

# ICPS newsletter

## Transition gains speed

**As the transition in Central and Eastern European countries and Baltic states (CEE) and the former Soviet Union (FSU) enters its second decade, the region as a whole is set to achieve its second consecutive year of growth. However, institutional change is inherently slow, and an imbalance has inevitably arisen between the creation of markets and the establishment of appropriate supporting institutions. This has resulted in the poor effectiveness of the labour market in many transition economies. These conclusions are presented in the Transition Report 2000 on transition progress in CEE and FSU countries, published by the European Bank for Reconstruction and Development. A presentation given at ICPS by Mr. Julian Exeter, senior economist at EBRD, covered cross-country comparisons of progress on transition, an analysis of the institutional aspects of development, and employment issues**

### Further reform progress depends on institutional development

The past year has seen the greatest progress in socioeconomic reforms since 1997, as measured by the EBRD's transition indicators. Progress has been achieved across most countries and dimensions of reform. Countries that have achieved the greatest progress in reform over the past year include Bulgaria, the Former Yugoslavia Republic of Macedonia, Georgia, and Tajikistan, as they continue to make progress on long-delayed reforms, particularly in the areas of price and trade liberalisation, small-scale privatisation, and competition policy.

Noticeable progress was achieved in some of the countries recently invited to begin negotiations on EU accession—particularly Lithuania but also Latvia, Romania, and the Slovak Republic. These countries made progress in the areas of privatisation and the financial sector. Three FSU countries (Belarus, Kazakhstan, and Russia) returned to earlier levels of liberalisation by revising some of the administrative controls on prices and trade that were imposed in the wake of the Russian crisis in 1998.

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. Over the past decade, the

following patterns in transition became well-established:

- Since the start of transition, the development of institutions that support markets has lagged behind progress in liberalisation and privatisation.
- Economic, social, and political conditions at the start of transition had a significant influence on future progress in reform in their respective countries.

Countries in Central Europe clearly benefitted 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 which function freely and fairly, the foundations appear to have been laid for steadily strengthening the performance of market-supporting institutions.

Thus, now a key challenge in transition is to ensure that newly

established values of democracy and market freedom underpin robust economic and political competition.

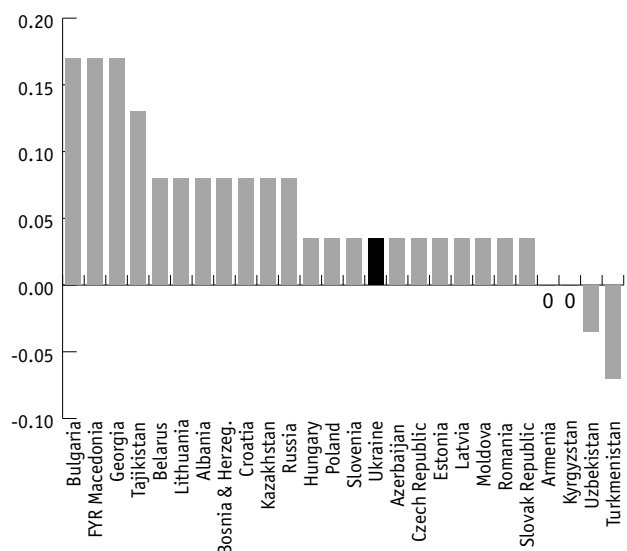
### Macroeconomic performance and prospects

The recovery following the 1998 Russian crisis is now in full swing, and the average growth for the region as a whole is estimated to be in the 4–5 percent range for 2000, which is a significant acceleration from the 2.5 percent recorded in 1999. The current growth is broadly based across the region, with average growth in FSU countries at 5.2 percent surpassing the levels in CEE countries, at 4.2 percent, for the second year running. Moreover, forecasts for 2001 point to a continuation of this trend.

Over recent years, strong growth in the EU accession countries has accelerated, thanks to commodity and service exports to Western Europe. However, membership candidates are held as hostages of the weakness in the euro and a growth slowdown in EU countries.

Accession to the EU will require additional expenditures on compliance with

*Change in average transition indicator scores 1999–2000*



environmental standards, transport infrastructure, and legal reforms and institution building, among other things. Against the background of already large public sectors and high statutory tax rates, the governments of accession countries will find it difficult to increase revenues in order to accommodate higher expenditures. This is particularly true in countries where privatisation-related financing is likely to decline soon. It is unlikely that CEE countries will be able to finance this gap entirely from abroad. To avoid having to raise already high taxes even further, CEE countries need to rationalise their public sectors.

Contrary to widespread belief, the recovery in FSU countries is driven not only by high oil prices but also (and to a much greater degree) by a recovery of industrial production on the back of sharp real enhanced rate depreciations, which has

### Key reform challenges in Ukraine

- After accession to the WTO, Ukraine will have the opportunity to eliminate the high tariff and non-tariff barriers that still remain a significant obstacle to trade.
- While a renewed large-scale privatisation programme can create investment opportunities, attracting more FDI also depends on improvement in the business environment, including comprehensive tax reform.
- Sustaining the recent improvement in cash collecting rates is the main challenge in the energy/power sector, which would encourage renewed investment and effective organisational reforms in the sector.

given domestic producers large cost advantages over imports. This view is supported by the fact that it is not only the resource-based economies such as Russia and Kazakhstan that are growing strongly, but also other countries in the region.

The principal risks to macroeconomic performance in the FSU countries continue to be the high dependence on commodity exports and rising debt service payments.

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 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. ■

### Labour market during the transition: Issues, progress, and prospects

The transition process has profoundly affected the lives of almost everyone in Central and Eastern Europe, including the former republics of the Soviet Union. For some people, it has given them the opportunity to acquire new skills and training, to live and work in other regions and countries, and to engage in entrepreneurial activity. For others, the transition has caused considerable hardship, with widespread layoffs in state-owned enterprises, rising unemployment and poverty, and a shrinking social safety net.

Labour market developments during the transition have varied widely across countries in the region. In the early years of transition, CEE countries experienced a sharp decline in employment. However, rapid progress in market-oriented reforms (liberalisation, privatisation, and, crucially, providing a favourable climate for entrepreneurial activity) has improved the situation.

In contrast, the slower pace of enterprise restructuring and other reforms in the FSU initially led to a less dramatic decline in employment, but workers have typically faced enormous real wage reductions and, in many cases, substantial wage arrears and involuntary leave. This attempt to preserve employment levels 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. When government policy creates a favourable investment climate, the mobility of the labour force is higher and entrepreneurship develops faster. The high level of mobility is extremely important for labour force reallocation from less to more productive economic sectors.

Interestingly, while overall turnover is higher for Russia (17 percent of Russians change their jobs over a one-year period) than for Poland or Hungary (13–14 percent), the ratio of switches to private sector jobs is highest for Poland (78 percent of moves in 1998) followed by Hungary (62 percent), and it is lowest for Russia (only 40 percent).

One of the most important reasons why self-employment and entrepreneurship are so critical for the rest of the economy is the link to job creation. In most countries, the self-employed tend to be better trained and more experienced than other workers. Self-employment is playing a far more important role in the advanced CEE countries than in the FSU. In terms of direct employment, the share of self-employment in total employment ranges from over 10 percent in Poland and Hungary down to less than 1.5 percent in Ukraine.

In most FSU countries, people don't have much opportunity to find a good job, hence they become involved in either multiple jobs or informal subsistence activities. Ukraine has experienced the highest level of multiple-job holding, with one quarter (25 percent) of the employed having more than one job, compared with around 10 percent in Poland.

Labour market performance could be enhanced substantially through institutional reforms, in particular by limiting the duration of unemployment benefits and combining social support programmes with active initiatives which enable the unemployed and under-employed to move into more productive jobs.

Foreign investors point out that transition economies lag behind advanced industrialised countries in terms of the quality of their workforce. Such quality gaps are even larger in the FSU than in the CEE, where a favourable investment climate has been created. These transition economies have the opportunity to upgrade their production processes, including the introduction of information technologies, thus their demand for skilled workers has increased.

The lack of restructuring in the economies of FSU countries means that many skilled workers are performing jobs that do not reflect their level of education. Over time, the continuing loss of skills will lead to an even greater gap in quality. Therefore, the governments of these countries need to pay increased attention to improving the conditions for investment and technological upgrading, and creating special training programmes to capitalise more on the relative abundance of well-educated workers.

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