EXECUTIVE SUMMARY

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1. In 2006 and the first half of 2007 the countries of Central and Eastern Europe have continued rapid economic growth, stimulated by systemic reforms, strengthened integration with international markets and favorable external environment. Political stability prevailed in Central Europe, where most advanced countries (CEE) have taken advantage of their membership in the European Union to speed up their economic growth and strengthen their economic structures. Less advanced countries of Southern and Eastern Europe (SEE) have been successfully overcoming various economic and political barriers to growth and stability, to catch up with their northern and western neighbors. Good economic performance has also been observed in the countries of the Commonwealth of Independent States (CIS), where political situation has been however less stable and the internal situation more diverse.

2. The political and economic divisions in the region have further deepened, with the main dividing line separating the western-oriented countries of Central and Southern Eastern Europe on the one side, and the countries of the former Soviet Union on the other side. The region has never been homogenous in the first place, and after the transformation started in 1989 the divergences have grown wider. Central and South-East European countries have embraced a European model of a liberal-democratic state based on the rule of law, with strong roles of parliaments and democratically accountable governments, and efficient market economies, based on competition and private ownership. The CIS countries have evolved towards a more authoritarian model of state, with a strong role played by presidents, and an economy which is to a large extent controlled by state authorities and informal groups consisting of politicians and representatives of various powerful lobbies, including influential business people (oligarchs) and members of secret services. The differences between the two groups are of fundamental nature and extend far beyond domestic economic and social policies, into the legal system, judiciary, security, defense and foreign policies.

3. Progress in political transformation has been uneven across the group and reflects diverging trends in development and state building strategies. CEE and SEE countries are functioning democracies, with considerable degree of political and civic freedoms. Political structures are based on a multi-party system, with political opposition, civic society, media and non-governmental organizations free to operate. True, the degree of political maturity differs, as reflected in varying values of indices such as the index of political freedom or the index of corruption perception. In this respect, countries of Central Europe that have joined the EU perform best, whereas less advanced countries of South-Eastern Europe still lagging somewhat behind. Nevertheless, these countries still differ enormously from most of the CIS countries, where presidents, having amassed large powers, rule in a more or less authoritarian way, typically being assisted or supported by various unconstitutional bodies that generally lack democratic accountability. Parliaments are relatively weak, political parties are not well established and changing frequently, and civic society institutions are underdeveloped and severely constrained in their activities. Evaluations made by independent international institutions, such as Freedom House, Transparency International or Economist Intelligence Unit rank the CIS countries (though with some notable exceptions, like Georgia or Ukraine) well behind Central and South-Eastern European countries in terms of civic and political rights, freedom of media and the extent of corruption.

4. Several Central European countries have recently experienced some political tensions, mostly caused by internal rivalries between main political forces. The Czech Republic has gone through a prolonged government crisis after the elections in June 2006 failed to establish a strong majority in the parliament. The socialist government in Hungary has come under strong political pressure to resign after it was revealed that prime minister had lied to the public about the actual state of the economy and public finances. In Romania, a rivalry between president and prime minister led to a serious political crisis just after the country entered the EU with the impeachment

procedure against the president finally rejected in a nation-wide referendum. In June 2006, Montenegro declared independence and separated from Serbia amid tensions between ethnic groups. But all these conflicts have not had lasting implications and have been solved through democratic procedures and with constitutional means.

5. In South-Eastern Europe protracted internal conflicts in some countries continue to complicate political situation in Western Balkans. The future of Kosovo is still a source of uncertainty, as Serbia rejects the EU-sponsored plan of granting the province a de-facto independence. The situation seems to have even further deteriorated after the elections in Serbia in January 2007 were won by nationalist parties. Little progress has been achieved in integrating the two constituent parts of Bosnia and Hercegovina which still does not have a functioning uniform government. Lingering tensions persist in Macedonia between the Albanian minority and the national authorities. However, the overall stability in the region does not raise immediate concerns, and may be further enhanced by international initiatives addressed to the Balkan states, such as the extension of NATO's Partnership for Peace program and EU's Stabilization and Association Agreements. Against this backdrop the political situation in Croatia remains stable and the country makes important advances on its road towards EU membership.

6. More precarious was the political situation in the CIS region. In Ukraine, a conflict between pro-western president and pro-Russian prime minister over fundamental choices in foreign policy destabilized the political scene for months, paralyzed the work of the parliament and forced the president to call early elections. Democratic oppositions challenged ruling governments in countries such as Azerbaijan and Belarus, and political tensions increased in Kyrgyzstan and Uzbekistan, both exposed to Islamic radical movements. Political situation remains uncertain in Turkmenistan after the sudden death of its authoritarian leader and the expected power shift. In Russia, political opposition to president Vladimir Putin, though still weak and divided, is nevertheless more and more active and outspoken, especially after the series of killings of journalists and independent political activists critical to the current government and restrictions imposed on registration of opposition political parties, freedom of media and NGO activities. The lack of progress in solving the so-called "frozen conflicts" in Transdniestria, Abkhazia, South Ossetia and Nagornyi Karabakh has also complicated the political situation in Moldova and the Caucasian region.

7. Throughout 2006 and during the first half of 2007, the countries of the transformation region maintained the fast pace of economic growth, some of them taking advantage from their integration with the EU, and others from the strong demand for oil, gas and other natural resources. All former socialist countries have also benefited from the good standing of the world economy and a rapid rise of world trade. The combined growth of output of the whole group reached 6.9% in 2007, the highest growth rate ever achieved by the group in the entire transformation period. However, the entire set of transformation countries has been subject to growing disparities, and the effective division into two distinct groups has deepened further. On the one hand, there are the new EU member countries of Central and Eastern Europe with effectively functioning market economies and the countries of South-Eastern Europe seeking to follow suit. On the other hand, there are the CIS countries, where the progress of reforms is slower or halted altogether.

8. The weighted average rate of GDP growth of eight Central European countries (Visegrad four, Baltic three and Slovenia) increased to 6.2% in 2006, up from 4.8% in 2005. Double-digits growth was recorded in Latvia and Estonia (11-12%), followed by Slovakia and Lithuania (7-8%). Hungary's growth was slowest, a result of drastic measures aimed at reducing yawning budget deficit. In South-Eastern European countries growth performance was more uniform, with GDP growth rates varying between 4.8% in Croatia up to 7.7% in Romania. Economic growth accelerated also in the CIS region to 7.5% from 6.8% in 2005, with Azerbaijan reporting an increase of GDP by one third (!) thanks to rapid expansion of output in the oil sector. The Russian economy, the largest in the region, expanded by 6.7% on the back of high prices and growing demand for oil and gas.

9. Central and Eastern Europe has benefited from strong economic recovery already for several years. In most countries the level of output in 2006 exceeded the pre-transformation levels by wide margins. In Central Europe, GDP level in 2007 was on average 42% higher than in 1989, which implies an average annual growth of 2% over the 18 years period. This average masks important differences between individual countries, with Poland scoring best average (2,6%), and Lithuania at the lower end of the spectrum (0,3%). This rate may not look very impressive, but it should be remembered that the time span covered includes several years of very sharp output decline in the early 1990. If the "transformational" recession of 1990-1993 is excluded, the average growth rates in the region vary around 5%, which is a remarkable

performance, especially against the backdrop of much slower growth of most of the "old" EU countries. The post-transition recovery was considerably weaker in South-Eastern Europe, where the average annual growth rate since 1989 was only 0,2%, and where some countries have not yet reached their pre-transformation output levels (all former Yugoslav republics, except Slovenia and Croatia). The situation is even worse in the CIS countries where despite vary rapid growth during last several the combined output level in 2006 was still 6% below that registered in 1989. The economic collapse was particularly severe in countries hit by internal wars and armed conflicts, such as Georgia and Moldova, where current output is still 50% lower than the officially registered GDP in 1989.

10. High inflation appeared in former socialist countries just at the beginning of transformation. In many countries the consumer price index reached three or even four digit levels annually. Most countries of the group have passed through a hyperinflation purgatory. Nowadays, inflation is no more a big problem in the most countries of CEE and SEE (except Serbia). In the majority of CEE countries, inflation rates in 2006 remained at relatively low levels, not exceeding 4-4.5%. The only exception is Latvia where the price hikes amounted to almost 7%. The best record belongs to Poland, with just 1% price rise in 2006. Altogether, this subgroup has recorded a moderate inflation of 3.7% (unweighted average), slightly more than in the previous year. South-Eastern Europe reported higher inflation – 5.3% on the average, a little less than in the previous year. However, some countries of this subgroup are still faced with quite high inflation rates – from 7% in Bulgaria and Romania to almost 13% in Serbia. While in most of the CIS countries inflation in 2006 was reduced, countries such as Russia, Ukraine, Moldova, Georgia, Azerbaijan, Kazakhstan, Tajikistan, Turkmenistan, and Uzbekistan still notice a high inflation, in the range between 9% and 17%. In 2006 the average (unweighted) inflation rate in this subgroup was 8.8%, slightly lower than in the preceding year. Altogether, for all the analysed group, the average (unweighted) inflation rate now is about 6%, somewhat less than in the previous year and much less than in the 1990s.

11. Unemployment is still a serious problem in the transformation region. It is predominantly of a structural nature, as countries undergoing transformation experience the mismatch between labour supply and demand – in terms of skills, age, gender and the geographical distribution of idle labour resources and work places. With the progress of reforms and improving economic performance, unemployment in the region has been declining steadily over several years. The average (unweighted) rate of unemployment in CEE countries is about 10%. Within this subgroup, the highest unemployment rates (12-15%) are reported by Poland and Slovakia. Still very high unemployment is observed in the countries of SEE – 21% on average. Most countries of this subgroup notice registered unemployment rates above 10%. In Bosnia and Herzegovina, Macedonia and Serbia, unemployment now amounts to 30-40% of total labour resources. The CIS countries exhibit significantly lower rates of registered unemployment (with the average equal to 8% in 2005), but these data are less reliable and rather incomparable with the relevant figures for the other countries. In 2004 and 2005, the highest rates of unemployment were reported by Georgia and Turkmenistan (14% and 30%).

12. Developments in public finances offered a mixed picture. In some countries, general government accounts improved in 2006 (Poland, Estonia), but in other CEE and SEE countries budget deficits widened, and in some cases reached very high levels, threatening macroeconomic stability (Hungary – 9,2% of GDP). Among the countries of CEE and SEE, only Hungary, Poland, Czech Republic and Slovakia have considerable deficits (-9.2%, -3.9%, and -3.4% of GDP respectively), exceeding the 3% limit established for EU member countries in the Stability and Growth Pact, while Estonia, Bulgaria and Serbia show a budget surplus (3.8%, 3.3%, and 2.7% of GDP). In the CIS, the pattern is more differentiated, with budgetary positions varying from surpluses of 9.2% in Russia and 6.4% in Kazakhstan to a deficit of 5.1% in Tajikistan. The CIS countries as a whole recorded the overall budget surplus of 0.7% of GDP. The relative amount of the public debt in the countries of transition, expressed as % of the yearly GDP volume is not oversized as compared to the world standards. According to EBRD figures, the volume of public debt ranges from 4.1% of GDP in Estonia, 6.1% in Kazakhstan, 6.9% in Belarus to 47.8% in Poland, 54.4% in Albania, 66.0% in Hungary and 71.7% in Kyrgyzstan. For the whole transformation group the average debt is 51.8% of GDP, somewhat higher than the average for high income economies (48.7%), but well below the average for the euro area (69.2%).

13. Most countries of the transformation region have a negative balance on current foreign accounts. It has been slightly aggravated in 2006 in all the three subgroups. All the countries of the CEE and SEE register a continuous current account deficit: from -0.4% of GDP in Macedonia and -2.3% in Poland to -13.0% in Latvia, -14.9% in Estonia, -14.8% in Bulgaria, and to a staggering -29.1% in Montenegro. These deficits are to a large extent

a mirror effect of large capital inflows to these countries in form of FDI and EU transfers. In the CIS countries, the pattern is more differentiated. Big oil and gas producers notice a surplus on their current accounts (from 1.0% of GDP in Kazakhstan, to 9.7% in Russia, 12.0% in Uzbekistan, 12.7% in Turkmenistan, and even 19.0% in Azerbaijan). At the same time the poorest countries, like Moldova and Kyrgyzstan, notice a big deficit on current account balance (-11.9% and -19.7% of GDP respectively), and the size of the deficit tends to increase.

14. The majority of the countries in the analyzed group can currently be considered as fully open economies, strongly dependent on exports and imports and the inflow of foreign investment. In 2006, most countries of the group registered rapid expansion of their exports, much above the world average. The best achievements have been observed in big oil producers: Kazakhstan and Azerbaijan (35% and 70% respectively). Azerbaijan has recorded a spectacular leap in exports thanks to the increase of sales of oil and gas through recently constructed pipelines to Caucasus and Turkey. All the remaining countries (except Moldova and Armenia) have also reported a heavy rise in their exports, in the range between 10% and 30%, much higher than the total growth rate of worldwide trade (9.2%). The total value of foreign trade of all the countries concerned in 2006 was $ 908 billion in exports and $ 838 billion in imports. This represented about 7-8% of the total world trade. The biggest exporters within the group are Russia, Poland, the Czech Republic, and Hungary.

15. An important external factor that has a major impact on the economic situation of the countries undergoing transformation is the inflow of foreign direct investment. FDI is usually considered to encompass the acquisition of existing enterprises, the creation of new businesses or the founding of firms with mixed capital, but with a dominant share of foreign capital. Altogether, over the 1989-2006 period cumulative FDI inflows to the former socialist countries amounted to almost $ 400 billion. Most of this sum was attracted by Poland, the Czech Republic and Hungary, followed by Romania, Kazakhstan, Ukraine, Russia, Slovakia, Bulgaria and Croatia. But in *per capita* terms the highest capacity to absorb foreign capital was observed in the smaller countries: the Czech Republic, Estonia, Hungary, Slovakia and Croatia. In 2006, the total FDI inflow to this group reached $ 71 billion, 30% more than in the previous year. The biggest inflows were recorded by Russia, Poland, and Ukraine. Though the amount of FDI inflows to the countries of this group is quite considerable, it still represents a relatively minor part of real capital flows worldwide: just 5.6% in 2005. It should be noted, that inflows of foreign direct investment into individual countries are dependent not only on the attractiveness of the potential returns, but also on the level of risk. According to the World Bank calculations, most safe and friendly to foreign investment were Slovenia, Latvia, the Czech Republic, Hungary, Estonia, Poland, Russia, Slovakia and Lithuania.

16. An assessment of overall economic performance has been made in the Report through the analysis of the pentagon graphs, representing, in a synthetic form, the progress achieved by individual countries in terms of five macroeconomic indicators: the rate of economic growth, the rate of unemployment, the rate of inflation, budget balance, current account balance. Keeping in mind obvious limitations of this analysis, it can nevertheless be said that the current macroeconomic situation in most countries of transition, except some SEE countries (Bosnia and Herzegovina, Macedonia, Montenegro, and Serbia), and less developed CIS countries (Moldova, Kyrgyzstan, Turkmenistan, and Uzbekistan) is generally quite good and improving, and in many respects comparable to the countries of the European Union. The most symmetrical and best-filled pentagons characterising the overall state of the economy belong to the Czech Republic, Poland, Slovenia, Armenia, Azerbaijan, Kazakhstan, and Russia. No country of this group was able to show an improvement of economic performance in terms of all five analysed criteria. A significant improvement of the overall economic situation was noticed in Poland and Ukraine while the macroeconomic position of some less developed countries, like Serbia or Moldova, rather worsened.

17. One of the most important issues in assessing the results of the transformation is the extent of real improvement in the living conditions of the citizens. Seen from this perspective, the transformation region is widely diversified. The *per capita* income figures for 2005 expressed in PPP show how enormous are the differences in the level of development between the countries, ranging from $ 1260 in Tajikistan (the poorest country) to $ 22160 in Slovenia (the most affluent country), and how great is the distance between these countries' incomes levels and the average income level in developed Western countries ($ 35643). However, the concept of social welfare obviously extends beyond material living standards, measured by *per capita* income or consumption. It also includes a number of other elements of the quality of life, such as housing conditions, health conditions, the availability and quality of education, public security, the rule of law, civil rights, and democracy (not all of these components can be measured).

18. The poverty rate is characterised as the proportion of the population with an income of less than $2 per day according to purchasing power parity. In the poorest countries of the analysed group (Tajikistan, Kyrgyzstan, the Caucasian republics) this rate reaches 20-45%. Low poverty rates officially reported by Belarus and Uzbekistan may be misleading. But also in some more developed countries (Albania, Romania, Russia, and Kazakhstan) a considerable part of the population lives below the absolute poverty threshold. In most CEE countries the absolute poverty rate is quite low, below 3% (except of Latvia and Estonia). There is a clear relationship between the poverty rate and the degree of inequality in the division of income. Countries with the largest poverty rates as a rule exhibit also the largest degree of income disparities. The data on income disparities in individual countries, as measured by the Gini index, show tremendous income differences among the citizens of most CIS countries (especially in Russia, Georgia and Turkmenistan). In CEE and SEE income distribution is generally more even. Within this group, income inequality is largest in the Baltic states, Poland, and Macedonia.

19. A composite index of living standards is published by the UNDP as Human Development Index – HDI. It is calculated on the basis of three component indices reflecting the following factors: GDP *per capita* at PPP, the education level, and the life expectancy. The ranking of individual countries in an international comparison covering 177 countries demonstrates that CEE countries occupy relatively high positions, from 27 for Slovenia to 45 in Latvia. SEE countries are assessed generally lower, from 44 for Croatia to 73 in Albania. Within the CIS, according to this index, Azerbaijan is on the top and Moldova is at the bottom, ranging from places 67 to 114 respectively. Looking at the evolution of the HDI index overtime, between 1995 and 2004, it may be observed that all the former socialist countries have improved their relative standing as to the living standards. At the same time, the differences between individual countries grew larger. Most spectacular progress has been made by the Baltic states.

20. Further improvement in fiscal discipline across the whole group of transformation countries has been noted in 2006. The overall public finance deficit declined from around 3% of GDP in 1999-2002 and 2.3% in 2003, to a tiny 0.5% last year (non-weighted average). Nonetheless, the scale of fiscal imbalances compared to 2005 increased in 12 countries, and it still remained excessive in many of them, which was a derivative of a lack of fundamental reform of public finance and a continuation of an expansionary fiscal policy. The situation of public finances was most difficult in Central Europe, with deepest fiscal imbalance recorded in Hungary (9.2% GDP). Generally, fiscal policy has been far too expansionary in most countries, exhibiting a clear procyclical stance. Overall, in 2006 four out of eight EU-8 countries failed to meet the fiscal criteria of nominal convergence required by the EU Stability and Growth Pact.

21. Monetary policy in the transformation countries has gradually switched from an accommodating monetary policy pursued in the 2003-2005 to a more neutral or moderately restrictive monetary stance. Faced by a difficult trade-off between rapid – yet more unbalanced – economic growth and higher inflation, many central banks have decided to raise interest rates, to introduce stricter regulations on minimum reserves or to embark on other anti-inflationary measures. More than half of transition economies experienced an accelerated growth of nominal money supply, often combined with the expansion of domestic credit, which reflected faster economic growth and rising inflation. In CEE countries the monetary authorities had to take strong measures last year to ensure price and exchange rate stability. In the Czech Republic, Hungary, Latvia and Slovakia central banks have all raised their interest rates since January 2006, responding to interest rate increases in the euro area. In turn, Estonia and Latvia introduced stricter regulations on minimum reserves and other anti-inflationary measures in response to strong domestic credit growth. Poland was the only country in the region to have cut its interest rate but this was from a rather restrictive stance. Similarly, central banks in SEE countries have been trying to grapple with the problems created by strong economic growth and credit expansion. Reserve requirements have been raised substantially in Bosnia and Herzegovina, Croatia and Serbia, while the central bank in Romania had to increase its interest rates several times since mid-2005. Also in the CIS region, central banks in several countries (Azerbaijan, Kazakhstan and the Kyrgyz Republic) decided to respond to higher inflation with interest rate hikes or introduced more direct means of controlling the money supply.

22. As of 2006, among the 28 former communist countries, 19 had floating exchange rates, while eight economies were operating under a fixed, quasi-fixed, or currency board exchange rate regime (one country – Montenegro – does not have its own currency). The majority of countries undergoing systemic transformation – regardless of the prevailing exchange rate regime – have experienced a trend towards a real appreciation of their domestic currencies. This trend has been a result of

a combination of factors, including fast productivity increases (the Balassa-Samuelson effect), large inflow of foreign direct and portfolio investment, and the acceleration of the growth of exports and a current account surplus in some countries. In addition, in the case of new EU members and EU candidate countries, the appreciation pressure was strengthened by the inflow of EU funds and the extra inflows of private capital, induced by the upgrading of creditworthiness of pertinent host countries by international rating agencies. After 2000 the largest increases in the real international value of domestic currencies were experienced in those countries that had made the most progress in the process of transforming their economic systems and structural reforms. This category included primarily the EU accession countries. National currencies appreciated strongly also in oil and gas producing CIS countries, including Russia, responding to large trade surpluses and inflows of foreign direct investments. As a result of these developments, the scale of real appreciation of Russia's currency was the largest in the whole analysed group (8.5% per annum in average). This trend made the Russian economy's exposure to the "Dutch disease" an increasingly real threat.

23. The scope and pace of structural reforms, and generally the progress of systemic transformation, varied considerably from one country to another. At one end of the spectrum were CEE countries and some SEE countries, which were recognized as functioning market economies by the EBRD. In this first group, the most advanced in the reform process are Hungary, the Czech Republic, Estonia and Poland. The other end of the spectrum comprised countries such as Belarus, Turkmenistan and Uzbekistan, where by 2006 market reforms were still in the nascent stage. Moreover, the latter group lag increasingly behind even those CIS countries (Armenia, Georgia, Russia, Kazakhstan, Kyrgyzstan and Ukraine) that have embarked on structural reforms much later than the CEE countries. As a result, the "institutional gap" between top-reformer countries and those lagging behind in the process has widened even further over the past several years.

24. In 2006 a number of former communist countries made further progress in pushing through with structural reforms. The advances were particularly noticeable in three areas: securities markets and non-bank financial institutions, banking reform and the liberalisation of interest rates, and competition policy. As far as individual countries are concerned, the largest improvement (by EBRD indicators) took place in Estonia (competition policy and securities markets and non-bank financial institutions), Bulgaria (small scale privatization and the development of securities markets), Romania and Macedonia (enterprise restructuring and competition policy), Kazakhstan (development of securities markets and infrastructure reform), Russia (banking reform and the development of securities markets) and Ukraine (reforms of the banking sector and infrastructure). The past several years have shown that structural reforms in CIS countries have lost their momentum compared with Central and South-Eastern Europe. After the initial market-oriented changes have been made, including the liberalization of prices and foreign trade and small-scale privatization, relatively little progress has been observed in developing key market institutions, such as the judiciary system, public administration, health service, pension system, labor market and the banking sector, as well as competition policy and effective bankruptcy procedures. Institutional reforms ran into resistance in the CIS countries wherever they were aimed at moving away from the traditional role of government as a direct participant of economic life.

25. The experience of CEE countries shows that the existence of an "external anchor" in form of the prospect of EU membership can significantly accelerate the reform process and facilitate structural reforms in the candidate countries. The use of this "anchor" can lead to different structural reform paths not only in transition economies, but also in a much broader, global context. The quality of institutions in the new EU member states is currently higher on average than in other countries at a similar level of development. In the remaining transition economies, particularly CIS countries, the development of the institutional market infrastructure is slightly lower than in other countries with a similar level of development. The progress of structural reform was an important determinant of economic growth in transition countries. The regression analysis conducted in the Report reveals that the countries which were most advanced in the process of systemic transformation achieved faster GDP growth on average in 1990-2005 than those lagging behind in the reform process. The positive correlation between these two variables is especially clear in Central Europe.

26. The progress of privatization in the transformation countries mirrors the progress of other structural reforms. The CEE countries which joined the EU in 2004 are most advanced in the process of ownership transformation. Among other sub-groups of countries, also Bulgaria, Croatia and Romania matched their achievements in some respects. At the opposite end of the spectrum were Belarus, Turkmenistan and Uzbekistan, where the domination of state ownership and the lack of

privatization progress were mainly due to political factors, combined with unwillingness to push ahead with far-reaching market reforms. Moreover, the analysis shows that there is clear positive correlation between progress in privatisation and the rate of economic growth across the entire analysed group, as well as in individual countries.

27. Economic freedom ranks among the basic yardsticks of progress in the process of building up a competitive market system. The scope of economic freedom was greatest in those countries that have shown most determination and resolve in systemic reforms and have made the most progress in the process. This group primarily included new EU member countries. By 2006, Estonia was the leader among these countries (and in the entire analyzed group); it was ranked seventh in the world by the Heritage Foundation. Economic freedom in the Czech Republic and Lithuania was also relatively large, with a tendency toward further improvement. Among other countries, the widest margin of economic freedom prevailed in Armenia, while most of other CIS nations (especially those in Central Asia as well as Azerbaijan, Belarus and Russia) were the worst performers in this area. Economic freedom in the latter countries was adversely affected by excessively developed government functions and widespread red-tape. In 2006 the average indicators of economic freedom improved in all the analysed country sub-groups. Among the new EU members, the Czech Republic recorded the most significant progress. At the same time, in two countries of this group – Hungary and Latvia – the situation deteriorated in 2006. The indices of economic freedom have improved in 2006 also in all but one (Bulgaria) countries of South-eastern Europe, especially in Romania, Albania, Croatia and Macedonia. Among the CIS countries the most spectacular progress took place in Armenia followed by Georgia and Kazakhstan. The opposite was true for the remaining CIS states (Azerbaijan, Belarus, Russia and Ukraine) where economic freedom last year suffered a backlash. The analysis in the Report shows also that economic freedom has been conducive to fast economic growth (and conversely – constraints on economic freedom have become a barrier to growth).

28. Data on perceived corruption in the transformation region, published by Transparency International, confirms the inverse relationship between economic freedom and the incidence of perceived corruption. This problem seems to be the least acute in Central European countries, while assuming much larger or even disastrous proportions in most South-Eastern European economies (including Romania) and all the CIS states. Last year has brought a decline in the corruption perception indicators in 17 out of the 27 former communist countries. In contrast to the previous few years, it occurred first of all in countries where the scale of corruption had already been smaller, i.e. the EU-8 group from Central Europe. On the other hand, in some CIS countries, and in particular Belarus, Kyrgyz Republic and Uzbekistan, the incidence of perceived corruption further increased.

29. The assessment of the scope of government regulations shows that Hungary, Slovakia, the Czech Republic and the Baltic States offer the best conditions for business activity. This is due to a small number of bureaucratic barriers in these countries, coupled with ease of entry and exit, and a judiciary system which is highly effective in enforcing contracts (except for Slovenia, where such a procedure lasts on average four years). On the other hand, the business environment in Poland and Slovenia ranked – by most means – among the least encouraging in CEE. These findings only partly confirm a pattern resulting from international experience, i.e. that market entry barriers are inversely related to the level of economic development. While this pattern appears to hold true for Central Europe and some of the South-Eastern European countries, the available evidence for the CIS countries does not support it.

The ability to generate, through an appropriate public spending policy, positive externalities for the private sector and thus reinforce the stimuli for development is an important function of efficient governments in developed economies. Two of the most important sources of these effects are the level of government support for the domestic research and development sector in individual countries and the results attained by the R&D sector, and the level of development and the spread of information and communication technologies (ICT). As far as the support for R&D is concerned, only one country (Slovenia) exhibited R&D spending exceeding 1.5% of GDP. In a number of other countries (the Czech Republic, Croatia, Serbia and Montenegro, Russia and Ukraine) this ratio was above 1.0% and showed an upward trend. Simultaneously, the same ratio for the OECD countries stood at 1.85%, while the European Union average was 1.93% of GDP. Inadequate government support for the development of science and technology in transition countries may be held responsible for these countries' low innovative capability.

31. An important yardstick of the progress of transformation and the advancement of structural reforms is the development of financial markets and the scope of financial intermediation. These changes were

reflected in the EBRD assessment of the reform progress in the financial sector, which in 2006 upgraded its scores for nine of the analysed countries: Estonia, Slovakia, Bulgaria, Croatia, Macedonia, Montenegro, Kazakhstan, Russia, Tajikistan and Ukraine. The report analyses three dimensions of financial intermediation: development of securities market, the scope of bank lending to the economy, and the degree of monetization. All three have been found to be positively correlated with GDP growth.

32. The new EU member states are expected to converge to the old EU member states in terms of *per capita* incomes. The convergence process has two dimensions: income-level convergence and cyclical convergence. The analysis carried out in the Report confirms a relatively slow convergence between the new EU entrants and the former EU-15 in terms of *per capita* incomes. The results obtained indicate that the CEE countries would need about 20-25 years to reduce by half the distance towards the EU-15. The convergence is seen both in country-to-country comparisons and in a regional approach, encompassing the two groups. The analysis of correlation between output changes in EU-8 and EU-15 has also evidenced a good degree of symmetry between cyclical movements in industrial output in EU-8 and EU-15, with particularly high business cycle synchronization in the case of Hungary.

33. Future growth prospects vary across the transformation region. The CEE countries that have joined the European Union appear to have particularly promising growth prospects. The Balkan countries need still to cope with serious challenges in the area of privatisation, enterprise restructuring and building market institutions; in this process they will have to rely mostly on their own resources. The greatest uncertainty surrounds the future development of the CIS countries. They seem still to focus on current problems rather than on developing their competitive output capacities. However, they have considerable reserves of production potential. This may ensure a satisfactory pace of economic growth for the next few years provided that there will be an acceleration of economic reforms. The rate of economic growth in individual countries in this broad group will also largely depend on the further inflow of foreign direct investment. In this regard, the best growth prospects may be seen again in the CEE and SEE countries. The prospects for the CIS countries with large stocks of natural energy resources (Russia, Kazakhstan and Azerbaijan) appear to be also favourable. In the remaining CIS countries (e.g. Ukraine, Georgia and Belarus) the rate of economic growth will depend mainly on the progress of reforms towards an open market economy and a democratic state based on the rule of law.

34. Regional cooperation among the transformation countries developed chiefly within particular sub-groups of countries, rather then across the region. Regional cooperative instruments and frameworks developed among the CEE countries have lost significance after these countries joined the EU. Regular contacts between high representatives of four Visegrad countries do not translate into a more coherent cooperation, either within the EU, or outside. Central European Free Trade Area (CEFTA) lost its original membership and status after the CEE countries became EU members, and has been formally transformed in 2006 into a regional free trade area of South-Eastern European countries. In this new set-up the organization is expected to provide trade and economic dimension to Stabilization and Association Agreements signed between the EU and the Balkan countries. Some new projects of regional cooperation have been initiated recently in the area of energy supplies and in the Black Sea region. On the other hand, the CIS countries continue with some limited forms of cooperation on the post-soviet territory, with Russia being the hub for these tendencies. The only exception to this pattern is GUUAM, an organization set up by Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova, with the main objective to seek more independence from Russia. An attempt to establish some form of multilateral cooperation in the area of energy supplies between some CEE countries and some oil- and gas-producing CIS countries has been launched in 2007 by Poland, but the results of this initiative remain to be seen.

35. Russia's more and more assertive foreign and regional policy has been a source of increasing political tensions in the region. In 2006 and the first half of 2007 a number of conflicts emerged between Russia and its neighbors on issues such as trade, energy supplies and transit, the status of Russian minorities in some CIS countries, and political rivalries in the areas of "frozen conflicts". Successful attempts to establish pro-western governments with democratic agenda in countries such as Ukraine or Georgia have prompted Russian authorities to react strongly with the use various policy instruments, including trade embargoes, increases of prices of, and sometimes cutting of, energy supplies, to discourage neighboring countries from pursuing more independent foreign policy. The measures in question include a ban on meat exports from Poland, established in 2005 and still in force, discontinuation of oil supplies through Druzhba pipeline to Lithuanian refinery in Mazeikie in 2006 (just after the bid to buy the refinery by Russian firm Lukoil was turned down by Lithuanian authorities and the deal was won by the Polish company PKN Orlen), sanctions and restrictions on trade, transit and air and rail traffic with Georgia, an embargo on imports of Moldovan wines,

sharp increases in prices of gas supplied to Ukraine, Georgia, Moldova and Belarus, and, most recently, a conflict with Estonia in relation to the removal of Soviet-era monument from the central square in Tallinn. All these disputes have been politically motivated and are clearly symptoms of a new, "neo-imperial" foreign policy course of the Kremlin, aimed at reestablishing a strong international position of Russia.

36. Regional trade developed rapidly after 2003, especially in new EU member states. In this group of countries, the annual average rate of growth of exports in 2004-2006 reached 20%, and that of imports 17,6%. This dynamic expansion resulted from several factors, chiefly including improved access to EU markets, accelerated growth of world demand, and increasing competitiveness of CEE countries due to earlier structural reforms. What is interesting, in most countries exports to non-EU markets increased faster than intra-EU trade. The fastest export increases were reported by Estonia, followed by Latvia. Imports growth was particularly dynamic in Slovakia, Estonia and Latvia, fuelled by very high GDP growth. By contrast, trade between CIS countries was sluggish and lagged behind trade between that group and non-CIS countries.

37. An important policy objective for the new EU member states is the accession to the euro area. Slovenia has been the first CEE country to introduce the single currency in January 2007. Two other new member states – Cyprus and Malta – have fulfilled the accession criteria in 2007, and have been invited to join the euro area as of 1 January 2008. The prospects for accession of other countries are less clear. While most of them have adopted specific timetables to introduce the euro between 2009 and 2012 (only Poland has not yet announced any fixed date for accession), they may still face difficult challenges on the road to the monetary union. Some countries, with their fixed exchange rate regimes based typically on strict currency board arrangements (Estonia, Lithuania, Bulgaria, and also Latvia), may have difficulties with keeping inflation under control, while some other countries (with flexible exchange rate regimes) may not be able (or willing) to make necessary cuts in their large budget deficits (Hungary, Poland), or may face problems in keeping the fluctuations of their currencies within narrow bands required by the ERM-2 system. Long delays in accession to the euro zone may result in a division of all EU members into two categories, with non-euro member states having clearly less clout over economic policies in the EU.

38. The new EU member states have greatly benefited from financial assistance under EU structural and cohesion funds. Total amount of funds allocated to EU-10 for the period 2004-2006 was 24,4 billion, with Poland accounting for more than 52% of the total. At the end of 2006, the actual absorption of the structural funds (with advance payments) was highest in Estonia (51,5%), Slovenia (51,4%) and Hungary (49,7%), and lowest in Cyprus (32,1%), the Czech Republic (33,3%) and Latvia (34,2%). While the funds allocated for 2004-2006 can still be used until the end of 2008 (according to the "n+2" rule), it is clear that at least some new member states (if not all) will have serious difficulties in fully using all the funds that have been put at their disposal in the EU budget.

39. The accession of Bulgaria and Romania in January 2007 has completed the biggest and most difficult enlargement ever undertaken in the EU. However, the accession of the two countries raised serious doubts as to their readiness and ability to take on all the obligations of EU membership. Both countries were criticized for lack of progress in fighting corruption and organized crime, for inefficiency of their judiciary and administrative systems, and weakness of their tax and financial systems. Nevertheless, the decision was eventually taken to admit the two countries on board, with long list of derogations and safeguard clauses attached to their Accession Treaties. It remains to be seen whether Bulgaria and Romania will be able to catch up quickly and improve the situation in the problematic areas.

40. Accession to the EU of other Balkan countries does not seem to be on the immediate agenda. Except for Croatia, which is much better prepared and well advanced in membership negotiations, the other SEE countries are still much less advanced in their structural adjustments and institutional reforms and certainly cannot fulfil the Copenhagen membership criteria any time soon. Continuous lack of political stability in some of these countries (Bosnia and Hercegovina, Serbia) is an additional impediment on the road to accession. Also, the political attitude in EU member states towards enlargement has changed, with symptoms of "enlargement fatigue" clearly evident. Nevertheless, the EU is determined to support the accession process and to cooperate closely with the Balkan candidate and candidate-to-be countries within the framework of Stabilization and Association Agreements, to stimulate necessary reforms and strengthen internal stability in the region.

41. The special study in this Report is devoted to the analysis of the current political situation in the Russian Federation. The dynamics of the political scene in 2006-2007 has been determined by intense power struggle between various groups representing different segments of

public administration, political “nomenklatura”, influential oligarchs and business people. Parliamentary elections in 2007, and especially presidential elections in 2008, may lead to significant power shifts between these various political groups. Given the extent of intimate links between politics and business in Russia, these shifts may result in a redistribution of economic influence and wealth on a considerable scale. Large powers amassed in the hands of President Putin and his *entourage,* combined with massive popular support, give him an extremely strong position in the Russian political system. Vladimir Putin will therefore be free to announce his preferred candidate for succession, and his declaration will most likely be a decisive factor behind the election. However, the power shift is not likely to change Russia’s situation in any significant way, as the successor is expected to continue with policies of the current administration.

42. In the short- and medium-term the political situation in Russia will remain stable, supported by strong economic growth on the back of favourable market conditions for fuels and energy. However, in the longer term perspective, Russia faces important challenges, such as the need to modernize and diversify the economy, negative demographic trends, corruption and social pathologies. The “presidential-oligarchic” model of state which has emerged in Russia during transformation may soon become an important obstacle in the process of implementing necessary reforms and overcoming structural weaknesses.