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COMMUNICATION FROM THE COMMISSION
TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

THE RUSSIAN CRISIS AND ITS IMPACT
ON THE NEW INDEPENDENT STATES AND MONGOLIA

1. Introduction

The European Council in Vienna last December expressed its concern at the deteriorating economic situation in the New Independent States (NIS), particularly those with close financial or trade links with Russia. The Commission was requested to provide a report on these developments, including proposals on how to address these economic issues, not only within the framework of the existing assistance programmes, but also through the Partnership and Co-operation Agreements as they come into force. This Communication sets out the Commission's analysis of the situation and the response of the international community, including that of the EU.

Since last August, Russia has been in a serious economic and financial crisis. This crisis has caused a sharp loss in confidence among investors. In the wake of the break-up of the former Soviet Union, a large majority of the NIS have remained closely inter-linked economically with Russia. As a result, they have been affected, in some cases severely, by Russia's current financial crisis.

In general, declining Russian imports and the sharp fall in remittances from their nationals working in Russia are having a serious negative impact on growth and the current accounts of these NIS. In addition, the economies of a number of NIS, notably Armenia, Georgia and Azerbaijan, are dependent on income from remittances of their nationals working in Russia. This revenue has been severely hit by the crisis and in some cases the pattern has even been reversed with families in these countries now having to support relatives in Russia.

Moreover, NIS budgets and capital accounts have been suffering from the collapse of the Russian banking system and from the re-evaluation by foreign investors of the risk of financing projects in the region. The efforts of some countries to defend the value of their currencies have exacerbated this critical situation.

At first, encouraged by their political independence, affected countries tended to minimise the impact of the Russian crisis, reluctant to recognise the interdependence of their economies with Russia. This has considerably delayed their response and requests for external support. Now, several months after the onset of the Russia crisis and its initial impact on the other NIS, these countries have profoundly reassessed the situation and begun voicing their concerns. In recent weeks, many of the NIS have presented formal requests for support.

In its assessment of the impact of the Russia crisis, the Commission has analysed the situation in the other NIS according to a number of socio-economic criteria. Details of the impact of the crisis on each country in the NIS and on Mongolia are provided below and in Annex I.

Agriculture has been considerably affected in a number of countries. These difficulties are particularly serious in Georgia, Ukraine and Moldova.

In the social sector, fiscal pressures caused by a slowdown in the domestic economies will cause further cuts in social spending and, as a result, increased poverty, which is already widespread. Through a combination of wage and pension arrears, reduced access to social services, employment losses and lower remittances, the poor will be hardest hit by the economic slowdown and are the least able to cope. As a result of growing social pressure, the countries may undergo a period of political instability.

The political and social costs in these countries are expected to be high, and pressures to reverse economic reforms and return to interventionist practices are intensifying. Privatisation as a whole will be affected. Restructuring in the banking and energy sectors as well as reform in the social sectors are in danger of being postponed or reversed.

In addition to close economic links with Russia, many of the NIS themselves have close economic and social inter-relationships. This introduces a serious risk of knock-on effects from one country to another. For example, severe economic difficulties in Georgia have an immediate, negative effect on the economies of Azerbaijan and Armenia.

2. Effects of the crisis

The Commission has analysed the situation in the NIS according to a number of socio-economic criteria. The conclusion is that Armenia, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan and Ukraine are significantly affected by the Russian crisis.

Armenia

The main immediate impact of the Russian crisis is likely to be felt on the social front. In the absence of sufficient and rapid additional donor assistance, the Government may have to delay planned expenditure, including in the social sphere. The Government will therefore face difficulties in financing education and health care. An accumulation of public sector arrears is likely. Private transfer and family support systems have come under pressure. This situation might result in a substantial increase of poverty.

The Armenian Government has notified the Commission that the most urgent needs for additional assistance are in the areas of the social safety net, education and health care. The Government has introduced a new benefit for vulnerable groups in the 1999 budget and a special benefit to assist the most vulnerable groups to cope with the increased electricity tariffs. It has also asked for additional balance of payments support in order to reduce the pressures on the budget caused by debt-servicing.

Azerbaijan

Trade related consequences in the short term are less significant than in some other NIS as trade with Russia has for some time been severely affected by the political instability in the North Caucasus.

Azerbaijan's economic problems have other origins. It will only capitalise on the oil revenues in three to four years at the earliest and is suffering severely from the depressed level of oil prices which are at their lowest levels for 10 years (the oil sector accounts for 20% of the economy and 45% of fiscal revenues). A further major difficulty arises from nearly one million refugees and internally displaced persons on its territory as a result of the Nagorno-Karabakh conflict. The crisis may lead to a reduction in social welfare directly through a cut in expenditure. Government spending was cut in 1998. Further cuts in 1999 will inevitably affect key social sectors.

It is envisaged that existing support, including the € 30 million exceptional Tacis assistance over three years which was agreed last year will be used to deal with the effects of the Nagorno-Karabakh conflict. A first instalment of € 10 million of this assistance has recently been disbursed.

Belarus

The Russian crisis is expected to have a major impact on Belarus, given its high level of dependence on the Russian economy and the poor economic record of the Government. GDP and industrial production are declining rapidly. Shortages of basic goods have forced the introduction of rationing. Social provisions are at risk.

The political situation in Belarus is not conducive to the implementation of Tacis assistance, which has been suspended by the Council, through the national authorities. It is therefore envisaged to continue employing existing assistance instruments, namely ECHO and the Tacis Civil Society programme.

Georgia

Russia accounts for approximately 30 % of exports from Georgia and is also a significant source of income through remittances from Georgian workers. As a result of the Russian crisis and poor agricultural performance, GDP growth for 1998 and 1999 was seriously affected. The most visible effect is the decrease in traditional exports of agricultural products to Russia. Moreover, the Georgian authorities, as those of other countries, fear that the food aid to Russia could have a further negative impact on their agricultural markets both by substituting their exports and being diverted on to their home markets. The current account deficit and the impact on the balance of payments are likely to be much larger than expected before the Russia crisis. The currency has already sharply depreciated. The foreign exchange market and Central Bank interventions have reduced the country's reserves by more than half.

Fiscal difficulties have worsened in 1998. Salary and social sector arrears have accumulated further. Privatisation and foreign direct investment has slowed down as investors' confidence dwindles. Through a combination of wage and pension arrears, reduced access to social services, employment losses and lower remittances, the poorest will be hardest hit by the slowdown.

In some parts of the country electricity supplies are down to two hours a day. Following renewed violence in Abkhazia in May, Georgia is having to cope with an additional refugee burden and is obliged to import electricity which had previously been produced by the Inguri Dam on the Georgia-Abkhaz front line. There is also a perennial shortage of medical supplies.

President Shevardnadze has requested specific support from the EC to finance the necessary energy supplies to help the country through the winter as well as budgetary support to alleviate the burden of salaries and pension arrears. Energy assistance should include importing electricity from Armenia and heating oil from Azerbaijan, countries which are also facing a serious shortfall in expected revenues. Georgia also requires urgent technical assistance to ensure the collection and management of tax revenues and to progressively eliminate corruption.

Kazakhstan

In the first six months of 1998, more than one third of Kazakh trade was with Russia. The impact of the Russian crisis on Kazakhstan is being felt principally through a reduction in trade. Kazakhstan has temporarily banned import of some Russian foodstuffs which are already produced inside Kazakhstan in sufficient quantity. Kazakhstan's problems are mainly due to the current low oil prices as a major proportion of government revenues

depends on the oil sector. The Kazakhstan authorities have expressed concern at the fact that EC food aid for Russia could affect Russian grain imports from Kazakhstan.

Kyrgyzstan

With almost 60 % of its exports going to the NIS countries, the Russian crisis is expected to have a negative impact on growth in Kyrgyzstan. The currency has depreciated. Price liberalisation for gas, heating, electricity, water and transport is now threatened as increased tariffs become problematic socially. Private sector interest for the restructuring is now likely to be further diminished, owing to higher risk assessment for the region. Overall privatisation may be slowed. Prospects for a strong foreign investment response are low.

There has been an increase in pensions and wage arrears. The budget has not been able to fund key health expenditure, including primary health care and medicine.

The Kyrgyzstan authorities have sent a formal request for special assistance. The new Government has already stated that it intends to improve tax collection and fight corruption, contraband and economic crimes. Additional support could be provided for energy, medicines and food aid to the most vulnerable groups.

Moldova

The main impact of the Russia crisis is being felt through trade as half of Moldovan exports go to Russia. Many farms and agro-enterprises have been unable to pay wages for several months.

The country is one of the hardest hit with sharply reduced growth, a rapidly depreciating currency and acute fiscal pressure.

The reform and liberalisation process implemented by the new Government is threatened. The crisis has sharply reduced investors' interest, hampering the privatisation efforts. The heavy withdrawal of deposits from commercial banks is a serious setback to the financial deepening process in Moldova.

Poorer households and vulnerable groups like the elderly are bearing the brunt of the shock. For example, the basic pension is 36.5 lei per month and yet it costs around 200 lei to heat a small apartment. Wages and the already inadequate pensions are increasingly in arrears and are leading to frequent strikes and protests. Public expenditure on the social sector is much lower than planned.

The Moldovan Government was the first country to request special assistance to the EC as a result of the Russian crisis. President Lucinschi has set out in detail the country's needs. Moldova has stated that it will be unable to cover essential energy requirements (coal, gas and electric energy) and social expenditure (hospitals, schools etc). Targeted assistance for energy supplies would bring substantial help to the social sector and could be monitored in an effective way. In addition, vaccines, medicines and specific nutritional elements, particularly for children, are needed, together with appropriate training of hospital staff. Food aid, medicines and hygiene parcels for elderly people living in the cities could also be envisaged.

Mongolia

Mongolia has been affected more by the Asian than by the Russian crisis. Weakening demand for the country's key exports - copper and cashmere - have had a negative impact on the state budget, much of which is derived from taxes on exporters. Shortfalls are creating some delays in areas such as payment of state benefits.

Tajikistan

The country had already been suffering from weak cotton and gold prices on world markets. In the absence of additional donor support, the fiscal situation has deteriorated further.

A large share of the population is unable to meet its basic needs for food, shelter, clothing, health and education services. The civil war has caused increasing poverty and has confronted the Government with the difficult challenge of dealing with refugees, internally displaced persons (700.000) and the demobilised soldiers. A recourse to salary, pension and social safety arrears is a distinct prospect, while budgetary support for the implementation of the peace agreement will be weakened by the economic crisis. This will endanger the fragile peace and may exacerbate social tensions.

In addition to the local political problems, the Russian crisis is seriously affecting the population. People will not be able to pay for energy and essential imported goods. Food Security assistance already granted by the EC has been blocked for security reasons. Exceptional financial assistance has been agreed in principle by the Council in 1997 but not formally adopted pending implementation by Tajikistan of a macro-economic stabilisation programme. Following recent adoption by the Tajik authorities of a comprehensive adjustment and reform programme supported by the IMF and the World Bank, this matter will now be reconsidered.

Tacis technical assistance and the EC food security programme to Tajikistan have been suspended since 1997 for security reasons, following the murder of a western expert. Given the ongoing insecurity in the country, the effectiveness of technical assistance remains doubtful.

Turkmenistan

The financial impact of the Russian crisis on the Turkmen economy is limited since financial markets are tightly controlled by the state and the exposure of Turkmenistan's banks in Russia is very limited. Russia's financial crisis as such is not expected to have a direct social impact on Turkmenistan.

Ukraine

Ukraine's economy, already facing problems, is closely linked to Russia's and is undoubtedly negatively affected by the crisis of its neighbour. The presence of foreign investors in Ukraine's financial markets has been reduced, the national currency has been de facto devalued. Foreign exchange reserves have fallen below one month of imports. It is estimated that in 1998 real GDP contracted for the eighth consecutive year and annual inflation reached 40%.

The IMF has suspended the \$ 2.2 billion Extended Fund Facility to Ukraine, approved in September 1998. Meetings are taking place to get the programme back on track. Following the Russian crisis, foreign investors are modifying their risk assessment for the countries in

the region and it is possible that their interest in investing in Ukraine and in particular in its privatisation programme will further decrease.

Wage and pension arrears are increasing; this is worsening the population's already difficult living conditions.

The Ukrainian authorities have presented a detailed request for EC support amounting to € 6.3 million.

Uzbekistan

The impact of the crisis is expected to be less severe than in some other countries. Uzbekistan has gradually been increasing its economic independence from Russia. Moreover, banks have little exposure in Russia and the country's financial markets are underdeveloped.

Russia is still a major market for Uzbek cotton and uranium. Trade in those products has only to a limited extent been affected by the Russian economic crisis.

3. Response from the International Community

3.1 Response of the IMF and World Bank

The IMF and the World Bank took the initiative in convening, on 11 December 1998, a Consultative Group (CG) aiming at providing a greater access to the financial facilities they implement and at convincing bilateral donors to increase their financial support in favour of some NIS countries.

The IMF has identified six countries – Armenia, Azerbaijan, Georgia, Moldova, Kyrgyzstan and Tajikistan – as being particularly badly affected by the Russian crisis. All six have made efforts in terms of macro-economic stabilisation and structural reform in the context of programmes supported by the IMF. The IMF asked the Commission to join the assistance effort.

Increased access for the six countries to the IFIs' financial facilities constitutes an important policy response to the impact of the Russian crisis on the other NIS. However, such resources are limited and the six already have considerable access in relation to their quota. Hence, during the Consultative Group meeting of 11 December 1998, the Fund and Bank were not in a position to make available more than US\$ 120 million additional funding in favour of these six countries and asked bilateral donors to make an exceptional complementary effort.

3.2. Response of bilateral donors

Japan envisaged the possibility to provide additional support in 1999, but made no pledges owing to the short notice of the above-mentioned Consultative Group meeting. The US is considering additional assistance amounting to some US\$ 30-35 million. Switzerland also expressed its willingness to contribute in the order of US\$ 8 million. Russia mentioned the possibility of additional debt relief.

EU member states supported assistance from multilateral donors and expressed their wish to participate through Community instruments. In addition, Netherlands and Sweden are considering providing assistance for the six NIS mentioned above in 1999.

Structural weaknesses in the economies of NIS countries have been seriously exacerbated by the crisis. These structural difficulties include weak legal and regulatory frameworks, insufficient industrial restructuring and privatisation, vulnerable currencies and poor revenue collection. Remedies for these problems must be provided through the economic reform policies by the countries concerned. The PCA framework and technical assistance support under the Tacis programme provide the best means of assisting the NIS in their efforts. In this context, the Commission appeals to the European Parliament and Member States to accelerate the process of ratifying these agreements.

The Tacis budget for 1999 has been reduced by approximately € 60 million compared to 1998. Likewise, instruments previously employed in the NIS including the rehabilitation programme, macro-economic assistance and food security assistance to the Caucasus and Central Asia, have also been significantly reduced since 1997.

Further details are set out below on the instruments being employed in the region and how they might best be employed to tackle the problems in the region including the effects of the Russian crisis.

4.1 Macro-financial and/or exceptional financial assistance

- Macro-financial assistance

This instrument can offer flexible and quick disbursing facilities, and it is probably the most appropriate instrument to respond to macro-economic external shocks. It has however important constraints. Firstly, EC financial assistance involving direct balance of payments or budgetary support, is conditional upon satisfactory implementation of IMF supported programmes. Furthermore, eligibility for macro-financial assistance is conditioned to strict geographical criteria and several NIS (notably Kazakhstan, Kyrgyzstan, Uzbekistan, and Turkmenistan) are unlikely to benefit from such support. Concerning Belarus which is eligible in principle to such assistance, the macro-economic conditions are not presently fulfilled since the reform process in this country has long been discontinued. Ukraine already benefits from a new macro-financial assistance package (€ 150 million) which could be implemented as soon as the reform programme is back on track.

The Commission intends also to propose shortly macro-financial assistance of some € 15 million for Moldova, taking into account the country's estimated residual financing needs in the context of the macro-economic programme that the country will implement with IMF support.

- Exceptional financial assistance

In the cases of Armenia and Georgia, a framework Council Decision for exceptional financial support has already been adopted (€ 265 million) in the form of a combination of loans and grants to be disbursed over a period of 5 to 6 years. However, full use of this assistance could be made possible only if the Budgetary Authority confirms the grant amounts referred to in the current Council Decision. Inclusion of Tajikistan in this framework decision may be envisaged on this occasion, since this country now meets the prior conditions mentioned in the Council's Agreement of February 1997. This would imply an increase of this assistance package by some € 100 million through a combination of grants and loans. (see also Annex II)

4.2. Food security assistance

The Commission has been implementing a major structural assistance programme for food security aiming to respond to insecurity caused by serious food shortages or food crises in developing countries in a post-emergency situation. Food aid operations of a humanitarian nature do not, in principle, fall within the scope of this programme¹, except in the event of a serious food crisis. The assistance is subject to prior agreement between the Government of the individual country and the IMF on specific measures in the field of food security (price policies, fiscality, ...)

The programme provides direct budgetary support for agricultural sector reform in some of the countries under review: namely Tajikistan, Armenia, Azerbaijan, Georgia and Kyrgyzstan. Other eligible NIS are Turkmenistan, Kazakhstan and Moldova. It will be difficult to provide additional support under this programme because funding is planned on a multi-annual basis and financing arrangements for 1999 and 2000 have already been made (€142 million).

The prompt implementation of this assistance requires the fulfilment of specific conditions and a satisfactory track record of IMF supported programmes but, as a result of slow implementation by some beneficiary countries in recent years, disbursement of several instalments under this assistance has been delayed.

In the case of Georgia, a € 6 million instalment of a wider food security package was liberated last December following a letter of President Shevardnadze committing his Government to take steps in order to improve fiscal collection and strengthen the fight against corruption. An additional € 4 million instalment is expected to be released by the end of January.

For Kyrgyzstan an amount of €8,5 million has been allocated for 1999.

4.3. Rehabilitation programme

The European Union has been implementing a programme focussing on rehabilitation of damaged infrastructure². Since 1997, as a complement to the Tacis programmes the Council decided that the rehabilitation programme should cover the Caucasus countries and Central Asia. In the period 1997-8, an amount of € 20.5 million was allocated for Azerbaijan, Georgia and Tajikistan.

This programme has the advantage of providing direct investment in infrastructure in countries which are suffering from severe destruction through war, civil disorder or natural disaster with priority being given to the least developed among them. Only developing countries are eligible i.e. Caucasus and Central Asian countries, this means that Moldova, Ukraine and Belarus cannot benefit from this programme. At present the most eligible countries are Azerbaijan, Georgia, Armenia, Kyrgyzstan and Tajikistan.

In 1997, € 12.5 million was mobilised for reconstruction and rehabilitation of electricity, water supply, irrigation and railways in South-west Azerbaijan (Fizuli and Agdam region).

¹ Council Regulation EC n° 1292/96 of 27 June 1996, L 166, 5.7.96, P. 1

² Council Regulation EC n° 2258/96 of 22 November 1996, L 306, 22.11.96, p. 1.

Over 30,000 people are benefiting from this operation. The majority of this population is Internally Displaced People (IDP), unable as yet to return to their homes in the areas affected by the civil war.

In Georgia, the rehabilitation works will concentrate on rehabilitation of schools, irrigation, electricity systems (for example, the Inguri Dam will guarantee an additional 8% electricity supply) and small agriculture projects. In Tajikistan, the EU plans to contribute to the restoration of more than 50 schools, severely damaged by the civil war.

In 1998, a total of € 14 million has been earmarked, out of which € 4.5 million for Azerbaijan, € 6.5 million for Georgia, and € 3 million for Tajikistan more forthcoming.

For 1999 a budget of € 10 million is available. Plans are drawn up to allocate these funds for Azerbaijan, Georgia and Tajikistan.

4.4. Humanitarian aid

In 1998, the most important humanitarian operation for ECHO in the NIS was Tajikistan. ECHO funded substantial food and medical projects (worth roughly € 16 million) to the victims of the civil war. Another € 11 million was allocated to the continuation of ongoing operations in the three countries of the Southern Caucasus (mainly focussing on refugees and IDPs). For security reasons, operations in the Northern Caucasus (Chechnya, Dagestan) had to be suspended in early 1998, although humanitarian needs in the area persist.

The continuing economic crisis has a major impact on the living conditions of common people all over the region. The Russian crisis has however not created a fundamentally new situation, but has rather severely exacerbated existing difficulties.

ECHO carries out its operations via humanitarian agencies (European NGOs, UN agencies, Red Cross). The number of humanitarian agencies differs from country to country. In some countries there are hardly any potential partner agencies present.

Against this background, ECHO is currently revising its strategy in the region in order to adapt its instruments in an optimal way to the current needs. In particular, its contribution at current levels for refugees in the Caucasus and Tajikistan will be maintained.

Following a request from the Kyrgyz government, ECHO will extend its medical programmes in the country throughout 1999 (medicine distribution; training; support for local production of IV fluids).

4.5. TACIS

- Ongoing assistance

The current TACIS programme provides Technical Assistance aimed at bringing about the transition to a market economy and reinforcing democracy. For example, in 1997/8, the Tacis programme allocated € 257 million to the NIS other than Russia and horizontal Tacis programmes.

Where possible, ongoing Tacis programmes have been adapted to finance urgent actions following the Russian crisis. For example, in the case of Ukraine funds were allocated to reinforce sectors, such as the banking sector, more exposed to risks. However, technical

assistance has an impact on the living conditions of the population only in the medium to long term.

4.6. Special programme to help the other NIS most affected by the Russian crisis

The Commission's assessment of the impact of the Russian crisis on the other NIS set out in this communication has revealed that Armenia, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan and Ukraine have been most severely affected. The Commission intends immediately to carry out, where needed, an in-depth evaluation of the urgent requirements of these countries.

Should this evaluation conclude that additional funds are needed to address humanitarian problems in these countries that have resulted from the Russian crisis, the Commission will propose to the budgetary authority that a maximum of €20 million be transferred for this purpose from TACIS to ECHO on an exceptional basis.

In the event that this evaluation identifies needs that cannot be addressed by ECHO, the Commission will examine the possibility of financing actions to address such needs within the €20 million mentioned above. These actions could be financed under TACIS, in line with the provisions of the existing TACIS regulation, or under other relevant EC instruments.

5. CONCLUSION

Quite significant structural weaknesses in the economies of NIS countries still exist. These structural difficulties include weak legal and regulatory frameworks, insufficient industrial restructuring and privatisation, vulnerable currencies and poor revenue collection. Remedies for these problems must be provided through the economic reform policies by the countries themselves. The PCA framework and technical assistance support under the Tacis programme provide the best means of assisting the NIS in these efforts.

In addition, the implementation of ongoing other EC instruments (macro-financial and exceptional financial assistance, food security assistance, rehabilitation programme, humanitarian aid) will continue, where possible and appropriate.

Despite their independence, the NIS have remained closely inter-linked with Russia. Therefore, the Russian crisis has affected several countries although the impact varies considerably.

Hence, the Commission intends:

- to make € 15 million available for macro-economic assistance for Moldova;
- to apply the EC rehabilitation programme to Azerbaijan, Georgia and Tajikistan;
- to release € 8.5 million for Kyrgyzstan under the food security programme;
- to continue humanitarian assistance for example in Belarus, Georgia, Kyrgyzstan and Tajikistan;
- to allocate exceptionally € 20 million under the Tacis budget 1999 to alleviate urgent needs in the most affected countries.

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Moldova, Tajikistan and Ukraine have been most severely affected. The Commission intends immediately to carry out, where needed, an in-depth evaluation of the urgent requirements of these countries.

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In the event that this evaluation identifies needs that cannot be addressed by ECHO, the Commission will examine the possibility of financing actions to address such needs within the €20 million mentioned above. These actions could be financed under TACIS, in line with the provisions of the existing TACIS regulation, or under other relevant EC instruments.

The Commission will regularly report to the other EU institutions on the development of the situation in the NIS and will implement its actions in close co-ordination with the IFIs and other donors.

Overview of the consequences of the Russian crisis

1. The financial crisis in the NIS (excluding Russia).

Structural causes

Although the immediate cause of current problems in the NIS is the Russian financial crisis, structural weaknesses in the domestic economies have dramatically exacerbated its impact. Even in those countries which have achieved macroeconomic stability and strong political institutions, transition to a market economy continues to be hindered in several fields:

Public finances

The tax base remains narrow in the NIS, partly owing to the large proportion of the economy that slips through the net; the black economy probably accounts for 30-40% of GDP in the region. This makes it hard for government to increase revenues when the main burden falls on the relatively small number of enterprises which do comply with tax laws. Most governments have had difficulty in moving away from their reliance on the shrinking state sector and towards collecting taxes directly from individuals and enterprises. Moreover, general government expenditures remain high, at close to 40% of GDP on average. Thus, most transition countries face persistent fiscal imbalances, which are likely to worsen as revenues from privatisation will dry up over the next few years, hence making tax reform increasingly urgent.

External side

The manufacturing sector in the NIS tends to produce low value-added goods that are not competitive on global markets; considerable amount of trade is done among the NIS, much of it by barter.

Those countries which are highly dependent on imports of raw materials, including energy, are particularly exposed to the effects of the current crisis, as the loss of export markets throughout the region could not be compensated elsewhere, which in turn results in additional needs to rapidly finance rising external deficits.

Financial sector

The development of capital markets and financial institutions has been slow, hindering the efficient transfer of ownership and valuation of assets. Many countries are making slow progress with the privatisation of the state banking sector, or have banks that are heavily burdened by bad loans. Efficient banking restructuring is undoubtedly key to the reform process.

Unless action is taken by the international Community to help weather the crisis, social and human costs in these countries are likely to be high, thereby increasing pressures to reverse economic reforms and to increase government intervention.

2. Direct impact of the Russian crisis

Trade and currency effects

Given the close links maintained between Russia and the other NIS, the Russian crisis could significantly reduce growth prospects. Variable progress has been made in reorienting their trade away from other former Soviet states (FSU), but most countries remain largely dependent on FSU links (see tables below). As a direct consequence of the current problems, the NIS export share to Russia and the other FSU will drop.

Direction of Exports*						
	Russia		Other NIS		EU15	
	1997	1-7/1998	1997	1-7/1998	1997	1-7/1998
Armenia	21.1%	17.9%	19.3%	23.9%	4.6%	4.1%
Azerbaijan	23.1%	25.7%	25.3%	23.8%	11.2%	12.8%
Belarus	64.5%	65.9%	8.8%	2.6%	6.6%	7.1%
Georgia	29.8%	24.3%	29.9%	25.8%	7.7%	19.1%
Kazakhstan	33.9%	39.0%	10.9%	7.0%	26.4%	19.4%
Kyrgyzstan	22.0%	24.2%	40.9%	26.5%	5.3%	29.8%
Moldova	58.1%	54.8%	11.4%	5.2%	10.3%	13.3%
Tadjikistan	15.1%	11.1%	50.0%	50.0%	13.1%	11.1%
Turkmenistan	7.5%	7.5%	16.1%	17.3%	6.4%	13.5%
Ukraine	22.4%	19.9%	11.6%	11.2%	12.6%	14.8%
Uzbekistan	31.3%	35.0%	22.2%	16.8%	16.9%	15.2%

*Source : Commission Services

Direction of Imports*						
	Russia		Other NIS		EU15	
	1997	1-7/1998	1997	1-7/1998	1997	1-7/1998
Armenia	12.5%	11.1%	5.0%	2.4%	15.5%	17.6%
Azerbaijan	19.1%	11.0%	25.2%	11.8%	12.6%	28.2%
Belarus	53.6%	55.6%	13.2%	1.8%	15.8%	17.3%
Georgia	13.4%	10.9%	23.0%	15.6%	21.0%	22.9%
Kazakhstan	46.0%	42.6%	8.0%	4.6%	20.9%	27.6%
Kyrgyzstan	24.1%	17.9%	34.6%	32.3%	11.7%	15.0%
Moldova	28.6%	27.6%	23.3%	4.1%	19.4%	28.6%
Tadjikistan	15.4%	14.9%	54.6%	44.9%	5.5%	6.6%
Turkmenistan	13.4%	13.7%	43.4%	25.7%	11.3%	12.3%
Ukraine	29.6%	25.3%	4.2%	4.1%	15.5%	15.4%
Uzbekistan	19.9%	14.1%	19.4%	11.4%	18.8%	15.6%

*Source : Commission Services

The currencies of the region have been variously affected by the devaluation. Those of the economies with the strongest economic fundamentals (for example Kazakhstan) showed only a modest nominal fall in the months following the Russian crisis. However, in these countries Russian goods will become cheaper and could displace the domestic suppliers currently serving local markets in some sectors. This will increase the level of imports and reduce domestic output. Again, this will exacerbate the existing trend for most states, and increase the trade deficit almost all these countries have with Russia. Since the start of the Russian crisis, industrial output has declined dramatically in all these countries.

The Russian financial crisis provoked massive capital flight from the other currencies (Moldova, Ukraine), bringing an end to a period of exchange rate stability. Central banks spent between 20%-50% of their reserves in supporting their respective currencies. The crisis is leading to a dramatic increase in the amount of trade conducted through barter.

Social aspects

The main immediate impact of the crisis is likely to be felt on the social front. Private transfer and family support systems are under strong pressure. This might result in an substantial increase in poverty all over the region.

EC assistance to NIS (except Russia)

in million €

NIS	TACIS 97-98	Rehabilitation 97/98	human.aid 97-98	food security 97-99	except. & macro- financ. assist.
Armenia	10.0		3.7	28.0	58.0
Azerbaijan	26.9	17.0	10.7	42.0	not eligible
Belarus (1)	5.0	not eligible	1.3		suspended
Georgia	16.0	6.5	12.2	42.0	165.0
Kazakhstan	24.0			eligible	not eligible
Kyrgyzstan	13.0		4.6	17.0	not eligible
Moldova	18.0	not eligible		eligible	15.0 (2)
Mongolia	11.0				
Tajikistan (1)	5.0	3.0	31.6	8 (1)	proposed
Turkmenistan	11.5			eligible	not eligible
Ukraine	88.0	not eligible	1.7		150.0
Uzbekistan	29.0				not eligible
Total	257.4	26.5	65.7	137.0	372.0

FINANCIAL IMPLICATIONS

THE IMPACT OF THE RUSSIAN CRISIS

ON THE NEW INDEPENDENT STATES AND MONGOLIA

At the request of the European Council in Vienna last December a report on the impact of the Russian crisis on the new independent states and Mongolia is made.

In the wake of the break-up of the former Soviet Union, a large majority of the New Independent States (NIS) have remained closely inter-linked economically with Russia. As a result, they have been affected, in some cases severely, by Russia's current financial crisis. The indirect knock-on macro-economic effects coming from the other similarly affected NIS' markets have compounded this situation. In general, declining Russian imports and the sharp fall in remittances from Russia are having a serious negative impact on growth and current account balances of these NIS.

The additional package for assistance would include:

- to make € 15 million available for macro-economic assistance for Moldova;
- to apply the EC rehabilitation programme to Azerbaijan, Georgia and Tajikistan;
- to release € 8.5 million for Kyrgyzstan under the food security programme;
- to continue humanitarian assistance for example in Belarus, Georgia, Kyrgyzstan and Tajikistan;

The report also makes a proposal for a possible transfer of maximum € 20 million from the Tacis 1999 budget line (B7-520) to B7-215 humanitarian aid NIS and Mongolia. The transfer to budget line B7-215 will only be proposed after the credits on that budget line have been used and only if necessary. The eventual amount also depends on a further in-depth evaluation of the needs in the most affected countries (Armenia, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan and Ukraine).

The actions will be carried out in the course of 1999.

The normal mechanisms for monitoring, evaluation and auditing under the respective EC instruments will apply.

The recipient varies depending on the projects formulated (NGO's, governments, agencies, ...).

In addition, the Commission will inform Member States notably via the relevant Committees and the European Parliament on the implementation of the special package.