

Executive summary

- Progress in reform during 2003-04 was most pronounced in south-eastern Europe. Elsewhere the pace of transition was uneven. Sustained structural reforms will stimulate growth in the longer term.
- The transition countries are expected to grow by 6.1 per cent in 2004, helped by a positive international trade environment. Rapid credit growth is boosting domestic consumption and investment.
- In the infrastructure sector, many countries have found it difficult to establish independent, accountable and credible regulatory agencies.
- Private sector participation is increasingly taking the form of concessions and management contracts rather than asset sales. Local investors are becoming more important.

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Chapter 1: Progress in transition and the link to growth

Although 2003-04 was a positive year for market reform in the transition countries, progress across the region was uneven. Reform accelerated in south-eastern Europe (SEE), especially in the EU candidate countries – Bulgaria, Croatia and Romania. Following EU accession, reform in central eastern Europe and the Baltic states (CEB) has slowed although countries continue to improve the business environment. In the Commonwealth of Independent States (CIS) 2003-04 was another year of only modest progress in transition. Reform may have been hindered by government caution during a year of elections in many countries.

Most progress was made in the difficult task of building market-supporting institutions. Financial services continued to develop and bank lending to the private sector accelerated. This was complemented by improvements in regulation and further banking consolidation. Progress in infrastructure and large-scale privatisation was also significant.

A sustained commitment to reform and sound fiscal policies has been associated with substantial benefits in macro-economic performance over the longer term. Higher growth can in turn spur further reform efforts, potentially leading to a “virtuous circle” of reform. However, the link between reform and growth is complex, and other factors need to be taken into account. They include an allowance for the catch-up and recovery process, external demand and terms of trade (especially in relation to oil prices).

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Chapter 2: The macroeconomic environment for transition

Most transition countries enjoyed strong economic growth in 2003-04. Growth in CEB is expected to increase to 4.9 per cent in 2004, driven primarily by domestic demand but also increasingly by an expansion of exports.

In SEE continued political stability, although still fragile in some places, and the prospect of EU membership for Bulgaria, Croatia and Romania have underpinned economic progress. Growth is expected to rise to 5 per cent in 2004, stimulated in part by a credit-driven boom in demand. This expansion in domestic credit has helped to deepen financial systems but has also raised concerns about the quality of rapidly expanding loan portfolios.

In the CIS high commodity prices have continued to underpin economic growth, which is forecast at 7.4 per cent for 2004. Although inflationary pressures are currently subdued, the rapid growth in base money associated with strong export growth and the expansion of bank credit bring the risk of higher inflation in the future.

Several transition countries have capitalised on the period of strong growth and consolidated their public finances. For others, particularly in CEB, consolidation remains elusive. Reform of the rules and institutions that govern fiscal policy needs to complement macroeconomic stabilisation.

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Chapter 3: Regulation of infrastructure services

This chapter presents evidence from a survey of regulators in the telecommunications, electricity and railways sectors on regulatory effectiveness. The results show that experience in establishing modern regulatory regimes for network utilities has been mixed. Many of the advanced countries in the region have succeeded in establishing independent and accountable authorities. Other countries have struggled to put credible arrangements in place. This is due in part to the weak institutional environment in which regulatory reform is taking place in many transition countries and to the ability of vested interests to seize control of or hinder the reform agenda.

Despite limited data, results from extensive surveys of industrial consumers of infrastructure services suggest that effective regulation helps to improve service delivery. Specifically, where regulators have taken steps to encourage more commercial discipline in infrastructure services (through tariff reform, improved collection rates and private sector investment) there has been less interruption in services.

Better regulation promotes private investment, and private operators have stronger incentives to raise collection rates, prevent arrears and ensure adequate revenue flows. However, the impact of private ownership on performance depends on the extent of competition.

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Chapter 4: Private sector participation in infrastructure

This chapter looks at the development and extent of private sector participation (PSP) in telecommunications, energy, water and transport services across the transition countries. The telecommunications sector has attracted most private sector interest, followed by urban transport and, to a lesser extent, the power sector. PSP has been most evident in CEB and the EU candidate countries of SEE.

The bulk of investment has come from Western – mostly European – utilities. However, utilities from within the transition region and small local investors are becoming increasingly important.

Governments have promoted PSP for a number of reasons – to raise fiscal resources, to improve the operating performance of utilities and to ensure adequate funds to meet future investment needs. Conclusive analysis of the consequences of PSP is still limited by the lack of data. Nevertheless, it is clear that PSP has helped to commercialise services, increase productivity and, in some cases, improve access to finance. At the same time, investors' expectations have not always been met. Returns in many privatised businesses appear modest relative to the cost of capital.

In the future, local investors are likely to play an increasing role in PSP. There is also likely to be a move away from outright asset sales to concessions and management contracts, which harness the expertise of the private sector but limit its financial exposure.