

New European Union Frontier Countries: Economic Situation and Investment Climate

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Introduction

The new European Union frontier countries (*NEF countries*) comprise a region that is truly emerging into a market economy. They include Bulgaria, Romania, Croatia, Ukraine, Albania, Macedonia, Moldova, Serbia and Montenegro, Bosnia and Herzegovina. These countries should be of particular interest to financial institutions and investors in Europe because they have the following attributes:

- sustainable economic growth and macroeconomic stability
- an improving business environment and investment climate
- a highly skilled, well educated labor force of significant size
- a low cost region at a strategic crossroads
- good access to the major markets of the European Union
- large domestic markets

In the last three years, these economies have been among the fastest growing economies in Europe and are unquestionably some of the most rapidly growing in the world. At the same time, this group is not homogenous. Some of them, such as Bulgaria, Croatia, Romania, and Ukraine, have shown extraordinary economic performance in the last four years that considerably exceeded the average level of the *NEF countries*. This group of four countries (Bulgaria, Croatia, Romania, and Ukraine) can be defined as the *More Advanced New European Frontier Countries (MA NEF countries)*. Although the performance of the *Less Advanced New European Frontier Countries (LA NEF countries)* including Albania, Bosnia and Herzegovina, Macedonia, Moldova, Serbia and Montenegro was lower than in *MA NEF countries*, it is still remarkable.

Although all countries of the *NEF* region show some progress in stabilizing their economies, improving the business environment and moving to a free market economy, the *MA NEF countries* performed substantially better than others in the region. Despite uneven improvement among *MA NEF countries*, most have made good progress in deregulating business activities, improving legal systems and governance, liberalizing trade, reforming the financial sector, and reducing public debt. For these economies, the desire to gain accession to the EU will continue to be the driving force of their policy-making agendas over the coming years, albeit with widely different time horizons in individual countries. One of the greatest benefits of EU accession for foreign investors is the transparency and homogeneity of the EU regulatory system, which all countries involved in the integration process are required to gradually introduce.

Labor resources in the *NEF countries* are highly competitive, as modern educational systems have provided a highly educated, skilled and motivated labor force in nearly every target country. For example, the university gross enrollment ratio in *NEF countries* is comparable with the existing ratio in Western European countries. This ratio in Ukraine is 54, which is the same as in France, and higher than in Italy or Portugal. At the same time, wage levels are much lower than in EU countries. In absolute terms, the US dollar wages in *NEF countries* are far lower than in EU countries, while the differences in the levels of productivity and skills are much smaller.

It should also be noted that *NEF countries* are very well positioned to benefit from the gradual "saturation" and the cost increases that will take place in the new EU member countries (Hungary, Poland, the Czech Republic, Slovenia) as a result of their accession to the European Union in 2004. EU enlargement will result in the adjustment of living standards in the new member states and additional cost increases associated with more stringent EU requirements. All of this will result in higher labor and production costs. Consequently, many businesses will be encouraged to relocate their production to the neighboring *NEF countries* with similar levels of productivity, skills and economic structures as in their new EU member counterparts. These countries will be able to take better advantage of their labor productivity and cost competitiveness. Proximity to the EU will bring new opportunities and challenges to the region's development. The *NEF* region, and *MA NEF countries* in particular, will become increasingly more attractive to investors.

The next few years present a window of opportunity to invest profitably and develop sound trade relationships with countries in the *MA NEF* region. Three countries of this region — Bulgaria, Romania and Croatia — are second-tier EU accession candidates slated to join the EU in 2007 and 2008. By then, undervalued investment opportunities will be more limited. Investments in Ukraine are also extremely promising, since Ukraine is growing extraordinarily fast. Over the last few years, it has been among the few countries in the world that has shown extraordinarily high GDP growth, low inflation, high current account surpluses, low fiscal deficits, and low public debt. Ukraine is the only non-oil exporting country in the world that has achieved such exceptional results.

The next few years, therefore, are the right time to seek business opportunities in the *MA NEF* region. Investments into *MA NEF* economies are very likely to produce substantial gains in the near term. Therefore, *MA NEF*

countries are becoming some of the world's most promising investment destinations, as investments made prior to 2007 are likely to produce high returns that could possibly exceed returns in such successful transition countries as Chile, Estonia, Czech Republic, Slovenia, Poland (*control group of countries*).

Table. Classification of Analysed Countries

New European Union Frontier Countries (NEF countries)		Control Group of Countries
More Advanced New European Frontier Countries (MA NEF countries)	Less Advanced New European Frontier Countries (LA NEF countries)	
Bulgaria Croatia Romania Ukraine	Albania Bosnia and Herzegovina Macedonia Moldova Serbia and Montenegro	Chile Czech Republic Estonia Poland Slovenia

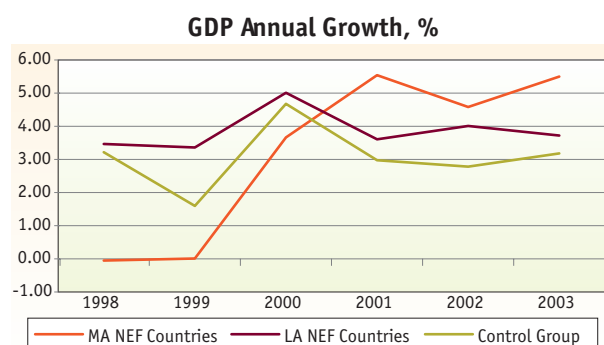
Macroeconomic Performance

MA NEF countries demonstrated significant economic improvements over the last three years. While growth of international production did not exceed 3% in 2003 and will very likely reach only 4% in 2004, economic growth within the group of *MA NEF countries* is significantly higher. Ukraine, which is the group leader, attained an economic growth rate of more than 9% in 2003 and is expected to grow at an even higher rate in 2004. The prospects for economic growth in other *MA NEF countries* in 2004–2005 also remain very favorable.

The governments of *MA NEF countries* have had significant success in implementation of economic reform programs. Although the depth of the changes and approaches to reforms differ from country to country, they include the following:

- liberalization and deregulation of business activities in the country
- re-construction of the country's tax system
- liberalization of international trade and capital movements
- agriculture sector reform
- privatization of state enterprises
- fiscal and financial sector reform

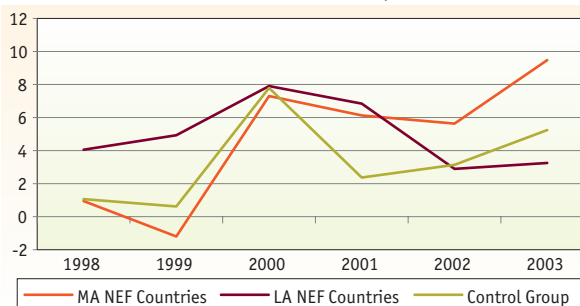
MA NEF countries have experienced significant growth of GDP. Over 2000–2003 the average annual growth rate in these countries was around 5%. Ukraine contributed significantly to the high growth in the region, with a 7.8% average growth rate. For comparison, the growth rate in the *control group of countries* (Chile, Estonia, Czech Republic, Slovenia, Poland) over the same time period did not exceed 3%. The *control group* performance was even lower than in *LA NEF countries*, where average annual growth was around 4%.



Sources: IMF, The Bleyzer Foundation's calculations

The main source for such remarkable growth in *MA NEF countries* is the rapidly growing industrial sector. In 2000–2003, the average rate of industrial growth in this group was more than 7%, while it was 5% in *LA NEF countries* and around 4.6% in *control group countries*.

Industrial Growth, %

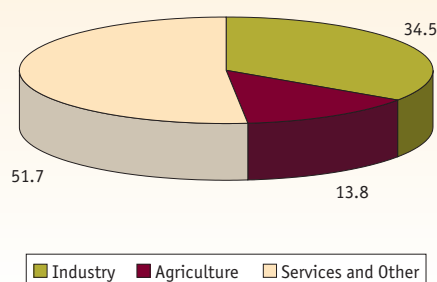


Sources: IMF, The Bleyzer Foundation's calculations

The current structure of the *MA NEF countries*' GDP suggests that two forces will further drive growth in this group: first, the growing importance of the industrial sector and services; second, the decreasing role of agriculture in generating GDP. In 2003, the industrial component is 36% of GDP for the *control group*, with services almost 59% and agriculture only 5%, while the structural composition of GDP is different in *MA NEF countries*. Although the share of industry does not differ significantly between these two groups, the share of services in the *MA NEF* group is almost 10 percentage points lower than in the *control group*, and the share of agriculture is 9 percentage points higher. Since such structural changes in the *control group* were made during their transition period, it should be expected that the share of the service sector will grow significantly in the *MA NEF* group with a corresponding decrease in the share of agriculture.

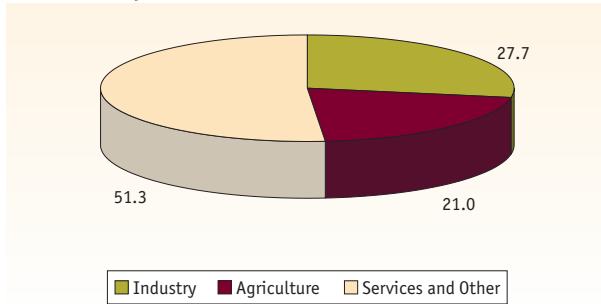
The level of investments in *MA NEF countries* is almost on the same level as in the *control group*. In 2001–2002, the average level of investments in *MA NEF countries* was 19% of GDP. The highest rate of investment was in Croatia (34%) and the lowest in Romania (10%). The performance of *LA NEF countries* was much worse. The average level of investments in the *LA NEF* group in 2002 was only 10% of GDP.

GDP Composition in MA NEF Countries in 2003, %



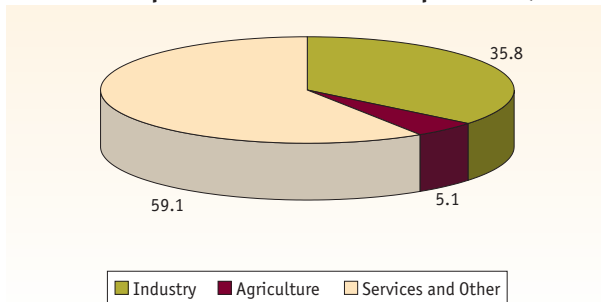
Sources: IMF, WB World Development Indicators, The Bleyzer Foundation's calculations

GDP Composition in LA NEF Countries in 2003, %



Sources: IMF, WB World Development Indicators, The Bleyzer Foundation's calculations

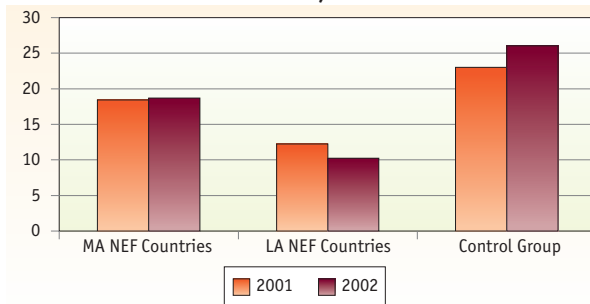
GDP Composition in Control Group in 2003, %



Sources: IMF, WB World Development Indicators, The Bleyzer Foundation's calculations

The existing high level of investment in the *MA NEF* group promotes further economic growth in these countries. However, generating growth in *LA NEF countries* will be impossible without increasing the level of investments with a corresponding decrease in consumption.

Investments, % of GDP



Sources: IMF, WB World Development Indicators, The Bleyzer Foundation's calculations

Growth in International Trade

Transition economies of the *NEF* region experience fairly large external imbalances. For the whole region, the current account deficit has been increasing over recent years and averaged between 5 and 6 percent of GDP in 2002 and 2003.

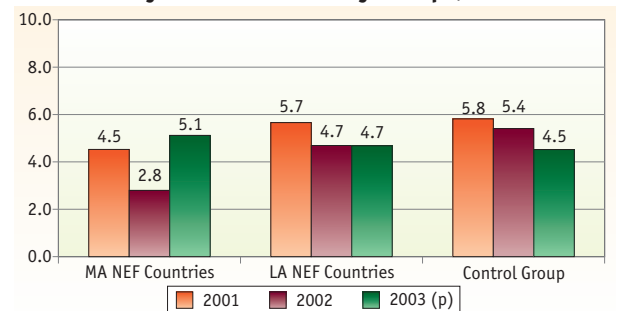
The same tendency remained in 2003. *MA NEF countries* were best performers among the three groups. They

demonstrated sustainable low external deficits, with an average that did not exceed 2.3% over the last four years. Moreover, Ukraine's current account was in surplus, accounting for over 5% of GDP. This means that Ukraine performed even better than the best performer from the *control group* — Chile, whose deficit over the last four years was not higher than 2%.

The average current account deficit in other countries from the *control group* was around 7% of GDP. In contrast, *LA NEF countries* experienced high current account deficits, reaching 8.5% of GDP in 2003. Not surprisingly, the highest external deficits are observable in all of the *LA NEF* post-war Balkan economies. In 2002–2003, Bosnia and Herzegovina and Serbia and Montenegro experienced current account deficits of around 20% and 10% respectively.

Due to the economic growth in *NEF countries*, it is expected that in 2004–2005 external position of all countries will be improved, with the remaining already existing leader — *MA NEF* group.

Dynamics of Current Account Deficits in 2000–2003 by Transition Country Groups, %



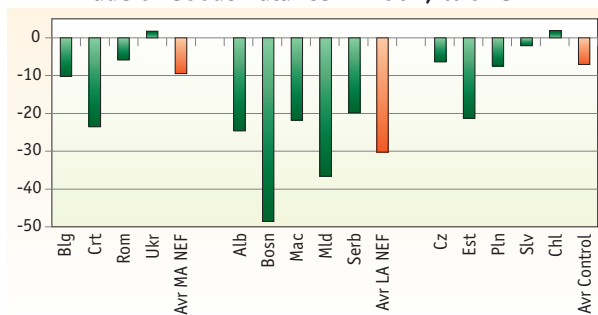
Sources: World Bank, IMF, The Bleyzer Foundation's calculations

Balances of services are positive throughout all three groups, with only the exception of Chile. Surplus of balance of services are higher in those *MA NEF* and *control group countries* where the tourism sector is well developed (Croatia, Bulgaria, the Czech Republic, Slovenia) and where there are high transit fees (Ukraine, Poland). Positive trade of services accounts and large current transfers narrowed current account deficits in the *NEF* region. Private transfers are important in all countries of the *NEF* region and mostly represent workers' remittances. For post-war economies of the Western Balkans, official transfers also represent an important source of foreign currency earnings (over 2% of GDP).

Gradual implementation of market reforms in *NEF countries* contributed to substantial expansion of foreign trade in recent years, although it was uneven across the countries. However, goods imports have outpaced exports, resulting in persistent and even increasing trade deficits. In 2002, the average total trade deficit in *NEF countries* reached an estimated 20% of GDP, ranging

from a 40% of GDP deficit in Bosnia and Herzegovina to a 2% of GDP surplus in Ukraine. In general, the *MA NEF countries'* average trade deficit was just over 9% of GDP, which is comparable to the *control group*.

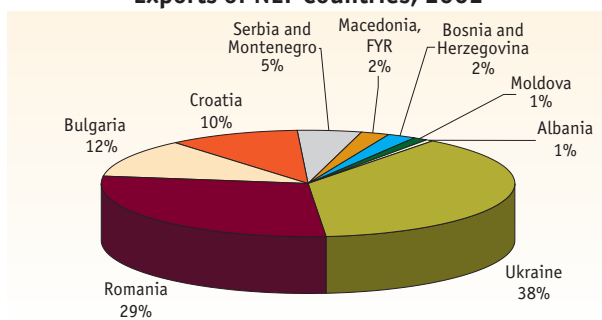
Trade of Goods Balance in 2002, % of GDP



Sources: World Bank, The Bleyzer Foundation's calculations

Merchandise exports of *NEF countries* have generally performed well since 2000. The combined exports of this group rose by 12.3% to \$49 billion in 2002 in current USD terms. This growth rate compares well with exports expansion in *MA NEF countries*, which demonstrated 13.5% annual growth of exports in 2002. It's worth noting that the two largest trading countries from the *control group*, the Czech Republic and Poland, produce almost half of the total exports of all the other countries from the three groups combined. The smaller size of *LA NEF* economies in terms of population and level of economic development explains the difference. *MA NEF countries* are runners-up in terms of export volumes for all three groups.

Exports of NEF Countries, 2002



Source: World Bank

However, there are significant differences across individual countries concerning their export performance. The appreciation of the euro in 2002 led to some real effective appreciation in the countries whose currencies are closely tied to the euro. Countries with greater shares of exports to the EU and larger real effective appreciation saw much slower or even negative export growth in 2002. In *NEF countries* in 2002, spectacular export performance is reported in two of the four *MA NEF* group. Romania reached 22% annual growth, and Bulgaria 12%. From the *LA NEF countries* Serbia and Montenegro was the best performer. Its exports in-

creased by 19%. At the same time, export volumes declined in other *LA NEF countries*. The most dramatic decline took place in Bosnia and Herzegovina, Macedonia, and Moldova. The main reason for this decline was the global economy slowdown in 2002. Export performance is expected to improve in 2004–2005 as import demand for *NEF countries'* goods strengthens.

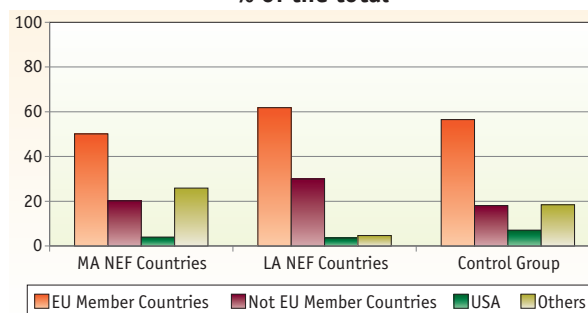
Foreign Trade of Goods Indicators

	1999	2000	2001	2002
NEF Countries				
Exports, fob, \$ billion	34.36	40.18	43.23	48.56
Exports, % yoy growth	-6.2	16.9	7.6	12.3
Imports, fob, \$ billion	44.27	50.60	58.64	65.53
Imports, % yoy growth	-14.0	14.3	15.9	11.7
Trade Balance, \$ billion	-9.9	-10.4	-15.4	-17.0
Control Group				
Exports, fob, \$ billion	84.59	86.64	85.90	85.74
Exports, % yoy growth	72.51	79.34	63.54	66.50
Imports, fob, \$ billion	82.13	84.49	83.81	83.49
Imports, % yoy growth	47.64	83.38	71.61	63.35
Trade Balance, \$ billion	69.85	69.55	69.48	69.64

Sources: World Bank, IMF

The EU is the main recipient of exports from *NEF countries*. In 2002, the share of exports to the EU in total exports was the largest in the *LA NEF countries* group. Over 65% of their exports went to EU countries. The export destinations of the *MA NEF countries* were varied. In 2002, 67% of Romania's exports went to EU countries, while Ukraine exported more to the new accession countries (which joined the EU on May 1, 2004) than to the rest of EU.

Geographical Destination of Exports in 2002–2003, % of the total



Source: UNCTAD Handbook of Statistics, 2003.

The dependence of *LA NEF countries* on the EU market explains some of the slowdown in export growth in this region, which occurred due to poor economic growth in the EU. More diversified export destinations create a brighter outlook for future export performance of the *MA NEF countries* in comparison to others. The bulk of exports from most of the *NEF countries* constitute labor intensive products primarily due to the relatively low labor costs (less than half than in the *control group coun-*

tries). The *control group countries* and Croatia (from the *MA NEF* group) have relatively high shares of capital intensive product exports. At the same time, resource intensive products represent a large part of Ukrainian and Chilean exports.

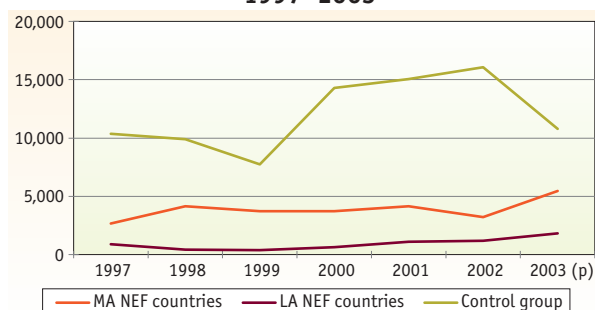
On the import side, the combined imports of the *NEF countries* rose by 11.7% to \$65.5 billion, representing some deceleration compared to the previous year's growth. A substantial growth in imports was observed in *MA NEF* group countries. The same tendency was observable in the *control group countries*. It reflects relatively high rates of fixed investment growth in 2002, as a large part of imported goods were investment goods. The EU is also one of the main origins of imports in Ukraine (around 30% of the country's total imports).

A large trade deficit is a fairly common feature of transition economies, and reflects the need to satisfy growing imports for domestic consumption and investment. Nevertheless, robust growth of capital goods imports to *NEF countries* along with continuous foreign capital inflow imply productivity growth and improved production capacities that can eventually result in more competitive export products and a gradual narrowing of external gaps in these countries.

International Capital and Debt

Solid macroeconomic performance and progress with market reforms brought robust capital inflows into the *NEF* region. These inflows represent an essential source of foreign currency earnings and play a significant role in financing current account deficits. Foreign direct investment (FDI) inflows are particularly important in *NEF* economies with limited ability to raise domestic savings and an urgent need to finance increasing consumption and investment.

Net FDI Inflows to Transition Countries by Group, 1997–2003



Sources: UNCTAD World Investment Report, World Bank, IMF

Since 1997, net FDI inflow into *NEF countries* has shown an upward trend. Over the last two years, these countries were among the world's most favored destinations

for foreign direct investment inflows. In 2001–2002, cumulative FDI inflows to all three groups of countries (excluding Chile) reached almost \$38 billion, which represented 2.6% of the world's FDI inflows.

However, FDI flows have been uneven across individual countries over the last few years. In 2001–2002, two countries from the *control group* (the Czech Republic and Poland) were the best performing in terms of FDI inflows, having attracted about \$25 billion of FDI. These two countries were among the world's top 30 FDI recipients in 2002. All other countries in the pool demonstrated less remarkable but nonetheless very good FDI performance. In 2001–2002, the total FDI inflow into *MA NEF countries* reached \$7.4 billion, while *LA NEF countries* were able to attract just \$2.3 billion over the same period. Much lower levels of FDI inflow to *LA NEF countries* is partly explained by the smaller size of their economies relative to control or *MA NEF* groups. In relative terms, FDI performance in *NEF countries* is comparable with that of the *control group*. On average, net FDI flows to *NEF countries* amounted to about 5% of the region's GDP over the last three years. In some *NEF countries*, such ups and downs in FDI inflows in recent years were attributed to one-off transactions linked to privatization, which is still under way in these countries.

Net FDI Inflows as % of GDP by Country, 2001–2003

Country	2001	2002	2003
Bulgaria	5.9	2.9	8.8
Croatia	7.2	4.0	5.9
Romania	3.0	2.5	3.2
Ukraine	2.0	1.9	2.6
MA NEF countries average	4.5	2.8	5.1
Albania	5.0	4.5	3.0
Bosnia and Herzegovina	2.7	6.1	5.8
Macedonia, FYR	12.8	2.1	1.2
Moldova	6.3	7.2	5.6
Serbia and Montenegro	1.4	3.6	7.6
LA NEF countries average	5.7	4.7	4.7
Czech Republic	9.6	12.0	6.3
Estonia	9.8	2.9	13.5
Poland	3.2	2.1	2.0
Slovenia	2.0	8.3	0.8
Chile	4.6	1.8	1.8
Control group average	5.4	4.2	4.2

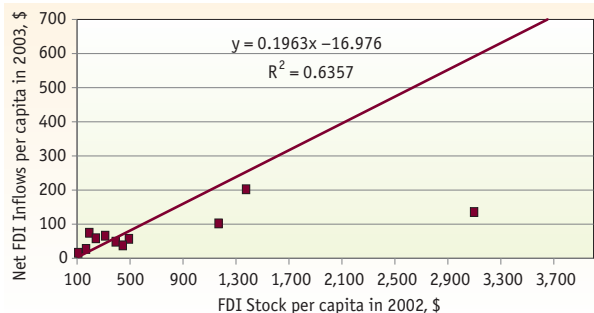
Sources: UNCTAD World Investment Report, World Bank, The Bleyzer Foundation's calculations

Note: 2003 (p) — preliminary

Nevertheless, persistently high FDI to GDP ratios in Bulgaria and Croatia, and good levels in Romania and Ukraine indicate that FDI inflows originally stimulated by privatization triggered further inflows in the form of greenfield projects and re-invested earnings. In particular, this was the case in all countries from the *control group*. It is important to note that net FDI inflows are

positively related to FDI stocks, which supports the idea that initial foreign investors tend to attract subsequent investors to the region if they are satisfied with the business environment. Thus, FDI performance of transition countries in previous years matters for the future FDI inflows.

Correlation of FDI Inflows and FDI Stocks



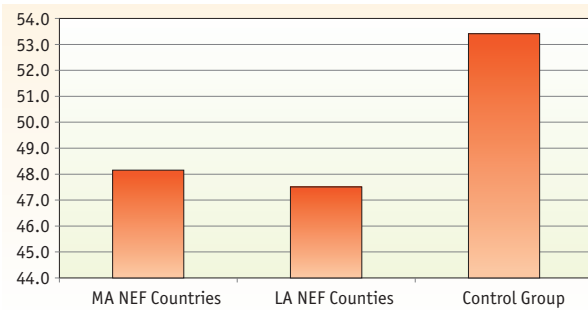
Sources: World Bank, IMF

In 2003, FDI inflows to *NEF countries* almost doubled to \$7.3 billion. The region's average ratio of FDI to GDP is estimated to have risen from 3.8% to 5.0%, which is equivalent to around \$70 per capita. In 2003, Croatia and Bulgaria performed far above the regional average. FDI per capita in these countries was \$315 and \$180 per citizen respectively. European countries from the *control group* had an estimated average FDI to GDP ratio of 5.7%, which corresponds to an average annual per capita inflow of about \$180. However, net FDI is estimated to have declined by 36% to \$9.5 billion in 2003. Also, there is evidence that FDI outflows are on the rise in this group of countries, and the trend is expected to persist. Outward FDI flows increased in Poland and the Czech Republic in 2003, while Slovenia even became a net exporter of FDI. The most likely reason for this development is that investors are relocating labor-intensive production to their lower-cost neighbors (the average monthly wage in Poland and the Czech Republic is about three times higher than in *MA NEF countries*). This implies that *MA NEF countries* are likely to receive substantial amounts of FDI inflows in the coming years.

Overall, the external debt level in *NEF countries* is moderate, averaging around 48% of GDP in 2002. This compares favorably with Latin American countries such as Chile, which accumulated external debt of 60.8% of GDP in 2002. That year, Ukraine (from the *MA NEF* group) and Albania (from the *LA NEF* group) had the lowest ratio of external debt to GDP in the *NEF* region (less than 30%), whereas Croatia had the highest ratio at 68%. In 2003, external debt levels in *NEF countries* are estimated to have decreased (except for Croatia). Serbia and Montenegro managed to cut its external debt to 61% of GDP in 2003 due to debt relief provided by Paris Club creditors. In relative terms, external debt declined in 2003 in Bosnia and Herzegovina, Macedonia, Albania, Moldova, and Romania. In 2002, many *NEF*

countries had external debt service to exports ratios below the sustainability margin of 25%. Nevertheless, these countries have good access to international capital markets.

External Debt in 2002, % of GDP



Sources: World Bank, IMF, national statistics

Determinants of the Investment Climate

In attempt to define the relationship between the flows of foreign direct investments (FDI) to a country and the attractiveness of a country's investment climate, SigmaBleyzer undertook a comprehensive research effort. The study reviewed 50 countries around the world and carried out statistical analyses to identify the policy measures that have the greatest impact on the flow of FDI. It identified the most important measures that a government can take to improve the business environment of a country and attract foreign direct investments.

Through benchmarking, it also identified best practices in economic reforms in a number of successful developing countries. Also, a model was built to predict the flows of foreign direct investments that a country could receive based on the implementation of these key "policy" investment drivers. The study concluded that "first generation" reforms — macroeconomic stabilization, achieved through sound fiscal and monetary policies — are essential preconditions to creating a favorable business climate and attracting foreign direct investments. But they alone are not sufficient to improve the business environment and ensure increases in international capital inflows. Within this macroeconomic framework, a number of "second generation" reforms are needed. Our benchmarking, statistical analyses and business surveys indicated that a significant portion of the variations in foreign direct investments in the group of 50 developing countries can be explained by nine economic policy drivers. Furthermore, studies showed that whereas there was a high correlation between the nine policy drivers and the flows of FDI, there was also a low correlation between FDI flows and the "natural characteristics" of a country (e.g. geographical location, country size, population, etc.)

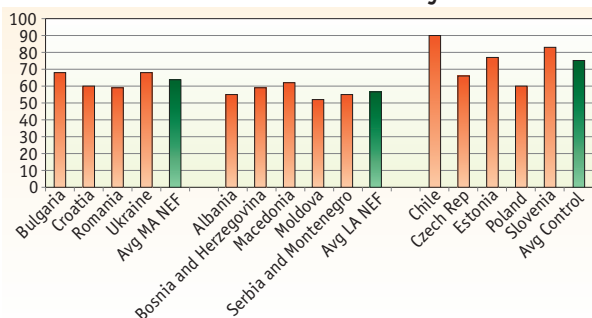
These key investment drivers were the following, in order of priority (see annex 2):

- (i) **Macroeconomic stability**, which includes policies and actions that ensure sound macroeconomic results and sustainable economic growth.
- (ii) **Business liberalization and de-regulation policies** to permit firms to operate freely by removing barriers to market entry, barriers to operations and barriers to exit.
- (iii) Policies to create a **stable and predictable legal environment** with well-defined "rules of the game" for all businesses, without discrimination or preferential treatment and with capacity to enforce business contracts.
- (iv) Policies to develop sound **corporate and public governance** that would protect ownership rights and shareholders, and avoid excesses of power by government agencies.
- (v) Policies to **liberalize foreign trade and international capital movements**, to facilitate the export and import of goods and the international transfer of capital.
- (vi) Policies to **create a healthy financial sector** capable of meeting the financing needs of growing businesses.
- (vii) Actions to **minimize corruption** and protect businesses from abuse of power by government officials.
- (viii) Actions to **minimize the effects of political uncertainties** on business activities.
- (ix) Actions to **promote and inform investors** about business opportunities in the country.

Driver 1: Macroeconomic Stability

The basis for sound macroeconomic performance and sustainable economic growth is macroeconomic stability, which is effectively long-term stability in prices and foreign exchange rates. Investors need stable prices and currencies since they are important elements affecting investment profitability. Stable prices and currency are also needed to minimize business risks and reduce the rate of return required by investors. This will increase the range of projects that could be attractive to international investors. Therefore, to encourage investments and enhance private sector confidence in the country, a stable economy is a major pre-condition; that is, the rates of inflation and currency depreciation should be under control. The determinants of macroeconomic stability are sound fiscal and monetary policies that are achieved through the government's ability to maintain control over the fiscal budget balance on the one hand, as well as control over the money supply on the other.

**SigmaBleyzer's Driver #1
Macroeconomic Stability**



The degree of economic stability of a country is dictated by the adequacy of its fiscal and monetary policies, which are discussed below.

Fiscal Policies

The fiscal policies of NEF countries have been more or less consistent with the objective of maintaining macroeconomic stability. Most countries performed well in terms of their fiscal policies. Best results in maintaining sound fiscal balances were demonstrated by MA NEF countries, in particular Bulgaria and Ukraine. These two countries managed to keep their overall fiscal balances within 1% of their nominal GDP for the past four or five years. Such superior fiscal performance was achieved through maintaining tight fiscal discipline, including control over expenditures, coupled with efficient functioning of the treasury system, and facilitated by clear reporting and auditing requirements. Romania has been successful in gradual reduction of the fiscal budget deficit from 4% of GDP in 2000 to 2.5% of GDP in

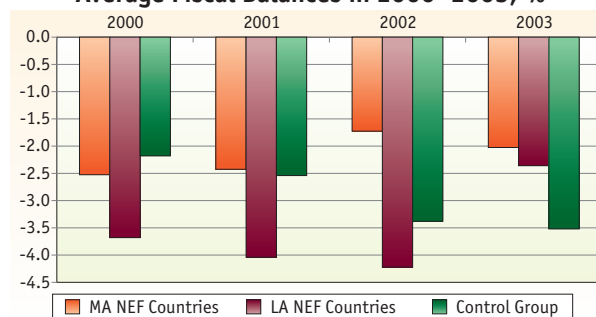
2003. This was done through continued application of tight fiscal policy measures by the government.

Some of the LA NEF countries also performed well. Moldova, Bosnia and Herzegovina demonstrated good control of their fiscal systems in 2003, which resulted in slight fiscal balance surpluses. However, while Moldova's situation was a result of windfall revenue from increased import taxes, the good fiscal performance in Bosnia was overshadowed by the size of the public sector. Bosnia's overall fiscal expenditures reached 60% of GDP in 2000 and 50% of GDP in 2002, which, although contracting, remain a barrier to effective private sector-led growth.

In 2003, the average fiscal deficit was 2% of GDP for MA NEF countries and 2.4% for LA NEF countries. Therefore, in terms of fiscal policies, the NEF transition countries performed much better than the new EU members. Four new EU members from the control group demonstrated fiscal deficits that were on average more than double those of MA NEF countries (4.1% of GDP in 2003).

The poor performance of the control group countries is due to Poland and the Czech Republic, whose fiscal deficits reached 6.9% and 8.6% of GDP in 2003, respectively. These countries are undergoing substantial structural changes, and have embarked on largely expansionary fiscal policies to battle economic slowdowns.

Average Fiscal Balances in 2000–2003, %



Sources: IMF, WB World Development Indicators,
The Bleyzer Foundation's calculations

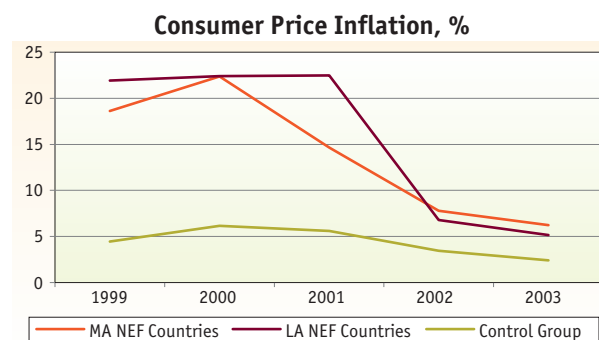
On the fiscal revenue side, the MA NEF countries managed to improve tax collection, lower the tax burden through reforms in tax policies (allowing them to broaden the tax base) and eliminate subsidies. Recent tax reforms in Romania and Ukraine reduced personal and corporate income taxes and resulted in greater revenue collection. In Croatia and Bulgaria, the introduction of stricter budgetary management procedures allowed for monthly review of fiscal revenue targets, with significant deviation triggering offsetting expenditure measures.

These best performers are closely followed by the *LA NEF countries*, which are in the process of introducing modern treasury systems to allow timely audit and reporting, and have initiated reforms aimed at streamlining and modernizing their fiscal systems and procedures.

Nearly all of the above countries achieved positive results in improving the allocation of public expenditures. More effective distribution of expenditures through transparent procedures is necessary to ensure efficient use of public funds and to avoid abuses of the fiscal system. Following these principles allowed the *MA NEF countries* to significantly reduce fiscal arrears and avoid excessive use of cuts in public expenditures as means of fiscal adjustment.

Monetary Policies

Monetary policies, being the basis for macroeconomic stabilization, often play critical roles in maintaining internal and external stability for transition economies. Overall, most *NEF countries* managed to maintain balanced monetary policies that allowed them to reduce inflation. *MA NEF countries* have officially or effectively pegged their currencies and adopted a currency board. Such exchange rate anchors have allowed the countries to maintain price stability and reduce inflation to low levels. In Bulgaria, inflation was reduced to 2.4% in 2003 after the country formally tied the exchange rate and adopted a currency board. In Ukraine, the de facto targeting of the exchange rate to the USD with the Dollar depreciating on international markets resulted in some real depreciation of local currency, which helped support price competitiveness without raising inflationary expectations. On the other hand, the *control group countries* were able to cut inflation through their continued policies of inflation targeting and floating exchange rates.



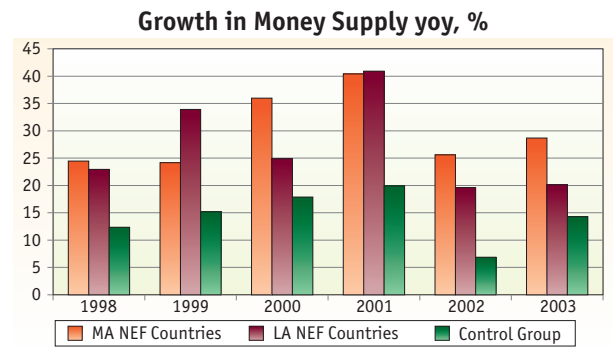
Sources: IMF, WB World Development Indicators, The Bleyzer Foundation's calculations

Out of all the *MA NEF countries*, Romania has been having the most difficulties in battling inflation. In earlier years, inflationary pressures were largely generated by high fiscal deficits that were financed by monetary

emission. Lately, inflationary pressures have been reduced as the fiscal deficit was brought under control. The country managed to cut consumer price growth from 45% in 2000 to 15% in 2003, and it now expects to finish 2004 with single-digit inflation.

The *LA NEF countries* achieved mixed results with regards to inflation. Prudent monetary policies allowed Albania, Macedonia and Bosnia to maintain price stability, while inflation has recently picked up in Moldova largely due to unsterilized foreign exchange purchases by the central bank that fuelled rapid money and credit growth.

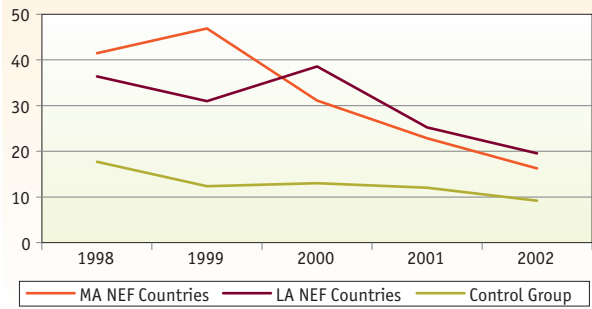
The *control group countries* managed to exert good control over their money supplies; their average growth in money supply was significantly less than in *NEF countries*. Consequently, lower inflation rates were achieved by the *control group*. On the other hand, in some of the *MA NEF countries* where monetary policies were not as tight (Ukraine, Croatia and Bulgaria), significantly growing money supply was accompanied by a dramatic increase in money demand that came from the growing real sector, which helped these countries avoid excessive inflationary pressures.



Sources: IMF, WB World Development Indicators, The Bleyzer Foundation's calculations

With the development of a robust financial sector in transition economies, commercial bank lending has become an increasingly popular means of financing. Such notable growth in commercial lending and consumer credit has been facilitated by falling interest rates: *NEF countries'* average lending rate steadily declined from nearly 30% in 1999% to 15% in 2002. Based on the early achievements of macroeconomic stabilization, banks in the European countries of the *control group* were able to offer lower lending rates than their counterparts in other transition economies. At the same time, some of the *MA NEF countries* such as Bulgaria and Croatia enjoyed commercial lending rates well below those of the *control group*. Even though high inflation in Romania and Ukraine increased the average lending rate of the group of *MA NEF countries*, they still managed to outperform the *LA NEF group*.

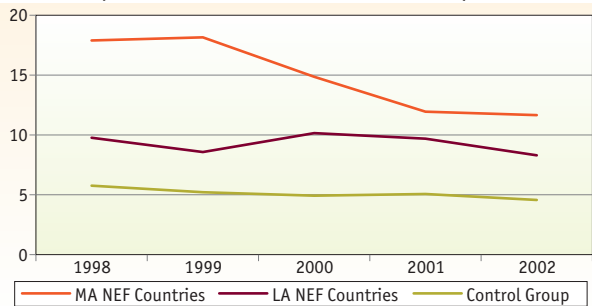
Commercial Banks Lending Rate, %



Sources: IMF, WB World Development Indicators, The Bleyzer Foundation's calculations

A relatively stable economic situation allowed the *control group countries* to maintain a rather low interest rate spread (the difference between the lending rate and the deposit rate) of about 5%. On the other hand, *MA NEF countries*, while building up their fiscal and monetary potential, succeeded in bringing down the interest rate spread from 18% in 1999 to less than 12% in 2002. These countries saw further improvement in this respect in 2003, when their commercial banking sector expanded and their economies continued their robust growth.

Interest Rate Spread (lending rate minus deposit rate), %



Source: WB World Development Indicators

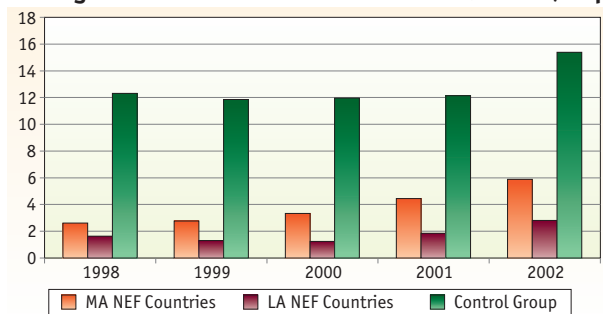
Overall, *NEF countries* exhibited relative stability of their currencies over recent years. Such stability stemmed from the mostly prudent exchange rate policies of the central banks, coupled with a favorable external environment. As mentioned above, *MA NEF countries* used the exchange rate as a nominal anchor to maintain price stability. For most *NEF countries* that adhered to this policy, the Euro was chosen as the nominal anchor due to the large exposures of these economies to their European counterparts. Therefore, following the nominal appreciation of the Euro against the Dollar, these countries saw their local currencies appreciate against the Dollar.

Ukraine, on the other hand, has effectively pegged its currency to the Dollar and has fiercely defended the sta-

bility of its currency against the Dollar while allowing it to fluctuate against the Euro. Following the depreciation of the Dollar on the international markets, Ukraine's local currency remained stable against the Dollar and lost its value against the Euro.

Countries' exchange rates stability hinge largely on the abilities of their central banks to conduct effective exchange rate policies, including management of international reserves. The central banks of the *NEF countries* were for the most part rather aggressive in their attempts to accumulate sizeable international reserves. The combined gross international reserves of the central banks increased from \$56.7 billion in 1998 to \$90.6 billion in 2002.

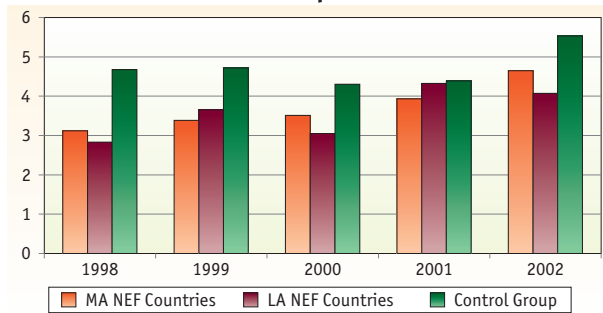
Average Gross International Reserves in \$billion, eop



Source: WB World Development Indicators

The average size of the gross international reserves that the first wave EU accession countries from the *control group* managed to accumulate is significantly greater than that of their less advanced neighbors. However, in terms of coverage of imports, the numbers are relatively similar across all the economies of the region. Over the last few years, one can see a clear upward trend in imports coverage figures across all the countries. However, the *MA NEF countries* experienced the highest rates of growth: the size of gross international reserves in terms of imports coverage rose by more than 50%, from 3.1 months in 1998 to 4.7 months in 2002.

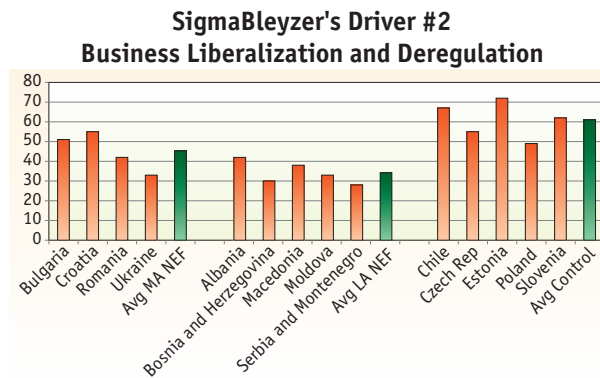
Gross International Reserves in Months of Imports, eop



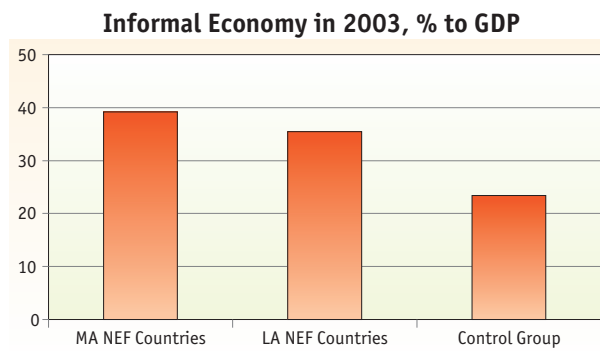
Source: WB World Development Indicators

Driver 2: Liberalization and Deregulation of Business Activities

This driver includes government policies and actions that reduce government interventions, enabling private businesses to operate freely and make profits in a competitive environment. Favorable conditions must be created for the three major components of business activities: entry, operations and exit.



Over the last five years, all NEF countries have made major efforts to reduce the regulatory barriers to business activities. Although MA NEF countries performed much better than LA NEF countries, they still trail the control group countries, which started to liberalize and deregulate business earlier.



Source: World Bank

Decreasing government involvement in business leads to a reduction of the informal economy and stimulates economic growth in the country. However, the informal sector is still a large part of the economy in many MA NEF countries, which suggests that governments still heavily regulate the private sector. In 2003, the informal sector was close to 40% of GDP in this group, on average. However, this number varies among MA NEF countries. Although the share of the informal economy was between 33% and 36% in Bulgaria, Croatia and Romania, it's around 50% of GDP in Ukraine. The same is true for the group of control countries, where the Slovenian and Polish informal sector is almost 30% of GDP, while in Chile it's only 19%.

A country's efforts in making the shadow economy part of the formal economy can provide additional stimulus for economic growth. Therefore, MA NEF countries can encourage their further development by decreasing government involvement in private business activity.

Barriers to Entry

Elimination of barriers to entry requires significant improvements in the countries' legislation. MA NEF countries have made notable progress in improving their procedures for registering new businesses. According to a recent enterprise level survey, MA NEF countries rank very high among other transition economies with regards to transparency of company registration procedures. Starting a business in these countries requires spending an average of 37 days to complete all the procedures, which is 40% less than in the control group countries and 30% less than in LA NEF countries.

Duration of Procedure to Initiate Business in 2003 (days)

25-40	41-55	56 and more
Romania, Chile, Bulgaria, Poland, Ukraine	Moldova, Serbia and Montenegro, Albania, Macedonia, Croatia	Bosnia and Herzegovina, Slovenia, Czech Republic

Source: World Bank

Starting a business in NEF countries is relatively easy. The number of procedures required to do this does not differ significantly among the countries. The average number of procedures in each of the three groups is 11.

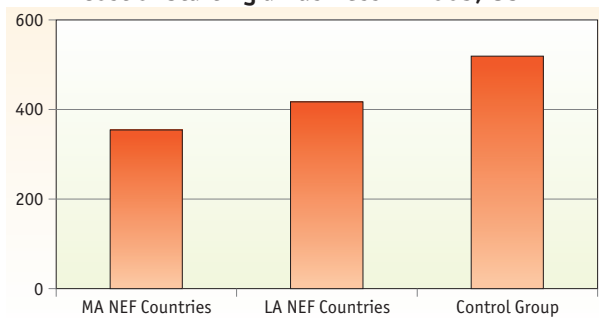
Number of Procedures to Initiate Business in 2003

10 or less	11	12	13
Bulgaria, Chile, Czech Republic, Estonia, Romania, Slovenia, Serbia and Montenegro	Albania, Moldova	Bosnia and Herzegovina, Poland	Croatia, Macedonia, Ukraine

Source: World Bank

Although business start-up costs in all three groups do not exceed \$1,000, they differ significantly. The MA NEF and control groups are very homogenous. Starting a business in MA NEF countries requires on average \$354, which is \$165 less than in control group countries. The highest level of variability within the group exists in LA NEF group of countries, where the procedure in Moldova requires a payment as low as \$121, while in Albania it can cost as much as \$897.

Cost of Starting a Business in 2003, USD



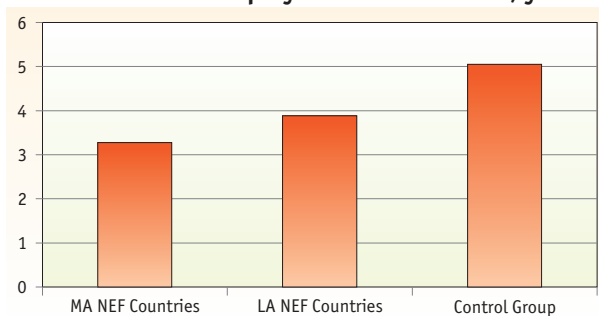
Source: World Bank

Barriers to Exit

The removal of barriers to exit requires the existence of sound legislation. New bankruptcy laws in *MA NEF countries* are considered to be some of the most progressive among transition countries. The common framework of the laws in *MA NEF countries* ensures debtor-led reorganization, a meaningful moratorium on payment and collection of pre-existing debt, and a tax forgiveness provision. The law emphasizes the need to rehabilitate enterprises to restore their operations and satisfaction of creditor's claims; bankruptcy is applied only as a last resort. The existence of a credible threat of bankruptcy is an effective way of ensuring the enforcement of contracts and payment discipline, and is therefore essential to the functioning of credit markets.

However, bankruptcy procedures are still cumbersome in *LA NEF countries* and in some *control group countries*. In some cases, like in Czech Republic, the process can take as long as nine years to resolve. In *MA NEF countries*, this time is the shortest among the groups. The average duration of bankruptcy procedures here is three years.

Duration of Bankruptcy Procedure in 2003, years



Source: World Bank

Taxes

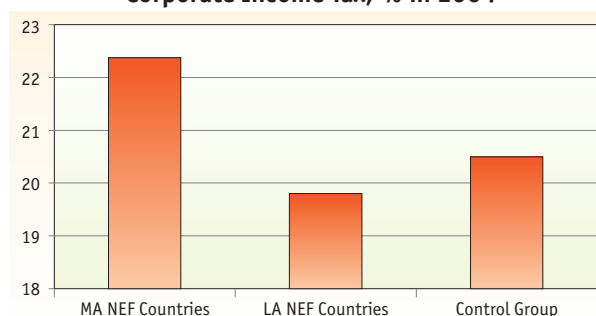
The investment climate in *MA NEF countries* has been improved by positive changes in the countries' tax legislation. Although each individual *NEF country* has individ-

ual tax rates, the major taxes applicable in all of these countries include:

- Corporate income tax
- Personal income tax
- Value added tax (VAT)
- Excise and custom duties
- Regional taxes and duties.

In 2004, the total corporate municipal and income tax in *MA NEF countries* is around 22% on average, compared to 24% in 2003. This decrease in tax rates demonstrates the willingness of governments to stimulate business activity and attract more investments.

Corporate Income Tax, % in 2004



Sources: Domestic Ministries of Finance, The Bleyzer Foundation's calculations

The *NEF countries'* VAT legislation is mainly based on the provisions of the EU's Sixth VAT Directive. Taxable supplies of goods or services and imports are subject to a VAT range of 17% in Serbia and Montenegro to 22% in the Czech Republic, Croatia and Poland. The average VAT rate in *MA NEF countries* is around 20%, which is 0.5% lower than the average in *control group countries*. With some small exceptions, the export of goods and services and re-export of goods is zero-rated. However, VAT refunds still remain a problem in many countries. Although the average refund time in the *NEF group* is four months, it can take up to six month in Ukraine and up to one year in Macedonia and Serbia and Montenegro to get it.

VAT standard rate, % in 2004

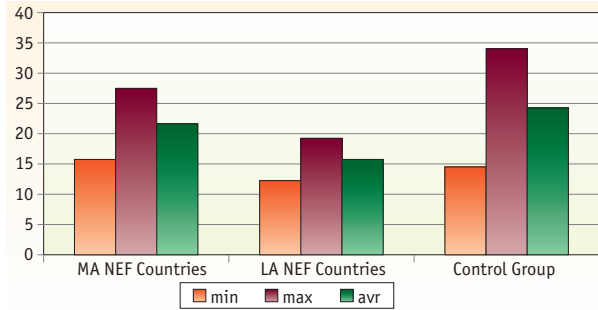
17	18	19	20	22
Serbia and Montenegro	Macedonia, Estonia	Romania, Slovenia, Chile	Ukraine, Bulgaria, Moldova, Albania, Bosnia and Herzegovina	Czech Republic, Croatia, Poland

Source: The Bleyzer Foundation's calculations

In terms of personal income tax, *NEF countries* have become some of the most competitive in Europe. The average rate in the *MA NEF group* is 20%, while it's 23% in the *control group*. Both Ukraine and Romania introduced a very low flat income tax. Although the Bulgar-

ian tax rate is using a progressive scale, it's very competitive. In general, good progress has been made in Croatia as well, where the average rate is on the level of Poland and does not exceed 30%.

Personal Income Tax, % in 2004



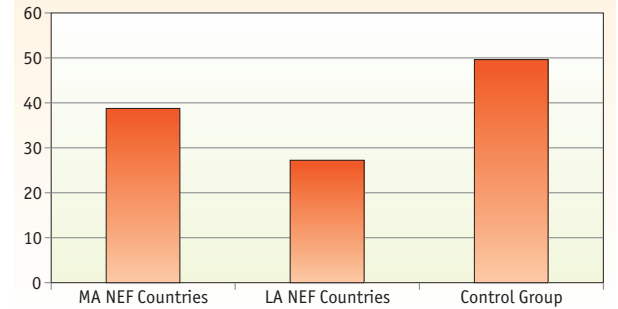
Source: The Bleyzer Foundation's calculations

Labor

Businesses in *NEF countries* are able to benefit from their highly competitive labor forces. The level of education in this group is much higher than in many parts of the world, including well-developed Western countries.

Ukraine, which leads the *MA NEF countries*, has much higher university enrollment than the average level in the *control group* and even higher than in some developed countries, such as Japan or Italy. However, labor costs in the *MA NEF* region are substantially lower than in developed countries or even in the *control group*.

University Enrolment Ratio in 2002, %

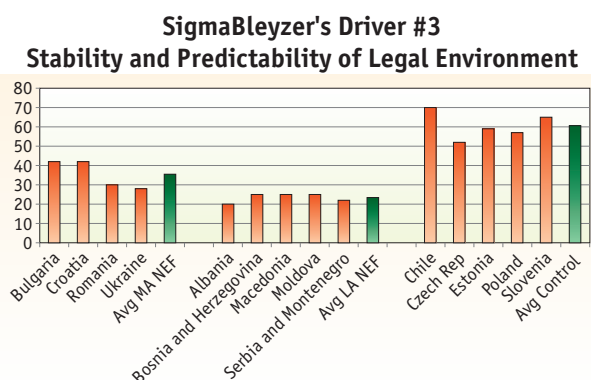


Source: UNESCO Global Education Digest 2004

It should be acknowledged that *MA NEF countries* have made significant progress in liberalizing and de-regulating their business environments. This group of countries has become very friendly to new investments.

Driver 3: Stability and Predictability of the Legal Environment

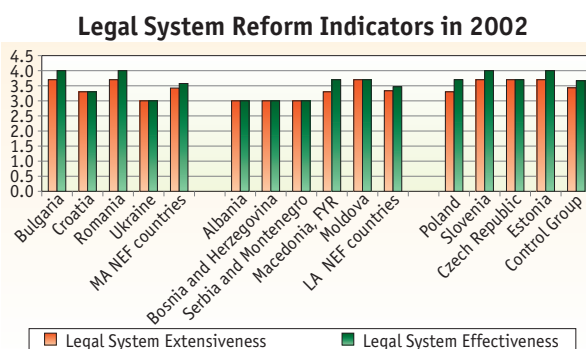
This driver includes policies and actions to enact and implement stable and predictable laws and regulations that would support and encourage private sector businesses in a free market. It calls not only for solid legislation and its effective implementation, but also for a transparent judiciary and recognition of international contracts and agreements.



The respect for the rule of law, the establishment of a transparent legal framework and its enforcement remain among the key conditions for the creation of a business-friendly environment. All NEF countries have made progress in reforming their legal system in recent years. These days, the legal framework in the majority of these countries can be seen as broadly in line with international standards, but the newly adopted laws and regulations may still be poorly implemented in many transition countries. The legal environment is a qualitative measure of the business environment, and in order to differentiate between the countries in our pool one can use the legal transition indicators developed by the European Bank for Reconstruction and Development (EBRD). The EBRD legal transition indicators assess the extent to which key commercial and financial regulations have reached internationally acceptable standards (extensiveness), and the degree to which these laws are implemented and enforced¹ (effectiveness). All of the NEF countries had pretty high legal reform indicators ranging from 3 to 4. In 2002, the best performing countries in terms of legal reform indicators from the MA NEF group were Bulgaria, Croatia, and Romania. Ukraine's score was in line with the scores of the LA NEF countries.

Despite differentiation in the legal reform indicators, most of the countries in the region have been constantly reporting changes in their civil and commercial codes, company and pledge laws, and bankruptcy legislation. The European countries from the control group

have fully adjusted their legislation to EU standards due to their recent accession to the EU. In 2001, the Czech Republic adopted changes to its civil code and pledge law, while Poland changed its commercial code and bankruptcy law in order to improve protection of minority shareholders. Over the last two years, the post-conflict Balkan countries (Bosnia and Herzegovina, Serbia and Montenegro) have made significant improvements in their commercial and financial legislation. In 2002, Estonia and Moldova adopted new civil codes. New versions of civil and commercial codes that give greater protection to property rights and to the rights of minority shareholders were adopted in Ukraine in 2003. However, there a number of inconsistencies among the two codes, and they should be amended to resolve those inconsistencies.



Source: EBRD's The Business Environment and Enterprise Performance Survey, 2002

Contract enforcement and property rights protection is critical for businesses to engage with new borrowers or customers that have short or no credit history. The institution that enforces contracts between debtors and creditors, suppliers and customers is the courts. In general, the court system needs substantial reform in most transition countries in the region.

Enforcing a Contract in 2003: Number of Procedures

15-20	21-25	26-30	31-35	36-40
Czech Republic, Poland, Croatia, Ukraine	Chile, Slovenia	Bulgaria, Macedonia, Romania	Bosnia and Herzegovina	Moldova, Albania, Serbia and Montenegro

Source: World Bank

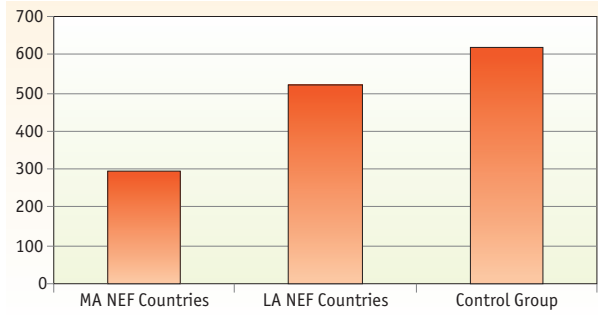
Ineffective contract enforcement was one of the main obstacles for many investors doing business in the NEF region. Although the LA NEF countries still suffer from this inefficiency, the situation in MA NEF countries has significantly improved. The average current number of

1 EBRD legal transition indicators are measures in a 4-point scale: 4 - corresponds to the best legal environment; 1 - corresponds to the worst legal environment.

procedures required for contract enforcement in *MA NEF countries* is 24, which is 50% less than in *LA NEF countries*, but still higher than in *control group countries*.

At the same time, the total duration of the contract enforcement procedure is the shortest in *MA NEF countries*. It takes only 300 days compared to more than 500 days in *LA NEF countries* and 600 days in *control group countries*.

Enforcing a Contract Time in 2003 (days)

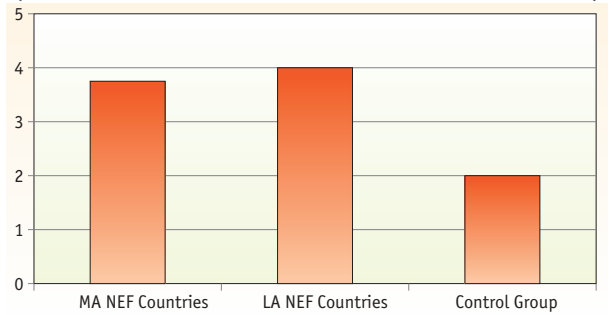


Source: World Bank

The Heritage Foundation's index of property rights protection examines the extent to which the government protects private property by enforcing laws, and helps to differentiate among the different countries in the region. On average, the level of private property rights protection in the *NEF countries* is perceived as moderate. This means that the court system is inefficient

and court trials are subject to delays, judicial corruption may be present, and the judiciary may be influenced by other branches of the government. The post-conflict Balkan countries from the *LA NEF* group have the worst scores among the other *NEF countries*. In general, the rule of law in *LA NEF countries* has been held back by political instability and a weak judiciary. The main reason for this is the low administrative capacity of the courts. Although the *MA NEF countries* are generally better than the *LA NEF* group, the judicial systems in Croatia and Ukraine are cumbersome and inefficient because they lack modern case management practices and suffer from overly politicized and inadequately trained personnel. The best protection of property rights among all three groups exists in Chile. However, property rights are also well-protected in other *control group countries*.

Property Rights Protection (5 — very low protection, 1 — very high protection)

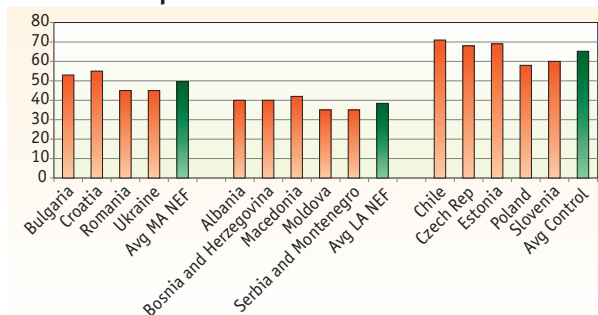


Sources: Index of Economic Freedom 2003, The Heritage Foundation

Driver 4: Corporate and Public Governance

This driver includes policies and actions aimed at improving the governance of private companies and public administration, to support private sector activities in a free market economy. They include policies related to **corporate governance, public administration and privatization.**

**SigmaBleyzer's Driver #4
Corporate and Public Governance**



Corporate Governance

The objective of corporate governance policies is to establish appropriate rules that would guide the activities of businesses in the best interest of their shareholders, protecting ownership rights. Key elements here include disclosure of information about corporations, shareholders' rights protection, public reporting requirements, and use of transparent accounting practices.

Over the last three years, NEF countries have made significant progress in building effective models of corporate governance. Recent and current regulatory reforms in these countries have improved the corporate governance legislative framework by providing a sound legal and institutional basis. Some countries launched initiatives to issue specific guidelines on corporate governance issues incorporating the world's best practices, as well as to establish corporate governance supervisory boards at the stock exchanges and professional associations in order to raise public awareness and improve practices. Overall, investors have become more aware of the issues and have pressed for change, while some large corporations pioneered to implement improved practices. Finally, stock exchanges and securities regulators have reinforced their monitoring of companies' conduct and have taken the lead in corporate governance reforms.

A legal framework for effective corporate governance includes mainly company law and securities law, as well as bankruptcy law. Nearly all countries from the NEF region can boast modern company laws that have been

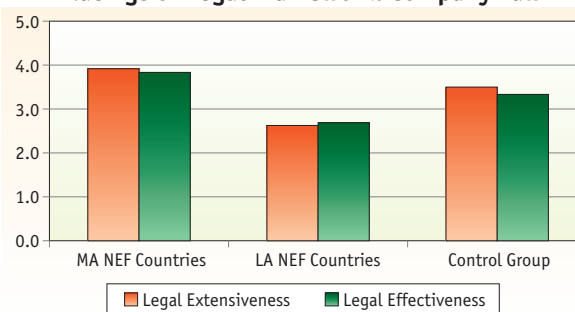
passed at early stages of their economic turnaround, since these laws were needed to provide the legal framework for the transformation of state-owned enterprises. Ukraine, however, is still struggling to pass modern company law that was drafted a few years ago due to a clash of vested interests directly affected by the implementation of this law.

National accounting standards in most NEF countries are moving towards international accounting standards in order to ensure greater transparency of business operations. However, only some countries (like Croatia) have fully adopted international accounting standards, while in other countries (such as Ukraine, Bulgaria and Romania) both standards operate in parallel.

With the development of the financial sector, the economies of the NEF region moved on to adopting legislation to regulate the stock market. This was followed by the adoption of bankruptcy laws. Since the above legislation was drafted based on international standards, it corresponds to internationally accepted principles. Ukraine's bankruptcy law, for example, has been widely praised as one of the most advanced in Europe.

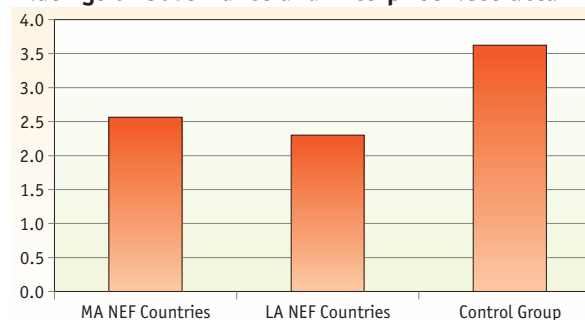
As reflected in the EBRD legal framework ratings (with regards to company law), the MA NEF countries fare better than the control group countries.

Ratings of Legal Framework: Company Law



Source: EBRD Transition Report 2002

Ratings of Governance and Enterprise Restructuring



Source: EBRD Transition Report 2002

In another measure of implementation of improvements in corporate governance, EBRD's Governance and Enterprise Restructuring indicators, the achievements of the *MA NEF countries* are rated above those of the *LA NEF group*, even though they fell short of the level of the countries in the region that have acceded to the EU.

Public Administration

The objective of public administration policies is to redefine the role of the government to support the private sector and secure the provision of sound and efficient government services without corruption. Progress in this area is achieved through implementation of transparent public administration procedures, sound procurement policies, and redefining the roles of government agencies.

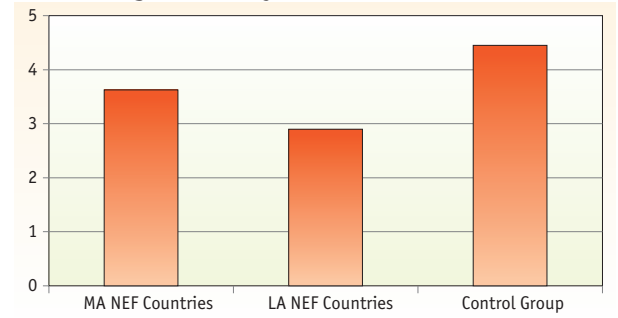
In recent years, *NEF countries* have continued to make progress in modernizing their public administration and redefining the scope of their governments. These efforts began with drafting the necessary legislation, combined with making institutional changes and adjustments. At the same time, implementation of civil service reforms has not always been fully successful, and further steps in reforms should include the depoliticization of public administration structures, streamlining administrative procedures and improving policy formulation and management.

Administrative structures and processes are generally well-designed in *MA NEF countries*, after significant improvements were made as part of public administration reforms. In Bulgaria, for example, the government has made substantial progress in enhancing policy consistency through more effective coordination between the government's two executive councils—the Council of Ministers and the Council for Structural Reforms. Ukraine's achievements in building an effective public administration system have recently been appraised through the EU's baseline assessment system designed by the OECD. According to the assessment, Ukraine has made significant progress towards the development of a civil service system that would be able to meet European standards in the medium term (up to five years from the present time). The areas that generally require further progress in most *MA NEF countries* include the professional level of public servants, an issue closely related to low wage bills that in turn leads to rent-seeking behavior.

Public administration systems of *LA NEF countries* are generally less efficient. These countries have either recently passed appropriate legislation, or are in the process of amending it to build a solid regulatory framework. Implementation of public service reforms is often underway, although the public administration systems are still often characterized by a high degree of political

interference, lack of transparency and low internal and external accountability.

Ratings of Quality of Public Administration



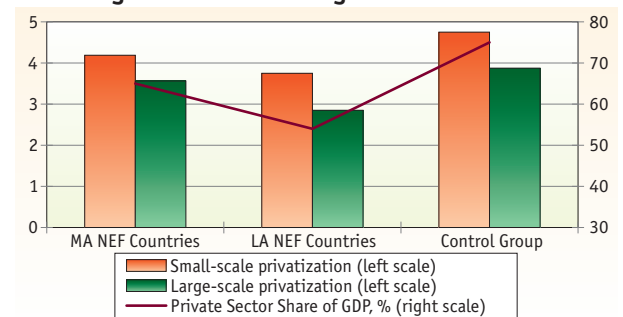
Sources: World Bank, The Bleyzer Foundation own estimates

Privatization

The objective of privatization-related policies is to improve the efficiency of resource use through private ownership, minimize the possibilities of undue market power by the authorities, and concentrate government resources on public goods. Key elements here include sound legislation to ensure a competitive privatization process, an independent agency in charge of privatization, along with private ownership of land.

Privatization has played a major role in the development of modern market-oriented economies in all *NEF countries*. While privatization proceeded at a different pace and achieved somewhat different results across the countries, it was definitely a key driver for expansion of the private sectors in these countries. At the end of 2001, the average share of the private sector in GDP for *MA NEF countries* reached 65%.

Ratings of Small- and Large-Scale Privatization



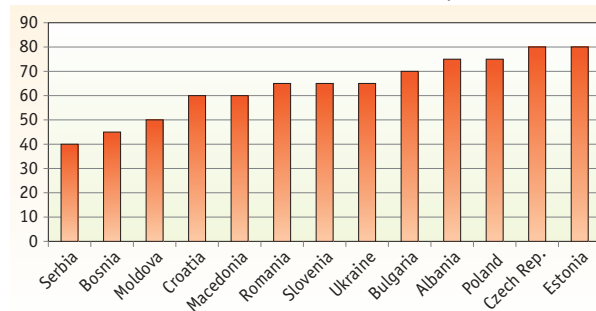
Source: EBRD Transition Report 2002

However, privatization began later in most *NEF countries* and proceeded slower than in the *control group*, which has by now essentially completed the process. For this reason, privatization is still largely in progress in most *NEF countries*, particularly large-scale privatization. The *MA NEF countries* have recently passed new privatization programs or amended existing ones, allowing for privatization of large strategic enterprises and infra-

structure monopolies formerly barred from the process. In Croatia, the government decided to divest all minority state shareholdings (a total of 967 companies) and to offer stakes in companies with majority state ownership (170 companies) through public tenders. Similar initiatives have been pursued by the government of Ukraine that target energy distribution companies and the national telecommunications monopoly. In many *NEF countries*, companies slated for privatization are required to undergo a restructuring process often performed by, or supervised by, an internationally renowned company. This is particularly the case with

state-owned utilities giants, which are typically characterized by large debts and non-payment problems.

Private Sector Share of GDP, %

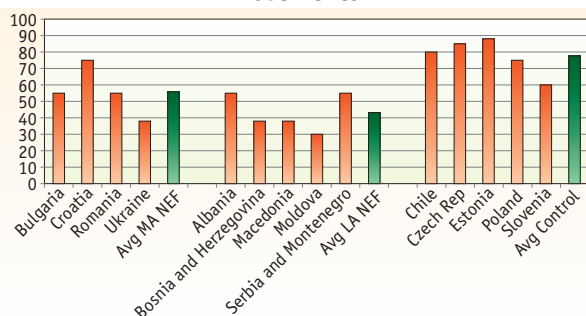


Source: EBRD Transition Report 2002

Driver 5: Liberalization of Foreign Trade and Capital Movements

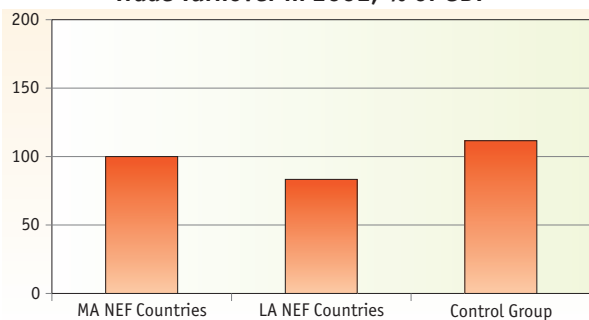
This driver includes policies and actions to facilitate the exports and imports of goods and transfer of capital internationally. This includes the removal of restrictions on both exports and imports including non-tariff restrictions, streamlining customs procedures and certification requirements, and liberalizing the foreign exchange regime.

SigmaBleyzer's Driver #5
Liberalization of Foreign Trade and Capital Movements



The degree of trade liberalization plays an important role in attracting FDI. Either because foreign investors need to import inputs, or because they use the host country as a platform for exporting, a liberalized trade regime is more conducive to foreign capital inflow and economic growth in both cases. Both *NEF* and *control group countries* have generally liberal and open trade systems. All countries (except for Poland) have foreign trade turnover to GDP ratios above 50%. The most open among all three groups is Estonia, where external trade turnover constituted more than 180% of the country's GDP in 2002. Although the average trade turnover for *NEF countries* is 90% of GDP, *MA NEF countries* are generally more open than *LA NEF countries*. However, the *LA NEF* group is the most heterogeneous. It includes Moldova being the most open economy in the pool (123% of GDP), and Serbia and Montenegro the least open (55% of GDP).

Trade Turnover in 2002, % of GDP



Source: World Bank

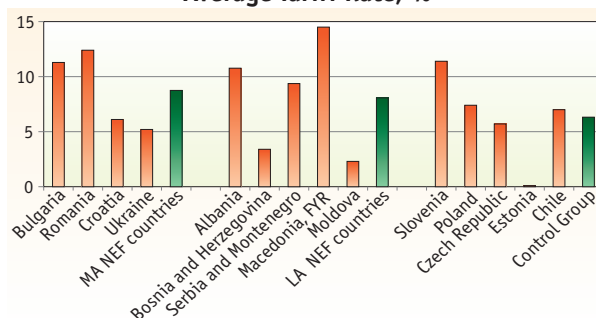
Fairly high trade openness stems from liberal tariff structures in all countries. Among the *control group countries*,

Estonia and Chile have been extraordinarily successful in creating and sustaining a liberal trade policy regime. Their success in sustaining such a trade policy has been facilitated by setting uniform tariffs and eliminating non-tariff barriers to trade. In the early 1990s, Chile and Estonia cut the uniform tariff barriers to a low level in order to enhance competition for domestic producers. And these two countries currently have one of the lowest average tariff rates in the world (0.05%).

The average tariff rate for *NEF countries* is a relatively low 8.4%, but tariff protection rates differ greatly across individual countries.

Although the average tariff rate for the *MA NEF* group is pretty low, Bulgaria and Romania maintain tariff rates at levels well above the *NEF* average. The same is true for Albania and Macedonia from the *LA NEF* group. Nevertheless, most of *NEF countries* still maintained significant non-tariff barriers to trade in the form of import quotas, licensing requirements, and inefficient customs clearance procedures.

Average Tariff Rate, %



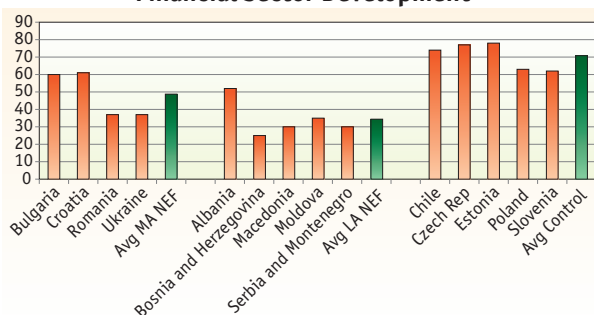
Sources: IMF, World Bank

Trade liberalization and trade cooperation is also facilitated through membership in the World Trade Organization (WTO) and regional free trade agreements. Three quarters of the countries in all three groups are members of the World Trade Organization (WTO), while Bosnia and Herzegovina, Serbia and Montenegro, and Ukraine are currently under in the process of obtaining WTO membership. Most of the *NEF countries* have preferential trade agreements with the EU as they have targeted EU membership as their development priority. Intraregional trade liberalization and trade cooperation has been facilitated through regional free trade agreements such as CEFTA (Central European Free Trade Agreement) and bilateral free trade agreements. *MA NEF countries* (excluding Ukraine) are members of CEFTA. However, *LA NEF countries* have not yet fully integrated their domestic market because of relatively recent armed conflicts on their territories, although a number of steps have been recently taken in this direction.

Driver 6: Financial Sector Development

This driver includes policies and actions to develop a healthy financial sector capable of meeting the financing needs of growing businesses. To achieve this, a country needs an independent central bank capable of effective bank supervision, a large number of private commercial banks, including foreign ones, functioning lending and deposit markets with liberalized interest rates, along with developed a stock market and an effective insurance system in place.

SigmaBleyzer's Driver #6
Financial Sector Development



All NEF countries have made significant progress in creating sound financial systems. With their economies for the most part on the rise, the financial sectors play an ever more important role in ensuring the countries' competitiveness. In most countries in the region, the financial sector is dominated by commercial banks (from 75% to 96% of total assets of all financial intermediaries), as the non-banking sector is still underdeveloped.

Generally, these countries offer favorable conditions for commercial bank operation: entry barriers have been eliminated, private capital controls most of the banking industry, and foreign financial institutions are encouraged to enter the market. The share of privately owned commercial banks is rather high, at about 90-95% of total assets on average, and it may soon reach 100% in some MA NEF countries as the governments are completing privatization of state-owned banks. Although the LA NEF group is also making substantial progress in banking sector privatization, a notable exception is Albania where the government is hoping to privatize the only state-owned bank, which accounts for 60% of the banking sector.

Foreign ownership of financial institutions has been instrumental to modernizing and widening the range of products and loan maturities, and has generally contributed to enhanced competition in the banking sector. Among all NEF countries, Croatia is characterized by the highest level of foreign ownership-about 90% of bank

assets, while in Bulgaria reputable foreign financial institutions are controlling the major private banks.

In some countries of the MA NEF region, consolidation of the financial sector continues. For example, the number of banks in Croatia has decreased by more than half since the end of 2001 to reach 10 institutions, mainly triggered by stepped up prudential capital requirements. In Ukraine, the central bank is considering the introduction of tighter capital requirements that are likely to lead to greater consolidation in the industry. However, in some countries of the LA NEF region like Albania and Macedonia, the banking sector is still characterized by a substantial degree of concentration, often from the large state-owned or state-controlled banks.

Over the last five years, Bulgaria and Croatia have experienced significant growth in bank credit to the private sector with average annual real growth rates reaching 33% and 12%, respectively. They were closely followed by a couple of LA NEF countries (Bosnia and Herzegovina, and Serbia and Montenegro) that exhibited similar growth patterns of bank credit to the private sector for the past two to three years. These results have been achieved thanks to robust growth of the real sector combined with continued improvements in and increased availability of financial services provided by commercial banks.

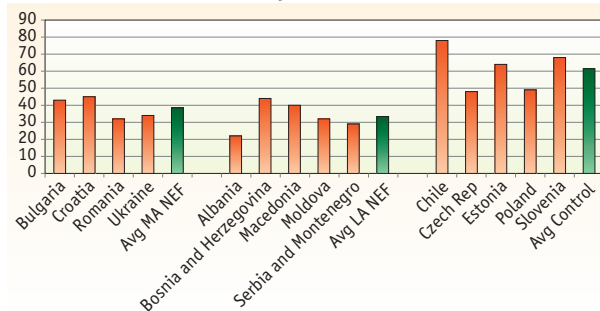
In general, the banking systems in the NEF region have developed into strong and stable systems distinguished by the high share of private capital, a large foreign presence and acute competition. Public confidence in the financial sector is increasing as evidenced by the growing bank deposits. Competition is rising, resulting in lower margins and a wider range of products and services, and the central banks have demonstrated firm control of the system.

The stock market has been developing rapidly in most economies of the NEF countries. The control group countries have led the way in both institutional and operational aspects, closely followed by MA NEF countries. In most NEF economies, the governments are introducing pension reforms that call for private pension funds. This, coupled with greater government activities on the bond markets, would give a further boost to development of the securities markets.

Driver 7: Corruption level

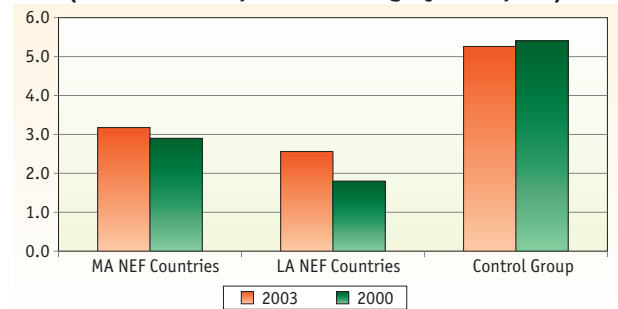
This driver includes policies and actions to minimize corruption and protect businesses from abuse of power by government officials. Key measures here range from creating the legal framework to ensure better enforcement of anti-corruption measures, to measures to prevent corruption and raise public awareness of the problem.

**SigmaBleyzer's Driver #7
Corruption Level**



As with many countries in transition, administrative corruption in NEF countries has been relatively high when compared to Western Europe. Although the level of corruption has increased in some countries from the control group (Poland, the Czech Republic), and in Moldova (from LA NEF group), other governments have been successfully dealing with administrative corruption. Transparency International confirmed the decline of corruption in the MA NEF region over the last three years by 0.3 points on average. At the same time, Bulgaria and Ukraine improved their situations even more significantly. Over 2000-2003, Bulgaria improved its rating from 3.5 to 3.9 and Ukraine improved from 1.5 to 2.3. However, corruption still remains one of the gravest impediments to successful development of a democratic society and a competitive market economy in MA NEF countries. It is a problem that spreads through nearly all aspects of the country's economic, political and social life.

**Degree of Corruption
(10 — no corruption; 0 — highly corrupted)**



Source: Transparency International

For many of these countries, the main problem in administrative corruption appears to be the structure and functioning of the government. The problems include:

- concentration of power
- weak legal environment
- poor accountability
- lack of transparency

Although the areas most affected by corruption differ from country to country, the most commonly affected areas are:

- government purchases
- system of taxation
- export-import regulations
- public services
- judicial system

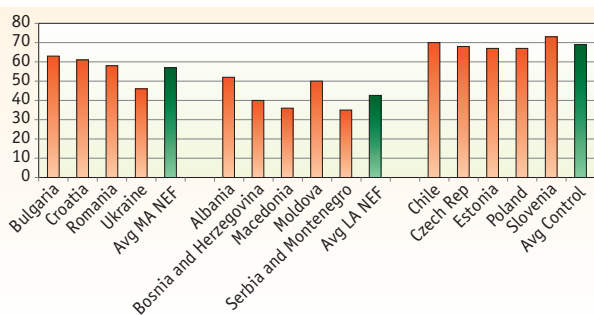
In recognition of these problems, the governments are implementing comprehensive strategies and plans of action. They are modernizing their system of governance, reforming the judicial system and fighting corruption directly. In addition, civil society is getting more involved in the process of eliminating corruption in the countries. The presence of foreign investors in the MA NEF region's private sector is also a positive factor in controlling corruption because these relatively new players do not participate in the existing network of corruption.

Although significant progress in fighting corruption in NEF countries has been made, the remaining tasks are still significant.

Driver 8: Political Risks

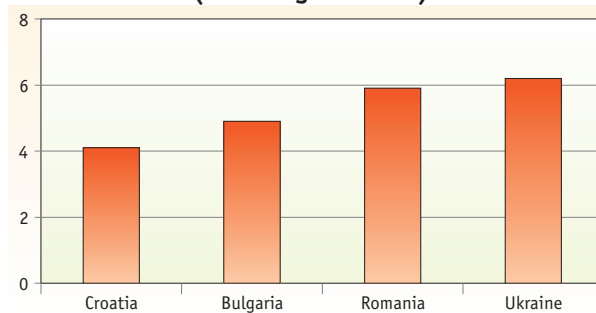
This driver includes policies and actions to minimize the effects of political uncertainties on business activities. This is achieved through effective functioning of the government unimpeded by vested interests, elimination of power abuses by the authorities, and minimizing the risks of civil disturbances that may affect businesses.

**SigmaBleyzer's Driver #8
Political Risks**



Since 1999 Bulgaria, Croatia, Romania and Ukraine have achieved positive results in eliminating their political risks. However, governance and political instability differs across these countries.

**Governance and Political Instability Score
(10 — highest level)**

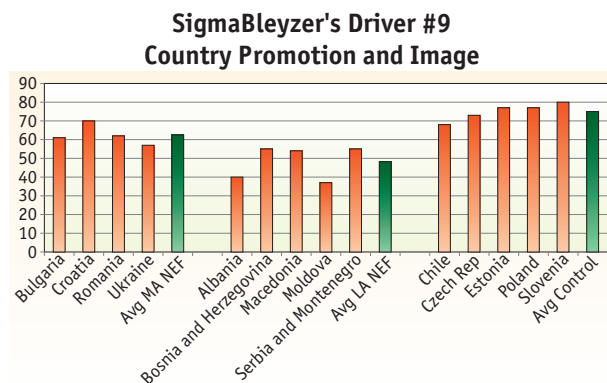


Source: The Bleyzer Foundation's calculations

The election of the coalition government in Croatia in 2000 and its substantial progress in implementing market reforms contributed greatly to the reduction of political risks in the country. In May 2002, Croatia joined NATO's Membership Action Plan, which improved relations between Croatia and the international community. Croatia and Bulgaria have recently had parliamentary elections. This fact should increase political stability in these two countries. Romania and Ukraine are waiting for new presidential elections in 2004, which increase the uncertainty in these countries and the political risks associated with them. Nevertheless, it is very likely that any new elected government will stand firmly on the track of reforms. Therefore, political risks in Romania and Ukraine should not be considered to be a serious impediment to invest in these two countries.

Driver 9: Country Promotion and Image

This driver includes policies and actions to promote the country and improve its image as perceived by foreign and domestic investors. Key measures include consistent and detailed government action plans on country promotion, support to current investors in resolving problem issues, and the country's active position internationally.



Bulgaria, Croatia and Romania have been quite successful in their countries' promotion efforts. However,

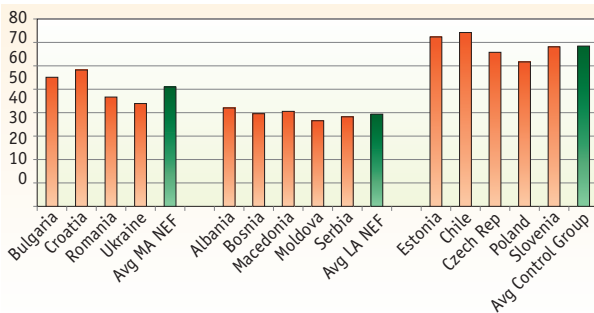
Ukraine performed worse in this field compared to the other MA NEF countries, although the investment climate in the country is in line with the others. The paradox of the situation in Ukraine is that it is doing much better than what it shows the world community. Consequently, the international image of the country does not fully reflect existing realities.

The experience of other MA NEF countries suggests that a country's promotion and image is very important for attracting new investments and securing economic growth. Over the last five years Bulgaria, Croatia and Romania have entered into a number of international agreements. The recent upgrades made by international rating agencies for the countries' sovereign bonds also indicate substantial improvements.

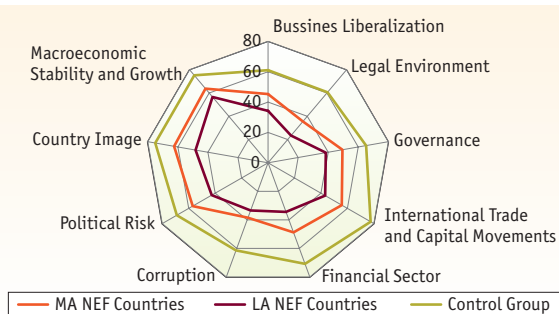
Over the last two years, the Moody's International Credit Rating Agency has raised the rating of the foreign and local currency bonds from B1 to Ba2 in Bulgaria, and from B2 to B1 in Ukraine. The ratings of Croatia and Romania have remained stable over the last two years at Baa3 and Ba3 respectively.

Conclusions

SigmaBleyzer's Investment Climate



SigmaBleyzer's Nonagon Investment Clima



Bulgaria, Croatia, Romania and Ukraine comprise a region of more advanced new European Union frontier countries that are truly emerging into a market economy. These countries are among the fastest growing economies in Europe. Moreover, they are among the most rapidly growing in the world.

Bulgaria, Croatia, Romania and Ukraine have significantly improved their business environments and made substantial progress in adopting a free market economy. These countries have made significant progress in deregulating business activities, improving legal systems and governance, liberalizing trade, reforming their financial sectors, and reducing public debt. For these economies, the desire to gain accession to the EU will continue to be the overriding driving force of the policy-making agenda over the coming years.

Labor resources in the *MA NEF* countries are highly competitive, as modern educational systems have provided a highly educated, skilled and motivated labor force in this region. At the same time, wage levels are much lower than in any of the EU countries. Therefore, Bulgaria, Croatia, Romania and Ukraine can take advantage of their labor productivity and cost.

The coming years present a window of opportunity to invest profitably and develop sound trade relationships with countries in the *MA NEF* region. Three countries of the region, namely Bulgaria, Romania and Croatia, are second-tier EU accession candidates slated to join the EU in 2007 and 2008. By then, undervalued investment opportunities will be more limited. Investments in Ukraine are equally promising, since Ukraine is growing extraordinarily fast and remains the only non-oil exporting country in the world that has achieved such superior results.

Therefore, the next couple of years are the right time to seek business opportunities in the *MA NEF* region. Investments into *MA NEF* economies are already producing and will produce substantial gains over the next few years, which could rival the returns in other successful transition countries.

Annex 1

Albania

Key Social and Economic Indicators

	Unit	2001	2002	2003
Poverty and Social				
Population	mn, eop	3.47	3.545	3.582
Unemployment Rate	%, eop	13.5	15.8	14.9
Average Monthly Salary	US\$	143	149	154
Real Sector				
GDP	US\$bn	4.65	4.81	5.29
GDP per Capita	US\$	1,340.1	1,357.7	1,476.3
Real GDP Growth	%, yoy	7.6	4.7	6
Industry Share in GDP	%	13	11	10
Agriculture Share in GDP	%	34	25	25
Gross Domestic Investments/GDP	%	24.9	22	22.3
Domestic Savings/GDP	%	18.7	13	13.8
Public Finance				
Fiscal Balance (IMF method)	% of GDP	-8.2	-6.9	-5.6
Fiscal Revenues	% of GDP	22.8	22.7	23.6
Fiscal Expenditures	% of GDP	30.4	29	28.5
Monetary Statistics				
Consumer Prices	% yoy, eop	3.1	5.2	2.3
Currency in Circulation	% yoy, eop	142.9	152.7	144.8
Money Supply-M3	% yoy, eop	394.3	416.7	445
Net Domestic Credit to Private Sector	US\$ mn	227.714	288.8482	373.8729
Foreign Exchange Rate	US\$, eop	120.3	133.7	135.3
Balance of Payments				
Exports of Goods	US\$ mn	305	330	426
Import of Goods	US\$ mn	1,332	1,485	1,797
Trade Balance	US\$ mn	-1,027	-1,155	-1,371
Trade Balance/GDP	%	-24.2	-23.9	-22.8
Net Services, Income & Transfers	US\$ mn	224	120	170
Current Account Balance	US\$ mn	-263	-435	-509
Current Account/GDP	%	-6.2	-9	-8.5
Net Foreign Investments	US\$ mn	204	135	192
Overall Balance of Payments	US\$ mn	127	81	90
Gross International Reserves	US\$ bn, eop	754	860	974
Public and Private Debt				
Public External Debt	US\$ bn eop	0.782	1.057	1.184
Private External Debt	US\$ bn eop	0.4164	0.1213	0.2207
Total External Debt	US\$ bn eop	1.1984	1.1783	1.4047
Total External Debt/GDP	%	28.2	24.4	23.3
Public Domestic Debt	US\$ bn eop	n/a	n/a	n/a

SigmaBleyzer's Nonagon Albania

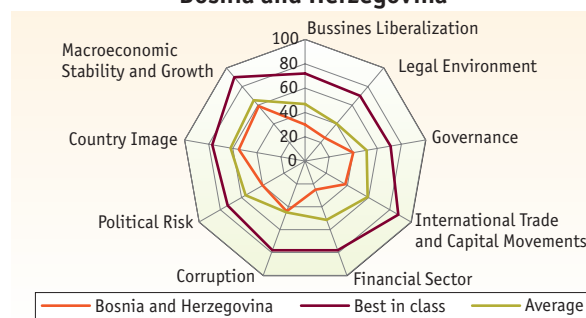


Bosnia and Herzegovina

Key Social and Economic Indicators

	Unit	2001	2002	2003
Poverty and Social				
Population	mn, eop	4.06	4.12	4.21
Unemployment Rate	%, eop	40.1	41	41
Average Monthly Salary	US\$	202	232	303
Real Sector				
GDP	US\$bn	4.9	6.00	7.60
GDP per Capita	US\$	1,206.9	1,456.3	1,805.2
Real GDP Growth	%, yoy	4.4	5.5	3.5
Industry Share in GDP	%	29.7	40.9	n/a
Agriculture Share in GDP	%	14.3	13	n/a
Gross Domestic Investments/GDP	%	18.9	20.4	19.9
Domestic Savings/GDP	%	2.7	1.9	2.5
Public Finance				
Fiscal Balance (IMF method)	% of GDP	-3.3	-2.2	0.4
Fiscal Revenues	% of GDP	49.7	48.1	46.7
Fiscal Expenditures	% of GDP	53.1	50.4	46.3
Monetary Statistics				
Consumer Prices	% yoy, eop	3.2	0.3	0.1
Money Supply-M1	% yoy, eop	92	10.3	3.1
Money Supply-M3	% yoy, eop	89.2	7	8.3
Net Domestic Credit to Private Sector	US\$ mn	1,479.8	2,148.0	3,176.8
Foreign Exchange Rate	US\$, aop	2.19	2.08	1.73
Balance of Payments				
Exports of Goods	US\$ mn	870	1,046	1,407
Import of Goods	US\$ mn	-2,701	-3,122	-3,845
Trade Balance	US\$ mn	-1,831	-2,076	-2,438
Trade Balance/GDP	%	-37.4	-34.6	-32.1
Net Services, Income & Transfers	US\$ mn	1,020	1,041	1,214
Current Account Balance	US\$ mn	-811	-1,036	-1,224
Current Account/GDP	%	-16.7	-18.8	-17.8
Net Foreign Investments	US\$ mn	130	230	320
Overall Balance of Payments	US\$ mn	711	37	457
Gross International Reserves	US\$ bn, eop	1,221	1,279	1,725
Public and Private Debt				
Public External Debt	US\$ bn eop	n/a	n/a	n/a
Private External Debt	US\$ bn eop	n/a	n/a	n/a
Total External Debt	US\$ bn eop	2.38	2.52	2.57
Total External Debt/GDP	%	48.2	42.2	34
Public Domestic Debt	US\$ bn eop	n/a	n/a	n/a

SigmaBleyzer's Nonagon Bosnia and Herzegovina

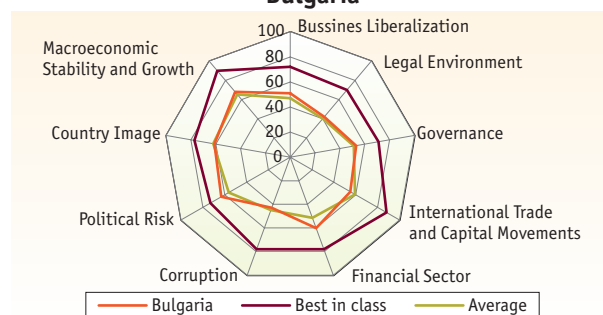


Bulgaria

Key Social and Economic Indicators

	Unit	2001	2002	2003
Poverty and Social				
Population	mn, eop	7.91	7.87	7.54
Unemployment Rate	%, eop	17.5	17.4	14.3
Average Monthly Salary	US\$	116	144	174
Real Sector				
GDP	US\$bn	13.6	15.2	18.9
GDP per Capita	US\$	1,730	1,984	2,400
Real GDP Growth	%, yoy	4.1	4.8	5
Industry Share in GDP	%	25.2	24.5	23.9
Agriculture Share in GDP	%	12.1	11	10.5
Gross Domestic Investments/GDP	%	20.7	19.7	20.4
Domestic Savings/GDP	%	13	13.1	13.9
Public Finance				
Fiscal Balance (IMF method)	% of GDP	-0.9	-0.6	-0.8
Fiscal Revenues	% of GDP	37.6	36.5	36.4
Fiscal Expenditures	% of GDP	38.4	37.2	37.1
Monetary Statistics				
Consumer Prices	% yoy, eop	7.5	5.8	2.6
Currency in Circulation	% yoy, eop	29.8	8.2	9.1
Money Supply-M3	% yoy, eop	26	12.4	11.7
Net Domestic Credit to Private Sector	US\$ mn	1,920	3,244	4,400
Foreign Exchange Rate	US\$, eop	2.22	1.88	1.85
Balance of Payments				
Exports of Goods	US\$ mn	5,113	5,688	6,771
Import of Goods	US\$ mn	-6,693	-7,281	8,610
Trade Balance	US\$ mn	-1,580	-1,593	-1,839
Trade Balance/GDP	%	-11.6	-10.5	-9.7
Net Services, Income & Transfers	US\$ mn	738	916	962
Current Account Balance	US\$ mn	-842	-677	-877
Current Account/GDP	%	-6.2	-4.4	-4.6
Net Foreign Investments	US\$ mn	685	450	928
Overall Balance of Payments	US\$ mn	373	715	342
Gross International Reserves	US\$ bn, eop	3.6	4.7	5.2
Public and Private Debt				
Public External Debt	US\$ bn eop	8.6	8.3	8.7
Private External Debt	US\$ bn eop	2	2.6	2.7
Total External Debt	US\$ bn eop	10.6	10.9	11.4
Total External Debt/GDP	%	78.1	71.9	60
Public Domestic Debt	US\$ bn eop	0.9	1	1.2

SigmaBleyzer's Nonagon Bulgaria



Croatia

Key Social and Economic Indicators

	Unit	2001	2002	2003
Poverty and Social				
Population	mn, eop	4.43	4.39	4.43
Unemployment Rate	%, eop	22.6	21.3	19.1
Average Monthly Salary	US\$	615	750	855
Real Sector				
GDP	US\$bn	19.5	22.4	28.3
GDP per Capita	US\$	4,433	5,107	6,189
Real GDP Growth	%, yoy	3.8	5.2	4.2
Industry Share in GDP	%	22.5	23.4	20.7
Agriculture Share in GDP	%	9.71	7.9	6.8
Gross Domestic Investments/GDP	%	23.6	28.7	28
Domestic Savings/GDP	%	19.9	21.6	22.1
Public Finance				
Fiscal Balance (IMF method)	% of GDP	-5.4	-4.3	-4.6
Fiscal Revenues	% of GDP	38.7	40.9	44.9
Fiscal Expenditures	% of GDP	44.2	45.2	49.5
Monetary Statistics				
Consumer Prices	% yoy, eop	4.9	2.6	2.2
Currency in Circulation	% yoy, eop	31.4	30.2	21.1
Money Supply-M4	% yoy, eop	45.2	9.4	8.3
Net Domestic Credit to Private Sector	US\$ bn	8.9	9.5	12.2
Foreign Exchange Rate	US\$, eop	8.35	7.86	7.07
Balance of Payments				
Exports of Goods	US\$ mn	4,752	4,995	6,291
Import of Goods	US\$ mn	-8,764	-10,274	-13,314
Trade Balance	US\$ mn	-4,012	-5,279	-7,023
Trade Balance/GDP	%	-20.6	-23.5	-22.0
Net Services, Income & Transfers	US\$ mn	3,389	3,732	4,629
Current Account Balance	US\$ mn	-617	-1606	-1680
Current Account/GDP	%	-3.1	-6.9	-5.9
Net Foreign Investments	US\$ mn	1,406	886	1,383
Overall Balance of Payments	US\$ mn	1,344	567	599
Gross International Reserves	US\$ mn, eop	4,704	6,208	7,078
Public and Private Debt				
Public External Debt	US\$ mn eop	6,537	6,356	6,936
Private External Debt	US\$ mn eop	4,780	8,928	12,421
Total External Debt	US\$ mn eop	10,742	15,356	19,358
Total External Debt/GDP	%	57.9	68.5	68.4
Public Domestic Debt	US\$ mn eop	3,140	4,181	5,056

SigmaBleyzer's Nonagon Croatia



Macedonia

Key Social and Economic Indicators

	Unit	2001	2002	2003
Poverty and Social				
Population	mn, eop	2.035	2.038	2.041
Unemployment Rate	%, eop	30.5	31.9	30
Average Monthly Salary	US\$	208	234	238.75
Real Sector				
GDP	US\$bn	3.437	3.73	4.33
GDP per Capita	US\$	1,688.9	1,828.8	2,121.0
Real GDP Growth	%, yoy	-4.5	0.7	2.8
Industry Share in GDP	%	32	30	31
Agriculture Share in GDP	%	12	12	13
Gross Domestic Investments/GDP	%	20.8	21.9	23
Domestic Savings/GDP	%	14	13.3	16.1
Public Finance				
Fiscal Balance (IMF method)	% of GDP	-5.8	-5.4	-1.6
Fiscal Revenues	% of GDP	22.2	23.8	21.8
Fiscal Expenditures	% of GDP	28	29.2	23.4
Monetary Statistics				
Consumer Prices	% yoy, eop	3.7	1	2.2
Currency in Circulation	% yoy, eop	n/a	n/a	-2.71
Money Supply-M3	% yoy, eop	56.7	-8.6	14.7
Net Domestic Credit To Private Sector	US\$ mn	609.5363	738.7436	n/a
Foreign Exchange Rate	US\$, eop	68	64.7	58.9
Balance of Payments				
Exports of Goods	US\$ mn	1,155	1,113	1,354
Import of Goods	US\$ mn	1,677	1,877	2,123
Trade Balance	US\$ mn	-521	-765	-769
Trade Balance/GDP	%	-15.16	-20.53	-17.76
Net Services, Income & Transfers	US\$ mn	n/a	n/a	n/a
Current Account Balance	US\$ mn	-282	-422	-395
Current Account/GDP	%	-6.80	-8.60	-6.90
Net Foreign Investments	US\$ mn	442.3	182.623	212.121
Overall Balance of Payments	US\$ mn	118	-120	16
Gross International Reserves	US\$ bn, eop	0.756	0.735	0.803
Public and Private Debt				
Public External Debt	US\$ bn eop	1.136	n/a	n/a
Private External Debt	US\$ bn eop	0.170	n/a	n/a
Total External Debt	US\$ bn eop	1.306	1.446	1.424
Total External Debt/GDP	%	38	38.8	32.9
Public Domestic Debt	US\$ bn eop	n/a	n/a	n/a

SigmaBleyzer's Nonagon Macedonia

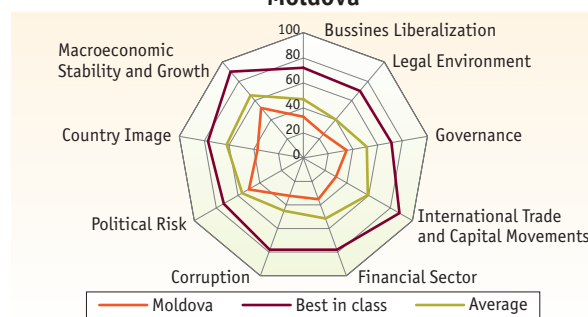


Moldova

Key Social and Economic Indicators

	Unit	2001	2002	2003
Poverty and Social				
Population	mn, eop	4.3	4.3	4.3
Unemployment Rate	000 persons	27.6	24	27.7
Average Monthly Salary	US\$	42	50	61
Real Sector				
GDP	US\$bn	1.48	1.62	1.72
GDP per Capita	US\$	345.8	379.5	402.8
Real GDP Growth	%, yoy	6.1	7.2	6.2
Industry Share in GDP	%	24.1	24.2	21
Agriculture Share in GDP	%	26.01	25.12	26
Gross Domestic Investments/GDP	%	n/a	n/a	n/a
Domestic Savings/GDP	%	n/a	n/a	n/a
Public Finance				
Fiscal Balance (IMF method)	% of GDP	-0.2	-1.8	-0.4
Fiscal Revenues	% of GDP	29.1	30	13.9
Fiscal Expenditures	% of GDP	29.3	32	14.3
Monetary Statistics				
Consumer Prices	% yoy, eop	6.4	4.4	11
Currency in Circulation	% yoy, eop	24.8	24.8	27.0
Money Supply-M3	% yoy, eop	36.3	36.0	25.9
Net Domestic Credit to Private Sector	US\$ mn	237	224	233
Foreign Exchange Rate	US\$, eop	13.091	13.822	13.313
Balance of Payments				
Exports of Goods	US\$ mn	569.2	445.00	350
Import of Goods	US\$ mn	882.8	1,038	577
Trade Balance	US\$ mn	-313.6	-593.0	-227
Trade Balance/GDP	%	-21.2	-23.3	-29.7
Net Services, Income & Transfers	US\$ mn	215.0	509.2	159.4
Current Account Balance	US\$ mn	-98.6	-83.8	-67.6
Current Account/GDP	%	-6.7	-6.3	-8.1
Net Foreign Investments	US\$ mn	156	117	97
Overall Balance of Payments	US\$ mn	-4.4	-51.1	-26.7
Gross International Reserves	US\$ mn, eop	228.5	268.8	260.1
Public and Private Debt				
Public External Debt	US\$ mn eop	979	1,010	1,018
Private External Debt	US\$ mn eop	300	376	384
Total External Debt	US\$ mn eop	1,577	1,687	1,709
Total External Debt/GDP	%	67.3	64.8	52.3
Public Domestic Debt	US\$ mn eop	n/a	n/a	n/a

SigmaBleyzer's Nonagon Moldova

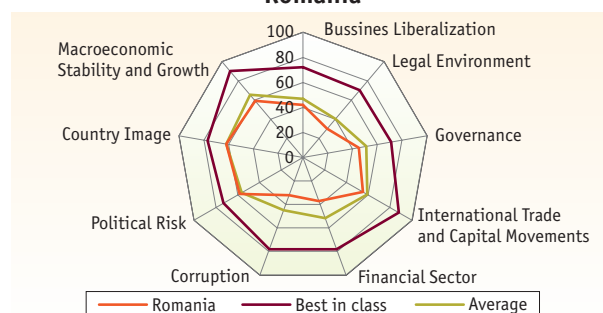


Romania

Key Social and Economic Indicators

	Unit	2001	2002	2003
Poverty and Social				
Population	mn, eop	22.4	21.700	21.6
Unemployment Rate	%, eop	8.6	8.1	8.9
Average Monthly Salary	US\$	147	165	164
Real Sector				
GDP	US\$bn	39.7	44.4	46.5
GDP per Capita	US\$	1,773	2,107	2,154
Real GDP Growth	%, yoy	5.30	4.30	4.70
Industry Share in GDP	%	34.6	35.6	n/a
Agriculture Share in GDP	%	15.0	14.8	n/a
Gross Domestic Investments/GDP	%	19	20	21
Domestic Savings/GDP	%	13.9	15	18
Public Finance				
Fiscal Balance (IMF method)	% of GDP	-3.1	-2.7	-2.5
Fiscal Revenues	% of GDP	30.5	30	36.7
Fiscal Expenditures	% of GDP	33.7	32.7	32.3
Monetary Statistics				
Consumer Prices	% yoy, eop	34.5	22.5	15
Currency in Circulation	% yoy, eop	38.4	27.9	16.4
Money Supply-M3	% yoy, eop	46.2	17.2	26.6
Net Domestic Credit to Private Sector	US\$ mn	4,069	5,495	8,051
Foreign Exchange Rate	US\$, eop	29,061	32,691	33,200
Balance of Payments				
Exports of Goods	US\$ mn	11,385	13,696	14,159
Import of Goods	US\$ mn	14,354	16,430	16,710
Trade Balance	US\$ mn	-2,969	-2,734	-2,551
Trade Balance/GDP	%	-7.5	-5.9	-5.9
Net Services, Income & Transfers	US\$ mn	584	1,159	79
Current Account Balance	US\$ mn	-2,385	-1,575	-2,472
Current Account/GDP	%	-5.84	-3.37	-6.10
Net Foreign Investments	US\$ mn	1,174	1,090	1,467
Overall Balance of Payments	US\$ mn	1,805	n/a	n/a
Gross International Reserves	US\$ bn, eop	6,381	6,948	7,900
Public and Private Debt				
Public External Debt	US\$ mn eop	7,673	9,551	10,877
Private External Debt	US\$ mn eop	3,739	5,699	6,624
Total External Debt	US\$ bn eop	11,653	15,250	17,501
Total External Debt/GDP	%	29.2	33.3	31.3
Public Domestic Debt	US\$ bn eop	0.9	n/a	n/a

SigmaBleyzer's Nonagon Romania

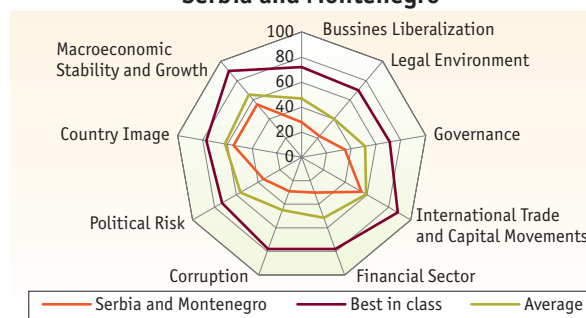


Serbia and Montenegro

Key Social and Economic Indicators

	Unit	2001	2002	2003
Poverty and Social				
Population	mn, eop	10.7	10.7	10.7
Unemployment Rate	%, eop	27	28.9	30
Average Monthly Salary	US\$	83	141	186
Real Sector				
GDP	US\$bn	11.6	15.7	19.8
GDP per Capita	US\$	1,084	1,467	1,850
Real GDP Growth	%, yoy	5.5	4	3
Industry Share in GDP	%	37.1	39.2	40
Agriculture Share in GDP	%	23.3	23.8	24
Gross Domestic Investments/GDP	%	13.6	16.1	16.5
Domestic Savings/GDP	%	-7.2	-7	-3.5
Public Finance				
Fiscal Balance (IMF method)	% of GDP	-1.4	-4.5	-4.5
Fiscal Revenues	% of GDP	38.9	42.8	40.5
Fiscal Expenditures	% of GDP	40.3	47.3	45.1
Monetary Statistics				
Consumer Prices	% yoy, aop	91	21	9
Currency in Circulation	% yoy, eop	131.6	49.4	9.4
Money Supply-M3	% yoy, eop	114.4	80.3	15
Net Domestic Credit to Private Sector	US\$ mn	n/a	n/a	n/a
Foreign Exchange Rate	US\$, aop	66.84	64.19	58.1
Balance of Payments				
Exports of Goods	US\$ mn	2,003	2,412	3,185
Import of Goods	US\$ mn	-4,837	-6,320	-7,935
Trade Balance	US\$ mn	-2,834	-3,908	-4,750
Trade Balance/GDP	%	24.4	24.9	24
Net Services, Income & Transfers	US\$ mn	2,306	2,524	3,053
Current Account Balance	US\$ mn	-528	-1,384	-1,697
Current Account/GDP	%	-4.6	-8.8	-8.7
Net Foreign Investments	US\$ mn	165	562	1,400
Overall Balance Of Payments	US\$ mn	605	783	-739
Gross International Reserves	US\$ bn, eop	1,169	2,280	3,550
Public and Private Debt				
Public External Debt	US\$ bn eop	10.9	10.9	11.1
Private External Debt	US\$ bn eop	1	0.9	1.7
Total External Debt	US\$ bn eop	11.9	11.8	13.8
Total External Debt/GDP	%	103	75	69
Public Domestic Debt	US\$ bn eop	n/a	n/a	n/a

SigmaBleyzer's Nonagon Serbia and Montenegro



Ukraine

Key Social and Economic Indicators

	Unit	2001	2002	2003
Poverty and Social				
Population	mn, eop	49.1	48.0	47.6
Unemployment Rate	%, eop	3.7	3.8	3.6
Average Monthly Salary	US\$	70	83	103
Real Sector				
GDP	US\$bn	205	221	246
GDP per Capita	US\$	720	859	958
Real GDP Growth	%, yoy	9.2	4.8	9.3
Industry Share in GDP	%	39.01	39.27	40
Agriculture Share in GDP	%	16.63	16.90	12.3
Gross Domestic Investments/GDP	%	21.8	18.9	20.4
Domestic Savings/GDP	%	20	22	25.1
Public Finance				
Fiscal Balance (IMF method)	% of GDP	-0.3	0.7	-0.4
Fiscal Revenues	% of GDP	26.9	27.6	26.8
Fiscal Expenditures	% of GDP	27.2	27.3	27.2
Monetary Statistics				
Consumer Prices	% yoy, eop	6.1	-0.6	8.2
Currency in Circulation	% yoy, eop	52.7	35.8	25.2
Money Supply-M3	% yoy, eop	41.5	41.7	47
Net Domestic Credit to Private Sector	US\$ mn	5,113	7,737	12,717
Foreign Exchange Rate	US\$, eop	5.4	5.3	5.3
Balance of Payments				
Exports of Goods	US\$ mn	162,65	17,957	23,080
Import of Goods	US\$ mn	15,775	16,977	23,021
Trade Balance	US\$ mn	490	980	59
Trade Balance/GDP	%	2.4	4.4	1.7
Net Services, Income & Transfers	US\$ mn	910	2,220	2,541
Current Account Balance	US\$ bn	1.4	3.2	2.9
Current Account/GDP	%	3.7	7.7	5.6
Net Foreign Investments	US\$ mn	769	784	1,186
Overall Balance of Payments	US\$ mn	0	0	0
Gross International Reserves	US\$ bn, eop	2.96	4.4	6.9
Public and Private Debt				
Public External Debt	US\$ bn eop	10.1	10.2	10.6
Private External Debt	US\$ bn eop	n/a	n/a	n/a
Total External Debt	US\$ bn eop	10.1	10.2	10.6
Total External Debt/GDP	%	21.3	24.6	22.5
Public Domestic Debt	US\$ bn eop	3.8	4.0	4.2

SigmaBleyzer's Nonagon Ukraine



Annex 2

IPCTF economic policy framework

Driver 1: Macroeconomic Stability

This driver includes policies and actions that would over time result in stable prices with low inflation (internal stability), and a stable foreign exchange rate (external stability). Internal and external instability increases the risk of doing business in the country. As a result, investors require significantly higher rates of return to compensate for the risks of instability. Because of this high risk premium, few projects would qualify for investments, reducing the overall level of investments and therefore economic growth. In order to achieve internal and external stability, two sets of policies are necessary: fiscal policies and monetary policies.

Fiscal policies are those that will lead to a government's fiscal budget in which the fiscal deficit can be financed by borrowings on a sustainable basis, normally no more than 3% of GDP. This includes actions to increase fiscal revenues (by increasing the tax base, eliminating tax exemptions, and improving tax structure, tax administration, and cost recovery of public services), and to improve management of public expenditures (by reducing current expenditures of government, improving treasury operations, reforming the pension system and eliminating subsidies.)

Monetary policies are those under which the creation of money (money supply) will not exceed the demand for money, which is affected by the level of income, inflation and interest rates.

Driver 2: Liberalization and Deregulation of Business Activities

This driver includes government policies and actions that reduce government interventions, enabling private businesses to operate freely and make profits in a competitive environment. An on-going system must be created to remove barriers to entry, operations and exit. The following are examples of what must be done in this area:

- Facilitate the formation of new businesses
- Reduce licensing and registration requirements
- Remove price controls and domestic trade restrictions
- Reduce the number of government inspections, interventions and interferences in business activities
- Simplify reporting requirements
- Reduce the cost of doing business, including taxation levels
- Simplify closure of failing enterprises

- Liberalize labor markets, improving labor mobility and reducing excessive labor costs imposed by the government (such as excessive minimum wages, payroll taxes, high unemployment compensation)

Driver 3: Stability and Predictability of the Legal Environment

This driver includes policies and actions to enact and implement stable and predictable laws and regulations that would support and encourage private sector businesses in a free market. They require, among others, the following actions by the executive, legislative and judiciary branches of the government:

- Enact appropriate legislation that would define the "rules of the game" for all businesses, without discrimination or preferential treatment, including modern civil, labor, tax and commercial codes and legislation to protect intellectual property rights, patents, technology transfer policies, and direct foreign investments
- Improve the processes for drafting, presenting, and carrying out public reviews of proposed business-related legislation
- Create an independent judiciary, with an independent budget
- Make the courts more efficient and capable of settling commercial disputes
- Empower the executive branch to enforce judgments made by the courts, including those on commercial contracts
- Review existing legislation for inconsistencies in different legal documents

Driver 4: Corporate and Public Governance

This driver includes policies and actions to improve the governance of private companies and public administration, to support private sector activities in a free market economy. They include policies related to corporate governance, public administration and privatization of state properties.

The objective of corporate governance policies is to establish appropriate rules that would guide the activities of businesses in the best interest of their shareholders, protecting ownership rights. Key policies and actions include:

- Enact appropriate corporate governance legislation
- Require all companies listed on stock exchanges to adopt international accounting standards and to submit annual reports
- Encourage the creation of non-government organizations to support corporate governance and issue corporate governance codes and model charters and by-laws
- Implement a comprehensive corporate governance training program for board members, shareholders, managers, etc.

The objective of public administration policies is to redefine the role of the government to support the private sector and secure the provision of sound and efficient government services without corruption. The implementation and sustainability of economic policy reforms over time also requires strong (though smaller) government, with strong management and administrative capacity. A public administration reform program should:

- Establish a clear strategy and vision for the role of the government as complementary to and supportive of the private sector.
- Introduce adequate regulations to avoid monopolistic behavior.
- Consolidate ministries and agencies to avoid responsibility overlaps
- Undertake "functional" and "operational" reviews of individual ministries and agencies
- Reform and modernize the civil service by providing adequate incentives for performance and market controls
- Reform government procurement practices
- Reform central-local government fiscal relationships
- Reduce shadow economy activities by drastically lowering cost of compliance with legislation in effect

The objective of privatization-related policies is to improve the efficiency of resource use through private ownership, minimize the possibilities of undue market power by the government, and concentrate government resources on public goods. Key measures include:

- Pass appropriate legislation to permit the privatization of land and state enterprises
- Develop appropriate mechanisms to register ownership rights, including land titling and land registration
- Create and encourage an independent agency to carry out the privatization of state properties
- Approve fair and transparent procedures for the privatization of state properties

- Rapidly complete the privatization of all state enterprises under clear and transparent procedures
- Take early actions to prepare state companies for privatization, including actions to protect minority shareholder rights, and transfer social assets to local authorities

Driver 5: Liberalization of Foreign Trade and International Capital Movements

This driver includes policies and actions to facilitate the exports and imports of goods and transfer of capital internationally. These actions would:

- Remove restrictions on exports, including export quotas, duties, indicative prices, advance deposits, and foreign exchange surrender requirements
- Remove restrictions on imports, including high import duties, critical import lists, and indicative prices
- Simplify and expedite customs services, including procedures for customs clearances
- Develop more modern and consistent procedures for certification requirements and standards for products
- Liberalize foreign exchange transactions and eliminate restrictions on foreign direct investments
- Cancel all restrictions on purchases of securities in foreign currency

Driver 6: Financial Sector Development

This driver includes policies and actions to develop a healthy financial sector capable of meeting the financing needs of growing businesses. Key measures are the following:

- Liberalize interest rates on bank deposits and lending
- Eliminate preferential credit programs imposed by the government on banks
- Increase the independence and autonomy of the Central Bank to operate efficiently without political considerations, with its main goal being the maintenance of internal and external stability
- Ensure the health of the banking sector by improving bank supervision and enforcing prudential regulations
- Develop appropriate mechanisms to deal expeditiously with troubled banks
- Strengthen the Securities and Exchange Commission

- Introduce international accounting standards and external auditing requirements for all banks and enterprises listed on stock exchanges
- Encourage competition and efficiency in the financial sector by facilitating the expansion of foreign banks and other financial institutions
- Develop appropriate legislation, regulations and enforcement capacity to ensure that stock market participants protect the rights of investors, do not engage in money laundering, provide all interested persons with free or equal access to all information on the stock market and its participants
- Establish a national regime for the investment activities of foreign investors, including liberalization of cash settlements on securities transactions with non-residents
- Develop an appropriate capital market infrastructure, including a central depository system and a system of Delivery Versus Payment

Driver 7: Corruption Level

This driver includes policies and actions to minimize corruption and protect businesses from abuses of power by government officials. Key measures would:

- Take measures to "prevent" corruption, reducing the opportunities for corruption and making corruption more difficult to undertake
- Develop a legal framework to ensure better enforcement of anticorruption measures and impose visible, harsh, swift and certain penalties for official corruption
- Get public support for anti-corruption programs by making people aware of their rights and the rules of the game

Driver 8: Political Risks

This driver includes policies and actions to minimize the effects of political uncertainties on business activities. Key measures include:

- Pass appropriate legislation to reassure investors that arbitrary expropriation of private property, including "creeping expropriation," will not be permitted in the country
- Introduce strong measures to eliminate power abuses by government authorities, bring tax collectors and local officials under the control of the central administration

- Give government the total authority to do their jobs unimpeded by vested interests
- Provide governmental stability, including the longevity of key officials
- Ensure law and order
- Minimize the risks of civil and external disturbances that may affect businesses

Driver 9: Country Promotion and Image

This driver includes policies and actions to promote the country and improve its image as perceived by foreign and domestic investors. Key measures should:

- Announce and widely disseminate the government's policy and commitment to implementing strong market-oriented policies and show implementation progress
- Vocally support foreign investment by changing the attitude of officialdom at central and local levels.
- Require all embassies abroad to have their commercial section strengthened, and to go on sales drives to better disseminate business opportunities. Assist in the establishment of a private investment promotion agency

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