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Growth, Productivity and Development

While the relationship between economic growth and sustainable development is complex, it is clear that the former is a precondition of the latter. Neither the scope of human freedoms, environmental equality, or protection against insecurity are likely to improve when incomes and consumption are shrinking. This has been amply demonstrated in the countries of the Commonwealth of Independent States (CIS), Southeast Europe, and the new member states of the European Union (EU). The 'transition recessions' that took hold during the early 1990s reduced household incomes and employment, and increased poverty, inequality, and insecurity. Likewise, the strong economic recoveries that have taken hold across this region since 1999 have been accompanied in many countries by significant reductions in income poverty, although progress in reducing inequality and the non-income dimensions of poverty in the region has been slower.

Economic growth reflects trends in productivity, particularly for labour (which is a key determinant of real wages and household incomes) and capital. In transition economies, prospects for improving labour and capital productivity are closely linked to the quality of institutions—particularly labour—and capital-market structures, but also state institutions. In turn, these structures are heavily influenced by the types of economic and governance reforms and policies pursued by governments. In this sense, prospects for growth and sustainable development are tied to the region's economic reform agendas, particularly in the CIS and Southeast European economies.

This issue of *Development and Transition* presents a compendium of articles that provide brief analyses of these issues written by some of the region's leading specialists on economic growth and productivity, affiliated with UNDP, the London School of Economics, and other research and policy centres. These include an overview of regional growth prospects (Ben Slay), and analyses of the evolution of capital- and labour-market institutions and legal structures (Saul Estrin, Andrei Sarychev, Art Durnev, Nicholas Maddock). It also includes articles on the Ukrainian economy (where GDP growth collapsed from 12 per cent in 2004 to 2 per cent in 2005—Akimova et al.), and on the importance of regional cooperation for economic growth and development in Central Asia (Jacek Cukrowski). Additional pieces focus on the quality of policy advice during the transition (Alf Vanags), and the difficulties in determining the drivers of growth in transition economies (Aghassi Mkrtchyan). Last but not least, this issue of *Development and Transition* includes an interview with UNDP Administrator and LSE alumnus Kemal Derviş who, as minister for economic affairs in Turkey and World Bank vice president, experienced many of these growth challenges first hand.

Ben Slay and James Hughes

Regional Economic Growth Prospects Through 2015

Ben Slay

Growth, poverty and development in the region

The countries of the Commonwealth of Independent States (CIS), Southeast Europe and the new EU member states, have accumulated a rather unusual economic growth record since the collapse of the Soviet bloc some 15 years ago (Table 1). The optimism of the initial years of transition (1990-1991) was confounded by the declines in output, incomes and living standards that followed immediately thereafter. Absolute poverty increased in many of these countries, and relative poverty rose virtually everywhere. While policy makers in Central Europe managed to get their economies growing during 1992-1993, for other countries in the region (and particularly the CIS) this "transition recession" lasted until the late 1990s. The beginnings of a broader economic upturn in the CIS were knocked sideways by the Russian financial crisis of 1998, while growth prospects in Southeast Europe suffered from the effects of the war in Kosovo in 1999, as well as the 1999 and 2001 currency crises in Turkey.

Table 1. Regional growth trends
Annual average GDP growth rates (unweighted averages)
source: National, EIU data, author's calculations

Region, country	1991-1995	1996-1999	2000-2005
New EU member states	-5%	4%	5%
- Baltic states (Estonia, Latvia, Lithuania)	-10%	4%	7%
- Central Europe (Czech Republic, Hungary, Poland, Slovakia, Slovenia)	0%	4%	4%
EU accession states (Bulgaria, Croatia, Romania, Turkey)	-1%	-1%	4%
Western Balkans (Albania, Bosnia and Herzegovina, FYR Macedonia, Union of Serbia and Montenegro)	-5%	2%	4%
CIS	-11%	2%	8%
- Russian Federation	-9%	-1%	7%
- Western CIS (Belarus, Moldova, Ukraine)	-12%	-1%	7%
- Caucasus (Armenia, Azerbaijan, Georgia)	-14%	6%	9%
- Central Asia (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan)	-9%	2%	7%
Overall	-7%	2%	6%

Since 1999, by contrast, the region's economies have amassed some of the world's best growth performances. With only the rarest of exceptions[1], as of 2005 these economies had recorded at least 6-7 years of unbroken GDP growth. Some of the highest growth rates have been recorded in the region's poorest economies, such as Tajikistan, Azerbaijan, and Armenia. By contrast, while Central Europe's leading transition economies consolidated their recoveries and acceded to the European Union (EU) during this time, their growth since 1999 has generally been much slower than growth in the CIS. Unemployment rates are much higher in Poland and Slovakia than in most CIS countries, although rates of absolute and relative poverty in the new EU member states are generally much lower than in the CIS.

Southeast Europe's economies have been something of an intermediate case. Annual GDP growth rates have accelerated in Bulgaria and Romania to the 5-7% range with the increasing likelihood of EU accession in 2007 (or 2008). Turkey has bounced back strongly from its currency crises, reporting average annual GDP growth above 7 per cent during 2002-2005. On the other hand, growth has slowed from the high rates of the late 1990s in Bosnia and Herzegovina and Albania. Macedonia has been the region's post-1999 growth slowcoach, while (along with Serbia and Montenegro, and Bosnia and Herzegovina) consistently reporting exceptionally high unemployment (although not necessarily high poverty) rates.

Economic growth does not, of course, automatically translate into poverty alleviation and sustainable human development. But without economic growth, the prospects for achieving the Millennium Development Goals (MDGs) through improvements in human development are bleak, to say the least. It is no accident that the World Bank's recent study on poverty in the region shows that declines in absolute poverty have accompanied the strong post-1999 economic recovery (World Bank, 2005). By the same token, prospects for achieving the MDGs in the region are closely linked to the continuation of these favourable post-1999 economic growth trends. What, then, are the drivers of the region's strong post-1999 growth, and what are the factors that could threaten its continuation between now and 2015?

Growth in transition economies

In many respects, transition economies grow for the same reasons that all economies grow. These can be reduced to increases in the quantities of productive inputs—labour, capital (in its physical and human forms), and natural resources—as well as the introduction of new technologies and better management. In addition, transition economies also experience what Yegor Gaidar has termed "recovery growth" (Gaidar, 2004), which can be described as:

- bouncing back from the economic dislocation and military conflicts (in the Balkans, Caucasus, Moldova and Tajikistan) of the early years of transition;
- the result of productively redeploying resources that had been trapped in inefficient uses during socialism; and
- progressive improvements in the quality of the decisions made and policies implemented by governance institutions.

In addition, four other factors have played critical roles in the region's post-1999 economic recovery: (i) favourable global economic trends (particularly in terms of world trade and investment flows, as well as terms-of-trade gains); (ii) European integration; (iii) Russia's role as the CIS's economic locomotive; and (iv) the absence of recent currency crises. Should reversals be suffered along these dimensions, the region's prospects for meeting the MDGs would worsen considerably.

Favourable global economic trends. Every economy in the region relies heavily on global and/or regional economic integration. Virtually all the CIS economies export natural resources or other primary products, such as energy (Russia, Kazakhstan, Azerbaijan, Turkmenistan, Kyrgyzstan), metals (Ukraine, Kyrgyzstan, Tajikistan), or agricultural and food products (Moldova, Uzbekistan, Ukraine, Belarus). Energy exporters benefited tremendously from the sharp increases in global energy prices that began in 1999, and from generally high (although with some variation) prices for cotton, grain, metals, and other primary products. Energy importing countries also benefited from the fact that Russia did not raise gas prices to world levels as quickly as could have been the case.

Thanks to large foreign direct investment (FDI) inflows, the new EU member states, as well as Romania, Bulgaria and Turkey, have dramatically increased exports, both to European markets and beyond. Rapid growth in global trade in transport, tourism, and financial services has also benefited Ukraine and Belarus, the Baltic states, and the countries of Southeast Europe. Growing import demand in China has boosted Central Asian exports, while continued growth in FDI and portfolio investment inflows has been fuelled by strong investor interest in emerging markets. As a result, no country in the region during 2000-2005 experienced the kind of external shocks felt by Russia in 1997-1998, when the price of a barrel of oil collapsed below $10 and foreign investors lost interest in emerging market risk.

European integration. The prospect of EU accession played a critical role in the successful transformation of the Central European and Baltic economies. Preferential access to the EU's single market, low unit labour costs, and accession-related reforms that improved business and investment climates helped these countries to attract significant FDI and portfolio investment. These inflows modernised these economies, helping them to withstand the competitive pressures of the single market, while simultaneously financing rapid growth in consumption and imports. European integration is helping the new member states to transition from "recovery growth" to "convergence growth", in which growth in foreign trade and investment in export-oriented sectors reflect the convergence of living standards and competitiveness towards levels present in other EU countries.

These lessons have not been lost on Southeast Europe, where the emulation of the reforms introduced earlier in the new member states is attracting growing amounts of FDI. Although living standards in Southeast Europe generally remain well below Central European levels, a number of Balkan countries—particularly Romania and Bulgaria—now seem increasingly well placed to repeat Central Europe's successes.

Russia's economic revival. The volume of Russia's imports from other CIS countries nearly tripled during 2000-2005. Since Russia remains the single largest market for manufactured exports (including foodstuffs) from other CIS countries, this strong Russian import growth has provided an important boost to industrial and agricultural production in the CIS. But the importance of Russia's revival for the other CIS economies goes well beyond trade. According to central bank data, by the end of 2005 Russia had amassed some $6 billion in foreign direct investments in other CIS countries. The capital and managerial expertise needed to modernise the other CIS countries' leading companies (typically in the energy and metallurgical sectors, but also food processing and increasingly finance) is increasingly coming from Russia. Nearly $4 billion was transferred from Russia to other CIS countries in the form of worker remittances and other transfers in 2004. In addition, Russian companies supply some $4 billion annually in transportation, financial, and tourism services to other CIS countries.

After Western investors lost interest in CIS markets following the 1998-1999 financial crisis, Russian investors stepped in to pick up the slack. Denied legal access to labour markets in OECD countries, millions of migrant labourers from other CIS countries are finding gainful employment in Russia. Russia's importance for the poorer Central Asian economies is particularly pronounced: Russia is the largest trading partner, the largest source of foreign investment, and the largest source of remittance income for Kyrgyzstan and Tajikistan.

Stable currencies. The currency crises experienced by the Soviet and Yugoslav successor states in the early 1990s, and again in Bulgaria in 1996, the Czech Republic in 1997, Russia and many other CIS countries in 1998-1999, and Turkey in 1999 and 2001, had very unfavourable implications for poverty in these countries. Sliding exchange rates boosted inflation and unemployment rates, and cut into household incomes and spending. The loss of confidence in national currencies threatened the solvency of healthy as well as weak financial institutions. In Russia, Bulgaria, and elsewhere, the panic buying that accompanied bank failures caused goods to disappear from store shelves.

The region is fortunate in that memories of these events are now fading. Instead, most of the region's currencies have appreciated against the dollar since 2002. Stronger exchange rates are making imported consumer and investment goods more affordable, raising living standards and improving competitiveness. Growing confidence in national currencies is increasing banking deposits, allowing banks to lower interest rates and offer more credit to domestic companies—including growing numbers of small and medium-sized enterprises.

"Let the good times roll" Or "Nothing lasts forever" ?

There is nothing in the region's current economic circumstances to suggest that these growth trends must quickly come to an end. On the other hand, a closer examination of the drivers of growth does point to their time-bound nature. For example:

"Recovery growth" does not last forever: at some point, the gains from re-engaging idle or misallocated resources must diminish. This is already becoming apparent on labour markets: declining populations and low labour force participation rates in many countries are keeping labour supply from keeping pace with labour demand. This is particularly the case in urban areas where foreign investment is often concentrated. Moreover, the capacity to adopt better economic policies is no guarantee of their actual implementation. For example, the sharp slowdown in economic growth experienced by Ukraine in 2005 has been partly attributed by at least some observers to reversals of reforms in tax policy and privatisation.

"Convergence growth" works well when exports from the new EU member states occupy only a small fraction of the relevant segments of the EU's single market. But because the Euro region as a whole is growing only slowly (1-2 per cent annually), sooner or later growth rates in the new member states will start to "converge downward" towards these levels. Moreover, while developing the state capacity needed to implement the *acquis communautaire* helped the new member states to improve their business climates and attract investment, the adoption of such "made in Brussels" regimes as the common agricultural policy can be expected to reduce growth.

Favourable global economic trends will not last forever. For example, rapid growth in public and external debt in the United States accumulated by the Bush Administration's fiscal and external deficits could precipitate a sharp external adjustment for the American economy, which would have a negative impact on exporters everywhere, including in the European and CIS economies.

Exchange rates: Too high, or too low?

2005 marked the fourth consecutive year of stable exchange rates for the region—its longest stretch of currency stability since 1990. Ironically, the threat of a currency crisis may now be greatest for some of the region's most advanced economies—those new EU member states that are seeking to adopt the Euro and join the Economic and Monetary Union (EMU). Euro wannabees must spend two years in the European Monetary System (EMS—the "EMU waiting room"), during which time they must observe the Maastricht treaty's "convergence criteria" for fiscal and monetary stability. Compliance with these criteria—particularly for price and exchange rate stability—could prove difficult for relatively dynamic transition economies. New EU member states that seek to reconcile exchange rate stability with relatively high inflation rates (Latvia) or large fiscal deficits (Czech Republic, Hungary, and Poland) could find their currencies vulnerable to speculative attacks. At present, these worries seem greatest in Hungary, which on a number of occasions during 2004-2005 had to raise interest rates in order to defend its currency.[2] Upcoming elections in the Czech Republic and Hungary, and the difficulties facing Poland's new minority government, suggest that rapid fiscal adjustments in these countries are unlikely.

In many countries, however, current debates on exchange rate policies are dominated by fears of the "Dutch disease" and excessively strong currencies. Azerbaijan, Estonia, Kazakhstan, and Russia have established off-shore stabilisation funds to keep large foreign exchange inflows from putting upward pressures on real exchange rates. Many countries in the region, including the new EU member states and those accession countries that do not have currency boards, are using gradual nominal exchange rate appreciation to slow inflation. Such "inflation targeting" strategies can be very difficult

for central bankers to manage—particularly if they ultimately want to fix their currencies against the Euro and join the EMU. But while the difficulties of meeting the Maastricht convergence criteria may be substantial, the benefits of adopting Europe's single currency—and putting fears of currency crises to rest—are generally seen by policy makers as even more compelling.

Energy prices: The biggest uncertainty?

Perhaps the greatest short-term threat to growth prospects (at least for the CIS countries) lies in energy prices. The sharp post-1999 increases in world oil and gas prices have provided energy exporters like Russia, Kazakhstan, Azerbaijan, and Turkmenistan with huge terms-of-trade gains, which have in turn been "recycled" to other CIS countries in two ways. First, Russia's soaring energy export revenues have fuelled the rapid import growth that is absorbing other CIS countries' manufactured exports. Second, because the prices Russia charges for energy exports to CIS countries have been well below prices paid by West European customers, Russia has subsidised energy-intensive manufacturing sectors in other CIS countries, particularly Ukraine and Belarus.

Table 2: Russian Gas Export Price Trends (2005-2006)

Source: BOFIT weekly, 5 January 2006 ; author's calculations.

	Yearly gas price (per 1000 m^3)		
Region, country	**2005**	**2006**	**2006 increase**
Western Europe*	$174	$250	44%
- Germany	$200		
- Slovakia, Slovenia	$180		
- Poland	$120		
- Baltic states	$85 - $95	$120 - $125	26% - 47%
CIS*	$60	$105	75%
- Armenia	$56	$110	96%
- Azerbaijan	$60	$110	83%
- Belarus	$47	$47	0%
- Georgia	$68	$110	62%
- Moldova	$80	$160	100%
- Ukraine	$50	$95	90%

* Unweighted averages.

As the Russian gas export price data in Table 2 indicate, these subsidies are now being reduced. CIS countries are facing large increases in imported energy costs in 2006, and beyond. In relative terms, these increases are well above the price hikes being absorbed by the European Union, since these countries (with the partial exception of the Baltic states) are already accustomed to paying world prices for imported energy. Moreover, because even the higher prices the CIS countries will pay for gas imports in 2006 are still well below world levels, energy import costs could continue to rise steeply after 2006, irrespective of subsequent world price trends. Whether the energy-inefficient CIS economies can sustain their industrial growth in the face of these price pressures remains to be seen.

On the other hand, sharp reductions in world energy prices, should they occur, could easily slow economic growth rates in Russia, Kazakhstan, Azerbaijan, and Turkmenistan. While these lower prices would benefit energy importing countries in the CIS (as well as in Southeast Europe, the new EU member states, and elsewhere), they could also slow the Russian import growth that has supported export growth in other CIS countries. Paradoxically, both today's high energy prices, and scenarios of sharp reductions in these prices, contain risks to growth trends in the CIS.

From growth to development

The strong post-1999 economic growth has not been a panacea for the region. The reductions in absolute income poverty levels produced by this growth have not been matched by commensurate improvements in relative poverty, or in the non-income dimensions of poverty. Significant pockets of poverty and regional disparities are present even in the new EU member states, affecting in particular Roma, and the residents of small towns and villages in eastern Poland, Slovakia, and Hungary. Extensive out-migration from rural areas is depopulating the countryside in many parts of the Balkans and the CIS. The economic growth recorded in the CIS and Southeast Europe has yet to translate into sustained improvements in environmental quality, and the remediation of many Soviet-era ecological hot spots has not yet begun. Signs of a turnaround in the worrying demographic and epidemiological trends afflicting many CIS countries—particularly apparent in high mortality rates and the rapid growth in HIV/AIDS and tuberculosis—are few and far between. Economic growth may be a necessary condition for sustainable development, but it is not a sufficient condition.

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1 Macedonia in 2001 (the year of civil conflict) recorded a 4.5 per cent GDP decline, and Kyrgyzstan in 2002 reported no economic growth.

2 On the other hand, successful EMS entry by Estonia, Lithuania, Slovakia, and Slovenia during 2005-2006 indicates that the adoption of the Maastricht criteria need not be the kiss of death for transition economies.

Gaidar, Y. (2004), "Recovery Growth and Key Features of the Current Economic Situation in Russia", Problems of Economic Transition, February, pp. 6-23.

World Bank (2005), Growth, poverty, and inequality: Eastern Europe and the Former Soviet Union, Washington D.C., November.

Privatisation in Transition Economies: What Did it Achieve?

Saul Estrin

Privatisation plays a central role in transition economies. Indeed, if the share of public ownership is a measure of socialist control, then progress in transition is indicated by the growth in the private sector share. But because almost the entire industrial sector was in state hands under the communists, privatisation in transition was no small task. This condition forced innovation in privatisation methods, leading to the widespread use of "mass privatisation"- distributing state assets at a zero or nominal price. Privatisation was very successful, in the sense that the state sector was rolled back rapidly everywhere. The bigger questions, which are the subject of this article, are whether privatisation also enhanced company performance and improved economic growth - and, if not, whether this was because of the methods of privatisation used.

Privatisation Methods

Every country used a variety of privatisation methods. For example, small firms were usually sold to the highest bidder, and utilities were floated on stock markets. However, it was possible by the time the bulk of privatisation was completed in the late 1990s, to discern the predominant method used in each country (see EBRD Transition Report, 1998). Mass privatisation was the most common; nineteen of the 25 countries listed used it as either a primary or secondary method. Management Employee Buyouts (MEBOs) were also important, with nine countries using them as their primary method, and six more as their secondary. Most transition economies therefore eschewed conventional methods of privatisation by direct sale: only five countries, themselves among the most developed, used this as their primary method.

Privatisation Outcomes

Few countries contained a private sector of any significance in 1990, except for Hungary and Poland, where the private sector already represented over 30 per cent of GDP. This makes the growth in the private sector share during the 1990s, reported in Table 1, even more dramatic. In only five years, the private sector share was above 50 per cent in nine countries, though in eight countries in the Commonwealth of Independent States (CIS), it remained below 30 per cent. By 2002, the private sector in thirteen additional countries had reached at least 50 per cent of GDP; only Belarus and Turkmenistan still had private sector activity at 25 per cent of GDP. Thus the privatisation process was in most countries effective in transferring the bulk of economic activity from state to private hands in the space of hardly more than a decade.

The Impact of Privatisation on Firms

Summary studies (e.g. Djankov and Murrell, 2002) usually conclude that the impact of privatisation on company performance has been positive and significant, though not in every circumstance. Most also conclude that the effect of privatisation on company performance has been much greater in Central Europe than in the CIS.

Two factors are usually cited as influencing whether privatisation enhances company performance. The first is the nature and characteristics of the new private owners. When the new owners are foreign firms, the improvement in most performance measures is quite marked. There is also some evidence that privatisation to domestic private outsider owners improves performance, though it can be important for the ownership shares to be concentrated. However, there is hardly any evidence indicating that company performance is improved when firms are privatised to insiders, either managers or workers. This is probably because insiders exploit their control to resist (rather than promote) the changes required to make firms competitive in the market environment. Insider ownership was a fairly common phenomenon, especially in the CIS. This probably goes some way to explain the weaker economic performance in many of those countries, compared to, for example, Hungary, Poland and the Czech Republic, where foreign direct investment flows have been much greater.

The second factor is the institutional and business environment in which privatisation takes place. Privatisation underscores the importance of corporate governance, which depends on a competitive market environment and the enforcement of property rights. In countries where the legal system is not functioning effectively and businesses face high levels of corruption and weak financial discipline, private ownership may not be sufficient to improve performance.

It is often argued that these deficiencies of governance and institutions can be traced back to the methods of privatisation, in particular the widespread use of mass privatisation. This argument has been strengthened by country studies highlighting problems of weak governance, corruption and tunnelling in the Czech and Russian mass privatisation programmes.

The Impact of Privatisation on Growth

There have been relatively few studies on the impact of private sector development on growth. However, Bennett, Estrin and Urga (2005) find that private sector development enhances growth, using a panel data model for 26 transition economies, 1991-2003. This study finds that a 1 per cent increase in the share of the private sector in GDP is found to increase GDP growth by 0.18 percentage points.

Figure 1.
GDP Growth and Private Sector Development

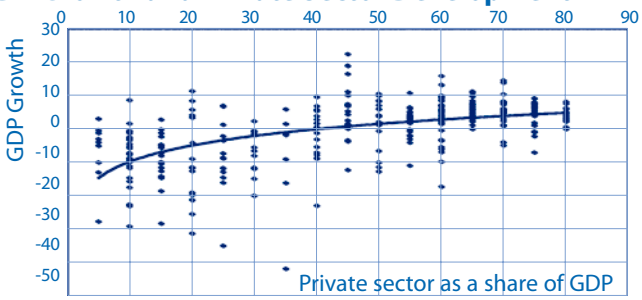

Figure 1 plots the relationship between GDP growth rates (ΔGDP) and the private sector share of GDP (PRIVSECT) in all the transition economies over the period. It shows that the relationship is positive, though with a diminishing effect and with higher variances in growth rates when the private sector share is lower. In a regression also containing country and time specific fixed effects, the relationship (figures in parentheses are t-statistics) was found to be: ΔGDP = -4.262 (-1.36) + 0.115 (1.73) PRIVSECT.

Bennett, Estrin and Urga (2005) also show that GDP growth in transition economies is driven by the same fundamental factors as in developed Western economies: employment growth, capital accumulation and improvements in human capital. They also find that only mass privatisation enhances growth in a statistically significant way. Sales of state owned firms and MEBOs do not accelerate the rate of growth. They link this to the speed with which mass privatisation allows firms to be removed from the state sector, and therefore for budget constraints to be hardened.

Conclusion

The most impressive feature of privatisation in transition economies has been the speed and scale at which it has occurred. The reforming governments of the late 1980s and early 1990s managed successfully to transfer the huge state owned sector into largely private hands in a time period of hardly more than a decade. Even so privatisation appears to have led to improved company performance, especially when the new owners are foreign or concentrated domestic ones. Privatisation has also apparently enhanced growth and provided governments with much needed revenues. Finally, while the micro-economic evidence appears to suggest that weak or perverse effects from privatisation may be associated with some methods of privatisation (in particular mass privatisation), our study demonstrates that this does not seem to have any appreciable influence on macro-economic outcomes.

Saul Estrin is a Professor of Economics and the Adecco Professor of Business and Society at London Business School. In August 2006 he will take up his new position as Convenor of the new Department of Management at the London School of Economics and Political Science.

Bennett, J., Estrin, S. and Urga, G. (2005): Privatisation and Economic Growth in Transition Economies, forthcoming.

Djankov, S. and Murrell, P. (2002): 'Enterprise Restructuring in Transition: A Qualitative Survey'. Journal of Economic Literature 40 (3): 739-793.

EBRD Transition Report (various years). European Bank for Reconstruction and Development, London.

Table 1: Private sector share in GDP and employment in Europe and CIS, 1989-94

	In GDP			In Employment		
	1991	1995	2002	1991	1995	2001
Albania	24	60	75	..	74	82
Armenia	..	45	70	29	49	..
Azerbaijan	..	25	60	..	43	..
Belarus	7	15	25	2	7	..
Bosnia and Herzegovina	..	..	45	..	..	..
Bulgaria	17	50	75	10	41	81
Croatia	25	40	60	22	48	..
Czech Republic	17	70	80	19	57	70
Estonia	18	65	80	11	..	..
FYR Macedonia	..	40	60	..	..	..
Georgia	27	30	65	25	..	..
Hungary	33	60	80	…	71	…
Kazakhstan	12	25	65	5	..	75
Kyrgyz Republic	..	40	65	..	69	79
Latvia	..	55	70	12	60	73
Lithuania	15	65	75	16	…	…
Moldova	..	30	50	36	..	..
Poland	45	60	75	51	61	72
Romania	24	45	65	34	51	75
Russia	10	55	70	5	..	..
Serbia and Montenegro	..	..	45	..	..	..
Slovak Republic	..	60	80	13	60	75
Slovenia	16	50	65	18	48	..
Tajikistan	..	25	50	..	53	63
Turkmenistan	..	15	25	..	..	..
Ukraine	8	45	65	..	..	..
Uzbekistan	..	30	45	..	..	..
Means	20	44	62			

Sources: EBRD Transition Report 1999, 2003

A Funny Thing Happened on The Way to The Market

Andrei Sarychev

To make the market work, the recipe calls for institutions. The difficulty is, they are almost invisible where they work, and hard to transplant. The good news is, the ingredient seems to be self-raising.

When socialist countries started market reforms, no Western economic advisor predicted the output decline that followed. This was a major puzzle in the 1990s; researchers of all persuasions and affiliations rushed in to offer an explanation, and indeed many causal factors contributed to the precipitous fall. Perhaps the best catch-all term for these factors is *disorganisation*, coined by Blanchard and Kremer. Economic actors in transition economies, even when subjected to market incentives, failed to organise mutually profitable agreements among themselves, because these proved hard to enforce. Suddenly the economics profession felt less sure about the standard neoclassical prescription that liberal legislation and strong law enforcement agencies should suffice to make the market work effectively. A reappraisal of the process of transition came about with the renewed interest in the new institutional economics in the mid-1990s. This literature emphasised multiple formal and informal mechanisms allowing firms and individuals to overcome problems of incomplete trust. Why should a society care? Because the lack of trust quickly reduces all economic activity to bartering, obliterating hopes of economic growth. Let us consider an example of ubiquitous arm's length inter-firm relationships.

Institutions based on community sanctions: Business associations

In a business partnership, whether the contract requires a partner to simply pay up for a shipment, or undertake an investment into a joint project, this typically requires trust. Unless there are ways to make their partners pre-commit to the terms of contract, firms prefer not to expose themselves to risk. When this happens, firms gear their production structure towards more primitive contracts, sometimes resorting to "bricks for vodka" deals.

Simply bringing the legislation up to standard and strengthening law enforcement agencies does not help much. Even in mature market economies, contracts are maintained both by invoking law and informal mechanisms, with the latter predominating. The simplest informal mechanism the economic theory studies is relational contracting. Firms care about maintaining bilateral relationships, because cheating a partner is penalised by forfeiting mutually profitable business in the future. In a growing dynamic economy this type of contracting has a disadvantage: established relationships tend to petrify: for example, firms hesitate to try out new partners even when that's more profitable. Economic theory offers a superior alternative to bilateral contracting in the form of community sanctions. Contract breach is prevented by the threat of a boycott by a *coalition* of firms. The coalition facilitates information flows and coordination, ensuring that offenders will lose their custom.

Empirical support

In a series of papers based on the large-scale 1997 EBRD survey of industrial enterprises in Poland, Romania, Russia, Slovakia, and Ukraine, Johnson, McMillan and Woodruff explored realities of contract enforcement. They found that the insecure contractual environment was the primary obstacle to investment, not the lack of outside finance. Members of business and social networks extend more trade credit and start new business relationships more often; they have higher chances of amicable dispute resolution and partnership survival; they also actively share information regarding contract violations. Most importantly, they perform better. The spontaneous emergence of new business networks was documented in the 1994 World Bank survey of Russian enterprises.

Other informal institutions

In publicly held companies, controlling shareholders have a variety of methods to expropriate the minority shareholders, not all of them prosecutable in a court of law (see Art Durnev's article on investor protection in this issue). A "thick" stock market where minority shareholders can choose among many competing shares provides a natural enforcement mechanism: the bad behaviour of majority shareholders affects their ability to attract funds after the abuse. Independent market analysts and private arbitrators help to disseminate information about malpractice and resolve uncertain cases. Hired managers face incentives to strip assets, expand beyond necessary, or simply choose sub-optimal corporate strategies that minimise their effort. The market for managerial labour and the takeover market serve as natural antidotes. The former punishes bad managers directly, damaging their future prospects for lucrative posts. The latter trades badly managed companies at a discount, which provides incentives for raiders to oust the management. There are many other examples of how the creativity of private agents, markets and informal institutions successfully substitutes for the Leviathan of the state (see Handbook of New Institutional Economics).

That institutions emerge spontaneously does not imply that economists and policy makers should not care about them. Good policies can significantly speed up the spontaneous processes, reinforce and cement informal market economy mechanisms.

Informal institutions: implications and the need for interdisciplinary collaboration

The hypothesis that the majority of contracts are enforced through informal mechanisms changes one's view on the policy priorities. Policies that, on the surface, have nothing to do with contract enforcement, may be extremely beneficial. Promoting stock market development, can have an impact on the quality of corporate governance. Competition policy can increase the number of players in financial, labour, and product markets, making community sanctions more effective. Land reform can increase overnight the stock of collateral, used to back up arm's length contracts. This suggests a more "holistic" view of optimal policy, promoting harmonious development in the diverse parts of the economy.

Many transition countries have made impressive progress in institution building, despite the fact that this was hardly on the agenda of the reformers. However, the progress could be swifter and more substantial, if an institutions-centered view were adopted earlier. Luckily, things are evolving in the right direction. From the initial neglect, institutional aspects have gained in prominence (over 35 per cent of journal articles on transition after 2002 involve discussion of these issues).

Yet the empirical appraisal of the role of informal institutions is still in its early days due to the data limitations. The few existing firm-level surveys dealing with contractual discipline are all limited in scope and quite dated. Social scientists from a variety of fields, data-collecting agencies and policy practitioners are in a position to provide help with building quantitative datasets on contract enforcement, whenever they venture to survey firms and individuals for their own purposes. At the rate institutional development is proceeding in Eastern Europe, soon students of this process will have nothing left to analyse if they do not self-organise.

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Capital Markets in Transition

Art Durnev

Functioning capital markets as a prerequisite for economic growth

In the 1990s, transition economies experienced both the privatisation of state companies and the creation of stock markets. Neoclassical economics argues that well-functioning capital markets are a prerequisite for economic development. Capital should be allocated towards the most productive use. To this end, capital markets mobilise and pool savings, facilitate trading, and improve diversification and risk management. Moreover, informative stock prices convey meaningful signals to managers (about the quality of their decisions) and to investors (if there is a need to intervene when the management's decisions are poor). The quality of corporate governance mechanisms such as shareholder lawsuits, executives' compensation, institutional investor pressure and merger and takeover markets depends on whether stock prices are trustworthy indicators of firms' value.

Numerous studies link financial development with faster economic growth. For example, Bekaert, Harvey and Lunblad (2001) find that in emerging markets financial liberalisation increases economic growth by up to 2 percentage points per annum.

Underdeveloped capital markets as a source of (often illegal) self-enrichment

The paths that transition economies have taken towards sounder capital markets are far from exemplary. In Russia and elsewhere mass privatisation enriched some oligarchs and created others; some of those made fortunes siphoning corporate wealth at the expense of minority shareholders. This investor expropriation, also called tunneling, can take many forms: self-dealing transactions by the insiders, transfer pricing, excessive managers' pay, risky loans, fraud with financial statements, outright stealing, dilutive share issuance, and trading on insider information.

Black et al. (1998) document cases in Russia where controlling shareholders increased company capital by as much as 10,000 per cent and placed the newly issued equity in the hands of their friends at a discount of at least 50 per cent to its market value. Similar targeted equity increases at discounts as high as 90 per cent happened in Bulgaria (Atanasov et al. (2004)). Widespread dilution of minority stakes can dramatically reduce the usefulness of stock markets, depressing equity valuations and stalling trade.

Regulatory environments and capital markets

Glaeser, Johnson, and Shleifer (2001) document that prior to reforms in 1994, the Czech stock market was twice as large as the Polish market in terms of the number of listed companies, and five times larger in proportion to GDP. Unlike the Czech Republic, which adopted a more laissez-faire stand towards securities regulations, Poland introduced restrictive investor protection and disclosure laws. Perhaps more importantly, the Polish government created the independent Securities Commission, charged solely with supervision of securities markets and possessing discretionary powers (e.g. revoking trading licenses of offenders without judicial recourse). In the Czech Republic a similar task was assigned to a small office in the Ministry of Finance, which remained largely indifferent to regulating securities markets.

The Polish Securities Commission's independence provided it with greater incentives to find violations than the Czech Ministry of Finance enjoyed. As a result, there were only a few governance scandals in Polish markets. New regulations enforced by the powerful watchdog increased investor confidence, fostered rapid capital market development and lowered the cost of financing for Polish companies. In contrast, the lenient stance of the Czech Republic combined with corruption in its judicial system led to rampant stealing of corporate resources and the transfer of wealth from minority to controlling shareholders and government officials. This undermined investor confidence, which lead to much slower development of the Czech financial system. By 1998, the valuation of the Polish market increased almost sevenfold whereas the valuation of the Czech market was only double its 1994 value. Few Czech companies were traded on the market, and most of them had to be delisted by the late 1990s.

Reform priorities

The corporate governance scandals in North America after 2000 and East Asia during the 1998 crisis served as cautionary tales for reformers in transition countries. Strengthening the institutional base and transforming legal systems became policy priorities in order to ensure better protection for investors.

The current reforms are mainly aimed at strengthening general property rights protection, improving investor rights, introducing better accounting standards and enabling local firms to source capital globally. This is important because the providers of capital need guarantees of the adequate return on their investment. Stringent accounting standards improve transparency and enhance investor confidence in capital markets.

Openness to global financial markets enables local entrepreneurs to acquire foreign capital backing. It also gives local investors alternative investment opportunities when local capital markets are monopolised by a few large players. Many companies in transition economies opted to source capital globally by listing their shares on major international stock exchanges (e.g., New York, London). While cross-listing on those exchanges subjects managers and controlling shareholders to stricter governance and disclosure standards (see e.g., Doidge, Karolyi and Stulz (2003)), it is a costly process, which only large and well-known firms can afford.

Internal corporate governance practices matter too

It is not only the quality of laws and regulations that matter in the development of capital markets but also firms' internal corporate governance practices. Durnev and Kim (2005) dispel the stereotype that all firms in weak institutional environments suffer from poor corporate governance. They show that firms with good invest-

ment opportunities voluntarily practice better governance and disclose more information. Good governance practices do not go unnoticed by the capital markets – shareholder value grows, making the effort worth the cost. In Durnev and Kim's study, an increase in firm governance score of 10 points (out of 100 maximum) increased the firm's market value by 9 per cent. This is good news for firms in countries with little or no institutional protection of outside investors: *Thou shall not steal and thou will be rewarded.*

Still a long way to catch up

Capital markets in transition economies are still immature compared to those in developed countries. Local and international investors will not part with their money and capital markets will not survive unless investors are confident that managers and controlling shareholders are honest. Governments of transition economies should improve regulatory and legal environments to make local capital markets an effective instrument of economic development.

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'Jobless Growth' in Macedonia

Nick Maddock

Economic growth is desirable in part because it generates employment, as well as income. In some countries in the Western Balkans, however, the economic recoveries of the last few years have been described as generating 'jobless growth', as unemployment rates have remained very high by international standards. While these stagnant employment trends may reflect solid growth in labour productivity and real wages, they also indicate that the benefits of the recoveries are not widely spread across the labour force. This is particularly the case in the Former Yugoslav Republic of Macedonia, where unemployment rates have consistently been above 30 per cent and have risen during the economic recovery that followed the civil conflict in 2001. Recent UNDP research shows that labour markets in Macedonia are very stagnant. This is apparent in the low rates of job creation, job destruction and job turnover compared to other transitional countries now and at similar stages in transition.

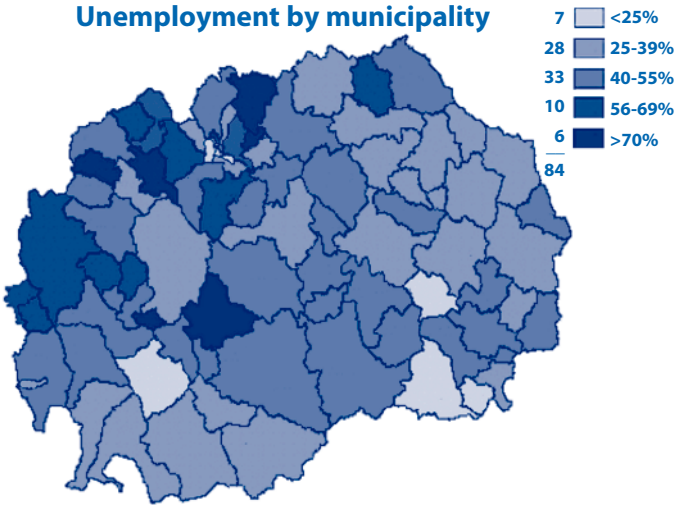
Job creation and destruction in Macedonia

UNDP estimates from large samples show that, in 2002-2004, Macedonia had job creation and destruction rates of around only 1 per cent. In comparison, Croatia in 2001 had a job creation rate of almost 4 per cent and job destruction of 5 per cent, while, in Lithuania in 1998-99, job creation and destruction rates were both 10 per cent and, in Bulgaria in 2000, 7 per cent and 11 per cent. In addition, the job creation rate in Macedonia has fallen since 1998 and is now similar to levels measured in 1995 and 1996. As in Croatia, there is surprisingly little variation between different parts of the country despite big differences in unemployment (with variations from less than 25 per cent to more than 70 per cent) with many of the sharpest spikes in the north-west, where the ethnic Albanian population is concentrated and which was the focus of the fighting during the 2001 crisis.

As expected, the private sector does better than the public sector in job creation, although still more private jobs are being destroyed than created (and public sector job destruction rates are now lower than the private sector). The difference is not as great as in Croatia, where private sector job creation rates in 2001 were double those in the public sector. The highest job creation rates are in small and medium enterprises employing up to 250 people, while job creation rates in larger private firms (more than 250 employees) are below national averages. This means that job creation in Macedonia is still concentrated in the emerging private sector, which has yet to produce many successful larger firms. Job creation is highest in low value-added sectors (wholesaling, retailing, and motor vehicle repair) and in the hotel and restaurant business, but these and most other sectors are still shrinking in employment terms with more jobs being destroyed than created. Only financial intermediation, education, health, and real estate services are expanding, while employment in agriculture and the public administration is stable.

These trends suggest that the labour productivity 'catch-up' associated with earlier overmanning in state and

socially-owned firms is still taking place. State enterprises are now facing intense competitive pressures in and from the emerging private sector, forcing them to reduce costs and employment and improve productivity. This all points to low demand for labour, which is at odds with the need to reduce unemployment. And while weak job creation rates rather than severe job destruction explain continuing high unemployment in Macedonia, evidence from other transition economies shows that higher job destruction rates are a



sign of restructuring and efficiency gains—workers are moving to more productive employment, either within the same industry or to new industries as old ones decline. Overall, a vibrant labour market with higher rates of job creation, destruction and turnover is better, in terms of economic growth and productivity, than when job destruction is kept low.

Policy responses

The Macedonian example underlines the importance of removing structural and legal barriers to job creation. Doing business in Macedonia is still not easy: Macedonia ranked 81st out of 155 countries in a recent survey (World Bank, 2006). This research also showed that the number of procedures needed to start a business in Macedonia is amongst the highest in the countries surveyed. Increasing the number of new firms is critical to job creation. Thus, efforts to improve the business environment could have a significant impact on unemployment.

The high costs of hiring and dismissing workers are associated with strict employment protection laws, which can also be a cause of labour market stagnation. If companies find it unduly costly to sack workers in response to changed circumstances, they are less likely to hire them in the first place. In Croatia, laws on dismissal and the level of termination benefits have been shown to be a principal cause of unemployment. Before they were reformed in 2005, Macedonia's employment protection laws were of comparable strictness to Croatia's—with the obvious likelihood of a similar impact. Now a new balance has been struck between flexibility and job security, making it easier to fire staff, allowing private employment agencies to operate (although still with limitations), and removing virtually all limits on the use of temporary contracts (which have lower levels of employment protection than 'normal' posts). Macedonia's law on temporary contracts is now much more liberal than in Slovenia (which limits the number and duration of successive temporary contracts), Slovakia (which limits fixed term contracts to three years) and France (where the limit is 18 months). Although time is needed for its effects to be fully felt, the liberalisation of employment protection legislation is recommended in a recent World Bank labour market study for Southeast Europe as a whole (World Bank, 2005).

The labour market reforms are not all-encompassing. For example, Macedonia's universal minimum wage remains much higher compared to the average wage rate of many other transition (and some EU-15) economies. The minimum wage in Macedonia is 65 per cent of average wages while, in Slovakia, it is 24 per cent and in Slovenia 33 per cent. This keeps Macedonia's average wages high compared, for example, to Bulgaria, Romania, Ukraine and other competitors with similar (or higher) rates of labour productivity. These high wage rates also help explain Macedonia's relatively poor performance in terms of attracting foreign direct investment.

Trends in their national employment data (and, specifically, the general uniformity of job creation rates) suggest that solutions to local labour market problems in the Western Balkans must often be found at the national level. On the other hand, problems of particularly high regional unemployment rates can sometimes be addressed by local development programmes that are tailored to specific local conditions but would not be appropriate or affordable at the national level. In Macedonia, this is being done with UNDP support through the revitalisation strategy for the former crisis areas (those worst affected by the 2001 crisis), while other local development programmes are under implementation elsewhere in the region. Turning 'jobless growth' into broad-based economic recoveries is likely to require solutions at both the national and local levels.

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Recommendations for Economic Reform in Ukraine

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Ukraine's strong economic recovery of 2000-2004 stalled in 2005. GDP growth fell to only 2.4 per cent, compared with 12 per cent in 2004. The economic slowdown contributed to the fall of the government of Prime Minister Yulia Tymoshenko in September 2005, and the parliamentary no-confidence vote in her successor, Prime Minister Yurii Yekhanurov, in January 2006. It also constitutes an important context for the current campaign for Ukraine's 26 March parliamentary elections.

Diagnosing the problem

As the data in Table 1 show, Ukraine's macroeconomic situation worsened considerably in several respects during late 2004 and in 2005:

- The consolidated government budget moved from being in balance in 2000-2003 to deficits in the range of 3-4 per cent of GDP in 2004 and 2005. The surpluses on the primary budget that had been recorded during 2000-2003 gave way to deficits of 2.4 per cent of GDP in 2004 and an estimated 3.2 per cent of GDP in 2005. If this swing is not reversed, the near default conditions that Ukraine experienced following the 1998 Russian financial crisis could return.

- Annual inflation rates returned to double digits in 2004-present. The hryvnia has appreciated in real terms, damaging the competitiveness of Ukrainian producers. Ukraine's trade and current account balances worsened significantly in 2005, on the back of rapid import growth.

- These trends also reflect generous increases in public sector wages, the minimum wage, and social transfers, which caused household incomes and consumption to grow rapidly. These policies began in the run-up to the 2004 presidential elections, and have continued.

- The growth in personal consumption squeezed investment spending, as well as net exports. The share of GDP devoted to gross fixed investment dropped from 25 per cent in 2003 to 21 per cent in the first half of 2005. The deteriorating investment climate was due in part to the Tymoshenko government's aggressive reprivatisation rhetoric, according to which hundreds of privatised companies were slated for renationalisation.

Macroeconomic policy recommendations

Monetary policy: Focus on disinflation. Bringing annual inflation (measured by the GDP deflator) back down to single digits in 2006 should be a key policy priority. A credible government commitment to a policy framework that can reduce inflationary expectations would be key to avoiding significant reductions in output and employment. Such a framework should be based on a reinvigorated commitment to an operationally independent National Bank of Ukraine (NBU). Disinflationary policies would also weaken the upward pressures on the real exchange rate. However, an aggressive depreciation ought to be prevented, in order to avoid a negative supply shock and further growth in the external debt burden. The downward pressure on the hryvnia that took hold in January 2006, following parliament's dismissal of the Yekhanurov government, is somewhat worrying in this respect.

Fiscal policy: Restore the primary budget surplus. A primary budget deficit means that the share of GDP devoted to servicing the public debt in the future will rise. In addition to reducing future living standards or export competitiveness, such a fiscal position tells market actors that the government is willing to resort to the inflation tax to finance its activities. The higher a government's primary deficit and debt/GDP ratios, the stronger its incentive to print extra money and inflate these problems away. Many financial market actors now believe that this is precisely what is happening in Ukraine. While

Table 1: Ukraine's Macroeconomic Trends (2000-2005)

Source: Ukraine state statistical office.

	2000	2001	2002	2003	2004	2005
Annual GDP growth (%)	5.9	9.2	5.2	9.6	12.1	2.4*
Annual consumer price inflation (%)	28.2	12	0.8	5.2	9	10.3
Consolidated government budget balance (% of GDP)	0.6	-0.3	0.7	-0.2	-3.2	-2.9**

* Official data for the first three quarters of 2005. ** Authors' estimate.

privatisation proceeds do not affect the primary budget, they can help slow the growth in public debt. The successful resale of the Kryvorizhstal metallurgical complex in late 2005 is exemplary in this respect: the proceeds from this sale reduced Ukraine's public debt from 20 per cent of GDP in 2004 to 16 per cent in 2005.

Towards a medium-term fiscal adjustment. A deeper fiscal adjustment, affecting both the revenue and the expenditure side of the government budget, should begin in 2006, in order to prevent unmanageable public debt growth. International experience indicates that fiscal adjustments, that are followed by faster growth in real GDP and employment, focus on reducing public consumption (i.e., public sector wages and social benefits), leaving the share of GDP collected as budget revenue and devoted to public investment relatively unchanged. Such an adjustment in Ukraine should not take the form of indiscriminate cuts in public sector wages. Instead, reductions in employment (as well as other economising measures) should be introduced, in order to finance salary increases for public sector specialists and thereby reduce incentives for corruption. Cuts in social spending should be combined with better targeting of benefits to the poor, and with reforms to increase the financial sustainability of the health care and pension systems.

Improving the investment climate: Property rights and deregulation

The Yekhanurov government sought to improve the investment climate by increasing the security of property rights and reducing regulatory burdens on business. These measures should be continued after the parliamentary elections. Although their effects might not be seen immediately, they are critical to longer-term prospects for investment and growth.

Limit reprivatisation and restart privatisation. Upon taking office in September, Prime Minister Yekhanurov announced that the reconsideration of already completed privatisation deals would be limited to a small number of cases that would be settled amicably. However, the parliamentary election campaign is keeping the reprivatisation debate on the front burner. The government could reduce this uncertainty by granting a general amnesty for privatisation deals; when necessary, their legitimacy can be contested in the courts. Opposition in parliament and elsewhere to further reductions in state ownership in Ukraine raises grave concerns about future prospects for privatisation and the security of private property rights. The design of a credible medium-term privatisation strategy therefore seems crucial for regaining investors' confidence. However, this process is now stalled, as is the new law on the State Property Fund.

Property rights violations in free economic zones should be reconsidered. The cancellation of Ukraine's free economic zones in spring 2005 was needed, in order to remove unjustified tax loopholes and create a level playing field. However, this cancellation flew in the face of the contracts that had already been concluded with investors, who claimed that their property rights had been violated. Respect for property rights dictates a reconsideration of this issue, either by rescinding the cancellation, or by compensating the owners for the value of their lost privileges.

Accelerate deregulation. The review of some 9,000 regulatory acts that was initiated by President Yushchenko in June 2005 has led to the amending or cancellation of 4,000 acts. In addition to cleaning up the regulatory environment, this initiative has helped improve the business climate and facilitated dialogue between the state and civil society organisations. However, significant reductions in the regulatory burdens on enterprises have not yet occurred. Doing so requires moving from the revision of regulations to the amendment of legislation, as well as generating more market-friendly operational procedures for regulatory bodies.

The adoption of the laws on state aid and joint stock companies, the abolition of the commercial code, and the re-shaping of the civil code, would also have a very positive impact on Ukraine's business environment.

Public administration reform for better policy coordination

As a consequence of the constitutional reforms introduced in 2005, the economic policy roles played by the prime minister, and of the government in general, will increase. Radical steps in reforming public administration—particularly in terms of functional reviews for government ministries, and of their links to the budget process—should therefore be undertaken without delay. In particular:

- Binding budget targets should be negotiated for all spending ministries at the beginning of the annual budget cycle. These targets should be aligned with multi-year fiscal programmes.

- The monitoring, oversight, and enforcement capacities of the Finance Ministry and the parliamentary committees overseeing the activities of the spending ministries should be strengthened.

- Budget processes should be made more transparent, in order to promote accountability and facilitate monitoring of all agents involved therein.

Prospects for economic reforms in 2006-2007

In many respects, Ukraine's deteriorating economic situation is unlikely to promote the adoption of the above measures. This is most apparent in the prospects for fiscal adjustment. The 2006 budget makes no attempt to reverse the large increases in social benefits introduced during 2004-2005. Reductions in public sector employment likewise seem most unlikely. Instead, the new government is likely to be tempted to ease Ukraine's fiscal problems by releasing inflation. Combined with the impact of higher prices for imported natural gas from Russia, these fiscal trends spell trouble for Ukraine's inflation outlook as well. The adoption of the law on joint-stock companies, or a comprehensive privatisation programme, seem equally unlikely. Prospects for a fiscal adjustment and structural reforms might improve in 2007, however, as the need to improve the investment climate and finance Ukraine's fiscal deficits in a non-inflationary manner becomes more pressing.

On the other hand, some measures to improve the investment climate seem likely in 2006, particularly in terms of limiting reprivatisation and making property rights more secure. Deregulation measures to reduce entry barriers for SMEs are a relatively uncontroversial proposition. Ukraine's prospects for administrative reform could also be relatively favourable, particularly if the elections produce a cohesive parliamentary majority and a relatively strong government.

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Evaluating Policy Advice

Alf Vanags

The political revolutions of the early 1990s in Central and Eastern Europe (CEE) and the USSR were fuelled by the desire to replace the previous command economy with a market one. This desire was perhaps stronger in the CEE states and the Baltic states than in Russia and other CIS states, but all of them had to integrate into the global market economy following the collapse of the socialist economic framework.

In most countries drastic changes created a vacuum in the economic policy sphere. This was quickly filled by foreign 'technical assistance' directed by Western economic advisers. International financial institutions, individual countries, as well as a number of well-known economists became involved in policy advice and the delivery of aid. The policy concerns of that time now seem very dated. For example, there was a debate on how fast currency convertibility could be introduced and respected commentators looked to Western European post-war experience as a possible model (Williamson, 1991). In practice, most countries introduced full current account convertibility very fast (Cooper, 1996). Today convertibility is simply not an issue in most of the transition countries. Another example that also now seems dated is the once-heated debate on 'big bang' vs. gradual transition.

Did Western economists succeed in influencing policy in the early transition? The experience was mixed. Estonia implemented the currency board arrangement in 1992 against the advice of the IMF. On the other hand, architects of national privatisations in CEE and CIS countries often followed Western templates. On balance, the impact of imported advice on the early transition outcomes was disappointing. The depth and the longevity of the transitional recession were seriously underestimated, as were the difficulty and the importance of institution building. Nowadays, when eight of the CEEs are full EU member states and another two are on the way, the international financial institutions have lost much of their influence. At the same time, in most of the transition countries a small but growing profession of Western educated economists is taking root.

The Global Development Network's (GDN) Bridging Research and Policy (BRP) programme provides 20 in-depth case studies of research-policy linkages in developing and transition countries (BRP, 2002-present). Two of the BRP studies concentrate on specific policy episodes, the financial market development in Ukraine and the pension reform in Bulgaria. A third study with a broader scope targets the Baltic states.

One indication of how policy makers regard economic research is their willingness to provide core funding for it. In Western Europe most countries have at least one research institute benefiting from public funds. For example, DIW in Berlin receives about half of its budget in the form of public grants, and the Economic and Social Research Institute in Ireland receives about one third of its income in the form of a government grant. Moreover, a lot of policy and theoretical research is done in universities. In contrast, in almost all transition coun-

tries public funding of economic research is minimal. In general, former research institutes have lost their prominence, though specialised 'sectoral' institutions, particularly in the field of agricultural economics, have sustained their role. With a few exceptions, universities do not have the capacity to carry out high quality research. Significant research is often conducted by Central Banks.

The vacuum in the five countries covered by the BRP studies (and elsewhere) has been filled largely by private institutions, often with some foreign funding, though eventually having to rely on project income. Many institutes aim to recruit Western-trained economists, although the limited supply and the precarious finances make this difficult. Where some core funding exists, such as for Praxis in Estonia (Soros funding) or the Institute for Economic Research and Policy Consulting (IER) in Ukraine (German TRANSFORM programme funding), it has been possible to develop ongoing research or monitoring programmes. For example Praxis has programmes in labour and social policy, innovation, health and education, while IER regularly monitors the Ukrainian economy. Otherwise the project portfolio of many institutes is determined in an ad hoc way by a combination of the interests of individual researchers, research projects won, and commissions obtained.

The BRP study of the Baltic states found little evidence of direct linkages between research and policy-making. Foreign expertise was more highly regarded than the local expertise, especially early on in the transition. Later, when the EU accession became reality, a lot of policies were prompted by the EU's harmonisation priorities, which also limited policy-makers' recourse to local expertise. In areas not covered by the EU accession imperative, e.g. in the reform of education finance in Lithuania or the reform of maternity/paternity benefits in Estonia and Latvia, the researchers' input was largely through participation in working groups rather than through policy studies.

In Bulgaria and Ukraine the BRP studies detected positive impacts of local research, although supplemented in all cases by foreign advice. Thus, in Ukraine the bank deposit insurance scheme was introduced in 1999 at the insistence of the World Bank as a condition for a major loan, while the reduction in 2002 of the bank reserve requirements resulted from the efforts of the local IER together with their German advisers and USAID. The election of Viktor Yushchenko in Ukraine resulted in the creation of a new International Expert Group under the auspices of UNDP. This group includes well-known 'transition names' such as Anders Åslund as well as successful transition economy reformers such as former Estonian Prime Minister, Maart Laar. In Bulgaria the pension reform implemented over 2000-2003 was developed with help from both the World Bank and USAID. Interestingly, in Bulgaria, too, a working group including local researchers served as an interface between 'knowledge' and policymaking.

In summary, in the transition countries of the BRP studies we observe a rather small modern economics profession, typically concentrated in externally-funded NGOs on a project basis, and having limited impact on policy. On the other hand, the importance of economists and the local research expertise may be exaggerated, given that the lack of solid economic advice has not prevented the Baltic states from posting the highest growth rates in Europe in recent years.

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BRP reports may be found at http://gdn.eerc.ru

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Growth and Cooperation in Central Asia

Jacek Cukrowski

In the first half of the 1990s, all of the economies of Central Asia[1] experienced sharp declines in output, incomes, and living standards (see Table 1). Real GDP in Kyrgyzstan and Tajikistan (the poorest Central Asian countries) today remains well below pre-transition levels: GDP in 2004 was down 20 per cent in Kyrgyzstan, and 31 per cent in Tajikistan, compared to 1989 levels. In purchasing power parity terms, GDP levels in these countries (and in Uzbekistan) are comparable with such African countries as Tanzania and Ghana. On the other hand, since the late 1990s Central Asia has been one of the world's fastest growing regions. In 2004, Central Asia's regional GDP growth rate reached 7 per cent, above average compared with all transition economies. This growth has been key to the reductions in poverty recently noted in these countries by the World Bank (World Bank, 2005).

Although the reliability of the macroeconomic data officially reported by Uzbekistan and, especially, Turk-

menistan has been questioned by the international financial institutions, it seems clear that the two large oil- and gas-exporting economies (Kazakhstan and Turkmenistan) have grown much faster than the rest of Central Asia since 1999. Growth in these two economies has mostly been driven by high energy export prices, foreign direct investment (FDI) and infrastructure investment. In contrast, the lower growth rates in the other Central Asian economies result from high cotton and gold prices, remittances from migrant workers, textile exports, some reforms, and foreign aid. Despite these differences, the World Bank and other forecasters expect growth to continue in the 7 per cent range over the next years.

Prospects for maintaining or exceeding these growth rates depend significantly on the extent of cooperation among the Central Asian countries in the area of transport, trade, and management of water/energy resources. The Central Asian countries are intimately connected with one another. All five countries have large ethnic minorities, including those who are titular majorities in neighbouring states. Although nationalism in Central Asia does not take on the virulent forms seen in other parts of the world, policy frameworks that have focused on creating and consolidating nation-states have alienated minority communities within each state. This resulted in emigration and fears of ethnic conflict, especially in the first half of the 1990s. Some countries also have territorial enclaves within their borders that belong to other countries. Tajikistan and Uzbekistan both import and export electricity to and from one another. The water that irrigates cotton fields in Uzbekistan and Turkmenistan flows from rivers whose headwaters rise in Tajikistan and Kyrgyzstan. Few parts of the world need regional cooperation as much as Central Asia does.

In some ways, the importance of regional cooperation has been recognised by the Central Asian leaderships since the creation of their new nation states. This is most apparent in the plethora of regional agreements that have emerged since independence, which alternatively envisage creating an economic union, a customs union, or at least a free-trade area. But instead of creating an economically integrated region with liberalised trade, the Central Asian countries have instead become involved in multiple regional organisations and concluded numerous bilateral trade arrangements. As these arrangements have often been mutually inconsistent and generally lack effective implementation mechanisms, their economic impact has been minimal. Leaders have instead focused on reinforcing controls over national territories and have been loathe to surrender elements of sovereignty. Elites and interest groups have sought to limit external competition that could threaten their ability to extract short-term rents.

Prospects for regional cooperation in Central Asia are further complicated by the role of large neighbours like China and Russia. The Russian Federation's role in Central Asia is particularly important: in addition to its profound historical and cultural influence, Russia is the region's largest single export market, supplier of foreign investment, and provider of remittance income. On the other hand, Russia's control over the pipeline infrastructure needed for Turkmenistan's and Uzbekistan's gas exports helps keep these countries' export prices below world market levels. Likewise, fear of competition from Chinese exports has limited the Central Asian countries' willingness to join the World Trade Organisation: at present, only Kyrgyzstan is a WTO member.

How large might the economic benefits of regional cooperation be? UNDP's recently published *Central Asia Human Development Report* (2005) estimates that the potential benefits from better regional cooperation in trade, transport and transit, could be extremely significant. The benefits of improved regional cooperation were estimated using a computable general equilibrium model, which assessed the impact of the direct and indirect effects of reducing tariffs and trade costs. These benefits were estimated for individual sectors, regions, and social groups within these countries, as well as the cumulative effects on the economies as a whole.

The results of the model indicate that if current barriers to trade, transport, and transit were to be removed, and reforms introduced to improve domestic business and finance conditions in Central Asia, per capita GDP could

Table 1. Real annual GDP growth (in percentage) Source: World Bank

	1990	1992	1994	1996	1998	'99	'00	'01	'02	'03	'04	'04-'08*
Kazakhstan	-4.6	-5.3	-12.6	0.5	-1.9	2.7	9.8	13.5	9.8	9.2	8.1	8.2
Kyrgyzstan	3.2	-13.9	-20.1	7.1	2.1	3.7	5.4	5.3	0	6.7	5	4.5
Tajikistan	-0.6	-29	-21.3	-16.7	5.3	3.7	8.3	10.2	9.1	10.2	8.5	6.1
Turkmenistan**	0.7	-5.3	-17.3	-6.7	6.7	16.5	18.6	20.4	19.8	16.9	7.5	7.5
Uzbekistan***	1.6	-11.2	-5.2	1.7	4.3	4.3	3.8	4.2	4.2	4.4	2.5	2.7

* Forecasts. **Historical data according to official statistics. Since 2001 these appear overstated. Alternative estimates place real annual GDP growth at around 8 % in 2002-03.

*** Historical data according to official statistics. The IMF's alternative estimates indicate lower GDP growth since 1997 (e.g., 1.5% in 2003).

increase by 50 to 100 per cent over the next 10 years. A 50 per cent reduction in tariffs over 2002 levels in Kazakhstan and Kyrgyzstan would increase real GDP in 2015 by about 20 per cent in Kazakhstan and 55 per cent in Kyrgyzstan. Real consumption would be 13 per cent higher in Kazakhstan and 66 per cent higher in Kyrgyzstan. While both countries' exports and imports would increase substantially, export growth would outpace input growth, helping to improve the trade balance in each country.

These simulations also suggest that greater integration into the global economy would be very beneficial for the Central Asian economies. WTO accession for the rest of the region (Kyrgyzstan is already a member) could help attract FDI and lock in the benefits of trade specialisation. Membership could also increase Central Asia's bargaining leverage vis-à-vis other countries. Should Uzbekistan join Kyrgyzstan in the WTO and help reduce cotton export subsidies in the United States and EU, the prices of Central Asian cotton exports could rise by as much as 71 per cent. *The Central Asia Human Development Report* estimates that the resulting gains in export revenues would boost GDPs annually by an estimated 6 per cent in Tajikistan, and by 3 per cent in Uzbekistan and Turkmenistan.

The magnitudes of these benefits are of course open to dispute. Still, it is clear that significant gains could accrue to all the Central Asian economies as a result of regional economic cooperation. Whether these countries have the political will to adopt the reforms required for these changes—particularly in their domestic policies—remains to be seen.

Jacek Cukrowski is Regional Millennium Development Goals advisor, UNDP Regional Centre, Bratislava.

1 Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan.

Bringing down barriers: Regional cooperation for human development and human security. Central Asia Human Development Report. UNDP RBEC Bratislava Regional Centre, Bratislava, December 2005 (available at http://europeandcis.undp.org).

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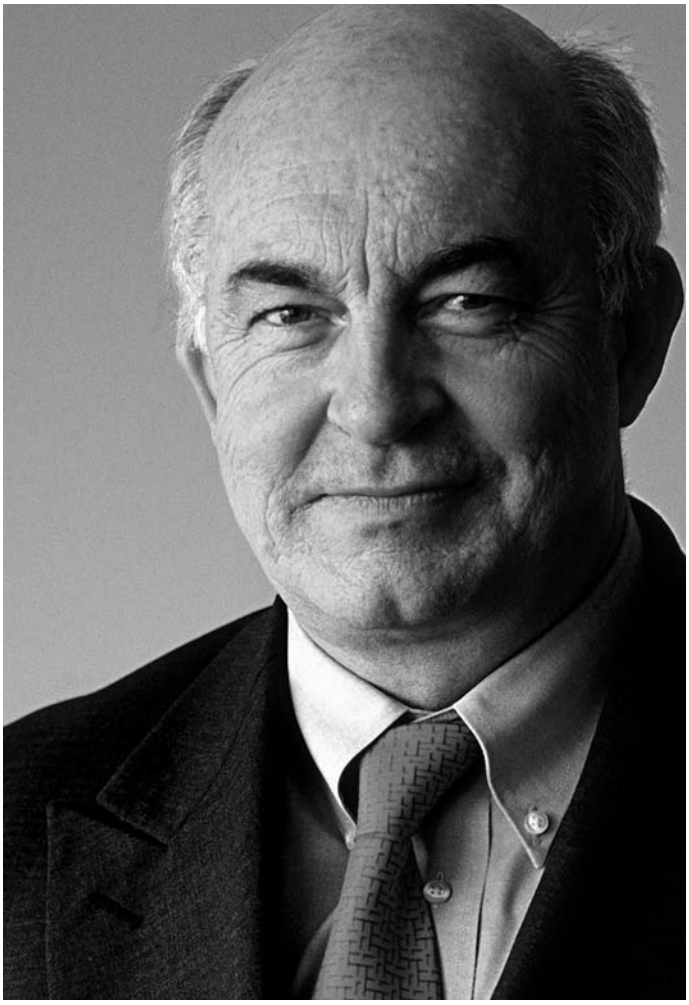
Interview with Kemal Derviş

conducted by Ben Slay



In *A Better Globalisation*, you argued that the international governance structure needs to be rebuilt, replacing the post World War II system with one more appropriate to the realities and requirements of the 21st century. What should be the role of UNDP, and the UN as a whole, in such a system?

Humanity went through its worst catastrophe in history in the middle of the 20th century, ending with World War II. The creation of the United Nations, and of related international institutions, was a response built on the hope that we could prevent such catastrophes in the future. Some of the specific features of these institutions reflect the world at that time 60 years ago. It is, therefore, natural and necessary to adjust the institutional architecture so we can now face the challenges of the 21st century. The UN remains at the centre of the international system and UN reform should be the driver for an overall renewal.

How have prospects for attaining this vision, been affected by September's World Summit? What specific innovations in the international governance architecture might we expect as a result of the Summit?

The Secretary-General proposed far-reaching policy and institutional reforms to the Summit, and the overall intent of these proposals was accepted. Unfortunately, agreement could not be reached on many of the specific innovations. Nonetheless, the Summit was a step forward, particularly in relation to the Millennium Development Goals. In terms of the follow-up, what needs to be done first is to continue to extend the reforms to the areas in which the Summit could not yet agree and try to reach consensus and support for these other dimensions, and second, to implement those decisions where agreement has been reached. We need to redouble our efforts to follow-up on the MDGs and to try to build a roadmap that allows as many countries as possible to reach these MDGs in 2015. The Summit strongly asked all of us to work together in that direction.

In what ways do the development challenges facing the transition economies in the Commonwealth of Independent States, the Balkans, and Central Europe differ from those of other UNDP programme countries? In what ways are they similar?

The development challenges of the Commonwealth of Independent States, the Balkans, and Central Europe have common features in that many of these countries have gone through a deep transformation of their political and institutional systems. In many cases, this transformation has been extremely disruptive and painful, particularly to the weakest segments of the societies in those countries. There is today a great hope for more prosperity in the future, and certainly in many cases participatory democratic institutions have been built. Nonetheless, serious equity problems – social service problems – remain. Serious governance problems threaten the stability of some countries. The region in some ways is similar to other parts of the world where UNDP has country programmes and in some ways it is different. The influence of the European integration process is particularly important in Central Europe and extends beyond the official EU members or candidates to the "European neighbourhood" to the East and Southeast. It is very important for UNDP and other organisations to work very closely with the European Union and to ensure our efforts are complementary.

Many transition economies no longer have strong programmes with the IMF and World Bank. For the new EU member states, this is because they have "graduated" from the Bretton Woods assistance, and can more easily finance themselves on international capital markets. However, the IFIs' cooperation with some of the region's poorest countries—Moldova, Uzbekistan, Turkmenistan—as well as middle-income countries like the Russian Federation, Ukraine, and Kazakhstan—is much less vibrant now than it was 5-10 years ago. These countries generally do not have the same beneficial access to international capital markets. Many of these countries have likewise not yet joined the World Trade Organisation, even though their exporters face significant protection on OECD markets. In light of this, what roles should UNDP, and the UN system, play vis-à-vis these countries?

In the area of financial cooperation, including IFI programmes and trade, the region's poorest countries have needs that are not very different from many of the poorer countries in other parts of the world. In the middle income countries, important financial needs remain due to the weakness of the fiscal systems and the need to build new social infrastructure. Some of the countries of the region have reasonable access to capital markets, some do not, or have access only to very expensive funds. UNDP's main role is to work with these countries on the software of development, on capacity building, and the strengthening of the human resource development processes in those countries. As is the case in some other parts of the world, such as Latin America, middle income countries are not yet ready to be solely and entirely dependent on commercial capital markets. These countries still require some element of development assistance which is best provided in the form of blending commercially sourced resources with some official development aid.

UNDP has undergone significant changes in the last 10 years. What changes still lie ahead? Where would you like to see UNDP, and the UN system, 10 years from now?

In 10 years I would like to see the achievement of the MDGs. Achievement of these goals will not be easy and will require constant work and vigilance on the part of everyone. We have seen tremendous progress in some regions of the world, while other regions have slipped even further into poverty or have fallen victim to disease and conflict. We must redouble our efforts and work closely with governments, civil society and the private sector to press ahead. I would also like to stress that achieving the MDGs is not just a question of resources. Resources are needed but we also need much better governance at both the national and international level. My hope is that in 2015 we have a secured and strengthened United Nations system reflecting the great needs of the 21st Century.

Thank you very much.

Kemal Derviş is the new Administrator in charge of the United Nations Development Programme, and an Under-Secretary-General of the United Nations.

CONUNDRUM: Productivity or Employment? Explaining Armenia's Rapid Growth

Armenia had an average of 12 per cent annual GDP growth during 2001-2005. Official statistics suggest that most of this growth results from extremely favourable trends in total factor productivity (TFP). If so, Armenia's annual 8 per cent TFP productivity growth during this time would be well above the rates posted by the more successful transition economies of Central and Eastern Europe. Could Armenia's TFP be inflated by inaccurate employment statistics?

In fact, there may be a hidden employment expansion that is not properly reflected in the country's growth accounting in two key areas. Firstly, the massive real-location of labour to agriculture during the 1990s is now being reversed in Armenia, and the full impact of this reversal may not be completely captured by the official employment statistics. Although the transfer of an underemployed rural worker to fuller employment in a city should be recorded as an increase in total employment, it may be captured in the official statistics as an increase in labour or total factor productivity. Secondly, privatisation has led to a reallocation of labour from less efficient sectors characterised by underemployment to the more efficient private sector. It may therefore be the case that employment growth is systemically under-reported in Armenia, thereby overstating the importance of productivity growth in the post-2000 economic recovery.

Aghassi Mkrtchyan, UNDP office in Yerevan

An extended version of this article is available at http://www.undp.am/econbriefs/productivity/

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11th Annual World Convention of the Association for the Study of Nationalities "Nationalism in an Age of Globalization' (Eastern Europe/Former Soviet Union) Columbia University, **New York 23-25 March 2006** For more info see: http://www.nationalities.org/Events.asp

British Association for Slavonic and East European Studies (BASEES) Conference Fitzwilliam College, **Cambridge, 1-3 April 2006** For more info see: http://www.basees.org.uk/~conference/

'Promoting Democratic Values in the Enlarging Europe: The Changing Role of the Baltic States from Importers to Exporters University of Tartu, **Estonia, 5-6 May 2006** . For more info see http://ec.ut.ee/conf06/

International Policy Dialogue on Economic Cooperation in Central Asia ~ Berlin on 17-18 May 2006. The Policy Dialogue is organised by UNDP and InWent Capacity Building International, in cooperation with the German Ministry for Economic Cooperation and Development. For more information Contact Christina Carlson, Programme Specialist, Central Asia Cluster, Regional Bureau for Europe and the CIS. christina.carlson@undp.org

The 12th annual conference of INFORUM May 23 to May 25 2006 in Prague. The conference focuses on professional electronic information resources for research, development, education and business purposes . A call for papers is open to anyone wishing to share his/her professional views during the conference programme. More details can be found here: http://www.inforum.cz/inforum2006/english/

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