**-12.7**	**-11.9**
External debt - reserves (in US$ million)	942.8	1,911.9	1,742.1	1,533.8	2,078.6	**2,758.0**	**na**
External debt/GDP (in per cent)	39.7	52.4	51.1	51.5	52.5	**49.1**	**na**
External debt/exports of goods and services (in per cent)	105.6	132.4	116.2	109.6	105.4	**102.4**	**na**

Georgia

Key developments and challenges

To improve banking sector stability and public confidence in banks, banking supervision needs to be further strengthened, focusing in particular on banks' risk management practices.

Further improvements in physical infrastructure and services of municipal utilities remain important challenges. A successful implementation of the reforms in the municipal utilities sector, including investment to modernise the infrastructure, is crucial to ensure the long-term financial sustainability of this sector.

Recent economic growth was largely driven by the financial services and construction sectors and the global financial crisis has emphasised the need for further economic diversification. The successful implementation of the government's programme to improve quality standards and competitiveness in the agricultural sector will contribute towards this goal, and similar initiatives are needed for other tradeable sectors.

Country data

Population (in millions)	**4.4**
Area ('000 sq km)	**70.0**
GDP (in billion US$, 2008)	**12.9**
Average transition score (scale: 1 to 4.33)	**3.11**

Progress in structural reform

Business environment and competition

The August 2008 military conflict with Russia and the international financial crisis have negatively affected the business environment. According to the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), a larger percentage of companies identified transport and access to finance as obstacles to doing business than in the previous 2005 survey. The conflict with Russia also had an impact on the functioning of state institutions, and almost 80 per cent of Georgian firms in BEEPS IV report political instability as an obstacle to their day-to-day operations.

In order to facilitate foreign investment, the government has allowed the establishment of two Free Economic Zones (FEZ). During 2008 the RAK Investment Authority (an investment vehicle of Ras Al Khaimah of United Arab Emirates) acquired full ownership of the Poti Seaport. The investor also acquired over 3 million square metres of nearby land to construct a new sea port and to establish a FEZ, the first stage of which is expected to be completed by the end of 2009. In April 2009 Egypt's Fresh Electric Company, together with a local company, created the Fresh Georgia company, which aims to establish a FEZ in Kutaisi. Fresh Georgia is expected to invest about US$ 1.2 billion over the next two years and contract 12 manufacturing factories.

The government has recently prepared a Strategy for the Agricultural Development of Georgia that focuses on improving competition and quality standards. The government also launched a state programme of "Cheap Credit" aimed at supporting farms and other agricultural businesses. Companies can also purchase state-owned agricultural land at concessional prices.

Infrastructure

With the help of the United States Agency for International Development (USAID) the government has designed and is currently implementing a reform agenda for the municipal water sector aimed at improving water infrastructure and, ultimately, water quality. An independent water regulator was established in mid-2008 and parliament has approved a tariff policy based on cost recovery. Current tariffs are about 20 per cent below cost recovery levels and the collection rate for the population is below 40 per cent. Following the passing of a resolution in June 2009 on the merger of various state-owned water-distributing companies, the government has created two regional companies covering western and eastern Georgia. The merger consolidated the 29 and 33 regional water-distributing companies and sewerage systems in west and east Georgia, respectively, and is intended to improve management and attract investment.

Competition in telecommunications has increased in the fixed-line and mobile operator market, resulting in lower tariffs and better services. The fixed-line market continues to be dominated by United Telecom (with a 70 per cent market share) although a number of smaller operators provide some competition. Competition has increased in particular in the mobile operators market with the entry of a third operator, Mobitel (Beeline), in 2007. Mobile penetration had increased from about 53 per cent in 2007 to about 93 per cent by mid-2009. Mobile networks now cover virtually the whole of Georgia while the fixed-line networks remain outdated in many places.

Financial sector

Domestic credit to the private sector doubled from 15 per cent of GDP in 2005 to 30 per cent of GDP in 2008. The August 2008 conflict and the international financial crisis have resulted in a fall in deposits and a dramatic slow-down in bank lending dropping by 4 per cent on annual terms at the end of August 2009. At the same time dollarisation of banks' portfolios increased from 65 per cent in July 2008 to more than 77 per cent at the end of July 2009. This has increased the credit risk for banks as foreign exchange risks have been passed on to unhedged borrowers. Non-performing loans had also increased to more than 18 per cent of total loans by August 2009.

The National Bank of Georgia (NBG) took a number of emergency measures to ease liquidity in the banking sector, including reducing the refinancing rate, lowering reserve requirements and supporting banks with liquidity. A new law is currently under discussion which proposes the merger of the Financial Supervisory Authority (established in 2008) with the NBG in autumn 2009. It is hoped this will give the NBG more influence in financial sector supervision and regulation so that it can strengthen financial stability. At the same time the authorities are working on a contingency plan for bank rescues to boost confidence in the banking sector and increase lending. To clarify the role of parent banks in case of crisis, the NBG has signed a Memorandum of Understanding with home country supervisors.

Macroeconomic performance

The Georgian economy suffered a deep contraction of 10.7 per cent in annual terms in the second quarter of 2009 after a contraction of 5.9 per cent in the first quarter. This contrasts sharply with positive real GDP growth of 8.3 per cent in the second quarter of 2008 (and 2.1 per cent growth during 2008 as a whole). This sharp slow-down is mainly due to lower investment, both foreign and domestic, and very limited bank lending. The construction, services and manufacturing sectors all experienced significant falls in activity during the first half of 2009.

Exports decreased by 37 per cent in the first half of 2009 compared with a year earlier due to lower external demand and metal prices. However, imports – especially of services – decreased by 43 per cent, contributing to a fall in the current account deficit to 10 per cent of GDP (compared with 22.7 per cent of GDP in 2008 as a whole). During the first half of 2009 foreign investment flows fell by about 80 per cent relative to the same period in 2008, and remittances declined by about 20 per cent at the end of July due to the economic slow-down in Russia.

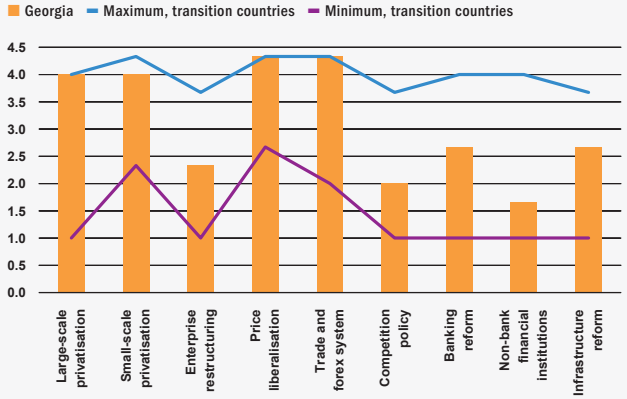
The conflict and intensification of the international financial crisis put pressure on the lari, which depreciated by 17 per cent during early November 2008. The exchange rate has remained relatively stable since then, at about 1.67 to the dollar, despite a decision by the NBG to increase exchange rate flexibility since May 2009. Inflationary pressures have eased as demand has weakened and the annual rate of inflation was negative at -3.1 per cent in August 2009 compared with 10 per cent at the end of 2008.

Although the crisis has negatively affected fiscal revenues, the government has recently amended the budget with public investment focused on conflict-related reconstruction and infrastructure, along with social spending. The expected increase of fiscal deficit to some 9 per cent of GDP is likely to be funded by donor funds.

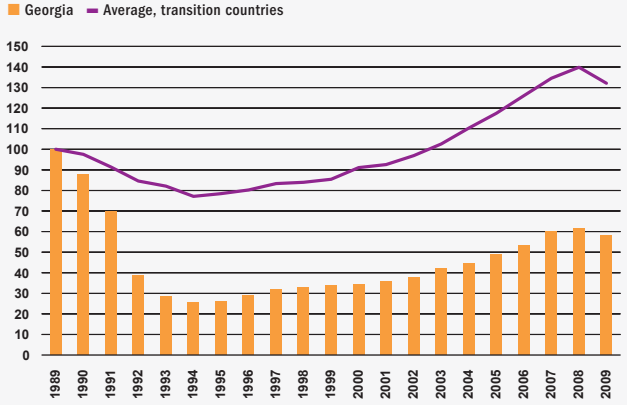
Outlook and risks

After the economic contraction in 2009, Georgia is likely to experience only a modest recovery in 2010, reflecting relatively low levels of domestic and foreign investment and limited bank lending. The large fiscal stimulus, mainly financed from international financial support, will provide some counter-cyclical effect. Remittances, although significant, are expected to decline further due to the recession in neighbouring countries, in particular Russia, which in turn will affect consumption. International financial support for the banking sector will help to limit the shrinking of banks' balance sheets and improve their lending capacity. However, non-performing loans may increase further due to the economic slow-down and the malaise in the real estate sector, while foreign currency risks remain large due to the dollarisation of bank assets. Risks to this already negative outlook include the possibility of an even sharper decline in foreign direct investment (FDI) flows and remittances, which could lead to pressures on the currency and banks' balance sheets.

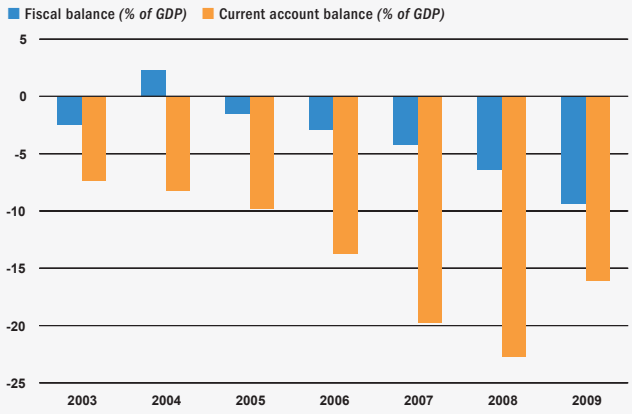
Transition indicators 2009



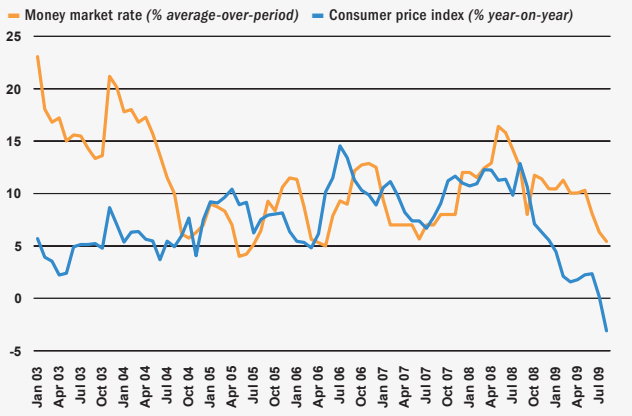
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradeability of land – **unlimited**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **under development**

Infrastructure

Telecoms regulatory assessment compliance – **high**

Independence of the electricity regulator – **partial**

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

Independence of the road directorate – **partial**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **no**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **30.4 per cent** (2005)

Government expenditure on health – **1.6 per cent** (2008)

Government expenditure on education – **2.9 per cent** (2008)

Household expenditure on power and water – **11.0 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	23.6	24.5	28.1	32.9	38.1	**41.8**	**na**
Private sector share in GDP (in per cent)	65.0	65.0	65.0	70.0	75.0	**75.0**	**75.0**
Private sector share in employment (in per cent)	77.3	77.9	77.7	79.0	79.0	**80.0**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	1.6	2.4	7.5	9.3	6.6	**na**	**na**
Share of industry in total employment (in per cent)	5.9	6.4	6.8	6.0	6.5	**6.5**	**na**
Change in labour productivity in industry (in per cent)	23.4	5.4	8.3	31.9	8.8	**na**	**na**
Investment/GDP (in per cent)	24.4	26.6	26.3	25.6	na	**na**	**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	3.7	3.7	4.0	**4.0**	**4.0**
EBRD index of enterprise reform	2.0	2.0	2.3	2.3	2.3	**2.3**	**2.3**
Markets and trade							
Share of administered prices in CPI (in per cent)	5.5	5.4	5.4	12.4	12.4	**12.4**	**na**
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Share of trade with non-transition countries (in per cent)	64.0	55.4	50.3	61.5	na	**na**	**na**
Share of trade in GDP (in per cent)	51.6	62.7	64.9	68.8	69.5	**68.3**	**na**
Tariff revenues (in per cent of imports)	6.8	8.0	8.4	7.2	5.4	**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**
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Financial sector							
Number of banks (foreign-owned)	24 (6)	21 (7)	19 (10)	17 (10)	19 (14)	**20 (16)**	**na**
Asset share of state-owned banks (in per cent)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Asset share of foreign-owned banks (in per cent)[1]	34.9	58.1	75.9	86.9	90.6	**90.8**	**na**
Non-performing loans (in per cent of total loans)	7.5	6.2	3.8	2.5	2.6	**12.8**	**na**
Domestic credit to private sector (in per cent of GDP)	8.7	9.7	14.8	19.7	27.1	**30.2**	**na**
Domestic credit to households (in per cent of GDP)	3.0	2.8	4.1	5.6	8.8	**13.2**	**na**
– Of which mortgage lending (in per cent of GDP)	0.5	1.0	1.1	1.4	2.6	**3.5**	**na**
Stock market capitalisation (in per cent of GDP)	5.3	3.8	5.5	8.3	13.0	**2.9**	**na**
Stock trading volume (in per cent of market capitalisation)	0.5	11.6	13.6	18.6	4.4	**1.0**	**na**
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	2.0	**5.0**	**na**
EBRD index of banking sector reform	2.3	2.7	2.7	2.7	2.7	**2.7**	**2.7**
EBRD index of reform of non-bank financial institutions	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	14.6 (15.6)	15.1 (18.6)	12.8 (26.3)	12.5 (38.6)	12.8 (59.7)	**12.8 (59.7)**	**na**
Internet users (per 100 inhabitants)	2.6	3.9	6.1	7.5	8.3	**8.3**	**na**
Railway labour productivity (1989=100)	72.6	68.6	93.4	118.4	110.9	**101.5**	**na**
Residential electricity tariffs (USc kWh)	4.1	4.2	4.9	7.5	9.8	**10.3**	**na**
Average collection rate, electricity (in per cent)	33	37	58	81	95	**98**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	4.7	4.9	4.9	na	na	**na**	**na**
EBRD index of infrastructure reform	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.7**
– Electric power	3.0	3.0	3.0	3.0	3.3	**3.3**	**3.3**
– 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	2.3	2.3	2.3	2.7	2.7	**2.7**	**2.7**
– Water and wastewater	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.3**

[1] Data on bank ownership is based on the legal registration of owenrship and not the beneficial ownership.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	11.1	5.9	9.6	9.4	12.4	**2.1**	**-5.5**
– Private consumption	3.2	7.6	0.1	29.1	9.8	**na**	**na**
– Public consumption	4.1	64.2	27.2	-3.6	7.8	**na**	**na**
– Gross fixed capital formation	20.9	9.0	12.0	-0.4	14.8	**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	14.0	12.2	13.0	16.2	15.0	**na**	**na**
Agricultural gross output	10.3	-7.9	12.0	-9.6	6.0	**-2.1**	**na**
Employment[1]			*(Percentage change)*				
Labour force (end-year)	-2.5	-0.5	-0.8	-0.1	-2.8	**-2.4**	**na**
Employment (end-year)	-1.3	-1.7	-2.2	0.2	-2.5	**-6.0**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	11.5	12.6	13.8	13.6	13.3	**16.5**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	4.9	5.7	8.4	9.2	9.3	**10.0**	**1.2**
Consumer prices (end-year)	7.0	7.5	6.4	8.8	11.0	**10.0**	**3.0**
Producer prices (annual average)	2.3	3.8	7.2	9.6	10.2	**12.0**	**na**
Producer prices (end-year)	5.4	0.7	8.2	10.9	16.9	**1.4**	**na**
Gross average monthly earnings in economy (annual average)	10.4	24.5	30.2	36.1	29.5	**40.3**	**na**
Government sector[2]			*(In per cent of GDP)*				
General government balance	-2.5	2.3	-1.5	-3.0	-4.2	**-6.4**	**-9.4**
General government expenditure	18.7	19.4	24.9	29.2	33.5	**37.1**	**na**
General government debt	61.5	47.0	36.6	28.9	22.9	**na**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M3, end-year)	22.7	42.6	26.4	39.3	50.3	**14.0**	**na**
Domestic credit (end-year)	14.7	7.4	39.8	34.5	28.8	**34.0**	**na**
			(In per cent of GDP)				
Broad money (M3, end-year)	12.4	15.2	16.4	19.3	23.5	**23.9**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Money market rate	16.9	11.9	7.7	9.5	7.8	**na**	**na**
Treasury bill rate (3-month maturity)[3]	44.3	19.2	na	na	na	**na**	**na**
Deposit rate (3-month)[4]	9.3	7.2	7.6	11.4	9.5	**10.4**	**na**
Lending rate (3-month)	32.3	31.2	21.6	18.8	20.4	**21.2**	**na**
			(Laris per US dollar)				
Exchange rate (end-year)	2.1	1.8	1.8	1.7	1.6	**1.7**	**na**
Exchange rate (annual average)	2.1	1.9	1.8	1.8	1.7	**1.5**	**na**
External sector			*(In millions of US dollars)*				
Current account	-294.0	-430.0	-628.0	-1,069.0	-2,005.8	**-2,904.6**	**-1,720.7**
Trade balance	-598.0	-719.0	-1,214.0	-2,019.0	-2,895.7	**-3,894.4**	**-2,669.6**
– Merchandise exports	730.0	1,272.0	1,472.0	1,667.0	2,088.3	**2,420.3**	**1,933.9**
– Merchandise imports	1,328.0	1,991.0	2,686.0	3,686.0	4,984.0	**6,314.8**	**4,603.5**
Foreign direct investment, net	335.0	420.0	529.0	1,115.0	1,740.1	**1,561.1**	**887.1**
Gross reserves, excluding gold (end-year)	190.9	383.0	473.9	881.0	1,361.0	**1,480.0**	**na**
External debt stock	1,954.0	2,039.0	2,137.0	2,000.0	3,136.0	**4,555.2**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	1.3	1.8	1.8	2.5	2.9	**2.6**	**na**
			(In per cent of current account revenues, excluding transfers)				
Debt service	10.0	10.2	5.6	10.5	9.0	**14.4**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	4.6	4.5	4.5	4.5	4.4	**4.4**	**na**
GDP (in millions of laris)	8,565.0	9,969.8	11,621.0	13,789.9	16,998.6	**19,069.6**	**17,925.4**
GDP per capita (in US dollars)	877.0	1,155.9	1,419.5	1,722.2	2,312.7	**2,908.1**	**na**
Share of industry in GDP (in per cent)	17.7	16.1	15.7	14.9	14.2	**13.5**	**na**
Share of agriculture in GDP (in per cent)	19.3	16.4	14.8	11.3	9.2	**8.9**	**na**
Current account/GDP (in per cent)	-7.4	-8.3	-9.8	-13.7	-19.7	**-22.7**	**-16.1**
External debt – reserves (in US$ million)	1,763.1	1,656.0	1,663.1	1,119.0	1,775.0	**3,075.2**	**na**
External debt/GDP (in per cent)	49.0	39.2	33.3	25.7	30.8	**35.6**	**na**
External debt/exports of goods and services (in per cent)	151.7	111.4	106.9	77.8	106.0	**127.9**	**na**

[1] Figures consistent with ILO methodology.

[2] General government includes the state, municipalities and extra-budgetary funds.

[3] Data relate to the average auction rates during the year.

[4] Data refer to average rates for local currency from international financial statistics.

Hungary

Key developments and challenges

The government has taken steps to contain the fiscal deficit in the wake of the recession and the crisis in external capital markets. Continued efforts in 2010 will be important to bolster financial market confidence, but also to gradually reduce Hungary's tax burden, which would ultimately benefit private investors.

The banking sector has weathered the financial crisis reasonably well, although government guarantees and liquidity injections have provided significant support. The challenge for the banking system is to increase its reliance on domestic sources of funding and revive credit growth without undue government intervention.

Hungary has established itself as an important location for export-oriented international companies from western Europe. Sustaining this role, especially in capital-intensive sectors, will require stable policies, particularly those concerning the tax regime and tariff-setting by utilities.

Country data

Population (in millions)	**10.1**
Area ('000 sq km)	**93.0**
GDP (in billion US$, 2008)	**155.9**
Average transition score (scale: 1 to 4.33)	**3.96**

Progress in structural reform

Business environment and competition

In light of the need to bring government finances back onto a sustainable footing, the government has not yet been in a position to meaningfully lower the corporate tax burden. However, the tax reductions on wage income and reductions in employers' social security contributions may help to contain labour costs for investors. Investor surveys, such as the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), indicate that Hungarian firms still see political uncertainty as the main obstacle to their operations and growth. The quality of Hungary's market-regulating bodies, by contrast, is on a par with the Organisation for Economic Co-operation and Development (OECD) average, although the BEEPS also found that labour regulations and the time taken to obtain business licences and permits were seen to be obstacles. Hungary maintains its positive attitude towards foreign direct investment (FDI), and major companies have continued relocating their operations there, including those that are knowledge-intensive, such as research and development. The expansion of foreign operations in the pharmaceuticals and semi-conductor industries is notable in this regard.

Infrastructure

The continuing uncertainty in the international financial markets has meant there remain substantial risks to the viability of public-private partnerships in the infrastructure sector. In this context, Hungary's success in awarding the concession for the M6 motorway was important, even though a tender for the M3 motorway was cancelled as EU cohesion funds are to be utilised. The government has also approved a long-awaited reform strategy that will assist in the restructuring of the railway sector.

Hungary's electricity market has been fully liberalised since early 2008. Nevertheless, the incumbent state-owned power company, MVM, retains its dominant position, including its long-term power purchase agreements, and retail prices have not declined. MVM has exclusive rights to buy over 70 per cent of electricity output, thus impeding competition. The government has changed a law that protected domestic energy companies from foreign take-overs, a provision that had been challenged by the European Commission. The investment environment for energy suppliers was, however, adversely impacted by the government's unilateral change of the pricing formula for gas supplies. The change reflected an attempt to shield households from tariff increases following the depreciation of the currency and the ensuing dispute with an important foreign investor was resolved only after some delay. The government also imposed a windfall tax on energy companies to counteract profits made during the period of record energy prices in early 2008.

Financial sector

By mid-2009 prudential indicators of the banking sector remained solid with profitability supported by cost reductions, capital adequacy that was well above the regulatory minimum and a still relatively low share of non-performing loans. Nevertheless, the long period of rapid credit growth and the deterioration in banks' lending standards underline the risks to future bank asset quality should the recession be prolonged. Some 70 per cent of banking sector loans to the private sector are denominated in foreign currencies and for households alone, this represents an exposure of 25 per cent of GDP. Such risky lending practices were only belatedly reined in by the supervisor, whose powers are now being expanded. In September 2009 the government and most commercial banks agreed a code of conduct on retail lending. The government also put in place a mortgage debt service guarantee scheme that would safeguard debt service of households without eroding credit discipline of households.

The foreign-owned bank subsidiaries that dominate the market are also setting tighter lending standards. For instance, loans in Swiss francs, which previously characterised the mortgage market, are now heavily restricted. European parent banks have confirmed their commitment to their exposure in Hungary, and their respective supervisors are cooperating closely with their counterparts in Hungary. Nevertheless, credit to the private sector is expected to decline in real terms, as banks seek to reduce their exposures, and demand for new credit remains subdued.

Social reform

Over many years, Hungary's traditionally high tax burden and generous social programmes have eroded incentives for employment and encouraged the growth of the informal economy. Within central Europe and the Baltic states (CEB), Hungary still has the highest share of social protection spending and the lowest rate of labour force participation. Under the fiscal reforms adopted in the spring of 2009 the retirement age was raised, pension benefits circumscribed and household subsidies for energy and other expenses were eliminated. Significantly, income taxes were reduced, and the revenue base shifted toward consumption and wealth. These reforms may improve labour market efficiency and contribute to raising long-term growth.

Macroeconomic performance

Given its openness to intra-European trade, and a high level of external debt, Hungary was severely impacted by the international financial crisis affecting the region in the autumn of 2008. Domestic factors, especially the urgent fiscal stabilisation efforts and credit retrenchment by domestic banks, accentuated the downturn in external demand. The expected contraction in GDP in 2009 (of about 6.5 per cent) is on a par with that of many other countries in the region, but comes after several years of weak growth.

To mitigate the risks of the crisis, an International Monetary Fund (IMF)-led financing programme was introduced in October 2008 (with the European Union providing about one-third of the €20 billion package). Hungary's public debt rose to 72 per cent of GDP at the end of 2008 and ensuring a sustainable path for public finances remains a key objective of this programme. The government, which has only a one-year mandate, implemented large spending cuts in the spring of 2009 (in the areas of public sector wages, pensions, and other social expenditures), in addition to the tax reforms that will ease the tax burden on wages. Given the impact of the domestic recession on revenues, the target of 3.9 per cent of GDP for 2009's deficit still represents a considerable tightening in the fiscal stance compared with previous years.

The impact of the forint devaluation on domestic demand and on the quality of banking loans to households emerged as a key concern during the financial crisis. In response to the pressures on the currency, the National Bank of Hungary (NBH) has steadily raised interest rates since early 2008, including a hike of 300 basis points (bps) in October 2008.

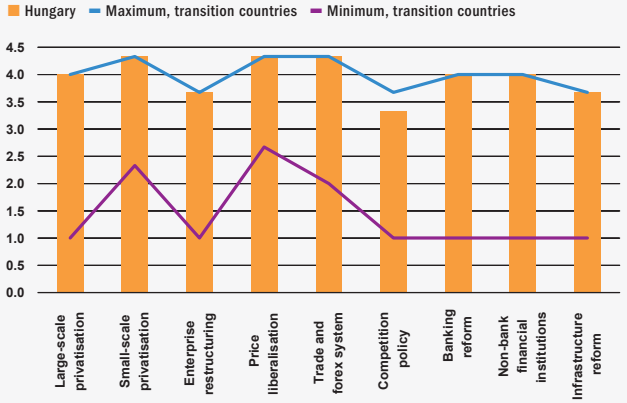
The international capital market environment had considerably improved by mid-2009. Risk spreads, as measured through credit default swaps, declined from over 629 bps in March 2009 to under 220 bps in early October 2009, and the forint recovered most of the losses made since October 2008. This underpinned the government's further issuance programme in the domestic and international bond markets; from July 2009 the NBH resumed the reductions in its policy interest rate.

Outlook and risks

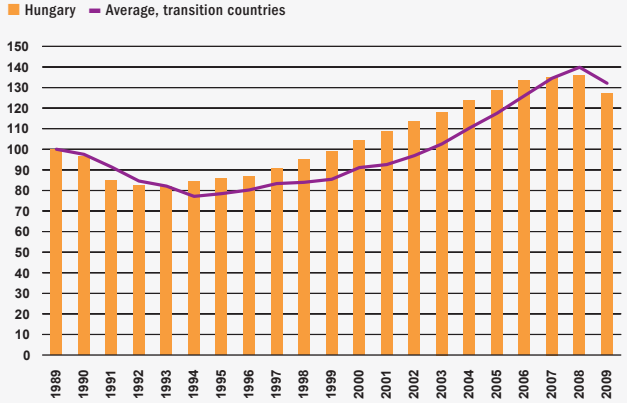
In the third quarter of 2009 the absence of inflationary risks and the relatively benign investor sentiment appeared to open the way for further reductions in interest rates by the NBH. Such a monetary policy stimulus may be necessary, as there is no scope for any easing of the fiscal stance. However, growth will remain subdued, reflecting the slow pace of recovery in the eurozone and the likelihood of a further retrenchment in credit to the private sector.

Over the medium term, Hungary's key challenge remains that of ensuring public finances are sustainable. Market sentiment remains fragile, and the assessment of debt sustainability is highly sensitive to the outlook for funding conditions. Therefore further expenditure cuts may well be necessary in 2010. In addition, reductions in Hungary's still very high tax rates would stimulate private investment and raise the long-term growth rate.

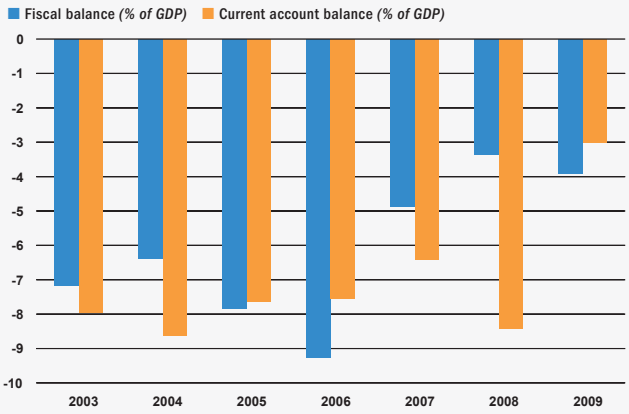
Transition indicators 2009



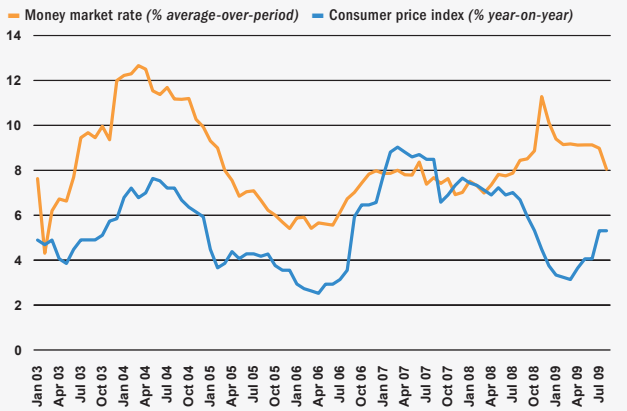
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **floating**

Wage regulation – **no**

Tradeability of land – **full except foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **advanced**

Infrastructure

Telecoms regulatory assessment compliance – **full**

Independence of the electricity regulator – **full**

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

Independence of the road directorate – **full**

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2.0 per cent** (2004)

Government expenditure on health – **5.5 per cent of GDP** (2005)

Government expenditure on education – **5.8 per cent of GDP** (2005)

Household expenditure on power and water – **10.9 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	30.9	31.5	32.0	33.3	33.5	**33.6**	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)	77.3	76.9	77.3	77.3	78.0	**78.1**	na
Budgetary subsidies and current transfers (in per cent of GDP)	3.3	3.8	3.8	4.1	4.0	**4.1**	na
Share of industry in total employment (in per cent)	33.3	32.8	32.4	32.3	32.6	**32.1**	na
Change in labour productivity in industry (in per cent)	5.5	5.7	5.3	4.6	3.8	**-5.2**	na
Investment/GDP (in per cent)	25.1	26.3	24.2	24.3	23.8	**23.7**	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**
EBRD index of enterprise reform	3.3	3.3	3.7	3.7	3.7	**3.7**	**3.7**
Markets and trade							
Share of administered prices in CPI (in per cent)	15.7	16.2	16.3	16.2	16.9	**16.2**	na
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	**2.0**	na
Share of trade with non-transition countries (in per cent)	82.4	80.8	77.1	73.7	72.8	**70.0**	na
Share of trade in GDP (in per cent)	127.1	133.0	136.9	154.2	158.3	**161.4**	na
Tariff revenues (in per cent of imports)	1.3	0.3	0.1	na	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	4.3	4.3	4.3	4.3	4.3	**4.3**	**4.3**
EBRD index of competition policy	3.0	3.3	3.3	3.3	3.3	**3.3**	**3.3**
Financial sector							
Number of banks (foreign-owned)	38 (29)	38 (27)	38 (27)	40 (28)	40 (27)	**39 (25)**	na
Asset share of state-owned banks (in per cent)	7.4	6.6	7.0	7.4	3.7	**3.5**	na
Asset share of foreign-owned banks (in per cent)	83.5	63.0	82.6	82.9	64.2	**84.0**	na
Non-performing loans (in per cent of total loans)	3.8	3.6	3.1	2.9	2.8	**3.3**	na
Domestic credit to private sector (in per cent of GDP)	41.0	44.6	49.8	54.1	59.1	**67.6**	na
Domestic credit to households (in per cent of GDP)	10.9	12.8	15.6	18.4	21.6	**27.4**	na
– Of which mortgage lending (in per cent of GDP)	8.0	9.5	11.5	13.8	16.4	**21.5**	na
Stock market capitalisation (in per cent of GDP)	18.3	25.0	31.6	33.8	32.3	**12.1**	na
Stock trading volume (in per cent of market capitalisation)	46.5	57.6	78.0	83.7	106.0	**93.0**	na
Eurobond issuance (in per cent of GDP)	0.5	4.2	6.1	6.0	2.7	**2.1**	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	3.7	3.7	4.0	4.0	4.0	**4.0**	**4.0**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	35.6 (78.4)	35.3 (86.4)	33.9 (92.5)	33.4 (99.1)	32.4 (109.9)	**30.9 (122.1)**	na
Internet users (per 100 inhabitants)	21.6	28.1	37.1	45.1	52.0	**54.9**	na
Railway labour productivity (1989=100)	133.9	145.1	160.8	177.5	173.2	**178.3**	na
Residential electricity tariffs (USc kWh)	11.4	13.5	14.8	14.4	18.8	**22.5**	na
Average collection rate, electricity (in per cent)	99	99	99	99	99	**100**	na
GDP per unit of energy use (PPP in US dollars per kgoe)	5.6	6.1	6.2	na	na	**na**	na
EBRD index of infrastructure reform	3.7	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	3.7	**3.7**	**3.7**
– Roads	3.3	3.3	3.7	3.7	3.7	**3.7**	**3.7**
– Telecommunications	4.0	4.0	4.0	4.0	4.0	**4.0**	**4.0**
– Water and wastewater	4.0	4.0	4.0	4.0	4.0	**4.0**	**4.0**

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	4.3	4.7	3.9	4.0	1.2	**0.6**	**-6.5**
– Private consumption	8.3	2.7	3.4	1.7	0.6	**-0.5**	**na**
– Public consumption	5.1	1.6	2.1	3.8	-7.5	**0.7**	**na**
– Gross fixed capital formation	2.2	7.9	5.8	-3.7	1.8	**-2.6**	**na**
– Exports of goods and services	6.2	15.0	11.3	18.6	16.4	**4.8**	**na**
– Imports of goods and services	9.3	13.7	7.0	14.8	13.4	**4.7**	**na**
Industrial gross output	4.4	3.7	3.9	5.1	4.8	**-7.8**	**na**
Agricultural gross output	-0.2	54.1	-3.9	-6.6	-21.4	**54.5**	**na**
Employment[1]			*(Percentage change)*				
Labour force (annual average)	1.4	0.1	0.8	1.0	-0.2	**-0.7**	**na**
Employment (annual average)[1]	1.3	-0.6	0.0	0.7	-0.1	**-1.2**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	5.9	6.1	7.2	7.5	7.4	**7.8**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	4.7	6.8	3.6	3.9	8.0	**6.1**	**4.5**
Consumer prices (end-year)	5.7	5.5	3.5	6.6	7.6	**3.5**	**6.0**
Producer prices (annual average)	2.4	3.5	4.3	6.5	0.2	**5.3**	**na**
Producer prices (end-year)	6.2	1.6	4.5	4.5	1.6	**-0.8**	**na**
Gross average monthly earnings in economy (annual average)	12.0	6.1	8.8	8.2	8.0	**7.5**	**na**
Government sector			*(In per cent of GDP)*				
General government balance[2]	-7.2	-6.4	-7.8	-9.3	-4.9	**-3.4**	**-3.9**
General government expenditure	49.1	48.9	50.1	51.9	49.6	**49.6**	**na**
General government debt	58.1	59.4	61.8	65.6	65.7	**72.6**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	13.6	9.9	13.0	11.8	8.6	**10.2**	**na**
Domestic credit (end-year)	21.0	14.1	16.3	18.5	12.8	**18.5**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	45.3	45.6	48.4	50.1	50.8	**53.5**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinance rate	12.5	9.5	6.0	8.0	7.5	**10.0**	**na**
Interbank interest rate (up to 30-day maturity)	12.2	9.7	6.1	8.1	7.6	**10.1**	**na**
Deposit rate weighted average (fixed for less than 1 year)	8.7	9.1	5.2	7.4	6.8	**9.9**	**na**
Lending rate weighted average (maturing within 1 year)	11.2	11.0	7.4	9.2	8.8	**12.3**	**na**
			(Forints per US dollar)				
Exchange rate (end-year)	207.9	180.3	213.6	191.6	172.6	**173.9**	**na**
Exchange rate (annual average)	224.3	202.7	199.6	210.4	183.6	**172.1**	**na**
External sector			*(In millions of US dollars)*				
Current account	-6,697.9	-8,791.3	-8,417.5	-8,533.4	-8,895.5	**-13,029.6**	**-4,000.0**
Trade balance	-3,271.2	-3,555.4	-2,795.4	-2,575.8	435.1	**126.3**	**5,000.0**
– Merchandise exports	42,793.9	55,279.9	62,827.3	73,321.0	93,434.1	**105,837.5**	**80,000.0**
– Merchandise imports	46,065.1	58,835.3	65,622.6	75,896.8	92,999.0	**105,711.2**	**75,000.0**
Foreign direct investment, net	478.8	3,404.8	5,586.3	3,639.7	2,197.2	**4,684.7**	**2,400.0**
Gross reserves, excluding gold (end-year)	11,411.5	14,495.9	19,830.6	20,535.6	22,313.3	**35,095.3**	**na**
External debt stock	51,976.9	68,499.6	84,247.9	102,279.3	134,260.2	**176,885.2**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.5	2.5	3.1	2.8	2.5	**3.4**	**na**
			(In per cent of exports of goods and services)				
Debt service[3]	14.0	14.8	15.3	12.5	12.4	**17.2**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	10.1	10.1	10.1	10.1	10.1	**10.1**	**na**
GDP (in billions of forints)	18,914.9	20,695.5	21,993.1	23,775.3	25,479.4	**26,620.5**	**26,000.0**
GDP per capita (in US dollars)	8,314.3	10,089.9	10,913.1	11,214.7	13,784.6	**15,381.6**	**na**
Share of industry in GDP (in per cent)	25.6	25.8	25.9	26.0	25.5	**25.1**	**na**
Share of agriculture in GDP (in per cent)	3.7	4.1	3.6	3.5	3.4	**3.7**	**na**
Current account/GDP (in per cent)	-9.4	-9.5	-8.3	-7.9	-6.9	**-8.6**	**-3.0**
External debt – reserves (in US$ million)	40,565.4	54,003.7	64,417.3	81,743.7	111,947.0	**141,789.9**	**na**
External debt/GDP (in per cent)	61.6	67.1	76.5	90.5	96.8	**114.4**	**na**
External debt/exports of goods and services (in per cent)	100.0	103.7	111.0	118.0	121.6	**140.5**	**na**

[1] Data from labour force surveys.

[2] Data are based on Eurostat methodology (ESA95), excluding part of the cost of pension reform.

[3] Excluding inter-company loans.

Kazakhstan

Key developments and challenges

The government has stepped up its involvement across the economy to respond to the economic crisis and implement its industrial policy. To promote economic diversification it is crucial to maintain a level playing field and fair competition, to avoid distorting market incentives, and to work transparently with private companies.

The financial crisis highlighted serious banking system weaknesses, including an over-reliance on foreign wholesale funding and foreign currency loans to unhedged borrowers. This needs to be addressed if the banking sector is to develop into a sustainable source of finance.

The government has tackled the crisis through aggressive counter-cyclical policies. The challenge will be to use a more conventional mix of fiscal and monetary policy to return to a sustainable growth path once the impact of the large fiscal stimulus subsides.

Country data

Population (in millions)	**15.6**
Area ('000 sq km)	**2,728.0**
GDP (in billion US$, 2008)	**135.6**
Average transition score (scale: 1 to 4.33)	**2.96**

Progress in structural reform

Liberalisation and privatisation

The government has extended its influence across the economy. In October 2008 the state holding company Samruk and the development fund Kazyna merged to form the National Welfare Fund or Samruk-Kazyna (SK), which has become the vehicle through which the government manages state assets, finances industrial projects and invests in infrastructure. In January 2009 the government created Tau-Ken Samruk as a national company to develop the mining and chemical industry under the SK umbrella. The government's stakes in two mining firms – ENRC and Kazakhmys – were transferred to this new organisation, as were those in the nuclear company Kazatomprom. Meanwhile, the state-owned hydrocarbons company KazMunayGas bought 58 per cent of the large Pavlodar oil refinery.

Government involvement has also increased at the firm and industry level. Large employers – in particular in the mining, metal and construction sectors – were asked by local authorities not to reduce their labour force (in some cases in return for tax advantages) in response to falling demand; and SK stepped up its involvement in the construction sector in order to guarantee the completion of large projects in Astana. Contracts were signed with various construction companies and suppliers of building materials stipulating that firms would sell at cost price to keep prices low throughout the supply chain, while SK would provide the financing. The authorities also took measures to limit price increases for various food products and fuel.

In June 2009 Kazakhstan suspended talks on membership of the World Trade Organization (WTO) and announced that it will seek WTO membership together with Russia and Belarus as a single customs union. Negotiations to join the WTO as a trilateral customs bloc are planned to start in early 2010.

Business environment and competition

A new tax code came into force in January 2009, which has widened the tax base but reduced several tax rates. The corporate income tax rate has been lowered from 30 to 20 per cent. Small and medium-sized enterprises (SMEs) are no longer required to make advance payments against corporate income tax, and the loss carry-over period has been extended from three to 10 years. These changes may result in significant improvements to the business climate since, according to the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), Kazakh firms have judged high tax rates to be the main obstacle to their development. Further improvements could also be made by streamlining the procedures for paying taxes, in particular by reducing the interaction between taxpayers and the tax authorities to limit the scope for corruption (another high-ranking concern among Kazakh respondents to the BEEPS IV).

Infrastructure

Over the last year Kazakhstan has increased and diversified its hydrocarbon transit and export capacity. A large segment of the Turkmenistan-China gas pipeline was completed, leaving the connection from western Kazakhstan to China to be built. In April 2009 the Kazakh parliament ratified an agreement on the pre-Caspian gas pipeline, which will follow the Caspian seacoast from Turkmenistan through Kazakhstan to Russia. Negotiations between Kazakhstan and Azerbaijan continue on the Kazakh-Caspian Transportation System project (KCTS). This entails the construction of an oil pipeline between Eskene and Kuryk (expected to begin in 2010), an oil terminal at the Kazakh Caspian coast and the development of a fleet of oil tankers.

Kazakhstan also started to make major investments to upgrade its road and rail infrastructure. In 2009 the government is raising US$ 3 billion of financing from the EBRD, World Bank, Asian Development Bank and the Islamic Development Bank to rehabilitate the road corridor from western China to western Europe, which stretches almost 3,000 km across Kazakh territory.

Financial sector

In response to the crisis in the banking sector, the government took equity stakes in 2009 in BTA (75 per cent), Halyk Bank (21 per cent) and KKB (20 per cent). The central bank continued to provide liquidity to banks, while the government stabilised the deposit base by ordering KazMunayGas to put substantial deposits in several large Kazakh banks. The quality of loan portfolios deteriorated rapidly during the second half of 2008 and throughout 2009, with a number of banks recording large losses due to real estate exposures, lending to dubious foreign parties, and fraud. Three financial institutions – BTA, Alliance Bank and Astana Finance – defaulted on debt payments. Negotiations commenced with foreign creditors to restructure the outstanding debt burden of these banks. In September 2009 a long-awaited Anti-Money Laundering Law was passed.

Macroeconomic performance

The sharp reduction in credit expansion, paralysis in the construction sector and the fall in the global demand for oil and metals all contributed to a significant slow-down in 2008. GDP growth slipped to 3.2 per cent in 2008, and GDP fell by 2.3 per cent in the first half of 2009 compared with a year earlier. Weaker growth has resulted in a gradual disinflationary trend, with the annual inflation rate slowing to 7.6 per cent by mid-2009. This allowed the central bank to reduce its refinancing rate in stages from 10.5 per cent at the end of 2008 to 7 per cent by September 2009. Monetary policy was further eased as a result of the devaluation in February 2009, when the tenge peg moved from 120/US$ to 150/US$. Fiscal policy has also been loosened, with the consolidated budget deficit expected at 2 per cent of GDP in 2009, narrowing to 0.6 per cent in 2010.

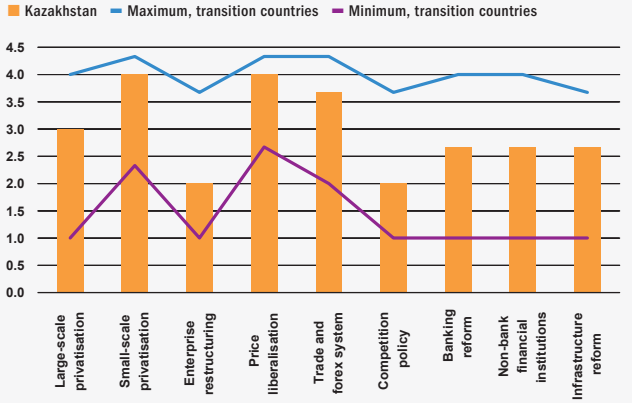
Lower growth of exports has meant that a current account deficit of 2.1 per cent of GDP is forecast in 2009. By mid-2009 the tenge devaluation had done little to reduce this external imbalance, although imports – in particular of cars – came down sharply. The current account deficit will be financed through a sharp reduction in portfolio investments held abroad, reflecting the sale of foreign assets by the National Oil Fund, as well as by foreign direct investment (FDI) flows, which are expected to be substantial in both 2009 and 2010. FDI has proven resilient to the crisis as investment by international oil and gas companies has continued in the Tengiz, Kashagan and Karachaganak fields. In addition, investments from a number of Western, Asian and Middle Eastern countries are expected for projects outside the hydrocarbons sector.

Outlook and risks

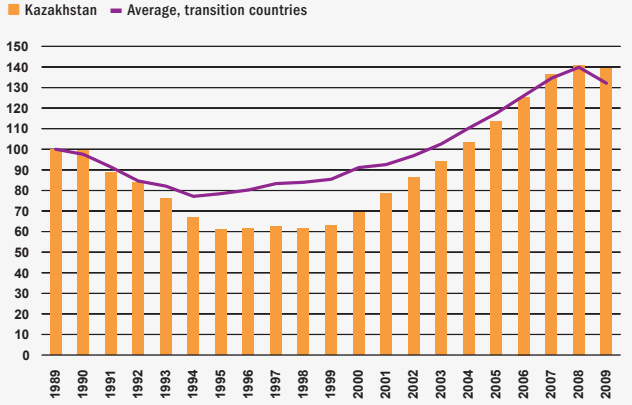
The economy is likely to contract by 1.3 per cent in 2009. Only a mild recovery is foreseen in 2010, as the effects of the government's substantial stabilisation package – of about 11 per cent of GDP – begin to stimulate the economy. In the short term, the main economic risks relate to the uncertainty surrounding the progress of the protracted debt restructuring negotiations of several banks. More generally, there is uncertainty surrounding the extent of the restructuring that the Kazakh banking system will have to undergo to reclaim trust among Kazakh households looking to deposit their savings and productive Kazakh firms needing a sustainable source of funding. In addition, short-term macroeconomic risks continue to hinge on the movements of the oil price.

Medium-term prospects for Kazakhstan remain good. The large Kashagan oilfield is expected to start production in 2013 and there is also potential for expanding uranium, copper and grain production. This also implies, however, that it will remain difficult to move the country away from its dependence on commodity exports, and may lessen the authorities' resolve to stimulate economic diversification through reform.

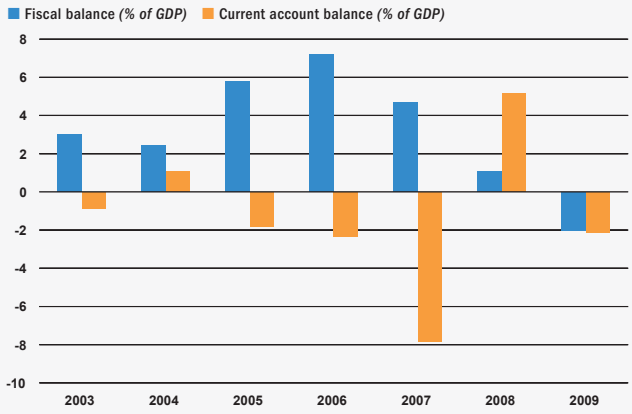
Transition indicators 2009



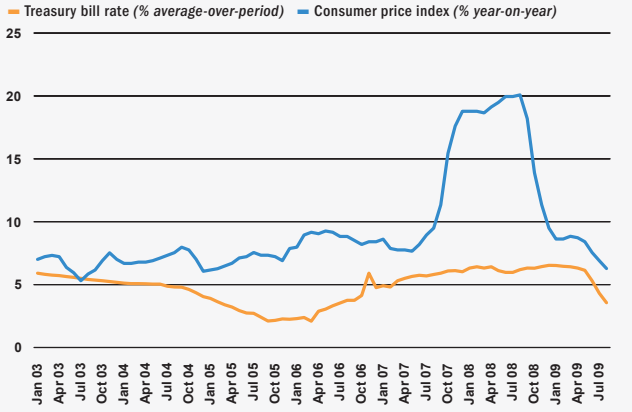
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **yes**

Interest rate liberalisation – **full**

Exchange rate regime – **pegged to US$**

Wage regulation – **no**

Tradeability of land – **full except foreigners**[1]

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **under development**

Infrastructure

Telecoms regulatory assessment compliance – **low**

Independence of the electricity regulator – **partial**

Separation of railway infrastructure from operation – **full**

Independence of the road directorate – **no**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **17.2 per cent** (2003)

Government expenditure on health – **2.3 per cent** (2007)

Government expenditure on education – **3.6 per cent** (2007)

Household expenditure on power and water – **3.7 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	28.9	29.0	29.2	29.7	30.1	**30.3**	**na**
Private sector share in GDP (in per cent)	65.0	65.0	65.0	65.0	70.0	**70.0**	**65.0**
Private sector share in employment (in per cent)	75.4	75.3	75.5	77.0	78.0	**76.0**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	0.1	0.1	na	na	na	**na**	**na**
Share of industry in total employment (in per cent)	12.2	12.1	12.3	12.9	12.1	**11.9**	**na**
Change in labour productivity in industry (in per cent)	5.1	8.6	7.6	3.8	7.7	**0.8**	**na**
Investment/GDP (in per cent)	25.7	26.3	31.0	32.8	30.1	**25.7**	**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**
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Share of trade with non-transition countries (in per cent)	62.3	63.5	62.4	61.9	62.3	**60.9**	**na**
Share of trade in GDP (in per cent)	73.9	79.8	81.1	77.6	76.8	**81.5**	**na**
Tariff revenues (in per cent of imports)[2]	3.0	2.7	2.6	3.6	3.7	**9.1**	**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	3.3	3.7	3.7	3.7	3.7	**3.7**	**3.7**
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Financial sector							
Number of banks (foreign-owned)	36 (16)	35 (15)	34 (14)	33 (14)	35 (18)	**37 (13)**	**na**
Asset share of state-owned banks (in per cent)	5.1	3.7	0.2	0.2	0.2	**0.5**	**na**
Asset share of foreign-owned banks (in per cent)	56.9	5.5	7.3	5.4	38.5	**12.9**	**na**
Non-performing loans (in per cent of total loans)[3]	3.9	4.2	3.3	2.4	2.7	**7.1**	**na**
Domestic credit to private sector (in per cent of GDP)	21.9	26.5	35.7	47.8	58.9	**48.8**	**na**
Domestic credit to households (in per cent of GDP)[4]	2.6	5.2	9.0	15.8	17.4	**12.6**	**na**
– Of which mortgage lending (in per cent of GDP)[5]	0.6	1.7	3.0	4.1	4.9	**4.9**	**na**
Stock market capitalisation (in per cent of GDP)	7.7	8.7	18.6	54.3	38.9	**23.0**	**na**
Stock trading volume (in per cent of market capitalisation)	22.0	30.3	14.9	14.7	20.9	**11.7**	**na**
Eurobond issuance (in per cent of GDP)	1.7	8.1	4.9	9.7	7.9	**2.6**	**na**
EBRD index of banking sector reform	3.0	3.0	3.0	3.0	3.0	**3.0**	**2.7**
EBRD index of reform of non-bank financial institutions	2.3	2.3	2.3	2.7	2.7	**2.7**	**2.7**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	14.9 (8.9)	16.9 (16.2)	17.8 (35.5)	19.1 (50.8)	21.0 (80.0)	**22.0 (96.1)**	**na**
Internet users (per 100 inhabitants)	2.0	2.7	4.0	8.4	12.3	**12.3**	**na**
Railway labour productivity (1989=100)	58.5	62.6	65.9	71.8	74.6	**75.3**	**na**
Residential electricity tariffs (USc kWh)[6]	2.8	3.1	3.1	3.7	4.9	**5.3**	**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)	2.3	2.4	2.5	na	na	**na**	**na**
EBRD index of infrastructure reform	2.3	2.3	2.3	2.7	2.7	**2.7**	**2.7**
– Electric power	3.0	3.3	3.3	3.3	3.3	**3.3**	**3.3**
– Railways	2.7	2.7	3.0	3.0	3.0	**3.0**	**3.0**
– Roads	2.0	2.0	2.0	2.0	2.3	**2.3**	**2.3**
– Telecommunications	2.3	2.7	2.7	3.0	3.0	**3.0**	**3.0**
– Water and wastewater	1.7	2.0	2.0	2.0	2.0	**2.0**	**2.0**

[1] Ownership of agricultural land is limited to residents of Kazakhstan and legal entities established under Kazakh law, including those that are fully or partially owned by foreign persons.

[2] Refers to taxes on international trade.

[3] The series has been revised. Non-performing loans include loans categorised as "loss" and "doubtful - category 5" according to the Kazakh FSA classification.

[4] National Bank of Kazakhstan, Statistical Bulletin.

[5] Data sources are Agency of the Republic of Kazakhstan for Regulation and Supervision of Financial Market and Financial Organisation and Kazakhstan Mortgage Company, and includes loans from non-bank financial institutions.

[6] Tariffs are given end-of-year.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	9.3	9.6	9.7	10.7	8.9	**3.2**	**-1.3**
– Private consumption	11.8	13.9	11.4	14.3	14.0	**6.1**	**na**
– Public consumption	8.9	10.6	11.8	18.0	18.5	**15.0**	**na**
– Gross fixed capital formation	8.0	22.5	11.9	24.0	18.6	**13.5**	**na**
– Exports of goods and services	7.5	10.9	1.4	7.1	5.4	**3.9**	**na**
– Imports of goods and services	-7.6	14.8	13.3	13.7	14.5	**9.7**	**na**
Industrial gross output	9.1	10.4	10.3	11.1	4.5	**2.1**	**na**
Agricultural gross output	2.1	-0.3	7.3	6.0	8.4	**-5.6**	**na**
Employment[1]			*(Percentage change)*				
Labour force (end-year)	3.5	2.4	0.8	1.6	2.5	**2.4**	**na**
Employment (end-year)	4.1	2.8	1.1	2.0	3.1	**3.0**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	8.8	8.4	8.1	7.8	7.3	**6.6**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	6.4	6.9	7.6	8.6	10.8	**17.2**	**7.2**
Consumer prices (end-year)	6.8	6.7	7.5	8.4	18.8	**9.5**	**5.8**
Producer prices (annual average)	9.3	16.9	23.7	18.4	22.7	**36.8**	**na**
Producer prices (end-year)	5.9	23.8	20.3	14.6	31.9	**18.6**	**na**
Gross average monthly earnings in economy (annual average)	13.8	21.7	20.5	19.7	30.6	**14.1**	**na**
Government sector[2]			*(In per cent of GDP)*				
General government balance[3]	3.0	2.5	5.8	7.2	4.7	**1.1**	**-2.0**
General government expenditure[4]	22.3	22.7	22.3	20.2	24.2	**26.5**	**na**
General government debt	15.0	11.4	8.1	6.7	5.8	**6.6**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	34.2	68.2	26.3	78.1	25.9	**35.4**	**na**
Domestic credit (end-year)	38.1	81.1	52.3	76.5	58.8	**2.2**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	21.1	27.8	27.2	36.0	36.0	**38.4**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	7.0	7.0	8.0	9.0	11.0	**10.5**	**na**
Treasury bill rate (3-month maturity)[5]	5.9	3.3	3.3	3.3	7.0	**6.5**	**na**
Deposit rate[6]	10.9	9.3	9.1	9.8	11.5	**11.3**	**na**
Lending rate[7]	14.9	13.7	13.0	12.2	14.8	**16.1**	**na**
			(Tenges per US dollar)				
Exchange rate (end-year)	144.2	130.0	134.0	127.0	120.7	**120.8**	**na**
Exchange rate (annual average)	149.6	136.0	132.9	126.1	122.6	**120.3**	**na**
External sector			*(In millions of US dollars)*				
Current account	-272.6	454.9	-1,036.8	-1,900.0	-8,219.0	**7,000.0**	**-2,250.0**
Trade balance[8]	3,679.0	6,785.4	10,371.2	14,700.0	14,142.0	**33,500.0**	**14,200.0**
– Merchandise exports	13,232.6	20,603.1	28,350.0	38,800.0	47,350.0	**72,000.0**	**43,200.0**
– Merchandise imports	9,553.6	13,817.7	17,978.8	24,100.0	33,208.0	**38,500.0**	**29,000.0**
Foreign direct investment, net	2,213.4	5,436.0	2,123.0	6,663.0	8,000.0	**10,700.0**	**8,200.0**
Gross reserves, excluding gold (end-year)	4,962.0	8,600.0	6,200.0	17,900.0	15,900.0	**18,100.0**	**na**
External debt stock[9]	22,920.6	32,946.0	43,430.0	74,100.0	96,700.0	**106,100.0**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)[10]	4.5	5.5	2.9	6.5	4.3	**4.3**	**na**
			(In per cent of exports of goods and services)				
Debt service	35.2	36.2	37.0	32.2	33.2	**33.4**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	15.0	15.1	15.1	15.4	15.5	**15.6**	**na**
GDP (in billions of tenges)	4,612.0	5,870.1	7,591.0	10,214.0	12,850.0	**16,313.0**	**15,863.0**
GDP per capita (in US dollars)	2,062.3	2,862.5	3,785.8	5,261.1	6,748.1	**8,719.0**	**na**
Share of industry in GDP (in per cent)	25.3	25.4	24.2	23.4	22.4	**22.2**	**na**
Share of agriculture in GDP (in per cent)	8.8	8.1	7.9	7.6	7.6	**6.9**	**na**
Current account/GDP (in per cent)	-0.9	1.1	-1.8	-2.3	-7.8	**5.2**	**-2.1**
External debt – reserves (in US$ million)	17,958.6	24,346.0	37,230.0	56,200.0	80,800.0	**88,000.0**	**na**
External debt/GDP (in per cent)	74.3	76.3	76.0	91.5	92.2	**78.2**	**na**
External debt/exports of goods and services (in per cent)	153.4	145.8	142.0	178.1	190.0	**139.6**	**na**

[1] Data based on labour force surveys.

[2] General government includes the state, municipalities and extra-budgetary funds and is on a cash basis.

[3] Government balance includes quasi-fiscal operations and transfers to the National Fund. Balance excludes privatisation revenues.

[4] Expenditures include extra-budgetary funds.

[5] Average effective yield of short-term National Bank of Kazakhstan notes.

[6] Deposit rate refers to the weighted average of interest rates on time deposits of individuals, in tenge by maturity.

[7] Lending rate refers to weighted average of interest rates on credits extended to legal entities, excluding banks in tenge by maturity.

[8] Exports at declared customs prices. They are not corrected for under-invoicing of oil and gas exports.

[9] Includes inter-company debt by branches of non-resident foreign enterprises and short-term debt.

[10] Excludes National Fund.

Kyrgyz Republic

Key developments and challenges

The resolution of a long-standing dispute with one of the largest private foreign companies should gradually improve investors' perceptions of the country and lead to higher flows of foreign direct investment (FDI). However, reforms to further increase the effectiveness of the court system are required to improve the business climate.

The government envisages a greater role for the private sector in developing road infrastructure, but it is important that the authorities clarify the procurement rules and improve procedures.

Despite the substantial capital base of the banking system, the increase in non-performing loans may constrain credit growth over the next few years. Close monitoring by the regulator will be key to detecting early problems in the sector and taking corrective action.

Country data

Population (in millions)	**5.3**
Area ('000 sq km)	**200.0**
GDP (in billion US$, 2008)	**5.0**
Average transition score (scale: 1 to 4.33)	**2.93**

Progress in structural reform

Business environment and competition

In April 2009 an agreement was reached between the government and Cameco Corporation of Canada as the two major shareholders in Centerra which operates the large Kumtor gold mine. Centerra will benefit from an expansion to the existing concession area and the application of a simplified tax regime in exchange for an increase in the government's stake in the company from around 29 per cent to 33 per cent.

According to the World Bank's *Doing Business 2010* survey, the Kyrgyz Republic's ranking improved significantly from 80th position last year to 41st. The main improvements were in the areas of gaining credit and registering a property. However, in the areas of contract enforcement and the closure of businesses – where an effective judiciary is crucial – the country made little progress.

Infrastructure

The government's new Country Development Strategy (CDS) for 2009-11 (adopted in February 2009 and superseding the previous CDS for 2007-10) accords a greater role to the private sector in the development of transport infrastructure. It envisages a "user pays" principle for road maintenance by introducing taxes and tolling on roads. It also foresees the separation of the road construction and maintenance units under the Ministry of Transport and Communications, as well as their corporatisation during 2011-13.

In February 2009 the Kyrgyz Republic and Russia agreed to set up a 50/50 joint venture between Russia's Inter RAO UES and Kyrgyzstan Power Plants (KPP, a state-owned company that controls 98 per cent of the country's electricity generation capacity). The venture will complete the Kambarata-I hydroelectric power plant, the construction of which stalled after the break-up of the Soviet Union. A pre-feasibility study on Kambarata-I will be financed by RAO UES, KPP and KazKuat (another Kazakh state-owned company). The total project cost is an estimated US$ 1.7 billion (representing 34 per cent of GDP). Kambarata-I will have a capacity of 1,900 MW, sufficient to meet the country's demand for power in the winter period. As it is located upstream of the Toktogul reservoir, the release of water from Kambarata-I to generate electricity during the winter will reduce the need for the Kyrgyz authorities to release water from the Toktogul reservoir. This should alleviate the concerns of those countries downstream, partly because they rely on the release of water from the reservoir for their spring planting season and because they should in future be less subject to winter flooding.

Financial sector

In response to the global financial crisis, the National Bank of the Kyrgyz Republic (NBKR) and the Ministry of Finance issued a joint resolution in late 2008 identifying the roles of both organisations in the resolution process of systemic banks. The introduction of deposit insurance was brought forward from 2010 to mid-June 2009 and the level of insurance per household was increased from the equivalent of around US$ 500 to US$ 2,500. The government also established a fund for the refinancing of banks, which provides loans to banks for on-lending. Kyrgyz banks can add no more than a 5 per cent margin over their funding cost when they on-lend these funds to sub-borrowers. By August 2009 two banks – AiylBank and FinansCreditBank – had submitted applications for this funding. Loan quality has deteriorated, with non-performing loans increasing from 3.6 per cent of total loans at the end of 2007 to 7.0 per cent by the end of the first quarter of 2009. The relatively high level of capitalisation (27.7 per cent of risk-weighted assets at the end of the first quarter of 2009) will provide some cushion in the event of a further deterioration in portfolio quality.

Social sector

To mitigate the impact of the economic downturn, and especially the effect of the reduction in remittances, monthly social benefits to the poor increased by 40 soms (around 1 US dollar) per beneficiary in October 2009, in addition to the 35 soms top-up introduced in October 2008. As of August 2009 the guaranteed level of monthly minimum consumption per capita which determines the level of social benefits was 160 soms (US$ 3.7).

Macroeconomic performance

Real GDP growth in 2008 was buoyant at 7.6 per cent, primarily reflecting the continued recovery of output from the Kumtor gold mine after the accident in 2006. This was sufficient to offset the effect of power shortages during the winter months, which curtailed manufacturing output, as well as a reduction in credit growth, mainly reflecting the position of Kazakh bank subsidiaries in the aftermath of the financial sector crisis in Kazakhstan. During the first half of 2009 output in the non-gold industrial sector slowed further, owing to reduced external demand. Consumption was reined in by the decline in remittances (down by 29 per cent year on year in the first quarter of 2009) and credit growth slowed to 5 per cent. These weaknesses were counterbalanced by higher public capital expenditures and growth in agricultural production, with GDP increasing by 0.3 per cent during the first half.

The rate of inflation declined from 20.1 per cent at the end of December 2008 to 4.9 per cent by June 2009. This enabled the NBKR to ease policy interest rates. When the som came under pressure at the beginning of 2009, after the depreciation of the Russian and Kazakh currencies against the US dollar, the NBKR initially intervened to prevent excessive exchange rate volatility, but then largely refrained from intervention to maintain foreign exchange reserves.

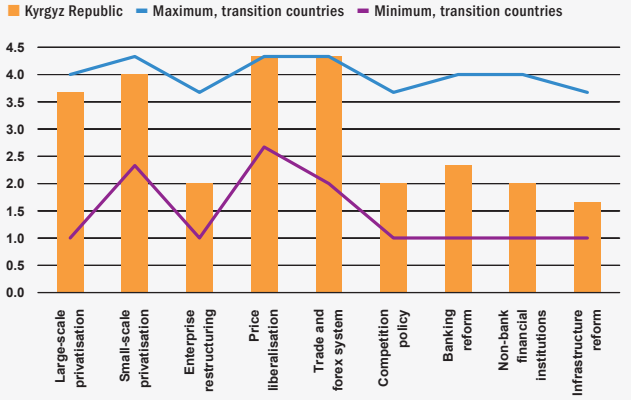
In December 2008 the government agreed a new US$ 100 million financial support programme over 18 months with the International Monetary Fund (IMF). The fiscal deficit narrowed to just 0.1 per cent of GDP in 2008 as the authorities cut back on non-priority expenditures. The budget for 2009 was also revised at the beginning of the year in light of further anticipated revenue shortfalls. The fiscal position has been strengthened as a result of financing provided by Russia in April 2009, amounting to around 9 per cent of GDP. Russia also cancelled US$ 194 million of existing debt.

The current account deficit increased significantly in 2008 to 8.2 per cent of GDP, primarily due to worsening terms of trade caused by increases in fuel and food prices. The deficit is likely to remain high in 2009 as export volumes and remittances decline.

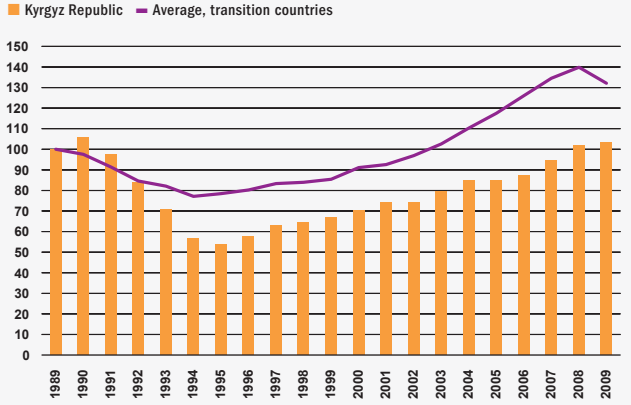
Outlook and risks

Real GDP growth in 2009 is likely to remain positive at 1.5 per cent. However, credit growth could be constrained in the short term by the worsening loan portfolios of banks and microfinance institutions, which could have an adverse impact on the real economy. In the medium term, construction of the Kambarata-I project should make a positive contribution to growth and, once completed, could provide foreign exchange revenues from electricity exports. However, the total external debt-to-GDP ratio will increase sharply over the next few years as loans to the project are disbursed, and the country could become more vulnerable to large economic shocks.

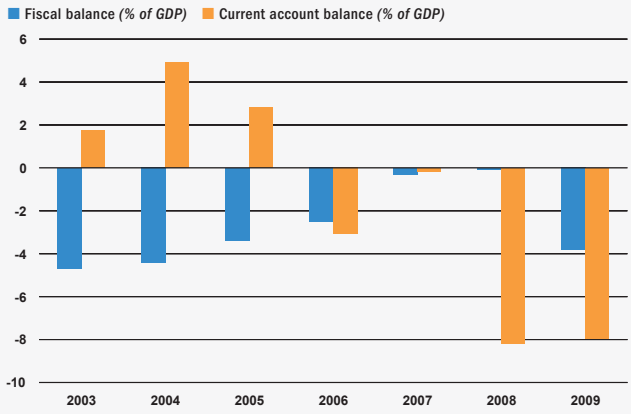
Transition indicators 2009



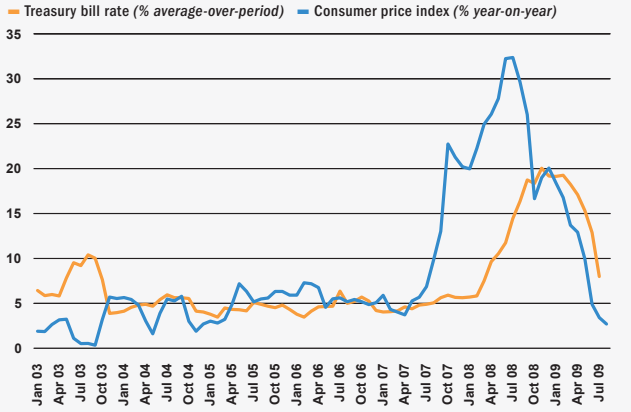
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Telecoms regulatory assessment compliance – **medium**	Capital adequacy ratio – **12 per cent**	Share of population living in poverty – **51.9 per cent** (2004)[2]
Controls on inward direct investment – **no**[1]	Quality of insolvency law – **medium**	Independence of the electricity regulator – **partial**	Deposit insurance system – **yes**	Government expenditure on health – **2.4 per cent** (2008)
Interest rate liberalisation – **full**	Secured transactions law – **modern/some defects**	Separation of railway infrastructure from operations – **no**	Private pension funds – **yes**	Government expenditure on education – **5.2 per cent** (2008)
Exchange rate regime – **managed float**		Independence of the road directorate – **no**		Household expenditure on power and water – **4.4 per cent**
Wage regulation – **no**				
Tradeability of land – **full except foreigners**				

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	3.2	7.2	7.4	7.4	7.6	**7.4**	**na**
Private sector share in GDP (in per cent)	65.0	75.0	75.0	75.0	75.0	**75.0**	**75.0**
Private sector share in employment (in per cent)	80.2	80.9	81.2	79.7	80.0	**80.3**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	3.2	3.1	3.4	3.7	3.6	**3.3**	**na**
Share of industry in total employment (in per cent)	9.7	10.3	10.2	10.7	10.7	**10.5**	**na**
Change in labour productivity in industry (in per cent)	0.7	-5.5	-14.4	-15.7	4.6	**16.0**	**na**
Investment/GDP (in per cent)	20.5	20.8	21.8	22.8	26.6	**24.8**	**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	3.7	3.7	3.7	3.7	**3.7**	**3.7**
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	na	12.0	12.9	12.5	17.7	**na**	**na**
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	2.0	2.0	2.0	**3.0**	**na**
Share of trade with non-transition countries (in per cent)	47.6	42.7	38.6	40.8	35.9	**71.6**	**na**
Share of trade in GDP (in per cent)	72.3	77.6	77.2	102.4	110.3	**116.5**	**na**
Tariff revenues (in per cent of imports)	1.3	1.2	3.7	3.9	3.9	**3.4**	**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**
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Financial sector							
Number of banks (foreign-owned)	21 (7)	19 (9)	19 (10)	20 (10)	22 (10)	**21 (10)**	**na**
Asset share of state-owned banks (in per cent)	7.2	4.1	4.8	3.4	8.7	**9.9**	**na**
Asset share of foreign-owned banks (in per cent)	61.2	70.1	73.6	71.5	58.7	**72.0**	**na**
Non-performing loans (in per cent of total loans)	11.2	6.1	7.7	6.2	3.5	**5.7**	**na**
Domestic credit to private sector (in per cent of GDP)	4.8	7.1	7.9	10.3	15.5	**15.0**	**na**
Domestic credit to households (in per cent of GDP)	0.5	0.9	1.2	2.2	3.3	**3.1**	**na**
– Of which mortgage lending (in per cent of GDP)	0.1	0.3	0.5	1.4	2.4	**1.9**	**na**
Stock market capitalisation (in per cent of GDP)	1.6	1.5	1.7	3.1	3.0	**2.0**	**na**
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	**na**	**na**
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
EBRD index of banking sector reform	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**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	7.7 (2.7)	8.1 (5.1)	8.4 (10.4)	8.7 (23.9)	9.0 (40.6)	**9.0 (40.6)**	**na**
Internet users (per 100 inhabitants)	3.9	5.1	10.5	12.3	14.0	**14.0**	**na**
Railway labour productivity (1990=100)	22.0	27.4	25.4	28.6	30.9	**33.5**	**na**
Residential electricity tariffs (USc kWh)	1.1	1.1	1.2	1.3	1.7	**1.6**	**na**
Average collection rate, electricity (in per cent)	76	86	74	79	79	**94**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	2.9	3.1	3.2	na	na	**na**	**na**
EBRD index of infrastructure reform	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
– Electric power	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Railways	1.0	1.0	1.0	1.0	1.0	**1.0**	**1.0**
– Roads	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
– Telecommunications	2.7	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Water and wastewater	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**

[1] All investments must be registered with the Ministry of Justice and statistical agencies.

[2] Based on the nationally defined poverty line, the percentage of the population living in poverty was 44 per cent in 2005.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	7.0	7.0	-0.2	3.1	8.2	**7.6**	**1.5**
– Private consumption	6.0	11.2	13.3	28.0	11.3	**14.7**	**na**
– Public consumption	4.7	0.1	-1.1	4.0	21.6	**1.6**	**na**
– Gross fixed capital formation	10.8	11.4	6.0	10.0	12.0	**-3.7**	**na**
– Exports of goods and services	21.2	20.0	-5.0	11.9	26.1	**17.9**	**na**
– Imports of goods and services	13.1	23.9	11.2	42.6	29.4	**19.1**	**na**
Industrial gross output	17.0	3.7	-12.1	-10.2	7.3	**14.9**	**na**
Agricultural gross output	3.2	4.1	-4.2	1.7	1.5	**0.7**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	4.9	3.6	4.5	1.5	2.6	**-2.0**	**na**
Employment (end-year)	4.3	3.1	4.3	0.9	2.7	**1.5**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	10.3	8.7	8.2	8.3	8.2	**na**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	3.1	4.1	4.3	5.6	10.2	**24.5**	**7.6**
Consumer prices (end-year)	5.6	2.8	4.9	5.1	20.1	**20.1**	**3.2**
Producer prices (annual average)	13.5	9.0	2.8	15.3	11.9	**26.4**	**na**
Producer prices (end-year)	13.5	4.3	6.3	10.4	20.6	**17.4**	**na**
Gross average monthly earnings in economy (annual average)	13.7	16.9	16.6	25.2	22.0	**36.0**	**na**
Government sector[1]			*(In per cent of GDP)*				
General government balance	-4.7	-4.4	-3.4	-2.5	-0.3	**-0.1**	**-3.8**
General government expenditure	27.2	27.7	28.1	28.9	31.0	**29.6**	**na**
General government debt	106.9	92.9	85.9	72.5	56.8	**48.6**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	33.4	32.1	10.2	50.3	33.4	**9.3**	**na**
Domestic credit (end-year)	11.3	-18.8	19.0	40.2	54.0	**15.5**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	17.5	20.6	21.2	28.3	30.2	**25.3**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Official rate	4.8	4.8	6.2	4.7	13.2	**18.3**	**na**
Money market rate[2]	4.0	4.0	4.3	4.2	5.6	**19.2**	**na**
Deposit rate[3]	5.0	6.7	5.8	5.6	5.4	**4.0**	**na**
Lending rate[3]	19.1	29.3	26.6	23.2	25.3	**19.9**	**na**
			(Soms per US dollar)				
Exchange rate (end-year)	44.2	41.6	41.3	38.1	35.5	**39.4**	**na**
Exchange rate (annual average)	43.7	42.6	41.0	40.2	37.3	**36.6**	**na**
External sector			*(In millions of US dollars)*				
Current account	33.4	109.1	68.8	-87.2	-5.8	**-413.2**	**-363.9**
Trade balance	-56.9	-90.0	-311.5	-686.5	-1,076.0	**-1,612.2**	**-1,330.6**
– Merchandise exports	666.2	813.8	794.0	1,106.0	1,559.5	**2,141.4**	**1,763.4**
– Merchandise imports	723.1	903.8	1,105.5	1,792.4	2,635.5	**3,753.5**	**3,094.0**
Foreign direct investment, net	45.5	131.5	42.6	182.0	208.1	**265.2**	**59.7**
Gross reserves, excluding gold (end-year)	364.6	528.2	569.7	764.4	1,107.2	**1,152.9**	**na**
External debt stock	1,985.6	2,107.6	2,103.9	2,205.1	2,291.1	**2,312.7**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	5.0	5.6	4.9	4.1	4.1	**2.9**	**na**
			(In per cent of exports of goods and services)				
Debt service[4]	14.3	8.7	7.1	5.7	4.4	**3.6**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	5.0	5.1	5.1	5.2	5.3	**5.3**	**na**
GDP (in millions of soms)	83,871.6	94,350.7	100,899.2	113,800.1	141,897.7	**185,013.6**	**199,139.4**
GDP per capita (in US dollars)	381.3	434.8	478.7	545.0	723.8	**952.5**	**na**
Share of industry in GDP (in per cent)	17.3	19.2	17.3	14.9	13.1	**14.0**	**na**
Share of agriculture in GDP (in per cent)	33.6	29.9	28.5	28.7	26.9	**25.8**	**na**
Current account/GDP (in per cent)	1.7	4.9	2.8	-3.1	-0.2	**-8.2**	**-7.9**
External debt – reserves (in US$ million)	1,621.0	1,579.4	1,534.2	1,440.8	1,183.8	**1,159.8**	**na**
External debt/GDP (in per cent)	103.3	95.2	85.5	77.9	60.3	**45.7**	**na**
External debt/exports of goods and services (in per cent)	240.9	205.9	199.7	148.5	102.1	**76.1**	**na**

[1] General government includes the state, municipalities and extra-budgetary funds. It also includes expenditure under the foreign-financed public investment programme and net lending.

[2] Weighted average rate on interbank loans in soms with 1-90 day maturities, the IMF's *International Financial Statistics*.

[3] Weighted average over all maturities from the IMF's *International Financial Statistics*.

[4] Debt service scheduled and excludes US$ 111 million debt rescheduling granted by the Paris Club of official creditors for 2002-04.

Latvia

Key developments and challenges

Macroeconomic stabilisation remains the key objective given the depth of the ongoing recession in Latvia. This will require strict adherence to the International Monetary Fund (IMF)/EU programme, and implementation of the fiscal adjustment measures approved by parliament.

Reviving bank credit to the private sector, in particular to small and medium-sized enterprises (SMEs), is a key challenge. This will require further efforts to strengthen banks' capital bases and support the restructuring of debt, in particular that of households.

More competition and private sector participation in the energy sector, public services and transport infrastructure will be important for further efficiency improvements once market conditions stabilise.

Country data

Population (in millions)	**2.3**
Area ('000 sq km)	**64.5**
GDP (in billion US$, 2008)	**34.0**
Average transition score (scale: 1 to 4.33)	**3.63**

Progress in structural reform

Liberalisation and privatisation

Over the past year Latvia has undergone a deep recession, and few initiatives to promote structural reform were taken. A number of important sectors still remain under the influence of dominant, state-owned companies or require further liberalisation. For instance, the privatisation of the fixed-line telecommunications operator, Lattelecom, planned for the end of 2008, has not materialised and the state still holds a 51 per cent stake.

Business environment and competition

Almost 40 per cent of all respondents in the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV) replied that an inadequately educated workforce is either a major or very severe obstacle to the operation of their businesses. According to the same survey, corruption is perceived to be an obstacle by almost 70 per cent of firms. Latvia's development towards higher-value-added production has been held back by a low rate of innovation, which reflects the low levels spent on research and development (in 2007, gross domestic expenditure on R&D represented only 0.6 per cent of GDP in Latvia versus 1.9 per cent in EU-27) and the lack of adequate human capital.

Infrastructure

New incentives for further energy diversification were created in the past year; the regulatory framework for renewables was strengthened with the introduction of a feed-in tariff and a mandatory offtake mechanism in February 2009. Producers of renewable energy are therefore able to sell energy for a guaranteed price. The increased emphasis on alternative sources of energy, as well as measures to support greater energy market integration within the Baltic region, are necessary in view of the expected fall in electricity supply after the planned closure of the Ignalina nuclear power plant in Lithuania by the end of 2009.

The quality of the road network remains poor and the construction and maintenance of roads is still dominated by state-owned companies. The first public-private partnership (PPP) in the road sector, the Riga Bypass-Senite road reconstruction and maintenance project, reached the preparation phase in mid-2009, but is likely to be delayed. A modern legal framework for PPP projects is being developed and should aid future private sector involvement in large infrastructure projects in general.

Financial sector

Following a sustained credit boom since 2000, growth of credit to the private sector began to decline year on year in the second half of 2008, falling to 2 per cent in June 2009. In expectation of the limited access to external funding on the international lending markets, banks tightened their credit standards and started to accumulate liquid assets instead of lending to the real economy. As economic conditions and asset values rapidly deteriorated, the share of non-performing loans in banks' portfolios climbed from 3.6 per cent in December 2008 to 11.3 per cent by June 2009. Capital outflows from the banking system (largely related to parent funding from Nordic banks, non-resident deposits and repayments of syndicated loans) reached close to €3 billion between November 2008 and May 2009. At its peak, the outflow reached €590 million in March 2009, contributing to a rapid decline in foreign exchange reserves that dropped by 35 per cent between February and June 2009. However, since then the rate of capital outflows has gradually decreased, indicating the repeatedly confirmed long-term commitment of the Nordic parent banks to the Baltic region.

In November 2008 the government nationalised a majority stake in Latvia's largest domestic banking group, Parex, in the face of a surge in deposit withdrawals. The state injected large amounts of liquidity into the bank, announced a comprehensive restructuring plan and the financial regulator imposed restrictions on deposit withdrawals. The acquisition of a 25 per cent equity stake in Parex by the EBRD, signed in April 2009, was designed to improve confidence, ease the financial burden on the Latvian government and assist in the restructuring process ahead of a transfer back into private ownership. The government has announced its intention to sell its majority stake in Parex as soon as possible, but the economic crisis casts doubts as to how quickly the government will be able to proceed. As non-residents were responsible for most deposit withdrawals from Parex, the episode has shown how vulnerable the banking sector is, with its heavy reliance on non-resident deposits. In line with wider EU anti-crisis measures, the deposit insurance limit has been increased to €50,000 with the aim of sustaining depositor confidence.

Macroeconomic performance

Of all the countries in the transition region, Latvia has been one of the most severely affected by the global economic crisis. GDP growth decelerated sharply from 10 per cent in 2007 to -4.6 per cent in 2008 and then GDP fell dramatically by 18.7 per cent in the second quarter of 2009 (year on year). The slow-down has been driven by a rapid decline in credit growth, falling asset prices and weakening external demand. As a result, unemployment had increased to 16.7 per cent by the second quarter and inflationary pressures have quickly abated, with annual inflation falling from 17.7 per cent in June 2008 to 3.4 per cent a year later.

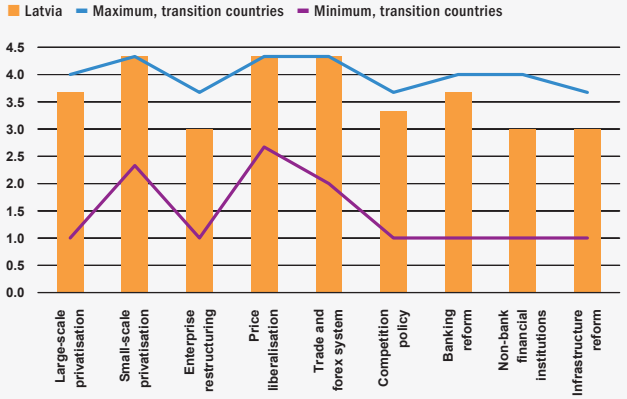
The economy's rapid adjustment to the recession has been evident in the development of the current account balance. This had turned positive by January 2009 and recorded a surplus of 14.2 per cent of GDP in the second quarter of 2009, compared with a deficit of 15.1 per cent a year earlier. This striking shift is mainly due to a fall in imports that has been much more rapid than that of exports and underlines the severity of the adjustment that the economy has undergone.

The financial crisis and a loss of confidence in the banking system led to increased pressures on the stability of the currency peg to the euro. In December 2008 Latvia reached an agreement with the International Monetary Fund (IMF), European Union, the World Bank, the Nordic countries and a number of other donors on an extensive funding package amounting to €7.5 billion to be disbursed over three years. Restoring confidence in the banking system, ensuring adequate finance for the budget and rebuilding competitiveness under the fixed exchange rate regime are the key objectives of the programme. However, the disbursement of funds has been repeatedly delayed due to the government's inability to reach the required fiscal targets. These delays, the reduction in exposure by foreign banks, non-resident deposit outflows and a number of other events fuelled speculation against the currency peg that culminated in early June 2009 when the central bank's purchases of the domestic currency reached their peak. Since then, the situation has stabilised, as first the European Union and then the IMF disbursed their second tranches of the loan. As a condition for these disbursements the Latvian government committed to further cuts in fiscal expenditures to contain the fiscal deficit.

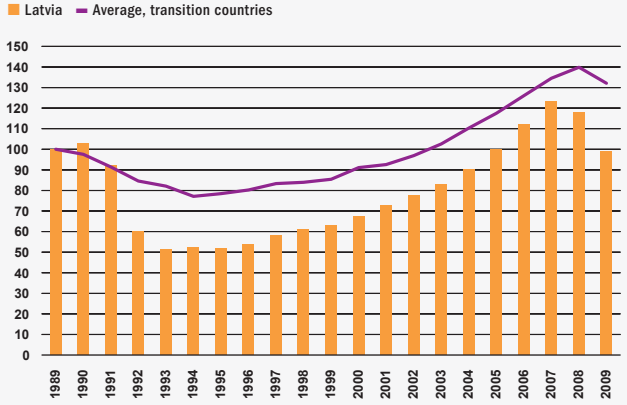
Outlook and risks

Output is projected to fall by 16 per cent in 2009 with the economic contraction likely to slow next year. Stabilisation will depend largely on a revival in bank lending to the real economy and on achieving a sustainable fiscal path. The implementation of the fiscal adjustment measures will prove to be painful for the economy, but they are necessary to maintain confidence in the economy and to attract new external credit. Sustained growth over the longer term will depend on diversifying the industrial base, focusing on the production and export of higher-value-added products and improving the rate of innovation.

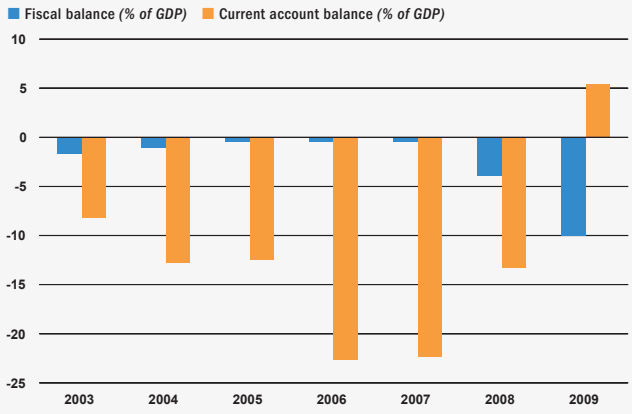
Transition indicators 2009



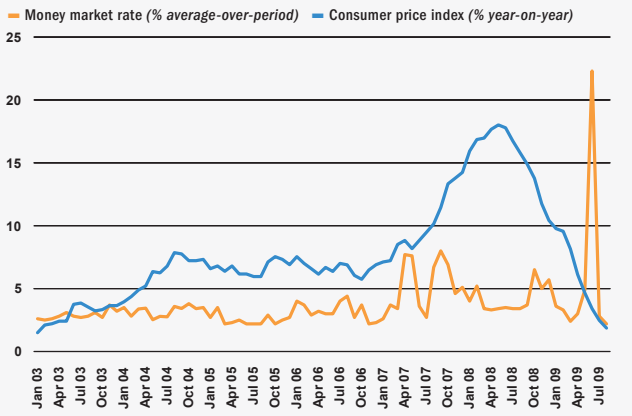
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**[1]

Interest rate liberalisation – **full**

Exchange rate regime – **fixed peg in ERM II**

Wage regulation – **no**

Tradeability of land – **full except foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **under reform**

Secured transactions law – **advanced**

Infrastructure

Telecoms regulatory assessment compliance – **full**

Independence of the electricity regulator – **full**

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

Independence of the road directorate – **partial**

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2.0 per cent** (2004)

Government expenditure on health – **4.5 per cent of GDP** (2007)

Government expenditure on education – **5.8 per cent of GDP** (2007)

Household expenditure on power and water – **3.8 per cent**[2]

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	9.0	9.5	9.6	10.5	10.6	**10.8**	**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)	62.2	63.8	65.3	66.5	68.6	**67.9**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	1.8	2.0	4.1	5.2	4.3	**4.9**	**na**
Share of industry in total employment (in per cent)	20.1	19.3	17.9	18.7	17.9	**18.1**	**na**
Change in labour productivity in industry (in per cent)	5.5	12.0	15.6	1.3	8.4	**-5.9**	**na**
Investment/GDP (in per cent)	28.8	33.0	34.4	39.7	40.4	**31.5**	**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	3.7	3.7	3.7	3.7	3.7	**3.7**	**3.7**
EBRD index of enterprise reform	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	16.3	16.2	14.4	14.0	12.9	**11.5**	**na**
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	**2.0**	**na**
Share of trade with non-transition countries (in per cent)	64.6	59.2	54.1	53.1	51.1	**47.8**	**na**
Share of trade in GDP (in per cent)	74.6	81.5	85.7	87.3	81.2	**74.5**	**na**
Tariff revenues (in per cent of imports)	0.6	0.2	0.0	0.0	0.3	**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**
EBRD index of competition policy	2.7	2.7	3.0	3.0	3.0	**3.0**	**3.3**
Financial sector							
Number of banks (foreign-owned)	23 (10)	23 (9)	23 (9)	24 (12)	25 (14)	**27 (16)**	**na**
Asset share of state-owned banks (in per cent)	4.1	4.0	4.3	4.4	4.2	**19.5**	**na**
Asset share of foreign-owned banks (in per cent)	53.0	48.6	57.9	63.3	63.8	**65.7**	**na**
Non-performing loans (in per cent of total loans)	1.4	1.1	0.7	0.5	0.4	**2.4**	**na**
Domestic credit to private sector (in per cent of GDP)	39.8	50.3	67.8	87.0	88.3	**89.6**	**na**
Domestic credit to households (in per cent of GDP)	11.6	17.6	26.8	38.0	42.7	**39.2**	**na**
– Of which mortgage lending (in per cent of GDP)	7.6	12.4	19.5	28.9	33.7	**31.1**	**na**
Stock market capitalisation (in per cent of GDP)	9.5	11.5	16.5	12.9	10.2	**4.9**	**na**
Stock trading volume (in per cent of market capitalisation)	15.7	8.1	4.6	4.3	4.8	**1.8**	**na**
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.8	1.3	0.0	**1.8**	**na**
EBRD index of banking sector reform	3.7	3.7	3.7	3.7	4.0	**4.0**	**3.7**
EBRD index of reform of non-bank financial institutions	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	28.2 (52.6)	28.2 (66.7)	31.9 (81.7)	28.8 (95.8)	28.4 (97.7)	**28.4 (97.7)**	**na**
Internet users (per 100 inhabitants)	27.0	33.2	42.3	50.3	55.2	**55.2**	**na**
Railway labour productivity (1989=100)	118.2	109.4	118.6	106.7	116.9	**123.0**	**na**
Residential electricity tariffs (USc kWh)	7.1	8.2	8.1	8.4	9.9	**11.8**	**na**
Average collection rate, electricity (in per cent)	100	100	100	100	100	**100**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	5.4	5.8	6.5	na	na	**na**	**na**
EBRD index of infrastructure reform	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Electric power	3.0	3.3	3.3	3.3	3.3	**3.3**	**3.3**
– Railways	3.3	3.3	3.3	3.7	3.7	**3.7**	**3.7**
– 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	**3.3**	**3.3**
– Water and wastewater	3.3	3.3	3.3	3.3	3.3	**3.3**	**3.3**

[1] There are controls on raffles and gambling for certain nationals.

[2] Estimate based on the poorest 20 per cent of households (lowest income quintile).

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	7.2	8.7	10.6	12.2	10.0	**-4.6**	**-16.0**
– Private consumption	8.4	9.7	11.2	21.2	14.8	**-5.4**	**na**
– Public consumption	1.9	2.1	2.7	4.9	3.7	**1.5**	**na**
– Gross fixed capital formation	12.3	23.8	23.6	16.4	7.5	**-15.6**	**na**
– Exports of goods and services	5.2	9.4	20.2	6.5	10.0	**-1.3**	**na**
– Imports of goods and services	13.1	16.6	14.8	19.4	14.7	**-13.6**	**na**
Industrial gross output	8.0	8.3	8.4	10.5	6.5	**-4.5**	**na**
Agricultural gross output	-2.4	3.4	9.3	-5.2	8.0	**-0.3**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	0.4	0.5	-0.4	2.3	1.8	**1.8**	**na**
Employment (end-year)	2.0	0.7	1.6	4.4	2.7	**0.1**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	10.7	10.6	8.8	7.0	6.2	**7.8**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	2.9	6.2	6.7	6.5	10.1	**15.4**	**3.6**
Consumer prices (end-year)	3.6	7.3	7.0	6.8	14.2	**10.4**	**-1.7**
Producer prices (annual average)	3.2	8.6	7.8	10.3	16.1	**11.5**	**na**
Producer prices (end-year)	4.1	11.4	7.0	13.2	13.1	**9.5**	**na**
Gross average monthly earnings in economy (annual average)	11.0	9.9	16.6	22.8	31.8	**20.4**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	-1.6	-1.0	-0.4	-0.5	-0.4	**-4.0**	**-10.0**
General government expenditure[1]	34.8	35.8	35.6	38.2	35.9	**39.4**	**na**
General government debt	14.6	14.9	12.4	10.7	9.0	**19.5**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	21.7	26.9	38.7	39.7	14.4	**-4.4**	**na**
Domestic credit (end-year)	39.3	40.0	67.6	53.4	32.9	**17.9**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	34.7	37.9	43.1	48.8	42.2	**36.7**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	3.0	4.0	4.0	5.0	6.0	**6.0**	**na**
Interbank market rate[2]	3.2	3.5	2.7	2.3	5.1	**5.7**	**na**
Deposit rate (short-term, under 1 year)	3.0	3.3	2.8	3.6	6.2	**6.3**	**na**
Lending rate (short-term, under 1 year)	5.4	7.5	5.9	7.2	10.0	**11.1**	**na**
			(Lats per US dollar)				
Exchange rate (end-year)	0.5	0.5	0.6	0.5	0.5	**0.5**	**na**
Exchange rate (annual average)	0.6	0.5	0.6	0.6	0.5	**0.5**	**na**
External sector			*(In millions of US dollars)*				
Current account	-920.7	-1,761.7	-1,992.6	-4,522.0	-6,421.7	**-4,491.2**	**1,500.0**
Trade balance	-2,003.2	-2,780.4	-3,018.3	-5,130.7	-6,898.1	**-6,013.7**	**-1,500.0**
– Merchandise exports	3,170.3	4,221.0	5,360.9	6,140.3	8,227.1	**9,634.2**	**7,100.0**
– Merchandise imports	5,173.5	7,001.4	8,379.2	11,271.0	15,125.2	**15,647.9**	**8,600.0**
Foreign direct investment, net	253.6	527.5	585.2	1,491.3	1,945.0	**1,091.5**	**300.0**
Gross reserves, excluding gold (end-year)	1,432.4	1,912.0	2,231.9	4,353.3	5,553.4	**5,028.1**	**na**
External debt stock[3]	9,400.0	13,448.5	15,179.2	23,769.0	38,954.2	**42,053.8**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.8	2.8	2.7	3.9	3.7	**3.2**	**na**
			(In per cent of exports of goods and services)				
Debt service	19.9	21.4	36.4	39.8	27.2	**29.6**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	2.3	2.3	2.3	2.3	2.3	**2.3**	**na**
GDP (in millions of lats)	6,392.8	7,434.5	9,059.1	11,171.7	14,779.8	**16,274.5**	**14,162.7**
GDP per capita (in US dollars)	4,798.0	5,934.6	6,951.7	8,687.8	12,609.5	**14,937.8**	**na**
Share of industry in GDP (in per cent)	20.0	19.9	19.1	19.3	20.5	**20.3**	**na**
Share of agriculture in GDP (in per cent)	3.7	4.0	3.5	3.1	3.2	**2.8**	**na**
Current account/GDP (in per cent)	-8.2	-12.8	-12.4	-22.7	-22.3	**-13.2**	**5.4**
External debt – reserves (in US$ million)	7,967.6	11,536.5	12,947.3	19,415.7	33,400.8	**37,025.7**	**na**
External debt/GDP (in per cent)	84.0	97.7	94.7	119.2	135.4	**124.0**	**na**
External debt/exports of goods and services (in per cent)	201.0	224.1	201.7	270.6	326.5	**296.7**	**na**

[1] General government expenditure includes net lending.

[2] Weighted average interest rates in the interbank market.

[3] Includes non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

Lithuania

Key developments and challenges

Stabilisation of the banking sector is essential for economic recovery. In the short term the priority should be to ensure banks have sufficient access to capital. In the long term, stability should be based on further improving the supervision of the banking sector.

Further integration into regional energy markets, the development of alternative sources of energy and advances in energy efficiency are necessary to improve the diversification and security of energy supplies. This is crucial given the planned closure of the Ignalina nuclear power plant and uncertainties over Russian energy supplies.

Although Lithuania's business environment is among the best in the transition region, entrepreneurs continue to face challenges related to corruption and competition from the informal sector. Strengthening administrative capacity and intensifying measures to fight corruption should thus remain government priorities.

Country data

Population (in millions)	**3.4**
Area ('000 sq km)	**65.3**
GDP (in billion US$, 2008)	**47.3**
Average transition score (scale: 1 to 4.33)	**3.70**

Progress in structural reform

Business environment and competition

Although it is one of the best in the transition region, Lithuania's business environment continues to be marked by concerns about corruption and low administrative efficiency. Almost 40 per cent of all respondents to the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV) indicated that corruption is a major or very severe obstacle affecting business operations. Furthermore, over 10 per cent of respondents cited competitors' practices in the informal sector as the single biggest obstacle.

Infrastructure

The need to diversify the sources of energy supply and enhance energy security are major issues given the planned closure of the communist era Ignalina nuclear power plant at the end of 2009 and the uncertainty over the reliability of gas supplies from Russia. In addition to continuing work on plans for building a new nuclear power plant in Visaginas, the Baltic countries have been working together to integrate their national energy markets by improving interconnections and taking measures to facilitate cross-border trade in energy. In May 2009 Latvia, Lithuania and Sweden confirmed in a Memorandum of Understanding that a "NordBalt" electricity link will be built between Lithuania and Sweden. The agreement came after months of negotiations over which of the Baltic countries should be connected to the planned underwater power cable to Sweden.

In May 2009 a Constitutional Court ruling found that the creation of the energy holding company, LEO LT, contravened the Lithuanian constitution. The majority state-owned energy holding company, created in April 2008 by merging the dominant transmission, power production and distribution companies, will be dissolved. Whether the demise of the state-controlled incumbent will facilitate a greater degree of unbundling and enable the private sector to have a greater role in the energy market remains to be seen.

Deeper transport sector integration is envisaged by the European Union's Rail Baltica project which plans to connect Lithuania to Finland and Poland via a high-speed rail link by 2014. The government had originally planned to share the estimated project cost of over €1.5 billion with the European Union. However, as a result of the fiscal pressures caused by the current economic crisis, the government has announced an interest in finding private sector partners.

Financial sector

As economic conditions have deteriorated rapidly, growth of credit to the private sector has decelerated from an annual rate of 50 per cent in early 2007 to 4 per cent in May 2009 and has been negative on a month-on-month basis since the beginning of 2009. The share of non-performing loans in the banks' portfolios has increased to record high levels, reaching 8.2 per cent in March 2009. As a result of the confidence crisis fuelled by the instability in neighbouring Latvia and deteriorated access to capital on international markets, the banking sector experienced massive deposit withdrawals in the period between September and December 2008, followed by much greater stability since the first quarter of 2009.

The banking sector is highly dependent on external funding, mostly provided by the Nordic parent banks to their subsidiaries which control over 80 per cent of all banking assets in Lithuania. Thus the loan-to-deposit ratio reached over 170 per cent in 2008. Although the Nordic banks have so far proved to be committed to the Lithuanian market, there is a risk of a further decrease in lending volumes should the access to external capital further deteriorate. Moreover, a high share of total deposits, especially of the smaller locally owned banks, is in the form of non-resident deposits which have proved to be relatively unstable during the run on Parex Bank in neighbouring Latvia.

In response to the crisis, and in line with wider EU anti-crisis measures, the authorities increased the deposit insurance limit from €22,000 to €100,000 with the aim of preventing further deposit runs. Information sharing through the credit registry has also been broadened and the required reserve ratio was reduced from 6 to 4 per cent in order to ease liquidity available to commercial banks. In July 2009 the parliament approved the Financial Stability Law which allows for swift recapitalisation of troubled banks by the state. In addition, the Swedish Central Bank reacted to the worsening outlook for Swedish banks in the Baltic region by building up foreign exchange reserves and by preventative stress-testing of those Swedish banks active in the region.

Macroeconomic performance

Economic activity in Lithuania has slowed drastically over the past year. Driven by strong domestic demand and substantial capital inflows, real GDP had risen at an annual average rate of 7.5 per cent since 2000, before moderating to 3 per cent in 2008 and falling by a dramatic 20.2 per cent year on year in the second quarter of 2009. The slow-down was triggered by the rapid retrenchment in bank credit, falling asset prices and weakening external demand for exports. Unemployment has been rising rapidly, reaching 13.6 per cent in the second quarter, and the rate of inflation has been declining in line with the falling domestic demand, to 2.6 per cent in August 2009. The rate of decline in industrial production reached over 25 per cent year on year in April 2009 but has been slowing down since then, to 13.2 per cent in August 2009.

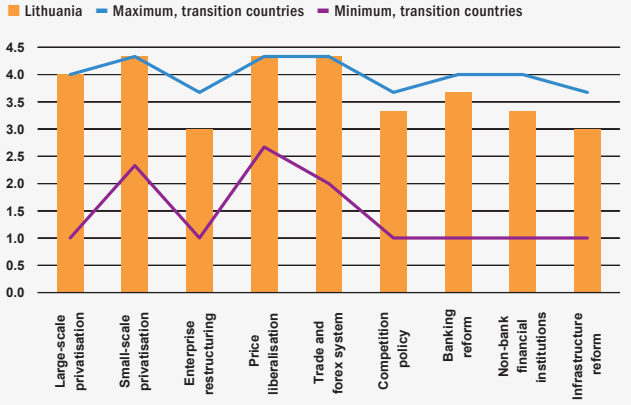
In reaction to the drastic fall in domestic demand, imports have been falling much faster than exports, with the year-on-year rate of decline reaching 44 per cent for imports and 31 per cent for exports in the first half of 2009. As a result of the faster than expected external adjustment, the current account moved into surplus in February 2009.

The fiscal deficit has widened due to the rapid fall in fiscal revenues and was 3.2 per cent of GDP in 2008. These trends continued into 2009 when the deficit is projected to reach 9 per cent of GDP for the year as a whole. As a consequence of the fiscal imbalance the European Union initiated the Excessive Deficit Procedure in June 2009 which means that Lithuania must reduce its fiscal deficit to below 3 per cent of GDP by 2011. In July 2009 the authorities adopted a number of measures to contain the deficit, including a VAT increase from 19 to 21 per cent and further salary cuts in the public sector. As a result of the fiscal tightening and fast external balance adjustment, Lithuania has been able to avoid speculative attacks on its currency board regime, which still enjoys broad political support within the country.

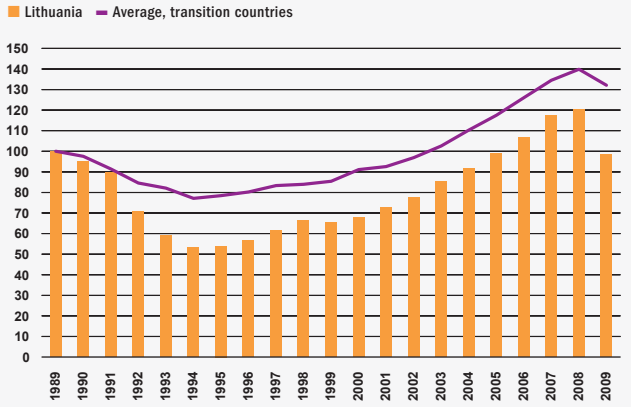
Outlook and risks

The economy will likely continue to shrink well into 2010. Subsequent growth is expected to be held back by constrained availability of credit and sluggish export demand. Containing the large fiscal deficit will continue to be a crucial policy goal for Lithuania. A tight fiscal policy is also necessary for the planned adoption of the euro and for increasing the attractiveness of the country for foreign capital needed for the resumption of economic growth. Over the medium term, a return to growth will depend on banks' ability to restart lending, especially to small and medium-sized enterprises, and on a recovery of external demand. Significant risks still remain in the financial sector which is highly dependent on external sources of funding.

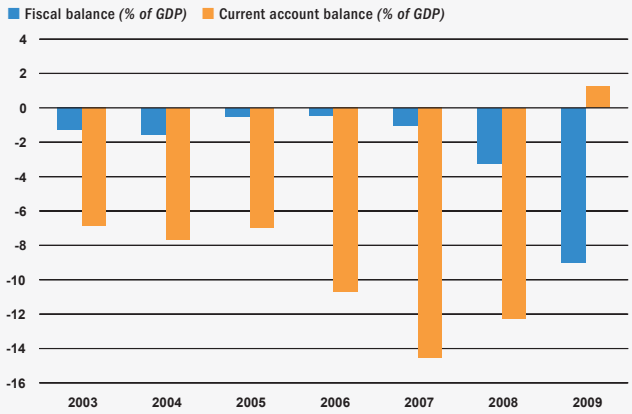
Transition indicators 2009



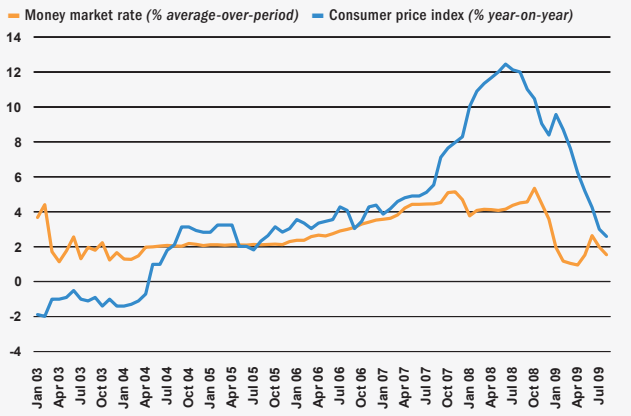
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**[1]

Interest rate liberalisation – **full**

Exchange rate regime – **currency board in ERM II**

Wage regulation – **no**

Tradeability of land – **full**[2]

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **advanced**

Infrastructure

Telecoms regulatory assessment compliance – **full**

Independence of electricity regulator – **full**

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

Independence of the road directorate – **partial**

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2.0 per cent** (2004)

Government expenditure on health – **4.3 per cent of GDP** (2005)

Government expenditure on education – **5.5 per cent of GDP** (2006)

Household expenditure on power and water – **3.8 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	12.7	13.3	13.7	16.5	16.6	**16.6**	**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)	71.9	72.1	72.3	73.7	73.8	**74.0**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	0.9	1.3	2.3	1.8	1.9	**2.0**	**na**
Share of industry in total employment (in per cent)	20.7	20.1	20.1	19.7	19.5	**19.6**	**na**
Change in labour productivity in industry (in per cent)	15.5	13.2	5.0	10.7	7.0	**1.7**	**na**
Investment/GDP (in per cent)	21.9	22.7	23.9	26.3	30.9	**27.0**	**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	3.7	3.7	4.0	4.0	4.0	**4.0**	**4.0**
EBRD index of enterprise reform	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	19.6	17.1	15.4	14.1	13.5	**12.6**	**na**
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	1.0	1.0	1.0	**1.0**	**na**
Share of trade with non-transition countries (in per cent)	62.4	57.1	53.3	51.4	51.4	**46.0**	**na**
Share of trade in GDP (in per cent)	91.4	93.1	100.3	108.1	102.7	**112.9**	**na**
Tariff revenues (in per cent of imports)[3]	1.0	0.7	0.1	0.1	0.1	**0.0**	**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**
EBRD index of competition policy	3.0	3.0	3.3	3.3	3.3	**3.3**	**3.3**
Financial sector							
Number of banks (foreign-owned)	13 (7)	12 (6)	12 (6)	11 (6)	14 (6)	**17 (5)**	**na**
Asset share of state-owned banks (in per cent)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Asset share of foreign-owned banks (in per cent)	95.6	90.8	91.7	91.8	91.7	**92.1**	**na**
Non-performing loans (in per cent of total loans)	2.6	2.4	3.4	3.1	2.7	**4.6**	**na**
Domestic credit to private sector (in per cent of GDP)	22.8	28.8	40.9	50.1	60.0	**na**	**na**
Domestic credit to households (in per cent of GDP)	4.2	7.1	12.0	17.9	24.4	**25.7**	**na**
– Of which mortgage lending (in per cent of GDP)	3.4	5.5	9.0	12.6	17.2	**18.6**	**na**
Stock market capitalisation (in per cent of GDP)	16.9	26.1	31.4	32.3	24.2	**8.0**	**na**
Stock trading volume (in per cent of market capitalisation)	17.5	8.2	10.1	22.8	10.1	**59.9**	**na**
Eurobond issuance (in per cent of GDP)	0.1	5.0	3.0	4.2	3.9	**0.0**	**na**
EBRD index of banking sector reform	3.3	3.3	3.7	3.7	3.7	**3.7**	**3.7**
EBRD index of reform of non-bank financial institutions	3.0	3.0	3.0	3.0	3.3	**3.3**	**3.3**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	23.9 (60.9)	23.9 (88.8)	23.5 (127.4)	23.4 (139.2)	23.8 (146.4)	**23.6 (151.2)**	**na**
Internet users (per 100 inhabitants)	24.0	29.1	34.2	42.4	49.5	**53.5**	**na**
Railway labour productivity (1989=100)	67.8	71.0	77.1	83.0	91.1	**93.4**	**na**
Residential electricity tariffs (USc kWh)	9.4	9.7	10.2	9.1	10.9	**10.5**	**na**
Average collection rate, electricity (in per cent)	91	97	100	100	100	**99**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	4.3	4.7	5.6	na	na	**na**	**na**
EBRD index of infrastructure reform	2.7	2.7	2.7	3.0	3.0	**3.0**	**3.0**
– Electric power	3.0	3.3	3.3	3.3	3.3	**3.3**	**3.3**
– Railways	2.3	2.3	2.3	2.3	2.3	**2.7**	**2.7**
– Roads	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Telecommunications	3.3	3.3	3.3	3.7	3.7	**3.7**	**3.7**
– Water and wastewater	3.3	3.3	3.3	3.3	3.3	**3.3**	**3.3**

[1] There are controls for national security, defence and lotteries.

[2] There is full tradeability of non-agricultural land. Ownership of agricultural land, however, is constitutionally prohibited for foreigners and partially restricted for Lithuanian legal persons.

[3] Refers to all taxes on imports excluding VAT and import duties.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	10.2	7.4	7.8	7.8	9.8	**2.8**	**-18.4**
– Private consumption	10.4	11.9	12.2	10.6	12.1	**3.6**	**na**
– Public consumption	4.1	8.2	3.5	3.7	3.2	**7.9**	**na**
– Gross fixed capital formation	13.7	15.7	11.2	19.4	23.0	**-6.5**	**na**
– Exports of goods and services	6.9	4.4	17.7	12.0	5.3	**9.7**	**na**
– Imports of goods and services	10.4	14.9	16.4	13.7	10.7	**10.5**	**na**
Industrial gross output	17.2	9.9	7.7	10.6	8.2	**1.0**	**na**
Agricultural gross output	7.4	-0.5	2.0	-10.0	13.1	**0.5**	**na**
Employment[1]			*(Percentage change)*				
Labour force (end-year)	0.7	-1.3	-0.9	-1.2	0.9	**0.7**	**na**
Employment (end-year)	2.3	-0.1	2.6	1.7	2.3	**-0.9**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	12.4	11.4	8.3	5.6	4.3	**5.8**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	-1.1	1.2	2.7	3.8	5.7	**11.0**	**4.2**
Consumer prices (end-year)	-1.3	2.9	3.0	4.5	8.1	**8.5**	**0.0**
Producer prices (annual average)	-0.4	6.1	11.4	7.6	7.0	**18.4**	**na**
Producer prices (end-year)	-0.2	6.8	13.5	2.8	19.4	**-6.8**	**na**
Gross average monthly earnings in economy (annual average)	5.8	7.2	11.0	17.2	20.5	**19.4**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	-1.3	-1.5	-0.5	-0.4	-1.0	**-3.2**	**-9.0**
General government expenditure[2]	33.2	33.3	33.3	33.6	34.8	**37.4**	**na**
General government debt	21.1	19.4	18.4	18.0	16.9	**15.6**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	19.4	21.4	31.9	21.5	21.4	**-0.4**	**na**
Domestic credit (end-year)	37.8	32.0	56.1	34.9	40.6	**17.4**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	32.3	35.7	40.9	43.3	44.0	**39.0**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Interbank interest rate	4.3	3.0	3.3	4.5	5.0	**3.0**	**na**
Treasury bill rate (3-month maturity)	2.6	2.2	2.4	2.9	4.2	**4.0**	**na**
Deposit rate	1.3	1.2	2.4	3.0	5.4	**7.6**	**na**
Lending rate	5.8	5.7	5.3	5.1	6.9	**8.4**	**na**
			(Litai per US dollar)				
Exchange rate (end-year)	2.7	2.5	2.8	2.6	2.3	**2.5**	**na**
Exchange rate (annual average)	3.1	2.8	2.7	2.8	2.5	**2.4**	**na**
External sector			*(In millions of US dollars)*				
Current account	-1,278.5	-1,724.4	-1,831.4	-3,218.4	-5,692.3	**-5,776.8**	**460.0**
Trade balance	-1,704.3	-2,382.3	-2,916.3	-4,209.6	-5,873.7	**-5,730.4**	**-400.0**
– Merchandise exports	7,658.2	9,305.3	11,775.8	14,151.8	17,161.6	**23,751.8**	**16,200.0**
– Merchandise imports	9,362.5	11,687.6	14,692.0	18,361.4	23,035.3	**29,482.2**	**16,600.0**
Foreign direct investment, net	142.0	510.4	689.0	1,550.7	1,408.6	**1,490.0**	**980.0**
Gross reserves, excluding gold (end-year)	3,485.4	3,519.0	3,919.4	5,672.1	7,593.1	**6,267.5**	**na**
External debt stock[3]	8,337.8	10,471.6	12,560.3	18,957.1	30,097.4	**32,472.6**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.9	3.2	2.8	3.3	3.4	**2.2**	**na**
			(In per cent of exports of goods and services)				
Debt service	16.6	14.9	16.6	16.9	17.5	**18.1**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	3.5	3.4	3.4	3.4	3.4	**3.4**	**na**
GDP (in millions of litai)	56,959.4	62,697.9	72,060.4	82,792.8	98,699.1	**111,189.8**	**94,541.6**
GDP per capita (in US dollars)	5,391.4	6,564.8	7,731.4	8,861.5	11,590.2	**14,034.5**	**na**
Share of industry in GDP (in per cent)	28.3	29.9	29.7	29.6	29.5	**28.9**	**na**
Share of agriculture in GDP (in per cent)	4.5	4.2	4.4	3.9	3.5	**3.9**	**na**
Current account/GDP (in per cent)	-6.9	-7.6	-6.9	-10.7	-14.5	**-12.3**	**1.2**
External debt – reserves (in US$ million)	4,852.4	6,952.6	8,640.9	13,285.0	22,504.3	**26,205.1**	**na**
External debt/GDP (in per cent)	44.8	46.4	47.6	63.0	76.9	**68.9**	**na**
External debt/exports of goods and services (in per cent)	87.4	89.1	84.4	106.6	142.1	**113.5**	**na**

[1] Data based on the population census.

[2] General government expenditure includes net lending.

[3] Includes non-resident currency and deposits and loans to foreign subsidiaries.

Moldova

Key developments and challenges

Further improvements in the business environment, such as reduced corruption and "red tape", a level playing field in the economy and stronger support for export-oriented sectors, would foster investment and help to diversify the economy away from agriculture and its substantial reliance on markets in the Commonwealth of Independent States (CIS).

Progress in reforming the energy and municipal sectors through commercialisation, increased transparency, economically based tariff-setting and resolution of the existing debt burden, is necessary to secure long-term financial sustainability in these sectors and improve the quality of services.

Falling budget revenues, declining remittances and limited access to external financing call for finding the right balance between the commitments to increase public expenditure and ensuring macroeconomic stability during the economic downturn.

Country data

Population (in millions)	**3.4**
Area ('000 sq km)	**33.80**
GDP (in billion US$, 2008)	**6.0**
Average transition score (scale: 1 to 4.33)	**3.0**

Progress in structural reform

Business environment and competition

Moldova's investment climate has gradually improved over recent years, although significant challenges remain, such as effectively implementing laws and regulations. According to the World Bank's *Doing Business 2010* survey, Moldova ranks only 94th of 183 countries surveyed for the ease of doing business. Particular problems were: dealing with construction permits, employing workers, protecting investors, paying taxes and trading across borders. These findings were broadly corroborated by the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV). In this survey, 40 per cent of Moldovan companies considered corruption to be a major or very severe obstacle to business, while tax administration and the practices of competitors in the informal sector were also seen as key obstacles. The economy remains non-diversified, with almost 40 per cent of exports in 2008 deriving from agriculture or agro-processing and more than one-third of exports directed towards Russia and the western CIS countries.

Infrastructure

The supply of gas to Moldova was severely disrupted in January 2009 due to a dispute between Russia and Ukraine. Gas import prices increased several times in 2008 and were set by Gazprom at US$ 333 per thousand cubic metres (tcm) for the first quarter of 2009, but subsequently declined to US$ 255 per tcm in the second quarter and US$ 186 per tcm in the third quarter, in line with the decline in international oil prices. End-user electricity and gas tariffs have been raised according to the revised tariff methodology and broadly reflect the increases in import prices. Nevertheless, the energy sector continues to face financial difficulties due to accumulated debts, partly the result of the financial problems of Termocom, the district heating operator in Chisinau. Progress in resolving these problems remains slow. The energy sector regulator, ANRE, has recently adopted secondary legislation for calculating feed-in tariffs and certificates of origin for renewable energy generation, a necessary step in the development of the sector following the adoption of the law on renewable energy in 2007. In mid-September 2009 the Chisinau municipal council approved substantial tariff increases for water and public transport, following a tariff freeze for several years. This measure is expected to improve the financial sustainability of the two municipal utilities, reducing the need for less-efficient budget financing of water services and public transport.

Financial sector

The global financial crisis has indirectly affected Moldova's financial system, mainly because the limited access of domestic banks to international capital markets meant they were unable to raise cheap funds in the boom years, but conversely they were not subject to large outflows in the downturn. The banking system remains generally sound, as assessed by an International Monetary Fund (IMF) *Financial System Stability Assessment* report in August 2008, but over the past year some banks have suffered temporary liquidity shortages and relatively large deposit withdrawals or conversions of local currency into foreign-denominated deposits. Local currency deposits declined by some 25 per cent in nominal terms between December 2008 and June 2009, while foreign currency deposits have remained relatively stable, reflecting concerns about the prospects of the leu and declining remittances.

Lending to the economy has fallen significantly – by about half in nominal terms in the first six months of 2009 compared with December 2008, most of which is attributable to the reduction in local currency loans for consumer lending, but small and medium-sized enterprises (SMEs) also report substantial difficulties in obtaining bank credit, partly related to the impact of the global crisis on the real sector. The quality of commercial banks' loan portfolios has deteriorated according to the National Bank of Moldova (NBM). The ratio of non-performing loans increased to 10.5 per cent at the end of June 2009 compared with 5.9 per cent at the end of 2008. Partly as a result of the crisis, a small commercial bank, InvestprivatBank, entered an orderly liquidation procedure in June 2009 and all its deposits were transferred to Banca de Economii, the state-owned bank. NBM has used various instruments to support the banking system and in May 2009 announced a programme of funding to Moldovan banks for terms up to 12 months at the base rate to provide liquidity and support lending to the real economy at affordable interest rates. The programme is estimated to amount to Lei 1.5 billion (US$ 135 million).

Macroeconomic performance

Following GDP growth of 7.2 per cent in 2008, the economy has been seriously affected by the global economic crisis since the beginning of 2009. In the first half of this year, GDP declined by 7.8 per cent compared with the same period of 2008. Industrial output was down by 25 per cent in the first half of 2009, investment was weakened and officially recorded remittances declined by about one-third in the first seven months of 2009.

Tight monetary policy throughout 2008, the limited availability of credit and the decline in remittances have led to a fall in inflation from 17 per cent to -2.2 per cent deflation between August 2008 and August 2009. While fiscal policy was relatively prudent in 2008 (the consolidated budget deficit was only 1 per cent of GDP), weaker revenue performance (as output and remittances fell) and generous pre-election public expenditure commitments contributed to an increase in the budget deficit to more than 8 per cent of GDP in the first quarter of 2009. The lack of significant fiscal reserves and the limited access to external finance have constrained the authorities' room to provide any significant fiscal stimulus to the economy. Thus, their crisis response has been largely confined to monetary policy through reductions in the policy rate and reserve requirements for commercial banks in 2009.

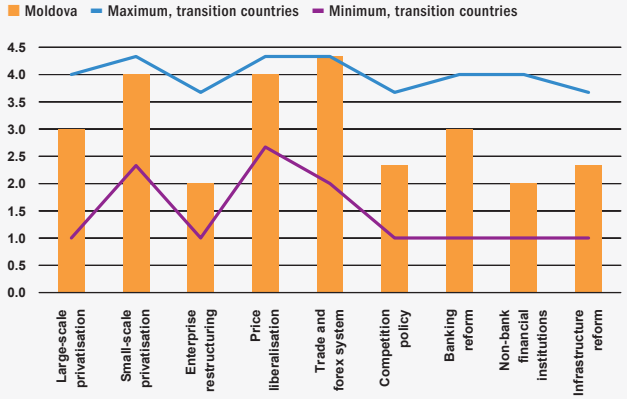
External imbalances increased further in 2008. The current account deficit reached almost 17 per cent of GDP but was successfully financed by commercial capital inflows in 2008, when foreign direct investment increased to a record US$ 679 million, or just above 11 per cent of GDP. The external account is undergoing a sharp adjustment in 2009 owing to the drop in external demand. There has been a sharp fall in both imports and exports with the trade deficit declining by more than 40 per cent year on year in the first half of 2009.

Official reserves declined by almost US$ 500 million in the first half of 2009, reaching US$ 1,210 million, or just above three months of imports of goods and services. Total external debt, mostly private, exceeded US$ 4 billion, or 68 per cent of GDP, by the end of 2008.

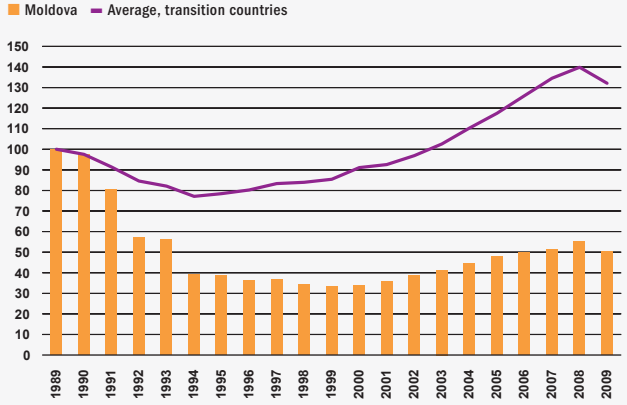
Outlook and risks

The economy is undergoing a severe contraction in 2009, as the global economic crisis has hit Moldovan exports and remittances. The industrial and construction sectors will continue to be the most severely affected. Financing the large budget deficit in 2009 will be challenging, even if expenditure is cut significantly. Maintaining macroeconomic stability in the short term will require a careful mix of fiscal, monetary and exchange rate policies, with an emphasis on the fiscal. The return to positive economic growth in 2010 and beyond partly depends on the pace of the expected recovery in Moldova's main trading partners, but it will also need to be underpinned by further improvements in the business environment.

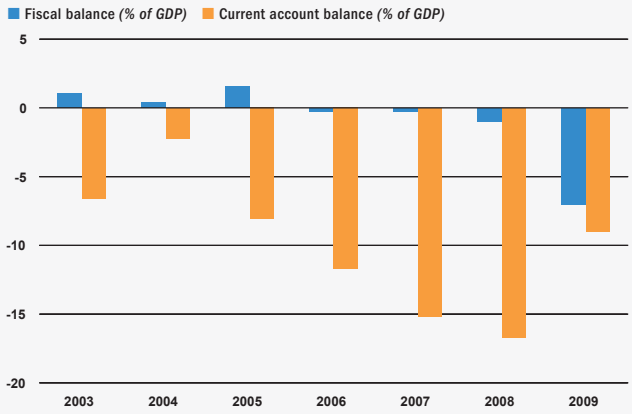
Transition indicators 2009



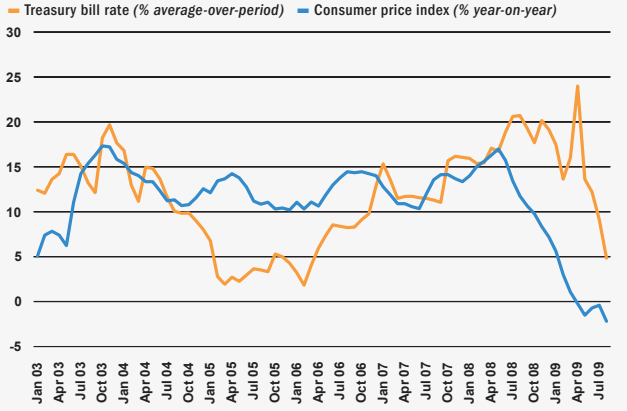
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradeability of land – **full (except foreigners)**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **modern/some defects**

Infrastructure

Telecoms regulatory assessment compliance – **medium**

Independence of the electricity regulator – **partial**

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

Independence of the road directorate – **no**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **28.9 per cent** (2004)

Government expenditure on health – **5.4 per cent** (2008)

Government expenditure on education – **8.2 per cent** (2008)

Household expenditure on power and water – **9.6 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	13.9	14.2	14.7	15.6	16.3	**18.3**	na
Private sector share in GDP (in per cent)	55.0	55.0	60.0	65.0	65.0	**65.0**	**65.0**
Private sector share in employment (in per cent)	60.0	60.0	60.0	60.0	65.0	**70.0**	na
Budgetary subsidies and current transfers (in per cent of GDP)	na	na	na	na	na	**na**	na
Share of industry in total employment (in per cent)	12.1	12.3	11.9	12.8	12.7	**13.1**	na
Change in labour productivity in industry (in per cent)	20.4	9.9	10.7	-7.6	0.7	**-2.6**	na
Investment/GDP (in per cent)	23.2	25.3	30.8	32.7	38.1	**37.0**	na
EBRD index of small-scale privatisation	3.7	3.7	3.7	3.7	3.7	**4.0**	**4.0**
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
EBRD index of enterprise reform	1.7	1.7	2.0	2.0	2.0	**2.0**	**2.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	**na**	na
Number of goods with administered prices in EBRD-15 basket	7.0	7.0	4.0	5.0	5.0	**5.0**	na
Share of trade with non-transition countries (in per cent)	34.5	34.3	34.2	35.2	37.3	**37.3**	na
Share of trade in GDP (in per cent)	112.8	105.6	113.8	108.5	113.4	**107.8**	na
Tariff revenues (in per cent of imports)	2.4	2.3	2.4	2.4	2.0	**2.3**	na
EBRD index of price liberalisation	3.7	3.7	4.0	4.0	4.0	**4.0**	**4.0**
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	**4.3**	**4.3**
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.3	**2.3**	**2.3**
Financial sector							
Number of banks (foreign-owned)	16 (9)	16 (9)	16 (7)	15 (6)	16 (7)	**16 (8)**	na
Asset share of state-owned banks (in per cent)	15.5	17.6	19.3	15.3	9.5	**9.1**	na
Asset share of foreign-owned banks (in per cent)	35.2	33.6	19.6	22.9	24.8	**31.6**	na
Non-performing loans (in per cent of total loans)	6.4	6.9	5.3	4.4	3.7	**5.9**	na
Domestic credit to private sector (in per cent of GDP)	20.3	21.2	23.6	27.5	36.8	**36.5**	na
Domestic credit to households (in per cent of GDP)	0.6	0.9	2.1	2.9	5.5	**5.1**	na
– Of which mortgage lending (in per cent of GDP)	1.0	1.1	1.5	2.6	4.0	**4.6**	na
Stock market capitalisation (in per cent of GDP)	24.4	22.3	na	na	na	**na**	na
Stock trading volume (in per cent of market capitalisation)	7.7	9.7	5.9	na	na	**na**	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	**0.0**	na
EBRD index of banking sector reform	2.3	2.7	2.7	2.7	3.0	**3.0**	**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**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	20.4 (12.2)	22.6 (20.6)	24.7 (29.0)	27.5 (36.6)	29.4 (51.3)	**30.7 (66.6)**	na
Internet users (per 100 inhabitants)	7.4	10.6	14.6	19.6	19.1	**22.0**	na
Railway labour productivity (1989=100)	29.5	31.0	31.3	40.0	34.7	**38.2**	na
Residential electricity tariffs (USc kWh)	5.6	6.0	5.9	5.7	6.9	**10.1**	na
Average collection rate, electricity (in per cent)	100	95	97	96	96	**95**	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.1	2.3	2.5	2.7	2.8	**na**	na
EBRD index of infrastructure reform	2.0	2.0	2.3	2.3	2.3	**2.3**	**2.3**
– Electric power	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Railways	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
– Roads	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
– Telecommunications	2.3	2.3	2.7	3.0	3.0	**3.0**	**3.0**
– Water and wastewater	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	6.6	7.4	7.5	4.8	3.0	**7.2**	**-8.5**
– Private consumption	18.5	6.2	10.1	7.0	3.6	**4.5**	**na**
– Public consumption	3.2	-16.2	6.3	5.3	5.2	**5.0**	**na**
– Gross fixed capital formation	13.5	10.5	11.0	15.1	22.0	**-0.9**	**na**
– Exports of goods and services	19.2	11.0	17.7	2.8	10.5	**-7.8**	**na**
– Imports of goods and services	28.7	3.6	18.1	10.3	14.6	**-6.1**	**na**
Industrial gross output	15.6	8.2	7.0	-4.8	-1.3	**0.7**	**na**
Agricultural gross output	-13.6	20.8	0.8	-1.1	-23.1	**31.9**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	-8.8	-2.8	-0.7	-4.6	-3.2	**-0.8**	**na**
Employment (end-year)	-9.9	-3.0	0.2	-4.7	-0.8	**0.3**	**na**
			(In per cent of labour force)				
Unemployment (end-year)[1]	7.9	8.1	7.3	7.4	5.1	**4.0**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	11.6	12.5	12.0	12.8	12.4	**12.8**	**0.0**
Consumer prices (end-year)	15.7	12.5	10.2	14.0	13.3	**7.2**	**1.3**
Producer prices (annual average)	7.8	5.6	5.3	12.2	26.5	**10.5**	**na**
Producer prices (end-year)	9.2	3.6	6.9	12.4	28.6	**3.3**	**na**
Gross average monthly earnings in economy (annual average)	28.8	23.8	19.5	28.7	21.6	**22.6**	**na**
Government sector			*(In per cent of GDP)*				
General government balance[2]	1.0	0.4	1.5	-0.3	-0.3	**-1.0**	**-7.0**
General government expenditure[2]	33.1	35.1	37.0	40.1	41.8	**41.6**	**na**
General government debt[3]	58.9	46.0	34.7	34.2	28.5	**21.4**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	24.4	44.7	36.7	12.2	47.3	**18.4**	**na**
Domestic credit (end-year)	24.3	25.8	15.8	30.1	39.0	**16.5**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	20.4	25.4	29.5	27.9	34.4	**34.7**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	14.0	14.5	12.5	14.5	16.0	**14.0**	**na**
Interbank interest rate (up to 30-days maturity)	13.0	13.3	6.3	9.5	12.3	**15.5**	**na**
Deposit rate (1 year)	12.7	15.2	13.0	11.9	15.1	**18.1**	**na**
Lending rate (1 year)	19.2	21.0	18.9	18.2	18.9	**21.0**	**na**
			(Lei per US dollar)				
Exchange rate (end-year)	13.2	12.5	12.8	12.9	11.3	**10.4**	**na**
Exchange rate (annual average)	13.9	12.3	12.6	13.1	12.1	**10.4**	**na**
External sector			*(In millions of US dollars)*				
Current account	-130.4	-57.6	-241.4	-399.0	-667.9	**-1,009.3**	**-463.0**
Trade balance	-623.4	-754.2	-1,191.5	-1,590.9	-2,243.5	**-3,223.4**	**-1,903.0**
– Merchandise exports	805.2	994.1	1,104.6	1,053.5	1,374.6	**1,646.7**	**1,202.0**
– Merchandise imports	1,428.5	1,748.2	2,296.1	2,644.4	3,618.2	**4,870.0**	**3,105.0**
Foreign direct investment, net	71.0	145.7	198.9	223.0	481.4	**679.4**	**75.0**
Gross reserves, excluding gold (end-year)	302.3	470.3	597.4	775.3	1,333.7	**1,672.4**	**na**
External debt stock	1,930.4	1,883.8	2,080.0	2,530.9	3,357.8	**4,108.2**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.1	2.7	2.6	3.0	3.8	**3.5**	**na**
			(In per cent of exports of goods and services)				
Debt service	18.7	21.0	16.5	18.7	13.0	**17.6**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)[4]	3.6	3.4	3.4	3.4	3.4	**3.4**	**na**
GDP (in millions of lei)	27,618.9	32,032.0	37,651.9	44,754.0	53,430.0	**62,840.0**	**57,517.1**
GDP per capita (in US dollars)	547.5	767.3	882.6	1,003.7	1,282.1	**1,766.0**	**na**
Share of industry in GDP (in per cent)	20.5	20.5	19.1	18.0	19.1	**19.5**	**na**
Share of agriculture in GDP (in per cent)	18.3	17.5	16.4	14.8	10.0	**8.9**	**na**
Current account/GDP (in per cent)	-6.6	-2.2	-8.1	-11.7	-15.2	**-16.7**	**-9.0**
External debt – reserves (in US$ million)	1,628.1	1,413.5	1,482.6	1,755.6	2,024.1	**2,435.8**	**na**
External debt/GDP (in per cent)	97.5	72.5	69.6	74.3	76.3	**67.9**	**na**
External debt/exports of goods and services (in per cent)	182.2	141.5	138.0	164.8	167.4	**164.6**	**na**

[1] According to ILO methodology.

[2] General government includes the state, local government, social security and health care.

[3] Includes public and publicly guaranteed debt.

[4] Excluding Transnistria.

Mongolia

Key developments and challenges

To create a stable business environment for the mining sector, the government needs to make clear decisions about the allocation of risks and rewards between the state and private investors. Fair and transparent rules should be introduced concerning the share of state ownership, ways of financing and the tax regime.

The government has initiated public-private partnerships (PPPs) in infrastructure. To make these successful, the legislative and regulatory framework should be fair and transparent.

A lack of transparency, flaws in corporate governance and weak risk management practices have contributed to instability in the banking sector. While recapitalisation and consolidation efforts are required, financial institutions also need to improve the transparency of their ownership structure and lending practices to restore confidence in the sector.

Country data

Population (in millions)	**2.7**
Area ('000 sq km)	**1,567.0**
GDP (in billion US$, 2008)	**5.2**
Average transition score (scale: 1 to 4.33)	**3.07**

Progress in structural reform

Business environment and competition

The law relating to the windfall profit tax was amended in November 2008, increasing the price threshold for gold from US$ 500 to US$ 850 per ounce, in order to boost investment in the mining sector. Copper and gold producers pay a 68 per cent tax on sales revenue when commodity prices are above certain thresholds. However, since the original law was passed in May 2006, the attractiveness of investing in the Mongolian copper and gold mining sectors was reduced, especially in the latter where "grey" gold sales have increased to avoid this tax. In August 2009 the tax was repealed by parliament.

There have been further delays in the approval of the investment agreement between the government and the Canadian and United Kingdom-based mining companies, Ivanhoe Mines and Rio Tinto, on the Oyu Tolgoi copper and gold mining project over the past year. The project is expected to provide substantial foreign direct investment (FDI) flows and could also pave the way for other large-scale mining projects. In December 2008 parliament officially delegated authority to the government to renegotiate certain conditions before signing the contract. The Investment Agreement was formally signed in October 2009.

Infrastructure

According to the World Bank, infrastructure investment needs in southern Mongolia alone (where many large-scale mining projects are to be undertaken) amount to some US$ 5.2 billion between now and 2015. Since this is beyond the government's means, it has decided to launch PPPs. The relevant legislation has been drafted (although by September 2009 it had not yet been submitted to parliament) and a special PPP unit is being created. In the meantime, the government has issued two railway licences to domestic mining companies and has indicated it is also willing to construct power stations in the South Gobi on a PPP basis. However, the government's implementation capacity remains limited and it also remains unclear whether strategic investors can be attracted for these upcoming PPP projects.

Financial sector

During 2008-09, the Mongolian banking system experienced a prolonged period of instability. Although Mongolian banks are only to a limited extent integrated within the global financial system, their two main domestic funding sources – retail deposits and interbank financing – became highly volatile. The stock of deposits fell by 12 per cent between September and December 2008, mainly because of high inflation and the resulting negative real interest rates on deposits. The reduced liquidity of banks constrained their lending, especially for longer-term commitments (such as construction financing and mortgages). Over this period asset quality deteriorated rapidly and the proportion of non-performing loans rose to 13.7 per cent by July 2009 (from 2.7 per cent in May 2008). In December 2008, Anod Bank – the fourth largest bank – was placed under administration by the central bank. However, as inflationary pressures eased in 2009 and following the introduction of a deposit guarantee system in November 2008, deposits have been slowly returning to the banking system during 2009.

In July 2009 Mongolia sold its first sovereign offshore note, a US$ 75 million one-year zero coupon private placement with Standard Bank. In 2006 the Trade Development Bank had already placed an international bond for the same amount, but this was the first sovereign issue in Mongolia's history.

Social sector

There has only been a marginal decline in the poverty rate in recent years, from 36.1 per cent in 2002-03 to 35.2 per cent of the Mongolian population in 2007-08, according to the latest household survey undertaken by the National Statistical Office. The declines were greatest in urban centres (from 30.3 per cent to 26.9 per cent), with Ulaanbaatar having one of the lowest poverty ratios at 21.9 per cent. In rural areas, however, those in poverty increased from 43.4 per cent to 46.6 per cent of the population. Poverty also remains widespread in the ger settlements (that is, households living in traditional Mongolian tents) around the main cities, a result of the continuing migration from rural to urban areas. Thus, despite strong economic growth in recent years, resulting in an increase in per capita GDP from US$ 562 in 2003 to US$ 1,970 in 2008, not all the population has benefited in the same way; instead, it has led to increasing income inequality.

Macroeconomic performance

Mongolia has enjoyed robust economic growth, averaging 9 per cent per year during the past three years. However, growth slowed sharply during the second half of 2008 and GDP declined by 4.2 per cent in the first quarter of 2009 (year on year). Weak economic growth mainly reflects lower export revenues and a reduction in investment due to the reduced availability of bank credit. However, inflation eased significantly over the year, from 33.7 per cent (year on year) in August 2008 to 4.9 per cent in July 2009.

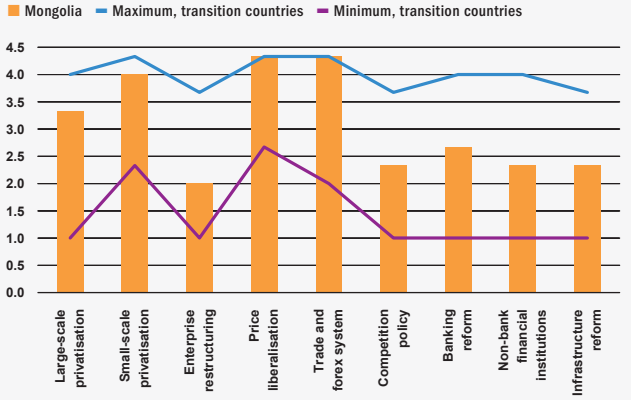
During 2008, government spending rose significantly with increases in public sector wages, social spending, as well as public investment, whereas fiscal revenues were adversely affected by sharply lower commodity prices, in particular, copper. As a result, the fiscal deficit increased to 5 per cent of GDP in 2008, compared with a surplus of 2.9 per cent in 2007. In March 2009 the government set up a special committee to deal with the impact of the financial and economic crisis. In the same month, parliament approved a US$ 1 billion economic stimulus plan to stabilise both the banking sector, as well as to fund projects in agriculture, energy and other infrastructure. The government also reached an agreement with the International Monetary Fund (IMF) in April 2009 on a US$ 229 million credit line under an 18-month stand-by arrangement. Further budgetary support of US$ 170 million will be provided by several key donors.

The current account recorded a deficit of 13.7 per cent of GDP in 2008, partly reflecting weaker export revenues, especially of copper. The resulting pressure on the exchange rate prompted the central bank initially to intervene in the currency market, but as reserves fell, the central bank stopped intervening in the currency market in early 2009 and the nominal exchange rate depreciated by around 20 per cent against the US dollar in the first three months of 2009. In March 2009 the central bank raised its policy rate from 9.75 per cent to 14 per cent, successfully stabilising the rate of the togrog at around 1,420 to 1,450 per US dollar. However, as export revenues from China had declined by roughly 30 per cent during the first half of the year, reflecting weaker Chinese growth, the current account is likely to remain in deficit in 2009.

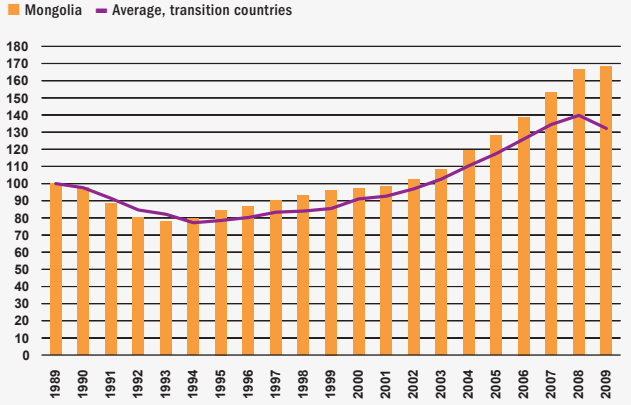
Outlook and risks

Despite the high economic growth rates of recent years, poverty remains widespread and income disparities have increased. Stronger economic growth is expected over the medium term, mainly on the back of mining sector development. In the long term, however, sustainable growth depends on structural reforms, including increased competition in the non-mining sector and a deeper integration of Mongolia into the global economy. A modest recovery is expected in 2009 if commodity prices remain higher than those of late 2008.

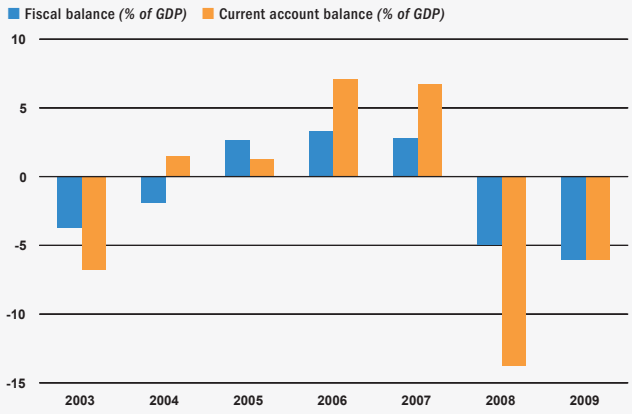
Transition indicators 2009



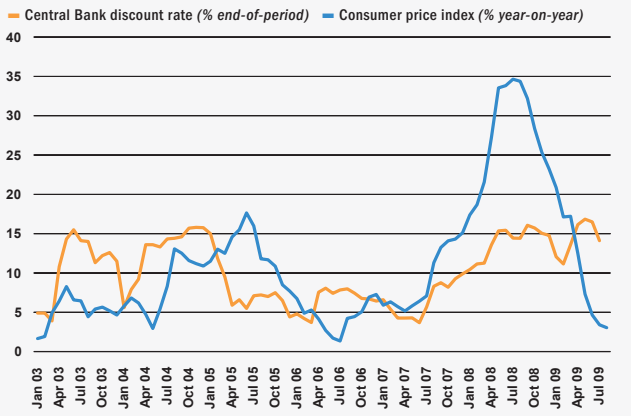
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradability of land – **limited de facto**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **malfunctioning**

Infrastructure

Telecoms regulatory assessment compliance – **medium**

Independence of the electricity regulator – **partial**

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

Independence of the road directorate – **no**

Financial sector

Capital adequacy ratio – **17 per cent** (2006)

Deposit insurance system – **yes**

Private pension funds – **no**

Social reform

Share of population living in poverty – **49 per cent** (2005)[1]

Government expenditure on health – **3.1 per cent** (2007)

Government expenditure on education – **5.5 per cent** (2007)

Household expenditure on power and water – **9.4 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	8.2	9.0	9.2	10.1	10.5	**10.7**	**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**
Budgetary subsidies and current transfers (in per cent of GDP)	7.6	7.5	7.0	7.2	11.1	**11.4**	**na**
Share of industry in total employment (in per cent)	15.6	16.1	16.7	17.3	17.9	**17.8**	**na**
Change in labour productivity in industry (in per cent)	-11.2	8.4	3.8	-1.1	2.3	**0.5**	**na**
Investment/GDP (in per cent)	35.5	36.5	35.5	35.9	40.7	**45.6**	**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	2.7	3.0	3.0	3.0	3.3	**3.3**	**3.3**
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Share of trade with non-transition countries (in per cent)	75.1	76.4	75.8	78.6	78.5	**77.9**	**na**
Share of trade in GDP (in per cent)	100.1	104.2	99.4	97.2	100.5	**108.0**	**na**
Tariff revenues (in per cent of imports)	3.5	3.7	3.9	4.0	4.3	**4.2**	**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**
EBRD index of competition policy	1.7	1.7	2.0	2.0	2.3	**2.3**	**2.3**
Financial sector							
Number of banks (foreign-owned)	17 (4)	17 (4)	17 (4)	16 (5)	16 (6)	**16 (6)**	**na**
Asset share of state-owned banks (in per cent)	6.2	5.3	3.8	0.0	0.0	**0.0**	**na**
Asset share of foreign-owned banks (in per cent)	na	38.9	39.1	45.8	46.4	**40.8**	**na**
Non-performing loans (in per cent of total loans)	4.8	6.0	5.6	4.7	3.2	**7.1**	**na**
Domestic credit to private sector (in per cent of GDP)	26.6	28.4	30.6	33.6	32.4	**29.8**	**na**
Domestic credit to households (in per cent of GDP)	7.6	9.8	11.4	13.5	18.1	**16.1**	**na**
– Of which mortgage lending (in per cent of GDP)	na	na	1.3	1.9	3.2	**3.6**	**na**
Stock market capitalisation (in per cent of GDP)	3.0	1.4	2.0	3.5	15.6	**8.4**	**na**
Stock trading volume (in per cent of market capitalisation)	2.2	2.3	6.0	13.5	14.7	**10.2**	**na**
Eurobond issuance (in per cent of GDP)	na	na	na	na	na	**na**	**na**
EBRD index of banking sector reform	2.3	2.3	2.3	2.3	2.7	**2.7**	**2.7**
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	**2.3**	**2.3**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	5.6 (12.8)	5.8 (17.0)	6.1 (21.9)	6.2 (30.0)	6.2 (35.1)	**6.2 (35.1)**	**na**
Internet users (per 100 inhabitants)	5.8	7.9	10.5	12.0	12.3	**12.3**	**na**
Railway labour productivity (1990=100)	159.8	189.2	202.6	198.3	186.2	**179.2**	**na**
Residential electricity tariffs (USc kWh)	4.6	4.6	5.0	5.0	4.9	**5.5**	**na**
Average collection rate, electricity (in per cent)	99	104	100	100	100	**94**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	na	na	na	na	na	**na**	**na**
EBRD index of infrastructure reform	2.0	2.0	2.0	2.0	2.0	**2.3**	**2.3**
– Electric power	2.3	2.3	2.7	2.7	2.7	**2.7**	**2.7**
– Railways	2.0	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Roads	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
– Telecommunications	2.7	2.7	2.7	2.7	2.7	**3.0**	**3.0**
– Water and wastewater	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**

[1] Estimate is for the poor households in Ulaanbaatar, based on UNDP's survey "Impact of Utility Charges on Poor Households" in Ulaanbaatar.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	5.9	10.1	7.3	8.6	10.2	**8.9**	**1.0**
Industrial gross output	3.0	15.0	9.6	7.0	6.9	**1.5**	**na**
Agricultural gross output	3.7	17.7	10.7	7.5	15.8	**5.0**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)[1]	6.4	2.7	1.5	4.2	1.1	**1.3**	**na**
Employment (end-year)	6.4	2.6	1.9	4.3	1.4	**1.7**	**na**
			(In per cent of labour force)				
Unemployment (end-year)[2]	3.5	3.6	3.3	3.2	2.8	**2.8**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	5.1	8.3	12.7	5.1	9.0	**26.7**	**8.1**
Consumer prices (end-year)	4.7	11.0	9.5	6.0	15.1	**23.2**	**7.5**
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)	22.0	30.4	5.4	26.2	35.5	**na**	**na**
Government sector			*(In per cent of GDP)*				
General government balance[3]	-3.7	-1.9	2.6	3.3	2.8	**-5.0**	**-6.0**
General government expenditure[3]	37.1	35.0	27.5	33.3	38.1	**40.2**	**na**
General government debt[4]	87.7	72.2	56.6	43.0	36.3	**33.2**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	49.6	20.5	37.2	30.8	57.3	**-5.5**	**na**
Domestic credit (end-year)	160.8	19.9	35.9	-7.4	72.5	**24.6**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	42.4	39.3	41.8	40.9	52.0	**36.9**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Central bank bills rate	11.5	15.8	4.8	6.4	9.9	**14.8**	**na**
Deposit rate[5]	14.0	13.2	12.6	13.5	13.4	**11.7**	**na**
Lending rate[5]	25.5	24.0	21.6	20.0	17.1	**18.6**	**na**
			(Togrog per US dollar)				
Exchange rate (end-year)	1,168.3	1,211.8	1,221.0	1,165.0	1,170.0	**1,267.0**	**na**
Exchange rate (annual average)	1,142.7	1,185.2	1,205.2	1,179.7	1,169.8	**1,165.7**	**na**
External sector			*(In millions of US dollars)*				
Current account	-98.6	26.6	29.2	222.0	265.0	**-721.9**	**-262.0**
Trade balance	-199.3	-149.1	-155.0	29.0	-54.0	**-612.5**	**-201.0**
– Merchandise exports	627.3	872.0	1,069.0	1,545.0	1,949.0	**2,534.5**	**1,858.0**
– Merchandise imports	826.6	1,021.1	1,224.0	1,516.0	2,003.0	**3,147.0**	**2,059.0**
Foreign direct investment, net	131.5	129.0	258.0	290.0	360.0	**585.5**	**409.9**
Gross reserves, excluding gold (end-year)	178.0	208.0	333.0	718.0	1,001.0	**657.0**	**na**
External debt stock	1,287.0	1,429.0	1,433.0	1,529.0	1,703.0	**1,961.0**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.0	1.8	2.5	4.6	5.0	**2.2**	**na**
			(In per cent of exports of goods and services)				
Debt service	34.0	7.4	2.9	2.2	2.1	**2.0**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	2.6	2.6	2.6	2.6	2.6	**2.7**	**na**
GDP (in billions of togrog)	1,660.4	2,154.2	2,779.6	3,715.0	4,599.5	**6,130.3**	**6,294.0**
GDP per capita (in US dollars)	562.7	695.2	871.4	1,191.4	1,489.4	**1,970.4**	**na**
Share of industry in GDP (in per cent)	25.3	29.9	31.1	36.0	35.3	**34.0**	**na**
Share of agriculture in GDP (in per cent)	20.1	20.9	21.7	19.5	20.5	**18.8**	**na**
Current account/GDP (in per cent)	-6.8	1.5	1.3	7.0	6.7	**-13.7**	**-6.0**
External debt – reserves (in US$ million)	1,109.0	1,221.0	1,100.0	811.0	702.0	**1,304.0**	**na**
External debt/GDP (in per cent)	88.6	78.6	62.1	48.6	43.3	**37.3**	**na**
External debt/exports of goods and services (in per cent)	154.1	118.2	96.6	75.3	67.5	**65.3**	**na**

[1] Economically active population registered at the employment registration office.
[2] Officially registered.
[3] General government revenue and expenditure include grants and net lending.
[4] Direct and assumed debt of the central government and loans guaranteed by the government.
[5] Weighted average over all maturities.

Montenegro

Key developments and challenges

Power sector restructuring is a priority reform to improve the electricity supply and support economic activity. It is important, therefore, that the partial privatisation of the state-owned power utility, EPCG, to an international strategic investor brings about the much-needed restructuring of the company.

Several measures have been introduced to improve the business environment, but corruption and bureaucracy, especially regarding licences and permits, are still seen as the main obstacles affecting businesses. Further efforts are needed to tackle these problems to improve the investment climate and to continue attracting foreign direct investment (FDI).

The growth of credit slowed dramatically in the wake of the global economic crisis and banks' reduced appetite for risk. Maintaining the necessary supply of credit to the private sector, especially to small and medium-sized enterprises (SMEs), will continue to be crucial to the crisis response.

Country data

Population (in millions)	**0.7**
Area ('000 sq km)	**13.8**
GDP (in billion US$, 2008)	**4.8**
Average transition score (scale: 1 to 4.33)	**2.85**

Progress in structural reform

Liberalisation and privatisation

Montenegro has made further progress with integrating into regional and global trading structures. Notably, the country formally applied for EU membership in December 2008. The European Commission is currently preparing an Opinion on Montenegro's application. In July 2009 the European Commission proposed that the Council of the European Union grant Montenegrin citizens (as well as those from FYR Macedonia and Serbia) visa-free access for the Schengen area from early 2010. Further progress has been made in the negotiations on membership of the World Trade Organization (WTO) over the past year and the country is close to achieving this goal.

A tender for the sale of a 54 per cent stake and a 30-year concession in the port operator, Marina Bar, was re-launched in June 2009. However, a previous privatisation is being reversed; in July 2009 in response to the economic crisis, the government approved the partial re-nationalisation of the financially troubled aluminium smelter KAP, the main Montenegrin industrial producer, and the related Niksic Bauxite mine. The private owner of the two companies, CEAC, is expected to transfer a 29 per cent stake in KAP and a 31 per cent stake in the bauxite mine to the state in exchange for financial support.

Business environment and competition

Montenegro has had some success in creating a favourable business climate and in attracting reputable foreign investors. During the first half of 2009 in spite of the global economic crisis, registration of new enterprises continued at a rate only slightly lower than in 2008. The Council for the Elimination of Business Barriers, established in mid-2008, adopted several measures to simplify procedures. These include allowing companies to register online with the commercial court, and record their taxes and contributions online. However, results from the latest round of the Business Environment and Enterprise Performance Survey (BEEPS IV) suggest that corruption and bureaucracy, especially in the area of licences and permits, are still perceived as among the main obstacles affecting businesses. Montenegro was ranked 71st (out of 183 economies) in the World Bank *Doing Business 2010* survey (up slightly from 77th the previous year).

Infrastructure

In December 2008 steps were taken to reduce the cross-subsidisation of electricity tariffs, with the energy regulator increasing electricity prices for households by 10.6 per cent. However, the Administrative Court overruled this decision in June 2009 so that the increase in electricity prices was reduced by 3 per cent and EPCG was requested to compensate customers for the over-payment (about €20 million). In September 2009 the tender for a minority stake in the state-owned power utility EPCG was successfully concluded. The winning bidder, Italian power company A2A, will acquire a 18.3 per cent stake in EPCG via a capital hike, with the government retaining 55 per cent. The unbundling of the sector started with the legal unbundling of EPCG's transmission unit into a separate company in March 2009.

Following a successful open tender, in June 2009 the Montenegrin government and a Croatian consortium signed a €2.7 billion concession agreement for the construction of the Bar-Boljare highway from the Adriatic coast to the Serbian border. The consortium will hold a 30-year concession for maintenance and management of the motorway, with construction expected to start by the end of 2009. In addition, the state-owned railways adopted a restructuring plan in line with EU directives (that is, vertical separation) in July 2008.

Financial sector

The banking sector continued to grow rapidly in 2008, but a slow-down became apparent in the last quarter of the year and accelerated dramatically in 2009 as a result of the global financial crisis. Credit growth decelerated and a sudden loss of confidence took place in October 2008 when households withdrew about 12 per cent of their deposits after Prva Banka, the second largest bank in the country, announced its troubled financial position. The authorities have taken steps to maintain the liquidity of the banking system, including the announcement of a full guarantee of all bank deposits and the removal of ceilings on credit growth. In addition, following the passage of a law in October 2008 authorising the government to provide support to banks, €44 million was subsequently lent to Prva Banka in December 2008. In June 2009 the rate of mandatory reserves on existing deposits was reduced to 10 per cent, with no reserve requirements for new deposits.

Macroeconomic performance

Montenegro's economy continued to expand at a strong pace in 2008, with real GDP growth estimated at 7.5 per cent, owing to robust domestic demand fuelled by large FDI inflows and rapid credit growth. On the supply side, services, especially financial services and tourism, continued to drive growth. The current account deficit, largely financed by FDI inflows, was at 33.7 per cent of GDP in 2008 and the overall external debt at 59.4 per cent of GDP, mostly pertaining to the private sector. The general government balance recorded a surplus of 1.5 per cent of GDP in 2008, owing to larger than expected revenues.

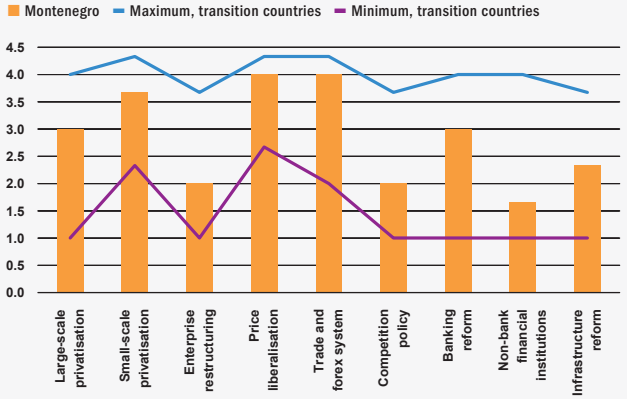
The impact of the crisis fully unfolded at the end of 2008 and during the first half of 2009, with credit growth slowing dramatically to 3 per cent year on year (compared with 95 per cent in 2008) and industrial production contracting by 20.2 per cent in the first half compared with the same period of the previous year. Following the contraction in the external demand for metals, the largest company, KAP, operated on a significantly reduced scale from October 2008 and the other main industrial producer, the Niksic Steelworks, halted its production for a month. In December 2008 the government approved a fiscal package estimated at €350 million (about 10 per cent of GDP) to stimulate the economy. The package included a significant increase in capital expenditure, a reduction in the rate of social contributions, the elimination of certain fees and subsidies for electricity payments for SMEs and households. The government also provided a guarantee for a €150 million loan to Montenegrin banks, negotiated with KfW and EIB, to be used to supply credit to SMEs.

Outlook and risks

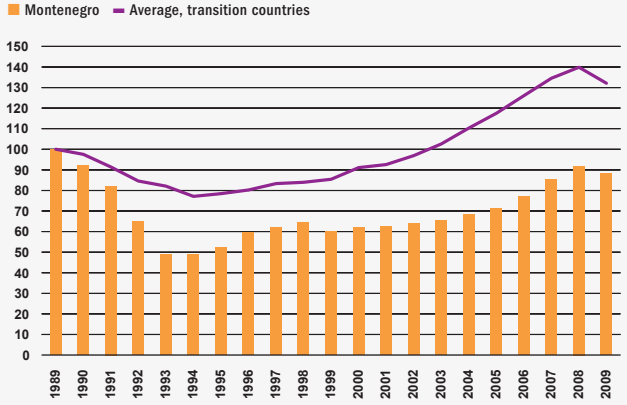
After years of strong economic growth, the near-term outlook is weak owing to the impact of the global economic crisis on the economy. Real GDP is expected to contract by 4 per cent in 2009, reflecting a much slower pace of consumption and investment due to lower FDI inflows, the slow-down in credit growth and the weakness of external demand. However, inflation is expected to significantly moderate below 2 per cent in 2009, as the demand-driven inflationary pressures ease. The downside risks to the outlook are significant, especially if tourism and FDI decline more sharply than anticipated.

However, the medium-term outlook for Montenegro remains bright. There should be a moderate rebound in growth once the global recession ends, reflecting the strong potential for growth in the tourism sector, for further FDI flows and the prospects for EU accession in the future. However, underlying external and domestic vulnerabilities still need to be addressed, especially the large external imbalances and the relative lack of diversification, if growth is to be sustained.

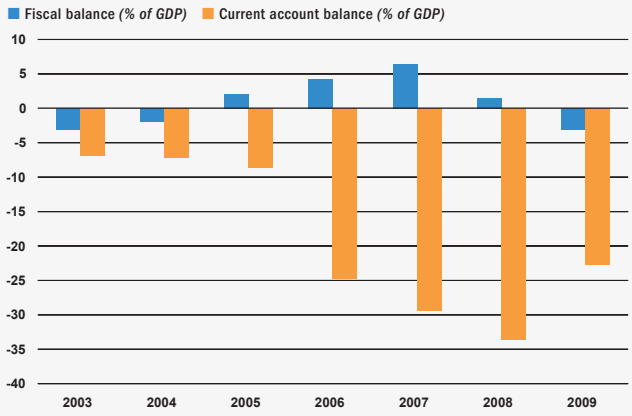
Transition indicators 2009



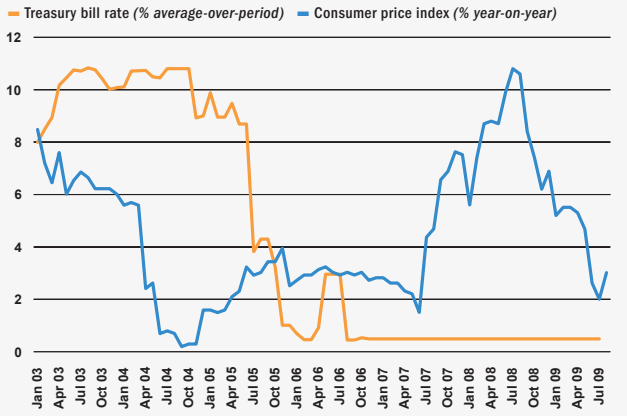
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **unilateral euroisation**

Wage regulation – **no**

Tradeability of land – **limited de jure**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **very high**

Secured transactions law – **modern/some defects**

Infrastructure

Telecoms regulatory assessment compliance – **medium**

Independence of the electricity regulator – **partial**

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

Independence of the road directorate – **partial**

Financial sector

Capital adequacy ratio – **10 per cent**

Deposit insurance system – **yes**

Private pension funds – **no**

Social reform

Share of population living in poverty – **8 per cent** (2007)

Government expenditure on health – **6.2 per cent of GDP** (2005)

Government expenditure on education – **5.4 per cent of GDP** (2004)

Household expenditure on power and water – **11.7 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	na	na	na	na	na	**na**	**na**
Private sector share in GDP (in per cent)	na	na	na	na	65.0	**65.0**	**65.0**
Private sector share in employment (in per cent)	na	na	na	na	50.0	**52.0**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	na	na	na	na	na	**na**	**na**
Share of industry in total employment (in per cent)	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)	na	na	na	na	na	**na**	**na**
EBRD index of small-scale privatisation	3.3	3.3	3.7	3.7	3.7	**3.7**	**3.7**
EBRD index of large-scale privatisation	2.7	2.7	3.3	3.3	3.3	**3.3**	**3.0**
EBRD index of enterprise reform	1.7	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	9.2	5.6	**5.6**	**na**
Number of goods with administered prices in EBRD-15 basket	na	na	na	2.0	1.0	**1.0**	**na**
Share of trade with non-transition countries (in per cent)	na	na	na	na	na	**na**	**na**
Share of trade in GDP (in per cent)	59.7	79.1	79.0	100.0	94.7	**85.8**	**na**
Tariff revenues (in per cent of imports)	na	na	na	na	na	**na**	**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	3.0	3.0	3.7	3.7	4.0	**4.0**	**4.0**
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.7	**1.7**	**2.0**
Financial sector							
Number of banks (foreign-owned)	10 (3)	10 (3)	10 (7)	10 (8)	11 (8)	**11 (9)**	**na**
Asset share of state-owned banks (in per cent)	19.2	16.4	5.1	0.0	0.0	**0.0**	**na**
Asset share of foreign-owned banks (in per cent)	23.5	31.0	87.7	91.9	78.7	**84.6**	**na**
Non-performing loans (in per cent of total loans)	4.7	5.7	5.2	2.8	3.2	**6.0**	**na**
Domestic credit to private sector (in per cent of GDP)	13.3	16.8	20.7	39.4	83.0	**87.2**	**na**
Domestic credit to households (in per cent of GDP)	3.6	4.8	6.4	17.3	32.8	**31.5**	**na**
– Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	**na**	**na**
Stock market capitalisation (in per cent of GDP)	na	na	na	62.0	89.5	**61.9**	**na**
Stock trading volume (in per cent of market capitalisation)	na	na	na	20.6	13.8	**3.2**	**na**
Eurobond issuance (in per cent of GDP)	na	na	na	na	na	**na**	**na**
EBRD index of banking sector reform	2.0	2.3	2.3	2.7	2.7	**3.0**	**3.0**
EBRD index of reform of non-bank financial institutions	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	na	46.0 (76.7)	55.9 (87.0)	56.9 (103.6)	56.9 (103.6)	**56.9 (103.6)**	**na**
Internet users (per 100 inhabitants)	na	25.4	38.9	42.8	45.1	**45.1**	**na**
Railway labour productivity (2000=100)	100.9	111.2	127.6	144.7	149.8	**165.1**	**na**
Residential electricity tariffs (USc kWh)	na	6.0	5.9	7.5	10.1	**12.4**	**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)	na	na	na	na	na	**na**	**na**
EBRD index of infrastructure reform	1.7	1.7	2.0	2.0	2.0	**2.0**	**2.3**
– Electric power	1.7	2.0	2.3	2.3	2.3	**2.3**	**2.3**
– Railways	1.0	1.0	1.0	1.0	1.0	**1.7**	**2.0**
– Roads	1.7	2.0	2.0	2.0	2.0	**2.0**	**2.3**
– Telecommunications	2.3	2.7	3.0	3.0	3.3	**3.3**	**3.3**
– Water and wastewater	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	2.5	4.4	4.2	8.6	10.7	**7.5**	**-4.1**
Industrial gross output	2.4	13.8	-1.9	1.0	0.4	**-2.0**	**na**
Agricultural gross output	na	na	na	na	na	**na**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	-6.1	13.0	-3.6	-2.3	0.7	**4.7**	**na**
Employment (end-year)	-3.3	29.9	2.0	3.7	5.5	**3.8**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	38.5	29.3	25.2	20.6	16.8	**17.5**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	6.7	2.4	2.3	3.0	4.2	**7.4**	**1.8**
Consumer prices (end-year)	6.2	1.5	2.4	2.8	7.7	**7.0**	**1.7**
Producer prices (annual average)	4.5	5.8	2.1	3.0	8.5	**7.5**	**na**
Gross average monthly earnings in economy (annual average)	17.8	12.2	7.6	15.3	14.1	**16.3**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	-3.1	-1.9	2.1	4.2	6.4	**1.5**	**-3.0**
General government expenditure	46.6	40.5	39.1	42.5	39.0	**42.9**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	na	16.3	49.6	87.9	72.9	**28.5**	**na**
Domestic credit (end-year)	na	42.4	10.6	142.3	175.5	**25.8**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	30.5	32.1	44.2	70.1	92.7	**101.8**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	na	na	na	na	na	**na**	**na**
Money market rate	na	na	na	na	na	**na**	**na**
Deposit rate	4.9	4.8	5.0	5.4	4.8	**na**	**na**
Lending rate (long-term)	na	na	12.1	9.9	9.2	**na**	**na**
			(Euros per US dollar)				
Exchange rate (official, end-year)	0.8	0.7	0.8	0.8	0.7	**0.7**	**na**
Exchange rate (official, annual average)	0.9	0.8	0.8	0.8	0.7	**0.7**	**na**
External sector			*(In millions of US dollars)*				
Current account	-116.3	-149.0	-197.3	-667.0	-1,129.6	**-1,617.3**	**-999.4**
Trade balance	-405.3	-517.9	-650.1	-1,066.4	-1,836.0	**-2,252.4**	**-1,738.7**
– Merchandise exports	305.9	561.4	581.8	813.9	903.0	**939.6**	**762.6**
– Merchandise imports	711.2	1,079.3	1,231.9	1,880.3	2,739.0	**3,192.1**	**2,501.2**
Foreign direct investment, net	44.0	63.3	481.9	585.3	717.4	**805.0**	**638.3**
Gross reserves, excluding gold (end-year)	63.7	82.0	204.0	432.7	732.4	**478.4**	**na**
External debt stock	462.1	488.8	524.5	939.0	1,841.0	**2,541.0**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	1.0	0.8	1.7	2.4	2.9	**1.5**	**na**
			(In per cent of exports of goods and services)				
Debt service	4.8	3.4	2.8	2.4	2.6	**2.4**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	0.7	0.7	0.7	0.7	0.7	**0.7**	**na**
GDP (in millions of euros)	1,510.0	1,670.0	1,815.0	2,149.0	2,810.0	**3,292.0**	**3,213.9**
GDP per capita (in US dollars)	2,582.8	3,142.8	3,478.3	4,084.2	5,827.2	**7,300.1**	**na**
Share of industry in GDP (in per cent)	na	na	na	na	na	**na**	**na**
Share of agriculture in GDP (in per cent)	na	na	na	na	na	**na**	**na**
Current account/GDP (in per cent)	-6.8	-7.2	-8.6	-24.7	-29.4	**-33.6**	**-22.8**
External debt - reserves (in US$ million)	398.4	406.8	320.5	506.3	1,108.6	**2,062.6**	**na**
External debt/GDP (in per cent)	27.1	23.6	22.8	34.8	47.9	**52.7**	**na**
External debt/exports of goods and services (in per cent)	88.6	56.1	52.6	70.1	100.9	**122.6**	**na**

Poland

Key developments and challenges

Poland has been less affected by the global financial crisis than most other countries in the region, reflecting its progress with macroeconomic policy in recent years. However, the fiscal balance and credit quality are deteriorating and unemployment is rising, providing significant challenges to macroeconomic and financial stability in the coming years.

Progress with privatisation, as well as further investment in transport and energy infrastructure, are key structural reform challenges in order to reap the efficiency gains of restructuring and secure higher potential future growth.

Additional efforts are required to provide better work incentives to raise the low rate of labour participation. Similarly, a greater focus is needed on measures to improve innovation and human capital in order to strengthen labour productivity and competitiveness.

Country data

Population (in millions)	**38.1**
Area ('000 sq km)	**313.9**
GDP (in billion US$, 2008)	**527.9**
Average transition score (scale: 1 to 4.33)	**3.78**

Progress in structural reform

Liberalisation and privatisation

As market conditions have had an adverse effect on the government's ambitious privatisation plans developed in 2008, the Ministry of Treasury has recently updated these plans. Up to Zl 36.7 billion (€8.7 billion) in privatisation revenues could be raised by the end of 2010, thereby helping to fund the rising budget deficit. The list of key projects focuses on companies in the energy and chemical sectors, including Enea, PGE and ZA Tarnów, the privatisation of the Warsaw Stock Exchange and the sale of minority stakes in several other large companies including KGHM, Europe's biggest copper producer.

Discussions to resolve the long-running dispute between the government and the Dutch insurer, Eureko, over the Polish insurance firm, PZU, have advanced with an agreement to pay Eureko as compensation for dropping Eureko's right to acquire a remaining stake to reach majority in PZU. Two important factors for the agreement relate to the dividend payout from previous years, which will strengthen both Eureko and the Polish government's liquidity; and the introduction of PZU on the stock exchange.

Infrastructure

Road construction infrastructure in Poland accelerated in 2008, partly because of the need to improve transport links ahead of the 2012 UEFA European football championship. A total of 241 km of motorways, express roads and ring roads was completed and another 475 km is currently under construction. Moreover, in the first half of 2009 contracts for the construction of a further 186 km of motorways were signed. Progress has partly reflected the removal of some legislative hurdles hindering construction as well as steps to bring environmental laws into accord with EU regulations. In addition, the costs of construction material and services have fallen while there has also been a reduction in labour supply constraints. Much of the financing has come from the European Union, but additional revenues have been sought through tolls and there are also plans to raise financing via bond issues at the end of 2009. Only two motorway stretches (the A1 and A2) are being constructed under public-private partnership (PPP) arrangements. Additional challenges remain however, with some 1,600 km of motorways and expressways to be constructed between 2010 and 2013.

Financial institutions

Poland's financial system is broadly sound and remains relatively unexposed to sophisticated financial instruments and high leverage. The loan-to-deposit ratio in the banking system is around 120 per cent, among the lowest in the central Europe and the Baltic states (CEB) region, and although foreign currency-denominated loans have become increasingly popular among households, their share in relation to GDP remains relatively low at around 16 per cent. However, the financial sector was heavily affected by the global financial crisis from October 2008, with capital outflows, rising interbank interest rates, reduced liquidity and a rapid depreciation of the Polish zloty. Having grown by an annual rate of over 40 per cent until September 2008, credit to the private sector has decelerated rapidly and turned negative by mid-2009. By February 2009 the zloty had depreciated by some 30 per cent against the euro, affecting households and firms with foreign currency loans, but since then it has recovered by some 15 per cent.

In response to the crisis, the government and central bank have taken measures to sustain economic growth during the financial crisis. The Confidence Pact by the central bank, announced in October 2008, aims to provide banks with zloty funds and foreign currencies and it broadened the banks' possibilities to obtain zloty liquidity through, for example, repo transactions. Swap arrangements with other central banks, including the Swiss National Bank and the European Central Bank, helped to calm fears over banks' foreign exchange liquidity, even if the scale of transactions was relatively low. The government focused on measures to strengthen the financial safety net, by improving cooperation between financial authorities, increasing the deposit guarantee to €50,000, and providing temporary support and recapitalisation of financial institutions. The government has also taken steps to stimulate investment and consumer demand by increasing State Treasury and loan guarantees for infrastructural and EU projects. In May 2009 the International Monetary Fund (IMF) approved a flexible credit line of US$ 20.6 billion for 12 months. This is intended as a precautionary credit line to strengthen investor confidence in Poland's capacity to access foreign funding.

Macroeconomic performance

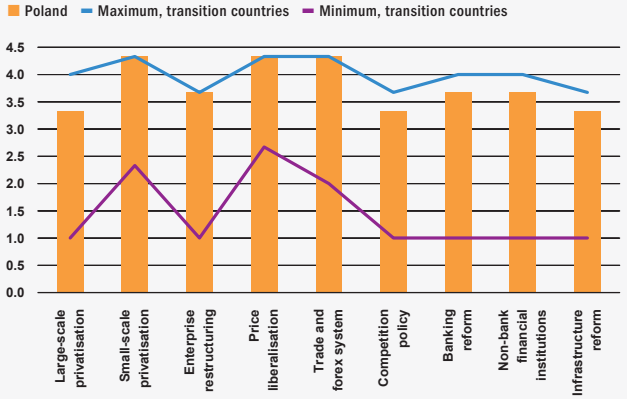
Real GDP growth slowed to 4.9 per cent in 2008 and further to 1.1 per cent (year on year) in the first half of 2009 as the financial turmoil started to affect Poland in late 2008. With the slow-down in economic activity, the unemployment rate rose to 8.2 per cent in July 2009. The reasons for Poland's relatively good performance reflect its comparatively small domestic and external imbalances before the crisis, the large domestic economy, a relatively un-leveraged banking system and less buoyant credit and housing markets in recent years. Moreover, with the rapid slow-down in import growth, partly reflecting the weakening currency, the contribution from net exports turned positive in early 2009. The annual rate of inflation slowed to 2.8 per cent in January 2009, but has since increased somewhat to 3.7 per cent in August in response to higher food and administered prices. The annual rate of wage increases slowed to 3.3 per cent in July 2009, compared with over 12 per cent a year ago, as labour market conditions weakened. In response, the Monetary Policy Council has decreased the policy interest rate six times since mid-2008, to 3.5 per cent by August 2009.

The improvements in the general government deficit in recent years have largely reflected cyclical rather than structural factors. Thus weaker economic growth has had a substantial impact on the public finances, with the fiscal deficit increasing to 3.9 per cent of GDP in 2008 (from 1.9 per cent in 2007) and widening further in the first half of 2009. Public debt increased to just over 47 per cent of GDP in 2008, among the highest in the CEB region. The current account deficit narrowed slightly to 4.4 per cent of GDP in 2008, and is expected to fall further in 2009 as the contraction in imports leads to a lower trade deficit. Inflows of foreign direct investment (FDI) moderated to US$ 11.7 billion in 2008, compared with a record of US$ 18 billion in 2007.

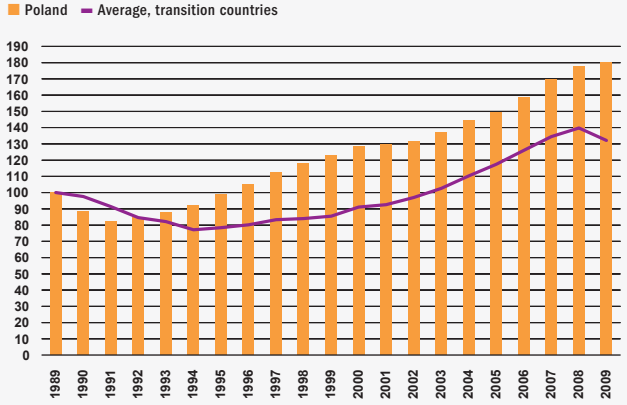
Outlook and risks

Although less vulnerable to the financial turmoil than many other countries, Poland is not immune to the global slow-down. GDP is projected to grow below potential in the coming years, while unemployment and credit quality are likely to continue to deteriorate. Growth is expected to be affected by reduced disposable income and frail financing conditions, with recovery dependent on a return of external demand and confidence in financial markets. The key challenges will be to ensure fiscal and financial stability. In addition, Poland has important investment needs in the coming years. The long-term outlook is largely dependent on progress in implementing important structural reforms including fiscal expenditure reform, privatisation, measures to improve the business environment and raise the exceptionally low labour participation rate (including the need to reform the farmers' social security system), as well as efforts to raise labour productivity, innovation and human capital. A credible plan for the adoption of the euro could help to anchor expectations and provide a medium-term goal for fiscal consolidation.

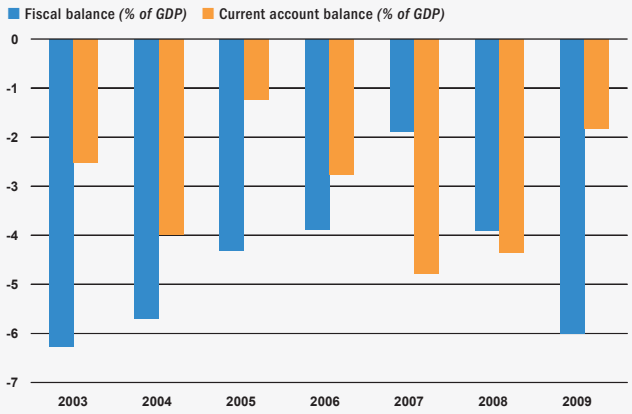
Transition indicators 2009



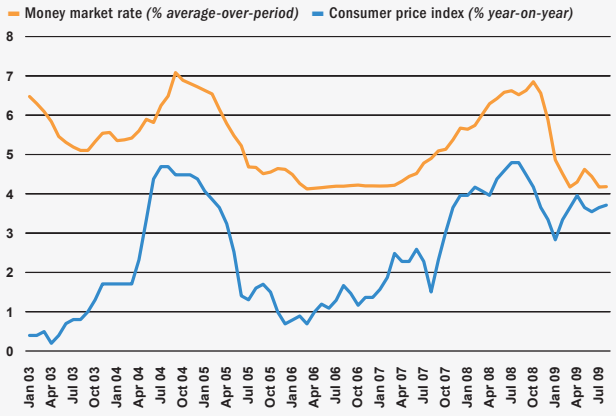
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **floating**

Wage regulation – **no**

Tradeability of land – **full except foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **modern/some defects**

Infrastructure

Telecoms regulatory assessment compliance – **full**

Independence of the electricity regulator – **full**

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

Independence of the road directorate – **partial**

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2.0 per cent** (2002)

Government expenditure on health – **4.2 per cent of GDP** (2004)

Government expenditure on education – **6.0 per cent of GDP** (2004)

Household expenditure on power and water – **6.8 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	12.4	13.5	13.9	14.0	14.2	**na**	**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)	68.5	70.3	70.5	71.0	73.3	**74.4**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	1.5	1.9	2.7	3.1	3.1	**3.0**	**na**
Share of industry in total employment (in per cent)	28.4	28.3	28.7	29.3	30.1	**31.5**	**na**
Change in labour productivity in industry (in per cent)	7.1	7.0	0.6	5.3	4.0	**na**	**na**
Investment/GDP (in per cent)	18.7	20.1	19.3	21.1	24.3	**23.9**	**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**
EBRD index of enterprise reform	3.3	3.3	3.7	3.7	3.7	**3.7**	**3.7**
Markets and trade							
Share of administered prices in CPI (in per cent)	1.0	1.0	1.2	1.0	1.0	**1.0**	**na**
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	**2.0**	**na**
Share of trade with non-transition countries (in per cent)	79.7	78.5	76.8	75.3	75.3	**74.3**	**na**
Share of trade in GDP (in per cent)	58.9	66.9	64.3	70.8	72.4	**72.0**	**na**
Tariff revenues (in per cent of imports)	1.7	0.9	0.4	0.4	0.4	**0.4**	**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**
EBRD index of competition policy	3.0	3.0	3.3	3.3	3.3	**3.3**	**3.3**
Financial sector							
Number of banks (foreign-owned)	58 (46)	57 (44)	61 (50)	63 (52)	64 (54)	**70 (60)**	**na**
Asset share of state-owned banks (in per cent)	25.8	21.7	21.5	21.1	19.5	**18.3**	**na**
Asset share of foreign-owned banks (in per cent)	71.5	71.3	74.3	74.2	75.5	**76.5**	**na**
Non-performing loans (in per cent of total loans)	25.1	17.4	11.6	7.7	5.4	**4.7**	**na**
Domestic credit to private sector (in per cent of GDP)	32.7	31.0	33.4	38.5	44.6	**55.0**	**na**
Domestic credit to households (in per cent of GDP)	10.3	10.6	12.4	15.6	20.0	**27.0**	**na**
– Of which mortgage lending (in per cent of GDP)	3.4	3.8	5.0	7.2	9.9	**15.0**	**na**
Stock market capitalisation (in per cent of GDP)	16.5	23.0	31.1	40.9	43.6	**21.0**	**na**
Stock trading volume (in per cent of market capitalisation)	26.6	33.1	36.3	45.3	47.5	**45.7**	**na**
Eurobond issuance (in per cent of GDP)	0.7	1.7	4.0	1.4	1.0	**0.4**	**na**
EBRD index of banking sector reform	3.3	3.3	3.7	3.7	3.7	**3.7**	**3.7**
EBRD index of reform of non-bank financial institutions	3.7	3.7	3.7	3.7	3.7	**3.7**	**3.7**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	32.1 (45.5)	32.8 (60.4)	31.0 (76.4)	30.1 (96.3)	27.1 (108.5)	**27.1 (108.5)**	**na**
Internet users (per 100 inhabitants)	24.9	29.2	35.3	40.4	43.9	**43.9**	**na**
Railway labour productivity (1989=100)	101.3	103.3	98.8	102.4	102.6	**97.9**	**na**
Residential electricity tariffs (USc kWh)	7.7	8.5	9.9	10.8	12.3	**20.0**	**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)	4.9	5.3	5.6	na	na	**na**	**na**
EBRD index of infrastructure reform	3.3	3.3	3.3	3.3	3.3	**3.3**	**3.3**
– Electric power	3.3	3.3	3.3	3.3	3.3	**3.3**	**3.3**
– Railways	4.0	4.0	4.0	4.0	4.0	**4.0**	**4.0**
– Roads	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Telecommunications	4.0	4.0	4.0	4.0	4.0	**4.0**	**4.0**
– Water and wastewater	3.3	3.3	3.3	3.3	3.3	**3.3**	**3.3**

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	3.9	5.3	3.6	6.2	6.8	**4.9**	**1.4**
– Private consumption	2.1	4.7	2.1	5.0	5.0	**5.4**	**na**
– Public consumption	4.9	3.1	5.2	6.1	3.7	**7.6**	**na**
– Gross fixed capital formation	-0.1	6.4	6.5	14.9	17.6	**8.1**	**na**
– Exports of goods and services	14.2	14.0	8.0	14.6	9.1	**7.2**	**na**
– Imports of goods and services	9.6	15.8	4.7	17.3	13.6	**8.3**	**na**
Industrial gross output	5.9	9.1	4.4	11.6	11.3	**na**	**na**
Agricultural gross output	2.7	6.9	-1.0	-2.2	-3.4	**na**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	-0.6	0.9	0.8	-1.7	0.0	**1.0**	**na**
Employment (end-year)	0.0	2.5	2.4	3.6	4.2	**3.0**	**na**
			(In per cent of labour force)				
Unemployment (end-year)[1]	19.3	18.0	16.7	12.2	8.5	**6.7**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	0.8	3.5	2.2	1.2	2.5	**4.2**	**3.4**
Consumer prices (end-year)	1.7	4.4	0.7	1.4	4.0	**3.3**	**3.1**
Producer prices (annual average)	2.7	7.1	0.7	2.2	2.2	**2.6**	**na**
Producer prices (end-year)	3.7	5.4	0.2	2.4	2.3	**2.7**	**na**
Gross average monthly earnings in economy (annual average)	3.2	4.0	9.8	5.0	9.4	**10.0**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	-6.3	-5.7	-4.3	-3.9	-1.9	**-3.9**	**-6.0**
General government expenditure	44.6	42.6	43.4	43.8	42.1	**43.1**	**na**
General government debt	47.1	45.7	47.1	47.7	44.8	**47.1**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	5.7	7.5	12.6	15.9	14.2	**16.5**	**na**
Domestic credit (end-year)[2]	5.2	4.2	13.8	23.0	27.0	**32.5**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	40.7	39.9	42.2	45.4	46.7	**50.3**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Rate on 7-day open market operations[3]	5.3	6.5	4.5	4.0	5.0	**5.0**	**na**
3-months WIBOR	5.6	6.7	4.6	4.2	5.7	**5.9**	**na**
Deposit rate[4]	2.9	2.9	3.4	3.1	3.8	**6.0**	**na**
Lending rate[4]	9.6	10.3	7.6	7.2	8.3	**9.6**	**na**
			(Zlotys per US dollar)				
Exchange rate (end-year)	3.8	3.0	3.3	2.9	2.4	**3.0**	**na**
Exchange rate (annual average)	3.9	3.7	3.2	3.1	2.8	**2.4**	**na**
External sector			*(In millions of US dollars)*				
Current account	-5,473.0	-10,067.0	-3,716.0	-9,394.0	na	**na**	**na**
Trade balance	-5,725.0	-5,622.0	-2,766.0	-7,006.0	-17,057.0	**-23,228.0**	**-9,444.0**
– Merchandise exports	61,007.0	81,862.0	96,395.0	117,468.0	145,337.0	**178,427.0**	**127,031.0**
– Merchandise imports	66,732.0	87,484.0	99,161.0	124,474.0	162,394.0	**201,655.0**	**136,475.0**
Foreign direct investment, net	4,284.0	11,761.0	6,951.0	10,727.0	17,987.0	**11,747.0**	**4,134.0**
Gross reserves, excluding gold (end-year)	32,594.0	35,335.0	40,875.0	46,381.0	62,978.0	**59,318.0**	**na**
External debt stock	107,274.0	129,990.0	132,927.0	169,636.0	233,074.0	**243,636.0**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	5.0	4.2	4.3	3.9	4.1	**3.1**	**na**
			(In per cent of exports of goods and services)				
Debt service	na	na	13.0	15.0	10.0	**10.4**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	38.2	38.2	38.2	38.1	38.1	**38.1**	**na**
GDP (in billions of zlotys)	843.2	924.5	983.3	1,060.0	1,176.7	**1,271.7**	**1,332.1**
GDP per capita (in US dollars)	5,674.7	6,624.9	7,967.1	8,956.1	11,152.2	**13,854.6**	**na**
Share of industry in GDP (in per cent)	29.2	30.8	30.7	31.3	26.3	**25.4**	**na**
Share of agriculture in GDP (in per cent)	4.4	5.1	4.5	4.3	4.3	**4.5**	**na**
Current account/GDP (in per cent)	-2.5	-4.0	-1.2	-2.8	na	**na**	**na**
External debt – reserves (in US$ million)	74,680.0	94,655.0	92,052.0	123,255.0	170,096.0	**0.0**	**na**
External debt/GDP (in per cent)	49.5	51.4	43.7	49.7	54.8	**46.2**	**na**
External debt/exports of goods and services (in per cent)	148.6	136.4	118.0	122.9	133.8	**113.8**	**na**

[1] According to Eurostat (ESA95).

[2] Includes domestic credit to non-financial sector and general government.

[3] In 2003 and 2004 the rate refers to 14-day open market operations.

[4] Weighted average, as reported by the National Bank of Poland. Calculation of the new rates has been conceptually adjusted to harmonised ECB requirements. The data since 2004 are adjusted to the new methodology.

Romania

Key developments and challenges

Businesses continue to struggle to maintain competitiveness in the EU single market, a problem exacerbated by the global economic crisis. Further efforts are needed to implement reforms in the areas of judiciary, business registration and law enforcement.

The banking sector is reasonably liquid and adequately capitalised but may be subject to further stresses. Close cooperation among regulators, domestic and foreign banks and international institutions is essential to ensure that the system continues to function smoothly and that private sector lending remains sufficient to meet investment needs.

The dramatic fall in economic growth is putting increasing strain on public finances. The government will need to show restraint on spending in order to maintain overall macroeconomic stability and to keep to its agreed commitments with international financial institutions.

Country data

Population (in millions)	**21.7**
Area ('000 sq km)	**238.4**
GDP (in billion US$, 2008)	**199.7**
Average transition score (scale: 1 to 4.33)	**3.44**

Progress in structural reform

Business environment and competition

Romania was ranked 55th in the World Bank's *Doing Business 2010* survey, down 10 places compared with the previous year. The main problems appear to lie with difficulties in employing workers, where the country ranks 113th, and in paying taxes (ranked 149th). These findings reflect some of the conclusions from the latest round of the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), where nearly 28 per cent of respondents claimed that tax rates were the biggest hindrance to doing business, and approximately 20 per cent of enterprises cited an inadequately educated workforce as the most significant obstacle. This may reflect the exceptionally low levels of unemployment in recent years, which has created difficulties for some rapidly expanding firms in finding well-qualified employees, although the rate has risen sharply in 2009 as a result of the deep recession.

Romania has taken a number of positive steps over the past year in the areas of judicial reform and the fight against corruption, according to the European Commission (EC's) latest annual assessment on progress under the Co-operation and Verification Mechanism, published in July 2009. The report stated that a new momentum had been established, but also noted that reforms had not yet taken hold and that there were still significant shortcomings in both areas. The situation will be reassessed by the European Commission in summer 2010.

Infrastructure

In the energy sector, the new government has amended the previous government's plans to set up a "National Champion". The new plan envisages the establishment of two nationally integrated companies, both of which would combine power generation (hydro, thermal and nuclear) with mines. Together, the two companies would initially account for around 90 per cent of electricity generation in the country, but this share would be expected to fall over time as extra generating capacity is created by private operators. The aim is for the two companies to compete against each other, but there are remaining concerns about the concentration of market power and the possible cross-subsidisation of inefficient and loss-making units within each company.

The Vinci-Aktor consortium was announced as the preferred winner of a tender for a 30-year concession on the Comarnic-Brasov highway in May 2009. The cost of the lease is in excess of €2 billion. Work on upgrading the highway is expected to begin in 2010 and to last approximately four years.

Financial sector

The main banks and the regulators have reacted well to the financial crisis. Overall, the system is well capitalised and has adequate liquidity, and to date most banks have been able to cope with the economic downturn. The support of foreign banks, whose subsidiaries dominate the market, has been crucial. At three meetings in March, May and August 2009, nine major foreign parent banks, representing more than 70 per cent of banking sector capital in Romania, committed to maintaining their existing overall level of exposure to the country and to increasing capital as required to maintain their capital adequacy ratio above 10 per cent. The average level of capital adequacy for the banking system at mid-year 2009 is 13.5 per cent. Stress tests carried out by the central bank in the first half of 2009 implied that some recapitalisation, of around €1 billion, would be needed to meet the new target of 10 per cent, depending on the extent of the economic downturn.

Social sector

A number of developments have taken place in the pension system during the past year, with important implications for the system's future sustainability. A 20 per cent increase in state pensions was brought forward by the previous government ahead of the general election last year. However, in recognition of the constrained fiscal situation, a revised legal framework on pensions, scheduled for approval by the end of 2009, will ensure a gradual move to indexation to inflation rather than average salary. In addition, starting from 2015, the age of retirement for women will be gradually equalised to 65 years, while the tax base will be enlarged by the inclusion in the tax net of the non-contributive employment segment. Meanwhile, the number of voluntary private pension schemes had risen to 13 by mid-2009 and these funds continue to generate good returns (7 per cent in the first half of 2009) despite the difficult economic climate.

Macroeconomic performance

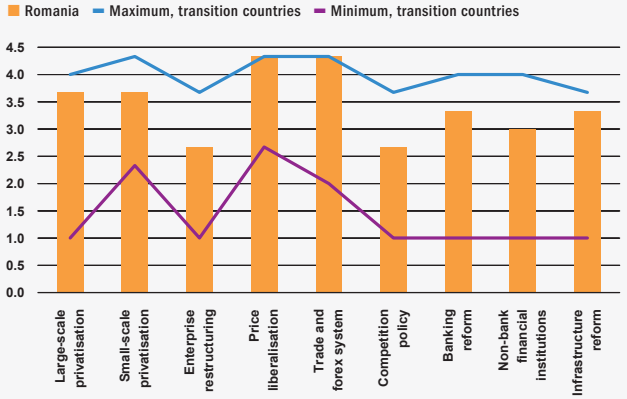
Economic activity weakened significantly in 2009, as a result of the financial crisis, after several years of very strong performance which culminated in a real GDP growth rate of 7.1 per cent in 2008. As of mid-2009, the economy was in a sharp recession. Industrial output was down by about 15 per cent year on year according to the mid-year monthly figures, while exports fell by more than 20 per cent over the same period. Construction activity fell sharply and credit growth slowed from the very high rates recorded in previous years to 11.2 per cent year on year in June as a result of the difficulties banks were facing finding viable projects.

In March 2009 the government agreed a two-year macroeconomic stabilisation stand-by agreement with the International Monetary Fund (IMF), backed by a €12.95 billion loan as part of a broader external aid package. The additional foreign financing will be provided by the European Union, the World Bank, the EBRD and the European Investment Bank. Under the terms of the programme, the government deficit was originally targeted at 4.6 per cent of GDP this year, but once the full extent of the economic downturn became clear, the target was revised in August 2009 to 7.3 per cent of GDP. Achieving this will require significant spending cuts, while part of the IMF's funding will be used for budget deficit financing. The central bank is aiming to lower annual inflation to within a targeted band of 3.5 per cent +/- one per cent by year-end; the rate fell to 5 per cent by the end of August 2009 compared with 6.3 per cent at the end of 2008. The government also announced in February 2009 the launch of a €13 billion stimulus package to help the country through the global economic crisis. Some €10.2 billion, equivalent to 7 per cent of GDP, will be spent on investments, mainly in infrastructure. The central bank has cut the key policy rate several times this year, with the latest cut in September from 8.5 to 8.0 per cent. The previous cut (in August) was accompanied by a reduction in the minimum reserve requirement rate for foreign currency liabilities with a residual maturity of less than two years and no pre-payment clauses, from 35 to 30 per cent.

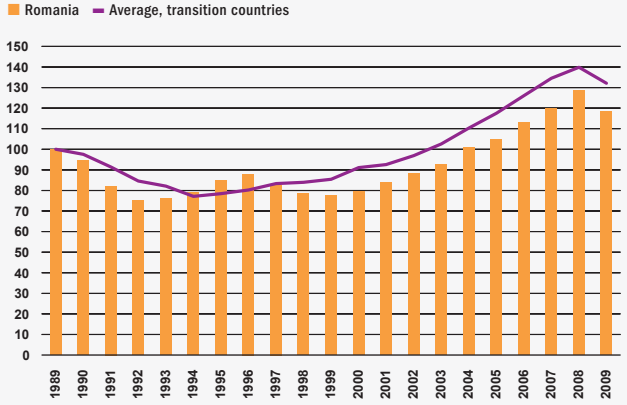
Outlook and risks

The economy is likely to suffer a significant output contraction of around 8 per cent in 2009, and a slow recovery is expected in the short term. The growth slow-down in Europe will have a negative impact on Romanian exports, while the global liquidity crunch will exacerbate external financing pressures and may also slow domestic investment. Highly leveraged sectors, such as real estate and construction, are likely to be the worst affected, and many small and medium-sized enterprises (SMEs) are also experiencing difficulties. The extent of foreign bank funding of domestic credit makes the country vulnerable to capital outflows, which could have knock-on effects for the banking, corporate and household sectors. However, this risk is mitigated by the strong support received from international financial institutions and the commitment of foreign parent banks to their subsidiaries in Romania. In addition, the current account deficit has fallen significantly this year (projected at around 6.0 per cent of GDP for 2009, compared with 12.3 per cent in 2008), helping to reduce vulnerabilities and alleviate risk perceptions. Over the medium term, Romania has favourable prospects for growth, with a well-diversified export structure, strategic location and potential for further catch-up on the rest of the European Union.

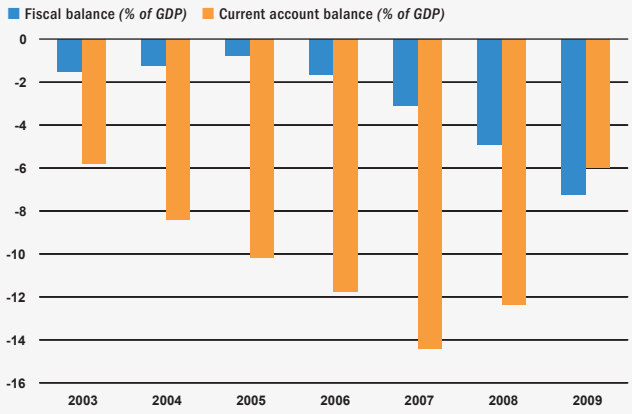
Transition indicators 2009



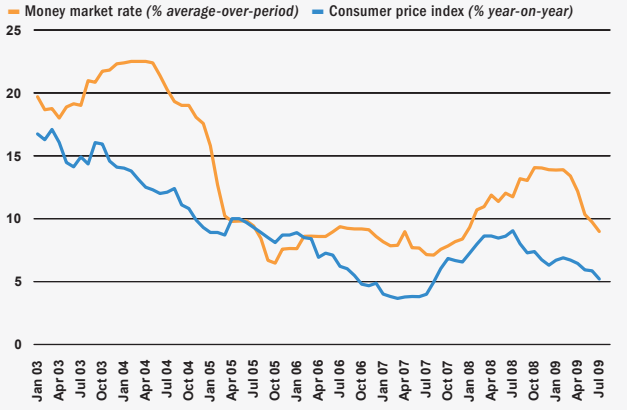
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Telecoms regulatory assessment compliance – **full**	Capital adequacy ratio – **12 per cent**	Share of population living in poverty – **3.4 per cent** (2005)
Controls on inward direct investment – **no**	Quality of insolvency law – **high**	Independence of the electricity regulator – **full**	Deposit insurance system – **yes**	Government expenditure on health – **4.5 per cent of GDP** (2006)
Interest rate liberalisation – **full**	Secured transactions law – **advanced**	Separation of railway infrastructure from operations – **full**	Private pension funds – **yes**	Government expenditure on education – **3.5 per cent** (2006)
Exchange rate regime – **managed float**		Independence of the road directorate – **full**		Household expenditure on power and water – **3.7 per cent**
Wage regulation – **yes**				
Tradeability of land – **full within EU**				

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	8.9	9.2	9.5	9.8	9.9	**10.0**	**na**
Private sector share in GDP (in per cent)	65.0	70.0	70.0	70.0	70.0	**70.0**	**70.0**
Private sector share in employment (in per cent)	56.5	58.0	64.9	66.3	68.0	**69.0**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	13.5	14.6	14.2	14.7	16.3	**17.1**	**na**
Share of industry in total employment (in per cent)	30.2	31.8	36.9	34.3	31.7	**na**	**na**
Change in labour productivity in industry (in per cent)	9.2	-0.3	74.8	12.7	9.1	**na**	**na**
Investment/GDP (in per cent)	21.8	23.8	22.6	26.5	31.6	**31.4**	**na**
EBRD index of small-scale privatisation	3.7	3.7	3.7	3.7	3.7	**3.7**	**3.7**
EBRD index of large-scale privatisation	3.3	3.7	3.7	3.7	3.7	**3.7**	**3.7**
EBRD index of enterprise reform	2.0	2.0	2.3	2.7	2.7	**2.7**	**2.7**
Markets and trade							
Share of administered prices in CPI (in per cent)	21.5	22.4	21.9	20.6	21.4	**21.0**	**na**
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
Share of trade with non-transition countries (in per cent)	77.5	75.1	72.5	71.8	68.7	**66.1**	**na**
Share of trade in GDP (in per cent)	66.7	71.0	66.9	64.9	63.1	**56.6**	**na**
Tariff revenues (in per cent of imports)	1.8	1.5	na	na	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	4.3	4.3	4.3	4.3	4.3	**4.3**	**4.3**
EBRD index of competition policy	2.3	2.3	2.3	2.7	2.7	**2.7**	**2.7**
Financial sector							
Number of banks (foreign-owned)	30 (21)	32 (23)	33 (24)	31 (26)	31 (26)	**32 (27)**	**na**
Asset share of state-owned banks (in per cent)	40.6	7.5	6.5	5.9	5.7	**5.6**	**na**
Asset share of foreign-owned banks (in per cent)	54.8	58.5	59.2	87.9	87.3	**87.7**	**na**
Non-performing loans (in per cent of total loans)	1.5	1.7	1.7	1.8	3.0	**4.5**	**na**
Domestic credit to private sector (in per cent of GDP)	13.7	15.7	20.0	25.9	35.8	**38.5**	**na**
Domestic credit to households (in per cent of GDP)	3.8	4.8	7.2	11.2	17.7	**18.8**	**na**
– Of which mortgage lending (in per cent of GDP)	0.3	0.5	0.6	0.9	1.4	**3.8**	**na**
Stock market capitalisation (in per cent of GDP)	9.2	13.9	22.2	24.4	27.3	**11.2**	**na**
Stock trading volume (in per cent of market capitalisation)	8.8	11.6	21.0	16.0	20.8	**11.3**	**na**
Eurobond issuance (in per cent of GDP)	0.9	0.0	1.2	0.0	0.0	**0.2**	**na**
EBRD index of banking sector reform	2.7	3.0	3.0	3.0	3.3	**3.3**	**3.3**
EBRD index of reform of non-bank financial institutions	2.3	2.3	2.3	2.3	2.7	**3.0**	**3.0**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	19.8 (32.3)	20.2 (47.0)	20.3 (61.7)	19.5 (74.2)	19.9 (95.2)	**23.6 (114.5)**	**na**
Internet users (per 100 inhabitants)	8.9	12.0	16.6	21.1	24.0	**24.0**	**na**
Railway labour productivity (1989=100)	53.7	60.0	55.1	63.2	60.3	**51.5**	**na**
Residential electricity tariffs (USc kWh)	8.1	8.6	11.3	12.9	15.9	**14.5**	**na**
Average collection rate, electricity (in per cent)	98	100	99	100	na	**na**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	4.4	4.9	5.3	na	na	**na**	**na**
EBRD index of infrastructure reform	3.0	3.3	3.3	3.3	3.3	**3.3**	**3.3**
– Electric power	3.0	3.3	3.3	3.3	3.7	**3.7**	**3.7**
– Railways	4.0	4.0	4.0	4.0	4.0	**4.0**	**4.0**
– Roads	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Telecommunications	3.0	3.0	3.0	3.3	3.3	**3.3**	**3.3**
– Water and wastewater	3.0	3.3	3.3	3.3	3.3	**3.3**	**3.3**

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	5.2	8.5	4.2	7.9	6.0	**7.1**	**-8.0**
– Private consumption	8.4	14.6	9.9	12.4	11.0	**10.8**	**na**
– Public consumption	7.7	-4.9	8.5	-3.1	5.6	**5.2**	**na**
– Gross fixed capital formation	8.6	11.1	12.7	19.3	28.9	**8.3**	**na**
– Exports of goods and services	8.4	13.9	7.7	10.6	8.8	**8.0**	**na**
– Imports of goods and services	16.0	22.1	16.0	22.4	26.1	**20.9**	**na**
Industrial gross output, unadjusted series	3.1	5.3	2.1	7.2	5.4	**5.0**	**na**
Agricultural gross output	7.6	16.8	-13.9	3.3	-17.0	**10.0**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	-9.9	-0.2	-1.7	0.3	0.4	**1.6**	**na**
Employment (end-year)	-8.1	0.7	-0.7	0.7	1.6	**2.0**	**na**
			(In per cent of labour force)				
Unemployment (end-year)[1]	7.2	8.8	5.9	5.1	4.1	**4.4**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	15.4	12.0	9.5	6.9	4.8	**7.9**	**5.3**
Consumer prices (end-year)	14.1	9.3	8.6	4.9	6.6	**6.3**	**4.5**
Producer prices (annual average)	19.5	18.5	12.3	11.9	8.6	**18.0**	**na**
Producer prices (end-year)	19.6	18.5	12.5	12.0	8.7	**18.5**	**na**
Gross average monthly earnings in economy (annual average)	23.6	22.5	17.0	18.9	22.6	**23.6**	**na**
Government sector			*(In per cent of GDP)*				
General government balance[2]	-1.5	-1.2	-0.8	-1.6	-3.1	**-4.9**	**-7.3**
General government expenditure	33.6	33.6	31.2	32.7	34.5	**37.6**	**na**
General government debt[2]	21.5	18.8	20.1	18.0	20.0	**21.6**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	23.3	37.1	36.5	28.1	34.0	**17.4**	**na**
Domestic credit (end-year)	49.0	40.2	43.7	52.0	64.5	**33.0**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	23.3	25.6	29.9	32.1	36.6	**34.5**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	20.4	18.0	7.5	8.8	7.5	**10.3**	**na**
1-week BUBOR	19.0	20.0	9.0	8.3	7.6	**11.4**	**na**
Deposit rate (average)	11.0	11.5	6.4	4.8	6.7	**9.5**	**na**
Lending rate (average)	25.4	25.6	19.6	14.0	13.4	**15.0**	**na**
			(Lei per US dollar)				
Exchange rate (end-year)[3]	3.3	2.9	3.1	2.6	2.5	**2.8**	**na**
Exchange rate (annual average)[3]	3.3	3.3	2.9	2.8	2.4	**2.5**	**na**
External sector			*(In millions of US dollars)*				
Current account	-3,454.5	-6,333.3	-10,054.2	-14,446.0	-23,842.7	**-24,554.6**	**-10,000.0**
Trade balance	-4,464.9	-6,611.5	-9,873.3	-14,770.1	-24,137.9	**-26,750.0**	**-11,000.0**
– Merchandise exports	17,627.0	23,518.4	28,148.9	32,469.4	40,175.6	**43,000.0**	**37,000.0**
– Merchandise imports	22,091.9	30,129.8	38,022.2	47,239.5	64,313.4	**69,750.0**	**48,000.0**
Foreign direct investment, net	2,156.2	6,368.0	6,587.3	10,956.7	9,629.2	**13,519.1**	**4,900.0**
Gross reserves, excluding gold (end-year)	8,049.9	14,805.6	25,668.8	32,242.0	38,219.3	**39,742.0**	**na**
External debt stock	22,398.0	29,700.8	38,501.0	52,680.6	80,364.5	**98,404.8**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.9	5.2	7.1	7.1	6.2	**6.1**	**na**
			(In per cent of exports of goods and services)				
Debt service[4]	16.7	15.5	20.0	21.7	24.6	**25.8**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	21.7	21.7	21.7	21.7	21.7	**21.7**	**na**
GDP (in billions of lei)[3]	197.6	246.5	288.2	344.5	404.7	**503.6**	**531.0**
GDP per capita (in US dollars)	2,738.0	3,484.5	4,550.7	5,651.5	7,636.0	**9,246.5**	**na**
Share of industry in GDP (in per cent)	25.0	24.7	24.6	24.3	24.4	**22.9**	**na**
Share of agriculture in GDP (in per cent)	11.6	12.6	8.4	7.8	5.8	**6.5**	**na**
Current account/GDP (in per cent)	-5.8	-8.4	-10.2	-11.8	-14.4	**-12.2**	**-5.8**
External debt – reserves (in US$ million)	14,348.2	14,895.2	12,832.2	20,438.6	42,145.2	**58,662.8**	**na**
External debt/GDP (in per cent)	37.6	39.3	38.9	42.9	48.5	**49.0**	**na**
External debt/exports of goods and services (in per cent)	108.5	109.5	116.2	133.4	158.9	**190.0**	**na**

[1] Officially registered unemployed. According to the ILO methodology, the rate of unemployment in Romania is lower than the official one.

[2] Calculated according to Eurostat methodology (ESA95).

[3] The Romanian lei was redenominated in July 2005. All data have been converted to new lei (RON).

[4] Debt service payments on private and public external debt.

Russia

Key developments and challenges

The economic downturn and fall in global commodity prices has emphasised the importance of further diversifying output and exports for sustainable long-term economic development. This will rely on upgrading infrastructure, strengthening competition and promoting innovation.

Timely measures such as ample liquidity support and the extension of deposit insurance, have helped to preserve financial stability. It is important that the supervisory authorities closely monitor the loan portfolio, enhance the standards of asset quality disclosure and preserve competition among private and public banks.

Prudent management of the resource boom helped the government accumulate substantial fiscal and foreign currency reserves, enabling it to deploy a sizeable stimulus package for the economy. The government must balance the prudent management of reserves and measures to boost domestic demand to achieve and sustain economic recovery.

Country data

Population (in millions)	142.0
Area ('000 sq km)	17,075.0
GDP (in billion US$, 2008)	1,676.6
Average transition score (scale: 1 to 4.33)	3.04

Progress in structural reform

Liberalisation and privatisation

To support struggling domestic industries during the financial crisis, Russia introduced a number of temporary protectionist measures in individual sectors including, for example, higher import duties on used cars from January 2009. While World Trade Organization (WTO) accession remains firmly on the agenda, recent statements by the authorities have been conflicting, leaving it unclear whether Russia will seek entry on its own or as part of a customs union with Belarus and Kazakhstan. The uncertainty casts doubt over the prospects of swift accession.

During the early stages of the crisis a few sizeable banks on the brink of failure, including Svyazbank and Globex, were swiftly nationalised through take-overs by state-owned entities. In the enterprise sector the role of state corporations has also been gradually increasing.

Business environment and competition

A number of measures have been adopted to fight corruption and improve the business environment. In December 2008 parliament passed a new law to combat corruption as well as a law protecting companies and entrepreneurs from predatory behaviour by regulators and supervisory agencies. More recently, in March 2009, a five-year programme of state service reforms was announced that includes the introduction of performance incentives for public servants. In April 2009 the Prosecutor General's Office created a new unit with offices in all regions to tighten enforcement of the law on protection of the rights of entrepreneurs whose businesses are subject to inspection by state agencies. In the same month a new law on the public disclosure of assets held by government officials and their families was implemented. The law constitutes a step towards greater transparency and higher ethical standards in government. Registration procedures for small and medium-sized enterprises (SMEs) in selected sectors, such as hotels and textiles, were streamlined in July 2009. Effective implementation of these laws and measures is yet to be tested.

The competition authority reviewed a growing number of cases of suspected violations of the competition law. It imposed heavy fines on several large oil and gas companies for abuse of market power.

The business environment remains difficult, in particular for SMEs, as reflected in their relatively modest shares in output and employment. Excessive regulation, notably in the form of licensing and permit procedures, negatively affects economic activity and innovation. Almost one in five respondents of the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV) named corruption or the need to obtain various licences and permits as the main obstacles to doing business.

Infrastructure

In June 2009 one of the landmark public-private partnerships (PPP) tenders a long-term concession for the redevelopment and operation of Pulkovo airport in St. Petersburg was successfully completed. The winner was a consortium of the state-owned bank, VTB, and Fraport, a foreign strategic investor. Following the unbundling and privatisation of electricity generation companies, the share of electricity traded in the liberalised market had increased from 30 to 50 per cent by mid-2009. However, the economic downturn risks delays or even reversals in the implementation of power sector reform, including the further planned liberalisation of energy trading and development of the capacity market.

Financial sector

The difficult operating environment in the banking sector forced many private banks to deleverage their balance sheets. The authorities responded with a series of measures, deployed in a timely manner and benefiting a wide range of players, to preserve financial stability. These measures included the provision of uncollateralised loans, expansion of deposit insurance coverage, capital injections into state-owned banks and placement of Treasury deposits with select commercial banks. The result has been a gradual increase in the market share of state-owned banks, albeit at a relatively slow pace.

The effect of the economic downturn on the consolidation in the financial sector has so far been limited, but may become more pronounced over time. In addition to a few banks that were nationalised, several smaller banks on the verge of failure were taken over by private banks, backed by long-term funding from the Deposit Insurance Agency. The new minimum capital requirement of 90 million roubles (€2 million), due to come into force in January 2010, will mean that around 150 small banks will be required to raise new capital or seek mergers. A further increase in minimum capital requirements – to 180 million roubles – is planned from 1 January 2012 and this could affect another 200 banks. While the situation with non-performing loans has remained manageable to date, the recession highlighted the need to strengthen the standards of asset quality disclosure by banks.

Macroeconomic performance

The Russian economy has been adversely affected by the global crisis through a number of channels. First, the economy has been exposed to a sharp terms-of-trade shock as the price of Urals brand oil plummeted from US$ 138 per barrel (pb) in July 2008 to an average of around US$ 44 pb in the first four months of 2009 before recovering to US$ 65 to US$ 70 pb in June. Prices of ore, metals and steel also fell sharply from their mid-2008 levels. Second, in August 2008 Russia experienced a large scale capital outflow as well as a withdrawal of deposits from the banking system, in particular from medium-sized and regional banks. These events prompted the central bank to inject large amounts of liquidity into the banking sector and to permit a gradual depreciation of the rouble by about 25 per cent against the dollar-euro basket. The stock market also lost around three-quarters of its capitalisation before bouncing back somewhat by mid-2009. The availability of trade finance and micro, small and medium-sized enterprises (MSMEs) credit has been sharply reduced, and the syndications markets have been shut for all but a few major borrowers.

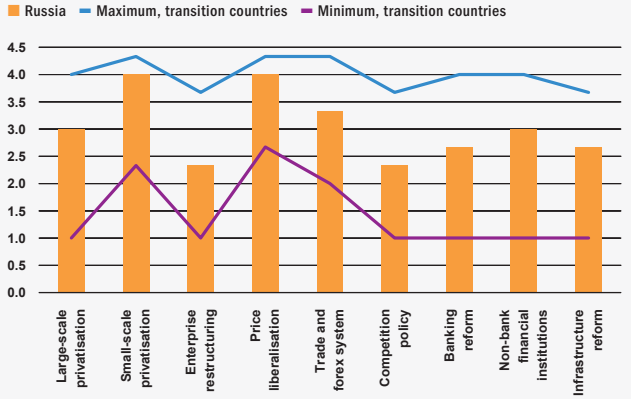
Lastly, weaker domestic and external demand and tight credit conditions have had a marked impact on the real sector. In the first half of 2009 industrial production declined by 15 per cent year on year, with the steepest declines in the automotive and construction-related sectors. Large corporates have been forced to scale down, postpone or cancel large modernisation projects, including those with important energy efficiency components. In the first and second quarters of 2009 output contracted by 9.8 and 10.9 per cent, respectively, year on year.

The government adopted a comprehensive fiscal stimulus package in April 2009, backed by its large fiscal reserves. The package centres on social transfers (unemployment benefits, retraining programmes, pensions, transfers to subnational governments primarily responsible for education, health and housing), as well as support for selected companies in single-industry towns. The budget deficit is expected to be less than 9 per cent of GDP in 2009, declining to around 7 per cent in 2010. In order to establish a market benchmark should the downturn prove to be longer than expected and external financing subsequently needed, a eurobond issue is being considered and a roadshow planned for late in 2009.

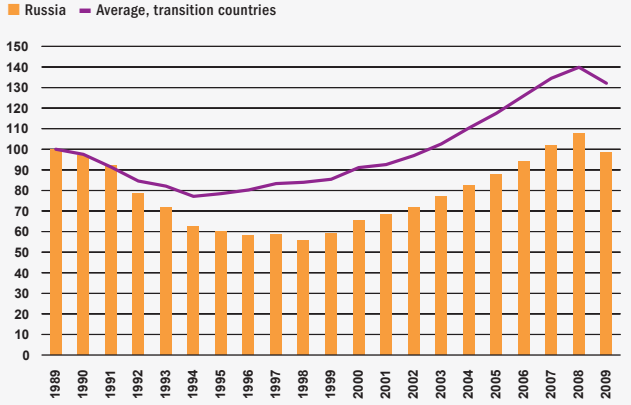
Outlook and risks

The stimulus provided by the fiscal package and liquidity injections into the banking system are expected to arrest the sharp fall in output observed in early 2009, with the economy returning to growth in late 2009 or 2010, supported by a combination of higher commodity prices, fiscal stimulus and a gradual recovery of external demand. However, the economy remains highly dependent on oil and gas export receipts, and the main risk is of a further decline in commodity prices which could delay recovery and put pressure on the rouble and the financial system.

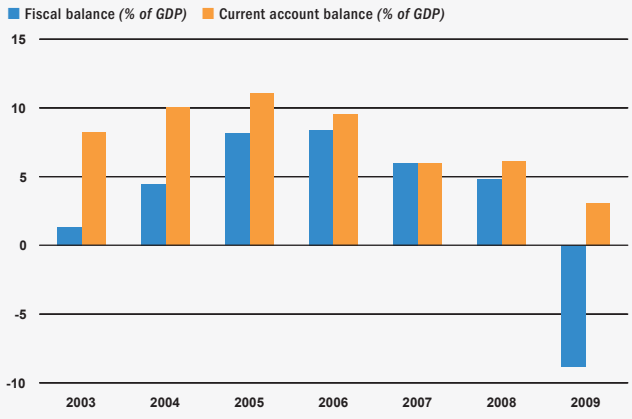
Transition indicators 2009



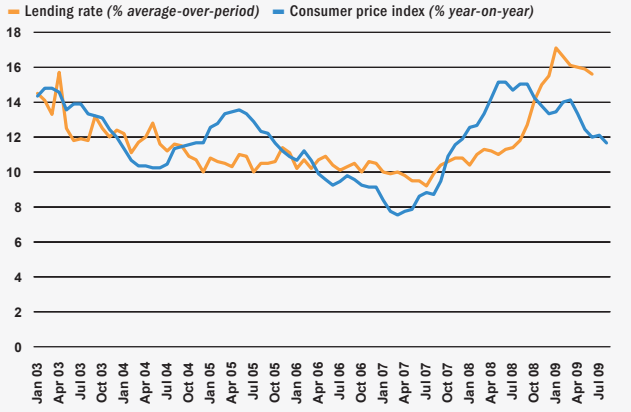
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

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

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradeability of land – **limited de facto**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **under development**

Infrastructure

Telecoms regulatory assessment compliance – **medium**

Independence of electricity regulator – **partial**

Separation of railway infrastructure from operation – **partial**

Independence of the road directorate – **partial**

Financial sector

Capital adequacy ratio – **10-11 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2.0 per cent** (2005)

Government expenditure on health – **3.7 per cent** (2008)

Government expenditure on education – **4.0 per cent** (2008)

Household expenditure on power and water – **6.6 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	5.6	6.2	6.3	6.4	6.5	**6.5**	na
Private sector share in GDP (in per cent)	70.0	70.0	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
Budgetary subsidies and current transfers (in per cent of GDP)[2]	4.3	3.7	3.5	3.5	4.7	**5.4**	na
Share of industry in total employment (in per cent)	22.6	22.2	21.7	21.3	21.2	**21.2**	na
Change in labour productivity in industry (in per cent)	8.4	8.9	6.2	5.8	6.4	**6.5**	na
Investment/GDP (in per cent)	20.8	20.9	20.1	21.4	24.3	**25.5**	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	3.0	3.0	3.0	**3.0**	**3.0**
EBRD index of enterprise reform	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
Markets and trade							
Share of administered prices in CPI (in per cent)	13.0	13.0	13.0	6.7	6.7	**na**	na
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	1.0	1.0	**1.0**	na
Share of trade with non-transition countries (in per cent)	66.5	71.5	69.4	71.2	69.4	**68.6**	na
Share of trade in GDP (in per cent)	49.1	47.4	48.3	47.3	44.6	**45.5**	na
Tariff revenues (in per cent of imports)[3]	19.4	30.6	47.4	51.6	42.1	**49.4**	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	**4.0**	**4.0**
EBRD index of forex and trade liberalisation	3.3	3.3	3.3	3.3	3.3	**3.3**	**3.3**
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
Financial sector							
Number of banks (foreign-owned)	1329 (41)	1299 (42)	1253 (52)	1189 (65)	1136 (86)	**1108 (102)**	na
Asset share of state-owned banks (in per cent)	na	na	na	na	na	**37.5**	na
Asset share of foreign-owned banks (in per cent)	7.4	7.6	8.3	12.1	17.2	**18.7**	na
Non-performing loans (in per cent of total loans)	5.4	3.5	2.7	2.6	2.6	**3.9**	na
Domestic credit to private sector (in per cent of GDP)	21.0	24.1	25.7	30.9	37.9	**41.0**	na
Domestic credit to households (in per cent of GDP)	1.9	3.2	4.9	7.1	9.0	**9.6**	na
– Of which mortgage lending (in per cent of GDP)	na	0.1	0.2	0.9	1.9	**2.5**	na
Stock market capitalisation (in per cent of GDP)	51.0	43.9	73.0	103.3	111.4	**93.2**	na
Stock trading volume (in per cent of market capitalisation)	46.0	53.0	39.0	64.1	58.9	**75.0**	na
Eurobond issuance (in per cent of GDP)	1.2	2.8	2.3	2.1	2.5	**1.1**	na
EBRD index of banking sector reform	2.0	2.0	2.3	2.7	2.7	**2.7**	**2.7**
EBRD index of reform of non-bank financial institutions	2.7	2.7	2.7	3.0	3.0	**3.0**	**3.0**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	25.0 (25.0)	26.8 (51.2)	28.0 (83.8)	30.8 (105.7)	31.1 (115.1)	**31.1 (132.6)**	na
Internet users (per 100 inhabitants)	8.3	12.9	15.2	18.0	21.1	**21.1**	na
Railway labour productivity (1989=100)	101.6	108.1	115.7	117.1	132.9	**151.2**	na
Residential electricity tariffs (USc kWh)[4]	2.6	3.2	3.9	4.8	5.7	**6.7**	na
Average collection rate, electricity (in per cent)	92	95	97	95	96	**na**	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.2	2.4	2.6	na	na	**na**	na
EBRD index of infrastructure reform	2.3	2.7	2.7	2.7	2.7	**2.7**	**2.7**
– Electric power	3.0	3.0	3.0	3.0	3.0	**3.3**	**3.3**
– Railways	2.3	2.7	2.7	2.7	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	**3.3**	**3.3**
– Water and wastewater	2.3	2.3	2.3	2.3	2.3	**2.7**	**2.7**

[1] FDI in non-financial companies requires an authorisation from the Central Bank of Russia.

[2] Expenditures on national economy of the consolidated budget (including industry, agriculture, the energy sector and housing subsidies of regional budgets).

[3] Refers to all taxes on international trade.

[4] For flats without electric ovens.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	7.4	7.1	6.4	7.4	8.1	**5.6**	**-8.5**
– Private consumption	7.5	12.1	11.8	11.4	13.7	**11.3**	**na**
– Public consumption	2.2	2.1	1.3	2.4	3.4	**2.5**	**na**
– Gross fixed capital formation	12.8	12.6	10.6	18.0	21.1	**10.0**	**na**
– Exports of goods and services	12.5	11.8	6.5	7.3	6.3	**0.5**	**na**
– Imports of goods and services	17.7	23.3	16.6	21.3	26.5	**15.0**	**na**
Industrial gross output	8.9	8.0	5.1	6.3	6.3	**2.1**	**na**
Agricultural gross output	1.3	3.0	2.3	3.6	3.3	**10.8**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	0.6	0.1	1.2	0.5	1.2	**0.6**	**na**
Employment (end-year)	1.3	0.0	2.2	0.8	2.4	**-1.7**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	7.8	7.9	7.1	6.7	5.7	**7.8**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	13.6	11.0	12.5	9.8	9.1	**14.1**	**12.3**
Consumer prices (end-year)	12.0	11.7	10.9	9.1	11.9	**13.3**	**11.9**
Producer prices (annual average)	16.4	23.4	20.6	12.4	14.1	**21.4**	**na**
Producer prices (end-year)	12.5	28.8	13.4	10.4	25.1	**-7.0**	**na**
Gross average monthly earnings in economy (annual average)	26.1	22.6	26.9	24.3	27.8	**26.7**	**na**
Government sector[1]			*(In per cent of GDP)*				
General government balance	1.3	4.5	8.1	8.4	6.0	**4.8**	**-8.8**
General government expenditure	29.9	27.4	31.5	31.1	34.4	**33.6**	**na**
General government debt	27.0	20.4	13.5	9.0	7.3	**6.5**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	50.5	35.8	38.6	48.8	47.5	**1.7**	**na**
Domestic credit (end-year)	30.6	20.9	5.0	30.0	43.6	**29.6**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	24.3	25.6	28.0	33.4	40.1	**32.4**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Central Bank refinance rate (uncompounded)	16.0	13.0	12.0	11.0	10.0	**13.0**	**na**
Treasury bill rate (all maturities)	5.4	4.5	3.9	na	na	**na**	**na**
Deposit rate	4.4	3.8	3.6	4.0	5.2	**7.0**	**na**
Lending rate	12.4	10.0	11.1	10.5	10.8	**15.5**	**na**
			(Roubles per US dollar)				
Exchange rate (end-year)	29.5	27.7	28.8	26.3	24.5	**29.4**	**na**
Exchange rate (annual average)	30.7	28.8	28.3	27.2	25.6	**24.9**	**na**
External sector			*(In millions of US dollars)*				
Current account	35,410.0	59,511.7	84,602.2	94,686.4	77,011.8	**102,399.3**	**39,021.9**
Trade balance	59,859.3	85,824.9	118,364.0	139,269.0	130,915.0	**179,742.0**	**112,414.8**
– Merchandise exports	135,929.0	183,207.0	243,798.0	303,550.0	354,401.0	**471,603.0**	**282,961.8**
– Merchandise imports	76,069.7	97,382.1	125,434.0	164,281.0	223,486.0	**291,861.0**	**170,547.0**
Foreign direct investment, net	-1,769.0	1,662.4	118.3	6,550.4	9,157.6	**20,424.5**	**707.8**
International reserves, excluding gold (end-year)	73,172.1	120,805.0	175,690.0	295,277.0	466,376.0	**411,494.0**	**na**
External debt stock	186,000.0	213,500.0	257,200.0	313,200.0	471,000.0	**483,500.0**	**na**
			(In months of imports of goods and services)				
International reserves, excluding gold (end-year)	8.5	11.1	12.8	17.0	19.8	**13.4**	**na**
			(In per cent of exports of goods and services)				
Debt service	26.0	24.1	26.3	28.0	28.3	**29.5**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	145.0	144.2	143.5	142.8	142.2	**142.0**	**na**
GDP (in billions of roubles)	13,243.2	17,048.1	21,625.4	26,903.5	33,111.4	**41,668.0**	**40,795.1**
GDP per capita (in US dollars)	2,975.8	4,103.1	5,328.0	6,928.8	9,102.6	**11,806.9**	**na**
Share of industry in GDP (in per cent)	27.4	31.5	33.7	32.9	31.8	**30.6**	**na**
Share of agriculture in GDP (in per cent)	6.3	5.7	5.2	4.8	4.7	**4.8**	**na**
Current account/GDP (in per cent)	8.2	10.1	11.1	9.6	5.9	**6.1**	**3.1**
External debt - reserves (in US$ million)	112,827.9	92,695.0	81,510.0	17,923.0	4,624.0	**72,006.0**	**na**
External debt/GDP (in per cent)	43.1	36.1	33.6	31.7	36.4	**28.8**	**na**
External debt/exports of goods and services (in per cent)	122.2	104.8	95.7	93.6	119.6	**92.5**	**na**

[1] General consolidated government includes the federal, regional and local budgets and extra-budgetary funds, and excludes transfers.

Serbia

Key developments and challenges

The global economic crisis has reduced foreign investor interest and hampered privatisation of remaining state-owned assets. Nevertheless, it is important that efforts continue to prepare viable companies for sale once international prospects improve.

Financial stability in the banking sector has been maintained after a difficult period in late 2008, but lending conditions are tight. Close cooperation among regulators, domestic and foreign banks and international financial institutions (IFIs) is essential to ensure that banks continue to meet businesses' and households' needs.

The economic crisis has led to a sharp drop in public revenues and has highlighted the need to lower spending on public administration and benefits. It is crucial that the government sticks to its commitments under the International Monetary Fund (IMF) agreement to keep the budget deficit under control.

Country data

Population (in millions)	**9.9**
Area ('000 sq km)	**102.0**
GDP (in billion US$, 2008)	**50.1**
Average transition score (scale: 1 to 4.33)	**2.89**

Progress in structural reform

Liberalisation and privatisation

Since signing the Stabilisation and Association Agreement (SAA) with the European Commission (EC) in 2008, Serbia has begun unilaterally to implement an Interim Trade Agreement with the European Union. However, implementation from the EU side remains blocked (as of August 2009) because of Serbia's perceived lack of full cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY) in The Hague. Nevertheless, the EC has recommended to the Council of Ministers that Serbian passport holders receive visa-free access to the Schengen zone from January 2010. Negotiations on membership of the World Trade Organization (WTO), which began in 2005, are at an advanced stage.

The privatisation programme suffered set-backs over the past year, partly because of the global crisis. The government's attempts to privatise several major companies, including the mining complex RTB Bor, JAT Airways and JAT Tehnika, failed. The government is, however, searching for a strategic partner to acquire 40 per cent of RTB Bor, with the possibility of extending to a majority stake over time. It is also unclear when major infrastructure companies such as Telekom Srbija and the state-owned power company EPS might be offered for sale. However, progress has been made in other, non-infrastructure areas. For example, the government plans to tender and sell a 70 per cent stake in the major pharmaceutical company, Galenika, in early 2010.

Business environment and competition

Successive governments have made several efforts to improve the business environment, although significant problems remain according to cross-country surveys. Serbia was ranked 88th in the World Bank's *Doing Business 2010* survey. In the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), enterprises identified tax rates, competition from the informal sector and lack of access to finance as the main obstacles to doing business. The government has established a "guillotine" project to promote regulatory reform and, as of mid-2009, an inventory of existing regulations has been prepared. In addition, a one-stop shop for company registration began operating in May 2009 in order to reduce the time needed to register companies from 23 days to five.

A new competition law was adopted in July 2009 and will enter into force in November 2009. One of its main aims is to strengthen the authority of the Competition Commission by giving it enhanced powers to impose penalties (of up to 10 per cent of revenues) on companies that fail to comply with the law. In addition, a new law on control of state aid, in line with EU law, has been adopted (effective from January 2010) under which any state aid that distorts competition is ruled out except under certain restricted conditions.

Infrastructure

In July 2009 the government signed a loan agreement with the World Bank to receive US$ 388 million for construction work on the major highway, Corridor 10. Several large projects have also been signed with IFIs to help restructure the state-owned railway company, Zeleznice Srbije.

Earlier in 2009 the dominant state-owned power company, EPS, launched expressions of interest for the construction of a new unit at a thermal power plant and for the completion of another power plant. The winning bidders will be selected by the end of 2009 and will acquire majority stakes in the ventures.

Financial sector

The banking sector was initially affected by the global financial crisis, but the authorities took firm steps to restore stability and confidence. A number of banks suffered high deposit withdrawals in the final quarter of 2008, estimated at €1 billion (about 20 per cent of total deposits). In response, the government raised the level of deposit insurance substantially in October 2008 from around €3,000 to over €50,000. The National Bank of Serbia (NBS) has also taken a number of measures to ease liquidity in the market. As a result, the deposit base gradually recovered and the banking system remains sound, well-capitalised and liquid. According to the central bank, stress tests, based on mid-2009 results, point to adequate capital and liquidity buffers in the 10 largest banks. Foreign banks, which own approximately 70 per cent of total banking assets, remain committed to their operations in Serbia. In March 2009 the 10 largest foreign-owned banks in the country promised to maintain their exposure in Serbia and to provide adequate support to their subsidiaries during the crisis.

Macroeconomic performance

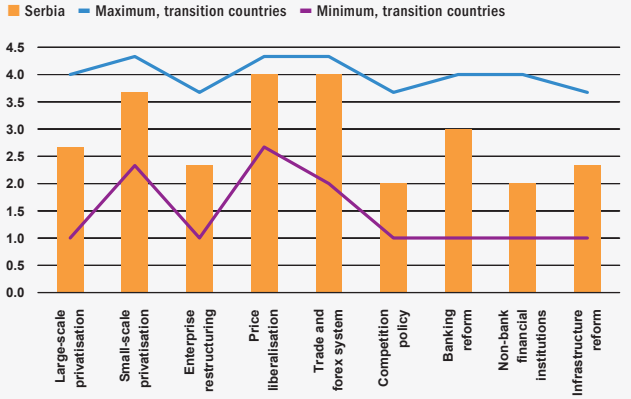
Following real GDP growth of 5.4 per cent in 2008, the crisis was increasingly felt in the first half of 2009, when the economy contracted sharply. Figures for the first half of the year showed a year-on-year fall of 4.1 per cent, while industrial output was down 17.4 per cent relative to the same period last year. Credit growth has slowed significantly from the rapid rates seen in recent years, and interbank interest rates stood at more than 13 per cent as of July 2009. The dinar depreciated sharply at the end of last year and the start of 2009, necessitating central bank intervention to prevent even greater falls, but has since stabilised. The NBS did not intervene further in the foreign exchange market between late February and September.

The authorities have responded to the crisis in several ways. Macroeconomic policy is now set in consultation with the IMF, following the signing of two agreements in 2009. A precautionary stand-by arrangement was agreed in January, but was replaced in May by an extended and significantly augmented arrangement (covering more than two years) to the value of around €3 billion. In February 2009 the government allocated €1.3 billion to stimulate production and exports by improving liquidity in the economy and purchasing power. The central bank also eased liquidity by scrapping reserve requirements for new foreign borrowing and by progressively lowering the key policy rate in a succession of cuts, the latest being from 12 to 11 per cent in October 2009. However, the government is struggling to keep to the commitments under the new arrangement with the IMF. In early September the IMF mission and the authorities agreed that the government deficit target for 2009 could be increased from 3 per cent to 4.5 per cent of GDP, but completion of the second review of the stand-by arrangement was delayed, pending further steps by the government to make firm commitments to reduce spending in 2010 and to implement reforms in health, education and pensions.

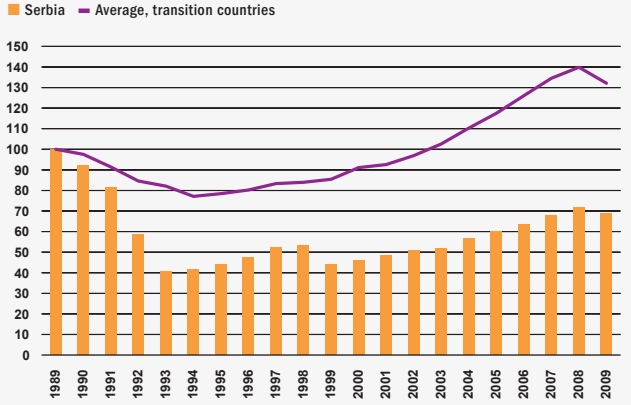
Outlook and risks

GDP is expected to contract by about 4 per cent in 2009, with a modest recovery in 2010. The main macroeconomic challenge is on the fiscal side, as the authorities try to control pressures for greater spending. On the external side, the key risk lies in the expected sharp reduction in foreign direct investment (FDI) this year, which will make it harder to finance the current account deficit (over 17 per cent of GDP in 2008, although falling sharply in 2009). While there is still a significant pipeline of privatisation projects, it may be difficult to obtain a politically acceptable price for these assets in the present environment. Furthermore, banks are reluctant to lend, especially to small and medium-sized enterprises, even though adequate funds are available. More positively, the country enjoys strong support from IFIs and from parent banks of subsidiaries in Serbia, and this is expected to continue. Over the medium term, prospects for further integration with the European Union should contribute to the country's good potential for resuming high growth rates.

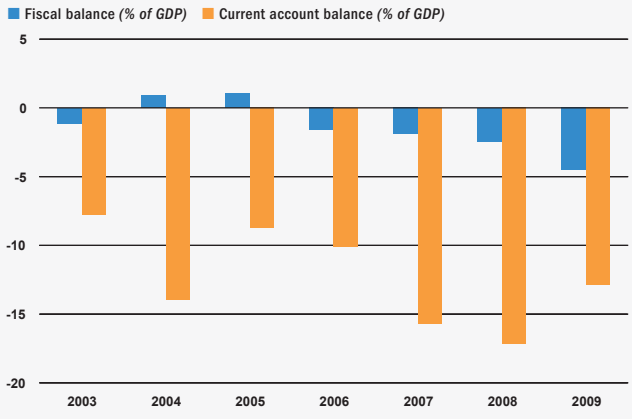
Transition indicators 2009



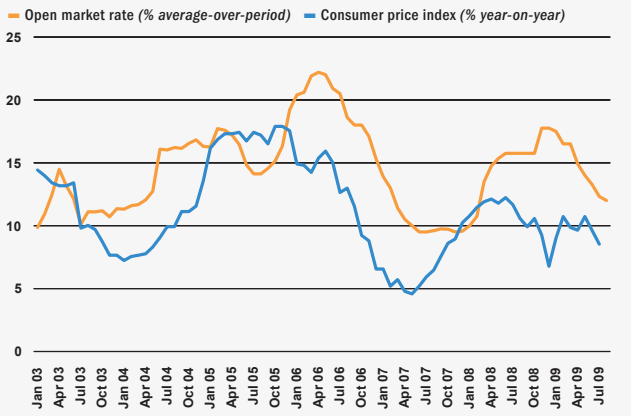
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradeability of land – **limited de jure**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **modern/some defects**

Infrastructure

Telecoms regulatory assessment compliance – **low**

Independence of the electricity regulator – **partial**

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

Independence of the road directorate – **no**

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

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

Government expenditure on health – **5.7 per cent of GDP** (2008)

Government expenditure on education – **3.8 per cent of GDP** (2008)

Household expenditure on power and water – **9.3 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	6.9	7.7	10.2	17.4	20.2	**21.4**	na
Private sector share in GDP (in per cent)	na	na	na	na	55.0	**60.0**	**60.0**
Private sector share in employment (in per cent)	na	na	na	na	na	**na**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	3.7	3.2	3.3	2.8	2.7	**2.7**	**na**
Share of industry in total employment (in per cent)	29.7	27.4	25.9	24.4	23.1	**22.1**	**na**
Change in labour productivity in industry (in per cent)	10.9	12.5	9.0	14.2	14.3	**14.0**	**na**
Investment/GDP (in per cent)	22.7	37.8	26.5	27.1	27.0	**28.0**	**na**
EBRD index of small-scale privatisation	3.0	3.3	3.3	3.7	3.7	**3.7**	**3.7**
EBRD index of large-scale privatisation	2.3	2.3	2.7	2.7	2.7	**2.7**	**2.7**
EBRD index of enterprise reform	2.0	2.0	2.3	2.3	2.3	**2.3**	**2.3**
Markets and trade							
Share of administered prices in CPI (in per cent)	11.2	11.2	9.2	9.9	5.7	**5.8**	**na**
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	2.0	3.0	3.0	**3.0**	**na**
Share of trade with non-transition countries (in per cent)	79.3	79.0	65.6	52.1	51.8	**49.5**	**na**
Share of trade in GDP (in per cent)	54.0	62.0	60.6	64.6	65.9	**65.3**	**na**
Tariff revenues (in per cent of imports)	7.4	6.0	5.7	5.3	5.5	**5.2**	**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	3.0	3.0	3.3	3.3	3.3	**3.7**	**4.0**
EBRD index of competition policy	1.0	1.0	1.0	1.7	2.0	**2.0**	**2.0**
Financial sector							
Number of banks (foreign-owned)	47 (16)	43 (11)	40 (17)	37 (22)	35 (21)	**34 (20)**	**na**
Asset share of state-owned banks (in per cent)	34.1	23.4	23.9	14.9	15.7	**16.0**	**na**
Asset share of foreign-owned banks (in per cent)	38.4	37.7	66.0	78.7	75.5	**75.3**	**na**
Non-performing loans (in per cent of total loans)	na	na	na	na	na	**na**	**na**
Domestic credit to private sector (in per cent of GDP)	21.0	24.8	30.7	30.8	35.3	**39.7**	**na**
Domestic credit to households (in per cent of GDP)	2.6	4.9	7.6	10.1	12.6	**13.9**	**na**
– Of which mortgage lending (in per cent of GDP)	0.4	0.7	1.4	2.4	3.8	**5.7**	**na**
Stock market capitalisation (in per cent of GDP)	6.8	13.7	23.1	33.3	54.4	**27.0**	**na**
Stock trading volume (in per cent of market capitalisation)	na	na	na	16.3	14.6	**6.9**	**na**
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.4	**0.0**	**na**
EBRD index of banking sector reform	2.3	2.3	2.7	2.7	2.7	**3.0**	**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**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	32.1 (na)	27.1 (47.8)	25.6 (55.9)	27.7 (67.6)	30.5 (86.0)	**31.4 (97.8)**	**na**
Internet users (per 100 inhabitants)	na	15.3	7.9	14.2	15.3	**24.0**	**na**
Railway labour productivity (2000=100)	127.7	161.6	199.6	251.9	282.4	**247.1**	**na**
Residential electricity tariffs (USc kWh)	4.7	5.3	5.1	5.8	7.5	**8.8**	**na**
Average collection rate, electricity (in per cent)	90	94	94	95	93	**94**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	na	na	na	na	na	**na**	**na**
EBRD index of infrastructure reform	2.0	2.0	2.0	2.0	2.0	**2.3**	**2.3**
– Electric power	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Railways	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Roads	2.3	2.3	2.3	2.7	2.7	**2.7**	**2.7**
– Telecommunications	2.0	2.0	2.0	2.3	2.3	**2.7**	**2.7**
– Water and wastewater	2.0	2.0	2.0	1.7	1.7	**1.7**	**1.7**

Macroeconomic indicators[1]

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	2.4	9.3	6.3	5.5	6.9	**5.4**	**-4.0**
Industrial gross output	-3.0	7.1	0.8	4.7	3.7	**1.1**	**na**
Agricultural gross output	-7.0	19.5	-5.3	-0.3	-8.0	**9.0**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	2.6	0.3	2.2	-1.1	-6.1	**-2.0**	**na**
Employment (end-year)	-1.3	0.5	0.9	-2.3	-1.5	**-0.1**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	31.7	31.6	32.4	33.2	29.9	**28.5**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	11.7	10.1	16.5	12.7	6.7	**11.7**	**8.3**
Consumer prices (end-year)	7.8	13.7	17.7	6.6	10.2	**8.6**	**8.0**
Producer prices (annual average)	na	na	na	na	na	**na**	**na**
Gross average monthly earnings in economy (annual average)	25.3	23.7	24.1	24.4	22.0	**17.9**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	-1.1	0.9	1.0	-1.6	-1.9	**-2.4**	**-4.5**
General government expenditure	42.8	41.6	41.9	45.4	44.3	**42.9**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	12.6	17.1	31.4	45.2	40.0	**1.2**	**na**
Domestic credit (end-year)	24.6	43.3	44.4	15.3	32.5	**34.2**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	11.0	10.6	11.4	14.1	16.5	**14.0**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	9.0	8.5	8.5	8.5	8.5	**8.5**	**na**
Money market rate	27.1	16.3	20.5	16.5	10.3	**18.5**	**na**
Deposit rate	2.1	3.6	3.7	5.1	4.1	**7.3**	**na**
Lending rate (long-term)	15.5	14.6	14.4	15.9	11.1	**18.1**	**na**
			(Dinars per US dollar)				
Exchange rate (official, end-year)	54.6	57.9	72.2	60.0	53.7	**62.9**	**na**
Exchange rate (official, annual average)	57.5	58.7	67.2	66.8	58.4	**55.7**	**na**
External sector			*(In millions of US dollars)*				
Current account	-1,532.0	-3,281.0	-2,194.0	-2,986.3	-6,334.9	**-8,721.3**	**-5,630.0**
Trade balance	-4,021.0	-6,469.0	-5,290.0	-6,271.0	-9,131.0	**-11,256.5**	**-7,400.0**
– Merchandise exports	3,319.0	4,082.0	4,970.0	6,442.0	8,755.0	**10,956.5**	**8,000.0**
– Merchandise imports	7,340.0	10,551.0	10,260.0	12,713.0	17,886.0	**22,213.0**	**15,400.0**
Foreign direct investment, net	1,365.0	966.0	1,550.0	4,264.0	2,523.2	**2,716.9**	**1,400.0**
Gross reserves, excluding gold (end-year)	3,411.0	4,096.0	5,628.0	11,648.0	13,892.0	**11,122.9**	**na**
External debt stock	13,575.0	14,099.0	15,467.0	19,606.0	26,236.0	**30,708.0**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	5.0	4.1	5.7	9.3	7.8	**5.0**	**na**
			(In per cent of exports of goods and services)				
Debt service	10.3	17.5	26.0	20.2	16.4	**17.3**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	7.5	7.5	7.5	7.5	7.5	**7.5**	**na**
GDP (in billions of dinars)	1,133.0	1,384.3	1,687.8	1,980.2	2,362.9	**2,831.0**	**2,985.0**
GDP per capita (in US dollars)	2,629.6	3,145.1	3,348.5	3,953.1	5,393.1	**6,773.9**	**na**
Share of industry in GDP (in per cent)	23.2	22.8	21.8	21.8	21.4	**20.7**	**na**
Share of agriculture in GDP (in per cent)	12.1	13.3	12.0	11.3	9.8	**10.1**	**na**
Current account/GDP (in per cent)	-7.8	-13.9	-8.7	-10.1	-15.7	**-17.2**	**-12.9**
External debt - reserves (in US$ million)	10,164.0	10,003.0	9,839.0	7,958.0	12,344.0	**19,585.1**	**na**
External debt/GDP (in per cent)	68.8	59.8	61.6	66.1	64.9	**60.4**	**na**
External debt/exports of goods and services (in per cent)	311.5	253.7	234.2	223.7	220.1	**204.9**	**na**

[1] All data exclude Kosovo.

Slovak Republic

Key developments and challenges

To maintain a stable operating environment for investors the government should refrain from intervening in important sectors of the economy such as energy and pensions. Improved market flexibility will be crucial to maintaining competitiveness.

The banking sector has shown resilience during the global financial crisis due to its conservative funding structure and focus on traditional banking activities. Given that asset quality and profitability are expected to decline in coming months, continued close supervision by the authorities will be necessary.

Smooth entry into the eurozone in January 2009 during the height of the global financial and economic crisis represents a commendable achievement. The short-term fiscal response to the crisis has been appropriate, but fiscal consolidation will be necessary once the crisis subsides.

Country data

Population (in millions)	**5.4**
Area ('000 sq km)	**49.0**
GDP (in billion US$, 2008)	**95.4**
Average transition score (scale: 1 to 4.33)	**3.78**

Progress in structural reform

Liberalisation

In the autumn of 2008 the government set up the Price Commission to monitor the development of prices and implement measures against "unreasonable" price increases. It also widened its powers in setting energy prices (see below). In addition, tri-partite discussions between the government, trade unions and employers in the middle of 2009 failed to reach a conclusion regarding increases in the minimum wage and hence the decision now rests with the government (in line with the recently amended Minimum Wage Act). The government's current proposals suggest increases in the minimum wage for 2010-12 that exceed (in percentage terms) the expected growth rate of productivity, and would thus exert pressure on competitiveness.

Infrastructure

Partly in response to the worsening economic climate the government has recently stepped up efforts to expand its nuclear power generation facilities. In June 2009 the dominant electricity producer, Slovenske Elektrarne (part-owned by the government) signed a contract with Czech Skoda JS for the construction of two new nuclear reactors at the Mochovce power station. The project is expected to double the currently installed capacity at Mochovce at an estimated cost of €2.7 billion. The government has also signed a contract with Czech CEZ for the construction of a new nuclear power plant to replace the recently decommissioned plant in Jaslovske Bohunice.

The government has also enhanced its powers to intervene in the regulatory framework for the energy sector. In July 2008 the government gave the Regulatory Office for Network Industries (URSO) more authority to control the extent to which rising energy prices were passed through to end-consumers and small enterprises. Subsequently, in the autumn of 2008 URSO rejected two applications by the Slovak gas utility, SPP, for price increases of between 13 to 24 per cent before agreeing on much lower increases. Moreover, in October 2008 parliament passed a new law on the setting of energy tariffs from 2009. The law gives the government stronger control in setting gas and electricity prices for households and small and medium-sized enterprises (SMEs).

Despite the difficult conditions in the financial markets, the government has made important progress in awarding the first public-private partnerships (PPP) concessions in the road sector. The procurement process for the R1 motorway was concluded in February 2009. The Granvia consortium (a special purpose vehicle owned by VINCI Concession and the Meridian Infrastructure Fund) won the bid and a concession agreement was signed in March 2009. A number of commercial banks and the EBRD will provide funding for this project (estimated at €1.1 billion). In 2009 the government also signed concession contracts for Phase I and Phase II of the D1 motorway.

Financial sector

The Slovak banking system has shown strong resilience to the global financial crisis, but the sector has been affected by the protracted economic downturn, a sharp decline in profitability (aggravated by the loss in revenue from foreign exchange transactions following eurozone entry) and a deterioration in asset quality. In response to the crisis the authorities have introduced several measures, including an unlimited guarantee for all deposits of individuals and SMEs until the end of 2010 and loan guarantees for SMEs. In addition there was a capital increase for the state-owned Exim Banka and the Slovak Guarantee and Development Bank, to enable them to maintain support for export-oriented industries. In November 2008 the National Bank of Slovakia introduced more stringent requirements on liquidity management for Slovak banks and has also stepped up supervision and cross-border coordination. In June 2009 as a precautionary measure, the government approved legislation that would allow it to guarantee bank bonds and recapitalise banks. More stringent requirements on loans for households and the corporate sector may have had the adverse effect that excess liquidity is flowing into government bonds, with the danger of crowding out effects for the private sector.

Social sector

Over the past two years the government has made a number of changes to the well-functioning and strictly regulated three-pillar pension system. These changes include the right of young people to opt out of the second pillar and the repeated opening of the second pillar to allow people to switch back into the first, pay-as-you-go (PAYG), pillar. The government initially allowed people to switch out of the second pillar for six months from January 2008 and again for seven and a half months from November 2008, although very few people ended up doing so. In May 2009 the government also decided to reduce pension fund management fees and discussions are ongoing as to whether to reduce contribution rates to the second pillar. These changes jeopardise the sustainability of government finances over the long term and undermine the operating environment for privately managed pension funds. In addition, the recent EU Council's Opinion of April 2009 recommends that the Slovak Republic advances with its reforms to the PAYG pillar in order to put government finances on a more sustainable footing over the long term.

Macroeconomic performance

The Slovak Republic became the second transition country to join the eurozone in January 2009, despite the global financial crisis. GDP growth has averaged 7.4 per cent in the last five years, combined with sound public finances and large inflows of foreign direct investment (FDI). However, the country is now experiencing the brunt of the economic downturn as a result of its dependence on the EU market for its exports of mainly cars and consumer electronics. GDP contracted by 5.6 per cent and 5.3 per cent year on year in the first and second quarters of 2009 (following growth of 6.4 per cent in 2008). By the middle of the year there were indications that economic activity was stabilising, albeit gradually. The Harmonised Index of Consumer Price (HICP) inflation reached a low of 0.5 per cent in August 2009.

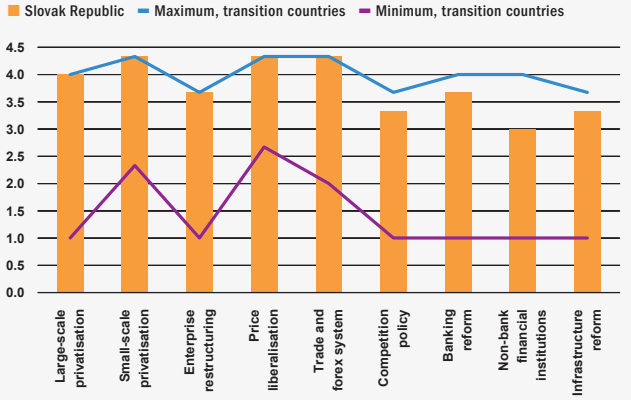
The favourable economic environment before eurozone entry had enabled a reduction in the general government deficit to 2.2 per cent of GDP and lowered the public debt ratio to 28 per cent of GDP by the end of 2008. However, in response to the crisis, the government introduced a range of stimulus measures in late 2008 and early 2009, including *inter alia*: temporary tax reductions, measures to improve the liquidity of enterprises, a car scrapping scheme, as well as steps to accelerate the utilisation of EU funds. These measures were not financed by extra expenditure, but rather by reallocations within the budget. Nevertheless, the budget deficit is forecast to widen substantially this year and next as a result of the unfavourable economic environment and the working of automatic stabilisers. To help finance this deficit, the country successfully placed a €2 billion eurobond in May 2009.

The current account deficit is likely to decline slightly on the back of a lower trade deficit for 2009 as a whole. During the first half of the year, imports and exports fell by 26 per cent over the same period last year, resulting in a trade surplus of €196 million. Net FDI inflows are likely to continue to decline in 2009.

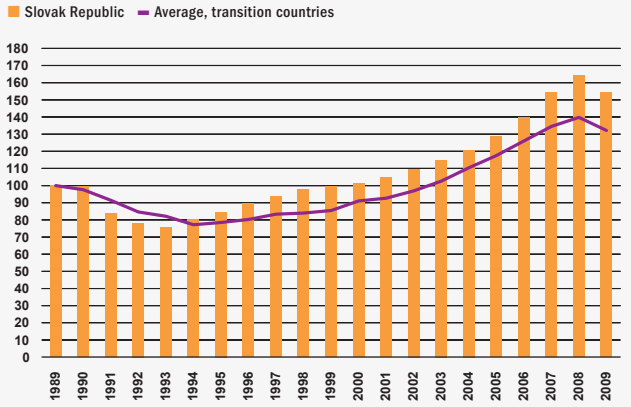
Outlook and risks

Signs of a turnaround are still tenuous and it may take a lot longer before a self-sustaining recovery is back on track. The economy is projected to decline by 5.4 per cent in 2009, followed by a slow recovery in 2010. Given its concentrated export structure, the economy remains vulnerable to demand in the European Union. Although eurozone entry has reduced macroeconomic risks, it has heightened the importance of improving the flexibility and competitiveness of the economy even further. These aims could be achieved by improving labour market flexibility, reducing regional disparities, reforming health care and education, and encouraging more private sector involvement in transport and municipal services. Above all, the authorities should build on the economy's success so far and maintain a stable operating environment for investors.

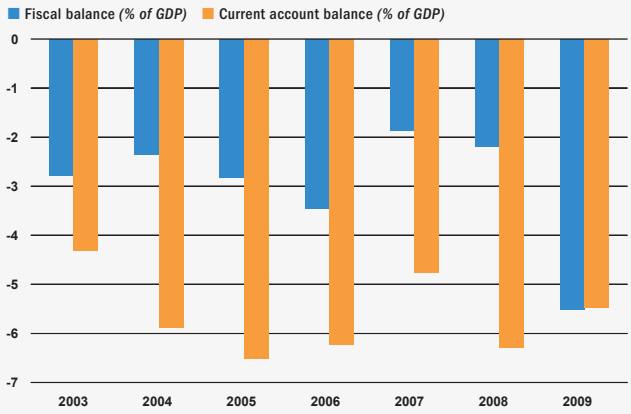
Transition indicators 2009



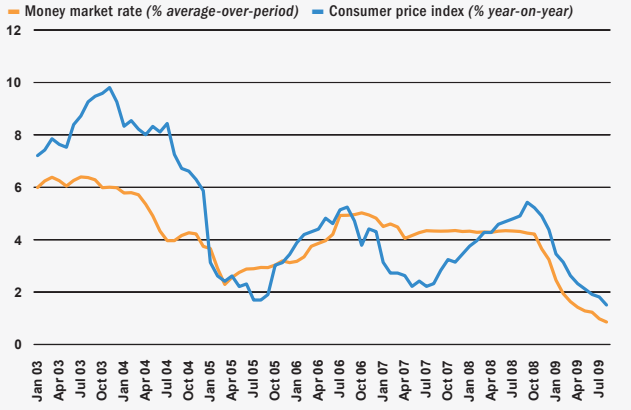
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **eurozone-floating**

Wage regulation – **no**

Tradeability of land – **full except non-EU foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **advanced**

Infrastructure

Telecoms regulatory assessment compliance – **full**

Independence of the electricity regulator – **full**

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

Independence of the road directorate – **full**

Financial sector

Capital adequacy ratio – **11 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2.0 per cent** (1996)

Government expenditure on health – **5.3 per cent** (2007)

Government expenditure on education – **4.4 per cent** (2007)

Household expenditure on power and water – **9.5 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	34.7	35.1	35.1	35.2	35.2	**na**	**na**
Private sector share in GDP (in per cent)	80.0	80.0	80.0	80.0	80.0	**80.0**	**80.0**
Private sector share in employment (in per cent)	75.0	75.0	75.0	75.0	75.0	**75.0**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	4.0	3.5	3.4	3.1	2.7	**4.4**	**na**
Share of industry in total employment (in per cent)	29.3	29.5	29.3	29.0	29.3	**28.9**	**na**
Change in labour productivity in industry (in per cent)	6.1	2.9	2.0	7.2	8.7	**0.1**	**na**
Investment/GDP (in per cent)	24.6	26.3	28.9	27.8	27.8	**28.8**	**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**
EBRD index of enterprise reform	3.3	3.3	3.7	3.7	3.7	**3.7**	**3.7**
Markets and trade							
Share of administered prices in CPI (in per cent)	20.7	19.9	21.9	23.4	24.1	**24.7**	**na**
Number of goods with administered prices in EBRD-15 basket	3.0	2.0	2.0	2.0	2.0	**2.0**	**na**
Share of trade with non-transition countries (in per cent)	64.6	62.4	60.4	60.5	61.9	**58.8**	**na**
Share of trade in GDP (in per cent)	96.7	101.1	106.2	123.6	137.9	**142.9**	**na**
Tariff revenues (in per cent of imports)[1]	0.0	0.0	0.0	0.0	0.0	**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**
EBRD index of competition policy	3.0	3.3	3.3	3.3	3.3	**3.3**	**3.3**
Financial sector							
Number of banks (foreign-owned)	21 (16)	21 (16)	23 (16)	24 (16)	26 (15)	**26 (16)**	**na**
Asset share of state-owned banks (in per cent)	1.5	1.3	1.1	1.1	1.0	**0.8**	**na**
Asset share of foreign-owned banks (in per cent)	96.3	96.7	97.3	97.0	99.0	**99.2**	**na**
Non-performing loans (in per cent of total loans)[2]	9.1	7.2	5.5	7.1	2.6	**3.5**	**na**
Domestic credit to private sector (in per cent of GDP)	31.6	30.4	35.1	38.6	42.4	**44.7**	**na**
Domestic credit to households (in per cent of GDP)	7.0	8.6	11.2	13.1	16.3	**18.5**	**na**
– Of which mortgage lending (in per cent of GDP)	2.2	2.9	3.6	4.1	4.5	**5.4**	**na**
Stock market capitalisation (in per cent of GDP)	7.4	9.4	9.4	8.8	8.6	**5.4**	**na**
Stock trading volume (in per cent of market capitalisation)	29.4	19.8	1.6	1.8	0.5	**0.4**	**na**
Eurobond issuance (in per cent of GDP)	0.3	2.1	0.0	0.0	0.0	**0.0**	**na**
EBRD index of banking sector reform	3.3	3.7	3.7	3.7	3.7	**3.7**	**3.7**
EBRD index of reform of non-bank financial institutions	2.7	2.7	2.7	3.0	3.0	**3.0**	**3.0**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	24.1 (68.4)	23.2 (79.4)	22.2 (84.3)	21.7 (90.8)	21.3 (112.5)	**20.3 (102.2)**	**na**
Internet users (per 100 inhabitants)	43.0	46.2	50.1	35.8	42.9	**51.3**	**na**
Railway labour productivity (1989=100)	60.5	61.7	64.8	71.0	70.1	**69.1**	**na**
Residential electricity tariffs (USc kWh)	10.9	13.7	14.9	12.8	15.4	**22.8**	**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)	3.9	4.3	4.5	na	na	**na**	**na**
EBRD index of infrastructure reform	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.3**
– Electric power	4.0	4.0	4.0	4.0	4.0	**4.0**	**4.0**
– Railways	2.7	2.7	3.0	3.0	3.0	**3.0**	**3.0**
– Roads	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.7**
– Telecommunications	3.3	3.3	3.7	3.7	3.7	**3.7**	**3.7**
– Water and wastewater	2.7	3.0	3.0	3.3	3.3	**3.3**	**3.3**

[1] Refers to import tariffs, customs duties and import surcharge.

[2] There is a break in the series. The methodology for defining non-performing loans was changed in 2006.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	4.7	5.2	6.5	8.5	10.4	**6.4**	**-6.0**
– Private consumption	1.7	4.6	6.5	5.8	7.0	**6.1**	**na**
– Public consumption	4.1	-2.2	3.3	10.2	-1.4	**4.3**	**na**
– Gross fixed capital formation	-2.7	4.8	17.6	9.3	8.7	**6.8**	**na**
– Exports of goods and services	15.9	7.4	10.0	21.0	13.8	**3.2**	**na**
– Imports of goods and services	7.4	8.3	12.4	17.7	8.9	**3.3**	**na**
Industrial gross output	5.0	4.1	3.2	10.1	12.7	**2.0**	**na**
Agricultural gross output	-9.6	1.5	-10.7	-2.4	5.6	**5.3**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	0.2	0.9	-0.5	0.3	-0.2	**1.6**	**na**
Employment (end-year)	1.8	0.3	2.1	3.8	2.4	**3.2**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	17.4	18.1	16.2	13.3	11.0	**9.6**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	8.5	7.5	2.5	4.5	2.8	**4.6**	**2.6**
Consumer prices (end-year)	9.3	5.9	3.4	4.3	3.4	**4.4**	**1.3**
Producer prices (annual average)	8.9	3.4	3.9	8.0	2.2	**5.8**	**na**
Producer prices (end-year)	9.5	3.5	6.2	5.6	2.5	**6.4**	**na**
Gross average monthly earnings in economy (annual average)	6.3	10.2	9.2	8.6	7.4	**8.1**	**na**
Government sector[1]			*(In per cent of GDP)*				
General government balance[2]	-2.8	-2.4	-2.8	-3.5	-1.9	**-2.2**	**-5.5**
General government expenditure	40.1	37.6	38.2	36.9	34.4	**34.9**	**na**
General government debt	42.4	41.4	34.2	30.4	29.4	**27.6**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	5.2	5.7	5.8	8.2	11.8	**5.5**	**na**
Domestic credit (end-year)	10.2	14.1	14.9	23.3	20.3	**25.5**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	61.3	58.2	56.5	54.7	54.8	**52.8**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	6.0	4.0	3.0	4.8	4.3	**2.5**	**na**
3-month BRIBOR	6.0	3.7	3.1	4.8	4.3	**3.2**	**na**
Deposit rate[3]	5.3	4.1	2.4	3.6	3.7	**na**	**na**
Lending rate[3]	8.5	9.1	6.7	7.7	8.0	**na**	**na**
			(Korunas per US dollar)				
Exchange rate (end-year)	32.9	29.1	31.9	26.2	22.9	**21.4**	**na**
Exchange rate (annual average)	36.8	32.3	31.0	29.7	24.7	**21.4**	**na**
External sector			*(In millions of US dollars)*				
Current account	-1,971.6	-3,297.4	-4,065.0	-4,309.8	-3,994.5	**-6,195.0**	**-4,855.6**
Trade balance	-637.3	-1,536.2	-2,385.2	-2,531.8	-865.3	**-1,007.5**	**-755.6**
– Merchandise exports	21,843.2	27,621.2	31,914.8	41,477.8	57,489.5	**69,921.8**	**52,441.3**
– Merchandise imports	22,480.4	29,157.4	34,299.9	44,009.7	58,354.8	**70,929.3**	**53,196.9**
Foreign direct investment, net	1,913.4	3,051.8	2,278.8	4,177.5	2,881.0	**3,155.9**	**2,000.0**
Gross reserves, excluding gold (end-year)	11,678.1	14,418.8	14,924.0	12,684.8	17,674.8	**17,854.1**	**na**
External debt stock	18,090.2	23,763.6	27,052.5	32,206.0	44,308.7	**52,526.7**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	5.3	5.3	4.6	3.1	3.3	**2.7**	**na**
			(In per cent of exports of goods and services)				
Debt service due	14.3	10.8	11.7	4.7	3.8	**3.4**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	5.4	5.4	5.4	5.4	5.4	**5.4**	**na**
GDP (in billions of korunas)	40.6	45.2	49.3	55.1	61.5	**67.3**	**64.9**
GDP per capita (in US dollars)	8,487.9	10,389.8	11,533.3	12,785.3	15,529.5	**18,210.5**	**na**
Share of industry in GDP (in per cent)	25.9	27.1	26.4	28.2	27.9	**27.0**	**na**
Share of agriculture in GDP (in per cent)	4.0	3.6	3.2	3.2	3.2	**2.8**	**na**
Current account/GDP (in per cent)	-4.3	-5.9	-6.5	-6.2	-4.8	**-6.3**	**-5.5**
External debt – reserves (in US$ million)	6,412.1	9,344.8	12,128.5	19,521.2	26,633.9	**34,672.6**	**na**
External debt/GDP (in per cent)	39.5	42.3	43.4	46.5	52.7	**53.3**	**na**
External debt/exports of goods and services (in per cent)	72.0	75.8	74.5	68.7	68.7	**67.0**	**na**

[1] General government includes central government, municipalities and extra-budgetary funds.

[2] The general government balance excludes privatisation revenues and is calculated according to Eurostat methodology (ESA95). In line with the Eurostat derogation the second pillar pension funds are included from 2005.

[3] Weighted average over all maturities.

Slovenia

Key developments and challenges

Further reductions in the regulatory burden for enterprises are necessary to enhance the economy's competitiveness. The government should promote better corporate governance, aid restructuring and plan for privatisations once market conditions improve.

While the largely state-owned financial sector has so far weathered the global crisis, it still relies on foreign financing and is vulnerable to sharp deteriorations in asset quality due to the impact the crisis is having on the real sector. The authorities should try to limit their direct involvement in bank decision-making, improve corporate governance and aim to reduce state control through privatisation, while ensuring banks maintain adequate capital.

Slovenia's entry into the eurozone and the recent fiscal response to the crisis are a testament to the country's sound macroeconomic management, but fiscal policy should be tightened as soon as the economy rebounds. Pension reform is urgently needed to ensure the sustainability of government finances.

Country data

Population (in millions)	**2.0**
Area ('000 sq km)	**20.5**
GDP (in billion US$, 2008)	**54.6**
Average transition score (scale: 1 to 4.33)	**3.41**

Progress in structural reform

Business environment and competition

While the overall business environment is good, competition continues to be hampered by the high regulatory burden on enterprises, state involvement in many sectors of the economy and the weakness of the competition authority. According to the 2009 Organisation for Economic Co-operation and Development (OECD) product market indicator, Slovenia ranks below the OECD average in terms of the ability of the economy to unleash market forces. The World Bank *Doing Business 2010* survey shows that the procedures required for hiring and firing workers, registering property, trading across borders and enforcing contracts are more burdensome than in most other OECD countries. In addition, the state or its investment funds still exercise effective control over many Slovenian enterprises, and the Competition Protection Office is still not an independent agency and lacks budgetary autonomy (although its powers have been strengthened in 2008).

Infrastructure

State-owned companies still dominate much of the country's infrastructure. There has been little development since the privatisation of the incumbent telecommunications operator, Telekom Slovenije (TS), was suspended in March 2008. TS still controls over 80 per cent of the fixed-line market and around half of the mobile and internet markets (through its subsidiaries), which is high by EU standards, although it is facing increasing competition from private operators. In February 2009 the independent telecommunications regulator, APEK, started proceedings against TS for alleged abuses of its dominant position; a decision is still pending. In addition, since TS's licence is about to expire, in June 2009 APEK announced a tender for five-year licences for new universal service providers. The licences will be awarded on a regional rather than a national basis, which will make it easier for smaller companies to apply.

There has been further reform in the power sector. Since 2007 the sector has been fully unbundled into generation, transmission and distribution, although all these remain under full state ownership. Private sector participation has increased, with 14 suppliers now active in the retail market, and an independent regulator is in place. However, in June 2009 the European Commission took action against Slovenia (along with 25 other member states) for not complying with EU directives on energy in three areas: inadequate alternative dispute settlement procedures for consumers, a lack of reliable information on the capacity of the network, and not allocating existing capacity well enough. The gas market is also still dominated by a state company, although the Italian company ENI entered the market as a new supplier of retail and wholesale natural gas in 2008.

Financial sector

So far the Slovenian banking system has withstood the global financial crisis relatively well. The authorities responded rapidly by *inter alia* providing an unlimited guarantee for all deposits by individuals and small enterprises until the end of 2010, making up to €12 billion available in state guarantees on new debt issuance by banks and earmarking a further €1.2 billion in state guarantees for loans to non-financial companies.

However, the financial crisis has highlighted the need to restructure bank balance sheets. Recent research by the International Monetary Fund (IMF) has shown that banking sector efficiency and profitability indicators have consistently been lower than those in most other EU countries in recent years. Slovenian banks have also been overly reliant on external funding (much of it short term), which now carries with it high refinancing risks. Moreover, a combination of rapid credit growth in the past, the severity of the downturn and the concentration of loans in certain badly affected sectors has led to a significant deterioration in credit quality over the past year.

Partly because of the crisis, the government has become more directly involved in the management of banks. The state and its investment funds remain majority owners of the two largest banks, NLB and NKBM, which have a joint market share of about 50 per cent. Plans to privatise both these banks remain on hold. The main foreign shareholder in NLB – the Belgian bank KBC – is still trying to sell its stake after failing to gain control. In the spring of 2009 the government prohibited banks benefiting from state guarantees from rolling over loans that had been made to some of the country's largest management buy-outs in recent years. Instead of rolling over overdue loans and as a result of the lower value of collateral, banks have started to seize equity stakes in some of Slovenia's largest firms. In June 2009 the government set up a company to manage the sale of these equity stakes to ensure the sales were reasonably priced.

Macroeconomic performance

Slovenia has been particularly affected by the collapse in external demand. After an impressive GDP growth of 5.6 per cent in the first half of 2008, growth rapidly decelerated through the end of 2008 and the beginning of 2009. In the first half of 2009 GDP decreased by 8.8 per cent compared with the same period in 2008. The credit squeeze and the collapse in exports have led to a rapid rise in corporate bankruptcies and unemployment, while inflation fell by mid-2009 to close to zero per cent.

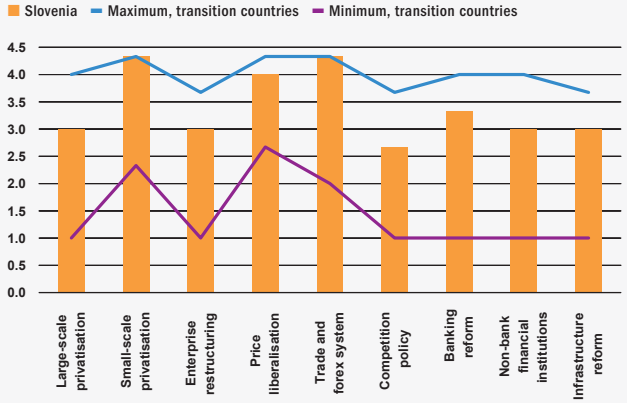
After several years of fiscal consolidation (which, according to Eurostat methodology (ESA95), lowered the fiscal deficit to 0.9 per cent of GDP in 2008), the government has implemented a more expansionary policy in response to the crisis. Between December 2008 and July 2009 the government adopted three anti-crisis packages, including increased investment for infrastructure projects, support to troubled companies and subsidies to employees on extended leave. These discretionary measures (estimated at 1.6 per cent of GDP) and the size of automatic stabilisers (estimated at 2.7 per cent of GDP) are expected to contribute to a rise in the consolidated government budget deficit to 5.5 per cent of GDP in 2009. To finance part of this deficit the government has so far successfully placed three eurobonds for a total of €4 billion in February, March and September 2009.

The current account deficit increased to 6.1 per cent of GDP in 2008 from 4.8 per cent in 2007, partly because of slowing exports, high prices for imported energy and higher interest payments on external debt. This deficit is forecast to decline significantly in 2009 on the back of lower commodity prices and falling imports. Given continued low levels of foreign direct investment (FDI), Slovenia's external debt levels are projected to continue to rise (external debt to GDP stood at 46 per cent at the end of 2008).

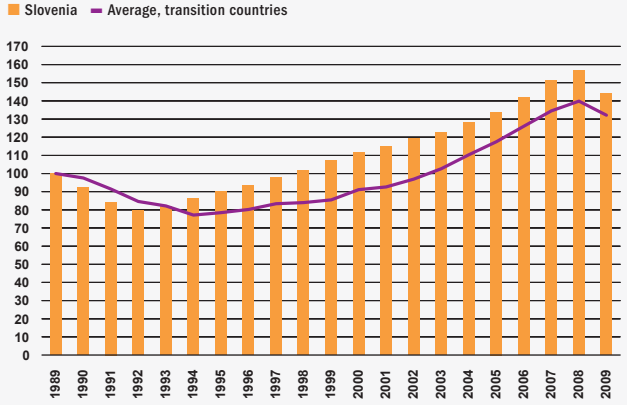
Outlook and risks

The economy is forecast to contract by close to 8 per cent in 2009 and then recover slowly in 2010. However, the outlook is dependent on a sustained rebound in external demand. The banking sector also remains vulnerable as a result of the high reliance on external funding and the uncertain credit quality of bank balance sheets, particularly in those banks where the state retains a significant share. More decisive reforms are needed to underpin a rapid recovery and sustained growth. These should include decreasing the regulatory burden on enterprises, improving labour market flexibility by further liberalising employment protection legislation and privatising large-scale enterprises and financial institutions once conditions improve. While the government has addressed the crisis with a range of fiscal measures, such measures should refrain from supporting ailing industries, and fiscal adjustment will be necessary once the crisis subsides. Substantial pension reform is still required to ensure that public finances are sustainable over the long term.

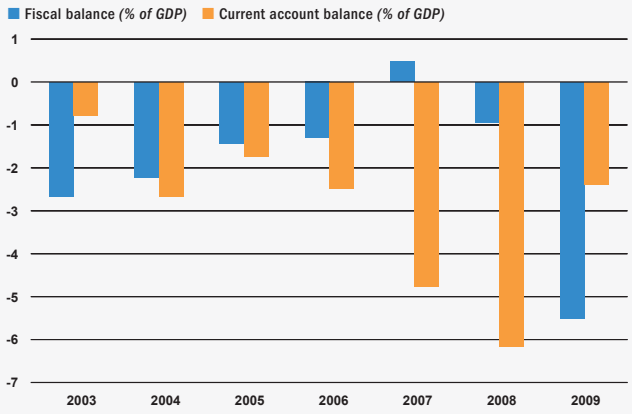
Transition indicators 2009



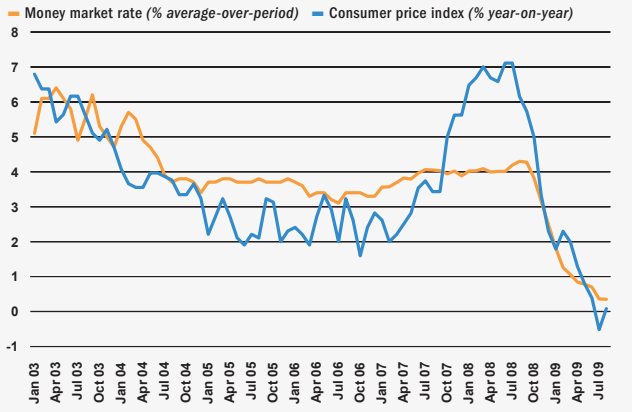
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**[1]

Interest rate liberalisation – **full**

Exchange rate regime – **euro-floating**

Wage regulation – **yes**

Tradeability of land – **full except non-EU foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **high**

Secured transactions law – **under development**

Infrastructure

Telecoms regulatory assessment compliance – **full**

Independence of the electricity regulator – **full**

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

Independence of the road directorate – **partial**

Financial sector

Capital adequacy ratio – **11.7 per cent** (2008)

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2.0 per cent** (2004)

Government expenditure on health – **6.6 per cent** (2005)

Government expenditure on education – **6.0 per cent** (2005)

Household expenditure on power and water – **9.1 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	4.7	4.7	4.8	4.9	6.4	**6.5**	**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)	69.0	69.0	69.0	70.0	71.0	**71.0**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	3.3	3.5	3.6	3.6	3.3	**3.6**	**na**
Share of industry in total employment (in per cent)	37.8	38.1	37.4	35.9	36.2	**27.6**	**na**
Change in labour productivity in industry (in per cent)	5.2	2.0	3.0	10.2	4.5	**26.4**	**na**
Investment/GDP (in per cent)	25.2	27.4	27.0	28.7	31.4	**32.2**	**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	**3.0**	**3.0**
EBRD index of enterprise reform	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	15.4	16.1	16.7	17.4	15.0	**13.1**	**na**
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	1.0	1.0	1.0	**1.0**	**na**
Share of trade with non-transition countries (in per cent)	75.0	76.6	72.0	70.9	69.0	**68.4**	**na**
Share of trade in GDP (in per cent)	93.3	99.3	105.0	113.3	119.4	**115.5**	**na**
Tariff revenues (in per cent of imports)	1.1	0.5	0.2	0.2	0.2	**na**	**na**
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	**4.0**	**4.0**
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	**4.3**	**4.3**
EBRD index of competition policy	2.7	2.7	2.7	2.7	2.7	**2.7**	**2.7**
Financial sector							
Number of banks (foreign-owned)[2]	22 (6)	22 (7)	25 (9)	25 (10)	27 (11)	**24 (11)**	**na**
Asset share of state-owned banks (in per cent)	12.8	12.6	12.0	12.5	14.4	**15.4**	**na**
Asset share of foreign-owned banks (in per cent)	18.9	20.1	22.6	29.3	28.8	**31.1**	**na**
Non-performing loans (in per cent of total loans)	9.4	7.5	6.4	5.5	3.9	**3.6**	**na**
Domestic credit to private sector (in per cent of GDP)[3]	41.3	48.1	56.3	65.8	78.8	**85.6**	**na**
Domestic credit to households (in per cent of GDP)	10.8	12.2	14.8	17.0	19.2	**19.9**	**na**
– Of which mortgage lending (in per cent of GDP)	2.3	2.8	4.2	4.5	6.2	**6.8**	**na**
Stock market capitalisation (in per cent of GDP)	22.5	26.2	22.0	37.1	57.0	**22.5**	**na**
Stock trading volume (in per cent of market capitalisation)	11.8	14.8	9.3	8.8	12.3	**6.9**	**na**
Eurobond issuance (in per cent of GDP)	0.0	0.7	0.0	0.0	6.3	**0.0**	**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	2.7	2.7	2.7	2.7	2.7	**3.0**	**3.0**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	40.7 (87.2)	40.6 (92.6)	40.8 (87.9)	41.8 (90.7)	42.6 (96.9)	**20.1 (102.0)**	**na**
Internet users (per 100 inhabitants)	31.9	36.4	46.2	50.0	52.8	**49.2**	**na**
Railway labour productivity (1989=100)	150.3	163.2	155.4	175.8	186.5	**169.6**	**na**
Residential electricity tariffs (USc kWh)	11.5	12.9	13.1	13.3	14.0	**18.4**	**na**
Average collection rate, electricity (in per cent)	93	na	90	96	99	**99**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	5.6	5.9	6.2	na	na	**na**	**na**
EBRD index of infrastructure reform	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Electric power	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Railways	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Roads	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Telecommunications	3.0	3.0	3.0	3.0	3.0	**3.3**	**3.3**
– Water and wastewater	3.3	3.3	3.3	3.3	3.3	**3.3**	**3.3**

[1] Direct investment by non-residents in the production or trading of armaments and military equipment requires a government licence.

[2] Two foreign branches are included in the figure.

[3] Source: Bank of Slovenia.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	2.8	4.3	4.5	5.8	6.8	**3.5**	**-7.8**
– Private consumption	3.3	2.7	2.6	2.9	6.7	**2.0**	**na**
– Public consumption	2.2	3.4	3.4	4.0	0.7	**6.2**	**na**
– Gross fixed capital formation	8.1	5.6	3.7	9.9	11.7	**7.7**	**na**
– Exports of goods and services	3.1	12.4	10.6	12.5	13.7	**2.9**	**na**
– Imports of goods and services	6.7	13.3	6.6	12.2	16.3	**2.9**	**na**
Industrial gross output	3.0	5.2	2.9	6.4	8.4	**-1.4**	**na**
Agricultural gross output[1]	-20.0	11.0	-0.7	-4.4	2.2	**0.2**	**na**
Employment[2]			*(Percentage change)*				
Labour force (end-year)	3.1	2.7	2.4	-1.5	2.0	**1.3**	**na**
Employment (end-year)	2.9	2.9	1.6	0.3	2.9	**1.8**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	6.8	6.6	7.4	5.7	4.8	**4.3**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	5.6	3.6	2.5	2.5	3.6	**5.7**	**1.8**
Consumer prices (end-year)	4.6	3.2	2.3	2.8	5.6	**2.1**	**0.2**
Producer prices (annual average)	2.5	4.4	2.8	2.4	5.5	**5.6**	**na**
Producer prices (end-year)	2.1	5.0	1.7	3.0	6.4	**3.5**	**na**
Gross average monthly earnings in economy (annual average)[3]	7.5	5.7	4.9	4.8	5.9	**8.3**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	-2.7	-2.2	-1.4	-1.3	0.5	**-0.9**	**-5.5**
General government expenditure	46.4	45.8	45.2	44.5	42.3	**43.6**	**na**
General government debt	34.1	35.0	33.9	33.8	29.9	**29.6**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	6.2	6.6	7.8	8.2	10.6	**5.1**	**na**
Domestic credit (end-year)	14.4	24.1	20.2	21.6	24.9	**14.9**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	50.5	49.9	50.7	50.8	50.5	**49.3**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	5.0	3.3	3.8	3.8	4.0	**4.3**	**na**
Interbank market rate (average)	5.6	4.7	4.0	3.6	4.1	**4.3**	**na**
Deposit rate (average 31-90 days)	6.0	3.8	3.2	2.8	3.6	**4.1**	**na**
Lending rate (average short-term working capital)	10.8	8.7	7.8	7.4	5.9	**6.7**	**na**
			(Euros per US dollar)				
Exchange rate (end-year)	0.8	0.7	0.8	0.8	0.7	**0.7**	**na**
Exchange rate (annual average)	0.9	0.8	0.8	0.8	0.7	**0.7**	**na**
External sector			*(In millions of US dollars)*				
Current account	-215.1	-892.4	-619.9	-997.2	-2,243.3	**-3,322.9**	**-1,134.7**
Trade balance	-622.2	-1,257.5	-1,258.1	-1,487.2	-2,330.4	**-3,880.3**	**-1,764.7**
– Merchandise exports	12,916.3	16,064.6	18,145.8	21,327.0	27,093.3	**29,607.1**	**23,685.7**
– Merchandise imports	13,538.5	17,322.1	19,403.9	22,814.2	29,423.7	**33,487.4**	**25,450.4**
Foreign direct investment, net	-174.1	281.1	-67.0	-215.2	-273.4	**518.8**	**-250.0**
Gross reserves, excluding gold (end-year)[4]	8,585.9	8,822.1	8,530.3	7,033.8	978.5	**876.7**	**na**
External debt stock	16,703.2	20,940.1	25,620.0	31,691.4	51,134.5	**55,160.8**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)[5]	5.9	4.8	4.6	3.1	0.3	**0.3**	**na**
			(In per cent of exports of goods and services)				
Debt service	16.6	16.9	17.5	18.4	18.4	**18.3**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	2.0	2.0	2.0	2.0	2.0	**2.0**	**na**
GDP (in billions of euros)	25.1	27.1	28.7	31.1	34.6	**37.1**	**34.9**
GDP per capita (in US dollars)	14,201.2	16,833.6	17,849.1	19,379.0	23,564.4	**27,134.7**	**na**
Share of industry in GDP (in per cent)	25.3	24.7	24.0	23.8	23.4	**22.4**	**na**
Share of agriculture in GDP (in per cent)	2.2	2.3	2.4	2.1	2.2	**2.1**	**na**
Current account/GDP (in per cent)[5]	-0.8	-2.7	-1.7	-2.5	-4.8	**-6.2**	**-2.4**
External debt - reserves (in US$ million)	8,117.3	12,118.1	17,089.8	24,657.6	50,156.0	**54,284.1**	**na**
External debt/GDP (in per cent)[5]	52.7	56.7	71.3	77.5	100.6	**105.7**	**na**
External debt/exports of goods and services (in per cent)[5]	95.3	97.6	115.1	116.8	145.3	**156.4**	**na**

[1] Agricultural value-added.

[2] Data based on labour force surveys (Eurostat).

[3] Data for enterprises employing three or more persons until 2004. From 2005 onwards, data for legal persons with 1 or 2 employees in the private sector also taken into account.

[4] From 1 January 2007 foreign exchange reserves of the Bank of Slovenia include foreign cash in convertible currencies, deposits abroad and first class securities of issuers from outside the EMU in foreign currency.

[5] Ratio calculated in euros.

Tajikistan

Key developments and challenges

The cancellation of farmers' cotton-related debt is a significant step towards increasing the financial soundness of the sector. A strengthening of the security and transferability of land-user rights is needed to facilitate farmers' access to finance.

Improving the financial transparency and governance of state-owned companies is the first step towards strengthening their performance. A plan to publish audited financial statements of these companies needs to be fully implemented.

The credibility of macroeconomic policy has increased with the improvement in the governance of the central bank. Nonetheless, as the banking sector remains vulnerable to liquidity and foreign exchange shocks, the central bank should take prompt corrective action against banks that violate regulatory requirements.

Country data

Population (in millions)	**6.5**
Area ('000 sq km)	**143.1**
GDP (in billion US$, 2008)	**5.1**
Average transition score (scale: 1 to 4.33)	**2.37**

Progress in structural reform

Liberalisation and privatisation

By October 2008 total debt in the cotton sector amounted to US$ 700 million (14 per cent of GDP), most of which was externally funded on the basis of guarantees and pledges by the National Bank of Tajikistan (NBT). Following a presidential decree in May 2009 to facilitate new commercial financing to the agricultural sector, all farmers' debt accumulated for the growing of cotton is being written off. For that portion of debt not guaranteed by the NBT, creditors will receive government securities as compensation. However, the debt owed by investors to finance cotton infrastructure, such as ginneries, will have to be repaid to the NBT. During 2009 the government has continued to provide financing to the agricultural sector through commercial banks but without limiting loans to cotton growing. The NBT has also taken steps to liberalise cotton exports.

Business environment and competition

To improve the governance and transparency of state-owned enterprises (SOEs), a supervisory unit for the 10 largest SOEs – including the Talco aluminium smelter – was established within the Ministry of Finance in late 2008. SOEs will be required to submit their business plans for 2010 for approval by the unit and the Ministry will publish their annual audited reports. The financial statements of Talco, which accounts for 3 per cent of GDP and 25 per cent of exports, will be audited by a major international audit firm. Companies registered with the Agency for Securities will also be required to disclose their beneficial ownership.

According to the World Bank's *Doing Business 2010* survey, the business environment improved slightly, with Tajikistan ranked 152nd out of 183 countries compared with 164th last time. The main shortcomings related to trading across borders and the procedures and time required to obtain construction permits. In May 2009 legislative amendments were adopted to reduce the length of time to register a new business from 49 to five days. Almost a quarter of enterprises in the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV) identified tax rates as the main obstacle to development. The authorities are progressing with reforms that include the simplification of the tax regime, strengthening of the VAT refund system and streamlining tax inspection. In May 2009 the VAT rate was reduced from 20 to 18 per cent.

Infrastructure

Electricity tariffs have been increased since the beginning of 2008, including a further increase in residential tariffs from 1 August 2009 to 7.5 dirams (1.7 US cents) per kWh. Part of the aim is to enable the state-owned vertically integrated electricity company Barki Tajik to reach cost-recovery levels by the end of 2010. Tajikistan continued to experience electricity shortages during the winter of 2008-09, partly because of low water levels at the Nurek reservoir. Electricity was imported from Kazakhstan, but rationing persisted as supplies from Turkmenistan were blocked by Uzbekistan until March 2009 due to a disagreement over transit fees. By mid-2009, as water levels in the key reservoirs increased, Tajikistan was able to repay Kazakhstan for its power imports through new generation and water release. Tajikistan's aim of achieving self-sufficiency in electricity was boosted when China agreed to invest over US$ 1 billion in the sector, including the construction of two hydroelectric and thermoelectric power plants in Dushanbe.

Financial sector

A special audit of the NBT, stipulated by the International Monetary Fund (IMF), has confirmed weaknesses in governance. In response, the NBT will publish its audited financial statements for the fiscal year 2009 and its internal audit function will be strengthened, while commercial banking laws will also be amended.

The banking system has been relatively stable and total loans outstanding have grown modestly in real terms in the year to mid-2009. However, some banks experienced liquidity problems towards the end of 2008. In response, banks increased deposit rates and reduced the supply of new credit. Non-performing loans increased from 0.8 per cent in January 2008 to 3.6 per cent of total loans by March 2009, reflecting the poor payment performance by cotton farms that received government-backed loans. The depreciation of the somoni during the first half of 2009 did not have an immediate impact on the capital adequacy of banks, but may have a negative effect on portfolio quality. To address this risk, the NBT is considering applying higher capital requirements for foreign-currency denominated loans to unhedged borrowers.

Macroeconomic performance

Real economic growth in 2008 amounted to 7.9 per cent, supported by record inflows of remittances (some 43 per cent of GDP), public spending on infrastructure and higher output from the non-cotton agricultural sector. However, the economy slowed towards the end of 2008 as the external environment deteriorated, reflected in declining aluminium exports and significantly lower remittances. In the first half of 2009, real GDP grew by 2.8 per cent year on year while the rate of inflation fell from its August 2008 peak of 27 per cent to 7.6 per cent in June 2009.

Tajikistan met the key conditions of a six-month, non-funded IMF programme (agreed in June 2008) and in March 2009 entered a new US$ 120 million three-year programme with the Fund. This unlocked other donor financing (around US$ 80 million) that had been frozen since the IMF became aware of the misreporting of pledges, guarantees and direct lending provided by the NBT for the cotton sector. The main focus of the facility is exchange rate flexibility, while accommodating the need for higher social spending and ensuring sustainable debt levels.

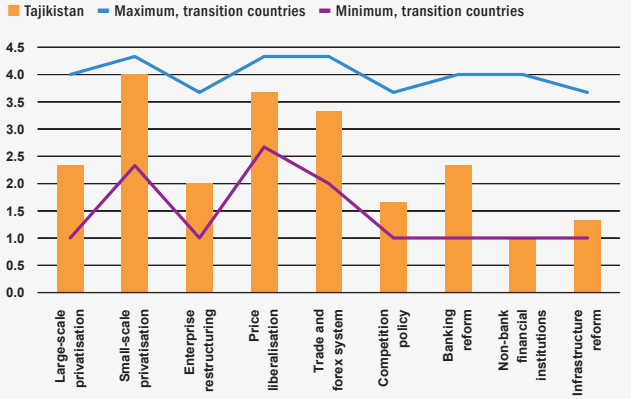
Total donor funding in 2009, representing around 3.7 per cent of GDP, should cover the expected revenue shortfalls (about 1.8 per cent of GDP) from the economic slow-down, while permitting some increase in social expenditure. The fiscal deficit is targeted to widen from 6.1 per cent in 2008 to 8.9 per cent in 2009. The exchange rate policy has remained flexible, mainly because of limited international reserves which amounted to less than one month of imports at the end of 2008. As the external environment has deteriorated, the exchange rate has come under pressure and the somoni depreciated by 22 per cent in nominal terms against the US dollar during the first half of 2009.

The current account deficit narrowed from 8.6 per cent in 2007 to 7.9 per cent in 2008, reflecting a sharp increase in remittances. However, the deficit is likely to widen in 2009 as remittances decline (by 35 per cent during the first half of the year) and the trade deficit increases due to a sharp fall in exports (by 48 per cent during the same period).

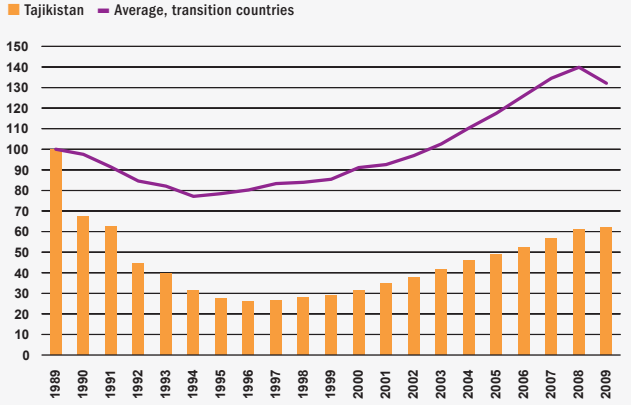
Outlook and risks

Economic growth in 2009 is likely to remain sluggish, but is expected to be followed by a modest upturn in 2010. The economy remains vulnerable to potential risks, such as a loss in confidence in the banking system or to further macroeconomic shocks. In the medium to long term, if reforms in agriculture are implemented as planned, there should be an additional stimulus to growth. Improved governance of SOEs should also enhance the productivity of enterprises that account for a significant proportion of the Tajik economy. External debt levels in relation to infrastructure investment could potentially become a source of macroeconomic vulnerability unless more emphasis is placed on selecting projects on the basis of their anticipated economic returns.

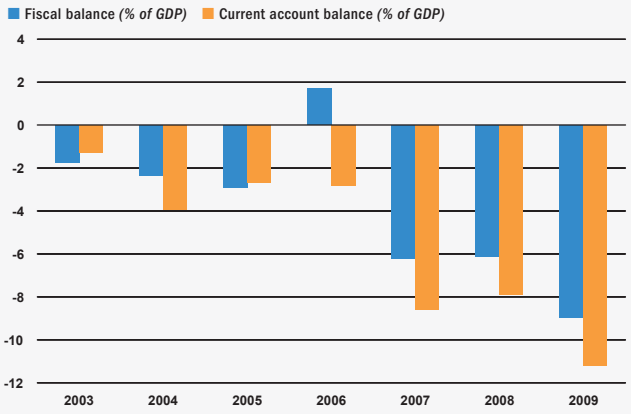
Transition indicators 2009



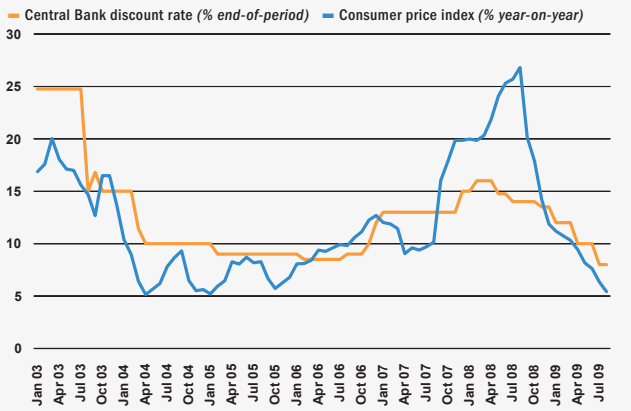
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**[1]

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradeability of land – **limited de facto**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **very low**

Secured transactions law – **malfunctioning**

Infrastructure

Telecoms regulatory assessment compliance – **low**

Independence of the electricity regulator – **no**

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

Independence of the road directorate – **no**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Private pension funds – **no**

Social reform

Share of population living in poverty – **50.8 per cent** (2004)

Government expenditure on health – **1.2 per cent of GDP** (2008)

Government expenditure on education – **3.4 per cent of GDP** (2008)

Household expenditure on power and water – **6.0 per cent**

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	6.3	6.7	7.2	7.8	7.9	**8.5**	na
Private sector share in GDP (in per cent)	50.0	50.0	55.0	55.0	55.0	**55.0**	**55.0**
Private sector share in employment (in per cent)	45.8	51.2	52.4	51.9	51.8	**53.6**	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.4	0.4	0.4	0.4	0.3	**0.3**	na
Share of industry in total employment (in per cent)	6.1	5.7	5.7	5.5	5.3	**4.8**	na
Change in labour productivity in industry (in per cent)	16.6	10.9	5.8	9.4	13.8	**5.8**	na
Investment/GDP (in per cent)	13.2	14.0	14.8	13.7	22.0	**20.7**	na
EBRD index of small-scale privatisation	3.7	3.7	4.0	4.0	4.0	**4.0**	**4.0**
EBRD index of large-scale privatisation	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
EBRD index of enterprise reform	1.7	1.7	1.7	1.7	1.7	**1.7**	**2.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	0.0	0.0	0.0	0.0	na	**na**	na
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	**0.0**	na
Share of trade with non-transition countries (in per cent)	33.2	38.7	38.5	38.7	36.2	**42.4**	na
Share of trade in GDP (in per cent)	122.5	112.3	56.8	60.0	65.8	**71.1**	na
Tariff revenues (in per cent of imports)	2.3	2.7	5.0	3.9	3.2	**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	3.3	3.3	3.3	3.3	3.3	**3.3**	**3.3**
EBRD index of competition policy	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
Financial sector							
Number of banks (foreign-owned)	15 (4)	12 (3)	12 (3)	10 (2)	11 (4)	**12 (4)**	na
Asset share of state-owned banks (in per cent)[2]	6.1	12.2	9.7	7.6	7.2	**na**	na
Asset share of foreign-owned banks (in per cent)[2]	3.6	6.2	8.9	6.5	6.6	**na**	na
Non-performing loans (in per cent of total loans)	73.6	18.7	13.8	11.4	4.9	**na**	na
Domestic credit to private sector (in per cent of GDP)	14.0	17.4	22.3	25.8	29.7	**26.1**	na
Domestic credit to households (in per cent of GDP)	0.5	1.8	1.5	2.1	3.6	**4.1**	na
– Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	**na**	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	**na**	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	**na**	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	**0.0**	na
EBRD index of banking sector reform	1.7	2.0	2.0	2.3	2.3	**2.3**	**2.3**
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.0	1.0	**1.0**	**1.0**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	3.8 (0.8)	4.2 (2.1)	4.3 (4.1)	4.8 (32.4)	5.1 (34.9)	**5.1 (34.9)**	na
Internet users (per 100 inhabitants)	0.1	0.1	0.3	0.3	7.2	**7.2**	na
Railway labour productivity (1994=100)	38.6	38.0	35.3	42.5	45.1	**45.9**	na
Residential electricity tariffs (USc kWh)	0.5	0.6	0.6	0.6	0.9	**1.1**	na
Average collection rate, electricity (in per cent)	73	85	74	97	99	**85**	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.5	2.7	2.8	na	na	**na**	na
EBRD index of infrastructure reform	1.0	1.3	1.3	1.3	1.3	**1.3**	**1.3**
– Electric power	1.0	1.7	1.7	2.0	2.0	**2.0**	**2.0**
– 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	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
– Water and wastewater	1.0	1.0	1.0	1.0	1.0	**1.7**	**1.7**

[1] Approval from the National Bank of Tajikistan is required.

[2] Including credit unions.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	10.2	10.6	6.7	7.0	7.8	**7.9**	**2.0**
Industrial gross output	9.9	13.8	8.5	6.7	9.9	**-3.5**	**na**
Agricultural gross output	9.1	11.3	3.1	4.8	6.5	**7.9**	**na**
Employment			*(Percentage change)*				
Labour force (annual average)	1.5	10.4	1.0	1.4	0.7	**0.7**	**na**
Employment (annual average)	1.5	10.8	1.1	1.2	0.6	**0.8**	**na**
			(In per cent of labour force)				
Unemployment (annual average)[1]	2.4	2.0	1.9	2.2	2.3	**2.2**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	16.4	7.2	7.3	10.0	13.2	**20.4**	**8.6**
Consumer prices (end-year)	13.7	5.7	7.1	12.5	19.8	**11.8**	**11.9**
Producer prices (annual average)	15.0	17.1	-1.0	22.0	18.4	**20.6**	**na**
Producer prices (end-year)	14.1	15.1	2.9	21.5	16.7	**-5.6**	**na**
Gross average monthly earnings in economy (annual average)	37.6	36.3	41.1	36.7	39.4	**43.1**	**na**
Government sector[2]			*(In per cent of GDP)*				
General government balance	-1.8	-2.4	-2.9	1.7	-6.2	**-6.1**	**-8.9**
General government expenditure	19.1	20.3	23.0	21.9	28.6	**28.2**	**na**
General government debt	66.6	42.9	41.6	34.5	34.9	**30.1**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	42.0	51.6	30.2	63.4	78.8	**6.3**	**na**
Domestic credit (end-year)	-6.5	52.7	32.7	27.2	71.0	**19.6**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	10.0	11.7	13.0	16.5	21.4	**16.5**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Monetary policy rate	15.0	10.0	9.0	12.0	15.0	**13.5**	**na**
Deposit rate (up to 3 months)	14.6	8.6	8.6	8.2	5.5	**5.4**	**na**
Lending rate (up to 3 months)	15.6	21.3	25.6	26.7	22.5	**19.6**	**na**
			(Tajik somoni per US dollar)				
Exchange rate (end-year)	2.9	3.0	3.2	3.4	3.5	**3.5**	**na**
Exchange rate (annual average)	3.1	3.0	3.1	3.3	3.4	**3.4**	**na**
External sector			*(In millions of US dollars)*				
Current account	-19.9	-81.6	-61.9	-78.8	-318.8	**-404.9**	**-521.7**
Trade balance	-103.1	-151.2	-622.0	-986.4	-1,673.0	**-2,733.2**	**-1,981.2**
– Merchandise exports	900.0	1,087.8	345.7	349.5	385.2	**457.3**	**348.6**
– Merchandise imports	1,003.2	1,239.0	967.7	1,335.9	2,058.1	**3,190.5**	**2,329.8**
Foreign direct investment, net	31.6	272.0	54.6	65.9	160.0	**300.0**	**100.0**
Gross reserves, including gold (end-year)	135.0	64.0	91.0	111.0	107.0	**199.0**	**na**
External debt stock	1,302.6	1,170.3	1,190.0	1,200.5	1,519.8	**2,410.9**	**na**
			(In months of imports of goods and services)				
Gross reserves, including gold (end-year)	1.4	0.5	0.9	0.8	0.5	**0.6**	**na**
			(In per cent of exports of goods and services)				
Debt service	11.2	28.1	17.9	32.7	13.2	**15.0**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	6.3	6.3	6.3	6.4	6.4	**6.5**	**na**
GDP (in millions of somoni)	4,758.0	6,157.5	7,201.1	9,272.2	12,779.7	**17,609.3**	**19,512.2**
GDP per capita (in US dollars)	248.1	328.5	364.3	440.5	578.3	**794.8**	**na**
Share of industry in GDP (in per cent)	na	na	na	na	18.3	**12.5**	**na**
Share of agriculture in GDP (in per cent)	na	na	na	na	19.4	**21.8**	**na**
Current account/GDP (in per cent)	-1.3	-3.9	-2.7	-2.8	-8.6	**-7.9**	**-11.2**
External debt – reserves (in US$ million)	1,167.6	1,106.3	1,099.0	1,089.5	1,412.8	**2,211.9**	**na**
External debt/GDP (in per cent)	83.8	56.5	51.5	42.7	40.9	**47.0**	**na**
External debt/exports of goods and services (in per cent)	132.3	96.7	197.9	182.9	198.2	**278.7**	**na**

[1] Officially registered unemployed.

[2] Includes externally financed public investment programmes.

Turkey

Key developments and challenges

Continued privatisation in the energy and transport sectors and renewed efforts to reform the municipal and environmental infrastructure sector are needed to promote greater private sector investment, including high inflows of foreign direct investment (FDI).

Tax reform and the introduction of more flexible labour market regulations, coupled with effective social protection measures, would help address the problems of growing unemployment, large regional disparities and a sizeable informal sector.

As the economy contracts, the authorities need to find the right balance between stimulating domestic demand and restoring fiscal discipline. Credible economic policies that would ensure medium-term debt sustainability and reduce spending pressures would help to improve investor confidence and meet the large domestic and external refinancing needs.

Country data

Population (in millions)	**69.7**
Area ('000 sq km)	**783.6**
GDP (in billion US$, 2008)	**730.0**
Average transition score (scale: 1 to 4.33)	**3.26**

Progress in structural reform

Liberalisation and privatisation

The Helsinki European Council of December 1999 granted Turkey EU candidate country status. Accession negotiations began in October 2005 and are ongoing. As of September 2009 negotiations had been opened on 11 out of the 35 chapters of the European Union's *acquis communautaire*[1] and only one, Science and Research, has been provisionally closed.

Privatisation has gained momentum in recent years. Privatisation revenues totalled US$ 6.3 billion in 2008, including the sale of two large companies, Tekel, a cigarette producer (US$ 1.7 billion) and Petkim, a petrochemical company (US$ 2 billion). In May 2008, an initial public offering (IPO) of a 15 per cent stake in Türk Telecom was launched, which raised US$ 1.9 billion – the largest IPO in Turkey to date. Despite the global economic crisis, the privatisation process continued in the first half of 2009, with the sale of two electricity distribution companies (Sakarya and Başkent) and the selection of preferred buyers for another two, plus the sale of several ports for a total of US$ 1.3 billion in privatisation proceeds and another US$ 2.4 billion in due receivables. There are currently 14 companies in the portfolio of the Privatisation Agency, including sugar factories; the Galata and Iskenderun ports; other power generation and distribution companies; and the National Lottery.

Business environment and competition

The business environment in Turkey has been improving slowly in recent years but a number of significant problems remain. According to the World Bank *Doing Business 2010* indicators, Turkey was ranked 73rd, down from 63rd last year. Licensing and regulation are major areas of concern, with the time taken to arrange construction permits, labour contracts and business liquidations well above the average for the transition region.

After access to finance, taxation and unfair competition by companies operating in the informal economy are among the main obstacles to doing business in Turkey, according to the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV). Action has been taken to reduce the size of the informal sector and support job creation, including a reduction of the corporate and income tax rates and the introduction of employment incentives in less-developed regions.

Infrastructure

Although liberalisation of the energy sector is proceeding, private sector participation remains limited. Power generation is dominated by the state-owned company, EUAS, and privatisation of the distribution segment has only just started. An independent regulator, EMRA, has been established and steps have been taken to adopt a pricing system that fully reflects costs. Retail electricity tariffs were raised in January, July and October 2008 by about 50 per cent on average and an automatic cost-based price-adjustment mechanism came into effect from 1 October 2008. Turkey ratified the Kyoto Protocol in February 2009.

Although municipalities are responsible for the delivery of services in the areas of municipal and environmental infrastructure, there remains a high degree of fiscal centralisation, and the corporate governance of some municipal companies – especially those in smaller municipalities – falls short of international best practice. Turkey's current approach to the granting of concessions, involving considerable uncertainties as to terms and strong and unilateral governmental termination rights, is an obstacle to private sector financing.

Despite rapid recent growth, the fixed-line telephony sector is still characterised by low penetration rates of around 24 per cent (2008). Turkey's mobile telephony market was liberalised ahead of fixed telephony services and has enjoyed strong growth since then, with a penetration rate of 89 per cent. There are three mobile phone operators, the largest of which has a 56.2 per cent market share. Number portability for mobile phones was introduced in November 2008.

Financial sector

The domestic financial system has shown a fair degree of resilience to the global financial crisis so far, partly because prudential regulation and supervision were strengthened following the 2001 banking crisis. However, Turkish corporates have relatively large, open, long-term foreign currency positions, which may affect the future quality of the loan portfolio of Turkish banks. Non-performing loans increased to an average of 5.07 per cent in July 2009, from 3 per cent at the end of 2008, and can be expected to increase further. The sector does, however, have a relatively stable base from which any future effects of the crisis can be addressed. These include capital adequacy ratios which averaged 20 per cent as of the end of July 2009, strong profitability and a system which is largely deposit-funded (the loan-to-deposit ratio is about 70 per cent) with minimal foreign currency exposure.

Macroeconomic performance

Turkey's economy has been hit hard by the global financial crisis, mainly through its trade links with the major industrialised economies. The fall in industrial output started in August 2008 and accelerated in the first quarter of 2009, led by a severe decline in manufacturing output, especially in the textile sector; the automotive sector; and metal production. After six years of uninterrupted growth averaging around 7 per cent annually, GDP growth slowed to 1.1 per cent in 2008 and fell by 14.3 per cent year on year in the first quarter of 2009, before rebounding to -7 per cent year on year in the second quarter. The unemployment rate peaked at 16.1 per cent in February 2009, before dropping to 13 per cent in June.

As inflation pressures subsided and economic activity slowed, the Central Bank of Turkey (CBT) surprised the markets with a series of aggressive interest rate cuts: 950 basis points in total since November 2008, taking the discount rate to 7.25 per cent by the end of September. This should provide some relief to corporates, whose funding costs increased as a result of the global credit crunch.

Fiscal discipline has been loosened since the last International Monetary Fund (IMF) stand-by arrangement programme ended in May 2008. In response to the economic crisis, the government increased public spending and announced temporary tax cuts and investment incentives aimed at stimulating the economy. As a result, the primary fiscal balance is projected to switch to a deficit for the first time this year since the 2001 crisis. According to the new medium-term economic programme for 2010-12 unveiled in September 2009, the primary budget deficit is expected to reverse into surplus in 2011, when the government plans to introduce a fiscal rule and establish prudent budgetary targets. The debt to GDP ratio, which increased to 43 per cent by the end of June 2009, is expected to stabilise by 2011.

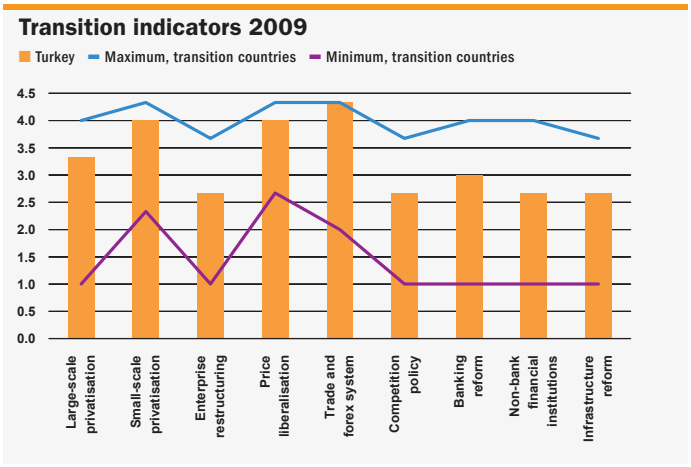
Lower global and domestic economic activity and cheaper commodity prices have had a net positive impact on Turkey's external balances. The current account deficit is expected to more than halve from US$ 41.5 billion in 2008 (5.7 per cent of GDP) to less than US$ 19 billion in 2009 (about 3 per cent of GDP) as the contraction in imports far exceeded that of exports.

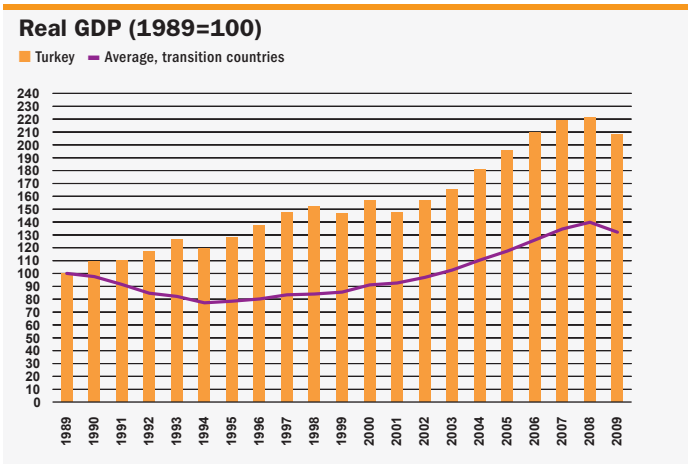
Outlook and risks

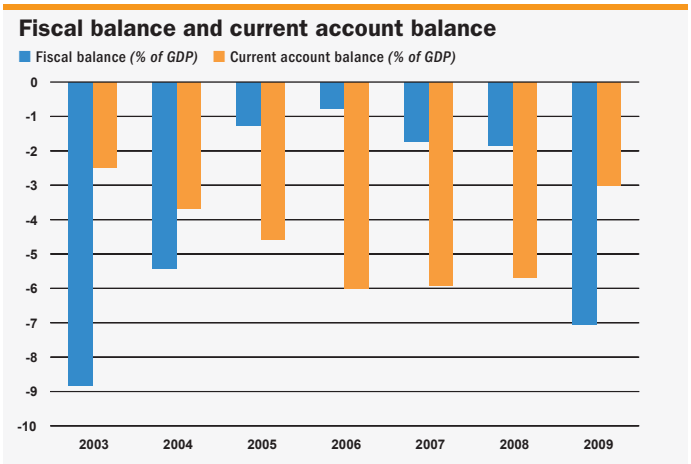
In the short term the economy is expected to contract by about 6 per cent in 2009 and bounce back in 2010, as a result of the global recession and weak domestic demand. In the medium term, the outlook remains positive, as the EU accession process should support convergence and sustainable long-term growth.

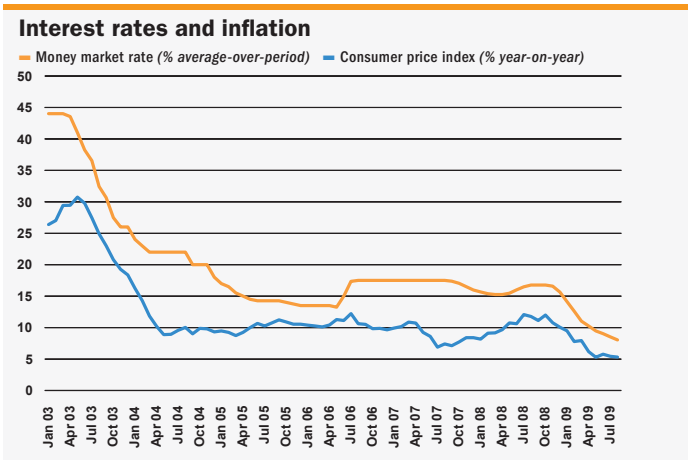
The main macroeconomic risks stem from low consumer and investor confidence; a slow recovery of Turkey's main trading partners; and failure to stabilise the growing fiscal imbalances. Turkey will remain dependent on domestic and external funding to finance its twin fiscal and current account deficits. These risks could be mitigated by a new IMF-supported programme that would help boost investor confidence and anchor the country's structural reform agenda.

[1] The *acquis communautaire* is the body of European law that countries must adopt to become EU members.









Liberalisation and privatisation

Current account convertibility – **full**

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

Interest rate liberalisation – **full**

Exchange rate regime – **float**

Wage regulation – **no**

Tradeability of land – **full**[2]

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **malfunctioning**

Infrastructure

Telecoms regulatory assessment compliance – **high**

Independence of the electricity regulator – **full**

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

Independence of the road directorate – **no**

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **9.0 per cent** (2005)

Government expenditure on health – **3.6 per cent of GDP** (2006)[3]

Government expenditure on education – **3.1 per cent of GDP** (2006)[3]

Household expenditure on power and water – **28.4 per cent** (2007)[4]

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	3.2	3.6	5.3	6.7	7.4	**8.2**	**na**
Private sector share in GDP (in per cent)	na	na	na	na	na	**70.0**	**70.0**
Private sector share in employment (in per cent)	31.6	34.6	40.6	42.2	45.0	**45.0**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)	na	5.0	5.4	7.2	8.2	**na**	**na**
Share of industry in total employment (in per cent)	18.1	18.5	19.5	19.7	21.3	**20.7**	**na**
Change in labour productivity in industry (in per cent)	9.7	7.8	1.2	8.8	-1.2	**0.0**	**na**
Investment/GDP (in per cent)	17.6	19.4	20.0	22.1	21.5	**22.1**	**na**
EBRD index of small-scale privatisation	na	na	na	na	na	**4.0**	**4.0**
EBRD index of large-scale privatisation	na	na	na	na	na	**3.3**	**3.3**
EBRD index of enterprise reform	na	na	na	na	na	**2.7**	**2.7**
Markets and trade							
Share of administered prices in CPI (in per cent)	5.9	5.9	5.9	5.9	5.0	**6.6**	**na**
Number of goods with administered prices in EBRD-15 basket	13.0	13.0	13.0	13.0	13.0	**13.0**	**na**
Share of trade with non-transition countries (in per cent)	85.0	83.0	81.2	79.1	77.0	**75.8**	**na**
Share of trade in GDP (in per cent)	39.0	40.8	39.3	43.0	42.9	**45.7**	**na**
Tariff revenues (in per cent of imports)	na	13.0	12.9	14.3	13.7	**13.0**	**na**
EBRD index of price liberalisation	na	na	na	na	na	**4.0**	**4.0**
EBRD index of forex and trade liberalisation	na	na	na	na	na	**4.3**	**4.3**
EBRD index of competition policy	na	na	na	na	na	**2.7**	**2.7**
Financial sector							
Number of banks (foreign-owned)	50 (16)	48 (15)	51 (17)	50 (21)	50 (23)	**49 (24)**	**na**
Asset share of state-owned banks (in per cent)	39.2	38.2	33.1	31.1	30.4	**30.5**	**na**
Asset share of foreign-owned banks (in per cent)	3.0	3.5	6.3	13.1	14.0	**17.0**	**na**
Non-performing loans (in per cent of total loans)	11.5	6.0	4.8	3.8	3.5	**3.7**	**na**
Domestic credit to private sector (in per cent of GDP)	14.5	17.3	22.2	25.9	29.5	**32.6**	**na**
Domestic credit to households (in per cent of GDP)	2.9	4.9	7.4	9.4	11.6	**12.8**	**na**
– Of which mortgage lending (in per cent of GDP)	0.2	0.5	2.0	3.1	3.9	**4.1**	**na**
Stock market capitalisation (in per cent of GDP)	21.0	23.6	33.5	30.2	39.5	**19.1**	**na**
Stock trading volume (in per cent of market capitalisation)	194.7	176.9	154.9	140.5	134.7	**118.5**	**na**
Eurobond issuance (in per cent of GDP)	na	na	na	na	na	**0.6**	**na**
EBRD index of banking sector reform	na	na	na	na	na	**3.0**	**3.0**
EBRD index of reform of non-bank financial institutions	na	na	na	na	na	**2.7**	**2.7**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	27.3 (40.2)	27.2 (49.4)	26.7 (61.3)	26.1 (73.1)	24.9 (84.9)	**23.7 (89.1)**	**na**
Internet users (per 100 inhabitants)	12.3	13.4	14.4	18.2	29.0	**33.1**	**na**
Railway labour productivity (1991=100)	147.5	149.0	186.5	179.8	171.4	**178.4**	**na**
Residential electricity tariffs (USc kWh)	10.6	11.2	11.8	10.9	11.9	**15.8**	**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)	6.0	6.2	na	na	na	**na**	**na**
EBRD index of infrastructure reform	na	na	na	na	na	**2.7**	**2.7**
– Electric power	na	na	na	na	na	**3.3**	**3.3**
– Railways	na	na	na	na	na	**2.0**	**2.0**
– Roads	na	na	na	na	na	**2.3**	**2.3**
– Telecommunications	na	na	na	na	na	**3.3**	**3.3**
– Water and wastewater	na	na	na	na	na	**2.7**	**2.7**

[1] Controls apply to the following sectors: mining sector; exploration/exploitation of petroleum; refining, transportation through pipelines and storage of petroleum; maritime transport, air transport and ground handling services; radio, television broadcasting; education; banks and other financial institutions; all sectors if the value of the investment is less than US$ 50,000; the accounting sector.

[2] Full except for foreigners.

[3] OECD Economic Surveys: Turkey 2008, page 74, in per cent of GDP.

[4] Household expenditures on housing and utilities.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	5.3	9.4	8.4	6.9	4.7	**1.1**	**-6.0**
– Private consumption	10.2	11.0	7.9	4.6	4.6	**0.3**	**na**
– Public consumption	-2.6	6.0	2.5	8.4	6.5	**1.8**	**na**
– Gross fixed capital formation	14.2	28.4	17.4	13.3	5.4	**-4.6**	**na**
– Exports of goods and services	6.9	11.2	7.9	6.6	7.3	**2.6**	**na**
– Imports of goods and services	23.5	20.8	12.2	6.9	10.7	**-3.1**	**na**
Industrial gross output	7.8	11.8	8.7	10.2	5.8	**-0.6**	**na**
Agricultural gross output	-2.0	2.8	7.2	1.4	-6.7	**4.1**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)[1]	-0.6	1.7	1.5	-0.2	-0.6	**1.9**	**na**
Employment (end-year)	-0.8	2.0	1.6	0.2	-1.0	**2.4**	**na**
			(In per cent of labour force)				
Unemployment (end-year)	10.5	10.3	10.2	9.9	10.3	**9.9**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	25.3	8.6	8.2	9.6	8.8	**10.4**	**5.9**
Consumer prices (end-year)	18.4	9.4	7.7	9.7	8.4	**10.1**	**5.8**
Producer prices (annual average)	na	14.6	5.9	9.3	6.3	**12.7**	**na**
Producer prices (end-year)	13.9	15.4	2.7	11.6	5.9	**8.1**	**na**
Gross average monthly earnings in economy (annual average)	32.2	7.6	12.5	na	na	**na**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	-8.8	-5.4	-1.3	-0.8	-1.7	**-1.9**	**-7.0**
General government expenditure	30.9	25.2	22.5	23.1	23.7	**23.3**	**na**
General government debt	63.2	57.4	51.8	46.0	39.9	**40.7**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	33.7	31.2	120.0	24.7	15.7	**26.7**	**na**
Domestic credit (end-year)	16.9	18.9	28.1	17.2	19.7	**20.2**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	18.2	19.4	36.8	39.3	40.8	**45.9**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	43.0	38.0	23.0	27.0	25.0	**16.3**	**na**
Interbank money market rate	26.0	18.0	13.5	17.5	16.0	**15.6**	**na**
Deposit rate	37.7	24.3	20.4	21.6	22.6	**22.9**	**na**
Lending rate	48.0	35.0	26.0	28.0	27.0	**26.5**	**na**
			(Liras per US dollar)				
Exchange rate (end-year)	1.4	1.3	1.3	1.4	1.2	**1.5**	**na**
Exchange rate (annual average)	1.5	1.4	1.3	1.4	1.3	**1.3**	**na**
External sector			*(In millions of US dollars)*				
Current account	-7,515.0	-14,431.0	-22,137.0	-31,893.0	-38,219.0	**-41,490.0**	**-18,250.0**
Trade balance	-13,489.0	-22,736.0	-32,988.0	-40,941.0	-46,677.0	**-53,043.0**	**-26,000.0**
– Merchandise exports	52,394.0	68,535.0	78,365.0	93,611.0	115,364.0	**140,801.0**	**100,000.0**
– Merchandise imports	65,883.0	91,271.0	111,353.0	134,552.0	162,041.0	**193,844.0**	**126,000.0**
Foreign direct investment, net	1,252.0	2,005.0	8,967.0	19,065.0	19,940.0	**15,633.0**	**7,000.0**
Gross reserves, excluding gold (end-year)	33,991.0	35,669.1	50,579.0	60,891.9	73,383.9	**70,976.2**	**na**
External debt stock	144,266.0	160,760.0	168,716.0	205,548.0	247,094.0	**277,114.7**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	5.6	4.2	4.9	5.0	5.0	**4.0**	**na**
			(In per cent of exports of goods and services)				
Debt service due	10.2	7.9	7.9	8.2	7.8	**6.8**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	65.9	66.9	67.9	68.1	68.9	**69.7**	**70.4**
GDP (in billions of liras)	454.8	559.0	648.9	758.4	843.2	**950.1**	**na**
GDP per capita (in US dollars)	4,599.0	5,861.5	7,112.9	7,792.4	9,390.4	**10,504.0**	**na**
Share of industry in GDP (in per cent)	24.9	24.8	24.7	24.9	24.8	**24.3**	**na**
Share of agriculture in GDP (in per cent)	9.9	9.5	9.4	8.3	7.6	**7.8**	**na**
Current account/GDP (in per cent)	-2.5	-3.7	-4.6	-6.0	-5.9	**-5.7**	**-3.0**
External debt – reserves (in US$ million)	110,275.0	125,090.9	118,137.0	144,656.1	173,710.1	**206,138.5**	**na**
External debt/GDP (in per cent)	47.6	41.0	34.9	38.7	38.2	**37.9**	**na**
External debt/exports of goods and services (in per cent)	204.9	175.7	160.7	172.8	171.6	**157.8**	**na**

[1] Annual results of household labour force survey, 2008.

Turkmenistan

Key developments and challenges

After the successful reunification and redenomination of the exchange rate, the financial sector needs to develop into a sustainable source of funding for the real economy. The entry of foreign strategic investors, a reduction of directed lending and the end of subsidised interest rates would help to meet this challenge.

Private sector development depends on further improvements in the business environment, in particular the lowering of entry barriers, the reduction of the regulatory burden on existing businesses, continued price liberalisation and the abolition of production targets in agriculture and textiles.

Although the establishment of the stabilisation fund is a welcome step towards creating a longer-term approach to public sector investment policy, the budgetary process and public sector finances need to be more transparent.

Country data

Population (in millions)	**6.5**
Area ('000 sq km)	**488.0**
GDP (in billion US$, 2008)	**19.0**
Average transition score (scale: 1 to 4.33)	**1.44**

Progress in structural reform

Liberalisation and privatisation

To further its ambitious target to increase the private sector share to 70 per cent of GDP by 2020, the government has taken several legislative initiatives. The new constitution adopted in October 2008 recognises – for the first time in Turkmenistan – the concept of a market economy with private property and independent enterprises. The new constitution complements the investment legislation passed in March 2008 that provides for long-term property leases and the repatriation of profits. In practice, however, the administrative burden on private businesses continues to constrain their development. The agricultural and textile sectors in particular are distorted by production targets and subsidised inputs.

Domestic prices for petrol were liberalised in 2008 with the aim of significantly decreasing car fuel consumption, given that, per capita, consumption of petrol is among the highest in central Asia. Market prices for petrol subsequently increased eightfold (although they remain well below the levels of other countries in the region). A more comprehensive energy reform package, covering not only individual petrol consumption but also the highly energy-inefficient industrial sector, has not been considered yet. Sixteen other basic commodities (including water, salt and bread) remain highly subsidised and price controlled.

Infrastructure

Physical infrastructure outside the capital, Ashgabat, still suffers from years of underinvestment. The government has developed a regional development plan that envisages significant increases in investment in rural infrastructure. However, this programme is yet to be implemented. Efforts to improve regional transport infrastructure, in particular a north-south trade and transportation corridor, have moved forward only slowly. The Iran-Turkmenistan-Kazakhstan rail link only recently secured funding (in July 2009) from the Islamic Development Bank for the southern segment. Disputes over the transit of electricity within Central Asia in January have severely disrupted Turkmenistan's exports of electricity via Uzbekistan to Tajikistan. However, renegotiated contract terms in March, in particular regarding electricity transit, have solved the issue for now and may allow for the necessary investment to upgrade the grid.

Financial sector

Despite the successful reunification of the exchange rate and the new exchange regulations that were introduced in 2008, reform of the financial sector has progressed slowly and continues to be dominated by state-owned banks. Directed lending with subsidised interest rates, in particular to the textile and agriculture sectors, remains endemic. The redenomination of the currency was completed in January 2009 and the central bank remains committed and has intervened regularly on the foreign exchange market to support the new exchange rate and satisfy the increased demand for foreign exchange from commercial banks. The requirement for all banks to use International Financial Reporting Standards (IFRS) as of 2009 has led to initial improvements in accounting. The central bank has also lifted a ban on international banking operations of commercial banks; they are now able to open correspondent accounts with foreign banks and conduct SWIFT transactions. The government has also launched consumer loans for educational purposes via the government-owned banks.

Social sector

To soften the impact of higher food prices, the government approved a small budgetary deficit for both 2008 and 2009 to allow a 10 per cent increase in public sector salaries and pensions as well as health allowances and scholarships. A new Labour Code is also being prepared, which will update the existing labour law that dates from 1993. The Code will expand the rights of employees, including part-time workers. It will limit the use of short-term contracts in the public sector that have, in the past, led to increased side payments to ensure job security. The law also includes provisions for longer annual leave.

With the support of the European Union, ongoing work on reforming the budgetary process has started to improve the transparency of budget operations. An important step was the closure of several extra-budgetary accounts and the establishment of a stabilisation fund under the supervision of the Ministry of Finance. Since October 2008 foreign exchange revenues have been transferred into this new fund. In the short term the fund will be used to counterbalance the limited effects of the global financial crisis. Ultimately it is intended that the fund should be used to make long-term investments targeted at infrastructure, education and health. The authorities aim to model this fund on similar funds in Norway and Russia, but explicit investment rules have yet to be published.

Macroeconomic performance

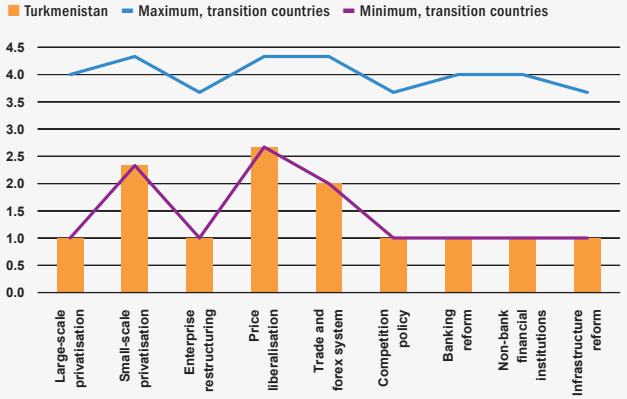
The Turkmen economy has grown strongly in the last few years, with double-digit GDP growth recorded every year between 2004 and 2008, mainly on the back of increasing hydrocarbon prices and higher negotiated off-take volumes. Large public investments in construction and infrastructure and growth in the service sector – particularly transportation, communication and retail – have supported double-digit growth in the non-hydrocarbon sector. The current account has been in strong surplus since 2004, and was nearly 19 per cent of GDP in 2008. Imports of goods and services were boosted by higher domestic demand and better access to foreign exchange. However, higher hydrocarbon earnings have led to a 20 per cent increase in export receipts. Turkmenistan successfully negotiated further significant increases in gas off-take prices and volumes for 2009 onwards and has, for the first time, linked these agreements to loans from off-takers to finance hydrocarbon infrastructure. Foreign direct investment (FDI) inflows continue to mainly finance investments in offshore oil and gas production in the Caspian Sea.

As gas exports prices converge with European levels, international reserves have further increased. Exchange rate unification was completed on 1 May 2008 at the rate of 14,250 manat per US dollar, a level broadly consistent with the country's strong external position. With liberalised petrol prices and higher food prices, inflation at one point reached 13 per cent in 2008. Credit grew strongly up to 2008, mainly reflecting increased directed lending to the cotton sector. A small fiscal deficit was budgeted for 2008 and 2009, but government revenues outperformed expectations and government investments were delayed, leaving the actual budget for 2008 in surplus. Tax collection has also improved, benefiting from streamlined tax and customs procedures.

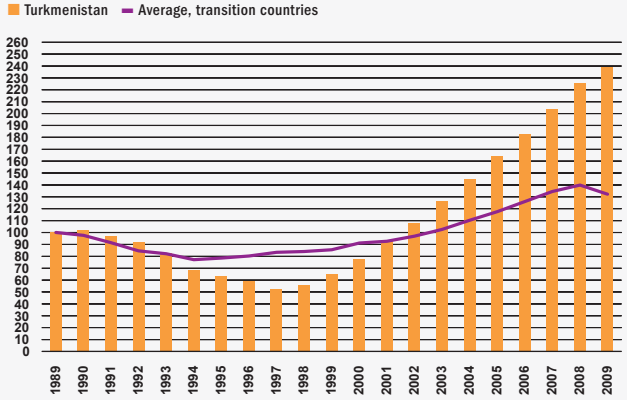
Outlook and risks

The overall outlook for 2009 is favourable given that Turkmenistan's gas export prices are still catching up with European market prices. With new onshore and offshore hydrocarbon discoveries, medium-term growth prospects remain positive. However, a technical accident in the main gas pipeline to Russia in April 2009 disrupted gas supplies and highlighted Turkmenistan's vulnerability regarding their biggest hydrocarbon off-taker. This has led to increased efforts to diversify Turkmenistan's exports. More broadly, Turkmenistan's undiversified economy remains vulnerable to commodity price fluctuations. The main macro risks are therefore related to potential renegotiations of gas off-take prices, lower than planned investment in hydrocarbon infrastructure and weaker than expected international demand for hydrocarbons. Channelling FDI into the non-hydrocarbon sector and creating a business environment that fosters the private sector outside of oil and gas remains a major challenge. Continued inflationary pressures and real appreciation are also a longer-term risk to the competitiveness of the private sector.

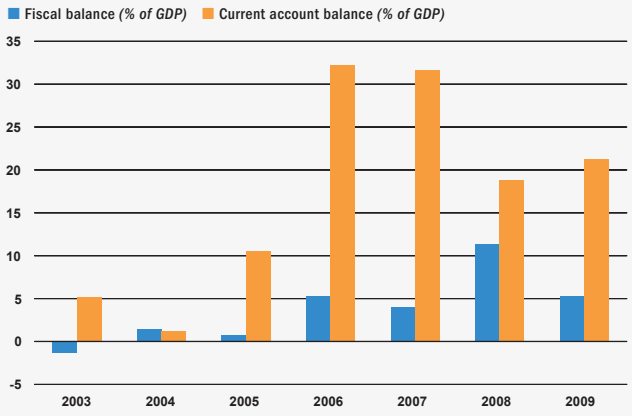
Transition indicators 2009



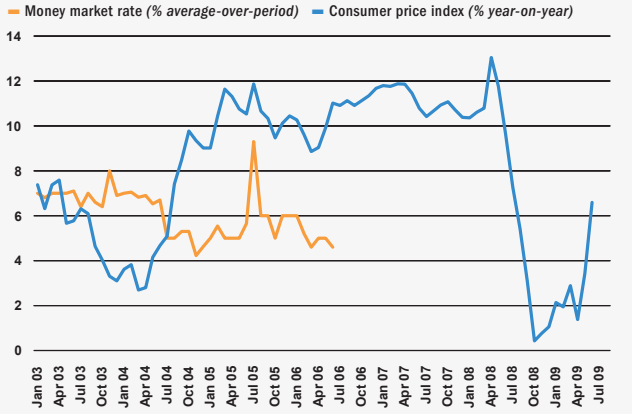
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **limited**	Competition office – **no**	Telecoms regulatory assessment compliance – **low**	Capital adequacy ratio – **10 per cent**[2]	Share of population living in poverty – **na**
Controls on inward direct investment – **no**[1]	Quality of insolvency law – **very low**	Independence of the electricity regulator – **no**	Deposit insurance system – **no**	Government expenditure on health – **4.8 per cent** (2005)
Interest rate liberalisation – **limited de jure**	Secured transactions law – **malfunctioning**	Separation of railway infrastructure from operations – **no**	Private pension funds – **no**	Government expenditure on education – **5.4 cent** (2005)
Exchange rate regime – **fixed**		Independence of the road directorate – **no**		Household expenditure on power and water – **0.3 per cent**
Wage regulation – **yes**				
Tradeability of land – **limited de jure**				

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	0.6	0.6	0.6	na	na	**na**	**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**
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)	13.8	14.0	na	na	na	**na**	**na**
Change in labour productivity in industry (in per cent)	10.7	12.0	na	na	na	**na**	**na**
Investment/GDP (in per cent)	25.3	23.8	na	na	na	**na**	**na**
EBRD index of small-scale privatisation	2.0	2.0	2.0	2.0	2.0	**2.3**	**2.3**
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	1.0	**1.0**	**1.0**
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	1.0	**1.0**	**1.0**
Markets and trade							
Share of administered prices in CPI (in per cent)	6.7	6.7	6.7	6.7	6.7	**6.7**	**na**
Number of goods with administered prices in EBRD-15 basket	5.0	6.0	6.0	6.0	6.0	**5.0**	**na**
Share of trade with non-transition countries (in per cent)	54.4	51.2	43.2	46.6	48.8	**na**	**na**
Share of trade in GDP (in per cent)	102.1	99.9	94.6	93.5	101.2	**90.5**	**na**
Tariff revenues (in per cent of imports)[3]	na	na	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	**2.0**	**2.0**
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	**1.0**	**1.0**
Financial sector							
Number of banks (foreign-owned)	12 (4)	11 (2)	11 (2)	11 (2)	11 (2)	**11 (2)**	**na**
Asset share of state-owned banks (in per cent)	96.1	96.6	96.3	94.8	93.7	**96.3**	**na**
Asset share of foreign-owned banks (in per cent)	1.6	1.0	1.0	1.0	1.1	**1.2**	**na**
Non-performing loans (in per cent of total loans)	0.5	0.4	0.3	0.2	0.2	**0.1**	**na**
Domestic credit to private sector (in per cent of GDP)	1.9	1.6	1.4	na	na	**na**	**na**
Domestic credit to households (in per cent of GDP)	0.5	0.5	0.7	0.6	0.8	**0.7**	**na**
– Of which mortgage lending (in per cent of GDP)	0.1	0.2	0.2	0.2	0.4	**0.3**	**na**
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	**na**	**na**
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	**na**	**na**
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
EBRD index of banking sector reform	1.0	1.0	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**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	8.0 (0.2)	8.1 (1.1)	8.2 (2.2)	8.6 (4.4)	9.2 (7.0)	**9.2 (7.0)**	**na**
Internet users (per 100 inhabitants)	0.4	0.8	1.0	1.3	1.4	**1.4**	**na**
Railway labour productivity (1991=100)	38.1	37.7	41.9	44.8	44.6	**44.2**	**na**
Residential electricity tariffs (USc kWh)	0.4	0.4	0.4	0.4	0.4	**0.3**	**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)	1.3	na	1.3	na	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	**1.7**	**1.7**
– Water and wastewater	1.0	1.0	1.0	1.0	1.0	**1.0**	**1.0**

[1] Investors are required to register with the State Service for Foreign Investments.

[2] Calculated with a risk weight of zero for all loans to state-owned enterprises. These are assumed to be implicitly guaranteed by the state.

[3] Refers to differential excise taxes on imports; Turkmenistan does not levy import tariffs.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP[1]	17.1	14.7	13.0	11.4	11.6	**10.5**	**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	4.0	11.2	28.3	44.9	27.4	**29.3**	**na**
– Imports of goods and services	40.8	22.1	-6.4	34.8	47.8	**41.9**	**na**
Industrial gross output	13.5	16.4	8.5	na	na	**na**	**na**
Agricultural gross output	9.5	13.0	4.0	na	na	**na**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	3.0	3.0	na	na	na	**na**	**na**
Employment (end-year)	2.2	na	na	na	na	**na**	**na**
			(In per cent of labour force)				
Unemployment[2]	29.8	30.2	na	na	na	**na**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	5.6	5.9	10.7	10.5	8.6	**12.0**	**5.5**
Consumer prices (end-year)	3.1	9.0	10.4	7.1	8.6	**8.9**	**6.0**
Producer prices (annual average)	na	na	na	na	na	**na**	**na**
Producer prices (end-year)	na	na	na	na	na	**na**	**na**
Gross average monthly earnings in economy (annual average)	84.2	5.7	21.6	na	na	**na**	**na**
Government sector[3]			*(In per cent of GDP)*				
General government balance	-1.3	1.4	0.8	5.3	4.0	**11.3**	**5.3**
General government expenditure	19.4	18.9	19.7	14.9	13.4	**12.3**	**na**
General government debt	na	na	na	na	na	**na**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M3, end-year)	33.4	13.6	5.6	10.7	96.4	**-7.6**	**na**
Domestic credit (end-year)	-0.6	3.6	-3.5	-6.7	31.0	**52.2**	**na**
			(In per cent of GDP)				
Broad money (M3, end-year)	13.2	12.3	10.2	9.2	15.0	**7.7**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinance rate	10.0	5.0	na	na	na	**na**	**na**
Interbank market rate	6.9	4.6	na	na	na	**na**	**na**
Deposit rate (6-12 months)[4]	15.4	11.3	na	na	na	**na**	**na**
Lending rate (6-12 months)[4]	20.4	17.3	na	na	na	**na**	**na**
			(Manats per US dollar)				
Exchange rate (end-year)[5]	10,390.0	10,540.0	10,870.0	10,690.0	10,690.0	**14,250.0**	**na**
Exchange rate (annual average)	10,033.5	10,375.0	11,015.2	10,881.9	10,690.0	**13,041.5**	**na**
External sector			*(In millions of US dollars)*				
Current account	305.0	82.2	876.9	3,347.2	4,036.0	**3,560.0**	**5,300.0**
Trade balance	886.0	705.5	1,997.1	4,597.8	5,334.0	**6,423.0**	**7,900.0**
– Merchandise exports	3,465.0	3,853.9	4,944.1	7,155.5	9,114.0	**11,786.0**	**14,500.0**
– Merchandise imports	2,579.0	3,148.4	2,947.0	2,557.7	3,780.0	**5,363.0**	**6,600.0**
Foreign direct investment, net	226.0	353.7	418.2	730.9	804.0	**820.0**	**1,355.0**
Gross reserves, excluding gold (end-year)[6]	2,673.0	2,714.0	3,442.0	7,477.2	na	**na**	**na**
External debt stock	1,519.0	1,273.0	1,007.0	805.0	na	**na**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	9.5	8.0	10.7	25.0	na	**na**	**na**
			(In per cent of exports of goods and services)				
Debt service[7]	11.6	9.6	5.7	3.9	na	**na**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	6.2	6.5	6.5	6.5	6.5	**6.5**	**6.5**
GDP (in billions of manats)	59,404.8	72,706.4	91,863.2	113,073.6	136,244.0	**247,152.0**	**361,670.0**
GDP per capita (in US dollars)	954.9	1,078.1	1,283.0	1,598.6	1,960.8	**2,915.6**	**3,837.3**
Share of industry in GDP (in per cent)	39.7	38.6	na	na	na	**na**	**na**
Share of agriculture in GDP (in per cent)	19.6	18.4	na	na	na	**na**	**na**
Current account/GDP (in per cent)	5.2	1.2	10.5	32.2	31.7	**18.8**	**21.2**
External debt – reserves (in US$ million)	-1,154.0	-1,441.0	-2,435.0	-6,672.2	na	**na**	**na**
External debt/GDP (in per cent)	25.7	18.2	12.1	7.7	na	**na**	**na**
External debt/exports of goods and services (in per cent)	40.8	30.2	19.1	10.7	na	**na**	**na**

[1] Official statistics until 2004, but EBRD estimates thereafter.

[2] Officially registered unemployed.

[3] Significant off-budget expenditures occur through extra-budgetary funds and lending.

[4] Unweighted average deposit and lending rates for individuals (in local currency) of state commercial banks.

[5] Before May 2008 Turkmenistan operated a dual exchange rate system. The series refers to a weighted average between the official exchange rate and the commercial rate (given as the black market rate). Weights are variable depending on official and shuttle trade.

[6] Includes foreign exchange reserves of the central bank plus the foreign exchange reserve fund.

[7] Excludes rescheduled amounts.

Ukraine

Key developments and challenges

Stabilisation of the financial sector is essential so that banks can restart lending to the real sector. In the medium term, financial sector reforms should focus on developing local capital markets, consolidating and improving transparency of the banking sector, and unwinding state participation in the failed systemic banks.

Raising additional finance to modernise the gas transit system, enhancing the security of gas supplies and improving energy efficiency depend on the implementation of gas sector reforms. These include restructuring and corporatising the state-owned energy company, Naftogaz, strengthening its transparency and governance, as well as raising domestic gas prices to cost recovery levels.

The economy has been exceptionally hard-hit by the crisis. To attain sustainable growth, the institutional environment must be improved, public sector spending more efficient and investments in infrastructure productive.

Country data

Population (in millions)	**45.8**
Area ('000 sq km)	**603.7**
GDP (in billion US$, 2008)	**179.6**
Average transition score (scale: 1 to 4.33)	**3.07**

Progress in structural reform

Liberalisation and privatisation

Ukraine's entry into the World Trade Organization (WTO) has helped mitigate protectionist pressures during the crisis, although the authorities resorted to temporary import duty surcharges on cars and refrigerators that expired in September. Negotiations on a comprehensive free trade area with the European Union are ongoing. After a long pause on privatisation, on 29 September 2009 the authorities auctioned the Odessa sea port plant, but cancelled the auction results due to alleged irregularities. The controlling stakes in 14 regional electricity distributors are being prepared for sale before the end of 2009.

Business environment and competition

A long-awaited joint-stock company law, designed to strengthen property and minority shareholders' rights, came into effect in April 2009. However, weaknesses in the property rights' regime, as well as the legal system overall, have tested foreign investors' commitment to Ukraine during the crisis as non-privatisation foreign direct investment (FDI) inflows declined for the first time in 10 years in 2008. According to the findings of the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), businesses continued to perceive the administration of justice system to be arbitrary and unfair, and corruption to be widespread. Ukraine ranks low among its peers in other surveys of business environment and governance. Recent initiatives to align Ukraine's institutions with those of the European Union could help to promote institutional reforms over the medium term.

Infrastructure

In January 2009 Ukraine's natural gas monopoly, Naftogaz, was engaged in a dispute with Russia's Gazprom over the terms of gas supply that caused supply disruptions to a number of other European countries. With the support of the international financial institutions (IFIs) and the European Union, the authorities have focused on the implementation of a long-standing reform agenda with the aim of restructuring and modernising the gas sector, improving Naftogaz's financial performance and reducing the sector's impact on public finances. Household gas tariffs were increased by 35 per cent in December 2008. Implementation of another 20 per cent increase has been delayed past the September target date owing to a legal challenge by trade unions, which the government has appealed. The critical outstanding reforms include raising household and utility gas tariffs to cost recovery levels, improving governance and transparency of Naftogaz, hardening of budget constraints for non-payers, taxing local gas production to reduce implicit subsidies, strengthening energy sector regulation, establishing effective internal and transit gas metering of gas flows and opening up the gas sector to foreign investor participation.

In February 2009 the government approved a reform plan for the road sector, envisaging the separation of the management for state and regional roads. Under this plan, Ukravtodor, a road maintenance agency, will administer state roads, and its regulatory functions will be transferred to a separate governmental entity. The responsibility for regional roads will be transferred to local road authorities. The financing of road maintenance will also be separated for state and regional roads. The plan also includes the development of by-laws relating to the procurement of road maintenance services.

Financial sector

The population's trust in the banking system was negatively affected by the failure of Prominvestbank in October 2008 and by liquidity problems in other financial institutions. A major deposit run ensued. As of August 2009 deposits in national currency had dropped by more than one-quarter since their peak in September 2008, while foreign currency deposits declined by approximately 15 per cent. As the crisis unfolded, the authorities introduced a temporary ban on early withdrawal of term deposits. The problems in the corporate sector contributed to a sharp increase in the proportion of non-performing loans; these rose from 3 per cent in the first quarter of 2008 to around 10 per cent by the end of the first half of 2009. With support from the International Monetary Fund (IMF), the authorities have pursued a bank resolution strategy, with pre-emptive bank recapitalisation as its key element. Fresh capital has been injected into two state-owned banks and the private owners of other large banks have been asked to recapitalise their banks. Three failed banks (Rodovid, Ukrgazbank and Kyiv) were nationalised in July 2009. As many of the systemically important banks are owned by international banking groups, their continued engagement – with assistance from domestic regulators and IFIs – remains crucial to ensure banking system stability.

In response to recurring pressures in the currency market, the National Bank of Ukraine (NBU) introduced various foreign exchange controls, reversing the progress made in recent years towards full financial account liberalisation. The situation in many locally owned banks remains difficult: around 20 have fallen under the central bank's administration and many others have been unable to identify sources of capital in line with the NBU requirements. A much-needed process of bank liquidation and consolidation has begun but has not yet reached the level that would be expected in a crisis of this magnitude.

Macroeconomic performance

Ukraine has been hit hard by the global financial crisis. Its economy has been affected by global de-leveraging, the collapse of external demand, and the precipitous decline in international prices for steel and chemicals. The terms of trade have also suffered from increases in imported gas prices from an estimated average of US$ 180 per 1,000 cubic metres in 2008 to US$ 210 per 1,000 cubic metres in 2009. To help assure macrofinancial stability, in November 2008 the IMF approved balance-of-payments support via a US$ 16.5 billion loan under a 24-month stand-by arrangement.

The Ukrainian real sector has contracted faster than in any other of the EBRD's countries of operations. In the first half of 2009 real GDP dropped by around 20 per cent year on year, mainly reflecting the collapse of steel output as well as the contraction of the construction and retail sectors. Bank lending has *de facto* been frozen due to widespread uncertainty about foreign exchange and counterparty risks. Industrial production declined by one-third in the first half of 2009 (year on year), although the pace of contraction has slowed recently. During this period, import and export flows have been compressed and the trade deficit has fallen sharply. Inflation has continued to slow, but still remains in double digits. Unemployment increased to 9.5 per cent by the end of the first quarter 2009.

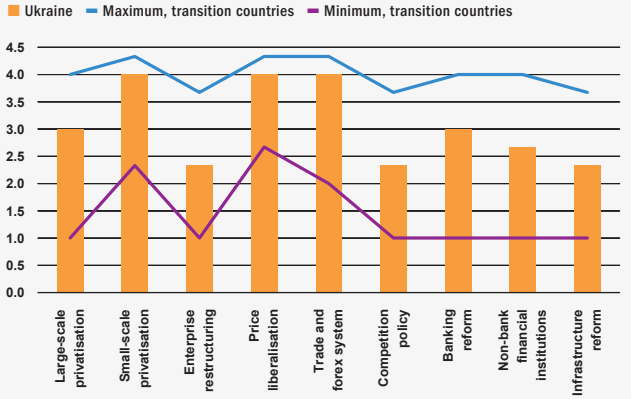
Since September 2008 access to international capital and credit markets has largely dried up. Although credit default swap spreads have more than halved since the February 2009 peak, they remained above 1,000 basis points at the end of September, reflecting market concerns about the high risk of default. The hryvnia lost almost half of its value against the US dollar since July 2008. During most of 2009 the hryvnia has been supported by interventions from the NBU. Gross foreign exchange reserves fell to an estimated US$ 28.0 billion at the end of September 2009 from US$ 37 billion at the end of August 2008.

The crisis has had a significant impact on public sector finances. The 2009 central government deficit target increased to 6 per cent of GDP compared with the balance in the initial budget reflecting primarily lower revenues. The public balance sheet has also been affected by the recapitalisation of several failed banks and Naftogaz. As a result, public sector debt is estimated to have increased from 13 per cent of GDP at the end of 2007 to around 30 per cent of GDP by the end of August 2009.

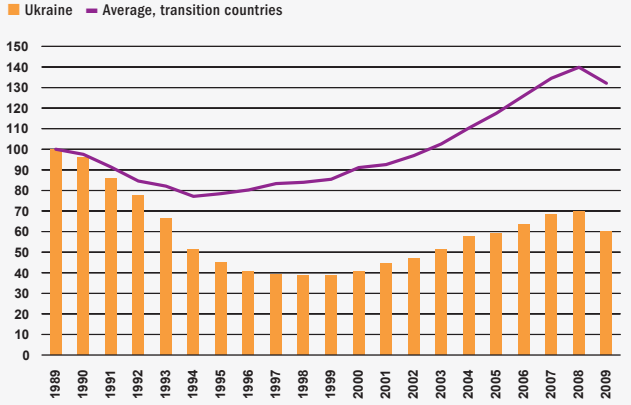
Outlook and risks

The prospects for recovery in the near term are constrained by weak external and domestic demand. On current trends, real GDP is likely to decline by around 14 per cent in 2009. The immediate challenges for the authorities are to avoid monetising public debt, return the public deficit to a sustainable path and stabilise the financial system. Achieving a fast and sustainable pace of economic growth over the longer term will require deep structural and institutional reforms, perhaps in the context of further approximation with the European Union.

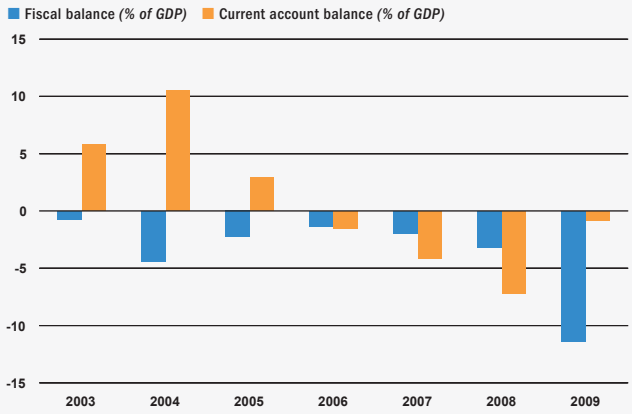
Transition indicators 2009



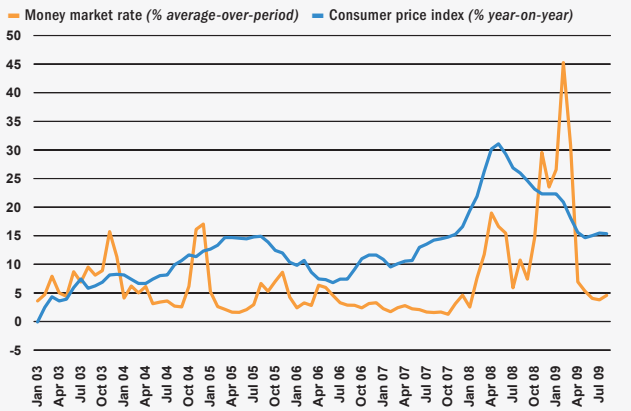
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**[1]

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradeability of land – **limited de facto**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **advanced**

Infrastructure

Telecoms regulatory assessment compliance – **medium**

Independence of the electricity regulator – **partial**

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

Independence of the road directorate – **partial**

Financial sector

Capital adequacy ratio – **10 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2.0 per cent** (2005)

Government expenditure on health – **3.7 per cent** (2007)

Government expenditure on education – **6.2 per cent** (2007)

Household expenditure on power and water – **9.1 per cent** (2008)

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	7.1	10.1	15.1	15.2	15.5	**15.5**	na
Private sector share in GDP (in per cent)	65.0	65.0	65.0	65.0	65.0	**65.0**	**60.0**
Private sector share in employment (in per cent)	37.7	na	na	na	na	**na**	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.2	2.2	2.2	3.1	2.8	**2.9**	na
Share of industry in total employment (in per cent)	20.4	20.1	19.7	19.5	18.9	**na**	na
Change in labour productivity in industry (in per cent)	18.5	13.8	3.2	7.1	12.6	**na**	na
Investment/GDP (in per cent)	20.3	21.2	22.6	24.8	28.2	**28.8**	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**
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.3**
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	8.0	**10.0**	na
Number of goods with administered prices in EBRD-15 basket	6.0	6.0	6.0	5.0	5.0	**5.0**	na
Share of trade with non-transition countries (in per cent)	48.7	45.1	44.8	46.4	46.6	**44.3**	na
Share of trade in GDP (in per cent)	95.2	97.4	82.6	77.2	77.3	**84.5**	na
Tariff revenues (in per cent of imports)[2]	3.0	3.2	3.6	3.3	3.3	**na**	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	3.3	3.3	3.7	3.7	3.7	**4.3**	**4.0**
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	**2.3**	**2.3**
Financial sector							
Number of banks (foreign-owned)	158 (19)	160 (19)	165 (23)	170 (27)	175 (40)	**184 (46)**	na
Asset share of state-owned banks (in per cent)	9.8	8.0	9.4	8.9	8.0	**11.5**	na
Asset share of foreign-owned banks (in per cent)	12.1	12.1	21.3	35.0	39.4	**51.1**	na
Non-performing loans (in per cent of total loans)	3.4	3.2	2.2	1.7	1.3	**2.3**	na
Domestic credit to private sector (in per cent of GDP)[3]	24.3	25.2	32.2	44.4	58.2	**79.8**	na
Domestic credit to households (in per cent of GDP)	3.7	6.6	8.1	15.3	22.5	**29.5**	na
– Of which mortgage lending (in per cent of GDP)	na	na	na	3.7	6.5	**15.1**	na
Stock market capitalisation (in per cent of GDP)	8.6	18.1	28.6	39.8	78.3	**20.6**	na
Stock trading volume (in per cent of market capitalisation)	2.9	2.5	3.6	3.5	2.6	**3.7**	na
Eurobond issuance (in per cent of GDP)	6.3	3.6	2.5	2.8	2.8	**0.5**	na
EBRD index of banking sector reform	2.3	2.3	2.7	3.0	3.0	**3.0**	**3.0**
EBRD index of reform of non-bank financial institutions	2.0	2.3	2.3	2.3	2.7	**2.7**	**2.7**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	23.3 (13.6)	25.7 (29.1)	24.9 (64.0)	26.5 (105.1)	27.8 (119.3)	**28.7 (121.1)**	na
Internet users (per 100 inhabitants)	5.3	10.6	17.0	19.3	21.6	**22.5**	na
Railway labour productivity (1989=100)	56.5	60.1	56.9	57.5	64.9	**64.5**	na
Residential electricity tariffs (USc kWh)	2.7	2.7	2.5	3.3	4.0	**4.6**	na
Average collection rate, electricity (in per cent)	94	92	99	100	95	**98**	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.5	1.7	1.8	na	na	**na**	na
EBRD index of infrastructure reform	2.0	2.0	2.0	2.0	2.3	**2.3**	**2.3**
– Electric power	3.0	3.0	3.0	3.0	3.0	**3.0**	**3.0**
– Railways	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
– Roads	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
– Telecommunications	2.3	2.3	2.3	2.7	2.7	**2.7**	**2.7**
– Water and wastewater	1.7	1.7	1.7	1.7	2.0	**2.0**	**2.0**

[1] Registration of foreign investment is required.

[2] Refers to taxes on international trade and transactions.

[3] Data from the IMF.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	9.6	12.1	2.7	7.3	7.9	**2.1**	**-14.0**
– Private consumption	11.5	13.1	16.6	15.9	17.1	**11.8**	**na**
– Public consumption	6.9	1.8	2.7	2.7	2.8	**0.4**	**na**
– Gross fixed capital formation	22.5	20.5	3.9	21.2	24.8	**1.6**	**na**
– Exports of goods and services	10.3	21.3	-12.2	-5.6	3.2	**5.2**	**na**
– Imports of goods and services	16.4	15.5	6.4	6.8	19.9	**17.1**	**na**
Industrial gross output	15.8	12.5	3.1	6.2	10.2	**-3.1**	**na**
Agricultural gross output	-9.9	19.1	0.4	2.5	-6.5	**17.1**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	-0.3	0.1	0.4	-0.2	0.3	**0.3**	**na**
Employment (end-year)	0.4	0.7	1.9	0.2	0.8	**0.3**	**na**
			(In per cent of labour force)				
Unemployment (end-year)[1]	9.1	8.6	7.2	6.8	6.4	**6.4**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	5.2	9.0	13.5	9.1	12.8	**25.2**	**16.0**
Consumer prices (end-year)	8.2	12.3	10.3	11.6	16.6	**22.3**	**14.0**
Producer prices (annual average)	7.6	20.4	16.7	9.6	19.5	**35.5**	**na**
Producer prices (end-year)	11.1	24.1	9.5	14.1	23.3	**23.0**	**na**
Gross average monthly earnings in economy (annual average)	22.9	27.9	36.4	29.7	29.3	**33.7**	**na**
Government sector[2]			*(In per cent of GDP)*				
General government balance	-0.7	-4.4	-2.3	-1.3	-2.0	**-3.2**	**-11.4**
General government expenditure	37.2	41.5	44.1	45.1	43.8	**47.3**	**na**
General government debt	29.3	25.5	18.7	15.7	12.9	**19.9**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	46.9	32.8	53.9	34.3	50.8	**31.0**	**na**
Domestic credit (end-year)	38.4	24.8	34.3	69.4	77.0	**76.9**	**na**
			(In per cent of GDP)				
Broad money (M2, end-year)	35.3	36.4	43.8	47.7	54.3	**54.0**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	7.0	9.0	9.5	8.5	8.0	**12.0**	**na**
Deposit rate[3]	7.0	7.8	8.5	7.6	8.2	**9.9**	**na**
Lending rate[3]	17.9	17.4	16.0	15.1	13.9	**17.6**	**na**
			(Hryvnias per US dollar)				
Exchange rate (end-year)	5.3	5.3	5.1	5.1	5.1	**8.1**	**na**
Exchange rate (annual average)	5.3	5.3	5.1	5.1	5.1	**5.3**	**na**
External sector			*(In millions of US dollars)*				
Current account	2,891.0	6,804.0	2,531.0	-1,617.0	-5,918.0	**-12,933.0**	**-900.0**
Trade balance	-269.0	3,741.0	-1,135.0	-5,194.0	-10,572.0	**-16,934.0**	**-3,500.0**
– Merchandise exports	23,739.0	33,432.0	35,024.0	38,949.0	49,840.0	**67,717.0**	**39,000.0**
– Merchandise imports	24,008.0	29,691.0	36,159.0	44,143.0	60,412.0	**84,651.0**	**42,500.0**
Foreign direct investment, net	1,411.0	1,711.0	7,533.0	5,737.0	9,218.0	**9,683.0**	**4,000.0**
Gross reserves, excluding gold (end-year)	6,731.0	9,302.0	19,413.0	22,300.0	31,972.0	**31,543.0**	**na**
External debt stock	23,811.0	30,647.0	39,619.0	54,512.0	82,189.0	**101,654.0**	**na**
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.9	3.2	5.3	5.0	5.3	**3.8**	**na**
			(In per cent of exports of goods and services)				
Debt service[4]	6.2	4.6	4.9	5.1	4.0	**2.7**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	47.4	47.1	46.7	46.5	46.1	**45.8**	**na**
GDP (in billions of hryvnias)	267.3	345.1	441.5	544.2	720.7	**949.9**	**920.0**
GDP per capita (in US dollars)	1,057.3	1,376.4	1,843.7	2,317.1	3,094.6	**3,930.8**	**na**
Share of industry in GDP (in per cent)	27.2	25.8	27.2	27.6	27.5	**27.3**	**na**
Share of agriculture in GDP (in per cent)	10.9	10.8	9.2	7.5	6.6	**6.8**	**na**
Current account/GDP (in per cent)	5.8	10.5	2.9	-1.5	-4.1	**-7.2**	**-0.8**
External debt – reserves (in US$ million)	17,080.0	21,345.0	20,206.0	32,212.0	50,217.0	**70,111.0**	**na**
External debt/GDP (in per cent)	47.5	47.3	46.0	50.6	57.6	**56.4**	**na**
External debt/exports of goods and services (in per cent)	82.2	77.2	89.3	108.5	128.4	**118.7**	**na**

[1] According to ILO methodology.

[2] IMF definition. General government includes the state, municipalities and extra-budgetary funds, and in 2009 Naftogaz and bank recapitalisation costs.

[3] Weighted average over all maturities.

[4] Refers to payments on official debt only.

Uzbekistan

Key developments and challenges

The response to the financial crisis has averted serious problems for exporters, but at the cost of introducing more distortions into the economy. The challenge is to reduce these distortions and increase the openness of the economy so that enterprises will not suffer a further erosion of competitiveness.

Recent survey results suggest that the business environment has not improved, despite a new tax code and tax cuts. Renewed efforts are needed to reduce the overall tax and administrative burden, which is particularly important for the development of new and existing small and medium-sized enterprises (SMEs).

The government's fiscal stimulus package has been appropriate and the economy has shown resilience to the global economic downturn. However, the increase in directed lending through commercial banks could potentially constrain future credit growth and should therefore be restrained.

Country data

Population (in millions)	**27.7**
Area ('000 sq km)	**448.9**
GDP (in billion US$, 2008)	**27.9**
Average transition score (scale: 1 to 4.33)	**2.15**

Progress in structural reform

Liberalisation and privatisation

In response to the deteriorating external environment, in December 2008 the government announced an anti-crisis programme to support exporters, producers of domestic goods and services and SMEs, while also promoting energy efficiency. Support for exporters includes allowing accelerated depreciation, the supply of working capital from commercial banks at subsidised interest rates, the restructuring of payment arrears to utilities and accelerating VAT refunds. Measures to assist local producers of goods and services include preferential treatment in state procurement, while the construction sector will benefit from tax advantages and a price cap on construction materials. SMEs will be supported through credit from financial institutions at preferential terms and through tax cuts. Steps will also be taken to improve the efficiency of the state-owned vertically integrated electricity company Uzbekenergo. The new government programme has been accompanied by a tightening of foreign exchange convertibility for importers. Enterprises are reporting convertibility delays for imports that can last up to six months, leading to costly higher working capital requirements. As a result, the difference between the official and the black market exchange rates has widened from around 5 per cent in 2008 to 20-25 per cent in 2009.

Business environment and competition

According to the World Bank's *Doing Business 2010* survey, the economy's ranking has deteriorated slightly from 145th place among 181 countries in 2008 to 150th (of 183 countries) in 2009. Areas such as paying taxes, trading across borders and dealing with construction permits remain problematic. Despite the new tax code adopted in 2008, the resulting streamlining of the tax regime and the lowering of tax rates, the administrative tax burden and overall tax payments remain high in Uzbekistan. High tax rates were also regarded as one of the most serious obstacles affecting businesses in the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV). The International Finance Corporation's 2008 survey on SMEs showed that, in spite of tax reductions, SMEs continue to pay taxes and obligatory payments equivalent to 170 per cent of retained net profit. The survey indicated that obtaining business permits remains a major concern for SMEs.

In January 2009 the government introduced further tax cuts in the context of the anti-crisis programme that are specifically targeted at exporters and industrial SMEs. The government also cut minimum, average and maximum personal income tax rates. However, as most of the tax reductions are specifically related to the size and nature of enterprises, the overall tax structure has become more complicated. The government plans to simplify the procedures for obtaining construction permits which, if implemented, should improve the country's *Doing Business* ranking in this respect.

According to the 2008/09 EBRD/World Bank Management, Organisation and Innovation (MOI) Survey, Uzbek enterprises performed relatively poorly as regards management practices compared with other transition economies, particularly in the area of operations and target management (see Chapter 5). MOI questions on innovation show that a very small percentage of Uzbek enterprises undertake research and development activities and register patents abroad, constraining their productivity growth.

Financial sector

The authorities have taken steps to recapitalise five state-owned banks – Uzpromstroybank, Asaka Bank, Mikrokreditbank, Pakhta Bank and Galla Bank – in response to the crisis. A total of sum 491 billion (around US$ 330 million) will be provided during 2009 funded from the budget, the Fund for Reconstruction and Development (FRD), and from other existing shareholders. Total lending by commercial banks to the real sector has been maintained, and grew by 36 per cent (year on year) in the first half of 2009, compared with growth of 34 per cent in 2008 as a whole. As part of the anti-crisis programme, banks took 78 bankrupt companies on to their books for recapitalisation during the first half of 2009, 30 of which were sold to investors.

A significant step was taken to enhance the country's anti-money laundering (AML) and countering the financing of terrorism (CFT) regime when the AML/CFT law was amended to comply with international standards in April 2009. The country had received repeated warnings from the Financial Action Task Force (FATF) to improve its AML/CFT measures. In June 2009 FATF welcomed the progress and called for the country to implement the regulations.

Macroeconomic performance

Real GDP growth remained buoyant at 9 per cent in 2008, supported by favourable commodity prices during the first half of the year and by Russia's demand for manufactured exports until the third quarter. The economy remained relatively resilient to the global economic downturn, with real GDP growing by 8.2 per cent (year-on-year) during the first half of 2009, mainly reflecting the growth of domestic consumption and investment.

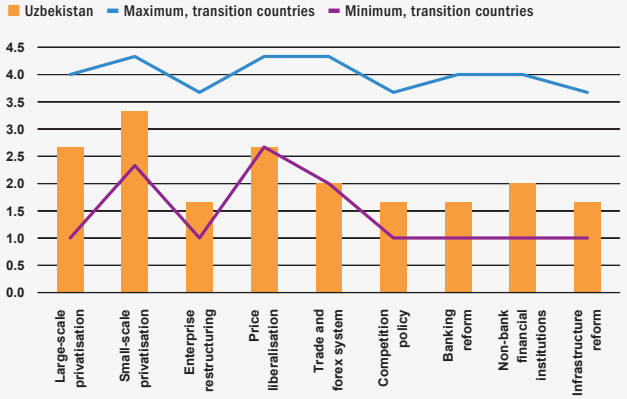
Increased revenues from gas and gold exports contributed to a fiscal surplus of 10.5 per cent of GDP (including funds accumulated in the FRD) in 2008. By the end of the year, the FRD held around US$ 2.7 billion, equivalent to 9.7 per cent of GDP. In late 2008 a fiscal stimulus package of around 4 per cent of GDP was adopted, which is likely to narrow the surplus in 2009. Inflation edged upwards in 2008, primarily reflecting increases in food prices, public sector wages, and utility prices, so that inflation was 7.8 per cent at the end of the year, according to national data (but much higher at 14.4 per cent according to International Monetary Fund estimates).

The current account surplus almost doubled in 2008 to 12.8 per cent of GDP. The increase was the result of favourable international prices of Uzbekistan's key export commodities (including gold, metals and cotton), an increase in the price of gas exports by around 40 per cent and strong demand from Russia for non-commodity exports such as passenger cars. The flow of remittances through official channels from Russia was around US$ 3.3 billion, or 13 per cent of GDP, in 2008 (according to data from the Russian Central Bank), boosting the current account surplus. However, there are reports that inflows have fallen sharply in 2009. Gross international reserves increased from 7.6 months of imports at the end of 2007 to 10 months at the end of 2008. The trade surplus narrowed by 36 per cent during the first half of 2009 as exports grew only modestly while the demand for imports of machinery and equipment remained robust.

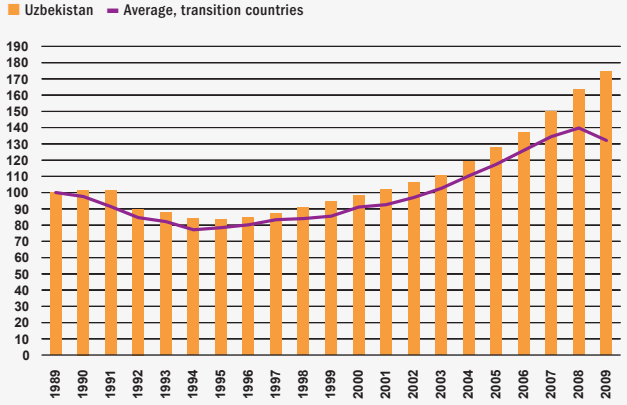
Outlook and risks

Uzbekistan's outlook for 2009 is one of the most favourable in the region, with real GDP expected to grow by 7 per cent. The fiscal stimulus package has cushioned faltering external demand and remittances. The country's relatively strong fiscal position should allow further fiscal expansion in 2010 and provide support should demand for manufactured goods from Russia remain weak and the inflow of remittances decline further. The main short-term risk is higher inflation due to the very restrictive policy towards imports. In the medium term, there is the risk that the financial sector will again be adversely affected by a rise in non-performing loans, while the competitiveness of enterprises could be compromised as a result of soft budget constraints and various protectionist measures.

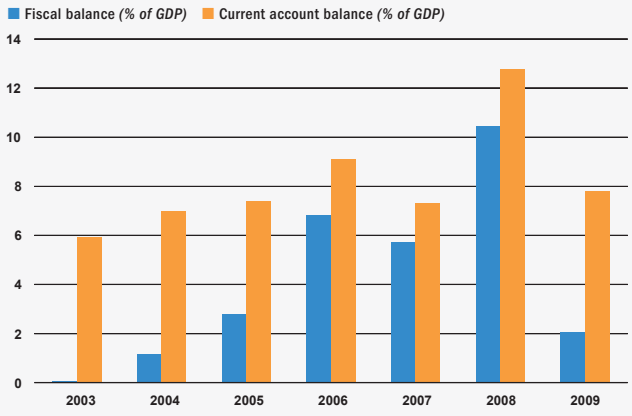
Transition indicators 2009



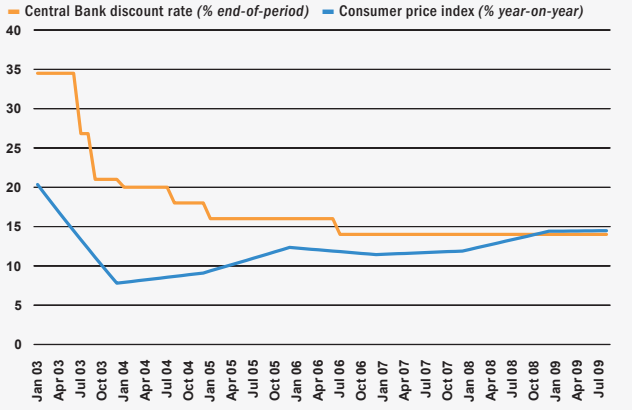
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **limited de facto**	Competition office – **yes**	Telecoms regulatory assessment compliance – **low**	Capital adequacy ratio – **10 per cent**	Share of population living in poverty – **76.7 per cent** (2003)
Controls on inward direct investment – **yes**	Quality of insolvency law – **very low**	Independence of the electricity regulator – **no**	Deposit insurance system – **yes**	Government expenditure on health – **2.4 per cent of GDP** (2006)
Interest rate liberalisation – **limited de jure**	Secured transactions law – **malfunctioning**	Separation of railway infrastructure from operations – **partial**	Private pension funds – **no**	Government expenditure on education – **8.9 per cent of GDP** (2007)
Exchange rate regime – **crawling peg**		Independence of the road directorate – **no**		Household expenditure on power and water – **5.2 per cent**
Wage regulation – **yes**				
Tradeability of land – **limited de jure**				

Structural and institutional change indicators

	2003	2004	2005	2006	2007	**2008**	**2009**
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	4.0	4.7	5.2	5.5	5.9	**6.3**	**na**
Private sector share in GDP (in per cent)	45.0	45.0	45.0	45.0	45.0	**45.0**	**45.0**
Private sector share in employment (in per cent)	na	na	na	na	na	**na**	**na**
Budgetary subsidies and current transfers (in per cent of GDP)[1]	5.1	5.2	4.9	4.6	3.8	**4.2**	**na**
Share of industry in total employment (in per cent)	12.4	13.0	13.2	13.4	13.5	**13.5**	**na**
Change in labour productivity in industry (in per cent)	5.6	1.4	2.1	6.4	8.7	**9.5**	**na**
Investment/GDP (in per cent)	20.7	24.5	28.0	24.8	21.3	**21.3**	**na**
EBRD index of small-scale privatisation	3.0	3.0	3.0	3.3	3.3	**3.3**	**3.3**
EBRD index of large-scale privatisation	2.7	2.7	2.7	2.7	2.7	**2.7**	**2.7**
EBRD index of enterprise reform	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
Markets and trade							
Share of administered prices in CPI (in per cent)	53.0	53.0	na	na	na	**na**	**na**
Number of goods with administered prices in EBRD-15 basket	8.0	8.0	4.0	4.0	4.0	**4.0**	**na**
Share of trade with non-transition countries (in per cent)	50.1	46.8	43.8	39.0	38.6	**44.3**	**na**
Share of trade in GDP (in per cent)	56.9	60.0	53.2	55.1	60.5	**68.7**	**na**
Tariff revenues (in per cent of imports)[2]	3.6	3.1	3.1	3.5	4.0	**2.3**	**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	1.7	1.7	2.0	2.0	2.0	**2.0**	**2.0**
EBRD index of competition policy	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
Financial sector							
Number of banks (foreign-owned)	33 (5)	31 (5)	29 (5)	29 (5)	29 (5)	**na**	**na**
Asset share of state-owned banks (in per cent)	70.0	67.6	na	na	na	**na**	**na**
Asset share of foreign-owned banks (in per cent)	4.3	4.4	na	na	na	**na**	**na**
Non-performing loans (in per cent of total loans)	na	na	na	na	na	**na**	**na**
Domestic credit to private sector (in per cent of GDP)	27.5	24.5	21.8	17.4	15.0	**15.0**	**na**
Domestic credit to households (in per cent of GDP)	na	na	na	na	na	**na**	**na**
– Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	**na**	**na**
Stock market capitalisation (in per cent of GDP)	0.1	0.0	0.3	4.3	8.8	**10.4**	**na**
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	**na**	**na**
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	**0.0**	**na**
EBRD index of banking sector reform	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	6.7 (1.3)	6.7 (2.1)	6.8 (2.7)	6.9 (10.2)	7.1 (21.9)	**7.1 (46.5)**	**na**
Internet users (per 100 inhabitants)	1.9	2.6	3.3	6.9	7.5	**8.9**	**na**
Railway labour productivity (1989=100)	51.8	47.9	45.6	69.3	71.9	**74.0**	**na**
Residential electricity tariffs (USc kWh)	1.7	na	2.6	2.9	3.4	**na**	**na**
Average collection rate, electricity (in per cent)	95	na	60	54	na	**na**	**na**
GDP per unit of energy use (PPP in US dollars per kgoe)	0.9	1.0	1.1	na	na	**na**	**na**
EBRD index of infrastructure reform	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
– Electric power	2.0	2.0	2.3	2.3	2.3	**2.3**	**2.3**
– Railways	2.7	2.7	2.7	2.7	2.7	**2.7**	**2.7**
– Roads	1.0	1.0	1.0	1.0	1.0	**1.0**	**1.0**
– Telecommunications	2.0	2.0	2.0	2.0	2.0	**2.0**	**2.0**
– Water and wastewater	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**

[1] Refers to low income support in the budget.

[2] Refers to custom duties and export taxes.

Macroeconomic indicators

	2003	2004	2005	2006	2007	**2008 Estimate**	**2009 Projection**
Output and expenditure			*(Percentage change in real terms)*				
GDP	4.2	7.7	7.0	7.3	9.5	**9.0**	**7.0**
Industrial gross output	6.0	9.4	7.2	10.8	12.1	**12.7**	**na**
Agricultural gross output	7.3	8.9	5.4	6.2	6.1	**4.5**	**na**
Employment			*(Percentage change)*				
Labour force (end-year)	2.6	3.5	2.8	2.6	2.5	**2.7**	**na**
Employment (end-year)	2.7	3.4	2.9	2.7	2.6	**2.8**	**na**
			(In per cent of labour force)				
Unemployment (end-year)[1]	0.3	0.4	0.3	0.3	0.3	**0.2**	**na**
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)[2]	11.6	6.6	10.0	14.2	12.3	**12.7**	**14.5**
Consumer prices (end-year)	7.8	9.1	12.3	11.4	11.9	**14.4**	**14.5**
Producer prices (annual average)	na	na	na	na	na	**na**	**na**
Producer prices (end-year)	27.4	26.5	28.2	24.0	10.9	**7.7**	**na**
Gross average monthly earnings in economy (annual average)	14.0	32.4	54.9	38.2	56.3	**39.1**	**na**
Government sector[3]			*(In per cent of GDP)*				
General government balance	0.1	1.2	2.8	6.8	5.7	**10.5**	**2.0**
General government expenditure	33.4	31.6	29.5	29.2	32.7	**32.7**	**na**
General government debt	41.6	35.1	28.2	21.3	15.8	**13.1**	**na**
Monetary sector			*(Percentage change)*				
Broad money (M3, end-year)	27.1	47.9	55.5	37.8	46.9	**35.6**	**27.0**
Domestic credit (end-year)	-0.6	2.1	3.1	-40.3	-64.2	**-137.2**	**na**
			(In per cent of GDP)				
Broad money (M3, end-year)	10.3	12.2	14.6	15.4	16.7	**17.3**	**na**
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	20.0	20.0	16.0	14.0	14.0	**14.0**	**na**
Treasury bill rate (3-month maturity)	na	na	na	na	na	**na**	**na**
Deposit rate (1 year)	20.3	16.1	15.5	15.0	19.4	**na**	**na**
Lending rate (1 year)	23.9	21.2	19.9	21.0	24.3	**na**	**na**
			(Sums per US dollar)				
Exchange rate (end-year)[4]	979.0	1,056.6	1,180.0	1,240.0	1,290.0	**1,388.5**	**na**
Exchange rate (annual average)[4]	995.5	999.2	1,072.3	1,219.8	1,263.7	**1,320.2**	**na**
External sector			*(In millions of US dollars)*				
Current account	587.0	859.6	1,097.0	1,551.9	1,630.7	**3,561.7**	**2,198.2**
Trade balance	807.6	1,241.7	1,289.0	1,369.8	1,893.5	**3,080.5**	**2,484.3**
– Merchandise exports	3,213.3	4,302.1	4,594.3	5,377.1	7,691.5	**11,129.9**	**10,528.7**
– Merchandise imports	2,405.7	3,060.4	3,305.3	4,007.3	5,798.0	**8,049.4**	**8,044.4**
Foreign direct investment, net	82.6	176.6	191.6	173.8	705.2	**711.3**	**711.3**
Gross reserves, including gold (end-year)	1,659.0	2,320.3	2,992.6	3,778.4	5,193.8	**9,072.2**	**na**
External debt stock	4,248.7	4,301.6	4,131.8	3,768.8	3,725.3	**3,747.6**	**na**
			(In months of imports of goods and services)				
Gross reserves, including gold (end-year)	6.0	6.7	7.9	8.5	7.6	**10.0**	**na**
			(In per cent of exports of goods and services)				
Debt service	19.9	16.5	13.8	11.1	8.0	**5.9**	**na**
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	25.6	25.9	26.2	27.0	27.4	**27.7**	**na**
GDP (in billions of sums)	9,837.8	12,261.0	15,923.4	20,759.3	28,186.2	**36,839.4**	**44,351.7**
GDP per capita (in US dollars)[5]	386.5	474.4	567.5	630.8	814.8	**1,007.4**	**na**
Share of industry in GDP (in per cent)	15.8	17.5	20.7	22.1	25.0	**25.8**	**na**
Share of agriculture in GDP (in per cent)	28.6	26.4	25.0	24.1	21.7	**20.8**	**na**
Current account/GDP (in per cent)	5.9	7.0	7.4	9.1	7.3	**12.8**	**7.8**
External debt – reserves (in US$ million)	2,589.7	1,981.2	1,139.2	-9.5	-1,468.5	**-5,324.6**	**na**
External debt/GDP (in per cent)	43.7	37.3	31.3	22.1	16.7	**13.4**	**na**
External debt/exports of goods and services (in per cent)	109.6	85.8	76.4	59.6	42.1	**29.9**	**na**

[1] Officially registered unemployed.

[2] Unofficial estimates; official figures are lower.

[3] Includes consolidated government and the Fund for Reconstruction and Development.

[4] Dual exchange rates were in operation until October 2003. Data show a weighted average of the official, bank and parallel market rates.

[5] Calculated at the weighted exchange rate for periods in which dual exchange rates were in effect.

Methodological notes

Sources of the summary data

GDP, 2008 (in billion US$)

Source: IMF World Economic Outlook.

Population

Source: IMF World Economic Outlook and national sources.

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 range from 1 to 4+ and are based on a classification system that was originally developed in the 1994 Transition Report, but has been refined and amended in subsequent Reports. In calculating averages, "+" and "–" ratings are treated by adding 0.33 and subtracting 0.33 from the full value. The infrastructure indicator reported in Table 1.1 is a simple average of the five components (see Table 1.3) and is obtained by rounding down; for example, a score of 2.6 is treated as 2+, but a score of 2.8 is treated as 3-. The overall average transition score (reported in the country pages) is a simple average of the nine transition indicators in Table 1.1. The score "1+" is not used and so an average of 1.3 for the infrastructure scores is rounded down to 1 in Tables 1.1 and 1.3.

Overall transition indicators

(see Table 1.1 on page 4)

Large-scale privatisation

1 Little private ownership.

2 Comprehensive scheme almost ready for implementation; some sales completed.

3 More than 25 per cent of large-scale enterprise assets in private hands or in the process of being privatised (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance.

4 More than 50 per cent of state-owned enterprise and farm assets in private ownership and significant progress with corporate governance of these enterprises.

4+ Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.

Small-scale privatisation

1 Little progress.

2 Substantial share privatised.

3 Comprehensive programme almost completed.

4 Complete privatisation of small companies with tradeable ownership rights.

4+ Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradeability of land.

Governance and enterprise restructuring

1 Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.

2 Moderately tight credit and subsidy policy, but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.

3 Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (for example, privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).

4 Substantial improvement in corporate governance and significant new investment at the enterprise level, including minority holdings by financial investors.

4+ Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring.

Price liberalisation

1 Most prices formally controlled by the government.

2 Some lifting of price administration; state procurement at non-market prices for the majority of product categories.

3 Significant progress on price liberalisation, but state procurement at non-market prices remains substantial.

4 Comprehensive price liberalisation; state procurement at non-market prices largely phased out; only a small number of administered prices remain.

4+ Standards and performance typical of advanced industrial economies: complete price liberalisation with no price control outside housing, transport and natural monopolies.

Trade and foreign exchange system

1 Widespread import and/or export controls or very limited legitimate access to foreign exchange.

2 Some liberalisation of import and/or export controls; almost full current account convertibility in principle, but with a foreign exchange regime that is not fully transparent (possibly with multiple exchange rates).

3 Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility.

4 Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full and current account convertibility.

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

Competition policy

1 No competition legislation and institutions.

2 Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms.

3 Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.

4 Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.

4+ Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.

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, railways, roads, telecoms, water and waste water. The classification system used for these five indicators is detailed below.

Infrastructure transition indicators

(see Table 1.3 on page 5)

Electric power

1 Power sector operates as government department with few commercial freedoms or pressures. Average prices well below costs, with extensive cross-subsidies. Monolithic structure, with no separation of different parts of the business.

2 Power company distanced from government, but there is still political interference. Some attempt to harden budget constraints, but effective tariffs are low. Weak management incentives for efficient performance. Little institutional reform and minimal, if any, private sector involvement.

3 Law passed providing for full-scale restructuring of industry, including vertical unbundling through account separation and set-up of regulator. Some tariff reform and improvements in revenue collection. Some private sector involvement.

4 Separation of generation, transmission and distribution. Independent regulator set up. Rules for cost-reflective tariff-setting formulated and implemented. Substantial private sector involvement in distribution and/or generation. Some degree of liberalisation.

4+ Tariffs cost-reflective and provide adequate incentives for efficiency improvements. Large-scale private sector involvement in the unbundled and well-regulated sector. Fully liberalised sector with well-functioning arrangements for network access and full competition in generation.

Railways

1 Monolithic structure operated as government department, with few commercial freedoms. No private sector involvement and extensive cross-subsidisation.

2 Rail operations distanced from state, but weak commercial objectives. Some business planning, but targets are general and tentative. No budgetary funding of public service obligations. Ancillary businesses separated, but little divestment. Minimal private sector involvement.

3 Commercial orientation in rail operations. Freight and passenger services separated and some ancillary businesses divested. Some budgetary compensation available for passenger services. Improved business planning with clear investment and rehabilitation targets, but funding unsecured. Some private sector involvement in rehabilitation and/or maintenance.

4 Railways fully commercialised, with separate internal profit centres for freight and passenger services. Extensive market freedoms to set tariffs and investments. Implementation of medium-term business plans. Ancillary industries divested. Private sector participation in freight operation, ancillary services and track maintenance.

4+ Separation of infrastructure freight and passenger operations. Full divestment and transfer of asset ownership implemented or planned, including infrastructure and rolling stock. Rail regulator established and access pricing implemented.

Roads

1 Minimal degree of decentralisation and no commercialisation. All regulatory, road management and resource allocation functions centralised at ministerial level. New investments and road maintenance financing dependent on central budget allocations. Road user charges not based on the cost of road use. Road construction and maintenance undertaken by public construction units. No public consultation in the preparation of road projects.

2 Moderate degree of decentralisation and initial steps in commercialisation. Road/highway agency created. Improvements in resource allocation and public procurement. Road user charges based on vehicle and fuel taxes, but not linked to road use. Road fund established, but dependent on central budget. Road construction and maintenance undertaken primarily by corporatised public entities, with some private sector participation. Minimal public consultation/participation on road projects.

3 Fair degree of decentralisation and commercialisation. Regulation and resource allocation functions separated from road maintenance and operations. Level of vehicle and fuel taxes related to road use. Private companies able to provide and operate roads under negotiated commercial contracts. Private sector participation in road maintenance and/or through concessions to finance, operate and maintain parts of highway network. Limited public consultation/participation and accountability on road projects.

4 Large degree of decentralisation. Transparent methodology used to allocate road expenditures. Track record in competitive procurement of road design, construction, maintenance and operations. Large-scale private sector participation in construction, operations and maintenance directly and through public-private partnerships. Substantial public consultation/participation and accountability on road projects.

4+ Fully decentralised road administration. Commercialised road maintenance operations competitively awarded to private companies. Road user charges reflect the full costs of road use and associated factors, such as congestion, accidents and pollution. Widespread private sector participation in all aspects of road provision. Full public consultation on new road projects.

Telecoms

1 Little progress in commercialisation and regulation. Minimal private sector involvement and strong political interference in management decisions. Low tariffs, with extensive cross-subsidisation. Liberalisation not envisaged, even for mobile telephony and value-added services.

2 Modest progress in commercialisation. Corporatisation of dominant operator and some separation from public sector governance, but tariffs are still politically set.

3 Substantial progress in commercialisation and regulation. Telecommunications and postal services fully separated; cross-subsidies reduced. Considerable liberalisation in the mobile segment and in value-added services.

4 Complete commercialisation, including privatisation of the dominant operator; comprehensive regulatory and institutional reforms. Extensive liberalisation of entry.

4+ Effective regulation through an independent entity. Coherent regulatory and institutional framework to deal with tariffs, interconnection rules, licensing, concession fees and spectrum allocation. Consumer ombudsman function.

Water and wastewater

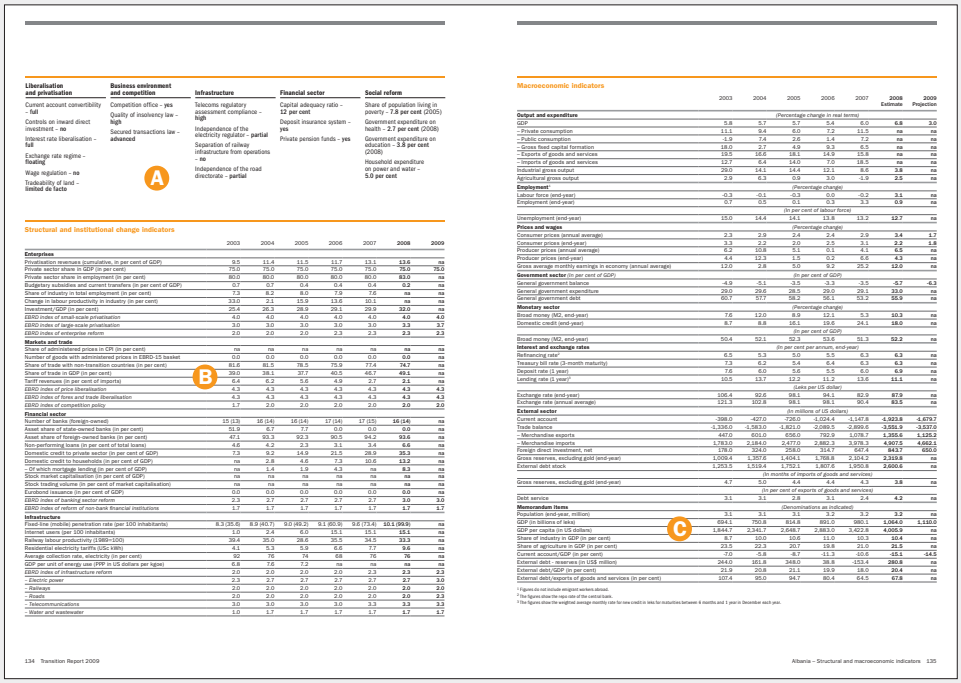
1 Minimal degree of decentralisation; no commercialisation. Services operated as vertically integrated natural monopolies by government ministry or municipal departments. No financial autonomy and/or management capacity at municipal level. Low tariffs, low cash collection rates and high cross-subsidies.

2 Moderate degree of decentralisation; initial steps towards commercialisation. Services provided by municipally owned companies. Partial cost recovery through tariffs; initial steps to reduce cross-subsidies. General public guidelines exist regarding tariff-setting and service quality, but both under ministerial control. Some private sector participation through service or management contacts, or competition to provide ancillary services.

3 Fair degree of decentralisation and commercialisation. Water utilities operate with managerial and accounting independence from municipalities, using international accounting standards and management information systems. Operating costs recovered through tariffs, with a minimum level of cross-subsidies. More detailed rules drawn up in contract documents, specifying tariff review formulae and performance standards. Private sector participation through the full concession of a major service in at least one city.

4 Large degree of decentralisation and commercialisation. Water utilities managerially independent, with cash flows – net of municipal budget transfers – that ensure financial viability. No cross-subsidies. Semi-autonomous regulatory agency able to advise and enforce tariffs and service quality. Substantial private sector participation through build-operate-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 Owaste-water services in major urban areas.



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **floating**

Wage regulation – **no**

Tradeability of land – **limited de facto**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **high**

Secured transactions law – **advanced**

Infrastructure

Telecoms regulatory assessment compliance – **high**

Independence of the electricity regulator – **partial**

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

Independence of the road directorate – **partial**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **7.8 per cent** (2005)

Government expenditure on health – **2.7 per cent** (2008)

Government expenditure on education – **3.8 per cent** (2008)

Household expenditure on power and water – **5.0 per cent**

A

Structural and institutional change indicators

	2003	2004	2005	2006	2007	2008	2009
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	9.5	11.4	11.5	11.7	13.1	**13.6**	ea
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)	80.0	80.0	80.0	80.0	80.0	**83.0**	ea
Budgetary subsidies and current transfers (in per cent of GDP)	0.7	0.7	0.4	0.4	0.4	**0.2**	ea
Share of industry in total employment (in per cent)	7.3	8.2	8.0	7.9	7.6	ea	ea
Change in labour productivity in industry (in per cent)	33.0	2.1	15.9	13.6	10.1	ea	ea
Investment/GDP (in per cent)	25.4	26.3	28.9	29.1	29.9	**32.0**	ea
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	**3.3**	**3.7**
EBRD index of enterprise reform	2.0	2.0	2.0	2.3	2.3	**2.3**	**2.3**
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	**0.0**	na
Share of trade with non-transition countries (in per cent)	81.6	81.5	78.5	75.9	77.4	**74.7**	na
Share of trade in GDP (in per cent)	39.0	38.1	37.7	40.5	46.7	**49.1**	na
Tariff revenues (in per cent of imports)	6.4	6.2	5.6	4.9	2.7	**2.1**	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	4.3	4.3	4.3	4.3	4.3	**4.3**	**4.3**
EBRD index of competition policy	1.7	2.0	2.0	2.0	2.0	**2.0**	**2.0**
Financial sector							
Number of banks (foreign-owned)	15 (13)	16 (14)	16 (14)	17 (14)	17 (15)	**16 (14)**	na
Asset share of state-owned banks (in per cent)	51.9	6.7	7.7	0.0	0.0	**0.0**	na
Asset share of foreign-owned banks (in per cent)	47.1	93.3	92.3	90.5	94.2	**93.6**	na
Non-performing loans (in per cent of total loans)	4.6	4.2	2.3	3.1	3.4	**6.6**	na
Domestic credit to private sector (in per cent of GDP)	7.3	9.2	14.9	21.5	28.9	**35.3**	na
Domestic credit to households (in per cent of GDP)	na	2.8	4.6	7.3	10.6	**13.2**	na
– Of which mortgage lending (in per cent of GDP)	na	1.4	1.9	4.3	na	**8.3**	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	**na**	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	**na**	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	**0.0**	na
EBRD index of banking sector reform	2.3	2.7	2.7	2.7	2.7	**3.0**	**3.0**
EBRD index of reform of non-bank financial institutions	1.7	1.7	1.7	1.7	1.7	**1.7**	**1.7**
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	8.3 (35.6)	8.9 (40.7)	9.0 (49.2)	9.1 (60.9)	9.6 (73.4)	**10.1 (99.9)**	na
Internet users (per 100 inhabitants)	1.0	2.4	6.0	15.1	15.1	**15.1**	na
Railway labour productivity (1989=100)	39.4	35.0	28.6	35.5	34.5	**33.3**	na
Residential electricity tariffs (US¢ kWh)	4.1	5.3	5.9	6.6	7.7	**9.6**	na
Average collection rate, electricity (in per cent)	92	76	74	68	76	**76**	na
GDP per unit of energy use (PPP in US dollars per kgoe)	6.8	7.6	7.2	na	na	**na**	na
EBRD index of infrastructure reform	2.0	2.0	2.0	2.0	2.3	**2.3**	**2.3**
– Electric power	2.3	2.7	2.7	2.7	2.7	**2.7**	**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**	**2.3**
– Telecommunications	3.0	3.0	3.0	3.0	3.3	**3.3**	**3.3**
– Water and wastewater	1.0	1.7	1.7	1.7	1.7	**1.7**	**1.7**

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Macroeconomic indicators

	2003	2004	2005	2006	2007	2008 Estimate	2009 Projection
Output and expenditure				(Percentage change in real terms)			
GDP	5.8	5.7	5.7	5.4	6.0	**6.8**	3.0
– Private consumption	11.1	9.4	6.0	7.2	11.5	**na**	na
– Public consumption	-1.9	7.4	2.6	1.4	7.2	**na**	na
– Gross fixed capital formation	18.0	2.7	4.9	9.3	6.5	**na**	na
– Exports of goods and services	18.5	16.6	18.1	14.9	15.8	**na**	na
– Imports of goods and services	12.7	6.4	14.0	7.0	18.5	**na**	na
Industrial gross output	29.0	14.1	14.4	12.1	8.6	**3.8**	na
Agricultural gross output	2.9	6.3	0.9	3.0	-1.9	**2.5**	na
Employment[1]				(Percentage change)			
Labour force (end-year)	-0.3	-0.1	-0.3	0.0	-0.2	**3.1**	na
Employment (end-year)	0.7	0.5	0.1	0.3	3.3	**0.9**	na
				(In per cent of labour force)			
Unemployment (end-year)	15.0	14.4	14.1	13.8	13.2	**12.7**	na
Prices and wages				(Percentage change)			
Consumer prices (annual average)	2.3	2.9	2.4	2.4	2.9	**3.4**	1.7
Consumer prices (end-year)	3.3	2.2	2.0	2.5	3.1	**2.2**	1.8
Producer prices (annual average)	6.2	10.8	5.1	0.1	4.1	**6.5**	na
Producer prices (end-year)	4.4	12.3	1.5	0.2	6.6	**4.3**	na
Gross average monthly earnings in economy (annual average)	12.0	2.8	5.0	9.2	25.2	**12.0**	na
Government sector *(in per cent of GDP)*				(In per cent of GDP)			
General government balance	-4.9	-5.1	-3.5	-3.3	-3.5	**-5.7**	-6.3
General government expenditure	29.0	29.6	28.5	29.0	29.1	**33.0**	na
General government debt	60.7	57.7	58.2	56.1	53.2	**55.9**	na
Monetary sector				(Percentage change)			
Broad money (M2, end-year)	7.6	12.0	8.9	12.1	5.3	**10.3**	na
Domestic credit (end-year)	8.7	8.8	16.1	19.6	34.1	**18.0**	na
				(In per cent of GDP)			
Broad money (M2, end-year)	50.4	52.1	52.3	53.6	51.3	**52.2**	na
Interest and exchange rates				(In per cent per annum, end-year)			
Refinancing rate[2]	6.5	5.3	5.0	5.5	6.3	**6.3**	na
Treasury bill rate (3-month maturity)	7.3	6.2	5.4	6.4	6.3	**6.3**	na
Deposit rate (1 year)	7.6	6.0	5.6	5.5	6.0	**6.9**	na
Lending rate (1 year)[3]	10.5	13.7	12.2	11.2	13.6	**11.1**	na
				(Lekë per US dollar)			
Exchange rate (end-year)	106.4	92.6	98.1	94.1	82.9	**87.9**	na
Exchange rate (annual average)	121.3	102.8	98.1	98.1	90.4	**83.5**	na
External sector				(In millions of US dollars)			
Current account	-398.0	-427.0	-726.0	-1,024.4	-1,147.8	**-1,923.8**	-1,679.7
Trade balance	-1,336.0	-1,583.0	-1,821.0	-2,089.5	-2,899.6	**-3,551.9**	-3,537.0
– Merchandise exports	447.0	601.0	656.0	782.9	1,078.7	**1,355.6**	**1,135.3**
– Merchandise imports	1,783.0	2,184.0	2,477.0	2,882.3	3,978.3	**4,907.5**	**4,662.1**
Foreign direct investment, net	178.0	324.0	958.0	314.7	647.4	**843.7**	650.0
Gross reserves, excluding gold (end-year)	1,059.4	1,397.6	1,404.1	1,768.8	2,104.2	**2,319.8**	na
External debt stock	1,253.5	1,519.4	1,752.1	1,807.6	1,950.8	**2,600.6**	na
				(In months of imports of goods and services)			
Gross reserves, excluding gold (end-year)	4.7	5.0	4.4	4.4	4.3	**3.8**	na
				(In per cent of exports of goods and services)			
Debt service	3.1	3.1	2.8	3.1	2.4	**4.2**	na
Memorandum items				(Denominations as indicated)			
Population (end-year, million)	3.1	3.1	3.1	3.2	3.2	**3.2**	na
GDP (in billions of lekë)	694.1	750.8	814.8	891.0	980.1	**1,064.0**	**1,110.0**
GDP per capita (in US dollars)	1,644.7	2,341.7	2,648.7	2,883.0	3,422.8	**4,005.9**	na
Share of industry in GDP (in per cent)	8.7	10.0	10.6	11.0	10.3	**10.4**	na
Share of agriculture in GDP (in per cent)	23.5	22.3	20.7	19.8	21.0	**21.5**	na
Current account/GDP (in per cent)	-7.0	-5.8	-8.7	-11.3	-10.6	**-15.1**	-14.5
External debt – reserves (in US$ million)	244.0	161.8	348.0	38.9	-153.4	**280.9**	na
External debt/GDP (in per cent)	21.9	20.8	21.1	19.9	18.0	**20.4**	na
External debt/exports of goods and services (in per cent)	107.4	95.0	94.7	80.4	64.5	**67.8**	na

[1] Figures do not include emigrant workers abroad.
[2] The figures show the repo rate of the central bank.
[3] The figures show the weighted average (subtly) rate for new credit in lekë for maturities between 6 months and 1 year in December each year.

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Albania – Structural and macroeconomic indicators 135

A. Structural indicators box
B. Structural and institutional change indicators table
C. Macroeconomic table

A: Structural indicators box – definitions and data sources

Liberalisation and privatisation

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.

Controls on inward direct investment

Options: yes (controls on foreign ownership, and/or minimum capital requirements); no (no restrictions on inward foreign direct investment, except in some cases on arms production and military equipment).

Source: 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 highly illiquid money or credit markets); limited de jure (restrictions on banks to set interest rates through law, decree or central bank regulation).

Source: EBRD staff assessments.

Exchange rate regime

Options: currency board pegged to euro; currency board in ERM II; de facto pegged to US dollar; de facto fixed to euro; fixed peg In ERM II; crawling peg; managed float; floating; unilateral euroisation; euro-floating.

Source: International Monetary Fund, Annual report on exchange arrangements and exchange restrictions.

Wage regulation

Restrictions or substantial taxes on the ability of some enterprises to adjust the average wage or wage bill upward.

Options: yes; no.

Source: EBRD staff assessments.

Tradeability of land

Options: full (no substantial restrictions on tradeability 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 tradeability of land, for example, limited enforceability of land rights, a non-existent land market, or significant obstruction by government officials); limited de jure (legal restrictions on tradeability of land rights); no (land trade prohibited).

Source: EBRD staff assessments.

Business environment and competition

Competition office

Competition or anti-monopoly office exists separately from any ministry, though it may not be fully independent.

Options: yes; no.

Source: EBRD staff assessments.

Quality of insolvency law

Level of compliance of insolvency laws with international standards, such as the World Bank's Principles and guidelines for effective insolvency and creditor rights systems, the UNCITRAL working group on legislative guidelines for insolvency law, and others.

Options: very high; high; medium; low; very low.

Source: EBRD Regional survey of Insolvency Laws 2009.

Secured transactions law

Level of reform assessed in relation to the EBRD Model Law on secured transactions and the EBRD 10 core principles of secured transactions laws.

Options: advanced; some defects; inefficient; malfunctioning.

Source: EBRD Regional Survey of Secured Transactions 2009.

Infrastructure

Telecom regulatory assessment compliance
Level of regulatory progress in the telecommunication sector compared to established world regulatory benchmarks.

Options: full; high; medium; low.

Source: EBRD Telecommunications Regulatory Assessment 2008.

Independent electricity regulator
Options: fully (institutional, financial, managerial and decision making independence granted); partially (some elements of independence, but not all four dimensions); no (no regulator with institutional independence).

Source: EBRD staff assessments.

Separation of railway infrastructure from operations
Separate entities responsible for track infrastructure and for freight and passenger operations.

Options: fully (institutional separation); partially (accounting only); no.

Source: EBRD staff assessments.

Independence of the road directorate
A road management agency that is separate from the government.

Options: fully (institutional, managerial and decision-making independence and an independent account); partially (some elements of independence, but not all four dimensions); no (part of a government body).

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 formal deposit insurance scheme.

Options: yes; no.

Source: EBRD staff assessments.

Private pension funds
Options: yes; no.

Source: EBRD staff assessments.

Social reform

Share of population living in poverty
Percentage of population living on less than US$ 2 a day (at 2005 international prices). Selected years.

Source: World Bank, World Development Indicators.

Government expenditure on health
Expenditures by general government, excluding state-owned enterprises, on health services including hospitals, clinics, public health, medicaments, medical equipment and applied research related to the sector. Expenditures are expressed as percentage of GDP. Latest available year.

Source: National authorities.

Government expenditure on education
Expenditures by general government, excluding state-owned enterprises, on education services including pre-primary and primary education, secondary and tertiary education, and subsidiary services to education. Expenditures are expressed as a percentage of GDP. Latest available year.

Source: National authorities.

Household expenditure on power and water
Share of total household expenditures used on electric power and water/waste-water services. Estimate based on the poorest 10 per cent of households (lowest income decile), latest available year.

Source: EBRD staff estimates, based on household survey data.

B: Structural and institutional change indicators table – definitions and data sources

Enterprises

Privatisation revenues (cumulative, in per cent of GDP)
Government revenues from cash sales of enterprises, not including investment commitments.

Sources: National authorities and IMF country reports.

Private sector share in GDP (in per cent)
"Private sector share" in GDP 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.

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 authorities 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 authorities and IMF country reports.

Investment/GDP (in per cent)
Gross domestic investment consists of additional outlays to the economy's fixed assets, plus net changes in inventory levels. Fixed assets include: land improvements (fences, ditches, drains, and so on); plant, machinery and equipment purchases; and the construction of roads, railways, schools, offices, hospitals, private residential dwellings, commercial and industrial buildings, and so on. Inventories are stocks of goods held by firms to meet temporary or unexpected fluctuations in production or sales and "work in progress". Net acquisitions of valuables are also considered capital formation.

Source: See the macroeconomic indicators tables.

Markets and trade

Share of administered prices in CPI (in per cent)
Administered prices include: directly regulated prices (price set up directly by the state); partly regulated prices (state has co-determination right in setting the price); quasi-regulated prices (in the case of goods which are subject to specific customer taxes); and indirectly regulated prices (goods for which the state guarantees a purchase quote).

Sources: EBRD survey of national authorities and IMF country reports.

Number of goods with administered prices in EBRD-15 basket
EBRD-15 basket consists of flour/bread, meat, milk, gasoline/petrol, cotton textiles, shoes, paper, cars, television sets, cement, steel, coal, wood, rents, intercity bus service.

Source: EBRD survey of national authorities.

Share of trade with non-transition countries (in per cent)
Ratio of merchandise exports and imports with non-transition economies to total trade (exports plus imports).

Source: IMF, Directions of Trade Statistics.

Share of trade in GDP (in per cent)
Ratio of exports plus imports to GDP.

Source: See the macroeconomic indicators tables.

Tariff revenues (in per cent of imports)
Tariff revenues include all revenues from international trade. Imports are those of merchandise goods.

Sources: National authorities and IMF country reports.

Financial sector

Number of banks (foreign-owned)
Number of commercial and savings banks, excluding cooperative banks. Foreign-owned banks are defined as those with foreign ownership exceeding 50 per cent, end-of-year.

Source: EBRD survey of central banks.

Asset share of state-owned banks (in per cent)
Share of majority state-owned banks' assets in total bank sector assets. The state includes the federal, regional and municipal levels, as well as the state property fund and the state pension fund. State-owned banks are defined as banks with state ownership exceeding 50 per cent, end-of-year.

Source: EBRD survey of central banks.

Asset share of foreign-owned banks (in per cent)
Share of total bank sector assets in banks with foreign ownership exceeding 50 per cent, end-of-year.

Source: EBRD survey of central banks.

Non-performing loans (in per cent of total loans)
Ratio of non-performing loans to total loans. Non-performing loans include sub-standard, doubtful and loss classification categories of loans, but excludes loans transferred to a state rehabilitation agency or consolidation bank, end-of-year.

Source: EBRD survey of central banks.

Domestic credit to private sector (in per cent of GDP)

Ratio of total outstanding domestic credit to private sector at end-of-year, to GDP.

Domestic credit to private sector comprises the claims on non-financial, majority private-owned, enterprises and households by: banking institutions; other banking institutions, which include institutions that do not accept deposits but perform financial intermediation (for example, mortgage banks, microfinance institutions); and the monetary authorities.

Sources: IMF, International Financial Statistics (IFS) and country reports.

Domestic credit to households (in per cent of GDP)

Ratio of total outstanding bank credit to households, at end-of-year, to GDP.

Source: EBRD survey of central banks.

Mortgage lending (in per cent of GDP)

Ratio of mortgage lending to households, at end-of-year, to GDP.

Source: EBRD survey of central banks.

Stock market capitalisation (in per cent of GDP)

Market value of all shares listed on the stock market, calculated by multiplying the share price by the number of shares outstanding; presented as a percentage of GDP, end-of-year. Listed domestic companies are the domestically incorporated companies listed on the country's stock exchanges at the end of the year.

Source: Standard & Poor's/IFC Emerging Stock Markets Factbook, Federation of Euro-Asian Stock Exchanges and local stock exchanges.

Stock trading volume (in per cent of market capitalisation)

Total value of shares traded during the period, divided by the average market capitalisation for the period.

Source: World Bank World Development Indicators, Standard & Poor's/IFC Emerging Stock Markets Factbook and local stock exchanges.

Eurobond issuance (in per cent of GDP)

Total value of the bond issuance (including sovereign, municipality and corporate issuance) denominated in a currency different to that of the country in which the bond was issued.

Source: JP Morgan.

Infrastructure

Fixed-line (mobile) penetration rate (per 100 inhabitants)

Fixed line refers to the number of telephone lines connecting a customer to the Public Switched Telephone Network (PSTN) and which have a dedicated port on a telephone exchange. Mobile refers to users of portable telephones subscribing to an automatic public mobile service using cellular technology that provides access to the PSTN.

Source: International Telecommunications Union.

Internet users (per 100 inhabitants)

Number of internet users per 100 inhabitants, based on nationally reported data.

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 are not available, average retail tariff.

Sources: International Energy Agency, Energy Regulators Association and EBRD survey of national authorities.

Average collection rate, electricity (in per cent)

Collection rate is defined as the ratio of total electricity payments received in cash and total electricity charges.

Source: EBRD survey of national authorities.

GDP per unit of energy use (PPP in US dollars per kgoe)

PPP of GDP per kilogram of oil equivalent for commercial energy use. GDP is converted to international US dollars using purchasing power parity exchange rates.

Source: World Bank, World Development Indicators.

C: Macroeconomic indicators table – definitions and data sources

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 incorporate the informal sector into their estimates of GDP.

Employment

For some countries, data reflect official employment records from the labour registries. In many countries, small enterprises are not recorded by official data. A number of countries have moved towards ILO-consistent labour force surveys in recording changes in labour force, employment and unemployment. Where available these data are presented.

Prices and wages

Data sourced from statistical offices or the IMF. In some countries, official CPI data may underestimate underlying inflation because of price controls and inadequate measurement of price increases in informal markets. Wage data are from national authorities and often exclude small enterprises as well as the informal sector.

Government sector

Data for the general government, including local government and extra-budgetary funds, incorporated where available. Budget balance data can differ from official estimates due to different budgetary accounting, in particular with respect to privatisation revenues and foreign lending.

Monetary sector

Broad money is the sum of money in circulation outside banks and demand deposits other than those of the central government. It also includes quasi-money (time, savings and foreign currency deposits of the resident sectors other than the central government). Data sourced from the IMF, International Financial Statistics, 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 sourced 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 national authorities and in IMF country reports.

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