European Bank
for Reconstruction and Development

TRANSITION REPORT 2012

INTEGRATION ACROSS BORDERS

ABOUT THIS REPORT

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

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 and the southern and eastern Mediterranean. 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 2012.

www.ebrd.com/transitionreport

Country abbreviations

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

Go to **page 80** to see images from around the region

CONTENTS

2 EXECUTIVE SUMMARY

4 FOREWORD

6 CHAPTER 1
PROGRESS IN STRUCTURAL REFORMS

8 Progress in structural reforms
8 Progress in transition
8 Sector transition indicators
11 Country transition indicators
12 Transition challenges in the SEMED region
12 Reform efforts
13 Sector transition indicators
14 Country transition indicators
15 Conclusion
16 Annex 1.1: Sector transition indicators 2012
18 Annex 1.2: Commercial courts in transition

26 CHAPTER 2
TRANSITION REGION IN THE SHADOWS OF THE EUROZONE CRISIS

28 Transition region in the shadows of the eurozone crisis
28 Growth
29 Labour markets
32 Inflation
33 Fiscal developments
34 Trade
35 Capital flows and credit growth
38 Vulnerability of transition economies to their external environment
42 Outlook and risks

44 CHAPTER 3
TOWARDS A PAN-EUROPEAN BANKING ARCHITECTURE

46 Towards a pan-European banking architecture
48 Do foreign banks do more harm than good?
51 Financial integration without institutional integration
53 Would a eurozone-based banking union be good for emerging Europe?
60 Conclusion

62 CHAPTER 4
REGIONAL TRADE INTEGRATION AND EURASIAN ECONOMIC UNION

64 Regional trade integration and Eurasian economic union
64 Customs union and Common Economic Space: an overview
68 Assessment
76 Cross-border value-added chains
76 Regional integration and economic institutions
78 Conclusion

80 IN FOCUS : SELECTED IMAGES FROM AROUND THE REGION

91 COUNTRY ASSESSMENTS

160 METHODOLOGICAL NOTES

168 ACKNOWLEDGEMENTS

EXECUTIVE SUMMARY

CHAPTER 1

The past year has been a difficult one for the transition region as growth weakened and the economic outlook worsened significantly. Nevertheless, there was no wholesale reversal of reforms, and progress has been made in some important areas. Policy-makers generally remain committed to the principles of markets and competition. Trade integration has been enhanced this year by the accession of Montenegro and Russia to the World Trade Organization. However, there is no sign of the major reform drive needed to boost growth rates towards their long-term potential.

A sectoral analysis of reforms and remaining challenges shows that most sectors across the region still face transition gaps that can be characterised as "medium" or "large". The largest gaps are typically in Central Asia and other parts of the former Soviet Union, but significant gaps also remain in the more advanced countries in central and eastern Europe. Over the past year, there have been reform reversals in the energy sector in Bulgaria and Romania, both EU members, and in Kazakhstan, as well as a downgrade in Hungary in the natural resources sector. In all cases, the downgrades reflect growing state interference and a move away from market forces. However, important progress has occurred in other sectors – notably in the financial sector where local capital markets have developed further – as well as in certain transport sectors.

For the first time in the Transition Report, this chapter discusses the reform histories of the southern and eastern Mediterranean (SEMED) countries and considers their current structural and institutional development. The analysis indicates that the region is in "mid-transition"; trade and capital flows in the SEMED region have been predominantly liberalised, and large parts of the economy are in private hands, albeit with important exceptions. However, while reforms carried out over the past two decades have improved the ease of doing business, market structure and institutional reforms need to be accelerated to enhance competitiveness, efficiency and productivity. Subsidies for basic foods and fuels tend to be more pervasive in SEMED distorting markets and placing heavy burdens on state budgets. At the sector level, power and energy stand out as the least reformed areas.

CHAPTER 2

Over the last year the transition region has experienced a significant worsening in the external environment. The *Transition Report 2011* presented a picture of ongoing recovery from the global financial crisis while pointing to risks from the region's exposure to the eurozone. Since then, as the eurozone sovereign debt crisis deteriorated, recovery has stalled in many countries that are particularly integrated with the single currency area. Growth has slowed down as exports and capital inflows declined. Crucially, the region's banks have lost significant external funding as eurozone banks reduced cross-border lending and withdrew financing from their subsidiaries in transition countries. This has depressed credit growth, which in turn contributed to slower output expansion.

An empirical analysis relating growth in transition countries to the fortunes of the eurozone, Russia and the world at large, along with oil prices and volatility in global financial markets, confirms that central and south-eastern Europe is more intertwined with the eurozone and eastern Europe and central Asia with Russia. The analysis also reveals that Ukraine is particularly exposed to developments both in Russia and in the eurozone, while Poland appears to be surprisingly resilient to changes in its external environment.

The outlook for the region continues crucially to be driven by developments in the eurozone crisis and its global repercussions, including its impact on commodity prices. In the baseline forecast, the region will see a substantial slow-down relative to 2011 both in this year and next as a result of the crisis. Central and south-eastern Europe will experience particularly slow growth and some of the countries have entered or will re-enter mild recessions. But countries further east have also already started feeling the impact of the crisis and are likely to grow more slowly as well. Possible further deterioration of the turmoil in the euro area poses the largest risks to already-slower projected growth in the region for 2012 and 2013.

CHAPTER 3

A eurozone-based "banking union" which would create an ECB-led single supervisor and pave the way for the direct recapitalisation of failing banks from the European Stability Mechanism (ESM) is likely to be crucial for making the eurozone more stable. But would it also address the deficiencies of nationally based supervision and resolution of multinational banks which have plagued financially integrated Europe in the last decade? Multinational banks have been a force of financial development and growth, but they have also exacerbated credit booms, adding to the pain of crises – particularly in emerging Europe. The prevention and mitigation of these crises has been complicated by poor coordination and conflicts of interest between the home and host countries of these banks.

Current official banking union proposals address these problems only in part, and may introduce some new complications. Bank resolution would still be handled by national authorities. Apart from continued coordination problems in resolving failing multinational banks, this could lead to moral hazard, since national authorities may not have the incentives to minimise fiscal losses when resources for recapitalising banks are available at the European rather than the national level. Furthermore, non-eurozone members could not access the ESM even if they opt into the single supervisory mechanism, putting the banking systems of these countries at a potential disadvantage.

A number of extensions or modifications to the proposed banking union may alleviate these and related concerns. In the absence of a European resolution authority, cross-border stability groups involving the European Central Bank (ECB) and the authorities of both home and host countries of multinational banks could help improve crisis management and develop burden-sharing models. To assuage concerns that the ECB might not be as concerned about local stability as national supervisors, the latter should be given a strong voice in the governance of the ECB's supervisory function, and retain certain macro-prudential instruments. Lastly, countries receiving ESM support could be required to share banking-related fiscal losses up to a pre-determined level.

Non-eurozone countries that opt into the supervisory mechanism should also have access to the possibility of direct recapitalisation by the ESM. In addition, intermediate options could be considered for European countries that either cannot or do not want to become full members of the banking union. This could include an "associate member status" through which non-eurozone countries would benefit from ECB liquidity support but not from fiscal support, and sharing of supervisory responsibility for multinational groups between the ECB and host country authorities.

CHAPTER 4

At the start of transition many old economic ties within and between countries in the former communist bloc were severed. However, economic fragmentation quickly gave way to the forces of regional integration initiatives, both among transition countries and with new trading partners in the West. One of the latest developments in regional economic integration is the creation of the Common Economic Space of the Eurasian Economic Community. In November 2009 Belarus, Kazakhstan and Russia agreed to establish a customs union. Further steps have since been taken towards deeper economic integration between these countries. New supranational institutions have been created and future geographical expansion of the union is being discussed.

There are many potential benefits of regional integration, including trade creation within the region, facilitation of exports to the rest of the world, more efficient markets across member countries, and an opportunity to build stronger economic institutions. The chapter considers the extent to which these benefits are likely to apply in the new customs union, drawing on early evidence on the impact of the customs union on trade, non-tariff barriers and export structure.

Common external tariffs introduced in 2010 had some impact on regional trade flows but the magnitude of this impact is small. Much of the rapid growth in trade between the three countries is explained by post-crisis recovery trends. The lowering of non-tariff barriers within the customs union also played a role. There is evidence that the benefits from reducing non-tariff barriers and improving cross-border infrastructure are much larger than from changes in tariffs.

The structure of exports from Belarus, Kazakhstan and Russia suggests that regional economic integration has the potential to act as a springboard for exports to the rest of the world. Goods first exported within the regional bloc are likely to later be exported to other destinations. Lastly, the quality of institutions in countries within regional economic blocs tends to converge, either towards the average or towards the higher level, in particular in the case of those blocs with deeper institutional integration. Within the Eurasian Economic Community there is currently little variation in terms of quality of institutions. However, the Community represents an opportunity to create supranational institutions with strong governance that have demonstration effects and could trigger demand for better domestic institutions.

CROSS-BORDER INTEGRATION – AN IMPORTANT RESPONSE TO THE CRISIS

This is the fourth consecutive Transition Report to be written in the shadow of an economic crisis in the transition region. Our 2008 report, dedicated to how growth in the region could be made more sustainable, was written as the storm was brewing. The 2009 report was entirely dedicated to the crisis – its causes, its impact and its possible long-term effects. In 2010, as the region was entering a fragile and uneven recovery, we focused on the post-crisis reform agenda, only to find new clouds gathering in 2011, when our report documented the effects of the 2008-10 crisis on households – both in economic terms and in their attitudes towards markets and democracy.

The nature of the crisis has changed fundamentally since 2008. What started as a banking crisis in a small group of countries has transformed into a sovereign crisis in the eurozone which has in turn weakened European banks and led to a withdrawal of funding from emerging Europe and to some extent from the southern and eastern Mediterranean (referring to Egypt, Jordan, Morocco and Tunisia and covered in full for the first time in this report). Unlike 2008, the new crisis has not hit emerging Europe at the height of an unsustainable boom. External imbalances have decreased and most governments have undertaken significant fiscal adjustment, some involving considerable sacrifice and leading to remarkable results. Yet, as Chapter 2 discusses, the region is still vulnerable, both because of legacies from the previous crisis and pre-crisis periods – high non-performing loans and foreign currency-denominated debt – and its strong dependence on the eurozone. Some of the southern and eastern Mediterranean countries which have experienced popular uprisings have also developed large fiscal deficits and would benefit from adjustment supported from the outside.

Slow-downs are projected in every central European, Baltic, and south-eastern European country and negative or near-zero growth in 2012 is expected in eight out of the 17 countries in this group . Importantly, the slow-down has begun to extend beyond the area most closely integrated with the eurozone, as growth in Russia has begun to decelerate, and with it economic activity in countries that depend on it through remittances and trade. In contrast, some southern and eastern Mediterranean countries are projected to recover somewhat this year as their economies emerge from the economic dislocation associated with political and social turmoil in 2011.

How the region will evolve in 2013 will depend largely on the policy response, both inside the region and particularly outside. An important dimension of this response, and one which will have implications beyond the crisis, is institutional integration: attempts to build stronger supranational institutions and legal frameworks. The foremost such attempt within the eurozone – which by now encompasses three transition countries: Estonia, the Slovak Republic and Slovenia – is the September 2012 "banking union" proposal made by the European Commission at the behest of the European Council. It suggests a single supervisory mechanism for the eurozone, with an "opt in" option for non-eurozone countries, which would potentially allow direct recapitalisation of eurozone banks using funds from the European Stability Mechanism (ESM).

To the extent that the proposed mechanism backstops European sovereigns in their current efforts to resolve failing banks – which was not assured as this report went to press, with some eurozone countries arguing that the proposed backstop should not apply to "legacy debt" – it could prove essential in stopping the ongoing crisis. This would benefit all of Europe, including emerging European countries that are outside the eurozone. At the same time, the proposed plans leave significant gaps and have raised concerns among emerging European countries. One concern is that the single supervisor will pay attention mainly to eurozone-wide stability threats and not sufficiently to financial system soundness for each member country. Another fear is that emerging European countries may become fiscally responsible for crises elsewhere. This is compounded by the fact that the banking union plans would, for the foreseeable future, leave the responsibility for resolving failing banks in national hands. Given that ultimate fiscal responsibility could be eurozone-wide, this creates a potential for moral hazard.

There are also concerns on the side of host countries of eurozone banks that do not expect to join the banking union anytime soon. Among them is a worry that supervisory coordination failures, which marred attempts to control national credit booms before the crisis, will persist when eurozone home supervisors are replaced by a single, powerful home supervisor – the ECB. Another fear is that the banking union would tilt the competitive balance inside the European Union against banks headquartered outside the banking union, as the latter would not be covered by the fiscal safety net provided to banking union members.

CROSS-BORDER "STABILITY GROUPS"

We argue in this report that it is possible to address both sets of concerns. A move towards supranational resolution mechanisms remains essential over the medium term, but if it cannot be achieved in the short term, the current proposal can be improved by other means. Moral hazard could be addressed by requiring countries receiving ESM fiscal support to share banking-related fiscal losses up to a pre-determined level. Coordination gaps can be reduced by cross-border "stability groups" that include home and host country authorities (including Ministries of Finance), the ECB and the European Banking Authority (EBA). These could draw up plans on how failing cross-border banks would be resolved. The governance structure of the single supervisory mechanism can

and should be designed to give sufficient voice to smaller member countries. Lastly, non-eurozone countries that opt into the single supervisory mechanism should also be allowed to opt into the ESM. Apart from full membership, intermediate options could also be considered which would extend some but not all benefits and obligations of membership to all financially integrated European countries – including countries outside the European Union (EU).

While the EU is focused on the institutions that manage financial integration, a different sort of institutional integration is unfolding further east. In November 2009 Belarus, Kazakhstan and Russia agreed to establish the Eurasian Economic Community (EEC), reinforcing the customs union between the three countries from 1999. A common external tariff was introduced in 2010, and further steps, including new supranational institutions, have since been taken. Initial concerns that the customs union would slow down, even prevent, Russia's World Trade Organization (WTO) accession turned out to be exaggerated; as it finally joined the organisation in August 2012 after 18 years of negotiations. Yet, important questions remain as to whether the customs union will facilitate or hinder the further integration of its members into the global economy. We present an early assessment of the arrangement, focusing on changes in tariff and non-tariff barriers, trade patterns and the geographical structure of exports.

Although the main rationale for the EEC was not the crisis but rather long-term economic and institutional benefits, we find evidence that its introduction helped the post-2009 recovery of trade in the three member countries. The driving force behind this was not so much the change in tariffs as the removal of non-tariff barriers such as trade regulations and customs. The report also presents evidence that suggests many of the non-tariff benefits of the arrangement may still lie ahead: for example, by helping to coordinate better cross-border infrastructure.

REGIONAL INTEGRATION

Perhaps most encouragingly, the report presents evidence that regional integration can act as a springboard for exports. Higher-value-added goods that are initially exported within the customs union can subsequently be exported elsewhere. Export patterns currently observed for Belarus and Russia suggest that this effect may already be at work. This means, for example, that the customs union might help Russia diversify its export structure away from natural resources. It might also help improve economic institutions in its member countries, although this will be challenging. International evidence suggests that customs union membership can enhance the institutions of its weaker members, but within the Eurasian Economic Community there is currently little variation in terms of institutional quality. However, it is possible that supranational institutions with strong governance at the level of the Community could trigger improvement in domestic institutions.

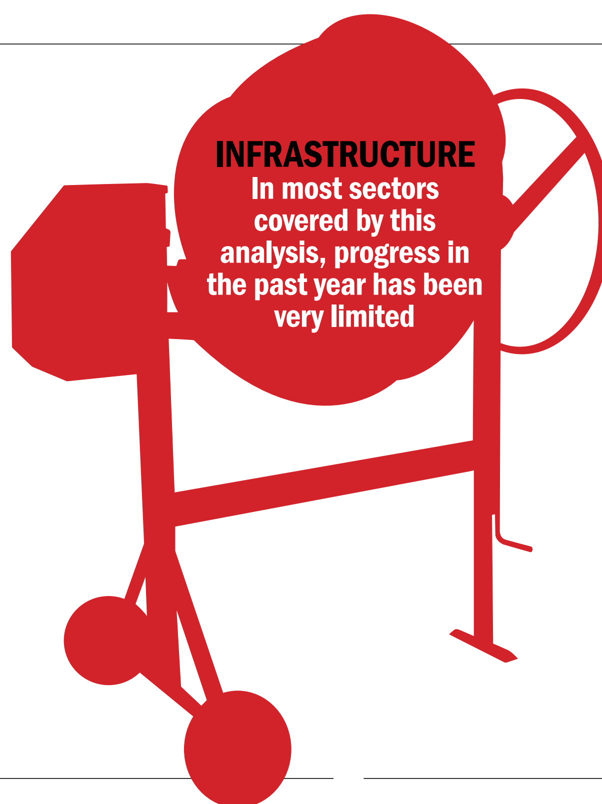
Many transition countries may go into a second dip of the crisis, with uncertain prospects of recovery. The outlook in the southern and eastern Mediterranean region, where countries are struggling with their respective political and economic transformations, is similarly unsettled. At the same time, the cliché that crisis breeds opportunity seems to hold some truth particularly when it comes to the new integration efforts. This is true in the east, where both institutional integration and actual economic integration have lagged, the new regional trade arrangement is reducing non-tariff trade barriers and may help its members become more competitive. In the west, the lag between financial integration and institutional integration has been threatening the sustainability of the former. A carefully executed banking union would address this tension. In the south, intraregional trade and investment are miniscule relative to potential, as are institutional structures supporting such integration, but in the wake of the Arab uprisings the governments of the southern and eastern Mediterranean are undertaking renewed efforts to revive regional cooperation. They are also seeking to expand and deepen their ties to the EU. Together, these new efforts could give Europe, its neighbourhood and the transition region at large a better foundation from which to resume its quest for prosperity and convergence.

Erik Berglof
Chief Economist
EBRD

CHAPTER 1
PROGRESS IN STRUCTURAL REFORMS

A review of structural reforms over the past year presents a mixed picture. On the positive side, it remains the case that, as in previous years, there has been more progress in reforms than reversals. However, major reforms at the sector and country level are still needed in order to return the region to a sustainable growth path. There are no signs of this happening yet in the region. Although, irreversible backsliding in reforms has not happened, the risk is stalled or feeble reforms will keep the region's growth well below potential for the foreseeable future.

THE FACTS AT A GLANCE



17

In terms of sector transition indicators, there were one-notch upgrades this year in 17 cases

FINANCIAL

One of the more positive features to emerge from the crisis has been the resilience of the financial sector throughout the transition region. Over the past year, there have been a number of modest improvements that have warranted an upgrade in sector scores, although downgrades have also occurred.

CORPORATE

Sector reforms warranting an upgrade have been limited over the past year.

ENERGY

The energy category – comprising natural resources, sustainable energy and electric power – is unusual this year in that, for the first time since the EBRD started scoring transition progress by sector, there are more downgrades than upgrades.

PROGRESS IN STRUCTURAL REFORMS

The year to end-September 2012 has been another difficult one for reform in the transition region as growth prospects have again weakened and the economic outlook has worsened. Some countries have not yet fully recovered from the impact of the 2008-09 crisis, and a few have slipped into recession again. There have also been isolated signs of populist dissatisfaction with painful economic adjustments. At the same time, and as a consequence of the deterioration in growth performance, governments have faced difficult fiscal challenges and rising levels of public debt. Inflation has not been a primary policy concern in most transition countries, but there are renewed pressures from increases in agricultural and other commodity prices. In much of the region, levels of unemployment and poverty are rising and adding to social stresses. It is no surprise, therefore, that the overall pace of reform has stalled.

Despite an exceptionally difficult few years, most of the reforms introduced in the previous two decades are still intact. There has not been a wholesale reversal of transition in any country in response to the crisis. Policy-makers are still broadly committed to the principles of markets, competition and open trade; Montenegro and Russia have joined the World Trade Organization (WTO) in the past year, and Croatia is on the verge of accession to the European Union (EU). However, there has been more regression in certain respects than in previous years, especially in the energy and financial sectors where state involvement has extended beyond what can be justified in the context of crisis response. Most importantly, there is no sign of the major reform drive that is still needed in most countries to boost growth rates towards their long-term potential.

This chapter provides an overview of some of the main reform themes since mid-2011 at the sectoral and country levels. As in previous years, the summary is based on an analysis of recent transition achievements and reversals along the path towards a well-functioning market economy and of the remaining “gaps”, or challenges. Updated numerical scores provide a snapshot of where each country stands in the transition process.

This *Transition Report* includes, for the first time, a detailed assessment of transition progress and challenges in the four countries of the southern and eastern Mediterranean (SEMED) region: Egypt, Jordan, Morocco and Tunisia. In the wake of the events of the Arab uprising in the first half of 2011, Jordan and Tunisia have recently become shareholder countries of the EBRD (Egypt and Morocco have been members since 1991). The following review aims to assess the economies of the four member countries of the SEMED using the same sector- and country-level methodology that the EBRD uses in its countries of operations.

PROGRESS IN TRANSITION

SECTOR TRANSITION INDICATORS

The EBRD’s numerical assessment of progress in transition has become a recognised indicator of the challenges facing each country across 16 sectors of the economy. The sectoral methodology underlying the assessment was explained in Chapter 1 of the *Transition Report 2010*, and the Methodological Notes on page 160 provide further technical detail. The EBRD’s economists draw on a range of public data, as well as laws “on the books” and regulations, to assess the size of transition gaps in a given sector, in terms of market structure and market-supporting institutions, to be bridged to reach the standards of a well-functioning market economy. Transition gaps are classified as “negligible”, “small”, “medium” or “large”, and gap scores are then combined to give an overall numerical rating for the sector, on a scale of 1 to 4+.

It should be noted that the sectoral methodology, although a significant advance on the more traditional country-level approach (discussed later in this chapter) in terms of transparency and rigour, is not an exact science. The numerical scores necessarily involve a significant element of judgement on the part of EBRD economists, mainly because laws on the books are not always implemented in the way intended. They can therefore complement other cross-country measures of reform that reflect legislative changes or the subjective perceptions of individual economic agents.[1]

SECTOR SCORES

Table 1.1 shows the transition scores for all sectors and countries, including for the SEMED region (discussed later in the chapter). Annex 1.1 contains the component ratings for market structure and market-supporting institutions and policies, respectively.[2] The extent of the transition gaps are represented in a “heat map”, with the dark red colour indicating major gaps and, therefore, low scores. Upgrades and downgrades (higher and lower scores) in Table 1.1 are highlighted by the upward and downward arrows, respectively. This year there have been 17 upgrades and 9 downgrades, the reasons for which are outlined in the rest of this section. (See also the Country Assessments later in this Report.)

ENERGY

The energy category – comprising natural resources, sustainable energy and electric power – is unusual this year in that, for the first time since the EBRD started scoring transition progress by sector, there are more downgrades than upgrades. In the electric power sector there have been downgrades for Bulgaria, Kazakhstan and Romania. In the case of Bulgaria and Romania, both EU members since January 2007, the downgrades partly reflect the slow progress of institutions and policies to meet EU commitments to deliver competition and encourage new private sector entrants to the market. Both countries have incurred EU action over delays in implementing liberalisation measures

[1] The annual World Bank *Doing Business* report is an example of a cross-country ranking exercise based mainly on laws on the books and formal regulations, while the EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS), carried out across the transition region every three to four years, elicits subjective impressions of enterprise owners and managers about the quality of the business environment.

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

Table 1.1
Sector transition indicator scores, 2012

	Corporate sectors				Energy			Infrastructure				Financial sectors				
	Agri-business	General industry	Real estate	Telecom-munica-tions	Natural resources	Sustainable energy	Electric power	Water and waste-water	Urban transport	Roads	Railways	Banking	Insurance and other financial services	MSME finance	Private equity	Capital markets
Central Europe and the Baltic states																
Croatia	3	3+	3+	4	4-	3-	3	3+	3+	3+↑	3-	3+	3	3-	2+	3
Estonia	3+	4+	4+	4	4	3-	4	4	4-	3	4	4-	3+	3	3-	3
Hungary	4	4-	4-	4	4-↓	3	4-	4	3+	4-	3+	3+	3	3	3	3+
Latvia	3	4-	4-	3+	3+	3+	3+	3+	4-	3	4-	3+	3+	3	3-	3
Lithuania	3+	4-	4-	4-	3+	3+	3+	3+	4-	3	3	3+	3+	3	2+	3
Poland	3+	4-	4-	4	3	3	3+	4-	4-	4-	4	4-↑	4-	3	3+	4↑
Slovak Republic	3+	4+	4	4-	3+	3	4	3+	3+	3-	3+	4-	3+	3+	2+	3
Slovenia	4-	3+	4	3+	3+	3+	3	3+	3+	3	3	3	3	3	3-↑	3
South-eastern Europe																
Albania	3-	2+	3-	3+	3-	3+	3	2+	3-	3-	2	3-	2	2+	1	2-
Bosnia and Herzegovina	3-	2	2-	2+	2	2	2+	2	2+	3	3+	3-	2+	2+	2-	2-
Bulgaria	3	3+	3+	4-	3+	3-	3+↓	3	3+	3-	3+	3	3+	3-	3-	3
FYR Macedonia	3-	3	3-	4-	2+	2+	3	2+	3-	3-	3-	3-	3-↑	2+	1	2-
Montenegro	2+	2+	2+	3+	3+	2	2+	2	3	2+	2+	3-	2+	2+	1	2+↑
Romania	3↑	3+	3+	3+	4-	3+	3+↓	3+	3+	3	3+	3	3+	3-	3-↑	3
Serbia	3-	3-	3-	3	2	2+↑	2+	2+	3-	3-	3	3-	3	3↑	2-	3-
Turkey	3-	3	3+	3+	3+	3↓	3+	3	3+	3-	3-	3+	3↓	3-	3-↑	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	2+↓	2	2	2	1	2	1	2-	2	2	1	2	2	2	1	2-
Georgia	3-	3-	3-	3-	2	3-	3+	2	2+	2+	3	3-	2	3-↑	1	2-
Moldova	3-	2-	2+	3	3	2+	3	2	3-	3-	2	2+	2+↑	2	2-	2+
Ukraine	3-	2+	3-	3-	2-	2+	3	2+	3-	3-	2+↑	3-	2+↓	2	2	3-
Russia	3-	3-	3-	3+	2	2	3+	3↑	3	3-	4-↑	3-	3-	2	2+	4-
Central Asia																
Kazakhstan	3-	2	3	3	2-	2-↓	3↓	2+	2+	2+	3	3-	2+	2	2-	3
Kyrgyz Republic	2+	2	2+	3	2+	2	2+	2-	2	2-	1	2	2-	2-	1	2-
Mongolia	3-	2+	2	3	2	2	2+	2	2	2-	3-	2+	2	2	2-	2+
Tajikistan	2	2-	2-	2+	1	2+	2	2	2	2-	1	2	2-	1	1	1
Turkmenistan	1	1	1	2-	1	1	1	1	1	1	1	1	2-	1	1	1
Uzbekistan	2	1	2	2	1	2-	2+	2-	2	1	3-	1	2	1	1	1
Southern and eastern Mediterranean																
Egypt	2	2	2+	3	1	2+	2+	1	2	2+	2-	2+	2+	2-	2	2+
Jordan	2	2+	3-	3+	2+	2+	3	2-	2+	3-	2	3	3-	2+	2	3-
Morocco	2+	3-	3-	3+	2-	3	2	2+	3	3-	2	3-	3-	2+	2+	3-
Tunisia	3-	3+	3-	3	2	3-	2	2	2+	2+	2+	2+	2+	2	2-	2+

Source: EBRD.

Note: The transition indicators range from 1 to 4+, with 1 representing little or no change from a rigid centrally planned economy and 4+ representing the standards of an industrialised market economy. For a detailed breakdown of each of the areas of reform, see the Methodological Notes on page 160. There were one-notch upgrades this year in 17 cases: agribusiness (Romania), sustainable energy (Azerbaijan and Serbia), water and wastewater (Russia), roads (Croatia), railways (Russia and Ukraine), banking (Poland), insurance and other financial services (FYR Macedonia and Moldova), MSME (Georgia and Serbia), private equity (Romania, Slovenia and Turkey) and capital markets (Montenegro and Poland). There were nine downgrades: agribusiness (Belarus), natural resources (Hungary), sustainable energy (Kazakhstan and Turkey), electric power (Bulgaria, Kazakhstan and Romania) and insurance and other financial services (Turkey and Ukraine). In addition, there were historical revisions in the following cases to take account of new data and to achieve greater cross-sector consistency: railways (Montenegro and Romania), banking (Turkey), insurance and other financial services (Tajikistan) and private equity (Ukraine).

and the failure to eliminate regulated prices. A further troubling development in Bulgaria has been the government's intervention to discourage more investment in renewable generation. In Romania a leading state-owned hydroelectric company was declared insolvent in July 2012, delaying attempts at partial privatisation. In both countries, however, changes were made to energy legislation in mid-2012 that, if implemented, should address some EU concerns. Kazakhstan's downgrade reflects the introduction of legislation in July 2012 creating a centralised investment incentive system, which is a significant retreat from a market-based regime.

Lack of competition and the dominance of state-owned companies also persist in Ukraine, as evidenced by the fact that recent tenders for shares in distribution companies attracted only two bidders. In Hungary the market institutions transition gaps in respect of the power and natural resources sectors have been raised from "negligible" to "small", reflecting a significant decline in private investment. This has been attributed to the introduction of a tax on energy groups in 2010 and state interference with the regulator's independence in the gas sector. In the natural resources sector Hungary's transition score has been downgraded from 4 to 4-.

In the sustainable energy sector, the picture is a little more encouraging. Azerbaijan and Serbia have received upgrades in recognition of the registration of Clean Development Mechanism (CDM) projects (one in Azerbaijan and four in Serbia), while in Mongolia a national action programme on climate change has been developed. However, new data on climate change emissions point to a growing problem in Latvia, consequently raising the transition gap for market structure.

FINANCIAL SECTOR

One of the more positive features to emerge from the crisis has been the resilience of the financial sector throughout the transition region. Over the past year, there have been a number of modest improvements that have warranted an upgrade in sector scores, although downgrades have also occurred. The only banking upgrade has been in Poland, where Financial Supervision Authority regulations have been strengthened and the systemically important PKO bank has become majority privately owned. In Latvia the market structure gap has been lowered from "medium" to "small" following the progress in resolving the portfolio problems of Parex Bank.

Another encouraging development in the past year has been the rise, if often from a low base, of private equity markets in the region. Three countries – Romania, Slovenia and Turkey – have been upgraded in this respect, reflecting increases in fund activity and strategies available in net committed capital. However, local capital market development across the region remains at a generally low level, and the only changes to the scores for this sector were an upgrade in Montenegro from 2 to 2+, following improvements in the functioning and monitoring of the stock exchange, and one for Poland (4- to 4) for progress in the legal and regulatory framework. In the insurance and other financial services sector, there were upgrades in FYR Macedonia, as a result of a significant increase in pension fund assets, and in Moldova, where leasing legislation has been improved. Leasing penetration has decreased substantially in Turkey, however, warranting a downgrade from 3+ to 3, while Ukraine was also downgraded in this sector, in part because it is no longer a member of the International Association of Insurance Supervisors (as of 2012). In respect of finance to micro, small and medium-sized enterprises (MSMEs), there were upgrades for Georgia, where the civil code was amended to broaden the range of assets that can be used as collateral, and for Serbia, reflecting improvements to the credit information and land registry systems.

A common theme across financial sectors in the transition region, which is not fully apparent in this sectoral assessment, has been the development of local currency financing and local capital markets more generally. This reflects an increasing awareness that the growth model on which much of the region had relied in the pre-crisis period, based on cheap inflows of foreign capital to fund credit booms, was inherently risky and unsustainable, and that developing local sources of funds and greater lending in local currency could lead to "safer" growth in the future.

There were notable developments in this regard in Hungary, Poland, Russia, Serbia and Ukraine, although in Hungary and Poland the large stock of foreign-currency mortgages remains an area of concern. In Hungary the government and the main banks reached agreement in December 2011 on burden sharing and alleviating bank losses arising from a previous provision that allowed mortgage holders to repay loans at preferential exchange rates. Meanwhile, the authorities in Poland have strengthened bank supervision, especially with regard to foreign currency mortgages, and the financial regulator has initiated a number of working groups to develop long-term bond issuance, including that of covered mortgage bonds. The Russian authorities have made progress towards establishing Moscow as an international financial centre through further liberalisation of the domestic sovereign rouble bond market, making it easier for non-residents to trade in Russian securities. In Serbia the central bank has been pursuing a "dinarisation" strategy and signed a Memorandum of Understanding with the previous government in April 2012 on the promotion of dinar use in financial transactions. In Ukraine amendments to the law on the securities market will, following parliamentary adoption, enable international financial institutions to issue bonds denominated in the local currency (the hryvnia).

INFRASTRUCTURE

In most infrastructure sectors covered by this analysis, progress in the past year has been very limited, although Russia achieved two upgrades in the railways and the water and wastewater sectors, respectively. The former reflects cumulative progress

over the years to the point where reforms are comparable to, or go beyond, those in many EU countries. In particular, the private sector provides well over half of all freight wagons and traffic, and competition in wagon provision (including through leasing) is intense. The water and wastewater upgrade is the result of an improved regulatory system (transferring functions from municipalities to a regional regulator) and the wider availability and use of commercial funds. There was also an upgrade for Ukraine's railways sector, although from a low level (2 to 2+), as a long-awaited restructuring and corporatisation law was finally adopted by parliament and private provision of wagons increased to about one-quarter of the market. The only other infrastructure upgrade was in the roads sector in Croatia, reflecting cumulative improvements over time, better procurement practices and the introduction of automatic tolling in the past year.

CORPORATE SECTORS

Corporate sector reforms warranting an upgrade have been limited over the past year. There were noticeable improvements in productivity in the agribusiness sector in Bulgaria and Romania, sufficient in the latter case to merit an upgrade from 3- to 3 (level with Bulgaria). However, Belarus was downgraded because of restrictions introduced in mid-2011 on the trade of agricultural goods, which (unlike other restraints – see below) have not been reversed. Other developments were mainly in the information and communications technology sector. Although scores remained unchanged in all cases, the market institutions gap was reduced in Bulgaria, Georgia and Poland, to reflect improved alignment of the regulatory framework with EU standards, and in Serbia, following the introduction in 2012 of full liberalisation of the fixed-line telecommunications service.

COUNTRY TRANSITION INDICATORS

One disadvantage of the sectoral transition assessment described in the previous section is that it may not fully capture reform progress or backtracking in broader, cross-cutting indicators such as trade policy, privatisation or the enforcement of corporate governance standards and competition policy. The EBRD has been tracking developments in these areas for many years and has been publishing annual transition indicator scores since the Transition Report was first published in 1994. However, the weaknesses of these indicators, in terms of their strong subjective element and failure to take sufficient account of the institutional framework, prompted the development of the sector-based methodology discussed earlier in this chapter. Nevertheless, the traditional indicators still constitute a useful snapshot of where a country stands in some important aspects of transition. It was decided therefore to retain the country-level scores for one more year; future years are likely to see a significant modification to the methodology and coverage of these indicators.

Table 1.2 contains the scores for six transition indicators (large-scale privatisation; small-scale privatisation; governance and enterprise restructuring; price liberalisation; trade and foreign exchange system and competition policy) on the same 1 to 4+ scale as in Table 1.1, but with arrows representing upgrades and downgrades in this instance. There were no upgrades or downgrades in small-scale and large-scale privatisation, signalling a lack of appetite for buying or selling state-owned assets. In the governance and enterprise reform category, there was an upgrade for Latvia, reflecting significant efforts by the government to enhance the transparency of state-owned companies. The decision by the energy company, Latvenergo, to have its long-term bonds quoted on the local exchange and to comply with the resulting listing requirements was a positive step in this respect.

There was a competition policy downgrade for Slovenia because of the significant drop in recent years in the number of cartel cases, the failure to issue any fines in 2011, and continuing staff and budget reductions. Some countries demonstrated progress in implementing competition policy, although not sufficiently to justify an upgrade at present. In Armenia, for example, a number of changes improved the functioning of the law, including the reinforcement of sanction measures. Moldova's new competition law, passed by parliament in July 2012, has been aligned with standards prevailing in the European Union (which provided technical assistance), while in Russia the government approved a so-called "third antimonopoly package", which entered into force in January 2012. This reform is aimed at liberalising the antimonopoly regulatory framework and reducing administrative barriers. It contains important clarifications and refinements, for example, with regard to cartel agreements.

There were several upgrades in trade and foreign exchange liberalisation. In the case of Montenegro and Russia this was mainly due to their long-awaited accession to the WTO. Montenegro had originally applied as part of the Federal Republic of Yugoslavia (subsequently the State Union of Serbia and Montenegro) and then in its own right after independence in June 2006. A further achievement for Montenegro in the past year was the launch of EU accession negotiations, which should lead to even greater integration into EU and global trade structures. Meanwhile, Russia's WTO accession completed a process that began back in 1993 and took effect in August 2012. Many of the provisions of entry include transition periods of up to nine years.

There were also upgrades in trade and foreign exchange liberalisation for Belarus and Turkmenistan, two of the traditional laggards in reform. They were, however, either from a very low base and/or reversed previous downgrades. In Belarus the multiple exchange rates that had emerged as a consequence of regulatory administrative measures and large external imbalances were unified in October 2011 as the government agreed to devalue the official exchange rate. In addition, restrictions on exports of most consumer goods, introduced during last year's crisis, were lifted in February 2012. Turkmenistan passed a new law on foreign exchange regulations in October 2011, abolishing the requirement of pre-payments

for exports and imports and allowing banks to conduct foreign exchange transactions with enterprises and individuals without seeking prior approval from the central bank. In another important step towards liberalisation, the Turkmen government decided in July 2012 to cancel the rationing of flour and loosen controls over meat prices.

TRANSITION CHALLENGES IN THE SEMED REGION

This section attempts to position the SEMED countries on the transition spectrum, based on the same criteria used for the other countries covered in this Report.

The economic histories of the former communist countries of eastern Europe and Central Asia and those in the SEMED region have common elements, including a decades-long experience of centralised state control (beginning in the 1950s in the SEMED case) followed by a progression to market-oriented reform. However, there are also significant differences. Reforms started a decade earlier in the SEMED countries, but were more gradual and remain incomplete. Another distinguishing SEMED feature has been the preponderance of young people in the population (unlike in post-communist eastern Europe), putting pressure on labour markets and creating alarming levels of youth unemployment, especially among the educated. In addition, the SEMED region continues to score worse than eastern European countries on most social indicators, including literacy and education.

The rest of this chapter outlines the reform histories of the SEMED countries and then considers their current structural and institutional development, including at the sector level. The analysis indicates that the region is in “mid-transition”, defined as ahead of most Central Asian countries but behind most in central and eastern Europe, and on a rough par with the Caucasus countries, Kazakhstan and Ukraine. Trade and capital flows in the SEMED region have been largely liberalised, and large parts of the economy are in private hands, albeit with important exceptions. However, subsidies for basic foods and fuels tend to be more pervasive, distorting markets and placing heavy burdens on state budgets. At the sector level, power and energy stand out as the least reformed areas.

REFORM EFFORTS

Egypt, Jordan, Morocco and Tunisia embarked on a process of market-oriented structural reform in the mid-1980s in order to create legal and institutional frameworks conducive to investment, entrepreneurship and market-driven growth, and to promote privatisation in their inflated and unproductive public sectors. Although these reforms were partly successful in achieving higher growth, unemployment remained chronically high, especially (and unusually) among the educated youth, and the benefits of growth were not evenly distributed. The reform agenda remains incomplete and the SEMED

Table 1.2
Country transition indicator scores, 2012

	Enterprises			Markets and trade		
	Large-scale privatisation	Small-scale privatisation	Governance and enterprise restructuring	Price liberalisation	Trade and foreign exchange system	Competition policy
Albania	4-	4	2+	4+	4+	2+
Armenia	4-	4	2+	4	4+	2+
Azerbaijan	2	4-	2	4	4	2-
Belarus	2-	2+	2-	3	2+↑	2
Bosnia and Herzegovina	3	3	2	4	4	2+
Bulgaria	4	4	3-	4+	4+	3
Croatia	3+	4+	3+	4	4+	3
Estonia	4	4+	4-	4+	4+	4-
FYR Macedonia	3+	4	3-	4+	4+	3-
Georgia	4	4	2+	4+	4+	2
Hungary	4	4+	4-	4+	4+	4-
Kazakhstan	3	4	2	4-	4-	2
Kyrgyz Republic	4-	4	2	4+	4+	2
Latvia	4-	4+	3+↑	4+	4+	4-
Lithuania	4	4+	3	4+	4+	4-
Moldova	3	4	2	4	4+	2+
Mongolia	3+	4	2	4+	4+	3-
Montenegro	3+	4-	2+	4	4+↑	2
Poland	4-	4+	4-	4+	4+	4-
Romania	4-	4-	3-	4+	4+	3+
Russia	3	4	2+	4	4↑↑	3-
Serbia	3-	4-	2+	4	4	2+
Slovak Republic	4	4+	4-	4+	4+	4-
Slovenia	3	4+	3	4	4+	3-↓
Tajikistan	2+	4	2	4	3+	2-
Turkey	3+	4	3-	4	4+	3
Turkmenistan	1	2+	1	3↑	2+↑	1
Ukraine	3	4	2+	4	4	2+
Uzbekistan	3-	3+	2-	3-	2-	2-
Egypt	3	4-	2	3+	4	2-
Jordan	3	4-	2+	4-	4+	2
Morocco	3+	4-	2+	4	4-	2
Tunisia	3	4-	2	4	4	3-

Source: EBRD.

Note: The transition indicators range from 1 to 4+, with 1 representing little or no change from a rigid centrally planned economy and 4+ representing the standards of an industrialised market economy. For a detailed breakdown of each of the areas of reform, see the Methodological Notes on page [160]. ↑ and ↓ arrows indicate one-notch upgrades or downgrades from the previous year. ↑↑ arrows indicate a two-notch upgrade.

countries face significant challenges in improving their business environments, consolidating fiscal positions and increasing institutional capacity.

In ***Egypt*** comprehensive reforms were introduced in two waves during 1991-98 and 2004-08. In the first round one-third of state-owned enterprises were privatised, many investment and production controls were abolished and tariffs and capital account restrictions were reduced. The second wave saw significant financial sector reforms (including the privatisation of the third-largest bank) and some improvements in the business environment, including an easing of conditions for enterprise start-ups and the creation of a competition agency. On the fiscal side, reforms aimed at modernising tax administration (coupled with increases in energy retail prices in 2005-06) led to a reduction in the fiscal deficit although it remained above 6 per cent of GDP for the budget sector.

However, major elements were lacking from the reforms, such as an effective strengthening of state institutions and a correction of key market distortions. The state's role as regulator, guarantor of competition and enforcer of contracts remains weak and judicial capacity is low, posing significant obstacles to private-sector development.

Jordan's first wave of structural economic reforms through the 1990s was characterised by fiscal consolidation and exchange rate devaluation to ease fiscal and external imbalances. The initial privatisation drive during this period was continued in the second round of reform in the early 2000s, which has seen the retreat of government ownership from most economic sectors. Since its accession to the WTO in 2000, Jordan has entrenched its open economy status through unilateral tariff reductions and trade liberalisation. In addition, financial sector regulations have been upgraded and improvements made in the business environment.

The main reform challenges for Jordan are to improve governance and to enhance competitiveness and private sector development. This requires an investment-friendly legislative framework, including appropriate public-private partnership mechanisms to enable the large-scale infrastructure development that the economy needs. Reducing vulnerability to external shocks is another challenge, especially in light of a worsening fiscal position caused by increases in subsidies and budgetary pressures resulting from disruptions to gas supplies from Egypt. The energy sector also needs major reforms to reduce import dependence and promote renewable sources.

Morocco made substantial progress in fiscal and structural reform in the early 2000s and implemented a number of large-scale privatisations in service industries. The energy, telecommunications and transport sectors were liberalised, import tariffs were reduced and there was an overall increase in competitiveness. Reforms in public finance were also carried out, increasing the efficiency and return of the tax administration system, and the current and capital accounts were liberalised for non-residents. In addition, reforms in the financial sector improved bank supervision and reduced foreign currency exposure.

Nevertheless, challenges still confront Morocco. Earlier privatisations omitted utilities and natural resources, and reforms (including to tariffs) are still necessary in the energy and infrastructure sectors. A key element of fiscal consolidation is subsidy reduction, which the government has sought to address by increasing fuel prices from June 2012. In addition, there is scope for improving the business environment and the competitiveness of various sectors by reducing burdensome regulation, improving corporate governance and strengthening institutional capacity. For example, the government's Plan Maroc Vert aims to address these issues in the agricultural sector (see below).

Tunisia undertook a series of stabilisation and structural reforms from 1986-2004 to diversify its economy after a fall in world oil prices led to unsustainable fiscal and external imbalances in the mid-1980s. These reforms also helped create a better institutional framework and business environment, enabling accession to the WTO in 1995. Reforms were also implemented to advance the financial sector, liberalise trade and exchange rates and privatise non-strategic industries. However, subsequent measures had the effect of boosting the competitiveness of an "offshore" sector of the economy (through generous benefits) at the expense of less developed "onshore" activities. Also, despite some efforts in 2005-10 to promote the privatisation agenda, the government still retains significant control in a number of sectors, especially finance.

Challenges still facing the Tunisian economy include addressing excessive labour market regulation to tackle the significant skills mismatch at the core of the country's high structural unemployment, and improving the business environment across sectors through more effective institutional frameworks and operation. Weaknesses in the financial sector, which have repercussions for many areas of the economy, also need to be overcome, by strengthening the banks and facilitating more private-sector involvement in economic activity.

SECTOR TRANSITION INDICATORS

The sector scores in the SEMED region (see Table 1.1) suggest significant transition gaps across the four broad sector categories (corporate, energy, financial and infrastructure).

The main challenges facing the ***manufacturing and services*** sector relate to the general business environment. While reforms carried out over the past two decades have improved the ease of doing business in the SEMED countries, market structure and institution reforms still need to be accelerated to enhance competitiveness, efficiency and productivity. In Egypt the privatisation agenda remains unfinished and weak institutional capacity (such as lack of judicial and competition authority independence), together with continued state involvement in many sectors, have hampered private business growth. To a lesser extent, Jordan and Morocco also need to improve

competition policy and the business environment in key industrial sectors (and face similar challenges to those of FYR Macedonia and Georgia, for example). However, privatisation efforts have generally proceeded at a faster pace in Jordan and Morocco than in Egypt. Meanwhile, Tunisia's successful reform efforts – from price and trade liberalisation to privatisation and tax incentives – have created a thriving offshore sector, although the onshore sector's development is hampered by legal complexities such as weak contract enforcement and low investor protection.

In the ***agricultural sector***, the SEMED countries face comparable reform challenges, although Morocco (where the government's Plan Maroc Vert aims to reform the sector to increase production by improving the quality and efficiency of value chains and increasing crop diversity) and Tunisia score better than Egypt and Jordan. As net importers of food, all are vulnerable to the volatility of global prices for commodities such as grain, on which they are highly dependent. In addition, fuel and food subsidies have led to market distortions and inefficiencies along the whole food value-chain. In Jordan, Morocco and Tunisia particularly, efficient use of scarce water resources is crucial to improving agricultural productivity, while all four countries are disadvantaged by underdeveloped processing, logistic and distribution capacity and (as in Russia and Serbia) fragmented land holdings. The state remains heavily involved in the agricultural sector across the SEMED region, whether through its presence in rural financing provision or through price controls and guarantees for core commodities (as in Turkey). Untargeted subsidies for consumers and producers are also in place in all four countries.

The SEMED countries have significant challenges in the ***energy sector***, most comparable to those in Central Asia and eastern Europe. Heavy state involvement and the prevalence of vertically integrated utility companies are defining characteristics of the sector across the region (and indicate a stage of development similar to that in Serbia and Ukraine). Privatisation has not progressed substantially, and the different subsectors have not been fully unbundled. Together with continued fuel and electricity subsidies, this has led to poor energy efficiency and distorted markets. In all four SEMED countries electricity tariffs are not cost reflective, placing additional fiscal burdens on governments. At the institutional level, there is a gap between reform intentions and actual implementation. The regulatory agencies that exist in Egypt and Jordan have no tariff-setting authority and political interference in their activities and in price control is considerable. In Morocco and Tunisia, with no independent energy regulators, tariffs and prices are set directly by government. Jordan and Morocco, however, face slightly narrower transition gaps as efforts have been made to reduce Jordan's dependence on imported fuels and to achieve energy sustainability in Morocco.

According to the transition scores, the SEMED region's level of ***infrastructure*** development is most comparable to that of the countries of eastern Europe and the Caucasus. Significant challenges still loom. This is partly due to the weak municipal infrastructure across the region, which reflects low private-sector participation, poor regulatory frameworks and limited financing options outside of central government. In all four SEMED countries, the water and wastewater sector is characterised by heavy state involvement and/or centralisation, low tariffs below cost- and investment-recovery levels and extensive subsidisation across sectors and of consumers (as in Belarus and Georgia). In Jordan a National Water Advisory Council was created at the end of 2011 to oversee and coordinate institutional efforts towards a harmonised water policy. Across the SEMED urban transport sector commercialisation and cost recovery are low. Jordan and Morocco, however, fare slightly better, due mainly to greater private-sector participation and decentralisation. This is similarly the case in Georgia and Moldova, although municipal transport services continue to suffer from weak regulatory capacity and service quality.

A more varied picture emerges in the SEMED region's ***financial sector***, the level of development of which (apart from Tunisia) is most comparable to that of south-eastern Europe on the institutional side, but closer to central Europe in terms of market structure. In Egypt the greatest challenges are improving access to finance for MSMEs and deepening insurance and other financial services (as is the case in Moldova). Jordan, on the other hand, has a stronger banking sector (and is comparable to Croatia in respect of financial market development), but needs to strengthen the effectiveness and enforcement of bankruptcy procedure. A private credit bureau should be established in 2012, helping to broaden bank lending capacity. Morocco's financial sector is also relatively well developed, but struggles to secure long-term funding to ease maturity mismatch risk. Tunisia's financial sector, however, is hampered by balance sheet weakness, high non-performing loans and state involvement in the leading banks (similar to Slovenia), as well as poor governance and capital market development. There remains much scope for improvement in capital markets and the provision of insurance and other non-banking financial services across all the SEMED countries.

COUNTRY TRANSITION INDICATORS

The SEMED countries score reasonably well on the country transition indicators, having benefited from the earlier opening up of their economies, along with substantial price and tariff liberalisation, through the reforms starting in the 1980s.
In respect of "first-phase" transition reforms – small-scale privatisation, price liberalisation and trade and foreign exchange system – the four countries scored 4- or better with the exception of a 3+ rating for Egypt relating to price liberalisation (see Table 1.2). However, the scores for the remaining indicators – large-scale privatisation, governance and enterprise restructuring, and competition policy – were significantly lower.

All four SEMED countries are members of the WTO and most have full current account convertibility and flexible exchange

rates (except for Jordan, which maintains a fixed, but stable, exchange rate). Also, with economies heavily reliant on trade, they have removed almost all export and import restrictions (with a few sector exceptions, such as agriculture). There has been large-scale privatisation since the reforms of the 1980s, which is almost complete in Morocco, but there is still significant state involvement in key economic sectors in Egypt, Jordan and Tunisia. However, most smaller enterprises operate firmly within the private sector and there are no legislative barriers to ownership of land or capital.

Some of the greatest challenges concern competition policy and governance, where the four countries typically rank in the middle, or the lower half, of the transition spectrum. Competition policy implementation remains weak (except in Tunisia, where an independent competition authority is in line with international standards), and is hampered by weak enforcement, the continued presence of state monopolies and low institutional capacity. Although steps have been taken to create or improve competition agencies in Jordan, Egypt and Morocco, these still lack enforcement capability and/or independence. In general, there remains a significant shortfall between *de jure* institutional frameworks and their operation and effectiveness. All four countries score between 2 and 2+ on governance and enterprise restructuring, largely due to the continued subsidisation of key industries and poor governance at most state-owned enterprises. In particular, energy subsidies have created market distortions and state involvement has deterred private-sector participation.

CONCLUSION

This chapter has summarised the main structural reform developments over the past year and provided a perspective on the remaining transition challenges facing the EBRD's traditional countries of operations and those in the SEMED region where the Bank is extending its activities. On the positive side, it remains the case as in all previous years that there has been more progress in reform than reversal, and any wholesale backsliding seems unlikely. However, further major advances are still necessary to underpin and ensure future sustainable growth. Although major, irreversible backsliding in reforms has not happened and is unlikely to happen in the future, the big risk is still that stalled or feeble reforms will keep the region's growth well below potential for the foreseeable future.

Table A.1.1.1
Sector transition indicators 2012: market structure

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

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 2012: market-supporting institutions

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

Source: EBRD

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

COMMERCIAL COURTS IN TRANSITION

Previous studies have linked the effectiveness of the judiciary with the pace of economic growth and the cost of credit in liberalised economies.[1] However, many transition countries are yet to reap the economic benefits that an effective judiciary can generate. Over the 20 years of legal transition, commercial laws in the EBRD region of operations have improved substantially. Despite this, their implementation and enforcement in the courts have often been fraught with problems, deterring business from engaging in these markets for fear that their legal rights cannot be protected. While foreign investors can sometimes bypass the courts through international arbitration, local investors, particularly small and medium-sized enterprises (SMEs) need the means to resolve commercial disputes locally.

This annex reports on an analysis undertaken by the EBRD between 2010 and 2012 of judicial decisions made in the Commonwealth of Independent States (CIS),[2] Georgia and Mongolia. The objectives were twofold: to provide investors in these countries, including the EBRD, with an insight into key problems confronting commercial courts and the risks involved in litigation; and to produce data which could be used to encourage and assist reform.

METHODOLOGY

Local legal experts evaluated selected judicial decisions in respect of seven dimensions, or indicators, of judicial capacity (see Box A.1.2.1) and scored them on a scale of 0 to 5, with 5 representing the highest standard of fairness and efficiency.

All the dimensions are underpinned by international standards and are also reflected in the EBRD's Core Principles for Effective Judicial Capacity. In each of the countries under review, the local experts selected at least 20 decisions considered typical and representative of the broader case law for analysis in a purposive, rather than a random sampling, exercise.

The decisions were drawn from three broadly defined commercial law areas: (i) protection and enforcement of creditors' rights, focusing mainly on enforcement of collateral and recovery of unsecured debt; (ii) disputes over proprietary (such as land title) and shareholder rights; and (iii) disputes with regulatory authorities over business licences, taxation and privatisation issues. These areas were considered important from the perspective of identifying systemic concerns about judicial capacity that transcend particular sectors. To ensure consistency in the evaluation process, all of the decisions, scores and comments of local experts were reviewed by an independent regional panel of three further experts.

Box A.1.2.1
Assessing the dimensions of judicial capacity

Predictability of decisions
Were decisions broadly predictable and jurisprudentially compatible with others in the same field?
Quality of decisions
Did decisions comply with procedural requirements, display understanding of the commercial issues, identify and correctly apply relevant law and reach well-reasoned conclusions?
Adequate legislative framework
Were there legislative and/or regulatory or procedural obstacles to the court's consideration of relevant issues?
Speed of justice
Did litigation proceed at a reasonable pace from the filing date to the final judgment and in compliance with statutory deadlines?
Cost of litigation
Were costs reasonable, considered as a percentage of the value of a claim?
Implementation/enforcement of judgments
Were court orders voluntarily implemented or compulsorily enforced (based on case file follow-ups and direct contact with litigants where possible)?
Perceived impartiality
Did decisions appear to afford procedural equality and give adequate weight to the parties' arguments, or were there discernible differences in the court's treatment of the parties?

RESULTS

The overall results of the assessment in 12 countries are set out in Chart A.1.2.1.[3] They identify different levels of judicial capacity in commercial law across the region. Nevertheless, some of the underlying challenges are similar and derive from the countries' common socio-economic history. This is borne out by an analysis of the seven dimensions, the various themes which pervade them and the relationships between them.

In Russia the general level of sophistication of judicial decisions was higher in most dimensions than in the other countries. This may reflect more developed markets (creating more complex disputes for the courts to deal with), better resources than the other countries and a more advanced stage of economic transition.

PREDICTABILITY OF DECISIONS

A measure of risk and uncertainty is in the nature of litigation. However, it should be possible for investors to obtain meaningful advice about the likely outcome of commercial disputes. Decisions should show consistency in the courts' treatment of disputes of a similar kind. The assessment concluded that

[1] See Laevan and Mojnoni (2003) and Sherwood (1994).
[2] Armenia, Azerbaijan, Belarus, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Ukraine and Uzbekistan. Turkmenistan is an associate member.
[3] In Turkmenistan decisions were not accessible and it was not possible to score the seven dimensions, although some information was gleaned from local counsel.

Chart A.1.2.1
EBRD Judicial Decisions Assessment: overall results by country

Source: EBRD Judicial Decisions Assessment.
Note: The diagrams depict the average scores given to the seven dimensions in the reviewed decisions, as assessed by local commercial law experts and a regional panel. The extremity of each axis represents an optimum score of 5, representing a high standard of fairness/efficiency. The larger the coloured area, the better the results.

decisions in the region indicated variable levels of predictability (see Chart A.1.2.2). For most countries local experts were able to discern patterns in the case law in each sector assessed, but with frequent divergences. Decisions were considered strongly predictable in Russia and Ukraine and least predictable in Mongolia and Tajikistan. In Turkmenistan, where case law is not available and the outcome of past decisions is not known, judicial proceedings are necessarily highly unpredictable.

Various factors affected the scores for predictability. Lack of predictability in a particular legal sector was often linked to uncertainties in the relevant legislation, reflecting the frequency of changes in the law and lack of consistency between primary legislation (statutes made by legislatures) and secondary legislation (rules and regulations made by executive authorities). However, the assessment found that the quality of legislation, although significant, was not an overwhelming factor driving predictability. Decisions in some sectors scored strongly for predictability despite more moderate scores for the adequacy of the legislative framework (see results for Russia and Ukraine in Charts A.1.2.2 and A.1.2.4); others were unpredictable within an adequate legislative environment. This suggests that lack of predictability often arises from underlying problems in judicial decision-making unrelated to legislative influences, a hypothesis supported by the correlation between the scores for the predictability and quality dimensions (compare Charts A.1.2.2 and A.1.2.3).

Another factor contributing to greater predictability was the presence of superior court mechanisms promoting the uniform application of commercial law, such as decrees, information letters and summaries on judicial practice and interpretative issues. Such instruments are present in all of the countries reviewed: in some they are binding on lower courts (Azerbaijan, Belarus, Russia and Turkmenistan), while in others only recommendatory (Moldova and Ukraine). In those sectors of law where such superior court guidance exists, predictable decisions were more prevalent. In Russia, which had the best scores for predictability, the instruments are well-developed; the Presidium of the Supreme Arbitrazh Court (the court of final instance in commercial disputes in Russia) has been very active issuing explanatory resolutions in many legal sectors, providing interpretative and procedural guidance for lower courts. In Tajikistan such mechanisms are also in place, although much less developed. The quality, frequency and comprehensiveness of superior court guidance, particularly dealing with topical and difficult areas where the possibility for confusion and divergent approaches is greatest, have a significant effect.

The accessibility of judicial decisions also had a strong correlation with predictability. By definition, predictability of decisions must be assessed within the known context of the broader case law. In countries where availability of decisions is limited, such as Tajikistan, predictability will be inherently lower, and trends in the case law, if they exist, will be less apparent. In contrast, commercial law decisions in Russia are widely available and searchable by subject matter on the web sites of the Arbitrazh Courts.

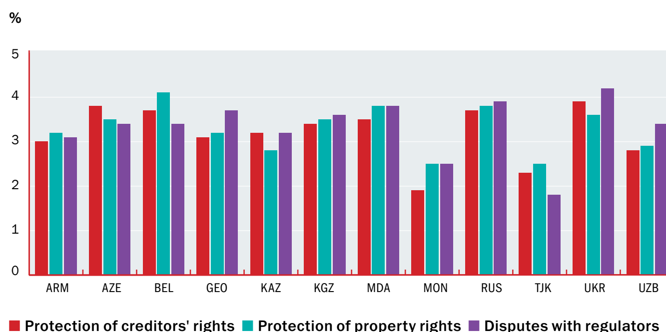
In addition, there was a moderate correlation between predictability and impartiality. Greater predictability in judicial decision-making can reduce the risk of improper influences on the court. The more coherent the case law, the more divergent approaches (including those resulting from corruption) tend to stand out, inviting scrutiny. However, predictability can have a negative manifestation where, on particular issues, court bias might be anticipated.

Chart A.1.2.2
Predictability of judicial decisions, by country and legal sector

Protection of creditors' rights · Protection of property rights · Disputes with regulators

Source: The EBRD Judicial Decisions Assessment.
Note: The chart depicts the average scores given to predictability in the decisions reviewed, as assessed by local commercial law experts and a regional panel. The maximum score is 5, which represents a high standard of predictability.

Chart A.1.2.3
Quality of judicial decisions, by country and legal sector



Protection of creditors' rights · Protection of property rights · Disputes with regulators

Source: The EBRD Judicial Decisions Assessment
Note: The chart depicts the average scores given to quality in the decisions reviewed, as assessed by local commercial law experts and a regional panel. The maximum score is 5, which represents a high standard of quality.

QUALITY OF DECISIONS

The highest quality of decisions was evident in Belarus, Russia and Ukraine, and the weakest in Mongolia and Tajikistan (see Chart A.1.2.3). Several thematic issues emerged.

In all of the countries assessed there were instances of courts wrongly applying *general* civil and procedure codes rather than the *specific* legal provisions of relevant commercial laws. For example, mortgage legislation in Moldova sets out exclusive grounds for the setting aside of orders to transfer pledged property; yet several of the reviewed decisions applied only the general civil and procedure code provisions, rather than invoking any of the relevant grounds stipulated in the mortgage law. Similarly, in Mongolia a challenge to the issue of a mining licence was resolved by reference to civil code provisions, without examining the relevant mandatory considerations. Decisions in several countries on the invalidation of privatisations also focused on general rather than specific provisions for example, in relation to time limitations.

Decisions often displayed rudimentary approaches to interpretation. Formalistic analysis was prevalent, while legislative intention and a law's commercial purpose were rarely considered. Decisions often lacked any detailed analysis of statutory or contractual provisions in circumstances where this was clearly required, and some displayed an overall paucity of reasoning. In cases that hinged on the meaning of contractual provisions, key clauses were often paraphrased rather than cited, making it difficult to follow the reasoning. Similarly, there was often scant reference to, or analysis of, the evidence.

In addition, the *operative* parts of courts' decisions frequently did not adequately reflect or address the parties' arguments. This was particularly the case in the Kyrgyz Republic, Mongolia, Tajikistan and Uzbekistan, where the parties' contentions were often identified in the introductory parts of decisions, but then not substantively dealt with. In one case a section in the judgment summarising the plaintiff's arguments reappeared *verbatim* in the dispositive part of the decision finding for the plaintiff, giving rise to a perception of partiality.

An underlying concern, particularly in early transition countries, is the low level of training provided to judges in commercial law, markets, economics and judicial decision-writing. Judges in many of the cases reviewed appeared to lack knowledge of specific commercial laws and concepts, although those in higher instance courts generally performed better. Improvement in judicial education is clearly a priority reform issue.

Chart A.1.2.4
Adequacy of legislation affecting judicial decisions, by country and legal sector

Source: The EBRD Judicial Decisions Assessment.
Note: The chart depicts the average scores given to the adequacy of the legislative framework from a litigation perspective in the decisions reviewed, as assessed by local commercial law experts and a regional panel. The maximum score is 5, which represents complete adequacy.

ADEQUACY OF LEGISLATIVE FRAMEWORK

There is no doubt that incomplete, ambiguous and poorly drafted legislation is detrimental to judicial decision-making. It is also conducive to corruption in the judiciary, as suspect or unlawful judgments are harder to identify.

Some legislative problems identified in the decisions reviewed related to the substantive law. In Russia and Ukraine local experts considered that existing legislation did not adequately proscribe sham bankruptcies, in which debtors siphon away assets and then have themselves declared insolvent. Courts' decisions in many such instances were considered of good quality, but could not compensate for shortcomings in the law.

However, in some cases it was legislation governing general civil litigation and its interaction with sector-specific laws that caused particular problems. For example, in Russia and Ukraine the law made it too easy for parties to re-open and undermine previously determined bankruptcy cases based on newly discovered circumstances. In such cases, the civil procedure legislation sometimes appeared ill-adapted to the relevant specific law, which might usefully have precluded or limited the reopening of litigation. In other cases, legislation had not kept pace with market developments, leaving gaps that courts struggle to fill through interpretation courts at a disadvantage. More positively, legislation in Russia governing disputes over the recovery of simple debts was identified by local experts as very straightforward and conducive to effective court proceedings.

Secondary legislation has also caused certain problems for courts. In one case, ambiguity over the land register rules in Mongolia led the parties to litigate a point where there was no apparent commercial dispute and to use the court to clarify the law in the abstract. Meanwhile in Ukraine, following extraordinary decrees of the National Bank issued during the financial crisis, it was not clear whether a temporary moratorium on creditor claims against banks covered retail depositor-holders. Ultimately the courts interpreted it broadly which, according to experts, was not how the decrees were supposed to work.

Legislation governing dealings between business and government agencies was often considered vague, in effect conferring substantial discretion on the regulators. This was especially so in Armenia and Azerbaijan, in respect to taxes and business licences, where the relevant law very broadly defines the

powers of the authorities to conduct inspections and to demand information and documents. In such cases, judicial decisions in favour of the authorities are the consequence of the legislation rather than judicial deference to authority; it can be difficult for courts to fault the actions of a regulator or authority conferred with such broad discretion.

SPEED OF JUSTICE

While large caseloads and backlogs delay judicial decisions and can affect the quality and delivery of court decisions, the speed of justice in most of the countries under review was not generally considered a significant problem, as Chart A.1.2.5 indicates. The best results were recorded in Belarus and Russia, which mirror the conclusions of the World Bank *Doing Business* reports in relation to enforcing contracts.

Causes of delays in the decisions reviewed included the late appointment of expert witnesses, motions for adjournments being too readily granted by courts, and the tendency of appeal courts to send cases back for further hearing rather than imposing their own decisions. In some instances it was suspected that judges delayed proceedings with a view to favouring a particular party (providing time, for example, to dilute assets or destroy evidence).

Courts generally dealt more swiftly with cases involving regulators than with creditor or property rights disputes. In seven of the countries reviewed, cases involving regulators were dealt with faster than others, while in all countries the speed of hearings in regulatory disputes exceeded the average speed for those in the other categories. This suggests that courts prioritised such cases, which is consistent with the perception of a pro-government judicial outlook (see also below).

Fast-track small claims procedures in some countries appear to have been very successful. Such procedures exist in Armenia, Moldova and Russia for relatively simple cases where there is no evidence in dispute and which can be resolved on the basis of available documentation.

COST OF LITIGATION

Cost was not viewed as a major concern in any of the countries assessed. In some instances legislation regulating court costs could have been clearer and the categorisation of different types of disputes, triggering different cost regimes, sometimes gave rise to contention. Payment of a state fee prior to filing a law suit is mandatory in all the jurisdictions and is one of the conditions for starting a proceeding in an economic case. The fee is normally expressed as an approximate percentage of the value of the claim and is therefore predictable. In all countries this was considered to be reasonable, although the potential maximum fees payable in Belarus and Turkmenistan were substantially higher than elsewhere.

IMPLEMENTATION/ENFORCEMENT OF JUDGMENTS

Enforcement of court orders remains a significant problem throughout the region. While implementation and enforcement were considered relatively good in Belarus and Georgia, none of the countries assessed scored highly. Some also have very large backlogs of unenforced decisions: in Ukraine, for example, the number is estimated at 2 million. Moldova, Russia and Ukraine have been respondents to a large number of cases brought by businesses in the European Court of Human Rights alleging a breach of the right to a fair trial because of a failure by the state parties to ensure implementation of court decisions.

A particular problem identified in the cases reviewed related to legislative shortcomings in the enforcement process. For example, in Russia there remains a need for stronger provisions, such as freeze orders or security for costs, preventing

Chart A.1.2.5
Speed of justice, by country and legal sector

Source: The EBRD Judicial Decisions Assessment.
Note: The chart depicts the average scores given to speed of justice in the decisions reviewed, as assessed by local commercial law experts and a regional panel. The maximum score is 5, which represents a good pace of litigation.

Chart A.1.2.6
Reasonableness of court costs, by country and legal sector

Source: The EBRD Judicial Decisions Assessment.
Note: The chart depicts the average scores given to reasonableness of court costs in the decisions reviewed, as assessed by local commercial law experts and a regional panel. The maximum score is 5, which represents a very reasonable cost regime.

respondents to commercial cases diluting or hiding assets during litigation. Another issue was a lack of clarity in the text of the judicial decisions. In Tajikistan judgment orders in cases "undoing" privatisations did not envisage and deal with consequential and financial issues related to the invalidation (for example, a change in the value of the privatised property). Poorly crafted orders can simply be impossible to execute.

A major problem in many countries, and particularly Armenia and Azerbaijan, was the poor functioning of the government agency responsible for enforcement of court decisions. Thematic concerns arising in this context included: low salaries and high turnover of personnel; heavy workloads; bailiffs allegedly delaying enforcement while seeking bribes from judgment creditors; lack of personal liability of bailiffs for non-performance of their duties; poor professional training; and the need for court powers to punish recalcitrant judgment debtors (for example, through fines for contempt of court).

However, measures are being taken in several countries to address these issues. In Moldova the bailiff service has been further professionalised, with incentives provided for good performance. In Georgia and Kazakhstan a dual system of private and government bailiffs that aims to raise enforcement standards has been established. Armenia has introduced statutory time limits for the enforcement of court decisions and Azerbaijan has passed laws substantially increasing the penalties for failure to perform court judgments.

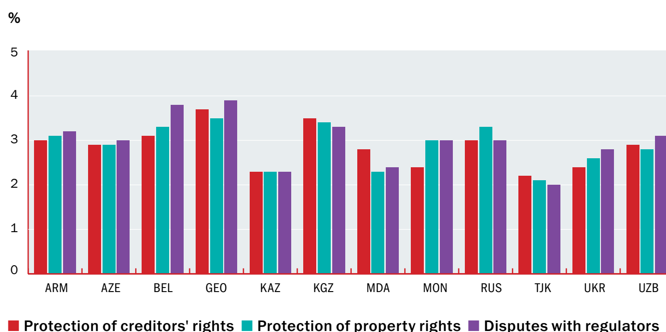
PERCEIVED IMPARTIALITY

In many of the countries reviewed a lack of judicial impartiality is seen as the major problem affecting the courts, whether in the form of corruption, lack of independence from the executive, or improper influences on judges from powerful individuals in business or government. Impartiality is a difficult dimension to measure in any categorical way, but reasonable inferences can be drawn from reviewing judicial decisions. The assessment results concluded that decisions reviewed displayed a moderate level of apparent impartiality, although scores varied considerably (see Chart A.1.2.8).

One of the main themes was an inference of court bias in favour of the state, either as a litigant in a commercial matter or as a regulator. In many decisions there appeared to be a discernible disposition towards arguments led by the state, particularly in cases involving challenges to the privatisation of state property. Courts did not always apply the same rigour and scrutiny to the arguments of state parties as they did to those of non-state litigants. For example, in a case in Moldova the court did not query the procurator's role in re-opening a privatisation transaction, when in fact the law required any challenge to be brought by the relevant state entity rather than the procurator, and there was no discussion of this issue in the judgment. Also, in Ukraine an appeal court heard and determined in the state's favour an apparently trivial matter within three weeks of the original decision, while other cases had been awaiting a hearing for many months. Such apparent special treatment, combined with the poor quality of the judgments concerned, gave rise to inferences of partiality.

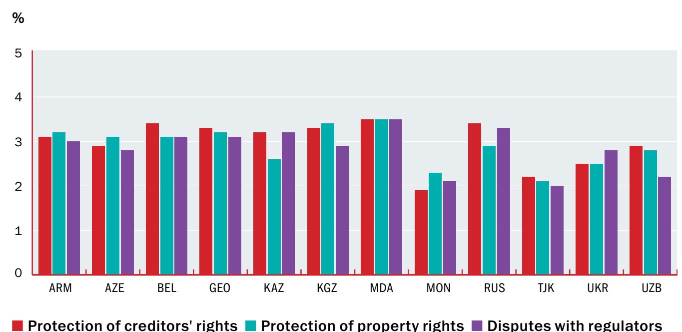
The extent of perceived bias in favour of the state varied. The state did not always win. Of 75 selected decisions in which the state or a public body was a litigant, the state was successful on 52 occasions. In cases involving regulators the perceived bias in favour of the state was generally not much worse than other forms of partiality inferred in the judgments reviewed. Only in the Kyrgyz Republic and Uzbekistan did decisions on disputes with regulators attract significantly worse scores for impartiality than other decisions. Nevertheless, in cases involving political and substantial economic interests, particularly privatisations or in

Chart A.1.2.7
Implementation/enforcement of judgments, by country and legal sector



Source: The EBRD Judicial Decisions Assessment.
Note: The chart depicts the average scores given to implementation and enforcement of the decisions reviewed, as assessed by local commercial law experts and a regional panel. The maximum score is 5, which represents reasonable ease of implementation and enforcement.

Chart A.1.2.8
Perceived impartiality, by country and legal sector



Source: The EBRD Judicial Decisions Assessment.
Note: The chart depicts the average scores given to perceived impartiality in the decisions reviewed, as assessed by local commercial law experts and a regional panel. The maximum score is 5, which represents a high standard of impartiality.

strategic sectors such as oil and gas, courts were considered to have a much more pronounced pro-state outlook.

The experts identified various factors contributing to judges' perceived bias in some of the cases reviewed. One was the practice whereby judges are appointed for an initial term of five years but are not guaranteed re-appointment, creating a perception that they will be wary of handing down too many decisions against government interests. Also, low judicial salaries, particularly in early transition countries, were considered to make judges vulnerable to improper influence. In some countries bribes were commonly believed to have been paid to obtain judicial postings, which appointees would then seek to recoup once on the bench.

Another factor was the absence in some countries of clear prohibitions on communications between an interested party (private or public) and a judge. In contrast, Georgian law expressly prohibits such communications prior to the court's judgment entering into force, and penalties for breach of these rules have been increased substantially. Many local lawyers believe that the bribing of judges has been all but eliminated in Georgia. This is consistent with broader public opinion gauged in the EBRD/World Bank 2010 Life in Transition Survey, which found that the level of perceived corruption in Georgia was as low as that in western European countries.

CONCLUSION AND POLICY IMPLICATIONS

In order to bolster business and investor confidence in the courts and to reap the full benefit of commercial law reform, the "law on the books" must be effectively applied and enforced in the courts. This assessment has found that commercial courts in the CIS, Georgia and Mongolia continue to face substantial challenges, particularly in ensuring the impartial treatment of litigants and the effective implementation of judgments. Overall, however, the quality and predictability of judicial decisions are better than many might have expected. Cost of, and, perhaps surprisingly, speed of justice do not pose major problems.

These results should be of interest to transition governments and invite further examination of the issues raised. For those involved in judicial reform, including the EBRD through its Legal Transition Programme, this assessment will help in formulating and targeting relevant technical assistance work. Priorities for reform include: better judicial training in commercial law, markets and decision writing; ensuring public access to all judicial decisions; improving the interaction of substantive and procedural law; better monitoring of training needs and the quality of judicial output; and greater judicial collaboration between court authorities and the business community on problems in the courts' handling of commercial matters and their possible solutions.

The EBRD has been providing technical assistance on projects to enhance judicial capacity in a number of countries covered in this assessment, including the Kyrgyz Republic, Moldova, Mongolia and Tajikistan. This work has included judicial training programmes in commercial law, institutional development of training and supervisory bodies, review and analysis of court structures and alternative dispute resolution. The Bank is also developing training products that focus on the interaction of law, markets, economics and accountancy for judges determining insolvency cases. These measures are designed to strengthen commercial courts and to enhance public, and in particular business, confidence in them.

References

Laevan and G. Mojnoni (2003)
"Does judicial efficiency lower the cost of credit?", World Bank Research Working Paper 3159.

R. Sherwood (1994)
"Judicial systems and economic performance", *Quarterly Review of Economics and Finance*, 34, Supplement 1, pp. 101-16.

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

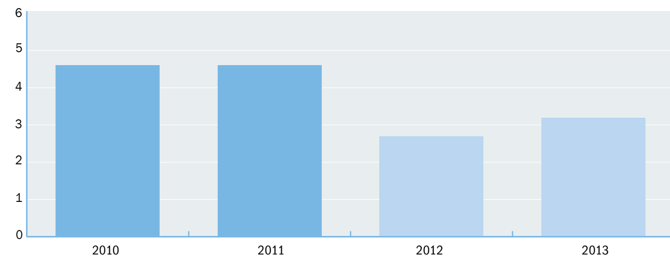
CHAPTER 2
TRANSITION REGION IN THE SHADOWS OF THE EUROZONE CRISIS

As the eurozone sovereign debt crisis deteriorated, recovery has stalled in many countries of the transition region. Exports and capital inflows declined and the region's banks have lost significant external funding from their eurozone parent banks. The region's exposure to the euro area has thus recently turned from a benefit into a disadvantage, especially for central and south-eastern Europe. The outlook for the region continues to be crucially driven by developments in the eurozone crisis. In the baseline, the region will see a substantial slow-down this year and next relative to 2011.

THE FACTS AT A GLANCE

Transition region projected to slow down

Year-on-year GDP growth of the transition region, per cent



■ Actual growth ■ Forecasted growth

Source: National authorities via CEIC data service and EBRD forecasts.

EXPOSURE TO THE EUROZONE

Estimated quarterly output loss a year after a 1% lower quarterly eurozone output

UKRAINE
3.7%

ROMANIA
2.0%

POLAND
0%

TRANSITION REGION IN THE SHADOWS OF THE EUROZONE CRISIS

The past year has seen a significant deterioration in the external economic environment for the transition region. The *Transition Report 2011* suggested an ongoing recovery from the global financial crisis, but pointed out the risks stemming from the region's exposure to the eurozone. Since then, as the eurozone's sovereign debt crisis has deteriorated, recovery has stalled in many transition countries which are particularly integrated with the single currency area. Growth has slowed as exports and capital inflows have declined. Crucially, banks, especially those in the western part of the transition region, have lost significant external funding as eurozone financial institutions have deleveraged and reduced cross-border financing of their subsidiaries in transition countries. This has depressed credit growth, in turn impacting on output expansion.

This chapter summarises the main macroeconomic and financial developments in the transition region over the past year. Since during that time the region's exposure to the eurozone has veered from a benefit to a disadvantage, it assesses the extent to which each transition country's growth depends on the fortunes of the single currency area as well as on other external factors, such as oil prices and the rate of growth in Russia. The results confirm the expectation that, in general, the countries of central Europe and the Baltic states (CEB) and south-eastern Europe (SEE) are more intertwined with the eurozone, while those of Central Asia (CA) and eastern Europe and the Caucasus (EEC) have closer links with Russia. However, the analysis also reaches some more surprising conclusions. For instance, within the transition region, Ukraine is particularly exposed to developments in its external environment, while Poland appears to be unusually resilient to them.

The outlook for the transition region remains dependent on the course of the eurozone crisis and its global repercussions, including its impact on commodity prices and global risk aversion. The transition countries will experience a substantial economic slow-down in 2012 and 2013 relative to 2011 as a result of the crisis. The CEB and SEE regions will see particularly slow growth and some of their countries have entered or will re-enter mild recession. As countries further east become more exposed to the impact of the crisis, their economies are also likely to flag. Possible further deterioration of the euro area turmoil poses the largest risks to already-slower projected 2012 and 2013 growth in the region.

GROWTH

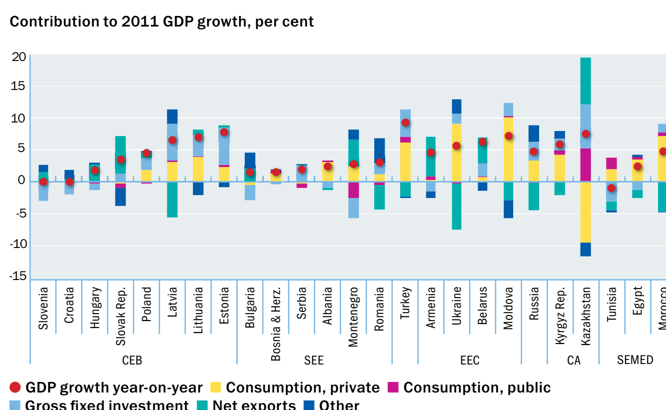
The intensification of the eurozone crisis occurred late enough in 2011 not to derail the transition region's full-year economic performance, which was rather better than that in 2010. With the benefit of high prices, commodity exporters in Central Asia grew robustly in 2011, particularly Mongolia, which expanded by over 17 per cent on the back of its mining boom, related foreign direct investment (FDI) inflows and highly pro-cyclical fiscal policy. Elsewhere, Turkey also maintained strong growth, fuelled by a credit boom financed largely by capital inflows, while Estonia, bouncing back from its deep and protracted 2007-09 recession, was the best performer in the CEB region. Within the EEC region, Georgia and Moldova returned unexpectedly strong results for the year, in part due to higher exports to neighbouring countries and recovery of agricultural output.

In contrast, Egypt and Tunisia in the southern and eastern Mediterranean (SEMED) region suffered recessions in 2011 as a result of declines in investment, tourism and FDI flows, reflecting political and economic uncertainties following their revolutions in the spring. While most SEE countries grew faster than in 2010, their recovery was dampened by the onset of the eurozone crisis. In the CEB region, Croatia and Slovenia recorded zero and slightly negative growth, respectively, as domestic factors (such as a troubled Slovenian financial sector) compounded the effects of the weak external environment. Meanwhile, a significant slow-down of the formerly booming Azerbaijani economy reflected a year of shrinking oil production.

Most countries that grew healthily in 2011 did so on account of private consumption (see Chart 2.1). Exceptions included Armenia and the Slovak Republic, which expanded due to substantially higher exports, and Kazakhstan, where a combination of stronger exports, greater government consumption and higher investment

Chart 2.1
Private consumption was a key growth driver in many countries

Contribution to 2011 GDP growth, per cent



Source: International Monetary Fund International Financial Statistics (IMF IFS)
Note: This chart depicts the contribution of components of national accounts to annual real gross domestic product (GDP) growth in 2011. "Other" component includes changes in inventories and statistical discrepancy.

compensated for a drop in private consumption. Investment was also an important driver in the Baltic countries. After the Baltic states increased their competitiveness through internal devaluations during the global crisis, exports have become a much more prominent component of their outputs, replacing real estate investment (see Chart 2.2). Now the export industry is beginning to stimulate a different kind of investment, mainly in the manufacturing sector. Exports have also increased in relative importance in many SEE economies since 2007, while Mongolia, in contrast, has seen a dramatic fall in the export share of its output as investments in mining (that should result in higher exports in the future) have become predominant.

More recently, in the first half of 2012, growth in countries across the transition region slowed down markedly as a result of the widening “spillovers” from the eurozone crisis. A large majority of transition economies recorded weaker year-on-year growth in the second quarter of 2012 relative to the third quarter of 2011 (see Chart 2.3).

Unsurprisingly, growth has slowed in most of the CEB countries, which are among the most vulnerable to developments in the single currency area. Having recorded successive quarter-on-quarter contractions in the first two quarters of this year, both Croatia and Hungary are now in a recession. Output in Slovenia contracted markedly in the second quarter of 2012, adding to its own “double dip” recession of early 2011. The Baltic states, Poland and the Slovak Republic performed better, although figures for the second quarter of 2012 suggest that Polish growth is slowing down as domestic demand weakens. In the SEE region Bulgaria and Romania also experienced a slow-down while the economies of FYR Macedonia and Serbia contracted relative to the first half of 2011. In the EEC region the two economies more closely intertwined with the eurozone – Moldova’s and Ukraine’s – saw their year-on-year growth slow from around 6 per cent in the third quarter of 2011 to 0.6 and 3 per cent respectively, in the second quarter of 2012.

Economies further east have also started slowing down. Since early 2012, the crisis has negatively impacted on oil and other commodity prices and on investor confidence. This has in turn undermined growth in Central Asia and, more importantly for the transition region as a whole, in Russia, where quarterly gross domestic product (GDP) and industrial production have slowed significantly during the first half of 2012. In addition to lower commodity prices, country-specific developments (such as problems at a gold mine in the Kyrgyz Republic) have contributed to weaker growth in Central Asia. Continuing political uncertainty has weakened growth performance in the SEMED region.

LABOUR MARKETS

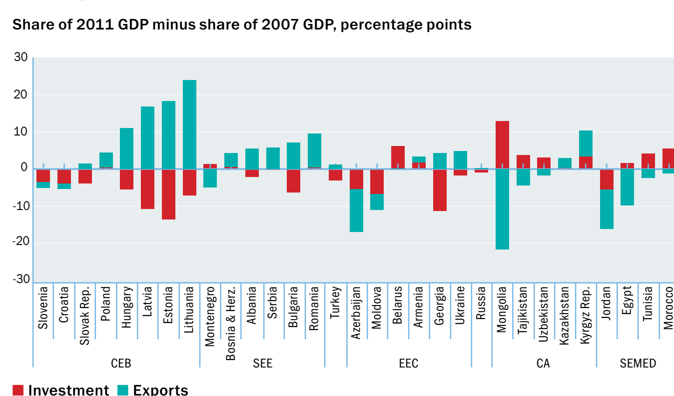
In many transition countries labour markets never fully recovered from the 2008-09 crisis. Now they are likely to face further strains in the face of eurozone developments. Employment has generally failed to keep pace with GDP growth since 2010, although countries in the region vary significantly in the extent to which growth results in job creation (see Box 2.1).

Over the past year unemployment rates have fallen in the Baltic states, but nevertheless they remain well above pre-crisis levels in all CEB countries (see Chart 2.4) except Poland (which avoided a recession during the global financial crisis). The SEE region has also seen a few apparent falls in unemployment, although from very high levels. Unemployment rates have been more stable in other regions, but have risen since late 2011 in Moldova and Ukraine, coinciding with a slow-down in growth. In the SEMED region the political and economic turmoil in the first half of 2011 contributed to rising unemployment in Egypt and Tunisia.

Chart 2.2

Exports have replaced investment in CEB countries' GDP since global crisis

Share of 2011 GDP minus share of 2007 GDP, percentage points

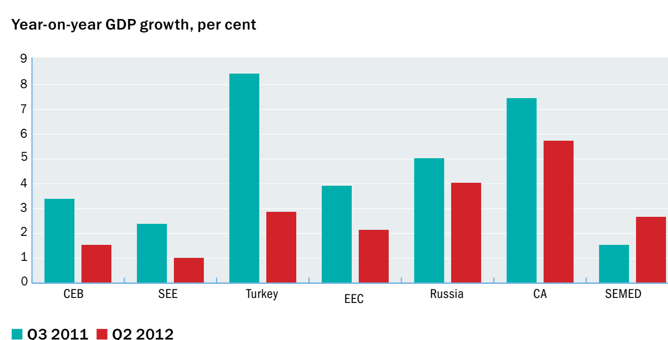


Source: IMF IFS.
Note: This chart shows the difference between the share of GDP in 2011 and the share of GDP in 2007 for gross investment and exports of goods and services, respectively.

Chart 2.3

Growth has dropped sharply in most transition regions in 2012

Year-on-year GDP growth, per cent



Source: National authorities via CEIC Data.
Note: This chart shows year-on year growth rates for the third quarter (Q3) of 2011 and the second quarter (Q2) of 2012. Regional aggregates are weighted using World Economic Outlook (WEO) estimates of nominal dollar GDP in 2011.

Box 2.1
The relationship between growth and employment in the transition region

The return of growth to the transition region in 2010 and 2011 largely failed to translate into a labour market recovery. Employment has lagged behind GDP in terms of average growth rates, which only turned positive in late 2010 (see Chart 2.1.1), and there has been no improvement in youth employment, which has continued to decrease in many countries ever since the 2008-09 crisis. Average figures, however, conceal a considerable degree of heterogeneity across the region. Some countries have seen employment rebound, while others have experienced a jobless recovery.[1] This analysis shows that countries vary in the extent to which growth is associated with job creation and relates this variation to differences in labour market institutions and in the share of long-term unemployment.

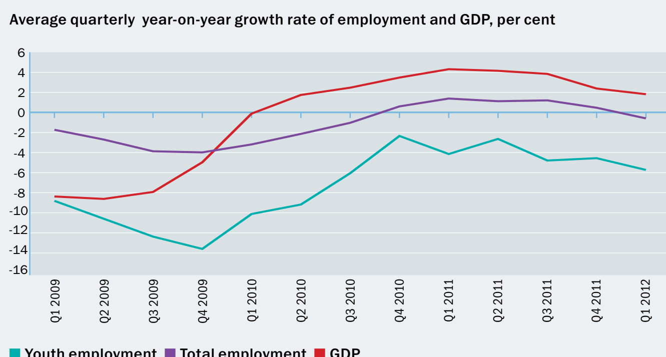
Economists typically expect a linear relationship between growth and changes in employment or unemployment, as encapsulated by Okun's law.[2] Estimates for individual transition countries show that a one-percentage point increase in quarterly growth is associated with a sizeable increase in employment in some economies but has no significant effect in others (see Chart 2.1.2). The speed of transmission also differs, with growth only leading to changes in employment with a lag in some countries (as in the case of Croatia, Hungary, Serbia and Slovenia). Similar analysis for youth employment reveals an even greater degree of heterogeneity. The results indicate there is a clear relationship in the Baltic states, where youth employment rose steadily prior to 2008 before falling by over 30 per cent in the wake of severe recessions, but not in Hungary and Romania, where employment among young people has been declining continuously for over a decade.

This variation could be due to a number of factors. Labour markets may differ in the extent to which growth generates vacancies, or in the efficiency of matching prospective workers to those vacancies.[3] Some transition economies also have large informal sectors, where job creation would not register in official employment figures. In others, public-sector employment, which is likely to be less responsive to growth, continues to represent a considerable share of the total.

A further explanation is that labour market rigidities in some countries dampen the effects of the cycle, preventing large falls in employment during recessions but acting as constraints in periods of growth. An analysis of employment and labour market institutions in the transition region between 2006 and 2011 provides some evidence for this. Table 2.1.1 shows the results of a panel regression in which annual employment growth was regressed on current and lagged growth rates, different measures of labour market institutions and, critically, the interaction between institutions and growth. The institutional measures are based on methodology from the World Bank *Doing Business* project and capture, respectively, the difficulty of hiring, the rigidity of hours and the difficulty of redundancy (see note attached to Table 2.1.1). Across the transition region, the correlation between these measures is surprisingly low, with many countries having a mixture of flexible and rigid institutions across different categories. The coefficients on the institutional measures are insignificant, which is to be expected since their *levels* are unlikely to have a direct effect on *changes* in employment. The interaction term estimates whether institutional rigidities dampen or amplify the effect of growth on employment. It

Chart 2.1.1
Employment returned to growth in late 2010 but youth employment has continued to decline

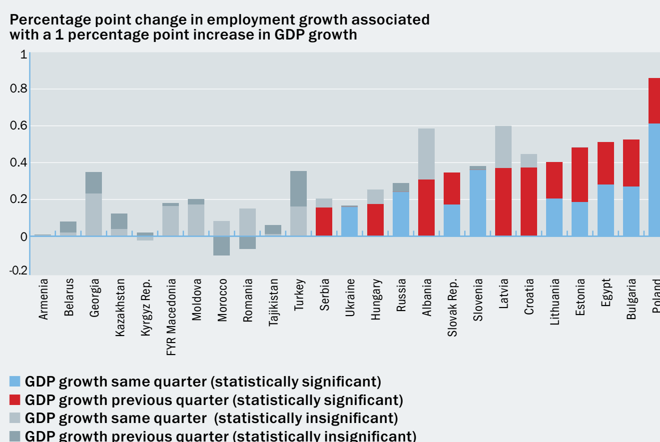
Average quarterly year-on-year growth rate of employment and GDP, per cent



Source: Eurostat and national authorities via CEIC Data.
Note: The chart shows unweighted averages for the transition region.

Chart 2.1.2
Heterogeneous impact of growth on total employment

Percentage point change in employment growth associated with a 1 percentage point increase in GDP growth



Source: Underlying data are from national authorities via CEIC Data.
Note: This chart depicts the results of country-by-country regressions of employment growth on real GDP growth and lagged real GDP growth using seasonally adjusted quarterly data for the period 1999-2011. Where significant, the chart shows the cumulative effect of contemporaneous (blue) and lagged growth (red).

[1] In Bosnia and Herzegovina, Bulgaria, Georgia, Moldova and Serbia, real GDP has surpassed its pre-crisis level while employment remains below 2007 levels.
[2] Okun's law, first documented by Arthur Okun in the 1960s, is a rule of thumb measure relating changes in the unemployment rate to changes in the growth rate.
[3] An analysis of vacancy rates and "Beveridge curves" which indicate how vacancy rates affect unemployment rates for selected transition countries provides some support for both explanations. Vacancy rates are more responsive to GDP growth in some countries than in others, while Beveridge curves indicate that the efficiency of matching also varies. Poland, where the estimated impact of growth on employment is the highest, is also the country where growth had the greatest effect on vacancies (in regressions of vacancy rates on growth and lagged growth) and where matching in the labour market has been most efficient in recent years (based on a comparison of estimated Beveridge curves).

is negative and significant for the difficulty of hiring measure (see column 1), which suggests that countries where hiring workers is costly and contracts are inflexible are likely to see smaller increases in employment for a given rate of growth. In contrast, rigid regulations governing working time or redundancy do not appear to affect the relationship between growth and employment (see columns 2 and 3).

These results imply that countries where growth does not result in job creation could benefit from structural reforms that facilitate hiring. At the same time, the lack of significance for other institutions and the low correlation between the indices, suggests a need for targeted reforms, such as restrictions on contracts and minimum wage laws,[4] rather than broader labour market liberalisation.

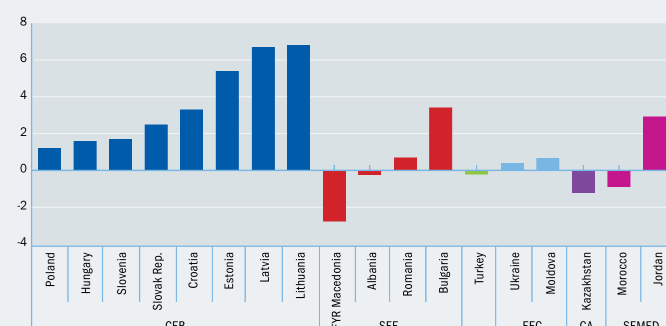
The cross-country variation in the relationship between growth and employment is also determined by a second factor – the extent of long-term unemployment. Individuals who remain unemployed for protracted periods of time begin to lose skills and become detached from the labour force and less attractive to employers. Compared with those who have been in recent employment, they are less likely to benefit from an increase in growth and a rise in vacancies. This dynamic also appears to affect labour markets at the aggregate level. Column 4 in Table 2.1.1 shows the results of including the proportion of the unemployed who are long-term jobless, and its interaction with growth, in the regression. The interaction term is negative and (just) statistically significant, implying that an increase in growth generates fewer jobs the greater the share of long-term unemployed among the job-seeking population.

In light of this finding, the rise in the long-term unemployment rate across many transition countries since 2008 (see Chart 2.1.3) may be of concern. Countries where this rate remains above pre-crisis levels (or rises due to a renewed downturn) could experience a lasting crisis impact on the transmission from growth to employment.

From the analysis of individual countries it appears that institutional differences and varying levels of long-term unemployment can account for part of the heterogeneity depicted in Chart 2.1.2. Of those countries where there was no significant relationship between growth and employment, Armenia and FYR Macedonia have a high proportion of long-term unemployed, while Moldova, Morocco, Romania and Turkey have relatively rigid institutions related to hiring.[5] In practice, the two factors are likely to be related, since institutional rigidities will determine how quickly those who become unemployed are able to re-enter the workforce.

Chart 2.1.3
Long-term unemployment has risen, particularly in the CEB and SEE regions

Change in long-term unemployment rate 2008-2011, percentage points



Source: Eurostat and national authorities via CEIC Data.
Note: The chart shows the long-term unemployment rate in 2011 minus the corresponding rate in 2008. Data are not available for some countries in the SEE, EEC, CA and SEMED regions.

Table 2.1.1
Restrictive hiring conditions limit the positive impact of growth on employment

Variables	Dependent variable: Annual change in employment			
GDP growth	0.487***	0.312***	0.350***	0.487***
	(0.000)	(0.000)	(0.000)	(0.000)
Lagged growth	0.083**	0.080**	0.089**	0.155
	(0.023)	(0.030)	(0.016)	(0.212)
Dificulty of hiring (DHI)	0.778			
	(0.486)			
DHI interaction with growth	-0.200**			
	(0.021)			
Rigidity of hours (RHI)		0.043		
		(0.968)		
RHI interaction with growth		0.023		
		(0.789)		
Dificulty of redundancy (DRI)			-1.095	
			(0.232)	
DRI interaction with growth			-0.025	
			(0.732)	
Share of long term unemployed				0.0210
				(0.212)
Long term share interaction				-0.005*
				(0.073)
Country fixed effects	(Coefficients not reported)			
Constant	-2.146	-1.612	-1.687	-2.195
	(0.143)	(0.275)	(0.110)	(0.002)
Number of observations	174	174	174	187
Period	2006-2011	2006-2011	2006-2011	1999-2011

Source: Underlying data from national sources via CEIC Data and Doing Business Employing Workers database.

Note: The table shows OLS regression coefficients with p-values in parentheses. "Difficulty of hiring", "Rigidity of hours" and "Difficulty of redundancy" describe several labour market institutions which affect labour market flexibility in the respective dimension, based on a methodology described in the Doing Business 2012 annex on employing workers, adapted from Botero, Djankov, La Porta, Lopez-de-Silanes and Schleifer (2004). The institutional measures in this analysis are dummy variables based on these indices which take the value of 1 if a country scores above the median (implying rigid institutions) and 0 if it scores below it (flexible institutions).

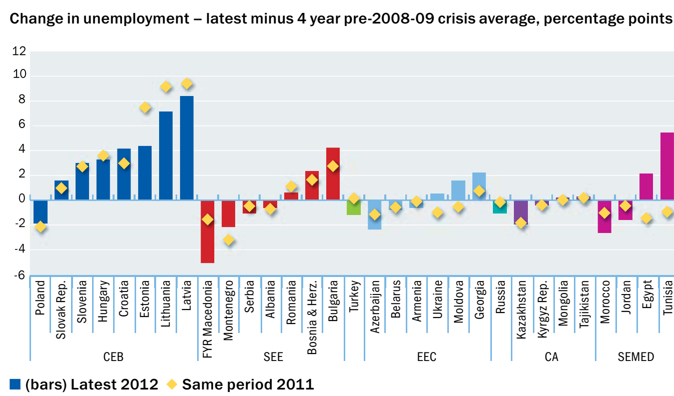
[4] "Difficulty of hiring" is an index based on the ratio of minimum wage to average wage, on regulations governing whether fixed-term contracts are prohibited for permanent tasks and on the maximum duration of fixed-term contracts.

[5] In Romania reforms to the labour code implemented in May 2011 allowed for greater flexibility in hiring, redundancy and the use of fixed term contracts. These changes are reflected in a drop in the 'Difficulty of hiring' index, which nevertheless remains above the median for EBRD countries (indicating relatively rigid institutions).

Chart 2.4

CEB unemployment is well above pre-2008-09 crisis levels

Change in unemployment – latest minus 4 year pre-2008-09 crisis average, percentage points

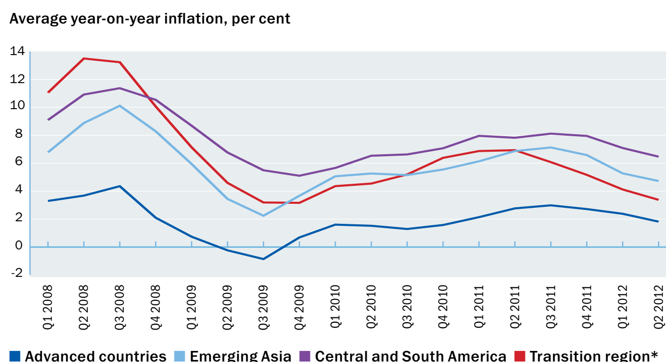


Source: National authorities via CEIC data service.
Note: This chart shows the latest unemployment rate and the corresponding rate in the previous year, minus the average unemployment rate in the same period in the four years preceding September 2008.

Chart 2.5

Inflation on the decline across the world, including in the transition region

Average year-on-year inflation, per cent



Source: IMF IFS and CEIC Data.
Note: The chart shows unweighted averages of year-on-year CPI inflation for each region. * The EBRD regional average does not include Belarus, where year-on-year inflation exceeded 100 per cent in Q4 2011.

INFLATION

Inflation has not been a pressing concern in the majority of transition countries, as slowing growth and easing world food prices led to a deceleration in price increases in much of the region between the third quarter of 2011 and mid-2012 (in line with a global trend towards disinflation) (see Chart 2.5). Indeed, inflation fell more quickly in the transition region than in other emerging markets. However, following a drought and poor corn harvest in the United States, food prices have again begun to accelerate in mid-2012, posing renewed risks to price stability in the region.

The drop in inflation was especially evident in some EEC and Central Asian countries, where food constitutes a larger share of the consumer price index (CPI) basket (see Chart 2.6). In Ukraine a good harvest led to a drop in food prices in the second quarter of 2012 and a currency appreciation against the euro reduced the cost of imports. There was also a large temporary fall in Serbia where the easing pressure from regulated prices, tightening of monetary policy and low demand allowed inflation to fall below 3 per cent for the first time in April 2012, but prices began to accelerate again in subsequent months.

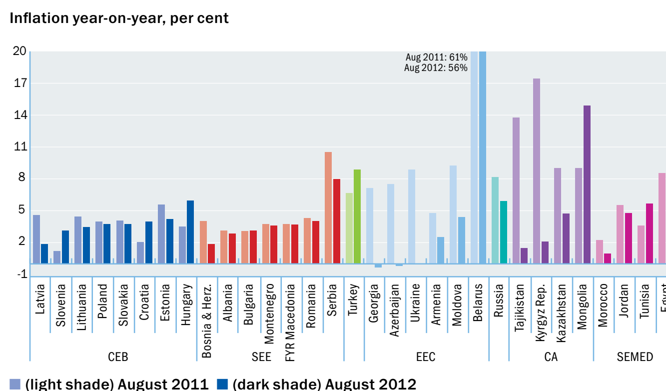
Core inflation has remained fairly stable in the majority of transition countries. Some rapidly growing economies, such as Turkey, continue to register elevated rates, but across the region there was no clear relationship between growth and core inflation in 2011.

Inflation remains a concern in a few cases. Hungary, where both food and energy prices increased at the start of 2012, is the only CEB country where headline inflation has breached 5 per cent. In Turkey, inflation remains high due to elevated core inflation. Belarus remains the country with the highest inflation

Chart 2.6

Inflation has decreased in most eastern European and Central Asian countries

Inflation year-on-year, per cent



Source: National authorities via CEIC Data.
Note: This chart shows year-on-year CPI inflation in August 2012 and August 2011.

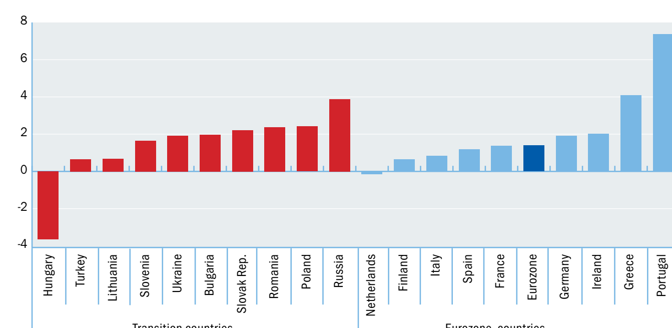
in the transition region, even though it appears to be returning to price stability as month-on-month seasonally adjusted inflation has remained below 3 per cent in 2012 after a period of very high inflation following the devaluation of its currency in May 2011. Loose fiscal policy and large capital inflows in Mongolia have fuelled a rapid expansion of consumer spending, causing a sharp acceleration of inflation.

Renewed pressure in world food markets that started in early summer 2012 could once again raise prices and therefore overall inflation rates in many transition countries. Although the impact of world food prices on local prices varies significantly

Chart 2.7

Fiscal consolidation in transition countries has been on a similar scale to that in the eurozone...

Change in cyclically adjusted primary balance, 2011, per cent

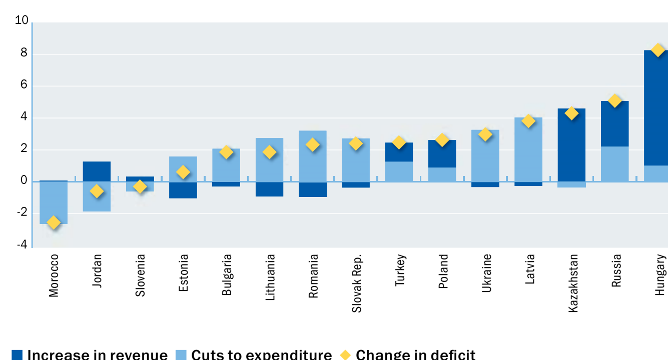


Data: IMF IFS.
Note: This chart shows the difference between the cyclically adjusted primary balance in 2011 and the same balance for 2010 (both as a per cent of potential GDP). The cyclical adjustment of actual balances is based on IMF staff calculations.

Chart 2.9

Consolidation in the CEB countries has been mainly expenditure-based

Change in government revenue and expenditure, 2011, per cent GDP

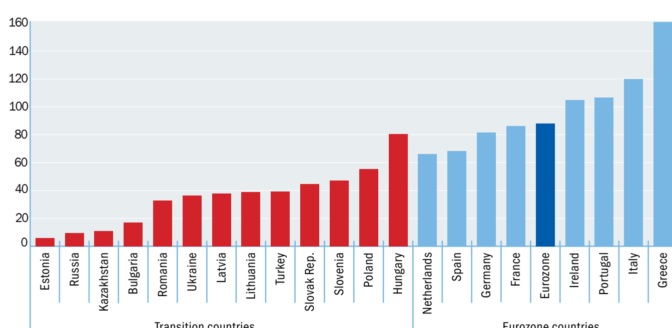


Source: IMF IFS.
Note: Changes that improve the fiscal balance are depicted as an increase in the chart, so a decline in government expenditure results in a positive value. Increase in revenue in Hungary includes the one-off effect of nationalising private pension funds, and in Kazakhstan and Russia the effect of higher commodity prices.

Chart 2.8

...but at significantly lower levels of debt

Government debt 2011, per cent of GDP



Data: IMF IFS.

across countries, the correlation between the former and the food component of domestic consumer price indices (CPI) has risen substantially in recent years in most countries of the region. Further food-related upward pressure on the CPI is therefore to be expected in the coming months and is already detectable in Albania, Bulgaria, Croatia, Estonia, FYR Macedonia, Montenegro, Morocco and the Slovak Republic. The speed and magnitude of the impact of world food prices on domestic inflation will likely be higher for those countries where food represents a larger proportion of their import and consumer spending. These include Albania, the three Caucasus countries and Egypt in particular, although policy interventions (such as subsidies in the case of Egypt) could lessen the direct effect on domestic prices.

Global food prices have become much more volatile, partly due to a higher frequency of climate change-induced extreme weather events. Coupled with the rise in the correlation between world and domestic food prices, this implies a greater fluctuation in domestic inflation, which can indeed be observed in almost all transition countries with the exception of Poland, Romania, Tunisia and Turkey. Even without a further large world food price spike, volatile food inflation and its impact on overall inflation has posed a challenge for central banks in the region.

FISCAL DEVELOPMENTS

Fiscal tightening in the CEB and SEE regions has contributed to the slow-down in growth caused by the euro area turmoil, as countries in these regions continue to implement austerity measures. Fiscal consolidation was on a scale comparable to that in the eurozone in 2011 (see Chart 2.7) and is forecast to follow a similar trajectory over the coming years despite much lower levels of debt (see Chart 2.8). While the ratio of public debt to GDP in transition countries increased significantly following the global financial crisis in 2008, it remains well below 60 per cent in the majority of the region. The notable exception in the CEB region is Hungary, which has an 80 per cent ratio and which saw its structural balance deteriorate in 2011 (although its actual balance was in surplus due to the one-off effect of the nationalisation of private pension funds).

Fiscal tightening in the CEB and SEE countries has been primarily expenditure-based (see Chart 2.9). Governments have implemented a range of policies including raising the retirement

age (in Bulgaria and Poland), restraining public-sector wage growth (in Latvia, Poland and Slovenia) and passing legislation limiting deficits at the national and local level (in Poland). Efforts to raise revenue, including through the introduction of new taxes, the removal of tax exemptions and increases in VAT, have generally been undermined by weakening economic conditions (Poland being the main exception).

Further east pro-cyclical fiscal policy, together with strong growth, resulted in more expansionary policies in 2011. Output gaps are positively correlated with changes in expenditure in a number of economies, including some commodity-producing countries in central Asia (see Chart 2.10). Spending also turned out mildly pro-cyclical in Russia, which nonetheless saw a substantial increase in its cyclically adjusted balance in 2011. The country's fiscal position has been bolstered by stable oil revenues, but it remains vulnerable to a decline in global energy prices.

In some countries reforms aimed at consolidation have been undermined by expansionary spending increases in the run-up to elections. In Mongolia, which held elections in June 2012, annual unconditional cash transfers to the population, to the tune of 7 per cent of GDP, added substantially to government spending. Prior to elections in the second half of 2012, public sector wages were increased in Belarus, while governments in Georgia and Ukraine announced plans to raise pensions.

In the SEMED region governments have sought to curtail spending in 2012, following large increases in subsidies, social welfare spending and public-sector wages during the political turmoil in 2011. Fuel and energy prices were increased in Morocco, and the authorities have announced further reforms to administered prices and subsidies. Similar measures encountered popular resistance in Jordan and have yet to be implemented in Egypt.

TRADE

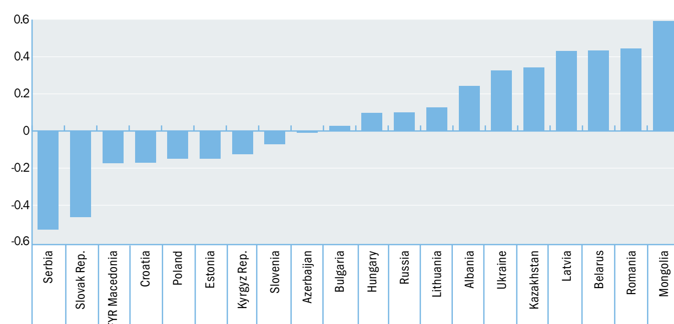
The onset of the eurozone crisis has led to a significant decline in exports from many transition countries, and in particular from all CEB and SEE states since the autumn of 2011 (see Chart 2.11). In contrast, countries further east enjoyed strong nominal export growth until mid 2012, before a dip in oil prices and the widening global slow-down led to a reversal. As Russian growth decelerated and its imports declined in the second quarter of 2012, countries in Central Asia and the EEC region experienced a drop in exports. The largest decline was seen in Azerbaijan where oil exports fell significantly in the first half of 2012.

The variation in export performance across the region can in part be attributed to different levels of exposure to the eurozone. The growth of imports to the single currency area gradually decelerated in 2011 and their volume began to decline as the crisis intensified late in the year. Transition countries with deeper trade linkages to the eurozone have seen steeper declines in exports than those with weaker ties (see Chart 2.12).

However, falling exports have been offset by an even faster decline in imports in some transition countries in the second half of 2011. Trade balances have thus largely improved, except in the SEMED region where rising imports and weak export performance have led to widening deficits.

Chart 2.10
Government expenditure was pro-cyclical in a number of transition countries

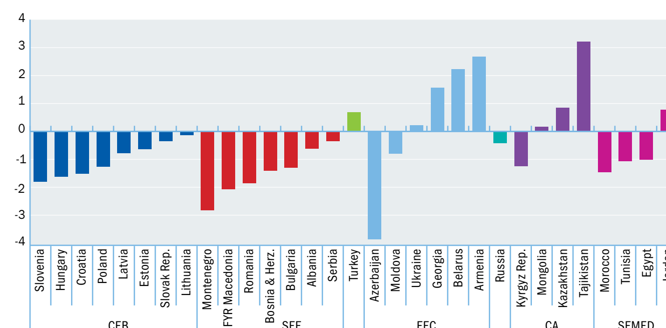
Correlation between output gap and government expenditure



Source: National authorities via CEIC Data.
Note: This chart shows the correlation between the output gap and seasonally adjusted quarter-on-quarter government expenditure for the period 2005-2011. The output gap is the difference between seasonally adjusted quarter-on-quarter actual and potential GDP, calculated using a Hodrick Prescott filter with λ = 1600. This analysis is based on the assumption that in developing countries, the elasticity of government expenditure to the output gap is zero. However, relaxing this assumption and computing the cyclically adjusted expenditure using the HP filter does not alter the results. The high correlation for Latvia is explained by pro-cyclical fiscal policies during the 2008-09 crisis when cuts to government spending coincided with a severe recession.

Chart 2.11
Exports from CEB, SEE and SEMED regions are declining

Average seasonally adjusted month-on-month export growth, Sept 2011-July 2012, per cent



Source: National Authorities via CEIC Data.
Note: Export data are in US dollar values.

CAPITAL FLOWS AND CREDIT GROWTH

In addition to depressing export levels, the ongoing turmoil in the eurozone has prompted the first overall private capital outflow[6] from the transition region since the global financial crisis of 2008-09. At that time substantial capital inflows, previously amounting to 2-3 per cent of annual GDP each quarter, had turned sharply negative. By late 2009 capital inflows had resumed, albeit at modest levels, helping to support nascent recoveries in many transition countries. Then, in the second half of 2011 as the eurozone crisis intensified, overall flows turned negative again. Just as in 2008-09, the reversal was driven by debt and portfolio flows, while FDI into the region dropped substantially but remained slightly positive.

The headline capital flow figures, however, mask important differences between transition regions and countries. Chart 2.13 shows both FDI and non-FDI private capital flows – reflecting mainly bank debt, portfolio investment (bonds and equities) and capital flight – for the main destinations of capital within the region. The drop in non-FDI flows in the second half of 2011 was largest in those countries and regions most integrated with the eurozone. In the CEB and SEE regions flows turned slightly negative, and in Turkey, where they had previously fuelled rapid expansion in an overheating economy, they halved. However, flows to these countries have subsequently started to recover, suggesting that the impact of the eurozone situation may have been temporary and peaked in the third quarter of 2011, when the eurozone crisis initially worsened.

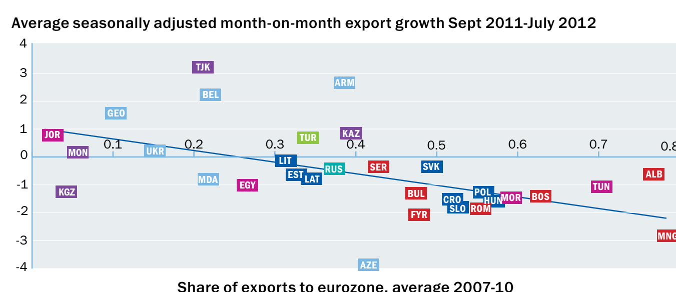
In contrast, non-FDI flows in Russia have been consistently negative since the third quarter of 2010 – a full year before the eurozone crisis intensified – due to portfolio outflows and also capital flight. This may reflect idiosyncratic Russian factors, including the outflow of resource revenues in an environment of high political uncertainty and elevated investment costs, as well as a more flexible exchange rate regime that is now discouraging "one-way bets" on the rouble. For the transition region as a whole, outflows from Russia more than offset inflows to CEB and SEE countries and Turkey in the second half of 2011. By mid-2012 outflows from Russia had eased. As CEB, SEE and Turkish flows began recovering, total flows into the region turned marginally positive in the first half of the year.

Following strong inflows in 2011, FDI declined sharply in the CEB and SEE countries and slowed in Turkey in the first half of 2012 (see Chart 2.14), coinciding with a drop in outward investment from the eurozone. Statistical analysis shows that FDI flows into these countries over the previous decade had been affected by economic conditions in the source country rather than by prevailing or past growth rates in the recipient state.[7] This suggests that FDI will not be insulated from weaknesses in the eurozone in countries where it has remained strong so far, particularly if a large share of that investment comes from the eurozone's periphery that entered, or remains in, recession in 2012.

Regions less affected by the eurozone crisis witnessed some significant increases in FDI flows. Countries in the EEC region saw substantial increases in 2011 but FDI declined in the first half of 2012, coinciding with a drop in outward FDI from Russia. Central Asia continues to see a rapid expansion. FDI rose in Mongolia where inflows in 2011, mainly into the natural resource extraction sector, were around 50 per cent of GDP. These are the

Chart 2.12
Exposure to the eurozone has determined export performance

Average seasonally adjusted month-on-month export growth Sept 2011-July 2012

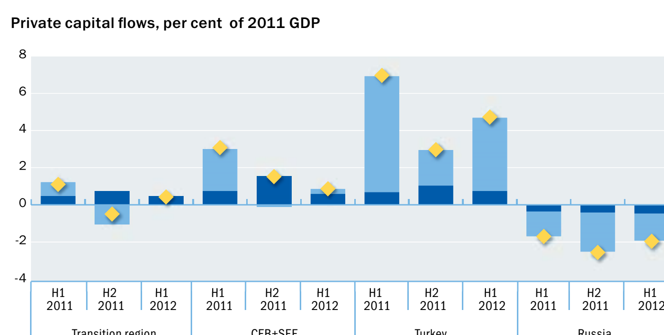


Share of exports to eurozone, average 2007-10

Source: National authorities via CEIC Data.
Note: Export data are in US dollar values.

Chart 2.13
Transition region saw capital outflows in the second half of 2011

Private capital flows, per cent of 2011 GDP



Non-FDI flows ■ FDI flows ◆ Total flows

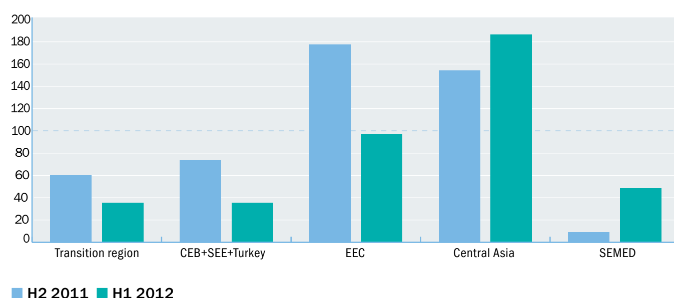
Source: National authorities via CEIC Data.
Note: Data are from the capital and financial account of individual EBRD countries. Private non-FDI flows are the sum of the capital account, portfolio investment, other investment and net errors and omissions, excluding flows to governments, flows to monetary authorities and trade credits. Net errors and omissions are included as this can be a significant channel of current account deficit financing or a major channel of capital flight in some countries.

[6] Throughout this section, capital flows refer to net, rather than gross flows.

[7] A panel regression using annual data on bilateral flows from six large eurozone economies to countries in the transition region between 2001 and 2010 shows that an increase in the source country's growth rate of 1 percentage point increases its stock of FDI in the receiving country by 5.9 per cent.

Chart 2.14
FDI flows to CEB, SEE and Turkey have declined and are well below pre-2008 levels

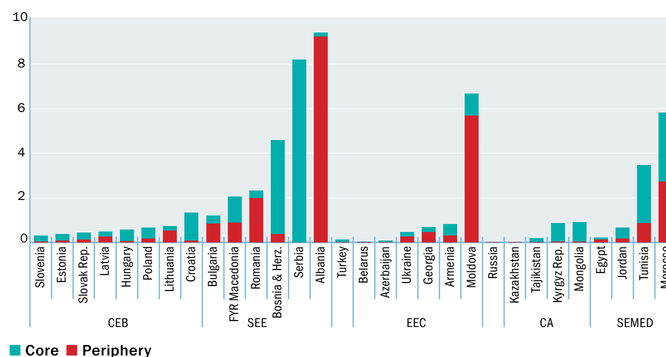
Net FDI flows (Index: 2007 average = 100)



Source: National authorities via CEIC Data.
Note: Chart shows net FDI flows in the second half of 2011 and first half of 2012 as an index with average net FDI flows in 2007 equal to 100.

Chart 2.15
Few transition countries depend on remittances from the eurozone periphery

Estimated remittances from the eurozone as a share of GDP, 2010, per cent



Source: World Bank data.
Note: This chart shows remittance inflows from the eurozone in 2010 as a share of 2010 GDP. The World Bank's estimates of bilateral remittance flows are based on migrant stocks, host country incomes and origin country incomes. Periphery includes Greece, Ireland, Italy, Portugal and Spain.

only transition regions where FDI flows have returned to pre-crisis levels. In SEMED there has been an ongoing decrease in FDI since 2008, with political uncertainty leading to acceleration of the decline in 2011, followed by a slight recovery in the first half of 2012.

Unlike private capital flows, remittances to the majority of transition countries have remained broadly stable as the eurozone crisis has thus far not had a significant impact through this channel. Despite the crisis, both remittance outflows from the eurozone and inflows to the transition region, increased in the second half of 2011 and first quarter of 2012. These aggregates, however, conceal a considerable degree of variation, which indicates that certain bilateral remittance corridors have been affected. Remittances from countries in the eurozone periphery have declined significantly; falling in year-on-year terms in Greece, Ireland, Italy, Portugal and Spain in the first quarter of 2012. At the same time, countries in the SEE region which receive a large share of their remittances from the periphery have seen declines. Chart 2.15 shows that remittances from the periphery constitute a substantial source of vulnerability for a handful of transition countries, accounting for between 2 and 10 per cent of GDP in Albania, Moldova, Morocco and Romania.

However, the eurozone crisis did significantly affect cross-border bank financing for the transition region. International bank claims on the region fell sharply in the third quarter of 2011 and continued to decrease at slower rates in the first half of 2012 (see Chart 2.16). The reduction in cross-border exposures has been most striking for the CEB region, whose banking systems are very closely integrated with eurozone parent banks. It started with a slight drop in the second quarter of 2011 followed by a very large flight in the second half of the year. The first half of 2012 saw a significant deceleration of outflows, but the decrease in exposures continued. This dramatic pattern was mostly driven by the largest CEB country, Poland, although all CEB economies witnessed slower cross-border deleveraging in the first half of 2012.

Elsewhere, Ukraine also saw significantly slower falls in international bank exposures after the outflows peaked in the third quarter of 2011, and Turkey returned to an increase in claims in the first two quarters of 2012. Deleveraging in the SEE region, however, has not showed signs of slowing and outflows from Serbia in particular worsened in early 2012.

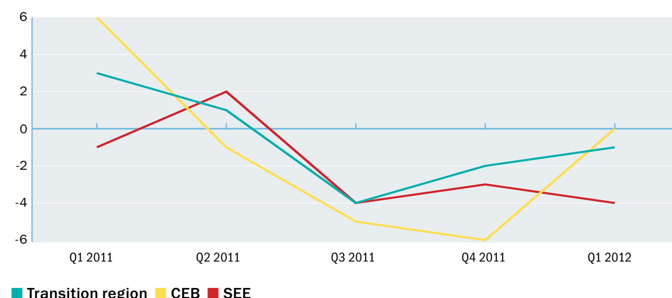
The cross-border deleveraging of the past 12 months has had a negative impact on credit growth (see Chart 2.17). According to the most recent available data, real credit contracted by at least 5 per cent in August 2012 relative to a year earlier in all CEB countries except Poland and the Slovak Republic (which, among the CEB economies, have been the least affected by the eurozone turmoil to date). In the larger SEE countries – Bulgaria, Romania and Serbia – credit growth never fully recovered from the 2008-09 crisis and has since lingered close to zero. Negative growth figures in August 2012 for Romania and Serbia, following several months of meagre real credit growth, suggest that the eurozone crisis has stymied whatever recovery may have been taking place in their lending markets.

Elsewhere in the transition region, real credit growth has been decelerating in Turkey, where the credit market is cooling after a capital inflow-driven boom in 2011, but has remained positive in Ukraine, despite its banking links with eurozone parent institutions. Ukraine, together with Bulgaria and Poland, saw a recent rise in domestic funding through bank deposits just about

Chart 2.16

Speed of cross-border deleveraging has diminished in early 2012

FX adjusted change in foreign bank claims, per cent of previous period's stock

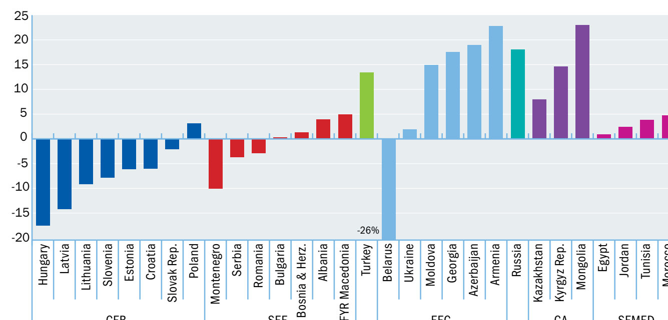


Source: Bank for International Settlements.
Note: This chart depicts the change in foreign bank claims as a percentage of previous period's stock, adjusted for foreign exchange movements.

Chart 2.17

Real credit growth is largely negative in CEB and SEE countries

Real credit growth year-on-year August 2012 (or latest), per cent



Source: National authorities via CEIC Data.
Note: Growth rate of credit is adjusted for foreign exchange movements and inflation.

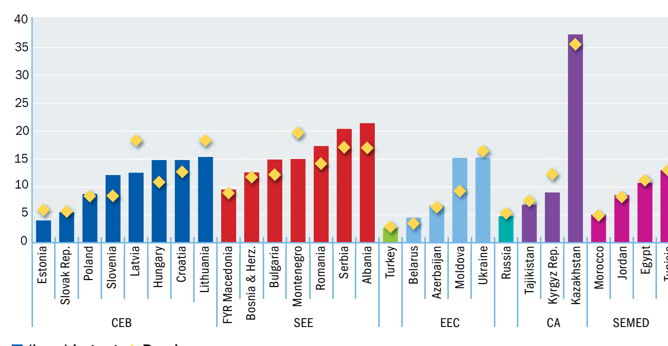
compensate for the loss of cross-border financing, which likely contributed to the positive growth. Real credit has meanwhile expanded in Central Asian and other EEC countries, which have more limited financial exposure to the single currency area, with the exception of Belarus where high inflation levels have eroded real lending increases.

Apart from lower cross-border funding availability, credit growth has also been dampened by high non-performing loan (NPL) ratios, which persist as a legacy of the 2008-09 crisis in many countries. In 2011 and the first half of 2012, there were further increases in the SEE region (see chart 2.18) where the average ratio is now above 15 per cent (compared with 4 per cent in 2008). A similar rise was seen in Croatia and Slovenia as well as in Hungary, where loans denominated in the appreciated Swiss franc are an ongoing concern. By contrast, efforts at resolution achieved some successes in the Baltic states, where NPLs fell over the past year. Further east, ratios remained broadly stable except in Moldova, where a sharp increase in the share of NPLs is partly due to a shift in reporting standards, and in the Kyrgyz Republic, which saw a decline as a result of economic recovery in 2011.

Chart 2.18

NPLs have risen in the SEE region, Croatia, Slovenia and Hungary

Non-performing loan ratio, per cent



Source: National authorities via CEIC Data.

VULNERABILITY OF TRANSITION ECONOMIES TO THEIR EXTERNAL ENVIRONMENT

Economic developments in the region since the deterioration of the eurozone sovereign debt crisis in the summer of 2011 clearly show that transition economies depend on the fortunes of the single currency area. Exports, capital flows and bank financing have all been affected by the euro area turmoil, resulting in lower overall growth by early 2012 in many countries and raising concerns about future prospects and possible further deterioration.

Chapter 1 of *Transition Report 2011* sought to quantify the transition countries' vulnerability to the eurozone through an index that measured, as a share of their GDP, the sum of their individual exposures in terms of exports to the area, short-term debt financing by it and FDI from it (see also Chart 2.19). It enabled the formulation of a clear country exposure ranking and identified the scale of each of the channels of vulnerability to the single currency area. The index revealed the particularly high exposure of many of the CEB and SEE countries to a downturn and instability in the eurozone, and has identified Ukraine as the most vulnerable country further east and Morocco and Tunisia in the SEMED region.

Simple correlations between the cyclical components of output growth rates of the euro area and of transition countries confirm that the business cycles of most CEB and SEE countries, as well as those of Russia, Turkey and Ukraine, are interlinked with those of the eurozone (see Table 2.1). Just like the eurozone exposure index, however, these correlations do not indicate the degree of output decline that transition countries would suffer as a result of further deterioration in the eurozone economies of a given magnitude.

An econometric analysis was therefore undertaken to estimate the size of that decline in each transition country as a result of a slow-down in the eurozone (or of the gains as a result of additional growth). The analysis conflates the various transmission channels from the eurozone to transition economies – such as exports, FDI and external debt financing, which made up the exposure index – and focuses on changes in output as a whole. The same approach is used to yield vulnerability estimates for external factors other than eurozone growth, including conditions in global financial markets and oil prices. It also calculates the impact of changes in the rate of economic growth in Russia – which represents a crucial component of the external conditions of many transition economies.

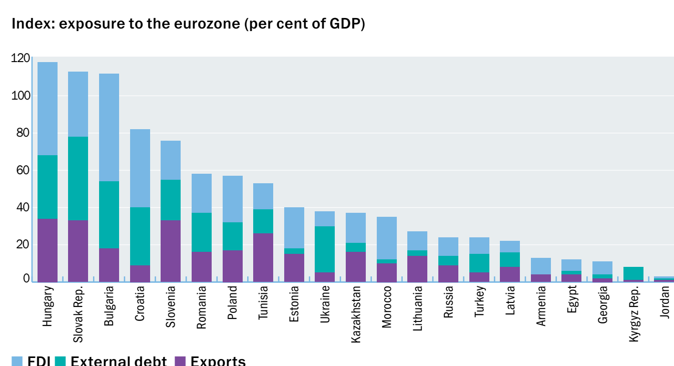
The analysis is based on a statistical technique called "means-adjusted Bayesian vector autoregression" (BVAR). Quarterly growth rates of transition economies are expressed as linear functions of the previous two periods' growth rates of each economy as well as those of the world as a whole, the eurozone and Russia (or, in the case of SEMED countries, Saudi Arabia). They are also a function of past oil price changes and realisation of the VIX index – the implied volatility of the Standard & Poor's 500 stock market index – which is a good measure of global financial market conditions (the higher the VIX value, the more unsettled the markets).[7]

The BVAR technique enables an estimation of the response of each country's output growth to shocks to the variables representing its external environment. Each of those shocks impact the transition country not only directly, but also by affecting the other elements of its external environment, which in turn influence the country's growth. Table 2.2, which presents the main results, contains the cumulative impact of a typical shock (a "one standard deviation shock") to each of the variables representing its external environment on domestic real output growth four quarters after the shock occurs. In the case of the VIX index, the "typical" shock is an 8-point change; in the case of the oil price, it is a 14 per cent change; and in the case of world, eurozone, Russian and Saudi Arabian growth, it is a change of 0.7, 0.6, 1.9 and 1.3 percentage points, respectively.[8] Charts 2.20, 2.21 and 2.22 translate these numerical results into "heat maps" that visually depict each country's vulnerability to the eurozone, to Russia and to financial market volatility, whereby the darker the shading of a given country, the higher that country's exposure to a component of its external environment.

Chart 2.20 reveals, not surprisingly, that most of the countries for which eurozone growth has a significant impact on output are in the CEB or SEE regions. However, the ranking of countries according to the econometric analysis is quite different from that suggested by the exposure index

Chart 2.19
CEB and SEE countries are the most exposed to the eurozone via exports, capital flows

Index: exposure to the eurozone (per cent of GDP)



Source: Eurostat, DOTS, BIS.
Note: The index is calculated as the sum of the share of eurozone countries in exports weighted by the share of exports in GDP, the share of eurozone cross-border claims on a country weighted by short term external debt as a share of GDP and the share of eurozone FDI weighted by the share FDI in GDP.

[7] The BVAR is run on a vector of variables that includes VIX, oil price changes, world, eurozone and Russian growth as well as each transition country's growth. All the BVARs regress the vector of variables on the first and second lag of that vector. The regressions are written in a means-adjusted form, which utilises priors on the variables' steady state values (taken to be intervals around their long-run means). The BVARs also incorporate priors on the variables' coefficients on their own first lags (taken from simple AR(1) processes). The transition country growth rates are treated as exogenous in the regressions, since they (except for the case of Russia) represent small economies and therefore do not affect the other variables in the model (which affect each other as well as the transition country growth rates). All models use data from Q2 1995 or earliest available through Q4 2011. For a more detailed description of the technique see, for instance, P. Osterholm and J. Zettelmeyer (2007). Details on model parametrisation are available on request (email: rickaf@ebrd.com).

[8] These "one standard deviation shocks" are much lighter than those experienced during the last crisis. For example, eurozone growth was about five standard deviations below its mean at the peak of the global financial crisis in the first quarter of 2009.

Table 2.1
Cycles in CEB, SEE countries but also Russia, Turkey and Ukraine are correlated with those in eurozone

	Eurozone	Oil price	VIX	World	Russia	Saudi Arabia
Croatia	0.760***	0.296*	-0.473***	0.457**	0.670***	0.293*
Estonia	0.678***	0.329**	-0.631***	0.434***	0.421***	0.311*
Hungary	0.680***	0.354**	-0.546***	0.435***	0.402***	0.329**
Latvia	0.470***	0.142	-0.363**	0.387**	0.317**	0.0983
Lithuania	0.621***	0.141	-0.372**	0.299*	0.375**	0.346**
Poland	0.260*	0.0634	-0.192	0.168	0.224	0.0507
Slovak Republic	0.391***	0.0677	-0.255*	0.276*	0.247*	0.181
Slovenia	0.632***	0.369**	-0.582***	0.543***	0.446***	0.143
Bulgaria	0.345**	0.182	-0.0941	0.307*	0.362**	0.103
Romania	0.634***	0.297*	-0.502***	0.430**	0.654***	0.301*
Serbia	0.247	0.0559	-0.135	0.169	0.164	0.151
Turkey	0.496***	0.381**	-0.400***	0.413***	0.300*	0.373**
Armenia	0.341*	0.288*	-0.487***	0.262	0.428**	0.00648
Azerbaijan	0.302*	-0.0590	-0.170	0.278*	0.165	-0.105
Belarus	0.377**	0.283	-0.442**	0.213	0.300*	0.280
Georgia	0.143	0.125	-0.0763	0.0326	0.178	0.0211
Moldova	0.464***	0.252	-0.271	0.214	0.576***	0.250
Ukraine	0.747***	0.502***	-0.536***	0.462**	0.876***	0.352*
Russia	0.573***	0.516***	-0.479***	0.508***	1	0.152
Kazakhstan	0.298*	0.198	-0.323*	0.225	0.245	0.0706
Kyrgyz Republic	0.227	0.322*	-0.161	0.0813	0.252	0.213
Tajikistan	0.108	0.147	-0.136	-0.00635	0.181	0.0150
Uzbekistan	0.0766	0.106	-0.187	0.160	0.0332	-0.122
Egypt	-0.0308	-0.0289	-0.0412	0.132	0.0935	-0.570***
Jordan	-0.0521	-0.284*	0.0419	0.182	-0.0455	-0.161
Morocco	0.0182	0.112	-0.0379	-0.0120	0.0724	0.0787
Tunisia	-0.0866	-0.163	0.0285	0.179	0.0907	-0.619***

Source: Underlying data from national sources via CEIC Data and from the IMF.

Note: The table shows simple correlations between the column and row variables, which are all quarterly GDP growth rates, with the exception of oil price growth and of VIX, which is an index value. Data used extends from Q2 1995 or earliest available through Q4 2011. The trend components of all variables have been removed using the Hodrick-Prescott filter; correlations were calculated using the remaining cyclical components of the variables only. ***, ** and * denote statistical significance at the 1, 5 and 10 per cent levels, respectively.

Table 2.2
Eurozone growth positively affects growth in most new EU members but also in Ukraine

	VIX	Oil price	World	Eurozone	Russia / Saudi Arabia
Croatia	-1**	0.2	0.6*	0.8**	0.7**
Estonia	-2.5**	0.2	1.3**	1.6**	0.2
Hungary	-0.7**	0.1	0.6**	0.7**	0.2
Latvia	-2.1**	-0.3	1.3**	1.7**	0.8*
Lithuania	-1.9**	-0.2	1.4**	1.8**	0.8*
Poland	-0.3	0.3	0.7**	0.2	0.4*
Slovak Republic	-1.3**	-0.2	1.4**	0.5	0
Slovenia	-1.5**	-0.1	1.2**	0.8**	0
Bulgaria	-0.7	0.2	1.4**	0.7*	0.7**
Romania	-1**	0.4	0.9**	1.2**	0.6**
Serbia	-0.9*	0.2	1.3**	0.3	0.6*
Turkey	-1.4**	0.1	2.2**	0.4	-0.1
Armenia	-2.7**	1.1	1.9*	1.5*	2.2**
Azerbaijan	-1.1	1	2.7*	1.8	1.5
Belarus	-1.3*	0.3	1.8**	0.6	0.7
Georgia	-0.8	0.3	1.3**	0.7	1.2**
Moldova	-0.6	0.3	1.5**	0.4	1.6**
Ukraine	-2.1**	1	1.7*	2.2**	1.6**
Russia	-1.2**	1**	1.8**	0.4	2.1**
Kazakhstan	-0.3	0.5	2.5**	1**	0.9*
Kyrgyz Republic	-0.2	0.6	1	0	0.6
Tajikistan	0.1	1*	2.4**	0.2	1**
Uzbekistan	0	0.3	2.1**	-0.4	0.5
Egypt	-0.3	0.1	1.5*	0	-0.5
Jordan	0.1	-0.5	1.6**	0.4	0.9**
Morocco	0.2	0.2	0.9**	0.2	0.3
Tunisia	0	0.2	0.5	-0.1	-0.4

Source: Underlying data from national sources via CEIC Data and from the IMF.

Note: The values in the table represent the response of the year-on-year quarterly growth rate of the row variables four quarters following a one standard deviation shock to the column variables, based on the Bayesian VAR model specified in the text. All variables are quarterly GDP growth rates, except for oil price growth and VIX, which is an index value. Last column measures response to a shock to output of Saudi Arabia in the case of the SEMED countries and to output of Russia for all other countries. Data used extends from Q2 1995 or earliest available through Q4 2011. ***, ** and * denote statistical significance at the 1, 5 and 10 per cent levels, respectively.

(in Chart 2.19). According to the econometric analysis, Ukraine is the most vulnerable country to fluctuations in eurozone output, followed by the three Baltic states. In the case of Ukraine, the analysis shows that its economy is quite susceptible to external shocks in general, and that relatively small changes in its external environment can swing the entire economy in one direction or another, irrespective of whether those changes originate in the east or the west. On the other hand, output in the Slovak Republic does not seem to depend significantly on eurozone fluctuations, despite its considerable exposure to the single currency area through its export, FDI and banking links. Slovak exports are concentrated in particular industries, including cars and electronics, which have been resilient to downturns in the eurozone, and the country's banks, while largely owned by eurozone parents, have been amply funded by domestic deposits. A similar result for Poland is perhaps less surprising: its relatively large economy with a smaller proportion of exports as a percentage of GDP has shown resilience even in the face of the global financial crisis, which is consistent with a lack of significant dependence on eurozone growth revealed in Chart 2.20. Beyond the EU and its neighbours, only Armenia and Kazakhstan appear to

significantly depend on growth in the single currency area.

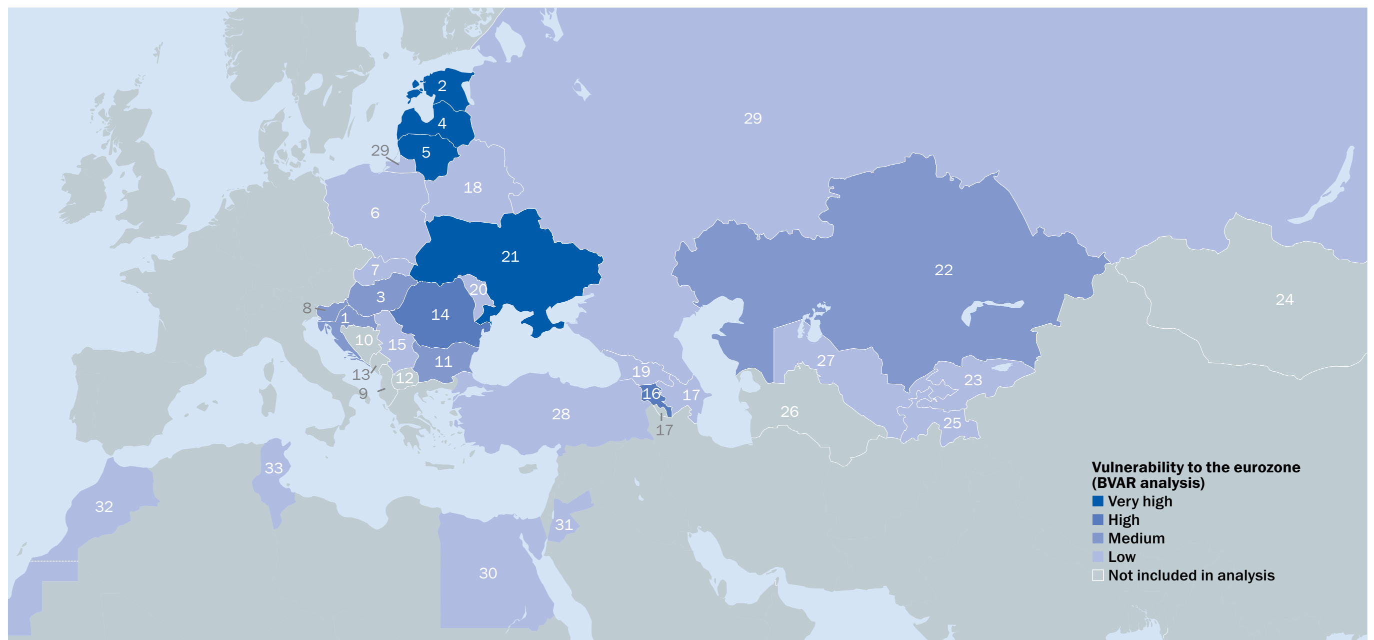
Germany is generally considered the main engine of the eurozone economy and is the principal trading partner of, and FDI source for, many transition countries. Is it therefore the case that the eurozone's effect on those countries derives solely from the impact of the German economy, or do the other members of the single currency area matter as well? The question can be answered by replacing eurozone growth with German growth in the BVAR model, and comparing how transition country growth rates react to shocks to German and eurozone growth rates. It transpires that, for most countries, the influence of the eurozone as a whole in this respect is at least twice that of German growth alone, indicating the importance of the entire eurozone to economic developments in the transition region. In fact, only in Slovenia among those countries for which eurozone growth matters in the first place is Germany singularly responsible for most of that effect (although it also represents a significant proportion of the eurozone impact for Estonia and Lithuania).

Russia's economy seems to have a perhaps unexpectedly wide geographical reach (see Chart 2.21). As expected, it affects the non-commodity exporting countries of Central Asia and the EEC region, including Armenia, Georgia, Moldova, Tajikistan and Ukraine. Most of these countries not only export to Russia but also rely on it as a source of remittances and FDI. The link between the Russian economy and those of Latvia and Lithuania is also understandable given the countries' close proximity. Higher Russian growth, however, also appears to have a positive economic effect in Bulgaria, Croatia, Poland and Romania.

For the SEMED economies, which are economically and geographically far more distant from Russia, the analysis instead considers the impact of Saudi Arabian growth as a potential external driver. Gulf Cooperation Council countries in general, and Saudi Arabia in particular, play a similarly important role for many Middle East and North African economies as Russia does for many Central Asian and EEC countries. The analysis suggests that, of the four SEMED countries, only Jordan responds significantly to higher growth in Saudi Arabia, reflecting its closer ties with the Gulf economies through remittances, exports and foreign grants.

Among the countries analysed, a higher oil price does not appear to have a statistically significant positive effect on growth in commodity-exporting transition countries except Russia. This is perhaps because oil money does not trickle down into their domestic consumption as readily as in Russia, or because the high volatility of oil and gas production in some countries, such as Azerbaijan, makes it difficult to isolate the growth impact of oil prices. For the non-commodity exporting countries of Central Asia and the EEC such as Armenia, Georgia or Moldova, it is thanks to Russia that higher oil prices do not have a more negative impact on their economies.[9]

Chart 2.20
Ukraine and the Baltic states are especially vulnerable to the eurozone



Note: for country legends see page 93.

[9] The BVAR model is estimated separately with Russia as an exogenous variable. This model specification isolates the direct impact of oil prices on each country's growth as opposed to the baseline specification, which captures the sum of the direct impact and an indirect impact on each economy via higher Russian GDP growth due to the higher oil price. The difference between the two effects is the attenuation of the potentially negative impact of oil prices due to the concurrent positive impact of additional growth in Russia.

Chart 2.21
Eastern Europe and the Caucasus are most vulnerable to Russia

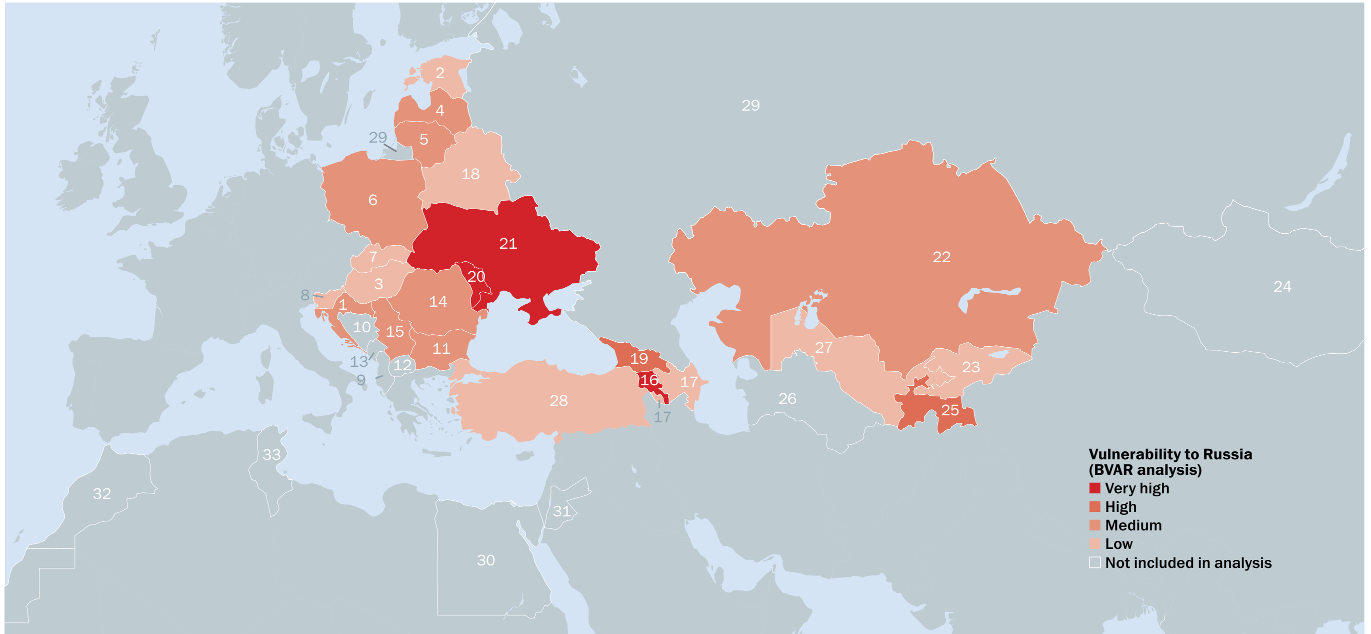
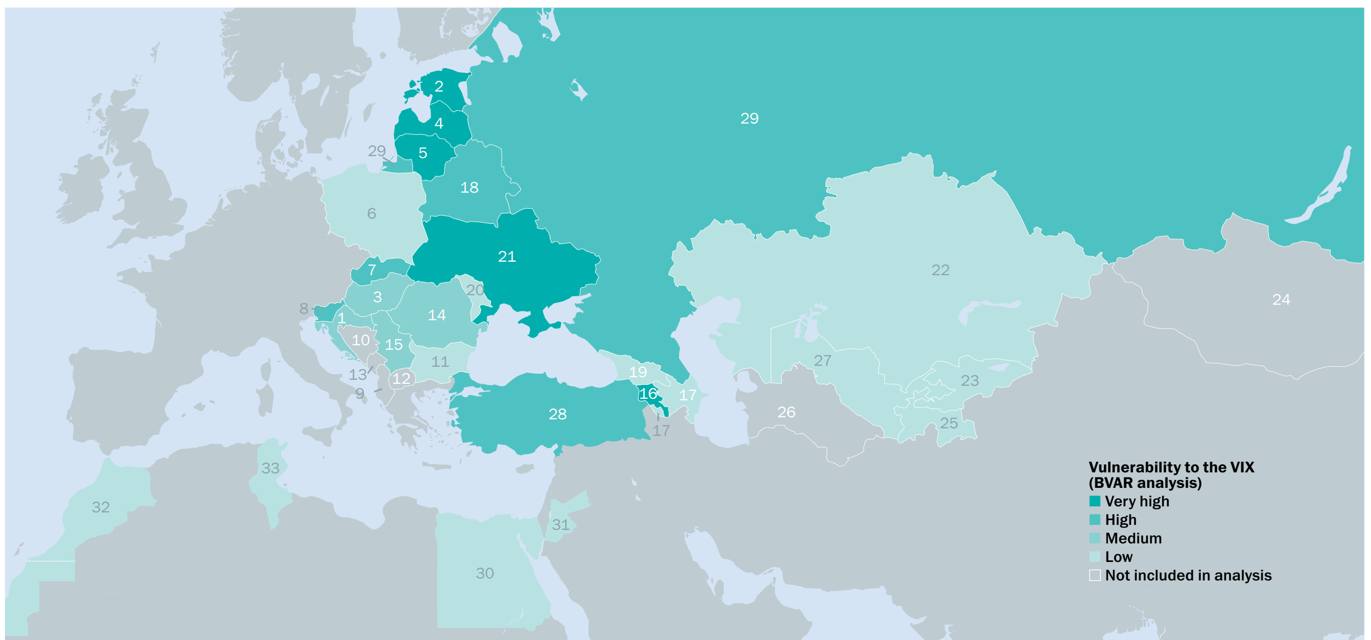


Chart 2.22
Majority of transition economies are exposed to financial market volatility



While the direct effect of higher oil prices may be negative, these countries also depend on the health of the Russian economy, which in turn benefits from higher oil prices, and therefore, on balance, they are at least no worse off.

The volatility in world financial markets significantly affects nearly all of the countries in the western transition region (see Chart 2.22). The Baltic states and Ukraine appear the most exposed, reflecting their historical dependence on external financing for continued growth. Elsewhere, the Armenian, Russian and Turkish economies also tend to contract when world financial markets become less stable. Poland, however, once again seems to be much less sensitive to external forces than virtually any other open transition economy.

It is also interesting to note that integration with the eurozone appears to attenuate the negative impact of world financial instability on transition economies.[10] A worse situation in the financial markets depresses growth in the eurozone, just as it does in the transition region and elsewhere in the world. The eurozone, however, is not as dependent on external financing as emerging markets, and therefore the response of its growth to a rise in the VIX is smaller. This in turn means that countries whose fortunes are closely linked to growth in the single currency area are shielded to some extent from financial market turmoil, which hurts their key partner less than it directly affects them. For some countries, including Estonia, Romania, Slovenia and particularly Ukraine, this effect is substantial, saving them a percentage point or more of year-on-year quarterly output growth compared with how they would otherwise react in response to a typical shock to the VIX.

OUTLOOK AND RISKS

The euro area crisis will continue to negatively impact growth in the transition region in the near future. The eurozone will most likely progress slowly and unevenly towards containment of the crisis and record a mild recession in 2012 and no growth in 2013. Real activity in the eurozone will suffer in the near term both due to fiscal contraction and credit decline although a full scale credit crunch should be avoided. This will continue to bear on the transition region's exports to and investments from the eurozone as well as on availability of finance for the region's banks and therefore credit growth.

In these conditions, GDP growth in the transition region is expected to slow down substantially to 2.7 per cent in 2012 and 3.2 per cent in 2013 from 4.6 per cent in 2011. Growth in countries that are the most integrated with the euro area, including many in the CEB and SEE regions, will decelerate substantially relative to 2011. Recessions in Croatia, Hungary and Slovenia will further deepen, but even the normally resilient Polish economy is now expected to grow less. The EEC region will see slower growth mainly due to the substantially weaker Ukrainian economy, where idiosyncratic factors will combine with the weak external environment of a eurozone recession and slowing growth in Russia.

Growth elsewhere in the region will also decelerate relative to 2011 as the protracted eurozone crisis is now affecting commodity prices and investor risk aversion. Weaker demand from the euro area is impacting growth across emerging markets, depressing global commodity demand. This limits commodity prices, which in turn directly affects growth in Russia and other commodity exporters. Continued capital flight from Russia, partly due to higher investor risk aversion, further weakens domestic demand and particularly investment. Growth in Russia is projected to slow down from over 4 per cent last year to 3.2 per cent this year and only 3.3 per cent in 2013. Elsewhere, Turkey will likely avoid a possible hard landing following its capital inflow-fuelled credit boom and Egypt's growth should improve after a period of political instability.

The eurozone crisis poses further downside risks to the outlook, as any worsening beyond the baseline assumption of a slow progress towards crisis resolution could have serious negative consequences for growth across the entire transition region. In a downside external scenario the eurozone troubles could become much worse before they are ultimately resolved. In particular, the crisis might not be contained before spreading to larger single currency area members, which would imply prolonged market turmoil and a severe western European recession with swift negative spill-overs for the global economy. This would result in lower growth in advanced and emerging economies and lower commodity prices. A negative eurozone crisis scenario would affect CEB and SEE countries and Ukraine via the same channels as in the baseline, including depressed exports and financing inflows, only more severely. Substantially lower commodity prices in the downside scenario would also cause a severe slowdown in Russia and other EEC and Central Asian commodity exporters. The weaker Russian economy would in turn seriously impact its non-commodity exporting neighbours. The probability of this downside scenario has reduced somewhat following the recent launch of the permanent European Stability Mechanism but especially the ECB's decision to support sovereign debt markets in the eurozone through Outright Monetary Transactions conditional on EU-supported stabilisation programmes in the countries concerned. The implementation of such a programme in Spain and consistent progress toward a banking union would further reduce the probability of this scenario.

[10] This statement is based on a variant of the analysis in which eurozone growth is treated as exogenous. See also footnote 9.

References

Botero, Djankov, La Porta, Lopez-de-Silanes and Schleifer (2004)
"The regulation of labor", *Quarterly Journal of Economics,* 119 (4).

A. Okun (1962)
"Potential GNP: its measurement and significance," Proceedings of the Business and Economics Statistics Section of the American Statistical Association.

P. Osterholm and J. Zettelmeyer (2007)
"The effect of external conditions on growth in Latin America," IMF Working Paper 07/176, Washington, DC.

CHAPTER 3
TOWARDS A PAN-EUROPEAN BANKING ARCHITECTURE

A eurozone-based "banking union" which would create a single supervisor for eurozone banks and open up the possibility of direct recapitalisation from supranational funds could be crucial for making the eurozone more stable. This is good for all of Europe, including emerging European countries. Recent banking union proposals have nonetheless raised concerns in some of these countries. Are these justified? Aside from helping resolve the eurozone crisis, would the proposals improve the supervision and resolution of multinational banks across financially integrated Europe? This chapter analyses current proposals and suggests some enhancements from the perspective of countries whose banking systems are dominated by these banks.

THE FACTS AT A GLANCE

Asset share of foreign-owned banks in national banking systems

FINANCIAL FRAGMENTATION has spilled over from the eurozone into the rest of Europe.

POOR CROSS-BORDER COORDINATION between supervisors undermined prudential policies to stem the 2004-08 credit boom.

SUPERVISION, RESOLUTION AND FISCAL RESPONSIBILITY should ideally be exercised at the same level of political authority.

TOWARDS A PAN-EUROPEAN BANKING ARCHITECTURE

During late 2007 and 2008 the international spillovers from the US financial crisis triggered calls for much greater cross-border integration of financial regulation, supervision and, in the event of bank failure, resolution. In Europe this resulted in a set of new supervisory institutions – the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority – which started work in early 2011. In addition, the European Systemic Risk Board (ESRB) was established, composed of representatives of national and European-level supervisory bodies, national central banks, the European Central Bank (ECB) as well as the European Commission and Council of Ministers. The purpose of these bodies is to achieve better coordination and information sharing among prudential supervisors and (through the ESRB) with central banks, to oversee the application of EU regulations and, if necessary, to arbitrate between national supervisors. However, with few exceptions and despite the endowment of emergency powers to the new bodies, the exercise of financial supervision and resolution of failed banks remains under national control.

Despite the infancy of these new European bodies, an additional and much bigger step towards the integration of financial sector institutions has recently gained momentum – the establishment of a full banking union at the level of the eurozone and possibly beyond. In late June 2012 eurozone governments committed to creating “a single supervisory mechanism involving the ECB” that could make it possible for troubled euro area banks to be recapitalised directly using European Stability Mechanism (ESM) funds. On 12 September the European Commission published a proposed Council regulation elaborating on this commitment, together with a “road map towards a banking union”, envisaging the eventual centralisation of bank resolution as well as supervision.

Unlike the 2008-10 reform drive that led to the new European supervisory bodies, the motivation behind the new initiative is not primarily to deal with the contradiction between “nationally based supervisory models … and the integrated and interconnected reality of European financial markets, in which many financial institutions operate across borders”.[1] It is rather that bank resolution costs in some European countries are feared to exceed the fiscal capacity of the national sovereign, putting pressure on sovereign and corporate borrowing costs, and further weakening economies and the credit quality of banks (see Box 3.1). This vicious circle between sovereign debt and the state of national banking systems has been undermining the effectiveness of ECB monetary policy and may ultimately threaten the currency union. Dealing with the problem requires a fiscal backstop at the European level – that is, a European fund such as the European Stability Mechanism (ESM) that can recapitalise banks in the event that other sources of funding – (including private shareholders, bank creditors and national public funds) – prove insufficient. In turn, this creates a need for European-level bank supervision to minimise the risk that European taxpayers will ultimately have to bear the costs of national banking crises in Europe.[2]

This chapter examines the proposed banking union from the perspective of financially integrated emerging European countries. Some of these countries are members of the

Box 3.1

Financial fragmentation in the eurozone

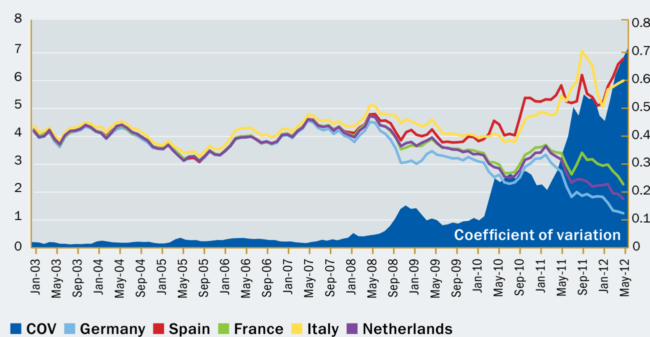
The crisis in the eurozone has been characterised by a fragmentation of European financial markets. In a reversal of earlier trends, financial conditions are diverging and increasingly driven by country-specific effects. From 1999 to 2008 the deepening financial integration in the eurozone was seen as evidence that monetary union was promoting economic convergence in Europe. The introduction of the single currency gave rise to a highly integrated money market and led to convergence in interest rates for governments and firms. The prospect of declining borrowing rates and stable, homogeneous conditions in a shared financial market made joining the eurozone seem an attractive proposition. However, the integration that was perceived to be a structural consequence of economic and monetary union has proved fragile in times of crisis, as evidenced by the growing dispersion of interest rates, the variation in banks’ funding costs and the decline in cross-border lending.

The divergence in sovereign yields between the eurozone core and periphery has been mirrored by the developments in interest rates for

Chart 3.1.1a

Divergence in sovereign borrowing costs

Yields on 10-year government bonds, per cent



COV Germany Spain France Italy Netherlands

Source: ECB statistical data warehouse.
Note: The chart shows the 10-year government bond yields of the five largest eurozone economies (on the left axis) and their coefficient of variation – COV (on the right axis).

[1] Regulation (EU) No. 1093/2010 of the European Parliament and of the Council establishing a European Supervisory Authority, 24 November 2010.

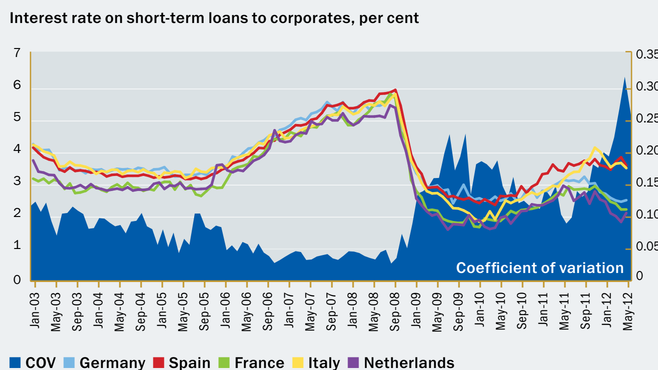
[2] A related argument for lifting supervision and resolution to the European level is that close links between government authorities and their national banking systems may lead to lax supervision (because supervisors may be close to local elites that benefit from bank lending) and excessive forbearance when it comes to cleaning up the banking system problem. When such a problem becomes very large relative to the fiscal backstop, the authorities may have an incentive to “gamble for redemption” by allowing the problem to fester (see Hellwig et al., 2012). Interestingly, it was the desire to break this link and harden budget constraints that originally led many countries in central and eastern Europe to reluctantly open up their banking systems to foreign entry. Hungary, for example, had four bailouts of its banking system in as many years before finally inviting in foreign banks. The view was that the presence of foreign banks would reduce bailout pressures. Paradoxically, the networks of these cross-border banks have since become so extensive that some are “too big, or too complex, to fail”.

firms and households. Charts 3.1.1a and 3.1.1b show the evolution of borrowing costs for governments and corporates in major eurozone economies.[3] Interest rates across all categories of loans had been converging until the 2008 Lehman Brothers collapse, after which there was a sharp increase in dispersion. The onset of the sovereign debt crisis has been marked by a further divergence in lending rates. The market's more differentiated assessment of sovereign risk has translated into adverse funding conditions for banks in the periphery, while core countries have benefited from a "flight to quality" and access to relatively cheap funding. On the asset side, increased sensitivity to corporate risk has also contributed to the dispersion in borrowing costs, with banking sectors in some countries exposed to a higher share of risky borrowers. The result has been a divergence in lending rates and an impaired transmission mechanism for monetary policy, with ECB cuts to policy rates failing to ease retail lending rates in the periphery (see ECB 2012a).

As financing conditions have diverged, markets have become more fragmented. The cross-border share of total money market loans has fallen from 60 per cent in mid-2011 to around 40 per cent in early 2012 as banks report giving added weight to country risk when assigning credit lines.[4] The eurozone interbank market is increasingly segmented, with banks reducing their claims on the periphery and transferring assets to perceived safe havens and Germany in particular. Countries experiencing outflows have generally also seen declining credit stocks (see Chart 3.1.2) and weak or negative deposit growth.

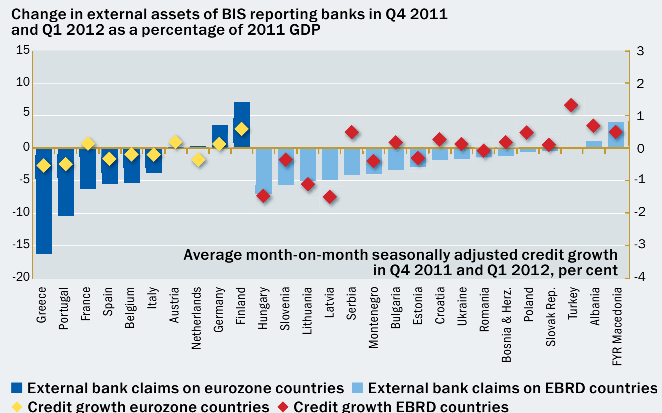
Chart 3.1.2 also shows the effects of financial retrenchment on the EBRD's countries of operations. While banks have reduced their exposures across the region, some countries have been hit much harder than others. In Hungary and Slovenia – both countries with domestic vulnerabilities; refer to the Country Assessments at the end of this report – outflows in the last quarter of 2011 and first quarter of 2012 exceeded 5 per cent of GDP, and were accompanied by a sharp contraction of credit (see Chapter 2). In contrast, countries perceived to be more stable, such as Poland and the Slovak Republic, saw relatively mild outflows over the same period (with inflows in the first quarter of 2012) and stable credit growth. The variation in credit growth in central and south-eastern European countries has been increasing steadily since the beginning of 2011. In this sense, financial fragmentation has begun to spill over from the eurozone into the rest of Europe.

Chart 3.1.1b
Divergence in corporate borrowing costs



Source: ECB statistical data warehouse.
Note: The chart shows the interest rates on loans to corporates with a maturity of less than one year for the five largest eurozone economies (on the left axis) and their coefficient of variation – COV (on the right axis).

Chart 3.1.2
External bank flows and total credit growth



Source: Bank for International Settlements (BIS), ECB statistical data warehouse and national authorities via CEIC Data.
Note: Data on external bank claims are from the BIS locational statistics. The chart shows foreign exchange-adjusted changes.

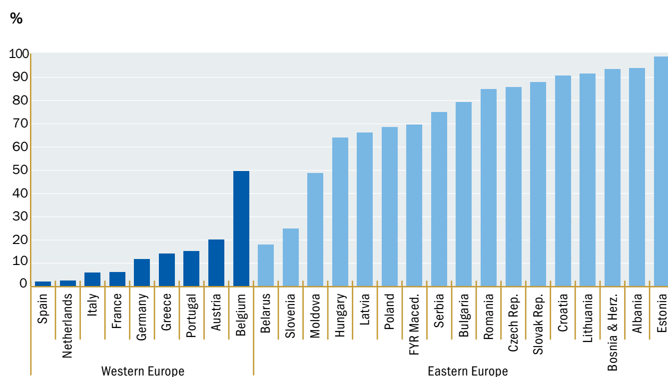
eurozone, but most are not. Several, including Georgia, Ukraine and countries in the Western Balkans where subsidiaries of eurozone banks have a strong presence are not even members of the European Union. The question is whether a proposal which is motivated mainly by specific problems within the eurozone would also serve the interests of these countries. Addressing the eurozone crisis is clearly of first-order importance for all of Europe and beyond, but could the proposed banking union also have drawbacks? And how far would it go in addressing the coordination problems between national supervisors and resolution authorities that used to be the principal motivation for calls for common European banking sector institutions?

The chapter proceeds in three steps.

First, it briefly reviews the case for and against foreign bank entry. The free movement of capital, goods and services within the European Union more or less compels member countries to be participants in an integrated financial system in which cross-border banking is likely to play a role. Countries outside

[3] The variation in Charts 3.1.1a and 3.1.1b would be even greater if Greece and Portugal were to be included. The charts show that divergence has occurred even in the five largest eurozone economies, where the risk of insolvency has been less acute.
[4] According to the results of a March 2012 survey of banks in the ECB Money Market Contact Group, "75 per cent of the respondents said that they apply different haircuts to the assets in repo operations depending on the geographic origin of the counterparty" (ECB response to media request, "Indicators of market segmentation", 8 August 2012).

Chart 3.1
Asset share of foreign-owned banks in national banking systems



Source: Claessens and Van Horen (2012).

the union can, however, restrict the extent of their financial integration and attempt to reduce the presence of foreign-owned banks. Until the 2008-09 crisis, such a policy would have seemed counterproductive to most economists and national authorities, but has the balance of arguments shifted as a result of that experience? If so, this might be an alternative to building stronger supranational institutions in the banking area.

Next, the chapter gives a "host-country" view of the problems created by national supervision and resolution in a financially integrated area. This is based on a review of pre-crisis attempts by host countries of European banking groups to tackle an externally fuelled credit boom as well as "home-host" coordination issues in managing financial stress.[5] The latter encompasses some experiences during 2011 when the new European supervisory regime, which in principle was created to address coordination failures among national authorities, was already in place.

In light of these experiences, the chapter then considers how the banking union might affect emerging European countries. Should the proposed design be adapted or complemented to accommodate their interests? Could membership be extended to countries outside the eurozone which, by virtue of keeping their own monetary and exchange rate policies, will retain significant influence over their national banking systems even if they are subject to common supervision? Short of full membership, are there ways of extending some of the benefits of the banking union to emerging European countries that either cannot join or choose to remain outside? A concluding section summarises the answers to these questions.

DO FOREIGN BANKS DO MORE HARM THAN GOOD?

Until the 2008-09 financial crisis the benefits of an integrated banking system in Europe were not seriously doubted. Cross-border and multinational banking was viewed as a natural element of economic integration and trade in services.[6] In eastern Europe, foreign bank entry through take-overs or new ("greenfield") investments helped introduce modern business practices into underdeveloped banking sectors. Foreign-owned banks became dominant in many central, eastern and south-eastern European countries, both nationally (see Chart 3.1) and locally (see Box 3.2). This progression was viewed as a key ingredient of financial development and a driver of economic growth.[7]

The 2008-09 crisis changed this perception. Foreign banks seemed to be a (or even the) main culprit of the 2005–08 credit bubble in foreign currency, which burst by 2009 and contributed to large falls in output of about 6 per cent on average in the countries of central Europe and south-eastern Europe (SEE) and 14-17 per cent in the Baltic states.[8] In addition, multinational banking was one of the conduits that transmitted the financial crisis from the West into the transition region.[9] As a result, foreign banks mutated from paragons of integration to pariahs of the crisis within barely a year. A review of the wealth of literature on multinational and cross-border banking based on evidence from before, during and after the 2008–09 crisis shows that both of these images are exaggerated.

PRE-CRISIS EVIDENCE

The evidence from the pre-crisis period focuses on the effects of foreign bank presence in several areas: access to finance and the efficiency of local financial systems, financial stability in the face of local shocks, domestic business cycles and the transmission of international shocks across borders.

Foreign banks improved credit availability in emerging markets and made the delivery of credit more efficient, and foreign creditors often introduced superior lending technologies and marketing know-how. Large banks, from high-income countries in particular, tend to perform well in less developed countries. In emerging Europe especially, where commercial banks were rare at the start of the 1990s, there were substantial efficiency gains following foreign entry.[10] Foreign banks also generated positive spillovers to domestic banks, for instance in terms of copying risk management methodologies, while competition tended to make bank lending cheaper. Some of these gains may initially have come at the cost of reduced lending to small and medium-sized enterprises (SMEs), as foreign banks will target the "best" customers and leave more difficult clients to domestic banks. However, recent studies find that foreign banks may increase SME lending in the medium term, using screening practices such as credit scoring. In line with this, the available empirical evidence for emerging

[5] "Home" and "host" refer to the "home" country of a multinational bank (for example, France for BNP Paribas) and the emerging European "host" country in which a branch or subsidiary of that multinational bank operates.
[6] In this chapter the term "cross-border banking" refers to the provision of loans by a bank's headquarters in country A directly (across borders) to a firm in country B. In contrast, "multinational banking" refers to banking groups that are headquartered in country A and set up local subsidiaries and branches in country B (and other host countries) to provide local borrowers with credit.
[7] See, for example, EBRD (2006).
[8] See, among others, EBRD (2009), Bakker and Gulde (2010) and Bakker and Klingen (2012).
[9] See Popov and Udell (2012).
[10] See Fries and Taci (2005).

Box 3.2

Foreign banks in emerging Europe: a local perspective

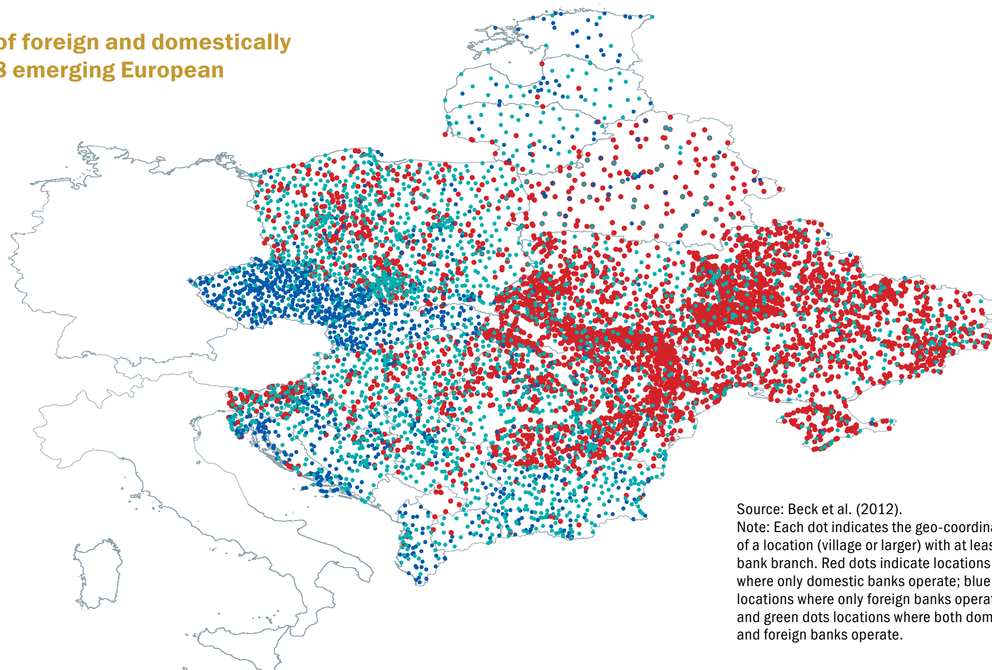
Country-level data may mask substantial intra-country variation in the presence of foreign banks. To illustrate this, Chart 3.2.1 shows new data on the geographical coverage of the branch networks of foreign and domestic banks across 18 emerging European countries. Two findings stand out.

First, foreign banks typically operate extensive networks in countries where they have established a presence. Branches are generally widespread (the blue and green dots) and not just clustered around the capital or main cities. This reflects the fact that foreign banks have often entered a country by buying banks with extensive existing branch networks. Consequently, it is not only firms and households in urban agglomerations which have access to the services of foreign banks, but those in more remote areas as well. This may alleviate concerns about "cherry-picking" by foreign banks (see main text).

Second, the chart shows clear cross-country variation in the presence of foreign banks. In the Czech and Slovak Republics and parts of the Balkan region particularly, there are very few localities where only domestic banks operate (the red dots). Further east, and especially in Belarus, Moldova, Romania and Ukraine, there are still many villages where firms only have access to domestic bank services. In Poland, on the other hand, there is extensive competition between foreign and domestic banks in cities and villages across the country.

Chart 3.2.1

Branch networks of foreign and domestically owned banks in 18 emerging European countries, 2012



Source: Beck et al. (2012).
Note: Each dot indicates the geo-coordinates of a location (village or larger) with at least one bank branch. Red dots indicate locations where only domestic banks operate; blue dots locations where only foreign banks operate; and green dots locations where both domestic and foreign banks operate.

Europe suggests that foreign bank entry has not led to a sharp reduction in small business lending.[11]

There is abundant evidence that foreign banks have a stabilising effect on aggregate lending during local episodes of financial turmoil. Unlike stand-alone domestic banks, foreign bank subsidiaries tend to have access to supportive parent institutions that provide liquidity and capital if and when needed. By the same token, however, access to foreign funding and lending opportunities means that foreign bank ownership can amplify domestic business cycles. When a single economy slows, multinational banks may withdraw funding and lend elsewhere, rather than cut margins in order to fund scarce domestic projects. When the wider economy is thriving, they may concentrate their attention on boom countries at the expense of slow-growing ones. As a result, foreign banks can exacerbate the "normal" business cycle (and make the job of monetary policy-makers harder) despite their stabilising influence during local financial crises.[12] This will be particularly true if foreign banks contribute to credit booms in foreign currency.

Foreign banks may also expose a country to foreign financial turmoil. Even before the 2008 Lehman Brothers collapse, it was amply clear that foreign banks can "import" financial crises and business cycle movements from abroad. Because parent banks reallocate capital across borders, they can

[11] See De Haas et al. (2010) and Giannetti and Ongena (2012).

[12] See De Haas and Van Lelyveld (2010) and Bruno and Hauswald (2012).

withdraw it from a host country if hit by a crisis and in need of additional capital or liquidity. For example, the drop in Japanese stock prices starting in 1990, combined with binding capital requirements, led Japanese bank branches in the United States to reduce credit. The 1998 Russian crisis spilled over to Latin America as banks, including foreign-owned ones, saw their foreign funding dry up and had to cut back lending. At the same time, the extent of these destabilising effects appears to depend on the structure of international bank linkages. Foreign bank lending through local subsidiaries tends to be less volatile than direct cross-border lending.[13]

To summarise, the pre-crisis literature paints a nuanced picture. Foreign banks generally boosted financial development in host countries and provided a source of finance that remained relatively stable during local financial crises. At the same time they tended to magnify business cycles and could be a channel for importing foreign financial turmoil. However, studies that consider both the positive effects of foreign bank entry on credit constraints, financial development and long-term growth as well as the potential destabilising effects tend to find that the former outweigh the latter.[14] In emerging Europe particularly, the presence of foreign banks seems to have contributed to long-term growth.[15] Also, it is not even apparent that the pre-2008 destabilising effects of foreign banking outweighed its stabilising influence.[16] Based on pre-2008-09 evidence, the overall impact of foreign bank entry on economic development seems to have been positive, despite some caveats.

LESSONS OF CRISIS TRANSMISSION

How did the experience of the 2008-09 global financial crisis change this picture? For the most part, it confirmed previous findings on international crisis transmission. Multinational banks transmitted the crisis to emerging markets, including eastern Europe, through a reduction in cross-border lending and local subsidiary lending. Although domestically owned banks – many of which had borrowed heavily on the international syndicated loan and bond markets before the crisis – were also forced to contract credit, foreign bank subsidiaries in emerging Europe generally reduced lending earlier and faster.[17]

The experience of 2008-09 also confirms that the structure of international financial linkages matters. For example, crisis transmission to Latin America was less severe in countries where foreign banks were lending through subsidiaries rather than across borders.[18] As in previous crises, cross-border lending turned out to be a relatively volatile funding source, with international banks refocusing on domestic clients while retrenching especially from distant countries and countries where they had less lending experience.[19]

That said, the 2008-09 experience was instructive in three respects particularly.

- Some of the generally positive impact of foreign banks on local financial systems prior to 2008 – in particular, allowing more firms and households to access credit – was revealed to be part of an unsustainable, and in many cases harmful, credit boom. Similarly, some products introduced by foreign banks – most notoriously, mortgage loans denominated in Swiss francs in Hungary – were now seen as risky practices rather than beneficial financial innovation. At one level, these experiences merely underline the well-known fact that the presence of foreign banks can exacerbate credit booms, but they also drove home the point that destructive credit booms and beneficial financial deepening can be difficult to distinguish, giving regulators and supervisors a critical role. As shown below, these roles can be particularly difficult to exercise in the host countries of large foreign banks.
- The crisis underlined just how extensive crisis transmission by foreign banks can be if their affiliates are of local systemic importance. This has been especially evident in some of the emerging European countries where one or more of the top three banks are in foreign hands. It was this combination of foreign ownership and local systemic importance that threatened financial stability in several of these countries – particularly those which had previously experienced large, foreign-currency denominated credit booms – and necessitated the ad hoc establishment of the European Bank Coordination ("Vienna") Initiative (see also page 53 below).[20]
- Funding structure turned out to be very important for banking stability. Excessive wholesale borrowing exposed banks to bouts of illiquidity in short-term funding and interbank foreign exchange (FX) swap markets. This lesson is relevant both for foreign and domestic banks. While foreign banks had easy access to parent bank and wholesale funding, many domestic banks were increasingly able to access international wholesale and FX swap markets as well. When the crisis struck, it was these domestic banks that proved the weakest link. They almost immediately lost access to cross-border borrowing or could no longer swap such funding into the desired currencies, such as Swiss francs, and had no recourse to a supportive group structure. At the same time, the Latin American experience showed that a large-scale foreign bank presence may go hand in hand with financial stability if sufficient local deposit and wholesale funding is available.[21]

The significance of the 2008-09 crisis, therefore, was not so much to offer fundamentally new insights into the risks of foreign bank presence – these were already understood by then – but rather in teaching a lesson on just how much damage these risks could cause in unprepared countries. At the same time, the crisis experience suggested some ways to reduce these risks while still reaping the benefits of financial integration. First, there is a prima facie diversification argument against foreign bank control of a large majority of banking assets – at least when these banks

[13] See Peek and Rosengren (1997), García Herrero and Martínez Pería (2007) and Schnabl (2012).
[14] See Rancière et al. (2006), Levchenko et al. (2009) and Bruno and Hauswald (2012).
[15] See Friedrich et al. (2012).
[16] See Arena et al. (2007).
[17] See Claessens and Van Horen (2012) and De Haas and Van Lelyveld (2011).
[18] See Kamil and Rai (2010).
[19] See De Haas and Van Horen (2012) and Giannetti and Laeven (2012).
[20] As part of the Vienna Initiative a number of western European banks signed country-specific commitment letters in which they pledged to maintain exposures and to support their subsidiaries in central and eastern Europe. De Haas et al. (2012) and Cetorelli and Goldberg (2011) provide empirical evidence on the stabilising impact of the Vienna Initiative.
[21] Ongena et al. (2012) and Kamil and Rai (2010).

are heavily dependent on external funding. Second, there seems to be a general stability argument for local funding, whether on the side of foreign or domestic banks. To make local funding a realistic option – particularly longer-term funding – some emerging European countries need to enhance the credibility of their macroeconomic frameworks in terms of inflation targeting and more flexible exchange rate regimes.[22] Such action has helped Latin America to de-dollarise and subsequently create a more stable form of financial integration. Lastly, the painful bursting of pre-crisis credit bubbles suggests a need to pay much greater attention to preventing them in the first place. As the next section explains, this can be difficult in an environment of cross-border and multinational banking as long as supervision remains only nationally based.

FINANCIAL INTEGRATION WITHOUT INSTITUTIONAL INTEGRATION

Research and policy experience over the last decade has shown that the gap between institutional integration and de facto financial integration leads to a number of complications which can threaten financial stability – particularly in host countries of multinational banks, but also more broadly. This section summarises the evidence in respect of supervision in normal times, crisis mitigation while banks remain solvent and operational, and resolution.

SUPERVISION IN NORMAL TIMES

Subsidiaries of foreign banks are effectively under dual supervision. As domestic entities they fall under host-country authority. In addition, the home-country supervisor has an interest in the health of an entire multinational group if the parent bank is based in that country's jurisdiction. That interest in principle extends to subsidiaries of the group.

In practice, however, the presence of two supervisory authorities can complicate the exercising of effective oversight, and particularly the application of macro-prudential instruments to mitigate credit booms.

- Home-country supervisors may have little incentive (and often no capacity) to police subsidiaries abroad unless they are "systemic" from the perspective of the group (rather than from that of the host country). As long as a subsidiary is relatively small in terms of the parent bank's total capital or operations and if the parent operates a diversified "portfolio" of such affiliates, home supervisors may not pay much attention to lending and risk management practices at the subsidiary level. Unless parent banks are heavily exposed to subsidiaries through longer-term funding, they could just abandon a subsidiary that gets into difficulties,[23] although they may have other reasons (for example, related to overall strategy or simply because the subsidiary is potentially profitable) for not doing so.
- Host-country supervisors may not have much information about the parent banks of subsidiaries that operate in their country. Information exchange between national supervisors is mostly difficult and will generally depend on the importance of the host-country operation from the perspective of the whole group. Host supervisors and central banks will also find it more difficult to limit subsidiary lending than lending by stand-alone local banks, as they will have little or no control over parent bank funding. As a result, standard macro-prudential instruments may be insufficient, or may only work if they effectively take the form of capital controls (see Box 3.3). Also, where supervisors manage to limit subsidiary lending, this can be circumvented if international banks replace lending through their subsidiaries with cross-border lending directly from the parent.

These problems could seemingly be addressed through home-host supervisory cooperation, but differences in mandates and incentives are likely to undermine such attempts. For example, when Estonian supervisors petitioned their Swedish counterparts for stricter bank capital requirements during the Baltic boom, the Swedish side felt that there was an insufficient legal basis to increase them for branches or subsidiaries when the group as a whole exceeded the requirements. As a result, host-country authorities often feel that their de facto control over subsidiary lending is quite limited, particularly inside the European Union (where countries cannot interfere with cross-border flows). Box 3.3 illustrates this by describing the experience of three emerging European countries in the run-up to the crisis.

REGULATION AND SUPERVISION IN A CRISIS

Where problems come to light in either the home or host country, supervisors will generally have an incentive to either retrieve liquidity behind national borders (particularly when parent banks have extended financing to subsidiaries) or engage in ring-fencing to prevent liquidity or assets from leaving the country to the detriment of the local financial system. Interfering with the internal capital and liquidity flows of a bank group may have negative externalities on the group as a whole, or parts of it, and give rise to further turmoil. Home-country supervisors may therefore have an incentive to play down problems at the parent or group level, exacerbating deficiencies in the exchange of information between home and host supervisors that might already exist even in normal times.

The threat of uncoordinated crisis management and communication breakdowns was particularly acute during 2008-09. Mechanisms that were set up before the crisis (such as the June 2008 *Memorandum of Understanding between Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Stability*) proved inadequate, prompting the establishment of the European Bank Coordination ("Vienna") Initiative. The aim

[22] See EBRD (2010), Chapter 3.
[23] For instance, when Riječka banka – the Croatian subsidiary of Bayerische Landesbank – suffered large currency losses in 2002 the parent did not rescue it.

Box 3.3
Using prudential tools to stem the credit boom in emerging Europe, 2004-08

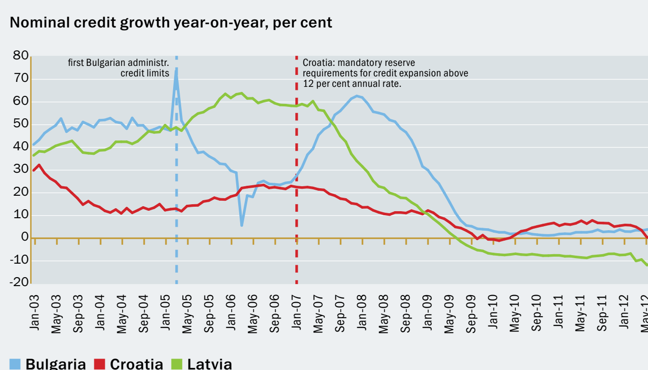
Towards the mid-2000s several countries in the CEB and SEE regions began to experience credit booms driven by capital inflows stemming from ample global liquidity and the expectation of rapid income convergence with western Europe. Given their open capital accounts, countries that had opted for a fixed exchange rate regime had only one means of restraining these inflows – to experiment with various macro-prudential policies and lending restrictions applicable to the banking system as a whole.

This box considers the experience of three countries – Bulgaria, Croatia and Latvia – which attempted such restrictions to varying degrees. The main conclusion is that while the measures appear to have had some effect – at least in Bulgaria and Croatia, where they were applied early and with greater determination – they were quickly circumvented through direct lending from parent banks and through the increased activity of non-bank entities, such as leasing companies.[24] This undermined prudential policies by leaving local subsidiaries with poorer quality borrowers, and shifting credit creation to less regulated parts of the financial sector. Differences in objectives and poor coordination between host and home-country supervisors played a key role in explaining these failures.

- **Croatia** implemented one of the most assertive prudential policies during the credit boom. From 2004 onwards the country gradually and successively implemented higher reserve requirements for credit growth above certain thresholds. The authorities also applied additional capital charges for market risks, unhedged foreign currency exposure or loan growth above certain thresholds, and intensified efforts to coordinate cross-border supervision. However, some of these measures, such as reserve requirements applying to banks' *foreign* borrowing, effectively amounted to a capital account restriction and were subsequently dropped in the run-up to Croatia's EU accession. It is noteworthy that credit growth in Croatia never became excessive, and that additional measures introduced in early 2007 contributed to a further slow-down (see Chart 3.3.1). However, quantitative limits on credit growth likely came at a cost, by disproportionately affecting small and medium-sized enterprises (which are more prone to rationing by banks), impeding competition within the banking system and leading to disintermediation towards cross-border lending and non-bank institutions, which are harder or impossible to supervise.
- **Bulgaria** implemented the highest minimum capital adequacy ratio of all new EU member states throughout the credit boom. The country nevertheless registered credit growth of almost 50 per cent in 2004. Liquidity measures taken in the early years of the boom (2004-05), such as reserve requirements and withdrawal of public deposits, were quickly deemed insufficient. The central bank then switched to more direct administrative limits on the expansion of credit in each institution (for example, punitive marginal reserve requirements on credit growth above a certain uniform permissible quarterly expansion). While there was some initial impact, banks quickly adapted by selling loans to parent banks and to affiliated non-bank entities within Bulgaria. After a brief drop in credit growth in 2006, private lending again accelerated to growth rates above 50 per cent.[25]
- **Latvia** experienced the most rapid boom in private sector credit of all three Baltic economies, fuelled by low financing costs within a fixed exchange rate regime, overly lax fiscal policy and expectations of rapidly rising incomes following EU accession in 2004. Institutional underdevelopment (for example, the absence of a comprehensive credit register) also contributed to the excessive boom, which only ended when the banks tightened credit in reaction to concerns by the Swedish supervisors in the summer of 2007. The Latvian authorities had been slow in utilising the few prudential tools at their disposal (such as tighter property valuation standards).[26] The Swedish authorities – supervising the key Swedish parent banks that control about 60 per cent of the Latvian banking market – were also slow to act. Even though the Swedish Riksbank flagged growing risks as early as 2005, the Swedish financial supervisor resisted raising capital adequacy standards.[27] What was perceived as poor coordination between the various supervisory bodies motivated the establishment of the Nordic-Baltic Memorandum of Understanding that was signed in 2010 (see Box 3.5).

Chart 3.3.1
Credit growth and national prudential measures in Bulgaria, Croatia and Latvia, January 2003–May 2012

Nominal credit growth year-on-year, per cent



Source: IMF IFS and IMF papers cited.

---

[24] See Bakker and Gulde (2010).

[25] See IMF (2007).

[26] See Purfield and Rosenberg (2010).

[27] "The crisis in the Baltic – the Riksbank's measures, assessments and lessons learned", speech by Governor Stefan Ingves (2 February 2010), available on the internet at: www.riksbank.se/en/Press-and-published/Speeches/2010/Ingves-The-crisis-in-the-Baltic--the-Riksbanks-measures-assessments-and-lessons-learned-/.

of the initiative was to agree on home- and host-country crisis management responsibilities and to coordinate the major multinational banking groups in order to prevent a run (since it might have been in the individual interests of banks to withdraw from the crisis-hit region even if it was in their collective interest to avoid rapid outflows).[28] The initiative was a success, in part because it received political backing in home and host countries – including a March 2009 EU summit decision that affirmed the right of parent banks to extend official support in their home jurisdictions to their subsidiaries, at least within the European Union – and also because it was monitored by, and had the backing of, international financial institutions. The EU and International Monetary Fund (IMF) supported emerging European countries by lending to governments, while the EBRD and other multilateral development banks supported the subsidiaries of multinational banks in the region.

Since 2011, coordination failures and disagreements between national banking authorities in the European Union can, in principle, be tackled by the EBA, the new EU-level body charged with coordinating and, if necessary, arbitrating between banking supervisors. However, as market pressures on the home countries of several eurozone banks have intensified with the widening crisis in the single currency area, some home and host authorities of these banks have undertaken a series of unilateral and seemingly ring-fencing measures (see Box 3.4). The fundamental cause of these measures is the fact that the responsibility for bank resolution and any associated fiscal losses remains national. In light of this, it is not surprising that EBA coordination has not eliminated ring-fencing and similar unilateral measures.[29] Partly in response to these developments, the Vienna Initiative has been revived to foster greater cooperation between authorities and provide a forum for discussions with the multinational banks.[30]

RESOLUTION

Home-host coordination is most difficult in the event of the failure of a multinational bank, due to a direct conflict of interest over how to share the fiscal burden of bank resolution. Indeed, it is the anticipation of such a situation that drives the diverging interests of home and host supervisors, both in normal times and during crisis management.

In bank resolution the primary responsibility of national authorities is towards domestic taxpayers, ignoring cross-border externalities (for example, if rescuing the parent bank helps the subsidiary, and *vice versa*) and instead focusing on minimising local fiscal costs. As a result, too little capital is likely to be invested in a failing multinational bank, as no country will be willing to pay for the positive externalities accruing to others. This may make it difficult to maximise the bank's value as a going concern, and may also induce outcomes that are both inefficient and detrimental for systemic stability – such as a break-up and separate nationalisation when the bank would have more value, in a future reprivatisation, as a single entity.[31]

A legislative proposal by the European Commission (*EU framework for bank recovery and resolution, June 2012*) proposes to address some of these problems by creating "resolution colleges", analogous to the supervisory colleges chaired by the EBA, and giving the EBA a mediation role between the national authorities sitting on these colleges. However, the EBA's scope for resolving conflicts of interest in this area would remain constrained by Article 38 of the EBA regulation, which compels it to "ensure that no decision adopted pursuant to [actions in emergency situations and settlement of disagreements between national authorities in cross-border situations] impinges in any way on the fiscal responsibilities of Member States." This means that it will not be able to take a decision on a bank resolution issue that determines how fiscal losses are distributed across countries which, unfortunately, is likely to be the main source of disagreement among national authorities.

Given this constraint, the most promising way to address resolution-related conflicts between countries may be to set up *ex ante* burden-sharing arrangements – as envisaged, in principle, by the cooperation agreement on cross-border financial stability, crisis management and resolution signed between the three Baltic states and five Nordic countries in August 2010 (see Box 3.5).

Alternatively, if countries are not willing to tie their fiscal hands, the next-best solution may be to ring-fence subsidiaries of multinational banks in each country *ex ante* – that is, a multinational's subsidiaries would manage their capital and liquidity in each country separately from each other and from the parent. In this case, a solvency or liquidity problem in one unit (a subsidiary or the parent) within a group would not, in general, threaten the solvency or liquidity of another, and could be resolved nationally without any international burden sharing. However, this would come at a potentially significant efficiency cost in normal times. In particular, the sum of ring-fenced pools of capital would need to be larger than the existing group capital, as banks could no longer exploit the benefits of international diversification. It would also imply that multinational banks could no longer serve as a conduit for lending deposits or savings from one country in another – a function which, while going too far during the 2005-08 credit boom in emerging Europe, can be a driver of investment and growth in the recipient countries.[32]

WOULD A EUROZONE-BASED BANKING UNION BE GOOD FOR EMERGING EUROPE?

The analysis so far has two main implications. First, in order to give supervisors and resolution authorities the incentives to avoid banking system losses, supervision, resolution and fiscal responsibility should all be exercised at the same level of political authority and within a remit that is responsive to the interests of taxpayers. Second, to minimise the negative externalities and ensuing coordination failures identified in the

[28] On the Vienna Initiative, see: EBRD (2009), Box 1.4; Bakker and Klingen (2012), Box 5.2; and Pistor (2011). The impact of the initiative is analysed empirically in Cetorelli and Goldberg (2011) and De Haas et al. (2012).

[29] Of course, it is possible (indeed, likely) that the presence of the EBA and/or EU rules on the free movement of capital prevented more drastic unilateral measures than those which materialised during 2011-12.

[30] The Vienna Initiative 2.0 was launched in the spring of 2012. A Full Forum meeting with representatives from the national authorities, the international institutions and the main cross-border financial institutions adopted a set of guiding principles for home-host coordination. See: http://ec.europa.eu/economy_finance/articles/governance/2012-03-13-ebci_en.htm.

[31] See Freixas (2003) and Goodhart and Schoenmaker (2009). The fragmentation of the financial conglomerate Fortis, systemically important in Belgium, the Netherlands and Luxembourg, is an example of how limited supervisory cooperation during an acute crisis may result in suboptimal outcomes.

[32] See Friedrich et al. (2012). Historic examples of sustained growth episodes driven by capital inflows episodes include Canada in the late 19th century, the Scandinavian countries in the late 19th and early 20th century, and west European income convergence after the Second World War. See EBRD (2009), Box 3.1.

Box 3.4

Unilateral measures to safeguard national financial stability[33]

Over the last two years, various national regulators in home and host countries have taken measures to raise regulatory standards further (known as "gold plating") and to insulate national banking systems from the funding pressures and capital adequacy concerns experienced by a number of large European banking groups (known as "ring-fencing").

Survey evidence has underlined the risk of faster bank deleveraging in host countries than in home countries (see, for example, the IMF *Global Financial Stability Report*, April 2012). In response, host-country authorities have introduced measures to ring-fence local capital and liquidity in order to support local lending. Such measures can either take the form of micro-prudential regulation or macro-prudential tools. For instance, at the end of 2011 the Czech regulator announced measures to reduce exposures of banks to affiliated entities mainly impacting transactions between highly liquid subsidiaries and their foreign parent banks. Several other host countries announced similar measures at around this time (see Table 3.4.1). These examples are likely to underestimate the prevalence of actions of this type, as banks report that supervisors also used informal moral suasion, or explicit but unpublished bank-specific guidance through the Supervisory Review and Evaluation Process (SREP) under the Basel II prudential requirements, to restrict the free movement of capital between subsidiary and parent.

Although some host countries implemented stricter national regulations than required by EU legislation well before 2007 (for example, Bulgaria, Poland and Serbia), such measures became more frequent during the crisis. Table 3.4.1 reveals a bunching of both host and home-country measures around 2010-11. These were mostly reactions to the deteriorating capital coverage and funding situation of eurozone banks, or somewhat delayed responses to earlier credit booms in host countries (as in the case of regulations on lending standards in Hungary, Poland and Romania). Prudential requirements therefore appear to have been pro-cyclical, as they were tightened in an increasingly subdued lending environment. Some home authorities, as in Austria, introduced measures and deployed moral suasion aimed at gradually reducing excessive exposures to subsidiaries, and established programmes to support ailing lending to the public and non-financial private sectors at home.

Although the individual legitimacy of these measures cannot in most cases be contested, their uncoordinated application may have had the unintended consequence of fragmenting the EU financial market by increasing the cost of funding for banking groups and provoking further safeguard measures.

Table 3.4.1

Selected unilateral financial sector measures in central, eastern and south-eastern Europe

Country	Home or host?	Type of measure	Description	Effective from
Bulgaria	Host	Capital	Required CAR 12%	Late 1990s
Serbia	Host	Capital	Required CAR 12%	December 2005
Romania	Host	Capital	"Desired" CAR 10 to 11%	End-2008
Hungary	Host	Lending conditions	Differentiated LTV and creditworthiness requirements for HUF and FX retail loans	January 2010
Poland	Host	Lending conditions	Differentiated creditworthiness check, LTV and DTI requirements for PLN and FX retail loans	March 2006/August 2010
Bulgaria	Host	Liquidity	Required liquidity buffers based on stress test results	October 2011
Romania	Host	Lending conditions	Differentiated creditworthiness check, LTV and DTI requirements for RON and FX retail loans	October 2011
Albania	Host	Legal form of operation	Conversion of foreign banks' branches into subsidiaries subject to local supervision	November 2011
Poland	Host	Capital	Dividend restrictions (minimum CAR above 12%, Tier 1 ratio above 9%, internal supervision commission rating (BION) below 2.5, 50% cap on foreign currency-denominated retail lending, parent bank's Tier 1 ratio above 9 %)	December 2011
Serbia	Host	Capital	Capital conservation buffer of 2.5% effectively ruling out profit distribution below 14.5% CAR	End-2011
Slovak Republic	Host	Capital	Minimum core Tier 1 ratio of 9%	
Slovak Republic	Host	Capital	Dividend restrictions (below core Tier 1 ratio 9.625% NBS recommends contributing all of their profits to build up capital buffers)	
Slovak Republic	Host	Liquidity	Maximum loan-to-stable-funding ratio of 110%	
Austria	Home	Liquidity	Net new lending to local stable funding ratio should remain below 110% as a guide	January 2012
Hungary	Host/home	Liquidity	Deposit (similar to the LCR) and balance sheet (liquidity ratio) coverage ratios	January 2012
Czech Republic	Host	Liquidity	Gross exposure limit to parents cut from 100% to 50% of Tier 1 and 2 capital	April 2012
Hungary	Host/home	Liquidity	FX funding adequacy ratio (similar to the NSFR but for FX assets and liabilities)	July 2012
Poland	Host	Capital	Higher risk weights on FX-denominated retail credit exposures	July 2012
Austria[34]	Home	Resolution	Group-wide recovery and resolution schemes	End-2012
Austria[34]	Home	Capital	CET1 4.5%	January 2013
Austria[34]	Home	Capital	Up to 3 percentage points surplus in CET1 for banking groups	January 2016

Note: abbreviations used: CAR Capital adequacy ratio (ratio of a bank's capital to its risk-weighted assets), CET1 Common equity Tier 1 (as defined in the Basel III framework)[35] DTI Debt-to-income ratio (ratio of the debt instalment to the borrower's income), FX Foreign exchange, HUF Hungarian forint, LCR Liquidity coverage ratio (as defined in the Basel III framework),[36] LTV Loan-to-value ratio (ratio of the outstanding loan amount to the value of the collateral), NBS National Bank of Slovakia, NSFR Net stable funding ratio (as defined in the Basel III framework)[36], PLN Polish zloty, RON Romanian leu, Tier 1 and 2 Tier 1 and 2 capital (as defined in the Basel III framework).[35]

[33] This box draws on D'Hulster (2011), Financial Stability Board (2012), and IMF (2012).
[34] After long negotiations with different stakeholders, Austria introduced these measures as non-binding guidelines (which in Austria have a tradition as fairly effective supervisory tools). See:www.oenb.at/en/presse_pub/aussendungen/2012/2012q1/pa_aufsicht__nachhaltigkeitspaket_fuer_oesterreichs_banken__246091_page.jsp#tcm:16-246091.
[35] See: www.bis.org/publ/bcbs189.pdf.
[36] See: www.bis.org/publ/bcbs188.pdf.

previous section, institutional integration should approximate the actual level of financial integration as closely as possible. It follows that if it is not feasible to formulate a banking union for the pan-European financially integrated area – because there is no institutional structure at that level that could be held accountable, directly or indirectly, to taxpayer interests – then it should be defined at the EU level, where such structures already exist in the form of the European Parliament and European Council.

Most of the key proposals for a European banking union that have been put forward by researchers and policy organisations in the previous two years are consistent with this conclusion, as is the roadmap articulated by the European Commission on 12 September 2012.[37] However, the actual *proposal* presented by the Commission in response to the eurozone governments' June 2012 request is more limited. Although the proposed single supervisory mechanism would be open to EU members outside the eurozone, they would not benefit from the possibility of direct bank recapitalisation by the ESM.[38] Furthermore, while the proposal would give the ECB responsibility for all banking supervision (including early intervention), bank resolution would for now remain at the national level, although within a common EU bank framework.

This scenario falls short of an ideal banking union in several respects. First, coordination problems in bank resolution will likely continue, even among eurozone members. Second, by leaving some financially integrated European countries out of the arrangement, coordination problems between the banking union authorities and the "outs" will also persist. Third, the lack of congruence between the three layers of the banking union – supervision, resolution and ultimate fiscal responsibility – could create an incentive problem. In particular, maintaining resolution authority at the national level while raising ultimate fiscal responsibility to the supranational level could be a source of moral hazard, as a national resolution authority may not be as robust in, for example, imposing losses on creditors of failing banks as they would be if fiscal losses were borne at the national level. Furthermore, the proposed system does not give the supervisory authority a fiscal incentive, even indirectly. Although these are not insurmountable difficulties, they create significant challenges and may be one of the reasons why the banking union proposal has not met with universal support in Europe.

The remainder of this chapter examines ideas that could improve the design of the current proposal within the basic framework proposed – in particular, maintaining the assumption that there will not be a common European resolution and deposit insurance authority in the foreseeable future for political and practical reasons.[39] Particular attention is paid to the perspective of emerging European countries, which tend to be host countries of eurozone-based multinational banks. The discussion focuses first on how the proposed banking union could be made more attractive for these countries and then explores options for extending the umbrella of the banking union – either wholly or partly – to host countries of eurozone banks that either could not or would not want to be part of the single supervisory mechanism under the current plan.

Box 3.5
The Nordic-Baltic memorandum on crisis management

A Memorandum of Understanding (MoU) on financial stability, crisis management and crisis resolution was signed by the ministries of finance, central banks and financial supervisory authorities of Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden in August 2010. Its establishment was in line with a 2008 EU-wide agreement that countries sharing financial groups should provide for specific and detailed crisis-management procedures.

The Nordic-Baltic MoU stands out for three reasons when compared with other memoranda of this kind. First, it engages ministries of finance along with central banks and supervisory agencies. This is crucial for coordinating action on resolution and burden sharing of fiscal costs arising from any intervention in individual banking institutions. Second, it establishes a permanent regional body – the Nordic-Baltic Cross-Border Stability Group (NBSG) – to examine financial stability issues, including during crisis times. Lastly, one of the tasks of the NBSG is to work out *ex ante* burden-sharing formulas.

Within Europe this agreement represents the best example to date of attempts to integrate cross-border supervisory efforts and prepare for cross-border crisis resolution (two intricately linked areas). The establishment of the NBSG has improved supervisory coordination and information sharing. By building relationships and rehearsing cross-border crisis responses in advance, it could also improve cooperation in a crisis even though the MoU lacks the power to legally commit the parties to a specific course of action. Whether or not it is successful in this regard remains to be tested.

ADDRESSING THE CONCERNS OF EMERGING EUROPEAN EUROZONE MEMBERS

To eurozone members that are not directly affected by the eurozone crisis, implementation of the Commission's proposal offers three main benefits.

- To the extent that it breaks the vicious circle between sovereign stress and banking system stress in crisis-hit eurozone countries, it should contain the crisis, and significantly reduce the chances that multinational banking groups based in the eurozone could come under serious pressure. This is a critical benefit for the majority of emerging European countries, in which subsidiaries of such groups have systemic importance. Even the Baltic countries, whose banking sectors are mostly owned by banks based in Sweden and other Nordic countries, have much to lose from continuing financial instability in the eurozone.
- By giving broad authority to the ECB it should remove all home-host coordination problems in respect of supervision, at least as far as eurozone-based multinational banks are concerned.

[37] European Commission (2012); see in particular section 3.2. Related proposals or discussions of proposals include Allen et al. (2011), Fonteyne et al. (2010), Schoenmaker and Gros (2012) and Pisany-Ferry et al. (2012).

[38] Article 6 of the proposed regulation would allow EU countries outside the eurozone to enter into "close supervisory cooperation" with the ECB, giving the ECB the same supervisory powers in these countries as within the eurozone. In return, there would be some form of participation of these non-eurozone countries in the ECB's decision-making structure with respect to supervision.

[39] As of October 2012, the debate on a eurozone-based banking union was very much in flux. The discussions that follow use the European Commission's September 2012 proposal as a benchmark for discussion, but the observations and suggestions that follow would also apply to other variants being proposed, so long as the banking union remains focused on the eurozone and does not encompass a resolution authority.

Box 3.6
Heterogeneity in European housing markets

Housing finance has received a great deal of attention as a driver of financial crisis. During the early 2000s international capital flows had been channelled into mortgage lending through structural changes and deregulation of the finance industry. In the wake of a severe mortgage credit crisis in the United States in 2007, the eurozone and the United Kingdom avoided the worst of the financial fallout by keeping mortgage rates at very low levels, although Ireland and Spain experienced ballooning defaults by real estate developers which led to banking crises. Hungary, which was unable to restrain debt service costs through central bank action, had to restructure its retail mortgage portfolio, and several other European countries are still seeking a soft landing from inflated house prices.

There are a number of policies and practices at national level which can determine the likelihood of housing-related financial crises. Many would not be automatically addressed under a European banking union. This analysis considers the most important ones and the prospect of EU-level remedial action.

Mortgage products and underwriting standards

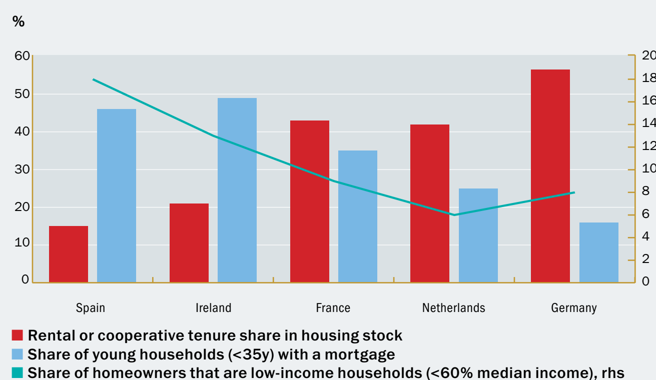
Mortgage product design and underwriting standards differ strongly across the European Union.[40] Products in western Europe vary mainly in respect of the amount of interest rate risk they convey to households. This was not the case before the 1980s, when mortgages in Europe were granted as either fixed-rate (on the continent) or with interest rate fluctuations smoothed by lenders (as in Ireland and the United Kingdom). Matched funding on these terms was provided by specialised mortgage banks issuing covered bonds, or specialised building societies. Universal commercial and savings banks had very low market shares.

Consequent upon financial liberalisation in the 1980s and 1990s, universal banks moved into the mortgage market. Variable-rate lending based on interbank indices quickly gained importance. In Portugal and Spain these products displaced fixed-rate lending altogether in the 1990s. In the following decade, the Irish and UK markets moved from managed variable interest rates to the more volatile indexed rates. Even the Danish market, where fixed-rate terms of up to 30 years had been the standard, eventually shifted to variable-rate lending. Germany and the Netherlands are the only remaining EU countries whose systems offer almost entirely fixed-rate loans, although Belgium and France maintain a significant fixed-rate market share. In central and eastern Europe, with the exception of the Czech Republic, variable-rate loans dominate the mortgage market. Interest rate risk in these countries is often compounded by the denomination of loans in foreign currency. In Hungary, for example, many households prior to 2008 borrowed in Swiss francs at low interest rates. In late 2008 the strong appreciation of the Swiss franc and an increase in Swiss franc loan rates produced a payment shock for borrowers whose incomes were mostly denominated in local currency.

While underwriting payment-to-income (PTI) limits in Europe do not vary much across countries, their effectiveness in shielding lenders from default risk is highly dependent on the mortgage product. Because variable-rate loans tend to have lower interest payments for a given loan amount than fixed-rate loans, mortgage lenders in countries such as Ireland and Spain allowed young and low-income borrowers into the market who would not have met PTI limits if they had been borrowing at a fixed rate. These borrowers were also exposed to interest rate volatility. When monetary policy rates rose in 2007, their payments quickly ballooned beyond PTI limits.

At the same time, there remains significant heterogeneity in underwriting loan-to-value (LTV) ratios across Europe. Excessively high LTV ratios of loans to low-income households enhanced the severity of the UK mortgage market crisis of the early 1990s. In Ireland LTV ratios offered by banks increased during the 2000s as new bank entrants targeted young and low-income households; later, lenders tried to catch up with rising house prices. In the Netherlands LTV ratios of 100 per cent and higher became the standard because of major tax subsidies, both for mortgage interest and repayment vehicles that retire the loan. In contrast, in neighbouring Germany, which does not permit interest deduction, an 80 per cent LTV ratio is considered the norm. As a result of this diversity, the European Parliament could not agree on defining 100 per cent as the LTV limit when deliberating on the Mortgage Credit Directive earlier in 2012.

Chart 3.6.1
Rental share and home ownership of low-income and young households



Source: ECB (2009) and OTB Research Institute for the Built Environment (2010).
Note: "(<35y)" stands for under 35 years of age, "<60%" for less than 60 per cent and "rhs" for right hand (side) axis.

[40] See ECB (2009) and Dübel and Rothemund (2011).

Table 3.6.1
Policies and frameworks governing European housing and housing finance
European and national responsibilities as of 2012

Policies defined largely by...	
European Union (Eurozone)	**Member State**
Capital Markets	
(Monetary policy)	Capital market taxation/subsidies
Investor protection	Capital market supervision
Bank / insurer investor regulation	General pension fund regulation
Investment vehicle regulation	Mortgage bond regulations
General securities regulation	Asset-backed securities regulations
Housing Finance Markets	
(Lender of last resort)	Banking/insurance taxation/subsidies
Depositor protection regulation	Banking supervision/resolution
Banking/insurance regulation	Special mortgage banking regulation
Consumer protection	Mortgage consumer protection
Competition/takeover	Public/non-profit banking investment
Cross-border collateral access	Sureties law (mortgage, guarantees)
Housing & Ancillary Markets	
	Collateral management/foreclosure
	Consumer insolvency
	Private rental housing regulation
	Public/non-profit rental housing regulation
	Public/non-profit rental housing investment
	Property taxation/subsidies
	Real estate brokerage regulation
	Land use, zoning, sub-divisioning and density regulations
	Urban transport policies

Source: Finpolconsult.
Note: Text in red denotes areas in which a full or limited transfer of responsibilities from the national to the European level is currently under discussion or implementation.

The structure of housing markets

Even if products and underwriting standards could be successfully standardised, cross-country differences in housing finance risks would remain because of variations in the structure of housing markets. These have an influence on borrower quality and house price dynamics in a way that regulation and supervision may not be fully able to offset.

Local housing supply policies greatly influence the risk environment of housing finance. Restrictive land use, density and zoning policies, as well as under-investment in infrastructure, increase the reaction of house prices to a given change in liquidity provided by banks. Within the transition region, for example, Estonia pursued elastic land supply policies around the capital, Tallinn, while Latvia maintained rigid urban land policies in Riga. As a result, the credit boom of the 2000s stimulated construction to meet demand in Tallinn, but fuelled sharp price rises in Riga. When credit and prices collapsed in 2009, default rates were far higher in Riga.

The existence of a sufficiently large rental housing market is perhaps the most important structural factor. As Chart 3.6.1 suggests, a large rental sector is likely to reduce the participation of young and lower-income households in the retail mortgage market. These groups tend to have low levels of housing equity and high vulnerability to changes in interest rates and unemployment. Making it easier for them to rent therefore reduces the average LTV ratio as well as PTI risk in the retail mortgage market, without necessarily preventing them from eventually owning a home. Although this implies that rental landlords will bear the default risk associated with younger and lower-income households, they may be in a better position to manage it than banks, not least because evicting a defaulting renter is far less costly than repossessing and auctioning a house. In addition, public housing allowances – which are harder to justify as a support for ownership – can help stabilise rent revenues.

For these reasons, the United Kingdom reversed its housing policy after its mortgage crisis in the early 1990s and started promoting non-profit rental housing associations and small landlords. These steps are likely to have mitigated the impact of the 2007-08 market downturn on mortgage defaults. Similarly, Germany's large rental sector (rather than mortgage regulation, which was liberalised in the 1980s) has likely kept its retail mortgage market stable. Denmark and the Netherlands, also with large rental sectors, can sustain elevated levels of mortgage debt carried mostly by middle-income households. In Ireland and Spain, in contrast, the absence of a rental housing option likely contributed to high default rates among young and low-income households. Rental housing had almost disappeared in Spain due to harsh rent controls and extensive tenant protection. Similarly, in most transition economies there is a severe shortage of rental housing catering to young and low-income households, as rental accommodation was decimated by mass privatisations.[41]

Prospects for harmonising European housing policy

A pan-European policy intended to minimise the risk of financial crises originating in the housing sector would have to regulate, and potentially intervene in, a number of markets. While the powers of the European Union are expanding, full synchronisation of national policies down to locally determined land and housing supply remains implausible, even in the long term (see Table 3.6.1).

The European Union is precluded from housing policy by its treaty, for fear of creating a similar sector to agriculture in terms of subsidisation. Assuming such concerns could eventually be overcome under a fiscal union, efficiency questions would also arise: housing investment policies have been systematically decentralised since the 1980s in the search for efficiency gains through tailored local models.

The mortgage sector is a good example for the time scale needed to reach even limited agreement on regulation. The Mortgage Credit Directive proposed by the European Commission in 2011 followed 20 years of discussion, but it only harmonises consumer protection regulation (for example, giving member countries leeway in setting LTV standards). There is little doubt that harmonising rental law would take decades.

The impossibility of a prompt unified housing policy means that a European banking union with full mutual insurance of bank debt could suffer from moral hazard problems. For example, member states might be dissuaded from investing fiscal resources in social housing programmes or forcing borrowers into costly fixed-rate protection, as bank lending to low-income households is indirectly protected against losses through membership of the banking union.

[41] Dübel et al. (2006).

[42] In practice, this could be one group in which most business is conducted by smaller committees focused on specific host countries; or possibly three groups focused on emerging European countries in the eurozone, the non-eurozone EU, and the EU neighbourhood, respectively.

- By granting potential access to direct recapitalisation by the ESM it creates a framework that could provide future support to countries which may not be in existing need. In the case of Slovenia, which has some banking sector issues of its own (see Country Assessments later in this report), this could be of more than just theoretical value.

At the same time, the proposal leaves important problems unaddressed – in particular, coordination failures with respect to resolution and with supervisory authorities outside the single supervisory mechanism – and may involve costs. Members of the eurozone would share fiscal responsibility (through the ESM) for crises elsewhere. A slightly less obvious but widely held concern is the possibility that the ECB might devote less attention to the supervision of a small country's financial system than a national supervisor. This could happen if the ECB were to focus supervision on large groups (essentially displaying the bias that has been attributed to home-country authorities) at the expense of preventing local banking crises which are unlikely to pose a systemic threat to Europe as a whole. Note that the Commission proposal gives the ECB supervisory responsibility for each individual financial institution – including the subsidiary level – rather than only the group level. However, there is scepticism on the side of the smaller countries on whether the ECB would have sufficient incentives to focus on the local as well as the union-wide systemic level.

To address these gaps and concerns, the European Commission's proposal could be complemented as follows.

First, the creation of one or several *cross-border stability groups for emerging Europe*, following the example of the Baltic-Nordic Stability Group (see Box 3.5). Membership would include host-country authorities, the ECB, the EBA, the European Commission, the European Financial Committee (representing the European Council), and home-country authorities (particularly Ministries of Finance, but also non-eurozone supervisory authorities).[42] The purpose of these groups would be three-fold.

- Following the example of the Baltic-Nordic Stability Group, they would attempt to minimise coordination problems in a crisis by undertaking crisis management exercises and agreeing ahead of time on how resolution cases would be approached.
- They would address any remaining supervisory coordination issues. This could arise when either host or home supervisors remain outside the single supervisory structure (the latter could include the Nordic countries, for example, or the United Kingdom).
- Lastly, they could create a link between resolution authorities and the ECB. The ECB would be aware of the concerns of resolution authorities – including, of course, host-country authorities – and could exercise its early intervention powers in coordination with these authorities. This may also assuage the concern that the ECB might not care enough about domestic financial stability in the smaller countries.

Second, the supervisory function within the ECB should be structured in a way that gives smaller members of the banking union sufficient voice. For example, in addition to a board that takes the main decisions, the supervisory function could be governed by a larger "Prudential Council" that would include representatives of national supervisors, which would exercise oversight over the actions of the executive board.[43]

Third, national authorities of member countries could be given the option to impose certain macro-prudential instruments, such as additional prudential capital buffers, on subsidiaries and domestic banks. These may be justified, for example, to deal with more volatile credit cycles in emerging European countries, or to offset higher macroeconomic and financial vulnerabilities. The ECB could set minimum buffers and retain a veto over national decisions which are deemed to run counter to system-wide stability.

Lastly, there should be an *ex ante* fiscal burden-sharing agreement between national fiscal authorities and the eurozone fiscal backstop that forces the national level to take some fiscal losses if (or indeed before) they are taken at the European level. Such burden-sharing may be implicit in the current proposal, but it is worth making it explicit. In the absence of such a rule, the combination of a European-level safety net with national resolution authority could give rise to moral hazard. Furthermore, national authorities inside the eurozone would retain additional policy instruments that could influence the probability and magnitude of banking crises. Fiscal instruments that could affect the behaviour of banks and borrowers would remain under national control (for instance, taxation of the financial sector or subsidisation of certain lending, guarantee or investment programmes) and so would policies that affect the housing sector – which historically have been *the* key source of banking problems, as clearly demonstrated by the mortgage-related banking collapses in Iceland, Ireland, Spain and the United States. Box 3.6 describes several channels through which policies governing this sector can affect the asset quality of banks – for example, by facilitating the development of a rental market and therefore providing housing services to population groups who might otherwise represent high-risk borrowers.

As with any insurance, some degree of moral hazard may be unavoidable and does not invalidate the case for insurance. However, moral hazard can be minimised, specifically by making insurance partial rather than full, and in a way that does not undermine the basic purpose of the fiscal backstop, which is to prevent sovereign liabilities resulting from banking sector problems rising to a level that triggers national bankruptcy. For example, losses could initially be shared equally – reflecting the joint responsibility of European authorities (through the single supervisory mechanism) and national authorities (through other channels such as housing policies). In the event that

[43] See Véron (2012).

losses exceeded a pre-determined and catastrophic point, they would have to be fully absorbed at the European level, although not before.

EXTENDING THE BENEFITS OF A BANKING UNION TO COUNTRIES OUTSIDE THE EUROZONE

Under the European Commission proposal, countries outside the eurozone, even EU states, would neither benefit from, nor contribute to, ESM support. By staving off financial chaos in Europe, the banking union would benefit these countries indirectly. At the same time, there is also a concern among some host-country authorities that a common fiscal backstop for the eurozone banking system may tilt the competitive balance against banks or banking groups which are headquartered outside the single currency area. Although foreign subsidiaries would not be eligible for direct ESM support, they might be expected to benefit indirectly through their parent banks, making it harder for domestically owned institutions outside the eurozone to compete.

A further concern is that home-host coordination problems will persist after the creation of the single supervisory mechanism. Non-EU countries could not join the mechanism, and although non-eurozone EU members could opt in, they are unlikely to do so, since they would continue to be excluded from the possibility of direct recapitalisation by the ESM and may not want to lose supervisory control. From the perspective of these "outs", the single supervisory mechanism would merely replace eurozone home authorities by one eurozone supervisor – the ECB. Although the ECB might be a better partner, given its attention to macro-prudential concerns and its role chairing the EU-wide ESRB, coordination is bound to remain an issue as long as home- and host-country supervision is not fully integrated.

One obvious remedy for EU countries that see net benefits from banking union membership would of course be to join the eurozone. However, many of these countries may not yet meet the macroeconomic criteria required for accession, or may wish to retain the benefits of autonomous monetary policy for some time. For these reasons, it is worth exploring whether the benefits of banking union membership could be extended to non-eurozone countries in full or in part. Several options are conceivable, none of them simple.

First, the ESM treaty could be modified to allow non-eurozone EU members to join if they also join the single supervisory mechanism, that is, to become full members of the banking union without necessarily adopting the single currency. In addition to access to the ESM, these countries should also be allowed access to euro liquidity (through swap lines with the ECB; see below).

Aside from political hurdles, this option presents a conceptual obstacle: countries outside the eurozone would retain significant extra power to influence their domestic banking sectors even if they submit to ECB supervision, since they would maintain control of banks' local currency funding and other instruments that could have implications for the asset quality of banks (such as exchange rate policy). Potential access to the ESM safety net could therefore create a moral hazard problem. However, as previously argued, this problem already exists within the eurozone and could be addressed partly through the design of the safety net, and in particular by letting national authorities absorb most of the "first loss" should anything go wrong in their banking sectors.

Second, it may be possible to establish an "associate member" status in the banking union for non-eurozone countries. Unlike their eurozone counterparts, they would not give up supervisory control, nor would they benefit from the ESM. However, the ECB could give them access to euro liquidity – in the form of foreign exchange swap lines, similar to those which the US Federal Reserve Board, the ECB and the Swiss National Bank arranged with other central banks (including, in the case of the ECB, Poland and Hungary) during the 2008-09 crisis. In return, national supervisors would agree to share information with the ECB and to a periodic review of their supervisory policies. Swap lines would be committed from one review period to the next, and rolled over subject to the satisfactory completion of the review. In addition to extending a liquidity "shield" to non-eurozone European countries – which, from their perspective, would likely be at least as important as access to the ESM – this arrangement would have the advantage of giving the ECB, as the home supervisor, an incentive to cooperate closely with host authorities in forestalling host-country credit booms, particularly those denominated in euros.

Third, it might be possible to devise a supervisory regime that allows the host country to retain significant supervisory control but at the same time mitigates the coordination problem in respect of multinational banking groups. As described above, although host countries have formal supervisory power over subsidiaries, they have sometimes had limited *de facto* control because of a lack of information about, and influence over, parent bank funding. One way of mitigating this problem would be to have the ECB and the host country "trade" some supervision rights and duties. The ECB would share supervisory responsibility for the subsidiaries of multilateral groups. In return, the host supervisor could be given access to information about, and some influence over, the supervision of the entire group. The latter could be contemplated at several levels, ranging from normal participation in the single supervisory mechanism (with respect to the group) to the right to be heard. Even if the host supervisor's influence over ECB decisions is ultimately weak, sharing the *formal* obligation of supervising subsidiaries of eurozone banks with the ECB might increase the *de facto* control of local supervisors, by aligning the incentives of the ECB (as the home supervisor) more closely with those of the host overseer.

The first of these options would (at best) apply to EU members only. However, there would seem to be no legal or conceptual reason why the second or third avenues could not also apply to European countries that are not (or not yet) members of the European Union.

CONCLUSION

Recent proposals to unify bank supervision, harmonise resolution frameworks and transform the ESM into a fiscal safety net for banking systems in the eurozone should go a long way towards arresting the present crisis and addressing coordination failures between home- and host-country authorities within the single currency area. They remain incomplete, however, because resolution authority would remain at the national level for the foreseeable future, and because access to the ESM-based safety net would be limited to eurozone members. The latter implies that few EU members outside the eurozone are likely to exercise their option to join the single supervisory mechanism.

As a result, the proposals have raised concerns in several European countries, both inside and outside the eurozone and especially in emerging Europe. Some eurozone members worry about transferring virtually all supervisory powers to a central supervisor that may not be as concerned about local financial stability as national authorities. Some countries outside the eurozone worry that giving banks in the euro area the possibility of direct recapitalisation from ESM resources will tilt the competitive balance against banks headquartered outside. There is also a concern that national resolution authorities may not face the right incentives if fiscal losses are mutualised at the eurozone level. Furthermore, unifying supervision in the eurozone does little to address home-host coordination failures that affect countries outside the single supervisory mechanism or coordination failures in respect of bank resolution (which can be particularly severe).

Cross-border stability groups modelled on the Nordic-Baltic Stability Group would help to close some of these gaps. They could be set up for all European host countries of multinational banks (eurozone or not), and would include host-country authorities, resolution authorities (including Ministries of Finance of the home countries), the ECB, the EBA and any home-country supervisor outside the single supervisory structure. In addition, national authorities that join the single supervisory mechanism might retain the power to exercise certain macro-prudential instruments, such as additional capital buffers, to mitigate local credit booms. Lastly, an understanding on *ex ante* burden sharing should be reached that would require countries receiving ESM fiscal support to share banking-related fiscal losses up to a pre-determined level.

Non-eurozone countries should be allowed to opt into the ESM if they also opt into the single supervisory mechanism. In addition, it is worth considering pragmatic extensions of the banking union for European countries that either cannot or do not want to become full members. This could include an "associate member" status through which non-eurozone countries would benefit from ECB liquidity support but not from fiscal support, and defining a regime in which the ECB and host-country authorities would share responsibility for supervising both the subsidiaries and the parents of multinational groups operating in host countries in a pre-agreed way.

References

F. Allen, T. Beck, E. Carletti, P. R. Lane, D. Schoenmaker and W. Wagner (2011)
Cross-border banking in Europe: implications for financial stability and macroeconomic policies, Centre for Economic Policy Research, London.

M. Arena, C. Reinhart and F. Vázquez (2007)
"The lending channel in emerging economies: are foreign banks different?", IMF Working Paper No. 07, Washington, D.C.

B. Bakker and A. Gulde (2010)
"The credit boom in the EU new member states: bad luck or bad policies?", IMF Working Paper No. 10/130, Washington, D.C.

B. Bakker and C. Klingen (2012)
"How emerging Europe came through the 2008/09 crisis", IMF (an account by the staff of the European Department), Washington, D.C.

Beck, Degryse, De Haas and Van Horen (2012)
"Branching out: foreign bank entry and access to finance", EBRD Working Paper, London, Forthcoming

V. Bruno and R. Hauswald, (2012)
"The real effects of foreign banks", Paolo Baffi Centre Research Paper No. 2009-50.

N. Cetorelli and L. Goldberg (2011)
"Global banks and international shock transmission: evidence from the crisis", *IMF Economic Review*, Vol. 59, pp. 41-76.

S. Claessens and N. Van Horen (2012)
"Foreign banks: trends, impact and financial stability", IMF Working Paper No. 12/10, Washington, D.C.

K. D'Hulster (2011)
"Incentive conflicts in supervisory information sharing between home and host supervisors", World Bank Policy Research Working Paper No. 5871, Washington, D.C.

R. De Haas, D. Ferreira and A. Taci (2010)
"What determines the composition of banks' loan portfolios? Evidence from transition countries", *Journal of Banking & Finance*, Vol. 34, pp. 388-98.

R. De Haas, Y. Korniyenko, E. Loukoianova and A. Pivovarsky (2012)
"Foreign banks and the Vienna Initiative: turning sinners into saints?", EBRD Working Paper No. 143, London.

R. De Haas and N. Van Horen (2012)
"Running for the exit? International bank lending during a financial crisis", *Review of Financial Studies*, forthcoming.

R. De Haas and I. Van Lelyveld (2010)
"Internal capital markets and lending by multinational bank subsidiaries", *Journal of Financial Intermediation*, Vol. 19(1), pp. 1-25.

R. De Haas and I. Van Lelyveld (2011)
"Multinational banks and the global financial crisis: weathering the perfect storm", EBRD Working Paper No. 135, London.

A. Dübel and M. Rothemund (2011)
"A New Mortgage Credit Regime For Europe – Setting the Right Priorities", CEPS special report, 6 July. Download: http://ceps.be/book/new-mortgage-credit-regime-europe-setting-right-priorities

A. Dübel, W. J. Brzeski and E. Hamilton (2006)
"Rental Choice and Housing Policy Realignment in Transition: Post-Privatization Challenges in the Europe and Central Asia Region", World Bank Policy Research Paper, WPS 3884, Washington, D.C.

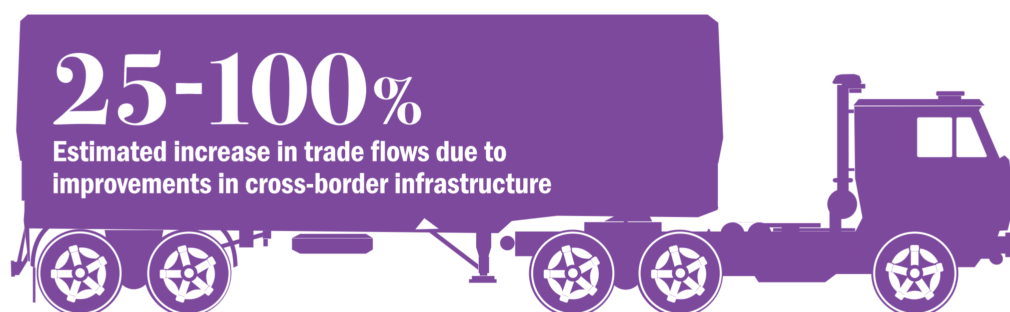
EBRD (2006)
Transition Report 2006: Finance in Transition, London.

EBRD (2009)
Transition Report 2009: Transition in Crisis?, London.
EBRD (2010)
Transition Report 2010: Recovery and Reform, London.
ECB (2009)
Housing Finance in the Euro Area. Structural Issues Report. Frankfurt. Download: www.ecb.int/pub/pdf/other/housingfinanceeuroarea0309en.pdf
ECB (2012a)
Financial Integration in Europe - April 2012, Frankfurt.
ECB (2012b)
"Indicators of market segmentation", ECB response to media request, 8 August. Download: www.ecb.int/pub/pdf/other/is120802_media_request.en.pdf
European Commission (2012)
"A roadmap towards a banking union", Communication from the Commission to the European Parliament and the Council, COM (2012) 510 final, Brussels.
Financial Stability Board (2012)
"Identifying the effects of regulatory reforms on emerging and developing economies: a review of potential unintended consequences", June.
W. Fonteyne, W. Bossu, L. Cortavarria-Checkley, A. Giustiniani, A. Gullo, D. Hardy, and S Kerr (2010)
"Crisis management and resolution for a European banking system", IMF Working Paper No. 10/70, Washington, D.C.
X. Freixas (2003)
"Crisis management in Europe", eds. J. Kremers, D. Schoenmaker and P. Wierts, *Financial Supervision in Europe*, Cheltenham: Edward Elgar, pp. 102-19.
C. Friedrich, I. Schnabel and J. Zettelmeyer
"Financial integration and growth – Why is emerging Europe different?", *Journal of International Economics* (www.sciencedirect.com/science/article/pii/S0022199612001298).
S. Fries and A. Taci (2005)
"Cost efficiency of banks in transition: evidence from 289 banks in 15 post-communist countries", *Journal of Banking and Finance*, Vol. 29(1), pp. 55-81.
A. García Herrero and M.S. Martínez Pería (2007)
"The mix of international banks' foreign claims: determinants and implications", *Journal of Banking & Finance*, Vol. 31(6), pp. 1613-31.
M. Giannetti and L. Laeven (2012)
"The flight home effect: evidence from the syndicated loan market during financial crises." *Journal of Financial Economics*, Vol. 104(1), pp. 23-43.
M. Giannetti and S.R.G. Ongena (2012)
"Lending by example: direct and indirect effects of foreign banks in emerging markets", *Journal of International Economics*, Vol. 86, pp. 167-80.
C. Goodhart and D. Schoenmaker (2009)
"Fiscal burden sharing in cross-border banking crises", *International Journal of Central Banking*, Vol. 5, pp. 141–65.
M. Hellwig, A. Sapir, M. Pagano, V. V. Acharya, L. Balcerowicz, A. Boot, M. K. Brunnermeier, C. Buch, I. Van den Burg, C. Calomiris, D. Focarelli, A. Giovannini, D. Gros, A. Ittner, D. Schoenmaker, and C. Wyplosz (2012)
Forbearance, Resolution and Deposit Insurance, ESRB Reports of the Advisory Scientific Committee No. 1/July 2012, Frankfurt.
IMF (2012)
Euro Area Policies: 2012 Article IV Consultation – Selected Issues Paper (Country Report No. 12/182), Washington, D.C.
IMF (2007)
Bulgaria: Selected Issues (Country Report No. 07/390), Washington, D.C.
H. Kamil and K. Rai (2010)
"The global credit crunch and foreign banks' lending to emerging markets: why did Latin America fare better?", IMF Working Paper No. 10/102, Washington, D.C.
Levchenko, R. Rancière and M. Thoenig (2009)
"Growth and risk at the industry level: the real effects of financial liberalization," *Journal of Development Economics*, Vol. 89(2), pp. 210-22.
S. Ongena, J.L. Peydró Alcalde and N. Van Horen (2012)
"Shocks abroad, pain at home? Bank-firm level evidence on financial contagion during the 2007-2009 crisis", mimeo.
OTB Research Institute for the Built Environment (2010)
"Housing Statistics in the European Union 2010", commissioned by Ministry of the Interior and Kingdom Relations of the Netherlands. Delft. Download: http://abonneren.rijksoverheid.nl/media/dirs/436/data/housing_statistics_in_the_european_union_2010.pdf
J. Peek and E.S. Rosengren (1997)
"The international transmission of financial shocks: the case of Japan", *American Economic Review*, Vol. 87, pp. 495-505.
K. Pistor (2011)
"Governing interdependent financial systems: lessons from the Vienna Initiative", Columbia University School of Law (Columbia Law and Economics Working Paper No. 396), New York.
J. Pisani-Ferry, A. Sapir, N. Véron and G. Wolff (2012)
"What kind of European banking union?", *Bruegel Policy Contribution*, issue 2012/12, June, Bruegel Institute.
Popov and G. Udell (2012)
"Cross-border banking, credit access, and the financial crisis", *Journal of International Economics*, Vol. 87(1), pp. 147-61.
C. Purfield and C. Rosenberg (2010)
"Adjustment under a currency peg: Estonia, Latvia and Lithuania during the global financial crisis 2008-09", IMF Working Paper 10/213, Washington, D.C.
R. Ranciere, A. Tornell and F. Westermann (2006)
"Decomposing the effects of financial liberalization: Crises vs. growth," *Journal of Banking & Finance*, Vol. 30(12), pp. 3331-48.
P. Schnabl (2012)
"The international transmission of bank liquidity shocks: evidence from an emerging market", *Journal of Finance*, Vol. 67(3), pp. 897-932.
D. Schoenmaker and D. Gros (2012)
"A European deposit insurance and resolution fund", Centre for European Policy Studies Working Document No. 364, Brussels.
N. Véron (2012)
"Europe's Single Supervisory Mechanism and the Long Journey towards Banking Union", briefing paper for the ECON Committee (Economic and Monetary Affairs) of the European Parliament, October.

CHAPTER 4
REGIONAL TRADE INTEGRATION AND EURASIAN ECONOMIC UNION

Regional economic integration has the potential to bring multiple economic benefits through trade creation, the facilitation of exports to the rest of the world, more efficient markets and the opportunity to build stronger economic institutions. To reap these benefits, the key challenges are to lower non-tariff barriers to trade, to improve cross-border infrastructure, limit the use of tariff barriers with other countries, extend liberalised market access to service sectors and strengthen institutions at the level of regional governance.

THE FACTS AT A GLANCE



AROUND **70%**
Overall increase in trade among Customs Union members between 2009 and 2011

12%
Share of firms in regions bordering Kazakhstan and Belarus which view customs and trade regulations as a major or very severe obstacle, compared with 31 per cent of firms in regions bordering other countries

LESS THAN **25%**
Share of goods that are exported only within the Customs Union

REGIONAL TRADE INTEGRATION AND EURASIAN ECONOMIC UNION

At the start of transition over 20 years ago many old economic ties within and between countries in the former communist bloc were severed. Initial centrifugal forces quickly gave way to regional integration initiatives, both among transition countries themselves and with new trading partners in the West. Between 1992 and 2007 most countries in central Europe and the Baltic states (CEB) and south-eastern Europe joined the Central European Free Trade Agreement (CEFTA) and 10 later joined the European Union. (Croatia will do so in 2013.)

The latest development in regional economic integration, and the first successful attempt involving constituent countries of the former Soviet Union, is the creation, within the Eurasian Economic Community,[1] of a Customs Union and Common Economic Space by Belarus, Kazakhstan and Russia and of new supranational institutions, including a Eurasian Economic Commission.

Based on the early evidence, this chapter assesses what the new Customs Union has achieved to date and what it could potentially accomplish in the future. It considers whether a common tariff policy is having any measurable impact, whether the Union is lowering non-tariff trade barriers and also what the potential effects on trade might be of reducing barriers further. It also examines whether regional economic integration can help to promote member countries' exports and contribute to better economic institutions, drawing additionally on experiences of trade integration elsewhere in the world.

CUSTOMS UNION AND COMMON ECONOMIC SPACE: AN OVERVIEW

The idea of a deeper regional economic integration within the Commonwealth of Independent States (CIS) is not new. It was put forward in the early 1990s by a number of economists, and the term Eurasian Economic Community was coined by Nursultan Nazarbayev, the President of Kazakhstan, in March 1994. However, progress towards integration has been slow; although an agreement to create a CIS free trade area was reached in principle in 1994, an actual free trade agreement was only signed 17 years later.

The integration process gained political momentum in November 2009 when Belarus, Kazakhstan and Russia signed an agreement establishing a Customs Union and started applying a common import tariff from 1 January 2010.[2] Internal border controls were removed, first between Belarus and Russia and then between Kazakhstan and Russia. Under the Customs Union framework, import tariff revenues accrue to national budgets in predetermined proportions (with Russia

Box 4.1

Comparative advantage through regional integration – the case of ASEAN

The ASEAN Free Trade Area (AFTA) is a trade bloc agreement set up by the Association of Southeast Asian Nations to increase their export competitiveness. It was originally signed in 1992 by six countries – Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand – and subsequently by Vietnam in 1995, Laos and Myanmar in 1997 and Cambodia in 1999.

AFTA's primary mechanism is the Common Effective Preferential Tariff (CEPT), which caps tariffs for goods originating within ASEAN to between 0 and 5 per cent. Unlike the European Union, AFTA does not apply a common external tariff to goods imported from outside the region. ASEAN's vision was to leverage intra-regional division of labour and specialisation to encourage exports to the rest of the world by eliminating tariff and non-tariff barriers to movement of goods along the supply chain within the region.

Using regional integration as a springboard for export growth is sometimes referred to as the "flying geese paradigm".[3] The metaphor derives from the idea that the less-developed nations, with lower labour costs, can be aligned successively in a wild-geese-flying pattern behind the advanced industrial nations according to their different stages of development. As the comparative advantages of the "lead goose" cause it to shed its labour-intensive production in favour of more capital-intensive activities, the low-productivity function is transferred further down the chain to upper-middle-income countries, then lower-middle-income countries and so on. Foreign direct investment and multinational corporations (MNCs) meanwhile facilitate the transfer of technologies among member states.[4]

Within ASEAN, Singapore emerged as the "lead goose" intermediating a large share of trade between the region and the rest of the world. Regional integration was essentially led by industries such as electrical and electronic products and industrial machinery. These industries developed a high degree of vertical specialisation, where intermediate components and semi-finished products were traded within the ASEAN region and final products were exported to the rest of the world. Intermediate goods account for as much as 40 per cent of intra-ASEAN trade, while dependence on Japan as a source of intermediate inputs has declined sharply.[5] This model has helped the ASEAN countries to leverage the substantial existing differences in per capita income and skills and achieve dynamic growth in the region as a whole.[6]

40%

Share of intermediate goods in trade within ASEAN

[1] The Eurasian Economic Community includes Belarus, Kazakhstan, the Kyrgyz Republic, Russia and Tajikistan.

[2] For a small number of products (including cars for personal use and pharmaceuticals) special transition arrangements have been agreed for Belarus and Kazakhstan.

[3] The paradigm was originally developed in the 1930s and is best summarised in Akamatsu (1962). It originally referred to the economic integration in east Asia and the role of Japan.

[4] See Menon (1996) for a discussion of the role of MNCs.

[5] See Fujita (2001).

[6] See Ng and Yeats (1999).

entitled to 88 per cent, Kazakhstan to 7 per cent and Belarus to 5 per cent, but subject to regular review). The Union is open to other countries provided that they share a common border with the existing members. Within the CIS, this stipulation currently precludes Armenia, Moldova and Tajikistan, but the Kyrgyz Republic is considering membership and Ukraine has been invited to join.

The next stage was launched on 1 January 2012 with the creation by Belarus, Kazakhstan and Russia of the Common Economic Space of the Eurasian Economic Community. It involves developing supranational institutions, modelled explicitly or implicitly on those of the European Union, headed by the Eurasian Economic Commission, with nine commissioners responsible for various areas of economic integration. The Commission is expected to gradually assume some of the competencies of national authorities, including import tariff-setting (previously delegated to its predecessor, the Customs Union Commission), technical regulations and competition policy.

Key decisions within this supranational framework will be taken by the Council of Country Representatives based on the one country-one vote principle. In some cases decisions require unanimous approval. The decisions of the supranational bodies become legally binding for member countries a certain period after their publication and will prevail over any inconsistent national norms. Any disputes can be taken to the Economic Court of the Eurasian Economic Community, the decisions of which are binding on member states.

The Eurasian Development Bank, based in Almaty in Kazakhstan, has a broader membership beyond the Customs Union countries and includes Armenia, the Kyrgyz Republic and Tajikistan. The Bank currently has an Anti-Crisis Fund (ACF) programme to help Belarus (subject to policy conditions and regular reviews), under which two disbursements totalling US$ 1.24 billion were made in 2011. Tajikistan is also a beneficiary of a US$ 70 million ACF programme.

The ultimate goal of the Eurasian Economic Community is free movement of goods, capital and people, as well as the harmonisation of macroeconomic and structural policies. As of 2012 the member countries agreed to codify various existing agreements and treaties by 2015 and then discuss steps towards further integration.

REGIONAL TRADE INTEGRATION: BENEFITS AND CHALLENGES

Regional economic integration can bring multiple benefits.

First, lower tariff and non-tariff trade barriers should increase trade and enhance consumer choice. In the case of the Eurasian Customs Union, the immediate "trade creation" effects would mainly reflect the elimination of administrative barriers as customs checks are removed from internal borders (since most trade between the member countries was already subject to zero customs duties). Improvements in cross-border regional infrastructure might also play an important role.

Second, producers within a regional integration grouping can benefit from increased market size. Market size, in turn, is an important factor facilitating innovation, the fixed costs of which can be spread across a larger customer base.[7] At the same time, consumers will also benefit from greater competition in product markets. These effects crucially depend not just on the creation of a single customs area, but also on the elimination of barriers to market access. Important progress has been made in this respect in Belarus, Kazakhstan and Russia where, with a few exceptions, firms have equal access to public procurement contracts in all three countries.

Third, exporting within a regional area may serve as a first step towards the expansion of exports worldwide – by initially building export capacity taking advantage of low tariff and non-tariff barriers within a union, and then leveraging this capability to achieve competitive advantage in exporting to other countries. For Kazakhstan and Russia, developing such export capability is a particularly challenging task given their existing relatively narrow, natural resource-focused export bases.[8]

Fourth, countries within a regional integration area can build cross-border production chains by leveraging each other's comparative advantages and subsequently exporting the finished product outside that area (see Box 4.1 for an example of such integration in the Association of Southeast Asian Nations). Links through foreign direct investment (FDI) typically play a prominent role in this scenario, as they did in the 1990s when CEB countries became increasingly integrated in European production chains.

Fifth, deeper regional economic integration can help member countries to strengthen their economic and political institutions. As some competencies are delegated to newly created supranational bodies, and other areas of economic policy undergo cross-country synchronisation, the opportunity arises to review and revise laws and regulations and to strengthen their implementation, in turn promoting business environment improvement and liberalisation. Accession to the European Union undoubtedly played a key role in enhancing institutions in the CEB countries, and the longer-term viability of CIS regional integration will depend largely on whether the Eurasian Economic Community can create institutions stronger than those of any of its member states.

Lastly, integration can encourage the liberalisation of services markets, which tend to be subject to greater regulation and protection compared with those for goods (and even within the European Union they remain fragmented to some extent). Nevertheless, in the context of Eurasian integration there is great potential for efficiency gains in these markets which could be realised by lowering entry barriers for firms and investors from other countries.[9]

Regional economic integration also comes with a number of challenges, the most important of which is to minimise negative effects on economic links with outside countries. Such effects typically occur through trade diversion, whereby a relative change

[7] See EBRD (2010) for a discussion of the relationship between exports and innovation.
[8] See EBRD (2008) and EBRD (2012).
[9] See, for instance, Jensen et al. (2007) and Tarr and Volchkova (2010) in the context of Russia.

Box 4.2
Asymmetries in regional trade integration – the case of Mercosur

Mercosur is an economic and political agreement among Argentina, Brazil, Paraguay, Uruguay and Venezuela. Founded in 1991 under the Treaty of Asunción, which was later amended and updated by the 1994 Treaty of Ouro Preto, it is a full customs union, which represents a significant stage in Latin American integration.

As with the Customs Union of Belarus, Kazakhstan and Russia, Mercosur members are very different in terms of their economic size. Brazil accounts for over 70 per cent of the region's population, territory and GDP, while Uruguay and Paraguay each account for less than 5 per cent. However, Brazil is not richer in income per capita terms than Argentina or Uruguay, and in fact includes Mercosur's poorest regions.

Given these disparities, Mercosur members have sometimes found it difficult to agree on common policies. The common external tariff (CET) is the cornerstone of the common trade policy, but only covers around 80 per cent of products. Further convergence has perhaps been hampered by the fact that the CET is often perceived as favouring Brazilian interests ahead of those of the smaller members.[10] The common tariff varies between 0 and 20 per cent, with higher tariffs levied on final consumption goods.[11] Many exemptions for smaller countries still remain, especially those covering capital goods and computing and telecommunication equipment, as do exceptions under bilateral trade agreements. Furthermore, member-state policies on investment, export promotion and anti-dumping protection are not necessarily coordinated.

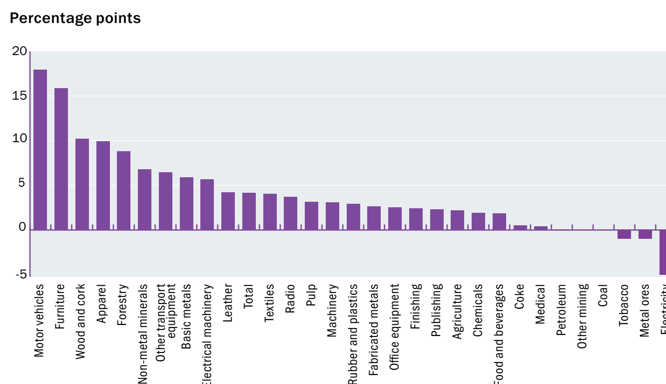
Despite these difficulties, Mercosur appears to have had regional benefits. In particular, there is evidence that it has promoted, rather than impeded, trade with countries outside the region. For a number of industries, including automotive manufacturing, certain petrochemicals and plastics, Mercosur has served as an initial platform for Argentine and Brazilian exporters, enabling them to further improve their productive capacity and organisation and to promote their goods to the rest of the world. Although the smaller member countries of Mercosur have more open and specialised economies, a substantial proportion of their total trade remains within the bloc as the other members represent a relatively large market for their products.

in tariff barriers can divert trade from more efficient external exporters to less efficient ones.[12] For example, should the introduction of a common external tariff by a regional bloc result in a relative increase in the import tariff for country A outside the region compared with that for country B inside the region, one would expect an increase in imports from country B and a drop in imports from country A. As a result, however, consumers must buy goods from the less efficient producer.

Concerns about trade diversion have been raised in the context of the Eurasian Customs Union. Its common tariff, which was formulated in the crisis environment of 2009, was also used in part as a tool of industrial policy to promote selected import substitution through an increase in tariffs (for example, in the case of the automotive sector). The common tariff's introduction resulted in significant changes to the import tariff structure in each constituent country, with tariff lines adjusted upwards and downwards. Kazakhstan's schedule underwent the most extensive changes, affecting more than 50 per cent of tariff lines (see Chart 4.1) and mostly in an upward direction. The empirical impact of these changes is examined in the next section.

Another concern, and particularly in relation to the Eurasian bloc, is asymmetry. The disparity in the economic size of the largest state, Russia, and that of the other members is perhaps greater than in any other regional economic grouping. Kazakhstan's population and gross domestic product (GDP) are around one-tenth of those of Russia, and those of Belarus are lower still. While comparisons with other integration ventures which include dominant countries (for example, Brazil in Mercosur – see Box 4.2) suggest that the benefits of regional integration are still substantial, asymmetries can become an obstacle. It is important to ensure that the decisions

Chart 4.1
Change in import tariffs in Kazakhstan



Source: World Bank (2011).
Note: This chart depicts the change in the average effective tariff rate at the industry level before and after the Customs Union came into force, inclusive of transitional provisions. Total refers to an overall average.

[10] See Olarreaga and Soloaga (1998). See also Laursen (2010) for a discussion of political aspects of integration.
[11] See Kume and Piani (2001).
[12] The term trade diversion was coined by Viner (1950). See Venables (2003) for a detailed discussion of the issue.

Box 4.3
A union of commodity exporters – the case of the Gulf Cooperation Council

The Gulf Cooperation Council (GCC), formed in 1981, is the political and economic union of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE). Much like the Eurasian Customs Union and Mercosur, it is characterised by a significant asymmetry between Saudi Arabia, the largest state, and the other members. Saudi Arabia has about 70 per cent of the total GCC population and accounts for more than half of total GCC GDP, while the UAE, the next largest, produces roughly 20 per cent of GDP. However, Saudi Arabia's income per capita is lower than that of most of the other countries.

An interesting feature of the GCC is its members' common reliance on oil and gas exports, mainly to Asia and the United States. For example, hydrocarbons account for over 90 per cent of the total exports of Saudi Arabia. As a result, intra-regional trade remains fairly limited; only Oman sends more than 10 per cent of its total exports to other GCC members. Also, although Oman imports machinery from the UAE and Bahrain imports oil and fuel products from Saudi Arabia, other GCC countries source less than 15 per cent of their imports from within the grouping.

This heavy reliance on oil and gas exports has shaped the evolution of the GCC and some of its unique features. The GCC has a high degree of infrastructure integration, including a unified pipeline network to distribute natural gas among the six member states, an integrated railway system and a unified power grid. It has also created a common market, launched at the start of 2008 to allow the unrestricted movement of goods, capital and labour. As a result, there has been a marked increase in cross-border investment, often involving mergers and acquisitions (M&A) and targeted largely at the service sector (notably telecommunications). Since December 2010 companies based in one GCC country have been able to set up branches in other member states. The distribution of cross-border direct investment has been fairly balanced, with Kuwait among the key sources and also key recipients of M&A flows.

However, the implementation of a customs union, first announced in 2003, has been postponed until at least 2013. Also, labour mobility has been slow to expand despite the fact that the common market grants the same economic rights to all GCC citizens, allowing them to work in the private and public sectors in each member state and to receive any applicable welfare benefits such as pension and social security payments. By 2010 only around 21,000 nationals (around 0.05 per cent of the total population) had taken up permanent employment in a GCC state other than their country of origin. All GCC economies nevertheless remain important employers of foreign labour due to a perceived shortage of manpower in the region.

Overall, given the limitations of trade links among these major oil and gas exporters in the short term, economic integration in the GCC has focused on common infrastructure, investment flows and liberalisation of mutual access to services markets. Over time, the structure of its constituent economies, and the GCC itself, may evolve as the natural resource endowments of the member states run out at different rates. At current production levels, oil reserves will last for less than two decades in Bahrain and Oman, but for more than 100 years in Kuwait and the UAE.

of supranational bodies are implemented by all member countries, and that dispute resolution mechanisms at the supranational level work well.

In a regional union dominated by commodity exporters, a further challenge is to leverage the benefits of economic integration. Partly due to the fact that Kazakhstan and Russia predominantly export oil and other commodities, the Customs Union is less economically integrated than commonly perceived: Belarus and Kazakhstan account for under 7 per cent of Russia's export and import trade, although Belarus, as a net energy importer, sources over half of its total imports from Kazakhstan and Russia. The Gulf Cooperation Council (GCC) is a similar example of a regional economic union dominated by major oil exporters (see Box 4.3). Regional integration does present substantial challenges in the case of outward-oriented commodity exporters (not least the challenge of harmonising approaches to taxation of commodity exports). Nevertheless, these countries can still benefit from cooperation in many areas, including the development of cross-border infrastructure, cross-border investment and the liberalisation of mutual access to services markets.

Lastly, while deeper economic integration may yield substantial benefits, it can also aggravate the macroeconomic vulnerabilities of member states. As production chains become more integrated, shocks to world trade (such as that in 2008) permeate quickly through regional economic blocs. Producers of intermediary goods may be particularly badly affected as suppliers of final goods cut orders and run down their existing stocks of input materials.[13] As a result, output contractions can be amplified through close trade linkages and so affect the strength of subsequent recovery.

[13] See Zavacka (2012) for a discussion of this so-called "bullwhip effect".

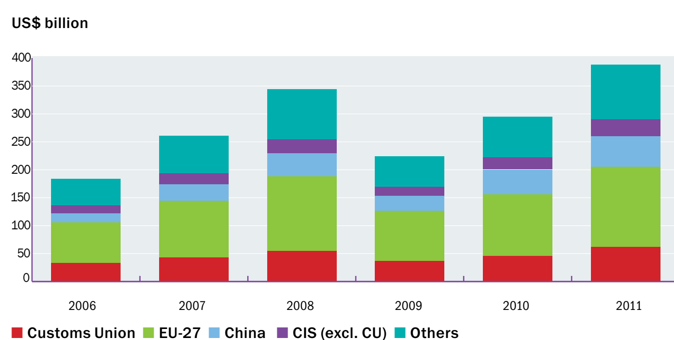
Table 4.1
Changes in imports

Dependent variable: change in imports	Kazakhstan					Belarus					Russia				
	World	CU	EU	China	CIS	World	CU	EU	China	CIS	World	CU	EU	China	CIS
Change in tariffs	0.0024	0.0076*	-0.0056	-0.0141**	0.0009	-0.0133***	0.0077	-0.0233***	-0.0078	-0.0015	-0.0114***	0.0026	-0.0099**	-0.0128**	-0.0061
	(0.0028)	(0.0039)	(0.0049)	(0.0071)	(0.0136)	(0.0032)	(0.006)	(0.0049)	(0.0132)	(0.013)	(0.0032)	(0.0084)	(0.0039)	(0.0051)	(0.012)
Change in bilateral imports, 2006-08		0.0068	-0.0556	-0.1514***	0.0101		0.1102***	-0.0033	0.0771	-0.0028		0.0243	-0.0721***	-0.0495***	0.0553
		(0.0372)	(0.0459)	(0.0447)	(0.0579)		(0.0423)	(0.036)	(0.0491)	(0.0548)		(0.023)	(0.0258)	(0.0183)	(0.036)
Change in bilateral imports, 2008-09		-0.2622***	-0.3146***	-0.4621***	-0.3133**		-0.3940***	-0.3118***	-0.0424	-0.3606***		-0.1474***	-0.3024***	-0.2980***	-0.2346***
		(0.0507)	(0.0675)	(0.0877)	(0.1275)		(0.0594)	(0.0688)	(0.148)	(0.0916)		(0.053)	(0.0338)	(0.032)	(0.0531)
Bilateral imports, 2009, log		-0.1267***	-0.1495***	-0.1569***	-0.3110***		-0.0452**	-0.1012***	-0.1469**	-0.033		-0.0567***	-0.0606***	-0.0499***	-0.0807***
		(0.0217)	(0.0284)	(0.0429)	(0.0753)		(0.0191)	(0.0208)	(0.0599)	(0.0477)		(0.0196)	(0.0082)	(0.012)	(0.0217)
Change in world imports, 2006-08	-0.1020***	-0.0330	0.0479	-0.0153	-0.2297**	-0.0195	-0.1110**	-0.0931*	-0.0581	-0.0145	-0.0651***	0.0143	0.0112	0.0562	-0.0166
	(0.0198)	(0.0509)	(0.0662)	(0.0752)	(0.1010)	(0.0163)	(0.0536)	(0.0483)	(0.0964)	(0.1061)	(0.0128)	(0.0479)	(0.0319)	(0.0342)	(0.053)
Change in world imports, 2008-09	-0.3218***	0.0690	-0.2468***	0.1664	-0.1135	-0.3655***	0.0394	-0.1654**	-0.1143	0.1658	-0.2625***	-0.1473***	0.0462	0.1983***	-0.0564
	(0.0294)	(0.0620)	(0.0907)	(0.1116)	(0.1837)	(0.0263)	(0.0759)	(0.0819)	(0.1974)	(0.1411)	(0.0174)	(0.0542)	(0.0376)	(0.0453)	(0.0713)
World imports, 2009, log	-0.1111***					-0.0500***					-0.0446***				
	(0.0129)					(0.0104)					(0.006)				
Constant	0.7099***	0.3902**	0.9338***	1.5044***	2.4767***	0.4791***	0.4085**	0.8852***	1.3077***	0.3447	0.6569***	0.5253***	0.7264***	0.8743***	0.8454***
	(0.1159)	(0.1978)	(0.2460)	(0.3662)	(0.6562)	(0.0891)	(0.1605)	(0.1736)	(0.4675)	(0.3884)	(0.0581)	(0.1731)	(0.0776)	(0.1064)	(0.1959)
Number of observations	1,323	486	542	295	156	1,578	640	747	143	187	2,917	508	2,084	1,250	460
R-squared	0.1760	0.1821	0.2995	0.2221	0.3393	0.1605	0.1795	0.257	0.1138	0.1374	0.109	0.0726	0.1293	0.1061	0.145
Number of industry fixed effects	133	99	93	77	55	147	109	119	55	66	162	109	151	136	106

Source: Authors' calculations.

Note: The table shows the results of ordinary least squares regressions of changes in imports in 2009-10 (in logarithmic terms). Robust standard errors in parentheses. Values significant at the 10 per cent level are marked with *; at the 5 per cent level with **; at the 1 per cent level with ***. A negative coefficient for the change in tariffs means that imports decreased in response to a higher tariff or that tariff increased in response to a lower import tariff.

Chart 4.2
Customs Union import volumes by trade partner



Source: Kazstat, Rosstat, Belstat and Customs Union Commission.
Note: CU is the Customs Union of Belarus, Kazakhstan and Russia, EU-27 are the 27 current members of the European Union.

ASSESSMENT

It is too soon to judge to what extent multiple benefits of regional integration within the Eurasian Economic Community may materialise, and whether the numerous challenges and risks can, respectively, be overcome and minimised. Nonetheless, it is useful to see what can be learned from the early evidence.

MARKET ACCESS AND TRADE CREATION

In 2010-11 intra-regional trade between Belarus, Kazakhstan and Russia increased by over two-thirds, and in the first five months of 2012 it continued to expand at the rate of 15.5 per cent year-on-year. Was this impressive growth a reflection of deeper economic integration or merely in line with global trends in the post-crisis recovery of trade?

In the wake of the 2008-09 crisis, overall imports into this Eurasian bloc contracted by 35 per cent (see Chart 4.2) and imports from within it similarly fell by over one-third. However, in 2010 imports started to recover, increasing by 31 per cent overall. This recovery was strongest for goods from China and the

CIS countries followed by goods from within the new Customs Union, although some trade volumes (for example, Kazakhstan's imports from the European Union) continued shrinking. In 2011 the recovery was maintained and imports from within the Customs Union surpassed the level of 2008 in nominal terms (by 12 per cent). The trends were similar for exports.

To gauge the magnitude of trade recovery effects, trade creation within and outside the Customs Union and trade diversion effects (if any), the highly disaggregated structure of exports and imports of each country can be examined. At the six-digit level of the Harmonized System (HS) classification, goods are divided into over 5,000 separate lines (such as bottles for sterilisation or washing machines, for instance). Changes in trade flows between various trading partners following the introduction of the Customs Union can be analysed by comparing the sectors where tariffs were revised and those where they were not.[14]

Chart 4.3 shows the distribution of tariff changes for different countries. As previously mentioned, in the case of Kazakhstan more than 50 per cent of tariff lines for non-CIS countries have been revised, and predominantly upwards (while CIS countries have retained a largely duty-free regime based on various bilateral treaties). In Belarus and Russia fewer tariff lines underwent changes and more six-digit tariff lines saw reductions rather than increases (in non-weighted terms). This is also consistent with the change in overall effective import tariff rates, calculated as the ratio of all import duties collected to all imports in a given year. For example, in Russia this ratio declined from an average of 9.1 per cent in 2006-09 to 8.6 per cent in 2010-11.[15]

Table 4.1 shows the results of a statistical analysis, undertaken separately for each member of the Customs Union, that seeks to explain changes in imports of a given product from a particular region (meaning other Union members, China, CIS countries outside the Union, the European Union or the world as a whole) in terms of past variations in import levels as well as changes in effective tariff rates since the start of the Customs Union.[16] The regression analysis confirms that changes in volumes of imports between 2009 and 2010 were largely driven by trade recovery effects. For the world as a whole, a 10 per cent decline in imports during 2009 was associated with an approximately 3 per cent increase the following year in all three countries. The same was true for trade with individual partners.[17] Collapses in trade during crises are indeed known to overshoot by far the contraction of demand, tending to herald a subsequent brisk recovery.[18] Moreover, as trade in intermediate goods tends to be affected more than trade in final goods, some trade partnerships may be affected much more than others.

Imports also exhibited market saturation properties: the higher the pre-Customs Union import level of a given type of product from a given partner, the slower the growth in imports.

The first row of coefficients in Table 4.1 reveals that changes in tariffs *per se* did not have a significant impact on the aggregate (world) import flows in Kazakhstan, at least in the short term. However, they did have some effect on trade

Chart 4.3a

Distribution of changes in tariffs on Customs Union's introduction – Kazakhstan

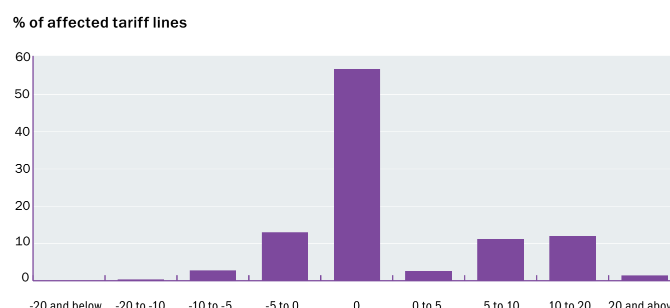


Chart 4.3b

Distribution of changes in tariffs on Customs Union's introduction – Belarus

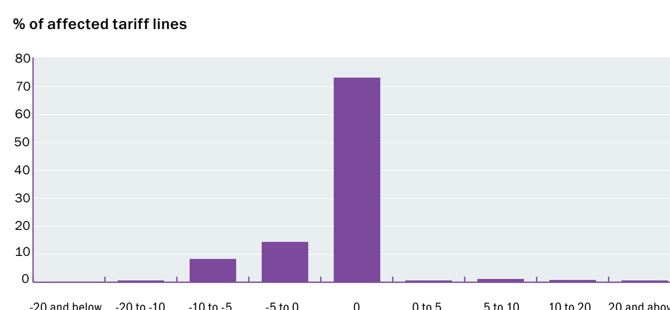
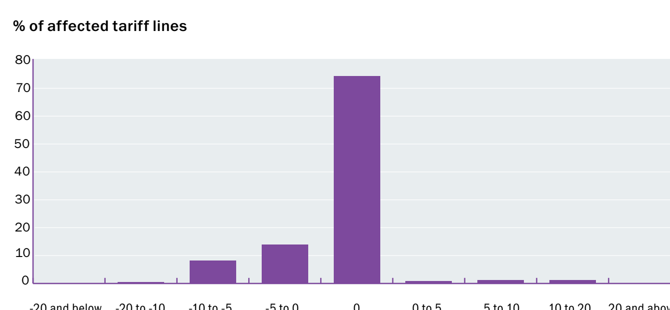


Chart 4.3c

Distribution of changes in tariffs on Customs Union's introduction – Russia



Source: National authorities, International Trade Centre, Customs Union Commission and authors' calculations.
Note: Distribution densities shown relate to non-trade-weighted changes in tariffs before and after the Customs Union came into force at the six-digit level of disaggregation, excluding transitional provisions and lines with no recorded imports. For intervals reported on the horizontal axis the lower bound is included and the upper bound is excluded. Both bounds are excluded in the 0 to 5 category.

[14] Trade flows are expressed in US dollar terms.
[15] Calculated using data from the Central Bank of Russia and the Russian Treasury taking into account all import duties and fees collected in Russia, including those subsequently transferred to the Treasuries of Belarus and Kazakhstan.
[16] See Isakova and Plekhanov (2012) for further discussion. Analysis excludes product lines for which exclusions from the common external tariff apply or trade volumes are less than US$ 1 million.
[17] Results for the rest of the world (not reported) are similar.
[18] See Baldwin (2009).

with individual partners. In particular, increases in tariffs had a statistically significant negative impact on imports from China. The coefficients imply that a 2 percentage point tariff increase (the average for the sample) led to a 2-3 per cent contraction in imports of respective goods from China. A similar increase in tariffs also led to a 1-2 per cent increase in imports from within the Customs Union.[19] Imports from the European Union, CIS and the rest of the world were broadly unchanged.

The coefficients for changes in tariffs may in fact combine two effects. For increases in tariffs, which were more common in Kazakhstan, a negative coefficient means that trade declined in response to higher tariffs. At the same time, in cases where tariffs were reduced, the same negative coefficient reflects an increase in trade in response to the tariff reduction.

It is therefore useful to check for asymmetries in the response of import flows to increases and reductions in tariffs (see Table 4.2). It turns out that in Kazakhstan significant changes in trade flows were only observed in response to increases in tariffs. This means that the positive relationship observed in Tables 4.1 and 4.2 between changes in tariffs and changes in imports from Customs Union countries reflects a trade diversion effect. For example, imports into Kazakhstan from Russia may have increased because imports from China became more expensive following the introduction of a higher common external tariff by the Customs Union members.

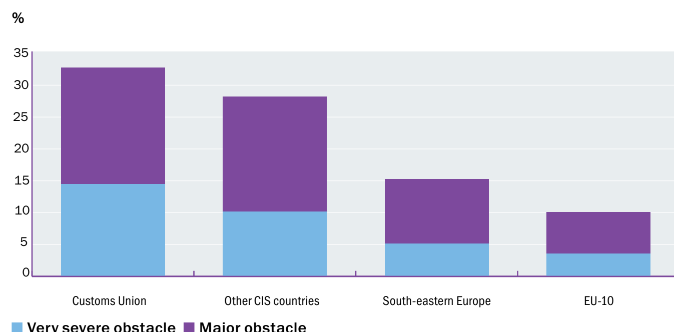
In the case of Belarus, Table 4.1 indicates that tariff changes had a significant negative impact on overall (world) import flows. Unlike Kazakhstan, however, the positive effect on imports from the Customs Union was small and statistically insignificant. This is possibly explained by the fact that tariff changes were much less drastic for Belarus, which already had a tariff structure similar to that of Russia. At the same time, tariffs had a small but statistically significant negative impact on trade with the European Union.

Again, this raises the question of whether these negative coefficients should be interpreted as reflecting trade creation or trade diversion. Table 4.2 suggests that, as in the case of Kazakhstan, significant responses in trade flows were observed only in response to increases in tariffs. A 0.5 percentage point tariff increase (the average for the sample) was associated with a 2-3 per cent reduction in imports from the European Union and a 1-2 per cent reduction in respective imports from the world as a whole.[20]

The Table 4.1 results for changes in import flows in Russia appear to be similar to those for Belarus. However, Table 4.2 suggests that imports into Russia from the world as a whole, and from the European Union in particular appear to have responded to reductions rather than increases in tariffs. Trade with China and the rest of the world appears to have responded both to increases and reductions in tariffs. The greatest of these effects is apparent for imports from China, where a 2 per cent fall in tariffs (the sample average) led to a 2-3 per cent increase in imports.

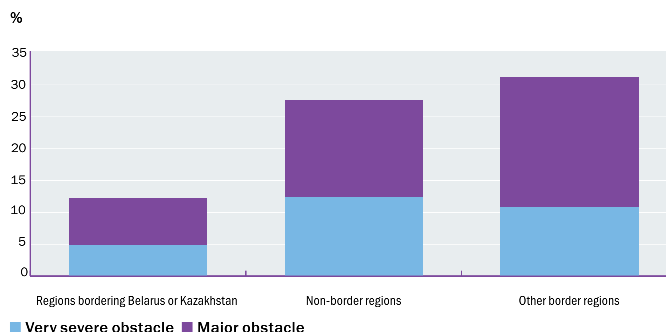
The overall finding of this analysis is that changes in tariff policy have to date had a fairly limited impact on trade flows to members of the Customs Union. Tariff-related increases in imports from within the Union were particularly small and statistically significant for Kazakhstan alone, where it appears to be a result of higher external tariffs in relation to non-Union countries. In addition, tariff increases have had statistically significant negative effects on trade between Customs Union members and selected trade partners. These effects were most pronounced for trade with China, and to a lesser extent with the European Union. This indicates some degree of trade diversion. To date, the Customs Union appears to have had tariff-related trade creation effects only for Russia, as reductions in external tariffs have been associated with higher imports from selected trade partners outside the Union.

Chart 4.4a
Percentage of firms viewing cross-border trade regulations and customs as serious obstacles



Source: BEEPS Survey and authors' calculations.
Note: Based on 2008-09 data.

Chart 4.4b
Percentage of Russian firms viewing cross-border trade regulations and customs as serious obstacles



Source: BEEPS Survey and authors' calculations.
Note: Based on preliminary data.

[19] Customs Union estimates for Kazakhstan are based on preliminary incomplete data. See Isakova and Plekhanov (2012) for details.

[20] This result is driven by a relatively small number of product lines for which the tariffs increased: 59 for the world as a whole and 29 for the European Union, predominantly in the food, automotive and construction materials sectors.

Importantly, this analysis may underestimate the eventual trade creation effects of tariff changes because of the short time period since the Customs Union came into effect. Establishing new trade links may take several years, and the speed of changes in trade flows may depend on the nature of the goods in question.[21] In addition, by focusing on products that have already been traded, the analysis ignores the introduction of new exports and imports. Furthermore, trade flows in 2009 may, to some extent, already have been affected by the anticipation of future tariff changes.

These caveats notwithstanding, the findings are consistent with the view that the value of modern trade agreements derives primarily from the removal of non-tariff barriers and from investment and service liberalisation, rather than changes in rules governing movement of goods, such as tariffs and quotas.[22]

NON-TARIFF BARRIERS TO TRADE

Not all of the increase in trade between the Customs Union members shown in Chart 4.2 can be explained by tariffs, recovery effects and past trade levels, as indicated by the fact that the regression constant in Table 4.1 is positive and statistically significant in all cases. The lowering of non-tariff barriers within the Union may also be a factor. Non-tariff and "behind the border" barriers take various forms, including corrupt customs officials, inadequate transport infrastructure and poor business environment. Obstacles of this kind are less visible than tariff barriers and harder to measure, but no less important. For example, a recent study estimated that one extra day spent by goods in transit is equivalent to an additional tariff of between 0.6 and 2.3 per cent.[23]

Regional economic integration creates multiple opportunities for lowering non-tariff barriers. For example, customs controls have been removed from Russia's borders with Belarus and Kazakhstan with the introduction of the Customs Union and the Asian Development Bank (ADB) has evidence that crossing the Kazakh-Russian border has indeed become substantially easier. The need for intermediary or facilitation payments may have also been reduced, in turn helping trade. At the same time, clearance times on the Kazakh border for trucks entering from non-Customs Union CIS countries (such as the Kyrgyz Republic) have increased significantly by up to 47 per cent.[24]

The 2008-09 round of the Business Environment and Enterprise Performance Survey (BEEPS), conducted just before the Customs Union was established, suggested that customs procedures were viewed as especially burdensome by firms in CIS countries and the Union in particular. Survey respondents (directors, owners or senior managers of firms) evaluated various elements of the public infrastructure and business environment, including trade regulations and customs, in terms of their perceived constraint on firms' operations. For example, trade regulations and customs were ranked on a five-point scale of obstruction (ranging from none to severe). Approximately 30 per cent of firms in Belarus, Kazakhstan and Russia which traded across borders viewed them as a serious problem, while only around 10 per cent did so in the new EU member states (the EU-10) (see Chart 4.4a).

The most recent round of the BEEPS survey in Russia also provides some indirect evidence of reduced non-tariff barriers in the Customs Union. This round included, for the first time, representative samples from 37 regions of Russia. Four of them (Omsk, Chelyabinsk, Novosibirsk and Smolensk regions) border Belarus or Kazakhstan, while 11 share a frontier with other countries.

Of those companies exporting or importing goods directly, 27 per cent viewed customs and trade regulations as a major or

Table 4.2
Changes in imports in response to negative and positive changes in tariffs

Dependent variable	Change in imports				
	Kazakhstan				
	World	CU	EU	China	CIS
Change in tariffs (reduction)	0.0038	0.0025	0.0011	0.0003	-0.0664
	(0.0061)	(0.0118)	(0.0111)	(0.0167)	(0.0413)
Change in tariffs (increase)	0.0019	0.0087*	-0.0081	-0.0190**	0.0168
	(0.0035)	(0.0046)	(0.0061)	(0.0088)	(0.0164)
Observations	1,323	486	542	295	156
R-squared	0.1760	0.1826	0.3002	0.2254	0.3595
Number of industry fixed effects	133	99	93	77	55
	Belarus				
	World	CU	EU	China	CIS
Change in tariffs (reduction)	-0.0019	0.006	-0.0049	-0.0062	-0.009
	(0.0041)	(0.0079)	(0.0066)	(0.0134)	(0.023)
Change in tariffs (increase)	-0.0353***	0.011	-0.0506***	-0.0696	0.0029
	(0.0059)	(0.0119)	(0.0082)	(0.0904)	(0.0172)
Observations	1,578	640	747	143	187
R-squared	0.1718	0.1797	0.2763	0.119	0.1386
Number of industry fixed effects	147	109	119	55	66
	Russia				
	World	CU	EU	China	CIS
Change in tariffs (reduction)	-0.0131***	0.0091	-0.0114**	-0.0110**	-0.0172
	(0.0039)	(0.0111)	(0.0048)	(0.0055)	(0.0141)
Change in tariffs (increase)	-0.0076	-0.008	-0.0066	-0.0235*	0.0252
	(0.0058)	(0.0144)	(0.0071)	(0.0136)	(0.0242)
Observations	2,917	508	2,084	1,250	460
R-squared	0.1092	0.0746	0.1295	0.1067	0.1504
Number of industry fixed effects	162	109	151	136	106

Source: Authors' calculations.

Note: The table shows the results of ordinary least squares regressions of changes in imports in 2009-10 (in logarithmic terms). Regressions include the same control variables and are based on the same samples as the corresponding regressions reported in Table 4.1. Robust standard errors in parentheses. Values significant at the 10 per cent level are marked with *; at the 5 per cent level with **; at the 1 per cent level with ***. A negative coefficient for the change in tariffs in case of reduction means that imports increased in response to a lower import tariff. A negative coefficient for the change in tariffs in case of increase means that imports declined in response to a higher import tariff.

[21] The analysis of changes over two years for Russia, where data are available, confirms that the effects increase somewhat over time but they remain qualitatively and quantitatively similar to those reported in Tables 4.1 and 4.2.
[22] See Baldwin (2011) and Schiff and Winters (2003).
[23] See Hummels and Schaur (2012).
[24] ADB (2012), based on the Corridor Performance Management and Monitoring data of the Central Asia Regional Economic Cooperation Programme.

very severe obstacle to their operations, a result broadly similar to that in the 2008-09 survey round. However, the percentage was significantly lower in regions bordering Belarus and Kazakhstan (12 per cent) than in those bordering other countries (31 per cent – see Chart 4.4b). This result also held when the obstacle variable was regressed on various firm characteristics and when the propensity of respondents to feel constrained by various other aspects of the business environment was taken into account: the difference in coefficients on the dummies for regions bordering Belarus and Kazakhstan and other border regions has the expected sign and is statistically significant. While the survey did not collect the data on destinations of trade, the evidence indirectly supports the view that trade with Belarus and Kazakhstan is subject to lower effective barriers.

In order to analyse the effect of customs as a barrier to trade more broadly, Table 4.3 looks at the experience of 24 exporters in emerging Europe and Central Asia. A gravity model of trade is used to explain export flows from these countries to key destinations worldwide. In particular, the size of bilateral trade flows in 2010 is explained by the average tariff that exports from a given country face at the border of the country of destination,[25] the distance between trading partners, whether they share a border and a number of characteristics of exporter countries (including access to the sea, GDP level and population size). The regressions also include a constant (fixed effect) for each importer to capture the fact that export volumes may depend on importer characteristics. Column 1 in the table shows that larger economies export more and that distance has the expected negative effect on trade. Sharing a border increases exports by about 45 per cent. Access to the sea also increases trade, by around 25 per cent.

Tariff barriers do have a negative impact on trade. A 1 percentage point reduction in the tariff faced by a country's exports of a particular type of product at the destination border is associated with a 4 per cent rise in exports to that country. However, as exports in the sample face an effective average tariff of around 2.5 per cent (non-weighted), total gains from reducing tariff barriers, while sizeable, are ultimately limited.

Column 2 adds a measure of the quality of customs and trade regulations based on BEEPS data, namely the percentage of exporting firms which view customs as a major or very severe obstacle to their operations. Its effect is large and highly significant: improving customs procedures from the average level of the Customs Union countries (where on average 29 per cent of firms see customs as a major or very severe obstacle) to that in the Baltic states (where the figure is only 10 per cent) would bring about a 44 per cent increase in exports. Column 3 confirms that this significant effect persists when controlling for a broader measure of institutions as well as the quality of infrastructure.

These results provide further evidence that the benefits of improving customs procedures within the Customs Union could be substantial. However, while progress to date has been encouraging, a number of additional non-trade barriers within the Common Economic Space have yet to be fully removed. In particular, technical and sanitary regulations are yet to be harmonised, and in many cases firms are still subject to national-level inspection and certification of their produce. Moreover, the legal regime governing imports into the Customs Union, which is underpinned by national and supranational legislation, is complicated and may entail increased compliance costs, in particular for smaller businesses.[26] Furthermore, there is a clear need to reduce non-tariff barriers in respect of export and import trade between Customs Union members and other countries.[27]

Another important non-tariff dimension that can severely constrain trade is poor infrastructure, including cross-border infrastructure. Trade relies on good roads, railways and ports and on sufficient capacity at customs checkpoints. Analysis shows that the potential gains from improvements in cross-border

Table 4.3
Customs procedures as a barrier to trade

Dependent variable	Bilateral exports, log		
	(1)	(2)	(3)
Simple average tariff	-0.044***	-0.049***	-0.049***
	(0.012)	(0.012)	(0.012)
Exporter GDP, log	1.361***	1.245***	0.749***
	(0.060)	(0.064)	(0.120)
Exporter population, log	-0.346***	-0.165**	0.472***
	(0.062)	(0.072)	(0.144)
Weighted distance, log	-2.364***	-2.337***	-2.330***
	(0.103)	(0.102)	(0.102)
Sea coast (exporter)	0.263***	0.133*	0.064
	(0.067)	(0.076)	(0.075)
Common border	0.450***	0.502***	0.547***
	(0.115)	(0.117)	(0.116)
Customs (share of firms complaining)		-0.024***	-0.020***
		(0.006)	(0.007)
Control of corruption, exporter			0.561***
			(0.146)
Infrastructure, exporter			0.306***
			(0.082)
Constant	6.681***	6.162***	5.036***
	(0.812)	(0.828)	(0.828)
Importer fixed effects	Yes	Yes	Yes
Observations	5,272	5,272	5,272
R-squared	0.581	0.583	0.586

Source: Authors' calculations.

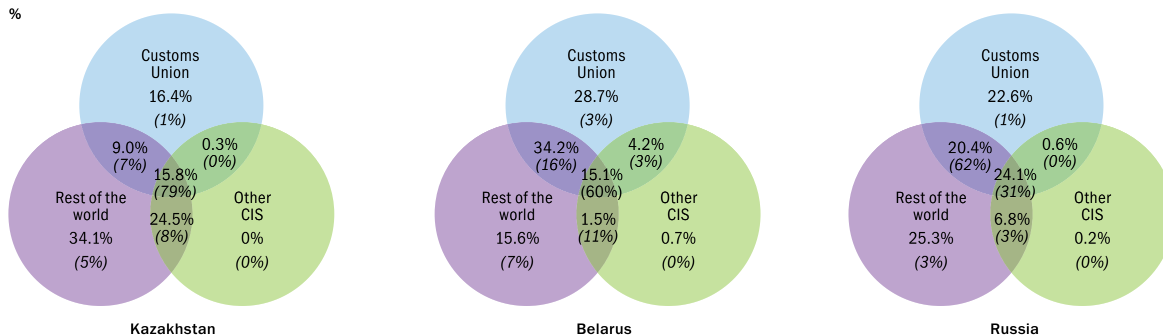
Note: Robust standard errors in parentheses. Values significant at the 10 per cent level are marked with *; at the 5 per cent level with **; at the 1 per cent level with ***. "Customs" variable is the percentage of exporting firms in the BEEPS Survey that see trade regulations and customs as a major or very severe obstacle to their operations. For description of control of corruption and infrastructure variables see Box 4.4.

[25] The average effective tariffs are computed for individual industries at the two-digit level of disaggregation – this includes industries such as processed food or durable goods.

[26] See Dragneva-Lewers (2012).

[27] See also Racine (2011) for a recent discussion of non-tariff barriers in the region.

Chart 4.5
Destinations of Customs Union exports, by product line



Source: International Trade Centre and authors' calculations.
Note: Based on classification lines with recorded trade flows of at least US$ 1 million. Numbers in italics represent shares in volume terms.

infrastructure far exceed the effects of lowering tariff barriers to trade (see Box 4.4). Such gains are greatest when improvements in infrastructure are simultaneous and complementary. For example, a good road on one side of a border may be of limited use if it does not meet a comparable connection on the other. The Common Economic Space can provide a framework for coordinating upgrades to the capacity of transport corridors and improvements in other infrastructure linkages, and can draw on the experience in this respect of other regional unions, including the European Union and the GCC.

EXPORT POTENTIAL AND VALUE-ADDED CHAINS FROM REGIONAL TO GLOBAL MARKETS

One of the immediate benefits of regional economic integration is to provide producers with a larger market, which can in turn spur innovation and product development. Can it also then help firms to develop broader export capabilities and access more challenging world markets? The following analysis suggests that this is indeed the case, despite a common perception that the export markets of the CIS countries, in particular Belarus and Russia, are fairly fragmented.

It has been argued that countries such as Kazakhstan and Russia export lower-value-added goods closely linked to commodity input (for instance, semi-finished metal products or fertiliser) to the European Union and broader world markets, while higher-value-added products are exported mainly to CIS countries. Such differences in export composition are indeed apparent in some instances (for example, Belarusian exports of capital goods), but this is not generally the case, as the data on exports of individual goods confirm.

Chart 4.5 summarises the typical destinations of exports from the three Customs Union members, based on six-digit product lines where country export flows exceed at least US$ 1 million in value.[28] The chart delineates overall exports from each country to other Customs Union members, to CIS countries outside the Union and to the rest of the world. It also shows overlaps between the three sets – and, in particular, the proportion of exports (in terms of product line numbers and export volumes) to Customs Union members and other countries.

The main insight from the chart is that goods exported within the Customs Union are also quite likely to be exported to destinations outside it. This is applicable to more than 50 per cent of Belarusian export products, about 45 per cent of Russia's and 25 per cent of Kazakhstan's. In value terms, these proportions are much higher, at 79 per cent, 93 per cent and 88 per cent, respectively. On average, fewer than 25 per cent of goods are exported solely within the Customs Union (in terms of the number of six-digit product lines, while in value terms the share is negligible), and there are virtually no goods exported to non-Customs Union CIS countries but not exported elsewhere.

Belarus has the highest proportion of goods that are exported solely within the Customs Union, but these still only account for 29 per cent of export lines. Similarly, only 15-35 per cent of its goods are exported to the rest of the world but not to Customs Union or other CIS countries. For all three countries, there is a significant triple overlap of goods exported within the Union, to other CIS countries and to the rest of the world. The proportion is greatest for Russia, at around 25 per cent of product lines. Kazakhstan has a similarly large overlap between goods exported to CIS countries outside the Customs Union and the rest of the world (but not to Belarus or Russia).

In Belarus and Russia the results are *not* driven by exports of commodities and commodities-linked products (although these account for a major slice of Kazakh and Russian trade,

[28] This exclusion eliminates lines with very low export volumes, but affects less than 2 per cent of total exports for each country.

Box 4.4
Cross-border infrastructure

Using a gravity model of trade, this analysis examines the impact of poor infrastructure as a non-tariff barrier to trade, and additionally considers the effect of corruption on the quality of the overall business environment.

To assess the impact of infrastructure on both sides of a national border, the gravity model of trade used to explain export flows from emerging Europe and Central Asia (see earlier in the chapter) has been extended to include characteristics of importer countries as well.

Physical infrastructure in exporter and importer countries is measured using World Economic Forum data that assess the quality of roads, air transport, railways, ports and electricity supply in each country. The variable is expressed as an index and rescaled to vary from -3 to 3, where higher values correspond to better infrastructure. The quality of institutions is proxied by the control of corruption index taken from the World Bank Governance Indicators.

Table 4.4.1
Determinants of bilateral trade flows

Dependent variable	Bilateral exports, log						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Simple average tariff	-0.07***	-0.08***	-0.07***	-0.04***	-0.04***	-0.04***	-0.05***
	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
Exporter GDP, log	1.40***	0.96***	1.00***	1.26***	1.28***	1.30***	0.88***
	(0.06)	(0.10)	(0.10)	(0.09)	(0.09)	(0.09)	(0.13)
Importer GDP, log	0.46***	0.50***	0.52***	0.39***	0.39***	0.40***	0.49***
	(0.03)	(0.05)	(0.05)	(0.05)	(0.05)	(0.05)	(0.06)
Exporter population, log	-0.37***	0.20*	0.16	-0.18*	-0.20**	-0.21**	0.34**
	(0.06)	(0.11)	(0.11)	(0.10)	(0.10)	(0.10)	(0.16)
Importer population, log	0.46***	0.40***	0.36***	0.52***	0.51***	0.52***	0.33***
	(0.05)	(0.07)	(0.07)	(0.06)	(0.06)	(0.06)	(0.07)
Weighted distance, log	-1.83***	-1.77***	-1.73***	-1.94***	-1.92***	-1.94***	-1.87***
	(0.05)	(0.05)	(0.05)	(0.05)	(0.05)	(0.05)	(0.06)
Sea coast (exporter)	0.15**	-0.02	0.00	0.21***	0.22***	0.23***	0.07
	(0.06)	(0.07)	(0.07)	(0.07)	(0.07)	(0.07)	(0.07)
Common border	0.64***	0.60***	0.58***	0.57***	0.57***	0.42***	0.38***
	(0.10)	(0.10)	(0.10)	(0.10)	(0.10)	(0.10)	(0.10)
Control of corruption, exporter		0.77***	0.79***				0.83***
		(0.13)	(0.13)				(0.14)
Control of corruption, importer		-0.11*	-0.21***				-0.48***
		(0.06)	(0.06)				(0.09)
Control of corruption, exp*imp			0.55***				0.39***
			(0.07)				(0.07)
Infrastructure, exporter				0.26***	0.25***	0.28***	0.23***
				(0.08)	(0.08)	(0.08)	(0.09)
Infrastructure, importer				0.21***	0.25***	0.24***	0.45***
				(0.06)	(0.06)	(0.06)	(0.08)
Infrastructure, exp*imp					0.12**	0.07	
					(0.05)	(0.05)	
Infrastructure, exp*imp*commonborder						0.48***	0.29***
						(0.12)	(0.11)
Constant	-16.35***	-20.30***	-20.84***	-18.51***	-18.73***	-18.93***	-19.36***
	(0.59)	(0.68)	(0.67)	(0.71)	(0.71)	(0.72)	(0.77)
Number of observations	5,457	5,229	5,229	5,112	5,112	5,112	4,884
R-squared	0.53	0.54	0.54	0.54	0.54	0.54	0.56

Source: Authors' calculations.

Note: Robust standard errors in parentheses. Values significant at the 10 per cent level are marked with *; at the 5 per cent level with **; at the 1 per cent level with ***.

It varies from -2.5 to 2.5 with higher values corresponding to lower perceived corruption.

The results (see Table 4.4.1) confirm that bilateral trade flows are explained by the size of economies, geography and effective tariffs. The estimates further reveal that non-tariff obstacles, such as poor infrastructure and corruption, affect trade to a much greater extent than tariffs.

In particular, half a notch improvement in infrastructure on the exporter side (less than one standard deviation) is associated with a 13 per cent increase in trade; a similar improvement on the importer side is associated with a further 10 per cent increase in bilateral trade flows. The effects of infrastructure are symmetrical.

In addition, it is likely that the effect of improvements in a country's infrastructure on trade may depend on the infrastructure of its trading partners. A new road linked to a highway on the other side of a border may have a strong impact on trade between two countries, while a road link that ends at a border will have no impact on the ease of further transport. Consequently, an interaction term between exporter and importer country infrastructure has been added in Column 5. As expected, it is positive and statistically significant. The coefficients imply that if a partner country has a poor infrastructure, improvements in infrastructure on one side of the border only will have virtually no impact on trade. In contrast, if infrastructure in the partner country is already of high quality, the additional benefits from improving infrastructure are significant: a one standard deviation improvement is associated with a more than doubling of trade flows.

It further transpires that the dependence of trade flows on the infrastructure of trading partners is driven primarily by experiences of countries that share a border and can therefore benefit from direct shipment routes. When the interaction term between source and destination country infrastructure is further interacted with the dummy variable for countries sharing a border (see Column 6), it is this triple interaction term that becomes large and statistically significant. For countries that do not share a border, the joint effect of exporter and importer infrastructure on trade is much smaller and not significant. This probably reflects the fact that trade between non-neighbouring countries may be significantly affected by infrastructure and institutions in third countries through which the goods are shipped.

Furthermore, countries with a higher perceived incidence of corruption tend to export significantly less and import significantly more – which is a serious drag on country growth performance. A one standard deviation improvement in the control of corruption index (0.6) is associated with a 50 per cent increase in exports. This effect is doubled if the destination country has a low level of corruption.[29]

Apart from its general impact on the economy, corruption often directly determines the severity of non-tariff obstacles to trade. Less corruption, among other things, means more efficient customs and more effective processing of tax refunds – issues that particularly affect the operations of exporters and importers.

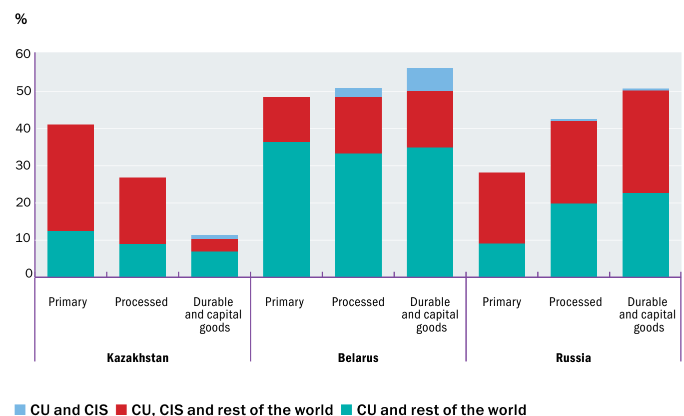
and a significant share of Belarusian exports in the case of potash fertiliser and petrochemicals). When all product lines are divided into three broad economic categories (primary goods/ commodities, processed goods and capital and durable goods), strong overlaps between export destinations are evident in all of the groups, including higher-value-added goods from Belarus and Russia (see Chart 4.6).[30]

In Kazakhstan, by contrast, the segmentation of export markets increases considerably by category (from commodities to processed goods to capital and durable goods). While around 40 per cent of product lines are exported to at least two major groups of trade partners, the proportion exported both within and outside the Customs Union falls to around 10 per cent. The picture is similar in volume terms.[31] This segmentation may largely reflect the scarcity of Kazakhstan's exports of capital and durable goods (with volumes over US$ 1 million accounting for only around 1 per cent of overall exports). This highlights the challenge of diversification of Kazakhstan's exports away from commodities and resource-related manufacturing products.

Overall, the breakdown of Customs Union members' exports suggests that the Common Economic Space has a potential to act as a springboard for exports, particularly for Belarus and Russia.[32] Lower-value-added and higher-value-added goods exported within the Customs Union can also be exported elsewhere, and not only to other CIS markets. Kazakhstan seems to differ in this respect, insofar as very few of its products beyond the commodity sector that are exported to Belarus or Russia are also exported outside the Customs Union.

Chart 4.6

Percentage of product lines which are exported both within and outside the Customs Union



Source: International Trade Centre and authors' calculations.
Note: Based on classification lines with recorded trade flows of at least US$ 1 million. CU is the Customs Union of Kazakhstan, Belarus and Russia.

[29] The coefficient on the interaction term between control of corruption on the exporter side and on the importer side in Column 3 is positive and statistically significant. It is also large in economic terms given that countries with strong institutions have control of corruption indices of around 2.

[30] Classification is based on the BEC (broad economic categories) – HS (harmonised commodity description and coding systems) concordance provided by the United Nations Office of Statistics.

[31] Where goods are exported to Customs Union countries, other CIS countries and the rest of the world, the volumes of respective exports largely reflect the relative sizes of the markets. One exception is Belarusian exports of durable and capital goods, where the CIS accounts for a higher share and the rest of the world for a lower share.

[32] This is also consistent with the view that regional trade integration may be most beneficial for countries with a structure of comparative advantages closest to the world average (see Venables (2003) for a discussion). Within the Eurasian Economic Community, Kazakhstan's economy has the highest degree of specialisation in natural resources (see Guriev et al., 2009).

CROSS-BORDER VALUE-ADDED CHAINS

A key benefit of regional economic integration is that it makes it easier for producers to join international supply chains.[33] This potential advantage has not been sufficiently exploited within the Eurasian Economic Community, where the structure of exports suggests that regional production chains with vertical specialisation have yet to evolve. If such chains were evident, there would be a greater share of (intermediary) goods exported within the bloc, although not necessarily to other countries, than has been the case to date (see Chart 4.7).

Another indication that regional production chains are comparatively undeveloped is the relatively low share of FDI sources from other countries within the Common Economic Space, with the exception of flows from Russia to Belarus. Belarus and Russia account for less than 5 per cent of Kazakhstan's FDI; for Russia the corresponding figure from Belarus and Kazakhstan is less than 0.5 per cent. There has been no discernible rise in the share of inward FDI coming from within the Common Economic Space following the formation of the Customs Union (see Chart 4.8).

In contrast, Russia accounts for around three-quarters of FDI into Belarus (see Chart 4.9), indicating deeper potential for integration through production chains.[34] Although Russia's contribution to Belarus's total inward FDI has fluctuated with no clear trend, the absolute value of cross-border flows has been growing rapidly. This suggests that Russian FDI has complemented, rather than crowded out, investment from other countries, such as Austria, Germany, Italy and, more recently, Latvia and Poland.[35] Also consistent with these stronger FDI links is the higher proportion of Belarusian goods that are solely exported within the Customs Union (around 30 per cent of processed and durable and capital goods in terms of numbers of product lines, although this accounts for only 2-5 per cent of the overall volume).

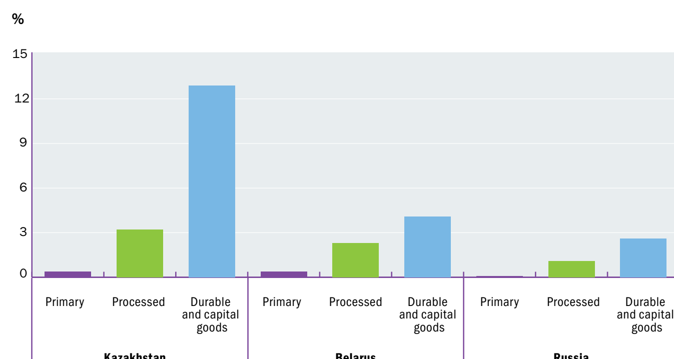
REGIONAL INTEGRATION AND ECONOMIC INSTITUTIONS

Leveraging regional economic integration to improve institutions is difficult. International evidence suggests that there is no clear trend in terms of institutional change in regional trade blocs. For example, if the quality of institutions is measured by the average of the six World Bank Governance Indicators (voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption), it has been declining, on average, in Mercosur countries and has exhibited no clear course in the Caribbean Community (CARICOM). This can be illustrated with reference to the specific indicator for regulatory quality (see Chart 4.10).

The European Union appears to be the main exception in this respect. The average quality of EU institutions has been improving, driven mainly by the convergence of the new member states towards the level of the more advanced countries. This could be attributable to the deeper institutional integration and the special role of supranational governance structures within the Union.

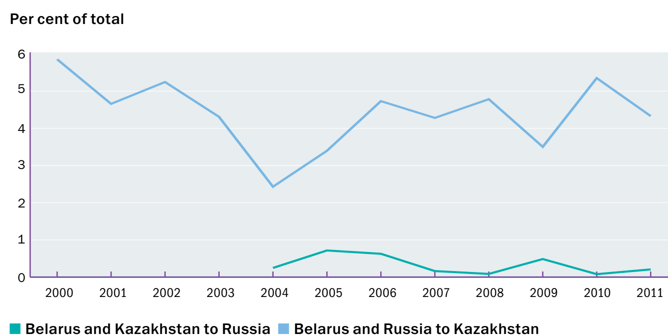
At the same time, deeper regional economic integration has typically led to some degree of convergence of institutional quality in member countries. This has occurred across a range of institutions and has been most apparent in terms of regulatory quality (see Chart 4.11). In particular, the standard deviation of the regulatory quality indicator (a measure of its dispersion across countries) has, on average, declined over time. Convergence has been most pronounced in the new, post-2004 EU member states (and similarly in parts of the Caribbean region – see Box 4.5). Some convergence was also discernible in other regional integration entities in the 1996-2010 period, although institutions tended to converge to the average, rather than best practice, level within their integration bloc. In contrast, there has been no clear convergence trend in the CIS over the last decade.

Chart 4.7
Percentage of goods exported solely within the Customs Union, by volume



Source: International Trade Centre and authors' calculations.
Note: Based on classification lines with recorded trade flows of at least US$ 1 million.

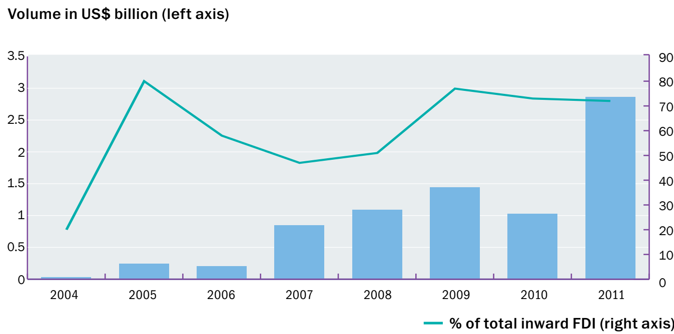
Chart 4.8
Customs Union FDI flows into Kazakhstan and Russia



Source: Central banks of Belarus, Kazakhstan and Russia and authors' calculations.
Note: Where available, data from the central bank of the destination country are used.

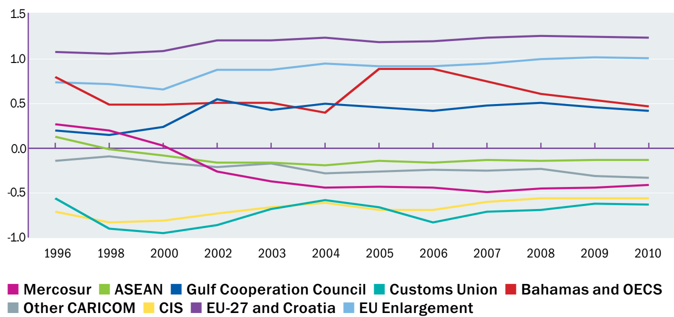
[33] See, for instance, Baldwin (2011).
[34] Based on central bank data.
[35] See Akulava (2011) for an overview of FDI in Belarus.

Chart 4.9
FDI flows from Russia to Belarus



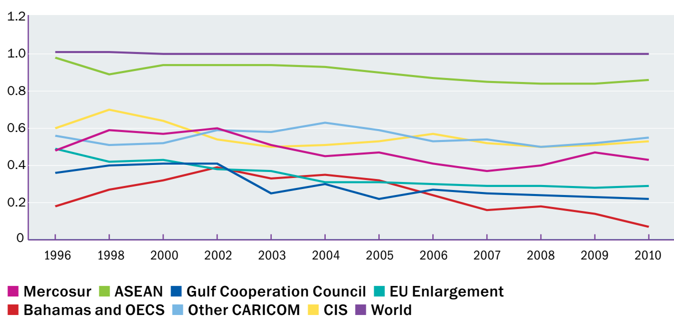
Source: Central banks of Belarus, Kazakhstan and Russia and authors' calculations.
Note: Where available, data from the central bank of the destination country are used.

Chart 4.10
Average regulatory quality indicators by regional bloc



Source: World Bank, Kaufmann et al. (2009) and authors' calculations.
Note: Higher values correspond to better institutions. Mercosur excludes Venezuela, ASEAN excludes Myanmar. OECS is Organisation of Eastern Caribbean States. EU Enlargement includes countries that acceded in 2004, Bulgaria, Romania and Croatia.

Chart 4.11
Standard deviations of regulatory quality indicator by regional bloc



Source: World Bank, Kaufmann et al. (2009) and authors' calculations.
Note: Mercosur excludes Venezuela, ASEAN excludes Myanmar. OECS is Organisation of Eastern Caribbean States. EU Enlargement includes countries that acceded in 2004, Bulgaria, Romania and Croatia.

Box 4.5
Institutional integration in CARICOM

The Caribbean Community (CARICOM) is a common market of Caribbean nations and dependencies, established by the Treaty of Chaguaramas in 1973. It has 15 full members (Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Suriname and Trinidad and Tobago). Despite vast differences between respective per capita incomes (by up to 29 times, compared with 16 in the European Union), the economies of many member countries are similarly dominated by tourism and international financial services and are relatively small. As a result, intra-regional trade remains limited, accounting for around 14 per cent of imports, and more than 80 per cent of this trade is contributed by Trinidad and Tobago, a major oil and gas producer.

Tariffs on goods originating in the common market were eliminated in the 1990s and all countries, except the Bahamas, have adopted the common external tariff and (with some exceptions) a common trade policy towards external partners. However, elimination of non-tariff barriers to trade has been slow and incomplete, including in the areas of food safety standards, technical regulations and licensing requirements in the service sectors. Labour mobility has also been subject to restrictions and remains limited.

Perhaps unusually, integration within CARICOM has arguably advanced further in institutional terms than in trade in goods and services and labour mobility. It has encompassed areas such as education, health, environment, disaster preparedness, information and communication and the control of illicit drugs. Notable successes include the Caribbean Examinations Council in secondary education and University of the West Indies at tertiary level, the Pan-Caribbean Partnership against HIV/AIDS, the Caribbean Agriculture Research and Development Institute, the Caribbean Centre for Development Administration and the Caribbean Disaster Emergency Response Agency. Such progress reflects the realisation of the need to pool scarce resources to achieve common objectives.

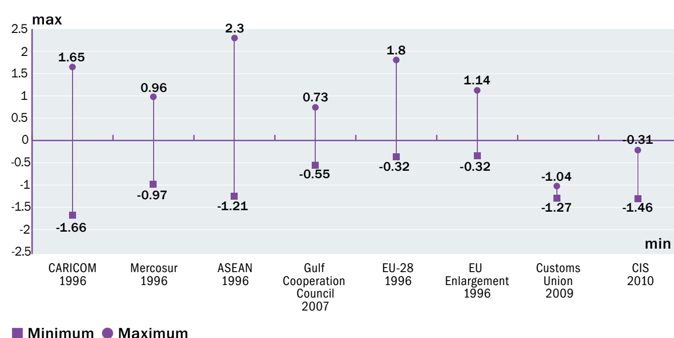
Seven members of CARICOM – Antigua and Barbuda, Dominica, Grenada, Montserrat, St Kitts and Nevis, St Lucia and St Vincent and the Grenadines – have further advanced their integration through membership of the Organisation of Eastern Caribbean States (OECS), established in 1981. Most OECS members have a common monetary authority (the Eastern Caribbean Central Bank) and share a common currency. They also share other functions such as judicial and security provision, a joint pharmaceutical procurement service, joint diplomatic missions and regulatory bodies for telecommunications and civil aviation. In 2010 OECS countries created an economic union allowing for the free movement of goods, services, labour and capital.

The scope for convergence is more limited within the Eurasian Economic Community, where there is little variation in institutional quality and no country has strong enough institutions to serve as a natural model to follow (see Chart 4.12). The challenge is therefore to leverage deeper integration with supranational governance structures in order to build collective institutions which are stronger than those in any individual member country. One opportunity to do so is to ensure good governance in newly established supranational-level structures.

Another mechanism that can help to improve institutions is a degree of competition between different jurisdictions. Within the Common Economic Space, for example, firms may choose to operate across borders and locate themselves in those environments that offer a better business climate and a lower regulatory burden. The World Bank *Doing Business* league suggests that there may be scope for such jurisdictional arbitrage, with Kazakhstan ranked 47th out of 183 countries (but 176th in the subcategory of trading across borders), Belarus 69th and Russia 120th. Within Russia, in turn, there are large regional variations in business environment quality.[36] This creates incentives for countries to improve various components of the business climate by adopting best practices from other bloc members and also from well-performing regions within countries.

Deeper integration may also prompt member countries to improve their macroeconomic policies. For example, in response to its 2011 balance-of-payments crisis, Belarus temporarily imposed price controls and multiple exchange rates, but this policy proved hard to sustain given the open border arrangement with Kazakhstan and Russia. At the same time, however, Belarus's recovery has been supported through a conditional Eurasian Development Bank assistance programme.

Chart 4.12
Range of quality of institutions in regional bloc member countries



Source: World Bank, Kaufmann et al. (2009) and authors' calculations.
Note: Average of the six World Bank Governance Indicators (voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption). Higher values correspond to better institutions. Mercosur excludes Venezuela, ASEAN excludes Myanmar. EU Enlargement includes countries that acceded in 2004, Bulgaria, Romania and Croatia. EU-28 includes all current EU members and Croatia.

CONCLUSION

Eurasian economic integration has the potential to bring multiple economic benefits through trade creation within the region, the facilitation of exports to the rest of the world and more efficient markets in goods and services. It also offers a unique opportunity to build stronger economic and political institutions.

A common tariff policy is often the first step in economic integration and early evidence suggests that this has already had some impact on trade flows. Its introduction heralded an increase in tariffs for many imports to Kazakhstan and, to a lesser extent, Belarus, which led in turn to a reduction in imports from a number of trading partners outside of the Customs Union. In the case of Kazakhstan, this was also associated to some extent with an increase in imports from within the Union in a trade diversion effect. At the same time, the common external tariff seems to have had mostly trade-creating effects for Russia, as tariff reductions have outweighed tariff increases. But the magnitude of such effects is small.

In addition to a recovery effect from the 2009 collapse in trade and (limited) changes in trade flows in the wake of the common external tariff, the recent rapid trade growth within the Common Economic Space may also reflect a reduction in non-tariff barriers, and particularly obstacles relating to customs and trade regulations. To sustain the momentum of trade creation, it will be crucial to lower non-tariff barriers further and to improve market access for firms across the region, including in the service sectors. Cross-country analysis suggests that improvements in cross-border infrastructure, especially, have a much higher potential to increase trade than tariff measures. Regional integration can provide the necessary institutional framework for coordinating such improvements.

Regional economic integration can also act as a springboard for exports. Higher-value-added goods that are initially exported within the Customs Union can subsequently be exported elsewhere. Export patterns suggest that this effect may already be at work in Belarus and Russia. In contrast, regional production chains with vertical specialisation, which can similarly help countries leverage their respective comparative advantage, are as yet less present in the region.

International evidence suggests that the differences in quality of institutions tend to diminish over time in more deeply integrated regional unions. In some cases the presence of member countries with stronger institutions can facilitate regulatory improvements in institutionally weaker economies. The members of the Eurasian Economic Community, however, are similar in terms of institutional quality and much-needed improvements cannot merely rely on the forces of convergence. Instead, member states face the challenge of creating supranational structures with better governance capacity than national institutions, which may eventually help lift the overall institutional standard in the region. Some initial steps, such as the governance structure of the Eurasian Development Bank, are encouraging in this respect.

[36] See World Bank (2012) and EBRD (2012).

References

ADB (2012)
"Implications for CAREC of the Customs Union between Russia, Belarus and Kazakhstan", Asian Development Bank Study.

K. Akamatsu (1962)
"A historical pattern of economic growth in developing countries", *Journal of Developing Economies*, Vol. 1, No. 1, pp. 3–25.

M. Akulava (2011)
"The impact of foreign direct investment on industrial economic growth in Belarus", BEROC Working Paper 011.

R. Baldwin, ed. (2009)
"The great trade collapse: causes, consequences and prospects", CEPR Voxeu.org publication.

R. Baldwin (2011)
"21st century regionalism: filling the gap between 21st century trade and 20th century trade rules", WTO Staff Working Paper ERSD-2011-08.

R. Dragneva-Lewers (2012)
"Legal regime of the Belarus-Kazakhstan-Russia Customs Union", University of Manchester, mimeo.

EBRD (2008)
Transition Report 2008: Growth in transition, Chapter 4, London.

EBRD (2010)
Transition Report 2010: Recovery and reform, Chapter 4, London.

EBRD (2012)
Diversifying Russia, Chapter 2, London.

M. Fujita (2001)
"Regional trade arrangement and strategies of multinationals: implications of AFTA for economic integration", in Satoru Okuda (ed.), *APEC in the 21st Century (Selected Issues for Deeper Economic Cooperation)*, APEC Study Center-Institute of Developing Economies.

S. Guriev, A. Plekhanov and K. Sonin (2009)
"Development based on commodity revenues", EBRD Working Paper 108.

D. Hummels and G. Schaur (2012)
"Time as a trade barrier", NBER Working Paper 17758.

A. Isakova and A. Plekhanov (2012)
"Customs Union and Kazakhstan's imports", CASE Network Studies and Analyses 442/2012.

J. Jensen, T. Rutherford and D. Tarr (2007)
"The impact of liberalizing barriers to foreign direct investment in services: the case of Russian accession to the World Trade Organization", *Review of Development Economics*, Vol. 11, No. 3, pp. 482–506.

D. Kaufmann, A. Kraay and M. Mastruzzi (2009)
"Governance matters VIII: governance indicators for 1996–2008", World Bank Policy Research Working Paper 4978.

H. Kume and G. Piani (2001)
"Mercosur: the dilemma between custom union and free trade area", IPEA Working Paper 841.

F. Laursen, ed. (2010)
Comparative Regional Integration: Europe and Beyond, Ashgate, Farnham.

J. Menon (1996)
"The degree and determinants of exchange rate pass-through: market structure, non-tariff barriers and multinational corporations", *Economic Journal*, Vol. 106, pp. 434–44.

F. Ng and A. Yeats (1999)
"Production sharing in East Asia: who does what for whom, and why?", World Bank Policy Research Working Paper 2197.

M. Olarreaga and I. Soloaga (1998)
"Endogenous tariff formation: the case of Mercosur", *World Bank Economic Review*, Vol. 12, No. 2, pp. 297-320.

J. Racine (2011)
Harnessing quality for global competitiveness in Eastern Europe and Central Asia, World Bank, Washington, DC.

M. Schiff and A. Winters (2003)
Regional Integration and Development, Oxford University Press, Oxford.

D. Tarr and N. Volchkova (2010)
"Russian trade and foreign direct investment policy at the crossroads", World Bank Policy Research Working Paper 5255.

A. Venables (2003)
"Winners and losers from regional integration agreements", *Economic Journal*, Vol. 113, pp. 747–61.

J. Viner (1950)
The customs union issue, Carnegie Endowment, New York.

World Bank (2011)
"Assessment of costs and benefits of the Customs Union for Kazakhstan", Report 65977-KZ.

World Bank (2012)
Doing Business in Russia 2012, Washington, DC.

V. Zavacka (2012)
"The bullwhip effect and the great trade collapse", Graduate Institute, mimeo, Geneva.

"...the cliché that crisis breeds opportunity seems to hold some truth particularly when it comes to the new integration efforts. This is true in the south... where they are also seeking to expand and deepen their ties to the EU. In the east, where both institutional integration and actual economic integration have also lagged, the new regional trade arrangement is reducing non-tariff trade barriers and may help its members become more competitive. In the west, the lag between financial integration and institutional integration has been threatening the sustainability of the former. A carefully executed banking union would address this tension... Together, these new efforts could give Europe, its neighbourhood and the transition region at large a better foundation from which to resume its quest for prosperity and convergence."

Erik Berglof
Chief Economist
EBRD

IN FOCUS
SELECTED IMAGES FROM AROUND THE REGION

Below: The transition region's banks have lost significant external funding (see Chapter 2).

Below: Foreign bank entry has not led to a sharp reduction in small business lending (see Chapter 3).

Below: Russia achieved an upgrade in the water and wastewater sectors (see Chapter 1).

Bottom: The SEMED region is described as being in "mid-transition" (see Chapter 1).

Below left: Regional integration can act as a springboard for exports (Chapter 4).

Bottom: Many transition countries may go into a second dip of the crisis, with uncertain prospects of recovery (Chapter 2).

Below: In the *infrastructure* category, Poland's urban transport sector attracts a 4- rating (Chapter 1).

This *Transition Report* includes, for the first time, a detailed assessment of transition progress and challenges in the four countries of the southern and eastern Mediterranean (SEMED) region: Egypt, Jordan, Morocco and Tunisia (Chapter 1).

Left: Following drought and poor corn harvest in the United States, food prices have again begun to accelerate in mid-2012, posing renewed risks to price stability in the transition region (Chapter 2).

Below: In many transition countries labour markets never fully recovered from the 2008-09 crisis. Now they are likely to face further strains in the face of eurozone developments (Chapter 2).

Right: How the region will evolve in 2013 will depend largely on the policy response, both inside the region and particularly outside (Chapter 3).

Below: Higher-value-added goods that are initially exported within the customs union can subsequently be exported elsewhere (Chapter 4).

Below: In Mongolia, which held elections in June 2012, annual unconditional cash transfers to the population, to the tune of 7 per cent of GDP, added substantially to government spending (Chapter 2).

Bottom: The majority of transition economies are exposed to financial market volatility (Chapter 2).

Bottom left: Countries further east enjoyed strong nominal export growth until mid 2012, before a dip in oil prices and the widening global slow-down led to a reversal (Chapter 2).

Bottom right: As net importers of food, all SEMED countries are vulnerable to the volatility of global prices for commodities such as grain, on which they are highly dependent (Chapter 1).

Below: The SEMED countries have significant challenges in the *energy* sector, that are most comparable to those in Central Asia and eastern Europe (Chapter 1).

Below: Trade balances have largely improved, except in the SEMED region where rising imports and weak export performance have led to widening deficits (Chapter 2).

Left: According to the transition scores, the SEMED region's level of *infrastructure* development is most comparable to that of the countries of eastern Europe and the Caucasus (Chapter 1).

Below: As Russian growth decelerated and its imports declined in the second quarter of 2012, countries in Central Asia and the EEC region experienced a drop in exports (Chapter 2).

Bottom: Despite the crisis, both remittance outflows from the eurozone and inflows to the transition region increased in the second half of 2011 and first quarter of 2012 (Chapter 2).

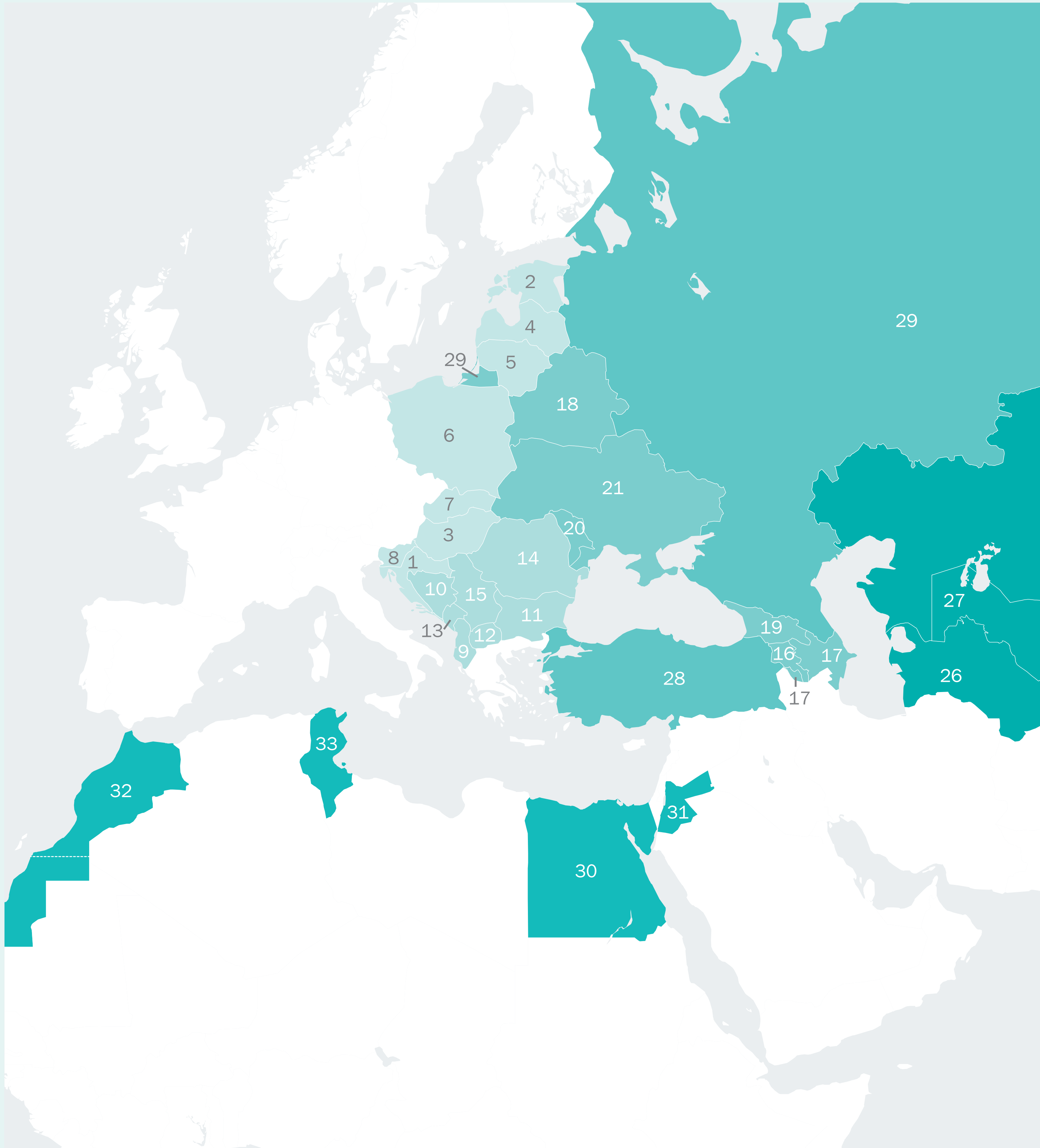
Below: Host-country supervisors may not have much information about the parent banks of subsidiaries that operate in their country (Chapter 3).

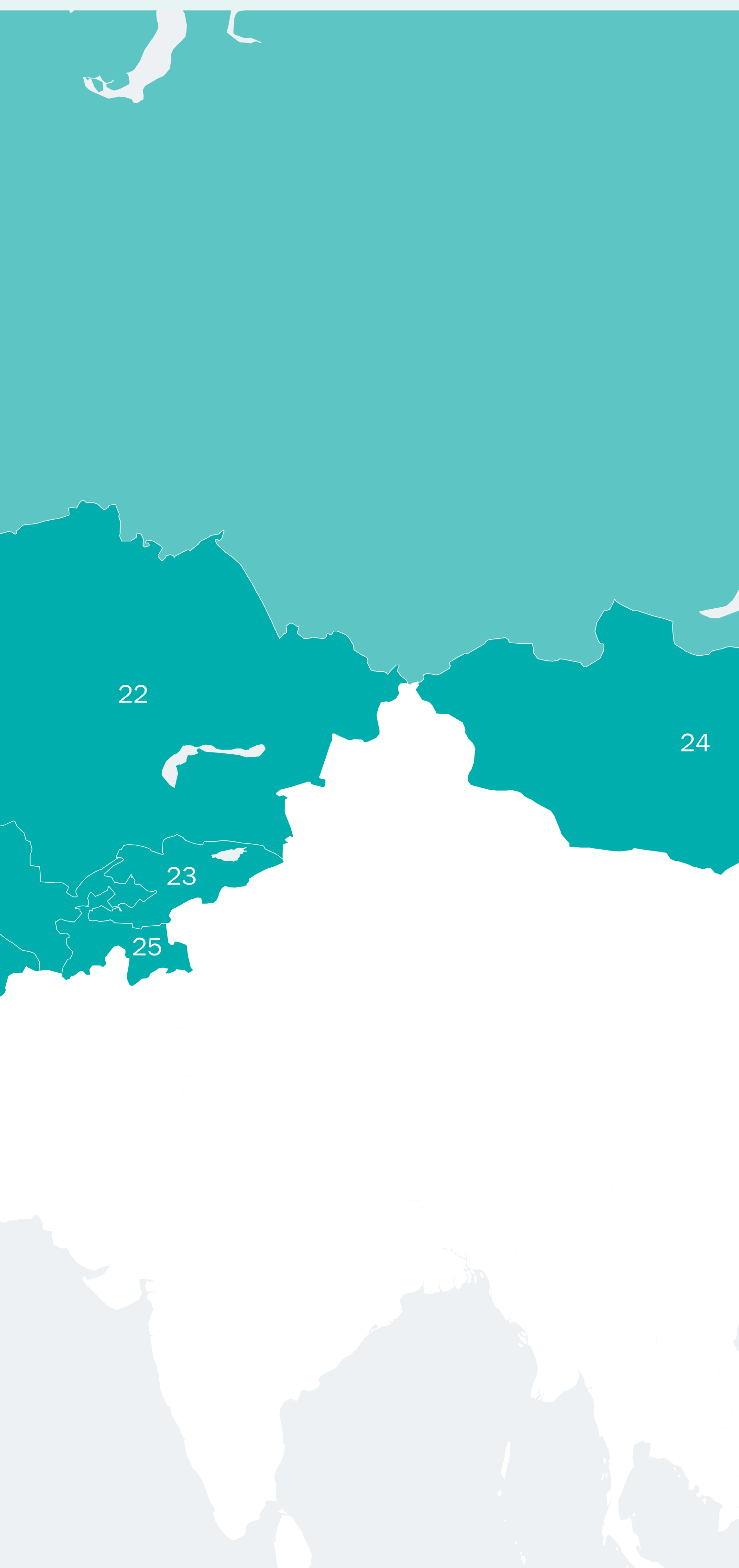
Below: The variation in credit growth in central and south-eastern European countries has been increasing steadily since the beginning of 2011 (Chapter 3).

Left: Continuing political uncertainty has weakened growth performance in the SEMED region (Chapter 2).

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-2011 to the third quarter of 2012. It also includes a brief table of key macroeconomic indicators, including forecasts for 2012. The "cut-off" date for data and other information was early October 2012. More detailed data, both historical and current, covering structural, institutional and macroeconomic developments are available at the EBRD web site, at www.ebrd.com/economics


1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
26
27
28
29
30
31
32
33



Central Europe and the Baltic states

1	**Croatia**	106
2	**Estonia**	110
3	**Hungary**	116
4	**Latvia**	124
5	**Lithuania**	126
6	**Poland**	136
7	**Slovak Republic**	144
8	**Slovenia**	146

South-eastern Europe

9	**Albania**	94
10	**Bosnia and Herzegovina**	102
11	**Bulgaria**	104
12	**FYR Macedonia**	112
13	**Montenegro**	132
14	**Romania**	138
15	**Serbia**	142

Eastern Europe and the Caucasus

16	**Armenia**	96
17	**Azerbaijan**	98
18	**Belarus**	100
19	**Georgia**	114
20	**Moldova**	128
21	**Ukraine**	156

Central Asia

22	**Kazakhstan**	120
23	**Kyrgyz Republic**	122
24	**Mongolia**	130
25	**Tajikistan**	148
26	**Turkmenistan**	154
27	**Uzbekistan**	158

28	**Turkey**	152
29	**Russia**	140

30	**Egypt**	108
31	**Jordan**	118
32	**Morocco**	134
33	**Tunisia**	150

ALBANIA

HIGHLIGHTS OF THE PAST YEAR

- **Growth was robust last year but is declining in 2012, mainly as a result of the eurozone crisis.** Economic growth exceeded 3 per cent once again in 2011, despite significant external pressures. However, various indicators in 2012 suggest a sharp slow-down in economic activity, and vulnerability to spillovers from the eurozone crisis is likely to remain present for some time.
- **Important steps have been taken to protect the banking sector.** These include measures to allow foreign bank branches to be converted into subsidiaries and new legislation to allow for the establishment of a bridge bank. So far, the banking sector has coped well with the pressures from the eurozone crisis.
- **Plans to increase hydropower capacity through private sector involvement are advancing.** The authorities have put a number of generation companies up for sale and have issued public-private partnership (PPP) tenders for new facilities.

KEY PRIORITIES FOR 2013

- **Further reforms are needed to advance in the EU approximation process.** Strengthening democracy and the rule of law are key to achieving this objective.
- **Albania should make further moves towards a sustainable energy sector.** The country has the potential to become a regional player in the renewable energy market, but this will require improved efficiency and viability of distribution and generation, a substantial increase in private sector participation in power generation, and an improved regulatory framework.
- **Continued vigilance is needed to address any fallout from the crisis in the eurozone periphery.** Albania is highly vulnerable to further escalation of the crisis due to its close trade, investment and remittance ties with the countries in the eurozone, particularly Greece and Italy.

MACROECONOMIC PERFORMANCE

The economy contracted in the first quarter of 2012. Albania was the only country in south-eastern Europe that continued to grow during the 2009 global financial crisis and beyond, with robust growth rates of over 3 per cent in 2010 and 2011. Some signs of growth deceleration emerged in the second half of 2011 in light of a weakening performance in some key EU markets, such as Greece and Italy, but it was only this year that the first contraction in output was reported in Albania. According to national statistics, GDP fell by 1.2 per cent in the first quarter of 2012 relative to the previous quarter. The unfavourable external environment is expected to persist this year, and various high-frequency macroeconomic indicators such as industrial production and retail turnover point to continued weak economic activity in the second quarter.

The inflation rate has remained moderate. In January 2012 inflation fell below the target range of 2-4 per cent. With concerns mounting over the weakening economic growth, the central bank began a series of cuts in the base interest rate this year, with the latest – in July 2012 – bringing down the interest rate to a historic low of 4 per cent. The government is targeting a deficit of 3 per cent of GDP in 2012, an ambitious target that will be difficult to achieve in light of the weaker than expected economic performance so far this year. Public debt is only just below the 60 per cent of GDP limit enshrined in the budget law.

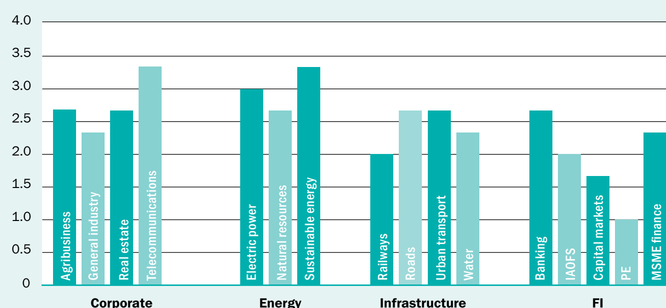
Only limited growth is expected in 2012 and 2013. Under baseline expectations of slow and uneven progress in containment of the eurozone crisis, the external environment will remain unfavourable to a recovery in economic activity following the first quarter decline. Domestic demand is also expected to remain weak, especially in light of weakening credit growth and the observed decline in remittances, which are a vital source of income for many Albanians. As a result, GDP growth in 2012 and 2013 is likely to be below the levels seen in recent years, and vulnerabilities will remain high as long as neighbouring eurozone countries stay in difficulties.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	3.3	3.5	3.1	0.6
Inflation (end-year)	3.7	3.4	1.7	3.1
Government balance/GDP	-7.4	-4.2	-3.5	-3.5
Current account balance/GDP	-14.0	-11.4	-12.3	-11.8
Net FDI (in million US$)	936	1098	989	850
External debt/GDP	32.9	33.6	33.7	na
Gross reserves/GDP	19.0	22.9	18.3	na
Credit to private sector/GDP	36.7	37.7	38.9	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The European Commission (EC) has recommended that Albania be granted EU candidate status, subject to the completion of certain key reforms, including in the judiciary and public administration. This was the main conclusion of the EC's latest Progress Report, published in October 2012, on Albania's track record in reforms. In its report, the EC welcomed the political dialogue in the country. The European Council will make a decision on this recommendation in December 2012.

Privatisation is well advanced, but some significant assets remain to be sold. Parliament approved the sale of state-owned oil producer Albpetrol in December 2011, and the government has confirmed its intention to proceed with the sale of its 100 per cent stake in the enterprise. An attempt to sell the company in 2010 failed. The government has also said it will offer a 15 per cent stake in Albania's only oil refinery ARMO as well as its remaining 16.8 per cent stake in Albtelecom, which dominates the domestic landline market.

Tariffs in the energy sector remain significantly below costs. Pricing issues have been at the core of a dispute between the private distribution company, CEZ, and the state-owned enterprise KESH, which controls nearly all production and transmission in the country. CEZ suffered significant financial losses over the past year because the energy regulator raised the prices at which electricity was sold by the generation company but maintained the final consumer tariffs, thus significantly squeezing CEZ's margins. CEZ was also unable to meet regulatory targets for reducing technical and non-technical losses. However, progress has been made in 2012 in resolving disputes among CEZ, KESH and budget entities, and CEZ has agreed to settle for a payment of approximately €40 million.

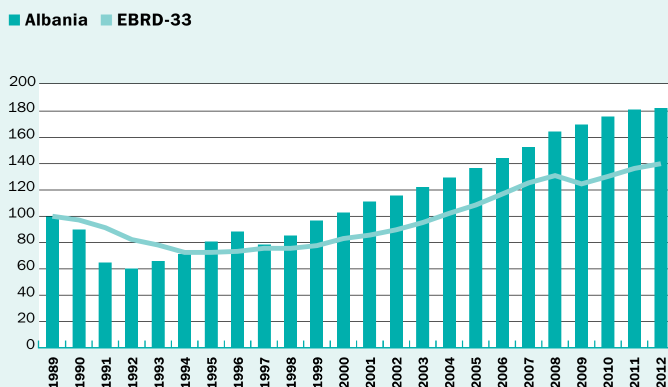
Limited progress has been made in improving the security of energy supply. The 400 kV interconnection line between Albania and Montenegro, which became operational in April 2011, has improved access to electricity imports. However, domestic electricity production remains vulnerable due to the near exclusive reliance on hydropower. In June 2012 the government announced a tender for the concession of the Fier thermal power plant. The plant has not been operational since April 2007 and requires significant rehabilitation before it can resume production.

The government is seeking to further increase its hydropower production capacity. In January 2012 it launched a tender for three hydropower BOT concessions for Vokopola 1, 2 and Gavran. Successful PPPs would enable an increase in private sector participation in the power generation sector, which remains largely controlled by the state-owned company, KESH. Privatisation of hydropower facilities is also under way; the government has tendered four hydropower plants – Bistrica 1 and 2, Ulza and Skopeti – in June this year.

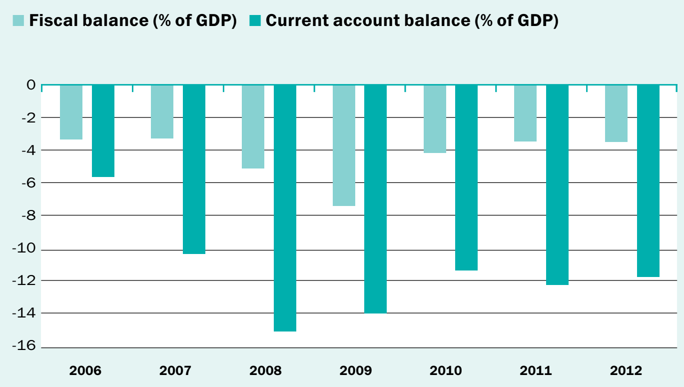
The government has continued to support improvements in the transport infrastructure. Construction is ongoing on two sections of the Tirana-Elbasan motorway. The entire road is expected to be completed by the end of 2012 and the Albanian authorities intend to introduce a toll system after its completion. The government announced a new concession for a motorway linking the port town of Durres with the country's Kosovo border. In August 2012 a new concession was also announced for the maintenance and operation of the eastern terminal of the port of Durres. The government has stated its intention to grant concessions for Albanian railways.

The government has taken important action to reduce risks in the financial sector. These moves are in response to growing concerns over the potential impact of the eurozone crisis on the Albanian banking system. Under the new regulation, which was approved by parliament in November 2011, the central bank can require that Albanian branches of foreign banks be converted into subsidiaries, subjecting them to local supervision. This will strengthen the local regulatory oversight with a view to limiting the risks of sudden liquidity outflows. In a related development, in June 2012 the Bank of Albania approved the establishment of a bridge bank, which would support domestic banks affected by the crisis. If the bank is a foreign subsidiary, the bridge bank will cover the costs of its transformation to a subsidiary. The measures were taken in light of the fact that over 90 per cent of banking assets in the country are controlled by foreign banks, of which about 30 per cent are Greek and Italian banks.

Real GDP (1989 = 100)



Fiscal balance and current account balance



ARMENIA

HIGHLIGHTS OF THE PAST YEAR

- **The authorities have continued to deregulate the economy and establish frameworks for competition and improved governance.** Reforms of business regulations, property rights and public inspections have been introduced, competition legislation was improved and a law on conflict of interest was adopted.

- **A new mining code was approved.** The new code is expected to improve the investment environment in the sector and lead to greater revenues over time, as taxation of the sector will be more closely tied to the sale of ores rather than reserves.

- **The authorities continue to implement policies to stimulate capital market development and reduce dollarisation.** The central bank continued to tighten the regulatory framework to encourage the use of local currency by obliging banks to keep required reserves in AMD. Regulations were adopted to enable issuance of foreign currency bonds by local enterprises and banks.

KEY PRIORITIES FOR 2013

- **It is critical to make a definitive breakthrough in the strengthening of the business environment.** The many recent reforms have to be implemented in letter and spirit, and the review of regulations should continue to ensure any unnecessary obstacles are eliminated.

- **More needs to be done to facilitate domestic and international trade.** Improvement of the transportation and communications infrastructure would aid development of export-oriented sectors and reduce the high implicit transaction costs.

- **The authorities should persevere with developing local capital markets.** The ambitious de-dollarisation agenda should be supported by a consistent shift of the monetary policy framework from *de facto* peg to inflation targeting. The upcoming pension reform should serve as a strategic opportunity to develop domestic markets for government securities, bank deposits and equities through an active institutional investor base providing steady demand for long-term investments.

MACROECONOMIC PERFORMANCE

The pace of recovery from the crisis has accelerated. After increasing by 4.7 per cent in 2011, output growth increased to 6.6 per cent year-on-year in the first half of 2012. Mining and manufacturing remain the main drivers of growth. The largely unreformed agricultural sector has also recovered from the slump of 2010 due to more favourable weather conditions and higher remittances. The construction sector has shown the first signs of recovery since the 2009 crisis. The authorities have continued fiscal consolidation to maintain sovereign debt at a sustainable level, under an IMF-supported programme. The economy continues to benefit from large remittance inflows and substantial official financing. Credit growth has been strong, reflecting a generally low level of financial intermediation. Since November 2011 inflation has remained within the central bank's target range of 4+/-1.5 per cent. External imbalances have been reduced although the current account deficit remains high at around 11 per cent of GDP.

Immediate economic prospects are clouded by the uncertain global environment. Maintaining output growth of around 4 per cent in 2012 and 2013 would require remittances and demand from international partners, in particular Russia, to remain buoyant, and reasonably high world prices on main commodity exports. Inflation is expected to remain in the central bank's target range. Recent depreciation of the dram should help support export competitiveness.

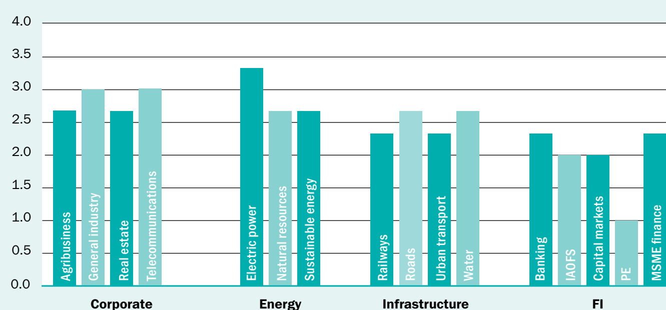
Long-term growth prospects remain uncertain. As a landlocked country with limited access to neighbouring markets, Armenia requires significant reforms of its business environment, increased competition and improved physical infrastructure. The country's relatively monopolised economy remains overly dependent on low value added commodity exports, which makes it vulnerable to negative shocks suffered by its trading partners.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-14.1	2.1	4.6	5.0
Inflation (end-year)	6.7	8.5	4.7	5.0
Government balance/GDP	-7.7	-4.9	-2.8	-3.0
Current account balance/GDP	-15.8	-14.7	-10.9	-9.0
Net FDI (in million US$)	725	562	447	500
External debt/GDP	56.4	65.6	70.7	na
Gross reserves/GDP	23.2	20.1	19.1	na
Credit to private sector/GDP	24.8	28.4	35.3	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The authorities have continued to implement various measures to improve the business environment. In addition to pursuing an action plan to improve the business environment and governance, in June 2011 the authorities embarked on a "Regulatory Guillotine." Modernisation of the tax administration is ongoing, with the support of the World Bank. The aims of this programme are to increase voluntary tax compliance, reduce tax evasion, reduce compliance costs and increase administrative efficiency. A green channel was introduced by customs at the beginning of 2012, leading to a considerable reduction in the time and complexity of customs formalities.

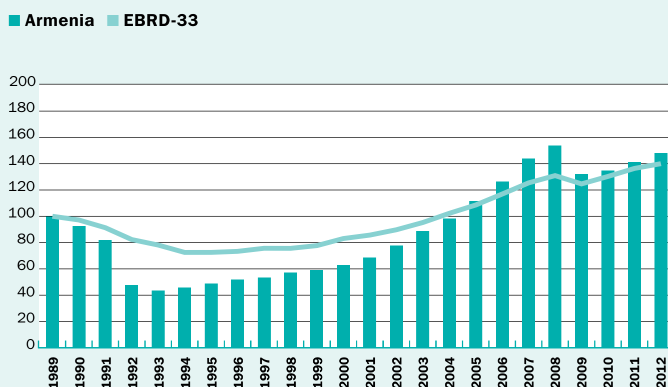
A number of positive changes in the area of competition legislation and policy have taken place. Legislative changes introduced in the course of 2011-12 included amendments and additions to the current laws (including introduction of leniency measures for participants in the anti-competitive agreements), specification of the fine amounts, reinforcement of sanction measures and specification of separate notions. In particular, anti-competitive agreements were divided into horizontal, vertical and mixed, and a qualitative indicator for dominant position in the market was introduced. In terms of enforcement, the State Commission for the Protection of Economic Competition (SCPEC) has further improved its efficiency, which is evident from the significant increase in the number of cases reviewed and decisions reached in 2011 in comparison with 2009. At the same time none of the decisions challenged in the court in 2011 were overturned. Since last year, SCPEC has also intervened in the activities of dominant fuel companies, pharmaceutical companies and medical centres.

Mining legislation has moved towards international standards. In November 2011 parliament approved amendments to the mining code. The new code, to be applied to most types of natural resources except for oil, gas, water and radioactive materials, specifies principles and rules of usage of sub-surface resources and their environmental protection. It streamlines the licensing process, therefore decreasing transaction costs for investors. The transition from exploration to production has been made more transparent and stable as the new code clearly defines the rights and obligations of mining investors and operators. The taxation of minerals was made more transparent, competitive and simpler. The new law is closer to international best practice and is expected to improve the investment environment in the sector and boost government revenues. Compared with the previous legislation, taxation of the sector will be tied more closely to the sale of ores rather than reserves.

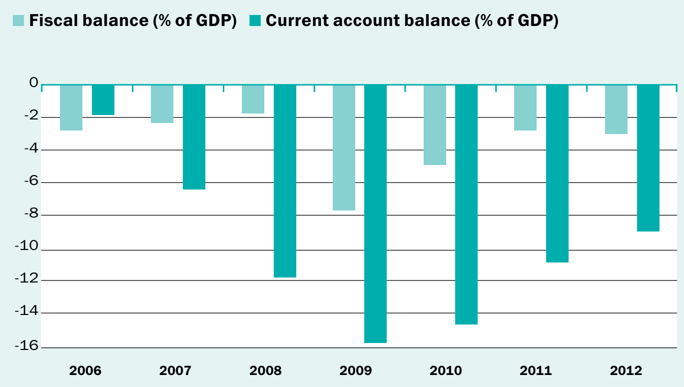
The authorities are pursuing policies to encourage exports. In December 2011 the government adopted an export-promotion strategy, targeting several sectors in which Armenia has a comparative advantage. A dedicated team was established in the Ministry of Economy with the resources and targets needed to ensure results. Free economic zones were also established to help develop the agricultural sector, high-tech industry and trade. The zone in Zvartnots airport, to operate in cooperation with Argentine Corporation America, will facilitate the export of fresh fruits and vegetables. Another zone, to be based at the Mars plant, is expected to develop industry using innovative technologies. The government also agreed to create a free economic zone with Iran for joint investments in the border region. However, the preferential tax treatments offered by these zones may pose risks to the government's tax base. In 2011-13, Armenia is expected to receive €32 million of assistance from the European Union to help prepare for the introduction of a free trade agreement with the EU and harmonisation of Armenia's laws and regulations with EU standards.

Ongoing reforms, in particular in the pension system, should support further de-dollarisation and further development of the local capital market. The Central Bank of Armenia (CBA) has continued to raise the proportion of required bank reserves that has to be kept in the dram, in order to increase banks' demand for local currency. This measure has had limited impact on deposit or loan dollarisation. In fact, foreign currency corporate loans have continued to expand both in absolute terms and as a share of the total. The EBRD launched a technical cooperation project supporting a broader IMF initiative to enhance the central bank's capacities to control inflation, as a lower inflation level and reduced volatility would help strengthen trust, and thus savings, in the local currency. The voluntary contributions into the second pillar of the pension system started in 2011 and will become mandatory in 2013. Although a large portion of the initial pension fund investments may be invested abroad because domestic financial markets are undeveloped, domestic investments are expected to increase over time and will help develop the country's debt and equity markets. In June 2012 the authorities adopted regulations allowing issuance of domestic bonds in foreign currencies. Although it may be initially utilised to place dollar-denominated bonds, the new law may help create the infrastructure needed for ultimate issuance of securities in the local currency.

Real GDP (1989 = 100)



Fiscal balance and current account balance



AZERBAIJAN

HIGHLIGHTS OF THE PAST YEAR

- **Rebalancing of the economy towards non-oil sectors has continued.** As oil output continued to contract, non-oil sectors expanded, stimulated by rising public expenditure.

- **The state-owned International Bank of Azerbaijan (IBA) was recapitalised.** Following an international audit, the government increased its stake in the bank and the central bank provided liquidity. Although the authorities hired an international adviser to support the bank's privatisation, little progress was made in this area.

- **The Shah Deniz consortium chose the Nabucco West pipeline as a potential export route to Europe.** The new pipeline, once built, will transport Caspian natural gas to Austria via Turkey, thus further diversifying export routes for Azerbaijan and import sources for the European Union.

KEY PRIORITIES FOR 2013

- **The authorities should continue to pursue policies needed to support diversification of the economy.** The business environment should be further improved to remove obstacles to private sector development. Opening the country to cross-border trade, which includes completing accession to the World Trade Organization (WTO), should open access of non-oil sectors to the international markets.

- **Competition policy should be further strengthened.** Sector regulators should be made independent and encourage greater competition (especially in telecommunications, transport and the financial sector) and stimulate the entry of foreign strategic investors. Redress procedures in the cases involving anti-competitive practices should be further clarified.

- **The financial sector requires significant reform.** The recent decision to recapitalise the state-owned IBA highlights the need to reduce its role in the banking system and ultimately privatise the bank in a transparent manner with a view to strengthening competition in the sector and reducing its quasi-fiscal activities.

MACROECONOMIC PERFORMANCE

The non-oil economy continued to expand as oil output contracted further. The 10 per cent contraction of the oil sector in 2011 was almost fully offset by the rapid increase of the non-oil sectors, in particular construction and services, mainly stimulated by rising budget expenditures. Real GDP grew by 1.3 per cent year-on-year in the first eight months of 2012, again led by the non-oil sectors. Growth of consumer prices decelerated to -0.2 per cent in August 2012 after peaking at 9.7 per cent in May 2011, with the decline largely due to favourable base effects and lower international food prices. The policy of maintaining a stable exchange rate of the manat against the US dollar has complicated the central bank's ability to maintain price stability. External debt remains low, and the public sector balance sheet is supported by a large oil fund. However, the non-oil fiscal deficit remains very large in light of the finite oil production, raising concerns about the long-term sustainability of the government's fiscal policy. Nevertheless, exports of oil and gas will likely ensure that the current account remains in surplus and the exchange rate remains stable.

Economic growth is expected to remain subdued as energy output stabilises and non-oil sectors reached capacity. As gas fields operate at full capacity and reviving oil output requires investment and time, hydrocarbon production should stay below the pre-crisis levels in 2012-13. Non-oil output growth is expected to reach around 8 per cent, for an overall rate of growth of 3.5 per cent in 2012. If the authorities avoid further fiscal expansion and non-oil sector capacity constraints are not binding, inflation should remain moderate but volatile as long as the central bank is unable to effectively utilise interest rate tools. Export of oil and gas will continue to account for around one half of GDP and ensure a current account surplus and a stable exchange rate.

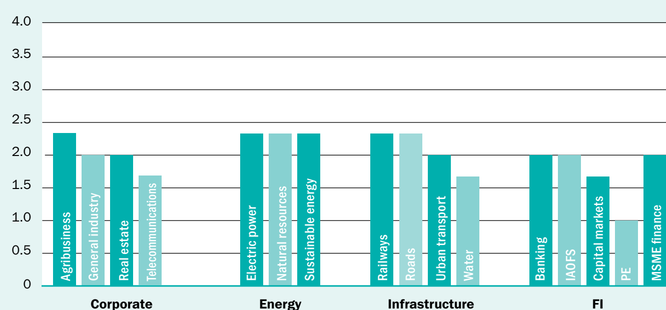
Risks stem mainly from a possible decrease in the oil price or extended disruption of oil export flows and their knock-on effects. In particular, risks are generated by real estate prices, a fall in which would affect the collateral value and portfolio quality of banks, undermining their lending capacity and hence growth in the non-oil sector. Further risks to forecasted growth derive from uncertainty regarding oil and gas production and potential political and external instability. Also, increasing global risks and the looming prospect of medium-term economic growth can affect oil and gas prices through decreasing global demand for hydrocarbons. This in turn will have a negative effect on the oil sector in Azerbaijan, making economic growth even weaker.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	9.3	5.0	0.1	2.0
Inflation (end-year)	0.7	7.8	6.6	1.9
Government balance/GDP	6.6	14.0	11.3	9.0
Current account balance/GDP	23.0	28.4	26.5	25.0
Net FDI (in million US$)	147	113	913	-300
External debt/GDP	20.8	21.3	17.8	na
Gross reserves/GDP	11.7	12.1	16.2	na
Credit to private sector/GDP	19.1	17.9	17.6	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Although the authorities continue to improve the business environment, corruption remains a serious problem. Azerbaijan's ease of doing business score in the 2012 World Bank's *Doing Business* Report improved last year by three places to 66th, as the authorities lowered some tax rates and simplified the process of paying corporate income tax and value added tax. Azerbaijan ranked 46th in the global competitiveness ranking released by the World Economic Forum in September 2012, climbing up by nine places. Access to credit was aided by an online platform allowing financial institutions to provide information to, and retrieve it from, the public credit registry. The new customs code, which came into effect in January 2012, includes strengthened provisions in various areas that are expected to bring regulations into line with international standards (including verification of the country of origin, valuation methods, single-window principle in customs administration, customs audit and electronic submission of information on goods to the customs authorities).

The dominant state bank was recapitalised, but its long-term future is yet to be decided. Following an audit, in February 2012 the government injected new capital into the majority state-owned International Bank of Azerbaijan and the central bank provided liquidity. The recapitalisation increased the share of the state in the bank to 50.2 per cent, thus raising concerns about the authorities' commitment to its privatisation. An international consortium of companies has been advising the state property fund on IBA's privatisation since mid-2011, although little actual progress has been made so far to begin implementing the privatisation. The authorities have made a decision on an export route to the European hydrocarbon markets. In June 2012 the Shah Deniz consortium chose the Nabucco West pipeline as a potential export route to Europe. This is a shorter version of the Nabucco pipeline and it will connect the Shah Deniz field to Austria. Also, Azerbaijan signed an inter-governmental agreement with Turkey on the construction of the TANAP pipeline, which is expected to start at the end of 2013 and will carry gas to Europe and Turkey. The new route should diversify Azerbaijan's export routes to the international markets and Europe's access to energy imports.

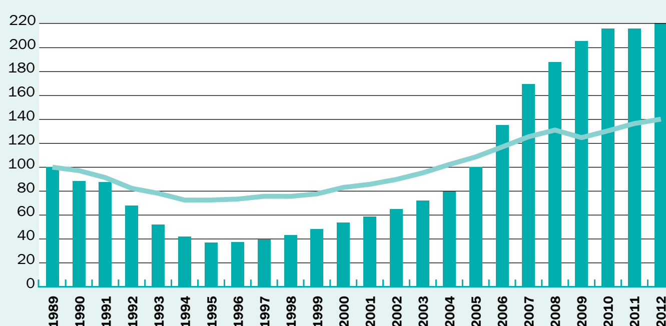
Large infrastructure projects to increase trade and capitalise on the country's strategic location are continuing. In March 2012 the government announced a tender for construction works and supply of goods and services for a new international sea port, to be located 65 km south of Baku. Construction of the port, the largest in the Caspian region, is expected to cost around US$ 1 billion. The first of the port's three stages is expected to begin to function in 2014. If successfully completed and run commercially, the port should help strengthen the country's role as a trade link between Europe and Asia.

The National Bank of Azerbaijan (NBA) continues to strengthen the regulatory framework and build capacity for inflation targeting. In July 2012 the NBA increased the threshold of aggregate capital of operational banks, as well as authorised capital for newly established banks to AZN 50 million. The new norm on the minimum capital requirement is to take effect from January 2014. Once implemented, the new norms should help strengthen the capital position of Azerbaijani banks. The central bank has also continued developing analytical skills and capacity to pursue the policy of inflation targeting over time, although it has continued to target the exchange rate as a nominal anchor. The capital market is expected to be affected by recent changes of the insurance legislation. The law "on compulsory insurance" regulating the principles and basis for mandatory insurance came into force in September 2011. In November 2011 the authorities established a Compulsory Insurance Bureau with the purpose of stabilisation and development of the system of compulsory insurance and fulfilment of duties prescribed by the law. These reforms are expected to increase the size of the insurance market and, over time, increase the stock of assets in the local capital market.

Negotiations continue on WTO accession.
In February 2012 at the ninth meeting of the working party on the accession of Azerbaijan, members reviewed Azerbaijan's trade-related reforms, examined legislative developments and evaluated the progress made in the bilateral negotiations on market access for goods and services. Azerbaijan is currently negotiating with 10 members and the next meeting of the working group is scheduled for late-November 2012. The progress in negotiations should pave the way for reforms in tariff policy and trade liberalisation.

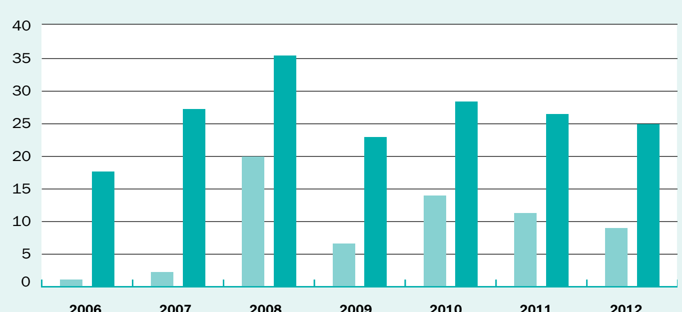
Real GDP (1989 = 100)

■ Azerbaijan ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



BELARUS

HIGHLIGHTS OF THE PAST YEAR

- **The economy moved towards stabilisation after a deep balance-of-payments crisis.** Following a large exchange rate devaluation, the authorities pursued tighter monetary and fiscal policies and trimmed the large directed lending programme.

- **Ambitious privatisation plans were abandoned.** The authorities decided to scrap the privatisation lists and instead pursue negotiation of privatisation agreements on a deal-by-deal basis, so far primarily with Russian state enterprises.

- **The authorities continued implementing some deregulation reforms.** Several measures to simplify access to land, lending to SMEs and reduce red tape were approved.

KEY PRIORITIES FOR 2013

- **Establishing a credible policy framework for macroeconomic policy is a key priority.** Output and dollar wage targets should be made consistent with the goal of price and external stability, while the central bank should target low inflation and a wage policy consistent with productivity growth.

- **The authorities should utilise improved terms of trade due to lower energy prices to pursue private sector development.** Public enterprises should be further commercialised, and their role in providing safety nets to employees reduced. Transparent privatisation, aimed at attracting strategic investors, should help modernise the country's industrial base and release some of the labour force into new industries. Directed lending should be reduced and made more transparent.

- **The authorities should improve the sustainability of municipal infrastructure and increase incentives for greater energy effficiency.** Improving municipal infrastructure requires greater commercialisation, based on economically justified user charges and cost recovery principles, while incentives for improving energy efficiency need to be strengthened through market pricing of energy and the establishment of a clear framework for renewable energy.

MACROECONOMIC PERFORMANCE

Belarus has undergone macroeconomic adjustment following a policy-induced balance-of-payments crisis. After generating very large external imbalances during and after the presidential election campaign in late 2010 and introducing various administrative measures in the spring-summer of 2011 to delay adjustment, the authorities devalued the rouble. After peaking at 108.9 per cent year-on-year in January 2012, inflation decelerated to 38.8 per cent in September. Investment activity decelerated as directed lending programmes were curtailed, negatively affecting the construction sector. However, as real wages declined, households switched from imported to domestically produced products and exports increased. As a result, overall output growth has remained positive, at 2.9 per cent in the first half of 2012, with industry being the largest contributor.

However, stabilisation gains may be reversed by the renewed pressure to increase wages and lending. The government is pursuing a high rate of GDP growth, which may require relaxation of the directed lending limits and once again engaging the central bank in providing soft loans. The national bank has been reducing policy interest rates steadily, which is still above the annualised rate of monthly inflation. In June 2012 President Lukashenko ordered a large increase in public sector wages on 1 August and 1 October to bring the average monthly wage to an equivalent of US$ 500 from around US$ 360 in May 2012. There is a high risk that these policies may lead to another bout of macroeconomic instability.

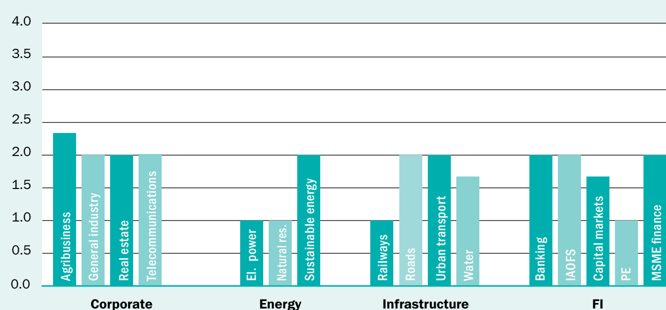
Longer term prospects depend to a large extent on the authorities' ability to pursue structural reforms. In the short run, the economy will continue to benefit from the improved terms of trade as energy prices paid to Russia remain significantly below the international levels. However, as most of the economy is state-owned, and enterprises' operations are not based on commercial principles, it is unlikely that the existing economic model would be able to generate productivity increases consistent with the authorities' real income targets. The government's ability to stimulate domestic consumption and investment is constrained by the rising public debt level and limited external reserves. Therefore, growth prospects continue to hinge on implementation of policies that would rebalance the economy towards new, commercially-operating activities and reforms that are needed to stimulate labour migration to the new sectors. Macroeconomic risks also stem from the economy's low energy efficiency and dependence on energy imports and uncertainty about the quality of assets in the state-dominated banking system.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	0.2	7.7	5.3	5.5
Inflation (end-year)	10.1	10.0	107.8	25.0
Government balance/GDP	-0.4	-1.8	3.3	0.0
Current account balance/GDP	-12.6	-15.0	-10.5	-3.0
Net FDI (in million US$)	1782	1352	3928	2000
External debt/GDP	45.6	52.1	62.5	na
Gross reserves/GDP	11.5	9.1	14.4	na
Credit to private sector/GDP	37.2	44.8	45.8	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The government reversed some, but not all, administrative measures implemented during the crisis. Many price controls introduced and expanded in the last year remain, and goods subject to controls now cover around 40 per cent of the consumer basket. Restrictions on exports of consumer goods by individuals, introduced as a response to the balance-of-payments crisis, were eliminated in February 2012. The export limits had been applied to goods and commodities with regulated prices, including cereals, pasta, cigarettes and domestic appliances. Although fuel prices were brought closer to their level within the Eurasian customs union, restrictions on fuel exports remain in place.

The privatisation process suffered from delays. In May 2012 the government decided to abandon the practice of issuing lists of enterprises designated for privatisation. Instead, it announced that future privatisations are to take place on an *ad hoc* basis. The agency for privatisation and investment, in operation since June 2011, is yet to sell any of its eight enterprises. On a trial basis, a minority stake in the Minsk factory of sparkling wines was made available for purchase by individuals via the local stock exchange, via a "people's IPO". Plans were also announced in July 2012 for the creation of a joint venture between Russia's KamAZ and Belarus' MAZ truck manufacturers.

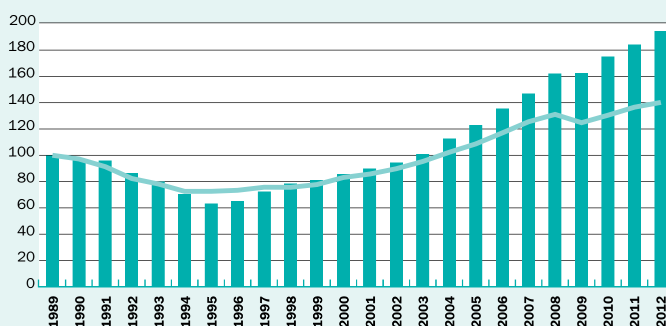
The authorities made further steps to reduce the regulatory burden on new companies. Over the past year, the government implemented numerous legislation acts to implement the presidential Directive No. 4, approved in December 2010. Access to land for certain business purposes was streamlined and may now be granted without the need for an auction. Legislative reforms are expected to increase access to credit by small and medium enterprises. Since the middle of 2011 the President has signed several decrees to stimulate entrepreneurial activity in the regions.

Commercialisation of the financial sector is progressing slowly. The large state banks continue to dominate the banking system. In January 2012 the government recapitalised the state-owned Belarusbank and Belagroprombank with 14.5 trillion roubles (US$ 1.7 billion, about 3 per cent of GDP) in bonds. The recapitalisation should cover some of the decline in capital ratios after the devaluation, as well as protecting against potential deterioration of the loan portfolio. The development bank, established in June 2011 to improve the targeting of directed lending and increase its transparency, is yet to become fully operational. In January 2012 the government announced a strategy to encourage FDI, which envisions *inter alia* the sale of the remaining stakes in the VTB Bank Belarus, controlling stakes in Belinvestbank and Paritetbank and minority stakes in Belarusbank and Belagroprombank.

The country's integration with Kazakhstan and Russia has brought benefits, but also market pressures. The customs union became fully operational in July 2010. Since then, the country has enjoyed an improvement in terms of trade after Russia eliminated export duties on oil and oil products exported to Belarus and reduced the natural gas price. Access of Belarusian products to the Russian and Kazakh markets was also simplified. At the same time, various manufacturing enterprises have suffered from the lowering of the effective rate of protection of their output in Belarus. The pressures are expected to rise as Russia further opens its market and the common external tariff is reduced to comply with Russia's commitments under its recent WTO accession. There is also evidence that labour is migrating from Belarus to Russia to benefit from higher wages and a more competitive market environment.

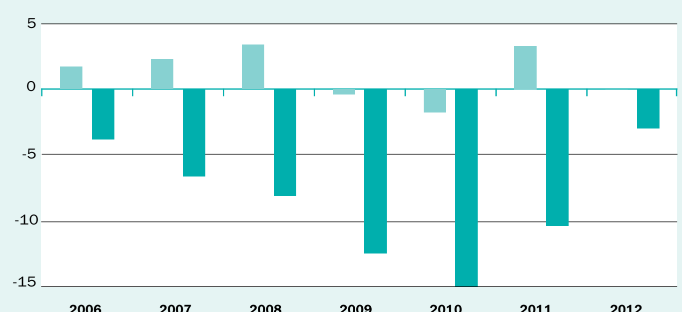
Real GDP (1989 = 100)

■ Belarus ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



BOSNIA AND HERZEGOVINA

HIGHLIGHTS OF THE PAST YEAR

- **Economic growth has been weak but some progress has been made on policies.** Only minimal growth has been recorded over the past year. Following the finalisation of the state and entity budgets, progress was made towards re-engaging with the IMF, culminating in the signing of a new programme.

- **Private sector involvement in the road sector is advancing.** A tender for a public-private partnership (PPP) in the transport sector based on best international practice has been announced for a concession of a section of a key international transport corridor in Republika Srpska.

- **Non-performing loans (NPLs) are rising in the banking sector, but liquidity remains sound.** The level of NPLs still remains below that of some regional peers and the direct impact of the international financial crisis on the local banking sector has been limited so far.

KEY PRIORITIES FOR 2013

- **Further progress is needed on EU approximation.** Bosnia and Herzegovina is the only SEE country that has not yet submitted an application for EU membership. Key priorities include political reforms, boosting competitiveness, reforming the social benefits system and improving the country's infrastructure.

- **Some basic investment climate reforms should be introduced.** The country's persistently low scores on many cross-country indicators suggest there is a lack of consensus on the need for deep economic reforms, as well as plenty of scope for improvements in areas such as licences and permits, and enforcement of contracts.

- **Major reforms are needed in the energy sector.** Bosnia and Herzegovina has significant potential in renewables, but the legal and institutional framework for sustainable energy remains weak.

MACROECONOMIC PERFORMANCE

Weak domestic demand, an unfavourable external environment and political stalemate have held back economic recovery. Following a year of anaemic growth in 2010, the economy showed some signs of revival in early 2011. However, weaker growth in the eurozone has negatively affected Bosnia and Herzegovina's exporting activity and capital inflows in the second half of the year and the beginning of 2012. Exports fell by 8.6 per cent between Q2 and Q4 of 2011. At the same time, domestic consumption has remained subdued, largely owing to the austerity measures implemented by the authorities in the past two years as well as the weakened contribution from remittances, which are significantly below pre-crisis levels. As a result, overall growth in 2011 was a modest 1.3 per cent. Inflation remains low. The disinflationary pressures that dominated much of the post-crisis period were reversed for a brief interval in early 2012, but inflation has been on a generally downward path since, and it stood at 1.8 per cent in August 2012.

A new Stand-By Arrangement (SBA) with the IMF was approved in September 2012. The 24-month US$ 520.6 million SBA will provide a buffer against external shocks from the ongoing eurozone crisis as well as an anchor for important structural reforms envisioned in the country's 2012-14 economic programme. The new arrangement follows the expiration of a 36-month SBA, which was put on hold in 2011 due to the political stalemate that left the country without a central government for over 15 months after the October 2010 elections. The authorities are planning a budget deficit of 3 per cent of projected GDP in 2012. The economic programme envisages continued fiscal consolidation accompanied by structural fiscal reforms to safeguard medium-term fiscal sustainability.

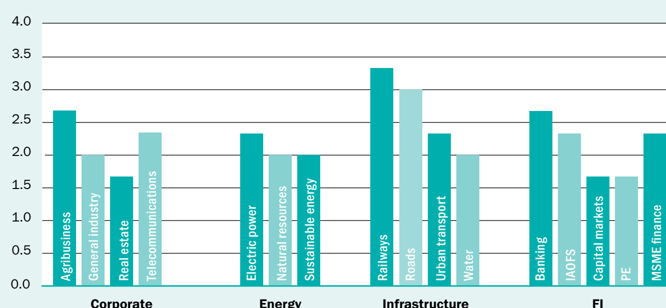
The economic outlook for 2012 and 2013 remains bleak. The weak external and domestic environment will constrain growth in Bosnia and Herzegovina this year and beyond. GDP growth is forecast at close to zero per cent in 2012 and only slightly higher in 2013. The economy remains vulnerable on many fronts, not only because the whole region is struggling but also because the internal complexity of the country's political structure and the poor investment climate are major deterrents to investment.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-2.9	0.7	1.3	0.1
Inflation (end-year)	0.0	3.1	2.7	1.7
Government balance/GDP	-5.9	-3.9	-3.1	-2.8
Current account balance/GDP	-6.3	-5.7	-8.8	-8.0
Net FDI (in million US$)	245	188	416	253
External debt/GDP	55.8	52.3	46.5	na
Gross reserves/GDP	19.0	20.5	19.9	na
Credit to private sector/GDP	54.4	63.8	55.1	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Limited progress has been made on EU approximation over the past year. In its annual Progress Report published in October 2012, the European Commission (EC) once again urged the country to make greater headway on economic and structural reforms. It highlighted the need for reforms to boost the productive capacity and competitiveness of the economy, including labour market reforms, and to improve the business environment and upgrade the country's infrastructure. The EC also emphasised the need for reforms in the social benefits system – particularly the high and poorly targeted social transfers – to boost job creation and reduce the high unemployment rate. Bosnia and Herzegovina is the only SEE country that has not yet submitted an application for EU membership. In June 2012 the European Union and the Bosnian authorities launched a High Level Dialogue on the Accession Process. However, the results so far have been uneven.

Business environment indicators remain poor. In the 2012 World Bank *Doing Business* Report, Bosnia and Herzegovina's ranking rose by two places compared with the previous year, mainly due to improvements in the ease of obtaining construction permits. However, at 125th place, Bosnia and Herzegovina remains the lowest ranked SEE country with respect to the overall ease of doing business and it has the second lowest ranking in the entire EBRD region of operations after Uzbekistan. The country continues to perform particularly poorly on construction permits, starting a business, obtaining electricity connections and enforcing contracts.

Some progress is occurring in promoting private sector involvement in transport. In August 2012 the government in Republika Srpska announced an open, competitive tender, based on best international practice, for the concession to the private sector for the design, construction and long-term maintenance of the Doboj-Vukosavlje motorway, a part of the trans-national transport corridor Vc. If successful, this would be the first PPP in the transport sector in Bosnia and Herzegovina.

An agreement was signed for the construction of a new thermal power plant. According to the terms of the agreement, the 300MW Stanari thermal power plant will be built by UK-based EFT Group with financing from the Chinese state development bank, and the project will also entail the expansion of the neighbouring EFT-owned Stanari Coal Mine. The benefits of the project, if fully implemented, are twofold. It will provide a welcome increase in domestic power generation capacity and it will increase private sector participation in the energy sector, which is currently very limited.

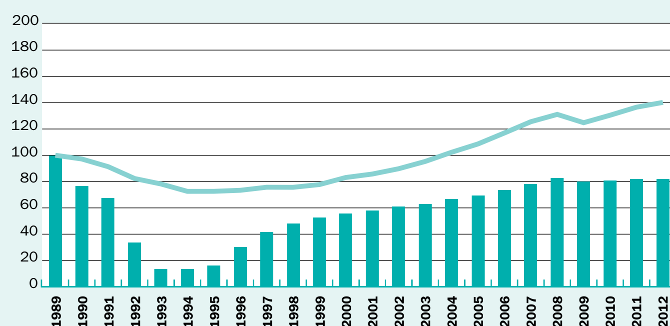
The quality of, and access to, broadband services are improving. The market for broadband internet and cable TV services in Bosnia and Herzegovina is nascent and dominated by the three incumbent telecommunications operators which operate within the boundaries of their respective entities. The rest of the market, including cable TV operators which offer broadband services, is highly fragmented and cannot effectively compete against the incumbents. Moreover, access to high-speed broadband is limited outside of the largest cities. Financial support is currently being provided for consolidation of small cable TV operators in the regions so as to allow for wider access to better quality internet and telephony services at more affordable prices. The consolidation in the sector will enable certain service providers to operate across the two entities, which is a rare case in the country today.

Micro and small enterprises (MSEs) are gaining access to more finance and a wider range of financial services. The key providers of finance for MSEs are non-profit microfinance institutions (MFIs), set up as NGOs and focusing on a narrow range of services while benefiting from favourable tax treatment. Since 2008 the microfinance sector has been in decline with gross loans from MFIs falling from €570 million at end-2008 to only €345 million at end-2011. With support from international financial institutions, the sector is being transformed into a commercially sustainable model, fully integrated with the rest of the financial sector, which will give MSEs better access to financial services and should improve transparency and corporate governance in the microfinance sector.

The banking sector in Bosnia and Herzegovina remains liquid and well-capitalised, but the level of NPLs is rising. Out of the 29 banks that operate across the two entities, 19 are foreign owned. More importantly, the foreign banks accounted for 92.1 per cent of total assets as of the end of 2011. The banking sector was not subject to the large credit outflows to parent banks, and the system remains fairly liquid. However, NPLs have been increasing substantially. In mid-2012 they stood at 12.6 per cent of total loans, compared with 7.1 per cent in 2010 and 5.9 per cent in 2009. Bosnia and Herzegovina has been a participant in the Vienna Initiative since 2009.

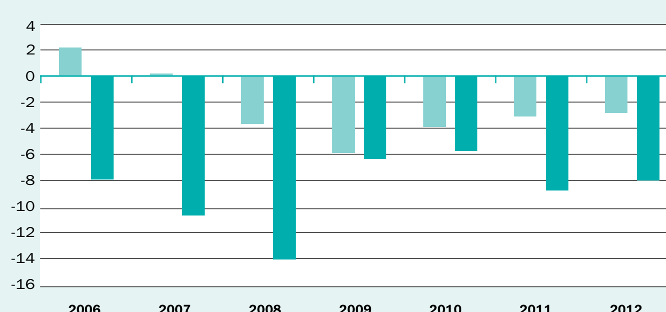
Real GDP (1989 = 100)

■ Bosnia and Herzegovina ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



BULGARIA

HIGHLIGHTS OF THE PAST YEAR

- **Growth remains limited but fiscal discipline has been strong.** As a result of its strong fiscal performance, Bulgaria was removed from the European Commission's excessive deficit procedure, but economic growth remains low in a difficult global environment.

- **The energy sector has seen mixed reform signals.** The government has responded to outside pressures by stepping up efforts to liberalise the electricity market, but revisions to the access charges for renewable generation may deter investment in the sector.

- **Banking sector stability has been maintained notwithstanding the relatively high share of Greek banks.** This has been achieved largely through strong local supervision.

KEY PRIORITIES FOR 2013

- **Private sector involvement can be further enhanced in infrastructure.** The remaining enterprises to be partly or fully privatised include some energy generation companies and all of the transmission system, transport operators and other municipal utilities, as well as bridges, ports and airports. There is room for further private sector participation in some large-scale construction projects in the transport and energy sectors.

- **Developing a financially strong and well-regulated municipal sector is a key priority.** The necessary steps include reducing the reliance on centrally-managed EU grants, strengthening municipalities' ability to meet contractual obligations and to attract commercial financing, and boosting their capacity to absorb EU funds.

- **Efforts to restructure companies' balance sheets and shift to more productive, export-oriented activities should be stepped up.** The government can also help by encouraging enterprises to improve the efficiency of energy usage.

MACROECONOMIC PERFORMANCE

The economic recovery is slowing down but the impact from the eurozone crisis has been managed relatively well. After virtually zero growth in 2010, the Bulgarian economy was recovering in the first half of 2011. However, in late 2011 and the first half of 2012, the recovery momentum began to slow down, as evidenced by several macroeconomic indicators. GDP grew by less than 1 per cent in the first two quarters of 2012. Export growth, which drove the recovery after the 2009 recession, has been weak or negative and, with consumer confidence feeble and credit growth limited, domestic demand remains subdued. There has also been a significant decline with regard to inflows of FDI. In 2008 FDI inflows accounted for about 19 per cent of GDP and in 2011 they fell to less than 3 per cent of GDP. Inflation remained below 2 per cent throughout the first half of 2012, but jumped to 2.4 per cent year-on-year in July on the back of a hike in electricity prices. Despite the slow-down, Bulgaria has been coping well with the crisis in the eurozone and is forecast to have the strongest GDP growth rate this year in the SEE region.

The government has maintained a prudent fiscal policy. The authorities tightened fiscal policy in 2011 and the general government deficit was kept below the targeted 2.5 per cent of GDP and firmly within the limit of 3 per cent as set by the European Union's stability and growth pact. As part of the reform package, an increase in the retirement age – for men from 63 to 65 and for women from 60 to 63 – became effective on 1 January 2012. In light of Bulgaria's recent strong fiscal performance and demonstrated history of fiscal prudence, the Council of the European Union decided in June 2012 to close its excessive deficit procedure for Bulgaria. The country also had a successful return to international debt markets in July 2012. In the first euro-denominated issue since 2002, Bulgaria sold €950 million of five-year Eurobonds at a yield of 4.25 per cent, which was viewed as highly favourable under existing market conditions. Continued fiscal consolidation is planned this year with the deficit targeted at 1.35 per cent of GDP. The authorities remain committed to the currency board but the government has recently indicated that entry into the ERM-II mechanism is not envisaged in the near future.

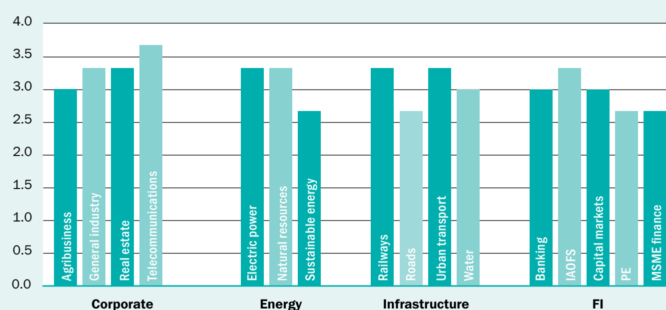
Weak growth is expected in the short term. Problems in the eurozone will continue to impact the economy in Bulgaria because of the close trade and investment links. Growth in 2012 is forecast to be a little above 1 per cent and only a mild recovery is expected in 2013. However, the economy's medium-term growth potential remains good; GDP per capita (adjusted for purchasing power standards) is estimated by Eurostat to be less than half the EU average, therefore implying considerable scope for catch-up growth in the future.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-5.5	0.4	1.7	1.2
Inflation (end-year)	1.6	4.4	2.0	4.5
Government balance/GDP	-0.9	-3.9	-2.0	-1.1
Current account balance/GDP	-8.9	-1.0	0.9	-0.3
Net FDI (in million US$)	3479	1374	1676	1378
External debt/GDP	113.5	102.4	87.1	na
Gross reserves/GDP	35.4	35.0	31.5	na
Credit to private sector/GDP	75.5	74.1	72.0	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Bulgaria continues to make progress in judicial reform and in fighting corruption and organised crime, but some concerns remain. In its annual report under the Cooperation and Verification Mechanism, published in July 2012, the European Commission (EC) noted that Bulgaria had come a long way since accession to the European Union in 2007. The report highlighted some recent reforms, including the establishment of an independent judicial inspectorate and specialised structures to pursue organised crime, and the improvement in asset forfeiture legislation. However, the report also noted the lack of direction in policy and the fact that questions remain about the direction of reform in these areas. The next assessment will be made at the end of 2013, but the EC will continue to monitor progress closely in the meantime.

Absorption of EU funds has accelerated in the past year. By the end of 2011 total financing paid by the European Union under the Structural and Cohesion Funds programme had reached nearly €1.26 billion (out of a total allocation for the period 2007-13 of €6.67 billion), compared with just €681 million a year earlier. By June 2012 absorption had risen further to €1.59 billion. The sharp rise reflects a concentrated effort by the authorities to implement projects, as well as enhanced support from several international financial institutions.

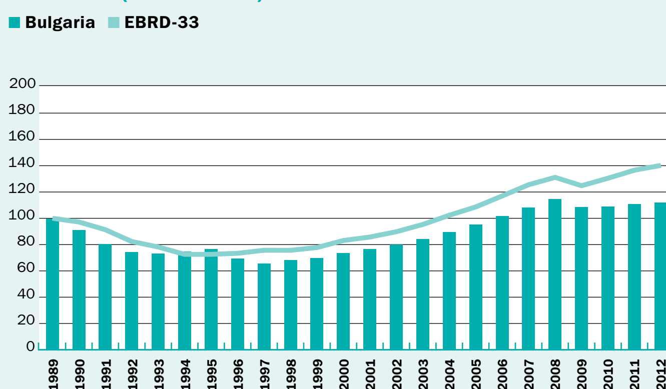
Productivity in agriculture has risen significantly. The progress has been particularly marked with regard to grain yields, which have increased substantially in recent years. Although the food industry overall is rather fragmented, the retail market is well organised in major cities with a number of large players present, and penetration in rural areas is increasing.

Changes to the energy law may boost competition, but concerns persist over delays in liberalisation and unexpected government intervention in the renewables market. In July 2012 parliament adopted a number of amendments to the energy law that are designed to boost competition in the market. Consumers should now be able to shop for an electricity provider, thereby giving an incentive to suppliers to compete for customers and increasing competition. However, these efforts come at a time of ongoing infringement proceedings. Recent cases have related to delays in implementing liberalisation measures and the continued use of regulated prices. In addition, concerns have been raised in recent months over the regulator's recent introduction of grid access fees for renewable generation, which has negatively affected the investment climate.

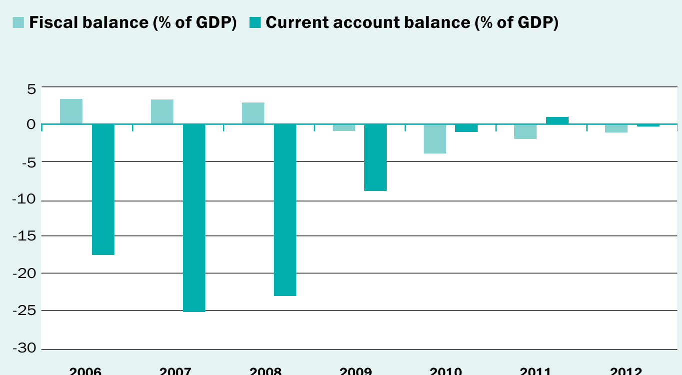
The regulatory framework for telecommunications has been further improved. Efforts have been made in the past year to align the relevant legislation with EU requirements, although implementation in the area of tariff rebalancing has not yet been fully completed. The mobile segment of the market is particularly competitive and broadband penetration has grown substantially over the past few years.

Competition remains strong in the banking sector. There are 31 banks currently operating, and the top five banks account for just over half of total assets in the sector. The capital adequacy rate was 17.5 per cent as of end-2011 and deposits have been growing robustly in the past year at double-digit levels, allowing banks to reduce somewhat their reliance on parent funding. Although the banking sector as a whole has managed to cope well with domestic and global pressures, the level of non-performing loans (NPLs) has been rising, reaching 14.9 per cent as of end-2011 (compared with 11.9 per cent at end-2010). Regulatory measures have been stepped up to deal with the fallout from the eurozone – and particularly Greek – crisis given the high share of Greek subsidiaries in the banking sector.

Real GDP (1989 = 100)



Fiscal balance and current account balance



CROATIA

HIGHLIGHTS OF THE PAST YEAR

- **The completion of EU accession negotiations is a key milestone for Croatia.** The country is scheduled to join the European Union on 1 July 2013 after a convincing endorsement of the Accession Treaty in a referendum and subsequently by parliament.

- **Important progress has been made in the transport sector.** Road sector reform has advanced significantly over the years, a concession for Zagreb airport has been awarded and restructuring of the railways is under way.

- **Economic performance remains exceptionally weak.** Economic output remained constant in 2011 after two years of negative growth, but is falling again in 2012, largely due to adverse external developments. However, efforts are being made to shore up the fiscal position and reduce the government deficit.

KEY PRIORITIES FOR 2013

- **The key priority is the implementation of a credible reform programme to boost growth prospects and prepare the country for EU membership.** This will require strengthening the institutional capacity to absorb EU funds, enhancing competitiveness by overhauling some of the restrictive practices that make the labour market inflexible and hinder the smooth setting-up and running of businesses, and improving payment discipline in public sector companies.

- **Regional connections in the energy sector need further development.** In addition, there is scope to develop further the power transmission and distribution network in order to adapt to increased wind power generation.

- **Successful privatisations in the financial sector could send an important signal about the willingness to reduce the size of the state.** The sale of the postal bank and a major insurance company could attract investments and strengthen competition and the provision of services in these sectors.

MACROECONOMIC PERFORMANCE

The economy is back in recession. Croatia experienced one of the most protracted recessions in the region as a result of the global financial crisis. After two years of declining output in 2009-10, and zero growth in 2011, GDP declined by 1.3 and 2.1 per cent respectively in first and second quarters of 2012 on the back of weak domestic demand and a decline in gross fixed capital formation. These trends reflect both spillovers from the ongoing eurozone crisis and the persistence of deep structural problems. Inflation has been rising since March 2012 and stood at 4 per cent year-on-year as of August 2012. The increase was partly related to a rise in the VAT rate by two percentage points to 25 per cent, which became effective in March, and partly to further deregulation of energy prices. Economic difficulties have resulted in pressure on the kuna this year, and the Croatian National Bank has intervened several times on FX markets to prop up the currency.

The government has begun to implement a fiscal consolidation plan. Changes in the tax system have been introduced. In addition to the aforementioned increase in the VAT rate, the government implemented a new tax on dividend payouts and abolished a tax on reinvested profits. Proposals for the introduction of property, capital gains and dividend taxes are also planned for later this year. The general government deficit in 2011 was 5.1 per cent of GDP (on ESA methodology), slightly below target. In 2012 the government is targeting a narrower deficit of 3.9 per cent of GDP, but given the worsening economic outlook and the GDP figures for the first quarter, this target will be difficult to achieve.

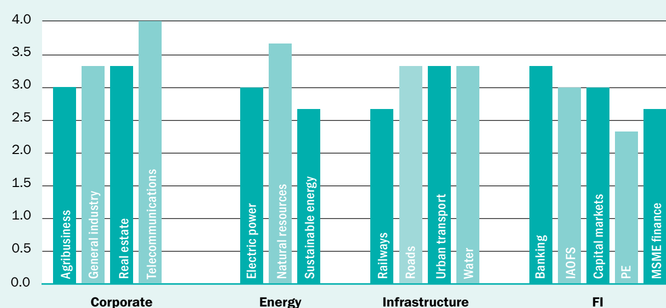
The prospects for recovery are bleak. The outlook is very uncertain given the protracted crisis in the eurozone and the risks on the downside are high. Under current baseline projections, Croatia will be in recession again in 2012, with output falling by around 1 per cent, and only a modest recovery is likely to take place in 2013. Over the medium term, however, there are hopes that the country will be boosted by EU accession and perhaps by the introduction of long-awaited reforms to public administration and the labour market, as well as the restructuring of publicly owned infrastructure companies.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-6.9	-1.4	0.0	-1.9
Inflation (end-year)	1.9	1.9	2.0	5.6
Government balance/GDP	-4.2	-5.1	-5.2	-4.4
Current account balance/GDP	-5.1	-1.1	-1.0	-1.2
Net FDI (in million US$)	2122	541	1450	1210
External debt/GDP	104.4	104.7	94.9	na
Gross reserves/GDP	23.5	24.7	23.2	na
Credit to private sector/GDP	65.9	70.1	72.2	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Croatia is scheduled to join the European Union in July 2013. Following the completion of accession negotiations during 2011, Croatia and the European Union signed the Accession Treaty in December 2011. The Treaty was endorsed in a national referendum on 22 January 2012 and subsequently ratified in March by the Croatian parliament. Ratification by EU member countries is ongoing. Continuing pre-accession screening by the European Commission (EC) of reforms in the areas of judiciary, competition policy, and of the fight against corruption is helping to address remaining problems. In May 2012 the government adopted an action plan of 51 measures needed to fulfil the remaining obligations of EU membership. In its latest comprehensive monitoring report on Croatia, published in October 2012, the EC noted the continued good progress towards membership while identifying a limited number of issues where increased efforts are needed. A final monitoring report will be issued in spring 2013.

A significant privatisation agenda still lies ahead. The government has said it is hoping to raise about HRK 2 billion (€260 million) this year in revenues from the sale of assets such as Hrvatska Postanka Banka, the insurance company Croatia Osiguranje and some smaller assets. In July 2012 the government launched a tender for an adviser on the privatisation of Croatia Osiguranje, for which a 50 per cent stake will be offered for sale. Efforts to restructure and sell the country's shipyards are ongoing, and the first transaction was signed in summer 2012.

Reforms to the business environment are under way. Enterprises in Croatia continue to face a number of persistent problems, according to cross-country studies. The 2012 World Bank *Doing Business* Report places Croatia at 80th out of 183 countries on overall ease of doing business, down one place from the previous year. Dealing with construction permits and protecting investors are identified as particular problems in this report. The government is planning to decentralise the process of granting construction permits to the county level and to introduce e-permitting. In addition, a new law on investment promotion, was adopted by parliament in September 2012.

Road sector reform is at an advanced stage. All contracts for road construction, rehabilitation and periodic maintenance are tendered on a competitive basis to the private sector. An automatic tolling system is now in place as of 2011 and procurement practices have been improved. Several road concession projects have been or are being implemented, although not always in line with best international practice.

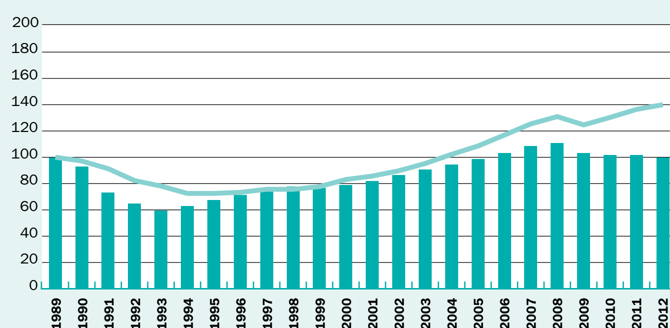
Railways restructuring is being prepared. Reforms in this sector have been limited to date. There is limited private sector participation and competition in the market, and the state-owned railway company, Hrvatske Zeljeznice (HZ) continues to receive significant subsidies from the central government. The government has prepared a restructuring programme under which the holding structure will be dismantled, the cargo company privatised and a labour restructuring programme implemented. Plans are under way to restructure the airline company, Croatia Airlines, as well as the state-owned motorway companies, HAC and Rijeka-Zagreb Motorway.

The banking sector is well developed but credit is falling. The banking system is well developed by regional standards, and the capital adequacy ratio is strong at above 20 per cent as of June 2012. However, the overall non-payment of suppliers is severely affecting working capital, with an increasing number of corporate accounts blocked due to the failure to meet official payments. The level of non-performing loans had risen to 13.3 per cent by June 2012. Deleveraging intensified in the second quarter of 2012. Negative credit growth was recorded for five consecutive months to July 2012.

Pension and labour market reforms are envisaged. The new government is facing a number of persistent problems with regard to the functioning of labour and pension markets in Croatia. The unemployment rate is 17.3 per cent as of June 2012, and the employment rate is just over 50 per cent, well below the EU average. Although the stagnant economy and restrictive labour practices are factors underlying low levels of employment, part of the reason is the structure of the pension system: the retirement age is officially 65 but the average age of pensioners is significantly lower, because previous governments had promoted early retirement for "excess" labour. The country has a three-pillar pension system, with a ratio of pension funds to GDP of around 10 per cent.

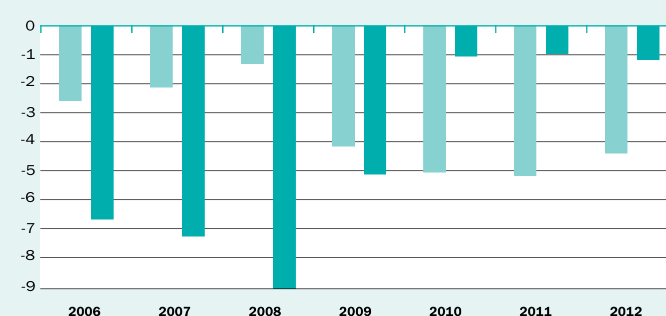
Real GDP (1989 = 100)

■ Croatia ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



EGYPT

HIGHLIGHTS OF THE PAST YEAR

- **Macroeconomic fundamentals have notably deteriorated during the lengthy political transition period.** The significant capital outflows and plummeting of tourist receipts have led to a precarious external position, with reserves reaching dangerously low levels. The authorities formally requested a US$ 4.8 billion loan from the IMF in August 2012.

- **Investors adopted a wait-and-see approach, especially due to continued uncertainty with regards to the political transition.** This has delayed the resumption of capital flows and FDI into the country. Following presidential elections, however, business sentiment may be turning more positive.

- **Structural reforms have not gathered much pace in light of the political transition under way.** Interim governments since the overthrow of the previous regime have not been able to implement substantial reforms, and delays are expected in the implementation of many key reforms under way.

KEY PRIORITIES FOR 2013

- **The key immediate challenges are to restore macroeconomic stability and achieve job-creating growth.** Structural skill mismatches and a lack of employment opportunities, especially among the youth, are chronic problems. A combination of restrictive labour market regulations and the lack of adequate training opportunities have led to persistent skill mismatches in the labour market.

- **Subsidies are a substantial burden on the budget and should be better targeted.** Subsidisation of many sectors – including food, energy, and utilities – constitutes more than a quarter of total public spending and distorts incentives across most sectors.

- **Strengthening the regulatory framework is required to ensure a level playing field for private business.** The state's role as regulator and competition enforcer is very weak. Egypt's judicial capacity is limited and state involvement is pervasive in many aspects of business.

MACROECONOMIC PERFORMANCE

The economy faced significant headwinds throughout the year. Real GDP growth reached 2.2 per cent at the end of the 2011-12 fiscal year (which runs from July to June), down from an average growth rate of 5 per cent in the past decade. The recent economic performance falls well below the estimated growth rate of 6-7 per cent required for Egypt to keep the unemployment rate unchanged. While tourism, mining, manufacturing and construction have somewhat recovered throughout the fiscal year, this is mostly due to favourable base effects associated with a near-stagnation of economic activity following the uprising, and they still remain significantly below levels seen in 2010. A more pronounced economic downturn was, however, avoided by buoyant private consumption. The unemployment rate has increased throughout the year, from 8.9 per cent in 2010 to 12.6 per cent by end-June 2012.

Egypt's balance of payments remains under significant pressure, mostly due to continued capital flight and falling tourist receipts. The current account deficit reached US$ 7.9 billion (3.2 per cent of GDP, up from 2.2 per cent the previous year) due to weak export growth and higher energy import costs. Tourist receipts fell by 11 per cent throughout the year. Further deterioration was, however, avoided by strong remittance inflows. In addition, the financial account remained weak, as FDI declined by 5 per cent during the year, coupled with a near doubling of portfolio outflows, especially as foreigners shed their treasury-bill holdings. Meanwhile, official foreign reserves reached US$ 15.1 billion in August covering just over three months of imports.

Weak economic activity and higher government spending on social benefits and subsidies have increased pressures on the fiscal front. The general government's fiscal deficit widened from 10 per cent of GDP in FY2010-11 to 11 per cent in FY 2011-12, surpassing the government's forecast of 8.6 per cent of GDP. Expenditures increased by 17 per cent, due to hikes in wages, social benefits and fuel subsidies, while borrowing costs continued rising. Subsidy spending rose by 23 per cent on the previous fiscal year, with petroleum subsidies constituting more than a fifth of total expenditure. In September 2012 the government provided details of a new pricing structure to reduce the burden of fuel subsidies on the budget by US$ 4.2 billion (around 2 per cent of GDP) and has been consulting with civil society to build consensus. However, the higher government spending has been to the detriment of public investment, which has fallen by 14 per cent over the fiscal year. While external debt has not increased significantly, the government has instead resorted to borrowing heavily and at a high cost from domestic banks, increasing the sector's exposure to sovereign credit risk and crowding out private credit.

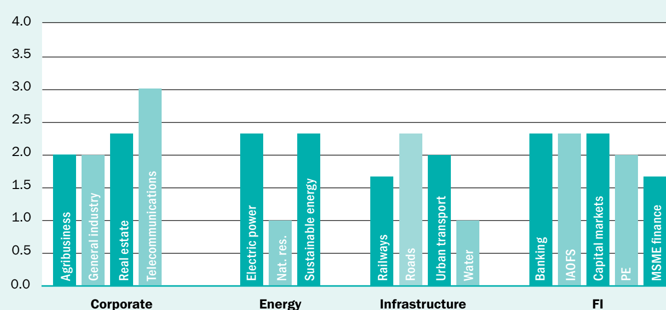
Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	4.6	5.1	1.9	2.2
Inflation (end-year)	11.5	10.5	10.1	8.0
Government balance/GDP	-7.0	-8.5	-10.1	-11.0
Current account balance/GDP	-2.5	-1.6	-2.3	-3.2
Net FDI (in million US$)	8113	6758	2189	2078
External debt/GDP	16.9	15.9	15.2	na
Gross reserves/GDP	17.5	17.2	12.0	na
Credit to private sector/GDP	7.7	7.0	1.6	na

Note: All figures are for the fiscal year July-June.

2012 sector transition indicators

Sector transition score



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

There are significant downside risks to the outlook associated with continued uncertainty. Egypt formally requested a US$ 4.8 billion loan from the IMF in August 2012, to financially support the government's economic reform programme, and to ease the country's deteriorating external and fiscal positions and boost investor confidence. The loan is likely to be conditional on major food and fuel subsidy reform, and will seek to attract other funds into the country. Consumer confidence has also been on a downward trend during the first half of the year, reaching lows seen during the most acute periods of the political turmoil in 2011, but business sentiment has picked up after the presidential elections in June 2012.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Egypt adopted several structural reform programmes over the past two decades with mixed results. The reforms included privatisation of state-owned enterprises, financial sector reforms, tariff reductions, capital account liberalisation, improvements in the business environment (for example, enhancing conditions for start-ups and creating a competition agency) and fiscal-structural reform (for example, income and corporate tax reforms and modernisation of tax administration). Although these reforms helped to bring about successful external liberalisation and a reduction in most trade and investment barriers, they did not manage to structurally reduce high unemployment rates or spread the reform benefits to large segments of the population.

The structural reform gaps in Egypt remain large and key market distortions persist. The state's role as regulator, guarantor of competition and enforcer of contracts has tended to be weak. In many sectors, regulatory functions are not fully separated from state operations. The Egyptian Competition Authority is not fully independent and the extent of its enforcement authority and mechanisms is unclear. In addition, Egypt's judicial capacity is weak and state involvement in many aspects of business remains heavy, leading to the lack of a level playing field for private businesses. Judicial procedures tend to be lengthy, costly and subject to political pressure and bureaucracy. Egypt ranked 110th (out of 183 countries) for ease of doing business in the 2012 World Bank *Doing Business* Report, below its SEMED peers and the regional average for the Middle East.

A number of reforms are still lagging in the agribusiness sector. Subsidies, export bans, and continued state ownership and dominance are prevalent in this sector. The agribusiness sector also lacks streamlined regulation to ease the process of owning and leasing agricultural land and reforms have yet to be developed which address the lack of alternative sources of collateral such as warehouse receipts, especially in light of severely constrained access to finance from banks.

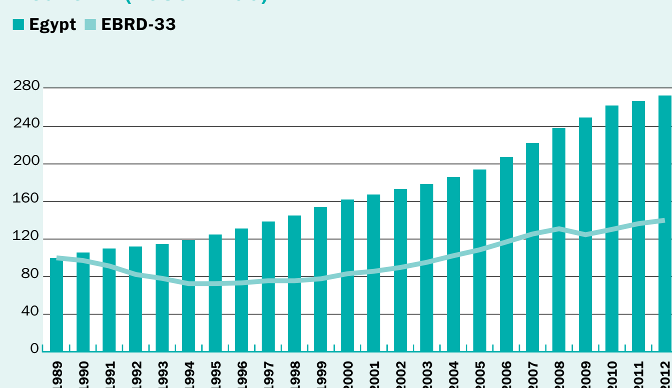
Key challenges exist in upgrading and decentralising the municipal infrastructure sector. Municipal services in Egypt are in urgent need of investment to provide better access and improved quality. Among the top priority areas are inadequate solid waste management and urban traffic management. Non-sovereign financing is limited, but decentralised financing solutions are being developed to move towards improved cost recovery and commercial discipline.

Egypt has yet to undertake substantial reforms in the energy sector. The current energy subsidy system places a heavy burden on the fiscal account and provides distorted incentives for energy use and energy efficiency. Reforms are still needed to unbundle and fully commercialise the energy sector. The authorities have expressed their intention to introduce public-private partnership (PPP) schemes that would expand private sector involvement, but concrete legislative action has yet to materialise. In addition, reforms are needed to provide incentives for investment in cleaner conventional and alternative fuels, in order for Egypt to both exploit its resources, notably in wind and solar, and alleviate pressure on domestic natural gas production.

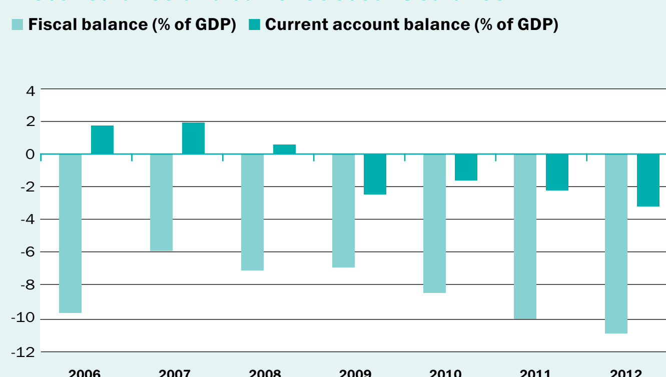
The regulatory frameworks in the transport and power sectors have not been sufficiently upgraded. These large infrastructure sectors continue to be dominated by state-owned enterprises with significant involvement and control by the central state authorities. In addition, Egypt has yet to reduce the high levels of subsidies for power, fuel and transport fares which keep prices for public services substantially below cost-recovery levels. In 2012 the Egyptian government announced plans to decrease fuel subsidies by 27 per cent. The authorities expect complete elimination of subsidies to be achieved by 2018, according to the latest announcements. Extensive regulation and the absence of market-based mechanisms for the pricing and delivery of services are also partly responsible for inefficiencies in public sector entities.

The financial sector is relatively well developed, but access to credit is limited. Improving access to finance for micro, small and medium-sized enterprises (MSMEs) is one of the key reform challenges in the financial sector. Poorly developed credit bureaus and weak contract enforcement are among the key obstacles to the further development of MSME finance. Since 2010 access to credit information has improved slightly with the addition of retailers to a private credit bureau database. However, credit to the private sector continues to be squeezed out by the government, and banks tend to favour lending to large, established companies. In addition, an unfinished privatisation agenda in the bank and non-bank financial sectors has left a number of institutions under state control.

Real GDP (1989 = 100)



Fiscal balance and current account balance



ESTONIA

HIGHLIGHTS OF THE PAST YEAR

- **Estonia showed the fastest growth of all EU countries last year.** However, the rapid expansion in exports in 2011, which currently stand at 26 per cent above pre-crisis levels, could make Estonia vulnerable to negative trends in the European economy.

- **Contributions into private pension funds are being gradually restored.** This underlines the authorities' commitment to a multi-pillar pension system and signals that a temporary crisis measure to restore fiscal balance can now be brought to an end.

- **The division of activities of the dominant energy supplier is positive for competition and market access.** The requirement for a divestment of supply activities by the current monopoly gas operator is compliant with EU directives.

KEY PRIORITIES FOR 2013

- **Capacity to generate local innovation should be expanded.** There is a continuing need to increase the growth of technology-intensive products. Education and innovation policies will need to be developed further towards this end.

- **Credit constraints for micro, small and medium-sized enterprises (MSMEs) should be relaxed and private equity and mezzanine capital developed.** Non-bank sources of finance need to be mobilised in order to facilitate the growth of innovative companies.

- **The framework for public-private partnerships (PPPs) could be developed further.** Estonia's reluctance to utilise PPPs risks going without the benefits inherent in private finance. Carefully designed projects should avert fiscal risk, and could possibly be blended with EU grant funds.

MACROECONOMIC PERFORMANCE

The economy has grown at the fastest pace of any EU country, at 8.3 per cent in 2011. Respectable growth among Estonia's main trading partners boosted exports, which rose by 27 per cent in volume terms in 2011. The main contributors to growth in industrial production (up by 16.8 per cent in 2011) were products with a higher added value, such as electronics, machinery and equipment. A clear slow-down in key export markets in the second half of 2011, and a weakening in Estonian GDP since the fourth quarter, underlined the vulnerability that stems from this export dependence. However, Estonia's ability to mobilise domestic investment and absorb the remaining EU structural funds has led to a more modest contraction in fixed capital formation during the crisis than in most other central European economies, and a more rapid recovery since then. Private sector investment has revived, growing at 26 per cent in 2011 compared with the previous year. In parallel, due to an obligation to invest revenues from the CO_2 quota trade as well as to increase the EU funds absorption before the budgeting period ends in 2013, the government remained a key driver of increasing investment activity. Unemployment has dropped from its peak in 2010 of just under 20 per cent to 10.1 per cent in mid-2012. Labour mobility with the rest of the European Union remains unusually high, and provided an important safety valve during the crisis. At the same time, this has contributed to the erosion of skilled labour available within Estonia.

Estonia's public finances stand out as the most prudently managed in the European Union. A key goal of government policy has been to keep the budget in balance, and there are no plans to issue government bonds. Gross debt currently stands at 6 per cent of GDP, and substantial fiscal reserves have been accumulated. There were small budget surpluses in both 2010 and 2011 (sales of CO_2 quotas amounted to 1.2 per cent of GDP), though the government plans to reach a deficit of about 1.5 per cent of GDP in 2012, due in part to the resumption of contributions into mandatory pension funds and in part to the environment-related investment obligations stemming from the 2011 sale of CO_2 quotas.

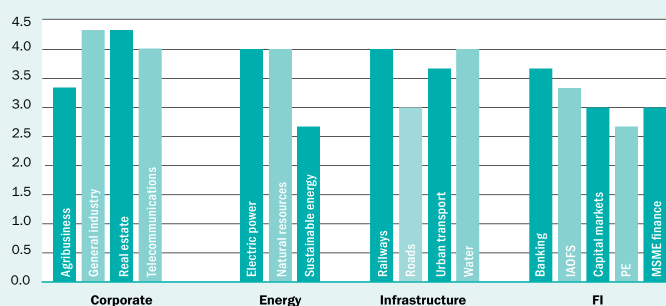
Over the next two years Estonia's growth will be substantially held back by weakness in European export markets. With nearly the entire banking sector being owned by foreign institutions, Estonia is exposed to the withdrawal of funding from foreign parents, which last year amounted to over 7 per cent of GDP, though the Nordic parent institutions are less exposed to funding constraints within the eurozone. So far, the contraction in credit to the private sector has been limited to the household sector, with corporate credit showing a modest expansion.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-14.1	3.3	8.3	2.3
Inflation (end-year)	-1.9	5.4	4.1	4.2
Government balance/GDP	-2.0	0.2	1.0	-1.5
Current account balance/GDP	3.4	2.9	2.1	1.0
Net FDI (in million US$)	293	1457	1715	817
External debt/GDP	125.0	115.8	98.5	na
Gross reserves/GDP	20.7	15.2	13.0	na
Credit to private sector/GDP	106.0	96.9	82.4	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Structural reforms in Estonia are well advanced. The business environment is among the soundest in the EBRD's countries of operations. A new anti-corruption law, passed in February 2012, is in line with efforts to underpin the country's role as an attractive foreign investment location. According to this law, the declaration of outside interests by public officials will be more straightforward and transparent than before. Another law was passed in parliament in March 2012 to clarify the notice period in collective labour contracts, and this further strengthens labour market flexibility and transparency of contractual rights.

The government adopted a programme aimed at further boosting the country's competitiveness. Tax revenues as a share of GDP are already well below the EU average, and a simple tax administration with extensive use of electronic submission and monitoring simplifies the system. The National Reform Programme, submitted to the European Union in April 2012, nevertheless envisages a further lowering of the tax burden to spur job creation, while preserving the current conservative fiscal approach.

Estonia remains the most knowledge-intensive economy in the transition region. High-technology goods account for about one-third of total exports to other EU countries. The country's labour force is highly skilled relative to other transition countries, and product innovation and the digital economy are encouraged through various policy initiatives, particularly in the public sector (e-government, public health system). Comprehensive programmes have been put in place to foster education at all ages and close remaining skills gaps.

The banking sector is adapting well to the withdrawal of foreign funding. Non-performing loans are the lowest of all three Baltic countries at only about 4 per cent of total loans, as of August 2012, and households continue to reduce their outstanding debt. In line with developments elsewhere in the transition region, the government has enacted reforms to enable household debt restructuring. A new law that came into effect in April 2011 allows households with debt servicing problems to restructure their debts while avoiding bankruptcy procedures. The law foresees a case-by-case restructuring of all liabilities without the use of public funds and aims to address the remaining problems among over-indebted households.

Private sector initiatives highlight a demand for non-bank sources of funding, and more risk-oriented capital. As elsewhere in the Baltic region, private equity capital remains sparse and investment strategies are limited to growth and venture capital funds. In the 2012 budget the government approved a gradual increase of contributions in private mandatory pension funds back to the level envisaged when these funds were first set up. While diversification motives and location of fund managers will still lead to the predominant part of these funds being channelled outside the country, a limited engagement within the Baltic region may now also become possible.

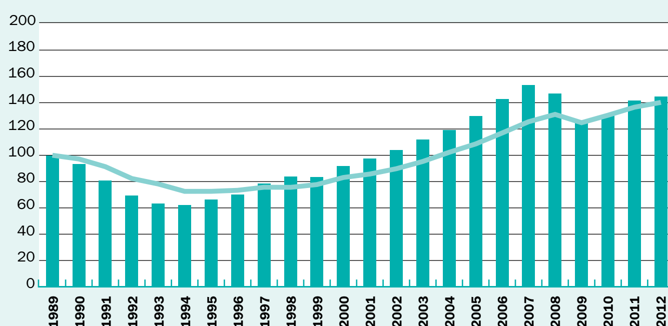
The government remains sceptical about the use of public-private partnerships. The authorities continue to regard EU structural funds as the principal source of funding to upgrade local infrastructure. In October 2011 the European Commission temporarily suspended fund disbursement due to irregularities in project oversight with government agencies. However, the problem was quickly rectified and funds are now being disbursed again.

Energy intensity remains about 75 per cent higher than the EU-15 level. Several public investments in energy efficiency were advanced, though improving energy efficiency in residential properties and transport remains a government priority. In January 2012 the government published draft amendments to its energy legislation which aim at reducing the feed-in support for renewables, including for existing installations. This could retroactively lower the support for already operating renewable generators.

Energy sector restructuring progressed, in particular through the separation of activities in the gas sector. The operational separation of divisions in the monopoly supplier, AS Eesti Gaas, has already achieved somewhat greater transparency. In June 2012 parliament passed a law in accordance with an EU directive on the separation of distribution activities requiring Eesti Gaas to divest its grid network within three years. The operator, which is majority owned by German E.On. and Russian Gazprom, has threatened arbitration against this move. While the immediate acquirer may well be a state entity, in the medium term this measure could ensure greater competition by allowing access to alternative suppliers.

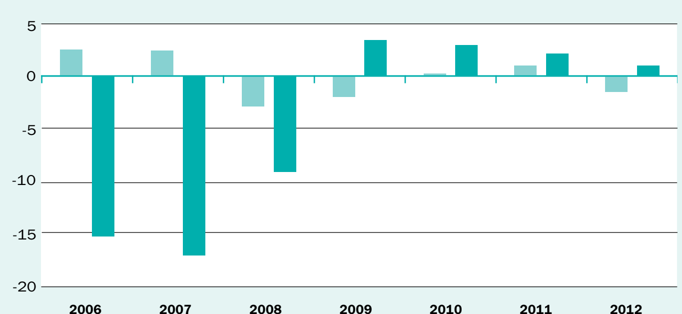
Real GDP (1989 = 100)

■ Estonia ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



FYR MACEDONIA

HIGHLIGHTS OF THE PAST YEAR

- **Efforts to improve the business environment and attract foreign investment have been stepped up.** FYR Macedonia's latest ranking on the 2012 World Bank's *Doing Business* scores is impressive, and some major investors are showing interest, but important business climate issues such as judicial reform and corruption remain to be fully addressed.

- **Macroeconomic stability has been preserved.** Growth in 2011 was close to 3 per cent and inflation and the government deficit were kept at low levels, but a clear slow-down is evident so far in 2012.

- **Privatisation of some of the remaining state-owned assets is proving difficult.** The failure over the past year of the state's efforts to sell some major companies highlights both the stringent tender conditions in some cases and the difficulties of offloading state-owned shares in the present climate.

KEY PRIORITIES FOR 2013

- **Reforms should be pushed forward in the context of the new high-level dialogue with the European Commission.** This dialogue offers an opportunity for the country to advance on an EU-oriented reform path even while formal accession talks cannot proceed because of the name dispute.

- **Regulatory authorities in some infrastructure sectors need to be strengthened.** In the energy sector, the regulatory authority is still subject to some intervention, and cross-subsidies are significant with household prices being kept artificially low.

- **The provision of financial services should be enhanced.** Competition in the banking sector is less vigorous than in some regional peers, and there is scope to develop a greater range of financial services than presently available.

MACROECONOMIC PERFORMANCE

The economy was less affected by the global economic and financial crisis than many regional peers but the impact of the eurozone crisis has been felt strongly in 2012. With a GDP growth rate of 2.9 per cent, FYR Macedonia was among the strongest performing SEE economies in 2011. However, the impact from the eurozone crisis began to be felt in the second half of the year and a significant slow-down has followed since. In the first half of 2012, the economy contracted on a year-on-year basis on account of the weaker export demand as well as the impact of lower foreign direct investment and reduced remittance inflows on domestic demand. Inflation stayed relatively low in 2011 and in the first half of 2012, but it accelerated recently, reaching 5.3 per cent year-on-year in September 2012. This is a temporary spike caused by rising food prices as well as increases in pensions and the introduction of a minimum wage. The currency remains pegged to the euro and international reserves are at relatively comfortable levels of 114 per cent of short-term debt and about four months of imports.

Fiscal targets have been met, but arrears are present. Given the currency peg to the euro and the limited sources of external funding, the government has implemented relatively tight fiscal policy. Over the past two years the government maintained the budget deficit within the targeted 2.5 per cent of GDP on a cash basis; this year, it is likely to reach 3.5 per cent of GDP. The government is taking measures to clear part of the accumulated budgetary arrears and delayed VAT refunds. In 2011 the government drew on the precautionary credit line (PCL) from the IMF to finance expenditures. The second review of the PCL was not completed, mainly because of IMF concerns about the arrears problem. The PCL is now dormant and will formally expire in January 2013.

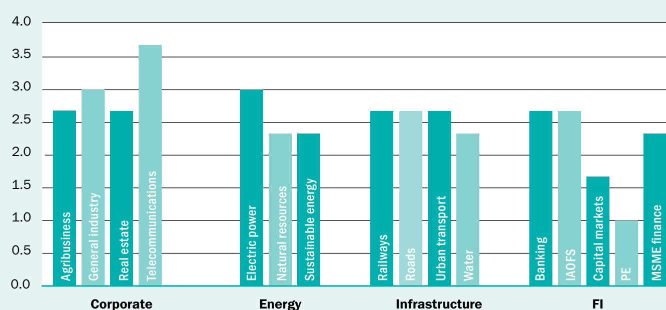
The eurozone's difficulties will continue to dampen growth prospects in 2012 and 2013. Following the contraction in the first half of the year and in light of continuing weakness in the eurozone, growth in 2012 will be minimal at best. A modest recovery is likely to occur in 2013 to around 2 per cent. A pick-up in growth is expected in the medium term, as the regional economy recovers and as FYR Macedonia reaps the benefit of sustained macroeconomic stability and investor-friendly reforms introduced in recent years.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-0.9	2.9	2.9	0.3
Inflation (end-year)	-1.6	3.0	2.8	5.9
Government balance/GDP	-2.7	-2.4	-2.5	-3.5
Current account balance/GDP	-6.8	-2.1	-2.7	-4.0
Net FDI (in million US$)	191	209	427	263
External debt/GDP	59.1	58.4	65.0	na
Gross reserves/GDP	22.1	23.4	21.5	na
Credit to private sector/GDP	43.9	45.5	46.3	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Moving to the next phase in the EU accession process remains stalled because of the name issue. Since receiving candidate status in December 2005, FYR Macedonia has made considerable progress in EU-oriented reforms. The country is on track to fulfilling the political and economic criteria for accession, but the name dispute remains a key obstacle to further advancement of the membership application. In March 2012 the government and the European Commission (EC) launched a High-Level Dialogue to boost the reform process. In its latest Progress Report, published in October 2012, the EC noted that this new Dialogue had already served as a catalyst for reforms in a number of key policy areas this year. The EC reiterated its recommendation for the opening of EU accession negotiations, stressing that this would consolidate the pace and sustainability of reforms.

Privatisation is largely complete, but efforts to sell some of the remaining state-owned enterprises have been unsuccessful. A number of attempts have been made to sell the state's 76.6 per cent stake in chemical manufacturer Ohis, but there have been no successful bids so far. Similarly, efforts to privatise the electrical engineering company EMO Ohrid, the tobacco company Tutunski Kombinat AD Prilep and the manufacturer of military kit, 11 Oktomvri Eurokompozit over the past few years have also failed. These four companies remain on top of the government's privatisation agenda. State capital remains concentrated in the energy sector (power generation and transmission companies are state-owned) and public utilities. The state also owns a significant minority stake in the country's profitable telecommunications company, Makedonski Telekom.

FYR Macedonia continues to perform well on business environment indicators. According to the 2012 World Bank's *Doing Business* Report, FYR Macedonia made the third highest improvement in ranking, moving up 12 places from 34th to 22nd (out of 183 countries) for overall ease of doing business. This places the country significantly ahead of regional peers on this business environment measure. The largest improvements were noted in dealing with construction permits, registering property and getting credit. The country still performs relatively poorly on access to electricity, cross-border trade and contract enforcement.

The country has attracted significant new foreign direct investments this year. The most notable is a €300 million construction project in Skopje by the Turkish company Cevahir Holding, which will include a shopping centre and four skyscrapers. In July 2012 an agreement was signed for the largest German greenfield investment in the country – a €35 million plant in the free zone of Kavadarci that will manufacture electronic installations and cables for the car industry. A week before, in the industrial zone in Bitola, construction began on another significant German investment – a €20 million plant that will also produce automotive parts. Major reinvestments by companies from the United Kingdom and United States are also under way in the car electronics and catalytic convertors industries.

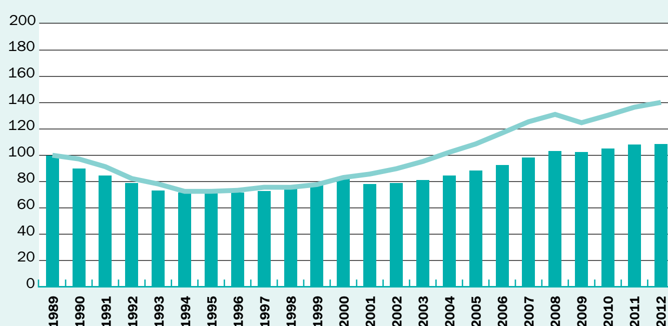
Restructuring of the railways sector is ongoing. The institutional mechanisms for the introduction of public service obligation contracts and access charges are under development. Over the past year the government provided financial guarantees for an IFI-funded loan to the national rail operator, Makedonski Zeleznicki Transport. The funds will be used to modernise the freight and passenger fleet in order to improve the company's operational efficiency. Under the umbrella of the project, technical assistance will be sought for the development of a Business Segmentation Strategy, which should result in a split of the freight and passenger service into two separate legal entities by 2017. In parallel, ambitious plans for energy efficiency improvements have been envisaged with both the national rail operator and the infrastructure management company.

Overall the financial sector remains less competitive than in neighbouring countries, but pension fund assets have increased. The three largest banks (Komercijalna Banka, Stopanska Banka and NLB Tutunska Banka) still control 64 per cent of the market while the top five banks account for 77 per cent of the total market. The market is dominated by foreign banks, which account for over 90 per cent of total banking assets. However, banks have relied primarily on domestic deposits to fund lending, so they were not as exposed as those in regional peers to deleveraging pressures during the crisis. Non-performing loans have recently started to increase again, reaching 10 per cent of total loans this year, although they are more than 100 per cent provisioned. One of the three largest banks – Stopanska Banka – is a subsidiary of a Greek bank while NLB Tutunska Banka is Slovenian owned. Spillover risks are limited, however, because the bank has largely relied on domestic deposits rather than parent bank capital to finance lending.

Pension fund assets have risen sharply. Past reforms in the pension system included the setting up of a mandatory defined-contributions pillar managed by private pension funds. Along with the introduction of two voluntary funds, this has led over the past year to a substantial increase in pension fund assets, which have reached over 3 per cent of GDP (up from 1.2 per cent in 2008).

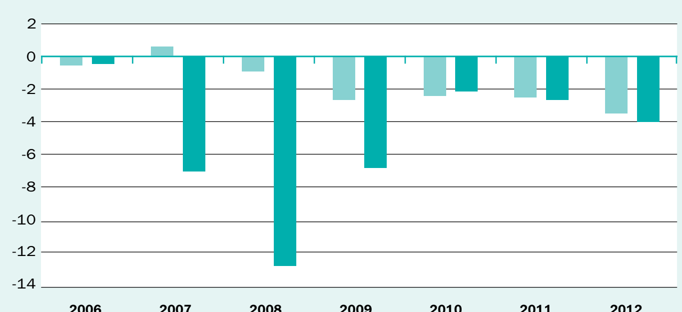
Real GDP (1989 = 100)

■ FYR Macedonia ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



GEORGIA

HIGHLIGHTS OF THE PAST YEAR

- **The government established a public fund to support private sector investment.** The Partnership Fund is endowed with equity stakes in the remaining major public enterprises and is intended to support commercially oriented private sector investment in priority areas.

- **The authorities have worked to harmonise revenue needs with a balanced and fair tax system.** The government introduced and later repealed legislation to prioritise tax payments with regard to secured lenders. The tax dispute resolution process was simplified and the tax ombudsman office was created.

- **The prominence of the country's difficult social issues increased during the parliamentary elections.** In September 2012 minimum retirement pensions were increased and mandatory health insurance for retirees was introduced. Both the outgoing and the incoming governments identified agricultural development, health and education as priority areas.

KEY PRIORITIES FOR 2013

- **Policies should support recovery of private investment.** It will be important to ensure that the newly established Partnership Fund operates on a commercial basis and foments, rather than substitutes for, foreign direct investment.

- **Complete restructuring and modernisation of the energy sector.** Despite the significant transformation of recent years, liberalisation of the energy market and the country's integration in regional energy markets remain incomplete and the sector still suffers from significant distribution losses and seasonal supply patterns inherent to Georgia's hydrology.

- **The government should continue to pursue policies to ensure that future development is more inclusive.** Policies to support retraining of the labour force, integration of the agricultural sector in the market economy and development of the labour intensive sectors should help support employment creation and higher wages over time.

MACROECONOMIC PERFORMANCE

Macroeconomic performance has been strong. Output expanded by around 7 per cent in 2011 and 8 per cent in the first half of 2012. Growth has been broad-based with manufacturing, financial services and tourism among the main contributors. As international food prices moderated, inflation declined rapidly to -0.1 per cent in September 2012. The central bank was able to loosen monetary policy by decreasing the refinancing rate from the peak of 8 per cent in June 2011 to 5.75 per cent in June 2012. Although the current account deficit rose to 12.5 per cent of GDP in 2011, rising private inflows caused appreciation pressures and enabled the central bank to replenish external reserves. The share of non-performing loans in the financial sector has declined steadily, to 4 per cent of total loans (according to the IMF's definition) at the end of July 2012. The general government deficit declined to 3.6 per cent of GDP in 2011. The authorities have been able to reduce reliance on official external financing, while maintaining a precautionary arrangement with the IMF.

The country's successful stabilisation and recent performance have been recognised by the markets. Several international rating agencies upgraded their ratings of Georgia's sovereign debt. The risk premium paid by the country narrowed to around 300 basis points as of September 2012. Georgian Railways, Georgian Oil and Gas Corporation (GOGC) and Bank of Georgia have been able to tap international markets. However, an international placement of the national railways' shares, scheduled for May 2012, had to be postponed in light of the difficult financial markets environment.

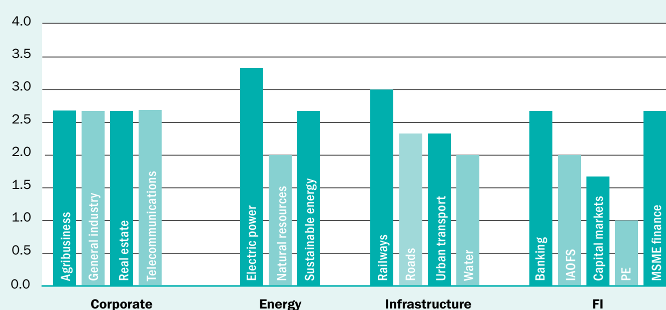
The uncertain global environment warrants continued engagement with IFIs. The short-term macroeconomic outlook is positive as broad-based growth is expected to continue at a fast pace, benefiting from credit expansion, public and private investment and remittances. However, the current account deficit remains large (at 12.5 per cent of GDP in 2011) and the level of the financial sector's dollarisation remains high although declining. The stock of external debt and overall external rollover needs are high for an emerging market economy. Replenished official international reserves and the precautionary Stand-By Arrangement with the IMF would ensure the country's high current account deficit can be financed, should private sector flows reverse, and exchange rate movements can be smoothed to avoid destabilising the financial sector. The central bank mandated commercial banks to hold additional capital as a buffer for potential exchange rate movements.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-3.8	6.3	7.0	6.5
Inflation (end-year)	3.0	11.2	2.0	3.3
Government balance/GDP	-9.2	-6.6	-3.6	-3.5
Current account balance/GDP	-10.6	-10.3	-11.8	-13.0
Net FDI (in million US$)	677	679	829	950
External debt/GDP	58.7	62.7	58.5	na
Gross reserves/GDP	19.6	19.5	19.6	na
Credit to private sector/GDP	30.9	31.8	32.8	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The government established a fund to support private sector investment. The Partnership Fund (PF), endowed with equity in the country's largest state enterprises (including Georgian Railways and GOGC), was established in June 2011 and commenced operations in the spring of 2012. It is intended to support commercially oriented projects in priority sectors in the form of minority equity stakes and debt financing. To ensure that the PF is transparently managed, it was set up as a joint stock company and will be subject to IFRS reporting and rating reviews by the international rating agencies. The fund's operations will not benefit from explicit state guarantees. However, further measures will be needed to strengthen the fund's governance and limit the associated fiscal risks.

Georgia's excellent investment environment has been affected by forceful revenue collection measures. At an ease of doing business ranking of 16th (out of 183 countries), Georgia is the best-rated country in the transition region in the 2012 World Bank's *Doing Business* Report. Large-scale privatisation is very advanced, tax and customs bodies are generally well run, and tangible results have been achieved in fighting corruption. However, over the past year, the tax administration has pursued aggressive tax collection measures, raising concerns about the magnitude and fairness of various penalties. The tax code was amended in January 2012 to allow for seniority of tax liabilities over secured lenders – potentially putting in question security of mortgages and other secured loans – a measure that was later reversed. At the same time, to improve efficiency of, and confidence in, the tax system the authorities have implemented electronic tax filing, improved customs clearance procedures, introduced advanced tax ruling option binding on the tax authority and created a tax ombudsman office.

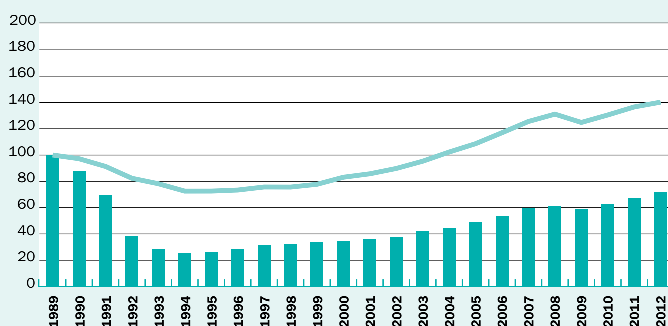
The country's social challenges were brought into sharp relief during the heavily contested parliamentary elections. Despite recent rapid growth, the rate of unemployment has remained high at around 15 per cent. Over half of the labour force is engaged in low productivity subsistence farming. About one-quarter of the population lives below the poverty line. The government has been piloting vocational training programmes, which has expanded employment opportunities for the participants. To integrate the agricultural sector into the market economy, the government is pursuing infrastructure development programmes and supporting projects to develop logistics and warehousing capacity although a fully-fledged strategy for agricultural development is yet to be articulated. The authorities continue to implement a national health care strategy for 2011-15 with the aim of improving the population's health through a reduction of disease burden and mortality by 2015. However, the recently implemented vertical integration of insurance companies and the hospital sector may lead to conflicts of interest that could negatively affect the quality of health care.

The government's plan to partially privatise several remaining public companies was shelved in the poor international market environment. The government has decided to delay the IPOs of minority stakes in several major state-owned companies due to difficult market conditions. The enterprises considered for market placement included stakes in the GOGC, Georgian Railways, and the capital electricity provider Telasi. Instead, in May 2012, GOGC successfully placed a five-year US$ 250 million Eurobond and, in June, Georgian Railways successfully placed a 10-year US$ 500 million Eurobond at the London Stock Exchange. The five-year issue, with a coupon priced at 7.125 per cent, was four times oversubscribed. The funds will be used for the construction of two hydropower plants in the Namakhvani Cascade of western Georgia. The issue should provide funds to support development of the export-oriented electricity sector and help strengthen GOGC's corporate governance and transparency.

The National Bank of Georgia (NBG) has continued to pursue the policy of inflation targeting while strengthening its financial stability frameworks. The NBG has been transitioning to an inflation targeting regime, and has set an inflation target of 6 per cent for the medium term. An EBRD technical cooperation project is helping the central bank to make more informed policy decisions and strengthen its policy credibility by enhancing its forecasting and communication capacities. As inflation declined and the exchange rate appreciated, the central bank was able to reduce the policy rate. The authorities have continued implementing measures to comply with Basel II and Basel III regulations. Financial disclosure rules are being modified in order to comply with Basel II recommendations. The central bank also developed a framework defining the need for countercyclical buffers, in line with Basel III. In response to development of the retail sector, the central bank enacted consumer protection regulations and created a consumer protection unit expected to improve financial education and transparency of retail products.

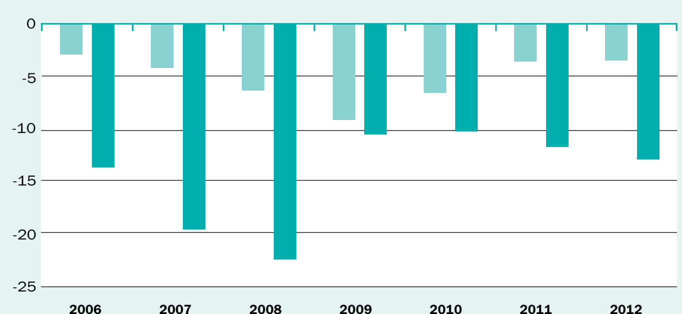
Real GDP (1989 = 100)

■ Georgia ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



HUNGARY

HIGHLIGHTS OF THE PAST YEAR

- **Fiscal discipline has been improved.** The government has made good progress in bringing headline public deficits back within the limits mandated under European treaties.
- **Overly generous social benefits have been capped.** These steps have been taken along with much-needed changes to entitlements in the state pension system.
- **The authorities have reached an agreement with the banking industry on restructuring foreign currency-denominated mortgages.** This is a significant step in finding a balanced solution to this long-running problem, though the scheme that allowed borrowers to pre-pay outstanding foreign currency mortgages at discounted exchange rates led to a considerable capital loss in the banking system.

KEY PRIORITIES FOR 2013

- **A predictable tax and regulatory regime and revived bank lending could enable corporate capital formation.** Problems in this long-running weakness have increased in the past year and constitute a key concern for long-term growth prospects.
- **Measures are needed to increase employment and participation rates.** However, it will be important not to raise the administrative burden on private enterprises or interfere in private employment contracts.
- **A speedy conclusion of the discussions on the IMF/EU programme would help to rebuild the confidence of investors.** This is important given the persistent vulnerability from external and domestic debt, and could stabilise expectations about financial regulation. A future programme would need to be backed up with comprehensive structural reforms that would limit quasi-fiscal deficits, in particular in the transport sector.

MACROECONOMIC PERFORMANCE

Hungary's growth last year remained well below the regional average and the economy has now re-entered a mild recession. Growth of 1.6 per cent in 2011 benefited from a good harvest and export-led industrial production growth until late in the year. Domestic demand remains among the weakest of all countries with household consumption stagnant over 2011 and well below pre-crisis levels. The economy re-entered a recession with two successive quarters of contraction in the first half of 2012. A particular concern is the continued erosion in the private sector capital stock. The ratio of fixed investment to GDP remains the lowest of all central European countries and, unlike in other countries, declined again in 2011.

The government made a genuine attempt to contain public debt but tax policies remain erratic. The budget recorded a sizeable surplus of over 4 per cent of GDP last year following the effective nationalisation of second pillar pension funds (accounting for about 9 per cent of GDP). Still, there has been a large deterioration in the underlying structural position. The so-called "crisis taxes" on a number of sectors, such as telecommunications, energy, retail and financial services have been widely criticised as discriminatory and punitive, and in the case of the telecommunications levy are before the European Court of Justice. Having failed to meet earlier EU demands for a fiscal correction, Hungary was briefly threatened with a suspension of about €500 million in EU cohesion funds. In its latest EU Convergence Programme in April 2012 the government presented consolidation measures of about 0.5 per cent of GDP for both this year and next. These measures would also include a new tax on the telecommunications sector and, from next year, a financial transaction tax (on top of the existing balance sheet tax). These proposals are encouraging for fiscal sustainability, though the composition of taxes and the erratic manner in which taxes are designed remain a problem for the investment climate.

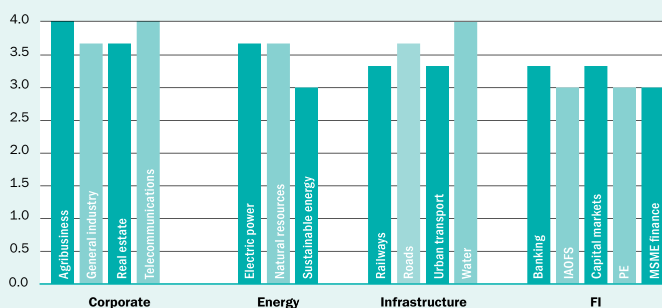
Monetary policy is restrictive, though some easing was initiated in August 2012. The restrictive monetary policy stance of the NBH has initially been motivated by high country risk premia and uncertain prospects for external financing. First reductions from the policy rate of 7 per cent were nevertheless undertaken in August and September 2012 and hinted at growing divisions within the monetary policy council. The central bank implemented a number of measures to stimulate stagnant lending in the economy, through broader collateral eligibility for central bank loans, a preferential two-year lending facility and a proposal to allow universal banks to issue mortgage bonds with support from a central bank mortgage bond purchase programme. Meanwhile, credit to the private sector contracted by 0.8 per cent of GDP in 2011 and showed a further contraction in the first half of 2012.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-6.8	1.3	1.6	-1.5
Inflation (end-year)	5.4	4.6	4.1	6.0
Government balance/GDP	-4.6	-4.2	4.3	-3.3
Current account balance/GDP	-0.2	1.1	0.9	1.5
Net FDI (in million US$)	131	960	-164	1035
External debt/GDP	158.1	142.0	123.5	na
Gross reserves/GDP	34.8	37.4	38.3	na
Credit to private sector/GDP	60.5	60.5	57.8	na

2012 sector transition indicators

Sector transition score



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

With the highest public debt ratio of all new EU member states, Hungary faces substantial refinancing requirements over the coming years. A second recession is likely to extend into 2013. The downgrade of Hungary's sovereign rating into speculative grade by the three main ratings agencies in late 2011 put in doubt the country's capacity to access capital markets. The government therefore requested a second financial support programme from the European Union/IMF at that time, and formal negotiations began in July 2012.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The government has recognised the need to address growing competitiveness concerns and revive corporate investment. Hungary's ranking in the 2012 World Bank's *Doing Business* indicators declined in 2011. Unit labour costs have fallen since the financial crisis, though largely as a result of stagnant domestic wages. Through an extensive programme on the business environment adopted in November 2011, the government seeks to address the costs of doing business, setting out a catalogue of over 100 measures, many aimed at the micro, small and medium-sized enterprises (MSME) sector.

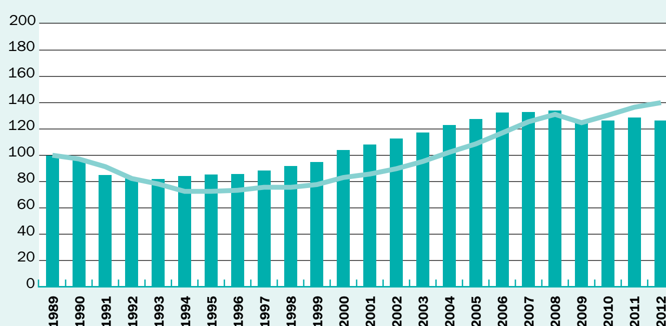
The government has adopted wide-ranging labour market reforms, though the effects on employment are as yet unclear, and the costs to private sector employers significant. Hungarian unemployment has not declined over the past year (remaining at 11 per cent according to Eurostat), with the youth unemployment rate well above the EU average. The participation rate in the labour force, while slightly increased, remains the second lowest in the EU at just under 63 per cent, well below the EU target of 75 per cent. Following a series of measures throughout 2011 the government announced a package of measures in July 2012 that included tax incentives for employers taking on workers who are marginalised due to age or lack of skills. Active labour market policies, along with these tax incentives, could in principle address the damaging effects of long-term unemployment, though there remain a number of rigidities in the social benefits system that have perpetuated the low participation rate in the Hungarian labour market. Also, a simplification of taxes for small and medium-sized enterprises (SMEs), through a lump sum payment settling a number of taxes and social security payments, is envisaged. At the same time, a reform of the personal income tax introduced in 2011, which included mandatory compensation by employers to low-wage earners, has been criticised as highly intrusive and potentially damaging to overall employment.

Financial sector taxation compounds deleveraging pressures. The financial sector as a whole has ample capital coverage, though it turned loss-making in 2011. A financial sector levy remains in place as part of the government's 2010 package of crisis taxes. The tax is the highest such tax in Europe (at about 0.8 per cent of the 2010 balance sheets of each financial institution, including non-bank institutions), though it is to be halved in 2013, and will then be revised in line with a possible European framework for such taxes.

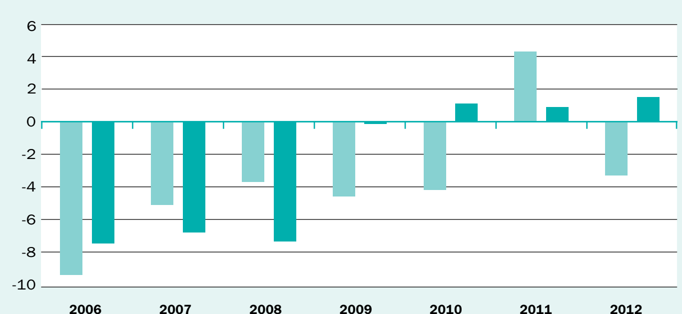
Further progress was made on the long-standing issue of foreign currency mortgages. Two measures on this issue were adopted in May and September 2011 (when early pre-payment at preferential exchange rates was permitted). This prompted several foreign banks to undertake substantial write-downs of their portfolios in Hungary and forced recapitalisations by these bank groups. The government found some reconciliation with the industry in an agreement in December 2011. This agreement allowed those banks which had booked losses through the early repayment of mortgages at preferential exchange rates (made possible through the regulation of September 2011) to credit 30 per cent of such losses against the special financial sector levy. The December agreement led to the restructuring of delinquent mortgages and the shielding of performing mortgage borrowers from excessive exchange rate fluctuations. On both aspects some burden-sharing between banks and the government was agreed.

Stability in financial sector regulation and taxation will be supportive of revived lending. The December 2011 agreement between the government and the banking industry also foresaw regular consultation on the role of the banking industry in stimulating growth, and a commitment not to impose a bank tax in 2014 higher than that in effect elsewhere in the European Union. Nevertheless, in July 2012 parliament adopted a tax that is to be levied on money transfers at a rate of 0.1 per cent up to a certain threshold per transaction, and on cash withdrawals (at 0.3 per cent), yielding an expected revenue of about 0.5 per cent of GDP in 2013 (earlier plans to also tax transactions by the central bank were dropped). While similar taxes have been prevalent in other emerging markets, transaction taxes are rare in the European Union, only used for securities, and so far there is no EU-wide transactions tax. While the government expects that this tax will be primarily borne by end-users of financial services, industry participants recalled the December 2011 agreement as specifically ruling out such additional taxes. An opinion on this tax by the ECB highlighted the risks to financial market liquidity and spillover effects in diverting financial activity into neighbouring countries.

Real GDP (1989 = 100)



Fiscal balance and current account balance



JORDAN

HIGHLIGHTS OF THE PAST YEAR

- **Jordan's economy proved vulnerable to external commodity price shocks as well as a worsening of its fiscal situation.** Both problems were likely to be amplified by regional political turmoil. The IMF has approved a request for a US$ 2 billion Stand-By Arrangement in August 2012.

- **Important progress has been made in financial sector reform.** Jordan has advanced in harmonising Basel III standards in capital, leverage and liquidity standards to strengthen banking supervision and risk management.

- **Legislation to improve the overall business environment is advancing.** A new Secured Lending Law has already been passed and a number of new draft laws have been developed on investment policy, bankruptcy and insolvency and an Islamic Sukkuk law.

PRIORITIES FOR 2013

- **Reform of the municipal infrastructure sector is urgently needed.** Significant resources are required to address water scarcity and enhance the efficiency of water usage and distribution. Private capital would help to fund upgrades of the urban transport systems through transparent public-private partnerships (PPPs).

- **Further efforts to improve energy efficiency need to be made.** A combination of a very energy intensive industrial sector coupled with persistent energy supply disruptions to the main gas pipeline from Egypt have resulted in an expensive overall energy bill. Reforms to increase the share of renewable energy are still outstanding and steps need to be taken to diversify sources of energy in the long term.

- **A key priority is addressing water scarcity and implementing reforms in the water and wastewater sectors,** in order to increase private sector participation, as well as to reform tariffs to reflect water scarcity. Improvements in water regulation and operational performance are also needed to meet increasing water demand.

MACROECONOMIC PERFORMANCE

The Jordanian economy continued to grow only moderately during the first half of 2012. Real GDP growth reached 3 per cent in the first quarter of 2012, and slowed slightly to 2.9 per cent in the second quarter, supported by a rebound in tourism and strong performance of the financial services sector, a key driver of economic growth. However, growth in the first half of the year was dragged down by a slow-down in manufacturing activity, along with contractions in agriculture, mining and construction. Policy space has been substantially reduced this year limiting the government's ability to boost economic growth. Inflation has risen throughout the year, reaching 4.8 per cent in August, up from 3.3 per cent in December, mostly due to increases in food prices, transportation and communication costs.

Fiscal and balance of payments pressures have intensified this year, prompting Jordan to seek and receive IMF assistance. The three-year, US$ 2 billion (7 per cent of GDP) Stand-By Arrangement approved by the IMF should help Jordan correct fiscal and external imbalances while maintaining the exchange rate peg. After reaching 12 per cent of GDP in 2011, the current account deficit has widened during 2012. Exports fell in the first half of 2012, but tourism and remittance flows have held up. FDI, however, remained depressed due to regional turmoil. The authorities have begun to implement a fiscal reform programme (a condition of the IMF loan) which will see increases in revenue-generating measures, such as tax increases on cars, tobacco, alcohol and airfares, along with cuts to subsidies and capital investments. The country remains dependent on foreign grants and loans, from bilateral sources (France, Japan, US and GCC) and IFIs, to secure its financing needs. Jordan also secured a US$ 250 million loan from the World Bank for budget support. In addition, the European Union has agreed to a €3 billion support package, to be disbursed over the next three years.

Risks to the economic outlook are significant. Growth will remain sluggish in 2012 and, with the conflict in neighbouring Syria likely to stay protracted, the negative repercussions on tourism and on investors' perceptions of the region are likely to be felt. Remittances are likely to remain strong especially since Gulf Cooperation Council economies are expected to perform well in 2012-13, but increasing energy prices and possibly unstable gas supply from Egypt could pose further problems.

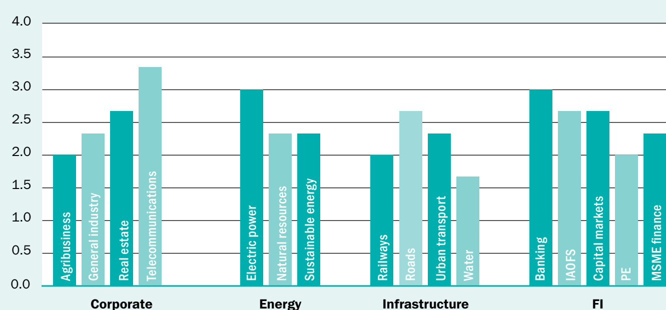
Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	5.5	2.3	2.6	2.6
Inflation (end-year)	-0.7	5.0	4.4	5.0
Government balance/GDP	-10.9	-7.5	-12.7	-10.5
Current account balance/GDP	-5.2	-7.1	-12.0	-14.0
Net FDI (in million US$)	1713	1172	1046	800
External debt/GDP	61.2	63.1	59.9	na
Gross reserves/GDP	48.1	48.6	39.0	na
Credit to private sector/GDP	4.7	7.8	9.0	na

Note: Government balance excludes grants.

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Economic reforms progressed cautiously throughout the year, with several important laws introduced since the beginning of 2011. These fall under the purview of the country's action plan, which is based on the Executive Development Programme of 2011-13. The programme is not only very comprehensive, addressing both regulatory and investment bottlenecks, but also demonstrates a clear focus on private sector involvement and support from the international community. Reforms in some key areas have already been undertaken, but they are lagging behind in others.

Jordan has made substantial progress in financial sector reforms. The appropriate regulatory framework and supervision mechanisms have been adopted through the completion of Basel II implementation in 2009, and the implementation of Basel III is ongoing in 2012. An automated data collection system was introduced in June 2010 and cross-border bank regulation has been enhanced. In 2010 the law establishing Private Credit Bureaux was adopted, but the first bureau is yet to be established. The low effectiveness of enforcement of bankruptcy procedures among borrowers, however, remains a significant impediment to increasing lending to both consumers and corporate borrowers.

While the government recognises the large challenges of the energy sector as one of its main priorities, it has only made limited progress so far on the reform side. The industrial sector remains very energy intensive, and significant reforms have not yet been enacted to increase the share of renewable energy in total generation. On the other hand, energy subsidies have expanded substantially in 2011. However, increasing fiscal pressures, associated partly with the rise of gas prices due to persistent disruptions to the pipeline from Egypt, have forced the government to modify some of those subsidies. As a result, subsidies on premium fuels were decreased in May 2012, while electricity tariffs for major industrial firms were raised.

Some reforms have been enacted to enhance competitiveness, investment, and private sector development along with labour market reforms. The legislative frameworks for both foreign and local investments have been improved. A new Secured Lending Law is now in place, in addition to a new draft Investment Law. Other laws that are in the pipeline for 2012 include a new Insolvency and Bankruptcy Law and an Islamic Sukkuk Law. Some structural issues with the labour market have been addressed, through a law easing the hiring and firing of workers. The government has also launched a US$ 211 million fund, running in partnership with the private sector and civil society, to promote inclusive growth and job creation. A US$ 1.41 million loan guarantee fund for SMEs was launched in August 2012 to facilitate SME access to credit.

Reforms are being enacted to ease conditions for local and foreign direct investment, especially in large infrastructure projects and in the municipal sector. Jordan has established public-private partnership-specific central government institutions and is in the process of enacting a PPP law (as opposed to the existing Privatisation Law, which is broader in focus). The government is also planning to launch a number of large infrastructure and renewable energy projects, which will require some sort of PPP formulation to attract the private sector.

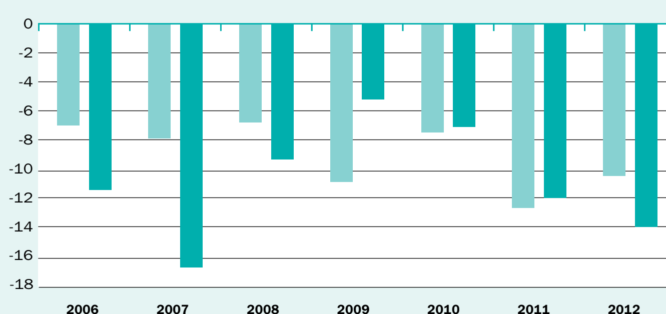
Despite considerable structural reform, the sustainable energy sector still faces substantial challenges. Jordan has made considerable progress in unbundling and corporatising its power sector, including drawing in substantial private sector involvement. However, the regulated tariff system, which is not cost-reflective, along with persistent energy subsidies, has limited competition in the sector and is in need of reform. On the renewable energy side (which accounts for less than one per cent of production despite Jordan's massive solar energy potential), the government published a framework in May 2012 to support and promote investment in the sector. However, due to limited fiscal space and constrained lending conditions in the banking sector, financing renewable energy projects remains a challenge. In this regard, a renewable Jordan Energy and Energy Efficiency Fund (JREEF) is in the process of being set up with the aim of providing some support for renewables and energy efficiency projects.

Real GDP (1989 = 100)

■ Jordan ■ EBRD-33

Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



KAZAKHSTAN

HIGHLIGHTS OF THE PAST YEAR

- **Gross domestic product (GDP) growth is strong but slowing down in 2012.** The deceleration of growth, to 5.6 per cent year-on-year in the first half of 2012, is largely explained by the poor performance in mining and construction, in part because of the unusually cold winter.
- **The banking sector remains weak.** Non-performing loans (NPLs) now exceed 30 per cent of total loans, while provisioning for NPLs remains sufficient according to official data. The third largest bank, BTA, started negotiations on a second debt restructuring in January 2012.
- **Further progress was made with regional economic integration.** Following the establishment of a customs union between Kazakhstan, Russia and Belarus in 2010, the three countries launched the next stage of economic integration – towards a common economic space – in January 2012.

KEY PRIORITIES FOR 2013

- **Restoring the health of the banking system is a key priority.** To reduce the high level of NPLs, the authorities need to conduct a thorough assessment of asset quality and ensure proper valuation and accounting of restructured loans.
- **State interference in business processes needs to be reduced.** This will help to balance public and private investments, with private businesses playing a greater role. The remaining price controls need to be phased out and corporate governance in state-owned enterprises should be strengthened further.
- **Energy sector reform is needed to address high energy intensity.** To enable investment in renewable energy, a comprehensive legislative and regulatory framework should be developed that includes feed-in tariffs and connection charges.

MACROECONOMIC PERFORMANCE

The economy grew strongly by 7.5 per cent in 2011 but growth has started to slow in 2012. The extraction and construction sectors experienced a contraction during the first quarter of 2012, in part because of unusually cold weather but also because of lower commodity prices. According to preliminary estimates, the economy rebounded in the second quarter but overall growth slowed to 5.6 per cent (year-on-year) in the first half of 2012. Lower global commodity prices have also caused inflation to fall to around 5 per cent during the first half of 2012.

The country's fiscal and external positions remain strong. The general government balance remained positive while the authorities have also managed to reduce the country's non-oil fiscal balance. The current account surplus rose to over 7 per cent of GDP in 2011, the highest level on record.

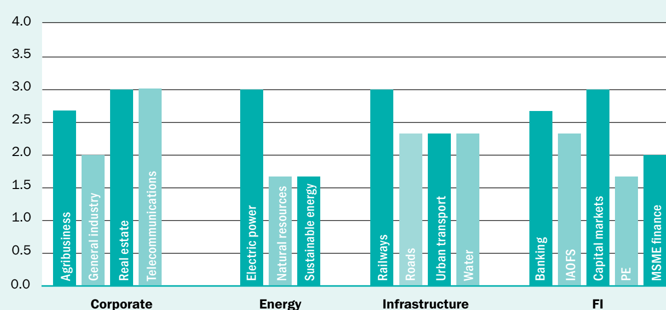
Bank credit growth recovered to over 17 per cent year-on-year in May, partly driven by subsidised state loan programmes. Several banking sector indicators remain weak: non-performing loans (NPLs) still exceed 30 per cent of total loans, provisioning for NPLs remains insufficient, and the third largest bank, BTA, is seeking a second debt restructuring less than two years after the first one. However, in April 2012 Fitch ratings agency upgraded the ratings of two of the largest banks, Halyk Bank and Kazkommertsbank, and confirmed the ratings of four other banks. Fitch characterised the sector overall as weak but stable.

On current trends, GDP growth is expected to slow to around 5.5 per cent in 2012. However, there are further downside risks arising from the impact of the eurozone crisis and prolonged global slow-down, which are likely to affect the country's main economic partners with spillovers to trade, finance and investment. Furthermore, the failure to restore the health of the banking sector could increase these downside risks.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	1.2	7.3	7.5	5.5
Inflation (end-year)	6.2	7.8	7.4	6.5
Government balance/GDP	-1.2	1.5	5.9	3.6
Current account balance/GDP	-3.6	1.6	7.6	6.2
Net FDI (in million US$)	10083	2931	9129	8979
External debt/GDP	97.9	79.9	66.5	na
Gross reserves/GDP	18.1	19.1	15.8	na
Credit to private sector/GDP	49.0	34.8	32.2	na

2012 sector transition indicators



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The role of the state has increased in a number of key sectors. In June 2012 the parliament approved amendments to legislation regulating state monopolies, limiting them to cases related to national security, defence, protection of public order and health. However, no concrete reduction in state monopolies has thus far been made; instead, the role of the state has increased in the natural resources and mining sectors. Following a long dispute with existing private shareholders, a 10 per cent stake in the Karachaganak Petroleum Operating (KPO) consortium was transferred to Kazakhstan in June 2012. In January 2012 the state also acquired the pre-emptive right to purchase raw and commercial gas, while the National Bank of Kazakhstan (NBK) obtained the pre-emptive right to purchase refined gold "in order to protect the national interest." Furthermore, there are proposals for new legislation that would require a mandatory 50 per cent state stake in any new oil or gas pipeline projects.

The implementation of the strategy to resolve problems in the banking sector has been slow. The new mechanism to deal with impaired loans launched by the authorities in April 2012 combined a centralised problem loans fund, established and funded by the NBK and other investors, and bank-run Special Purpose Vehicles (SPVs). In late-2011, parliament approved legislation to remove some of the tax disincentives for NPL write-offs and to create a second Distressed Asset Fund, effective from 2012, but the latter is expected to begin operating only towards the end of 2012.

Kazakhstan has improved its ease of doing business ranking. According to the 2012 World Bank *Doing Business* Report, Kazakhstan improved its ease of doing business ranking from 58th to 47th position among 183 countries. Major improvements were made in the area of investor protection with adoption of stricter regulation on transactions between interested parties. At the same time, the country still ranks poorly in trading across borders and dealing with construction permits.

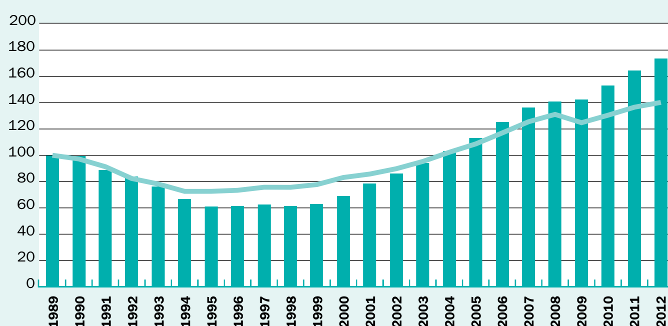
Railway sector reform has been slow, but there has been some recent progress. Kazakhstan Temir Zholy (KTZ), the main railway carrier, proceeded with the implementation of the restructuring plan adopted in November. In March 2012 KTZ completed implementation of an anti-corruption programme, which included specialised training for KTZ staff, adoption of a corporate ethics code, and a campaign for zero-tolerance towards corruption. In the power sector, new legislation adopted in July 2012 introduces a long-term capacity payment system, which represents a step away from a market-based system. In addition, the development of competition in the sector in the medium term may be constrained by the use of a single buyer system to award contracts for new generation capacity.

Further progress has been made with regional economic integration. Following the establishment of a customs union between Kazakhstan, Russia and Belarus in 2010, the three countries launched the next stage of economic integration in January 2012. This stage envisages the creation of a common economic space within the Eurasian Economic Community. The stated ultimate goal of the community is free movement of goods, capital and people, as well as harmonisation of macroeconomic and structural policies. The Eurasian Economic Commission, a newly established supranational body of the community, is expected to gradually take over a number of responsibilities from the national authorities in areas such as competition policy, technical regulations and environmental standards. Key decisions will be taken by the Council of country representatives based on the "one country, one vote" principle. Thus far there is not much evidence that the integration process under the Russia-Kazakhstan-Belarus Customs Union (CU) has increased trade between the CU countries, but larger benefits are likely to come from gradually liberalising services sectors and market access within the economic union.

Bilateral World Trade Organization (WTO) accession talks are expected to be concluded by the end of 2012, in which case Kazakhstan could join WTO around mid-2013. The remaining discussions focus on support for agriculture, export duties on natural resources and local content requirements in the hydrocarbon industry.

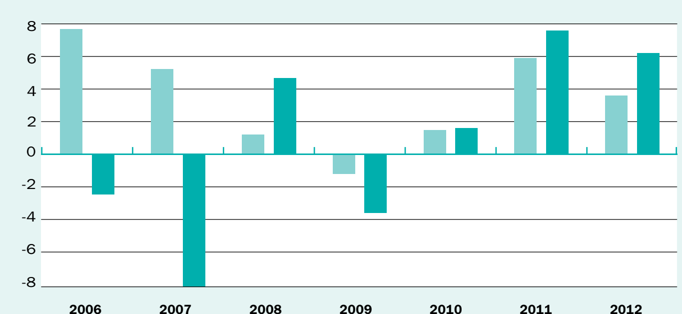
Real GDP (1989 = 100)

■ Kazakhstan ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



KYRGYZ REPUBLIC

HIGHLIGHTS OF THE PAST YEAR

- **The authorities have embarked on an ambitious reform programme.** It includes major cuts in the number of licences and inspections, as well as plans for radical reforms in public administration, fiscal policy, mining and energy.
- **The economy grew strongly in 2011 but contracted in the first half of 2012.** Real GDP grew by 5.7 per cent in 2011 after a decline in 2010, but problems at the biggest mining site in February 2012 caused a temporary economic contraction in the first half of the year.
- **The fiscal framework has been strengthened.** Key measures included the establishment of a public financial management committee, extension of treasury coverage of general government operations and adoption of a medium-term debt management strategy.

KEY PRIORITIES FOR 2013

- **The new government should continue its ambitious plans to improve the business climate.** Key priorities for the country are strengthening governance and transparency, protecting private property rights and lowering the cost of doing business by radically simplifying regulation, inspections and licences.
- **The role of the state in the banking system should be reduced.** The main challenge is to increase confidence in the banking system, including through a successful and transparent privatisation of two large banks.
- **The energy sector is in need of modernisation and structural reform.** A recently adopted medium-term strategy for sector development needs to be implemented, with a focus on improved public administration over the sector, improved corporate governance and transparency and increased operational efficiency.

MACROECONOMIC PERFORMANCE

The economy has recovered well from the 2010 socio-political crisis. Political stability improved following the presidential elections in October 2011 and the successful formation of a new four-party government. Macroeconomic stability returned as well, with GDP growth recovering to 5.7 per cent in 2011 on the back of strong growth in manufacturing, transport and telecoms, combined with higher gold prices and a rebound in neighbouring countries. The general government deficit was kept below 5 per cent of GDP in 2011, reflecting higher tax revenues and lower than planned expenditures. Inflation decelerated sharply from above 20 per cent in early 2011 to below zero in April 2012 and remained around that level until June, mostly reflecting international commodity price developments. A combination of industrial action and difficult weather conditions in the high-altitude pit at the Kumtor gold mine in early 2012 caused gold production to decline by 65 per cent year-on-year in the first quarter of the year and hence a GDP contraction of almost 6 per cent during the first half of the year. Nevertheless, non-gold GDP has continued to grow by nearly 4 per cent during the same period.

The external position is expected to deteriorate in 2012. The current account balance deficit narrowed in the first half of 2011 due to strong export demand, favourable gold prices and a rapid recovery of remittance inflows, mostly from Russia but remained around 6 per cent of GDP at the end of 2011. The early indications of a slow-down in Russia and Kazakhstan are likely to have a negative impact on exports and remittances in 2012. The situation is not helped by the fact that Kazakhstan introduced various barriers for Kyrgyz food exporters in late 2011. Meanwhile, financial stability has improved and further banking system restructuring is under way. Private sector credit increased by 21 per cent in 2011 and non-performing loans declined from 16 per cent at the end of 2010 to 10 per cent in December 2011. The microfinance sector remains very vibrant and helps to ensure that credit continues to flow to small and medium-sized enterprises.

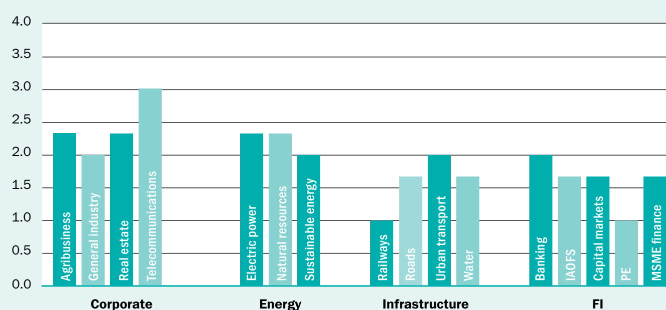
GDP growth in 2012 will likely be negative. This is a result of the temporary mining sector contraction and unfavourable weather conditions affecting agriculture. The outlook for GDP will depend to a large extent on eurozone developments, which will affect the gold price, as well as economic developments in Russia and Kazakhstan, which will influence remittances and exports.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	2.9	-0.5	5.7	-1.1
Inflation (end-year)	0.0	18.9	5.7	7.5
Government balance/GDP	-8.0	-5.6	-4.9	-6.0
Current account balance/GDP	-2.5	-6.4	-6.3	-12.8
Net FDI (in million US$)	190	438	694	432
External debt/GDP	91.6	87.7	76.9	na
Gross reserves/GDP	32.0	33.6	31.0	na
Credit to private sector/GDP	12.5	12.4	11.4	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The new government has embarked on a radical reform programme to improve public administration and boost the business environment. The first presidential election under a new form of republic governance took place in October 2011. Following the elections, the new government has made major progress with their 100-day action plan focusing on anti-corruption measures. The financial police was liquidated, 72 types of licences were abolished in early 2012 and the number of activities subject to licensing requirements is expected to be reduced further, from 500 before the start of reforms to 220. The level of civil service staff was cut by 15 per cent as a result of restructuring and consolidation of various agencies and a substantial reduction in the number of agencies conducting regular inspections of businesses. Various services provided by the state had been reviewed and their total number was drastically reduced, from around 20,000 to 386. The authorities also adopted a plan for fighting corruption in 2012-14. Related measures include a moratorium on checks and inspections of businesses and implementation of a form of performance-based budgeting which takes into account progress in terms of reforms in various areas as measured by national polls and international rankings of the quality of business environment.

Banking sector reform is proceeding slowly. The banking sector continues to be characterised by a large state presence, but there are plans to privatise two of the largest banks, Zalkar Bank and the Savings and Settlements Company (SSC). The privatisation of Zalkar Bank is expected to be concluded by the end of 2012, while plans for the privatisation of SSC remain uncertain. At present, the authorities use SSC to implement the lending support programme to farmers. The legal framework for the resolution of banking sector problems is weak and impedes restructuring of the four banks currently under conservatorship. The authorities have also progressed in establishing a State Development Bank (SDB) to support economic activity, mainly in agriculture. However, there is no agreement so far on the source of funds for the SDB.

There has been good progress in the area of public finance management (PFM) and the achievements in this area remain on track. Establishment of a high level PFM committee, which became operational in 2012, was a major step forward in this area. The authorities also adopted a decree to extend treasury coverage to the remaining extra-budgetary funds, including the Social Fund. A medium-term debt management strategy was developed and adopted. Further steps are however necessary to strengthen the fiscal framework through better organisation of the Ministry of Finance, and upgrading standards of public procurement.

The authorities have drafted a new law on natural resources and new regulations on licensing in the natural resources sector. These plans were included in the “100 days” reform programme. In April 2012 the government adopted amendments to the regulations on mining licences that would force some holders of a mining licence to establish a business entity and transfer a 20 per cent share of this entity to the state. This was, however, cancelled in June after consultation with investors and representatives of the mining sector. Recently, the parliament has ordered a review of the agreements between Kumtor and the country with a possible increase in the participating rights of the Kyrgyz Republic state. These developments could have a negative impact on the investment climate as they may increase state influence in the sector and create uncertainty among foreign investors regarding the protection of private property rights.

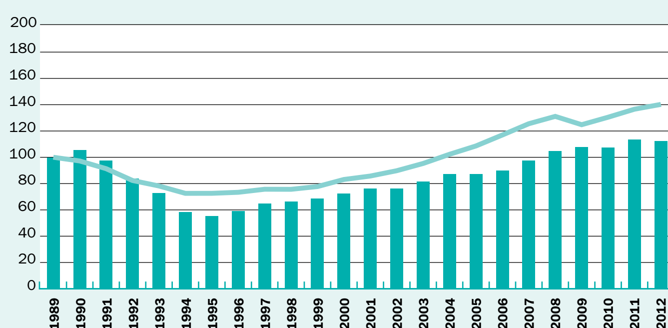
The energy sector remains largely unreformed but the authorities have adopted a medium-term energy sector strategy for 2012-17. The strategy, adopted in July 2012, was prepared in cooperation with the World Bank, the Asian Development Bank and USAID. The priorities identified in the medium-term are improvement of the public administration over the sector, a better management of the energy companies, including improved corporate governance and transparency, and increasing energy efficiency and output.

A new law on public-private partnerships (PPPs) was enacted in February 2012. The law defines a concept of PPPs and provides for private sector participation in the design, financing, construction, restoration and reconstruction of infrastructure facilities under concessions for up to 50 years.

The Kyrgyz Republic became the sixth full member of the Eurasian Development Bank. Membership occurred in September 2011, with the country joining Armenia, Belarus, Kazakhstan, Russia and Tajikistan. Potential accession of the Kyrgyz Republic to the customs union of Belarus, Kazakhstan and Russia remains under negotiation.

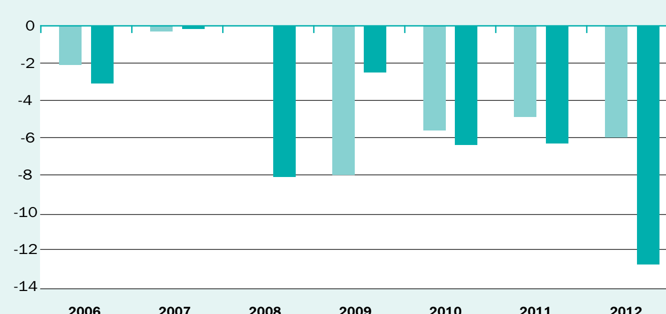
Real GDP (1989 = 100)

Kyrgyz Republic EBRD-33



Fiscal balance and current account balance

Fiscal balance (% of GDP) Current account balance (% of GDP)



LATVIA

HIGHLIGHTS OF THE PAST YEAR

- **The EU/IMF programme was successfully concluded at the end of 2011.** This paves the way for compliance with key Maastricht criteria for public finances, and the government remains committed to euro adoption in 2014.
- **The authorities have delivered a strong policy performance.** As a result, Latvia has regained its investment grade sovereign credit rating and managed to return to international capital markets with substantial issues at manageable yields.
- **The restructuring of the financial sector has progressed well.** This applies particularly with regard to the successor institution to Parex, formerly the second largest bank in the country. The restructuring of Mortgage and Land Bank (MLB) is also under way.

KEY PRIORITIES FOR 2013

- **The government should continue to pursue its competitiveness agenda.** Skill mismatches are an increasingly prominent constraint on growth. Poor indicators for private research and development (R&D) and vocational training in comparison with European partners underline the need for improvements in these areas.
- **The government should implement plans to improve the management and transparency of state-owned companies.** Important proposals include moving to partially centralised ownership of state-owned enterprises, and regular publication of financial accounts.
- **The gradual reinstatement of contributions to private pension funds should continue.** The substantial assets accumulated in this process could begin to feed local needs for long-term funds, with prudent portfolio diversification remaining the key priority.

MACROECONOMIC PERFORMANCE

Latvia has seen a consistent recovery since early 2010, following a dramatic 20 per cent drop in GDP in 2008-09. The year 2011 saw one of the highest growth rates in the European Union (at 5.5 per cent) despite the implementation of further fiscal austerity measures. Exports remained on a steady expansion path in spite of the slow-down in the core eurozone economies in the second half of 2011, with capital and consumption goods performing particularly strongly. Industrial production weakened from the second half of last year, though still showed growth of about 7 per cent in annual terms in the first months of 2012. Despite this weakening in the external environment the economy showed one of the strongest quarterly growth rates of all EU countries in the second quarter, with a 1 per cent expansion compared with the previous quarter. Unemployment continues on a steady downward trend to currently almost 16 per cent.

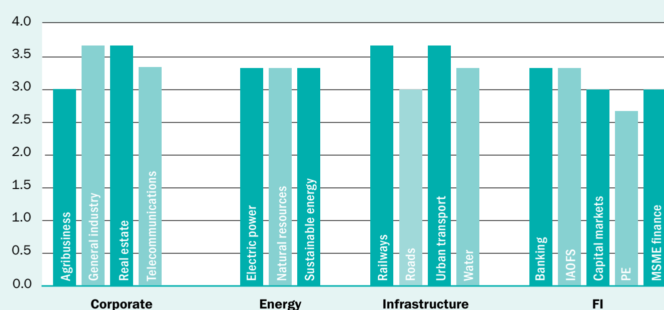
Latvia concluded its three-year financial programme with the European Union and IMF in December 2011, and the balance-of-payments position (with a very small current account deficit in 2011) had adjusted to the point where the government did not need to draw on a substantial share of the available programme funds. The government remains, in principle, committed to eurozone accession in 2014, on which a decision will be taken by mid-2013. Euro membership could further reduce the cost of major refinancing needs in the coming years.

Further fiscal measures have already brought the fiscal deficit down to a much better than expected 3.5 per cent of GDP in 2011, and in the first half of 2012 the budget has similarly outperformed plans. External assessments by the European Commission (EC) and the IMF therefore expect that ambitious fiscal targets this year can be met. The target for inflation (which in July 2012 stood at only 1.7 per cent compared with a year ago) is similarly likely to be met, and reductions in indirect taxes have helped in this regard. The positive policy performance has been reflected in a number of sovereign rating upgrades, which paved the way for Latvia's return to the capital markets in summer 2011 and again in February 2012. Overall credit to the private sector contracted by 8 per cent in 2011, though in the face of emerging capacity constraints corporate lending has expanded modestly. As in the other Baltic economies, foreign-owned bank subsidiaries continue to reduce their liabilities to their parents.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-17.7	-0.9	5.5	4.2
Inflation (end-year)	-1.4	2.4	3.9	1.9
Government balance/GDP	-9.8	-8.2	-3.5	-2.0
Current account balance/GDP	8.7	3.0	-2.2	-2.0
Net FDI (in million US$)	157	359	1457	1024
External debt/GDP	164.3	165.0	137.2	na
Gross reserves/GDP	25.7	31.7	22.5	na
Credit to private sector/GDP	108.8	104.2	93.9	na

2012 sector transition indicators



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

The short-term outlook is for a substantial weakening in growth as the eurozone stagnates. Continuing tight fiscal policy, wage adjustments in the face of still considerable unemployment and the contraction in credit remain key impediments to Latvia's growth in the next two years. There is also an ongoing risk to bank asset quality, with the share of non-performing loans still remaining at around 12.5 per cent.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The government has focused on strengthening competitiveness and the investment regime. An action plan of 645 measures in such areas as human capital, innovation and investment promotion was adopted by parliament in February 2012. Strengthening education is a key priority; for instance, enrolment in vocational education in Latvia remains one of the lowest in the European Union. The action plan comprises measures on higher education, where infrastructure and equipment are to be modernised, and legislative changes aimed at enhancing flexibility and focusing on study fields more in line with demand expressed by industry. Private R&D spending remains the lowest in the European Union, though the government is seeking to take steps to accelerate the commercialisation of scientific research, for example, by establishing competence centres and stimulating knowledge transfer.

Latvia remains an attractive location for foreign direct investment. Inflows accounted for about 5 per cent of GDP in 2011, in line with the other Baltic economies. A recent initiative by the president is to give greater autonomy to regional governments in giving incentives for investment in production facilities. The government remains committed to strengthening attractiveness to FDI investors in priority sectors, such as export-oriented manufacturing or energy efficiency investments.

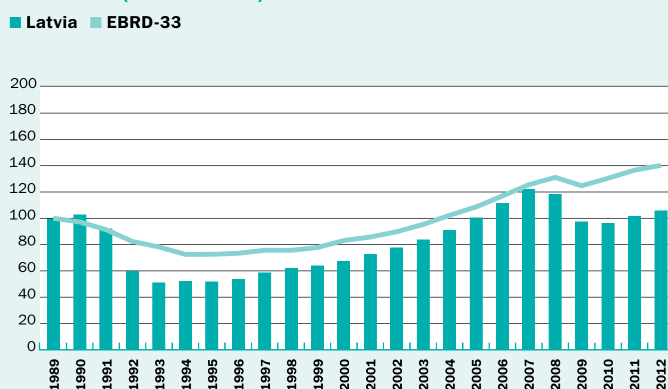
The governance and anti-competitive conduct of state-owned companies remains a concern for private investors, though the government is pursuing measures to address these issues. The government's intention is to partially centralise ownership of state-owned enterprises, and to enhance transparency through regular publication of financial accounts. The decision by Latvenergo to have its long-term bonds quoted on the local exchange and to comply with the resulting listing requirements is a step in this direction. The nationalisation of the remaining shares in the state airline, Air Baltic, became necessary following the failure of Lithuanian Bank Snoras, and of its Latvian subsidiary. However, the airline remains loss-making and required a substantial cash injection by the government in October 2011. This may give rise to a state-aid investigation by the EC.

Integration in the regional energy markets remains a priority. In August 2012 the government announced measures that mandate large enterprises to contract their electricity in the open market (as opposed to transacting at regulated prices). This is expected to enhance competition, ultimately also benefiting households. The planned nuclear power plant and LNG terminal in Lithuania could also help to reduce energy costs in Latvia.

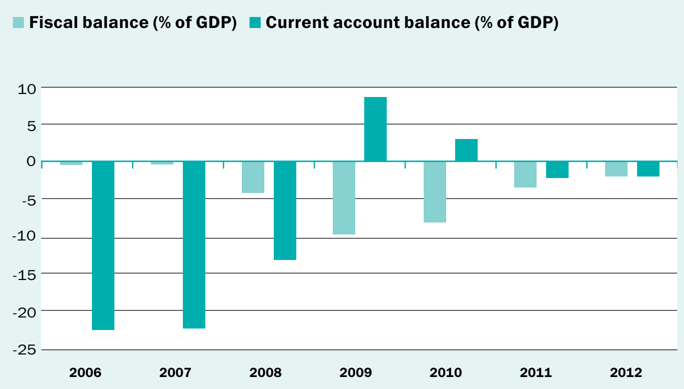
The financial sector continues to return to health. The liquidation in November 2011 of Krajbanka, the subsidiary of Lithuanian Bank Snoras, was due to an isolated case of fraud at the parent bank. The supervisor has since confirmed through more in-depth on-site inspections that no similar problems exist in other banks. This bank failure did, however, highlight some remaining inefficiencies in the coordination of supervisory intervention with other countries in the region, even though this coordination is in principle very close, given the contacts built up through the Nordic-Baltic Memorandum of Understanding (MoU). Elsewhere, Citadele Bank, the "good bank" successor to Parex Bank following its nationalisation in late 2008, is continuing its restructuring programme, including through the sale of various foreign participations in agreement with the competition directorate of the EC. This should facilitate the ultimate objective of transferring the bank back into private ownership and reviving growth in credit in the domestic credit market. The remaining institution – also named Parex Bank – that took over delinquent assets ceased commercial banking operations in March 2012. Renamed Reverta, it continues to manage delinquent assets with a view to maximising recoveries. The sale of Mortgage and Land Bank (MLB), Latvia's eighth largest bank and the remaining state participation in the sector, is progressing and, according to the government, should be concluded by the end of 2012.

The government is committed to gradually reinstating contributions to private pension funds. During the severe 2009 recession, Latvia reduced contributions to mandatory (second pillar) pension funds from 8 to 2 per cent of gross salaries, similar to measures also adopted by several other countries in central Europe and the Baltics.
In July 2012 the government approved a gradual increase of contributions from 2013 to ultimately 6 per cent in 2016, underlining a commitment to the three-pillar model. These funds, which currently hold assets of about €1.5 billion, could be an important source of local long-term capital, which is increasingly sought by large domestic enterprises. The decision to gradually increase the retirement age to 65 years, from the current 62 years, along with several other changes in entitlements, should also help to put the finances of the state system on a more sustainable footing.

Real GDP (1989 = 100)



Fiscal balance and current account balance



LITHUANIA

HIGHLIGHTS OF THE PAST YEAR

- **Lithuania recorded the EU's second highest growth in 2011.** The country benefited from good diversification in exports across markets and products. Relatively low household debt and a reviving labour market have supported private consumption, underpinning a balanced recovery.
- **A mid-sized, locally owned bank was closed in late-2011.** This was due to an isolated case of fraud and the bank's closure and safeguarding of deposits was handled well by the authorities. This incident has nevertheless prompted greater attention to bank governance.
- **The government has adopted an ambitious programme on raising skills and competitiveness.** Among other measures, the programme aims to make improvements in the governance and transparency of state-owned enterprises.

KEY PRIORITIES FOR 2013

- **More technology-intensive sectors that are oriented towards export markets should be developed.** Knowledge absorption could be raised not just through policies aimed at domestic innovation but also through facilitating Lithuanian firms to establish a foothold in foreign markets.
- **There is a need to further develop sources of equity capital outside the banking sector, such as private equity and venture capital.** Risk-oriented and long term capital are sparse within a banking sector that continues to adopt tight credit standards and reduce foreign liabilities.
- **Energy intensity of the Lithuanian economy remains one of the highest in the European Union and diversifying sources of energy supplies remains a key objective of the government.** Energy efficiency investments will need to be stepped up, in particular in public buildings, and a wider set of regional electricity connections should be established.

MACROECONOMIC PERFORMANCE

In 2011 Lithuania experienced the second fastest expansion in the EU, as gross domestic product (GDP) grew by 5.9 per cent. This recovery from the deep recession of 2008-09 has been balanced between external demand and domestic private consumption and now enters its third year. Along with other countries in the region Lithuania showed a clear weakening in growth towards the end of 2011 following the renewed instability in the euro area. Growth figures for the first half of 2012 showed a reduced pace of about 3.5 per cent growth compared with a year earlier. Robust export growth is underpinned by much-improved competitiveness indicators. In early 2012 exports stood at 24 per cent above the level of 2008. With nominal wage reductions in the face of the financial crisis, real unit labour costs have fallen by about 7 per cent since early 2008, in contrast to several other central European countries. On the back of recovering corporate profits and regaining flows in credit to the corporate sector fixed capital investment has also recovered, showing a growth of 18.5 per cent in 2011. Unemployment, which peaked at over 18 per cent in mid-2010, has since dropped markedly (though it was still at 13.2 per cent in mid-2012). The labour market nevertheless remains a concern as youth unemployment stands at 24.8 per cent and the employment rate at only 60.7 per cent is significantly below the EU-wide target of 75 per cent.

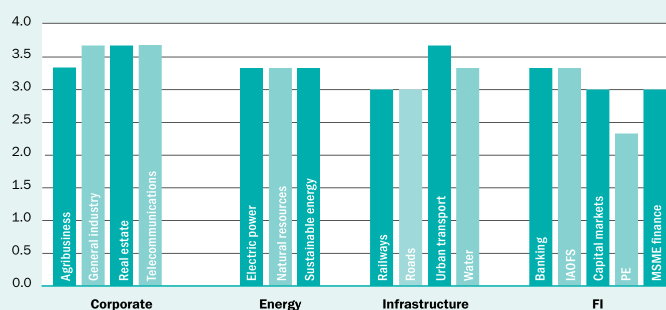
Lithuania's general government deficit remained precariously high in both 2010 and 2011. The country hence witnessed a rapid deterioration in its public debt indicators, with public debt now projected to continue climbing to a peak next year at just over 40 per cent of GDP. The authorities seek to comply with Maastricht deficit criteria already in 2012, notwithstanding the government's somewhat lower growth expectations. These plans were backed up in 2011 through a four per cent across-the-board spending cut. Given excessive pre-crisis foreign funding, banks in Lithuania continue to reduce external liabilities, last year at a rate of about 3 per cent of GDP.

Short-term growth prospects are constrained by internal and external factors. As in the other Baltic economies the constraints in credit availability coupled with weakness in export markets will likely keep growth below 3 per cent this year and next. While the government is committed to a timeline for accession to the European Monetary Union (EMU) in 2014, it remains opposed to using indirect taxes and administered prices towards that end.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-14.8	1.4	5.9	2.7
Inflation (end-year)	1.2	3.6	3.5	3.5
Government balance/GDP	-9.4	-7.2	-5.5	-3.0
Current account balance/GDP	3.7	0.1	-3.7	-2.5
Net FDI (in million US$)	-184	666	1081	1005
External debt/GDP	91.5	85.8	76.1	na
Gross reserves/GDP	17.4	19.6	19.1	na
Credit to private sector/GDP	66.7	59.4	50.1	na

2012 sector transition indicators



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Lithuania has revived its efforts in structural reforms. Most of its policy ambitions have been articulated under the National Reform Programme which was updated in April 2012, and assessed by the EU Council, based on a proposal by the European Commission. The updated programme identifies some well-known obstacles to growth – principally, imbalances in the public finances, still insufficient competitiveness and productivity, problems in the business environment, underdeveloped infrastructure and high unemployment.

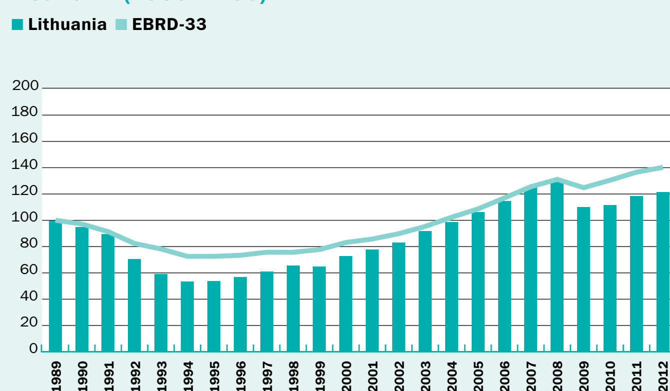
The government is taking steps to level the playing field for investors. These measures are taken in light of the ongoing concerns of private investors over governance issues and competition from the informal sector. The government continues to hold numerous stakes in state-owned companies, importantly in the energy, transportation and postal services sectors. For these companies there has been some progress in improving transparency and strategic planning. The Reform Programme underlines the fact that this sector has shown good revenue growth and has returned to profit in 2011. A full separation of regulatory functions from the ministries which also manage the ownership stakes in these enterprises remains the government's ambition.

The national reform programme emphasises the need to raise competitiveness. The programme targets technology-intensive production through stimulating research and development. Private equity, which could be instrumental in providing seed capital for young and innovative firms, remains underdeveloped. The government's programme recognises the long-term nature of many of these plans, for instance in raising participation in the labour market, improving standards in education and training or in the development of clusters of innovative technologies. Education expenditure in Lithuania is already among the highest in the CEB region. However, the European Commission's 2012 Ageing Report suggests that over the next 50 years Lithuania's total population will decrease by 19.6 per cent with a parallel drop in the total workforce of almost 36 per cent. As a result, the dependency ratio (population aged 0-14 plus 65 and over relative to the workforce aged 15-64) is expected to increase from 45 to 82 per cent over that period.

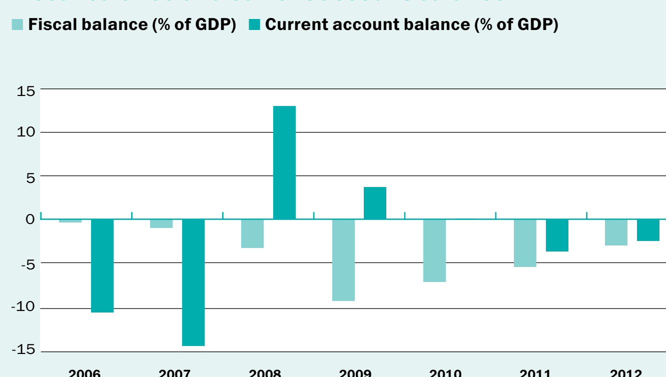
The energy sector remains a focus of the government's work. In 2010 the government adopted the Energy Independence Strategy, which is aimed at expanding generation capacity, raising energy efficiency and securing supplies through the connection to markets in continental Europe. In line with these plans some consolidation in the domestic electricity operators was implemented in 2011. The need to diversify sources of energy supply and enhance energy security has emerged as a major challenge following the closure of the Ignalina nuclear power plant and the uncertainty over the reliability of gas supplies from Russia, from where all gas is imported. In May 2012 the government gained full control over the gas distribution network within the country and in July an agreement on the construction of a floating LNG terminal in the port of Klaipeda was reached, which bodes well for the government's energy independence strategy. Plans for a new nuclear power plant have progressed but were subject to a referendum in October 2012.

In the financial sector, the authorities are keen to put in place a regulatory framework that will prevent the excesses of the previous lending boom. The personal bankruptcy law was streamlined, and in September 2011 a regulation for responsible lending was adopted that aims to prevent the re-emergence of unsustainable credit and house price developments. The failure of a mid-sized local bank (Bank Snoras) in November 2011 motivated greater government attention to the governance and business models of locally owned banks. The bank's failure was due to an isolated case of fraud, but it briefly eroded depositor confidence in the viability of the few remaining locally owned banks, as was evident in deposit flight from such institutions immediately following this incident. This bank closure was handled expeditiously and all retail deposits of Snoras were honoured, though as a result of the closure of the bank the public sector has assumed a liability of at least 2.5 per cent of GDP in excess of the assets in the deposit insurance fund.

Real GDP (1989 = 100)



Fiscal balance and current account balance



MOLDOVA

HIGHLIGHTS OF THE PAST YEAR

- **The authorities are pursuing ambitious reforms to improve the business environment and public sector governance.** The government is implementing a second round of the "Regulatory Guillotine" to further reduce the regulatory burden on the economy. A law on state inspections reduced the frequency of inspections and set limits on inspectors' discretion.
- **The rules on ownership and governance of banks have been improved.** The central bank and the government now require prior authorisation of the transfer of banks' shares, and parliament has approved legislation requiring greater transparency of banks' ownership.
- **The ban on privatisation of a number of large enterprises was lifted.** Privatisation of national railway, airline companies, Banca de Economii and the telecommunications incumbent is now permitted.

KEY PRIORITIES FOR 2013

- **New policies on governance of locally owned banks should be implemented.** Implementation of new rules on disclosure of beneficial owners and enforcement of the central bank's fit and proper policies will likely test the government's commitment to reform and the country's weak judicial system. However, there is strong potential to significantly improve the business environment and depoliticise the sector.
- **The role of the state in the economy should be further reduced.** The authorities should proceed with privatisation of the landline incumbent and the national airline and consider divesting the railways.
- **Moldova's dependence on energy imports highlights the need to focus on energy security.** Implementation of the country's commitments to the European Energy Community should help diversify energy sources over time.

MACROECONOMIC PERFORMANCE

After growing rapidly in 2011, the economy slowed down in 2012. GDP expanded by 6.4 per cent in 2011 as manufacturing, wholesale and retail trade benefited from the favourable external environment and the agricultural sector recovered from the 2010 drought. However, the pace of output growth declined to 0.8 per cent in the first half of 2012 as industrial output suffered from the contracting external demand and lower agricultural production following a harsh winter. Remittances have also fallen although remain significantly higher than during the 2008-09 crisis. Consumer price inflation peaked at 9.2 per cent in August 2011, declining to below 4 per cent in June 2012 as global food prices decelerated and base effects of last year's large increase wore off. After tightening monetary policy in 2011 to contain inflation, the central bank reduced policy interest rates significantly as inflation subsided.

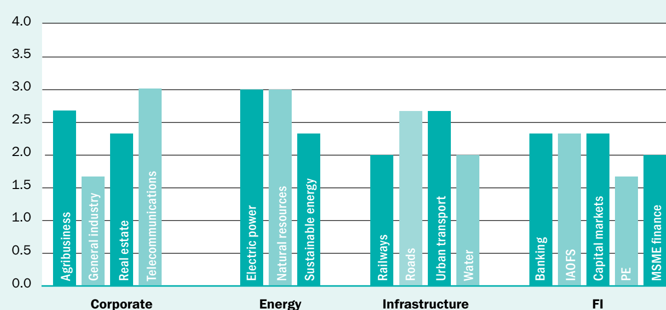
The authorities' reform programme continues to benefit from significant international assistance. The fiscal adjustment programme is progressing, although corrective measures were needed in early 2012 to address revenue shortfall, unbudgeted revenue commitments and external assistance delays. The central bank continues to pursue inflation targeting. The banking sector remains generally stable, and the risk of spillover from the eurozone crisis limited. However, in February 2012 the central bank put a small bank into liquidation. This measure had only a limited impact on the stability of the overall banking system. However, the state-owned Banca de Economii has seen its financial situation deteriorate further. The current account deficit widened in 2011 to around 12 per cent of GDP.

The country's longer term prospects depend on the government's ability to create a conducive environment for private sector development. In the immediate future, the economy will continue to be affected by the developments in the European Union and Russia. With output per capita very low, Moldova has strong potential to increase labour productivity and maintain a fast pace of growth over time. However, as the public sector balance sheet is relatively stretched and the country requires fiscal adjustment to be able to graduate from dependence on international financial support, growth would have to come from the private sector. Reforms to improve the functioning of the judiciary, reduce public sector corruption and strengthen tax administration and customs and gain greater access to the CIS and EU markets should help attract significant foreign and domestic investment in the export-oriented sectors.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-6.0	7.1	6.4	1.0
Inflation (end-year)	0.5	8.2	6.1	6.6
Government balance/GDP	-6.3	-2.5	-2.4	-1.5
Current account balance/GDP	-8.6	-7.9	-11.5	-12.0
Net FDI (in million US$)	139	194	253	260
External debt/GDP	65.5	67.3	64.4	na
Gross reserves/GDP	27.2	30.5	29.5	na
Credit to private sector/GDP	35.6	33.4	35.9	na

2012 sector transition indicators



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The authorities have made strides to improve the country's business environment. Reforms to cut red tape, improve competitiveness, and stimulate trade are ongoing. In the 2012 World Bank's *Doing Business* Report, Moldova advanced by 18 positions to rank 81st (out of 183 countries) on ease of doing business and came second in the top reformers list. The report highlighted that Moldova improved conditions for starting a business and its credit information system, made enforcements of court judgments more efficient, and amended the insolvency law to grant priority to secured creditors. The authorities have been implementing a "Regulatory Guillotine 2" programme to systematically reduce unnecessary regulations and improve legislation. The government is also pursuing a strategy of justice system reform. The main objective of the medium-term reform programme is to establish an independent and accessible justice system, consistent with EU standards. If implemented, the announced reforms should help make the judicial system more effective, decrease corruption and ensure citizens' equality before the law.

A draft law on state control over business has been passed. The law, passed by the parliament at its first reading in March 2012, is aimed at improving the business climate in the country by reducing the number of state bodies controlling business from 64 to 33, as well as decreasing the number of state control measures over businesses. A single system of audit and inspection activities will be introduced, and no inspecting agency will benefit from revenues generated from penalties levied on inspected enterprises. If implemented, the law could help to significantly improve the business environment by further limiting red tape, which is an important constraint to doing business in Moldova.

Legislation was amended to strengthen governance of financial institutions and increase transparency of banks' ownership. In January 2012 the parliament approved amendments to Laws on Financial Institutions and Securities Markets, mandating that equity interest in the capital of a commercial bank may be transferred from one entity to another only with the prior written consent of the National Bank of Moldova, and requiring more transparency of shareholders. The amendments, adopted in response to several high profile illicit transfers of banks' equity in the summer of 2011, should help improve corporate governance and the stability of Moldova's financial sector. In July 2012 parliament adopted legal amendments to increase the transparency of banks' beneficiary owners.

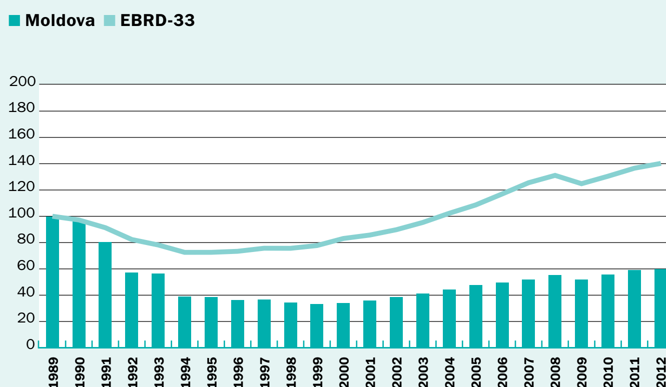
The government is pursuing privatisation of medium companies and expanding the privatisation list to include several large companies. In February 2012 the government auctioned the Chisinau jewellery factory raising US$ 5 million. In July 2012 the list of companies excluded from possible privatisation was amended to allow privatisation of Banca de Economii, the national airline and railways companies, and the landline telephone incumbent Moldtelecom. Privatisation of the majority state-owned Banca de Economii, if it goes ahead, should help modernise the banking system. However, the bank will need significant pre-privatisation restructuring and its governance problems will need to be addressed to attract a reputable international bidder at a time when bank equity is very difficult to raise. Other large-scale privatisations would also be expected to increase competition and address the fundamental conflict of interest whereby the government is both a regulator and owner of dominant enterprises in the sector.

Competition policy has been strengthened. The government has started to apply the new law on competition, approved in September 2011, which intends to emulate best EU practices and strengthen procedures for identifying, investigating and eliminating anti-competition practices. A council on competition will be established as a legal successor of the National Agency for Protection of Competition. The law was developed with assistance from the European Union, in the context of the country's ongoing negotiations on a deep and comprehensive free trade area with the European Union. The legislation on competition will be supported by a legal framework for state aid, aimed at creating a fair competitive environment in the economy.

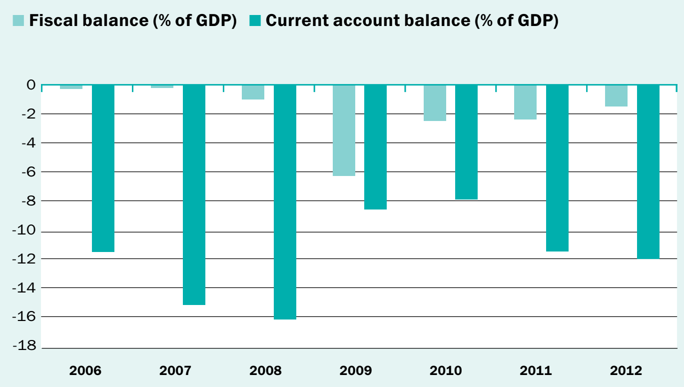
Reforms to facilitate debt resolution should increase financial intermediation over time. The financial sector in Moldova had suffered from complicated procedures for debt restructuring and execution of loan collateral. The procedures could last for years, thus making collateral effectively worthless. Amendments to the relevant laws, passed in June 2012, will simplify the procedures for debt collection and restructuring by clarifying instances when rights on collateral property can be exercised automatically and specifying the procedures for transfer of the collateral property to a claimer.

Monetary policy tools to fight inflation are being enhanced. The National Bank of Moldova switched to explicit inflation targeting in 2010, setting the medium-term target at 5 per cent, and has been following forward-looking policies, thus contributing to economic stability. An EBRD technical cooperation project is helping the central bank to make more informed policy decisions and strengthen its policy credibility by enhancing its forecasting and communication capacities.

Real GDP (1989 = 100)



Fiscal balance and current account balance



MONGOLIA

HIGHLIGHTS OF THE PAST YEAR

- **The mining boom in Mongolia continues.** Economic growth accelerated from 6.4 per cent in 2010 to 17.5 per cent in 2011 and foreign direct investment (FDI), predominantly mining-related, reached 44 per cent of gross domestic product (GDP) in 2011, up from 26 per cent in the previous year.

- **The government has further strengthened the fiscal framework.** The Integrated Budget Law (IBL) will improve the reporting of government contingent liabilities and strengthen public investment planning.

- **A new foreign investment law imposes new restrictions on foreign investment in mining, banking and other strategic industries**. Significant foreign investments in these industries will now be subject to government or parliamentary approval.

KEY PRIORITIES FOR 2013

- **The fiscal stability law (FSL) needs to be adhered to.** The FSL passed in 2010 is the cornerstone of Mongolia's fiscal framework for managing commodity revenues. It comes into force in 2013 and needs to be adhered to fully to ensure credibility of the overall framework.

- **The system of cash transfers to the population needs to become fiscally sustainable.** The unconditional monthly cash payment to each individual out of the Human Development Fund (HDF) imposes a high fiscal burden and is difficult to accommodate within the existing macroeconomic framework.

- **Sustained financial development calls for further strengthening of the legal framework for financial markets.** Improvements are needed, in particular, in the areas of deposit insurance, collateralised lending and securities trading.

MACROECONOMIC PERFORMANCE

The mining boom in Mongolia continues. Real GDP growth accelerated from 6.4 per cent in 2010 to 17.5 per cent in 2011 and remained strong in the first half of 2012 (13.2 per cent year-on-year). Growth has been supported by sustained high prices of copper and other commodities and record levels of FDI, which reached over 50 per cent of GDP in 2011. Expansionary fiscal policy also played a role: despite high growth, the general government recorded a deficit in excess of 3 per cent of GDP, largely due to increases in social transfers and public sector wages. This trend continued in the first half of 2012 in the run-up to the parliamentary elections held in June 2012. As a result, a larger fiscal deficit may be recorded in 2012 even as high commodity prices continue to boost government revenues.

In this context, stricter fiscal discipline would help Mongolia to better manage risks and avoid overheating. Against the backdrop of procyclical fiscal policy, inflation accelerated sharply, from 4 per cent year-on-year at end-May 2011 to 16 per cent at end-April 2012. The 2010 FSL, which introduces various measures aimed at improving fiscal discipline, will come into full force in 2013-14. Full adherence to the conditions of the FSL would require fiscal consolidation efforts as the law caps the structural fiscal deficit at 2 per cent of GDP (the structural fiscal deficit is calculated based on revenues estimated using historical average commodity prices).

The banking sector also experienced a boom. The mining boom led to a rapid credit growth (at the rates of 50 to 75 per cent year-on-year and even faster in the consumer segment). Consequently the non-performing loans ratio declined rapidly, to below 5 per cent, excluding the two banks in receivership, although the true quality of new assets is yet to be tested. Higher commodity revenues enabled the central bank to build up reserves of around US$ 2.5 billion (around four months of imports). The Bank of Mongolia also extended its swap line with China to US$ 1.6 billion equivalent. The economic boom also led to a sharp drop in the headline poverty rate, from 39 per cent in 2010 to 30 per cent in 2011, according to official estimates.

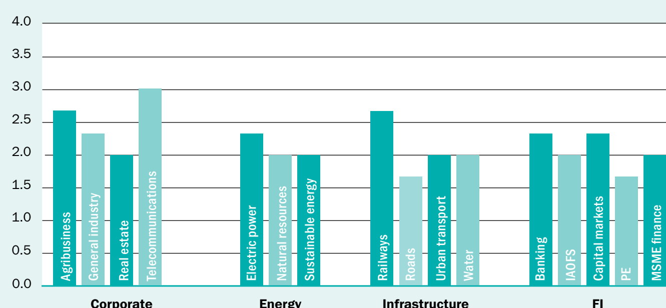
The economic outlook remains strong. Output growth is expected to reach 11.5 per cent in 2012, and perhaps accelerate further as new mining developments come on stream. The Oyu Tolgoi mine, one of the largest copper and gold deposits in the world, is on track to start operations in 2013 under the management of Ivanhoe Mines and Rio Tinto. Various options for development of Tavan Tolgoi, a multi-billion coal mining project, are currently being considered. At the same time, a downturn in global commodity prices may substantially weaken investment and economic activity given Mongolia's high, and growing, dependence on mining.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-1.3	6.4	17.5	11.5
Inflation (end-year)	4.1	13.0	10.3	15.0
Government balance/GDP	-5.0	1.2	-3.5	-9.5
Current account balance/GDP	-9.0	-14.9	-31.8	-31.4
Net FDI (in million US$)	496	1574	4620	2003
External debt/GDP	46.0	49.2	45.0	na
Gross reserves/GDP	28.2	36.6	28.1	na
Credit to private sector/GDP	43.9	44.0	47.0	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The fiscal framework has been further strengthened with an Integrated Budget Law (IBL) and a revised Procurement Law. The IBL was passed in December 2011 to complement the existing FSL. The law further improves reporting of government contingent liabilities, strengthens public investment planning, and lays the foundation for fiscal decentralisation whereby more responsibilities may over time be devolved to the local governments. A move towards an inflation targeting framework by the central bank is currently being considered.

In January 2012 the parliament also passed a Social Welfare Law, which provides for a means-tested poverty benefit. The benefit is expected to reach around one-fifth of households and include an additional child allowance. Over time, it may partially or fully replace unconditional cash transfers disbursed out of the Human Development Fund (HDF). At the same time, in the first half of 2012 the monthly payments out of HDF (MNT 21,000 per citizen, or US$ 17) continued and were complemented with larger disbursements to the elderly and the disabled (with the first tranche of MNT 330,000, [US$ 250]).

The government further announced distribution of a portion of shares of the state-owned coal company, Erdenes Tavan Tolgoi (ETT), to the population. Under the scheme, each member of public is entitled to a certain number of shares of ETT. Overall, up to 20 per cent of ETT shares have been earmarked for this scheme, while additional minority stakes may be sold later via an initial public offering (IPO) in the local and international markets. Prior to the June 2012 elections the government made an offer to members of the public to exchange their ETT ownership entitlement for a single cash payment in 2013 set at MNT 1 million (approximately US$ 775). The majority of the population opted for a cash payment and the authorities are expected to clarify further modalities of this scheme. In particular, some shares in ETT may be sold to local companies prior to the IPO in order to raise financing for cash transfers.

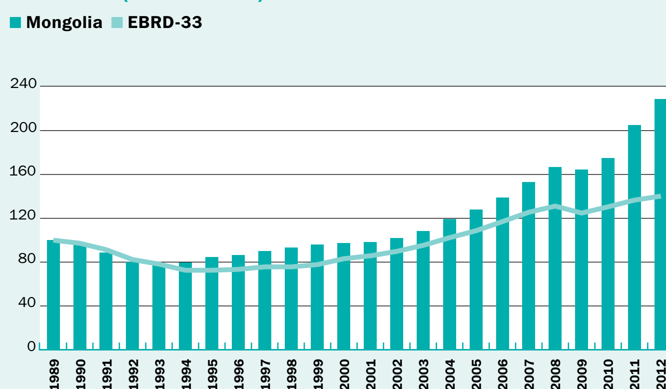
The recently established Development Bank of Mongolia (DBM) broadened its funding base. DBM, a state-owned development agency inaugurated in the middle of last year, managed to place US$ 600 million (around 8 per cent of GDP) in government-guaranteed five-year bonds at a 5.75 per cent yield. This yield is relatively favourable and suggests there is sustained investor interest in Mongolia. The use of proceeds is likely to include a combination of infrastructure and social housing projects, in line with the mandate of DBM.

In May 2012 Mongolia passed a law on foreign investment. The new law requires government approval for all investments by state-owned foreign entities. It also requires parliamentary approval of foreign ownership in excess of 49 per cent in companies operating in industries designated as “strategic”, namely, mining, finance, media and telecommunications. Large transactions involving minority foreign stakes in these sectors will be subject to government approval (within a 45-day period). The law aims to strike a delicate balance between the interests of the Mongolian people and the need to attract foreign expertise in key sectors, including mining. The parliamentary discussions of the law could have been in part influenced by the change of ownership of a major coal mining license in April 2012 when Ivanhoe Mines sold its majority stake in South Gobi Resources to China Aluminium Corporation (Chalco), majority owned by the Chinese state. The deal aimed to raise additional funds for development of Oyu Tolgoi, the core asset of Ivanhoe Mines and Mongolia’s largest mining development to date.

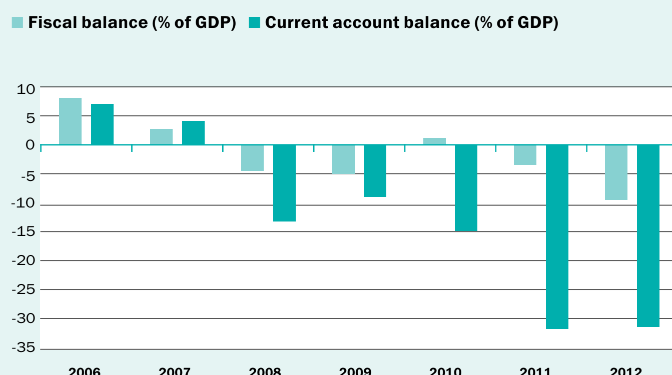
A number of legislative act governing the financial sector are being considered. The blanket deposit guarantee is set to expire in November 2012 and is expected to be extended and gradually replaced with a comprehensive deposit insurance scheme. A new securities law is a precondition for the planned dual listing of ETT shares.

Mongolia has adopted a law on gender equality. The law, adopted in February 2011, explicitly prohibits gender discrimination and introduces a 20 per cent quota for female candidates nominated by parties to stand in parliamentary elections. This provision was applied for the first time in the context of the June 2012 general elections.

Real GDP (1989 = 100)



Fiscal balance and current account balance



MONTENEGRO

HIGHLIGHTS OF THE PAST YEAR

- **Montenegro has begun EU accession negotiations.** The decision of the European Council in June 2012 to endorse the European Commission's recommendation reflects substantial and sustained progress in reforms in both the political and the economic spheres.

- **Montenegro became a member of the World Trade Organization.** This marks n important milestone in the country's trade integration agenda, and is likely to boost the country's growth potential in the medium to long run.

- **Important steps have been taken to develop Montenegro's energy potential.** Tariff reforms have progressed in the power sector, and plans are advancing in the development of an underwater interconnection cable between Montenegro and Italy.

KEY PRIORITIES FOR 2013

- **The fate of the main industrial enterprise needs to be resolved.** The future viability of the aluminium company KAP is highly uncertain. The government needs to come up with a clear action plan for either major restructuring or closure of this company, which still employs a significant portion of the labour force and accounts for a large share of exports.

- **Further strengthening of the financial system and maintaining adequate access to financing for the private sector, especially small and medium-sized enterprises (SMEs), is vital for economic recovery.** The state's involvement in this sector should be designed to ensure a level playing field and transparent regulation, rather than focused on support for selected troubled banks.

- **Moving ahead with the restructuring of the power sector is a priority to improving 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.

MACROECONOMIC DEVELOPMENTS

Economic performance has weakened substantially. After the severe economic contraction in 2009, Montenegro was on its way to a modest but steady recovery, growing at 2.5 per cent in 2010 and 3.2 per cent in 2011. Exports and tourism were the main drivers of growth in 2011, countering the drop in FDI inflows and an ongoing credit crunch. However, external demand has weakened substantially this year as a result of the impact of the eurozone crisis and, combined with weak domestic demand, this has resulted in a slight fall in GDP in the first half of the year. The weak external environment affected the aluminium producer KAP, Montenegro's largest enterprise and exporter, which was reflected in very volatile industrial production figures. In December 2011 industrial production marked the largest fall in two years, plunging 37.5 per cent year-on-year. In January 2012 it was down 24.5 per cent year-on-year. The current account deficit, which narrowed to 19.4 per cent of GDP in 2011, remains the highest in the region. Inflation has been on a generally upward trend this year. It stood at 4.4 per cent year-on-year in July 2012.

The fiscal position has been weakened by KAP nationalisation and weaker than expected growth. On the fiscal side, policies have become more prudent in the past couple of years, but the deteriorating economic situation and the activation of state loan guarantees related to KAP have prompted revisions of the 2012 budget. Public debt was close to 50 per cent of GDP as of August 2012. Following its country mission in February 2012, the IMF has expressed readiness to start negotiations for a credit arrangement with Montenegro.

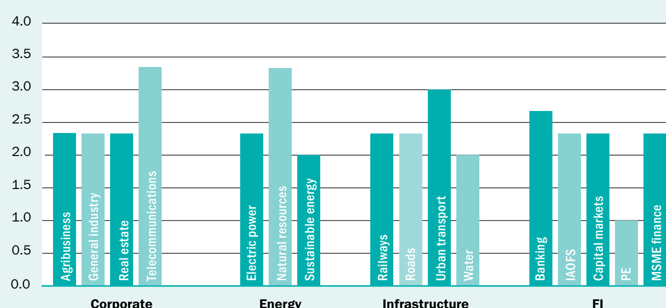
Negligible growth is expected in the short term. The eurozone crisis will continue to negatively impact Montenegro's economy and growth is forecast at negligible levels in 2012, with only a small rise in this figure expected in 2013. Diversification of the economy remains a challenge for building sustainable growth in the medium term, but the visible progress in the EU approximation process should help to attract further FDI and ultimately boost the country's growth prospects.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-5.7	2.5	3.2	0.3
Inflation (end-year)	1.7	0.7	2.8	3.5
Government balance/GDP	-5.7	-4.9	-6.5	-5.1
Current account balance/GDP	-29.6	-24.6	-19.5	-20.0
Net FDI (in million US$)	1485	733	541	474
External debt/GDP	98.0	96.0	94.6	na
Gross reserves/GDP	13.8	14.4	11.0	na
Credit to private sector/GDP	76.5	66.9	55.2	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Montengero's EU membership aspirations have received a significant boost. In June 2012 Montenegro received official approval from the European Council to proceed to the next stage of the EU accession process. The Council endorsed the European Commission's assessment that Montenegro was sufficiently compliant with the membership criteria to be able to start accession negotiations. The Council also highlighted that the government needs to make further efforts in addressing important remaining challenges, particularly the strengthening of judicial independence, tackling corruption and fighting against organised crime.

Montenegro has become a member of the World Trade Organization. Accession to the WTO finally took place in December 2011. Montenegro had started WTO membership negotiations in December 2004, but its accession was delayed due to disagreements on the bilateral treaty with a member of the WTO. When an agreement was finally reached and the bilateral treaty was signed in November 2011, the path was clear for Montenegro's accession in December. WTO accession may help boost trade and economic growth in the medium to long term.

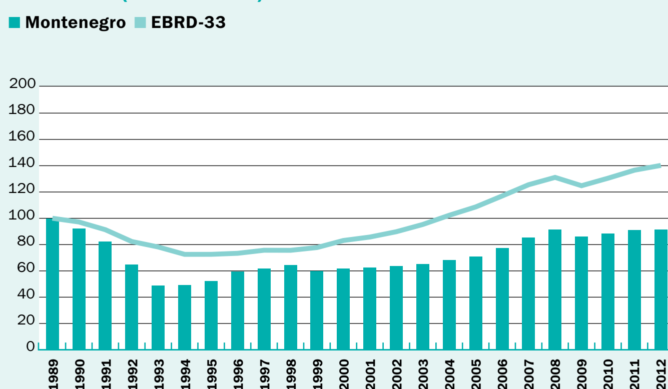
The state has repaid a major loan of KAP, for which it had provided a sovereign guarantee. In April 2012 the government paid from the budget €23.4 million (€22 million principal and €1.4 million interest and other expenses) to Deutsche Bank. Substantial payments to the Hungarian bank, OTP, are also overdue and are being negotiated. Although there have been some disagreements with the other major shareholder of KAP, that is, Russian EN+ Group, over how to manage the company's debt, the government has decided not to cancel the privatisation contract with EN+. KAP's financial situation is difficult and the company made a net loss of €21 million in the first half of 2012. Meanwhile, the government had a success in April 2012 when it managed to sell the steel company, Zeljezara Niksic, to a Turkish investor for €15 million. Two previous tenders for the sale of the company had failed to attract any bids.

Electricity tariffs are rising towards more cost-reflective levels. In December 2011 the energy regulatory agency of Montenegro approved an increase in electricity prices to compensate the electricity generation company, EPCG, for its rising production and import costs. The regulator approved an average increase in tariffs of 6.13 per cent. The highest increases of on average 6.7 per cent were applied to households. This represents a partial reversal of moves by the energy regulator last year to lower consumer tariffs.

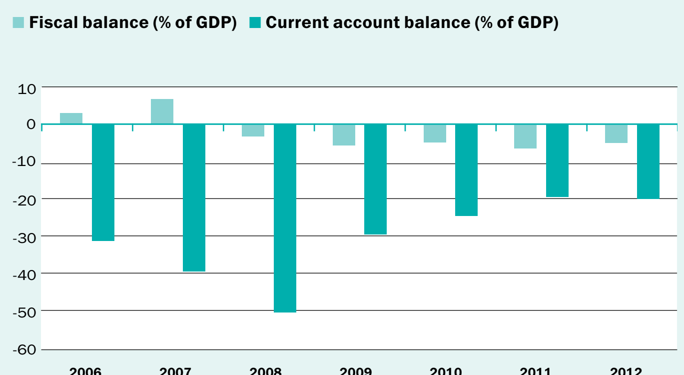
Plans are advancing for a major underwater cable with Italy. The construction of the Italy-Montenegro interconnection cable is expected to start by the end of 2015. The agreement on the establishment of a submarine interconnection between Montenegro and Italy was signed in November 2010. The interconnection cable will be 415 km long (of which 390 km will be under the sea). The Italian company, Terna, will begin the construction of the electricity transmission infrastructure. The company announced completion of the authorisation process on its side but this process is still ongoing on the Montenegrin side as the expropriation and public land (including maritime property) rights acquisition processes have not yet been completed. The detailed spatial plan has been approved by the Montenegrin government.

Deleveraging continued in the financial sector in the past year. Prior to the crisis between 2006 and early 2008, Montenegro reported annual credit growth rates of over 100 per cent. Since the crisis, however, significant deleveraging has taken place and this trend has continued at a vigorous pace over the past year. Private sector credit as a percentage of GDP fell from 69 per cent at the end of 2010 to 55 per cent of GDP at the end of 2011. The banking sector is also characterised by a high level of non-performing loans (NPLs). NPLs declined from about 21 per cent of total loans in 2010 to 15.5 per cent in mid-2012, but this figure is still at the higher end of the spectrum in the SEE region as well as the transition region more broadly.

Real GDP (1989 = 100)



Fiscal balance and current account balance



MOROCCO

HIGHLIGHTS OF THE PAST YEAR

- **Following robust economic growth in 2011, economic activities slowed down in 2012.** A weak agricultural harvest due to drought along with persistant weaknesses in the eurozone, the major source of external demand for Morocco, continue to dampen growth prospects.

- **The widening of both the current account and fiscal deficits pose significant risks to the outlook.** In response to the crisis last year, the government raised wages and increased subsidies and spending. The IMF programme agreed in August provides both confidence and a buffer against future shocks.

- **Notwithstanding major progress, some crucial reforms are still incomplete.** These are needed to enhance competitiveness in major sectors in the economy, as well as to improve the general business environment.

KEY PRIORITIES FOR 2013

- **Significant reforms are required in the energy, power, and natural resource sectors.** A combination of state-owned monopolies within a single-buyer market and considerable energy subsidies has created substantial market distortions. Subsidy expenditures can be reduced in conjunction with policies to replace open-ended commitments with targeted support for the poor.

- **There are urgent reform needs in the infrastructure sector, especially at the municipal level.** The challenge is to build municipal capacity to manage, run and efficiently operate large infrastructure projects including transparent participation of the private sector through PPPs.

- **The renewable energy sector is growing, and the ambitious green energy plan requires resources and investment.** To make use of wind and solar energy to generate power in Morocco, it is necessary to overhaul the transmission systems and introduce a competitive market for electricity.

MACROECONOMIC PERFORMANCE

Although the overall macroeconomic position held up well in 2011, the resilience of the Moroccan economy has weakened in 2012. While real GDP growth reached 5.0 per cent in 2011, the economy slowed considerably to 2.8 per cent year-on-year in the first quarter of 2012, and to 2.3 per cent in the second quarter, on the back of a sharp decline in agricultural production (around 15 per cent of GDP) due to droughts, and moderating domestic demand. Manufacturing and mining activity declined throughout the first six months of the year, and capacity utilisation rates in the third quarter point to continued weakness. In addition, construction (which was a driver of growth in the first quarter) slowed down, dragged down by diminished business confidence and a slow-down in the real estate sector. FDI, however, increased by 6 per cent year-on-year in H1 2012, reflecting improved prospects of large-scale projects materialising in the short to medium term.

The fiscal and current account deficits have widened over the year, and pressures have persisted in the first half of 2012. This has prompted the Moroccan authorities to seek and receive a US$ 6.2 billion Precautionary and Liquidity Line from the IMF to help cushion the economy against any further external shocks. Morocco's trade deficit rose in the first quarter of 2012, after reaching 20 per cent of GDP in 2011, but improved slightly in the second quarter, on the back of reduced energy prices per volume. The external current account deficit reached 8 per cent of GDP in 2011, and widened further in H1 2012, on the back of faltering exports and a pickup in imports associated with higher energy prices, but is expected to narrow throughout the year as oil prices moderate. However, continued weakness in the eurozone (Morocco's main trading partner) contributed to lower tourist receipts, exports and remittances. On the other hand, the general government deficit in 2011 rose to 7 per cent of GDP (excluding privatisation receipts), its highest level in 20 years. Much of it reflects subsidies for basic food staples and energy products, which amounted to six per cent of GDP (with fuel subsidies alone amounting to 17 per cent of spending), and wage increases to alleviate political and social unrest.

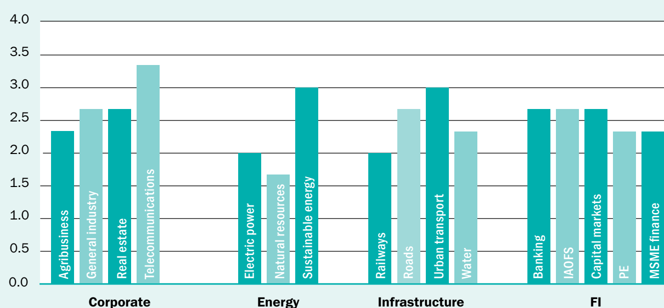
Several factors pose a risk to a strong economic recovery in Morocco. First, a further deterioration in the eurozone would negatively impact Morocco's growth prospects substantially, given the close external trade and financial links. External shocks could further widen the current account deficit, while a growing budget balance could reduce the government's fiscal space. Lastly, the failure so far by the authorities to enhance Morocco's competitiveness through improvements in human capital and in the business environment poses further downside risks to the medium-term outlook of the country.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	4.8	3.6	5.0	2.3
Inflation (end-year)	-1.6	2.2	0.9	1.9
Government balance/GDP	-2.2	-4.4	-6.9	-6.1
Current account balance/GDP	-5.4	-4.3	-8.0	-7.4
Net FDI (in million US$)	3212	3868	2988	1800
External debt/GDP	27.1	29.6	31.5	na
Gross reserves/GDP	23.5	23.8	20.1	na
Credit to private sector/GDP	8.8	10.7	10.0	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Reforms that have been enacted in Morocco have been largely successful. Substantial progress has been made in the privatisation agenda since the beginning of the last decade, resulting in a boost to competitiveness in a number of sectors, including telecommunications and other service sectors. As a result the privatisation agenda, with the exception of utilities and natural resources, is by now almost complete. These efforts were coupled with structural reforms in the transport, energy and telecommunications sectors. Average import tariffs were substantially reduced even though non-tariff barriers, in particular in the agricultural sector, still remain substantial. However some capital account restrictions on residents remain, including surrender requirements for export proceeds and limits on foreign investments by local institutional investors such as pension funds.

There remains a significant unfinished reform agenda. Reforms are needed to improve the business environment in general, as regulatory capture has had an adverse impact on entry and competition across a number of industrial sectors. Barriers to entry, cross-ownership in some sectors and low levels of corporate governance have contributed to lower levels of competitiveness. In addition, labour market rigidities have contributed to the high unemployment rates in the country.

In response to its deteriorating fiscal position, the government raised the prices of key subsidised items in 2012. In June energy prices were hiked by 16 per cent, while subsidies on soft wheat imports were reduced by 15 per cent in September. The government is considering plans to further reform the subsidy system, including measures such as adjustments of administered prices, conditional cash transfers and targeted programmes.

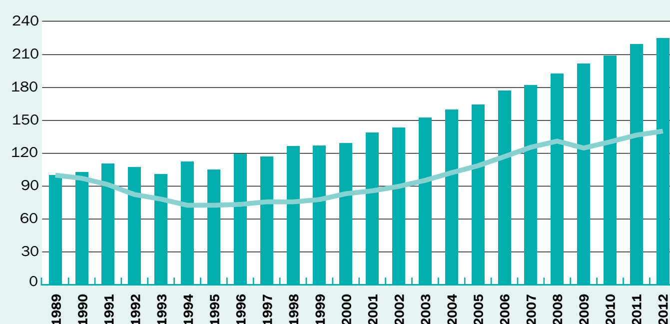
Reforms are crucially lacking in the energy and infrastructure sectors, and tariff reform is needed across the board to improve cost recovery. Delivery of municipal services faces large reform challenges and is constrained by poor local capacity. After many years of delay, regulatory agencies in some sectors, including energy, insurance and securities, have recently moved to become more independent. Reforms are needed in the energy sector to ensure unbundling of the sector, gradual liberalisation of prices, creation of a competitive wholesale market, independence of regulatory agencies, and improvement in energy efficiency. In this regard, the Ministry of Energy has recently decided to move ahead with the unbundling of the vertically integrated energy utility ONE and corporatising its units, with EU assistance.

Measures have been put in place to exploit Morocco's potential in the sustainable energy sector. The use and development of renewable energy technologies has been a priority for the government, but has only recently become a major policy objective. Ambitious programmes exist, such as the Green Energy plan, to increase the share of renewables in the country's total energy demand. Morocco has started to develop the legal and regulatory framework in order to achieve these targets. The government passed four laws dealing with renewables and energy efficiency in early 2010. Under these laws, a renewable energy agency as well as an agency (ANDEREE) to promote solar technology, were established. The laws provide financial incentives and government guarantees for renewable energy producers, including long-term off-take agreements with ONE at pre-determined prices.

Reforms in the financial sector have been successful, but some additional measures are needed to increase the sector's robustness. Regulatory frameworks are reasonably advanced in both the banking and non-banking sectors, with further improvements in the pipeline, including independence of regulatory agencies for the insurance and securities markets. While the money and government bond markets are well developed, securities markets are small and lack liquidity and the regulatory and tax frameworks for more advanced products (such as securitisations and derivatives) are yet to be developed.

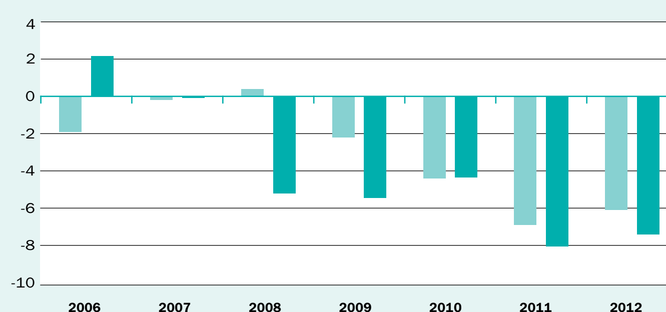
Real GDP (1989 = 100)

■ Morocco ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



POLAND

HIGHLIGHTS OF THE PAST YEAR

- **Poland has continued to record strong growth.** A soundly supervised banking system and fiscal consolidation have further improved investor risk perceptions and attracted capital inflows into local equity and government bond markets. Weaker indicators in early 2012 have nevertheless led to a significant downward revision in growth expectations.

- **The government has initiated important fiscal reforms.** These include measures to improve the state pensions system and prevent a further increase in public debt.

- **Privatisation volumes have been substantial.** The four-year programme to 2011 was met in terms of revenue targets, and a new programme for another 300 companies has been announced. The state's stake in the country's largest bank, PKO, has been reduced to a minority one, though the state continues to exercise management control.

KEY PRIORITIES FOR 2013

- **A long-standing challenge is to develop more sustainable private financing mechanisms in infrastructure, adopting best practice on public-private partnerships (PPPs).** EU structural funds will be more focused and more constrained in future years, in particular given the budget constraints of local governments.

- **Links with European parent banks – and close coordination with their supervisors – should be preserved.** These links will be increasingly important in light of the current risks to European financial integration, and new institutional mechanisms on bank supervision within the eurozone.

- **Local long-term debt funding should be developed further, in particular for banks.** Bond market development will require a number of changes in legislation and prudential supervision, for example, in transferring titles for covered bond issuance, and should be supported through the emergence of well-diversified local institutional investors such as pension funds.

MACROECONOMIC PERFORMANCE

Growth in Poland remained buoyant in 2011 and, although it has slowed in 2012, it remains well above the regional average. Against the headwinds of fiscal consolidation and a slowing EU economy, the Polish economy registered 4.3 per cent growth in 2011. Over the past two years, household consumption and capital investment continued to be the main drivers of growth. The accelerated absorption of EU grant funds and increased infrastructure spending ahead of the 2012 European Championships were key factors behind this success. Since early 2012 exports and industrial production have been slowing markedly, though private consumption, accounting for 61 per cent of GDP, continued to grow at 1.8 per cent in the first half of the year relative to a year earlier. Public investment is expected to fall sharply from the second half of 2012 as fiscal consolidation will significantly weigh on local governments' capital expenditure, and their capacity to co-finance EU grants, which are about to come to an end under the current budgeting period.

Poland has benefited from strong capital inflows though portfolio investment in the domestic bond markets remained volatile. In 2011 capital inflows were primarily directed into the domestic government bond market, and substantial grant inflows from EU structural funds financed a still sizeable current account deficit (4.9 per cent of GDP last year). In contrast, bank funding showed considerable outflows over the second half of last year, though direct investment within Poland has remained unaffected so far, and the gross FDI inflows of about 3.7 per cent of GDP are relatively high compared with other countries in the region.

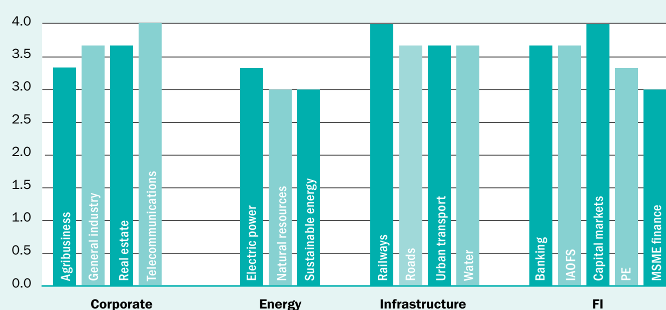
The government embarked on a long-delayed fiscal deficit and public debt reduction programme. During the financial crisis of 2009 Poland allowed its fiscal deficit to widen, which mitigated the effects of the crisis. The reduction in the deficit last year stemmed in good measure from the reduction in the contributions into mandatory pension funds, but also from a freeze in the public sector wage bill, and cuts in certain social security expenditures. Following the election in October 2011, the Prime Minister announced a plan to reduce the general government deficit to the Maastricht-compliant level of 3 per cent of GDP in 2012, and then gradually to 1 per cent in 2015, although the 2012 target will be missed given recent growth weaknesses. According to the government's strategy, public debt is set to stay well clear of the legal limit of 55 per cent of GDP, and should be cut to 47 per cent towards the end of the government's term in 2015. A more rigorous fiscal rule that will constrain expenditure more tightly from 2015 is under discussion.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	1.6	3.9	4.3	2.5
Inflation (end-year)	3.8	2.9	4.5	3.8
Government balance/GDP	-7.4	-7.8	-5.1	-3.5
Current account balance/GDP	-3.8	-5.1	-4.9	-3.5
Net FDI (in million US$)	8460	3574	9120	9527
External debt/GDP	65.0	67.1	64.8	na
Gross reserves/GDP	17.7	19.4	19.0	na
Credit to private sector/GDP	46.6	48.1	50.7	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The government initiated a number of fiscal reforms that will have profound implications for public investment. As part of a strengthened legal framework for public finances announced in early 2012, the Finance Ministry set limits on local government deficits. The rule envisages a gradual reduction in the total deficit of local authorities to 0.4 per cent of GDP (from 0.8 per cent last year). Local authorities have been central to the government's relatively good record in the absorption of EU structural funds, which according to government estimates boosted GDP growth by 0.8 per cent of GDP in 2011. EU structural funds in total represented a net transfer of 2.4 per cent of GDP in 2011, increasing from 0.9 per cent three years previously. A cap on local government deficits may be desirable from the perspective of overall fiscal governance, though it may constrain the co-financing normally mobilised by local authorities, and hence local investment overall.

There has been only limited progress in mobilising private finance for infrastructure through PPPs. In the roads sector two attempts to launch tenders for motorways under the PPP framework were unsuccessful and were cancelled. PPPs encountered major difficulties in relation to open and transparent tendering and during implementation (for example, with regard to land acquisition, cost overruns and lower than expected traffic) which explained a lack of interest from private investors.

The government has begun to tackle the long-outstanding reform of the public pensions system. Following months of difficult public dialogue, in May 2012 parliament adopted an increase in the retirement age. Under this law, starting in 2013, the retirement age will be gradually raised to 67, from the current 60 for women and 65 for men. Labour force participation remains one of the lowest in the EU. Early pension rights for uniformed personnel, a key beneficiary group in the public pension system, will also be restricted. This reform package will begin to address the chronic deficit in ZUS, the state pensions provider, though the longer term demographic challenges are likely to necessitate further reform. The 2011 budget benefited from a considerable reduction in the contributions going into private mandatory pension funds, which will again rise gradually in the period to 2017. In April 2012 the Finance Ministry prepared a plan to partially liberalise the investment allocation restrictions of these private funds and allow the investment of larger shares of portfolios abroad. Also, guarantee requirements that incentivised defensive portfolio allocations have been lifted.

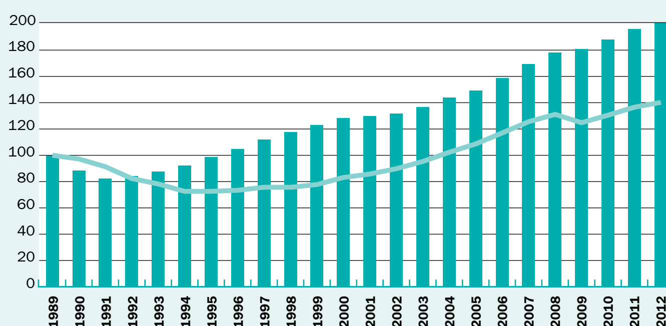
The government, the National Bank, and the financial regulator, KNF, have jointly taken on an agenda to further strengthen the resilience of the financial sector. This includes strengthened macro prudential supervision, following European recommendations in that area, the establishment of a bank resolution regime, and stepped-up bank supervision, in particular with regard to foreign currency mortgages. Given the still dysfunctional inter-bank market, dividend payments, including to these foreign parent banks, have been curtailed. In this area the authorities actively collaborate with other European supervisors, including under the Vienna Initiative. KNF has initiated a number of working groups to develop long-term bond issuance, through the issuance of covered mortgage bonds.

The government announced a new privatisation plan for 2012-13. Sales of state-owned entities accelerated under the previous programme in the four years to 2011, over which about PLN 50 billion or 3.3 per cent of 2011 GDP in privatisation revenues has been raised. Nevertheless, these were primarily small stakes, and key sectors such as petrochemicals, other energy, and chemicals remain state-dominated. Further ownership transformation is now targeted for 300 companies, though in about 45 important companies (mainly in the energy, finance and defence sectors) majority stakes will be retained. According to this plan, the government will seek to raise innovation the potential and competiveness, exercise more active supervision, and attract more innovative financing. Privatisation revenues may partly be directed to a reserve fund for the public pensions system and into the Fund for Polish Science and Technology. The programme also mentions potential benefits of the development of local capital markets, and of Warsaw as a regional financial centre, given the likely higher stock exchange capitalisation and market turnover. The sale in July 2012 of a 7.8 per cent state stake in PKO BP, the country's largest bank, was a notable step in this agenda and reduced the state's share to less than an outright majority. The management of the bank, however, continues to be appointed by the state as the largest shareholder.

The government seeks to further reduce administrative barriers to enterprises. The 2012 World Bank's *Doing Business* Report showed a slight decline in Poland's relative ease of doing business ranking (to 62nd place out of 183 countries worldwide), and the low score (relative to most EU countries) is, in a large part, due to barriers to starting a business and tax administration. According to the Polish Confederation of Private Employers, the main obstacle for business growth is the overregulated labour code that makes it difficult to increase employment. Following re-election, the government re-launched a programme that aims to gradually reduce regulations on more than 200 professions. A number of measures were also adopted in 2011 with a view to reduce red tape for business, for instance, through greater scope for self-certification.

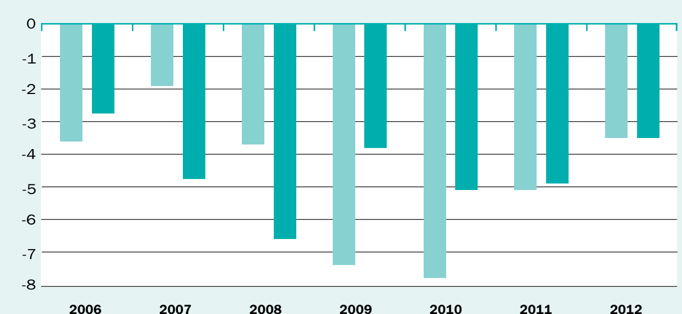
Real GDP (1989 = 100)

■ Poland ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



ROMANIA

HIGHLIGHTS OF THE PAST YEAR

- **Growth has resumed and macroeconomic stability has been preserved.** The growth rate in 2011 was influenced by an exceptional performance in agriculture, and inflation fell to historically low levels, but economic performance in 2012 is being adversely affected by the eurozone crisis.
- **Problems persist in the energy sector but are being addressed.** Romania has faced infringement action by the European Commission over the persistence of regulated prices, but the government has committed to phase these out over time.
- **Financial sector contingency planning has been stepped up.** The banking sector has coped well with the crisis but vulnerabilities remain; the authorities have taken steps to strengthen coordination and bank resolution powers.

KEY PRIORITIES FOR 2013

- **The key overall reform priority is to make further improvements to the investment climate.** Heightened efforts are needed to remove red tape and licensing problems, which are cited as problems by enterprises in business climate surveys.
- **Important privatisations in key sectors should be advanced.** The government has expressed its commitment to proceed with the sale of important assets, but implementation has been slow and should be accelerated if sales are to be achieved next year.
- **The quality of the transport network needs significant improvements.** Now that the appropriate legislation for private sector involvement is in place, the authorities should step up efforts to attract private investment and know-how to key transport projects.

MACROECONOMIC PERFORMANCE

Economic growth is weakening. Romania continues to be highly exposed to negative developments in the eurozone and the summer 2012 political crisis has also had a negative impact on the economy. Growth in 2011 reached an estimated 2.5 per cent, aided by an exceptional performance in the agriculture sector in the third quarter. However the economy slowed down significantly towards the end of 2011, contracting on a quarter-over-quarter basis in real terms in the fourth quarter, and growth has been minimal in the first half of 2012. Inflation fell to a historic low of 1.9 per cent year-on-year in April 2012, but it is on the rise again, reaching 5.3 per cent year-on-year in September as a result of higher agricultural and fuel prices, as well as increases in some administered prices.

Significant risks continue to lie in the fiscal sector. The budget deficit target was revised from 1.9 per cent to 2.2 per cent of GDP in 2012. The IMF approved an increase in the deficit target this year to account for an increase in public wages (8 per cent in June; to bring up to a total of 15 per cent increase by the end of the year) and the repayment to pensioners of illegally collected tax revenues. The fact that the IMF programme – a 24-month precautionary Stand-By Arrangement of €3.4 billion signed in March 2011 – is on track provides some comfort. Further comfort comes from the relatively low level of public debt and strong foreign reserve coverage.

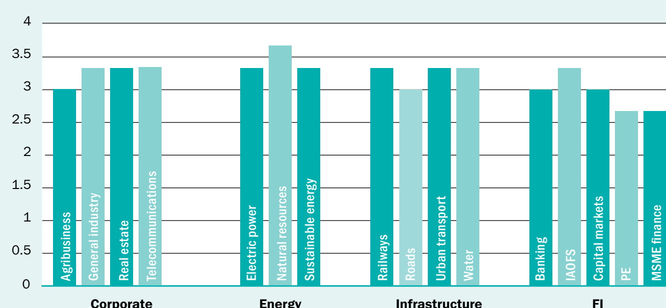
Growth projections for this year have been revised downwards. The revisions reflect both base effects (agriculture this year is unlikely to repeat the strong performance of last year), the worsening outlook in major export markets and possible turbulence in credit markets. GDP growth is expected to fall below 1 per cent in 2012 with only a modest rise in 2013. However, medium-term prospects remain favourable, reflecting the diversified economy and strong catch-up potential in a country where GDP per capita (adjusted for purchasing power standards) is less than half the EU average, according to Eurostat estimates.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-6.6	-1.7	2.5	0.5
Inflation (end-year)	4.7	8.0	3.1	5.5
Government balance/GDP	-7.3	-6.4	-4.1	-2.2
Current account balance/GDP	-4.2	-4.5	-4.4	-3.7
Net FDI (in million US$)	4950	2970	2645	1542
External debt/GDP	72.1	74.3	68.4	na
Gross reserves/GDP	24.9	27.7	20.5	na
Credit to private sector/GDP	39.5	46.1	38.0	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The European Commission (EC) has expressed concerns over Romania's commitment to the rule of law and judicial independence. In its annual report under the Cooperation and Verification Mechanism (CVM), published in July 2012, the EC noted that the country has taken important steps over the previous five years in judicial reform and the fight against corruption. However, events in July 2012, particularly the perceived undermining of the constitutional court, pose a serious threat to the progress achieved to date by Romania, according to the EC. The government has promised to address these concerns. The EC will monitor progress closely and will adopt another report under the CVM before the end of 2012.

Absorption of EU funds has increased but remains at a low level. In September 2011 a new Ministry for European Affairs was established, with the primary aim of accelerating the absorption rate of EU structural and cohesion funds, which at the time was below 5 per cent of the allocated amount of around €20 billion for the period 2007-13. Although the situation has improved since then, absorption rates remain low at around 8.5 per cent as of July 2012. The government is targeting a rate of 20 per cent by year-end.

Several important privatisations have been delayed. Under its standby arrangement with the IMF, Romania has committed to a significant privatisation agenda in several key sectors, including electric power, gas, railways and chemicals. One achievement was the sale in March 2012 of an additional 15 per cent stake in the electricity transmission company, Transelectrica, on the stock exchange. However, the privatisation of other companies, including the chemical company Oltchim (in which the state has a majority stake) and the copper mine Cuprumin, is behind schedule. The government has committed to move forward this year with the sale of shares in several energy and gas companies, as well as a majority sale of the railway company, CFR Marfa. The planned partial privatisation of the hydro-electric company, Hidroelectrica, has been delayed by the company's filing for insolvency in July 2012. The company had entered into bilateral contracts that meant it was selling energy at below production cost.

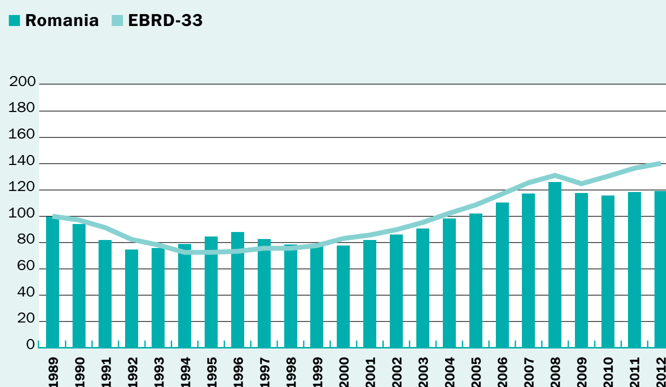
A new electricity and natural gas law is aimed at liberalising the market. The law was endorsed by parliament in June 2012 and is in line with the EU's Third Energy Package adopted in 2009. The objectives include the granting of financial and operational independence for the energy regulator. In addition, the government has committed to start phasing out regulated electricity prices from September 2012, with the process to be completed by end-2017. In the gas market, full liberalisation is envisaged by end-2018.

These measures, if implemented, should address various problems that have arisen in recent years in the power sector, notably, the continuing failure of institutions and policies to deliver competition and new private sector entrants to the market, as well as ongoing infringement action by the EC over the persistence of regulated prices.

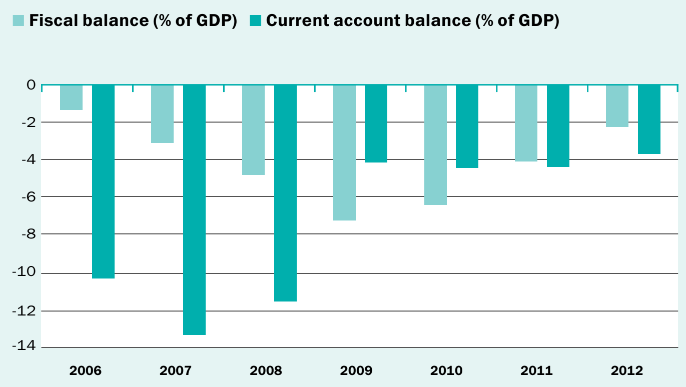
Important amendments have been made to the public-private partnership (PPP) law. These amendments were introduced in October 2011, following feedback from the EC on the law enacted in 2010 and amended in April 2011. The aim is to make the procedures for awarding a PPP contract consistent with EU directives on public procurement. While the legal framework is now broad enough to allow the implementation of different types of PPPs, including concessions, it remains the case that no major projects in the roads sector have yet been carried out through concessions or other types of PPPs. Progress is also lagging behind in reforms to the railways, as well as in urban transport, where public service contracts are rarely in line with international standards and responsibilities and payment mechanisms are often unclear.

Contingency planning in the financial sector has been strengthened. The Romanian banking system remains liquid and well capitalised, but significant vulnerabilities remain, especially in light of the eurozone crisis. Credit institutions as a whole became loss-making again in the period March-June 2012. The authorities have taken significant steps in the past year to strengthen the degree of preparedness for possible future stresses. The National Bank of Romania and the Deposit Guarantee Fund (DGF) have signed a Memorandum of Understanding (MoU) that outlines measures to ensure a greater flow of information to the DGF and, along with the Ministry of Public Finance, stronger coordination on the implementation of new bank resolution powers, including the power to establish a "bridge bank" in cases where a large bank falls into serious difficulties. Since 2009, Romania has been an active participant in the Vienna Initiative, which now aims to improve coordination between home and host country authorities in order to manage cross-border deleveraging.

Real GDP (1989 = 100)



Fiscal balance and current account balance



RUSSIA

HIGHLIGHTS OF THE PAST YEAR

- **The Russian economy has not been immune to the impact of the eurozone crisis.** Both external and domestic demand growth slowed down in 2012, driven by the weaker global environment and lower investor and consumer confidence.
- **Price stability has become a top priority.** Inflation started rising again after reaching a record historical low rate of 3.6 per cent in early 2012, but the authorities have confirmed commitments to inflation targeting and a floating rouble.
- **Russia joined the World Trade Organization (WTO) in August 2012.** After 18 years of negotiations, the terms of accession were agreed at a Ministerial Conference in Geneva in December 2011 and ratified by the Russian parliament in July 2012.

KEY PRIORITIES FOR 2013

- **The key long-term priority for Russia is diversification of the economy away from its strong dependence on oil and gas exports.** This requires modernisation of the economy, and serious improvements in productivity and the investment climate.
- **The benefits of economic growth and development need to be shared more equally across regions.** In addition to fiscal transfers, this requires major improvements in the regional business environments, so as to attract more private investment.
- **The role of the state in the economy needs to be further reduced.** Faster progress with privatisation can help to increase the country's productivity and competitiveness (particularly important following WTO accession) provided that the privatisation process is transparent and increases competition.

MACROECONOMIC PERFORMANCE

The Russian economy is beginning to be affected by the global economic slow-down through falling export demand and weaker investor and consumer confidence. Output grew by 4.3 per cent in both 2010 and 2011, aided by expansionary fiscal policies, high oil prices and associated services sector growth. However, as eurozone developments started to affect the Russian economy from the end of 2011, industrial production and retail sales growth slowed down, while agricultural output fell due to adverse weather conditions. Net capital outflows have continued and reached US$ 57 billion during the first three quarters of 2012. The official unemployment rate declined to the pre-crisis level of around 5.5 per cent by mid-2012 but does not capture unofficial unemployment and differs widely between Russia's 83 regions. On current trends, GDP growth is expected to slow down to 3.2 per cent in 2012 and record a similar level in 2013.

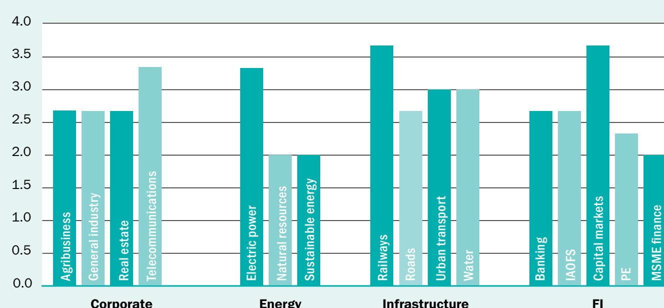
The Central Bank of Russia (CBR) has started to put more emphasis on price stability as a priority and has already significantly increased exchange rate flexibility. In part as a result of, but also helped by, falling global food prices and delayed administered price increases, inflation declined to a record low of 3.6 per cent year-on-year in April-May 2012, from 8.4 per cent in 2011. However, inflation has picked up since then to 6.6 per cent in September and is expected to be close to 7 per cent by the end of the year – well above the 5-6 per cent inflation target. The CBR aims to keep its end-year inflation target at 5-6 per cent for 2013 and to reduce it to 4-5 per cent for 2014-15. It plans to complete the transition to inflation targeting and a free floating rouble by 2015, which should help to improve the economy's resilience to shocks.

Russia's outlook for growth remains highly dependent on commodity prices, particularly oil and gas. Other vulnerabilities stem from significant private external debt of around US$ 500 billion, or over 25 per cent of GDP, and the high sensitivity of the fiscal balance to the oil price. General government gross debt was around 12 per cent of GDP at the end of 2011. The non-oil deficit now exceeds 10 per cent and the budget-balancing oil price has increased to around US$ 115 per barrel. A sustained drop in the oil price would thus threaten fiscal sustainability and could lead to additional capital outflows, further pressure on the rouble and a credit freeze. In late June 2012 the government approved the use of an additional RB 200 billion from the Reserve Fund for real and financial sector support in case global market conditions deteriorate further. However, fiscal space is more limited now than during the 2008-9 crisis, when similar anti-crisis measures amounted to RB 1.2 trillion.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-7.8	4.3	4.3	3.2
Inflation (end-year)	8.8	8.8	6.1	6.8
Government balance/GDP	-5.9	-4.0	0.8	0.1
Current account balance/GDP	4.0	4.7	5.3	5.2
Net FDI (in million US$)	-8125	-8599	-14342	-16857
External debt/GDP	38.2	32.9	27.6	na
Gross reserves/GDP	32.6	29.8	26.9	na
Credit to private sector/GDP	42.4	41.8	42.9	na

2012 sector transition indicators



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

To improve fiscal sustainability, the authorities plan to limit government spending and make fiscal policy more countercyclical. In the autumn of 2012 a new fiscal rule was adopted, according to which future budgets will be based on the long-term average oil price rather than on the expected oil price during the budget year. However, implementation of this fiscal rule is likely to be delayed as it would only be gradually phased in, and the 2013 budget will still be based on a higher oil price than that implied by the new rule. Nevertheless, the draft medium-term budget framework aims to reduce spending growth and targets a balanced budget by 2015.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Russia joined the WTO in August 2012. The terms of accession were agreed at a Ministerial Conference in Geneva in December 2011. The Russian parliament ratified the agreement in July 2012 thus completing a long accession process that started back in 1993. Under the terms of the accession, Russia has made a number of commitments. These include: gradually lowering a number of import duties in agriculture and manufacturing (by around 2-3 percentage points on average); relaxing restrictions on foreign entry in the services sectors such as insurance and telecommunications; limiting future agricultural subsidies; and introducing non-discriminatory tariffs for trans-shipment of goods through the country. Many provisions include transition periods of up to nine years, depending on the sector. Work on Russia's accession to the Organisation for Economic Co-operation and Development (OECD) is ongoing.

In January 2012, Belarus, Kazakhstan and Russia launched the next stage of economic integration. This stage envisages the creation of a common economic space within the Eurasian Economic Community, building on the Customs Union between Belarus, Kazakhstan and Russia launched in 2010. The stated ultimate goal of the Community is free movement of goods, capital and people, as well as harmonisation of macroeconomic and structural policies. The Eurasian Economic Commission, a newly established supranational body of the community with nine members (three from each country), is expected to gradually take over some responsibilities from the national authorities in areas such as competition policy, technical regulations and environmental standards. Key decisions will be taken by the Council of country representatives based on the "one country, one vote" principle. The exact modalities and timetable for the next steps of integration are yet to be fully clarified.

Despite delays, some progress was made with privatisation. The revised privatisation programme announced in June 2012 is broadly in line with the previous versions. It foresees the sale or initial public offerings of shares in state-controlled companies in various sectors including transport, power generation, agribusiness, banking and insurance. Implementation of the previous privatisation programme was slower than initially envisaged but recent noteworthy sales have included a majority stake in Freight One, a former cargo subsidiary of Russian Railways, and minority stakes in United Grain Company and Sberbank. Other sales anticipated in the near future include minority stakes in Novorossiysk Commercial Seaport and Sovkomflot, a maritime company specialising in oil and gas shipping. Further selected majority privatisations are envisaged in the coming years.

Two major oil companies have established a strategic alliance. The landmark deal, signed in September 2011 between Rosneft, a leading state-owned oil company, and ExxonMobil, a major international oil company, envisages the establishment of joint ventures to explore oil and gas in the Russian Arctic where Rosneft will hold two thirds of shares and ExxonMobil the rest. Rosneft in turn is expected to get stakes in at least six projects of ExxonMobil. Estimates of long-term investment needs for exploration in the Arctic range within US$ 200-500 billion and the strategic alliance is expected to give a major boost to the development of new oil and gas fields.

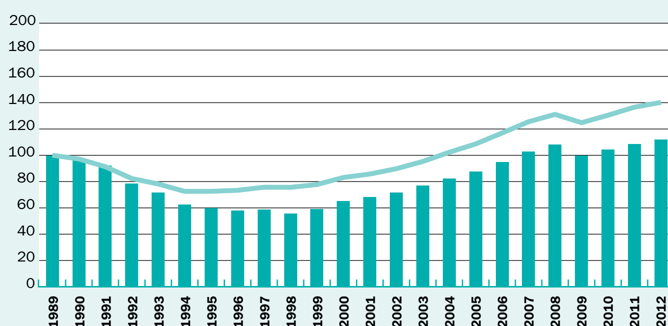
The Direct Investment Fund (DIF) has started operations. The fund was set up in 2011 with the objective of promoting innovation and modernisation of the economy through leveraging private co-investment by foreign companies. It is managed by a fully owned subsidiary of VEB, the state development bank. In April 2012 DIF and China Investment Corporation (CIC) agreed to each contribute US$ 1 billion to a joint investment fund, with further contributions from Chinese institutions expected in the future. The fund's management company will be owned 60 per cent by the Russian state (via VEB) and 40 per cent by the Chinese state (via CIC). The fund will target investments in Russia and the CIS as well as Chinese companies actively dealing with Russia.

The work on development of local capital markets continued. In December 2011 the parliament passed a law on Central Depository. As part of the agenda of transforming Moscow into an international financial centre, a number of measures have been adopted to liberalise the domestic sovereign rouble bond market and make it easier for non-residents to trade in Russian securities through international clearing systems such as Euroclear.

Amendments to the competition law have made rules of competition enforcement clearer. Under these amendments, collusion and cartel behaviour have become more explicitly defined while a number of other offenses have been decriminalised, contributing to a better, more predictable business environment.

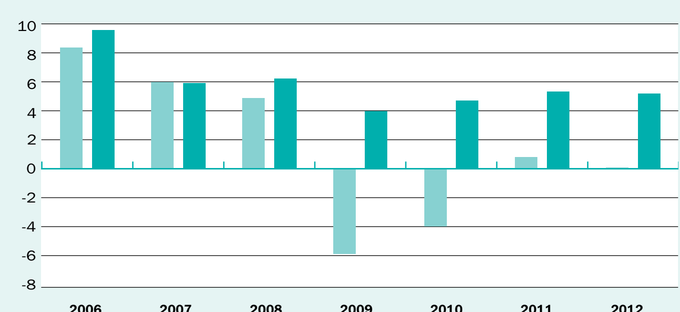
Real GDP (1989 = 100)

■ Russia ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



SERBIA

HIGHLIGHTS OF THE PAST YEAR

- **Serbia has become an EU candidate country.** The decision by the European Council in March 2012 is in recognition of Serbia's cumulative reform efforts. However, no date has yet been set for beginning the accession talks.

- **Reforms have advanced in several infrastructure sectors.** In telecommunications, the market has now become fully liberalised and competition is increasing, while in railways, further steps have been made towards the separation of infrastructure from transport.

- **Macroeconomic discipline has been weakened.** The fiscal deficit increased substantially in the first half of the year above 7 per cent of gross domestic product (GDP), and the level of public and publicly guaranteed debt is now above the 45 per cent ceiling set by the Budget System Law.

KEY PRIORITIES FOR 2013

- **Restoring fiscal prudence is essential for overall macroeconomic stability.** Given the weak short-term growth outlook, the new government will have to implement some difficult measures in order to reduce the size of the fiscal deficit to more manageable levels.

- **Regulatory independence in the energy sector should be strengthened.** The removal of government interference in tariff-setting should help in improving energy efficiency and investor confidence.

- **Efforts to strengthen local capital markets should be intensified.** Measures to promote "dinarisation" by the central bank are bearing fruit and further progress in this area would help in the development of a more sustainable financial sector.

MACROECONOMIC PERFORMANCE

The economy contracted in the first half of 2012. In 2011 the Serbian economy grew by a meagre 1.6 per cent, one of the lowest growth levels recorded in the SEE region, and growth has significantly weakened further this year. In the first and second quarters of 2012, GDP fell by a real 2.5 and 0.8 per cent respectively year-on-year due to a combination of weak external and domestic demand. Industrial production and exports have continued to decline in the second quarter of 2012, and, more recently, a summer drought has badly affected agricultural output.

After a year of decline, inflation is on the rise again. Inflation dropped from a peak of 14.7 per cent in April 2011 to 3.2 per cent in March 2012 before beginning to climb again. In September 2012 inflation stood at 10.3 per cent year-on-year. The National Bank of Serbia (NBS) expects inflationary pressure to persist due to a combination of higher agricultural prices, a recent VAT increase (see below) and an expected increase in some regulated prices, and as a result, it anticipates that inflation will temporarily remain well above the upper limit on the target band of 4 ± 1.5 per cent. In response, NBS raised the key repo rate to 10.5 per cent in three consecutive months (June, July and August 2012), and to 10.75 per cent in October 2012. It also tightened reserve requirements. The dinar has weakened in nominal terms by about 7 per cent relative to the euro between January and August, alongside significant central bank intervention to prevent further depreciation (the NBS has sold €1.35 billion on the intrabank foreign exchange market so far this year to support the dinar).

Substantial fiscal adjustment is needed in the short term. The budget deficit, currently estimated at over 7 per cent of GDP, significantly exceeds the target of 4.25 per cent of GDP that had been agreed with the IMF under the Stand-By Arrangement. At an estimated 55 per cent of GDP, public debt exceeds the administrative limit of 45 per cent of GDP. In light of these figures and the weakening economic performance, there is a need for urgent fiscal adjustments (according to the Fiscal Council, an estimated €1 billion in savings needs to be implemented in 2012 and 2013 to avoid a debt crisis). In September 2012, the government adopted a revised budget for 2012 which aims to bring down the deficit to 6.7 per cent of GDP this year. New measures include an increase in the VAT rate (from 18 to 20 per cent) and limits on salary and pension indexation. However, spending has been raised in some areas and it is unclear if even this new target will be reached.

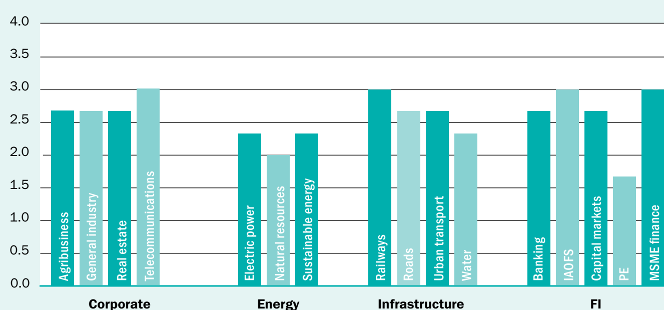
Further output reductions are likely in the short term. The combination of weak domestic demand and the ongoing crisis in the eurozone is having a major dampening effect on the economy. The necessary fiscal retrenchment expected in the

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-3.5	1.0	1.6	-0.7
Inflation (end-year)	6.6	10.3	7.0	12.0
Government balance/GDP	-3.7	-3.7	-4.2	-6.7
Current account balance/GDP	-7.1	-7.4	-9.5	-11.5
Net FDI (in million US$)	1904	1133	2531	633
External debt/GDP	78.9	85.2	84.9	na
Gross reserves/GDP	36.9	34.5	27.0	na
Credit to private sector/GDP	45.2	51.3	52.1	na

2012 sector transition indicators

Sector transition score



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

coming year will also weigh heavily on growth prospects. However, medium-term prospects remain favourable once confidence returns to the domestic and foreign investor community.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Serbia has become an EU candidate country. Candidate status was granted by the European Council at its meeting on 1 March 2012. No date has yet been set for starting accession talks. In its latest progress report, published in October 2012, the European Commission (EC) stated that Serbia is broadly on track in fulfilling the criteria under the Stabilisation and Association process. However, in light of recent rulings by the Constitutional Court, the EC also noted that Serbia should focus more on the rule of law, in particular ensuring the independence and impartiality of the judiciary. The EC also indicated that recent developments call for increased attention on the rights of vulnerable groups as well as the independence of key institutions such as the central bank.

A major steel company has been renationalised. In January 2012 the government repurchased the local unit of US Steel, which was privatised in 2003, for a nominal price of one US dollar. US Steel decided to exit the Serbian market as a result of increasing losses and the global downturn in the steel market. The unit was subsequently shut down on 10 July because of the depressed market conditions and, as of late-September, had not yet reopened. The government issued a tender, which was subsequently cancelled, and is continuing to search for a strategic partner.

The fixed-line telecommunications market has been liberalised. The final steps to achieve full liberalisation occurred in 2012. Companies that wish to compete in the market now only need a permit, rather than an operating licence as previously required. However, implementation of a number of competitive safeguards, such as local loop unbundling or fixed number portability, is lagging behind. In addition, the fixed line market remains dominated by Telekom Srbija, which is still state-owned following a failed privatisation attempt in 2011. At the end of 2011, Telekom Srbija agreed to buy back a 20 per cent share from the Greek-owned company, OTE.

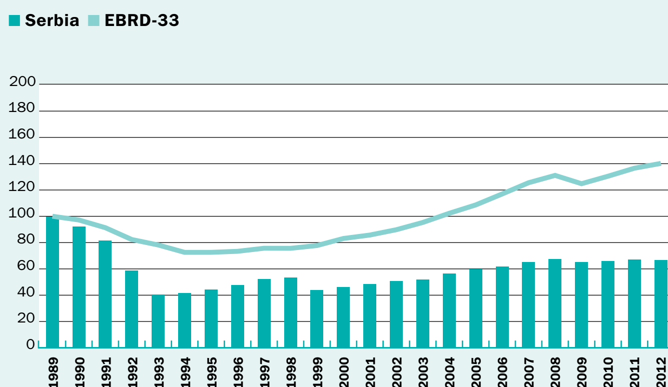
Regulatory independence remains limited in the power sector. For example, the regulatory agency still does not have the power to determine the final tariff levels (though they set tariff methodologies), which rests with the Serbian government. Proposed changes to the Energy Law to give the regulator full control over tariffs have yet to be passed by the government or the parliament. The new government has announced that it has no plans to privatise the state-owned power company, EPS. However, EPS intends to open up tenders this year for the construction of eight small hydropower plants, as well as for the rehabilitation of 15 existing plants.

Significant reform efforts are ongoing in the railways sector. A new law that allows for important institutional restructuring was adopted in August 2011. Under this law, the operating and policy-setting functions have been separated, and core railway businesses are also financially and operationally separated. The aim is to enable greater competition and improved services. Another development in 2011 was the conversion of the state-owned railways company into a joint-stock company. The new structure is intended to lead to the complete separation of infrastructure from transport, in line with EU directives. Notwithstanding these efforts, however, the pace of reforms remains slow and the sector is still a significant burden on the budget.

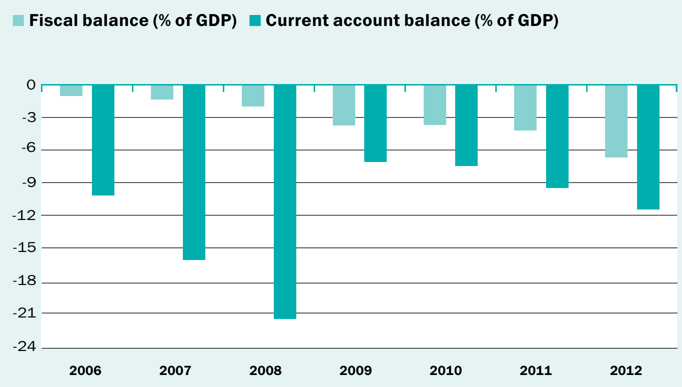
Non-performing loans are rising, but the institutional framework for small business finance has improved. The banking sector has coped well with the crises of the past few years and the capital adequacy ratio remains strong at 19.7 per cent as at the end of 2011. However, the level of NPLs has continued to rise and stands above 20 per cent as of mid-2012. In May 2012 the National Bank of Serbia (NBS) removed the licence of Agrobanka, which had been under administration for five months, and licenced instead a new, state-owned bank, Nova Agrobanka. Meanwhile, some of the architecture for financing SMEs has been strengthened in the past year. The credit information system has increased in effectiveness, with coverage increasing to cover 100 per cent of adults. The cadastre system has also been improved in 2011 as the registration process accelerated.

Efforts to promote local currency use have been strengthened. The National Bank of Serbia's "dinarisation" strategy rests on three pillars: strengthening the macroeconomic environment; promoting dinar-denominated instruments and markets and developing hedging instruments for foreign currency risk in the non-bank sector. Several measures were introduced in late-2011 to advance these objectives, including a new law (applicable in December 2011) on the protection of financial services consumers, under which the first offer of a loan must be made in dinars and, if a subsequent quote is made in foreign currency, the bank must inform the customer of the risks associated with exchange rate movements. In April 2012 the NBS and the then government signed a Memorandum of Understanding (MoU) on the promotion of the dinar in financial transactions. Since 2009, Serbia has been an active participant in the Vienna Initiative, which now aims to improve coordination between home and host country authorities in order to manage cross-border deleveraging.

Real GDP (1989 = 100)



Fiscal balance and current account balance



SLOVAK REPUBLIC

HIGHLIGHTS OF THE PAST YEAR

- **Growth in the Slovak Republic remains well above the regional average.** The continued expansion of a number of foreign owned manufacturing plants underlines the success of the country's growth model.

- **Banks remain relatively sheltered from the European banking crisis, and continue to show growth in credit to the private sector.** Traditionally prudent funding models have underpinned this success.

- **The government has made a promising start with a fiscal consolidation strategy.** However, certain tax measures risk distorting private sector incentives.

KEY PRIORITIES FOR 2013

- **An education policy focused on addressing skills shortages and efforts to facilitate investment in the country's eastern regions are needed.** Despite a relatively strong recovery since the 2009 recession, there has not been a significant dent in long term unemployment and social exclusion.

- **The framework for private pension funds should be made more predictable.** European Monetary Union (EMU) membership does not obviate the need to build local sources of funding for longer-term assets, of which pension funds could be a valuable source. While the banking sector remains well capitalised, taxation of the sector could be a risk and should hence be limited to the revenue target announced.

- **Private finance of road infrastructure should play a stronger role.** While EU structural funds will remain the principal source of such finance, the private sector's capacity to design and partially complement such funding is as yet under-utilised.

MACROECONOMIC PERFORMANCE

The Slovak Republic has shown a very rapid recovery from the severe 2009 recession. Growth in 2010 stood at over 4 per cent and at 3.3 per cent in 2011, well above the regional average. Growth remains closely correlated with, and hence vulnerable to, the cycle in German industrial production. Exports account for 80 per cent of gross domestic product (GDP) and value added in manufacturing for about 35 per cent of GDP, and this sector is in turn concentrated in a few products, mainly vehicles and electrical equipment. After a brief weakening, indicators for exports and industrial production in early 2012 again showed signs of a surprisingly strong revival, primarily driven by automotive related industrial production, confirming this pattern. However, unemployment rates have increased notably over the last few years, peaking at just under 15 per cent in early 2010 and still at 14 per cent in mid-2012, with youth unemployment at 32 per cent, the highest in the CEB region.

Banks have been comparatively unaffected by problems of its peers elsewhere in the euro area. Capital ratios are generally sound with aggregate non-performing loans (NPLs) at 5.5 per cent of total loans. Prudent funding practices are evident in the very low loan-to-deposit ratio of about 90 per cent. The stock of domestic credit to the private sector remains relatively low (at about 46 per cent of GDP at end-2011), and both corporate and household credit have shown some increases.

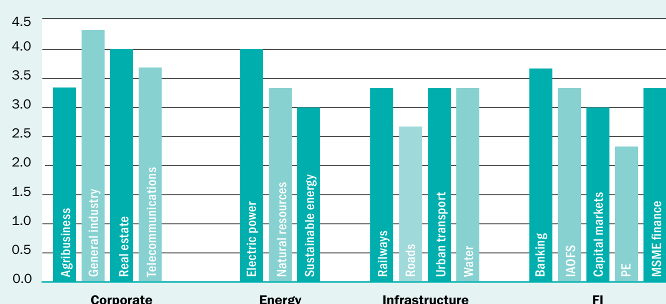
The new government has strongly committed itself to further fiscal consolidation. As the budget deficit and public debt had risen sharply following the 2009 recession the previous government already implemented a significant consolidation, reducing the deficit from 7.7 per cent of GDP in 2010 to 4.8 per cent in 2011. Public sector pay cuts and an increase in the VAT rate over the course of 2011 led to a renewed fall in net disposable income. The new government adopted a mixture of further expenditure cuts and a wide-ranging reform of the tax system. Through these new measures the budget balance could reach the EU-mandated target of 3 per cent by 2013. In December 2011 the then outgoing government adopted a Fiscal Responsibility Law under which public debt will be limited and gradually brought down to 50 per cent of GDP. Fiscal performance will now be monitored by an independent fiscal council.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-4.9	4.2	3.3	2.7
Inflation (end-year)	0.0	1.3	4.6	4.0
Government balance/GDP	-8.0	-7.7	-4.8	-3.3
Current account balance/GDP	-2.6	-2.5	0.1	1.0
Net FDI (in million US$)	-913	198	1654	2119
External debt/GDP	74.5	75.4	77.3	na
Gross reserves/GDP	0.9	0.9	0.8	na
Credit to private sector/GDP	44.1	44.6	46.2	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Deficit reduction remains a key guiding principle in the programme of the new government. Strengthened tax collection and administration is a central theme of the government's efforts in this area. In a significant departure from the long-standing model of a flat personal tax (which has been at 19 per cent since 2004) the new government announced that a second tax band for high earners will be introduced.

The new government announced major revisions to the corporate tax system. The corporate income tax is to be raised from 19 to 23 per cent, and a one-off levy on regulated enterprises (telecommunications, utilities and banks) may be introduced. A bank tax was introduced in 2011 at a relatively high rate of 0.4 per cent of liabilities net of insured deposits and equity, which was particularly burdensome for banks relying on corporate deposits. This tax is to be broadened from 2013 to include retail deposits, though discounting the insurance premium paid to the deposit guarantee fund. The government has also indicated that the tax will be time-bound, and be phased out once a certain revenue target has been reached.

The direction on the outstanding privatisations remains unclear. The previous government's privatisation programme remained controversial and did not make progress. The new government's manifesto envisages a review of this programme (which was, in particular, aimed at heating companies).

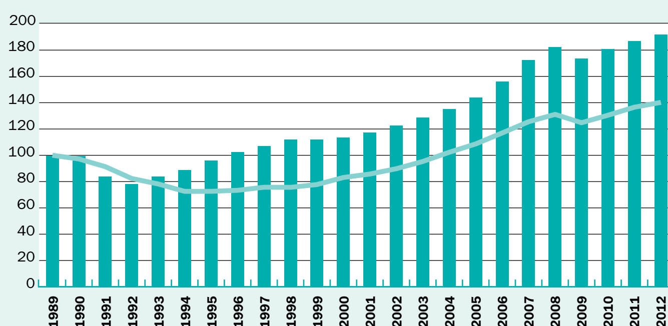
The government will seek to primarily use EU structural funds to finance infrastructure projects, importantly for the unfinished parts of the highway to the eastern part of the country, though it remains open to the use of public-private partnerships (PPP) schemes, possibly in combination with structural funds.

The banking sector is well regulated, though the central bank announced some prudential tightening in inter-bank exposures. The central bank in January 2012 announced new measures to raise mandatory capital standards, limit dividend payments within a certain range of capital ratios, and enforce a cap on loan-to-deposit ratios. While these prudential measures are not binding on most banks, they have underlined the central bank's determination to resist any deleveraging pressures through banking linkages to the rest of the euro area.

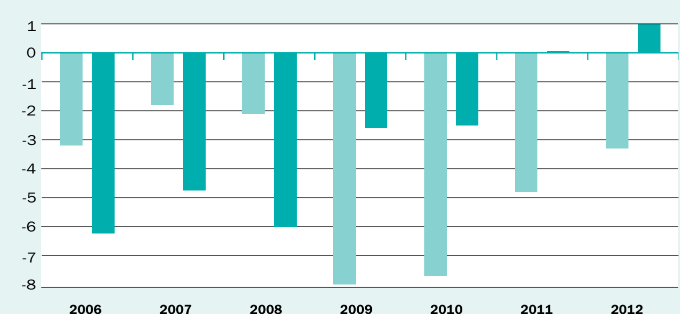
The regulation of private pension funds has again been revisited. A reduction of the employer contributions into the funds from nine to around four per cent of gross salaries became effective in September 2012. The industry is particularly opposed to the guarantee requirements, which have skewed portfolios into defensive allocations, though some more growth-oriented fund allocations with long-term guarantee requirements may now emerge. The European Commission's 2012 Ageing Report suggests that over the next 50 years the total population is foreseen to decrease by 6.1 per cent with a parallel drop in the total workforce of almost 30 per cent. As a result of these trends the dependency ratio (population aged 65 and over relative to the workforce 15-64) is expected to increase from 19 to 68 per cent between 2010 and 2060. This will considerably heighten pressure on the sustainability of the public pension system.

Stimulating the knowledge economy remains a key objective for the new government. The new administration will seek to encourage the growth of technology-intensive local enterprises and other SMEs, in particular those focused on job creation in the more remote parts of the country. A strategy for the knowledge economy ('Minerva 2.0') was drawn up by the previous government and listed 26 measures in the areas of human resources, support of scientific and innovative research and the reform of the institutional and legal framework. A close collaboration in this area was envisaged between government, educational institutions and business.

Real GDP (1989 = 100)



Fiscal balance and current account balance



SLOVENIA

HIGHLIGHTS OF THE PAST YEAR

- **The economy entered a second recession in 2011.** As yet the fallout in terms of further increases in unemployment remains contained although estimates of loan delinquencies are rising.
- **The new government is committed to fiscal consolidation and has initiated pension reform and other expenditure measures.** It has reached agreement on key changes with important trade unions, which should make parliamentary Acts less exposed to popular votes.
- **The government has signalled its support for the substantial Šoštanj Thermal Power Plant (TES).** It has announced that it intends to provide a state guarantee for part of a loan.

KEY PRIORITIES FOR 2013

- **A key challenge remains to secure adequate and lasting capital support in the banking system, particularly for the largest bank, state-owned Nova Ljubljanska Banka.** Clearing the banking system of non-performing loans (NPLs) will ultimately require restructuring delinquent loans while outside strategic investors will likely seek full operational control of the remaining banking institutions.
- **The corporate sector is similarly in need of fresh external capital and governance reform.** The proposed new holding for state assets should be adequately empowered to implement privatisation of all non-strategic assets and the withdrawal of indirect state ownership. Reducing the state's involvement in the economy would be appropriate given Slovenia's state of development.
- **Securing fiscal stability is a key priority.** In light of long-term fiscal challenges due to rapid ageing and the renewed recession, further fiscal reforms, including adjustments to the pension system, will be needed.

MACROECONOMIC PERFORMANCE

Slovenia was the first new EU member to enter a double-dip recession. Initially, the country experienced a weak recovery after the deep recession in 2009, though in 2011 GDP again contracted throughout the year. In mid-2012 all indicators of economic activity remained well below pre-crisis levels, for instance, fixed investment was over 40 per cent below the levels in 2008. Private and government consumption have remained stagnant. Competitiveness indicators also remain poor. In the central Europe region, Slovenia shows the highest relative increase in real unit labour costs, in contrast to most new EU member states which have shown declines. Following a temporary acceleration in exports and industrial production between mid-2010 and late-2011, export growth has again been very slow since early 2012, in particular given weak demand in Italy to where 12 per cent of exports are directed. Nevertheless, given the depressed domestic demand, over the past three years Slovenia has shown no more than modest trade deficits, and overall roughly balanced current accounts.

This absence of a meaningful recovery has been reflected in mounting fiscal deficits. The general government deficit has been above 6 per cent of GDP in each of the past three years, leading to a rapid deterioration in public debt levels to about 50 per cent of GDP in mid-2012, from only 22 per cent in 2008. Soon after taking office in April 2012, the new government therefore adopted a comprehensive restructuring of public expenditure to meet a deficit target that is mandated at 3 per cent of GDP for 2013 under the EU Excessive Deficit Procedure. These measures could be adopted after the government had reached some reconciliation with the unions, preventing a recurrence of the large-scale strikes that had disrupted the public sector earlier in the year. Nevertheless, the small share of public debt that is publicly traded showed a significant deterioration in yield spreads early in the year. The public sector has very limited refinancing requirements until a Eurobond falls due in 2013. A fiscal rule, limiting public expenditures as the country approaches critical debt levels, has not yet been adopted.

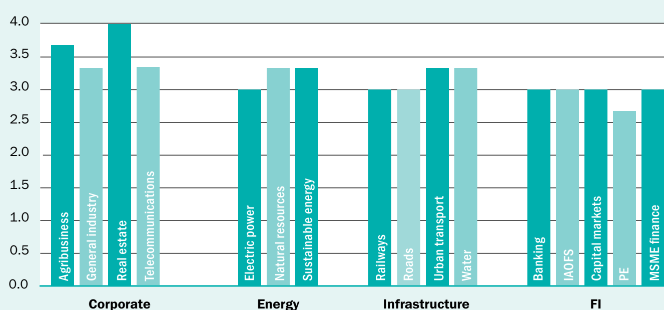
Prospects for a return to growth are dim given weak trading partner growth, further credit contraction and continued fiscal consolidation. Slovenia remains exposed to weaknesses in other countries of the eurozone periphery, especially the recession in Italy, Slovenia's largest trading partner. With no impetus in sight to domestic demand, and given the stagnation in the rest of the eurozone and fiscal consolidation under the new government, a consensus has developed that there will be a continued GDP contraction in 2012.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-7.8	1.2	0.6	-2.5
Inflation (end-year)	2.1	2.2	2.1	3.0
Government balance/GDP	-6.1	-6.0	-6.4	-4.0
Current account balance/GDP	-0.7	-0.6	0.0	1.0
Net FDI (in million US$)	-915	571	888	659
External debt/GDP	133.5	134.6	131.3	na
Gross reserves/GDP	2.0	2.0	1.7	na
Credit to private sector/GDP	82.2	84.6	81.7	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Progress with structural reforms has been slow over the past year. Weak support for the previous coalition government undermined three reform bills that were voted down in referenda last year, including a crucial pension reforms bill. This stalemate and the ensuing fiscal risks resulted in a number of downgrades in sovereign credit ratings (which all envisage further deterioration in risks). Following early elections in December 2011, a five-party coalition came to office in February 2012 and announced a swift reform to pension entitlements, a number of immediate expenditure cuts, and the privatisation of key banks (while retaining control through minority ownership stakes). Success will depend on preventing fresh referenda from blocking such initiatives, as has been the case repeatedly. An agreement with the trade unions on austerity measures in the public sector, reached in May 2012, is somewhat encouraging in this respect.

The financial sector remains essentially unreformed, with state banks in an increasingly entrenched position. Economic weakness has further weighed on the quality of bank assets, with non-performing loans rising to 13.1 per cent of total loans in July 2012, according to the central bank. Rating agency assessments, based on independent loan reclassifications, suggest an even higher level of loan delinquencies. Unlike other central European economies, the capital coverage of the banking sector overall is relatively low at only 9 per cent of core tier one capital, underlining the need to raise capital amid a second recession, vulnerable collateral values, and ongoing losses within the sector. Funding levels nevertheless remain secure, and the banking system as a whole has drawn down about €2.5 billion through the long-term refinancing operations (LTROs) with the ECB. Overall, the sector remains a drag on economic activity with the corporate sector repaying outstanding credit of about 3 per cent of GDP in the year to mid-2012.

Slovenia's largest and state-owned bank, Nova Ljubljanska Banka (NLB), remains in need of an adequate and durable capital basis. As the bank failed to meet capital standards in the EU-wide stress tests in October 2011 a further capital injection was made by the state. The most significant foreign investor in Slovenia's banking sector, Belgian bank KBC, will have to withdraw from its participation in NLB by year end, and did not participate in this capital increase. The government currently contemplates separating out poorly performing assets to make the bank more attractive for possible outside investors.

The enterprise sector continues to suffer from a high level of direct and indirect government involvement, excessive leverage and generally poor corporate governance standards. In advance of accession to the OECD in July 2010 Slovenia adopted legislation to improve the corporate governance framework for state-owned enterprises, minority shareholder protection and securities regulation though an independent agency for state-assets is now being closed down. The government has introduced in parliament a plan for a more comprehensive state holding agency, though there are concerns over the independence of its supervisory board, and to include delinquent banking sector assets.

Given a rapidly ageing population over the coming years, Slovenia will experience a rapid increase in its age-related expenditures, in particular pension payments, a factor that already weighs on sovereign credit assessments. According to projections by the European Commission, the old-age dependency ratio is expected to double within the next 30 years. The new government introduced to parliament some limited changes to the state insurance system in May 2012, though a more comprehensive reform the retirement age and of the privileges of specific groups is still outstanding. Low labour force participation rates also continue to weigh on the sustainability of finances. The government has announced plans to establish a three-pillar pension system which would require reforming the holdings of the state pension company, KAD.

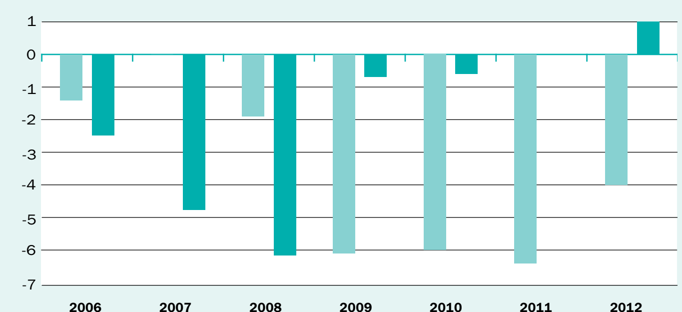
Slovenia's access to inward direct investment remains limited. Since the crisis began, inward flows have almost halved. Restrictive labour practices, regulatory impediments, and pervasive direct and indirect participations with no prospect of a comprehensive privatisation strategy continue to discourage greater access by foreign investors. The bid by a Croatian investor for Slovenia's largest retail chain, Mercator, was put on hold, given resistance by its largest shareholder, NLB.

Real GDP (1989 = 100)

■ Slovenia ■ EBRD-33

Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



TAJIKISTAN

HIGHLIGHTS OF THE PAST YEAR

- **Economic growth has remained stronger than expected.** Official estimates suggest that gross domestic product (GDP) growth reached 7.4 per cent in 2011 and continued at the same rate during the first half of 2012, driven mainly by services, construction and agriculture. The services sector was boosted by robust growth of remittance inflows, mostly from Russia.

- **The authorities adopted a comprehensive restructuring plan for Barqi Tojik, the integrated national power sector company.** The plan covers the period 2011-18 and envisages operational and financial restructuring of the company, divestment of its non-core assets, as well as unbundling and privatisation during later stages.

- **Vulnerabilities in the banking sector remain.** Banking sector liquidity has improved due to significant government and central bank support, but heavy state interference through directed lending and other non-market practices persists.

KEY PRIORITIES FOR 2013

- **Confidence and transparency in the banking system need to be increased.** Capital and liquidity injections should be conducted in a transparent way and any support to the real sector should be done through the government budget rather than through state-directed lending. Banking supervision should be strengthened further as well.

- **Further steps are necessary to complete the Agrarian Reform and the implementation of the new Land Code.** In particular, land rights will need to become transferable, which would increase access to finance for farmers.

- **Energy reform needs to continue.** This will help to ensure long-term sustainability of the power supply and gradual improvement in operational efficiency in generation, transmission and distribution.

MACROECONOMIC PERFORMANCE

GDP growth has remained stronger than expected at 7.4 per cent in both 2011 and the first half of 2012. The data suggest that this strong economic performance was driven to an important extent by increasing aluminium prices in 2011, continued high remittance growth and the largest-ever cotton harvest. The fiscal deficit was better than expected at around 2.1 per cent of GDP in 2011, while the current account moved from a slight deficit in 2010 to a surplus in 2011 of 0.6 per cent of GDP.

Inflation fell to less than five per cent year-on-year by mid-2012 following the global trend of decreasing commodity prices. However, given the recent development in the world wheat market and internal energy price hikes, inflation could rise again in the second half of 2012.

The situation in the banking sector has continued to deteriorate. State-led lending practices continued during 2011 and 2012 and overdue loans remained relatively high at around 15 per cent of total loans. Capitalisation and liquidity have improved due to significant government and central bank injections of capital and liquidity, but some banks remain undercapitalised and largely dependent on the liquidity loans from the NBT. At the beginning of 2012 the interest rate for government securities issued to compensate for the write-off of directed cotton sector loans was increased. However it remains below the refinancing rate of the NBT and the average inflation rate in the past two years.

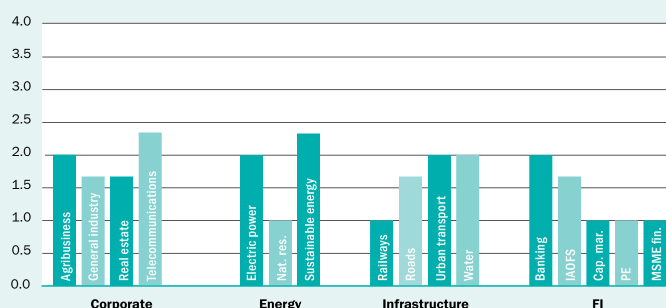
Economic growth is expected to slow down in the short term. Eurozone developments and their impact on Russia are bound to affect Tajikistan through lower exports and remittance inflows. Moreover, recent measures to reduce railway traffic through Uzbekistan will also negatively affect trade and economic activity in Tajikistan.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	3.9	6.5	7.4	6.0
Inflation (end-year)	5.0	9.8	9.3	9.5
Government balance/GDP	-5.2	-3.0	-2.1	-2.9
Current account balance/GDP	-5.9	-0.3	0.6	-4.0
Net FDI (in million US$)	16	16	11	160
External debt/GDP	51.7	50.5	48.1	na
Gross reserves/GDP	3.4	5.8	4.6	na
Credit to private sector/GDP	25.0	23.6	13.7	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Progress with agricultural sector reform has been slow. Several initiatives are ongoing but little progress has been made with none brought to completion. The sector employs around 70 per cent of the population and remains heavily controlled by the state. Development of the sector is held back by the limited access to finance, insufficient protection of property rights and the lack of the necessary infrastructure for non-cotton agriculture. The new Land Code was adopted on 19 July 2012 and the working plan on the agrarian reform process has been adopted.

There have been positive reform developments in the energy sector. The comprehensive restructuring plan of the Barqi Tojik, the integrated national power sector company, was adopted in August 2011. The plan covers the period 2011-18 and envisages operational and financial restructuring of the company, divestment of its non-core assets, unbundling and, potentially, privatisation towards the end of the period. Four working groups have been created to support implementation of the plan. Tajiktransgas's restructuring has been underway since 2009, with the public unitary enterprise Tajikgas transformed into a joint stock company and its functions divided into transportation and distribution. The privatisation of the company is planned for late 2012.

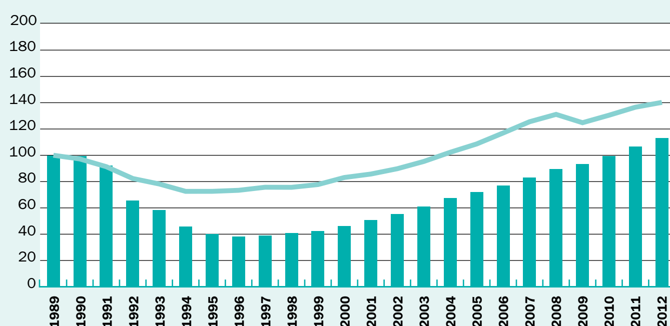
The business environment remains weak but important improvements are underway. In the 2012 World Bank *Doing Business* Report, Tajikistan's ease of doing business ranking improved slightly from 152th to 147th position. Major improvements were made in the area of starting a business where the country went up by 67 positions. This follows a decision in 2011 to allow entrepreneurs to pay in their capital up to one year after the start of operations, thereby eliminating the requirements related to opening a bank account. Tajikistan has also acceded to the Convention on Recognition and Enforcement of Foreign Arbitral Awards in May 2012. This is a major step forward in improving the investment image. The new tax code draft has been prepared and is a significant improvement over the current version, but the authorities are concerned over potential revenue loss. The revised tax code draft is to be submitted to the parliament in September 2012.

Banking sector vulnerabilities remain significant. There have been improvements in accounting and provisioning under the Financial Sector Stability Action Plan (FSSAP) but profitability remains low with high non-performing loans ratio. State directed lending practices have further exposed banks to risks related to poor credit quality.

Tajikistan made first steps towards joining the Extractive Industries Transparency Initiative (EITI). The first meeting of the working group for introduction of the EITI in Tajikistan took place in Dushanbe in October 2011. The initiative is aimed at strengthening transparency, good governance and accountability in extractive industries.

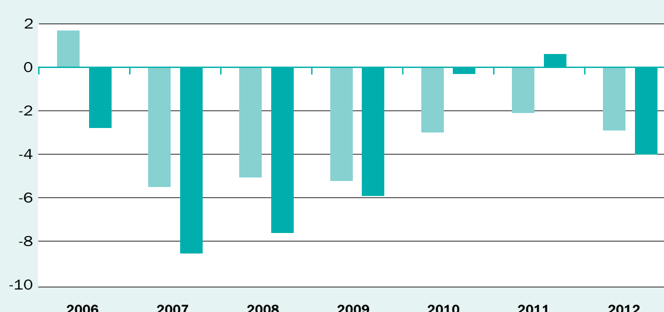
Real GDP (1989 = 100)

■ Tajikistan ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



TUNISIA

HIGHLIGHTS OF THE PAST YEAR

- **The macroeconomic situation is particularly precarious.** GDP contracted by an estimated 1.5 per cent and unemployment jumped to over 18 per cent in 2011, amid rising twin fiscal and current account deficits.

- **The outlook for the economy hinges on the political transition and the external environment.** Recent political developments have had adverse effects on confidence, and the eurozone's persistent weakness continues to weigh on growth.

- **Despite earlier reforms, a level playing field has not been established in many sectors, and steps to improve the business environment have not yet been taken.** Unemployment has continued to rise over the past year, driven by excessive labour market regulations and a significant mismatch of skills.

KEY PRIORITIES FOR 2013

- **Addressing the systemic risks in the financial sector should be a top priority.** Major balance sheet restructuring is needed as non-performing loans (NPLs) continue to rise. The poor state of the banking sector limits small and medium-sized enterprises' (SMEs) access to credit and the broader capital market is underdeveloped.

- **The infrastructure and transport sectors lack investment and require regulatory reforms.** A strategy is needed to disentangle operational and regulatory responsibilities in order to attract private capital into these sectors. Developing transparent PPP solutions to attract private sector participation will be important for structural policy as well as fiscal sustainability reasons.

- **Tunisia's most pressing economic issue is its persistently high level of unemployment, especially among the educated youth and women.** Excessive labour market regulations and a significant mismatch of skills are some of the core issues in need of attention. Shifting towards a more inclusive growth model could also help reduce the stubbornly high and rising unemployment rate.

MACROECONOMIC PERFORMANCE

The economy continues to face substantial challenges, brought about by weak external conditions and an increasingly uncertain domestic political environment. The economy contracted by 1.5 per cent in 2011, despite a slight recovery following the Arab uprising and a boost associated with the end of the Libya conflict. Tourism revenues fell by 33 per cent in 2011, along with a fall by 26 per cent of FDI. The economy registered a sharp slow-down in the second quarter of 2012, with GDP growth of 2.7 per cent year-on-year, owing to slumping manufacturing and industrial activities. On the positive side, agriculture and the services sectors remained resilient. In particular, tourism has continued to recover, posting its second consecutive year-on-year growth in five quarters. The economy is expected to grow only moderately in 2012, due to overall weakness in both domestic and foreign demand, and this will delay reducing the country's high unemployment, which jumped to 18.9 per cent in 2011, up from 13 per cent in 2010.

The external position weakened markedly. The current account deficit widened to 7.4 per cent of GDP in 2011 as tourism receipts fell by 33 per cent and foreign direct investment inflows declined by 26 per cent. The increase in the current account deficit continued in the first half of 2012, on the back of faltering exports and a high energy import bill. On the capital account side, FDI inflows have started to recover, but remain low by historical standards. Despite robust international financial support, Tunisia has not managed to fully fund its external financing gap. As a result, gross central bank reserves declined to a critical level of US$ 6.9 billion in August 2012 (equivalent to just 2.5 months of imports) from US$ 9.5 billion at end-2010.

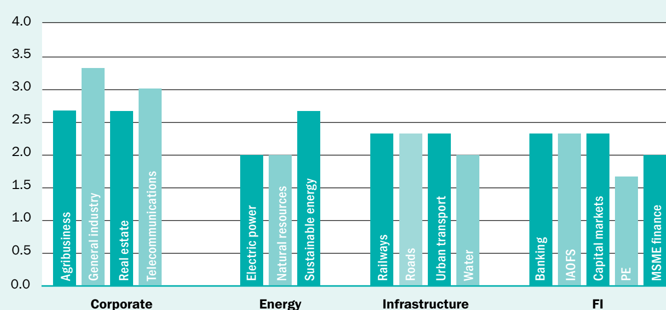
The fiscal deficit deteriorated throughout the year. It widened to 3.8 per cent of GDP 2011 from 1.1 per cent in 2010 due to increases in wages and subsidies, especially for energy. This has led to funding pressures and limits room for further fiscal stimulus. Estimates for Tunisia's financing needs in 2012 range from US$ 5 billion to US$ 6 billion. So far, the government has been able to tap into both domestic and foreign sources to fund the fiscal deficit. In 2011, the country received US$ 1.3 billion (including two US$ 500 million budget support loans from AfDB and World Bank), in addition to a US$ 500 million loan from Qatar in April 2012. In July 2012 Tunisia issued a seven-year, US$ 485 million US government-guaranteed bond at 1.69 per cent, marking the country's entry back into capital markets for the first time since 2007.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	3.2	3.2	-1.5	2.4
Inflation (end-year)	3.7	4.5	3.5	5.3
Government balance/GDP	-3.0	-1.1	-3.8	-6.6
Current account balance/GDP	-1.8	-4.7	-7.4	-7.5
Net FDI (in million US$)	1688	1520	1143	1050
External debt/GDP	49.5	49.7	51.4	na
Gross reserves/GDP	22.8	20.5	16.1	na
Credit to private sector/GDP	9.9	19.3	13.5	na

2012 sector transition indicators

Sector transition score



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

The most pronounced threat to the economy stems from an uncertain political transition coupled with the rising twin deficits. There is a risk that the current political set-up, which rests on a fragile coalition of three parties, could begin to unravel if differences remain acute. These differences have already led to the dismissal of the central bank governor and the resignation of the finance minister, which have had adverse impacts on markets: in July 2012, Moody's downgraded Tunisia's sovereign debt rating to Baa3 reflecting these developments.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

A number of structural reforms are needed to complement those that were undertaken in the first half of the last decade. Coupled with prudent macroeconomic policies, earlier reforms brought about higher growth rates and a more diversified economy, but failed to generate sufficient jobs to resolve the structurally high unemployment rates, especially among the youth and the educated. In addition, the privatisation agenda remains incomplete, especially in the financial sector, where around a third of banking assets are under majority state ownership. In this regard, the Government Action Plan for 2012 includes a commitment by the government to divest some of its assets. Reforms are needed to close the gap between the liberalised, FDI-attracting, export-oriented "offshore" economy and a backward "onshore" economy with no similar tax incentives and continued government intervention. More generally, improvements to the business environment can be achieved by narrowing the gap that exists between *de jure* institutional frameworks and their implementation and effectiveness.

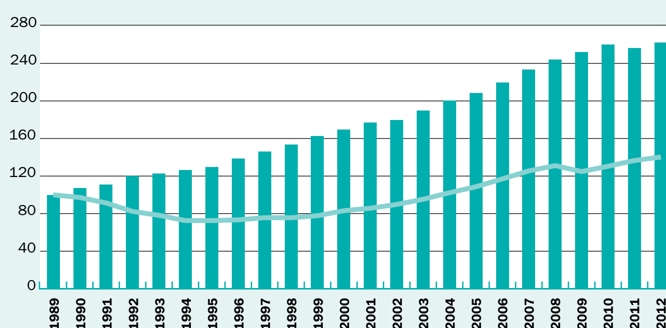
A number of reforms need to be enacted in the financial sector, which is plagued by solvency and liquidity issues. High non-performing loans (NPLs) indicate a weak balance particularly in the state-owned banks that have been involved in directed lending to connected business and over-exposed to a few sectors. Major restructuring of these banks is needed. These banking system weaknesses have partly crowded out lending to SMEs. Strengthening the supporting institutional framework for lending to SMEs will be required to enhance their access to finance. Information on borrowers is limited and there are major information gaps in the existing credit registry, especially with regards to the smaller loans. There is no unified collateral agency, and contract enforcement is currently a lengthy and costly process.

Additional reforms are needed in the power and energy sectors. Although there have been efforts to encourage private sector participation in power generation, it still only accounts for around a fifth of total generation. The power sector in Tunisia is dominated by the state with natural monopoly elements, especially in transmission and distribution. While account unbundling has taken place within the main state-owned company, further steps are still needed in the form of legal, management, and ownership separation. On the regulatory side, current laws need to be supplemented by additional reforms to address the lack of an independent energy regulator and the single buyer wholesale model that is non-conducive to competition and heavy subsidies for both fuel and financing. Lastly, support schemes to promote the implementation of sustainable energy measures have been introduced through direct financial incentives and tax incentives.

Reforms in infrastructure, especially in the municipal and transport sectors, have had mixed success, and there is only limited decentralisation and decision-making at the local level. Further unbundling, tariff reform, and regulatory independence are key reform challenges. Laws have not yet been developed to ensure the separation of regulatory and operational responsibility of municipalities, negatively affecting the efficiency of water and wastewater services as well as urban transport management. In a sector with an ineffective tariff system, in which service fees cover only half the operating costs, and a high dependence on subsidies, developing transparent public-private partnership (PPP) solutions to attract private sector participation is an important pillar of structural reform policy. In this regard, the legal framework based on the Concessions Law is adequate for PPP formulations, but does not provide a formal platform for private sector engagement, and the more specific PPP Law currently being drafted could contribute to lower negotiation times and greater cost effectiveness. This can be modelled after the success of the Digitial Economy Initiative, in which a PPP framework was established to channel digital economy-related PPP projects regarding the upgrade of the country's ICT sector.

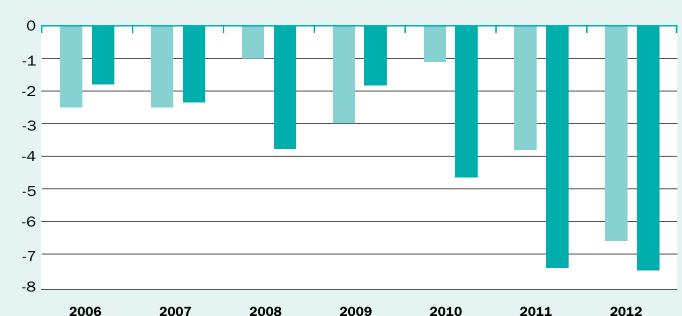
Real GDP (1989 = 100)

Tunisia EBRD-33



Fiscal balance and current account balance

Fiscal balance (% of GDP) Current account balance (% of GDP)



TURKEY

HIGHLIGHTS OF THE PAST YEAR

- **Economic growth is decelerating.** Growth rates have come down from 8.5 per cent in 2011 to 2.9 per cent in the second quarter of 2012, driven by substantially declining domestic demand, a key driver of growth, and spill-overs from the eurozone.

- **Structural reforms in 2011-12 were targeted on helping to boost domestic savings through supporting the private pension system.** A combination of lower taxes for longer-term bank deposits and state contributions up to US$ 125 per month to the individual's private pension account were introduced in 2012.

- **Efforts to tackle unemployment and improve labour market efficiency are under way.** The government has started to implement a number of measures to reform existing labour market regulations, including reduction in severance payments and more flexible working hours.

KEY PRIORITIES FOR 2013

- **Municipal financing could attract more private sector investment by decentralisation and further commercialisation.** Corporatisation, coupled with good financial performance, is an important prerequisite to attract private sector investors. In addition, expansion of public-private partnership (PPP) structures can complement fiscal decentralisation which would in turn enhance local sustainability, especially in the least developed regions.

- **Further capital market development to ensure a stable long-term local currency source.** The corporate bond market is still small and asset-backed or covered bond offerings have been limited, but these could provide a viable source for long-term capital – in particular, in light of exposure to a deteriorating eurozone.

- **Further reforms in the natural resources sector are needed.** Progress should be made in unbundling, corporatising the state-owned gas company and establishing transparent regulatory mechanisms, including setting oil and gas transport tariffs as well as third party storage access.

MACROECONOMIC PERFORMANCE

After a strong growth performance in 2010 and 2011, the Turkish economy has slowed down significantly in 2012. Real GDP grew by only 3.3 per cent year-on-year in the first quarter of 2012, down from 5.2 per cent in the fourth quarter of 2011, and continued to slow in the second quarter, reaching 2.9 per cent year-on-year, its slowest pace since 2009. The key macroeconomic vulnerability of the Turkish economy remains the current account deficit, which stood at 10 per cent in 2011, but has gradually narrowed throughout 2012, with the 12-month rolling deficit reaching 7.9 per cent of GDP in July. To tackle the trade deficit the government raised indirect taxes in several categories of imported consumer durables (mobile phones and some high-end cars) and introduced wide-ranging investment incentives aimed at import substitution in areas such as mining, chemicals and defence electronics that contribute to the trade deficit.

Inflation is only slowly declining from its double digit heights of end-2011. The central bank cut its lending rate for the first time in seven months in September 2012. It also increased banks' reserve option coefficients in order to manage currency pressures associated with potential capital inflows brought about by quantitative easing in the US and the ECB's bond purchase programme. In an effort to help tame domestic consumption, the central bank succeeded in guiding bank credit growth to 19 per cent in August down from as high as 40 per cent in 2010. Moderating food, energy and import prices during the first half of the year has led to a lowering of inflation, which has fallen in recent months to 8.8 per cent year-on-year in August, down from 11.1 per cent in April. The central bank has maintained its inflation target of 5.5 per cent by end-2012, but has revised its end-year inflation forecast in July from 6.5 per cent to 6.2 per cent. Meanwhile, the general government deficit has fallen by more than half to 1.4 per cent of GDP in 2011 from 3.6 per cent in 2010.

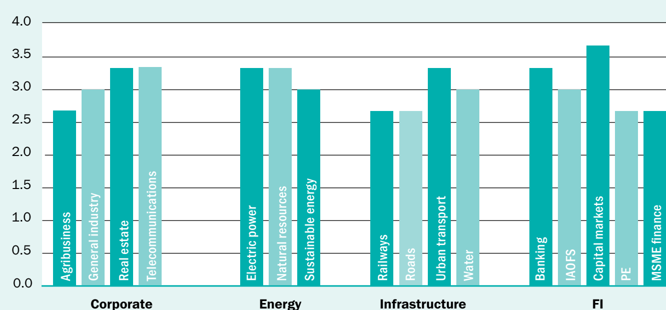
The economy is likely to continue to grow but the possibility of a significant drop in growth remains. While the current account deficit has begun to fall, the pace of re-balancing has been moderate in the first half of the year, and there are risks that it will lose momentum in the second half as domestic demand picks up and the lira appreciates. However, the government has also shown its readiness to act promptly if needed to smooth the possible adverse impact of the new global financial turmoil and economic slow-down by the means of monetary and fiscal policies.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-4.8	9.2	8.5	3.0
Inflation (end-year)	6.3	8.6	6.5	9.1
Government balance/GDP	-5.6	-3.7	-1.4	-2.6
Current account balance/GDP	-2.2	-6.4	-9.9	-7.5
Net FDI (in million US$)	6858	7574	13440	11300
External debt/GDP	43.7	39.4	38.5	na
Gross reserves/GDP	11.2	10.8	9.9	na
Credit to private sector/GDP	13.4	40.4	32.8	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The government is supporting the private pension system with new incentives. The essence of the new law adopted in June 2012 is a combination of tax incentives, such as a zero tax withholding tax rate for equity mutual funds (versus a 10 per cent tax for all other mutual funds), a lower withholding tax rate for longer-term bank deposits and, most crucially, direct government contribution to the private pension system. The government will start matching 25 per cent of individual contributions, up to a limit that is based on 25 per cent of the minimum wage (currently about US$ 125 per month, helping reduce incentives for early retirement). An important difference to other pension systems is that Turkey's private pension system is a voluntary defined–contribution system with currently only 2.8 million members, and the majority of Turkish citizens still relying on the government-funded social security PAYG (pay as you go) system. The new incentive package is expected to increase pension fund growth, supporting the Turkish government's overall efforts to help develop local capital markets. However, the reform package does not include any measures towards making overall asset management more competitive.

Progress has been made in developing infrastructure PPPs. The government has identified a number of road sections to be developed on a PPP basis and BOT contracts for both the Eurasia Tunnel and the Gebze-Izmir Road have been tendered, with financing packages currently under negotiation. Also a number of potential PPPs in the railways sector await tendering, including a high speed railway line between Istanbul and Ankara.

Reforms on improving labour market competitiveness are ongoing. As part of a reform package under the "National Employment Strategy (NES)" the government has started to implement changes to mandatory severance pay, flexible working hours as well as providing for different fixed-term contract options. In April 2012 a new incentive scheme was introduced to minimise the cost of labour, whereby new employees hired in the least advanced eastern regions are exempt from employer social contributions and from employee contributions and income taxes.

Some reforms in the financial sector have been adopted to strengthen the robustness of the system and contain expanding credit to the economy. In mid-2011, the Financial Stability Committee (FSC) was established to foster the necessary cooperation between monetary and financial market authorities to contain credit booms fuelled by capital inflows. Members of the committee include the central bank, the Treasury, the Banking Regulation and Supervision Authority (BRSA), the Saving and Insurance Deposit Fund and the Capital Market Board.

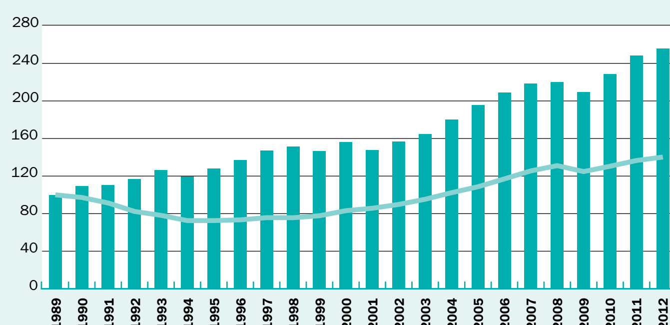
The FSC is also tasked with monitoring and containing systemic risk to the financial sector. Additional measures to reign in credit expansion were undertaken in June 2011, in which the BRSA imposed loan-to-value ceilings on commercial, housing and real-estate loans, and raised provisioning requirements on loans. As a result, growth in credit to the private sector fell throughout the year, from 41 per cent year-on-year in June 2011 to 21 per cent in June 2012. Finally, Turkey's financial sector switched to the Basel II regime in July 2012, encouraging improvements in risk management and mitigation.

An incentive package has been adopted to spur domestic and foreign investments. Having come into effect in June 2012, the new incentives complement the existing incentive structure by encouraging additional capacity in the tradeable sector, with a special emphasis on the least developed provinces. Priority sectors have been identified to receive stronger investment incentives in tourism, mining, rail and maritime transport, and pharmaceuticals. Other incentives target sectors that reduce Turkey's import dependence.

Agriculture reforms have been accelerated. After identifying around 30 agricultural areas in 2010 designated to receive differentiated support, the government has stepped up its commitments in 2012. Area-based payments are being disbursed, especially for irrigation investments, and land consolidation efforts have been accelerated, particularly in regions that have been defined as top priority, such as the south-eastern and eastern parts of the country. Irrigation projects are being designed to promote efficient use of water.

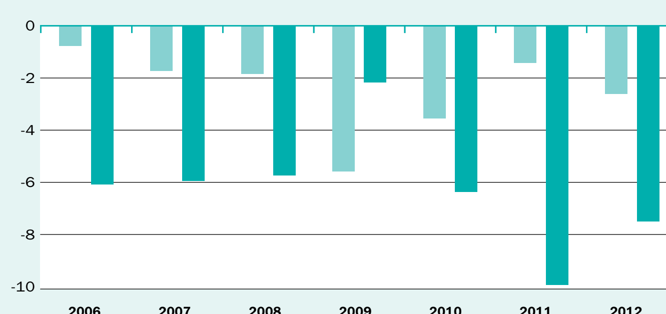
Real GDP (1989 = 100)

■ Turkey ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



TURKMENISTAN

HIGHLIGHTS OF THE PAST YEAR

- **Turkmenistan's economy was among the fastest growing economies in the world in 2011.** GDP grew by 14.7 per cent in 2011, driven by increasing hydrocarbon production and surging public infrastructure spending. Increased gas exports to China as well as growing exports of oil have supported the strong external balance.

- **Prices for food and other products and services remain regulated by the state.** The threefold increase in prices for bread in July 2012 and looser controls over meat prices were a step in the direction of price liberalisation, but constituted an unexpected negative shock for consumers.

- **Some progress has been made in the area of structural reform.** State regulation in the agriculture sector has decreased and IFRS accounting standards have been introduced for banks. A number of programmes have been developed in other areas but progress with implementation has been slow.

KEY PRIORITIES FOR 2013

- **The government should speed up progress with its stated goals to increase the share of the private sector and reduce government intervention in the economy.** A number of sectors remain distorted by production targets and subsidised inputs that hamper their productivity and the effective use of resources. The remaining controls on prices, interest rates and the exchange rate should be gradually phased out and production targets should be abolished.

- **The business climate needs to be further improved.** Participating in various cross-country surveys would help the authorities to identify major obstacles to businesses and develop policies to improve the business environment and investment climate.

- **Further exchange rate regime liberalisation would boost trade and financial intermediation.** The new law on foreign exchange regulations is an important step forward, as it allows for advance payments on imports, but faster progress needs to be made with implementing the regulations.

MACROECONOMIC PERFORMANCE

Economic growth in Turkmenistan has been among the fastest in the EBRD region and reached 14.7 per cent in 2011. This was mainly driven by good performance in the hydrocarbon sector and by state-supported infrastructure spending. Inflation remained moderate compared with other countries in the region. However, in July 2012 the price of bread and meat increased, with the price of the former soaring by three times. Further price increases are expected throughout 2012, likely related to lower than expected (targeted) wheat production. Moreover the announced 10 per cent increase in government wages and 15 per cent in pensions from 2013 may lead to a spike in inflation.

Gas exports have become more diversified with increased exports to China and Iran. In May 2012 the governments of Turkmenistan and Afghanistan signed a long-awaited Memorandum of Understanding (MoU) on long-term gas cooperation, while the state gas company Turkmengaz simultaneously signed sales agreements with its Indian and Pakistani counterparts. There are, however, a number of concerns including financial support to the pipeline construction through the territory of Afghanistan due to security reasons. Recently China offered to build another pipeline that would go through Afghanistan to China, offering investment for building the infrastructure.

The country's vast hydrocarbon revenues have helped create twin surpluses. After having been in deficit for two years, the current account balance turned into a surplus of around two per cent of GDP in 2011, driven by higher oil and cotton exports and lower FDI-related imports. At the same time, the fiscal balance was estimated to have reached a surplus of 3.6 per cent of GDP in 2011.

Credit growth reached about 30 per cent in 2011, mostly due to state-supported lending programmes financed by stabilisation fund resources. While most banking system lending has continued to be channelled to state-owned enterprises, directed lending by the central bank has decreased and credit to the private sector has started to increase, in part due to state-subsidised lending programmes for small and medium enterprises and agriculture.

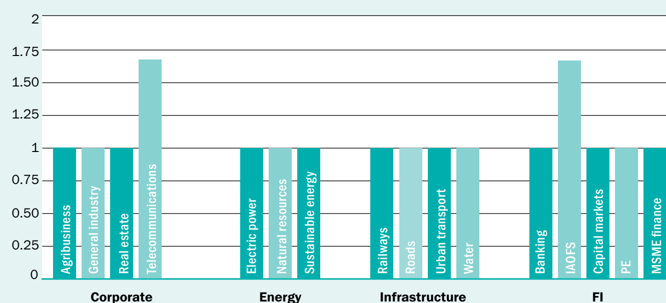
The growth outlook remains positive with balanced risks. In the short term, GDP growth will continue to be driven by hydrocarbon production and further diversification of export routes. The economy is expected to continue to grow at a double-digit rate in 2012. However, heavy dependence on hydrocarbon production and exports and excessive state regulation and intervention impedes progress with market-oriented reforms and will weigh negatively on the outlook in the longer term.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	6.1	9.2	14.7	10
Inflation (end-year)	0.1	4.8	5.6	6.5
Government balance/GDP	7.0	2.0	3.6	6.8
Current account balance/GDP	-14.7	-10.6	2.0	0.0
Net FDI (in million US$)	4553	3631	3399	3159
External debt/GDP	2.4	10.6	7.3	na
Gross reserves/GDP	na	na	na	na
Credit to private sector/GDP	1.4	2.0	2.5	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Turkmenistan remains among the least reformed of all transition countries, but the authorities continue to express commitment to gradual privatisation and private sector development. Although small-scale privatisation has proceeded since the start of transition, an estimated 75 per cent of the national economy remains under the control of the state and large-scale privatisation still needs to be started in a significant way. However, the authorities have begun drafting a privatisation law. They have also stated their intention to privatise state banks between 2016 and 2020 and they continue to express their commitment to their stated goal of increasing the share of the private sector to 70 per cent of non-hydrocarbon GDP by 2020.

Some progress was made with strengthening the banking sector, but state involvement remains prevalent. As part of the government's programme to develop the banking system during 2010-30, various new laws have been adopted, including a Law on Accounting and Financial Reporting Standards (July 2010), new laws on the CBT and on Lending Institutions and Banking (March 2011) and a Law on Microfinance (April 2011). The government has a banking sector development programme for 2010-30, which also envisages the privatisation of all state banks between 2016-20. Foreign shareholders do not appear to be excluded. In addition to various laws adopted in 2010 and the first half of 2011, two important reforms that will help this privatisation process are: (i) the introduction of IFRS reporting standards in all banks as of January 2012, and (ii) the transfer of all state-directed loans financed by the Stabilisation Fund (constituting an estimated 70-80 per cent of all banking assets) to the newly created State Development Bank as of November 2011. This has helped to clean banks' balance sheets and could increase competition between banks for private sector projects.

There are plans to develop non-bank financial institutions and securities markets. The government has adopted a programme to develop private insurance companies (currently there is only one insurance company, which is state-owned) and is drafting a new insurance law that is expected to be adopted in 2012. The authorities also aim to establish a notional defined-contribution pension fund in 2012 and the Ministry of Social Affairs is working with the UNDP on pension reform. In addition, efforts are under way to establish a legal framework to support the government's programme and action plan for securities market development for 2012-16 that was approved in November 2011. The World Bank is offering technical assistance in this area.

Plans to increase private sector involvement in the telecommunications sector have been announced. In 2011 the authorities announced plans to privatise the state-owned mobile operator Altyn Asyr and to create three more private mobile companies with foreign participation under condition of 50 per cent ownership by Turkmenistan. There has, however, been no progress in this area. MTS, the Russian mobile operator, whose license had been suspended in December 2010, has been in negotiations with the authorities and is expected to resume its work in August 2012.

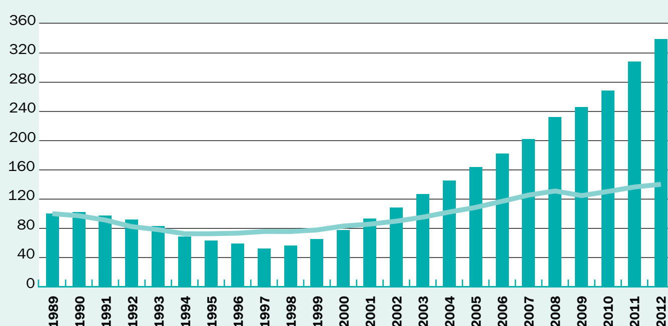
Negotiations on the Turkmenistan – Afghanistan – Pakistan – India (TAPI) pipeline project have progressed. Turkmenistan has continued its export-diversification policies and has signed a number of important agreements for construction of the TAPI pipeline. The challenge now is to find a commercial champion for the project.

State regulation has decreased in the agricultural sectors. In mid-2012 the government cancelled the flour rationing that had been introduced by the previous President in the early 2000s as part of a social protection package. At the same time, the maximum price of bread increased threefold and controls over the meat price were eased, also leading to an increase in meat prices.

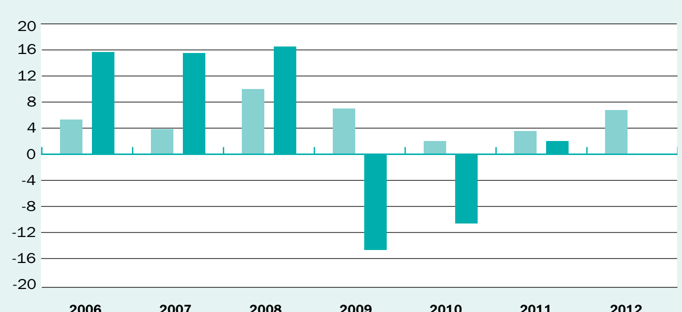
Some progress was made in the area of foreign exchange and trade restrictions. In particular, local private small and medium-sized enterprises (SMEs) can now have foreign currency accounts to conduct import/export operations without needing a license or permission from the cabinet of ministers. Moreover, under the new foreign exchange law adopted in October 2011, residents will now be allowed to provide trade credit to non-residents (that is, local firms will be able to make advance payments for imports and deferred payments for exports). In addition, it allows banks to conduct foreign exchange transactions with non-public customers without seeking prior approval from the central bank. These are long-awaited reforms, but they have not yet become effective as the relevant central bank regulations and other enabling legislation remain to be developed.

The business climate remains weak. The country lags behind other Central Asian countries in terms of reforms. While barriers to entry for new private businesses remain very large, there is evidence that they were reduced somewhat in 2011, including: a reduction in state duties for registration; elimination of the commission needed to register a local company; elimination of the requirement to re-register a company when adding a shareholder; and the distribution of land for project sites to entrepreneurs in late 2011. This was not reflected in any international business environment surveys (such as the 2012 World Bank's *Doing Business* Report), as Turkmenistan is one of the few countries that does not yet participate in them.

Real GDP (1989 = 100)



Fiscal balance and current account balance



UKRAINE

HIGHLIGHTS OF THE PAST YEAR

- **The pace of recovery from the crisis has slowed down.** As the global economic environment deteriorated, growth of Ukraine's commodity-based export sectors decelerated. Credit growth has suffered from deleveraging by European banks and tight monetary policy focused on a stable exchange rate.

- **The business environment has deteriorated further, notwithstanding recent administrative reforms.** Illegal corporate raids have increased. Tax administration policies - including delayed VAT refunds, limited ability of companies to deduct investments from corporate tax and advance tax payments - have deterred investors.

- **The authorities made steps to reform the gas sector.** A decision was made to reorganise the national oil and gas company Naftogaz along functional lines into production, transit and distribution units. Licenses to explore shale gas were auctioned to multinational companies, and discussions initiated to widen geographic sources of gas imports.

KEY PRIORITIES FOR 2013

- **Improvement of the country's difficult business environment remains a top priority.** The justice system should be reformed to ensure that procedures for resolution of commercial disputes are fair, and commercial courts should be de-politicised. The government should effectively implement various measures adopted in recent years to improve governance and reduce corruption.

- **The announced reforms of the gas sector should be implemented.** Household gas tariffs should be adjusted towards the import parity levels and implicit energy subsidies should be monitised. Reorganisation of Naftogaz along functional lines should be completed, and individual companies' accounts be made transparent.

- **Post-crisis stabilisation in the financial sector should be completed.** It will be necessary to reverse the unconventional crisis-time policies, such as local currency provisions on foreign currency loans, that exposed banks to currency movements. The National Bank and the government should pursue policies to develop capital markets in local currency.

MACROECONOMIC PERFORMANCE

The pace of economic recovery has slowed down. After expanding quickly through much of 2011, Ukraine's output growth decelerated to 2.5 per cent in the first half of 2012 due to a substantial slow-down in the steel and chemical sectors and machine building, and stagnation of agriculture and construction. More recent data suggest that agriculture and construction have also declined. For much of the year, the contraction of external demand was offset to some extent by buoyant domestic consumption, stimulated by fast growth of public sector wages and social expenditures. The National Bank of Ukraine (NBU) and the government adopted various measures to contain depreciation pressures, which included tightening further the banks' open currency positions, introducing additional administrative requirements on forex purchases by households, issuing domestic dollar, euro and devaluation-protected hryvnia bonds and removing export tariffs on some grains to stimulate exports. The Eurobond issue in July 2012 at a historically high interest rate, the rollover of VTB loans and new credits from China should provide temporary relief. Inflation has decreased from 11.9 per cent year-on-year in June 2011 to a record low of minus 1.2 per cent in June 2012, due to lower global food prices and tight monetary policy. Inflation increased more recently as food prices crept up again.

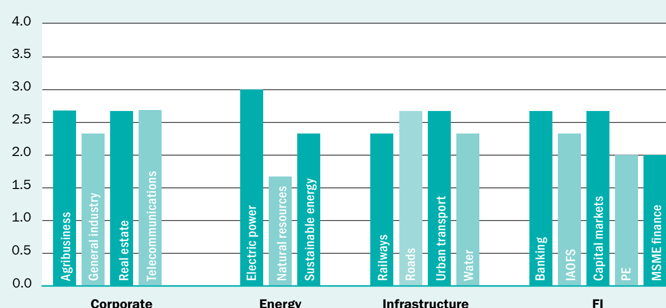
The economy remains vulnerable to external shocks. Although Ukraine's exports are less energy and resource-dependent than those of neighbouring countries, the share of low value-added steel and chemicals remains very high. The stock of external private and public debt is also high, most of it with relatively short maturities and denominated in foreign currencies, and gross external financing requirements remain large. After a large devaluation in 2008, the hryvnia - de facto pegged to the US dollar since then - appreciated in real terms against currencies of its main trading partners, thus erasing most of the competitiveness gains. A further escalation of EU banking and sovereign crises may have a negative effect on the Ukrainian financial sector as it is highly exposed to the euro area.

A return to fast growth experienced before the crisis is unlikely without deep structural reforms. The financial sector is recovering from the crisis and is unlikely to stimulate demand for some time as most banks prefer reducing their balance sheets to further capital injections. The public sector's future ability to provide a countercyclical boost will be limited by the high gross financing needs. Growth is expected to remain subdued, at around three per cent in 2012-13 as spare capacity left after the crisis is exhausted, the external environment remains difficult and bank lending is limited. Over the longer term, acceleration of growth will primarily depend on external demand, but also the authorities' ability to credibly stabilise the financial system, pursue countercyclical macroecnomic policies based on a floating exchange rate, and attract significant domestic and foreign investment.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-14.8	4.1	5.2	1.0
Inflation (end-year)	12.3	9.1	4.5	4.1
Government balance/GDP	-11.3	-9.9	-5.3	-5.3
Current account balance/GDP	-1.5	-2.2	-5.5	-7.0
Net FDI (in million US$)	4654	5759	7015	7000
External debt/GDP	88.2	86.0	76.4	na
Gross reserves/GDP	22.6	25.3	19.2	na
Credit to private sector/GDP	73.4	62.4	55.9	na

2012 sector transition indicators



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Progress in improving the country's difficult business environment has been mixed. The National Anti-Corruption Committee, chaired by President Yanukovych, has focused the authorities' attention on the country's long-standing corruption challenge. Although the tax authorities increased the share of VAT refunds paid through the fast-track system, many international companies continue to face long delays. To boost tax revenues, tax legislation was amended in November 2011 to slow the pace of deduction of capital investments from the corporate profit tax. Companies also report frequent requests of advance tax payments by the tax authorities. The procurement legislation was amended to exempt state enterprises from public procurement rules. The increasing incidence of illegal corporate raids has had a negative effect on Ukraine's image as a destination for foreign direct investment.

Development of the financial sector continues to suffer from the legacy of the crisis. The authorities have been working to improve regulatory frameworks for the financial sector, by developing policies to increase transparency of banks' ownership, supervision and resolution frameworks. Although the banking system is reasonably well capitalised, following the mandatory recapitalisations of 2009-10, banks' balance sheets are weakened by a large stock of non-performing and restructured loans, which are 9.2 per cent of the total as of July 2012. The balance sheets of many international banks have long *de facto* positions in hryvnias, reflecting the unconventional crisis-time policy of the National Bank to require provisioning in local currency on foreign currency loans aimed at exchange rate stability. The stock of liquidity provided to the banking system during the crisis remains high, at around five per cent of GDP, and several banks nationalised during the crisis have suffered from governance problems and are yet to be resolved. The country has become a participant in the Vienna 2 Initiative, which aims at improvement of home-host country coordination and managing the process of bank develiveraging.

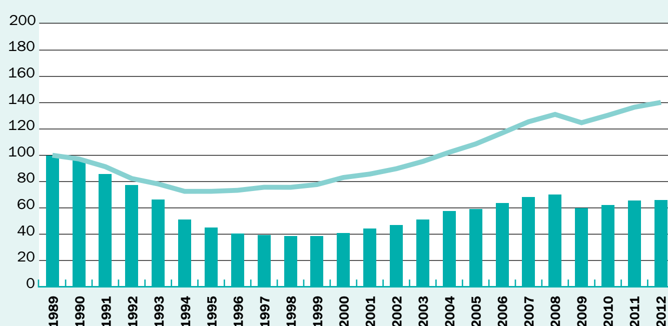
A new Customs Code was implemented. The new code, which came into force on 1 June 2012, is intended to simplify import procedures, by permitting registration of imports at any customs agency, including before goods are imported, reducing the length of customs registration procedures from one day to four hours, introducing electronic declarations and implementing the single-window principle. The new rules also provide for decriminalisation of merchandise smuggling and restrict the customs service's authority to confiscate contraband. If implemented in letter and spirit, the code should help improve Ukraine's business environment as difficult and cumbersome procedures have complicated Ukraine's integration into international production chains.

The authorities have continued to reform the country's gas sector. In March 2012 the parliament approved legislation allowing the government to separate the national energy company Naftogaz into production and transportation divisions. If implemented, the reform will move Ukraine towards compliance with EU legislation, which requires the separation of energy production, transportation and sales, a commitment Ukraine made as a member of the European Energy Community. The government has been working to diversify sources of gas consumed in Ukraine. In May 2012 it auctioned licenses to explore the Olesska and Yuzivska blocks of shale gas, purchased by major international companies Chevron and Shell. Discussions on potential imports of gas from western Europe and construction of an LNG terminal are ongoing. However, the sector continues to suffer from very low domestic household gas tariffs. Naftogaz generates a deficit of two per cent of GDP, covered by the government, and distributes around five per cent of GDP in implicit subsidies.

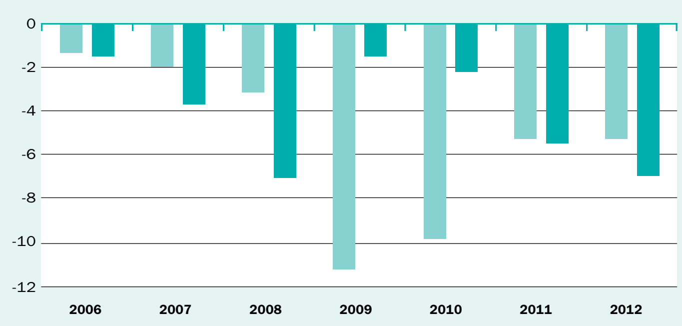
The government has pursued policies to increase private sector participation in the modernisation of the country's infrastructure. In February 2012 the parliament passed a law allowing transformation of the state railway agency and related enterprises into a state-owned joint stock company. The corporatisation should lead to separation of regulatory functions from operations, promoting transparency, efficiency and competitiveness and paving the way for greater involvement of private businesses in the railway sector. In June 2012 the law on sea ports was adopted permitting leasing and concession of sea ports to private operators. Privatisation of remaining public stakes in the regional energy producing and distributing companies should improve quality of delivery, if underpinned with a robust regulatory framework. In May 2012 the government adopted the draft bill on changes in the legislation on lease or concession of water and wastewater and district heating utilities, which among other things is aimed to facilitate private investments in the sector. Tariff setting responsibilities, which were until recently within the purview of the municipalities, have been transferred to the single national regulator. The main risk is that privatisation of infrastructure services would only benefit sector incumbents, who would also control the regulatory bodies.

The institutional framework for development of the local capital market is being established. In May 2012, the parliament approved in first reading amendments to the Law on Securities Market that would enable international financial institutions to issue hryvnia bonds. The draft changes include requirements that issuance volumes and interest levels are to be approved by the Cabinet of Ministers and bond proceeds are to be used exclusively for the crediting of Ukraine's real economy or long-term development projects. The amendments should enable the further development of local capital markets in Ukraine. Derivatives legislation is under preparation.

Real GDP (1989 = 100)



Fiscal balance and current account balance



UZBEKISTAN

HIGHLIGHTS OF THE PAST YEAR

- **Uzbekistan's economy continues to show strong growth.** In 2011 the economy was reported to have grown by 8.3 per cent, driven by strong domestic demand and fiscal stimulus, including through the state industrialisation programme. To support further growth the government approved a number of sector development programmes for 2011-15.

- **The authorities announced a new privatisation programme for 2012-13.** The new programme includes minority and majority stakes in almost 500 enterprises that will be offered to local and foreign investors via open public tenders.

- **The overall business environment remains difficult, notwithstanding the streamlining of a number of registration and licensing procedures.** Firm registration and tax reporting procedures have been simplified and a significant number of licenses and permits have been abolished. At the same time, the overall business environment remains difficult and businesses remain constrained by foreign exchange restrictions.

KEY PRIORITIES FOR 2013

- **The economy needs to be liberalised with government intervention further reduced.** Priority measures include reducing discriminatory barriers against imports and eliminating state procurement quotas in agriculture. The role and the function of a regulator in each sector should be clearly defined. Privatisation should proceed in a transparent fashion.

- **Distortions and indirect restrictions in the foreign exchange market need to be eliminated.** Increased exchange rate flexibility and easier access to foreign currency are crucial in order to reinvigorate trade and private investment.

- **Financial sector development will require better banking supervision and reduction of state interference in the banking system.** Direct lending at preferential rates distorts competition among banks, interferes with a sound risk culture and challenges effective banking supervision. More transparent banking practices would enhance the supervision ability of the central bank.

MACROECONOMIC PERFORMANCE

Uzbekistan's economy continues to grow at above eight per cent according to official statistics. Official GDP growth amounted to 8.3 per cent in 2011, driven mainly by fiscal stimulus and strong domestic consumption, and supported by large wage and pension increases and continued state investment as well as increasing remittance inflows. According to official estimates, growth has continued in the first half of 2012 and reached 8.1 per cent year-on-year. Despite lower global food prices in 2011 and early 2012, inflation in Uzbekistan remained on the rise caused by fiscal stimulus, currency depreciation and administrative price hikes. The fiscal and current account balances remained firmly in surplus. Imports have increased, reflecting growing capital goods imports under the ongoing government programme for industrial modernisation.

The banking sector remains stable but has required continued capital injections by the authorities. Banking supervision and regulation remain weak. According to the rating agency Moody's, the banking sector outlook remains stable in 2012-13 based on the assumptions of favourable growth prospects and continued state support. The non-performing loan portfolio of state-owned banks was massively restructured in 2011 with nearly 20 per cent being debt-to-equity swaps and capital injections by the state to support funding needs. This has positively affected the banks' balance sheet.

Uzbekistan signed the CIS free trade agreement at the beginning of 2012 that eliminates custom duties for its products including those going to its major trade market, Russia. While it is likely that Uzbekistan will remain outside of the custom union, the elimination of customs duties will increase the competitiveness of its products in CIS markets.

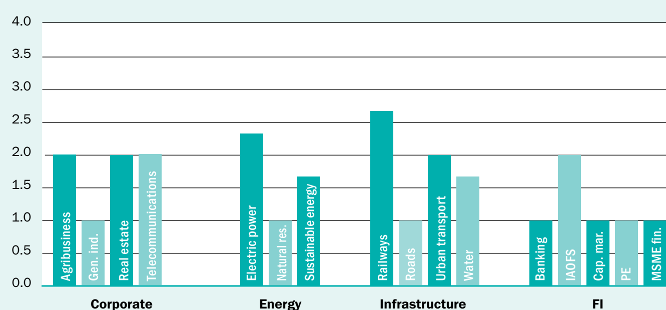
The government is expected to keep economic growth high at around eight per cent in 2012 and 2013, with the help of continued large government spending. In the medium-to-long term, however, Uzbekistan's growth prospects will likely be constrained by the slow progress with structural reforms, continued directed lending practices by the state, limited currency convertibility and continued disengagement with international financial organisations.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	8.1	8.5	8.3	7.5
Inflation (end-year)	10.6	12.1	13.3	11.5
Government balance/GDP	2.8	4.9	9.0	3.0
Current account balance/GDP	2.2	6.2	5.8	4.7
Net FDI (in million US$)	842	1628	1467	1094
External debt/GDP	15.0	14.8	13.3	na
Gross reserves/GDP	30.5	29.1	37.6	na
Credit to private sector/GDP	16.7	16.6	na	na

2012 sector transition indicators

Sector transition score



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

MAJOR STRUCTURAL REFORM DEVELOPMENTS

State ownership and interference in the economy remain dominant. The authorities have recently renewed a privatisation programme that includes a list of almost 500 enterprises, with minority or majority stakes possibly being offered to private and foreign investors. The list includes enterprises across all sectors of the economy, including oil and gas and mining. In addition, the authorities drafted a list of over 50 enterprises where production facilities are currently unfinished or inactive. These can be transferred to interested investors free of charge in exchange for binding investment obligations on the part of investors. While this programme could signal the beginning of a renewed transition process, the prospects are still uncertain given previous privatisation announcements that did not materialise. Major investment programmes and projects will be supported by the Fund for Reconstruction and Development into which the government has accumulated nearly US$ 10 billion.

There has been some progress with improving banking regulations and state directed lending practices. All banks are currently audited by international agencies under IFRS standards, and the banking system has remained stable due to the capital injections by the government. However, the regulatory framework remains weak. While some foreign banks are operating in the country, the state still owns 70 per cent of the banking sector. There has been increasing competition in the sector and major state-owned banks are undergoing internal restructuring and transformation. The state support programmes now target specific sectors, with control over use of funds performed by the relevant line ministries and specialised agencies.

The situation in non-banking financial institutions has deteriorated. In 2011 the government revoked the licenses of all credit unions, on the grounds that they lacked transparency and were engaged in money laundering. At that time there were nearly 140 licensed credit unions providing funding access to entrepreneurs and involved in the micro lending industry. This move has potentially pushed a sector accounting for 15-20 per cent of loans to the grey economy.

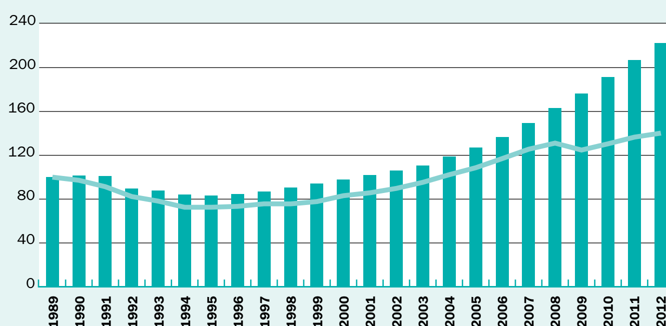
There has been no progress with eliminating distortions in the foreign exchange market. Foreign traders continue to experience major market distortions with respect to trade and foreign exchange, related to delays in currency conversion for imports, restrictions on cash and foreign exchange availability and a restrictive trade policy. The lack of a liberal trade and foreign exchange regime continues to be a major constraint to foreign investment and private sector development.

The energy sector remains largely unreformed and state controlled and has only recently embarked on a programme of efficiency improvements. However, implementation of this programme is complicated by obsolete equipment that requires substantial investment for modernisation and reconstruction. Based on its renewable energy programme, the government has received nearly US$ 500 million in support from the Asian Development Bank. There are now four solar panel plants in the country with two already in operation. In the telecommunications sector the license of a major mobile operator, subsidiary of MTS of Russia, was suspended in July 2012 on the basis of alleged tax irregularities and other violations. Other foreign operators remain present in the market.

The business climate remains very poor but may benefit from a number of recent initiatives. Uzbekistan ranked 166th among 183 countries in ease of doing business in the 2012 World Bank *Doing Business* Report. The country scored poorly in every component of the ranking, although improvements were recorded in the area of starting a new business as the authorities reduced the minimum capital requirement, eliminated a number of procedures and lowered the cost of registration. Moreover, a presidential decree signed in July 2012 significantly reduced the number of financial, statistical and tax reporting procedures as well as procedures for obtaining licenses and permits. Eighty permission procedures and 15 licenses were eliminated from 1 August 2012, and the requirement for monthly tax reporting by businesses will be abolished from 2013. From 2014 businesses should be able to obtain licenses and permissions online. In August 2012 procedures for opening business bank accounts and authorising bank payments have been streamlined. A law on pledge registry has been drafted and is expected to be adopted by the end of 2012.

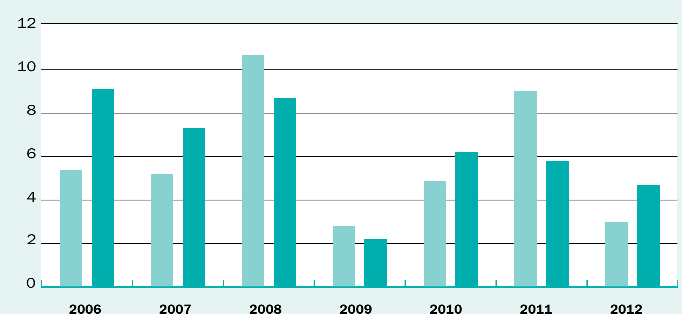
Real GDP (1989 = 100)

■ Uzbekistan ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



METHODOLOGICAL NOTES

SECTORAL TRANSITION INDICATORS

(see Table 1.1 on page 9)

The sectoral transition indicators 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. The table to the right serves as a guide, defining the ranges for those cases where the two component assessments are the same, however exceptions can be made to this rule.

Table M.1.1.1
Transition cut-off points

Cut-off points	
Transition gaps (MS/MI)	**Potential scores**
Large/Large	from 1 to 2+
Medium/Medium	from 2+ to 3+
Small/Small	from 3+ to 4
Negligible/Negligible	4+

The following tables show for each sector the weighting attached to the two components (market structure and market-supporting institutions and policies), the criteria used in each case (and the associated weights), and the indicators and data sources that fed into the final assessments. For the corporate and financial sectors, the exact sources are listed in the tables. The assessment of remaining transition challenges in the energy sectors is based on cross-country factual data and information on the energy sector (oil, gas, mining, electric power) in the EBRD's countries of operations, including from external agencies (International Energy Agency, EC Progress Reports on accession countries, Business Monitor International sector reports, Energy Regulators Regional Association, and so on). For infrastructure sectors, the assessment relied both on quantitative indicators (for example, cost recovery tariffs based on information from EBRD projects) and qualitative assessments of the less quantifiable measures, such as the relations between municipalities and their utilities. Sources encompassed in-house information from investment projects and cross-country data and assessments from several external agencies (including the World Bank, the European Commission and the OECD).

Corporates

Table M.1.2.1
Rating transition challenges in the agribusiness sector

Components	Criteria	Indicators
Market structure [50%]	Liberalisation of prices and trade [15%]	Wheat: producer price to world price ratio (FAO GIEWS and PriceSTAT, 2008) MFN applied tariff, simple average, agricultural products (WTO, 2010) NRA to agriculture (World Bank Distortions, 2004-07) WTO membership (WTO)
	Development of private and competitive agribusiness [40%]	Wheat: yields per ha (FAO ProdSTAT, 2012) Wheat: average change in yields per ha (FAO ProdSTAT, 2012) Mass grocery retail sales in per cent of total grocery retail (BMI, latest available data) Processing mark-up in agriculture (EBRD calculation based on UNIDO, 2008)
	Development of related infrastructure [25%]	EBRD railways infrastructure (EBRD Transition Report, 2011) EBRD road infrastructure (EBRD Transition Report, 2011) Tractors per 100 ha arable land (World Bank, 2009) Pump price for gasoline (World Bank Development Indicators, 2010)
	Development of skills [20%]	Ratio of a percentage of tertiary graduates in agriculture over a percentage of agricultural share in GDP (EBRD calculations based on UNESCO and CEIC, 2012) Value-added per worker in agriculture (World Bank World Development Indicators, 2010)
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, 2012) Registering property (World Bank Doing Business, 2012)
	Enforcement of traceability of produce, quality control and hygiene standards [40%]	Overall TC 34 (ISO, 2009) Hygiene standard implementation (EBRD assessment, latest available)
	Creation of functioning rural financing systems [20%]	Ratio of percentage of lending to agriculture relative to percentage of agricultural share in GDP (EBRD calculations, latest available)

Source: EBRD.

Table M.1.2.2
Rating transition challenges in the general industry sector

Components	Criteria	Indicators
Market structure [60%]	Market determined prices [20%]	Subsidies in % of GDP (CEIC, latest available data) Energy intensity (World Bank Development Indicators, 2012)
	Competitive business environment [40%]	MFN applied tariff, simple average, non-agricultural products (WTO, 2011) Lerner index (EBRD calculation based on UNIDO, 2008) Large scale privatisation (EBRD Transition Report, 2011)
	Productivity and efficiency [40%]	Expenditures on R&D in % of GDP (UNESCO, 2009) R&D effectiveness (EBRD calculation based on WIPO and UNESCO, 2005-09) Value-added, manufacturing, per employee (UNIDO, 2008) Knowledge Index (World Bank, 2012)
Market-supporting institutions and policies [40%]	Facilitation of market entry and exit [40%]	Starting a business (World Bank Doing Business, 2012) Closing a business (World Bank Doing Business, 2012) 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, 2012)
	Corporate governance and business standards [30%]	Composite country law index (EBRD Legal Transition Team 2010) ISO certification (EBRD calculation based on ISO and World Bank data, 2009) Investor Protection (World Bank Doing Business, 2012) Investor Protection (World Bank Doing Business, 2012)

Table M.1.2.3
Rating transition challenges in the real estate sector

Components	Criteria	Indicators
Market structure [40%]	Sufficient supply of quality assets in all sub-segments (warehouse/office/retail/hotels) [60%]	Class A industry supply per capita (Colliers, DTZ, King Sturge, CB Richards Ellis, Jones Lang LaSalle) 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) Hotel room supply per capita (WEF Tourism Competitiveness Index, 2011)
	Market saturation and penetration of innovative construction technologies [40%]	Market saturation index (EBRD, 2012) Index on penetration of innovative construction technologies (EBRD, 2012)
Market-supporting institutions and policies [60%]	Tradeability and accessibility of land [20%]	Accessing industrial land: Lease rights (World Bank, 2010) Accessing industrial land: Ownership rights (World Bank, 2010) Access to land (BEEPS, 2008)
	Development of an adequate legal framework for property development [30%]	Quality of primary legislation in the property sector (EBRD, 2012) Quality of secondary legislation in the property sector (EBRD, 2012) Mortgage market legal efficiency indicators (EBRD 2011)
	Presence and effectiveness of energy efficiency support mechanisms [10%]	Sustainability of government support mechanisms (EBRD, 2012)
	Adequacy of property-related business environment [40%]	Registering property (World Bank Doing Business, 2012) Dealing with construction permits (World Bank Doing Business, 2012) Property rights (WEF Tourism Competitiveness Index, 2011-12) Level of corruption for construction related permits (BEEPS, 2008)

Energy

Table M.1.3.1
Rating transition challenges in the electric power sector

Components	Criteria	Indicators
Market structure [40%]	Restructuring through institutional separation, unbundling and corporatisation [33%]	Extent of corporatisation (setting up of joint stock companies, improved operational and financial performance) 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 [33%]	Degree of private sector participation in generation and/or distribution
	Competition and liberalisation [33%]	Degree of liberalisation of the sector (third party access to network on transparent and non-discriminatory grounds) 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
	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 and price liberalisation [40%]	Presence of cost-reflective 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, EITI/PWYP compliance
	Regulatory structure [40%]	Degree of financial and operational independence of the regulator Level of standards of accountability and transparency

Table M.1.3.3
Rating transition challenges in the sustainable energy sector: energy efficiency (EE), renewable energy (RE) and climate change (CC)

Components	Criteria	Indicators
Market structure [67%]	Market determined prices [50%]	Quality of energy pricing: end-user cost-reflective electricity tariffs 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, RE and CC Number of projects in EE, RE and CC Expenditure data on projects in EE, RE and CC

Source: EBRD.

Infrastructure

Table M.1.4.1
Rating transition challenges in the railways sector

Components	Criteria	Indicators
Market structure [60%]	Restructuring through institutional separation and unbundling [33%]	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 [33%]	Number of new private operators Extent of privatisation of freight operations and ancillary services
	Competition and liberalisation of network access [17%]	Extent of liberalisation of network access according to non-discriminatory principles Number of awards of licences to the private sector to operate services
	Institutional Development [17%]	Extent of introducing good corporate conducts (for example, Business Plans, IFRS, MIS and so on) Extent of introducing good corporate governance standards Extent of introducing best practice energy and/or energy efficiency accounting and management
Market-supporting institutions and policies [40%]	Tariff reform [50%]	Extent of freight tariff liberalisation Extent of introduction of public services obligations (PSO) Extent of cost recovery tariffs Extent of elimination of cross subsidies
	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

Table M.1.4.2
Rating transition challenges in the roads sector

Components	Criteria	Indicators
Market structure [60%]	Restructuring through institutional separation and unbundling [33%]	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 [33%]	Extent of private sector companies in construction and maintenance (BOT-type concessions, management or service contracts, other types of public-private partnerships (PPPs)) Degree of decentralisation of local roads responsibility
	Competition [17%]	Index on rules for open tendering of construction and maintenance contracts Index on practices for open tendering of construction and maintenance contracts Degree of privatisation of road construction and maintenance units
	Institutional Development [17%]	Extent of introducing good corporate conducts (for example, Business Plans, IFRS, MIS and so on) Extent of introducing good corporate governance standards Extent of introducing best practice energy and/or energy efficiency accounting and management
Market-supporting institutions and policies [40%]	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%]	Existence and quality of road act and other road related legislation Extent and quality of PPP legislation
	Development of the regulatory framework [25%]	Extent that the regulatory and policy making functions are separated from the road administration functions Degree of requlatory capacity on roads safety availability, environmental aspects, pricing and competition for road construction and maintenance, etc

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 commercial 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 commercial 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

Table M.1.4.5
Rating transition challenges in the telecommunications sector

Components	Criteria	Indicators
Market structure [50%]	Competition and private sector involvement: mobile telephony [40%]	Expansion of services to rural areas, proxied by % of population covered by mobile signal (World Bank, 2009) Mobile penetration rate (International Telecommunications Union, 2010) Percentage of private ownership in the incumbent mobile operator (Global Insight, BuddeCom, 2011) Market share of the largest mobile operator (Business Monitor International, Global Insight, BuddeCom, 2011) Mobile number portability (Business Monitor International, Global Insight, BuddeCom, 2011) Level of competition for mobile telephone services (World Bank, 2009)
	Competition and private sector involvement: fixed telephony [20%]	Fixed-line teledensity (International Telecommunications Union, 2010) Percentage of private ownership in fixed telephony incumbent (Business Monitor International, Global Insight, 2011) Market share of the largest fixed telephony provider (Global Insight, BuddeCom, 2011) Fixed number portability (Business Monitor International, Global Insight, 2011) Level of competition for international long distance services (World Bank, 2008) Mobile and fixed line subscribers per employee (World Bank, 2008)
	IT and high-tech markets [40%]	Internet users penetration rates (International Telecommunications Union, 2010) Broadband subscribers penetration rate (International Telecommunications Union, 2010) International internet bandwidth (World Bank, 2009) Level of competition for internet services (World Bank, 2009) Piracy rates (Business Software Alliance, 2010)
Market-supporting institutions and policies [50%]	Regulatory framework assessment [70%]	Market liberalisation (EBRD, 2012) Sector organisation and governance (EBRD, 2012) Market entry for wired networks & services (EBRD, 2012) Fees and taxation on electronic communication services (EBRD, 2012) Progress towards implementation of information society (EBRD, 2012)
	Preparedness of the country to develop a knowledge economy [25%]	Knowledge Economy Index: Economic incentives (World Bank, 2012) Knowledge Economy Index: Innovation (World Bank, 2012) Knowledge Economy Index: Education (World Bank, 2012)
	Freedom of media [5%]	Freedom of press (Reporters without borders, Freedom House, 2011 / 2012)

Source: EBRD.

Financial institutions

Table M.1.5.1
Rating transition challenges in the banking sector

Components	Criteria	Indicators
Market structure [35%]	Degree of competition [43%]	Asset share of five largest banks (EBRD Banking Survey 2012) Net interest margin, (EBRD Banking Survey 2012) Overhead cost to assets (EBRD Banking Survey 2012, official statistical sources)
	Ownership [29%]	Asset share of private banks (EBRD Banking Survey 2012, bankscope official statistical sources) Asset share of foreign banks (subjective discount relative to home/host coordination) (EBRD Banking Survey 2012 and latest EBRD assessment)
	Market penetration [14%]	Assets/GDP (EBRD Banking Survey 2012, official statistical sources)
	Resource mobilisation [14%]	Domestic credit to private sector/ total banking system's assets (EBRD Banking Survey 2012, official statistical sources)
Market-supporting institutions and policies [65%]	Development of adequate legal and regulatory framework [40%]	Existence of entry and exit restrictions (EBRD assessment, latest estimates) 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 (EBRD assessment, latest estimates) Deposit insurance scheme with elements of private funding (EBRD assessment based on official sources, latest estimates)
	Enforcement of regulatory measures [50%]	Compliance with Basel Core principles (EBRD assessment, latest estimates) Unhedged FX lending to the private sector / total lending to the private sector (EBRD Banking Survey 2012, national statistical sources via CEIC, latest estimates) Banking strength – actual risk weighted capital to assets ratio (IMF, National Sources) Sophistication of banking activities and instruments (EBRD assessment, latest estimates) Deposits to GDP (EBRD Banking Survey, 2012, official statistical sources) Non-performing loans (IMF, EBRD Banking Survey 2012, official statistical sources)
	Corporate governance and business standards [10%]	Proportion of banks which have good corporate governance practices (EBRD assessment, latest estimates)

Table M.1.5.2
Rating transition challenges in the insurance and other financial services sector

Components	Criteria	Indicators
Market structure [45%]	Market penetration [60%]	Insurance premia (% of GDP) (National Insurance Associations, UBS, World Bank, EBRD, latest available) Life insurance premia (% of GDP) (National Insurance Associations, UBS, World Bank, EBRD, latest available) Non- life insurance premia (% of GDP) (National Insurance Associations, UBS, World Bank, EBRD, latest available) Leasing portfolio (% of GDP) (Leaseurope, national statistical sources, latest available) Availability of insurance products (UBS and own EBRD assessments, latest estimates) Mortgage debt/GDP (EBRD Banking Survey 2012) Type of pension system (Pillar I, II, III) (Axco) Pension fund assets/GDP (Axco, Renaissance Capital, other official sources, latest available)
	Competition [10%]	Market share of top 3 insurance companies (Axco, EBRD, latest available)
	Private sector involvement [10%]	Share of private insurance funds in total insurance premia (UBS, national authorities, EBRD, latest available)
	Development of skills [20%]	Skills in the insurance industry (UBS and own EBRD assessments, latest estimates)
Market-supporting institutions and policies [55%]	Development of adequate legal and regulatory framework [88%]	Existence of private pension funds (Social Security Administration - ISSA) Pillar II 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 [12%]	AIS member (International Association of Insurance Supervisors- IAIS) Internationally accredited actuarial body (official sources)

Source: EBRD.

Table M.1.5.3
Rating transition challenges in the capital markets sector

Components	Criteria	Indicators
Market structure [40%]	Market penetration [50%]	Stock market capitalisation/GDP (World Bank, FESE, FEAS, national stock exchanges, 2011) Number of listed companies (World Bank, FESE, FEAS, official statistical sources, 2011) Securities (bonds and stocks) traded as % of GDP (World Bank, FEAS, ASEA, official statistical sources, 2011)
	Market infrastructure and liquidity (50%)	Money Market Index (EBRD 2010 Survey) Government Bond Index (EBRD 2010 Survey) Turnover ratio (World Bank, FEAS)
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)

Table M.1.5.4
Rating transition challenges in the private equity sector

Components	Criteria	Indicators
Market structure [50%]	Competition [35%]	Effective number of fund managers per thousand companies (Company websites, Prequin, EMPEA, latest available)
	Market penetration [65%]	Scope of fund type/strategy (EMPEA, Prequin, Mergermarket and EVCA, EBRD estimates, latest available) Active PE capital as % of GDP (EMPEA, Prequin, Mergermarket and EVCA, EBRD estimates, latest available) PE capital available for investment as % of GDP (EMPEA, Prequin, Mergermarket and EVCA, EBRD estimates, latest available)
Market-supporting institutions and policies [50%]	Development of adequate legal and regulatory framework [70%]	Barriers to institutional investor participation (EBRD, latest estimates) 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)

Table M.1.5.5
Rating transition challenges in the MSME finance sector

Components	Criteria		Indicators
Market structure [50%]	Non-banking financing [10%]		Leasing (respective ATC score) Private equity (respective ATC score) Capital Markets (respective ATC score)
	Banking financing [90%]	Competition	Competition in banking (respective ATC score) Interest margin between bank lending to SMEs and large corporates (short-term and long-term)
		Access to bank lending	Share of SME lending to total lending/ weighted by distance of domestic credit to GDP to that in EU area Outreach of commercial banks (branches per 100,000 adults)
		Skills	Existence of Specialised SME department in banks (Internal EBRD survey 2012) Extent of use of SME lending methodologies (Internal EBRD survey 2012) Presence of trained loan officers in SME lending (Internal EBRD survey 2012)
Market-supporting institutions and policies [50%]	Development of adequate legal framework [50%]		Ability to offer and take security over immovable property (cadastre) Credit information services Registration system for movable assets - Ability to offer and take non-possessory security over movable property Collateral and provisioning regulatory requirements Enforcing secured creditor rights

Source: EBRD.

COUNTRY TRANSITION INDICATORS

(see Table 1.2 on page 12)

The country transition indicators 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.

LARGE-SCALE PRIVATISATION

1 Little private ownership.
2 Comprehensive scheme almost ready for implementation; some sales completed.
3 More than 25 per cent of large-scale enterprise assets in private hands or in the process of being privatised (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance.
4 More than 50 per cent of state-owned enterprise and farm assets in private ownership and significant progress with corporate governance of these enterprises.
4+ Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.

SMALL-SCALE PRIVATISATION

1 Little progress.
2 Substantial share privatised.
3 Comprehensive programme almost completed.
4 Complete privatisation of small companies with tradeable ownership rights.
4+ Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradeability of land.

GOVERNANCE AND ENTERPRISE RESTRUCTURING

1 Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.
2 Moderately tight credit and subsidy policy, but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
3 Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (for example, privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).
4 Substantial improvement in corporate governance and significant new investment at the enterprise level, including minority holdings by financial investors.
4+ Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring.

PRICE LIBERALISATION

1 Most prices formally controlled by the government.
2 Some lifting of price administration; state procurement at non-market prices for the majority of product categories.
3 Significant progress on price liberalisation, but state procurement at non-market prices remains substantial.
4 Comprehensive price liberalisation; state procurement at non-market prices largely phased out; only a small number of administered prices remain.
4+ Standards and performance typical of advanced industrial economies: complete price liberalisation with no price control outside housing, transport and natural monopolies.

TRADE AND FOREIGN EXCHANGE SYSTEM

1 Widespread import and/or export controls or very limited legitimate access to foreign exchange.
2 Some liberalisation of import and/or export controls; almost full current account convertibility in principle, but with a foreign exchange regime that is not fully transparent (possibly with multiple exchange rates).
3 Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility.
4 Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full and current account convertibility.
4+ Standards and performance norms of advanced industrial economies: removal of most tariff barriers; membership in WTO.

COMPETITION POLICY

1 No competition legislation and institutions.
2 Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms.
3 Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.
4 Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.
4+ Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.

ACKNOWLEDGEMENTS

This *Transition Report* was prepared by the Office of the Chief Economist (OCE) of the EBRD, under the general direction of Erik Berglof. It also includes a contribution from the Office of the General Counsel (Annex 1.2).

This year's editors were Jeromin Zettelmeyer, Franto Ricka and Peter Sanfey.

The writing teams for the chapters, boxes and annexes comprised:

Chapter 1
Written by Heike Harmgart, Hanan Morsy, Peter Sanfey and Nafez Zouk. **Annex 1.1** was prepared by Katrin Weissenberg, based on assessments prepared by OCE sector economists. **Annex 1.2** was prepared by Alan Colman.

Chapter 2
Written by Jonathan Lehne and Franto Ricka, with inputs from Heike Harmgart, Hannah Levinger and Hoda Youssef and with research support from Marina Kaloumenou, Beatriz Perez and Cecilia Rolander. **Box 2.1** was prepared by Jonathan Lehne.

Chapter 3
Written by Jeromin Zettelmeyer and Ralph de Haas, with inputs from Alexander Lehmann, Piroska M. Nagy and Peter Tabak and research support from Krisztina Gyovai, Jonathan Lehne and Marek Waskiewicz. **Box 3.1** was prepared by Jonathan Lehne, **Box 3.2** by Ralph de Haas, **Box 3.3** by Alexander Lehmann, **Box 3.4** by Peter Tabak and Marek Waskiewicz, **Box 3.5** by Alexander Lehmann and **Box 3.6** by Achim Dübel.

Comments from and discussions with Bas Bakker, Katia D'Hulster, Achim Dübel, Christoph Klingen, Beatrice Weder di Mauro, Stefan Nyberg, Nicolas Véron and the European Commission are gratefully acknowledged.

Chapter 4
Written by Zsoka Koczan and Alexander Plekhanov, with contributions from Veronika Zavacka.
Boxes 4.1, **4.2**, **4.3** and **4.5** were prepared by Zsoka Koczan.
Box 4.4 was prepared by Zsoka Koczan, Alexander Plekhanov and Veronika Zavacka.

The country assessments were prepared by the regional economists of the Office of the Chief Economist and edited by Peter Sanfey. Piroska M. Nagy provided comments and general guidance and Marina Kaloumenou data support. The main authors were:
- Central Europe and the Baltic states (excluding Croatia): Alexander Lehmann, assisted by Marek Waskiewicz.
- South-eastern Europe and Croatia: Peter Sanfey, assisted by Marija Kuzmanović.
- Eastern Europe and Caucasus: Alexander Pivovarsky, assisted by Asset Irgaliev.
- Russia: Nienke Oomes, assisted by Asel Isakova.
- Turkey: Heike Harmgart, assisted by Nafez Zouk.
- Central Asia: Alexander Plekhanov, assisted by Asel Isakova.
- Southern and eastern Mediterranean: Heike Harmgart and Hanan Morsy, assisted by Nafez Zouk.

Editorial and production guidance was provided by Dan Kelly, Amanda Railson, Jane Ross, Natasha Treloar and Bryan Whitford in the EBRD Communications department and by Richard German and Matthew Hart.

The Report was designed and print managed by Andy Ritchie and Julia Aleksieieva, with project management by Clare Ritchie from bn1creative.

The Report benefited from comments and feedback from the EBRD Board of Directors and their authorities, the EBRD Executive Committee, the EBRD's Resident Offices and Country Teams, and staff from the European Commission, International Monetary Fund and the World Bank.

Both Satimat Silk and
Edixion Offset are FSC
certified and manufactured
using EFC (Elemental
Chlorine Free) pulp.

The mills for both are
accredited with ISO 9001
& ISO 14001 and are
FSC certified.

Fulmar Colour are
ISO 14001 certified,
CarbonNeutral,
Alcohol Free and FSC Chain
Of Custody certified.

The inks used are vegetable
oil based.

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, including photocopying and recording, without the written permission of the copyright holder. Such written permission must also be obtained before any part of this publication is stored in a retrieval system of any nature. Applications for such permission should be addressed to permissions@ebrd.com.

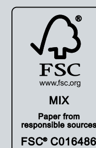
Designed and produced by bn1creative and the EBRD

Photography by EBRD, Thinkstockphoto.com
and Mike Ellis

250 Transition Report 2012 (E/3,500)

Printed in England by Fulmar which operates an environmental waste and paper recycling programme.

© European Bank for Reconstruction and Development



European Bank for Reconstruction and Development
One Exchange Square
London
EC2A 2JN
United Kingdom

Switchboard/central contact
Tel: +44 20 7338 6000
Fax: +44 20 7338 6100

Information requests
For information requests
and general enquiries,
please use the information
request form at
www.ebrd.com/inforequest

Project enquiries
Tel: +44 20 7338 7168
Fax: +44 20 7338 7380
Email: projectenquiries@ebrd.com

EBRD publications
Tel: +44 20 7338 7553
Fax: +44 20 7338 6102
Email: pubsdesk@ebrd.com

Web site
www.ebrd.com
www.ebrd.com/transitionreport

ISBN 978-1-898802-38-9
ISSN 1356-3424