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Globalization and interdependence: integration of the economies in transition into the world economy

Integration of the economies in transition into the world economy

Report of the Secretary-General**

Summary

The present report is an overview of the progress made in the integration of the economies in transition into the world economy. It examines the challenges that they face and the progress that they have achieved in the past two years. The report analyses macroeconomic developments and policies, the role of the European Union (EU) and efforts in continuing economic restructuring, so as to enhance the ability of the economies in transition to integrate further into the world economy through trade and capital flows, including direct investments. It also examines the external debt situation of, and notes some special concerns for, the smaller countries belonging to the Commonwealth of Independent States (CIS).

Considerable progress has been made in further integration of the economies in transition into the world economy, but that progress varies over the different dimensions of transition as well as by countries. Domestic policies and commitments of international institutions have significantly contributed to fostering growth in those countries but further efforts are still needed from both sides. Broadening and deepening of integration of some countries, in particular some members of CIS, are important for sustaining growth and reducing poverty. Further assistance is needed to ensure a smooth and efficient path to transition from plan to market and to fully integrate those economies into the world economy.

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** The present document was submitted late to the conference services without explanation required under paragraph 8 of General Assembly resolution 53/208 B, by which the Assembly decided that, if a report was submitted late, the reason should be included in a footnote to the document.

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I. Introduction

1. In its resolution 57/247 of 20 December 2002, the General Assembly reaffirmed the need for the full integration of the countries with economies in transition into the world economy. While noting the progress they had made towards greater stability and growth, as well as their need to sustain such positive trends into the future, the Assembly recognized the difficulties faced by those countries in responding to the challenges of globalization and the problems they faced in ensuring favourable market access for their exports and securing the foreign direct investment (FDI) necessary for their ongoing development.

2. In the same resolution, the General Assembly requested the Secretary-General to submit to it, for consideration at its fifty-ninth session, a report on the implementation of the resolution, with a particular focus on the progress achieved in the integration of the economies in transition into the world economy. The present report has been prepared in response to that request. Also in resolution 57/247, the Assembly called upon the organizations of the United Nations system to continue to provide policy advice and technical assistance to the Governments of the countries with economies in transition in order to strengthen their social, legal and political frameworks so as to enable them to complete the necessary market-oriented reforms. Previous reports have covered the activities of the United Nations system in these fields (see A/57/288, A/55/188, A/53/336 and Add.1 and A/51/285). An updated report on these activities, based on contributions from 19 funds, agencies and organizations of the United Nations system as well as other relevant international institutions,[1] is available from the United Nations web site at http://www.un.org/esa/policy.

3. The present report analyses the current process of integration of the economies in transition into the world economy by tracing their progress through the channels of trade in goods and services, and capital and labour flows, with particular attention to the role that the enlargement of the European Union (EU) has played in some of these countries. While this report focuses on long-term issues, it also provides a brief overview of recent macroeconomic developments.

II. Macroeconomic developments in 2002-2003

4. *Overall trends*. The global recovery, which started in the second half of 2003, has helped the economies in transition to strengthen as a whole. In 2003, aggregate gross domestic product (GDP) growth of these economies accelerated to 5.7 per cent, outpacing the world economy by 3 percentage points (see table 1).[2] The resilience of these countries with respect to global sluggishness in 2002 and the beginning of 2003 was largely due to rapid growth in their domestic demand. In addition, their continuing progress in restructuring and institutional reform (see sect. VI) has raised their competitiveness and boosted consumer and business confidence.[3]

5. As the economies of Central and Eastern Europe continued to expand, the dynamism within this group shifted from Central to South-eastern Europe, largely owing to modest export performance and stagnant investment in most of Central Europe in 2002-2003. Domestic consumption, fuelled by an expansionary fiscal policy, only partially sustained growth in those countries. South-eastern Europe registered strong economic growth, reflecting the first results of the economic reforms undertaken earlier. Buoyancy in the economies of the Baltic States was the result of

several years of consistent reforms, which had entailed a restructuring of their real sectors and banks, in conjunction with prudent macroeconomic policies. Therefore, despite an uncertain recovery in Western Europe in 2003, output in the Baltic States expanded. Strong domestic demand underpinned this growth, which transferred into job creation, a unique experience among transition economies.

6. The strong recovery of the economies in the Commonwealth of Independent States (CIS) region, after a slowdown in 2002, continued in 2003. Average regional output grew by 7.6 per cent in 2003, supported by rising prices for energy and commodities, and by robust domestic demand. Although it largely reflects the strong rebound of the economy of the Russian Federation, regional output growth was further supported by the upsurge in other large economies of this subgroup, namely, Kazakhstan and Ukraine.

7. *Macroeconomic stabilization and policy*. Prudent macroeconomic policies have helped the economies in transition to function in a low-inflation environment, providing the foundation for further integration with other market economies. Although price liberalization and relative price adjustments have continued, inflation rates have dropped significantly and continue to decline in many countries. Monetary policy, in general, was relaxed in Central Europe. The aim was to promote exports by weakening the exchange rate, which had appreciated owing to large inflows of speculative capital. Macroeconomic policy in the economies of the CIS region has contributed to a significant reduction in inflation in the past few years, although it remains at a level higher than in the rest of the economies in transition. In many countries of the region, the continued weakening of the United States dollar resulted in a real effective depreciation of the currency, the Russian Federation being an exception. Exchange-rate volatility was largely stabilized in the oil-exporting countries through the stabilization funds in Azerbaijan, Kazakhstan and the Russian Federation.

8. Fiscal policies have significantly improved public finances in the region, though results vary by country. Fiscal balances in Central Europe remained mostly in deficit, in spite of the frequently declared intention of reducing them. The reason lay in the structural nature of these deficits and the use of fiscal spending to compensate for weak export performance, as well as pre-electoral spending in Central Europe in 2002. Following the EU enlargement, new EU members adopted strategies of gradual financial consolidation to prepare for the adoption of a single currency. The fiscal situation was much better in some countries of South-eastern Europe, where economic policy was coordinated with the International Monetary Fund (IMF) and determined by conditions of IMF stand-by loans. In many of the successor countries of the former Yugoslavia, a large informal sector remained a problem, affecting tax revenues in particular. There was a general tendency towards fiscal consolidation in the economies of the CIS region. Together with high GDP growth, this provided more room for manoeuvring to support economic growth in 2003. Some exceptions were due to accumulated foreign debt, as in Georgia, or by growing public spending, as in Armenia and Tajikistan.

9. Current accounts in the region remain in deficit. Heavy reliance on remittances, a slowing down of official aid to some countries in South-eastern Europe and a heavy dependence on natural resources in much of the CIS region increased the vulnerability of these economies to external shocks.

Table 1
Macroeconomic indicators for economies in transition, 2002-2004

	Growth of real GDP (annual percentage change)			*Consumer price inflation (average annual percentage change)*			*Unemployment rate (percentage)*		
	2002	*2003*[a]	*2004*[b]	*2002*	*2003*	*2004*[a]	*2002*	*2003*[a]	*2004*[b]
Economies in transition	4.0	5.7	5.8	9.3	7.3	6.9			
Central and Eastern Europe and Baltic States	2.8	3.8	4.3	4.6	3.0	4.0			
Central and Eastern Europe	2.7	3.6	4.1	4.7	3.1	4.1			
Albania	4.7	6.0	6.0	5.5	3.0	2.4	15.8	14.0	15.0
Bosnia and Herzegovina	5.5	3.2	4.0	0.9	0.2	0.5	42.7	42.0	42.0
Bulgaria	4.9	4.3	4.3	5.8	2.3	5.0	16.3	14.3	12.8
Croatia	5.2	4.3	4.0	4.7	1.5	2.5	21.3	19.5	19.0
Czech Republic	2.0	2.9	3.6	1.8	0.1	3.2	9.8	9.3	10.9
Hungary	3.5	2.9	3.2	5.3	4.7	7.0	8.0	8.4	8.2
Poland	1.4	3.7	4.6	1.9	0.8	2.0	20.0	20.0	19.6
Romania	5.0	4.9	4.8	22.5	15.0	12.0	8.4	7.2	8.0
Serbia and Montenegro	3.8	2.0	3.0	19.2	9.6	8.0	25.0	28.0	28.0
Slovakia	4.4	4.2	4.3	3.3	8.6	7.8	17.8	15.6	15.2
Slovenia	3.4	2.3	3.0	7.5	5.6	3.5	11.6	11.6	10.8
The former Yugoslav Republic of Macedonia	0.9	3.0	3.6	2.3	1.2	2.5	45.3	45.3	43.0
Baltic States	6.3	7.5	6.5	1.6	0.7	2.2			
Estonia	6.0	4.7	5.2	3.5	1.3	2.7	6.8	6.1	5.7
Latvia	6.1	7.4	6.8	1.9	2.9	2.9	8.5	8.0	7.2
Lithuania	6.8	9.0	7.0	0.3	-1.2	1.4	10.9	9.2	8.5
Commonwealth of Independent States	5.1	7.6	7.2	14.1	11.7	9.8			
Armenia	12.9	13.9	8.0	1.0	4.7	3.5	9.1	9.8	9.5
Azerbaijan	10.6	11.2	9.5	2.8	2.2	3.5	1.3	1.4	1.3
Belarus	5.0	6.8	6.5	42.8	28.5	25.0	3.0	3.1	3.5
Georgia	5.5	8.6	5.0	5.7	4.8	5.0	[c]	[c]	[c]
Kazakhstan	9.8	9.2	8.5	6.0	6.4	6.5	2.6	1.8	1.5
Kyrgyzstan	-0.5	6.7	5.0	2.1	3.1	4.0	3.1	3.0	2.8
Republic of Moldova	7.8	6.3	5.5	5.3	11.7	8.0	1.5	1.2	1.1
Russian Federation	4.7	7.3	7.0	15.1	12.0	10.0	8.8	8.1	8.0
Tajikistan	9.5	10.2	8.0	12.2	17.1	15.0	2.7	2.4	2.3
Turkmenistan	9.0	9.0	8.0	15.0	11.0	12.0	[c]	[c]	[c]
Ukraine	5.2	9.4	8.5	0.8	5.2	3.5	3.8	3.6	3.5
Uzbekistan	4.2	4.4	6.0	24.2	22.0	19.0	[c]	[c]	[c]

Source: UN/DESA, based on data of Economic Commission for Europe (ECE).

[a] Partly estimated.

[b] Forecast.

[c] Data unavailable.

10. While recent stabilization policies and their outcomes in the economies in transition have improved expectations for a lower-inflation environment, unemployment has remained a concern for many countries in the region, owing in part to growing labour productivity in the industrial sector and low mobility (see table 1). Unemployment has been largely structural in many of these countries and hence was not significantly affected by increasing output.

III. Role of the European Union in integrating economies in transition into the global economy

11. The role of EU in integrating the economies in transition into the global economy has increased continuously over the past decade owing both to the EU enlargement process, covering most of Central and Eastern Europe and the Baltic States, and to the more active involvement of EU in the region's affairs as a whole. The prospect of EU membership, leading to implementation of the EU *acquis*, has been an even more powerful stimulus for market-oriented reforms and liberalization of trade and capital flows than potential membership in other international institutions, including the World Trade Organization.

12. The most recent EU enlargement took place on 1 May 2004, when 10 new members, among them 8 transition economies (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia), joined EU. For the new members, this has meant removal of the remaining trade barriers with EU and participation in the EU Common Commercial Policy. The impact on new members of full trade liberalization with the EU-15, though beneficial in the long run, will vary in the short run, depending on individual economies and industries. Disparate results are particularly likely in the agricultural sector: while some will face difficulties owing to increased competition in their domestic markets, other will sharply increase their agricultural exports to the EU-15 owing to duty-free and quota-free trade. Meanwhile, consolidation of capital markets of the new members with those of EU is also taking place.

13. European integration is now moving towards its next phase — monetary integration — as the new EU members are expected to join the single currency area. Estonia, Lithuania and Slovenia have already joined the European Exchange Rate Mechanism, ERM II, and are aiming at adopting the euro in two years. Following the euro area enlargement and the consequent reduced exchange- and interest-rate risk, intraregional trade and investment flows are expected to strengthen further.

14. Proceeding with monetary integration, however, poses a risk for the new EU members. Despite the fact that there is a high degree of business cycle synchronization between the new entrants and the EU-15 as well as large intra-industry trade, timing of the entry into the euro zone remains crucial. In upcoming years, the new members may still need to pursue independent monetary policies. The challenge for the new EU members is to avoid stabilizing their exchange rates at a misaligned level, which would impose heavy costs on their economies. A certain degree of real convergence is needed before adoption of the single currency. The countries should meet a number of macroeconomic performance criteria for joining the single currency area. Among them are attaining low inflation and reducing the fiscal deficit to less than 3 per cent of GDP. The countries are therefore challenged to pursue policies that balance these

criteria and growth-oriented policies and reduce the negative effects on the most vulnerable groups of the population.

15. The new EU members will no longer formally be eligible to receive assistance from EU through pre-accession programmes,[4] such as the PHARE programme (originally created to assist Poland and Hungary) designed to assist applicant countries of Central and Eastern Europe in the restructuring of their economies in preparation for their joining EU,[5] the Instrument for Structural Policies for Pre-Accession (ISPA) and the Special Accession Programme for Agriculture and Rural Development (SAPARD). They will benefit instead from EU regional aid, as well as structural and cohesion funds. However, financing through these pre-accession programmes will continue up to 2006, as embedded in the EU budget. Bulgaria and Romania, which are particularly advanced in their negotiations and are expected to join EU in 2007, will continue to benefit from the PHARE, ISPA and SAPARD programmes, as well as from grants and loans from the international financial institutions co-financed by EU. EU allocated 4.5 billion euros in pre-accession aid for Bulgaria and Romania in 2004-2006.

16. EU relations with other countries in South-eastern Europe have also changed in recent years, following the adoption of the Stability Pact for South-eastern Europe and the Stabilization and Association Process for South-eastern Europe in 1999. During the European Council meeting in Thessaloniki, Greece, in June 2003, the countries of this subregion — namely, Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia and Serbia and Montenegro — were offered the prospect of eventual EU membership. In 2004 the European Commission responded favourably to Croatia's application to join EU, granting candidate country status to the latter, and negotiations are expected to start soon. A similar application from the former Yugoslav Republic of Macedonia is under consideration. This prospect is supposed to be a catalyst for political and economic reform. In addition to the political, economic and institutional criteria required to join the Union, these countries also need to satisfy criteria specific to the Stabilization and Association Process (such as cooperation with the International Tribunal for the Prosecution of Persons Responsible for Serious Violations of International Humanitarian Law Committed in the Territory of the Former Yugoslavia in 1991, respect for minority rights, the return of refugees, etc.). The European Commission proposed a number of instruments, such as European Partnerships, to be introduced into the Stabilization and Association Process. Based on the annual reports of the European Commission, these Partnerships will identify short- and medium-term goals for each country, and gradually shift their focus to implementation of the EU *acquis*. These Partnerships will also serve as a basis for allocating the assistance to these countries through the Community Assistance for Reconstruction, Development and Stability in the Balkans (CARDS) programme. EU envisages providing up to 4.5 billion euros to Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia and Serbia and Montenegro in 2000-2006 through the CARDS programme, conditional on their progress and cooperation. The assistance is focused on post-conflict reconstruction, upgrading infrastructure and energy facilities, institution-building and regional integration. In addition, EU macro-financial assistance supports exceptional balance-of-payments needs and supports structural reforms agreed upon with IMF. In assisting in the development of a business environment, EU aims to boost small and medium-sized enterprises and to strengthen these countries' financial systems. Assistance in rebuilding infrastructure and energy also aims at creating a pan-European transport

network. Although, as a result of these EU policies, the countries of South-eastern Europe are now closer to EU, no road map for accession has thus far been presented. To rebuild the region, including its energy and transport infrastructure, greater effort from EU is likely to be needed.

17. EU aims to create a strong and enlarged single market in the region, thereby gradually establishing a free-trade area with neighbouring countries. While asymmetric trade preferences were offered by EU to the countries of South-eastern Europe, the potential of such preferences is not fully utilized. The reason was in the subregion’s weak productive capacity and its limited export base, as post-conflict reconstruction is not yet completed. There are also difficulties in complying with EU standards. All countries participating in the Stabilization and Association Process were granted duty-free and quota-free access to the EU market for most of their products. About 80 per cent of the exports of Albania, Bosnia and Herzegovina, Croatia and the former Yugoslav Republic of Macedonia currently enter EU duty-free.

18. At the same time, EU has become more involved with countries in the region that are not currently contemplating EU membership, including a number of transition economies (the Russian Federation, Belarus, Ukraine, the Republic of Moldova and countries of the Caucasus), and has adopted a “new neighbourhood” strategy. The European Neighbourhood Policy proposed in 2003 was presented in a strategy paper in May 2004. Conditional on a number of political and economic factors and adopting market economy principles, EU will offer the long-term prospect of free trade, capital and labour movements, and envisages individual action plans for these countries. Currently, EU intends to provide assistance in implementing this strategy mainly through the existing programmes, and to introduce European Neighbourhood Instruments from 2007. Provided this new neighbourhood strategy is implemented, it will have a profound impact on all targeted countries. The trade agreement between EU and the Russian Federation, signed in May 2004, on the pace of tariff adjustments in the energy sector and on trade tariffs between the parties is a step towards further integration. In addition, this agreement includes EU support for the Russian Federation’s accession to the World Trade Organization.

IV. Integration through trade

19. There has been considerable progress in the integration of the economies in transition into the multilateral trading system. As reforms further change these countries’ domestic markets and their institutions improve, their trade capacities are growing and their trade diversifying, both geographically and in terms of products.[6] Trade regimes, which have been evolving over more than a decade, vary by country, but there is a general trend towards a more liberal stance and this has further fostered integration.[6]

20. There has also been progress in these countries’ integration into the multilateral trading system via World Trade Organization membership. Armenia and the former Yugoslav Republic of Macedonia became World Trade Organization members in 2003, thus increasing the total number of countries with economies in transition that are members of the World Trade Organization to 17 out of 27 (table 2). Negotiations with Bosnia and Herzegovina, Serbia and Montenegro, Kazakhstan, the Russian Federation and Ukraine are also showing progress with respect to their eventual World Trade Organization membership.

Table 2
Status of economies in transition vis-à-vis the World Trade Organization, April 2004

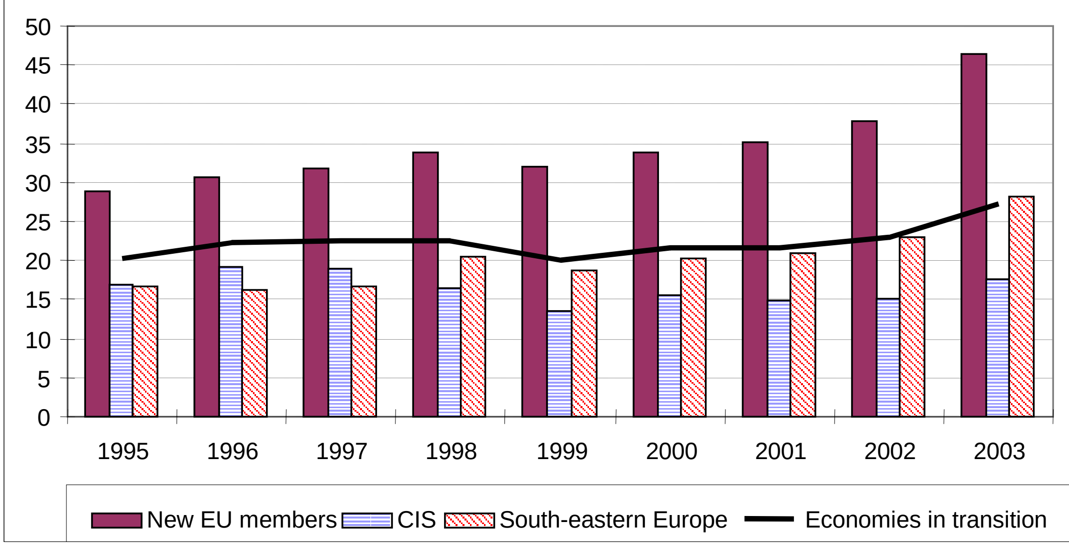
	General Agreement on Tariffs and Trade (GATT)/World Trade Organization Date joined
Eastern Europe	
Albania	September 2000
Bosnia and Herzegovina	Negotiating
Bulgaria	December 1996
Croatia	November 2000
Czech Republic	January 1995
Estonia	November 1999
Hungary	January 1995
Latvia	February 1999
Lithuania	May 2001
Poland	July 1995
Romania	January 1995
Serbia and Montenegro	Negotiating
Slovakia	January 1995
Slovenia	July 1995
The former Yugoslav Republic of Macedonia	April 2003
CIS	
Armenia	February 2003
Azerbaijan	Negotiating
Belarus	Negotiating
Georgia	June 2000
Kazakhstan	Negotiating
Kyrgyzstan	December 1998
Republic of Moldova	July 2001
Russian Federation	Negotiating
Tajikistan	Negotiating
Turkmenistan	Not negotiating
Ukraine	Negotiating
Uzbekistan	Negotiating

Source: World Trade Organization (see http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm).

21. Establishing liberal trading and foreign exchange rate regimes was beneficial for integration of the economies in transition into the world economy and was promoted strongly by EU (see sect. III). The countries in the South-eastern European region have relatively liberal trade policies, but weak institutions and poor governance are often obstacles to trade. Most trade restrictions in CIS have been removed, and there is a trend towards further liberalization. The CIS countries, with the exception of Uzbekistan, maintain relatively open trade regimes and six of them, namely, Armenia, Azerbaijan, Georgia, Kyrgyzstan, the Republic of Moldova and Tajikistan, have a rating between 1 and 2 on the 10-point scale of the IMF index of trade restrictiveness.[7]

22. As the economies in transition liberalize further their exchange-rate and trade regimes, their openness to the world economy is increasing. In the new EU member countries, there has been an improvement in openness, measured by the ratio of exports and imports to GDP,[8] and these countries have become more open to the world economy than the rest of the economies in transition (see figure I). Another positive aspect of the integration of these countries into world markets is the fact that trade integration took place almost simultaneously with financial integration (most notably, increased FDI flows), thereby reinforcing their transition (see sect. V). A similar trend of liberalization has been observed in the economies of South-eastern Europe and Croatia, albeit from a low level and at a slower pace after 1999.

Figure I. External trade[a] in relation to GDP for economies in transition, by subgroup, 1995-2003
(Percentage)



Source: IMF, *International Financial Statistics* (Washington, D.C.); and IMF, World Economic Outlook database.

[a] Total of exports and imports.

23. The opening up of the economies in the CIS region followed a mixed path. The ratio of trade to GDP, on average for this group, had increased at the onset of reform, but slowed down after 1996 and declined sharply during the August 1998 crisis in the Russian Federation. There has been further, though slow, progress in the last two years, underpinned by the strong rebound of the economy of the Russian Federation and the other large CIS economies, namely, Kazakhstan and Ukraine. The fact that the level of openness of those countries is significantly lower than that of the rest of the economies in transition is explained largely by their geographical location, the weakness of their physical infrastructure and institutions, different barriers to trade, governance problems in customs and transportation, political tensions among the countries in the region, and restrictions on market access. Delays and incomplete market reforms are also negatively affecting trade capacities there.

24. Reorientation of trade of economies in transition towards developed economies continued, led by the new EU member countries (see table 3). For this subgroup, competitiveness has been improving and capacity in the export sectors expanding, supported recently by FDI. However, economic growth — both in new EU member States and in those countries in South-eastern Europe aspiring to membership — is becoming heavily dependent on developments in the EU-15. A bulk of their exports goes to EU. Some diversification of trade took place in 2002-2003, given the slowdown in these economies' major trading partners in EU and exports to developing countries from Central and South-eastern Europe grew stronger than exports to EU.

25. Based on strong economic growth, trade increased in all CIS countries in 2003, reinforcing the pattern of trade where trade with non-CIS countries is about three times as large as intraregional trade. The recent and slightly faster growth of trade within the region reflects the continued growth in the economy of the Russian Federation, as well as the real appreciation of the ruble against other CIS currencies. Increased demand for imports in the Russian Federation from the rest of the CIS countries of over 28 per cent in value terms in 2003 boosted exports performance in many countries of the region (table 3). Strong intraregional exports of the Russian Federation in 2003 was outpaced by increasing exports to developing countries, which became an important destination of sales.

26. The EU Stabilization and Association Process encourages bilateral free-trade agreements in South-eastern Europe, in line with World Trade Organization provisions, and free movement of capital and labour. A network of free-trade agreements have been completed in South-eastern Europe in response, though not yet fully implemented. Intraregional trade remained below potential in this subregion, owing to similar, generally labour-intensive, patterns of production.

Table 3
Foreign trade in economies in transition by direction, 2001-2003
(Value in billions of dollars; growth rate as percentage)

	Exports					*Imports*				
	Value			*Growth rate*[a]		*Value*			*Growth rate*[a]	
Country or country group	*2001*	*2002*	*2003*	*2002*	*2003*	*2001*	*2002*	*2003*	*2002*	*2003*
***Baltic States**, to and from*:										
World	9.9	11.2	14.6	13.5	30.0	14.2	16.6	21.5	17.2	29.5
Eastern Europe and CIS	3.1	3.3	4.3	8.5	27.7	4.8	5.4	7.4	12.6	36.7
CIS	1.3	1.5	1.8	15.2	20.6	2.9	3.0	4.2	6.7	37.7
Baltic States	1.3	1.4	1.9	8.3	33.0	0.9	1.1	1.5	26.0	34.0
Central and South-east Europe	0.5	0.4	0.6	-9.2	33.9	1.0	1.2	1.7	17.1	36.6
Developed market economies	6.4	7.3	9.8	14.7	33.8	8.1	9.7	12.2	18.9	26.3
European Union	5.7	6.4	7.9	11.7	23.6	7.1	8.4	10.5	18.4	25.6
Developing countries	0.5	0.6	0.6	29.9	-2.8	1.2	1.5	1.9	24.2	23.9
***Central Europe**, to and from*:										
World	121.9	138.6	179.5	13.7	29.5	145.3	161.0	203.3	10.8	26.2
Eastern Europe and CIS	25.4	28.9	38.2	14.0	31.8	29.9	32.1	41.3	7.3	28.5
CIS	5.4	5.9	7.7	9.7	29.7	13.5	13.9	17.2	3.1	23.3
Baltic States	1.3	1.6	2.2	20.9	38.7	0.4	0.4	0.6	-10.7	51.8
Central and South-east Europe	18.7	21.5	28.3	14.8	31.9	16.0	17.8	23.6	11.3	32.1
Developed market economies	91.3	103.5	133.8	13.4	29.2	100.2	109.3	135.9	9.1	24.4
European Union	84.0	95.2	122.9	13.3	29.1	87.0	95.5	119.0	9.7	24.7
Developing countries	5.3	6.2	7.5	17.0	21.9	15.1	19.6	26.1	29.5	33.1
***South-eastern Europe**, to and from*:										
World	25.4	28.9	36.6	13.6	26.6	42.7	49.0	63.9	14.8	30.5
Eastern Europe and CIS	5.3	5.7	7.3	8.3	28.3	12.2	13.4	17.1	10.5	27.2
CIS	0.8	0.7	0.8	-11.7	12.2	5.4	5.5	6.7	2.2	22.6
Baltic States	0.0	0.0	0.0	4.4	41.6	0.0	0.0	0.0	36.8	105.5
Central and South-east Europe	4.4	4.9	6.5	12.0	30.6	6.8	7.9	10.3	17.1	30.2
Developed market economies	17.0	19.2	24.3	13.5	26.3	25.4	29.0	37.7	13.9	30.1
European Union	15.0	17.1	22.2	13.9	29.5	22.5	25.9	33.9	15.2	31.1
Developing countries	3.2	4.0	5.0	22.9	26.0	5.1	6.6	9.2	29.4	39.2
***Eastern Europe**, to and from*:										
World	157.3	178.8	230.7	13.7	29.0	202.1	226.6	288.7	12.1	27.4
Eastern Europe and CIS	33.7	38.0	49.7	12.6	30.9	46.9	50.9	65.7	8.7	29.0
CIS	7.5	8.1	10.2	8.3	26.5	21.7	22.5	28.1	3.4	25.1
Baltic States	2.7	3.0	4.1	14.4	36.0	1.3	1.5	2.1	14.7	39.1
Central and South-east Europe	23.6	26.8	35.4	13.8	31.7	23.8	27.0	35.5	13.2	31.7
Developed market economies	114.6	130.1	167.8	13.5	29.1	133.8	147.9	185.8	10.6	25.6
European Union	104.8	118.7	152.9	13.3	28.8	116.6	129.7	163.5	11.3	26.0
Developing countries	9.0	10.7	13.1	19.8	22.0	21.4	27.7	37.1	29.2	34.1

Country or country group	Exports					Imports				
	Value			Growth rate[a]		Value			Growth rate[a]	
	2001	2002	2003	2002	2003	2001	2002	2003	2002	2003
***Russian Federation**, to and from*:										
World	100.0	106.2	133.5	6.2	25.7	41.9	46.2	57.3	10.2	24.1
Intra-CIS	14.6	15.6	20.4	6.8	31.0	11.2	10.2	13.2	-8.7	28.6
Non-CIS countries	85.4	90.5	113.0	6.1	24.8	30.7	35.9	44.1	17.1	22.8
Eastern Europe	16.5	15.9	19.2	-3.7	20.9	3.1	3.7	4.8	20.4	29.0
Baltic States	3.8	4.1	4.6	6.6	13.8	0.4	0.6	0.7	29.5	27.8
Central and South-east Europe	12.6	11.8	14.6	-6.8	23.4	2.6	3.2	4.1	19.0	29.2
Developed market economies	47.0	50.4	60.2	7.2	19.5	20.8	23.6	28.6	13.5	21.2
European Union	36.7	37.6	46.9	2.3	24.9	15.4	18.3	22.1	18.4	20.8
Developing countries	21.9	24.3	33.6	10.9	38.3	6.8	8.6	10.7	26.6	24.4
***CIS countries**, excluding Russian Federation, to and from*:										
World	42.8	46.1	58.7	5.0	27.3	41.1	43.0	56.0	3.3	30.4
Intra-CIS	15.5	14.4	18.2	-6.8	25.9	21.9	22.6	28.3	2.8	25.5
Non-CIS countries	27.3	31.7	40.5	11.7	27.9	19.1	20.4	27.7	3.9	35.9

Sources: National statistics and direct communications from national statistical offices to ECE secretariat.
[a] Calculated based on value expressed in dollars.

27. There has been increased interest in regional cooperation and agreements within the CIS region as well, a recent manifestation of which has been the initiative to establish a Single Economic Space (SES) among four countries.[9] SES is open to other countries from the region and aims at laying the foundations of a large economic area with free mobility of goods and services, capital and labour. Progress has been made towards the establishment of a monetary union between Belarus and the Russian Federation, though there have been delays in pegging the Belarus currency to the Russian ruble as an initial step. There are some other regional arrangements, such as the Eurasian Economic Community, which signed several agreements in 2003 aimed at fostering the preparation and synchronization of the countries' accession to the World Trade Organization. These arrangements, however, are also at an early stage.

28. The smaller CIS countries receive limited FDI, and they could benefit from the establishment of liberalized regional trading blocs as foreign investors are attracted by a larger market. This is particularly important for those regions where transport costs are higher. Regional transportation and facilitation projects on road and transportation networks have proceeded in the Caucasus and in Central Asia, supported by the World Bank and the Asian Development Bank, respectively. These projects complement the EU Transport Corridor Europe-Caucasus-Asia (TRACECA) project, designed to build a transportation corridor between the Caucasus and Central Asia. Constraints on the availability of trade finance, in particular to the emerging private sector in those countries, are addressed through the Trade Facilitation Programme of the European Bank for Reconstruction and Development: support to foreign trade in Kyrgyzstan and Uzbekistan was provided through this programme and as a result, the volumes of trade credit increased significantly there. Restructuring of enterprises, as well as improvements in corporate governance and the banking sector, is also crucial for the countries in

South-eastern Europe and the CIS region if they are to use effectively the funds allocated to them.

V. Foreign direct investment

29. Capital flows play a key role in the integration of economies in transition into the world economy. The interrelatedness of investment, technology transfers, labour skills and managerial practices has affected growth in these countries and has started to change the pattern of behaviour of economic agents as foreign companies penetrate these markets and impact domestic companies. Net private capital flows to the economies in transition expanded from US$ 8.9 billion in 2000 to US$ 25.6 billion in 2002 and continued to increase in 2003, though at a more moderate pace. FDI and commercial bank lending were the main sources of net capital inflows, having steadily recovered after the Russian crisis in August 1998.[10]

30. FDI flowing into the economies in transition has manifested different patterns in terms of sectoral distribution: FDI has been concentrated in export-oriented sectors in Central and Eastern Europe and the Baltic States, while in the CIS region it tends to be oriented towards exports of natural resources and domestic supply, or import substitution. These tendencies reflect specific features of the recipients' economies, such as size, ownership structures, geography, labour costs, natural endowments and institutional factors.[11]

31. While FDI has remained a resilient source of capital inflows for transition economies (see figure II), the dynamics of FDI have followed a different path throughout the subregions (see table 4). FDI inflows slowed down in the new EU members in 2003 because of completion of privatization and rising real wages. At the same time, there was an increase of outward direct investment from the new EU members — Hungary, in particular, reflecting the maturity of that country's corporate sector. Prospects for future FDI following the EU enlargement are favourable; but whether such flows are forthcoming will be determined, among other factors, by the corporate tax level, which eventually is expected to be unified with that of EU.

32. Growth of FDI has been more pronounced in the countries of South-eastern Europe, where inflows expanded by over 60 per cent in 2003. FDI to Bulgaria and Romania sharply increased, following a number of privatization deals. FDI flows to other countries of South-eastern Europe also increased in 2003, reaching 3 billion euros (5 per cent of GDP), in part owing to privatization in Croatia and Serbia and Montenegro, Croatia having been the largest recipient. To continue to attract FDI, further progress is needed as regards large-scale privatization (small and medium-scale privatization has been mostly completed) as well as in developing a more transparent legal framework and business-friendly environment. A degree of trade liberalization is also crucial to attracting FDI. Since domestic markets are small, an integrated regional market will be more attractive to potential investors.

Figure II. Economies in transition: ratio of net FDI to GDP, 1991-2003
(Percentage)

Source: UNCTAD, *World Investment Report 2001*: *Promoting Linkages* (United Nations publication, Sales No. E.01.II.D.12), annex tables B.1 and B.2; and *World Investment Report 2004* (United Nations publication, Sales No. E.04.II.D.33); World Bank, *Global Development Finance: Analysis and Summary Tables, 1991-2002* (Washington, D.C.); and IMF, *Balance of Payments Statistics Yearbook*, and *International Financial Statistics* (Washington, D.C.).

Table 4
Foreign direct investment in economies in transition, 1995-2003

	Cumulative FDI inflows	*Cumulative FDI inflows per capita*	*FDI inflow per capita*			*FDI inflow as share of GDP*		
	(1995-2003)	*(1995-2003)*	*2001*	*2002*	*2003*	*2001*	*2002*	*2003*
	($ millions)	*($)*	*($)*	*($)*	*($)*	*(%)*	*(%)*	*(%)*
New EU members	142 734.9	214.8	249.9	307.4	156.2	5.1	5.6	2.4
Czech Republic	36 987.3	399.5	549.6	827.6	252.2	9.9	12.2	3.0
Hungary	31 724.8	351.8	396.9	288.3	251.6	7.6	4.4	3.0
Poland	50 110.0	144.3	148.1	107.2	109.7	3.1	2.2	2.0
Slovakia	10 197.5	210.1	293.2	762.5	105.5	7.6	17.0	1.8
Slovenia	3 275.6	183.0	185.9	810.0	91.4	1.9	7.3	0.7
Estonia	3 608.5	284.0	394.0	209.0	662.1	9.7	4.4	10.6
Latvia	3 103.9	141.4	67.9	160.5	151.2	2.1	4.6	3.8
Lithuania	3 727.4	112.0	120.8	198.8	48.8	3.8	5.2	1.0
South-eastern Europe	31 242.9	63.5	81.8	75.5	123.1	4.6	3.6	5.1
Albania	959.5	33.8	65.9	42.7	56.6	4.9	2.8	3.0
Bosnia and Herzegovina	1 132.5	33.1	32.0	64.3	91.5	2.6	4.7	5.4
Bulgaria	6 198.8	85.6	103.3	116.1	183.9	6.0	5.6	8.1
Croatia	9 044.4	216.1	335.4	241.4	367.7	8.0	5.3	7.5
Romania	9 873.0	48.8	51.7	51.2	70.3	2.9	2.5	2.9
The former Yugoslav Republic of Macedonia	999.7	55.1	216.1	37.9	46.0	12.8	2.1	2.0
Serbia and Montenegro	3 035.0	32.0	15.7	45.1	129.4	1.4	3.0	6.6
Commonwealth of Independent States	62 370.6	24.4	24.9	32.0	31.6	1.7	2.0	1.6
Armenia	983.6	28.9	23.2	39.5	41.0	4.0	6.3	5.9
Azerbaijan	8 639.3	120.5	28.0	170.9	400.9	4.0	21.9	44.7
Belarus	1 750.2	19.0	9.4	24.5	16.9	0.8	1.7	1.0
Georgia	1 394.0	29.4	21.0	31.7	65.1	3.4	4.9	8.6
Kazakhstan	14 821.4	101.2	176.1	161.6	129.5	12.8	10.6	7.1
Kyrgyzstan	411.9	9.5	1.0	1.0	4.9	0.3	0.3	1.4
Republic of Moldova	737.1	19.0	34.1	27.3	13.7	9.9	7.0	3.0
Russian Federation	25 367.0	19.3	17.1	24.1	8.0	0.8	1.0	0.3

	Cumulative FDI inflows	Cumulative FDI inflows per capita	FDI inflow per capita			FDI inflow as share of GDP		
	(1995-2003)	*(1995-2003)*	*2001*	*2002*	*2003*	*2001*	*2002*	*2003*
	($ millions)	*($)*	*($)*	*($)*	*($)*	*(%)*	*(%)*	*(%)*
Tajikistan	193.2	3.6	1.5	5.8	5.1	0.9	3.0	2.0
Turkmenistan	1 131.9	27.2	35.2	20.3	19.9	2.6	1.3	1.3
Ukraine	6 154.0	13.7	16.1	14.2	29.5	2.1	1.6	2.9
Uzbekistan	787.0	3.6	3.3	2.5	2.7	0.7	0.7	0.8

Source: UNCTAD, *World Investment Report 2004* (United Nations publication, Sales No. E.04.II.D.33); and IMF, *International Financial Statistics* (Washington, D.C.).

33. In 2002-2003, international financial flows followed a divergent pattern among the countries of the CIS region. The Russian Federation's position as an important net exporter of capital was strengthened, while their important role as capital importer was observed in many other countries in the region. The macroeconomic stabilization and the strong recovery, in conjunction with high oil prices, made the resource-rich countries of the CIS region important destinations of FDI. In 2003, Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan and Turkmenistan benefited from increased flows of capital. FDI expanded at a significant rate in the countries of Central Asia, driven by export revenues emanating from high oil prices. Flows of capital in the Russian Federation started to grow in the first half of 2003, but a reversal in this tendency in many segments, such as portfolio investments and FDI, turned the net inflows to the country negative for the year as a whole.

34. Last, but not least, among factors that could increase the attractiveness of the transition countries and improve foreign investors' inclination to invest in these economies would be the deepening of reform in the real and banking sector, including the creation of a strong private sector, further building up of institutions, foreign exchange and trade liberalization and development of the legal system, all of which will also foster the transition. In the past, privatizations in the region were often conducted in an ineffective and non-transparent manner and driven by a necessity to close budget gaps; furthermore, the fact that, in many instances, some companies were granted monopoly powers, is inconsistent with the World Trade Organization framework.

35. FDI remains critical to generating investment, upgrading technology, modernizing the economy and thereby increasing economic growth via productivity gains and spillover effects. Some downside risks, however, are associated with FDI. One of these is possible profit repatriation by foreign investors and its impact on the current-account deficit (see table 5). Competition for domestic producers, created by FDI, may lead to higher productivity but may also crowd out domestic investors. The impact of FDI on employment is negative in the short term. Increased outsourcing by foreign companies from Eastern Europe to Asia, as real wages in the region grow, contributes to the increased volatility of FDI.

Table 5
Repatriation of profits from selected countries of Central and Eastern Europe, 1996-2002
(Millions of United States dollars)

	1996	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
Bulgaria	0.0	0.0	6.1	32.4	19.8	115.5	115.0
Croatia	7.6	20.8	27.4	13.1	55.4	137.6	170.8
Czech Republic	75.3	56.0	173.3	247.5	279.0	428.7	546.0
Estonia	9.3	22.0	28.5	56.7	83.2	68.6	170.3
Hungary	259.4	440.0	925.1	832.2	785.9	784.9	1 021.3
Latvia	8.0	4.2	11.2	20.3	11.8	21.0	51.5
Lithuania	2.8	28.1	37.7	12.2	29.2	53.4	43.1
Poland	217.0	362.0	466.0	430.0	559.0	982.0	1 365.0
Romania	24.0	30.0	154.0	49.0	59.0	108.0	186.0
The former Yugoslav Republic of Macedonia	0.0	0.0	0.6	1.5	6.9	12.7	24.0

Source: IMF, *Balance of Payments Statistics Yearbook, 2003* (Washington, D.C., 2003).

36. While there has been progress in the integration of the economies in transition into the world economy through trade and capital flows, by contrast, the third major channel of integration — the movement of labour — continues to be limited in scope everywhere in the region. While immigration barriers exist both westward and eastward, the low level of mobility within these countries reflects rigid labour markets as well as a lack of the infrastructure and institutions necessary to support labour movements. Most of the EU-15 countries imposed a ban for up to seven years on the free movement of labour even from the new EU members. Strict enforcement of the new EU border will complicate labour mobility from the countries of the CIS region westward; hence, and the newly proposed European Neighbourhood Policy foresees the free movement of labour only as a long-term prospect.

VI. Continuing economic restructuring and liberalization

37. In 2002-2003, the economies in transition continued to make progress in structural and institutional reform. This has enhanced their ability to further integrate into the world economy. In particular, the stronger private sector, created through small-scale and large-scale privatization, has attracted FDI. Reduced State activity is indicative of progress almost everywhere in the economies in transition. These reforms have resulted in an increased private sector share in total economic activity in many countries (see table 6). Only three have shares under 25 per cent. By mid-1997, the private sector's contribution to GDP had risen to 50 per cent or over in 15 of the 27 economies in transition. In mid-2002, 23 countries met this criterion. Using a variety of indicators, the European Bank for Reconstruction and Development has ranked economies in transition in terms of progress achieved in several areas, like small-scale privatization, large-scale privatization, governance and enterprise restructuring, price liberalization, trade and foreign-exchange

liberalization, banking reform, financial institutions, infrastructure, etc.[12] While in 2002-2003, the highest rating of 4+, for standards and performance typical of advanced industrialized economies, had been received by many economies in transition for price liberalization, only Hungary had this rating in banking reform and interest-rate liberalization (see table 7).

38. Adjustments in the economic structures of the eight new EU economies in transition to the *acquis* of EU have already taken place, marking notable progress in the area of enterprise restructuring in Slovakia and the Baltic States. Despite this, however, problems related to underdeveloped financial markets, as well as the problems inherent in restructuring strategic sectors — such as energy, heavy industry and agriculture — remain. In addition, there have been delays in public administration reforms, including judicial reforms, at the regional and municipal levels.

Table 6
Private sector activity in economies in transition, mid-2002

Share of GDP	*Countries*
75 per cent or over	Albania, Bulgaria, Czech Republic, Estonia, Hungary, Lithuania, Poland, Slovakia
50-74.9 per cent	Armenia, Azerbaijan, Bosnia and Herzegovina, Croatia, Georgia, Kazakhstan, Kyrgyzstan, Latvia, the Republic of Moldova, Romania, the Russian Federation, Slovenia, Tajikistan, the former Yugoslav Republic of Macedonia, Ukraine
Less than 50 per cent	Belarus, Serbia and Montenegro, Turkmenistan, Uzbekistan

Source: EBRD, *Transition Report, 2003: Integration and Regional Cooperation* (London, November 2003), p. 16.

Table 7
Selected indicators of progress in transition, 2002-2003[a]

Rating	*Small-scale privatization*	*Large-scale privatization*	*Trade and foreign exchange (FOREX) system*	*Banking reform and interest-rate liberalization*
Less than 3	Belarus, Turkmenistan	Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Serbia and Montenegro, Tajikistan, Turkmenistan, Uzbekistan	Belarus, Turkmenistan, Uzbekistan	Albania, Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Republic of Moldova, Romania, Russian Federation, Serbia and Montenegro, Tajikistan, Turkmenistan, Ukraine, Uzbekistan
Between 3 and 4	Armenia, Azerbaijan, Bosnia and Herzegovina, Bulgaria, Republic of Moldova, Romania, Serbia and Montenegro, Tajikistan, Uzbekistan	Bulgaria, Croatia, Georgia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Republic of Moldova, Poland, Romania, Russian Federation, Slovenia, Ukraine, The former Yugoslav Republic of Macedonia	Azerbaijan, Bosnia and Herzegovina, Kazakhstan, Russian Federation, Serbia and Montenegro, Tajikistan, Ukraine	Bulgaria, Croatia, Czech Republic, Estonia, Kazakhstan, Latvia, Lithuania, Poland, Slovakia, Slovenia, the former Yugoslav Republic of Macedonia
4 or over	Albania, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Poland, Russian Federation, Slovakia, Slovenia, the former Yugoslav Republic of Macedonia, Ukraine	Czech Republic, Estonia, Hungary, Slovakia	Albania, Armenia, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kyrgyzstan, Latvia, Lithuania, Republic of Moldova, Poland, Romania, Slovakia, Slovenia, the former Yugoslav Republic of Macedonia	Hungary

Source: EBRD, *Transition Report, 2003* (London, 2003), p. 16.

[a] EBRD classification is based on a 1-4+ scale, where 1 signifies an economy with no reforms, and 4+, a developed market economy. For more details, see EBRD, *Transition Report, 2003*, p. 17.

39. Notwithstanding delays in some areas, such as large-scale privatization, restructuring is moving ahead in the three other countries that are to join EU: Bulgaria, Croatia and Romania. In the other Balkan countries — Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and Serbia and Montenegro — to which EU has reaffirmed its commitments (see sect. III), restructuring advances are linked to the results of small-scale privatization and improvements of the business environment.

40. In the CIS region, market confidence in the Russian Federation, Kazakhstan and Ukraine has strengthened as a result of reforms, with declining capital flight and increasing levels of FDI. Further reform of the electricity sector, liberalization of trade and currency and institutional development such as pension reform have been undertaken in the Russian Federation in 2003 and 2004. Restructuring elsewhere in the region remains partial and more limited in scope. Ukraine has made progress in small-scale privatization, as have Armenia, Kazakhstan, Kyrgyzstan and Tajikistan.

41. Legal and regulatory frameworks still have to be improved in many countries and, coupled with high existing administrative barriers and weaknesses in the judicial system, represent a major obstacle to enterprises in the region. The fact that several countries — Bosnia and Herzegovina, Bulgaria and Latvia — have improved their bankruptcy laws and procedures, should facilitate market exit and foster enterprise restructuring.

42. In the financial sector, most progress has been achieved in non-bank financial institutions. For instance, improvements in the legal and regulatory framework for pension and insurance funds, as well as increasing transparency and sophistication in the securities markets in the Russian Federation, Serbia and Montenegro and Slovakia, have been achieved. Financing for enterprises remains a significant bottleneck, especially for small and medium-sized ones. The financial sector remains underdeveloped and the overall level of financial intermediation is very low compared with that of EU. The banking sector in CIS remains fragmented and many banks are weak. In the countries of Central and Eastern Europe and the Baltic States, reforms in the financial sector have continued as part of the impetus for EU accession. Many of these reforming banks are foreign-owned and have more sophisticated and diversified products. The prospect of further economic integration into EU has also encouraged similar reforms in other countries that aspire to closer ties with EU, most notably in South-eastern Europe.

VII. Special challenges for smaller member countries of the Commonwealth of Independent States

43. Notwithstanding the strong economic performance in the low-income countries of the CIS region, namely, Armenia, Azerbaijan, Georgia, Kyrgyzstan, the Republic of Moldova, Tajikistan and Uzbekistan, during 2001-2003, where average annual GDP grew over 7 per cent, challenges to their further integration into the world economy remain. Many of these countries suffered long and protracted recessions in the initial phase of transition. While declines in income have been partly reversed in recent years and poverty is no longer on the rise, and while fiscal discipline has been adopted, pre-transition levels of output have not been reached. In addition, there are delays in restructuring the real and banking sectors. Indeed, coordinated international efforts, within the CIS-7 Initiative,[13] have contributed to progress in

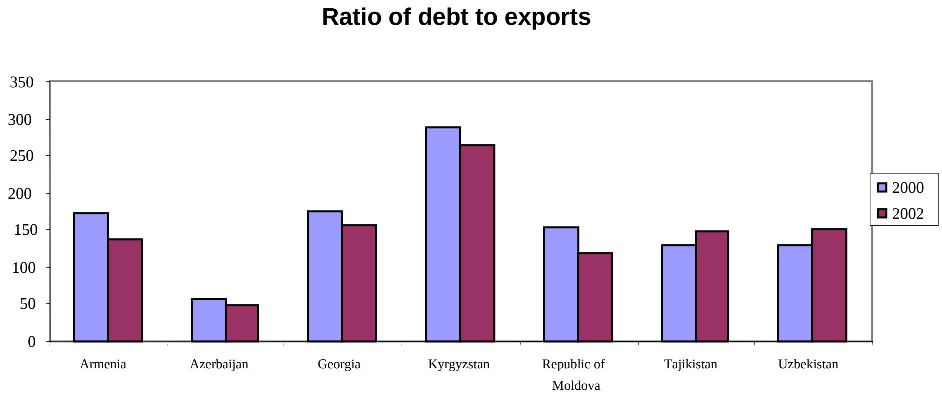
several aspects of economic development. This Initiative, launched by IMF, the World Bank, the European Bank for Reconstruction and Development and the Asian Development Bank, has strengthened cooperation between these countries and the international community, on one hand, and among the countries themselves, on the other, and has been successful in several key areas. These areas include participatory approaches to poverty reduction strategies, public expenditure management, reforms in the energy sector, health, education and labour markets, financial sector supervision, public debt management, and public goods.[14]

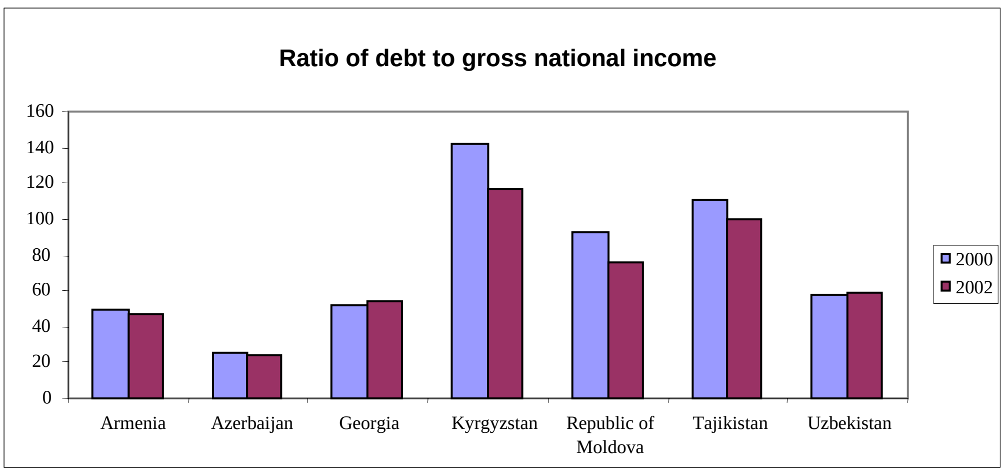
44. Significant progress has been made for the last two years in reducing the external debt of the CIS-7 countries — debt which had accumulated since 1991 and had been exacerbated by external shocks and expansionary policies in the 1990s. External debt indicators improved in most of these countries (see figure III), with debt-to-export ratios having declined in 2003 for all the countries except Uzbekistan. The external public debt service ratios went down by 20 per cent, on average, for 2003 compared with 2002, largely owing to robust output growth and supported by debt relief. Notwithstanding these improvements, external debt service was still over 38 per cent of central government receipts in 2003.[15] While the overall trend in debt has generally improved, individual countries' performances have increasingly diverged. In Armenia, for example, the debt service-to-exports ratio fell to 9.9 per cent owing to strong export growth and bilateral debt restructuring in 2003. However, in the Republic of Moldova and Georgia, this indicator went up, driven by political instability and a lack of consistent reforms.

45. Donor support on highly concessional terms has been important for these countries in order to enable them to proceed with market reforms even if they are faced with limited, or no, access to international capital markets. The grant part of the new loan commitments of the official creditors to the CIS-7 rose from 50 per cent in the late 1990s to 74 per cent in 2002.[16] Armenia, Kyrgyzstan and Tajikistan benefited from the debt relief granted.

46. The challenge ahead for these countries underscores the importance of debt management and sound macroeconomic policies. There is a need to take measures to restructure enterprises and enhance the business environment. Countries in the region are extremely vulnerable to external shocks because of the high concentration of exports in commodities, as is the case for Kyrgyzstan with gold, and for Tajikistan with aluminium. The situation remains fragile, and countries like Georgia and the Republic of Moldova are especially vulnerable, so that further assistance is crucial.

Figure III
External debt ratios for the CIS-7 countries, 2000 and 2002
(Percentage)





Source: World Bank, *Global Development Finance,* 2004 (Washington, D.C.); and *World Development Indicators, 2004* (Washington, D.C.).

47. Despite signs of progress, there are difficulties in improving the investment climate and achieving sustained growth and poverty reduction in many of these countries. Therefore, the challenge for these countries is to build up and implement a coherent framework of policies and institutions, so as to balance potentially conflicting needs, namely, spending more on poverty reduction, on the one hand, and maintaining a tight fiscal stance, on the other.

48. Poverty and unemployment in these countries are still at high levels and, coupled with the spread of HIV/AIDS and tuberculosis, have become a growing concern. Spending on education and health has dropped, and reforms in these areas have been slow and protracted in many countries. Environmental issues require special attention, especially in those countries where economic growth is driven by natural resources and polluting industries.

VIII. Policy issues and conclusions

49. The economies in transition have further integrated themselves into the global economy. This, in turn, has contributed to an acceleration of their transformation from planned to market economies. Progress has been achieved across all the dimensions of transition: liberalization of markets, institution-building, and upgrade of industrial capacity through trade and FDI, factor movements and the communication of economically useful knowledge and technology. Progress however, has been uneven and mixed across the countries in the region. In the Central European and Baltic States, integration of the eight countries into EU has been a major success and a manifestation of their advancement. At the same time, many countries in South-eastern Europe and the smaller, low-income CIS countries continue to experience difficulties and still need international assistance to support growth and balance their resources in respect of achieving functioning structures there.

50. The process of further integration of the economies in transition into the world economy poses several risks to those economies, related to the increasing dependence on trade partners and products. Therefore, further diversification of trade and penetration into different market segments are crucial. To maintain sustainable domestic demand, small and medium-sized enterprises should be strengthened in South-eastern Europe and the CIS region and provided with more access to banking services and better infrastructure.

51. For the new EU member countries, strong financial market supervision and competition are important prior to their entering the euro zone in order that misalignment of the exchange rate may be avoided. Strengthening banking supervision will also reduce the risks of a credit boom, which may follow after their joining the euro area.

52. While the economies in transition require better access to international capital markets in order to replace obsolete capital and foster investment-oriented growth, such access also poses risks to recipients owing to the greater mobility of capital. Premature liberalized capital flows and trade can be a source of instability if economic fundamentals and policies are weak, as was the case in the Russian Federation in 1998. Macroeconomic policies — such as shifting to more flexible exchange rates — could reduce vulnerability to external shocks.

53. Integration is a political process, as well as an economic one, and therefore further progress requires coordinated efforts among Governments, institutions, and societies in these countries, and international organizations, in order to ensure that the economies in transition raise their capacities as regards the utilization of their human, technological and natural resources.

Notes

[1] The report is based on contributions from the Department of Economic and Social Affairs of the United Nations Secretariat, the Economic Commission for Europe (ECE), the Economic and Social Commission for Asia and the Pacific (ESCAP), the United Nations Conference on Trade and Development (UNCTAD), the United Nations Environment Programme (UNEP), the United Nations Population Fund (UNFPA), the United Nations University (UNU), the International Labour Organization (ILO), the Food and Agriculture Organization of the United Nations (FAO), the United Nations Educational, Scientific and Cultural Organization (UNESCO), the International Civil Aviation Organization (ICAO), the International Monetary Fund (IMF), the World Meteorological Organization (WMO), the International Maritime Organization (IMO), the World Intellectual Property Organization (WIPO), and the United Nations Industrial Development Organization (UNIDO).

[2] For more details on the analysis of current economic situation and prospects in the world economy and economies in transition, see *World Economic Situation and Prospects 2004* (United Nations publication, Sales No. E.04.II.C.2) and the forthcoming *World Economic and Social Survey 2004* (United Nations publication, Sales No. E.04.II.C.1).

[3] A comprehensive analysis of the recent economic developments in economies in transition is presented biannually in the *Economic Survey of Europe*, issued by the Economic Commission for Europe. The most recent issue is *Economic Survey of Europe, 2004*, No.1 (United Nations publication, Sales No. E.04.II.E.7).

[4] The PHARE programme is focused on institution-building, development of public administration, and convergence with the EU *acquis*, accompanied by necessary investment. ISPA focuses on environmental and transport infrastructure and SAPARD focuses on agricultural and rural development and implementation of the *acquis* in areas involving EU Common Agricultural Policy.

[5] Initially created to assist Poland and Hungary, the PHARE programme currently includes Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia and Romania.

[6] For an overview of trade liberalization of economies in transition since the start of their transformation from planned to market economies, see the report of the Secretary-General entitled “Integration of the economies in transition into the world economy” (A/57/288) of 9 August 2002.

[7] The IMF trade restriction index is an average of the tariff protection, measured by statutory tariff rates for imports, and the coverage of non-tariff barriers to trade in the economy.

[8] The indicator of trade openness is estimated as a ratio of exports and imports to GDP, measured at purchasing power parity (PPP) exchange rates. For a survey on measurement of openness, see A. Berg and A. Krueger, *Trade, Growth and Poverty: A Selective Survey*, IMF Working Paper, No. 30 (Washington, D.C., 2003).

[9] The agreement for establishing the Single Economic Space (SES) was signed in September 2003 by the heads of Belarus, Kazakhstan, the Russian Federation and Ukraine. For details on the framework of the SES, see *Economic Survey of Europe, 2004*, p. 18-21, No. 1, sect. 1.3 (iii).

[10] For an overview of the recent developments in FDI and policies in global and regional levels, see *World Investments Report, 2003: FDI Policies for Development: National and International Perspectives* (United Nations publication, Sales No. E.03.II.D.8).

[11] For a comprehensive overview of the FDI determinants, see European Bank for Reconstruction and Development, *Transition Report 2003: Integration and Regional Cooperation* (London 2003).

[12] Ibid.

[13] For an overview of the CIS-7 Initiative, see *World Economic and Social Survey, 2003* (United Nations publication, Sales No. E.03.II.C.1), chap. III.

[14] International Monetary Fund and World Bank, “Recent Policies and Performance of the Low-Income CIS Countries: An Update of the CIS-7 Initiative”, 23 April 2004, available from http://www.imf.org/external/np/oth/042304.htm (accessed 21 September 2004).

[15] Ibid.

[16] Ibid.