

Executive summary

Chapter 1: Globalisation and regional integration

Globalisation and regional integration have transformed the world economy in the past half-century. Nowhere have these two processes been more dramatic than in the 27 countries of central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) in which the EBRD operates.

These countries have emerged from long periods of communism and economic self-sufficiency within the Council for Mutual Economic Assistance (CMEA), the Soviet-era trade bloc. Their transition towards a market economy has involved in most – but not all countries – a clear outward focus through trade liberalisation and openness to foreign investment. The resulting changes in the structure and direction of trade and the inflow of capital have been substantial. The change in the structure of production has also been dramatic. While initial disruptions to production were severe, and in some countries prolonged, the region has in recent years seen a strong and increasingly broad recovery.

The impact of globalisation, however, is not confined simply to changes in output. Globalisation dramatically increases the freedom of choice of consumers and producers and of savers and employees, which is important in its own right. Globalisation has had a significant influence on the role of government in industrialised market economies and it is a key factor in driving reform of the state in transition economies, too. Indeed, to benefit from globalisation, governments not only need to tear down barriers to trade and investment but also to build strong institutions that support markets and provide social assistance to those losing out.

The process of globalisation also reveals the need for effective governance at the regional and global levels. For example, the need for global environmental protec-

tion requires a global response. Similarly, the expansion of trade from the transition economies to global markets requires the regional integration of transport infrastructure, for which regional government cooperation is crucial.

On balance, the processes of globalisation and regional integration have been and will continue to be beneficial to those affected by them. Where there have been losers – and where there may be more in the future – the response should be not to raise the drawbridge but to create mechanisms to safeguard the losers against deprivation and hardship. Where there are increased interdependencies among countries, the response should be to develop mechanisms and institutions that support the effective management of these ties.

Part 1: Transition and economic performance

Chapter 2: Progress in transition

The past year has seen sustained progress in reform across most dimensions of transition. A number of countries that have been lagging behind in reform have taken significant strides over the past year, including Bosnia and Herzegovina, the Federal Republic of Yugoslavia and Romania on the basis of favourable political and economic developments in SEE. Supported by a strong recovery, a number of CIS countries also achieved significant reform gains, in particular Russia but also Azerbaijan, and, from low levels, Belarus and Uzbekistan. At the same time, many countries at more advanced stages of transition that are candidates for accession to the European Union continued to make steady progress in strengthening the performance of their market-supporting institutions. Only in Turkmenistan, where the political commitment to reform has been weak, was there backtracking in reform.

These recent reform developments largely conform with well-established patterns of transition. In most countries of the region, this includes liberalisation and small-scale privatisation ahead of large-scale

privatisation and the development of market-supporting institutions. Moreover, the foundations for sustained progress in market-oriented reform appear to have been laid in countries where liberalisation has taken root and where a private sector has begun to develop through small-scale privatisation and the elimination of market entry barriers. Well-functioning democratic political systems also point towards sustained progress. This process is not guaranteed, however. It is also important to recognise that the process of international integration can complement domestic factors and help to sustain reform progress. The prospect of EU accession has had a significant influence on the extent of reforms in many CEB and SEE countries. For the CIS this highlights the need to promote greater international trade and investment through accession to the World Trade Organization (WTO).

Chapter 3: Macroeconomic performance and prospects

Following record growth in 2000, weakening world economic performance has begun to have an impact on the transition economies. Moreover, the events of 11 September have heightened the uncertainty surrounding the outlook for the region. Nonetheless, the region as a whole is still expected to record its third successive year of positive growth in 2001 at 4.4 per cent. Unfolding world events are, however, expected to affect the various parts of the region in different ways.

Having redirected their activity towards Western markets and investors, CEB is most exposed to a slowdown in western Europe, with growth in 2001 likely to slow down to 2.9 per cent and to 2.7 per cent in 2002. While this year will be the first in which SEE and CIS growth is expected to exceed that of CEB, at 4.0 per cent and 5.8 per cent respectively, the outlook for 2002 in both regions is more uncertain. In SEE, growth in 2002 is still expected to remain robust at 3.8 per cent but could suffer as exports decline and foreign

financing becomes less available. In the CIS the outlook depends on developments in the price of oil. The EBRD's forecast of 4 per cent growth for 2002 is based on the assumption that prices will decline only moderately from present levels.

While the emerging macroeconomic challenges will vary by sub-region, so too will the ability of policy to respond to those challenges. In CEB the main policy challenge will be to support growth against a backdrop of falling net exports without exacerbating already high fiscal and external deficits. A combination of fiscal tightening and flexible monetary policy will be necessary to support balanced growth. Fiscal policy is even more constrained in SEE while monetary policy is also less flexible due to high inflation rates or exchange rate arrangements. Consequently SEE should focus on encouraging FDI flows through improvements in the investment climate, continued privatisation and effectively targeted investment incentives.

As the outlook for oil prices remains uncertain, Russia and the resource-rich CIS countries must adapt and strengthen financial policies to reduce the impact of commodity price volatility on domestic stability. Finally growing intra-CIS trade has underpinned the recent recovery in the sub-region, highlighting the potential benefits of reducing intra-CIS trade barriers in conjunction with measures aimed at international integration.

Part II: Energy in transition

Chapter 4: Managing energy resource wealth

Transition countries are rich in both traditional and renewable energy resources. Russia and the Caspian countries in particular are increasingly dependent on their energy wealth and have the potential to become important international suppliers of energy, particularly of natural gas. However, so far these countries have not taken full advantage of their resource wealth. A large fraction of the generated income has been dissipated unproductively, often in the form of energy subsidies. Energy-rich countries have, on average, also made less progress on market liberalisation and reform.

Huge investments are required if the region is to realise its energy potential. Much of this capital will have to come from external sources. To attract foreign funds, energy-rich countries will have to provide a stable investment climate and competitive tax arrangements. Equally, the incumbent domestic producers need to improve their corporate governance and financial transparency to become attractive to outside investors. Another crucial reform step, therefore, is to change the role of the state in the energy sector.

Governments need to divest from productive assets and focus on regulatory supervision of the sector, on reducing widespread corporate governance violations, and on ensuring compliance with environmental best practice. A particularly important role for government is to foster competitive market access by regulating existing transport monopolies and by creating the conditions – including through intergovernmental cooperation – for alternative pipelines to be built. Finally, as energy revenues are beginning to flow, better resource management is increasingly needed to avoid macroeconomic instability and to ensure long-term sustainable development.

Chapter 5: Improving efficiency in energy conservation and use

The centrally planned economies were highly inefficient in the use of energy. Since the start of transition, energy consumption and associated emissions of pollutants have fallen significantly. However, this is largely due to the fall in output by heavy energy users, particularly in the CIS. While energy efficiency, measured as the ratio of energy consumption per unit of output, has improved in CEB and SEE, all transition countries still lag significantly behind the OECD in this respect.

Slow progress in energy sector reform and flawed tariff policies have been the main factors delaying improvements in energy efficiency. As a result, pollution levels remain high while more efficient and environmentally sustainable technologies have not been widely introduced. In addition, old-style energy "guzzlers" have been allowed to survive on low energy prices and weak cash collection, at significant costs to society.

Price reform is the key to improved energy efficiency. However, if they are to be politically and socially acceptable, price increases need to be accompanied by explicit support for poor households. The current policy of across-the-board subsidisation should be replaced with targeted support, which costs less and enhances incentives to reduce waste. Price reforms also need to be complemented by institutional changes. This should involve the progressive introduction of the private sector alongside steps to improve the regulatory and competitive environment. The order in which these reforms are introduced is critical.

Experience shows that a sound regulatory framework must be established prior to privatisation. Privatisation should, where possible, involve strategic investors and, given the widespread absence of payments discipline, should generally focus first on distribution, with privatisation of generation coming later. The experience of countries most advanced in energy sector reforms reveals that comprehensive steps undertaken in the correct order can help to save energy, reduce pollution and increase the reliability of power and heat supplies while constraining social hardship and limiting the fiscal costs of energy subsidies.