

Operational environment

The operational environment for the EBRD continues to be characterised by very diverse conditions in its 26 countries of operations. This diversity partially reflects the different initial conditions prevailing across the region when reforms were started a decade ago. But it is also increasingly a result of divergent transition paths followed by the countries of central and eastern Europe and the CIS. The methods adopted in pursuit of the establishment of market economies have differed greatly across the region. Variation in reform policies as well as specific structural, political and cultural legacies constitute a challenging operational environment for the EBRD, in which maximum flexibility and strategic vision are required to fulfil the Bank's mandate.



The turmoil in emerging markets in 1998 has put the quality of reforms in transition economies to the test. Although a wide range of factors have determined the vulnerability of these economies to crisis, the key to preserving macroeconomic stability and sustainable growth has been the role of the state. Of particular importance is the capacity of the state to enforce laws and curb corruption, to collect taxes, to regulate banks and financial markets, to implement bankruptcies, to promote enterprise restructuring and effective corporate governance, and to build the institutional and social foundations for a well-functioning market economy. These are the fundamental challenges of the current phase of transition and they remain at the top of the agenda for all countries of the region.

Trends in the transition process

Progress in structural reform

The transition encompasses many dimensions, from the liberalisation of markets and the privatisation of state assets to the more complex institutional reforms of establishing well-functioning financial institutions and introducing adequate corporate governance in the enterprise sector. Initial reform efforts across the region concentrated on liberalisation and privatisation, measures that forced the state to refrain from intervening in production and exchange. By contrast, the institutional reforms characteristic of the current phase of transition, which emerged vividly in 1998, require the state to take on new roles: as a regulator, as an impartial arbiter, and sometimes as an active partner facilitating economic restructuring. The tasks associated with building market-oriented institutions are of such magnitude and complexity that they cannot be completed overnight. Although rules, procedures and organisations

can often be quickly set in place, the capacity of institutions to change expectations and shape behaviour can be developed only over the long term.

The EBRD's assessment of progress in transition, published in its annual *Transition Report*, reflects the differences in the time profile of the various reform dimensions. These assessments show that the majority of transition economies have achieved very rapid progress in price and trade liberalisation as well as small and large-scale privatisation. The private sector share of GDP exceeds 50 per cent in 19 of the EBRD's 26 countries of operations. In some advanced countries, such as Hungary, the privatisation process is virtually complete. On the other hand, few countries have made similar headway in the more difficult institutional reforms, such as enterprise restructuring, addressing corporate governance, competition policy, and reforms of banking systems and securities markets. Legal systems, in particular their effectiveness, also remain underdeveloped.

Against the background of a difficult external environment, overall progress in transition in 1998 was less rapid than in previous years. Progress in reform continued strongly, however, in a number of countries, such as Armenia, Azerbaijan and Tajikistan, which have been catching-up on previously delayed reforms. In Bulgaria, the new reform momentum that gained hold after the change in government in 1997 continued in 1998. However, in countries such as Belarus, Turkmenistan and Uzbekistan, structural reforms are proceeding more gradually. Russia experienced backtracking on several dimensions following the August crisis, when administrative controls on prices and domestic trade were introduced as a short-term measure in some regions, restrictions were imposed temporarily on foreign exchange operations, and the financial system went through a major retrenchment.

Institutional reforms
needed to complement
progress in
liberalisation and
privatisation

Private sector development

Progress in privatisation has differed significantly among transition economies. While small-scale privatisation is virtually complete in most countries, there has been significant variation in the level of privatisation of medium-sized and large companies. By mid-1998, the Czech Republic, Hungary and the Slovak Republic had reached a degree of private ownership close to that of established market economies. In other central and east European countries, large-scale privatisation has been more sluggish, especially in Bulgaria, Croatia, FYR Macedonia and Romania, although these countries have recently intensified their privatisation efforts. In the CIS, Armenia, Georgia and Kazakhstan took new initiatives in large-scale privatisation during 1997-98 after lagging behind in previous years. By contrast, Belarus and Turkmenistan appear to have abandoned previous intentions to accelerate privatisation. Uzbekistan is also following a cautious approach to privatisation.

Over the past two years there has been an increasing shift towards trade sales and investment tenders as the preferred privatisation method. The telecommunications sector is particularly prominent, with four successful tenders concluded in 1998 (Armenia, Lithuania, Poland and Romania) and several more planned in 1999 (for instance, in Albania, Estonia, Georgia, Kyrgyzstan and the Slovak Republic). In 1997-98, strategic stakes in large manufacturing enterprises were also sold to foreign investors in Armenia (cognac), Bulgaria (copper), Estonia (shipping), Kazakhstan (oil and mining), and Latvia (gas). In Georgia, management contracts with buy-out options have been awarded to foreign investors for two large industrial enterprises. The emerging markets crisis has in many countries temporarily disrupted privatisation efforts and delayed sales of strategic stakes to foreign investors. With market confidence returning in the more advanced countries in the region, however, several large privatisations were recently announced, including the sale of Poland's largest commercial bank.

In some transition economies, the growth of the new private sector has become an important contributor to economic growth and the rising share of the private sector in GDP. In Poland, new private firms are outperforming privatised and state enterprises on all measures of performance. In Hungary, greenfield investments by international corporations are contributing over half of all export revenues. In the Caucasus, the growth of the new private sector is a key factor behind the rapid pace of recovery. In many

other countries, however, entrepreneurial initiative remains stifled by weaknesses in the investment climate. Tax rules are opaque and tax rates cripple investment. The law is confused and ineffective. Complicated registration and licensing procedures discourage entry. A large proportion of private economic activity is thereby driven to the informal economy. A number of estimates suggest that the share of the unofficial economy in GDP may exceed a third in many CIS economies, including the Caucasus, Russia and Ukraine.

Legal environment

In general there has been an overall improvement in the legal environment across the region, but this improvement has been uneven. While many countries have established a fairly comprehensive commercial legal system (pledge, bankruptcy and company laws), implementation and enforcement of these new laws and regulations remains less effective. In a few countries (notably Croatia and Russia) there was a decrease in the effectiveness of the commercial legal structures, possibly due to the adoption of new and comprehensive laws that the countries are not yet equipped to put fully into practice. Overall, the creation of institutions to effectively implement commercial laws continues to lag behind the enactment of these new laws.

Similar developments can be seen in the banking, securities market and telecommunications sectors. While many countries have enacted modern, comprehensive laws and regulations in these sectors, they have yet to make the political and resource commitment necessary for the effective implementation of this legal framework. In the banking and securities markets, impediments to proper enforcement include lack of trained personnel, a failure to conduct regular supervisory examinations and an inability (due to lack of capability or to political constraints) to take prompt and frequent corrective action with respect to problematic institutions. In the same way, while most countries have taken steps to liberalise their telecommunications sector, the regulatory framework needed to ensure open and fair competition in the sector is in need of further attention and development.

In light of the financial crises in Asia and in Russia, there has been a growing recognition of the important role played by the legal institutions that underpin a modern market economy. As the EBRD has emphasised, legal institution building is crucial to a Russian recovery and the general strength of the transition process. This increased interest in legal reform has

Growing demand for Bank's legal services and technical assistance

meant a growing demand for the services and technical assistance provided by the Office of the General Counsel (see box).

The EBRD continued its participation in the United Nations Commission on International Trade Law's efforts to develop international consensus on guide-

lines for specific commercial transactions. In particular, the EBRD participated in the experts group preparing legislative guidelines on privately funded infrastructure projects.

Governance and financial discipline

Despite continued gains in labour productivity, particularly in central Europe and the Baltic states, the pace of enterprise restructuring remains slow and inconsistent in most transition economies. The most obvious indication of this is the persistence of unprofitable enterprises. In many countries, losses are concentrated among a few large enterprises. In Poland, the state-owned defence, chemicals, coal, steel and shipyard industries continue to record high losses. In the Czech Republic, two large conglomerates accounted for about a quarter of total losses in the industrial sector. In Russia, most large privatised companies in manufacturing were unprofitable even before the recent crisis. Restructuring the large loss-makers has proven to be a very difficult task, both in economic and political terms, especially in cases where these companies account for the livelihood of a whole city or region, which is a particular problem in Russia.

Poor corporate governance remains a key obstacle to enterprise restructuring and sustainable growth. Privatisation through vouchers and management-employee buy-outs has produced insider-dominated governance structures in many countries. Corporate control is often exercised by management without effective checks by independent shareholders or by the state, which often maintains residual stakes in privatised firms through its pension or privatisation funds. This has inhibited restructuring, especially reductions in the unproductive workforce. Yet there is little evidence that majority ownership by domestic outsiders has resulted in faster restructuring. Domestic banks and investment funds not only have little expertise in managing and restructuring firms, but often suffer from similar corporate governance problems themselves, most notably in the Czech Republic. There is evidence, however, that the profitability of new private enterprises and enterprises with a foreign majority owner exceeds that of state-owned and domestically privatised companies.

Weak financial discipline has remained the Achilles heel of many transition economies in the current phase of transition and is among the most important challenges for the future. Despite efforts to harden budget constraints for enterprises, there has been surprisingly little market exit of loss-making firms. Creditor-led bankruptcy is almost non-existent in

Legal transition

The EBRD's Legal Transition Programme (LTP) works to improve the legal environment of the Bank's countries of operations by fostering interest in, and helping define, legal reform throughout the region. Assisted by funding from a number of donors,¹ the LTP supports this goal by providing or mobilising legal technical assistance. LTP activities focus on the development of the legal rules, institutions and culture on which a vibrant market-oriented economy depends.

In the telecommunications sector, specific EBRD assistance was provided in 1998 to Belarus, Bosnia and Herzegovina, Lithuania and Poland. In Bosnia and Herzegovina the EBRD worked with the International Telecommunications Union and the Office of the High Representative, to help the authorities agree on a state telecommunications law and regulations for the establishment of the independent regulatory agency. A model of the licence for international service and a tariff policy were also agreed. In addition, the EBRD finalised funding and a consulting contract to provide telecommunications regulatory assistance to Albania. Future projects are expected to begin early in 1999 in Armenia, Kazakhstan and Ukraine.

Another growing area for legal technical assistance is the development of capital markets and improvement in corporate governance. During 1998, the EBRD finalised the funding and consulting agreements for a project to help the Czech Republic develop its Securities and Exchange Commission. A similar project is in the pipeline for the Slovak Republic for 1999. At the end of 1998, the EBRD finalised plans to work with the Russian Federal Commission for the Securities Market. Work will focus on developing specific capital market regulations and company law provisions to increase the transparency of Russian markets and to improve minority shareholder protection and other aspects of corporate governance. A similar project is expected to begin in Romania in 1999.

In 1998 the EBRD continued to provide assistance to its countries of operations in the development of secured transaction laws and the registry systems needed to effectively implement these laws. Specific assistance continued to be rendered to Hungary, Latvia and Romania, while new assistance was provided to Tajikistan. In Moldova, the EBRD and the German Agency for Technical Assistance produced a feasibility study for the introduction of a computerised pledge registry and are promoting changes to the existing pledge law. New secured transaction projects in 1999 are expected in the Czech Republic, Slovenia and Turkmenistan.

The EBRD continued to provide assistance to the Russian Government in 1998 on the implementation of its new bankruptcy law. The Bank also continued to provide assistance on the development of concession laws in the region, with a project in this area for Romania.

In addition to technical assistance, the EBRD enhanced its efforts to promote legal reform with the expansion of the Bank's legal journal, *Law in transition*. With an extended distribution list and issues in both English and Russian, *Law in transition* will be able to reach those people who make and influence legal reform in the EBRD's countries of operations.

¹ Donors to the LTP comprise the European Community, France, Germany, Ireland, Italy (Central European Initiative), Japan, Luxembourg, Netherlands, Taiwan and the United Kingdom (Know How Fund).

many transition economies, despite recent improvements in bankruptcy legislation in such countries as Azerbaijan, the Czech Republic, FYR Macedonia, Kyrgyzstan, Lithuania, the Russian Federation and the Slovak Republic. A common problem is the lack of institutional capacity on the part of the state to implement the law. Equally important has been the state's unwillingness to accept the employment implications of large-scale bankruptcies and to oppose existing vested interests that gained from the early stages of the privatisation process. In Russia, for instance, a range of enterprises in sectors such as defence, energy and agriculture as well as enterprises deemed of "strategic" importance have been shielded from bankruptcy by special decrees issued by the new government.

Governments have tended to move away from direct enterprise subsidies and towards greater use of indirect support through "soft budget constraints". These include low input prices and – increasingly – tolerance for tax arrears and arrears to the state utilities. In Russia and Ukraine there has also been a steep increase in barter and other non-monetary forms of payments, estimated at mid-1998 at over 50 per cent of industrial sales. Payments in kind to tax authorities and utilities often overstate the true value of the goods. Subsidised bank credits and, more often, the continued extension of credits to firms with a poor debt service record are still common in many countries, especially when there is cross-ownership between loss-making enterprises and banks. The state has also taken a prominent role in pressuring large banks (including privatised ones) to continue extending credit to loss-making enterprises.

In December 1998 the Working Group on Governance, Corruption, and Capacity Building of the Multilateral Development Banks (MDBs) met at the EBRD's headquarters. This working group was established at the last meeting of the heads of the MDBs in an effort to increase coordination and share lessons learned across regions on combating corruption and developing good governance in the EBRD's countries of operations. The Working Group's report was presented at the annual MDB meeting in January 1999.

Banking reform

The banking sector in transition economies remains generally underdeveloped, and bad loans continue to pose problems, largely due to weak lending practices maintained during the transition. However, progress on bank privatisation was made in 1998 in a number of countries, including Armenia, Bulgaria, Croatia, the Czech Republic, Kazakhstan, Poland and

Romania. In some transition economies – including Albania, Azerbaijan, Belarus, Bulgaria, FYR Macedonia, Romania, Turkmenistan and Uzbekistan – extensive state influence remains a characteristic of the banking sector. While directed credits have been largely phased out, many state-owned banks continue to provide loans at artificially low interest rates to "priority" sectors, especially to agriculture.

Most transition economies made progress in adopting and implementing tighter prudential regulation over the past year. Minimum capital requirements and capital adequacy standards were gradually increased; international accounting standards and new regulations on connected lending and single-party exposure were implemented. However, a survey conducted by the EBRD in 1998 of legal experts in the region confirmed the substantial gap that exists between the extensiveness and the effectiveness of legal rules in banking and security activities, particularly in the CIS. In addition, central bank supervision remains very weak in a number of countries.

Joint Vienna Institute

In 1998 the EBRD delivered seminars on practical banking skills and enterprise management to senior managers in the EBRD's client companies and financial institution partners. These were undertaken through the Joint Vienna Institute (JVI), an international institution founded in 1992 by the EBRD, the Bank for International Settlements, the International Bank for Reconstruction and Development (World Bank), the International Monetary Fund and the Organisation for Economic Co-operation and Development. The JVI is also sponsored by the Austrian Government, the European Community and various bilateral donors.

The seminars were sponsored by the Bank's TurnAround Management Programme (see page 38), the Russia Small Business Fund (see page 27) and other EBRD teams, such as the power and energy team, with participation from EBRD lawyers. The Bank also continued to participate in the JVI's corporate governance and course design.

As of 1 January 1999, the JVI was expanded to include the World Trade Organization as a partner. In addition, all the sponsoring institutions elected to continue their involvement with the JVI for another five-year period until August 2004. The EBRD's decision was based on its view that a continuing demand for such training exists and that the JVI represents a cost-effective means of meeting this demand.



Supervisory weaknesses against the background of a growing intermediation of foreign capital flows through the domestic banking system have exacerbated the vulnerability of a number of transition economies to banking crises as a result of the collapse in investor confidence. The most glaring example is the financial crisis developing since mid-1998 in Russia, discussed below. Its effects have spilled over into other transition economies, most notably Latvia where some banks proved to have excessive exposure to the Russian state securities market. Inadequate domestic lending practices also continue to undermine the stability of banks across the region. In 1998, Croatia's fifth-largest bank collapsed, following over-exposure to a single party with risky investment projects, and the Slovak Republic's third-largest bank was put under forced administration.

The non-bank financial sector remains as underdeveloped as the banking sector, despite gradual improvements in the regulatory and institutional framework. Market capitalisation on stock exchanges was relatively low in most transition economies in 1997 and decreased further in 1998 as a result of falling share prices. Many shares are illiquid and few are listed on the top tier of the market where stricter reporting requirements apply. Initial public offerings (IPOs) and capital increases through the stock market remain rare except in the context of the privatisation process.

The crisis in Russia and its implications

Events in 1998 were overshadowed by the serious downturn in economic activity in Russia, combined with the financial crisis and an effective default by the government on much of its domestic and foreign debt. The origins of the crash of Russia's financial markets lie in the country's incomplete stabilisation, allied to persistent macroeconomic imbalances and disappointingly slow structural reforms, especially enterprise reforms. Since 1995, the Russian government replaced monetary financing of the deficit with borrowing on the Treasury-bill market and on the international capital markets. In principle, this approach bought the government time to make progress in deficit reduction, structural reform and enterprise restructuring. However, channels of soft financing to enterprises

remained significant. In addition, the Asian financial crisis raised the costs of borrowing and contributed to a decline in commodity prices.

As the stock of government debt grew without substantial progress in fiscal adjustments and structural reforms, domestic and foreign holders of Russian debt lost confidence in the government's repayment capacity, precipitating a devaluation of the currency on 17 August and a default on Russian domestic state securities. In a vain attempt to protect major Russian banks rocked by the devaluation and the default, the government declared a moratorium on payments of private sector debt to foreign creditors. These measures further undermined confidence and added to the financial crisis.

At the end of 1998, Russian policy-makers focused on short-term decision-making to stabilise the situation while continuing to avoid major structural and policy changes. Although a promising bank restructuring programme was approved, little progress has been made on implementation, especially the identification of the list of economically and socially important large banks to be rescued and the fate of failed financial institutions. The proposed 1999 budget, while not incorporating major new government expenditure as earlier feared, has still been criticised as unrealistic by the IMF. Agreement with the IMF over additional balance of payments support would be crucial, however, in paving the way towards restructuring Russia's external debt obligations and the return of foreign capital to Russia.

The Russian crisis has provided a stark reminder of the inter-relationship between microeconomic adjustment, the investment climate and the sustainability of macroeconomic stabilisation efforts. Russia's ultimate policy response to its ongoing deep crisis will be a key factor determining both directly (through its immediate economic impact) and indirectly (through its demonstration effects) the pace and direction of the transition process in the foreseeable future in much of the CIS.

Trends in macroeconomic developments

Economic growth

A review of the macroeconomic performance of the transition economies in 1998 reveals wide disparities. Output continued to grow strongly in a number of countries, exceeding 5 per cent in seven cases. However, economic activity in the region's largest economy, Russia, fell by an estimated 5 per cent, and prospects for a recovery in 1999 appear remote

although industrial activity benefited from massive devaluation in the last months of 1998. The fallout from the Russian crisis has affected economic performance in part of the region, in particular in neighbouring CIS countries with weak economic fundamentals and strong trade links to Russia.

In central and eastern Europe and the Baltic states (CEE) the momentum behind strong economic growth evident during the first half of 1998 slowed in the second half. Average growth for the year is estimated

Fall in average growth
in 1998

Trade exposure to the Russian Federation, Ukraine and Belarus

In per cent

	Share of exports of goods to Russia ¹	Share of exports of goods to Ukraine ¹	Share of exports of goods to Belarus ¹	Total	Share of exports in GDP ¹	GDP exposure ²
Central and eastern Europe and the Baltic states³						
Bulgaria	7	3	0	10	47	5
Croatia	4	0	0	4	22	1
Czech Republic	2	1	na	4	43	2
Estonia	6	5	2	13	49	6
FYR Macedonia	2	8	1	11	36	4
Hungary	5	1	0	7	43	3
Latvia	21	4	3	28	32	9
Lithuania	7	9	12	28	44	12
Poland	4	5	1	10	20	2
Romania	3	1	0	4	24	1
Slovak Republic	3	3	0	6	45	3
Slovenia	4	1	0	5	47	2
Average	6	4	2	11	38	4
Commonwealth of Independent States						
Armenia	23	2	1	26	14	4
Azerbaijan	23	4	0	28	21	6
Belarus	59	15	–	74	55	41
Georgia	30	4	0	34	9	3
Kazakhstan	39	3	0	42	30	13
Kyrgyzstan	21	1	1	23	37	9
Moldova	63	5	2	70	38	26
Russia	–	9	6	14	20	3
Tajikistan	8	1	1	10	60	6
Turkmenistan	5	0	0	5	41	2
Ukraine	22	–	5	27	31	8
Uzbekistan	31	6	2	39	26	10
Average	29	5	2	33	32	11

Sources: IMF, *Direction of Trade Statistics Yearbook*, 1997; EBRD staff calculations.

Notes:

na not available. Totals may differ from the sum of individual columns due to rounding.

¹ Exports of merchandise only. Figures from national authorities for total exports give considerably higher figures for all three Baltic countries.

² Calculated as the total share of exports of goods to Russia, Belarus and Ukraine multiplied with the share of exports of goods in GDP. Indirect/second round effects are ignored.

³ Data for Albania and Bosnia and Herzegovina were not available from the IMF. National sources for Albania indicate only minor trade exposure to Russia.

Inflation continued to decline in a majority of the Bank's countries of operations in 1998

to have fallen to around 2.8 per cent compared with 3.6 per cent in 1997. None the less, the Slovak Republic and Slovenia have now joined Poland among the CEE countries where income levels exceed their 1989 level. Two of the countries less advanced in the transition – Albania and Bulgaria – showed a significant rebound of growth after severe crises in 1997, demonstrating the benefits of renewed commitment to stabilisation measures. In contrast, the Romanian economy continued to decline, by 4.5 per cent in 1998, reflecting underlying macroeconomic weaknesses, such as large fiscal and current account deficits, exacerbated by delays in implementing necessary structural reforms.

In the remainder of CEE, growth was remarkably resilient over the year, with the exception of the Czech economy, which had negative growth for the first time since 1992. The CEE region has benefited from the revival of domestic demand in western Europe, particularly in France and Germany. Growth fell significantly relative to the previous year, however, in the three Baltic countries.

Developments in the CIS in 1998 were affected by the recent events in Russia, and this has already had substantial implications for the remainder of the CIS. Although trade linkages have been much reduced since the beginning of transition, trade exposure (see table on page 17) meant that 1998 saw very few significant improvements (an exception being Turkmenistan following the collapse of gas exports and hence GDP in 1997). Ukraine shares many of the underlying structural weaknesses of Russia and has come under severe pressure following the devaluation of the rouble. As a result, economic recovery has been postponed yet again, and GDP is likely to have fallen around 1.5 per cent in 1998. The decline in oil and metal prices has significantly hurt Russia and all Central Asian economies, as well as Azerbaijan, albeit to varying degrees. Tajikistan also remains very volatile, given the continuing political disturbances there, and the sustainability of the reported high growth rates in Belarus is highly questionable.

Stabilisation

Inflation continued to decline in a majority of countries in 1998, helped by low commodity prices and the tightening of domestic liquidity following capital outflows from the region during the second half of the year. In CEE, achievements in the reduction of inflation in Albania and Bulgaria from high and hyper-inflationary levels respectively in 1997 are particularly notable, with the latter achieving a fall in the end-year inflation rate from over 500 per cent in 1997 to 1 per cent in 1998. Improvements in Romania have been slower to materialise, largely because of stalled economic and political reforms and rising fiscal imbalances. End-year inflation stayed close to 50 per cent in 1998. Elsewhere in CEE, inflation rates for 1998 were in single-digit or low double-digit figures. Latvia, Lithuania and FYR Macedonia now have end-year inflation rates close to or below the EU average of around 2 per cent, while Hungary and Poland, which are among the five countries of the region that have started the EU negotiation process, recorded end-year inflation considerably above this level.

In the CIS, the progressive reduction in end-year median inflation achieved over the previous years was not repeated in 1998 as the median rate increased from 13 per cent in 1997 to 18.3 per cent in 1998. Below this trend of moderately higher inflation lie very substantial cross-country differences, both in inflation rates and in the direction of change. In Armenia, Azerbaijan, Kazakhstan and Tajikistan, exchange rates held up in the face of significant pressure after the Russian crisis, and as a result these countries have experienced substantial reductions in inflation on the back of tight monetary policies and cheap imports from Russia. In the remainder of the CIS, exchange rate depreciation has driven inflation up, although only Russia and Belarus have experienced serious monetary destabilisation, with end-year inflation reaching 85 per cent and 178 per cent respectively in these two countries.

The reversal in macroeconomic stabilisation in Russia highlights the risks of a stabilisation strategy that relies almost exclusively on monetary policy and fails to address underlying fiscal imbalances. While governments may finance budget deficits temporarily through issuing securities on the region's nascent capital

markets, structural reforms need to be undertaken simultaneously to help close the financing gap. Otherwise, confidence may easily break down – leading as in Russia to a currency collapse and a serious financial crisis. Against this background, the continuing fiscal imbalances across many countries in the region are a cause of concern.

Revenue collection remains the most pressing issue in much of the CIS. In countries such as Georgia and Tajikistan, both of which have suffered serious internal conflict, revenues are barely 10-15 per cent of GDP. Estimates for 1998 indicate that the number of countries in the region with fiscal deficits exceeding 5 per cent of GDP grew from six in 1997 to eight in 1998, five of which are in the CIS.

Foreign direct investment

(net inflows recorded in the balance of payments)

	1994	1995	1996	1997 (revised)	1998 (estimate)	Cumulative FDI-inflows 1989-98	Cumulative FDI-inflows 1989-98 per capita	FDI-inflows per capita 1997	FDI-inflows per capita 1998	FDI- inflows as % of GDP in 1997	FDI- inflows as % of GDP in 1998
	(in millions of US dollars)						(in US dollars)		(% of GDP)		
Albania	65	89	97	42	45	423	132	13	14	1.9	1.5
Bulgaria	105	82	100	497	240	1,162	140	60	29	4.8	1.9
Croatia	102	88	529	346	700	1,874	416	72	156	1.8	3.4
Czech Republic	749	2,526	1,388	1,275	1,600	9,073	881	124	155	2.5	2.9
Estonia	212	199	110	130	400	1,208	833	90	276	2.8	7.4
Hungary	1,146	4,453	1,983	2,085	1,700	17,134	1,694	206	168	4.6	3.6
Latvia	155	244	376	515	200	1,584	634	206	80	9.3	3.2
Lithuania	31	72	152	328	950	1,563	422	89	257	3.4	9.2
FYR Macedonia	24	13	12	30	115	194	97	14	58	0.9	3.7
Poland	542	1,134	2,768	3,041	6,600	15,066	389	79	171	2.2	4.5
Romania	341	417	263	1,224	1,900	4,370	193	54	84	3.5	4.3
Slovak Republic	250	202	251	177	360	1,614	299	33	67	0.9	1.7
Slovenia	128	176	186	321	165	1,239	619	161	83	1.8	0.8
Central and eastern Europe and the Baltic states	3,851	9,694	8,216	10,011	14,975	56,503	368	65	98	2.0	2.8
Armenia	3	19	22	51	140	235	63	14	38	3.1	7.6
Azerbaijan	22	282	661	1,093	1,077	3,155	415	144	142	28.4	26.2
Belarus	11	7	70	190	50	344	34	19	5	1.4	0.3
Georgia	8	6	54	189	219	477	89	35	41	3.6	4.3
Kazakhstan	635	964	1,137	1,320	1,300	5,829	383	84	86	5.9	5.9
Kyrgyzstan	45	96	46	83	52	332	72	18	11	4.9	3.1
Moldova	18	73	56	64	100	342	79	15	23	2.9	5.8
Russia	539	1,710	1,700	3,752	1,500	9,201	63	25	10	0.8	0.5
Tajikistan	12	17	20	30	12	100	17	5	2	2.7	1.0
Turkmenistan	103	233	129	108	110	762	157	23	23	5.9	5.2
Ukraine	100	400	526	600	700	2,726	54	12	14	1.2	1.7
Uzbekistan	73	-24	90	167	170	533	23	7	7	1.2	1.2
Commonwealth of Independent States	1,568	3,783	4,511	7,647	5,430	24,036	85	27	19	1.3	1.3
Total	5,419	13,477	12,727	17,658	20,405	80,539	185	40	41	1.6	1.8

Sources: IMF, central banks and EBRD estimates.

Note:

For most countries, figures cover only investment in equity capital and in some cases contributions-in-kind. For those countries (e.g. Estonia, Slovak Republic) where net investment into equity capital was not easily available, more recent data include reinvested earnings as well as inter-company debt transactions. The increasing outward FDI flows of transition economies are driving a wedge between net and gross FDI inflows. For instance, in Croatia gross inward FDI was US\$ 346 million, whereas outward FDI flows amounted to US\$ 150 million.

External balances and capital flows

Fiscal deficits continue to be “twinned” in a number of countries with current account deficits. External balances in the transition economies in 1998 have been subjected to a combination of external shocks, including the impact of the Asian crisis on world markets (which has put severe downward pressure on commodity prices), and more recently a dramatic swing in Russia’s current account balance. After moving into deficit during the first half of the year, the devaluation of the rouble and the associated decline in demand for foreign goods has led to a positive end-year balance in Russia. This swing in Russia’s external balance is expected to have a deep impact on most countries in the CIS, and some countries in CEE, and has generally led to wider current account deficits in 1998 than were earlier anticipated.

High current account deficits have been a characteristic of a large number of transition economies in recent years. Current account deficits above 7 per cent of GDP were recorded in 15 countries in 1998 against nine such cases in 1997. Current account deficits have in the past been partially driven by substantial capital inflows, reflecting growing investment opportunities across the region and trends in global capital markets. In central European countries such as Hungary and Poland, current account deficits are associated with booming investment activity and intense restructuring of domestic production. Higher investment rates are contributing to better export performance, and thereby laying the basis for a future redemption of foreign liabilities incurred during the period of reconstruction.

However, with the reversal of liquidity conditions in the international capital market, only the most advanced reformers are likely to be able to continue to finance current account deficits with stable long-term flows. In many CIS countries, including Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Moldova and Turkmenistan, current account deficits and the loss of competitiveness *vis-à-vis* Russia have begun to trigger policy adjustments in the form of exchange rate depreciation and a tightening of the fiscal stance.

The Asian and Russian crises fundamentally altered conditions on international capital markets in 1998. While the 1990s were characterised by the rapid growth of private capital flows to emerging markets, the scale of losses made by international investors in Russia as well as in Asia is likely to moderate sharply their appetite for risk. Large institutional investors may retreat from these markets for some time. Moreover, the scramble for liquidity since mid-August

has led to “technical” sales by international investors to meet margin calls, driving down asset prices and leading to an outflow of short-term funds largely across all emerging markets.

None the less, the impact has been highly differentiated both across countries and across types of capital flows. Markets discriminate between borrowers on the basis of their macroeconomic fundamentals, and may have overreacted initially in some of the more advanced transition economies, which continue to display strong fundamentals. Spreads on international bond issues by borrowers from the region are already reflecting a sharp differentiation.

With respect to the types of capital flows, in the short run, countries relying on foreign direct investment (FDI) are likely to be less affected by the present volatility in international capital markets than countries where short-term portfolio investment played a major role in external financing. FDI in particular is motivated by the long-term economic opportunities in the region and comes together with significant changes in corporate governance in the recipient enterprises. Foreign direct investors therefore have both the ability and the incentives to maintain their assets through “voice” or active involvement, rather than through “exit”. Indeed, recent projections for FDI into seven major east European recipient countries do not suggest a significantly negative impact from the Russian crisis, except for Russia itself (see table on page 19). A slow-down of FDI inflows into the region is none the less a possibility, and it would become far more likely should governments delay structural reforms in response to external difficulties.

The impact on other types of capital flows is likely to be more pronounced than in the case of FDI. A number of transition economies postponed Eurobond issues planned for 1998, including Kazakhstan and Moldova. Syndicated lending will also be cut, as banks become more cautious lenders and take time to rebuild their capital – a process already in evidence during much of 1998. More immediately, a large number of countries, including the most advanced transition economies, were affected by an outflow of short-term portfolio investments in the domestic money and equity markets.

Financial crises in 1998 fundamentally altered conditions on international capital markets

However, the withdrawal from the fixed income markets of the Czech Republic, Hungary and Poland earlier in 1998 has already been largely reversed, whereas capital outflows from countries with weaker fundamentals, such as Romania, Russia and Ukraine, are unlikely to turn around in the near future. Most other CIS countries have not attracted significant

portfolio flows in the past. Official financing, including from the IFIs, should cushion somewhat the impact of external shocks to these countries' balance of payments, although countries such as Kazakhstan and Turkmenistan are also likely to experience a net outflow of short-term bank lending.

EU accession process shares common objectives with Bank's transition mandate

Accession to the European Union

Negotiations on accession to the European Union were initiated on 30 March 1998 with five countries of operations of the EBRD: the Czech Republic, Estonia, Hungary, Poland and Slovenia. The other accession countries among the EBRD's countries of operations are Bulgaria, Latvia, Lithuania, Romania and the Slovak Republic. The accession process will contribute to strengthening the institutional framework of applicant countries while fostering trade and investment in the region. For these reasons, the EBRD believes that accession to the EU will promote growth and stability in the countries concerned. The Bank recognises that the enlargement of the EU will have important implications for EBRD operations in advanced countries. The Bank's strategy also emphasises the common objectives shared by the EU accession process and the EBRD's transition mandate. In 1998 the level of EBRD investment in accession countries increased significantly.

To assist the accession to the EU, the European Commission is enhancing its financial assistance for the accession countries to promote the adoption of EU legislation. The European Commission took the initiative to coordinate with the EBRD and other IFIs to ensure that their combined activities in the accession countries achieve maximum impact. A memorandum of understanding between the EBRD, the European Commission and the World Bank, concluded on 30 March 1998, outlines principles of cooperation and establishes the eligibility and selection criteria for co-financing projects in the candidate countries. Regular high-level and Working Group meetings have been set up to facilitate cooperation and joint action. This process has already been launched for Phare, and it will also be extended to the new EU structural instruments for pre-accession and agricultural reform.

Co-investment is the main area of direct cooperation between the EBRD and the European Commission. In 1998 EU Phare co-invested ECU 60 million alongside the EBRD in environmental, municipal infrastructure and transport projects in accession countries. Further work took place during the year on the co-financing pipeline for 1999, in particular on two joint-finance facilities: the SME facility, targeting SMEs in accession countries; and the dairy facility, supporting Polish dairies in need of investments to meet EU standards. Both are expected to become operational in 1999.

The EBRD cooperates closely with the European Commission in key industrial sectors, such as steel, energy production, nuclear safety, the environment, transport and telecommunications. The Bank also continued to provide technical services to Phare and its beneficiary countries in 1998 on a cost-recovery basis. During the year EBRD bankers and lawyers advised the Czech Securities and Exchange Commission, the Agency for Industrial Development in the Slovak Republic and the Government of Romania on the design of new security and concession laws.

