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Economic Commission for Europe

Review of the implementation of OSCE commitments in the economic and environmental dimension

Investment climate: A UNECE report

Twelfth OSCE Economic Forum, Prague, May 31- June 4 2004

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Foreword:

The OSCE Participating States, in preparation for the Annual Economic Forum’s session dealing with the review of the implementation of commitments, advised the OSCE Secretary General to request the UNECE, as a transitional arrangement, creating no precedent of a future comprehensive arrangement, to prepare a report on review of commitments, following as much as possible the practice of previous years, but with a focus on the review of commitments on the main topics related to the 12th OSCE Economic Forum in Prague May-June 2004. As a result, and following consultations between the OSCE and UNECE secretariats, it was agreed that the UNECE’s review for 2004 would cover the topic of the review of implementation of the OSCE commitments in the area of investment climate.

There are explicit and implicit references to investment climate as an OSCE commitment in the Document of the Bonn Conference on Economic Co-operation in Europe, in the Charter for European Security, and in the OSCE Strategy Document for the Economic and Environmental Dimension. Specifically, the Bonn Document states that “the participating States wish to create favourable conditions for a harmonious development” and “they therefore agree to improve business conditions” (paragraph A.1). In addition, “the participating States are prepared, insofar as the appropriate conditions exist, to foster a favourable climate for investment” (paragraph A.6). The Charter for European Security notes that “economic dimension [will] receive appropriate attention” with a view “to ensure the rule of law and the development of a transparent and stable legal system in the economic sphere” (paragraph 31). Finally, the OSCE Strategy Document notes that participating States “will step up exchange of information and experience on the best means of attracting investment, in particular foreign direct investment, and removing the obstacles to it” (paragraph 2.1.13).

The UNECE therefore presents the following report for the consideration of the OSCE participating states. It is organized into two parts. Section A reviews OSCE participating States commitments in the area of investment climate. Section B suggests a methodology for the future reviews of OSCE commitments in the economic and environmental dimensions of security.

Section A: Review of OSCE participating States commitments in the area of investment climate

I. Integrated measures of investment climate

The purpose of this paper is to describe and review some key elements of investment climate in the UNECE/OSCE member states. It is – to some extent – a benchmarking exercise where countries are compared in terms of various factors that affect investment decisions. The statistical data used in this paper come from a variety of sources: national statistical agencies, surveys by research institutions and estimates by think tanks and international organizations. The paper focuses on the rationale behind decisions to invest in physical capital by individual entrepreneurs and companies.

In general, a sound investment climate could be described as the conditions that make up the enabling environment in which private enterprises thrive by investing and
producing. Because there are many elements that make up the investment climate, it is difficult to define it precisely, but characterizations such as “conduciveness of private investment and enterprise growth” or “the state of enabling environment for private enterprise” have been used to describe it.

In general, one can envisage two major integrated measures of investment climate: foreign direct investment and the size of informal economy. While domestic entrepreneurs often escape what they perceive as an unfavourable investment climate by hiding their activities from governments, foreign investors—facing unreasonable risks—simply do not invest. Foreigners—given their global perspective—can be expected to invest only in the countries that meet their investment criteria.¹

The investment climate also depends on a large number of factors that can be grouped into three broad clusters: macroeconomic conditions, institutions and physical infrastructure. Prudent macroeconomic policies are those policies that result in low inflation and fiscally responsible actions. In contrast, overly loose and unpredictable macroeconomic policies clearly raise the costs by increasing the risks of conducting business.² Secondly, microeconomic and institutional framework conducive to productive investment centres on the legal and regulatory system that promotes competition, good governance and improves access to financial services. Thirdly, the quality and availability of physical infrastructure such as electricity supply, road network and telecommunication links play an important role and can have a significant impact on the incentives to invest.

This review of OSCE participating States commitments in the area of investment climate includes descriptions of two integrated indicators of investment climate: the value of foreign investment flows and the size of informal economy. The review also describes recent economic developments in the OSCE region that are relevant to and shape macroeconomic stability. Key elements of institutional framework which are crucial for investors as well as physical infrastructure which often plays an important role in decisions to invest are also discussed.

**Foreign direct investment:**

Foreign investors select a specific location based, *inter alia*, on the expected profitability and on the type of investment. The rationale for making investments is determined by the specific characteristics of the preferred location: market size, availability of cheap and skilled labour, presence of natural resources, proximity to the home country or access to good financial and physical infrastructure.³ Depending on their interest, foreign investors will place varying emphasis on the particular elements of an investment climate. For example, those seeking access to abundant

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¹ It should be noted that large multinational corporations often receive preferential treatment from governments in order to be enticed into the domestic market. These incentives may range from subsidies, tax breaks and favourable institutional environment—all of which are frequently unavailable to domestic entrepreneurs.


³ There are three main reasons for FDI. The first is “market-seeking” where investment is made for the purpose of selling into the large and growing domestic market. The second is “resource-seeking” where investment is made take advantage of the existence of abundant natural resources. The third is “efficiency-seeking” where close proximity to the home country allows for profitable expansion.
reserves of natural resources may not be as concerned with macroeconomic stability or barriers to competition as opposed to access to modern transportation networks.

Figure 1 presents cumulative FDI inflows as a share of GDP over the 1980-2002 period in 48 UNECE/OSCE member states. (In general, data for FDI inflows covers 1990-2002 for former centrally planned economies and 1980-2002 for all others). While it illustrates the above-noted differences in the rationale for making investments by foreigners, there are some marked distinctions. For example, the large inflows into Azerbaijan and Kazakhstan - closely related to the abundance of crude oil, natural gas and base metals in these countries – can be contrasted with relatively small FDI inflows into Russia: a country with a large domestic market and a wealth of natural resources.

In the context of the former centrally planned economies, of particular importance to the investment decision are deficiencies in the institutional framework that are largely related to reforms of the state. When the institutions necessary for market exchange do not exist or they do not perform their tasks properly, the government becomes an impediment to economic activity. In many cases, this has discouraged foreign investors and deterred investment.

While reforms of the state in the former centrally planned economies are ongoing, large differences across countries can be observed. For instance, Figure 1 illustrates a high ranking of Estonia – a country whose economy can be characterized as one of the few that offers the most economic freedom. Slovakia also ranks relatively high. Its government has recently implemented many pro-investment reforms: reduced taxes, liberalized prices and restructured the banking sector. Partly as a result of these actions, foreigners appear to have identified Slovakia as an attractive investment destination (the country is often referred to as “the Detroit of Europe” due to its large car manufacturing output). Towards the bottom of the chart, the economies in Belarus and Uzbekistan feature high level of protectionism, barriers to foreign investment, restrictions to banking and finance and generally weak protection of property rights. As can be asserted from Figures 1 and 2, foreigner investors do not appear to be attracted to economies with these types of characteristics.

**Figure 2**

**FDI Inflow per capita, 2003**

(in US dollars)

Source: UNECE Database and national statistics
In theory, the potential for foreign capital flows to increase economic growth is well recognized. FDI is important for upgrading a country’s physical and human capital, for increasing export capacity and for boosting the momentum for structural reform. It is also a means for the transfer of technology and managerial skills. Because of these positive characteristics, FDI flows have the potential to improve the investment climate. In practice, however, the actual pattern of inward direct investment has been explained in terms of existing economic fundamentals such as macroeconomic stability, natural resource endowments, direct barriers to capital movement and institutions (government red tape or the quality of governance in general). While these factors explain foreign investment flows in general, some countries tend to do better than expected given their economic fundamentals and the existing political and social situation, approximated by variables such as income levels, telecommunications infrastructure, research and development expenditures, education levels and country risk.

Figure 3 presents a matrix of countries that are judged to be performing above and below their potential. (“Front-runners” and “underperformers” are perceived to attract FDI commensurately with their “estimated potential capacity”). Notably, many of the former Soviet Union countries have attracted more FDI than could be expected. This is largely due to projects related to the exploration and development of natural resources, transportation infrastructure such as pipelines and debt for equity swaps to settle energy debt.

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5 These and other variables are rated and averaged in order to produce the UNCTAD Inward FDI Potential Index. See Annex table A.I.7 in UNCTAD, *World Investment Report 2003*, FDI Policies for Development: National and International Perspectives, United Nations.
Informal economy:

Another way of circumventing the complexity of finding causes contributing to a specific business environment, while simultaneously gauging the overall investment climate, is to review the size of informal markets. Informal markets (often called underground economies) are present in all countries. Informal markets are the direct result of government intervention in the marketplace (through taxation, regulation or outright prohibition). Some economists have suggested that an increasing burden of taxation and social security payments are the major driving forces for the size and growth of the informal economy. In Russia, for example, one of the goals of the large-scale overhaul of the tax system (with major changes taking place in 2001-2003) was to encourage individuals and businesses to legalize shadow (undeclared) earnings. In this particular area the reforms do not appear to have been very effective as Russian economists estimated that the share of shadow earnings was high (about one-third) in 2003. It is believed that the unified social tax which imposes a heavy tax burden is the main cause of evasion. In addition, evasion is facilitated by low risks of being detected.

In addition, some economists have suggested that the institutions – particularly in the former centrally planned economies - that govern the economy are to blame for the emergence of informal economies. Overregulation, corruption and a weak legal system bear primary responsibility for driving businesses underground. In other words, it is not higher taxes per se but the ineffective and discretionary application of the tax rules and government regulations. An inefficient and corrupt state finds it difficult to draw business out of the shadows – no matter what the tax rates are – if overregulation remains a tool for predatory actions by public officials. It has been found that private firms, in response to the above-described features of the business climate, tend to underreport their revenues. In general, hiding output is driven by low benefits of operating officially and low costs of crossing over to the unofficial economy. Specifically, businesses hide their revenues to escape over-regulation, taxes and corruption.

6 “Informal” markets are considered here to be equivalent to “underground” markets: they feature unreported income from the production of legal goods and services, either from monetary or barter transactions. See F. Schneider, Size and Measurement of the Informal Economy in 110 Countries, available at Doing Business, worldbank.org or F. Schneider and D. Enste, Informal Economies: Size, Causes and Consequences, The Journal of Economic Literature, 38/1, 2000, pp.77-114.

7 The concept of informal markets is also difficult to define. For alternative classifications, see UNECE, Non-Observed Economy in National Accounts, Survey of National Practices, Geneva, 2003.

8 Russia: Tax reform’s impact has been less than hoped for, Oxford Analytica, 26 March 2004.

9 It should be noted that in many cases the lack of administrative capacity, experience and skills are often a factor limiting the ability of governments to draw business out of shadows.

Figure 4 illustrates the most recent estimates of the shares of informal economies for 40 UNECE/OSCE member states. The estimates range from about 9 per cent to two-thirds. In general, the OECD members appear to have the lowest shares of informal economies while some countries of the former Soviet Union have the highest.

### II. Macroeconomic stability

Macroeconomic stability is one of the most important elements of friendly investment climate. In general, macroeconomic stability relates to government’s responsibility for the objectives of full employment, economic growth and the balance of payments, using the instruments of fiscal, monetary and exchange rate policies. Ideally, the goal of macroeconomic stability would be achieved by assigning fiscal policy to address full employment, monetary policy to ensure low interest rates and exchange rate policy to target commercial policies. In practice, however, major difficulties and challenges to governments arise when not all interrelationships between these targets and policy instruments are taken into account. Therefore, governments have continued to apply multiple policy instruments in an attempt to simultaneously achieve the desired policy outcomes.
Recent economic developments in the UNECE region show promising impacts of greater economic stability and growth. They also point out to longer-term structural imbalances and vulnerabilities that are significantly related to security risks. A number of factors that significantly affect macroeconomic stability include, but are not limited to, the growth in GDP, price stability, financial stability, fiscal and current account balance (Table 1).

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<tr>
<th>Major economic indicators, UNECE region, 2003</th>
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There is increasing evidence that a global recovery finally took hold in the second half of 2003. The recovery is being led by the United States, where economic activity accelerated in 2003, supported by robust domestic demand, largely reflecting a very expansionary economic policy. Real GDP rose by 3.1 per cent in the United States in 2003 compared with the preceding year. Additional support for the global recovery has come from the cyclical upturn in Japan and the continued strong growth in Asian emerging markets, notably China and India. In the United Kingdom, moreover, economic growth has regained strong momentum and continues to be more closely aligned with the United States’ growth cycle rather than with that in continental Europe.

The forces for a recovery, however, still look fragile in the euro area, where domestic demand has remained weak and the impact of the sharp appreciation of the euro on exports has been offsetting the stimulus from an easing of monetary policy. Economic activity has been particularly sluggish in France, Germany and Italy, the three major economies of the euro area. The aggregate fiscal policy stance in the euro area was slightly restrictive in 2003.

In the euro area, which remained the principal “weak spot” of the global economy in 2003, real GDP rose by only 0.5 per cent. For the European Union as a whole, real GDP rose by 0.8 per cent in 2003, slightly more than for the euro area because of the resilient United Kingdom economy. For western Europe, the aggregate annual rate of economic growth was 0.9 per cent in 2003, down from 1.3 per cent in the preceding year.

The disappointing overall performance of most of the current EU member states contrasts with the strong economic growth in the ten countries that has joined the Union in May 2004. Real GDP in these ten countries combined rose by 3.6 per cent in 2003, up from 2.5 per cent in 2002. Had these countries already been members in 2003, annual growth of real GDP in the enlarged Union would have been 1 per cent, i.e. 0.2 percentage points higher than for the EU-15. This small improvement reflects the relatively small economic weight of the accession countries, which currently account for only some 5 per cent of the nominal GDP of the enlarged EU.

Aggregate GDP growth in eastern Europe accelerated to 3.8 per cent in 2003, almost one percentage point more than a year earlier. This was largely due to the recovery in eastern Europe’s largest economy Poland: after two years of near stagnation, growth in Poland gained momentum during the year and GDP rose by 3.7 per cent.

For the region as a whole, domestic demand remained (as in 2001 and 2002) the principal source of growth; with very few exceptions, net exports pulled down the growth of output. Thanks to the ongoing restructuring of the east European economies and the expansion of their productive capacity, domestic suppliers were able to benefit from the strong domestic demand. Improved financial intermediation and an expanding credit market, a consequence of successful banking reforms, also contributed to the general strengthening of economic activity in the region.
After some deceleration in 2002, economic activity in the CIS region surged in 2003, led by rapid growth in Russia. Aggregate GDP in the CIS grew by 7.6 per cent, making it one of the fastest growing regions in the world. A combination of favourable external conditions (especially higher export prices for oil and gas) and a continuing strong recovery in domestic demand contributed to this outcome. The enduring buoyancy in domestic demand – reflecting growing consumer and investor confidence in many of the CIS economies – is a sign that the difficult reforms in these transition economies are finally starting to bear fruit.

The average rate of growth in the CIS reflects the strong performance of the region’s largest economies, Russia, Ukraine and Kazakhstan, where GDP increased by 7 to 9 per cent. Apart from the factors outlined above, the strong upturn in Russia was also underpinned by an expansionary monetary policy. There were also signs of a deeper and more extensive restructuring of the Russian enterprise sector, partly in response to growing competitive pressure.

Consumer price inflation in the euro area averaged 2.1 per cent in 2003, slightly less than in the preceding year and marginally higher than the ECB’s definition of price stability. Price developments in the course of 2003 were influenced by the fall in oil prices after the first quarter of 2003, which brought about a significant fall in overall energy price inflation. The economic downturn has continued to take its toll, albeit modestly, on the euro area’s labour markets. Employment fell slightly in 2003. The unemployment rate, which was 8 per cent in the last quarter of 2001 edged up to 8.8 per cent in March 2003 and remained there for the rest of the year. Total economy labour productivity increased very modestly in 2003, reflecting the combination of moderate gains in output and relatively stable levels of employment.

Disinflation in most of the east European economies continued in 2003, for the third consecutive year. With few exceptions, annual rates of change in consumer prices fell to historic lows and well below the reduced official targets; in some of them inflation was even below the EU average of 2.1 per cent. There were some signs of improvement in the east European labour markets in the first three quarters of 2003. Employment in the region stopped falling and in most countries unemployment fell. The current improvement follows several years of adjustment in the east European labour markets that involved a massive relocation of labour as part of an intense process of enterprise restructuring. Unemployment rates remain very high in many countries. In November 2003, the total number registered as unemployed, although some 300,000 less than a year earlier, amounted to 8 million people and the average unemployment rate was close to 15 per cent of the labour force.

The downward trend in inflation, which started in 2000 and accelerated through 2002, came to a halt in 2003. With few exceptions, the increases in consumer prices were larger than in 2002 and they exceeded even the more pessimistic official forecasts made in the second half of the year. Bad harvests, both in the spring and autumn, led to large increases in the prices of food. With respect to labour markets, in contrast to developments in eastern Europe, the recovery in the CIS is so far characterized by “jobless growth”. One of the possible explanations for this is that it partly reflects a delayed adjustment due to the considerable levels of excess employment, mainly in the form of unpaid administrative leave and part-time employment in the CIS economies. This type of labour hoarding has largely disappeared in most of eastern
Europe but in the CIS the relocation of this excess labour is only slowly getting underway in some of these countries.

The protracted economic slowdown and the associated impact of automatic stabilizers left their mark on government budgets in 2003. In general there was a rise in budget deficits or a fall in surpluses, which in some countries also reflected budgetary slippages. In France and Germany deficits were significantly above the threshold of 3 per cent fixed in the Stability and Growth Pact. Given the absence of special factors, which allow for a temporary “excessive deficit”, this was the second consecutive year in which the rules of the EU’s fiscal framework were broken. For the euro area as a whole, the weighted average budget deficit rose to 2.7 per cent of GDP in 2003, up from 2.3 per cent in 2002. Changes in cyclically adjusted budget deficits suggest that fiscal policy, on average, was slightly restrictive in 2003. The level of general government gross debt in the euro area rose to more than 70 per cent of GDP in 2003, up from 69 per cent in 2002. Debt levels are below the 60 per cent Maastricht ceiling in only 5 of the 12 euro area member states (Finland, Ireland, Luxembourg, the Netherlands and Spain). In Belgium, Greece and Italy, the debt ratios have been declining in recent years, but they are still more than 100 per cent of GDP.

With the gradual improvement in the external environment in 2003, the macroeconomic policy focus throughout most of eastern Europe shifted, albeit slightly, from targeting aggregate demand (a major preoccupation during the global slowdown) towards targeting macroeconomic equilibrium. Mounting concern about macroeconomic imbalances in some countries also encouraged such a shift in the focus of policy and there was a notable tightening of fiscal policy in a number of east European economies. Almost all east European countries reported shrinking or unchanged general government deficits in 2003. The average deficit in eastern Europe fell from 4.1 per cent in 2002 to 3.1 per cent in 2003. In Poland and Serbia and Montenegro, there was a further widening of already large general government deficits. And although there was some reduction in the deficits of Albania, Croatia, the Czech Republic, Hungary and Slovakia, they still remained large and a source of policy concern. Recently there was also a worrisome rise in the levels of public debt in Hungary and Poland. In only half of the EU acceding economies (the three Baltic states and Slovenia) were fiscal deficits within the Maastricht deficit target in 2003.

In recent years fiscal policies in most CIS economies have been dominated by the drive to correct large deficits. As a result, general government deficits in the CIS region are, on average, considerably lower than those in eastern Europe. The strong recovery in activity – which has been underway for several years – has also helped improve the public finances throughout the region. The tentative estimates of the fiscal balances in the CIS in 2003 suggest that in the main there was no substantial further tightening of fiscal policy. Where government financial balances did improve in 2003, this was mainly a by-product of positive cyclical effects as solid output growth boosted public revenue. In addition, governments in commodity exporting countries, where taxes on commodity exports are price sensitive, benefited from the increase in world market prices. Thus, in Kazakhstan and Russia, increased general government surpluses were largely due to larger than projected oil-related revenue.

Despite a certain relaxation in some countries, government financial balances in most CIS countries remained in relatively good shape in 2003. With the possible exception
of Kyrgyzstan, fiscal balances do not seem at present to be a source of major policy concern. Moreover, most countries with relatively large deficits (such as Armenia, Kyrgyzstan, the Republic of Moldova, Tajikistan and Uzbekistan) envisage their further reduction in 2004.

The ECB reacted to concerns at the downside risks to economic growth by reducing its main refinancing rate, first by 0.25 percentage points in March 2003 and then by a further half a percentage point to 2 per cent in June 2003. Since then the stance of monetary policy has remained unchanged. Inflation is forecast by the ECB to fall below the 2 per cent threshold later on in 2004. Historically, nominal short-term and long-term interest rates are now quite low. It is estimated that a 1 percentage point decline in short-term interest rates will raise real GDP in the euro area by about half a percentage point after two years.

Two countervailing factors affected the stance of monetary policy in eastern Europe. On the one hand, the continuing fall in inflationary expectations (partly due to relatively moderate rates of imported inflation) justified some relaxation in the policy stance. However, the persistence of large fiscal imbalances, often coupled with current account deficits, limited such moves and some central banks even reverted to monetary tightening. Thus, despite some relaxation, the overall stance of monetary policy in most east European economies remained relatively tight.

With most exchange rates in eastern Europe now pegged to or targeting the euro, the major realignment of international currencies in 2003 has had important economic implications for these economies. As virtually all currencies in the region appreciated against the dollar, the east European economies have faced increased competitive pressure from countries whose trade is denominated in dollars, especially the south-east Asian economies, which are often competing directly with the products of east European countries. Exchange rate realignments per se did not cause much turbulence on east European financial markets. The few cases of turmoil in the foreign exchange markets (such as the attacks on the Hungarian forint) were related more to domestic rather than international factors.

An important development in east European financial markets has been a long-lasting boom in credit demand. This credit expansion is an indication of the rising confidence of both investors and consumers in these countries as well as an evidence of progress in the restructuring and modernization of their banking systems. The credit boom is all the more remarkable given the fact that real interest rates on credit (as well as nominal interest rate spreads) remain high in most east European countries reflecting the large risk premia still charged by local banks. It can be expected that interest rates in these economies will continue to fall (especially in the new EU members) and that this will fuel further increases in credit demand.

Progress in macroeconomic stabilization and the general lowering of inflationary expectations in the region allowed the central banks in a number of CIS countries to relax their monetary policies in 2003. Despite the general trend towards monetary loosening in 2003, real interest rates on bank credit remained relatively high in most CIS countries; however, this mostly reflected the high business risk premia still charged by local banks. Belarus and, partly, Russia are exceptions to this pattern but for different reasons. The banking system in Belarus is still largely unreformed and
the authorities have continued to intervene directly in its day-to-day operations. The steady flows of directed soft credit to local enterprises at negative real interest rates – allocated under political pressure – are effectively implicit subsidies to these firms. The result is a very weak banking system and persistent inflationary pressure generated by the excessive money creation. In Russia, the negative real interest rates on bank credit in 2002 and 2003 reflected the substantial loosening of monetary policy in these years when the main preoccupation of the monetary authorities was to prevent an excessive real appreciation of the rouble even at the expense of higher rates of inflation.

In general, the banking reforms in most CIS economies have not made much progress compared with that in eastern Europe and financial intermediation through the banking systems still plays a relatively limited role in these countries. The level of monetization is also still relatively low. Obviously, this is one of the policy areas where an acceleration of the reform process could bring significant and tangible economic benefits to the population at large. As shown by the experience of some east European countries, bank credit can operate as an important engine for the revitalization and modernization of the transforming economies.

III. Institutions

One of the necessary conditions for sustainable economic development – and for the creation of favourable investment climate - is to build institutions that support a market system. These institutions range from formal rules such as laws and informal customs that govern behaviour to mechanisms such as organizations or reputation that enforce these rules. Governments – as elected representatives of societies - play the key role in the design and implementation of formal institutions. The most comprehensive survey of investment climate to-date has confirmed the primary role governments play in shaping the investment climate.11 Figure 5 illustrates the percentage of respondents who rated specified areas as “major or moderate” constraints to doing business. Regulations, taxes, financing, political instability and inflation have been identified as key concerns for businesses around the world.

The common characteristic of all these major impediments to investment is their capacity to raise costs to investors. High taxes clearly raise costs and deter investment. Business and labour regulations as well as customs procedures impose direct costs while compliance with regulatory requirements may also raise costs indirectly by increasing the work burden. Business decisions are more costly when there is less certainty about government policies; when macroeconomic instability exists and when governments introduce laws and regulations in an unpredictable and inconsistent way.

The difficulty in financing also raises costs and presents a business impediment through high interest rates, limited access to credit, unreasonable collateral requirements and lack of credit information about customers. Figure 6 provides a ranking of 38 countries based on conditions in their domestic credit markets. The rating consists of the following sub-components: percentage of deposits held in private banks, presence of foreign banks, percentage of credit extended to private
sector and interest rate controls. In sum, the countries using a private banking system to allocate credit to private sector and those countries that have no interest rate controls in place command higher rankings.

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**Figure 6**
Credit Market Regulations, 2001

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**Note**: Scale from 0 (in principle, a state-owned banking sector allocates credit to state-owned enterprises) to 10 (a private banking system allocates credit to private sector).

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**Property rights:**

As alluded to above, private capital is unlikely to be attracted by countries where the institutional framework for market-based activity is deficient and/or protection of property rights is weak. Secure property rights are the foundation of incentives for individuals and firms to invest – simply put, without strong property rights, a

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12 Each sub-component is placed on a scale from 0 to 10 that reflects the underlying data. The sub-components are then averaged to generate the rating for credit market regulations. For more details on methodology see Economic Freedom of the World: 2003 Annual Report, Fraser Institute, fraserinstitute.ca.
company cannot be sure of its ability to lay claim to a business it builds. In general, market based transactions may be meaningless unless they are accompanied by secure property rights, the effective enforcement of contracts and just settlement of disputes. That is why protection of persons and property is the most important function of the government. Its key elements are the rule of law, security of property rights, and an independent and impartial judiciary.

In the ideal case, an environment of secure private property should feature effective government guarantees, courts that efficiently enforce contracts, a justice system that punishes those who unlawfully confiscate property and a corruption-free setting. In contrast, when property ownership is prohibited, or is predominantly state-owned, where a corrupt judiciary prevails and frequent expropriation takes place – property rights are considered to be insecure or non-existent. In such unfavourable circumstances, individuals have little incentive to engage in productive activities such as investing. In the context of foreign direct investment in the CIS countries, for example, it has been suggested that inadequate property rights protection (such as corruption, crime, theft and excessive regulation) are a key impediment to investing and doing business in the region.13

**Figure 7**

Legal structure and security of property rights, 2001

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**Note:** Scale from 0 to 10. The higher the rating, the greater the security of property rights

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Figure 7 provides a ranking that describes the security of property rights in 38 countries. In particular, it measures how well the protective function of government is performed. The ranking is a combination of five elements: judicial independence, impartial courts, protection of intellectual property, military interference in the political process and integrity of the legal system. The data contained in Figure 7 appear to be polarized: in the upper half, property rights are perceived to be clearly more secure in the OECD and developed western European countries (except Spain, Greece and Turkey) than in all former centrally planned economies. These latter economies, without exception, are placed in the lower half of the ranking. This situation is a reflection of one of the unfavourable legacies of decades of central planning where private ownership was discouraged or forbidden outright.

If economic development – as noted above - crucially depends on property rights and contracts enforcement, why would the governments decide not to provide an efficient legal system by deliberately choosing not to reform or not to invest in the legal infrastructure? Some have argued that low investment in the legal infrastructure may be the rational choice of policy makers. The so-called time inconsistency problem may arise where the incumbents bear the costs of reforming the legal system but do not reap the benefits; the incumbents may prefer more discretion in decision-making; and inefficient property rights may yield more tax revenues to the incumbent generating a disincentive for legal reforms. Other contributing factors include: rent-seeking activities or a status quo bias.

Government regulation of business:

All governments limit property rights by regulation. Regulation consists of governmental actions to control price, sale and production decisions of firms in order to achieve some public benefit. Typically, regulation aims to address market failures, to create and sustain competitive markets, to compensate for inadequate information, to ensure consumer safety or to meet some other social objective. Regulations are effectively a form of taxation. They are a cost that makes it more difficult for entrepreneurs to start and maintain a business. If regulations are unnecessary or designed and/or implemented inappropriately, they may limit a company’s ability to compete, distort its business decisions or deter investment entirely.

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14 Each of the five sub-components is placed on a scale from 0 to 10 that reflects the underlying data. The sub-components are then averaged to generate the rating for the security of property rights. The ratings are based on surveys done by PRS Group, The International Country Risk Guide (an in-house panel of experts) and by World Economic Forum, Global Competitiveness Report (a survey of business decision-makers). For more details on methodology see Economic Freedom of the World: 2003 Annual Report, Fraser Institute, Fraserinstitute.


16 All taxes increase costs of doing business so they deter investment, but well designed and implemented tax regimes aim at minimizing the adverse consequences. However, taxes are not discussed in this paper. For an overview of EU members and acceding countries tax regimes see, Tax Reform in the EU Acceding Countries, The Economic Survey of Europe, no.1, 2004, UN Economic Commission for Europe, Geneva, pp. 139-168.

17 For example, a recent study has found that Albanian government policies and regulations are “seriously flawed and characterized by over-complexity, lack of clarity and transparency, and investor unfriendliness. Bureaucratic delays, discretionary and arbitrary treatment, and high costs, including frequent un-official payments are common.” Albania, Removing Administrative Barriers to
Figure 8 presents a ranking of 34 countries illustrating the extent of business regulations. The ranking is made up of several components: price controls, administrative procedures, estimated time spent with bureaucracy, the ease of starting a new business and the necessity of paying bribes (e.g., additional “irregular” payments related to licences, permits, exchange controls, police protection and tax assessments). The ranking tries to identify the extent to which regulatory restraints and bureaucratic procedures limit competition and the operation of markets.

**Figure 8**

**Business Regulations, 2001**

The existence of excessive regulation not only imposes additional costs on businesses, but also often creates and supports – what is called - administrative corruption. Administrative corruption is bribery associated with the implementation of laws and regulations and it occurs when rent-seeking public officials design programs or apply the law in ways to maximize bribe revenues. Routine government actions give public officials power to allow a certain activity to take place. This “monopoly” power,

often accompanied by discretion, non-transparent or ambiguous procedures, permits the officials to refuse, delay or generally obfuscate the implementation procedures with the purpose of extracting bribes. As a result, citizens and businesses are forced to spend inordinate amounts of time dealing with bureaucrats. To minimize this, they frequently choose to pay a bribe. Clearly the economic costs of administrative corruption are higher than just the costs of paying up. The most immediate is the time spent away from productive activities such as managing a business to deal with red tape. Moreover, while paying a bribe can shorten the waiting time it also creates incentives to those with discretion to continue to introduce vaguely specified rules to generate more payoffs. The obvious policy measure to counteract administrative corruption is to eliminate the redundant regulations. Overall, there is need to shift the emphasis from regulating business operations to building institutions that facilitate business by supporting effective functioning of markets.

IV. Physical infrastructure:

Physical infrastructure is an important part of the enabling environment for economic growth. In many countries, however, access to quality infrastructure services is insufficient and significant financial resources are required to develop and/or enhance it. Global estimates suggest that average spending on infrastructure in order to meet the necessary needs in the areas of energy, transport, telecommunications and water would need to double (ie., to increase by up to five per cent of GDP). Clearly, financing this additional spending will be a major challenge. Similarly, in the OSCE region, many member states are unable to accumulate the needed resources for the purpose of investing and upgrading physical infrastructure due to fiscal constraints. Moreover, private investment in infrastructure faces a challenging regulatory and institutional environment in many countries, particularly in the former centrally planned economies (see Figure 9).

Additional financial resources are therefore necessary, but they are not enough. A more effective institutional framework that facilitates private sector involvement must accompany public investments in physical infrastructure. Because both domestic and foreign companies’ investment decisions are influenced, to some extent, by the state of physical infrastructure as well as government actions and policies towards infrastructure provision, the overall improvements in institutional capacity will not only make infrastructure investment more attractive but will also have spillover effects for investments in other areas.

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18 D. Kaufmann and S-J. Wei, Does “Grease Money” Speed Up the Wheels of Commerce?”, NBER Working Paper No. 7093, April 1999 have found that “firms that pay more bribes are also likely to spend more, not less management time with bureaucrats negotiating regulations, and face, higher, not lower, cost of capital”.

19 Meeting the needs for infrastructure service provision requires mobilizing resources from all sources: domestic, foreign, private and public. Traditionally, about 70 per cent of infrastructure spending has been publicly funded, the private sector has contributed about 20-25 per cent while the rest has come from the official international development assistance.

V. Conclusions:

Given that entrepreneurship exists everywhere, what attracts and sustains investment? First, investors – both domestic and foreign - require a stable macroeconomic environment. Moreover, market economies are based on the principle that economic players are free to enter into agreements. These contracts must be honoured and enforced by both authorities and the legal system.21 As a result, the second requirement is the presence of essential institutional and legal infrastructure for a market economy. In this respect, for investors the rule of law is paramount.

Property law defines private ownership that is obtainable, definable and transferable for all kinds of assets from real estate to copyright. Corporate law must promote entrepreneurship while providing protection for shareholders, workers and the public against mismanagement and fraud through information and accounting standards. Financial law has to ensure safe, sound and efficient banking practices along with corresponding prudential regulations that minimize the risk of bank collapses.

21 For more see REF.SC/2/97 paper distributed at the Fifth OSCE Economic Forum, Prague, 11-13 June 1997.
Competition law prevents the establishment of monopolies, predatory market dominance and uncompetitive practices.

In addition, there are laws that regulate government’s activities. Tax laws provide societies with the necessary revenues to pay for goods that benefit society as a whole or to redistribute incomes from the wealthy to the needy. Social and labour laws aim to provide a sense of security and stability through the provision of unemployment benefits, pensions, medical care and collective labour agreements. All these various legal fields must interact with each other in a consistent fashion ensuring their overall cohesiveness.

Once there is consensus among the market participants that economic activities – including investment – are governed by the rule of law: laws must apply to all equally. Entrepreneurs also require stability because investment requires long-term planning. If laws are not predictable – subject to arbitrary changes – investment will be discouraged. Laws need to be clear because textual clarity reduces uncertainty. Finally, in case of disagreements, equal, timely and cost-effective access to litigation must be provided and subsequent verdicts must be enforceable and enforced.

In closing, investment climate (and prosperity in general) depends on three building blocks: macroeconomic stability, institutions and physical infrastructure. In particular, it depends crucially on setting up institutions that are necessary to support economic growth and structural change. The fact that these institutions are rooted in a complementary framework of moral values, social traditions and political institutions is often ignored. Institutions are also the result of a long evolutionary process. The outcome of this process depends on the rate at which the underlying moral and social values respond and adapt to new problems, tasks and challenges. In economies where economic and social institutions do not perform effectively, there can be no presumption that private entrepreneurs will invest nor that investment – if undertaken - will lay the foundation for sustainable growth and higher standards of living.

Section B: Draft Methodology of the Review of OSCE Commitments in the Economic and Environmental Dimensions of Security

The first phase: review of the Bonn Document

The UNECE has been asked on an annual basis to review OSCE commitments in the economic and environmental dimension of security since 1996. The first (and last) comprehensive review – based on the 1990 Bonn Document – was conducted in 1996, requiring considerable resources. The Swiss Chairmanship summarized the role of the OSCE in the economic and environmental field the following way: “It is commonly understood that the comparative advantage of the OSCE lies in the fact that, in its economic dimension, it deals with economic issues which have a direct bearing on security. The cutting edge of the OSCE lies precisely in this multidisciplinary approach. It was commonly agreed that the OSCE should not duplicate the activities of existing economic organizations in their respective fields of competence but should co-operate closely with them, inviting them to pay special attention to problems, which have security implications.”
The subsequent reviews (1997-2003), using, as before, existing resources of the UNECE were more limited in depth and detail, still served their purpose: they generated a substantial discussion on the subject at the annual meetings of the Economic Forum of the OSCE. The discussions were to put peer pressure on governments to improve the implementation of the commitments they had agreed to. The effectiveness of the whole review process, however, has been somewhat weakened by the gradual decline of the interest and the level of activity of the participants and the lack of systematic follow-up.

The commitments contained in the Bonn Document focus on issues which were (and still are) important for the transition from command to market economy and improving east-west economic cooperation: development and diversification of economic relations, industrial cooperation, cooperation in specific areas, like energy and raw material saving techniques, environmental issues and the exchange of know-how as well as the reform of monetary and fiscal systems. Since then a number of countries have graduated from the transition phase by joining the European Union and others prepare to join it. This requires a new approach to the review.

The UNECE has repeatedly signalled that the review process should be refocused and strengthened. The 2002 UNECE review remarked: “…it is also worth reflecting on ways of improving the modalities of the review process. There are several new approaches that might be considered. One approach might be to set benchmarks of good practice…” The joint UNECE-OSCE seminar in July 2003 in Villars, Switzerland discussed new concepts of and approaches to conflict prevention and security in the economic and environmental dimension. At the September 20, 2002 meeting of the OSCE Sub-Committee on Economic and Environmental Activities, the UNECE representative presented a paper entitled: “A Proposal on Formulating New Commitments under the OSCE Economic Dimension”.

A new phase: the Strategy Document

The OSCE Strategy Document for the Economic and Environmental Dimension adopted at the 11th Ministerial Council in Maastricht brings the commitments in line with new political, economic and social developments. It focuses on the new challenges and threats in the economic and environmental dimension and on effective cooperative responses to them. It covers a number of new areas, like integration into the global economy, regional integration, market access, investment, small and medium-sized enterprises, transport, good governance, transparency and the fight against corruption, human capital development and sustainable development. It not only pays more attention to issues directly linked to security in the economic and environmental dimension but also calls for improving the review of implementation of commitments as well as strengthening the capacity of the OSCE to mobilize advice and assistance from other organizations.

The Strategy Document is a great step forward: it adopts a more integrated approach and facilitates an effective and coherent response to new challenges to security, which are either in the economic and environmental field or are directly related to it (e.g. weak governance, trafficking in human beings, illegal migration, organized crime, corruption, drug smuggling). The effective implementation of and full use of the potential offered by the Strategy Document very much depends on whether the
commitments contained in it will be reviewed in a regular, coherent and professional manner with the active participation of all stakeholders.

The UNECE – as the main partner of the OSCE in the review process – has recently undertaken considerable efforts to develop new methodologies for the review. The UNECE team of the Inter Secretariat Task Force has worked on a number of closely related issues, including objectives, methodology and structure of the review, as well as resource requirements. It has been the understanding of the UNECE throughout this process that a decision on the frequency, structure, methodology and comprehensiveness of the review, as well as on resource implications (directly linked to requirements) will have to be taken by the OSCE.

Objectives

A number of international organizations, institutions as well as banks and private companies e.g. the OECD, the World Bank, IMF, EBRD, UNEP or the Economic Intelligence Unit monitor and analyze developments in the economic and environmental domain. Their analyses cover the majority of specific issues (contained in the form of commitments) in the relevant OSCE documents, from the point of view of the reviewing institution or organization (investment promotion, economic reform, macro-economic stability, human security, poverty alleviation). Large, highly specialized and professional teams, capable of independent research regularly produce analytical reports, periodically discussed by experts and policy-makers. In order to avoid duplication and overlap, the objective of the OSCE review of commitments should be clearly defined: methodology depends on the objective. The distinguishing feature of the OSCE is that its review process focuses on those developments in the economic and environmental dimension, which are most important for stability and security in its area as well as its ability to mobilize advice and assistance from other organizations through appropriate policy recommendations.

Methodology

The implementation of OSCE commitments in the economic and environmental dimension of security is measured by various methods depending on the particular field they concern: relevant internationally recognized indices, statistical data, soft measurement based on peer reviews or reviews in the field, benchmarks set by authoritative international organizations and institutions, accession to and implementation of relevant conventions and international agreements. The combination of two or more of these methods considerably increases the accuracy, comprehensiveness and reliability of the review.

A comprehensive review of an increased number of commitments (Bonn Document plus the Strategy Document) based on the combination of the above methods would inevitably increase the resource-intensiveness of the process. It necessitates the involvement of several international organizations and institutions: a professional review of the new set of commitments would require a broad array of expertise going beyond the capability of a single international organization or institution. It would take a significant amount of coordination and effective leadership throughout the process to ensure that high quality inputs from various fields of expertise are merged into a coherent and well-structured document.
In order to facilitate efficient coverage of a large number of rather general commitments and the coordination of different contributions by partner organizations as well as to offer an opportunity for a reasonable spread in time of the increased tasks (e.g. in the form of annual focused reviews), the Inter-Secretariat Task Force proposed to form five clusters from OSCE commitments in the economic and environmental dimension of security (1. Integration, Trade and Transport 2. Investment Climate 3. Public and Corporate Governance 4. Poverty, Social Exclusion, Education 5. Environment, Energy and Sustainable Development). UNECE in-house expertise covers a significant part of commitments in these clusters but not all of them. Therefore only the involvement of other organizations and institutions can ensure the required degree of professionalism of the review process.

**Strengthening the capacity of the OSCE to mobilize advice, assistance and improve coordination: a combination of monitoring, review and early warning**

The regular monitoring and review is directly linked to a future joint UNECE-OSCE early warning mechanism in the economic and environmental dimension of security, foreseen in the Strategy Document. While early warning theories and methodologies usually emphasize the importance of a comprehensive approach (which includes the political, military, human, economic, environmental dimensions of security), in reality organizations, institutions and NGOs active in this field rarely have the capability and capacity to look at the whole picture: in most cases they tend to concentrate on those indicators/fields where they have readily available expertise.

The OSCE has a network of missions which – together with its institutions, like the Office of Democratic Institutions and Human Rights or the High Commissioner on National Minorities – regularly monitors, analyzes and reports on processes and developments relevant for early warning, primarily in the politico-military and human dimensions and to a lesser extent concerning the economy and the environment. The UNECE on its part has professional in-house expertise and analytical capability and it is the custodian of a number of international conventions (plus standards and recommendations) in the economic and environmental dimension, which can be used for the monitoring of developments in these areas. The newly developed joint early warning mechanism in the economic and environmental dimension of security should be fully integrated with similar activities carried out by OSCE in other dimension of security.

The joint UNECE-OSCE early warning mechanism should provide for the selection, fusion and analysis of relevant indicators. It should be sensitive to differences in culture, tradition or the level of social and economic development. Its trigger mechanism should be built on the recognition that it is the inter-linkage among a broad variety of factors, which can reveal emerging risks and challenges to security. The end result should be a truly comprehensive early warning mechanism, covering all dimensions of security, owned by all member States of the UNECE and OSCE.

The new early warning mechanism should strengthen synergy among on-going efforts through a new approach to coordination and information exchange with partners. It should facilitate early responses to emerging threats and challenges, without overlaps and duplication. It should provide effective support to the stabilization strategies of
the international community, giving timely warning of developments that might negatively effect implementation.

The joint work should not just concentrate on the indicators and the mechanism itself. Parallel efforts should also be made to improve general conditions for the functioning of the mechanism. As several studies on conflict pointed out, scarcity and unreliability of statistical data and other relevant information concerning potential areas of instability makes early warning and early action very difficult.

The precondition of a reliable early warning mechanism in the economic and environmental dimension of security would be the improvement of the local statistical apparatus as well as monitoring and analytical capabilities where it is necessary. Properly disaggregated and reliable data in relevant areas and the insight of well-trained local monitors, specializing in economic and environmental matters, would significantly improve the accuracy of early warning. The UNECE has considerable in-house expertise to provide the required technical assistance in the field of statistics as well as economic and environmental monitoring and analysis.

Insufficient transparency too, puts severe limitations on the accuracy and reliability of any early warning system. The UNECE could assist member States to overcome these problems by acceding to relevant international instruments (e.g. the Aarhus convention) and properly implementing them.

The way forward

The UNECE Inter Secretariat Task Force has identified a number of options concerning the methodology and structure of the reviews. It is up to the OSCE to decide how it wants to review its commitments in the future. The UNECE Secretariat – in line with the decisions of the 59th annual session of the ECE – stands ready to continue the decade-long fruitful cooperation with the OSCE in the review of commitments in the economic and environmental dimension of security.