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Economic situation and economic reform in Central and Eastern Europe

INTRODUCTION

Stabilization and liberalization have been largely completed in all the CEECs. Nevertheless macroeconomic policy continues to be dominated by the need to control inflation and, in those countries faced with fiscal crisis, by the need to reduce budget deficits.

The fall in output of recent years has begun to bottom out, and some countries experienced growth in 1993, notably Poland, whose GDP rose by 4.5%. Most countries saw a slight improvement in their external accounts in 1993, but the trade balance deteriorated acutely in Hungary and Poland, and less sharply in Bulgaria and Slovenia.

Between 1989 and 1993 the weighted average decline in the CEECs' GDP was perhaps about one quarter and in industrial production about one third.

The fall in output has inevitably had adverse effects on individuals, in the form of falling real incomes. At the same time people have seen their savings eroded by inflation, and open unemployment, almost unknown under central planning, has risen steeply in most countries. Furthermore, the wider dispersion of incomes that has resulted from increasingly decentralized market-based decision-making has prompted resentment among those who have seen their relative position deteriorate.

All these effects have caused perceptions of the transition to become more negative. The high hopes of four years ago are giving way to despondency, frustration and political apathy. This makes it all the more important to ensure that these economies achieve rapid and sustainable growth.

The decline in output that accompanied the initial stages of reform has been arrested and reversed, but the prospects for strong growth are not good. Most of these economies are hampered by weak investment and by an external constraint.

The most disturbing aspect of the decline in output has been the steep fall in investment. If the CEECs are to achieve economic performance that allows them to begin to catch up with Western Europe, they will need much new investment, both to modernize infrastructure and to transform productive capacity. Several factors explain the very negative trend in investment: fiscal pressure has forced cuts in government spending, and these have fallen hardest on capital spending; inadequacies of the financial sector have meant a shortage of investment credit and high interest rates; and uncertainty has been generated by a variety of factors, including delays in economic recovery, slow progress in privatizing and restructuring enterprises, the lack of a sufficiently stable and effective framework for private sector initiative, and impediments to trade.

Furthermore, high rates of investment growth would probably lead to unsustainable external deficits within a short time, if it is assumed that roughly a quarter of new investment needs to be imported. Some CEECs, notably Hungary and Poland, are already running trade deficits that are close to the limit of what they are able to finance. This means that either exports will have to grow faster or import growth will have to decelerate substantially. Unless slower import growth is accompanied by a shift in the composition of imports from consumer goods to capital goods, fewer capital goods will be imported and consequently future growth prospects will be curbed.

The prospects for East European exports are uncertain. Export volumes, after the remarkable gains of 1991 and 1992, fell significantly in 1993. Several factors may explain this. Eastern Europe's main market, the EU and particularly Germany, has been in recession. Eastern price competitiveness has been much eroded by a sizeable real appreciation of exchange rates, which has dampened inflation but also exports. It may be that trade with the West has reached a temporary plateau: there is a lack of supply of exportable goods, which will last until new investments in new export products come on stream.

To alleviate the constraints on growth the CEECs will need to mobilize domestic savings, curb fiscal deficits, attract larger flows of foreign direct investment and expand their exports.

In several countries a substantial part of domestic savings is having to go to finance budget deficits, and everywhere domestic financial intermediation is unequal to the task of channelling savings efficiently. In all CEECs improved tax administration would help boost revenues, and those countries that have fiscal problems should make further efforts to control expenditure.

The fragility of the financial sector throughout the region is extremely worrying: at a minimum it is preventing the market from operating properly. Action is needed to ensure that the financial sector, which for the time being means the banks, fulfil their key role of allocating credit and controlling enterprises. A definitive solution has to be found to the problem of bad loans, and banks must enforce financial discipline.

Most CEECs have established an institutional framework appropriate to a market economy, but to attract more foreign investment they will need to ensure that legislation is implemented effectively and consistently. Restructuring and privatization of industry will enable the CEECs to exploit their comparative advantages and so to expand exports.

The CEECs are benefiting less than they could from the free trade arrangements that they have with the EU and with EFTA, because these arrangements are bilateral and trade barriers between the CEECs remain. This not only restrains trade but also discourages investment: investors planning facilities from which to supply the region will tend to locate them in an EU or EFTA country, from which they can benefit from free trade throughout the EU, EFTA and the CEECs.

Albania

Albania is predominantly an agricultural economy, with about 65% of the work-force engaged in farming. The country's small industrial sector produces mostly basic consumer goods. Albania also produces energy and has relatively important chrome and copper mines. Already before the collapse of the communist regime the level of economic development was the lowest in Europe; the political events of 1990 and 1991 resulted in an immediate and deep economic collapse.

During 1992-93 the authorities implemented a series of measures aimed at addressing major problems in the economy. A floating exchange rate was adopted on 1 July 1992 and is determined freely within a unified market. The lek has gradually stabilized against the dollar since the autumn of 1992, while gross official reserves, excluding gold, rose to $168m in June 1994, as a result of higher than projected private transfers and capital inflows. Interest rates were raised substantially, and real rates have now become positive, though they continue to be set administratively because of the lack of banking competition. Individual bank credit ceilings were adopted, and a system of reserve requirements for all banks was introduced. A new bankruptcy law took effect on 1 January 1993, but the authorities have initiated liquidation proceedings against only three enterprises to date. An unemployment benefit system was introduced, and a new and less generous social safety net has been created.

All wholesale and retail prices have been freed, with the exception of wheat, bread, home heating fuels and a number of non-food items produced under monopolistic conditions (rents, medicines, telecommunications, urban transport, etc.). For these items, a new series of price rises was implemented in mid-1993, which included the doubling of the prices of wheat, flour and bread and two-to-threefold increases in public housing rents and household energy. In an effort to cushion the social impact of this measure the government designed a large compensation scheme, which is being phased out in the course of 1994.

To contain the general government budget deficit, which reached 22% of GDP in 1992, strict targets for the domestic financing of the deficit have been set. The authorities have sought to diversify the sources of tax revenues, which used to be virtually all drawn from the ailing enterprise sector. The main revenue sources are a surcharge on customs duties, a new turnover tax and a profit tax, which were put in place in early 1992. A personal income tax was introduced in mid-1992. However, the large number of tax holidays and exemptions has complicated the task of tax administration and eroded the tax base. Expenditures rose substantially in the second half of 1993 because of increased investment (albeit from artificially low levels) and social safety net expenditures. The budget deficit was reduced to about 16% of GDP in 1993, of which about 10% was financed domestically. Private sector contributions will make up 37% of 1994 revenues, up from 26% in 1993.

After the catastrophe of 1990-91, Albania's economic situation began to improve in 1992 and the positive trend was maintained in 1993. GDP rose by 11% in 1993, but still remains about 30% below its pre-crisis level. The main engine of recovery has been agriculture, which has responded favourably to price reform and privatization, with output recovering by 18% in 1992 and an estimated 14.4% in 1993. Following the near-collapse of 1992 (–60%), industrial output shrank by a further 10% in 1993; enterprises continued to close or to operate far below capacity. Inflation declined in 1993, except during the third quarter when there was a surge following the increases in administered prices, and continued to fall during the first half of 1994. Exports rose by 50% in 1993, although they still remain at very low absolute levels compared to the central planning era, while most imports were financed through foreign aid. The rapid rise of imports decelerated in 1993 (+11% over 1992), as the country's food production continued to grow. Initial trade data for the first half of 1994 point to a continuing rise of exports and a stabilization of imports. However, as exports are much smaller than imports, the trade account continues to be in deficit.

TABLE 1 : **ALBANIA — Main Economic Indicators**

Area ('000 km^2)			27.5		
Population (millions)			3.4		
Population density (per sq km)			124		
		1992	1993	1994	latest
GDP at constant prices	(a)	–9.7	11.0		
Agricultural production	(a)	18.0	14.4		
Industrial production	(a)	–60.0	–10.0		
Consumer price index	(a)	226.0	85.0		
Unemployment rate, in %	(b)		18.0	14.0	Apr
Budget balance, % GDP	(c)	–21.8	–16.0		
Trade balance, $ bn	(d)	–0.5	–0.5	–0.2	Jan-June
Current account, $ bn	(d)	–0.4	–0.4	–0.1	Jan-June
Gross foreign debt, $ bn	(b)	0.70	0.83		
Debt-export ratio, %	(e)	994	794		

(a) Percentage change over (the same period of) the previous year.
(b) End of period.
(c) Consolidated state of budget deficit, accrual basis.
(d) In convertible currencies.
(e) Gross hard-currency debt as a percentage of hard-currency exports.

Following the completion of the stand-by arrangement with the IMF for 1992-93, the government reached agreement with the Fund on a new programme, which is being supported by a three-year arrangement under the enhanced structural adjustment facility (ESAF) for an amount of SDR 42.4m. The principal macroeconomic objectives of the programme are real GDP growth of 3-4% during 1993-94; reduction of annual inflation to 33% by mid-1994, which has been attained if the one-off effect of energy price liberalization is excluded, and a further strengthening of the external position, including the building up of official reserves to three months' imports by mid-1994, which was nearly achieved. Interest rates will be kept at positive levels; real state-sector wages will be maintained at around present levels; and price reform will be continued. Fiscal adjustment remains a central element of the programme; in view of the expected decline of food aid counterpart revenues and the need to attend to a number of critical expenditure needs that can no longer be deferred (including investment and structural reforms), the commitment to reduce the domestic financing of the budget to 7% of GDP will constitute a major challenge. The 1994 budget passed by Parliament in March implies a deficit of about 19% of GDP, including financing from external sources.

A further government objective is to normalize relations with the country's external creditors. New credit from foreign commercial banks is unlikely to be forthcoming, as Albania is confronted with a huge outstanding external debt, of US$834m (74% of GDP) at end-1993, of which US$621m is due in the form of arrears on short-term credits with some thirty European commercial banks. The Bank of Albania has asked for a debt rescheduling, and contacts with commercial banks resumed in late 1993. The Bank would like to negotiate a buy-back of commercial arrears at a substantial discount, with the support of the IDA debt reduction facility.

The privatization process has so far centred primarily on small and medium-sized units in trade and services, as well as on state farms and agricultural co-operatives. All state retail and service shops have been privatized, usually through direct sales to employees. In agriculture, 93% of former co-operative farms, which constitute about 75% of arable land, have been privatized. State farms occupy the remaining 25% of the land; the government has distributed 91% of this land to private tenants. However, the vast majority of arable land is currently occupied by subsistence-oriented small farms, which will constrain growth of agricultural output in the future. A large number of small and medium-sized industrial enterprises are in the process of being privatized by auction. However, the country's weak legal and institutional framework has hampered efforts to privatize large enterprises. There are long-standing plans to sell about 300 medium-sized and large companies through mass privatization using a voucher scheme. A number of these companies have since been reclassified as small or medium-sized enterprises because of a reduction in the number of workers employed or because stocks have been rendered worthless and subsequently excluded from the enterprises' book value; these will therefore be privatized by auction. The authorities have begun to print the vouchers which will be used in the mass privatization scheme. There will be no attempt to restructure these enterprises before privatization.

Most large enterprises are operating at low levels of output and will find it impossible to continue to operate without budgetary support, as their capital stock is obsolete, the domestic market is small and impoverished and there is no tradition or experience of export-oriented production and marketing. The government has identified 32 key enterprises whose situation is particularly sensitive, since they are large employers, and has created an agency charged with restructuring, privatizing or closing them over the next few years. These companies will continue to receive budgetary support during restructuring. About 60-70 strategic groups, nearly all of which are involved in the production of oil and minerals, are to be privatized eventually, but only after they have been restructured with foreign technical assistance.

A two-tier banking system was introduced in mid-1992, with all commercial banks being allowed to operate as universal banks, taking deposits and lending to households and enterprises. Yet the commercial banking sector has developed very slowly, mostly because of the lack of uniform legal standards for accounting and auditing, poor reporting procedures, an inadequate payments system and lack of experience with modern banking techniques. The sector has continued to be characterized by market segmentation and specialization. Foreign banks, which could provide an impetus for the modernization of the banking sector, have been slow to arrive; only two foreign banks had begun operations as joint ventures by end-1993. There exist no domestic private banks to date.

The structural transformation of the Albanian economy entails the enactment of legislation and the setting up of institutions which will regulate private economic activity as well as modernize the foreign and domestic trading systems and create a modern financial system. In view of the very weak enterprise sector and the extremely limited outside contacts that Albania had before 1991, it has a particular need for foreign investment. The foreign investment law which was passed in October 1993 strengthens the legal guarantees available to foreign capital, but foreigners are still not allowed to own land in Albania; they may lease it for 99 years. Total foreign investment so far has amounted to $235m, most of which is for joint ventures.

Bulgaria

Economic reform and restructuring continue to make only slow progress in Bulgaria. In 1993, GDP fell by an estimated 5%. This followed declines of 9%, 12%, and 6% in 1990, 1991 and 1992 respectively. Unemployment rose to over 16% of the labour force by mid-1993, before stabilizing at this level. Recent months have seen an improvement in the figures: in June of this year there were some 80,000 fewer registered than in June 1993, which brought the rate below 14%. However, this is likely to be as much a reflection of lack of progress in reforming state enterprises as a sign of economic recovery.

The legacy of central planning included an excessively developed heavy industrial sector, based in part on artificially cheap energy from the Soviet Union, and lax regulation of pollution. Since 1990, the country has also suffered a number of serious external shocks. The collapse of trade with the CMEA hit Bulgaria particularly hard. To this were added the effects of international embargoes on Iraq and Serbia, and the lack of access to commercial credit as a result of the unilateral moratorium on external debt declared in March 1990.

Despite these difficulties, substantial progress has been made in many areas. The passage in July 1994 of the long-awaited bankruptcy law means that the basic legal framework necessary for a functioning market economy is now in place. Prices have been largely liberalized, and the currency is convertible for current account purposes. Foreign trade has been reoriented towards western markets, despite the considerable difficulties caused by UN sanctions against Serbia-Montenegro, which effectively close Bulgaria's main transit routes to the West. In these circumstances, the dollar value of exports stagnated in 1993, while imports increased by over 10%. This resulted in a trade deficit of US$700 million.

TABLE 2 : **BULGARIA — Main Economic Indicators**

Area ('000 km^2)			112.5		
Population (millions)			8.5		
Population density (per sq km)			76		
		1992	1993	1994	latest
GDP at constant prices	(a)	–5.7	–4.2		
Agricultural production	(a)	–7.7	–9		
Industrial production	(a)	–7.0	–8.5	–4.8	Jan-May
Consumer price index	(a)	91.1	72.8	77.4	Jan-June
Unemployment rate, in %	(b)	15.6	15.9	13.4	June
Budget balance, % GDP	(c)	–14.0	–15.1		
Trade balance, $ bn	(d)	0.0	–0.7	0.0	Jan-Mar
Current account, $ bn	(d),(f)	–0.4	–0.9		
Gross foreign debt, $ bn	(b)	14.2	14.7		
Debt-export ratio, %	(e)	405	404		

(a) Percentage change over (the same period of) the previous year.
(b) End of period.
(c) Consolidated state budget deficit, accrual basis.
(d) Due basis.
(e) Gross hard-currency debt as a percentage of hard-currency exports.
(f) In convertible currencies.

Restitution of urban property has helped the emergence of a dynamic private services sector, with well over half of retail trade in private hands. Overall, the private sector is estimated to have generated over one-third of GDP in 1993. Agricultural land restitution has advanced more slowly, as validating claims and precisely determining land boundaries has proved to be a painstaking process. By end-1993, 44% of land had been definitively restored to private owners, and an additional 25% was in private hands on temporary title. The private sector is estimated to have accounted for almost 60% of agriculture's contribution to GDP in 1993. However, many of the restored plots are very small. The development of private agriculture has also been impeded by failure to make greater progress in restructuring the food-processing industries. Agriculture in general has suffered the effects of severe drought in 1992 and 1993.

In 1993 and 1994 Bulgaria has seen improvements in its relations with the international community. In late 1993, Bulgaria reached agreement with the IMF on an economic programme for 1994 that could be supported by a one year stand-by arrangement (a previous arrangement had run off track in late 1992). By mid-1994, the programme was still broadly on target.

In June 1994, Bulgaria and its foreign commercial creditors signed a debt and debt-service reduction agreement (DDSR). Overall, the agreement reduces Bulgaria's US$8.2 billion debt to western commercial banks by an estimated 47%. Under the terms of the deal, Bulgaria is required to make up-front payments of US$750 million, while interest payments are expected to amount to about US$250-270 million per annum in the next seven years. Much of the initial cost will be met by loans from the international financial institutions, the European Union and the G-24. The completion of the agreement restores normal relations between Bulgaria and the international financial community, and should improve the flow of foreign investment to the country.

The major challenge facing reform in Bulgaria is the problems of the financial and enterprise sectors. Although good progress was made initially in transforming state enterprises into joint-stock companies, this was not followed up by the development of something approaching a normal commercial environment. State-owned commercial banks, already burdened with non-performing loans from the period of central planning, continued lending to insolvent state enterprises. A number of factors help to explain this behaviour. First, bankruptcy legislation was inadequate, making it difficult for creditors to pursue their debtors. Second, banks feared that pursuing indebted state enterprises would expose the fragile nature of their own assets. Third, there was an expectation on the part of both enterprises and banks that the state would ultimately bail out both sides. To an extent, this is what happened, as in late 1990 parliament passed a law transferring non-performing loans pre-dating reform from the banks to the state. This law does, however, appear to have had a positive effect on the behaviour of the banks, as they believe that the state will not intervene to clear their books again. Faced with an absence of soft credit from the banking sector, state enterprises have run up sizeable arrears — to their employees, to each other, and to the state budget.

The enterprise sector has been further weakened by the slow pace of privatization. By early 1994, barely 100 enterprises had been privatized. To try to accelerate the process, parliament has recently adopted legislation to facilitate mass privatization. The first round of mass privatization, covering 340 state enterprises, is intended to be completed by the end of this year. Responsibility for privatization is divided among local authorities, the Privatization Agency, and branch ministries, with nobody clearly in charge. Faced with this situation, state enterprise managers have taken matters into their own hands. "Spontaneous" or "profits privatization" is believed to be widespread. This is a practice whereby managers of state enterprises enter into unfavourable buying and selling contracts with private enterprises in which they have an interest. Although firm figures on the extent of this activity are not available, some indication of its size may be gleaned from the fact that for 1993 losses of the state enterprise sector are reported at 20% of GDP.

The deteriorating performance of the state enterprise sector has had repercussions on the state budget, as enterprise profit taxes were one of the main sources of revenue. Tax reform and tax administration have been unable to keep pace with these developments. Although subsidies have been cut, from 15% of GDP in 1990 to 4% in 1993, the erosion of the tax base coupled with the increasing cost of interest payments on domestic debt caused the cash budget deficit to reach 13% of GDP in 1993. The 1994 budget included a planned deficit of 6.5% of GDP. Indications are that the budget remained on course during the first half of the year, with revenues a little higher than programmed – probably boosted by the higher than forecast price increase – and expenditures slightly lower than their budgeted levels. However, the government delayed adjusting wages and social welfare payments to compensate for inflation until July.

The large budget deficit has contributed to keeping inflation at a level of 4 to 6% per month since mid-1992. A combination of the introduction of VAT on 1 April and a sudden sharp depreciation of the currency (which may in part have been due to an import surge to avoid VAT) caused monthly inflation to rise to 8% in March, and then to jump to over 20% in April. A further increase in prices of 8% in May meant that the full-year target of 45% inflation was passed in just the first five months of the year. In June, prices rose by just over 4%, which suggests that the risk of an inflationary spiral has been averted.

Bulgaria's DDSR may have played a part in the decline in the lev, which has lost some 40% of its value against the dollar since the deal was announced in November 1993. Although most of the initial costs of the agreement will be met by loans, the payments will still leave the National Bank's reserves somewhat depleted. Because of this constraint, the National Bank has been unable for some months past to intervene directly against speculative attacks on the currency, resorting instead to an increase in interest rates. Most recently, in an effort to bear down on inflation, the Bank has increased minimum reserve requirements for commercial banks from 8 to 10 per cent.

Commonwealth of Independent States

Russia

Russia's bleak economic record of recent years is showing some signs of improvement, but the overall situation remains difficult, and prospects are highly uncertain. Attempts to get inflation under control have been pursued more consistently in recent months, and have met with some tenuous success. The trade balance is in surplus. The exchange rate is appreciating in real terms. The private sector and service industries now account for substantial shares of total activity. Yet, output continues to fall sharply. Investment has been hit particularly hard. The fiscal situation is extremely fragile, with weak revenues and high pressures on spending, which calls into question the prospect of further decreases in inflation. Enterprise restructuring is still in its very early stages. Legislative and institutional reform remain patchy.

The inherent difficulties of economic transition have been exacerbated by a serious lack of political consensus. From the start of reform there were several competing centres of power: the president and his entourage, the government and the factions within it, Parliament, the central bank, the representatives of large state enterprises. Also, many local and regional authorities set their policies independently, choosing a slower or faster pace of reform than the central government, or emphasizing different elements.

TABLE 3 : **RUSSIA — Main Economic Indicators**

Area ('000 km^2)			17075		
Population (millions)			148.7		
Population density (per sq km)			9		
		1992	1993	1994	latest
GDP at constant prices	(a)	−19.0	−12	−17	Jan-June
Agricultural production	(a)	−9.0	−5.0	−4.5	Jan-Mar
Industrial production	(a)	−18.8	−16.0	−25.8	Jan-June
Consumer price index	(a)	1534	877	552	Jan-June
Unemployment rate, in %	(b)	1.0	1.4	1.6	June
Budget balance, % GDP	(c)	−4.7	−6.8	−10.4	Jan-June
Trade balance, $ bn	(d)	5.9	15.8	5.2	Jan-Mar
Current account, $ bn	(d)	−4.2	6.7		
Gross foreign debt, $ bn	(b,e)	77.7	83.5		
Debt-export ratio, %	(e,f)	174	184		

(a) Percentage change over (the same period of) the previous year.
(b) End of period.
(c) Rouble cash flow budget including local authorities, but excluding off-budget operations. Including off-budget operations, the 1992 deficit was estimated at 20% of GDP.
(d) Includes both FSU and non-FSU transactions.
(e) Assuming Russia takes over 100% of ex-USSR debt.
(f) Gross debt as a percentage of exports, both excluding FSU transactions.

The initial reform programme, started in January 1992, aimed at rapid macroeconomic stabilization and profound structural change. Fiscal and monetary policies were set to be extremely tight, with drastic spending cuts and an overhaul of the tax system. Central price controls were lifted for most products. The system of multiple exchange rates was abolished in mid-1992, and replaced by a single rate determined at regular inter-bank auctions. But substantial slippage started as early as the spring of 1992, when the government proved unable to resist pressures to increase producer and consumer subsidies. On top of this, the central bank continued to provide credit to enterprises in very large quantities and at sharply negative real interest rates. Massive import subsidies were a severe drain on government finances. Large export credits to other former Soviet states added further to inflation. Fiscal policy has been hampered by disagreements between the central authorities and local governments over tax revenue sharing, with increasing shares being retained at local level, sometimes by unilateral decision. The result of these macroeconomic disequilibria was that inflation, after the price level adjustment in January 1992, remained very high – generally in the range of 20–25% per month – throughout most of 1992/1993.

In April 1993 a referendum provided unexpectedly large public support for President Yeltsin's reform strategy. Shortly afterwards, agreement was reached between the government and the central bank – which had been at loggerheads over financial policy until then – to reduce credit emission, increase interest rates, and limit the budget deficit, so as to bring down inflation. Monetary policy was tightened; the Central Bank finance rate was raised in steps from 100% to 210% (actually some 590% if correct compounding rules are observed). This was much closer to the rate of inflation, and the measure had its most notable effect on the exchange rate: its steep fall was arrested and it has in fact gradually appreciated in real terms since mid-1993. The government also reduced grain subsidies, formally freed coal prices and cut import subsidies. Taxes on oil and natural gas – which were priced at about 20% and 5% respectively of world market levels – were increased. In subsequent months, some increase in fiscal restraint and a sharp cut in trade credit for other CIS states indeed brought down money supply growth.

The strong showing of nationalist and conservative forces in the elections of December 1993, and the subsequent resignation from the government of several key reformers, has not led to backtracking from this relatively rigorous monetary and fiscal policy stance. As a result, inflation fell to well below

10% per month between March and June, and the Central Bank finance rate could be lowered gradually (to 155% by the end of June, or 330% when properly compounded) while remaining high in real terms. Yet in other respects economic policy in recent months has not been particularly forceful, and many key decisions incurred long delays. Parliament adopted the 1994 budget only in late June; this budget provides for a deficit of just under 10% of GDP. Limiting the deficit to even such a relatively high number looks impossibly ambitious. Tax collection is running far below target, and there is much pressure from many interest groups, including the armed forces, for higher spending.

This relatively rigorous macroeconomic stance has had its costs. The decline in output accelerated markedly during the first quarter of 1994, although it appears to have slowed again during the second quarter. Enterprises are adjusting to the squeeze through real wage decreases (e.g. by delayed payment, which rapidly lowers the value of wages because of inflation), by further cuts in investment, and by arrears both to the tax authorities and to suppliers. Official unemployment figures are still low, and even data compiled according to standard ILO methodology put it at a moderate 6% or so. Yet there is ample evidence of large-scale hidden unemployment. One reason is that firms may deduct up to six times the minimum wage per employee as costs for tax purposes, so retaining low-paid workers allows them to pay others more.

In late May, President Yeltsin, who thus far had mostly left economic policy-making to the government, adopted a more active stance in this area by issuing a set of decrees intended to accelerate reform. They aim to streamline the tax system and to encourage foreign investment; some implementing legislation is still required, however. Another key measure was the reduction of export limitations on oil; if this had been implemented as planned on 1 July, it would have had the double benefit of increasing export earnings and of raising domestic oil prices, which in turn would increase tax receipts, allow the ailing energy sector to invest more, and foster energy saving. In fact, resistance from vested interests which obtain large rents from the existing distortions proved too great, and the measure was delayed for six months at least.

External trade and payments have contracted sharply, with serious knock-on effects on domestic production. Trade with other parts of the former Soviet Union declined by over 30% in volume terms during 1992. Trade with countries outside the former Soviet Union declined also, but continued to yield a surplus of some $5 billion. Trade statistics for 1993 show exports flat in dollar terms, but imports down by 27% compared to 1992; this led to a sharply increased trade surplus of $16 billion. First-quarter data for 1994 show a similar trend. In fact, this surplus may well be much smaller, since imports are probably under-reported. Also, much of the surplus is probably leaking away. There are signs of massive capital flight, which often seems to take the form of state enterprise managers keeping export proceeds outside the country.

Structural reform has progressed only slowly in most respects — except as regards privatization. This has been a key component of the government's strategy, and it is the one area that has remained almost unaffected by the deep divisions paralysing economic policy-making. A substantial share of small enterprises have been privatized, essentially in retail trade and services. For large enterprises, a mass privatization programme was developed, under which free vouchers were distributed to the public in the last months of 1992. These vouchers could be used until end-June 1994 to bid for shares in privatization auctions. Under this process, well over half of all firms have been privatized. From July, a second phase was to start under which many remaining state assets will be sold off; however, the parliament has so far refused to endorse this second stage. Moreover, changes in ownership do not necessarily imply that restructuring is taking place, or that enterprises are starting to behave in a commercial fashion.

Progress with putting the legislative and institutional framework for a market economy in place has been patchy, and much remains to be done. A bankruptcy law came into force in March 1993, but has not begun to be implemented; this will in any case be difficult in view of the ill-equipped legal system. The privatization of land, long a highly emotive and divisive issue, has been legally possible since 1993 but has barely begun to be implemented. In other areas, major reforms have yet to begin. One crucial issue is the social safety net: it will need to be reorganized, streamlined and better targeted if it is to withstand the pressures of increasing unemployment that will accompany enterprise restructuring. So far, there has been no constituency for social sector reform, though: radical reformers have tended to focus on fiscal discipline and cost-cutting, and more conservative forces wish to avoid unemployment by keeping firms operating. Also, there is no industrial policy to speak of, and the weak and disorganized financial sector is a major brake on restructuring.

Ukraine

At the beginning of 1994, the economic situation in Ukraine continued to deteriorate at an alarming rate. Gross domestic product declined by an estimated 14% in 1993, and by more than 30 per cent during the first three months of 1994, before stabilizing thereafter. Official GDP estimates may well overstate the real decline, but this is a very mixed blessing: inflation, corruption and an erratic and often punitive tax system are driving more and more activity into an informal, unregistered and inefficient barter society.

TABLE 4 : **UKRAINE — Main Economic Indicators**

Area ('000 km^2)			603.7		
Population (millions)			52.2		
Population density (per sq km)			86		
		1992	1993	1994	latest
GDP at constant prices	(a)	–17	–14	–34	Q1
Agricultural production	(a)	–9	–1	–5	Q1
Industrial production	(a)	–15	–16	–38	Jan-May
Consumer price index	(a)	1200	4700	2200	June
Unemployment rate, in %	(b)	0	0.3	0.3	Q1
Budget balance, % GDP	(c)	–29	–13	–15	Q1
Trade balance, $ bn	(d)	0.5	1.6		
Current account, $ bn	(d)	0.5	1.9		
Gross foreign debt, $ bn	(b)	10			

(a) Percentage change (over the same period of) the previous year.
(b) End of period.
(c) Consolidated state budget deficit, accrual basis.
(d) In convertible currencies.

The Ukrainian economy thus continues the downward spiral that began in 1991, and in early 1994 registered economic activity reached only about 40 per cent of its 1990-level. The key reason for this has been the continued absence of sufficient political support for any strategy to deal with the crisis which was caused by the disintegration of economic structures and links within the former Soviet Union, and by economic mismanagement. Another major factor has been Ukraine's acute shortage of energy and raw materials, which were traditionally imported from Russia and other former Soviet republics at prices significantly below world market prices, and for which Ukraine cannot pay under the new regime because of a lack of hard-currency reserves and hard-currency exports. Also, uncontrolled and unbacked credit and money emissions have been largely responsible for run-away inflation, and a payments crisis intensified the severity of the economic downturn.

In late 1993, the authorities' primary economic concern became the elimination of hyperinflation. Since December 1993 the National Bank of Ukraine has been attempting to exercise greater monetary restraint, refinancing of commercial banks has been limited, and interest rates have risen. Nevertheless, they remained sharply negative in real terms before monthly inflation came down to single-digit figures in March. The five-month credit squeeze has played a significant role in ending the burst of hyperinflation that began last September. Whether it will bring lasting improvement remains to be seen.

Until October 1992, when the government had to step down after the parliament passed a vote of no confidence, the thrust of economic policy design had been determined mainly by nationalist forces intent on asserting independence from Moscow, who had neglected to introduce the legal and institutional framework necessary for a well-functioning market economy. Indeed, the dominant role of state intervention and central planning had never really been challenged, and the necessary adjustment of the economy was not really allowed to proceed. Ministries were not prepared to reduce their grip on economic activity, employees did not accept a decline in real wages or an increase in productivity, which — in times of declining economic activity — would have required major labour-shedding, transfer recipients successfully fought for their allowances to be indexed, and enterprises passed on price increases for inputs to users instead of seeking to increase efficiency and reduce input requirements. In attempting to maintain economic activity throughout the country, government, president and parliament had opted for a soft-budget and central-planning approach, handing out subsidies to enterprises, allowing them to borrow on a large scale and channelling supply and demand by means of state orders.

As a result, the government of Prime Minister Kuchma, which came to power in October 1992, was confronted with the daunting task of stabilizing the economy and stemming the fall in output. Because of the severity of the crisis, the government was granted powers to rule by decree on economic issues for a period of six months. An ambitious economic reform programme was adopted by the government in early January 1993.

However, a political stalemate between the president, the government and the parliament prevented the pursuit of credible stabilization policies. The package of measures agreed with the IMF was effectively sabotaged in March 1993 when parliament, controlled by conservative enterprise and farm managers, authorized a credit emission double that envisaged by the government (the National Bank of Ukraine is answerable only to parliament).

The political crisis, essentially rooted in the struggle over economic reforms, came to a head in late May and early June 1993, when the prime minister asked for a prolongation of his special powers and presented a new plan to stabilize the economy. It consisted of a two-year programme to speed up the privatization of industry and agriculture, a tough credit policy, controls over wages, further liberalization of foreign trade, the creation of free economic zones and further incentives to foreign investment.

The conservative parliament, however, refused to provide the prime minister with the powers he asked for, and the political stalemate continued to drag on and to paralyse economic policy design. In the mean time, the economy drifted further towards chaos, the Ukrainian currency tumbled even against the Russian rouble and inflation continued unabated. By end-September 1993 the country was without a government, as the prime minister and his government resigned, social unrest was spreading across the country, and economic policy was going in the direction of reintroducing central planning mechanisms. Indeed, price controls as well as state orders for goods were reintroduced after the president took over as head of government.

Since then, the economic crisis has deepened, and inflation accelerated to above 60 per cent per month by the end of the year. During the first six months of 1994, inflation was brought down substantially as the central bank tightened credit. Inflation for the month of June was about 4 per cent. This was expected to have led mainly to a sharp increase in arrears rather than to much real adjustment. However, sources from the National Bank of Ukraine claim that the arrears of credits issued have not been substantial so far, which suggests that the drop in inflation may be more durable than was first expected.

The value of the Ukrainian interim currency has tumbled even against the Russian rouble: it stood at over 23 karbovanets per rouble in May 1994, having started out at par less than three years earlier. Public finances are weighed down by extremely high social transfers and a dwindling tax base. The deficit was some 30% of GDP in 1992, and probably well in excess of 10% in 1993. Furthermore, Ukraine's balance-of-payments problems have worsened, and the trade deficit (essentially with Russia) is being financed by arrears. The shortage of imported energy threatens to reduce economic activity further.

Officially, unemployment is not a problem in Ukraine. Indeed, the unemployment rate published by the Ministry of Statistics is still well below 0.5 per cent of the labour force. However, in his address to parliament, the outgoing acting prime minister (Zviagilskiy) estimated that some 2.2 million Ukrainians (about 10 per cent of the labour force) were on unpaid leave in early 1994 because their enterprises had ceased production.

Economic policy seems to be relying on muddling through rather than following any strategy, and an end to economic decline and unsustainably high current-account deficits is not likely in the short run. The parliamentary elections in March 1994 led to a defeat of reformist forces, with the former communists emerging as the strongest force. The political stalemate continues, and it is unclear whether after the presidential elections there will be an opportunity to initiate comprehensive and consistent economic reform. Indeed, the election campaigns neglected economic issues and focused on the problem of Ukrainian independence from Russia. However, implementing a coherent economic reform programme and improving relations with Russia, the dominant supplier of key inputs for the Ukrainian economy will have to be core elements of a policy aimed at stabilizing economic activity. The newly elected President Kuchma gained a reputation for supporting economic reform when he led the government between late 1992 and mid-1993.

Other states

The situation in the other newly independent states varies considerably. All republics are more or less suffering from the collapse of inter-republic links and the weakening of old structures which have not yet been replaced by market-oriented institutions. With the exception of Turkmenistan, Uzbekistan and Belarus, where GDP declined by about 5 to 10% in 1992, GDP dropped by about 15 to more than 50 per cent in all the other republics in 1992 (Kazakhstan and Kyrgyzstan: 15 to 20%; Moldova, Azerbaijan, Tajikistan and Georgia: 30 to 40 per cent; and Armenia: more than 50 per cent). This decline in output went hand in hand with runaway inflation and soaring budget deficits. In 1993 the deterioration of all key economic indicators continued in most republics, though at a slower pace. Only in Uzbekistan and Turkmenistan is output estimated to have stabilized or even recovered, thanks to increased gas production. On the other hand, economic decline was steeper in 1993 than in 1992 in Belarus and probably also in Kyrgyzstan. Some newly independent states are making headway with economic reform. Furthermore, a number of NIS (Belarus, Moldova, Kazakhstan) have concluded arrangements with the IMF under the Systemic Transformation Facility, and are negotiating stand-by arrangements with the Fund. Such an arrangement concluded with the Fund by Kyrgyzstan in May 1993 is on track, and Turkmenistan, which is rich in natural resources, has adopted an IMF-supported reform programme. Other states, however, have as yet done little to change the inherited economic structures. Some are hardly in a situation which allows them to contemplate systemic reform: Armenia is suffering a blockade, Tajikistan and Georgia are devastated by civil war or ethnic unrest.

Inter-state issues

The Commonwealth of Independent States (CIS) founded by eleven of the fifteen ex-Soviet republics (all but the Baltic states and Georgia) was initially heralded as the Soviet Union's successor. In mid-1992 Azerbaijan left the CIS, but rejoined in September 1993. Georgia joined in early 1994. So far, the CIS has mostly been a declaration of intent to maintain economic, political, and military cooperation among these ex-Soviet republics. No institutional framework has been created. Disagreements and mutual suspicion between Russia and Ukraine have been a major factor behind this lack of results.

Nevertheless, the negative consequences of economic disintegration have led all the CIS states to reconsider closer economic cooperation with each other. Furthermore, five Central Asian states (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan) are contemplating forging closer economic ties among themselves.

In early 1993 CIS heads of state reached agreement on cooperation in several areas, but not in the central fields of trade and money. In May nine CIS countries (all but Ukraine) signed a declaration of intent on setting up a closer economic alliance, and in mid-July Belarus, Ukraine and Russia agreed to cooperate more closely in some areas of economic policy. At the end of September, nine CIS states (all but Ukraine and Turkmenistan) signed a treaty setting up a unified economic space, a unified customs regime and duty-free commodity traffic. Ukraine and Turkmenistan will be associate members. To be effective, however, this treaty will have to be adopted by the parliaments of the republics involved and will have to be followed by several agreements specifying the policies and procedures provided for in the signed framework agreement.

Trade among the CIS states has declined sharply during the past years. This has had serious knock-on effects on output, since the Soviet economy was both highly integrated and monopolistic: disruption of traditional trade flows thus often means that firms are cut off from essential inputs, as the basic philosophy of central planning had been vertical and regional interdependence rather than horizontal and regional competition. The decline in trade is linked to Russia's position as the dominant economy and the major source of energy and raw materials. Russia has decided to reduce its trade surplus with the other republics through a series of inter-state bilateral agreements; these limit the trade deficits other states can have with it, and rely on state orders. Nevertheless, trade deficits of the other republics grew rapidly and are expected to widen in the future, once Russia charges world-market prices for its exports of oil and gas. This could make other republics' current-account position unsustainable unless large-scale external borrowing bridges the financing gap.

In July 1993 Russia decided to invalidate as legal tender in Russia all rouble banknotes issued before 1993. This unilateral decision took the Russian population as well as the member states of the CIS by surprise. Those republics which still used the rouble either as their own legal tender or as a parallel currency feared that the Russian decision would adversely affect their monetary stability and cross-border trading. After some weeks of negotiation, six countries of the CIS (Russia, Belarus, Kazakhstan, Uzbekistan, Armenia and Tajikistan) signed a framework agreement to keep the Russian rouble as their common currency. This agreement provides for a string of bilateral and multilateral treaties setting up a rouble zone in which five member states will have to adjust their customs, tax, banking and credit policies to standards set by Moscow before they are allowed to use the Russian rouble. In the mean time, however, all republics except Tajikistan have introduced their own currency in order to acquire an additional instrument of monetary policy. Whether these new currencies will serve only as interim currencies for Belarus, Kazakhstan, Uzbekistan and Armenia pending the establishment of the envisaged rouble zone is not yet clear. Most advanced are negotiations between Russia and Belarus, which signed an agreement on the unification of their monetary systems in April 1994.

Czech Republic

In the second half of 1994, the Czech Republic is well advanced in the process of economic transformation and integration into the world economy. Public finances are showing a surplus, and so is the current account. Inflation seems to be under control, with a monthly rate of less than one per cent, and unemployment is negligible. Indeed, the Czech labour market seems to suffer from a shortage of labour. After four years of economic decline, production has stabilized and will probably show modest growth in 1994. The private sector, which scarcely existed under central planning, accounted for about 60 per cent of total production in early 1994. The country seems to have digested the separation from Slovakia quite well, and the Czech Republic remains attractive for foreign investment. Political stability and a broad social consensus on the reform path are other facets of this favourable picture.

In 1993, the Czech Republic's economic performance was negatively influenced by the economic consequences of the separation of the Czech and Slovak Republics, which led to a significant disintegration of the highly integrated Czechoslovak economy. Indeed, while economic activity began to recover in the second half of 1992 after almost three years of sharp decline in domestic and external demand, a major economic setback took place in early 1993, the first months after the separation.

A major reason for this setback was the sharp deterioration in export and import performance vis-à-vis Slovakia. While external trade with Western Europe showed dynamic growth rates, despite the recession in the most important western markets, trade with Slovakia initially shrank by more than a third, before recovering somewhat. Total exports showed only slight growth in 1993, and imports shrank. In consequence, net exports were the most important source of economic recovery in the course of 1993, while the running down of inventories, which continued for the second consecutive year, was the most important negative influence on economic activity. Public finances remained balanced, and inflation, which picked up in January 1993 as a result of the introduction of VAT, came down to less than 1 per cent per month later in the year.

In 1994, following a three-year decline and stagnation in 1993, the Czech economy began to show an upward trend. According to the Czech Statistical Office's preliminary data, GDP in Q1 1994 grew by 3.5 per cent against the depressed level of the same period of 1993. Construction and selected services were the main contributors to growth on the supply side, while industrial production stagnated. On the demand side, vigorous growth continues in retail sales, up by 6.5 per cent in comparable prices. On the other hand, export growth slowed down and imports grew at an accelerating pace.

The underlying trend in public finances remains healthy, with the budget posting a surplus equivalent to about 2 per cent of GDP for the first half 1994. Annual inflation, which in February came down to less than 10 per cent for the first time since mid-1992, remained at this level for five consecutive months. However, money supply (M2) grew at an annualized rate of more than 15 per cent in the period until May, which called in question the central bank's inflation target of less than 10 per cent. In consequence, the Czech National Bank tightened monetary policy by offering additional T-bills and by increasing the minimum reserve requirement from 9 to 12 per cent in August.

TABLE 5 : **CZECH REPUBLIC — Main Economic Indicators**

Area ('000 km^2)			78.9		
Population (millions)			10.4		
Population density (per sq km)			132		
		1992	1993	1994	latest
GDP at constant prices	(a)	–7	0	3.5	Q1
Agricultural production	(a)	–12	–1		
Industrial production	(a)	–11	–5	4.6	May
Consumer price index	(a)	11	21	9.7	June
Unemployment rate, in %	(b)	3	3	3.0	June
Budget balance, % GDP	(c)	–1	0	2	H1
Trade balance, $ bn	(d)	–0.7(g)	0.2	0.1	Jan-May
Current account, $ bn	(d)	0.2(f)	0.6	0.3	Q1
Gross foreign debt, $ bn	(b)	9.5(f)	8.7	8.6	Q1
Debt-export ratio, %	(e)	84(f)	68		

(a) Percentage change over (the same period of) the previous year.
(b) End of period.
(c) Consolidated state budget deficit, accrual basis.
(d) In convertible currencies.
(e) Gross hard-currency debt as a percentage of hard-currency exports.
(f) Refers to CSFR.
(g) Excludes trade with Slovak Republic.

The tight labour market remains an extraordinary feature of the Czech transformation process which is not present in other Central and East European countries. Indeed, wage inflation started to accelerate in the course of 1993, mainly because of this tightness, the previous sharp fall in real wages, and lax wage discipline in enterprises that were still state-owned. This induced the government to re-establish wage controls, in the form of an excessive-wage tax. However, once recently privatized large enterprises begin to restructure and to improve labour productivity (through labour-shedding), the labour market should become less tight, which should help to contain wage inflation.

Although the net inflow of foreign direct investment slowed down in 1993 to US$ 517 m (from US$ 980 m in 1992), the Czech Republic has been experiencing a surge in other capital inflows since the third quarter of 1993. Net portfolio investment (to a large extent in the form of equity purchases) in 1993 reached US$ 1062 m, and Czech enterprises borrowed abroad US$ 750 m (mainly in the form of bank credits). Furthermore, the Czech National Bank last year successfully placed several international bond issues. This increased presence of the Czech Republic on international capital markets has been reinforced since the international rating agencies upgraded it to an "investment grade" in autumn 1993.

The combination of a healthy current account position and a strong capital inflow has put upward pressure on the nominal exchange rate and has resulted in a rapid growth of official foreign exchange reserves, which stood at US$ 5.1 bn in early June 1994, compared to US$ 0.7 bn at end-1992. In order to relieve the upward pressure on the exchange rate, the Czech National Bank is planning to make the crown convertible for capital account transactions and to implement a phased liberalization of controls on capital outflows. In early March it announced that it will gradually waive the obligation of Czech exporters to surrender to the central bank their hard-currency proceeds.

The Czech economy can be described as a fully fledged market economy insofar as all the institutions for a working market economy are in place. Indeed, prices and trade were liberalized at the outset of the transformation process, and current-account convertibility of the domestic currency was established. Since then large parts of state-owned property have been privatized, the tax system and the system of social security contributions and benefits have been brought into line with western standards, and the legislation necessary for efficient decentralized economic decision-making has been put in place.

The privatization process is continuing with the second wave of voucher privatization, in which 770 companies worth Czk 145 bn are expected to be privatized. About six million people were registered as having bought voucher books, which is even more than in the first wave. The transfer of ownership of the assets sold under the second wave of large-scale privatization should be completed by end-1994, by which time about 90% of the productive capacity of the economy will be in private hands.

The transformation process is still far from complete, and difficult microeconomic issues have still to be tackled. Now that the institutional framework has been established, it will be necessary to set the microeconomic incentives in a way that will maintain or establish competition on factor and goods markets, to foster efficiency in both the private and the public sector, and to provide a social safety net and other public goods which do not financially overburden future generations. Furthermore, some bad legacies of the old system, such as the indebtedness of old enterprises, the poor state of the capital stock, or environmental burdens will continue to absorb scarce resources and will make the transformation path ahead difficult.

Estonia

The decline in GDP which began in 1990 appeared to bottom out in 1993. The fall in 1993 was only 7.8% compared to 23% in 1992. Moreover, there are signs that industrial output began to recover from mid-1993 onwards. The root cause of the decline was the deterioration in trading conditions, which was aggravated by the stabilization policies pursued. The Estonian authorities expect growth to resume in 1994.

Registered unemployment has yet to reach significant levels in Estonia, despite the reduction in economic activity. In June 1994 unemployment stood at 2.1% of the labour force. Enterprises are reluctant to implement redundancies, as this renders them liable for up to eight months' severance pay. They avoid these provisions by allowing workers to go on indefinite leave, or by retaining them at the minimum wage level, effectively concealing unemployment and delaying restructuring.

Estonia's trade deficit more than doubled from $62.7m in 1992 to $141.9m in 1993 as imports steadily picked up with the recovery of economic activity. The deficit has continued to grow in 1994, amounting to about $150m in the first five months of the year. However, the strength of Estonian freight and shipping earnings during 1993 bolstered the services balance, which limited the increase in the current account deficit. A significant reorientation of trade towards the west began in mid-1992 and continued in 1993. A free trade agreement with Latvia and Lithuania has been in force since 1 April 1994.

Estonia has consistently managed to achieve budget surpluses over the past three years, despite difficult circumstances: tax arrears in the enterprise sector remain significant (estimated at about 3% of GDP), and pressure on expenditures, particularly the financing of the social safety net, is intense. A surplus of 0.2% of GDP was achieved in 1993. The government programme for 1994 envisages a deficit of no more than 1% of GDP.

TABLE 6 : **ESTONIA — Main Economic Indicators**

Area ('000 km^2)			45.1		
Population (millions)			1.5		
Population density (per sq km)			33		
		1992	1993	1994	latest
GDP at constant prices	(a)	–23.0	–7.8		
Agricultural production	(a)	-21.3			
Industrial production	(a)	–38.7	–28.4		Jan-Nov
Consumer price index	(a)	1075.9	89.8	47.5	Jan-June
Unemployment rate, in %	(b)	1.5	1.7	2.1	June
Budget balance, % GDP	(c)	0.8	0.2		
Trade balance, $ bn	(d)	–0.1	–0.1	–0.2	Jan-May
Current account, $ bn	(d)	0.0	0.0		
Gross foreign debt, $ mn	(e)	66	85.0		June

(a) Percentage change over (the same period of) the previous year.
(b) End of period.
(c) Consolidated state budget deficit, accrual basis.
(d) In convertible currencies.
(e) End of period. Not including liabilities of the USSR.

Price liberalization has progressed well in Estonia, and most subsidies have been removed. Inflation has been brought under control since the currency reform in mid-1992, although not as quickly as had been expected. Recent months have seen a resurgence of inflationary pressures in the economy: since November monthly inflation has averaged 4.1%, peaking at 8.9% in March. The strong increase in the prices of imports from Russia is cited as one of the main reasons for the upturn in inflation, but the rise in foreign currency reserves and the corresponding increase in domestic money supply is perhaps a more important factor. Monthly inflation has fallen consistently since March and reached a two-year low in June at 0.7%.

Beginning in mid-1992, a tax-based incomes policy was successful in keeping real wages broadly constant, thereby protecting Estonia's competitiveness. The tax-based incomes policy has since been replaced by pre-announced semi-annual inflation targets, which form the basis of pay claims, along with firm-specific productivity agreements.

A two-tier banking system has been established. The central bank (Bank of Estonia) was founded in 1990 and took on full central banking responsibilities at the beginning of 1992, when it absorbed the Estonian branch of Gosbank. The private commercial banking sector comprised 43 banks in September 1992. A number of these banks were established by groups of state enterprises specifically to serve their financing needs and were effectively 'tied' to the enterprises. A liquidity crisis began towards the end of 1992, since when the central bank has revoked a number of banks' licences and has raised the minimum capital requirements. The subsequent merger activity resulted in the reduction in the number of commercial banks to 22. Banks' asset portfolios remain burdened with bad loans. In addition, the great majority of deposits are short term, which also limits banks' new lending activities to short-term projects, such as trade financing. This, combined with the banks' general caution engendered by the uncertain economic environment, has severely limited the supply of long-term credit to the enterprise sector, which hinders restructuring. Most banks are currently trying hard to augment their capital by equity issues and foreign partnerships.

Estonia left the rouble zone by introducing its own currency, the kroon, in June 1992. The kroon is pegged to the DM and is convertible for current account purposes, with controlled capital account convertibility. So far the kroon has maintained its peg to the DM despite a significant real appreciation resulting from Estonia's higher domestic inflation. A currency board system has been established which strictly limits the issue of money to the amount of reserves held. The currency was initially backed by about $120m-worth of reserves, with a further $40m of free reserves also held by the central bank. Reserves have subsequently increased strongly and now total over $300m. It remains to be seen whether the currency board will be retained as domestic demand recovers and a more flexible monetary regime is needed.

Privatization in Estonia began with the sale of small enterprises, of which over 80% have now been sold into private ownership. Privatization of larger enterprises has progressed more slowly. The major impediment has been the long-drawn-out restitution process. With the deadline for restitution claims now passed, successful claimants will receive either restitution of physical property or compensation through privatization vouchers or bonds. Under the medium- and large-scale privatization programme 52 enterprises had been privatized by the end of 1993 out of a total of 155 offered for sale. A further 56 enterprises were recently advertised in the fifth round of auctions. In an effort to encourage investment, the authorities have changed the criteria for the selection of successful bids in the most recent round, moving away from a 'best price basis' and emphasizing the quality of the business plan. Preparations are under way for privatizations by public share subscription, and the government is in the process of elaborating a plan for privatization through vouchers. A separate department has been established in the Ministry of Economy with responsibility for restructuring state firms before privatization. This department set up 'industry boards' which are designed to fulfil the role of shareholders. They have the power to dismiss and replace the management of a state-owned enterprise if performance is considered to be inadequate.

Hungary

In spite of the collapse in exports, the recession started to bottom out in 1993 with, for the first time in four years, increases in domestic demand. In 1994, economic indicators are pointing to an overall strengthening of the recovery: wages are increasing strongly, exports are starting to grow again, corporate tax is yielding higher returns than expected, investment and order indicators are improving, unemployment is decreasing further. However, severe macroeconomic imbalances make this growth unsustainable: in 1994, public deficits are likely to remain in the order of 6 to 7% of GDP for the third consecutive year, and the current account deficit will be, as in 1993, close to 7% of GDP; in addition, government debt, which increased from 50.8% of GDP in 1990 to 73.7% of GDP in 1993, will place a heavy strain on the economy. The newly elected socialist-liberal coalition intends to restore macroeconomic balances and has declared that 1995 will be the year of self-restraint.

According to recently published national accounts, GDP declined by, respectively, 4.3% and 2.3% in 1992 and in 1993. It is forecast at best to grow by less than 2% in 1994. The gloomier than expected economic outcome in 1993 was entirely related to the bad external performance of the Hungarian economy: in volume, exports fell by 12% and imports grew by 19%. On the domestic side, encouraging developments occurred in consumption and investment. Private consumption increased by 1.4%, as a result of a reduction of savings: the savings ratio fell from 19.6% in 1992 to 11.2% in 1993, while real disposable income declined further. Fixed investment stagnated. The main driving forces of the recovery process in 1993 were the rebuilding of stocks and public consumption, which increased by 30.5% in real terms.

Recent output trends indicate that a modest recovery is under way. Industrial output rose by 4% in 1993 over 1992. Apart from food industries and the mining and energy sectors, all sectors recorded positive growth rates, with the best performance in machinery and building material industries. In the first four months of 1994, industrial output grew, year on year, by 7.8%, but with a big jump in January and a continuous fall thereafter. The fall is concentrated, mainly, in two sectors: machinery and furniture. Industrial output growth in 1993 did not compensate for the 6% fall in agricultural output. In 1994, both sectors are expected to record positive growth.

TABLE 7 : **HUNGARY — Main Economic Indicators**

Area ('000 km^2)			93.6		
Population (millions)			10.3		
Population density (per sq km)			110		
		1992	1993	1994	latest
GDP at constant prices	(a)	-4.3	-2.3		
Agricultural production	(a)	-23.0	-6.0		
Industrial production	(a)	-9.8	4.0	7.8	Jan-Apr
Consumer price index	(a)	23.0	22.5	17.6	Jan-June
Unemployment rate, in %	(b)	12.2	12.1	11.0	June
Budget balance, % GDP	(c)	-7.8			
Trade balance, $ bn	(d)	0.0	-3.2	-1.1	Jan-May
Current account, $ bn	(d)	0.3	-3.5	-1.4	Jan-May
Gross foreign debt, $ bn	(b)	21.4	24.5	25.6	Apr
Debt-export ratio, %	(e)	214	302		

(a) Percentage change over (the same period of) the previous year.
(b) End of period.
(c) Consolidated state budget deficit, accrual basis.
(d) In convertible currencies.
(e) Gross hard-currency debt as a percentage of hard-currency exports.

After a peak of 705,000 in February 1993, the number of registered unemployed steadily declined to 549,880 in June 1994, corresponding to 11.0% of the work-force. This trend partly reflects the decreasing number of people receiving benefit, and effective unemployment is thought to be nearly 30% higher than registered unemployment. However, most of the labour-shedding related to restructuring is believed to be over. After four years of decline, real wages started to grow again in 1994, with a year-on-year increase of 7.1% in real net average earnings in the first five months of 1994. The new government views such large gains as unjustified and intends to impose wage moderation through a social pact in the autumn. This will be a test for the credibility and support of the new coalition, which intends as well to increase the tax burden on households and to reduce social benefits.

Inflation remained high in 1993 with an inflation rate of 22.5%, close to the 1992 level of 23%. In 1994, inflation expectations are still high, ranging between 17% and 22%, but the results for the first six months point to the lower limit of the range: the consumer price index rose by 17.6% compared to the same period last year.

Fiscal restraint and public finance reforms are at the top of the new government's agenda. Thanks to substantial tax revenues at the end of the year, the 1993 deficit target was met with an estimated deficit of 6.2% of GDP. The 1994 budget was approved by the Parliament in December 1993 with a consolidated budget deficit of Ft 330 bn. Mid-year results show that the mid-year target was overshot by Ft 20 bn. The new government will submit a supplementary bill to the Parliament in October to seek approval for a public expenditure cut of Ft 50 bn. This will entail mainly freezing the unspent budgetary reserve, but might also imply bringing forward the switch to a single-tier VAT or cancelling the Expo world fair. In the longer term, the government intends to undertake a systematic review and redefinition of all budget lines. The 29 extra-budgetary funds, which amount to 17% of budget expenditures in 1994, will be integrated into the budget. Only the regional, agricultural and employment funds will remain. To streamline public expenditure, a public procurement law will be prepared. Pension and health benefits will be scaled down by shortening maternity leave, raising the retirement age for women, reducing family allowances and tightening entitlement to sick leave. The tax burden will be shifted away from the corporate sector and investment to household income and consumption, and from central to local government. Tax collection and discipline will be strengthened.

The collapse of exports in 1993 resulted in large deficits of US$ 3.2 billion for the trade account and US$ 3.5 billion for the current account. The trade and current accounts showed deficits of, respectively, US$ 1.1 bn and US$ 1.4 bn at the end of May 1994. Projections for 1994 foresee again a current account deficit of more than US$ 3 bn. In contrast with the across-the-board decline of exports and increase in imports in 1993, the trade dynamics changed slightly in 1994: in the first five months of 1994, exports and imports grew simultaneously by, respectively, 4.7% and 4.2% over the same period last year. Exports of energy and food products, in relative terms, grew faster, while import growth mainly reflected greater demand for food and consumer goods. After a temporary reversal in 1993, the share of the European Union in Hungarian trade started to grow again in 1994, reaching 44.1% of imports and 50.1% of exports.

In view of Hungary's debt service obligations of about US$ 3 bn per year, the target level for official reserves in foreign currencies is US$ 6 bn. Official reserves expanded throughout 1993 and reached US$ 6.2 bn at the end of April 1994 compared to US$ 4.4 bn at end-1992. Correspondingly, the gross external debt in convertible currencies increased to US$ 25.6 bn at the end of April 1994 from US$ 21.4 bn at the end of 1992. Foreign direct investment nearly doubled in 1993 compared to each of the two previous years, rising to US$ 2.3 bn; almost half of this amount was the result of a single cash payment for Hungarian Telecom. In the first four months of 1994, US$ 302 million came into the country, slightly below average monthly inflows recorded in the last four years. But large transactions related to privatization are expected later in the year and should ensure that the inflow of direct investment is close to last year's record.

The forint was under severe attack on the domestic inter-bank foreign exchange market following the victory of the socialist party in May. The new government, however, has made very clear its intention to continue the past anti-inflationary exchange rate policy through regular small devaluations to keep the real exchange rate constant. The forint was devalued by 15% against the dollar-ECU basket in 1993, and was again devalued by 1.9% in January, by 2.6% in February, by 1% in May, and by 1.2% in June 1994. This has not closed the controversy about the exchange rate policy, and the advocates of a large one-off devaluation still claim that a devaluation would be less painful than fiscal restraint to restore external balance. Progress towards convertibility was made in January 1994, with the NBH's decision to discontinue its foreign exchange transactions at fixed selling and buying rates and to intervene exclusively on the inter-bank foreign exchange market. It was decided to allow foreigners to hold convertible forint accounts from 1 June so as to permit the Forint to be used in international transactions. In May 1994, the NBH replaced the D-Mark by the ECU in the currency basket to which the Forint is pegged. The new basket is composed of the ECU (70%) and the US dollar (30%).

With the change in government, privatization is now coming to a turning point: after a slowdown in the privatization process in 1993 and a near-freeze in the first half of 1994, the privatization strategy is being completely revised. Privatization will be accelerated with the aim of completing it by 1996. The socialist-liberal coalition intends to suspend the Small Investor Share Programme; to merge the privatization agency, SPA, and the state asset management holding, Av Rt; and to wind up as quickly as possible the compensation programme of Ft 300 bn. The list of companies that are to remain permanently state-owned will be revised and bank privatization will be speeded up. The management of companies under permanent state ownership will be delegated to banks or investment companies. Privatization methods will be developed with a view to expanding portfolio investment.

The restructuring strategy is also being changed. The new government's intentions regarding the ongoing financial sector reform are not known. The new government will likely discontinue or sharply cut back the bank consolidation scheme launched in November 1993 to recapitalize the banks by converting the banks' bad debts into 20-year treasury bonds and assisting banks to set up work-out units to deal with insolvent enterprises. Its intention is also to tighten eligibility criteria for government support to indebted companies. In addition, in companies which were rescued with public resources, financial discipline, in particular wage discipline, will be strengthened.

The new government is adopting a courageous stand on fiscal and company restructuring issues. The overall impact on the economy has not been quantified yet, but if the government gets the political and social support to implement its policy in the autumn, it is unlikely that the optimistic official forecast announced in the spring of modest GDP growth in 1994 will materialize.

Latvia

The continuous fall in GDP since 1991 came to an end in the fourth quarter of 1993 when economic activity began to pick up again. The overall decline in GDP in 1993 was 12%. The sharp contraction during the previous three years was a result of the substantial terms-of-trade loss, the general breakdown in traditional trading patterns and the reduction in domestic demand brought about by the stabilization measures. The government's stabilization efforts are currently being supported by the IMF through a stand-by loan and a systemic transformation facility loan. The government expects GDP to grow by 4% in 1994.

In May unemployment in Latvia accounted for 6.6% of the work-force. Unemployment has increased sharply since the first quarter of 1993, as the government has become more willing to accept widespread bankruptcies. However, hidden unemployment is still prevalent; many industrial employees are on indefinite unpaid leave and wage payments are being delayed by a number of months. The government expects open unemployment to increase to about 12% in 1994.

The balance of trade showed a $68m deficit in 1993, but strong shipping and freight earnings resulted in a slight current account surplus. Imports have picked up in 1994 as economic activity has recovered, resulting in the emergence of a current account deficit.

In 1993, despite lower than expected revenues and significant enterprise tax arrears, the budget showed a surplus amounting to 1% of GDP. In order to boost revenues and help balance the budget the government increased the basic rate of VAT from 12% to 18% from November 1993. This increase was also extended to food products from the beginning of June 1994. The government envisages a budget deficit of up to 2% of GDP in 1994.

Price liberalization has proceeded at a steady pace in Latvia since January 1991 and is now virtually complete. Real wages have declined significantly since the introduction of active incomes policies in mid-1992. Inflation had moderated considerably by mid-1993 but increased again in the final quarter of the year. In the first six months of 1994 inflation continued at well above the target of an average monthly rate of 0.5%. Increases in food prices contributed most to the overshooting. These are partly a result of the protection of domestic agricultural producers by tariffs on imported food products. Food prices increased further in June following the increase in VAT on food items. Large capital inflows have led to increases in domestic money supply, which have also had a significant impact on price developments.

A parallel currency — the Latvian rouble — replaced the rouble in July 1992, and the national currency (the lat), fully replaced the Latvian rouble in October 1993. Under a floating exchange rate regime monetary policy was initially tight, and the Latvian rouble/lat accordingly appreciated against its counterparts in other former Soviet republics, and against the US dollar and the Deutsche Mark. The unprecedented increases in capital inflows, however, have resulted in both an appreciation of the lat and an overshooting of the reserve money performance criterion under the IMF stand-by programme. Consequently Latvia has been unable to purchase the next tranche under the stand-by agreement. The authorities intend to allow the lat to continue under a managed float with no formal peg but with reference to the SDR.

The Bank of Latvia was established in 1990 and subsequently took over the functions of the Latvian branch of Gosbank, as well as the state commercial banks. In June 1992, however, the state commercial banks were effectively separated from the central bank. The bank is responsible for monetary and exchange rate policy. The 48 branches of the central bank have been audited, and 27 have been privatized individually. The remaining 21 were consolidated under one core bank, Unibank. This bank is to be recapitalized using money raised from a 57.5m-lat state bond issue and foreign assistance. The private banking sector has expanded; about 60 banks had been created by the end of September 1993. So far, one foreign bank has set up business in Riga. The central bank has developed its prudential supervisory capacity. Two banks were closed during 1993. The central bank has raised the minimum capital requirement from 25,000 lats to 100,000 lats. The combination of confidence in the currency and liberal foreign exchange regulations has resulted in deposits being attracted from throughout the former Soviet Union, particularly Russia. These deposits carry high rates, as the banks are currently able to finance highly profitable short-term re-export activity at even higher loan rates. This effectively crowds out longer-term productive investment by enterprises.

TABLE 8 : **LATVIA — Main Economic Indicators**

		1992	1993	1994	latest
Area ('000 km^2)			64.5		
Population (millions)			2.6		
Population density (per sq km)			40		
GDP at constant prices	(a)	–32.9	–12.0		
Agricultural production	(a)	–13.0	–2.8		
Industrial production	(a)	–35.1	–39.6		Jan-June
Consumer price index	(a)	909.6	109.2		Jan-Nov
Unemployment rate, in %	(b)	2.3	5.3	32.4	Jan-June
Budget balance, % GDP	(c)	–1.4	1.0	6.6	May
Trade balance, $ bn	(d)	–0.1	–0.1		
Current account, $ bn	(d)	0.0	0.0		
Gross foreign debt, $ mn	(e)	23.5			

(a) Percentage change over (the same period of) the previous year.
(b) End of period.
(c) Consolidated state budget deficit, accrual basis.
(d) In convertible currencies.
(e) End of period. Not including liabilities of the USSR.

Privatization so far has progressed only slowly in Latvia, mainly because of the problems surrounding the restitution issue and the definition of property rights. Out of a total of nearly 250,000 claims only some 70,000 have been processed. The only area of significant progress has been small-scale privatization: 55% of eligible small-scale enterprises have been privatized. By December 1993 only 22 large-scale enterprises had been privatized. To accelerate the pace of privatization the government has submitted a number of laws for parliamentary approval. First, the deadline for restitution claims is to be brought forward. Second, the government has created a single privatization agency. The government is aiming to complete about 200 privatizations this year through public auctions and tenders. In addition, a state property fund has been created to manage those enterprises remaining in the public sector. Vouchers have been issued for use in a comprehensive privatization programme covering all state-owned property, including land, apartments, shares in enterprises and special privatization investment funds.

Lithuania

GDP is estimated to have declined by 17.0% in 1993, following declines of 37.7% in 1992 and 12.8% in 1991. This came about mainly because of the deterioration in the trade situation and the macroeconomic stabilization programme. The government expects modest growth (1.2%) to resume in 1994. The IMF, however, expects stronger growth, in the region of 4% to 5%.

According to the Department of Statistics, industrial production was 46% lower in 1993 than in 1992. This figure, however, does not reflect the more modest decline in GDP in 1993. The Ministry of Economy estimates industrial production to have fallen by 25% in 1993, which is more consistent with the GDP figure. Moreover, this large overall decline masks the stabilization in activity that occurred from mid-year. The large agricultural sector was severely affected by the drought in 1992, when the decline in output was estimated at 24%, but the sector declined less severely in 1993. Registered unemployment stood at 3.2% of the work-force in June 1994. Hidden unemployment, however, is estimated to be as high as 140,000 or 7.4% of the work-force; many workers are working part-time or on indefinite unpaid leave.

Price liberalization has progressed to the extent that all goods and services except household energy products and monopoly products are decontrolled. With the introduction of active stabilization policies in July 1992, incomes policy was set so as to control inflation by using forward-looking guidelines based on the inflation targets of the stabilization programme. Real wages remained broadly stable during 1993. Monthly inflation averaged 14.2% in the first half of 1993, declining to an average of 4.7% in the second half of the year. This last figure conceals, however, the recent upturn in inflation, which averaged 6.8% per month in the final quarter of 1993. Inflation persisted at relatively high rates, averaging 3.5% per month, in the first six months of 1994. This increase is a result of a combination of factors, including further reductions in subsidies; seasonal increases in food prices and the effect of higher tariffs on food imports; and the rise in the price of essential imports from Russia. In addition, the rise in domestic money supply resulting from increased capital inflows has adversely affected price developments.

The trade balance moved into deficit in 1993 as imports picked up in line with economic activity. Trade continues to be heavily oriented towards former Soviet republics, mainly Russia. Although the government publishes indicative lists of items that are required by former Soviet republics which retain the system of state orders, there is no obligation for Lithuanian enterprises to fulfil these lists and trading is on an enterprise-to-enterprise basis only. Trade with former Soviet partners recovered somewhat during 1993. However, in the absence of a convertible currency in most of these countries, enterprises tend to resort to barter deals.

The 1993 budget showed a surplus of about 1% of GDP. A deficit of between 1% and 1.5% of GDP is programmed for 1994. The deficit in the first half of 1994, however, exceeded expectations mainly because of a large shortfall in social security revenues. The government has begun to finance this deficit by the sale of treasury bills.

TABLE 9 : **LITHUANIA — Main Economic Indicators**

		1992	1993	1994	latest
Area ('000 km^2)			65.2		
Population (millions)			3.7		
Population density (per sq km)			57		
GDP at constant prices	(a)	–37.7	–17.0		
Agricultural production	(a)	–24.0	–8.0		
Industrial production	(a,b)	–51.6	–46.0		
Consumer price index	(a)	1020.5	410.1	99.3	Jan-June
Unemployment rate, in %	(c)	1.0	1.6	3.2	June
Budget balance, % GDP	(d)	0.6	0.9		
Trade balance, $ bn	(e)	0.1	–0.3		
Current account, $ bn	(e)	0.1	–0.2		
Gross foreign debt, $ mn	(f)	126			

(a) Percentage change over (the same period of) the previous year.
(b) State-owned sector only.
(c) End of period.
(d) Consolidated state budget deficit, accrual basis.
(e) In convertible currencies.
(f) End of period. Not including liabilities of the USSR.

The rouble was replaced first by a coupon (the talonas) in October 1992 and then by the full national currency (the litas) in July 1993. The litas was initially backed by reserves of about $200m and is convertible for current account purposes. Growing confidence in the currency has resulted in a substantial inflow of hard currency. This has led to an appreciation of the litas and increases in reserve money beyond the limits set out in the IMF programme. The central bank is criticized by the industrial lobby for the strength of the litas and at the same time faces pressure from the IMF to limit the emission of domestic currency. A solution to this problem would be to sterilize the capital inflows and corresponding litas emissions by sales of government paper on the open market. The prime minister, however, has put a stop to this, as it reduces the central bank's profits from seignorage, which are used for budget purposes. This problem led the government to introduce a currency board, thereby replacing the reserve money performance criterion with the requirement of full foreign currency backing of the currency board liabilities. The currency board came into force on 1 April this year, with the litas pegged to the dollar.

Privatization initially progressed rapidly in Lithuania, but has slowed in recent months. The basic mechanism employed has been to issue citizens with vouchers which can be used in part payment, with cash, for the various privatization offerings. So far these have included the privatization of residential property (nearly 90% of privatizations requested by the occupants have been completed); the privatization of small firms by auction (over 80% of total completed); and the privatization of medium-sized and large enterprises (1,981 in total, representing 23% of all such enterprises). Certain selected enterprises have been sold to foreign investors through a tender process. By the first quarter of 1994 about 45% of all state productive assets had been privatized, most of which was accounted for by large enterprises. However, little attention has been devoted to restructuring: many firms are now effectively worker-controlled, which further hinders rationalization and labour-shedding. In order to limit this, the government has promulgated legislation that would remove all preferential treatment for employees and managers in the privatization process. Implementation of the bankruptcy law is difficult and is hampered by the lack of capacity of the courts. Nevertheless, bankruptcies have taken place and indications are that enterprise indebtedness has stopped growing, which suggests that financial discipline is being imposed. The government intends to revise the bankruptcy law with a view to making implementation easier.

Agricultural privatization has progressed with the breaking up of collective farms into smaller units. The process is expected to continue as the thousands of restitution claims are processed. This has already resulted in a reduction in farm size to an average of 8.6 ha, which the authorities consider to be too small to be efficient. To promote consolidation, the authorities are considering offering compensation rather than land to a larger number of restitution claimants, and providing preferential credit for holdings above 15 ha. The government has also banned further breaking up of units already below 20 ha.

Significant progress has been made in dismantling the monobank and replacing it with a two-tier banking structure. Twenty-two commercial branches have been separated from the central bank as fully private concerns, and the remaining ten commercial branches have been separated by the creation of the State Commercial Bank. This last, along with the State Agricultural Bank and the State Savings Bank, will be audited in the coming months with a view to eventual privatization. The government has undertaken to cover the assets of the Savings Bank that are held in Moscow and are unlikely to be returned. A referendum is to be held on the question of indexation of personal savings deposits. The banking sector generally is beset with problems of non-performing loans and is in need of restructuring. The introduction of a comprehensive new set of banking laws has been delayed in parliament because of the urgency of the currency board legislation. The World Bank has temporarily suspended lending activity in Lithuania until the legal framework of the banking sector has been improved. In particular, the Bank is concerned about the growth of unlicensed para-banking institutions which do not fall under the central bank's supervision. In the case of licensed banks, however, the Bank of Lithuania has become more active in its supervision policy, compelling banks to comply with regulatory norms by temporarily suspending new loan/deposit activity.

Poland

The Polish economy has continued to grow strongly since the onset of recovery in 1992. In 1993 GDP is estimated to have increased by 3.8% while industrial output grew by 7.9%. In the first half of 1994 industrial output increased by 9.9% compared to the same period in 1993. However, output remains well below the level achieved in 1989, before the launching of the economic stabilization and reform programme. The government expects GDP to increase by 4.5% in 1994.

The stabilization programme helped to reduce inflation from 640% in 1989 to 35.3% in 1993. This last figure, however, exceeded the government's target of reducing inflation in 1993 to 32%. The overshooting of the target was caused by unexpectedly large increases in monthly inflation of 4.0% in November and 5.6% in December. Although the rate of price increases in the first six months of 1994 has fallen from these high levels, inflation remains higher than had been expected, prompting the Central Planning Office to revise upwards its forecast for end of year inflation from 27% to 31%.

TABLE 10 : **POLAND — Main Economic Indicators**

Area ('000 km^2)			318.3		
Population (millions)			38.5		
Population density (per sq km)			121		
		1992	1993	1994	latest
GDP at constant prices	(a)	1.5	3.8		
Agricultural production	(a)	–11.0	1.5		
Industrial production	(a)	4.2	7.9	9.9	Jan-June
Consumer price index	(a)	43.0	35.3	31.9	Jan-June
Unemployment rate, in %	(b)	13.6	16.1	16.6	June
Budget balance, % GDP	(c)	–6.0	–2.8		
Trade balance, $ bn	(d)	0.5	–2.3	–0.3	Jan-May
Current account, $ bn	(d)	–0.3	–2.3	–0.4	Jan-May
Gross foreign debt, $ bn	(b)	49.9	47.0		
Debt-export ratio, %	(e)	357	346		

(a) Percentage change over (the same period of) the previous year.
(b) End of period.
(c) Consolidated state budget deficit, accrual basis.
(d) In convertible currencies.
(e) Gross hard-currency debt as a percentage of hard-currency exports (NBP figures).

Privatization of state enterprises and new private sector activity have resulted in an increase in the contribution of the private sector to total GDP. This rose from 28% in 1989 to over 50% in 1993. However, the recession and the restructuring of enterprises have resulted in increased unemployment, which rose from negligible levels at the start of 1990 to 16.6% of the work-force in June 1994. Moreover, the effects of restructuring have been particularly acute in the many areas that depend on single large plants or sectors, and substantial regional variations in unemployment have emerged. The rate ranges from 7.5% in Krakow to over 25% in some regions.

The combination of a fairly restrictive incomes policy and the fear of unemployment has limited wage growth, and resulted in an overall decline in real wages of about 2% in 1993. The government abolished the tax on excessive wages on 1 April 1994 with the intention of replacing it with a system of norms and widening the scope of the law to include the private sector. Although the law was approved by parliament, it was rejected by the President. The law has since been amended to exclude the private sector and has been passed to come into effect on 1 August. In the intervening period, however, real wages have grown significantly.

The budget for 1993, which formed one of the performance criteria of the IMF stand-by loan, was planned to be PLZ 82 trillion (5.1% of GDP). Revenues exceeded expectations during 1993, as the financial condition of state enterprises improved. As a result, the deficit in 1993 was lower than expected at PLZ 43.8 trillion (2.8% of GDP). The 1994 budget envisages a deficit of PLZ 83 trillion in 1994. This is expected to be about 4.0% of GDP.

The NBP maintained tight control of the money supply in 1993, which resulted in a decline of 2% in money supply in real terms. The NBP set a limit on Treasury bill purchases of PLZ 30 trillion in 1993 and intends to continue this limit in 1994. Despite the more favourable fiscal outlook, the government has experienced difficulties in financing the deficit under its Treasury bill programme. Moreover, as the burden of financing the budget is expected to be much higher in the second half of the year, it can be expected that there will be increasing competition for funds over the coming months. This means that yields might rise in the second half of the year. Monetary growth is expected to be 5% in real terms in 1994, and the target for annual inflation is 27%. The unanticipated high monthly inflation in recent months, however, means that it is unlikely that this target will be achieved. The NBP recently cut interest rates by two percentage points to bring the refinancing rate to 33%.

The introduction of convertibility and the adoption of a liberal trade regime in 1990 were aimed at importing the world price structure and promoting trade with the west. To a large extent this strategy has been successful, although in 1991 the rapid breakdown of CMEA trade, the rise in energy prices and the real appreciation of the zloty resulted in a weak trade balance. Polish trade data are extremely difficult to interpret: NBP data, based on flows of funds, show a trade deficit of $2,293m in 1993, while customs data show a much bigger deficit. The NBP provide the only up-to-date data for 1994, which show a $320m trade deficit for the first five months of the year.

A 'crawling peg' policy has been in operation since October 1991, which was adjusted at the same time as the last one-off devaluation in August 1993, from 1.8% to 1.6% per month, in line with the reduction in monthly inflation.

Poland had been unable since 1981 to service fully its external debt, which in February 1991 stood at around $48.5bn, of which about $32bn was owed to 17 of the Paris Club of government creditors. In March 1991 Poland reached an agreement with the Paris Club, which provided for a reduction of the net present value of the debt by 50%. The first 30% reduction was to be achieved by March 1994. In March 1993, the IMF agreed to provide Poland with a one-year stand-by loan. Following the fulfilment of the conditions of this agreement in March 1994, the second debt-reduction tranche of 20% became available. The Polish government has achieved a similar deal on the $9.4bn owed to commercial banks, plus $2.7bn of overdue interest. The agreement envisages a reduction of 42.5% in the net present value of the debt over a 30-year period. Poland has agreed a further stand-by loan with the IMF, which will in part be used to meet the increased debt servicing entailed by the London Club deal. Total foreign debt amounted to $47.0 bn at the end of 1993.

By the end of 1993, 26% of state-owned enterprises had been assigned to some form of privatization path, while 13% of enterprises had actually completed the privatization process. After much delay, preparations for the mass privatization scheme are now under way. Under this scheme 367 state enterprises, to be managed by 20 National Investment Funds, are to be transferred to private ownership. Polish citizens will be able to purchase participation certificates in the funds with either cash or vouchers. To encourage fund managers to maximize the value of the companies for which they are to be responsible, they will receive both a flat-rate payment and further payment on the basis of the enterprises' performance.

In addition, certain specified groups of state enterprises will be given the option to decide upon their preferred privatization method and to submit a plan for restructuring. Acceptable plans will then receive favourable terms for debt rescheduling, tax arrears and workers' equity and representation. Failure to submit a suitable plan will result in commercialization on less favourable terms. The government intends to set up a state property ministry to manage those firms remaining in the state sector for the time being. This body will then be charged with accelerating the commercialization of the remaining 5,300 state enterprises. The government intends to play a more active role in the restructuring of industry, paying particular attention to the declining steel and mining sectors.

A two-tier banking system was created, by the removal of the 'big 9' state commercial banks from the control of the National Bank of Poland. So far two of these have been privatized. In addition, a liberal licensing policy has resulted in the creation of over eighty new private banks. However, the big 9 banks continue to manage most commercial credit, the large majority of which goes to state enterprises. Most of these banks inherited portfolios beset with problems of bad loans, which have since been exacerbated by the recession. The government aims to recapitalize and restructure the banks using up to $600m from the Polish Stabilization Fund, along with a $450m loan from the World Bank. The government has also made provision in the budget for the recapitalization of the Bank for Food Economy, but this has been criticized on the grounds that no prior restructuring of the bank is envisaged.

The tax system is being overhauled, with the aim of increasing tax revenues from the rapidly expanding private sector and expanding the base to include the shadow economy. Personal income tax was introduced from 1 January 1992, and value-added tax was introduced on 5 July 1993.

Romania

The conditions under which Romania embarked on economic reform were particularly difficult. The country had no net foreign debt, but this was achieved at a substantial human and economic cost. During the last years of the Ceaucescu regime imports were kept very low; for a decade virtually no western machinery was imported. Exports (most notably of agricultural goods) were stimulated, but they were made possible by repressed consumption at home. A deliberate policy was followed of holding down services and high technology in favour of heavy industry and manual labour. Moreover, significant resources were squandered on prestige projects. As a result, Romania's industrial infrastructure is among the most backward in Europe, and its work-force is particularly demoralized and badly trained.

The Romanian economy showed a mixed performance in 1993. After five consecutive years of decline, the authorities' estimate indicates that output stabilized. This was partly due to stronger-than-expected growth in public consumption and exports. However, inflation accelerated during 1993, as a result of the elimination of most remaining price subsidies in May and the introduction of VAT in July. The continuing depreciation of the leu, the large nominal wage increases without corresponding rises in labour productivity, and the lack of financial discipline of state enterprises have also served to fuel inflationary pressures. Inflation during the first five months of 1994 stabilized at around 6% per month. Unemployment continued to rise slowly during the first half of 1993 but has recently stabilized, largely because of increased job creation in the private sector. Trade and current account deficits were recorded in 1990-92, caused by the disintegration of the CMEA and the sharp fall in domestic production. During 1993 further trade liberalization resulted in substantial increases in exports and imports (+5.5% and +3.1% respectively over 1992), and in the first five months of 1994 they continued to grow (+38.4% and +10.1% respectively over the same period of 1993). Official exchange reserves remained at extremely low levels throughout 1993 but have gradually increased in 1994. Gross foreign debt is low ($4.4bn at end-1993), but is rising fast.

TABLE 11 : **ROMANIA — Main Economic Indicators**

Area ('000 km^2)			232		
Population (millions)			22.8		
Population density (per sq km)			98		
		1992	1993	1994	latest
GDP at constant prices	(a)	–13.6	1.0		
Agricultural production	(a)	–12.1	14.0		
Industrial production	(a)	–21.8	1.3	–1.8	Jan-May
Consumer price index	(a)	199.0	295.0	225.9	Jan-May
Unemployment rate, in %	(b)	8.4	10.2	10.8	June
Budget balance, % GDP	(c)	–4.6	–0.1		
Trade balance, $ bn	(d)	–1.0	-0.7	–0.2	Jan-May
Current account, $ bn	(d)	–1.5	–1.3	–0.2	Jan-May
Gross foreign debt, $ bn	(b)	3.4	4.4		
Debt-export ratio, %	(e)	79	90		

(a) Percentage change over (the same period of) the previous year.
(b) End of period.
(c) Consolidated general government budget deficit, accrual basis.
(d) In convertible currencies.
(e) Gross hard-currency debt as a percentage of hard-currency exports.

Following long and difficult negotiations, the IMF Board approved in early June 1994 a 19-month loan agreement worth $700m. In return Romania has pledged to reduce annual inflation to two digits by the end of 1994, to speed up privatization and state sector restructuring and to maintain internal convertibility of the leu.

The authorities have opted for a gradual approach to price liberalization and have maintained ad hoc intervention. In early May 1993 all remaining subsidies were eliminated, except on drugs, rents, public transport and some energy prices, including electricity. The wholesale prices of certain key products have continued to be administratively controlled, but the government raised energy prices to world levels in mid-1994.

The consolidated general government deficit for 1993 declined from 4.6% of GDP in 1992 to only 0.1% in 1993. This was achieved through significant reductions in the payment of consumer subsidies (6% of GDP in 1993 against 13.6% in 1992), strict control of expenditures, including public sector wages, and better than expected revenues from the introduction of VAT in July 1993. The budget deficit, however, does not accurately reflect the country's fiscal position, as extra-budgetary expenditure remains substantial. The government plans to introduce personal income tax in 1994, as well as a land tax and increased local and excise taxes. At the same time, provisions have been incorporated in the 1994 budget for the creation of a social safety net. The Finance Ministry and the National Bank of Romania (NBR) have also launched the country's first Treasury bill.

Monetary policy has been tightened considerably since mid-1993. The central bank authorities discontinued the financing of the central budget deficit, and all preferential credits were abolished. The refinancing of the commercial banks by the central bank has been carried out by auction since August 1993, with commercial banks bidding for funds and the possibility of interest rate rises if demand exceeds supply. The discount rate of the central bank, which had risen from 70% in mid-1993 to 170% in early May 1994, declined to 130% by end-June. These trends reflect the reduced need for additional funding by the main commercial banks, which has come about because people are now more willing to hold lei, thanks to the attractive interest rates offered to household depositors, and because the NBR has raised interest rates for banks' minimum reserve deposits from 10% to 30%. The authorities intend to achieve and maintain positive real interest rates this year.

Current-account convertibility for residents was introduced in November 1991. The value of the leu depreciated rapidly from early 1992; the authorities repeatedly intervened and attempted to hold the exchange rate at levels which were clearly unsustainable in view of the prevailing rate of inflation. This resulted in large discounts on the parallel market, the build-up of large foreign currency deposits by exporters and the depletion of official reserves. In April the functioning of the foreign exchange auction was substantially liberalized. A market-clearing mechanism was introduced in the foreign exchange auction, and banks are now allowed to buy and sell unlimited amounts of foreign exchange for their own account in the auction. As a result the auction rate has recently converged on rates in the parallel market. The NBR plans to replace the auction with a fully fledged inter-bank market in the near future. The depreciation of the leu is expected to improve the country's export performance and achieve a rapid build-up in the foreign exchange reserves of the central bank but also to increase inflationary pressures.

Progress towards structural reform has been slow in Romania because of the lack of an internal political consensus on the reform process and the country's limited institutional and administrative capacity. The Parliament approved a new four-year economic reform programme in March 1993. This programme aims to accelerate privatization and the financial restructuring of enterprises, promote competition and encourage foreign investment. A Restructuring Agency has been set up to restructure enterprises in key industrial sectors. Programmes will be drawn up to redeploy labour and to ease the social costs of the adjustment process.

The privatization process has moved forward at a satisfactory pace in small enterprises and in the agricultural sector. By the end of 1993, over 50% of retail trade had been privatized. At the same time, the number of new private firms has grown rapidly, particularly in the service sector. These developments are reflected in the increasing contribution of the private sector to GDP, which was about 32% in 1993. Private sector participation in foreign trade activity has also grown rapidly and currently accounts for over a quarter of exports and nearly one third of imports.

Privatization of small plots of farmland is nearly complete, with 91% of land in private ownership as of January 1994. Following a slow start, almost all of the provisional land ownership certificates have now been issued. However, the complicated process of restoring plots to their former owners and the inflexible legal regime which regulates transactions of land holdings resulted in a fragmentation of arable land and a drop in land productivity.

Some slow progress has been achieved in the privatization of large state-owned enterprises. Large privatization is provided for in a July 1991 law which envisages the privatization of about 6,200 firms, or 55% of state-sector equity, over ten years. Implementation of the law, however, has been delayed by inter-institutional disputes. About 550 companies had been transferred to the private sector by May 1994, accounting for only 3% of total state-sector equity. In August the government will publish a list of 3,000 enterprises which are to be sold to citizens under a mass privatization scheme. Free vouchers were distributed to the public in 1992 entitling holders to a 30% share in these firms. The other 70% will be held by the state and will be gradually privatized by 1998. Two of the five major state-owned banks are being prepared for privatization in 1995.

Little has been done to restructure the state-owned industrial sector, although activity has picked up in recent months. A pilot programme is under way, whereby thirty of these enterprises have been isolated from the banking system and plans for their restructuring have begun to be implemented, including the liquidation of three seriously troubled companies. However, there is no timetable for the completion of the pilot programme and the process so far has been cumbersome and slow. The Ministry of Finance has shortlisted another 25 loss-making state-owned enterprises which are to undergo emergency restructuring procedures during 1994. Furthermore, 200 enterprises have been identified for rehabilitation and placed under the surveillance of the Restructuring Agency; their restructuring programmes are to be drafted by October 1994. The authorities' failure to impose financial discipline on industry and the lack of a legislative framework governing enterprise behaviour have meant that most firms have not adapted to market conditions. The government intends to pass a new bankruptcy law by mid-August 1994. In the mean time a small number of state-owned enterprises has been declared financially insolvent in order to prevent them from accumulating further inter-enterprise arrears and so as to allow creditors to open legal proceedings and recover part of their debts.

Financial markets have also been slow to emerge in Romania; the passage of the long-awaited securities and exchange law by the lower house of the Romanian parliament opens the way to the setting up of a stock exchange in Bucharest, currently expected for November 1994.

A fairly liberal framework law on foreign direct investment was approved in April 1991. It allows wholly foreign-owned companies to be set up in all sectors of the economy, and grants significant tax and import duty relief to investors; all profits may be repatriated in hard currency after the payment of a 10% tax. Foreign investments are granted full protection by the constitution, but the Parliament rejected draft legislation which would have allowed foreigners to buy land. Flows of direct foreign investment into Romania fell from $269m in 1992 to $217m in 1993.

Slovak Republic

The Slovak Republic has had to face the difficult tasks of building a market economy and, at the same time, establishing the institutions of an independent state. Indeed, the process of separation considerably complicated Slovakia's economic difficulties. Political instability and the lack of a broad social consensus on the path of economic reform presented additional obstacles to the transformation process. Also, the termination of fiscal transfers from the Czech Republic (tentatively estimated at 7 per cent of Slovak GDP in 1992) unmasked a large underlying fiscal and external imbalance.

In 1993 all key indicators of economic activity on the supply side, as well as most key demand-side indicators, showed a continued downturn in the Slovak economy, and rising financial imbalances towards the end of the year. Monthly inflation came down to less than 2 per cent, despite a surge at the beginning of 1993 caused by the introduction of a new tax system, and a second - smaller - surge in the autumn in the wake of an increase in VAT rates and of the 10% devaluation of the Slovak crown in July. The budget deficit was kept under control from the middle of the year, although some deterioration occurred late in the year, when social expenditures were increased and revenue collection fell short of expectations, partially as a result of fast-growing tax arrears. For the whole year the deficit reached about 7.5 per cent of GDP. This result was obtained in a context of high unemployment and without any fiscal transfer from the Czech Republic.

From early 1993 the weak balance-of-payments situation, continuing recession, and a large budget deficit were issues of major concern. By mid-1993, given the already tight macro-economic stance, actions directly targeted at improving the external balance were warranted. After devaluing the currency against all other currencies by 10 per cent in July 1993, and against the clearing ECU used for bilateral Czech-Slovak balance-of-payments transactions, by 5 per cent in December 1993, the Slovak authorities decided to impose an import surcharge of 10 per cent on most consumer goods and foodstuffs in March 1994.

Despite a sharp compression of domestic demand and the devaluations of the Slovak crown, total trade and current account deficits in 1993 reached US$ 915 m (9% of GDP) and US$ 432 m (4.2% of GDP). The trade and current account balances suffered a sharp deterioration in the final months of the year; indeed, more than 50% of the 1993 trade deficit and all of the current account deficit were produced in the last quarter of 1993 alone.

TABLE 12 : **SLOVAK REPUBLIC — Main Economic Indicators**

Area ('000 km^2)			49		
Population (millions)			5.3		
Population density (per sq km)			108		
		1992	1993	1994	latest
GDP at constant prices	(a)	–6	–4	3.6	Q1
Agricultural production	(a)	–12	–7		
Industrial production	(a)	–13	–14	3	Feb
Consumer price index	(a)	9	23	13.9	May
Unemployment rate, in %	(b)	1	14	13.9	May
Budget balance, % GDP	(c)	–4	–7.5	0.1	H1
Trade balance, $ bn	(d)	–0.2(g)	–0.9	–0.1	Jan-May
Current account, $ bn	(d)	0.2(f)	–0.4	0.1	Jan-Apr
Gross foreign debt, $ bn	(b)	9.5(f)	3.4		
Debt-export ratio, %	(e)	84(f)	63		

(a) Percentage change over (the same period of) the previous year.
(b) End of period.
(c) Consolidated state budget deficit, accrual basis.
(d) In convertible currencies.
(e) Gross hard-currency debt as a percentage of hard-currency exports.
(f) Refers to CSFR.
(g) Excludes trade with Czech Republic.

Until mid-1994 Slovakia had serious trouble financing the current account deficit. Net foreign direct investment, amounting to US$ 134 m in 1993, continued to be of little significance. In addition, Slovakia lacked ready access to the international capital markets, partly because, unlike the Czech Republic, Slovakia could no longer benefit from the solid international economic reputation that the federal government had built since the beginning of the reforms. Finally, speculation about a devaluation of the Slovak crown had resulted, both in the first half of 1993 and at the turn of the year, in a significant outflow of short-term capital.

To help ease the balance-of-payments constraint, the IMF lent Slovakia SDR 64.35 m (US$ 89 m) under the Systemic Transformation Facility (STF) in July 1993. In April 1994 the IMF reached agreement with the Slovak authorities on an economic policy programme that could be supported in the coming months by a stand-by arrangement, mobilizing up to US$ 460 m, and, possibly, a second purchase from the STF. In addition, the World Bank approved in November 1993 a US$ 80 m Economic Recovery Loan.

Since March 1994, the external performance of the Slovak economy has been improving considerably. Data for the first four months of the year show a trade deficit of only US$ 117 m and the current account in surplus by US$ 54 m, reflecting lower imports from the Czech Republic and rising exports to western countries. The main factors behind this improvement seem to be continuing weakness of domestic demand (despite some recent signs of revival), the devaluations of the Slovak crown last year, and the import surcharge.

Domestic economic indicators have also become more favourable. GDP in the first quarter recovered significantly if compared to the first quarter of last year, when the trough of the economic downturn was reached, but it was still below the level of last spring and summer. Nevertheless, output seems to be about to stabilize, inflation has come down to less than 10 per cent at an annualized rate, and the budget is showing the first surplus since independence. Finally, unemployment seems also to be about to stabilize, although at a high level.

Slovakia has made progress towards establishing the institutional framework of a market economy. Prices and trade were liberalized at the outset of the transformation process, and current-account convertibility of the domestic currency was established. Since then large parts of state-owned property have been privatized, the tax system and the system of social security contributions and benefits have been brought into line with western standards, and the legislation necessary for efficient decentralized economic decision-making has been put in place. However, most of these achievements in the transformation process were the results of reforms undertaken by the federal government of Czechoslovakia between 1990 and 1992, before the split of the country. From then until March 1994, little was done to advance the transformation process. The lack of financial resources was said to be the major, if not the only, obstacle to the process of restructuring the economy. Enterprises were and are still entangled in the problem of the insolvency of clients. Banks' capacity to provide new credits has also been very limited because of the large share of "bad debts" in their portfolios, and tight monetary and fiscal policies.

The new coalition government formed in late March 1994 has adopted a comprehensive stabilization and reform programme for 1994-95 to reinforce and complete the process of adjusting to the loss of fiscal transfers from the Czech Republic, and to accelerate the process of structural reform that had been slowed down considerably following independence. The programme, which is supported by an IMF arrangement, complementary assistance from the EU/G-24, and World Bank operations, extends far beyond the parliamentary elections set for end-September 1994, though it specifically includes important immediate actions in the area of structural reform that are aimed at making the process irreversible. Core elements of the programme are the amendment of the state budget to limit the deficit to 4 per cent of GDP in 1994, and the launching of a second wave of voucher privatization.

Slovenia

Although Slovenia has been spared the heavy damage inflicted on other parts of ex-Yugoslavia by the civil war, the resulting economic dislocation and in particular the dramatic reduction of trade with the former Yugoslav republics have accentuated existing production and supply problems. Since independence in October 1991, Slovenia has managed to stabilize its economy to a considerable extent. However, the positive results of stabilization, which are reflected in the significantly reduced inflation rate, were accompanied by a sharp decline in output, increased unemployment and serious difficulties in the financial sector.

After having stagnated for more than a decade, GDP fell during 1989-92. Output grew modestly in 1993. Some domestic demand components grew significantly in 1993, particularly private consumption, which rose by more than 10% over 1992, and gross fixed investment, which turned positive for the first time in seven years. Further evidence of recovery has been provided by the steep rise in industrial production, which rose by 5.8% in the first five months of 1994 over the same period of 1993, thus ending the decline that began in 1989. Real wages also moved sharply upwards during the first half of 1994. The current account surplus, which had been a constant feature of the Slovenian economy in recent years, declined significantly in 1993. The trade balance moved into deficit from the previous year's surplus.

Monetary stabilization has been successful: the monthly inflation rate declined to single digits by April 1992; prices rose by 32.3% in 1993 over 1992, the lowest figure in the past eleven years. This trend continued during the first six months of 1994. Slovenia had traditionally been a full-employment society, but the number of registered unemployed rose sharply from early 1991 until it stabilized in early 1994. Most job losses have occurred in the socially owned enterprise sector; employment has risen in the government sector and particularly in the private sector.

TABLE 13 : **SLOVENIA— Main Economic Indicators**

Area ('000 km^2)			20		
Population (millions)			2		
Population density (per sq km)			100		
		1992	1993	1994	latest
GDP at constant prices	(a)	–6.5	1.0		
Agricultural production	(a)	–17.0			
Industrial production	(a)	–13.2	–2.8	5.8	Jan-May
Consumer price index	(a)	201.0	32.3	20.5	Jan-June
Unemployment rate, in %	(b)	13.3	15.4	14.6	Apr
Budget balance, % GDP	(b)	0.6	0.5		
Trade balance, $ bn	(c)	0.1	–0.4	–0.1	Jan-May
Current account, $ bn	(c)	0.9	0.2	0.2	Jan-May
Gross foreign debt, $ bn	(b)	1.8	1.9		
Debt-export ratio, %	(d)	26	31		

(a) Percentage change over (the same period of) the previous year.
(b) End of period.
(c) In convertible currencies.
(d) Gross hard-currency debt as a percentage of hard-currency exports.

Trading activity has contracted because of the disintegration of the Yugoslav federation and the collapse of the CMEA. However, exporters have succeeded in finding new markets in the West. Imports have also risen strongly, particularly of consumer goods and equipment, fuelled by high real wage increases. The invisibles balance suffered in 1991 because of the drop in receipts from tourism and emigrants' remittances, though it picked up again in 1992 and 1993. Foreign exchange reserves rose rapidly during the first year of independence and stood at about $1.9bn by May 1994.

The cornerstone of Slovenia's economic stabilization programme has been the implementation of a tight monetary policy through the maintenance of high real interest rates, although the Bank of Slovenia has been under pressure from the government since early 1994 to reduce rates. This policy has succeeded in drastically reducing inflation, but at the cost of sharp declines in output. Inflationary impulses last year came from exchange rate depreciation and increases in government-controlled prices. However, the main threat to price stability came from the centralized and rigid wage-setting process: the wage structure was indexed on the minimum wage, which was negotiated monthly between the authorities and the trade unions. Following lengthy negotiations, a new agreement among all social partners was signed in April 1994 which entails a decline in real wages for one year. The agreement was enshrined in law in order to ensure implementation.

Fiscal policy has been prudent. Public expenditures grew strongly in 1993, mostly to accommodate the high costs of enterprise and bank rehabilitation and to cover the costs of rising unemployment benefits and improved social services. The rise in revenues in 1993 was less than expected because of the output losses and the shift from a pay-roll tax to a personal income tax, which has increased the scope for tax evasion. Nonetheless, the budget showed a small surplus. During the first half of 1994 expenditures fell by 2% compared with the same period of 1993, thanks to lower capital expenditures and decreased payments for consumer subsidies. At the same time the stronger economic growth recorded in the first half of 1994 and rising real wages have resulted in a steep increase in state revenues for this period (8%). The personal income tax regime will be amended in 1994 so as to ensure a fairer distribution of the tax burden among the population. A new property tax will be introduced in 1994 and a value-added tax in 1995.

Since independence the parliament has adopted legislation which has liberalized prices, deregulated the banking sector and liberalized foreign exchange operations. Government price controls are still applied on a few basic foodstuffs and public services, as well as on electricity and petrol; their prices are increased periodically. Budget subsidies are provided for a limited number of foodstuffs and public services, amounting to about 2% of total budget expenditure.

Slovenia introduced its own currency, the tollar, in October 1991. Currently the central bank targets a specific rate for the tollar against the DM and intervenes in the market to maintain this rate. Full convertibility for current account transactions was achieved in early 1992. Some exchange controls remain on capital account transactions.

Since mid-1993 the authorities have given priority to the financial restructuring of state-owned industry. Enterprise losses and insolvencies increased dramatically during the first nine months of 1991, as a result both of market reforms and of external shocks, such as the collapse of the ex-Yugoslav market. In response the authorities pre-empted bankruptcy by declaring a moratorium on bankruptcy proceedings in September 1991. Since then the position of many enterprises has deteriorated further, and they have accumulated huge bad debts to the domestic banking system. Because the government feared that a lifting of the moratorium would trigger a chain of bankruptcies, it launched a restructuring project for the most distressed companies. A Development Fund was set up which provides emergency stabilization funding to enterprises that are salvageable or initiates winding-up procedures for those that have no realistic prospects of survival. The main problem faced by the Fund is the limited financial resources available for its operations.

A primary objective of the government has been to encourage private sector development through legal reforms and the introduction of a regulatory framework. The most important pieces of reform legislation, enacted in 1993, include the Competition Law, the Company Law, the Law on Auditing and the Law on Security Markets. A new bankruptcy law came into force in March 1994. Accounting standards have also been introduced.

Progress towards privatization has been rather slow. Laws on the restitution of previously nationalized and confiscated property have been enacted. In the housing sector well over a third of the socially owned apartments had been sold to private owners by early 1993. In agriculture a law on farm cooperatives was enacted in early 1992, providing for the denationalization of farmland and forests. However, its implementation has been delayed by disputes over the restitution of land to former owners and to the church.

Following nearly two years of debate in Parliament, the Law on Ownership Transformation of Enterprises was passed in November 1992. A total of 2,200 socially owned enterprises are due to be converted into share-holding companies by end-1995. The law provides for a combination of free distribution to citizens and employees with commercial privatization of enterprises. All citizens of Slovenia were given free non-transferable certificates (equivalent to 40% of the total social capital of all the enterprises), which they can use to buy shares in companies or in investment trusts. The authorities can sell either a whole enterprise or a controlling interest.

Foreign direct investment in Slovenia is currently characterized by a large number of projects of low individual value, concentrated mostly in the service sector and aimed at marketing foreign goods and services; few investments are aimed at the creation of new productive facilities. The only investment restrictions apply to foreign ownership of land. Foreign direct investment flows amounted to $ 112m in 1993, almost exactly the same level as in the previous year. The government has presented a new law on foreign investment to Parliament.

Principal economic policy measures — July 1994

Community (EUR–12)
11.7. EcoFin Council adopts its recommendation on the Broad Economic Policy Guidelines of the Member States and of the Community.

Belgium (B)
13.7. The central bank reduces its official rates, cutting its central rate and the rate on advances within the ceiling by 0.05 percentage point to 4.90% and 6.40% respectively.
22.7. The central bank reduces its official rates, cutting its central rate and the rate on advances within the ceiling by 0.05 percentage point to 4.85% and 6.35% respectively.
24.7. The government adopts the draft budget for 1995, which envisages revenue of BFR 1424.8 billion (up 2.7%) and expenditure of BFR 1695.9 billion (up 1.2%), giving a budget deficit of BFR 271.1 billion, i.e. 4.3% of GDP. The Finance Council estimated that BFR 70 billion needed to be saved at Federal level. In order to achieve this, the government has increased the budgeted proceeds from asset sales in 1995 from BFR 10 billion to BFR 13.5 billion, reduced primary Federal expenditure to the maximum extent possible (BFR 20 billion) and pruned BFR 3.7 billion off the social security budget. In the light of a 14% increase in the first six months of the year, it has also revised upward to 10.4% the growth of tax revenue for 1994. In 1995 tax revenue is projected to rise by 6%. Primary expenditure such as interest charges should stabilize or even diminish in real terms. Lastly, on the social security front, savings of BFR 3.7 billion have been necessary so that the INAMI spending allocation of BFR 402.8 billion is not overshot. The purpose of these measures is to exercise tighter control over health expenditure.

Denmark (DK)
7.7. The Danish central bank reduces its 14–day repurchase rate on government paper by 0.10%, to 5.50%.

Germany (D)
None.

Greece (GR)
5.7. The Bank of Greece decides to pay 9% interest on half the commercial banks' reserve requirements, which previously had earned no interest at all. This is a retrospective measure covering the period 1 January to 30 June 1994.
11.7. The Bank of Greece abolishes the commercial banks' overdraft daily penalty rate of 0.1%.
15.7. The government raises the 12–month Treasury bill rate by 175 basis points, to 20.25%.

Spain (E)
15–22.7. The Spanish government approves the revision of the Spanish convergence programme (1994–97). Economic targets for 1994 are unchanged. GDP is projected to grow by 2.8% in 1995 and by 3.9% in 1996–97. The general government deficit is budgeted to fa ll from 6.7% of GDP in 1994 to 5.9% in 1995, 4.4% in 1996 and 3% in the following year.

France (F)
30.6. The upper limit permitted on CO DEVI (subsidized saving accounts) is raised from FF 20 000 to FF 30 000.
30.6. The Banque de France cuts its intervention rate from 5.2% to 5.1%.
1.7. Exemptions from death duties and ownership transfer duties on residential construction are extended to the end of 1994.
1.7. Minimum wage (SMIC) up by 2.1%, to FF 6 006.64 from 1 July.
4.7. An amount of FF 15 billion will be allocated to CEPME (Crédit d'Equipement aux Petites et Moyennes Entreprises) in the period 1994–97 to finance SME investment at a low interest rate.
28.7. The Banque de France cuts its intervention rate from 5.1% to 5%.

Ireland (IRL)
None.

Italy (I)
21.7. The government approves the medium–term financial and economic plan (Documento di Programmazione Economica e Finanziaria – DPEF) for the years 1995–97. This document sets the general public finance objectives for the next three years, although it doe s not include the specific measures by which they are to be achieved. The objectives set by the DPEF and the framework for government action can be summarized as follows:
– a small adjustment is planned for the present year. An amnesty on construction abuses, subject to the payment of a fee, and cuts in social security expenditure, still to be specified, should reduce the deficit from 9.7% to 9.4% of GDP;
– an adjustment equivalent to 2.6% of GDP is aimed for in 1995 to cut the deficit from an estimated 10.7% to 8.1%. This should be achieved thanks to extra revenue of LIT 18 trillion and expenditure cuts of LIT 27 trillion . The exra revenue should come mainly from an administrative reform to deal with cases of tax evasion which are coming to light and to settle past disputes between taxpayers and the tax authorities. The Minister for Finance expects these reforms to yield some LIT 11 trillion next year. The expenditure cuts of LIT 27 trillion should come mainly from a reform of the national health service and the social security system;
– further fiscal packages of the order of 1.8% of GDP are planned for 1996 and 1997.

Luxembourg (L)
None.

Netherlands (NL)
14.7. The Nederlandsche Bank decides to reduce its rate on special advances by 0.10 percentage point to 4.80% with effect from 15 July 1994.

Portugal (P)
27.7. The Bank of Portugal reduces its money market intervention rate by 0.5 point. It also reduces the nine-day bond rate from 11% to 10.5% and the rate for advances on securities from 13.5% to 13% for a 24-hour allocation of ESC 100 billion.

United Kingdom (UK)
None.

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