Transition Report 2010

Recovery and Reform

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 2010.

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The past year has been another difficult one for policy-makers in most countries of the region. Not surprisingly, the pace of new reforms has slowed further. Nevertheless, there have been very few examples of reform reversals, highlighting the resilience of the reforms introduced in most of the region over the previous two decades. The low number of upgrades and near absence of downgrades to the EBRD transition indicators support the view that the past year has generally been a period of reform stagnation (or slow reform at best) rather than reform reversal. Only two countries – Poland and Tajikistan – received more than one upgrade.

This year's *Transition Report* takes the first step towards reforming the EBRD transition indicators, both to expand their sectoral coverage, and to place more emphasis on the quality of market-enabling institutions. In addition to presenting a number of new sector-level indicators, particularly in the corporate and energy sectors, an alternative set of financial sector indicators is introduced. Both "old" and "new" transition indicators are reported. While the two sets of indicators are highly correlated across countries, significant differences arise between traditional and new scores in the financial sector. This is mostly attributable to the fact that the traditional indicators emphasised financial deepening and placed comparatively little weight on the quality of regulatory and supervisory institutions.

In common with the traditional indicators, the highest sectoral scores are typically in central Europe and the Baltic states, followed by Turkey, while the lowest scores are uniformly in Central Asia. Even in EU member countries, however, significant reforms are necessary in some areas, particularly in sustainable energy, transport, and some areas of the financial sector.

From crisis to recovery

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Over the last year, most countries in the EBRD region have started to recover at varying speeds. In some central European countries, and most commodity-rich countries in eastern Europe and Central Asia, the recovery has been solid, although growth remains significantly below its 2005-08 average. In a few cases, such as Armenia, Moldova, Poland and Turkey, capital inflows or renewed remittance inflows have contributed to growth in 2010. In contrast, the recovery in most south-eastern European countries is progressing slowly.

Three main factors contributed to these differences: the capacity of transition countries to take advantage of the incipient recovery of the world economy through higher exports; fiscal policies; and the unwinding of pre-crisis imbalances, which continue to weigh on credit growth in many countries. Commodity exporters, countries with export concentration in intermediate inputs such as machinery, and countries with large real exchange rate depreciations during the crisis are benefiting disproportionately from the recovery of global trade. In addition, the recoveries in Russia and Germany are contributing to a return of remittance flows to some of the smaller countries in the region. In contrast, capital inflows are generally recovering more slowly than in other emerging market countries, with the notable exception of Turkey and Poland.

Looking ahead, the multi-speed recovery is expected to continue. Exports will continue to drive growth in most countries in the next year, as domestic demand growth generally remains muted due to fiscal adjustment. Downside risks arise from the international environment, but also from pre-crisis legacies – particularly large stocks of foreign currency-denominated debt – as well as counterproductive taxation and regulation decisions in response to fiscal and sometimes populist pressures.

Developing local currency finance

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Developing local currency finance is key to both vigorous and less volatile growth in the transition region. Local currency debt markets help mobilise domestic savings and make countries less dependent on capital imports. And reducing unhedged foreign currency borrowing, which continues to be commonplace in most banking systems in the region, is critical to making countries less vulnerable to a depreciation of the currency.

However, it is critical to address the causes of unhedged foreign currency borrowing rather than just its symptoms. Three factors stand out: inflation volatility, which may imply that the macroeconomic risks of local currency borrowing are even higher than those of foreign currency borrowing; fixed or heavily managed exchange rates, which create the perception of low currency risk; and a lack of domestic funding sources, which leads banks to turn to foreign currency borrowing to fund credit expansion.

The extent to which these causes apply varies widely across transition countries, and so should strategies to develop local currency finance. In some eastern European and Central Asian countries, inflation has been traditionally volatile and hard to predict. These countries need to reform their macroeconomic institutions and policy frameworks before undertaking other steps to develop local currency finance. In contrast, countries with reasonable track records of macroeconomic stability can use several tools, including: allowing more exchange rate flexibility; developing local currency bond markets, which with few exceptions are still in their infancy; and reforming bank regulation to encourage local currency use.

Invigorating trade integration and export-led growth

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During 2000-08, growth in the transition region was driven mainly by buoyant capital inflows and domestic demand. As a result, export growth was often outpaced by import growth, leading to large external deficits in many countries. After the crisis, a return to this "growth model" looks neither feasible nor desirable. Instead, the region must invigorate exports in order to restore growth without the associated external imbalances. Analysis shows that there is a close link between exports and innovation in transition countries, and hence between export performance and growth in the long term.

As the chapter documents, export growth – albeit overshadowed by even faster import growth – does in fact have a respectable track record in the transition region: between 2000 and 2008, its share in world exports almost doubled from 5 per cent to nearly 10 per cent, and it also became more diversified, with growing intra-regional trade and exports to non-traditional trading partners. However, this growth was based on factors that cannot be guaranteed to continue in the coming decade, including low initial unit labour costs and reductions in tariff barriers to low levels. Invigorating exports will hence require additional policy effort. In addition to supportive macroeconomic and labour market policies, progress in two areas is critical: non-tariff barriers, which must either be reduced or which firms must learn to navigate better; and improvements in the business environment that are closely linked to competitiveness. This includes, in particular, facilitating customs procedures, reducing corruption and improving the rule of law.

Evaluating and improving the business environment

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Improving the business environment is a cornerstone of the post-crisis growth agenda. But which aspects of the business environment matter most to firms? And how can policy-makers in the region address them? In principle, the EBRD-World Bank Business Environment and Enterprise Performance Surveys (BEEPS), in which firms in the transition region rate the main obstacles to doing business every three years, should help answer these questions. But in practice, the views expressed in the BEEPS are difficult to compare across firms and countries, and they are not easy to relate to objective differences in institutions and policies on the ground.

One way to overcome these difficulties is to focus on *relative* obstacle ratings by firms, which removes firm differences in reference points and "tendencies to complain" from the data. This approach reveals that many transition countries share the same three main business environment concerns, namely: skills availability, corruption and tax administration. Poor physical infrastructure and crime are also among the top concerns, particularly further east in the transition region.

This chapter shows how countries can address these deficiencies by drawing on the experiences of their transition peers, both at the present time and over the past 10 years. For example, Georgia can provide its peers at a similar level of development with ideas on fighting corruption and Estonia on improving tax administration. Regression analysis of constraint determinants can provide further pointers for alleviating business obstacles. Its results suggest, for example, that despite the rise of mobile telephony, landline availability still matters; that transparent implementation of tax rules may matter more than just simpler documentation or less tax preparation time; and that removing skill bottlenecks is more important than generic increases in education spending.

New country assessments

The *Transition Report*'s country assessments pages give an overview of the main macroeconomic and structural reform developments over the past year, as well as an outline of the key challenges facing each country. They serve as a compact overview of mostly factual information about countries in the region and provide a handy guide to some of the main issues of interest to investors, analysts and policy-makers.

The structure of the pages has changed this year, with greater emphasis on the main challenges ahead, both at the country-wide and the more specific sectoral levels. For each country, the assessment starts with three key developments and challenges, highlighting the most significant events and taking a view on the top policy priorities. The next section covers macroeconomic performance and summarises the short-term outlook and the key risks. A short table of key macroeconomic indicators follows. More detailed data, both on selected economic indicators and on structural and institutional changes, are published on the EBRD web site.

The rest of the assessment is devoted to structural reform issues. A short paragraph gives a big picture overview of the state of transition, reflecting the effect of cumulative reforms introduced over the years. The assessment goes on to summarise the main structural reform developments since the middle of 2009, covering some or all of the main sectors – corporate, energy, infrastructure and finance. Lastly, the assessment outlines three structural reform priorities, reflecting the analysis of sectoral reforms and challenges outlined in Chapter 1.

Foreword

Erik Berglöf Chief Economist

> Complacency would threaten not only recovery, but also long-term growth. There can be no return to the region's pre-crisis dynamism without new reform.

The EBRD's region is emerging from the crisis. It is doing so more hesitantly than other emerging market regions, predominantly because its pre-crisis imbalances were larger and are taking longer to unwind. The speed of recovery varies widely: some countries are undergoing sharp rebounds, while others, particularly in south-eastern Europe, are only just starting to recover. In 2011 the EBRD is expecting positive – albeit in some cases modest – growth in all of its countries of operations for the first time since 2007.

What conclusions should policy-makers in the region draw from the crisis? The depth and length of the recession, and the sense that they were causally related to the preceding boom period, have led to calls for a "new growth model". The concerns that prompt these calls are the right ones, but the conclusions go too far. The "old" growth model is one of internationally integrated, private-sector driven economies supported by market-enabling government institutions. This system has been fundamentally successful. Incomes *did* converge with those in the West during the last decade: even with the effects of the crisis, purchasing power adjusted output per capita in the transition region is almost twice as high this year as it was 10 years ago. This success reflects all aspects of the growth model – including the effect of financial integration, as shown in last year's *Transition Report: Transition in crisis*.

That said, it is clear that the transition region's growth model – or at least its implementation – suffered from significant flaws. Some weaknesses we were aware of, others have been thrown into sharp relief by the crisis. Two decades of transition had taught us the importance of market-supporting institutions, but the weaknesses of financial regulation and supervision and the vulnerabilities of exports to the global crisis surprised us. In some sectors, particularly in the financial sector, our efforts to measure the quality of these institutions proved inadequate. Partly for this reason, Chapter 1 of this year's *Transition Report* unveils a new set of sectoral transition indicators, including a new, expanded set of indicators for the financial sector, which gives much more prominence to the institutional aspects of transition.

How exactly, then, should the transition region's growth model be adapted? Fundamentally, reform must serve two objectives.

The first is to make growth less volatile. While pre-crisis policies were successful in generating high growth, they did so, in many countries, at the price of enormous risks in the form of large current account deficits and excessive private borrowing, predominantly in foreign currency, which in turn caused bubbles in sectors such as construction and retail. These bubbles have now burst.

The second objective is to reinvigorate and rebalance the drivers of long-term growth. This is in response partly to the expectation that capital flows cannot be assumed to flow back into the transition region in the same way they did pre-crisis. Hence, the region will need to seek alternative sources of growth.

For the most part, however, the need for a new growth agenda (if not a new growth model) comes in response to a problem that has little to do with the crisis. Aside from rapid capital inflows and a credit boom – factors that cannot persist to the same degree, nor would we wish them to – growth in the last decade was fundamentally the result of impressive export growth and trade integration into the world economy. This needs to continue, and become the main driver of growth in the post-crisis period. However, achieving this will not be easy. As argued in Chapter 4, the drivers of export growth in the pre-crisis decade were: cost competitiveness; trade agreements and tariff reductions; and strong trading partner demand. But today's unit labour costs are much higher than 10 years ago – a natural consequence of convergence and labour market integration; average tariff rates are now in the single digits; and slower world growth is forecast for many years ahead.

Partly because of this sense that the "low-hanging fruit" feeding growth had been plucked, the 2008 *Transition Report: Growth in transition* argued that policy-makers in the region needed to pay more attention to fundamental drivers of growth such as education, competition and diversification. These messages apply with equal if not greater force after the crisis. At the same time, it is now especially important to focus on reforms that specifically improve the trade-off between fast growth and volatile growth. For these reasons, this year's *Transition Report* focuses on two main reform areas.

The first reform area concerns the development of domestic capital markets and local currency finance. Financial development is a source of growth; at the same time, greater reliance on local savings makes economies less vulnerable to swings in international capital flows. More local currency lending, particularly to unhedged borrowers, will make economies less vulnerable to sudden exchange rate depreciations. While the threat of mass bankruptcies resulting from unhedged foreign exchange exposures was ultimately contained during the crisis, this required both tight macroeconomic policies that had large output costs, and large-scale international crisis lending. Chapter 3 analyses the causes of the widespread use of foreign currency in the region, and concludes that the remedies are complex – involving not only capital market development but also macroeconomic reforms, and regulation – and to a significant extent must be country-specific.

The second area of reform is the improvement of the business environment. This has been a mainstay of the growth agenda in the transition region and beyond, but the challenge has always been to be more specific about what aspects of the business environment are most critical, and how to improve. This year's *Transition Report* takes up this challenge, at least in part. Chapter 4 analyses what aspects of the business environment matter the most for export growth. Chapter 5 presents a novel approach to extracting the top concerns of firms from the Business Environment and Enterprise Performance Survey (BEEPS), which the EBRD and World Bank last conducted in 2008-09, and tries to link them to country policies.

In recovering economies, where memories of the crisis are still fresh, conditions for reform should be favourable. But the opportunity could be missed. Renewed capital inflows in some countries and preoccupation with short-term concerns in others tend to foster complacency about deep reform. Lack of progress risks generating new bubbles and leaves the region vulnerable to the whims of the world economy. Even if recovery is in evidence in the region, the external downside risks, not least those emanating from advanced Europe, are still substantial.

Complacency would threaten not only recovery, but also long-term growth. There can be no return to the region's pre-crisis dynamism without new reform. The challenge for policy-makers is not just to ensure that the future becomes safer, but to do so in a way that sustains convergence in Europe.

Erik Berglöf Chief Economist

Chapter 1
Progress and measurement of transition

The transition region has experienced another exceptionally difficult year in the wake of the global crisis. Although output had largely bottomed out by late 2009, many countries have continued to feel the economic aftershocks. Nevertheless, while progress in structural reform in the past year has been limited, there have been very few examples of reform reversals.

Although the worst of the global and regional economic crisis is over, many countries have continued to feel the economic aftershocks, including falling revenues, rising unemployment and extra pressures on social spending. Perhaps not surprisingly, the pace of new reforms has slowed further. Nevertheless, a key finding of the 2009 *Transition Report* that there had been very few examples of reform reversals, or indeed political shifts presaging such reversals, remains valid as of late 2010.[1]

This chapter assesses the remaining challenges that lie ahead for the region, using a refined and expanded EBRD methodology for evaluating the level of transition achieved in each country and the size of the remaining transition "gap". The Bank's traditional transition indicators have been in place since the mid-1990s, and were in need of some modernisation to reflect the evolving consensus among economists and policy-makers on what constitutes a well-functioning market economy. In particular, some of the traditional indicators say too little about the quality of market-enabling institutions – a factor that became apparent during the crisis as many financial sectors proved to be weaker than their high transition indicator scores had earlier suggested.

The traditional indicators also provide limited sector-level information, which does not adequately reflect how the remaining transition challenges differ across sectors of the economy. An expanded scoring system, using a data-based analysis of 16 different sectors, is therefore being introduced this year. This is the first step in a two-stage reform, which is eventually expected to lead to a revised set of transition indicators at both the sector and country levels. The traditional country-level and new expanded sector scores are contrasted, with the aim of providing a more complete picture of the transition agenda facing each country. The reform agenda in the financial sector is the subject of Chapter 3 in this report; while reform angles cutting across sectors – but affecting in particular the corporate and infrastructure sectors – will be taken up in Chapters 4 and 5.

Transition indicators: a brief history

Measuring transition is difficult. The EBRD indicators formulated in 1994 represented one of the first attempts at quantifying the level of progress achieved in various aspects of transition. There were initially six indicators, covering three broad aspects of transition: enterprises (incorporating small- and large-scale privatisation and enterprise restructuring); markets and trade (price liberalisation and competition, and trade and foreign exchange system); and financial institutions (banking reform). They were measured on a scale from 1 to 4, where 1 represented little or no progress in reform and 4 meant that a country had made major advances in transition in a particular aspect.

The indicators have since been broadened and refined. The scoring system was modified in two stages: in 1995 an extra category of 4* was added for equating policies and performance standards with those of an advanced industrial economy, and in 1997 pluses and minuses were introduced to allow for finer distinctions among the different categories (with 4* redefined as 4+). The number of indicators was also extended. In 1995 the price liberalisation and competition indicator was separated into two components: price liberalisation and competition policy. In the same year an extra financial institutions category was added – securities markets and non-bank financial institutions (SM & NBFI). That year's *Transition Report* also included an index of legal reform, which was modified significantly in 1998. From 2002 onwards, the index of legal reform was replaced in the *Transition Report* by studies addressing the level of transition in specific areas of commercial and financial legislation.[2]

There was an important extension in 1999 as a set of infrastructure indicators was introduced covering five subsectors: telecommunications, electric power, railways, roads, and water and wastewater. Over the next few years almost all indicators were backdated to 1989. Between 2005 and 2009 the methodology underlying some of the infrastructure indicators was modernised and extended, in particular by linking the indicators more tightly to observable institutional characteristics of each sector. When necessary, this led to a revision in the historic series.

The EBRD indicators have proved useful and popular. They often receive attention in the local media, they can help in exerting peer pressure on countries (that is, if neighbouring countries are receiving better scores) and they have been widely used in academic research that focuses on the link between reforms and other variables such as economic growth.[3] Structural reform indicators have also been developed by the World Bank and other institutions, but none has been used as frequently as the EBRD transition indicators.

However, drawbacks have become increasingly apparent.[4] One problem is the subjective nature of the scoring and possible non-transparency of the demarcation between categories. It clearly makes sense to allow some subjectivity when economists have access to more information than is summarised in the publicly available data. However, too much can undermine the credibility of the index. This is because it cannot be easily validated externally and creates a risk that a country's overall economic performance might influence the judgement about (and scoring for) its transition progress (which, in the extreme, would render regressions of growth on the transition indicators meaningless).

A more fundamental objection is that, with the exception of the infrastructure indicators, many of the scores reflect a rather simplistic view that a successful transition is mainly about removing the role of the state and encouraging private ownership and market forces wherever possible. The problem with this view is that markets cannot function properly unless there are well-run, effective public institutions in place. For example, selling off a large state-owned enterprise or utility to private ownership will not necessarily lead to greater efficiency and ultimate benefits to consumers unless there is a regulator in place to enforce rules and ensure fair competition. Similarly, the rapid growth of lending and the introduction of private banks and new financial products may give a misleading impression of progress if these developments are not accompanied by institutional safeguards to prevent excessive and imprudent lending. That is why, in some countries, the scores for large-scale privatisation and banking reform may have exaggerated the actual progress made in these sectors.[5]

[1] See EBRD *Transition Report* (2009), Chapters 1 and 6.
[2] Secured transactions (2003); insolvency (2004); corporate governance (2005); concessions (2006); securities laws (2007); telecommunications (2008); electricity markets (2009); and public procurement (2010 – see Annex 1.2).
[3] Previous research on the link between reforms and growth using the EBRD transition indicators includes Berg et al. (1999), Havrylyshyn and Van Rooden (2003), Falcetti et al. (2002) and Falcetti et al. (2006). A more recent example is Eicher and Schreiber (2010).
[4] This discussion draws on Besley et al. (2010).
[5] The recognition that well-functioning institutions are crucial to the transition process is fully consistent with the approach promoted by the EBRD since the 1990s through its Legal Transition Programme, within which the EBRD assesses progress in commercial and financial law reform and implements technical cooperation projects to establish and develop legal rules and institutions required for a market-oriented economy. See www.ebrd.com/pages/sector/legal.shtml.

With these arguments in mind, this year's *Transition Report* embraces the improvements in the infrastructure indicator methodology since 2005 and the substantial work on additional sector-based indicators that began in 2009 (and was presented briefly in Chapter 5 of last year's *Report*) and introduces two significant innovations.

- First, the sector indicators are broadened from five infrastructure and two financial sector indicators to 16 indicators within four sector groups – corporate, energy, infrastructure and financial (see also Table 1.3). The financial sector indicators distinguish not only between bank and non-bank aspects but also make distinctions within the latter, separately rating insurance and other financial services (such as leasing, pension funds and other asset management services), private equity, capital markets and micro, small and medium-sized enterprise (MSME) finance.

- Second, all sector indicators embody the new methodology (already underlying last year's infrastructure indicators), and aim to measure not only the structure and extent of markets but also the quality of market-supporting institutions, and to relate the findings either to published data or observable criteria. One important consequence is that the picture of transition emerging from the five new financial sector indicators is somewhat different from that derived from the traditional two (see below).

The traditional country-level indicators and (for comparative purposes) the two traditional financial sector indicators are retained this year. The latter will be discontinued as of next year, while the former will be reviewed and are likely to be retained in modified form.

Traditional indicators: scores in 2010

Table 1.1 presents the traditional transition scores, with upgrades and downgrades identified by upward- and downward-pointing arrows, respectively. As in previous years, this table also includes an overall infrastructure score based on the five subindicators of electric power, water and wastewater, roads, railways and telecommunications (the detailed scores are folded into the sectoral analysis below). The justifications for the changes are given briefly in Table 1.2. As shown in Table 1.1, there have been only 9 upgrades this year (including two for overall infrastructure) a record low since the scores were created. However, there have also been just two downgrades (banking reform and interest rate liberalisation in Hungary and securities markets and non-bank financial institutions (SM & NBFI) in the Slovak Republic) compared with four last year. The low number of upgrades and near-absence of downgrades suggests that the past year has been generally one of reform stagnation (or slow reform at best) rather than reform reversal. Only Poland and Tajikistan received more than one upgrade.

There were one-notch increases in the price liberalisation indicator for Belarus and Tajikistan. In the case of Belarus, a traditional laggard in reform, the upgrade is warranted by the removal of restrictions on price and trade margins for many goods and services and the substantial reduction of the list of minimum export prices. However, the country is still ranked lower on this indicator than all others except Turkmenistan and Uzbekistan. The upgrade for Tajikistan is based on progressive liberalisation in the important cotton sector.

Elsewhere, the EBRD's latest survey of competition authorities in the region has revealed positive developments in two south-eastern European countries, justifying an upgrade on the competition score. In Romania, the upgrade is based on continuous improvements in law enforcement, while in Serbia important changes have been made to competition law to harmonise it with European Union (EU) regulations and strengthen the powers of the competition commission.

In the banking sector there have been no upgrades this year, perhaps not surprisingly given the ongoing problems many countries are experiencing in this respect. The downgrade in Hungary is based mainly on the government's decision to impose a temporary but substantial levy on banks and other financial institutions. While the levy reflects an urgent fiscal need, it is disproportionate compared with similar measures under consideration in other countries, and is likely to discourage the financial deepening and international financial integration that have served Hungary well during the crisis. The downgrade in the Slovak Republic in the SM & NBFI category reflects the previous government's changes to the pension system, which have made the operating environment for pensions more uncertain. In contrast, Poland received an upgrade in this indicator because of the successful introduction of a new bond trading platform, an innovation that is expected to stimulate the development of local capital markets.

One of last year's downgrades – for large-scale privatisation in Montenegro – has been reversed this year. The downgrade last year was based on the reacquisition by the state of a major share in the country's largest company, the aluminium conglomerate KAP. While this move has not yet been reversed, the authorities have pushed ahead with important sales in the ports sector and a large minority stake in the dominant power company, EPCG. In Ukraine, a World Trade Organization (WTO) member, the authorities have reversed some of the foreign exchange controls introduced during the worst stage of the crisis and have taken steps to further liberalise the foreign exchange market, but some important restrictions remain, preventing a return to 4+ on trade and foreign exchange systems after last year's downgrade to 4.

Sectoral indicators: coverage and methodology

The new sector-based approach to measuring transition progress is fundamentally forward-looking. Instead of concentrating on what has been achieved in the past, this section examines different sectors of the economy and assesses the remaining transition gap for each. This is done in terms of the changes to market structure or market-supporting institutions necessary to bring them up to the standards of the most advanced market economies rather than in relation to financing or investment needs. The assessments therefore contain analyses of laws and regulations "on the books" and how well they are being implemented.

Table 1.3 lists the 16 sectors that are part of the assessment. In addition to the new financial sector indicators, there are indicators for agribusiness, general industry and real estate grouped under a corporate heading. Electric power, for which an indicator has existed since 1999, has been joined in the energy group by a new indicator for natural resources and another for sustainable energy (which has been largely ignored in previous assessments of transition progress).[6] There is also a new infrastructure indicator for urban transport.

[6] This indicator is based on the EBRD's Index of Sustainable Energy Index (see EBRD *Transition Report*, 2008, Annex 1.3).

Table 1.1
Transition indicator scores, 2010

			Enterprises			Markets and trade			Financial institutions		Infrastructure
	Population mid- 2010 (million)	Private sector share of GDP mid-2010 (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-	3-↑
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	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	4-↑	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	2-↑
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	60	3	4	2+	4	4	2+	3	3-	2+
Uzbekistan	26.0	45	3-	3+	2-	3-	2	2-	2-	2	2-

Source: EBRD.
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 beginning on page 156. The private sector share of GDP is calculated using available statistics from both official (government) and unofficial sources. The share includes income generated from the formal activities of registered private companies, as well as informal activities where reliable information is available. The term "private company" refers to all enterprises in which private individuals or entities own the majority of shares. The accuracy of EBRD estimates is constrained by data limitations, particularly in the area of informal activity. EBRD estimates may, in some cases, differ markedly from official data. This is usually due to differences in the definition of "private sector" or "non-state sector". For example, in the CIS+M, the "non-state sector" includes collective farms, as well as companies in which only a minority stake has been privatised. ↑ 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 transition scores

Country	Transition indicator		Reason for change
Belarus	Price liberalisation	3 to 3+	Removal of price and trade restrictions on many goods and reduction of list of minimum export prices.
Hungary	Banking reform and interest rate liberalisation	4 to 4-	Imposition of a large levy on financial institutions.
Montenegro	Large-scale privatisation	3 to 3+	Important sales of state shares in port and power sectors.
Poland	Large-scale privatisation Securities markets and non-bank financial institutions	3+ to 4- 4- to 4	Substantial progress in large-scale privatisation programme. Successful introduction of a new bond trading platform.
Romania	Competition policy	3- to 3	Continuous improvements in law enforcement in area of competition.
Serbia	Competition policy	2 to 2+	Changes to competition legislation to harmonise with EU regulations and strengthen the powers of the competition commission.
Slovak Republic	Securities markets and non-bank financial institutions	3 to 3-	Changes to the pension system that have made the market for private pensions more uncertain.
Tajikistan	Price liberalisation	4- to 4	Progressive liberalisation of price-setting in the cotton sector.

Source: EBRD.
Note: See Table 1.1 for transition indicator scores for all transition countries. Furthermore, upgrades to overall infrastructure scores also occurred in Bosnia and Herzegovina and Tajikistan and are based on the five energy and infrastructure sector scores which have an asterix next to them in Table 1.3, and for which scores were available in previous years.

Table 1.3
Sector coverage of new transition indicators

Corporate	Agribusiness General industry Real estate
Energy	Electric power* Natural resources Sustainable energy
Infrastructure	Railways* Roads* Urban transport Water and wastewater* Telecommunications*
Financial institutions	Banking Insurance and other financial services Capital markets Private equity MSME finance

*Existing transition indicators.

As previously noted, the new approach differs from the earlier methodology in that it assigns roughly equal weights to institutional quality and more traditional structural criteria such as private ownership and market-based price formation. Also, the ratings for these institutional and structural subcomponents are derived from a more transparent and often data-based assessment. This involved the following steps (see also Box 1.1 for a specific example).

- EBRD economists selected subcategories of the market structure and institution components that seemed relevant to a specific sector; for example, price setting, ownership, market power of incumbent operators (in the case of electric power or railways), or vertical unbundling for market structure, and independent regulation, regulatory capacity, competition policy or the sector-specific legal framework and quality of its enforcement for market-supporting institutions.

- A means of scoring these subcomponents was then developed, based on either publicly available data or observable characteristics of market structure and institutions (for example, regulatory independence or specific legislation).

- Based on the results of this scoring exercise, remaining transition gaps for market structure and institutions were classified as “negligible”, “small”, “medium” or “large”.

- Each sector was then assigned a transition indicator on the usual 10-point scale of 1 to 4+, based on the transition gap ratings given to the two components, market structure and market-supporting institutions.[7] However, because transition gaps ratings are broad categories (for example a “large” gap may mean no progress in transition, but also encompasses a situation in which considerable progress has been made, while the distance to the transition frontier nonetheless remains large) the same combination of the two components are consistent with a range of transition indicator scores. For example, two ratings of “small” that are fairly close to “negligible” may warrant an overall score of 4, while two ratings of “small” that are close to “medium” may yield a score of 3+. To achieve a reasonable compromise between flexibility and consistency, the final score was restricted to lie within a defined range in cases where the two components have the same rating. For example, a “medium-medium” combination must yield a score between 2+ and 3+ inclusive. When the two components differed, the scores were calibrated accordingly, reflecting sector-specific weights applied to market structure and institutions (see the Methodological Notes on pages 156-163 for more details).

Although the new approach continues to involve judgement and allows EBRD economists some flexibility in determining the final transition score, it imposes significantly greater discipline and transparency than the traditional method. While the latter focused on justifying an upgrade or downgrade based on a transition indicator level inherited from the past, the new approach requires a numerical framework that justifies the *level* of each indicator and its subcomponents at every point in time.

Another important attraction of the new approach is that it shows the different ways in which a country (or sector) may face significant challenges in completing transition. The numerical score is a useful first guide to the size of the transition gap, but the underlying institutional and structural subcomponents and their subcategories give a fuller picture. This promotes more concrete policy guidance than the traditional indicators. It also highlights an important conceptual point: that transition is not a simple linear progression from state control to the free market, but may involve different paths, and consequently different reform needs, for countries and sectors, even if these receive similar sector ratings.

[7] The scale has 10 points because the score “1+” is never used.

Box 1.1
Scoring methodology for the agribusiness sector

The new sector-based scores have been derived partly from data but also from judgements that, although subjective, are simpler to document and explain than was the case using the traditional approach. This box explains how the scores for the agribusiness sector have been calculated. Other sector scores have been reached through a broadly similar methodology, but using different data sources (see the Methodological Notes on pages 156-163 for details).

The first step in constructing the indicators was to list the relevant criteria for market structure and market-supporting institutions and policies, and the associated data sources – see Table 1.1.1. These data sources range widely from multilateral institutions, such as the World Bank or WTO, to niche reports from Business Monitor International or in-house EBRD studies.

The weights chosen for different criteria were based on EBRD economists' assessment of their importance in the overall rating. For example, "development of private and competitive agribusiness" was deemed the single most important criterion for market structure (40 per cent), followed by "development of related infrastructure" (25 per cent), "development of skills" (20 per cent) and "liberalisation of prices and trade" (15 per cent). Market structure and market-supporting institutions and policies were weighted equally (50 per cent each); in other sectors, however, either may be given a greater weight.

In the agribusiness sector, the raw data for each criterion were converted into "z-scores"; that is, the mean and variance of the indicators across countries were calculated and then scaled according to the normal distribution. The z-scores were then ranked and converted into percentiles, giving a comparable scale across all indicators. The percentiles for each criterion (for example, for *Ratio of a percentage of tertiary graduates in agriculture* and *Value-added per worker in 2005* under *Development of skills*) were averaged, with each percentile given an equal weight.

Using these scores, and then applying the weights associated to each criterion, two average scores in each country – one for market structure and one for market-supporting institutions – could be calculated. These were used to assign a "negligible", "small", "medium" or "large" rating to the size of the remaining transition gap. It is important to note, however, that an input of judgement, based on other information for which numerical measures are not available and the discernment of EBRD economists, was also central to the assessment process.

Lastly, the ratings were combined into an overall numerical score for the sector, ranging from 1 to 4+. As described above, this score reflects not just the underlying gap scores for market structure and institutions, but also the underlying data. For example, a rating of small on market structure and medium on market-supporting institutions might have yielded a score of 3 in one country but 3- in another, depending on how close to other thresholds the small and medium gaps were judged to be (see the Methodological Notes on pages 156-163 for more details).

Table 1.1.1
Rating transition challenges in the agribusiness sector

Components	Criteria	Indicators
Market structure [50%]	Liberalisation of prices and trade [15%]	Price liberalisation (EBRD *Transition Report*, 2009) Forex and trade liberalisation (EBRD *Transition Report*, 2009) Producer price of wheat in USD per tonne (Food and Agriculture Organization (FAO), PriceSTAT, 2007) Simple average MFN-applied imports tariffs on agricultural products (WTO, 2008) NRAs to agriculture in per cent (World Bank distortions, 2004-07) WTO membership (WTO)
	Development of private and competitive agribusiness [40%]	Wheat yields per ha (FAO ProdSTAT, 2008) Independent grocery retail sales in per cent of total grocery retail (BMI, 2008) Mass grocery retail sales in per cent of total grocery retail (BMI, Food and Drink, 2008) Small-scale privatisation (EBRD *Transition Report*, 2009) EBRD enterprise reform indicator (EBRD *Transition Report*, 2009)
	Development of related infrastructure [25%]	EBRD railways infrastructure (EBRD *Transition Report*, 2009) EBRD road infrastructure (EBRD *Transition Report*, 2009) Tractors in use per 100 inhabitants (FAO, 2007) Ratio of producer price over world wheat price (FAO PriceSTAT, 2007)
	Development of skills [20%]	Ratio of a percentage of tertiary graduates in agriculture over a percentage of agricultural share in GDP (UNESCO 2007, own calculations) Value-added per worker in 2005 in constant USD (World Bank World Development Indicators Database, 2009)
Market-supporting institutions and policies [50%]	Legal framework for land ownership, exchanges and pledges [40%]	Tradeability of land (EBRD *Transition Report*, 2009) Warehouse receipt programmes (FAO Investment Centre WP, 2009) Building a warehouse – Dealing with Construction Permits (World Bank *Doing Business*, 2009) Registering property (World Bank *Doing Business*, 2010) EBRD Business Environment and Competition (EBRD *Transition Report*, 2009)
	Enforcement of traceability of produce, quality control and hygiene standards [40%]	Overall TC 34 (www.iso.ch, 2009) Quality index based on average of TC34/SC4, TC34/SC5 and TC34/SC6 (www.iso.ch, 2009) Extent of disclosure index (World Bank *Doing Business*, 2010) Extent of director liability index (World Bank *Doing Business*, 2010) Strength of investor protection index (World Bank *Doing Business*, 2010)
	Creation of functioning rural financing systems [20%]	Ratio of a percentage of lending to agriculture relative to a percentage of agricultural share in GDP (own calculations)

Source: EBRD.

Sector scores

Table 1.4 shows the new sector transition scores for all sectors and countries. Appendix Tables A.1.1.1 and A.1.1.2 contain the component ratings for market structure and market-supporting institutions and policies, respectively.

Out of a total of 464 sector/country ratings, 52 are rated between 4- and 4+, 207 between 3- to 3+, 166 fall between 2- and 2+, while 39 are in the 1 category. The scores allow a rough comparison across sectors and countries. Treating pluses and minuses as +0.33 or -0.33 (for example, 3+ is 3.33 and 3- is 2.67) and taking simple averages, the sector with the highest score of 3.08 is telecommunications, while the least advanced sector is private equity, which has an average transition score of just 1.76. At the country level, the highest average score is 3.56 in Hungary, closely followed by Poland and Estonia at 3.48; while Turkmenistan brings up the rear with an average of 1.08.

The scores for the infrastructure sector group (except urban transport) and for electric power are updated transition indicator scores and therefore allow a comparison with last year. There are 10 upgrades – four in railways, two each in roads and water/wastewater, one in electric power and one in telecommunications – and just one downgrade (electric power in Hungary, because of new legislation introducing price caps on electricity to households).[8] Most of the upgrades reflect either the passing of important laws to strengthen institutions or a significant increase in private-sector involvement and competition in the provision of services. However, the background data reveal that infrastructure quality in many rural areas is particularly poor. The legacy of central planning in terms of inefficient use of energy resources is still noticeable everywhere, and much remains to be done to improve market structures and supporting institutions to secure energy sustainability.

In the corporate sector group, improvements in efficiency and business standards remain a challenge throughout the region. Progress in the legal framework (for example, in respect of intellectual property rights) is necessary for the development of a knowledge-based economy.

The challenges in the financial sector group are particularly daunting at two levels. Regulatory and supervisory frameworks and institutions are often inadequate (in some cases to an unexpected extent that was revealed by the crisis – see below). In addition, the crisis has created a new set of transition challenges, insofar as it led to far greater state intervention in the control of credit and lending terms, or even to state ownership. Although these steps were generally justified at the time, some need to be reversed and replaced by effective but arms-length supervision to enable private sector-driven financial deepening to resume.

Regional overview

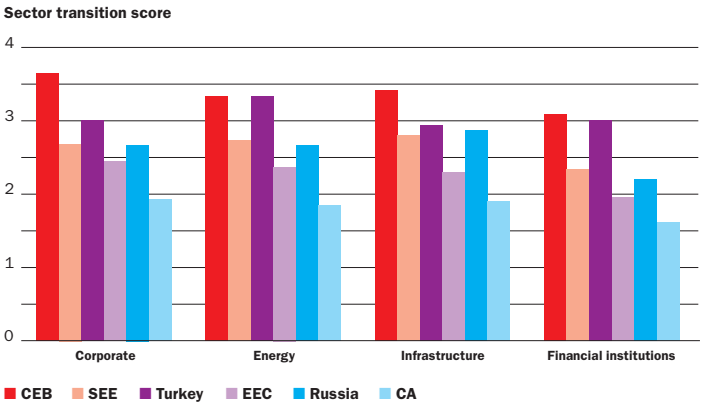
This section summarises the results for each of the EBRD subregions in the four broad sector groups, while Box 1.2 considers the sustainable energy challenges facing all countries as they try to tackle climate change and retain competitiveness within a low carbon economy context. Chart 1.1 presents the average score for each region in the four main categories (corporate, energy, infrastructure and financial institutions) by converting pluses and minuses to +/- 0.33 and taking simple averages across sectors in the four broad groups and across countries within each region. It shows that the highest scores are typically in Central Europe and the Baltic states (CEB), followed by Turkey, while the lowest scores are uniformly in Central Asia.

Central Europe and the Baltic states (CEB)

The transition indicators are highest in the CEB countries, with real estate and general industry having the largest concentration of 4- to 4+ ratings. The high corporate sector scores reflect the fact that the remaining transition challenges are mostly small and relate to improving efficiency, productivity and competition. Estonia achieved the highest score of 4+ in real estate and – on par with the Slovak Republic – a 4 in general industry. However, the restructuring of sensitive industries (such as chemicals in Poland) and the continued high level of state involvement and/or ownership (notably in Slovenia) still need to be addressed. Also, hurdles remain in business start-up bureaucracy, bankruptcy procedures and access to finance, especially in the context of constrained liquidity. In the agribusiness sector Hungary is the highest-rated country at 4, but in a number of other countries hygiene and packaging standards still need to be improved.

Chart 1.1

Summary of 2010 sector transition indicators



Source: EBRD.
Note: Simple averages of sector transition indicators shown in Table 1.4, treating pluses and minuses as +0.33 or -0.33, respectively.

[8] In addition, in 13 other cases (two in the railway sector, four in roads, three in electric power and four in water and wastewater, see Table 1.4) the historical series were revised to achieve cross-sector consistency in the relationship between transition indicators and the underlying transition gaps.

Table 1.4
Sector transition indicators 2010: overall scores

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

Source: EBRD.
Note: Uses same transition indicator scale as Table 1.1. The scores for five infrastructure sectors – electric power, telecoms, water and wastewater, roads and railways – are comparable to previous years. There were one-notch upgrades this year in 10 cases: electric power (Montenegro), telecoms (Serbia), water and wastewater (Armenia and Turkey), roads (Moldova and Tajikistan) and railways (Bosnia and Herzegovina, FYR Macedonia, Mongolia and Serbia). There was one downgrade electric power in Hungary. In addition, there were historical revisions in the following cases to take account of new data and information and to achieve greater cross-sector consistency: electric power (Bosnia and Herzegovina, Estonia and Mongolia), water and wastewater (Albania, Belarus, Poland and Serbia), roads (Armenia, Georgia, Poland and Ukraine) and railways (Lithuania and Turkey).

Box 1.2
Progress in sustainable energy

The move to an energy-efficient and low-carbon economy is a major challenge. Transition countries have a massive handicap in this respect after many years of environmental neglect and wasteful use of energy. Some of the larger countries are significant emitters of greenhouse gases and have the most energy-intensive economies. Poor energy efficiency weakens the region's competitiveness, and the development of institutions and market structures to address these problems has generally lagged behind other areas of reform. This box considers the challenges ahead, based on the new transition indicator for sustainable energy.

Despite some progress, the new EU member states still face significant transition challenges in establishing market-supporting institutions and implementing effective price-incentive schemes to improve energy efficiency, reduce carbon emissions and promote renewable sources of energy. Energy prices usually fall short of reflecting full environmental costs, although such considerations are gradually being built into market prices through mechanisms such as the EU Emissions Trading Scheme and EU environmental standards. Energy intensity, although dramatically reduced since 1990, is still significantly higher on average than in the EU-15 (the 15 EU member states before the 2004 expansion). The legal and institutional framework for sustainable energy has improved, but still lags behind and further institutional strengthening is needed. Compliance with EU targets on climate change and a commitment to attaining these targets is particularly difficult for countries that depend on domestic fossil fuels. Project development and implementation of commercially viable renewable energy and energy-efficiency investments, especially in housing and small and medium-sized enterprises (SMEs), still face institutional barriers. These may include underdeveloped regulation for housing associations or energy-performance contracting, or crowding out of energy service companies by government funds. Compared with western Europe, market infrastructure in the transition region is at a much earlier stage of development, resulting in higher risk premiums and transaction costs that cannot be effectively mitigated because of the lack of affordable risk management instruments or tailored financial products.

In non-EU SEE countries legal and institutional frameworks for sustainable energy are nascent and as yet incomplete, and the implementation capacity is generally weak. Some appropriate policies are already in place – such as obligatory off-take of all generated power at fixed prices above market rates (feed-in tariffs). However, in most countries renewable energy projects are hampered by subsidised fossil fuel costs and generally poor enforcement of legislation. In some countries energy efficiency projects are held back by institutional barriers.

In Turkey basic institutions and policies have been established, but further significant efforts are needed to encourage energy savings and achieve more effective implementation.

Despite progress in some areas, Russia still faces medium or large transition gaps. Wholesale electricity prices should be liberalised by 2011, according to the government schedule. However, end-user domestic gas, heat and electricity prices are not yet cost-reflective and do not provide adequate incentives to use energy efficiently. Legislation on energy efficiency and renewable energy was adopted in 2009, but its impact will be limited until a regulatory framework covering technical rules and standards, price support, grid access and off-take agreements is implemented.

Most countries in the EEC and Central Asia regions have large transition gaps and have made little or no progress in reducing them. The gaps in Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan in particular reflect the market dominance of unreformed and non-transparent state companies. Low domestic tariffs, together with slow progress in enterprise restructuring, mean that energy efficiency remains poor. The major barrier to growth of renewable energy projects is subsidised domestic fossil fuels and nuclear energy, which distorts competitiveness. In Belarus and Ukraine transition challenges are large across the sustainable energy spectrum. Armenia is the only country in the Caucasus with targeted policies for renewable energy. Kazakhstan adopted a renewable energy law in 2009, but this has yet to be supported by secondary legislation on tariff determination, grid access and project selection procedures. The Kyrgyz Republic adopted legislation on renewable energy in 2008, and Tajikistan passed an energy efficiency law in 2009 that also regulates support for alternative energy sources. Only Armenia and Georgia, and to a lesser extent Azerbaijan, have made noticeable progress in reducing transition gaps in sustainable energy in recent years.

In the energy sector, the majority of countries have liberalised the electricity market in harmonisation with EU legislation, but there are still some remaining issues. In general, the need for full unbundling of incumbent operators (as in Hungary) and promotion of increased competition in power generation (such as in Lithuania or Slovenia) are still significant challenges across the region. Key targets in the municipal and environmental infrastructure sector are the establishment of multi-year incentive-based tariffs to stimulate investment and efficiency improvements, the fine-tuning of service contracts to allow greater private-sector participation, the improvement of governance and the limiting of political interference. In the transport sector there are still too few good examples of successful public-private partnerships (PPP), while concession policies and financing arrangements fall generally short of EU standards and full commercialisation of the railways has yet to be achieved in most cases.

In the financial sector the crisis has revealed weaknesses in the underlying institutional framework. In most countries – particularly the Baltic states, Croatia and Hungary – vulnerabilities such as high foreign currency exposure and dependence on foreign funding are still apparent even after the crisis. The private equity sector is fairly developed and countries generally show high compliance levels with corporate governance core principles. However, barriers to local investor participation remain. Poland leads the CEB countries, with the Warsaw Stock Exchange providing viable exit opportunities for private equity funds. While institutional frameworks are in place, access to finance for the MSME sector remains a challenge. The CEB countries are nearly fully compliant with International Association of Insurance Supervisors (IAIS) standards, but insurance penetration levels remain moderate by Organisation for Economic Co-operation and Development (OECD) standards.

South-eastern Europe (SEE)

In the SEE countries the general industry and real estate sector scores are rather mixed, with the highest ratings in the two EU members – Bulgaria and Romania – and the lowest in Bosnia and Herzegovina. Overall, the ratings reflect the progress achieved over the years with privatisation and restructuring. Regulation is gradually being aligned with EU norms, and countries like Albania and FYR Macedonia have made significant advances in the World Bank *Doing Business* indicators in recent years. However, there remain large differences between the quality of laws on the books and their application in practice, and the implementation capacity of regulatory authorities still needs strengthening. With regard to the property market, the main challenge is to promote development in regional cities and to develop liquid secondary property markets. The challenges are generally medium in agribusiness, with all countries scoring either 3- or 3, except Montenegro with 2+.

In the energy sector significant progress has been made with legal unbundling of incumbent operators, which are still often state-owned. In some countries the electricity market has been fully opened up (as in Bulgaria and Romania), while in others market liberalisation remains at an early stage (for example, Bosnia and Herzegovina). In general, private-sector participation and effective competition in the sector can be improved. With regard to natural resources, the main challenges are in unbundling and strengthening the institutional framework, especially the independence of regulators.

Municipal services that have been decentralised and corporatised in SEE countries generally show weak financial performance. In most towns, water and heating tariffs remain below cost-recovery levels. Also, regulatory performance is erratic, even in Romania, which is one of the few transition countries with a national water regulator. In the railways sector, significant improvements have been made in FYR Macedonia and Serbia, where commercialisation is well under way.

Transition challenges in the financial sector diverge widely. Regulatory frameworks are generally reasonable, although developments in global market conditions emphasise the necessity of coordination with other international regulators, as well as the need for introducing sustainable lending standards. Structural vulnerabilities with respect to the widespread use of foreign currency and foreign funding are generally similar to those in the Baltic states. The private equity sector is relatively small and too fragmented to have attracted sufficient international investor interest. Private equity activities are heavily concentrated in Bulgaria and Romania, with widely varying penetration elsewhere. There are still some targets to be met in the insurance industry, as only Bulgaria and Romania comply with IAIS standards, and penetration levels remain low. Access to finance as well as institutional framework challenges remain substantial in the MSME sector across the SEE region.

Eastern Europe and the Caucasus (EEC)

The general industry sector in the EEC countries has weak standards of governance and transparency and significant barriers to market entry and exit. Armenia stands out as the best performer with a 3 score, followed by Georgia with 3-. However, Ukraine's accession to the WTO in 2008 and Belarus' significant improvement in price liberalisation and small-scale privatisation are encouraging. The real estate sector in most countries is quite underdeveloped, while in agribusiness all countries score 3- except Azerbaijan with 2+.

The power sector is generally unbundled and liberalised, but reforms are far from complete. Competition in retail and generation is constrained by the dominance of state-owned incumbent operators, and although sector regulators are formally independent their decisions are often undermined by political interventions. In the natural resources sector significant gaps remain relating to limited private participation and state participation in production-sharing agreements; for instance, the main subsidiaries of Naftogaz Ukrainy control gas production in Ukraine as well as the transportation and part of the distribution sector.

Municipal utility services are largely decentralised in terms of ownership and decision-making. However, while legal frameworks allow for cost-reflective tariffs, this rarely happens in practice and tariff reform, including the elimination of cross-subsidies, continues to represent a substantial challenge. Private-sector participation is usually limited to deregulated minibus services. Key challenges include improvements in the technical, operational and financial performance of utilities, the rehabilitation of physical infrastructure, the clear separation of operating companies from regulatory bodies and the establishment of sound regulation.

In Moldova and Ukraine significant advances have been made in the roads sector. In Moldova tendering for real estate and periodic maintenance has become mandatory, and road maintenance expenditure has increased significantly since it became rule-based (precluding annual negotiations with the Ministry of Finance) in 2009. In Ukraine a series of increases in road-user charges has enabled the government to triple the budget for the sector over the past 10 years. In the telecommunications sector Georgia and Moldova stand out as having achieved a fair level of regulation and regulatory independence.

Despite major banking improvements in recent years, EEC countries continue to face regulatory and supervisory challenges. Banking remains very concentrated, with large public entities dominating in many cases. In Georgia the introduction of supervisory coordination between home and host countries has narrowed the transition gap to some extent, and private-sector credit growth has revived in Armenia and Belarus. Apart from Ukraine, the development of the non-bank financial sector has been limited. Countries have not yet attracted significant interest from international private equity funds (except for some irregular investments by regional funds), and insurance markets generally remain very small, with inadequate industry skills. The leasing sector is still at an early stage of development in the majority of countries. Although Armenia recently introduced an SME-targeted special government credit line in general, access to finance in the MSME sector is insufficient. Unhedged foreign currency exposures remain an issue almost everywhere.

Turkey

In the corporate sector the legislative and regulatory framework for starting and operating a private business needs strengthening, particularly the implementation of existing laws and enforcement of contracts. Also, the legislative and regulatory environment regarding the property market requires improvement. As the real estate market nears saturation, especially in the large cities of Istanbul and Ankara, the major challenges lie in the development of underserved regions.

There has been limited progress in the natural gas market, where generation and transmission, including the extensive pipeline network, are controlled by the state-owned and market-dominant Botaş company. A recent positive development was the granting of concessions for gas distribution to private companies in several regions. However, most issues concerning the market structure, the unbundling of transmission activities from supply operations and rules for access to the network are still pending.

In the transport sector potential PPP road and railway projects have been identified but not yet been tendered, while tenders for concessions in ports have been initiated but with limited progress to date. Access to municipal services, particularly in smaller municipalities, is still a problem and concessions legislation needs further improvement. The telecommunications regulatory framework remains weak, and formerly state-owned Turk Telekom dominates the wholesale broadband market due to the reach of its network and lack of significant competing infrastructure.

The banking sector has proved resilient through the global financial crisis, with limited direct foreign exchange risk and relatively little reliance on foreign funding. Recent years have seen regulatory improvements, but the sector remains small and highly concentrated, with over 30 per cent of total assets in banks with majority state ownership. Turkey is aiming to align its legislation and supervision with EU standards in regard to the non-bank financial sectors, and shows very high compliance levels with the core principles of corporate governance, although structural weaknesses remain in the private equity markets sector and MSME segment, where major access to finance obstacles remain.

Russia

The corporate sector needs to increase efficiency and to promote effective competition and best practice corporate governance and business standards. Also, the state continues to play a large, and in some cases expanding, role in the economy, especially (although not exclusively) in strategic sectors. A number of support measures for agribusiness are in place, but lack coherence and distort prices.

The economy depends heavily on oil and gas production and suffers from the legacy of a highly energy-intensive industrial structure. Low domestic gas prices are being progressively adjusted to international levels, which should provide incentives to use energy efficiently and invest in renewable energy projects. Progress has been made in reforming the power sector. Legal and functional unbundling is in place, although state involvement is pervasive.

While important progress has been made in the municipal sector, including the introduction of competitive tendering requirements for concession awards, tariff adjustments have not been implemented across the country. The setting up of PPPs for municipal services presents a major challenge in the prevailing financial environment, requiring innovative methods of channelling know-how and funding to the sector.

In the telecommunications sector competition in the local fixed-line market has been hampered by the lack of an effective network access regulatory regime, with alternative operators consequently deploying their own network access infrastructure.

The central bank's response to the financial crisis was effective but further regulatory changes in the banking sector are required. A major development has been the adoption of an insider trading law, which should be enacted in 2011. However, in order to function efficiently, this legislation needs to be complemented by an exact definition of insider information by the Federal Committee of Financial Markets. Russia's insurance market has started to grow, but there are limited skills available and the sector remains dominated by institutions that are either formally or informally state-controlled. The private equity market is well-developed, with funds active in several categories (growth, buy-out, venture, and so on) but penetration relative to the size of the economy remains limited. Large transition challenges remain in Russia's MSME sector.

Central Asia (CA)

There are large transition gaps in nearly all sectors in Central Asia, and scores are correspondingly lower for most indicators than in other subregions. State interference in the industrial sector is high in Tajikistan, Turkmenistan and Uzbekistan, and increasingly so in Kazakhstan. Corporate governance standards and business conduct are lower than elsewhere. Reducing barriers to market entry for new enterprises remains a significant challenge. In the agribusiness sector, quality standards and controls are often inadequate, promotion of competition and restructuring is weak and transport infrastructure is generally poor. Also, with the exception of Kazakhstan, real estate sectors are still at an early stage of development.

Most municipal utilities operate inefficiently and are not fully commercialised. Improving their financial and operational performance is a key objective. This necessitates tariff reform, as water and district heating charges barely cover costs, and improvements in governance, regulation and contractual arrangements.

With the exception of Kazakhstan and Mongolia, core railway businesses continue to operate under state control, and the road sector remains largely unreformed, with little private-sector participation, limited commercial financing and a rudimentary institutional framework. In Kazakhstan and Tajikistan the first road concessions have started operations, but many irregularities have been observed and PPPs do not yet reflect international best practice.

Major transition challenges also remain in the financial sector. Substantial improvements in legislation and regulation are required to meet international best practice. Significant commercial private equity sectors have yet to develop, other than in Kazakhstan, while limited investment opportunities and difficult business environments, have deterred significant interest from international investors. Insurance sectors are mostly state-dominated, and provision for private pension funds exists only in Kazakhstan and the Kyrgyz Republic. Access to finance for medium and small enterprises in the regions remains a major challenge.

Comparing old and new transition scores

The expanded sector-level transition indicators introduced in this report provide a more granular assessment of what still needs to be done to advance the transition process in each country. However, do the new scores tell a fundamentally different story from the traditional country-level indicators? At first glance, the answer is no; if a simple average of the country-level transition scores is compared with that of the new sector scores, the cross-country correlation is remarkably close and the ranking of countries is broadly similar (see Chart 1.2). It is worth noting, however, that the average score for the traditional indicators is above that for the new sectoral indicators in every country. This can be explained mainly by the fact that even relatively unreformed countries can score highly on indicators such as price and trade liberalisation and small-scale privatisation.

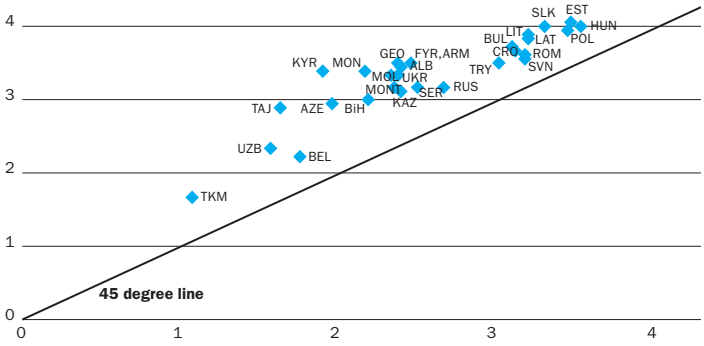
Chart 1.3 shows a scatter plot comparing traditional and new transition indicators in the banking sector – the only traditional sector for which scores under both the new and old methodologies are available. Although the scores are somewhat closer than the average country-level and sector scores that are compared in Chart 1.2, it is clear that the new scores are generally lower, with several significant deviations. The reason is that the earlier indicators were too heavily biased towards market development and put insufficient weight on the importance of market-enabling institutions. As a result, some countries appeared to be more advanced in banking transition because credit growth was rapid and sophisticated products were entering the market to meet a high demand. In reality, however, market-supporting institutions – particularly those designed to curb excessive credit growth and other risky practices – were often weak and these shortcomings were exposed with the onset of the financial crisis. In addition, the assessment of market structure that is part of the new scores is derived from better data in terms of competition and ownership structure in the sector, reflecting less subjective judgement.

For example, in several Baltic, central and south-eastern European countries, the traditional indicator scored transition in banking highly, on the grounds of high competition, dominance of private banks, little preferential lending or state interference with interest rates, and substantial financial deepening. But some of this rapid financial deepening led to an unsustainable credit boom, reflecting weaknesses in regulation and prudential supervision, and lack of systematic coordination with supervisors in other countries. Under the new methodology, these institutional aspects are weighted more heavily, leading to transition indicator scores of 3 or 3+ rather than 4- or 4 in countries such as Bulgaria, Croatia, Hungary, Latvia, Lithuania and even Poland.[8] In Slovenia, however, concerns about state participation and impediments to entry in the banking sector were already reflected in the existing transition indicator, which explains why the new and old scores are not very different. As in other sectors, EU membership does not imply adherence to a common standard for all market institutions, as banking supervision is only now being strengthened and coordinated across the Union.

Differences in old and new banking sector scores are also evident in Moldova and Mongolia, which can again be explained by the lesser weight put on market-supporting institutions under the old methodology. The banking sectors in these countries developed rapidly during 2007-08 (from a low base) by expanding credit and developing a range of financial services, supported by an increase in foreign ownership in the case of Moldova. However, both countries (in common with many others) lacked appropriate prudential regulation and supervision to deal with the associated risks and vulnerabilities. The onset of the crisis led to a rapid increase in non-performing loans, which contributed to the failure of two large banks – Anod Bank and Zoos Bank – in Mongolia and a medium-size bank – InvestPrivatBank – in Moldova. This in turn has negatively affected the competitive and ownership structure in these markets. Both countries have since taken important steps to strengthen their capacity to avoid future shocks. A new banking law in Mongolia has introduced stricter regulations regarding lending to related parties, single obligor limits and banking supervision, while the Moldovan authorities have strengthened the regulation on related-party lending and established a financial stability committee to improve coordination among all relevant public agencies.

[8] Several countries sought to limit credit growth and contain emerging credit risks ahead of the crisis. Poland, for instance, adopted Regulation S on mortgage lending in 2006 and in 2007 Croatia introduced measures to penalise excessive credit growth. Following the crisis, many countries are attempting to strengthen their regulatory frameworks, particularly to deal with foreign currency lending (see Chapter 3 and Box 3.6).

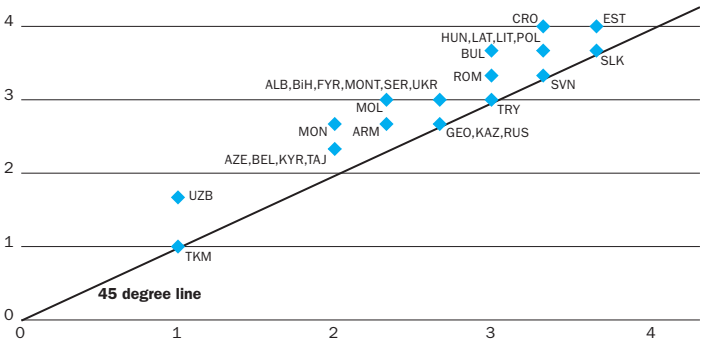
Chart 1.2
Country-level versus expanded sector-level indicators, 2010



Source: EBRD.
Note: On the y-axis the chart shows simple averages of the six country-level transition indicators under the headings "enterprises" and "markets and trade" in Table 1.1 and on the x-axis the simple averages of the 16 sector-level indicators shown in Table 1.4. Country abbreviations are as follows:

Albania	ALB	Armenia	ARM	Azerbaijan	AZE	Belarus	BEL
Bosnia and Herz.	BiH	Bulgaria	BUL	Croatia	CRO	Estonia	EST
FYR Macedonia	FYR	Georgia	GEO	Hungary	HUN	Kazakhstan	KAZ
Kyrgyz Republic	KYR	Latvia	LAT	Lithuania	LIT	Moldova	MOL
Mongolia	MON	Montenegro	MONT	Poland	POL	Romania	ROM
Russia	RUS	Serbia	SER	Slovak Republic	SLK	Slovenia	SVN
Tajikistan	TAJ	Turkey	TRY	Turkmenistan	TKM	Ukraine	UKR
Uzbekistan	UZB						

Chart 1.3
New sector indicator for banking versus traditional banking reform indicator, 2010



Source: EBRD.
Note: See Chart 1.2 for definition of country codes.

Conclusion

This chapter has reviewed the methodological issues surrounding the measurement and assessment of progress in transition. It is vitally important for national authorities, and for institutions like the EBRD, to gauge how far countries have advanced along the transition path and to identify the principal remaining challenges. The usefulness of the EBRD transition indicators as a guide to reformers has lessened over the years, prompting the introduction of the extended, sector-based approach outlined above.

The sector-based transition scores do not fundamentally alter the perception of which countries have made the most progress in transition and which ones lag furthest behind. However, they do provide a more rigorous basis for assessing the size of the remaining transition gaps and the reforms needed to address them. At the subregional level, the greatest challenges are evident in Central Asia and in parts of eastern Europe and the Western Balkans. Lesser, but still significant, reforms are necessary in the EU member countries, particularly in the sustainable energy, transport and some areas of the financial sectors.

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Table A.1.1.1

Sector transition indicators 2010: market structure

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

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

Table A.1.1.2

Sector transition indicators 2010: market-supporting institutions

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

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

Annex 1.2

Public procurement legal frameworks

During 2010 the EBRD has been conducting its first assessment of the public procurement (PP) sector in all 29 countries of operations concurrently, examining government purchasing in terms of both "law on the books" and "law in practice". Although the review of the latter is not yet complete, the assessment has produced some initial findings and analysis on legislation in force and on the efficiency of enforcement procedures.

Public procurement frameworks regulate the interaction between public sector purchasers and the market, and therefore determine how a government's purchasing power is exercised in relation to private-sector tenderers. As PP constitutes a major economic activity for all governments, its regulation is a significant component of a country's legal framework and an essential supplement to public finance legislation. It is a challenge for any government to develop a legal regime that will balance the often competing considerations of competition policy, transparency safeguards and efficiency requirements, and in a manner which takes account of local market conditions and prevailing legal and business cultures.

The assessment aims to provide an impartial review of law on the books and law in practice and of institutional frameworks in the countries of operations. The project team has included EBRD staff, international consultants, local contracting authorities, contracting entities in the utilities sector and law firms providing legal advice to contractors and suppliers. In each country the project team has sought to enlist the cooperation of the national PP regulatory bodies.

Mindful of the different levels of market development in the Bank's countries of operations, the assessment has been based on a specifically designed benchmark structured around the critical elements of the PP process. The benchmark indicators have been adapted from major international legal instruments, including those already in force and some which have a status of "well-accepted drafts".[1] To facilitate the evaluation of those areas of the procurement process not covered by these instruments, the benchmark has been supplemented by best practice indicators in World Bank and EBRD procurement policies.

The main focus of the assessment is the evaluation of the level of development of PP law and practice across the region and the identification of those elements that reduce the efficiency and effectiveness of the procurement process. This annex presents some preliminary observations.[2]

Assessment benchmark

Difficulties in the modelling of PP regulation include deciding what constitutes international best practice, assessing how relevant regulation is to a country's economic and social standing and adequately reflecting local market conditions, the national business culture and the level of a country's communications technology development. National contract laws and suppliers and contractors active in the market must also be taken into account. In addition, regulation will vary depending upon whether the procurement process is to be funded by a state/municipal budget or by a contracting entity in the utilities sector. Similar considerations are relevant to PP evaluation.

[1] The 2004-07 European Union PP Legislative Package; revised 2010 United Nations Commission on International Trade Law (UNCITRAL) PP Model Law; and revised 2007 World Trade Organization (WTO) Government Procurement Agreement.
[2] A more detailed report is forthcoming in spring 2011.

For the assessment benchmark, the project team selected the most comprehensive and innovative elements of international best practice structured around the EBRD Core Principles on an Efficient Public Procurement Framework (see Box A.1.2.1). The Core Principles are based on the assumption that the primary role of a PP law is not to ensure unrestricted international trade, or to save public money, but rather to facilitate the process of negotiating a business contract in a public-sector context.

Box A.1.2.1
EBRD Core Principles on an Efficient Public Procurement Framework

- **Accountability.** The framework should promote accountability across all stages of the procurement process, balancing the public and business dimensions.
- **Integrity.** The framework should promote integrity between the procurement function, transparency in delivering government policy and value for money.
- **Transparency.** For public procurement to be acceptable to all stakeholders it should be seen to be public, transparent and objective. Any suggestion of an undisclosed resolution must be avoided.
- **Competition.** The framework should promote fair competition and prevent discrimination. Tenders and tenderers of equivalent status should be given equal treatment, without regard to nationality, residency or political affiliation. The law should not allow domestic preferences.
- **Efficiency.** Sound programming and planning are crucial to agreeing a cost-effective and accurate public contract. The framework should ensure that value for money is achieved, and promote methods of tender evaluation that consider both the quality and cost of purchase.
- **Economy.** The law should enable PP to be accomplished professionally in a reasonable time.
- **Proportionality.** Effective and efficient procurement regulation calls for a proportionality rule, whereby the formality and extent of the procedure should reflect the scope and size of the procurement. The contracting entity should align the value and scope of the contract with an appropriate choice of contract type and tendering procedure.
- **Uniformity.** The framework should be comprehensive and limit derogations to reasonable exemptions acknowledged by international instruments, yet should distinguish between state and utilities PP. Regulation should be unitary and cover all public contracts.
- **Stability.** Stakeholders must be aware of their roles, rights and obligations within a stable legislative framework.
- **Flexibility.** The framework should be flexible, so as to accommodate a changing market.
- **Enforceability.** PP law should be easily enforceable. Regulatory mechanisms should be able to assess the compliance of the contracting entities and employ corrective measures when necessary.

Law on the books: initial findings

For evaluation purposes the PP Core Principles have been divided into three general categories: (i) integrity safeguards, (ii) efficiency instruments and (iii) institutional and enforcement measures. These have then been sub-divided into 11 indicators (see below), with the overall score calculated for each country (on a scale of 0 to 100) based on the assumption that all indicators have an equal influence on the effectiveness of the procurement process. For each country, a "spider" diagram reflects the quality and comprehensiveness of the national regulatory framework (see Chart A.1.2.1). The "spider" is based on the PP legal framework in force on 30 June 2010. Each diagram captures the 11 indicators: accountability, integrity, transparency, competition, efficiency, economy, proportionality, uniformity, stability, flexibility and enforceability. The total score has been calculated for each country on the basis of a legislation and institution checklist.[3] The scores for compliance range through "very high" (above 90 per cent of the benchmark), "high" (76-90 per cent), "satisfactory" (60-75 per cent), "low" (50-59 per cent) to "very low" (below 50 per cent). The wider the coloured "web" in each diagram, the better the regulatory system.

The results show that only one country (Hungary) achieved "very high" compliance, while three countries (Estonia, Latvia and Lithuania) scored "high" for compliance. Two countries (Tajikistan and Ukraine) had a "low" level of compliance, and three (Azerbaijan, Turkmenistan and Uzbekistan) registered a benchmark score of 50 per cent (a "very low" level of compliance). The remaining countries are rated as "satisfactory".

It is perhaps surprising that the European Union (EU) countries in the EBRD region, which scored "very high" on basic framework features, such as prevailing open tender procedures or liberal public procurement eligibility rules, did not perform better, with only Hungary having a framework which is more than 90 per cent compliant.

[3] Before this review of the laws in the EBRD region started, the legislation and institution checklist providing a basis for the "law on the books" assessment was put to the test using public procurement legislation of developed countries such as the UK and Switzerland, as well as the US federal public procurement policies, which all obtain very high marks for compliance.

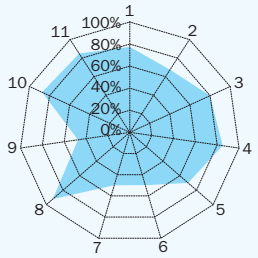
Chart A.1.2.1

Quality of PP legal frameworks in EBRD countries

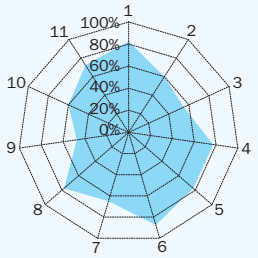
The spider diagrams reflect the quality of the regulatory framework of each EBRD country. Each diagram includes the indicators numbered below. For each indicator, the diagram presents the scores as fractions of the maximum achievable rating. The scores begin at zero at the centre of each chart and reach 100 at the outside so that, in the overall chart, the wider the coloured "web" the better the scores in the assessment.

1 Accountability
2 Integrity
3 Transparency
4 Competition
5 Efficiency of the contract
6 Economy of the process
7 Proportionality
8 Uniformity
9 Stability
10 Flexibility
11 Enforceability

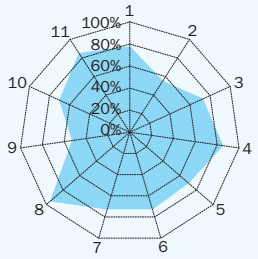
Albania



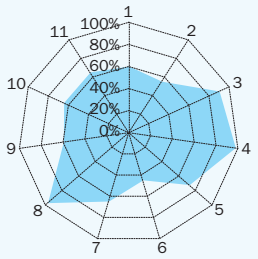
Armenia



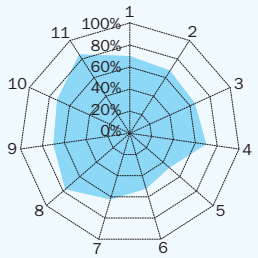
Croatia



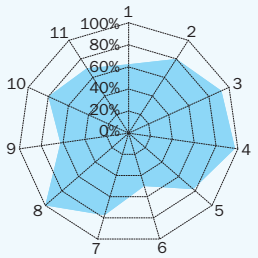
Estonia



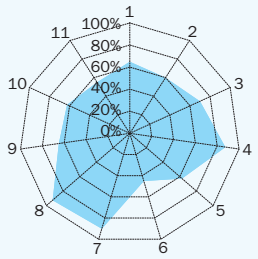
Kyrgyz Republic



Latvia



Poland



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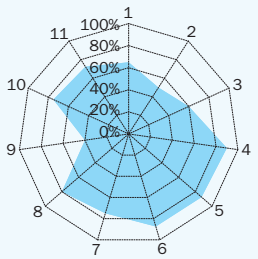

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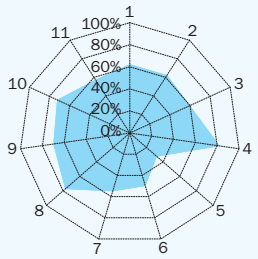
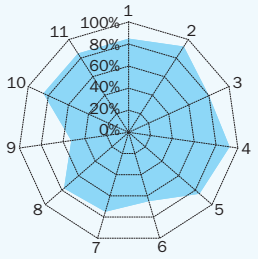
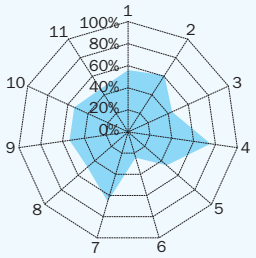


Turkey



Source: EBRD Public Procurement Legal Frameworks Assessment, 2010.
Note: The chart shows the score for extensiveness and comprehensiveness of national PP laws for each country in the region. The scores have been calculated on the basis of a legislation questionnaire, based on the EBRD Core Principles on an Efficient Public Procurement Framework (see Box A.1.2.1). Total scores are presented as a percentage, with 100 per cent representing the optimal score for these benchmark indicators.

Azerbaijan



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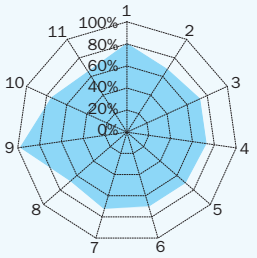
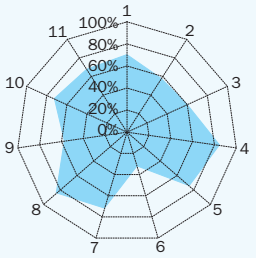


Bosnia and Herzegovina



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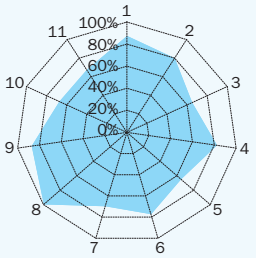

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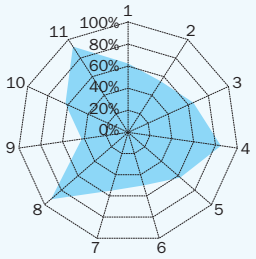

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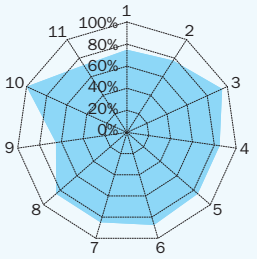
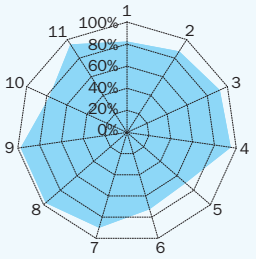


Hungary



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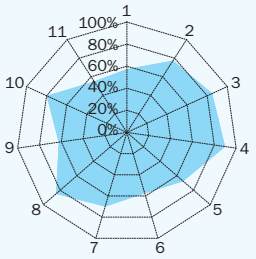
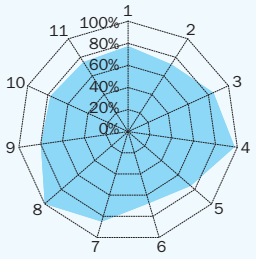
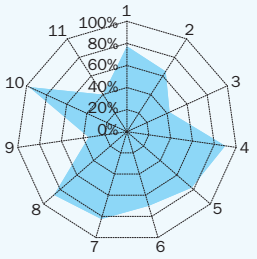


Lithuania



Moldova



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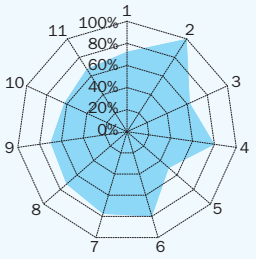
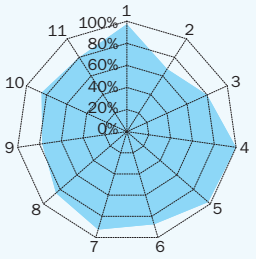
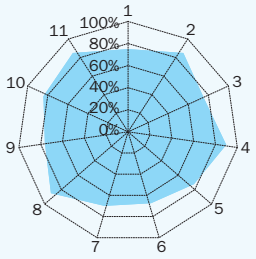


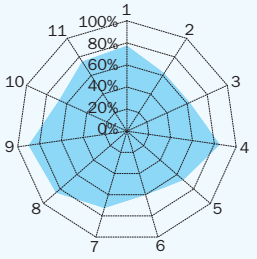
Montenegro



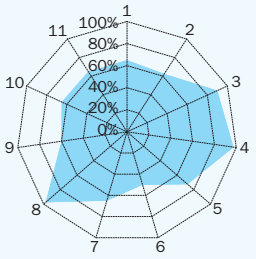
Russia



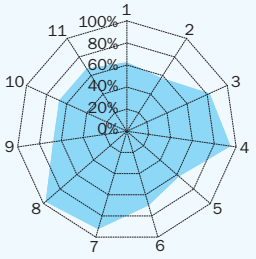
Serbia



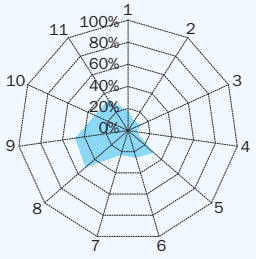
Slovak Republic



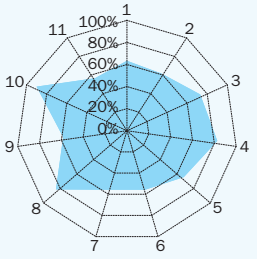
Slovenia



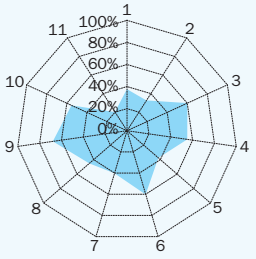
Turkmenistan



Ukraine



Uzbekistan



Law on the books: further analysis

This section analyses the results from the review of law on the books. It addresses the following questions:

- Is PP policy-making adequate to the prevailing national business culture and market development?
- Does the scope of PP regulation embrace the public sector as a whole?
- Are the PP eligibility rules clear, consistent and not able to be modified prejudicially by the particular contracting entity?
- Does the PP legislation regulate all of the procurement process phases (pre-tendering, tendering and post-tendering)?
- Does the PP legislation enable the efficient selection of tender type or method based on the specifics of the purchase and contract profile?

Adequacy of PP policy-making

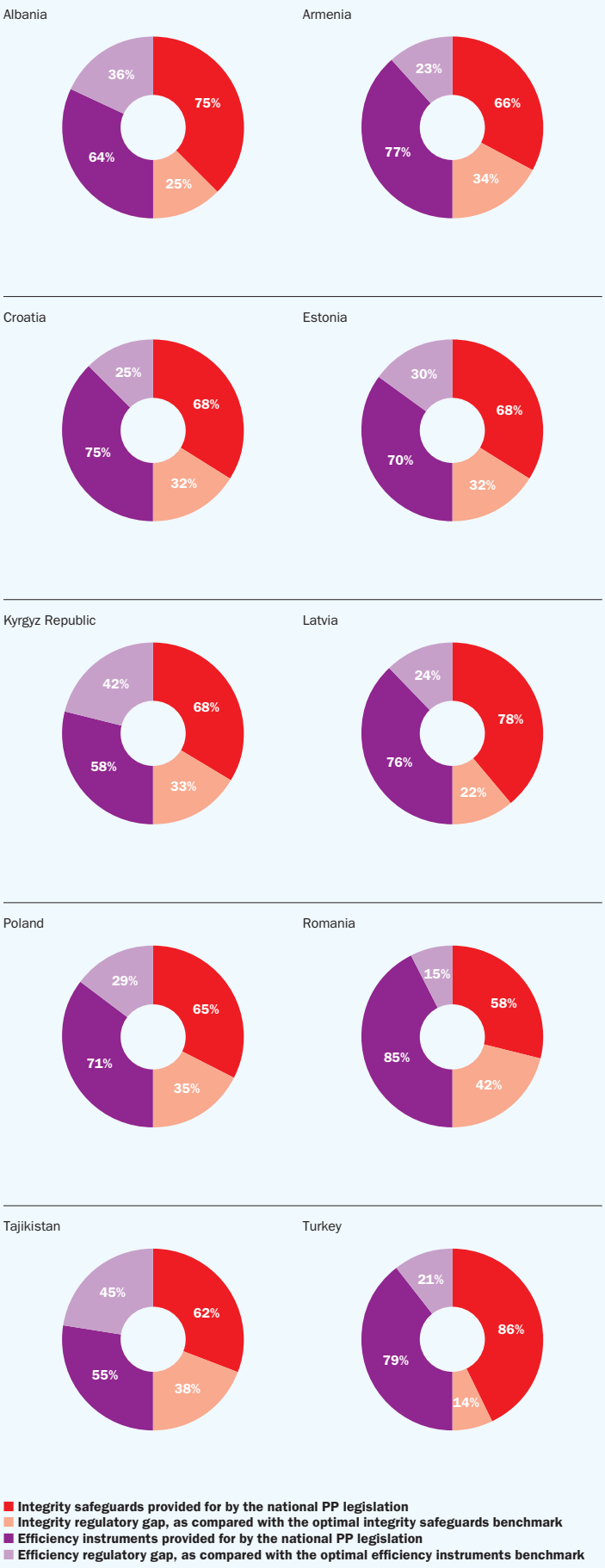
Some of the benchmark indicators described above can be categorised as anti-corruption or integrity safeguards (accountability, integrity and transparency) and efficiency instruments (competition, economy of the process, efficiency of the contract and proportionality) when reviewing the balance of national policy-making in respect of PP regulation. Historically integrity safeguards have always been a major element in PP policy-making, and should still be considered of paramount importance as a regulatory factor for countries where corruption is perceived to be a serious problem. The incorporation of efficiency instruments in PP regulation is the product of valid concerns about the "value-for-money" of public spending, but can typically only be a dominant policy feature in those countries where legal and business cultures are relatively sophisticated and unaffected by corruption.

Chart A.1.2.2 reflects the balance of integrity safeguards and the efficiency instruments in the national regulatory framework for each country in the EBRD region. For each country, the two heavily shaded areas of the chart show the percentage of the maximum possible score achieved by the country in integrity safeguards (the shaded red area) and efficiency measures (the shaded purple area). The non-shaded areas in the diagrams therefore indicate the size of the PP framework regulatory gap; it thus reflects which policy choice is prevailing for the reviewed national framework.

The results show that not many of the countries in the EBRD region achieved an appropriate balance between the integrity and efficiency measures. In addition, the regulatory gap between what has been achieved and what remains to be done in terms of integrity safeguards is greater than that for efficiency in the legal frameworks of several countries. This may be a significant challenge for countries associated with low business ethics and a high level of corruption.

Chart A.1.2.2

Integrity safeguards and efficiency measures in PP regulation frameworks



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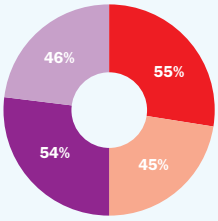
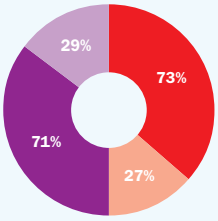
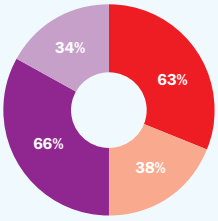


Belarus



Bosnia and Herzegovina



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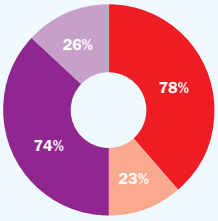
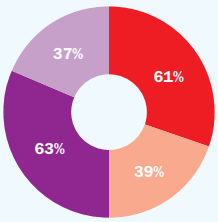


FYR Macedonia



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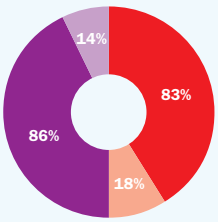

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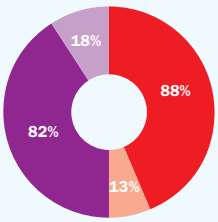

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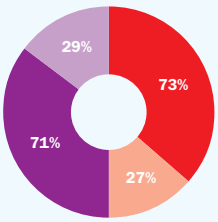
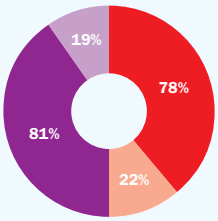
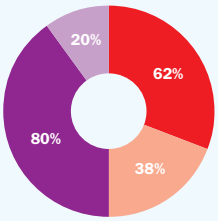


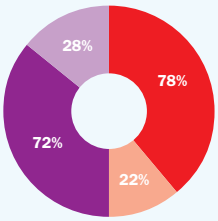
Lithuania



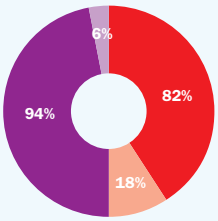
Moldova



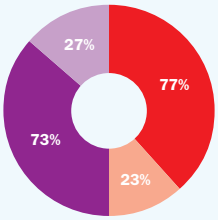
Mongolia



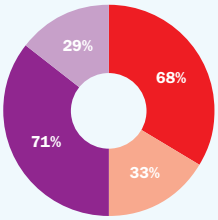
Montenegro



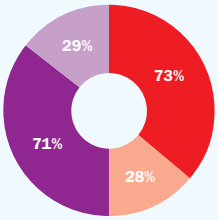
Russia



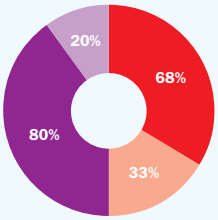
Serbia



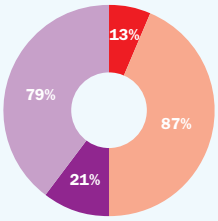
Slovak Republic



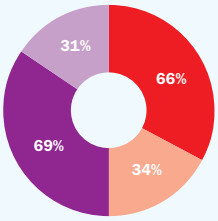
Slovenia



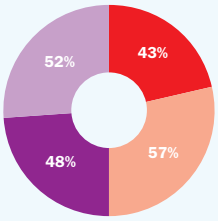
Turkmenistan



Ukraine



Uzbekistan



Source: EBRD Public Procurement Legal Frameworks Assessment, 2010.
Note: The chart shows the score for integrity safeguards implemented by national PP laws compared with the score for efficiency instruments, as provided by national PP legislation, for each country in the region.
The scores have been calculated on the basis of a legislation questionnaire, based on the EBRD Core Principles on an Efficient Public Procurement Framework (see Box A.1.2.1).

Total scores for integrity safeguards and efficiency instruments are presented as a percentage, with 50 per cent (half of the pie chart) representing the maximum, optimal score for each of these benchmark indicators. A regulatory gap, a difference between the marks for observed quality of national PP laws "on the books" and the benchmark, regarded as optimal for these two recommended regulatory features, is marked in light red and light purple, respectively.

Scope of PP regulation

In addition to the 11 principles captured in the earlier spider charts, the survey also includes a number of general system features, of which one important issue is the scope of public procurement legislation. Specifically, the coverage of the PP regulatory framework includes: government procurement and local government procurement (which together comprise "state" procurement); utilities sector procurement (public services monopolies); public law institutions' procurement; and public grants beneficiaries' procurement. It is important to note that, in quite a few countries, it is only government procurement that is covered by public procurement laws. A large section of the municipalities and utilities sector remains outside general regulation or is covered by PP legislation on an ownership basis only.

Table A.1.2.1 summarises the regulatory coverage in each country in the EBRD region. In general, the EU member states, with regard to the scope of regulation, have the most comprehensive and consistent approach. In other countries legislation may not cover all public-sector entities, even if those countries are signatories or observers of the World Trade Organization (WTO) Government Procurement Agreement.

PP eligibility rules

Competition is a critical aspect of public procurement. Primary PP eligibility rules that define who can submit a tender or proposal (or be excluded from the competition) for a public contract are of huge importance for the development of international trade. With the exception of the EU member states, there is no consistent concept or regular understanding of PP eligibility in the EBRD region. It is also significant that PP legislation in some countries does not distinguish between minimum eligibility requirements and candidate qualification criteria individually established by contracting entities for their projects.

Chart A.1.2.3 indicates that a number of countries are deficient in terms of consistency of eligibility rules. For instance, in FYR Macedonia the primary PP eligibility rules were found to be non-compliant with the standard UNCITRAL specifications and, moreover, were confused with EU candidate qualification criteria.

Table A.1.2.1
Scope of PP regulation

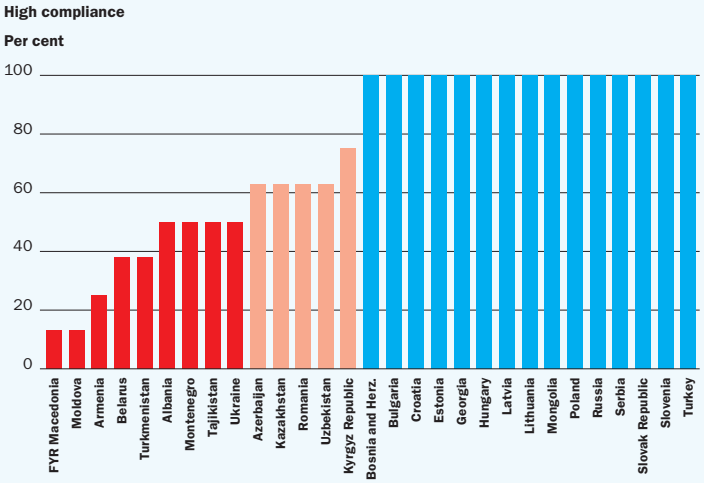
Based on scores with PPA revision for all countries

Country	Government	Local government	Utilities	Public law institutions
Albania				
Armenia				
Azerbaijan				
Belarus				
Bosnia and Herzegovina				
Bulgaria				
Croatia				
Estonia				
FYR Macedonia				
Georgia				
Hungary				
Kazakhstan				
Kyrgyz Republic				
Latvia				
Lithuania				
Moldova				
Mongolia				
Montenegro				
Poland				
Romania				
Russia				
Serbia				
Slovak Republic				
Slovenia				
Tajikistan				
Turkey				
Turkmenistan				
Ukraine				
Uzbekistan				

Fully covered by PP primary laws
Covered by PP primary or secondary laws, with some exceptions
Not covered by PP primary or secondary laws
Not regulated

Source: EBRD Public Procurement Legal Frameworks Assessment, 2010.
Note: The table presents desirable features of PP legislation for each country in the region. Marks have been allocated on the basis of a legislation questionnaire. The descriptions are graded from what is considered to be the least (marked in red) to the most satisfactory (marked in light blue), representing optimum quality of PP laws.
Based on assessment scores for all countries as at 22 July 2010, except Bulgaria.

Chart A.1.2.3
National PP eligibility rules



100% National PP legal framework provides a distinction between (a) general PP eligibility criteria and (b) qualification and technical requirements to be met by tenderers as defined by the contracting entity
51–75% National PP legal framework establishes primary eligibility rules compliant with the UNCITRAL standard. According to the UNCITRAL standard, tenderers are considered to be ineligible to participate in public procurement in the case of (a) bankruptcy or similar proceedings (b) administrative suspension or disbarment proceedings (c) conviction of a criminal offence by the tendering firm or its directors concerning professional conduct (d) failure to fulfil certain tax and social security obligations
0–50% National PP legal framework does not establish primary eligibility rules compliant with the UNCITRAL standard

Source: EBRD Public Procurement Legal Frameworks Assessment, 2010.
Note: The chart shows the score for PP eligibility rules in the national PP legal frameworks for each country in the region. The score has been calculated on the basis of a legislation questionnaire. Total scores are presented as a percentage, with 100 per cent representing the optimal score for this benchmark indicator.

Regulation of procurement tendering phases

The comprehensiveness of a PP framework may be gauged by whether the entire procurement process – embracing the pre-tendering, tendering and post-tendering phases – or just the tendering phase is regulated by legislation. This is measured by the "economy" indicator in the spider diagrams (in Chart A.1.2.1).

In several countries of the EBRD region, including the EU member states, the PP legal framework is lacking appropriate regulation of the pre-tendering phase (procurement planning, in particular) and of the post-tendering phase (public contract management). This means that there is a risk that the allocation of public funds will not adjust properly over time to changes in the market value of goods and services.

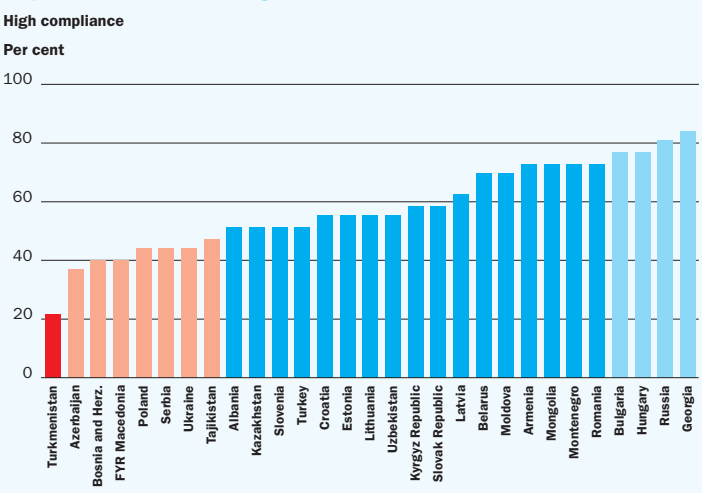
This can best be illustrated in relation to public contract management regulation. For each transition country, Chart A.1.2.4 shows the extent to which the national regulatory framework covers the post-tendering phase of the public procurement process. Each indicator in the chart presents the scores as percentages of the maximum achievable rating for the regulation of the post-tendering phase.

Flexibility of procurement procedures

The law on the books assessment also considered the flexibility of the PP framework, in order to help gauge the extent to which specialised negotiation procedures are available to the contracting entities in the region. This relates to the "efficiency" aspect of the PP Core Principles (see above). The review revealed that, contrary to recommended best practice, in several countries (the Central Asian republics in particular) the only procurement procedure available was a lowest-price tender (see Chart A.1.2.5).

Chart A.1.2.4

PP post-tendering phase – regulation of public contract management

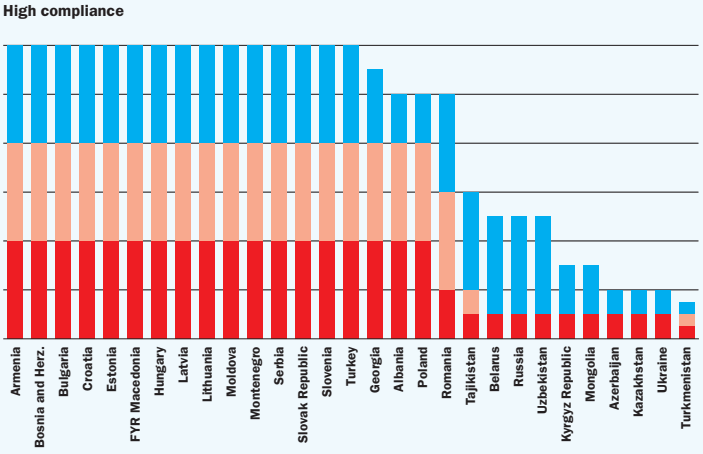


- 100% • National PP legal framework requires a mandatory scrutiny of contract variations by an official body
  • National PP legal framework provides for procurement staff having adequate contract management capabilities
  • National PP legal framework requires the contract monitoring and administration to be computerised
- 75% • National PP legal framework requests that contracting entities provide for contract administration of the public contract
  • National PP legal framework includes a clear test as to when the contracting entity should seek a contract performance guarantee, and limit its maximum amount
- 50% National PP legal framework requires the preparation and inclusion of a business case into the contract
- 25% National PP legal framework requires the selection of tender type to be based on the specifics of the purchase and contract profile
- 0% The PP legal framework does not provide for any recommended feature

Source: EBRD Public Procurement Legal Frameworks Assessment, 2010.
Note: The chart shows the score for regulation of the PP post-tendering phase with respect to PP contract management for each country in the region. The score has been calculated on the basis of a legislation questionnaire. Total scores are presented as a percentage, with 100 per cent representing the optimal score for this benchmark indicator.

Chart A.1.2.5

Regulation of public procurement procedures in the national PP legal frameworks



- Does the law provide for both tendering and negotiated procedures?
- Is there a clear test as to the choice between tendering and negotiated procedures?
- Is the selection of tender type or method based on the specifics of the purchase and contract profile?

Source: EBRD Public Procurement Legal Frameworks Assessment, 2010.
Note: The chart shows the score for regulation of PP procedures for each country in the region. The score has been calculated on the basis of a legislation questionnaire. Total scores are presented as a percentage, from low to high compliance regarding three recommended features (adequacy, flexibility and certainty), with 100 per cent representing the optimal score for these benchmark indicators.

Box A.1.2.2

During the course of the EBRD assessment, Bulgaria and Georgia undertook significant revisions of their PP regulations, resulting in changes to their laws and, consequently, their ratings in the assessment.

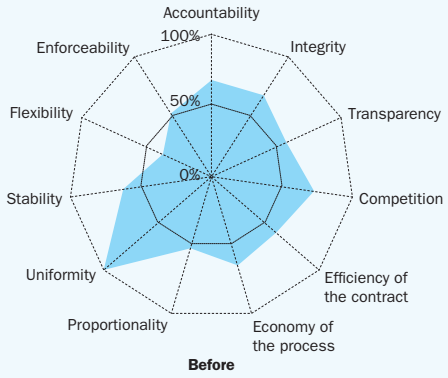
The diagrams below give a "before" and "after" comparison of the legislative changes, focusing on:

- each country's total score in the assessment, calculated according to each of the EBRD's Core Principles
- the correlation between anti-corruption safeguards and efficiency instruments in previous and new national PP policy
- the development of the PP institutional framework.

While neither country reaches a maximum score on the benchmark, both national PP legal frameworks have been improved with respect to every Core Principle.

Chart A.1.2.2.1 Bulgaria

PP framework's total score in the assessment



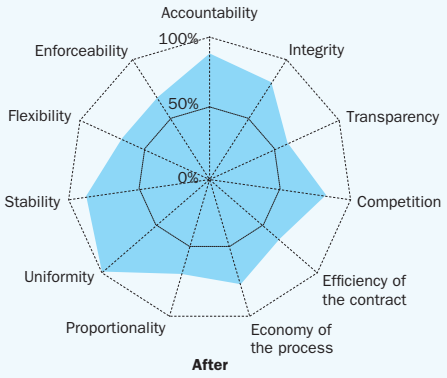
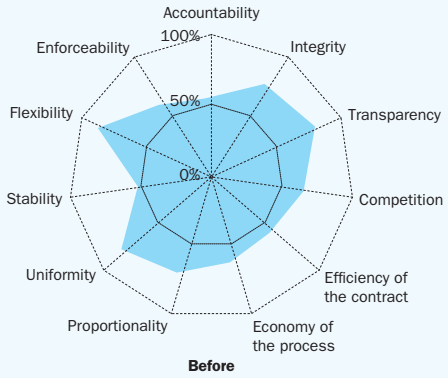


Chart A.1.2.2.2 Georgia

PP framework's total score in the assessment



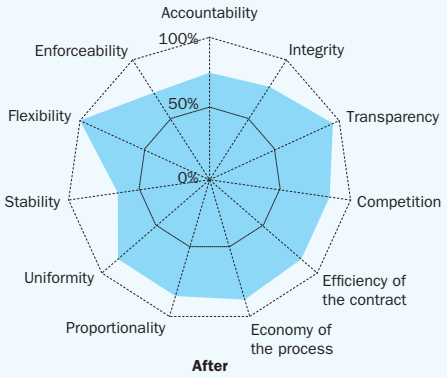


Chart A.1.2.2.3 Bulgaria

The correlation between anti-corruption safeguards and efficiency instruments in the previous and current PP policy

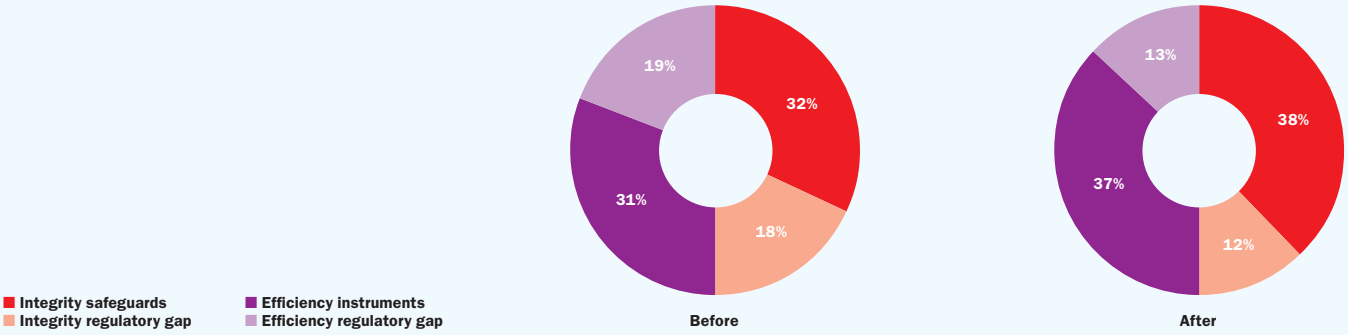


Chart A.1.2.2.4 Georgia

The correlation between anti-corruption safeguards and efficiency instruments in the previous and current PP policy

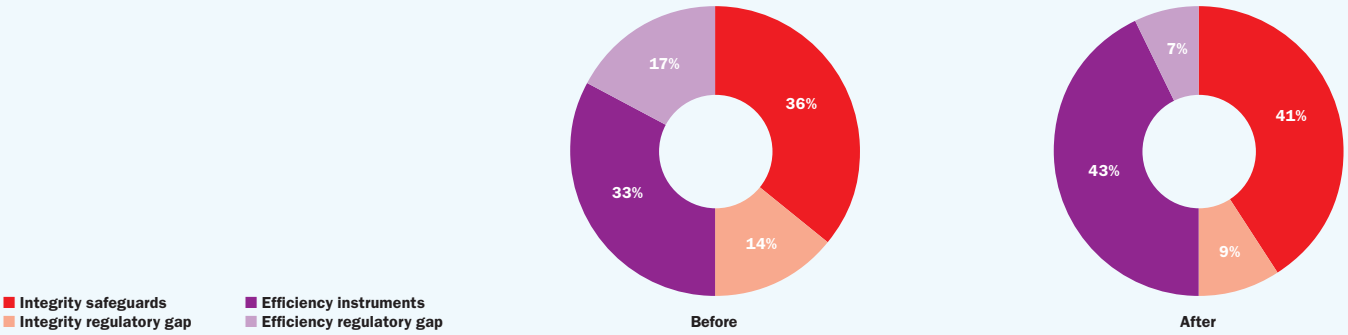


Chart A.1.2.2.5 Bulgaria

Improvements in the PP institutional framework

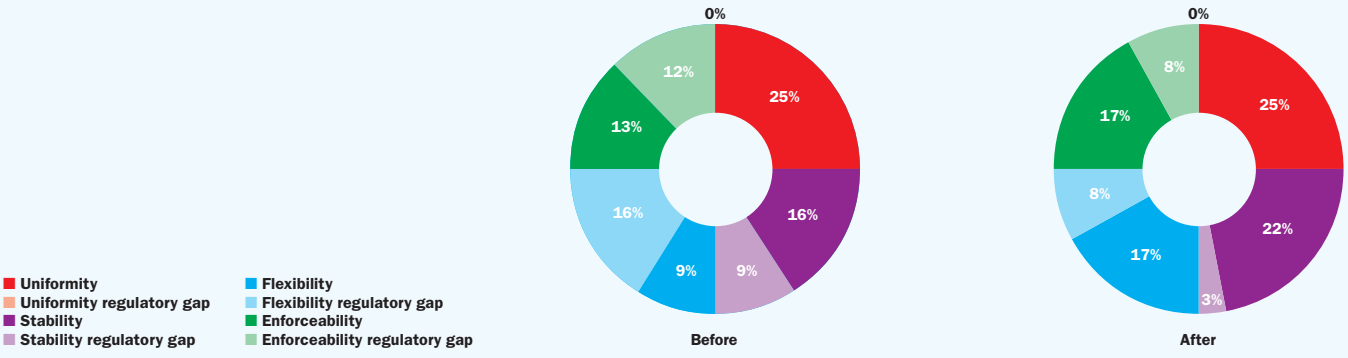
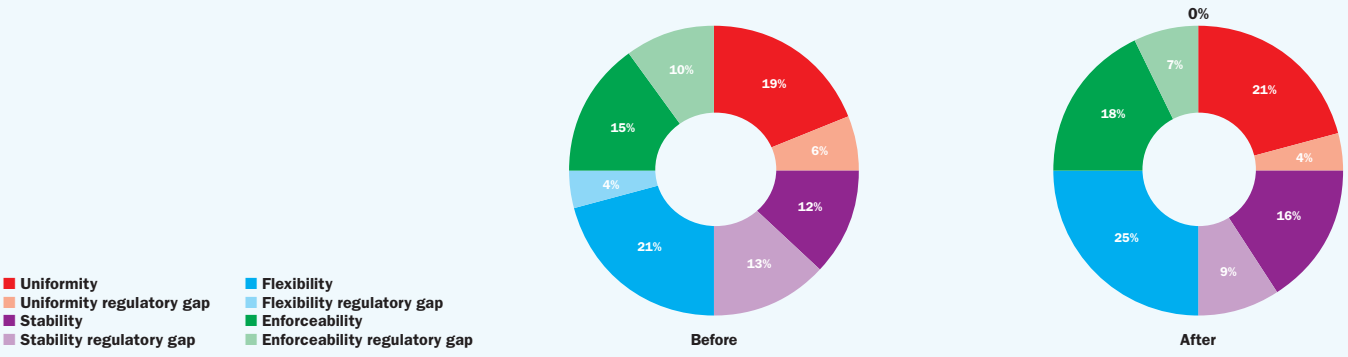


Chart A.1.2.2.6 Georgia

Improvements in the PP institutional framework



Access to regulatory and tender information

The review of PP law on the books was originally intended to be conducted in English and Russian, as it was anticipated that most of the national PP laws in the EBRD region, with international bidders in mind, would be available in one of these languages of international trade (as recognised by the United Nations). The initial research, however, revealed a low availability of national legislation in English or Russian. None of the countries in the region, including the EU member states, was found to have all current PP legislation translated into at least one of these languages. Only Montenegro has all of its PP laws well compiled, translated into English or Russian and made available on the national PP regulatory body web site. Indeed, there is very limited regulatory information on the web sites of other national PP regulatory bodies other than in their national language. The original aim to review only laws readily available to an international tenderer had to be abandoned.

Most of the national PP laws reviewed do not require contracting entities to publish contract notices in any of the recognised UN languages, although in the EU member states summaries are translated on eNotices into languages other than that of the contracting entity.

eProcurement

Several countries in the EBRD region are attempting to implement eProcurement, namely the conduct of the procurement process through electronic means, usually online. So far, it is mandatory only in Albania; however, most national PP regulations require an electronic publication of contract notices. In addition to Albania, several countries have passed laws whereby, for certain goods (for example, medical supplies), the communication or tender submission of procurement must be made by electronic means (Latvia, Montenegro, Romania and Turkey). For most of the countries in the region electronic communication availability is dependent on the decision of the contracting entity in question.

Efficiency of enforcement procedures

A final regulatory issue is enforceability. For any public procurement system bringing together the public and private sectors, the use of unbiased and uncorrupted mechanisms to ensure that the regulatory aims are achieved is particularly important. Consequently, the EBRD assessment included a section on the issues of enforceability of PP regulation. National legislation has been analysed, focusing on the availability of dedicated administrative enforcement and/or monitoring mechanisms and review and remedy procedures, and also on the independence of remedies bodies. Chart A.1.2.6 shows the availability of each legal instrument in the legislation of each country in the EBRD region. For each indicator, the chart presents the scores as fractions of the maximum achievable rating.

The maximum score was achieved by Albania, Armenia, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Georgia, Hungary, Latvia, Lithuania, Mongolia, Montenegro, Serbia, Slovak Republic and Ukraine. Belarus, Moldova, Tajikistan and Turkey registered a score of between 50 per cent and 75 per cent, while Azerbaijan, Turkmenistan and Uzbekistan scored below 50 per cent, signalling a need for significant regulatory improvements.

To illustrate the disparity between the law on the books and law in practice review scores with respect to the enforceability of the PP regulatory frameworks, Chart A.1.2.7 gives the comparative results.

An implementation gap – meaning the difference between the quality of law on the books and the level of implementation – has been identified in 14 countries in the EBRD region. It occurs in countries with both low and very high scores for the quality of their enforcement regulation.

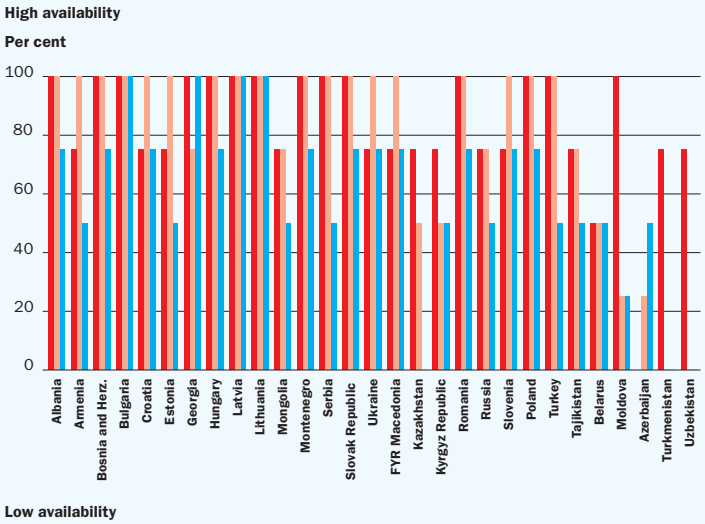
As might perhaps have been expected, the higher the law on the books score, the bigger the implementation gap. The largest gaps are evident in Albania (27 per cent), Montenegro (17 per cent), Hungary and FYR Macedonia (13 per cent) and the Kyrgyz Republic, Mongolia and Turkey (10 per cent, respectively). This indicates the need for more effective enforcement of existing legislation. There was no implementation gap for Estonia, although a relatively low 65 per cent benchmark compliance for enforcement legislation on the books and in practice was recorded.

The review revealed that it remains possible to challenge a decision of a contracting entity in countries where no dedicated remedy mechanisms exist (such as Azerbaijan, Belarus, Tajikistan, Turkmenistan and Uzbekistan) by seeking compensation in the courts. Although this cannot result in a PP procedure being corrected or a contract being annulled, it does at least provide affected parties with a form of redress, and may act as a deterrent to unlawful behaviour on the part of contracting entities.

In several countries, the quality of the practice of review and remedy mechanisms scored higher than the provisions of the

Chart A.1.2.6

PP review and remedies mechanisms



■ **Availability of the dedicated PP enforcement mechanism**
■ **Availability of the remedies system**
■ **Availability of the independent remedies body**

Source: EBRD Public Procurement Legal Frameworks Assessment, 2010.
Note: The chart shows the score for regulation of PP enforcement for each country in the region. The score has been calculated on the basis of a legislation questionnaire. Total scores are presented as a percentage, from low to high compliance regarding three recommended features (dedicated PP enforcement mechanism, PP remedies system and independent PP remedies body), with 100 per cent representing the optimal score for these benchmark indicators.

existing regulatory legislation. This may be attributed (in the case of Azerbaijan, Belarus, Moldova, Tajikistan, Turkmenistan and Uzbekistan) to the adjudication of the civil courts making up for the shortcomings in the regulatory framework, or to the judicial capacity of independent remedies bodies, whose professionalism and impartiality may even enhance highly compliant regulatory frameworks (as in Bulgaria, the Slovak Republic and Slovenia).

It is also apparent that there is no correlation between the efficiency and the actual cost of PP review and remedy procedures in the EBRD region, including in the EU member states (see Chart A.1.2.8).

Conclusion

The EBRD assessment indicates that countries in the region can be categorised according to the level of development of their PP laws as follows:

- EU member states that aim for full compliance with EU PP directives and have achieved at least a satisfactory level of compliance with international standards
- south-eastern European countries, together with Georgia, Mongolia and Turkey, which have introduced new PP laws but need to focus on implementation issues and institution-building
- other countries where legislative reform may be under way, but procurement laws have yet to comply with international standards.

The analysis has shown that, in many countries, integrity safeguards and efficiency instruments have been incorporated into national PP frameworks with no consideration for the local business culture and prevailing market conditions. Furthermore, in some countries PP regulation does not cover the whole public sector, leaving a significant number of public entities outside the procurement system, or legislation is not comprehensive enough and does not regulate all of the PP tendering process. In addition, regulation of the tendering phase does not always ensure the appropriate selection of tender type or method, therefore hindering the efficiency of the public contract.

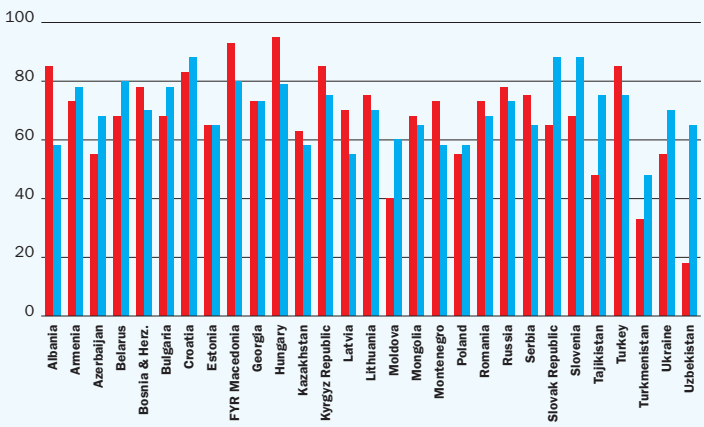
Other shortcomings identified in the assessment include:

- unclear and inconsistent primary PP eligibility rules
- a lack of understanding of primary PP eligibility
- no enforcement in several national PP laws of a uniform practice between contracting entities in the same jurisdiction
- a lack of independent institutional regulatory agencies, which are a desirable feature in a modern PP framework.

Fully independent dedicated remedies bodies can only be found in the EU member states in the EBRD region. In other jurisdictions either an administrative or judicial review is available, but may not afford impartiality and objectivity. Nevertheless, in those jurisdictions where the PP review function is provided by civil or administrative courts, the quality of practice is relatively higher. A limited number of monitoring or auditing procedures is available in EU member states and the Balkan countries (which are generally utilised for special donor funding such as the EU structural funds). The lack of regulation of procurement planning, budgetary approval procedures and public contract management is a common weakness. The assessment confirms that reforming and upgrading PP legal frameworks and performance across the EBRD region should be on many governments' agendas.

Chart A.1.2.7

PP framework enforcement mechanisms



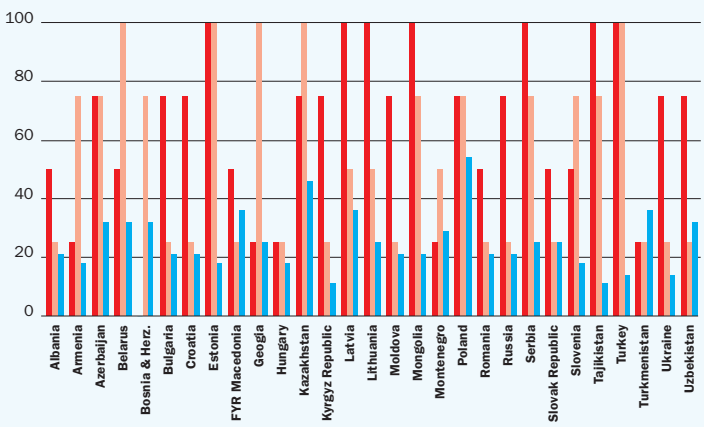
■ **Availability of the remedies system**
■ **Availability of the dedicated PP enforcement mechanism**

Source: EBRD Public Procurement Legal Frameworks Assessment, 2010.

Note: The chart shows the correlation between the score for the PP enforcement legislation and marks for PP enforcement practice for each country in the region. The scores have been calculated on the basis of a legislation questionnaire and a checklist and a case study completed by local practitioners, respectively. Total scores are presented as a percentage, from low to high compliance, with 100 per cent representing the optimal score for these benchmark indicators.

Chart A.1.2.8

Comparison of cost effectiveness of PP remedy systems



■ **Are PP remedies fees affordable by law?**
■ **Are PP remedies fees affordable in practice?**
■ **Is the national PP remedies system efficient?**

Source: EBRD Public Procurement Legal Frameworks Assessment, 2010.

Note: The chart shows the correlation between the level of fees imposed directly on the complainant for using the remedies procedure, as required by national PP laws and in practice, and efficiency of national PP remedies systems, as observed by local practitioners, for each country in the region.

The scores have been calculated on the basis of a legislation questionnaire and a checklist and a case study completed by local practitioners. Total scores for each indicator are presented as a percentage, with 100 per cent representing the optimal score for this indicator.

Chapter 2
From crisis to recovery

Most countries in the EBRD region have started to recover, albeit at varying speeds. In some central European countries and most commodity-rich countries, the recovery is well on track, but it has barely started in most of south-eastern Europe. This reflects varying capacities to take advantage of the incipient world recovery through higher exports; fiscal policies; and the unwinding of pre-crisis imbalances, which continue to weigh on credit growth in many countries.

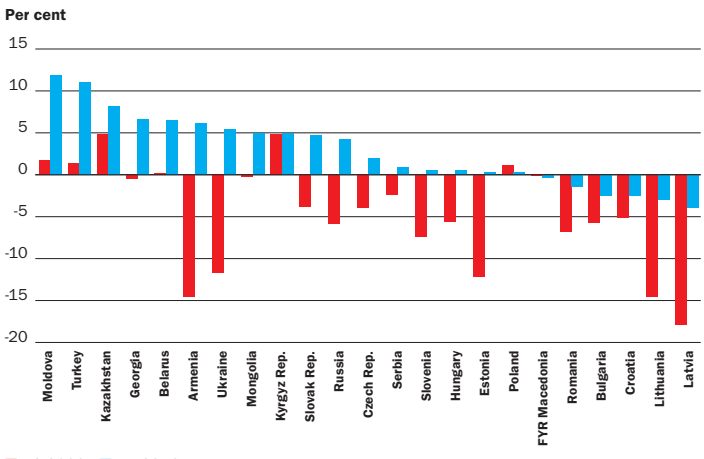
During the past year most of the countries in the EBRD region have begun to recover from their worst recessions since the early transition years. The recovery, however, has been more sluggish than in other emerging markets and has been heterogeneous within the EBRD region. The countries of south-eastern Europe, in particular, suffered output declines well into the first half of 2010. By contrast, most other countries have benefited from export-led recoveries to varying degrees; particularly those that are commodity exporters, and central European countries with high export shares to Germany. In a few cases, such as Armenia, Moldova, Poland and Turkey, renewed remittance inflows or capital inflows have contributed to growth in 2010. In contrast, the recovery in most south-eastern European countries is progressing slowly.

This chapter attempts to shed light on this heterogeneity and the factors that drive it. It begins by asking why some countries seem to have been in a better position to benefit from the global recovery of international trade than others. It then analyses the reasons why domestic demand has generally not recovered, focusing particularly on the role of credit and fiscal policy, and examines recent trends in inflation. It considers the atypical behaviour of international capital flows during the crisis and post-crisis period. Lastly, it examines the implications of this analysis for the short-term outlook.

An export-led recovery

As early as the second quarter of 2009, real GDP began to increase (in seasonally adjusted quarter-on-quarter terms) in most countries (see Chart 2.1). The return to growth was lagged by a couple of quarters in the Baltic countries, where the need to unwind pre-crisis imbalances remained substantial. South-eastern Europe, however, has struggled to emerge from recession. Real GDP continued to contract through much of 2009 and into early 2010 in Bulgaria, Croatia and Romania. In addition, domestic events such as political turmoil in Kyrgyz Republic; uncertainty surrounding presidential elections in Ukraine; and the closure of a nuclear reactor in Lithuania depressed growth during the first half of 2010 in those countries.

Chart 2.1
Real GDP growth (year-on-year)



Source: National Statistical Offices, Eurostat.

The recovery was initially mostly driven by net exports. By the first quarter of 2010, exports had recovered from their collapse in the winter of 2008-09, in line with the recovery in global trade (see Chart 2.2a). Commodity exporters (Armenia, Kazakhstan, Mongolia and Russia) benefited from rebounding commodity prices, while countries with a heavy export concentration on machinery (Czech and Slovak Republics, Hungary, Poland and, to a lesser extent, Romania) benefited from the global cyclical rebound. Exports from countries whose real exchange rates depreciated during 2009 and 2010 increased disproportionately (see Box 2.1). With few exceptions, export growth offset a rebound in imports from their compression in winter 2008-09. As a result, the contribution of net exports to growth was positive in most countries until the first quarter of 2010, leading to lower current account deficits or even surpluses across the region and easing exchange rate pressures (see Charts 2.2b to 2.2d). However, beginning in the second quarter of 2010, import growth has begun to outpace export growth in several countries, reflecting a steady recovery in domestic demand.

Legacy of the crisis weighs on private domestic demand

Until the first quarter of 2010, domestic demand continued to contract in many countries as unemployment remained high and business prospects uncertain. The drop in domestic demand was particularly pronounced in the Baltic states and south-eastern Europe, where recessions have been deep and the recovery has lagged. As early as mid-2008, unemployment rates soared in the Baltic states and other economies where growth had begun to slow in 2007 (for example, Turkey and Ukraine). In contrast, in central and south-eastern Europe, unemployment rates started to increase only in mid-2009, and even later in south-eastern Europe (see Chart 2.3a). Despite gradual declines by the second quarter of 2010 in some countries, unemployment remains high. Fortunately, its effect on demand is being mitigated by a resumption of worker remittance flows to key recipient countries (the Caucasus, Central Asia and FYR Macedonia) (see Charts 2.3b and 2.3c).

Investment growth has been sluggish as business confidence has recovered only gradually. The global financial crisis weakened business confidence sharply; in most countries confidence in the manufacturing or industrial sectors dropped by 20-50 per cent from the fourth quarter of 2007.[1] By the third quarter of 2010, confidence had recovered to pre-crisis levels only in Estonia, Hungary and Turkey (see Chart 2.3d). As a result of the weak recovery, non-performing loans (NPLs) of banks have stabilised at high levels or, in some cases, continued to rise (see Chart 2.4a).

Despite the gradual recovery of economic activity in many countries, private sector credit growth has mostly stagnated or continued to shrink (see Chart 2.4b). This has especially been the case in countries with large pre-crisis credit booms and weakly capitalised pre-crisis banking systems: two factors that turn out to be strikingly correlated with the behaviour of credit since late 2009 (see Chart 2.5 and Box 2.2 for a more detailed analysis). This group includes the Baltic countries, most countries in south-eastern Europe, Kazakhstan and – because of its household lending segment – Russia. In Kazakhstan credit has stagnated as banks remained cut off from foreign funding. In Ukraine, too, credit shrank until the presidential elections in February 2010, after which time capital inflows returned and credit to corporates began to grow slowly.

[1] Kazakhstan is an exception since its industry is dominated by oil production.

Box 2.1
What drove the recovery in export growth?

Not every country benefited to the same extent from the rebound in global trade. To better understand the reasons, year-on-year real export growth for a sample of 55 advanced and emerging markets was analysed at two points in time: the first quarter of 2009 – when global trade had dropped to its nadir – and the first quarter of 2010, to capture the recovery from the trough to one year later. Two cross-country regressions, one for each of the two periods, describe the shift in the key factors driving the export collapse and the recovery. In both cases, real export growth was regressed on trade-weighted real GDP growth of trading partners as a proxy for external demand, on year-on-year real effective appreciation (Consumer Price Index-based) to capture changes in competitiveness, the share of machinery in total merchandise exports as a measure for export structure, and a "Herfindahl index" of the share of individual export markets in total exports. The latter measures how concentrated exports are in terms of export destinations.

The main results are as follows (see Table 2.1.1 for details):

- When global trade collapsed in winter 2008-09, a country's product structure played a key role: exporters of machinery were hit the hardest. Real depreciation did not mitigate the collapse. More diversified export markets may have buffered the collapse, but its statistical significance is weak.
- In recovery the export product structure seems to have lost some of its overwhelming importance, although there is still some indication that exporters of intermediate inputs may have recovered faster than other countries. Rather, gains in competitiveness (real depreciations) both during the crisis and thereafter seem to be the main factor that helps explain cross-country variations in the recovery.

Table 2.1.1
OLS regression of year-on-year real export growth

	Q1 2009	Q1 2010
Trade-weighted trading partner real GDP growth (year-on-year, %)	0.948 [0.180]	0.351 [0.527]
Real effective appreciation Q1 2009 (year-on-year, %)	-0.0937 [0.409]	-0.214** [0.0160]
Real effective appreciation Q1 2010 (year-on-year, %)		-0.175* [0.0842]
Share of machinery in merchandise exports (%, 2008)	-17.29*** [0.00617]	4.81 [0.178]
Concentration of export markets	-28.45† [0.121]	9.817 [0.374]
Constant	2.32 [0.501]	1.269 [0.519]
Observations R-squared	54 0.247	54 0.155

Source: Global Insight Database, IMF IFS database, official authorities.
Note: p-values in parentheses.
*** p<0.01, ** p<0.05, * p<0.1, † for p<0.15
Data from the IMF DOTS for trade weights and the share of export markets in total exports, IMF IFS for the CPI-based real effective exchange rate, and UN Comtrade data for the share of machinery in total merchandise exports. The share of fuel or metal commodities was also used but not significant.

Box 2.2
Where is credit growth beginning to recover?

A cross-country ordinary least squares (OLS) regression of growth in private sector credit between January and June 2010 on measures of pre-crisis banking system structures,[2] the pre-crisis build-up of macroeconomic vulnerabilities,[3] cyclical variables and institutional variables helps identify the patterns in credit to the private sector. The focus is on the EBRD region only. The regressions results (see Table 2.2.1) suggest the following patterns:

- banking systems that were better capitalised before the crisis in 2007 show stronger post-crisis (2010) credit growth
- post-crisis credit growth is lower in countries that experienced larger pre-crisis credit booms
- banking systems with the closest client relationships, that is, extensive branch networks, have increased credit the fastest.

These effects are robust to the inclusion of institutional controls, such as the cost of contract enforcement.[4]

In this sample, we do not find a statistically significant effect of the recovery or prospects thereof on the strength of credit growth, regardless of how the recovery is measured (real GDP growth in 2010, projected change in real GDP growth between 2009 and 2010, or the change in the unemployment rate between 2008 and 2009). A possible interpretation is that the recovery has so far been "credit-less", as is typical after financial crises in advanced countries (Blanchard, 2009; Claessens et al., 2009) and emerging markets (Calvo et al., 2006).

Table 2.2.1
Dependent variable: growth in private sector credit December 2009-June 2010[1]

	Baseline	I	II
Number of branches per person per square km, 2007		0.0804* [0.084]	0.0788* [0.098]
Capital adequacy ratio end-2007	0.448* [0.063]	0.472** [0.034]	0.474** [0.039]
Change in credit-to-GDP ratio 2001-2007	-0.193*** [0.000]	-0.130** [0.012]	-0.133** [0.016]
Dummy on state-supporting lending		5.288** [0.046]	5.174* [0.056]
Dummy on capital inflows		4.848* [0.084]	4.718† [0.101]
Cost of enforcing contracts (WB DB)			-0.026 [0.709]
Constant	3.106 [0.415]	-1.962 [0.479]	-1.244 [0.731]
Observations[2] R-squared	25 0.567	23 0.762	23 0.763

Source: Official authorities, EBRD Banking system survey.
Note: Robust p-values in parentheses. *** p<0.01, ** p<0.05, * p<0.1, † for p<0.15
[1] Credit growth in 2010 measured as FX-adjusted total private credit stock at end-June 2010 divided by the end-December 2009 stock of credit.
[2] Sample in the first column includes all EBRD countries of operations excluding Mongolia, Montenegro, Turkmenistan, Uzbekistan. Bulgaria and Russia are excluded in the second and third columns due to the missing data on the number of bank branches in Bulgaria and Russia being an outlier in terms of population density.

[2] EBRD Banking Survey 2007, 2008; Beck at el (2009).
[3] Based on a dataset from Berglof et al. (2010).
[4] The World Bank's Doing Business 2010 survey indicators are used as the source of institutional variables.

Chart 2.2a

Contribution to real GDP growth, H1 2009 and H1 2010[1] (year-on-year)

Per cent

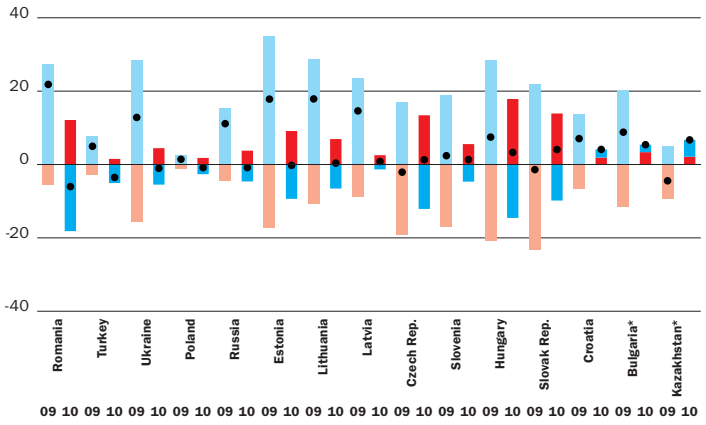


Chart 2.2b

Contribution to real GDP growth, H1 2009 and H1 2010[2] (year-on-year)

Per cent

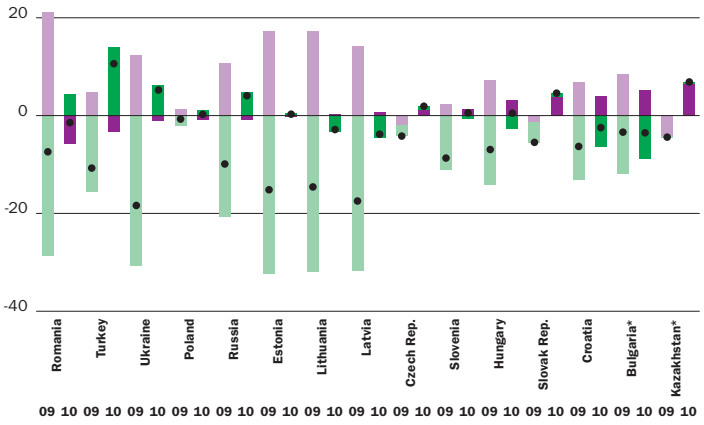


Chart 2.2c

Current account balance (four-quarter rolling total)[2]

Per cent of GDP, 4-quarter rolling total

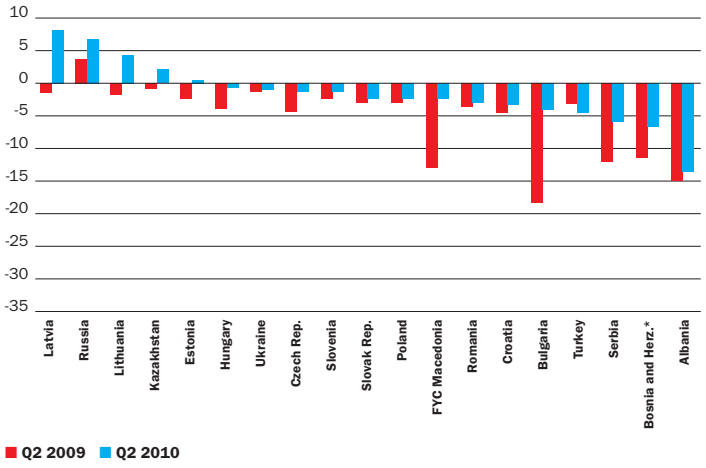
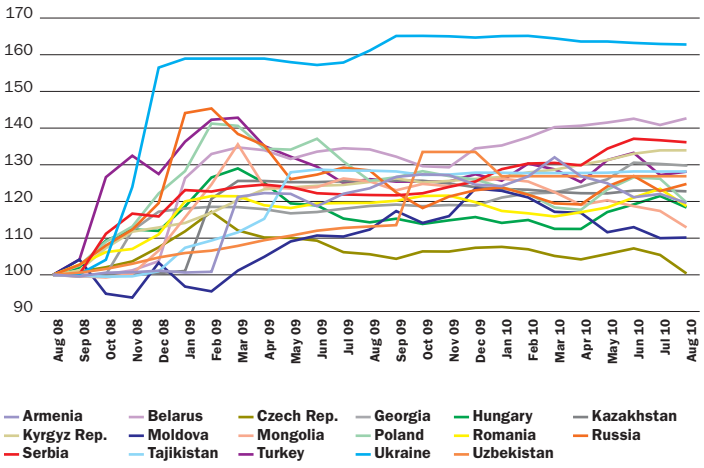


Chart 2.2d

Nominal exchange rates (local currency per anchor currency)[3]

Index (August 2008 = 100)



Sources: National Statistical Offices, IFS, Eurostat.
Note:
[1] Positive real import growth is displayed in the chart as a negative contribution of imports to real GDP growth.
[2] An asterisk (*) indicates that data for Q2 2010 were not available and hence data for Q1 2010 is shown.
[3] Anchor currency US dollar for Armenia, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Mongolia, Russia, Tajikistan, Turkey, Ukraine and Uzbekistan. Anchor currency euro for all other countries.

Chart 2.3a
Unemployment rate (Index Q4 2007 = 100)

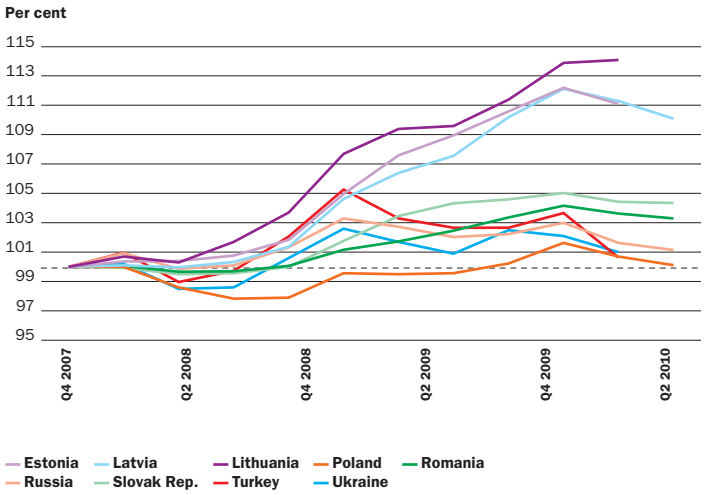


Chart 2.3b
Transfers from persons abroad (year-on-year growth)

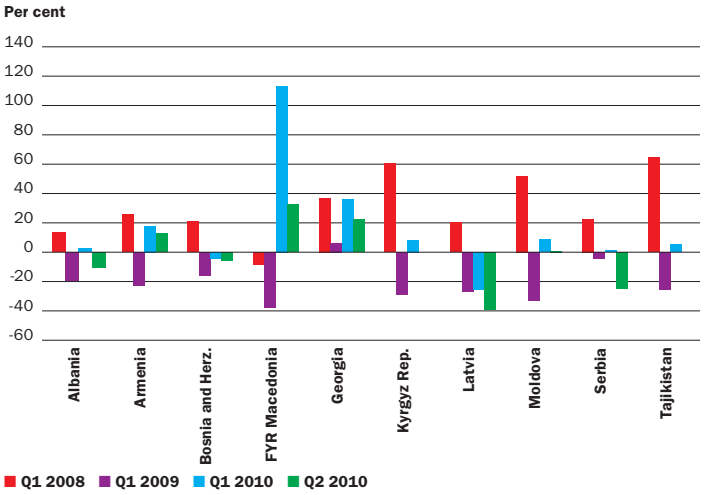


Chart 2.3c
Personal remittances from Russia (year-on-year growth)

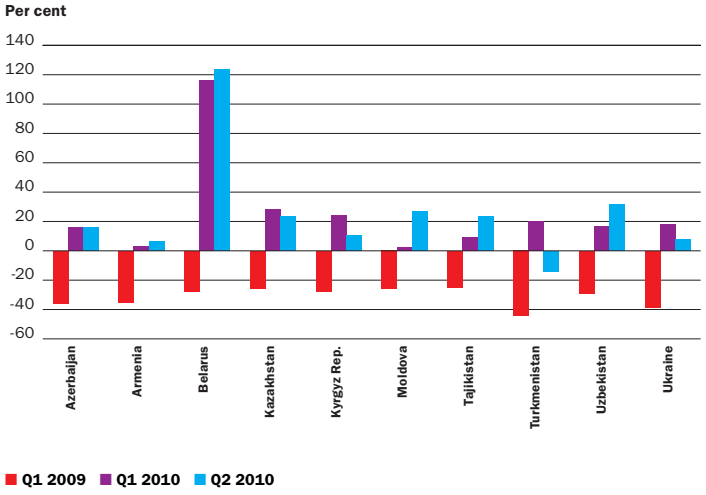
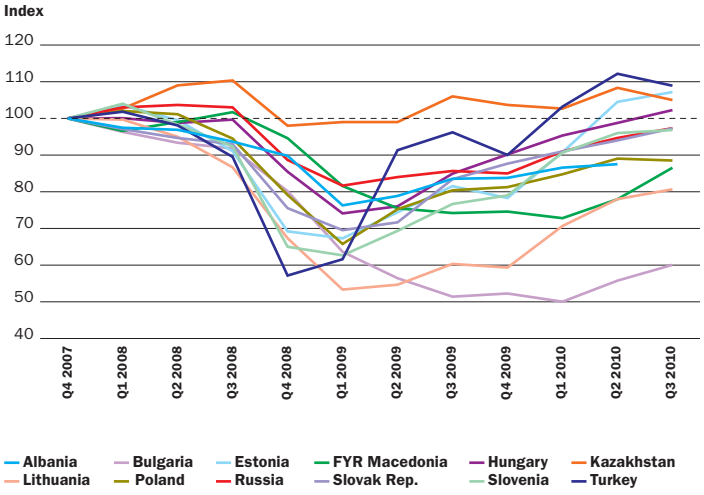


Chart 2.3d
Business confidence in manufacturing[1] (Index Q4 2007 = 100)



Sources: IMF IFS, Central Bank of Russia.
Note: [1] Confidence indicators are from industry for Albania, Estonia, Kazakhstan and Slovak Republic; manufacturing for the remaining countries.

Chart 2.4a
Non-performing loans to total loans

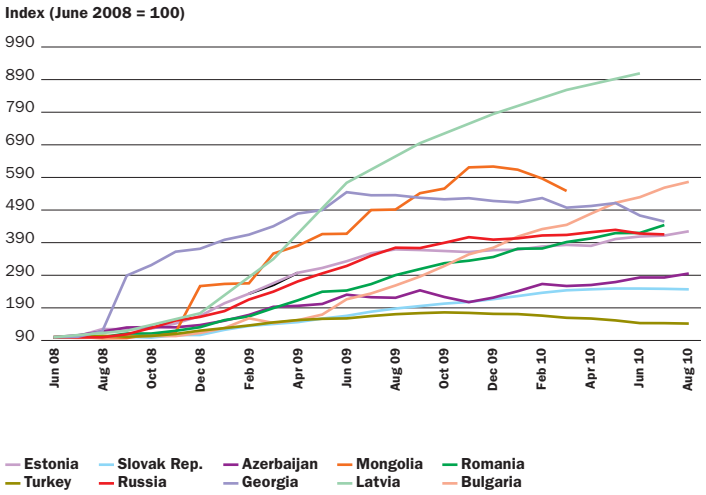
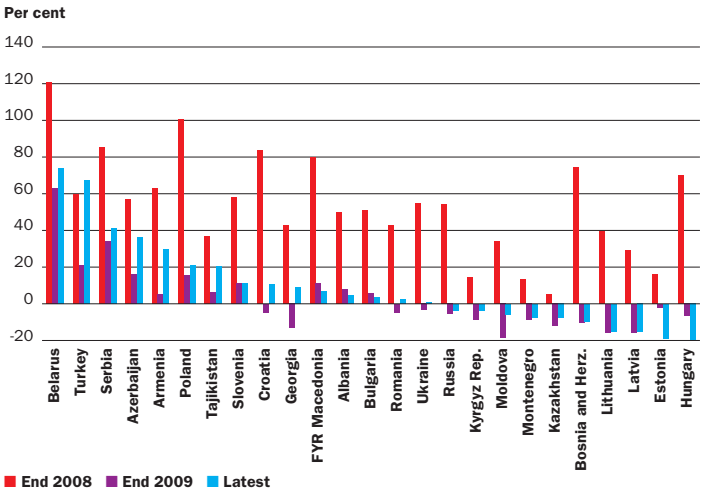


Chart 2.4b
Credit to the private sector (year-on-year growth)



Sources: IMF IFS, National central banks, BIS, CEIC.

Chart 2.5a

Credit recovery and pre-crisis banking system capitalisation

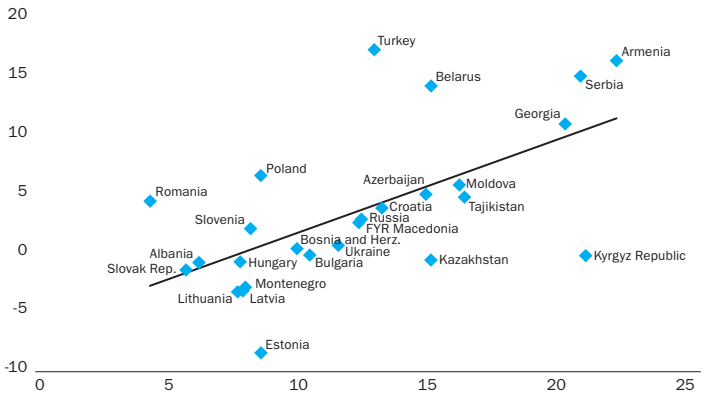
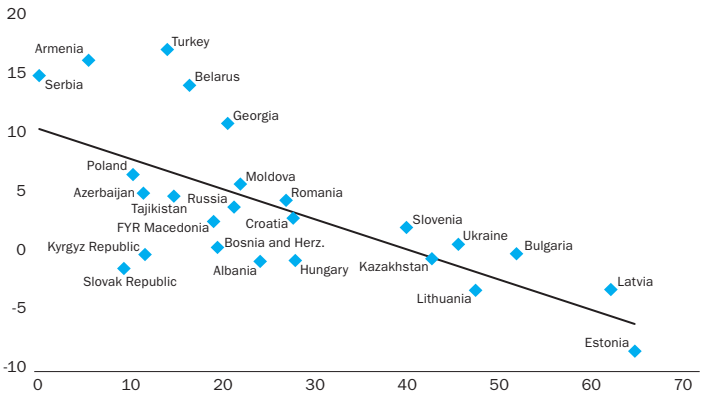


Chart 2.5b

Credit recovery and pre-crisis credit growth



Sources: CEIC database, official authorities, EBRD Banking Survey.

Chart 2.4b also shows a handful of exceptions, in which credit has been growing quite vigorously. This group includes countries with state-directed or state-subsidised lending (Armenia, Belarus, Serbia) or lending to state-owned enterprises (Slovenia). It also includes a few countries that benefited from exceptionally large returns in balance of payments inflows, either in the form of capital inflows (Turkey) or remittances (for example, Armenia and Moldova).

Fiscal tightening, partly mitigated by monetary policy

Fiscal consolidation packages were approved in many transition countries even before the eurozone sovereign debt market turmoil highlighted the risks of continued high deficits. Following large crisis-related revenue declines and interruptions in market access, many 2010 budgets in the region included measures to consolidate fiscal deficits by 0.5 to 5.0 per cent of GDP, most sharply in the Baltic states and Montenegro (see Chart 2.6). In contrast, commodity producers with pre-crisis fiscal surpluses (Azerbaijan, Kazakhstan and Russia) or larger emerging markets (Poland, Slovak Republic and Turkey) implemented fiscal stimulus packages in 2009 and/or 2010 that are expected to be reversed gradually over the next few years.

Fiscal tightening was mitigated by accommodative monetary policy. Monetary policy rates, sharply reduced between mid-2008 and mid-2009, were either cut further or kept on hold with few exceptions. Armenia, Georgia, Kyrgyz Republic, Mongolia, Serbia and Turkey have begun to raise policy rates, either on concerns about inflation or to ease exchange rate pressures, and some central banks (especially those of Hungary and Poland) have made statements holding out the prospect of policy rate increases. Exchange rates had depreciated sharply in the fourth quarter of 2008 and/or the first quarter of 2009 in all countries in the region with some degree of exchange rate flexibility (currency boards and official pegs were maintained). In the larger emerging markets (Czech Republic, Hungary, Poland, Romania, Russia and Turkey) and in some countries in the Caucasus, exchange rates have since appreciated again, although they remain weaker than their pre-crisis levels of August 2008. In contrast, in the smaller countries and Ukraine, pressures on the exchange rate have continued, especially since the turmoil in the western European sovereign debt markets in the spring of 2010.

Core inflation remains subdued

The region disinflated sharply in 2009 as economies slid into deep recessions (see Chart 2.7a). In 2010, however, inflation increased again in several countries, for three main reasons.

- Adverse summer weather conditions destroyed significant portions of the wheat harvests in Kazakhstan, Russia and Ukraine. An export ban by Russia and export restrictions by Ukraine, imposed in response to rising local wheat prices, drove up global wheat prices by 70 per cent between early June and mid-August 2010, feeding into price levels across the region.
- As part of fiscal consolidation, many countries in south-eastern and central Europe and the Baltic states increased value-added taxes or excise taxes on tobacco and alcohol sharply (Belarus, Croatia, Hungary, Latvia, Moldova and Romania). In Turkey, the expiry of a stimulus-related excise tax cut added to inflation.
- Global energy price increases, adjustments to regulated prices, and the closure of the Ignalina nuclear reactor in Lithuania led to steep hikes in electricity and/or gas prices for households in net energy-importing countries (Albania, Armenia, the Baltic states, Belarus, Bulgaria, FYR Macedonia, Kyrgyz Republic and Serbia).

Core inflation, however, has mostly continued to shrink (see Chart 2.7b), suggesting that most of the recent increases in inflation could be one-off. The notable exception has been Turkey, where core inflation has remained stubbornly high as the recovery gained momentum.

Easing external financing pressures interrupted by eurozone sovereign debt market turmoil

External financing constraints have eased since mid-2009 with the gradual return of capital inflows. By the second quarter of 2009 net portfolio and other investment inflows returned to many countries in central Europe and the Caucasus and some countries in south-eastern Europe (see Chart 2.8). Inflows to Turkey resumed one quarter later. Whereas net inflows into other countries were volatile and slowed down or reversed as the eurozone sovereign debt turmoil unfolded, those to Poland and Turkey gathered strength over the second half of 2009 and into 2010. In the Baltic states, the steady net outflow of capital also appears to have begun to turn around in the first quarter of 2010 as the deep recession in the Baltic states bottomed out. Net capital outflows from Ukraine and Kazakhstan continued into the first half of 2010 in the run-up to presidential elections in Ukraine and amid the restructuring of a large Kazakh bank. Following elections, these outflows reversed sharply in Ukraine in the second quarter of 2010. In Kazakhstan, new foreign direct investment (FDI) inflows into the energy sector offset non-FDI capital outflows. Armenia, Belarus, Czech Republic and Poland also saw net FDI inflows rebound to near pre-crisis levels while in most other countries net FDI inflows returned only gradually. Bosnia and Herzegovina, Hungary and Lithuania were the exception, with continuing net FDI outflows through the second quarter of 2010.

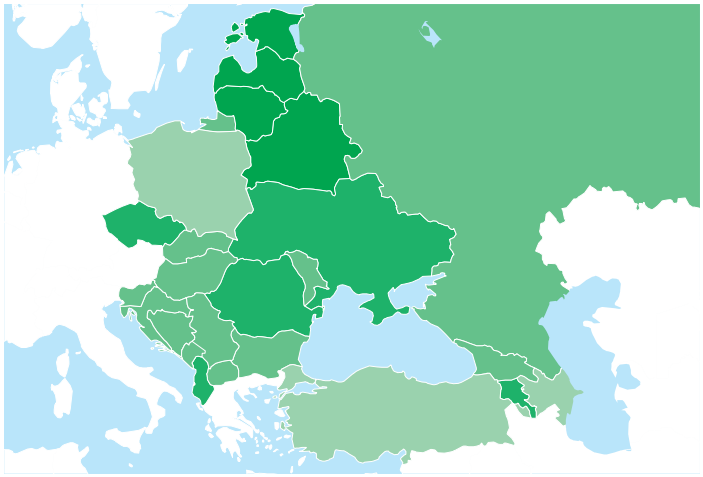
The halting return of net portfolio and other investment inflows to the region is also reflected in bank flows reported by the Bank for International Settlements' (BIS) reporting banks (see Box 2.3). For the most part, the EBRD region did not conform to the cycle of sharp outflows in late 2008 followed by vigorous inflows beginning in the second quarter of 2009 that is typical for other emerging market countries. Instead, many countries in central and south-eastern Europe have seen milder, but also much more persistent outflows. Russia experienced very large outflows early in the crisis, but so far capital has not returned in significant amounts. The main exceptions in this regard are Poland, Turkey and more recently Ukraine.

Prospects for 2011

The recovery in the EBRD region is likely to mirror the "multi-speed" recovery that appears to be under way globally (International Monetary Fund [IMF], 2010). Many countries remain heavily dependent on exports to the European Union (EU). EU growth, while stronger than expected in 2010, is likely to slow in 2011 as fiscal austerity packages gather pace and room for further monetary policy easing in the eurozone appears limited. Lending by eurozone banks is likely to remain sluggish in the face of higher future capital adequacy standards (see below) and the EU-mandated restructuring of some important banks in the region (including Commerzbank, KBC and Hypo-Alpe-Adria). As a result, a return to strong credit growth financed by capital inflows from eurozone banks is unlikely. That said, capital inflows may increasingly recover, fed by abundant liquidity resulting from continued monetary easing in several large advanced countries. This will support credit growth and exert appreciation pressures in countries with larger financial markets, leading to a rebalancing of demand growth from external to domestic sources.

Chart 2.6

Fiscal consolidation packages, 2010 (per cent of GDP)



0% GDP 0-1.5% of GDP 1.5-3% of GDP 3+% of GDP

Source: News reports, IMF Staff Reports, WEO October 2010.

Chart 2.7a

Inflation (year-on-year)

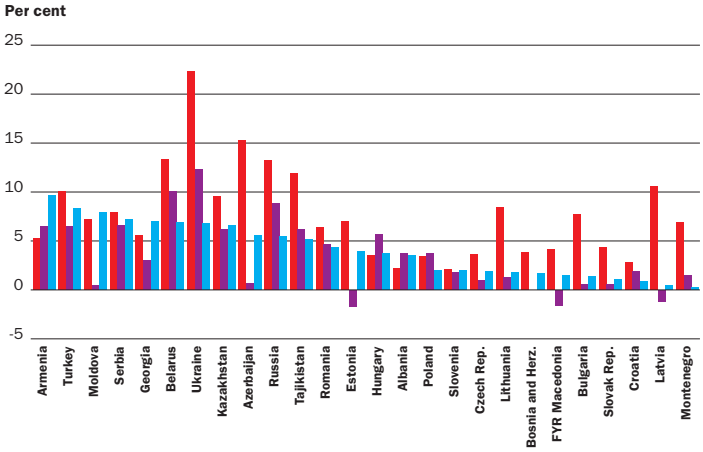
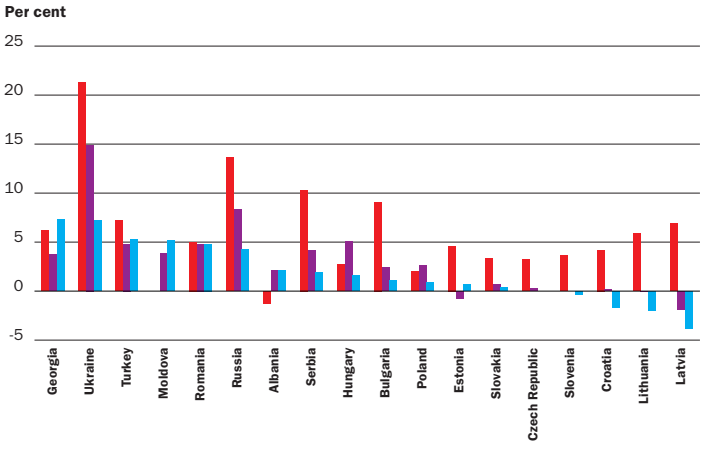


Chart 2.7b

Core inflation[1] (year-on-year)



Sources: IMF IFS, National central banks, BIS, CEIC, staff calculations of core inflation for Georgia and Albania.
Note: [1] Core inflation defined as overall inflation excluding food and energy.

Box 2.3
Cross-border lending during the crisis and post-crisis

At the height of the international financial crisis, BIS-reporting banks[5] reduced their assets abroad quickly and globally. The effect of this on the EBRD region was quite different compared with other emerging market regions, with central Europe and the Baltic states (CEB) and south-eastern Europe (SEE), in particular, experiencing more gradual but also much more persistent outflows than emerging Asia and Latin America.

In the two quarters after the Lehman shock, the combined CEB and SEE regions saw cross-border assets of BIS-reporting banks fall by 9 per cent, compared with much larger drops of 28 and 17 per cent, respectively, in the latter two regions.[6] However, emerging European economies also lagged behind when the recovery of bank lending flows got under way in emerging Asia and Latin America in mid-2009. CEB and SEE reported continued outflows, and had experienced cumulative withdrawals of 12 per cent of end-2007 assets by early 2010. By that time, vigorous inflows to emerging Asia and Latin America had compensated for some of the earlier losses and, as a consequence, the total loss since the Lehman shock had shrunk to 5 and 3 per cent of end-2007 assets, respectively. Much of the new lending to these two regions was due to three large countries – Brazil, China and India – but even excluding these countries, inflows to Latin America and Asia have resumed strongly (see Chart 2.3.1).

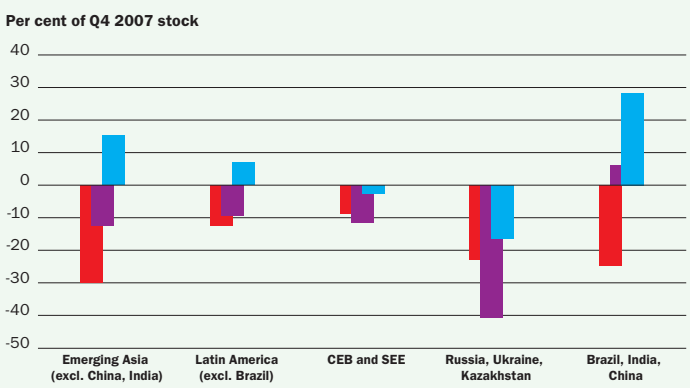
While the experience of the CEB and SEE as a whole contrasts with that of the other regions, there were also considerable differences within the region. Two groups of countries stand out on either side of the spectrum. On the positive side, Poland and Serbia weathered the financial crisis reasonably well. Poland experienced a sharp shock in late-2008 but benefited from new lending to its private and public corporates in 2009. Similarly, Serbia was hit hard and early (in the third quarter of 2008) but then became one of few countries with resilient inflows into its banking sector in 2009. At the opposite end of the spectrum, the Baltic states experienced large and persistent outflows from early 2009 until early 2010.

Cross-border lending to Russia, Kazakhstan and Ukraine contracted even more than in other emerging markets, both in the downturn and in the recovery. The initial outflows from these markets were comparable with those in emerging Asia but the return of inflows proved as elusive as in the CEB and SEE. By early 2010 Kazakhstan, Russia and Ukraine had lost around 40 per cent of their combined end-2007 assets (see Chart 2.3.1).

What could explain the much milder, but more persistent outflows from the CEB and SEE compared with other emerging market regions? One explanation could be that most banks in the region are subsidiaries of foreign banks. The need to refinance these subsidiaries may have slowed the pace of outflows. In addition, under the "Vienna Initiative", international financial institutions (IFIs) and home- and host-country regulators sought commitments from European banks to maintain exposures in the region.[7] The much faster return of capital inflows in Asia and Latin America may in part be a rebound effect – that is, the reversal of an overshooting that never happened in the CEB and SEE – and could also be related to much smaller pre-crisis credit booms and the much faster economic recoveries in these countries (see Chart 2.3.3).

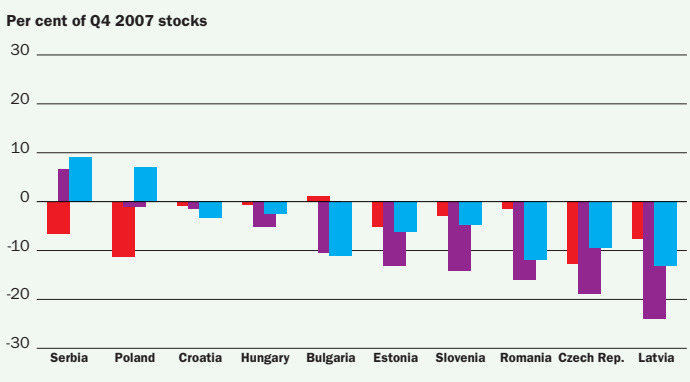
In addition, much of the cross-border lending to emerging Europe came from European banks that were faced with similarly sluggish recoveries in their home countries. These banks may have responded by limiting their expansion in both advanced and emerging European markets (see Chart 2.3.4). The return of inflows into advanced Europe in early 2010 provides some hope that inflows into the CEB and SEE may be following soon.

Chart 2.3.1
Cross-border bank lending to emerging markets



Sources: Bank for International Settlements locational statistics, Table 6A.
Note: Peak outflows are defined as the sum of exchange rate-adjusted changes in BIS cross-border bank assets in the crisis quarters Q4 2008 and Q1 2009. Recovery flows are defined as the sum of exchange rate-adjusted changes in BIS cross-border bank assets ("flows") in the period Q3 2009 to Q1 2010. Total flows are defined as the sum of exchange rate adjusted changes in BIS cross-border bank assets from Q4 2008 to Q1 2010. All three measures are normalised with end-2007 stocks of cross-border bank assets held in the regions.

Chart 2.3.2
Cross-border bank lending in selected central and south-eastern European countries



Source: Bank for International Settlements locational statistics, Table 6A.
Notes: Peak outflows are defined as the sum of exchange rate-adjusted changes in BIS cross-border bank assets in the crisis quarters Q4 2008 and Q1 2009. Recovery flows are defined as the sum of exchange rate-adjusted changes in BIS cross-border bank assets ("flows") in the period Q3 2009 to Q1 2010. Total flows are defined as the sum of exchange rate-adjusted changes in BIS cross-border bank assets from Q4 2008 to Q1 2010. All three measures are normalised with end-2007 stocks of cross-border bank assets held in the regions.

[5] BIS-reporting banks are defined as deposit-taking institutions resident in one of the 41 countries that report to the locational statistics of the Bank for International Settlements (namely, OECD countries plus a small group of international financial centres and emerging market countries including Bahrain, Brazil, India, Hong Kong, Malaysia and Singapore).

[6] Emerging Asia and Latin America lost 30 and 13 per cent of foreign bank assets, respectively, when excluding Brazil, India and China; see Chart 2.3.1.

[7] See Berglof et al. (2009) and EBRD (2009), Box 1.4.

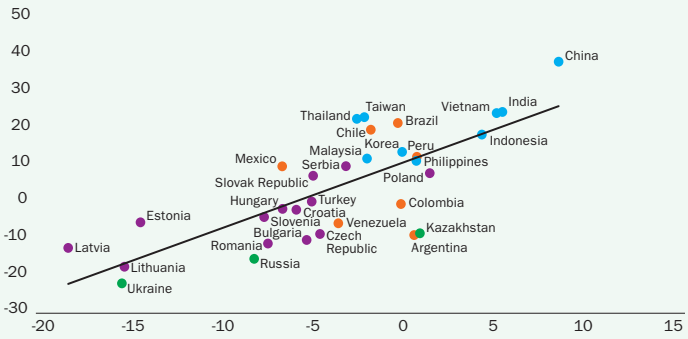
Box 2.3 continued

An important component of cross-border lending flows are syndicated loans to corporations, other banks, or the public sector. In line with the idea that cross-border lending to emerging Europe was different from other regions mainly because of the special role of bank lending to subsidiaries, the developments in syndicated lending flows to the region do not look very different from those of other regions. As the crisis unfolded, syndicated loan markets for all emerging market regions shrank by 40-90 per cent (see Chart 2.3.5). Countries with heavier reliance on the syndicated loan market were affected more severely. This includes Kazakhstan, Russia and many of the Asian economies, and is likely to have contributed to the large bank lending outflows from these countries (see Chart 2.3.6).[8]

Chart 2.3.3

Real GDP growth 2009 and recovery of cross-border bank lending flows

Changes in BIS cross-border bank assets in the period 2009 Q3 to 2010 Q1, in % of end-2007 stocks



2009 GDP growth

CEB, SEE **RUS, UKR, KAZ** **Emerging Asia** **Latin America**

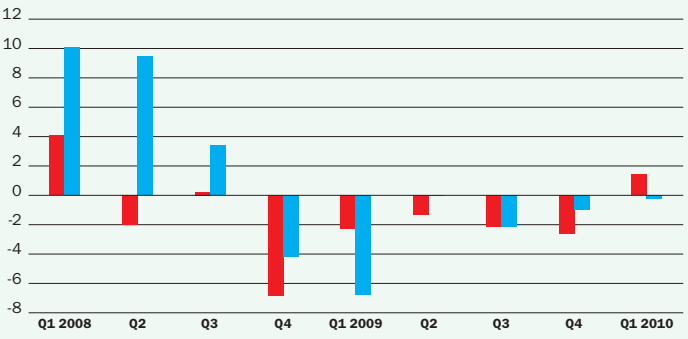
Source: IMF World Economic Outlook. Bank for International Settlements, locational statistics, Table 6A.

Note: Recovery flows are defined as the sum of exchange rate-adjusted changes in BIS cross-border bank assets ("flows") in the period Q3 2009 to Q1 2010 divided by end-2007 stocks of these assets.

Chart 2.3.4

Cross-border lending flows to advanced and emerging Europe

Per cent of Q4 2007 stocks



Advanced Europe **CEB & SEE**

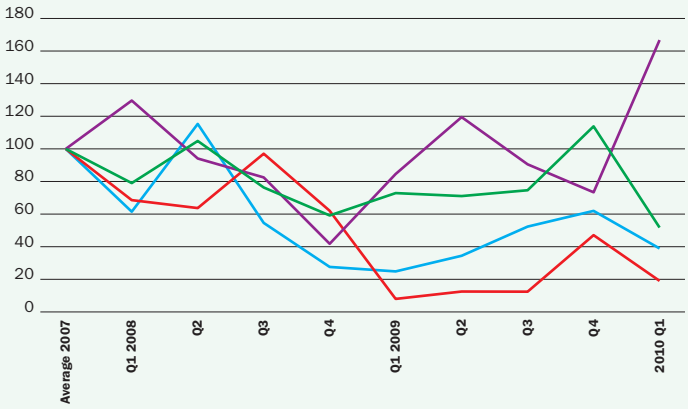
Source: Bank for International Settlements, locational statistics, Table 6A.

Note: Cross-border lending flows are exchange rate-adjusted changes in BIS cross-border bank assets divided by end-2007 stocks of these assets.

Chart 2.3.5

Syndicated lending to emerging market regions (Index 100 = average lending in 2007)

Per cent



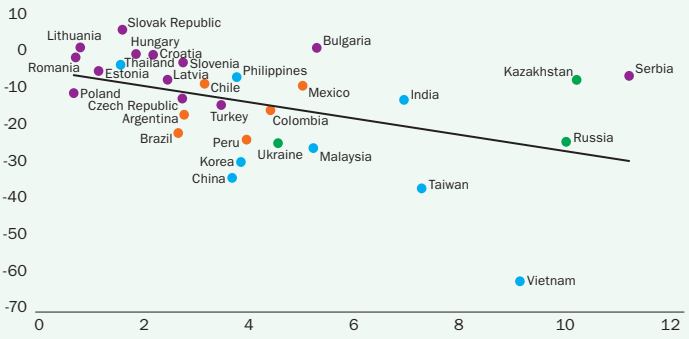
CEB and SEE **RUS, KAZ, UKR** **Emerging Asia** **Latin America**

Source: Dealogic Loan Analytics.

Chart 2.3.6

Reliance on syndicated lending and peak outflows (In per cent of end-2007 stocks of BIS cross-border bank assets)

Changes in BIS cross-border bank assets in the period 2009 Q3 to 2010 Q1, in % of end-2007 stocks



Average 2007 syndicated lending, in % of end-2007 cross-border bank assets

CEB, SEE **RUS, UKR, KAZ** **Emerging Asia** **Latin America**

Source: Bank for International Settlements, locational statistics, Table 6A. Dealogic Loan Analytics.

Note: Peak outflows are defined as the sum of exchange rate-adjusted changes in BIS cross-border bank assets in the crisis quarters Q4 2008 and Q1 2009. Reliance of syndicated lending is average syndicated lending in 2007. Both measures are normalised with end-2007 stocks of BIS cross-border bank assets. Venezuela has been excluded as an outlier with an extreme reliance on syndicated lending. In Kazakhstan, the peak outflow measure underestimates the true extent of its cross-border lending losses because in this country these had started already in 2007.

[8] This is in line with García Herrero and Martinez Peria (2007) and De Haas and Van Lelyveld (2004).

Some countries will be better placed than others to take advantage of global growth when it materialises. An analysis of real export growth of 32 advanced and emerging market countries since 2000 suggests that the degree to which countries benefit from global growth will depend on each country's competitiveness (as measured, for example, by unit labour costs); its export market diversification; and its product specialisation (see Box 2.4). In addition, commodity-rich countries may benefit from further increases in their export prices if the global recovery picks up pace.

Domestic factors not supportive of short-term growth in most countries

On average, fiscal deficits in the EBRD region were similar to those in advanced countries at end-2009 (at around 3 per cent of GDP), but sovereign debt *stocks* were significantly lower (about 32 per cent of GDP compared with about 65 per cent; see Chart 2.9a). In a few countries, however, these comparatively low debt levels are likely to rise rapidly as the crisis has opened unsustainably large fiscal deficits. In many countries, therefore, fiscal adjustment is still necessary to stabilise public debt levels. In most countries, these consolidation needs are modest (in the order of a few percentage points of GDP) compared with those of many advanced countries (see Chart 2.9b and Annex 2.1). While fiscal consolidation is required in countries such as Armenia, Latvia, Lithuania, Montenegro and Ukraine, this is already under way in most cases and some will occur automatically as the economy recovers. Such consolidation will help competitiveness in the medium term, but is likely to detract from short-term growth.

A potential obstacle to the recovery is continued sluggishness in credit growth. With NPLs at around peak levels, bank balance sheets remain under stress. In addition, regulatory tightening will limit the degree to which the recovery is supported by credit growth. Following the adoption of the proposals by the Basel Committee of Bank Supervisors in September 2010, EU countries and accession candidates and pre-accession countries are likely to phase in stricter requirements on bank capital and liquidity over the period 2013-18 (see Box 2.5). While the long-term growth impact of these measures could well be positive, there is general agreement that they will have output costs over the medium term, with estimates for the advanced countries ranging from a loss of GDP of 0.4 per cent over five years (BIS, 2010) to 3.1 per cent (IIF, 2010).

In addition, individual governments have imposed *ad hoc* taxes on banks (Hungary has imposed a particularly high bank tax to support fiscal consolidation) or are discussing them. In anticipation of such taxes and stricter regulatory requirements, banks are in the process of building capital and liquidity buffers and unwinding potential tax bases. More cautious lending decisions are likely to result, which could weigh on consumption and investment.

Outlook and risks

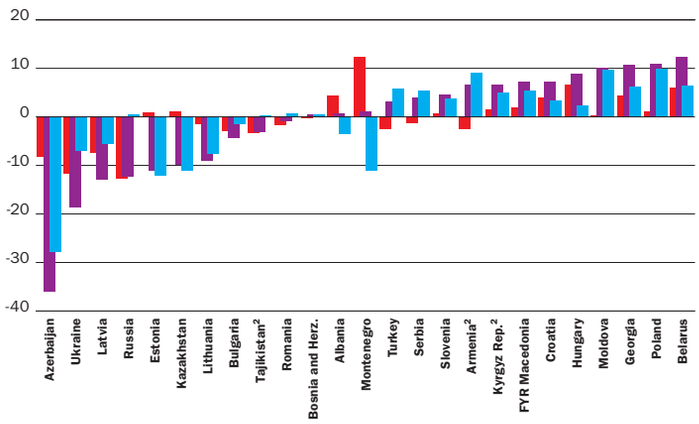
Based on these considerations and the recovery that is already under way in some countries, real GDP in the EBRD region is expected to grow by an average of about 4 per cent in both 2010 and 2011. Particularly in central Europe and the Baltic states, growth is set to gather pace as exports recover across the region. The wage compression in the Baltic states and the depreciation in Poland will improve competitiveness, while the Slovak Republic will benefit from global growth in cyclical commodities. Offsetting factors include fiscal consolidation and the bank tax in Hungary, which is expected to discourage bank asset growth in the short term. Central Asia is expected to grow more briskly on the back of strong commodity prices, the opening of new commodity export markets in the East, and sustained growth momentum in Russia. The recessions in south-eastern Europe are likely to come to an end as major export markets recover. In some economies in eastern Europe, such as Armenia and Belarus, a slowing of recovery is expected as the fiscal stimulus no longer adds an impulse to domestic demand and remittance-driven recoveries in balance of payments inflows slow down. Only a few countries, including Turkey and Poland, are expected to benefit from capital inflows.

Risks to this outlook are both on the upside – driven mainly by faster-than-expected global recovery, and/or abundant global liquidity as monetary policy in advanced countries remains loose – and the downside. Downside risks arise from the international environment, crisis legacies and counterproductive domestic policy actions. A double-dip recession in advanced countries cannot yet be precluded. Perhaps more relevantly (and closer to home), sovereign debt problems in some advanced EU countries, while less acute than in the second quarter of 2010, will require continued fiscal adjustment effort. Any slippage (or much worse than expected growth) could bring a renewed bout of market instability that may well spill over into some countries of emerging Europe through financial and trade ties. Emerging Europe continues to be vulnerable due to its own crisis legacies, in particular large stocks of foreign-currency denominated corporate and household debt. In addition, counterproductive regulatory and taxation decisions – which have become more likely both as fiscal pressures have increased and as long recessions boost economic populism – could trigger capital flight, put pressure on exchange rates and dampen credit growth.

In addition to resisting populist pressure to undertake such measures, governments will need to seek to further reduce underlying vulnerabilities, particularly through fiscal-structural improvements that give more room to fiscal policy in the short term, and by weaning financial systems off their dependence on foreign currency finance. The latter will require efforts to develop local currency capital markets, in the context of a broader growth agenda that emphasises domestic sources of growth: both with respect to financing and the improvement of domestic institutions. This agenda is the subject of the remaining chapters of this report.

Chart 2.8
Net portfolio and other investment inflows[1]

Per cent of 2009 GDP

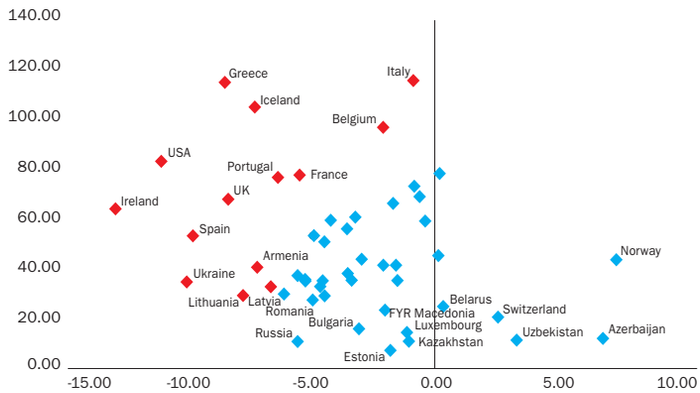


Peak outflows **Total flows** **Recovery flows**

Source: IFS, CEIC.
Note:
[1] Excluding net trade credit and net other investment of monetary authorities. Peak outflows are defined as flows during Q4 2008 and Q1 2009. Recovery flows are defined as flows during Q2 2009-Q2 2010.
Total flows are defined as the sum of peak outflows and recovery flows.
[2] Data for Armenia, Kyrgyz Republic are up to Q1 2010. Data for Tajikistan end in Q4 2009.

Chart 2.9a
Sovereign debt and deficits, 2009[1]

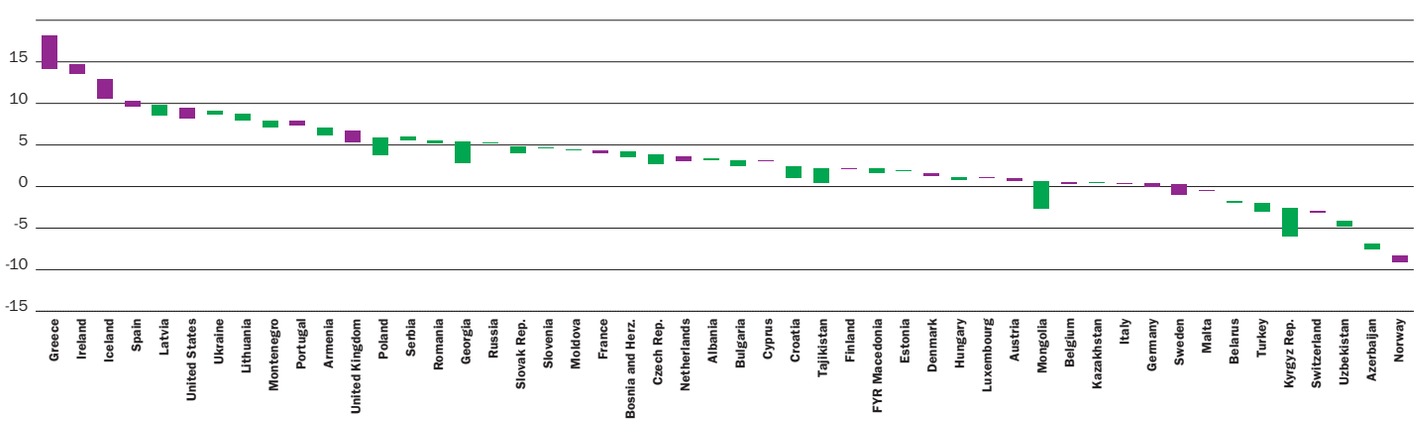
Public debt to GDP 2009 – per cent



Primary deficit to GDP ratio 2009 – per cent

Chart 2.9b
Consolidation needs, 2009[2]

Per cent of GDP



Sources: Bloomberg, news reports, IMF Staff Reports, WEO October 2010.
Note:
[1] Red = consolidation need above 7% of GDP; blue = consolidation need in below of 7% of GDP.
[2] Purple = advanced countries; green = EBRD countries of operations. Calculation of consolidation needs is explained in Annex I.

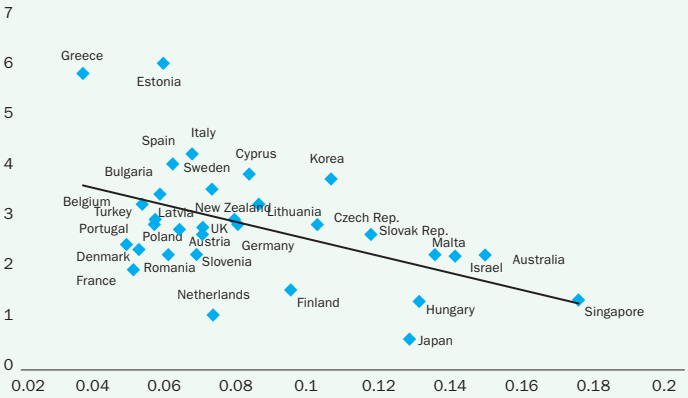
Box 2.4
Who will benefit most from a global recovery?

The elasticity of real export growth to trading partner real GDP growth and ULC-based real effective appreciation was estimated for a group of 32 emerging market and advanced countries, using country-specific OLS regressions for the pre-crisis period between 2000 and the third quarter of 2008.[9] The country-specific regressions included up to eight lags of real effective appreciation and trading partner real GDP growth. The country-specific export elasticities implied by the regression coefficients were subsequently summarised and compared across countries with different export product and export market structure (see Chart 2.4.1). The results suggest the following conclusions.

- The "income" elasticity of exports – that is, the elasticity of real export growth to trading partner real GDP growth – was weaker among countries with a more concentrated export product structure (those with a high Herfindahl index of product concentration, based on 99 product categories using Comtrade data, see Chart 2.4.1). Countries with a wider range of export products (a low Herfindahl index in Chart 2.4.1) were apparently able to better take advantage of high-growth export markets.
- The "price" elasticity of exports – that is, the elasticity of real export growth to real effective appreciation – was stronger among emerging market countries that exported to a smaller range of export markets (those with a higher Herfindahl index of export market concentration in Chart 2.4.2). In emerging markets, the fixed cost involved in exporting new products or to new markets (Melitz, 2003) appears to discourage a move into new markets when countries lose market share in existing export markets as their competitiveness weakens.

The countries best-placed to benefit from a global recovery are therefore likely to be those with a wide export product base. For those countries with more concentrated export product structures, a significant improvement in competitiveness could raise export growth, especially if their export market destinations are not well diversified. In many countries, especially in south-eastern Europe and the Baltic states, such an improvement is under way as fiscal austerity plans put downward pressure on labour markets.

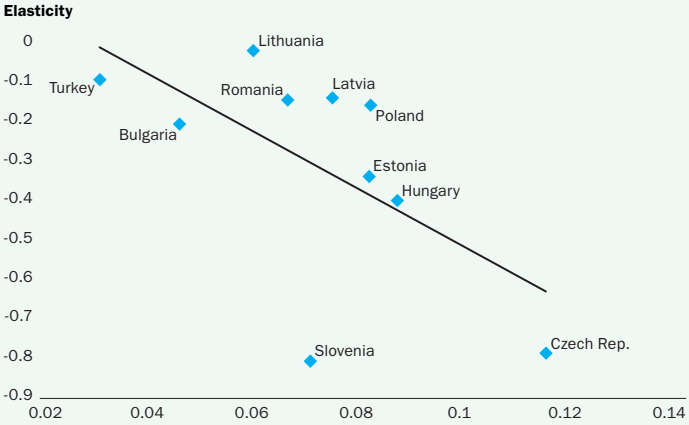
Chart 2.4.1
Elasticity of real export growth to trading partner real GDP growth in relation to export product structure



Herfindahl index of export products, 2008

Sources: IMF IFS database, Global Insight, official authorities.
Note: Includes full sample.

Chart 2.4.2
Elasticity of real export growth to real effective appreciation in relation to export market concentration



Herfindahl index of export market destinations, 2008

Sources: IMF IFS database, Global Insight, Official authorities.
Note: Includes only countries of operations. The negative correlation holds also if all emerging markets in the sample are included except for Mexico, which is an outlier. The negative correlation is weaker in the full sample.

Box 2.5
Reforms in financial regulation and their potential impact on lending volumes

The ongoing reform of the European Union and international financial regulation is likely to strengthen the resilience of banking systems and of cross-border supervision, while simultaneously making excessive bank credit growth – and the associated deterioration in lending standards – less likely. This is particularly relevant for the new EU member countries in the CEB region, and for the accession candidates and pre-accession countries, where strengthened international rules on bank supervision under the Basel accord are likely to be phased in from 2013.

EU financial supervision framework

In September 2010, EU finance ministers adopted proposals for a considerable strengthening of supervision within the bloc. Three pan-European supervisory agencies for banking, financial markets and insurance will work towards a convergence of supervisory practices and facilitate information sharing regarding cross-border financial institutions. A European Systemic Risk Board will be mandated to address country-level developments and certain systemically important institutions. It will be in a position to recommend "macro-prudential" measures – affecting

[9] Data for ULC-based real effective exchange rate from Eurostat, national central banks and compiled using industrial production, wage indicators, and industrial employment data from CEIC. CPI-based real effective exchange rate from IMF International Financial Statistics (IFS). Data for trade-weighted trading partner real GDP growth from IMF IFS and DOTS. Data for real export growth from IMF IFS, CEIC, and national sources. The elasticity of real export growth to trading partner real GDP growth is defined as the cumulative coefficient on year-on-year trade-weighted trading partner real GDP growth at all lags. The elasticity of real effective appreciation is defined as the cumulative coefficient on year-on-year real effective appreciation at all lags.

Box 2.5 continued

the financial system as a whole – and demand explanations from member countries not complying with such recommendations. There has been some progress on closer cooperation among supervisors, including an agreement in August 2010 between the Baltic states and six Nordic countries, which establishes a presumption for burden-sharing following a bank restructuring.

Bank taxes

Little progress has been made in establishing a European framework for bank restructuring and sharing the fiscal burden of such rescues. In May the EU Commission proposed a system of national bank taxes, and several EU member countries are in the process of adopting such measures, including Poland and Hungary among the new EU member states. At the same time, there is no agreement about the tax base or tax rate for such measures, or about how proceeds are to be deployed, and whether specific rescue funds are to be established. Some of the proposed measures are designed to bridge shortfalls in budgetary revenues rather than to address systemic risks. Given the close financial interlinkages between the CEB and SEE countries on the one hand and western Europe on the other, this risks substitution through cross-border credit flows, and re-allocation of capital, thereby undermining the efforts of national supervisors.

Reform to the Basel accord on bank supervision

In September 2010 the Basel Committee on Bank Supervision adopted wide-ranging proposals for a substantial strengthening of banks' capital and liquidity standards, in line with previous G-20 announcements. These proposals will be phased in through national legislation over the period 2013-18, with the EU and accession candidates and pre-accession countries likely to do so first, and key CIS countries implementing these standards later.

These proposals improve the quality of bank capital by excluding certain categories, and raise capital ratios, through both a risk-adjusted capital ratio and a simple leverage ratio. While the CEB and SEE countries generally show high risk-adjusted capital adequacy ratios (see Chart 2.5.1), there has been concern over limits to consolidation of minority stakes of their subsidiaries among parent banks. Additional capital requirements may be imposed on systemically important banks, and counter-cyclical capital charges may be designed by national supervisors to stem excessive credit growth. The latter element could be particularly important in transition countries, which are prone to large swings in credit, given underdeveloped financial markets, the proclivity to asset price bubbles, and exposure to volatile international capital flows. The complexity and cumulative impact of new capital requirements could initially introduce more uncertainty to the capital budgeting of international bank groups active in the region.

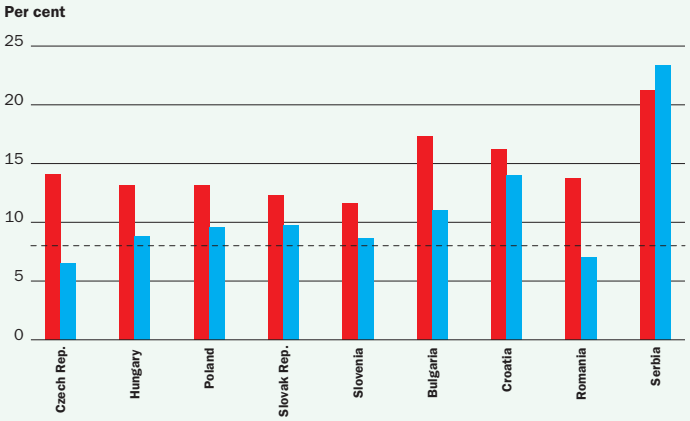
Of particular concern for transition countries have been the proposals for liquidity standards, given the generally short term nature of liabilities and the ensuing maturity risks, as highlighted by still high loan-to-deposit ratios in a number of countries (see Chart 2.5.2.). However, a requirement that long-term assets need to be matched by long-term liabilities (the so-called net stable funding ratio) will be delayed to 2018. While liquidity risks are an important concern – evident in the 2009 disruptions in foreign exchange swap markets – banks have already implemented a more conservative liquidity management in response to the crisis.

The likely impact as banks prepare for stricter requirements

In the implementation phase, a small number of European banks may need to raise additional capital, thereby constraining their lending capacity. Counter-cyclical capital requirements applied by host countries will bind capitalisation at the parent level. However, over the long term, these new requirements are designed to reduce the probability of financial crises within advanced countries, and the associated output contractions. BIS studies find benefits for a wide range of parameters, and only a modest impact on growth. Given banks' greater resilience once these standards are fully implemented, banks may be able to lower their funding costs, a benefit that may be passed on to CEE subsidiaries. For the CEE region greater harmonisation and coordination of supervision – and investor recognition that such standards are applied across the region – could well support the recovery in bank lending to the region.

Chart 2.5.1

Capital and risk-weighted capital to asset ratios

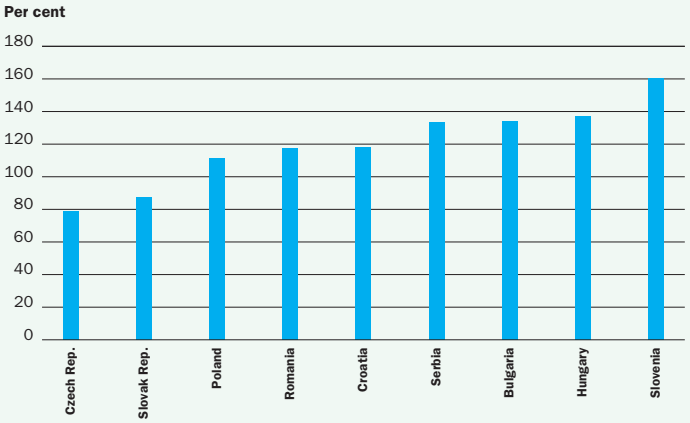


■ Regulatory capital to risk-weighted assets ■ Capital to assets

Source: IMF Global Financial Stability Report, April 2010.

Chart 2.5.2

Loan-to-deposit ratios



Source: CEIC, latest available data for all countries; for Slovak Republic, this was end 2008 data.

Annex 2.1

Assessing sovereign debt sustainability in the EBRD region

In order to compare debt sustainability for a wide range of countries based on a set of common assumptions, the calculations of consolidation needs (also underlying Chart 2.9) are based on the standard concept of the debt-stabilising primary fiscal deficit, defined as:[10]

$$B^* = D\frac{i-g}{1+g},$$

where B^* is the debt-stabilising primary fiscal balance in per cent of GDP, D is the stock of debt in per cent of GDP, i is the real interest rate, and g is the GDP growth rate. The formula illustrates the link between market conditions and debt sustainability: if interest rates are below real GDP growth ($i < g$), countries can outgrow their stock of debt even in the presence of "small" primary deficits; otherwise, they have to run primary fiscal surpluses to stabilise their stock of debt. The formula has the advantage that it can be applied in a consistent manner to a large group of countries, including those for which only limited data is available. The disadvantage is, of course, that it is sensitive to the assumed values for i and g; that it does not take into account short-term rollover risk inherent in the maturity structure of the stock of debt; and more generally that it answers a limited question: namely, what the primary deficit would need to be to stabilise debt at the current levels. These may not be the desired levels from the perspective of markets or country governments. However, when B^* is larger than the actual primary balance B, the difference between the two gives an overall sense of the minimum adjustment that needs to take place for debt to *eventually* stabilise (to the extent that stabilisation is delayed, actual adjustment may be higher).

The actual i and g used in order to apply the formula depend on the currency composition of the public debt stock.

- If the stock of sovereign debt is predominantly local currency denominated – as it will be in most of the advanced countries in our sample – g refer to the real GDP growth rate. i then needs to be interpreted as the long-term nominal interest rate on local-currency denominated sovereign debt, deflated by the average annual GDP deflator during 2010-15. We typically approximated this nominal interest rate with the average five-year local currency government bond yield, as reported by Bloomberg.[11]

- If the stock of debt is predominantly foreign currency denominated, g needs to be interpreted as growth in dollar-denominated nominal GDP. In this case i is proxied by the local currency nominal interest rates and converted into foreign currency by subtracting expected long-term depreciation.[12]

Consolidation needs depend on current primary balances and debt stocks but can change significantly once consolidation packages are implemented. We therefore assessed consolidation needs both based on the most recent actual primary balances and debt-stocks (end-2009) and, to acknowledge fiscal consolidation plans already under way, on projected medium-term primary fiscal balances and debt stocks (end-2015). We assumed that the authorities' fiscal plans to 2015 are captured by the primary balances and general government debt stocks reported in the International Monetary Fund (IMF)'s *World Economic Outlook*. Average annual real and US dollar-denominated nominal GDP growth data for 2010-15 was also taken from the IMF's *World Economic Outlook*.

We establish the fiscal consolidation need as the difference between the debt-stabilising fiscal balance and the actual fiscal balance.

Consolidation need $= B_t - B^*$

Consolidation needs are calculated both for 2009 and 2015 data. The calculation using 2009 data illustrates the *current* need for fiscal adjustment to stabilise debt-consolidation needs that are already included in fiscal plans for many countries. The calculation for 2015 gives a sense of the fiscal consolidation required *in addition to current fiscal plans* (see Table A.2.1.1) once the business cycle has run its course and the output gap has closed.

The results shown in columns 15 and 16 of the table suggest lower fiscal adjustment needs in transition economies compared with advanced countries – *provided current fiscal plans are implemented*. In particular, the sustainability of fiscal debt in countries such as Ukraine, Latvia and Bosnia and Herzegovina is predicated on continued fiscal adjustment. In a few cases, notably Lithuania and Montenegro, the authorities will need to undertake fiscal adjustment beyond that which is currently projected over the medium term in order to stabilise public debt.

Significantly, interest rate and implementation risk can yet undermine fiscal debt sustainability in several countries. The relatively favourable outlook is partly the result of the current historically low interest rates. An interest rate hike would tip the sovereign debt of some of the countries of operations into the unsustainable range. For example, an interest rate increase of 1-2 per cent would make the debt of the Slovak Republic and several advanced countries unsustainable at the current primary deficit levels.

Source: IMF WEO April 2010, IMF staff reports, Bloomberg and EBRD staff calculations.

[10] See Chalk and Hemming (2000) and Sturzenegger and Zettelmeyer (2006, appendix).

[11] Croatia, Czech Republic, Estonia, Hungary, Kazakhstan, Poland, Russia, Slovak Republic, Turkey and Ukraine. For Ukraine and Kazakhstan, only dollar-denominated five-year government bond yields were available (for Kazakhstan only the yield for state-owned Kaz Development Bank is available). We added depreciation in 2010 to date to convert them into local currency. For Bulgaria and Serbia, government bond data was not available, but CDS spreads were. We approximated the five-year government bond yield in local currency with the five-year government bond yield of the German bund plus the average CDS spreads in 2010 to date, as reported by Bloomberg, plus exchange rate depreciation during 2010 to date. Where Bloomberg data was not available, the government bond yield was used, as reported by the IMF's IFS, making the assumption that this referred to foreign currency-denominated bonds, and adding depreciation in 2010 to date. For all remaining countries, the local currency interest rate assumed in the public debt sustainability framework from the most recent IMF country report was applied.

[12] For those countries where Bloomberg or IFS data is not available, the foreign currency interest rate assumed in the most recent IMF country report was used.

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Table A.2.1.1

Underlying data and assumptions for the debt sustainability analysis

	Debt to GDP ratio (per cent)	GDP growth rates (per cent)		Real interest rate (per cent)					Primary balance (per cent of GDP)					Consolidation needs			Debt stabilising interest rate, (per cent)	
Source	IMF WEO, 2009	IMF WEO 2015, LC	IMF WEO 2015, USD nominal	Nominal interest rate, IMF/WB sustainability framework LC	5-year bond yield or (bund yield+CDS spread) LC	WEO, long-term GDP inflation	LC real interest rate	$ interest rate	Debt stabilising, 2010 LC	Debt stabilising, 2010 FX	Debt stabilising, 2015 LC	Actual 2009	Actual, 2015	2010 LC	2010 FX	2015 LC	2015 LC	2015 FX
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
EBRD region																		
Albania	59.5	5.0	7.9	6.4	NA	3.1	3.2	2.7	-1.0	-0.9	-1.1	-4.2	-1.2	3.2	3.4	0.1	3.0	5.9
Armenia	40.6	4.0	6.2	7.5	NA	4.0	3.4	1.2	-0.2	-1.2	-0.2	-7.3	-1.0	7.0	6.1	0.7	1.2	3.4
Azerbaijan	12.1	0.9	2.8	2.6	NA	1.5	1.1	3.5	0.0	-0.6	0.0	6.9	23.6	-6.9	-7.4	-23.5	NA	NA
Belarus	25.1	4.5	10.5	4.9	NA	7.0	-2.0	4.8	-1.6	-1.4	-1.4	0.3	0.6	-1.9	-1.7	-1.9	7.1	13.3
Bosnia and Herz.	35.4	4.5	6.6	1.7	NA	2.5	-0.8	0.8	-1.8	-1.1	-1.4	-5.3	0.4	3.5	4.2	-1.8	6.0	8.2
Bulgaria	16.1	5.0	6.9	2.6	5.0	3.8	1.1	4.7	-0.6	0.1	-1.0	-3.1	-2.1	2.5	3.2	1.1	0.0	0.0
Croatia	35.4	3.0	5.6	6.9	4.4	3.0	1.4	4.4	-0.6	0.9	-0.7	-1.5	-0.1	1.0	2.4	-0.6	2.8	5.4
Estonia	7.1	3.1	4.4	6.3	6.3	1.8	4.4	6.0	0.1	0.2	0.2	-1.8	-3.1	1.9	2.0	3.3	0.0	0.0
FYR Macedonia	23.5	4.0	7.4	5.3	NA	3.2	2.1	6.5	-0.4	0.1	-0.5	-2.0	-0.8	1.6	2.2	0.3	0.7	3.9
Georgia	37.4	5.0	8.2	2.9	NA	6.0	-2.9	6.4	-2.8	-0.2	-3.0	-5.6	-0.9	2.8	5.4	-2.0	2.5	5.6
Hungary	78.3	3.0	5.0	5.6	6.9	2.4	4.3	5.6	1.0	1.3	1.1	0.2	0.2	0.8	1.1	0.9	3.2	5.2
Kazakhstan	10.9	6.5	14.4	10.8	5.0	3.8	1.2	9.4	-0.5	-0.6	-1.1	-1.1	1.4	0.5	0.5	-2.5	12.9	21.2
Kyrgyz Rep.	59.4	4.7	8.0	1.2	NA	8.1	-6.4	2.0	-6.3	-2.9	-6.8	-0.4	-2.3	-5.9	-2.5	-4.5	0.9	4.1
Latvia	32.8	4.0	4.5	6.7	11.0	1.1	9.9	11.1	1.9	3.1	2.0	-6.7	4.1	8.6	9.8	-2.1	15.9	16.5
Lithuania	29.5	3.6	5.4	5.9	5.8	2.1	3.6	5.9	0.0	0.8	0.0	-7.8	-2.4	7.9	8.7	2.4	0.0	1.0
Moldova	27.6	5.0	10.9	1.4	7.0	4.0	2.9	6.1	-0.5	-0.5	-0.6	-5.0	0.5	4.4	4.5	-1.1	6.9	12.9
Mongolia	53.4	12.8	12.6	5.9	NA	2.1	3.7	2.8	-4.3	-7.6	-4.8	-4.9	4.0	0.6	-2.6	-8.9	20.3	20.2
Poland	50.9	4.3	4.4	5.8	5.3	2.5	2.8	8.8	-0.7	1.4	-0.8	-4.5	-0.4	3.8	5.9	-0.4	3.5	3.6
Romania	29.9	4.2	13.6	5.2	7.5	5.7	1.7	5.3	-0.7	-1.0	-0.8	-6.2	0.2	5.4	5.2	-1.1	5.0	14.5
Russia	10.9	4.0	9.7	9.8	6.0	5.7	0.3	9.1	-0.4	-0.3	-0.5	-5.6	-2.4	5.2	5.3	1.9	0.0	0.0
Serbia	35.6	5.0	8.1	4.0	15.8	4.0	11.4	13.7	2.2	2.5	2.1	-3.4	0.7	5.6	5.9	1.4	7.1	10.3
Slovak Rep.	35.7	4.2	5.8	NA	2.6	2.1	0.6	2.8	-1.3	-0.4	-1.6	-5.3	0.1	4.0	4.9	-1.6	4.5	6.1
Slovenia	29.4	0.0	5.2	NA	3.9	3.2	0.6	3.5	0.2	0.1	0.2	-4.5	0.6	4.7	4.6	-0.4	1.7	7.0
Tajikistan	33.0	5.0	11.0	1.5	NA	11.0	-8.6	2.4	-4.3	-2.5	-6.0	-4.7	-4.0	0.4	2.2	-1.9	0.0	1.3
Ukraine	34.6	4.0	7.2	5.9	6.8	5.7	1.0	4.0	-1.0	-1.5	-1.0	-10.1	-0.2	9.1	8.7	-0.7	3.3	6.4
Uzbekistan	11.2	6.0	7.5	1.2	NA	10.0	-8.0	2.0	-1.5	-0.8	-2.6	3.4	3.2	-4.8	-4.1	-5.8	NA	NA
Turkey	45.5	4.0	7.0	9.5	4.1	4.3	-0.2	2.2	-1.8	-2.9	-1.6	0.1	2.2	-2.0	-3.0	-3.7	9.8	13.0
Montenegro	38.2	4.0	4.5	5.2	14.7	1.0	13.5	14.3	3.5	4.3	5.3	-3.6	-0.9	7.0	7.9	6.2	2.4	2.9

Table A.2.1.1 continued

Underlying data and assumptions for the debt sustainability analysis

	Debt to GDP ratio (per cent)	GDP growth rates (per cent)		Real interest rate (per cent)					Primary balance (per cent of GDP)					Consolidation needs			Debt stabilising interest rate, (per cent)	
Source	IMF WEO, 2009	IMF WEO 2015, LC	IMF WEO 2015, USD nominal	Nominal interest rate, IMF/WB sustainability framework LC	5-year bond yield or (bund yield+CDS spread) LC	WEO, long-term GDP inflation	LC real interest rate	$ interest rate	Debt stabilising, 2010 LC	Debt stabilising, 2010 FX	Debt stabilising, 2015 LC	Actual 2009	Actual, 2015	2010 LC	2010 FX	2015 LC	2015 LC	2015 FX
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
Advanced																		
Austria	66.4	1.8	3.4	2.2	2.2	1.9	0.3	0.3	-1.0	-0.7	-1.2	-1.7	-2.0	0.7	1.0	0.3	0.0	1.4
Belgium	97.0	1.9	3.5	2.5	2.5	2.2	0.3	0.3	-1.6	-1.8	-1.8	-2.1	-1.9	0.5	0.3	-0.3	0.6	2.1
Cyprus	56.2	3.0	5.0	4.6	4.6	2.5	2.1	2.1	-0.5	-0.5	-0.6	-3.6	-3.0	3.1	3.1	2.1	0.0	1.0
Czech Rep.	35.3	3.0	9.3	4.5	2.9	2.2	0.6	2.6	-0.8	-1.9	-1.3	-4.6	-3.0	3.8	2.7	1.7	0.0	3.6
Denmark	41.5	1.9	3.5	2.7	2.6	1.9	0.6	0.6	-0.5	-0.8	-0.6	-2.1	-3.7	1.6	1.3	0.6	0.0	0.9
Finland	43.9	1.8	3.3	1.9	1.9	2.0	-0.1	-0.1	-0.8	-0.8	-1.2	-3.0	-3.0	2.2	2.1	1.8	0.0	0.0
France	77.7	2.1	3.5	2.0	2.0	1.9	0.2	0.2	-1.4	-1.2	-1.6	-5.5	-2.3	4.1	4.3	-2.0	2.4	3.8
Germany	73.2	1.3	2.4	1.8	2.2	1.5	0.7	0.7	-0.4	-0.8	-0.4	-0.8	-1.0	0.4	0.0	-0.8	1.8	2.9
Greece	115.1	2.7	3.4	8.7	8.7	1.0	7.6	7.6	5.6	9.5	6.5	-8.6	1.0	14.1	18.1	0.6	7.2	7.9
Iceland	105.1	3.1	5.2	7.9	11.4	2.6	8.5	8.5	5.5	3.2	4.0	-7.4	3.9	12.9	10.5	-2.0	11.3	13.5
Ireland	64.0	3.5	4.9	3.5	6.1	1.9	4.2	4.2	0.4	1.6	0.7	-13.1	-5.3	13.5	14.6	1.4	2.8	4.2
Italy	115.9	1.3	2.8	2.8	2.8	1.9	0.9	0.9	-0.4	-0.5	-0.4	-0.9	1.5	0.4	0.4	-2.8	3.2	4.8
Luxembourg	14.5	2.6	3.6	3.6	3.5	1.3	2.2	2.2	-0.1	-0.2	-0.1	-1.1	-3.3	1.1	1.0	1.0	0.0	0.0
Malta	69.1	2.5	4.6	4.2	3.6	2.5	1.1	1.1	-1.0	-1.1	-1.0	-0.6	0.1	-0.4	-0.5	-1.7	3.6	5.7
Netherlands	60.9	1.9	2.5	1.9	2.7	1.1	1.7	1.7	-0.1	0.3	-0.2	-3.3	-2.6	3.1	3.6	1.7	0.0	0.0
Norway	43.7	2.0	2.7	2.8	2.8	2.7	0.1	0.1	-0.8	-1.6	-1.0	7.4	9.1	-8.2	-9.1	-9.9	18.8	19.7
Portugal	76.8	1.2	2.6	4.0	4.0	1.6	2.3	2.3	0.9	1.4	1.1	-6.4	-1.2	7.3	7.8	2.8	0.0	0.7
Spain	53.2	2.0	3.4	3.1	3.1	1.6	1.4	1.4	-0.3	0.3	-0.5	-9.9	-3.7	9.6	10.2	0.5	0.8	2.1
Sweden	41.6	3.4	4.7	2.2	2.2	2.0	0.2	0.2	-1.3	-2.5	-0.9	-1.6	-0.8	0.3	-1.0	-1.5	5.7	7.0
Switzerland	20.7	2.0	1.5	0.9	0.9	1.0	-0.1	-0.1	-0.4	-0.6	-0.7	2.6	1.1	-3.0	-3.1	-1.6	4.4	3.9
United Kingdom	68.1	2.6	5.0	2.4	2.4	2.3	0.0	0.0	-1.7	-3.1	-2.1	-8.4	-3.5	6.7	5.3	-2.6	3.1	5.6
United States	83.2	2.6	4.4	2.0	2.0	1.7	0.3	0.3	-1.8	-3.1	-2.4	-11.2	-4.5	9.3	8.1	0.3	0.1	1.8

Source: IMF WEO October 2010, IMF Staff Reports, Bloomberg and EBRD staff calculations.

Chapter 3
Developing local currency finance

Developing local currency capital markets should be a critical component of the post-crisis reform agenda for the transition region. It represents a means of reducing household and corporate foreign currency indebtedness, which was, and continues to be, a significant source of macroeconomic, financial and personal risk. It will also allow domestic sources of bank and corporate financing to be tapped, in turn stimulating growth, and making the transition region less dependent on capital inflows and less vulnerable to their potential reversal.

One of the legacies of the crisis is a new scepticism about the role of cross-border finance. Last year's *Transition Report* showed that external finance has had two faces in the transition region: it was a driver of long-term growth since the mid-1990s, but it also fuelled a large credit boom that went bust in the crisis.[1] Many of these loans were made in foreign currency. When capital flows reversed, and exchange rates came under pressure, repaying these loans became a serious problem for many corporations and households. Although the situation was eventually brought under control – with the exception of Ukraine large currency collapses were avoided – doing so required large-scale international crisis lending and forced many governments, particularly in countries with pegged exchange rates, into painful fiscal adjustment.

While it is neither desirable nor feasible for the region to close itself to foreign finance, reforms that reduce the risks of financial openness should hence be front and centre as the crisis gradually recedes. Chief among these reforms is the development of local currency capital markets. First, it represents a means of reducing household and corporate foreign currency indebtedness, which was, and continues to be, a significant source of macroeconomic, financial and personal risk.[2] Second, it will allow domestic sources of bank and corporate financing to be tapped, in turn stimulating growth, and make the transition region less dependent on capital inflows and less vulnerable to their potential reversal.

Unfortunately, developing local currency finance is a long-term and complex process – although not an impossible one, as many emerging market countries have demonstrated in the past decade.[3] While this process is likely to involve regulatory instruments, which are often the first recourse of policy-makers wishing to reduce the use of foreign currency, it goes far beyond regulation alone. Depending on country circumstances, policy-makers may need to focus on inflation stabilisation; reforming and building the capacity of macroeconomic institutions; creating or reforming the legal framework underpinning capital markets; developing a local institutional investor base; or introducing specific micro-institutional features that allow the money and bond markets to be transparent and active. In many cases, they may need to pursue several of these reforms at the same time. There are no "quick fixes", but there could be high returns derived from acting decisively and in a coordinated fashion in several of these policy areas – particularly now that inflation is relatively low in many transition countries for cyclical reasons and the dangers of foreign currency finance are still under the spotlight.

This chapter begins with an overview of the use of local and foreign currency in the banking systems and capital markets in the transition region. It then looks at the possible reasons why foreign currency use – particularly foreign currency lending to corporations and households – has been, and continues to be, so prevalent. There are multiple potential causes, and developing the right policy response requires the correct diagnosis. Doing so rigorously for all countries in the region, or even just one, is beyond the scope of this analysis.[4] However, the chapter will give an overview of how transition countries compare with regard to the basic structural features that influence the prevalence of foreign currency in local financial systems. In so doing, it will break some new ground, particularly in comparing the development of local currency money and government bond markets. Based on these results, some initial policy conclusions can be drawn.

[1] EBRD (2009), Chapter 3.
[2] That is assuming, of course, that households or corporations do not have significant sources of foreign currency income. For example, exporting firms are naturally hedged against foreign currency risk.
[3] The list of success stories includes Brazil, Chile, Colombia, Israel, Mexico, Poland, and more recently Egypt and Peru. Their experiences are summarised in Box 3.5.

Local versus foreign currency finance

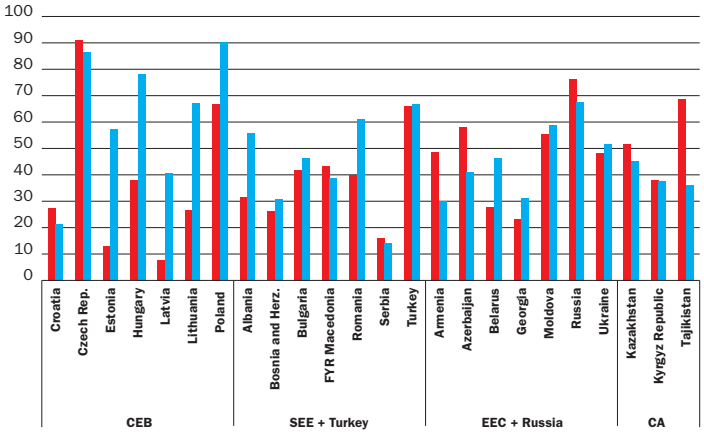
Chart 3.1 provides a snapshot of the status of local currency finance in the banking systems of the transition region. The height of the bars denotes the proportion of local currency-denominated loan and deposit stocks, respectively. In most of the advanced economies, these would be close to 100 per cent.[5] Bars of less than 50 per cent in height indicate that foreign currency finance dominates local currency finance.

The chart shows that local currency finance comes second to foreign currency finance in most countries in emerging Europe and Central Asia. Local currency loans and deposits exceed 60 per cent in only four countries – Czech Republic, Poland, Russia and Turkey.[6]

Not surprisingly, the share of local currency deposits and loans tends to be correlated across countries, but in a few cases they diverge widely. In Armenia, Azerbaijan and Tajikistan, the share of local currency loans significantly exceeds that of local currency deposits, while in Albania, Estonia, Hungary, Latvia, Lithuania, Poland and Romania the opposite is true. One possible interpretation is that differences in the degree of local currency

Chart 3.1
Share of local currency loans and deposits in domestic banking systems

Per cent of all loans or deposits



Sources: CEIC Data Company, International Monetary Fund (IMF) country reports.
Note: Latest available data is generally end-2009. For Bosnia and Herzegovina, Croatia, FYR Macedonia and Serbia, data excludes foreign currency (FX)-indexed local currency loans and deposits. CEB refers to central Europe and the Baltic countries, SEE to south-eastern Europe, EEC to eastern Europe and the Caucasus countries, and CA to the countries of central Asia.

[4] It is, however, part of an initiative on which the EBRD embarked in May 2010 in collaboration with the IMF and World Bank (see below). This is expected to yield a detailed report by May 2011.
[5] There are exceptions. Austria, for example, witnessed a boom in Swiss franc lending in the years running up to the crisis. Nevertheless, the stock of local currency loans even then was around 80 per cent of the total.
[6] The chart, and most of the discussion in this chapter, does not include Slovak Republic and Slovenia, whose currency is the euro. Like Czech Republic, Slovak Republic had high rates of local currency use before adopting the euro in January 2009.

use on the deposit side have to do with confidence in low and stable inflation, which is likely to be higher in the second group of countries than in the first. (Some evidence on this point is offered below.) In contrast, foreign currency use on the lending side could in addition be influenced by the preferences and incentives of specific lenders (for example, government agencies or donors in the first group of countries and banks funded mainly from abroad in the second).

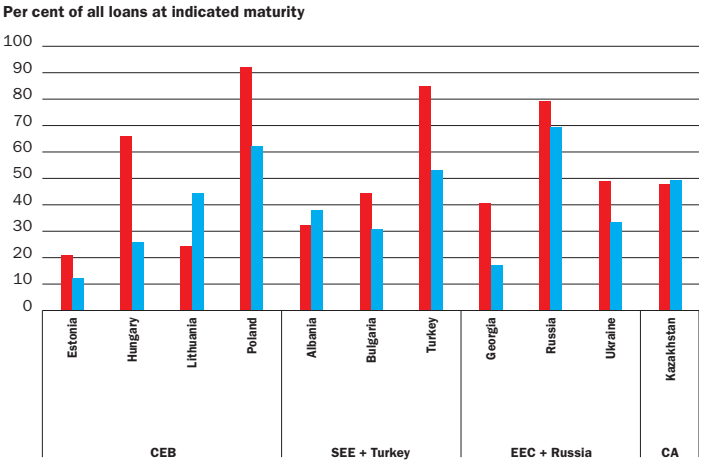
Chart 3.2 more closely examines local currency use on the lending side, focusing on a sample of countries in which bank lending for the most part reflects commercial practices rather than government policies. In most of these countries, the share of local currency lending tends to be particularly low at longer maturities. A possible explanation for this is that the real value of the local currency is harder to predict over longer time-scales, making longer term bank funding and lending more expensive (see also below).

Chart 3.3 shows the evolution of the local currency share in bank lending at three points in time: in 2001 (before the credit boom that took place in most transition countries between 2003 and 2008),[7] in 2005 and in 2008 (just after the peak of the boom). Two facts are worth highlighting. First, a relatively low share of local currency lending has been a feature of domestic bank systems in transition economies for a long time.[8] Second, while there were large changes in the degree of local currency use during the boom period in some countries, they do not all follow the same pattern. In Hungary and Latvia, for example, the use of local currency fell sharply, from a high-to-medium share in lending stocks to a low one. This suggests that the lending boom mostly took place in foreign currency. In contrast, in several countries in the Caucasus and Central Asia regions, the use of local currency increased, although from very low levels.

How did the subsequent crisis period influence the currency composition of lending in transition countries, if at all? Chart 3.4 focuses on (cumulative) net credit *flows* rather than stocks, distinguishing between foreign and local currency lending and examining lending to households and corporations separately between September 2008 and June 2010.

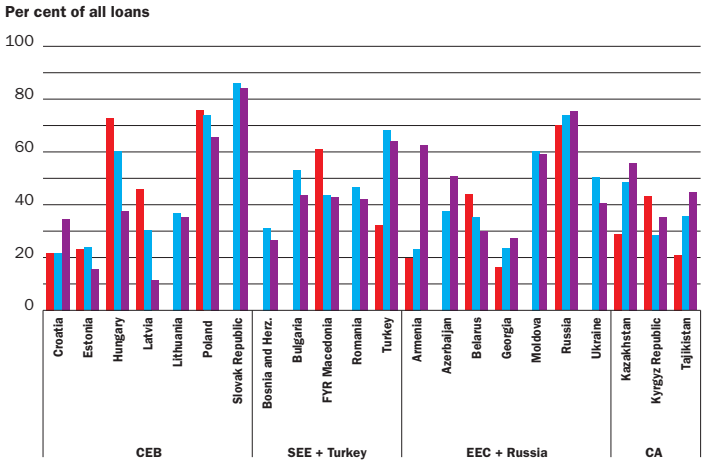
[7] See EBRD (2009, Chapters 2 and 3) and Bakker and Gulde (2010).
[8] See, for example, Sahay and Végh (1996).

Chart 3.2
Share of local currency loans by maturity



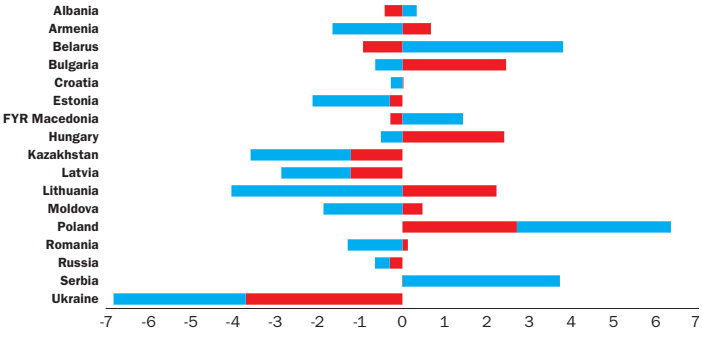
Sources: CEIC Data Company, IMF country reports.
Note: Latest available data is mostly end-2009. The countries that comprised the former Yugoslavia are excluded due to the prevalence of foreign currency-indexed local currency loans.

Chart 3.3
Share of local currency loans: evolution since 2001



Sources: CEIC Data Company, IMF country reports.
Note: For Belarus, Georgia and Turkey, the first observation relates to 2002, for Hungary and Latvia to 2003 and for Ukraine to 2006. For the countries of the former Yugoslavia, foreign currency-indexed local currency loans are excluded.

Chart 3.4a Households
Cumulative bank lending, September 2008-June 2010



Sources: EBRD calculations based on CEIC Data Company and IMF *World Economic Outlook*.
Note: Lending flows are adjusted for exchange rate fluctuations.

Chart 3.4b Corporations
Cumulative bank lending, September 2008-June 2010

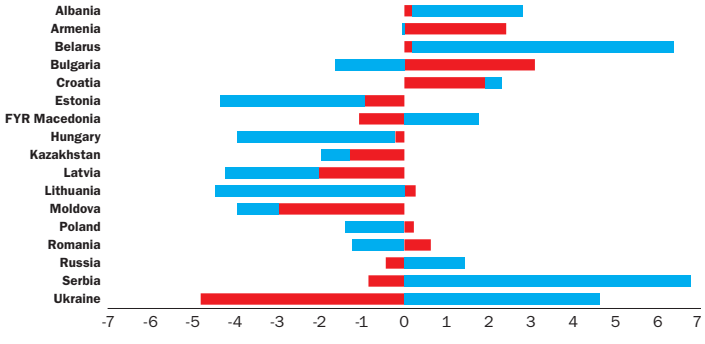


Chart 3.4b indicates strikingly large flows of local currency credit to corporations in Belarus, Serbia and Ukraine (and to a lesser extent in Albania, FYR Macedonia and Russia). These flows are likely to reflect state-subsidised or state-directed lending during the crisis, coupled, in the case of Ukraine, with the prohibition of foreign currency (FX) lending to unhedged borrowers in October 2008. Apart from these instances, it appears that the crisis period has, if anything, further increased the reliance on foreign currency lending, with negative local currency flows generally larger in absolute value than negative foreign currency flows and most positive net flows in foreign currency. A notable exception is Poland where new local currency credit flows to households seem to exceed foreign currency flows (perhaps reflecting Poland's local currency-friendly environment as apparent in Charts 3.1 and 3.3).

Having focused so far on the choice of currency in loans to households and corporations, the chapter turns to public debt. Chart 3.5 shows that the countries in which local currency dominates bank lending – Czech Republic, Poland, Russia, Turkey and (to a lesser extent) Kazakhstan – also tend to have the largest local currency shares in public debt (left axis). In Albania and Hungary public debt is also mostly in local currency even though households and firms in these countries are predominantly indebted in foreign currency.

Chart 3.5 also indicates that even among most countries that have some share of their public debt in local currency, the absolute size of local currency debt outstanding is very small (right axis). The exceptions are Czech Republic, Hungary, Poland, Russia, Turkey and, to a lesser extent, Romania. This raises the question of whether public local currency debt outside this small group of countries is sufficiently liquid (or whether there is a sufficiently steady stream of debt issuance) to act as a pricing benchmark for privately issued debt.

Why is foreign currency lending so prevalent?

The most commonly given answer to this question is that foreign currency lending is usually cheaper. Chart 3.6 shows the spread (difference) between local currency and foreign currency bank interest rates for one-year loans from June 2006 to June 2010 for groups of countries for which such data is available. With two exceptions – Azerbaijan and Tajikistan, in which negligible or negative spreads reflect abnormally high foreign currency lending rates[9] – spreads have been positive and sometimes substantial. Within central Europe and the Baltic states (CEB), Hungary stands out, with extremely high interest rate differentials, which gradually declined between 2006 and 2008 only to rise again in the crisis period. In south-eastern Europe (SEE), the rise of spreads in Romania during the crisis period is striking. Differentials have since come down from their crisis peaks in several countries, but generally remain above their pre-crisis lows.

Consumers taking out loans at high local currency interest rates at the time of borrowing generally also ended up paying high real interest rates *ex-post*. For example, a Hungarian household taking out a one-year consumer loan in forints in early 2006 would have been charged an interest rate of about 22 per cent. However, year-on-year inflation in January 2007 turned out to be only about 8 per cent. Therefore, the borrower would have paid a real interest rate of 14 per cent. Had the same borrower taken out the loan in euros, he or she would have paid an interest rate of about 7 per cent, which would have implied a zero *ex-post* real interest rate (based on Hungarian inflation, and the fact that the euro-forint exchange rate was roughly unchanged over the year). It is not surprising, therefore, that most Hungarian consumers chose to borrow in euros or Swiss francs, which were available at even lower interest rates.

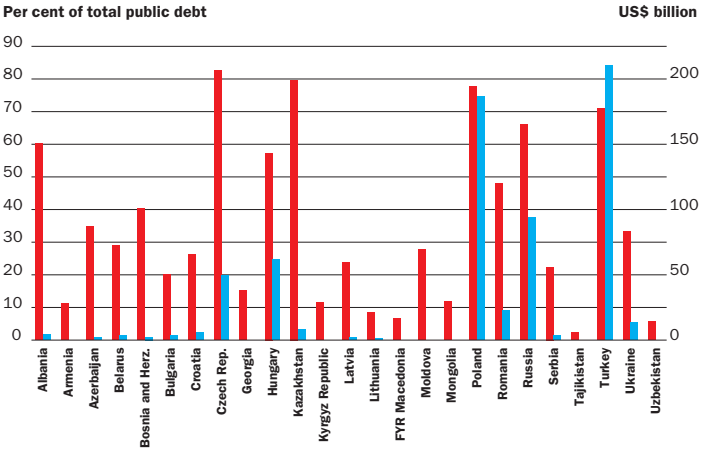
Or is it? Presumably, in a financial system in which interest rates are market-determined, there is a reason why local currency rates are high relative to foreign currency rates. In the case of Hungary, an International Monetary Fund (IMF) mission visiting the country in 2006 concluded that "the state of public finances—epitomised by endemic deficit overshooting—is undermining economic stability and growth prospects" and warned of "the risk of a fiscally-induced crisis".[10] High forint interest rates reflected the possibility of a crash of the currency and a possible associated spike in inflation. Consumers borrowing in forints would have been protected from the consequences of such a crash, while consumers borrowing in euros would have seen the local currency value of their debts rise sharply. In the event, the government began implementing a fiscal consolidation programme and there was no crash (until 2008 – in the context of the global financial crisis). However, the possibility was real at the time. Nevertheless, most borrowers chose to accept the risk of devaluation rather than paying a higher real interest rate as an "insurance premium" – but why?

The answer to this question is the holy grail of a large body of literature on "financial dollarisation" (so-called because most emerging market banking systems that rely on foreign currencies tend to denominate lending and deposit rates in US dollars, although euros and Swiss francs tend to dominate in most European transition countries). Aside from the possibility that some borrowers (particularly among households) do not fully understand the risks of foreign currency borrowing,[11] explanations for financial dollarisation in the transition region may be grouped in three broad categories, as follows.[12]

1. Most consumers and corporations might not want to pay the "insurance premium" because it was in fact excessive. In the case of Hungary, where the difference in real interest rates between forint and foreign currency lending was as high as 10 percentage points during the mid-2000s, this explanation has some plausibility. What might generate such excessive spreads? The answer given in the literature points to the role of rapid credit growth coupled with relatively low levels of financial development. In an environment in which consumers are eager to borrow and banks are keen to lend – as a result, for example, of macroeconomic stabilisation and/or structural reforms, accession to the European Union, or fight for market share between incumbent banks and new entrants – local bank funding may not be enough to finance credit demand. At a time of ample global liquidity, this means that lending will be mostly foreign-financed. With banks unwilling (or unable, because of regulatory restrictions) to take foreign currency risk, the result is cheap lending in foreign currency.[13]

[9] For example, US$ lending rates were 26 per cent in Tajikistan and 21 per cent in Azerbaijan in June of 2010, compared with about 10 per cent in Georgia.
[10] See IMF (2006).
[11] In principle it should be possible to deal with this problem through financial literacy campaigns and by requiring banks to disclose the risks of foreign exchange borrowing. Several countries, including Hungary, Kazakhstan, Poland and Turkey, have such requirements by now (see Box 3.6).
[12] See Zettelmeyer, Nagy and Jeffrey (2010) for a survey.
[13] See Luca and Petrova (2008), Basso, Calvo-Gonzalez and Jurgilas (2007), Brown, Kirschenmann and Ongena (2009) and Bakker and Gulde (2010).

Chart 3.5
Public sector debt in local currency

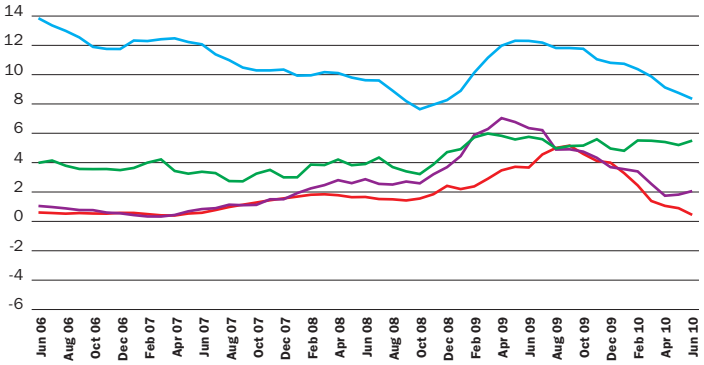


Share of public debt in local currency (left axis) **Local currency public debt (right axis)**

Sources: IMF country reports and *International Financial Statistics*, national authorities.
Note: Data refers to end-2009. For Belarus, Bosnia and Herzegovina, Bulgaria, Czech Republic, Latvia, FYR Macedonia and Uzbekistan, data reflects estimates for 2009.

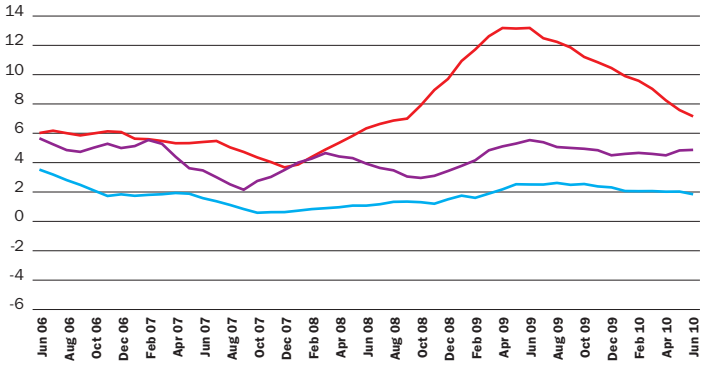
Chart 3.6
Differential between local currency and foreign currency lending rates, June 2006-June 2010

3.6a CEB countries



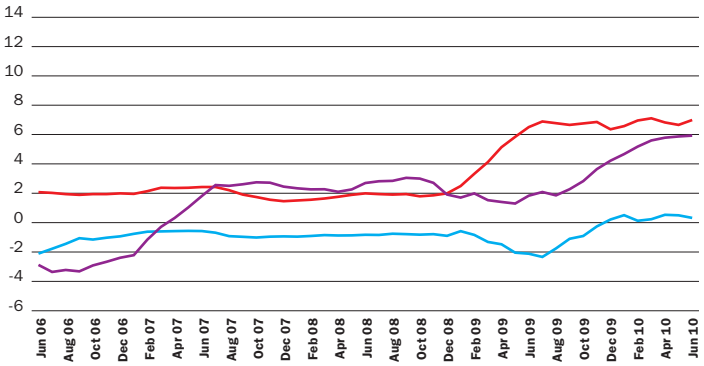
Lithuania **Hungary** **Estonia** **Poland**

3.6b SEE countries



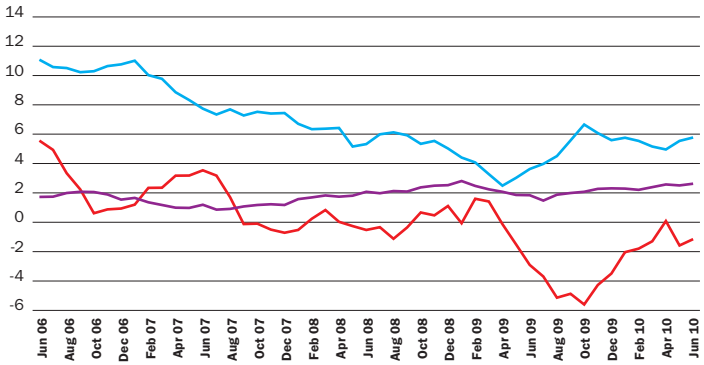
Romania **FYR Macedonia** **Albania**

3.6c EEC countries



Belarus **Azerbaijan** **Armenia**

3.6d Central Asian countries



Tajikistan **Mongolia** **Kazakhstan**

Sources: EBRD calculations based on CEIC Data Company and national central bank data.
Note: Charts show six-month moving average of interest differentials, calculated using one-year lending rates.

2. Borrowers might prefer foreign currency borrowing because they do not expect to fully bear the associated risks or, alternatively, because they do not fully receive the benefits of the decision to borrow in local currency. For example, foreign currency borrowers may assume that the government will come to their rescue if they face insolvency as a result of devaluation, particularly in countries with commitments to fixed or stable exchange rates. In that case, part of the risk of their decision to borrow in foreign currency would be borne by the taxpayer. Even when this is not the case, the decision to borrow in local currency may imply a social benefit (by making the economy less vulnerable) that the borrower is not fully compensated for. Because of either or both of these "distortions", borrowers may opt for the cheaper form of borrowing. The extra risk that this implies seems worth it from a private perspective, even if not from a social one.[14]

3. It is conceivable that people prefer to borrow in foreign currency simply because it is the less risky strategy in an environment in which inflation is hard to predict. The key point is that although people's incomes and corporate revenue are generally denominated in local currency units, these fluctuate with inflation. When inflation is very volatile, borrowing in foreign currency may be preferable to borrowing in local currency at fixed nominal interest rates, because it helps firms and individuals hedge against inflation risk (see Box 3.1).[15] An even better hedge, of course, would be inflation-indexed lending, but this requires a reliable index. In the absence of such an index, denominating financial contracts in foreign currency is a way of approximating inflation indexation – but with the disadvantage of exposing borrowers to abrupt fluctuations in real exchange rates (that is, exchange rate movements that are not passed on to domestic prices and wages). These could be the result, for example, of a currency crisis.

Understanding which of these three broad categories applies in the case of a particular country is critical for developing a successful strategy for expanding the use of local currency. For example, if the reason for foreign currency borrowing lies in the first two – which are both linked to mispricing of risk – then regulation can surely be helpful. This is particularly true for explanations in the second category, which are based on the premise that there is a discrepancy between social and private risks faced by individual foreign currency borrowers. Regulation can in principle close that gap by making foreign currency borrowing more expensive, and align private incentives with social welfare.

Box 3.1
Lack of inflation credibility as a cause of foreign currency borrowing: an algebraic example[16]

Imagine a country in which the central bank has made progress in reducing inflation to a low level. For the sake of simplicity, assume that inflation is currently zero. However, the central bank does not have a good track record in controlling inflation. As a result, inflation is expected to rise again to a high level –π– in the future with some probability, denoted p.

Suppose that a firm needs a long-term loan – I – from a bank to finance production. That production generates a real stream of revenue – r – (expressed in today's currency units) in the future. Assume that $r \geq I$, and that the firm's real revenue is sufficient to cover repayment of the loan.

The bank offers the firm a long-term loan at a fixed interest rate – R. Assume for the sake of simplicity that there is no credit risk and that the bank sets its lending rate to equal expected inflation: $R=p\pi$. In this case, the firm would need to repay its original loan, I , plus interest, RI, regardless of what happens to inflation. Because $R=p\pi$, it will hence end up paying $(1+p\pi)I$.

If inflation turns out to be high, this is good news for the firm, as its nominal revenues – $(1+\pi)r$ – will also be high and will exceed its repayment. However, if inflation remains low, the firm's nominal revenues are just r. In this case, the firm may not be able to repay, because it is locked into an interest rate that is high compared with its revenue. If $(1+p\pi)I>r$, the firm will go bankrupt in the low inflation state.[17] Anticipating this possibility, it may not want to borrow at fixed nominal rates in local currency in the first place.

The solution is for the firm to borrow long term, but at an interest rate that is indexed to inflation. If inflation turn out high, the firm repays $(1+\pi)I$. If inflation is low (zero in this example) it just repays I. Since the firm's nominal revenue will also depend on inflation – it will be $(1+\pi)r$ if inflation is high and r otherwise – this means that the firm will always be able to repay (since it was assumed that $r \geq I$).

In practice, inflation indexation may be difficult (for example, because no reliable official inflation index exists). In such circumstances, indexation to the exchange rate (or equivalently, foreign currency lending) may be an alternative to inflation indexation. Assuming that the high inflation state is accompanied by a devaluation of the domestic currency, this will lead to higher local currency liabilities when inflation and revenues are high and to lower local currency liabilities when they are low. If the exchange rate devalues exactly in the amount of inflation, then foreign currency lending will produce the same results as inflation-indexed lending.

In reality, of course, the correlation between inflation and exchange rate movements is not perfect. The exchange rate can move abruptly for reasons entirely unrelated to domestic inflation shocks – for example, a sudden stop in capital inflows. This is what makes foreign currency lending so problematic for firms selling domestically. Nevertheless, in environments in which inflation is very volatile, this may still be the lesser of the two problems from the domestic borrower perspective.

[14] Studies that relate foreign currency borrowing to actual or perceived state support include Dooley (2000); Burnside, Eichenbaum and Rebelo (2001); Schneider and Tornell (2004); and Rancière et al. (2010). The idea that foreign currency borrowing involves a social externality is attributable to Korinek (2009).

[15] The key reference is Jeanne (2003). See also Rajan and Tokatlidis (2005), and Ize and Levy Yeyati (2003) for a related argument about deposit rather than loan dollarisation.

[16] This box follows the logic of Jeanne (2003).

[17] Note that if the bank took this possibility into account when setting its fixed interest rate – that is, if it had taken into account credit risk – then this would make a default in the low inflation state even more likely, since the interest rate R would have been set even higher.

However, regulation may not be sufficient, at least not without additional supporting measures, if the main reason for foreign currency borrowing is lack of financial development (as implicitly or explicitly assumed in the first category). In that case, what is needed is targeted institutional and legal reform creating or expanding local currency capital markets, aided by the presence of large and regular benchmark borrowers in the public sector, and investors (such as pension funds) that can provide liquidity and impetus.

Regulation might in fact be counter productive if the deep reasons why firms and individuals choose to borrow in foreign currency are inflation volatility and lack of monetary policy credibility. While regulation that prohibits foreign currency borrowing or makes it very expensive may succeed in reducing its use, it will do so at the price of either reducing credit and financial intermediation or forcing borrowers and lenders to take excessive inflation risk, or both.

In addition to regulation and local capital market development, a third potential remedy for excessive use of foreign currency is macroeconomic policy and macro-institutional reform. To use a medical analogy, macroeconomic policy reform is rather like a broad-spectrum antibiotic: whatever the cause of the foreign currency "infection", macroeconomic reform helps, although it may sometimes be less effective than a more specialised remedy. If the cause of financial dollarisation is high inflation volatility and lack of monetary policy credibility, then reform of macroeconomic institutions – both monetary and fiscal, since monetary policy is rarely credible when countries do not have sound public finances – is *the* remedy. But macroeconomic policy can also help in the other two instances. For example, when foreign currency lending is exacerbated by credit booms driven by foreign financing, fiscal policy can have a dampening effect. Similarly, if lending is fuelled by the expectation that foreign currency risks will be absorbed by the government, a floating exchange rate can suggest that the government does not "guarantee" any particular rate level and that firms and households borrowing in foreign currency do so at their own peril. Indeed, there is evidence that allowing exchange rates to float was a key step in the financial "de-dollarisation" in several Latin American countries.[18]

A recent EBRD survey[19] examines the empirical evidence on the three explanation categories for foreign currency lending in the transition region and finds that all three have some support. The best predictors of the share of foreign currency lending in the transition region are:

- the differential between local currency and foreign currency interest rates
- exchange rate volatility and/or the exchange rate regime (stable or pegged exchange rates tend to have higher rates of foreign currency lending, which supports the view that pegs act as implicit guarantees that governments will shield firms and households from foreign exchange risk)[20]
- inflation volatility
- foreign financing of the domestic banking system (consistent with the idea that foreign currency lending is fuelled by the lack of local currency funding on the one hand and abundant foreign financing on the other).[21]

A new study based on the EBRD's 2005 Banking Environment and Performance Survey (BEPS) corroborates many of these findings using bank-level information on the currency composition of bank loans by 193 banks in 20 transition countries (see Box 3.2). It shows that the currency composition of bank deposits was a critical determinant of the currency composition of lending (for a given macroeconomic environment). The study also indicates that take-overs of domestic banks by foreign banks did not seem to change their propensity to lend in foreign currency, suggesting that foreign bank ownership was not in itself a critical factor driving foreign currency lending, at least not during the 2001-04 period on which the study is based. This finding does not exclude the possibility that foreign funding may have contributed to dollarisation or euroisation, since both foreign- and domestically owned banks had access to such funding (for example, through the syndicated loan market). The study concludes that a bank's local deposit base and the macroeconomic environment are the most important determinants of the currency composition of its lending.

Fundamental determinants of local currency finance: how countries differ

The discussion so far suggests some fundamental domestic factors that determine foreign currency lending in transition countries:

- macroeconomic conditions, particularly monetary and fiscal policy credibility, affecting inflation volatility and the interest differential, and exchange rate volatility
- bank access to local currency funding, which depends on its local currency deposit base (itself a reflection of macroeconomic and other factors), and the development of local currency money and bond markets.

Regulation may be an additional influence, and may indeed be part of the policy response to high financial dollarisation. However, the literature has not found a strong regulatory impact on foreign currency use in the transition economies, perhaps because systematic regulatory measures are relatively new in the region.[22] This section therefore concentrates on a comparison of transition economies with regard to macroeconomic conditions and local currency market development.

Macroeconomic conditions

Inflation volatility is the key risk that may prevent individuals and companies whose incomes fluctuate with inflation to enter into debt obligations denominated in fixed local currency units (see Box 3.1). Chart 3.7a, b and c compare inflation volatility for a number of transition countries, based on monthly year-on-year inflation data, using a standard statistical technique that allows an estimation of volatility at each point in time.[23] Three groups of countries can be distinguished:

- Many countries have had relatively low inflation volatility consistently over the last decade (see Chart 3.7a). This group includes most (but not all) CEB and SEE countries, including some that are not shown (to avoid overcrowding the chart) such as Poland. The units on the scale represent a standard deviation, expressed in percentage points of annual inflation. Therefore, average fluctuations of inflation for these countries were within about 5 percentage points in either direction and never exceeded 10 – notwithstanding an up-tick in 2008, when inflation rose in response to commodity price increases and overheating in some countries and then fell during the crisis.

[18] See Kamil (2008) for Latin America.
[19] Zettelmeyer, Nagy and Jeffrey (2010).
[20] IMF (2010) corroborates this finding.
[21] See Luca and Petrova (2008), Brown, Ongena and Yeşin (2009), Rosenberg and Tirpák (2008), Basso, Calvo-Gonzalez and Jurgilas (2007), EBRD (2009, Chapter 3) and Brown and De Haas (2010, summarised in Box 3.2).
[22] See Luca and Petrova (2008) and Rosenberg and Tirpák (2009). Note that regulation may, to some extent, have deterred a rise of foreign currency lending during the 2005-08 credit boom; in particular, Poland's "Recommendation S", described below and in more detail in Box 1 of Zettelmeyer, Nagy and Jeffrey (2010).
[23] Namely, a Generalised Autoregressive Conditional Heteroskedasticity or GARCH process. See, for example, Campbell, Lo and MacKinlay (1997), Chapter 12.2.

Box 3.2
Bank-level evidence on foreign currency lending in transition countries

A recent study used the EBRD Banking Environment and Performance Survey (BEPS) – conducted in 2005 among 220 banks in 20 transition countries – to analyse the determinants of foreign currency bank lending. The BEPS collected information on the loan and deposit structure of each bank in the years 2001 and 2004. These data were matched with information from Bureau van Dijk's BankScope database and to macroeconomic indicators.[24]

A cross-sectional analysis of bank lending in 2004 suggests that a number of bank- and country-level factors seem to influence the foreign currency lending of banks. The currency composition of a bank's deposits turns out to be a key determinant of the currency composition of its loans. A 10 per cent increase in foreign currency (FX) deposits corresponds to an increase in the proportion of FX loans of 6 per cent. Macroeconomic factors also matter (over and above their potential effect on FX deposits). Interest differentials in relation to the eurozone and domestic inflation volatility encourage FX lending to both firms and households. Exchange rate volatility, by contrast, dissuades clients from taking FX loans. In addition, compared with domestic banks, foreign banks seem to lend significantly more in FX to corporate clients but not to households (see Table 3.2.1). Newly established foreign banks (categorised in the table as "greenfields") and foreign banks that derive from a take-over have 12 per cent and 17 per cent more of their corporate loan portfolios in FX, respectively.

In principle, the higher FX share of corporate loans at foreign banks could have two explanations. First, the characteristics of foreign banks' corporate clients could be different (for example, in terms of export orientation or ownership structure) in ways that cannot be measured with the available data. That is, foreign banks may be lending more FX to corporate clients because their clients are better suited to FX borrowing than the clients of domestic banks. Alternatively, foreign banks may be keener to lend in FX because of better access to foreign financing (for example, through parent banks).

To help decide which explanation is right, the study compares 28 domestic banks that were acquired by foreign financial institutions between 2000 and 2002 to 98 similar banks that were not taken over. If foreign banks lend more in FX compared with domestic banks (for example, because they have access to abundant foreign funding or mistrust host-country macroeconomic policies), an increase in FX lending after a domestic bank is acquired by a foreign strategic investor might be expected. The analysis does not detect any such effect. While new subsidiaries may get access to FX-denominated parent bank funding, this does not have a large or immediate effect on the proportion of FX lending.

In summary, the analysis suggests that both the macroeconomic environment and the currency structure of bank deposits are key determinants of FX lending. In contrast, it does not support the proposition that foreign banks, driven by their access to cross-border wholesale funds, contribute more to euroisation of credit than domestic banks. Importantly, this does not mean that foreign financing of domestic credit expansion does not exacerbate FX lending – a proposition for which there is support from other studies based on country-level data.[25] Rather, it suggests that in an environment of relatively easy international funding through wholesale capital markets (that is, syndicated lending and bonds), foreign ownership may not have had a very important effect on the ability of banks to serve as a conduit for foreign financing.

Table 3.2.1
Explaining foreign currency lending by banks

Dependent variable	**FX loans corporates**			**FX loans households**		
Model	(1)	(2)	(3)	(4)	(5)	(6)
Foreign greenfield	18.10** [7.694]	4.555 [10.86]	12.16** [6.018]	17.49* [9.993]	-1.229 [12.73]	-7.909 [9.672]
Foreign take-over	13.63** [5.689]	4.836 [10.85]	17.46*** [5.805]	11.870 [8.948]	5.254 [9.606]	2.738 [7.543]
Assets		0.844 [2.481]	-0.653 [1.450]		1.535 [2.185]	2.612 [1.929]
Loan size (corporate/households)		-0.228 [0.783]	-0.189 [0.628]		0.002 [0.888]	-0.100 [0.677]
Real estate loans (corporate/households)		0.003 [0.0861]	0.129 [0.0880]		0.259 [0.161]	0.311*** [0.101]
Wholesale funding		0.362* [0.179]	0.174 [0.150]		0.153 [0.117]	0.074 [0.219]
FX deposits		0.387** [0.150]	0.723*** [0.149]		0.631*** [0.172]	0.515*** [0.183]
Method	OLS	OLS	IV	OLS	OLS	IV
Country-fixed effects	yes	yes	yes	yes	yes	yes
R^2	0.39	0.58	0.70	0.46	0.63	0.69
# banks	179	132	110	174	138	112
# countries	20	20	20	20	20	20

Sources: BEPS survey, BankScope, IMF International Financial Statistics, Brown and De Haas (2010).
Note: The table shows results for regressions where the dependant variable is the share of bank lending to corporates and households in FX in 2004. The dummy variable *Foreign greenfield* = 1 for foreign-owned banks established from scratch. The dummy variable *Foreign take-over* = 1 for foreign banks that are the result of the take-over of a domestic bank. *Assets* is total bank assets (log US$). Loan size is the average loan size of the bank (in log US$) to corporate customers and households, respectively. *Real estate* loans is the share of real estate loans in all loans to corporate clients and households, respectively. *Wholesale funding* measures non-customer liabilities as a share of total bank liabilities (in %). FX deposits measures the share of FX-denominated customer deposits in all customer deposits (in %). Models 1-2 and 4-5 report OLS (Ordinary Least Squares) estimates. Models 3 and 6 report IV (instrumental variables) estimates in which *Wholesale funding* and Customer deposits in 2004 are instrumented with their values in 2001. All models include country-fixed effects. Standard errors are reported in brackets. In models 1-2 and 4-5 standard errors are adjusted for clustering by country. ***, **, * denote significance at the 0.01, 0.05 and 0.10-level.

[24] See Brown and De Haas (2010), "Foreign currency lending in emerging Europe: Bank-level evidence", paper prepared for the April 2011 panel meetings of the journal *Economic Policy*.

[25] See Rosenberg and Tirpák (2008) and EBRD (2009).

- The next group of countries also generally had fairly low inflation volatility, but were not quite as successful in keeping inflation stable in 2007-10. Some of these countries (Romania, Russia and Serbia) began the decade with very high volatility, but then stabilised their inflation rates over the next few years.
- The last group of countries had a much more pronounced rise in inflation volatility in 2007-10. Two of them – the Kyrgyz Republic and Tajikistan – also began the decade with very high volatility.

In summary, while all transition economies had fairly low inflation volatility during the steady growth years of the decade – before overheating and before the financial crisis – some have far shorter track records of stabilisation than others. Furthermore, in a handful of countries volatility rose sharply during the shocks of 2007-10. Inflation should therefore be more difficult to predict in those countries. To see whether this is the case, inflation projections from the IMF for one and two years ahead (published twice a year) were compared with actual inflation out-turns for the time period covered in Charts 3.7a, b and c. Chart 3.8 describes the average errors that IMF forecasters made for each country.

The cross-country differences are again substantial. In most CEB and SEE countries forecast errors were relatively small. Within the CEB group, the Baltic states and Hungary had larger forecast errors than the rest. Within the EEC group, Armenia (a low inflation volatility country according to Chart 3.7a) and Georgia enjoyed much more predictable inflation than the other countries. Inflation was clearly hardest to predict in Azerbaijan, Kazakhstan, Mongolia, Tajikistan, Turkmenistan and Ukraine, with average forecast errors in excess of 6 percentage points. This group largely overlaps with the high volatility countries in Chart 3.7c. (Turkmenistan was missing from the analysis because it lacks monthly inflation data.)

Lastly, an important factor in encouraging local currency use is the degree of exchange rate variability. Table 3.1 summarises two recent classifications of actual exchange rate regimes published by the IMF. In this respect, the transition region clearly has a long way to go. As of 2008, only 12 out of 30 countries (excluding Slovenia, which has belonged to the eurozone since 2007) were classified as managed or independent floats by the IMF, and only five as independent floats. It is also interesting to note that between 2006 and 2008 – the peak of the boom

Chart 3.7a Low volatility countries

Inflation volatility in transition economies

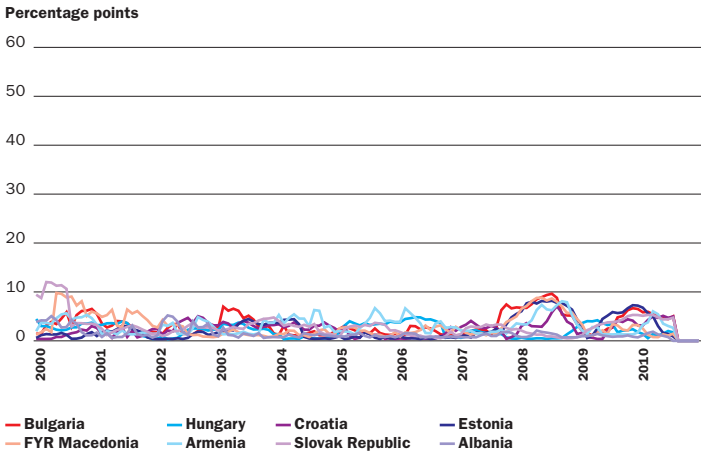


Chart 3.7b Medium volatility countries

Inflation volatility in transition economies

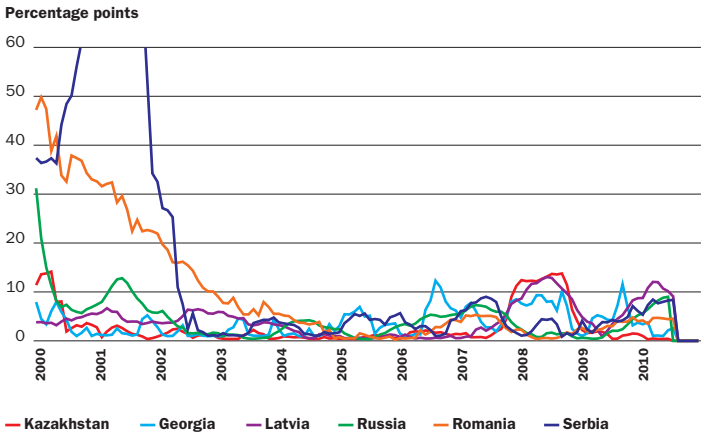
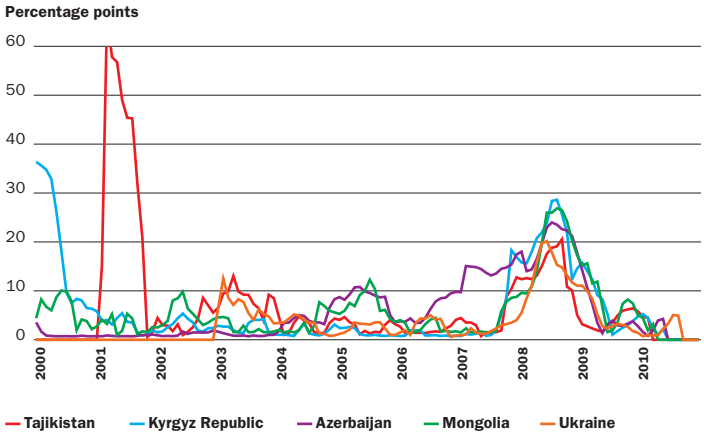


Chart 3.7c High volatility countries

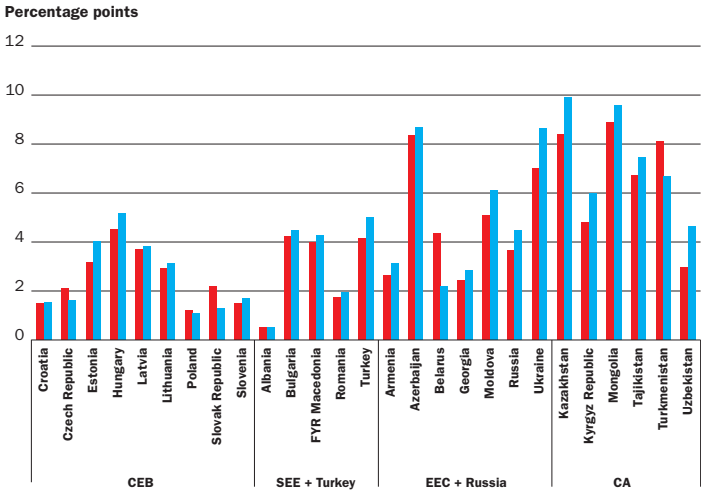
Inflation volatility in transition economies



Sources: EBRD calculations based on IMF *International Financial Statistics* and CEIC Data Company.
Note: The charts show the square root of the conditional variance of each country's inflation. Inflation is expressed as year-on-year changes of the consumer price index. The conditional variance is calculated using the predicted variance generated by a GARCH(1,1) regression, which estimates the variance of each month's error term as a function of the size and variance of the error term in the preceding month. The sample period underlying the regressions starts in the early 1990s and varies across countries depending on data availability. Data series from Ukraine and Tajikistan are shorter and start only in the early 2000s. Some extreme outliers were dropped or interpolated.

Chart 3.8

Average inflation prediction errors, 2000-09



Source: EBRD calculations based on IMF *World Economic Outlook*.
Note: For each country the chart shows the average deviation (root mean squared error, RMSE) between actual inflation and inflation predictions made one or two years in advance, respectively, in the IMF *World Economic Outlook*.

– the number of countries in this category declined, as many managed floats were reclassified as pegs. However, several other countries, including Armenia, Georgia, Kazakhstan, Moldova and Serbia, have moved towards greater exchange rate flexibility since the crisis. Armenia has been floating since March 2009. Kazakhstan widened its exchange rate band in early 2010. Serbia adopted a formal inflation targeting framework in 2009, although it has continued to intervene in the foreign exchange market in response to pressures on the dinar.

Local currency capital market development

There is evidence that constraints in the availability of local currency funding from banks contributed to foreign currency lending in transition countries as banks turned to foreign currency funding sources. One way to overcome this is for banks to further develop their local currency deposit base, particularly at longer maturities. While this is important, the growth and maturity structure of local currency deposits is partly determined by the pace of improvement in macroeconomic conditions (as described in the last section). Banks can also seek funding through local currency bond markets, which can in addition be direct sources of corporate local currency funding. Local bond markets are therefore critical for the development of local currency finance in the transition region.

While corporate bond markets are not well established anywhere in the region, some transition countries are much closer than others to meeting two necessary conditions for their development. These are the presence of an institutional investor base and the existence of well-functioning money and government bond markets.

Local institutional investors – primarily pension and mutual funds and insurance companies offering long-term savings products – are critical for the growth of local currency finance because they have an intrinsic interest in investing in local currency assets. They are therefore an important segment of the demand side of local currency markets. Chart 3.9 shows the extent to which such investors are present in some countries of the region for which data is available and in some advanced comparator countries. The chart shows that even the front-runner among the transition economies – Hungary – still lags far behind EU member countries such as Portugal, both in absolute amounts (in US dollars) and in terms of national GDP. Developing these investor bases is a matter of gradual entry and sector growth, but also depends on pension reform as well as the legal frameworks of non-bank financial sectors.

Well-functioning money and government bond markets constitute the other fundamental condition. These imply the presence of a market infrastructure that can be used by private as well as public issuers. Money and government bond markets also provide interest rate benchmarks that support the pricing, and therefore issuance, of private debt. In addition, they constitute channels for monetary transmission that make monetary policy more effective; and they reflect inflation expectations, thereby providing an indicator of the credibility of government monetary and fiscal policies. The longest liquid local currency government bond usually defines the maximum maturity of private issues. Money and bond markets are also the basis for the development of interest rate swap markets, which enable market participants to manage the risks associated with local currency debt instruments.

Table 3.1

Exchange rate regimes in emerging Europe and Central Asia

	Year	
Exchange rate arrangement	2008	2006
Exchange arrangements with no separate legal tender	Montenegro	
Currency board arrangements	Bosnia and Herzegovina Bulgaria Estonia Lithuania	Bosnia and Herzegovina Bulgaria Estonia Lithuania
Other conventional fixed peg arrangements	Belarus Croatia Kazakhstan Latvia FYR Macedonia Mongolia Russia Tajikistan Turkmenistan	Belarus Latvia FYR Macedonia Turkmenistan Ukraine
Pegged exchange within horizontal bands	Slovak Republic	Hungary Slovak Republic Slovenia
Crawling peg or band	Azerbaijan Uzbekistan	Azerbaijan
Managed floating with no predetermined path for the exchange rate	Armenia Georgia Kyrgyz Republic Moldova Romania Serbia Ukraine	Armenia Croatia Czech Republic Georgia Kazakhstan Kyrgyz Republic Moldova Mongolia Romania Russia Serbia Tajikistan Uzbekistan
Independently floating	Albania Czech Republic Hungary Poland Slovenia[1] Turkey	Albania Turkey Poland

Source: International Monetary Fund.
Note: The IMF's system for classifying exchange rate arrangements was redefined in 2009, including to sharpen the distinction between managed and free floating (defined as regimes with only exceptional foreign exchange market interventions). Under the new system, of the countries classified as "independently floating" in the 2008 classification, only the Czech Republic, Poland and Slovenia (as a member of the euro area) were considered "free floating" as of end-April 2009. Albania, Hungary and Turkey were classified as "floating", with exchange rates deemed to be "largely" market determined.
[1] Member of the euro area.

To gauge the development of money and bond markets, this chapter introduces two new indices. They are based on a combination of public sources and interviews conducted by the EBRD's Treasury department with money and bond market participants in the transition region and in some advanced countries (see Box 3.3).[26] Both focus on two main characteristics of the respective markets: basic market infrastructure and market liquidity. In the case of the money market, the key infrastructure element is a reliable interest rate index (or alternatively, as a partial substitute, a steady flow of government or central bank bills with a publicly observable, market-determined interest rate). The infrastructure of government bond markets comprises such elements as the existence of an over-the-counter market, a primary dealer network and the quoting of issues and prices on standard information platforms such as Bloomberg or Reuters. Market liquidity is gauged according to standard trade size (higher means more liquid) and bid-offer spreads (lower means more liquid) at various maturities. Higher scores are given for liquidity at longer maturities (see Box 3.3). The results are presented in Charts 3.10 and 3.11.

[26] The EBRD government bond market index overlaps with some categories of the GEMLOC indicator of "investibility" of local currency bond markets compiled by CRISIL on behalf of the World Bank since 2008 (see http://indices.markit.com/download/products/guides/CRISIL_investibility_report.pdf). The main differences are as follows. First, "investibility" is a broader concept that measures the attractiveness of local currency bond markets from the perspective of foreign investors, scoring not only market infrastructure and liquidity (which are the focus of the EBRD index) but also categories such as capital controls and taxation. Second, the liquidity component of the GEMLOC indicator is based on information from publicly available sources, whereas the EBRD index uses information gained from interviews with traders to overcome the limitations of publicly available information to enable the scoring of markets for which information is not publicly available. "Investibility" scores are available for Turkey and seven transition economies (Croatia, Hungary, Kazakhstan, Poland, Romania, Russia and Ukraine), as well as a number of other emerging market countries, but not for the remaining transition countries covered by the EBRD indices.

Box 3.3
Rating the development of local currency markets

Many countries in the transition region lack functioning money and government bond markets that are sufficiently developed to support the use of local currency debt in the financial system. This box proposes two new indices of market development, which are applied both to transition countries and (for comparative purposes) to some advanced countries. The indices attempt to measure a combination of market infrastructure and liquidity, using information collected by the EBRD Treasury department in interviews with market participants in each country in September 2010. Their rationale and methodology is described below. The dataset underlying the construction of the indices is available on the EBRD web site at www.ebrd.com/economics.

Index of money market development

The money market involves short-term (usually up to one year) debt instruments traded mostly by commercial banks. It supports the operations of these banks by enabling the reallocation of liquidity between them and, in countries with inflation- or interest rate-targeting monetary systems, transmits monetary policy signals to market interest rates. A liquid and transparent money market is essential for predicting interest rates and, therefore, for the pricing of local currency instruments both at short and longer maturities.

The EBRD index of money market development is based on two main components measuring the development of money market benchmarks and money market activity (see Table 3.3.1).

- *Money market benchmarks.* In advanced market economies the main reference for short-term interest rates is usually an index (such as LIBOR, for example) that aggregates individual banks' inter-bank money market quotations. In the absence of such an index, a similar benchmarking function can in part be performed by frequent auctions of short-term government securities (provided that they operate on commercial terms). Therefore, the index captures either the existence and reliability of a money market interest rate index or the regularity and frequency of government or central bank bill auctions. As a proxy for reliability, the index gauges the degree of utilisation of an index as a reference in banks' dealing with their clients and other capital market transactions and, most importantly, in derivative transactions (such as swaps and forward rate agreements). The proposed reliability test may not fully capture all potential uses of the formal money market indices, particularly since the crisis disrupted different markets with varying degrees of severity.

- *Money market activity.* The three main privately traded segments of the market are the unsecured inter-bank market and currency forward market (usually the most active) and the secured inter-bank market. Among the EBRD countries of operations, the money market in Poland is widely viewed as relatively sophisticated due to its liquidity, size and the variety of traded instruments. For this reason, the standard trade size and bid-offer spreads of the Polish market at different maturities are used to normalise the same indicators for other countries included in the index, thereby constructing a measure of liquidity. The sub-indices for each maturity are then summed, with greater weight given to indices for longer maturities. Countries are given credit in the index for the liquidity of either their unsecured or secured markets and, separately, for the liquidity of their foreign exchange forward markets.[27]

Government securities index

In addition to its financing function for governments, the government securities market plays an important role in setting benchmarks for longer term market interest rates, as governments are almost always the highest-quality borrowers at each point on the yield curve in their domestic currencies. High liquidity in the government securities market therefore enhances the role of the government yield curve as an economy-wide benchmark. In addition, government bonds that can be sold or purchased quickly and with low transaction costs are valuable tools for liquidity management by capital market participants. If highly liquid local currency assets are absent, domestic participants may be forced to resort to more liquid foreign currency-denominated assets. In addition, a government bond yield curve can promote awareness among participants in the domestic capital markets of the need to develop tools for interest rate risk management, such as interest rate swaps.

The EBRD government securities index therefore includes three main groups of components. The first two reflect market infrastructure at different stages of market development, while the third attempts to measure liquidity (see also Table 3.3.2).

- *Primary market.* For the market to develop, a minimum size of government securities denominated in the local currency is required, as well as regular and reasonably frequent government bond auctions. The index scores primary markets according to these three basic characteristics.

- *Basic infrastructure to support the secondary market.* The existence of an over-the-counter market is the most basic indicator of secondary market activity. Many governments appoint primary dealers of government securities, which are required to make bids in the primary auctions, quote prices, actively participate in the secondary market and share information with national treasuries about the state of the market. In addition, information flows on the market need supporting platforms or outlets to ensure that data on the stocks, issuance volumes and spreads is easily accessible.

- *Liquidity in the secondary market.* The size of transactions and the tightness of bid-offer spreads are defining features of more liquid markets. If standard transactions are small, participants may not be able to access sufficient liquidity quickly and at reasonable cost. Secondary market liquidity is therefore measured by combining information on the size of standard trades in the secondary market and the bid-offer spread at which this size can be transacted for short (1-3 years), medium

[27] This reflects the view that, while it would be desirable for countries to develop both secured and unsecured markets, they can to some extent substitute for each other (indeed, they tend to be liquid simultaneously or not at all). Therefore, differences between countries would be exaggerated if all scores were added up separately in an index. The foreign exchange forward market, on the other hand, can be an important additional tool. A liquid forward market allows local currency interest rates to be derived with reference to foreign currency interest rates, which is especially useful because liquid foreign exchange forward markets often span longer maturities than domestic inter-bank markets. Furthermore, it enables banks with significant foreign currency cash needs or surpluses to better manage balance sheet mismatches, which are often a problem in the EBRD's countries of operations, especially those where the credibility of the domestic currency is not fully established. For example, in some countries the currency denomination of banks' deposit bases can vary significantly depending on market conditions, and foreign exchange forward markets can be a crucial hedging tool.

Box 3.3 continued

(3-5 years), long (7-10 years) and ultra-long (over 10 years) bonds. In constructing the index, for each market the standard traded size is divided by the average size of a bond in each of the maturity brackets in order to obtain the proportion of the average bond that can be traded in one standard transaction. (This adjustment normalises both for the total size of each market and for the different maturity profiles of government bond markets.) This measure is divided by the ratio of the bid-offer spread for each country and the benchmark bid-offer spread (for Poland, as above) and then by the benchmark-adjusted normal market size in order to obtain a relative liquidity score. The bid-offer spreads are given greater weight in the calculation to capture the importance of this variable as a signifier of liquidity in the market. Lastly, a minimum threshold amount is defined, above which countries get credit for liquidity in a given maturity bracket. The liquidity scores for each maturity bracket are then averaged to form the index.

Significantly, the poll data underlying these liquidity measures represent a snapshot of liquidity conditions in different markets, and as such may be sensitive to market conditions and, to a lesser extent, to the sample of participants polled. The poll will therefore mix structural features with cyclical and other temporary influences, but by repeating it at regular intervals in the future it should be possible to disentangle these factors.

Table 3.3.1

Index of money market development: definition

	Subcomponent			
Main component	No.	Criterion	Coding[1]	Weight
Money market benchmarks	1	Existence of an interest rate index	1 if Yes; 0 if No	0.50
	2	Use of index as reference for loans	1 if Yes; 0 if No	0.75
	3	Use of index by market issuers	1 if Yes; 0 if No	0.75
	4	Use of index in derivative transactions	1 if Yes; 0 if No	2.00
			OR	
	5	Regular primary issuance of T-bills	1 if Yes[2] and if sum of 1 through 4 < 1; else 0	1
Activity in secured or unsecured market up to 3 months	6	Activity in secured inter-bank market	A_s [3 4]	Maximum score of the two components
			OR	
	7	Activity in unsecured inter-bank market	A_u [3 4]	
Activity in currency forward markets up to 12 months	8	Activity in currency forward market	A_f [3 5]	

[1] Data sources: IMF, national authorities and EBRD Treasury based on polls of market participants in the countries covered.
[2] Regular primary issue of T-bills is defined as issuing short-term bills at least every two weeks.
[3] For each market *i*, A_i equals sum of standard trade size in relation to per capita GDP for a given country divided by the sum of standard trade size in relation to per capita GDP for Poland, times the ratio of the bid-offer spread for Poland to the bid-offer spread for the country.
[4] The index is repeated and summed for overnight (15% weight), one week (15% weight), one month (20% weight) and three months (50% weight). The score for Poland is normalised to 4 points.
[5] The index is repeated and summed for overnight (12.5% weight), one week (12.5% weight), one month (15% weight), three month (20% weight), six month (20% weight) and one year (20% weight) forwards. The score for Poland is normalised to 2 points.

Table 3.3.2

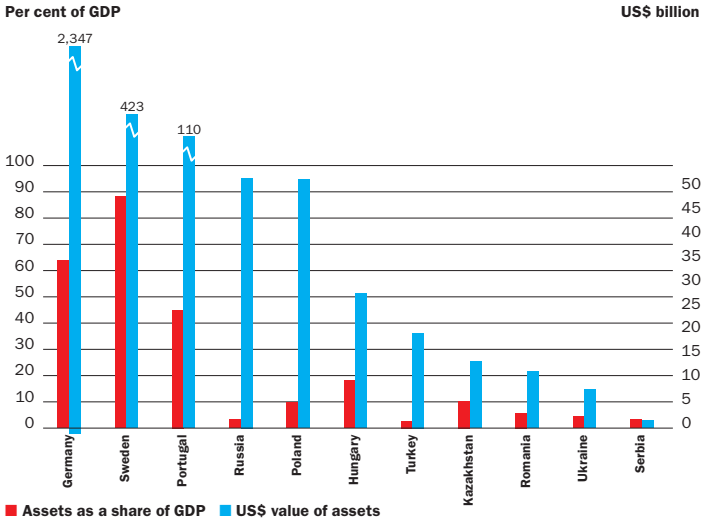
Index of government bond market development: definition

	Subcomponent			
Main component	No.	Criterion	Coding[1]	Weight
Primary market development	1	Minimum size	1 if size of market > US$ 25 million or > 1 percent of GDP; 0 if No	Equally weighted sum
	2	Regular issuance of government securities via auctions	1 if Yes; 0 if No	
	3	Frequent issuance of government securities via auctions	1 if issuance at least twice a month	
Secondary market development	4	Existence of over-the-counter (OTC) market	1 if Yes; 0 if No	Equally weighted sum
	5	Liquidity in short (1-3 year) market	1 if Yes; 0 if No	
	6	Bond quoted on Bloomberg or Reuters	1 if Yes; 0 if No	
Secondary market liquidity	7	Liquidity in short (1-3 year) market	$L_{(1\text{-}3)}$, if standard trade size (STS) > €0.5 million,[2] else 0	Equally weighted sum
	8	Liquidity in medium (3-5 year) market	$L_{(3\text{-}5)}$ if STS > €0.4 million,[2] else 0	
	9	Liquidity in long (7-10 year) market	$L_{(7\text{-}10)}$ if STS > €0.3 million,[2] else 0	
	10	Liquidity in ultralong (>10 year) market	$L_{(>10)}$ in STS > €0.2 million,[2] else 0	

[1] Data sources: IMF, national authorities and EBRD Treasury based on polls of market participants in the countries covered.
[2] For each maturity bracket *b*, L_b = (Standard trade size/average bond size) for a given country divided by (Standard trade size/average bond size) for Poland, times the ratio of the bid-offer spread for Poland to the bid-offer spread of the country raised to the power of 1.5. The score for Poland is normalised to 4.

Chart 3.9

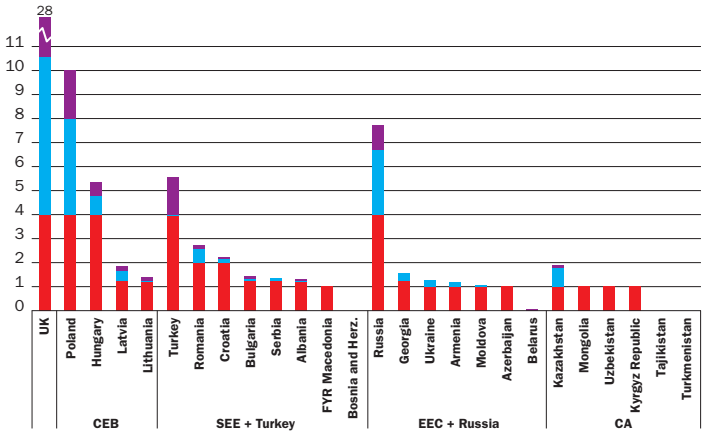
Assets of insurance corporations and pension funds



Sources: OECD, national authorities.
Note: Data refers to end-2008, except for Romania, where the data refers to end-2007. Numbers above the bars for Germany, Sweden and Portugal indicate total US$ asset values, as the height of the bars was truncated for these countries.

Chart 3.10

EBRD money market development index



Source: EBRD calculations based on information from country authorities and interviews with money market participants.
Note: See Box 3.3 for definitions and methodology. Number above the bar for UK indicates the index value, as the height of the bar was truncated in this case.

In Chart 3.10 the index for the money market is divided into three components measuring the presence and reliability of an interest rate benchmark, market liquidity at shorter maturities (secured and unsecured money markets up to three months) and liquidity in the currency forward market (maturities up to 12 months). Market liquidity is expressed relative to its level in the Polish market, which is considered relatively sophisticated. If a country's short-term money markets and longer-term currency forward markets are as liquid as Poland's, it earns four and two points, respectively. Since Poland also receives the maximum of four points for its interest rate benchmark, it scores 10 points in total. For comparative purposes the chart also includes one advanced country – the United Kingdom. Like Poland, it scores full marks on the interest rate benchmark, but its liquidity ratings are far beyond the chart scale resulting in a total score of 28 points.

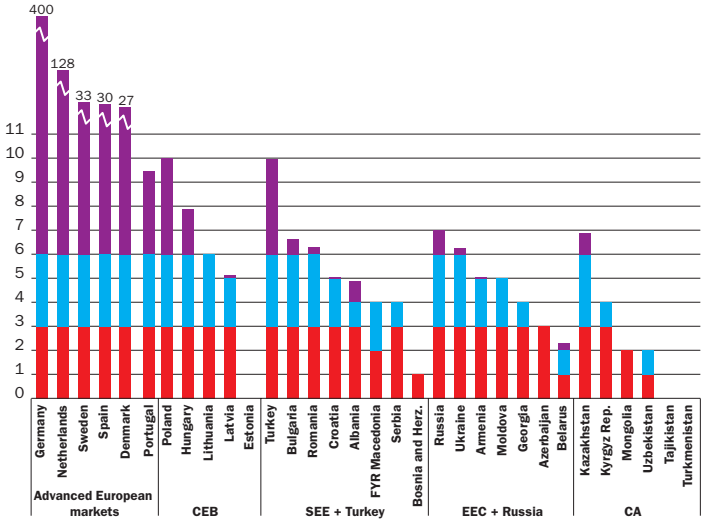
No other EBRD country of operations reaches Poland's level of money market development, although Russia comes close. Like Poland, it gets full marks on its interest rate benchmark (Mosprime; see Box 3.4), but its markets are somewhat less liquid. All other countries have essentially underdeveloped money markets. Kazakhstan has some liquidity in the shorter market, but scores low on the interest rate benchmark. (Although a Kazakh benchmark has been developed – Kazprime – it is not yet actively utilised by market participants.) Therefore, the country scores one point on account of a steady flow of primary government bill issues, in common with many other countries in the region. Romania does better on the interest rate benchmark (two points), but scores low on market liquidity.

Chart 3.11 presents the corresponding index for the government bond market in transition countries, Turkey, and six advanced comparator countries. In this case there are two infrastructure components that rate characteristics of the primary market (such as minimum size and the regularity and frequency of bond issues) and of the secondary market – each scoring up to three points. In addition, there is a secondary market liquidity measure, which is again defined with respect to Poland. A country whose secondary market is as liquid as Poland's earns four points in this component. Except for Portugal, the advanced country comparators significantly exceed Poland with respect to the market liquidity measure (100-fold in the case of Germany); for this reason, their total index values are again off the chart's scale. With regard to the rest of the transition region, Turkey is the only country to match Poland, followed by Hungary and then Kazakhstan and Russia.

The comparison between Charts 3.10 and 3.11 suggests that differences in government bond index scores between the top-performing countries and the rest are less extreme than in the case of the money market. This reflects the fact that basic market infrastructure accounts for six out of 10 points in the government bond index and many countries score full marks in this respect. However, secondary market liquidity is generally very limited even in most countries that have basic market infrastructure in place.

Chart 3.11

EBRD government bond market development index



Sources: EBRD calculations based on interviews with money market participants.
Note: See Box 3.3 for definitions and methodology. Numbers above the bars for Germany, the Netherlands, Sweden, Spain and Denmark indicate the index value, as the height of the bars was truncated for these countries.

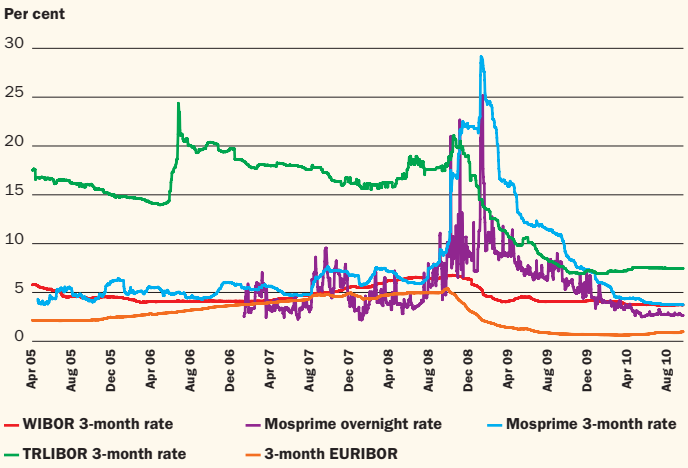
Box 3.4
Mosprime – Russia's benchmark interest rate

Credible money market indices are key to local capital market development. In Russia, the Mosprime interest rate has increasingly been used by market participants as a reference rate for lending, funding and hedging operations. Mosprime is the average yield for money-market time deposits offered by top-tier banks in the Russian market to financial institutions of comparable credit standing.[28] The index, launched in 2005, is quoted daily by Russia's National Foreign Exchange Association for several tenors: overnight; one week; two weeks; one month; two months; three months; and six months. At present, the market for longer term rouble deposits is not sufficiently liquid to provide indices for tenors above six months.

Mosprime has tended to exceed the benchmark rates for major reserve currencies (notwithstanding the appreciation of the rouble during the pre-crisis period) although it generally remained below the rate of consumer price inflation (CPI). However, with the onset of the financial crisis, Mosprime rose sharply and the gap between the overnight rate and the three-month rate widened drastically (see Chart 3.4.1). As in advanced economies and some other emerging economies, the rise in the benchmark interest rate reflected the drying up of liquidity and growing concerns about counterparty risks even with respect to top-rated institutions. However, the magnitude of the spike was much higher in Russia: three-month Mosprime surpassed the level of 20 per cent by mid-November 2008 and peaked at over 29 per cent in January 2009, in line with interest rate spikes observed in other countries trying to resist or manage a devaluation in the middle of a financial crisis.[29] In contrast, countries such as Poland or Turkey that allowed their exchange rates to float did not face similar money market pressures. A contributing factor in Russia was depositors' flight away from the rouble: the share of foreign currency household deposits in the total stock of deposits jumped by over 20 percentage points before declining again (see Chart 3.4.2).

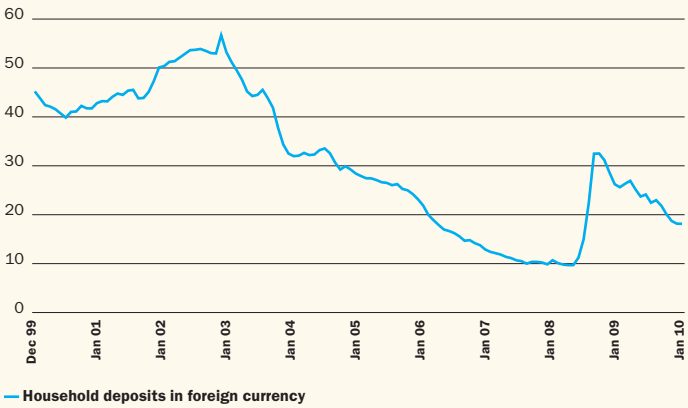
As the crisis eased and liquidity and confidence were restored, the Mosprime rate gradually declined and reached an all-time low of 3.75 per cent in August 2010.

Chart 3.4.1
Money market interest rates in Poland, Russia, Turkey and the eurozone



Source: Bloomberg.
Note: EURIBOR, Mosprime, TRLIBOR and WIBOR are the benchmark interest rate indices for the euro, Russian rouble, Turkish lira and Polish zloty money markets, respectively. Except for the Mosprime overnight rate, all rates shown are three month interest rate indices.

Chart 3.4.2
Share of foreign currency-denominated household deposits in Russia



Source: Central Bank of Russia.

[28] Mosprime is based on rates offered by 12 banks: Bank of Moscow, Citibank, Deutsche Bank, Gazprombank, HSBC, ING Bank, Raiffeisenbank, RBS, Sberbank, Unicredit, VTB and WestLB Vostok. The index is calculated as a simple average of rates offered by these banks after excluding up to two of the highest and up to two of the lowest quotes.

[29] For example, pressures on the currency led to a rise of overnight rates in Chile from about 15 to over 40 percentage points during August and the first half of September 1998, and money market interest rates rose by an average of 70 per cent in Sweden in September 1992.

Box 3.5
Transitions to local currency finance: country experiences

One way of arriving at policies for reducing the use of foreign currency in domestic financial systems is by determining the causes of financial dollarisation and devising reforms that address them. This is the approach that the chapter has taken so far. Another way is to examine the policies of countries that have managed to switch from foreign currency- to local currency-dominated financial systems and compare them with the experiences of less successful countries. In addition to providing a consistency check, the latter method can reveal policies that can help during the transition.[30]

Despite many failed de-dollarisation attempts, particularly in Latin America, there have been a handful of success stories, including Chile, Israel, Mexico and Poland in the 1990s and early 2000s, and more recently Egypt and Peru.[31] In addition, several countries that already had fairly low levels of dollarisation in lending, such as Brazil and Colombia, managed to reduce them further during this period. Their experiences are, by and large, consistent with the findings of the broader literature on dollarisation (particularly on the roles of price stability, exchange rate flexibility and local capital markets development), as follows:

- stabilisation from high and volatile inflation seems to be a necessary but not sufficient condition for de-dollarisation. In several countries, dollarisation remained stubbornly high, or even continued to increase, some years after inflation had fallen to moderate levels
- the adoption of genuinely floating exchange rate regimes, often in the context of formal inflation targeting, is what seems to have made the real difference in moving from merely stable to falling levels of foreign currency loans, particularly in Latin American countries
- falling dollarisation of bank lending went hand in hand with the gradual lengthening of public debt maturity. Within a few years (or less) of introducing formal inflation targeting regimes, most countries were able to issue local currency public debt issues of maturity above five years.

In addition to macroeconomic policy reforms and the creation of local currency interest rate benchmarks, successful de-dollarising countries typically also resorted to regulation, such as higher reserves requirement on foreign currency deposits, higher liquidity and/or provisioning requirements on foreign currency lending and, in some cases (Brazil, Chile, Colombia and Mexico), strong restrictions or prohibitions on foreign currency deposits and some forms of foreign currency lending. At the same time, failed de-dollarisation attempts (for example, in Bolivia and Venezuela, and in Peru in the 1980s) suggest that such restrictions do not work unless they are accompanied by sustainable macroeconomic stability and exchange rate flexibility. Instead of promoting local currency use, they merely lead to financial disintermediation and capital flight.[32] Even in Croatia, which has enjoyed consistently low inflation over the last decade while maintaining a stable exchange rate, marginal reserve and liquidity requirements on foreign currency or foreign-indexed loans did not succeed in sustainably reducing euroisation.

Lastly, several countries – most notably Chile, Colombia, Israel and, to a lesser extent, Mexico – introduced inflation-indexed deposit and lending instruments as substitutes for foreign currency instruments. Israel initially substituted its foreign currency public debt with CPI-indexed debt, and then gradually shifted from indexed- to non-indexed local currency debt. Chile undertook the most systematic and protracted experiment in indexation; following a disastrous currency and banking crisis in the early 1980s, foreign currency-denominated debt was converted to indexed debt and the money market and monetary policy framework were recast to promote CPI-indexation. Only in the late 1990s did Chile move away from an indexed financial system, after introducing formal inflation targeting, independent floating and a nominal policy benchmark interest rate.

There is no doubt that CPI indexation was instrumental in reducing dollarisation in these cases. At the same time, the experiences of Chile and Israel show that indexation can persist for a long time after inflation volatility has come down, and that moving from indexed- to non-indexed local currency finance requires additional policy effort. Nevertheless, CPI indexation was useful in achieving de-dollarisation before inflation volatility had subsided and, in the case of Chile, at a time when the central bank was still pursuing an exchange rate target.

[30] This box draws on Offenbacher and Stein (2003), Reinhart, Rogoff and Savastano (2003), Galindo and Leiderman (2005), Herrera and Valdés (2004), International Monetary Fund (2005, Box 3), Fernández-Arias (2006), Kamil (2008), Kokenyne, Ley and Veyrune (2010) and García-Escribano (2010).

[31] In addition, some countries, such as Argentina and Pakistan, undertook forced currency conversions in the context of financial crises.

[32] See Kokenyne, Ley and Veyrune (2010) and Fernández-Arias (2006).

In summary, most countries in the EBRD region, with the exception of Hungary, Poland, Russia and Turkey, are a long way from attaining well-functioning money and bond markets. Three problems stand out in particular: the absence of a functioning money market benchmark; the lack of meaningful currency forward markets; and lack of liquidity in the government bond market, particularly at longer maturities.

Strategies for developing local currency finance

In determining a policy agenda for developing local currency finance in the transition region, several important insights emerge from the preceding two sections.

- A group of countries, identified in Chart 3.7c and Chart 3.8, have found it difficult to predict inflation and did much worse than their peers in maintaining stable inflation in 2007-09. In these countries, the large-scale use of foreign currency in their financial systems may well be the lesser of two evils (given the current state of their macroeconomic institutions) compared with local currency finance (unless the former involves inflation indexation in some form – see below).[33]

- While there is strong evidence suggesting the importance of floating exchange rates in encouraging local currency use, many countries in the region remain committed to pegged exchange rate regimes – including euro pegs that are part of a broader developmental and integration strategy.

- The small group of transition countries with relatively high rates of local currency use in their domestic banking systems are, without exception, the same countries that outstrip their peers with respect to local capital market development. Both theory and evidence suggests that there is a connection between the two.

Based on these observations and the preceding evidence, the policy agenda for developing local currency finance could comprise three main strategies, depending on country circumstances and the preferences of policy-makers.

First, countries in which high inflation volatility makes foreign currency the preferred choice in the financial system should make the improvement of macroeconomic institutions and policies the main focus of their de-dollarisation agenda. This involves improvements in the quality and credibility of monetary policy frameworks (in particular, by moving to inflation-targeting regimes, coupled with flexible exchange rates) and the maintenance of solid public finances, possibly backed by fiscal rules.

Aggressive regulation discouraging foreign currency use is not advisable in these countries, because it may either unduly restrict credit, or push individuals towards local currency credit that may be even riskier due to the unpredictability of inflation. Instead, policy-makers should aim to improve consumer price index (CPI) measurement, lower inflation and make it more predictable, and take steps to develop a functioning money market. The latter requires a central bank commitment to act as a liquidity provider of last resort (for example, through repurchase agreements with banks) and a functioning interest rate benchmark.

When a reliable CPI index is present but inflation credibility is still limited, the authorities can seek to encourage CPI-indexed lending by issuing CPI-indexed government debt and by creating legal conditions that allow for CPI-linked private lending (in some cases, this may include adjustments to consumer protection laws, which may impede interest rate adjustments in response to high inflation). While CPI indexation will not by itself lead to stabilisation or capital market development, it helps borrowers and lenders manage macroeconomic risk while inflation is still volatile. Historically, CPI-indexation has been an important intermediate step in the de-dollarisation process in several countries (see Box 3.5).

The second strategy applies to those countries – which are likely to be in the majority in the transition region – that already have reasonable track records of inflation stability, and for whom the exchange rate regime represents a policy instrument that can in principle be employed for the development of local currency finance. This would involve continuing macroeconomic reforms and policy improvements (particularly moving towards independent exchange rate floats or at least managed floats, in the context of formal inflation-targeting regimes), regulation and local currency capital market development.

The main elements of this strategy are implicit from the previous section and Box 3.3. They involve improving market infrastructure – for example, through the creation of benchmark interest rate indices and by assigning primary dealers of government securities – and making money and government bond markets more liquid through a steady flow of public issues and a gradual lengthening of the yield curve. This does not mean that public debt needs to be high – only that in addition to fiscal objectives, public debt management needs to have market development and liquidity objectives in mind. As in the first strategy, CPI-indexed instruments can be useful in offering savers and borrowers an inflation-proof alternative to foreign currency instruments while the authorities build a track record of low and stable inflation.

The second strategy also applies to countries, such as Russia, Turkey and Poland, that already enjoy relatively modest levels of loan and deposit dollarisation and received relatively high scores in terms of market development – aided by the size of their markets as well as market development policies. Nonetheless, there remains room for improvement. In the case of Russia, market confidence in local currency remains fragile, as highlighted by a rapid dollarisation of the deposit base in late 2008 and early 2009 (see Chart 3.4.2); inflation levels and volatility remain relatively high by the standards of large emerging markets; and bond and asset management markets are relatively shallow. Reducing inflation volatility will require moving towards inflation targeting and floating exchange rates in the medium term. While Turkey's monetary policy framework is more conducive to local currency finance – it already allows its currency to independently float – it can go further in reducing targeted inflation levels. Lastly, neither Russia, Turkey nor Poland have liquid corporate bond markets. Developing these markets (for the benefit of banks as well as corporations) is the next frontier of local currency finance in these countries.

[33] This conclusion is backed by calculations that show that for most of these countries, national output expressed in foreign currency (euros or US dollars) would have been more stable over time than that expressed in local nominal currency units. See Box 2 in Zettelmeyer, Nagy and Jeffrey (2010).

Box 3.6
Regulation to encourage local currency lending

Many countries use bank regulation, and sometimes taxes penalising foreign exchange inflows, to discourage foreign currency borrowing. Measures of this type existed even before the crisis, and have been increasingly applied since.

Pre-crisis boom

During the pre-crisis boom period, several countries introduced limits on foreign exchange borrowing from abroad. This mainly took the form of higher reserve requirements on foreign currency lending and/or provisioning (for example, in Croatia, Romania and Serbia) or even quotas on such lending (in Croatia). Kazakhstan, meanwhile, introduced higher risk weights for foreign lending in capital adequacy calculations. In some cases these measures had the desired effect (most noticeably in Croatia), but for the most part credit expansion and foreign currency lending continued.

There were few macro-prudential or risk management requirements in transition countries. The exceptions included Poland, which set higher creditworthiness and disclosure requirements for residential loans in foreign exchange (under "Recommendation S on Good Practices Regarding Mortgage-Secured Credit Exposures", introduced in 2006), and Romania, where stricter loan-to-value (LTV) ratios were applied.[34]

An early cross-border supervisory intervention took place in early 2007 in the Baltic states. Growing concerns by Swedish home supervisors led Swedish banks to reduce sharply (foreign) financing to their subsidiaries in the three Baltic states, bringing to a halt the expansion in credit that had taken place almost exclusively in foreign exchange. This triggered a slowing of economic growth well in advance of the impact of the financial crisis.[35]

Crisis

With foreign capital inflows slowing or even reversing in late 2008, regulatory policies penalising foreign exchange inflows and foreign currency lending were generally relaxed or eliminated. Additional reserve requirements on foreign currency loans were reduced or ultimately abolished in Romania and Serbia. In countries supported by crisis lending by the IMF and European Commission, these policies were agreed under the European Bank Coordination "Vienna Initiative" to help international bank groups bolster their subsidiaries (as in Bosnia and Herzegovina, Romania and Serbia).

In a few countries policy reactions were sharply different, driven by the sudden perception of the risks associated with foreign currency lending rather than an attempt to minimise the credit crunch. Ukraine banned foreign currency lending to households in late 2008. Heavy regulatory disincentives were put in place in Kazakhstan in the form of differentiated reserve and liquidity requirements. However, these cases remained exceptions.

Recovery

Since the end of the acute phase of the crisis in mid-2009, regulatory attention in many countries has started to focus on the systemic risks arising from foreign currency lending. In countries where sharp devaluations led to increases in foreign currency debt servicing and associated defaults, this has often been part of a government- or central bank-led de-dollarisation plan (for example, in Georgia, Kazakhstan, Serbia and Ukraine).

A survey of policies in transition countries undertaken for this *Transition Report* revealed a wide variety of macro-prudential and administrative measures in place to discourage foreign currency lending. Chart 3.6.1 summarises the main measures in place in each country. The most frequently used instruments include:

- stricter eligibility criteria for potential foreign currency borrowers
- higher capital requirements on foreign currency loans
- higher reserve requirements on foreign currency loans
- limits on the open foreign currency position of banks (as part of bank prudential regulation).[36]

Poland introduced a regulation – "Recommendation T" – in February 2010 to restrict access to foreign currency loans for customers with lower incomes (and with debt payments exceeding 50 per cent of monthly income), to improve the use of credit registries and to provide more information to borrowers on risks, especially those related to foreign currency loans.

Hungary has been at the forefront of macro-prudential regulation of foreign currency lending. In March 2010 it assigned significantly higher LTV and debt servicing requirements for foreign currency mortgages, and set income requirements for unsecured consumer borrowing in foreign exchange that significantly limited access to such loans. These new regulations distinguish between euro lending (a prospective currency in Hungary in the future) and other foreign currencies, to which stricter limitations apply. The regulations have started to have an effect, with about 70 per cent of new household loans dominated in local currency in June 2010. They were combined with measures by the National Bank of Hungary to revitalise the covered bond market. The Hungarian government has also introduced an administrative measure to prohibit the registration of foreign exchange-denominated mortgages loans. At a time when local currency longer term lending alternatives have not yet sufficiently developed, this move has effectively frozen the mortgage market.

While most countries have by now introduced some form of regulation, only three – Hungary, Moldova and Ukraine – have imposed an effective ban on some forms of foreign currency lending.

[34] Poland's "Recommendation S" is described in Zettelmeyer, Nagy and Jeffrey (2010), Box 1.
[35] EBRD (2009, Chapter 2).
[36] The open currency position is the percentage difference between foreign currency liabilities and assets.

Box 3.6 continued

Some regulatory authorities have also become concerned about the exposure of bank groups to unhedged foreign exchange borrowing in their home countries. This is particularly true for Austria, which also has a long history of Swiss franc mortgage lending. Austrian regulators have strengthened restrictions for foreign exchange lending in their home market, and are extending some restrictions to the operations of the subsidiaries of bank groups based in Austria.

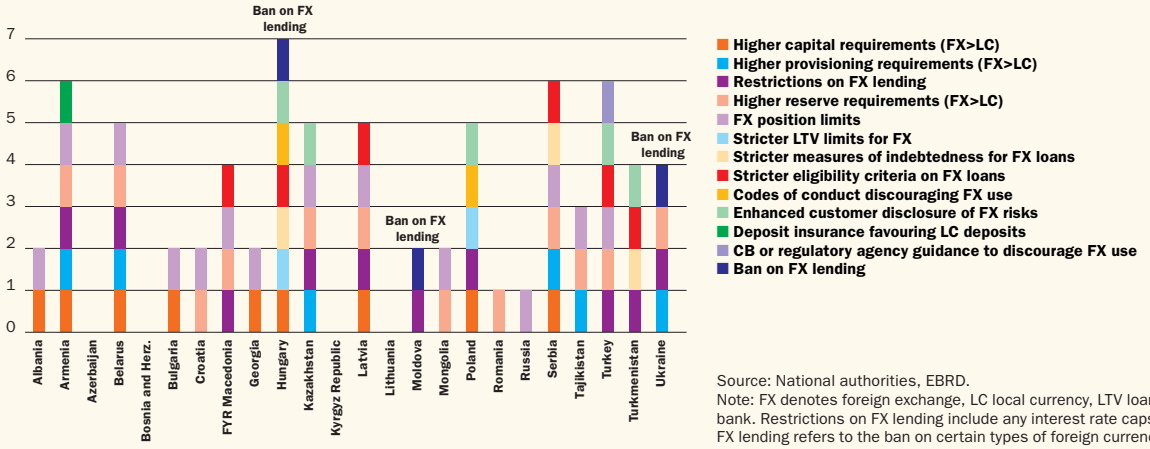
The attitude of private sector banks to regulation has evolved over the past year. The industry was initially opposed to virtually any regulation of foreign exchange borrowing, advocating voluntary improvements in internal risk management practices instead. This view has changed over time as non-performing foreign currency loans have increased; new entrants to the mortgage market, unencumbered by non-performing loans, have restarted some of the most risky forms of foreign currency lending and gained market share. Also, discussions with official authorities on local currency finance have evolved, particularly in the context of the European Bank Coordination "Vienna Initiative". As a result, there is now a broad acceptance of the need for coordinated country-by-country regulation.[37]

The regulatory measures discussed above deal with the issue of new credit, but do not address the large stocks of foreign currency debt in several countries. To the extent that future exchange rate volatility can be managed, the debt stock problem may decline over time. The challenge of managing it also depends on the maturity of outstanding stocks. For example, in Hungary the average maturity of household mortgages (which are mostly in foreign currency) is over 20 years, while in Serbia it is only around five years. Furthermore, some EU member states or candidate countries have the potential to join the eurozone in time, which may naturally eliminate the problem. (It would not, however, address the problem of Hungary's large mortgage loan stock in Swiss francs.)

In general, the crisis recovery phase has seen an intensification of regulation to discourage foreign currency lending to unhedged borrowers in a fairly measured way. There has not been a rush by countries (although with some exceptions) to overregulate. The need for fair and equal regulation is recognised by virtually all financial participants, including banks. Some cross-border coordination in the context of the Vienna Initiative has taken place, but more may be needed, including between country regulators.

Chart 3.6.1

Regulatory instruments to discourage foreign currency lending



Source: National authorities, EBRD.
Note: FX denotes foreign exchange, LC local currency, LTV loan-to-value ratios and CB central bank. Restrictions on FX lending include any interest rate caps on foreign currency loans; ban on FX lending refers to the ban on certain types of foreign currency lending or collateral registration.

[37] See the forthcoming report of the private-public sector Working Group on Local Currency Capital Markets under the European Banking Coordination "Vienna Initiative".

Lastly, a different strategy is likely to apply for countries with fixed exchange rates that are not willing to reconsider their exchange rate regimes, particularly aspiring members of the eurozone. While there are cases of emerging market countries (particularly large countries with reasonable track records of macroeconomic stability) that have reconciled high rates of local currency use with pegged or heavily managed exchange rates, there does not seem to be a precedent for a small, open economy that has managed to de-dollarise from high levels of foreign currency use while maintaining a peg. Consequently, the best option for these countries might be to manage the risks of foreign currency use through a combination of regulation (which prevents unhedged corporations and households from overborrowing in foreign currency) and prudent macroeconomic policies that secure sufficient fiscal and liquidity buffers to withstand a large shock to external financing.

As with all financial sector regulation, it is important to structure regulatory measures so that they do not stifle desirable credit creation; they address country-specific causes of excessive foreign currency lending; and they involve cross-border coordination to avoid easy circumvention (for example, by borrowing directly in the home country of an international banking group or its subsidiary in a neighbouring country rather than its local subsidiary). With this in mind, several forms of regulation can be useful.

- Rules requiring banks to disclose the risks associated with foreign currency lending should be standard, even in those countries where inflation volatility may impose even bigger risks. (More generally, clients could be advised on the relative merits of various forms of borrowing depending on their bank balances and income structures.)

- Where the structure of bank funding or implicit guarantees (for example, associated with pegged exchange rates) leads to an underpricing of foreign currency loans, this can be corrected by differentiating reserve and capital requirements or provisioning rules according to the currency composition of bank assets.

- Banks can be asked to differentiate their lending policies in a way that takes the currency composition of their borrowers' loans and income sources into account. Higher standards of creditworthiness would need to be applied to unhedged foreign currency borrowers.[38]

In contrast, bans of foreign currency lending will generally do more harm than good. Given that local currency lending instruments are not well developed, such action is likely to result in a freeze in credit. Also, it does not address the causes of the lack of local currency finance development.

Many countries in the transition region have by now adopted regulatory measures that fall into (and sometimes go beyond) the three categories described above (see Box 3.6). To be successful, national authorities will need to communicate both with each other and with home country regulators, and ensure that regulatory measures are accompanied by capital market development and/or (at a minimum) supportive macroeconomic policies. The latter is particularly important, since pre-crisis credit booms in foreign currency have left countries with a large stock of foreign currency debt that may take years to clear.

Given that memories of the crisis are still fresh, local currency interest rates are declining and international forums are increasingly focused on financial sector reform,[39] the development of local currency finance in the transition region should be off to a good start. As external pressures recede and other problems – particularly fiscal issues – gain prominence, the challenge will be to sustain this development.

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[38] In principle, banks could voluntarily coordinate on more conservative lending standards. However, this may be difficult as new entrants seek market share. For this reason, established banking groups have recently been supportive of regulation of foreign currency lending as a means of levelling the competitive environment.

[39] See European Banking Coordination "Vienna Initiative" (2010). For background on the Vienna Initiative, see EBRD (2009, Box 1.4).

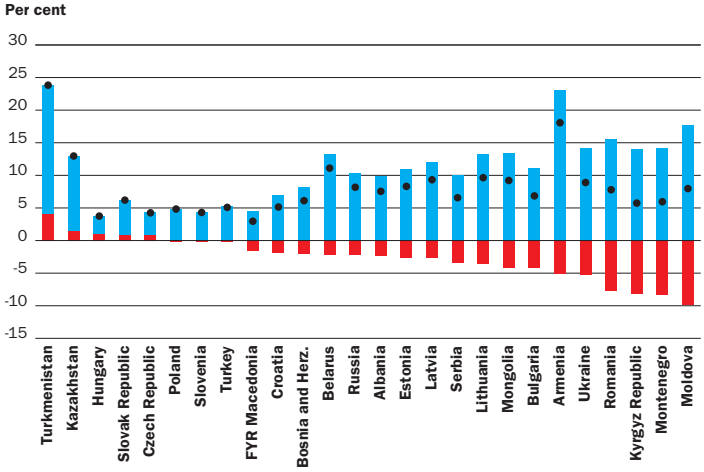
Chapter 4
Invigorating trade integration and export-led growth

During the past decade, transition economies forged close trade ties with neighbouring countries and new trading partners. Much of the resulting surge in exports, however, was based on factors that were unique to the decade: a low initial unit labour cost, new free-trade agreements and high world economic and trade growth. To deliver similar export growth in the future, policy-makers need to create an environment conducive to exports. This will be all the more important as domestic demand, the other source of growth, will likely remain weak for the foreseeable future.

A salient feature of the pre-crisis decade was the central role of domestic demand as a driver of growth in most EBRD countries. This was to some extent a natural consequence of transition: in planned systems, domestic consumers were heavily underserved and property prices generally undervalued. As the transitional recession came to an end in the mid-1990s, consumption growth rose and investment picked up sharply, particularly in underdeveloped retail, services and construction sectors. Chart 4.1 shows that domestic demand grew at double-digit rates annually in many countries during the boom years of 2000-08, while net exports were negative except for some central European countries and two natural resource-rich countries (Kazakhstan and Turkmenistan).

However, as the transition region emerges from the crisis, a return to this growth pattern looks neither feasible nor desirable. While domestic demand growth before the crisis partly reflected needed structural change, it was also exacerbated by easy global financial conditions and expectations of fast integration with advanced European economies. This driver of demand will be missing for some time: unlike other emerging markets, most countries in the transition region have not received large new inflows in the wake of the crisis, and are unlikely to do so in the foreseeable future (see Chapter 2). Even if inflows did return on a large scale, policy-makers should – and likely would – take action to dampen their impact. While capital inflows and related credit booms supported growth before the crisis, they also created vulnerabilities in the form of large current account deficits and rapidly increasing levels of corporate and household debt, often in foreign currency. Mindful of these consequences, policy-makers will want to use fiscal policy and macro-prudential instruments to lean against a resurgence of growth that is overly reliant on domestic demand.

Chart 4.1
Contribution of net export and domestic demand to average annual real GDP growth, 2000-08



Source: IMF *World Economic Outlook*, October 2010.
Note: The contribution of net exports to real GDP growth is defined as the average change in real net exports between 2000 and 2008, divided by real GDP in 2000. The contribution of domestic demand to real GDP growth is defined as the difference between average annual real GDP growth and the contribution of real net exports.

As a result, exports will need to become a much more prominent driver of growth if the convergence process is to continue. As this chapter will show, this is true not only insofar as exports are a critical source of demand, allowing more balanced growth than has been typical in the past decade, but also because they are an important motor of innovation, and therefore of higher sustainable long-term growth.

What are the chances of vigorous export-led growth in the transition region? The analysis that follows gives some grounds for optimism, but also highlights significant challenges. On the one hand, the chapter shows that export growth in the transition region over the past decade has in fact been highly dynamic, and in line with leading Asian performers such as China. On the other hand, it turns out that this success (which is rarely fully recognised, perhaps because export growth was overshadowed by even faster import growth) was caused in part by factors that were unique to the last decade: low initial unit labour cost (ULC); a series of important free trade agreements; and rapid global economic expansion. To avoid a slow-down in exports as an engine of growth, the region will therefore need to make efforts in addition to dismantling tariff barriers: surmounting non-tariff obstacles to trade and improving the institutional environment.

The chapter begins by documenting export developments since about 2000. Next, using firm-level data for the EBRD region, it analyses some of the potential gains from export activity for productivity-enhancing innovation that is ultimately the foundation of sustainable growth. Lastly, it presents cross-country evidence on the measures that policy-makers could take to create an enabling environment for export expansion.

Export performance since 2000

Over the past decade the transition region has expanded into global trade networks in terms of both volume and reach. Amid a surge in world exports (see Chart 4.2a), the region's share increased from under 5 per cent in 2000 to almost 10 per cent in 2008 (see Chart 4.2b). This increase almost rivals that of China. These figures, however, ignore the region's importance in supplying intermediate inputs to other exporting countries. The region has tended to export to heavily export-based economies (for example, Germany). In 2000, on average, 57 per cent of the region's exports were sold in markets that themselves exported more goods than they imported. This compares with 45 per cent of China's exports. One common indicator that captures jointly the direct weight of a country in the trade network and its indirect weight through its "connectedness" to other countries with a large presence in the global trade network is shown in the red bars in Chart 4.2b.[1] By this measure of "connectedness" into the network, the transition region's weight in world exports in 2008 rises slightly to 10 per cent, while that of China shrinks to about 6 per cent. By virtue of their size, the CEB subregion (central eastern Europe and the Baltic states – and particularly Hungary and Poland), Russia, Turkey and Ukraine were the main exporters, but even the smaller subregions increased their share of global exports significantly (see Chart 4.2c).

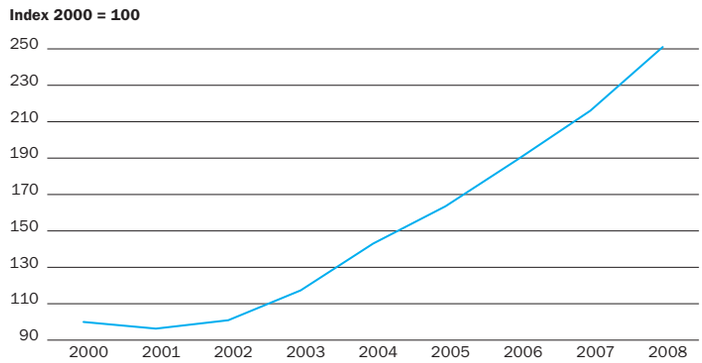
Unlike some other emerging markets, the transition region has also reached into a wide range of export markets, as indicated in Chart 4.3a, which shows the concentration of export destinations for several world regions in 2000 and 2008. For example, emerging Asia's exports have become increasingly focused on their own region, while export market concentration in the Middle East and North Africa (MENA) has remained broadly unchanged. In contrast, EBRD countries (and also those in Latin America) have diversified their export markets significantly. Much of this diversification took place as *intra*regional exports grew faster – especially within the SEE (south-eastern Europe) and the CEB regions and to a lesser extent within the EEC (Eastern Europe and the Caucasus) countries – than trade to large outside importers such as Russia or the European Union (EU) (see Charts 4.3b and 4.3c).[2] Central Asian countries, in contrast, shrank their internal trade and instead strengthened ties with countries such as Belarus and Ukraine as well as Asia. Turkey strongly increased its exports to the SEE and MENA regions.[3]

[1] A network is typically thought of as a matrix whose elements are all the links between all the participants in the network. There are several commonly used measures of the importance of any one element (a "node") of such a network. One of these measures is the eigenvector (see, for example, Bonacic, 1987). By using the eigenvector, the researcher *de facto* interprets links to very connected "nodes" as more important than links to unconnected "nodes". The measure has become standard in parts of the literature on social networks (Mintz and Schwartz, 1985) and is used in Google's PageRank algorithm.

[2] Chapter 4 of the 2008 *Transition Report* already noted the beginnings of this trend in data to 2005.

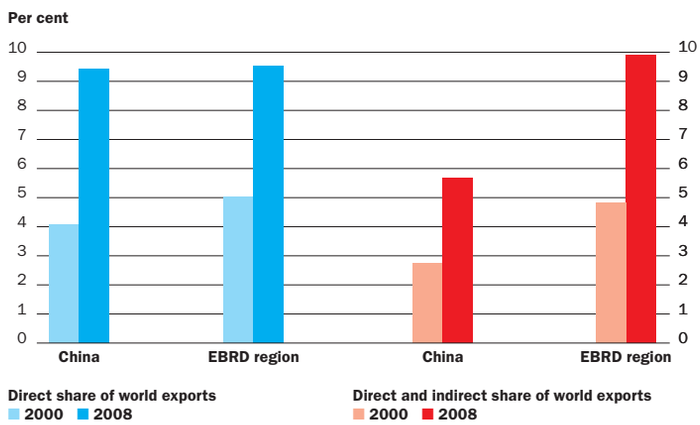
[3] The fact that EBRD countries, with the exception of some commodity exporters, are by now quite well diversified in terms of export markets becomes even clearer when adjusting for country size (as large countries tend to have naturally more diversified export markets than small countries and most EBRD countries are relatively small).

Chart 4.2a
World exports



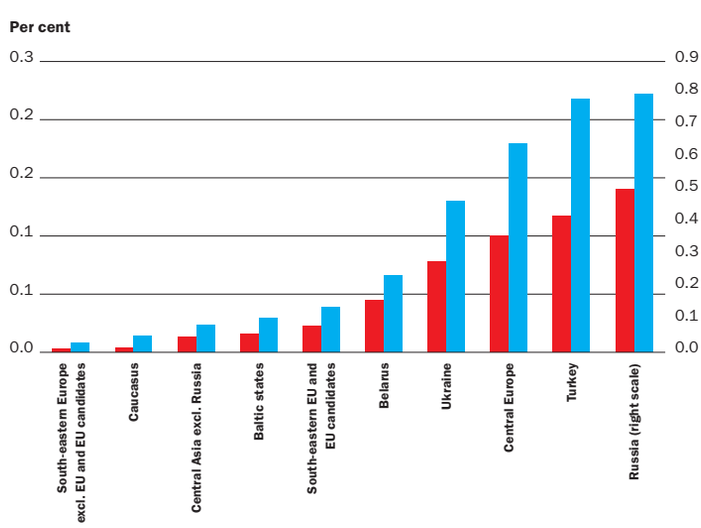
Source: IMF *Direction of Trade Statistics*.

Chart 4.2b
Share of total world exports[1]



Source: IMF *Direction of Trade Statistics*.
Note: [1] The indirect share of exports is defined as the elements of the left eigenvector of the trade matrix, as explained in Footnote 1 below.

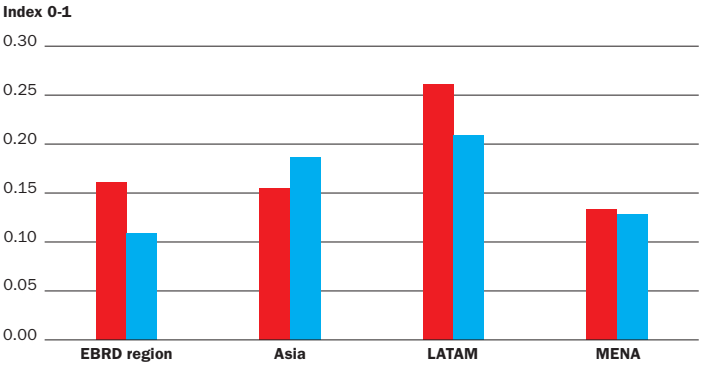
Chart 4.2c
Average share of world exports



Source: IMF *Direction of Trade Statistics*.
Note: Excludes traditional trading partners in EU-15 countries and the EBRD region.

Chart 4.3a

Concentration of export destinations[1]



Source: IMF *Direction of Trade Statistics*, August 2010.
Note: [1] The concentration of export destinations is measured using the Herfindahl index. The Herfindahl index is the sum of the squares of the shares of each export destination in total exports, rebased to a scale of 0 to 1, where 1 denotes the highest concentration. LATAM stands for "Latin America" whereas MENA stands for "Middle East and Northern Africa".

What drove the rapid export growth in transition countries? An analysis of standard determinants indicates three main factors.

- *Rapid global trade growth.* Real imports of trading partners doubled for most EEC and CIS (Commonwealth of Independent States) countries and the Baltic states and rose by at least 40 per cent for the other countries, in line with the rapid expansion in global trade over the period (see Chart 4.2a).
- *Low unit labour cost at the beginning of the decade.* According to the International Labour Organization, countries in the CEB and SEE subregions had lower unit labour cost than most other emerging markets in 2001 (see Chart 4.4a). ULC in the Czech Republic, Poland, Hungary, the Slovak Republic and Turkey was estimated to be about 35-40 per cent of those in the United States. However, some of this competitive advantage has since evaporated. Between 2001 and 2008 ULC in transition countries grew between twice (in the Czech and Slovak Republics) and 10 times (in Latvia) as much as those in the United States (see Chart 4.4b).

Chart 4.3b

Share of exports to country groups, 2000 (per cent)[1]

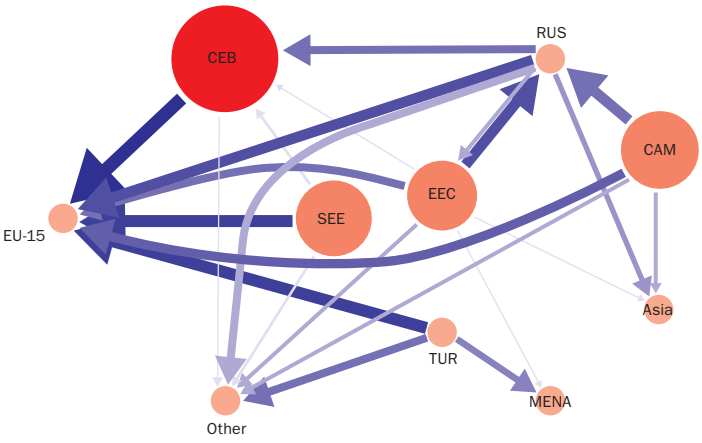
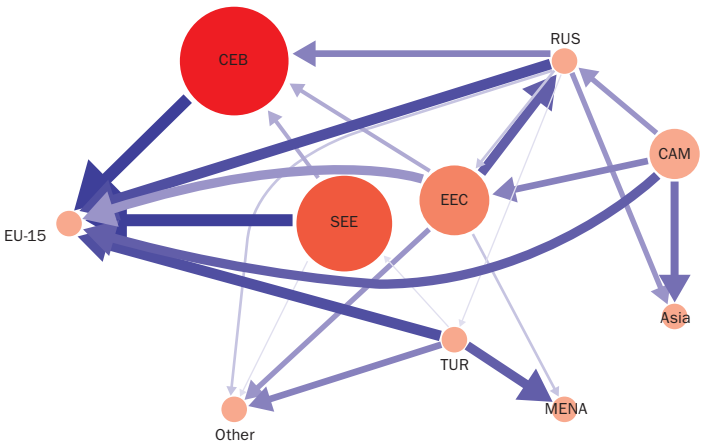


Chart 4.3c

Share of exports to country groups, 2008 (per cent)[1]



Source: IMF *Direction of Trade Statistics*, August 2010.
Note: [1] The size of the arrows is proportional to the share of exports to this destination in the source country's total exports. For the sake of clarity, all arrows representing export shares below 6 per cent are omitted. The size of the bubbles for EBRD regions is proportional to the share of intraregional trade. The bubbles for non-EBRD regions (Other, Asia, MENA, and EU-15) are unscaled. CAM stands for "Central Asia and Mongolia", EU-15 includes all advanced EU countries, RUS stands for Russia and TUR stands for Turkey.

Chart 4.4a

Unit labour cost, 2001

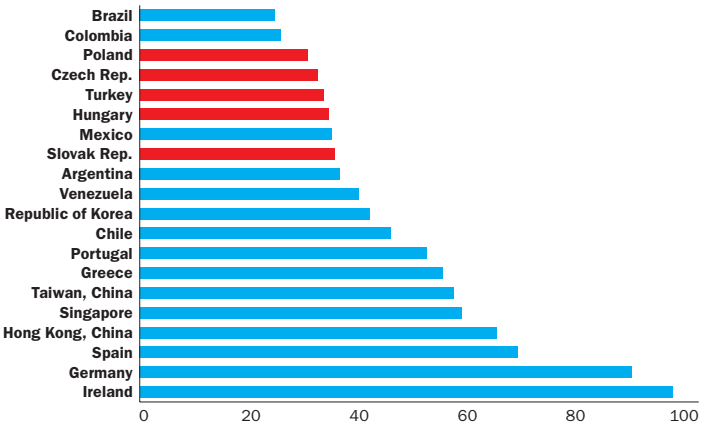
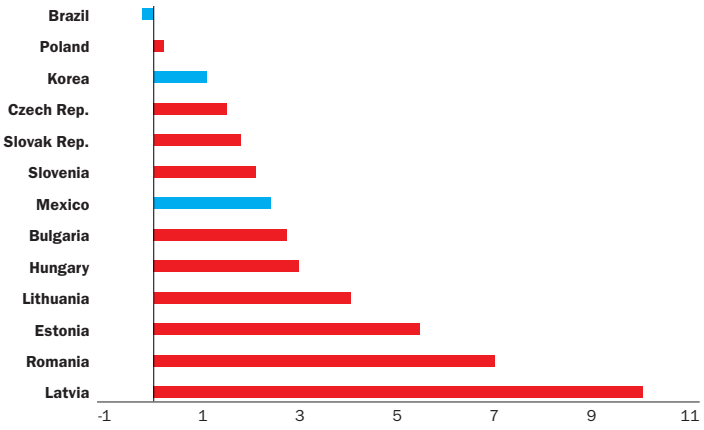


Chart 4.4b

Growth in unit labour cost, 2001-08[1]



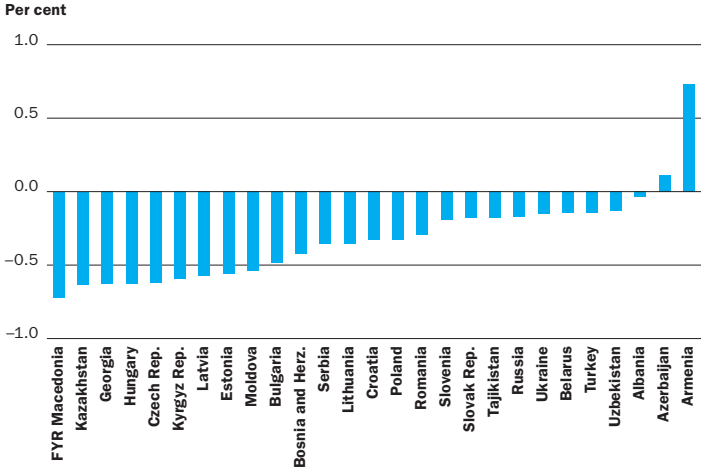
Source: ILO (2003) and OECD database.
Note: EBRD countries are marked in red while non-EBRD countries are marked in blue.
[1] 2001-06 data for Romania are the latest available data.

- *Free trade agreements reducing tariffs.* An important avenue into global trade networks has been trade liberalisation, encompassing the 2004 and 2007 waves of accession to the European Union and the multilateral Free Trade Agreement among SEE countries in 2006. Other trade liberalisation agreements during the period have included those between the European Union and Albania, Algeria, Bosnia and Herzegovina, Chile, Egypt, Korea, Lebanon and Montenegro; between Turkey and countries in the SEE region (Albania, Bosnia and Herzegovina, Croatia and FYR Macedonia) and the MENA region (Egypt, Lebanon, Morocco, Syria and Tunisia); and between Ukraine and Belarus, FYR Macedonia, Moldova and Tajikistan. As a result, tariffs faced by CEB and SEE exporters have fallen. Although the average decline has been modest (see Chart 4.5a), some industries have faced large changes, with tariffs falling by as much as 20 per cent or rising by up to 5 per cent (see Chart 4.5b).

Tariff cuts benefiting exporters in the transition region were partly offset by increasing non-tariff barriers, including both explicit trade barriers such as quotas and anti-dumping measures, and more subtle obstacles to trade such as licensing requirements and regulatory standards. Chart 4.6 shows trade-weighted average non-tariff trade barriers faced by exporters in each of their export markets.[4] Except in Albania, Azerbaijan and some central European countries, exporters faced increasing barriers between 2000 and 2007.[5] The effect of these barriers on trade is examined in the final section of this chapter.

Chart 4.5a

Average tariff change, 2002-08[1]



Source: WTO Tariff Analysis Online and EBRD calculations.
Note: [1] Average of tariffs applied to exports for 99 two-digit HS2002 or HS1996 industries, weighted by value of exports.

Chart 4.5b

Range of tariff changes, 2002-08

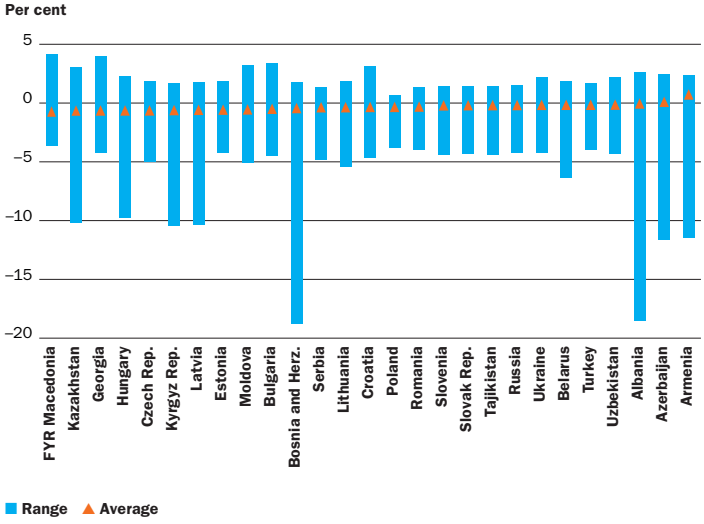
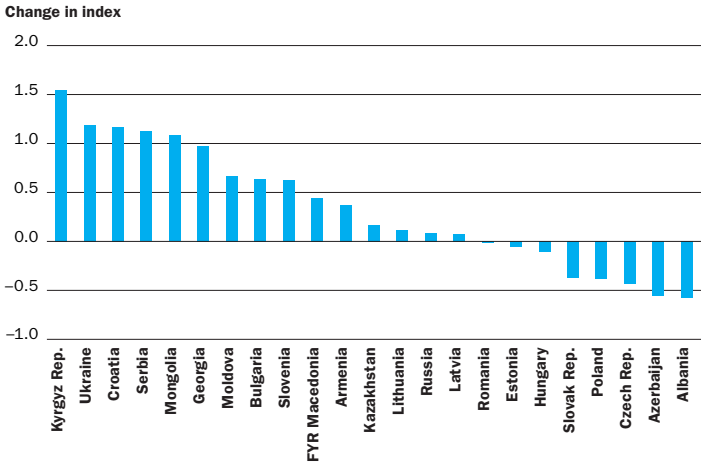


Chart 4.6

Changes in non-tariff barriers faced by exporter, 2000-07



Source: Fraser Institute's World Economic Freedom, 2009.

[4] The Fraser Institute compiles an index of non-tariff barriers that includes the new EU member countries from 2000-07 and other countries in the EBRD region from 2003-05. The index is based on the following question in the World Economic Forum's *Global Competitiveness Report*: "In your country, do tariff and non-tariff barriers significantly reduce the ability of imported goods to compete in the domestic market?"

[5] The data shown in the chart used fixed 2008 weights for calculating non-tariff barriers. It may overstate the increase in non-tariff barriers faced by exporters to the extent that exporters may have switched away from countries with high non-tariff barriers.

Exporting and innovation: firm-level evidence

Would export-led growth help the region mainly by making growth more balanced and less dependent on capital inflows, or would it also raise long-run growth? An abundant amount of academic literature indicates that exporting firms are likely to experience higher productivity and productivity growth than non-exporting firms. However, the literature is less unanimous on causality. Based on US and German data, several authors have argued that high productivity growth turns firms into exporters. More recently, and based on data from emerging market and small advanced country economies, there appears to be increasing evidence that exporting activity raises productivity (see Box 4.1). Two main reasons are cited in the literature. Exporting expands market size and makes it easier for firms to pay for the fixed costs of innovation. This could explain why the link from exports to productivity is more readily found in emerging market or small advanced countries than in US or German data (with US and German firms already having large domestic markets). In addition, exporting may result in exposure to new technologies and preferences as firms engage with foreign clients and competitors.[6]

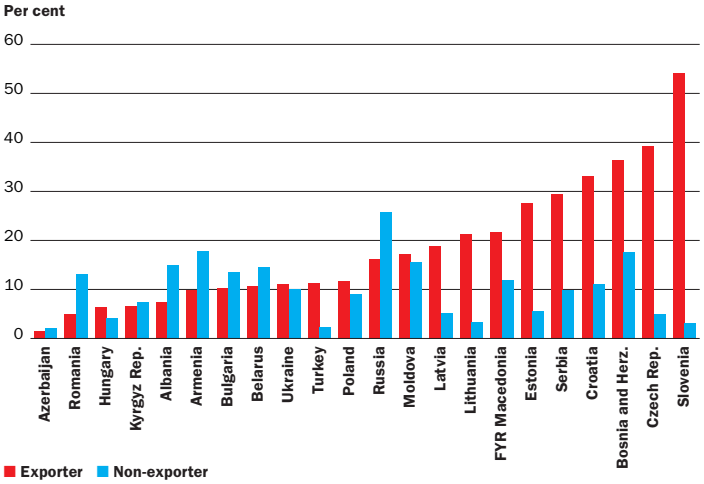
To assess the link between exports and innovation, this chapter uses firm-level data from the Business Environment and Enterprise Performance Survey (BEEPS) between 2005 and 2009.[7] Importantly, this dataset spans the EU accession of two economies (Bulgaria and Romania) in 2007 and the Free Trade Agreement in the Balkans in 2006. It includes three questions that are used to define two measures of innovation:

- "In the last three years, has this establishment produced new products or services?"
- "In the last three years, has this establishment upgraded an existing product line or service?"
- "In the past fiscal year, did this establishment spend on research and development (R&D) activities, either in-house or contracted with other companies (outsourced)?"

In the following analysis, innovators are defined as firms that respond positively to either of the first two questions. The analysis also examines how exports influence the propensity to answer yes to the third question. This is carried out separately from the analysis of answers to the first two questions, since fewer firms engage in R&D spending in the transition region compared with firms undertaking product innovation and because product innovation and R&D are different in nature.

Not surprisingly, the raw data shows a similar pattern to that found in the samples of other studies, in that exporting firms also tend to innovate. In 14 out of 22 countries for which reasonable sample sizes are available, the percentage of firms that engage in R&D is larger among exporters than non-exporters. The exceptions tend to be commodity-producing countries and those with a large state-owned or agricultural sector (see Chart 4.7).

Chart 4.7
Percentage of R&D-spending firms among exporters and non-exporters



Source: BEEPS (2005-09).
Note: Sample includes only those firms which are included in the firm-level regression of Box 4.2.

Box 4.1
Firm-level link between exporting and innovation

A series of studies in the late 1990s spawned a body of literature on the link between exporting and firm-level productivity growth or innovation. In particular, using US and German firm-level data, Bernard and Jensen (1999) and Bernard and Wagner (1997) found that productivity growth allowed firms to export.

Since then, several authors have examined firm-level data from emerging markets and smaller advanced country economies (Aw, Chung and Roberts (2000) for Korea and Taiwan; Baldwin and Gu (2003) and Lileeva and Trefler (2007) for Canada; Van Biesebroeck (2004) for sub-Saharan Africa; Hallward-Driemeier et al. (2005) for East Asia; Fernandes and Isgut (2005) for Colombia; Jiang et al. (2009) for China; de Loecker (2007) for Slovenia; Bustos (2010) for Argentina; and Bratti and Felice (2009) for Italy). These studies have generally found the reverse of the earlier literature, and concluded that it is exporting activity that makes firms more productive and innovative. Lileeva and Trefler (2007) speculate that the difference is explained by the large size of the domestic US market, insofar as that market is itself sufficiently large to recoup the fixed cost of investment in innovation. This is not the case for emerging markets and smaller advanced country economies.

To address the problem of endogeneity – that is, the possibility that productivity growth and exports may influence each other in both directions, and that they depend on unobservable firm characteristics – several studies use an instrumental variable regression. In some the instrument is implicit, as they examine firms that started exporting after trade liberalisation (for example, Bustos, 2010). In others, explicit instruments are used. Lileeva and Trefler (2007) use industry-specific tariff changes due to NAFTA (North American Free Trade Agreement) accession as instruments to identify new exporters; Bratti and Felice (2009) use industry-specific trade-weighted average distances from export markets as instruments to identify exporters.

[6] For a related reason, openness to imports tends to enhance innovation. For example, in firm-level data for Chile, Fernandes and Paunov (2010) find that increased competition from imports can be beneficial for innovation.

[7] Although BEEPS surveys have been conducted since 1999, the focus here is on the most recent surveys since 2005.

However, in which direction does the causality run? Does innovation make firms more likely to export or does exporting make firms more likely to innovate? To answer this question, an "instrumental variables" approach was used to examine how innovations react to variations in export performance that are attributable to such factors as differences in tariffs (across countries and over time), the size of export markets and the distance to export markets. These factors are not themselves affected by innovation, and should affect innovation *only* through their effect on exports. They should therefore help identify the effect of exports on innovation, rather than the reverse (see Box 4.2).

Based on this approach, the analysis confirms a statistically significant effect of export activity on innovation. For product innovation, the effect turns out to be economically small, as exporters and non-exporters both tend to innovate their product lines quite frequently. The probability of product innovation for a typical non-exporter is about 76 per cent, but increases to 79 per cent for an exporter. For R&D spending, however, the effect is much larger. Only 25 per cent of non-exporting firms engage in R&D spending, compared with 32 per cent of exporting firms. Export activity therefore raises the probability that a firm will engage in R&D by almost one-third.

The greater difference for R&D spending than for product innovation may be due to the kind of products that transition economies mainly produce. These are likely to be existing products where incremental improvements are constantly made without large fixed cost. As such, the barriers to product innovation are low for exporters and non-exporters alike, therefore also dampening the advantage of greater market size for exporters. In contrast, R&D requires specific investments in capital and skills. As a result, sales market size really matters.

The analysis also indicates how tariffs, export market size and distance to markets influence exporting. As expected, lower tariffs in export markets and larger markets encourage exporting. Distance to export markets matters only by reducing the positive effect of export market size on a firm's probability of exporting. The analysis also confirms that, not surprisingly, foreign and large firms and those with a better-educated workforce are more likely to export.

Box 4.2
Estimation of the effects of export activity on innovation

The effect of exports on innovation was estimated using firm-level data from the 2005 and 2008-09 rounds of the BEEPS.[8] Following Gorodnichenko and Schnitzer (2010), two distinct innovation variables were defined: product innovation, which takes the value of 1 if the firm either introduced a new product or upgraded an existing one, and 0 otherwise; and R&D, which takes the value of 1 if the firm has any spending on R&D activities, and 0 otherwise. Export status is defined as a dummy variable of 1 if the firm reports that it currently exports, and 0 otherwise. Given that exporting is rare among service firms, the analysis is limited to firms in the manufacturing sector.

The key feature of the dataset that makes it possible to identify the effect of exports on innovation, rather than merely a correlation, is that each firm in the sample is assigned a detailed industry classification for its main product.[9] Firm-level instruments can therefore be defined by matching detailed industry-level tariff and trade data from the World Trade Organization (WTO) and Comtrade to each firm. In particular, the following instruments are used:

- *foreign tariffs faced by exporters:* the WTO's Tariff Analysis Online database assembles detailed data on tariffs by industry and country that exporters face in each of their export markets. Weighted averages for all export destinations of each industry-specific tariff were matched to the firms in the BEEPS dataset, similar to the approach of Lileeva and Trefler (2007).
- *distance to export markets as a proxy for transport cost:* for each industry in each country, the share of exports to a particular destination country in relation to total industry exports was used to weight the distance to export markets, similar to the approach of Bratti and Felice (2009) and using the dataset on distances from Mayer and Zignago (2006). The regression uses the logarithm of this industry-specific distance to export markets.
- *size of the global export market:* the UN Comtrade database contains detailed industry-level data on imports to each country. For each country and detailed industry, the total size of the global export market was calculated as the sum of imports of all other countries in the dataset in the industry. The regression below uses the logarithm of this industry-specific export market size.

Tariffs, export market size and distance to markets should each affect firms' decisions to export, as tariffs and transport cost affect the cost of exporting, while the size of foreign markets affects the expected return. However, tariffs of foreign countries, transport costs and export market size are unlikely to directly impact firms' decisions to innovate except through the channel of exporting into foreign markets. They therefore probably constitute valid instruments.

[8] Two recent studies by Gorodnichenko and Schnitzer (2010) and Gorodnichenko et al. (2009) also use BEEPS data to examine potential determinants of innovation, but focus on factors such as access to finance and competition rather than exports. The estimation strategy in this chapter is similar to that of these two studies.

[9] Each firm is assigned an industry classification at the four-digit level of the ISIC Rev 3.1 classification. Imports into all countries in the world are available at the six-digit level of the HS classification. Tariffs faced in export markets are available for 99 industries at the two-digit level of the HS classification. Despite being at a more aggregated level than the firm-level data, the 99 industries are sufficiently detailed to ensure cross-firm heterogeneity in the variable: none of the 99 industries covers more than 15 per cent of the firms in any of the country surveys in the sample.

Box 4.2 continued

Using the three instrumental variables, the following equation is estimated:

$$\text{innovation} = \alpha\ \text{export activity} + \beta_1 \text{SIZE} + \beta_2 \text{SIZE}^2 + \beta_3 \text{AGE} + \beta_4 \text{FOREIGN} + \beta_5 \text{STATE} + \beta_6 \text{EDU} + \beta_7 \text{SKILL} + \beta_8 \text{CU} + \beta_9 \text{MICROCITY} + \beta_{10} \text{SMALLCITY} + \beta_{11} \text{MEDIUMCITY} + \beta_{12} \text{LARGECITY} + \varepsilon$$

where, as firm-level control, SIZE is the logarithm of employment, AGE the age of firm, FOREIGN is a dummy that is 1 if the firm has a foreign owner, STATE is a dummy that is 1 if the firm is state-owned, EDU is the share of the workforce that had a university degree, SKILL is the share of skilled full-time production workers in the workforce, CU is the degree of capacity utilisation, and CITY dummies are 1 if the firm is located in a micro, small, medium or large city.[10] Ideally, a firm-level measure of competitiveness should be included. For lack of unit labour cost, let alone total factor productivity, competitiveness is proxied by a dummy that is 1 if the firm has received a subsidy in the past fiscal year. Since the panel dimension of the dataset is too small to obtain robust results, the analysis is based on a pooled bivariate probit regression of the whole BEEPS dataset for 2005-2009. Country and year dummies are included in all regressions.

Table 4.2.1 shows the results, which confirm a significant effect of export activity on both types of innovation considered in the regressions. Columns I and II show the results of a bivariate probit regression if innovation is defined as product upgrades or product introduction. As can be seen from column I, exporters are more likely to engage in product innovation, even when the reverse causality from innovation to exporting is stripped out by using the predicted values of the regression in column II. Column II shows that lower tariffs and greater export market growth make firms more likely to export, unless markets are very far away. Foreign and larger firms with a better-skilled and educated workforce are also more likely to export. Similarly, columns III and IV show the results if innovation is defined as engaging in R&D spending—an activity that far fewer firms do in this sample. As described in the text, the effect is economically more significant for R&D spending than for product innovation. Beyond the effect of exporting on innovation, the table shows that larger firms, younger firms and private firms with better-educated employees are more likely to innovate than their peers. In addition, firms receiving subsidies find it easier to innovate.

Table 4.2.1

Instrumental variable probit estimates of the effects of export activity on innovation

	IV regression			
	Product innovation		R&D spending	
		Stage 1 regression		Stage 1 regression
	I	II	III	IV
Distance to export markets		0.739 (0.190)		0.701 (0.199)
Size of export markets		0.260** (0.019)		0.263** (0.014)
Tariffs faced in export markets		-0.020** (0.024)		-0.023*** (0.009)
Distance* size of export markets		-0.068** (0.032)		-0.067** (0.030)
Exporter	0.508* (0.058)		0.999*** (0.000)	
Foreign	-0.118 (0.280)	0.656*** (0.000)	-0.266*** (0.002)	0.634*** (0.000)
State	-0.729*** (0.000)	-0.069 (0.637)	-0.343** (0.021)	-0.049 (0.734)
Size	0.293*** (0.001)	0.365*** (0.000)	0.166** (0.048)	0.356*** (0.000)
Size^2	-0.027*** (0.006)	0.010 (0.425)	-0.007 (0.460)	0.011 (0.376)
Age	-0.063** (0.036)	0.008 (0.774)	0.008 (0.772)	0.004 (0.895)
Edu	0.002 (0.161)	0.003** (0.039)	0.006*** (0.000)	0.003* (0.054)
Skill	0.001 (0.276)	0.001*** (0.000)	0.001 (0.377)	0.001*** (0.000)
Subsidy	0.302*** (0.002)	0.110 (0.198)	0.133* (0.084)	0.108 (0.199)
CU	0.001 (0.643)	0.001 (0.736)	-0.004*** (0.001)	0.001 (0.615)
Constant	-0.052 (0.819)	-5.051** (0.011)	-1.566*** (0.000)	-4.999*** (0.009)
Observations	3250	3250	3251	3251

Sources: BEEPS, WTO Tariff Analysis Online and UN Comtrade.
Note: Robust p-values in parentheses, where *** p<0.01, ** p<0.05, * p<0.1. The dependent variable in the main regression is one of two binomial measures of innovation: product innovation or R&D spending, as described above. The dependent variable in the first stage regression is a dummy that is 1 if the firm exports and 0 otherwise. Distance to export is calculated as the logarithm of the trade-weighted average distance to all export markets. Tariffs faced in export markets are defined as the trade-weighted average of tariffs faced in all export markets. The size of export markets is defined as the logarithm of the sum of all world imports of a particular product, except those into the home country. SKILL is the share of skilled production workers, EDU is the share of workers with secondary education, SUBSIDY is a 0-1 dummy variable if the firm has received a subsidy, STATE and FOREIGN are 0-1 dummy variables if the firm is state- or foreign-owned, respectively, AGE is the age of the firm, and SIZE is the logarithm of the firm's number of full-time employees. Country and year fixed effects are included in the regression.

[10] About 1,000 firm observations are lost by including EDU and SKILL. However, the results are robust to broadening the sample by excluding these two variables.

Box 4.3
Estimation approach for country-level results

The results described in Table 4.1 are based on an annual dataset for more than 130 advanced and emerging market countries from 1999 until 2009, which contains data on real export growth, trade-weighted trade-partner real GDP (or import) growth and real effective appreciation (in both consumer price and unit labour cost terms), as well as the following structural variables:

- *tariffs:* a trade-weighted average of average country-level tariffs, published in the Fraser Institute's Economic Freedom of the World Index, is calculated. To control for obstacles to importing intermediate goods to production, domestic tariff levels from the same source are initially also included
- *non-tariff barriers:* a trade-weighted average of all partner-countries' non-tariff barriers, also compiled by the Fraser Institute, is calculated
- *institutions*: survey-based relative obstacle ratings developed in Chapter 5 of this *Transition Report* are used as primary institutional variables. Other measures of institutional quality (Transparency International's Corruption Perceptions Index and the Kaufmann, Kraay and Mastruzzi (2009) dataset) are also examined. These variables are complemented with cross-sectional data for 2008-09 from the World Bank's *Doing Business* database, including US dollar export cost per container, number of days to export and number of documents required.

The use of survey-based institutional measures constrains the sample to countries and years in which surveys were conducted. Therefore, for regressions using institutional variables, the sample is collapsed into three periods, each of which covers one of the three main waves of BEEPS surveys: 1999-2002, 2003-05 and 2007-09. Country-fixed effects are included in the panel regression in column I of Table 4.2.1, but not in the regressions in columns II-IV of Table 4.1 that use institutional variables, because in this instance cross-country differences are the main source of variation.

Creating an enabling environment for exports

The previous section showed that exporting has made firms in the EBRD region more likely to innovate, but what can governments do to make their firms more competitive? Answering this question requires a fuller examination of the country-level determinants of export performance.

This section presents a regression-based analysis focusing on two sets of potential structural determinants of exports:
- tariffs and non-tariff barriers
- institutional variables, including measures of customs barriers, the quality of the rule of law, domestic infrastructure and the legal system, corruption, crime and the effectiveness of government.

In addition, the analysis takes into account the effect of trade-partner growth as a proxy for external demand, and real effective appreciation as an indicator of competitiveness that rests on macroeconomic rather than structural conditions (see Box 4.3).

Column I of Table 4.1 shows the results of a baseline regression using annual data for about 130 advanced and emerging-market countries between 1999 and 2009. Not surprisingly, trade-partner real GDP growth and nominal effective depreciation (albeit with a lag) raise real export growth. The effect of trading partner tariffs is not statistically significant, while non-tariff barriers detract significantly from export growth. The lack of statistical significance of one of these two variables is not surprising given that tariff and non-tariff barriers are correlated.[11] The fact that the significant variable turns out to be the measure for non-tariff barriers suggests that these may be more relevant than tariffs as an obstacle to export growth – at least in this sample in which tariff barriers are already fairly low, reflecting trade liberalisation during the 1990s.[12]

Measures of institutional quality are also included in the regressions. While similar regressions were run for a range of institutional variables, only three had any statistically significant correlation with real export growth:
- difficulties in clearing customs, as defined in Chapter 5 of this *Transition Report* (see column II in Table 4.1)
- lack of corruption (see column III)
- the rule of law (see column IV).

Interestingly, it is not the level of these three measures of institutional quality that affects real export growth, but their interaction with non-tariff trade barriers. All three dampen or strengthen the effect of non-tariff trade barriers on real export growth. The rule of law and the lack of corruption mitigate the downward pressure on export growth from non-tariff trade barriers abroad, while cumbersome customs procedures exacerbate their effect.

[11] The correlation is partly an artefact of the variable definition, since the variable is an index based on the following survey question for the World Economic Forum *Global Competitiveness Report:* "In your country, do tariff and non-tariff barriers significantly reduce the ability of imported goods to compete in the domestic market?"

[12] The result may also be related to the fact that average country-level tariff data is an imperfect measure of actual relevant tariffs, because it does not capture special exemptions, and that tariff data underlying the estimation ends in 2008, excluding crisis-related increases in tariffs. Lastly, the cross-country variation in tariffs is subsumed in the country fixed effects that are included in column I.

Table 4.1

Panel regressions: dependent variable real export growth

	Annual growth	Average annual growth during 1999-2002, 2003-05, 2006-09		
	Column I	II	III	IV
External demand[1]	2.663*** (0)	2.758** (0.012)	2.238* (0.086)	1.843 (0.121)
Real effective exchange rate change, %	-0.049 (0.561)	-0.476 (0.162)	-0.284** (0.035)	-0.260* (0.051)
Lagged real effective exchange rate change, %	-0.174*** (0.003)			
Annual mean tariff[2]	0.646 (0.315)			
Non-tariff trade barriers[3]	-0.233 (0.665)			
Trade-partner tariff barriers[4]	-1.638 (0.173)	6.625 (0.233)	1.184 (0.85)	2.064 (0.71)
Trade-partner non-tariff barriers[5]	-3.202* (0.051)	-10.785** -0.031	-8.567** -0.032	-12.310*** -0.009
Dummy for regional trade agreements[6]	0.036 (0.811)			
Customs[7]		28.665 (0.831)		
Trade-partner tariff barriers *Customs		31.919 (0.253)		
Trade-partner non-tariff barriers *Customs		-45.205* (0.076)		
Control of corruption			-0.866 (0.257)	
Trade-partner tariff barriers *corruption			0.019 (0.806)	
Trade-partner non-tariff barriers *corruption			0.130** (0.046)	
Rule of law rank				-1.427 (0.128)
Trade-partner tariff barriers *Rule of law				0.024 (0.751)
Trade-partner non-tariff barriers *Rule of law				0.199** (0.015)
Constant	27.605** (0.036)	12.533 (0.631)	36.001 (0.5)	58.026 (0.299)
Years	1991-2007		1999-2008	
Observations	695	114	198	198
R-squared	0.39	0.844	0.735	0.748

Sources: Global Insight database, IMF Direction of Trade Statistics database, World Economic Forum database, BEEPS database, authors' calculations.
Note: Robust p-values in parentheses, coefficients are significant at *** p<0.01, ** p<0.05, * p<0.1 levels. Country fixed effects are included in regression I, but not reported. In columns II-IV, the sample is based on 3-4 years averages.

[1] External demand defined as trade-partner weighted average growth of real GDP; 2008 weights are used.

[2] Annual mean tariff measure is based on the unweighted mean of tariff rates. The formula used to calculate the zero to- 10 rating for each country was: (Vmax – Vi) / (Vmax – Vmin) multiplied by 10. Vi represents the country's mean tariff rate. The values for Vmin and Vmax were set at 0% and 50%, respectively. This formula will allocate a rating of 10 to countries that do not impose tariffs. As the mean tariff rate increases, countries are assigned lower ratings. The rating will decline toward zero as the mean tariff rate approaches 50%. (Note that except for two or three extreme observations, all countries have mean tariff rates within this range from 0% to 50%). Sources: World Trade Organization, World Tariff Profiles (various issues).

[3] Non-tariff trade barriers measure is based on the World Economic Forum *Global Competitiveness Report's* survey question: "In your country, do tariff and non-tariff barriers significantly reduce the ability of imported goods to compete in the domestic market?" The wording of the question has varied slightly over the years. Source: World Economic Forum, *Global Competitiveness Report* (various issues).

[4] Defined as trade-partner weighted average of annual mean tariff measure; 2008 weights are used.

[5] Defined as trade-partner weighted average of non tariff trade barriers; 2008 weights are used.

[6] Total number of regional trade agreements in which the country is involved, based on Baldwin and Jaimovich (2010) until 2005 and authors' calculations thereafter.

[7] Same as defined in Chapter 5 of *Transition Report* 2010.

Using the data and coefficient estimates of Table 4.1, Charts 4.8a, b and c show the contribution of non-tariff trade barriers to real export growth over the past decade. Improvements in some aspects of the institutional environment could clearly encourage real export growth. For example, Chart 4.8a (based on regression 2 in Table 4.1) suggests particularly adverse effects of customs procedures on exports from Kazakhstan, Ukraine and some SEE countries (in this case the complaint refers to the customs of the exporting country). Charts 4.8b and 4.8c (based on regressions 3 and 4, respectively) show the results of similar analysis for corruption and the rule of law. Not surprisingly, institutional obstacles vary across countries. In FYR Macedonia difficult customs procedures detract more from real export growth than corruption and shortcomings in the rule of law, whereas the reverse appears to be true for Serbia and Ukraine. In Russia corruption and deficiencies in the rule of law restrain real export growth, while customs procedures are more benign. Meanwhile, in Bosnia and Herzegovina corruption is less of a problem than rule of law and customs failings.

Interestingly, the charts also indicate that several EU member countries appear to face trading partner non-tariff trade barriers. In some cases, these might refer to red tape that could be improved by coordinated action across countries. In others, they could refer to standards and regulations that cannot (and quite possibly should not) be modified. Helping exporters adjust to and comply with these standards and regulations would be one way to stimulate export growth even within existing free trade areas.

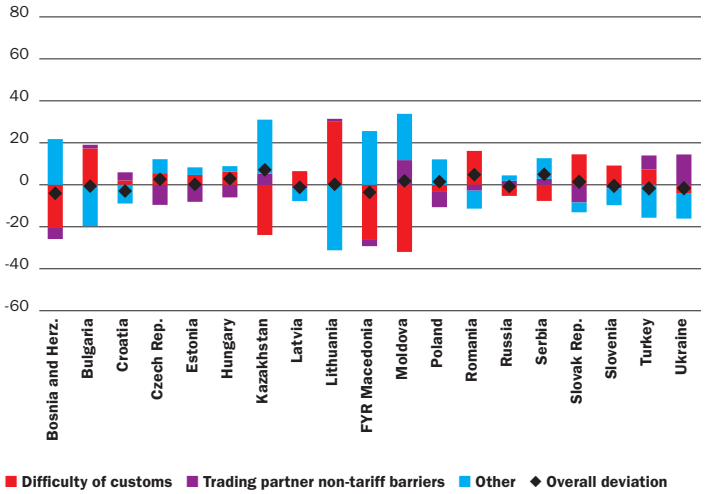
Conclusion

To continue their convergence with advanced economy incomes in the post-crisis world, countries in the EBRD region will need to rely more heavily on exports as a source of innovation and growth. This will become more difficult as one-off effects from entering free trade areas subside and unit labour costs catch up with those of trading partners. Policy measures will therefore be necessary to sustain rapid export growth. In particular, policy-makers can support greater export-orientation by lowering non-tariff trade barriers that impede new and major existing export markets – a policy that Turkey, for example, has actively pursued during the past few years. They can also improve key aspects of the domestic business climate by reducing corruption and improving the rule of law and customs procedures.

Chart 4.8
Contributions to export growth, average 1999-2009

4.8a Difficulty of customs procedures

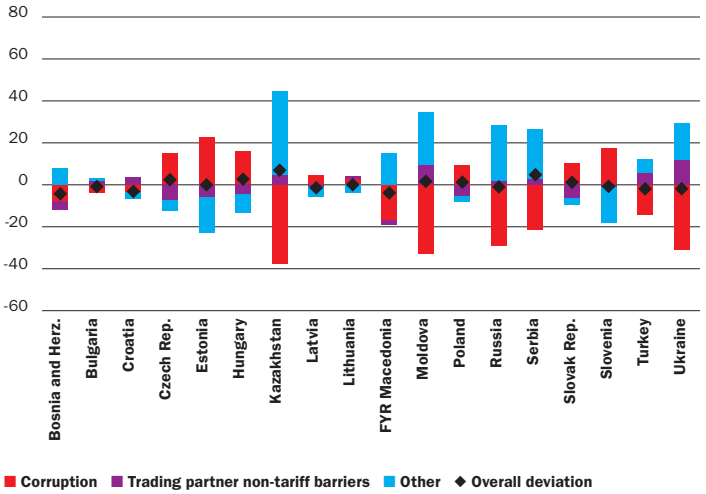
Deviation from sample average, per cent



Difficulty of customs **Trading partner non-tariff barriers** **Other** **Overall deviation**

4.8b Corruption

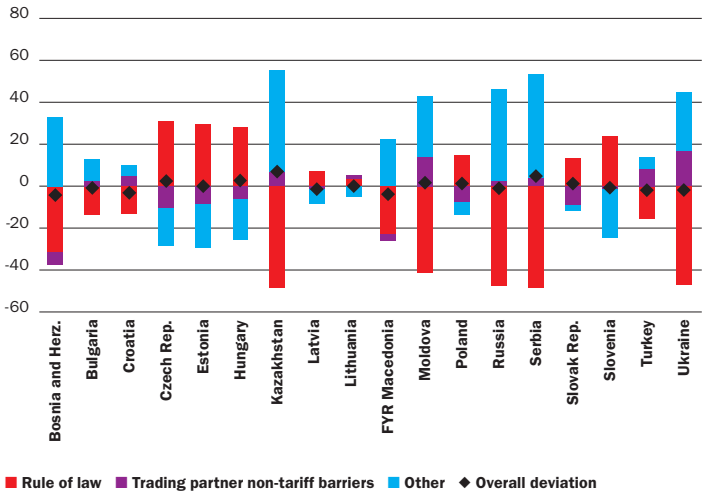
Deviation from sample average, per cent



Corruption **Trading partner non-tariff barriers** **Other** **Overall deviation**

4.8c Rule of law

Deviation from sample average, per cent



Rule of law **Trading partner non-tariff barriers** **Other** **Overall deviation**

Source: EBRD estimates.
Note: The contribution of non-tariff trade barriers is defined as the coefficient estimate for non-tariff trade barriers *x* the average deviation of non-tariff barriers from the sample. The contribution of institutional variables is defined as the coefficient estimate on the interaction between institutional variables and non-tariff trade barriers *x* the average deviation of the product of non-tariff trade barriers and the institutional variables from the sample average. The contribution of "Other" is defined as the difference between average real export growth during 1999-2008 and the contribution of *non-tariff* trade barriers and the institutional variables.

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Chapter 5
Evaluating and improving the business environment

Improving the business environment is a cornerstone of the post-crisis growth agenda. But which aspects of the business environment matter most to firms? One way to answer this question is to focus on relative obstacle ratings by firms. This approach reveals that many transition countries share the same three main business environment concerns: skills availability, corruption and tax administration. Poor physical infrastructure and crime are also among the top concerns, particularly further east in the transition region.

Improving the business environment is considered to be the cornerstone of the post-crisis growth agenda in the transition region. Many elements of what firms would define as a sound business environment – such as efficient and predictable government institutions, an educated labour force, a good physical infrastructure and access to finance – have direct links to economic growth.[1] A sound business environment is likely to be particularly important for commodity-dependent countries because it supports the development and growth of non-resource-sector firms and, therefore, economic diversification and long-term growth.[2]

However, recognising that the business environment needs to improve does not easily translate into concrete policy. In part, this is because the concept is so broad. In circumstances of limited institutional and fiscal capacity, which of the many elements of the business environment should reforms focus on? Also, what kinds of policies and reforms are likely to succeed in improving their quality?

Answering these questions requires an in-depth analysis at the country level, and is outside the scope of this chapter. However, the chapter does aim to lay some of the foundations for such an analysis in three ways. First, it summarises the relative strengths and weaknesses of the business environment in each transition country using a novel approach to evaluating the results from a comprehensive EBRD-World Bank survey of firms, the Business Environment and Enterprise Performance Survey (BEEPS) (see below). While the top constraints to doing business vary by country, the most endemic problems in transition economies turn out to be skills availability, corruption and tax administration. Second, the chapter provides some clues as to how countries can address these deficiencies by drawing on the experiences of their transition peers, both at the present time and over the past 10 years. For example, Georgia can provide its peers with ideas on fighting corruption and Estonia on improving tax administration. Lastly, and most importantly, it provides researchers and policy-makers with tools for a data-based diagnostic of the state of the business environment in their countries and for developing strategies for reform, and demonstrates, if only superficially, how these tools can be applied.

Interpreting the BEEPS: a novel approach

The EBRD and World Bank have undertaken the BEEPS in the transition region periodically since 1999. The survey was conducted for the fourth time in 2008-09, covering nearly 12,000 firms in 29 countries. It asked firms to rate the severity of a list of 16 potential obstacles to doing business (encompassing all the major areas that could influence economic growth) on a five-point scale – 0 (no obstacle), 1 (minor), 2 (moderate), 3 (major) and 4 (very severe).[3] In addition, the survey collected data on a variety of firm characteristics.

Given such comprehensive information, identifying the specific strengths and weaknesses of the business environment across countries and the reforms necessary to address them would seem to be straightforward. However, the actual experience with the BEEPS data has been more mixed, triggering extensive debates on how to make the best use of subjective measures of the business environment and on whether they are useful at all (see Box 5.1).

There are significant difficulties with interpreting the constraints reported by firms. The quality of institutions, education, infrastructure and so on that a firm encounters is only one of several possible factors that influence that firm's reported assessment of the severity of an obstacle. Another is the sensitivity of the firm to a particular aspect of the business environment. This might depend on company characteristics, such as the sector in which the firm operates. For example, an export-oriented manufacturing firm may be more concerned about customs regulations than a firm providing local services, while a high-technology company may view the quality of education as a more important factor than a less specialised firm. It may also depend on the firm's level of development: a rapidly expanding company may perceive a whole range of elements of the business environment as more constraining than a lesser-performing firm, simply because it needs them more.[4] Firm-level characteristics will therefore influence each company's demand for aspects of the business environment that are otherwise supplied equally by a country's authorities and institutions to all enterprises.

In addition, survey respondents may have divergent interpretations of what constitutes no obstacle, a minor, moderate, major or very severe obstacle. This may be due to differing reference points (for example, firms in less advanced countries may apply a lower standard to some aspects of the business environment than those in advanced ones) or may simply be because some firms have a greater tendency to complain than others. Such differences may be correlated within countries: for example, two Slovak firms may be more likely to have a similar understanding of what constitutes a major obstacle than a Slovak and a Tajik firm. Consequently, cross-country comparisons of simple average scores of reported constraints are problematic, if not impossible.

Another problem is how policy-makers should react to reported constraints. Even if higher reported obstacles in a particular country really reflect a weaker business environment, rather than firm characteristics or differences in reference points, it is not immediately clear what policies would lead to an improvement. And attempts to study links between reported constraints and differences in policies are made difficult by the fact that reported constraints are not a very good measure of institutional quality to begin with.[5]

[1] See Acemoglu et al. (2005), Banerjee and Duflo (2005), Caselli (2005) and Easterly (2005).
[2] See EBRD (2008, Chapter 5), EBRD (2009, Chapter 4) and references cited in the latter.
[3] The potential obstacles are: access to finance; access to land; business licensing and permits; corruption; courts; crime, theft and disorder; customs and trade regulations; electricity; inadequately educated workforce; labour regulations; political instability; practices of competitors in the informal sector; tax administration; tax rates; transport; and telecommunications. See EBRD (2009, Chapter 5) for details and a summary of the responses from the 2008-09 survey round.
[4] See, for example, Aterido and Hallward-Driemeier (2009).
[5] For example, a simple comparison of average BEEPS scores for various business environment constraints in Serbia and Montenegro would suggest that Serbian businesses face much tougher obstacles across all measured constraint categories, without exception. However, this cannot be correct, as the two countries are far too similar for Serbian businesses to face far worse constraints than their Montenegrin counterparts.

Box 5.1
Dealing with subjective measures of the business environment

A country's economic performance is closely intertwined with enterprise growth and innovation, which in turn is assumed to reflect the state of the business environment. There has consequently been significant policy interest in datasets that attempt to measure the various components of that environment,[6] among others in the joint EBRD-World Bank BEEPS and Enterprise Surveys undertaken by the World Bank. The BEEPS and Enterprise Surveys collect perception-based data on a number of aspects of the business environment facing firms and quantitative data on firm operations. They are based on face-to-face interviews with the owners or senior managers of companies.

While the use of qualitative or subjective indicators is widespread among policy-makers and members of the private sector, there is significant scepticism among economists about their reliability.[7] The wording and order of questions and the scales used to classify answers can affect responses to surveys. Interpretations of what constitutes a major or severe obstacle to business operations may differ, depending on the firm or country. They may also be influenced by firm characteristics such as company size or performance, or differing assessments of the relative severity of business constraints. In addition, firms may muddle internal factors, which they can influence, with external difficulties outside of their control in their assessment of business environment constraints. Survey respondents may also differ in their willingness to report whether potential obstacles are constraining.

Some pitfalls can be minimised during the survey design stage (such as wording and ordering of questions), while others can be addressed at the survey analysis stage. Several researchers have used the fact that the BEEPS and Enterprise Surveys include subjective as well as objective measures of the business environment to show that subjective rankings are significantly correlated with objective measures: for example, firms experiencing more power outages on average rank electricity higher as an obstacle to their business.[8] Correlations with the business environment measures from other data sources, such as the World Bank *Doing Business* survey, have been explored as a consistency check.

A number of studies have examined the relationship between firm performance and business environment using perceptions data at the country, industry and firm levels.[9] Commander and Svejnar (2010) attempt to estimate the average effect of institutions, as measured by firm perceptions of the business environment, on firm performance. To eliminate the possibility that the reported severity of the constraint is affected by the firm's own performance, they use either instrumental variables or the average value of each business environment constraint reported by other firms, where the average is based on responses of either all other firms in a given industry, country and year, or of all other firms of a given size in a given industry, country and year. To take into account possible interactions between the various business environment constraints, they enter them all at once, and they also account for country-, year- and sector-fixed effects. Their main result is that business environment contraints seem to have effects on firm performance in line with expectations when constraints are analysed individually, but not if they are analysed jointly or when country-, year- and sector-fixed effects are introduced. This could be due to the fact that the use of country-fixed effects, while accounting for possible omitted variables, absorbs information that would otherwise be attributed to country-level differences in various business constraints, or to the fact that some perceived constraints are correlated across countries.

Carlin et al. (2010) propose an alternative analytical framework. Their study makes the distinction between the country-wide supply of business environment aspects and an individual firm's scoring of those aspects, which is necessarily influenced by how much of each aspect the firm actually needs for its operation and therefore how much of it that it demands. This approach therefore removes factors determined by company characteristics that affect a firm's reporting of business environment ratings to obtain a country-wide measure of supply of each aspect of the business environment. It also interprets the severity of business obstacles reported by firms as reflecting the direct costs that these obstacles impose on firm sales or output and that businesses can enumerate in their responses. An increase in the reported severity of a constraint is assumed to generate a similar cost to the firm, regardless of the constraint.

The approach in this chapter is based on the Carlin et al. (2010) framework, in that it seeks to estimate the supply of business environment factors at the country level. However, unlike the Carlin et al., survey answers are expressed as relative deviations from the average severity of reported constraints. This has the advantage that firm- and country-level differences in "reference points" and tendencies to complain are removed from the data. The cost of this approach is that countries cannot be compared in terms of absolute quality of their business environment. However comparisons in relative terms, which are likely to be more reliable, are still possible.[10]

[6] Such as governance (Kaufmann et al. 1999 and 2002), transparency (Transparency International), competitiveness (World Economic Forum's Global Competitiveness Report) and economic freedom (Heritage Foundation, Fraser Institute).
[7] See Bertrand and Mullainathan (2001) and Gelb et al. (2007) for more details.
[8] See, for example, Pierre and Scarpetta (2004), Gelb et al. (2007), Aterido and Hallward-Driemeier (2009).
[9] For an overview, see Commander and Svejnar (2010).
[10] In addition to making comparisons about the quality of the business environment across countries, Carlin et al. (2010) also use their measures to make pair-wise country comparisons of each aspect of the business environment relative to the average constraint score at the country level. This approach yields results that are quite similar to those presented in this chapter.

The aim of this chapter is to suggest a methodology for overcoming these problems (see Box 5.2) and present some initial results, having applied it to the survey data. The approach expresses the BEEPS severity ratings as deviations from the *average* severity of reported constraints. This removes firm-specific differences due to different reference points or varying propensities to complain. The means-adjusted responses are then statistically related to firm-level characteristics that may affect firms' demand for certain services, and therefore lead to different perceptions about the severity of specific constraints. Using this analysis, means-adjusted responses are computed for a *typical* firm in each country.[11]

The result is a country-level measure of the quality of the business environment for each constraint category, expressed as deviations from the average constraint that firms face in that country. It should be noted that the *relative* nature of this measure makes it impossible to compare countries in terms of the *absolute* quality of their business environments. However, it gives concrete and reliable information to country authorities on how a *typical* firm in their country would rank various aspects of the business environment comparatively.[12]

The chapter then attempts to ascertain what could be determining some of these differences in relative constraints. For several areas of the business environment, it compares the relative constraint measures across the EBRD countries of operations and derives insights as to what may affect relative business constraints in some of them. It then goes on to look more closely at a few selected pairings of countries, and attempts to relate differences in constraints to differences in policies or economic

Box 5.2
Calculation of constraint-specific country-level adjusted mean deviation scores

While this chapter focuses on insights from the 2008-09 round of the BEEPS, its analysis utilises business responses in the previous three rounds, as well as numerous Enterprise Surveys conducted by the World Bank. The dataset contains information collected from over 110,000 firms in 115 countries and territories over the period 1999-2009.

Businesses that participated in the BEEPS and Enterprise Surveys rated how big an obstacle various business environment issues presented on a four- or five-point scale (from no obstacle to major obstacle, or on to very severe obstacle), depending on the specific survey. In order to create a unique 4-point scale across the surveys, the major and very severe obstacle categories, wherever both appear, are collapsed into one.[13] This analysis focuses on 10 constraint areas, including infrastructure (with the three subcomponents of telecommunications, electricity and transport, where available), land access, skills, tax administration, labour regulations, customs, licensing, courts, corruption and crime.

Firm- and country-level fixed effects or "tendencies to complain" were eliminated through the demeaning of the businesses' responses at the firm level. For each constraint category i, firm j provided its rating of the constraint it faced, C_{ij}. Then for each firm j the demeaned value or deviation from the mean obstacle, ΔC_{ij}, was calculated as

$$\Delta C_{ij} = (C_{ij} - \overline{C}_j)/\overline{C}_j,$$

where $\overline{C}_j$ is the mean obstacle value for firm j,

$$\overline{C}_j = \left(\sum_i C_{ij}\right)/10.$$

Subsequently, country-wide adjusted averages of ΔC_{ij} were calculated. These averages represent the supply of each business environment feature at the country level, separate from firm-driven factors that help determine constraint scores reported by the enterprises. Following Carlin et al. (2010), for each constraint i a linear regression model is estimated as $\Delta C_{ij} = a_{jk} + X_j B_i + e_{ij}$, where k is a particular survey (that is, it represents a specific country-year combination, such as Georgia in 2005 or Albania in 1999) and B_i is a vector of firm-level characteristics. The vector is defined in such a way that a representative firm emerges whenever all individual characteristics equal zero. The representative enterprise has 30 employees, is in manufacturing, is privately owned with no state-owned predecessor, has less than 10 per cent foreign ownership, exports less than 10 per cent of its sales and has no reported change in employment in the previous three years.

The linear regression model is estimated on the full sample of surveys and countries, which reaches far beyond the 2008-09 BEEPS. The coefficients on firm-level properties, which are assumed to be the same across time and countries, are then computed from the entire dataset described earlier. The estimate of a_{jk} is obtained as the sum of the regression constant and the survey-level fixed effect estimate.

Since $B_i = 0$ for the representative firm, the estimated value $\hat{a}_{jk}$ is the value that this hypothetical firm would respond to a question regarding constraint j in country-year pair k. The representative firms have the same characteristics across countries and years, as described above. Measures $\hat{a}_{jk}$ are therefore comparable across countries and across time, regardless of the specific composition of the various survey samples in terms of firm characteristics.

[11] This approach, which acknowledges that reported constraints reflect both the quality of business environment factors supplied on a country-wide level and demand for these factors determined by firm characteristics, is due to Carlin et al. (2010).

[12] Following Carlin et al. (2010), business obstacle ratings for availability of finance and tax rates are excluded from this analysis because they do not constitute business environment public goods that are provided, even if only in theory, to all businesses equally. While good availability of finance is crucial to businesses, and the lack of it may present a serious obstacle, not all enterprises should in fact be able to obtain financing from banks or other institutions. Similarly, taxes are payments to the authorities rather than a business environment service provided by those authorities. In contrast, tax administration and good customs services are public services, and as such are included in the analysis.

[13] The scales presented to respondents in a survey have an impact on the results, as outlined in an example by Bertrand and Mullainathan (2001). A 5-point scale, such as the one used in BEEPS IV, is preferable to a 4-point scale used in the previous three rounds of the BEEPS from a perspective of accuracy of information. Had the respondents participating in BEEPS IV been shown the 4-point scale instead of the 5-point scale, the distribution of their answers across the categories available would likely be different. With this caveat in mind, in order to be able to compare the results across surveys and countries, we combined the major obstacle and very severe obstacle categories from the 5-point scale to correspond to the major obstacle category on the 4-point scale.

circumstances. The chapter also compares the development of policy priorities in relation to constraints over time, based on the 1999 and 2008-09 BEEPS results. Lastly, regression analysis is used on the full dataset of countries in the transition region as well as elsewhere to identify systematic influences of external factors on the relative severity of constraints.

It is important to emphasise that, notwithstanding their potential usefulness for policy-makers, the constraint rankings identified in this chapter do not automatically translate into policy priorities for reform. The chapter provides little, if any, information on the relative *costs* of improving various aspects of the business environment (although in some cases, the policies or conditions that are linked to differences in business environment conditions across countries can give an indication of such costs). Also, the concerns of BEEPS respondents – even though selected as representative for the business sector as a whole – may not be representative of the concerns of the population as a whole. As a result, company-based measures of the quality of the business environment may not take account of some important aspects of public institutions. For example, there may be valid social reasons for labour market regulations, even if firms view them as a severe business obstacle. In addition, from the perspective of BEEPS respondents, transforming a major obstacle into a medium obstacle in one category may not necessarily be better than converting a medium obstacle to a small one in another.

Nevertheless, it is reasonable to assume that firms feel most concern about the obstacles that they rate as most severe, and that basic reforms in areas of the business environment that are performing very poorly are less costly, or at least no more costly, than raising an already high standard of public goods provision even further. Under these assumptions, the top-rated constraints identified in this chapter's analysis – lack of skills, corruption, tax administration and, in some countries, the functioning of the judiciary and crime – would indeed be policy priorities, at least from the perspective of providing better operating conditions for businesses. Fortunately, these top-rated constraints do not seem to fall into categories that might involve conflicts of interest between businesses and workers or consumers.

Top business obstacles

Chart 5.1 shows the three most severe obstacles that businesses have reported in each transition country (see also Table A.5.1 in the Appendix for the full rankings by country). They are the country-level adjusted means[14] of firm-level deviations from their own average constraint scores. Each deviation represents how much more important a constraint is, relative to the average obstacle that firms face in a given country. The deviations are reported on a relative scale with respect to the average constraint. For instance, the 0.31 rating for corruption in Albania means that businesses are concerned about corruption about 31 per cent more than they are about the average constraint that they face in their operations; 0.10 for skills availability in Armenia, on the other hand, suggests that enterprises see that as a 10 per cent more important obstacle than the average constraint.

Skills availability, corruption and tax administration emerge as the top three business environment constraints in transition countries. Firms in over one-third of countries consider skills availability to be the most severe obstacle, and only six countries do not have this category in their top three concerns. The importance of skills availability transcends regional boundaries. Skills are the most important concern to enterprises from Kazakhstan to Poland. The prominence of skills as an issue may be partly due to the timing of the 2008-09 BEEPS at the end of a period of economic expansion. Also, transition countries are probably branching into more advanced industrial activities that require them to adapt and expand the skills of their labour force appropriately.

Corruption is also rated very highly as a constraint by firms. It is the top concern for businesses in eight of the transition countries, and among the top three in another third of them. It is not the highest-ranked problem in any of the countries in central Europe and the Baltic states (CEB), where higher levels of income or development may in part be linked to the authorities' ability to reduce the extent or perception of corruption. It is also possible that firms in more advanced countries are better able to circumvent the problem. Nevertheless, there are exceptions. In Bulgaria and Turkey, which are both relatively well-off transition countries, businesses see corruption as the top obstacle.

Tax administration is the most important obstacle to firms in five transition countries. In another third of the countries it is among the top three concerns. Interestingly, those countries where tax administration is the main problem are in the same geographic area – Bosnia and Herzegovina, Croatia, Hungary, Montenegro and Romania.

Only in six countries do constraints other than skills availability, corruption or tax administration emerge at the top. Businesses in the Czech Republic and Georgia complain mainly about infrastructure,[15] while in FYR Macedonia the courts clearly do not meet firms' needs or expectations. Licensing appears to be the most important issue for businesses in Mongolia. Labour regulations are the most constraining factor for firms in Slovenia and crime is the most serious concern for businesses in Uzbekistan. Customs and land access are the only constraints that do not appear in any country's top three concerns.

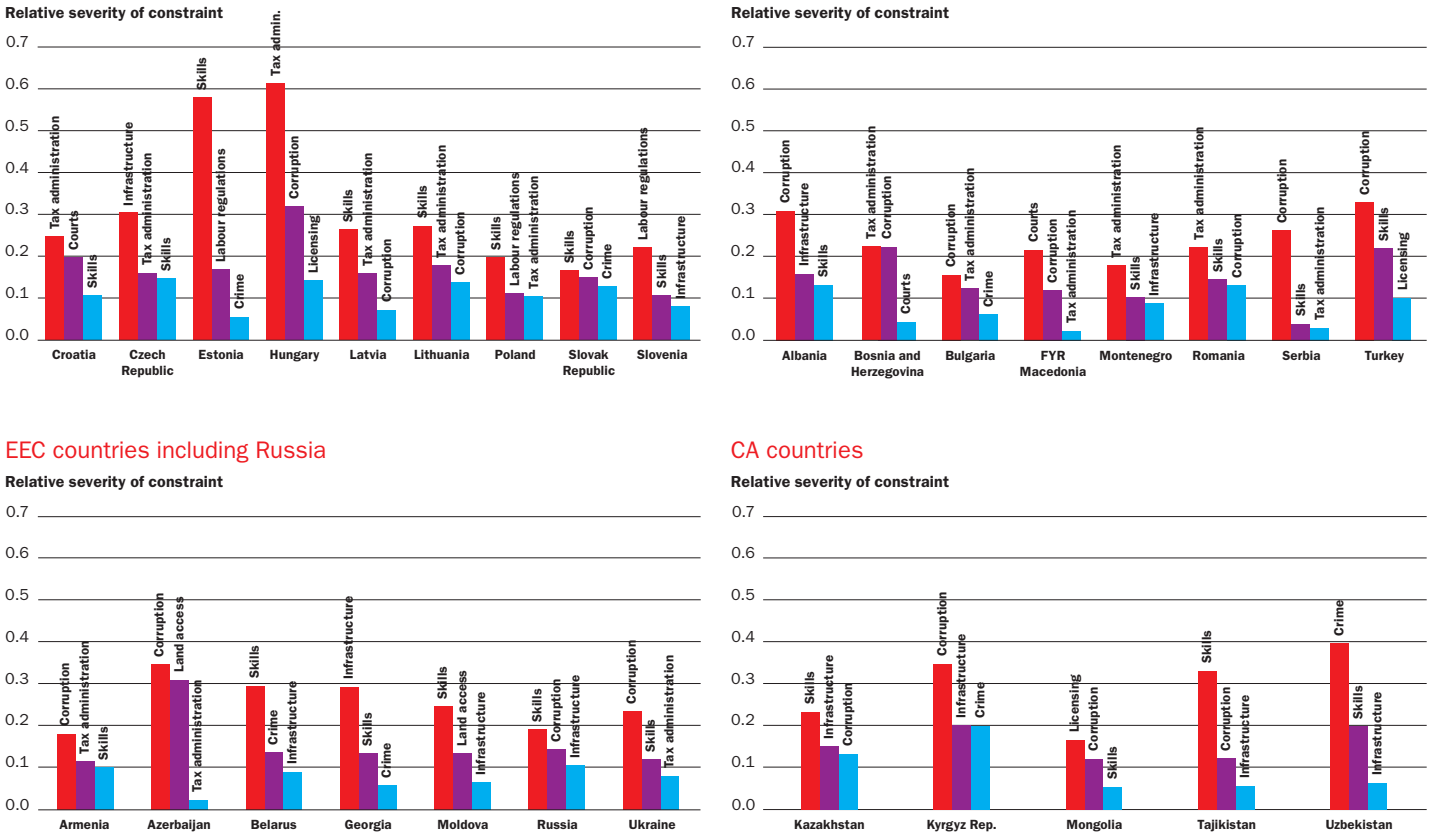
The three main constraints identified in Chart 5.1 would appear to be prime candidates for attention from authorities attempting to improve the business environment in their countries. They merit further investigation in order to understand what determines the relative concerns of firms in these areas and what means are available to governments wishing to address those concerns.

Some severe business obstacles may arise due to policy deficiencies, others because of more general economic circumstances. Significant relative obstacles may also arise when all or most other constraints are not significant on an absolute scale, thus rendering the obstacle in question more severe in comparison. The following comparative analysis of cross-country and pairing differences and of developments over time, as well as regressions of constraints on external factors, attempts to explain why some constraints are more problematic for certain countries and what their authorities could do to alleviate them.

[14] The country-level means have been adjusted to effectively represent the relative constraint values a typical firm would report in each country. This firm has the same characteristics across countries and surveys considered (see Box 5.2 for details).

[15] Given different levels of economic development, the specific concerns about infrastructure are likely to be different in Georgia compared with the Czech Republic.

Chart 5.1
Top three business environment obstacles by country



Source: BEEPS IV.
Note: Higher bars indicate that firms complain more about those particular business constraints relative to the average constraint that they face in their operations.

Cross-country comparisons: insights from outliers

This section considers what may be gleaned from cross-country comparisons of constraints that businesses consider the most severe. Relative scores for several business environment areas reveal interesting patterns, where either individual countries or regional groups exhibit significant positive or negative differences from the rest of the transition region. For example, labour regulations have come to be of concern to businesses in more developed countries (see Chart 5.2). The opposite experiences of Hungary and Estonia with regard to tax administration (see Chart 5.3) would indicate that businesses appreciate a simpler tax system that is easier to navigate. In Croatia and FYR Macedonia, slow progress in legal reforms has resulted particularly in business complaints about the courts in those countries (see Chart 5.5). Meanwhile, crime is a major issue in Uzbekistan (see Chart 5.6), implying that the country's criminal code and penal policy is failing to create a safe environment for its firms.

Chart 5.2 shows that the CEB countries, with the exception of the Slovak Republic, see labour regulations as an above-average obstacle. The European Union (EU) requires its members to meet minimum standards in certain aspects of labour regulations, including working hours. Clearly, implementation or more consistent enforcement of these stricter regulations in the CEB countries following their entry into the European Union has resulted in firms perceiving them as rather onerous. The government in the Slovak Republic seems to have successfully countered this tendency through a more flexible labour code, adopted in 2003.[16] Recognised by the World Bank as one of the most flexible in the European Union,[17] the labour code allows employers to choose from a wide variety of labour contracts[18] and offers an expanded list of possible reasons employers can give for the termination of employment.

Chart 5.3 shows relative tax administration constraints by country and highlights the opposite extremes apparent in Estonia and Hungary. Estonia is one of the few transition countries where tax administration is considered to be a below-average problem by businesses. The country has a very efficient and well-functioning system that incorporates streamlined e-filing. The e-system was introduced in 2000 and has since developed further. On the other hand, Hungary is the country where firms place the highest priority on tax administration. As Hungary has consolidated its fiscal position in recent years, new taxes have been introduced. In 2006 the authorities instituted a "solidarity tax" payable by most companies and high-earning individuals. In 2007 further new levies were imposed, including an environmental tax, a vehicle registration tax and a compulsory minimum tax based on 10 per cent of turnover. Although tax rates lower than

[16] See Fuentes (2007).
[17] Along with Bulgaria, Czech Republic and Hungary – see Kuddo (2009) – where, however, the businesses still perceive the labour regulations constraint as a higher-than-average business constraint that they face in their operations.
[18] Such as a regular employment contract; a part-time employment contract concluded for less than 40 hours per week; a part-time employment contract concluded for less than 20 hours per week; an agreement on performance of work concluded for less than 300 hours per year; an agreement on performance of work with a student for less than 100 hours per year.

the standard ones do exist, businesses have to prove that they qualify and frequently face a strict audit by tax authorities. An additional tax on the profits of certain energy suppliers and trading companies was introduced in 2008. Hungary certainly needed fiscal consolidation in the years leading up to the 2008-09 round of the BEEPS, and the higher tax rates and stricter application of tax rules that were part of the package may explain part of the business discontent apparent in the chart. The implementation of the consolidation, however, also imposed extra bureaucracy on businesses and has clearly created a significant hindrance. Based on the lessons from Estonia and Hungary, it seems that a streamlined tax administration does indeed result in a lower perceived relative constraint. Countries in need of further tax revenue should, while increasing tax rates, also attempt to keep the tax rules as simple as possible.

The availability of appropriate skills is an above-average concern in almost all transition countries (see Chart 5.4). This looks particularly apparent in Estonia, although most of its business environment is quite well developed and so skills availability on an absolute scale is rather good. Moreover, Estonia has experienced a particularly rapid change in its "product space" (or mix of products), with firms moving into high-technology activities. Hungary is the only country where skills availability appears not to be an issue for businesses. This is probably because the country has a comparatively good education system[19] and a very low outflow of skilled labour relative to its CEB neighbours.[20] There may be non policy-induced social or language reasons that deter potential Hungarian migrants. Its example shows, however, that policy-makers must strive to not only create, but also act to preserve, the pool of skills necessary to supply the enterprises.

Chart 5.5 shows that businesses in Croatia and FYR Macedonia are particularly concerned about the functioning of their countries' courts. In Croatia there is a large backlog in the courts despite some progress, and the length of proceedings remains excessive. In addition, the judicial system is weak, leading in particular to enforcement shortcomings in the areas of creditor and property rights.[21] Registering property is a lengthy and onerous process and Croatia significantly underperforms compared with the OECD (Organisation for Economic Co-operation and Development) average in this respect (taking 104 days, as opposed to 25, according to the World Bank *Doing Business 2010* survey). Given the country's level of development, the capacity of Croatia's courts to service the needs of businesses appropriately needs to be improved. FYR Macedonia also has significant shortcomings in the area of law enforcement. Despite some progress in recent years, court and legal procedures are still slow. It appears that the main weakness is the lack of enforcement capacity, attributable primarily to ongoing inadequacy in training of personnel.[22] This particularly undermines the implementation of court rulings. Clearly, for both countries, the slow pace of reform directly translates into real obstacles for businesses.

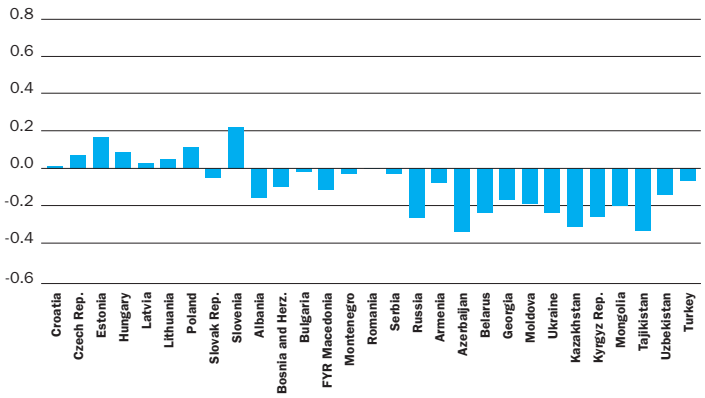
Crime is by far the biggest relative concern for businesses in Uzbekistan (see Chart 5.6), despite the fact that the country's criminal code and penal policy have a reputation for being particularly strict. It would therefore appear that the prospect of stern punishment does not necessarily achieve lower levels of crime and a safer environment for businesses to operate in.

[19] Hungarian students achieve at or around the CEB average according to the OECD's PISA (Programme for International Student Assessment) 2006 study results.
[20] Of the labour force, 0.6 per cent worked abroad in 2006 as opposed to an average of 5.8 per cent for the CEB countries as a whole, according to Tirpak (2007).
[21] See the Croatia 2009 Progress Report by the Commission of the European Communities (2009a).
[22] See the Former Yugoslav Republic of Macedonia 2009 Progress Report by the Commission of the European Communities (2009b).

Chart 5.2

Labour regulations are a significant issue across most EU entrants

Relative severity of labour regulations constraint

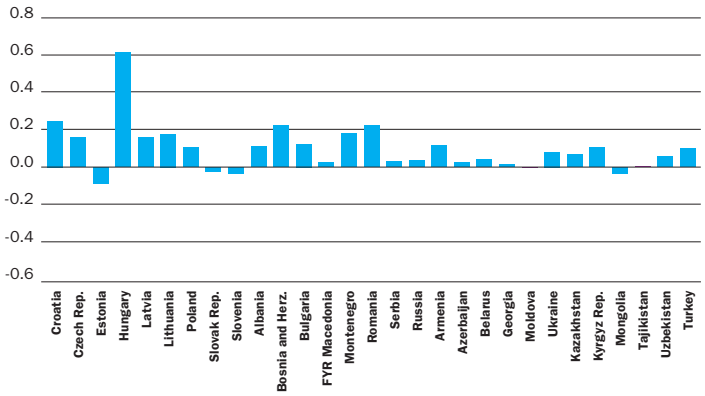


Source: BEEPS IV.
Note: Higher bars indicate that firms complain more about the labour regulations constraint relative to the average business constraint that they face in their operations. Positive values thus represent a higher-than-average labour regulations constraint, whereas negative values represent a lower-than-average labour regulations constraint relative to the average business constraint firms face in their operations.

Chart 5.3

Hungarian businesses see a serious tax administration obstacle

Relative severity of tax administration constraint

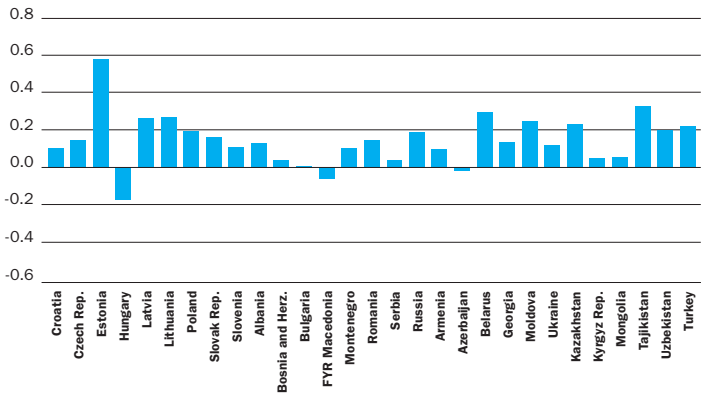


Source: BEEPS IV.
Note: Higher bars indicate that firms complain more about the tax administration constraint relative to the average business constraint that they face in their operations. Positive values thus represent a higher-than-average tax administration constraint, whereas negative values represent a lower-than-average tax administration constraint relative to the average business constraint firms face in their operations.

Chart 5.4

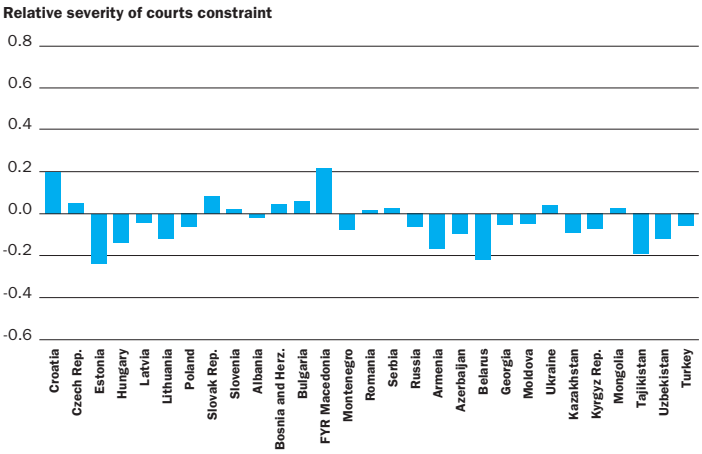
Estonian firms are severely constrained by skills availability

Relative severity of skills availability constraint



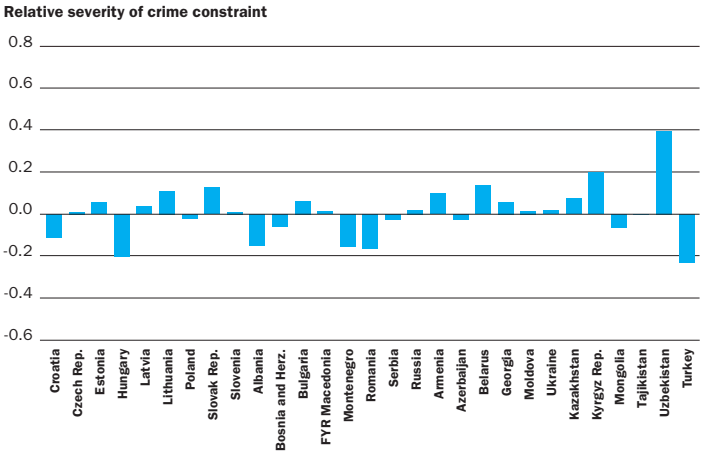
Source: BEEPS IV.
Note: Higher bars indicate that firms complain more about the skills availability constraint relative to the average business constraint that they face in their operations. Positive values thus represent a higher-than-average skills availability constraint, whereas negative values represent a lower-than-average skills availability constraint relative to the average business constraint firms face in their operations.

Chart 5.5
Functioning of courts constrains firms in Croatia and FYR Macedonia



Source: BEEPS IV.
Note: Higher bars indicate that firms complain more about the functioning of the courts constraint relative to the average business constraint that they face in their operations. Positive values thus represent a higher-than-average functioning of courts constraint, whereas negative values represent a lower-than-average functioning of courts constraint relative to the average business constraint firms face in their operations.

Chart 5.6
Crime poses serious issues for firms in Uzbekistan



Source: BEEPS IV.
Note: Higher bars indicate that firms complain more about the crime constraint relative to the average business constraint that they face in their operations. Positive values thus represent a higher-than-average crime constraint, whereas negative values represent a lower-than-average crime constraint relative to the average business constraint firms face in their operations.

Perceptions may have been unduly influenced during the 2008-09 BEEPS fieldwork period when migrant workers began returning to Uzbekistan as the economic environment worsened elsewhere and, faced with few viable earning opportunities, might have contributed to increased criminal activity. However, policy-makers in Uzbekistan should still perhaps reconsider their approach to the criminal and penal system and investigate further why businesses place such an emphasis on the problem of crime.

Comparisons of constraints in selected country pairings

To help clarify the reasons behind cross-country differences in reported relative constraints, three country pairings – Bulgaria and Romania, Estonia and Lithuania and the Kyrgyz Republic and Tajikistan – have been selected for closer comparison and analysis. Each pairing is at a comparable level of development (as characterised by GDP per capita and other macroeconomic variables) and from the same subregion, with similar experiences in the years before the start of transition and since. The pairings are intended to serve as examples of the further research that could be performed to reach country-specific recommendations for other transition economies.

The analysis focuses on business constraints that are of particular operational concern to firms in one paired country but significantly less so to firms in the other. Such differences may, in some instances, suggest interesting policy and development options for the country where a particular obstacle is significant. Based on the following findings, it would appear that Romania could look to Bulgaria for ideas on improving its tax administration (while outperforming its southern neighbour on the issue of crime); Estonia's experience could help Lithuania fight corruption more effectively; and Tajikistan could match the Kyrgyz Republic on availability of skills if it increased its focus on education.

Bulgaria and Romania

Neither Bulgarian nor Romanian businesses have significant concerns over infrastructure, land access, labour regulations or business licensing (see Chart 5.7). Customs seem to be the lowest priority for enterprises in both countries, which may be due to the beneficial impact of their EU accession on the constraint.

On the other hand, Romanian firms have serious issues with the availability of appropriate skills in the workforce, whereas Bulgarian managers do not view this as a priority. During the boom years up to 2007-08, Bulgaria's economic expansion was driven largely by growth in construction, which requires less skilled labour. Economic development in Romania, however, was less focused on construction and real estate, thus increasing firms' relative demand for more skilled labour. Moreover, the outflow of skilled labour from Romania is likely to have been higher than from Bulgaria: according to one measure, in the period from 2000-05 net migration from Bulgaria as a fraction of total population was 0.5 per cent as opposed to 1.2 per cent in Romania.[23] Language skills may be part of the explanation: a large number of Romanians work in Spain and Italy,[24] both Romance-language speaking countries like Romania itself, whereas Bulgarians are more limited to Anglo-Saxon countries such as the United Kingdom.

Businesses in both countries see important constraints in tax administration, although more so in Romania (as confirmed by Romania's 149th position in the World Bank 2010 *Doing Business* "Paying Taxes" ranking of 183 countries). This seems particularly attributable to the large number of tax payments businesses have to make each year, which significantly exceeds the OECD average (113 as compared with 12.8 and consistently increasing). Bulgaria, on the other hand, is ranked 95th in the 2010 *Doing Business* survey and most tax categories are in line with the OECD average or lower. However, the country still falls short on the time it takes to prepare, file and pay taxes, which exceeds the OECD average by a very significant 422 hours. Nevertheless, Romania might want to emulate some of its southern neighbour's tax administration initiatives.

Crime is a priority concern for businesses in Bulgaria, but less so in Romania. This is consistent with the higher crime rate (the total

[23] World Development Indicators. This official figure may represent only a fraction of actual migration, but can serve as a good indicator for the difference between the two countries.

[24] See, for example, BBC (2006).

number of crimes per capita) recorded in Bulgaria (almost 50 per cent higher than Romania's, according to Eurostat). Even though the total number of crimes in Bulgaria is declining, organised crime remains a serious issue in the country.[25]

Corruption is perceived as one of the most severe impediments to doing business in Bulgaria and Romania. In the Transparency International (TI) 2009 Corruption Perceptions Index, both score poorly at 3.8.[26] Although each government has extended the fight against corruption in recent years in order to comply with EU demands, significant shortcomings remain.

Estonia and Lithuania

Estonian and Lithuanian businesses do not face major constraints in infrastructure, land access, licensing or the courts (see Chart 5.8). As in Romania and Bulgaria, customs are the lowest priority as both countries have been EU members since May 2004.

Skills availability is the priority concern for businesses in both countries, although even more so in Estonia. Estonia faces a significant brain drain, in addition to having the lowest proportion (along with Latvia) in the CEB subregion of 20-24 year olds who have completed secondary education (at 80.9 per cent in 2007).[27] This is an especially constraining factor, as companies in Estonia are attempting to move into production of higher value-added goods and information and communications technology (ICT) activities, which require highly skilled labour. Lithuania, on the other hand, has a larger and more diversified economy, but which on average produces lower value-added products such as textiles and furniture. In this respect, because of the increasing sophistication of its economy, Estonia has clearly hit a constraint not yet experienced by Lithuania.

Tax administration appears to be the second most important issue for firms in Lithuania, but has little impact on Estonian businesses. This is perhaps because Estonia has a very advanced and efficient tax system that is comparable to the Scandinavian countries. The tax filing e-system in Estonia was introduced in 2000, whereas the more recent e-system in Lithuania is not as advanced and streamlined. Lithuania may very well achieve the Estonian level of tax administration efficiency over time if it simply fine-tunes its current policies.

Corruption is a relatively important constraint in Lithuania, but not an issue of above-average significance in Estonia. In 2009 Estonia ranked 27th on the TI Corruption Perceptions Index with a score of 6.6, a figure comparable to France. Lithuania, however, was placed 52nd with a score of 4.9. Specific anti-corruption initiatives in Estonia have included the setting up of a detailed web site by the Ministry of Justice providing simple guidelines, forms and hotlines to report official corruption. Lithuania could therefore step up its anti-corruption efforts by perhaps emulating some of Estonia's apparently successful policies.

Kyrgyz Republic and Tajikistan

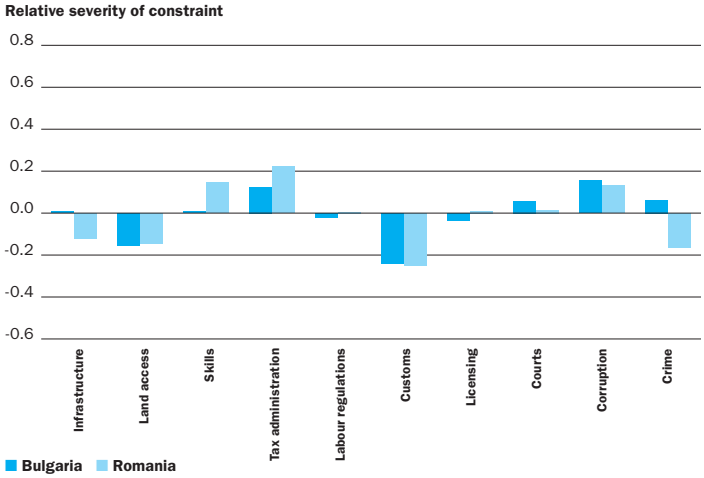
Firms in the Kyrgyz Republic and Tajikistan do not see land access, tax administration, labour regulations, customs, business licensing or the courts as the most serious business environment constraints, relative to the other obstacles they face (see Chart 5.9).

The difference in perception of infrastructure as an issue in the two countries is largely due to the slightly above-average constraints reported in telecommunications by Kyrgyz businesses (see Table A.5.1). Tajik firms, on the other hand, see telecommunications as a low-level customs constraint.[28] Electricity, however, remains a major issue in both countries. Tajikistan suffers electricity shortages and outages. The Kyrgyz Republic also experiences outages, and went through an energy crisis at the time of the 2008-09 BEEPS fieldwork.

Availability of skills is a much higher priority concern for businesses in Tajikistan than in the Kyrgyz Republic. Education spending and

Chart 5.7

Bulgaria and Romania: corruption is constraining firms in both countries

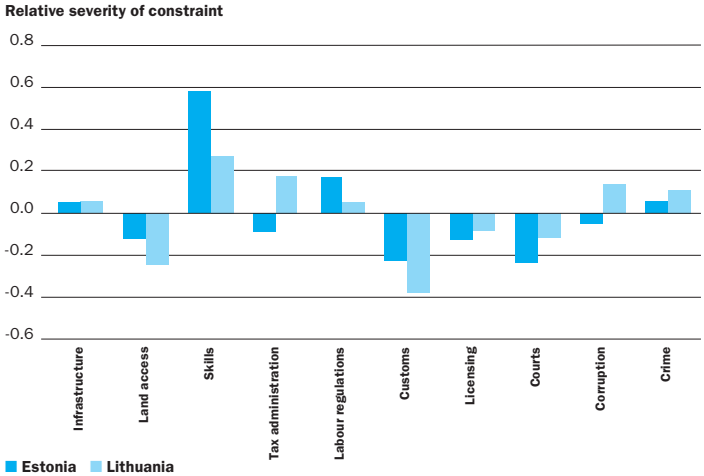


Source: BEEPS IV.

Note: Higher bars indicate that firms complain more about a particular business constraint relative to the average constraint that they face in their operations. Positive values thus represent a higher-than-average constraint, whereas negative values represent a lower-than-average constraint relative to the average business constraint firms face in their operations. The infrastructure constraint is the average of electricity, telecommunications and transport constraints.

Chart 5.8

Skills availability is far more constraining in Estonia than in Lithuania



Source: BEEPS IV.

Note: Higher bars indicate that firms complain more about a particular business constraint relative to the average constraint that they face in their operations. Positive values thus represent a higher-than-average constraint, whereas negative values represent a lower-than-average constraint relative to the average business constraint firms face in their operations. The infrastructure constraint is the average of electricity, telecommunications and transport constraints.

[25] See the Report from the Commission to the European Parliament and the Council on Progress in Bulgaria under the European Commission's Co-operation and Verification Mechanism (2010).

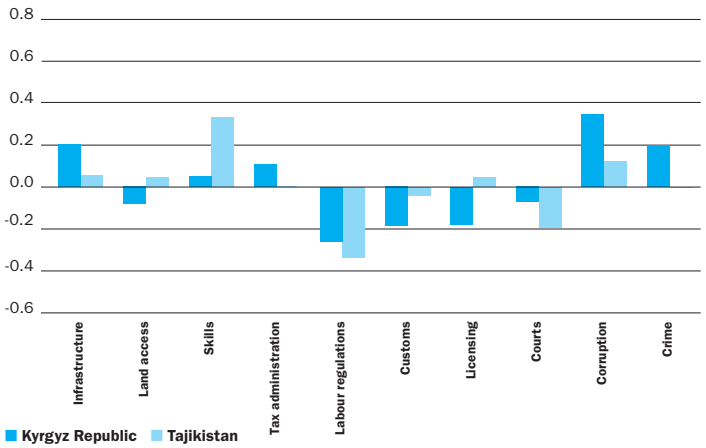
[26] TI Corruption Perceptions Index is measured on a scale from 0 (the highest level of corruption perceptions) to 10 (the lowest possible level of corruption perceptions).

[27] Source: Eurostat.

[28] Even though the landline, mobile, internet and broadband penetration rates are lower in Tajikistan than in the Kyrgyz Republic.

Chart 5.9

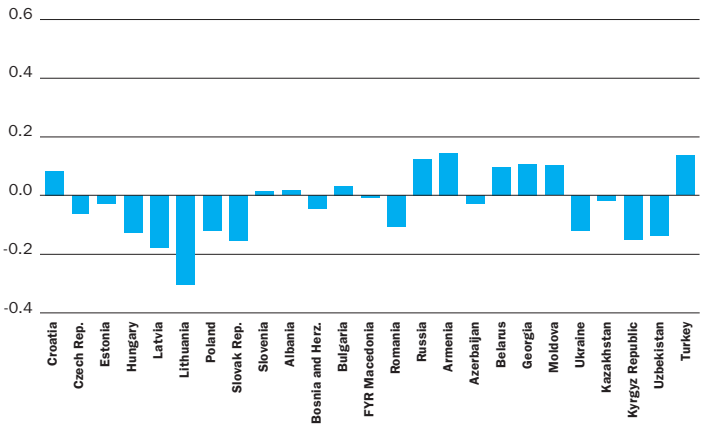
Corruption is a major issue in Kyrgyz Republic, skills in Tajikistan



Source: BEEPS IV.
Note: Higher bars indicate that firms complain more about a particular business constraint relative to the average constraint that they face in their operations. Positive values thus represent a higher-than-average constraint, whereas negative values represent a lower-than-average constraint relative to the average business constraint firms face in their operations. The infrastructure constraint is the average of electricity, telecommunications and transport constraints.

Chart 5.10

EU entrants improved on customs since 1999



Source: BEEPS I and IV.
Note: BEEPS I was not conducted in Mongolia and Tajikistan, and Serbia and Montenegro were part of Yugoslavia at the time and cannot be distinguished in the data. Negative values represent an improvement in customs as a business obstacle, meaning that customs was perceived as less of an obstacle at the time of BEEPS IV than it was during BEEPS I.

achievement in Tajikistan are significantly lower. Tajikistan spent only 3 per cent of GDP on education in 2008, compared with 7 per cent in the Kyrgyz Republic, and its tertiary school enrolment remained below 20 per cent in 2005-08, whereas that in the Kyrgyz Republic edged towards 50 per cent during the same period.[29] Public policy in Tajikistan clearly places far less emphasis on education, and this leads to a lower availability of appropriate skills for businesses. This is compounded by the significantly larger outflow of labour out of Tajikistan, at around 1 million relative to a total population of 6.8 million, compared with 300,000 out of a population of 5.5 million in the Kyrgyz Republic. This should provide sufficient incentive for Tajikistan's policy-makers to consider raising their commitment to education and skills development to levels closer to those in the Kyrgyz Republic.

Businesses in the Kyrgyz Republic complain more about corruption relative to their average constraint than enterprises in Tajikistan, although the TI Corruption Perceptions Index rankings for both countries are similar. A possible explanation is that most of the corruption in Tajikistan is associated with the aluminium and cotton sectors in the south of the country, which were not included in the BEEPS survey as it only covers the manufacturing and service sectors. The average response may then underestimate the level of corruption in the economy as a whole.

Tajik enterprises do not view crime as such a priority concern as their counterparts in the Kyrgyz Republic. This probably reflects the difference in the two countries' crime rates. Although the rate dropped from 641 per 100,000 inhabitants to 551 per 100,000 inhabitants[30] between 2005 and 2008 in the Kyrgyz Republic, it remains significantly above the rate of 158 per 100,000 inhabitants in 2008 in Tajikistan. Nevertheless, the Kyrgyz Republic may already be moving in the right direction in its fight against crime.

Changes over time: 1999-2008

Only results from the 2008-09 BEEPS have so far been considered in this chapter's analysis. Further inferences may be drawn from a comparison of this data with survey responses from the first round of the BEEPS in 1999. Transition countries saw very significant changes to their economies during the years between the two surveys. They also implemented an array of reforms impacting on the business environment, which have influenced how entrepreneurs and managers perceive various constraints to their operations. Analysing changes in these perceptions over time can shed some light on which reforms have been more effective than others. For example, most of the new EU members complain much less about customs since their accession to the Union, while businesses in Georgia now see corruption as less of a problem than in 1999 in the wake of a government anti-corruption campaign. Similarly, after successful efforts to reduce crime in Albania, the problem is viewed by businesses as a much smaller obstacle than in 1999.

Chart 5.10 indicates the change in the relative perception of customs as a business constraint between 1999 and 2008. Most of the new EU entrants saw a decrease in the importance of customs as an obstacle, which most likely reflects the abolition of customs procedures for trade within the Union. The actual size of the decrease may depend on how much firms interact with counterparts outside of the European Union. It is clear, however, that entry into a customs union does have the expected beneficial impact on businesses in terms of simpler procedures.

Georgia has seen by far the most progress in reducing perceptions of corruption as an obstacle to businesses (see Chart 5.11). The country's score in the TI Corruption Perceptions Index was 1.8 in 2003 and improved significantly to 4.1 in 2009. Since the "Rose Revolution" in 2003, impressive reforms have been implemented in governance and the fight against corruption. The number of civil servants has been reduced substantially, and the remuneration of those remaining has been increased to reduce the incentive to accept bribes. Moreover, Georgia was one of the first transition countries to introduce legislation that holds its companies criminally liable for bribery. Georgia's radical approach has been particularly effective at eradicating low-level corruption and its businesses clearly appreciate the results, offering a positive policy example to other countries facing a similar problem.

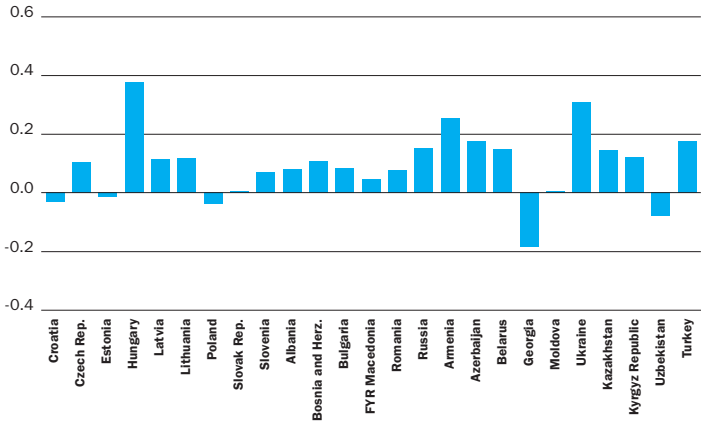
[29] See the World Development Indicators.

[30] The crime rate is calculated as the ratio of the number of registered crimes to total population. Source: National Statistical Committee of the Kyrgyz Republic and Statistical Agency under the President of the Republic of Tajikistan.

Chart 5.11

Georgia shows the biggest improvement in corruption since 1999

Difference in relative severity of corruption constraint, 2008-1999

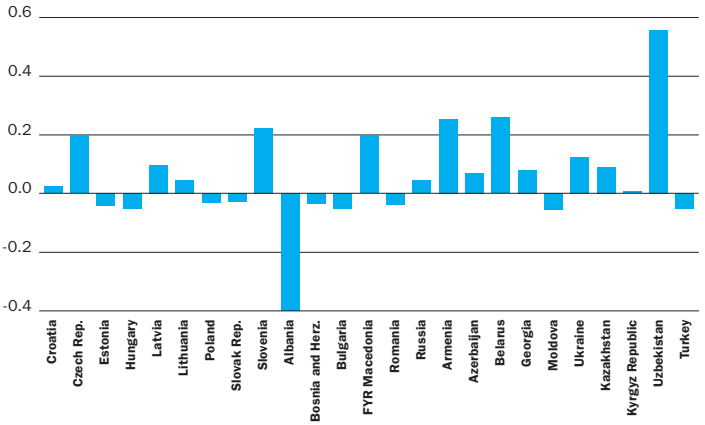


Source: BEEPS I and IV.
Note: BEEPS I was not conducted in Mongolia and Tajikistan, and Serbia and Montenegro were part of Yugoslavia at the time and cannot be distinguished in the data. Negative values represent an improvement in corruption as a business obstacle, meaning that corruption was perceived as less of an obstacle at the time of BEEPS IV than it was during BEEPS I.

Chart 5.12

Albanian firms much less concerned about crime in 2008

Difference in relative severity of crime constraint, 2008-1999



Source: BEEPS I and IV.
Note: BEEPS I was not conducted in Mongolia and Tajikistan, and Serbia and Montenegro were part of Yugoslavia at the time and cannot be distinguished in the data. Negative values represent an improvement in crime as a business obstacle, meaning that crime was perceived as less of an obstacle at the time of BEEPS IV than it was during BEEPS I.

In Albania the level of actual criminal activity declined between 1999 and 2008, (as evidenced by a fall in the homicide rate from 6.6 per 100,000 inhabitants in 2001 to 3.3 per 100,000 inhabitants in 2007),[31] and the perception of crime as a business obstacle decreased substantially (see Chart 5.12). Despite the challenges still facing its police force, the country's capacity to fight against organised crime and drug trafficking has been improving. As highlighted earlier in the chapter, Uzbekistan, in contrast, has failed to implement effective criminal and penal system policies, and the perception of crime as a business constraint has worsened significantly as a result.

Regression analysis

While the above analysis yields some important insights into what might be determining the differences in the business environment across countries and over time, it relies on a limited number of specific examples. This section provides a more systematic exploration of which external factors, whether policy-related or not, influence constraints in a significant way.

Where possible, data on external factors relating to all business constraints were collected. To make the analysis as comprehensive as possible, countries from inside and outside the EBRD region of operations were included, using data from the BEEPS and other Enterprise Surveys conducted between 1999 and 2008. Regression analysis was then applied to ascertain which external factors, if any, help explain how business environment constraints are perceived by firms (see Box 5.3). Six findings relating to telecommunications, transport, skills, tax administration, customs and crime are particularly worth highlighting.

Telecommunications

When the country-average score deviations are regressed on a variety of telecommunications- and ICT-related external variables, the data show that internet and broadband penetration does not significantly affect firms' perceptions of telecommunications constraint. Similarly, a country's expenditures on ICT do not influence how great a relative obstacle the telecommunications environment represents to businesses.

On the other hand, higher penetration of mobile and landline telephones in an economy is associated with a drop in the relative importance of telecommunications as an obstacle to the firms' operations. Importantly though, when both mobile and landline telephone penetration rates are included in the same regression, only the landline effect remains. The regressions control for time effects, which may be significant for this constraint, as the technology relevant to the telecommunications environment has changed substantially between 1999 and 2008.

As technology develops further, governments may focus their policies more on solely supporting mobile telecommunications and ICT, especially internet penetration. The above evidence, however, suggests that that may not be sufficient to reduce the obstacles businesses face within the telecommunications sector. At least some effort to improve the landline service may still be appropriate.[32]

Transport

Country-average score deviations for transport as a business environment constraint were regressed on measures of road and rail density, of road, rail and air freight transported and of gasoline prices and cars per capita in each country. Three of the objective transport environment measures were significantly associated with the transport constraint, while also controlling for the macroeconomic conditions in each country.

A higher rail density and level of freight transported are both significantly associated with a decrease in the extent to which businesses complain about the transport constraint relative to others. Therefore, while a larger rail network apparently helps businesses, the overall development of rail freight transport is also beneficial to them. Costs of transport, however, as approximated by the price of gasoline, turns out to be the variable that is most closely linked to firms' complaints about transport in their country. For example, according to the regression estimation, a US 10 cent price fall in the price of gasoline per litre is associated with an over 2 percentage point decrease in the relative importance of transport as a business constraint.

[31] Source: United Nations Office on Drugs and Crime.

[32] A landline may be required for internet access in certain countries or parts of countries, which may help explain why landline penetration rates are associated with a drop in the relative importance of telecommunications as an obstacle and broadband penetration rates themselves are not.

Governments and policy-makers may not, therefore, be able to have a significant impact (other than marginally through the excise tax on gasoline) on how the transport constraint is perceived by businesses if the price of gasoline works against them. At a given gasoline price level, however, they may want to look particularly at the quality of and focus on their country's rail network if they want to reduce the transport constraint on businesses.

Skills

The analysis of the skills availability constraint considered the impact of a range of explanatory variables, including education spending, primary and secondary school completion rates, literacy and the proportion of the labour force that has completed primary, secondary or tertiary education. None has the expected effect on the reported skills constraint – that is, none is significantly associated with the reduction in the relative importance of labour skills constraint for businesses.

On the other hand, regressions reveal a fairly robust relationship between purchasing power parity (PPP)-adjusted GDP per capita levels, unemployment rates and the skills availability constraint. Businesses in richer countries complain more about issues related to skills availability. It seems that as countries develop and their businesses and industries become more sophisticated, skill levels in their labour forces have trouble keeping up with the pace of change. Also, not surprisingly, enterprises in countries with higher unemployment rates complain about issues related to skills availability relatively less. As more of the labour force is available for hire, finding employees with the right set of skills becomes less of an obstacle. Numerical results suggest that an unemployment rate increase of 1 per cent is associated with a 1 percentage point drop in the relative importance of the skills availability constraint to businesses.

Even when countries successfully maintain low unemployment rates and become richer over time, they need to continue to focus on skills development in their workforces. However, simply spending more on education programmes does not necessarily reduce the skills constraints faced by firms. Policy-makers may have to work more closely with businesses to develop and support relevant and targeted training and education.

Tax administration

The impact of three variables relevant to the tax administration constraint on businesses was explored: the number of tax payments firms must make each year; the total time it takes to prepare, file and pay taxes; and the amount of time spent by firms in meetings with tax officials each year. It is the last variable that is significantly associated with the constraint. One additional meeting with tax officials is associated with a 1 percentage point increase of the constraint on firms' relative scale of importance. Firms also manage to separate the impact of the tax rate they face on their operations from the impact of the tax administration on their operations – the rate of tax has no significant impact on the tax administration constraint.

While the simplification of tax administration in terms of documentation or the time to prepare and pay taxes may help businesses, the transparent and efficient implementation of whatever rules are in place matters more. If businesses are not distracted by numerous interactions with tax officials, they may regard tax administration as a lower priority business constraint.

Customs

A variety of objective measures were explored to help explain why businesses complain about customs. These included the average time it takes to clear customs, the average tariff rate, the number of documents necessary to export and import, lead time to export and import and the overall cost to export or import in US dollars per container. The overall cost measures included costs for documents, administrative fees for customs clearance and technical control, customs broker fees and other charges. They did not include tariffs or trade taxes.

The volume of paperwork, the lead time and cost to export and import and higher tariff rates are all associated with making customs more of an obstacle to businesses. It is the cost to import and especially the cost to export, however, that are particularly significant, even when macroeconomic variables are included in the regression. More specifically, a US$ 100 increase in the cost to export a container of goods is associated with a 1 percentage point increase in the customs constraint on firms' relative constraint scale. Similarly, a US$ 150 increase in the cost to import is associated with a 1 percentage point increase in the customs constraint on the scale.

Policy-makers can clearly alleviate some business concerns about customs by decreasing tariff rates and simplifying customs procedures. However, it is the official fees associated with the import and export process that firms find most constraining and that raise the perception of customs as a problem.

Crime

The analysis considered data on various types of crime, including assault, burglary, car theft, theft and homicide, but the only significant factor in explaining the relative importance of crime as a business constraint is the homicide rate (as an indicator of the most violent sort of crime). Reducing the homicide rate by one homicide per 100,000 inhabitants is associated with a 1 percentage point decrease in crime's relative importance as a constraint.

Fighting crime is always a priority for any society and government. The analysis suggests that focusing on the most violent types of crime, including the homicide rate, would have the biggest impact on the businesses environment. Of course, this leaves the question of how to go about this most effectively – including whether addressing minor forms of crime may have beneficial spillovers for more violent forms.

Conclusion

Academics and policy-makers maintain that the quality of the business environment is an important determinant of economic growth and development. Using a novel approach to analysing firm-level data on business obstacles from the BEEPS and related Enterprise Surveys, this chapter has considered which aspects of the business environment constrain businesses the most and how country authorities might respond.

The analysis has focused on country-wide *relative* measures of how constraining businesses view 10 different areas of the business environment relative to the average obstacle that they face in their operations. These measures avoid two inherent problems with firm-level data on business environment quality. They remove the firm- and country-specific "tendencies to complain", which could cloud the meaningfulness of survey responses. They also adjust responses for firm-level factors that determine how a given firm views a particular aspect of the business environment and therefore may distort its reporting of the actual institutional quality that it faces.

The main finding is that many transition countries share the same three main business environment concerns. In over two-thirds of countries, firms feel most constrained by skills availability, corruption or tax administration. In a few others, infrastructure, labour regulations, licensing, the functioning of courts or crime are the top concerns. Customs and land access are not the most important concern for businesses in any country.

Comparisons of relative business constraints across countries and across time yield interesting policy lessons and insights. Countries may often be able to improve an aspect of their business environment by emulating policies implemented by their peers. For example, the successful reduction of corruption as a business constraint in Georgia and the lack of concern regarding tax administration in Estonia may suggest appropriate courses of action for other countries at a similar level of development.

A linear regression analysis of constraint determinants suggests further pointers for alleviating business obstacles. Its results show, for example, that despite the rise of mobile telephony, landline availability still matters, that rail transport may be more important to firms than roads, and that governments need to spend more strategically – rather than simply more – on education to provide appropriately skilled workforces. It also shows that business managers want a transparent and systematic tax administration system, and are particularly concerned about the costs of customs bureaucracy and violent crime.

Countries aiming to improve their business environment will need to perform a more exhaustive examination of the constraints facing firms and the options for addressing them than this analysis has undertaken. However, in so doing, they may utilise both the relative measures of business constraints defined in this chapter and some of the approaches the chapter introduced to relate those measures to facts on the ground.

Box 5.3
Using linear regression to explore drivers of constraints

Simple linear regression models are used in this chapter to investigate the relationship between the relative prioritisation of various business environment constraints and external factors, whether determined by policy or the economic environment. See Table 5.3.1 for a list of external variables used as explanatory variables for each business constraint measure.

Regression analysis was only applied in cases where several distinct external submeasures were available for a particular area of the business environment. For instance, regressing the BEEPS-based measure of corruption on Transparency International's single measure of corruption was avoided. Even if a correlation was to be found, no clear policy messages could be formulated regarding which aspect of corruption authorities should try to tackle first.

The analysis is performed on the full sample of surveys, covering the years 1999-2009 and countries within and outside the transition region (as the BEEPS data were augmented with Enterprise Surveys in other regions of the world – see Box 5.2). Due to the limited number of surveys, and therefore datapoints in the sample where appropriate explanatory variables are also available, most regressions are run on one such variable at a time. All regressions are also estimated with macroeconomic control variables, including GDP per capita levels (purchasing power parity-adjusted), GDP growth rates and inflation rates. They are also re-run with regional dummies, with separate dummies defined for transition, Sub-Saharan, Latin American, South Asian, Middle Eastern and East Asian countries. Lastly, all model specifications are also estimated using year fixed-effect models, which allow for impact of explanatory variables on perceived importance of business constraints to vary over time. Especially for technology-related constraints such as telecommunications, this is an important modification of the model that reveals new results, as described in the main text.

The most interesting results of the regression analysis are summarised in the main text. Table 5.3.2 provides a more detailed set of results for the estimated linear regressions to explain differences in relative prioritisation of transport as a constraint.

Table 5.3.1
Explanatory variables in the regression analysis and their sources

Business constraint	Explanatory variable	Source
Telecommunications	Telephone lines (per 100 people)	WDI
	Mobile cellular subscriptions (per 100 people)	WDI
	Internet users (per 100 people)	WDI
	Fixed broadband internet subscribers (per 100 people)	WDI
	ICT expenditure (% of GDP)	WDI
Transportation	Air transport, freight (million tonne-km)	WDI
	Roads, goods transported (million tonne-km)	WDI
	Railways, goods transported (million tonne-km)	WDI
	Road density (km of road per sq. km of land area)	WDI
	Rail density (km of road per sq. km of land area)	WDI
	Motor vehicles (per 1,000 people)	WDI
	Pump price for gasoline (US$ per litre)	WDI
Skills availability	Labour force with primary education (% of total)	WDI
	Labour force with secondary education (% of total)	WDI
	Labour force with tertiary education (% of total)	WDI
	Expenditure per student, primary (% of GDP per capita)	WDI
	Expenditure per student, secondary (% of GDP per capita)	WDI
	Literacy rate, adult total (% of people ages 15 and above)	WDI
	Primary completion rate, total (% of relevant age group)	WDI
	Public spending on education, total (% of GDP)	WDI
Tax administration	Average number of times firms spent in meetings with tax officials	WDI
	Tax payments (number)	DB
	Time to prepare and pay taxes (hours)	DB
	Total tax rate (% of profit)	DB
Customs	Average time to clear exports through customs (days)	WDI
	Tariff rate, applied, simple mean, all products (%)	WDI
	Documents to export (number)	DB
	Documents to import (number)	DB
	Lead time to export (days)	DB
	Lead time to import (days)	DB
	Cost to import (US$ per container)	DB
	Cost to export (US$ per container)	DB
Crime	Homicide	UNODC
	Theft	UNODC
	Auto theft	UNODC
	Robbery	UNODC
	Burglary	UNODC
	Assault	UNODC

Note: WDI – World Development Indicators; DB – World Bank *Doing Business* survey; UNODC – United Nations Office on Drugs and Crime.

Table 5.3.2
Regression results for transport as a constraint

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Rail density	-1.468* (-2.16)						
Road density		-0.0000882 (-0.24)					
Rail transport			-471.2** (-3.23)				
Road transport				271.5 (1.92)			
Air transport					1424.8 (0.24)		
Gasoline price						0.235*** (5.43)	
Cars per capita							-0.0000262 (-0.12)
GDP per capita	-0.0224 (-1.31)	-0.0379 (-1.92)	-0.0550*** (-3.74)	0.0114 (0.54)	-0.0341* (-2.59)	-0.0691*** (-5.01)	-0.0547 (-1.53)
GDP growth	-0.00502 (-1.36)	0.00708 (1.42)	-0.00468 (-1.27)	0.00710 (1.81)	0.00579 (1.59)	0.0102* (2.46)	-0.000951 (-0.19)
Inflation	-0.000416 (-0.28)	-0.00725 (-1.79)	0.000475 (0.31)	-0.00185 (-1.02)	-0.000354 (-0.22)	-0.000260 (-0.18)	0.000572 (0.18)
Observations	104	62	107	52	130	93	57
R-squared	0.116	0.173	0.167	0.138	0.081	0.354	0.145
Adjusted R-squared	0.080	0.115	0.134	0.065	0.051	0.325	0.080

Source: BEEPS I, II, III, IV and Enterprise Surveys.
Note: t-statistics in parentheses; *** – significant at 0.1 per cent level; ** – significant at 1 per cent; * - significant at 5 per cent level.

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Annex 5.1

Table A.5.1
Country-level conditional means of relative constraint scores

Country	Infrastructure	Telecoms	Electricity	Transport	Land access	Skills	Tax administration	Labour regulations	Customs	Licensing	Courts	Corruption	Crime
Albania	0.16	0.06	0.73	-0.08	0.01	0.13	0.11	-0.16	-0.12	-0.16	-0.02	0.31	-0.15
Armenia	0.02	-0.08	0.13	0.10	-0.10	0.10	0.12	-0.08	0.05	-0.23	-0.17	0.18	0.10
Azerbaijan	-0.16	-0.27	-0.02	-0.19	0.31	-0.02	0.02	-0.34	-0.11	-0.06	-0.10	0.35	-0.02
Belarus	0.09	0.03	0.13	-0.04	-0.02	0.30	0.04	-0.24	-0.10	0.08	-0.22	-0.06	0.14
Bosnia and Herz.	-0.11	-0.21	0.02	-0.10	-0.19	0.04	0.22	-0.10	-0.12	-0.03	0.04	0.22	-0.06
Bulgaria	0.01	-0.05	0.16	-0.04	-0.16	0.01	0.12	-0.02	-0.24	-0.04	0.06	0.16	0.06
Croatia	-0.17	-0.26	-0.15	-0.13	-0.20	0.11	0.25	0.01	-0.17	-0.10	0.20	0.08	-0.11
Czech Rep.	0.30	0.18	0.44	0.15	-0.16	0.15	0.16	0.07	-0.26	-0.15	0.05	-0.02	0.01
Estonia	0.05	0.02	0.15	0.04	-0.12	0.58	-0.09	0.17	-0.23	-0.13	-0.24	-0.05	0.05
FYR Macedonia	-0.07	-0.17	0.14	-0.07	0.02	-0.06	0.02	-0.11	-0.11	-0.10	0.22	0.12	0.01
Georgia	0.29	0.16	0.60	0.16	0.06	0.14	0.01	-0.17	-0.08	-0.12	-0.05	0.02	0.06
Hungary	-0.11	-0.18	0.11	-0.17	-0.36	-0.17	0.61	0.09	-0.29	0.14	-0.14	0.32	-0.20
Kazakhstan	0.15	0.05	0.31	0.10	-0.04	0.23	0.07	-0.31	-0.11	-0.04	-0.09	0.13	0.07
Kyrgyz Rep.	0.20	0.02	0.55	0.00	-0.08	0.05	0.11	-0.26	-0.19	-0.18	-0.07	0.35	0.20
Latvia	-0.07	-0.20	0.03	0.03	-0.11	0.26	0.16	0.03	-0.30	-0.14	-0.04	0.07	0.04
Lithuania	0.06	0.01	0.24	-0.12	-0.25	0.27	0.18	0.05	-0.38	-0.08	-0.12	0.14	0.11
Moldova	0.07	-0.05	0.15	0.01	0.14	0.25	0.00	-0.19	-0.10	-0.14	-0.05	0.02	0.02
Mongolia	-0.05	-0.31	0.09	0.08	-0.08	0.05	-0.04	-0.20	0.04	0.17	0.02	0.12	-0.06
Montenegro	0.09	-0.13	0.36	0.07	-0.06	0.10	0.18	-0.03	0.00	0.04	-0.08	-0.03	-0.16
Poland	0.06	0.04	0.20	-0.09	-0.07	0.20	0.10	0.11	-0.23	-0.05	-0.06	-0.05	-0.02
Romania	-0.12	-0.22	-0.07	-0.15	-0.14	0.15	0.22	0.00	-0.25	0.01	0.01	0.13	-0.16
Russia	0.11	0.06	0.20	-0.03	0.07	0.19	0.04	-0.27	-0.13	-0.05	-0.06	0.14	0.02
Serbia	0.00	-0.06	0.22	-0.03	-0.08	0.04	0.03	-0.03	-0.13	-0.11	0.03	0.26	-0.03
Slovak Rep.	0.03	-0.12	0.26	0.00	-0.12	0.16	-0.02	-0.05	-0.29	-0.08	0.08	0.15	0.13
Slovenia	0.08	-0.01	0.19	0.08	0.04	0.11	-0.04	0.22	-0.20	-0.09	0.02	-0.12	0.01
Tajikistan	0.06	-0.12	0.45	0.00	0.04	0.33	0.00	-0.34	-0.04	0.04	-0.19	0.12	0.00
Turkey	-0.04	-0.04	0.09	-0.06	-0.27	0.22	0.10	-0.06	-0.19	0.10	-0.06	0.33	-0.23
Ukraine	-0.05	-0.12	0.05	-0.13	0.04	0.12	0.08	-0.24	-0.25	-0.07	0.04	0.24	0.02
Uzbekistan	0.06	-0.06	0.35	-0.07	-0.11	0.20	0.06	-0.14	-0.17	-0.11	-0.12	-0.05	0.40

Source: BEEPS IV.
Note: Underlying Infrastructure scores are calculated as averages of telecommunications, transport and electricity scores. Values represent the value of each constraint relative to the average constraint faced by the typical firm in each country. Positive values thus represent a higher-than-average constraint, whereas negative values represent a lower-than-average constraint relative to the average business constraint firms face in their operations.

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-2009 to the third quarter of 2010. It also includes a brief table of key macroeconomic indicators, including forecasts for 2010. The "cut-off" date for data and other information was early October 2010. More detailed data, both historical and current, covering structural, institutional and macroeconomic developments are available on the EBRD web site, at www.ebrd.com/economics.

Country Assessments

Albania

Key developments and challenges

Although the economy is mostly in private hands, the state retains control over key enterprises in the oil, energy and insurance sectors. Once market conditions improve, a major challenge is to complete long-anticipated privatisations in these areas.

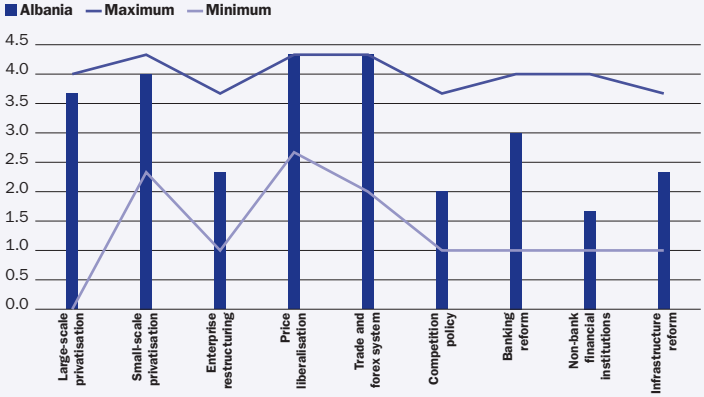
The authorities have shown a strong commitment to upgrading the road infrastructure, but the general quality and standards of maintenance still lag behind the level attained in the rest of south-eastern Europe. In light of the ongoing fiscal constraints, further upgrades will require greater private sector involvement along with a strengthening of regulatory entities.

The economy has managed to cope relatively successfully with the global crisis. A debut sovereign rating assigned by Standard & Poor's in early 2010 is an important signal to international financial markets. However, the main short-term challenge is to survive possible contagion effects from economic weaknesses in the eurozone, especially in neighbouring Greece.

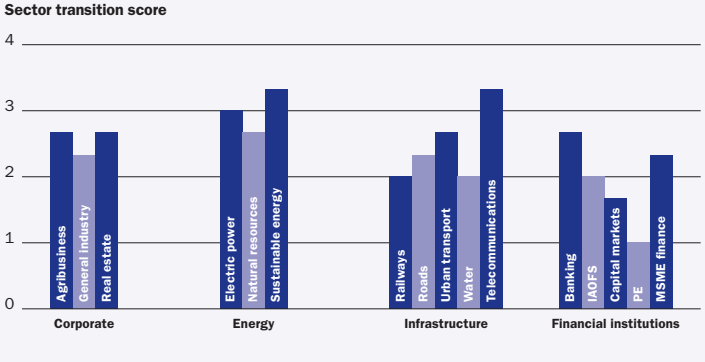
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	5.9	7.7	3.3	3.0
Inflation (end year)	3.1	2.2	3.5	3.0
Government balance/GDP	-3.5	-5.5	-7.4	-5.2
Current account balance/GDP	-10.7	-15.4	-15.4	-9.2
Net FDI (in million US$)	647	888	942	694
External debt/GDP	25.8	27.6	34.1	na
Gross reserves/GDP	19.7	17.8	19.1	na
Credit to private sector/GDP	30.0	35.2	36.6	na

Transition indicators 2010



2010 sector transition indicators



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

Macroeconomic performance

Albania remains one of the few transition economies that have weathered the global crisis reasonably well until now, partly because the economy is less integrated with global markets than others. Real GDP is estimated to have grown by 3.3 per cent in 2009, a slower pace relative to previous years but well above the regional average. Foreign direct investment (FDI) inflows continued to be strong throughout 2009 at €680 million, mainly attributable to privatisation projects, but recent figures indicate that inflows slowed during the second half of 2009 and during the first half of 2010. Consumer prices rose moderately in early 2010 and inflation stood at 3.4 per cent year-on-year in September 2010. The current account deficit remains high at around 15 per cent of GDP in 2009.

The authorities introduced several important measures during the past year to help cope with the crisis. The Bank of Albania (BoA) lowered its policy rate in three consecutive steps from 6.25 per cent in January 2009 to 5.0 per cent as of July 2010 and repeatedly intervened in the foreign exchange market in response to significant depreciation pressures. The government revised its 2009 budget deficit from its original target of 4.2 per cent to 6.9 per cent of GDP, mainly because of a large increase in expenditure and lower-than-expected revenue collections.

A combination of reduced industrial output, lower capital inflows, falling private transfers and slower credit growth has resulted in a considerable reduction in domestic demand in the first half of 2010. As a result of these factors the growth of GDP this year is expected to decrease to 3.0 per cent, although higher government spending has helped to prevent a sharper economic slow-down. Inflation is expected to remain within the BoA's target range of 3.0 +/-1.0 per cent for 2010. The key macroeconomic risk stems from potential spillover effects from Greece, mostly in the form of falling investment, lower remittances, higher costs for local subsidiaries of Greek banks and reduced trade flows. The relatively large public debt and high current account deficit also remain important risk factors.

Structural reform

Albania has made steady progress with structural reform, despite having to overcome serious institutional weaknesses and one of the most difficult starting points for transition. In 2009, Albania submitted a formal application for EU membership. However, the country faces major reform challenges in a number of areas. The need to improve the quality of the infrastructure is a requirement, although the government does have major

investment plans for roads, railways and electric power. The banking sector has limited reach as a source of finance outside of the main cities, and non-bank financial institutions are at a very early stage of development.

Recent developments

Further progress has been made over the past year in the area of EU approximation. In April 2010, the authorities returned to the European Commission (EC) the completed accession questionnaire, a requirement for acquiring candidate status. The EC's opinion on Albania's application is expected to be submitted to the EU Council in November. The long-awaited liberalisation of visa requirements to the Schengen Zone, granted to several other countries in south-eastern Europe last year, is now expected by the end of this year. According to the European Union's Progress Report 2009, Albania has made progress in a number of areas, but major concerns remain in the field of effective policy implementation, the rule of law, the enforcement of secure property rights and the fight against corruption and organised crime.

A number of important privatisations remain on hold. Major projects planned for the coming months include the privatisation of the state oil producer, Albpetrol, and the further sale of parts of the state-owned power company, KESH. The privatisation of the state insurer, INSIG, has been somewhat delayed, but a tender is expected to be called before the end of 2010. The government is planning to finalise the privatisation of most public properties by the end of 2010, but strategic companies such as the country's hydropower utilities will remain in state hands for the time being.

The functioning of KESH remains problematic, even after the privatisation of the distribution arm to the Czech power company, CEZ, in spring 2009. In its first year of operation, CEZ failed to reduce the level of electricity theft and losses, partly due to a number of judicial and political obstacles that prevented CEZ from effectively tackling the issue, as well as a lack of political will to address the problem. As a result, capital transfers from the state to KESH remain substantial, imposing financial strains on the government, although KESH has recently made a significant loan repayment.

In April 2010, the government signed an agreement with a Turkish/Chinese consortium to set up a company to explore the feasibility of chrome production from mines in Kalimash and Vlahne. If the project goes ahead, it is expected to produce around 210,000 tonnes of chrome per year.

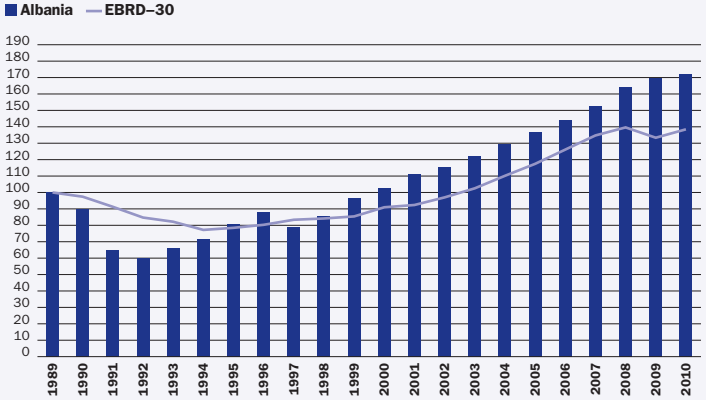
Confidence in the Albanian banking sector is growing, reflected in the growth of deposits by 16.6 per cent year-on-year as of August 2010. The growth of credit remained substantial throughout much of 2009, increasing at double-digit rates, but has decelerated recently and stood at 8.6 per cent year-on-year as of August 2010.

In March 2010, the Supervisory Council of the BoA decided to abolish restrictions introduced a year ago on financial transactions of foreign-owned banks to their parent banks, following a substantial increase in deposits at commercial banks.

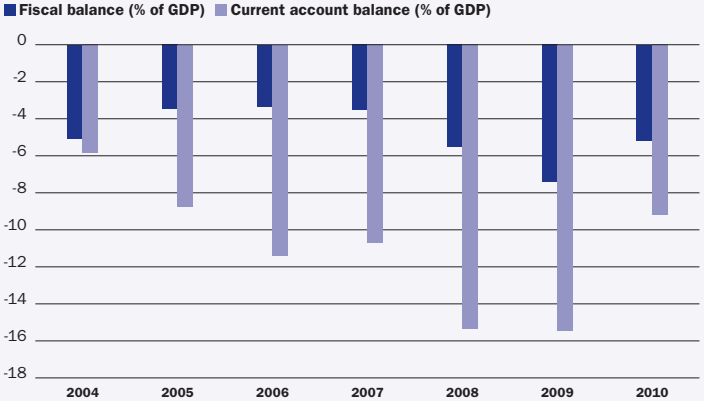
Structural reform priorities

- More private capital is needed to help finance infrastructure investment, especially in transport and electric power. The priority is to accelerate the preparation of investment projects while ensuring that tenders are carried out in an open and transparent manner.
- The system of tariff-setting at the municipal level is often non-transparent and politicised and hinders restructuring and investment in this sector. Reforms in this area should be pushed forward as soon as possible.
- The level of development in the non-banking financial sector is still quite low by regional standards. A key priority in this regard is to come to a resolution on the sale of INSIG, which is scheduled for this year.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Armenia

Key developments and challenges

The global crisis highlighted the vulnerability of Armenia's dependence on remittances and commodities. A significant strengthening of the institutional environment and an improvement of the transport and communications infrastructure are needed to increase productivity and attract investments in export-oriented sectors.

Despite the government's successful anti-crisis policies to stimulate lending to small and medium-sized enterprises (SMEs), the latter's access to credit remains limited. It will be important to support prudential and regulatory measures aimed at increasing local currency lending, including steps to encourage the development of local capital markets.

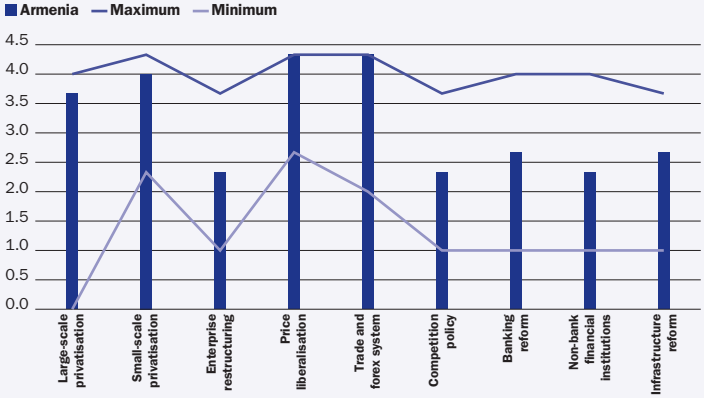
The authorities need to strengthen the fiscal position after the crisis, while continuing to protect social and essential capital expenditures. An acceleration of tax and customs administration reforms is crucial for supporting this adjustment in a credible way. In addition, improvements in public debt management should focus on developing longer-term dram instruments.

Main macroeconomic indicators (%)

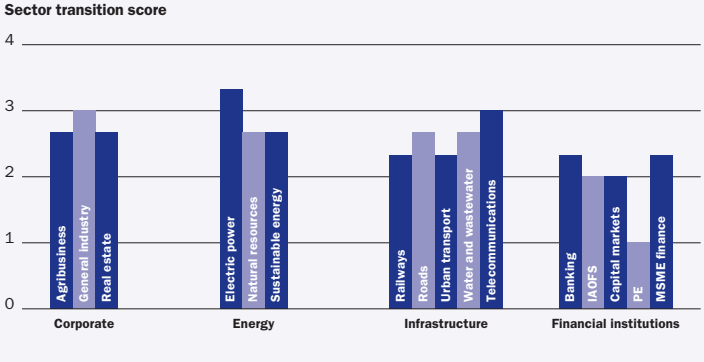
	2007	2008	2009 estimated	2010 projected
GDP growth	13.7	6.9	-14.2	4.0
Inflation (end year)	6.6	5.2	6.5	8.0
Government balance/GDP[1]	-2.3	-1.8	-7.8	-4.8
Current account balance/GDP	-6.4	-11.8	-16.0	-14.0
Net FDI (in million US$)	701	940	725	750
External debt/GDP	31.6	29.5	58.8	na
Gross reserves/GDP	18.0	12.1	23.5	na
Credit to private sector/GDP	12.9	17.1	22.3	na

Note: [1] Government balance covers central government only.

Transition indicators 2010



2010 sector transition indicators



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

Macroeconomic performance

The economy experienced a sharp contraction in 2009 as GDP fell by 14 per cent owing to a collapse of remittance-financed construction and lower commodity prices, which affected the copper and other metal sectors. The government responded by loosening the deficit target by 6 per cent of GDP. Dollarisation ratios increased significantly, in particular after the March 2009 depreciation. Despite this significant depreciation and a contraction of imports due to the crisis, the current account deficit remained high at 16 per cent of GDP. It was mainly financed through donor assistance and foreign direct investment.

The recovery started in 2010 on the back of the authorities' anti-crisis policies, sizeable donor support and better conditions in Armenia's main trading partners. Remittances picked up moderately and external demand and prices for base metals improved. In the first seven months of 2010 GDP expanded by 4.0 per cent. At 9.6 per cent year-on-year in August 2010, inflation remains above the central bank's target of 4.0 per cent, but is expected to fall back within the target range by 2011. The key elements of the authorities' stabilisation programme, supported since July 2010 by a new medium-term arrangement with the International Monetary Fund (IMF), include commitment to sound macroeconomic policies, tax administration reforms, further strengthening of financial sector supervision and structural reforms to improve the business environment.

Output is expected to expand by about 4 per cent in 2010, with export-oriented base metal industry and services likely to be the main drivers of growth. An important challenge for the authorities is to sustain the pace of fiscal consolidation as the stock of public debt, expected to approach 50 per cent of GDP by 2011, remains high for an emerging economy. The key short-term risks include the uncertainty over the pace of recovery in the Russian economy and the level of demand and prices for Armenia's main commodity exports. The current account deficit is expected to remain high, and its financing is an important source of uncertainty.

Structural reform

Armenia has made substantial progress in structural reforms over the past few years. However, significant reform challenges remain across the board. The overall business environment is difficult, as businesses continue to complain about problems with tax and customs administration, corruption and crime. The transport and telecommunications infrastructure require

further improvement and reform. The banking system became highly dollarised again during the crisis and the non-bank financial sector remains largely undeveloped.

Recent developments

Following several years of very slow progress in reforming the tax administration, the government is now committed to speeding up the pace of these reforms. Recent measures include legislation that permits the tax authorities to subject only high-risk VAT refunds to routine review, which is an important step for establishing an automated VAT refund mechanism. Additional efforts are ongoing to make tax administration fairer and more transparent. The appeals process is being improved and laws, regulations and procedures on taxes, duties and mandatory fees will be clarified and applied consistently to all taxpayers, starting in September 2010.

Armenia continued to make progress in strengthening energy security and improving its energy infrastructure. The gas-for-electricity swap programme with Iran expanded significantly when the new Yerevan thermal power plant became operational in April 2010. This helped mitigate the impact on the economy of the price increase for imports of natural gas from Russia. Armenia has good potential for developing small hydropower plants. By mid-2010 about 72 such plants were in operation, generating some 5 per cent of total electricity processed in the country, and 70 more have been licensed.

Progress is under way to improve the transport infrastructure as construction of the North–South Highway, connecting Armenia with Georgia and later Iran, is due to commence before the end of the year, with the Asian Development Bank (ADB) providing most of the financing. Preparations are also under way to begin construction of a railway link with Iran, following an agreement reached in April 2009, although the net economic value is uncertain given its high expected cost and the limited anticipated traffic on that route.

A third mobile network operator was launched in November 2009. It has already captured a significant market share from the incumbents, with overall mobile penetration rates increasing by over 20 percentage points during the past year. Increased competition has led to improvements in quality and coverage and contributed to the introduction of new services, such as tariff plans for mobile internet and high-definition (HD) voice services. The broadband internet market has also experienced rapid growth.

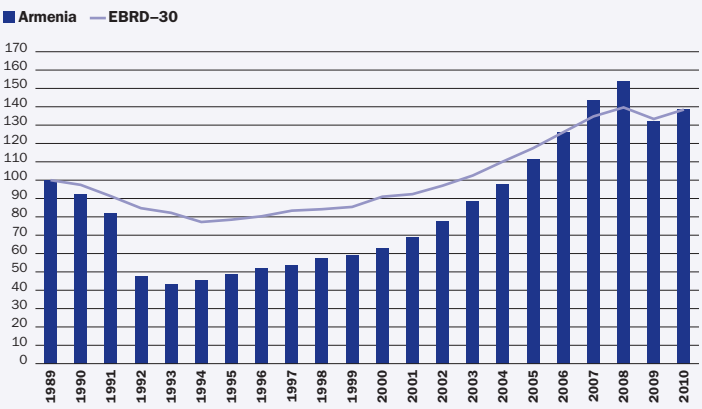
The financial sector survived the crisis relatively well. The banking sector is well capitalised and non-performing loans as a percentage of gross loans have declined from their August 2009 peak of 11.0 per cent to 5.6 per cent in March 2010. The government's on-lending programme, implemented as part of the anti-crisis package and financed by loans from the World Bank and Russia, has supported local currency lending to the corporate sector. The central bank has adopted several prudential measures to contain dollarisation.

In 2010 the authorities adopted several policies that should help boost the development of capital markets, including a law on compulsory vehicle insurance as well as reforms to the pension system, both of which will come into effect in January 2011. The pension reform includes the introduction of a voluntary accumulative pension pillar, which is expected to become mandatory in 2014.

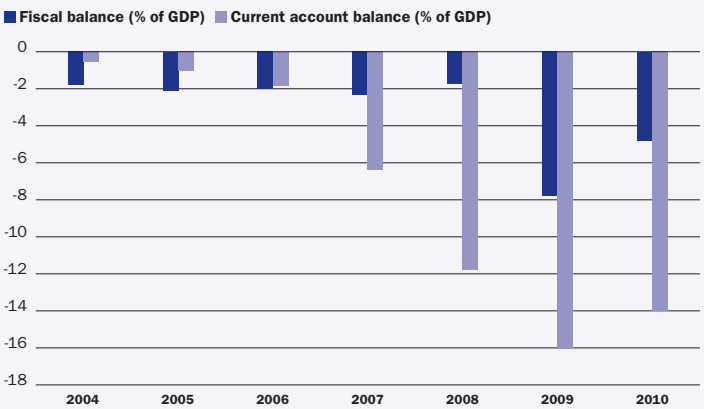
Structural reform priorities

- A key priority is to upgrade the internal transportation and communications infrastructure to offset the high cross-border transaction costs. Given the country's land-locked status it is important to ensure domestic transport costs, including those of air travel, are minimised and that telecommunications services are well developed and competitive. Although the landline incumbent has been privatised, the company still holds a *de facto* monopoly position in the market. To strengthen competition in this sector, the regulator should become more independent and be given stronger regulatory tools.
- In the financial sector, there is a need to further develop local capital markets and reduce dollarisation. The authorities should finance a greater share of public debt domestically and ensure that financial regulations continue to support the development of local currency lending.
- Further efforts are also needed to improve energy security and continue to diversify the sources of imports of energy supplies.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Azerbaijan

Key developments and challenges

The key challenge for Azerbaijan is to diversify its economy as the recent oil production boom is coming to a close. The economic crisis underscored the vulnerability of the economy to fluctuations in commodity prices as the terms of trade deteriorated sharply. To increase non-oil exports, it will be necessary to improve the business environment, encourage competition and attract more foreign strategic investors.

Although the financial sector has weathered the crisis well, it requires significant reforms. The banking sector is dominated by a large state bank, but with many small private banks it remains fragmented and inefficient. Reforms should promote consolidation and modernisation through increased competition.

Over the medium term the authorities will need to implement a programme of fiscal consolidation to reduce the reliance on oil revenues and to ensure that the accumulated oil wealth is used effectively.

Macroeconomic performance

Azerbaijan weathered the crisis relatively well. In 2009 output grew by 9.3 per cent, driven largely by the oil sector. The relative autarky of Azerbaijan's financial sector helped to prevent a financial crisis, although liquidity pressures emerged and credit growth collapsed. The authorities resisted drawing on the state oil fund and kept the non-oil primary deficit largely unchanged. The defence of the dollar peg by the central bank helped maintain confidence in the currency and the financial sector and prevented a large increase in dollarisation.

The non-oil economy is beginning to recover from the crisis. However, GDP growth has slowed recently as oil output expansion decelerated. In the first half of 2010 GDP grew by 3.8 per cent with the oil sector expanding at 2.0 per cent and the non-oil sector at 4.8 per cent (compared with 15.0 per cent and 3.0 per cent in 2009, respectively). The authorities initially adopted a conservative budget for 2010, targeting a non-oil primary deficit of 35.6 per cent of non-oil GDP (2.9 per cent lower than the outturn for 2009). However, they have since passed a supplementary budget implying an increase in the deficit of about 5 per cent of non-oil GDP. At the same time, as oil prices recovered, overall fiscal balance is projected to improve. Although credit growth has recovered somewhat, it remains subdued.

Over the medium term, GDP growth will remain largely dependent on developments in the oil and gas sectors. In 2010 GDP is expected to grow by 4 per cent and remain subdued in 2011. It may accelerate somewhat in future years as the Shah Deniz II gas field comes into operation, and stabilise after that unless new oil and gas reserves are discovered. While there appears to be a moderate recovery of credit, the extent to which the financial sector will be able to support the non-oil sector is expected to be limited owing to the increase of non-performing loans during the crisis.

Structural reform

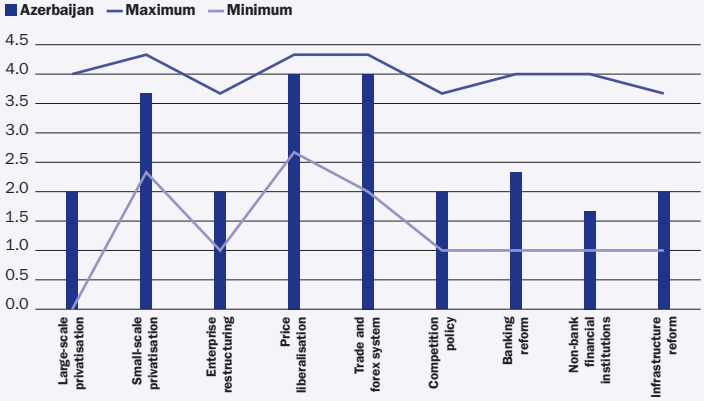
The progress of structural reforms has been uneven. Large transition challenges remain across most sectors with the exception of agribusiness, natural resources and transport. The financial sector is dominated by a large state-owned bank and a number of smaller, undercapitalised and non-transparent banks. State companies continue to dominate many key industries, including the oil, gas, electricity and telecommunications sectors. The private sector suffers from bureaucratic hurdles in registration and licensing procedures and a high level of corruption, which particularly affects small and medium-sized enterprises (SMEs).

Main macroeconomic indicators (%)

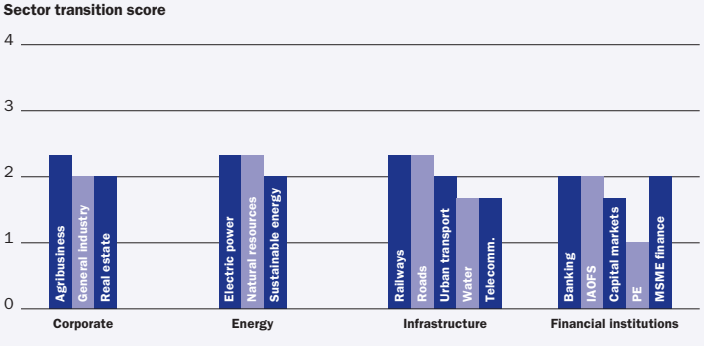
	2007	2008	2009 estimated	2010 projected
GDP growth	25.0	10.8	9.3	4.0
Inflation (end year)	19.5	15.4	0.7	6.0
Government balance/GDP[1]	2.3	20.0	6.8	14.0
Current account balance/GDP	27.3	35.5	23.6	24.0
Net FDI (in million US$)	-5035	-541	147	450
External debt/GDP	21.3	19.1	19.9	na
Gross reserves/GDP	12.9	13.9	12.5	na
Credit to private sector/GDP	17.4	18.8	24.3	na

Note: [1] Government balance excludes municipalities.

Transition indicators 2010



2010 sector transition indicators



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

Recent developments

The government has improved tax administration procedures with a view to both reducing tax compliance costs for businesses and increasing the tax collection rate. With effect from January 2010 the tax authorities launched a new electronic tax filing procedure, thus further simplifying the filing process for tax payers. Despite these measures, businesses continue to consider the unpredictable and uneven implementation of tax and customs administration a major hurdle for doing business.

In 2009 Azerbaijan reformed certain aspects of its labour regulations. While redundancy costs remain fairly high, the process of hiring workers has been significantly simplified, contributing to greater labour market flexibility. This brought its World Bank *Doing Business* survey rank for employing workers from 62 in 2009 to 33 in 2010.

To ensure the reliability of hydrocarbon exports, the authorities have continued to diversify export routes during the past year. In July 2010 the President approved the realisation of the Azerbaijan–Georgia–Romania (AGIR) project, which will deliver gas from the Caspian Sea, via Georgia and the Black Sea, to Romania and then onto the European market. Azerbaijan is also participating in the Nabucco gas pipeline project, which will serve to export most of the gas produced by the Shah Deniz II field. In 2010 Azerbaijan finalised gas sale and transit terms with Turkey, via whose territory Nabucco is to be laid.

The government has continued to place importance on improving the transport infrastructure. The North–South rail corridor, linking Azerbaijan with Russia and Iran, as well as the country's main East–West railway transport corridor, are being upgraded with the support of the World Bank and other international financial institutions (IFIs). Both projects are expected to be completed by 2012. Construction started this year on a new International Sea Trade Port Complex, due to be completed by 2016. This port is strategically located at the cross section of the North–South and East–West transport corridors.

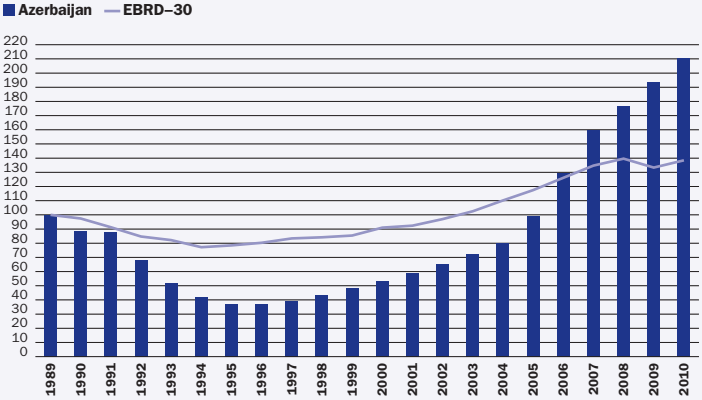
The authorities are contemplating further measures to strengthen the banking sector and attempting to further develop the non-bank financial sector. In addition to the measures adopted during the crisis, such as raising the maximum size of deposits ensured by the government, they are working to improve banking supervision and contemplating privatisation of the state-owned International Bank of Azerbaijan (IBA). The law on non-bank credit institutions, adopted in December 2009 and promulgated in February 2010, creates a legal framework for non-bank credit institutions and strengthened the central bank's supervision of the sector.

Azerbaijan's authorities continue to pursue negotiations on entry to the World Trade Organization (WTO), which commenced in 1997. Bilateral discussions on market access are under way on the basis of revised offers of goods and services.

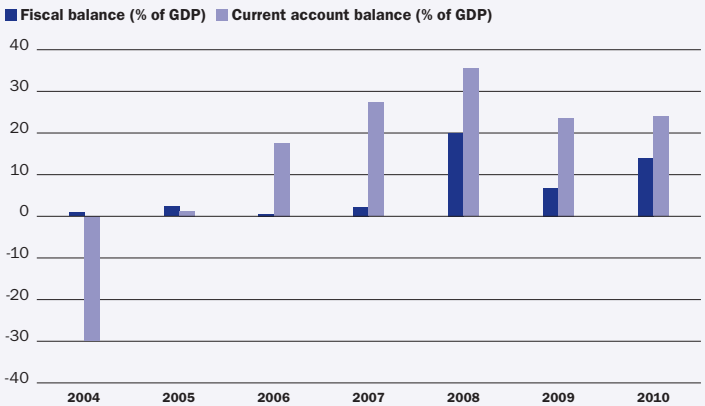
Structural reform priorities

- The key challenge for Azerbaijan is to promote economic diversification. In the short term measures to further strengthen tax and customs administration, encourage greater competition, especially in telecommunications and transport, fight corruption and stimulate the entry of foreign strategic investors would all contribute to this objective. The role of state enterprises in the non-oil sector should be reduced, either through privatisation or changes in regulation.
- Trading across borders is complicated by the weak customs administration. The completion of negotiations to join the WTO is essential as it would assist the development of non-oil export industries and also necessitate improvements to the customs regime.
- To support financial sector deepening it will be necessary to improve governance in the sector and encourage consolidation, while at the same time increasing competition. IBA should be privatised and the entry of international strategic banking groups encouraged.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Belarus

Key developments and challenges

Recent regulatory reforms and privatisations have strengthened the banking sector. However, further improvements in the efficient allocation of capital in the economy depend on a greater commercialisation of financial sector operations along with a gradual decrease in the dependence of the real sector on government-subsidised credit.

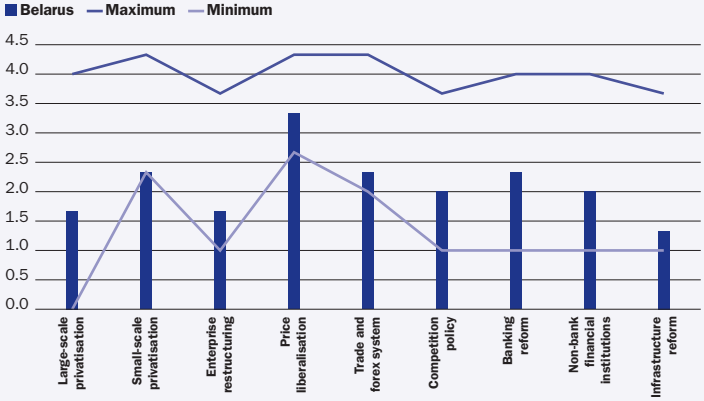
The newly established agency for investment and privatisation is a welcome step. The challenge is to make it an effective tool for attracting investment to key industries and services through transparent privatisations and high-quality greenfield projects.

Recent measures to deregulate and liberalise the economy have contributed to an improvement in the investment climate. However, enhanced protection of property rights and further deregulation are necessary to encourage entrepreneurship, diversify sources of external financing and create the conditions for long-term sustainable growth.

Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	8.2	10.0	0.2	6.0
Inflation (end year)	12.1	13.3	10.1	10.4
Government balance/GDP	-1.9	-3.5	-0.7	-1.8
Current account balance/GDP	-6.7	-8.7	-13.1	-14.0
Net FDI (in million US$)	1770	2149	1833	1500
External debt/GDP	27.7	25.2	44.4	na
Gross reserves/GDP	8.8	4.5	9.9	na
Credit to private sector/GDP	22.7	26.3	34.3	na

Transition indicators 2010



Macroeconomic performance

After slowing to 0.2 per cent growth in 2009, the economy has recovered in recent months with GDP growing by 7.0 per cent year-on-year in the first seven months of 2010, supported by stronger exports and higher domestic consumption. In March 2010 Belarus successfully completed a 15-month stand-by arrangement (SBA) with the International Monetary Fund (IMF), amounting to US$ 3.5 billion. Disbursements under the SBA boosted currency reserves, which at around US$ 5.3 billion at end-July 2010 covered around two months of imports.

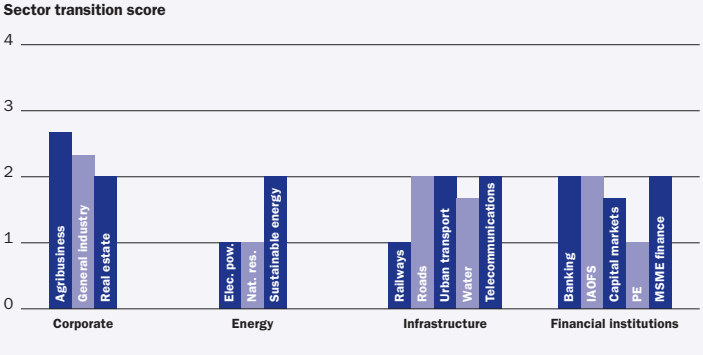
In early 2010 Belarus reached a new agreement on imports of oil from Russia, whereby Russia will apply the full export duty on oil shipments beyond a specified amount earmarked for domestic consumption within Belarus. This, coupled with the continued gradual increases in the price of imported gas, will put additional upward pressure on the current account deficit, which reached 13.1 per cent of GDP in 2009. To finance the external deficit and establish a market benchmark, in July 2010 Belarus made a debut eurobond issuance, placing US$ 1 billion at the cost of approximately 8.7 per cent a year. Inflation pressures have eased with annual inflation amounting to 6.8 per cent by July 2010. The central bank policy rate was gradually reduced from 14.0 per cent in November 2009 to 11.0 per cent by August 2010.

The economy is expected to grow by 6.0 per cent in 2010, decelerating somewhat in 2011 as the initial momentum of the recovery subsides. Significant current account deficits are expected to persist and these are most likely to be financed through external borrowing by the sovereign from official sources and international markets, as well as from foreign direct investment (FDI). The main risks include the possibility of lower external demand and steeper-than-expected gas price increases.

Structural reform

In recent years Belarus has made some progress in structural reform, albeit from a low base. The measures include improvements in the environment for small and medium-sized enterprises, streamlining of taxation, price liberalisation and selected privatisation. However, state intervention in the economy remains widespread through state ownership, state-sponsored lending programmes, regulations on prices and wages and red tape. The banking sector has also developed rapidly in recent years, supported by strengthened regulation and supervision and a number of institutional changes aimed at attracting private investors. However, the non-bank financial sector remains at a relatively early stage of development.

2010 sector transition indicators



Note: Elec. pow. – Electric power; Nat. res. – Natural resources; Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

Recent developments

The authorities completed a significant privatisation in the financial sector with the sale of a 93 per cent stake in Belpromstroibank, a formerly state-owned bank with a market share of approximately 7 per cent. The stake was sold to Sberbank of Russia following the completion of bilateral negotiations in December 2009. Further privatisations in the banking sector are currently under consideration.

A new agency for investment and privatisation was enacted by a presidential decree in May 2010 as a successor to the investment agency of the Ministry of Economy, and is expected to start operating shortly. The new agency will report to the Prime Minister and a supervisory council comprising 10 representatives of various ministries and the Presidential Administration. It is expected to coordinate the implementation of the privatisation programme, which remains high on the policy agenda but appears to have lost some of its initial momentum.

The tax system was further streamlined in 2010, leading to a lower overall tax burden. The government raised VAT from 18 to 20 per cent in January 2010, enabling them to abolish local sales taxes and turnover taxes. In addition levies to the innovation funds have been limited to state-owned enterprises (and mixed ownership enterprises in proportion to the state share), with the exception of private construction firms which remain liable. The extent of cross-subsidisation of energy and utilities tariffs within the industry has also been reduced.

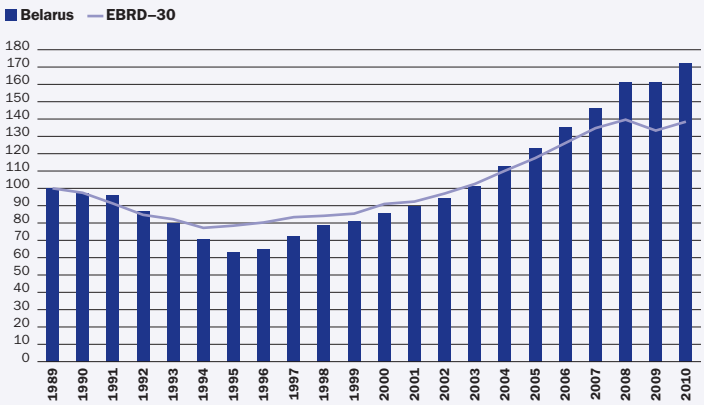
Over the past year, the authorities have made further progress with deregulation, introducing measures to liberalise prices and to reduce the administrative burden on businesses. Price controls have been limited to a list of 48 basic food staples, as well as pharmaceuticals, children's goods and medical services. Restrictions on prices or trade margins for other goods and services have been lifted. The list of minimum export prices has been substantially reduced. The Decree on Inspections, which came into force on 1 January 2010 and applies to a broad range of authorities with controlling and licensing powers, substantially limits the scope for arbitrary inspection of all businesses, and newly registered firms in particular, introduces formal inspection checklists, guarantees the presumption of innocence of inspected entities, acknowledges independent audits and introduces the notion of "minor discrepancy" in reporting.

In November 2009 Belarus, Kazakhstan and Russia signed documents establishing a Customs Union. After some uncertainty during the first half of 2010 Belarus adopted the Union Customs Code, which came into force in July 2010 and provides for a common external tariff structure. Harmonised tariffs are now set by the Customs Union Commission, although temporary exemptions have been agreed with respect to a number of sensitive items (such as passenger cars). The next step, expected to be completed by the end of 2011 at the latest, involves creation of a joint customs area and the elimination of internal border controls. The union is expected to facilitate trade between the three countries and strengthen the position of Belarusian manufacturers in the Russian and Kazakh markets. However, it may also introduce additional complications in terms of members' accession to the World Trade Organization (WTO) insofar as the decisions on customs tariffs and regulations are now delegated to a supranational body.

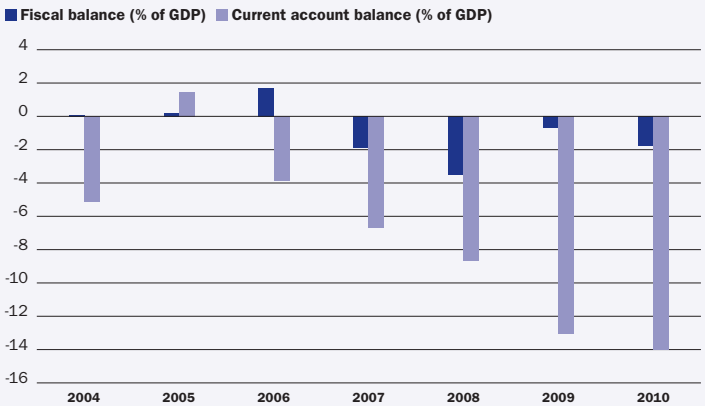
Structural reform priorities

- To modernise the industrial base of the economy there is a need for further improvements in the business environment for domestic and FDI. This in turn requires further reform to promote liberalisation and deregulation as well as steps to phase out the high dependence of the real sector on subsidised and "recommended" credit through government controlled banks.
- The transparent privatisation of state-owned enterprises remains a key challenge. It needs to be facilitated by improvements in corporate governance standards, valid market-based valuations of state assets and balanced assessments of investment requirements.
- The highly centralised municipal utilities and infrastructure sectors need to undergo commercialisation and modernisation if they are to meet the growing demand from other sectors of the economy. There is a clear scope to make tariff policies more cost-reflective and to gradually increase private sector participation, which is currently confined to urban transport.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Bosnia and Herzegovina

Key developments and challenges

The major challenge in Bosnia and Herzegovina remains constitutional reform, without which further progress towards a more efficient state, implementation of a comprehensive reform and growth agenda and EU approximation will be difficult to achieve.

The privatisation process has virtually come to a stand-still in recent years, depriving the entities of much-needed privatisation revenues, in particular in the Federation of Bosnia and Herzegovina (FBH).[1] The sale of major companies in the aluminium, construction, telecommunications and trade sectors remains a priority.

The International Monetary Fund (IMF) stand-by arrangement (SBA) signed in July 2009 remains on track. The agreement includes a commitment by the authorities to public sector reform, in particular in the FBH, and continued implementation of politically difficult cuts to benefits and public sector wages.

Macroeconomic performance

Economic indicators over the past year reveal a mixed picture. Real GDP is estimated to have fallen by 2.8 per cent year-on-year in 2009, industrial production has been struggling and foreign direct investment (FDI) dropped significantly by more than 70 per cent to €177 million. However, both the trade and current account deficits declined substantially and annual inflation remains very low, rising slightly to 2.5 per cent as of June 2010.

The authorities succeeded in limiting the impact of the financial crisis. Confidence in the banking sector was strengthened with a further increase in the deposit insurance limit in March 2010 to KM 35,000 (€18,000), following an initial increase in 2009. The SBA was temporarily put on hold at the start of 2010 when the parliament of the Federation failed to pass a law envisaging the reform of benefits to war veterans. The situation was, however, resolved when the law was finally adopted in February 2010. In March, the IMF Board approved the first review, and the second and third tranches amounting to €140 million were released.

Following the contraction in 2009, a bottoming out of GDP seems to be taking place, but growth is expected to be negligible this year and modest in 2011. Growth is likely to stem from a recovery in exports as demand for Bosnian goods picks up, especially for steel and aluminium, from the eurozone and neighbouring countries. The currency board will continue to anchor macroeconomic policy and governments at all levels will need to control spending and coordinate more effectively, with the support of the National Fiscal Council. The main risks to the outlook lie in the possibility of governments reversing or failing to implement the fiscal consolidation measures necessary to remain on track with the IMF programme.

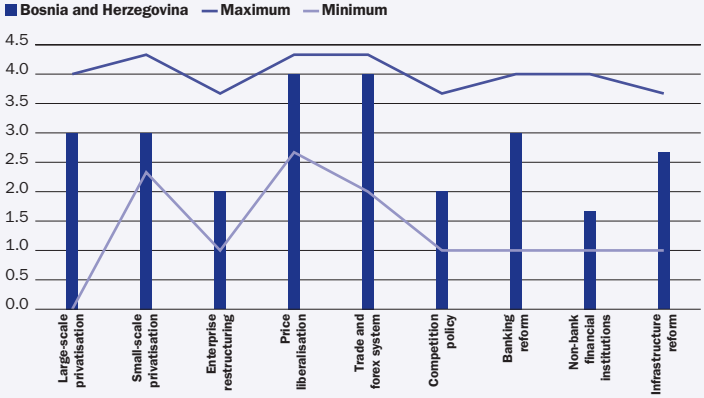
Structural reform

Bosnia and Herzegovina's progress in transition has been effectively stalled for some years, and as a result the country lags behind all others in south-eastern Europe. The country's complicated political and constitutional structure is a major hindrance to reform and good governance. A significant privatisation agenda lies ahead but, in the FBH at least, there appears to be little appetite for bringing major enterprises slated for sale to the market. As a result of the reform paralysis, the country also lags behind other EU candidates or potential candidates in the region in terms of EU approximation.

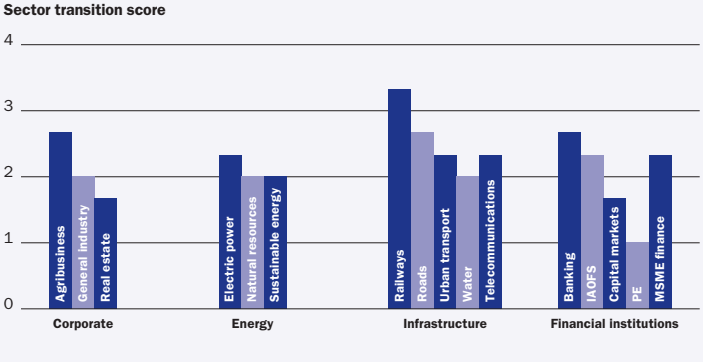
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	10.8	6.0	-2.8	0.8
Inflation (end year)	4.9	3.8	0.0	2.0
Government balance/GDP	-0.1	-4.2	-4.6	-5.0
Current account balance/GDP	-9.3	-13.3	-6.6	-5.5
Net FDI (in million US$)	2040	1044	256	262
External debt/GDP	42.5	37.9	46.6	na
Gross reserves/GDP	26.2	16.7	16.7	na
Credit to private sector/GDP	48.4	51.8	51.4	na

Transition indicators 2010



2010 sector transition indicators



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

Recent developments

The implementation of the Stabilisation and Association Agreement (SAA) with the European Union is progressing adequately and the authorities are adhering to their trade commitments under the SAA and the regional Central European Free Trade Agreement (CEFTA). In September 2009 the Constitutional Court abolished a controversial customs law, which had reintroduced customs tariffs on meat and dairy products from Croatia and Serbia. The abolition has promoted regional trade liberalisation and expanded competition in the domestic market.

According to the EU Progress Report 2009, policy reform efforts have been negligible and structural rigidities continue to hamper the investment and business climate. There has been virtually no progress over the past year in privatisation, both due to the adverse market conditions and a lack of political will to sell-off economically sensitive enterprises. The FBH 2010 Privatisation Plan had foreseen the sale of nine major companies including, among other things, the aluminium maker Aluminij d.d. Mostar, the engineering company Energoinvest and the construction company Hidrogradnja. Most of these companies had been designated for sale under the previous privatisation plan.

The rehabilitation of the railway sector continued over the past year with the signing of several projects intended to upgrade and modernise the railway system. In November 2009 a consortium of the two Austrian construction companies, Alpine and Swietelsky, won the public tender to upgrade the railway tracks in both Entities to allow trains to travel at a higher speed. Furthermore, public service obligations (PSOs) have been signed earlier in 2010, increasing the accountability and transparency of services to railway passengers and aligning regulations to European standards.

In September 2009, the ongoing construction of four sections of the Corridor Vc was suspended because of political difficulties. The paralysis was finally resolved in March 2010 when the parliament amended the legal framework to allow the start of construction without the approval of the Ministry of Physical Planning. Work is expected to resume in the coming months.

In June 2010 the government of the RS cancelled an agreement signed last year with the Austrian construction company, Strabag, to establish a joint venture to construct a highway network in the RS. Strabag encountered difficulties in securing finance, as the deal had been signed without a public tender and therefore prevented international financial institutions (IFIs) such as the EBRD and the European Investment Bank (EIB) from providing loans.

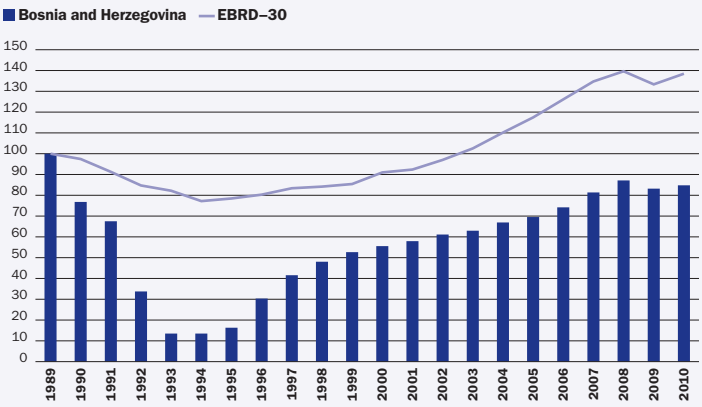
The banking system has remained sound, despite the global crisis and the significant outflow of deposits of around KM 800 million (about €410 million) in the fourth quarter of 2008. By early 2010, the total level of deposits had returned to pre-crisis levels, and the deposit insurance scheme was strengthened significantly in January 2010 with a €50 million EBRD loan. The Vienna Initiative agreement among the main banks has been successful in preventing outflows of funds back to the foreign parent banks. In order to counteract a rise in non-performing loans, regulations regarding debt restructuring were loosened in both Entities early in 2010, enabling debtors to restructure their obligations to commercial banks and extend their maturities to one year.

Structural reform priorities

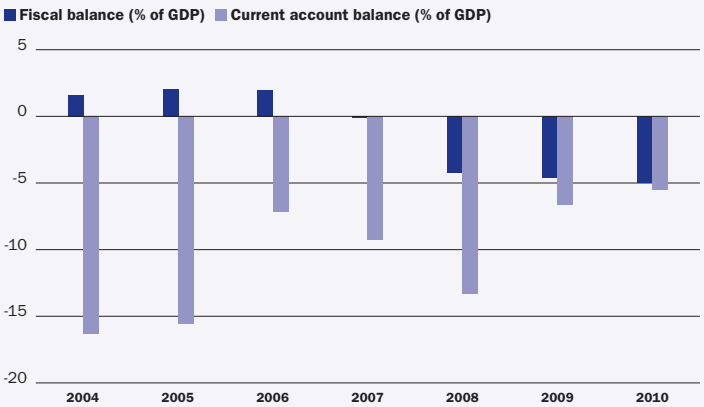
- In the corporate sector, a key priority is to lessen the role of the state and proceed with important privatisations, particularly for profitable companies in the metals and telecommunications sectors. The authorities that come to power after general elections in October 2010 should take the necessary steps to bring these companies to sale. In addition many companies privatised by a voucher system have poor corporate governance and need to be either restructured or entered into bankruptcy.
- All infrastructure sectors are hampered by the extremely limited role for commercially oriented players and the resulting lack of cost-effectiveness. The regulators in the roads and railways sectors need to be strengthened and further unbundling is a priority in the power sector.
- In the financial sector banks are generally well capitalised and the sector is quite competitive, but the establishment of a unified system of banking supervision remains a key priority, while the development of non-bank financial markets, including equity markets, is still at a very low level.

[1]The constitutional entities distinguished in this assessment include the State of Bosnia and Herzegovina (BH), the Federation of Bosnia and Herzegovina (FBH) and its Cantons, and the Republika Srpska (RS). The FBH and the RS are referred to as the "Entities".

Real GDP (1989 = 100)



Fiscal balance and current account balance



Bulgaria

Key developments and challenges

The Bulgarian economy has been severely affected by the global downturn. A return to a sustainable growth path will depend on the implementation of policies that can facilitate a successful structural shift from the non-tradeable to the tradeable sector, as well as a clearly communicated medium-term fiscal framework within the Maastricht criteria.

Improvements in infrastructure and related services will underpin the competitiveness of the economy. Such improvements need to be pursued not only via government transfers, but also by strengthening of the municipal sector through greater fiscal decentralisation, stronger regulation and capacity-building at the local level.

Increasing the capacity and attracting more investment in the Bulgarian energy system should be pursued through policies that promote further market opening and interconnectivity with neighbouring countries.

Macroeconomic performance

The impact of the global economic crisis has been substantial, leading to an economic contraction of 4.9 per cent in 2009. Initially, exports and industrial output fell dramatically in parallel with a steep contraction in investments that followed the abrupt halt of private capital inflow to the country. Throughout 2009, the economic slow-down spread into the service sectors and further reduced employment and domestic consumption. External demand has gradually recovered in 2010, but domestic demand has remained subdued. Inflationary pressures have also fallen in line with the economic cycle, and the consumer price index was up only 1.4 per cent year-on-year in June 2010.

The fiscal position remains challenging. After several years of prudent fiscal policies, a larger-than-expected budget deficit of 3.9 per cent of GDP in 2009 forced the authorities to postpone plans to join the Exchange Rate Mechanism II (ERM II). Significant revenue shortfalls as well as increasing social expenditures in the first half of 2010 continued to put severe constraints on public finances. In May these pressures led the government to significantly revise its planned budget deficit for 2010 from an initial target of 0.7 per cent of GDP to 4.8 per cent of GDP (on a cash basis).

A gradual economic recovery has been under way since the second quarter of 2010. The short-term outlook foresees exports continuing to rise and consumer demand increasing moderately in the second half of 2010. In combination with an expected improvement in business sentiment, foreign direct investment (FDI) is also anticipated to return slowly, supporting a gradual recovery during the latter part of this year and throughout 2011. Real GDP is expected to expand by approximately 0.5 per cent in 2010 before resuming a more robust GDP growth in 2011. The main risks reflect the possibilities of weaker-than-expected external demand and deterioration in the quality of banks' portfolios if there is a prolonged economic slow-down.

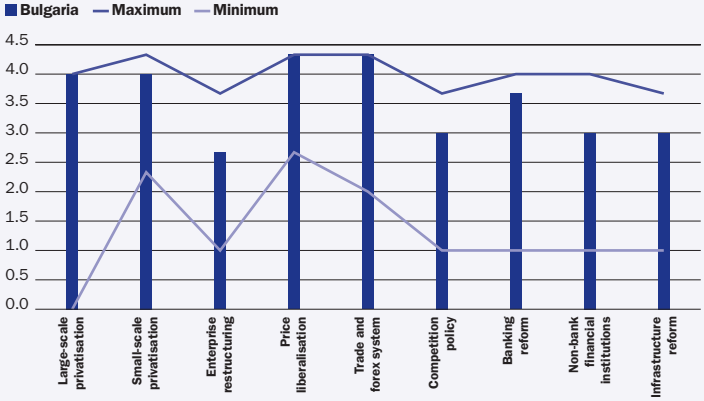
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	6.4	6.2	-4.9	0.4
Inflation (end year)	12.5	7.8	0.6	3.2
Government balance/GDP	3.3	2.9	-3.9	-3.8
Current account balance/GDP	-28.4	-23.9	-9.6	-3.0
Net FDI (in million US$)	12903	9195	4335	1341
External debt/GDP	101.1	102.4	107.6	na
Gross reserves/GDP	39.1	32.5	35.2	na
Credit to private sector/GDP	60.6	69.8	73.1	na

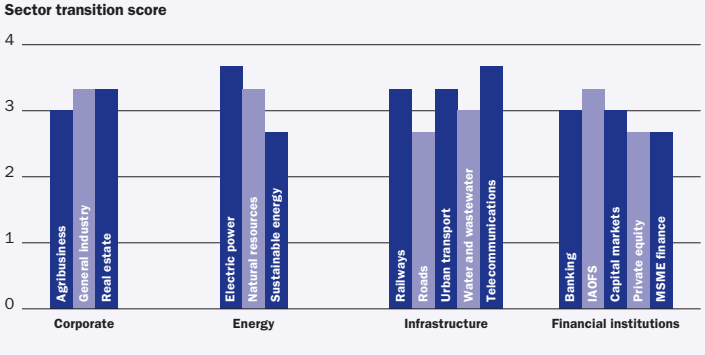
Structural reform

As an integrated part of the internal market within the European Union, market liberalisation has been initiated or has fully taken place in most sectors while most of Bulgaria's planned privatisations have also been completed. The remaining enterprises to be partly or fully privatised include the difficult case of Bulgartabac, a few energy utilities and some transport operators. There should also be room for further public-private partnerships (PPPs) related to some of the country's large-scale construction projects in the energy sector. Progress in building on

Transition indicators 2010



2010 sector transition indicators



Note: IAOFS – Insurance and other financial services

the real achievements that have been made with past structural reforms have been hampered over the last year as the new government has had to work in a difficult economic climate.

Recent developments

Steps have been taken over the last few years to reduce start-up costs and the administrative burden for enterprises. These include strengthening the one-stop-shop for the registration of new enterprises that was set up in 2008 and further reducing the minimum required capital for firm registration to Lv 2 (€1) in October 2009. Some legal and judiciary reforms have been implemented. However, an effective framework for the resolution of commercial disputes as well as insolvency procedures is not yet fully in place.

The government has made substantial efforts in the past year in the fight against organised crime and corruption. This was recognised by the European Commission (EC) in July 2010 in its annual assessment under the cooperation and verification mechanism (CVM). The EC concluded that while success will require a sustained commitment, Bulgaria has established a strong reform momentum in the judicial sector and in its efforts to combat corruption and organised crime.

In recent years the country's renewable power generation capacity has expanded and adequate feed-in tariffs have made investment in renewable generation capacity attractive for investors. However, progress in further market opening of the electricity sector as a whole has halted and 85 per cent of electricity sales are still subject to regulated tariffs, despite the fact that the electricity law provides for full market liberalisation since 2007. Some structural reforms are being pursued, such as the partial unbundling of Bulgarian Energy Holding, which currently includes state-owned energy companies in areas such as power generation and transmission as well as gas supply and transmission.

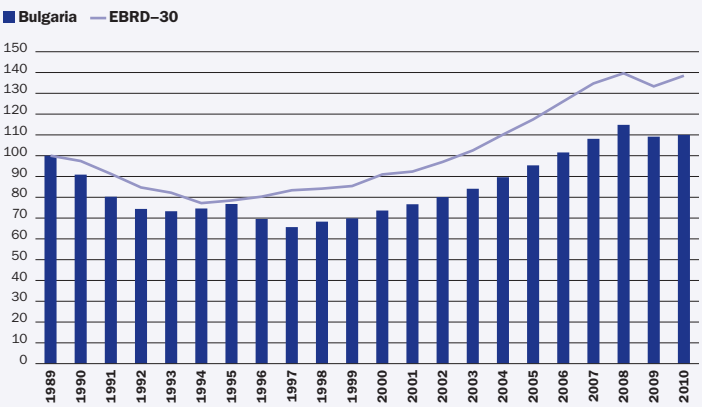
In summer 2010 the United Nations Compliance Committee of the Kyoto Protocol revoked Bulgaria's accreditation to participate in the trading of greenhouse gas emission quotas. This is because flaws were found in the country's emission monitoring and reporting system. A re-assessment is expected at the end of the year. The restoration of accreditation under the Protocol mechanisms would allow Bulgaria to benefit from the opportunities for carbon trading.

The banking sector has weathered the global crisis and external turbulence well. While some concerns have been expressed regarding parent banks' strength and commitment, both during the height of the global liquidity crisis and the Greek debt crisis, the banking sector in Bulgaria has proven to be robust with continued support from its foreign parents. Deteriorating asset quality has been a concern. The recession has caused the non-performing loan (90 days overdue) ratio to increase to 9.5 per cent in June 2010. This, however, has not led to any liquidity withdrawals or other stress scenarios among the domestic or foreign banks operating in the country. The stability of the sector reflects the fact that banks are both well capitalised and well regulated. At the end of 2009 the aggregate capital adequacy ratio for the sector was 17 per cent, the highest ratio in the European Union.

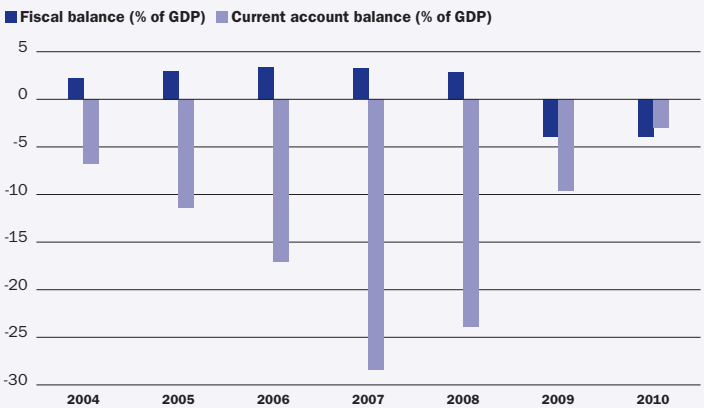
Structural reform priorities

- A key priority is to develop the municipal sector so that it is financially strong and well regulated. The necessary steps include strengthening the municipalities' ability to meet contractual obligations and to attract commercial financing as well as boosting the country's capacity to absorb EU funds targeted for investment in municipal infrastructure.
- Further reforms are needed to improve the business environment. These include reforms in the education system and vocational training policies in line with the needs of the business community, as well as legal reforms to provide flexible labour contracts and more effective insolvency procedures.
- Full market opening in the power sector is another key priority. This requires a gradual reduction in the share of electricity sales subject to regulated tariffs, well-defined regulation and contractual arrangements, and political support that encourages investments in the network capacity and interconnectivity with neighbouring countries.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Croatia

Key developments and challenges

Croatia's progress towards EU accession has advanced significantly in the past year and was given a further boost by the positive outcome of the Slovenian referendum on the arbitration agreement regarding the unsolved border settlement. It is crucial that momentum is maintained towards completion of negotiations of the *acquis communautaire* in the coming months.

Many large commercial companies continue to be supported by the state, notably in the shipyard industry where attempts to sell off assets have failed. A renewed effort is needed to address these problems effectively.

The economy has contracted for the past two years and remains vulnerable to weakness in the global economy. The government's commitment to fiscal stability is commendable but few steps have been taken to reduce expenditure, and implementation of the government's ambitious reform programme is crucial for achieving sustainable growth in the medium term.

Macroeconomic performance

GDP declined by almost 6 per cent in 2009, and foreign direct investment (FDI) fell by more than 50 per cent. Data for the first few months of 2010 show little sign of a recovery in the economy. GDP declined by 2.5 per cent year-on-year in the first and second quarters and, after two consecutive months of positive growth, industrial production turned negative again in March 2010 and stood at -4 per cent in June year-on-year. However, the exchange rate has been stable in relation to the euro, while inflation continues to be very low at 0.7 per cent in the year to June 2010.

Following several revisions to the budget during 2009, the budget deficit amounted to 3.3 per cent of GDP. For 2010 the government was targeting a deficit between 2.5 and 3.0 per cent of GDP, but in August it raised the target to 4.2 per cent. To ensure liquidity of the banking sector, the mandatory reserve requirement ratio was reduced from 14 per cent to 13 per cent in February 2010, and credit growth restrictions were eased. In April 2010 the government presented its new economic recovery programme (ERP) with plans to cut income tax and restructure the public administration. The crisis tax introduced in 2009 is also scheduled to be gradually abolished this year and was partly removed in July.

Real GDP is likely to decline further in 2010, reflecting slow annual credit growth (0.2 per cent as of April 2010) and continued tight fiscal policy. An improvement is expected in 2011, especially if EU accession negotiations are successfully concluded. The main risk to the growth outlook largely depends on the strength of the recovery in the eurozone as private consumption could be restrained by increasing unemployment.

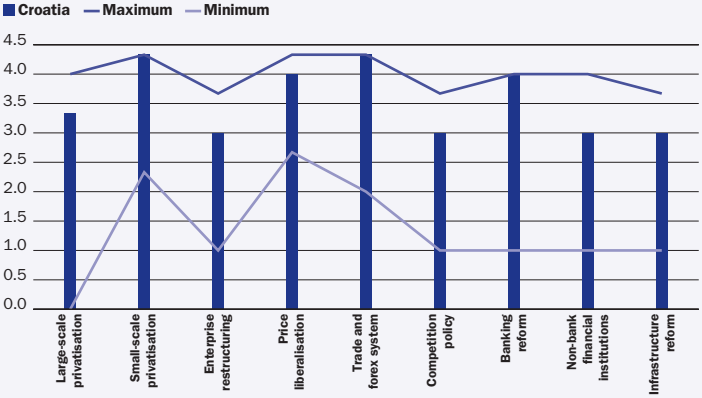
Structural reform

Croatia has long been considered among the most advanced of the transition countries, with a broadly liberalised economy, a relatively high degree of sophistication in financial services, and a country where significant progress has been made on infrastructure reform. The banking sector weathered the financial crisis well and remains sound and liquid. However, some major enterprises and financial institutions continue to rely on state subsidies although the level of subsidies has fallen significantly since 2005. The quality of the business environment remains a concern, according to cross-country surveys, such as the World Bank's *Doing Business survey* and reflects the need to tackle obstacles to doing business, such as the cumbersome permit process, as well as the need to implement urgent public administration reforms.

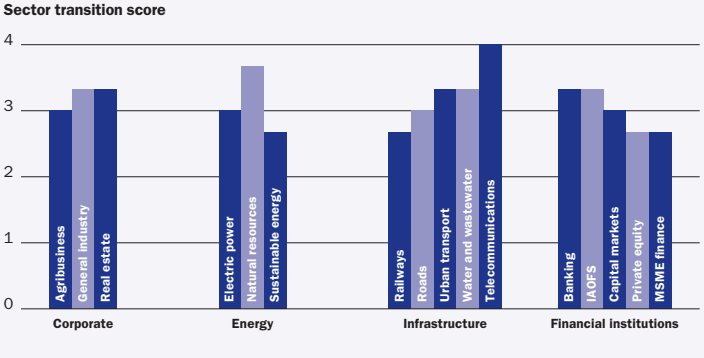
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	5.5	2.4	-5.8	-1.5
Inflation (end year)	5.8	2.9	1.9	2.8
Government balance/GDP	-2.5	-1.4	-3.3	-4.7
Current account balance/GDP	-7.6	-9.2	-5.2	-3.8
Net FDI (in million US$)	4736	4653	1600	390
External debt/GDP	83.4	81.9	101.9	na
Gross reserves/GDP	23.3	18.7	23.6	na
Credit to private sector/GDP	63.4	65.3	66.5	na

Transition indicators 2010



2010 sector transition indicators



Note: IAOFS – Insurance and other financial services

Recent developments

In April 2010 the government unveiled its comprehensive ERP, which includes over 100 measures intended to increase the competitiveness of the domestic economy. Among the main proposals are efforts to increase labour market flexibility, the reduction of business costs through limiting some non-tax revenues, and reform of the judiciary. The programme achieved widespread support from the business community, but implementation is at an early stage.

Croatia has reached the final stage in the EU negotiation process. All policy chapters of the EU's *acquis communautaire* have been opened and negotiations may be completed in the course of 2011. However the European Commission's Progress Report 2009 emphasised the need for further public administration reform and the significant challenges remaining with regard to judicial independence and efficiency. The Commission's report also noted that corruption is still prevalent in many areas. The authorities have increased efforts to tackle corruption and some high-profile arrests took place in 2009. Within the framework of the ERP, the government is also currently drafting new regulations in an attempt to facilitate bankruptcy proceedings.

A significant number of large enterprises await privatisation. The flagship sale was intended to be that of six state-owned shipyards, for which the completion of privatisation and restructuring is required for closing the competition chapter of the *acquis*, but this has proved difficult. A first tender failed last year, despite the fact that four of the shipyards were offered for sale at a nominal price of one kuna along with the associated liabilities of these companies. A second tender was launched in February 2010 and, as of early September, the Commission of the Government and the Croatian Privatisation Fund (HFP) have finished the first round of evaluation of bids for three shipyards at the same symbolic price. A valid offer for these shipyards, along with a restructuring plan, has been received and is currently under evaluation by the Croatian Competition Agency and it is expected to be sent to the European Commission for approval.

Croatia's infrastructure, with the exception of some regional roads, is well developed. However, a number of public infrastructure companies continue to receive large state subsidies. In April 2010 the government decided to provide HRK 650 million (€89.6 million) to assist with the financing of infrastructure projects of the national railway company Hrvatske Zeljeznice (HZ) as well as a further HRK 700 million (€96.5 million) to modernise rolling stock.

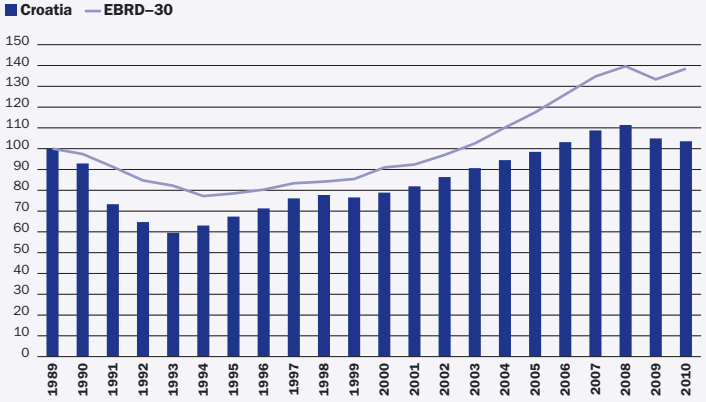
In October 2009 the government adopted a new energy development strategy, envisaging a total investment of €15 billion in the Croatian power sector until 2020. The strategy aims at upgrading the electricity infrastructure, the production, processing, transport and storage of oil and gas, modernising the heating system, as well as commencing the construction of various power plants. Within this framework, the operation of the new Ernestinovo-Pecs power transmission line started in April 2010.

In December 2009 the Croatian Central Bank (HNB) removed the obligation of commercial banks to purchase HNB bills at an interest rate of 0.25 per cent in the event that credit growth exceeds 12.0 per cent annually, a measure that was introduced three years ago. Risks in the banking sector continue to stem from substantial external liabilities. In an attempt to address these vulnerabilities, the HNB further increased the capital adequacy ratio from 10 per cent to 12 per cent in April 2010 in line with the adoption of the Basel II framework.

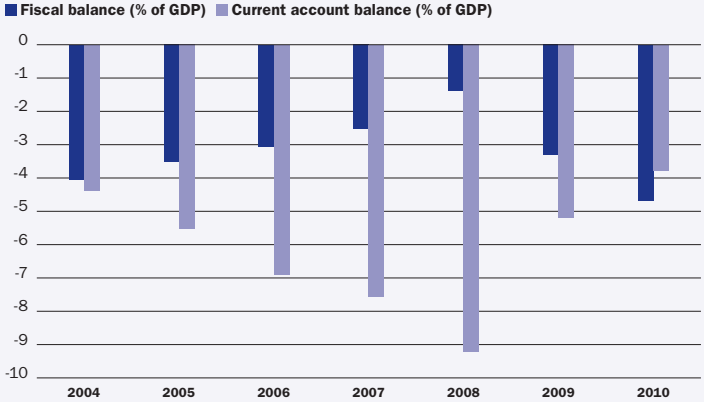
Structural reform priorities

- Croatia's main short-term priority is to complete negotiations on the European Union's *acquis* and proceed to membership of the European Union, which is currently expected in 2012.
- The implementation of the government's reform programme will be the key challenge in creating the conditions for a return to economic growth. This will require a fundamental overhaul of some of the restrictive practices that render the labour market inflexible and hinder the smooth setting-up and running of businesses.
- The degree of private sector involvement in infrastructure and energy is limited to date, and the level of competition suffers accordingly. Further private sector involvement could be attracted by means of well-designed and transparent tenders.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Estonia

Key developments and challenges

Estonia has emerged from a deep recession and confidence is returning quickly given the imminent adoption of the euro and exceptionally sound public finances. To safeguard the competitive advantages that will attract foreign investment, further reforms in the areas of education, innovation, competition policy and infrastructure are necessary.

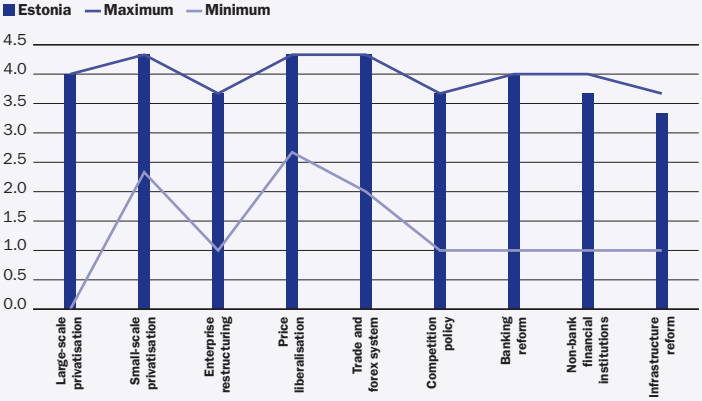
Modernising the municipal and environmental infrastructure remains a priority. The main sources of funding include the European Union structural and cohesion funds, the private sector and where possible, commercial co-financing from local sources.

A key challenge remains the promotion of energy efficiency as well as alternative energy supplies, including renewable sources of energy, to enhance sustainability, reduce energy intensity and meet environmental targets. Important decisions will be required regarding the restructuring of oil-shale based power plants and the development of new power links to regional energy markets.

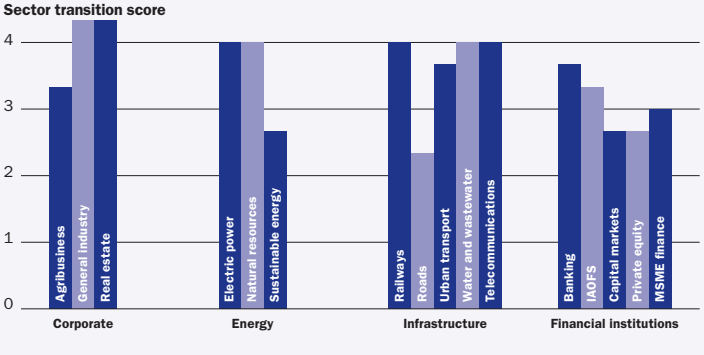
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	6.9	-5.1	-13.9	2.4
Inflation (end year)	9.6	7.0	-1.7	3.2
Government balance/GDP	2.6	-2.8	-1.7	-1.5
Current account balance/GDP	-17.2	-9.9	4.6	4.0
Net FDI (in million US$)	986	615	182	200
External debt/GDP	117.8	113.8	130.0	na
Gross reserves/GDP	15.4	16.6	20.8	na
Credit to private sector/GDP	88.5	94.2	105.3	na

Transition indicators 2010



2010 sector transition indicators



Note: IAOFS – Insurance and other financial services

Macroeconomic performance

Following the abrupt reversal of Estonia's credit boom, and associated fall in asset prices, the country registered seven consecutive quarters of falling output. In 2009 the fall in GDP amounted to 13.9 per cent. The fiscal reserves that had been built up over previous years were instrumental in protecting the economy against the worst effects of the recession as the government was able to meet its immediate financing needs. Nevertheless the government implemented significant expenditure cuts which have kept the budget deficit below 3.0 per cent of GDP in 2009, and will likely do so in 2010. This was crucial for Estonia's successful bid to enter the eurozone in early 2011.

In the second quarter of 2010 the economy appears to have turned around with a solid 3.1 per cent annual increase in GDP. On a quarter-by-quarter basis, this was the third consecutive quarter for which growth was positive, reaching 1.9 per cent in the second quarter of 2010 on a seasonally adjusted basis. As in other countries in the region, exports benefited from a strong rebound in industrial production in the European Union, while domestic demand continued to suffer from a severe shortage of credit, as credit to the private sector declined by 5.7 per cent on an annual basis in August 2010. Unemployment has risen substantially, though is likely to have peaked at 18.6 per cent in the second quarter of 2010 (according to Eurostat definitions).

The adoption of the euro and greater stability in asset prices are likely to boost consumer confidence, which is crucial for a recovery in consumer spending. Unlike many other European Union countries there are few concerns about public sector solvency as Estonia's public debt ratio was only 7.2 per cent of GDP at the end of 2009. The positive outlook in sovereign ratings also points to greater confidence among investors. Following three consecutive quarters of growth, the economy now seems to be on a path of self-sustaining recovery, with GDP expected to grow at 2.4 per cent this year, followed by a stronger recovery next year. The main risk to this outlook is that prospects for exports will falter, damaging export growth and confidence in Estonia.

Structural reform

Progress in transition has been slow in recent years as Estonia has already largely achieved the standards of a well-functioning market economy (in May 2010 the country was invited to join the OECD). Fiscal policy has been centred on meeting the targets of the Maastricht convergence criteria for euro adoption in 2011, which entailed a number of tax and benefit reforms. In 2009 Estonia

had already adopted a new flexible labour market law. Progress was also made in the power sector (for example through the Baltic electricity market), in privatisation and with a further strengthening of financial supervision.

Recent developments

The business environment in Estonia has long been well advanced, with low levels of corruption and other impediments to business. 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 continues to rank relatively low. In addition, persistent regional differences in employment and skill mismatches point to barriers to mobility, which are a concern in reducing unemployment.

In October 2009 the government divested its remaining minority stake in the telecom company Eesti Telekom to the Swedish majority owner, which now has near complete control. In June 2010 the government raised its stake in the unprofitable national carrier, Estonian Air, to 90 per cent, justifying the acquisition by the positive spill-over effects stemming from transport connections with mainland Europe. The government has publicly considered further sales of some of the remaining state-owned firms, such as the postal service and Tallinn Airport. However, full-scale privatisation of the electricity monopoly, Eesti Energia, and the Port of Tallinn have been ruled out.

In June 2010 the parliament adopted a law establishing price regulation for companies in a dominant market position in Estonia. The law gives additional powers to the Competition Board to exercise supervision over the pricing of thermal energy and water supplies, and in the environmental assessment of production technologies.

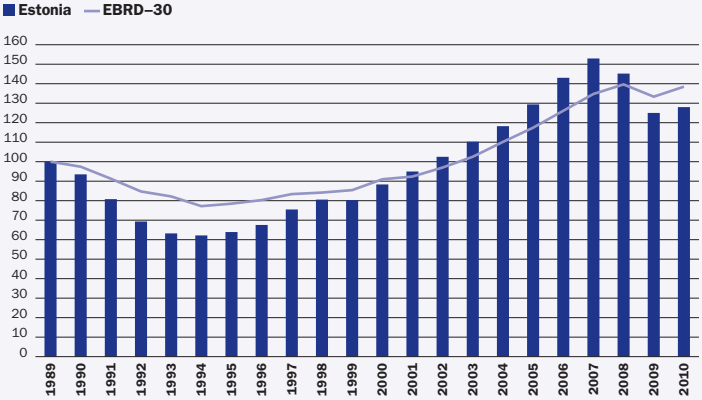
The issues of securing sustainable energy and the development of renewable energy remain of major importance in Estonia, especially following the closure of the Ignalina nuclear power plant in Lithuania. Various wind parks have started operation over the past years, and installed wind capacity in Estonia reached 142 MW at the end of 2009, an increase of 350 per cent since the end of 2006. Revenues from the sale of emission rights to Spain will be used to develop wind energy and environmentally friendly transport.

In the financial sector, long-term credit to the corporate and household sectors is still contracting at rates of 6.0 and 3.2 per cent respectively in July 2010. The weak domestic economy, particularly in the housing and construction sectors, has meant that asset quality has deteriorated. However, non-performing loans have remained relatively stable as a percentage of total loans (7.3 per cent in August 2010). Swedish parent banks, which account for the predominant share of lending, have raised new capital to absorb expected credit losses. The imminent adoption of the euro will ease liquidity constraints due to currency risks and provide access to the re-financing mechanisms offered by the European Central Bank. Banking supervision was further strengthened in August 2010 through a regional support agreement among supervisors that clarified information flows and burden sharing following a crisis.

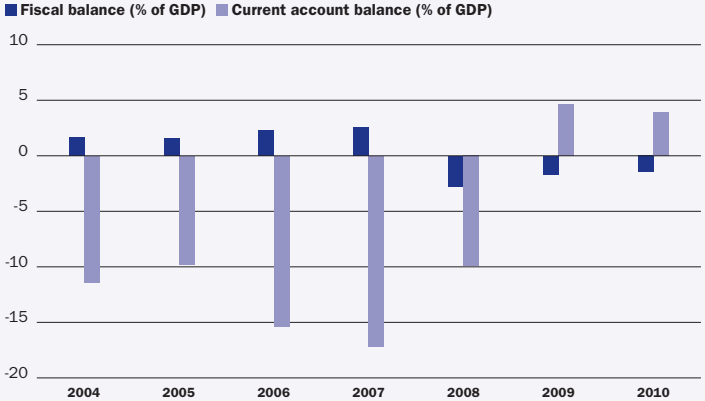
Structural reform priorities

- The key priority is to lay the foundations for more sustainable growth. In particular there is a need to increase the production and export of technology-intensive products to the rest of the European Union and emerging markets. While there are few remaining obstacles in the business environment, education and innovation policies should be oriented more consistently towards meeting this objective.
- Modernising municipal and environmental infrastructure and reforming the power sector in coordination with the Baltic neighbours are the main remaining challenges in infrastructure, which include doing so through utilising EU funds.
- As the banking sector stabilises, banks will again seek to finance corporate projects with sound prospects in EU markets. The development of venture capital and other private equity sources of financing could supplement this funding.

Real GDP (1989 = 100)



Fiscal balance and current account balance



FYR Macedonia

Key developments and challenges

FYR Macedonia's candidacy for EU membership remains stalled, as no date has yet been set for beginning negotiations on the European Union's *acquis communautaire*. A resolution is important in order to maintain the reform momentum of recent years.

The government needs to build on its recent efforts to introduce business-friendly laws and enhance the country's attractiveness to foreign investors. Further efforts are needed to enforce new laws and strengthen the judicial system.

The economy weathered the worst of the crisis in 2009, and economic performance this year has been improving gradually. A key challenge is to preserve the tight fiscal and prudent monetary policies that have delivered stability to the economy throughout the past decade.

Macroeconomic performance

The economy was less affected by the global crisis than most others in the region; real GDP declined by just 0.8 per cent in 2009. However, industrial production dropped substantially in early 2010, although recent data point to a gradual recovery. After several months of disinflation in late 2009, prices have accelerated again and annual inflation was 2.0 per cent in September 2010. Bank lending to the private sector slowed significantly to only 3.5 per cent growth in the year to April 2010 and non-performing loans increased significantly.

In September 2010 the government introduced the fourth package of anti-crisis measures. The package included measures to simplify fiscal procedures, accelerate the privatisation of land, improve small and medium-sized enterprises' (SMEs') access to credit and promote agricultural employment. For 2010 the government plans a budget deficit of 2.5 per cent of projected GDP (after a deficit of 2.6 per cent of GDP in 2009). On the monetary side, the central bank (NBRM) remains committed to the current fixed exchange rate system and has intervened occasionally in the foreign exchange market over the past year. Despite this development, the level of foreign exchange reserves has increased in the past 12 months.

After disappointing first quarter GDP figures the economy grew marginally (0.4 per cent) in the second quarter, suggesting that a tentative recovery may be under way. Inflation is expected to remain at positive levels during the remainder of 2010. The exchange rate peg will remain in place, given the country's access to both private and official sources of funding (mainly from the European Union and the international financial institutions) as well as the NBRM's commitment to intervening on the foreign exchange market in support of this aim. However, the combination of falling capital inflows, limited growth in the main export markets and possible contagion effects from the crisis in Greece has increased external risks.

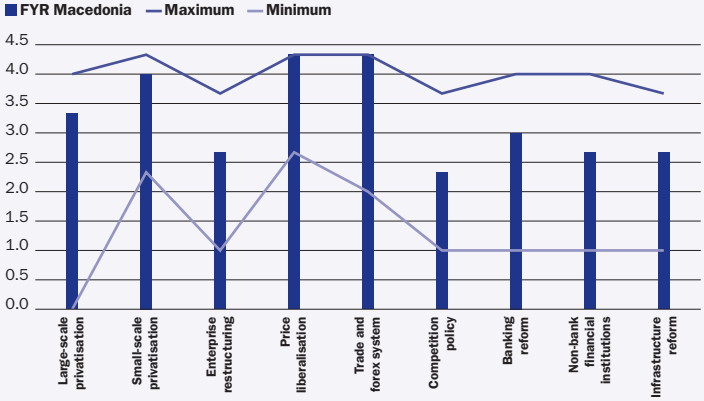
Structural reform

Overall, progress in reform in FYR Macedonia throughout the transition period has been steady if somewhat slow, as the country has been hampered by weak administrative and institutional capacity. In the financial sector competition among banks is less vibrant than in neighbouring countries and the development of capital markets is in its infancy. The country's infrastructure also faces significant investment needs in the coming years.

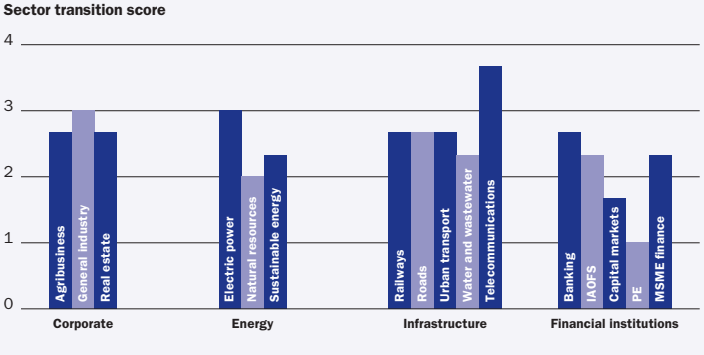
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	5.9	4.8	-0.8	0.8
Inflation (end year)	6.1	4.1	-1.6	2.5
Government balance/GDP	0.6	-1.0	-2.6	-2.5
Current account balance/GDP	-7.6	-12.8	-6.9	-3.9
Net FDI (in million US$)	700	601	235	241
External debt/GDP	52.5	49.1	58.8	na
Gross reserves/GDP	26.3	20.2	24.5	na
Credit to private sector/GDP	36.1	43.1	43.1	na

Transition indicators 2010



2010 sector transition indicators



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

Recent developments

Improving the country's investment climate has become a priority area for the government. The European Commission's Progress Report 2009 on FYR Macedonia recommended the opening of accession negotiations and praised the progress the authorities had made in some priority fields. The country's cadastre system has been reformed successfully and the authorities are promoting technological industrial development zones in order to attract more FDI. Fifty concession agreements have already been signed to develop such zones (although some plans are on hold) and in April 2010 a plant has opened in Bunardzik, the first zone developed. The construction of additional zones is ongoing.

Progress towards the government's aim of completing privatisation slowed over the past year. Four loss-making state-owned enterprises including the chemical manufacturer, Ohis, the tobacco producer, Tutunski Kombinat, the electronics maker, EMO and the military equipment production company, Eurokompozit Prilep, are currently up for sale. The deadline for the tenders has been postponed several times due to lack of interest. With the exception of Ohis, which will be sold separately in a tender that has been delayed until further notice, the deadline for the other companies was set for the end of September 2010.

In March 2010 the concessionaire of the country's main airports, Turkish TAV (which won the 20-year €200 million concession tender in 2008), started work on its projects after several postponements. In addition, following the government's plans to upgrade the country's regional and local roads, in November 2009 a public tender was announced for two 35-year road concession projects. Progress has also been made in the railway sector in recent years. Since 2009 an independent rail regulator, reporting to parliament, has been in place with responsibilities for both technical and economic regulation. The Ministry of Transport is in the process of setting up a directorate to take responsibility for railway safety.

One of the country's key priorities is the development of a gas distribution network. In June 2010, the authorities of both FYR Macedonia and Russia signed a debt agreement that will clear Russia's Soviet-era debt to FYR Macedonia in return for a US$ 60 million investment by Gazprom to support the development of the gas supply infrastructure. The project increases the possibility of FYR Macedonia participating in the South Stream gas pipeline project, which was discussed by the two parties in early October.

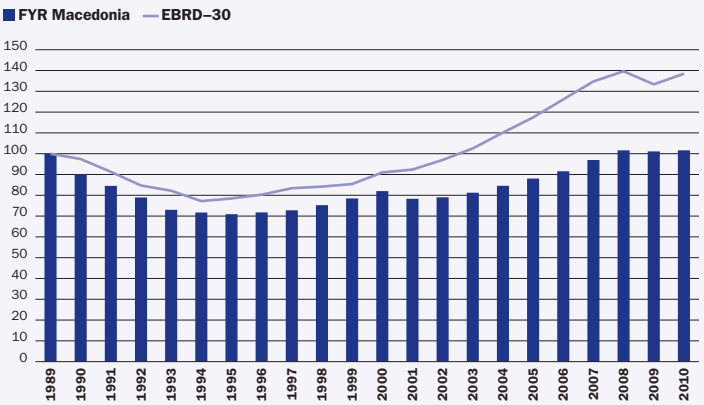
Amendments to the law on electronic communications were enacted in June 2010. Under the new law, telecommunication operators are obliged to submit standard subscription agreements to the Agency for Telecommunication for approval and must also respond to complaints within 15 days. The amended law requires real estate developers to provide secure access to telecommunication networks.

The quality of banking supervision helped to mitigate the impact of the global financial crisis and the banking sector remains well capitalised. Legal changes to facilitate an intervention in troubled banks by the NBRM and the removal of managers that do not meet adequate standards of integrity are currently being discussed. In addition, new policies to counteract money-laundering have been developed. In an effort to kick-start the development of capital markets, in April 2010 the government abolished the 10 per cent ceiling on foreign ownership of securities at the Skopje stock exchange.

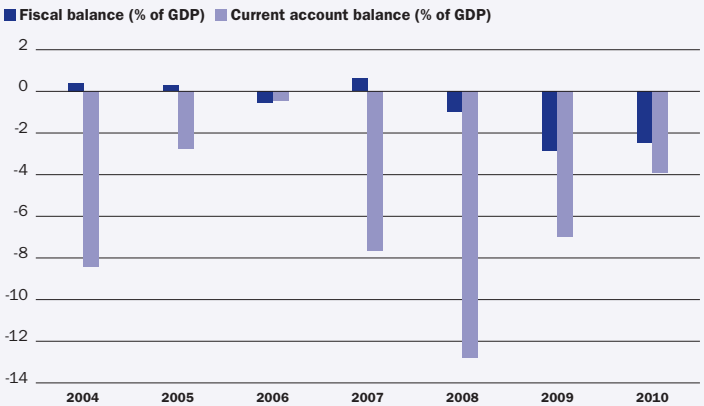
Structural reform priorities

- FYR Macedonia has made significant progress in recent years in passing new laws, but the challenge now is to ensure effective implementation. In the corporate sector, the priorities are to continue efforts to reduce or remove uncertainty over property rights and to accelerate progress in reforming the judicial system.
- High-quality infrastructure is also critical for further economic development and the attraction of FDI. In this regard, the key reform priority is to ensure that the regulatory authorities established in recent years in the transport and energy sectors can function effectively to ensure greater competition and efficiency in the delivery of services.
- In the financial sector, the priority in the coming years is to facilitate a much-needed consolidation of the sector and a greater diversity of financial products.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Georgia

The main challenge for Georgia is to attract private investment after the crisis. There is considerable uncertainty about the future pace of foreign direct investment (FDI) inflows – a key driver of pre-crisis growth. Therefore, it is important for the authorities to focus on structural reforms to encourage domestic savings and investment.

Further reforms are required in the financial sector to ensure continued recovery from the crisis and stable growth in the longer run. A credible shift of the monetary policy framework to inflation targeting, further strengthening of prudential policies and deepening of the local capital market are the key issues. Over time, these policies should help reduce dollarisation of the banking system.

Although the government has pursued fiscal consolidation in 2010, the overall deficit remains high and public debt has yet to stabilise. It will be important for the government to make a credible commitment to implementing a responsible fiscal policy in the future to support a recovery of market confidence.

Macroeconomic performance

In 2009 the Georgian economy continued to suffer from the double shock of the August 2008 military conflict with Russia and the subsequent impact of the world financial crisis. Real GDP fell by 3.9 per cent last year. Private investment collapsed along with the drop in FDI inflows and was only partially compensated by public capital outlays. Although the current account deficit almost halved as both investment- and consumption-related imports declined, it remained high and had to be covered by funding from official sources. The government loosened fiscal policy to help stabilise the economy, with the help of large multilateral and bilateral financing. The exchange rate has also been allowed to depreciate by about 30 per cent since the August 2008 conflict.

Real output increased by 6.6 per cent in the first half of 2010 as both domestic and export demand improved. Manufacturing has led the way, although other sectors have also contributed. There are signs of a recovery in the lending market, with increasing loan volumes and decreasing interest rates. The government contained spending in an effort to decrease the budget deficit from 9.2 per cent of GDP in 2009 to a targeted deficit of 6.3 per cent of GDP in 2010. Deficit reduction is currently contingent on renewed FDI inflows fuelling the economy and public revenues. The pace of FDI began to recover in the second quarter of 2010, but remains below its exceptional pre-crisis level, a sign that investors remain cautious.

The economy is expected to grow by about 5.5 per cent in 2010 with growth decelerating somewhat in 2011. A recovery in lending from the domestic banking sector is expected to compensate for the diminishing fiscal stimulus this year and beyond. The most significant downside risk relates to the uncertainty about the size of future foreign investment inflows, a key element in the authorities' growth strategy. The financial sector also poses risks to recovery as it is heavily dollarised and the level of non-performing loans remains high.

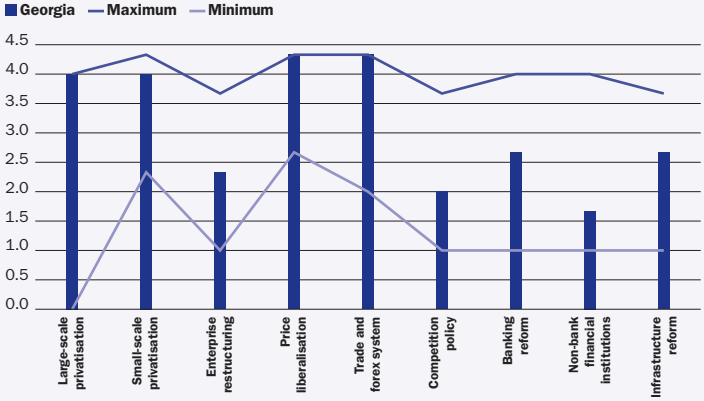
Structural reform

Georgia's structural reforms have been significant in the last few years. Large-scale privatisation is very advanced; tax and customs bodies are generally well run; and tangible results have been achieved in fighting corruption. Progress in these areas has meant that the business environment is considered to be among the best in the countries of eastern Europe and the Caucasus. However, large transition challenges remain, especially in the municipal sector and environmental infrastructure,

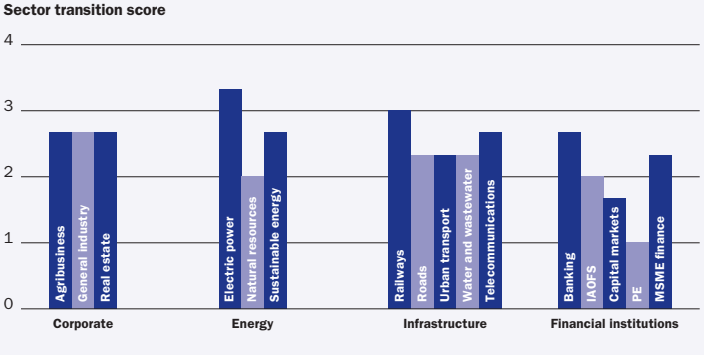
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	12.3	2.3	-3.9	5.5
Inflation (end year)	11.0	5.5	3.0	10.0
Government balance/GDP	-4.7	-6.3	-9.2	-6.3
Current account balance/GDP	-19.7	-22.7	-11.7	-12.0
Net FDI (in million US$)	1675	1523	765	650
External debt/GDP	38.6	44.4	58.4	na
Gross reserves/GDP	13.3	11.5	19.6	na
Credit to private sector/GDP	27.2	31.8	29.3	na

Transition indicators 2010



2010 sector transition indicators



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

where regulatory capacity is weak, and in natural resources, where competition is limited. The construction of the Black Sea Transmission Network, which started in April 2010, should help establish a regional energy market. Significant transition gaps also remain within the financial sector, as the banking sector remains highly dollarised and the non-bank financial sector is under-developed.

Recent developments

The government's extensive reform agenda, with its focus on improving the business environment, has already achieved important results since implementation began in 2009. The World Bank's *Doing Business 2010* survey ranked Georgia 11th out of 183 countries by its composite ease-of-doing business measure, a further improvement on the country's 16th position a year earlier. Its ratings in both paying taxes and trading across borders exhibited especially large improvements, reflecting the progress with reforms in these areas. Georgia also moved up slightly in Transparency International Corruption Perception's Index for 2009 to 66th globally, a level above any Commonwealth of Independent States (CIS) country by a wide margin.

The government has continued to further simplify and streamline the tax system, building on the changes implemented in 2009. These eliminated the tax on dividends from publicly traded enterprises, on interest income from bank deposits and on capital gains. The 2010 reforms, to be implemented in 2011, are set to introduce a number of tax breaks for micro and small businesses, including the elimination of profit tax on small businesses, provided they submit relevant accounting documentation. These reforms should help reduce the size of the shadow economy. To further reduce corruption, the new tax code will establish a board of auditors to supervise the tax inspectors. At the same time, the previously foreseen decrease in income taxes will be delayed in order to satisfy budget revenue requirements.

The government is creating a supportive environment for the development of the country's nascent information technology (IT) sector. IT use in Georgia is already growing rapidly, as evidenced by the almost 50 per cent increase in the number of broadband users in 2009. By 2011 the authorities plan to implement a bill on the creation of virtual IT zones, with significantly faster issuance of relevant licenses. However, the exemption of companies operating in the zones from all taxes and customs duties may complicate tax administration.

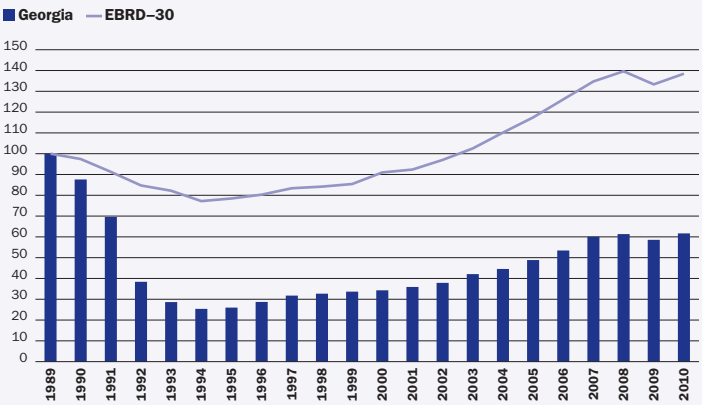
The government is continuing its privatisation drive, in part to generate additional budget income for the country. In July 2010 the authorities passed a bill amending the list of strategic state assets not subject to privatisation. One important change was that the North–South gas pipeline used to deliver Russian gas to Armenia was removed from the list and is thus likely to be privatised in the future. The government has therefore expanded the range of assets for sale and now faces the challenge of finding suitable buyers.

The National Bank of Georgia (NBG) introduced new measures and policy instruments in 2010 designed to increase the effectiveness of monetary policy in a heavily dollarised financial system. Among these measures, which the NBG hoped would also boost lari lending, were guaranteed refinancing instruments with variable interest rates and an expansion of the range of collateral, which can be used to tap central bank refinancing. The measures had a limited impact on reducing dollarisation, however. Ongoing efforts to build capacity to adopt a credible inflation targeting regime should help build confidence in the ability of the NBG to maintain price stability and, consequently, in the lari. Combined with further strengthening of prudential policies and deepening of the local capital market, these policies would help reduce dollarisation over time.

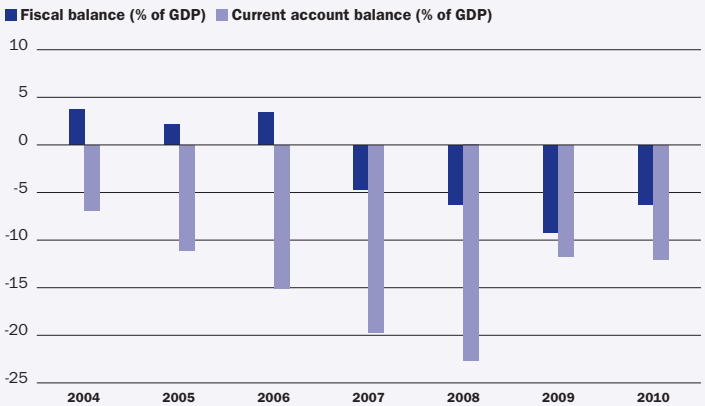
Structural reform priorities

- The main challenge for Georgia is to revive private investment after the crisis. The authorities' efforts to encourage FDI should be broadened to stimulate domestic savings and investment, including development of privately funded pension systems. Financial sector policies should focus on strengthening prudential policies (including supporting de-dollarisation of the banks' balance sheets), addressing the large stock of non-performing loans and extending the maturity profile of the local capital market.
- Further changes are necessary in municipal infrastructure, where the major challenges include rehabilitation of physical infrastructure, tariff reform and restructuring of municipal enterprises to improve efficiency. In the natural resources sector, particularly oil and gas transit, the role of the dominant state-owned player, the Georgian Gas and Oil Corporation, should be reduced to increase competition.
- Despite recent improvements, major challenges remain in improving the trade and investment climate. The government should focus particularly on reinforcing the rule of law, stimulating educational attainment and acquisition of skills by its population and promoting further improvement of public sector governance along the lines of the EU *acquis*.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Hungary

Key developments and challenges

International financial markets are alert to potential debt sustainability issues, as Hungary's traditional vulnerabilities – high foreign currency exposures among households and a large public debt burden – remain a concern. Fiscal policy will therefore need to focus on reducing the remaining tax distortions while new taxes should be designed in consultation with the private sector and in line with European Union (EU) principles of non-discrimination.

Key state-owned enterprises require urgent reform to support private sector growth, and to relieve pressures on the budget. The reform of the railways, which the authorities have already initiated, should be advanced swiftly.

The low participation rate in the labour force remains a key weakness. Key reforms to welfare provisions and pensions are necessary to boost the labour supply and increase the economy's potential growth rate.

Macroeconomic performance

The Hungarian economy experienced a reasonably strong recovery in the first half of 2010, following six consecutive quarters of economic contraction up to the third quarter of 2009 and an overall GDP contraction of 6.3 per cent in 2009. Recent activity indicators point to the strength of both industrial production and exports, which have benefited from a recovery in the main eurozone economies. However, domestic demand remains weak, as it is held back by rising unemployment (which stood at 10.9 per cent in August 2010 according to Eurostat) and the continued contraction in credit to both households and the corporate sector. As a result, Hungary continues to run current account surpluses. The improved perceptions of country risk up to May 2010 have underpinned a resumption of inflows of portfolio capital.

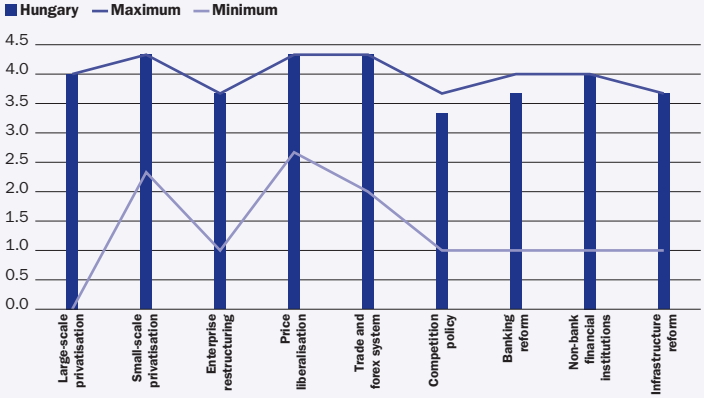
While there was broad concern in international bond markets about the sustainability of public debt levels in EU countries, contagion from the eurozone periphery to Hungary remained limited up to May 2010. However, when the new government took office in June 2010 senior officials made a number of statements on the outlook for public debt that led to considerable volatility in the forint and bond markets. The government subsequently announced a number of important changes to fiscal policy, including a flat-rate personal income tax, limits on public sector salaries and reductions in taxes on small and medium-sized enterprises (SMEs), with a view to keeping the budget deficit target at 3.8 per cent of GDP as agreed under the International Monetary Fund (IMF)/EU programme.

The economy is forecast to grow at slightly under 1 per cent this year, accelerating modestly in 2011. As of September 2010 the extension of the IMF/EU financing programme that was put in place in late 2008 remains unclear. Public sector funding needs are limited and were due to be met by continued issuance in domestic and external bond markets, assuming favourable conditions persist. Nevertheless, the household sector remains vulnerable to swings in the forint rate, and the central bank has indicated its readiness to respond to adverse market conditions through renewed interest rate hikes. In that case, Hungary's considerable public debt burden (about 80 per cent of GDP) could again become a concern for the market, with the risk of derailing the currently favourable growth prospects. The recent announcement of large *ad hoc* tax measures on industries, particularly those where foreign ownership is significant, has raised investor uncertainty over the overall business environment and only postpones the introduction of fiscal reform measures that are needed to underpin a sustainable deficit reduction path.

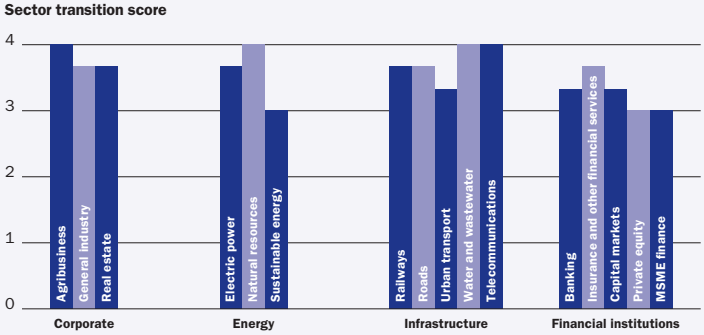
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	1.0	0.6	-6.3	0.8
Inflation (end year)	7.4	3.5	5.6	3.5
Government balance/GDP	-5.0	-3.7	-4.0	-3.9
Current account balance/GDP	-6.8	-7.2	0.3	1.0
Net FDI (in million US$)	1795	3999	0	-2500
External debt/GDP	97.9	115.7	140.4	na
Gross reserves/GDP	16.1	22.8	32.8	na
Credit to private sector/GDP	51.9	59.3	59.4	na

Transition indicators 2010



2010 sector transition indicators



Structural reform

Hungary's fiscal consolidation and its reform of unsustainable welfare expenditures accelerated under the IMF/EU programme. The government that held office up to June 2010 re-energised reforms, in particular in the financial sector. The new government has a different emphasis on making growth more inclusive, in particular by reducing the tax burden on SMEs and through the introduction of a flat-rate personal income tax. Nevertheless, important weaknesses remain to be addressed, especially given the need to reform the key state-owned enterprises and to raise the participation rate in the labour force.

Recent developments

Hungary has traditionally been a very attractive destination for export-oriented foreign direct investment from other EU countries, attracting in total about 3 per cent of GDP in foreign direct investment (FDI) inflows in 2008, a figure that was sharply reduced in the recession of 2009. The World Bank's *Doing Business 2010* survey ranks the country at 47 (a slight decline from last year), with the tax system and concerns over investor protection flagged as problematic.

In the financial sector the regulator and the central bank have addressed risks in retail lending through limitations introduced since March 2010 on the loan-to-value ratios that are differentiated by currency. Requirements regarding disclosure and transparency in relation to retail borrowers and contractual rights were strengthened through an industry code of conduct shortly thereafter. The new government subsequently considerably tightened these limitations through a ban on registering collateral for mortgages denominated in foreign currency.

Foreign currency-denominated lending has already shrunk considerably and some limited reforms in the capital market may facilitate the issuance of mortgage backed securities. These recent measures are likely to constrain overall mortgage lending, but there is a risk they may be circumvented. Outside observers, including the European Central Bank (ECB), have encouraged the authorities to stimulate local currency financing on a more sustainable basis.

The new government imposed a temporary financial sector levy which will be in effect in 2010 and 2011. This levy is substantial relative to GDP or relative to the size of the assets held by institutions, which will define the tax base. Unlike taxes proposed in other EU countries, this tax is designed to meet a shortfall in public revenues and is not aimed at reducing systemic risks in the financial sector.

In the power sector the dominant position of the state-owned supplier, MVM, has been curtailed somewhat in previous years, although full unbundling of the sector remains to be completed, as MVM still retains activities in the wholesale and transmission areas. In mid-2010 the new government submitted legislation to parliament regarding a cap on prices that can be charged by universal suppliers of gas and electricity to households and other consumers. Such broad regulation of prices in an essentially competitive wholesale market could interfere with the operation of the market.

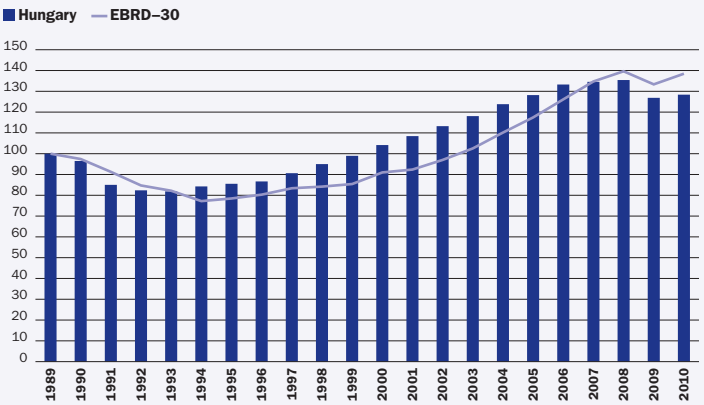
The national airline (Malev) was re-nationalised in February 2010, as a Russian investor surrendered the largest part of its stake three years after privatisation. The government now owns a 95 per cent stake in the loss-making carrier.

In the railway sector important reforms had already been undertaken in 2007 when freight and passenger functions were separated. However, the financial performance of MAV, the state-run company operating the rail network, remains poor and it requires ongoing and substantial support from the budget. This has prompted the new government to consider more wide-ranging restructuring measures, including the sale of land and reductions in the workforce.

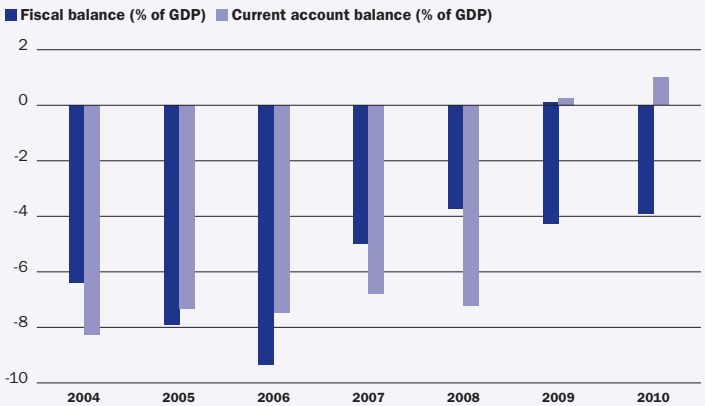
Structural reform priorities

- Ensuring the country's position as a location for export-oriented and technology-intensive FDI is a key priority to raise the country's trend growth rate. This requires adhering to a non-discriminatory and predictable tax policy, addressing some of the impediments to establishing a business, and strengthening innovation and workforce skills.
- The country's employment rate remains extremely low by European standards. Reforms to the pension system and a shift in the tax burden from labour to consumption are expected to lead to an increase in labour force participation. However, further welfare reforms are needed as an ageing population will aggravate the problem.
- To ensure the financial system plays an integral part in the recovery, taxation and new regulation should be designed in coordination with the industry and other European countries. The benefits of financial openness should be safeguarded, while competition should be strengthened and information sharing within the industry enhanced through a comprehensive positive credit registry. A vibrant asset management and pension fund industry, and more liquid local capital markets, could further help put financial markets on a more sustainable footing.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Kazakhstan

Key developments and challenges

Long-term sustainable growth requires significant diversification and industrialisation. The challenge is to strike a balance between continued state investment in infrastructure, education and worthwhile industrial projects, while at the same time encouraging active private sector involvement to ensure an efficient allocation of available resources.

An effective resolution of non-performing loans, further improvements in prudential regulation and the development of local capital markets would help to ensure that the financial sector emerges stronger from the crisis and can better support the real sector in achieving sustainable economic growth.

Fiscal policy will need to reconcile the goals of supporting economic recovery in an uncertain external environment, attaining the country's medium-term development objectives and prudently managing volatile oil and gas revenues.

Macroeconomic performance

The Kazakh economy returned to growth in the last quarter of 2009, driven primarily by extractive industries, related manufacturing and a record grain harvest. For 2009 as a whole, GDP rose by 1.2 per cent. The growth momentum has been sustained in 2010 with GDP expanding by 8.0 per cent year-on-year in the first six months, supported by higher commodity prices and a continued fiscal stimulus. The economic stabilisation programme, augmented several times since the start of the crisis, has been funded mainly by the offshore National Oil Fund.

Inflation pressures have edged up reflecting both an upturn in economic activity and an increase in average import duties following the launch of the Customs Union of Belarus, Kazakhstan and Russia. In February 2010 the central bank widened the trading band of the currency to 127.5 to 165.0 tenge per US dollar. This move, allowing for gradual nominal appreciation of the local currency, is aimed at keeping inflation in check while limiting the adverse impact of appreciation on the competitiveness of the manufacturing sector.

The rebound in oil prices is a positive development for the current account, which moved back into surplus in the fourth quarter of 2009 and is expected to remain in surplus in 2010-11. In addition, net foreign direct investment (FDI) has held up well throughout the crisis at about 10 per cent of GDP a year. External private debt remains very high at 95 per cent of GDP (53 per cent when intra-company loans are excluded), but the public sector balance sheet remains strong.

Despite subdued credit growth reflecting the depth of problems in the banking sector, economic growth is expected to reach 6 per cent in 2010 before decelerating slightly in 2011, supported by increased oil production, substantial infrastructure investment and a continued fiscal stimulus. The volatility of the price of oil remains the key risk to this short term growth scenario.

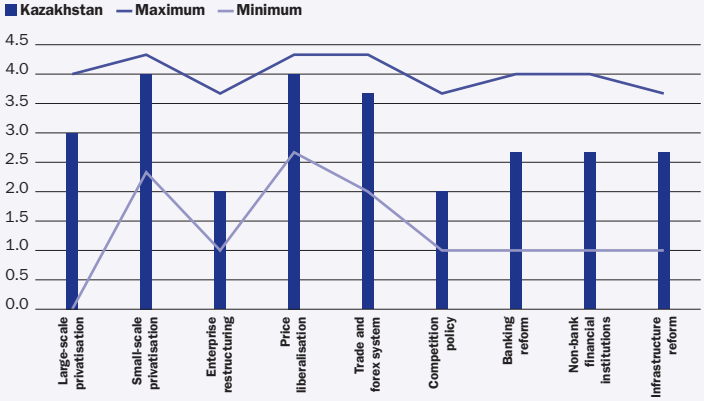
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	8.9	3.2	1.2	6.0
Inflation (end year)	18.8	9.5	6.2	6.5
Government balance/GDP	4.7	1.1	-1.5	-3.2
Current account balance/GDP	-8.1	4.6	-3.2	2.6
Net FDI (in million US$)	7966	14783	9526	9700
External debt/GDP	93.9	79.5	103.7	na
Gross reserves/GDP	15.3	13.2	19.1	na
Credit to private sector/GDP	57.4	45.7	48.1	na

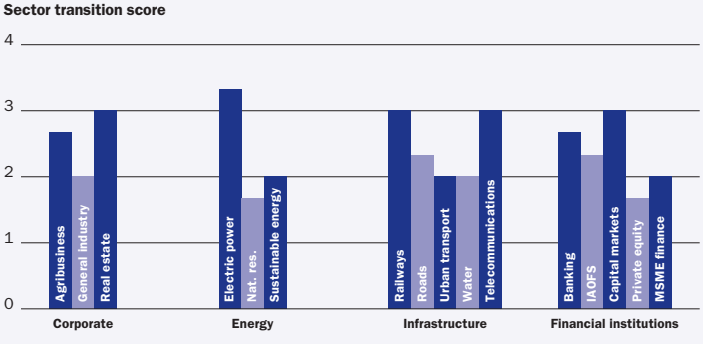
Structural reform

Despite progress in recent years, both the structure of markets and the institutions that help markets work need substantial further improvement. State interference in the industrial sector continues to be high and has increased recently as the government has stepped up its implementation of industrial policy through the National Welfare Fund, Samruk-Kazyna (SK). Further efforts are needed to improve efficiency and productivity in the real sector, enable successful restructuring, allow for effective competition, reduce barriers for the entry of new enterprises

Transition indicators 2010



2010 sector transition indicators



Note: Nat. res. – Natural resources; Water – Water and wastewater; IAOFS – Insurance and other financial services

and improve standards of corporate governance and business conduct. The global financial crisis has exposed a number of underlying and deeper vulnerabilities in the banking system.

Recent developments

The banking system was severely affected by the sudden stop of external financing in the second half of 2007, with several banks unable to meet their obligations having to be nationalised. Restructuring of bank debt and the cleaning of balance sheets have continued over the past year, but very substantial challenges remain. In May 2010 external creditors of BTA, a major bank now majority-owned by SK, voted in favour of restructuring more than US$ 12 billion of debt. Earlier, Alliance Bank restructured over US$ 4 billion in external obligations and negotiations are under way among a number of smaller banks, including Temir Bank and Astana Finance.

The aggregate capital base of the banking sector remains low, but non-performing loans (estimated to stand at 26 per cent of the total loans on a 90-day-overdue basis) have been more than fully provisioned. To avoid an excessive reliance on external financing, a major factor in the severity of the banking crisis within Kazakhstan, the authorities have implemented restrictions on overseas borrowing by banks and raised provisioning requirements on foreign currency denominated loans to unhedged borrowers. In addition the authorities are expected to impose a maximum loan-to-deposit ratio of 150 per cent. Although loan-to-deposit ratios have been falling steadily, in many banks they continue to exceed this threshold.

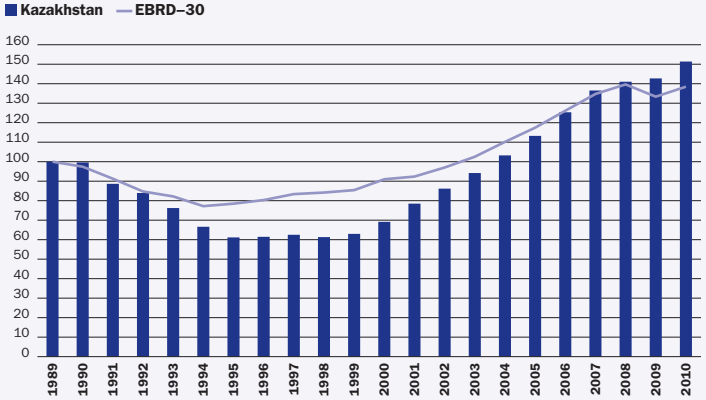
More than US$ 70 billion (or 50 per cent of GDP) worth of assets across various sectors of the economy, including the financial sector, are now controlled by SK. The involvement of the government in the economy through SK is likely to remain high as the crisis-related fiscal stimulus package blends into the 2010-15 industrialisation plan, which encompasses investment in various large infrastructure and industrial projects. The plan will be partially financed by resources attracted from China (over US$ 10 billion) and a number of multilateral development banks.

In November 2009 Belarus, Kazakhstan and Russia signed documents establishing a Customs Union. The Customs Code, which incorporates a common external tariff structure for the three countries, came into force in July 2010. The Customs Union Commission is now in charge of setting and revising harmonised tariffs, although a number of sensitive items (such as passenger cars) are covered by temporary exemptions from the common duties. Internal border controls are expected to be eliminated by the end of 2011 at the latest when the joint customs area should be finalised. While the union is expected to facilitate trade between the three countries and strengthen the position of Kazakh exporters in the Russian and Belarusian markets, it may also introduce additional complications in terms of Kazakhstan's accession to the World Trade Organization (WTO) insofar as customs tariff-setting powers are now delegated to a supranational body. The authorities remain committed to pursuing WTO accession. Extreme weather conditions in Russia, Ukraine and parts of Kazakhstan during the summer of 2010 underscored the importance of Kazakhstan as a major grain exporter playing a key role in regional food security.

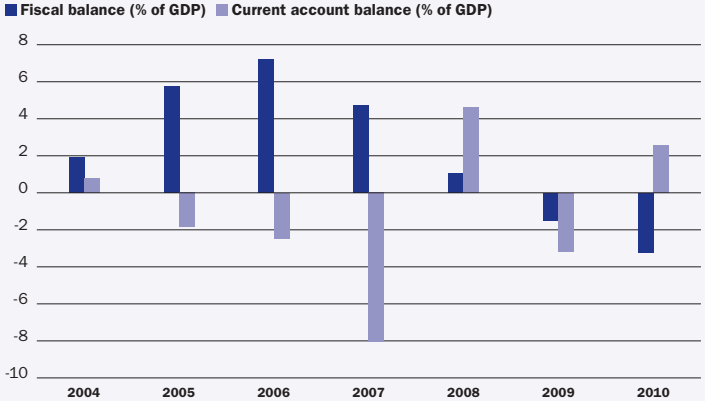
Structural reform priorities

- Diversification of the economy away from excessive natural resource dependence and modernisation of industry are recognised as overarching policy priorities. Developing specialised transport and storage infrastructure and improving quality standards and control could help Kazakhstan better realise its significant agricultural potential along the entire value-added chain.
- Kazakhstan ranks among the most carbon intensive countries among all parties to the UN Framework Convention on Climate Change (UNFCC). Reducing the energy intensity of output through technological modernisation, appropriate tariff policies and the further commercialisation of utilities remains a key priority.
- Banks will need to develop a more sustainable funding model in which they rely increasingly on local capital markets and the domestic depositor base and the nationalised banks will need to be prepared for future privatisation. A top priority is to amend the provisions of the Tax Code, which currently provide a disincentive to remove non-performing loans from the balance sheets of both banks and companies.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Kyrgyz Republic

Key developments and challenges

The socio-political crises of April and June 2010 have seriously dented growth prospects and significantly increased fiscal expenditure needs. Donors have pledged fiscal support until 2012, but in the medium term, fiscal discipline needs to be restored to ensure public debt sustainability.

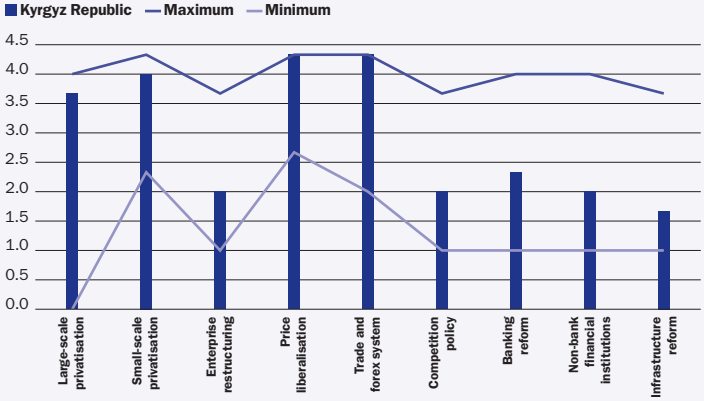
The crises have also highlighted the need to tackle deep-rooted corruption and nepotism. The new constitution that envisages the introduction of a parliamentary system of governance could help to address these issues, but it is also important to adhere to the rule of law and establish an impartial judiciary.

The overall credibility of the public administration and regulatory bodies, especially that of the banking sector regulator which was severely eroded under the previous regime, needs to be restored so that the private sector can undertake meaningful policy dialogue to improve the investment climate.

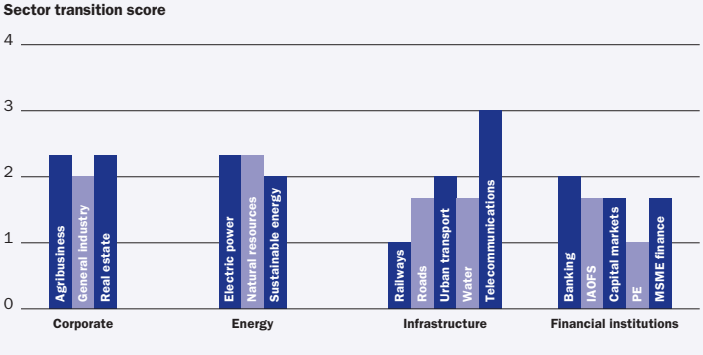
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	8.5	8.4	2.3	-3.5
Inflation (end year)	20.1	20.1	0.0	9.0
Government balance/GDP	-0.3	0.0	-3.7	-12.0
Current account balance/GDP	-0.2	-8.0	2.1	-5.3
Net FDI (in million US$)	208	265	140	188
External debt/GDP	60.2	45.1	59.6	na
Gross reserves/GDP	29.1	22.4	32.6	na
Credit to private sector/GDP	14.9	13.5	12.9	na

Transition indicators 2010



2010 sector transition indicators



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

Macroeconomic performance

Real GDP grew by 2.3 per cent in 2009, down from 8.4 per cent in 2008. A sharp decline in industrial production was partly off-set by robust growth of agricultural output and strong growth in construction, supported by higher public capital expenditures. The level of growth accelerated in the first quarter of 2010 to 16 per cent year-on-year, largely driven by an increase in gold production, but the socio-political disturbances of April and June have cut the growth momentum short.

The authorities responded to the global economic downturn in 2009 by adopting an expansionary fiscal policy under the International Monetary Fund's (IMF) Exogenous Shocks Facility (ESF), with higher capital expenditures and tax cuts as well as financial support from Russia. Monetary policy has been eased as price pressures receded, with the rate of inflation declining from 20.1 per cent at the end of December 2008 to 0 per cent by December 2009. As a result of weaker import demand, in part reflecting the fall in remittances, the current account recorded a surplus of 2.1 per cent of GDP in 2009. External public debt remained at a manageable level of 54.1 per cent of GDP at the end of 2009.

The economy is likely to contract by 3.5 per cent in 2010 owing to the events in April and June which disrupted agricultural production, trade and other services through border closures and internal unrest. The disturbances have also severely eroded investor confidence. There will be significant pressures on government spending for reconstruction, and the overall fiscal deficits for 2010 and 2011 have been projected at 12 and 8.5 per cent of GDP respectively. In July 2010 donors pledged US$ 1.1 billion (24 per cent of GDP) over 30 months, including for budgetary support, which will ease the financing requirements and will also address the social needs of those who were severely affected by the events. The main risk however is that possible prolonged political and social instability will have an even more severe detrimental impact on output.

Structural reform

Transition challenges remain large in all sectors of the economy especially with respect to establishing sound market-supporting institutions. For enterprises, deep-seated corruption and nepotism are still a serious problem. Some progress was achieved in streamlining bureaucratic procedures, but more needs to be done to implement the changes. In infrastructure, the progress made with recent reforms was reversed by the new regime that came to power in April as the process was considered to have been

non-transparent. In recent years, the development of the financial sector has been hindered by weak regulatory enforcement.

Recent developments

The investment climate has deteriorated sharply following the April and June events. According to a survey conducted in April and May (prior to the June events) of 134 businesses that are members of the International Business Council, respondents expected planned investment to fall by 11 per cent over the next 12 months compared with investments undertaken over the past year. The overall confidence in the investment climate dipped to an all time low of -95 (on a scale of -100 to +100). The respondents' main concerns were over the issues of safety, security and terrorism, followed by the predictability of rules, laws and regulations.

Some of the measures taken by the new regime which penalised those that were considered to be associated with the previous regime, such as the creation and publication of a "black-list" of entrepreneurs and the confiscation of property, have eroded confidence in the rule of law.

Infrastructure reforms advanced under the previous regime. Household tariffs were more than doubled from 71 tiyns (US$ 1.9 cents) to 150 tiyns effective from 1 January 2010 and were planned to be increased to 190 tiyns from 1 July 2010, fully eliminating cross subsidies and reaching cost recovery levels. The government also introduced compensations to mitigate the impact of tariff increases.

Two regional electricity distribution companies – Severelectro (SE) and Vostokelectro (VE) – were privatised in December 2009 and February 2010, respectively to Chakan GES, a Kyrgyz company. In February 2010 KyrgyzTelecom (KT), a telecommunications operator that has a *de facto* monopoly over fixed line services, was sold to a consortium consisting of entities with unknown ownership (one local company, two off-shore companies and a Kazakh company). These privatisations were widely considered at the time to be non-transparent. The new regime has reversed tariff increases and re-nationalised or cancelled privatisations of SE, VE and KT, citing irregularities in the privatisation process.

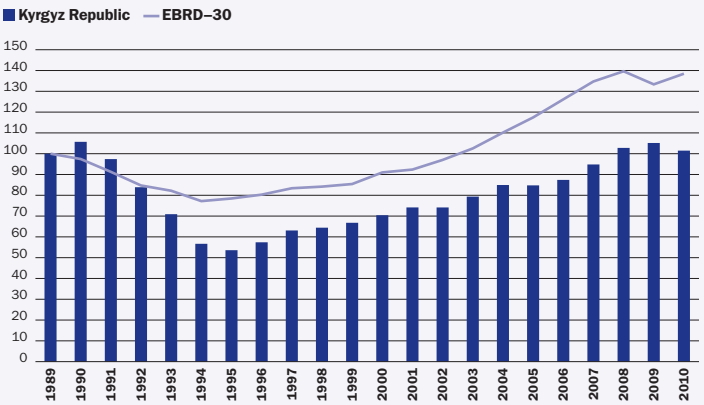
Although the financial system withstood the 2009 economic crisis, the events of April and June 2010 adversely affected the stability of the sector. While there was a significant outflow of non-resident deposits from the largest bank, there was no major bank run following the April and June events. Seven banks were placed under temporary administration (TA), although this was subsequently removed for two small banks. The largest of these banks – Asia Universal Bank (AUB) – which accounted for almost 45 per cent of the system's deposits, was placed under conservatorship in early June and subsequently nationalised to protect the interests of depositors and creditors. It is estimated that for AUB to be fully capitalised it requires a capital injection of around US$ 33 million (equivalent to 0.7 per cent of GDP). In August 2010, the authorities decided to separate the AUB into a good and bad bank with a view to privatising the good bank.

Throughout the financial system, loan portfolio quality has deteriorated, but capital adequacy levels appear reasonable. Microfinance institutions have been particularly badly hit by the turmoil in the south, with classified loans rising to 5.9 per cent by June compared with 1.6 per cent as of the end of May.

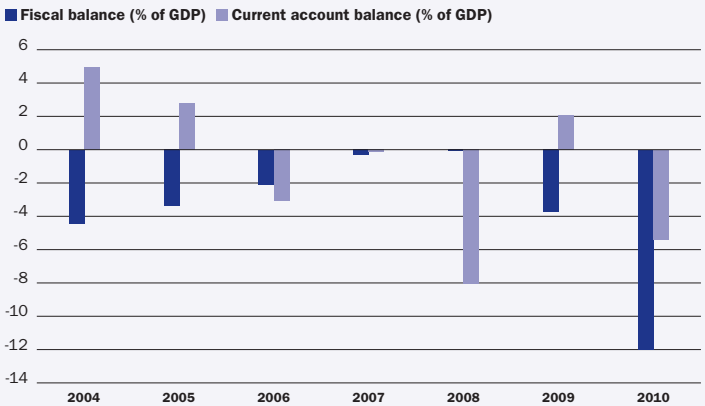
Structural reform priorities

- Rebuilding confidence, including that of investors, should be the main priority for the new government. This depends on restoring law and order, establishing the rule of law and developing an impartial judiciary.
- While the reversal of infrastructure reforms by the new regime can be justified, further tariff increases in the electricity sector are needed to finance essential investment in the sector. Such increases should be combined with a reorientation of the relatively un-targeted compensation in place right now to well-targeted energy subsidies for the most vulnerable.
- The independence of the National Bank of the Kyrgyz Republic needs to be strengthened so that banking regulation is applied in accordance with the law. The position of AUB and the other banks under TA need to be resolved through restructuring in order to restore overall confidence. In the medium term, the key challenge is to have a level playing field for all market participants in the banking sector.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Latvia

Key developments and challenges

Latvia is emerging from the deepest recession since the onset of transition. Ensuring sustained growth and a reduction in unemployment in future years will depend on further improvements in competitiveness and diversification, focusing on the production and export of products which are more intensive in skills and technology. This will need to be supported through a business environment that is more conducive to innovation.

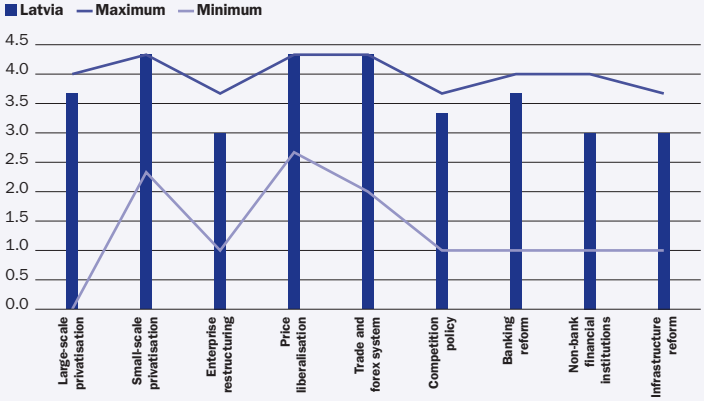
Credit to the private sector is still contracting and non-performing loans have reached record levels. The need to revive bank credit to the private sector, in particular to small and medium-sized enterprises (SMEs), remains a key challenge. The re-privatisation of the former Parex Banka would support this objective and allow the unwinding of crisis-related interventions.

More competition and greater private sector participation will be important to raise efficiency levels in all segments of the power sector (generation, transmission and distribution). In the electricity market, systems for future regional market integration with Baltic neighbours and other Nordic countries need to be established.

Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	10.0	-4.2	-18.0	-1.0
Inflation (end year)	14.2	10.4	-1.2	1.3
Government balance/GDP	-0.3	-4.1	-10.2	-8.0
Current account balance/GDP	-22.3	-13.3	8.8	5.0
Net FDI (in million US$)	1945	1092	150	300
External debt/GDP	135.5	125.2	161.9	na
Gross reserves/GDP	19.3	14.9	25.5	na
Credit to private sector/GDP	81.0	82.2	95.5	na

Transition indicators 2010



Macroeconomic performance

Economic activity recorded a major decline in 2009, with the GDP falling by 18 per cent. Unemployment had risen to over 20 per cent by the first quarter of 2010, depressing domestic demand and adding to the pressures on the ability of borrowers to repay their loans. As a result the share of non-performing loans (overdue by more than 90 days) in the banking sector continue to increase, and in August 2010 stood at over 19 per cent. However, in early 2010 the economy began to show signs that it was gradually stabilising, driven mainly by improvements in external demand. By July 2010 industrial production had risen in monthly terms for five consecutive months, exports had recorded a strong performance and the unemployment rate started to decline, reaching 19.5 per cent by the second quarter of 2010.

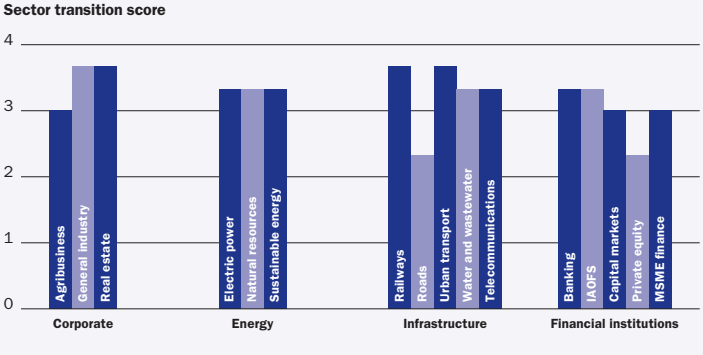
Latvia has continued to benefit from a comprehensive funding programme provided by a number of lenders, including the International Monetary Fund (IMF), the European Union (EU), the World Bank and the Nordic countries. The implementation of a range of measures, including deep public sector wage and employment cuts has meant that the government has complied with the fiscal objectives agreed with the lenders, including limiting the budget deficit to 9.0 per cent of GDP in 2009. The continuation of the programme requires the authorities to meet a fiscal deficit target of no more than 8.5 per cent of GDP in 2010 and 6.0 per cent in 2011. Given the improved economic performance it now seems possible that Latvia will not have to draw down the whole amount of the funding available under the programme.

The economy is expected to show a further small contraction in 2010, mainly due to strong negative carry over from 2009, followed by a return to growth in 2011. Tight fiscal policy, continuing wage adjustments, high unemployment and weak credit supply remain key risks and could hold back the recovery in domestic demand. However, the economy should continue to benefit from improving export performance, although this will depend on the speed of recovery in the EU.

Structural reform

Although Latvia is an advanced transition country, the financial crisis has highlighted the need for further reform. A number of important sectors, including power and transport, still remain under the influence of dominant state-owned companies or require further liberalisation. In addition, the grey economy remains substantial in Latvia and has been estimated by the World Bank to account for almost 42 per cent of GDP, the highest proportion in the EU. State influence in the banking sector should be diminished once the newly created Citadele Bank is privatised.

2010 sector transition indicators



Note: IAOFS – Insurance and other financial services

Recent developments

The financial and economic crisis brought into sharp relief the need to balance public finances and achieve long term fiscal sustainability. In the context of the EU/IMF financial programme the government has implemented wide-ranging reforms in the tax system, large expenditure cuts and a streamlining of public administration. A number of taxes have been increased or were revised (for example a progressive real estate tax, and a simplified tax on individual entrepreneurs and SMEs). Between June 2008 and March 2010 the average wages of public sector employees fell by about 26 per cent. In the education and health care sectors savings were achieved through wide-spread layoffs and closing underused facilities. A number of administrative agencies have also been merged. Binding rules for long term fiscal sustainability are to be set out in a planned law on fiscal responsibility.

The authorities have made significant progress in restructuring Parex Banka, formerly the second largest bank. The bank was locally owned, but the government nationalised a majority stake in November 2008, with the EBRD subsequently acquiring a 25 per cent equity stake in 2009. Based on the restructuring plan submitted by the authorities to the European Community (EC) under the EU state aid rules, core performing assets of Parex were transferred to the newly created Citadele Bank and the other non-performing or non-core assets remained in the residual resolution bank. This restructuring should facilitate the ultimate objective of transferring the bank back into private ownership and reviving growth in credit. The authorities are also committed to transforming the second state-controlled bank in Latvia, the Mortgage and Land Bank, into a development bank.

The government also strengthened financial supervision over the past year in light of the banking sector vulnerabilities revealed at the outset of the financial crisis. Recently, a Memorandum of Understanding with other supervisors and fiscal authorities in the Baltic and Nordic countries has adapted the coordination of cross-border supervision to the underlying deep integration of banking markets. The liquidity and credit risk management regulations have been revised and the independence of the deposit insurance system has been strengthened, as has the legal framework for faster payments to depositors. Incentives for market-based debt restructuring have also been improved. Guidelines were issued and existing legislation on foreclosure procedures amended, thereby streamlining the rehabilitation of viable firms and corporate liquidation proceedings, and improving the personal insolvency framework. Further efforts are under way to remove tax disincentives to debt restructuring.

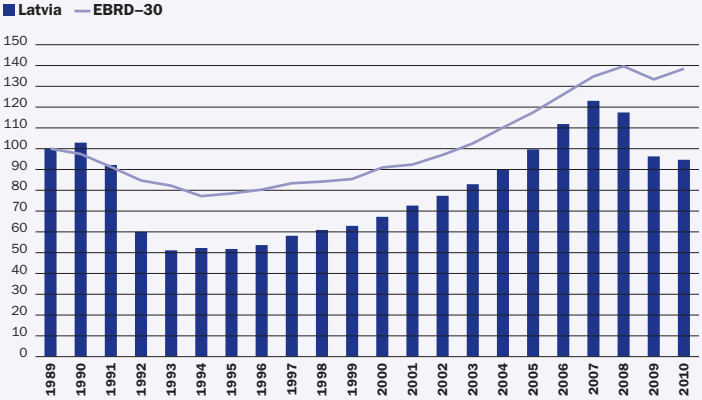
The closure of the Ignalina nuclear power plant in neighbouring Lithuania and the related reduction in electricity supplies underlined the need to develop alternative energy sources. Efforts to upgrade the existing power facilities, such as the recent modernisation of Latvenergo's plant in Riga, are improving generation efficiency and thus moving the country closer to the best standards of practice. At the same time Latvia has not yet established a power market price area that would allow the country to trade electricity in an integrated regional market with its Baltic neighbours and Nordic countries (which operate the NordPool platform).

The Ministry of Economy has prepared a new action plan to improve the quality of the business environment, such as simplifying the procedures for starting a business, tax administration and developing electronic means of government. The authorities have also proposed a number of measures to tackle the grey economy, including a simplification of administrative controls for companies meeting specified transparency criteria.

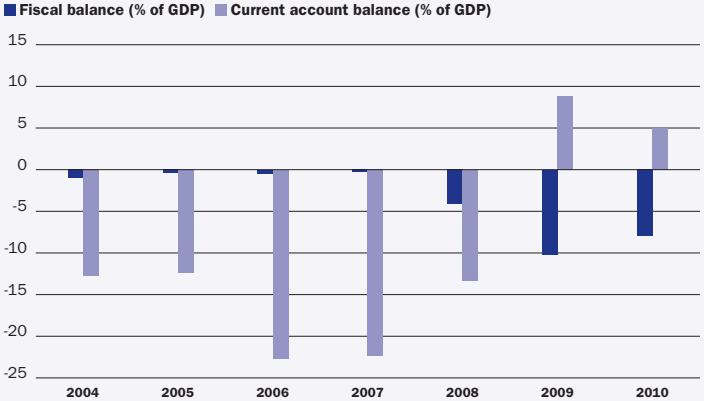
Structural reform priorities

- The government's immediate priority is to adhere to a stringent fiscal consolidation policy, and competitiveness. Against this background, it is important that the authorities dismantle the remaining barriers to private sector growth by implementing measures under the new business environment action plan, and improve governance and transparency in state-owned enterprises.
- Accelerating the development of projects in the sustainable energy sector is a key priority. The focus should be on removing the remaining institutional barriers to investments in energy efficiency, mainly in the municipal, household and SME sectors.
- In the banking sector, the priorities include improving access of SMEs to finance, which would be helped by steps to facilitate debt restructuring, more efficient absorption of EU funds and the restructuring and privatisation of the remaining state-owned banks. Additionally, the further facilitation of non-bank funding sources, including venture capital funds, could help to increase investment in technology-intensive enterprises.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Lithuania

Key developments and challenges

With the establishment of the new Baltic Power Exchange in Lithuania, an important first step has been taken towards the regional integration of national power markets. The authorities could also improve the security of energy supplies by developing alternative sources of energy and promoting energy efficiency.

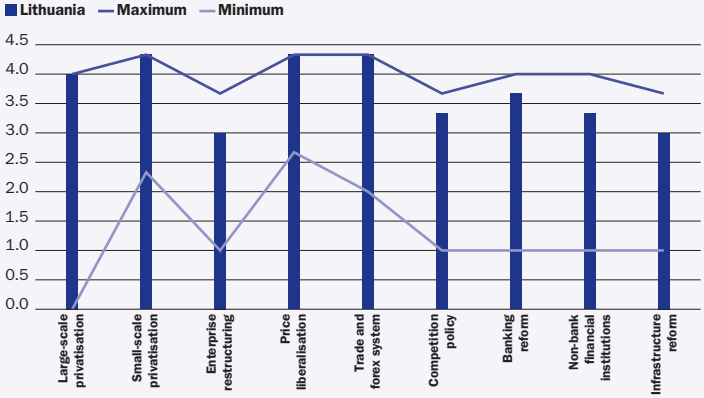
The extent of the grey economy remains an impediment to investment. Strengthening the enforcement of existing tax laws and other regulations as well as expanding the incentives for adherence could contribute to a reduction in the size of the informal sector and encourage sustainable growth in the formal economy.

Lithuania will need to develop more technology-intensive sectors, especially to increase the share of these goods in exports. This will require a tax regime that favours research and development and innovation and also discourages the outward migration of skilled workers. Over the longer term it requires an education system that ensures human capital has the appropriate skills.

Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	9.8	2.8	-14.8	0.5
Inflation (end year)	8.1	8.5	1.3	2.0
Government balance/GDP	-1.0	-3.3	-9.2	-7.2
Current account balance/GDP	-14.6	-13.5	4.5	-2.1
Net FDI (in million US$)	1409	1715	-50	150
External debt/GDP	77.0	68.7	90.2	na
Gross reserves/GDP	19.4	13.4	17.5	na
Credit to private sector/GDP	56.6	59.3	66.6	na

Transition indicators 2010



Macroeconomic performance

GDP contracted sharply by 14.8 per cent in 2009, and the unemployment rate has continued to climb to over 18 per cent in the first half of 2010. However, the economy had begun to stabilise by the end of 2009 and was showing signs of recovery in the first half of 2010. Stabilisation was underpinned by a recovery in exports, reflected in an improvement in industrial production, which has increased by more than 8 per cent in the first half of 2010, although domestic demand has remained weak. The total stock of credit to the private sector has been falling since its peak in November 2008 and by July 2010 it was down by almost 12 per cent since the high point.

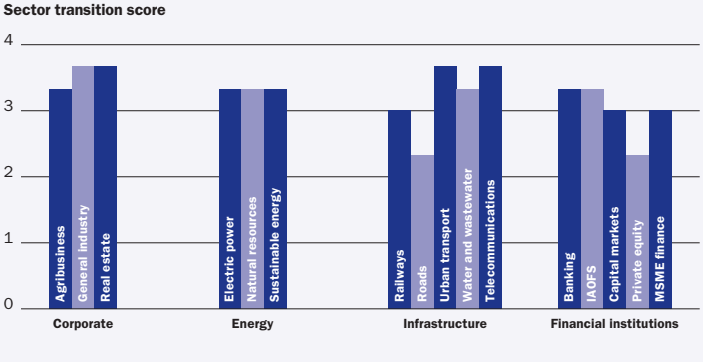
Over the course of the recession there has been a considerable deterioration in public finances, with public debt projected to reach nearly 40 per cent of GDP by the end of 2010 from 30 per cent at the end of 2009. The government deficit also increased from 3.3 per cent of GDP in 2008 to 8.9 per cent in 2009. In response, the authorities have cut expenditure and streamlined public administration. By March 2010, gross wages in the public sector had fallen by over 13 per cent from their peak in the last quarter of 2008 (similar to the overall reduction in labour costs in the economy), including salary cuts of between 20-30 per cent for senior government officials. Pension benefits have also been reduced, although a comprehensive reform of the social security system remains outstanding. The government declined financial assistance from the European Union (EU) and International Monetary Fund (IMF) and decided to meet its funding needs predominantly in the European bond markets (between August 2007 and August 2009 Lithuania placed six eurobond issues, totalling €1.4 billion and US$ 3.5 billion). Net foreign direct investment (FDI) flows have also stabilised after a sharp drop from their peak in the third quarter of 2008.

Overall the economy is likely to register only modest growth in 2010. A tight fiscal policy, continuing wage adjustments, high unemployment and the weak supply of credit will continue to depress domestic demand and pose key risks for the recovery. However, the economy should continue to benefit from improving trade prospects, though this is largely dependent on the speed of recovery in the EU.

Structural reform

Over the past three years the authorities have been preoccupied with tackling the fallout from the international financial crisis and restoring growth. The need to diversify the sources of energy supply and enhance energy security has emerged as

2010 sector transition indicators



Note: IAOFS – Insurance and other financial services

a major challenge following the closure of the communist era Ignalina nuclear power plant and the uncertainty over the reliability of gas supplies from Russia. The share of the private sector in the economy is already relatively high, though the state retains important stakes in a number of sectors including energy, transportation and postal services. The financial crisis has severely hit the financial sector but also motivated further improvements in its supervision, such as the ongoing efforts to develop better coordination between the supervisors of the Baltic and Nordic countries.

Recent developments

Private investors continue to list corruption and competition from the informal sector as key obstacles in the business environment, even though Lithuania's score in Transparency International's Corruption Perceptions Index improved from 4.6 in 2008 to 4.9 in 2009. Tax loopholes and a relatively low level of tax compliance continue to hinder administrative efficiency. Lithuania was ranked 26th globally in the World Bank *Doing Business 2010* survey, down one place compared with the previous year. This is one of the highest rankings among all the EBRD countries of operations, even though the scores for employing workers, starting a business and protecting investors are somewhat lower.

Lithuania, in common with many other countries that experienced a pre-crisis credit boom, has suffered from a severe contraction in credit over the course of the recession. By May 2010 the stock of credit to the private sector had fallen by almost 7 per cent compared with a year earlier. The share of non-performing loans in the banks' portfolios has also increased further, reaching over 19 per cent in March 2010 (the share of loans more than 60 days overdue). However, banks' capitalisation has improved significantly especially among the major Nordic banks which injected substantial amounts of additional capital, enabling them to maintain their exposures.

The quality of financial supervision has improved in recent years, following the progress in implementation of the Financial Stability Law and the signing of regional Memorandums of Understanding on the coordination of supervisory activities with Nordic and Baltic countries. The new agreement between Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden sets up a system for information sharing as well as burden sharing in a financial crisis.

The modernisation of a key power plant near Vilnius with a state-of-the-art combined cycle gas turbine (CCGT) unit is expected to be completed by 2012 and should increase overall generating capacity and improve efficiency. The opening of the electricity exchange in January 2010, based on the NordPool platform, was an important step towards regional integration of the Baltic and Nordic power markets. So far in 2010, between 40 to 60 per cent of the total amount of electricity consumed in Lithuania has been traded via the new exchange. Further power market integration will likely be achieved by completing the planned "NordBalt" electricity link between Lithuania and Sweden.

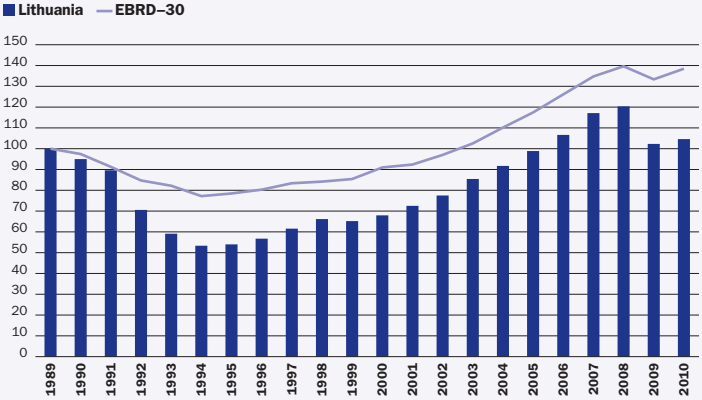
Although there are currently no plans to privatise the Klaipedos Nafta oil export terminal, the government announced in March 2010 that it will build a new rail line to the terminal and thus significantly improve logistics and the infrastructure for the important oil refining sector.

A first tender for the Rail Baltica project was launched by the state railway operator, Lietuvos Gelezinkeliai, in July 2010. The planned high-speed rail link co-financed by the EU, should connect Lithuania to both Finland and Poland and thus lead to deeper integration of national transport sectors within the Baltic region. In June 2010 Estonia, Finland, Latvia, Lithuania and Poland signed a Memorandum of Understanding specifying the distribution of responsibilities in carrying out the project.

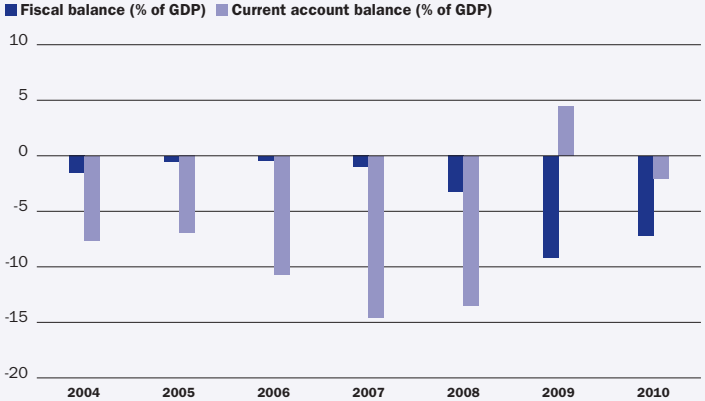
Structural reform priorities

- A key priority is to arrest the very rapid rise in public debt ratios to safeguard Lithuania's traditionally low risk premia. A comprehensive reform of the pension system and efficiency improvements in the education and health sectors could supplement other fiscal consolidation efforts. This would also support Lithuania's macroeconomic convergence process with the eurozone and eventual adoption of the single currency.
- The authorities will need to put in place reforms that secure sustainable growth without having any scope to implement additional fiscal stimulus measures. These reforms should include improvements in the business environment to attract more strategic investors, to encourage research and development activities and to upgrade the technological content of exports.
- In addition, the authorities will need to develop projects in the sustainable energy sector. Policies to assist in developing sources of funding outside the banking sector, such as the venture capital industry, focused on technology intensive enterprises, could contribute to this aim.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Moldova

Key developments and challenges

The financial crisis highlighted Moldova's economic dependence on consumption partly financed by remittances. The challenge for the authorities is to encourage greater export orientation through reforms to improve the institutional environment, including reducing corruption and the arbitrary interference of the state in the economy, and through measures to increase investment in infrastructure.

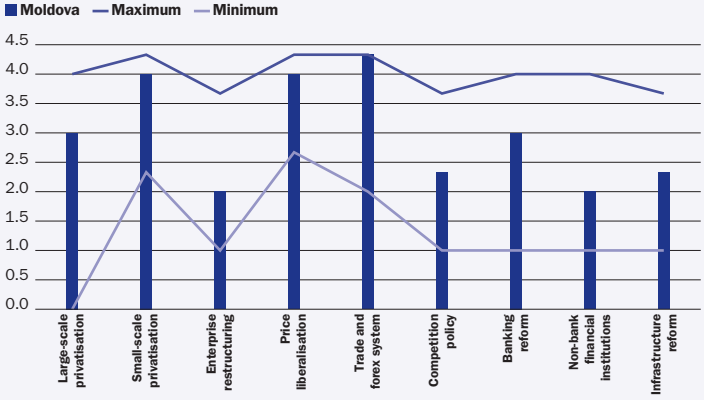
The regulatory framework for the financial sector should be further improved. Measures are needed to strengthen banks' governance as well as to prevent the build-up of macroeconomic vulnerabilities, including from foreign currency lending to un-hedged borrowers.

Fiscal policies should be put onto a sustainable path, while protecting necessary social and capital expenditures. A consolidation of the public education sector, civil service reform and a greater share of domestic funding in raising public debt could all contribute to this aim.

Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	3.0	7.8	-6.5	4.5
Inflation (end year)	13.1	7.2	0.4	8.1
Government balance/GDP	-0.2	-1.0	-6.4	-5.4
Current account balance/GDP	-15.3	-16.3	-8.1	-11.0
Net FDI (in million US$)	522	691	114	200
External debt/GDP	62.7	55.9	68.0	na
Gross reserves/GDP	30.3	27.6	27.4	na
Credit to private sector/GDP	36.9	36.5	36.2	na

Transition indicators 2010



Macroeconomic performance

The crisis affected the Moldovan economy primarily via a sharp contraction of external inflows (including remittances and foreign direct investment [FDI]) as well as a slow-down in bank credit. In 2009 real GDP fell by 6.5 per cent, reflecting a decline of 8.0 per cent in private consumption and a fall in private investment of almost one-third. The budget came under substantial strain as revenues declined while expenditures increased after the larger wage and pension increases implemented before the 2009 elections. The financial sector experienced major stress as liquidity dried up and one bank failed as its governance problems became apparent.

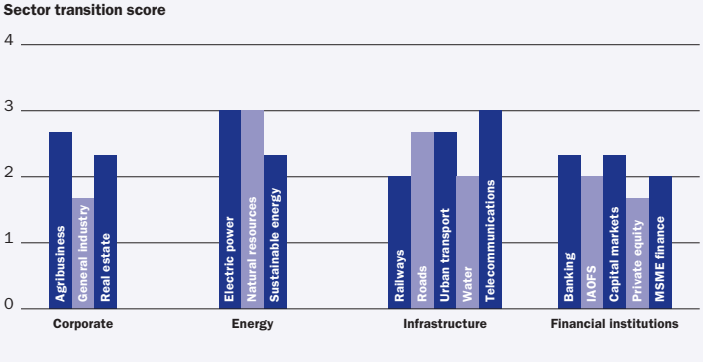
The macroeconomic situation has improved more recently as the external environment brightened, supported by an improvement in competitiveness after the exchange rate depreciated at the end of 2009. Industrial output and trade turnover recovered as export demand increased, enterprises built up inventories and household consumption was supported by higher remittances. Credit to the private sector, however, picked up only recently. The key elements of the authorities' stabilisation programme have been supported since February 2010 by International Monetary Fund (IMF) medium-term financial facilities. The main elements include fiscal adjustment while safeguarding public investment and targeted social support, the transition to a flexible exchange regime and inflation targeting, and policies to ensure financial stability and structural reforms to raise the economy's potential. In March 2010 the authorities secured some €1.9 billion in financing pledges from multilateral and bilateral donors.

The recovery is expected to continue in 2010-11, driven by external demand as recovery occurs among Moldova's main trading partners in both the European Union and the Commonwealth of Independent States (CIS). Funding from the IMF and official donors will boost public finances and provide an external anchor. Growth in 2010 is expected to reach 4.5 per cent and continue at a similar rate in 2011, provided political stability is maintained through the forthcoming parliamentary elections. The main risks to the outlook stem from external factors, including the high volatility of remittances and uncertainty over export demand, partly due to trade restrictions on Moldovan agricultural exports implemented in Russia.

Structural reform

Despite recent progress Moldova continues to face significant transition challenges, especially with respect to the need to strengthen governance. The regulatory institutions fall well

2010 sector transition indicators



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

below the standards of most developed countries. The judiciary is viewed as an obstacle by most businesses, and the degree of corruption is high. Many large enterprises, including the main landline telecom provider and the national airline, remain in public ownership and are inefficiently run. Despite some improvements in banking supervision both before and in response to the crisis, the banking sector continues to suffer from non-transparent ownership structures and inadequate corporate governance. Access to finance by small and medium-sized enterprises (SMEs) is limited, and the non-bank financial sector is in a nascent state. The transport infrastructure and municipal services also require comprehensive modernisation.

Recent developments

The privatisation programme for 2010 mainly involves conducting an inventory of public assets, divesting a few small enterprises and some real estate. Several large companies, including Moldtelecom, Air Moldova, and the national railway company, remain under state ownership and there are no definitive plans at present to put these companies up for tender. Although these companies generate significant public revenues and provide employment, the lack of multiple operators and private sector involvement hinders competition and efficiency.

A number of obstacles to both trade and business licensing procedures were eliminated in 2009. They included the removal of restrictions on the export of wine, grapes and grain as well as a simplification of customs controls as the mandatory certification of every shipment of imports was abolished. The licensing requirements for business registration were further simplified, with the abolition of licensing requirements for several activities and the elimination of overlapping regulatory requirements of different state authorities. In addition all proposals for regulatory changes in the economic sphere are now required to undergo a consultation process involving the various stakeholders.

The authorities have continued to make progress in stabilising the energy and municipal utility sectors. Electricity and gas tariffs were increased in January 2010 to reflect higher import costs. Administrative interference in the tariff-setting process has been reduced, starting in 2010 when the National Agency for Energy Regulation (ANRE) assumed the responsibility for setting tariffs at all stages, including production, transportation and distribution of electricity, gas and district heating. The tariffs for district heating in the capital, Chisinau, are now set at cost recovery levels.

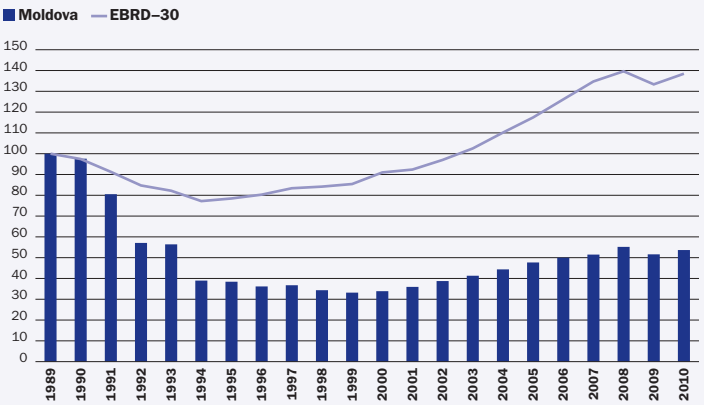
Important steps towards improving the financial sustainability of the utility sector were also undertaken in the past year, as local utility tariffs for water, urban transport and district heating were increased in several municipalities, including Chisinau.

After stabilising the financial system, the central bank has mandated the recapitalisation of banks based on stress tests of their balance sheets and has also increased minimum statutory capital requirements. A Financial Stability Committee was established to strengthen coordination among all relevant public agencies in a crisis. Three banks are now majority foreign owned by strategic investors, although their market share is still relatively small at around 20 per cent of total banking sector assets. However, the ownership structure of some locally owned banks remains non-transparent, and information is insufficient to assess owners' compliance with fit-and-proper review criteria. The development of local capital markets receives little policy attention in the context of significant concessional public inflows and pressures are high to further liberalise foreign currency lending, including to un-hedged borrowers.

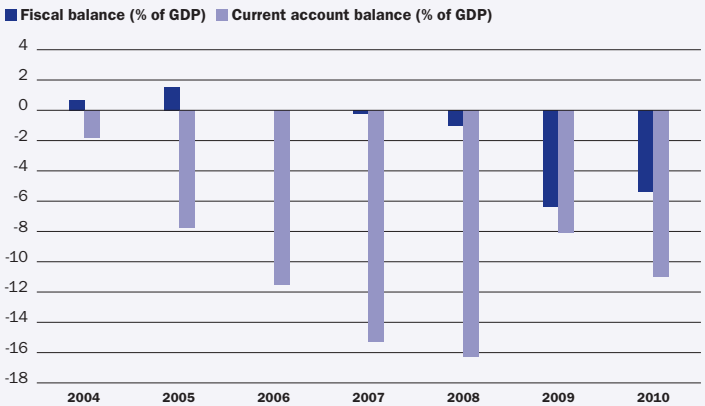
Structural reform priorities

- There is a major need to upgrade the internal transportation and communications infrastructure to offset the high cross-border transaction costs. The authorities should proceed with privatising the telecommunications and transport entities, strengthen competition and engage in private-public partnerships (PPPs) to improve the road infrastructure.
- The governance of locally owned banks should be strengthened before the banking system is allowed to expand further. It remains important to identify all the main beneficiary owners and ensure that the fit-and-proper criteria are met. Reliable channels of communication with the home country supervisors of foreign-owned banks should be established. Financial sector policies should focus on prudential measures to mitigate the macroeconomic impact of dollarisation.
- In view of Moldova's extremely high dependence on energy imports, more investment is required in the energy sector to integrate Moldova into the EU energy market and reduce technical losses, combined with regulations and tax policies to increase energy efficiency of end users.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Mongolia

Key developments and challenges

The recently adopted banking law is an important step in strengthening regulation, but further reforms to create an efficient, adequately capitalised and well-regulated banking sector are needed to help the economy move towards sustainable growth.

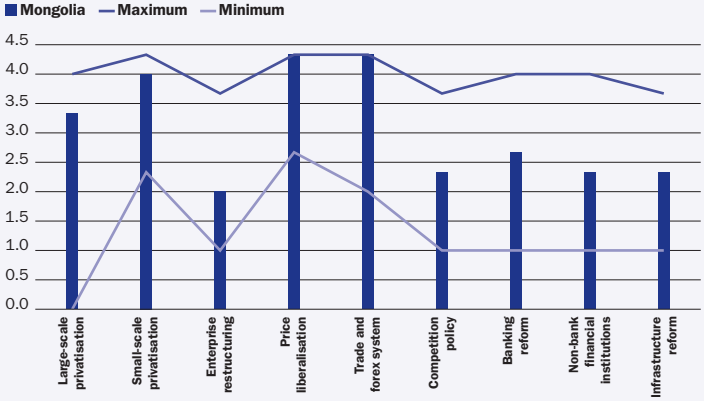
The size and scope of investments envisaged in the mining sector will necessitate additional investment in the country's infrastructure. This, in turn, calls for the effective design and implementation of concessions and public-private partnerships (PPPs) in various infrastructure sectors, building on the recently adopted legislative and policy frameworks.

The macroeconomic framework for managing expected revenues from increased commodity exports needs to be developed further, based on the recently passed Fiscal Responsibility Law. In particular it is necessary to ensure that the benefits of economic growth are shared broadly and that inflationary pressures are avoided.

Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	10.2	8.9	-1.6	7.0
Inflation (end year)	17.8	22.1	4.1	9.0
Government balance/GDP	2.9	-4.9	-5.4	-6.9
Current account balance/GDP	4.4	-14.4	-7.2	-8.2
Net FDI (in million US$)	360	586	527	791
External debt/GDP	43.3	31.9	49.8	na
Gross reserves/GDP	20.4	11.2	30.7	na
Credit to private sector/GDP	42.9	43.5	43.9	na

Transition indicators 2010



Macroeconomic performance

Economic growth turned negative in 2009 (GDP fell by 1.6 per cent) as a consequence of a drop in commodity prices and an exceptionally cold winter, which caused the loss of over 2 million livestock. However, results for the first half of 2010 attest to a strong economic recovery with GDP growth of 5.0 per cent year-on-year supported by a rebound in the prices of copper and other commodities and an expansionary fiscal policy. The combination of strong fiscal expansion, liquidity injections by the Bank of Mongolia (BoM) and a sharply reduced domestic supply of meat following the exceptionally cold winter have led to a renewed rise in inflation, which approached 12 per cent year-on-year by May 2010. To contain inflationary pressures the BoM increased the policy rate in May 2010 by 1 percentage point to 11 per cent.

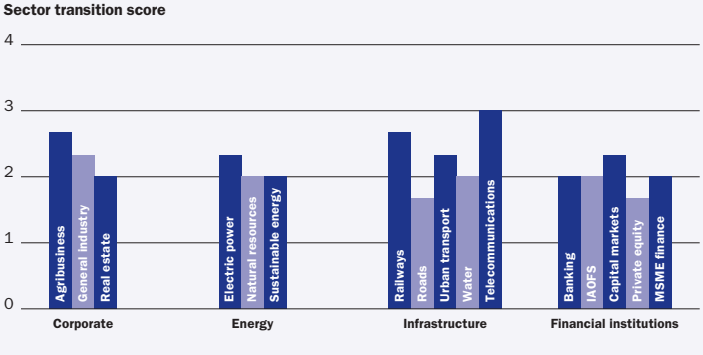
With a rising fiscal deficit (4.9 per cent of GDP in 2008 and 5.4 per cent in 2009) and strong political pressure to spend additional commodity-related revenues, the Fiscal Stability Law was passed in June 2010 with the aim of improving fiscal discipline. The law introduces a cap on public external debt, an effective ceiling on annual expenditure growth, a transparent formula for copper price projections (one of the key fiscal parameters), and strengthens the role of medium-term budgeting. It also provides for the establishment of a stabilisation fund, into which excess commodity-related revenues could be paid during the periods of high commodity prices. Such a stabilisation fund would be complementary to the existing Human Development Fund which is currently used as a vehicle for distributing cash transfers to the population.

Output growth is expected to reach 7 per cent in 2010 and to remain high in the medium term supported by a sustained rebound in commodity prices and major investments in the mining sector. However, the key risk is that commodity prices will be lower than expected.

Structural reform

Mongolia is relatively far advanced in terms of promoting private ownership, and market distortions are fairly limited, although further efforts are needed to address shortcomings in standards of corporate governance and business conduct and to reduce carbon intensity of the economy. Progress has been made in attracting investment for the mining sector, which is likely to remain the driver of economic development in the near future. In this sector, issues surrounding the share of state ownership, the rules governing the allocation of risks and rewards between the state and private investors, ways of project financing and the tax

2010 sector transition indicators



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

regime have all been subject to change and uncertainty. Despite some recent progress in this area, further reforms are needed to create a more stable business environment for investors.

Recent developments

In October 2009 the government completed a long-awaited US$ 4 billion investment agreement for the Oyu Tolgoi copper-gold mine with Canada-based miner, Ivanhoe Mines, backed by Anglo-Australian mining giant, Rio Tinto. The government is also currently preparing an institutional framework for the development of a major coal deposit of Tavan Tolgoi. The government is expected to retain majority control of the mine while initial public offerings (IPOs) on the local and international exchanges are currently being considered with the possibility of distributing a portion of the shares to the population.

The controversial Windfall Profit Tax on mining profits will be abolished from January 2011 to improve the attractiveness of mining projects to foreign investors. At the same time the government is preparing amendments to the mining law aimed at tightening the regime for exploration licenses. The issuance of exploration licenses has been suspended since May 2010 pending amendments.

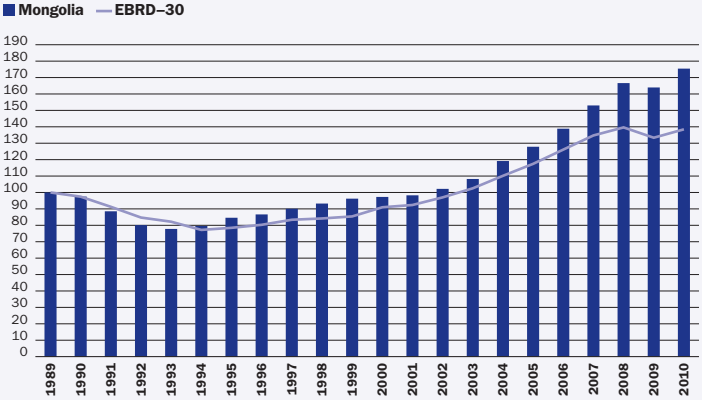
The authorities have adopted a number of laws to meet growing investment and infrastructure needs in connection with the forthcoming expansion in mining activity. These include the State Policy on PPPs which was adopted in October 2009, the Law on Concessions (January 2010) and a Railway Policy (July 2010). A PPP unit was subsequently created under the State Property Committee and by May 2010 it had prepared a list of 29 potential PPP projects, although their feasibility has yet to be verified. The railway policy foresees the construction of a 1,100 km broad-gauge rail link across Mongolia from Tavan Tolgoi mines through Saishand with a connection to the Baikal-Vladivostok line in Russia. The policy also provides for private concessions to build and operate narrow-gauge railways from major mining sites in South Gobi to China, but the modalities of such concessions have yet to be clarified.

The recession exposed significant problems in the banking sector. Following the near-failure and conservatorship of Anod Bank in December 2008, another major bank, Zoos, was put under central bank administration in November 2009. Although the non-performing loans ratio has largely stabilised, albeit at an elevated level of around 15 per cent as of August 2010 (inclusive of banks in receivership), weaknesses in the banking system remain a concern, and a number of banks need to strengthen their capitalisation. The new banking law, which came into force in March 2010, strengthens regulation and supervision by clarifying the definition of related party lending, introducing stricter single obligor limits and provides for more thorough oversight of changes in bank ownership. It also clarifies the enforcement powers of the BoM linked to prudential regulation and incorporates provisions on consolidated supervision and audits.

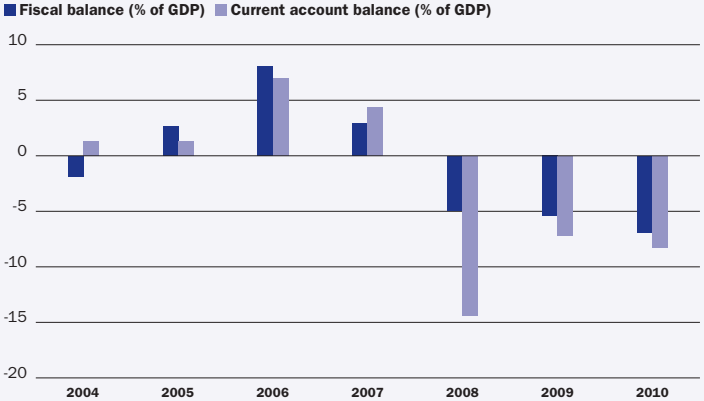
Structural reform priorities

- The envisaged expansion of mining projects will increase the pressure on basic infrastructure, necessitating the strengthening of market frameworks. This includes the restructuring of power sector companies, debt restructuring, improving environmental practices, strengthening the independence of the regulator and promoting the gradual introduction of market liberalisation. Tariff methodologies will need to be revised to reflect environmental costs, attract investment into ageing and inefficient assets and to provide strong incentives to use energy efficiently.
- It is important that rapid progress is made with the draft legislation on a deposit insurance scheme so that it can be introduced to replace the blanket deposit guarantee introduced in 2008 and extended in 2009.
- The cold winter of 2009-10 underscored the importance of further development of cattle, crops and other forms of insurance.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Montenegro

Key developments and challenges

Montenegro's infrastructure is gradually improving, but further development is needed to support the expanding tourism industry. A greater private sector involvement in roads and municipal services could help to accelerate this process.

Further steps were made in the government's privatisation programme, notably through the sale of a minority stake in EPCG, the state-owned power utility. The challenge now is to complete restructuring in this sector in order to bring about much-needed improvements in electricity supply and efficiency.

The collapse in output last year has highlighted the fragility of the banking system and the vulnerability of the economy to weaknesses in a few key sectors. Achieving sustainable growth will require a more diversified economy, the resumption of credit growth and greater emphasis on improving standards of governance and removing barriers to doing business.

Macroeconomic performance

Montenegro's economy was severely affected by the global financial and economic crisis. Real GDP fell in 2009 by 5.7 per cent, with industrial production contracting by about 32 per cent, following the sharp fall in mining and manufacturing activities. Growth in the construction and tourism sectors is also estimated to have slowed significantly. Furthermore, inflationary pressures eased, with inflation slowing down to 1.5 per cent year-on-year in December 2009. After a further decline during the first quarter of 2010, industrial production started to recover in the second quarter, growing by 22.0 per cent year-on-year in this quarter, strongly reflecting the low base effect.

Foreign direct investment (FDI) remained strong in 2009, increasing by 31 per cent in 2009 and 40 per cent in the first quarter of 2010. The upsurge in 2009 mostly reflected the successful partial privatisation of the power sector while the 2010 figure is due largely to commercial bank recapitalisations. Meanwhile, after years of fiscal surpluses fuelled by the booming economy, the overall government budget recorded a deficit of 3.6 per cent of GDP in 2009. As a result of higher borrowing needs, public debt significantly increased to 38.9 per cent of GDP in 2009 from 29 per cent in 2008.

The economy is expected to recover slowly, with real GDP growth remaining slightly negative at -0.6 per cent in 2010. Domestic demand will remain weak owing to the limited availability of credit from the banks to the private sector. Furthermore, only a moderate pick-up in external demand is expected as a result of the sluggish pace of recovery in the eurozone. Economic performance is expected to improve in 2011, reflecting higher consumption and investment and supported by sustained FDI inflows and resumed credit to the private sector, but key risks include the growing level of external debt, the high level of non-performing loans and exposure to global metals prices.

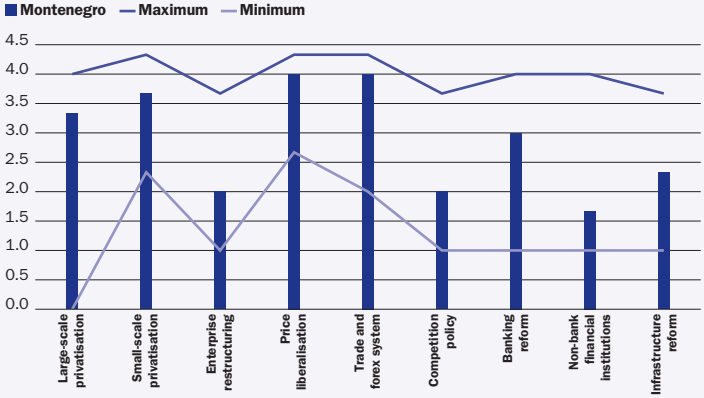
Structural reform

The Montenegrin authorities have made important advances in several areas, notably in price and trade liberalisation and financial sector development. Privatisation is advanced, with most state assets having been sold off. The banking sector had grown very rapidly in the years before the crisis and progress has been made in strengthening supervisory and regulatory structures. Lastly, Montenegro has had some success in creating a favourable business climate and in

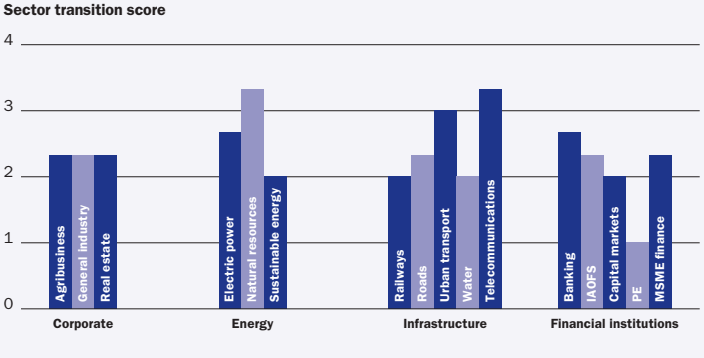
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	10.7	7.5	-5.7	-0.6
Inflation (end year)	7.7	6.9	1.5	2.0
Government balance/GDP	6.3	-0.4	-3.6	-7.1
Current account balance/GDP	-29.4	-50.7	-30.1	-17.0
Net FDI (in million US$)	717	806	1264	408
External debt/GDP	75.8	95.6	96.9	na
Gross reserves/GDP	17.9	9.6	13.8	na
Credit to private sector/GDP	77.8	88.5	77.7	na

Transition indicators 2010



2010 sector transition indicators



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

attracting reputable foreign investors. Nevertheless, the country still has a significant transition agenda ahead. The challenges are particularly large in the infrastructure sector, notably in the power sector, which is crucial to supporting economic activity.

Recent developments

Montenegro formally applied for European Union (EU) membership in December 2008. In April 2009, the EU Council invited the European Commission (EC) to submit its opinion regarding this application, which is currently being prepared. According to the European Commission's latest annual progress report on Montenegro and the conclusions of the European Council of December 2009, Montenegro has made progress in many areas. However, the country needs to strengthen its administrative capacity, to ensure the rule of law and judiciary independence and to show sustainable results in the fight against corruption and organised crime.

Montenegro's planned accession to the World Trade Organization (WTO), expected in February 2010, has been delayed. A new round of bilateral talks with Ukraine, which started in July 2010, is expected to lead to Montenegro's membership.

Progress in large-scale privatisation has been mixed. The tender for the sale of a 54 per cent stake and a 30-year concession in the port operator, Marina Bar, was concluded successfully in early 2010. A tender for acquiring a long-term concession on the Bijela port infrastructure and the area surrounding the Bijela shipyard was launched in June 2010. The government has also issued a tender for the privatisation of the Railways Cargo Company (MonteCargo). However, the tender for the sale of the majority stake in the port operator, Kontejnerski Terminal, failed. Furthermore, the partial re-nationalisation of the aluminium conglomerate KAP became effective in November 2009 with the state acquiring a 29 per cent stake in the plant and a 31 per cent stake in the related Niksic Bauxite mine in exchange for a guarantee worth €135 million.

In September 2009 the Government transferred an 18.3 per cent stake in EPCG, the state-owned vertically integrated power utility, to Italy's AZA. The Government also signed a €720 million agreement for the construction of an undersea power transmission line with Italy. The project, which is expected to make Montenegro an important node in the regional power market, will be implemented jointly by the Italian company Terna and the recently unbundled Montenegrin transmission system operator, Prenos.

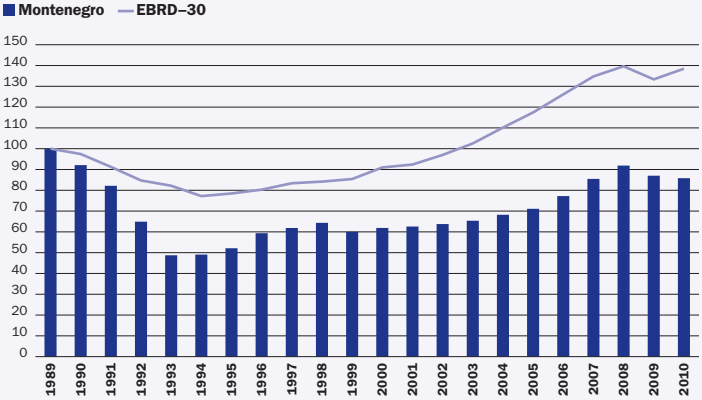
The concession agreement to construct the Bar-Boljare motorway, signed in 2009, has not yet closed and construction has been severely delayed, mainly attributed to the failure of the first-ranked bidder to provide all the required documents and the length of the negotiations.

The Montenegrin banking sector was severely hit by the global financial crisis, with the result that bank credit to the economy contracted by 14.3 per cent year-on-year in 2009. The authorities implemented several measures to prevent a liquidity crisis and stabilise the banking system, including a law authorising the government to provide direct support to banks in the form of credit lines and re-capitalisation. The government provided such support in two cases: a loan of €44 million for the financially troubled Prva Banka, and a guarantee of €150 million to cover KfW and European Investment Bank (EIB) loans to Montenegrin banks to finance small and medium-sized enterprises (SMEs). A package of laws in the financial sector was approved in July 2010, including a new law on the central bank and a new deposit protection law.

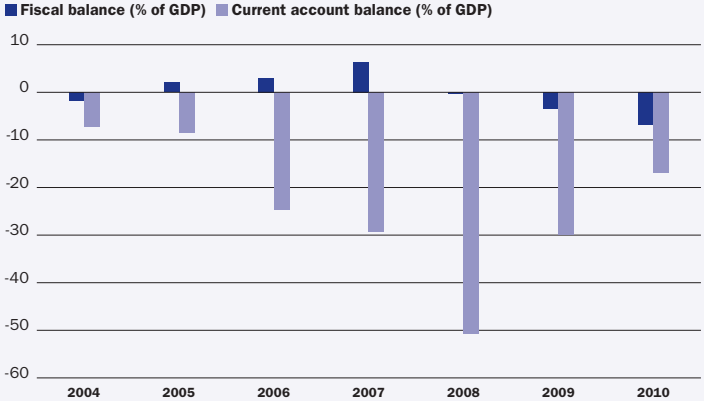
Structural reform priorities

- Improving the quality of infrastructure is vital for supporting economic activity, especially the further development of the tourism sector. Facilitating the involvement of the private sector through concessions could help to speed up the process.
- Moving ahead with the restructuring of the power sector is a priority to improve electricity supply and efficiency. The government has adopted an ambitious Energy Development Strategy, but concrete programmes and implementation instruments to promote renewable energy and energy efficiency have yet to be established.
- Strengthening the financial system in the post-crisis environment and maintaining adequate access to financing for the private sector, especially SMEs, will be vital to supporting the recovery of the economy. The state's involvement should be designed to ensure a level playing field and transparent regulation, rather than focused on continued support for selected troubled banks.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Poland

Key developments and challenges

Further progress has been made with the privatisation programme, though reducing state involvement in the economy remains an important challenge, especially in the energy and natural resources sectors.

An inefficient power sector continues to hold back growth and also means that European Union (EU) environmental standards are unlikely to be met. Additional investment is necessary to proceed with the restructuring and full privatisation of the larger power groups.

While Poland's stock market is among the largest in the region, liquidity is low and the private bond market remains in its infancy. A new trading platform represents important progress, but a further easing of constraints on issuance and investment by institutional investors is necessary to promote the development of financial markets.

Macroeconomic performance

Growth in Poland remains resilient and well balanced. Real GDP grew by 1.7 per cent in 2009, so that Poland was the only country in the Central Europe and the Baltic States (CEB) region to avoid recession. In the first half of 2010 the rate of economic growth continued to exceed the regional average. Poland's exports have benefited from the strong recovery in industrial production in Germany, to which a quarter of exports are directed. Growth in private consumption has remained relatively robust, as has been the case throughout the financial crisis.

The government's decision to let the fiscal balance adjust in line with weaker growth provided crucial support throughout the crisis. However, as a result the general government deficit widened to 7.1 per cent of GDP in 2009, and has remained at a similar ratio in 2010. Public sector debt has hence risen rapidly, to about 50 per cent of GDP at end-2009 (according to the national statistical definition). Under national law stringent corrective action will need to be taken once the debt ratio exceeds 55 per cent, and the Constitution imposes a limit of 60 per cent. The banking system registered strong outflows in late 2008 and early 2009, but this trend appears to have reversed since. Nevertheless, both the demand for and the supply of new loans have declined and credit to the corporate sector continues to contract, falling by 4 per cent in annual terms. Non-performing loans had increased to 8.6 per cent of total loans by August 2010.

The economy is expected to grow by about 3.3 per cent in 2010, making Poland among the best performers once again in the CEB region. However, the risks from a mounting public debt burden and from any adverse developments in the eurozone are increasingly apparent.

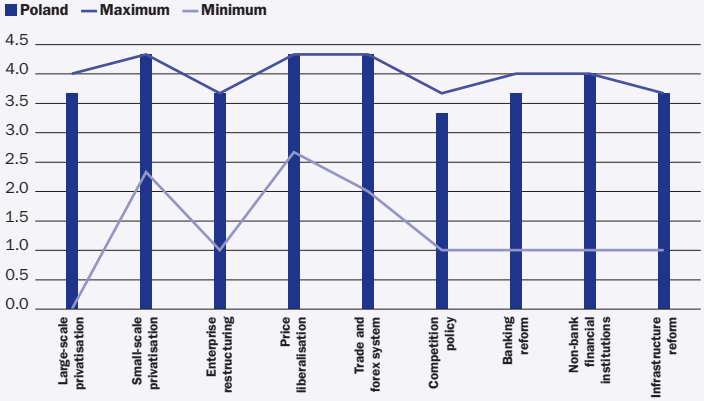
Structural reform

Poland has made significant progress in the transition to a modern market economy. The structural reforms initiated in the 1990s have been successful and their implementation far-reaching. The reform agenda in recent years focused on the adoption of the EU *acquis communautaire* and entry to the European Union in May 2004. However, there is still room for improvement in the areas of large-scale privatisation, competition policy, banking, non-bank financial institutions and infrastructure reform. Implementation of key reforms has been slower than expected in recent years, in particular with regard to the privatisation agenda.

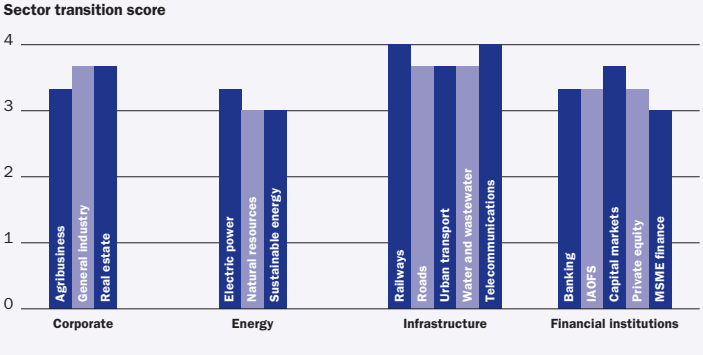
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	6.8	5.1	1.7	3.3
Inflation (end year)	4.0	3.3	3.6	2.5
Government balance/GDP	-1.9	-3.7	-7.2	-7.5
Current account balance/GDP	-4.8	-5.1	-1.7	-2.2
Net FDI (in million US$)	17987	11747	8622	11000
External debt/GDP	55.1	46.1	65.1	na
Gross reserves/GDP	14.8	11.2	17.7	na
Credit to private sector/GDP	36.2	46.3	46.7	na

Transition indicators 2010



2010 sector transition indicators



Note: IAOFS – Insurance and other financial services

Recent developments

Despite efforts to improve the business environment, Poland's ranking on the World Bank's "ease of doing business" rating remains low according to the *Doing Business 2010* survey. In this report, Poland was ranked 72nd out of 183 countries, the lowest ranking among the new European Union member states. The main problem areas according to the survey are in dealing with construction permits, starting a business and paying taxes.

Poland is one of the European Union economies where the involvement of the state is most pervasive, notably in the power, natural resources and banking sectors. A new law on public-private-partnerships was recently passed, though private financing in infrastructure remains minimal. The government's privatisation programme for the years 2008-11 provided an opportunity to attract fresh investment and stem the rise in public debt ratios. The programme made important progress when capital market conditions improved markedly in 2010, although the programme has also benefited from streamlined procedures and greater transparency. Privatisation revenues in the first half of 2010 exceeded half the target set for the year, with 111 stakes successfully sold. However, important companies such as the Warsaw Stock Exchange still await the sale of majority ownership stakes.

Having reversed unbundling through the consolidation of four major regional state-owned energy groups in 2006, the government began a privatisation process in 2008 and in August 2009 announced that two companies, ENEA and Energa, would be fully privatised, with ENEA in advanced negotiations with a number of strategic investors. The recent government decision to sell Energa to the largest state-owned group, PGE, may be detrimental to competition and investments in the sector. An initial public offering (IPO) of energy group PGE was successfully closed in November 2009, and a majority stake in Tauron was sold on the Warsaw Stock Exchange in June 2010. In November 2009, the government also adopted a long-term energy strategy up to the year 2030. This provides broad aims for the sector, such as reducing the energy intensity of growth, raising energy efficiency to the level of the EU-15 and diversifying the sources of energy supply.

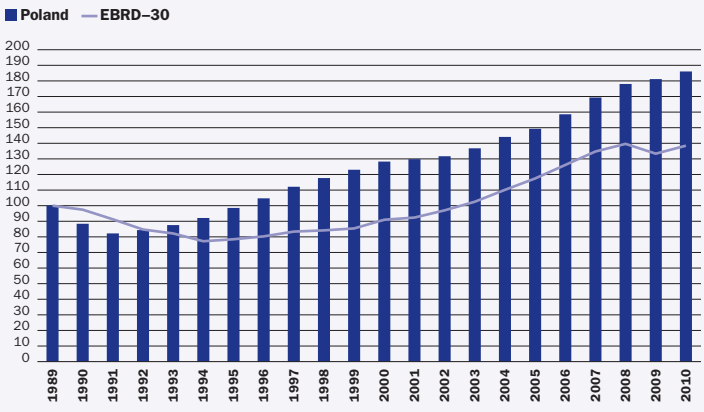
Following the shock to liquidity in foreign exchange swap markets in early 2009, the central bank entered swap arrangements with other European central banks, and on-lent this liquidity to domestic commercial banks. Since then market conditions have eased and banking regulators have again focused on the need to limit risks in newly generated credit. Recommendation T, introduced in February 2010, tightens credit assessment procedures, with a requirement that lenders undertake more rigorous credit checks and stress-test potential borrowers. This has contributed to a further decline in lending in foreign currency to only 32.6 per cent of new net credit generated in February 2010.

Capitalisation on the Warsaw Stock Exchange is substantial, with 343 companies listed by mid-2010 of which 23 were foreign. However, turnover remains limited. In this context the planned privatisation of the stock exchange and the moves to increase cooperation with other European exchanges could deepen the market and improve access to equity capital. In September 2009 an integrated system was launched at the Warsaw Exchange for the issuance and trading of corporate and municipal bonds. This represents important progress, although this market remains small with debt market capitalisation only about 30 per cent of GDP.

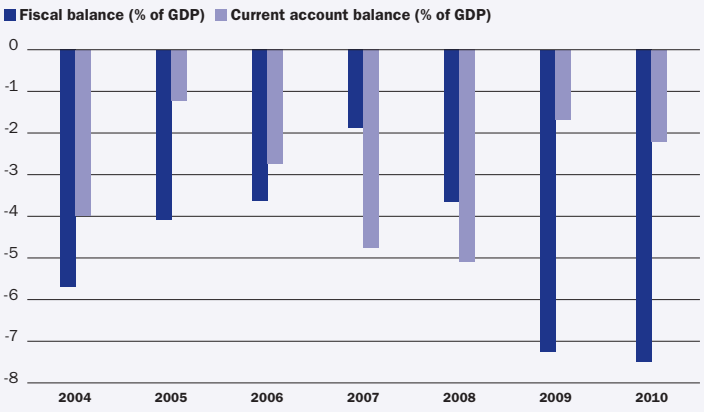
Structural reform priorities

- The key structural reform challenge is to adapt the economy to the less benign prospects for regional growth and financial markets and to address the fiscal challenges. Reducing the influence of the state is an overriding priority, for which perseverance with implementing the privatisation programme is essential.
- In the power sector the restructuring and privatisation of the four large power companies remain key challenges. The sector will require substantial investment in the coming years, to which foreign investors could make an important contribution.
- In the banking sector the main challenges are to overcome the constraints on providing credit to the important small and medium-sized enterprises (SMEs) sector as well as to develop capital market instruments that could help to bridge funding shortfalls for major infrastructure investments. In addition, measures are required to make more sustainable long-term local currency instruments available to the banking sector.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Romania

Key developments and challenges

The environment for doing business has proven to be very difficult during the crisis, highlighting the need to push ahead with labour market and fiscal reforms and the removal of excessive licensing procedures.

Infrastructure development is a major priority for the country but further delays have occurred over the past year. The authorities need to increase technical and administrative capacities in the public sector in order to boost the absorption of available EU funds and increase financial resources for infrastructure projects.

The International Monetary Fund (IMF) stand-by arrangement (SBA) includes a commitment by the government to implement a stringent fiscal consolidation programme, including significant reductions in current spending. Although these measures may depress domestic demand in the short term, they are necessary to create the conditions for a return to sustainable growth.

Macroeconomic performance

The Romanian economy is struggling to recover from the effects of the crisis after a fall in real GDP of more than 7.0 per cent in 2009. Private sector credit slowed dramatically throughout 2009 and has subsequently recorded negative year-on-year growth rates since January 2010. Industrial production contracted from December 2009 to February 2010 but recently published GDP figures indicate a tentative bottoming out in the second quarter of 2010 (0.3 per cent quarter-on-quarter growth seasonally adjusted). The exchange rate has been stable this year and official interest rates remain relatively low.

The government's crisis response programme is anchored by the SBA signed in March 2009. As a result of the deteriorated economic outlook, the IMF review mission in May 2010 agreed to raise the budget deficit target in 2010 to 6.8 per cent of GDP (on a cash basis). To achieve even this revised target, the government committed to a 25 per cent cut in public sector wages, a 15 per cent cut in most social benefits, as well as to a 5 percentage point increase in VAT in July. In March 2010, the parliament further approved the new law on fiscal responsibility, aimed at improving medium-term fiscal planning, and the establishment of a Fiscal Council is currently under way. The central bank cut its key policy rate by another 25 basis points in May 2010 to 6.25 per cent and kept it at that rate as of August, in spite of rising inflationary pressure stemming from the VAT hike.

Real GDP is likely to decline in 2010 by about 2 per cent. Domestic demand is expected to recover only slowly while public sector wages contract and external demand is likely to remain weak, in line with the slow recovery in the eurozone. Credit growth to the private sector is expected to be limited in the short term. The main risk is that the political will to implement fiscal consolidation falters, especially if the recovery expected in 2011 is slower than anticipated.

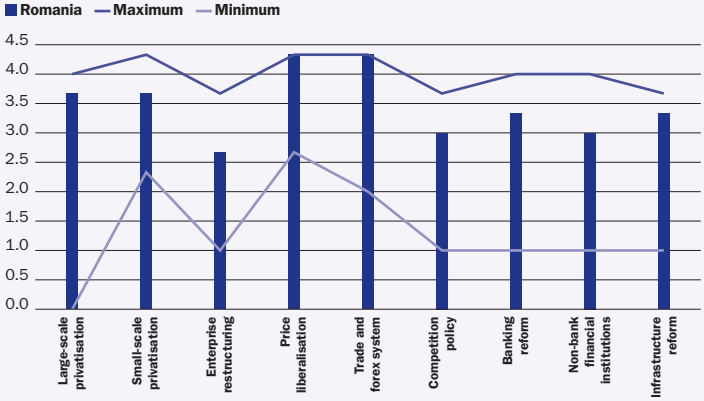
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	6.3	7.3	-7.1	-2.0
Inflation (end year)	6.7	6.4	4.7	7.9
Government balance/GDP	-2.5	-5.4	-7.4	-6.8
Current account balance/GDP	-9.8	-11.9	-4.5	-5.1
Net FDI (in million US$)	7049	9310	6128	4674
External debt/GDP	34.4	35.9	48.8	na
Gross reserves/GDP	14.9	13.0	14.3	na
Credit to private sector/GDP	34.7	37.6	40.0	na

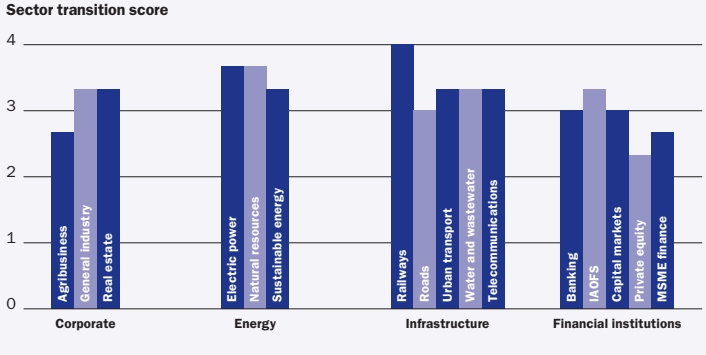
Structural reform

As an EU member since 2007 Romania faces transition challenges that are mostly classified as small or medium in most sectors. Some of the biggest challenges lie in the infrastructure and energy sectors. The quality of the road network is well below typical EU standards, and although concession legislation is in place, no public-private partnership project has yet been effectively implemented. In the energy sector state-owned enterprises still dominate electricity generation and competition is limited. The banking sector survived the negative fallout from the financial

Transition indicators 2010



2010 sector transition indicators



Note: IAOFS – Insurance and other financial services

crisis and is reasonably well capitalised. However, financing for small and medium-sized enterprises (SMEs) is limited outside of the main urban areas and capital markets are underdeveloped.

Recent developments

According to the European Commission (EC) the country needs to strengthen substantially its technical and administrative capacities in order to effectively absorb EU structural and regional funds. It has noted that Romania's absorption of these funds for the period 2007-13 is of a low level even though it is now halfway through the funding period. The IMF has also raised concerns about Romania's poor absorption capacity of funds that could be used to alleviate the impact of the global downturn on the economy.

Romania has made progress in law enforcement, reforming the judiciary and in the fight against corruption, but significant shortcomings remain according to the latest EC assessment on progress under the Cooperation and Verification Mechanism, published in July 2010. The report notes that the reform momentum has decelerated and the authorities lack a clear commitment to a comprehensive reform programme. In particular, the report criticises recent amendments to the law on the National Integrity Agency (ANI), a pre-condition for accession in 2007, on the grounds that they reduce the transparency of financial and economic interests of public officials.

Although the government has made the upgrade of the country's road network a priority, progress has been limited and there have been delays in the completion of some important projects. For example, the construction of a second bridge over the Danube between Bulgaria and Romania has been delayed and is now not expected to be completed before the end of 2011, while the concession for the Comarnic-Brasov highway was annulled in April 2010.

The development of a new nuclear power generator is at the core of Romania's energy strategy. Expansion of the nuclear power plant at Cernavoda is scheduled for 2011, and is intended to double nuclear power's share of total energy consumption to 36 per cent by 2016-17. The renewed plans by the government to combine all state-owned electricity utilities into two "national champions", Hidroenergetica and Electra, have been delayed. The proposal is currently being reviewed by the antitrust body, reflecting concerns by many over the possible negative effects on competition if the plans go ahead. The government has indicated that it envisages gradually reducing subsidies for the coal mining sector at the end of 2010 and developing an exit strategy.

The banking system has successfully weathered the worst effects of the economic crisis. In September 2010, the level of exposure of subsidiaries of foreign-owned parent banks have committed to under the "Vienna Initiative" was eased to 95 per cent compared with end-March 2009 levels. The initiative has proven successful in Romania; parent banks provided additional capital to banks throughout 2009-10 and the capital adequacy ratio of all subsidiaries has remained above 10 per cent.

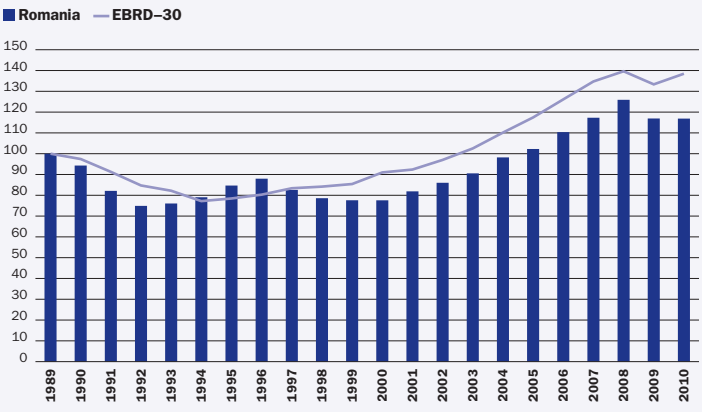
In June 2010 the government approved a bill proposed by the antitrust and consumer protection body, ANPC, to eliminate fees currently applying to early repayment or termination of bank loans with interest rates linked to money market indicators. The new law should increase competition in the Romanian banking sector and brings the legislation into line with EU law.

The pension system is also undergoing reform. A pension reform law, approved by parliament in September 2010, introduces a uniform pension scheme for civil servants, gradually harmonises the retirement age for men and women, and links benefits to inflation rather than increases in salaries. However, the law was returned to parliament by the President in early October.

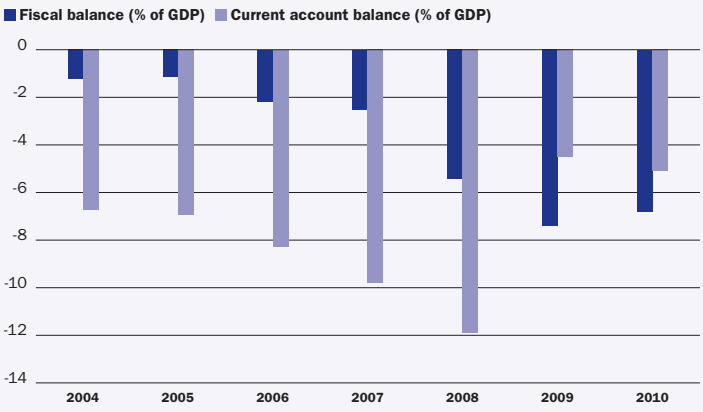
Structural reform priorities

- The key overall reform priority in the coming years is to make further improvements to the investment climate to create the conditions for a resumption of sustainable growth. Therefore, heightened efforts are needed to remove red tape and licensing problems, which are cited as constraints by enterprises in business climate surveys.
- In the energy sector, further clarity is needed regarding the government's long-term plans. A decision is needed soon regarding the government's intentions to create two nationally integrated power companies, and whether another solution more favourable for private investment will be adopted. Without such clarity, much-needed investment is unlikely to be available for the power sector.
- Domestic capital markets are also in need of further development, including those in local currency, which is an important consideration given that adoption of the euro is some years away.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Russia

Key developments and challenges

The authorities have placed increasing emphasis on the need to modernise industry and the service sectors and diversify the economy away from excessive dependence on oil and gas exports. Improvements in the business environment, further regional development, deregulation and investment-friendly policies will be needed to advance these objectives and reach a more sustainable growth path.

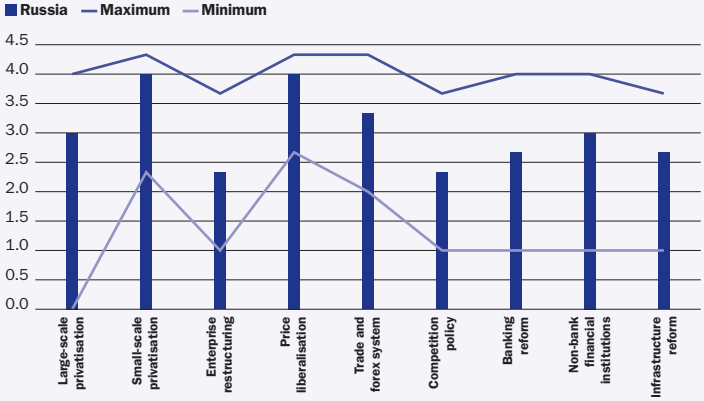
Important steps have been made to facilitate progress towards the stated objective of turning Moscow into an international financial centre. This goal could be further advanced by strengthening banking supervision, improving the legal and technical financial infrastructure and creating an enabling environment to attract institutional investors.

The recent growth of GDP has been supported by a large fiscal stimulus. The challenge now is to consolidate the fiscal position without jeopardising the economic recovery.

Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	8.5	5.2	-7.9	4.4
Inflation (end year)	11.9	13.3	8.8	8.0
Government balance/GDP	6.0	4.9	-6.2	-5.3
Current account balance/GDP	5.9	6.1	4.0	4.6
Net FDI (in million US$)	9158	20425	-7335	1143
External debt/GDP	36.2	28.8	38.3	na
Gross reserves/GDP	35.9	24.4	32.4	na
Credit to private sector/GDP	37.6	40.7	42.1	na

Transition indicators 2010



Macroeconomic performance

The Russian economy has returned to growth after output contracted 7.9 per cent in 2009, with GDP growth of 4.0 per cent recorded in the first half of 2010. Crisis management after the deep collapse last year has been broadly appropriate. The recovery has been supported by higher oil prices, the fiscal stimulus package carried over into 2010 and extended with further pension increases and ample liquidity in the banking system. The unemployment rate, which had been broadly stable at around 8.5 per cent in seasonally adjusted terms throughout 2009, edged downwards in the first half of 2010. Following the economic rebound the rouble has strengthened against the euro-dollar basket, but remains around 15 per cent below the pre-crisis peak. The Bank of Russia has gradually lowered the policy interest rate, from 13.00 per cent in December 2008 to 7.75 per cent in July 2010, as inflation pressures eased. The non-performing loans ratio appears to have stabilised, but private sector credit growth has remained subdued owing to the need for deleveraging in the banking system and concerns over borrowers' creditworthiness.

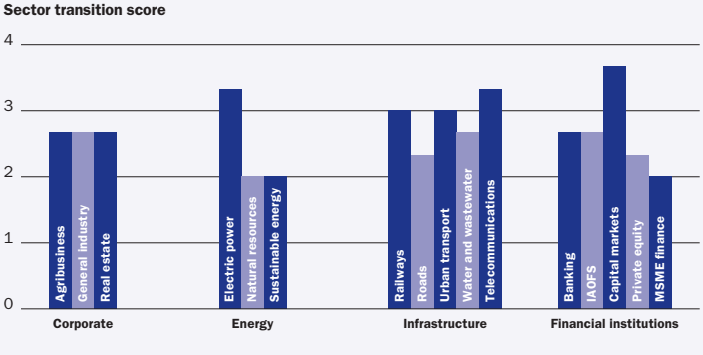
The 2009 and 2010 comprehensive fiscal stimulus package, backed up by fiscal reserves, centres on social transfers and includes support for selected industries and companies in one-company towns. In April 2010 Russia placed US$ 5.5 billion in eurobonds in 5- and 10-year tranches at favourable rates (a spread of 135 basis points over US Treasuries).

The moderate growth momentum of the first half of 2010 is likely to be sustained, implying a growth of about 4.4 per cent in 2010, strengthening slightly in 2011. The key risk remains the price of oil and other commodities. Policy-makers will face a challenge of balancing the need to sustain the still fragile economic recovery while also achieving fiscal consolidation over the medium term. This is especially important as the eventual depletion of the fiscal reserve fund (which had fallen to approximately US$ 125 billion by mid-2010 from US$ 225 billion in early 2009) could make the economy more volatile to swings in commodity prices.

Structural reform

Despite progress in recent years, significant challenges still remain for Russia to increase efficiency, promote more effective competition and follow best practice corporate governance and business standards, and the energy intensity of output remains relatively high. The state also continues to play a large – and in some areas growing – role in the economy, especially but not exclusively in strategic sectors and banking. Significant differences also persist across regions within Russia. Regulation and supervision have been strengthened in the banking sector

2010 sector transition indicators



Note: IAOFS – Insurance and other financial services

and higher minimum capital requirements for banks being phased in over 2010-12 may lead to some consolidation among smaller regional players.

Recent developments

The government has announced a revival of the privatisation programme, backed by a higher fiscal revenue target for 2010 at around US$ 2.5 billion, rising further over 2011-13. To facilitate implementation of the programme, the privatisation law was amended in mid-2010 to allow investment banks and other private consultants to be engaged in privatisations. The revenue target is expected to be achieved primarily through sales or initial public offerings (IPOs) of minority shares in state-controlled companies in various sectors including transport, power generation, pipelines, banking and insurance. Overall the list of entities earmarked for potential privatisation includes around 5,000 items, mostly stand-alone minor assets in the regions. The extent of investor interest and full modalities of the programme are yet to be clarified.

In November 2009 Belarus, Kazakhstan and Russia signed documents establishing a Customs Union. From July 2010 a common Customs Code came into force, which incorporates a standard external tariff structure. Harmonised tariffs are now set by the Customs Union Commission, although a number of sensitive items (such as passenger cars) are covered by temporary exemptions. A joint customs area eliminating internal border controls is expected to be finalised by the end of 2011 at the latest. While the union is expected to facilitate trade between the three countries, it may introduce additional complications in terms of members' accession to the World Trade Organization (WTO). This is mainly because customs tariffs and regulations are now set at a supranational rather than national level, although a number of tariff increases introduced by Russia in response to the economic crisis have also been incorporated into the Customs Union's external tariff structure. At the same time, the Russian authorities have reiterated their commitment to seeking WTO accession and continue bilateral and multilateral negotiations. Following widespread damage to crops caused by forest fires, in August 2010 Russia, a major supplier of grain to the global market, introduced a temporary ban on the export of wheat.

The law on insider trading, which will come into force in 2011, is an important milestone in the development of the institutional framework for the financial sector. However, the definition and interpretation of insider information have yet to be clarified by the Federal Service for Financial Markets. Recently passed amendments to the competition law are aimed at strengthening the competition framework. They will mostly affect the food retail sector where limits on the regional market share of individual players are likely to be binding.

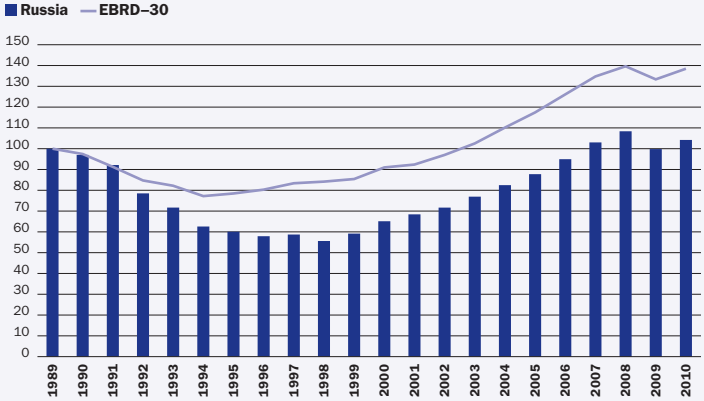
The development of special economic zones dedicated to innovation, manufacturing, cargo transportation and tourism has received new momentum in the context of the modernisation agenda. Increased government spending on infrastructure, combined with significant tax incentives in the technology and innovation zones granted at both federal and regional levels (in Moscow, the Moscow Region, St Petersburg and Tomsk), are attracting increasing investor interest. In addition, Skolkovo is expected to become a major centre for innovation. In May 2010 the immigration law was amended to facilitate the employment of highly skilled international experts both inside and outside special economic zones.

The energy efficiency law adopted in December 2009 regulates various aspects of energy efficiency in the industry, government and residential construction, including energy efficiency requirements and certification for new buildings, although many relevant regulations are yet to be developed. The law on heating, which was adopted in July 2010, further clarified tariff-setting principles for district heating, responsibilities for network planning and metering and sanctions for non-payment. Regulatory asset base (RAB) tariffs for heat transportation and electricity are also currently being piloted in a number of regions. Power sector liberalisation continued, supported by the introduction of rules for the long-term capacity market. Several public-private partnerships (PPPs) in the transport sector reached successful financial close in 2010.

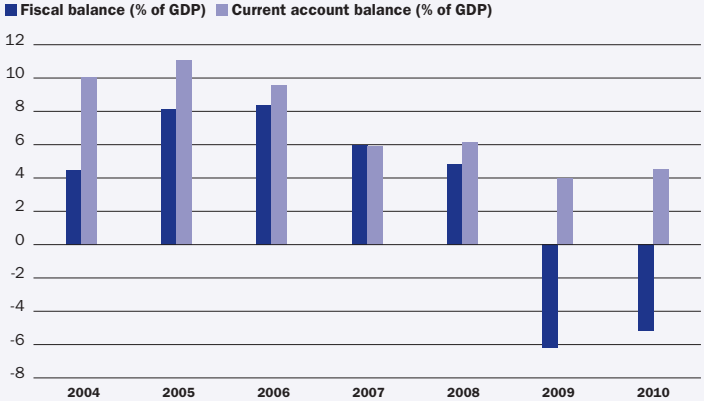
Structural reform priorities

- The economy remains heavily dependent on oil and gas production and suffers from the legacy of a highly energy-intensive industrial structure. Diversification of the economy away from excessive dependence on natural resources and modernising industry and services will depend on improving skills, creating an innovation-friendly environment through deregulation and upgrading infrastructure.
- Power sector reform, which has been largely successful to date, needs to be advanced further. The main steps include: completion of market liberalisation; implementation of the long-term capacity market to ensure the viability of new investments; commercialisation and privatisation of distribution companies; and the roll-out of the RAB tariff system in transmission and distribution.
- Progress in the establishment of Moscow as an international financial centre requires a further strengthening of banking sector regulation and supervision, upgrading the legal framework (including pledge law), improving the legal and technical infrastructure for payment systems and clearing and supporting the growth of institutional investors.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Serbia

Key developments and challenges

Serbia has made welcome progress in EU approximation over the past year, with the unblocking by the EU of the Interim Trade Agreement. Further progress in aligning laws to EU standards will bring additional benefits once the country becomes a candidate for membership.

Large-scale privatisation has slowed, but steps have been taken recently to reinvigorate the process, notably in the telecommunications and aviation sectors. A successful outcome would be a positive signal of Serbia's commitment to completing the privatisation process.

Within the framework of the International Monetary Fund (IMF) stand-by arrangement (SBA), the government has committed to undertake a large-scale public sector reform, including spending and employment cuts and reform of the pension system. These measures are necessary to ensure the macroeconomic conditions for sustainable growth remain in place.

Macroeconomic performance

Real GDP declined by 3.1 per cent in 2009, driven by a large drop in industrial activity as well as by falls in construction and trade. Figures for the first half of 2010 suggest a modest recovery may be under way. Inflation remained within the central bank's target zone of 6 +/- 2 per cent at 5.1 per cent in July 2010 but has increased more recently. However, the currency has been under pressure since the beginning of the year, depreciating by almost 11 per cent between January and August. This is despite significant intervention by the central bank (NBS) of over €1.5 billion to support the dinar.

In the past year, the NBS has greatly reduced reserve requirements on external borrowing from high levels. It has also cut the key policy rate by a cumulative 925 basis points since January 2009, a process that was reversed in August 2010 when the policy rate was raised by 50.0 basis points to 8.5 per cent (and by a further 50 basis points in September). The government approved a new economic stimulus package in January 2010, including the provision of credit lines to local lenders. In May, the authorities agreed with the IMF to raise the budget deficit target for 2010 to 4.8 per cent of GDP from the initial planned 4.0 per cent of GDP because of a revenue shortfall. Following a positive assessment of Serbia's performance under the SBA programme, the fifth tranche was made available for release in late September.

The economy is expected to recover modestly in 2010 with GDP growth of 1.6 per cent. Inflation is likely to remain moderate, reflecting the relatively prudent monetary policy of the NBS and its commitment to exchange rate stability. The IMF programme is expected to remain on track, but the main risk is that the government fails to follow through on the tough spending reductions necessary to adhere to the fiscal targets. New fiscal responsibility legislation, currently before parliament, would help to mitigate this risk.

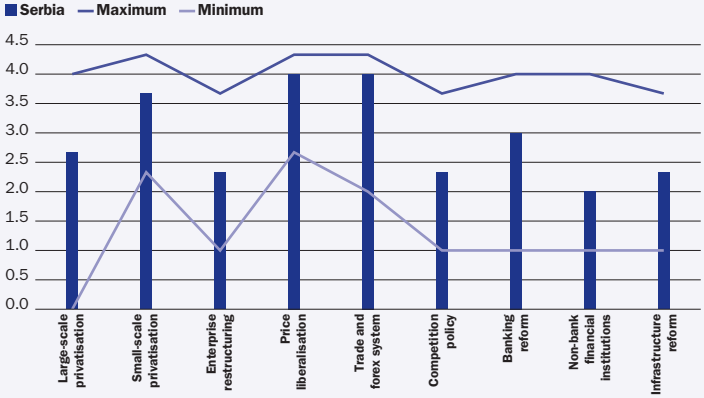
Structural reform

Serbia began the transition later than most other countries, but has been catching up steadily over the past decade. Nevertheless, a major structural reform agenda still lies ahead. The challenges are particularly large in most infrastructure sectors, especially in the energy sector, which remains dominated by one state-owned company. A significant number of large enterprises also await privatisation once market conditions improve, both in the corporate sector and in parts of the financial sector, including the largest insurance company.

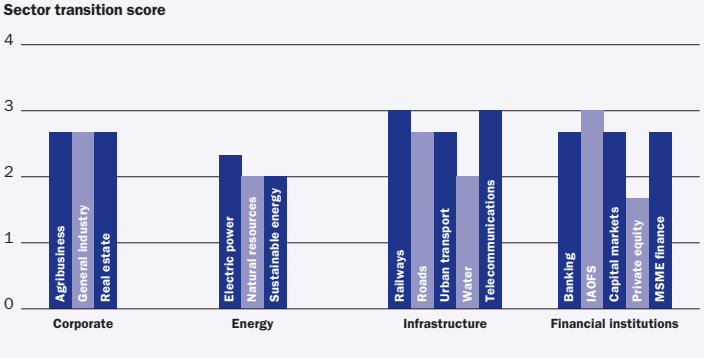
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	6.9	5.5	-3.1	1.6
Inflation (end year)	11.0	8.6	6.6	7.7
Government balance/GDP	-1.9	-2.6	-4.2	-4.8
Current account balance/GDP	-15.7	-17.9	-5.6	-9.6
Net FDI (in million US$)	2523	2717	1865	1364
External debt/GDP	64.9	65.5	73.6	na
Gross reserves/GDP	34.3	22.8	34.4	na
Credit to private sector/GDP	32.5	38.0	40.6	na

Transition indicators 2010



2010 sector transition indicators



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

Recent developments

In December 2009, the European Union (EU) unfroze the Interim Trade Agreement (which Serbia had previously been implementing unilaterally), enabling the gradual removal of customs duties and the introduction of special quotas on certain Serbian products. The ratification of the Stabilisation and Association Agreement, signed in 2008 and a key step in the EU accession process, started in June 2010. In line with these developments, the 2009 European Commission Progress Report praised Serbia for its commitment to EU integration and positively assessed reform efforts in the areas of anti-corruption policy and strengthening of the judiciary.

The government has taken a number of steps to revive the large-scale privatisation programme in recent months. In April 2010 the government resumed its attempts to privatise the national airline carrier, JAT, and revealed a new plan for its restructuring. In the same month the government announced its intention to privatise a 40 per cent stake in Telekom Srbija, while advisers have proposed 51 per cent, a recommendation subsequently accepted by the government in October. The preparation of the tender is currently under way.

Progress has also been in made liberalising the telecommunication sector. In January 2010, a second landline telephony license was issued to the Norwegian telecommunication operator, Telenor, thereby removing the monopoly of Telekom Srbija. However, a dispute over the cost of accessing Telekom Srbija's telecommunication infrastructure arose in March 2010. In addition, a new law on electronic communications was implemented in June, which should increase competitiveness in the sector and align Serbia's legislation to the EU *acquis*.

Serbia has also introduced important changes to the competition law so that it is now more harmonised with EU competition rules and gives the Competition Commission the rights to initiate investigations and inspections and to directly impose fines and other sanctions.

The government has invested in large-scale road and railway infrastructure over the past year, with the help of the international financial institutions (IFIs) and bilateral donors. In April 2010 the authorities agreed on a US$ 800 million loan from Russia to finance projects to upgrade the railway sector, which are expected to start next year. Furthermore, the regulatory framework for the railway sector has been strengthened through the agreement on public service obligations (PSOs) in September 2009 and an access charge regime was adopted in March 2010. In June 2010 the government presented its transport sector strategy. It envisages investments of €22 billion in the road, railway, water and aviation networks until 2027 in order to bring the country's infrastructure in line with European standards.

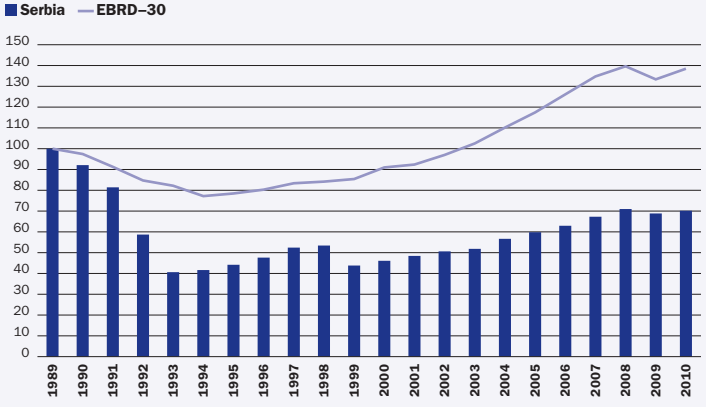
A joint venture between Russia's Gazprom and the state-owned gas company, Srbijagas, was signed in February 2010. The agreement is seen as an initial step in the establishment of a gas storage facility which is necessary for Serbia to become part of the South Stream gas pipeline project. The feasibility study for the Serbian part of the pipeline is expected to be finalised by the end of the year, with construction scheduled to commence in 2013.

The banking system has continued to cope well with the effects of the financial crisis, and the system overall is highly liquid and well capitalised, although non-performing loans to the corporate sector are increasing. Under an agreed modification to the Vienna Initiative, banks were allowed to lower their exposure to 80 per cent of the level of exposure in December 2008, as of April 2010.

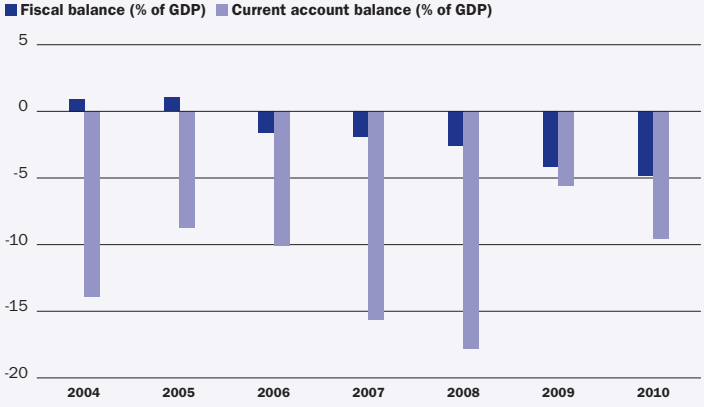
Structural reform priorities

- Greater private sector involvement and fresh capital and know-how are needed to improve productivity and efficiency levels in the corporate sector. The main priorities are to complete the currently planned privatisations for several large enterprises and to make further progress in improving the business environment.
- The country's infrastructure requires major investment, for which private sector involvement would also be beneficial, highlighting the need for the development of successful concession projects.
- In the financial sector, the key priorities are to further strengthen the regulation of financial institutions and to encourage the development of local capital markets. Development of the latter should focus in particular on local currency given that EU membership and eventual adoption of the euro are unlikely to occur for some years.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Slovak Republic

Key developments and challenges

The largely foreign-owned banking sector has weathered the financial crisis well, although credit to the private sector shows little growth and lending standards remain tight. The economic recovery needs to become better established to improve lending conditions, and cooperation with home country supervisors may need to be strengthened, including through the new European framework.

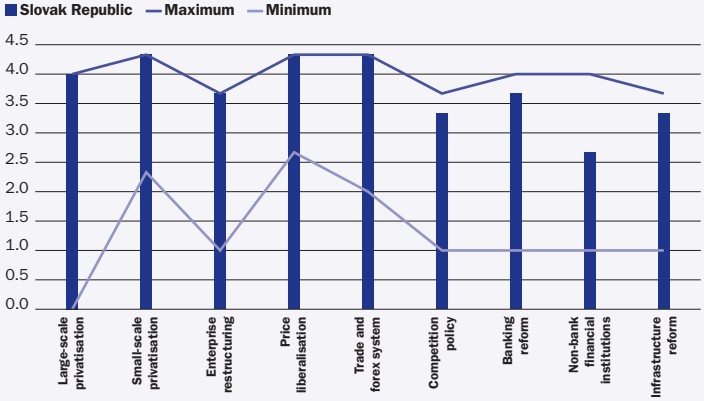
The development of alternative energy sources, including renewable energy, and the promotion of greater energy efficiency continues to lag behind regional standards, highlighting the need for greater emphasis in this critical area.

The economic crisis has led to a sharp rise in the public deficit due to a significant drop in revenues. It is therefore essential that the new government puts in place a credible fiscal consolidation strategy, especially in the areas of health, social security and pensions.

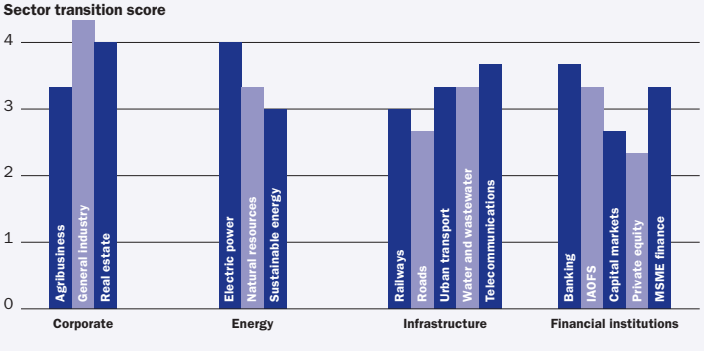
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	10.6	6.2	-4.7	4.0
Inflation (end year)	3.4	4.4	0.5	1.0
Government balance/GDP	-1.8	-2.1	-7.9	-7.5
Current account balance/GDP	-4.7	-6.3	-3.2	-1.5
Net FDI (in million US$)	2881	3156	-481	1500
External debt/GDP	52.7	53.4	74.3	na
Gross reserves/GDP	21.0	18.1	0.8	na
Credit to private sector/GDP	1108.4	1203.2	1316.6	na

Transition indicators 2010



2010 sector transition indicators



Note: IAOFS – Insurance and other financial services

Macroeconomic performance

The Slovak Republic is recovering from a severe recession in 2009 when GDP fell by 4.7 per cent. Both the economic sentiment indicator and industrial production have been on a robust upward trend since the middle of 2009. Industrial production has posted sharp increases on a monthly basis since the beginning of 2010 and grew by over 17 per cent in the year to July, benefiting in particular from renewed growth in exports to the rest of the eurozone. Retail sales, by contrast, have stagnated and the unemployment rate has been on a steep upward trend since the end of 2008, reaching 15 per cent in July 2010.

The new government that came to power in June 2010 faces the urgent task of lowering the fiscal deficit. The various stimulus measures introduced by the previous government in response to the crisis led to a general government deficit of nearly 8 per cent of GDP in 2010. The budget deficit is forecast to remain at around 6.0 per cent in 2010, given the collapse in revenues (with VAT revenues and social and health contributions sharply down and a marked deterioration in municipal budgets). Public debt as a percentage of GDP was the seventh lowest within the European Union by the end of last year (35.7 per cent of GDP), but is now rising rapidly. In September the government proposed a substantial consolidation effort for next year, amounting to 2.5 per cent of GDP, including drastic salary cuts in the civil service wage bill and a VAT increase.

On the back of a recovery in industrial production and exports the economy is likely to record robust growth this year and next, with 2010 growth projected at 4 per cent. The main vulnerability remains the country's highly concentrated export structure in cyclical industries such as cars and consumer electronics. The economy is hence exposed to any renewed deterioration in demand in EU markets, especially in Germany, the main export market.

Structural reform

Past progress with structural reforms reduced the Slovak Republic's vulnerability to the global financial crisis. Since late 2008 the authorities have focused on dealing with the economic downturn and the run-up to elections in June 2010 and the reform momentum has slowed. The previous government placed emphasis on social welfare issues, introducing changes to the labour code which reduced labour market flexibility. Changes to pension legislation also made the environment for the second privately managed pillar more complicated. In addition key privatisations were halted and state involvement increased

in the energy sector. Plans are under way by the new government to accelerate reforms, but the public's appetite for far-reaching changes is yet to be tested.

Recent developments

According to cross-country surveys, Slovak Republic continues to rank as one of the most competitive economies in the central Europe and the Baltic states (CEB) region. In the World Bank's *Doing Business 2010* survey Slovak Republic was ranked 42 out of 183 countries, with the procedures and time required for starting a business, dealing with construction permits, trading across borders and enforcing contracts considered more onerous than the average for OECD countries.

The Slovak banking sector is almost entirely foreign-owned and has shown considerable resilience to the global financial crisis due to its conservative funding structure and focus on traditional banking activities. Recent stress tests have also shown that the banking sector can absorb a variety of domestic shocks, including a severe decline in output and employment. However, the sector has been affected by the protracted economic downturn. Profitability has declined sharply (aggravated by the loss in revenue from foreign exchange transactions following eurozone entry) and asset quality has deteriorated. At the end of the first quarter of 2010, the share of non-performing loans stood at around 6.0 per cent, up from 2.6 per cent at the end of the third quarter of 2008, while the return on equity was close to 7.0 per cent, down from 16.0 per cent at the end of 2008. There has been very little growth in lending, as evidenced by credit to the private sector, which is still decreasing on an annual basis.

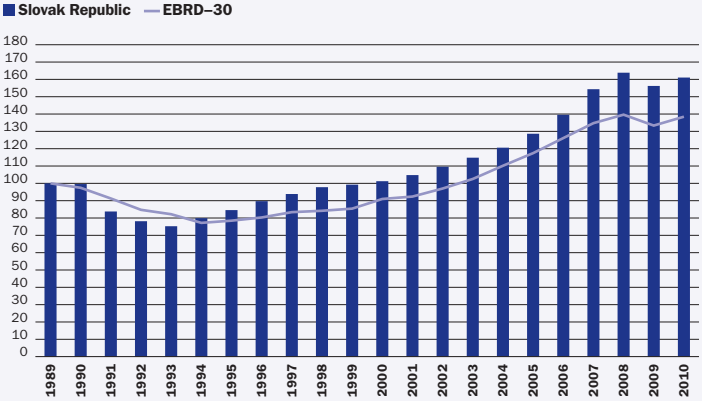
Following the substantial fall in fiscal revenues and given the perceived loss in confidence in private pension funds following the financial crisis, the previous government introduced a series of changes to its multi-pillar pension system. Even though some changes have since been reversed, or are in the process of being reversed, such changes could compromise the long-term sustainability of government finances and have made the operating environment for private pension funds more uncertain. Recent plans by the new government to improve the operating environment for private pension funds and make the system more sustainable would be welcomed by market participants. The new government also plans to introduce changes in labour legislation to increase flexibility.

Despite the difficult conditions in the financial markets in 2009, the previous government made important progress with regards to upgrading the road infrastructure through public-private partnerships (PPP) projects. Financing of the first PPP project for the R1 motorway between Nitra and Tekovske Nemce was concluded in the middle of 2009. However, in early September 2010 the Transport Ministry cancelled the first phase of the PPP for the D1 motorway between Martin and Presov, due to the fact that the concessionary company, Slovenské Dial'nice, which was to build the sections and operate them for 30 years, was not able to achieve financial closing by 30 August. As a result, the construction of the D1 motorway has now been delayed until 2011-12 and is likely to be primarily financed by the EU Cohesion Fund and the state budget.

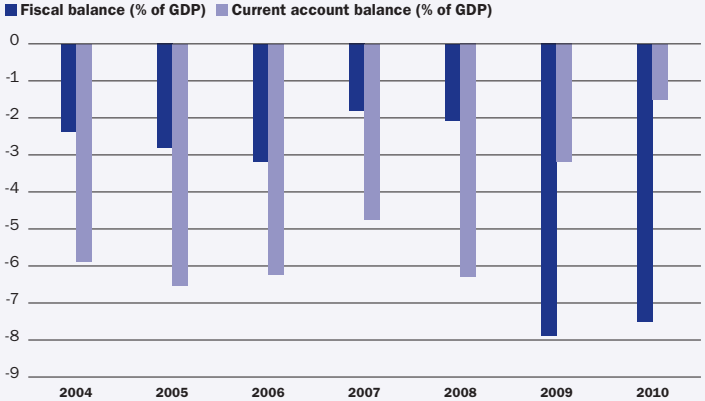
Structural reform priorities

- Additional improvements to the business environment and increased labour market flexibility remain key to addressing regional differences as well as the persistently high structural and youth unemployment. Specific measures required include reorienting education and research and development activities, as well as reducing high labour costs and improving the incentives for lower-skilled workers to enter the labour force.
- Close cooperation with financial supervisors in European home countries remains essential given the extent of foreign ownership in the sector. Domestic supervision will need to adapt to the requirements of the EU's Solvency II frameworks for insurance and pension providers, and prepare for future prudential requirements in the banking sector.
- In the energy sector, further privatisation and the promotion of energy efficiency and renewable energy remain priorities, while safeguarding security of supply. Given the strained state of municipal finances, modernisation of municipal infrastructure will depend on assistance from EU structural and cohesion funds, and a facilitating framework for private sector involvement and commercial co-financing from local sources.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Slovenia

Key developments and challenges

For many of the enterprises in which the state retains a controlling stake, the global economic crisis has underlined the need for better governance, far-reaching restructuring and eventual privatisation to make them viable given the strong competition from within and outside the European Union.

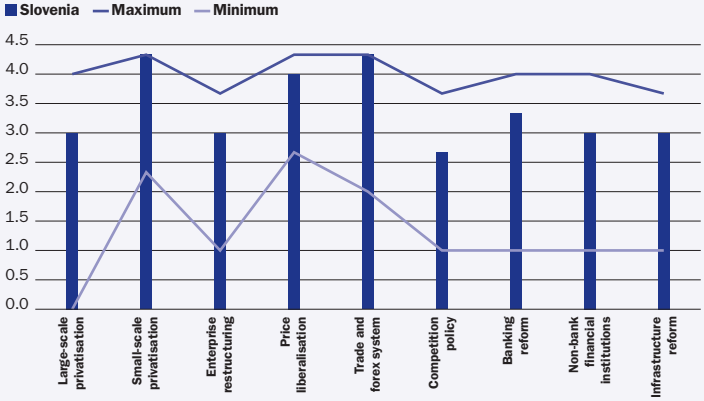
The banking sector has withstood the global crisis well with the support of the government, but guarantees will eventually need to be withdrawn. As a result the banking sector will need increased capital injections to build buffers for growing non-performing loans, strengthen bank balance sheets and ease lending conditions.

The economic crisis has led to a sharp rise in the public deficit and has highlighted the need for expenditure cuts in the health, social and pension sectors. It is crucial that the government implements its ambitious fiscal consolidation plan to put in place the conditions for a return to sustainable growth.

Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	6.9	3.7	-8.1	1.1
Inflation (end year)	5.6	2.1	1.8	2.1
Government balance/GDP	0.0	-1.8	-5.8	-5.7
Current account balance/GDP	-4.8	-6.1	-1.0	-1.0
Net FDI (in million US$)	-273	514	-743	-200
External debt/GDP	100.6	105.2	113.4	na
Gross reserves/GDP	17.2	13.6	14.4	na
Credit to private sector/GDP	70.1	76.2	83.8	na

Transition indicators 2010



Macroeconomic performance

After several years of robust growth, Slovenia was severely affected by the international crisis. Real GDP fell by 7.8 per cent in 2009 – Slovenia's first recession since independence and the largest contraction in the eurozone. The economy continued to contract in early 2010 as domestic demand remained subdued and industrial production was weak during the first half of 2010. The credit squeeze and the collapse in exports and investment have led to a rapid rise in corporate bankruptcies. Unemployment peaked at 7.0 per cent in June 2010 and fell to 6.8 per cent in July.

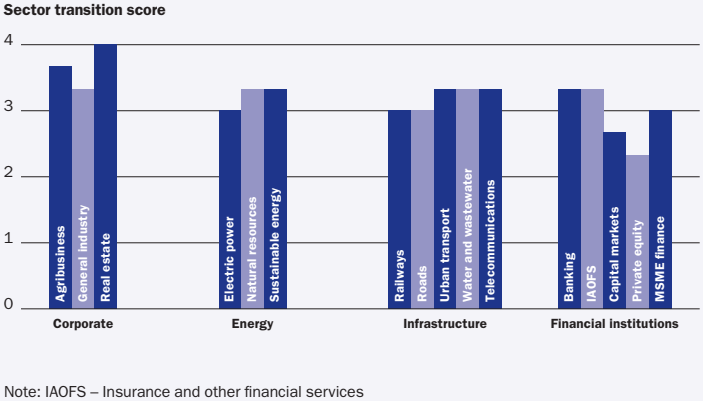
In response to the crisis the government has adopted a range of measures, aimed at increasing investment for infrastructure projects, supporting troubled companies and subsidising employment. In the banking sector the authorities made available guarantees on retail deposits for new debt issuance by banks and for loans to non-financial companies. These discretionary measures, combined with the effect of the automatic stabilisers, contributed to a rise in the consolidated government budget deficit to 5.5 per cent of GDP in 2009 (breaking the conditions of the European Union's Stability and Growth Pact). Although the budget deficit is likely to remain high in 2010, the government has presented an ambitious fiscal consolidation strategy from 2011 which foresees a gradual reduction in the fiscal deficit to 1.6 per cent of GDP by 2013.

Growth is expected to be modest in 2010 and to recover slowly in 2011. In the short term the recovery will be constrained by the continued weakness in demand, the deleveraging by firms and tight credit conditions. A return to robust growth over the medium term depends crucially on implementing the fiscal consolidation plan and on structural reforms to labour and product markets. The success of the fiscal consolidation plan partly hinges on progress with expenditure cuts as well as on crucial health, social and pension sector reforms.

Structural reform

Slovenia's tradition of consensus-based policy-making has meant that progress with structural reforms has been slower than in other central Europe and the Baltic states (CEB) countries. The enterprise sector continues to suffer from a relatively high level of government involvement and many enterprises require far-reaching restructuring to make them internationally competitive. Slovenia's banking sector is still dominated by two large state-controlled banks. A restructuring of bank balance sheets and improvements in governance are needed to advance the sector's efficiency and enable it to resume lending to enterprises. In the power sector,

2010 sector transition indicators



Note: IAOFS – Insurance and other financial services

the state is still the majority owner of all generation capacity, while there is limited private sector participation and little effective competition in distribution.

Recent developments

In July 2010 Slovenia became a member of the Organisation for Economic Co-operation and Development (OECD). As part of the accession process, Slovenia adopted legislation to improve the corporate governance framework for state-owned enterprises, minority shareholder protection and securities regulation. In April 2010 the Slovenian Parliament adopted legislation establishing a central ownership agency to manage all of the State's direct interests in state-owned enterprises (SOEs). The Slovenian authorities are also preparing legislation to define the relationship between the new central ownership agency and the two key state institutions overseeing the pension fund (KAD) and restitution fund (SOD). These developments could pave the way for the necessary corporate governance changes, restructuring and eventual privatisation of state-owned companies and financial institutions.

The latest 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. The decision in January 2010 to increase the minimum wage by 23 per cent risks further entrenching labour market rigidities.

Slovenia's banking sector continues to be dominated by two large state-controlled banks (NLB and NKBM), with a combined market share of close to 50 per cent of the sector's total assets. The sector has suffered from low efficiency and is now experiencing a severe shortage of wholesale funding and a rapid deterioration in asset quality.

The country's largest bank, the state-controlled NLB, narrowly passed the European Union's banking sector stress test in July 2010 (it was the only Slovenian bank to participate in the test), but subsequently announced another attempt to raise €400 million in fresh equity to bolster its balance sheet. A previous attempt to raise additional capital in December 2009 failed because the minority shareholder, Belgian Bank KBC, failed to participate (its attempts to gain a majority stake in the bank have been repeatedly refused in the past, a right it still claims to have).

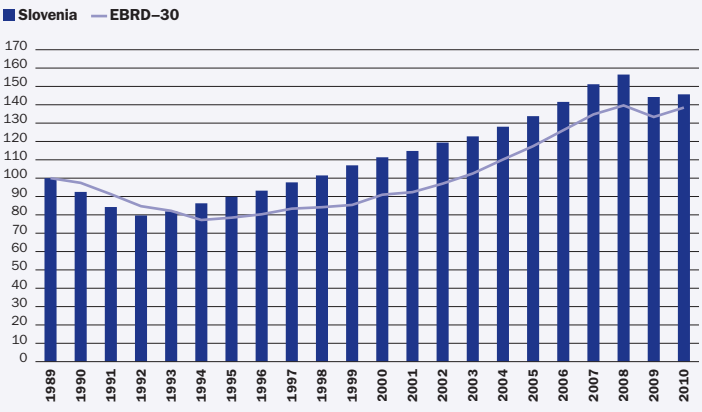
In the energy sector there are plans to modernise the Šoštanj Thermal Power Plant (TES), a fully owned subsidiary of the state-owned Holding Slovenske Elektrarne (HSE), the biggest producer and wholesale supplier of electricity in Slovenia. The modernisation will include the construction of a new state-of-the-art coal-fired (lignite) unit with a capacity of 600 MW that will replace older and less efficient units. The new plant will have full environmental protection systems, is estimated to cost €1.2 billion and will be financed by the EBRD, the European Investment Bank (EIB) and commercial banks.

The independence of the Slovenian telecommunications regulator was questioned by the European Commission (EC) following a government decision in November 2009 to dismiss the regulator's director.

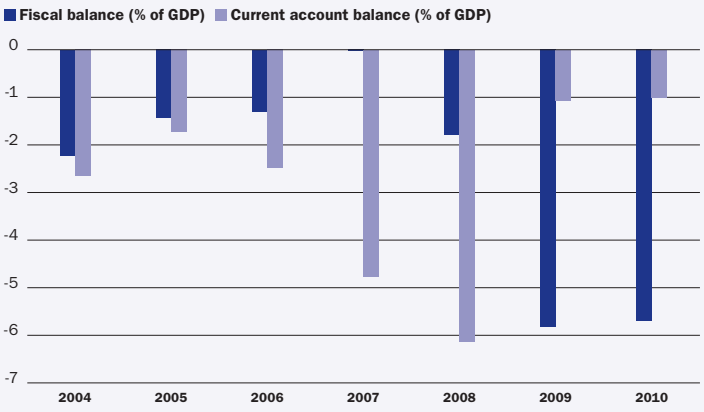
Structural reform priorities

- In order to aid the restructuring and eventual privatisation of state-controlled enterprises, the central ownership agency should be established as soon as possible with clear terms of reference to pursue this agenda. Plans to make the Competition Protection Office an independent agency with budgetary autonomy would also assist in raising efficiency.
- In the financial sector, the authorities should seek to gradually withdraw government guarantees to the sector, reduce their direct involvement in bank decision-making and plan for the privatisation of state-owned banks.
- There is a clear need to increase private sector participation in several key sectors of the economy. This includes the energy sector, where the state is the majority owner of all generation and much of the distribution components, as well as in the railway and port infrastructure sectors. The municipal sector requires improved incentive-based contractual arrangements and the elimination of cross subsidies between consumer groups.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Tajikistan

Key developments and challenges

The Roghun campaign, aimed at achieving energy independence, has had adverse social and macroeconomic consequences. The decision to suspend the campaign is positive, but close attention needs to be given to the project's social, environmental and macroeconomic impact, including debt sustainability.

Progress has been made recently in improving the transparency of state-owned enterprises (SOEs). The challenge is to improve the performance of these companies, establish accountability and prepare them for future privatisation.

The portfolio quality of commercial banks has worsened, partly because the government has not fully compensated them for losses incurred in connection with the write-off of cotton debt owed by farmers. For banks to continue lending to agriculture, it is important to provide full compensation as well as establish the transferability of land-user rights that could be used as collateral.

Macroeconomic performance

Real GDP grew by 3.4 per cent in 2009 – down from 7.9 per cent in 2008 – mainly due to a sharp decline in industrial production owing to the contraction of output at the state-owned aluminium smelter. Growth was supported by higher output from the non-cotton agriculture sector, aided by ongoing reforms. With the improving external environment, both for remittances inflows and aluminium exports, GDP growth accelerated to 7.4 per cent in the first half of 2010. This occurred despite the share sales campaign for the Roghun hydropower plant (HPP) (see below), whereby the government effectively taxed the economy the equivalent of more than 3 per cent of annual GDP. Inflationary pressures receded as international commodity prices eased. The rate of consumer price index (CPI) inflation declined from 12 per cent in the year to December 2008 to 5 per cent a year later, where it has remained during the first half of 2010.

The fiscal deficit narrowed slightly from 5.9 per cent of GDP in 2008 to 5.2 per cent in 2009. Current expenditures on goods were restrained while social spending and wages and salaries were increased. Monetary policy has focused on building up net international reserves. Interventions in the foreign exchange market, when the somoni came under pressure in early 2009, were limited to smoothing excess volatility.

The economy is likely to grow by 5.5 per cent in 2010 followed by more moderate growth in 2011. The main external risks in the short term are a continuation of blockages of railway cargoes into the country from Uzbekistan and the ban on wheat exports imposed by Russia. These problems could exert inflationary pressures on the economy which would adversely impact the poor, and put additional pressure on corporate and financial sector balance sheets. In the medium term, construction of the Roghun HPP project could have an adverse impact on debt sustainability unless it is carefully managed.

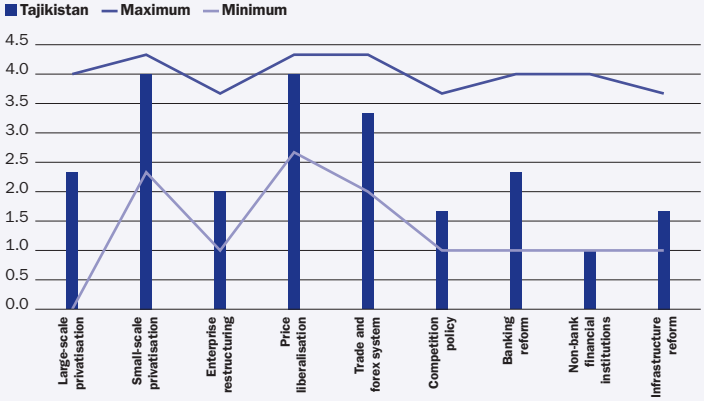
Structural reform

Across the economy, large challenges remain in advancing reforms. Nonetheless, reforms in agriculture (which accounts for around a quarter of GDP) have progressed in recent years, especially with the decision by the government to abolish policies that had led to the excess plantation of cotton resulting in declining yields. These policies had also led to the accumulation of debt owed by farmers amounting to US$ 700 million by October 2008. The decision to write off this debt in May 2009 has removed the key bottleneck for advancing reforms in the sector. In other sectors the focus of reform has been mainly on large SOEs, including

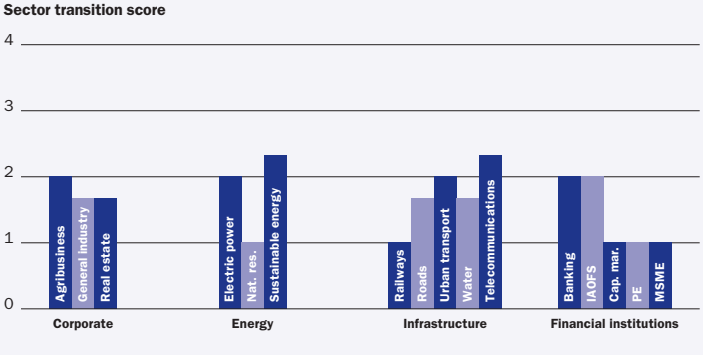
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	7.8	7.9	3.4	5.5
Inflation (end year)	19.8	11.9	4.9	10.0
Government balance/GDP	-6.2	-5.9	-5.2	-4.4
Current account balance/GDP	-8.6	-7.6	-4.9	-3.6
Net FDI (in million US$)	160	300	35	90
External debt/GDP	40.9	46.3	51.6	na
Gross reserves/GDP	2.3	2.9	5.6	na
Credit to private sector/GDP	29.6	26.4	25.0	na

Transition indicators 2010



2010 sector transition indicators



Note: Nat. res. – Natural resources; Water – Water and wastewater; IAOFS – Insurance and other financial services; Cap. mar. – Capital markets; PE – Private equity; MSME – MSME finance

those in aluminium production and electricity supply. Efforts to improve the business climate are in progress, albeit very slowly.

Recent developments

To raise financing for the construction of the Roghun HPP, in January 2010 the government started to sell shares of the company to the general public. The cost of the first phase of the project was estimated at US$ 1.4 billion – more than a quarter of GDP. The compulsory element of the share sales raised concerns about the impact on poverty and growth. According to estimates by the World Bank, the campaign has temporarily increased the poverty rate by 2 percentage points as households reduced consumption to replenish savings invested in shares. The government subsequently decided to suspend the advertising campaign in mid-April. The World Bank has offered to lead an international financing consortium if the outcomes of the technical, social and environmental impact assessments are positive.

At the end of 2009, the 10 largest SOEs submitted their 2010 financial plans to the supervisory unit established within the Ministry of Finance. Talco, the state-owned aluminium smelter, has completed an International Financial Reporting Standards (IFRS) audit for the 2006-08 financial years, and has published the results on its web site. An external audit of Talco Management, an offshore entity that undertakes purchase of inputs and outputs for Talco, is also planned for the 2008-09 financial years, and could further improve transparency and accountability.

The first road concession was signed with a contract for the operation of tolling and maintenance of the Dushanbe–Khujand–Chanak highway – an important road connecting the south of the country with the north – with Innovative Road Solutions (British Virgin Islands) in April 2010. Toll stations have been built on the highway and vehicles are charged per kilometre and in accordance with the size of vehicles. However, it is not clear whether the contract was awarded through a transparent tendering process. Road-user charges (road tax) have also increased by more than 50 per cent in comparison with the previous year.

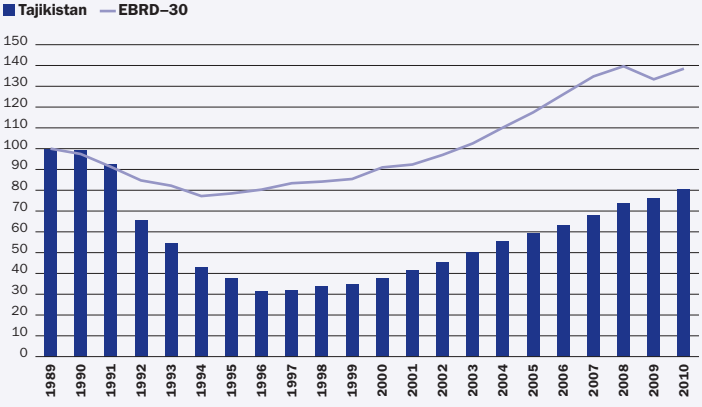
The schedule to increase electricity tariffs has been delayed. As of 1 January 2010, the weighted electricity tariff (covering general industry, Talco and residential consumers) had increased by 21 per cent compared with January 2009. No further increases are envisaged for 2010. It is not expected that prices will be raised to reach a level commensurate with cost recovery by the end of 2011. Nonetheless, the average tariff collection rate remains poor at 62 per cent in 2009, down from 65 per cent in 2007.

The portfolio quality and profitability of banks deteriorated in 2009 with classified loans accounting for over 20 per cent of total loans at the end of the year. This was largely due to loans in the cotton sector, including the write-off of debt owed by farmers before October 2008 and new government loans provided through commercial banks in 2008-09. Loan growth has also slowed down. In 2010 the government decided to compensate banks with only 80 per cent of the nominal amount of the cotton debt that was written off, providing the banks with government securities with only a 2 per cent interest rate. This has negatively impacted the capital adequacy of some commercial banks and could lead to a further slow-down of lending. The sales of Roghun shares have also significantly tightened liquidity, although the subsequent placing of funds with commercial banks through tender have somewhat mitigated the impact.

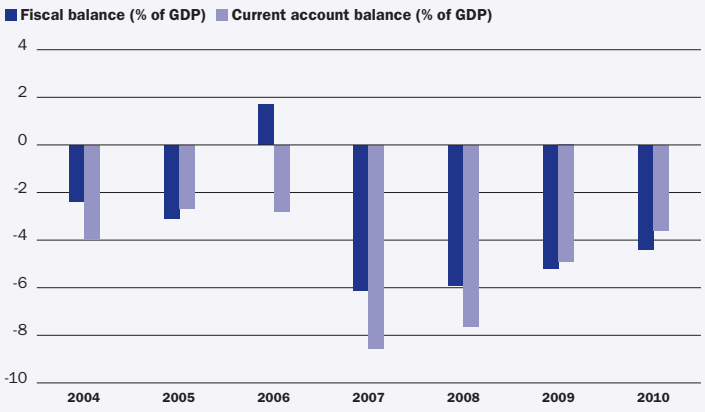
Structural reform priorities

- In the agriculture sector, the main reform priority is the transferability of land-user rights which could facilitate borrowing by farmers. In the enterprise sector, full financial transparency of SOEs through the posting of their financial statements on the public web site should be achieved. A one-stop shop should be established to ease business registration and licensing procedures for small and medium-sized enterprises (SMEs).
- In infrastructure, the government needs to develop a strategy for the first phase of restructuring of Barki Tojik, a vertically integrated state-owned electricity company, and achieve full recovery of its short-term operating costs. While the first concession in the road sector is encouraging, it is important to ensure transparency of the procedure for awarding concessions.
- Financial sector supervision needs to be strengthened further by establishing a framework for resolution of credit institutions and enhancing the capacity of the regulator. The development of local currency interest rate benchmarks through the regular issuance of treasury bills is also important.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Turkey

Key developments and challenges

Some state entities in the energy and transport sectors were privatised in 2009-10. The challenge is now to accelerate the pace of reform and undertake further privatisation projects in the municipal and environmental infrastructure sectors.

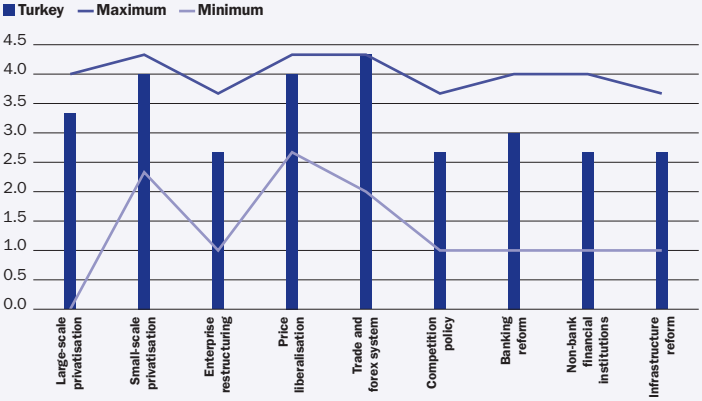
A return to sustainable growth will require the authorities to amend rigid labour market regulations, which continue to discourage formal labour market participation and employment.

Fiscal and monetary policy has been suitably accommodative during the crisis. Fiscal prudence, entrenched in a fiscal responsibility law, could reassure investors about the authorities' commitment to fiscal sustainability and limit the growth of public debt.

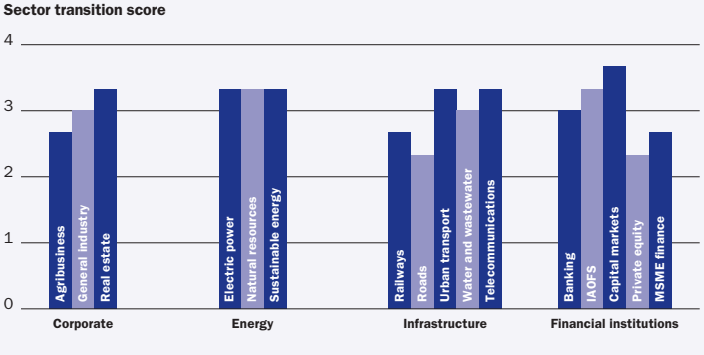
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	4.7	0.7	-4.7	8.0
Inflation (end year)	8.4	10.1	6.5	8.2
Government balance/GDP	-1.7	-1.9	-5.5	-4.1
Current account balance/GDP	-5.9	-5.7	-2.2	-6.0
Net FDI (in million US$)	19940	15720	6879	8500
External debt/GDP	38.4	37.9	43.6	na
Gross reserves/GDP	13.7	12.7	12.2	na
Credit to private sector/GDP	34.0	38.7	40.8	na

Transition indicators 2010



2010 sector transition indicators



Note: IAOFS – Insurance and other financial services

Macroeconomic performance

After a fall in real GDP of 4.7 per cent in 2009, a significant recovery is under way. So far the upturn has been largely driven by domestic demand supported by the government's stimulus programme, capital inflows and credit growth. The budget deficit rose to 5.5 per cent of GDP in 2009, but the recovery means that the government's deficit target of 4.0 and below 3.0 per cent of GDP for 2010 and 2011, respectively, appears within reach. The adoption of a fiscal rule, intended to sustain sound fiscal policy over the medium term, has been postponed, at least until 2011 elections. Following three consecutive months of decline, inflation jumped again to 8.3 per cent year-on-year in August 2010. High inflation, compared with Turkey's main trading partners, has resulted in a substantial appreciation of the real exchange rate over the past year.

In 2009, the Central Bank of Turkey (CBT) continued its policy easing by cutting overnight rates to 6.5 per cent in November 2009 (from 16.75 per cent in October 2008), and the rate has been kept on hold since then. In April 2010 the CBT began a stepwise increase in reserve requirements on both local and foreign currency deposits to 5.5 and 11 per cent, respectively, by October 2010. A temporary exemption from the general provisioning for new loans and eased regulations for loan restructuring, which were implemented as a crisis response measure, was maintained in order to continue to support the growth of credit.

Growth in the first half of 2010 reached 11 per cent year-on-year, mostly reflecting a strong domestic demand, as well as the rebound effect. The recovery is expected to continue with growth of 8 per cent in 2010 and somewhat slower growth in 2011, on the back of increased external demand and some restocking, and supported by renewed capital inflows and growth of domestic credit. However, Turkey's robust cyclical recovery has been accompanied by widening external imbalances. Despite an active government policy to increase investment and attract strategic foreign investors, political uncertainty before the 2011 elections may yet constrain investment activity.

Structural reform

Transition challenges in Turkey are generally considered medium across the board, but they vary significantly between the regions. In agribusiness, the lack of proper irrigation, the relatively small and uneconomic size of individual family-owned farms and the shortage of capital for modern production inputs, including machinery, prevent the country from realising its full agricultural

potential. Although privatisation in general industry has progressed in recent years, restructuring and improvements in corporate governance and business conduct remain significant challenges in view of the need to raise the productivity and competitiveness of Turkish firms. The banking sector has weathered the crisis well but remains concentrated and important banks are still state-owned.

Recent developments

In 2009 a total of 106 privatisation deals were completed, including 52 small-scale hydropower plants, electricity distribution companies in 13 regions and infrastructure. Tenders were announced or completed for another eight distribution companies between November 2009 and August 2010. Privatisation also progressed in the transport sector, with two ports sold this year: Samsun and Bandirma. Further sales of state-owned ports, toll motorways and bridges are envisaged in the privatisation portfolio for 2010-11. In total, privatisation revenues amounted to US$ 2.3 billion in 2009 (0.4 per cent of GDP compared with a target of 0.5 per cent) and US$ 941 million for the period of January to July 2010 (the target for a year as a whole is 1.0 per cent of GDP). Foreign direct investment (FDI) inflows in 2009, which contracted by more than half compared with the previous year, were mainly directed at the electricity, gas and water supply sectors, in line with the government's 2009-10 privatisation programme.

Efforts are under way to diversify Turkey's energy sources. In May 2010 the government signed an agreement with Russia, estimated at US$ 20 billion, for a Russian firm to build and own a majority stake in Turkey's first nuclear power plant. Another agreement valued at US$ 1 billion was signed with Iran to construct a new gas export pipeline from Iran via Turkey to Europe, with construction expected to take three years. Lastly, important progress has been made on the Nabucco pipeline, with a memorandum of understanding signed by Turkey and Azerbaijan in June 2010 to develop trade in natural gas.

Turkey has made a concerted effort to open new export markets for Turkish companies with a series of regional trade and visa agreements. Over the past year such agreements were signed with Jordan, Lebanon, Russia and Syria, and most recently, with the Association of Southeast Asian Nations (ASEAN) countries.

Turkey has one of the youngest labour forces in Europe, with two-thirds of the population between the ages of 15–64. However, rigid labour market regulations continue to adversely affect formal labour market participation and employment while encouraging employment in a thriving informal sector. Employment protection laws, in particular limitations on temporary and fixed-term employment contracts and the requirement for employers to pay high severance payments, discourage formal employment. Partly as a result, almost half of the labour force is employed in the informal economy, according to World Bank estimates.

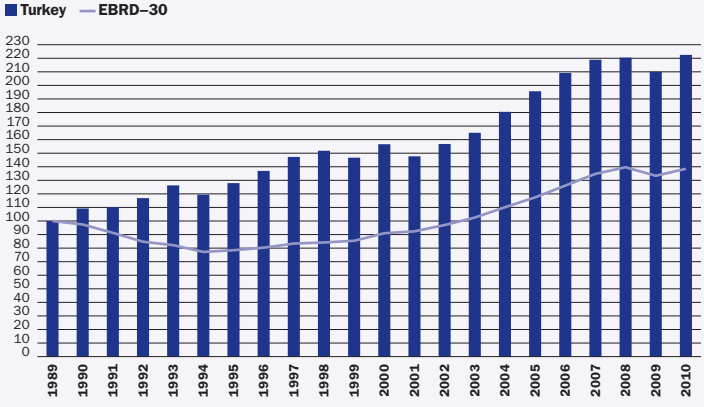
Turkey's judiciary is vigorously independent and generally has the experience and legislative framework to adequately enforce contracts and property. At the same time, foreign legal firms are not allowed to practice Turkish law and the legal market in Turkey remains dominated by domestic companies. In anticipation of a gradual opening of the market, the major international law firms are increasingly establishing relationships with local firms.

Turkey has signed several international protocols regarding the protection of intellectual property rights (IPR) and, in line with membership of the World Trade Organization (WTO), has signed the key Agreement on Trade-Related Aspects of Intellectual Property Rights. However, there are continuing problems over trademark violations and patent infringement, with the result that Turkey remains on the US government's priority watch list for insufficient protection of IPR.

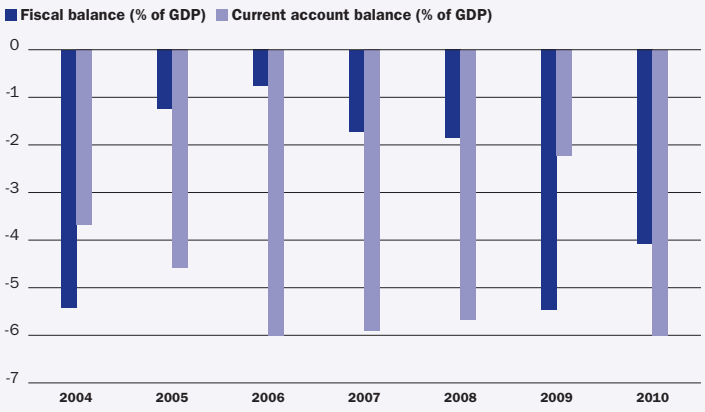
Structural reform priorities

- Competitiveness could be enhanced by structural reforms that help to shift activity from the informal to the formal sector. Implementation of the new strategy currently being developed to increase labour force participation and enhance labour market flexibility is needed.
- Competitiveness would also benefit from a more efficient agricultural sector. Better access to finance for the agricultural sector could support developing economies of scale and could help adjustment to international (especially EU) quality standards that would improve export market access.
- Some large privatisations, especially in banking, energy and the railway sector, remain outstanding. Their implementation would enhance efficiency and improve service delivery.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Turkmenistan

Key developments and challenges

Diversification of the economy away from excessive dependence on natural resources, including the modernisation of industry, is the crucial policy priority. To meet this aim it is essential to attract private sector investment into more sectors and although new investment legislation is in place, private enterprises continue to suffer from extensive regulatory burden and red tape.

Access to finance remains difficult, especially for small and medium-sized enterprises (SMEs), mainly because the financial system suffers from state dominance and directed lending. Attracting private commercial banks would improve liquidity and efficiency in the sector.

Recent foreign direct investment (FDI) into the power grid infrastructure is a welcome first step in ensuring the more consistent supply of electricity in the future. However, the authorities need to develop a comprehensive regulatory framework for the sector.

Macroeconomic performance

The Turkmen economy has remained largely insulated from the global recession due to its dependence on hydrocarbons and the limited degree of its integration with world markets. However, following a pipeline blast in April 2009, Russia (which off-takes most of Turkmenistan's gas) has decreased its off-take volumes and these were only partially compensated by higher volumes sold to China and Iran. As a result the growth of GDP moderated from over 10 per cent in 2008 to 6.1 per cent in 2009.

The government has introduced several measures to counter the problems that led to a decline in the budget surplus in both 2009 and 2010. The fall of the surplus was largely the result of a considerable expansion of the government's investment programme, as well as less buoyant receipts from the hydrocarbon sector, which normally accounts for about two-thirds of fiscal revenues. In addition, following the increases in public sector wage and pensions in each of the last two years, the government implemented a 10 per cent salary increase for all public sector employees in 2010. The unified exchange rate remained stable throughout 2009-10 at TMM 2.85/US$ 1 (after the successful redenomination in January 2009). The central bank engaged in sizeable sterilisation operations to keep foreign exchange inflows from boosting the money supply and creating inflationary pressures. As a result of this tight monetary policy, lower import prices and increased access to foreign exchange, inflation has been comparatively modest at around 5 per cent since 2009.

Economic growth is expected to rise to 11 per cent in 2010 on the back of increased gas exports to China and Iran and robust growth in construction, services, agriculture and public investment. Downside risks are limited and stem mainly from a possible decrease in international demand for gas exports and gas off-take prices.

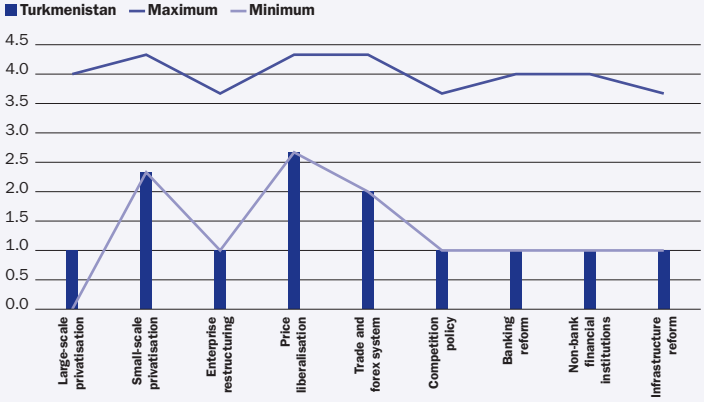
Structural reform

Turkmenistan remains the least reformed of all transition countries and has only started the process of transition in the last two years. The authorities face a large number of fundamental challenges, especially in the financial sector. Despite the important reform of the exchange rate regime, which resulted in the successful reunification and redenomination of the currency, the small state-dominated banking sector severely constrains both the private sector's access to finance as well as the more general aim of diversifying the economy. The establishment of a stabilisation fund and the intensified collaboration with the European Union are important first steps to improving public sector finances,

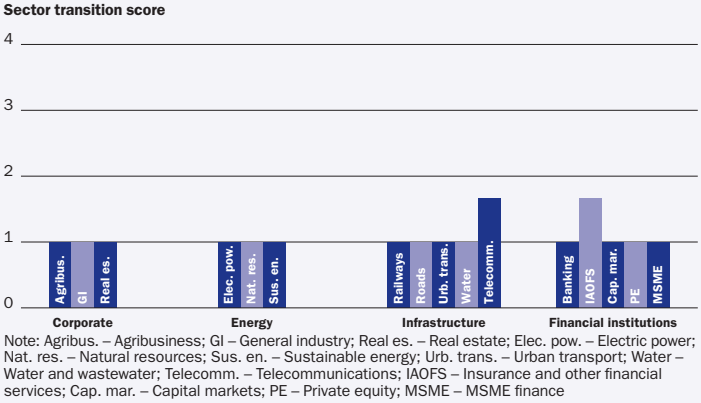
Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	11.6	10.5	6.1	11.0
Inflation (end year)	8.6	8.9	0.2	4.6
Government balance/GDP	3.9	11.3	7.8	2.8
Current account balance/GDP	15.5	18.7	-16.1	-4.7
Net FDI (in million US$)	856	1277	3867	2083
External debt/GDP	2.4	3.2	2.7	na
Gross reserves/GDP	103.7	88.2	102.6	na
Credit to private sector/GDP	1.3	1.2	1.4	na

Transition indicators 2010



2010 sector transition indicators



Note: Agribus. – Agribusiness; GI – General industry; Real es. – Real estate; Elec. pow. – Electric power; Nat. res. – Natural resources; Sus. en. – Sustainable energy; Urb. trans. – Urban transport; Water – Water and wastewater; Telecomm. – Telecommunications; IAOFS – Insurance and other financial services; Cap. mar. – Capital markets; PE – Private equity; MSME – MSME finance

but increased transparency is crucial to providing the correct incentives to attract more investment into the public sector.

Recent developments

In May 2010 the government adopted the National Programme for Socio-Economic Development of Turkmenistan for 2011-30. The Programme envisages diversification of the economy, increased competition and recognises the importance of further market and institutional reforms. For the first time this explicitly includes privatisation of SMEs. Moreover, tenders to privatise some of the country's public companies have been recently launched. In August 2010 the government submitted new draft laws on banking and currency regulation to parliament, aimed at improving the national banking system through the introduction of international reporting standards and increasing the transparency of banking operations.

Following the establishment of the Stabilization Fund of Turkmenistan (SFT) in October 2008, the European Union has commenced an intensive fiscal advisory programme and the first proposals are expected to be published and presented to the legislative bodies towards the end of the year. The reserves of the SFT will help fund medium-term infrastructure investments, although relevant investment rules have yet to be disclosed.

Additional gas export volumes as well as new on- and offshore gas discoveries will allow Turkmenistan to continue to diversify its export routes. The first phase of the new Central Asia-China gas pipeline came on-stream in December 2009 and is currently delivering 10 billion cubic metres (bcm) on an annualised basis, projected to increase to 15 bcm by the end of the year. The second phase of the pipeline is under construction and by the end of 2011 the total capacity for potential gas exports to China should be around 30 to 40 bcm.

New onshore gas discoveries and changes in the foreign investment law have led to a significant increase in FDI since 2009, mainly into the hydrocarbon sector. In December 2009 the authorities signed a production sharing agreement (PSA) with a Chinese–South–Korean–United Arab Emirates (UAE) consortium to develop Turkmenistan's substantial South Yolotan field. RWE of Germany was granted exploration rights in a licence block in the Caspian Sea and has started seismic surveys and the drilling of an exploration well. More recently, the government has intensified its effort to diversify gas export routes by actively engaging in discussions about the Nabucco pipeline project with the OMV-led consortium. Discussions about a gas pipeline project linking Turkmenistan, Afghanistan, Pakistan and India (TAPI) were also revived in July 2010, having remained largely dormant since 2008.

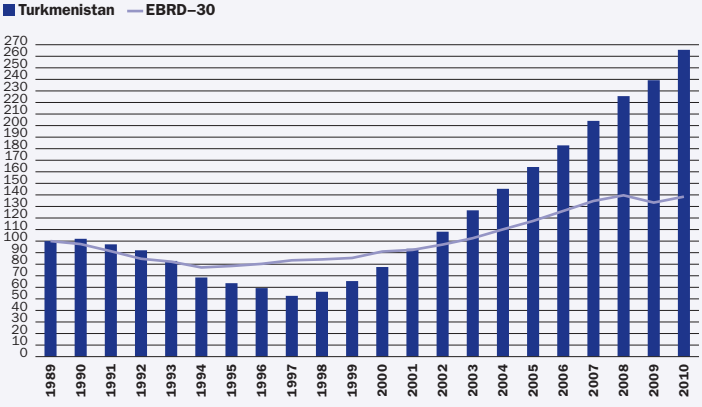
Construction of the country's largest pipeline, East–West, was launched in May 2010. The new pipeline will run for 1,000 km across the territory of Turkmenistan and will create a unified gas supply system. Turkmenistan has also started to diversify its oil exports (which accounted for about one third of the total hydrocarbon exports in 2009) and has begun pumping up to 40,000 barrels per day through the Baku–Tbilisi–Ceyhan (BTC) pipeline. Oil from Turkmenistan currently accounts for 4-5 per cent of the total amount of oil pumped through the BTC pipeline.

Several international power companies have finalised an agreement for a US$ 3 billion project investment to upgrade Turkmenistan's power grid. The project will be implemented in several stages and is unlikely to be completed before 2020. In conjunction with a project to upgrade Balkanbat, the country's largest power plant, power generation capacity is expected to triple by 2020.

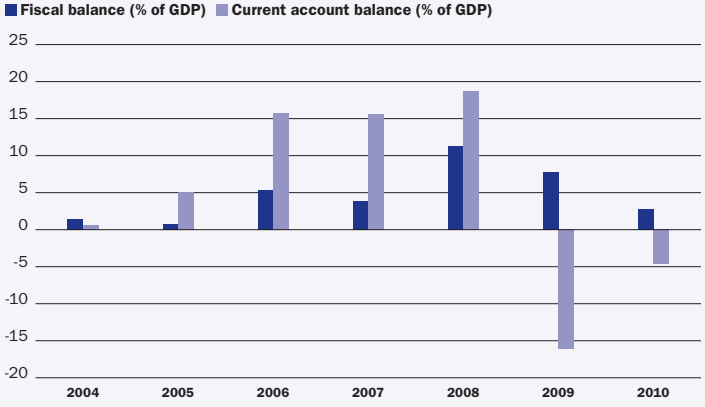
Structural reform priorities

- The main reform priority is to improve the business and investment climate to attract more FDI to contribute to diversifying the economy. Further measures are required to reduce administrative burdens and simplify registration and licensing procedures for private enterprises.
- Efforts are needed to increase the private sector share in the banking sector. It remains state-dominated and is characterised by state-directed lending. The ongoing reform of the banking law will contribute to better access to credit, which is crucial for the SME sector as it currently lacks the necessary access to credit to grow. The entry of a private microfinance provider could help to address this issue.
- A number of sectors of the economy remain distorted by production targets and subsidised inputs that hamper their productivity and effective use of resources. The removal of these targets and subsidies would level the playing field and ultimately help lead to more sustainable growth.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Ukraine

Key developments and challenges

Stabilising the public finances is the key economic policy priority. If this objective is combined with much-needed improvements to the institutional environment and more efficient investments in infrastructure, it should help the economy to attain a more sustainable growth path.

The authorities have embarked on reforms to the gas sector to strengthen the sector's security and sustainability. In addition to raising domestic gas prices to import parity levels, the state-owned energy company, Naftogaz, should be restructured and corporatised to strengthen its financial viability, support competition and help raise additional finance to modernise the gas transit system.

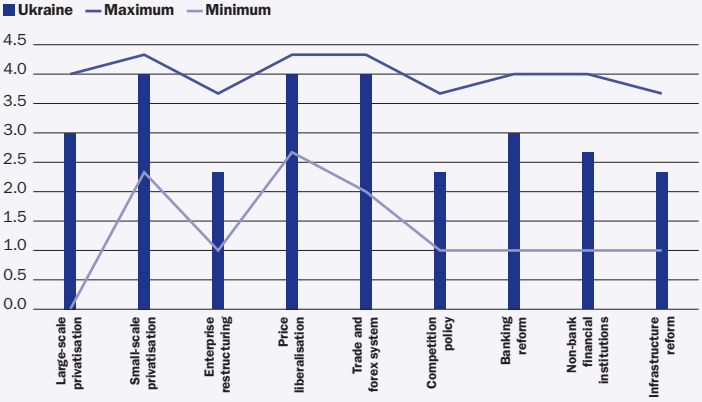
Now that the banking sector has achieved greater stability after the crisis, financial sector reforms should focus on further consolidation as well as improving the transparency of the sector, unwinding state participation in the nationalised banks and developing local capital markets.

Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	7.9	2.1	-15.1	5.0
Inflation (end year)	16.6	22.3	12.3	15.0
Government balance/GDP	-2.0	-3.2	-11.3	-9.9
Current account balance/GDP	-4.1	-7.1	-1.6	-0.9
Net FDI (in million US$)	9218	9903	4654	5000
External debt/GDP	56.0	56.4	88.0	na
Gross reserves/GDP	22.3	17.1	21.8	na
Credit to private sector/GDP	58.4	76.2	76.9	na

Note: [1] Overall government balance includes Naftogaz and other debt-creating flows.

Transition indicators 2010



Macroeconomic performance

Ukraine's economy underwent a very sharp adjustment in 2009 as output contracted by 15 per cent. A collapse in demand for metals and chemicals together with a rise in gas import prices constrained the positive contribution of net exports to growth, which turned positive during the crisis. Domestic demand suffered from the reversal of external capital flows as well as banking sector instability and de-leveraging. After losing almost half of its value, in 2009 the hryvnia was *de facto* re-pegged to the US dollar and supported through the crisis by selective central bank interventions and exchange control measures. The public sector balance sheet deteriorated rapidly as the authorities increased spending to cushion the impact of the crisis. In 2009 the overall deficit of the general government, including recapitalisation of failed and state-owned banks and the balance of the national gas monopoly, reached 11.3 per cent of GDP.

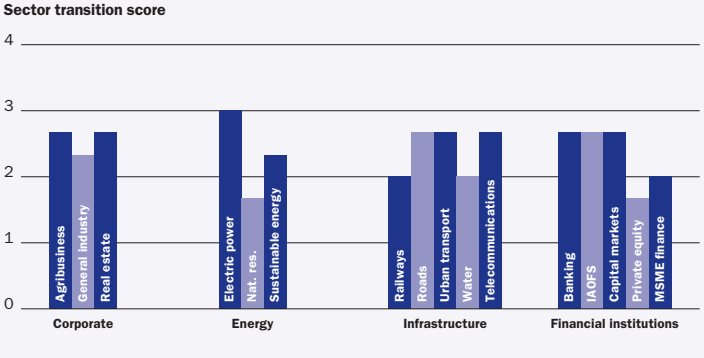
The economic situation has improved more recently: in the first half of 2010 industrial output grew by 11.0 per cent and GDP by 5.5 per cent year-on-year. Investor confidence recovered following the February 2010 presidential elections and especially after the authorities reached agreement with the International Monetary Fund (IMF) on a new medium-term arrangement in July 2010. Yields on public sector debt declined, the stock market has boomed and the central bank has been able to replenish foreign exchange reserves. However, competitiveness gains from the 2008 devaluation have proven short-lived as the annual rate of inflation has remained high at 8.3 per cent as of August 2010.

The process of recovery is expected to be slow. GDP is expected to grow by around 5 per cent in 2010, largely due to the base effects of the post-crisis rebound, as well as recent stabilisation of the market sentiment. The strengthening of the independence and accountability of the National Bank of Ukraine (NBU) and the setting of price stability as its primary objective, once credibly implemented, should help bring down inflation over time. However, downside risks remain considerable and partly reflect uncertainties about the authorities' ability to deliver on commitments under the IMF-supported programme. Domestic consumption and investment are expected to remain weak as households adjust to lower real incomes and corporations improve their balance sheets. Public debt is increasing rapidly, although access to capital markets has recently improved.

Structural reform

Ukraine continues to face significant institutional and structural reform challenges across the board. Despite recent improvements,

2010 sector transition indicators



Note: Nat. res. – Natural resources; Water – Water and wastewater; IAOFS – Insurance and other financial services

Ukraine ranks low among its international peers in global surveys of business environment and governance. Significant hurdles remain in the areas of competition policy, setting up new businesses and bankruptcy procedures, while business governance standards remain weak. Businesses face difficulties when accessing land, which remains largely non-tradeable. Sector-specific transition gaps also tend to be large. However, the authorities' reform agenda, unveiled in June 2010, includes a comprehensive action plan in all key structural areas and, if implemented, should help institutional and infrastructure reforms over the medium term.

Recent developments

At the end of 2009 several laws were amended to improve the business climate in Ukraine. Minimum capital requirements to set up a new corporation were reduced; the validity of business licenses was extended, in some cases indefinitely; the presumption of regulatory consent was established within a limited period after receipt of relevant applications; and a one-year moratorium on inspections of small enterprises was introduced. Legislation on public-private partnerships (PPPs), promulgated in July 2010, is intended to help engage the private sector in the much-needed improvement of municipal and other physical infrastructure.

Business confidence was negatively affected by the protracted process of settling large VAT refund arrears accumulated during the crisis. The arrears, which exceeded 2 per cent of GDP in mid-2010, seriously affected cash flows and financial viability of many exporters, before much of their stock was securitised at submarket terms. The government also made a public commitment to eliminate the arrears by the end of 2010.

With greater stability having been attained in the financial system, the authorities unwound some of the crisis-related foreign exchange controls introduced in 2009. In April 2010 the parliament reversed the restrictions on early repayment of foreign loans and abolished mandatory foreign investment registration requirements. In June 2010 the turnover tax on foreign exchange transactions was suspended.

The authorities have started to implement some of the much-needed reforms in the gas sector. In line with the joint European Union-Ukraine 2009 Brussels declaration on the modernisation of Ukraine's gas transit system, in July 2010 the parliament approved a new gas law intended to support competition, transparency and promote greater efficiency in the sector and pave the way for Ukraine to join the European Energy Community. In the summer of 2010, gas prices paid by enterprises were aligned with import parity prices and the prices paid by households and utilities were increased by 50 per cent. However, financial viability of Naftogaz continues to be hampered by its poor corporate governance and cross-subsidisation among the main business lines.

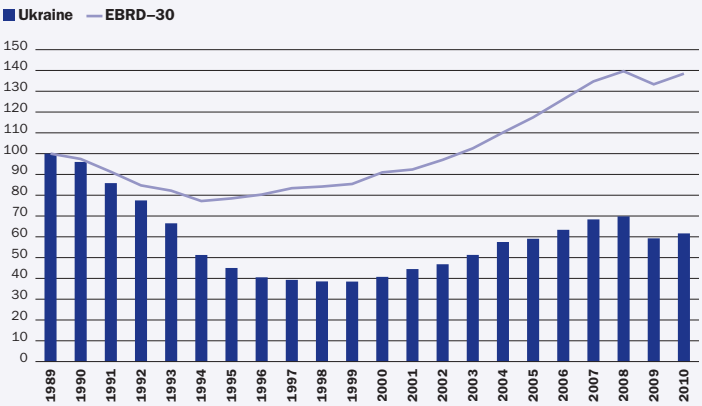
The new procurement law, approved in June 2010, should help improve the efficiency of capital expenditures in the public sector. A law establishing an independent utility regulator was passed in July 2010 and the regulator is expected to be functional by the end of 2010.

The authorities have adopted policies to strengthen the financial sector after the crisis. In April 2010 the central bank completed a new round of diagnostic studies of all banks with a view to improving systemic stability and capitalisation. Owners of banks suffering from capital shortfalls (together controlling around two-thirds of the system's assets) are required to inject new capital into the banks by the end of 2010. The amount of additional capital they are required to provide is the equivalent of around 5 per cent of GDP. Approximately one-third of this amount will be provided by the government to recapitalise state-controlled banks, including those banks nationalised during the crisis.

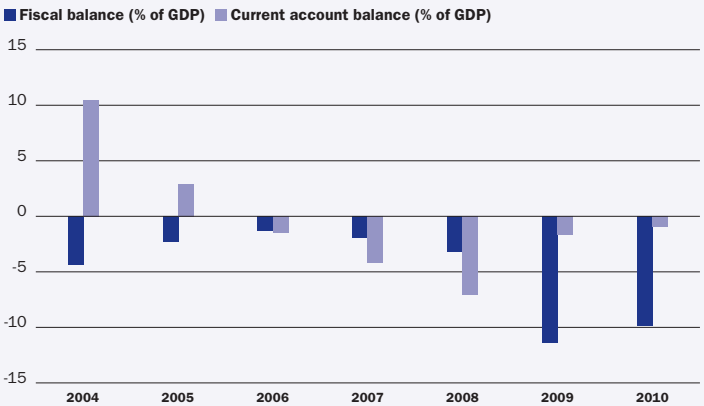
Structural reform priorities

- Priorities to improve the business environment include the establishment of fair conflict resolution procedures including political checks and balances, honest courts and public administration, the resolution of long-standing problems with land ownership and use rights and the avoidance of policies that could be perceived as unfair by investors.
- Following the decision to raise domestic gas prices to import parity levels, the state-owned energy company, Naftogaz, should be restructured and corporatised to strengthen its financial viability, support competition and help raise additional finance to modernise the gas transit system.
- Financial sector reform priorities should focus on consolidating the fragmented financial sector and further improving transparency, developing a strategy for reducing the role of state financial institutions, including by improving management and ultimately divesting nationalised banks and developing local capital markets.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Uzbekistan

Key developments and challenges

To increase competitiveness and growth in the private sector, government intervention needs to be reduced. Policy challenges include reducing discriminatory barriers against imports, liberalising state procurement prices in agriculture and implementing privatisation in a transparent manner.

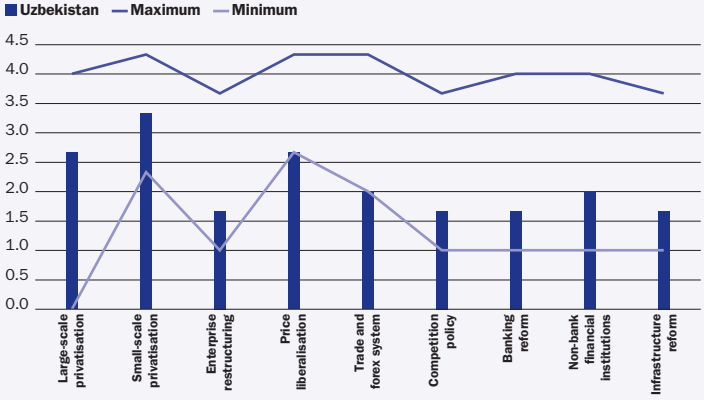
The banking sector has been strengthened through measures on capital requirements for new commercial banks, capital replenishment of state-owned banks and the unification of reserve requirements on foreign and local currency deposits. However, further reforms are needed to reduce the dominance of state-owned banks and the amount of direct lending.

Though the anti-crisis stimulus package has been successful, the focus on maintaining real exchange rate stability has contributed to an increased wedge between the official and black market rate, increasing the costs for importers and adding to a greater currency risk for all traders. Providing equal and ready access to foreign currency to the private sector remains a crucial policy challenge.

Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	9.5	9.0	8.1	8.2
Inflation (end year)	11.9	14.4	10.6	12.5
Government balance/GDP	5.3	10.7	3.2	2.2
Current account balance/GDP	7.3	8.7	2.7	3.8
Net FDI (in million US$)	705	711	711	822
External debt/GDP	16.7	13.1	15.3	na
Gross reserves/GDP	23.3	32.5	36.9	na
Credit to private sector/GDP	15.0	15.0	14.6	na

Transition indicators 2010



Macroeconomic performance

The Uzbek economy has remained largely resilient to the global economic crisis and economic contraction among its major trading partners. GDP growth remained robust at 8.1 per cent in 2009. Construction was the best-performing sector, growing by over 30 per cent in 2009, supported by an increase in fixed capital investment. Uzbekistan was, however, affected by weaker external demand as well as subdued remittance inflows from Kazakhstan and Russia. Exports to Uzbekistan's main markets, namely Kazakhstan, Russia and Ukraine, were heavily affected. Exports of machinery were among the worst hit, falling by some 60 per cent. However, this was partially offset by strong global demand for gold and natural gas. As a result of declining export growth and increased imports the current account surplus fell from 8.7 per cent in 2008 to 2.7 per cent in 2009. Inflation has been slowly declining since 2008 with 10.6 per cent at the end of 2009 and only 6.0 per cent for the first half of 2010.

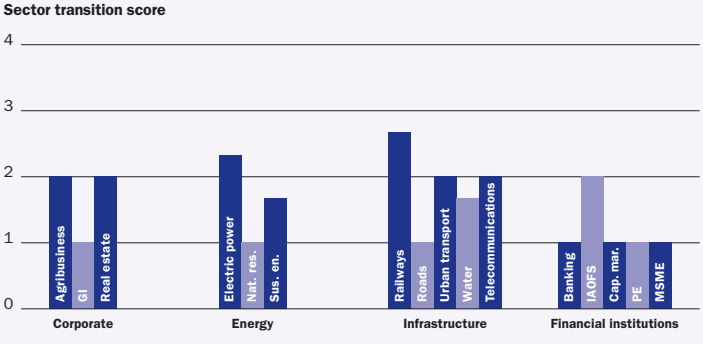
Early in the crisis the government embarked on a substantial fiscal stimulus package equivalent to 4 per cent of GDP. The package included substantial public infrastructure investments, tax reductions for exporters and small and medium-sized enterprises (SMEs), an increase in public sector wages and recapitalisation of commercial banks. The package benefited in 2009-10 from healthy budget revenues and good export performance of gold and natural gas, and was financed through the government budget, state-owned enterprises and the Fund for Reconstruction and Development (FRD), a sovereign wealth fund, established in 2006. The government also increased public sector wages, pensions and social welfare spending in 2010, putting further pressure on the government budget and the FRD. At the beginning of 2010 the government introduced various tax cuts, including a reduction of 1 percentage point in the rates of profit tax and personal income tax. Nevertheless the budget was in surplus in the first half of 2010 with 0.1 per cent of GDP.

The economy is forecast to continue to grow strongly at above 8 per cent again in 2010, with first half-year growth of 8 per cent. The downside risks are limited, but severe underlying weaknesses associated with the many distortions in the economy continue to weaken long-term growth prospects.

Structural reform

Uzbekistan remains at an early stage in its transition towards a market economy and still has a substantial structural reform agenda. The energy sector remains largely unreformed and state-controlled and has only recently embarked on a programme of

2010 sector transition indicators



Note: GI – General industry; Nat. res. – Natural resources; Sus. en. – Sustainable energy; Water – Water and wastewater; IAOFS – Insurance and other financial services; Cap. mar. – Capital markets; PE – Private equity; MSME – MSME finance

efficiency improvements. Tariff reforms were adopted to ensure cost-recovery but lack proper collection mechanisms, payment systems and discipline. Foreign traders continue to experience major market distortions with trade and foreign exchange owing to delays in currency conversion for imports, restrictions on cash and foreign exchange availability, the restrictive trade policy and the continuation of state procurement quotas in cotton and wheat.

Recent developments

Uzbekistan continued with its extensive public sector investment package as part of the anti-crisis plan, which was adopted at the end of 2008. This included recapitalisation of commercial banks as well as a commitment to provide around US$ 250 million to recapitalise five state-owned banks. Further measures have included an increase in public infrastructure development and tax exemptions to support exporting industries and SMEs.

The first free industrial economic zone (in the Navoi region) that was established in December 2008 provides preferential tax and customs facilities for foreign investors, depending on their size of investment. By mid-2010 the government had signed over 37 investment agreements with various foreign investors amounting to more than US$ 500 million.

Public utilities have undergone significant reforms in Uzbekistan. The municipal companies that are providing the utilities are now nearly all financially self-sufficient. The installation of modern water and gas meters has proceeded so that over 97 per cent of all apartments that have access to gas now have modern meters, allowing for more effective monitoring. Electricity tariffs have been at cost-recovery levels since 2005, and gas and water tariffs are being steadily raised to meet their own cost recovery levels. These increases contributed to a rise in the average overall tariff for all public utilities of 6 per cent in 2009.

Inflows of foreign direct investment (FDI) continued to increase in 2009-10 to just over US$ 710 million, although remain mainly concentrated in the energy sector. Much of the recent interest in investment opportunities has come from Chinese and Russian gas and petroleum joint ventures. The China National Petroleum Corporation (CNPC), which is developing the Mingbulak oilfield in eastern Uzbekistan, has increased its investment plans to US$ 212 million over the next four years to cover the costs of further exploration and development. In June 2010 Uzbekneftegaz (UNG) and CNPC reached an agreement regarding the export of 10 billion cubic metres of gas from Uzbekistan to China. The agreement is an important part of the government's aim to identify new markets for Uzbekistan's energy exports.

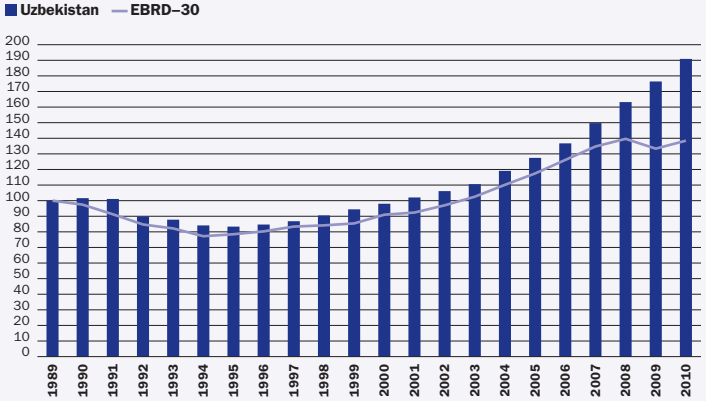
The Asian Development Bank has recently signed an agreement with the government to support the development, construction and management of a regional highway network from Uzbekistan to its neighbouring Central Asian republics. The agreement provides for a series of loans worth US$ 600 million over 10 years. These will be used to upgrade Uzbekistan's outdated road system, including the improvement of road asset management and the construction of training facilities.

The crisis response policies aimed at recapitalising the banking system have led to an increase of the banking system capital of around 44.5 per cent and an increase in banking assets by 34.3 per cent in the first half of 2010 compared with the same period last year. During the same period, the number of registered small enterprises has increased by 3.7 per cent following the introduction of government support measures for small businesses, while the volume of credit to small enterprises and private entrepreneurs has increased by 50 per cent.

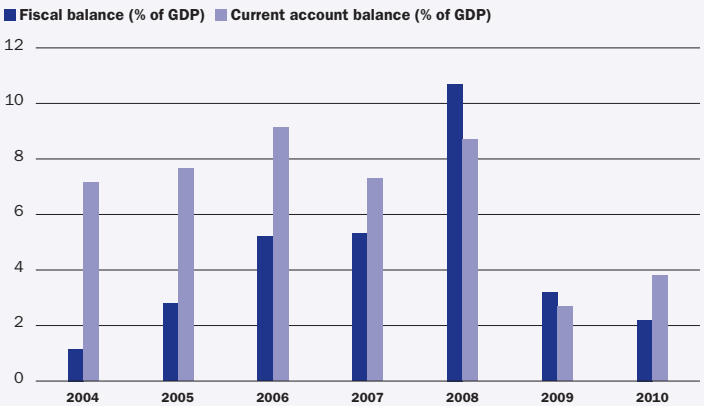
Structural reform priorities

- The improvement of the business environment is crucial for sustained and diversified economic growth. The immediate priorities are to reduce the high transaction costs incurred by business, especially micro, small and medium-sized enterprises (MSMEs), due to the lengthy period for currency conversion for imports, the restricted access to cash and bureaucratic red tape.
- The privatisation programme is proceeding slowly. It is probable inflows of FDI would be stronger if the state ceased to sponsor new joint ventures in which it will retain stakes of 50 per cent or more.
- In the financial sector, institutions could be strengthened through the removal of non-core functions from commercial banks such as tax collection and the elimination of policies to ensure that credit is only allocated on a fully commercial basis. Other important reforms include the advancement of credit and risk management skills and strengthening the supervisory capacity of the regulator.

Real GDP (1989 = 100)



Fiscal balance and current account balance



Methodological Notes

The transition indicator scores in Chapter 1 reflect the judgement of the EBRD's Office of the Chief Economist about country-specific progress in transition.

The scores 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 energy and infrastructure components for which scores are available in previous years (see the sectors with an asterix next to them in 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-.

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.

Sectoral transition scores

The sectoral transition scores reflect the judgements of the EBRD's Office of the Chief Economist about progress in transition by sector and the size of the remaining transition "gap" or challenges ahead. The scores range from 1 to 4+ and are based on an assessment of the size of the challenges in two components: market structure and market-supporting institutions and policies. The scoring for the components is based on either publicly available data or observable characteristics of market structure and institutions. Based on the results of this scoring exercise, remaining transition gaps for market structure and institutions were classified as either "negligible", "small", "medium" or "large". The final numerical score is based on these gap ratings as well as the underlying information, guided by the ranges defined in the table below for those cases where the two component assessments are the same (see the discussion on page 5 in Chapter 1 for more details).

Table M.1.1.1
Transition cut-off points

Cut-off points

Transition gaps (MS/MI)	Potential scores
Large/Large	from 1 to 2+
Medium/Medium	from 2+ to 3+
Small/Small	from 3+ to 4
Negligible/Negligible	4+

The tables below show for each sector the weighting attached to the two components (market structure and market-supporting institutions and policies), the criteria used in each case (and the associated weights), and the indicators and data sources that fed into the final assessments. For the corporate and financial sectors, the exact sources are listed in the tables. The assessment of remaining transition challenges in the energy sectors is based on cross-country factual data and information on the energy sector (oil, gas, mining, electric power) in the EBRD's countries of operations, including from external agencies (International Energy Agency, EC Progress Reports on accession countries, Business Monitor International sector reports, Energy Regulators Regional Association, and so on). For infrastructure sectors, the assessment relied both on quantitative indicators (for example, cost recovery tariffs based on information from EBRD projects) and qualitative assessments of the less quantifiable measures, such as the relations between municipalities and their utilities. Sources encompassed in-house information from investment projects and cross-country data and assessments from several external agencies (including the World Bank, the European Commission and the OECD).

Corporates

Table M.1.2.1
Rating transition challenges in the agribusiness sector

Components	Criteria	Indicators
Market structure [50%]	Liberalisation of prices and trade [15%]	Price liberalisation (EBRD *Transition Report*, 2009) Forex and trade liberalisation (EBRD *Transition Report*, 2009) Producer price of wheat in USD per tonne (Food and Agricultural Organization (FAO), PriceSTAT, 2007) Simple average MFN applied imports tariffs on agricultural products (WTO, 2008) NRAs to agriculture in per cent (World Bank distortions, 2004-07) WTO membership (WTO)
	Development of private and competitive agribusiness [40%]	Wheat yields per ha (FAO ProdSTAT, 2008) Independent grocery retail sales in per cent of total grocery retail (BMI, 2008) Mass grocery retail sales in per cent of total grocery retail (BMI, Food and Drink, 2008) Small-scale privatisation (EBRD *Transition Report*, 2009) EBRD enterprise reform indicator (EBRD *Transition Report*, 2009)
	Development of related infrastructure [25%]	EBRD railways infrastructure (EBRD *Transition Report*, 2009) EBRD road infrastructure (EBRD *Transition Report*, 2009) Tractors in use per 100 inhabitants (FAO, 2007) Ratio of producer price over world wheat price (FAO PriceSTAT, 2007)
	Development of skills [20%]	Ratio of a percentage of tertiary graduates in agriculture over a percentage of agricultural share in GDP (UNESCO 2007, own calculations) Value-added per worker in 2005 in constant USD (World Bank World Development Indicators Database, 2009)
Market-supporting institutions and policies [50%]	Legal framework for land ownership, exchanges and pledges [40%]	Tradeability of land (EBRD *Transition Report*, 2009) Warehouse receipt programmes (FAO Investment Centre WP, 2009) Building a warehouse – dealing with construction permits (World Bank *Doing Business*, 2010) Registering property (World Bank *Doing Business*, 2010) EBRD Business Environment and Competition (EBRD *Transition Report*, 2009)
	Enforcement of traceability of produce, quality control and hygiene standards [40%]	Overall TC 34 (www.iso.ch, 2009) Quality index based on average of TC34/SC4, TC34/SC5 and TC34/SC6 (www.iso.ch, 2009) Extent of Disclosure Index (World Bank *Doing Business*, 2010) Extent of Director Liability Index (World Bank *Doing Business*, 2010) Strength of Investor Protection Index (World Bank *Doing Business*, 2010)
	Creation of functioning rural financing systems [20%]	Ratio of percentage of lending to agriculture/relative to percentage of agricultural share in GDP (own calculations)

Source: EBRD.

Table M.1.2.2
Rating transition challenges in the general industry sector

Components	Criteria	Indicators
Market structure [60%]	Market determined prices [20%]	Price liberalisation (EBRD *Transition Report*, 2009) Subsidies in % of GDP (CEIC database, 2008) Energy intensity (World Bank Databank, 2007)
	Competitive business environment [40%]	MFN trade weighted tariff (World Bank World Trade Indicators, 2009/2010) Lerner index (EBRD calculation from UNIDO dataset, 2007) Large scale privatisation (EBRD *Transition Report*, 2009)
	Productivity and efficiency [40%]	Expenditures on R&D in % of GDP (UNESCO 2007) Value-added, manufacturing, per employee (UNIDO 2006 and CEIC Database 2007) Knowledge economy index (World Bank, 2009)
Market-supporting institutions and policies [40%]	Facilitation of market entry and exit [40%]	Starting a business (World Bank *Doing Business*, 2010) Closing a business (World Bank *Doing Business*, 2010) Percentage of firms identifying permits and licenses as major constraint (EBRD and World Bank, 2005-09)
	Enforcement of competition policy [30%]	Competition index (EBRD *Transition Report*, 2009)
	Corporate governance and business standards [30%]	Composite country law index (EBRD Legal Transition Team 2010) New ISO 9001 and ISO 14001 registrations/number of firms (ISO Survey 2008)

Source: EBRD.

Table M.1.2.3
Rating transition challenges in the real estate sector

Components	Criteria	Indicators
Market structure [50%]	Sufficient supply of quality assets in all sub-segments (warehouse/office/retail) [40%]	Class A industry supply per capita (Colliers, DTZ, King Sturge, CB Richards Ellis, Jones Lang LaSalle) Modern office space per capita (Colliers, DTZ, King Sturge, CB Richards Ellis, Jones Lang LaSalle) Prime retail space per capita (Colliers, DTZ, King Sturge, CB Richards Ellis, Jones Lang LaSalle)
	Availability of property-related financing [30%]	Construction share in GDP (EBRD, latest available year) Residential mortgage debt (EBRD, EMF Hypostat, latest available year) Availability (tenor) of construction debt finance (EBRD Syndications dataset)
	Market saturation and penetration of innovative construction technologies [30%]	Market saturation index (EBRD, 2010) Index on penetration of innovative construction technologies (EBRD, 2010)
Market-supporting institutions and policies [50%]	Tradeability and accessibility of land [20%]	Tradeability of land (EBRD *Transition Report*, 2009) Access to land (BEEPS, 2008)
	Development of an adequate legal framework for property development [50%]	Quality of primary legislation in the property sector (EBRD, 2010) Quality of secondary legislation in the property sector (EBRD, 2010) Mortgage market legal efficiency indicators (EBRD Legal Transition Team)
	Presence and effectiveness of energy efficiency support mechanisms [10%]	Sustainability of government support mechanisms (EBRD, 2010)
	Adequacy of property-related business environment [20%]	Registering property (World Bank *Doing Business*, 2010) Dealing with construction permits (World Bank *Doing Business*, 2010)

Source: EBRD.

Energy

Table M.1.3.1
Rating transition challenges in the electric power sector

Components	Criteria	Indicators
Market structure [40%]	Restructuring through institutional separation, unbundling and corporatisation [40%]	Extent of corporatisation (setting up of joint stock companies, improved operational and financial performance) Extent of legal unbundling of generation, transmission, distribution and supply/retail Extent of financial unbundling of generation, transmission, distribution and supply/retail Extent of operational unbundling of generation, transmission, distribution and supply/retail
	Private sector participation [20%]	Degree of private sector participation in generation and/or distribution
	Competition and liberalisation [40%]	Degree of liberalisation of the sector (third party access to network on transparent and non-discriminatory grounds) Ability of end-consumers to freely choose their provider Degree of effective competition in generation and distribution
Market-supporting institutions and policies [60%]	Tariff reform [40%]	Presence of cost-reflective domestic tariffs Existence of cross-subsidisation among consumers Degree of payment discipline as measured by collection rates and payment arrears
	Development of an adequate legal framework [20%]	Energy law in place to support full-scale restructuring of the sector and setting up of a regulator Quality of taxation and licensing regime Existence and relative strength of the regulatory framework for renewables
	Establishment of an independent energy regulator [40%]	Degree of financial and operational independence of the regulator Level of standards of accountability and transparency

Source: EBRD.

Table M.1.3.2
Rating transition challenges in the natural resources sector

Components	Criteria	Indicators
Market structure [40%]	Restructuring through institutional separation and corporatisation [40%]	Degree of unbundling of different business lines into separate legal entities (joint-stock companies) Existence of separate financial accounts for different lines of businesses Extent of unbundling of different business lines into separate legal entities Extent of measures adopted to improve operational and financial performance Degree of transparency and corporate governance
	Private sector participation [20%]	Degree of private sector participation in upstream and/or downstream/supply
	Competition and liberalisation [40%]	Degree of liberalisation of the sector (third party access to network) Ability of end-consumers to freely choose their provider Degree of effective competition in upstream/extraction, supply and retail
Market-supporting institutions and policies [60%]	Tariff reform [40%]	Presence of cost-reflective domestic tariffs Existence of cross-subsidisation among consumers Degree of payment discipline as measured by collection rates and payment arrears
	Development of an adequate legal framework [20%]	Energy law in place to support full-scale restructuring of the sector and setting up of a regulator Quality of taxation and licensing regime Extent of transparency and accountability on revenues from extractive industries and management of the oil stabilisation fund, EITI/PWYP compliance
	Establishment of an independent energy regulator [40%]	Degree of financial and operational independence of the regulator Level of standards of accountability and transparency

Source: EBRD.

Table M.1.3.3
Rating transition challenges in the sustainable energy sector: energy efficiency (EE), renewable energy (RE) and climate change (CC)

Components	Criteria	Indicators
Market structure [67%]	Market incentives [50%]	Quality of energy pricing: end-user cost-reflective electricity tariffs Level of enforcement of pricing policies: collection rates and electricity bills Amount of wastage: transmission and distribution losses Quality of tariff support mechanisms for renewables (tradeable green certificate schemes /feed-in tariffs/no support) Presence of carbon taxes or emissions trading mechanisms
	Outcomes [50%]	Level of energy intensity Level of carbon intensity Share of electricity generated from renewable sources
Market-supporting institutions and policies [33%]	Laws [25%]	Index on laws on the books related to EE and RE (such as those that support renewable technologies, compel minimum standards in various areas of energy use, provide guidance for sectoral targets in terms of energy savings and provide incentives and penalties for achieving desirable targets) Stage of institutional development in implementing the Kyoto Protocol
	Agencies [25%]	Existence of EE agencies or RE associations (autonomous/departments within government) Index on employment, budget and project implementation capacity of agencies Index on functions of agencies: adviser to government, policy drafting, policy implementation and funding for projects
	Policies [25%]	Sustainable energy index: existence, comprehensiveness and specific targets of policies on SE Renewable energy index: existence of specific sectoral regulations for RE (renewables obligation, licensing for green generators, priority access to the grid) Climate Change Index: existence of policies (emissions targets and allocation plans)
	Projects [25%]	Index on project implementation capacity in EE, CC and RE Number of projects in EE, CC and RE Expenditure data on projects in EE, CC and RE

Source: EBRD.

Infrastructure

Table M.1.4.1
Rating transition challenges in the railways sector

Components	Criteria	Indicators
Market structure [55%]	Restructuring through institutional separation and unbundling [40%]	Extent of corporatisation of railways Extent of unbundling of different business lines (freight and passenger operations) Extent of divestment of ancillary activities
	Private sector participation [40%]	Number of new private operators Extent of privatisation of freight operations and ancillary services
	Competition and liberalisation of network access [20%]	Extent of liberalisation of network access according to non-discriminatory principles Number of awards of licences to the private sector to operate services
Market-supporting institutions and policies [45%]	Tariff reform [50%]	Extent of freight tariff liberalisation Extent of introduction of public services obligations (PSO)
	Development of an adequate legal framework [25%]	Presence of railways strategy and railways act
	Development of the regulatory framework [25%]	Establishment of a railway regulator to regulate the network access according to non-discriminatory principles Degree of independence of the regulator and level of accountability and transparency standards Level of technical capacity of the regulator to set retail tariffs and regulate access to the track

Source: EBRD.

Table M.1.4.2
Rating transition challenges in the roads sector

Components	Criteria	Indicators
Market structure [55%]	Restructuring through institutional separation and unbundling [40%]	Degree of independence of the road management from the Ministry Extent of divestment of construction from road maintenance, engineering and design activities
	Private sector participation [40%]	Extent of private sector companies in construction and maintenance (BOT-type concessions, management or service contracts, other types of public-private partnerships (PPPs))
	Competition and liberalisation of network access [20%]	Index on rules for open tendering of construction and maintenance contracts Index on practices for open tendering of construction and maintenance contracts
Market-supporting institutions and policies [45%]	Tariff reform [50%]	Level of road maintenance expenditures (that is, it should be sufficient to maintain the quality of state roads and motorways) Introduction of road user charges based on vehicles and fuel taxes Level of road user charges (that is, it should be sufficient to cover both operational and capital costs in full) Comprehensiveness index of road user charges (extent of accordance with road use, extent of incorporation of negative externalities, and so on)
	Development of an adequate legal framework [25%]	Extent and quality of PPP legislation Existence of road act
	Development of the regulatory framework [25%]	Creation of a road agency Index of road agency effectiveness (decision making power, resource allocation, management capacity across road networks)

Source: EBRD.

Table M.1.4.3
Rating transition challenges in the urban transport sector

Components	Criteria	Indicators
Market structure [50%]	Decentralisation and corporatisation [33%]	Extent of decentralisation (that is, transfer of control from the national to the municipal or regional level) Degree of corporatisation of local utilities to ensure financial discipline and improve service levels, including in smaller municipalities
	Commercialisation [33%]	Level of financial performance (no concern for financials/a few financially sound utilities in the country/solid financial performance is widespread) Level of investment financing (only through grants/selective access to commercial finance/widespread access to commercial finance) Level of operational performance: progress in tackling cost control (labour restructuring, energy cost control, reduction of network losses), demand side measures (metering and meter-based billing, e-ticketing), focus on quality of service
	Private sector participation and competition [33%]	Extent of legal framework and institutional capacity for PPP and competition Extent and form of private sector participation
Market-supporting institutions and policies [50%]	Tariff reform [50%]	Degree of tariff levels and setting (cost recovery, tariff methodologies) Existence of cross-subsidisation among consumers
	Contractual, institutional and regulatory development [50%]	Quality of the contractual relations between municipalities and utility operators Degree of regulatory authority capacity and risks of political interference in tariff setting

Source: EBRD.

Table M.1.4.4
Rating transition challenges in the water and wastewater sector

Components	Criteria	Indicators
Market structure [50%]	Decentralisation and corporatisation [33%]	Extent of decentralisation (that is, transfer of control from the national to the municipal or regional level) Degree of corporatisation of local utilities to ensure financial discipline and improve service levels, including in smaller municipalities
	Commercialisation [33%]	Level of financial performance (no concern for financials/a few financially sound utilities in the country/solid financial performance is widespread) Level of investment financing (only through grants/selective access to commercial finance/widespread access to commercial finance) Level of operational performance: progress in tackling cost control (labour restructuring, energy cost control, reduction of network losses), demand-side measures (metering and meter-based billing, e-ticketing), focus on quality of service
	Private sector participation and competition [33%]	Extent of legal framework and institutional capacity for PPP and competition Extent and form of private sector participation
Market-supporting institutions and policies [50%]	Tariff reform [50%]	Degree of tariff levels and setting (cost recovery, tariff methodologies) Existence of cross-subsidisation among consumers
	Contractual, institutional and regulatory development [50%]	Quality of the contractual relations between municipalities and utility operators Degree of regulatory authority capacity and risks of political interference in tariff-setting

Source: EBRD.

Table M.1.4.5
Rating transition challenges in the telecommunications sector

Components	Criteria	Indicators
Market structure [50%]	Competition and private sector involvement: mobile telephony [40%]	Expansion of services to rural areas, proxied by % of population covered by mobile signal (International Telecommunications Union and World Bank, 2009) Mobile penetration rate (International Telecommunications Union, 2009) % of private ownership in the incumbent mobile operator (Business Monitor International *Global Insight*, 2010) Market share of the largest mobile operator (Business Monitor International, BuddeCom via ISI, 2010) Mobile number portability (Business Monitor International, BuddeCom, *Global Insight*, 2010)
	Competition and private sector involvement: fixed telephony [20%]	Fixed-line teledensity (International Telecommunications Union, 2010) % of private ownership in fixed telephony incumbent (Business Monitor International *Global Insight*, 2010) Market share of the fixed telephony incumbent/Presence of alternative operators (Business Monitor International, *Global Insight*, 2010) Fixed number portability (Business Monitor International, *Global Insight*, 2010)
	IT and high-tech markets [40%]	Internet users penetration rates (International Telecommunications Union, 2009) Broadband subscribers penetration rate (International Telecommunications Union, 2009) Piracy rates (Business Software Alliance, 2009) Expenditure on R&D as a percentage of GDP (UNESCO, 2007)
Market-supporting institutions and policies [50%]	Institutional framework assessment [30%]	Regulatory independence (EBRD, Legal Transition Team, 2009) Dispute resolution and appeal (EBRD, Legal Transition Team, 2009)
	Development of the regulatory framework aimed at promoting the emergence of competition within the sector [60%]	Market access assessment (for non-scarce resources) (EBRD, Legal Transition Team, 2009) Operational environment assessment: SMP and safeguards (EBRD, Legal Transition Team, 2009) Operational environment assessment: interconnection and special access (EBRD, Legal Transition Team, 2009)
	Preparedness of the country to develop a knowledge economy [10%]	Knowledge Economy Index (World Bank, 2009)

Source: EBRD.

Financial institutions

Table M.1.5.1
Rating transition challenges in the banking sector

Components	Criteria	Indicators
Market structure [35%]	Degree of competition [33%]	Based on net interest margin, loan-deposit interest spread, overhead cost to assets, and asset share of five largest banks (EBRD Banking Survey, official statistical sources, 2010)
	Ownership [67%]	Asset share of private banks (EBRD Banking Survey, official statistical sources, 2010) Asset share of foreign banks 2009 (subjective discount relative to home/host coordination) (EBRD Banking Survey, 2010 and latest EBRD assessment)
Market-supporting institutions and policies [65%]	Development of adequate legal and regulatory framework [50%]	Existence of entry and exit restrictions (EBRD assessment, latest estimates) Adequate liquidity requirements (EBRD assessment, latest estimates) Other macro prudential measures (EBRD assessment, latest estimates) Supervisory coordination (home-host country) (EBRD assessment, latest estimates) Dynamic counter cyclical provisioning and creating capital buffers by requiring higher capital adequacy ratios in good times (EBRD assessment, latest estimates) Deposit insurance scheme with elements of private funding (EBRD assessment, latest estimates)
	Enforcement of regulatory measures [40 %]	Compliance with Basel Core principles values (FSAP/IMF, EBRD assessment, latest estimates) Currency mismatch index (EBRD Banking Survey 2010, national statistical sources via CEIC, latest estimates) Banking strength – actual risk weighted capital to assets ratio (IMF Global Financial Stability Report 2010, National Sources, latest estimates) Sophistication of banking activities and instruments (EBRD assessment, latest estimates) Deposits to GDP (EBRD Banking Survey, 2010 and latest EBRD assessment)
	Corporate governance and business standards [10%]	Proportion of banks which have good corporate governance practices (EBRD assessment, latest estimates)

Source: EBRD.

Table M.1.5.2
Rating transition challenges in the insurance and other financial services sector

Components	Criteria	Indicators
Market structure [45%]	Market penetration [60%]	Insurance premia (% of GDP) (National Insurance Associations, UBS, World Bank, EBRD, 2008/2009) Leasing portfolio (% of GDP) (Leaseurope, national statistical sources, latest estimates) Availability of insurance products (UBS and own EBRD assessments, latest estimates)
	Private sector involvement [20%]	Share of private insurance funds in total insurance premia (UBS, national authorities, EBRD, latest estimates)
	Development of skills [20%]	Skills in the industry (UBS and own EBRD assessments, latest estimates)
Market-supporting institutions and policies [55%]	Development of adequate legal and regulatory framework [80%]	Existence of private pension funds (Social Security Administration - ISSA, latest estimates) Pillar 2 legislation (Organisation of Economic Co-operation and Development, World Bank, national official sources, EBRD, latest information) Quality of insurance supervision assessment (UBS, EBRD, latest estimates) Legislation leasing (National authorities, International Finance Corporation, EBRD, latest information)
	Business standards [20%]	IAIS member (International Association of Insurance Supervisors- IAIS, 2010)

Source: EBRD.

Table M.1.5.3
Rating transition challenges in the capital markets sector

Components	Criteria	Indicators
Market structure [40%]	Market penetration [35%]	Stock market capitalisation traded annually 2007 (World Bank, Financial Structure Database, 2010)
	Market infrastructure and liquidity (65%)	Money Market Index (EBRD 2010 Survey) Government Bond Index (EBRD 2010 Survey)
Market-supporting institutions and policies [60%]	Development of adequate legal and regulatory framework (100%)	Quality of securities market legislation (EBRD Legal Transition Survey, 2007) Effectiveness of securities market legislation (EBRD Legal Transition Survey, 2007)

Source: EBRD.

Table M.1.5.4
Rating transition challenges in the private equity sector

Components	Criteria	Indicators
Market structure [50%]	Competition [35%]	Effective number of fund managers per thousand companies (EMPEA, Prequin, Mergermarket, and EVCA, latest available)
	Market penetration [65%]	Scope of fund type/strategy (EMPEA, Prequin, Mergermarket and EVCA, latest available) PE capital available for investment as % of GDP (EMPEA, Prequin, Mergermarket and EVCA, latest available) Active capital as % of GDP (EMPEA, Prequin, Mergermarket and EVCA, latest available)
Market-supporting institutions and policies [50%]	Development of adequate legal and regulatory framework [70%]	Barriers to institutional investor participation (EBRD, latest estimates) Quality of securities market legislation (EBRD Legal Transition Survey, 2007) Effectiveness of securities market legislation (EBRD Legal Transition Survey, 2007)
	Corporate governance [30%]	Effective framework (EBRD Corporate Governance Legislation Assessment, 2007) Rights and role of shareholders (EBRD Corporate Governance Legislation Assessment, 2007) Equitable treatment of shareholders (EBRD Corporate Governance Legislation Assessment, 2007) Responsibilities of board (EBRD Corporate Governance Legislation Assessment, 2007) Disclosure and transparency (EBRD Corporate Governance Legislation Assessment, 2007)

Source: EBRD.

Table M.1.5.5
Rating transition challenges in the MSME finance sector

Components	Criteria	Indicators
Market structure [50%]	Market saturation and penetration of MSME financing [20%]	Number of years firms operated without formal registration, (World Bank/EBRD Business Environment and Enterprise Performance Survey, 2008)
	Availability of MSME related financing [80%]	Access to checking/savings accounts (World Bank/EBRD Business Environment and Enterprise Performance Survey, 2008) Access to overdraft facility (World Bank/EBRD Business Environment and Enterprise Performance Survey, 2008) Access to credit loan from financial institution (World Bank/EBRD Business Environment and Enterprise Performance Survey, 2008) Access to finance presents a major/severe obstacle (World Bank/EBRD Business Environment and Enterprise Performance Survey, 2008)
Market-supporting institutions and policies [50%]	Development of adequate legal and regulatory framework [50%]	Registering property (World Bank *Doing Business*, 2010) Getting credit (World Bank *Doing Business*, 2010)
	Business environment [50%]	Closing a business (World Bank *Doing Business*, 2010) Enforcement of contracts (World Bank *Doing Business*, 2010)

Source: EBRD.

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