

Executive summary

Chapter 1: Human dimensions of transition

As the transition in central and eastern Europe and the Baltic states (CEE) and the Commonwealth of Independent States (CIS) enters its second decade, the region as a whole is set to achieve its second consecutive year of growth. Two years ago, when the crisis in Russia held the region in its grip, the current pace of recovery would have seemed an optimistic prediction. However, the sharp rise in world oil prices, the gains in competitiveness from currency depreciations and the smooth presidential transition in Russia helped to defy the pessimistic predictions for Russia and other CIS countries. At the same time, the acceleration of EU growth has helped to spur exports and investment in central eastern Europe and the Baltic states (CEB), while prospects for south-eastern Europe (SEE) have brightened with the new reform-oriented Croatian government and the heavy electoral defeat of the ruling coalition in the Federal Republic of Yugoslavia.

Despite these favourable developments, the transition has imposed very severe human costs on many people, and improving their living conditions will be of vital importance if progress in reform is to be sustained in the coming years. This *Transition Report* focuses on the processes of adjustment in the labour markets of transition economies. In particular, it investigates how individuals and enterprises are responding to the pervasive economic changes brought about by transition as well as by the rapid pace of innovation and technological change in the advanced market economies. The Report shows the resourcefulness of individuals in a difficult environment and how they have responded to the decline in formal state employment through self-enterprise and multiple job holdings. However, the focus on the active responses of individuals should not distract attention from the challenge of building viable systems of social support for those who have suffered social and economic upheaval. Chapter 1 argues that social security reforms to provide basic and targeted support to the poor are not only

a moral but also an economic imperative for a successful transition.

Part I: Transition and economic performance

Chapter 2: Progress in transition and institutional performance

The past year has seen the greatest progress in reform since 1997, as measured by the EBRD's transition indicators. Progress has been achieved across most countries and dimensions of reform, as several countries at the early stages of transition have taken significant strides towards a market economy, particularly in the areas of privatisation and liberalisation. The 1998 crisis in Russia that led a number of CIS countries to backtrack in reform has also been largely overcome, with the lifting of most temporary trade and exchange restrictions imposed in response to the crisis. However, even where sustained liberalisation and comprehensive privatisation have been achieved, countries continue to face considerable challenges in developing the institutions that are necessary to support their nascent market economies. The countries of CEB have slowly but steadily strengthened the performance of their market-supporting institutions, but the countries of SEE and the CIS continue to lag well behind in terms of institutional performance.

These recent developments largely conform with patterns in transition that have become well-established over the past decade. These patterns include the introduction of liberalisation and privatisation ahead of the development of market-supporting institutions and the significant influence of economic, social and political conditions at the start of transition on future progress in reform. The countries in central Europe clearly benefited from relatively favourable initial conditions, although the initial advantages of these countries are gradually fading. Moreover, where there has been sustained liberalisation and comprehensive privatisation, openness to international trade and investment, and the establishment of democratic political

systems that function freely and fairly, the foundations appear to have been laid for strengthening steadily the performance of market-supporting institutions. At the same time, it is important to recognise that such evolutionary progress is not automatic. There are many pitfalls that can trap the reform process. For example, a formal framework for democracy and civil liberties does not necessarily prevent powerful private interests from exercising undue influence over the state and from "capturing" it for their own benefit. A key challenge in transition is to ensure that newly established economic and political freedoms underpin robust economic and political competition.

Chapter 3: Macroeconomic performance and prospects

The recovery following the 1998 Russian crisis is now in full swing and average growth for the region as a whole is estimated to be in the 4-5 per cent range in 2000. The current growth is broadly based across the region, with average growth in the CIS at 5.2 per cent surpassing levels in CEE at 4.2 per cent for the second year running. Moreover, forecasts for 2001 point to a continuation of this trend. The region has clearly benefited from an unexpectedly favourable international environment with the acceleration of growth in the EU and – for Russia and the energy-rich countries of the CIS – the increase in world oil prices. However, domestic policy adjustments to the impact of the Russian crisis have also helped to sustain growth in much of CEE and to spur a quick recovery in the CIS.

Significant risks to macroeconomic stability remain, however. Given the importance of a strong external environment to the recovery, deterioration in the international economy would increase pressure on the region. Regarding domestic policies, the advanced countries of CEE will need to pay particular attention to tight fiscal management in order to sustain macroeconomic balance. Pressure on fiscal policy is likely to result from accession-related public investment requirements, while the need to

maintain external competitiveness calls for continued budgetary caution. The principal risks to macroeconomic performance in the CIS continue to be the high dependence on commodity exports and rising debt service payments following sharp real currency depreciation. Improvements in revenue collection and tax administration are also a priority, as are structural reforms aimed at removing obstacles to new private businesses and restructuring large industrial enterprises. The chapter argues that the present external environment and the temporary cushion provided by the large currency depreciation have created a window of opportunity to address these critical domestic reform issues.

Chapter 4: Cross-border capital flows

Capital flows to the region have become more clearly differentiated since the Russian crisis, both in terms of recipient countries and in types of flows. Net private flows into the whole region contracted by 65 per cent between 1997 and 1999, although they are recovering slightly in 2000. Most of the decline in net private capital is accounted for by flows to the CIS and SEE. The capital flow to the relatively advanced transition countries in CEE has showed considerable resilience and continued to rise in recent years. In terms of types of flows, FDI has been the most robust, increasing by 20 per cent in the whole region in 1999. However, while direct investments in CEE doubled between 1996 and 1999, FDI declined by about 25 per cent in the CIS. Net official flows to the region fell sharply to less than US\$ 0.5 billion in 1999 from almost US\$ 9 billion in 1998, reflecting net repayments of Kazakhstan, Romania, Russia and Ukraine.

International capital flows into the transition economies can make a significant contribution to realising the region's growth potential. However, weighing against these benefits are the risks of exposure to a volatile international environment. As shown by the market turbulence in 1998, these risks are highest in countries that have integrated themselves into the international capital markets without first establishing the structural and institutional foundations for macroeconomic and financial stability. While emphasising the importance of appropriate macroeconomic policies, the chapter underlines that limiting the ability to access a wide range of

international financing instruments can restrict the impact of volatile capital flows. In countries such as Romania, Russia and Ukraine it has been the reliance on just one or two types of capital flows, and the absence of significant FDI, that has contributed to significant swings in net capital flows and to economic volatility. Moreover, the chapter shows that progress in structural reforms in banking, corporate governance and the regulation of securities markets has had a positive impact on attracting a range of capital flows to the transition economies.

Part II: Employment, skills and transition

Chapter 5: Labour markets, unemployment and poverty during the transition

Labour market developments during the transition have varied widely across countries. In CEE countries, where progress in market-oriented reforms has been more rapid, a recovery in employment levels is now firmly entrenched after the sharp decline in the early years. In contrast, the slower pace of enterprise restructuring in the CIS initially led to a less dramatic decline in employment, but workers have typically faced large real wage reductions and, in many cases, substantial wage arrears and involuntary leave. This approach to transition has resulted in particularly severe rises in poverty for large sections of the population.

A detailed analysis of individual and household surveys for selected countries shows that individuals have responded in widely divergent ways to the changing labour market environment. Where the investment climate has been favourable, some individuals have adjusted through active strategies, such as moving to new jobs or regions and engaging in entrepreneurial activities. Self-employment in particular has been a very successful high earnings strategy, although the relatively low numbers of self-employed, even in advanced transition countries, imply that obstacles to business start-ups remain significant. Adjustments by many individuals in countries at less advanced stages of reform have involved multiple job holdings and subsistence informal activities. Labour market performance could be enhanced substantially through institutional reforms, in particular by limiting the duration of unemployment benefit

and combining social support programmes with active programmes that enable the unemployed and under-employed to move into more productive jobs.

Chapter 6: Human capital, technology and skills

The dramatic structural changes in transition economies, together with the rapid and widespread technological changes in advanced market economies, have created strong pressures for enterprises to adapt the composition of their workforces. Where firms in the transition economies have begun to upgrade their production processes, including the introduction of information technology, their demand for skilled workers has increased. However, in many countries an unfavourable investment climate has limited the extent of structural change, with implications for the demand for skills. To assess the extent of changes in production technologies and to investigate the types of jobs that are being created in the transition economies and the availability of skills, the chapter draws on new surveys of foreign investors and domestic enterprises.

The surveys show that there is considerable variation in the extent to which firms have upgraded their technologies. In general, it appears that there is a strong positive relation between the overall extent of reform in a country and the extent of upgrading. Moreover, firms in transition economies lag behind advanced industrialised countries in terms of the quality of their workforce. Such quality gaps are larger in the CIS than in CEE. This finding qualifies the view that the region has abundant human capital resources, despite considerable achievements in formal education. Moreover, the lack of restructuring in the less reformed economies of the region means that many skilled workers are performing jobs that do not reflect their levels of education. Over time, there will be a continuing loss of skills, leading to an even greater gap in quality.

Therefore, governments and firms need to pay increased attention to training, including improved systems of vocational training. Governments must also improve the conditions for investment and technological upgrading in order to capitalise more on the relative abundance of well-educated workers.