

WORLD ECONOMY RESEARCH INSTITUTE

**TRANSITION COUNTRIES:
ECONOMIC SITUATION IN 2008
AND THE PROGRESS OF
MARKET REFORMS**

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1. INTRODUCTION

The aim of this study is to assess current economic situation of 28 post-socialist countries in Europe and Asia undergoing systemic transformation towards an open market economy, their macroeconomic policies and the progress of structural reforms. We focus on the situation prevailing in 2008 and the changes against the previous year, though some estimates regarding future prospects are also included.

The analysis refers to our earlier assessments contained in the yearly reports on transformation presented at the Economic Forum in Krynica-Zdrój¹ and other publications on the subject mentioned in the bibliography. In order to facilitate multi-year comparisons and the identification of long run trends, this analysis has a similar framework and coverage. Nevertheless, it is an entirely new analysis based on the newest data, which evaluates current economic situation in the countries of the group and probable short-term and medium-term prospects.

The focus in this analysis is on the impact of the global financial and economic crisis on macroeconomic performance in the countries of the region. We also present the most recent projections of the basic macroeconomic indicators for 2009 and forecasts for 2010 and 2014, assuming a gradual recovery of world economy from the current crisis.

The study includes two parts: (1) Economic situation in transition countries, (2) Macroeconomic policy and structural reforms. Both parts are functionally interrelated: macroeconomic policies performed by the governments and the course of structural reforms depend, to a large extent, on real economic developments in the countries concerned while macroeconomic performance, in turn, depends on the progress of economic reforms and the policies performed by the governments.

Our analysis is based on the newest available data from the World Bank, EBRD, IMF, OECD, Eurostat, UNDP, and other international sources, most published in 2009, just before completing our study.

The analysed group is highly diversified in terms of development levels, size and structure of the economy, international links, development of market institutions, progress in structural reforms, and economic policies pursued by the governments. This diversity makes it very difficult to compare the state and prospects of the economies and the progress of reforms.

For the purpose of this study, we have distinguished three following subgroups: (a) Central Eastern Europe (CEE), (b) South Eastern Europe (SEE), (c) Commonwealth of Independent States (CIS).² However, this division does not solve all the problems concerning comparisons.

Macroeconomic performance of the countries in transition depends to a great extent on world economic development and international trade. During the last two years the external environment changed very unfavourably due to the global financial and economic crisis. According to the IMF estimates³, total world output increased by 5.2% in 2007 and 3.0% in 2008, but it will decrease by 1.1% in 2009. The volume of world trade, which increased by 7% in 2007 and 3% in 2008 is expected to fall by 12% in 2009. The countries of the analysed group, both in the CEE and SEE and in the CIS, strongly reacted to the reduction of import demand in world markets, and to the squeeze in the international financial markets, and most of them fell into a deep recession. Beyond any doubt, economic prospects of the transition countries for the next few years depend to a great extent on the expected recovery in the global economy and the revival of international trade.

2. ECONOMIC SITUATION IN TRANSITION COUNTRIES

2.1. Size of the economy

¹ Eg. *New Europe. Report on Transformation* (ed. D.K. Rosati), XVII Economic Forum, Krynica-Zdrój, September 6-9, 2007, Foundation Institute for Eastern Studies, Warsaw 2007.

² Georgia left the CIS in 2009, but it is still included in this subgroup in our presentation for reasons of geography and similarities of economic structure.

³ IMF, *World Economic Outlook*, October 2009; IMF, *Database*, October 2009.

We begin our analysis by describing the economic potential of this group. Table 1 provides the basic data on the size of 28 transition countries. The data refer to 2007 and come from the World Bank, supplemented whenever necessary by EBRD estimates.

The combined economic potential of the countries of the group is big, although vastly underutilised and unevenly distributed. The group encompasses almost 18% of the world's total surface area and more than 6% of the world's population. But the share of the group in global output is smaller than the size of the territory and the amounts of available resources could warrant.

According to the estimates published by the World Bank, in 2007 the total gross national income of all the countries in the group amounted to US\$ 2 501 billion if converted at current exchange rates (OER) and US\$ 4 667 billion in terms of purchasing power parity (PPP). These figures represented 4.7% and 7.1% of total world output and income respectively.

Using PPP GNI figures, three countries, namely Russia, Poland and Ukraine, account for 63% of total national income in this group, while another three, the Czech Republic, Romania and Hungary, represent a further 15%. European countries (including Russia) account for 83% of total output and income, while the Asian countries contribute just 17%. The countries of CEE and SEE, which account for just 6% of the total area and 30% of the population, are responsible for 40% of the total output of this group while the CIS countries (including Russia) – with an incomparably greater area and population – make up only 60%. This comparison makes it clear how big are the divergences between these two subgroups in the degree of utilisation of their resources, the effectiveness of business activity, and labour productivity.

These divergences are also reflected in a comparison of *per capita* national income. The *per capita* GNI figures for 2007 calculated at PPP evidence how enormous are the differences in the level of development between the individual countries (with *per capita* income ranging from \$1 710 in Tajikistan to \$26 230 in Slovenia) and how great is the distance between the countries of this group and the highly developed countries (for the advanced countries the average income in 2007 was \$36 340).

Charts 1 and 2 give a transparent ranking of the transition economies in terms of total and *per capita* GNI calculated at official exchange rates (OER) and purchasing power parities (PPP).

A major problem in international comparisons of national income is the appropriate conversion rate of national currencies against US dollar. For former socialist countries, like for most developing countries, GNI or GDP figures expressed in US dollars at current exchange rates are much lower than the alternative estimates based on purchasing power parities, due to the relatively lower price levels.⁴

Table 1. Area, population, and national income, 2007

Country	Surface area	Population	Gross national income			
			at official exchange rates		at purchasing power parity	
	thousand km ²	millions	total \$ billion	<i>per capita</i> \$	total \$ billion	<i>per capita</i> \$

⁴ In international comparisons of national income (GNI or GDP), there are two systems of converting the currencies into US dollars: (a) current official exchange rate; (b) purchasing power parity (PPP). Purchasing power parity is a conversion factor of the real value of money, taking into account price differences; it reflects the real purchasing power of US dollar relative to the goods and services produced in the given country. In other words, it shows how much the output produced in the given country would cost at the prices prevailing in the USA. The purchasing power parities of national currencies against US dollar are estimated annually by the World Bank experts. The international PPP dollar has the same purchasing power as a US dollar in the USA.

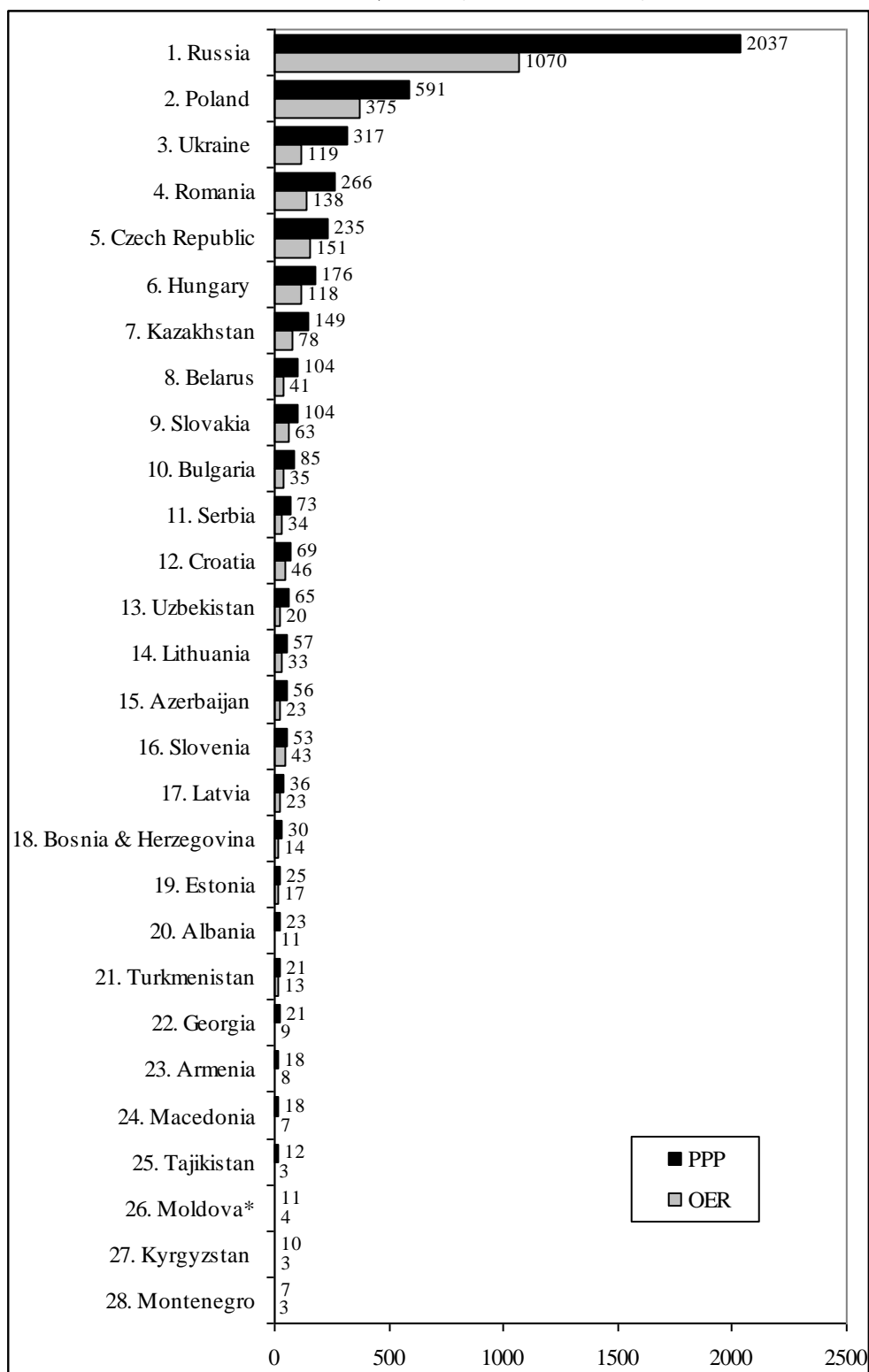
Central Eastern Europe						
Czech Republic	79	10	151	14 580	235	22 690
Estonia	45	1	17	12 830	25	18 830
Hungary	93	10	118	11 680	176	17 470
Latvia	65	2	23	9 920	36	15 790
Lithuania	65	3	33	9 770	57	16 830
Poland	313	38	375	9 850	591	15 500
Slovakia	49	5	63	11 720	104	19 220
Slovenia	20	2	43	21 510	53	26 230
Subtotal	729	71	823	.	1 276	.
South Eastern Europe						
Albania	29	3	11	3 300	23	7 240
Bosnia & Herzegovina	51	4	14	3 790	30	8 020
Bulgaria	111	8	35	4 580	85	11 100
Croatia	57	4	46	10 460	69	15 540
Macedonia	26	2	7	3 470	18	9 050
Montenegro	14	1	3	5 270	7	11 780
Romania	238	22	138	6 390	266	12 350
Serbia	78	7	34	4 540	73	9 830
Subtotal	604	51	288	.	572	.
Commonwealth of Independent States						
Armenia	30	3	8	2 630	18	5 870
Azerbaijan	87	9	23	2 640	56	6 570
Belarus	208	10	41	4 220	104	10 750
Georgia	70	4	9	2 120	21	4 760
Kazakhstan	2 725	15	78	5 020	149	9 600
Kyrgyzstan	200	5	3	610	10	1 980
Moldova	34	4	4 ^a	1 210	11	2 800
Russia	17 098	142	1 070	7 530	2 037	14 330
Tajikistan	143	7	3	460	12	1 710
Turkmenistan	488	5	13 ^b	1 570 ^b	21	4 350
Ukraine	604	47	119	2 560	317	6 810
Uzbekistan	447	27	20	730	65	2 430
Subtotal	22 134	278	1 390	.	2 820	.
Total	23 467	400	2 501	.	4 667	.
As % of world total	17.5	6.1	4.7	.	7.1	.

^a Excluding Transnistria.

^b EBRD estimate.

Sources: The World Bank, *World Economic Indicators 2009*, Washington 2009; EBRD, *Transition Report 2008*, London 2008.

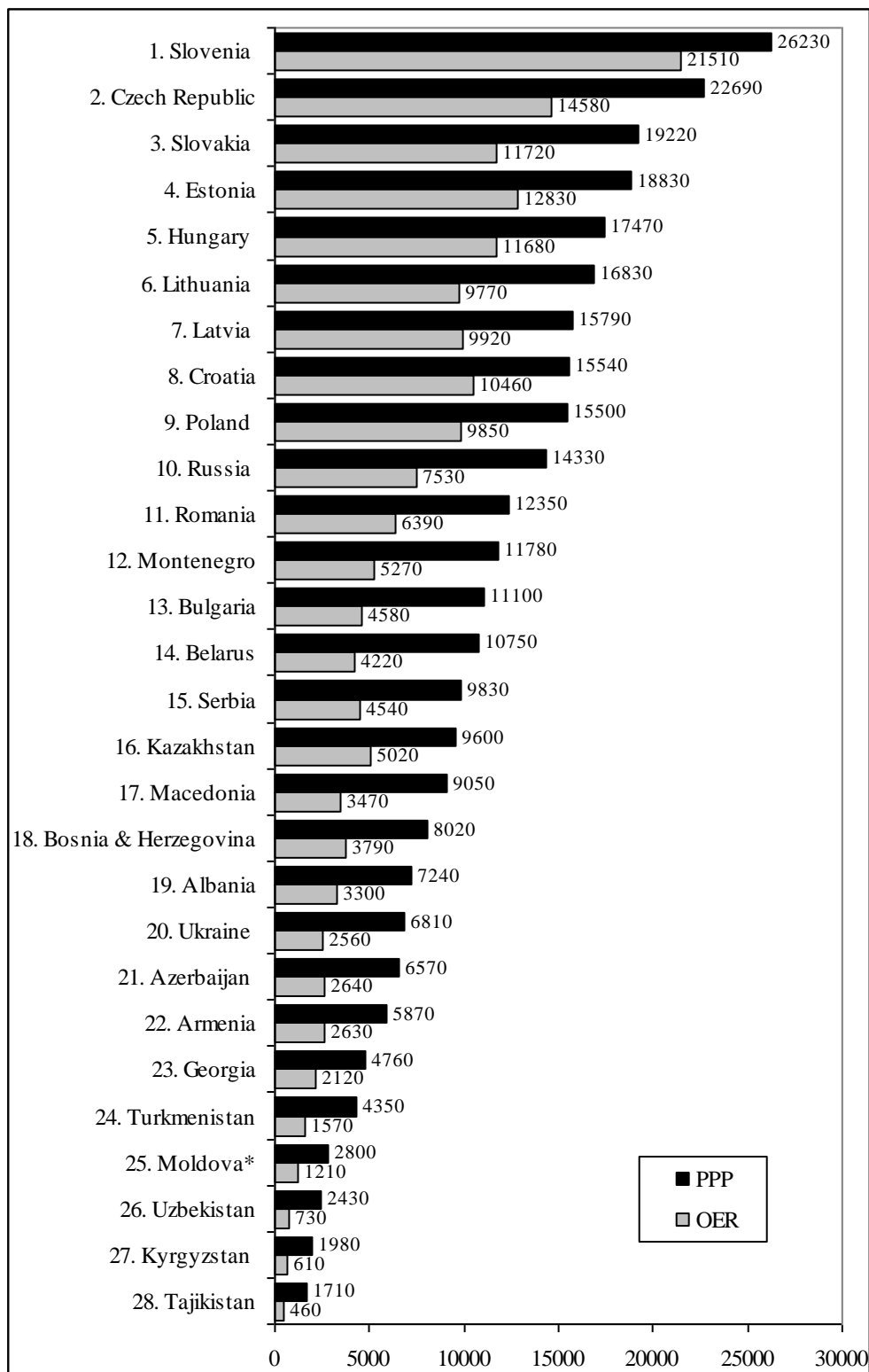
Chart 1. Gross national income, 2007 (billions of US\$)



* Excluding Transnistria.

Source: The World Bank, *World Development Indicators 2009*, Washington 2009.

Chart 2. Gross national income per capita, 2007 (US\$)



* Excluding Transnistria.

Source: The World Bank, *World Development Indicators 2009*, Washington 2009.

2.2. Structure of the economy

There are also big differences between the countries of the analysed group as regards the structure of their economies. Table 2 illustrates the production structure and the share of the private sector in the economy.

In most transition countries the share of the private sector in GDP is already quite high, ranging between 60 and 80%. This evidences the big progress made in privatisation, which constitutes the major part of transformation. In the countries of CEE that have joined the European Union, the share of the private sector in the economy ranges between 70% in Latvia and Slovenia and 80% in the Czech Republic, Estonia, Hungary, and Slovakia. In Poland, as well as in Lithuania, this share amounts to 75%. It may be said that the privatisation process in those countries has been almost completed, and the existing differences in the relative size of the private sector largely reflect different national views on the role of the public sector in the economy and the desired degree of privatisation. In SEE the privatisation process is also advanced, and the share of the private sector in GDP ranges between 60% in Bosnia & Herzegovina and Serbia and 75% in Albania and Bulgaria. In the CIS the privatisation process is still underway and the degree of privatisation is very differentiated among the countries, ranging from 25-30% in Turkmenistan and Belarus to 70-75% in Kazakhstan and Kyrgyzstan, as well as in Georgia, Armenia, and Azerbaijan. Russia, Ukraine and Moldova rank in the middle, with the estimated share of the private sector about 65%.

In CEE countries the share of the private sector in the economy has not changed during the last few years. Among the countries that have significantly increased this share in the last five years there are Azerbaijan, Kyrgyzstan, Georgia, Moldova, Serbia, Croatia, and Bosnia & Herzegovina. The only country where the share of the private sector has decreased as compared to the beginning of this decade is Russia.

Central Eastern Europe now reveals an output structure similar to that seen in the highly developed countries: agriculture represents 2-5% of GDP, industry 22-39%, services 59-75%. South Eastern Europe continues to maintain a bigger share of agriculture (7-21%), a similar share of industry (20-36%), and a slightly lower share of services (55-69%). The two biggest CIS economies – Russia and Ukraine – have retained a high share of industry, including mining, and a moderate share of services. The less developed CIS countries rely mostly on agriculture and the exploitation of natural resources. Oil and gas producers (Azerbaijan, Kazakhstan, and Turkmenistan) have quite a high share of industry while typically agricultural countries (like Kyrgyzstan, Tajikistan, Uzbekistan and Armenia) still feature a high share of agriculture.

In the last 10-15 years, most countries of the analysed group have experienced profound changes in their production structure that were generally consistent with the development seen in the world economy: a decline of the share of agriculture and industry (in particular, raw materials extraction and heavy industry), accompanied by the increased role of manufacturing and services (including finance and trade). Only a few CIS countries have not yet undergone changes in line with this trend. However, in the case of big oil and gas producers, this is fully understandable.

Table 3 shows the structure of demand, namely the share of gross capital formation, private and public consumption, and exports and imports in GDP. In countries with a negative foreign trade balance, the sum of domestic demand exceeds 100% of GDP, because the disposable quantity of goods and services available for consumption and capital formation is higher than the value of output produced domestically (by the surplus of imports over exports).

Table 2. Production structure

Country	Share of the private sector	Structure of output					
		Agriculture		Industry		Services	
	2008	1995	2007	1995	2007	1995	2007
% of GDP							
Central Eastern Europe							
Czech Republic	80	5	3	38	39	57	59
Estonia	80	6	3	33	30	61	67
Hungary	80	7	4	32	30	61	66
Latvia	70	9	3	30	22	61	75
Lithuania	75	12	5	34	33	55	61
Poland	75	8	4	35	31	57	65
Slovakia	80	6	3	38	36	56	61
Slovenia	70	4	2	35	34	60	63
South Eastern Europe							
Albania	75	56	21	22	20	22	59
Bosnia & Herzegovina	60	21	10	26	22	54	69
Bulgaria	75	14	6	35	32	50	61
Croatia	70	11	7	34	32	55	61
Macedonia	70	13	12	30	30	57	59
Romania	70	21	9	43	36	36	55
Serbia	60	.	13	.	28	.	59
Commonwealth of Independent States							
Armenia	75	42	20	32	44	26	36
Azerbaijan	75	27	6	34	73	39	21
Belarus	30	17	9	37	42	46	48
Georgia	75	52	11	16	24	32	65
Kazakhstan	70	13	6	32	41	55	53
Kyrgyzstan	75	44	34	20	19	37	47
Moldova	65	33	12	32	15	35	73
Russia	65	7	5	37	38	56	57
Tajikistan	55	38	21	39	28	22	51
Turkmenistan	25	17	.	63	.	20	.
Ukraine	65	15	8	43	37	42	55
Uzbekistan	45	32	23	28	31	40	46

The share of the private sector is EBRD estimate. Production structure according to the World Bank data.

Agriculture includes forestry and fishing. Industry covers mining, manufacturing, construction, electricity, water, and gas. Services include trade, banking and financial services; this sector is derived as a residual (GDP less agriculture and industry) and may not properly reflect the sum of services output.

Sources: The World Bank, *World Development Indicators 2009*, Washington 2009; EBRD, *Transition Report 2009*, London 2009.

Table 3. Structure of demand, 2007

Country	Private consumption	Public consumption	Gross capital formation	Exports	Imports
	% of GDP				
Central Eastern Europe					
Czech Republic	48	20	27	80	75
Estonia	56	17	38	74	85
Hungary	66	10	22	80	79
Latvia	65	18	37	44	65
Lithuania	66	17	30	55	67
Poland	60	19	24	41	44
Slovakia	56	17	28	86	87
Slovenia	52	18	31	70	71
South Eastern Europe					
Albania	88	9	30	28	54
Bosnia & Herzegovina	90	22	23	39	74
Bulgaria	69	16	37	63	85
Croatia	56	20	33	48	56
Macedonia	78	18	23	55	75
Romania	69	13	30	31	44
Serbia	81	18	23	29	51
Commonwealth of Independent States					
Armenia	72	11	37	19	39
Azerbaijan	26	11	21	72	30
Belarus	54	19	33	62	68
Georgia	70	22	35	32	58
Kazakhstan	47	10	36	49	43
Kyrgyzstan	101	18	26	45	90
Moldova	95	19	38	46	98
Russia	49	18	25	30	22
Tajikistan	114	9	22	21	66
Turkmenistan	46	13	23	65	48
Ukraine	60	19	27	45	51
Uzbekistan	54	17	19	40	30

Private consumption is meant as household final consumption expenditure and public consumption is meant as general government final consumption expenditure. Gross capital formation includes fixed capital investment and the increase in stocks. Exports and imports are total turnovers in goods and services.

Source: The World Bank, *World Development Indicators 2009*, Washington 2009.

The proportions of national income allocated for consumption and capital formation – essential for the current welfare and future prospects – tend to be rather independent from the current income levels.

More developed countries, with relatively high *per capita* income, can afford to spend a relatively lower portion of national income on current consumption, without constraining the absolute consumption level. In 2007, the countries of CEE allocated 68-79% of GDP for private and public consumption and 22-38% of GDP for investment. In SEE this proportion was 82-112% and 23-37% respectively. In the CIS, the share of accumulation in GDP was between 19 and 38% whereas the share of consumption was highly differentiated, ranging from 37% to 123% of GDP, depending on net exports. Some less developed countries, like Bosnia & Herzegovina, Moldova, Kyrgyzstan and Tajikistan spend more on their current consumption than they produce. This is, however, not the rule. Some other relatively poor

countries, like Azerbaijan, Kazakhstan, and Turkmenistan, devote a relatively small share of their GDP for consumption. This is because the share of consumption in national income depends not only on the level of economic development, the propensity to save and the relationship between exports and imports, but also on the size of government expenditure, the bulk of which constitutes public consumption.

The level of capital formation (accumulation) is determined mainly by current economic conditions in the country and by the inflow of foreign direct investment. In 2007, the highest shares of capital formation – 30% of GDP or more – were recorded in some of the most developed countries in the group (Estonia, Latvia, Slovenia, Bulgaria, and Croatia), as well as in some of the least developed countries (Armenia, Georgia, Moldova, Belarus). Similarly, the lowest rates of capital formation – about 20% of GDP or less – were observed in the countries with very different development level (Hungary, Macedonia, Serbia, Azerbaijan, Tajikistan, and Uzbekistan). Most analysed countries have an investment rate of 20-30% GDP, which is comparable to the average world standard.

An interesting point is to what extent we can explain the differences in the rates of economic growth between the countries of the group by the difference in the size of capital formation. Economic growth theories suggest a positive relationship between the growth of output and the size of investment, assuming that investments – by increasing production capacity and introducing new products and technologies – are the principal factor of output growth. An empirical verification of this hypothesis would require an analysis over a longer period of time. In an international cross-section, especially within a highly differentiated group of countries, the relationship between the rate of economic growth and the share of capital formation in national income may not be clearly visible, or may be even negative, due to diverse economic structures and different efficiency of investments in individual countries, and also due to different amounts of replacement investment and investment in stocks, i.e. the components of gross capital formation that are not directly related to the growth of output.

The World Bank compiles, apart from gross capital formation, a new measure of accumulation, called adjusted net savings, expressed as percent of GNI. Gross national savings are the difference between gross national income and private and public consumption, plus net current transfers from abroad. Net national savings are gross savings minus depreciation (consumption of fixed capital). Consumption of fixed capital is the replacement value of capital used up in production. Adjusted net savings are net savings plus education expenditure minus the estimated value of natural resource depletion (energy depletion, mineral depletion, net forest depletion) and the cost of environmental damage (caused by carbon dioxide and particulate emissions). In order to calculate the adjusted net savings we have thus to deduct from gross capital formation the consumption of fixed capital (depreciation), the estimated consumption of natural resources and the estimated cost of environmental damage, and add education expenditure meant as investments in human capital.

The adjusted net savings are, as a rule, much lower than gross capital accumulation. For instance, for some of the countries of the analysed group this indicator was estimated in 2007 to be (as % of GNI): Czech Republic – 15%, Hungary – 8%, Poland – 12%, Slovakia – 13%, Slovenia – 18%, Romania – 9%, Georgia – 8%, Ukraine – 11%. For big oil and gas producers it was either very low or negative: 1% in Russia, –7% in Azerbaijan, and –10% in Kazakhstan. In spite of the limited accuracy of such estimates, they shed some new light on the long-term prospects of the economies concerned and warn that the concentration of investment efforts on the extension and modernisation of fixed assets, without a parallel build-up of human capital, as well as an excessive drain of natural resources and the lack of an adequate concern about environmental damage, may turn to be detrimental for long-run economic growth.

The shares of exports and imports in national income are very differentiated in the analysed group, depending on the size and geographical location of individual countries,

available resources, and the willingness to open up the economy. We will discuss this question in section 8.

2.3. Economic growth

Table 4 presents the estimates of the growth rates of real GDP in the analysed group over the period 1989-2009.

Almost all of the post-socialist countries experienced a deep economic crisis at the beginning of the transformation, caused by the thorough change of economic system, reorientation of external links and changes in the structure of output. In most countries the transformation crisis lasted several years and led to a deep fall in the production volume, sometimes by half or even more. In some countries (e.g. Ukraine) the recession lasted virtually throughout the entire decade of the 1990s, and economic growth was restored only in the 2000's. Some other countries also experienced a second recession, after the recovery from the transformation crisis (e.g. the Czech Republic, Bulgaria, Romania, and Russia).

For all the countries of the CIS and many countries of CEE and SEE the decade 1990-2000 brought a decrease of real GDP as compared to its initial level. The countries of CEE, except Latvia and Lithuania, have noted a very moderate growth over the first decade of transformation, with the exception of Poland, which achieved quite a good growth record despite the fall of output at the beginning of transformation. In the SEE, Bulgaria, Romania, Serbia and Macedonia noted a decrease in real GDP over the decade.

The second decade of the transformation period, the 2000's (at least until 2007), is marked by a vigorous growth in almost all post-socialist countries. This is reflected in the average annual growth rates of GDP calculated for the three subgroups: 6% in CEE, 5% in SEE, and more than 9% in the CIS, with the overall arithmetic average of 7% per year.

The year 2007, however, was the last year of this impressive expansion. In 2008, due to the world economic and financial crisis and a slowdown of global output and world trade, as well as in the result of various internal tensions, most countries of this group noted a considerable deceleration of economic growth. Among the CEE countries, the rate of growth of real GDP decreased in Poland from 6.8% in 2007 to 4.9% in 2008, in the Czech Republic it fell from 6.1% to 2.7%, in Slovakia from 10.4% to 6.4%, in Hungary from 1.2% to 0.6%, and in the most rapidly growing Baltic states the expansion was totally stopped and turned into recession. Altogether, the average growth rate in this subgroup, calculated as an unweighted average, fell from 7.3% in 2007 to merely 1.6% in 2008.

In SEE the deceleration of economic growth began a little later and it is not so clearly seen in the output growth rates recorded for the whole year 2008. Albania, Bulgaria and Romania have maintained high rates of economic growth of 6-7% per year while the post-Yugoslav states, especially Croatia, saw a slower growth. This is reflected in the average GDP growth rate for this subgroup, which decreased only slightly from 6.8% in 2007 to 5.7% in 2008.

Among the CIS countries, the most pronounced slowdown occurred in the countries highly dependent on raw materials exports. The growth rate of real GDP fell in Kazakhstan from 8.3% to 3.2%, in Azerbaijan from 23.4% to 11.6%, in Georgia from 12.3% to 2.1%. The two biggest countries of this region, Russia and Ukraine, have also noted a considerable decrease of the rate of economic growth: in Russia it fell from 8.1% to 5.6% and in Ukraine from 7.9% to 2.1%. But the remaining countries, less dependent on world markets, continued to develop rapidly. Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan sustained high growth rates recorded in the previous year, amounting to 8-11%, and Belarus and Moldova reported even a faster growth, by 10% and 7% respectively. On the average, the CIS region noted some deceleration of economic growth from 10.3% in 2007 to 7.0% in 2008. For the whole group the slowdown was reflected by the decrease in the average growth rate from 8.4% to 5.1%.

Table 4. Growth of gross domestic product

Country	Real GDP growth rate (%)					Index of real GDP in 2008 (1989= 100)
	Annual average		2007	2008	2009 ^b	
	1990-2000	2000-2007				
Central Eastern Europe						
Czech Republic	1.1	4.6	6.1	2.7	-4.3	142
Estonia	0.4	8.1	7.2	-3.6	-14.0	147
Hungary	1.5	4.0	1.2	0.6	-6.7	136
Latvia	-1.5	9.0	10.0	-4.6	-18.0	118
Lithuania	-2.7	8.1	8.9	3.0	-18.5	120
Poland	4.7	4.1	6.8	4.9	1.0	178
Slovakia	2.2	6.0	10.4	6.4	-4.7	164
Slovenia	2.7	4.3	6.8	3.5	-4.7	156
Average ^a	1.1	6.0	7.2	1.6	-8.7	145
South Eastern Europe						
Albania	3.5	5.3	6.3	6.8	0.7	163
Bosnia & Herzegovina	.	5.3	6.8	5.5	-3.0	84
Bulgaria	-1.8	5.7	6.2	6.0	-6.5	114
Croatia	0.6	4.8	5.5	2.4	-5.2	111
Macedonia	-0.8	2.7	5.9	4.9	-2.0	102
Montenegro	.	4.7	10.7	7.5	-4.0	92
Romania	-0.6	6.1	6.2	7.1	-8.5	128
Serbia	-4.7	5.6	6.9	5.4	-4.0	72
Average ^a	.	5.0	6.8	5.7	-4.1	108
Commonwealth of Independent States						
Armenia	-1.9	12.7	13.7	6.8	-15.6	153
Azerbaijan	-6.3	17.6	23.4	11.6	7.5	177
Belarus	-1.7	8.3	8.6	10.0	-1.2	161
Georgia	-7.1	8.3	12.3	2.1	-4.0	61
Kazakhstan	-4.1	10.0	8.9	3.2	-2.0	141
Kyrgyzstan	-4.1	4.1	8.5	7.6	1.5	102
Moldova	-9.6	6.5	3.0	7.2	-9.0	55
Russia	-4.7	6.6	8.1	5.6	-7.5	108
Tajikistan	-10.4	8.8	7.8	7.9	2.0	61
Turkmenistan	-4.8	14.8	11.6	10.5	4.0	226
Ukraine	-9.3	7.6	7.9	2.1	-14.0	70
Uzbekistan	-0.2	6.2	9.5	9.0	7.0	163
Average ^a	-5.4	9.3	10.3	7.0	-2.6	123
All transition countries ^a	.	7.1	8.4	5.1	-4.8	125

^a Unweighted averages.

^b IMF projection.

Annual averages 1990-2000 and 2000-2007 according to the World Bank estimates (for Montenegro and Turkmenistan calculated from IMF data). GDP growth rates for the years 2007, 2008, and 2009 are taken from IMF. Index of real GDP in 2008 (1989 = 100) is EBRD estimate.

Sources: The World Bank, *World Development Indicators* 2009, Washington 2009; IMF, *World Economic Outlook*, October 2009; EBRD, *Transition Report 2009*, October 2009.

As the result of a generally poor growth record in 1990-2000 and a good growth performance in 2000-2008, the index of real GDP for the whole group, compiled as an unweighted average from the estimates made for the individual countries by the EBRD for the period 1989-2008 (1989=100), has reached the level 125. It means that the total volume of output in the group has increased on the average by only 25% over the two decades of the transformation process. In the CIS countries the output volume now is on the average 23% higher as compared with its level at the beginning of transformation, in SEE it is higher by merely 8%, in CEE it is higher by 45% on the average.

As we can see, in spite of the substantial increase in output in the 2000's, several countries of the analysed group have not yet restored their output levels seen at the start of the transformation process. This is true for some parts of the former Yugoslavia, namely Bosnia & Herzegovina, Montenegro, and Serbia, as well as for some of the former Soviet Union republics: Georgia, Moldova, Tajikistan, and Ukraine. In Ukraine and Serbia the volume of real GDP now is by 30% lower as compared with 1989, and in Georgia, Moldova and Tajikistan it is lower by about 40%. This is the consequence of the unsuccessful macroeconomic policy, the slow pace of economic reforms, as well as military conflicts, which hampered economic growth.

All the countries of CEE have noted a considerable increase of real GDP as compared to 1989, the highest in Poland (78%), Slovakia (64%), and Slovenia (56%). The average unweighted increase of GDP in this region is 45%.

In SEE, the growth patterns have been greatly differentiated: Serbia, Bosnia & Herzegovina, and Montenegro show a decrease of GDP over the whole period by 10-30% while Bulgaria, Croatia and Romania show an increase by 10-30%. Albania has the best growth record – an increase of real GDP by 63%.

The CIS region as a whole reveals a moderate growth of real GDP over the whole period since 1989 by 23% on the unweighted average. Among the CIS, the countries lagging behind in the process of economic reforms (Turkmenistan, Uzbekistan, and Belarus), big oil producers (Azerbaijan and Kazakhstan), and Armenia (a country well advanced in economic reforms and appreciated for a good business environment) show a considerable increase of real GDP. Russia, in spite of a rapid growth in the 2000's, shows only a slight increase in total output by 8% over the whole period.

In view of different measures employed in the calculation of national product and income in the past and at present, and in view of the imprecision of national income accounting in some countries of the group, all the estimates of real economic growth in this region over the period 1989-2008, given by EBRD, are tentative and should be treated with caution.

The latest projections for 2009 indicate a general slowdown of economic growth in the countries of this region, which is directly related to the global crisis, but in some countries reinforced by internal problems, delays in economic reforms, and the failures of macroeconomic policy. In most countries of the group the year 2009 will be marked by a deep recession.

According to the latest IMF estimates of October 2009 (which do not differ much from the newest estimates released by the EBRD), the year 2009 will be closed with a significant drop of real GDP in all the countries of CEE except of Poland. The Czech Republic, Slovakia and Slovenia will notice a fall of real GDP by 4-5%, Hungary by 7%, and the Baltic states, which pay off the cost of the boom on credit, will see a big drop by 14-19%. In SEE, Bulgaria and Romania will see a decrease of real GDP by 7-9%, and the post-Yugoslav countries by 2-5%, the only non-recession country in the region being Albania. Among the CIS countries, the deepest crisis is faced by Ukraine and Armenia, with the expected fall of real GDP by 14-16%. Russia will also note a deep decrease of GDP, most probably by 8%, similarly like the poor Moldova. Georgia, Kazakhstan, and Belarus would face a lesser drop. The remaining countries of the CIS, namely Azerbaijan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan, will see only a more or less pronounced slowdown of economic growth.

2.4. Inflation and unemployment

A heavy inflation appeared in the former socialist countries just at the beginning of transformation. In many countries the consumer price index grew by three or four digits annually. Most countries of the group have passed through a hyperinflation. Only few countries have avoided big inflation by keeping basic prices under strict state control.

Inflation in the transition countries was initially caused by an excess demand, arising from deferred consumption, wage increases, and rising government expenditure. The increase in incomes was not met by an increase in the supply of goods and services, due to the decline in domestic output, not always offset by an adequate increase of imports. In the further development, cost pressures also emerged, resulting from the growth of wages at a rate exceeding the rise in the productivity of labour, inefficiency of many public and private enterprises, as well as rise in the prices of imported raw materials (including oil) and investment goods. Inflation was aggravated by budget deficits, increases in administrative prices and indirect taxes and price hikes imposed by producers with a strong market position. Restrictive monetary policy – which had been effective in constraining the excess demand – lost its power against a new constellation of inflationary factors. In many countries of the group, it led in the late 1990's to a slowdown of economic growth and increased unemployment.

Nowadays, inflation is no more a big problem in the most countries of CEE and SEE (except the Baltic states, Bulgaria, and Serbia) but many countries of the CIS still notice an inflation of about 10% per year or more.

Table 5 presents data on inflation and unemployment in the countries in transition for the last three years. The inflation figures are annual increases in the prices of consumer goods and services, recorded by the IMF. Unemployment rates are taken from labour force surveys and reported according to the ILO.

In the Baltic states, where inflation seemed to be already eradicated, it jumped to 6-10% in 2007 and 10-15% in 2008. In Poland, Czech Republic and Slovakia it accelerated from less than 3% to more than 4-6%. Hungary was the only country in the group that saw a slightly lower inflation though it has remained quite significant (6%). On the average, CEE witnessed an amplified inflation, which increased from 5% in 2007 to 8% in 2008.

The same appeared in the SEE where the average inflation rate doubled from 4% in 2007 to 8% in 2008. Quite high inflation was seen in Bulgaria and Serbia (12%), slightly lower (6-9%) in Romania and in most post-Yugoslav countries. Only Albania continued to maintain a low inflation of about 3% per year.

In all the CIS countries except Armenia the CPI inflation in 2008 jumped again to two digit levels. On the unweighted average, the inflation rate increased from 11% in 2007 to 16% in 2008. The heaviest price hikes, by more than 20%, took place in Azerbaijan, Kyrgyzstan, Tajikistan, and Ukraine. In Russia, inflation increased from 9% to 14%, and in Belarus it almost doubled, from 8% to 15%. The only countries where the inflation rate did not rise, were Georgia, Moldova and Uzbekistan.

A noteworthy fact is that the acceleration of inflation occurred parallel to the deceleration of the output growth, contrary to some simplified macroeconomic beliefs. This was mainly due to the worldwide increase in the prices of food and energy, the halt in foreign funding, and the fall of local currencies.

The projection of CPI inflation recently published by IMF envisages that inflation in the given group will generally decline in 2009 as the result of the current recession. For CEE the average projected inflation rate is 2.3%, with practically no inflation in Estonia and Slovenia, and about 3% in most other countries. In SEE inflation should fall to 3.3% on the average, ranging from -0.5% in Macedonia (disinflation) to 5.5% in Romania, but in Serbia it is supposed to keep up on the high level of about 10%. Among the CIS countries, there can be practically no inflation in Georgia, Moldova and Turkmenistan, but the inflation rate in

Russia, Belarus and Ukraine will remain high: 12-16%. A simple average suggests a decrease of inflation from 16% to 7%, but it may be misleading because four largest economies in this region – Russia, Ukraine, Kazakhstan, and Belarus – still face a heavy inflation.

Table 5. Inflation and unemployment

Country	CPI inflation (%)			Unemployment (%)		
	2007	2008	2009 ^b	2007	2008	2009 ^c
Central Eastern Europe						
Czech Republic	2.9	6.3	1.0	5.3	4.4	7.0
Estonia	6.6	10.4	0.0	4.7	5.5	13.7
Hungary	7.9	6.1	4.5	7.4	7.8	9.7
Latvia	10.1	15.3	3.1	6.0	7.5	19.7
Lithuania	5.8	11.1	3.5	4.3	5.8	14.1
Poland	2.5	4.2	3.4	9.6	7.1	8.2
Slovakia	2.7	4.6	1.5	11.0	9.6	12.0
Slovenia	3.6	5.7	0.5	4.6	4.2	5.9
Average ^a	5.3	8.0	2.2	6.6	6.5	11.3
South Eastern Europe						
Albania	2.9	3.4	1.7	13.4	12.8	.
Bosnia & Herzegovina	1.5	7.4	0.9	29.0	23.4	.
Bulgaria	7.6	12.0	2.7	6.9	5.6	7.6
Croatia	2.9	6.1	2.8	9.6	8.4	8.9
Macedonia	2.3	8.3	-0.5	34.9	33.8	32.7
Montenegro	3.5	9.0	3.4	16.8	17.5	.
Romania	4.8	7.8	5.5	6.4	5.8	6.7
Serbia	6.5	11.7	9.9	18.1	13.6	.
Average ^a	4.0	8.2	3.3	16.9	15.1	.
Commonwealth of Independent States						
Armenia	4.4	9.0	3.0	7.1	6.3	.
Azerbaijan	16.6	20.8	2.2	6.5	6.1	.
Belarus	8.4	14.8	13.0	1.0	0.8	1.0
Georgia	9.2	10.0	1.2	13.3	16.5	.
Kazakhstan	10.8	17.2	7.5	7.3	6.6	.
Kyrgyzstan	10.2	24.5	8.0	8.2	.	.
Moldova	12.4	12.7	1.4	5.1	4.0	6.1
Russia	9.0	14.1	12.3	6.1	6.3	8.5
Tajikistan	13.2	20.4	8.0	2.5	2.2	.
Turkmenistan	6.3	14.5	0.4	.	.	.
Ukraine	12.8	25.2	16.3	6.4	6.4	9.5
Uzbekistan	12.3	12.7	12.5	0.3	0.2	.
Average ^a	10.5	16.3	7.2	5.8	5.5	.
All transition countries ^a	7.2	11.6	4.7	9.3	8.8	.

^a Unweighted average.

^b IMF projection.

^c Latest available data.

CPI inflation according to IMF. Unemployment rates (from labour force surveys) according to ILO, supplemented by the newest Eurostat data.

Sources: IMF, *World Economic Outlook*, October 2009; ILO, Database, October 2009; Eurostat, Database, November 2009.

Unemployment emerged in the former socialist countries at the very beginning of the transformation, with the closure of many public enterprises and the liquidation of state and cooperative farms. This was accompanied by a reduction of employment in public administration. As big state enterprises were privatised, rationalisation of employment resulted in mass layoffs. The transformation crisis, aggravated in some countries by the war damage, resulted in an additional increase in unemployment.

Unemployment in transition countries is mainly structural in nature. It reflects the mismatch between labour supply and demand – in terms of skills, age, gender, and geographical distribution – of idle labour resources and the structure of the available jobs. Theoretical concepts that attempt to explain unemployment by excessively high wage levels do not have a direct reference to the situation existing in the countries under analysis, because they disregard structural unemployment and rely on a fictitious assumption of perfect labour mobility. One of the causes of unemployment is a big difference between net earnings received by the employees and gross salaries paid by employers, as the result of high income taxes and social insurance contributions. This phenomenon (called ‘the tax wedge’), coupled with a relatively generous system of benefits and social assistance for the unemployed, reduces the willingness to undertake legal employment and encourages people to work in the ‘grey economy’, at the same time hampering the creation of new jobs.

Government policy as regards the labour market in this group of countries is generally inconsistent and ineffective. It is focused on the provision of sufficient funds for paying benefits to the unemployed. Active programmes for reducing long-term unemployment, such as job information and advisory services, vocational training and retraining of the unemployed, public works, loans for the creation of small enterprises and individual businesses, as well as support for the handicapped, are not sufficiently developed.

In the 2000’s, the unemployment in many transition countries was partially mitigated by massive job-seeking emigration. Thousands of people, including well educated young people, left their home countries, looking for temporary or permanent job and settlement in Western Europe or North America. The outflow of labour resources was seen not only from the new EU member countries, but also from the countries of former Yugoslavia, as well as from Ukraine, Russia and other countries of the CIS. This phenomenon reduced the registered unemployment figures, but it has not solved the real problem, not to say that the outflow of qualified and highly productive labour resources is detrimental for the future development. With the beginning of the global crisis, due to the tightness of labour markets in Western Europe, we can observe an opposite transfer of former emigrants, who are returning home, exacerbating difficulties in the local labour markets.

The unemployment statistics is very imprecise and published with a substantial delay. It is also not fully comparable in international comparisons due to different registration procedures and different benefit standards and because of different size of employment in the grey economy. There are two sources of data on unemployment: official data about the registered unemployment and estimates based on labour surveys. In international comparisons the figures from labour surveys are usually preferred as more adequate, though they are often lower than the official data on the registered unemployed. In this analysis we use the data taken from labour surveys and published by the ILO.

According to these data, the unemployment rates recorded in 2008 in the CEE remained on about the same levels as noted in 2007, the last year of rapid expansion. The unemployment rate increased in the Baltic states, but it remained roughly the same in Hungary and Slovenia whereas in Poland, Slovakia and Czech Republic it actually decreased. In most countries of this subgroup unemployment rates reported in labour surveys were relatively low, between 4% and 8%, with the exception of Slovakia where unemployment amounted to 10% of the labour force.

In the SEE unemployment in 2008 was quite moderate (6-8%) in Bulgaria, Romania, and Croatia, but it was high in the remaining countries: Albania, Serbia, Bosnia & Herzegovina,

and Macedonia (13-34%). In all the countries of this subgroup, unemployment levels in 2008 were slightly lower than recorded in the previous year.

The CIS countries as a rule report quite low rates of unemployment, but the available data for this region are less reliable and not fully comparable. Moreover, unemployment data for this subgroup are released with a substantial delay. In 2007 the highest unemployment rate (13%) was recorded in Georgia whereas Belarus, Tajikistan and Uzbekistan continued to report almost no unemployment. All other countries, including Russia, Ukraine and Kazakhstan, reported relatively moderate unemployment rates, in the range of 5-8%. For 2008, the available data suggest that unemployment levels in the main countries of the region remained basically unchanged. Russia, Ukraine, Kazakhstan, and Azerbaijan reported an unemployment rate of 6-7% whereas Belarus, following its own standards, keeps up with the figure 1%.

For 2009 we have at this moment some unemployment data for only 16 out of 28 countries of this group and virtually no forecasts for the whole year. The data are not fully comparable since they were collected in different months. For most countries we observe some increase in unemployment levels, related to current recession, but the increase is relatively small, except for the three Baltic republics where unemployment jumped to 14% (in Estonia and Lithuania) or 20% (in Latvia). It is probably too early to see the full impact of the decrease in output on the unemployment level because changes in employment are usually lagged and are not so sharp as changes in output levels.

2.5. Deficits and debts

The two most significant factors hindering the pursuit of an active economic policy and detrimental to economic growth are deficits in state budgets and current foreign accounts. Most post-socialist countries have been struggling with the problem of budget deficits for many years. The magnitude of this problem was generally mitigated during the rapid economic growth in the early 2000's, but this does not mean that it has been definitely resolved. With the fall of output in 2009, most countries of this group saw a sharp increase in the deficits of state budgets. The current economic crisis exerts a strong pressure on public finances because tax revenues tend to decrease while government expenditures must be increased. As the result general government balances tend to deteriorate.

Although high budget deficits imply an increase in total demand, they often contribute to a rise in inflation rather than to the output growth. At the same time, they lead to a continuous rise of public debt, which can threaten the future economic growth. Persistent budget deficits result from excessive public spending, accompanied by meagre tax receipts, small proceeds from privatisation, customs duties and other government revenues.

Current account deficits are mainly the result of a high propensity to import (partly a consequence of inefficient and uncompetitive domestic production) as compared with the existing export opportunities (which are limited, on the one hand, by the slow growth of external demand and, on the other, by the available resources, technology, and competitiveness of domestic production). The current account balance is composed of the currency flows representing net exports of goods and services, income flows (e.g. withdrawal of profits from foreign investments), and transfer payments (e.g. foreign aid), but the main part of it is usually foreign trade balance. Unless offset by a positive balance of capital turnovers, current account deficits weaken the domestic economy and its currency and increase foreign debt, imposing a burden on future economic growth.

Table 6. Deficits and debts

Country	General government balance			Current account balance			Public debt	Foreign debt
	% of GDP							
	2007	2008	2009 ^b	2007	2008	2009 ^b	2008	2008
Central Eastern Europe								
Czech Republic	-0.6	-1.4	-6.0	-3.1	-3.1	-2.1	29.5	41.6
Estonia	2.9	-2.3	-3.6	-17.8	-9.3	1.9	4.6	114.1
Hungary	-4.9	-3.4	-3.9	-6.5	-8.4	-2.9	72.6	114.4
Latvia	0.7	-3.4	-13.0	-21.6	-12.6	4.5	19.5	124.0
Lithuania	-1.0	-3.3	-10.3	-14.6	-11.6	1.0	15.6	68.9
Poland	-2.0	-3.1	-5.8	-4.7	-5.5	-2.2	47.1	46.2
Slovakia	-1.9	-2.5	-5.3	-5.3	-6.5	-8.0	27.6	53.3
Slovenia	0.3	-0.3	-5.9	-4.2	-5.5	-3.0	29.6	105.7
Average ^a	-0.8	-2.5	-6.7	-9.7	-7.8	-1.5	30.8	83.5
South Eastern Europe								
Albania	-3.8	-5.5	-6.3	-9.1	-14.1	-11.5	55.9	20.4
Bosnia & Herzegovina	-0.1	-4.0	-4.7	-12.7	-14.7	-8.8	.	42.5
Bulgaria	3.5	3.3	-0.8	-25.2	-25.5	-11.4	19.6	103.5
Croatia	-1.2	-0.9	-3.5	-7.6	-9.4	-6.1	33.6	82.4
Macedonia	0.6	-1.0	-2.8	-7.2	-13.1	-10.6	21.3	49.1
Montenegro	6.4	-0.3	-6.7	-29.4	-16.0	-11.0	.	52.7
Romania	-3.1	-4.9	-7.3	-13.5	-12.4	-5.5	21.6	49.0
Serbia	-1.9	-2.5	-4.5	-15.6	-17.3	-9.1	.	60.4
Average ^a	0.1	-1.9	-4.6	-15.0	-15.3	-9.3	30.4	57.5
Commonwealth of Independent States								
Armenia	-2.2	-1.3	-7.5	-6.4	-11.5	-13.7	20.0	23.9 ^c
Azerbaijan	2.8	20.8	6.3	28.8	35.5	19.6	9.7	13.8
Belarus	0.4	1.4	-1.7	-6.8	-8.4	-9.6	13.0	24.6
Georgia	-4.7	-6.3	-9.4	-19.7	-22.7	-16.3	22.9 ^c	35.6
Kazakhstan	4.7	1.1	-1.9	-7.8	5.1	-2.0	6.6	78.2
Kyrgyzstan	-0.3	0.0	-3.8	-0.2	-8.2	-7.8	48.6	45.7
Moldova	-0.2	-1.0	-8.0	-17.0	-17.7	-11.8	21.4	67.9
Russia	6.8	4.3	-6.6	5.9	6.1	3.6	6.5	28.8
Tajikistan	-6.2	-6.1	-6.7	-8.6	-7.9	-13.7	30.1	47.0
Turkmenistan	3.9	11.3	9.3	15.5	18.7	17.8	.	.
Ukraine	-2.0	-3.2	-6.0	-3.7	-7.2	0.4	19.9	56.4
Uzbekistan	5.1	10.5	2.0	7.3	12.8	7.2	13.1	13.4
Average ^a	0.7	2.6	-2.8	-1.1	-0.5	-2.2	19.3	39.6
All transition countries ^a	0.1	0.1	-4.0	-7.5	-6.8	-4.0	25.4	57.9

^a Unweighted average. ^b IMF projection. ^c 2007.

General government balance and current account balance according to IMF data. Public debt (general government debt) and foreign debt according to EBRD data; for the Czech Republic these are preliminary EBRD estimates, published in 2008.

Sources: IMF, *Regional Economic Outlook: Europe*, October 2009; IMF, *Regional Economic Outlook: Middle East and Central Asia*, October 2009; EBRD, *Transition Report Update*, London 2008; EBRD, *Transition Report 2009*, London 2009.

The impact of the deficit in the state budget and current foreign account deficits on the economy depends not only on their size, but also on the means of their financing. A budget deficit covered by privatisation receipts, government bonds or foreign aid does not fuel inflation to the same extent as a deficit financed by the issue of additional money. Similarly, a current account deficit offset by the inflow of foreign capital does not exert such a negative impact on the development of the domestic economy as a deficit that leads to an increase in foreign indebtedness.

The size of deficits in state budgets and current accounts with abroad, and the volumes of public and foreign debts in the countries of the analysed group are shown in Table 6. It should be noted that data on general government balance refer to the consolidated state budget, which is a broader measure of public finance than central government budget. All the data are expressed as percent of GDP for the sake of comparability.

The condition of public finances in this group of countries has generally improved over the last few years as the result of a vigorous economic growth in the early 2000's. In 2007, general government balance was positive in 12 countries of the group (with the highest surplus, equal to 7% of GDP, noted by Russia), but it was negative in the remaining 16 countries (with the biggest deficit, equal to 6% of GDP, recorded in Tajikistan). In CEE and SEE, 6 countries (Estonia, Latvia, Slovenia, Bulgaria, Macedonia, and Montenegro) reported a surplus in general government balance while the deficit seen in the state budget of the remaining 6 countries was generally moderate, up to 3% of GDP, except for Hungary and Albania where it was slightly higher. In the CIS, 6 countries (Russia, Belarus, Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan) had a positive budget balance while the remaining 12 countries saw a deficit, mostly small, but quite significant (5-6% of GDP) in Georgia and Tajikistan.

In 2008 the state of public finance in CEE and SEE rather deteriorated, though not significantly. All the countries of this group except of Bulgaria reported a deficit in the state budget, mostly in the safe range up to 3% of GDP, but significantly higher (4-6%) in Albania, Bosnia & Herzegovina, and Romania. In the CIS, some countries noted an improvement in their government balance (especially Azerbaijan, Turkmenistan, and Uzbekistan), some other countries (notably Russia, Ukraine, Georgia, and Kazakhstan) saw a deterioration. High budget deficit (6% of GDP) was noted in Georgia and Tajikistan while the most spectacular surplus (from high oil revenues) was recorded in Azerbaijan (21% of GDP).

The economic crisis has weakened fiscal stance in all the analysed countries, with the exception of Turkmenistan (for which the information may not be accurate). The recent IMF estimates suggest that all the countries of the group, except of Azerbaijan, Turkmenistan and Uzbekistan, will fall into significant budget deficits in 2009. In CEE and SEE, the highest budget deficits (10-13% of GDP) are expected in Latvia and Lithuania, but they will be also quite high (6-8% of GDP) in Poland, Czech Republic, Slovenia, Albania, Romania, and Montenegro. Within the CIS, the regular surplus-gainers will either see a considerable decrease of the surplus (Azerbaijan, Turkmenistan, and Uzbekistan) or will fall into deficits (Russia, Belarus, and Kazakhstan). The biggest deficits in state finances (6-9% of GDP) are expected in Georgia, Armenia, Moldova, and Tajikistan, but also in Russia and Ukraine.

Most countries of the analysed group face deficits in current account balance. The only exceptions are big oil and gas exporters: Russia, Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.

In 2008 the relative size of current account balances in the analysed group did not change much as compared with the situation in 2007. In the CEE, Estonia and Latvia saw a reduction in the deficit on current foreign accounts due to a substantial reduction of imports, but all the Baltic states remained net importers, with relatively large current account deficits (9-13% of GDP). The remaining CEE countries have relatively lower deficits in current accounts with abroad (6-8% of GDP). In the SEE, all the countries note big deficits in their current account balance (10-15% of GDP or more). Bulgaria is the biggest net importer in this subgroup, with the deficit equal to 25% of GDP. Among the CIS countries, Russia sustained the size of its

surplus on foreign current accounts (6% of GDP) and the remaining oil and gas exporters have improved their standing, with the largest surplus (36% of GDP) noted by Azerbaijan. On the other hand, the remaining CIS countries continued to note sizeable deficits (mostly 7-8% of GDP). The biggest deficits were recorded by Moldova and Georgia (18-23% of GDP).

In 2009, due to the fall in output and a decrease in imports, most countries of the region will report an improvement in their current account balances, except of the big oil and gas producers: Russia, Azerbaijan, Kazakhstan, and Uzbekistan, which will suffer more from the reduction of export revenues as compared with the reduced spending on imports.

The state of the general government balance affects the evolution of public debts. The relative amount of public debts in transition countries, expressed as percent of the yearly GDP value is not oversized as compared to the world standards. There are some differences between the EBRD and World Bank estimates of the relative size of public debt in this group of countries. According to EBRD figures, the volume of public debts ranged from 5% of GDP in Estonia, 7% in Kazakhstan, and 10% in Belarus to 47% in Poland, 56% in Albania, and 73% in Hungary. For CEE and SEE the average is about 30% of GDP, and for the CIS it is about 25% of GDP. As compared with the relative size of public debts in the advanced economies, this is not an excessive burden. Nevertheless, most countries of the group are quite concerned about the state of public finance and the size of public debts.

The foreign indebtedness of the countries of this group is quite differentiated, ranging from 13% of GDP in Uzbekistan to 124% of GDP in Latvia. In most countries of CEE and SEE, as well as in the CIS, the volume of foreign debts relative to GDP is not too high and comparable with the world averages for the less and medium-developed economies. As a matter of fact, in order to assess the ability of a given country to repay its external debt, we should compare the amount of debt not only with the yearly value of GDP, but also with the yearly value of exports, which constitutes the main source of foreign exchange necessary for debt repayment. External debt stock may be also compared with the value of the official gross reserves. However, this would require a separate detailed analysis.

In the last few years there was a dramatic increase of foreign debts in Estonia, Latvia, Hungary, Slovenia, and Bulgaria, where the value of external debt reached a dangerous level of over 100% of GDP. Foreign debt is also relatively high in Lithuania, Croatia and Serbia (60-80% of GDP). In Poland external debt represents 46% of GDP. Among the CIS countries relatively high foreign debts (70-80% of GDP) are seen in Kazakhstan and Moldova, though Kazakhstan could repay its external obligations quite easily out of big revenues from oil.

2.6. International trade and the inflow of foreign investment

Most transition countries can be considered now as open economies, strongly dependent on exports and imports and the inflow of foreign investment. The basic data on foreign trade and the inflow of foreign direct investment (FDI) into the region are shown in Table 7.

A basic indicator of the openness of economies is the share of foreign trade in GDP. The first column of the table shows the average share of exports and imports of goods and services in GDP (the sum of exports and imports divided by 2). The data come from the World Bank. In most countries of CEE and SEE, the share of foreign trade in the economy is high, typical for small and open economies, i.e., 50%-80%. In larger countries (e.g. Poland and Romania), this ratio is lower, about 40%. In Russia, the share of exports and imports in GDP is 26%. Other CIS countries exhibit a diverse pattern, with the share of foreign trade in the economy ranging 30-70%. A significant part of their trade continues to be conducted with Russia. In general, the CEE and SEE countries represent a more open type of economies whereas the CIS countries continue to be less involved in international trade, for historical and economic reasons, but also due to transportation costs.

Table 7. Foreign trade and foreign investment

Country	Foreign trade ^a	Exports	Imports	Foreign direct investment (net inflow)				
	% of GDP	\$ billion		\$ billion			\$ per capita	% of GDP
	2007	2008	2008	1989-2008	2007	2008	1989-2008	2008
Central Eastern Europe								
Czech Republic	77.8	166.3	155.5	75.2	9.0	9.0	7 287	4.2
Estonia	81.3	17.7	18.8	8.8	1.0	0.9	6 530	3.7
Hungary	80.1	126.0	124.1	53.2	2.2	4.7	5 295	3.0
Latvia	55.2	14.1	18.5	8.8	1.9	1.1	3 857	3.2
Lithuania	63.7	28.0	33.4	9.3	1.4	1.5	2 779	3.2
Poland	42.0	195.3	212.7	111.5	18.0	11.7	2 927	2.2
Slovakia	88.0	73.7	72.4	27.1	2.9	3.2	5 011	3.2
Slovenia	75.7	37.2	38.4	3.1	-0.3	0.5	1 531	0.9
Subtotal	70.5 ^b	658.3	673.8	297.0	36.1	32.6	4 402 ^b	3.0 ^b
South Eastern Europe								
Albania	37.3	3.5	6.8	3.5	0.6	0.8	1 101	6.6
Bosnia & Herzegovina	52.4	6.4	11.9	6.2	2.1	1.0	1 639	5.3
Bulgaria	75.4	30.2	41.6	41.4	11.4	8.5	5 454	17.0
Croatia	53.3	29.1	34.9	23.2	4.7	4.6	5 215	6.6
Macedonia	65.2	5.3	7.4	3.2	0.7	0.6	1 570	6.4
Montenegro	47.4 ^c	1.9	3.3	2.8	0.7	0.8	4 229	16.7
Romania	39.4	55.0	74.3	58.2	9.6	13.5	2 683	6.8
Serbia	33.0 ^c	15.7	27.8	15.0	2.5	2.7	2 005	5.3
Subtotal	50.4 ^b	147.1	208.0	153.5	32.3	32.5	2 987 ^b	8.8 ^b
Commonwealth of Independent States								
Armenia	31.6	1.8	4.7	3.3	0.7	0.8	1 006	6.5
Azerbaijan	33.4	31.3	11.8	3.2	-5.2	-0.6	384	-1.2
Belarus	65.1	39.3	42.9	6.7	1.8	2.1	694	3.6
Georgia	41.7	3.9	7.6	6.6	1.7	1.6	1 510	12.2
Kazakhstan	45.7	80.3	53.8	49.5	8.0	10.7	3 183	7.9
Kyrgyzstan	64.4	2.7	4.7	1.2	0.2	0.3	231	5.2
Moldova	71.8	2.6	5.9	2.4	0.5	0.7	713	11.2
Russia	26.2	537.7	362.1	43.1	9.2	20.4	304	1.2
Tajikistan	62.9	0.9	3.0	1.1	0.2	0.3	166	5.8
Turkmenistan	50.6 ^c	8.7	6.7	4.7	0.8	0.8	730	4.3
Ukraine	48.1	65.3	86.3	40.8	9.2	9.7	889	5.4
Uzbekistan	30.3 ^c	11.7	8.8	2.9	0.7	0.7	103	2.5
Subtotal	47.7 ^b	786.2	598.3	165.5	27.8	47.5	826 ^b	5.4 ^b
Total	55.2 ^b	1 591.6	1 480.1	616.0	96.2	112.6	2 465 ^b	5.7 ^b

^a Exports + imports of goods and services divided by 2.

^b Unweighted average.

^c Merchandise trade.

Foreign trade as % of GDP according to the World Bank data supplemented for Serbia and Montenegro and for Turkmenistan and Uzbekistan by EBRD estimates. The value of exports and imports of goods and services according to the World Bank data. Net FDI inflows according to EBRD.

Sources: The World Bank, *World Development Indicators 2009*, Washington 2009; The World Bank database, October 2009; EBRD, *Transition Report 2009*, London 2009.

In the years 2004-2007, all the CEE countries recorded rapid growth of trade, with the volume of exports and imports increasing by 10-20% a year. Bulgaria and Romania saw a huge growth of imports and a moderate rise in exports. Much of the same may be said of Russia and Ukraine where the increase of exports was much slower than the increase of imports. Other countries of the CIS showed a differentiated record, with oil and gas producers leading in the dynamics of exports.

In 2008 the overall picture has changed. Under the impact of the worldwide slowdown, many countries in the group saw a significant decrease in the growth of their exports. At the same time, with the slowdown in their own economies they reduced the increase in their demand for imports. Most countries of the region noted a significant drop in the dynamics of both exports and imports, or even an absolute decrease in the volume of trade (e.g. Estonia, Latvia, and Moldova). A sharp decline in the dynamics of foreign trade was recorded in Slovakia, Slovenia, and Bulgaria. Russia failed to note any further increase in the volume of exports. Almost all countries of the group significantly reduced the increase in their imports. Beyond any doubt, the current year 2009 will strengthen these tendencies, at least until the expected recovery in the world economy.

Table 7 also shows the value of exports and imports of the countries belonging to this group. The total value of their exports and imports in 2008 was \$ 1592 billion and \$ 1480 billion respectively. This represented about 8% of the total world trade. The biggest exporters within the group are Russia, Poland, Czech Republic, and Hungary. These four countries represent about 2/3 of the total value of exports from this region.

The second external factor that has a major impact on the economic development in transition countries is the inflow of foreign direct investment. Data on FDI reported by different sources vary considerably, depending i.a. on the definitions used. Foreign direct investment is usually meant as acquisition of existing enterprises, creation of new businesses or founding of firms with a dominant share of foreign capital. EBRD data on the inflow of FDI into the transition economies, shown in Table 7, refer to net inflows (inflows minus outflows).

Over the whole period of 1989-2008, total FDI inflows to the transition countries amounted to \$ 616 billion. The biggest amounts of foreign capital have been received by Poland, Czech Republic, Romania, Hungary, Kazakhstan, Russia, Bulgaria, and Ukraine. On *per capita* basis the highest capacity to absorb foreign capital was observed in the Czech Republic, Estonia, Hungary, Slovakia, Bulgaria and Croatia.

In 2008, the total FDI inflow to this group was \$ 113 billion, 17% more than in the previous year. The biggest inflows, of \$ 10 billion or more, were recorded by Russia, Romania, Poland, Kazakhstan, and Ukraine.

In 2009, according to the newest EBRD estimates, the total net FDI inflow to the countries of this group will decrease to \$ 43 billion, which means a dramatic fall by 62% as compared with the amount noted in the preceding year. The new FDI inflow to Russia will be less than \$ 1 billion. Only four countries of the region: Poland, Bulgaria, Romania, and Kazakhstan may still see a sizeable inflow of foreign capital.

Though the amount of FDI inflows to the countries of this group is quite considerable, it represents a relatively minor part of real capital flows worldwide: just 4.5% in 2007. The share of the countries of the region in total FDI inflows is thus comparable to their share in the global GDP calculated at OER, but considerably lower than their share in world trade.

The inflow of FDI to the transition countries is a very important factor of their development. FDI represent a considerable part of total investments made in those countries. They bring new technology and know-how and increase the efficiency of business. They introduce new products, open up new export markets, and increase the competitiveness of domestic production. FDI may also have some negative impact on the hosting economies, including the withdrawal of a part of profits, and the increase in the propensity to import, but it has been proved in many analyses that the net effect of FDI on economic development in the countries of the region is positive.

2.7. General assessment of macroeconomic performance

Our general assessment of the current condition of the transition economies will be based on five macroeconomic indicators presented and analysed in the previous sections of this

paper: the rate of growth of the real GDP (GDP), the rate of unemployment (UNE), the rate of inflation (INF), general government balance as % of GDP (GOV), and current account balance as % of GDP (CAB). These are the main macroeconomic indicators usually taken into account when assessing current economic situation in individual countries.

Chart 3 presents the pentagons showing current macroeconomic performance of individual countries of the group in 2008 in terms of the five mentioned criteria. The scale of the axes has been adjusted to the actual value distribution of the data.

The tips of the pentagons, representing maximum or minimum values for each of the indicators, are considered to be desirable (positive) targets, although in some cases this could be disputable. For example, a high surplus in the current account balance or in the general government balance may not be the optimal result. Likewise, no unemployment or zero inflation may not be the best. More advanced economies that experience moderate economic growth, apply active economic policies and are open to foreign trade, often exhibit on the graphs a figure flattened at the bottom and the top. Another problem is the fact that low unemployment is often accompanied with high inflation and vice versa. A separate issue is the significance of each of the criteria (e.g. whether low inflation is of the same importance as low unemployment). All these reservations need to be taken into account when interpreting such charts.

According to the graphs, in 2008, on the eve of world economic crisis, the overall macroeconomic situation in Poland, Czech Republic, Slovakia and Slovenia was still quite good: a moderate or rapid growth of output was combined with low inflation, tolerable deficits in state budgets and current accounts and relatively low unemployment (except of Slovakia). Hungary continued to have serious financial and structural problems that have resulted in a prolonged stagnation of output. The Baltic states, following a “borrowed” expansion, fell into recession, coupled with high current account deficits and a renewed inflation; the fixed exchange rates have strengthened the fall in output.

Most SEE countries continued to develop rapidly, keeping the deficits in state budgets under control, but inflation in all the countries of this group except Albania has accelerated to a dangerous level together with big deficits in current accounts. In post-Yugoslav countries a very high unemployment was the additional serious problem.

Among the CIS countries, the overall macroeconomic performance was differentiated because of different position of individual economies, different production structures, and different degree of the dependence on foreign markets. Most countries of this group combined rapid growth with low unemployment and a good fiscal stance, but inflation continued to run on two-digit levels and actually it has accelerated. As regards current account balance, the group was still split between net exporters and net importers, depending mainly on the availability of oil and gas or other natural resources. The most proportional and best-filled pentagons, showing a well-balanced economic growth, can be observed for Russia, Kazakhstan, Uzbekistan, Armenia and Belarus whereas the least harmonious and shapeless figure, indicating a very poor macroeconomic performance, was exhibited by Kyrgyzstan. This small mountainous country, in spite of its gold deposits, is actually, along with Tajikistan, the poorest country in the group, and it is quite delayed in economic reforms. It should be noted that Azerbaijan would represent the best macroeconomic proof in the CIS region if it could cut down inflation, as actually is expected in 2009.

Chart 3. Macroeconomic performance in 2008

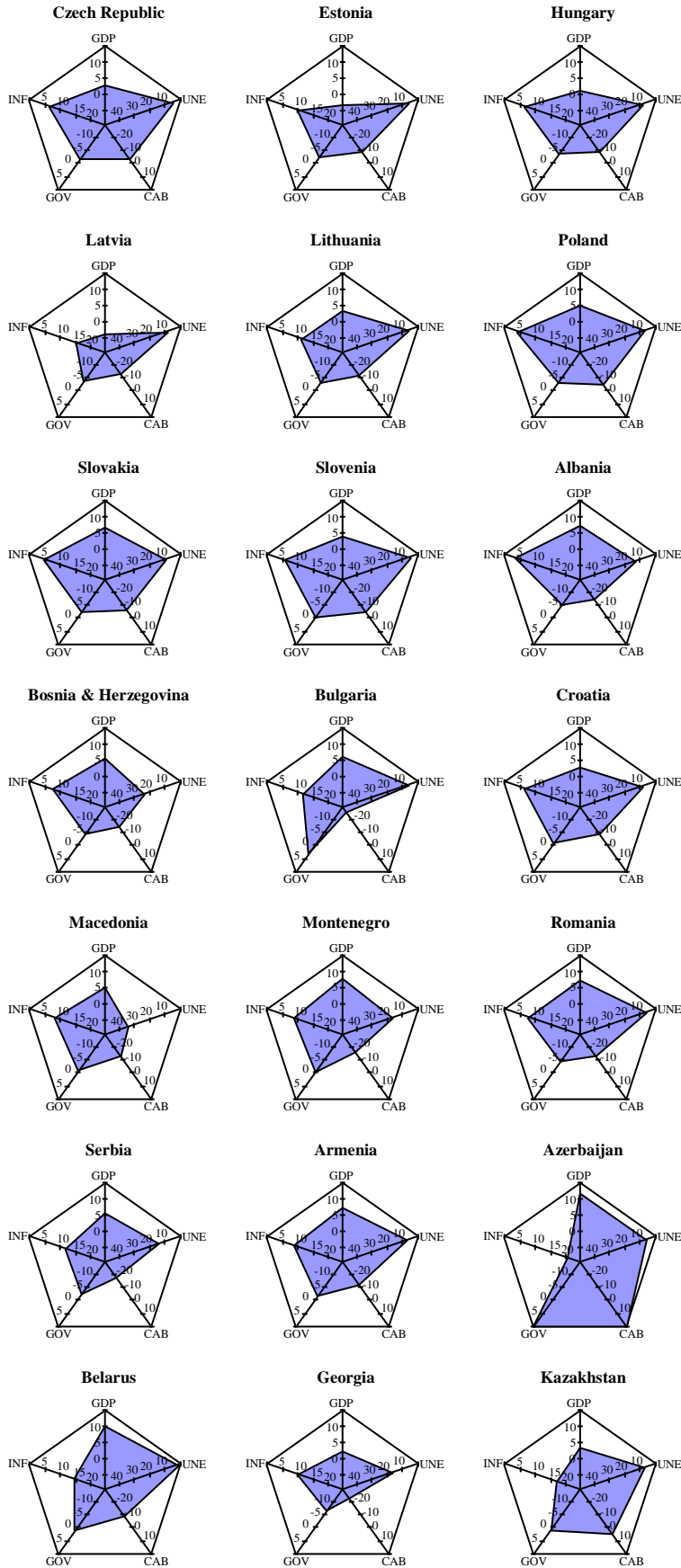
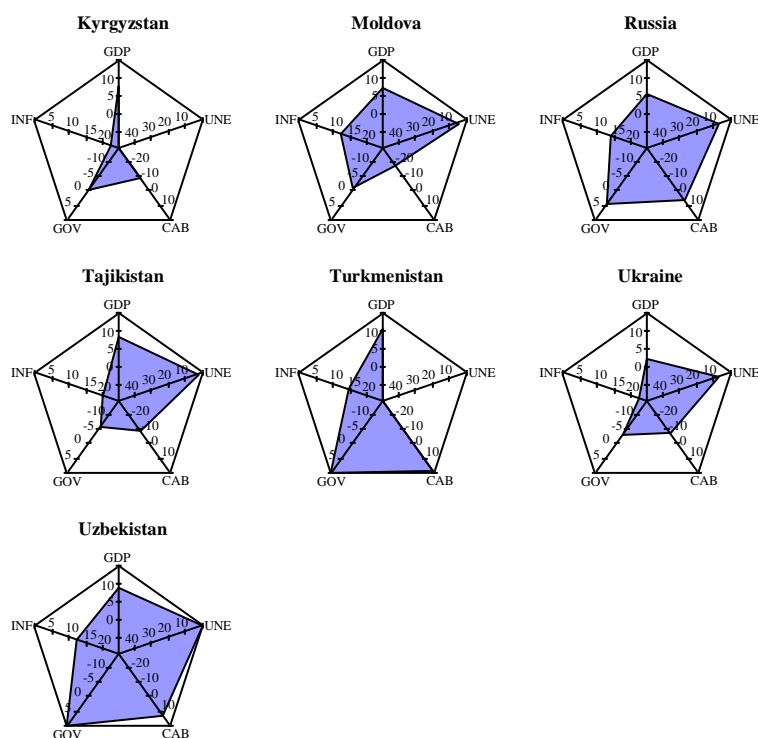


Chart 3. Economic performance in 2008 (cont.)



- GDP – real GDP growth rate (%)
- UNE – unemployment rate (%)
- CAB – current account balance (% of GDP)
- GOV – public government balance (% of GDP)
- INF – consumer price inflation (%)

Unfortunately, because of the lack of current unemployment data (data presented in Table 5 refer mainly to the first half of the year), we are not able to show, according to the same scheme, the change in economic situation of the countries concerned, which appeared in 2009 under the impact of world economic crisis. Nevertheless, the analysis presented in the preceding sections has shown that the current crisis is marked by a considerable slowdown or fall of output, a rise in unemployment, and worsening of the general government balance. At the same time, with the decrease of total demand, there is decline in the rates of inflation and sometimes also an improvement in foreign account balance.

2.8. Social welfare and living standards

Perhaps the most important issue in assessing the results of the transformation is to what extent the changes that have taken place in the political and economic system, translate into a real improvement in the living conditions of the citizens. In other words, what is the balance of social costs and benefits of the transformation process for families and individuals. The answer to this question is of fundamental importance for our understanding of people's attitudes towards transition.

The concept of social welfare obviously extends beyond material living standards, measured by *per capita* income or consumption. It also includes a number of other elements of the quality of life, such as housing conditions, health status, the availability and quality of education, public security, law and order, citizens' rights, and democracy. Not all of these components can be measured.

Table 8 presents the key indicators of living standard in post-socialist countries, based on the latest available data. Most data refer to the situation in 2007.

As to the income levels, comparing the data on *per capita* GDP expressed in PPP \$, we see big differences between the countries of the group that have been already discussed in section 1. There is a huge disparity between Tajikistan (\$ 1750) and Slovenia (\$ 26 753) as well as a big distance between the average income level in this group and the average income in the highly developed countries.

The international poverty rate shows the percentage of the population living on less than \$ 2 a day. In the poorest countries of the CIS (Tajikistan, Uzbekistan, Turkmenistan, Kyrgyzstan, and Moldova) this proportion is between 30 and 75%. It is also quite high in Armenia, Georgia and Kazakhstan. In CEE and SEE this rate is usually below 2%, except of Albania and some post-Yugoslav countries. But the extent of poverty understood as lack of the basic means necessary for survival is also considerable in such countries like Russia, Ukraine and Belarus, as well as in many countries of Central and South Eastern Europe. Millions of people in this region live in miserable conditions, suffering constant privation and hardly meeting the ends.

Not all the people enjoy the living standard in line with the average income level recorded in national accounts. The degree of income disparities in individual countries is reflected by the Gini index. It shows tremendous income differences among the citizens of most CIS countries (especially in Russia, Georgia, Moldova, Turkmenistan and Uzbekistan), but also in some countries of CEE and SEE, notably in the Baltic states and post-Yugoslav republics.

Another measure of income inequality is the ratio of income or consumption gained by the richest 10% of households and by the poorest 10%. This ratio is very high in Georgia, Turkmenistan, Uzbekistan, and Macedonia (10-16), but also in Russia, Estonia, Latvia, and Lithuania (about 10). The ratio equal to 10 means that the average income earned by the richest 10% families is ten times higher than the average income obtained by the poorest 10% of families.

Table 8. Indicators of social welfare and living standards, 2007

Country	GDP <i>per capita</i> in \$ at PPP	Gini index	Poverty rate (%)	Life expectancy at birth (in years)	Infant mortality rate (per 1000 live births)	Education index	Human development index (HDI)
Central Eastern Europe							
Czech Republic	24 144	25.8	<2	77	3	0.938	0.903 [36]
Estonia	20 361	36.0	<2	73	4	0.964	0.883 [40]
Hungary	18 755	30.0	<2	73	6	0.960	0.879 [43]
Latvia	16 377	35.7	<2	71	7	0.961	0.866 [48]
Lithuania	17 575	35.8	<2	71	7	0.968	0.870 [46]
Poland	15 987	34.9	<2	75	6	0.952	0.880 [41]
Slovakia	20 076	25.8	<2	74	7	0.928	0.880 [42]
Slovenia	26 753	31.2	<2	78	3	0.969	0.929 [29]
South Eastern Europe							
Albania	7 740	33.0	7.8	76	13	0.886	0.818 [70]
Bosnia & Herzegovina	7 764	35.8	<2	75	13	0.874	0.812 [76]
Bulgaria	11 222	29.2	<2	73	10	0.930	0.840 [61]
Croatia	16 027	29.0	<2	76	5	0.916	0.871 [45]
Macedonia	9 096	39.0	3.2	74	15	0.880	0.817 [72]
Montenegro	11 699	.	.	74 ^a	.	0.891	0.834 [65]
Romania	12 369	31.5	3.4	73	13	0.915	0.837 [63]
Serbia	10 248	30.0	.	73	7	0.891	0.826 [67]
Commonwealth of Independent States							
Armenia	5 693	33.8	43.4	72	22	0.909	0.798 [84]
Azerbaijan	7 851	16.8	<2	67	34	0.881	0.787 [86]
Belarus	10 841	27.9	<2	70	12	0.961	0.826 [68]
Georgia	4 662	40.8	30.4	71	27	0.916	0.778 [89]
Kazakhstan	10 863	33.9	17.2	66	28	0.965	0.804 [82]
Kyrgyzstan	2 006	32.9	51.9	68	34	0.918	0.710 [120]
Moldova	2 551	35.6	28.9	69	16	0.899	0.720 [117]
Russia	14 690	37.5	<2	68	13	0.933	0.817 [71]
Tajikistan	1 753	33.6	50.8	67	57	0.896	0.688 [127]
Turkmenistan	4 350	40.8	49.6	63	45	0.906	0.739 [109]
Ukraine	6 914	28.2	<2	68	20	0.960	0.796 [85]
Uzbekistan	2 425	36.7	76.7	67	36	0.888	0.710 [119]

^a 2006.

Gini index measures household income dispersion. The higher is the index, the greater is income inequality.

Poverty rate is the percentage of the country's population living below the international poverty line (US \$ 2 a day).

Data on Gini index and poverty rate refer to 2003, 2004 or 2005 depending on the date of the last survey (except of the Czech Republic and Slovakia, for which the data refer to 1996, and Turkmenistan, for which the data refer to 1998).

Life expectancy at birth refers to children born in 2007.

The education index considers the percentage of the adult able to read and write and the proportion of children and youth attending schools of all the levels.

Human Development Index is a summary measure of social development and living standards, compiled by the UNDP. This is an arithmetic average of three indices: *per capita* GDP, life expectancy, and education. The indicator assumes values 0 to 1. Figures in brackets show the country's position in an international ranking covering 182 countries in 2007.

GDP *per capita* at PPP according to the World Bank estimates. Poverty rate, life expectancy and children mortality according to the World Bank. Education index and Human Development Index according to the UNDP.

Sources: The World Bank, *World Development Indicators 2009*, Washington 2009; UNDP, *Human Development Report 2009*, New York 2009.

There is a clear relationship between the poverty rate and the degree of income inequality. Countries with the largest poverty rates as a rule exhibit also a high degree of income

dispersion. This is because poverty in the countries undergoing transformation has two main sources. The first was the decline in incomes caused by the transformation crisis, followed by the increase in unemployment. The second is the growing disparity of incomes, which is partially the consequence of the introduction of market economy, but also the result of faults in economic and social policies and the weakness of law.

Poverty, malnutrition, poor housing and sanitary conditions, the lack of hygiene, and limited access to medical care (not to say about the quality of its service) – all of these factors take a negative toll on the health of the population. This is evidenced by high infant mortality rates and relatively low life expectancy.

Life expectancy at birth in transition countries is low as compared with the standards reached by the highly developed countries where it is currently estimated to be 79 or 80 years. In CEE and SEE it is between 71 and 78 years. In the CIS countries (with exception of the Caucasus, where people are known for their longevity), it is in the range between 63 and 69 years. It should be remembered that this indicator refers to the chances of newborn children. The actual duration of life across the entire population is much lower. Another health problem in less developed countries of this group are infectious diseases.

The infant mortality rate in the highly developed countries is about 0.6% on the average. In Western Europe it is below 0.4%. Close to these standards are only CEE countries. The SEE countries, except Croatia and Serbia, show much higher infant mortality rates, between 1.0% and 1.5%. In the CIS, mortality rate among newborn ranges from 1.2-1.3% in Russia and Belarus to 2.0% in Ukraine, 2.8% in Kazakhstan, and 5.7% in Tajikistan.

The basic education level in most transition countries is quite good both as regards the number of adults with writing and reading capacity and the rates of school attendance. But the quality of education is often low and its effect on vocational abilities is insufficient.

Many young people from poor families face material difficulties in the access to schools and limited opportunities to obtain a proper education that would secure a good job and a perspective of professional career. This petrifies, both in the individual feelings and in the social sense, a highly negative and troublesome phenomenon called the poverty trap, or the vicious circle of poverty.

The level of education and health obviously depends on the amount of government finance. Public spending on education and healthcare in this group of countries is very diverse. In CEE public expenditure for these aims amounts to 3%-6% of GDP. In most SEE and CIS countries it is significantly lower.

A composite index of living standards compiled by the UNDP is called Human Development Index (HDI). It is calculated on the basis of three component indices reflecting the following factors: (a) GDP *per capita* at PPP, (b) education level, (c) life expectancy. This index assumes values from 0 to 1. The last column of Table 9 presents the numerical values of this indicator for the countries of the analysed group (the position of individual countries in an international ranking covering 182 countries is given in brackets).

The CEE countries occupy relatively high positions in this ranking, from 29 for Slovenia to 48 in Latvia. The SEE countries perform worse, taking the positions from 45 for Croatia to 76 in case of Bosnia & Herzegovina. Within the CIS, according to this index, Kazakhstan is now on the top, placed on the 82nd position, while Tajikistan is on the bottom, placed on the 127th position among 182 countries classified. In the worldwide ranking, Poland is number 41, and Russia is number 71. Looking at the evolution of the HDI index over time, between 1995 and 2007, we may see that all transition countries have increased the value of the index, but not all of them have improved their position in the worldwide ranking.

Summing up, in the course of transformation, and partly thanks to it, most countries of the analysed group have noticed a considerable increase in living standards. But the effects of the transformation on social welfare are not very impressive. The average living standard in the least developed countries of the group has rather decreased. Even in countries that have seen a fast economic growth and have modernised markedly their economies, many citizens have not

noticed a real improvement in their living standards. The increase in national income has been distributed unevenly between metropolitan and rural areas and between different social groups. The problem of mass unemployment has emerged, practically unknown under the previous system. Crime and corruption have risen sharply. Much social criticism is evoked by the functioning of public services, government administration and justice.

Reforms of the insurance and healthcare systems have restricted access to medical services and have led to a radical increase in the prices of medical services and medicines. The progress in education is big, but its quality and the effect on the working ability is still insufficient. The modern teaching programs and better school equipment have contributed to an improvement in the quality of education, reducing the gap towards the more developed countries. On the other hand, privatisation of schools, especially on the university level, provides new problems both as regards the quality of education and the amounts of fee.

In many areas of social life (e.g. housing conditions, communications, transport, and financial services) notable progress has been made, with a direct effect on living standards. A tremendous improvement has been achieved in the functioning of trade and in the availability of consumer goods and services in the market. It is now much easier to meet material needs, provided that one has the necessary money. The problem is that the latter condition is not always fulfilled.

3. MACROECONOMIC POLICY

The main objective of macroeconomic policy (equivalently also referred to as stabilisation policy or demand management policy) is to achieve fast economic growth and ensure equilibrium on four basic markets (those for goods, money, labour and foreign exchange). While pursuing this objective, the government influences various components of aggregate demand with a view to stabilise output close to its potential level (or – in dynamic terms – to minimise the deviations of actual output from its long-run growth trend). At the same time it aims to ensure macroeconomic stability that is, *inter alia*, a low inflation and balanced public finances.

The government applies three basic tools for demand management: fiscal policy, monetary policy and exchange rate policy. Each of these tools affects the individual components of aggregate demand in a different way. This impact can either take place directly (as is the case with budget spending) or indirectly (e.g. the effect of interest rates on consumption and investment or of the exchange rate on net exports). There are also time lags of various lengths between the implementation of particular tools and the full adjustment of economic agents.

3.1. Fiscal policy

In the conditions of countries undergoing systemic transformation, the fiscal stance may be approximated as the change in the size (or sign) of the general government balance. Compared to the beginning of the present decade, last year brought an improvement in fiscal discipline across the whole group of transition economies – the public finance deficit declined from some 3% of GDP in 1999-2002 and 2.3% in 2003, to 0.0% (balanced budget) last year (non-weighted average) or 0.9% if we exclude the special case of Azerbaijan, which noted an extreme surplus of 26% of GDP. However, compared to 2007 the aggregate fiscal stance deteriorated in most countries of the region as the result of slower economic growth due to the forthcoming economic crisis. The scale of fiscal imbalances increased in fifteen countries; it still remained excessive in a number of transition economies, which was a derivative of a lack of fundamental reform of public finances, a continuation of an expansionary fiscal policy, and lower tax revenues. Simultaneously, fiscal discipline improved in five countries. Eight countries of the region recorded a positive general government balance in 2007 and 2008.

The situation of public finances was the most difficult in Central Eastern Europe (Table 9). In 2008, the fiscal imbalance in all these countries except Hungary significantly increased. As a result, all the countries of this subgroup noticed a budget deficit in 2008. The deepest fiscal imbalances prevailed in Latvia and Poland. In 2008, the general government deficit in these countries reached 4.0% and 3.9% of GDP respectively. The fiscal policy has also exhibited an expansionary stance in Hungary and Lithuania; the budget deficit there exceeded the 3% ceiling of the Maastricht Treaty. Slovakia, that has adopted euro since 2009, fulfilled Maastricht criterion, reaching a deficit of 2.2% of GDP in 2008. It is worth to emphasize that, whereas until 2007 only Hungary failed to meet the fiscal criteria of nominal convergence or the eligibility conditions for the Economic and Monetary Union (EMU) membership, by 2008 four out of seven CEE countries (excluding Slovenia) remained above the 3% ceiling of the Maastricht Treaty. Nevertheless, as the UN Economic Commission for Europe pointed out, the budget deficit in these countries was of a predominantly structural nature⁵. Moreover, in three Central European economies (the Czech Republic, Poland and Slovakia) it was estimated at a level exceeding 3% of GDP (see Box 1).

⁵ See: *Economic Survey of Europe*, UN Economic Commission for Europe, 2005 no. 1, Geneva, p. 36 and box 3.3.

Table 9. Main indicators of fiscal policy, 2003-2008 (% of GDP)

Country	General government revenue		General government expenditure		General government balance		
	Average 2003-2008	2008	Average 2003-2008	2008	Average 2003-2008	2007	2008
Central Eastern Europe							
Czech Republic	41.4	40.9	44.4	42.4	-3.0	-0.6	-1.4
Estonia	36.4	37.1	35.2	39.9	1.2	2.6	-2.7
Hungary	43.4	46.2	49.9	49.6	-6.5	-4.9	-3.4
Latvia	35.3	35.4	36.6	39.4	-1.3	-0.4	-4.0
Lithuania	32.9	34.2	34.3	37.4	-1.3	-1.0	-3.2
Poland	39.0	39.2	43.3	43.1	-4.3	-1.9	-3.9
Slovakia	34.5	32.7	37.0	34.9	-2.6	-1.9	-2.2
Slovenia	43.3	42.6	44.6	43.6	-1.4	0.5	-0.9
South Eastern Europe							
Albania	25.4	27.4	29.7	33.0	-4.3	-3.5	-5.7
Bosnia & Herzegovina	44.5	47.9	43.6	50.9	0.9	-0.1	-3.0
Bulgaria	39.1	39.5	36.9	36.5	2.2	3.5	3.0
Croatia	39.4	39.4	42.6	40.8	-3.2	-2.5	-1.4
Macedonia	34.0	34.2	34.2	35.2	-0.1	0.6	-1.0
Montenegro	43.3	44.4	41.8	42.9	1.5	6.4	1.5
Romania	31.7	32.7	33.9	37.6	-2.2	-3.1	-4.9
Serbia	42.3	40.5	43.2	42.9	-0.8	-1.9	-2.4
CIS							
Armenia	17.6	20.3	19.6	21.7	-2.0	-2.3	-1.4
Azerbaijan	31.6	53.0	26.6	27.6	5.1	2.4	25.5
Belarus	48.2	51.0	48.0	49.5	0.2	0.4	1.4
Georgia	24.6	30.7	27.1	37.1	-2.5	-4.2	-6.4
Kazakhstan	27.1	27.6	23.0	26.5	4.0	4.7	1.1
Kyrgyzstan	26.2	29.6	28.8	29.6	-2.6	-0.3	-0.1
Moldova	38.4	40.6	38.1	41.6	0.2	-0.3	-1.0
Russia	36.8	38.4	31.3	33.6	5.5	6.0	4.8
Tajikistan	20.6	22.1	23.5	28.2	-2.9	-6.2	-6.1
Turkmenistan	20.0	23.6	16.4	12.3	3.6	4.0	11.3
Ukraine	40.9	44.2	43.2	47.3	-2.3	-2.0	-3.2
Uzbekistan	36.0	43.2	31.5	32.7	4.5	5.7	10.5

Source: EBRD, *Transition Report Database*, October 2009; own calculations.

The underlying reasons for public finance imbalances in Hungary, Latvia, Lithuania, and Poland are unresolved structural problems, institutional barriers, and slower economic growth implying lower tax revenues. Although, according to earlier government documents submitted to Brussels, general government balances should have reached the Maastricht

reference value around 2007-2009, it is rather impossible for the countries involved to achieve this goal. The projections for 2009 are even more pessimistic, especially for the Baltic states that suffer a deep recession. It is particularly worth emphasising that the size of fiscal deficit then is to be a derivative of practical application of the so-called golden rule of public finance, which makes it possible to largely reconcile the contradicting goals of nominal and real convergence in the new member states (see Box 1).

Fiscal policies pursued by Bulgaria, Slovenia, and also Slovakia⁶ have been even more disciplined. In Bulgaria an additional factor enforcing the fiscal discipline was due to the currency board regime, which implies the introduction of a nominal foreign exchange anchor in the economy. Simultaneously, it reduces the sovereignty of the domestic monetary authorities and enhances the role of fiscal policy. This regime, however, also appears in the Baltic states (or its equivalent in the case of Latvia), that noted large general government deficits in 2008.

Box 1. The golden rule of public finance

The essence of the “golden rule” comes down to the postulate for the excess of public expenditure over revenue (the fiscal deficit, or more precisely, the borrowing requirement of the government) to be used for the financing of public investment. Thanks to such investment, particularly in infrastructure, positive externalities for the private sector arise and it is possible to sustain or even accelerate the rate of economic growth (real convergence), despite fiscal tightening and the reduction of the deficit (nominal convergence).

The Table below contains data on the present and anticipated size of structural deficits and public investment in the new EU-8 countries in Central Europe.

Selected fiscal indicators in the new EU member states, 1998-2007 (% of GDP)

	Structural deficit 2003	Structural deficit 2007 (forecast)	Public investment (average for 1998- 2003)
Czech Republic	5.2	3.6	3.6
Estonia	-2.6	-0.1	4.2
Lithuania	1.8	1.8	2.6
Latvia	1.4	2.0	1.4
Poland	5.0	3.7	3.4
Slovakia	3.7	3.1	2.9
Slovenia	1.5	0.7	2.2
Hungary	6.2	2.7 ^a	3.7
EU-15	1.6		2.3

a – 2008.

Source: *Economic Survey of Europe*, op. cit, p. 36.

In the transition economies of South Eastern Europe, the scale of fiscal imbalances has also been quite large in several countries (notably in Albania, Romania, Bosnia &

⁶ Slovenia joined the euro area on 1 January 2007, and Slovakia – on 1 January 2009.

Herzegovina, and Serbia). Croatia and Macedonia recorded low budget deficits (about 1% of GDP) while Montenegro and Bulgaria noted a fiscal surplus.

In the CIS countries, in 2008 the fiscal stability improved in average terms, but this statistical outcome was mostly due to an extraordinarily good performance observed in four oil and gas exporting countries: Azerbaijan, Turkmenistan, Uzbekistan, and Russia, that recorded very high general government surpluses (at the level of 25.5%, 11.3%, 10.5%, and 4.8% of GDP respectively). Low fiscal surplus was noticed by Belarus and Kazakhstan. The remaining CIS countries recorded budget deficits which – in the case of Georgia, Tajikistan, and Ukraine – were quite large (3-6% of GDP).

3.2. Monetary policy

Compared to the past few years, the macroeconomic environment of the monetary policy in most of the transition countries has changed in 2008 – a rapid economic growth combined with higher prices of many imported inputs triggered a rising inflationary pressure. Facing a difficult trade off between fast – yet more unbalanced – economic growth and higher inflation many countries switched from an accommodating monetary policy pursued in the 2003-2005 period to a more neutral or even restrictive monetary stance during 2006-2008. Many central banks have decided to raise interest rates, to introduce stricter regulations on minimum reserves or to embark on other anti-inflationary measures. In 2008, only four transition economies – as the data in Table 10 indicates – experienced an accelerated growth of nominal money supply. The remaining countries revealed a decreasing rate of money growth and – in four of them (Latvia, Lithuania, Armenia, and Turkmenistan) – the level of money supply even fell in absolute terms. The same trend was observed in the case of credit growth. After a considerable boom at the credit market in the last few years, in 2008 about 20 countries of the group noted a deceleration of credit growth.

Between 2006 and 2008, the central banks in most EU-8 countries have gradually tightened the monetary policy in reaction to the risks posed by rising wages, capacity constraints and rapid credit growth. However, the monetary policy stance in the Baltic states remained still too loose, with low real interest rates.

At the end of 2008 and early 2009, the trend of the monetary policy has been reversed. It became more expansionary in order to offset the negative effects of the observed slowdown and projected recession. All the CEE countries cut the interest rates in late 2008 or the 1st half of 2009.

Similarly, some central banks in South Eastern European countries have loosened its monetary policy during end-2008 or early 2009. This occurred after a period of quite restrictive monetary stance in 2006-2008, aiming at combat the inflationary pressure and excessive credit expansion. Notably, Albania, Bulgaria, Romania, and Serbia slashed their interest rates between 2008 and 2009.

Table 10. Basic indicators of monetary policy, 2002-2008

Country	Broad money (% annual change)		Domestic credit (% annual change)		Real interest rate (%)		
	2007	2008	2007	2008	2002	2005	2008
Central Eastern Europe							
Czech Republic	16.3	8.3	19.5	n.a.	3.8	6.1	4.5
Estonia	13.4	5.5	34.2	8.1	2.6	-0.3	0.7
Hungary	8.6	10.2	12.8	18.5	2.2	6.1	6.1
Latvia	14.4	-4.4	32.9	17.9	4.2	-3.7	-2.9
Lithuania	21.4	-0.4	40.6	17.4	6.6	-1.3	-1.7
Poland	14.2	16.5	27.0	32.5	9.6	4.1	3.9 ¹
Slovakia	11.8	5.5	20.3	25.5	6.1	4.2	6.8 ¹
Slovenia	10.6	5.1	24.9	14.9	5.1	6.1	2.5
South Eastern Europe							
Albania	5.3	10.3	24.1	18.0	11.6	9.3	10.3
Bosnia & Herzegovina	21.6	4.3	29.5	22.3	7.9	7.3	-0.4
Bulgaria	31.3	8.7	58.8	33.0	4.6	4.7	-0.5
Croatia	18.3	4.3	12.9	12.6	9.0	7.6	3.5
Macedonia	28.1	7.1	67.1	39.4	14.4	8.0	2.4
Montenegro	72.9	28.5	175.5	25.8	n.a.	n.a.	-0.1
Romania	34.0	17.4	64.5	33.0	9.7	6.5	0.9
Serbia	40.0	1.2	32.5	34.2	-4.1	1.6	4.8
CIS							
Armenia	42.3	-1.2	78.4	n.a.	18.3	14.3	8.0
Azerbaijan	141.8	38.2	98.5	33.7	13.8	0.8	-1.0
Belarus	40.0	26.3	22.2	51.7	-5.5	-6.4	-9.9
Georgia	50.3	14.0	28.8	34.0	24.5	12.7	10.2
Kazakhstan	25.9	35.4	58.8	2.2	n.a.	n.a.	n.a.
Kyrgyzstan	33.4	9.3	54.0	15.5	22.3	18.2	11.6
Moldova	47.3	18.4	39.0	16.5	12.5	9.1	10.3
Russia	47.5	1.7	43.6	29.6	0.1	-7.2	-2.4
Tajikistan	78.8	6.3	71.0	19.6	-5.4	12.6	-3.9 ¹
Turkmenistan	96.4	-7.6	31.0	52.2	n.a.	n.a.	n.a.
Ukraine	50.8	31.0	77.0	76.9	19.2	-6.7	-9.0
Uzbekistan	46.9	35.6	-64.2	-137.2	n.a.	n.a.	n.a.

1 – 2007. n.a. – data not available.

Broad money and domestic credit according to the EBRD data. Real interest rates according to the World Bank.

Sources: EBRD, *Transition Report Database*, October 2009; World Bank, *World Development Indicators Database*, October 2009; World Bank, *World Development Indicators 2009*, Washington 2009.

The strong economic growth across the CIS countries has brought increasing prosperity but also significant policy dilemmas. Monetary authorities in resource-rich economies were

seeking to manage the strong inflow of foreign exchange and prevent the domestic currencies from appreciating in nominal terms in order to protect the competitiveness of non-energy (non-commodity) export industries. On the other hand, a stronger currency may be instrumental in dampening the inflationary pressure. The difficulties of this balancing exercise have been compounded in most of CIS economies by the lack of sufficiently developed domestic money and capital markets – which make the impact of interest changes on the real economy less effective.

3.3. Exchange rate policy

As of 2008, among the 28 former communist countries, 19 had floating exchange rates, while eight economies were operating under a fixed or quasi-fixed exchange rate regime.⁷ A special case of a fixed exchange rate regime is the currency board, present in four countries. This issue has been discussed in more detail in Rosati (2002)⁸.

The majority of countries undergoing systemic transformation – regardless of the prevailing exchange rate regime – have experienced a trend towards a real appreciation of their domestic currencies. This trend was predominantly a derivative of fundamental factors, but in some countries and in some periods, it was also fuelled by determinants of a speculative nature. Among the fundamental factors, the most significant stemmed from a steady rise in the productivity of labour and capital (the Balassa-Samuelson effect) that was faster than in developed countries, triggered by the micro- and macroeconomic reforms carried out in those countries. The effect of this factor was strengthened by the inflow of foreign direct and portfolio investment, which has, *inter alia*, led to a surplus on the financial and capital account of the balance of payments (making it possible to more than offset the current account deficit) and the acceleration of the growth of exports and a current account surplus in some countries (the so-called “generalised Dutch disease”). In addition, in the case of new EU members, the appreciation pressure was strengthened by the inflow of EU funds and the extra inflow of private capital, induced by the upgrading of credit worthiness of pertinent host countries by international rating agencies.

As indicated by the data in Table 11, after 2002 the real effective exchange rates of the domestic currencies in all thirteen countries shown have appreciated albeit some of them displayed signs of a short-term volatility. Among the CEE and SEE countries, the Slovak koruna appreciated the most strongly in real terms; its international value increased at the average annual rate of 8.5%.⁹ The domestic currencies in Bulgaria, Czech Republic, Romania, and Hungary were also subject to a considerable strengthening (4.9%, 4.8%, 4.7%, and 3.9% annually respectively). On the other hand, the real effective exchange rates in Poland and Croatia appreciated in a much slower pace (about 2%). Macedonia was the only country from this group with quite stable currency (an appreciation of 0.5% annually). The CIS countries showed a very differentiated performance. On the one hand, Armenia and Russia recorded an appreciation of their currencies of 7% annually while Ukraine and Moldova noted an appreciation of about 2%. Simultaneously, the majority of the currencies involved (except those in Slovakia, Bulgaria, Croatia, and Russia) were occasionally subject to short-term depreciations.

Generally speaking, after 1995 the largest increases in the real international value of domestic currencies were experienced in those countries that had made the most progress in the process of transforming their economic systems and structural reforms. This category included primarily the EU accession countries, exhibiting the fastest growth of labour

⁷ One country, Montenegro, has no currency of its own, having adopted the German mark as sole legal tender from 2000 and then the euro from 2002.

⁸ *New Europe. Report on Transformation*, edited by D. Rosati, Eastern Institute, Warsaw 2002.

⁹ In the earlier period, until 2001, the highest rate of real appreciation was observed in Poland; in the years 1995-2001, it amounted to 5.6% annually.

productivity pace, and hosting the largest inflow of foreign direct investment (additionally stimulated by the imminent prospects of EU membership of these countries). The decline in price competitiveness, however, did not prevent these economies from continuing the expansion of their exports, in particular to the European Union markets.

Table 11. Changes of the real effective exchange rate, 2002-2008 (2002=100)

Country	2002	2004	2006	2008	
				2002=100	Average annual growth rate (%)
Central Eastern Europe					
Czech Republic	100.0	99.7	111.7	132.8	4.8
Hungary	100.0	109.3	106.9	125.8	3.9
Poland	100.0	89.0	101.9	116.2	2.5
Slovakia	100.0	124.2	136.0	163.4	8.5
South Eastern Europe					
Bulgaria	100.0	109.1	114.5	133.3	4.9
Croatia	100.0	102.6	106.8	112.9	2.0
Macedonia	100.0	100.8	98.1	102.9	0.5
Romania	100.0	99.3	126.1	131.6	4.7
CIS					
Armenia	100.0	95.6	116.7	150.0	7.0
Georgia	100.0	99.6	112.2	134.6	5.1
Moldova	100.0	108.3	104.4	111.8	1.9
Russia	100.0	111.1	132.3	149.0	6.9
Ukraine	100.0	89.8	103.7	115.0	2.4

Note: increase of the index implies a real appreciation of the domestic currency, while a decrease – its real depreciation.

Source: International Monetary Fund, International Financial Statistics, September 2009, Washington D.C.

Russia is a distinct case. The currency of this country was subject to strong real appreciation until 1997, which was mainly due to a sizeable export surplus (arising from the exports of oil and its products, as well as mineral raw materials). As a result of the crisis in August 1998, the exchange rate of the rouble collapsed. In 2000, the international purchasing power of the Russian currency began to rise again – yet in this period, some other factors were at the source of these developments. Although the trade surplus continued to rise, at the same time the inflow of foreign direct investment to Russia began to grow, encouraged by the positive perception by international markets of the country's macroeconomic performance (including a budget surplus). Over the past four years, the appreciation was most strongly fuelled by record prices of oil and other energy resources exported by the country. As a result of these developments, the scale of real appreciation of Russia's currency was very large

(6.9% per annum in average). This trend made the Russian economy's exposure to the "Dutch disease" an increasingly real threat.

To conclude the analysis in this subchapter, it is worth undertaking a brief assessment of the effectiveness of macroeconomic policies pursued in the new EU member countries from Central and Eastern Europe, in terms of their ability to meet the Maastricht nominal convergence criteria (Box 2).

Box 2

Criteria for nominal convergence in new EU member states (data as of 2008)					
Country	Inflation	General government balance	Public debt	Interest rates ¹	Exchange rate ²
Reference value	4.1	-3.0	60.0	5.6	+/- 15%
Bulgaria	12.0	3.0	19.6	7.8	..
Czech Republic	6.3	-1.4	29.5	4.3	10.8
Estonia	10.6	-2.7	4.6	8.5	0.0
Hungary	6.0	-3.4	72.6	8.3	8.3
Latvia	15.3	-4.0	19.5	9.0	6.7
Lithuania	11.1	-3.2	15.6	9.0	0.0
Poland	4.2	-3.9	47.1	5.7	19.0
Romania	7.9	-4.9	21.6	8.4	..
Slovakia	3.9	-2.2	27.6	4.7	7.3

1 – December 2008, 2 – 2005.

Sources: EBRD, *Transition Report Database*, October 2009; Eurostat.

According to the data for 2008, the only country that fulfilled all criteria was Slovakia (i.e. the country that adopted euro in January 2009). Other countries achieved much worse results. The main reason is a global financial crisis and a subsequent economic slowdown, which led to an accelerating inflation and high budget deficits. Except Slovak Republic, none of the countries fulfilled the inflation criterion, and, in the Baltic States and Bulgaria, inflation even reached a double-digit level. In turn, the public finance deficit did not exceed the target of 3% of GDP in Estonia, Czech Republic, and Bulgaria, the latter country noted even a budgetary surplus. To sum up, the best performance belongs to the Czech Republic which does not fulfil only one criterion (inflation). Poland notes also good results because it fails to fulfil a budget balance criterion and only marginally exceeds the inflation and interest rates target. Meanwhile, Hungary was the farthest away from the euro zone, failing to fulfil all four criteria for EMU membership.

4. STRUCTURAL REFORMS

4.1. Overall assessment

The most important structural changes in transition economies, on their road from central planning to a market system, included privatization, liberalization of markets and broadening the scope of economic freedom. The latter encompassed steps such as stifling corruption and removing bureaucratic barriers that impeded the development of entrepreneurship. Other structural changes comprised support for the development of markets and competition; a public finance reform, combined with a comprehensive reform of government institutions designed to upgrade their effectiveness and strengthen functions stimulating economic development (through measures such as creating positive externalities for private entrepreneurship); an expansion of financial intermediation and the development of financial markets.

Generally, systemic transformations in the former communist countries—as seen from today’s perspective in terms of their scope and depth—deserve positive evaluation. As a group, these countries have made substantial progress liberalizing and opening their economies, creating market mechanisms and building basic institutions to ensure the efficient functioning of the market.

The scope and pace of structural reforms, and generally the progress of systemic transformation, varied considerably from one country to another. At one end of the spectrum were Central and Eastern European countries (CEE) and some South-Eastern European nations (SEE), which were recognized as functioning market economies by the EBRD. In this first group, the most advanced in the reform process are Hungary, Estonia, the Czech Republic, and Poland. The other end of the spectrum comprised countries such as Turkmenistan, Belarus, and Uzbekistan, where by 2008 market reforms were still in the nascent stage. Moreover, the latter group has begun to lag increasingly behind even those CIS countries (Armenia, Georgia, Ukraine, Russia, Kazakhstan, and Moldova) that have embarked already on structural reforms. As a result, the “institutional gap” between top-reformer countries and those lagging behind in the process has widened over the past several years. Table 13 provides a list of indicators used by the EBRD, showing the advancement of systemic transformation in individual countries in 2008.

As the data in Table 12 shows, in 2008 a number of former communist countries made a further progress in pushing through with structural reforms. The progress in question was particularly noticeable in three areas: banking reform and the liberalisation of interest rates, securities markets and non-bank financial institutions, and trade and exchange rate regime.

As far as individual countries are concerned, the largest improvement – as measured by EBRD indicators – took place in Serbia (trade and exchange rate regime, banking reform, and infrastructure reform). It was followed by Belarus (strong improvement in large-scale privatization and enterprise restructuring), Albania (large-scale privatization and banking reform), Bosnia & Herzegovina (trade and exchange rate regime and banking reform), Bulgaria (competition policy and the development of securities markets), Armenia (securities markets and infrastructure reform), and Ukraine (strong improvement in trade and exchange rate regime).

The past several years have shown that structural transformations in CIS countries have lost their momentum compared with Central and South-Eastern Europe. Most of the reform effort to date has focused on fundamental market reforms, including the liberalization of prices and foreign trade and small-scale privatization, or the transformation of retail trade and consumer services. On the other hand, relatively little progress has been made in developing key market institutions. This especially holds true for the judiciary system, public

administration, health service, pension system, labor market and the banking sector, as well as competition policy and creating effective bankruptcy procedures. Institutional reforms ran into resistance wherever they were aimed at moving away from the traditional role of government as a direct participant of economic life in favour of its new functions such as regulation and designing institutions that are supposed to create a market environment and conditions for its efficient functioning.

Table 12. Progress in systemic transformation in transition countries, 2008

Country	Enterprise sector			Development of markets and competition			Financial institutions		Infra-structure	Average score
	Large scale privatization	Small scale privatization	Governance and enterprise restructuring	Price liberalization	Trade and exchange rate regime	Competition policy	Banking reform and liberalization of interest rates	Securities markets and non-bank financial institutions	Infra-structure reform	
Central Eastern Europe										
Czech Republic ^a	4	4.3	3.3	4.3	4.3	3	4	3.7	3.3	3.81
Estonia	4	4.3	3.7	4.3	4.3	3.7	4	3.7	3.3	3.93
Hungary	4	4.3	3.7	4.3	4.3	3.3	4	4	3.7	3.96
Latvia	3.7	4.3	3	4.3	4.3	3	4	3	3	3.63
Lithuania	4	4.3	3	4.3	4.3	3.3	3.7	3.3	3	3.70
Poland	3.3	4.3	3.7	4.3	4.3	3.3	3.7	3.7	3.3	3.78
Slovakia	4	4.3	3.7	4.3	4.3	3.3	3.7	3	3	3.74
Slovenia	3	4.3	3	4	4.3	2.7	3.3	3 ↑	3	3.41 ↑
Average for CEE										3.74
South Eastern Europe										
Albania	3.3 ↑	4	2.3	4.3	4.3	2	3 ↑	1.7	2.3	3.04 ↑
Bosnia & Herzegovina	3	3	2	4	4 ↑	2	3 ↑	1.7	2.3	2.78 ↑
Bulgaria	4	4	2.7	4.3	4.3	3 ↑	3.7	3 ↑	3	3.56 ↑
Croatia	3.3	4.3	3	4	4.3	2.7	4	3	3	3.52
Macedonia	3.3	4	2.7	4.3	4.3	2.3	3 ↑	2.3	2.3	3.18 ↑
Montenegro	3.3	3.7	2	4	4	1.7	3 ↑	1.7	2	2.82 ↑
Romania	3.7	3.7	2.7	4.3	4.3	2.7	3.3	3 ↑	3.3	3.44 ↑
Serbia	2.7	3.7	2.3	4	3.7 ↑	2	3 ↑	2	2.3 ↑	2.85 ↑↑
Average for SEE										3.15
CIS countries										
Armenia	3.7	4	2.3	4.3	4.3	2.3	2.7	2.3 ↑	2.7 ↑	3.18 ↑
Azerbaijan	2	3.7	2	4	4	2	2.3	1.7	2	2.63
Belarus	1.7 ↑↑	2.3	1.7 ↑↑	2.7	2.3	2	2	2	1.3	2.00 ↑↑
Georgia	4	4	2.3	4.3	4.3	2	2.7	1.7	2.3	3.07
Kazakhstan	3	4	2	4	3.7	2	3	2.7	2.7	3.00
Kyrgyzstan	3.7	4	2	4.3	4.3	2	2.3	2	1.7	2.93
Moldova	3	4 ↑	2	4	4.3	2.3	3	2	2.3	3.00 ↑
Russia	3	4	2.3	4	3.3	2.3	2.7	3	2.7	3.04
Tajikistan	2.3	4	1.7	3.7	3.3	1.7	2.3	1	1.3	2.37
Turkmenistan	1	2.3 ↑	1	2.7	2	1	1	1	1	1.44 ↑
Ukraine	3	4	2	4	4.3 ↑↑	2.3	3	2.7	2.3	3.07 ↑
Uzbekistan	2.7	3.3	1.7	2.7	2	1.7	1.7	2	1.7	2.15
CIS Average										2.66

a – 2007.

Note: Scale from 1 to 4.3; the higher the score, the greater is the progress in the reform process.

Source: EBRD, *Transition Report Database*, October 2009.

One of the most important determinants of the rate and breadth of structural reforms in former communist countries was the prospect of EU membership. As shown, *inter alia*, in

annual EBRD assessments, countries invited to join the EU¹⁰ initiated their structural reforms earlier, implemented them much more effectively and with greater commitment, and today are much more advanced in the reform process than the remaining transition economies¹¹.

The foregoing analysis leads to three important conclusions. First, it turns out that the existence of an “external anchor” or the prospect of EU membership and the need to make the necessary institutional adjustments, can significantly accelerate the reform process and facilitate structural reforms in the candidate countries. Second, the use of this “anchor” can lead to different structural reform paths not only in transition economies, but also in a much broader sample of countries. As IMF assessments show, the quality of institutions in the new EU member states is currently higher on average than in other countries at a similar level of development. In the remaining transition economies, particularly CIS countries, the development of the institutional market infrastructure is slightly lower than in other countries with a similar level of development.¹²

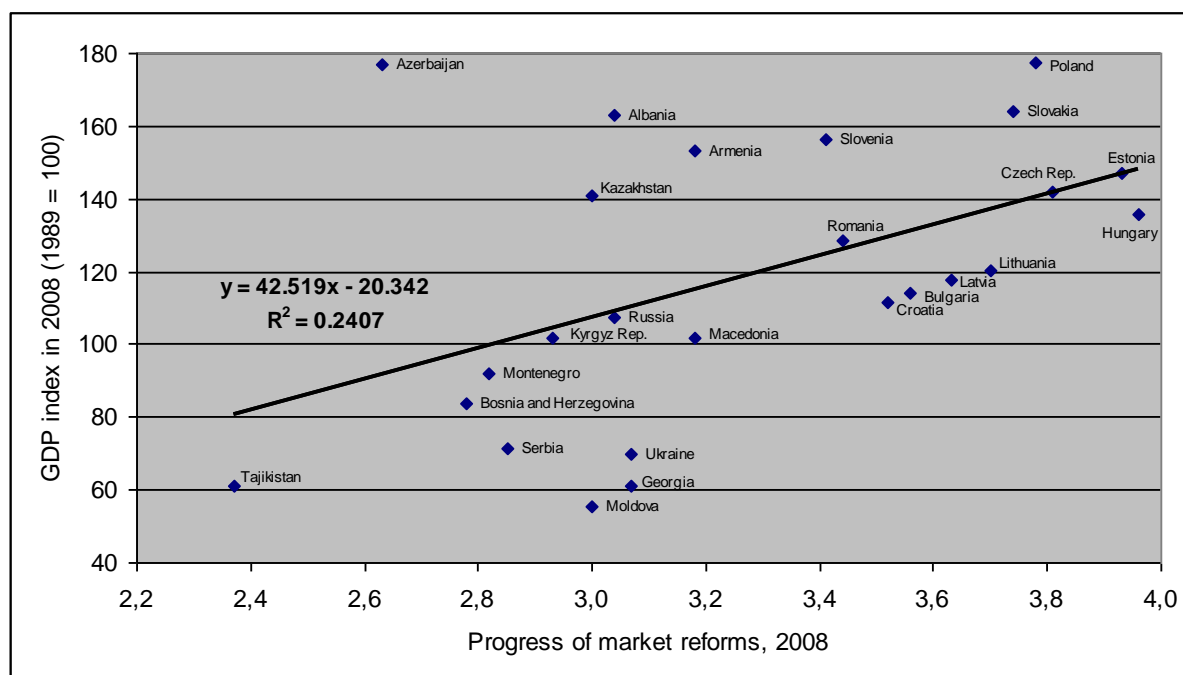
Third, the progress of structural reform was an important determinant of economic growth in transition countries. The regression analysis conducted (Chart 4) reveals that the countries, which were the most advanced in the process of systemic transformation achieved faster GDP growth on average in 1990-2008 than those lagging behind in this process. The positive correlation between these two variables is especially clear in Central Europe. By contrast, in countries such as Tajikistan, Bosnia & Herzegovina, Montenegro, Serbia, Moldova, Georgia, and Ukraine, the lack of major structural reforms contributed to negative GDP growth rates throughout the analyzed period.

¹⁰ The eight countries from the first group, which joined the EU on May 1, 2004, and Bulgaria and Romania, who followed suit on 1 January, 2007.

¹¹ The only exception is Croatia, which stands out favorably in the advancement of structural reform, even compared with the most recent EU members, i.e. Bulgaria and Romania.

¹² See IMF, *World Economic Outlook 2002*, Washington D.C. 2002, p. 102.

Chart 4. The progress of structural reforms and economic growth in transition countries*



* – excluding Belarus, Turkmenistan and Uzbekistan.

Source: Authors' calculations.

As a wrap up it should be stressed that the EU accession does not automatically entail the end to the process of structural reform and institutional adjustment in ten new member countries from Central and South-Eastern Europe. On the contrary, they will have to intensify their structural reforms, so as to be able to fully discount the benefits of membership and enter a path of fast real convergence of their economies to the level of the “old” EU¹³. A particularly significant challenge for the new member states in this regard is broadening the scope of financial intermediation and deepening their financial markets, restructuring of strategic sectors such as energy, heavy industry and agriculture, and the reform of public administration (including the justice system), particularly at the regional and local level. Weaknesses present in these areas can be seen, *inter alia*, as factors adversely affecting their capability to efficiently absorb the EU funds and make the best use of them.

4.2. Privatisation

The privatization of state-owned enterprises (SOEs) has been one of the key determinants of success in the transition from central planning to a free market. The transfer of property rights to private hands by the state is a prerequisite for increasing the efficiency of allocation and use of resources in the economy and improving its international competitiveness. Although privatization is, no doubt, indispensable for improved efficiency, it is not a sufficient condition. Experience gained in many countries, including those analyzed in this text, shows that ownership changes alone do not automatically make privatized firms

¹³ See: R. Rapacki (ed.), *Wzrost gospodarczy w krajach transformacji: konwergencja czy dywergencja (Economic growth in transition economies: real convergence or divergence)*, PWE, Warsaw 2009; R. Rapacki and M. Próchniak, *The EU Enlargement and Economic Growth In the CEE New Member Countries*, paper prepared for the international workshop on “Five years of an enlarged EU – a positive-sum game”, the European Commission, Brussels, 13-14 November 2008.

behave like market entities—just as they do not guarantee greater efficiency. Private ownership ensures optimal economic effects only when firms are subject to competitive pressures (in a proper market structure) and when properly designed institutions provide the right market environment. These institutions should ensure security of transactions and the predictability of business activity, while supporting entrepreneurship and innovation. From this point of view, the most important institutions include a stable and clear legal system and a regulatory framework, combined with an effective enforcement system, a simple and neutral tax structure, and, most importantly, an efficient and accountable government operating according to transparent rules, along with a public administration friendly to private entrepreneurs.

In our earlier studies we gave a detailed account of ownership changes in 1990-2007 and the diversity of privatisation paths in the countries undergoing systemic transformation. The indices listed in Table 13 illustrate the progress in privatisation in these countries as of end-2008.

A more detailed analysis of this data leads to a number of conclusions. Firstly, the Central European countries, which joined the EU in 2004 were the most advanced in the process of ownership transformation. Among other sub-groups of countries, Bulgaria, Croatia and Romania matched their achievements in some respects, while Belarus, Turkmenistan and Uzbekistan were at the opposite end of the spectrum. The domination of state ownership and the lack of privatization progress in these countries were mainly due to political factors, combined with unwillingness to push ahead with far-reaching market reforms.

Table 13. Progress in privatisation, 2008

	Freedom House privatisation index			EBRD large privatisation index		EBRD small privatisation index		EBRD enterprise restructuring index	Share of private sector in GDP (%)
	2001	2002	Trend	2001	2008 ^a	2001	2008 ^a	2008 ^b	2008 ^b
Central Eastern Europe									
Czech Republic	1.75	1.75		4	4 ^c	4.3	4.3 ^c	3.3 ^c	80
Estonia	2.50	1.75	↑↑	4	4	4.3	4.3	3.7	80
Hungary	1.50	1.50		4	4	4.3	4.3	3.7	80
Latvia	2.50	2.50		3	3.7↑	4.3	4.3	3	70
Lithuania	1.75	2.25	↓↓	3.3	4↑	4.3	4.3	3	75
Poland	2.00	2.25	↓	3.3	3.3	4.3	4.3	3.7	75
Slovakia	3.00	2.00	↑↑	4	4	4.3	4.3	3.7	80
Slovenia	2.25	2.50	↓	3.3	3↓	4.3	4.3	3	70
Average	2.44	2.06	↑	3.61	3.75↑	4.3	4.3	3.39	76
South Eastern Europe									
Albania	3.75	3.25	↑↑	2.3	3.3↑	4	4	2.3	75
Bosnia & Herzegovina	5.00	5.00		2.3	3↑	2.7	3↑	2	60
Bulgaria	3.50	3.00	↑↑	4	4	3.7	4↑	2.7	75
Croatia	3.50	3.25	↑	3	3.3↑	4.3	4.3	3	70
Macedonia	4.00	4.25	↓	3	3.3↑	4	4	2.7	70↑
Montenegro	3.3	..	3.7	2	65
Romania	3.75	3.75		3.3	3.7↑	3.7	3.7	2.7	70
Serbia	5.00	4.75	↑	1	2.7↑	3	3.7↑	2.3	60↑
Average	4.07	3.89	↑	2.66	3.33↑	3.63	3.80↑	2.46	68
CIS									
Armenia	3.25	3.25		3	3.7↑	3.7	4↑	2.3	75
Azerbaijan	4.75	4.25	↑↑	2	2	3.3	3.7↑	2	75
Belarus	6.00	6.00		1	1.7↑	2	2.3↑	1.7↑	30↑
Georgia	3.25	3.25		3.3	4↑	4	4	2.3	75

Kazakhstan	4.25	4.00	↑	3	3	4	4	2	70
Kyrgyzstan	4.50	4.25	↑	3	3.7↑	4	4	2	75
Moldova	3.50	4.00	↓↓	3	3	3.3	4↑	2	65
Russia	3.75	3.50	↑	3.3	3↓	4	4	2.3	65
Tajikistan	5.75	5.50	↑	2.3	2.3	3.7	4↑	1.7	55
Turkmenistan	6.75	6.75		1	1	2	2.3↑	1	25
Ukraine	4.25	4.25		3	3	3.7	4↑	2	65
Uzbekistan	6.00	6.00		2.7	2.7	3	3.3↑	1.7	45
Average	4.67	4.58	↑	2.55	2.76↑	3.39	3.63↑	1.92	60

a – Arrows represent the changes between 2001 and 2008.

b – Arrows represent the changes between 2007 and 2008.

c – 2007.

Notes: Freedom House index of privatization – scale from 1 to 7; the higher the score, the less advanced is the ownership transformation process.

EBRD index – scale from 1 to 4.3; the higher the index, the more advanced is the privatization process.

The assessment criterion for privatization progress used by the EBRD is chiefly the number of privatized SOEs, while the Freedom House index takes also account of the legal framework for privatization.

Sources: *Nations in Transit 2002*, Freedom House 2003; EBRD, *Transition Report 2001*; EBRD, *Transition Report Database*, October 2009.

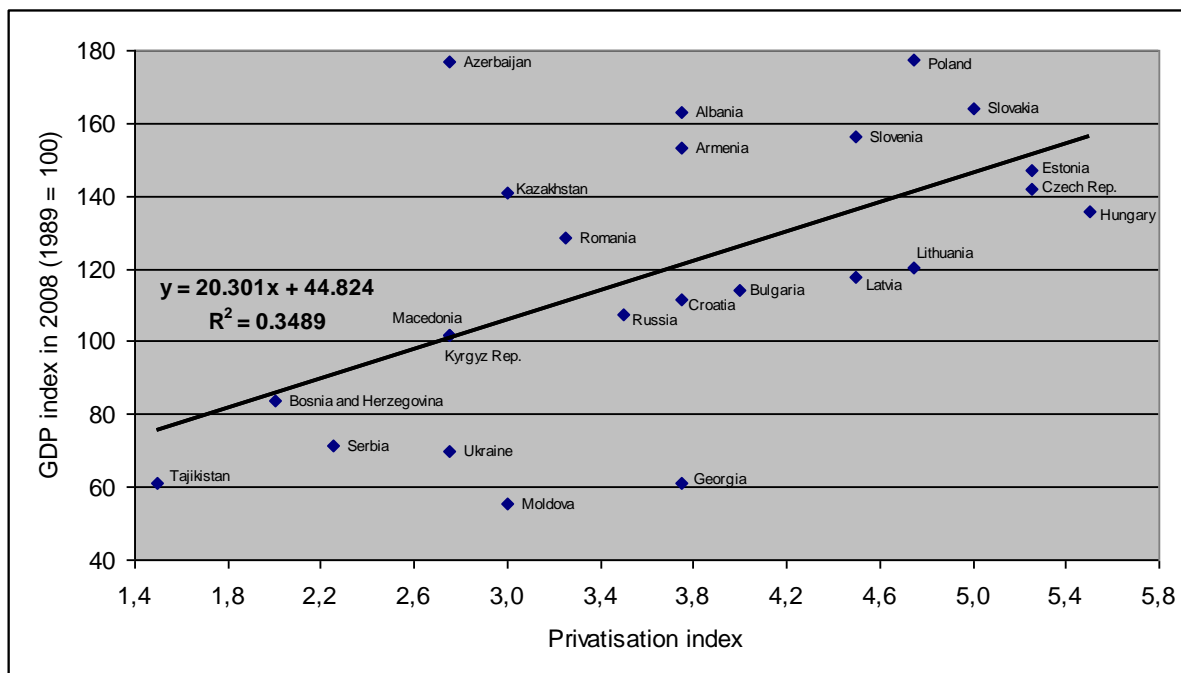
Secondly, as shown in Chart 5, over the whole transformation period, there was a clear positive correlation between progress in privatisation and the rate of economic growth across the entire analysed sample, as well as in individual countries. The correlation in question becomes statistically significant once the countries where privatisation has been halted or has not yet commenced (Belarus, Turkmenistan, Uzbekistan) are excluded from the sample.

Thirdly, the majority of transition economies have made far more progress in small-scale privatisation than in ownership changes in the large enterprise sector. This is not surprising as the privatization of large SOEs has encountered barriers such as a limited stock of domestic capital, resistance from organized special interest groups (in particular trade unions), various social concerns (including fear of unemployment) and political considerations.¹⁴

Fourthly, the data in Table 13 seems to support, at least in part, our earlier claim that a change of the legal form of ownership does not by itself guarantee market success and a rapid rise of efficiency. This is confirmed by a comparison of indicators that illustrate privatization progress, on the one hand, and progress made in the restructuring of privatized SOEs and in the development of corporate governance, on the other. The privatization progress indicator tends to be higher than the score of enterprise restructuring and corporate governance. Among the top-reformer countries, particularly large discrepancies between these indicators are noted in Bulgaria and Romania, as well as in Latvia, Lithuania and the Czech Republic. Certain deviations from this pattern can be found in Poland and Slovenia. In Poland, they result not only from the progress in restructuring privatized SOEs, but also from the halting of big-ticket privatization deals since 2001.

¹⁴ These include attempts by politicians to maximize the stream of “political goods” to increase their election chances, a trend that is widely discussed in the literature on the theory of public choice. See, for example, Gwartney, J.D., R.L. Stroup and R.S. Sobel, *Economics. Private and Public Choice*, 9th edition, Dryden Press, Fort Worth 2000.

Chart 5. Progress in privatization* and economic growth in transition countries**



* – Freedom House index, 2003.

** – excluding Belarus, Turkmenistan and Uzbekistan.

Note: Privatization index for Serbia includes also Montenegro (in 2003, both regions constituted one country).

Source: Authors' calculations.

Fifthly, in 2008, a further progress took place in the process of ownership transformation in some transition economies. It mainly concerned large- and small-scale privatisation while improvements in corporate governance and restructuring of privatised SOEs were only marginal. The pertinent progress occurred mostly in South-eastern Europe, in particular in the area of large-scale privatisation. In some countries of this sub-group, the EBRD also upgraded its score for the advancement of small-scale ownership transformation (Bosnia & Herzegovina, Bulgaria, and Serbia). In two countries (Macedonia and Serbia) the share of private sector in GDP increased between 2007 and 2008. On the other hand, in a number of the CIS countries (Armenia, Azerbaijan, Belarus, Moldova, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan) it was the small-scale privatisation that recorded a sizable improvement between 2001 and 2008. During 2007-2008, the private sector contribution to GDP augmented only in one country (Belarus). Unlike in the past several years, some progress in privatisation was also recognised in the EBRD ranking in the EU-8 countries (Latvia and Lithuania).

It should be stressed against this background that despite the general progress of ownership transformation in the whole analyzed group, large-scale privatization substantially decelerated, with a regression in some countries. This particularly applied to Slovenia and Russia, where the privatization of large SOEs virtually ground to a halt.

These trends are due to two basic factors. The countries most advanced in the process of structural reform are slowly running out of resources (assets and enterprises) that are the subject of “easy” privatization. The government has been left with (i) SOEs struggling with financial problems and consequently difficult to sell, and (ii) strategic assets that politicians are reluctant to part with.

4.3. Economic freedom

Economic freedom ranks among the basic yardsticks of progress in the process of transition from a command economy to a market system. Economic freedom depends on a number of different factors; the most crucial comprise legal determinants of business activity (such as e.g. market entry and exit regulations). Other factors include the effectiveness of the judiciary system in enforcing the law and in resolving business disputes, the tax system, the scope of government regulation and the role of the state in the economy. Economic freedom is greatly enhanced by privatization and, in general, by a growing share of the private sector in the economy. By contrast, corruption adversely affects economic freedom (while economic freedom evidently contributes to stifling corruption).

Table 14 shows aggregate indicators of economic freedom and corruption perception for all the analyzed countries. The indicators are for 2000-2009; they show both the present situation in these areas and the changes that took place in a given period. Later in this chapter, the discussion of these general indicators will be supplemented by an attempt to offer a more detailed assessment of selected factors that may have affected the aggregate index of economic freedom. The analysis will in particular focus on bureaucratic barriers created by the government that adversely influence business environment (Table 15), as well as on the size of government, measured with the share of public revenue and expenditure in GDP (Table 9).

A more in-depth analysis of the data in Table 14 leads to a number of observations. Firstly, the scope of economic freedom was the greatest in those countries that have shown the most determination in systemic reforms and have made the most progress in the process. This group primarily included new EU member countries (again, the “external anchor” effect). By 2009, Estonia was the leader among these countries (and in the entire analyzed group); it was ranked thirteenth in the world by the Heritage Foundation. Economic freedom in Lithuania, Slovakia, and the Czech Republic was also relatively large, with a tendency toward further improvement. Conditions for business activity in the other EU-8 states (negative exceptions against this background included only Slovenia and Poland) were slightly less advantageous. Among other countries, the widest margin of economic freedom prevailed in Armenia and Georgia, while Bosnia & Herzegovina and several CIS nations (especially Belarus, Russia, Turkmenistan, Ukraine, and Uzbekistan) were the worst performers in this area. Economic freedom in the latter countries was adversely affected by excessively developed government functions and widespread red-tape.

Secondly, in 2009 (compared to 2008) the average indicators of economic freedom did not improve in any of the analysed country sub-groups. Among the EU-8 countries, only Czech Republic and Slovenia recorded the progress. Poland achieved the same score as in 2008 while the situation of the remaining EU-8 economies slightly deteriorated.

The indices of economic freedom have improved in 2009 in all but one (Bosnia & Herzegovina) countries of South-eastern Europe, especially in Romania, Albania, Croatia, and Bulgaria. Among the CIS countries, the most spectacular progress took place in Azerbaijan followed by Russia, Turkmenistan, Kyrgyzstan, Georgia, and Tajikistan. The opposite was true for most of the remaining CIS states and in particular Moldova, Ukraine, Uzbekistan, and Kazakhstan where economic freedom last year suffered a backlash.

Table 14. Indicators of economic freedom and corruption, 2000-2009

Country	Index of Economic Freedom, <i>Heritage Foundation</i>				Corruption Perception Index, <i>Transparency International</i>	
	2000	2008	2009	Trend	2007	2008
Central Eastern Europe						
Czech Republic	68.6 (30)	68.1	69.4 (37)	↑	5.2 (41)	5.2 (45)
Estonia	69.9 (24)	77.9	76.4 (13)	↑↑	6.5 (28)	6.6 (27) ↑
Hungary	64.4 (49)	67.6	66.8 (44)	↑	5.3 (39)	5.1 (47) ↓
Latvia	63.4 (57)	68.3	66.6 (45)	↑	4.8 (51)	5.0 (52) ↑
Lithuania	61.9 (67)	70.9	70.0 (30)	↑↑	4.8 (51)	4.6 (58) ↓
Poland	60.0 (75)	60.3	60.3 (82)	↑	4.2 (61)	4.6 (58) ↑
Slovakia	53.8 (108)	70.0	69.4 (36)	↑↑	4.9 (49)	5.0 (52) ↑
Slovenia	58.3 (84)	60.2	62.9 (68)	↑	6.6 (27)	6.7 (26) ↑
Average	62.5	67.9	67.7	↑↑	x	x
South Eastern Europe						
Albania	53.6 (110)	62.4	63.7 (62)	↑↑	2.9 (105)	3.4 (85) ↑
Bosnia & Herzegovina	45.1 (140)	53.9	53.1 (134)	↑	3.3 (84)	3.2 (92) ↓
Bulgaria	47.3 (131)	63.7	64.6 (56)	↑↑	4.1 (64)	3.6 (72) ↓
Croatia	53.6 (109)	54.1	55.1 (116)	↑	4.1 (64)	4.4 (62) ↑
Macedonia	n.a.	61.1	61.2 (78)	↑	3.3 (84)	3.6 (72) ↑
Montenegro	n.a.	n.a.	58.2 (94)		3.3 (84)	3.4 (85) ↑
Romania	52.1 (115)	61.7	63.2 (65)	↑↑	3.7 (69)	3.8 (70) ↑
Serbia	n.a.	n.a.	56.6 (109)		3.4 (79)	3.4 (85)
Average	50.3	59.5	59.5	↑↑	x	x
CIS						
Armenia	63.0 (62)	69.9	69.9 (31)	↑↑	3.0 (99)	2.9 (109) ↓
Azerbaijan	49.8 (124)	55.3	58.0 (99)	↑↑	2.1 (150)	1.9 (158) ↓
Belarus	41.3 (147)	45.3	45.0 (167)	↑	2.1 (150)	2.0 (151) ↓
Georgia	54.3 (107)	69.2	69.8 (32)	↑↑	3.4 (79)	3.9 (67) ↑
Kazakhstan	50.4 (120)	61.1	60.1 (83)	↑↑	2.1 (150)	2.2 (145) ↑
Kyrgyzstan	55.7 (102)	61.1	61.8 (74)	↑↑	2.1 (150)	1.8 (166) ↓
Moldova	59.6 (78)	57.9	54.9 (120)	↓	2.8 (111)	2.9 (109) ↑
Russia	51.8 (117)	49.8	50.8 (146)	↓	2.3 (143)	2.1 (147) ↓
Tajikistan	44.8 (141)	54.4	54.6 (122)	↑↑	2.1 (150)	2.0 (151) ↓
Turkmenistan	37.6 (150)	43.4	44.2 (169)	↑	2.0 (162)	1.8 (166) ↓
Ukraine	47.8 (129)	51.0	48.8 (152)	↑	2.7 (118)	2.5 (134) ↓
Uzbekistan	38.1 (149)	51.9	50.5 (148)	↑↑	1.7 (175)	1.8 (166) ↑
Average	49.5	55.8	55.7	↑↑	x	x

Notes: Index of economic freedom – scale from 0 to 100; the higher the index, the broader is the scope of economic freedom. The index is an average of scores in ten areas (1) business freedom, (2) trade freedom, (3) fiscal freedom, (4) government size, (5) monetary freedom, (6) investment freedom, (7) financial freedom, (8) protection of property rights, (9) freedom from corruption, and (10) labour freedom. Places in ranking were provided in brackets – in 2009 it included 179 countries.

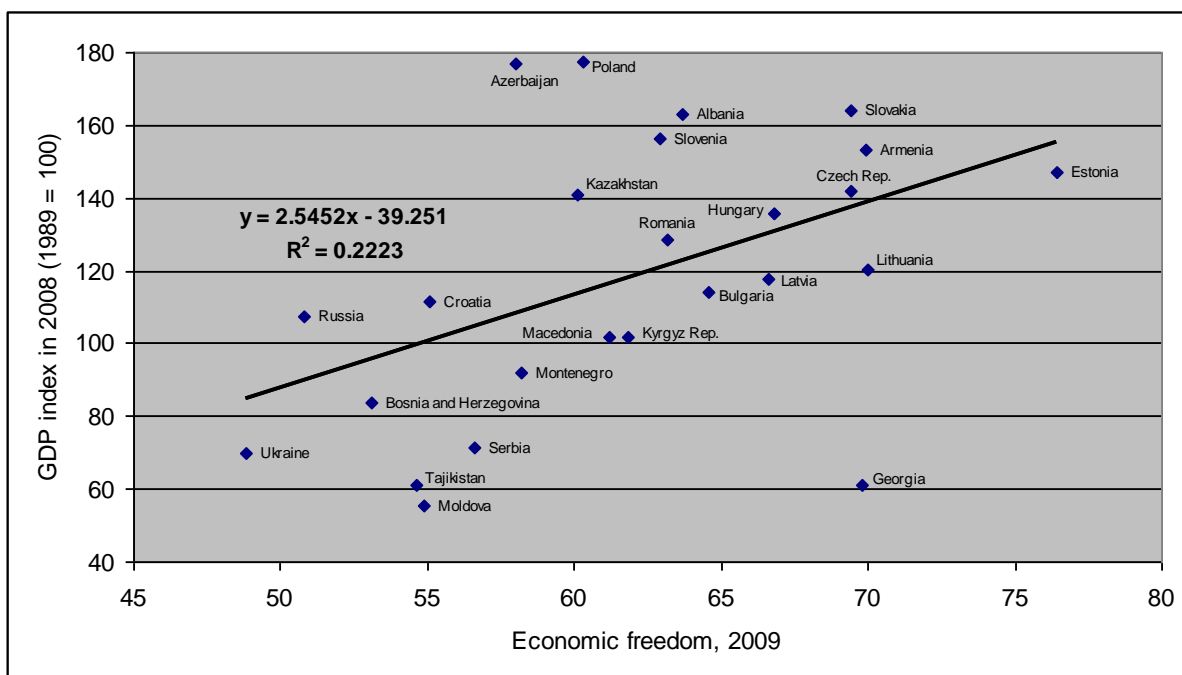
Transparency International corruption index – scale from 1 to 10; the higher the index the lower is the corruption level. The index is calculated based on similar indices of other institutions and own research. Figures in brackets represent countries' places in the ranking – in 2008 the ranking covered 180 countries.

↑ indicates an improvement while ↓ a deterioration.

n.a. – data not available.

Sources: The Heritage Foundation, *2009 Index of Economic Freedom*, Washington, D.C. 2009; Transparency International, *Corruption Perceptions Index*, 2009; own calculations.

Chart 6. Economic freedom and economic growth in transition countries*



* – excluding Belarus, Turkmenistan and Uzbekistan.

Source: Authors' calculations.

A regression analysis conducted by the authors indicates that economic freedom has been conducive to fast economic growth (and conversely – constraints on economic freedom have become a barrier to growth). This relationship finds support in Chart 6, showing the correlation between the scope of economic freedom and the GDP growth rate (especially after excluding from the sample countries where the transformation has been halted or has not yet begun).

According to a widespread view there is a trade off between economic freedom and the incidence of corruption. Although the roots of corruption appear to be of a much more complex nature, it is definitely promoted by the lack of clear rules governing political life. Other determinants include excessively developed government functions; lack of transparency in decision-making; unclear and overly complicated legal regulations that leave day-to-day economic decisions to the discretion of public administration officials and politicians; and excessive bureaucracy in the economy. The influence of red tape (measured by the scope of market entry barriers created by the state administration) is more universal in nature. As other studies indicate, there is a positive correlation between the incidence of corruption and the number of bureaucratic procedures required to start a business activity. This relationship is evident not only in the transition countries, but throughout the world.¹⁵

The data on perceived corruption in Table 14 prompts the following two conclusions. First, the data in part confirms the inverse relationship between economic freedom and the incidence of perceived corruption. This problem seems to be the least acute in Central European countries, while assuming disastrous proportions in most South-Eastern European economies and all the CIS states (excluding Georgia).

Second, last year has brought a decline in the perception of corruption in 14 out of the 28 former communist countries. In contrast to the previous few years, it occurred first of all in countries featuring the smallest scale of the phenomenon, i.e. the EU-8 group from Central

¹⁵ See *New Europe: Report on Transformation* (in Polish), ed. by D. Rosati, charts 3.3 and 3.4, p. 89. Institute of Eastern Studies, 13th Economic Forum, Krynica, September 4-6, 2003.

Europe (the most spectacular improvement taking place in Poland) and in some South-eastern European states (Albania, Croatia, Macedonia). On the other hand, in all CIS countries, except for Georgia, Kazakhstan, Moldova, and Uzbekistan, the incidence of perceived corruption further increased.

Table 15. Business environment in transition economies (as of June 2008)

Country	Entry regulations				Contract enforcement		Employing workers	Insolvency procedures
	Number of start up procedures	Time required to start a business (days)	Number of procedures required to register property	Time required to register property (days)	Number of procedures	Time required (days)	Employment rigidity index (scale from 0=flexible to 100=rigid)	Time to resolve insolvency (years)
Central Eastern Europe								
Czech Republic	8 ↑	15 ↑	4	123	27	820	28 ↑	6.5
Estonia	5	7	3	51 ↑↑	36	425	58	3.0
Hungary	4 ↑	5 ↑↑	4	17 ↑↑	33 ↑↑	335 ↑↑	30 ↑	2.0
Latvia	5	16	7 ↑	50 ↑	27	279	43	3.0
Lithuania	7	26	2 ↑	3	30	210	48	1.7
Poland	10	31	6	197	38	830	37	3.0
Slovakia	6 ↑↑	16 ↑	3	17	30	565	36	4.0
Slovenia	5 ↑↑	19 ↑↑	6	391	32	1350	59 ↑	2.0
South Eastern Europe								
Albania	6 ↑↑	8 ↑↑	6 ↑	42 ↑	39	390	35	4.0 ^a
Bosnia & Herzegovina	12	60 ↓	7	128 ↑↑	38	595	46 ↓	3.3
Bulgaria	4 ↑↑	49 ↓↓	8 ↑	19	39 ↑	564	29	3.3
Croatia	8	40	5	174	38	561	50	3.1
Macedonia	7 ↑	9 ↑	6	66 ↑↑	38 ↑	385	47 ↑	3.7
Montenegro	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Romania	6	10 ↑	8	83 ↑↑	31 ↑	512 ↑↑	62 ↑	3.3
Serbia	11	23	6	111	36	635	39 ↑	2.7
CIS								
Armenia	9	18	3	4	49 ↑	285	31	1.9
Azerbaijan	6 ↑↑	16 ↑↑	4 ↑↑	11 ↑↑	39	237 ↑↑	3 ↑↑	2.7
Belarus	8 ↑	31 ↑↑	4 ↑↑	21 ↑↑	28	225	27	5.8
Georgia	3 ↑	3 ↑	2 ↑↑	3 ↑	36	285	7	3.3
Kazakhstan	8	21	5 ↑↑	40 ↑↑	38	230	23 ↑↑	3.3
Kyrgyzstan	4 ↑↑	15 ↑	7 ↓↓	8 ↓	39	177 ↑↑	38	4.0
Moldova	9	15 ↑	6	48	31	365	41 ↓	2.8
Russia	8	29	6	52	37	281	44	3.8
Tajikistan	13	49	6	37	34	295	51	3.0
Turkmenistan	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Ukraine	10	27	10	93	30	354	45	2.9

Uzbekistan	7	15	12	78	42	195	34	4.0
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a – June 2007. n.a. – data not available.

Notes: ↑ indicates an improvement and ↓, a deterioration.

Source: World Bank, *World Development Indicators 2009*, Washington 2009.

Table 15 gives account of the scope of government regulation of key areas in transition economies. The data, which supplements general economic freedom indicators, provides some vital information on the strength and number of bureaucratic hurdles (including entry and exit barriers) that constrain business activity in individual countries. At the same time, the data shed some light on the quality of institutions that form the market environment and influence business climate (quality of the legal system, the effectiveness of law enforcement, and the time and cost of resolving contractual disputes in courts). The table also includes data that illustrates procedures linked with the registration of property and government regulation of the labor market.

The data reveals that Hungary, Slovakia and the Baltic States offer the best conditions for business activity. This is due to a small number of bureaucratic barriers in these countries, coupled with ease of entry and exit, and a judiciary system which is highly effective in enforcing contracts. On the other hand, the business environment in Poland and Slovenia ranked – by most means – among the least encouraging in Central and Eastern Europe (e.g. in Slovenia, a procedure of contract enforcement lasts on average four years).

These findings only partly confirm a pattern resulting from international experience, i.e. that market entry barriers are inversely proportional to the level of economic development. While this pattern appears to hold true for Central Europe and some of the South-Eastern European countries, the available evidence for the CIS countries does not support it.

Key determinants of business environment also include the labor market regulations that set out procedures for hiring and firing employees. Seen from this angle, the most favourable conditions for business prevailed in the Czech Republic, whose labor market was the most flexible, as well as in Hungary, Slovakia and Poland. On the other hand, in the Baltic states and Slovenia, the index of labour market rigidity was above the average for the group of new EU member countries. Among other transition economies the most flexible labour markets existed in Azerbaijan and Georgia.

In the past year alone, only four transition countries (Bosnia & Herzegovina, Bulgaria, Kyrgyzstan, and Moldova) suffered a slight deterioration in the conditions for private business activity. In most of the countries, the opposite trend occurred. At the level of particular sub-groups, the positive trend prevailed mainly in the CEE countries (including Romania) and the non-Asian CIS states. At the level of individual countries, it is worth commending in particular the efforts of the authorities to remove the barriers constraining the development of entrepreneurship in Hungary, Albania, Macedonia, Romania, Azerbaijan, Belarus, Georgia, and Kazakhstan.

4.4. The government and the economy

One of the greatest challenges of systemic transformation was the need to redefine the basic functions of the government in an emerging market economy. As a result, one of the key

dimensions of institutional reform was the transformation of the government itself aimed to downsize its *dominium* (thanks to measures such as privatization and withdrawal from many of the functions performed in a centrally planned economy). At the same time, the government was supposed to take on new functions arising from the logic of a modern market economy. The downsizing of the state was also meant to contribute to its increased efficiency and effectiveness. In other words, the government in its new role was to become a special case of a pure public good.¹⁶

We shall confine our assessment in this section to two aspects of government functions in transition economies: (1) the size of government as measured by the share of public revenue and expenditure in GDP; and (2) the role of public expenditure as a potential source of positive externalities for businesses.

4.4.1. Size of government

While assessing the size of government, it is useful to refer back to Table 9 (Section 3.1). The relevant data indicates that the most extensive government functions were performed in Central European countries (except Slovakia), as well as in Belarus, Bosnia & Herzegovina, Montenegro, Serbia and Ukraine where the share of public expenditure and revenue in GDP tended to significantly exceed 40%. The share indices were somewhat lower in the Baltic states, the majority of South-eastern European countries and in the European CIS countries. On the other hand, the smallest-government countries were to be found in the Trans-Caucasian republics and, except of Uzbekistan, in Central Asia. This pattern seems to imply a relationship between the size of government and the level of economic development, measured by *per capita* GDP.

It is worth comparing the pertinent data for transition economies with the results of broader empirical studies, covering also other regions of the world. These studies reveal a positive correlation between the level of economic development of a country and the relative level of public expenditure. For example, in one study covering 102 countries, it was shown that in 1997, the average share of public spending in GDP in countries at the level of economic development (*per capita* GDP in the \$2500-\$5000 range) similar to that of Central European economies (as well as the South-eastern European states) amounted to 23.4%, while in the most developed Western countries (*per capita* GDP in the \$20 000-\$25 000 range) it was 40.3%¹⁷. This implies that the size of government, measured with the ratio of public spending to GDP, in the top-reformer transition economies, was excessive in relation to their level of economic development. Moreover, a comparison of these countries' current indicators with past data shows that they proved unable to significantly downsize the functions of government – which had been overly developed under the command economy – throughout the systemic transformation period.¹⁸ This means that institutional reforms (including the reform of the state as a special case) are still incomplete, even in top-reformer transition countries.

4.4.2. Government and externalities for the private sector

As we have already pointed out, one of the most important dimensions of the allocative function of the government in the former communist countries is its ability to generate, through an appropriate public spending policy, positive externalities for the private sector and

¹⁶ Such an interpretation of an efficient government can be found in, e.g., J.E. Stiglitz, *Economics of the Public Sector*, New York/London, Norton 2000.

¹⁷ See K. Polarczyk, *Sektor finansów publicznych w krajach OECD [General government sector in OECD countries]*, BSiE Report, Sejm Chancellery, Warsaw 2000.

¹⁸ Important deviations from this general trend can be noticed in Baltic countries and Slovakia where the relative level of both public expenditure and revenue substantially declined between 1996 and 2008.

thus reinforce the stimuli for development. Table 16 shows the data for two of the most important sources of these effects: the level of government support for the domestic research and development sector in individual countries and the results attained by the R&D sector; and the level of development and the spread of information and communication technologies (ICT).

The basic yardsticks of the size of state support for the development of science and technology include the share of R&D spending in GDP. Obviously, the level of R&D expenditure alone is not a sufficient condition for ensuring a high innovative capability of an economy, but it is a necessary requirement. Looking at the situation prevailing in transition economies from this angle, one can see that only four countries (Czech Republic, Slovenia, Serbia, and perhaps Macedonia) exhibited R&D spending exceeding 1.5% of GDP¹⁹. In a number of other countries (Estonia, Russia, Ukraine, and Hungary) this ratio ranged between 1.0% and 1.5% and showed generally an upward trend. Simultaneously, the same ratio for the high income countries stood at 2.48%, while the euro area average was 2.01% of GDP. What is more, between 1996 and 2006, the relative level of R&D expenditure financed by government tended to steadily decline in some transition countries (e.g. Poland).

Table 16. The development of science and technology and information technologies (IT) in transition countries, 2000-2007

Country	R&D expenditure (as % of GDP) 2000-2006 ^a	High-tech exports (% of manufactured exports) 2007	Licence trade		Access to IT (number per 1000 citizens)			Spending on information and communication technologies (as % of GDP) 2007
			Receipts (\$ mln) 2007	Payments (\$ mln) 2007	Personal computers 2007	Internet users 2007	Broadband lines 2007	
Central Eastern Europe								
Czech Republic	1.54	14	35	653	274	483	127.2	7.1
Estonia	1.15	12	10	40	522	637	207.0	n.a.
Hungary	1.00	25	841	1596	256	519	142.1	5.9
Latvia	0.69	7	13	40	327	550	64.2	n.a.
Lithuania	0.80	11	0	22	183	492	150.4	n.a.
Poland	0.56	4	108	1575	169	440	89.9	6.0
Slovakia	0.49	5	149	124	514	559	87.5	6.0
Slovenia	1.63	5	18	169	425	526	170.9	4.7
South Eastern Europe								
Albania	n.a.	12	5	8	38	149	3.1	n.a.
Bosnia & Herzegovina	n.a.	3	n.a.	n.a.	64	280	22.4	n.a.
Bulgaria	0.48	6	10	73	89	309	82.1	7.7
Croatia	0.87	9	40	214	199 ¹	447	87.3	0.0 ¹
Macedonia	24.77 ^b	1	3	9	368	273	49.3	n.a.
Montenegro	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Romania	0.46	4	41	242	192	239	90.5	5.3

¹⁹ It is worth noting that this figure also includes expenditure by the private sector; however, in the former communist countries, the government tends to provide more than half of the overall spending on research and development. For example in Poland, in 2002 government R&D spending amounted to 0.34% of GDP, while that of the private sector, to 0.33%.

Serbia	1.65	4	n.a.	n.a.	244	203	44.1	n.a.
CIS								
Armenia	0.21	2	n.a.	n.a.	319	57	0.7	n.a.
Azerbaijan	0.22	4	0	5	24	108	0.7	n.a.
Belarus	0.68	3	7	69	8	290	1.2	n.a.
Georgia	0.18	7	11	5	54	82	10.6	n.a.
Kazakhstan	0.28	23	0	68	n.a.	123	17.5	n.a.
Kyrgyzstan	0.20	2	2	12	19	143	0.6	n.a.
Moldova	0.81	5	6	7	111	184	12.4	n.a.
Russia	1.08	7	396	2806	133	211	28.1	4.1
Tajikistan	0.10	n.a.	1	1	13	72	0.0	n.a.
Turkmenistan	n.a.	n.a.	n.a.	n.a.	72	14	0.0 ¹	n.a.
Ukraine	1.03	4	53	577	45	215	17.2	7.1
Uzbekistan	n.a.	n.a.	n.a.	n.a.	31	45	0.3	n.a.

a – the latest data available;

b – the extremely high level of R&D spending in Macedonia published by World Bank is doubtful;

n.a. – data not available. 1 – 2006.

Source: World Bank, *World Development Indicators 2009*, Washington 2009.

It is also worth emphasising that the data on the relative level of R&D spending, presented in Table 16, do not appear to be clearly correlated with the level of economic development of the analysed countries. For example, the R&D spending was relatively low in Latvia, Poland, and Slovakia while it was comparatively high in Russia and Ukraine, i.e. countries with *per capita* GDP much below the levels prevailing in the former group (see relevant data in Section 2 of this paper).

Inadequate government support for the development of science and technology in transition countries may be held responsible for these countries' low innovative capability, as reflected, *inter alia*, by the data in Table 16.

One of the basic gauges of an economy's ability to innovate is the share of high tech exports in exports of manufactured goods. The latest available statistics indicate that by 2007 this share was the highest in Hungary (25%), the Czech Republic (14%), Estonia (12%), and Lithuania (11%). On the other hand, in the remaining new EU member countries it was quite low (4%-7%) and has shown no clear signs of improvement in recent years.

An important measure of the innovative capability of an economy is also the level of export receipts from the sales of licences and the balance of licence trade. Hungary was definitely the best performer in this area. The transition countries (except Slovakia, Georgia, and Tajikistan) for which the relevant data are available were net importers of licences, with Poland and Russia recording the largest deficits in licence trade. The ratio of export revenue to import spending in the former country stood at 1:15 in 2007 while the latter displayed the largest deficit in absolute terms.

As a wrap up of this part of the discussion, it may be claimed that policies aimed to support the R&D activities turned out to be ineffective – both in terms of their goals, design and outcomes – in most transition countries and hence have to be assessed as a clear symptom of government failure in these countries.

Similar to the case of research and development, the state can be a source of positive externalities for the private sector, through creating conditions that are conducive to the development of information and modern communication technologies and to improving access to these technologies (the Internet).

The data provided in Table 16 points to enormous divergences in this area among the former communist countries. While in the new EU member states, as well as in Croatia, the advancement of information and communication technologies has been very rapid, in the remaining transition countries, the development of a modern information economy remains very much a dream. Particularly large are the disparities between the new EU countries (including Croatia) and the remaining countries in terms of broadband Internet access.

Estonia leads the way, with the highest indicators for the development of and access to information and communication technologies, followed by Slovenia, Slovakia, Hungary, and Latvia. At the same time, the situation is the worst in Central Asia and the Trans-Caucasus region, as well as in Albania and Belarus.

4.5. The development of financial markets

An important yardstick of the progress of transformation and the advancement of structural reforms is the development of financial markets and the scope of financial intermediation. As shown in Table 17, as well as in annual assessments published by the EBRD, in recent years the former communist countries have made a considerable progress in this area.

Table 17. Selected indicators of the development of financial markets in transition countries, 1995-2008 (% GDP)

Country	Interest rate <i>spread</i> ^a		Domestic credit to private sector		Stock market capitalisation		Monetisation ratio (broad money /GDP)	
	2002	2008	1995	2008	1995	2008	1995	2008
Central Eastern Europe								
Czech Republic	4.7	4.6	46.7	51.0	30.2	25.5	75.3	65.0 ⁹
Estonia	4.0	2.8	14.0	91.9	9.4 ²	8.6	26.5	50.4
Hungary	2.8	0.3	22.7	67.6	5.8	12.1	41.9	53.5
Latvia	4.7	5.5	7.5	89.6	0.2	4.9	22.5	36.7
Lithuania	5.1	0.8	12.3	62.7	2.5	8.0	22.7	39.0
Poland	5.8	3.3 ⁹	12.7	55.0	3.9	21.0	36.1	50.3
Slovakia	3.6	4.3 ⁹	26.3	44.7	6.7	5.4	65.4	52.8
Slovenia	4.9	2.6	27.3	85.6	1.8	22.5	27.8	49.3
South Eastern Europe								
Albania	6.8	6.2	3.6	35.3	n.a.	n.a.	46.8	52.2
Bosnia & Herzegovina	8.2	3.5	8.9 ²	53.5	n.a.	31.3	14.8	50.9
Bulgaria	6.4	6.4	21.1	74.5	0.5	18.5	65.4	68.5
Croatia	11.0	7.2	22.9	68.1	3.1	40.4	25.0	65.8
Macedonia	8.8	3.8	23.1	43.9	2.3 ¹	9.0	11.0	44.9
Montenegro	7.1 ⁸	5.4	9.2 ^{b1}	87.2	4.7 ^{b5}	61.9	33.1 ⁶	101.8
Romania	16.2	5.5	7.8	38.5	0.4	11.2	25.3	34.5

Serbia	17.1	10.8	9.2 ^{b1}	39.7	4.7 ^{b5}	27.0	16.6 ²	14.0
CIS								
Armenia	11.5	10.4	5.3	17.4	1.0 ²	1.4	7.7	18.7
Azerbaijan	8.7	7.5	n.a.	16.5	0.1 ²	n.a.	12.3	16.0
Belarus	10.0	0.0	6.2	28.8	3.5 ²	n.a.	15.0	24.0
Georgia	22.0	10.9	3.4	30.2	0.8 ³	2.9	5.0	23.9
Kazakhstan	4.0 ⁶	4.8	6.1	48.8	8.2 ²	23.0	11.4	38.4
Kyrgyzstan	18.9	15.9	12.5	15.0	3.0 ¹	2.0	17.2	25.3
Moldova	9.3	3.1	5.8	36.5	32.3 ³	n.a.	16.5	34.7
Russia	10.8	6.5	8.7	41.0	4.8	93.2	15.5	32.4
Tajikistan	5.0	14.4 ⁹	4.0 ¹	26.1	n.a.	n.a.	19.1	16.5
Turkmenistan	5.0 ⁶	6.0 ⁷	5.7 ¹	1.4 ⁸	n.a.	n.a.	18.8	7.7
Ukraine	17.4	7.5	1.5	79.8	1.9 ³	20.6	12.7	54.0
Uzbekistan	3.6 ⁶	4.8 ⁹	27.9 ⁴	15.0	0.4 ¹	10.4	18.2	17.3

1 – 1996. 2 – 1998. 3 – 1999. 4 – 2000. 5 – 2002. 6 – 2003.
7 – 2004. 8 – 2005. 9 – 2007.

a – lending rate minus deposit rate (% points); b – data for Serbia and Montenegro.

n.a. – data not available.

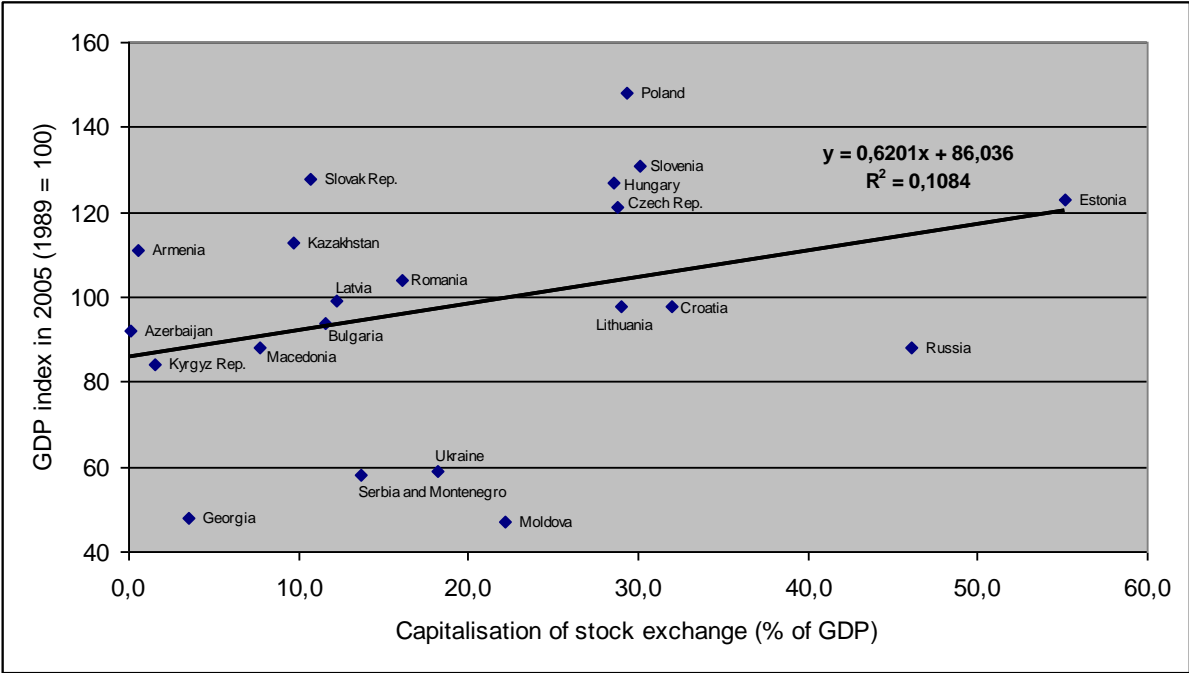
Stock market capitalisation and monetisation ratio (for 2008) according to the EBRD data. Domestic credit (for 2008) according to the EBRD, supplemented – when necessary – by the World Bank data. Interest rates according to the World Bank, supplemented – when necessary – by the EBRD data. Data for 1995 are taken from the previous edition of the report [D. Rosati, 2007].

Sources: EBRD, *Transition Report Database*, October 2009; World Bank, *World Development Indicators Database*, October 2009; World Bank, *World Development Indicators 2009*, Washington 2009; D. Rosati (ed.), *New Europe. Report on Transformation*, Eastern Institute, Warsaw 2007; own calculations.

The progress has been chiefly embodied in improved legal foundations and regulatory framework underlying the functioning of pension funds and the insurance market. It also entailed the increasing complexity, as well as the transparency and efficiency, of the securities markets. Simultaneously, the role of banks as financial intermediaries and a source of credit for the economy increased. These changes were reflected in the EBRD assessment of the reform progress in the financial sector, which in 2008 upgraded its scores for nine of the analysed countries. These included Slovenia (the emergence and development of insurance and pension funds), Albania (establishment of a new Credit Bureau and more effective implementation of the new banking law), Bosnia & Herzegovina (strong progress in the quality of the banking sector and increasing financial intermediation, particularly in the case of leasing and microfinance companies), Bulgaria (continued development of the insurance and leasing markets, and introduction of an improved trade platform on the Sofia Stock Exchange), Macedonia (implementation of a new banking law and general improvements in financial practice of the banking sector), Montenegro (important credit growth, and implementation of sound regulatory measures that may facilitate an orderly slowdown in credit growth), Romania (privately managed compulsory pension funds started to operate), Serbia (strong growth in financial intermediation and expansion of financial products within an improved regulatory framework), and Armenia (cumulative improvements in the regulatory framework for the trading of securities).

As indicated by the data in Table 18, between 1995 and 2008 in the majority of former communist countries, the securities markets developed in quantitative terms, as reflected by the increase in their capitalisation. In 2008, the CEE and SEE countries (except the Baltic states, Slovakia, Albania, and Macedonia) revealed the highest capitalization ratios (at a two-digit level), though some CIS countries – notably Russia, Kazakhstan, and Ukraine – had also relatively developed capital markets.

Chart 7. Development of securities market* and GDP growth in transition countries**



* – capitalization of stock exchange (% of GDP) in 2004,

** – excluding Belarus, Turkmenistan and Uzbekistan.

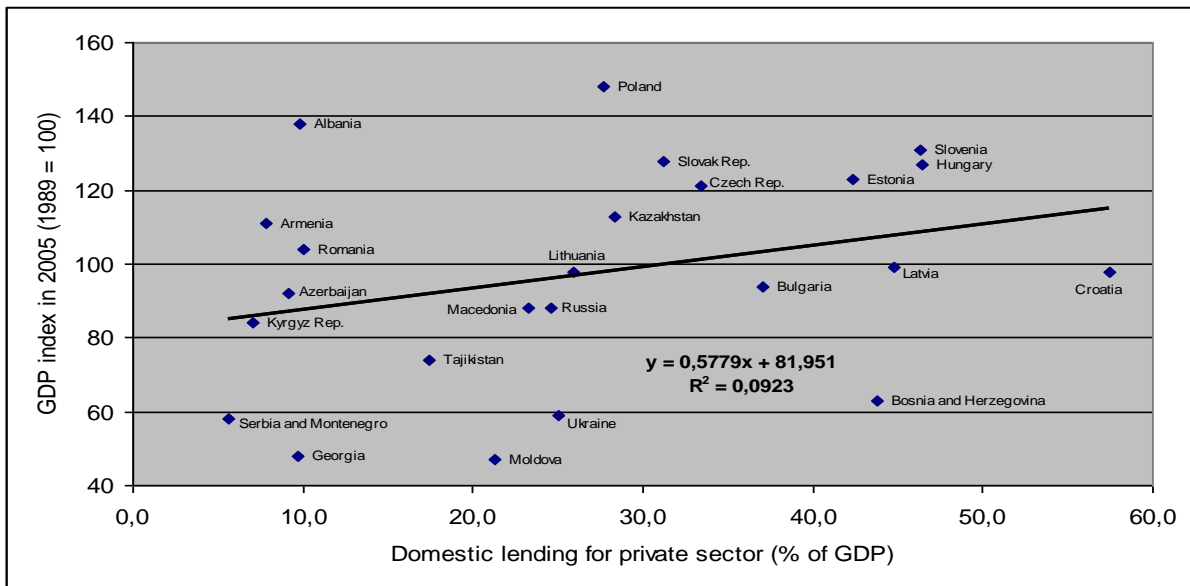
Source: Authors’ calculations.

The development of securities markets was a factor conducive to economic growth in the countries in transition. As shown in Chart 7, economic growth in 1990-2005 tended to be faster in those countries that exhibited higher capitalisation of their stock exchanges.

Nevertheless, this does not contradict the fact that the role of the securities markets (in particular the stock market) as a mechanism for the allocation of resources remains fairly limited in the transition countries, in comparison to developed Western economies.

Another widely used measure of financial markets development is the ratio of domestic lending for the private sector to GDP. This indicator allows for an assessment of the scope – i.e. width and depth – of financial intermediation of the domestic banking sector. In 1995-2008, all the analyzed economies as a group made undoubted progress in this area (only the statistics for Turkmenistan and Uzbekistan do not confirm this tendency due to lack of the respective data). The banking systems in most new EU member states in Central Europe as well as in Montenegro, Bulgaria and Croatia were the most developed in these terms. However, it should be borne in mind that the relevant indicator for industrialized Western economies amounts in average to 160%, which highlights the huge gap that still needs to be bridged, even in those transition countries that are the most advanced in the process of structural reform.

Chart 8. The scope of financial intermediation* and GDP growth in transition countries**



* – domestic lending to private sector (% of GDP) in 2004.

** – excluding Belarus, Turkmenistan and Uzbekistan.

Source: Authors' calculations.

The broadening of the scope of financial intermediation has also contributed to the acceleration of economic growth, although its effects were less pronounced than those produced by the increase in the capitalisation of the securities markets. This relationship is confirmed by an econometric analysis; the findings are shown in Chart 8.

The most comprehensive measure of the development of the financial sector and its role in the economy is monetisation, or the ratio of broad money to GDP. The transition countries, with some exceptions, made a considerable progress in this area between 1995 and 2008. The highest ratios were recorded in Montenegro, Bulgaria, Croatia, and the Czech Republic. They were comparable to the average for the EU-15 and OECD countries. Generally, the monetization of the economy in the analyzed group was relatively closely related to the level of economic development. Monetization was the highest (above 35 percent) in Central and South-Eastern European countries (except for Serbia), while the lowest figures were recorded in CIS countries, excluding Ukraine, Kazakhstan, Moldova, and Russia.

While assessing the development of financial markets and the scope of financial intermediation in the former communist countries, it is also worth noting the huge differences between the prevailing levels of interest rates on domestic loans and bank deposits (or interest spreads). These discrepancies reflect the high level of risk involved in the financial system and the economy as a whole, along with low banking system efficiency. They result from the immaturity of financial institutions in most these countries and poor adjustment of banking supervision and prudential regulations to the growing volume of lending. However, the situation in this area varied considerably from one country to another, much as in the case of other areas of structural reform discussed in this paper. Generally, bank interest spreads displayed a negative correlation with the advancement of systemic reforms: they were the lowest in Central and Eastern Europe, while South-Eastern Europe and CIS countries exhibited the highest interest spreads.

5. Short- and medium-term growth prospects

The recent forecast for the world economy published by IMF in October 2009 assumes that, following the fall of global output by 1.1% in 2009, world economy as a whole will recover in 2010, showing an increase of total output by 3.1%. The rise in the global output will be stimulated by the expected recovery in the United States and in Japan, with the increase in real GDP by 1.5% and 1.3% respectively, and by a further vigorous growth in the developing countries of Asia by 7.3%. At the same time, Western Europe will stagnate, with a very slight growth in the euro area by about 0.3%.

Against this background, Central and South Eastern Europe is expected to raise the output by 1.8% and the CIS by 2.1%, both on the weighted average.

According to this forecast, Poland can see a growth of real GDP by about 2%, Slovakia by 4%, and the Czech Republic and Slovenia by about 1%. Hungary will note a further decrease by about 1%, and the Baltic states will remain in the prolonged recession, with the expected further drop of real GDP by 3-4%. In SEE, Serbia, Macedonia and Albania can report an increase in real GDP by about 2%, Romania will stagnate, and Bulgaria will see a further drop in output by 2-3%. In the CIS, all the countries except Moldova are supposed to raise their output levels, mostly by 1-3%. Three oil and gas producers, Azerbaijan, Turkmenistan and Uzbekistan, will continue to grow rapidly, by 7% or more, but Kazakhstan will grow by only 2%. Russia and Ukraine will increase their GDP by 1-2%.

Table 18. Forecast of basic macroeconomic indicators for 2010 and 2014

Country	Real GDP growth (%)		CPI inflation (%)		General government balance (% of GDP)	Current account balance (% of GDP)	
	2010	2014	2010	2014	2010	2010	2014
Central Eastern Europe							
Czech Republic	1.3	4.0	1.1	2.0	-7.0	-2.2	-2.5
Estonia	-2.6	4.0	-0.2	2.5	-3.0	2.0	-3.2
Hungary	-0.9	3.5	4.1	3.0	-3.8	-3.3	-3.4
Latvia	-4.0	4.0	-3.5	1.1	-12.0	6.4	4.1
Lithuania	-4.0	4.0	-2.9	1.6	-7.6	0.5	-2.5
Poland	2.2	4.0	2.6	2.5	-6.5	-3.1	-3.1
Slovakia	3.7	4.2	2.3	2.3	-4.4	-7.8	-3.8
Slovenia	0.6	3.3	1.5	3.0	-5.6	-4.7	-4.8
Average ^a	-0.5	3.9	0.6	2.3	-6.2	-1.5	-2.4
South Eastern Europe							
Albania	2.2	6.0	2.0	3.0	-4.0	-8.0	-3.1
Bosnia & Herzegovina	0.5	4.5	1.6	2.5	-4.0	-9.1	-7.0
Bulgaria	-2.5	5.0	1.6	3.4	-1.8	-8.3	-5.6
Croatia	0.4	4.0	2.8	3.0	-3.8	-5.4	-6.3
Macedonia	2.0	4.0	2.0	3.0	-2.8	-9.7	-6.2
Montenegro	-2.0	4.0	2.1	3.1	-9.2	-11.0	-9.0
Romania	0.5	5.0	3.6	3.5	-5.9	-5.6	-6.0
Serbia	1.5	5.5	7.3	4.7	-3.5	-10.6	-4.2
Average ^a	0.3	4.8	2.9	3.3	-4.4	-8.5	-5.9
Commonwealth of Independent States							
Armenia	1.2	4.5	3.2	4.0	-5.9	-13.7	-7.5
Azerbaijan	7.4	0.9	5.3	6.0	14.9	23.1	15.8
Belarus	1.8	6.9	8.3	6.0	-1.7	-7.1	-3.2
Georgia	2.0	5.0	3.0	5.0	-7.3	-17.6	-14.9
Kazakhstan	2.0	7.5	6.6	6.0	-0.4	3.9	4.1

Kyrgyzstan	3.0	5.6	6.7	4.5	-6.3	-12.4	-5.1
Moldova	0.0	5.0	7.7	4.0	-6.0	-11.9	-13.0
Russia	1.5	5.0	9.9	7.5	-3.2	4.5	2.9
Tajikistan	3.0	6.0	10.9	6.5	-6.4	-13.3	-7.8
Turkmenistan	15.3	8.0	3.5	4.5	9.4	29.1	39.0
Ukraine	2.7	5.8	10.3	5.0	-3.0	0.2	-2.8
Uzbekistan	7.0	6.0	9.5	8.0	5.3	6.7	5.1
Average ^a	3.9	5.5	7.1	5.6	-0.9	-0.7	1.1
All transition countries ^a	1.6	4.8	4.0	4.0	-3.4	-3.2	-1.9

^a Unweighted average.

Sources: IMF, *World Economic Outlook*, October 2009; *Regional Economic Outlook: Europe*, October 2009; *Regional Economic Outlook: Middle East and Central Asia*, October 2009.

As regards inflation, the IMF forecast for 2010 suggests that most CEE and SEE countries, except Hungary, Romania and Serbia, will see a low inflation of 1-3% or even disinflation (in case of the Baltic states). In Hungary and Romania, prices may rise by about 4% and in Serbia by 7%. On the average, the CEE and SEE region will sustain a very low inflation. At the same time, inflation rate in the CIS countries will remain relatively high. Inflation will decrease to 10% in Russia and Ukraine, and 7-8% in Belarus and Kazakhstan. On the other hand, it will rise in Azerbaijan, Armenia, Georgia, and Moldova, as well as in Tajikistan. As a whole, most countries of the region will note slightly lower inflation as compared with 2009.

The situation of public finance in this group will not improve much in 2010 despite the assumed improvement in the output levels. All the CEE and SEE countries will note deficits in the general government balance, the highest one in Latvia (12% of GDP). In Poland, Czech Republic, Lithuania and Romania, the deficit in the state budget may amount to 7% of GDP. In Hungary, Slovakia, Bulgaria, Albania, Croatia and Serbia, it will be lower, up to 4% of GDP. All the countries of CIS except of big oil and gas producers will also see deficits in state budgets. In the smaller and weaker economies, like Armenia, Georgia, Kyrgyzstan, Tajikistan and Moldova, the deficits may be quite high, like 6-7% of GDP, while in the more advanced countries, including Russia, Ukraine and Belarus, they will be probably held on a tolerable level up to 3% of GDP. At the same time, big oil and gas exporters, namely Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan, will continue to note a balanced state budget or a big surplus ranging between 5 and 15% of GDP.

The same IMF forecast assumes that most countries of the region, except oil and gas exporters, will continue to record in 2010 a negative current account balance with abroad. In the CEE, only the Baltic states are supposed to note a surplus as the result of the reduction of imports. Poland, Hungary and the Czech Republic will see moderate deficits in foreign accounts (up to 3% of GDP), which will be offset by FDI inflows. SEE will face larger deficits in foreign turnovers, ranging from 5 to 10% of GDP. Among the CIS countries, Russia, Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan will sustain big surpluses on current accounts with abroad, ranging from 5% to 30% of GDP. Ukraine is assumed to maintain a zero current account balance while the remaining countries will probably see deficits in the range between 5 and 15% of GDP. On the whole, the situation in this respect will not change much from the results seen in 2009.

The medium-term forecast for the transition economies should also be related to the expected development of world economy. According to the recent forecast published by IMF, total world output is expected to resume the growth rate of 4-5% recorded prior to the crisis, with a continuous rapid growth in developing Asia and an accelerated growth in the United States and Western Europe (but not in Japan). Central and South Eastern Europe will speed up their economic growth to 4% and the CIS to over 5% on a weighted average. Inflation in the advanced economies is assumed to be kept under control, below 2% on the average, while in

the emerging and developing countries it is supposed to be about 4%. In Central and South Eastern Europe inflation rate will be about 3% on a weighted average while in the CIS it will be still much higher, about 7%.

The CEE and SEE countries are supposed to restore a moderate growth rate of real GDP equal to 3-5% a year (a little higher in case of Albania and Serbia) with a simultaneous control of inflation, which should not surpass 3% a year (a little higher in Bulgaria, Romania and Serbia). Russia will restore a sustained output growth at the rate of 5% per year, and the remaining CIS countries, on a weighted average, will grow at a rate of 6% per year. Noteworthy is the expected expiration of a rapid growth in Azerbaijan. Inflation in Russia will continue to run at a high rate of 8% per year while in the other CIS countries except Uzbekistan it may be slightly lower, amounting to 5-6%.

The results in the current account balance will remain generally comparable with the situation foreseen in 2010. A considerable decrease of foreign trade deficit may be expected in Slovakia, Albania and Serbia, as well as in Armenia, Belarus, Kyrgyzstan and Tajikistan, while the surplus previously seen in Estonia and Lithuania may disappear, and the surplus on current account in Russia and Azerbaijan will be reduced. Altogether, CEE and SEE will keep up a moderate current accounts deficit of about 4% of GDP while the CIS will record a surplus amounting to 3% of GDP, both taken on a weighted average.

As regards general government balance, no worldwide medium-term forecasts are being prepared because of unforeseeable elements involved in government policies shaping the evolution of state budgets and public finance.

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