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1. Economic Transition in the Former Communist Countries in 1998: A Strategic Overview

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EXECUTIVE SUMMARY

The building of a market economy in the former communist countries requires the creation of markets, of market-oriented enterprises, and of the wide range of institutions and business practices needed to support them. Some aspects of a market economy can and have been created quickly in these transition economies, in particular through market liberalisation and privatisation. However, developing the institutions and business practices required for a well-functioning market economy takes much longer. There is thus an inherent imbalance in the transition process. The full implications of this imbalance are starting to reveal themselves.

The turbulent events that followed the 1998 financial crisis in Russia have led to contrasting developments across the countries in Central and Eastern Europe (CEE) and the Commonwealth of Independent States (CIS). While some countries were severely affected by the crisis of confidence in emerging markets, others have shown more resilience and have been able to maintain growth, albeit at a slower rate. Although the crisis is not yet over, it is clear that countries - mainly in CEE, and especially Poland, Hungary and the Czech Republic - that have pushed ahead with the more challenging structural and institutional reforms have survived the stress-test of the past year and have been able to maintain macroeconomic stability.

In most of the other countries, in particular Russia, the contagious effects of East Asia's financial-economic crisis were readily propagated in an environment where reforms were unsound and incomplete. Problematic corporate governance, arbitrary government behaviour and corruption, slow restructuring and weak financial systems imposed a serious handicap on the transition process, constraining growth prospects and exacerbating instability. In many cases, these defects in reform reflected weaknesses in the state itself. In Russia, but not only there, the government failed to overcome strong and manipulative vested interests, both from the old structures and new oligarchs, in its attempt to pursue reform. The recognition of these political bottlenecks led to a collapse in the confidence of financial investors and to crisis. The Russian experience further underscores that institutional reform is essential if the potential gains from privatisation and liberalisation are to be realised in terms of growth and stability.

The fall-out from the crisis in Russia has affected economic performance in the rest of the region, particularly in neighbouring CIS economies with weak macroeconomic fundamentals and strong trade links to Russia. The most affected CIS countries were Belarus and Moldova, whose export trade with Russia is above 50%, followed by Kazakhstan and Ukraine. Latvia and Lithuania were also strongly affected by their trade linkages and energy dependency on Russia. Economies in CEE more advanced in the transition process were less affected by trade exposure to Russia and, with strong foundations for growth and stability, should be able to weather the turbulence on international markets. A slow-down in growth in Western Europe would, however, significantly dampen economic prospects in CEE.

Reversals in macroeconomic stabilisation as the transition progresses point to the fragile foundations in many countries for sustained growth and stability. Large and persistent fiscal imbalances, particularly in the CIS, reflect underlying structural weaknesses, including soft budget constraints for loss-making enterprises, an opaque and distorted tax system, and inefficient tax administration. As a result the tax base is small (and shrinking), the burden on those enterprises still paying taxes is excessive, and tax avoidance and evasion are widespread. In some countries, like Romania and Bulgaria, fiscal imbalances are also contributing to current account deficits. In contrast, rapid export growth and buoyant investment activity in most of central Europe, but especially in Hungary, Slovenia and more

recently Slovakia, reflect the gains in competitiveness achieved through deep enterprise restructuring.

Looking ahead, it is important to consider to what extent the economies of the former communist countries are going to be affected by future political, economic and financial developments in the region. It is clear that the international macroeconomic environment has become less favourable for some of the transition economies that are not yet firm on the road to reform. However, those countries where the foundations for solid economic performance have been laid through persistent structural reforms should be able to withstand possible future pressures on their external balances, exchange rates and output growth emanating from the crisis in Russia and any general decline in investor confidence. For countries where government imbalances and external deficits remain high, the coming years will pose a crucial stress test of their governments' commitment to structural reforms. A retrogression in transition is no solution to present circumstances and would almost certainly increase the costs of adjustment to a changing global economy.

3. INTRODUCTION

For the countries of Central and Eastern Europe, the Baltic States and the Commonwealth of Independent States (CIS), 1998 has been a year of stresses and contrasts. The crisis of confidence in emerging markets sparked a collapse of the Russian financial system, forced Ukraine to renegotiate its domestic debt, unhinged the Slovak Republic's fixed exchange rate, and required countries across the region to brace themselves against the danger of contagion. Even if technically the financial crisis in Russia is over, many of its effects are yet to be revealed. However, while the initial market reaction was severe across the region, a number of the transition economies have demonstrated an impressive resilience. Domestic money market rates and exchange rate shifts – key indicators of domestic and foreign investor confidence – showed a pattern of striking variation across the region as investors have begun to adopt greater selectivity in the wake of a broad reassessment of economic fundamentals and risks. This variation confirmed the theory that the hard-won achievements of liberalisation and privatisation must be balanced by progress in institutional reform¹ in order to sustain macroeconomic stability and to build strong foundations for growth.

During 1998, substantial variation in the progress of institutional reforms has been reported by transition indicators. On one hand, some countries of the region, such as Poland and Hungary, have shown further progress in tackling challenging institutional reforms in such areas as the financial sector and in corporate governance². On the other hand, there has also been considerably more backtracking in reforms in 1998 than the previous years. Severe economic problems in a climate of uncertainty have prompted some countries, most notably Russia, to revert to direct state controls on economic activity. Other countries, such as Belarus, Turkmenistan and Uzbekistan, have continued to delay essential reforms, and even to reverse earlier achievements, suggesting a more general lack of commitment to market-oriented reforms. As a result, the reform paths of the region's transition economies are differing sharply.

There are several factors underlying these striking differences. As nearly all countries of the region begin to tackle the challenges of the next phase of transition – strengthening economic and corporate governance, building effective regulatory frameworks, deepening financial intermediation and promoting enterprise restructuring – they face different obstacles shaped by their own historical experiences and by the results of the first phase of transition. Tackling these challenges goes beyond simple changes of government policy and requires broad efforts to transform expectations and deep-rooted patterns of behaviour, which are, in many respects, unique to each country. Like all major transformations, these tasks run the risk of intensifying political and social strains in societies that have already endured years of hardship and uncertainty. Indeed, a recognition of the implications of these strains is to be taken into consideration when analysing the strategic developments due to the economic transition within this region. This is more apparent if we recognise that governments in the region have already shown substantial differences in their willingness to take on such risks as well as in their capacity to develop and implement these challenging reforms. Explaining this variation calls for a recognition of different historical legacies, and an understanding of the complex political and economic diversity of the transition process.

The first phase of transition has left many countries of the region with serious imbalances across different dimensions of market-oriented reforms. The rapid pace of liberalisation and privatisation has not been matched by concomitant progress in the development of institutions necessary to support a well-functioning market economy. These imbalances have caused serious market distortions in the transition economies, which have generated substantial gains to particular interest groups (often with close ties to the government) while imposing great costs on the rest of society. For example, liberalisation of the financial system without an effective regulatory framework has generated extremely high profits for banks in many transition economies, while the basic financial infrastructure that could support the real economy remained severely underdeveloped. Meanwhile, in many countries of the region, rapid privatisation without effective corporate governance structures has also resulted in big gains for ex-communist managers without real improvements in enterprise performance.

But while the process of institution-building inevitably takes longer than the policy reforms and asset redistributions of the first phase of transition, some countries have made significant progress and have shown a strong commitment to these challenging reforms for the future. Where this commitment has been lacking, however, vested interests have emerged to sustain and to take further advantage of the market distortions rooted in reform imbalances, thereby preserving their extraordinary gains at a significant social cost. Recognising the problems associated with reform imbalances should not be taken to suggest that some countries should have pursued a slower course of liberalisation and privatisation, but rather emphasises the importance of the government's commitment to institutional reforms throughout the transition period.

The institutional challenges are manifested most strikingly in the financial sector, as financial institutions and markets in transition economies remain relatively underdeveloped in their service, compared with countries at similar income levels. The legal framework for sound finance is also very weak. It is therefore a priority to foster sooner rather than later an expansion of this sector, driven by the market, while ensuring that relevant laws and regulations, including the capacity for their enforcement, keep pace with the growth. Particular consideration should be given to the role of sound banking in transition economies, as it is central to the stability of the financial sector and to promoting growth. Moreover, competition and private ownership are crucial to enhance the performance of banks in mobilising savings and in allocating credit to the private sector. Yet competition must be managed effectively and careful consideration should be given to different approaches to bank privatisation, particularly from the perspective of their effects on post-privatisation corporate governance.

But why has the pace of reforms slowed as the former communist countries face the challenges of the next phase of transition? And why do these challenges appear to entail even greater risks and unforeseeable consequences for the region than the difficult tasks of the first phase? To answer these questions, we must recognise that after Russia's financial crisis in the summer of 1998, the political and economic dynamics of the reform process have changed both in response to the current challenges and to the new policy-making environment shaped by the early years of transition.

4.

5. THE FINANCIAL CRISIS IN RUSSIA

The re-election of President Yel'tsin in July 1996 and the appointment of a team of high-profile economic reformers nine months later sparked a huge inflow of foreign portfolio investment into Russia's nascent equity and Treasury bill markets. This inflow was part of a worldwide boom in capital flow into emerging markets. The Yel'tsin victory appeared to mark the turning point in Russia's reform process, holding out the promise that the country would belatedly follow the Central East European countries' path of economic recovery after a cumulative 40% decline in GDP since 1991. Backed by a new Extended Fund Facility from the International Monetary Fund (IMF), the government committed itself to fiscal consolidation and a vigorous programme of structural reforms. With a framework of property rights apparently created by mass privatisation, investors were optimistic that substantial corporate restructuring would finally lead to sharp increases in asset prices. Meanwhile, many investors anticipated that growing international reserves would

enable the Central Bank to maintain a predictable exchange rate policy within a sloping corridor. Although the opposition-dominated State Duma would continue to protest, a newly adopted constitution granted it minimal powers to block any reforms that had the President's strong backing. Agreements with the Paris and London Clubs of creditors on restructuring defaulted Soviet-era foreign debt cleared the way for new wave of investment in Russia.

But the capital inflows led to a spectacular price bubble, with the stock market rising 142% in 1996, and a further 184% in the first half of 1997. In the new environment, commodity exporters and regional governments were able to borrow in dollars, avoiding high domestic interest rates. Commercial banks increasingly borrowed in dollars, using the proceeds to buy high-yields Treasury bills as well as corporate shares on sale at privatisation auctions and on the booming stock market. By the summer of 1997 investors appeared to be buying Russian securities indiscriminately.

The euphoria had a similar effect on the growing market for government debt. From 1995, the federal government financed much of its deficit by issuing short-maturity (less than one year) rouble-denominated Treasury bills (GKOs) and larger-dated coupon-bearing bonds (OFZs). As a result of a sharp increase in government spending and a broad tax amnesty leading up to the presidential elections, the market value of the stock of GKOs and OFZs grew by 170% in real terms in the course of 1996, from 3.4% to 8.2% of GDP. By October 1996, the stock of GKOs and OFZs had exceeded the total stock of rouble deposits in the banking system. Therefore, the government relied increasingly on foreign financing. Meanwhile, foreigners rushed into the high-yielding Russian debt market and, by the end of 1997, held an estimated 33% of the total stock of GKOs and OFZs. Despite the rapid growth in the domestic debt stock, inflows of foreign capital caused yield to fall steadily from 170% just before the 1996 presidential elections to 18 percent in July 1997.

A consequence of the reliance on GKO-OFZ financing was that the fate of the rouble, as the domestic debt stock and the banking system became intertwined. With the advent of East Asian financial crisis in July 1997, investors began to reassess economic fundamentals and risk across all emerging markets, prompting a broader flight to "quality". In the light of the newly increased awareness of the dangers of crony capitalism and weak banking systems following the crisis, Russia's economy, having still achieved only modest progress in key structural reforms and with looming fiscal problems, looked particularly vulnerable. Worse still, falling commodity prices hit Russia's main sources of export earnings, sending the current account into deficit and raising questions about the vulnerability of the rouble.

What began as a price correction turned into much deeper worries in March 1998 when President Yeltsin dismissed the political coalition under Prime Minister Viktor Chernomyrdin, which had been in government, with varying members, since late 1992. A prolonged nomination battle between the President and Duma to appoint a successor threw into doubt the new government's ability to carry out its reform programme in the face of Duma opposition. Further doubts about the ability of the banking system arose following the Central Bank's decision to place Tokobank, which had been one of the most active in attracting foreign credits, under temporary administration. Foreign banks became increasingly unwilling to roll over maturing loans to Russian banks. With the value of their share and Treasury bill portfolios plunging, some large Russian banks were forced to make margin calls, which further depressed the stock and bond markets and put still more strain on the banks' balance sheets.

As a result of all these circumstances, in the summer of 1998 the eyes of the world focused on Russia, where the turbulence following the East Asian crisis exposed in a dramatic fashion the frailties of its economic governance and reforms. Indeed, on 17 August 1998 Russia simultaneously devalued its currency, defaulted on much of its domestic government debt and declared a moratorium on debt principal payments to foreigners by Russian companies and banks. The move prompted a run on the banks, a sharp fall in the exchange rate well beyond the parameters of the announced devaluation and a substantial acceleration in monthly inflation to a level not seen since 1992. The severe strain on the banks led to a breakdown in the payments system, which along with the increased uncertainty caused a dramatic slowdown in economic activity. Within a week of the measures, the government of Sergei Kiriyenko had fallen after just four months in office. Following a three-week stalemate over the appointment of a new Prime Minister, the government of Yevgeny Primakov declared its intention to make substantial changes to the course of economic reform.

By analysing the entire situation, it could be said that the origins of the crash of Russia's financial markets lay in the country's flawed stabilisation. Extremely high levels of inflation between 1992 and 1994 were fuelled by an increase in the volume of credits from the Central Bank at highly negative real interest rates.

These credits were provided to cover the federal government's persistently large budget deficits and to support enterprises that consistently resisted pressures to restructure. The government's stabilisation programme in 1995 managed to bring down the inflation, but it did not address the underlying causes of macroeconomic imbalance. The government was not prepared to accept the consequences of enforcing hard budget constraints both in terms of the social and economic dislocation, and the opposition of entrenched interest groups. Instead, it replaced monetary financing of the deficit with non-inflationary borrowing on a newly created Treasury bill market and on the international capital markets. It also used the exchange rate as an anchor to fight inflation. In principle, this approach bought the government time to make progress in deficit reduction and enterprise reform. However, channels of soft financing to enterprises remained significant.

As the exchange rate appreciated and as the dollar wages outpaced productivity growth, the devaluation expectations of investors raised with them the interest rates they required to hold the stock of increasingly short-term government debt. In addition, the onset of the East Asian financial crisis sharply raised the costs of borrowing throughout all emerging markets. The growing interest payments, in turn, aggravated the gap in the government's finances and thus compounded the already difficult problem of rolling over its short-term debt. This forced the Russian government to increase debt issues and further raise rouble interest rates to extraordinarily high levels. As the stock of debt grew without substantial progress in structural reforms, domestic and foreign holders of Russian debt increasingly believed that either the rouble would be devalued or the government would default on its domestic debt. Both results occurred, precipitating a profound financial crisis.

In this context it is fair to say that at the root of Russia's macroeconomic problems have been persistently high federal budget deficits, which came down dramatically in 1995 only to rise again in 1996 during the presidential election campaign. Deficit reduction began in earnest again only towards the end of 1997, with the primary deficit falling from its peak of 2.8% of GDP in the first quarter of 1997 to 1.7% in the fourth quarter, and moving into surplus in 1998. By that time, however, investor confidence had already begun a downward spiral. The fundamental causes of the budget deficit were political: an inability to rein in government spending, weak tax discipline among politically influential firms and an excessive devolution of revenue to regional governments. Pressure to spend came both from the Duma, which repeatedly passed unrealistic federal budget laws, and from within the government, where ministries resisted attempts by the Ministry of Finance to control their spending promises. As a result, the Finance Ministry's only lever of control was to sequester disbursements of cash from the Treasury to keep the deficit within the limits of available financing. This policy successfully averted a return to monetary financing, but caused a substantial build-up of wage and expenditure arrears. Federal government payment arrears reached 67 billion roubles (3% of the GDP) by 1 January 1997.

Poor control over spending commitments also worsened the deficit by contributing to the erosion of tax discipline. Non-payment for goods and services by the federal government and by budget-financed organisations made it easier for large companies, particularly utilities and companies with strong political connections, to withhold taxes from the federal budget. The federal government repeatedly tried to wipe the slate clean by using the so-called 'money offset' scheme of clearing mutual debts between companies and the budget, but each time tax and spending arrears reappeared. Soon, large companies became unwilling to pay their taxes in cash because of 'powerful offset expectations', as one government analyst described it.³ Non-cash tax payments to the federal budget amounted to 2.1% of GDP in 1995, 4% in 1996 and 3.6% in 1997. In November 1997, the President signed a decree banning new clearing operations from 1 January 1998, but the parliament later overrode this decree in a clause of the 1998 Budget Law.

Federal revenues were also reduced by outflow of revenue to sub-national governments. In the early years of reform, the federal government shifted expenditures to lower levels of government in an effort to alleviate pressures on the federal budget and to satisfy the separatist demands of its resource-rich ethnic republics.⁴ To compensate for additional responsibilities, however, regional administrations gained a greater share of general government revenue by signing special bilateral deals with the centre and by creating non-transparent off-budget funds. Between 1992 and 1997, on-budget regional revenues rose from 11.8% of GDP to 13.5%. Meanwhile, the federal budget bore the full brunt of the post-stabilisation revenue decline, with revenues falling from 15.6% of GDP in 1992 to 12.0% in 1997.

But if fiscal deficits represented the main problem of Russia's macroeconomic policy which forced the 1998 financial crisis, the enterprise restructuring policy, or the lack of it, is considered by analysts as the main on-going obstacle in the present recovery process. It is true that Russia's fiscal problems have undermined the entire large corporate sector, and have inhibited growth, encouraged capital flight, limited tax collection and reduced domestic savings. But from the very beginning Russia's politicians had been unwilling to draw sharp distinctions between public and private property or to impose hard budget constraints on large enterprises, both out of fear of the unemployment implications, and to preserve rent-seeking opportunities for powerful vested interests. The rapid privatisation of state property between 1993 and 1995 moved over 125,000 enterprises into private hands, but it did not create effective corporate governance or place effective limits on state interference. The federal government gave up most attempts to intervene in company management, but regional governments have continued to exert a strong influence over the actions of key enterprises, whether or not they have been formally privatised. At the same time, small and medium-sized private companies are subject to harassment and expropriation by local officials and tax inspectors, leading them to hide as much of their operations as possible from the state. Thus, the large insolvent corporate sector inhibits what has been dubbed the *virtual economy*, while smaller and new private firms conceal their activities and launder their profits in the shadow economy. A third category of enterprises *particularly profitable commodity exporters* have adopted a number of effective tax-avoidance strategies.⁵

Since the state has been unwilling to liquidate large insolvent enterprises, profitable companies, such as commodity exporters, have had a strong incentive to masquerade as bankrupt ones. Elaborate schemes involving *transfer pricing*, shadowy intermediary companies, complex multilateral barter operations and offshore bank accounts have been used to hide profits and conceal holders. The State Tax Service has the authority to deduct funds from domestic rouble bank accounts, but it has little success in seizing property or accessing offshore accounts. In practice draconian measures that stopped short of bankruptcy *such as heavy fines and frozen bank accounts* have made matters worse by driving debtor companies further into barter and the shadow economy.⁶

In contrast to the official indulgence shown towards large enterprises, fully private companies and foreigners have experienced an extremely difficult business climate. Surveys of Russian shop-owners show a steady pattern of regulatory interference by local government officials and by criminal organisations. Joint-ventures and foreign firms report having to obtain dozens of licenses, many requiring bribes to bureaucrats, before they could start operations. The distorted and burdensome tax code, all but irrelevant for large enterprises, has been mercilessly applied to these private companies by tax inspectors. Some foreign companies operating in Russia have co-opted local authorities by giving them an equity stake in their business, further blurring the distinction between public and private responsibilities.⁷

The pervasive soft budget constraints and weak property rights prevented Russia from experiencing an economic recovery and hence a revival in tax revenues, leaving the macroeconomic stabilisation extremely fragile. Ambiguous and unprotected property rights discouraged savings and investment, while giving companies and individuals a strong incentive to keep their capital offshore. The persistence of insolvent but politically influential enterprises blocked new private firms from entering the market. Given the courts' reluctance to take action against debtors, banks were understandably wary of lending to unaffiliated companies. Together with fiscal deficits, these phenomena left the Russian financial system in a precarious position. Economic decline has, in turn, made political decisions to cut back budget entitlements and redistribute the tax burden much more painful and difficult. Yet unlike the fiscal situation, which was gradually improving in the first part of 1999, the enterprises sector has remained in an inefficient, unproductive equilibrium.

In sum, Russia became during the last decade an emerging market of striking contrasts. The gap between the rapid pace of liberalisation and privatisation and the insignificant development of critical market-supporting institutions has been as stark as in other countries in the region. Rapid privatisation was not combined with effective reforms able to promote good corporate governance, competition through new market entry, and proper financial discipline. The explosive rise of commercial banks and complex financial instruments quickly outpaced the capacity of institutions to enforce effective prudential regulations. The state

grew dependent on volatile foreign capital inflows without paying sufficient attention to the necessary improvements in the investment climate to secure sustainable access to these inflows. Indeed, banks were able to trade sophisticated financial derivatives, but were virtually unable to attract ordinary household deposits. Trading on the stock market reached volumes of over US\$ 100 million per day, but stock owners were often unable to exercise their most basic shareholder rights.

On the other hand, vast financial-industrial groups (FIGs) were created to promote synergies between banks and large-scale enterprises, while an ever-increasing number of firms resorted to barter to stay afloat. The self-styled "oligarchs" in command of these FIGs amassed substantial fortunes, while leaving workers and the state with a mushrooming backlog of wage and tax arrears. Foreign portfolio investors moved aggressively into the Russian market, hedging their currency risks with Russian banks but taking inadequate account of the implications of an accumulating mountain of derivative contracts on the overall stability of the banking system. Indeed, the Russian crisis has demonstrated quite clearly that the absence of necessary institutional reforms led the economy to become vulnerable to macroeconomic instability which, in turn, incurred a heavy cost on growth. Unfortunately, the economics "domino principle" proved to be right once again, and as a result of the Russian financial crisis all the other countries in transition were affected to a larger or smaller degree.

6. PROGRESS IN MARKET-ORIENTED TRANSITION IN 1998

7. The turmoil in emerging markets and the Russian financial crisis of 1998 put the quality of reforms in transition economies to the test. Although a wide range of factors has determined the vulnerability of these economies to crisis, the key to preserving macroeconomic stability and sustainable growth has been the strength of, and commitment to, market-supporting institutional reforms. The crisis in Russia has highlighted the critical importance of the capacity of the state to enforce law and to 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 social foundations for a well-functioning market economy. These are the key challenges of the next phase of transition and they remain at the top of the agenda for all countries in the region.⁸

General trends in transition

During 1998 the transition economies faced an increasingly similar set of challenges, but their responses, and hence their progress, have differed substantially. The 1998 crisis in the emerging markets and in Russia has highlighted even more sharply the fact that the countries of the region have pursued strikingly different paths of macroeconomic stabilisation, structural reform and institutional development. The difference among them, both in terms of the nature of the reforms adopted and the pace of change in different dimensions of the reform process, have largely determined the vulnerability and the resilience of each country in the face of global market pressures (Table 1).

Table 1 - Progress in transition in Central and Eastern Europe, the Baltic states and the CIS*

sector	Private		Governance &		Trade &		Non-bank	
	Population	share of	Large-scale	Small-scale	Price	Competition	Banking	financial
GDP			enterprise	enterprise	exchange	system	Reform	
Country	(mil.1997)	(%)	Privatisation	privatisation	Liberalisation	policy	institutions	
1998)			restructuring					
Albania	3.2		2	4	3	4	2	2-
75			2		2			
Armenia	3.7		3	3	3	4	2+	2
60			2		2			
Azerbaijan	3.6		2	3	3	3	2	2-
45			2		1			
Belarus	10.2		1	2	2	1	1	2
20			1		2			

Bosnia Herz. 35	4.1	2 2-	2	3 1	2	2	1
Bulgaria 50	8.3	3 2+	3	3 2	4	3-	2
Croatia 55	4.5	3 3-	4+	3 2	4	3-	2+
Czech Rep. 75	10.3	4 3	4+	3 3	4+	3	3
Estonia 70	1.5	4 3	4+	3 3-	4	3+	3
Macedonia 55	2.0	3 2	4	3 1	4	3	2-
Georgia 60	5.4	3+ 2	4	3 2	4	2+	1
Hungary 80	10.1	4 3+	4+	3+ 3	4+	4	3+
Kazakhstan 55	15.7	3 2	4	3 2	4	2+	2
Kyrgyzstan 60	4.6	3 2	4	3 2	4	3-	2
Latvia 60	2.5	3 3-	4	3 3-	4	3-	2+
Lithuania 70	3.7	3 3-	4	3 2+	4	3	2+
Moldova 45	4.3	3 2	3+	3 2	4	2+	2
Poland 65	38.7	3+ 3	4+	3+ 3	4+	3+	3+
Romania 60	22.5	3- 2	3+	3 2	4	2+	2
Russia 70	147.2	3+ 2	4	3- 2+	2+	2	2-
Slovak Rep. 75	5.4	4 3-	4+	3 3	4+	3-	2+
Slovenia 55	2.0	3+ 3-	4+	3 2	4+	3	3
Tajikistan 30	6.1	2 2-	2+	3 1	3-	1	1
Turkmenistan 25	4.7	2- 2-	2	2	1	1	1
Ukraine 55	50.9	2+ 2	3+	3 2	3-	2	2
Uzbekistan 45	23.6	3- 2	3	2 2	2-	2-	2

The numerical indicators represent the cumulative progress in the movement from a centrally planned economy to a market economy. Classification system for transition indicators:

- 1** Little progress
- 2** Moderate progress
- 3** More than 25% of programmes implemented
- 4** More than 50% of programmes implemented and substantial progress realised

* Source: The Economist Report (London: The Economist Intelligence Unit, March 1999).

While the gaps between countries may have grown, progress in tackling the difficult challenges of the next phase of transition has generally been slow throughout the region, especially in comparison with the rapid pace of reforms in the first phase. For many countries, progress in transition, as reflected in the 1998 transition indicators, has been slower and more erratic than in any year since the fall of the Berlin Wall. Indeed, the 1998 transition indicators show a significantly slower pace of overall progress than in previous years, as well as more frequent instances of backtracking on previously implemented reforms. The contrast has become still more apparent between the achievements of the first phase – liberalisation and privatisation – and the modest progress in such areas as financial sector reform, governance and restructuring, competition policy and the development of market-oriented infrastructure. Policy reversals have become more common. A large number of countries have resorted to administrative controls in response to crisis. The hard-won gains of the first phase of transition have been placed increasingly at risk.

The progress over the year has been concentrated in countries that have been catching up on long-delayed reforms. These include Armenia, Azerbaijan and Tajikistan. The latter recently adopted an IMF/World Bank recovery programme following the cessation of the civil war, which led to further progress in price and foreign trade liberalisation, small-scale privatisation and initial efforts to deal with enterprise arrears and to harden budget constraints. Azerbaijan continues to liberalise its trade and foreign exchange regimes as it approaches World Trade Organisation (WTO) standards. Armenia has accelerated its privatisation process by placing greater emphasis on cash auctions and international tenders. Other countries have begun to show impressive progress in tackling the different challenges of the next phase of transition. Poland has made major strides in privatising its banking sector. Hungary has achieved real progress in governance and enterprise restructuring, owing to the important role that foreign investors have played in establishing effective corporate governance and the continued tightening of financial discipline.

Despite this progress, the 1998 transition indicators show more instances of backtracking on reforms than any previous year since the fall of communism. Reform reversals were registered in ten instances across six countries. Russia stands out in this regard following the 1998 financial crisis. Indicators have been decreased in four areas: banking reform, security markets, price liberalisation, and trade and foreign exchange liberalisation. This reflects the major retrenchment of the banking system and the virtual standstill of the financial markets following the rouble devaluation, forced restructuring of government debt, and the limited moratorium on commercial debt payments. The crisis in Russia also had a limited effect on the indicators of other countries, most notably Latvia, where large bank holdings of Russian state security revealed serious weaknesses in the effectiveness of the prudential regulation of Latvian banks.

Not all of the backtracking on reforms, however, can be attributed to the direct or indirect effects of the Russian crisis or broader pressures in emerging markets. One group of countries – Belarus, Turkmenistan and Uzbekistan – has demonstrated a consistent pattern in recent years of delaying or retreating from market-oriented reforms across a number of different dimensions. This pattern of backtracking does not appear to derive from economic constraints. Rather, governments in these countries have explicitly favoured an alternative economic path that has, over time, increasingly diverged from the reform patterns of other transition economies. In 1998 Belarus and Uzbekistan both introduced further price controls, leading to reductions in their transition indicators in this area. Turkmenistan continued to delay its modest programme for large-scale privatisation.

Over the years, there is some evidence of an increasing clustering of countries within each geographical region according to their average scores on the transition indicators, as well as increasing similarities in the patterns of reform across the regions. The pattern shows that average transition indicator score decreases as the focus moves from west to east. Indeed, the indicators decrease from the group of countries in Central and Eastern Europe (Hungary, Poland, Czech Republic, Slovak Republic, Slovenia and Croatia) to the Baltic states (Estonia, Latvia and Lithuania) and Southeastern European countries (Romania, Moldova, Bulgaria,

Albania and Macedonia), while central CIS countries (Russia, Ukraine and Belarus), Caucasus (Georgia, Armenia, Azerbaijan) and Central Asia (Kyrgyzstan, Kazakhstan, Uzbekistan, Tajikistan and Turkmenistan) are even more far away. Furthermore, the indicators show a tighter clustering of countries in Central Eastern Europe than in the regions of the CIS. Over time, transition indicators have been converging in Central Europe, Southeastern Europe and Caucasus. The average indicators for the countries of the central CIS countries and Central Asia, however, have continued to diverge.

There are numerous possible explanations for this strong regional pattern of economic transition. These include historical and cultural links to the market economy, initial socio-economic conditions, opportunities for integration with international and regional institutions, the structure of politics and political institutions, or differences among countries in the way in which the previous communist system collapsed. But to separate these intricately related explanations would be extremely difficult. However, the maintenance of these regional patterns of economic reform, even as the transition advances, suggests an interesting relationship between initial conditions, the early patterns of reforms and later policy choices. Of course, this does not imply that progress in transition is shaped by some geographical determinism or trapped in an immutable path of reform. A comparison of the neighbouring states of Russia and Belarus, or Kazakhstan and Turkmenia, for instance, clearly suggests that policy choices can lead countries to veer away from the regional pattern of reform.

The causes of the declining pace of progress and increased backtracking have been varied. In a small group of countries – Belarus, Turkmenistan and Uzbekistan – governments appear to be veering off the reform path, delaying basic reforms and reversing earlier achievements in pursuit of their own strategy of economic development. Each year they lag further behind the other transition economies. Other countries, such as Russia and Ukraine, have re-imposed a number of administrative controls over the economy in response to crisis. In most cases, backtracking and the postponement of necessary reforms can be traced to the opposition of strong vested interests in the political system, both inherited from the former command system and, more often, forged in the early stages of the transition itself. The politics of building the institutions necessary for economic stability and sustainable growth have proven to be extremely complex and fraught with risks to the entire reform process.

These risks were demonstrated all too dramatically with the unfolding of the crisis in Russia, where extreme fiscal pressures in the context of inadequate structural reforms and a highly uncertain political environment produced one of the sharpest setbacks of the reform process in the short history of the transition. However, the Russian crisis and reform reversals in other transition economies should not overshadow the progress that many transition economies have continued to make in 1998. Several countries in which reform was derailed by the pressures of war – Armenia, Azerbaijan, Bosnia-Herzegovina, Georgia and Tajikistan – have begun to make up lost ground, implementing long-delayed plans or adopting new reform programmes. The challenge ahead will be to maintain the commitment to implementing these reforms and to begin to tackle the difficult institutional reforms necessary for a well-functioning market economy.

Countries such as Hungary and Poland have begun to show real progress in tackling the challenges of the next phase of transition, particularly in the difficult areas of banking reform and enterprise restructuring. Indeed, the resilience that these economies demonstrated in the face of the crisis in emerging markets is a strong testament to the importance of these institutional reforms for maintaining stability and growth. There remain, however, a number of authoritarian regimes, particularly in Belarus and in most of the countries of Central Asia, where effective multi-party democracy has not taken root. The experience of transition so far has shown that the reliance of these regimes on manipulation and control undermines sound economic decision-making and prevents an effective response to economic difficulties once they arise. Economic policy-making in a number of countries, notably Russia, is further distorted by powerful interconnections between industry, finance, the media and politics, which also weaken the functioning and stability of democracy. It is not by chance that the quality of economic governance is higher where the consolidation of multi-party democracy is stronger.

Contagion and transition

The Russian crisis has had a deep impact on financial markets across the whole region. The immediate determinant of the market's reaction in many instances has been an adjustment to the worldwide shift in portfolio preferences. Hence, even in countries with a strong underlying framework, stock markets have slumped and exchange rates have come under pressure following Russia's devaluation on 17 August. However, in the more advanced transition economies, the exit of international investors proved to be temporary. In others, the market's response to the crisis has been more muted so far despite underlying weaknesses, but a build-up of stronger pressures in the future cannot be excluded.

The fall in share prices and exchange rates across the region did not show a strong relationship with the underlying macroeconomic strengths and the weaknesses manifested by the transition economies. However, developments in domestic money markets, in the secondary market for Eurobonds and in international reserve positions show a much clearer differentiation among countries, and one that conforms better with prior expectations of potential vulnerability.

Estonia, Lithuania, Romania, the Slovak Republic and Ukraine have all experienced a significant tightening of domestic liquidity as their currencies have come under strong pressure - culminating in the shift in the exchange rate band in Ukraine on 4 September and the abandonment of the fixed exchange rate in the Slovak Republic on 1 October. The change in international reserves further reveals that the tightening of domestic liquidity was associated with a net resource outflow in Romania, Ukraine and, to a lesser extent, the Slovak Republic, while the Baltic states seem to have benefited from an inflow of foreign currency, as many Russians in particular shifted deposits across the border.

In the medium term the impact of the Russian crisis on the region is likely to be more differentiated than the immediate market reaction suggested. In evaluating the impact that the Russian crisis is likely to have on the region, it is useful to distinguish between four channels of contagion: trade linkage, banking sector exposure, capital markets and a potential world economic slowdown.² As a result of the Russian crisis, growth in 1998 and projections for 1999 show a moderate slowdown in Central and Eastern Europe due to a lower export demand from Russia and a slowdown in west European growth. The Baltic states and the CIS have been more strongly affected by trade linkages with Russia. In a number of countries, weak underlying fundamentals posed a significant risk of financial contagion. In these cases, growth was slowed by a contraction in domestic demand following a rise in interest rates and a reduction of current account imbalances forced by more limited access to international capital flows.

- Trade linkages

The loss of export due to demand contraction and/or real exchange rate depreciation in a major trading partner can directly squeeze incomes and weaken the balance of payments. This may in turn force the government to adopt contractionary macroeconomic policies to restore external balance, thereby amplifying the impact on aggregate demand. Trade exposure to Russia is more important to the CIS. All CIS countries with the exception of Tajikistan and Turkmenistan conduct 20% or more of their merchandise export trade with Russia; this share is above 50% in Belarus and Moldova, and close to 40% in Kazakhstan (Table 2).

8. Table 2 - Trade exposure to Russia*

East Central Europe and the Baltic states

Exports to Russia %	Exports to Ukraine %	Exports to Belarus %
---------------------	----------------------	----------------------

Bulgaria	7	3
Croatia	4	0
	2	1

Czech Rep.	6	5
Estonia	2	8
Macedonia	5	1
Hungary	21	4
Latvia	7	9
Lithuania	4	5
Poland	3	1
Romania	3	3
Slovakia	4	1
Slovenia	6	4
Average		
CIS		
Armenia	23	2
Azerbaijan	23	4
Belarus	59	15
Georgia	30	4
Kazakhstan	39	3
Kyrgyzstan	21	1
Moldova	63	5
Russia	-	9
Tajikistan	8	1
Turkmenistan	5	-
Ukraine	22	-
Uzbekistan	31	6
Average	29	5

* Source: IMF, Direction of Trade Statistics Yearbook, 1998.

If we have to include trade exposure to Ukraine and Belarus as countries more likely to experience a sharp contraction in import demand over the next 18 months, Latvia and Lithuania are also strongly affected by trade linkages. Service trade, including above all transport of energy, is of considerable importance in the Baltic states as well as in Belarus and Ukraine. In addition, indirect trade links exist through intermediary markets. In Hungary, for instance, indirect trade exposure was recently estimated at 30% of total export, and a significant proportion of Macedonia's exports through Yugoslavia was ultimately destined for Russia. Some sectors of industry in central and Eastern Europe are also affected, especially food processing and pharmaceuticals.

- Banking sector exposure

Heavy banking sector exposure to an economy in crisis and resulting capital losses from exchange rate movements and fall in asset prices may precipitate banking crisis, with potential

knock-on effect on economic activity and macroeconomic stability. Direct banking sector exposure would seem to be a major risk only in the case of Latvia. Some Latvian banks are heavily exposed to the Russian GKO market; total exposure may equal 10 % of banking sector assets. Indirect exposure through the reduction of trade finance opportunities and economic difficulties of borrowers engaged in exports to the Russian market may nonetheless present a financial burden for many banks in the region.

A weak banking system is an element of vulnerability that may interact with spill-overs in goods and capital markets to precipitate financial instability. While there has been no evidence so far of such indirect financial linkages through the banking sector, present circumstances highlight the need to strengthen prudential regulations and banking supervision.

- Portfolio shifts in capital markets

Shifts in investor sentiment can increase the cost of borrowing and put pressure on currencies. This can force countries into contractionary policies and lead to disruption in financial markets. Financial linkages may spawn contagious effects both directly, through the pressure on international investors to sell parts of their portfolio in order to meet liquidity needs, and indirectly, through a general "flight to quality" leading to an outflow of capital from all emerging markets. Both direct and indirect financial linkages have been important in spreading financial turmoil to the transit economy. Russia was affected by the partial liquidation of Latin America and East Asia holdings in late 1997 and early 1998.

The flight to quality by international investors was evidenced in the substantial decline in equity markets in all transition economies following the Hong Kong stock market slump in late October 1997, and more dramatically since the end of July 1998. However, a closer look at the effects of the East Asian crisis on the region reveals that once the dust of the initial turmoil settles, international investors differentiate strongly among countries according to their underlying strengths and weaknesses.¹⁰ Indeed, one effect of the recent turmoil has been to fully expose the weaknesses in macroeconomic policies in several transition economies. Their problems as a result of the Russian crisis have at least as much to do with inadequate domestic policies as with financial contagion per se.

Among the macroeconomic fundamentals, the existence of "twin" fiscal and current account deficits in a number of transition economies is at present the biggest source of concern. On this line, Romania appears to be particularly vulnerable to a loss of investor confidence. Large current account deficits in the Baltic states, Croatia and the Slovak Republic also raise concerns about these countries' ability to mobilise sufficient financing, and some macroeconomic adjustment may be required. In most CIS countries, the lack of foreign direct investment (FDI) in their capital accounts limits the degree of vulnerability to international financial contagion, despite the existence of large fiscal and current account deficits in some cases.

The large financial requirements of some governments in Eastern Europe and the CIS and their accumulation of short-term debts pose particular risks to the balance of payments and the exchange rate regime. Short-term debt can pose a significant risk to an exchange rate commitment if a substantial amount of debt is falling due and investor sentiment deteriorates. Most short-term debt in the transition economies has been placed with the banking sector and in the domestic money markets.¹¹ In this context, the ability of monetary authorities to fend off a sudden decline in the demand for domestic assets depends to a considerable extent on the strength of its reserve position relative to the size of outstanding domestic liabilities.

The lack of liquid domestic assets confirms the particular vulnerability of Ukraine in addition to Russia's unrivalled position. Belarus and the Slovak Republic also have a ratio of liquid domestic liabilities to international reserves comparable to the levels in East Asia prior to the 1998 financial crisis. In Belarus, the lack of confidence in the currency led to a collapse of the exchange rate on the parallel market since mid-August 1998. While convertibility restrictions may limit the immediate impact on the country's balance of payments, the external financing constraint is nonetheless likely to severely dent growth prospects. The Slovak koruna was devalued on 1 October 1998 in response to repeated speculative attacks.

- World economic slow-down

Since the onset of the crisis in Russia, the financial turmoil that spread from East Asia across emerging markets since mid-1997 has also reached out to the economies of western Europe and North America. For the economies of Central and Eastern Europe and the Baltic states, a slow-down in economic growth particularly in western Europe would have significant negative implications, more so than developments in Russia. Thus, in Central Europe, where exports to the European Union account for between 20 and 40% of GDP, a reduction in import demand from western Europe by only 2% could shave around 1% off growth in 1999. Among the CIS countries, the resource-rich economies of Central Asia would be particularly affected through depressed commodity prices as a result of a downturn in world economic activity. In the remainder of the CIS, the degree of trade integration with the rest of the world is much less significant, and the additional impact of a slowdown in world growth is likely to be small.

9. MACROECONOMIC PERFORMANCE AND PROSPECTS

1998 has been a turbulent year for Russia and its largest economy in the region, as well as for many other countries in Central and Eastern Europe and the Baltic States (CEE), and the Commonwealth of Independent States (CIS). While Russia's modest output recovery in 1997 was largely responsible for the first year of average growth in the region as a whole, the 1998 crisis is causing a substantial downturn in its economy and at least a temporary return to high inflation. The fall-out from the Russian crisis is affecting economic performance in the rest of the region, in particular in neighbouring CIS economies with weak macroeconomic frameworks and strong trade links to Russia. Moreover, NATO intervention in Kosovo and postponement of a strong recovery in Western Europe will harm growth prospects in Central Europe too, although its direct exposure to the Russian economy through trade and financial linkages is limited.

The overall picture from the 26 countries in the region, however, is positive in many respects. The severity of the current crisis in Russia and its potential consequences should not cloud the real strengths underlying robust economic performance in many transition economies in recent years, in particular in those countries that have achieved sound progress in the transition. Indeed, a number of countries have enjoyed annual growth rates of 5% or higher for more than two years, and data from 1998 show a consolidation of the recovery in a majority of cases. Several Central European economies are now achieving official levels of output that are higher than before the transition, and considerably higher if the unrecorded economy were taken into consideration. Moreover, for most countries, the problem of high inflation appears to have been solved, although inflation persists at double-digit annual levels in a number of them. For many of the fast-growing countries, a continuing challenge remains the financing of large current account deficits. Prudent macroeconomic management will be required to prevent a further increase in external imbalances as conditions on international capital markets tighten.

On the other hand, economic performance has been disappointing in several other countries, most of them in the CIS, and all of them at an early or intermediate stage in the transition to a market economy. The crisis in Russia once again highlights the risk that progress in macroeconomic stabilisation can be quickly reversed when underlying structural weaknesses are not addressed. A primary concern in this regard, particularly in the CIS, is the problem of large fiscal deficits, combined in some countries with external imbalances financed by rapid increases in short-term foreign debt. The evidence provided by analysing the developments in growth and inflation in 1998, and the macroeconomic outlook over the next year reveals the close connection between lack of progress in structural reforms and the vulnerability to macroeconomic setbacks.

Output and growth

The region as a whole experienced a landmark year in 1997, with positive growth recorded in both CEE and CIS (Table 3). GDP in Russia expanded in 1997 for the first time since 1989. In 1998 the reversal in Russia and its implications for the economic performance across the region have been the main issues. Russia's GDP decline of 5% in 1998 caused total GDP in the CIS to fall by over 3%. A number of CIS economies were directly affected by the Russian crisis and will record much lower growth in 1999 than predicted earlier. In CEE the momentum behind strong economic growth which was evident during the first half of 1998 was moderated during the remainder of the year, and average growth fell well below its 1997 level of 3.6%.

An examination of official GDP data reveals considerable variation in cumulative growth performance across the region. Caution is warranted in comparing pre- and post-transition GDP figures, given the considerable conceptual and measurement difficulties in each and every country in the region. Bearing in mind these shortcomings, real GDP in Slovakia and Slovenia reached the 1989 level, joining Poland, where this was achieved in 1996. In contrast, official GDP levels in most CIS countries remain below 60% of the 1989 level in spite of the return to growth to many former Soviet Union republics. Taking into account the substantial increases in the unofficial economy in this part of the region¹² the differences in cumulative growth performance are less obvious. However, per capita income levels remain significantly lower in the CIS, underlying the urgency of structural reforms that create a climate favourable to investment and growth.¹³

Table 3 - Growth in real GDP in Central and Eastern Europe, the Baltic states and the CIS*

GDP	Real GDP	(p e r c e n t a g e c h a n g e)						Real	in
		1992	1993	1994	1995	1996	1997	1998	
1997	in 1998	(1989-100)						(1989-100)	
Albania 80	-7.2 87	9.6	9.6	8.9	9.1	-7.0	9.0		
Bulgaria 63	-7.3 66	-1.5	1.8	2.1	-10.9	-6.9	4.0		
Croatia 76	-11.7 79	-8.0	5.9	6.8	6.0	6.5	4.2		
Czech Republic 98	-3.3 97	0.6	3.2	6.4	3.9	1.0	-1.0		
Estonia 73	-14.2 77	-9.0	-2.0	4.3	4.0	11.4	5.0		
Macedonia 56	-21.1 59	-9.1	-1.8	-1.2	0.8	1.5	5.0		
Hungary 4.6	90	-3.1 95	-0.6	2.9	1.5	1.3	4.4		
Latvia 56	-34.9 58	-14.9	0.6	-0.8	3.3	6.5	4.0		
Lithuania 61	-21.3 63	-16.2	-9.8	3.3	4.7	5.7	3.0		
Poland 112	2.6 118	3.8	5.2	7.0	6.1	6.9	5.2		
Romania -8.7	1.5	3.9	7.1	4.1	-6.6	-5.0	82	78	
Slovakia 95	-6.5 100	-3.7	4.9	6.9	6.6	6.5	5.0		
Slovenia 99	-5.5 103	2.8	5.3	4.1	3.1	3.8	4.0		
Central and Eastern									

Europe and the

Baltic states 96	-3.8 99	0.4	3.9	5.5	4.0	3.6	3.0
Armenia 38	-52.6 40	-14.8	5.4	6.9	5.8	3.1	6.0
Azerbaijan 40	-22.6 42	-23.1	-19.7	-11.8	1.3	5.8	6.7
Belarus 71	-9.6 75	-7.6	-12.6	-10.4	2.8	10.4	5.0
Georgia 32	-44.8 35	-25.4	-11.4	2.4	10.5	11.0	9.0
Kazakhstan 63	-2.9 63	-9.2	-12.6	-8.2	0.5	2.0	1.0
Kyrgyzstan 57	-19.0 60	-16.0	-20.0	-5.4	7.1	6.5	4.0
Moldova 35	-29.1 35	-1.2	-31.2	-3.0	-8.0	1.3	-2.0
Russia 58	-14.5 55	-8.7	-12.7	-4.1	-3.5	0.8	-5.0
Tajikistan 40	-29.0 41	-11.0	-18.9	-12.5	-4.4	1.7	3.0
Turkmenistan 42	-5.3 44	-10.0	-18.8	-8.2	-8.0	-26.0	5.0
Ukraine 37	-13.7 37	-14.2	-23.0	-12.2	-10.0	-3.2	0.0
Uzbekistan 87	-11.1 88	-2.3	-4.2	-0.9	1.6	2.4	2.0
CIS 57	-14.2 55	-9.3	-13.8	-5.1	-3.5	0.9	-3.6
CEE & the CIS 73	-9.7 72	-5.1	-6.2	-0.6	-0.2	2.0	-1.0

* Data for 1992-97 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank, the OECD and the Institute of International Finance. Data for 1998 represent IMF projections.

In CEE, output developments in 1997 and 1998 in three countries illustrate the benefits of decisive action to redress macroeconomic imbalances and to introduce financial discipline, as well as the considerable costs of delaying structural reforms. In 1997, Albania, Bulgaria and

Romania experienced large falls in output, on the back of serious financial crisis (Albania and Romania) and the implementation of a macroeconomic austerity package (Romania). Negative growth rates in these three countries, and the considerable deceleration of growth in the Czech Republic following a currency crisis in spring 1997, were largely responsible for the fall in average growth in CEE to 3.6% in 1997 down from 4% in 1996.

Data for 1998 show a significant rebound of growth in Albania and Bulgaria, reflected in the positive growth levels registered in both countries. Following changes in government, both countries rapidly adopted measures to stabilise their economies and to restore confidence in the domestic currency, and both have initiated the restructuring of their financial systems. In contrast, Romania is still in the midst of a macroeconomic crisis, and the decline in GDP in 1998 reflects underlying weaknesses, such as large fiscal and current account deficits, exacerbated by political paralysis and delays in implementing necessary structural reforms. The Czech economy was also performing sluggishly, and after growth of only 1% in 1997, the decline continued to some extent into 1998. However, there is no doubt that the economic effect of NATO's military intervention in Kosovo is going to be harsh for all Balkan states, and even a long-term restructuring programme is not going to help these countries, and especially Romania, to obtain positive growth in 1999.

In the remainder of CEE, growth has been remarkably resilient over the 1997-98 period. Output grew in excess of 5% in six out of 13 CEE countries in 1997, including the region's biggest economy, Poland. Growth in 1998 was lower in all of these countries, but to a significant degree only in Latvia and Lithuania due to close trade links with Russia. Growth has benefited from the revival of domestic demand in Western Europe, particularly France and Germany, although it is not certain that this will continue in 1999 due to the Kosovo crisis. In general, the more advanced countries in Central Europe have withstood well the stress test and the effects of the Asian and Russian financial crisis, underlying their strong macroeconomic and structural foundations, and the military intervention in Kosovo is not expected to change this pattern in 1999.

While 1997 saw the return to positive growth in Russia and the CIS as a whole, 1998 brought about renewed decline as a result of a substantial output contraction in Russia. The extent of the downturn in Russia had substantial implications for the remainder of CIS countries. Given the close trade links with Russia, 1999 is likely to witness slow or no growth in a number of countries.¹⁴ After a decline in GDP of 3.2%, Ukraine's official level of production in 1998 fell below 40% of its 1989 level, as the country shares many of the underlying weaknesses of Russia and has come under severe pressure following rouble devaluation. Economic recovery is therefore unlikely in 1999, although the IMF agreed a US\$2.2 billion extended fund facility in September 1998. The experience of 1998 demonstrates that growth in many CIS countries is quite volatile. In some countries, such as Kyrgyzstan, Moldova and Uzbekistan, the agricultural sector is a key determinant. In these countries, GDP growth is heavily dependent on the weather. The decline in oil and metal prices has significantly hurt Kazakhstan since the second half of 1997. Turkmenistan's GDP has been dominated by gas and cotton, the latter's revival lying in part behind the recovery which began last year. Tajikistan also remains very volatile, given the political disturbances there, and the sustainability of the reported high growth rates in Belarus is highly questionable.¹⁵

Inflation

Inflation continued to decline in a majority of countries in 1997 and 1998. However, the past two years have been marked by reversals in macroeconomic stabilisation: Albania, Bulgaria, Romania and Tajikistan in 1997, and Belarus and Russia in 1998 (Table 4). Less pronounced increases in end-year inflation were also recorded in 1997 in Armenia, and in 1998 in Moldova, Turkmenistan and Ukraine. The fragility of macroeconomic stabilisation, which has been a feature of the transition for some time, should not obscure the real achievements in stabilisation made in most countries, but points to the need to strengthen the foundations for stability.

In Russia the hard-won gains in the fight against inflation are in serious danger of being lost. Having reduced inflation to an end-year rate of 11% in 1997, the collapse of the rouble and the crisis in the banking system produced an end-year inflation in 1998 of 150%. Macroeconomic stabilisation will now depend first and foremost on restoring confidence in the rouble through a comprehensive fiscal consolidation. It will then require deep structural reforms to ensure that an increase in the use of money in all economic transitions and a reduction in barter accompany the renewed build-up of liquidity in the country's financial system. In CEE, achievements in the reduction of inflation in Albania and Bulgaria from high levels in 1997 are particularly notable. Both managed to achieve an end-year rate for 1998 of around 10%. Improvements in Romania have been slower to materialise, largely because of stalled economic and political reforms and rising fiscal imbalances. As a result, end-year inflation reached 45% in 1998.

Elsewhere in CEE, inflation rates in 1997 continued to decline in the majority of countries, although small increases in end-year inflation were recorded in Croatia, the Czech Republic, Slovakia and Macedonia. Inflation rates have come down very rapidly in the Baltic states and to a lesser extent in Poland, while disinflation has been slower in Hungary. With the exception of Romania, inflation rates in all countries of CEE for 1998 are in single-digit or very low double-digit. Two of the former Yugoslav republics, Croatia and Macedonia, have had the lowest rates in the region in recent years, and come closest to the EU average of 2.1%.

Turning to the CIS, the picture is one of average improvement but significant individual setbacks. The average end-year inflation rate was almost halved in 1997 to 13% and, on the back of reductions to single-digit or low double-digit end-year levels in six of the 12 CIS countries, has been maintained at almost the same level, at 17%. Lower inflation in many countries reflects the growing importance of security markets, which have allowed persistent budgetary deficits to be financed in the short term in non-inflationary ways. However, the reliance on monetary policy alone to bring down inflation carries very substantial risks, as demonstrated by the collapse of Russia's stabilisation efforts. Moldova's and Ukraine's inflation rates also rose to over 20% by year-end, as nominal exchange rate devaluations fed through to their domestic price levels. Stabilisation remains precarious in Turkmenistan, the major contributor to the decline in average inflation in 1996, as a result of continued directed credits to the agricultural sector.

Public finances in transition

A feature of the transition process is the severe and continuing pressure on government budgets, and the resulting fiscal imbalances that have arisen in most countries in the region (Table 5). The pattern has continued in 1997 as with a few exceptions, governments are continuing to run budget deficits, which in many cases are large relative to the size of the economy. Revenue collection remains a pressing concern, especially in the CIS. Data indicate that the group of countries with fiscal deficits in excess of 5% of GDP grew from six in 1997 to seven in 1998, five of which are in the CIS.

Table 4
 - End-year inflation in Central and Eastern Europe, the Baltic states and the CIS* (change in year-end retail/consumer price level, in %)

1992

1993

1994

1995 1996 1997 1998

Albania 42.1	10.0	236.6	30.9	15.8	6.0	17.4
Bulgaria 578.5	10.0	79.4	63.8	121.9	32.9	310.8
Croatia 3.8	6.0	938.2	1,149.0	-3.0	3.8	3.4
Czech Republic 10.0	9.0	12.7	18.2	9.7	7.9	8.6
Estonia 12.0	8.0	953.5	35.6	42.0	29.0	15.0
Macedonia 2.7	1.4	1,925.2	229.6	55.4	9.0	-0.6
Hungary 18.4	13.5	21.6	21.1	21.2	28.3	19.8

Latvia 7.0	4.6	959.0	35.0	26.0	23.1	13.1
Lithuania 8.5	4.2	1,161.0	188.8	45.0	35.5	13.1
Poland 13.2	10.0	44.3	37.6	29.4	21.6	18.5
Romania 151.4	45.0	199.2	295.5	61.7	27.8	56.9
Slovakia 6.4	9.0	9.1	25.1	11.7	7.2	5.4
Slovenia 8.8	7.0	92.9	22.8	19.5	9.0	9.0
Central Eastern Europe						
& the Baltic States 10.0	9.0	199.2	35.6	26.0	21.6	13.1
Armenia 21.8	3.0	na	10,896.0	1,885.0	31.9	5.8
Azerbaijan 0.4	3.9	1,395.0	1,293.8	1,788.0	84.5	6.5
Belarus 63.0	60.0	1,159.0	1,996.0	1,960.0	244.0	39.0
Georgia 7.1	5.0	1,176.9	7,487.9	6,474.4	57.4	14.3
Kazakhstan 11.3	9.0	2,984.1	2,169.0	1,160.0	60.4	28.6
Kyrgyzstan 14.7	12.0	1,259.0	1,363.0	95.7	31.9	35.0
Moldova 11.2	30.0	2,198.0	837.0	116.0	23.0	15.1
Russia 10.9	150.0	2,506.1	840.0	204.0	128.6	21.8
Tajikistan 163.6	10.1	1,364.0	7,344.0	1.1	2,133.0	40.5
Turkmenistan 21.5	28.0	644.0	9,750.0	1,328.0	1,262.0	446.0
Ukraine 10.1	22.0	2,730.0	10,155.0	401.0	182.0	39.7
Uzbekistan 50.0	33.0	910.0	885.0	1,281.0	117.0	64.0
CIS 13.0	17.0	1,364.0	2,082.0	1,220.5	100.8	31.8

* Data for 1992-98 represent the most recent official estimates as reflected in publications

from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance.

Table 5 -

Government balances in Central and Eastern Europe, the Baltic states and the CIS*

- in percentage of GDP -

		1992	1993	1994	1995	1996	1997
1998							
Albania		-20.3	-14.4	-12.4	-10.3	-12.1	-
12.7	-13.9						
Bulgaria		-5.2	-10.9	-5.8	-5.6	-10.4	-
2.1	-2.0						
Croatia		-3.9	-0.8	1.6	-0.9	-0.4	-
1.3	-0.5						
Czech Republic		-3.1	0.5	-1.2	-1.8	-1.2	-
2.1	-2.4						
Estonia		-0.3	-0.7	1.3	-1.3	-1.5	
2.2	2.5						
Macedonia		-9.6	-13.8	-2.9	-1.2	-0.5	-
0.4	-0.8						
Hungary		-6.8	-5.5	-8.4	-6.7	-3.1	-
4.9	-4.9						
Latvia		-0.8	0.6	-4.1	-3.5	-1.4	
1.4	1.0						
Lithuania		0.5	-3.3	-5.5	-4.5	-4.5	-
1.8	-3.6						
Poland		-6.7	-3.1	-3.1	-2.8	-3.3	-
3.1	-3.1						
Romania		-4.6	-0.4	-1.9	-2.6	-4.0	-
3.6	-5.5						
Slovakia		na	-7.0	-1.3	0.2	-1.9	-
3.8	-4.0						
Slovenia		0.2	0.3	-0.2	0.0	0.3	-
1.1	-1.0						
Central Eastern Europe							
& the Baltic States		-5.1	-4.5	-3.4	-3.2	-3.4	-
2.6	-2.9						
Armenia		-13.9	-54.7	-10.5	-11.0	-9.3	-
6.3	-5.8						
Azerbaijan		na	-15.3	-12.1	-4.9	-2.8	-
1.7	-3.6						
Belarus		0.0	-1.9	-2.5	-1.9	-1.6	-
2.1	-3.0						

Georgia		-25.4	-26.2	-7.4	-4.5	-4.4	-
3.8	-2.5						
Kazakhstan		-7.3	-1.4	-7.2	-2.5	-3.1	-
3.7	-5.5						
Kyrgyzstan		na	na	na	-17.0	-9.0	-
9.4	-8.1						
Moldova		-26.2	-7.4	-8.7	-5.7	-6.7	-
7.5	-8.0						
Russia		-4.1	-4.2	-9.0	-5.7	-8.3	-
7.4	-8.0						
Tajikistan		-28.4	-23.6	-10.2	-11.2	-5.8	-
3.3	-3.3						
Turkmenistan		13.2	-0.5	-1.4	-1.6	-0.2	
0.0	-4.0						
Ukraine		-25.4	-16.2	-9.1	-7.1	-3.2	-
5.6	-3.0						
Uzbekistan		-18.4	-10.4	-6.1	-4.1	-7.3	-
2.3	-3.0						
CIS		-13.6	-14.7	-7.7	-6.4	-5.1	-
4.4	-4.8						

* Data for 1992-98 represent the most recent official estimates as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance.

The substantial fiscal imbalances characteristic of most transition economies early in the reform process and still prevalent in many CIS countries are closely related to the process of structural reform in the public sector. On the revenue side, transition from a command to a market economy requires that governments collect revenues from individuals and private enterprises rather than directly retain resources from state-owned enterprises. Balancing the decline in profit and turnover taxes from the contracting state sector with increased revenues from other sources necessitates a major shift in the tax base, as well as a healthy and growing private sector.

On the expenditure side, the transition-related pressures have been equally severe, although the nature of these pressures in the more advanced transition economies of Central Europe differs from those in the CIS. In Central Europe, budgetary outlays on social security increased significantly in the early stages of transition and have led to the accumulation of large contingent liabilities in state pension systems. In the CIS and some East European countries, while price liberalisation allowed a reduction in most budgetary subsidies, various forms of "off-budget" support (directed credits, tax and energy payment arrears) have emerged that undermine the fiscal position of the consolidated government. These observations suggest that government balances would follow a U-shaped pattern during the course of transition. Initially, large deficits would be expected as revenues declined sharply. With fiscal reforms progressing and growth returning to the region, these deficits should be reduced over time.

The presumption of a U-shape development of government balances in the transition is borne out by the evidence for most countries, although deficits have re-emerged or remained persistently high in a number of cases. In both CEE and the CIS, the gap between revenue and expenditure was at its widest about two to three years after the start of reforms. In CEE, there has been a very gradual narrowing of the gap from an average peak of -5.1% of GDP in 1992 to

-2.6% in 1997, and a slow, steady decline in both revenue and expenditure as a percentage of GDP. However, both remain high relative to countries with similar income, as general government expenditures in 1997 were still close to 40% of GDP on average. In the CIS, expenditure initially increased as a percentage of GDP following the break-up of the Soviet Union, leading to substantially wider initial imbalances. The subsequent rapid fall in expenditure and a mild recovery in revenue in the CIS, following the return of average positive growth after 1996, allowed the average fiscal deficit in this part of the region to fall from -14.7% of GDP in 1993 to -4.4% in 1997. In contrast to CEE, both revenue and expenditure are low in the CIS by international standards, reaching barely 10-15% of GDP in countries such as Georgia and Tajikistan.¹⁶ The decline in government outlays in absolute terms has been even more dramatic, as GDP has slumped, causing in many cases a disruption to the functioning of vital public institutions.

Managing the fiscal transition will remain a crucial challenge for macroeconomic policy and structural reforms alike during the next stage of reform. Indeed, the problems of revenue collection in the less advanced transition economies cannot be solved overnight. The overhaul of the tax system will take time, as will measures to strengthen tax administration. Given these constraints, governments will have to pay equal attention to an efficient use of public resources. A solution to the fiscal problems will have to tackle the waste of scarce resources through public sector over-employment, off-budget subsidies and corruption. Increasing efficiency in the use of public resources is all the more important as pressures on expenditure across the whole region will remain severe for the foreseeable future.

Another aspect to this problem is the fact that most countries in CEE are beginning to address the issue of accession to the EU. Until now, ten countries have formally applied for EU membership, with accession likely to take place in the first decade of the next century. Membership of the EU carries a number of responsibilities in terms of minimal environmental and regulatory standards and harmonisation of taxes, and therefore implies changes in revenue and expenditure, some of which are already taking place. The World Bank estimates that Poland, for example, will face direct investment costs during 1999-2000 of about US\$ 6 billion in order to satisfy EU directives concerning regulatory and administrative structures on infrastructures and the environment. This represents an annual cost of about 1.5% of GDP. However, Poland and other accession countries will be eligible for substantial structural funds from the EU to help finance these expenditures with the major influx into the budgets of accession countries expected after 2000.¹⁷

In sum, the key points of the analysis of fiscal balances in transition are as follows:

- ? Fiscal deficits have been a feature of the transition in most countries. While the overall trend in recent years is towards lower deficits, the persistence of deficits in a number of countries is worrying.
- ? Deficits are a particular source of concern in countries with large government debt and high interest payments on the debt.
- ? On the positive side, the experience of a number of transition economies demonstrates that substantial efforts to reduce large fiscal deficits can enhance growth prospects.
- ? Fundamental changes in the tax base away from a reliance on corporate taxes are required in a number of CIS countries, but these changes must be combined with concerted efforts to reduce tax evasion and arrears and to improve the efficiency of public spending.

External balance

Current account deficits have been a feature of transition economies for several years and 1998 was no exception. Table 6 shows that 17 out of 26 countries in CEE and the CIS had current account deficits in excess of 5% of GDP, a level often seen as a "rule of thumb" danger signal, and in seven countries current account deficits exceeded 10% of GDP. External balances in the transition economies in 1998 have been subjected to a combination of external shocks, including the impact of the East Asian crisis on world markets, and in particular 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 led to an end-year balance close to the result achieved in 1997. This swing in Russia's external balance had a deep impact on most countries in the CIS and some countries in CEE. This led to wider current account deficits in 1998 than earlier anticipated.

The size of external imbalances currently observed in several transition economies has raised concerns over their sustainability. In the majority of countries, current account deficits are driven by substantial increases in investment during the process of recovery, which in turn is contributing positively to export growth. However, in some countries current account deficits have resulted at least in part from declines in domestic savings and increases in consumption, highlighting the need for corrective macroeconomic policies. Of greater concern are current account deficits associated with large fiscal imbalances in some less advanced transition economies, emphasising the need for fiscal adjustment discussed above.

There are two reasons why external deficits in the transition economies would tend to widen during the process of economic recovery. First, there are offsetting pressures on the aggregate savings rate as output recovers. Although enterprise profits tend to improve with the resumption of growth, household savings rates are likely to fall as expectations of future incomes rise and uncertainty recedes.¹⁸ Second, since much of the capital stock has been both rendered obsolete by the introduction of market prices and product market competition and depleted by years of neglect, the returns to fixed investment are high and demand tends to surge with growing output and increasing confidence.

Table 6 - Current account and trade balances in Central Eastern Europe, the Baltic states (CEE) and the CIS*

		- in million of US dollars -				- in% of	
GDP -							
Current	Trade	Current	Trade	Current	Trade	Current	Trade
account	balance	account	balance	account	balance	account	balance
1998	1998	1997	1997	1998	1998	1997	1997
Albania		-276	-519	-399	-675	-12.2	-
22.9	-13.7	-23.3					
Bulgaria		433	381	-100	-200	4.2	
3.7	-0.8	-1.6					
Croatia		-2,435	-5,224	-1,737	-4,778	-12.6	-
27.0	-8.6	-23.7					
Czech Republic		-3,156	-4,600	-1,700	-3,000	-6.1	-
8.8	-3.1	-5.5					
Estonia		-564	-1,129	-576	-1,250	-12.0	-
24.1	-10.6	-22.9					
Macedonia		-275	-388	-238	-349	-8.3	-
11.7	-7.5	-11.0					

Hungary			-987	-1,700	-1,600	-2,400	-2.2	-
3.8	03.4	-5.1						
Latvia			-345	-848	-514	-1,000	-6.2	-
15.3	-8.6	-16.89						
Lithuania			-981	-1,147	-1,563	-1,651	-10.3	-
12.0	-15.1	-15.9						
Poland			-4,300	-11,300	-6,500	-14,000	-3.2	-
8.3	-4.5	-9.7						
Romania			-2,398	-1,971	-3,400	-2,600	-5.7	-
5.7	-6.4	-6.4						
Slovakia			-1,340	-1,470	-1,950	-2,117	-6.9	-
7.6	-9.4	-10.2						
Slovenia			37	-772	-80	-785	0.2	-
4.2	-0.4	-1.1						
Central Eastern Europe								
& the Baltic States			-	-	-	-	-6.2	-
11.4	-7.1	-12.0						
Armenia			-472	-560	-535	-500	-29.0	-
34.4	-28.7	-26.8						
Azerbaijan			-915	-567	-1,480	-850	-23.7	-
14.7	-32.7	-18.8						
Belarus			-799	-1,335	-950	-1,350	-6.0	-
10.0	-7.7	-11.7						
Georgia			-347	-484	-500	-600	-6.6	-
9.3	-9.0	-10.8						
Kazakhstan			-953	-385	-1,8000	-1,100	-4.2	-
1.7	-7.5	-4.6						
Kyrgyzstan			-139	-15	-165	-40	-8.3	-
0.9	-9.5	-2.3						
Moldova			-292	-319	-293	-330	-13.4	-
14.7	-13.2	-14.9						
Russia			3,300	17,300	4,000	17,000	0.7	
3.8	1.4	5.9						
Tajikistan			-60	-64	-69	-70	-5.4	-
5.7	-5.5	-5.5						
Turkmenistan			-596	-245	-676	-431	-32.5	-
13.3	-32.8	-20.3						
Ukraine			-1,300	-4,300	-1,200	-3,000	-2.6	-
8.4	-2.9	-7.3						
Uzbekistan			-584	-72	-492	-242	-4.1	-
0.5	-3.8	-1.9						

CIS	-	-	-	-	-11.3	-
9.2	-12.7	-9.9				

*** Data for 1992-98 represent the most recent official figures reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance.**

The case of Poland is a good example for the typical pattern of domestic private savings and investment that may be observed in a number of transition economies during the process of economic recovery.¹⁹ Poland's private savings rate and the difference between government savings and investment have remained roughly constant as a share of GDP since 1993. Poland's positive example is in contrast to developments in Latvia and Romania, where a fall in private savings and rising fiscal deficits were the main factors behind the growth in the current account deficit in both countries to well over 5% of GDP in 1998. Latvia's case is partially mirrored in the other Baltic countries too. Estonia had a very substantial decline in private savings between 1993 and 1994, followed by a fall in government savings, which against constant investment rates has contributed to very high external deficits. Lithuania has experienced a fall in government savings since 1993 against the background of recent increases in both private consumption and investment.

Over the period 1994-97, countries with larger private investment rates have recorded higher export growth. Although the short term volatility of the supply of international funds could force corrective policy measures to reduce current account deficits across the region, the evidence reviewed here suggests that for the more advanced transition economies, and on the bases of macroeconomic fundamentals, external imbalances remain sustainable. That is, these countries should be able to service their current account obligations without drawing down reserves and without recourse to repeated devaluations of their currencies.

On the other hand, the examples of Romania in 1998 and Hungary during 1994-95 highlight the danger of running large government and external imbalances. In both countries substantial macroeconomic instability has been associated with the drying-up of capital inflows in view of weak fundamental structures. Tough, corrective action has since greatly improved the situation in Hungary, while Romania is still in a very difficult financial imbalance, being forced to service over US\$ 2 billion of its debts during 1999. The same situation is also characteristic of a number of CIS countries, including Armenia, Georgia, Kyrgyzstan, Moldova and in 1998, Turkmenistan. With the exception of the latter two countries, the reliance on official sources to finance these deficits has so far attenuated the risk of serious balance of payments difficulties, but further efforts are needed if a costly external adjustment including a fall in private investment is to be avoided.

External balances in the transition economies in 1998 have been affected by a combination of shocks, starting with the impact of the East Asian crisis on world trade and on commodity prices, and, from August 1998, the Russian devaluation. Trade linkages between the region and East Asia are minor and competition in third markets has been offset by the strength of the recovery in Western Europe in 1998. The impact of falling commodity prices and reduced Russian imports demand, however, is expected to lead to a substantial deterioration of external balances in raw materials exporting countries and Russia's main trading partners, most of them in the former Soviet Union. At the same time, the availability of external financing to cover current accounts deficits has declined or has become much more costly. As a result, a decline of both exports and imports is likely in 1999, particularly for countries that are unattractive for foreign direct investment.

Since their peak in June 1997 and the beginning of the East Asian crisis, oil prices have declined by over 50% by the end of 1998. This has had an impact on external balances in Azerbaijan, Kazakhstan, Russia and Turkmenistan, each of which relies on oil for more than 20% of export revenue. Data for 1998 indicate that export values in these countries were down by 10% or more. In all four countries, margins for oil producers were substantially reduced, and this negatively affected fiscal revenues, which are dependent to a large extent on their share of profits from natural resource extraction. In this context, Russia's devaluation

can be understood in part as an attempt to restore profit margins to this important sector in the Russian economy. In the remainder of the region, falling oil prices had the opposite effect on external balances, as import growth was moderated in value terms. Indeed, for much of the CEE low commodity prices provided a relief to external balances during 1998, and this trend is likely to continue in 1999.

As expected, the impact of the Russian crisis on trade across the region was highly differentiated. The CIS countries which are conducting significant export trade with Russia have been very much affected. The Baltic states and to a lesser extent Poland (on account of its substantial cross-border trade) have also been affected by the contraction in Russia's GDP and in the resulting slump in demand for their exports. For most countries in CEE, direct trade linkages and competition on third markets are far less important. However, the general outlook for exporters from the region has become less favourable and macroeconomic policy will have the challenge of preventing further increases in current account deficits against the background of tighter international capital markets.

In sum, the analysis of the sources of external imbalances in the transition economies leads to the following conclusions:

? Current account deficits remain a feature of the transition, as more than half of the countries in the region had deficits in excess of 5% of GDP.

? In some countries in CEE, these deficits reflect increased private investment, which can generate sustained export growth and long-term solvency.

? In other countries, especially in the CIS, current account imbalances are twinned with fiscal imbalances. Concessionary loans from external sources can finance current account deficits in the short run, but not indefinitely.

? The Russian economic crisis and currency devaluation may significantly worsen current account deficits in some CIS countries for the years to come.

CONCLUSIONS AND CHALLENGES AHEAD: HOW VULNERABLE IS THE REGION?

It is clear from this analysis that growth and stability have been maintained in those countries where discipline in macroeconomic management and the depth of reform have been strongest. Structural reforms and effective macroeconomic management are closely intertwined. Weak reforms generate financial institutions and enterprises that are financially unsound and fail to meet obligations to customers, other enterprises and the government. In turn, financial institutions or firms can collapse, or where they do not, may fail to pay taxes. Fiscal positions deteriorate and macroeconomic difficulties arise. Heavy government borrowing requirements distort the development of financial institutions, which focus on the relatively easy task of lending to government rather than to private industry. In this way, financial intermediation is stunted, private investment is "crowded out" and long-term prospects are damaged. Investors have come to recognise this logic and the recognition of flawed reforms has led to crisis.

In order to avoid crisis and to sustain growth, countries must therefore push ahead with institutional reforms. The main challenges still facing most countries include improving business practices and corporate governance, restructuring enterprises, strengthening financial institutions and reforming the fiscal system. Throughout the region, weaknesses in these areas are both a manifestation and a cause of weaknesses of the state and its failure to adapt to its new role in a market economy.

This leads directly to the specific challenges faced by Russia. The priorities for the short-term should focus on fiscal adjustment and rebuilding the financial sector. A strong improvement in the fiscal position in the coming years, of about 5-6% of GDP, is essential. In the absence of willing lenders or other outside funders in the near future, a fiscal balance is required and that is roughly the required adjustment, excluding the revenue required for meeting debt obligations. If this is not achieved, the likely reaction would be to print money. This will not lead to the rising of significant resources, but will lead to very high inflation, thereby effectively

reducing real expenditure. The result would be great hardship of the type that occurred in Russia in 1993-94, with sharp increases in poverty and mortality rates. It must be emphasised, however, that the current problems in Russia, at least in principle, are still manageable. One sign is the fact that in 1998 there was a primary surplus, and tax revenues were starting to grow. But it is essential that tax revenue performance is improved, and further reform of the tax code is a key ingredient.

The second urgent set of measures to restore the Russian economy concerns bank restructuring. In many cases, the state will need to inject capital, acquire a controlling interest and replace management. Other non-viable banks should face liquidation. It is vital that those procedures move forward quickly and in an open, transparent and non-discriminatory manner. If the process reflects discrimination or cronyism, the old problems are likely to return. Meanwhile, a lasting solution to the current crisis also requires strong measures to increase the pace of restructuring and improvement in the corporate governance of Russian enterprises. Experience in other transition economies strongly suggests that successful restructuring not only requires strategic investors but also limiting the scope for groups that might in the short run be adversely affected by restructuring from blocking those changes. What is required is a combination of policies aimed at increasing alternative employment prospects and targeted income support.

Because of all these problems, the Russian crisis is not simply an economic crisis. It goes straight to the heart of the relationship between state and civil society. For reforms to proceed, a new and viable political consensus is required, just as much as a coherent programme. While assistance from outside can undoubtedly prove helpful at critical junctures, bringing forward the reform agenda will depend primarily on domestic decisions and leadership. At the present time, it is difficult to see in Russia a new political consensus for reform emerging rapidly. Yet the costs of prolonged delay are likely to be severe.

Indeed, even after President Yel'tsin fired Primakov as prime minister in May 1999 in order to "re-invigorate Russia's faltering economy", and appointed Sergei Stepashin as the new premier, the Russian government continued to send mixed signals concerning its economic priorities. On the one hand, such is the state of disarray in the economy that Stepashin stated in his first speech in the capacity of prime minister in front of Duma deputies that the major plank in his future government's platform is progress on the economic front: *"Our mission is to create a principally new economic context, and to take correct decisions capable of guaranteeing better living conditions and renewing the greatness of such a powerful country as Russia. It is no secret that we find ourselves in an extended economic crisis? You know as well as I do how difficult our situation is with domestic and foreign debt, and how difficult it is after the August financial crisis to resurrect our finances and banks, how hard it is to pay current wages and pensions."* Stepashin also signalled, in his Duma speech, his intention to sort out alleged misuse of funds appropriated from the IMF and other international lenders: *"That's why from the very first day of work in the capacity of prime minister, I ordered a thorough analysis of the issue of how foreign loans have been used. I will immediately establish an intergovernmental economic commission chaired by myself"*.²⁰

On the other hand, three days after the new Russian cabinet was formed, President Boris Yel'tsin signed a decree sacking Mikhail Zadornov as first Deputy Prime Minister and Finance Minister. This resignation openly questioned Stepashin's ability to choose his own government and more than that, to sort out serious economic problems, in an acute moment when Russia was involved in complex negotiations with international loan agencies and creditors on crucial loan resummptions and debt restructuring. However, the appointment of Mikhail Kasyanov as the new finance minister, and the flurry of announcements by the new government on economic policy did not manage to eliminate the persistent confusion as to who is in charge of the Russian economy and to what extent the new government will be able to sort out the enduring Russian crisis. And indeed, in spite of the approval of a package of stiff economic measures requested by IMF prior to the release of a \$4.5 billion loan, the Russian government has done very little so far to impose fundamental economic changes, and in tackling the existing crisis.

However, as the health of Russia's economy depends very much on commodity prices, in particular oil, there is some optimism about this year's economic performance. Since last

December, oil prices have risen more than 40%, and the prices of other commodities have also risen or are holding stable. As a result, higher world commodity prices and a weaker rouble have helped Russian companies in the last few months to boost their output. But although external factors might be helping the economy, the basic tasks for the Russian government remain the same. And few in Russia believe that the newly appointed Prime Minister, Sergei Stepashin, can fix the country's economic problems and stimulate a recovery.

But the pressures on Russia's economy are more or less the same in all the transition economies, and growth prospects for 1999 across the region are subject to a considerable amount of uncertainty. It is true that the direct impact of the Russian crisis on the region is likely to be quite different across various exposure groups, with the CIS most affected. For most countries in CEE, growth prospects largely depend on the economic consequences of the Kosovo crisis and on the performance of the western European economies. However, growth forecasts for 1999 indicate a continuation of variations across the region, with the gap between countries in CEE and the CIS projected to widen. Among the CIS countries, those most advanced in structural reforms seem to be most sheltered against adverse developments in the Russian economy.

Growth prospects for the countries of CEE are generally evaluated positively by most observers. The average of growth forecasts for every country in CEE is considered to be positive in 1999, and the average rate is expected to increase from 3.0% in 1998 to 3.6% in 1999. However, this increase is largely due to the return to marginal positive growth in Romania, the fourth-largest economy in the region. The average growth shows no change in CEE, while the output expansion in Croatia, Hungary, Poland and Slovakia is expected to slow from its previous high levels. In particular, the substantial reductions in growth forecast for Slovakia and (less) for Croatia indicate observer's scepticism that the high growth rates of past years could be sustained without a more thorough commitment to structural reforms and given the need to reduce high external imbalances. The relatively high trade exposure of the Baltic states to Russia and the western parts of the CIS underlines their substantially lower post-crisis growth forecasts for 1999, with Estonia - as in 1998 - least affected.

A number of CEE countries may see improved output performance in 1999, mainly those where growth has been negative (Romania) or subdued (Bulgaria, Czech Republic and Slovenia) in recent years. Initiatives to improve the attractiveness of these economies to foreign direct investments will be key to sustaining the recovery against the background of a less accommodating international environment, and the postponement of a long-term financial package for the countries affected by the Kosovo crisis.

Average projections for the CIS are largely driven by estimates for Russia. The majority of observers forecast a further decline in Russian GDP by around 4-7%, reflecting the depth of crisis gripping the country. If a successful stabilisation programme can be implemented, the decline could be confined to the lower end of this range, but should stabilisation fail, an even larger decline would be possible, as demonetisation and the absence of effective governance lead to further disintegration of the official economy. The variation in growth projected for the other CIS countries is illustrative of the gains from structural reforms for macroeconomic resilience. Armenia and Georgia are projected to continue growing at rates of 5% or more, as in Azerbaijan. For the latter, as for Turkmenistan, this is primarily on the back of growing commodity exports. In contrast, Ukraine and Uzbekistan will see their recovery further hindered by the Russian crisis as foreign investment inflows dry up and the environment for domestic business formation remains clouded by government interference. Furthermore, Belarus and Moldova are likely to fall into recession due to close trading linkages with Russia and unsustainable macroeconomic foundations.

As a result of these forecasts, the World Bank's top officials dealing with Russia and the other transition states in Central and Eastern Europe are painting a sobering, even daunting, picture of what many in the region will face over the next few years. According to them, most of the countries of the former Soviet Union have seen nothing but decline and deterioration since the transition began 10 years ago, and the region will face a protracted crisis of economic, social, and, most recently, security problems, especially over the next 12 months. They acknowledged in the bank's 1998 annual World Development Report published in Washington on 25 April, before the start of the annual meetings of the World Bank and the IMF, that Russia and Ukraine

especially are going to face serious economic difficulties: *"We continue to expect a decline in output and an uncertain political outlook due to elections that are coming up this year and next year,"* adding that *"the social situation in these countries is fragile since incomes are continuing to decline and social support systems are continuing to weaken. Poverty is on the rise, in Russia, for example, and in our estimate almost 20 percent of the population is in extreme poverty. And we of course also see a situation where structural and social reforms are incomplete and proceeding only very slowly and with limited political support."*²¹

They also assessed that Hungary, Poland, and the Czech Republic are the good news, noting that these countries remain relatively stable and unaffected by the ongoing Russian financial crisis because of early reforms and strong policies. But for most former Soviet countries, the impact of that crisis has been severe and will be felt for a long time to come. The global economy does not make a real difference among these nations, as their future economic development depends on their own policies and their proximity to Russia. Regarding the lessons learned from the Asian and Russian financial crises, the World Bank's report considers the necessity of strong domestic reforms as one of the most important. Another important lesson drawn from Russia's collapse last summer was the Russian leadership's strong defence of currency exchange rates. Indeed, a major part of the IMF's last loan drawing for Russia was eaten up in the Central Bank's attempt to defend the exchange rate of the rouble. The Bank assesses that this kind of policy could lead to severe crises: *"Ukraine is a good example where in fact a rather sensible management of getting away entirely from a fixed exchange rate in fact prevented the kind of meltdown we see in Russia"*.

The weakness of banking systems and supervision, linked with the exposure of short term debts, in appropriate foreign exchange positions - again Russia being a good example - is another important lesson drawn from last year's financial crisis. But more than that, it is the danger of a weak social safety net. Very weak social protection systems are unable to deal with the fallout of severe economic crisis, and the case of Russia was particularly bad: *"There were difficulties in engaging the Russians through 1996 in an active dialogue on social reforms,"* the declaration noted, *"and there are still many difficulties in Ukraine today. Earlier attention to reforms of social systems and then more significant action also would have helped in crisis response."* The World Bank report also pointed out that Russia has still not dealt adequately with its social safety net and the deepening crisis only makes clearer that Russia cannot afford further postponement of reform. Indeed, in a recent study of the social system in Russia, the bank predicted that the worst of the crisis is still ahead in the coming 12 months. Next winter is predicted to be the hardest time, far worse than this year. The bank projects that real personal incomes in Russia will fall an average of 13% through 1999, with the extreme poverty rate rising to more than 18% of the population, while social expenditures by the government will fall by 15%.

However, the major lesson for the region from the Russian crisis is considered to be the necessity of a political consensus on reforms. This conclusion was drawn from a comparative analysis of the situation in Bulgaria and Romania. Bulgaria has now in fact recovered from a severe financial crisis only two years ago because it has pursued a consistent and comprehensive reform and stabilization process based on a reasonably clear and sustainable political consensus between the president, the government, parliament, and wide segments in the population. Romania, by contrast, has had considerable difficulties that one can trace back to the lack of political consensus and the difficulty of forming a clear political underpinning for reform and stabilization. The World Bank is, however, hopeful that in looking forward, Romania can find a more consensus-oriented reform process, as Romania is one of the pilot countries for the comprehensive development framework where the Bank will focus very much in the near future with the government and under the leadership of the president, on trying to build this broader consensus.

In sum, the international macroeconomic environment has become less favourable for the transition economies during 1998 as a result of the Asian and Russian crisis, and this will affect economic performance across the region in the years to come. However, those countries where the foundations for solid economic performance have been laid through persistent structural reforms should be able to withstand the pressures on their external balances, exchange rates and output growth emerging from the crisis in Russia and any general decline in investment confidence. For countries where government imbalances and external deficits remain high, the

coming years will pose a crucial stress test of their governments' commitment to structural reform. A retrogression in transition is no solution to present circumstances and would almost certainly increase the costs of adjustment to a changing global economy.

However, a response to existing economic crisis in most of the former communist states should go beyond the reform efforts of the transition economies. The industrialised countries must also recognise that the current global market environment has powerful implications for the economies of the region. A special responsibility falls on the richer nations to take account of the effects of demand and of trade openness in industrialised countries on emerging markets. A loosening of monetary policy in industrialised countries would help to ease liquidity pressures and to dampen the re-balancing of global investment portfolios away from emerging markets. The United States, Japan and the European Union each has its own special structures and pressures, and any policy measures they adopt will have to take them into account. The effects of their actions on emerging markets in general and for the process of transition in the former communist countries in particular, are profound and embody great responsibilities. It is vital, therefore, that these responsibilities are reflected in the choices they make in response to the difficulties this global economy now faces.

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¹ The term "institutional" is used here to include: the functioning of the state and the behaviour of its officials, including the issue of corruption and of personal safety; the regulatory and legal framework and its effectiveness; the structure and functioning of enterprises – in particular their market-orientation; financial institutions; and political and social institutions, including the democratic process, the freedom of the press and a social safety net.

² Governance is defined as the "manner of governing".

³ See Karpov P., *On the cause of low tax collection, general causes of the "arrears crisis"*. (London: Interagency Balance Commission, 1997).

⁴ Treisman, D., "The politics of intergovernmental transfers in post-Soviet Russia?", *British Journal of Political Science*, Vol. 26, 1996, pp. 299-335.

⁵ On the "virtual economy" see Gaddy, C., and Ickes, B., "Beyond a bailout: time to face reality about Russia's "virtual economy"?", *Foreign Affairs*, Vol.77, 1998, pp.53-67.

⁶ On the "shadow economy" see Kaufman, D., and Kaliberda, A., "Integrating the unofficial economy into the dynamics of post-socialist economies", in Kaminski, B., (ed.), *Economic Transition in Russia and the New States of Eurasia*, (New York: M.E.Sharpe, 1996), pp.54-58.

⁷ See Fry, T., and Shleifer, A., "The invisible hand and the grabbing hand", in *American Economic Review Papers and Proceedings*, Vol.87, 1998, pp. 354-359.

8 Elster, J., Offe, C., et al. *Institutional Design in Post-communist Societies: Rebuilding the Ship at Sea*, (Cambridge: Cambridge University Press, 1998), pp.7-9.

9 This classification has been suggested by Adams, C., and Mathieson, D., in *International Capital Markets. Developments, Prospects, and Key Policy Issues*, International Monetary Fund, World Economic and Financial Survey, Fall 1998.

0 This argument is developed in Fries, S., Raiser, M. and Stern, N., *Why is the market so unforgiving?* (University of Maryland, September 1998).

1 Short-term foreign liabilities are large by international comparison only in Russia and in the Baltic states.

2 For evidence see S., Johnson and D., Kaufmann, *Politics and Entrepreneurship in Transition Economies*", Working Paper No. 57, (University of Michigan: The William Davidson Institute, 1997).

3 Given the steep falls at the start of transition, more than a decade of growth at double-digit rates would be required in many CIS countries to reach official output levels recorded in 1989.

4 An exception is Turkmenistan, but this follows a drastic decline in real GDP in 1997. Output fluctuations in this country have been caused by volatile gas exports, although a greater part of these have not been paid and the decline in GDP hence tends to overstate the decline in real income of the population.

5 While official figures suggest that Belarus is growing rapidly, increasing inflation, a burgeoning current account deficit and the collapse of the exchange rate on the black market point to the lack of sustainability of the country's present growth performance.

6 It is important to note that Russia is one of the countries in the CIS with the highest share of government revenue in GDP (total revenue was 31.8% of GDP in 1997). As reported before, Russia's fiscal problems are related in equal measure to its inability to raise sufficient tax revenues and wasteful and unaccountable use of public resources.

¹⁷ See World Bank Report (1998).

8 For a detailed discussion on this subject see Denizer, C., and Wolf H., *Aggregate Savings in the Transition: A cross-country study*, (World Bank, mimeo, April 1998).

9 The situation is very similar in the Czech Republic and Slovakia, with private savings rates at around 23% of GDP and private investment rising rapidly from roughly 20% to 30% of GDP over the 1993-96 period, and a subsequent downward adjustment in 1997, following the Czech currency crisis.

2⁰ Quoted in Frost, M., *Russia: Who's in Charge of Finances?*, on www.rferl.org/nca/features/1999/28/05.

2¹ For a detailed analysis of the 1998 World Bank's report see Lyle, Robert, *World Bank predicts rough year ahead for most East European states*, on www.rferl.org/newsline/1999/28-290499.html