CHAPTER 6

Services Trade and Investment in Eastern Europe and the Former Soviet Union

Introduction

Since 1990, the services sector has grown rapidly in all of the countries in the Region. The share of services in total employment and GDP in many of the countries is now close to that observed in OECD countries. Foreign investment, especially foreign direct investment (FDI), has played an important role in this process—much greater than the norm in many countries—reflecting the relatively limited experience and understanding of the need for market-based services among the inhabitants of the Region.

One of the stylized facts of economic development is that the share of services in GDP and employment rises as per capita incomes increase (Francois and Reinert 1996). The rise in the share of services reflects a number of factors, including increasing specialization and exchange of services through the market ("outsourcing"), with an associated increase in variety and quality that may raise the productivity of firms and the welfare of final consumers, in turn increasing demand for services. It also reflects the fact that the scope of (labor) productivity in services provision is less than in agriculture and manufacturing, implying that over time the (real) costs of services will rise relative to merchandise, as will the share of employment in services (Baumol 1967; Fuchs 1968).

Services also play a critical role in international trade. Transport services are a key input into trade in goods, and technological advances in transportation have had a major impact on the observed expansion of trade in goods. Services themselves are also becoming increasingly tradable as a result of the greater mobility of people and developments in information, computer, and telecommunications industries. This has resulted in the ever-increasing specialization in production of goods also extending to services. To a large extent, the process of globalization reflects the internationalization of production, consumption, and trade in services.

An implication of these technological developments is that the competitiveness of firms—both domestic enterprises operating on the local market and exporters on international markets—increasingly depends on the availability of low-cost and high-quality producer services in an array of areas. To illustrate with a few examples, *telecommunications and related services* are crucial for the international diffusion of information and knowledge. For some services, telecommunications technology serves as the means of export delivery. Ensuring access to modern networking technology is a vehicle that allows the economy to diversify by utilizing information technologies to export labor-intensive services. Well-known examples are call centers and back-office processing activities. Efficient *transport and distribution services* ensure that goods and people arrive in foreign countries in a timely manner. In places where it is expensive to ship goods abroad and service delays are frequent, transportation can become a prohibitive barrier to trade or can bias the geographic composition of exports and preclude countries from participating in the global production sharing that increasingly characterizes international trade. Access to *financial services*—working capital, export credit, insurance—is critical if firms are to obtain and fulfill orders from abroad; the existence of markets for foreign exchange, forward contracts, options, and other derivatives can reduce exporters' risk exposure. Efficient producer services and the proliferation of e-commerce (Internet) are of great importance in expanding export earnings and fostering economic growth. For some economies where the biggest export industry is *tourism*—a service export par excellence—good transportation and communications infrastructure are also key for growth.

Under central planning, services industries were generally neglected. Marxist thinking emphasized the importance of tangible (material) inputs as determinants of economic development, and classified employment in the services sector as unproductive. Bićanić and Škreb (1991) also note that the properties of modern producer services, namely marketability, tradability, and small scale of business,

did not comply with features of Marxist economies and the bias in favor of large company scale. A result was excess demand for producer services under central planning. In market economies, producer services are among the fastest-growing services subsectors and have been subject to increasing externalization (outsourcing). A similar development was not feasible under central planning. The lack of producer services in the Region's countries was reflected in transport bottlenecks, lack of telephones and low quality of existing lines, an obsolete banking structure, and extremely low employment in services (for example, less than 1 percent of the labor force was employed in finance and insurance).

This situation severely hampered economic development in the Region before 1990. One example concerns the role of vertical integration of transport services. Because of the preference for large company size, transport services were often integrated into production firms—there was no market for such services. The lack of services also helps explain economic developments after 1990. Campos and Coricelli (2002) note that under central planning, countries had high savings rates, with the central bank allocating funds according to political priorities. This resulted in inefficient (often over-) investment, reflected in part in the low quality of the physical capital stock before 1990. After 1990, price liberalization was implemented, along with tight monetary policies. Given the absence of an effective private financial system, this led to a credit crunch in many transition economies.

Services also play an important role in coordination of economic activity in a market economy. Under central planning, economic relations were highly specific (that is, firms were locked in relationships with other firms). Input prices were administered, and firms did not accumulate information on other firms and markets. The decentralized bargaining process with many potential business partners and customers that characterizes a market economy requires flows of information and an efficient service infrastructure, which did not exist.

Thus, the former centrally planned economies of the Region inherited very weak services sectors. Many of the services that are critical to the efficient functioning of a market economy—not just a financial sector that could allocate investment funds efficiently but also the design, packaging, distribution, logistics, management, and after-sales services that are needed in order to establish, maintain, and expand market share, whether domestically or on international markets—simply did not exist. This chapter provides an overview of the status quo on services in the countries of the Region, with a more in-depth discussion of developments on trade in services. In terms of policy, the primary focus of the chapter is on policies toward trade and

investment in services. There are large differences in the policy stances toward trade and investment in services across the Region. In part, these differences reflect the strategies that were chosen by governments in terms of liberalization and regulatory reform more generally. In part, they also are the result of differences in "access" to, and use of, trade agreements.

The EU-8 countries—the Baltic and the Central and Eastern European (CEE) states—have used the prospect of accession to the EU as a focal point for reform and reregulation of the services sector. Accession implies that the *acquis communitaire* become the template for legislative and regulatory changes. For those countries where accession is not on the agenda, this "EU convergence" strategy is in principle still available because the "template" is common knowledge. An important policy challenge confronting countries that are not in line for EU accession is to determine to what extent other multilateral instruments such as the WTO and regional cooperation can be used as a signaling device and a focal point for reforms. The ongoing Doha Round offers an opportunity for non-EU-accession candidates to substantially expand specific commitments on market access and national treatment for service sectors.

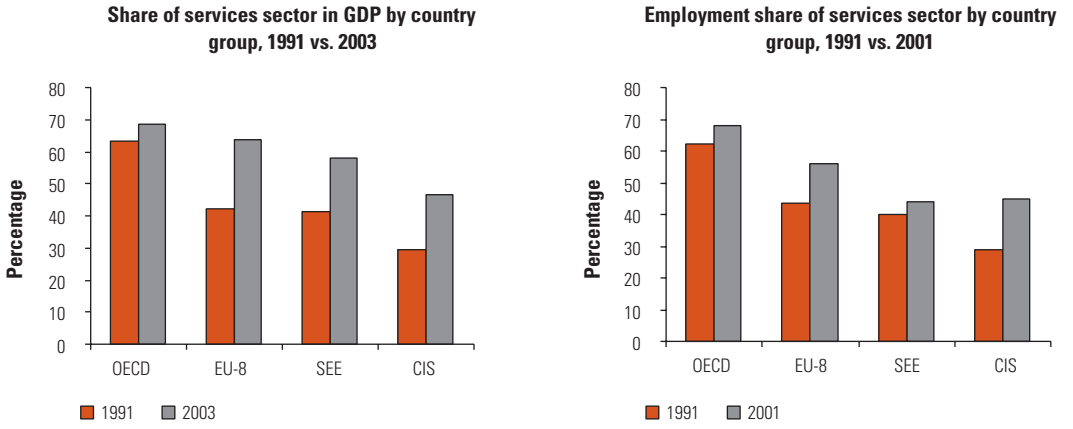
This chapter opens with a discussion of the changes that have occurred in the structure of the Region's economies in terms of the share of services in GDP and employment. Changes in trade and FDI in services, respectively, are then analyzed. This is followed by a review of the policy stances toward international transactions in services across the Region's countries, focusing in particular on so-called "backbone" service industries: finance, telecommunications, and infrastructure. The relationship between services policies and changes in services intensity of the Region's economies and aggregate growth performance are analyzed next. The chapter concludes with a summary of a number of policy conclusions.

Shifts in the Structure of Services in the Region

The share of services in GDP and employment has grown significantly in the last 15 years. Compared with the high-income OECD average in 1990—when the share of services in employment and GDP was around 63 percent—the Region's countries clearly lagged far behind: services accounted for 30–40 percent of GDP and employment. As of 2003, these services shares had increased substantially, with the greatest growth observed in the Baltic States, which have now almost converged on the OECD average of 68 percent in terms of GDP shares

FIGURE 6.1

Changes in the Share of Services in GDP and Employment



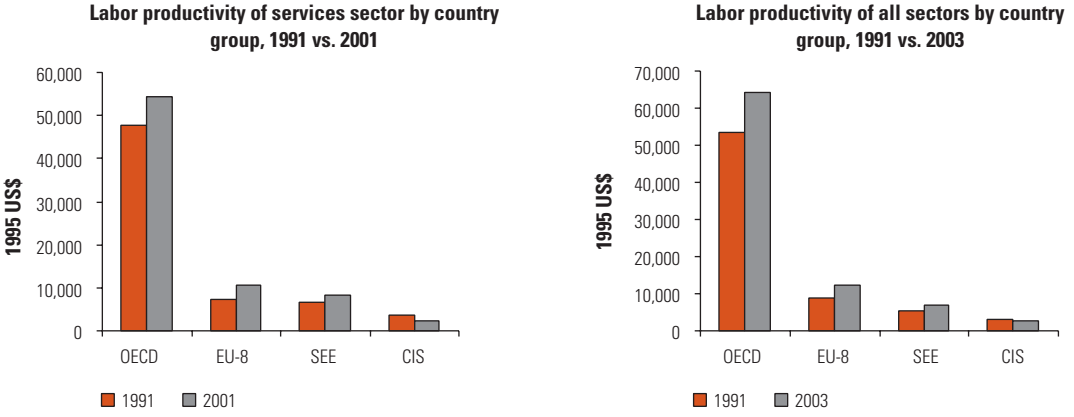
Source: World Bank World development indicators.

(although employment shares remain lower). While the EU-8 states have come close to converging, much less progress has been made by the CIS, where natural-resource-based activities continue to constitute a major share of GDP (see figure 6.1). SEE countries lie in between, but are much closer to the level of the EU-8.

Labor productivity performance has demonstrated great increases in many of the Region's countries. As is the case with regard to the share of services in GDP and employment, there is a distinct pattern, with the EU-8, and to a lesser extent SEE, registering an increase in productivity, both overall and within services (broadly defined to include government); see figure 6.2.[1] Conversely, for those other sub-Regions for

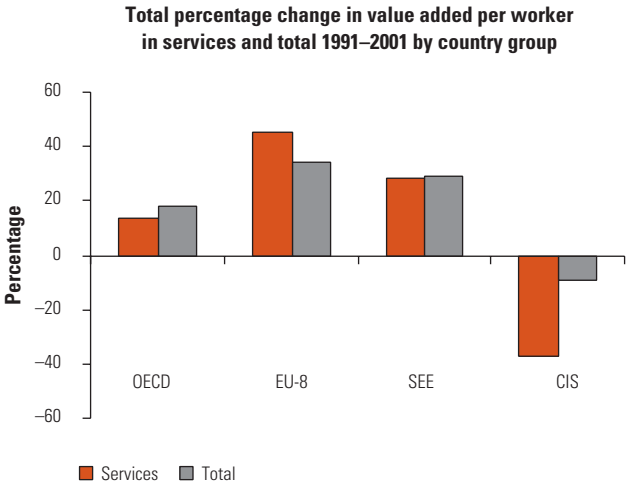
FIGURE 6.2

Labor Productivity



Source: World Bank World development indicators.

FIGURE 6.3
Change in Value Added per Worker



Source: World Bank World development indicators.

which data are available, there has been a decline in the value of services output per employee. Nor have these countries increased their overall labor productivity performance in the last decade. The performance of the Baltic countries—where labor productivity in services outpaced the productivity increase in other sectors of the economy—is noteworthy. The charts also show, however, that convergence with respect to high-income OECD countries in terms of productivity levels is still in the earlier stages for all of the Region's countries, regardless of the total progress and deterioration shown in figure 6.3.

Trade in Services in the Region

Services differ from goods in that they are intangible and often cannot be stored—they must be consumed as they are produced. These characteristics make them difficult to trade internationally at arm's length in a manner analogous to goods. Although technological developments are increasingly making it easier to exchange services through telecommunications networks and the Internet, trade in services often requires the physical movement of either the supplier or the consumer so that they can be in the same location. As a result of this technological "constraint," the WTO has defined four so-called "modes of supply" through which international trade in services may occur (see box 6.1). Mode 1 is cross-border supply, which applies when service suppliers resident in one country provide services in

another country without either supplier or buyer/consumer moving to the physical location of the other. Mode 2, consumption abroad, refers to a consumer who is the resident of one country moving to the supplier's country to consume a service. Mode 3, commercial presence, refers to legal persons (firms) moving to the consumer's location on a long-term basis to sell services locally through the establishment of a foreign affiliate or branch. Essentially, this comprises FDI. Mode 4 is the mode of supply through which services can be traded by the temporary movement of natural persons to the location of the consumer or demander of the service. Note that if the movement is long-term, this would constitute immigration. National accounting conventions do not regard immigration as trade insofar as the output produced by immigrants is part of the host country's GDP.[2]

The primary source of data on the magnitude of trade in services is the balance of payments (BOP). Unfortunately, this is only an imperfect source. Most countries do not collect detailed statistics on each of the four modes, which is also the case for the countries of the Region. The balance of payments generally has reasonably good coverage of Mode 2 (consumption abroad) because this tends to overlap to a large extent with the expenditures associated with tourism and business travel. Mode 3 (local sales of foreign affiliates) tends to be very badly covered, if at all—in almost all cases, data on this must be collected separately through surveys. The same is true of Mode 4. Insofar as this is recorded in the balance of payments, it will be conflated in the labor income and remittances categories. Finally, Mode 1 services are also imperfectly captured because such services trade may not give rise to a movement of foreign exchange, as is often the case with intrafirm cross-border transactions.

In short, there is a large discrepancy between the conceptual classification of trade in services and the available statistics. The latter capture trade in services only very imperfectly. As a result, it is necessary to use the existing BOP classifications—which distinguish trade in transport services; foreign exchange transactions associated with the travel of natural persons; and all other types of services exchanges, ranging from financial to educational services. In practice, any or all four of the modes of supply may be used—it is generally not possible to determine which mode has been used. In this chapter, use is made of BOP data and information on the services share of inward FDI flows. Unfortunately, no data are available on the sales of foreign affiliates—that is, the magnitude of the trade in services that is associated with FDI flows (stocks) in services.

Although all of the Region's countries have seen the share of services in GDP and employment expand in recent years, this does not

BOX 6.1

Modes of Trade in Services as Defined by WTO

- *Mode 1—Cross-border*: services supplied from the territory of one Member into the territory of another. An example is software services supplied by a supplier in one country through mail or electronic means to consumers in another country.
- *Mode 2—Consumption abroad*: services supplied in the territory of one Member to the consumers of another. An example is a consumer moving, for example, to consume tourism or education services in another country. Also covered are activities such as ship repair abroad, where only the property of the consumer moves.
- *Mode 3—Commercial presence*: services supplied through any type of business or professional establishment of one Member in the territory of another. An example is an insurance company owned by citizens of one country establishing a branch in another country.
- *Mode 4— Presence of natural persons*: services supplied by nationals of one Member in the territory of another. This mode includes both independent services suppliers, and employees of the services supplier of another Member. Examples are a doctor of one country supplying through his or her physical presence services in another country, or the foreign employees of a foreign bank.

Source: Broadman 1994.

necessarily translate into an expanding share of services in total trade (see table 6.1). Indeed, for many of the advanced countries in the Region, the opposite is observed—the relative importance of services has been declining, reflecting the expansion of trade manufactures or other tangible goods. Most countries in the Region are not heavily dependent on services as a source of foreign exchange—the two exceptions are Albania and Croatia. For both, services are more than 50 percent of total exports (goods plus services). In both cases, the activity that underlies the high dependence on services is travel (tourism), accounting for some 75 percent of total services receipts. Also noteworthy is that for both countries, the share of services in total receipts has grown very substantially since 1996, reflecting a recovery in tourism in the case of Croatia.

Three of the Region's countries see significant growth in their share of services exports: Bulgaria, FYR Macedonia, and Moldova. Tourism is again the explanation for the rise in Bulgaria; data constraints do not allow a determination for FYR Macedonia, while in the case of Moldova, the growth is the result of an expansion in services other than transport and travel. In contrast to these countries, the countries

TABLE 6.1

Share of Services in Foreign Exchange Receipts, 1996 and 2003 (%)

Country	Services (% of total exports)		Transport (% of all services)		Travel (% of all services)		Other services (% of all services)	
	1996	2003	1996	2003	1996	2003	1996	2003
Albania	35.0	61.7	23.4	9.6	59.4	72.5	17.2	17.9
Armenia	21.0	23.0	46.5	35.2	15.2	35.1	38.3	29.7
Azerbaijan	19.0	14.1	36.0	45.9	30.5	13.4	33.5	40.8
Belarus	14.0	12.9	52.6	57.0	6.1	17.8	41.3	25.2
Bosnia and Herzegovina	n.a.	24.6	n.a.	7.8	n.a.	48.1	n.a.	44.0
Bulgaria	22.0	29.8	32.2	29.7	28.4	52.4	39.4	17.9
Croatia	41.0	57.8	22.3	9.1	63.1	74.0	14.7	16.9
Czech Rep.	27.0	13.8	16.3	27.6	49.9	45.8	33.8	26.6
Estonia	38.0	32.7	39.8	44.1	43.7	30.2	16.5	25.7
Georgia	n.a.	34.7	n.a.	44.9	n.a.	33.3	n.a.	21.9
Hungary	27.0	15.6	6.4	12.7	60.7	43.1	32.9	44.1
Kazakhstan	10.0	11.4	64.0	48.4	29.5	33.2	6.4	18.4
Kyrgyz Rep.	6.0	n.a.	23.0	n.a.	13.4	n.a.	63.6	n.a.
Latvia	43.0	32.5	62.8	58.7	19.1	14.5	18.2	26.8
Lithuania	19.0	19.7	44.9	49.7	39.6	34.0	15.5	16.4
Macedonia, FYR	12.0	19.3	31.4	n.a.	13.4	n.a.	55.2	n.a.
Moldova	11.0	23.7	52.2	50.6	31.6	23.2	16.2	26.2
Poland	26.0	15.5	28.2	35.8	32.4	36.4	39.4	27.8
Romania	16.0	14.7	36.6	39.8	33.8	14.8	29.6	45.4
Russian Fed.	13.0	10.5	27.3	38.2	53.5	28.1	19.2	33.7
Serbia and Montenegro	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Slovak Rep.	19.0	13.1	31.1	n.a.	32.6	n.a.	36.3	n.a.
Slovenia	20.0	17.8	22.5	27.6	58.1	47.9	19.4	24.5
Tajikistan	n.a.	8.9	n.a.	55.3	n.a.	1.7	n.a.	43.0
Turkmenistan	5.0	n.a.	76.1	n.a.	8.9	n.a.	15.0	n.a.
Ukraine	24.0	18.0	84.0	67.4	4.8	17.9	11.2	14.7
Uzbekistan	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Turkey	30.0	27.2	13.1	11.4	42.1	69.2	44.9	19.4
World average	20.1	20.8	22.9	21.2	32.3	29.3	44.9	49.4

Source: IMF balance of payments.

Note: n.a. = not available.

that have recently acceded to the EU have experienced a decline in the share of services in total exports—often by 50 percent or more. Underlying this relative drop is a relatively stagnant level of services receipts combined with more dynamic exports of manufactures. Noteworthy is the fall in the relative importance of tourism receipts for the CEE and the Baltic countries, offset by a relative increase in transport and other services. The latter catchall category expands substantially as well in the cases of Romania and Russia. Croatia and Lithuania are the only countries where services export growth has outpaced merchandise exports since 1995.

These data reveal differences between subsets of the Region's countries. In the EU-8, exports of manufactures have dominated,

with the exception of Estonia and Slovenia. In the case of the CIS and SEE, the share of services in total exports has grown significantly. Services exports as a share of GDP more than doubled for all of these countries on average since 1995. This development is not exceptional, in that the ratio of service exports to GDP has simply been converging toward those found in other parts of the world (table 6.2). Thus, this can be seen as one dimension of the transition to a more market-based economy. A similar pattern can be discerned on the import side—a process of convergence on the part of the Central Asian republics and SEE toward the pattern that already prevailed in the EU-8 and the EU-15 (table 6.3). However, this does not appear to be

TABLE 6.2

Exports of Services as a Share of GDP

Percentage

	1990	1995	1996	2002	2003
CIS (excluding Central Asia)		2	1	5	5
Central Asia		3	4	5	5
SEE	2	6	7	10	11
EU-8	4	10	10	8	8
The Region	1	5	5	6	6
The Region and Turkey	2	6	7	7	7
European Union (15)	5	6	6	8	8
Latin America and the Caribbean	3	3	2	3	3
Middle East and North Africa	4	5	5	4	n.a.
Africa	4	4	4	4	3
East Asia	2	3	3	4	3
South Asia	2	2	2	5	1

Source: IMF balance of payments.

TABLE 6.3

Imports of Services as a Share of GDP

Percentage

	1990	1995	1996	2002	2003
CIS (excluding Central Asia)		3	4	9	11
Central Asia		5	5	7	7
SEE	2	5	6	7	7
EU-8	3	7	7	7	7
The Region	1	4	5	6	6
The Region and Turkey	1	5	5	7	7
European Union (15)	5	6	6	8	8
Latin America and the Caribbean	3	3	3	4	4
Middle East and North Africa	8	8	8	6	n.a
Africa	7	8	8	6	4
East Asia	3	4	4	5	4
South Asia	2	3	3	4	1

Source: IMF balance of payments.

accompanied by any distinct pattern in the relative performance of services compared with goods imports.

Input-output tables for the year 2001, the latest available year for many of the Region's countries, provide information on differences in economic structure and the extent to which the countries have converged with comparable countries in the rest of world in regard to both intermediate services use and final demand, as well as on the service intensity of exports. Tables 6.4 and 6.5 report such information for a sample of the Region's countries for which input-output tables are available, drawn from the Global Trade Analysis Project (GTAP) database. Table 6.6 reports information on the sectoral intensity of exports: the direct contribution of agriculture, mining, manufactures, and services to total exports, expressed as a share of total exports. (Note that this export revenue includes services as well as goods exports). The data confirm that Albania, Croatia, and the Baltic States are much more services-intensive in their export structure than are other countries in the Region.

Another measure of services intensity of exports that can be derived from input-output information is the sum of the direct and indirect contributions made by all sectors to a unit of foreign exchange earnings, taking into account the linkages between activities. This can be calculated by taking the direct contributions by sectors to total exports and using the input-output structure to determine how much activity a unit of exports generates. Any export, whether of a good or a service, will generate demand for inputs from all other sectors of the economy.

TABLE 6. 4

Sectoral Intensity of Exports

Sectors' share of total export revenue (percentage)

	Agriculture/Food/ Mining	Manufactures	Services
Albania	19	35	46
Croatia	9	49	42
Czech Rep.	5	80	15
Hungary	7	76	17
Poland	10	73	17
Romania	4	85	10
Slovak Rep.	4	86	10
Slovenia	4	81	15
Estonia	11	66	22
Latvia	13	64	24
Lithuania	13	63	24
Russian Fed.	40	52	8
Memo:			
Greece	12	29	58

Source: GTAP input-output data derived from Social Accounting Matrices for 2001.

TABLE 6.5

Total Export-related Activity

Direct plus indirect linkages, 2001

	Total "Multiplier" (index)	Shares (%)			
		Agriculture/Food	Mining	Manufactures	Services
Albania	4.8	20	4	24	52
Croatia	2.9	18	1	36	45
Czech Rep.	3.0	10	2	61	27
Hungary	2.8	10	2	51	37
Poland	4.2	17	3	43	38
Romania	6.6	27	3	39	30
Slovak Rep.	2.9	12	3	57	28
Slovenia	2.9	10	1	58	31
Estonia	2.5	15	2	49	35
Latvia	3.0	17	1	36	47
Lithuania	3.5	17	4	36	42
Russian Fed.	3.6	14	17	30	39
Memo:					
Turkey	3.7	17	2	40	41
China	3.7	18	3	62	17
Malaysia	2.1	8	3	64	25
Germany	3.3	7	1	49	43

Source: GTAP input-output data derived from Social Accounting Matrices for 2001.

TABLE 6.6

Inward FDI Stock by Sector, Selected Countries in the Region

End-2003 unless otherwise indicated; shares in total stock (%)

Sector	Czech Rep. 2002	Hungary 2002	Poland 2002	Slovak Rep.	Slovenia 2002	Estonia	
Agriculture, forestry, fishing	0.1	1.3	0.4	0.2	0.0	0.4	
Mining and quarrying	1.4	0.3	0.3	0.8	0.0	0.4	
Manufacturing	35.5	45.8	35.8	37.5	43.3	18.2	
Electricity, gas, water supply	6.9	4.6	2.6	11.7	1.0	2.4	
Construction	1.9	1.1	2.6	0.7	0.1	2.5	
Distribution and repair services	11.9	11.1	17.1	11.2	14.5	15.9	
Hotels and restaurants	1.2	1.1	0.6	0.5	0.4	1.7	
Transport, storage, and communications	13.6	10.1	10.4	10.0	4.4	17.7	
Financial intermediation	15.9	10.3	21.3	23.5	18.8	28.1	
Real estate, rental, and business act.	9.3	11.7	7.5	3.2	15.2	11.4	
Education, health, social work	0.2	...	...	0.4	0.1	0.1	
Other community and personal services	2.4	...	...	0.3	0.5	0.8	
Other not classified activities	...	1.0	1.4	...	1.7	0.4	
Purchase of real estate by foreigners	...	1.5	...	...	...	...	
Total services share[a]	56.2	47.9	60.9	49.8	55.7	78.6	
Value of services FDI stock ($ bn)	26.7	22.9	36.8	5.6	2.8	5.1	
Services FDI stock as % of GDP	31.6	27.7	17.6	17.6	7.7	60.7	

Source: wiiw-WIFO database on FDI, July 2004 edition.

Note: a. Includes finance and business services. b. Covers all industry, including mining/energy. c. Includes hotels and restaurants. d. Not including utilities.
... = not available.

The extent to which such demand is for service-related activities provides another measure of the relative service-intensity of an economy. The results of such a calculation are reported in table 6.5, where (for convenience) activities are aggregated into four broad categories.

The first column in table 6.5 is the sum of the direct and indirect linkage effects generated by a unit of export revenue—it indicates the total activity generated by (going into) one unit of foreign exchange (exports). The average "multiplier" is 3.6 for the countries of the Region covered in the sample (that is, every dollar of exports generates $3.6 in economic activity, both direct and indirect demand). Of greater interest from a services-intensity perspective is how much of this is the result of services. On average, a little over one-third of this total activity is services-related, ranging from a high of 52 percent (Albania) to a low of 27 percent for the Czech Republic. Even taking into account the indirect linkage effects, Albania, the Baltic states, and Croatia are relatively services-intensive. However, many the Region's countries are more services-oriented than many developing countries such as China or Malaysia, two comparators reported in table 6.5. On this measure, they are rather similar to EU countries.

Balance of payments data provide no information on the origin and destination of trade. Given the absence of customs statistics—the source of such data for goods trade—it is very difficult to determine

	Latvia	Lithuiania	EU-8	Bulgaria	Croatia	Romania	Russian Fed. flow 2000–2002	Ukraine 2002
	1.5	0.8	0.5	0.3	0.3	0.7	0.4	2.1
	0.6	0.8	0.7	1.1	3.1	...	...	2.4
	15.5	31.1	37.0	33.4	30.6	54.3	45.0[b]	46.4
	3.4	4.4	4.8	1.0	1.1	...	...	1.6
	1.0	1.2	1.8	2.7	0.9	2.4	2.2	2.9
	18.0	17.9	14.0	18.0	6.9	16.4	22.0[c]	18.5
	1.3	1.6	0.9	1.7	4.0	2.4	...	2.3
	11.9	17.1	11.5	15.7	25.0	7.8	9.5	7.2
	15.0	15.7	17.5	17.7	24.6	...	1.8	8.1
	24.5	7.3	9.3	3.9	3.1	...	8.2	4.7
	0.1	0.2.	0.1	0.3	...	...	...	2.3
	1.1	1.5	0.8	0.8	0.5	...	0.2	1.5
	6.0	0.3	0.9	3.2	...	16.0[a]	11.0	...
	...	...	0.3	...	...	...	...	...
	78.9	62.8	57.1	65.2	64.9	45.0	54.6	47.5
	2.6	3.1	106.6	3.3	7.4	5.7	35.5	3.6
	26.8	37.8	...	16.6	26.1	9.4	8.2	7.3

who are the partners for the observed foreign exchange flows associated with services. A sense can be obtained of the origin and destination of services exports and imports by using data that should be highly correlated with certain types of trade in services. For example, telecommunications traffic is collected by telecom firms on a bilateral basis, and this should be closely correlated with Mode 1 trade. Similarly, the origin of tourist arrivals may provide information on Mode 2 trade. Finally, FDI data and immigration flows will provide some information on the geographic pattern of Modes 3 and 4 trade.

The available data for the Region on the origin and destination of travelers are very weak—statistics provided by the World Tourism Organization are very incomplete and not comparable across destination countries. One source of data that can be used to assess the origin and destination of trade in services is merchandise trade statistics, because these will by necessity be accompanied by transport services. (These were discussed in chapter 2.) The other source on origin and destination is telecommunications flows. These are reported in figure 6.4, for various subgroups of the Region's countries, for the year 2002. These data give an indication not only of the current situation but also of the change that has taken place since 1990 because before that, the presumption is that virtually all international telecommunications traffic would have taken place between the Region's countries, reflecting the closed nature of the economic regime.

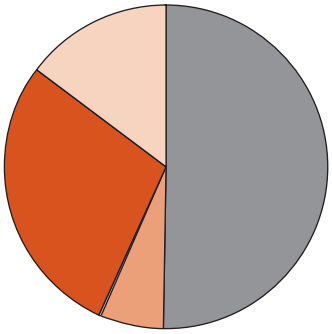
The telecom data reveal substantial differences in the origin and destination of "trade in services." For the Central and Eastern European (CEE), Southeastern European (SEE), and Baltic countries, the EU accounts for about 50 percent of all outgoing traffic, with the SEE share being slightly higher and the Baltic share slightly lower than this. The relative importance of the other countries of the Region, taken as a whole, varies greatly across these three groups: in the Baltics, other countries of the Region account for almost the same share in traffic as does the EU-15 (43 percent as opposed to 46 percent). In the SEE countries, other countries of the Region account for 20 percent of the total, as compared with 28 percent for CEE. Other (non-EU) OECD countries represent between 4 and 6 percent of outgoing traffic. Turkey is also an important destination (4.5 percent).

The pattern is quite different for the three other subgroups. Here, rather than CEE, SEE, or the Baltics, Russia in particular accounts for the lion's share of outgoing traffic, ranging from a low of 69 percent for the Caucasus to a high of 81 percent for the Central Asian countries. All of the Region's countries account for 77 percent of outgoing traffic on average for Russia, Ukraine, Belarus, and Moldova. The EU-15 represents 8 percent of total outgoing traffic for these four coun-

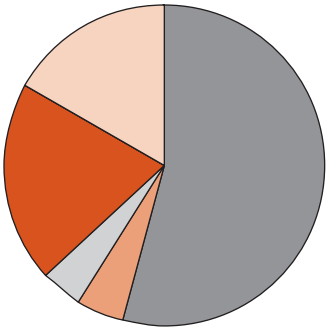
FIGURE 6.4

Bilateral Telecom Traffic, 2002

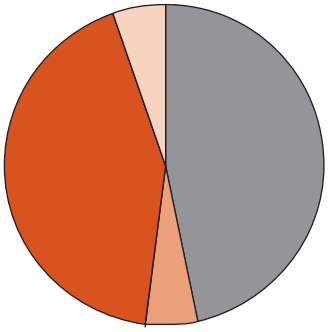
CEE, shares of destination areas in outgoing telecom traffic, 2002



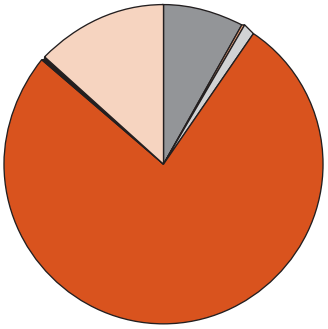
SEE, shares of destination areas in outgoing telecom traffic, 2002



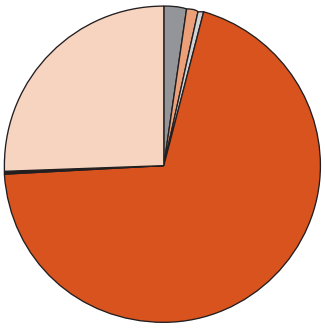
Baltics, shares of destination areas in outgoing telecom traffic, 2002



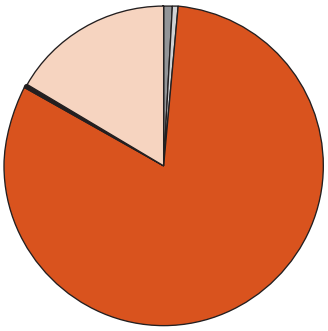
CIS (excl. CARs & Caucasus), shares of destination areas in outgoing telecom traffic, 2002



Caucasus, shares of destination areas in outgoing telecom traffic, 2002



Central Asia Republics, shares of destination areas in outgoing telecom traffic, 2002



EU-15 Non-EU OECD Turkey Region Middle East/Asia Not specified

Source: International Telecommunications Union.

tries; the EU-15 accounts for only 1–2 percent for most of the other CIS countries. Similarly, other OECD countries account for only negligible shares. While it should be noted that some of these CIS countries report relatively large shares of outgoing traffic as "not specified," so that it is not clear whether the outgoing share toward OECD countries or Asia is actually as low as is reported, the data do show unambiguously that there has not been much diversification away from traditional partners in much of the CIS. In contrast, there has been a very marked shift away from other countries in the Region, in particular Russia, in the CEE and SEE countries.

FDI in Services in the Region

Given that services trades (sales) often require proximity between service provider and consumer, FDI is an important mode of international trade in services. For the countries of the Region, FDI is an important avenue through which to acquire access to best practices and new service varieties and technologies. There are substantial differences across the Region's countries in the pattern of services vs. nonservices FDI, as well as in terms of the magnitude of FDI inflows.

Table 6.6 reports data on the share of services in total inward FDI in the Region for countries for which these data are available.[3] Overall, services account for some 62 percent of the stock of FDI in the reporting countries—that is, services FDI tends to reflect closely the prevailing share of services in the GDP of OECD countries. Finance, transport, communications, and distribution services account for the largest share of this FDI. The intensity of FDI in services is highest in the Baltic states, presumably reflecting their relatively small size and limited manufacturing base, and lowest in Romania and Ukraine. In the case of Estonia, financial services are the number-one sector for FDI, including nonservices sectors, while for Latvia, business and real estate services are the largest sector.

In general, the EU-15 generate about 80 percent of inward FDI into the Region's countries, with Germany, the Netherlands, and Austria generally being among the top three foreign investors (see also chapter 7). Geographic proximity and historical links play an important role in some instances—for example, Sweden and Finland are major investors in the Baltics, France has large shares in FDI inflows into Romania and Poland, and Greece in Bulgaria. For Russia, Ukraine, and resource-rich Central Asian Republics, FDI from the United States is important—the United States is the major investor in both Russia and Ukraine. As can be seen from table 6.6, services FDI

is also very high as a ratio of GDP in the Baltic states, is highest in the Czech Republic among the CEE states, and is lowest in Romania, Russia, and Ukraine. Croatia, the only SEE country for which such data are available, also has a very high share of services FDI, consistent with the high service intensity of its exports.

The pattern that emerges is similar to that suggested by the services trade data—there is a distinct difference between the EU-8 states and the Central Asian Republics. The former have attracted large flows of services FDI, whereas the latter have not. The magnitude of the associated capital inflow is significant in the former countries, with Estonia and Lithuania being the outliers. Given that FDI in services can be expected to be associated with new technologies, higher service standards, and more effective delivery—as illustrated by the indexes discussed below—these inflows help to explain both the observed higher labor productivity performance in services noted earlier and the aggregate growth performance of these countries.

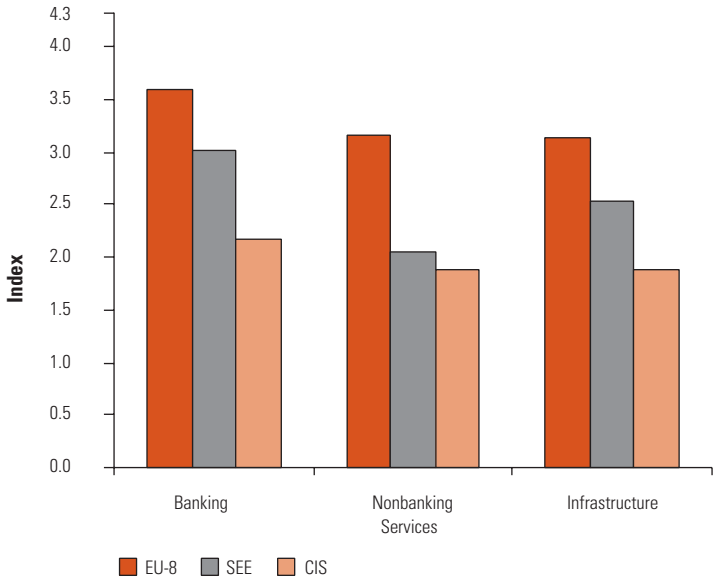
Policy Stances and Reform Progress

Services sector reform involves a mix of deregulation (the dismantling of barriers to entry and promotion of competition) and improved regulation (putting in place an appropriate legal environment, strengthening regulatory agencies and increasing their independence and accountability, and ensuring universal access to key services). The policy challenge is to achieve a balance between traditional regulation and the introduction of competition (see chapter 4). Much has been done by countries in the Region to reform and adapt policies and regulatory regimes for services industries. Figure 6.5 plots three indicators of the extent of policy reform for banking, nonbank financial services, and infrastructure. In all three cases, the value of this index is set at zero for 1989. Thus, the 2004 value of the index provides a measure of the progress that has been made by countries in converging to "best-practice" standards—measured by a maximum value of 4.3. Box 6.2 discusses the construction of these indexes.

The EU-8 (the CEE and the Baltic countries) have made the most progress on all three fronts. For the other country groups, there is significant variation across the three indexes. SEE has advanced the most on reforms in banking and infrastructure, followed by the Caucasus. Belarus, Moldova, Russia, and Ukraine have done the most in the nonbank financial area, followed by SEE. The Central Asian Republics have made the least progress in all three areas, with one country—Turkmenistan—not advancing at all in any of the three areas.

FIGURE 6.5

Services Reform Index, 2004



Source: EBRD 2004a.

BOX 6.2

The EBRD Reform Indexes

The index ranges from 1(little progress) to 4.3 (most advanced implementation of reform agenda).

Banking and interest rate liberalization: A 4.3 means full convergence of banking laws and regulations with Bank for International Settlement (BIS) standards, provision of full set of competitive banking services.

Securities markets and nonbank financial institutions: 4.3 means full convergence of securities laws and regulations with International Organization of Securities Commissions (IOSCO) standards, fully developed nonbank intermediation.

Infrastructure: average of the following five infrastructure reform indicators:

- *Electric power*: 4.3 means tariffs are cost-reflective and provide adequate incentive for efficiency improvements. Large-scale private sector involvement in the unbundled and well-regulated sector. Fully liberalized sector with well-functioning arrangements for network access and full competition in generation.

What follows provides an overview of the state of reform in services sector policy regimes, with a particular focus on banking, telecommunications, and other utilities and infrastructure services. A more detailed overview of the stance of policy reforms in banking and telecommunications and their evolution over time can be found in annex tables 6.1 and 6.2.

Banking

The banking sector in the EU-8 countries is characterized by small shares of credit allocated through state-owned banks, high foreign participation, and stronger regulatory regimes. Evidence from these countries indicates that foreign banks have been contributing to the modernization of the sector. Bottlenecks relevant to sustained financial development do, however, often persist within the legal framework (tax system, creditor rights, and the bankruptcy code). Central bank independence has also been strengthened in most of these countries. Cukierman, Miller, and Neyapti (2001) use a measure of

- *Railways*: 4.3 means separation of infrastructure from operations, and freight from passenger operations. Full divestment and transfer of asset ownership implemented or planned, including infrastructure and rolling stock. Rail regulator established and access pricing implemented.
- *Roads*: 4.3 means fully decentralized road administration. Commercialized road maintenance operations competitively awarded to private companies. Road user charges reflect the full costs of road use and associated factors, such as congestion, accidents, and pollution. Widespread private sector participation in all aspects of road provision. Full public consultation on new road projects.
- *Telecommunications*: 4.3 means effective regulation through an independent entity. Coherent regulatory and institutional framework to deal with tariffs, interconnection rules, licensing, concession fees, and spectrum allocation. Consumer ombudsman function.
- *Water and wastewater*: 4.3 means water utilities fully decentralized and commercialized. Fully autonomous regulator exists with complete authority to review and enforce tariff levels and quality standards. Widespread private sector participation via service/management/lease contracts. High-powered incentives, full concessions, and/or divestiture of water and wastewater services in major urban areas.

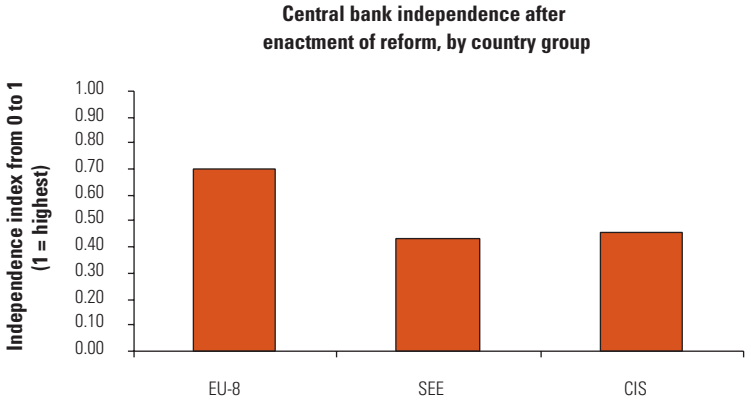
Source: EBRD 2004a.

independence called LVAW with 16 weighted components. As figure 6.6 shows, the degree of independence in the eight new EU member countries has converged toward the level achieved by the German Bundesbank during the 1980s. All of other countries in the Region, however, fall substantially short of the most advanced ones. Note that this indicator reflects only legal, not actual, independence. If the latter were to be taken into account, the picture would look even more pronounced. The Central Bank of Belarus, for instance, has a high degree of legal, but a low degree of actual, independence.

Banking markets in the vast majority of CIS countries, as well as in some SEE countries, tend to be relatively closed in both a formal and an informal sense. Nevertheless, Armenia's financial sector is rather open and sound, underlining that this country is the reform engine of the Region in financial services. Belarus, in spite of its relative proximity to the EU, is one of the least advanced countries in that sense, as are some Central Asian countries. While actual or potential limits on foreign participation (globally or in an individual bank) do play a role in some countries, bureaucratic impediments seem to play a more prominent role in inhibiting foreign participation. Among the factors reported are limitations on bringing in foreign staff, lengthy licensing procedures, financial repression, public ownership of major banks, and inadequate regulatory practices. In general, the banking sector in these countries suffers from weak capital bases and lack of confidence. These impediments to financial development are reflected in figure 6.7, which illustrates that the depth of the banking sector has developed accordingly. Again, the EU-8 countries fare best. Box 6.3 discusses in somewhat greater depth the impacts of policies that restrict

FIGURE 6.6

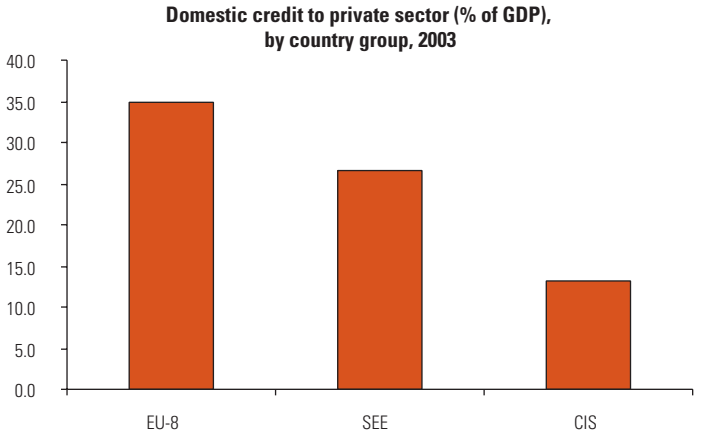
Central Bank Independence



Source: Cukierman, Miller, and Neyapti 2001.

FIGURE 6.7

Financial Sector Performance



Source: WDI 2004.

foreign providers' access to the financial sector, based on the experience of Russia.

Regulated Utilities

Regulated utility and infrastructure services such as telecommunications can play an important role in fostering (or deterring) international integration because they can greatly affect the transactions costs of international exchanges. Their cost, quality, and accessibility become central to international integration. Although much reform progress has been made in some of the Region's countries, significant challenges to the efficient provision of utility and infrastructure services to firms and consumers in the Region remain. In part, current problems have their roots in the obsolescence of equipment resulting from perverse investment incentives that linger from the era of central planning and the concomitant disrepair after the fall of Communism. The key challenges include tackling regulatory problems in the provision of utility and infrastructure services, which have been subject to extensive cross-subsidization, inefficient pricing, poor revenue collection, insufficient separation of industry branches, and overall poorly designed regulatory frameworks. These problems led to distortions in the development and operation of utility and infrastructure services markets and stifled needed investment in the Region.[4]

The lack of competition in specific segments of these markets in most of the national economies of the Region signals an urgent need for institutional and structural reform. The rules and institutions established in each country that govern these services are important

BOX 6.3

Foreign Participation in Russia's Banking System—Experiences and Perspectives

Since the late 1980s, the Russian banking system has undergone fundamental changes. So far, these changes do not include a sustained opening of the sector to foreign participation. The prospect of WTO accession, however, puts the topic back on the agenda. It is therefore worth taking a brief look at respective past and future policy changes, as well as their impact on the sector and the entire economy. As a first step, however, a look at the general financial-sector background against which market opening occurs seems useful. Reforms in the banking sector go back to 1987, when first attempts at establishing a two-tier banking system were made with the registration of special state and commercial banks. In the early 1990s, this process continued under the auspices of the Russian Central Bank and a large number of commercial banks emerged in a short time. Growing private demand for credit and low-cost liabilities attracted new market entrants. Most banks, however, were inefficient and managed to survive only because of low returns on deposits. The financial crisis that took off in August 1998 disrupted the process of financial deepening. The government failed to service its debt, the ruble devalued, and creditors panicked. As a result, households and nonresident creditors suffered substantial losses, whereas the real economy was hardly affected. As a matter of fact, banks' assets were not too heavily involved in the production side of the economy. Postcrisis market consolidation was weak and primarily affected banks with a high share of foreign liabilities. Instead, insiders often stripped and recycled assets. After the crisis, financial services again became more concentrated in state-owned banks, which were most heavily involved in funding production activity. In 2000, for instance, state banks were given special privileges such as implicit guarantees, capital injections, and preferential funding sources.

Positive economywide fundamentals, as well as risk-averse strategies adopted by banks, subsequently improved financial health in general. Improvements in the legal and regulatory framework are under way. Deficiencies in depositor protection, however, have remained in place. This

because they affect service delivery and the size and nature of the market in which they are supplied. The regulatory framework needs not only to reflect the cost of, and demand for, these infrastructure services, as well as the rate of technical progress in the field, but also to ensure equal access and prevent domination by incumbents in many portions of the market. Regulatory institutions affect the scope for competition by opening segments of these markets to privatization and liberalization (see World Bank 2004h).

Introducing competition into these sectors has brought about increased efficiency in the provision of regulated utility and infrastruc-

fact helped trigger a minor run on deposits following the closure of a bank in mid-2004. This, along with a weak capital base and the prevalence of short-term liabilities, poses important policy challenges. Foreign banks increased their market share in the wake of the financial crisis. They became a haven for both domestic and international depositors. In spite of these favorable conditions, their market share never significantly exceeded 10 percent. Even though the policy regime is formally liberal, market access is not easy. Licensing discrimination, practices and subnational regulations violating federal law, abuse of power, and other problems have been noted in the entire services sector. In financial services in particular, the federal law on "Banks and Banking Activity of 1996" allows the Central Bank to impose a ceiling on the total amount of foreign capital as a share of total bank capital in Russia. In addition, since 1997, the Central Bank has required of foreign banks that at least 75 percent of their employees and 50 percent of their management board be of Russian nationality. Heads of foreign banks' Russian offices are required to be proficient in Russian. There are other restrictions requiring work experience in the country. These issues are currently subject to WTO negotiations.

Potential benefits of liberalizing the sector are manifold: more foreign presence provides enterprises with easier access to cheaper, long-term financial resources. The net return to capital increases, which fosters capital accumulation and improves the investment climate. Both quality and quantity of financial services may improve. The financial sector's capital base increases and deposits become safer and more long-term. More efficient credit allocation may imply the adoption of better production technologies, which may spill over into the whole economy. This has a positive effect on total factor productivity. Jensen and Tarr (2004) estimate the welfare gains from Russian WTO accession to amount to between 3.3 and 11 percent of GDP in the medium and long run, respectively. They assert that most of these gains would result from the liberalization of barriers against FDI in the services sectors. A negative implication is the likely squeeze of Russian commercial banks by foreigners and state-owned banks, which receive high international credit ratings. The commercial banks may be taken over by foreigners, leaving the rest of the sector in the hands of the state.

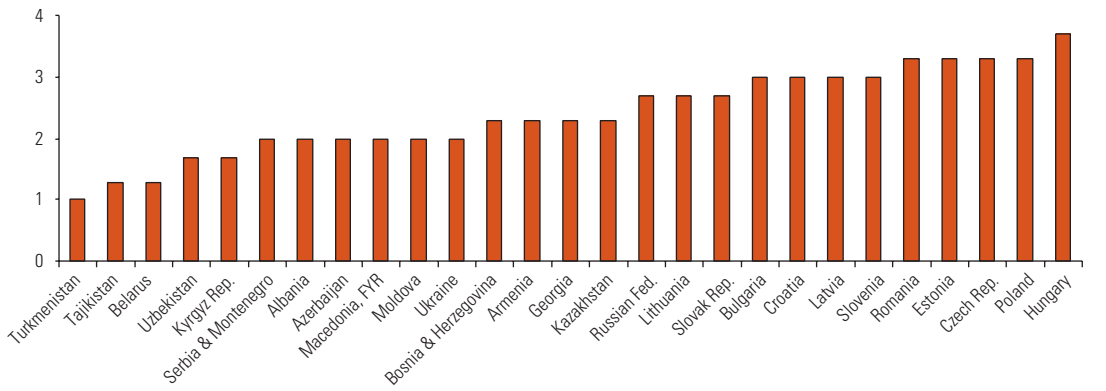
Sources: Vedev 2004; Jensen and Tarr 2004; Mikhailov et al. 2001.

ture services in the Region. Two main reforms have been responsible for this: (i) allowing entry of new domestic (or foreign) infrastructure providers; and (ii) opening the domestic market to imports of such services. Complementary to the issue of entry into these industries is the process of change of ownership. Privatization of utilities and infrastructure service providers is, however, not a necessary condition for improved efficiency in the provision of these services. The incumbent provider might remain state-owned, but as long as the regulator allows for the entry of new providers into the market, such competition can yield efficiency gains in the industry overall (see EBRD 2004a).

The experience to date of countries in the Region in developing modern regulated utilities and infrastructure services providers has been quite mixed. The EBRD index for these sectors reveals the heterogeneity found in the Region (figure 6.8).[5] The index shows little or no progress in utility and infrastructure reform in Belarus, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan as opposed to the advancements made in the Czech Republic, Estonia, Hungary, Poland, and Romania. The relatively high rankings of Bulgaria, Croatia, the Kyrgyz Republic, Romania, and Russia reflect the growing recognition and actions by the governments in these countries to invest efforts in crafting better regulation, commercialization, and tariff reform for the effective provision of utility and infrastructure services. Figure 6.9 disaggregates the infrastructure index along five sectoral dimensions—electric power, roads, railways, telecommunications, and water and wastewater—and assesses the cumulative reform progress in each of the Region's countries. On average for the Region, progress has been most pronounced in the sectors of telecommunications and electric power. These higher rankings are likely a result of commercialization, including deregulation and the successful privatization of the national telecom companies (see below).

In the telecommunications sector, fixed-line services are still quite underdeveloped in most of the Region's economies. This has given rise to a faster growth of, and stronger competition in, the mobile services sectors. As can be seen in figure 6.10, however, this holds pri-

FIGURE 6.8
Index of Infrastructure Reform, 2004

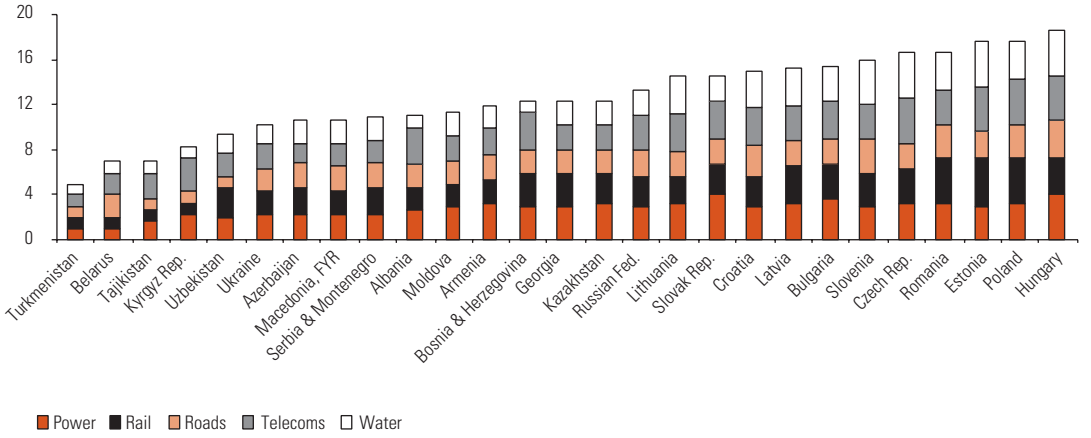


Source: EBRD 2004a.

Note: The ratings are calculated as the average of five infrastructure reform indicators covering electric power, roads, railways, telecommunications, and water and wastewater. See box 6.2.

FIGURE 6.9

Infrastructure Reform, by Country and Sector, 2004



Source: EBRD 2004a.

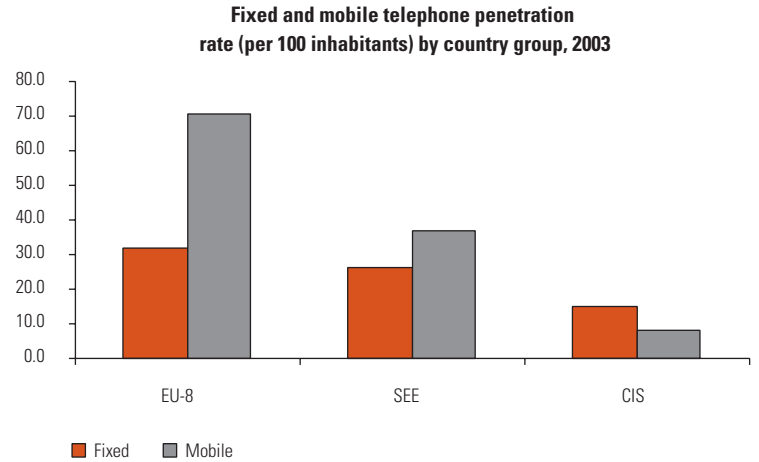
Note: Each indicator ranges from 1 to 4.3, with 1 representing little or no change from a rigid centrally planned economy, and 4.3 representing the standards of an industrialized market economy. The scale ranges from 0 to 20, representing the cumulative progress for each country. For a detailed classification system for the five indicators, refer to the EBRD Transition Report 2004, p. 200.

marily for the EU-8, and to some extent for SEE. In the rest of the Region, mobile penetration rates fall short of even fixed-line services.

In many countries in the Former Soviet Union, independent telecom regulators have yet to be established. Although regulatory independence is also compromised in some EU-8 countries, this adversely affects fixed-line services, where competition requires network access. Interconnections between different operators should be pro-

FIGURE 6.10

Telephone Services



Source: EBRD 2004a.

moted. The incumbent fixed-line operator often impedes the conclusion of interconnection agreements with other providers. Tariffs are low and distorted in many countries. There are cross-subsidies between different types of calls and customers. These issues will have to be tackled in the future, taking into account social concerns about low-income groups.

On average, the least progress has been made across the Region in the rail, road, and water sectors. Reforms in road transport appear to be lagging behind the railway sector in many countries. Private sector participation remains limited. Only some EU-8 and SEE countries, such as Croatia, Hungary, and Poland, have introduced private sector participation through toll roads. Success, however, has been mixed so far because of traffic diversion to alternative roads and high risks associated with private investment. Toll-based concessions in Hungary have been converted into payments to the private investors via the public budget. This transfers traffic risk back to the state while maintaining the character of the public-private partnership. Reforms in the railway sector are also at an early stage in terms of private sector participation, although the separation of infrastructure from operations is either planned or has been put in practice in many countries.[6] The EU-8 countries have in theory adopted EU standards of open access, although implementation has been lagging. The challenges to reform of the water sector are illustrated in box 6.4 for the case of Albania, but the messages are pertinent for many other of the Region's countries.

Regulatory Reform, Privatization, and International Integration

Case-study research in various countries in the Region documents that improvements in transport have been crucial for enhancing the movement of goods from one country to another; that progress in reform of telecommunications and the role of the Internet have provided a low-cost channel for supplier and customer searching internationally and the conduct of related transactions; and that financial-service reforms have facilitated cross-border payments for goods and services (for case-study work on Russia, see Broadman [2002] and for Southeastern Europe, see Broadman et al. [2004]).

The modest (or small) size of some the Region's countries can create a challenge to exploit the economies of scale and scope—and hence reduced costs—that often are generic to the provision of utility and infrastructure services. Cross-border supply of such services—that is, through imports—can provide opportunities to realize such economies. For example, a firm operating in one of the Region's

BOX 6.4

Challenges in Water Reform in Albania

Albania faces acute challenges in watershed and flood management; water sanitation; irrigation and drainage; and management of lakes, wetlands, and coastal areas. The country also lags in institutionalizing a framework with broad stakeholder ownership and water services delivery institutions. The government did not liberalize the national uniform water supply tariffs until July 1998, when it established the Utility Regulatory Commission, with tariff-methodology and tariff-setting powers. However, even then the allowed tariff for many local water utilities was well below the requested one. The country continues to experience water problems resulting from outdated supply and sanitation systems and from sluggish progress with reforms. In Tirana, more than 50 percent of the water is lost because of leakages and illegal connections. In the urban areas, some 40 percent of the population has a sewerage connection, and around 80 percent has access to piped water. Although the privatization of the water sector has started, major efforts are needed in modernizing and maintaining the sector.

Source: World Bank 2003i, "Water Resource Management in Southeast Europe," and EU Stabilization and Association Report Albania 2003.

countries might find it cheaper to purchase electricity through wheeling from a provider based in a neighboring country (or even farther away) rather than from a utility based in the home country. With the heterogeneous resource endowments and variation in market sizes across the countries in the Region, the potential benefits of creating a regional market for the provision—and hence regulation—of infrastructure services might well be substantial. Box 6.5 discusses the experience of the SEE countries and Turkey in establishing a regional energy market.

Privatization of utility firms is another channel through which deregulation and infrastructure reform and international integration are linked. While there are some (in fact, quite few) cases where FDI in these sectors has taken the form of greenfield investment, the vast majority of FDI inflows associated with these sectors in the Region has been through the privatization process.[7] Not surprisingly, the extent of privatization activities varies tremendously by country and sector, as presented in figures 6.11 and 6.12. The EU-8 countries are the leaders in attracting FDI in the utilities sectors, with more than $30 billion in cumulative FDI inflow for the period 1992–2003. The SEE countries as a sub-Region have attracted the least. From a sectoral perspective, the highest revenues have come from the privatization of telecommunications companies in the Region, followed by

BOX 6.5

Benefits and Challenges to a Regional Energy Market in SEE and Turkey

The international community's support for Southeastern Europe (SEE) within the energy sector has gradually shifted from emergency support and efforts to address reconstruction needs to a more coordinated regional long-term approach. With the SEE Electricity Regulatory Forum initiative, the European Commission has proposed a coherent vision with respect to the development of a competitive regional energy market. It has set the basis for the Region's electricity standards to catch up, in the medium to long term, with the standards of the European Union. This initiative proposes that countries open their national electricity markets by 2006. This regional market will be based on the principles of the European Commission's Electricity Directive (96/92) and the relevant secondary legislation. The intended result will be that the electricity systems and companies of the Region will participate fully in the internal electricity market of the European Union.

The benefits of the process potentially include increased reliability in electricity supply; lower operating costs; reduced needs for additional-capacity investments, especially in generation; improved opportunities for intra- and interregional trade, including peak load by hydroproducers in the Region; and lower prices for the end customers. However, the challenges entailed in the transition to the new systems are considerable. They include adopting numerous new laws and regulations; setting up independent regulatory agencies; training personnel; and introducing new business concepts and practices, stranded assets, and protection of the poorest customers.

Under a memorandum of understanding, which was signed in Athens in 2002, all SEE countries, together with Turkey, have committed to undertaking steps toward opening their energy markets. These steps include adopting energy strategies; setting up independent regulators; unbundling industry; and developing grid codes, cross-border transmission pricing, congestion management principles, and trading and commercial codes. Markets for eligible customers are expected to be open by 2007.

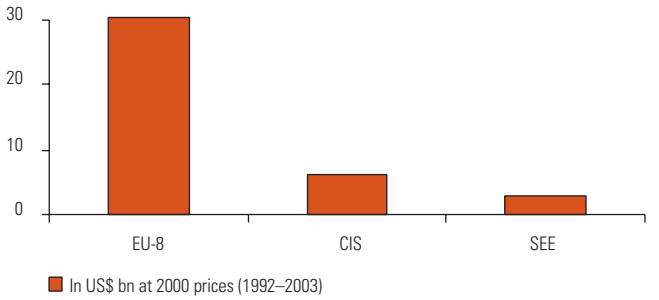
Source: Adapted from Broadman et al. 2004.

proceeds from gas and power transmission privatizations. Transport and water services privatization has generated the smallest revenues for the Region in comparison with the other utilities sectors.

Further liberalization of access in telecom markets by foreign providers of telecommunications services—especially through FDI—would generate substantial gains for the countries concerned. Recent analysis for Russia, for example, concludes that this could increase Russian real consumption by 1.6 percent (see box 6.6). While private sector participation is relatively developed in telecommunications in

FIGURE 6.11

Utility Privatization Proceeds in the Region, by Sub-Region, 1992–2003

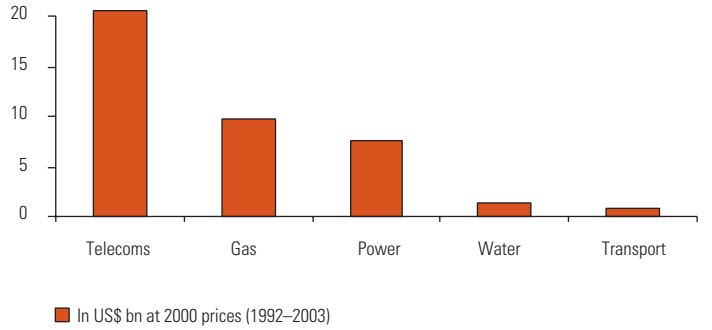


Source: EBRD 2004a.

Note: Includes telecom, gas, power, water, and transport proceeds from privatization.

FIGURE 6.12

Utility Privatization Proceeds by Sector for the Region, 1992–2003



Source: EBRD 2004a.

many transition economies, in the CIS, there is less progress in opening the sector to private investors and in reforming the sector's policy framework. State control and monopolies still prevail in fixed-line services in many of the countries in question. Where privatization of incumbents has occurred, its objective has often been the maximization of revenue. As a result, private investors were granted monopoly status for significant periods of time. Armenia, for instance, provided its Greek investor with a 15-year exclusivity clause.

International experience suggests that countries that have had the objective of maximizing privatization revenues or a desire not to be accused of getting a price that is "too low" have tended to grant whole or partial monopoly privileges to new private incumbents. This can come at the expense of future improvements in the network, as well as high prices that over time will generate high profits for the owners of the firms.[8] Empirical evidence indicates that what matters most is

BOX 6.6

The Gains from Foreign Direct Investment in Service Sectors

A growing body of evidence and economic theory suggests that the close availability of a diverse set of business services (like telecommunications services) is important for economic growth. Liberalization of barriers to foreign direct investment in services plays an important role in this regard, especially in sectors such as financial services and telecommunications. The key idea is that a diverse set (or a higher-quality set) of business services allows users to purchase a quality-adjusted unit of business services at lower cost. As services markets are opened to foreign entry (FDI), domestic businesses and consumers will have improved access to services—whether they are telecommunications, banking, insurance, transportation, or other business services. This will lower the cost of doing business and increase the productivity of the economy.

Research suggests that liberalization of barriers to FDI in services may generate gains that substantially exceed those that come from merchandise trade liberalization undertaken in isolation. In the case of Russia, for example, recent analysis concludes that opening access to services FDI in the context of accession to the WTO will generate about three-quarters of the total gains to Russia from WTO accession in the medium term—an increase in consumption of some 6 percent —because the ad valorem equivalent of barriers to FDI is a multiple of the average tariff on imports of goods. Estimates for Russia of the tariff equivalent of barriers to FDI in services average around 33 percent for nontransport services and some 80–90 percent for air and maritime transport (Jensen and Tarr 2004).

Among the key restrictions against foreign telecom suppliers in Russia are that (i) Rostelekom maintains a monopoly on long-distance fixed-line telephone services, (ii) affiliate branches of foreign banks are prohibited, and (iii) there is a quota on the multinational share of the insurance market. The protocol on Russian accession signed between the European Union and Russia on May 21, 2004, calls for the termination of the Rostelekom monopoly by 2007 and allows for an increase in the upper limit of the multinational share of the Russian insurance market. Jensen and Tarr (2004) conclude that elimination of barriers to FDI in telecommunications alone will result in a gain in Russian consumption of 1.6 percent (conversely, if Russia were not to lower barriers to FDI in telecommunications, the gains to Russia would be reduced by 1.6 percent of Russian consumption). Thus, reduction of barriers to FDI in telecommunications is one of the more important actions Russia could take in order to improve Russian real income.

Source: World Bank staff.

competition in markets and the incentives confronting management of monopoly providers, not ownership. Indeed, countries that first privatized network service providers (such as telecoms) and then gradually opened up the market to competition saw worse performance of the sector in terms of service delivery—for example, the num-

ber of fixed lines added to the telecom network—than that of countries that introduced competition immediately (Fink, Mattoo, and Rathindran 2003).[9] The penetration rates in most of the CIS countries, as opposed to the EU-8, where privatization and market opening were more synchronized, confirm this. In Latvia, the partial privatization with exclusivity clause lasting till 2013 was therefore converted into a faster market opening (2003 instead of 2013).

Regulatory Effectiveness and Rate Structures

The effectiveness of the regulatory process is critical when establishing competitive markets. Another key aspect is the structure of rates and other elements of the pricing schemes for the provision of the services. Enhancing regulatory efficiency is uneven in the Region, not only across the countries, but also among the sectors within a country. The literature increasingly focuses on several dimensions of an effective regulatory system: coherence, predictability, capacity, independence, accountability, and transparency (see EBRD 2004a). Table 6.7 summarizes achievements in regulatory effectiveness in each country of the Region[10] across four sectors (electricity, railways, telecommunications, and water) along one of the dimensions of regulatory efficiency: establishment of an independent regulator. These data suggest that the Czech Republic, Estonia, Latvia, Poland, and the Slovak Republic have made the most progress in this area, whereas many of the CIS countries have made very poor progress. The SEE economies are somewhere in between.

Nevertheless, even with an independent regulator, the difficult challenge facing a national government is to endow that entity with technically competent people and give those people the authority and budget needed to effectively implement the entity's mandate—a problem common in many of the countries in the Region. In this regard, some case studies are telling: there are only five employees in the recently established electricity regulator in FYR Macedonia, compared with several hundred in some of the EU-8 countries. Less than $100,000 was budgeted for the creation of an independent electricity regulator in the Kyrgyz Republic, in comparison with several million dollars in the EU-8.[11] Thus, assessing overall regulatory effectiveness needs to take into account the interrelationships among the various dimensions. The EBRD (2004a) provides an assessment of the five other dimensions of regulatory efficiency for these countries and sectors.

The effective provision of regulated utility services also requires the establishment of tariffs that both reflect costs and take into account differences in value of service across customer classes (Vis-

TABLE 6.7

Indicators of Regulatory Effectiveness in the Region, by Country, 2004

Country	Electricity (year autonomous regulator established)	Railways (autonomous regulator)	Telecommunications (year autonomous regulator established)	Water (decentralized)
Albania	1996	No	1998	No
Armenia	1997	No	Planned	Planned
Azerbaijan	—	No	Planned	Planned
Belarus	—	No	—	No
Bosnia	2004	No	2001	No
Bulgaria	1999	No	2002	Planned
Croatia	2002	Planned	2002	Full
Czech Rep.	2001	Yes	2000	Full
Estonia	1998	Yes	1998	Full
Serbia and Montenegro	Planned	No	—	Partial
Macedonia, FYR	2003	No	—	Partial
Georgia	1997	No	2000	Partial
Hungary	1994	Planned	1993	Full
Kazakhstan	2002	Yes	2002	Partial
Kyrgyz Rep.	1996	No	2001	No
Latvia	1996	Yes	2001	Full
Lithuania	1997	No	2001	Full
Moldova	1998	No	2000	Partial
Poland	1998	Yes	2002	Full
Romania	1999	No	2002	Full
Russian Fed.	2004	Planned	2004	Partial
Slovak Rep.	2001	Yes	2000	Full
Slovenia	2001	No	2001	Partial
Tajikistan	—	No	Planned	No
Turkmenistan	—	No	—	No
Ukraine	2000	No	—	Partial
Uzbekistan	2000	No	—	Partial

Source: EBRD 2004a.

Note: — = not available.

cusi, Vernon, and Harrington 2000). There are two main regulatory mechanisms—rate-of-return regulation and price-cap regulation—for establishing pricing rules.[12] The choice depends on a variety of country and sector characteristics, including the quality of cost accounting and auditing systems, the availability of economic and technical expertise, the institutional checks and balances, and the investment requirements of the regulated sectors.

In light of the scarce technical expertise and severe informational problems in many of the Region's countries, utilities must set up clear regulatory goals and simplify administrative procedures as much as possible. The role of the regulator can be limited to imposing floors on prices to protect against predation and imposing ceilings on prices to protect against monopolistic behavior. These floors and ceilings should be based on an economic analysis of costs or on appropriate

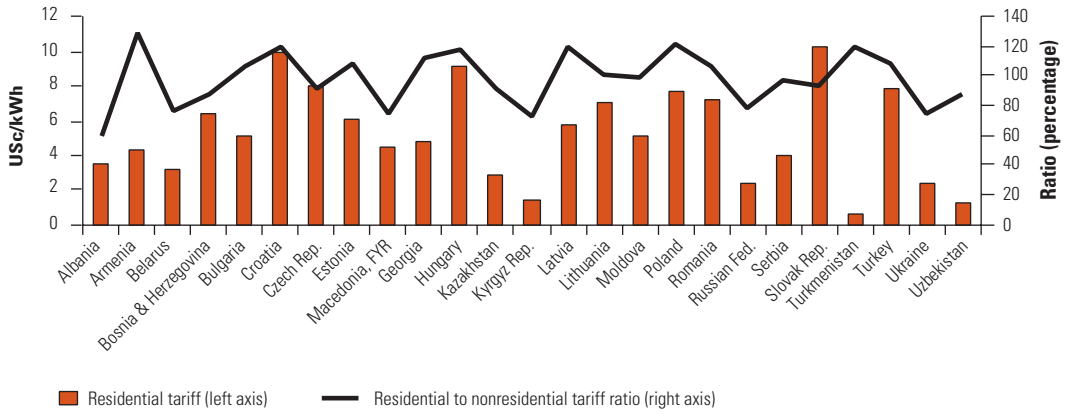
international benchmarks. In the final analysis, in order to ensure that real sector businesses behind the border face "hard budget constraints" to foster efficiency, productivity, and international competitiveness, in accordance with the discussion in chapter 4 and above, prices charged to them for utility and infrastructure services generally should be subsidy-free; at the same time, payments should be made to the utility and infrastructure services providers in full and on time.

In many of the Region's countries, cross-subsidization is evident in the rates charged for various utility services. For example, local calls are essentially free, while international calls are very expensive (by international standards) in many CIS countries. Cross-subsidization is also practiced among customer groups. For example, railway companies in Russia cover their losses from passenger traffic by using revenues collected from freight customers. Figure 6.13 illustrates that cross-subsidization in the electricity sector, for example, prevails in about one-half of the countries in the Region. Generally, industrial consumers, many of whom have the ability to switch fuels or operate with interruptible service, should be charged lower tariffs in comparison with their residential customer counterparts.[13] This is not the case in 13 of the Region's countries.

Finally, there is the issue of rate setting for cross-border sales of utility services. If the market structure for such utilities services is competitive, then, ultimately, the utilities' international and domestic prices would have a tendency to converge on a regional level, should the necessary economic investments in transmission or transportation networks be undertaken and if prices are subsidy-free. In the case of

FIGURE 6.13

Cross-Subsidization in the Electricity Sector in the Region and Turkey



Sources: EBRD 2004a. Data for Bosnia and Herzegovina and Turkey are World Bank staff estimates.

Russia, however, dual pricing of natural gas might prove to be the most beneficial option for the country as long as the internal domestic price of natural gas is close to the long-run marginal costs and subsidy-free. This has meant a doubling of the domestic price of natural gas in Russia. However, the export price of the country's natural gas to Europe was, up until recently, about five times the Russian domestic price, and price convergence would not have been beneficial to the world's largest gas exporter. Taking advantage of its natural economic power on the international gas market, Russia should be able to benefit from charging export prices on European markets that are different from its domestic ones. Box 6.7 discusses the economics of gas pricing in Russia.

BOX 6.7

Dual Pricing of Russian Natural Gas

Within the context of Russia's WTO accession, some WTO members had sought a commitment by Russia to unify gas pricing—in other words, to align the prices charged for gas in the domestic market and the prices charged to customers outside Russia. The World Bank undertook an examination of the economic effects of gas pricing on Russia and on its major consumers and concluded that it is not in Russia's interest to introduce unified pricing of natural gas.

Russia is endowed with very significant natural gas resources. Its proved reserves of 47 trillion cubic meters represent about 27 percent of the world's proved reserves. Its 2003 production of 579 billion cubic meters (BCM) constituted 22 percent of world production and its reserves-to-production ratio is in excess of 80 years, higher than any other major producer. Russia is also by far the world's largest exporter of natural gas. In 2003, it exported about 134 BCM to Europe and Turkey and about 40 BCM to CIS countries.

It is in Russia's interest to try to maximize the overall revenues associated with export volumes. Russia can achieve this through a combination of prices and volumes. Two factors, however, constrain the volumes that can be delivered to export markets. In the medium term, the primary constraint is the availability of transportation facilities. This constraint provides a current incentive for Russia to maximize the sales price to export markets. The transportation constraint can be overcome, which would create increased capacity to deliver gas. However, Russia would then run up against the second constraint, which is the absorptive capacity of the markets. Russia's proven reserves are sufficient to support a doubling, or even tripling, of its production capacity. In order to absorb this volume of gas, markets in Europe would have to increase dramatically. As a result, Russia would not be able to sell significantly more natural gas in Europe without applying substantial downward pressure on the price there. Russia would thus face a trade-off between the added revenues from additional sales of gas and the lost revenue resulting from lower prices.

Trade Agreements: EU Accession, Regional Cooperation, and the WTO

The overall picture emerging from the preceding analysis is one of a clear clustering of countries and sectoral reform progress, as well as number of outliers. While sectoral policies are roughly equally advanced in all EU-8 countries, the Baltics fare somewhat better in horizontal policies relevant to foreign activity such as the bankruptcy code (see annex tables 6.1 and 6.2); in some CEE countries, these horizontal impediments contain the progress made in sectoral policies. In much of SEE, there has been less, but still substantial progress,

These two factors will effectively constrain for the foreseeable future the volumes of gas that Russia can sell to export markets below the levels that Russia could potentially supply. The economic value of gas in the domestic market therefore is dictated by the long-run marginal cost (LRMC), not by export parity price levels. In Russia, Gazprom is likely to retain its monopoly power for some time. If the domestic price of natural gas is set above LRMC, there will be inefficiency from monopoly constriction of output. If the price is below LRMC, the product will not be efficiently used, and production levels will decline from lack of investment.

The World Bank has estimated that the LRMC for natural gas is in the range of $35 to $40 per thousand cubic meters (MCM). Domestic prices have been increasing and approaching the LRMC levels. The average domestic price in 2004 was on the order of $28/MCM. In December 2004, the Federal Tariff Service approved increases of 35 percent and 21 percent respectively for gas sales to households and to industrial customers starting on January 1, 2005. This will increase the price to households to about $27.95 per thousand cubic meters and the price to industrial customers to about $37.15 per thousand cubic meters, and the average price will increase to about $34 per thousand cubic meters, just below the LRMC range. At present rates of consumption (about 400 BCM), increasing domestic prices by about $20/MCM would increase the overall cost to consumers by about $8 billion per year. Consumption of natural gas, however, would be reduced and more efficiently allocated, generating a welfare gain to the economy. Based on the assumption of a market elasticity of –0.5, this would generate a welfare gain on the order of $1.25 billion per year.

The alternative of reducing export prices to LRMC parity levels would require a significant reduction in prices. In the first half of 2004, the export parity price averaged about $130/MCM; thus a reduction on the order of $90/MCM would have been required, which would have translated into an annual loss of revenue on the order of $12 billion.

The WTO negotiators ultimately accepted that a dual pricing system makes economic sense in Russia's case and would not constitute an export subsidy for Russian exporters, provided that domestic prices are increased to LRMC levels.

Source: Tarr and Thomson 2004.

despite political tensions and military conflict. In the CIS, the picture is far more mixed, if not sober. Belarus is an outlier in the sense that its proximity to the EU has had no effect on speed of reform. In the Caucasus and Central Asia, Armenia has made the most progress in reform, while Turkmenistan and Uzbekistan have achieved the least.

Much of the enduring services policy reform that has taken place in the Region during the transition has been and continues to be implemented in the context of efforts to integrate into the EU—this is the case for more than one-third of the countries in the Region. The prospect and process of preparing for accession to the EU provide a ready-made template for services liberalization. The EU is a common market, and free trade and investment in services constitute a major objective pursued by incumbent and aspiring EU member states.

Over time, a large number of directives and regulations and case law that define the "rules of the game" for intra-EU competition in services have emerged: these are contained in the *acquis communitaire*. The *acquis* spans a large number of service sectors—that is, it contains specific directives that must be implemented by a member state. These cover sectors such as financial services and telecommunications, as well as transport and energy, to mention two important backbone services industries (box 6.8). The *acquis* also involves a set of general obligations and disciplines that are aimed at ensuring that markets are contestable for other EU (as well as non-EU) providers. These include the competition policy provisions of the EU Treaty: provisions that discipline horizontal anticompetitive practices such as market sharing and price fixing (cartels) and that restrict the ability of governments to provide subsidies to national incumbents and the ability of monopoly providers to engage in cross-subsidization and abuse of a dominant position in a market.

The EU *acquis* "template" is largely nonnegotiable for accession countries—there is some flexibility in regard to timing and sequencing of reforms, but there is a body of law with which all members must conform. This clearly facilitates the design of policy reforms—accession governments have simply to implement measures that will satisfy the conditions laid down by the *acquis*. This is not to say that the prospect/process of accession is a panacea. In the case of Turkey, for example, accession was already being discussed in the 1960s. Very little progress was made to converge toward EU norms until the early 1990s, and thus accession talks did not proceed very far (see box 6.9).

Countries that do not have any prospect of accession to the EU—most of the CIS—do not have to adhere to the policy reforms set implied by the EU template. This has potential benefits—there is no need to undertake actions that may have little immediate payoff, and the EU *acquis* extends far beyond economic policy narrowly defined.

BOX 6.8

The EU *Acquis* Spans All Services

EU directives and regulations go well beyond the financial and telecommunications sectors, the two industries on which most policy attention often focuses. For example, the *acquis* for the transportation sector revolves around the EU's common transport policy, which aims to develop integrated transport systems based on advanced technologies that contribute to environmental and safety objectives, improving the functioning of the single market and strengthening transport links between the EU and third countries. A major emphasis is put on the strict application of competition rules and state aid disciplines, with a recent focus on increased liberalization of rail transport, landing rights/access to airports (allocation of slots), the abolition of the queuing system for inland waterway markets, and enforcement of rules on work practices in the road haulage sector. Public monopoly providers of port, rail, and other transport services must separate out and report on the results of each of their activities (to identify cross-subsidies) and end cross-subsidies from ports to rail or from freight to passenger traffic by shifting to a system of direct subsidies to achieve social objectives such as universal service.

EU energy policy objectives include the improvement of competitiveness, security of energy supplies, and protection of the environment. The energy *acquis* consists of rules and policies, notably regarding competition and state aid (including in the coal sector); the internal energy market (for example, opening up of the electricity and gas markets, promotion of renewable energy sources, crisis management, and oil stock security obligations); energy efficiency; and nuclear energy. There are five main challenges associated with adoption of EU norms in this area: market opening, unbundling, third-party access, public service obligations, and regulation.

These two policy areas illustrate the primary objective of EU rules: to create a single market for services. This is pursued through measures requiring member states to ensure that their markets are contestable for foreign service providers (the competition aspect) and requiring that measures be taken to harmonize regulatory provisions so as to further integrate the market. Part of the latter agenda revolves around setting standards to achieve easier interconnection—whether of roads, rail, electricity grids and networks, or gas pipelines.

Source: World Bank staff.

In the environmental area, for example, there are numerous requirements, many of which necessitate large-scale investment, which may not be a priority for some countries. However, it also has costs: the burden of identifying policy reforms, sequencing them, and ensuring their implementation and enforcement must be determined and carried out by national governments. As a result, and because of politically strong vested interests that will oppose reform, there may be less of a focus on taking actions to liberalize access to services markets.

BOX 6.9

The Incentive for Services Reform in Turkey in the Context of EU Accession

In 1999, the European Council officially recognized Turkey as a candidate state for accession. Under an Accession Partnership, the EU works with Turkey on adoption of the *acquis communitaire*. A Department for EU Affairs was set up in 2000 to coordinate Turkey's policies related to accession. A Reform Monitoring Group chaired by the deputy prime minister supervises the reforms. Major regulatory reforms in the post-1999 period have covered several sectors, including the energy and banking sectors.

In the area of energy, Turkey confronts five main challenges: market opening, unbundling, third-party access, public service obligations, and regulation. The Turkish electricity sector has historically been dominated by state-owned enterprises that provide distribution, generation, trading, and transmission services. Privately owned electricity firms have entered the industry through build-operate-transfer (BOT) or auto-generator schemes. They account for about 21 percent of electricity generation. In addition, competitive bidding for build-operate-own (BOO) contracts for electricity generation has been occurring, and transfer-of-operating-rights contracts have been awarded in a number of regions. Privatization of generation assets is envisaged to start in 2006 and be completed in 2011. All assets in the distribution sector will be divested by mid-2006. A new Electricity Law, passed in 2001, provides for the establishment of an independent Energy Market Regulatory Authority and the introduction of a market model that will transfer most of the task of supplying and distributing electricity to the private sector, eliminate the need for additional state-guaranteed power-purchase agreements, and minimize costs through competitive pressures on producers and distributors. The government will largely withdraw from the electricity-generation and -distribution businesses; and electricity-generation companies will negotiate directly with distribution companies, without government guarantees. The government's role will be largely confined to determining sector policy, owning the transmission system, and ensuring that the rules are respected and that prices are competitively determined. Once the law is fully implemented, the regulatory and supervisory regime for the electricity sector will have been brought up to the level of international practice in line with EU standards. The various

The distinct differences in depth of reform and service sector performance suggest that the EU accession process played an important role in promoting liberalization of services trade and investment and in the subsequent trade and FDI inflow response. However, "initial conditions" also have an important bearing on performance—the CEE countries were almost all GATT (General Agreement on Tariffs and Trade) members during central planning and were founding members of the WTO. This implies that they had already made some international commitments on services trade and investment policies.

BOT and BOO contracts signed in the past imply that the establishment of a competitive environment will take time, however.

A weak banking sector has been a cause of recurrent macroeconomic crises in Turkey. Governments have used state banks for noncommercial objectives such as agricultural support; income redistribution; and industrial, urban, and physical infrastructural development. As a result, banks came to confront unrecoverable costs from mandates carried out on behalf of the government (so-called "duty losses"). Since 1999, Turkey has reformed the regulatory and institutional framework of the banking sector and restructured both state and private banks. In 1999, the Parliament passed a new banking law, which called for the creation of an independent Banking Regulatory and Supervisory Agency (BRSA) to take over bank regulation and supervision responsibilities from the Treasury and central bank. In the case of state banks, the Treasury issued bonds (floating rate notes) to securitize their duty losses and strengthen their capital base. A law was introduced that prohibited state banks from running more duty losses: that is, any support provided to the state banks will henceforth have to be budgeted. The regulation of all banks was greatly strengthened. As of 2004, Turkish prudential requirements were in general in conformity with those in the EU regarding capital adequacy standards, loan classification and provisioning requirements, limits on large exposures, limits on connected lending, and requirements for liquidity and market-risk management. A major remaining issue concerns the privatization of state banks. In 2001, private domestic banks accounted for 53.6 percent of total assets of the banking sector, with foreign banks' shares amounting to only 2.6 percent. This compares with 77 percent in Greece, 31 percent in Spain, 61 percent in Hungary, and 51 percent in the Czech Republic.

Arguably, everything that has been and is being done by Turkey could be done unilaterally. Many of the benefits from reforms undertaken to date were undertaken autonomously—for example, measures to strengthen the banking system. How much the templates provided by the EU model helped is not possible to determine. Clearly, however, the *prospect* of accession helped in the pursuit of many of these reforms.

Source: Hoekman and Togan 2005.

While in principle the EU accession process forced these countries to do more as far as trade policy is concerned, much if not all of what is required by the EU *acquis* can also be pursued unilaterally.

Moreover, even when EU accession is not a realistic prospect, international cooperation on services can be pursued through the WTO and bilateral/regional trade agreements, both with the EU and with neighboring countries (see chapter 3). Indeed, in many areas, regional cooperation has the potential for supporting national reforms by increasing the payoffs and reducing costs. The trade and transport

facilitation program that has been put in place by the countries of SEE is an example of such intraregional cooperation on services. As discussed in chapter 5, here the focus is specifically on international facilitation. Similar initiatives could be pursued in other areas of the Region and in other sectors. As mentioned earlier, regional cooperation in the area of energy is already being pursued (see box 6.5).

A number of countries in the Region acceded to the WTO after 1995 (that is, they were not GATT contracting parties). These include Albania (which acceded to the WTO in 2000), Armenia (2003), Croatia (2000), Georgia (2000), the Kyrgyz Republic (1998), and Moldova (2001). Others are in the process of negotiating accession to the WTO. In either case, this requires that commitments be made to liberalize access to foreign providers of services, both cross-border and through FDI under the General Agreement on Trade in Services (GATS) (see chapter 3). There is, however, a major difference between the WTO and the EU accession processes: the former does not require complete liberalization of services trade and investment. Rather, the extent of liberalization is the outcome of a negotiating process that depends in part on how attractive the market is to potential foreign entrants and on the preferences of the acceding government. A feature of the WTO's GATS disciplines on services is that governments can decide how much they want to open up—a so-called "positive list" approach is taken to the sectoral coverage of commitments made by members; see Broadman 1994.

One potential advantage of the WTO's GATS approach is that the process of expanding the access of foreign suppliers to services markets can be managed so as to increase competition gradually. This can allow incumbents to improve their competitiveness and may create alternative employment opportunities in the sectors concerned and thus help mobilize support for trade liberalization more generally. The mechanism that can be used in this connection is to precommit to reforms over a period of time. Given the advantages of incumbency in industries characterized by high fixed costs and with substantial network externalities, the process of gradual introduction of competition can allow management of the public companies concerned to improve productivity over a period of time, attenuating the social impact in terms of the magnitude of possible layoffs, and increasing the value of the firm as a prelude to privatization.

The countries in the Region that acceded to the WTO between 1998 and 2003 all made significant commitments on services. For example, the Kyrgyz Republic made commitments in 11 out of 13 services sectors, compared with 5.7 on average for all WTO members. The same is true for the other countries—specific commitments were

made in all of the major services categories that are distinguished in the GATS classification list. As a group, the Region's countries stand out as having made more commitments than either OECD or developing countries (figure 6.14).

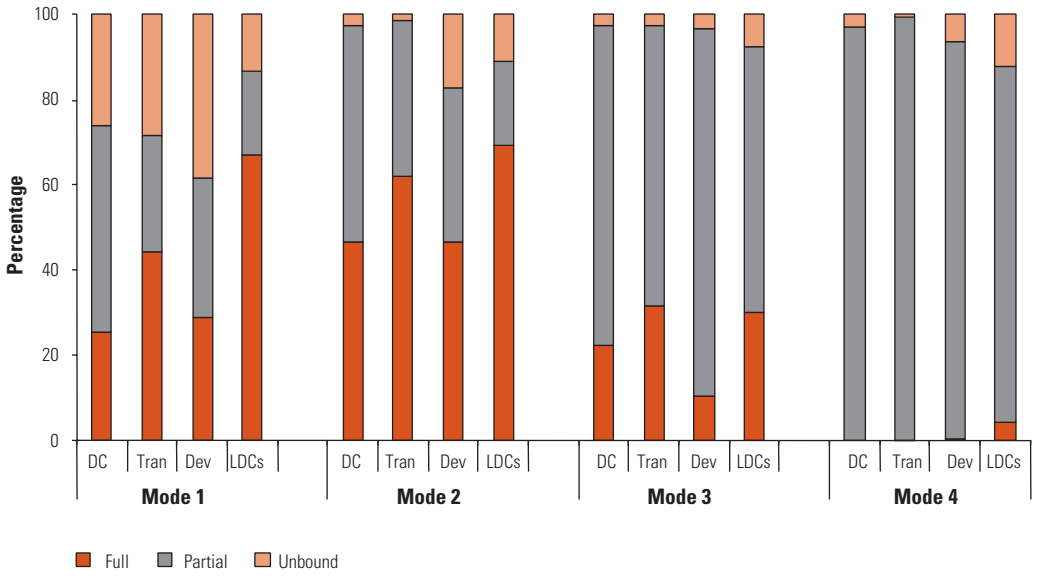
However, these countries' WTO GATS commitments have not, for the most part, translated into increases in services trade comparable to those registered by the EU-8 countries. In part this may simply be a reflection of time—all of these countries, with the exception of the Kyrgyz Republic, have acceded to the WTO only recently. Geography and other fundamental institutional factors play a major role as well. But as can also be seen from figure 6.14, although the Region's countries as a whole have made significant commitments under the GATS, there is still much to be done with regard to making full liberalization commitments and in the sense of locking in open market access and national treatment, including for Modes 1 and 3—cross-border trade and FDI, respectively.

The ongoing Doha Round negotiations—which span services—offer an important opportunity to further enhance commitments in those sectors and modes of supply that are most important for improving the performance of the economy. They also offer an oppor-

FIGURE 6.14

WTO Market Access Commitments in Services Trade Liberalization, by Mode

Percentage of bindings



Source. Marchetti 2004, based on WTO database.

Note: Calculated on the basis of a sample of 37 sectors deemed representative for various services areas (actualizes WTO document S/C/W99). DC (Developed Countries); Tran (the Region's Transition Economies); Dev (Developing Countries); LDCs (Least-Developed Countries).

tunity to seek better access to export markets, including through the temporary movement of natural persons supplying services. Indeed, for those countries that are not on track to join the EU, the WTO is an important instrument through which to seek to offset some of the preferential access that has been granted to the new member states of the EU from the Region. There will be a quid pro quo demanded for such improved access, however. But as the experience of the Baltic and CEE countries reveals, this quid pro quo—the opening up of services sectors to foreign participation—can have significant payoffs that are in the national interest.

The big difference between the EU accession process and the WTO is that, while the latter is much less specific about how liberalization will be achieved, the EU is much more prescriptive. This raises the question of whether it makes sense for countries that have little prospect of acceding to the EU to unilaterally adopt the "EU model" (the *acquis*). A good case can be made for considering the implementation of specific aspects of the *acquis*, especially those parts that revolve around the introduction of market disciplines, controlling state aids, and encouraging competition from foreign service providers on the domestic market. Integrating transport and energy markets with those in neighboring countries also makes good economic sense, as do measures aimed at increasing the contestability of these markets and removing competition-distorting cross-subsidies.

This is not to say that the EU model in these areas is optimal. The point is, however, that it is better than the status quo ante that once prevailed in all of the Region's countries, and that continues to prevail in the CIS and some SEE countries. The EU *acquis* is a public good in the sense that any country can avail itself of that body of legislation and regulation. What matters is implementation, which in turn requires commitment and that the relevant institutions apply the standards. In the case of countries that have acceded or are in the queue, the regular monitoring and interaction between the European Commission and the partner government, facilitated by the provision of technical and financial assistance, can do much to help maintain progress. However, accession does not have to be part of the equation for countries to obtain such assistance—a very similar structure is available in the form of the EU's Association and Partnership Agreements that numerous countries have signed with the EU. They also offer a model for implementation of commitments under the GATS. That said, and as stressed in the analysis of behind-the-border reforms in chapter 4, while trade-agreement-based commitments of the type made in the WTO can be helpful, they are not sufficient to achieve and cement far-reaching policy reforms and

liberalization. What matters more is the overall investment climate that prevails.

Services Reforms and Growth Performance

It is clear that many countries in the Region have implemented significant services sector policy reforms. What matters of course is whether these reforms are subsequently associated with better economic performance. One method that can help determine whether there is a positive relationship between reforms and performance is the use of econometric evidence to assess the links between service sector development and economic growth. Will cross-country growth regressions, where the share of domestic investment in GDP is used as the main explanatory variable for per capita GDP growth, reveal a linear, positive relationship between various measures of service sector policy reform and per capita GDP growth?

To test this proposition, it is more appropriate to use the investment share in GDP as an explanatory variable in such regressions than the usual set of control variables that measure initial income because, even after controlling for policy variables determining different steady states (such as inflation, political stability, size of government, and so forth), it is likely that in transition economies, the macroeconomic shocks incurred in the early 1990s were greater in countries where initial income was lower because of the absence of market institutions. Thus, use of initial income may bias results because there is likely to be a correlation between income levels and services sector development. Cross-country evidence generally suggests that per capita income growth is strongly related to the (past) investment share of GDP (for example, Levine and Renelt 1992). This is not the case for many transition economies, reflecting the fact that investment in centrally planned economies was often of poor quality. To measure the quality of the service sector framework in the estimated regressions, the three sectoral EBRD reform indexes for banking, nonbanking financial services, and infrastructure are used. (Recall that the latter is a composite indicator of progress in five areas of infrastructure policy reform: power, railways, roads, telecom, and water services.) The variables are all averaged over the 1990s.

The regression analysis reported in table 6.8 (column 4) is consistent with the literature in finding a positive relationship between growth in per capita income and investment (statistically significant at the 5 percent level). However, when the services policy reform indexes are added as explanatory variables, this positive association

TABLE 6.8

Results of Some Simple Growth Regressions

Dependent variable	Adj. R^2	Constant	Gross domestic fixed investment (% of GDP)	EBRD infrastructure reform index	EBRD nonbanking financial sector reform index	EBRD banking sector reform index
Per capita GDP growth	0.13	–11.3 (–2.7)**	0.41 (2.1)**			
Per capita GDP growth	0.28	–16.1 (–3.8)***	0.32 (1.73)*	4.23 (2.3)**		
Per capita GDP growth	0.32	–14.4 (–3.8)***	0.1 (0.46)		5.65 (2.65)**	
Per capita GDP growth	0.42	–16.8 (–4.5)***	0.22 (1.3)			4.74 (3.37)***

Note: Coefficients and t-values in brackets; *** = significant at the 1percent level; ** = significant at the 5 percent level; * = significant at the 10 percent level. Number of observations: 23 for all equations.

gradually disappears. All three reform indexes are highly significant determinants of per capita income growth, but most striking is the performance of the banking sector variable. The model fit increases from 0.13 to 0.42 in terms of adjusted R^2 as one moves from the first to the last equation. These econometric results therefore suggest a clear positive association between the adoption of policies that promote the efficient functioning of the service sector and economywide economic growth performance.

The prominent role of the banking sector in this regard is noteworthy. In those transition economies where financial intermediation existed during the 1990s, the output collapse was much less pronounced, and the subsequent recovery occurred at a faster pace. Creating confidence in the private commercial banking sector by means of generating an adequate policy framework therefore is of great importance. Indeed, in many of the countries in question, potential depositors still shy away from banks, and credit remains influenced by, or subject to, direct or indirect government control. Full compliance with banking and securities markets best practices (as defined by the IMF, Bank for International Settlements [BIS], and the International Organization of Securities Commissions [IOSCO] and other standards-setting bodies) and credible and effective implementation-cum-enforcement are important dimensions of creating an independent and competitive financial sector. As discussed above, the policy reform agenda in infrastructure spans many dimensions, including procompetitive regulation of public providers (for example, tariffs that reflect costs and provide incentives for efficiency improvements); actions to increase the scope for private provision (including privati-

zation of monopolies, ensuring access to networks, and interconnection on reasonable terms); and the development of effective, independent regulatory bodies to establish and implement a coherent regulatory and institutional framework.

Conclusions

Firms in the Region's services sectors, such as finance, telecommunications, and transport, are major inputs into the production of goods (and other services)—including agriculture as well as manufacturing. The costs of these inputs can account for a major share of the total cost of production and are thus an important factor affecting the competitiveness of firms. Services are also important determinants of the productivity of workers in all sectors—education, training, and health services are key "inputs" into the formation and maintenance of human capital. Thus, service sector reforms can help reduce the costs of trade liberalization by assisting industry and agriculture in confronting competition from imports through lower input costs and higher-quality inputs. They can also play an important role in creating the employment opportunities that are required to allow structural adjustment to occur (and absorb new entrants into the labor force).

While trade and structural reforms must be tailored to national circumstances, efficient services—both public and private—are a vital element of any successful strategy for attaining and sustaining high rates of growth. A comprehensive behind-the-border policy reform agenda focusing on services can help attract much-needed investment, both domestic and foreign, and in the process enhance the benefits of merchandise trade liberalization. Inefficient and high-cost intermediate "backbone" services are a burden on the economy because they reduce the competitiveness of firms, thus impeding trade expansion and investment.

Openness to foreign competition—through policies that permit foreign participation in domestic markets—is a key element of good services sector policy. No good measure of the "multiplier" effect of services openness is available. The experience of the EU-8 reveals clearly that an open merchandise trade policy is important; the evidence from these countries shows that liberalization of trade with the EU and the rest of the world led to significant improvements in productivity and trade performance. But merchandise trade liberalization is not enough—services trade and investment policy are also important. The limited stock of inward FDI in countries such as Turkey and Central Asian economies is in striking contrast to the EU-8 countries.

So is the overall economic performance of these different countries, measured in terms of both average performance and its volatility. The stark differences in the levels and sectoral distribution of FDI in services indicate that foreign investors perceive the attractiveness of locating in many countries in the Region to be limited or that prevailing barriers to FDI are prohibitive. Simulation analyses for countries such as Russia also reveal the potential of liberalization of trade and investment in services—for example, Jensen and Tarr (2004) conclude that services liberalization that allows FDI in all sectors would generate a multiple of the gains that could be achieved through merchandise trade liberalization.

Liberalization—greater participation by foreign services firms in domestic markets—is of course not sufficient. Given the characteristics of services and services markets—often characterized by asymmetric information or high fixed costs and associated barriers to entry—there is a need for effective regulatory supervision of both domestic and foreign operators. In an environment characterized by limited (if any) competition in key network services industries (energy, telecoms, transport), a weak financial sector, and limited fiscal discipline (and thus extensive cross-subsidization and transfers), trade liberalization is not enough. As discussed in chapter 4, it needs to be complemented by measures to harden budget constraints and to ensure that markets are contestable. Actions also will be needed to ensure that social (equity) objectives such as universal service obligations are realized. Taken together, this calls for a regime of *procompetitive* regulation.

To be sure, this is a significant reform challenge for many countries in the Region. Given that the EU-8, and increasingly some SEE countries, offer relatively attractive policy environments for FDI and have done much to converge on OECD (EU) regulatory standards in services, the policy reform thresholds for the CIS countries are becoming much more competitive. Institutional barriers to FDI, monopoly provision of services by state-owned enterprises, and slow privatization all reflect political decisions. In the case of the countries that have already acceded to the EU or are in the process of doing so, there is a template for reform that all must satisfy. Although the experience of Turkey and a number of the "second wave" of EU accession candidates illustrates that progress can be slow, the fact remains that, by necessity, much of the behind-the-border reform agenda must be implemented for EU accession to become feasible.

In the case of countries that do not have a near-term prospect of accession to the EU, the burden of liberalization, regulatory reform, and strengthening of enforcement capacity falls squarely on national governments. The prospect and process of accession cannot be used

as mechanisms to push forward reforms by governments that desire to deepen services liberalization and reforms. Other instruments do exist, however: in particular the WTO, regional cooperation, and association agreements with the EU. Trade agreements may help by allowing gradual commitments to be made in a more credible manner, but much depends on the substance of the reforms. For any international agreements (multilateral or regional) to be effective in supporting reforms, there must be extensive coverage of services and investment policies.

The ongoing Doha Round negotiations—which span services—offer an immediate and important opportunity to further enhance market access and national treatment commitments for all service sectors, especially for those modes of supply that are most important—cross-border trade and FDI. They also offer an opportunity to seek better access to major export markets, including through the temporary movement of natural persons supplying services. The implication of this is that for those countries that are not on track to join the EU, the WTO is an important instrument through which to seek to offset some of the preferential access that has been granted to the new member states of the EU from the Region. Signaling greater openness through enhanced GATS commitments is not a panacea, given that the new EU member states have already effectively made commitments for complete openness vis-à-vis the EU and the need for complementary efforts to improve domestic regulation. However, making such commitments can not only have a powerful signaling effect, it will also help ensure that the domestic policy efforts to put into place the complementary regulatory framework are made.

ANNEX TABLE 6.1A

Restrictiveness of Service Sector Policies in Transition Economies: Banktruptcy Regime and Telecom

Criterion of restrictiveness	No.	Czech Republic	Hungary	Poland	
Bankruptcy regime	**1**				
Major post-1990 changes in bankruptcy law	1a	1993/1998	1991/1993	1998/2003	
Length of process (years), high-income OECD=1.6	1b	9.2	2	1.4	
Cost (% of estate), high-income OECD= 6.8	1c	18	23	18	
Recovery rate, high-income OECD= 72.2	1d	16.8	30.8	68.2	
Telecom sector general assessment	**2**				
Infrastructure reform index 1995/2004 (see EBRD Annual Report, 1 to 4.3=best)	2a	3.3/4.0	3.3/4.0	2.7/4.0	
Fixed-line (mobile) penetration rate 2003	2b	36.0 (96.5)	33.4 (78.3)	31.9 (45.1)	
Market access/national treatment	**3**				
MA Trade: restrictions in (a) domestic and international leased-line/networks, (b) third-party resale, c) connections of leased-lines/private networks to PSTN	3a	n.a.	n.a.	n.a.	
MA invest (fixed and mobile):					
Fixed:	3b	In 2001, fixed-line market was officially opened; some competition in local services before 2001	In 2002 fixed-line market was officially opened	In 2003 fixed-line market was officially opened	
Number of firms in the market	3c	n.a.	n.a.	n.a.	
Competition in sector (local, domestic long-distance, international, data, leased lines) (a) monopoly, (b) partial, (c) full competition	3d	n.a.	n.a.	n.a.	
Percentage of incumbent privatized investors	3e	49, mainly to Telsource (Ned) Swisscom, AT&T, currently 51% for sale	100, German Telecom and Ameritech, rest publicly traded state: 1 share	47.57 France Telecom, also Polish investors	
Mobile: Number of firms in the market	3f	3	4	3	
Competition in sector: (a) monopoly, (b) partial, (c) full competition	3g	(b) partial	n.a.	n.a.	
Percentage of incumbent privatized investors	3h	49 (1996), now 100 % owned by Cesky Telecom	49 Deutsche Telecom, 51 fixed incumbent	34 France Telecom, rest fixed incumbent	
NT trade: Call-back services allowed ?	3i	n.a.	n.a.	n.a.	
NT invest: % of foreign ownership allowed in competitive carriers (a) fixed, (b) mobile	3j	n.a.	n.a.	n.a.	
Licensing discrimination (mobile)	3k	n.a.	n.a.	n.a.	
Regulation	**4**				
Regulator independent (since) ?	4a	yes (2000)	yes (1993)	yes (2002)	
Quality of independence	4b		1997 extended		

Sources: EBRD; OECD; World Bank; Contessi, Cukierman, Miller, and Neyapti 2001.

Note: n.a. = not available.

	Slovak Republic	Slovenia	Albania	Bosnia & Herzegovina	Bulgaria	Croatia
	1998/2000	1994	1995/2002	2003	1994/96	1997/99/2003
	4.7	3.6	4	3.3	3.3	3.1
	18	18	38	8	8	18
	39.6	23.6	24.6	32.1	34.2	26.1
	2.3/3.3	1.0/3.0	1.0/3.3	1.0/3.3	2.3/3.3	1.0/3.3
	24.1 (68.4)	40.7 (87.1)	8.3 (35.8)	22.5 (27.4)	37.2 (50.0)	43.3 (58.4)
	n.a.	n.a.	restrictions in (a) and (b)	restrictions in (a) and (b)	restrictions in (a) and (b)	n.a.
	In 2003 fixed-line market was officially opened	End of monopoly in 2001	Monopoly in 2004	There are three operators, but each is a monopoly in a region	End of monopoly in 2003	In 2003 fixed-line services were opened to foreign competition. Croatian Telecom had transition period until end of 2004
	n.a.	n.a.	1, 2 for local	3	1	
	n.a.	n.a.	(a) Monopoly (b) Partial in local services	Sprske (a) Fed. (c), but (a) for intern.	(a) Monopoly	
	n.a.	By 2001 33.5% had been sold to Slovenian private investors	0	n.a.	65 (2004) Viva Ventures (Austria)	51, 35 (1999), 16 (2001), German Telec., remaining 7% to be sold
	n.a.	3	2, 3 as of 2005	2	3	2, third to be tendered 2004
	n.a.	n.a.	(b) partial	(b) partial	(b) partial	(b) partial
	n.a.	100% owned by fixed-line incumbent	85 (2000), Norw./Greek consortium	n.a.	100, 60 of them Austrian, rest international	35 (1999) 16 (2001)
	n.a.	n.a.	no	no	no	n.a.
	n.a.	n.a.	(a) 100 (since 2003), (b) 100 FDI is 49%	(a)100, but no FDI, (b) n.a.,	(a) 0 before 2003 (b) 100	n.a.
	n.a.	n.a.	no	no	no	n.a.
	yes (2000)	yes (2001)	yes (1998)	yes (2001)	yes (2002)	yes (2002)
			Limited			

ANNEX TABLE 6.1B

Restrictiveness of Service Sector Policies in Transition Economies: Bankruptcy Regime and Telecom

Criterion of restrictiveness	No.	Estonia	Latvia	Lithuania	Belarus	Moldova	Russian Fed.	
Bankruptcy regime	**1**							
Major post-1990 changes in bankruptcy law	1a	1996	1996	1997/2001	1991	2001	1998/2002	
Length of process (years), high-income OECD=1.6	1b	3	1.1	1.2	5.8	2.8	1.5	
Cost (% of estate), high-income OECD= 6.8	1c	8	4	8	4	8	4	
Recovery rate, high-income OECD= 72.2	1d	40	85	52.4	11.9	29.3	48.4	
Telecom sector general assessment	**2**							
Infrastructure reform index 1995/2004 (see EBRD Annual Report, 1 to 4.3=best)	2a	3.0/4.0	2.7/3.0	1.0/3.3	1.0/2.0	2.0/2.3	2.3/3.0	
Fixed-line (mobile) penetration rate 2003	2b	33.9 (72.3)	28.3 (52.9)	25.3 (66.6)	31.1 (11.3)	16.3 (8.2)	26.0 (25.0)	
Market access/national treatment	**3**							
MA Trade: restrictions in (a) domestic and international leased-line/networks, (b) third party resale, (c) connections of leased-lines/private networks to PSTN	3a	(b) n.a. (a) and (c) no restrictions	(b) n.a. (a) and (c) no restrictions	Restrictions in (b) likely	n.a.	Restrictions in (a) and (b)	Restrictions in (b) and (c)	
MA invest (fixed and mobile):								
Fixed:	3b	Market was opened to competition in 2001	Fixed-line monopoly established in 1994 as joint venture, to last until 2013	Market was opened to competition in 2003	Fixed-line services still operated by national monopoly	Privatization of national monopoly not successful so far; bids have been rejected	De facto monopoly in international and long-distance calls, also local	
Number of firms in the market	3c	3	1	1	1	1	n.a.	
Competition in sector (local, domestic long-distance, international, data, leased lines) (a) monopoly, (b) partial, (c) full competition	3d	(c) full competition	(c), monopoly expired 2003, not 2013	(c) full competition	n.a. lines, (a) rest	(a) monopoly	(c) for data and leased	
Percentage of incumbent privatized investors	3e	73, 49 of them sold to Baltic Tele AB (Sweden, Fin.)	49 (1994), sold to consortium of European operators	90	0	0	62	
Mobile:								
Number of firms in the market	3f	3	2	4	2	2	More than 3	
Competition in sector: (a) monopoly, (b) partial, (c) full competition	3g	(c) full competition	(c) full competition	(c) full competition	(c) full competition	(b) partial	(b) partial	
Percentage of incumbent privatized investors	3h	n.a.	100	100	n.a.	90	100	
NT trade: Call-back services allowed ?	3i	Yes	No	No	n.a.	No	Yes	
NT invest: % of foreign ownership allowed in competitive carriers (a) fixed, (b) mobile	3j	(a) and (b) 100	(a) and (b) 100	(a) and (b) 100	n.a.	(a) and (b) 100	(a) and (b) 49	
Licensing discrimination (mobile)	3k	n.a.	n.a.	n.a.	n.a.	No	n.a.	
Regulation	**4**							
Regulator independent (since) ?	4a	Yes (1998)	Yes (2001)	Yes (2001)	No	Yes (2000)	Yes (2004)	
Quality of independence	4b							

Sources: EBRD; OECD; World Bank; Heritage Foundation.

Note: n.a. = not available.

	Ukraine	Armenia	Azerbaijan	Georgia	Kazakhstan	Kyrgyz Rep.	Tajikistan	Turkmenistan	Uzbekistan
	2000	1995/1997	1994/1997	1997	1997	1997	n.a.	1992	1994/1996
	2.6	1.9	2.7	3.2	3.3	3.5	n.a.	n.a.	4
	18	4	8	4	18	4	n.a.	n.a.	4
	25.5	39.6	33.2	20.4	13.4	24.4	n.a.	n.a.	12.5
	1.0/2.3	2.0/2.3	1.0/1.7	1.0/2.3	1.0/2.3	2.0/3.0	1.0/2.3	1.0/1.0	1.0/2.0
	22.4 (13.4)	14.8 (3.0)	11.8 (13.0)	13.3 (10.7)	14.7 (9.4)	7.9 (1.2)	3.7 (0.7)	7.7 (0.2)	6.7 (1.3)
	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	National monopoly long considered as strategically important, now privatization is on the agenda	National monopoly sold to foreign investor with exclusive rights	Fixed-line services still largely under state control, entry only through joint venture, many small state-owned companies, one major public fixed-line network	n.a.	State monopoly in long-distance and international fixed-line calls to expire 2005	State monopoly in long-distance and international fixed-line calls to expire 2003	n.a.	n.a.	National monopolist has exclusivity rights for international fixed-line services till 2006
	n.a.	1		n.a.	n.a.	n.a.			
	n.a.	(a) monopoly until 2013		n.a.	(a) domestic long-distance	(a) domestic long-distance			
	n.a.	90 (1997) OTE (Greece)		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	More than 3	1	2 joint ventures with ministry	n.a.	n.a.	n.a.	n.a.	2, exclusivity rights till 2004	n.a.
	n.a.	(a) monopoly until 2013	Further privatization is under way	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	n.a.	n.a.	64.3 (1996)	n.a.	n.a.	51% (2003)	n.a.	49	n.a.
	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	No	No, but planned	No, but planned	Yes (2000)	Yes (2002)	Ues (2001)	No, but planned	No	No
					Limited	Limited			

ANNEX TABLE 6.2A

Restrictiveness of Service Sector Policies in Transition Economies: Banking

Criterion of restrictiveness	No.	Czech Rep.	Hungary	Poland	Slovak Rep.	Slovenia
Banking sector general assessment	**1**					
Banking sector reform index 1995/2004 (See EBRD Annual Report, from 1 to 4.3=best)	1a	3.0/3.7	3.0/4.0	3.0/3.3	2.7/3.7	3.0/3.3
Financial sector restrictiveness index 1995/2005 (from 1 to 5, 1=free, see Heritage Foundation)	1b	1.0/1.0	3.0/2.0	3.0/2.0	3.0/1.0	n.a./3.0
Credit to private sector (% of GDP) 2003	1c	34.0	43.0	29.0	33.2	43.8
Policy framework and outcome in a nutshell	1d	High degree of openness and privatization	High degree of openness and privatization	High degree of openness and privatization	High degree of openness and privatization	Concentration and restrictions persist
Restrictions on commercial presence	**2**					
Allocations of new banking licenses? (a) no, (b) up to 6, (c) yes	2a	Sector is liberal. Largest banks are owned by foreign investors, range of financial products has increased to standards of other market economies	Foreign participation is very high, total foreign ownership is about 60% of total capital, foreign know-how helped modernization of many banks	Sector is liberal. Penetration of foreign investment very high, especially in large banks	n.a.	Sector is very concentrated, and state still holds a large stake in some important banks. Foreign share is not as high as in some other countries
Licensing discrimination	2b					
Maximum equity share in domestic bank (%)	2c					
Market entry through joint venture required? J.V. (a) not allowed, (b) required, (c) possible	2d					
Possible forms of establishment? (a) Subsid, (b) branches, (c) represent. offices	2e					
Foreign staff entry possible? (a) no entry, (b) entry up to 3 or (c) 5 years or more Staff: exec., senior managers, and/or specialists	2f					
Other restrictions	**3**					
Can banks raise funds domestically? (a) no, (b) restricted, (c) yes	3a	n.a.	Regulation was brought roughly in line with EU standards	Regulation was brought roughly in line with EU standards	n.a.	Regulation is almost fully in line with EU standards
Restrictions on lending? (a) no, (b) some services, (c) no domestic clients	3b					
Can banks provide non-banking services? (a) no, (b) restricted, (c) yes	3c					
Restrictions on number of banking outlets? (a) yes (1), (b) no	3d					
Temporary entry of foreign staff allowed ? up to (a) 30, (b) 60, (c) 90 days or more Staff: exec., senior managers, and/or specialists	3e					
Foreign/private market share	**4**					
Number of banks (foreign-owned):	4a					
1995		55(23)	43(21)	81(18)	33(18)	39(6)
2003		35(26)	38(29)	58(46)	21(16)	22(6)
Asset share of state-owned banks:	4b					
1995		17.6	49	71.7	61.2	41.7
2003		3	7.4	25.7	1.5	12.8
Regulation	**5**					
Enactment of central bank reform	5a	1991	1991	1997	1992	1991
Subesequent degree of legal independence (0 to 1=highest, Germany 1980s=0.69)	5b	0.73	0.67	0.89	0.62	0.63
Capital adequacy ratio	5c	8%	8%	8%	8%	8%
Deposit insurance system	5d	Yes	Yes	Yes	Yes	Yes
Secured transaction law	5e	Yes	Yes	Yes	Yes	Restricted
Securities commission	5f	Yes	Yes	Yes	Yes	Yes

Sources: EBRD; OECD; World Bank; Heritage Foundation.

Note: n.a. = not available.

	Albania	Bosnia & Herzegovina	Bulgaria	Croatia	Macedonia, FYR	Romania	Serbia & Montenegro
	2.0/2.7	1.0/2.7	2.0/3.7	2.7/4.0	3.0/2.7	3.0/3.0	1.0/2.3
	3.0/3.0	n.a./2.0	3.0/2.0	n.a./2.0	n.a./2.0	3.0/3.0	n.a./n.a.
	7.8	42.1	25.8	55.2	19.4	9.0	n.a.
	Open, but still rudimentary, cash economy	Confidence is increasing, weak capital base	High degree of openness and privatization	High degree of openness and privatization	Weak sector, many bad loans, but improving	Weak sector, but openness is improving	Inefficient with weak capital base, closed
	(c) Yes, new licenses issued	(c) Yes, new licenses issued	(c) Yes, new licenses issued	(c) Yes, new licenses issued	(c) Yes, new licenses issued	(c) Yes, new licenses issued	No foreign entry
	No	No	No	No	No	No	n.a.
	100	0	100	100	100	100	100
	(c) Joint venture possible	(c) Joint venture possible	(c) Joint venture possible	(c) Joint venture possible	(c) Joint venture possible	(c) Joint venture possible	Privatization is more advanced in Montenegro than in Serbia
	(a), (b), (c) are all allowed	(a), (b), (c) are all allowed	(a), (b), (c) are all allowed	(a), (b), (c) are all allowed	only (a) and (c) are allowed	(a), (b), (c) are all allowed	
	(c) Foreign staff entry allowed up to 5 years	(b) Foreign staff entry allowed up to 1 year	(b) Foreign staff entry allowed up to 3 years	(c) No time limit on foreign staff entry	(c) Foreign staff entry allowed up to 5 years	(b) Foreign staff entry allowed up to 1 year	Foreign share smaller than in other countries
	(c) Yes	(c) Yes	(c) Yes	(c) Yes	(c) Yes	(c) Yes	n.a.
	(a) No	(a) No	(a) No	(a) No	(a) No	(b) In some services, yes	n.a.
	(b) Restricted	(b) Restricted	(b) Restricted	(b) Restricted	(b) Restricted	(b) Restricted	n.a.
	(b) No restrictions	(b) No restrictions	(b) No restrictions	(b) No restrictions	(b) No restrictions	(b) No restrictions	n.a.
	(c) More than 90 days	(c) More than 90 days	(c) 90 days	(c) 90 days	(c) 90 days	(c) More than 90 days	n.a.
	6(3) 15(13)	n.a. 37(19)	41(3) 35(25)	54(1) 41(19)	6(3) 21(8)	24(8) 30(21)	112(3) 47(16)
	94.5 51.9	n.a. 5.2	n.a. 0.4	51.9 3.4	n.a. 1.8	84.3 40.6	94.7 34.1
	1992	n.a.	1991	1992	1995	1991	n.a.
	0.51	n.a.	0.55	0.44	0.41	0.34	n.a.
	12%	12%	12%	10%	8%	12%	8%
	Yes	Yes	Yes	Yes	Yes	Yes	No
	Yes	No	Yes	Yes	Yes	Yes	Yes
	Yes	Yes	Yes	Yes	Yes	Yes	Yes

ANNEX TABLE 6.2B

Restrictiveness of Service Sector Policies in Transition Economies: Banking

Criterion of restrictiveness	No.	Estonia	Latvia	Lithuania	Belarus	Moldova	Russian Fed.
Banking sector general assessment	**1**						
Banking sector reform index 1995/2004 (See EBRD Annual Report, from 1 to 4.3=best)	1a	3.0/4.0	3.0/3.7	3.0/3.0	2.0/1.7	2.0/2.7	2.0/2.0
Financial sector restrictiveness index 1995/2005 (from 1 to 5, 1=free, see Heritage Foundation)	1b	2.0/1.0	n.a./2.0	n.a./1.0	3.0/4.0	5.0/3.0	3.0/4.0
Credit to private sector (% of GDP) 2003	1c	36.0	39.6	20.6	12.0	20.4	20.9
Policy framework and outcome in a nutshell	1d	System sound, open, efficient. No. 1 in Baltics	High degree of openness and privatization	High degree of openness and privatization	Inefficient and largely state-owned sector	Moderately restricted, officially open	Capital base is weak, sector is rather closed
Restrictions on commercial presence	**2**						
Allocations of new banking licenses ? (a) no, (b) up to 6, (c) yes	2a	(c) Yes, new licenses issued	(c) Yes, new licenses issued	(c) Yes, new licenses issued	Sector is highly distorted: four of the main banks remain in public hands until 2010; directed credit programs and interest rate ceilings still in place	(c) Yes, new licenses issued	(c) Yes, new licenses issued
Licensing discrimination	2b	No	No	No		No	No
Maximum equity share in domestic bank (%)	2c	100	80	100		100	100
Market entry through joint venture required? J.V. (a) not allowed, (b) required, (c) possible	2d	(c) Joint venture possible	(b) Joint venture required	(c) Joint venture possible		(c) Joint venture possible	(c) Joint venture possible
Possible forms of establishment? (a) Subsid, (b) branches, (c) represent. offices	2e	(a), (b), (c) are all allowed	(a), (b), (c) are all allowed	(a), (b), (c) are all allowed		only (a) and (b) allowed	(a), (b), (c) are all allowed
Foreign staff entry possible? (a) no entry, (b) entry up to 3 or (c) 5 years or more Staff: exec., senior managers, and/or specialists	2f	(c) Foreign staff entry allowed up to 5 years	(c) Foreign staff entry allowed up to 5 years	(b) Foreign staff entry allowed up to 3 years		(c) Foreign staff entry allowed up to 5 years	Substantial limitations on foreign staff
Other restrictions	**3**						
Can banks raise funds domestically? (a) no, (b) restricted, (c) yes	3a	(c) Yes	(c) Yes	(c) Yes	Central bank contiues to strengthen its supervisory policies	(c) Yes	(b) Restricted
Restrictions on lending? (a) no, (b) some services, (c) no domestic clients	3b	(a) No	(a) No	(a) No		(a) No	(a) No
Can banks provide non-banking services? (a) no, (b) restricted, (c) yes	3c	(b) Restricted	(b) Restricted	(b) Restricted		(b) Restricted	(b) Restricted
Restrictions on number of banking outlets? (a) yes (1), (b) no	3d	(b) No restrictions	(b) No restrictions	(b) No restrictions		(b) No restrictions	(b) No restrictions
Temporary entry of foreign staff allowed? up to (a) 30, (b) 60, (c) 90 days or more Staff: exec., senior managers, and/or specialists	3e	(c) 90 days per 6 months	(c) 90 days	(c) 90 days		(c) 90 days	Substantial limitations on foreign staff
Foreign/private market share	**4**						
Number of banks (foreign owned)	4a						
1995		19(5)	42(11)	15(0)	42(1)	25(n.a.)	2297(21)
2003		7(4)	23(10)	13(7)	30(17)	16(9)	1329(41)
Asset share of state-owned banks	4b						
1995		9.7	9.9	61.8	62.3	n.a.	n.a.
2003		0	4.1	0	63.7	15.5	n.a.
Regulation	**5**						
Enactment of central bank reform	5a	1993	1992	1991/96	1992	1991	1995
Subesequent degree of legal independence (0 to 1=highest, Germany 1980s=0.69)	5b	0.78	0.49	0.28/0.78	0.73	0.38	0.49
Capital adequacy ratio	5c	10%	10%	10%	10%	12%	8%
Deposit insurance system	5d	Yes	Yes	Yes	Yes	Yes	Restricted
Secured transaction law	5e	Yes	Restricted	Yes	Restricted	Restricted	Yes
Securities commission	5f	Yes	Yes	Yes	No	Yes	Yes

Sources: EBRD; OECD; World Bank; Heritage Foundation.

Note: n.a. = not available.

	Ukraine	Armenia	Azerbaijan	Georgia	Kazakhstan	Kyrgyz Rep.	Tajikistan	Turkmenistan	Uzbekistan
	2.0/2.3	2.0/2.3	2.0/2.3	2.0/2.7	2.0/3.0	2.0/2.3	1.0/2.0	1.0/1.0	1.7/1.7
	3.0/3.0	n.a./1.0	n.a./4.0	n.a./3.0	n.a./4.0	n.a./3.0	n.a./5.0	n.a./5.0	n.a./5.0
	24.6	6.0	6.7	8.8	22.8	4.9	16.4	n.a.	n.a.
	Capital base is weak; strong state influence	High degree of openness and privatization	Sector is weak, cash economy, state prevails	Some progress, but still weak, cash economy	Strong state influence, but sector is stable	Sector is weak though open, cash economy	Inefficient and largely state-owned sector	Inefficient and largely state-owned sector	Inefficient and largely state-owned sector
	Ukraine has one of the most liberal regimes of the CIS; foreign penetration is slow, however	No retrictions on establish-ment of foreign-owned resident banks as long as licenscing and prudential requirements are met; high foreign share in the system	Establishing a foreign bank involves lengthy procedures, restrictions on obtaining licenses persist, limit on foreign bank ownership increased from 30 to 50%	Foreign investment in amounts to about one-third of total assets, but consists essentially of minority share-holdings	High degree of concentration in the sector; no private/ foreign equity limits; only (a) and (c) allowed competition comes from foreign banks	Sector open to foreigners since 1993; no private/ foreign equity limits, but sector remains small and underdeveloped; weak capital base	n.a. n.a. Below 50 % System is very underdeveloped and capital base is weak	No formal restrictions n.a. 35% Government influence still prevails; little private and foreign participation	Foreign entry free since 1996 Most assets are concentrated in a single state-owned bank Only c) allowed n.a.
	n.a.	Central bank contiues to strengthen its supervisory policies	Capital base is weak; super-visory policies need further strengthening; privatization still in early stages	Capital base is weak, super-visory policies need further strengthening	Regulatory framework has improved; substantial amount of consolidation	Regulatory framework is still insufficient; legal situation, political interference and lack of deposit insurance undermine confidence	Regulatory framework is still insufficient	Regulatory framework is still insufficient	Regulatory framework is still insufficient
	230(1) 158(19)	35(3) 19(8)	180(5) 46(4)	101(3) 24(6)	130(8) 36(16)	18(3) 21(7)	18(n.a.) 11(1)	67(3) 13(4) (in 2002)	31(1) 28(5)
	n.a. 9.8	2.4 0	80.5 55.3	48.6 0	24.3 5.1	69.7 7.2	n.a. 6.1	26.1 95.7 (in 2002)	38.4 91.0
	1991	1993	1992/96	1995	1993/95	1992	1993	1992	1991/95
	0.42	0.3	0.22/0.25	0.73	0.32/0.44	0.52	0.36	0.26	0.41/0.56
	10%	12%	12%	12%	12%	12%	12%	10%	8%
	Yes	in 2005	No	No	Yes	No	No	No	Yes
	Yes	Yes	Restricted	Restricted	Yes	Yes	Yes	Restricted	Yes
	Yes	Yes	Yes	Yes (not indep.)	Yes	Yes	Yes	No	Yes

Endnotes

1. Output data are measured in constant 1995 U.S. dollars, as reported in the World Bank development indicators.
2. This is also the case for FDI. However, because of the increasing prevalence of FDI in services, the convention has emerged that the sales of foreign affiliates in a host country are regarded as trade in services for the purposes of trade agreements.
3. Aggregate data on FDI inflows are available for a wider set of countries, but these are not broken down across services sectors. The missing countries account for about 90 percent of the total stock of inward FDI in the Region.
4. For an overview of the problems, see EBRD (2004a).
5. The index comprises the following components: electric power, railways, roads, telecommunications, water and wastewater (EBRD estimates).
6. In terms of actual reform measures, a few examples are worth mentioning. Estonia, for instance, has fully privatized its railway system. Network maintenance is carried out privately in the Czech Republic, Kazakhstan, Poland, and Romania. Passenger services are not profitable in many transition economies and are in general subsidized. In the Czech Republic, Latvia, and Romania, the operation of some passenger services has been handed over to private companies. In Kazakhstan, Poland, Romania, and Russia, private rail freight services have developed following gradual liberalization in this area.
7. See chapter 7 for more details on FDI.
8. Granting monopolies to new private owners (restricting competition) generally does not stimulate investment. A monopolist's market power makes it less, not more, likely to undertake a given investment, because monopoly profits are typically obtained by providing lower quantities of the good or service at higher prices. A firm with a guaranteed monopoly is also likely to invest less because it does not have to worry about more efficient competitors stealing market share. The mere threat of entry—which is typically the situation when reforms are introduced—can be enough to induce the incumbent to invest (see chapter 4).
9. In a sample of about 20 countries that privatized their telecommunications firms, Wallsten (2000) found that private investors were willing to pay more for an exclusivity period, but that telecom investment was substantially lower in countries that granted such exclusivity periods.
10. These data exclude Turkey.
11. For more specific details, see EBRD (2004a), chapter 3.
12. Fixed-rate-of-return or cost-plus contracts offer no incentives to firms to reduce costs because any variation in cost is appropriated by the regulator (and through the regulator, by the government). A fixed-price contract induces the right amount of effort because the regulated firm appropriates any reduction in cost. The enterprise is the residual claimant for cost savings.
13. See World Bank 2004h.