Organization for Security and Co-operation in Europe

Review of the implementation of economic dimension commitments contained in the Document of the Bonn Conference on Economic Co-operation in Europe

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EXECUTIVE SUMMARY AND MAIN CONCLUSIONS

Objective of report

1. The purpose of this report is to review the commitments made by the participating states contained in the 1990 Document of the Bonn Conference on Economic Cooperation in Europe. Before summing-up each chapter, a few general conclusions are proposed.

Main Conclusions

2. The Bonn document was a notable success in the history of the CSCE and OSCE process. Despite wide ranging differences amongst the states and at a time of great political turmoil within many states participating in the Bonn Conference, they, nevertheless succeeded in agreeing on a remarkably consistent set of principles. The document is indeed worthy of detailed review.

3. The document itself had three related but distinct objectives:

   (a) to highlight a strategy of economic reform for the countries whose economies had been centrally planned;

   (b) to agree on a framework of principles that would stimulate enterprise cooperation and investment flows in the region; and

   (c) to determine areas where inter-governmental cooperation should be promoted to advance these objectives.

4. However, although the document is consistent, it does not provide a completely satisfactory framework for analysing progress in meeting these three objectives. With regard to economic reform, it was silent on the need for systemic reform, i.e. privatization. In fact, the word transition, referring to the transition to a market economy, did not appear anywhere in the document. It was thus not a blueprint for transition to a market economy. The principles and measures of transition were only elaborated after the Bonn Conference took place. On enterprise cooperation and investment, while it covered the need for investor protection in 1990 quite well, it did not, or could not foresee, some of the other protections that have become necessary as privatization has rapidly developed, notably the need to protect passive investors and the rights of minority shareholders in enterprises which has become apparent in some CIS countries. It also failed to enunciate the concept of a liberal investment regime where policy distortions are kept to a minimum and which forms the best basis for developing inter-enterprise cooperation and international investment. Finally, with respect to inter-governmental cooperation, it did not identify actual projects for financing or indeed commit any participating states to make financial contributions in order to implement proposals and projects.

5. The following presents the conclusions on the extent to which the participating states have complied with these three main objectives. However, the above-mentioned shortcomings should be borne in mind. It should be noted too that because these objectives referred principally
to the countries of central and eastern Europe and the Soviet Union, the analysis focuses on the extent to which the economies in central and eastern Europe and the CIS have complied with these commitments, not western countries. In addition, another purpose of the Bonn document not referred to here, should also be noted, i.e. to enhance economic cooperation to promote greater political security in the region. Security problems emerging from the evolution of the economy, e.g. income distribution or unemployment will be left for discussion at the OSCE Conference in Prague in March 1996, as their significance can only be considered in relation to political, ethnic and social considerations. Similarly, the necessary cooperation for fighting against crime and corruption which can particularly threaten small states was not addressed.

Economic Reform

6. On the progress of economic reform the first and most important conclusion to recognize is the achievement of the Bonn document in enunciating a broad strategy for reform which has been embraced by every participating state. The commitment of the countries which participated in the Conference to the implementation of this strategy is confirmed by the reforms which they have undertaken. And, it is of political significance that the newly independent states which emerged afterwards, following the dissolution of the USSR and Yugoslavia as well as from the separation of Czechoslovakia, have chosen to follow the same strategy. Furthermore, the states have embraced the principles so completely - very often the actual reforms have been much more radical and far reaching than envisaged in the Bonn document - that a return to the old system is now virtually unthinkable. Of course, there will continue to be problems. Many have been mentioned in this review. But the encouraging aspect has been the way in which problems have emerged and then been overcome. This conclusion, that despite serious difficulties the ultimate goal will be achieved, does offer considerable hope to the countries which have furthest to go in becoming fully fledged market economies.

7. There is no room for complacency however. At the macroeconomic level - prices, trade, currency and monetary policy - reforms have been made quickly. In contrast, at the microeconomic level, reforms have not taken root as well. Difficulties have been encountered in the establishment and functioning of new institutions by lack of resources and well trained staff. Similarly, internationally agreed conventions and norms are not effectively applied because domestic laws have not been adopted or because of the lack of monitoring capacities. Much has still to be done to permit various agents to work effectively in this new framework. Administration, lawyers, professional groups, entrepreneurs - all these have to be properly integrated to make the micro-economy work more effectively.

8. The impact of reforms has also been unequal from one country to another because of the lack of continuity in the approach adopted or because of political resistance. This, plus the fact that the reform process was initiated at different times, explains the great diversity in situations. The reforms in the CIS countries, for example, which have not advanced so fast, only began just over three years ago or even less, much later than in central and eastern European countries, many of which had begun their reforms six or indeed seven years ago.

9. The economic and social costs too have been much higher than anticipated, and this has been felt by each member of the population. Benefits have failed to trickle down from the relatively small groups where reform has brought substantial benefits. The divergence between the hope of reforms and the sobering reality has probably been the single most important factor
behind the recent changes in the political climate in the region. This poses a serious challenge to policy makers, politicians and the international community and requires more, not less cooperation and solidarity with the transition economies.

Enterprise Cooperation and International Investment

10. The conditions for enterprise cooperation and international investment have improved dramatically. The legal restrictions on establishing enterprises have been removed in most of the countries of central and eastern Europe and only in a few CIS countries do the residual vestiges of the old investment regimes remain. Here too progress continues at a rapid pace. There are few if any major restrictions on repatriation of capital and profits. The strengthening of local currencies and their convertibility means that companies can earn good profits in the region. Financing (referred to in Chapter D) is, however, difficult with local banks favouring only short-term maturities but the growing establishment of foreign banks is a positive sign of the increasing confidence in the region. Getting legal audits is now possible and well established even though it takes longer and costs more. Human resources have everywhere tended to be a success story. Few investors have been disappointed in the calibre of human resources which they have found. Foreign investors have become substantial employers and have encountered no significant problems with trade unions and the local workforce either. Crucial in the success of this opening up has been the elimination of obstacles to exports on western markets, particularly to the European Union as a result of Association Agreements and other arrangements, although improvements are required in the area of agriculture and high technology products. Trade facilitation techniques need to be improved too at all borders and amongst all business operators for integration to be more effectively achieved.

11. The quality of local partners has also made rapid progress although the formation of small and medium-sized enterprises has been slower than hoped due to the difficult economic situation and the problems of obtaining financing from local banks. Multilateral institutions such as the EBRD have been active in this area to improve the access of SMEs to lines of credit. Overall the conditions for doing business have improved notably.

12. Even so, the volume of investment is still too small, particularly to the CIS. This review has tried to identify why investment has not kept in line with the opening up of markets. At the beginning of the reforms, most Governments had thought the removal of barriers would lead automatically to a flood of foreign capital. The main difficulty has been the legal framework, enforcement, institutions that work and the new problem mentioned above but not alluded to in the Bonn document, namely organized crime and corruption. All of these factors have created a negative perception amongst the investor community and particularly amongst the most vulnerable, the SMEs. In addition, fears about political change are also attributable factors to this relatively poor performance in attracting investment. There is no doubt that most laws are now in place, that legal counsel has improved and that the court system is rapidly adapting. However, even when investors obtain a favourable judgement, there is no guarantee that it will be enforced. There are also problems of registering title and collateral although this is now more a problem in the CIS than in central Europe.

13. In response to this situation, cooperation and assistance from agencies involved in improving investment conditions - OECD, UN/ECE, World Bank, EBRD, etc concentrated first on the drafting of laws. However, much remains to be done. Cooperation between these
institutions should be developed to increase the impact of their efforts. The focus should be extended to monitor implementation and enforcement and how assistance can help in this area. Wherever possible, many private investors should be involved in this process. Although there have been investment meetings, there is no substitute for organizing forums between business and national Governments in order for discussions on improving investment conditions to take place. This has been recognized by several OSCE delegations. Participating States may also consider cooperation to develop multilateral principles on protection and promotion of investment that will reinforce national legislation and policy towards outside investors. Only by this effort of building sound frameworks will investors have sufficient confidence to invest the large sums of capital which the countries of central and eastern Europe and the CIS need.

Economic Cooperation

14. The Bonn document discussed cooperation not technical assistance. This is an important point. The last five years have seen a tendency for the countries to be demarcated according to donors and recipients and this line has sometimes created problems and difficulties and made assisted projects less effective. There is no doubt that allusions to west and east are less and less helpful. The initial tenet of the Bonn document has arguably been forgotten and should be rectified if cooperation is to become more effective.

15. Technical assistance has been useful in the design of legislation and rules and in training. It would also be helpful in the establishment of monitoring mechanisms, where it could be combined with some financial support. It has therefore to be pursued. Nevertheless, technical assistance is sometimes confusing and time consuming for recipient countries, and coordination has not proved to be efficient or feasible. International or national institutions providing assistance should therefore limit themselves to their area of expertise and recipient countries should exercise more judgement in the selection of advisers.

16. Exchanges of experiences and of information among officials or private actors, as suggested in many of the provisions of the Bonn document, have proved to be extremely useful and productive, provided that those involved have direct responsibility or expertise on the issue under discussion. They help economic actors to establish relationships and networks and decision makers to be informed of different possibilities and experiences before deciding on a policy. Neutral fora such as ECE and OSCE are well equipped, depending on the issue at stake, to organize such exchanges and to implement follow-up work.

17. In view of the high social costs of adjustment, especially affecting the old, unskilled and those employed by the state and the growing level of discontent with reform policies, official assistance should be aimed at developing projects which can increase both social stability and the commitment to reform. New projects should focus on retraining the establishment of social security provisions, and institutions for creating increased mobility in the workforce.

Final remarks

18. Governments should continue to implement the conclusions of the Bonn document and at the same time pursue new projects and areas which were not identified in the Bonn document and which have been singled out in the following report.
19. Governments, after selecting these key areas, may wish to give political impulses to appropriate organizations to carry out their proposals. For example, in view of the difficult investment climate in some states and their commitment, as expressed in the Bonn document, to create a favourable business environment, Governments may wish to consider developing a set of principles for the region on the protection and promotion of international investment which could assist some states in bringing their policies up to required international standards. In doing so they may wish to involve the private sector in the process.

20. Another suggestion in the light of the preceding remarks is to give thought, in the framework of reflections on economic security, to the social costs of economic reform in the region and on how economic cooperation should address this problem.

General findings

Chapter A. Development and Diversification of Economic Relations

21. In Chapter A the participating states agreed to cooperate to remove a number of legal, informational and structural barriers for each other's enterprises to establish in their countries, which had arisen as a result of their former relations and from the differences in their economic systems. It also provided several basic conditions and measures for the establishment of the private sector and the good functioning of the market economy.

22. One important barrier facing investors was the lack of information about the countries of central and eastern Europe and the Soviet Union. The Bonn document thus gave a high priority to improving information flows for decision takers and investors on the true performance of the economy and enterprises and to developing better statistics. Progress has been very substantial in the area of statistics since 1990 with willing cooperation between the countries themselves and the international agencies which are assisting them, but much remains to be done. All countries recognize the importance of good national account statistics and are adopting the international standard system of national accounts with varying degrees of progress. Production data in some major sectors are improving but still do not adequately track small and medium-sized enterprises. Balance of trade and payments data are now available including from most CIS countries although the move to new methods of data collection is still not complete. The need for the wide availability of statistics is now recognized by most Governments and is reflected in the cooperation amongst countries themselves and in the international agencies, coordinated under the auspices of the ECE Conference of European Statisticians.

23. Notwithstanding this progress in statistics, there has been much less advance in collecting and disseminating information on enterprises. The multiplicity of new enterprises and the hidden economy inevitably make data gathering very difficult and uncertain. The lack of reliable information on enterprises constitutes a considerable barrier to investment and capital market development in many of the economies of central and eastern Europe and improvement in preparing audited statements and in general market and business information services is required, particularly for the countries of the CIS.

24. In 1990, the barriers to the establishment of foreign enterprises in central and eastern Europe and the Soviet Union were considerable, e.g. limits on equity, exclusion from certain
sectors, arcane approval procedures, poor legal structure etc. In central and eastern Europe, the removal of these barriers has been rapid and impressive. A few CIS states, however, have continued to use approval and screening techniques in response to investor enquiries and have failed to clarify through legislation the sectors closed to investors. The Bonn document identified a number of practical difficulties - access to services, commercial premises, and to the recruitment of local staff etc. - in establishing an enterprise. In central and eastern Europe since 1990, these difficulties have, for the most part, been overcome. Services are available for all on a non-discriminatory basis and local labour markets have become very flexible. Some difficulties, however, have occurred in the acquisition or leasing of commercial properties due to slow progress in the liberalization of the property market as well as lack of access to information on enterprises as mentioned above. Difficulties are still apparent in the CIS.

25. The participating States correctly recognized that the free establishment of enterprises could not occur unless restrictions on businessmen entering their territories were removed. They stopped short of committing themselves to the free establishment of natural persons but did encourage the promotion of direct business contacts and free and unrestricted entry of businessmen into their respective territories. However, there are still many obstacles put in the way of business travellers, particularly those from eastern Europe. Some small CIS countries would benefit from the establishment of a basic investment promotion capability to provide businessmen with more information about their countries. In addition, businessmen sometimes encounter restrictions from their own Governments which, out of preoccupation with capital flight as well as with monetary and reserve problems, have limited the rights of their own nationals in establishing outside their territory.

26. The Bonn document did not address the considerable barriers to trade which existed in 1990 but instead urged improvements in processing goods across borders. Since 1990 the liberalization of trade has made substantial progress. However, the facilitation of trade, in contrast, remains a major problem due to the liberalization of trade itself and the introduction of new procedures, the lack of qualified customs officers and poor trade infrastructures. Electronic standards - notably UN/EDIFACT - can assist the Governments of transition economies in laying the groundwork for developing a more efficient trade system in the future.

27. The importance of promoting the development of small and medium-sized enterprises (SMEs) was strongly stressed. Indeed, they are widely considered to be one of the principal driving forces behind economic development in all economies. However, the honouring of this commitment has been patchy. Not all economies give the task of promoting the SME sector the priority it deserves. In the CIS countries the lack of legislation, financial resources, and limited understanding in the bureaucracy of the concept of entrepreneurship, have become major obstacles to developing effective policies for developing SMEs. Improvements are required in developing financial intermediaries more tailored to SMEs needs, in improving information on business development and in training. Despite considerable and much needed technical assistance, proper support infrastructures have not been developed. Technical assistance projects themselves need to be improved by becoming more demand driven and more centred around implementing Governments’ own policies on developing SMEs.

28. SMEs, as all enterprises, need adequate business operating conditions, including the access to export and business services. These have improved only marginally since 1990. The options facing many countries in the region, i.e. setting up an official export promotion agency, trade points, or developing links between businesses from western counties providing these
services with domestic companies, should all be considered. On the need for training managers, this is an ongoing problem but one which has, arguably, diminished in some central and eastern European countries due to the influx of FDI which has created a pool of capable local managers, as well as to the establishment of local training facilities with support from western management schools. Although training for managers continues to be required, particularly in the emerging financial sector, and for some CIS states, it can no longer be stated, as it could be in 1990, that the lack of suitably qualified local managers constitutes a barrier to the establishment of joint ventures and, FDI in the region.

29. Other barriers to establishment and economic cooperation, however, have emerged since 1990, the most disturbing being the rise of organized crime and official corruption. Where this is rife, it constitutes a strong disincentive to foreign companies, particularly small and medium-sized enterprises, to invest in these countries.

Chapter B. Industrial Cooperation

30. The participating States in this section identified conditions for creating a favourable climate for investment and industrial cooperation, listing a number of legal, institutional, and international measures. They were correct in focusing on the need to promote international investment as this almost always offers host countries significant benefits in terms of technology, management skills and technical know-how and capital even though in some countries, without proper enforcement of policies, it can have negative effects on competition.

31. It was not surprising that a key element in the Bonn document to create a favourable environment for investment was the protection of intellectual and commercial property rights. Such rights to private ownership had been severely restricted. Progress of certain countries in central and eastern Europe and the CIS in enacting laws to protect intellectual property has been impressive although enforcement - due to a lack of lawyers, judges and police experienced in this kind of "crime" - has been generally poor. The document was silent on the right of foreigners to acquire land and from hindsight this was probably a mistake. This right would permit investors from abroad more opportunities to plough their profits into the local economy giving them more ability to raise capital for their business plans and it would also serve as a catalyst to developing a viable market in land. Most countries in central and eastern Europe continue to restrict foreign ownership of land while most CIS countries prohibit foreign ownership altogether. Alternatives to ownership, such as leasing, might be offered to foreign companies.

32. A reliable legal framework is a basis for attracting FDI and promoting industrial cooperation, consisting of fiscal, insolvency, company and arbitration laws, investment protection, accounting systems and a well-functioning administrative framework. Generally speaking, many of these laws have been enacted but problems have occurred in enforcement. First, the skills required are insufficient. Enforcing competition laws, for example, demands a specialized knowledge of the role of enterprises in a market economy and the ability to identify the precise activities of an enterprise responsible for generating a monopoly structure, and the ability to draw-up plans if necessary for an effective break-up of the enterprise concerned. Second, many of the institutions are not in place to record property rights. This is true for registers of various types of security. Thirdly, new practices based on new laws cannot be changed overnight and need to be administered and implemented by various professional groups which in many countries in central and eastern Europe are underdeveloped. Finally, there are not
enough lawyers and judges competent in civil and commercial law that are experienced in drawing up and enforcing contracts.

33. A related problem has been the difficulties for countries in central and eastern Europe and the CIS in fulfilling the recommendation to develop the necessary systems of disseminating information about recently enacted laws. In part this problem is due to the speed of the legislative programme itself. The systems cannot cope with the huge volume of new legislation which is coming on to the statute books. It is also due to the poor quality of the public administrations in several CIS countries, a function of very low pay, and to official obfuscation, a legacy of the old times when legal information had only a restricted circulation and was at the discretion of those in power.

34. Given the weaknesses in domestic legislation at that time of countries in central and eastern Europe and the CIS, the Bonn document thought to emphasize the need for a further layer of security to investors through bilateral and multilateral arrangements for the protection and promotion of international investment. More progress in complying with this recommendation has been made bilaterally than multilaterally. In terms of investor protection and promotion, many new bilateral treaties have been signed amongst the participating states. Several eastern European countries have also signed Association Agreements with the EU and several CIS states have concluded special partnership and cooperation agreements with the EU which contain agreements on mutual protection of investments. The commitment to develop multilateral standards on the protection and promotion of investment is currently being implemented by the OECD and should be finalized in late 1997. OECD is at present the only forum where multilateral guidelines are being drawn up, although without the participation of all of the participating States of the Bonn document. The Energy Charter contains state-of-the-art provisions on salient problems faced by investors in all the region but covers only the energy sector.

35. The difficulties which some of the participating states have had in creating an environment conducive for investment are reflected in the disappointing figures on foreign direct investment to the countries of central and eastern Europe and the CIS. The CIS countries in particular, despite huge natural resources and large markets have not attracted a significant volume of FDI. Those few central European countries which have managed to do so generally have enjoyed the benefits which were expected. Accordingly, production quality has been improved, consumer goods have been expanded, and domestic products have benefited from the wider marketing opportunities provided by foreign firms. However, there has been less evidence of technology transfer, investments in high technology or cooperation between enterprises from western countries and enterprises from central and eastern Europe and the CIS in technology partnerships with firms from western countries than was hoped. Cooperation remains at the low end of the technology spectrum even though as a result of the new technologies this is not always easy to define.
Chapter C. Cooperation in Specific Areas

36. Chapter C of the Bonn document urged Governments to cooperate to promote the use of energy saving technologies and to separate and recycle waste components through establishing information databases and by undertaking various projects and programmes. In fact, several multilateral and bilateral programmes have been established to promote energy efficiency, such as the Energy Centres established by the European Commission and the UN/ECE Efficiency 2000 Project, and database networks have been developed. Numerous national energy conservation agencies have helped to disseminate information and to develop business cooperation. The multiplication of local demonstration zones and more exchanges of experience would accelerate the process.

37. Progress within each participating State in developing energy saving schemes has, however, varied. The groundwork has been laid in the form of new institutions, regulations and legal structures. Progress would be more significant if new equipment such as energy meters were installed and monitoring mechanisms put in place. This should be accompanied by the lifting of controls on energy prices, the introduction of environmental taxes and incentives, the promotion of new environmentally sound sources of energy, the encouragement of foreign investment and new financing arrangements for the transfer of energy saving technologies.

38. In the field of environment, the participating States of the Bonn document urge Governments to strengthen international cooperation, promote public awareness about environmental issues, develop and standardize the practice of environmental assessment and monitoring, encourage the participation of enterprises in this work and give priority to techniques designed to promote the health and safety of their populations. Overall the participating States have made progress in all these areas.

39. Following the decision of the 1989 Sofia CSCE Meeting on the Protection of the Environment, States adopted, under the auspices of the UN/ECE, two Conventions in 1992 on the Transboundary Effects of Industrial Accidents and on the Protection and Use of Transboundary Watercourses and International Lakes. The Conventions themselves have increased public awareness and helped to strengthen the role of NGOs, the private sector and the public at large in decision-making. More follow-up work, i.e. training, legal advice, will be required, however, if these Conventions are to be effectively implemented. Similarly, commitment to monitoring has improved with the adoption, under UN/ECE auspices, of a Convention on environmental impact assessment. But, recommendations for developing standardized approaches for pollution monitoring, have not been implemented at the national level due to insufficient financial and human resources. In all the region industry, too, has become more active since 1990 in improving the efficiency of its technologies, infrastructures and waste disposal systems although progress has been slower in the countries of central and eastern Europe and the CIS due to the lack of financial resources to introduce the necessary technologies.

40. Progress in cooperation in the sector of food processing, production of consumer goods and in the manufacturing of food production equipment has been significant in central and eastern Europe, less significant in the Russian Federation, but very limited in the other CIS countries particularly due to the slowness of privatization in these sectors. The idea noted in the Bonn document in this context that the conversion of military to consumer production may give rise to new business opportunities did not materialize for military, financial and social reasons. It seems, however, rather likely that cooperation in military production will develop in central Europe.
41. The participating States, furthermore, referred to the need to utilize town planning to redress urban problems. It is today now broadly recognized that urban problems may cause a deterioration in the quality of life and that effective town planning, including zoning, building codes, appropriate architectural methods etc. can minimize some of the negative externalities. Cooperation and exchange of information as called for in the document are carried out either on a bilateral basis or in international fora, through the executive body of the Council of Europe, through the ECE Committee on Human Settlements, OECD, IBRD. Progress is more noticeable when there is a democratic control of local authorities and when private owners maintain their houses.

42. Transport is only briefly mentioned in Chapter A para 1 of the Bonn document. States recognize the need for cooperation, which has a long tradition, in order to ensure that national goals of developing an efficient, safe and environmentally sound transport system, are realized. For example, the fact that transport vehicles cross borders makes it advisable that national transport systems be developed in a coordinated manner and according to uniform rules and standards agreed at the international level. This is particularly important in a region such as Europe, which unlike others, e.g. North America, is composed of numerous countries and where transport often entails border crossing. Many of these rules and regulations have been developed in a number of international conventions elaborated and kept under review by the ECE.

Chapter D. Monetary and financial aspects

43. Chapter D addressed the macroeconomic conditions required for promoting economic and enterprise cooperation among the participating states, relating to price liberalization and currency reform as well as to the institutions, measures and mechanisms needed to achieve these objectives.

44. In fact the recommendation in the Bonn document to introduce undistorted internal pricing has been largely achieved with all the east European countries lifting most of the price controls in existence at the start of the reform. The process of liberalization has been slower for the CIS countries. Some price controls have been maintained, however, for a few staple items. Energy prices have taken longer to liberalize than expected and the result has been the development of significant gaps between prices in eastern and western Europe. While an alignment with world market, energy prices should be achieved within 3 to 5 years, prices of other items such as for the services of public utilities will remain, to some extent, under control. This may be advisable in view of their monopolistic structures, but prices should nevertheless be allowed to rise to correspond broadly to world prices and avoid distortionary effects on production and consumption.

45. Currency convertibility was also emphasized as an essential means of introducing relative prices from world markets into these countries' internal markets, and thereby competition. According to IMF definitions, currency convertibility is achieved by stages: internal, current and capital account. Practically all countries of central and eastern Europe had achieved the first stage - internal convertibility - very early. By October 1995, they and the three Baltic States had achieved current account convertibility. In contrast, progress towards currency convertibility has been much slower in Russia and most of the other members of the CIS. Few countries have achieved full capital account convertibility, the three exceptions being Latvia and Estonia, which introduced it in early 1994 and the Czech Republic in October 1995. At present, though, the arguments against moving to capital account convertibility tend to weigh more heavily than the
advantages given the vulnerability of their currencies to speculative attack and higher risks of capital flight.

46. The Bonn document listed a number of supporting mechanisms and institutions required to achieve price liberalization and convertibility one of which was the development of an appropriate banking system. The reforms of this sector have taken far longer than envisaged particularly because of the inheritance of old debts and because of the lack of creditworthiness of their main customers some of whom, particularly in the CIS, are the principal owners of banks as well. Reform should consist of privatization, with foreign bank involvement, and the more robust implementation of bankruptcy proceedings against bad debtors. Fiscal reform has been more successful in contrast; but priority should now be given to improving tax collection and extending it to the “grey economy”.

47. The Bonn document also emphasized the need for private investment to become the principal source for financing economic development and in fact the direct involvement of the Government in investment has been substantially reduced. Another feature of moving the state out of economic activity has been the progress in privatization, which has been a trend of all participating states since 1990 even though the word did not appear in the document itself. One lesson that can be learned from the various methods which Governments have used to privatize, is that states should adopt a flexible approach combining various strategies of free distribution and commercial sale. Where no means of ensuring a proper system of governance on the managers of enterprise can be created, Governments should at least, prior to privatization, ensure that enterprises and their managers are obliged to operate within a more commercial, legal and competitive framework.

48. The most immediate tasks identified in the Bonn document - the freeing of prices, the liberalization of business activities, the introduction of currency convertibility and the establishment of markets - were in fact carried out in the early stages of transformation. The tasks which remain pertain to changes in economic structure and the further consolidation of market institutions. These require more international cooperation and external support. The EBRD, the establishment of which was supported by the Bonn conference, together with all the multilateral financing institutions, has become an important source of assistance to the transition economies. Initially, financial and other support went more to the countries of central and eastern Europe than the CIS which had trouble in meeting the conditions of these institutions. This has changed in the last two years. CIS countries have become recipients of more financial assistance while the leading reformers have made less recourse to them because of their ability to raise funds from other sources. Of note are the impressive strides which some countries have made in raising finance on the international capital markets, reflecting their growing appreciation of the need to raise funds from private sources and the advance of their reforms. Much technical assistance has been channelled through the international financial institutions which although difficult to evaluate, has been generally better received by economies in the region than in the early years of reform.

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INTRODUCTION

1. The Bonn document was prepared shortly after the fall of the Berlin Wall, when most of the east European countries had just made their historic decisions to abandon Soviet-type socialism and espouse democratic political systems and the market economy. In early 1990, those countries were at the very beginning of a radical economic and political transformation; in fact, only Poland and Hungary had actually begun the process of implementing market reforms, whereas most of the other countries were still at various stages of preparing their reform programmes. In the former Soviet Union there were still discussions as to the nature of the economic system that should be developed. Consequently, the scope, speed and general content of reform programmes in the region were initially rather uncertain.

2. This initial uncertainty is reflected in the Bonn document, which in many respects is a collection of general declarations rather than a programme of action, and provides a vision rather than a concrete and comprehensive picture of the future economic system to be introduced. Nevertheless, the strategic orientation of the desired reforms was clear: the document calls for the creation of efficient markets in the east European countries, and of comprehensive, cooperative links between them and the western market economies.

3. It is clear that the transition countries have made enormous progress in the last six years in nearly all the required areas of economic transformation. They have dismantled central planning, liberalized business activities, privatized large parts of previously state-owned assets, and opened up their economies to international trade and foreign capital. The actual reforms have in fact been much more radical and far-reaching than envisaged in the Bonn document. On the other hand, even though all the transition countries have embarked on genuine market reform programmes, the results after six years differ widely across the region, reflecting differences in both initial economic conditions and in the reform strategies and policies adopted.

4. The commitments continued the Bonn document are almost all worded in terms such as "improving," "encouraging," "facilitating," "recognizing," and "paying special attention to" specific activities. In almost all cases, the countries of the OSCE have improved, encouraged, facilitated, etc. the activities in question. Because the Bonn document provides no benchmarks against which activities or progress could be measured, evaluation of the relative levels of implementation must remain, to a certain extent, subjective.

5. This paper attempts to provide an overview of the extent to which actual developments in the transition economies and in their relations with the western market economies have followed the path envisaged in the Bonn document. Part I contains a general overview of the transition process since 1990, which emphasizes not only the considerable progress made but also the marked divergence between original expectations and outcomes. This overview echoes the general principles set at the beginning of the Bonn document on economic cooperation. Part II successively assesses the implementation of the four sets of conclusions contained in the Document which are presented in four chapters, under the same headings: A. Development and diversification of economic relations; B. Industrial cooperation; C. Cooperation in specific areas; D. Monetary and financial aspects. Nevertheless, the assessments presented in chapter D which addresses the specific points on macroeconomic issues raised in the Bonn document should be kept in mind while considering developments in individual sectors and progress in implementing certain institutional and microeconomic reforms as macroeconomic policies set the
climate under which they are conducted and have an impact on their acceptability and success. Similarly, the reform of statistics which is analyzed at the beginning of section A has a major role to play in the transition from centrally planned to market economies and will affect not only the efficiency of macro and microeconomic policy making but also the effectiveness of the private business sector. Change in many of these micro or sectoral areas is often difficult to measure and the evaluation of progress must therefore remain somewhat subjective. Moreover, even when certain changes can be monitored - the degree of privatization, the passage of legislation on specific subjects, for example - assessing their effectiveness in producing the desired economic consequences is more problematic.
PART I. FIVE YEARS OF REFORM: A BRIEF RETROSPECTIVE

6. Looking back at "the hard road to reform" in eastern Europe and the former Soviet Union since 1989, it is not easy to draw up a balance sheet. It is clear that important progress has been achieved in creating democratic institutions and transforming the centrally planned economies into market systems, but the economic and social cost of transition has been much higher than anticipated. A prolonged economic downturn, high levels of unemployment, sharply reduced social security, widening income and wealth differences, failing health standards and the rise of organized crime, have all contributed to frustration, disillusion and mounting political tensions. As a result, the current mood among the east European populations is very different from the enthusiasm and hope which were raised by the fall of the Berlin Wall in late 1989. It is a curious irony that in all but one of the east European countries governments are now in the hands of political forces with direct roots in the communist past.

7. The divergence between expectations and reality has probably been the single most important factor behind the recent turn around in the political and social climate in the region. Whether the transition could have been less costly in terms of economic losses and social welfare, and whether different policies could and should have been used to minimize these costs, remains, and probably will remain for some time, a hotly debated issue among economists and policy makers. Nevertheless, there is an almost universal consensus that the recession has been much deeper and longer than initially expected, and that the transformation has not yet delivered on many of its explicit and implicit promises.

(i) Building capitalism: the rise and fall of expectations in eastern Europe

8. It is instructive to recall what the expectations were in 1989-1990. What was the early vision of transition from plan to market and from totalitarian socialism to democracy? What was the hoped for outcome of the transformation? In answering these questions it is important to remember the gap between popular expectations, shaped mainly by the dismal performance of the central planning system vis-à-vis the western economies, and the expectations of political elites.

9. The initial reform programmes consisted of varying combinations of stabilization measures, institutional reforms and structural policies, including privatization. Monetary and fiscal restraint was aimed at reducing inflation, restoring financial equilibrium, and setting the stage for a stable macroeconomic environment. Liberalization of the external sector would help to establish correct relative prices and impose a desired measure of competition on the domestic market. Resources were expected to flow from loss-making firms into new, profitable activities, which would be undertaken and managed chiefly by newly emerging private entrepreneurs. The overall level of social welfare would rise, even though there would also be some "losers", especially in the sectors which had enjoyed exceptional privileges under central planning: namely, heavy engineering, metallurgy, mining and the bureaucracy. However, the adjustment costs were expected to remain relatively limited, partly because of substantial foreign direct investments which were expected to flow into transition economies attracted by low manpower costs and "virgin" markets.

10. The transformation was not expected to be completed quickly; it was clear – at least for a majority of policy makers – that the creation of an efficient market system would take years. But it was also assumed that at least some of the benefits would materialize fairly quickly.
especially the elimination of shortages, improved access to goods and services, and the liberalization of business activities. Although most reformist governments did not set precise dates, indirect evidence suggests that they all expected economic growth to resume after a relatively short adjustment period, perhaps within a year to two.\(^1\)

11. Popular expectations, on the other hand, were much more unrealistic. The massive critique of the inefficiencies and failures of central planning seemed to be perfectly consistent with the “demonstration effect” stemming from the affluent markets of Western economies: the result was a widely held popular assumption that the substitution of capitalism for communism would be a rather simple exercise, and that the shift would bring about a substantial and rapid improvement in the long depressed standards of living of the East European populations.

12. The reality proved to be much harsher than the predictions of such rosy scenarios. Recession and unemployment hit all the countries in the region very hard. When the expected improvement was not quickly forthcoming, the reformist governments were accused of incompetence, wrongdoing and corruption; quite frequently, conspiracy theories were invoked to explain the lack of success. For many people, it was impossible to understand why the divorce from communism should be such a painful experience. This “reform fatigue” spread, manifesting itself in frequent changes of government and in a shift of political support in favour of opposition, sometimes populist, parties.

(ii) “Infant” capitalism?

13. It cannot be denied that the East European countries have gone a long way since they started their transition to capitalism five years ago. Democratic and pluralistic political systems have been established in all of them and there is little question of reversing the trend towards the market economy. The straight-jacket of central planning and state controls was dismantled: prices have been liberalized, domestic currencies are convertible, consumers and producers are essentially free to make decisions according to their preferences. Inflation has been greatly reduced and endemic shortages eliminated. A large part of output is now produced in a dynamic private sector, and domestic markets offer a large variety of goods and services, comparable to that in Western countries. According to official national statistics, the non-state sector’s share in GDP already exceeds 50 per cent in most countries, an indicator of the enormous distance they have covered since 1989 when the share was generally less than 5 per cent (except in Poland where it was around 30 per cent because of largely private agriculture). Even if these statistics must be treated with some caution, because the rules of statistical reporting and sectoral classification are not always clear and consistent, the radical change in the ownership structure is clearly evident.

14. The governments of transition countries have also made considerable progress in integrating their economies into the global market economy: most of their foreign trade is now conducted with developed market economies at international prices and in convertible currencies.

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and their international links have been further strengthened by inflows of foreign direct and portfolio investment. Many new market institutions have been established and developed, such as stock exchanges, monetary and credit instruments, anti-monopolistic regulations, bankruptcy legislation, etc. By the end of 1994, most east European economies had passed the low point of the economic recession, and the long-awaited recovery appears to be underway.

15. The results of transformation so far lend credibility to recent claims that the transition economies "have put the essential foundations of a market economy securely in place". They also show that the countries' strategic decision to dismantle central planning and organize their economies according to market rules and principles was justified. But all the achievements notwithstanding, there have also been failures and disappointments; in fact, after five years, capitalism in the transition economies is still in its infancy: growing fast, but still immature and turbulent.

(iii) "Transitional" recession: too deep, too long

16. Perhaps the most disturbing and unexpected outcome of the 1989 revolutions was the "transitional recession", which depressed output and employment well below pre-transition levels. The official statistics show that the cumulative contraction of output between 1989 and 1993 in the transition economies was on a massive scale and unprecedented since the Great Depression of 1929-1933. The recession was particularly dramatic in Bulgaria and Romania, the two east European countries commonly considered as being the least prepared for market reforms, and in nearly all the countries of the former Soviet Union. Another common feature is that the cumulative fall of (gross) industrial output was larger, generally by more than a half, than the fall of GDP, and by the end of 1993 it exceeded 50 per cent in the worst cases (Bulgaria, Romania, Russia, Ukraine and the Baltic states).

17. What was surprising about the recession was not the fall of output itself, because "some" recession had indeed been anticipated, but rather that it was so deep, so widespread and so persistent, and that the subsequent adjustment on the supply side has been so weak. Official forecasts, which accompanied the launching of the stabilization-cum-reform programmes, typically predicted a temporary and relatively mild contraction of output, followed by a strong recovery fuelled by efficiency gains, the expansion of private business activities, and inflows of foreign investment. In reality, however, the behaviour of output followed an L-shaped pattern, instead of a U-shaped one.

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3 In 1990, the Polish government assumed that the fall of GDP would be restricted to between 3 and 5 per cent, and would be followed by recovery already in the second half of 1990. Even in early 1991, when the Polish economy was in a downward spiral, the government was still predicting 3.5 per cent GDP growth for 1991 - actually, the economy contracted by another 7 per cent. The same errors of underestimation were made in other countries. The Hungarian government predicted 2-3 per cent growth for each year 1991-1993, but GDP actually fell by 12, 5 and 2 per cent, respectively. At the outset of the reforms in Czechoslovakia in 1991, the government cautiously reckoned with a possible decline of output of between 5 and 10 per cent, the actual result was a 14 per cent fall in 1991 alone, followed by another drop of 7 per cent in 1992. During the first two years of stabilization...
18. The unexpected depth and persistence of recession is still a puzzle to be explained. Attempts to explain it have in most cases focused on the structural and institutional characteristics of centrally planned economies. Specifically, it has been argued that under the new, market-based regime a large part of the previously produced output becomes unsustainable for various reasons, but at the same time the necessary restructuring is inherently slow.

19. However, the deep fall of output is still intriguing because the very collapse of communist regimes was supposed to bring about a substantial and rapid improvement in economic performance and standards of living, precisely because the traditional communist system was commonly regarded as so wasteful and inefficient. Removal of the command system and transition to a market economy was thus seen as an efficiency- and welfare-improving socio-economic innovation. It is therefore somewhat surprising that most experts now tend to regard the registered fall of output in the transition economies as something quite natural and largely inevitable.

20. A number of possible explanations of the "transitional" recession have been suggested over the last few years. They range from Keynesian demand-deficiency to Schumpeterian institutional interpretations, from concepts of structural rigidities and distortions typical of Soviet-type economies to views regarding the recession as a statistical artefact. None of them is fully convincing, but considered jointly they allow for some conclusions.

21. First, it should be noted that the recession was real and not imaginary: while there seems to be no doubt that the official statistics do tend to overestimate the extent of the actual fall in output, it may also be argued that the margin of error is probably smaller than commonly believed. Second, the recession was the joint outcome of a combination of factors working both from the demand and supply sides; but the adverse impact of stabilization programmes on domestic demand appears to be quite substantial. With the benefit of hindsight, it can be argued that the stabilization policies were probably too restrictive, as they were guided by a mistaken judgement of the initial degree of macroeconomic disequilibrium. Third, it might have been

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expected that the shift away from communism would release large “X-efficiency gains” which would generally work in favour of output expansion rather than contraction,7 that these gains have not materialized underlines the excessive optimism that prevailed in 1989 as to the responsiveness of the supply side of the transition economies. Whether micro-supply responses could have been stronger with a different set of policies is an open question.

(iv) Structural unemployment

22. It is a well established proposition of traditional comparative economics that the near-full employment levels observed under central planning were artificially achieved because of low work-discipline, an ideological commitment to full employment, and low wages. Large-scale lay-offs during the transition were therefore predicted, but it was also assumed that rapidly increasing demand for labour in the expanding service and private business sectors would absorb most of the excess manpower in industry, and that unemployment would remain moderate. In reality, the jobless rate in most east European countries is well over 10 per cent of the labour force and has remained high, despite the emerging recovery of output.

23. An important message from labour market statistics is that not only are unemployment rates high in the transition economies, but also that there has been only a small reduction in “excess employment” (as indicated by the difference between the cumulative change in GDP and the cumulative change in employment) between 1989 and 1994. In Bulgaria, Hungary, Poland and Slovenia employment levels have fallen broadly in line with the fall of output, thus leaving the initial level of overemployment practically unchanged; in all the other countries, but especially in the former Soviet republics and Yugoslavia, the level of overemployment has increased, with obviously negative implications for labour productivity and wages.

24. Since the major reason for high unemployment has been the “transitional” recession, the recovery might in principle have been expected to at least alleviate the problem. Unfortunately, the emerging recovery cannot be counted on to radically improve the labour market situation because the flow of new jobs is likely to be broadly offset by new entrants to the pool of unemployed coming from schools, an overmanned agricultural sector and shrinking state enterprises. As a result, the transition countries are likely to have to live with double-digit unemployment rates for several years to come.

25. Long-term and high rates of unemployment, however, involve serious risks. First, as more and more persons remain without a job for a long time they will tend to drop out of the active labour force permanently because of a loss of skills. This “hysteresis” effect will thus reduce the potential output of the transition economies in the future and put additional burdens on their fiscal expenditures on extensive social safety nets. The share of the long-term unemployed (more than 12 months without a job) in total unemployment has been gradually increasing in eastern Europe, and is now more than 40 per cent on average and close to 60 per cent in countries such as Bulgaria and Slovenia. Another worrying fact is that there are more and

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7 In most general terms, the X-efficiency idea refers to the closing of the difference between actual and maximum output, the gains arising from better use of inputs for a given output, varying degree of work effort and discipline by individuals, varying degree of diverging interests in agent-principal relationship, inertial costs and some other factors. For a more detailed exposition see H. Leibenstein, General X-Efficiency Theory and Economic Development (New York and Oxford, Oxford University Press, 1978), pp. 17-38.
more young people and school leavers among the unemployed – a tendency which carries a high risk of their remaining more or less permanently without a job. The implications of this are daunting: not only is the economy likely to suffer from the waste of manpower resources, but social and political stability may be endangered if too many people are unemployed for too long. There are no simple solutions to this problem, but structural policies aimed at improving the workings of the labour markets and active labour market policies, including training and retraining programmes, would appear to be priority areas for action. But, there must also be a recovery to sustained, employment-creating rates of output growth if the inflow to the pool of unemployed is to be reduced significantly.

(v) Persistent inflation

26. High rates of inflation and widespread shortages were characteristic of the final days of the central planning system. Liberalization of prices and the initial devaluation of domestic currencies further added to inflationary pressures; in fact, the “corrective” inflation in most countries strongly overshot the levels envisaged in the stabilization programmes. To restore fundamental price stability was thus one of the central objectives of the reformist governments. Experience has shown that reducing inflation from near hyper-inflation levels to manageable proportions is a relatively easy task, and can be done quickly with standard measures of financial restraint implemented within a credible and consistent programme. However, most of the east European countries which have succeeded in lowering inflation to 20-40 per cent per annum, seem to be finding it very difficult to reduce it further to one-digit rates.

27. The persistence of inflation at so-called “moderate” levels cannot be easily explained with standard theories. The growth of money supply does not seem to have been a primary inflationary factor, because it has generally lagged behind the consumer price index in all eastern European countries (except the Czech Republic where, however, inflation is the lowest in the region), and even more so in Russia and the other CIS countries. Also, there is no uniform pattern in the impact of budget deficits: although there seems to be a clear link between fiscal deficits and inflation in Russia and in Ukraine, the evidence is less clear for east European countries (Hungary and Slovakia have had lower inflation rates and higher deficits than Poland or Romania). Wages have been kept under control throughout the region, generally increasing less than consumer prices (again, the exceptions include countries with the lowest inflation rates in the region).

28. Even where inflation is considered “moderate”, it nevertheless varied in 1994 from 10-13 per cent in the Czech Republic and Slovakia to some 55 per cent in Poland, and such rates are likely to have an adverse impact on economic activity. Interest rates, both nominal and real, are kept high, thus hampering economic recovery; uncertainty is maintained in the business sector and investment horizons are shortened; and social unrest may be provoked because of its undesired effects on income redistribution.

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29. The nature of the current inflation appears to be different from that observed in the initial stages of the transition when the liberalization shocks, excess demand, and monetization of fiscal deficits played the most important roles. "Moderate" inflation seems to be caused chiefly by inertial mechanisms, such as various indexation schemes for wages and pensions, frequent foreign exchange rate adjustments, periodic increases of key commodity prices (mostly energy and food), and inflationary expectations. Attempts to stop such inflation with the standard instruments of tight monetary policy tend not be very effective, especially when inflows of short-term capital boost the domestic money supply under pegged exchange rates (Czech Republic, Poland). A conservative monetary policy is still needed, but it should be combined with other measures which would dampen inflationary expectations through the breaking up of inertial mechanisms.

(vi) Enterprise reform and privatization

30. Policy makers in the transition economies were clearly aware of the systemic weaknesses of traditional state enterprises and seem to have recognized that, unreformed, they were likely to behave in a perverse way in a market environment because of the distorted structure of incentives facing not only managers but also banks, workers and government agencies. In the initial stage, these dangers were to be avoided through rigid tax-based incomes policies, and thereafter through privatization. And yet the composition of the stabilization packages in most countries suggests that they were based on an implicit assumption that the reaction pattern of state enterprises to stabilization measures would be broadly similar to that observed in developed market economies. This may help to explain the lack of early reforms of state enterprises and banks, and the slow pace of privatization. Indeed, instead of discontinuing inefficient production, laying off excessive manpower and responding to market signals in a standard, profit-maximizing way, state enterprises preferred to raise prices, protect employment and lobby heavily for government support and assistance.

31. Incomes policies, although instrumental in reducing inflationary expectations, proved to be only partly effective in imposing wage discipline and keeping unemployment low; in many cases they proved to be an impediment to restructuring, and were often considered to be socially unfair and politically unacceptable. On the other hand, privatization proved to be much more difficult and time-consuming than initially envisaged.

32. From the economic perspective, the role of privatization was to introduce efficient corporate governance and additional sources of funding for enterprises, in addition, and in many cases primarily, it was seen as an important underpinning of the political transformation. Very broadly, two different privatization strategies were followed: one based on the free distribution of state assets to the public at large; the other following a case-by-case "commercial" approach. In the first case, the transfer of ownership rights can be carried out relatively fast, and the share of the non-state sector in the economy is expanded “at the stroke of a pen”. However, the main advantage of this method is essentially its speed: as for the economic objectives of

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privatization, it takes much longer for effective corporate governance to be established, since give-away schemes create dispersed ownership with the dominance of passive owners. As a result, while managers are liberated from government supervision, they are not put under the control of new owners. Effective controls can be imposed only gradually, no matter how fast the formal ownership rights are distributed. A good illustration of the problem is provided by the results of privatization in the Czech Republic, widely regarded as the most successful in eastern Europe. Even though the state managed to divest itself of more than half its industrial property within less than three years, the behaviour of enterprises has in fact changed very little, if at all, because the new owners are either dispersed or, if they hold strategic stakes, are unable to exert the desired influence on managers because of a lack of information, conflict of interest or general passivity. The privatized enterprises are thus "non-state", but they are not yet fully private in the western sense of that term. Moreover, only limited funds have been channelled to enterprises as a result of this method of privatization. Voucher privatization in Russia is another example of the rapid "formal" transfer of ownership away from the state which is followed neither by effective governance, nor by an inflow of new capital.

33. Under the second strategy, when a state enterprise is sold to a new owner (owners), corporate governance is immediately established, additional financing is often forthcoming, and the necessary adjustments begin to follow; but since the strategy proceeds case by case, it takes a long time to privatize a majority of state enterprises. The dilemma is therefore to choose between a wide and shallow privatization, or a deep and narrow one. It is now clear, that whatever alternative is selected, the process of economic restructuring will take years to complete.

(vii) Banking reform

34. The need to overhaul the whole financial sector in the transition economies was only fully recognized when the banks and other financial institutions emerged as a major obstacle to the process of reform. The main weaknesses of the financial sector include: the absence of many important institutions of financial intermediation (such as pension funds, mutual funds, specialized savings and loans organizations, security firms, equity and bond markets, etc.); the small capital base of the existing commercial banks; the excessive dependence of banks on a limited number of clients (mainly large state enterprises); lack of experience in credit operations; and either absent or inadequate prudential regulations and bank supervision. However, policy makers did not seem to fully realize that the reform of the financial system was not only an integral component in the creation of a market economy, but that it should have been initiated at the very beginning of the transformation process.

35. The failure to reform the financial sector at the start of the transition has had a number of important implications. The most important is probably the rapid accumulation of bad loans in the commercial banks, a phenomenon common to all the transition countries. Some of the bad loans are an inheritance from the regime of central planning, when state enterprises were largely unconstrained in their investment activities, but much more significant are those accumulated

11 The bad loans include non-performing assets on banks' balance sheets, mostly in the form of overdue credits, extended to enterprises which - for various reasons - were unable or unwilling to service them.
during the transition period. The latter resulted from a lack of appropriate adjustment by enterprises and banks to the sudden change in the macroeconomic environment. Protracted recession and the collapse of traditional export markets in former CMEA countries also led to many technical and actual insolvencies in the enterprise sector.

36. The problem of bad loans is now at the centre of economic discussions in all the transition economies. Any efficient and lasting solution to the problem should combine two types of initiative. First, the existing stock of bad loans has to be dealt with through a comprehensive financial restructuring programme. Second, the recurrence of bad loans (the flow problem) has to be forestalled, which implies a fundamental change in the behaviour of economic organizations which, in turn, requires a radical change in the structure of incentives faced by the managers of banks and enterprises.

(viii) Foreign investments

37. From the very beginning of the transition process, the governments of both western countries and east European countries regarded foreign direct investment (FDI) as playing a key role in the restructuring and transformation of the former centrally planned economies. FDI was to provide an infusion of capital, technology, management, and marketing expertise; to help in the creation of export capacity, and in other ways contribute to promoting economic growth. The initial optimism surrounding the role of FDI was based essentially on a number of perceived characteristics of the transition economies: an abundance of cheap skilled labour, geographical proximity to western markets, the anticipation of a rapid growth of internal demand and liberal commercial legislation.

38. The balance after five years of transition looks rather modest. The actual volume of FDI in transition economies has been lower than expected, and very unevenly distributed across countries. (Hungary has attracted the bulk of the region's FDI since 1990), and its growth has not been sustained, despite the progressive improvement in the investment climate during the last few years and the recent recovery of output. After falling markedly in 1994, the inflow of FDI into eastern Europe picked up in the first half of 1995 (but not in the European members of the CIS), although the amounts still remain relatively modest. Apart from a few large investments in the early 1990s, such as Fiat's planned $1.8 billion investment in Poland, Volkswagen's purchase of a stake in Skoda car manufacturing in the Czech Republic, or General Electric's acquisition of Hungary's Tungsram, foreign investment has tended to be hesitant and on a small scale.

39. One possible explanation of this outcome is that foreign investors picked up the best companies in eastern Europe, in terms of their market potential, expected profits and the risks involved, and are not in a hurry to invest in other, typically more debt-ridden and overstaffed, companies. But a more general explanation for the reticence of foreign investors is probably linked to more general systemic factors, such as the uncertain legal, political and institutional environment, and the lack of an adequate business infrastructure. In a few countries the high level of unionization and a tradition of frequent industrial disputes may also be a factor. The delays, frequent changes and sometimes reversals of earlier government decisions on privatization have also created uncertainty by sending confusing signals to foreign investors and thus blocking
an important channel for FDI. In many transition economies, the privatization of state assets, still a general precondition for FDI flows, has been slow and the role of foreign investors has been restricted to varying degrees.

40. Apart from limited inflows of FDI, its distribution may also be sometimes questionable. Casual observation and case studies suggest that FDI often tends to concentrate in sectors and branches with a relatively high potential for rent-seeking which may arise from quasi-monopolistic positions or from special arrangements with the host governments of transition countries. Thus, foreign investment in east European car manufacturing was typically made conditional on the granting of special privileges to investors in the form of high customs tariffs (in Poland for example). Similar motives may be behind the attempts by large multinational companies to establish control over east European markets for tobacco products.

41. In general, the relative weakness of FDI in the transition economies has not been offset by official assistance. Project lending by the development institutions corresponds broadly to the types of investments made by FDI enterprises, although that of the former is concentrated in the infrastructure and energy sectors. Project-related disbursements to the transition economies by these institutions show a rapid increase in 1994, but not by enough to compensate for the fall in FDI in that year, although the prospects for further growth in project disbursements appear to be good, given the accumulation of new commitments in the past five years.

(ix) The need for structural reforms

42. Despite marked differences in the history and rates of advance of market reform and in current macroeconomic performance, the transition countries of eastern Europe display many similarities. Most of them have made considerable progress towards stabilizing their economies, strengthening their domestic currencies and developing a strong and dynamic private sector. They have also managed to recoup much of their trade from the depressed eastern markets to the more competitive markets of western Europe. But these successes notwithstanding, the east European countries also face some common problems which— if not addressed in an appropriate way— may hamper the economic recovery and even lead to political instability in the region. In particular, they are all confronted with essentially the same task of a massive reconstruction of their productive capacities, a task which includes a substantial reallocation of resources and probably the closing down of many inefficient enterprises. In this context, the slow pace of structural reforms raises some concern. Political obstacles to the restructuring of state enterprises, privatization, the lack of funds for new investment and the rehabilitation of the

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12 The recent decision by the Russian government to restore partial state controls over already privatized enterprises, or the withdrawal of the offer by the Hungarian government to sell a state-owned hotel chain to an American consortium provide examples of "stop-go" policies vis-à-vis foreign investors.

13 There appears to be little or no discussion of the welfare implications of allowing foreign companies to introduce modern advertising and distribution methods in the cigarette industry. Male mortality rates from smoking-related diseases in eastern Europe and the former Soviet Union are the highest in the world, while those for females are among the lowest. R. Peto et al., Mortality from Smoking in Developed Countries 1950-2000 (New York and Oxford, Oxford University Press, 1994).

existing plants, and the problems involved in the large-scale reallocation of resources all conspire to hold back the reforms and contribute to high interest rates and inflation. The implications, actual or anticipated, of restructuring for the distribution of income and wealth are also a cause of bitter political in-fighting in most transition countries, which is also a factor slowing the progress of reforms. Improving the working of an inefficient and underdeveloped financial sector is also taking a great deal of time and effort, and the burden of bad debts has negative repercussions on the ability of the commercial banks to finance the enterprise sector. The reform of public finances has not yet been completed, and the rapid increase of budgetary expenditures on social security threatens to upset the fragile stability of state budgets in the near future. Domestic public debt has been increasing in virtually all countries, and in some of them it may soon reach alarming proportions.

43. As argued above, the economic performance of the east European transition countries will also depend heavily on continued export expansion if over-dependence on foreign capital is to be avoided or, since the latter seems unlikely to be available in significant amounts anyway, if the balance of payments is not to be a constraint on growth. Given the need for imports of new technology to support the restructuring process, an expanding capacity to import will therefore largely depend on the growth of exports. The recovery of output in 1994 was chiefly driven by the expansion of exports to western markets; in 1995 this was added to by domestic demand. The moderate growth expected in OECD countries in 1996 gives even more importance to domestic sources to maintain the current rates of growth in the transition economies. The positive impact of exports on growth may, however, be extended and strengthened if better access to west European markets is granted for the transition countries, and this in turn may encourage an "outward-looking" FDI which can have a useful role to play in expanding exports over the longer term. But export growth can also be supported by export promotion efforts directed not only at western Europe but also at the more dynamic economies in Asia and other parts of the developing world. This, in turn, will require improvements in the trading infrastructure of the transition economies, along the lines discussed in the trade promotion programme quoted above.

44. The other major constraint on growth, which is likely to be increasingly encountered by all transition countries, is the relatively low rate of domestic savings, which limits the potential for domestically financed investment. This is not only due to the currently low level of per capita incomes in these countries. (It is worth noting that a considerable part of the household savings accumulated in the pre-transition period were wiped out by inflation and exchange rate changes.) Policies to encourage more savings are urgently needed in the transition countries. In this context, real positive interest rates on bank deposits are an important but not sufficient incentive. A variety of attractive and secure savings instruments needs to be developed, such as mutual funds, pension funds, bonds and equity shares. Also, accessibility of more expensive goods (consumer durables, housing) could be increased through the development of financial instruments allowing people to save a larger proportion of their incomes in order to finance long-term purchases and investments (mortgages, consumer credits, and so on).

45. Economic prospects will also depend on the political developments in the transition economies. In this context, an important question is whether the almost universal shift of political support in the last two years away from economic liberalism and political conservatism, which had dominated the early years of transition, has implications for the direction and pace of economic reform. The shift of political power to the social democratic left started in Lithuania and in Poland in 1993, was followed by similar political changes in Bulgaria, Hungary and
Slovakia in 1994 and, in early 1995, in Estonia. The immediate concerns and uncertainty about
the sustainability of market reforms in the wake of these political changes have so far proved
largely unfounded. While most of the new governments display somewhat less enthusiasm for
rapid, or spontaneous, privatization - and, indeed, the pace of ownership transfers has slowed
down in some countries - there seems to be little question about their genuine commitment to
continue with the process of market transformation and democratic reforms. But it is important
to underline the problems facing these governments. After five years of reform considerable
progress has been made in transforming economies and political institutions and in many of them
the first signs of a recovery in output have appeared. Many people in eastern Europe are
benefiting considerably from this progress, especially the educated young, the skilled and those
with entrepreneurial drive. But there are also many losers, especially the old, the unskilled, those
employed by the state and many of those in the professions. Their growing discontent is now a
factor that no government in eastern Europe can ignore, and if their numbers continue to increase
then both social stability and the commitment to continued reform is likely to be undermined.
Foreign private investors are unlikely to be interested in solving such problems, only in whether
they are likely to increase the risks of investment. But this is where more generous and well
targeted levels of official assistance from western governments and international institutions can
play a vital role in helping to ease some of the social costs of adjustment while helping transition
economy governments to keep the reforms on track. It is frequently claimed by western
governments that they cannot afford such assistance, but such claims abstract from the questions
of political will and the calculation of longer-run self-interest. The costs of a stalling or failure of
the transition processes in eastern Europe and the former Soviet Union are likely to be far greater
than the cost of supporting them in advance.

(x) Conclusion

46. In 1989-1990, the countries of eastern Europe enthusiastically embraced the capitalist
model of economic organization. But since then, reservations have emerged and grown large,
mainly because of the unexpected social and economic costs of transition and slow improvement
in living standards. These reservations pose important challenges to policy makers: they call for
imaginative domestic policies aimed at sustaining economic growth, checking and reversing the
rising trend in unemployment, and speeding up the necessary structural change, while maintaining
financial discipline and macroeconomic stability. For political leaders, the current mood of
disillusion creates a strong temptation to resort to populist measures, which could have
disastrous economic consequences. Finally, popular reservations about the market reforms also
pose a serious challenge to the international community, which should read them not simply as
symptoms of impatience and naiveté on the part of east European populations but as the
reflection of real social distress and, often, disorientation, conditions which call for more not less
cooperation and solidarity with the transition economies. The ways in which the main political
and economic actors respond to these challenges will have a considerable influence on the
sustainability of the market reforms in the transition countries in the next few years.
PART II. IMPLEMENTATION OF THE CONCLUSIONS CONTAINED IN THE BONN DOCUMENT

A. DEVELOPMENT AND DIVERSIFICATION OF ECONOMIC RELATIONS

47. The Bonn Conference on Economic Cooperation took place in the early years of the region’s free-market reforms, when the collapse of the preferential system for their mutual trade greatly increased the need of the countries with formerly centrally planned economies to develop new relations with the outside world and new means of integrating themselves into the world economy. High on the list of priorities of these countries was the need to attract foreign capital.

48. Chapter A presents what can be described as the basic measures for establishing a new set of relations in which foreign capital was to be given a key role. The commitments contained in this chapter were designed to remove some of the barriers to international investment directly related to the specific features of the centrally planned system. These barriers included restrictions on the establishment of foreign enterprises (chapter A, point 1); the lack of information available to prospective investors and other decision-takers on the true performance of the economy and on enterprises (chapter A, points 2 and 3); the un conduc tive industrial structure for investments and the need to remove the restrictions on the formation and development of small and medium-sized enterprises (chapter A, points 3, 4 and 5), the inadequate or non-existent business and export services (chapter A, point 6) and the lack of appropriate human capital resources, especially managers (chapter A, point 7).

49. This review examines the extent to which the member countries have succeeded in complying with the commitments made in 1990 to remove barriers and restrictions to diversifying economic relations and how further economic cooperation can assist in the removal of those barriers which remain.

(i) Developing better flows of information: role of statistics (chapter A, points 2 and 3)

50. The provision of comprehensive and reliable economic statistics is not simply a service to the business sector but a public good which makes a crucial contribution both to the optimal working of the market economy and to the support of democratic institutions by helping to promote public discussion and scrutiny of government policies. The provision of such statistics is also essential for the closer integration of the eastern countries into the world economy: not only are they required for conducting international business at the enterprise level, but they are also a condition of membership of most international institutions. For this reason, the review of progress made in the production and diffusion of statistics goes beyond the areas mentioned in the Bonn Document and should be kept in mind when discussing other chapters, particularly chapter D.

51. The Bonn Document set high priority on an improvement of information flows, in particular as regards the preparation and timely dissemination of economic, commercial and demographic statistics conforming to international standards (chapter A, points 2-3), to serve as the “basis for economic research, cooperation and efficient conduct of business operations”. The
document specifically mentioned national product, foreign trade and balance of payments
statistics, as well as some other fields (transport, tourism, environment, energy and other raw
materials). It also defined statistics as one area in which international cooperation and joint
activities should be undertaken. It paid little attention, however, to the expansion of statistical
coverage to the new areas necessary for the functioning and international opening of a market
economy, such as monetary and financial statistics and the publication by corporate management
of enterprise data for the information of lenders, stockholders or potential investors, which have
since assumed great importance.

52. Progress has indeed been very substantial in the area of statistics since 1990. The main
agencies concerned with trade, balance of payments and GDP are the UN Statistical Office in
New York, OECD, the Statistical Office of the European Communities (Eurostat) and the IMF
(which has recently launched a major new initiative to improve the quality of economic statistics
from member States), in addition to the UN/ECE itself. All are involved in a concerted effort to
assist OSCE member countries in improving their data and in collecting and publishing
comparable international statistics. The countries themselves are also showing a willingness to
publish, and otherwise disseminate, what data they have to improve both quality and
comprehensiveness. But it should also be noted that progress has been rather uneven between
countries and subject areas, and much still remains to be done.

53. Almost all transition countries have converted their national accounts statistics to the
international SNA standard, at varying degrees of articulation. There has everywhere been an
expansion of statistical coverage to monetary and financial, and also social, data which were
formerly not reported or even collected. The publication of foreign trade and balance of
payments data has greatly improved, but in many countries the quality of these data is still very
uncertain, and in some cases adherence to international standards is doubtful. International
cooperation has played a very significant role in facilitating these improvements through advisory
activities, the transfer of know-how and also of relevant technology, as well as in supplying
channels for the dissemination of data in the publications of international organizations.

54. Both progress and shortfalls must be seen in the light of the problems confronting the
statistical agencies of the transition countries, problems which are large because so many things
changed at once in their field of work. Among these changes, the following particularly affected
the work of data-gathering and processing: (i) The multiplication of economic actors to be
tracked. (ii) The coverage of developments in the new private sector and the hidden economy in
most countries remains the weakest side of statistical coverage. (iii) The need to cover new
subject matter relevant to the market economy (financial, commercial/enterprise, business
expectations). (iv) The need to shift to new and unfamiliar methodologies of data gathering and
processing in order to adhere to international standards. (v) In the statistics on external
transactions (foreign trade and finance), additional problems stemmed from the creation of new
international frontiers in the wake of the breakup of several States in the region. (vi) In all
statistical fields, the high rates of inflation for at least part of the period in most transition
economies posed problems which are inherently difficult to resolve. In spite of the progress
achieved in the last five years, with the substantial assistance of western countries and
international organizations, the distorting effects of these factors are still very great.

(a) National accounts
55. **National accounts** data summarize the evolution of economies in a complex, interdependent scheme of accounts to reflect the process of production of goods and services, the distribution of incomes generated in the process, the expenditure of these incomes and the resulting final uses of output. Almost all transition countries had by 1995 moved in principle from the Material Product System of national accounts (MPS), which largely ignored the "non-material" (services) sphere, to the more comprehensive System of National Accounts (SNA) used internationally, generally in the form of the last revision of the standard (SNA 1993). However, only a few of the most advanced transition countries are as yet in a position to provide fully articulated sets of national accounts tables; in many countries only the most aggregate SNA variables are published, and in some cases, especially in the newly independent states of the former Soviet Union, these in the first few years were still rather rough conversions of the MPS aggregates with the addition of some SNA adjustors. Available data usually are annual estimates, although, increasingly, countries also provide quarterly GDP estimates, which are important because of the relative lateness of annual data.

56. Almost all countries in transition now participate in the European Comparison Programme (ECP). The ECP is a joint venture of OECD, Eurostat, the Austrian Central Statistical Office and the ECE, which enables national GDP levels to be compared taking into account the purchasing power of their respective currencies.

57. Further intensive work on the improvement of national accounts estimates, equally as regards methodology, coverage (especially for the private sector and the "hidden" economy), deflation problems for the real indicators, and "within-year" (quarterly) estimates, would appear to be a high priority, especially for the south European transition countries and most CIS countries. A significant effort in this direction now seems to be under way in collaboration between OECD, the World Bank and others, and the statistical offices of the newly independent states.

(b) Production data

58. General **production data** on major sectors (industry, construction, agriculture, transport, etc.) are now published in all countries in a very timely manner (usually on a monthly basis) and in substantial detail. Coverage problems, however, remain important; only the more advanced transition countries appear to have been able to put into place the sampling methods necessary to cover reliably the new private sector with its small and medium-sized enterprises. In a number of countries the published statistics explicitly cover only state and cooperative enterprises. This is quite disturbing for economic analysis as trends are likely to be quite the opposite in the old state and the new private sectors - contraction in the former and expansion in the latter.

59. Also of concern for the analysis of developments is the hesitancy in some countries to publish their data as time series, including revisions of previously published data for preceding periods. It is to be hoped that the statistical services still adhering to this mode of reporting will soon be able to shift to the presentation of standard "time series".

60. Comparative economic and industrial analysis require compatible statistics, measured according to the same definitions with the same methods. This in turn assumes the implementation of internationally accepted nomenclatures as well as business registers with wide coverage as the basis for the collection of statistical data. All countries in the region are working towards harmonization of nomenclatures which is a continuous process. In eastern Europe
progress is unequal. Further promotion of statistical harmonization in the whole of the OSCE region requires concerted efforts, and in particular, an information network connecting nomenclature experts from all the countries of the region still needs to be established.

(c) Foreign trade and balance of payments

61. The compilation and publication of foreign trade and balance of payments data has also improved markedly over the last few years. The major change in the foreign trade sphere was the transfer of the main data gathering function from reporting of state foreign trade enterprises to data collection at the frontier by a customs agency on the basis of internationally standardized customs documents. While this transfer is by now generally completed in most transition economies except for some of the CIS countries, reports from many countries indicate that the new systems do not yet work in a fully satisfactory manner. Probably this is largely an issue of “teething” problems, but for the time being it means that customs data often have to be complemented with more or less uncertain estimates for components of trade not yet captured by the statistical services.

62. More severe problems in capturing all trade flows arise, at least initially, in the “new” foreign trade which formerly was domestic trade within a state unit that has broken up (Czechoslovakia, SFR Yugoslavia, Soviet Union). A special case in this respect is intra-CIS trade, for which data are on the whole very poor and, moreover, very difficult to interpret since these transactions are conducted under a price regime which is still very different from world market prices.

63. Virtually all European transition economies (but not the Asian CIS countries) make balance of payments, debt and foreign exchange data available (monthly or quarterly) on a reasonably timely basis. However, in spite of extensive assistance from the IMF, a few either fail to release any external financial data at all or provide certain series irregularly, often with a long lag, and the full range of key series may not be available in relevant national publications. In general the gaps cannot be filled from international sources, either because certain transition economies are not yet covered, or key series not yet included, or because the statistics are reported only with a long lag.

64. Methodologies applied in compiling balance-of-payments statistics, their presentation, and definitions of debt, continue to vary from country to country, and sometimes they are changed in successive reporting periods. The transition economies are gradually shifting to reporting balance of payments statistics in accordance with the recommendations of the Fifth Edition of the IMF Balance of Payments Manual. Some, however, appear to have adopted certain recommendations but not others. All of this limits the comparability of the statistics.

(d) Dissemination

65. In chapter A, point 3, the Bonn document stresses the exchange of information among the participating States. Thus, developments in the dissemination of data and their accessibility to interested users are of relevance for this review.

66. (i) There has been a substantial expansion in the number of monthly, quarterly and annual publications of national statistical agencies, in general with a significant rise also in the quality of methodological annotation. In almost all cases, the accessibility of this material has
been much improved in that text and tables are accompanied by translation into one or several international languages (mostly English). Wide differences between countries remain in the quality and analytical usefulness of these publications.

67. (ii) A very welcome new phenomenon in a number of transition countries is the assumption of a very active role in the dissemination and analysis of official statistics by research institutions attached to government offices or non-governmental bodies, which offer alternative data presentations and often concentrate on economic forecasts.

68. (iii) A very substantial expansion has occurred in the participation of transition countries in multilateral channels of data dissemination. In this respect, the OECD Centre for Co-operation with the Economies in Transition (CCET) has taken on a particularly active and highly useful role with its quarterly Short-Term Economic Indicators: Transition Economies, which now provides macroeconomic time series data from all CIS countries, the three Baltic States and seven (out of 12) eastern European countries, and other publications.

69. Member countries of the United Nations have of course always been represented in the publications of the UN Statistical Office. The COMTRADE database of the UN Statistical Office was specifically mentioned in the Bonn document as an outlet for foreign trade data of the transition countries. This engagement has been taken up rather slowly: at the time of this review, 6 countries - including only one CIS country (Moldova) - report annual data (at the 5-digit level of SITC), and none, so far, quarterly data. Quarterly statistical reports from almost all transition countries to the ECE secretariat back the analytical work in the annual Economic Bulletin for Europe and the Economic Survey of Europe.

70. Statistical coverage of transition countries in the publications of the IMF Statistical Bureau has also increased, but still remains somewhat patchy (e.g. in the monthly International Financial Statistics, there are now country pages for 9 transition economies, out of 27, of which only 1 CIS member country). In view of its strong involvement in most transition countries, this undoubtedly represents only the tip of the iceberg of data available at the IMF.

71. Finally, under this heading, the very useful role assumed by the CIS Interstate Statistical Committee should be mentioned, which in its periodicals (Statisticheskii byulleten' and others) brings together, with some attempts at standardization, the data from the CIS member countries.

(ii) Facilitating business establishment - (chapter A, point 1)

(a) Rights of establishment of foreign companies

72. In chapter A, point 1 the participating States agree to improve conditions, facilities and practices of each other's firms in their respective markets, based on freedom of establishment. This liberalizing measure was highly desirable. Western capitalist firms had only been legally permitted to establish themselves in the countries with centrally planned economies a few years before the Bonn Conference took place and an array of restrictions and protection of domestic enterprises persisted. In 1990, a foreign enterprise seeking to establish itself in a country which was a member of the Council for Mutual Economic Assistance (CMEA) had to negotiate the following:
• mandatory, complicated and time-consuming procedures for obtaining authorization from Governments. All applicants had to seek approval from the authorities and to provide considerable documentation in the process: names of partners; the subject and scope of the business activity; the funds required by the firm to commence business; evidence that the applicant firm was creditworthy etc. An applicant had also often to undertake a feasibility study of the proposed project. Applications made by joint ventures could only usually be made by the domestic, not the foreign partner. Approval was typically required from several different governmental agencies one after another. These procedures which could take more than a year to complete sat uneasily with the commitment contained in the Bonn document to facilitate the “prompt entry” of businessmen into their territory.

• restricted ownership rights. Foreign investors were only allowed to own a percentage of the enterprise established - usually less than 50 per cent.

• widespread exclusion from specific sectors. Foreign investors were prohibited from establishing businesses in specific sectors, notably banking and financial services. Certain “sensitive” sectors were also listed as being barred to foreign investment. A negative list of industries was identified where foreign enterprises could not invest. This list, however, was often not published and it remained at the discretion of the authorities responsible whether the sector in which the proposed investment was being made, was acceptable or not.

• minimum capital and performance requirements. Foreign investors often had to assure the authorities that the project met the targets set in the national plan or complied with certain goals of public policy. Investors from abroad had to commit a certain amount of capital to the venture in order for it to be authorized.

• limited legal form to establish a company. Foreign companies had difficulty in the legal form in which the operator could establish. Under centrally planned economies, where all enterprise had been state owned, the concept of corporate personality for a private enterprise did not exist.

73. The Bonn document, by enunciating the principle of freedom of establishment, meant that participating States were duty bound to modify these barriers or remove them altogether. Accordingly, States introduced a number of liberalizing policies. Today, in the transition economies, as a result of these policies, the rights of establishment of foreign investors have significantly improved:

• Approval procedures: The need for government authorization has been substantially reduced. In principle none of the transition economies, except Lithuania, still require authorization for all foreign investment. Authorizations are still required for large investments in Belarus, Kazakhstan and Latvia and for investment in Moldova, over USD 250,000 in value.

• Legal form: There are no restrictions on the legal form of the investment as long as it is incorporated in the host country. Most countries allow the most common kind of companies, i.e. limited liability companies, joint stock companies and partnerships. A few allow a broader range of companies such as unlimited liability companies in Hungary and cooperatives in Belarus. Some countries, such as Latvia, Lithuania and Ukraine also allow
shareholding associations and individual enterprises. In Poland, only joint stock companies and limited liability companies are allowed.

- Equity limitations: Foreign enterprises are no longer compelled to establish joint ventures. Foreign investors can now establish fully owned companies in the region.

- Sectors closed to foreign investors: Some limitations on establishment are still in place but as in the case with all countries these tend to be made for reasons of national security, health and safety, environmental considerations, etc.

74. In certain transition economies, however, restrictions still apply where the foreign investor wishes to establish a presence through the acquisition of domestic corporate assets, particularly those in so-called strategic industries - telecommunications, power companies, railways etc. Many acquisitions in these sectors still take place but the negotiations can drag on. Some restrictions on establishment have also been applied in specific sectors. For example, the Russian Federation, for a transitional period, has made exceptions to national treatment on the establishment of foreign companies in its banking sector which concern: higher minimum capital requirements, a ceiling of 12 per cent on the overall share of foreign capital in Russian banks, a minimum level for balances on accounts of each physical person and a prohibition to carry out transactions with Russian residents.

75. Furthermore, in certain jurisdictions in CIS countries investment screening and licensing procedures persist. Establishment is complicated also by the preferences, mainly tax incentives, which some types of investment get over others. Giving preferences to large investments, for example, may be counterproductive. It may invite demands for additional concessions from investors, force Governments to evaluate requests on ill-defined terms with no specific criteria; contribute to an environment of deal-making with the Government; and compound the discretionary role of Governments, which can create problems in their dealings with foreign companies. Incentives are also offered for FDI that meets certain targets.

76. Aside from these legal rights of establishment, the participating states identified some more practical establishment problems that appeared significant in 1990, namely “the acquisition of equipment and transport facilities, access to telecommunications, utilities and social services, the carrying out of audits as well as the unhindered recruitment of local staff required by firms”. With the passage of time, however, and the opening of markets, these problems have lost their importance. With regard to local staff recruitment, for example, it is fair to say that labour markets in many transition economies are more flexible than in some western European countries.

On the other hand, the renting and purchasing of commercial premises continues to be difficult for foreign investors. In Russia, for example, despite efforts by central Government authorities, limited success has been achieved in removing the barriers to acquisition of commercial properties. The country’s commercial real estate is still owned by the Government. Rather than divesting its ownership rights, the central Government has decentralized these rights to local

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15 “Equal Footing”, Business Central Europe. September 1995. In this report it is argued that Governments are taking more time to reflect on the economic consequences of acquisitions of individual companies in strategic industries and as a consequence privatization is tending to slow down.

governments, both regional and municipal. Although this practice is quite common among other countries in transition, Russia is different because local governments have a virtual monopoly over commercial real estate and have not moved toward commercial real estate leasing using market mechanisms. Highly inefficient users occupy valuable commercial space, contributing very little to local budgets, while private sector development is blocked by the unavailability of property. One of the reasons why local authorities have not used long commercial leases to solve this problem is that the law of 1994 allows the lessee the right to buy the property after five years and at low prices.

(b) Rights of establishment of natural persons

77. The participating States, particularly western ones, can take much less credit from their records in complying with their commitments to facilitate direct contact between their businessmen and the prompt entry, stay and free movement in their respective territory. The Bonn document did not contemplate the rights of establishment of natural persons but it did recognize that freedom of contact and association was a necessary accompaniment to implementing their commitment to the free establishment of enterprises. However, the practice of some western States in enforcing tight visa formalities has had the effect of obstructing the free passage of businessmen into their territories. As a rule, it is far easier for businessmen from western countries to travel to an eastern European country than vice versa. Some CIS States, because their countries are still relatively unknown to western businessmen, could also be more active in encouraging direct contacts between businessmen at all levels, particularly with regard to publicizing the opportunities for investing in their countries in western business circles.

78. The Bonn document should also not be interpreted solely as committing participating states to permit the entry of businessmen into their territories. It also clearly commits participating States not to put anything in the way of their own businessmen carrying out their activities abroad. However, because of preoccupations with capital flight and monetary and reserve problems the Russian Federation has reserved the right to place restrictions on its own nationals from making direct investments abroad.

(c) Trade facilitation

79. The last barrier referred to in chapter A. point 1 is on trade. But rather than discussing the considerable barriers caused by the participating States' respective trade polices, the Document refers to problems relating to processing goods and people at the borders. Of course, efficient customs procedures, expeditious processing of goods and the like are also a function of liberal trade policies but at this stage the participating States chose to emphasize the former not the latter. Ironically, liberalization of trade has made considerable strides since 1990 within the region while the problems of facilitating trade have become more difficult. This is because

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18 As the result of a number of global and sub-regional developments, significant progress has been made, and can be expected in the future, in the opening of borders for the expeditious processing of goods. Among these
liberalizing trade policies changes customs practices and requires adequately trained staff at the borders to implement the new practices effectively. In addition, since 1990 a number of new States have come into being which has meant the creation of an entirely new infrastructure at newly established borders. The staff of many Customs Administrations has had to be increased considerably or created from scratch and it has taken time for these new recruits to be trained. In addition, the new borders are located hundreds of kilometres from the nearest water and electricity supplies, food and assistance.

80. The process of transition to modern commercial borders for these countries, however, despite these problems, is well underway, and there is great willingness on the part of Governments to install modern systems and methods. There has also been a positive response on the part of their western trading partners, and particularly the European Union, to assist them in this process. However, assistance to Customs Administrations could be made more effective if it were packaged in more comprehensive programmes involving fewer ad hoc solutions. To assist in consolidating both technical assistance and national efforts, the World Customs Organization (WCO) has instituted a diagnostic studies programme which helps national administrations to analyse their own problems and determine the best solutions for themselves. They have also set up a database indicating the assistance required and work to be done in many administrations.

81. Customs constitutes only one part of the administrative, transport and warehousing infrastructure required at borders. The rest of this infrastructure is also in serious need of development. The benefit of clearing customs in a few minutes, for example, is quickly lost if it takes a week to process the goods through a port and its warehousing system in order to get them on a truck. Improvement to this "import/export" commercial and transport infrastructure could be made in many Western - as well as transition economy - countries throughout the OSCE region.

82. A body of recommendations exists on the facilitation of international trade transactions, many of them created by the ECE. However, there is not enough awareness of these recommendations on the part of trade operators, and, too often, not on the part of the providers of technical assistance. Within the last year the ECE has undertaken significant efforts to increase awareness and has begun to examine these recommendations within the context of an international trade transaction model which will allow gaps in the recommendations to be identified and corrected.

83. Chapter A, point 1 concludes by stressing the importance of trade facilitation and electronic data interchange for their trade relations. The development of electronic data interchange (EDI) as a means of improving trade relations was also stressed. This recommendation was prescient as EDI is revolutionizing the way modern business is conducted and the ECE standard, UN/EDIFACT, has become the world standard in this field.19

developments are the finalization of the Uruguay Round and the establishment of the WTO, the implementation of the Single European Market within the EU and its expansion, the implementation of NAFTA, the Schengen agreement within Western Europe and various other trans-Atlantic, bilateral and multilateral agreements.

19 Trade facilitation identifies and removes procedural barriers to trade, as well as increases the efficiency of the trading process. It enables global businesses, trade and administrative organizations to exchange products and relevant services effectively. Its focus is to facilitate international transactions through the simplification and harmonization of procedures and information flows. By doing so it contributes to the growth of global commerce.
(iii) Small and medium-sized enterprises (chapter A, points 4 and 5)

84. Because of the risk that state monopolies could constitute a barrier to investment, it was no surprise that the participating states chose to focus on the need to promote small and medium-sized enterprises. This was also appropriate because the western countries themselves were interested in developing this sector and could bring practical help, experience and policy advice to the transition economies to assist them in this task. The participating States listed in chapter A, points 4 and 5 have several measures to promote the development of SMEs. Small and medium-sized enterprises (SMEs) are considered to be one of the principal driving forces in EU economic development and governments have designed policies to support SMEs and stimulate their competitiveness. In 1993, SMEs accounted for 71 per cent of the 100 million total employed in non-primary private enterprises in the countries of the European Union.

85. Not all transition economies approach the promotion of SMEs in the same way. The Czech Republic, Hungary, Poland, Slovakia and Slovenia have recognized that the development of SMEs is a crucial element of industrial restructuring and an essential part of the privatization process and economic reform. In addition to those countries, Romania and the Baltic States share the same commitment despite having only begun to implement their policies rather recently. A coherent SME policy, in contrast, has still to be developed in many countries of the Southern European region, while in the CIS countries the lack of legislation, understanding of entrepreneurship, and the lack of infrastructure and financial means are major obstacles in the way of designing appropriate polices for developing SMEs. Thus the honouring of the commitment contained in the Bonn document has been patchy despite significant assistance received.

(a) Financing of SMEs

86. Much has been achieved in financial areas of activity in the advanced central and eastern European countries through establishing credit and credit guarantee schemes for SMEs (chapter A, point 5). In other countries in transition, the lack of facilities to finance SMEs is hampering their further development. Large banks and international financial institutions such as the World Bank and EBRD are not targeting start-ups and small businesses, and many Governments in the transition economies are not able to create significant national funds for SME promotion. The participating States and their financial institutions, should review their policies for financing the creation and promotion of SMEs. Possible solutions could include provisions of state guarantees for credits for SMEs granted by private banks. The significant expansion of such schemes might be possible with the help of funds specifically allocated to this purpose under western assistance programmes (including PHARE and TACIS).

(b) Business information

Trade facilitation techniques not only reduce costs, but create efficient flows of information affecting the way business is carried out. Clear, easy-to-follow import/export procedures and the promotion of modern business communication techniques provide more than economic advantages. They also provide to potential investors a concrete demonstration of a Government's willingness to modernize and to cooperate with the private sector.
87. Compared with the developed market economies, the system of information networks in the countries in transition is not adequate. There are general complaints from businessmen about difficulties and delays in obtaining information on recent changes in regulations on trade, foreign direct investment, currency and other issues. State policy-making bodies in those countries should consider the dissemination of such information a major task. This could and should be a priority for business cooperation and trade promotion agencies. Data banks (on potential partners, available technologies, know-how, legislation, customs regulations, general advice on entering foreign markets, etc.) should play an important role in the development of SMEs. Nevertheless almost all the data banks set up in the countries in transition have a limited range of activities. Moreover, the majority of such databases are run by private companies with very high fees for SMEs, thus limiting access to valuable information. In order to facilitate cooperation between European countries in the development of SMEs, linkages have been established between central and eastern European countries and the EU network of information centres such as BC-NET and Euro-Info Centres. However, centres in the CIS countries have no direct access to western European information centres and there is no network connection between the national centres of the transition economies.

(c) Training

88. Training is a key component in all activities concerning SME promotion. The development of human resources and managerial skills is a key objective not only in economies in transition but also in the EU, which is reflected in the growth of private business schools in the region. However, only a limited number of these offer a good level of training for SMEs. Special attention, therefore, should be paid to the creation of training opportunities for SMEs including the introduction of special business schools/courses, programmes, curricula, elaboration of modular training packages, videotapes, etc.

(d) Assistance to the development of SMEs

89. The promotion of SMEs has benefited from considerable assistance from the EU. Between 1990 and 1993, the PHARE programme made available ECU 320 million to support SME development in the 11 PHARE beneficiary countries. TACIS supported only grassroots initiatives in the establishment of SMEs in the newly independent States. Funds committed to these programmes amounted to no more than ECU 40 million between 1992 and 1994. Bilateral donor countries assisted individual countries in transition, and these activities facilitated the creation of entrepreneurship. As a result of EU assistance for the development of SMEs within the PHARE programme, a total of 120 new SME support institutions has been set up in 11 countries. These institutions include Business Support Centres, Business Advisory Centres, National SME Agencies, Local Enterprise Agencies, Regional Advice and Information Centres, etc. But this is alone insufficient since it includes less than 50 per cent of the countries in transition, and these new institutions, especially the business advisory and consulting centres, need further financial and know-how support in order to become self-supporting.

90. As concerns other providers of assistance (chapter A, point 4) the role of the UN and other international organizations in assisting countries in transition in the development of SMEs was very modest, due to lack of financing. The ILO has a local enterprise development approach targeted at the restructuring of so-called “company-towns” in many countries of the CIS (mostly huge military complexes), to generate new economic activity by the creation of SMEs. In 1995,
the ECE, within the framework of the Regional Advisory Services Programme has launched a
Global Programme for the Development of SMEs in countries in transition. It focuses on the
development of national SME-policies, infrastructure building, statistics and training.
UNCTAD’s Trade and Development Board has created an Ad Hoc Working Group on the Role
of Enterprises in Development, the activities of which include the promotion of the development
of SMEs also in some of the countries in transition.

91. The Governments of the transition economies still need independent but professional
assistance in formulating their legislation, national policies and elaborating support programmes,
and government officers responsible for the development of SME policies and representatives of
SME support institutions would benefit from the regular exchange of views and experiences.
ECE could provide such a forum.

(iv) Business operating conditions (chapter A, points 6 and 7)

92. The participating States, mindful of the imminent collapse of the trading system of the
former CMEA countries emphasized the need to develop support services, advertising,
consulting, factoring and other business services as well as the organization of seminars, fairs
and exhibitions and to permit prospective market investigation and research to be conducted on
their respective territories, to fill the gap that was developing.

93. The Bonn document mentioned these support services to exporters but they could very
easily have added the following services:

- Commercial intelligence on foreign markets. Printed information on the general trade
environment of the country, sector/product specific information, directories or references
for professional services, product standards etc.

- Market investigation and research. Market research conducted on an on-going basis for
specific clients or on specific products and sectors.

- Advice on transport and shipping, providing information on points of entry and exit to the
country, best shipping routes, costs, availability, and reliability.

- The provision of consultancy service for exporters. Assistance in preparing business plans,
feasibility studies, financial arrangements and the like, to increase the country’s export
potential and build the local exporter’s capacity to enter world markets.

- Production assistance and quality control. At a more basic level than product design,
improvement of manufacturing methods, absorption of new technologies, institution of
quality controls and other methods of improving products.

- Packaging assistance, technical assistance in packaging design and quality to assure
appropriate standards for export markets.

94. These services, absent in transition economies in 1990, are still urgently needed in most
transition economies and most acutely in the CIS today. It is worth recalling that under the
previous system, most firms concentrated on production issues, and had poorly developed
marketing functions. There were no direct or “outside” sales and all transactions were

26
coordinated by the responsible buying organizations. With the collapse of the system some firms did not know the identity of their former buyers. This weakness applies to domestic markets as well, but is more acute for foreign markets. Most firms do not know how to get information that could help them begin the process of selling goods, particularly in foreign markets. The main organizations with some expertise in providing export services are the surviving former state trading companies. Often these are still state-owned but no longer receive direct budgetary support and are financially self-sufficient and autonomous. However, they lack the ability to raise additional capital and have limited resources and tend to be used as a last resort by private companies rather than as standard source of expertise and assistance.²⁰

95. The question which was not addressed in the Bonn document is how these badly needed export services should be delivered, what type of policy is required to promote these services and what type of economic cooperation is necessary to assist the transition economies in fostering such services?

96. There are several policy options that might be considered by Governments in response to these questions. These options, mentioned below using public and private sectors, are not mutually exclusive but could be selected on the basis of the needs of the economy in question and in particular its trading needs and available resources:

97. (i) Setting up an official export promotion agency. Some countries in transition are considering the establishment of publicly funded export promotion agencies (EPAs) with bilateral and multilateral assistance.²¹ The UNCTAD/WTO with support from the Swiss Government, for example, held a seminar in Warsaw in September 1995 to examine the feasibility of establishing export promotion agencies in the region. Generally, there is a good case for providing some services through an official export promotion agency. Services considered as a “public good” - that is when they provide benefits for one firm, they provide benefits for other firms - may in principle be most efficiently provided through a public agency. But there are relatively few services so characterized e.g. facilitating participation at trade fairs, maintaining commercial representation abroad etc. and at the current stage of export development of many CIS States such an organization could risk becoming a drain on the treasury while providing little help to exporters.

98. (ii) Trade points. A more cost effective policy that makes use of the latest technologies in trade information consists of setting up trade points. Multilateral assistance through UNCTAD has been gradually setting up such points in several CIS countries and although only recently established, promises much for the future. For example, it is hoped that all Trade Points will be interconnected to a Global Trade Point Network and will be equipped with efficient telecommunications tools to link up with other global networks.

99. (iii) Using the services of private companies. Many CIS countries lacking the necessary resources may benefit more in the short term from the links and cooperation being developed


²¹ Romanian established its official export promotion agency on 1 January 1996.
between local private enterprises and foreign companies. In Georgia, for example, some local enterprises have begun to establish the type of overseas contacts that can help resolve some of the problems. These formal joint ventures, agency/distributorships, marketing agreements and other forms of assistance all provide a mechanism to secure vital assistance in the areas mentioned in the Document. In these arrangements, for example, the foreign partner is often providing inputs of required quality, production/quality control assistance, final packaging and labelling and in some cases financing to make up for deficiencies on the part of domestic firms.

100 Government policy and economic assistance should be geared to facilitating the establishment of these types of links in order to successfully broaden their range of exports.

(v) Human capital resources and the need for managers (chapter A, point 7)

101 A final barrier to investment identified in the Bonn document and mentioned in chapter A, point 7 was human capital. In 1990, indeed one of the major obstacles to establishing companies with foreign capital was finding suitably qualified managers. Delays in getting joint ventures operational\textsuperscript{22} after registration and approval was attributable to the difficulties foreign companies had in finding suitably qualified local managers to run the enterprises. Local managers, while possessing excellent engineering ability, typically lacked the skills necessary for the market economy - accounting, marketing, human resource management - as well as the qualities of leadership organization and initiative. None of the transition economies had the local training facilities, know-how or financial resources to address this challenge of re-training existing managers and training new ones. The Bonn document, not surprisingly, therefore, recognized the value of cooperation in this field.

102 The Bonn document called for training in both host countries and in countries of origin and many western management schools began training eastern European managers often assisted by technical assistance funds from bilateral and multilateral donors. However, the experience of these early initiatives was disappointing. Western management schools offered courses which did not take into account the local conditions of the trainee managers from eastern Europe. Western trainers themselves had little knowledge of conditions in the east. The courses were often too short - sometimes only lasting for two weeks - to have any lasting effect. Accordingly, the assistance effort shifted towards building up training resources within the host countries. Western management schools still played an important role but their work concentrated on training the trainers and on developing links with their counterpart establishments in the east. EU assistance is and has been helpful in developing contacts between academic establishments from western and eastern Europe for management training purposes.

103 There is no doubt that the need for training still exists, particularly for managers in the emerging banking and financial sector (the Bonn document only specifically mentioned product promotion and marketing), but the lack of trained managers - apart from some CIS countries - no longer constitutes the barrier that was identified by the participating States in 1990. Clearly, the availability of assistance funds from EU and bilateral sources have played a major role.

However, the principal reason why this problem has receded, particularly in the central European countries, has been the impact of foreign direct investment. In Hungary, Poland and the Czech Republic, following the initial flows of FDI and the establishment of many new companies, local managers obtained first hand, on-the-spot training from western companies. People with exposure to western management thinking are now moving on, either setting up their own companies or taking their know-how to other firms. Besides creating a large pool of capable managers, FDI can also be credited with vast improvements in knowledge and awareness in packaging, marketing and financial arrangements (especially in consumer goods areas), which has all led to higher sales and profits. Some of the large foreign investors have set up in-house training centres for their eastern European managers. ABB, for example, the Swiss-Swedish power generating multinational, established its own “university” in Warsaw to train its managers and has been exploring ways of offering these facilities to managers from outside their company.

(vi) Conclusions

104. Chapter A of the Bonn document addressed some of the primary barriers to the establishment within the OSCE region of foreign enterprises. Six years on it can be observed that some of these barriers still remain significant; others have been more or less overcome, while completely new obstacles and barriers have emerged:

105. Statistical information (chapter A, points 2 and 3) - The Bonn document set high priority on an improvement of information flows. Progress has indeed been very substantial in the area of statistics since 1990 with willing cooperation between the countries themselves and the international agencies which are assisting them, but much remains to be done. The multiplicity of new enterprises and the hidden economy inevitably make data gathering very difficult and uncertain. The importance of good national accounts statistics is recognized in all countries and all are aiming at the international standard System of National Accounts with varying degrees of progress. Production data in some major sectors are better than most but still not adequately tracking small and medium enterprises. Balance of trade and payments data are now available from all but some CIS countries although the establishment of new frontiers and the move to new methods of data collection is still not complete. Data dissemination is very much improved but there are still great differences between countries. Some publish frequently and comprehensively and sometimes in foreign languages (quite often English) whilst others publish only very infrequently and with very large gaps and questionable methodology. The wide availability of comprehensive statistics is fundamental to a market economy and a democracy. This is recognized by most governments and is backed by cooperation among the countries themselves and between the countries and international agencies coordinated by a number of means under the umbrella of the ECE Conference of European Statisticians;

106. Rights of establishment of companies (chapter A, point 1) - Barriers to establishment have been substantially removed in the transition economies although some difficulties remain in CIS countries where improvement is required. In the spirit of the Bonn document, Governments should resist the temptation of setting up screening and evaluation procedures. Generally the country should go with the judgement of private foreign businessmen, who are willing to risk capital in the country, over that of government officials. The screening approach, which is still prevalent in many CIS countries, should be abandoned in favour of a simple (and preferably short) negative list, which states the sectors or types of activity in which the Government wishes to restrict foreign ownership. The best establishment regimes are those
where such restrictions are as transparent as possible with little discretion given to government authorities. International experience shows that setting performance targets for international investors e.g. percentages of production for exports etc., is rarely effective because Governments fail to monitor whether the investment meets its target.

107. Rights of establishment of natural persons (chapter A, point 1) - Restrictions on permitting entry and travel of businessmen in some participating States has been reported. All participating States should facilitate the issuing of visas and residents' permits in order to encourage the free passage of businessmen in their territories. In order to encourage direct contacts between businessmen at all levels many CIS countries should develop a basic investment promotion capability. Such a capability need not demand huge resources. Rather the agency established should set out to provide some basic services which could include compiling lists of existing laws and procedures, publishing promotional material with basic economic information, and providing a centralized location to respond to investor inquiries.

108. Trade facilitation (chapter A, point 1) - The transition economies are making considerable progress in liberalizing their trade. While trade policy is being liberalized, facilitation, however, is becoming an increasing, rather than a receding problem. Electronic standards - notably UN/EDIFACT can assist Governments of transition economies in laying the groundwork for developing a more efficient trade system in the future.

109. Small and Medium-sized Enterprises (SMEs) (chapter A, points 4 and 5) - The development of SMEs has broadened the spectrum of potential partners but in many countries difficult business and operating conditions, particularly the high interest rates charged by banks, constitute a major barrier to the development of these companies. Technical assistance projects have been sponsored by bilateral and multilateral donors but despite this scale of effort, studies have shown these to be relatively ineffective. Much more still needs to be done particularly in the CIS.

110. Export and business services (chapter A, points 6 and 7) - Governments should make greater commitments to developing export and business services, particularly in the CIS. Consideration may be given to establishing centralized trade information centres. Such an agency would compile basic information on main overseas markets, standards and trade agreements. Such a centre would not be intended to be the first stage of the creation of a trade promoting agency; rather it might ultimately be transferred into a private sector business association. Establishment of large export promotion agencies in some countries may prove to be a waste of resources if the volume and structure of trade of the country is insufficient to justify it.
111. Training (chapter A, point 7) - Most significant improvements in training have been reported where countries have attracted FDI; the private sector needs to establish closer links with training institutions in the host counties if progress is to be achieved. Governments should encourage training of locals by foreign and domestic enterprises.

112. Overall, many of the barriers to establishment have been lifted and the transition economies have made remarkable progress in a relatively short period of time. However, there are still difficulties in diversifying relations and encouraging foreign capital to establish in countries in transition. New issues, moreover, are going to emerge on the same theme and will need to be closely assessed and monitored by the participating States. For example, the establishment of enterprises has generally been discussed in terms of western companies establishing operations in the transition economies. Increasingly, enterprises from the transition economies are seeking to exploit their competitive advantages outside their borders, including in western economies. This may be difficult for many of these firms as the vast majority are not listed on stock exchanges and have no proven track record of doing business that can provide authorities and investors with necessary information.

113. Furthermore, since the Bonn Conference took place, new barriers to economic cooperation have emerged that need to be urgently addressed by the participating States. The most disturbing new development has been the rise of organized crime and the problem of official corruption. This problem spreads across borders. As it concerns the transition economies, some economists have perceived the development positively. It is a sign of wealth flowing into the region and of the emergence of new businesses. This view, however, ignores the costs of this development. Although it is difficult to quantify, higher costs to security firms etc. and the negative image it creates, acts as a deterrent to establishment in the region, particularly to smaller firms. Official corruption means Governments lose revenues from taxation. Amongst the solutions are higher pay for civil servants and more efficient tax raising systems. Cooperation in addressing this problem, however, is necessary.
B. INDUSTRIAL COOPERATION

114. Having laid down in chapter A of the Bonn document the necessary pre-conditions that would permit enterprises to be established in each other's territories, the participating States in chapter B identify the actual conditions for creating a "favourable climate for investment" (chapter B, point 6) and industrial cooperation. Some of the principles they enunciated in chapter A are repeated in chapter B, notably the principle of freedom of establishment and non-discrimination and a number of other measures are identified, namely: protecting industrial, commercial and intellectual property rights (chapter B, point 2) and providing foreign investors with adequate means to guarantee these rights (chapter B, point 2); creating an appropriate and reliable legal and administrative framework (chapter B, point 3); providing comprehensive and up-to-date information on all legal provisions (chapter B, point 5); developing multilateral and bilateral instruments for the protection and promotion of investment (chapter B, point 6); and standardization (chapter B, point 6).

115. This section reviews each of these commitments in turn to determine the extent to which they have been honoured by the participating States. Some evidence of the success of the participating States in honouring these commitments and in creating a "favourable climate for investment" can be seen by the amount of foreign direct investment (FDI) and the extent of industrial cooperation which has occurred in the transition economies since the Bonn Conference. Therefore, this review starts by examining the extent of FDI and industrial cooperation.

(i) FDI joint ventures, industrial cooperation (chapter B, point 1)

116. Chapter B of the Bonn document is entitled "industrial cooperation" although the term FDI is used synonymously. The use of the term "industrial cooperation" reflects the old style, more narrow type of cooperation between state-owned enterprises and western private firms which had taken place in the 1980s and which generally had a limited economic impact. Foreign direct investment (FDI) is quite another type of "industrial cooperation". In contrast to other forms of capital transfer such as short-term debt instruments or portfolio investments or the technology licensing agreements of previous-industrial cooperation, FDI represents the most permanent flow of private capital across borders. It reflects the decisions and strategies of international corporations. As international corporations pursue their long-term strategies such investment can reinforce a country's comparative advantage. FDI has thus a much wider impact on enterprise and economic restructuring and can play an important role in transition to the market economy. Even in 1990, FDI had already overtaken old style industrial cooperation in importance.

117. The participating States were correct in focusing on this type of "industrial cooperation". Among the various types of private international capital flows, FDI has always offered particular benefits to recipient countries. Its value stems from the concurrent deployment of technology, the transfer of managerial and marketing expertise, and more broadly, the enhancement of efficiency and the promotion of comparative advantage in international economic relations. Once successfully established, foreign investment creates its own virtuous cycle of reinvestment and expansion. While simultaneously stimulating competition and technological innovation, it encourages adaptation horizontally among rivals and vertically among suppliers.
118. While FDI can act as a catalyst for trade promotion and the restructuring of an economy’s productive base, the process is, however, not automatic. Beneficial trade effects do not occur simply by a country attracting large FDI flows. In fact, there are several potential problems to which FDI can give rise. These include the possibility that such ventures serve only the home market rather than contributing to exports; that they may threaten the growth of small indigenous firms and lead to monopolistic markets; and may not develop local R & D capabilities.

119. It should be recalled that the flow of FDI in Latin America in the 1970s (behind high tariff walls and protected domestic markets) did not raise output, productivity or exports. In these and other developing countries, complaints were often raised that foreign firms exported too little and imported too much. Indeed, some complaints have been raised in the transition economies that the economic contribution of FDI has not been as great as was expected: the protection of domestic markets, large western companies in specific oligopolistic industries - cars, telecommunications, tobacco, etc. - have often demanded and obtained from Governments, can distort trade and have negative effects on enterprise restructuring. But there are significant improvements due to FDI in the exports of the transition economies.

120. The participating States do not explicitly state what they specifically want to achieve from FDI but this can be inferred from point 1 which identifies what can be achieved by a favourable climate for investment. Accordingly, the participating States are seeking to reap the following benefits: a large volume of investments, managerial and technical know-how, the upgrading of the quality of production, the exchange and application of technology and improved marketing opportunities.

(a) Volume of investments

121. In 1990 when the Bonn document was approved, the estimated value of FDI stock in European transition economies was 4.8 billion USD. By the beginning of 1995, this figure had grown to 24.5 billion USD, a five-fold increase (see table 1). The most important aspect of this figure is that the bulk of FDI has gone to where the transition and reform has been most apparent. Generally, most new FDI by international companies tends to be based on the underlying prospects for market growth and profitability. Conversely, new FDI flows to countries that continue to have major market distortions are low. Accordingly, as much as three quarters of the cumulative inflow of FDI went to countries leading in economic reform (Hungary, Poland, the Czech Republic, Slovakia and Slovenia). The CIS countries in general have failed so far to attract the desired volumes of foreign investment.

122. Thus, by 1995 few of the participating States can be satisfied with their performance in attracting a significant level of FDI.
TABLE 1
FDI stock in European transition economies, October 1990-July 1995
(Million of US dollars)

<table>
<thead>
<tr>
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<th></th>
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<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Czech and Slovak Republics</td>
<td>340.0</td>
<td>1 829.5</td>
<td>2 532.3</td>
<td>3 580.4</td>
<td>4 016.3</td>
</tr>
<tr>
<td>Hungary</td>
<td>1 080.0</td>
<td>5 501.9</td>
<td>8 342.0</td>
<td>9 907.7</td>
<td>9 989.9</td>
</tr>
<tr>
<td>Poland</td>
<td>210.0</td>
<td>1 644.1</td>
<td>2 542.5</td>
<td>3 574.2</td>
<td>3 910.2</td>
</tr>
<tr>
<td>Romania</td>
<td>...</td>
<td>516.2</td>
<td>651.9</td>
<td>1 134.8</td>
<td>1 380.2</td>
</tr>
<tr>
<td>CIS European member States b</td>
<td>3 208.0e</td>
<td>...</td>
<td>2 923.6</td>
<td>3 777.1</td>
<td>4 229.2</td>
</tr>
<tr>
<td>Other</td>
<td>...</td>
<td>...</td>
<td>756.0</td>
<td>1 444.9</td>
<td>1 671.1</td>
</tr>
<tr>
<td>Subtotal</td>
<td>4 838.0</td>
<td>...</td>
<td>17 748.3</td>
<td>23 419.1</td>
<td>25 196.9</td>
</tr>
<tr>
<td>Ex-Yugoslavia</td>
<td>1 163.7</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
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</table>

* Preliminary.

Source: UN/ECE secretariat and national statistics.

(b) Managerial and technical know-how

123. As has been shown in commenting on chapter A, point 7 the impact of FDI on human capital has been significant in raising the standards of managerial and technical know-how in countries like Hungary which by January 1995 had attracted almost 10 billion USD in FDI. Many of the firms taken over by foreign companies had previously lacked the managerial and technical know-how, particularly in the areas of cost control, to become market leaders. The foreign firm, by introducing this know-how, has improved the competitiveness of local companies and made them more important market players.

124. However, this positive impact has tended to take place in markets where FDI has been permitted access to privatization and where the volume of FDI has been rather large and a critical mass has been created. The same sort of impact has not been observable in other countries where investments have been small.

(c) Upgrading the quality of production

125. Foreign companies have invested in modernizing the machinery in factories in order to achieve higher quality standards in output. Several companies with foreign participation have managed to bring their plants up to ISO standards. By bringing up local production to internationally recognized standards, western companies have raised the export competitiveness of the host economy.
(d) The exchange and application of technology and improved marketing opportunities

126. Access to western technology appears to have been a principal objective of some transition economies in promoting greater industrial cooperation. FDI has not, however, occurred, with a few exceptions, in high technology industries. In addition, western firms have been establishing international networks of enterprises to cooperate in developing, exchanging and applying new technologies. To date, enterprises from eastern Europe have not figured strongly in such networks. Consequently, until a full appraisal of the role of FDI in central and eastern Europe in transferring and applying technology has been conducted, the evidence that significant benefits have been created by FDI is inconclusive.

127. Marketing opportunities, in contrast, have been one of the areas where FDI has made a major contribution. Companies have established distribution and retail networks which have boosted the sale of local and foreign brands dramatically. In addition the distribution channels abroad of foreign companies have allowed domestic firms to sell more in foreign markets. Components, made in a transition economy have also been sent for processing to another enterprise within the firm's international production network. Over 40 per cent of Hungary's total exports were accounted for by enterprises with foreign participation in 1993.²³

128. In addition to these objectives which the participating States were seeking to achieve in fostering industrial cooperation and FDI, the participating States also specified other goals related to specific industrial sub-sectors which are addressed in Part C, (iii) and (iv).

(ii) Property rights (chapter B, point 2)

129. The participating states, as an important element of a favourable climate for investment, gave a high priority to the need to protect industrial, commercial and intellectual property rights.

(a) Intellectual Property Rights

130. Intellectual property rights are necessary to protect the innovators and creators of non-tangible property. Where these rights are not protected and trademark counterfeiting and copyright piracy is rife, investment generally will be weak. Intellectual property rights include copyright, patents, trademarks, industrial design and know-how. Laws protecting these rights should give the innovator exclusive legal right for economic exploitation of the innovation for a certain period of time, including the sole right to license others to use the innovation for commercial purposes. Under the former legal systems, little legal protection was afforded to intellectual property.

131. National legislation in the field of intellectual property has been substantively transformed in the transition economies. Patent and trademark laws modelled on western

legislation have recently been passed in Belarus, Estonia, Kazakhstan, Latvia, Lithuania, Ukraine, Romania, the Czech and Slovak Republics and Russia. Copyright laws, moreover, have been passed in Bulgaria, Estonia, Kazakhstan, Latvia, Poland, Ukraine and Russia. Legislation has recently been enacted to protect industrial designs in Belarus, Kazakhstan, Latvia, Russia and Ukraine. Some countries have still to revise their intellectual property laws. Nevertheless, as the above demonstrates transition economies have made substantive progress in developing their national legislation. Many states – for example, Poland, Hungary, Czech Republic, Slovak Republic, Bulgaria, Russia and Ukraine have enacted highly sophisticated, modern legislation to protect the new information technologies e.g. integrated circuits, databases and utility models.

132. The transition economies have also made much progress in bringing their intellectual property legislation up to international standards for the protection of patents, trademarks, industrial designs and copyright. Some countries have ratified the 1883 Paris Convention for the International Protection of Industrial Property and the Patent Co-operation Treaty (PCT) of 1970. Russia, Latvia, Ukraine, Estonia have ratified the 1886 Berne Convention on copyright. In March 1994, the Eurasia Patent Convention was signed, granting mutual patent protection an registration between the participating States of many CIS states. The European Patent Office has since 1980 issued European Patents which grants protection in any or all of the European Patent Office’s 17 member states. Extension agreements have recently been signed with Slovenia, Lithuania and Latvia (other agreements are expected to follow), thereby incorporating these countries into the EPO’s protective framework. In addition at the international level, the implementation of the WTO Agreement on trade-related aspects of intellectual property rights by 1996 will further add to the development of intellectual property protection.

133. The participating States also committed themselves to guarantee these rights to foreign individuals and companies by providing them with access to the courts and the appropriate administrative bodies. This commitment however, has not been realized in almost all the transition economies. Laws may exist – even very sophisticated ones – but in many states the appropriate administrative bodies have not yet been created or the lawyers trained in drawing up the complex legal documents for patent applications. In the CIS, local offices for registering patents are still in the process of being established. Poor or non-existent enforcement also prevents foreign businesses from benefiting from the full protection of these rights in most transition economies. Lawyers and judges as well as the local police, for example, are inexperienced in intellectual property matters and in outlawing what constitutes as “theft” of intellectual property. Even in the Czech Republic whose laws conform with EU standards, the average period for criminal proceedings from indictment to sentencing in copyright cases is two and half years. In this country local businessmen have been organizing training courses to educate the relevant bodies and the police in better enforcement of intellectual property laws.

(b) Commercial Property Rights

134. The participating governments also committed themselves to protecting the commercial property rights of foreign investors and their rights to acquire such rights in their territories. With regard to commercial property - defined as property required for businesses - factories, offices, etc.-enterprises with foreign participation are generally allowed to acquire ownership rights to the

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buildings necessary for business purposes, provided proper authorization is secured: for example, government authorization is required in Bulgaria and the Czech and Slovak Republics and authorization from the Ministry of Interior in Romania, Belarus, and Poland is needed. In Hungary, authorization is required only for foreign nationals and not for foreign owned enterprises incorporated in Hungary. Different rules apply in most countries if the buildings were acquired in the course of privatization.

135. However rights to commercial property are restricted in other countries. In Russia as we have noted local administrations can restrict access to commercial properties to foreign investors.

136. The Bonn document is silent on the rights of foreign investors to acquire land for their businesses and, it could be argued, that this is a weakness. Land ownership by a foreign investor can bring many benefits to a local economy. In particular, it injects capital into the economy and encourages the development of a market in real property which generates wealth, employment and tax revenues. Land also serves as security when an investor seeks to raise credit from a bank. Restrictions on ownership of land can therefore create a barrier to new investment in plant and machinery.

137. Initially, limits existed on the ownership of land and immovable property throughout the region due to the long legacy of state ownership and the administrative difficulty in identifying representatives of the state with whom to negotiate a sale. Claims from former owners to have their lands restored after they had been expropriated by the former communist government also delayed implementation of the privatization of land. Many restrictions have been or are being lifted. However, many countries are still reluctant to allow foreign investors to acquire non-agricultural land because of a fear of land speculation. Foreign enterprises may purchase the land needed for business purposes in Bulgaria, Estonia, Hungary, Latvia, Poland and Romania, and for certain activities in Albania and Belarus. The Czech Republic and Slovakia do not allow foreign registered businesses to own real estate; the foreign business must first be locally registered before it can do so. Many of the other countries prefer to authorise foreign investors to lease land, for a period of up to 99 years in Lithuania and up to 50 years in Ukraine.

138. Law in itself is not sufficient to protect real property rights. New institutions are needed as well. There are, for example, innumerable problems in registering land in the transition economies. A properly functioning land registry is necessary to secure property rights and to allow land to be bought, sold and used as security. Owners need to be able to demonstrate proof of ownership and their power to sell. Buyers need to know what rights, burdens and mortgages exist on a property in which they contemplate purchase. Banks need to be satisfied that the title is sound if they are to lend money.

139. In order to create norms and standards of best practice in the buying and selling and leasing of land, the UN/ECE's group of legal experts has been active in preparing guides on the adaptation of land law in the transition economies, hosting seminars of interested legal and financial experts from the private sector and in offering advice to transition economies on their legislation. This work has been undertaken in close cooperation with the EBRD which has

worked to develop more security for lenders in transition economies. For example, it has drawn up a model law on secured transactions which has helped several CIS States draft relevant legislation.

(iii) An appropriate and reliable legal and administrative framework (chapter B, points 3-6)

140. Good clear legislation is an essential part of the infrastructure for a competitive business environment. The Bonn document emphasises the need for an appropriate and reliable legal and administrative framework as a key element of a favourable climate for investment and contains a relatively detailed list of the constitutive elements of such a framework. In reviewing these elements it is not sufficient to note their presence. Laws need to be enforced to be effective and so the institutional and administrative arrangements for this task also need to be examined. In reviewing the commitments to establish an appropriate legal framework it is worth recalling that in 1990 the vast majority of transition economies did not have the basic commercial and property laws for a market economy.

(a) Fiscal laws

141. New modern taxation laws have been enacted in all transition economies. The burden has shifted away from enterprises to private citizens. The collection of taxes and recording of income liable for tax remains however, a problem in many transition economies. The lack of coordination between the various authorities responsible for levying taxes also can create an additional difficulty for investors.

(b) Competition laws

142. Most transition economies have introduced competition laws - against monopolies, trade restraint, and restrictive business practices - rather early in the transition process as a prelude to privatization. It was believed rightly that privatization could not be successful if enterprises, once privatized, were allowed to resume their dominant position. Generally however, these new laws have tended to be poorly enforced and Governments have relied on the other means, - useful but in many cases less effective - for creating a competitive business environment such as trade and price liberalization. It is hardly surprising that competition laws in the transition economies have tended to be weakly enforced. Implementing such laws requires specialist skills and knowledge about how enterprises behave in a market economy and how they generate monopolies in specific industries. Obtaining such skills requires extensive training and takes time.

143. The Czech Republic, Estonia, Hungary, Poland and the Slovak Republic have modelled their legislation on EU norms but many other transition economies have either no legal or administrative frameworks created for this purpose. It has also been reported that in some countries of the CIS, competition policy is being used as a tool to continue widespread price controls. Competition laws also are being applied, it appears, to slow down privatization: in

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the Russian Federation, for example, so-called “monopolies” must obtain government approval for privatization even though the threshold - a market share of more than 35 per cent - seems rather low.

(c) Bankruptcy and insolvency legislation

144. Since the beginning of reform all governments have enacted bankruptcy and insolvency legislation. Ideally this legislation should provide a fair system of economic rehabilitation for both companies and individuals. Unviable companies should be wound up in an orderly fashion, but there should be a range of effective rescue mechanisms for viable companies with temporary business problems. In transition economies bankruptcy or the threat of bankruptcy also acts as an incentive to enterprises to pay back overdue borrowing as well as induces essential corporate and industrial restructuring.

145. Enforcement of bankruptcy has varied throughout the region. In central and eastern European countries and the Baltics, companies have been declared bankrupt. In Hungary for example, since enacting its bankruptcy law in 1992, close to 6,000 companies have since filed for bankruptcy, a third of which have undergone liquidation proceedings. In the CIS in contrast a far limited number of enterprises have been declared bankrupt.

(d) Company laws

146. A company enables a private individual to carry out economic activity with the protection of limited liability. Because individuals are the prime users of this business entity, company law must be easy to understand and the procedures for company formation must be simple, quick, inexpensive and transparent and be accompanied by a minimum of formalities.

147. All transition economies have enacted company laws. In some transition economies, however, the civil codes establishing procedures for registering joint stock companies and providing some rudimentary corporate governance provisions impose many restrictions on the creation and operation of business enterprises and rely too heavily on prohibiting, rather than enabling provisions. Relevant laws should restrict or minimize the ability of government bodies and agencies to impose licensing requirements. Delays in company registration have also been reported in some jurisdictions.

(e) Arbitration procedures

148. An effective judiciary must also be willing to recognize and enforce foreign judgements and foreign arbitral awards rendered in investment disputes without re-examining the merits (in those circumstances where the law permits such recognition and enforcement). Most of the countries of the region do not recognize foreign judgements, even though many are required by their treaty obligations to enforce foreign arbitral awards covered by the 1958 New York Convention.

149. In eastern Europe, foreign arbitral awards are generally recognised and enforced without a re-examination of the merits. In other countries of the region, even if such awards are recognised, there is often a lack of an effective mechanism to enforce the award.

(f) Investment protection

150. Investment protection is provided not only in national legislation, but also in negotiated bilateral investment treaties between the governments of home and host countries. National treatment is the most important element of investment protection, but protection against expropriation and nationalisation and the repatriation of profits, invested capital, salaries and other payments such as interest, income, and capital gains, and guarantees against adverse changes in legislation are other important elements. 28

151. The principle of national treatment is widely applied. In their national legislation and in their bilateral investment treaties, all host countries in principle accord foreign-owned enterprise operating on their territory treatment that is not less favourable than that granted to national investors in comparable situations. This does not exclude the possibility that foreign investors may sometimes be granted more favourable treatment.

152. Protection against expropriation in the public interest and nationalizations are granted to foreign investors by all countries. In the event of nationalization or expropriation of assets, all countries guarantee compensation in convertible currency equal to the amount of the investment both in bilateral treaties and in domestic legislation. 29

(g) Free transfer of profits in foreign currency

153. Almost all countries now allow the repatriations of profits, capital invested, capital gains and interest income. However there are still some restrictions on the expatriation of expatriate salaries in Bulgaria, Kazakhstan and Hungary. In Hungary, only 50 per cent of an expatriate's salary may be converted into hard currency and repatriated. In some countries, neither the foreign investment law, nor exchange controls address the issue of wage repatriation. Such is the case for the Ukraine.

154. If the foreign investor is not allowed to convert his local currency profit into hard currency and repatriate it, then he is likely to invest only if an export market exists for his product. In some countries, however, a complicated system of export licensing is in place and potential foreign investors are not guaranteed the opportunity to export.

(h) Accounting systems


29 OECD. Ibid.
155. The need to bring accounting systems to internationally accepted standards, which allow investors to determine the true worth of an enterprises and its ability to make profits was perceived at the early stages of reform as vital if the transition was to succeed. Few enterprises in transition economies were familiar with the practice of producing financial statements consisting of a profit and loss account or a balance sheet. There were no laws which set out what information enterprises should provide in these statements. 

156. Transition economies rather rapidly enacted new accounting legislation and enterprises have begun to restate their accounts to international standards. Training of accountants has begun and professional associations of accountants formed to maintain high standards. In many instances the role of large western accounting firms active in privatization has helped transition economies build up their expertise and knowledge in this area. The EBRD which insists on scrupulously prepared audits of each project proposed for funding has also contributed to raising expertise in the transition economies.

157. However, accounting issues continue to cause problems none more so than the problem of valuing corporate assets. This problem first emerged in early privatizations, when some governments accused western consultants of under-valuing corporate assets. Many governments wished that valuations be conducted using the cost approach - based on the theory of "substitution" i.e. a hypothetical purchaser should pay for property the cost of replacing it. This approach, while justified on the grounds that there were no past sales to guide the valuer, ignored demand and supply considerations and the way the market thinks or acts. An industrial property, for example, where there is no buyer (and in the east European context, this concerns much property because of over-supply) may have a market value totally unrelated to its 'cost' value.

158. The adoption of more market based valuation approaches is gradually taking place. To facilitate the adjustment to this accounting practice however requires both western and local government support. This assistance should focus in promoting cooperation between established professions in the west and emerging valuation profession in the east in order to develop appropriate academic standards for practitioners as well as professional bodies to enforce proper standards. Governments in transition economies can also help in promoting these professional groups by formalizing their role e.g. by requiring banks, by law, to use professional valuers to screen mortgage applications.

159. The UN/ECE, which has worked in accounting and valuation issues related to privatization, has organized several international meetings which have attracted professional appraisers from the region. Particular interest has been shown in such meetings by the new professions in transition economies reflecting their own wish for more recognition from their own Governments in the work they undertake. The UN/ECE, under the auspices of its working

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groups, including its working group of legal experts, could continue to provide a forum for these meetings in the future. 32

(i) Enterprise autonomy

160. Many jurisdictions have enacted laws which remove all restrictions related to the legality of private enterprise activity. But some civil and commercial codes still however contain reference to private business activity as being illegal.

(j) Reliable administrative framework

161. Poorly administered laws result in delays and uncertainty, thereby increasing transaction costs for the investors and undermining the positive impact of an otherwise favourable legal regime.

162. Securing property rights is the work of the law, but it requires an adequate administrative structure as well. As noted above, clear and reliable real property rights depend on the Government having created an effective and up-to-date, land registry system. Similarly, secured transactions depend on shares and other security interests (such as mortgages and liens) being noted on public registers.

163. Registers exist in many east European countries for company shares and property. Although almost all countries of eastern Europe do have systems enabling the establishment of registers for land and security interests, the register files in many countries are inaccurate. Generally, in the CIS, there is no adequate system for registers, or they are incomplete or outdated. Another impediment is the requirement to pay fees on the notarisation or registration of the security instrument. These fees often bear no relationship to the administrative cost incurred in providing the service but are more akin to a tax, sometimes levied at excessive rates, and especially against foreigners.

164. Certain laws provide for the priority registration of security interests of lenders in respect of asset or capital of borrowers. The utility of laws, however, is sometimes compromised by the absence of registers or by the incompleteness of records resulting from the failure of the Government to maintain an up-to-date register.

165. There are also not enough judges and lawyers trained in civil and commercial law. In many countries the judges are not remunerated in accordance with legally prescribed standards. Many jurisdictions require administration laws which define the rights and obligations of civil servants.

(k) Comprehensive and up-to-date information on all legal provisions affecting investment

   (chapter B, point 5)

166. A favourable economic environment for investment requires that reliable information about FDI policies and practices, including information on laws are available. Laws and

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Box: EBRD Survey on laws for investing in transition

Laws that cannot be enforced are not of any value. In the countries in central and eastern Europe, the laws however well drafted may be worthless if they lack the appropriate administrative and judicial backing.

In response to investor concern at the poor record of enforcing laws in the region the EBRD conducted a survey of law firms operating in the countries and some Government officials where the Bank has operations. This survey drew the following conclusions:

- First, only a few countries have legal rules on investment that approximate generally accepted standards with Hungary and Poland performing best;
- Second, that countries with relatively good legal rules can have them severely compromised through poor accessibility and enforcement. Russia stands out as the prime example here;
- Third that almost all countries have made more progress in enacting investment laws conducive to investment than they have in ensuring that the laws are effective;
- Fourth that in a few countries, while the investment laws are not optimal, the legal system which supports them are basically in good shape and that in itself is conducive in fostering an environment supportive of investment. Croatia, Estonia and Slovenia fall into that category.

These conclusions reveal that by and large, all countries are taking steps to improve their investment laws but that there is substantial work ahead in making these laws truly effective. For investment laws to be effective they have to be true, clear and accessible and adequately supported both administratively and judicially. In some countries, this requires a radical change in the way in which laws are made, disseminated and their implementation funded, as well as in attitudes toward the roles of the courts.

Source: EBRD, Survey Transition Report 1995

regulations should be published formally and deliberate administrative obfuscation and secrecy eliminated. The participating governments commit themselves to provide a comprehensive and up-to-date information on all legal provisions affecting investment.

167. But there have been considerable shortcomings in complying with this commitment as the following examples indicate:

- Laws are only published well after their enactment: in certain CIS countries it is not unusual for laws to be first published more than six months after being enacted;
- Laws may be published but they are poorly disseminated: many countries have still not established a public service of information on laws and other events important to the individual citizen,
• There is limited dissemination of draft laws: publication of draft bills in advance of introduction, allows consultation to take place on clarity of structure and presentation, as well as on policy;

• Fees, important export licenses and other government regulations are subject to frequent change - often without notice;

• Laws affecting investment are issued by executive decrees and are often considered to be unclear or to impose requirements which conflict with federal laws;

• Important court decisions are not usually published or are easily accessible by practitioners;

• Laws particularly on taxation are subject to abrupt change. Indeed, in some jurisdictions it is impossible to keep up-to-date because the laws are constantly changing.

168. Such shortcomings are extremely serious and account for the insecurity which many investors feel in investing in the region. While in the old Soviet Union, obtaining the legal texts of new laws or decrees presented little difficulty, the marketing system used in the central planned economy no longer functions today. A reliable private sector alternative has yet to replace it. In all CIS countries the situation has become the same so that it is extremely difficult to get hold of the laws and statutes.

(l) Multilateral and bilateral arrangements for investment protection and promotion
(chapter B, point 6, chapter D, point 4)

169. Multilateral and bilateral instruments can play a useful role in providing investors with an additional layer of security to that provided in national legislation. The participating governments to the Bonn Conference on several occasions committed themselves to concluding bilateral and multilateral instruments on the protection and promotion of investment.

Bilateral arrangements for investment protection

170. Before the Bonn Conference, the countries of central and eastern Europe (Bulgaria, Czechoslovakia, Poland, Romania) had already concluded many investment treaties with OECD countries. The trend continued throughout the period 1990-1995. In total, around 90 agreements with European states, the US and Canada were concluded. Furthermore these countries, especially Poland, the Czech Republic and Hungary, have signed a large number of investment treaties with other transition economies. (Poland has concluded about 17 such treaties). In the Baltic region, agreements have been signed since 1991 and amount to a total of 33 with OECD countries. Only two agreements have been concluded between the three Baltic states and other transition economies namely Poland and the Czech republic. The data available on Slovenia and Croatia, suggests that the former Yugoslav countries have been less active in concluding investment agreements. Croatia has currently only one agreement with Poland, and Slovenia two with OECD countries and two with other transition economies.

171. The Russian Federation inherited 8 investment agreements signed with OECD countries in 1989 and has since concluded 8 others with three OECD countries and 5 with other transition economies. The other CIS countries have only signed a few agreements with OECD countries. Amongst those who have signed the most are the Ukraine with 9, followed by Kazakhstan and
Belarus with 8 respectively. Other CIS countries (Azerbaijan, Tajikistan) have only recently started negotiating such treaties. The number of agreements signed with other transition economies is equally low, ranging between 1 for the bulk of CIS countries and 5 in the Ukraine.

172. It should be recalled that many countries from central and eastern Europe have Association agreements with the EU where agreements to protect mutual investments are included.

Multilateral arrangements for the protection and promotion of international investment

173. In addition to bilateral investment protection agreements, the participating states also commit themselves to concluding multilateral arrangements for investment protection and promotion. This is an important commitment in view of what has been observed above; the bureaucracy, exclusion from privatization; monopoly positions held by domestic enterprises; limited information on laws and poor enforcement; ad hoc state interference, performance requirements, limited protection of property rights; continuing problems over establishment, authorization and screening procedures etc.

174. It is clear that elimination of these obstacles and international standards on national treatment, non-discrimination etc could further increase the flow of FDI to these countries. Multilateral standards on investment that are accepted by the eastern partners will greatly increase the confidence of western investors. Multilateral standards on investment which take account of the specific investment problems in the region, e.g. protection of property rights, sub-regional enforcement, would provide particularly CIS states with useful guidelines that would assist them in bringing their investment regimes up to international standards. Standards would be of particular benefit to SMEs who cannot afford to pay the high transaction costs of doing business in an insecure environment where buying favours and 'security' imposes undue burdens.

175. To date multilateral standards for the protection and promotion of international investment do not exist. It has been argued, that a general body of rules can be distilled from the various bilateral treaties, national investment codes and a few existing multilateral instruments (UNCTC draft Code of conduct on transnational Corporations and the OECD Guidelines for Multinational enterprises).33 However, it is important to bear in mind that these rules were not directed at Governments but at multinational companies and are thus of less use to modern requirements. Also some principles that appear to be an international standard of best practice towards a foreign investor, e.g. the principle of national treatment, are often open to wide interpretation in many western countries. For example, currently in the United States some argue that "national treatment" should be made "conditional" depending on whether the home country of the foreign investor provides market access to US enterprises.34 It is this lack of consensus on standards - such as national treatment - that has obliged the OECD to develop a multilateral investment agreement of liberal investment standards. Until this instrument is developed


however, in some years hence, there may be a lack of multilateral standards which may hamper FDI flows into the OSCE region.

176. Multilateral forums have addressed these weaknesses in the investment environment in the countries of central and eastern Europe and the CIS. On 17 December 1994, an Energy Charter Treaty was signed in Lisbon to facilitate energy related investments in central and eastern Europe and the CIS. While it contains comprehensive rules on investment protection, trade-related investment measures, transfer of funds etc., the Treaty only covers activities in the energy sector.

177. Relevant to the promotion and protection of FDI are a number of other Multilateral instruments. For example, Bulgaria, Belarus, Czech Republic, Hungary, Latvia, Poland, Romania, the Russian Federation, Slovakia and Ukraine are parties to the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards, which obliges participating States to recognize arbitration awards on FDI made in foreign courts. Bulgaria, Czech Republic, Hungary, Poland, Romania, the Russian Federation are also parties to the Paris Convention for the Protection of Industrial Property of 1883. The Washington Convention on the Settlement of Investment Disputes between States and nationals of other states of 1965 had been ratified by Albania, Belarus, Czech Republic, Estonia, Hungary, Kazakhstan, Lithuania Romania, and the Russian Federation. As of June 30 1995, almost all the transition economies had become members of the Multilateral Investment Guarantee Agency (MIGA) or had acquired Category two membership. Five other countries - Armenia, the Republic of Bosnia-Herzegovina, Latvia, Tajikistan, and the Federal republic of Yugoslavia - were in the process of fulfilling MIGA's membership requirements. Finally, the European Convention on International Commercial Arbitration of 1961 whose purpose was to promote the use of arbitration in commercial disputes and is used as a model for domestic law and practice in those countries who have signed the Convention, has been ratified by several newly independent states. Under the powers of the Convention, the office of the Executive Secretary of the UN/ECE has facilitated the work of a "Special Committee", which resolves trade and investment disputes, and which is set up under Article IV of the Convention.

(iv) Conclusions

178. This review of the extent to which the transition economies have developed a "favourable climate for investment" and industrial cooperation has revealed significant progress but also shortcomings.

179. On the positive side it has been demonstrated that:

- where foreign direct investment and industrial cooperation have been encouraged, it has brought substantial benefits to the host economy, particularly in raising managerial and technical know-how, upgrading the quality of production and in expanding marketing opportunities.

- virtually all the transition economies have enacted the main laws for industrial cooperation and FDI, particularly commercial laws, e.g. company, fiscal, bankruptcy laws etc. They have also developed new laws on property rights, particularly the protection of intellectual property;
* investment protection - national treatment, protection against expropriation, free transfer of profits - has become enshrined in the national legislation of transition economies.

180. On the less positive side, it has been observed that:

* many countries particularly in the CIS have failed to attract foreign direct investment;

* the poor performance in developing cooperation and FDI is due primarily to an unfavourable climate for investment whose main weakness is the absence of sufficient enforcement of existing legislation, and the absence of adequate institutional and administrative systems. This unfavourable environment is compounded by the lack of up-to-date information on laws affecting investment and too many restrictions are placed unnecessarily on foreigners acquiring real property;

* legislation particularly on taxation is subject to change often without notice in some CIS states;

* despite progress in formulating bilateral measures, the participating states have not been able to develop a comprehensive multilateral instrument on the protection and promotion of foreign direct investment.

181. This balance sheet has been drawn up using the criteria for creating a favourable environment for investment laid down in chapter B. This framework is useful but is not entirely satisfactory. Firstly, it is silent on the need for systemic reform i.e. privatization. Favourable conditions cannot be created unless there is full commitment by Governments to systemic reform. Secondly, a distinction ought to be drawn between an environment 'conducive to investment' and a liberal investment environment where policy distortion are kept to a minimum. As noted above, some FDIs in the transition economies have been attracted by high import tariffs, exclusive deals with state operators or by having the monopoly of local markets. It should be made clear that such practices distort free markets and are inefficient. Only markets which set out to liberalize are in the interests of participating states in the long-run. Third, states should underline the importance of free trade and market access as a condition of economic and industrial cooperation.
C. COOPERATION IN SPECIFIC AREAS

182. Chapter C of the Bonn documents covers cooperation in some specific areas: energy, environment, agro industry, consumer goods, town planning and transport. While giving an important place to intergovernmental cooperation, it rightly stresses that governments' role is to create favourable framework conditions and that the initiative of enterprise directly concerned is of paramount importance. The contributions from enterprises, particularly through the international exchange of information and technologies, and through direct investment, will only develop if appropriate conditions, as described in chapters A and B are met. The limited involvement of enterprises so far has therefore to be assessed, taking into account the review made in the two proceeding chapters.

(i) Energy (chapter C, points 2 and 3)

183. In chapter C (points 2 and 3) of the Bonn document, governments are urged to enhance the diffusion and use of energy and raw material saving technologies and equipment, and to separate and recycle waste components. Actions have been taken and progress made, but their impact would have been far greater if they had been implemented a comprehensive market-oriented legal, regulatory and administrative system as well as within the framework of an energy policy aimed at providing consumers and investors with appropriate market-based signals and incentives through the elimination of subsidies on energy consumption and the internationalization of social costs.

(a) Energy savings

184. Programmes to sensitize consumers and investors to energy savings, and to promote the exchange of information about energy saving technologies, and the marketing of these technologies have been developed through several multilateral and bilateral programmes and projects such as the Energy Centres established by the European Commission in central and eastern Europe, the UN/CE Energy Efficiency 2000 Project, the use of the database networks of the IEA CADDET and GREENTIES Projects and the IAEA database DECADES, the trade and cooperation activities of UNIDO, UNDP, the European Commission's PHARE, SAVE, SYNERGY, TACIS and THERMIE Programmes and its OPET network in the economies in transition.

185. National energy conservation agencies have helped to disseminate information and develop cooperation. They were created as autonomous institutions or within existing ones; among them the following are worthy of note: ADEME (France), ETSU (United Kingdom), CCE (Portugal), CRES (Greece), EnEffect (Bulgaria), SEVEN (Czech Republic), DEA (Denmark), ENEA (Italy), EOLAS (Ireland), EVA (Austria), IDEA (Spain), IFE (Norway), KFA (Germany), NOVEM (Netherlands), ACRE (Romania), ARENA-ECO (Ukraine), FEWE and KAPE (Poland) and CENEf (Russian Federation).

186. The use of energy-saving and environmentally sound energy technologies has also been enhanced by the implementation of International Environmental Agreements and Conventions, such as the UN/ECE Convention on Long-range Transboundary Air Pollution and its various Protocols. Programmes promoting greater energy conservation and efficiency, and the use of
new and renewable energy sources have been among the measures most favoured by ECE Governments to reduce energy-related air pollutants in conformity with these international agreements and protocols.

187. Trade promotion in energy saving and environmentally sound energy technologies has also been enhanced through the multilateral programmes mentioned above, through bilateral cooperation programmes and by the establishment of the Energy Conservation Department at the EBRD, the activities of the World Bank and other multilateral development banks such as the Nordic Investment Bank.

188. While all economies in transition have achieved progress in energy efficiency, the pace of reforms and results have been varied. In some important respects, progress in central Europe has been greater than in the Russian Federation and other CIS countries. End-use technical modifications, such as the installation of energy meters (for gas, electric power and heat consumption) have been introduced in the Czech Republic, for example, opening the way for greater consumer responsiveness to rising energy prices. This is an example of policy reform - price liberalization - supported by nationwide technical change - introduction of meters.

189. Even if unequal from one country to another, the development of institutions, regulations and legal structures and the reorientation of policies in the field of energy efficiency and environmental protection have laid the ground for progress which could rapidly be achieved if supported by carefully measured and articulated policies. Policies and technologies aimed at saving energy could be deployed simultaneously in Energy Efficiency Demonstration Zones\(^{35}\) which have been proposed at 27 sites in 15 central and eastern European ECE member States. This would develop the local capacities in the design of regulatory measures, energy pricing policies, management practices and technologies needed to achieve efficiency improvements on a national scale. In small-scale demonstration zones progress can be achieved more rapidly, at lower cost to national authorities and foreign partners, with reduced risk, before policy measures are pursued on a national scale. The use of renewable sources of energy, competitive with and complementary to traditional energy technologies, should be included in Energy Efficiency Demonstration Zones as well as projects designed to accelerate the implementation of international agreements and conventions.

190. Greater cooperation between institutions working in this field or at least greater exchange of information on ongoing projects could stimulate the concentration of technical assistance, investment and commercial resources at specific sites to produce tangible results. A region-wide energy efficiency strategy leading to operational conclusions and recommendations for participating States and organizations would also help stimulate further progress in the

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\(^{35}\) An energy efficiency demonstration enterprise zone is a city-scale project, a town, district, or other limited area, in which favourable conditions in every sphere are established to stimulate enterprise and initiative in market approaches to energy efficiency, in the same way as urban or regional economic development zones have been successfully established in western countries. It demonstrates, on a city-wide scale, the combined effect of energy-efficient technology; energy pricing policy; favourable tariff structures; advisory services; information campaigns; metering, monitoring and controls; energy audits; tax incentives; grants and government-guaranteed loan schemes; international technical assistance and trade development programmes. The intention is to replicate successful measures nationally once proven on a limited scale.
implementation of energy efficiency and environmentally sound technology in the region. This strategy could be implemented through a forum of international institutions and national energy efficiency agencies in eastern and western States. Monitoring of the progress in energy efficiency and the use of renewable sources of energy, and the dissemination of relevant information would promote the wider adoption of sustainable energy supply and demand patterns throughout Europe. Moreover, the prospect of enhanced cooperation among economies in transition offers another important opportunity for achieving widespread efficiency improvements in energy systems in the region; transition countries can learn from each other's experiences in this area.

(b) Macroeconomic framework policies

191. Progress would be faster if information, demonstration and technology promotion were to be accompanied by market-oriented legal, administrative and financial instruments:

- Changes in pricing policy so that energy prices at least reflect the costs of production or import should be pursued in the economies in transition, together with the widespread installation of measuring, metering and monitoring equipment for energy consumption. Price signals to industry and consumers and the means to control energy use are essential for the deployment of sustainable energy policies. Greater use of renewable sources of energy will also be required to achieve sustainable development and to overcome energy supply constraints.

- Steps to internalize the environmental costs of production in energy prices should be considered as an instrument of government policy. The introduction of environmental taxes and incentives has been slow in the OSCE region as a whole. Internalizing environmental costs would give clear price signals and promote the greater use of environmentally benign sources of energy.

- As in other sectors, investments require greater clarity on the legal status of property rights and ownership of buildings, industrial plants and the use by energy service companies of infrastructure networks.

- The widespread dissemination of energy efficient and environmentally benign technology in central and eastern Europe requires the development of innovative financial mechanisms, the promotion of joint ventures especially in the establishment of energy service companies and the development of the financial engineering skills of energy managers.

- In some cases, progress can be achieved in the promotion of trade and technical cooperation between economies in transition, especially in the production of energy efficient technologies manufactured in former military factories. This could have major benefits for employment generation.

(ii) Environment (chapter C, points 4-7)

192. The instruments for international cooperation in the area of environment - exchange of information, promotion of public awareness, elaboration of standards - as mentioned in the Bonn document (chapter C, points 4 to 6) are in place. In addition, further conventions have been signed or are in the course of negotiation and technical assistance support has been provided. Concrete progress has been achieved in the reduction of sulphur emissions. Enterprises are more aware of their responsibilities and are making efforts to save energy and raw materials and to reduce waste. These are examples of cooperation on energy saving or clean technologies carried
out on a commercial basis (chapter C, point 6). Environmental NGOs are more and more active in transition economies. Nevertheless, at the national level much remains to be done in central and eastern Europe and even more in CIS countries and war-torn countries. The implementation of signed conventions or agreed norms and standards is constrained by the lack of trained personnel and financial resources.

193. There is a broad agreement of principles of what should be done. While continuing to develop new conventions and norms where necessary, attention should focus on implementation, monitoring, mobilization of public opinion and integration of environmental considerations into all sectoral policies so that economic growth takes place in accordance with the principle of sustainable development, as recommended in the 1995 Sofia Document by the Ministers of Environment. Comments on progress and short-comings are grouped under the following headings: conventions, public awareness, environmental impact assessment and monitoring, involvement of enterprises, and health, technology and environment.

(a) Conventions

194. Pursuant to the relevant decisions of the 1989 Sofia CSCE Meeting on the Protection of the Environment, States negotiated and adopted under ECE auspices two Conventions in 1992 on the Transboundary Effects of Industrial Accidents and on the Protection and Use of Transboundary Watercourses and International Lakes. These Conventions provide procedures, standards and norms for countries to facilitate and better structure their conduct and relationship on matters related to industrial accidents and water management, promote the convergence of relevant policies, strategies and practices at OSCE regional level and offer concrete tools for conflict prevention and dispute settlement, thus contributing to the improvement of security and cooperation among States concerned.

195. Following the provisions of the Transboundary Water Convention, administered by the ECE, a number of new water agreements have been concluded by riparian countries at river basin level and existing bilateral and multilateral agreements have been revised, supplemented and updated to meet the exigencies of integrated water management, including pollution monitoring, waste-water treatment and control of transboundary water pollution. Many of the long-established treaties, however, need such adaptation to provide efficient legal tools for preventing further deterioration of water quality and promoting rational water use, and to comply with the recommendation endorsed by Ministers at their 1995 Sofia Conference “Environment for Europe” to implement in a transboundary context and by way of agreements between riparian parties sustainable water management schemes established by joint bodies including the restoration of transboundary aquatic ecosystems, such as wetland ecosystems and the renaturalization of watercourses. The other water-related 1995 Ministerial recommendations regarding water demand management, pollution discharges, monitoring, assessment and compatible information systems bear witness to the concern and interest of States to also improve their cooperation in these fields, taking advantage of the existing international infrastructures and conventions, such as the Transboundary Water Convention, which is expected to enter into force in 1996.

196. The integrated approach for the environmentally sound management of inland waters, developed under UNEP auspices, is intended to provide an effective tool to strengthen cooperation, in particular in central and eastern Europe, in order to solve the complex problems faced by huge areas such as the Aral and Caspian sea areas. Support for the development of
environmentally sound technologies in urban and freshwater management is provided by the UNEP International Environmental Technology Centre.

197. Progress in the ratification of the Industrial Accident Convention, however, has been much slower than expected, mainly because many signatories first need to establish new domestic legislation or adjust significantly their existing legislation, and set up an adequate administrative infrastructure cross-cutting various domestic sectors. Despite such obstacles, Governments are further strengthening cooperation under the Industrial Accident Convention administered by ECE mainly through networking of regional and national centres aimed at reducing the risk and severity of major technological hazards and accidents (Budapest Centre) and raising the level of preparedness through training and exercises (Warsaw Centre). In the course of simulation exercises it has become apparent that the new ECE Accident Notification System established for the communication across boundaries between relevant national authorities in the event or threat of industrial accidents, including mutual assistance, has not yet been implemented satisfactorily. This calls for additional ratifications of the Convention in order to have it enter into force. Such additional momentum would also be necessary for commencing procedures to create more favourable conditions for the exchange of technologies for improved industrial safety and emergency response as stipulated by that Convention.

(b) Public awareness

198. The provisions of public participation, included in the environmental conventions developed by the United Nations Economic Commission for Europe, have strengthened the role and active involvement of the public in general and that of NGOs and private sector organizations in decision making to promote sustainable development. The Environment Programme for Europe endorsed by Ministers at their 1995 Sofia Conference “Environment for Europe” provides policy direction for future cooperation among States in major priority issues, including environmentally sound technology, to ensure the environmental sustainability of economic development. Furthermore, States were urged by Ministers in their 1995 Sofia Declaration to apply the Economic Commission for Europe Guidelines on Access to Environmental Information and Public Participation in Environmental Decision-making, as endorsed by them at the Sofia Conference. Their implementation will be reviewed by the ECE in 1997. The Conference, furthermore, urged the ECE Committee on Environmental Policy to draft a Convention on Public Participation in Environmental decision-making.

199. The UNEP programme to raise awareness and preparedness for emergencies at the local level (APELL) is a complementary tool for countries to strive for the prevention of major technical hazards and accidents. In the event or threat of natural disasters and environmental emergencies countries now have at their disposal an emergency response system provided by the joint UNEP/DHA Environment Unit through a network of national focal points.
(c) Environmental impact assessment and monitoring

200. States negotiated and adopted under ECE auspices the Convention on Environmental Impact Assessment in a Transboundary Context, which provides procedures to assess potential impacts to the environment, human beings and their properties from proposed economic development projects and programmes at early planning stages with the aim of integrating environmental and sectoral policy considerations into decision-making process and promoting the preventive, public participation and precautionary principles and sustainable development. Although the Convention is expected to enter into force in 1996, it would not fully achieve its purpose if it were to remain a mere expression of good will on the part of countries. For it to be significant it must be rapidly and efficiently implemented and complied with by as many Participating States as possible, and translated into practical rules and procedures at the national level. To this end, much work needs to be undertaken under the convention, including legal advice, training, capacity and confidence building and assistance to countries, in particular those in transition.

201. Cooperation on pollution monitoring, another priority area of the 1990 Bonn document is high on the region's agenda. The availability and reliability of data on water and air quality are improving, and progress is being made in the introduction and use of harmonized data collection, reporting and assessment procedures. Cooperation under the Transboundary Water Convention and in particular under the Convention on Long-range Transboundary Air Pollution and its protocols has contributed considerably to this result, especially through the harmonization of rules for the setting up and operation of monitoring programmes, measurement systems, devices, analytical techniques, data processing and evaluation procedures, and methods for the registration of emitted/discharged pollutants. Moreover, current work programmes further develop the harmonization of pollution-monitoring activities and continue to provide coordination for the monitoring of air and water pollution and its transboundary effects. In many cases, this has already avoided piecemeal solutions by countries/groups of countries. However, the implementaion at the country level of harmonized approaches to pollution monitoring has slowed down, in particular due to the lack of financial and human resources, and the gaps in the administrative structure and legal framework in countries in transition. Strategic support by OSCE would strengthen cooperation in this field and speed up pollution monitoring and data exchange at all levels. Earthwatch, UNEP's global environmental assessment programme, monitors natural resources, air, water and climate, and aims to promote cooperation among countries. Within this programme, Environment and Natural Resource Information Networks are being developed in the countries in transition.

202. Important International cooperation in assessing the environment, collecting data, and processing and disseminating relevant information is being promoted under the auspices of the European Environment Agency. At the Sofia Conference, "Environment for Europe", Ministers were concerned by the findings of the first assessment of Europe's environment as a whole, "Europe's Environment: the Dobris Assessment", which demonstrated the need for far-reaching action in a number of environmental sectors. As decided by the Ministers, the Agency will report on progress made in respect of the main issues covered by the assessment, provided that the necessary resources are made available. The Agency will also work to fill the information gaps identified by the Dobris Assessment, establish a pan-European environment information network and assist countries in transition in capacity building on environmental data. All European countries are called upon by the Sofia Ministerial Declaration to take steps to participate in the
work of the Agency in order to harmonize and coordinate existing data collection systems. It has also been decided to develop cooperation of central and eastern European countries with the Agency through the EC’s PHARE programme (1995-97). With the help of financing provided by PHARE the task of setting up such cooperation has begun. Consultations are underway with the management of the EC’s TACIS programme to identify and finance projects that could make it possible to start at least limited cooperation with other European countries not covered by the PHARE programme. Regarding the longer term implications of the Sofia Conference a structured plan is needed for the fulfilment of the pan-European tasks and cooperation between the Agency and third countries. A proposal will be drawn up in cooperation with ECE to identify and resources for the specific activities required.

203. The assessment of chemicals which is an integral part of the UNEP International Register for Potentially Toxic Chemicals programme includes a chemicals data bank and capacity building activities. Cooperation also needs to be strengthened in the area of improving the treatment and disposal of toxic and dangerous waste which is an integral part of the activities of the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal, administered by UNEP. Concrete cooperation programmes will be launched by the technological regional centre for the management of dangerous wastes to be set up in Slovakia.

204. As the global United Nations organization in the environment field, UNEP is actively promoting scientific and technological cooperation for the protection of the environment and the promotion of sustainable development. In line with its coordinating mandate, these activities are usually carried out jointly with other organizations, particularly ECE and other bodies of the United Nations system. A database on environmental activities and priorities in Europe is in preparation as a tool for policy and priority setting in the region. Problems of transboundary pollution caused by energy production, conversion and consumption will be assessed in 1996-1997 in an overview of the environmental impact of production and consumption and the critical linkages with socio-economic forces.

205. The role of ECE in enhancing cooperation in the field of environment was reconfirmed by the Ministers in their 1995 Sofia Declaration which entrusted ECE with tasks related to the implementation of the Environment Programme for Europe and the enlargement of the environmental performance review (EPR) programme to the entire ECE region. Within the framework of this programme, a peer review process allows States to examine the extent to which a particular country has implemented domestic environmental policy objectives and relevant international commitments. The principal aim of the EPR is to help countries to improve their individual and collective performance in environmental management. More specifically, EPRs help Governments judge their progress, promote environmental improvements and stimulate greater accountability towards public opinion. An EPR is also an opportunity for countries to learn from the environmental experience of other countries. The process has started for countries in transition with Estonia, Poland and Bulgaria, the latter two in cooperation with OECD. Belarus will follow. However, a final decision has not yet been taken by participating States to launch a fully-fledged process of some 4 to 5 reviews of countries in transition per year mainly due to slow resource mobilization. The OSCE could provide its strategic support to speed up decision-making for such an important cooperative endeavour.
(d) Involvement of enterprises

206. Substantial improvements in overall environmental performance, energy efficiency and rational use of raw materials have occurred are well documented in many recent industrial activities, in particular in developed countries. As the cost of all these factors has increased considerably in the countries in transition, industry in those countries is seeking effective solutions to improve its cost performance and become globally competitive. The problem in wider adoption of environmentally-sound technologies in a reasonable time frame is making the right choice and securing the necessary funds.

207. Industry should be committed to improving its global environmental, health and safety performance worldwide. Only a global approach will lead to an improvement of the performance of this sector. In this respect there are three basic issues: sustainable development through implementing the best available, environmentally sound but at the same time economically viable technologies, the transfer of which is a commercial operation but access to and promotion requires international cooperation; decreasing the environmental impact of existing technologies and plants, and the introduction of environmental management into enterprise policy; and remediation of past damage to the environment. Within the ECE region, the most severe cases of polluted sites perhaps exist in the countries of central and eastern Europe. Their clean-up will involve finding technical solution and require huge financial resources. Pilot projects demonstrating successful clean-up operations would promote and facilitate further action.

208. Key segment of industry are material- and energy-intensive. The efficient use of resources is therefore of paramount importance as regards competitiveness and further development. Industry has to be committed to continuously improving the efficiency of the technologies it applies and the infrastructure it uses; to waste minimization through reduction at source and better utilization of by-products; and to developing recycling technologies and promoting the application of recycled materials. Work is progressing in all these areas. In order to accelerate the progress and make better and wider use of the results, cooperation between those involved should be enhanced. Assistance to countries at a lower level of development, sharing of experiences and know-how, in particular in the form of local capacity building, should be encouraged and promoted at the international level.

209. The lack of a comprehensive inventory of real needs as regards technological and structural revamping (including marketing aspects) on the part of the less developed countries as well as the lack of an objective mechanism to match these needs with commercially available solutions has hindered the process of technological upgrading. Limited locally available financial resources and local know-how capacities are among other restrictions.

210. Environmentally sound technologies are a key element for the protection of the environment as they are less polluting, use resources in a more sustainable manner and recycle more of their by-products, residues and waste than the technologies for which they are substitutes. The economies in transition urgently need such technologies since their sometimes obsolete production facilities endanger the environment even on a global scale. The problem is not in the lack of scientific and technological information on the best technologies available for preventing damage to the environment but in the limited financial and human resources which Governments and industrial entities in the economies in transition can afford to invest in order to introduce these technologies. In this respect, the task of Governments should be to create
conditions which make the introduction of these technologies more profitable for entrepreneurs both in western countries and the economies in transition.

(e) Health, technology and environment

211. Recognizing the growing importance of health impacts related to environmental conditions and their significance in relation to overall quality of life, Ministers of health and of environment convened a second European Conference on Environment and Health in Helsinki in June 1994. In response to the European Charter on Environment and Health approved by the First Conference, held in Frankfurt in 1989 and to the document of the CSCE Bonn Conference in 1990, more than 50 member States of the European Region provided data, which were compiled, analysed and published by the WHO Regional Office for Europe in the report “Concern for Europe's Tomorrow”. This report highlighted issues of importance throughout the region including the health implications of polluted air and water, of food contamination, of road, home and work-related accidents and the complex range of environmental issues related to urban development. It demonstrated the growing gap in health status between the populations of the eastern and western parts of the region, in which environmental conditions may play a significant role.

212. The Ministers at Helsinki recognized that these inequalities required regional solidarity to resolve them, and this is reflected in the Helsinki Declaration, which established a European Environmental Health Action Plan. This defines necessary action by countries, including those which will benefit from international support. The Ministers undertook to develop National Environmental Health Action Plans by 1997 and most participating States have already commenced this task. In addition, many priority actions have already been identified, particularly in “hot spots” in the countries in transition, where immediate response is required, often with external support and intensified international cooperation to overcome deficiencies in assessing the impact of environmental stress on the population and to create conditions enabling the various elements which contribute to an improved quality of life to be developed.

213. The work will build on the achievements of many participating States since the 1990 Bonn document in terms of improved preventive measures to avoid negative effects on health and to remedy existing conditions which are adversely affecting health. The “Concern for Europe's Tomorrow” report clearly recognizes, however, that the pace of action needs to be accelerated, particularly in the countries in transition. Participating countries have recognized that the necessary actions cannot be carried out solely within the health and environmental sectors, although they both have crucial roles to play. Not only must other governmental sectors be actively involved, such as industry, agriculture and transport, but the role of business and industry is an essential one, as much of the necessary investment and effort must come from the private sector. In view of the widespread public concern about the potential impacts of environmental conditions on human health, improved public information and consultation was regarded by Ministers as a sine qua non for the successful development of the Action Plan, and it was recognised that non-governmental organizations have an important role to play in this process.

214. In order to create synergies and avoid duplication of effort, Ministers in their 1995 Sofia Declaration urged that further development of cooperation under the “Environment for Europe” process take account of environment and health activities at the pan-European level. To this effect cooperation among experts from the environment and health sector has been already developed under the auspices of the European Environment and Health Committee, which was
established within the terms of the Helsinki Declaration. The Committee comprises four members chosen by the WHO Regional Committee for Europe and four chosen by the ECE Committee on Environmental Policy, together with representatives of ECE, UNEP, WHO, EC, OECD and the World Bank. This cooperative effort which focuses in particular on health-related topics addressed in the 1990 Bonn document would greatly benefit from strategic support by OSCE.

215. The environmental conventions and related protocols administered by ECE on air pollution, water management, environmental impact assessment and industrial accidents cover adverse effects particularly on the environment, human health and safety or the interaction among these factors. Insufficient attention has yet been paid to health aspects in the implementation of these legal instruments mainly due to institutional and logistical reasons. In November 1995 preliminary steps were taken by the European Environment and Health Committee to overcome this deficiency. The strategic support of OSCE would provide further momentum to this end.

(iii) Agro-industry and food processing (chapter C, point 8)

216. The participating States of the Bonn document affirms the importance of co-operation in agro-industry and food processing, including natural food production. Central and eastern European countries, Poland, Hungary, and the Czech Republic in particular, are receiving large investments in agri-manufacturing areas and marked progress is evident. In contrast, foreign investment remains low in most CIS countries and in other transition economies. If food expenditures are used as an economic indicator, these countries continue to reveal falling living standards.

217. The food-processing industry and the food industry in general including natural food production, food preparation and conservation, food distribution etc. constitute a huge complex of interrelated research, manufacturing and service establishments. The agro-food complex has an important role to play in addressing the nutritional problems in the economies in transition. The world's leading food and drink companies with annual sales between USD 20 billion and 50 billion (such as Philip Morris, Unilever, Nestle) are important investors in some transition countries where they are contributing successfully to the restructuring of industries. However, the current situation in most transition economies is far from satisfactory - the restructuring of the agricultural and food production complex is very slow and inefficient.

218. One of the barriers to greater FDI and restructuring in this sector has been the slowness with which enterprises involved in the agro-industry sector are being privatized. Thus in attracting FDI into this sector, states should commit themselves to privatization of the relevant enterprises.

219. In terms of donor assistance, the EU's agro-industrial research programmes have invited participation from non-member countries throughout the region, such as the Food-linked Agro-Industrial Research (FLAIR) programme. In addition, EU's TACIS and PHARE programmes have contributed to the integration of certain target countries of eastern and central Europe into market-oriented trade activities. In addition, the role of agriculture in the transition economies is monitored by the OECD which it has contributed significantly to the policy framework for privatization and promotion of smaller scale farm units. Particular emphasis is being placed on the study of the impact of the Uruguay Round on agriculture.
(iv) Consumer goods (chapter C, point 9)

220. Chapter C, point 9 of the Bonn document mentions that increased cooperation among partners producing consumer goods machinery helped in responding better to the needs of consumers. In western countries, highly developed production offers consumer goods of various quality and at various prices to all groups of the population. In contrast, the situation in the majority of the economies in transition, is far from satisfactory - they produce a limited range of consumer goods of inadequate quality in most cases and consequently these goods are not competitive in domestic and foreign markets. Cooperation between business enterprises of western countries and economies in transition in consumer goods offers the best opportunity to raise the quality of products and their competitiveness on markets and to better satisfy the needs of the population.

221. With chronic food shortages, particularly of quality food, the potential in this area is significant for western firms and already many FDI projects have been started. The greatest scope lies in projects which introduce superior packaging technologies and cut down on food waste because of poor processing, transport and/or storage which would improve the productive capacity and quality. Hence, Alfa-Laval/Tetra Pak (Sweden) has established joint ventures to produce food-packaging materials, and APV (UK) is constructing food processing machinery in several plants in the region. Such FDI typically follows large-scale investment by consumer goods companies such as Unilever, Nestlé, Proctor & Gamble BSN, etc. So far in most CIS states outside Russia, few foreign investments in consumer goods have occurred and hardly any in the industry which manufactures machinery to produce consumer goods. Where investment has occurred, it has been where Governments have permitted foreign enterprises to acquire local companies. Thus if companies wish to promote FDI in the industry which manufactures consumer goods machinery and in consumer goods, they should promote privatization.

222. The participating states further proposed that converting military to consumer production would increase the access to consumer goods and at the same time present new business opportunities. Unfortunately, although extremely attractive as a proposal, the record of success worldwide of conversions - understood as reallocating resources from the defence to the civilian sector - has been very limited. In fact, three out of every four "conversions" fail after the first three years. In the countries of central and eastern Europe, some conversion has been completed but many enterprises, faced with a sharp fall in orders and no alternative markets, have simply down-sized or stopped production. Adjustment has been painful. Currently, almost all the enterprises which are continuing in the business of armament production are doing so thanks to government subsidies without which they would be bankrupt.

223. Governments have attempted to aid the conversion process by introducing incentives at the microeconomic level. In 1992, the then Federal Government of the Czech and Slovak Republic, for example, provided substantial funds to assist individual enterprises in the switch to civilian production. However, the enterprise managers, still thinking in terms of a planned economy, were unable to come up with projects that were marketable, efficient and appealed to

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consumer taxes, preferring to focus instead on the technical feasibility of conversion.\textsuperscript{37} As a
general principle, rather than ineffective microeconomic policies, Governments can make a more
valuable contribution at the macroeconomic level where governments allow market forces to
allocate resources and create the conditions for economic growth.\textsuperscript{38}

224. Despite the hopes of the participating states of the Bonn Conference, FDI to date, has
been little interested in conversion. Rather, any cooperation between foreign and local armaments
companies has taken place within this industry and not in attempts to convert it. For example,
cooperation with US, French, Swedish and South African firms have, by all accounts, given the
Polish armaments industry greater competitiveness. Indeed more business opportunities for FDI
within the armaments industry of eastern and central Europe will be created as a result of these
states closer ties to the EU. The modification of these countries existing weapons in order to
increase their interoperability with arms used by the NATO militaries will entail substantial
cooperation between the defence firms in the central and eastern European countries and those
in the western countries.

225. The issue of conversion from military to civilian production is probably even more
complicated for the Russian Federation where currently at least 9 million people work for the
military-industrial complex (almost 10 per cent of the workforce) and 33 Russian regions (out
of 88) are considered to be predominantly involved in military production. The Russian
Federation’s economy relies much more heavily on the defence industry than any other transition
economy. Here too, while considerable efforts have been made to reoriented military production
to civilian applications, the results have also been disappointing. The lack of budgetary financing
for restructuring production, huge social problems, an unstable economic and political situation
which is not conducive to the inflow of foreign investment etc. are the main factors which cannot
be resolved overnight. The military-industrial complex needs new partners for the production of
new goods based on accurate domestic and market studies. This area deserves further action on
the part of Governments.

(v) Town planning and human settlements (chapter C, point 10)

226. It is now broadly recognized that urban problems may lead to significant deterioration in
the quality of life and that the sustainable development of cities demands effective town planning
including zoning, building codes, appropriate architectural methods to minimize negative
externalities and the participation of all parties concerned (chapter C, point 10).

227. Countries are promoting practical instruments, strategic planning and management
techniques to redress urban problems which have caused a substantial deterioration in the quality
of life. Focus in recent planning and management practices has gradually shifted from measuring
success primarily in terms of economic growth to giving equal consideration to environmental
and social costs and benefits. Attempts are being made to meet the need for adequate urban

\textsuperscript{37} “Defence Conversion in East Europe”. by Thomas S. Szayna in East-Central Economies in Transition.

\textsuperscript{38} Ibid.
services and to promote better integration of transport into urban planning policies and the use of public transport, as well as adequate water-supply and sewerage systems and improved energy efficiency. Clarification of ownership rights, has stimulated private housing, modernization, renovation and construction in many cities of central and eastern Europe. City authorities are diversifying financial resources to secure a steady inflow of capital for the provision of technical infrastructure in areas of urban growth. Many cities in central and eastern Europe and Russia have made successful efforts to maintain and renovate historic and cultural monuments. Tourism has developed and has become a significant source of income in historic cities.

228. Cooperation and exchange of information on these issues, as called for in the Bonn document, are carried out either on a bilateral basis or in international fora, through the executive bodies of the Council of Europe, through the ECE Committee on Human Settlements, OECD and the World Bank. Information exchange and cooperation are facilitated through the organization of seminars, workshops, expert task forces and training courses. Another example of cooperation is that within the framework of legally binding conventions. For example, in the International Cooperative Programme on Effects of Air Pollution on Materials, including Historic and Cultural Monuments under the Convention on Long-range Transboundary Air Pollution, countries are assessing critical and/or target levels and calculating costs due to material damage for decision-making on future air pollution abatement strategies which are needed to protect monuments and restore the architectural heritage. Another example is the priority given to the development of a regional Convention on Public Participation with the appropriate involvement of NGOs, as a result of the Ministerial Conference in Sofia. This reflects the greater awareness of the important role that society has in determining its own quality of life.

229. Urban congestion, a problem increasingly common to all the countries of the region, was addressed in a conference in Bratislava in 1994 and will again be dealt with in the Conference on Transport and Environment to be held under the auspices of ECE. In 1996 the UN Conference Habitat II will provide another opportunity to exchange information and experience on housing, urban development and management.

230. As called for in the Bonn document, an exchange of information and new approaches to urban management is taking place. Significant progress has been made where legislation permitting owners and private enterprises to maintain, modernize and build houses has been adopted and where democratic elections sanction management and the decisions of local authorities. These components which were not explicitly mentioned in the Bonn document have proved to be essential in central Europe. The situation remains unequal. Cities which are dependent on the activity of one large declining enterprise are facing very serious financial problems, particularly if they have to assume the social responsibilities traditionally borne by the enterprise, not to mention the disastrous situation of cities destroyed by wars. These facts call for further efforts on ownership rights, public participation and financing of public infrastructures and social welfare.

(vi) Transport (chapter C, point 10)

231. Transport is briefly mentioned in chapters A point 1 and C point 10 of the Bonn document. There is, however, a long tradition of cooperation in the field of transport within the framework of ECE which has been encouraged by the CSCE on the occasion of several meetings. Since the end of the cold war, the European Commission has also been mandated by the G24 to coordinate assistance to countries, including in the field of transport, and in the framework of the
PHARE and TACIS programmes has financed feasibility studies, training and border crossing facilitation. The EBRD, EIB and World Bank are financing several infrastructure investment projects.

232. Governments endeavour to develop an efficient, safe and environmentally sound transport system in view of its impact on economic development and the everyday life of populations. This includes the facilitation of international transport, which is vital to the development of international trade and tourism. The fact that transport vehicles cross borders makes it advisable that national transport systems are developed in a coordinated manner and according to uniform rules, regulations and standards. This is particularly important in a region such as Europe which is composed of numerous countries and where transport often entails crossing borders.

233. Governments have developed such uniform rules, regulations and standards in a number of international agreements and conventions which have been elaborated and are kept under review by government experts within the framework of ECE. These legal instruments establish uniform transport safety and environmental standards, simplify border crossing procedures and provide the basis for the development of coherent international infrastructure networks for road, rail and combined transport.

234. Unfortunately, although the number of countries which have acceded to these legal instruments has sharply increased in recent years, not all ECE member countries have yet done so. This is mainly due to the fact that the implementation of these legal instruments is the responsibility of Governments themselves, and many, particularly the newly independent States, are not yet able to comply with the requirements contained in them. The insufficient financial resources and administrative capacities of these Governments, as well as transport legislation and institutions which are not yet adapted to market economy principles after decades of a different transport and economic policy, are hampering this process. Furthermore, infrastructure is often inadequate, insufficiently maintained and of a low standard.

235. The training of personnel at all levels of government ministries and agencies, to acquaint them with modern management techniques and standards applied in other European countries, is urgently required. Financial resources to maintain and upgrade rail and road infrastructures and border crossing facilities should be mobilized to avoid transport becoming a bottleneck to efficient international trade with these countries. International financial institutions could be called upon to consider increasing their funds for urgently needed investments in transport. Governments of central and eastern European countries have undertaken to cooperate under the framework of the TEM and TER projects in the development of their international road, rail and combined transport infrastructures. Further support should be provided to those projects.

236. In the field of transport, Governments must continue to cooperate, including in the framework of ECE, with a view to the achievement of an efficient, coherent and well-balanced transport system, based on principles of market economy and pursuing the objectives of safety, environmental protection and energy saving. To this end, they must continue to adapt their legislation to the requirements of market economy and to the provisions of the international legal instruments developed in the framework of ECE. They must also continue to place their transport systems increasingly under market conditions including through privatization and institutional restructuring. A special emphasis should be placed in the creation of the appropriate
(vii) Conclusion

(a) Energy (chapter B, points 2 and 3)

237. In general, the commitments to enhance trade and co-operation in energy efficiency and environmentally benign technology, to use European data bases, to exchange information and to provide training, have been fulfilled. But the circumstances and opportunities for trade and co-operation have change enormously since 1990. Five years of economic transition in central and eastern Europe have seen a remarkable development of institutions, regulations, legal structures and re-orientation of policies in the field of energy. This transition to a greater reliance on market-oriented legal structures and policies now has to be strengthened and, in some cases, accelerated. Furthermore, these changes need to be complemented by a more comprehensive and coherent set of energy policies aimed at changing consumer behaviour and investment patterns through appropriate pricing policies (such as the elimination of subsidies), the use of economic instruments (such as taxation), the application of innovative planning and regulatory mechanisms (such as integrated resource planning and least cost energy planning) and the facilitation of trade and investment (through inter alia, the development of innovative financial mechanisms).

(b) Environment

238. The concept of sustainable development is useful in determining goals for the future environment related activities in the region. This means that economic growth is desirable, but it has to be achieved without causing damage to human health, the environment and the natural resourcebase, including biodiversity.

239. The "Environment for Europe" Ministerial process has gathered all the major institutions and organizations in a region-wide cooperative framework. This has enabled governments to increase cost-effectiveness and reduce over-lapping work on different fora. ECE as the main coordinating organization has an important role in overseeing the work and contributing to its efficiency as well as preparing key elements of the substantive input.

240. International environmental legislation provides a good tool to reduce environmental problems and increase cooperation and convergence in the region. The Conventions and Protocols include measures for concerted reduction of the pollution burden, but also constitute an useful basis for cooperation on technology, monitoring and implementation as well as scientific activities. A number of new legal instruments are required during the next few years, e.g. on air pollution abatement and public participation in environmental decision making. At the same time increasing attention will be given to the prudent implementation of existing and new legal instruments.

241. The introduction of environmental performance reviews in the whole OSCE-region brings about a new dimension in the environmental cooperation. The substantive review-work by outside experts and the concluding peer-review by government representatives on selected countries provides an in-depth tool to assess member countries' overall environmental performance including their implementation of and adherence to international agreements. The
process also enhances integration of environmental considerations in all sectoral activities in countries by including all sectors of environmental relevance in the reviewing work.

242. The work on specifically reducing the huge environmental problems in many parts of central and eastern Europe has gained a lot of useful experience and produced some significant positive results. Up to date, however, much of the reduction of the pollution load is the result of the decrease in overall output.

243. Clearly targeted and prioritized foreign financial assistance is still needed to secure a good take off in the environmental investments in transition countries. The real challenge is ensuring sustainability in the economic growth-process that is beginning to take place in most of these countries. Every effort must be made to introduce environmentally friendly substituting and new technologies in this process.

244. Building up administrative capacities and expertise is still a key challenge. Only a consistent legal and administrative framework on a national level can successfully implement the broad range of measures needed. The international environmental community as well as member countries on a bilateral level should continue providing targeted and cost-effective workshop and other learning activities in order to build capacities that render transition countries self-sufficient in implementing environmental obligations.

245. The follow-up of the European state-of-the-environment exercise, carried out for the first time under auspices of the European Environment Agency producing the "Dobris Assessment", is crucial for identifying the most pressing regional and environmental problems. Satisfactory resources for this work has to be provided for. The most recent scientific findings on the development of the state-of-the-environment and the effects of environmental measures taken have to be made available to decision makers in a comprehensive manner. The instruments for international cooperation in the area of environment - exchange of information, promotion of public awareness, elaboration of standards - as mentioned in the Bonn document (chapter C, points 4 to 6) are in place. In addition, further conventions have been signed or are in the course of negotiation and technical assistance support has been provided. Concrete progress has been achieved in the reduction of sulphur emissions. Enterprises are more aware of their responsibilities and are making efforts to save energy and raw materials and to reduce waste. These are examples of cooperation on energy saving or clean technologies carried out on a commercial basis (chapter C, point 6). Environmental NGOs are more and more active in transition economies. Nevertheless, at the national level much remains to be done in central and eastern Europe and even more in CIS countries and war-torn countries. The implementation of signed conventions or agreed norms and standards is constrained by the lack of trained personnel and financial resources.
(c) Food production and consumer goods

246. Progress in cooperation in the sector of food processing, production of consumer goods and in the manufacturing of food production equipment has been significant in central and eastern Europe, less significant in the Russian Federation, but very limited in the other CIS countries particularly due to the slowness of privatization in these sectors. The idea in the Bonn document in this context that the conversion of military to consumer production may give rise to new business opportunities did not materialise for military financial and social reasons. It seems, however, rather likely that cooperation in military production will develop in central Europe.

(d) Town planning and transport

247. Participating states now recognize that urban problems may lead to significant deteriorations in the quality of life and town planning measures including zoning, building codes are required to be developed. As called for in the Bonn document, an exchange of information and new approaches to urban management is taking place and this cooperation should continue.

248. In the field of transport, in addition to issues related to urban congestion, Governments must continue to cooperate, with a view to the achievement of an efficient, coherent and well-balanced transport system, based on principles of market economy and pursuing the objectives of safety, environmental protection and energy saving. To this end, they must continue to adapt their legislation to the requirements of market economy and to the provisions of the international legal instruments developed in the framework of ECE. They must also continue to place their transport systems increasingly under market conditions including through privatization and institutional restructuring. A special emphasis should be placed in the creation of the appropriate legal, financial and technical framework for the development of infrastructure investment including from the private sector.
D. MONETARY AND FINANCIAL ASPECTS

(i) Price liberation

249. A key recommendation in the Bonn document was the introduction of undistorted internal pricing (chapter D, point 1). In fact, progress in this area has been substantial: all the east European transition countries have lifted most of the price controls in existence at the start of the transition, and at present more than 90 per cent of all prices are freely determined by the market mechanism. The process of price liberalization has been somewhat slower in most of the countries of the CIS: after partial price decontrol at the end of 1991, further progress has been only gradual during 1992-1995.

250. Price controls, however, have been maintained for a number of specific products. Although the scope of these controls is not identical across individual countries, they typically apply to the prices of staple foods, fuels and energy, housing rents, and transport tariffs. From the very beginning it was assumed that liberalization of these prices would take some time: energy prices, in particular, were to be raised gradually to world market levels over a period of several years. In practice however, the process has been much slower than expected. As governments became concerned at the inflationary implications of a more rapid rate of price liberalization. As a result, energy prices, for industrial users and for households, in 1995 were still subject to various forms of government control in all the transition countries, their levels being much lower than in western Europe. Electricity prices in eastern Europe, for example, are between 30 percent (Hungary, Slovakia) to 60 per cent (Romania) below the average in the European Union countries. The gap is somewhat smaller for petroleum and other fuels. In the former Soviet republics, the differences between domestic and international prices for energy products and some essential services are even larger.

251. Alignment of internal energy prices with those prevailing on international markets is a condition for efficient markets and should be achieved in a medium-term perspective (perhaps within 3-5 years). This could be effected through an announced programme of future price increases. Large price changes should be avoided as they tend to have strong pass-through effects on other prices and wages, but the expectation of eventual alignment with the international price level needs to be firmly established.

252. Transport fares, telecommunications tariffs, and housing rents will probably remain subject to, at least partial, controls for some time to come. Their full liberalization would not perhaps be advisable given their monopolistic production structures which cannot be easily dismantled and transformed into competitive ones. Even though controlled, these prices should nevertheless be set at levels corresponding broadly to those prevailing in west European countries, in order to avoid distortionary effects on production and consumption.

(ii) Currency convertibility

253. Another important recommendation of the Bonn document was currency convertibility (chapter D, points 1 and 2), which was considered necessary for “importing” correct relative prices from the world markets to the transition countries, imposing a measure of competition on domestic monopolies, attracting foreign investment and generally boosting the credibility of the
reform programmes. Practically all the transition countries of eastern Europe, as well as the Baltic states, quickly adopted so-called "internal convertibility", which combined more or less free access to foreign exchange for residents for commercial (trade and service) transactions with some restrictions on outward transfers and transactions effected by non-residents, and with extensive capital controls. Internal convertibility was formally applied under the IMF’s Article XIV, which allows for some temporary exchange controls, provided that the countries applying them intend to eliminate them once the external balance improves sufficiently. By October 1995, the three Baltic states plus five east European countries (Croatia, the Czech Republic, Poland, Slovakia and Slovenia) had established convertibility in the sense of the IMF’s Article VIII, which, essentially requires countries to refrain from imposing restrictions on current account transactions or from engaging in discriminatory or multiple currency practices without IMF approval.

254. In contrast to the Baltic and east European countries, progress towards currency convertibility has been much slower in Russia and most of the other members of the CIS. By October 1995, only Kyrgyzstan and the Republic of Moldova had convertible currencies according to Article VIII of the IMF.

255. The introduction of internal current account convertibility was generally accompanied by substantial devaluations. In those countries which adopted a fixed exchange rate regime, domestic currencies were devalued by large amounts in order to restore balance between the demand and supply of foreign exchange; but in other countries, the introduction of (partial) convertibility was also accompanied by sharp falls in their foreign exchange rates.

256. The choice of foreign exchange regime was mainly dictated by initial conditions: those countries which received substantial international assistance decided to introduce a fixed exchange rate regime, using the exchange rate as a "nominal anchor" to stabilize domestic inflation. Countries adopting a floating exchange rate system, tended to use domestic monetary targets as the main focus for anti-inflationary policy. Experience suggests, that the “nominal anchor” approach is more effective in stabilizing the domestic economy; but if maintained for too long, it tends to undermine the competitiveness of exports.

257. Hardly any transition countries have taken steps to introduce capital account convertibility, the main exceptions being Latvia, Estonia, which introduced it in early 1994, and the Czech Republic, which liberalized most capital account transactions in October 1995. For the moment, the arguments against capital account convertibility tend to weigh more heavily than the advantages for transition countries. With imperfect or non-existent capital markets and relatively low reserves, domestic currencies may be vulnerable to speculative attacks and increased risk of capital flight; in addition, in a small open economy, the absence of capital controls reduces the scope for independent macroeconomic policy.

258. It should be noted, however, that although formal capital account liberalization has been postponed, in some countries de-facto capital mobility is already rather substantial, particularly as regard to the inflow of funds, while many of the existing restrictions on capital outflows are often difficult to enforce.
(iii) Institutional changes

259. Much of the Bonn document is devoted to the institutional changes required for the transition to a market economy (chapter D, points 2 and 3). The institutional dimension of the transition process, however, has proved even more important and difficult than initially envisaged. The Bonn document correctly identified certain key areas of institutional reform as being necessary for establishing efficient markets, including reform of the banking system, transformation of public enterprises, the creation of efficient taxation systems, the re-organization of labour and capital markets, and the reconstruction of national statistical systems. In those and other areas of institutional change, however, progress during the last six years has been generally slower than expected; it has also varied considerably across countries. Just as difficult has been the necessary restructuring of national economies, including the privatization of state enterprises.

(a) The financial system

260. As mentioned earlier Part I, point vii), the reform of the banking system was not given very high priority in the early stages of transition. Only when the deep contraction of output and sales stemming from the "transitional recession" resulted in a financial crisis in the enterprise sector and, consequently, in a rapid accumulation of unpaid debts to the commercial banks, did the problem of bank reform receive more attention. The banks in the transition countries are generally suffering from a low capital base, a lack of experience in evaluating credit risks, and distorted incentives facing all levels of management. Radical solutions, such as massive bankruptcies of banks and enterprises, were rejected as politically dangerous and economically costly; likewise, further state support for the banking system was considered unfeasible for budgetary and efficiency reasons. The reforms adopted in most east European countries during 1992-1994 combined partial re-capitalization of the banks with enforced restructuring of indebted enterprises, including a degree of privatization of both banks and enterprises.

261. The results of the reform are so far mixed. Re-capitalization funded by the state budget and the overall improvement of business activities during the last two years, have helped the banks to survive and to restructure their asset portfolios. But their financial position is still precarious; moreover, with the prevailing large degree of uncertainty and high interest rates, the banks are reluctant to finance large fixed investments, preferring instead to concentrate on security and currency markets. Another deficiency of many banks, especially in the countries of the former Soviet Union, is their small size and excessive dependence on a few large debtors, which makes them particularly vulnerable to financial crises. As a result, there have been bank failures in a number of transition countries.

262. Further reforms need to proceed in several directions. Commercial banks should be rapidly privatized, possibly with foreign participation to secure additional capital funds and strengthen bank management. A larger involvement of foreign banks, however, is still resisted in many transition countries. Legal procedures for dealing with insolvent debtors, including bankruptcy, need to be simplified and streamlined. Some of the "bad loans" of privatized state enterprises could be consolidated and swapped for long-term state bonds.

263. Other parts of the financial system in the transition countries are also only in the early stages of development. Financial intermediation through investment and pension funds is almost non-existent, partly because the necessary legal basis for their operations has not yet been established. Insurance markets are dominated by large state firms offering a limited range of
services, and with little competition from abroad. Capital markets are developing fast, with bond and equity markets established in practically all the transition economies, but their financial capacity is still very limited.

264. Considerable progress has been made in the reform of fiscal systems. All transition countries have engineered a shift from direct taxation of enterprises as the main source of budgetary revenues, to indirect taxes (VAT) and individual income taxes. This change has broadened the tax base and made revenues less vulnerable to swings in the level of economic activity. But overall, the system of public finance in the transition countries remains rather precarious. Substantial budget deficits in the early stages of the transition have led to large increases in the levels of domestic and foreign public debt, and the servicing of the debt has become a major item of public expenditure.

265. In order to bring budget deficits under control, urgent adjustments are required on both the revenue and expenditure sides of the accounts. As regards revenues, the level of taxation is already high and may prove difficult to increase further. The reforms should therefore focus on achieving greater discipline in tax collection, including its extension to the “grey economy”. On the expenditure side, many of the existing social welfare programmes need to be substantially reduced or adjusted. Perhaps the most important areas for reform are the social security systems which - if continued in their present form - are likely to destabilize the budgetary balance in most countries in the coming years. But the reform of social security systems requires substantial resources and political determination: neither may be in sufficient supply in the transition countries.

(b) Privatization

266. Budgetary reform is closely related to the broader issue of the disengagement of the state from a wide range of economic activities. The Bonn document emphasized the need for private investment to become the principal source of financing economic development, with the role of the state limited to a narrow range of well-defined public-sector projects. In fact, direct involvement of the government in investment activities is now negligible, partly because of fiscal pressures, and private investment accounts for more than half of total fixed investment in the more advanced east European economies.

267. One crucial area of de-statization, the privatization of state enterprises, received almost no attention in the Bonn document, a reflection of the fact that large-scale privatization was not on the immediate agenda of the transition economies in early 1990. Privatization was initially limited to transferring small-scale businesses into private hands through auctions and leasing agreements. With the passage of time, however, policies for the privatization of large state enterprises were drawn up and put into practice in a variety of ways in virtually all the transition countries.

268. The speed and scope of privatization varies widely from one transition country to another. Some countries have opted for mass privatization, involving the free distribution of ownership rights in the form of vouchers to the public at large. Others have preferred commercial methods of privatization, including individual sales of enterprises to private investors, domestic and foreign. One important lesson which can be drawn from the experience of the last five years is that a “mixed” strategy may be desirable, combining elements of free distribution and commercial sales. Another is that the rate at which corporate governance can effectively be
established in newly privatized enterprises should be an important consideration determining the speed of the privatization process. As proper governance cannot be achieved overnight, a large number of enterprises will have to stay and operate under non-private ownership for some time. However, to minimize losses from possible mismanagement, several steps can be taken. First, state enterprises should be legally remoulded in order to create an economically desirable structure of incentives facing managers. This can be done through "corporatization" and "commercialization", which would precede privatization proper. Second, both the managers and members of the board should be offered a stake in their enterprise's future market value (e.g. a call option for shares to be issued in a future privatization) to prevent asset squandering and dissipation. Third, all effort should be undertaken to assure competitive environment for state enterprises, both in the sense of minimum intervention from the government and efficient banking supervision and control.

269. The privatization process, though well advanced, is still far from complete. It has proved particularly difficult in the case of large state enterprises, which have considerable problems but also wield considerable informal influence over governments. Also, political resentments and prejudices against foreign investors have further complicated privatization plans in some transition countries. On the other hand, in those countries which have managed to sell or give away a majority of state enterprises, the expected positive impact of privatization on efficiency and growth is still to come.

(iv) International cooperation and external support

270. The most immediate tasks for the transition process, identified in the Bonn document -- the freeing of prices, the liberalization of business activities, the introduction of currency convertibility and the establishment of markets -- were in fact carried out fairly rapidly in the early stages of the transformation. The tasks which remain pertain mostly to changes in economic structure and the further strengthening and consolidation of market institutions. Not only do these tasks call for new, imaginative policies; they also require political determination, stable democratic procedures, and considerable financial resources. The role of international cooperation and external support for the transition economies is essential if they are to meet these challenges successfully.

271. The hopes of the Bonn document for a successful conclusion of the talks on establishing the EBRD (para 4) have been fulfilled and that institution is now playing an important role in supporting development in the transition economies, especially in the areas of financing, privatization, and infrastructure development. More generally, the *multilateral financial institutions* have become an important source of assistance to the transition economies. They have provided balance of payments support, funds for restructuring, project financing, technical assistance, and have helped to mobilize other international funds, including those of private investors. Their support has been essential in the early stages of the transition, when the transition economies have lacked access to private finance. However, borrowers have had to meet the conditions of each institution, which has often taken time and delayed the disbursement of funds. In general, the most advanced transition economies were the first to meet such conditions and thus were able to supplement the limited inflows of private capital. Other transition economies, including most of the CIS, have found it difficult to meet the conditionality of the international institutions. The result has been a failure of multilateral funds to offset the lack of foreign private capital, at times leaving these economies without the necessary external support.
272. During the past two years, there has been a shift in the flow of multilateral funds towards the CIS. The leading reformers, on the other hand, have made less recourse to multilateral funds because they are attracting increasing amounts of private capital. Overall, it is essential to maintain the supply of multilateral funds to the transition economies. Some will continue to require balance of payments support and need to strengthen their foreign currency reserves. Consideration should be given to making multilateral funds available more quickly in those circumstances where lack of other external financing threatens key macroeconomic policy objectives. The financing of many infrastructure projects by the multilateral development banks will remain important given the scope of the task and the lack of interest of foreign private investors. However, since the overall supply of official finance has declined in recent years, it cannot be counted on to meet the future large capital needs of the transition economies.

273. In the transition economies, there is a growing appreciation of the importance of attracting private capital. From the very beginning of the economic transformation, foreign direct investment (FDI) was seen, by western and many transition economies alike, as a major instrument of economic reform. However, as discussed above (Part I, point viii), expectations of large inflows generally have not materialized, FDI tending to wait for reforms to prove effective rather than playing a leading role. Domestic securities markets have developed quickly in many countries paving the way for portfolio investments. In the first half of 1995, portfolio investment in several transition economies picked up in some cases surpassing FDI. In general, these flows still remain small, reflecting the rudimentary nature of the securities markets and embryonic regulatory institutions. Impressive strides have been made in developing access to international capital markets. By the end of 1995, four countries had obtained credit ratings from the major international agencies. Of these, three are investment grade, a rating required in order to tap the large resources of institutional investors. A record number of transition economies raised private funds internationally in 1995 surpassing the previous annual borrowing by this group. Those countries where reforms are most advanced have been the most successful in this regard.

274. The international financial institutions, together with other multinational institutions and a host of bilateral programmes, have provided a broad range of technical assistance designed to help create market-supporting institutions, to provide policy advice in numerous areas, and to assist in the production of statistics, project evaluation, and so on. Given the plethora and nature of these projects, their impact is difficult to assess. It seems to have been largely positive given the appreciation shown by the recipient governments and various anecdotal evidence, such as the fact that government institutions have difficulties retaining the services of experts trained with the help of such programmes. Early in the transition, the effectiveness of western consultants, often provided for very short periods and possessing little knowledge of the transition process and the eastern economies, was questioned, but that no longer seems to be the case. Recent indications in several countries of a diminishing need for technical assistance suggest that such funds and expertise should be refocused on those transition economies whose requirements remain large and urgent.

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19 In comparison, outside Asia, only three developing countries have investment grade ratings