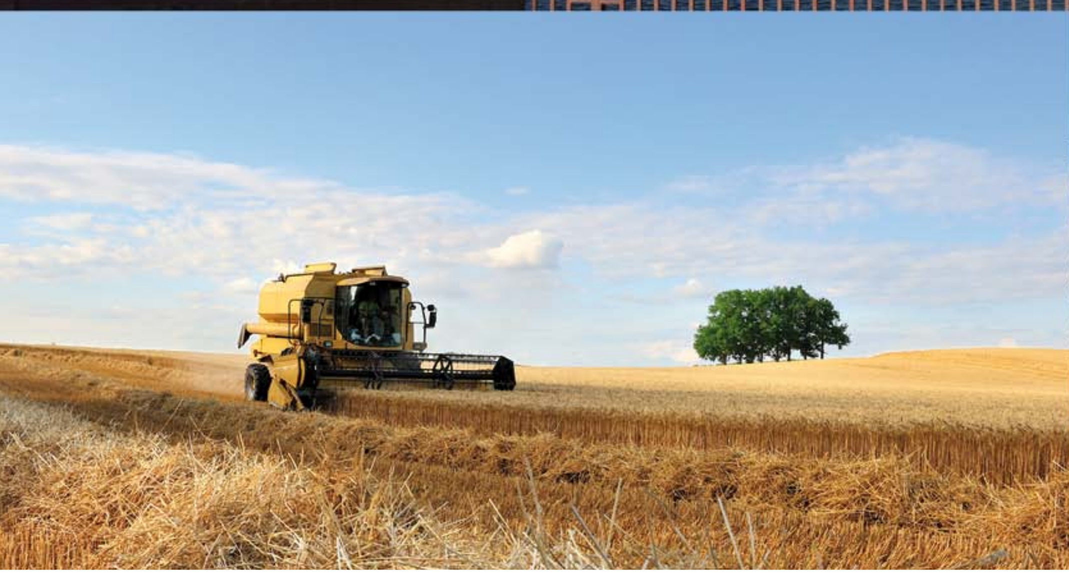
Development in Eastern Europe and the South Caucasus

ARMENIA, AZERBAIJAN, GEORGIA, REPUBLIC OF MOLDOVA AND UKRAINE



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EURASIA
COMPETITIVENESS PROGRAMME

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For more information on the programme, please see www.oecd.org/daf/psd/eurasia.

Foreword

The OECD is celebrating its 50th anniversary this year. Throughout its history, the OECD has assisted countries in reforming and improving their policies to promote economic growth and development. It has fostered more open societies and the rule of law and has helped build the institutions necessary for the good functioning of market-based economies. This experience has been particularly valuable to countries undergoing political and economic transitions.

This publication, *Development in Eastern Europe and the South Caucasus,* provides detailed country reviews of Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine. It explores current economic performance and the challenges of economic development and competitiveness. Despite differences in economic structures and policy reforms, all these countries face similar challenges arising from the transition from a centralised to a market economy in a climate of rapid political and societal change.

The transition process in the five countries which were subject to a detailed review has proven to be difficult for several reasons: managing the political change, overcoming existing conflicts and overcoming the loss of competitiveness. In order to manage the transition process efficiently, the study puts forward four key recommendations:

- promoting "green energy" and higher quality food as part of product and market differentiation;
- rehabilitating infrastructure and better connecting national and regional markets;
- addressing the skill gap and promoting regional mobility;
- promoting Greenfield investments and facilitating access to finance.

We hope that this study provides a useful contribution to the policy debate and delivers practical guidance for private sector development in Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine. The OECD stands ready to accompany these countries as they consolidate the important progress made in the last few years.

Angel Gurría
OECD Secretary-General
May 2011

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The macroeconomic overview of each country was prepared under the supervision of Colm Foy, Co-ordinator of the Development Centre's *Black Sea and Central Asia Initiative.* Stéphanie Char, Policy Analyst at the Development Centre, co-authored all the individual country studies which were drafted by Armen Hovhannisyan (Armenia), Elkhan Kasimov (Azerbaijan), Dimitri Japaridze (Georgia), Tatiana Lariushin (Republic of Moldova), and Olga Kupets and Tatiana Melnyk (Ukraine). Anna Tchoub, Public Affairs officer for the *Black Sea and Central Asia Initiative*, provided communications and logistical support.

The Private Sector Development sections of each country study and the regional overview are the outcome of work conducted by the OECD Eurasia Competitiveness Programme under the authority of the Eastern Europe and South Caucasus Initiative Steering Committee (referred to in this publication as the "OECD" when policy recommendations are formulated). They were prepared under the supervision of Fadi Farra, Head of the OECD Eurasia Competitiveness Programme, DAF/PSD, with input from the OECD Centre for Entrepreneurship.

The Private Sector Development sections of each country study were co-authored by Marina Cernov and Daniel Quadbeck, Policy Analysts, OECD Eurasia Competitiveness Programme (DAF/PSD).

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Acronyms and Abbreviations

ACG	Azeri-Chirag-Guneshli pipeline
AIOC	Azerbaijan International Operating Company
AMD	Armenian Dram (national currency)
AZN	Azerbaijani Manat (national currency)
BSEC	Organisation of the Black Sea Economic Co-operation
BTC	Baku-Tbilisi-Ceyhan
CASE	Centre for Social and Economic Research
CBA	Central Bank of Armenia
CI	Core Inflation
CIS	Commonwealth of Independent States
CPI	Consumer Price Inflation
DAC	Development Assistance Committee
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECA	Europe and Central Asia Region, The World Bank
EESC	Eastern Europe and South Caucasus
EIU	Economist Intelligence Unit
EU	European Union
ETF	European Training Foundation
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GDS	Gross Domestic Savings
GEL	Georgian Lari (national currency)
GFCF	Gross Fixed Capital Formation
GoA	Government of Armenia
ICSID	International Centre for Settlement of Investment Disputes
IFC	International Finance Corporation
IMF	International Monetary Fund
IOM	International Organization for Migration
HIV/AIDS	Human Immunodeficiency Virus / Acquired Immune Deficiency Syndrome
LFS	Labour Force Survey
LLM	Low to Low-Middle income countries
M&A	Mergers and Acquisitions
MDGs	Millennium Development Goals
MDL	Moldovan Leu (national currency)
Mom	month on month

NAER	National Agency for Energy Regulation (of the Republic of Moldova)
NBM	National Bank of Moldova
NBS	National Bureau of Statistics (of the Republic of Moldova)
NSS	National Statistical Service (of Armenia)
OA	Official Aid
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PPI	Producer Price Index
PPP	Parity Purchase Power
Qoq	quarter on quarter
SDR	Special Drawing Rights (international reserve assets)
SITC	Standard International Trade Classification
SOCAR	State Oil Company of the Azerbaijan Republic
SOFAZ	State Oil Fund of the Azerbaijan Republic
TEU	Twenty-foot Equivalent Unit
UAH	Ukrainian Hryvnia (national currency)
UN	United Nations
UNDP	United Nations Development Programme
UNCTAD	United Nations Conference on Trade and Development
UNICEF	United Nations Children's Fund
USAID	United States Agency for International Development
UNSD	United Nations Statistics Division
UN WTO	United Nations World Tourism Organisation
WB	World Bank
WHO	World Health Organization
WTO	World Trade Organization
Yoy	year on year

PRE FACE

Preface

The transition from a centrally planned to a market economy is not an easy process and has required strong political will and wide ranging economic reforms in the countries of Eastern Europe and the South Caucasus (EESC). The boom years from 2000 up to the global financial crisis masked, to a certain extent, inherent weaknesses of the region's economies in two key areas: social policy issues, such as health, education and gender equality, and private sector competitiveness. However, the 2009 crisis brought these persistent structural challenges once again to the forefront.

The study *Development in Eastern Europe and the South Caucasus* is the result of close co-operation between governments and private sector actors of the region, the OECD Development Centre and the OECD Directorate for Financial and Enterprise Affairs. Based on evidence from five country reviews, involving Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine, this study puts forward a number of recommendations to assist policy makers in formulating action plans for unleashing the development and competitiveness potential of the EESC region.

There is now an acute recognition of the need for governments to adopt coherent policies to meet a twin challenge: improving social services and supporting private sector development. Reforms in these two areas should go hand in hand. To sustain new industrial dynamism in the region, for instance, it is critically important to raise educational standards and adapt the priorities of educational establishments to the needs of the job market. This will require both central and local governments to address the skills gap that hampers economic progress and job creation in the EESC countries.

The recommendations presented here reflect the views expressed by economic actors through workshops and surveys conducted over the past year. We hope this study will make a useful contribution to the region's current endeavours for policy reform.

Mario Pezzini
Director, OECD Development Centre

Carolyn Ervin
Director, Directorate for Financial
and Enterprise Affairs

May 2011

EXECUTIVE SUMMARY

Executive Summary and Policy Conclusions

Development in Eastern Europe and the South Caucasus provides detailed country reviews of Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine. It explores current economic performance and the challenges of economic development and competitiveness. Despite differences in economic structures and policy reforms, all these countries face similar challenges arising from the transition from a centralised to a market economy in a climate of political uncertainty and societal change. For this reason, this book considers the five countries of the EESC as a region where the transition is "incomplete" in terms of the development of market economy conditions and institutions and where the competitive potential has yet to be realised.

Eastern Europe and the South Caucasus: A region with strong competitiveness potential

The five countries studied in this report, referred to as Eastern Europe and the South Caucasus (EESC), are part of the Organisation of the Black Sea Economic Cooperation (BSEC). The BSEC comprises 12 countries of the Black Sea area including Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine (EESC countries), as well as Albania, Bulgaria, Greece, Romania, Russia, Serbia and Turkey (or non-EESC countries). In this study, the BSEC will be also referred to as the "Black Sea" region.

The EESC countries account for 65.5 million people, nearly a third of the Black Sea population, when excluding Russia. Ukraine is the biggest of the five countries and accounts for over 60% of their total GDP. The EESC region is strategically located between Europe, the Middle East, the Black Sea and Central Asia with considerable access to these markets. The region is rich with natural resources, such as iron ore, copper, coal, steel, oil and natural gas, and land (Ukraine being among the world's top three grain exporters). In all the countries except for Armenia and Azerbaijan, services are becoming more important as the main sector of the economy, accounting on average for 50% of total EESC GDP in 2010. Though involving the largest part of population, agriculture has a declining trend as a percentage of GDP, with a share of around 13% in 2010.

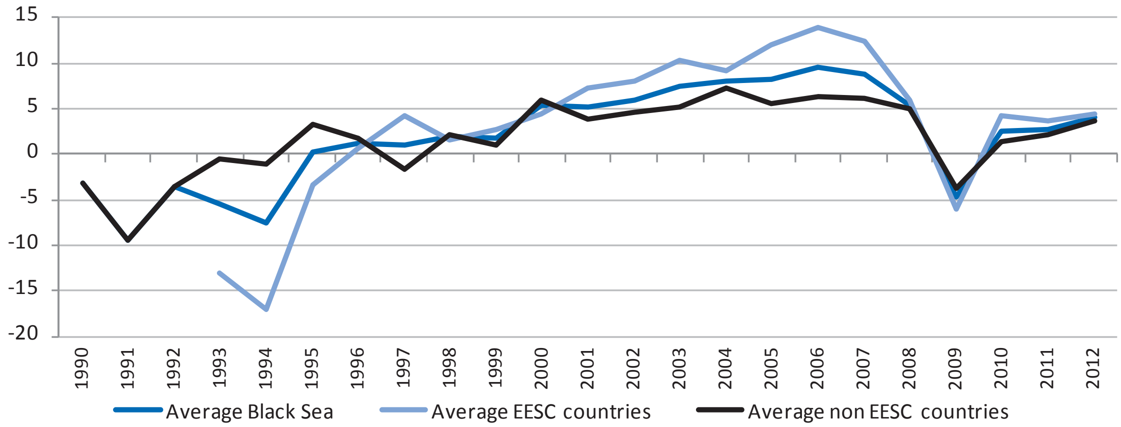
The EESC countries are well placed to link their vast resources to future growth in the global markets. With appropriate policies, this region can contribute to meeting the increasing global demand for food and energy. By 2050, feeding an additional 2.3 billion people globally will require a 70% increase in food production with more efficient resource use.[1] The region can therefore become a major food supplier, benefiting from a mild climate and from black soil; Ukraine accounts for one quarter of the world's black soils. Water is also an important asset in the region as Georgia and Armenia are developing hydropower plants with a view to self sufficiency and exports (renewable energies) and as irrigation systems are at the heart of the development of agriculture. However, for the potential of the region to be realised, reforms are necessary in a number of areas.

Difficult transition and impact of the financial crisis

After the collapse of the Soviet Union, the EESC countries entered a difficult transition period, experiencing negative double-digit growth rates. From 2000 up to the global crisis, the EESC countries enjoyed some of the fastest growth in the world, alongside increasing GDP per capita, mainly driven by rapid export growth (due to high international demand and prices for commodities such as steel and oil), high capital inflows – both from remittances and foreign direct investments, strong domestic consumption and expansionary fiscal policies. However, these developments turned to be unsustainable and paved the way for the sharp fall of 2009.

As the *Black Sea and Central Asia Outlook: Promoting Work and Well-being* (BSECAO), published in 2008, showed, these countries still suffer from transition problems such as large informal sector, brain drain due to emigration, high reliance on remittances and increasing health issues. The 2009 crisis was therefore accentuated by these structural problems.

Figure 0.1. GDP growth in the Black Sea countries (1990-2012)



Source: authors' calculation based on the IMF's World Economic Outlook, October 2010.

The 2008/9 global crisis hit the EESC countries hard (except Azerbaijan) resulting in the worst economic performance of all developing regions. Armenia and Ukraine registered the sharpest declines in the Black Sea region (14.4% and 15% respectively). In 2010, anti-crisis measures, coupled with the IMF and the World Bank's programmes, helped them to achieve modest recoveries.

The crisis highlighted the same vulnerabilities and challenges in the EESC economies as those stated in BSECAO. These are the social dimensions of economic performance and private sector development, which will be discussed below.

Social development and private sector growth pose major challenges across the region

"Quality of life" issues, such as improving national health conditions, reducing the need to emigrate and improving households' purchasing power, need to be given serious attention. Analysis of the region through the prism of the Millennium Development Goals (MDGs) reveals persistent poverty levels, poor health services, inadequate education and static or retreating levels of gender equality. Indeed, unemployment is strikingly high and wages remain very low, close to national subsistence level. Health conditions have been worsening since 2000, with increasing maternal and child mortality, and fast spreading HIV/AIDS – mostly in the Republic of Moldova and Ukraine where the rate is already high and, to a lesser extent, in the South Caucasus. Despite official high literacy rates, the quality of education has been worsening since the end of the Soviet Union owing to lack of investment. Gender inequality remains an issue in terms of both wages and working conditions, despite appropriate legal framework conditions.

The private sector represents the largest part of the economy (between 60% and 70% of contribution to GDP and over 90% of contribution to employment) and has been characterised by large privatisation waves since the end of the Soviet Union. The private sector is, however, unequally developed in these countries with concentration in main cities at the expense of rural areas. Over 90% of registered companies are small and medium-sized enterprises (SMEs) with their share in total GDP varying from 16% (Ukraine) to nearly 50% (Armenia) and accounting for the largest part of employment. Due to the large informal sector these figures underestimate the real size and contribution of SMEs and individual entrepreneurs to employment and GDP. Better framework conditions for private sector development and sustained economic growth are required through enhanced access to finance, a stronger human capital base and a second round of investment policy and promotion reform to increase competitiveness across the EESC region.

Main recommendations: a need to create an enabling environment for increased competitiveness

While the recommendations put forward by BSECAO (2008) are still valid, much more needs to be done to unleash the development and competitiveness potential of the EESC region. Four key areas have been identified and are addressed in this publication.

- First, promoting "green energy" and higher quality food as part of product and market differentiation.

After the collapse of the Soviet Union, the EESC countries continued to produce products according to their Soviet era specialisation (*e.g.* grain from Ukraine, wines from Georgia and the Republic of Moldova, etc.), rather than diversifying production and seeking new consumer markets. Exports in these countries are still relying on low value-added goods and services and on a small number of trading partners, namely the Commonwealth of Independent States (CIS), which makes the EESC countries highly dependent on both international commodity prices and the political and economic situations of their neighbours, with Russia remaining the region's dominant trading partner.

Energy is a key issue in the EESC region, as oil resources are declining in Azerbaijan and no other EESC country benefits from enough oil or gas resources, which makes them highly dependent on the Russian Federation. Ukraine, Georgia and Armenia could, however, drive "green energy" in the region. Indeed, there is potential to transform the region into a strategic energy hub. Ukraine could exploit its biofuel potential for an estimated output of up to 100 000 tonnes as the country is largely endowed with both black soils and scientific knowledge. Georgia is already exploiting its many rivers through hydropower plants and has succeeded in becoming self sufficient in electricity, with a strong export potential. Investments should be sustained in this area to create a regional network of energy distribution which is currently lacking and would enable Georgia to export to its neighbour countries. Armenia could also develop its hydropower energy. Agri-business could also drive agriculture in the EESC countries and provide jobs in rural areas where most of the population lives. It could sustain a large share of domestic food production, previously imported, such as canned food in Armenia, the Republic of Moldova and Ukraine.

- Second, rehabilitating infrastructure and better connecting national and regional markets.

Throughout the EESC countries, power, transport and telecommunication infrastructures are either lacking or in poor condition. Efforts should be made to upgrade and develop pipelines in Ukraine and Azerbaijan, electrical grids in Georgia and Armenia and roads in the Republic of Moldova. The more balanced development of port facilities could also be needed to increase trade in the Black Sea. Internet access should be widened and its speed improved. At a country level, a first priority should be to connect rural areas to big cities. Infrastructure includes not only basic economic facilities but also improved access to clean and drinkable water, directly connected to houses, and widespread efficient irrigation systems. Better connecting the internal market could therefore develop off-farm jobs and boost growth in rural areas. The private sector has a key role to play in rehabilitating infrastructure as its participation can demonstrate the longer-term viability of infrastructure projects.

Intra-regional trade should also be enhanced between the EESC countries. The gains from increased regional trade could be considerable, especially for SMEs that could benefit from economies of scale and hence lower unit costs by supplying to a larger market. Increased competition with countries of similar export structure (*e.g.* metals in Armenia, Georgia and Ukraine) can drive modernisation of their respective economies. Countries with different export structure could benefit from trade complementarity. Trade enhancement measures should be adopted, such as lower trade barriers, simplified formalities and procedures, harmonised laws and regulations, and enhanced infrastructures – which could be enabled by cross-border projects (such as the South Caucasus Pipeline and the Baku-Tbilisi-Ceyhan Pipeline, from Azerbaijan to Turkey through Georgia).

- Third, addressing the skill gap and promoting regional mobility.

Reforming and developing health and education services is an imperative, as this is the highway to an efficient and healthy labour force, increased competitiveness and reduced poverty. Despite a near full literacy rate in the EESC countries, the quality of education has been worsening since the end of the Soviet Union. Lack of investment in education, mostly in rural areas has led to the shortage of qualified staff (due to low wages), lack of equipment and increasing skill gaps. Governments of the region need to explore ways of keeping skilled workers, especially in the education system.

They need to develop a full workforce strategy programme, currently non-existent in all of the EESC countries, to link job market requirements to educational programmes. Training in these programmes should therefore be strengthened to match labour market needs. Moreover, strategies should be implemented to retain teachers, who are underpaid, in the education system and therefore raise the quality of education. There is a need for further co-operation between the public and private sectors to take measures improving licensing, staff incentives, re-training, support for re-equipment, and concessionary financing for the construction of new facilities.

Moreover, intra-regional labour mobility should be supported and common migration policies should be sought after as a higher degree of mobility enables the transfer of ideas, technology and best practices. This could help reduce brain drain from the region.

- Fourth, promoting Greenfield investments and facilitating access to finance.

Foreign direct investments (FDI) have so far resulted from privatisations and mergers and acquisitions. Despite a liberal investment policy framework, the EESC countries have yet to promote Greenfield projects. Knowledge-intensive and high value-added sectors are lacking in all of the EESC countries. With the end of the big privatisation waves and as a result of the global financial crisis, FDI flows are forecast to gradually decrease. To attract quality FDI, investment policy frameworks must be improved by reducing corruption and burdensome regulatory procedures, and by bringing different laws and regulations in line. The objective would be to channel FDI to technology-driven enterprises, such as in the field of green energy, to provide the necessary capital input, create jobs and ensure the development of new skills.

Another priority for EESC countries would be to improve access to finance for SMEs, mostly start-ups, whose growth prospects are often held back by high interest rates and collateral requirements. With the global crisis, credit tightening further limits SMEs' access to finance. Channelling the large remittances received by the EESC – net emigration countries – into the banking sector, through more attractive interest rates, could be one means of financing SMEs to make productive investments. Co-operatives are another answer to the lack of financing as they facilitate bank loans by guaranteeing the required collaterals. Creating an appropriate regulatory environment for further development of guarantee schemes and micro-financing could be a first step. Other means of financing, such as business angels and venture capital, should also be considered as policy instruments to support private sector development.

Structure of the country chapters

Each country study provides an overview of recent economic developments followed by an analysis of key economic sectors such as agriculture, industry and services. This is complemented by an analysis of main macroeconomic policies that governments have introduced covering fiscal policy, monetary policy and the external sector. Achievements in the social sphere are benchmarked against the United Nations Millennium Development Goals (MDGs). Each country study ends with an analysis of policies affecting private sector development, such as human capital development, access to finance, and investment policy and promotion. Targeted policy recommendations have been developed to support competitiveness and private sector development. The methodology applied in this section is based on the OECD Policies for Competitiveness Framework (PfC)[2] which is a self-assessment tool used by both public authorities and private sector representatives.

NOTES

1. Food and Agriculture Organization (FAO).
2. The Policies for Competitiveness Assessment Framework is a tool developed by the OECD Eurasia Competitiveness Programme, based on the OECD Policy Framework for Investment, which aims to assess, monitor and analyse the business environment in the countries of the Eurasia region. Through a series of surveys, the government, private sector representatives as well as civil society are requested to express their views and experience related to three key policy levers affecting a country's business environment: human capital development, access to finance and investment policy and promotion.

CHAPTER ONE

ARMENIA: COUNTRY REVIEW

SUMMARY

Armenia recorded an average economic growth of 13% in 2002-07. In 2008, gross domestic product (GDP) had doubled to USD 10.3 billion compared to its level in 2002 in real terms. Investments in the construction sector, powered by migrant worker remittances and to a lesser extent by foreign direct investment (FDI), provided the basis for economic growth. This boom was accompanied by a three-fold increase in imports between 2005 and 2008 while low-value exports increased at a much slower rate, leading to a huge trade deficit fuelled by remittances and Official Development Assistance (ODA). The economic sectors lack diversification, a competitive environment - many sectors in the industry are still highly monopolised - and modernisation.

The 2008 global crisis hit the real sector of the economy in Armenia, with an economic decline of 14.4% when measured in Armenian drams (AMD). Macroeconomic stability maintained by Armenia for the past decade allowed the government to mobilise significant external resources to launch counter-cyclical initiatives. However, the crisis further underscored the importance of improving the tax and customs administration and the business environment.

Major achievements prior to the crisis included declines in the number of people living below the poverty line and in child and maternal mortality. A number of major social problems still need to be addressed such as unemployment, environment, health and education, and regional inequality.

The report identifies main challenges and provides recommendations on measures to be strengthened in order to overcome the negative impact of the global economic crisis and achieve sustainable economic growth:

- decrease reliance on remittances and increase economic diversification;
- shift production and exports to higher value-added products and services (*e.g.* information technology);
- reinforce the insufficiently developed small and medium-sized enterprise (SME) sector through FDI-SME linkages programmes;
- reform the inefficient public finance and tax management systems.

INTRODUCTION

The Armenian economy collapsed in 1992 due to the fall of the Soviet Union. The ceasefire of 1994 with Azerbaijan, liberalisation and reforms then enabled the economy to grow steadily until 2008. From 2002 to 2007 it even recorded yearly double-digit growth. The consequent growth of per capita GDP resulted in the World Bank reclassifying Armenia from a low-income to lower middle-income country and poverty declined from 50% in 1999 to 23% in 2008. The economic priority of the government shifted from poverty reduction to sustainable development.

However, the country still remains comparatively poor with uneven distribution of income and wealth. Anti-competitive practices thrive in key sectors of the economy.

Major problems to be addressed are: reforming the tax system, the brain drain, unemployment, the huge trade deficit and reforming the health and education systems. The country's productive potential remains largely unused as the employment-to-population ratio has been around 35% since the early 1990s. There are also considerable shortcomings related to the quality of education on all levels. Armenia is in a region where the HIV/AIDS epidemic is growing fast and tuberculosis has increased. In parallel, migration remains high with more than 800 000 people (out of 3.8 million in 1991) having left Armenia in the 1990s in search of better economic opportunities. Finally, women's participation in social and economic life is unequal and much still needs to be done concerning women's rights.

For years Armenia maintained a large trade deficit that was financed predominantly by remittances and ODA. Since 2000, exports (mainly metals, diamonds and alcohol) have been 3-4 times lower than imports and more than 60% less in terms of types of commodities. More than half of exports go to the European Union (EU) and the rest to the Russian Federation and other Commonwealth of Independent States (CIS) countries.

The crisis reached Armenia by the end of 2008. In contrast to the two-digit economic growth of previous years, the growth rate decreased to 7% in 2008. The trend lasted throughout 2009, when GDP declined by 14.4%. According to the Economy and Values Research Centre survey, 70% of the population and 90% of entrepreneurs felt the effect of the crisis. The deformed structure of the economy was the primary reason for such a consequence as previous economic growth was based on unsustainable ground, with construction being fed by remittances and transfers from abroad.

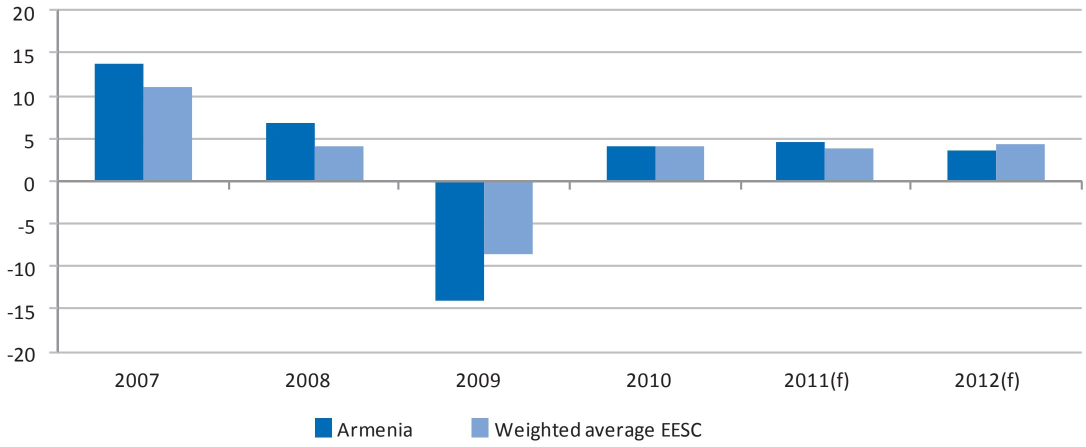
ODA has been secured for Armenia for the coming years, but significant risks remain if the resources are invested in incompetently planned public and private projects and if the public finance and tax management system remain on the current inefficient level. With the economic priority of the government shifting from poverty reduction to sustainable development, the development of Armenia's economy must not depend on construction; even so only 4% GDP growth is projected for 2010 and 4.6% for 2011.

RECENT ECONOMIC DEVELOPMENTS

In 2008, the economic growth rate in Armenia slowed down significantly. In 2007 it was 13.8% and projections for 2008 were between 8% and 10% prior to the crisis (EBRD, GoA). The global crises reached Armenia in the third and fourth quarters of 2008; overall, the economy recorded only 6.8% growth. In 2008 growth projections for 2009 were at around 8%, but the economy plummeted 14.6%. The economic decline for the EESC countries[1] was 8.5% (excluding Azerbaijan). Armenia is the only country of the group for which annual growth ranks as low as that of Ukraine for 2009 (-15%).

By the end of 2009 and early 2010, prospects brightened, the International Monetary Fund (IMF) and the Government of Armenia (GoA) suggested 1.2% growth for 2010, but after the economy registered 5.5% in the first quarter the projections were corrected to 5.3%.

Figure 1.1. Real growth rate in Armenia
(annual percentage change)

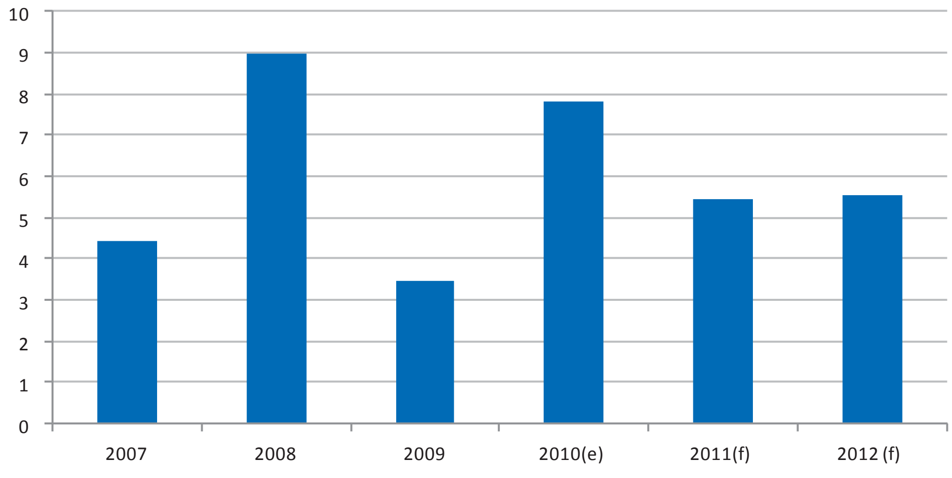


Source: IMF, WEO, Oct 2010.

According to official statistics, remittances contribute to around 20% of total GDP. In reality, however, this figure could easily rise to half of GDP, when considering that one third of total remittances are being sent through informal channels (World Bank), so lower remittance inflows would explain part of the GDP drop linked to the crisis.

Inflation was low in 2009 at 3.4% compared to 9% in 2008, as a result of declining incomes and demand. With the signs of recovery in early 2010, the consumer price index started to grow steadily, reaching 8% (in comparison with the same period of 2009) in April 2010.

Figure 1.2. Inflation, average consumer prices
(annual percentage change)



Sources: IMF and NSS.

The continuous growth up until 2008 resulted in GDP that was almost twice the size it was in 2002 (as well as in 1990) in real terms. National savings reached 31% of GDP in 2008 (IMF and NSS). Net new investments, measured by Gross Fixed Capital Formation (GFCF), doubled from 21% of GDP in 2002 to 40% in 2008, used predominantly to investment in buildings. GFCF decreased to 33% in 2009, to AMD 1 014.4 million – from AMD 1 418.8 million in 2008 and AMD 1 163.2 million in 2007 – and was sustained by the counter-cyclical initiatives of the GoA, financed by external loans.

Analysis by account

Consumption

Between 1999 and 2008 household incomes and expenditures grew 2.4 and 2.3 times respectively in nominal AMD; inflation in the corresponding years was 0.6% and 9%. Incomes registered a higher share of salaries and social transfers, while the share of unidentified other earnings, including remittances and sales of previously accumulated assets (gold, real estate, other) sharply decreased.

Economic growth and development of the mortgage market increased access to finance for the population. However, Armenian banks lend conservatively and the consumer and mortgage credits still have a wide margin for development. In 2006 mortgage credits totalled AMD 25.4 billion (USD 61 million), or around 10% of credit investments. This is quite a low number, compared to mortgage credits in developed countries that make up more than a half of total credits.

Table 1.1. Monthly income evolution between 1999 and 2009

Total expenditure	1999	2008	2009
Average monthly total income per capita (AMD)	11 217.0	26 866.0	28 038.0
Share of wages and salaries (% of total)	42.0	62.8	60.1
Share of social transfers	10.0	18.1	20.0
Share of sales earnings	16.0	6.8	6.1
Share of other earnings	32.0	12.3	13.8

Source: NSS.

Table 1.2. Monthly expenditure evolution between 1999 and 2009

Total expenditure	1999	2008	2009
Average monthly total expenditure per capita (AMD)	12 443.0	28 878.0	27 667.0
Share of food and tobacco (% of total expenses)	70.7	56.2	55.7
Share of non-food goods (%)	14.6	16.4	15.5
Share of services (%)	14.7	27.4	28.8

Source: NSS.

The expenditure structure changed towards a lower share of food and a higher share of non-food and especially services. While the economy grew at high rates, imports increased from USD 0.7 billion to 4.7 billion (IMF and MinFin), fuelling domestic demand. Following the crisis, consumption levels dropped along with economic growth and imports (by 14.4% and USD 1.1 billion respectively).

As of March 2010, roughly a year and a half after the crisis, a study by the World Food Programme revealed that almost half of households eat less of certain expensive food items, such as meat. In rural areas, the main food items consumed are potatoes, bread, pasta, dairy products (for those with animals) and beans. However, the diet of remittance receivers, workers in the mining sector and well-paid workers in Yerevan has not changed compared to the pre-crisis period, as their incomes mostly remained on the same level.

Government expenditures and revenues

Government revenues increased 4.3 times from 2000 to 2008. In 2009 revenues decreased by 10% from AMD 731 billion to AMD 655 billion, 20% and 21% of the GDP respectively. Total expenditures grew by 3.5 times from 2000 to 2008. In 2009 they increased by 12.6% from AMD 793 billion to AMD 893 billion, totalling 22% and 28% of GDP respectively (IMF).

Table 1.3. Evolution of government debt, revenue and expenditure
(AMD billion)

	2000	2008	2009	2010(e)
Total revenue and grants	172.2	730.8	654.6	738.4
Total revenue	163.6	715.6	634.4	676.3
Tax revenues	143.7	597.9	505.9	546.7
VAT	66.8	296.3	239.2	258.4
Profits, simplified and presumptive	20.4	113.3	104.9	103.6
Personal income tax	13.4	53.7	60.2	65.1
Customs duties	8.7	37.3	25.1	32.1
Other	34.4	97.3	76.5	87.5
Social contributions	8.8	104.1	102.9	105.2
Other revenue	11.1	13.6	25.6	24.4
Grants	8.5	15.1	20.2	62.1
Total expenditure	222.9	793.4	893.1	925.4
Expenses	168.6	652.0	712.0	753.5
Wages	19.5	73.0	83.5	87.2
Pensions	-	4.1	4.6	4.8
Subsidies	7.3	38.4	18.4	17.6
Interest	13.9	10.4	16.2	37.1
Social allowances and pensions	36.5	206.2	239.9	242.4
Of which: social insurance	-	153.5	176.0	178.0
Goods and services	91.4	133.1	150.7	153.4
Grants	-	52.9	62.0	66.8
Other expenditure	-	133.9	136.6	144.4
Transactions in non-financial assets	38.7	141.5	181.1	171.9
Acquisition of non-financial assets	31.8	162.6	191.8	172.0
Of which: projects related to the Russian loan	-	-	26.5	22.0
Disposals of non-financial assets	6.9	21.1	10.6	0
Overall balance (above-the-line)	-	-62.7	-238.5	-187.0
Statistical discrepancy	-	21.0	-9.2	0
Overall balance (below-the-line)	-	-41.7	-247.7	-187.0
Financing	50.8	41.7	247.7	187.0
Domestic financing	28.3	23.7	-108.5	39.2
Banking system	-	-9.6	-40.0	49.8
CBA	-	-33.0	-54.4	11.1
Of which : deposits related to the Russian loan	-	0	-76.6	37.1
Commercial Banks	-	23.4	14.4	38.7
Non banks	28.3	33.4	-68.5	-10.6
Privatisation proceeds	21.5	31.6	-	-
T-Bills	1.8	3.5	8.7	3.0
Promissory note/other	5.0	-1.2	-3.2	-2.0
Net lending	-	-0.5	-74.0	-11.6
Of which : financed with the Russian loan	-	-	-78.8	-13.1
External financing	22.5	17.9	356.2	147.8
Gross inflow (with IMF support)		48.8	395.6	191.1
Of which: Russian project loan	-	-	-	-
Amortisation due	-	-4.9	-6.3	-10.2
Net lending	-	-26	-33.1	-33.1

Sources: Ministry of Economy AED 2009, IMF.

Consumption in 2009 was backed by heavy borrowings from international sources. The external debt-to-GDP ratio reached 34% in 2009 in contrast to 13.2% in 2008. The ratio was projected by the IMF to reach 43% by the end of 2010 but had already reached 52% by November 2010 according to the National Statistical Service of Armenia (NSS). However, this debt accumulation has been in line with GoA's anti-crisis policy, which among other measures covers several large infrastructure-related projects (water supply, roads and nuclear power station).

The total external debt stock reached USD 3.23 billion in November 2010, up from USD 2.97 billion in 2009 and USD 1.58 billion in 2008, *i.e.* external debt increased by USD 0.26 billion between 2009 and November 2010 compared to an increase of USD 1.39 billion between 2009 and 2008, as a consequence of the crisis. Since the crisis, the IMF has already disbursed USD 458 million (under the Stand-By Arrangement [SBA], of the total access to USD 810 million) and the World Bank USD 60 million under the First Development Policy Operation (DPO-1). The Asian Development Bank (ADB) allocated USD 80 million for budget support (USD 36 million for the Water Supply and Sanitation Sector Project and USD 47.9 million for the Rural Roads Sector Project) and USD 60 million as the first tranche of North-South corridor construction in 2008 (total of USD 500 million in 7 years). The Russian Federation provided USD 500 million to finance infrastructure expenditures and on-lending for large and small to medium enterprise (SME) support and development.

Table 1.4. Schedule of repayments to the IMF
(SDR million, currently calculated at 1 SDR = USD 1.52)

	2010	2011	2012	2013	2014
Principal	14.13	14.44	101.00	162.04	72.38
Interest	3.24	4.32	4.09	2.28	0.52
Total	17.47	18.76	105.09	164.31	72.90

Source: Republic of Armenia: Third Review Under the Stand-By Arrangement, IMF, April 2010.

Foreign debt accumulation pushed GoA to start fiscal consolidation. Their commitment to narrowing the budget deficit and the recovery of the economy since early 2010 signal that the debt is sustainable and that the repayment schedule is possible. Indeed, Armenian and international economic recovery, returning flows of remittances and the growth of metal exports are some of the many variables to support this conclusion. However, the most important issue is the political will of the authorities to introduce real changes into the economic system, making it fair, competitive and diversified.

According to the debt-management strategy provided by GoA to the IMF, GoA will reduce the budget deficit to 4.8% of GDP in 2010, improve tax administration along with the tax-to-GDP ratio, and keep spending at budgeted amounts, cutting non-priority expenditures if needed. With strong tax-administration reform GoA projects tax revenues to increase by 1.7% of GDP during 2010-13. GoA has also announced a reduction in the lending programme financed by the USD 500 million Russian loans.

The major factor that could negatively affect the state budget and debt repayments is the exchange rate, which, in case of depreciation, would create heavier pressure on the budget. However, AMD depreciation may not be much of a concern since, with the economic recovery in Russia, remittance flows have also been recovering. Moreover, keeping the AMD at a stable rate is in the interest of the ruling elites, since most of them are involved in import businesses, the profitability of which directly depends on the exchange rate.

The real risk is that the debt may be rolled over, since the IMF financing has a short maturity with repurchase obligations during 2012-14. Along with remittance flows and economic recovery, levering this risk will depend on GoA's budget discipline and tax administration reforms to increase tax collection by bringing large businesses into the legal field.

Table 1.5. Debt service ratio

	2007	2008	2009	2010	2011	2012	2013
Nominal external debt (USD million)	1 449	1 577	2 967	3 553	3 727	3 593	3 225
Nominal external debt stock (% GDP)	15.7	13.2	34.0	43.0	44.9	41.8	35.6
External debt-to-exports ratio (%)	81.6	92.2	223.5	235.5	220.6	194.1	159.0
External debt service (% exports)	2.9	3.2	5.4	6.3	6.2	13.4	21.6

Source: Republic of Armenia: Third Review Under the Stand-By Arrangement, IMF, April 2010.

Investments

Investments in the construction sector powered by remittances and to some extent by FDI provided the basis for growth, leading private transfers to Armenia to be correlated with real estate prices. FDI increased from USD 104 million in 2000 to USD 935 million in 2008, while remittances, according to official figures, grew from USD 761 million in 2004 to USD 2.3 billion in 2008 (USD 1.6 billion in 2009). According to the World Bank *Migration and Remittances Factbook 2011*, remittances inflows declined to USD 0.7 billion in 2009 and should amount to USD 0.8 billion in 2010 (World Bank, 2011).

The bulk of FDI has turned since the mid-2000s to transport (airport, railway) and telecommunications, metals and mining, banking and construction sectors while in the 1990s and early 2000s it was directed towards privatised public utilities (water, gas, electricity).

The crisis proved that Armenian economic growth was based on unsustainable grounds. *S*ince 2000 its major driver has been construction fuelled by remittances and international and diaspora donor-backed programmes, along with resource dominated exports (metals). These pillars collapsed with the first signs of recession in global markets. The most vulnerable to recession was the construction sector, which decreased by more than a half in the first and second quarters of 2009, the fall of metals exports was almost the same in that period, and private transfers decreased by 30%.

Only investments in consumer industries, such as retail and food processing, proved to be viable in the long run. These sectors recorded some positive trends, even in the crisis year.

Trade

Armenia has limited land and capital resources and has been relying heavily on imports. Imports have traditionally been around two to three times higher than exports, which has had negative qualitative and quantitative effects on GDP growth. The trade balance has been deteriorating even in periods of high economic growth since the trade deficit has been the counterpart to increased inflows of FDI, ODA and remittances.

The trade deficit increased from USD 367 million in 2002 to USD 2.6 billion in 2008, decreasing to USD 2.1 billion in 2009. The exports to imports ratio was stable between 2002 and 2005 at 0.55, before declining in 2006 and reaching 0.25 in 2008, reflecting a higher increase in imports compared to that of exports. The current account deficit was 1.8% of GDP in 2006, 6.4% in 2007, 11.5% in 2008 and 13.8% in 2009 (IMF).

Armenia's primary exports are low value-added metals (ore, concentrate, etc.); high value-added metals, however, in the form of machinery and equipment, are a significant share of imports. The focus should be on increasing exports' value-added by channelling the appropriate investment towards processing Armenia's primary products (*e.g.* refined ore).

The main goods imports have been minerals, metal products and machinery (together 39% of the total in 2008 and 45% in 2009), including petroleum, natural gas, equipment and mechanisms, as well as ready-made food and transport (together 21% of the total in 2008 and 15% in 2009).

The main goods exports have been minerals and base metals (together 49% of the total in 2008 and 52% in 2009), including copper, iron and aluminium, as well as ready-made food and precious stones and metals products (together 32% of the total in 2008 and 29% in 2009), which, in essence, represent alcoholic beverages and processed diamonds.

Table 1.6. Major items in services trade in 2009
(USD million)

	Transport	Communication services	Insurance services	Computer and information services
Balance	-273.75	34.75	-40.95	38.4
Credit/Exports	108.66	51.7	10.54	43.23
Debit/Imports	-382.41	-16.95	-51.5	-4.83

Source: NSS Yearbook 2009, BoP, Current Account.

Informal economy[2]

According to the World Bank, the informal economy in Armenia accounts for about 35-40% of the GDP, contrary to the opposition parties' claim of 70%, and in the retail trade and services sector the share may be as high as 80%. Schneider's 2007 estimate fixes this share at around 41.1% of GDP, but this may have risen due to the crisis (Schneider, 2010). Indeed, in 2010, up to half of the economy could be informal and "double dipping" could push this figure up to 60% of GDP.

The IMF in Armenia maintains that the level of tax collection in comparison with the actual volumes of the economy is extremely low. The IMF has constantly kept in focus the issue of effective tax administration, but even with its assistance the GoA has not had satisfactory results. The levels of tax revenue ranged between 13% and 16.4% of GDP between 2001 and 2008. The IMF analysis finds there is a gap of 6.5% between what should be collected and the actual figures, which is a result of weak institutions and a large shadow economy (IMF, 2007).[3]

Two main negative consequences of the informal economy should be mentioned for Armenia: the reduction of budget revenues and the distortion of the competitiveness field. On the positive side is the mitigation of unemployment.

There has been no improvement in the informal economy share in Armenia since the 1990s, and none of the subsequent governments registered really positive results. Governments initially sought to apply tax models of the developed Western countries in Armenia without taking into account the resource capacity of the state.[4] Distinctive features of these tax models are their complexity and high rates. Such models can work only in the environment of effective public institutions and regulation mechanisms, as well as adequate material and technical capacities of tax authorities.

The level of the informal economy in Armenia is a natural reaction to the insufficient quality of public administration. The reduced quality and quantity of public services - among others law enforcement, judiciary, infrastructure, health and education - compared to the high level of taxation lead the tax burden in Armenia to be prohibitive. Indeed, the costs and benefits of being on the informal side outweigh those of operating in the formal sector. Attempts at administrative control are doomed to failure in the absence of healthy public administration strategies and with inadequate tax policies and a legislation that provokes corruption, which, in turn, favours the informal economy's development and reduces state revenues available for public services.

Overall, the three major conditions to fight informal economy and corruption are: *i)* the political will of the leadership; *ii)* efficient tax regulations; and *iii)* an effective judicial system. The most prevalent of these is the political will of relevant authorities to improve public services and stop this vicious circle; a good example is the positive economic changes in Georgia under the administration of President Saakashvili.

It should be possible to reduce the informal economy by fighting corruption, simplifying tax laws and bringing tax policies in line with the resource capabilities of the state. The quality of services provided by the state should be improved and sound fiscal policies conducted so as not to hinder, but to promote private sector development.

ANALYSIS BY ECONOMIC SECTOR

Armenia recorded double-digit economic growth at 13% on average from 2002 to 2007. Almost all sectors of the economy grew and new ones, such as IT and Telecoms, developed in this period. However, the growth has been fuelled not by the increase of the productive sectors, but by multibillion dollar migrant workers' remittances and the expansion of the construction sector.

Table 1.7. **Main sectors of the economy**

	2001	2007	2008	2009	2001/07	2008	2009
	Structure in nominal GDP (%)				**Growth rate** (%)		
Main Sectors	69.1	68.7	66.9	56.7	12.5	5.6	-
Construction	9.7	24.5	26.9	18.2	26.7	7.2	-36.4
Agriculture	25.6	18.3	15.9	17.6	8.0	1.3	-0.1
Industry Total	23.2	15.0	13.1	21.0	-	-	-7.8
Mining	0.8	2.3	1.8	2.9	10.1	1.5	7.6
Manufacturing	15.7	9.4	8.3	13.9	7.1	0.6	-8.8
Electricity, gas and water supply	6.7	3.3	3.0	4.1	0.1	8.0	-13.3
Trade, repair	10.6	10.9	11.0	-	13.6	7.9	-

Source: National Statistical Service of Armenia, *Armenia Economic Report 2009*, Authors' calculations. See also the "GDP by Sector in 2008" Table in the Annex.

Agriculture

General overview

Agriculture is one of the main areas of the Armenian economy and the primary source of income for the rural population. Agricultural production in Armenia is comprised of one-third of cattle breeding and two-thirds of crop production. The most cultivated plants in Armenia are wheat, barley, potatoes, tomatoes and a variety of fruits and vegetables. Up until today the loss-making character of individual farms is one of the most serious problems in agriculture. Low profitability of agricultural production in Armenia is the major factor that deters the development of large-scale commercial farms. Agricultural output is thus declining. In 2010, up until November, it totalled AMD 596.7 billion (USD 1.5 billion), a yoy decrease of 14.5%: AMD 385.8 billion in crop production (USD 1.0 billion) and AMD 210.9 billion in livestock (USD 0.55 billion).

As a result of a rushed land reform in 1991, around 900 collective farms were liquidated and their assets (worth billions of dollars) were embezzled, mostly by farm managers and local authorities.[5] The number of livestock (cattle, sheep and pigs) decreased significantly; cattle by 42%, sheep by 68% and pigs by 75% (between 1985 and 1995). Cultivated land area also decreased by one-third.

Table 1.8. **Number of livestock in Armenia before/after independence**
(head-count in thousands)

Years	Cattle		Pigs	Small ruminants	Poultry
	Total	of which cows			
1985	874.6	326.0	322.1	1 969	12.13
1990	566.5	251.1	224.4	1 023	3.40
1995	503.7	276.0	82.3	636	2.90

Source: The Food and Agriculture Organization of the United Nations (FAO).

Access to land, providing the opportunity to produce food for household consumption (subsistence agriculture), improved the living conditions of many rural inhabitants at the time of the economic collapse of the early 1990s. However, by 2000, agricultural labour productivity had declined dramatically, by four times according to some estimates. In the same year, Armenia produced only around 40% of the agricultural output of 1986.[6]

The agricultural sector of Armenia improved in the years of high economic growth, increasing on average by 8% between 2001 and 2007, starting from a very low starting base. Farms started to rebuild herds, develop market gardening and revamp vineyards. Large-scale poultry farms were set up. The positive trend came as a result of spontaneous development rather than a targeted agricultural policy.

Table 1.9. Main crop production between 2000 and 2009
(thousand tonnes)

	2000	2009
Vegetables	375.7	819.8
Potatoes	290.3	593.6
Grain (weight after processing)	224.8	374.9
Fruit and berries	128.5	332.2
Grapes	115.8	208.6
Watermelons and melons	52.8	216.6

Source: NSS.

Agricultural activities occupy about 44% of all land. The basic crops are melons and watermelons, potatoes, wheat, grapes, fruits, essential oil plants, tobacco and sugar beet. The livestock sector specialises in dairy-meat cattle breeding and sheep breeding in the mountains.

Table 1.10. Main livestock production between 2000 and 2009
(thousand tonnes)

	2000	2009
Meat (slaughter weight)	50.5	70.7
Of which:		
beef and veal	30.1	49.6
pork	9.6	7.2
mutton and goat meat	5.5	8.9
poultry meat	5.3	5.0
Milk	452.1	653.0
Eggs (million units)	385.4	630.1
Wool (physical weight)	1 310	1 307

Source: NSS.

In value (at current AMD prices), the sector remained almost at the same level in 2009 compared to 2008, but the volume decreased by around 5.5%. Wheat and potato production decreased, contrary to fruit production, specifically grapes and watermelons, cattle breeding and fish breeding, which increased.[7] The volume of production remains insufficient. Starting in 2010, there has been an unprecedented increase in the price of fruit, vegetables and meat (from 40% to more than 100%), both wholesale and retail. For example, there has been a striking increase in the price of mutton as a result of the unprecedented volume of sheep exports (110 000 sheep compared to 13 000 in 2008) to neighbouring Iran.[8] Mutton prices in December 2009 had already doubled year on year (yoy) (from USD 4 per kilogram to USD 8).

Grape cultivation for alcohol production (mainly wine and brandy) has traditionally been an important sector for Armenian agriculture. The collapse of the economy in the early 1990s resulted in the loss of export markets and the liquidation of vineyards. Grape cultivation started to recover in the early 2000s. However, restoring vineyards is a difficult task that requires serious investments. State support is very limited, the price of water is high and the wholesale price of the final product is low (around 25 cents per kg).

If wine and cognac producers were able to increase export volumes, as a result of growing demand in Russia and increased output of existing (Pernod Ricard, Yerevan Brandy, Proshyan) and new (Armenian) producers (foreign and local capital), especially as the harvest was high in 2010, the sector could be well on its way to a form of recovery.

Prior to the crisis, from 2004 to 2008 the gross agricultural output grew by 25%. However, during this same time, the ratio of imports to exports of food products increased from 2.5 to 1 to 3.1 to 1 (note, in 1998 the ratio was 13.3 to 1).

Armenia is far from self sufficient in vegetable oil, sugar and poultry, as well as in wheat and pork. This situation is quite natural taking into account the fact that Armenia is a small, mountainous country with a limited area of arable land, accounting for only 21% of total land area (or 450 400 hectares). However, there is a potential to increase the stock of poultry and pork, returning to the high levels of production of Soviet times.

Reforms

The institutional framework for the agriculture sector in Armenia was put in place with the adoption of the "Peasant and Peasant Collective Farms Law" and the "Land Law" in February 1991, followed by legislation for land privatisation. 70% of arable land was divided between individual farmers, while the remainder was leased to farmers as reserved state land. Most of these leases run from one to three years, the majority comprised of hay meadows and pastures. This state reserve land was to be sold to private farmers in larger amounts later on. After this wave of privatisation, around 300 000 farms were created, a number that has remained stable. Only 3% of farms belong to commercial organisations, the rest being owned by households. A survey carried out in early 1998 found that around 60% of farms are between 0.5 to 2.5 hectares, with a median farm size of 1.5 hectares (NSS, FAO).

In 2004-05 there was a major institutional transformation in terms of property rights of land, when state-owned land was transferred to local authorities. The communities acquired the right to sell, lease or manage the land.

Since membership of the World Trade Organization (WTO) in 2003, Armenia has been trying to improve the regulatory framework, institutional base, sanitary and phytosanitary control, consumer protection (food safety) and other areas within the requirements of the WTO.

Currently Armenia is in the process of harmonisation of the sanitary, phytosanitary and veterinary controls with the CIS countries. An Intergovernmental Council for the agricultural sector has been set up to co-ordinate activities aimed at integrating the agricultural sectors of the CIS countries.

Armenia has a significant potential for producing organic products, which can be competitive because of favourable climatic conditions and affordable costs of land and labour. The law "On Organic Agriculture" was adopted on 8 April 2008 to regulate the production, preservation, processing, transportation and sale of agricultural products and to define the principles of management of organic agriculture: improvement of the soil's qualities, ensuring maximum preservation of biological value of agricultural foodstuff in processing; and elimination of environmental pollution (use of synthetic chemical substances) and genetically modified crops. The law also stipulates state support to organic agriculture by assisting to introduce innovations and modern technology; organising business forums and fairs, thus strengthening co-operation between countries and fostering exports; and financing "target projects".

Agriculture was made the priority area in 2010. The strategy and the implementation plan for 2010-20 sustainable development in agriculture were discussed in February 2010 (GoA). A noteworthy initiative on the side of the government has been a plan to create a free economic zone adjacent to Yerevan international airport that will help export agricultural products. The concept envisages full engagement of the production-processing-marketing link.[9] According to estimations the project will result in a 20% increase in exports (mostly to Russia and to the European Union [EU]) of Armenian agricultural products within a year after implementation. In 2009, the export value of agricultural products totalled USD 19 million.

Table 1.11. National food balance of Armenia, 2008
(thousand tonnes)

	Opening stocks	Production	Imports	Total supply	Food consumption	Food use	Waste	Seed	Exports	Other use	Closing stock	Total utilisation	Self-sufficiency ratio
Wheat	162.2	225.7	342	729.9	442.4	57.3	11.5	23.3	0.9	0	194.5	729.9	39.8
Potatoes	483.9	648.6	4.3	1 136.8	148.6	67.4	139.3	137.2	3.6	0	640.7	1 136.8	99.9
Vegetables	26.1	1 007.5	22.9	1 056.5	942.1	17.2	49.3	0.8	17.4	0	29.7	1 056.5	99.5
Fruits (except grapes)	76.5	317.8	36.7	431	294.8	0	35	0	14.1	0	87.1	431	93.4
Legume crops	3.1	6.2	4.5	13.8	9.5	0	0.6	0.2	0	0	3.5	13.8	57.9
Vegetable oil	1.9	0.4	23.3	25.6	23.3	0	0.4	0	0	0	1.9	25.6	1.7
Sugar	4.1	3.8	108.4	116.3	108.5	0	1.7	0	1.2	0	4.9	116.3	3.4
Eggs	0.3	31.7	0.3	32.3	29.5	0	0.8	1.5	0.2	0	0.3	32.3	99.7
Milk (except for butter)	72.2	661.9	20.5	754.6	583.2	66.2	3.1	0	4	0	98.1	754.6	97.6
Beef	0.3	49.3	19.5	69.1	67.1	0	0.8	0	0.9	0	0.3	69.1	72.8
Pork	0.1	7.5	16.5	24.1	23.7	0	0.2	0	0.1	0	0.1	24.1	31.4
Mutton and goat meat	0	7.4	0	7.4	7.3	0	0.1	0	0	0	0	7.4	100
Poultry	0.2	6.7	41.1	48	47.6	0	0.1	0	0.1	0	0.2	48	14
Grapes	7.9	185.8	1.8	195.5	11.2	0	8.8	0	2.9	161.8	10.8	195.5	100

Source: NSS, Food security and poverty, January-March 2010.

Policy implications

Armenia has been facing a troubling phenomenon: a growing economy with deteriorating trade balance, stagnating real incomes of farmers, unprofitable agricultural activities. There is a real danger of liquidation of small farms in the absence of effective agricultural policies. As the rural sector was left out of economic growth until 2008, and despite the increase in average monthly nominal wages in agriculture from AMD 30 000 to AMD 69 000, it is still preferable for farmers to engage in other economic activities or to look for better opportunities as migrant workers (mostly to Russia), as their absolute amount of income is very low.

The most important problems for agriculture in Armenia remain: the poor state of the irrigation network, climate dependency, inability to buy quality seeds, chemicals, diesel fuel, lack of agricultural equipment, lack of quality roads, low purchasing prices, high costs of veterinary services and lack of access to technical information and technology.

In Soviet times, Armenia had a specialised collective-based agriculture, which collapsed as a result of the privatisation process, with deterioration of land, labour, enterprises and technology. Therefore effective agricultural policy also faces several challenges such as the management of communal pastures, extreme fragmentation of existing peasant farms, establishing sustainable land management and drawing up plans to modernise agricultural production.

An effective agricultural policy is still needed for Armenia, to ensure both self-sufficiency and a positive trade balance in food. Strategies must be developed to focus on consolidation, specialisation and commercialisation. The share of commercial organisations in agriculture is negligible and was already on a downward trend prior to the crisis, from 3.8% in 2004 to 2.8% of the total commercial organisations in 2008. Through consolidation and commercialisation, it would therefore be possible to increase yield and productivity. Finally, particular attention should be paid to infrastructure-related issues, such as irrigation, roads and communication, in order to increase both productivity and sales, and thus revenues.

Industry

General overview

The major issues for industry in Armenia are diversification, lack of a competitive environment and modernisation. Many sectors in the industry remain highly monopolised despite the fact that GoA approved amendments to the Law "On Protection of Economic Competition" in 2004.[10]

GoA sees industrial development for the near future to be based on new technologies and advanced management.[11] Producers that use domestic resources to manufacture competitive products should be supported. The state-owned Armenian Development Agency (established in 1998) is one of the tools created to provide technical and marketing support to competitive export-oriented enterprises and to act as a "one-stop shop" for assisting investors. However, the operations of this agency are widely criticised for ineffectiveness, both in public and in private circles.

In January 2010, GoA approved a concept of industrial development. The principal goal is to increase the share of industry in GDP. The concept envisages the formation of an advanced and export-oriented industrial system. Operational headquarters will be set up to review financing of specific projects. It remains to be seen if and how this concept will be implemented, but considering industry's current situation and its resource base there is not much room for optimism.

The main industrial sub-sectors in Armenia are manufacturing, mining and energy. The largest branch of manufacturing is food processing (almost half); others include chemical industry, tobacco and jewellery. Electric power production and distribution represent 70% of the total energy and water sector, with 10% of total production being exported to Georgia and Iran.

According to the NSS in January-April 2010, industrial output increased by 13% to exceed the pre-crisis output level. Such progress is quite impressive, considering that in 2009 industry declined by around 8%. It should be noted, however, that the indicator of industrial growth is limited mostly to the mining sector. By November 2010, industrial output had reached AMD 734.6 billion (USD 1.9 billion) a yoy increase of 9.8%. The increase in 2010 was due to the growth of the world metals market, which drove the domestic mining sector and thus industry and the GDP and the pick-up is therefore not directly related to GoA economic policies and strategies. The crisis revealed the lack of diversification of the sector as industry is predominantly based on molybdenum, copper and cognac.[12]

Mining

Introduction

Armenia does not produce energy resources such as coal, oil and natural gas. All energy resources are imported from Russia and Turkmenistan (14.6% of total imports). However, Armenia possesses the second-largest reserves of copper in the world (70% of the mining sector), significant reserves of molybdenum (15%) and to a lesser extent zinc and gold. Copper, molybdenum and gold are exported to Europe, Russia and China. There are no domestic markets in Armenia such as processing and manufacturing industries to use copper and molybdenum to produce high value-added products, which leads the country to produce low value-added raw materials.

Mining has always played an important role as Armenia used to be a major producer of molybdenum in the Soviet Union (one-third of total consumption) with outputs of 8 000 tonnes per annum. In this respect, the country is quite complementary to two of its neighbours, Georgia and Azerbaijan. If Georgia is a direct competitor in steel and non-ferrous metals (but in lesser proportion), the country mainly possesses energy and fuel resources, such as coal. Azerbaijan, on the other side, is not rich in metals (with little aluminium, lead, steel and zinc) but is one of the world leaders in petroleum and gas.

In 2001-07 the average annual growth of the mining sector was 10% (NSS). Around 40% of Armenia's exports in 2009 were mining products. The decline in prices for copper and molybdenum in the world market due to the crisis resulted in a considerable decline of the sector (11%) at the beginning of 2009. Exports also dropped more than two-fold. However, later in the year, it started to recover and finally showed a 7.6% growth. This trend continued in 2010 due to a pick-up international demand.

There are several issues in the mining sector such as high transportation costs and environmental damage. Since Armenia is a landlocked country, there is insufficient infrastructure to carry mining products to the markets abroad since there are no railways or quality roads to connect the mining areas with ports. Companies are thus obliged to transport their product via low quality roads to Yerevan and then to Georgian ports by rail or by truck.

Mines and smelters have also polluted the nearby rivers, soil, forests and air. Despite a lack of finance and regulations, a Special Environment Protection fund has been established and for the past five years mining companies have been paying compensation (in total around AMD 300 million or USD 1 million) for damage to the soil. GoA also charged the mining companies AMD 4 billion in 2006 for "nature use", mostly for the treatment of waste water, storage, treatment and disposal of solid wastes and soil remediation.[13]

Current situation of the mining industry

Zangezur Copper Molybdenum Combine in the south is the largest enterprise, with 87% and 8% of the total regional deposits of copper and molybdenum respectively. It is operated by Cronimet and works at optimal capacity. Armenia Copper Programme (ACP) manages the Alaverdi copper mines and smelter in the north. The present operation of the smelter is at 40% of the total capacity since the smelting technologies are outdated and most of the copper concentrate is being exported before getting to the smelter. The Ararat Gold Recovery Company (AGRC) manages two gold mines (Zod and Megradzor). The annual gold production ranges from two to three tonnes. An expansion programme started recently (worth USD 100 million) that will introduce new technologies and equipment to the production process.

The decline in prices for copper and molybdenum in the world market due to the global crisis resulted in a considerable decline of the sector at the beginning of 2009. In June 2009, in order to support the sector the GoA decided to provide loans of USD 44 million to copper and molybdenum-producing companies (taken from a Russian loan of USD 500 million), which they mostly used to avoid layoffs and maintain production. This measure proved to be justified. Later in the year the industry started to recover and finally showed a 7.6% growth.

As a sign of economic recovery, in January-April 2010 output of molybdenum and copper concentrate in volume (tonnes) increased by 68% compared to the same period in 2009 (copper by 77%, molybdenum by only 1%); 39 000 tonnes of copper concentrate and 2 800 tonnes of molybdenum concentrate were produced (NSS). In November, total mining output had reached AMD 130.9 billion (USD 0.34 billion).

Due to the growth of the mining sector, its share in total industrial production (including energy) peaked to 19% in 2009, compared to 12.6% in 2008. It is expected that with intensification of production and development of new reserves of copper, molybdenum and gold the industry and the GDP will grow significantly. The question remains if this growth will have a positive effect across the economy and benefit the general public.

Taxation and main policies adopted

According to Armenian legislation all mineral deposits belong to the state, the Ministry of Energy and Nature Resources issuing licenses to explore and exploit the subsoil resources, and the Ministry of Nature Protection is responsible for environmental controls. The Subsoil Code and the Law on Concessions of 2003 along with their amendments create legal premises to regulate the mining industry. According to the amendments to the Concessions Law of 2003 variable royalty (turnover tax) on mining production has been set. The royalty starts at 1% and reaches 1.8% depending on the profitability of the enterprise. The mining licences entitle the holder to carry out mining operations for periods of up to 12 or up to 25 years.

According to the Code, foreign enterprises are free to obtain exploration and mining licences. Indeed, there have been considerable investments in the sector from abroad. All mining enterprises were privatised by 2005. In 2003-04, the German Cronimet acquired Zangezur plant and the United States-based Comsup Commodities bought Agarak plant. It is claimed that these companies have invested around USD 200 million to modernise production facilities at the plants. In reality most of this investment went to increase capacity, *i.e.* on machines to dig and transport the ore, whereas the plants are still equipped with grinders and other production equipment from Soviet times. US-based Global Gold Corp recently acquired the Toukhmanuk gold property and processing plant.

Potential

According to the Ministry of Economy, Armenia's copper resources are sufficient to support mining at current rates for another 300 years. Total copper reserves of Armenia are estimated at 7 200 megatonnes and total molybdenum reserves at 790 000 tonnes (Mining Communications Ltd., 2005). Gold deposits are rather small, total reserves estimated at 390 tonnes.

Table 1.12. Mineral production by plant in 2001/02
(tonnes)

Mine	Minerals	Capacity tonnes)	Result (tonnes)	Utilisation rate (%)
Kajaran	Copper	9 100 000	8 067 000	88.6
Agarak	Copper	3 200 000	1 855 000	58.0
Kapan	Total	1 300 000	264 620	20.4
	Copper	1 000 000	181 441	18.1
	Polymetallic	300 000	83 179	27.7

Source: Study on Mining Sector Development Master Plan in the Republic of Armenia final report, 2003.[14]

Barriers to full potential of mining

Infrastructure factors that may hinder mineral resources development in Armenia are transportation, railways and roads, as well as electric power. Copper and molybdenum concentrates produced at a plant in the south of the country cannot be transported by rail via the Azerbaijani enclave of Nakhichevan, due to the unresolved Karabakh conflict and the closure of borders.

There is a project called the North-South Road Corridor, sponsored by the ADB, under which a highway will be constructed to run from the Iranian border in the south to the Georgian border in the north. The preliminary studies and calculations have been made and it remains to be seen how long it will take to start and complete the actual construction of the highway. Once constructed, it will allow easier access to the Georgian ports of Poti and Batumi on the Black Sea.

The cost of electric power in Armenia is another hindering factor for mining. Electric power in Armenian mining enterprises accounts for about 30% of the total production cost. The country depends on energy imports, mostly from Russia (gas, and uranium for the nuclear power plant) and to a far lesser extent from Iran (since the launching of the Iran-Armenia gas pipeline). In theory, Armenia could benefit from Azerbaijani oil exports, if the Karabakh conflict was resolved and friendly relations established between the two countries, although this is a somewhat unrealistic scenario under the present state of conflict resolution. Other possibilities include the construction of high-voltage transmission lines between Georgia and Armenia for imported hydropower electricity and developing hydropower plants in Armenia where there are many mountain rivers, as used by Zangezur Combine and Alaverdi Smelter. This issue, however, has to be given state attention, since electric power production is beyond the expertise and capacity of mining companies.

It is important for Armenia to train skilled labour to serve mining and industry in general. There are serious deficiencies with the education system, especially in the technical sphere, alongside a shortage of skilled specialists within the Ministry of Economy to develop the sector. Another deficiency affecting the mining sector is related to value-added tax (VAT). The mining sector is supposed to receive a full rebate on VAT (20%) paid to the state. However, refund of VAT is a complex and time-consuming matter and is processed with extensive delays.

Policy recommendations

With such significant metal resources, Armenia's main concern for the mining industry and for industry in general is to use domestically produced raw materials for domestic manufacturing, to produce, if not finalise, higher value-added products, and move away from the export of low value-added raw materials. An example of higher value-added products could be in processing aluminium, where Armenia has a comparative advantage. The country imports the raw material, processes it to various foils and exports it. Instead of just exporting the copper concentrate, Armenia could produce copper plates or copper wires, adding some value to the raw material, and export higher value-added products. Other possibilities exist.

Manufacturing

The manufacturing sector accounts for 60% of industry's total output. The largest branch of manufacturing is food processing (almost half) and tobacco. Other branches include chemical industry, mechanical engineering and jewellery. In 2009 growth in manufacturing was stalled. It even decreased by 8.8% by the end of that year. Along with the signs of economic recovery, the volume of manufactured output increased by 9% in January-April 2010 and reached AMD 484.4 billion (USD 1.26 billion) in November 2010.

Since the mid-1990s, food processing has been one of the leading sectors, constituting around 40% in value of manufacturing. Food-processing enterprises mainly specialise in alcoholic beverages, fruit and meat and meat products, dairy products, vegetable canning, tobacco and cigarettes. The domestic market mainly consumes the dairy and meat products, along with a sizeable portion of tobacco, whereas the larger share of the sector's products, alcoholic drinks and canned produce, go to export, mainly to the CIS (85%), including Russia (75%).

Brandy and wine production is the largest part of the food-processing industry, alongside canned vegetables and fruit. Large investments have been made in this sector, both foreign and local.

GoA states that food processing is one of its priority sectors. The strengths of this sector lie in the high quality of local agricultural products, idle production capacity, availability of a qualified workforce and relatively low labour costs. The sector is considered by experts to have a high development potential in particular through co-operation with foreign companies, on exports of high value-added products.

The performance of the food-processing sector is very unequal as it relies on the agriculture sector, which is experiencing a decline in production, and on agricultural imports. From January to October 2010, the production of meat and vodka fell yoy by nearly 12% and butter by nearly 15%, while natural juices increased by 52.1% and cognac, wine and beer by over 35.4% (mostly due to the increase in demand in Russia).

Apart from food processing, other manufacturing sectors have relatively small shares in total industrial production. Among these are the production of diamonds and jewellery, mechanical engineering and the chemical industry, which were the three main sectors of the economy during the USSR.

Representing only a small portion of manufacturing, diamonds and jewellery have been important for Armenia, ensuring around one third of total exports (to Belgium and Russia).[15] In November 2010, jewellery output totalled AMD 8.4 billion (USD 21.8 million). With the transition to a market economy the state lost its monopoly over the production of jewellery and precious stones, which have turned into fast-growing branches of the economy since the late 1990s. One-third of total investments in this sector came from abroad (including such companies as Fer-fano Corporation and De Beers). In 2007, this branch registered USD 214 million in sales (about 10 times more than 10 years ago). The number of enterprises reached 50, while the number of jobs reached 5 000. In 2008, even before the global crisis, this branch started to decline. Experts ascribed this to an overvalued dram. Indeed, after its depreciation in early 2009 and with the signs of global economic recovery, the production of diamonds registered a 57% growth in January-April 2010.

The mechanical engineering industry was one of the leading branches of the industrial complex of the former Soviet Union, which was highly export-oriented. Its share in total industrial production totalled 15% on average. Due to obsolete technologies and old production lines the sector has been shrinking since independence. However, with existing infrastructure, it still holds a significant potential. To meet current demands, large investments in advanced technologies should be made. Production lines should be modernised and the labour force retrained. If such a modernisation is carried out in the companies involved in mechanical engineering, the sector will develop dynamically as a few examples in the country show, such as "Mshak" CJSC, an electronics and computer company, who is developing dynamically due to the use of modern technologies and competent market research.

The Armenian chemical industry used to be one of the other leading sectors in Armenia in Soviet times. Giant chemical combines operated in Yerevan and Kirovakan (Vanadzor). However, after the collapse of the Soviet Union, the onset of the Karabakh conflict and the Georgian-Russian-Abkhasia conflict[16] with the ensuing blockade of Armenia, the sector collapsed (as raw materials for chemical production came mostly from Russia).

As stated by GoA the strategic goal for the chemical industry is a competitive and sustainable system that would satisfy the local and foreign demand, with priority and support given to those few branches operating in an enabling environment, in order to restore and expand their capacities. One such example is the privatisation and revival of Nairit plant in Yerevan (Rhinoville Property Limited, UK) after which the sector started to recover. In 2007 more than 8 000 tonnes of synthetic rubber was produced, of which half was exported to the EU, 30% to Russia and the rest to the United States and other countries.

Growth was stalled in 2008 and 2009 due to the crisis, but picked up in 2010. In November 2010, total output reached AMD 7.9 billion (USD 20.5 million). The production of rubber alone increased by 66.1% between January and October 2010 and other chemical branches have grown at the same time, although at a much lower rate, *e.g.* coatings (paints) by 5.9% and detergents by 2.2%.

However, the main weaknesses of the Armenian chemical industry remain high reliance on imported raw materials, obsolete technologies, high cost of electricity and geographical difficulties.

Services

Construction, trade and other services have become the largest sectors of the economy accounting roughly for two-thirds of the GDP, leaving less than one-third for industry and agriculture. Overall, the services sector in Armenia grew from 51% of GDP in 2001 to 69% in 2008 (NSS). As of the first quarter of 2010, services for construction grew by 8.8%, for industry by 12%, trade showed stability at 2.3% and other services grew by 6.4% (NSS). In January-November 2010, services (excluding trade) reached AMD 709.5 billion (USD 1.8 billion), a yoy increase of 6.6%.

Construction

The construction sector fuelled the economic boom in 2000-08, growing at an average annual rate of 20%. More than half of the construction has been residential, with 85% of real estate realised in the capital city, Yerevan. The other half of the construction sector was realised in energy, agriculture, and communications structures. Total share of the construction sector in GDP increased from 10% to 27% of GDP, respectively from 2001 to 2008. This figure is unusually high compared to other countries, but is similar to the levels in Ukraine and other Black Sea countries, and has led to a strong bias in the economy. The sector employed 60 400 persons in 2008 compared with 46 500 in 2000, 5.4% and 3.6% of the workforce respectively. These numbers are, however, highly underestimated since most of the construction workers are hired on a seasonal basis and many of them are not registered officially.

A significant share of remittances to Armenia is invested in construction. Remittance-receiving households tend to buy durable goods and real estate. More importantly, there is evidence suggesting that more than half of all real estate purchases (including corporate construction) are made by the Armenian diaspora, mostly from Russia. Thus, the residential construction boom in Armenia has been largely fuelled by external demand (IMF, 2008 and Policy Forum Armenia, 2008).

Indeed, the largest share of these remittances (72% of total as per the Central Bank of Armenia [CBA]) comes from Russia; these are strongly correlated with the Russian economy (particularly its two sectors, trade and construction). This rendered the Armenian economy vulnerable as global economic growth has been strongly relying on the construction sector growth making the Russian economy a determinant variable for economic growth and stability in financial markets in Armenia.

The flow of FDI in the construction sector amounted to USD 1.03 million in 2004, USD 6.41 million in 2006 and USD 1.59 million in 2008, with net stock of FDI in construction by the end of 2008 at USD 20.38 million. Decline in investments as a result of the global financial crisis had started already from the fourth quarter of 2008, and in 2009 the volumes of construction dropped by 36.4%. Consequently, its share in the economy fell from 27% in 2008 to 18% in 2009. Total output of the construction sector fell by 32.2% in 2009, to AMD 579.7 billion (USD 1.5 billion). Despite this sharp fall, construction picked up in the first quarter of 2010, growing by 8.8%, compared to the same period in 2009, although its share in GDP continued to decrease to 8.6%. The construction sector continued to decline throughout 2010, with total output in January-November 2010 of AMD 497.8 billion (USD 1.3 billion), an overall yoy decrease of 4.8%.

Information technology and telecommunications

There is a strong potential in developing an IT sector in Armenia based on a qualified workforce at competitive prices, alongside solid government and diaspora support of the industry.

Since the early 2000s there has been significant development of the IT sector in Armenia. Foreign, predominantly US, companies (such as Synopsis and Synergy, owned by Armenian Americans) established their subsidiary offices in Armenia where labour costs and other business expenses have been comparatively low. Major IT items produced by these companies in Armenia are chip design, web programming and web design. The exports of these IT products, mainly to the United States, had reached USD 70 million by 2008, and the number of IT specialists reached 5 000. However, due to the crisis, the sector slowed down and some companies closed their operations in Armenia, such as Lycos, one of the largest companies with more than 300 employees, specialising in web programming (search, communication, communities and shopping).

With special attention from the Government, IT started to recover, growing 17% in 2009 (USAID, GoA). Several IT conferences were held in Yerevan in 2009.

For the Telecom industry, 2009 was marked by the entrance of Orange (with French capital), as the third mobile communications operator, competing with Beeline and Vivacell-MTS (both with participation of Russian capital; Beeline is also the fixed communications provider). With increased competition in the sector, prices fell by more than 20%, to the benefit of general consumers.

Mobile communications make up two thirds of the total communications sector, around USD 280 million in 2009. It is noteworthy that Internet, though only 6% of the communications sector, grew by 3.3 times to USD 28 million in 2009 (NSS). This is due to the rapid development of broadband connections provided by mobile (via 3G) and fixed telecom providers as well as several other specialised Internet providers (Icon, ADC).

Table 1.13. Main telecommunications data

	2000	2005	2008	2009(e)*	2010(e)*
Telephone lines (per 100 people)	17.3	19.4	20.3	20.0	21.0
Mobile cellular subscriptions (per 100 people)	0.6	10.4	99.9	80.0	83.0
Internet users (per 100 people)	1.3	5.2	6.2	4.0	4.0
Investment in telecoms with private participation (USD million)	33.0	132.0	110.6	-	-

Note: **Research and Markets* website.

Source: WB, WDI 2010.

Banking and financial sector

Armenia's financial system is small but generally healthy and was resistant to the crisis. In 2008 the financial sector accounted for 3.5% of GDP and employed about 1% of the total workforce. Monetary policy and supervision of the financial system is conducted by the CBA. The CBA grants licences for the operation of financial institutions, including both domestic and foreign banks and other investors. The government has been successful in regulating and controlling the financial sector, which has contributed to the public trust in the system.

Banking and financial sector overview

The banking sector in Armenia is stable and sound, with high capitalisation, profitability and liquidity (GoA), in compliance with Basel II. The Central Bank defines the rules of bank secrecy, asset classification and provisions for losses, currency control and regulation. Since the mid-1990s it has been undertaking reforms to improve the banking system to help boost confidence in banks and to make risk management more effective. After significant consolidation, the banking sector was reduced to 22 commercial banks, 25 credit institutions and 11 insurance companies in 2008, while total assets were estimated at USD 3 million. There is no state ownership in banking or insurance. Elimination of banks engaged in risky activities improved the quality of bank assets and made banks more reliable.

The Deposit Insurance Fund is based on mandatory quarterly contributions of all banks operating in Armenia. Local currency deposits are guaranteed up to AMD 2 million (about USD 5 715), and foreign currency up to AMD 1 million. The Central Bank raised the minimum capital requirement for banks to AMD 5 billion (about USD 14.3 million) as of 1 January 2009. That year, the CBA issued new regulations on insurance business, ensuring the harmonisation of licensing procedures with those that apply to other financial institutions (such as banks and credit organisations), in compliance with the European standards.

Approximately 70% of the total capital of the banking system is foreign-owned. As of mid-2009, domestic financial institutions had a total of USD 327 million in deposits and USD 507 in debt to foreign banks abroad. The private sector had USD 515 million in obligations to foreign banks located abroad.

Banks do not have the right to provide insurance services (except insurance agent services) and vice versa; a holding company is able to own a bank and an insurance company. Since 2006, the Central Bank regulates and supervises insurance companies, as well as oversees the securities markets. The insurance sector is small, if measured by assets and total premiums to GDP (0.3% and 0.2% respectively in 2008), but comprises ten companies (two having ceased to exist in 2010). Foreign ownership of insurance companies is more than 60% and consolidation is awaited for a final number of five or six insurance companies by 2012-13.

Stock markets are still very small in Armenia. The Central Depository of Armenia and the stock exchange were privatised to become the NASDAQ OMX Group in 2008. In 2008 the total volume of transactions in the securities market totalled AMD 821 billion (about USD 2.4 billion), of which 97 billion were government securities, the rest in equities and corporate bonds.

The underdeveloped securities market and the absence of pension and investment funds are the main causes for remittances not being channelled as real investments in the economy. There is also no culture or awareness of using various institutions to invest (ADB, 2008).

How the sector resisted the crisis

Banks in Armenia entered the crisis with a margin of stability, a high level of capitalisation and liquidity; they had considerable control to cover the losses and possible deposit outflows. With the crisis, banks revised their internal procedures, tightened requirements for borrowers and became more conservative in the management of currency risks.

Overall, the banking sector was expected to grow by 10-15% in 2010. An improvement in earnings performance was also expected, compared to 2009. The increase in bad loans is likely to continue, but their rate falls far short of those registered in 2009 and capital reserves should help overcome possible problems.

Credit and credit terms

The impact of the crisis on the system as a whole was moderate compared with the experience of other CIS countries, thanks to a very low level of external financing, reducing refinancing risks. The dramatic fall of the construction sector was not a burden for the banking sector as it accounted for only 6% of total loans in 2009. In addition, despite the high rate of credit growth in recent years, the ratio of loans to GDP was 19% as of end 2008. The crisis, however, contributed to the deterioration of the quality of assets of the banking system, reducing profitability, lending and other banking activities. The AMD devaluation in March 2009 led to significant losses in banks with unbalanced currency positions, increasing bad loans. New loans were stopped alongside foreign exchange positions and liquidity was accumulated. In 2010, the Central Bank tightened its monetary policy and fought dollarisation. It absorbed excess liquidity and eliminated possible risks of inflation.

Growth in credits followed positive shifts in the economy from the beginning of 2010. In March 2010 credit grew by 4.7% to AMD 791 billion (USD 2.2 billion). The share of loans in drams in the total credit portfolio (extended and overdue loans exclusively) made up 46.8% or AMD 352 billion (a 4.3% growth yoy) and the share of foreign exchange loans made up 53.2% or AMD 400 billion (32.4% growth yoy) (NSS).

As of April 2010, the interest rates on loans in drams dropped by 20% yoy. Business loans above USD 1.5 million are provided for a five-year period at an interest rate of 15% for AMD, 14% for USD and 13% for EUR. Express loans up to USD 100 000 (or similar in AMD) are provided for a period of up to one year at 18%. Banks prefer to issue foreign currency denominated loans. Loans are issued exclusively on a collateral guarantee, at 50% value of an immovable asset, and 40% value of a movable asset (Ameria Bank).

Few businesses can afford the rates and terms offered by Armenian banks. However, with growth of competition and restrained inflation, rates are likely to decrease.

Retail trade

The growing income levels boosted the growth of the retail sector. The annual total retail turnover (NSS classification) reached AMD 1 059 billion in 2008, AMD 1 075 billion in 2009 and AMD 967.4 billion (USD 2.5 billion) in January-November 2010. Major shares in total retail turnover were food, building materials, furniture and clothing. Years 2008 and 2009 hit the retail sector to some extent, but the sector still managed to grow 13.4% in 2008, 1.5% in 2009 and is expected to reach the same level in 2010.

Branded retail chains, such as supermarkets (SAS, Star, Yerevan City), financed locally and from abroad, are expanding quickly. Smaller shop retail has been decreasing, but the sector remains fragmented since most of the turnover is still generated through smaller retail outlets (as well as produce markets). The estimated share of supermarkets in the retail trade of Yerevan is roughly

10%, while the average market share of supermarkets in Europe is 44% to 81%. Another emerging cluster of retail chains is construction material outlets.

Much still needs to be done in the retail sector. An advanced retail sector will enable local manufacturers to access a stable distribution system and, more importantly, to generate a large volume of employment.

MAIN MACROECONOMIC POLICIES

General overview

In the decade from 2000, Armenia maintained macroeconomic discipline within double digit economic growth and a low debt-to-GDP ratio setting. The fiscal and debt space allowed the government to mobilise significant external resources to launch counter-cyclical initiatives with the onset of the economic crisis. With the help of external partners (IMF, World Bank, ADB and the Russian Federation) around USD 1 billion was made available in 2009 for the budget support and the anti-crisis programme.

The programme proved to be effective since, in the first quarter of 2010, the economy grew by 5.5%, fuelled by industry (the mining sector) and services, but the recovery mostly depended on the improvement in the external economic environment since two of the most important sources of income for the Armenian economy are metals exports and remittances. Indeed, the economic growth registered in Russia, whose economy has a profound impact on Armernia's (because of remittances, FDI and trade), created a favourable atmosphere for investments and exports in 2010. A tightening of the policy is planned for 2011 and it remains to be seen whether the upward trend in the economy in 2010 will persist and the government will manage to achieve the objectives to which it committed under the loan agreements with the IMF and the World Bank.

Significant risk to the sustainability of the macroeconomic framework would occur if the resources were invested in incompetently planned public and private projects and if the public finance and tax management system remained on the current inefficient level. The priority for Armenia must be a strong policy framework and institutional reforms.

Fiscal policy

In 2003-08 fiscal deficits ranged between 1% to 3% of GDP, inflation averaged 3.4% and foreign reserves were maintained well above the equivalent of three months of imports. Tax revenue increased from 14% to 17% of GDP, public expenditures grew, and the external debt-to-GDP ratio was kept at 14.5%. While the fiscal position was good in the pre-crisis period, revenue administration was poor and ineffective.

The economic crisis resulted in increased fiscal tension. The deficit rose to 7.8% of GDP in 2009 from 1.1% in 2008, despite significant budget cuts. Tax collection decreased but the external funds coming from the IMF, World Bank, ADB and Russia (totalling USD 1.1 billion, see above under "government expenditures and revenues", see also IMF conditionality[17]) allowed the government to implement counter-cyclical policies with additional spending on infrastructure projects and the social sphere. As the fiscal position improved in 2010 and economic recovery continued, the authorities are keen to move on with the tax administration reforms.

Taxation

Since 2000 there has been a steady increase in tax revenues. The target for increasing the tax revenue to GDP ratio to over 16% by 2008 was achieved, but efforts to strengthen tax administration have proceeded slowly. Tax revenues fell from AMD 598 billion in 2008 to AMD 506 billion in 2009, which corresponds to a USD 247 million decrease (when applying the corresponding exchange rate of AMD 373 to USD 1).

Table 1.14. Taxes as a percentage of GDP, and total government revenues and grants (Gov Rev)

	2000		2008		2009		Jan-Nov 2010	
(percentage)	GDP	Gov Rev	GDP	Gov Rev	GDP	Gov Rev	GDP	Gov Rev
Tax revenues	13.9	83.2	16.4	82.0	16.0	77.2	16.9	76.0
of which (among others): VAT	6.5	38.8	8.1	40.5	7.6	36.5	8.9	40.0
Enterprise profits	2.0	11.8	3.1	15.5	3.3	16.0	2.3	10.3
Personal income	1.3	7.7	1.5	7.3	1.9	9.1	2.2	9.7
Customs duty	0.0	5.0	1.0	5.1	0.8	3.8	0.9	4.0

Sources: Ministry of Economy and IMF.

The economic crisis further underscored the importance of improving the tax and customs administration and the business environment, tax evasion being high because of high compliance costs and cronyism. The World Bank's *Doing Business 2011*, even ranked Armenia 159th on "paying taxes" from 183 countries (World Bank, 2010b).

Customs regulations and practices continue to pose a serious barrier to businesses, despite the fact that the August 2009 Business Environment and Enterprise Performance Survey (BEEPS) showed that there were fewer complaints about unofficial payments to customs (EBRD/World Bank, 2009). In the Customs Administration Strategy for 2008-12, adopted in December 2008, a Direct Trader Input system (designed to reduce interactions between importers and customs agents and hence opportunities for corruption) was to be set up in all customs points. However, by September 2010 this system had not yet been introduced.

Under the World Bank's proposed First Development Policy Operation (DPO-1, USD 60 million, June 2009), USD 500 000 will be used to carry out an independent analysis for business process re-engineering in key tax areas, and around USD 180 000 to deepen the customs reforms focusing on green-channel customs clearance. Within the 2009-11 action plan the State Revenue Committee will improve audit and enforcement functions, strengthen taxpayer services and the Large Taxpayer Unit, set up a one-stop shop for all taxpayers and electronic tax filing.

An electronic filing system for tax and customs returns is of key importance. The IMF will also provide technical assistance in this regard. It is expected that all large taxpayers will electronically file their returns in 2010. SMEs that have a turnover of over AMD 58 million (around USD 150 000) are also expected to start filing taxes electronically in 2010. Smaller companies will e-file their tax reports by 2011.

Budget

Armenia maintained good budget discipline in 2000-10. The budget has been realistic and largely executed as planned. Revenue forecasts were not only met but also exceeded. The deficit was maintained at the planned level and cutbacks and arrears were avoided.

In 2005-08 the average state budget deficit was under 2% of GDP. The 2009 budget and the Medium-Term Expenditure Framework (MTEF) for 2009-11 were based on GDP growth projections of 8-9% per annum (done by GoA before the crisis). In addition, projections were based on the expectation of a sustained increase in the tax-to-GDP ratio. However, not only did revenues decline in nominal terms in the first months of 2009, but the tax-to-GDP ratio also declined (raising concerns about revenue administration).

Under the conditions of revenue shortfall, the government had to suspend expenditures of around USD 250 million, about 10% of the total 2009 budget, on lower priority items (business travel, maintenance and representation expenses). In contrast to the 1.0% projected before the crisis the deficit reached 7.8% of GDP.

External resources served as the exclusive source of deficit financing. These were loans from the IMF, WB, ADB and the Russian Federation. The funds have been used both for closing the budget gap and for the implementation of the anti-crisis programme. The latter contains the following measures: maintaining the level of social spending, carrying on the infrastructure development projects, providing credits and guarantees to private enterprises.

Most of the donor loans were secured by June 2009. The IMF disbursed USD 458 million (SDR 302 million by February 2010; of the total SDR 534/USD 810 million under the Stand-By Arrangement [SBA]), the World Bank provided USD 60 million under the First Development Policy Operation (DPO-1) and the ADB allocated USD 80 million for budget support. The USD 500 million loan from Russia was used to finance infrastructure expenditures and on-lending for SME development.

The authorities aimed at lowering the deficit in 2010 to 5.6% of GDP, based on increasing tax revenues, restraining capital expenditures and maintaining public spending at its 2009 level. Budget deficit decreased yoy by almost half in January-November 2010, from AMD 114.9 billion (USD 0.3 billion) to AMD 52.4 billion (USD 0.1 billion). Substantial fiscal adjustments will be necessary from 2011 to reverse debt accumulation. Hence, the importance of revenue and tax administration reforms, which are within the framework of the IMF SBA conditionality.

Table 1.15. Selected indicators for 2010 (projected)

Budget deficit (% GDP)	5.6
GDP growth (%)	1.8
Average CPI growth (%)	6.8
Exports growth (%)	13.6
Imports growth (%)	3.9
Nominal revenue growth (%)	12.8
Minimum subsistence level (dram, 2008)	17 232
Minimum monthly wage (dram, 2008)	25 000

Sources: IMF, National Statistical Service of Armenia.

The government has committed itself to ensuring that all investment projects with public funds will be properly reflected in the budget to ensure accountability and transparency. Advanced public investment project appraisal systems will be introduced. The state support to the private sector will be temporary. The government will remain loyal to liberal economic policy principles, to WTO and other international commitments.

The authorities promise that reforms will be implemented in the spheres of budget planning, the treasury system, state procurement, and audit. They claim that there is an institutional base for the reform implementation and willingness on the donor side to support them.

Table 1.16. Fiscal framework 2009-11
(percentage of GDP)

	2007*	2008	2009	2010	2011*
State budget revenue and official transfers	20.1	20.0	20.7	22.1	20.8
Tax revenue	16.0	16.4	16.0	16.4	17.1
State budget expenditure	22.4	21.8	28.2	27.7	24.0
Current expenditure	17.2	17.9	22.5	22.6	20.6
Capital expenditure*	5.2	3.9	5.0	5.2	3.4
State budget deficit	-2.3	-1.7	-7.8	-5.6	-3.2

Note: * As presented and projected in June 2009 WB IDA's First Development Policy Operation (DPO-1).

Sources: IMF, World Bank.

Since 2003, the Armenian authorities have improved budget preparation procedures, some of which are:

- budgeting in advance policies in different sectors, which find their reflection in long-term strategies (Poverty Reduction Strategy Papers [PRSPs]);
- adopting medium-term expenditure frameworks (MTEFs) each year;
- introducing programme budgeting, making sector strategies more complete and comprehensive;
- enabling by law the National Assembly to scrutinise at an early stage the fiscal policies, the medium-term fiscal framework and priorities of the budget proposal, as well as the details of expenditure and revenue; and
- establishing a Chamber of Control to submit reports to the Parliament (Ministry of Finance, October 2008).

The budget in all ministries is prepared according to the IMF's *Government Finance Statistics Manual 2001* (GFS 2001) classifications. Internal audit offices have been set up in all ministries since 2008 with the aim of establishing full accountability for spending budget funds. This initiative is still at an early implementation stage and, even in the GoA's assessment, it falls short of international standards; the outcomes are not yet visible. All state non-commercial organisations (SNCOs) are submitting financial reports; information on budget policies and macroeconomic forecasts is publicly available and published in mass media and on the official websites of relevant government agencies.

The Ministry of Finance, with the support of the World Bank, initiated the Public Financial Management (PFM) system performance assessment in late 2008. The ultimate objective of this assessment is to get a true picture of the PFM quality and to develop a monitoring system. The performance measurement report was published in October 2008, providing quite a complete picture on current status in this sphere. The GoA decided to train experts in Public Finance Management in order to implement the reform in the following stages: preparation, process organising, infrastructure development and implementation. Several workshops on PFM reform with the participation of the Prime Minister and relevant GoA bodies were held in 2009 and 2010. GoA has given particular importance to enhancing fiscal discipline, tying resources to priority policies, securing value for money in the use of public funds. However, the reform is still in progress and an effective PFM monitoring system is not yet established.

Despite some predictability in the execution of the budget, there are still outstanding issues specifically in the area of control. There are problems with such public sector entities as state and community non-commercial organisations and companies, where a clear picture of performance is missing with ensuing problems for maintaining fiscal discipline. Although this issue does not produce significant risks for budget credibility, GoA has been taking measures to address it. The financial positions of SNCOs from balance sheets were used first to compile a database of SNCOs, which is currently updated regularly. Financial position indicators are used to analyse economic activities of SNCOs. The GoA is enforcing the 2006 decree (163-N) to ensure the reporting discipline of SNCOs; weaknesses of the reporting forms are also being addressed.

Monetary policy

Recent developments

Government policies directed at monetary easing helped to a certain extent to mitigate the impact of the crisis. The flexible exchange rate regime introduced in March 2009 countered overvaluation and contributed to the implementation of monetary easing. The Armenian dram continued depreciating from then to end 2010 at the annual average rate of AMD 373.3 per USD (before March 2009 the rate was AMD 305 per USD). Inflation pressures resulting from the depreciation currently persist.

From March 2009 to December 2009 the interest rate was lowered by 275 basis points, from 7.75 to 5.00. However, with the weak transmission mechanism, high dollarisation and higher credit risk, monetary easing translated into a liquidity build-up in the banking system rather than higher credit growth. Though the Armenian population does not rely heavily on credit, the banks' increased proficiency in risk assessment and management could have boosted credit growth to the private sector, mainly SMEs, which would have benefited the economy.

Credit growth started to improve again in Q1 2010 but inflation picked up at the same time and the CBA had to raise the interest rate up to 7.0% by April 2010 leading to unattractive credit conditions.

According to the evaluation of the IMF in March 2010, the monetary policy is moving from an accommodative to a neutral stance in order to counter inflation pressures. The commitment to the flexible exchange rate regime and the well capitalised financial sector are a good sign. The monetary transmission mechanism has to be strengthened, and structural reforms continued. The authorities have to enhance productive capacities, open trade regime, business environment and governance.

Table 1.17. Monetary effects of the crisis

Year	2007	2008	2009	2010
Current account balance (USD million)	- 589	- 1372	- 1205	- 1072
Current transfer balance (USD million)	945	1138	808	888
Consumer Price Index, period average (%)	4.4	9.0	3.4	6.8
Total national currency deposits (AMD billion)	235.0	219.5	170.7	188.6
Total national currency deposits in USD (AMD billion)	130.3	172.6	370.6	393.7
Exchange rate AMD/USD (end of period)	304.2	306.7	377.9	373.7

Source: IMF.

Inflation and prices

The monetary policy in 2006-08 had the aim of containing inflationary pressure but with the economic crisis the pressure significantly weakened.

From December 2008 the Central Bank started gradually lowering the interest rate, from 7.75% to 6.75% by March 2009. However, to avoid speculation, it had to push up the rate by 1% immediately after the depreciation on 3 March.

Despite the depreciation, inflation remained at about 3.4% (period average) up to December 2009, given weak domestic demand and low import prices. The inflation target band was set at 4 ±1.5% in 2009, but recent projections have a higher figure of 6.2.

Table 1.18. Inflation rates
(percentage)

	2006	2007	2008	2009	2010
CPI (end of period)	5.2	6.6	5.2	6.5	6.2
CPI (period average)	2.9	4.4	9.0	3.4	7.8*
PPI (period average)	0.9	0.6	2.2	7.1	39.9**

Notes: * January-September 2010, EIU Armenia Monthly Report, November 2010; ** Growth from January-February 2009 to January-February 2010.

Source: NSS, 2010 projection of IMF.

Inflationary pressures appeared again from early 2010 stemming from the growth of international prices of raw materials, fuel and a number of food products. Inflation in the first quarter of 2010 reached 8.4%. This is nearly double the full-year inflation target set by the authorities (8% instead of 6% in April 2010). This is mainly due to a 17% increase in the import price of natural gas from April 2010 that pushed up utility tariffs and was passed on to higher consumer goods and services prices. In November 2010, yoy inflation had reached 9.5%.

Despite relatively high levels, inflation has not been a burden so far, as it has been accompanied by accelerating economic recovery with 5.5% GDP growth recorded in the same period. The CBA believes this inflationary pressure is only temporary and that the toughening of the monetary-credit conditions from the beginning of 2010 continues to mitigate the inflation atmosphere. The CBA also forecasts high demand for Armenian drams up until 2011 as a result of positive macroeconomic recovery. Yet, the abundant dram liquidity still flowing into the system can weaken the exchange rate and further increase price pressures. The Central Bank took pre-emptive measures increasing the interest rates and suspending purchases of government securities.

Monetary aggregates (M2, Reserves)

Broad money supply in local currency fell by 34% from December 2008 to March 2009, and then started to grow, slowly regaining 21% by December 2009. In foreign currency, money supply grew by 114% from December 2008 to December 2009, thus contributing to the overall growth of 15.1% (CBA).

An expansionary monetary policy was followed throughout 2009. The CBA injected local currency liquidity through various channels to boost credit growth, including outright purchases of government securities and increasing the maturity of its repo operations. In spite of the Central Bank's expansive behaviour, the banks showed conservative behaviour that stemmed from the increasing risks. Given the weak transmission mechanism and economic uncertainty, lower interest rates had a limited effect on credit growth, but rather led to a build-up in liquidity in the banking system.

In May 2009 the volume of credit compared to December 2008 increased by only 1.5%, whereas in May 2008 it had increased by 23% compared to December 2007. While banks and private enterprises were hesitant to lend and borrow, the authorities introduced on-lending programmes to support credits to SMEs and provided government credit and guarantees to systemically important enterprises.

In the times of uncertainty consumers and businesses turned to the dollar and euro. Foreign currency deposits and loans increased and contributed to the dollarisation of the economy. Part of the challenge for monetary policy is dealing with the deposit dollarisation ratio of 65-70% (in September 2010). Indeed, under high dollarisation conditions, setting the interest rate becomes inefficient since the CBA can only affect Armenian drams. Once the macroeconomic situation stabilises, it is expected that the dollarisation will decrease.

As for gross official reserves, by early 2009 they had fallen to USD 1.1 billion or to 3.9 months of imports, the lowest level since 2006, but with fresh loans, foreign reserves started to accumulate climbing to USD 2 billion (6.6 months of imports) by the end of 2009. This is likely to increase to USD 2.17 billion by the end of 2010.

Under conditions of increased public debt GoA will focus efforts on addressing external imbalances, enhancing revenue management and rationalising spending. It is expected that revenues will increase with greater economic activity and improved tax administration. Fiscal consolidation should bring the deficit to 6% of GDP in 2010 (down from 7.5% in 2009) and 2% by 2013. If revenues fall below expectations, GoA plans to implement contingency measures to reach the target. The deficit is still going to be significant; financing will come from external donors and from issuing t-bills.

GDP is expected to grow by 4% in 2010, supported by gradual recovery of domestic demand, investments, exports and remittances. The current account deficit is expected to narrow to 14% of GDP. A more active intermediating financial sector will help stimulate domestic demand.

The IMF approved a USD 540 million Stand-By Arrangement, of which the first USD 240 million disbursement was made in March 2009, the remaining USD 300 million being disbursed in eight quarterly instalments. The interest rate of the first USD 270 million was set at 1.56%, the next USD 135 million at 2.56%, and the final USD 135 million at 3.56% (IMF). The loan has a five-year maturity, including three years of grace period. Some of the conditions under the loan agreement are: a flexible exchange rate regime, financial sector strengthening, and fiscal deficit target of around 3%, along with protected social spending, public investments (up to USD 200 million) and SME lending.

The Russian loan of USD 500 million will be repaid over 15 years, with a four-year grace period. The interest rate will be LIBOR+3%. There are no particular conditions attached to this loan. This ADB

60 million tranche from the USD 500 million loan for the North-South corridor has a 32-year term with an eight-year grace period. Interest is 1% initially then 1.5%.

The USD 60 million loan from the World Bank is a part of the First Development Policy Operation (DPO-1, the first in a series of three DPOs worth USD 100 million) disbursed for GoA anti-crisis measures and after-crisis recovery, such as road construction, education and irrigation. The maturity is 20 years, with a 10-year grace period and 0.75% interest rate. Conditions include social reforms and poverty reduction projects.

GoA has not published or made otherwise available information on how it is planning to repay the interest and the principal of the loans. It pledged to the IMF to develop a clear debt management strategy. Most of the loans have a grace period and the interest is quite manageable ranging from 0.75 to LIBOR+3%.

Exchange rate

In order to stop the drain of foreign currency reserves and to meet IMF conditions, the CBA let the national currency float overnight on 3 March 2009; the dram immediately depreciated by 20% (from AMD 305 to AMD 365 per USD). This measure however did not result in overall panic in financial markets as there was an awareness of the fact that the nominal exchange rate did not represent economic realities and such a step was expected. The response to devaluation was rushing to US dollars and euros both on the supply and demand side.

The local currency continued to depreciate throughout 2009 by moderate rates (another 10%), dollarisation accelerated, the share of deposits held in foreign currency doubled and that of loans grew by half, compared to 2008. Total lending volumes picked up after the third quarter of 2009 and increased by 17.5%. The share of nonperforming loans was 4.2%, which did not pose a particular problem for the well-capitalised banks.

The CBA has announced it will keep the exchange rate floating so it matches macroeconomic fundamentals and absorbs negative risks in the economy. It will only interfere to smooth tremors and to counteract speculative initiatives.

The dram further depreciated to peak at AMD 404.4 to the dollar at the end of March 2010, before appreciating at around AMD 360 to the dollar on average in December 2010. A strategy was designed with the support of the IMF to limit interventions, which helped rebuild foreign reserves without targeting a particular level or band. The CBA's interventions since then have been in line with the strategy, leading to the appreciation of the dram.

External sector

Main figures

During the years of economic growth, trade relations of Armenia expanded significantly. Foreign trade increased by 25% in 2008, and made up USD 5.5 billion or 46% of the GDP. Exports made up only 20% of the trade (USD 1.1 billion), while imports made up 80% (USD 4.4 billion).

Armenia's main exports have traditionally been metals and mining products, processed diamonds and alcoholic drinks. For years, exports have been three to four times less than imports and more than 60% less in terms of types of commodities. The indicator for Armenia in terms of export/GDP ratio is the lowest among the countries of the region. The largest export markets for Armenia are the EU, more than a half, and the CIS countries, about a third of the total. Most of the imports come from China, Germany, Ukraine, Russia and Turkey.

Among important initiatives of the government for the external sector have been discussions of a Free Trade Agreement with the EU and the protocol with Turkey to reopen the common border. The process of approving the protocol in the Turkish Parliament was stalled and the whole process of rapprochement froze as of April 2010.

Table 1.19. Selected lines from the balance of payments
(USD million)

	2007	2008	2009	2010
Current account balance	- 589	- 1372	- 1205	- 1072
Current account balance (% of GDP)	- 6.4	- 11.5	- 13.7	- 13.0
Trade balance	- 1 600	- 2 654	- 2 080	- 2 102
Exports (FOB)	1 197	1 066	729	838
Imports (FOB)	- 2 797	- 3 720	- 2 809	- 2 940
Capital and financial account	1 191	1 124	1 318	970
FDI net	701	929	478	525

Source: IMF.

At the end of 2009, it was projected that exports would rise by 15% in 2010 as a result of strengthening in the diamond-processing and metals sectors. Imports were projected to grow by around 5%, as internal demand slowly recovered.

In the first quarter of 2010, Armenia registered an unexpected 5.5% economic growth (compared to the same period in 2009) and exports grew remarkably by more than 61% mostly due to the increased demand for metals. Exports reached USD 199 million, while imports increased by 23%, making USD 814 million (the negative balance of the foreign trade still remained significant at USD 615 million).

The IMF decided to review its 2010 forecasts for Armenia, where the first quarter results exceeded expectations. The new forecast is 4% compared to previously noted 1.2%.

Exports

Exports fell by 8% yoy in 2008 to USD 1.1 billion and further by 34% in 2009 to USD 0.7 billion. The devaluation of the local currency did not contribute to the export growth as expected. The decline of exports in 2009 was caused predominantly by the reduction in export volumes to EU countries of ferro-alloys, diamond, copper, molybdenum, aluminium, as well as a decline in exports to CIS countries and Georgia of alcoholic beverages, cement and chemical rubber.

Table 1.20. Share of main exports of goods by category in total exports
(USD million)

SITC Revision 3	2009	Share (%)
Food & live animals	38 114.3	5.57
Beverages & tobacco	88 675.7	12.96
Mineral fuels	6 241.6	0.91
Chemicals	9 210.7	1.35
Textiles	6 601.4	0.97
Iron & steel	87 395.0	12.78
Machinery & transport equipment	30 680.8	4.49
Clothing	7 665.4	1.12
Footwear	794.1	0.12
Commodities and transactions not classified elsewhere in SITC	32 830.9	4.80
Total of above	**308 209.8**	**45.06**
Total of all exports	**683 989.4**	**100**
Other categories of exports	375 779.6	54.94

Source: World Integrated Trade Solution (WITS).

Base metals and products thereof, which account for 33% of total exports, fell by 33% in 2009 to USD 2 031.1 million. Precious and semi-precious stones and metals fell by almost 40% in 2009, from USD 173.1 million in 2008 to USD 105.0 million in 2009; with a constant share of 15% of total exports.

Imports

The import of commodities in 2008 was worth USD 4.4 billion, increasing by 36% from the previous year. In 2009 imports fell by 25% to USD 3.3 billion and in the first quarter of 2010 they increased by 23%, to USD 814 million.

Table 1.21. Share of main imports by category in total imports
(USD million)

SITC Revision 3	2009	Share (%)
Food & live animals	448 260.1	14.12
Beverages & tobacco	106 995.5	3.37
Mineral fuels	491 476.8	15.48
Chemicals	325 791.2	10.26
Textiles	34 935.3	1.10
Iron & steel	129 981.7	4.09
Machinery & transport equipment	756 854.1	23.84
Clothing	50 512.6	1.59
Footwear	20 705.9	0.65
Commodities and transactions not classified elsewhere in SITC	39 428.3	1.24
Total of above	**2 404 941.3**	**75.75**
Total of all exports	**3 174 631.2**	**100.00**
Other categories of imports	769 689.9	24.25

Source: WITS.

The reopening of the Turkish-Armenian border initiated since October 2009 would have had an immediate impact on the decline of transportation costs to Armenia by as much as 10% to 20% (currently a detour has to be made through the Georgian territory). This would have translated into lowering import prices for the benefit of consumers. More importantly the 80-million Turkish market could have opened up to Armenian exporters (although Armenian producers would have suffered from more cost-competitive Turkish imports).

Balance of payments

By the end of 2008 the external position deteriorated and the balance of payments weakened. The pressure on the exchange rate grew but the floating regime introduced in March 2009 reduced concerns about financial stability.

Table 1.22. Balance of payments
(USD million)

Balance of payments	2006	2007	2008	2009	Jan-Sept 2010
Current account balance as % of GDP		- 6.4	- 11.5	- 13.7	- 29.9
Current account	-117.1	-589.3	-1381.8	-1205	-820.6
Goods and services (balance)					
Goods (balance)	-895.9	-1 600.3	-2 663.5	-2 080	-1 392.13
Services (balance)	-130.4	-212.5	-327.1	-237	-173.75
Income (balance)	215.2	278.8	471.2	304	182.58
Current transfers (balance)	694.0	944.8	1 137.6	808	562.75
Capital and financial account	132.9	591.5	1 369.3	1 189	807.39
Capital account	86.4	142.8	148.9	98	60.49
Financial account	46.5	448.7	1 220.4	-	746.90
Direct investment	450.1	701.0	925.2	478	354.89
Portfolio investment	9.2	-9.2	8.4	-	5.81
Other investment	-46.8	303.1	53.3	-	1 000.82
Reserves assets	-366.0	-546.2	233.5	-	-614.62
Net errors and omissions	-15.8	-2.2	12.5	16	13.16

Sources: Central Bank of Armenia, IMF for 2009 and 2010 data.

Falling exports coupled with low remittances and FDI have widened the current account deficit despite the sizeable fall in imports. Though declining from USD 1.38 billion in 2008 to USD 1.21 billion in 2009, it widened in relation to the narrowed GDP (deficit/GDP) to 13.7% in 2009 from 11.5% in 2008. According to IMF projections, the current account deficit was expected to remain almost at the same level in 2010, before gradually falling to 10% of GDP by 2013.

As for the banking sector, it remained sound in 2010 despite the worsening loan portfolio in 2009. Capital and liquidity ratios continue to be high and the leverage ratio low, providing a strong buffer to economic fluctuations. The system-wide capital adequacy ratio has remained well above the required 12% (at more than 20%). The proposed increase in the Deposit Guarantee Fund, which was submitted to the Parliament in 2009, is another step to strengthening the banking sector; with the floating dram the banking system is now less exposed to exchange rate risks.

With budgetary and anti-crisis financial support from donors, external debt doubled from USD 1.6 billion to USD 3 billion by the end of 2009. The debt-to-GDP ratio had hit 40% as of early 2010. IMF projections indicate that the debt ratio may peak at 45% in 2011 before falling to 36% by 2013. The CBA and the Ministry of Finance have been working with the IMF to clarify debt service obligations. Both the authorities and the IMF regard debt dynamics as sustainable. However, the latter are subject to risks if improvements in the fiscal sector and economic growth fail to materialise. In this situation the IMF may put a limit on contracting or guaranteeing new non-concessional loans.

In 2008 FDI stock reached USD 3.5 billion or about 6% of the average annual GDP. This is quite a low volume compared to other countries in the region. FDI mainly flowed to transport and communications sectors, metal and mining industries, food processing and construction. FDI stock increased by only USD 0.11 billion in 2009, compared to USD 1.07 billion in 2008, and is projected to be on the same low level in the short term.

Policy implications

There are ample challenges if Armenia is to recover economic growth and foster its development: improving tax administration and business climate, conducting effective fiscal and monetary policies, limiting the external debt, broadening the production base and adding trade partners.

The authorities seem to acknowledge the need for effective reforms, specifically in the areas of tax policy and administration, competitive business environment and anti-monopoly policy. The government recognises the existence of oligopolies and will continue efforts to reduce cronyism and corruption. It should also improve public finance management and strengthen the civil service and judiciary.

According to the development strategy proposed by the Ministry of Economy, Armenian industry must replace resource-based activity. Information technologies should boost productivity and the knowledge-based economy. Developing the chemical and mining sectors is of special importance. These sectors should shift from low to high value-added production. Within the services sector special attention must be paid to tourism, healthcare and education that are considered to have a great potential for development.

Since more than half of the exports go to EU markets, negotiations were initiated in 2009 by the government to sign a free trade agreement with ensuing institutional reforms. If such an agreement is signed, Armenia will get an excellent chance to develop export industries with resulting revenue and economic growth.[18] Maintaining ties with traditional trade partners will also have to be a priority, with the reopening of the Turkish-Armenian border and Armenia will have to be prepared in order to benefit from bilateral trade, investments, tourism, immigration and property rights.

MILLENNIUM DEVELOPMENT GOALS

The period of strong economic growth of the past decade resulted in a significant improvement of most human development indicators in Armenia.

Aspects of human development and poverty reduction emphasised in the MDGs were included in the first Armenian Poverty Reduction Strategy Paper in 2001. The first nationalised MDG Status Report was published in 2005. The first United Nations Development Assistance Framework (UNDAF) was prepared in 2004 and covered the period from 2005 to 2009. The second UNDAF covering 2010-15 was prepared in late 2009 and had the aim of establishing a co-operation programme between the government and the UN. In March 2010 the United Nations Development Programme (UNDP) completed the second MDG Progress Report, which evaluated the main trends and the state of progress with regard to reaching the goals (UNDP, 2010).

Basic indicators

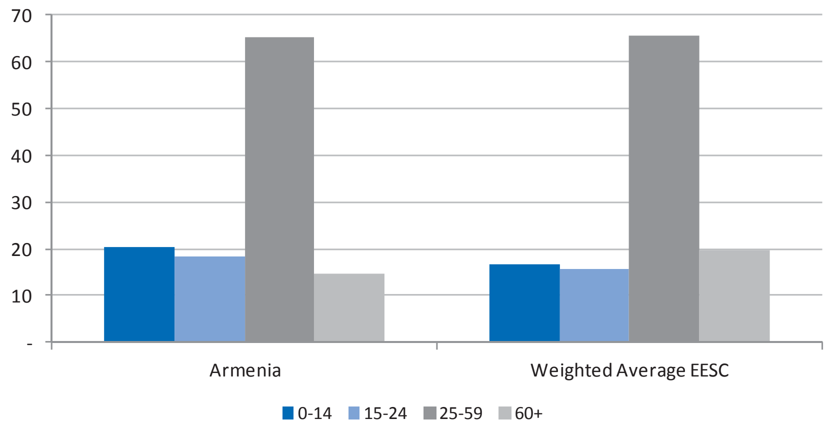
Migration has long been a major issue for Armenia. More than 800 000 people (out of 3.8 million in 1991) left Armenia in the 1990s in search of a better life. The demographic situation is not encouraging. There is a tendency to have fewer children (1.6 children per woman [NSS]) and family sizes have been declining. Armenia's current population of 3.2 million is ageing, since a significant part of emigrants are young people (under 24 years old, according to NSS). Average life expectancy has improved from 71 years in 2000 to 74 years in 2008, with longer life for women at 77 years and shorter for men at 70 years. Median age, however, remains at 32 years old.

Table 1.23. Age-population distribution comparison

Armenia	0-14	15-24	25-59	60+
2010	0.2	18.5	65.3	14.5

Source: WB WDI 2010.

Figure 1.3. Age-population distribution comparison
(between Armenia and the other EESC countries)



Source: World Bank 2010.

Goal 1: Reduce poverty

Target: Achieve full and productive employment and decent work for all

Despite the recent economic growth unemployment continues to be a major problem. The employment to population ratio has been around 35% since the early 1990s, meaning the country's productive potential remains largely unused. Women have fewer opportunities of employment, are paid less and have lower positions in the hierarchy.

Table 1.24. Employment patterns evolution
(percentage)

	2001		2008		2009	2010
	ILO*	Official	ILO	Official	Official	Official
Unemployment rate	38.4	10.4	28.6	7.0	3.6	7.0
Women unemployment rate	-	14.1	-	9.3	9.8	-
Unemployed youth (16-30)	-	29.0	-	18.0	18.9	-

Note: * Unemployment rate by International Labour Organization methodology[19] (ILO).

Source: National Statistical Service of Armenia (NSS).

Informal employment in Armenia is at a high level. According to the April 2010 survey of the NSS, informal employment in the non-agriculture sector was at 29%. There is low motivation to officially register as unemployed since the benefit is only about USD 45 (AMD 18 000, 60% of the minimum wage). Most of the unregistered unemployed work in the informal sector, where both employers and employees minimise their expenses. Those who work in the informal sector do not register as unemployed (to receive the unemployment compensation) because of the bureaucracy associated with registration.

According to a survey on labour migration conducted by Gallup,[20] only 25% of adults in Armenia are permanently employed. Currently one-third of Armenians are interested in seeking employment abroad. Russia is the primary country of destination for Armenian labour migrants; 31% of Armenians have at least one family member working in Russia.

Target: Eradicate extreme poverty and hunger

As a result of economic growth the number of people living below the poverty line decreased from 55% in 1999 to 27% in 2008. The proportion of those in extreme poverty (minimum level of dietary and energy consumption) decreased even more sharply from 23% to 3% during the same period (as per the official data).

Table 1.25. Poverty indicators

	1999	2008
Poverty gap	…	3.1
Poverty total (% population)	55.0	26.6
Extreme poverty (% population)	22.9	3.1

Note: Poverty gap is the mean distance below the poverty line as a proportion of the poverty line where the mean is taken over the whole population (the non-poor haveing a 0 shortfall).

Source: NSS.

The current poor are those who have not benefited from the economic growth of the last years. Income distribution in Armenia is very unequal. The Gini coefficient[21] remains between 0.36 and 0.40 (in the EU it is around 0.30). The richest quintile (20% of the population) receives 40% of the total income, while the poorest quintile receives 7%. The numbers by deciles (10%) are correspondingly 27% for the richest and 2% for the poorest.

Poverty in urban areas (except for Yerevan) is more prevalent than in rural areas. Small and medium towns, where 30% of the population lives, have very limited employment opportunities. Poverty reduction there has relied on fiscal transfers and private remittances. Most of the 36% of the population who live in rural areas are engaged in subsistence agriculture. Although their income levels are far below the per capita average only 1.7% of them were living below the extreme poverty line in 2008.

In urban areas, 99% of households and in rural areas 85% have access to the centralised water system. This has been improving in rural areas recently, a trend which will continue since water supply and irrigation development are included in the government's anti-crisis programme.

Policy implications

Public spending and social transfers will decide the progress towards the poverty MDGs in the medium term and should be sustained at sufficient levels. Social transfers' (pensions and family allowance) share in the GDP will probably increase compared to the pre-crisis levels. It is projected by the UNDP that by 2015 they will consume 37% of the total budget. Implementation of this approach will be one of the biggest challenges for the government.

Another way to solve the problem is to foster a fertile business environment, both in the capital and in the regions, for both the urban and the rural population.

Goal 2: Increase access to quality lifelong education

Target: Complete full primary education

Armenia has educated human resources, which is a Soviet heritage. According to the NSS, the adult and youth literacy rates in the country are at 99% with no gender disparities. About 30% of the population in Armenia has some degree of a tertiary/professional education.

Table 1.26. Main education data

	2000	2008
Pre-primary enrolment (%)	17.2	24.9
Primary enrolment rate (%)	74.0	96.0
Teacher to student ratio in primary schools (%)	10.2	9.5
Secondary enrolment rate (%)	76.0	91.0
Secondary education students	566 590	414 781
Secondary education students to teacher ratio (%)	10.2	9.7
Tertiary enrolment rate (%)	57.0	73.0

Note: In 2009.

Source: NSS.

According to the UNDP assessment, Armenia appears to be on track to meet the MDG target of "Universal Primary Education". The government has been allocating sizeable funding for education, 12.7% of the budget in 2008, 13.4% in 2009 and 10.7% in 2010. However, as a percentage of the GDP, this figure is still low, 2.8% compared to 4.5% in OECD countries. The target in the national MDGs is 4.5% of GDP by 2015.

A major concern for Armenia is regional and income-based inequality in access to education. The number of people with incomplete elementary education is higher in the rural areas. Rural residents are half as likely to attend tertiary education than urban residents. There is inequality in enrolment rates of the poor population in the tertiary and pre-school education.

There are considerable shortcomings related to the quality of secondary (general) education. Students have to take private lessons to take university exams. The quality and accessibility of pre-school education have also deteriorated.

Policy implications

The biggest challenge in all sub-sectors of the education system is quality. It is essential to improve the quality so that education meets the need of the changing economy and of global competitiveness in order to transfer Armenia into a knowledge-based economy. Equality concerns related to families' income levels, in terms of access to pre-school and especially tertiary education, should be addressed.

The introduction of a quality assurance and monitoring system in secondary and higher education is one of the most important steps to take. It will be beneficial to have the higher education system in accordance with international standards and the Bologna process.[22]

Goal 3: Ensure gender equality

Fundamental rights of women and gender equality norms are ensured by the Armenian Constitution and relevant legislation. Armenia is a signatory of the Convention on the Elimination of all forms of Discrimination Against Women (CEDAW). However, legal rights do not ensure real opportunities; women do not participate equally in social and economic life. Gender inequality issues derive mostly from widely accepted traditional norms of the society.

Armenian women are well educated and have a high capacity for professional development. In upper grades of general secondary schools and in tertiary education they represent a majority, 52% and 56% respectively. The share of women among the officially employed has been increasing, from 46% in 2004 to 49% in 2008 according to the NSS, but only 80% of them have full time employment, while men enjoy 90%.

Women are discriminated against despite their high professional capabilities; the average monthly nominal wage for women was AMD 68 000 in 2008, AMD 117 000 for men. The share of women among professionals is 57% but the number of women managers is 3.6 times less. Among those who have a second job with high or post-graduate education 66% are women (NSS, 2009).

Women are largely under-represented within legislative and executive authorities. Only 11 out of 131 Members of Parliament and only 2 out of 18 ministers are women. In 2008, only 23 out of 866 village mayors were women. Armenia committed to MDGs where women would make up at least 25% of the Parliament and 10% of the heads of local authorities by 2015. But under the current situation the specified goals are unrealistic.

As per the CEDAW recommendation a gender specific approach should be adopted in state laws, policies and programmes. Gender equality awareness campaigns should be conducted among community leaders, parents, teachers, and young girls and boys. CEDAW believes this will help change the stereotypes and cultural practices in society.

Health issues

Table 1.27. Major causes of death
(in 2002, percentage of total)

Ischemic heart disease	33
Cerebrovascular disease	16
Diabetes mellitus	6
Trachea, bronchus, lung cancers	4
Chronic obstructive pulmonary disease	3
Inflammatory heart diseases	2
Hypertensive heart disease	2
Breast cancer	2
Stomach cancer	2
Cirrhosis of the liver	2

Source: WHO.

Goals 4 and 5: Reduce maternal mortality and mortality rate under 5 by 17% each

According to the NSS data and the UNDP calculations, maternal mortality in Armenia on a three-year average basis has reduced from 32.6 deaths per 100 000 live births in 1989-91 to 26 deaths per 100 000 live births in 2006-08. The maternal mortality ratio is lower than the corresponding indicators in the CIS (27.5), but higher than in the EU (less than 10).

Due to the absence of family planning services and corresponding knowledge, abortion remains the main means of fertility control. According to Demographic and Health Surveys (NSS), pregnancies ending in abortion declined since 2000 by 10%, but almost half of all pregnancies end in induced abortions. The surveys indicate a decrease in the use of both modern and traditional methods of contraception among married women in Armenia. Since the society is quite traditional in Armenia there are very few extra-marital pregnancies.

Child mortality rates are higher than in Europe, but lower compared to the CIS average. Infant and under-5 mortality indicators have been declining, from 23.8 per 1 000 live births in 1990 to 12.2 in 2008. This was largely due to a considerable decline in post-neonatal mortality rates, while neonatal mortality has changed little (8.9 in 1990 and 8.3 in 2007). The number of infants with a low birth weight (less than 2.25 kg) has increased from 6.5 in 1990 to 7.4 in 2008. Infant mortality rates are much higher among poor families.

If measures to improve prenatal health care and to reduce neonatal mortality become priorities for the health sector it will be possible for the country to achieve the MDG target of fewer than 10 deaths per 1 000 live births by 2015.

Goal 6: Reduce and slow down the spread of HIV/AIDS by 13%

It is estimated by the National Center for AIDS Prevention that there are approximately 2 300 people living with HIV in Armenia though official statistics indicate only 674 new registered cases of HIV between 1988 and 2008. According to the WHO/UNAIDS classification Armenia belongs to the region with fast growth of the HIV/AIDS epidemic. More than 80% of HIV-infected males and females are young people between the ages of 20-44. Half of the HIV transmission cases are through heterosexual practices and 43% from drug use. People living with HIV/AIDS are not fully integrated into society because of stigma and discrimination.

The current educational system does not properly address the issue and the awareness of HIV among youth and adolescents (13-19) is low. This concern is particularly acute when considering that about 60% of boys and 25% of girls have their first sexual relationship between the ages of 13 and 19 (Knowledge Attitude Practice and Behaviour/KAPB survey 2005). It is encouraging that reproductive and sexual health of adolescents is currently identified as a priority area for the government.

Respiratory diseases

Tuberculosis (TB) incidence per 100 000 of the population increased from 25 in 1995 to 46 in 2008, with the peak of 62 in 2006. Since not all TB patients are registered, TB incidence may be much higher. Deterioration of the socio-economic conditions was the primary reason for such an increase. Around 12% of newly registered cases and 40% of previously treated patients are multi-drug-resistant TB according to the Ministry of Health.

The treatment success rate of 72% (2007) is low. The quality of directly observed treatment should be improved. Among the major issues are availability of TB drugs, planning, supervision and data management. But the most important issue remains human resources (doctors) capacity and motivation. Stigma and discrimination also affects people with TB. With financial support from donors, TB intervention projects in the civilian sector are currently being launched.

Main health reforms

The Armenian health sector was quite developed during the late Soviet period. The potential is still there and, considering this as a competitive advantage, the government has announced that Armenia should be transformed into a regional health centre. However the current state of affairs is rather discouraging. The physical conditions are poor and the management level is low in hospitals even in the capital. There is uneven distribution of health professionals among the capital and the regions.

Public-sector expenditure for health comprised only 1.4-1.5% of GDP in 2003-08, which is very low by international standards. Health sector expenditures are predominantly private (around 75%). Out-of-pocket payments constitute 61%, which is a major barrier to health-care access for the poor.

Table 1.28. **Main health expenditure**

2008	Armenia	OECD 30
Private health expenditure (in % GDP)	4.5	-
Public health expenditure (in % GDP)	1.5	6.8
Out-of-pocket expenditure (%)	61.0	-
Health spending per capita, public (USD)	50.4	3 365.0

Source: NSS and UNDP, authors' calculations.

Goal 7: Ensure sustainable environmental development

Target: Reduce pollution

The negative environmental impact grew with the economy, especially with the growth of the mining sector. Emissions from copper processing (sulphur dioxide) increased rapidly. The town of Alaverdi, the centre of the industry (located in the forested northern region, close to the Georgian border) became the most polluted city in Armenia.

Table 1.29. Environmental data
(1 000 tonnes)

	2000		2009	
Total emission of pollutants (1 000 tonnes)	29.1	**% of total**	74.7	**% of total**
Emissions of sulphur anhydride	8.4	29.0	22.9	30.7
Emissions of nitrous oxides	1.2	4.0	1.4	1.9
Emissions of carbon monoxide	8.6	30.0	2.2	2.9
Emissions of VOC (volatile organic compounds)	0.5	2.0	0.5	0.7

Source: NSS and authors' calculations.

The air quality in Yerevan is mainly affected by transport emissions and dust particles from construction works. Leaded petrol was prohibited in 2000. A positive development has been the fact that most private cars and minibuses (a major means of public transportation) transferred to a much cheaper natural gas system, which significantly reduced exhaust emissions. A major concern for Yerevan remains the reduction of green areas and parks.

Armenia joined the Kyoto Protocol in 2002 and since then has embarked on the development of Clean Development Mechanism (CDM) projects. Currently there are 18 projects at different stages of implementation. There are several programmes adopted, according to which the government has to harmonise environmental legislation with EU directives.

Armenia hosts one of the largest high altitude freshwater depositories in the world – Lake Sevan. The water of the lake was drained by 16 metres in Soviet times and the issue of the lake became a top priority on Armenia's environmental agenda. Consistent efforts and favourable weather contributed to the rise of water recently by 2.5 metres, but problems such as the unregulated use of the shoreline and the replenishment of fish stocks persist. A proper treatment of the inflowing waters and rivers into the lake also remains a problem. (In the framework of an EBRD loan provided in 2007, sewage treatment facilities will be built in three towns of the Lake Sevan basin.)

Inefficient practices in agriculture resulted in increased salinity and alkalisation of the soil. Overexploitation of pastures has led to erosion and threatened biodiversity. Forest management and biodiversity have deteriorated with massive fellings during the energy crises of the early 1990s, and the trend continues.

The issue of safe ecological disposal of municipal and industrial wastes has not been resolved. All sorts of waste are being disposed of without distinction in urban and rural dumps and they are burned, causing environmental pollution. Waste recycling enterprise development is at an early stage.

Target: Access to clean and drinkable water

Food- and water-borne diseases account for between 8% and 18% of new cases of infectious and parasitic diseases (unidentified infectious enteritis, Shigella and Hepatitis A) diagnosed each year. The incidence is more than 7 000 cases a year. The actual level may be 10 times higher, *i.e.* about 70 000 cases a year. These diseases are mostly related to contaminated water supplies (household and irrigation), as well as contaminated uncooked or undercooked foods. Despite recent improvements in water treatment and water distribution, statistics still show recurring problems with water contamination mostly in the smaller towns.

Two major food safety issues are botulism, caused by improper home-canning (households seek low-priced home-style vegetable preparations) and the consumption of poisonous mushrooms. There are also environmental health hazards, such as metal contamination of soil and water (because of mining operations) and persistent organo-chloride pesticides (Agriculture and Rural Development Department, ECA, WB).

It is unlikely that the country will achieve its environment related MDGs by 2015.

Policy implications

The government should regulate and monitor the mining industry so it applies the most advanced environmentally clean technologies. Waste separation, treatment and recycling should be brought on to the agenda. Disposal of radioactive wastes generated by the nuclear power plant should also be the focus of the government and public attention. Projects in the areas of biodiversity and forest management must be continued. Water resources management is of critical importance for Armenia. Special attention should be paid to the implementation of Lake Sevan related programmes.

PRIVATE SECTOR DEVELOPMENT

Although Armenia witnessed strong economic growth between 2000 and 2008 with an annual average growth rate of 11.2%, incomes remain low and the country is highly reliant on external financing. Armenia's economy is highly dependent on the Russian economy, particularly regarding energy exports and remittances. Trade contacts with its nearest neighbours remain minimal due to political problems and inadequacy of transport routes. The financial crisis has had a deeper impact on the Armenian economy than expected, resulting in a 14.2% contraction of real GDP in 2009 (IMF, 2010), and has highlighted over-dependence on external sources of finance and high global metal prices. The crisis thus revealed that relying on remittances and high global metal prices will not suffice in order to enhance competitiveness and support private sector development.

The private sector is a source of knowledge, skills and resources, and a key engine of growth for economic development. In this context, the role played by micro, small and medium-size enterprises is particularly important. Efforts to foster private sector growth should focus on improving the business environment for SMEs by providing a regulatory framework that fosters entrepreneurship through better policy design, including improving business regulation, the education system and providing access to finance for SMEs that would encourage the entry of new firms as well as increase the share of employment and contribution to GDP in the private sector.

The methodology applied in this section is based on the OECD Policies for Competitiveness Framework (PFC) which has been developed as an assessment tool based on the Policy Framework for Investment (PFI) Instrument. This tool follows a horizontal approach, looking systematically at key policy dimensions affecting the business climate to identify and analyse key constraints in the ability of firms to produce, invest and grow. Apart from giving a general introduction into the business environment, three key dimensions are featured in this section covering skills development, access to finance and investment framework conditions affecting SME growth.

General overview

In Armenia, the private sector accounts today for 75% of GDP (EBRD, 2010). According to national statistics data, it is dominated by micro, small and medium enterprises (98%) which contribute to a significant share of GDP (42%) and employment (42%). However, these figures underestimate the real contribution of SMEs to the economy, as the informal sector remains large and is estimated at 41.1% (Schneider, 2010). Excessive regulatory burdens provide little incentive for firms to move from the informal to the formal sector, which is required for enterprise growth and reaching high-scale production. Moreover, anti-competitive practices in the informal sector and an overall burdensome business environment, particularly in the areas of customs regulation, tax administration and corruption (EBRD/World Bank, 2009) pose a significant threat to registered SMEs which are thus not competitive on external markets.

One of the key obstacles to business growth in Armenia is the difficulty in accessing qualified personnel who match labour market requirements. According to the OECD PFC assessment, the large skills gap stems mainly from a lack of collaboration between the private and the public sector. Moreover, Armenia suffers from the "brain drain" phenomenon as skilled workers leave the country due to the lack of employment alternatives. More than half of migrants who left the country in 2002-07 had either secondary or secondary professional (vocational) education and almost 20% had a bachelor's or master's degree.

SMEs also face significant difficulties in accessing finance to start a business or to expand business activities. According to the OECD PFC assessment, there is a lack of innovative financing mechanisms through venture capital or business angel networks that would allow start-ups to access capital other than bank financing. Business angel capital fills the gap in start-up financing between "friends and family" who provide seed funding as well as hands-on advice to entrepreneurs based on personal experience which increases the chance of success. To improve access to finance for SMEs, the government should also consider introducing new financial instruments such as guarantee schemes and leasing arrangements.

To further build a supportive environment in which SMEs can benefit from increasing internationalisation, Armenia will need to unlock the full potential of investment opportunities across sectors and industries. In the short term, the country can attract investors towards labour-intensive sectors, but in the long term the challenge remains on moving towards higher value-added sectors which increase the overall competitiveness of the country. However, as privatisation in Armenia is largely over, the challenge will be to create new greenfield investment opportunities, particularly outside the sectors of metallurgy and mining. If successful, such a shift could further widen Armenia's export product base which is critical to reduce the trade deficit. Other key sectors attracting foreign investment are telecommunications, power and utilities, food processing, trade, construction, information technologies and hotel services.

The increasing role of the private sector

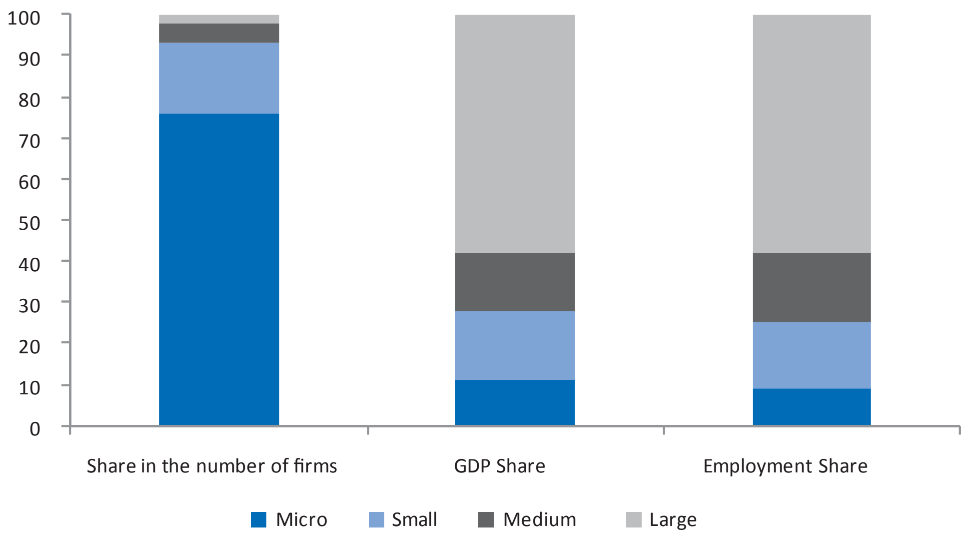
After a severe recession in the 1990s, the private sector has played an increasingly important role in Armenia and contributed to employment and economic growth. Large scale privatisation campaigns of state-owned enterprises and land led to higher government income through sales and increasing tax revenues. Introduction of new management practices helped increasing efficiency and competitiveness and the private sector expanded with the entry of new enterprises and growing employment. In 2008, the private sector share of GDP in Armenia reached 75% and contributed to 78.2% of employment.[23]

The process of privatisation has largely come to an end. It started in 1991-92 with the transfer of public assets to private owners and by August 2000, 90% of small enterprises and 83% of medium and large enterprises had been privatised.[24] Opportunities for private investors remain largely in the energy, water and irrigation sectors. The business entry rate in 2007 was 6.77% (World Bank, 2010a), well below the OECD average of 11.7%[25] and the lowest in the Eastern Europe and South Caucasus (EESC) region. This figure is overestimating the real entry rate given that it includes registered rather than active firms, and no statistics on exit rates are given.

The private sector remains highly polarised between a large informal sector of self-employed and small enterprises, and a concentrated formal economy. In Armenia, small-scale enterprises are divided in micro, small and medium enterprises,[26] which are defined based on the number of employees and the sector in which they are active. According to the Law of the Republic of Armenia "On State Support of Small and Medium Entrepreneurship" (5 December 2000), all the enterprises with fewer than 5 employees are considered micro firms. For small and medium enterprises, different definitions apply according to the sector in which a company is operating, *e.g.* an enterprise in industry is small if it has 5 to 50 employees; medium if it has 50-100 employees and large if it employs more than 100 workers; in construction, power engineering, science or education, a firm is small if it employs 5-25 employees, medium if it employs 25-50 employees and large if it employs more than 50; in transport, trade and services, a firm is small if it has 5-15 employees, medium in the case of 15-30 and large for more than 30 employees.

According to the National Business Register, on 1 January 2010, 132 923 SMEs and individual entrepreneurs were registered which represent 97.7% of the total number of enterprises, as reported by the SME Development National Centre (DNC) of Armenia. According to official national statistics, SMEs contributed to 41.7% of GDP in 2008 and 42.5% in 2009. This indicator has doubled since 1999 showing both an increase in importance of the SME sector and movement from the informal to formal sector. However, these figures do not take into account the large informal sector.

Figure 1.4. Structural indicators of the formal private sector in Armenia, 2009
(percentage)



Source: SME DNC (2010), Small and Medium Entrepreneurship Sector in Armenia 2007-09.

The largest contribution of SMEs to GDP in 2009 was in trade (49.4%), services (45%) and construction (37.2%). Industry and transport, and communications sectors are dominated by large enterprises with SMEs contributing only to 30.7% and 28% of GDP respectively.[27] Despite this large number and significant contribution to GDP, SMEs perform relatively badly on external markets. The value of SME exports represented 17.7% of total exports in 2009 which is slightly lower than in 2008 (17.9%), but higher than in 2007 (17.4%). One of the reasons for low external trade performance is excessive regulations for exporting procedures, identified as an obstacle by 26.5% of firms that participated in the EBRD-World Bank Enterprise Survey 2009.[28]

Since 2001, annual programmes for state support to SMEs have been drawn up and implemented. The Small and Medium Size Enterprise Development National Centre (SME DNC), established in 2002 by the government of Armenia, supported SMEs through the implementation of Annual SME State Support Programmes with resources allocated from the state budget. Since its 2008 membership in the Enterprise Europe Network (EEN), the SME DNC has been hosting an EEN Centre providing business, innovation, technology and research related services to Armenian companies while also rendering assistance to European SMEs seeking business opportunities in the Armenian market. Several amendments in tax legislation for SMEs, adopted in 2009, entered into force in January 2010.

Business environment

The business environment for SMEs has improved since 2006 and the procedures for registering property and licensing are more straightforward than in other countries in the EESC region. In 2009, Armenia ranked 43 according to the World Bank's *Doing Business 2011* report, compared to 50 in 2008. In 2011, Armenia fell back to the 48th position, losing four ranks compared to 2010. The only category that significantly increased is "trading across border", with an increase of 21 positions (to 82nd). All other components decreased only slightly, such as "Dealing with construction permits" (-6) and "Closing a business" (-5).

Overall, significant improvements were made in the areas of starting up a business since 2000. According to BEEPS 2009, the cost of start-up procedures decreased from 8.4% to 2.6% of gross national income (GNI) from 2003 to 2009, as did the number of start-up procedures to register a business, down from ten to six days (World Bank, 2010b). Business registration procedures were simplified. For example, in 2000, the Ministry of Justice introduced laws by which business registration would go through 4 instead of 12 state bodies and the SME Development National Centre was established in 2002 to provide technical and financial support to SMEs. The requirement for approval of a charter at registration and the minimum capital requirement have been removed and no permissions from the police are required to obtain a company seal. With ADB assistance, the government is introducing an online business registry system.

Other areas that showed some improvements include dealing with construction permits and trading across borders (World Bank, 2010b). In August 2009, the government decided to launch an electronic system for submitting import and export declarations which could have a positive impact on exports going forward. However, closed borders with Turkey and Azerbaijan have an impact on transportation cost in tradeable sectors and overall customs regulations continue to pose serious barriers to businesses. Moreover, land access to the Russian market is absent because of the ongoing confrontation between Georgia and Russia.

A VAT threshold was introduced as part of the anti-crisis programme in 2009. Enterprises with an annual turnover of less than AMD 58 million (USD 150 000) have not been required to pay VAT. There is a commitment on the side of the Government to reduce delays in VAT refunds. A ceiling was introduced on the 20% profit tax which should be no less than 2% and no more than 10% of the total business turnover.

Tax reporting procedures were simplified, businesses were allowed to file quarterly instead of monthly reports and send them by mail instead of taking them to the tax authorities personally. Fixed, instead of profit, taxes were introduced for several employment generating sectors, such as taxis, hotels and restaurants. To encourage manufacturing sector development, businesses importing equipment worth more than AMD 300 million (USD 770 thousand) were allowed to defer the value-added tax (VAT) payment for three years.

A large number of Armenian firms continue to perceive tax administration, customs regulation and corruption as major obstacles for business development. This shows that effective reforms are still needed in the areas of tax policy and administration to create a more competitive business environment. Prime Minister Tigran Sargsayan pledged in early 2009 that the creation of a level playing field for all businesses would be one of his government's main objectives. In early 2010, he stated that SMEs carried the main burden of taxes in 2009 and big businesses would come under strict scrutiny. In April 2010, the government announced that the 300 companies with annual revenue of over AMD 1 billion (USD 2.5 million) would be required to file and publish their financial reports to tax authorities certified by independent auditors starting in the second quarter of 2010. These companies accounted for almost half of the overall tax revenue in 2009.

Among many other disadvantages of excessive regulatory requirements they are likely to open the door for corruption which is persistent within the government and at the lower level of public service. Transparency International's Corruption Perception Index 2010 ranked Armenia 123rd on the list of 178 countries. On the other hand, according to the International Finance Corporation Enterprise Surveys (IFC, 2009) the percentage of firms that reported that they were expected to pay bribes as a result of tax inspections fell from 71% in 2005 to 9% in 2009. The average number of interactions with tax officials decreased from 2.8 to 2.3, and this decline was even more significant for small firms.

Further specific policy challenges for Armenia include skills development, access to finance and the investment framework for SME growth. These three areas have been identified as key areas to address to create better conditions for private sector development, competitiveness and investment. The OECD conducted a policy assessment based on a self-assessment provided by both public and private representatives. This assessment aims at assessing the current policy environment and identifying areas for reform.

Human capital development

Strengthening skills development has been identified as one of the key contributors to competitiveness. The positive correlation between human capital and productivity has become increasingly important in the globalised world. Razzak and Timmins (2008) report a strong positive relation between the increase of university-qualified workers and the levels of labour productivity as measured by GDP per person. It is believed that relying on natural resources, cost competition and strategic alliances does not suffice for reaching sustainable development (Memon *et al*., 2009).

Enhancing competitiveness in Armenia will require a higher commitment to invest in human capital as well as introduce reforms which will ensure that the educational system produces skills that match the demand of the labour market and further support private sector development. Five areas have been selected for an in-depth evaluation of the education system including:

- strategy formulation;
- inputs to initial education;
- vocational education and training (VET);
- continuing education and training (CET);
- human capital outcomes.

In Armenia, three areas have been identified as being particularly important to support business development in the country: the lack of a nation-wide workforce skills strategy, the lack of a strategy for teacher recruitment and retention and the lack of a CET system.

Armenia's quality of educational system ranks 119 out of 139 according to the World Economic Forum (WEF) 2009. Spending on education after the collapse dropped by half in the first years of transition: from 20.45% out of total government expenditures in 1990 to 10.27% in 1995. Despite high adult literacy rates (99.5%) and secondary and tertiary enrolment rates (88.13% and 34.21%, respectively),[29] the quality of the education system does not match with job market requirements. In *TIMSS 2007*, Armenia showed an increased average achievement compared to *TIMSS 2003*, but still below the international average (IEA, 2007a and 2007b).[30]

The government is committed to moving towards a knowledge-based economy and aims at regaining its Soviet-era competitive advantage of a highly skilled labour force (NTO, 2007). However, there is no workforce strategy programme in place that would ensure that labour market needs for skills are covered by the national education system. According to the Employers and University Graduates Assessments of Knowledge and Skills Taught in Professional Education Institutions survey, 59.8% of employers of university graduates, 57.3% of employers of VET graduates and 25.6% graduates of Armenian Universities think that the knowledge taught at universities is of a theoretical nature and practical skills are lacking (UNDP, 2006). A website for discussion of a new draft law is to be launched in 2011 which aims at collecting feedback from the private sector. The development of a CET system based on private-public co-operation would further facilitate bridging the gap between the private sector demands and the educational system outcomes.

The shortage of qualified teaching staff as well as equipment and materials limits the potential achievements of students. Qualified teachers leave the education sector due to low wages (USD 210.56 in June 2010[31] which is 28% lower than the average wage in the economy). There is a need for a national strategy for teacher retention and development that would include providing increased funding for salaries and equipment. A Teacher Professional Development Scheme funded by the International Development Association is to be launched at the end of 2010.

Moreover, emigration of the skilled labour force continues to be a severe problem for employers. Armenia has suffered from severe migration since 1988 (the majority left during 1992-94); 55.7% of the emigrants who left Armenia during 2002-07 had general secondary school education, 16.1% had vocational, and 18.7% had university and post-university education.[32] Emigration is still a problem and measures are needed to retain the brightest individuals in the framework of the national strategy of workforce development such as job opportunities and competitive salaries.

Access to finance

Access to finance is one of the critical issues for enhancing a country's competitiveness. At any stage of business development, businesses face a number of financial constraints. Access to bank financing for SMEs, particularly in the remote regions, remains limited and, in 2009, 33% of Armenian companies identified access to finance as a major constraint, a sensitively higher score if compared to the average of the region of 24% (EBRD/World Bank, 2009). This, together with an average interest rate spread of 10% (World Bank, 2010b) might explain why only 32% of the companies use banks to finance investments, six points less than enterprises in other countries of the region.

In 2005 and 2006 the banking sector was completely privatised and subjected to the control of the Central Bank of Armenia. Generally, banks are well capitalised, liquid and profitable even if activities for the private sector remain inadequate. The domestic credit provided by the banking sector to the private sector as a percentage of the GDP more than doubled from 2004, and reached 17.4% in 2008. On the other hand, the relative insulation and lack of sophistication of the Armenian banking system has also limited the direct impact of the global financial crises on the Armenian financial system

The Central Bank, with the support of private banks, introduced several measures (secured transactions, unified supervision regime) in 2008 that contributed to a rapid increase in bank loans to the private sector. Armenia's score on "Ease of getting credit" as measured by the *Doing Business* report improved significantly between 2005 and 2008. The government states it will continue efforts to strengthen the financial sector and ensure that credit resources are available for SMEs.

Commercial bank loans to the private sector as share of GDP grew from 8.4% in 2005 to 17.4% in 2008. The value of collateral required to secure a loan fell from 173% to 75% of the loan value. Despite the significant credit growth, to finance investments Armenian companies turn to equity and owners' contributions - around a third of their total investment. Only about a fourth of the investment is financed through banks and the rest comes from the internal funds (IFC, 2009).

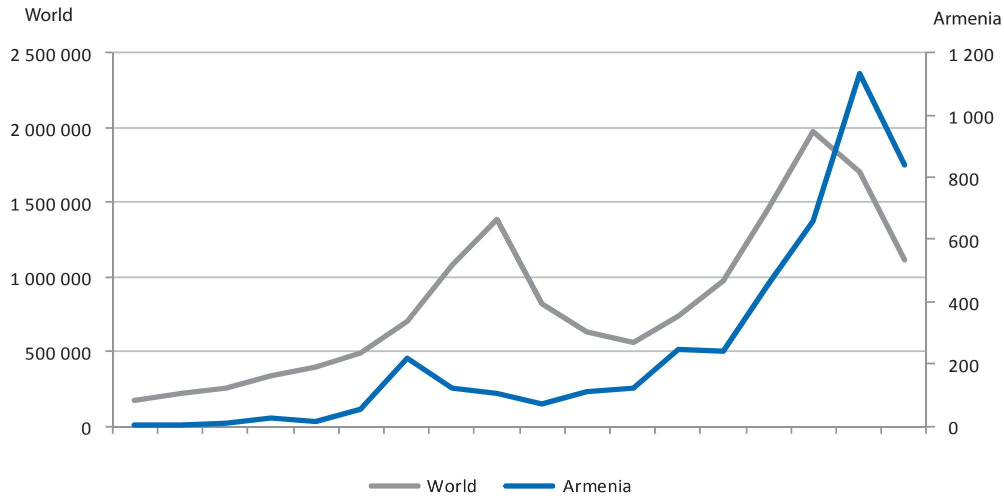
The government of Armenia has undertaken a number of programmes in order to facilitate access to finance for small enterprises. The "Loan Guarantees Provision Programme" allows solvent entrepreneurs to get loans in terms of insufficient pledge amount and low liquidity, which is particularly specific for the SMEs operating in distant and close to the border regions of Armenia. The "Partial Subsidising of Credit Interest Rates" aims to support SMEs through partial subsidising of credit interests. In particular, this programme is available for SMEs operating in remote, low-populated (up to 1 000 habitants) rural settlements. The "Start-up support programme" provides financial support (loans) to start-up entrepreneurs (through the partner banks of the SME Development National Center of Armenia) supporting them with business plans leading to the creation of new businesses.

Nevertheless, respondents from the public and private sectors identified early-stage finance and guarantee schemes as priority areas for further improvement. This is especially important for start-ups which, unlike mature enterprises, cannot rely on working capital nor on supplier financing. Because of the early stage of their development they do not yet dispose of well established links and partnerships with other businesses. Therefore, loans from commercial banks constitute the main source of available financing, but at a high cost.

Investment framework for SME growth

Even if Armenia attracted higher-than-average FDI inflows between 2002-08 with an annual cumulative growth rate of 29% compared to 14% in the world, it may face challenges in maintaining high FDI inflows now that the privatisation period is largely over. Moreover, as a result of the global crisis, the competition to attract FDI is likely to intensify as worldwide FDI flows are estimated to slow down and consolidate their positions in home markets. Total FDI inflows into Armenia in 2009 totalled about USD 838 million (UNCTAD) which equals approximately USD 1 110 per capita.

Figure 1.5. Armenia: net FDI flows 1992-2009
(current USD million)



Source: UNCTADstat.

To further support improvements in the investment framework for SME growth the OECD developed an in-depth evaluation framework for investment policy and promotion. This framework provides comprehensive coverage of FDI policy, investment promotion and facilitation, and transparency. Successful jurisdictions reform their investment laws and regulations while promoting their advantages simultaneously. Using a framework that incorporates both aspects recognises this two-fold approach and provides policy makers with a single window to assess their progress in that regard.

Armenia's investment environment is relatively open to foreign investors and the government is committed to attract further FDI.[33] The 1994 Law on Foreign Investments provides the regulatory framework for FDI and includes guarantees for national treatment and non-discrimination. Article 6 of this law states that: "The legal regime governing foreign investments and the methods of their implementation of the Republic of Armenia cannot be less favourable than the regime governing the property, property rights and investment activities of citizens, legal entities and unincorporated enterprises of the Republic of Armenia. To encourage foreign investments in the most significant fields of social and economic development, additional privileges for such investments may be established in a manner provided by legislation of the Republic of Armenia".[34]

Foreign and domestic investors are treated equally by law. Foreign investors and foreign employees are entitled to freely export their property, revenues and other means legally gained as a result of investments or as a payment for labour. Restrictions imposed on currency exchange and transfer have been abolished and the national currency is fully convertible. Both national and foreign companies are able to open bank accounts in both national and foreign currency. Armenia has been a member of the World Intellectual Property Organisation (WIPO) since 1993. Its domestic legislation including the 2006 Law on Copyright and Related Rights is in full conformity with the requirements of WTO provisions on intellectual property including the Trade Related Aspects of Intellectual Properties (TRIPS) Agreement. However, law enforcement remains weak and foreign investors have suffered from inadequate protection of intellectual property rights.

Foreign enterprises registered in Armenia are allowed to acquire ownership of land and there is no discrimination about the administrative procedures of registration among national and foreign representatives. Property is protected by the Armenian Constitution and expropriation of foreign investments is not allowed except in cases of natural or state emergency and upon appropriate compensation. Moreover, Armenia is a member of the Multilateral Investment Guarantee Agency (MIGA) which allows foreign investors to receive guarantees against political risks including transfer restrictions, expropriation, war and civil disturbance, and breach of contract.

Major issues that remain today include insufficient law enforcement mechanisms as well as coherent review mechanisms to benchmark the scope of restrictions to national treatment relative to practices in other countries. Establishing such a review process would also enable governments to undertake detailed cost-benefit or regulatory impact analysis to see whether restrictions meet their intended policy purposes or should be removed. Ideally, this process should also seek inputs and observations of national and international investors and other relevant stakeholders.

Investment promotion services and activities are offered by the Armenian Development Agency (ADA) which was established in 1998 to attract FDI and promote exports. ADA acts as a "one-stop shop" for investors providing assistance in setting up a business, supporting project implementation, performing a liaison role between the investor and the government, providing information on investment opportunities in the country, as well as on investment related regulations and laws. In its export promotion activities, ADA helps to identify markets for products, undertakes market studies and seeks out partners for joint ventures aimed at increasing the volume of exports and development of Armenian enterprises.

To improve efficiency of investment promotion activities further, Armenia needs to take a more integrated approach to investment promotion which is focused on sector competitiveness and regional development. By doing so, investment promotion can serve as a tool to foster sector and geographic diversification of FDI. This can be achieved by looking at how to develop longer-term capabilities through targeted and sector-specific FDI-led policy reforms. Improving a sector's competitiveness requires a thorough identification of policy barriers in every step of the value chain. Such an activity-based analysis can help assess the potential financial impact of poor policy and regulation on companies seeking profitable investment opportunities

In order to support local economic development, Armenia should consider implementing FDI-SME linkage programmes to actively support the development of small and medium-sized enterprises by introducing schemes that specifically help them to benefit from the presence of foreign investors. This normally entails approaching local SMEs and conducting strategic audits to assess their capacity to participate in a specific linkage programme as well as defining a development plan, promotional campaigns and a database to generate interest by foreign enterprises. Experience suggests that the facilitation of creating linkages can lead to sustainable business networks which are invaluable to both foreign investors and domestic companies.

NOTES

1. Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine.
2. Informal economy refers to all legal production activities that are deliberately concealed from public authorities for the following kinds of reasons: to avoid payment of income, value-added or other taxes; to avoid payment of social security contributions; to avoid having to meet certain legal standards such as minimum wages, maximum hours, safety or health standards, etc. It does not concern illegal activities.
3. As per IMF resident representative in Armenia Guillermo Tolosa, the ratio of tax collection level to GDP in Armenia is lower than in African countries (PanARMENIAN.Net, 2010).
4. For example, the introduction of VAT in Armenia was contrary to best practices. Instead of a gradual rise in rates from the minimum to the optimal level, the maximum possible rate was introduced. World experience of VAT collection has shown that because of the high fixed costs and administrative complexity of this tax the optimal rate should be at 10-15%. Evolution of the standard VAT rates in the global tax practice took place on the level of 8-10% (Austria, United Kingdom, Denmark, Turkey, Germany) to the current 14-16% in Spain, Germany and 17-20% in United Kingdom, Greece, Italy and France. The highest tax rate of 25% is established in Denmark and Sweden.
5. Former "Chairman of the Village Council" and "Chairman of the Collective Farm" in Soviet times.
6. 1986 referred to as one of the peak years for the Armenian economy in general and agriculture in particular before the devastating earthquake of 1988 and the turmoil related to the collapse of the Soviet Union and the Karabakh conflict.
7. Fish breeding in Armenia is a recent phenomenon. Armenia enjoys favorable conditions for fish breeding as fish farms are located in the Ararat valley, which is rich in high-quality artesian waters. Fish farming is developing quite fast. Only 20 tonnes of fish was produced in 1996, and more than 3 000 tonnes in 2009, mainly sturgeon and trout. Producers are currently willing to expand to foreign markets. They say the potential of fish breeding is much bigger as they can produce 300 000 tonnes annually. Only about 5-7% of fish went for export so far (Armenian media; see For Further Reading).
8. Exporting sheep is a new trend in Armenia and can be considered a postitive development. However, allegedly, the export number is at least twice as big as that officially reported and most importantly, mothering sheep have also been exported, which endangers the future of sheep breeding in Armenia.
9. Points will be set up in rural areas to collect the produce and transport it to the free zone where it will be stored, packaged and exported to foreign markets by air. Three such agricultural produce collecting points have already been set up.
10. Empowering the State Commission for Protection of Economic Competition the law states that, if during the year a company twice or more abuses its dominant position in the market by "creating obstacles and restrictions to competition" the commission may consider splitting it up.
11. After the world crisis the GoA is keen on creating a "post-industrialised" model of society according to the Prime Minister. The priorities of the state policy will be focused on innovative technologies, health care, education and financial sectors.
12. In January-April 2010 there were only two metal cutting machines produced, compared to only one in the same period of 2009 (NSS).
13. Waste management related problems are of urgent priority for Armenia. There are no or very few specially allocated sites for treatment and final disposal of industrial and household wastes that comply with sanitary-hygienic norms. There is no system for separation of industrial and household wastes. Unsorted waste is disposed of at the same urban and rural waste dumps. Infrastructure for processing waste as a secondary raw material is poorly developed in Armenia (National Chemicals Management Profile, Yerevan 2009).

14. Japan International Co-operation Agency (JICA), Steering Committee of Study on Mining Sector Development Master Plan of the Government of the Republic of Armenia, *Study on Mining Sector Development Master Plan in the Republic of Armenia final report, 2003.*

15. Armenia joined the Kimberley Process, which excludes illegal trafficking of conflict diamonds.

16. With the self-proclaimed independence of Abkhasia, rail and highway transportation from Russia to Georgia and to Armenia was closed down.

17. Excerpts from Republic of Armenia: Third Review Under the Stand-By Arrangement, IMF, April 2010, Structural Benchmarks:
"*Tax administration: 1.* Meet the statutory 90-day processing deadline for all VAT refund claims filed in 2009. Continuous in 2009. Outcome – Goal Met. 2. Submit legislation to parliament that allows only high-risk VAT refunds to be subject to review. March 2010. 3. Adopt a government decree establishing a mechanism for implementing a fully functional risk management approaches in VAT refund processing. December 2010.
Tax and social policy: 4. Develop a strategy to further strengthen the targeting of social safety nets. December 2009. Outcome – Goal Met. 5. Submit legislation to parliament to bring petroleum and tobacco products within the regular tax regimes (excise tax, customs duties, profit tax, and VAT), effective January 2011. December 2009. Outcome – Goal Met. 6. Submit legislation to parliament amending the Law on Presumptive Taxes. September 2010.
Fiscal sustainability: 7. Submit a medium-term fiscal framework (2011−13) to the government. July 2010
Financial sector: 8. Issue prudential regulations to specifically address currency-induced credit risk. June 2010. 9. Formalise the Committee for Financial Stability in a Memorandum of Understanding. September 2010. 10. Issue prudential regulation requiring banks to prepare their contingency plans. December 2010."

18. The Ministry of Economy indicates that there are a number of commodities of Armenian origin, around 500 items, which have a high export potential while being currently exported at very small volumes. These are, for example: "Chemical products, rubber", "Fur, leather, products made thereof", "Wood and Paper Products", "Textile, shoes", "Products made of stone, ceramics, glass, gypsum". They state that the small export volumes are limited by low production and not by external market demand. Consequently, there is a lack of export-oriented clusters and if such clusters are developed and demand markets identified, exports can be diversified and shift to a new level.

19. The International Labour Organization (ILO) measure of unemployment assesses the number of jobless people who want to work, are available to work and are actively seeking employment. It is used internationally so comparisons can be made between countries. It also enables consistent comparisons over time. The ILO measure is calculated using data from surveys of a country's labour force; it can therefore be subject to sampling differences between one country and another. It differs from the claimant count unemployment measure, which only includes people claiming unemployment-related welfare benefits. The ILO measure gives a higher figure than the claimant count measure as it includes those who are classified as available for work but who are not claiming jobless benefits. The ILO measure may include students who are actively seeking work but may not qualify for jobless benefits. Similarly, second earners within a household may be reluctant to claim jobless benefits but would be classified as unemployed under the ILO measure as they are available for work.(Source: Reuters, from http://glossary.reuters.com/index.php/ILO_Measure_of_Unemployment).

20. The Gallup Organisation, known primarily as Gallup, provides a variety of management consulting, human resources and statistical research services. It has over 40 offices in 27 countries. World headquarters are in Washington, DC.

21. The Gini coefficient is a measure of statistical dispersion developed by the Italian statistician, Corrado Gini, in 1912. The Gini coefficient is a measure of the inequality of a distribution, a value of 0 expressing total equality and a value of 1 maximal inequality; for example it equals 0.23 in Sweden and 0.70 in Namibia.

22. Bologna Process: European Higher Education Area making academic standards and quality assurance standards more comparable and compatible throughout Europe.

23. United Nations Commission for Europe (UNECE) Statistical Database, http://w3.unece.org/pxweb/Dialog/.
24. World Bank Factsheet Armenia.
25. The entry rate of enterprises in OECD countries is calculated as the number of new employer enterprises as a percentage of existing active population of enterprises.
26. Despite being divided in micro, small and medium categories, the small business sector is referred to as Small and Medium Enterprises (SMEs).
27. The data are obtained using the extrapolation method by SME DNC Armenia; this evaluation does not include the distribution of SMEs and large enterprises in agriculture.
28. Also Business Environment and Enterprise Performance Survey (BEEPS).
29. UNESCO Statistics Database, 2008 for secondary and 2007 for tertiary education enrolment rates.
30. In mathematics Armenia moved from being below the scale average at the fourth grade in 2003 to having achievement similar to the scale average at the eighth grade in 2007, and in science it kept the same relative position; http://timss.bc.edu/TIMSS2007/intl_reports.html.
31. AMD 373.46 per USD official exchange rate for June 2010.
32. National Human Capital Development Survey 2009, Sampling Survey of Armenia's External and Domestic Migration carried out by the UNHCR and the National Statistical Service of Armenia in 2007.
33. Cf. Concept on Investment Policy of the Republic of Armenia, www.mineconomy.am/files/docs/35_en.pdf (unofficial translation).
34. The Law on Foreign Investments, Article 6, 1994.

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CHAPTER TWO

AZERBAIJAN: COUNTRY REVIEW

SUMMARY

The global economic boom of 2000-08 and the steep rises in petroleum prices resulted in very rapid growth for Azerbaijan. Prior to the 2008/09 downturn, GDP grew at over 20% per year, reflected in sharp increases in fiscal revenues. In consequence, and in order to support the further expansion of the oil industry, there was a high rate of both public and private investment in oil-industry-linked infrastructure investment, particularly around the Caspian Sea and the capital, Baku. These investments created a large number of new jobs and led to a significant decline in the rates of extreme poverty. State revenues also allowed the government to make progress on the Millennium Development Goals (MDGs) of the United Nations and further social progress is within reach.

The dependence on oil and petroleum-related industries presents challenges for Azerbaijan. According to various estimates, oil reserves could be exhausted in a relatively short time span. Hence, it is urgent to develop other sectors of the economy, especially agriculture, services and non-oil industries. With this perspective, small and medium-sized enterprises (SMEs), and the private sector in general, need support in the form of opening up of opportunities for investors, access to finance for SMEs, reform of the education system to match the needs of the economy with the output of institutes of learning and reform and modernisation of health services to enhance the quality of life of the population.

Reforms are underway to underpin competitiveness and bring market regulations into line with international standards. More needs to be done, however, to support SMEs, which are the basis of diversified growth. While reforms in the health and social services have been significant, the quality of health care remains below internationally acceptable targets. Finally, the country remains handicapped by the still-unresolved conflict with neighbouring Armenia and coping with a million displaced persons.

The report identifies main challenges and provides recommendations on measures to be strengthened in order to overcome the negative impact of the global economic crisis and achieve sustainable economic growth:

- shift production to support the non-oil sector;
- develop comprehensive investment promotion strategies;
- ensure transparency in business regulation and licensing procedures.

INTRODUCTION

Since 1996, Azerbaijan has experienced macroeconomic stability and dynamic economic development. A number of significant policies, to be developed further, have been implemented to promote socio-economic development, with a high priority on oil strategy with the development of the Caspian energy resources. Since the "Contract of the Century"[1], signed in 1994 between the State Oil Company of Azerbaijan Republic (SOCAR) and the Western Oil Consortium to develop Azerbaijan's Caspian oil reserves (Azeri-Chirag-Gunashli), the level of foreign and domestic investment in Azerbaijan from 2004 to 2009 amounted to USD 70 billion, half of which was foreign investments. Macroeconomic stability was therefore achieved as a result of the entrance of oil giants in the domestic market. Processes to create acceptable economic infrastructure and adopt new laws regulating the business environment were initiated as early as in 1993, under former President Haydar Aliyev.

Despite the positive macroeconomic results, there are still a number of problems to be tackled, especially the improvement of the economic and social situation of the population, fairer distribution of incomes, the reduction of unemployment and the diversification of the economy.

The economy of Azerbaijan, in many respects, still depends on the extraction of hydrocarbons. With the growing volumes of receipts from oil exports and the inadequacy of monetary instruments available to the government, controlling inflation and excessive evaluation of the national currency have become major problems.

Azerbaijan's dependence on the oil sector leads to fears of Dutch Disease: negative economic consequences arising from natural-resource price increases with a negative effect on industrial and manufacturing development. Moreover, forecasts led by British Petroleum and SOCAR have shown the peak of extraction of these resources in Azerbaijan to be reached in 2014 (OECD/IEA, 2010), leading to the exhaustion of possibilities of extensive growth. In parallel, the global economic recession of 2008-09 emphasises vulnerability to international energy shocks, in a country where more than 90% of all exports are oil-related, raising issues of diversification and the development of non-oil sectors. Hence, it is necessary now to involve new resources for steady economic growth, such as processing industries.

RECENT ECONOMIC DEVELOPMENTS

Azerbaijan's economy has fundamentally changed since 2006, when oil started to be dispatched through the Baku-Tiblisi-Ceyhan (BTC) pipeline, as a new phase of development was implemented and oil revenues began to flow.

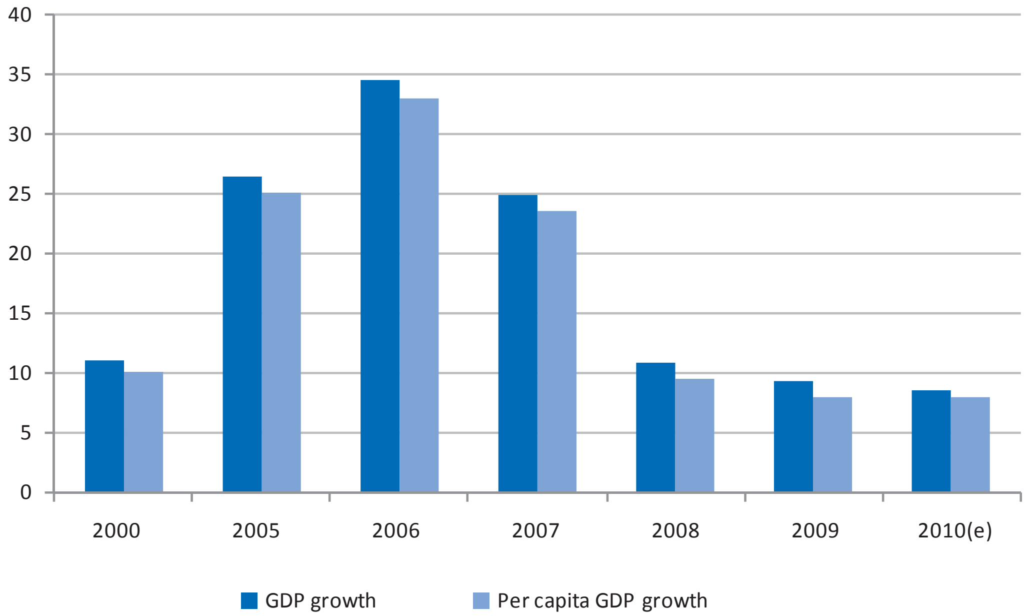
Industry, construction and services showed strong turnover and wages growth. Foreign currency inflows (US dollar) boosted the state budget and fuelled inflation – which averaged 18% in 2007-08. The role of the state oil fund, SOFAZ, during this period allowed a tight control of revenues and expenditures in the oil sector, which prevented Dutch Disease.

The rise in oil prices allowed the government to engage in large-scale infrastructure projects to pave the way for the non-oil sectors; a real challenge for the country's future development. The government has engaged in important modernisation of social services programmes mostly since 2000, which have played a vital role in reducing poverty. The major expenditures of SOFAZ being transfers to the state budget (50% of budget revenues), the government was able to increase pensions and wages and to invest in schools, universities and hospitals. Consequently, poverty decreased significantly from 49% to 11.2% between 2001 and 2009. The national poverty line indicator increased by 3.7 times from 24 Azerbaijani manat (AZN) to AZN 89.5 over the same period.

Although the country managed to record positive growth in 2009, nearly all macroeconomic indicators were affected by the global downturn. For the first time, the country was forced to increase production for less profit, which is a distinctive feature of raw materials exporting countries. If the crisis had not taken place, annual nominal GDP was forecast to increase by an additional AZN 4 billion in 2009. The reduction of the nominal GDP to AZN 34.6 billion was caused by falling oil prices and moderate rates of the non-oil sector development. Indeed, the oil sector contributed to a rise of 14.3% of GDP, while the non-oil sector of only 3.2%.

Azerbaijan returned to high growth in the second half of 2009 with an increasing oil price. Therefore, the country's GDP increased by 9.3%, while forecasts done by the IMF for 2010 and 2011 show growth of 7.5% and 4.1% respectively, the highest in the Black Sea region. GDP per capita grew by 7.9% in 2009, amounting to AZN 3 917.3, before decreasing to AZN 2 539.9 in January-November 2010. According to the International Monetary Fund (IMF), per capita GDP in parity purchase power (PPP) terms for 2000-08 increased by 3.9 times and reached the level of USD 8 600 which is very high for a transition country (IMF, 2009). As a consequence, the end of the "transition period" was officially announced by President Ilham Aliyev in the first quarter of 2010.

Figure 2.1. Real GDP and per capita GDP growth rate
(annual percentage change)

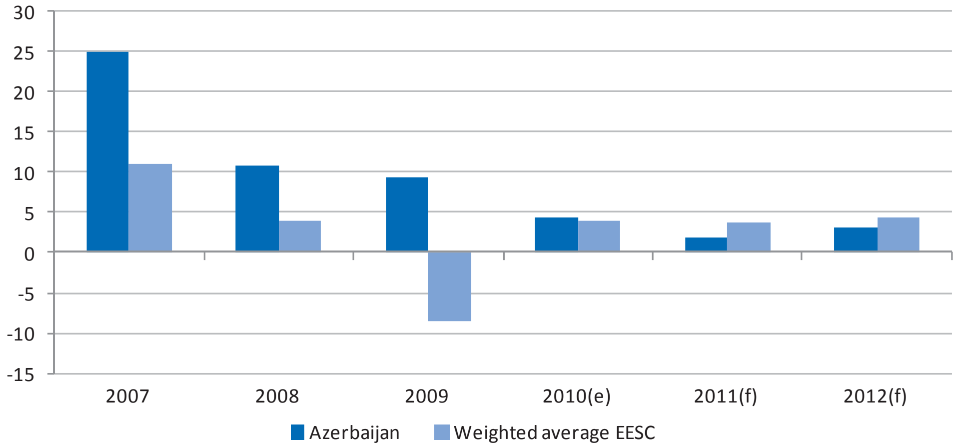


Source: The State Statistical Committee of Azerbaijan.

It is interesting to note that real GDP has grown at a faster rate than the per capita GDP. This is due to a constant increase of the population since 2000 with the return of the economic boom in Azerbaijan.

Azerbaijan showed better economic performance in 2000-10 than any of the other EESC countries[2] by increasing its GDP from AZN 4.7 billion in 2000 to AZN 36.7 billion in 2010.

Figure 2.2. Real growth rate in Azerbaijan
(annual percentage change)



Source: IMF WEO, October 2009.

General overview

In 2010, Azerbaijan's gross domestic product (GDP) growth reached 4.3%, compared to 9.3% in 2009; in current prices, GDP growth in 2010 totalled 6%. The country is relatively less integrated in the world economy and was not affected as severely by the international crisis as were other Eastern Europe and South Caucasus (EESC) countries like Ukraine, for example, with a contraction of 15%. The government's support to banks and continuous commitments to infrastructure projects also mitigated the impact of the crisis. Nonetheless, the drop in oil returns in the first half of 2009 highlighted Azerbaijan's vulnerability to energy shocks and the commodity exports dependency risk. In 2009, some sectors, such as construction and metallurgy, acknowledged serious difficulties. Despite that, nearly all sectors registered growth. Moreover, 45.5% of production occurred in the non-oil sector, with growth of 3.2%. In 2010, the non-oil sector made up 42.4% of total GDP, an annual increase of nearly 6% in value.

Figure 2.3. Share of non-oil sector in GDP

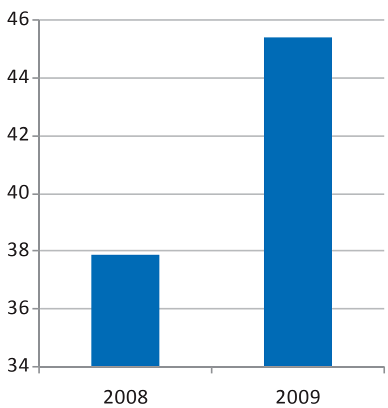
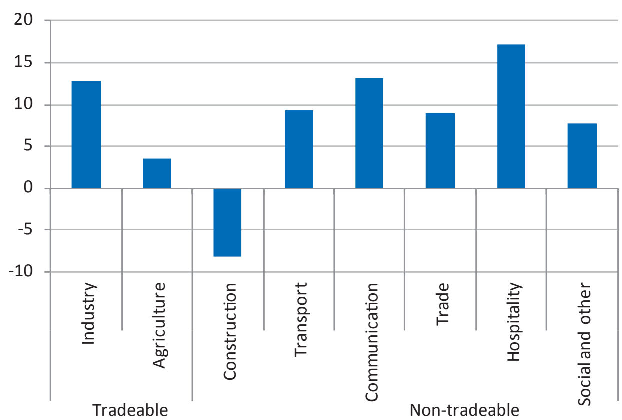


Figure 2.4. Real economic growth rates in 2009, by sector (percentage)



Source: The State Statistical Committee of Azerbaijan Republic.

According to the State Statistical Committee of Azerbaijan, quarterly GDP increased by 5.4% in the first quarter of 2010 compared to the first quarter of 2009, amounting to AZN 9.5 billion. Quarterly GDP peaked at AZN 10.6 billion in Q2 2010 before declining to its Q1 2010 level in the third quarter.

Inflation

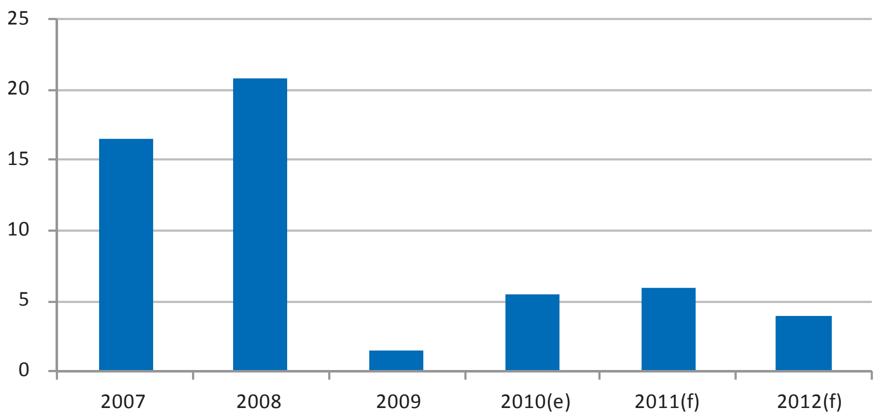
Azerbaijan succeeded in reducing inflation to a single digit between 2000 and 2006. Indeed, the Central Bank performed well over these years, keeping money supply and inflation under strict control until 2007 and 2008, when it recorded inflation rates of 16.7% and 20.8% respectively. According to the State Statistical Committee of Azerbaijan, the price adjustment in 2000 between nominal and real GDP was 112.5%, reduced to 78.8% in 2009. External (import-cost push) as well as internal (growth of wages, income and employment) factors led to the increase of consumer goods prices.

These factors have also been backed by a huge increase in expenses of the state budget and a strong increase in monetary aggregates (that expanded several times), which have raised expectations since 2005.

The state monopoly also led to an increase in tariffs of electricity, gas and petrol[3] since 2007, causing a supply shock in the economy with a multiplicative effect on the services sphere. Besides, inflation usually leads to decreased investment, which reduces the speed of economic growth with a negative effect on poverty, since lower incomes become vulnerable. Therefore protecting the poor from inflation pressure remains an important issue for Azerbaijan.

The purchasing power of the population showed two-digit growth against one digit in agriculture, implying excess of demand over food supply, which can be explained by the exhaustion of current agricultural capacity and lack of development in agriculture.

Figure 2.5. Inflation, average consumer prices

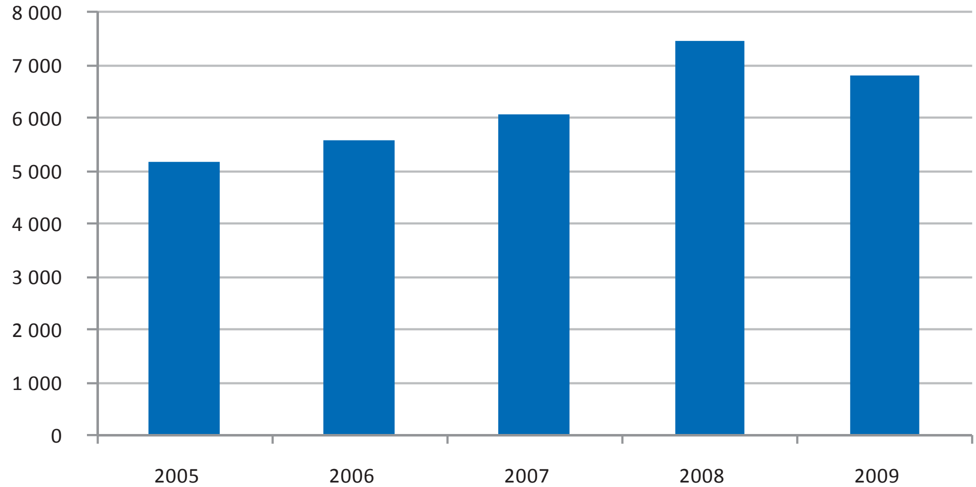


Source: IMF WEO, October 2009.

On the other hand, inflation in Azerbaijan is mostly demand-driven, which, at moderate levels, can increase investment in the national economy by absorbing excessive supply.

Oil fields, along with pipeline construction, have generated a significant amount of both domestic and foreign direct investment (FDI) in the country. The volume of investments in the oil and gas sector of Azerbaijan has exceeded USD 38 billion of which more than USD 20 billion have been directed to studies of the subsoil area of "Azeri-Chirag-Guneshli" (ACG), a large complex of oil fields in the Caspian Sea, where 850 000 barrels of oil are extracted daily.

Figure 2.6. Gross fixed capital formation (new investments)
(AZN million)



Source: The State Statistical Committee of Azerbaijan Republic.

Analysis by account

Consumption

As a result of rapid economic growth, nominal incomes of the population increased by 20.5%, from AZN 4 billion in 2000 to AZN 22.7 billion in 2010, which is three times higher than average inflation (7.2%) in the same period. In 2009, 58% of income structure came from wages and entrepreneurial income; agricultural activities and pensions/social facilities accounted for 15.3% and 15.7% respectively.

Positively impacted by household revenue growth, total real household consumption rose from AZN 3 billion in 2000 to AZN 14.8 billion in 2009 (4.9 times). Its share in GDP decreased from 63% to 42.8% over this period. Unlike in previous years, consumption was the major source of economic growth in 2009, while between 2006 and 2008 it was trade which dominated aggregate demand.

Consequently, the share of food in households' expenditure decreased between 2002 and 2009, from 64% to 51% for the urban population and from 74% to 56% for rural households, thus increasing the share of non-food consumption goods.

Table 2.1. Monthly expenditure evolution between 2002 and 2009

Total expenditure:	**2002**	**2009**
Average monthly total expenditure per household (AZN)	46.2	129.6
Share of food (% of total expenses)	53.6	52.9
Share of manufactured goods and services (%)	37.0	34.5
Share of non-consumption expenditures (%)	9.4	12.6
Loan to deposit ratio*	109.0	177.0

Note: *Annualised, author's estimation.

Source: The State Statistical Committee.

**Source:* the Central Bank of Azerbaijan Republic, author's calculations.

Monthly per capita income grew at a faster pace than per capita expenditure between 2006 and 2008. Indeed, average monthly expenditure grew 2.8 times from 2002 to 2009.

Average monthly wages grew considerably from AZN 44.3 in 2000 to AZN 298 in 2009, a 23% annual increase, which was also more than average inflation over the same period. However, these average indicators do not display an accurate picture of the situation, since there is a ten-fold difference between salaries in the mining industry, leader of the economy, and in agriculture, which is the lowest-paid sector. The financial sector, real estate and rents are also high while education, health and social services share the lower pay scales.

Consumption was also supported by persistent access to bank loans, which increased from AZN 0.04 billion in 2000 to AZN 2.33 billion in 2009. Household loans' share in total credits increased from 8.9% in 2000 to 35.4% in 2007 (which increased expenditure to manufactured and non-consumption goods and services), then decreased to 27.7% in 2009, due to the crisis and tougher lending rules, consequently hindering the process of stimulating aggregate demand.

Government expenditures and revenues

In 2005-09, due to the oil boom, the government implemented policies to improve living standards and upgrade and expand critical infrastructure. Current expenditure increased by a cumulative 6.2 times in nominal terms from 2000 to 2009 (7% and 13% of total consumption respectively), while total consumption increased from AZN 3.8 billion to AZN 19.4 billion over the same period.

Public consumption is of goods and services purchased from the state budget; 32.4% of the budget was composed of wages, pensions and purchases of goods and services, up by 8.6% in 2009 compared to 2008. Public expenditure increased from AZN 0.7 billion to AZN 4.4 billion between 2000 and 2009, a steady share of GDP of 12% on average.

Table 2.2. Evolution of government debt, revenue and support

Debt, taxes and budget support	2000	2009
Short-term debt (% of external debt sources)	11.8	34*
Debt (% of GDP)	25.6	7.9
Total debt service (as % export of goods, services and income)	5.8	1.0
General government final consumption expenditure (% of GDP)	15.2	12.9
Tax revenues (% of GDP)	14.5	16.2
Net official development assistance – ODA (USD million) and official aid – OA (USD million)	139.0	235.0**

Notes: *2007, **2008.

Sources: The State Statistical Committee, OECD, World Bank WDI.

Government borrowing rose from USD 1.3 billion in 2002 to USD 3.4 billion in 2009, while its correlation to GDP decreased substantially from 22% to 8% over the same period, thanks to the huge increase of GDP. Per capita debt increased from USD 159 to USD 380 between 2002 and 2009. Approximately 90% of external resources went to investment. Investment in the power supply sector took about 40% of total FDI, 3.7% was on agricultural development and highway engineering, the transport sector accounted for 25%, systems of water supply and land reclamation took 9% and the oil and gas sector, along with the chemical industry, took up 6% of foreign financings.

Government spending from the state budget in the social sphere[4] doubled, from AZN 1.7 billion in 2007 to AZN 2.9 billion in 2009. Its average growth rate reached 30% (without the economic crisis, it was expected to reach an average of 45%), while accounting for 6.5% of GDP, its share in the state budget was 25% over the same period. Despite this serious growth in social spending, its budget share and share of GDP, health and social security expenditures in particular, are below levels in developed economies. Moreover, these expenditures are mostly directed to fixed needs of the social sphere rather than enhancing human capital.

Investments

Investments in fixed capital increased from AZN 0.968 billion in 2000 to AZN 9.9 billion in 2008, only to decline to AZN 7.7 billion (22.3% of GDP) in 2009. In November 2010, capital investments totalled AZN 7.7 billion (USD 9.6 billion). As much as 73.4% of total gross investment (AZN 5.7 billion) was directed towards the non-oil sector in 2009 against 34.9% (AZN 2.0 billion) in 2005. The share of foreign investment in total investments decreased from 68.7% in 2005 (USD 4.8 billion) to 42.7% in 2009 (USD 5.5 billion).

International organisations and countries such as the United Kingdom, the United States of America, Japan, France, Norway, Czech Republic and Turkey had a total share of 87.3% (AZN 1.3 billion) of foreign investment in 2009; the United Kingdom's accounting for 51% of total investments (AZN 0.7 billion) that year. Moreover, on 16 August 2010, British Petroleum (BP) bought the shares of Devon Energy Corporation (the largest American independent oil and gas company) in the Azerbaijani oil and gas project ACG, a transaction worth USD 2 billion.

FDI to the country has been largely directed to the oil sector. Although there are numerous opportunities for foreign investors in fields such as agriculture and services, little FDI reached beyond the oil sector. Foreign investments in the non-oil sector are concentrated in construction, telecommunications and services. The industrial sector and agricultural processing have also attracted foreign investment in recent years. The slow pace of privatisation of public utilities has restricted the levels of FDI to the sector. The economic crisis also affected FDI inflows despite the government's efforts in infrastructure and overall business improvement.

Trade

Azerbaijan's export value was multiplied by 11.5 between 2000 and 2010 (from USD 1.9 billion to USD 21.8 billion), and imports by 5 (from USD 1.5 billion to USD 6.5 billion). The increase is due to the execution of large projects in the oil and infrastructure sectors. Analysis of the balance of payments shows that external trade operations in the oil and gas sector have been positive, but negative in non-oil sectors. Receipts in the oil and gas sector mainly come from the export of oil and inflow of foreign capital, while expenditure consists of capital repatriation and equipment imports.

The economic crisis led exports and imports to reduce sharply from USD 30.6 billion (31.0%) and from USD 7.6 billion (14.0%) respectively between 2008 and 2009. The trade balance decreased by 36.5% from USD 23 billion over this period.

Overall, the country's trade balance increased by 51 times in 2010 reaching USD 15.3 billion, from USD 0.3 billion in 2000. This growth was mainly due to the price and production increase in oil.

Table 2.3. Current account balance

	2005	2006	2007	2008	2009	2010*	2011**	2012**
Current account balance (USD billion)	0.2	3.7	9.0	16.4	10.2	13.1	13.1	13.3
Current account balance (% GDP)	1.3	17.6	28.8	35.5	23.6	25.3	24.2	23.5

Notes: *Expected, **Forecast.

Source: IMF WEO 2010.

Azerbaijan sold commodities to around 140 countries in 2009. Foreign trade with CIS countries accounted for 10.4% of the total foreign trade. Trade relationships with Italy, the United States, France, Israel, Turkey, Russia, Chinese Taipei, Indonesia, Canada and the United Kingdom represent 69.8% of total trade. Exports of goods are more than 90% composed of oil while imports are more diversified with civil engineering, equipment and motor vehicles.

Informal economy[5]

Local estimates of the share of informal economy in total GDP vary between 5% and 10% of GDP. According to Schneider (2010), the informal sector in Azerbaijan represents as much as 52.0% of GDP; the average for the OECD countries being 11.0% and 49.3% for the region's average.[6]

The higher figure would indicate that informal economy in Azerbaijan has reached a critical level and mostly takes place by double accounting and tax evasion. Indeed, while the Statistical Committee announced 73 600 new jobs (74% of which were permanent) in 2009, individual income tax only grew from AZN 637 million in 2008 to AZN 642 million in 2009, against much higher expectations. Remittances inflows witnessed a similar trend over 2009, as recorded in the Social Security Fund. Moreover, due to little diversification of the economy, local experts estimate a high share of shadow money transiting in the real sector.

Although the prevalence of the informal economy impedes the expansion of the state budget, concealing real incomes of individuals also hampers their creditworthiness and thus the overall expansion of the economy. Moreover, the informal economy leads to undervalued GDP, tax base limits, budget constraints, an underdeveloped banking system and corruption. It can also hamper foreign investments. However, it also had a positive impact in creating employment (though fragile), developing infant business and fostering competition by reducing bureaucracy.

The government needs to bring this shadow economy back into the visible sector by providing reforms at the microeconomic level to foster infant business development and stimulate competition.

Analysis by economic sector

The share of agriculture in total GDP fell from 16.1% in 2000 to 6.7% in 2009 due to the huge expansion in mining and quarrying (major component of industry) which increased from 28% to 45% over the same period and consequently raised industry to an average of 58% of GDP between 2006 and 2008 from 36% in 2000. As a result, services declined from 51% in 2000 to 43.3% in 2009. In 2009, despite the economic crisis, industry successfully accounted for 50% of total GDP.

Agriculture

Despite tax exemptions, low fuel prices and a high level of subsidies, agriculture did not take off and still has low growth rates. Agriculture plays a dominant role in the reduction of unemployment, as it employs two-fifths of the total labour force and because 46% of the total country population live in rural areas. 55% of total land (4 757 000 ha) is arable. However, due to low investments in the sector – around 2% of total investments in the country (AZN 336 million out of a total of AZN 16.2 billion in 2008) – and comparatively lower wages, the agricultural labour force moved towards the construction sector and other services between 2001 and 2007. Although the employment share of agriculture fell from 41% in 2001 to 38.5% in 2009, overall growth in agriculture was positive over the same period, which can be attributed to improvements in total factor productivity.

General overview

Livestock breeding and plant cultivation are the major fields of the country’s agriculture.

Table 2.4. Main crop production
(million tonnes)

	2000	2009
Cereals and dried pulses	1 540.2	2 988.3
Cotton	91.5	31.9
Tobacco	17.3	2.6
Potatoes	469.0	983.0
Vegetables	780.8	1 178.6
Vegetables and melon	261.0	410.8
Sugar beet	46.7	188.7
Sunflowers for seeds	3.7	14.4

Source: The State Statistical Committee of the Republic of Azerbaijan.

Azerbaijan's agricultural sector has been growing by 5% annually, doubling its production between 2000 and 2010. Since 1995, the production of cereals, potatoes, vegetables, sugar beet and sunflowers has increased significantly, while tobacco and cotton decreased, despite increasing international prices for cotton since 2005 (due to costs still higher than profits and slow renewal of equipment).

Livestock breeding has seen reasonable development, increasing various products by around 5% annually between 1996 and 2007. However, the share of imported livestock is expected to reach 60% of all agricultural imports in 2010. It is also expected that the country will meet its entire domestic demand for grain in 2010.

Table 2.5. Main livestock production between 2000 and 2009
(million tonnes)

	2000	2009
Meat	0.2	0.3
Milk	1.0	1.4
Eggs (billion units)	0.5	1.2

Source: The State Statistical Committee of the Republic of Azerbaijan.

One of the important objectives for Azerbaijan is boosting the economic development of rural areas and improving the agricultural output. As a result of reforms carried out since 1995 in the sector, excluding the Nagorno-Karabakh region, 99.5% of all land has been distributed by the government, of which 23% went to municipalities and 20% to private property.

Within the bounds of state support, agricultural output reached AZN 2.3 billion in 2009 (6.7% of GDP), down from a record of AZN 3.3 billion in 2008 before increasing to AZN 3.4 billion (USD 4.3 billion) in January-November 2010 (the highest level since independence). A record grain harvest, 2 988 300 tonnes, was collected in 2009, overtaking the previous year by 490 000 tonnes. However, the crisis hit plant-growing and cotton-growing, and cotton volumes even fell by 44.2%, to 30 900 tonnes. With Azerbaijan's real effective exchange rate appreciating only moderately, and institutional reforms in the business environment and the agricultural sector falling behind, the sector has been operating significantly below its potential (World Bank, 2009a). In production terms, the ineffective use of potential export sectors (pomegranates, potatoes, tomatoes, fresh fruits and vegetables and hazelnuts) and import-substitution (wheat, apples, and juices and concentrates) have prevented benefits optimisation.

Poverty remains high, particularly among the refugees and internally displaced persons resulting from the collapse of the USSR and the Nagorno-Karabakh conflict. Approximately 30-35% of the rural population live below the poverty line. These communities have adequate access to food, but they suffer from low productivity and high prices. Although there have been large improvements in infrastructure over the last years, with priority to supplying gas and electricity, living conditions remain poor. Health and education services also need to be improved.

The long-term growth of the economy, with rational use of existing manpower, natural and economic potential, increase in employment and reducing poverty levels have been the major problems of the sector. To improve agricultural performance, institutional and policy developments along with modernising infrastructure are also required. Moreover, the local banks are unwilling to finance the sector. The share of loans (in total loans to the real sector) issued to agriculture (and processing) decreased from 7.9% (AZN 37 million) in 2000 to 4.7% (AZN 395 million) in 2009.

In addition to investment policy, special tax or credit incentives can be considered. There are two priorities for agricultural development in the country: foreign finance and technologies and manufacturing experience. Trying to raise the confidence of landowners is a major issue. This increased confidence would encourage them to use their potential and expand commercial collaboration between local workers and foreign businesses. Efforts should be made to stimulate local workers to find contacts abroad, to establish relations and to produce export-oriented goods. Moreover, steps should be taken in focusing the attention of banks on financing the sector.

Major reforms

The government has undertaken real efforts for the sector's development through specific policies and programmes[7] and by allocating funds from the state budget since 1995. As a result of serious structural transformations in agriculture, the state farms and the collectives were liquidated and their property was divided between their members. The transition to a market economy and a new kind of property increased farmers' incomes and reduced poverty. Though land distribution was a first step for access to financing, more favourable conditions are needed to fully develop the sector.

The government's "State Programme on Social-Economical Development of the Regions of the Republic of Azerbaijan", which came into force for 2009-13, and the "State Programme on Reliable Provision of the Population with Food in the Azerbaijan Republic" adopted in 2008 and implemented in 2009-15, are aimed primarily at achieving food security and the development of rural areas.

In 2004, the government established the "Agroleasing" Open Stock Company, to strengthen the material and technical basis of agricultural producers and to supply agro-technical services. In particular, farmers can access agricultural machinery, fertilisers and thoroughbred cattle through the company. The company provides softer conditions than the market for loans and prices for equipment and machinery and large-scale projects.

Subsidy policies

Subsidies to agriculture by the state are among the highest among the Commonwealth of Independent States (CIS) countries. On the other hand, joining the World Trade Organization (WTO) may have a negative effect on national agriculture outputs because of lower customs duties, reduced subsidies and declining competitiveness. Hence, Azerbaijan hopes to join the WTO as a developing country, which will allow the maintenance of high financial support to the agrarian sector. The government allocates special subsidies to wheat producers of AZN 40 per hectare and per year since 2008 for fuel and motor oil and AZN 80 million is annually allocated to farmers from the state budget. In addition, the National Fund for Entrepreneurship Support lends a certain amount of funds for agricultural projects. The "State Programme on Reliable Provision of the Population with Food in the Azerbaijan Republic" (2009-15) is aimed at achieving sustainable agricultural development in the country.

Industry

General overview

The "Contract of the Century" laid the foundations for development of the petrochemical industries of the country with a transition from old Soviet technologies to the latest western ones. Among significant socio-economic impacts associated with the involvement of major foreign oil companies are skill enhancement, long-term employment opportunities and improved working conditions.

The country's manufacturing industries have grown considerably since 1995 and industry accounted for 50% of GDP in 2009. Located mostly in the industrial cities, Azerbaijan manufactures equipment for the oil and gas industry, electrical equipment, various appliances and technical instruments. The leading branches of heavy industry are power, manufacturing, petrochemical and chemical production.

The light industry of Azerbaijan consists of basic manufactured consumer goods. It also includes processing of foodstuffs, alcoholic drinks, textiles and building materials. Raw materials transformation used to represent the bulk of light industry in Azerbaijan but the retrenchment of wool and silk production severely lowered its share in total production. However, light industry does have certain prospects. Though suffering from outdated equipment, the existence of raw-materials resources and other commodities could stimulate significant capital inflows and develop the sector; especially in textiles and clothing which were one of the most important industries in the Soviet era.

Although there are advantageous investment opportunities, apart from the oil and gas sector, the country has failed to attract large volumes of greenfield investments oriented towards exports.

Energy sector

Oil

Oil and gas production in the country is carried out by SOCAR, one of the largest oil companies in the world. Established in 1992, SOCAR controls a full production cycle – "from drilling to the consumer". While the sector employs only 1% of the country's total labour force, SOCAR represents 60 000 people.

The Caspian basin field has about 3-5 billion tonnes of oil and 5 trillion m^3 of gas, according to SOCAR. At the same time, estimates of hydrocarbon deposits in the Azerbaijani sector vary from 4 to 8 or 10 billion tonnes of conditional fuel. It is also expected that Azerbaijani oil revenue will amount to an average of USD 200 billion over 20 years between 2005 and 2025. IMF projects the State oil fund (SOFAZ) assets to increase by 6.5 times reaching USD 98 billion in 2015 from USD 15 billion in 2009, which could lead to human capital development in the country. Indeed, although the oil sector is pulling the economy, it only accounts for about 1% of total employment. Therefore, a National Employment Strategy was initiated in 2002 by the government to convert "black gold into human gold" (oil wealth into human development) by enhancing educational programmes and training, easing the population's access to social infrastructures and technical assistance. According to BP, the oil companies' expenditures in social fields accounted for a total of USD 39 million between 2002 and 2008. In 2009, BP spent around USD 3 million in Azerbaijan on sustainable development projects, like BP's new Geosciences and Engineering Speaker Series (BPGESS) initiative, or the Memorandum of Understanding (MOU) signed between BP Azerbaijan and the Baku-based Qafqaz University (BP Azerbaijan Business Update, 2010).[8]

FDI, since 1995, has revitalised the country's oil sector through the development of new large-scale projects and the restoration of existing facilities. To date, Azerbaijan has signed over 20 major field agreements with approximately 30 companies from 15 countries. Azerbaijan's increase in oil production since 1997 has mainly come from the Azerbaijan International Operating Company (AIOC), an international consortium which represents over 70% of Azerbaijan's total oil exports. AIOC, which is composed of ten big international oil companies,[9] operates the offshore ACG mega oil field. Oil production from ACG accounted for 193 million tonnes between the date of commencement (1997) to the first quarter of 2010, and Azerbaijan's participation in oil production by the consortium reached 72.6 million tonnes in Q1 2010, according to Trend news agency. Beside ACG, AIOC also made a significant investment on construction of the South Caucasus Pipeline (SCP) and the BTC pipelines. British Petroleum, in Azerbaijan since 1992, is the largest foreign investor. Oil production in Azerbaijan increased from 180 000 barrels per day in 1997 to 1.02 million barrels per day in 2009. Oil production from AIOC and SOCAR fields is expected to reach 1.2 million barrels per day in 2010 and could be sustained at a volume of 1 million barrels per day until 2019 if AIOC and the government approve the USD 10 billion project to tap the oil reserves below the ACG fields (Energy Information Administration 2010). Expectations have been prudent since BP's setback in the Gulf of Mexico.

Not discovering new oilfields is the major condition on forecasts of oil exhaustion by 2020. It is also possible that new reserves could be insignificant and their exploitation could demand considerable capital expenses.

Two major fields are still to be explored for production expansion: lithologic and statigraphic strata – 30% of which were not fully assessed regarding their hydrocarbons production potential (Aliyev, 2010) – and the development of off-shore deposits, mostly in the Caspian Sea which is only exploited to 34% of its total capacity. Moreover, as the legal status of the Caspian Sea is still undefined, many offshore fields have been left untapped. While ACG is the most successful project, not all of Azerbaijan's foreign investment projects have been successful, with several projects announcing disappointing drilling results and several production-sharing agreements shutting down in recent years.

In 2009, from 50.9 million tonnes of oil, Azerbaijan exported 44.3 million tonnes to 24 countries, according to SOCAR. The remaining 6.09 million tonnes were dispatched to refining. SOCAR's share from total exports was 29.9 million tonnes, while the remaining 14.4 million tonnes went to the other international companies involved. It is expected to produce 52 million tonnes of oil in 2010.

Azerbaijan also has two oil refineries, operated by SOCAR, with a refining capacity of 22 million tonnes of oil per year. The country is highly interested in acquiring oil refineries around the Black Sea region. For example, it already holds 51% of the Turkish company Petkim, since 2007.

Natural gas

Prior to starting up the Shah Deniz natural gas field in 2007, Azerbaijan used to be a net natural gas importer from Russia. Now it has become a net exporter. In 2009, Azerbaijan produced 23.6 billion m^3 of natural gas but only consumed 10.6 billion m^3. Almost all of Azerbaijan's natural gas is produced from offshore fields. The country's leading natural gas fields are the ACG and the new Shah Deniz natural gas field. The country's Sangachal Terminal, is one of the world's largest integrated oil and gas processing terminals. It receives, stores and processes both crude oil and natural gas from both gas fields, which are then shipped through the different pipelines for export. The main gas pipeline is the SCP, also known as Baku-Tbilisi-Erzurum (with a capacity of 16 billion m^3 per year), which runs parallel to the BTC oil pipeline.

A major gas production increase is expected to come from the continuing development of the Shah-Deniz field. Moreover, Shah Deniz is one of the world's largest natural gas fields, discovered in the last 20 years. It has been estimated by SOCAR to have produced 28.5 billion m^3 of gas in 2010.

With the start of Shah Deniz's second phase in 2014-15, Azerbaijan will be able to double production to about 40 billion m^3 of gas per year. Although the figure is below 1% of the European consumption of gas, it can make the country a valuable player for European markets. It will also lead to further development of the gas industry and initiate prospects of USD 20 billion investment to the national economy. For this purpose, it is necessary to exploit high extraction technologies and to define the major routes of gas transportation. One of them could be the Nabucco gas pipeline project (construction beginning in late 2010) for gas transportation from the Caspian region and the Near East to the European Union (EU).

Industrial production

According to the State Statistical Committee in 2008, the degree of deterioration of basic production assets varied between 54% and 73% of total fixed assets in many branches of the manufacturing industry, such as metallurgy, chemistry, recording, electrical machinery, equipment, transport and mineral products. The intensification of manufacturing and raising quality to international standards are the most important issues. Lack of competitiveness is caused by low technological levels of production, poor product lines, weak diversification (both of products and enterprises) and reduction of the share of production of manufacturing industry in total exports. Many enterprises in the chemical, petrochemical, oil refining, electro-technical industry and oil mechanical engineering work at only 30% of their total capacity.

The mining industry accounted for 78.6% of total output, while share of manufacture and distribution of electric power, gas and water accounted for 4.7%: only 16.7% came from the manufacturing industry in 2008. A total of AZN 27.2 billion was invested in industry between 2000 and 2008, of which AZN 19.7 billion (72.4%) was FDI and AZN 7.5 billion (27.6%) were domestic investments. An insignificant part was directed towards enhancing technological innovation: just AZN 113 million between 2004 and 2008.

Business weakness results from lack of own capital resources, insufficient financial support from the state, low demand for new products, high innovation costs, high economic risk, long-term payback, low innovative potential of enterprises, unqualified personnel, a lack of information on new technologies, sluggish reaction to innovations, lack of information on commodity markets and lack of possibilities for co-operation with other enterprises and scientific organisations.

Table 2.6. Output of industrial products
(current prices, AZN million)

	2000	2005	2006	2007	2008	2009
Total industry	3 639.5	9 290.5	15 509.4	22 441.4	29 697.6	22 203.7
Chemical industry	102.2	199.0	194.7	213.0	219.7	110.4
Extractive industry	1 625.8	5 672.6	10 565.9	16 412.8	22 631.3	16 798.6
Manufacturing industry	1 552.5	3 074.2	4 312.2	4 920.4	5 701.4	4 199.2
Production and distribution of electricity, gas and water	461.2	543.7	631.3	1 108.2	1 364.9	1 205.9
Manufacture of food products, including beverages and tobacco	698.9	1 197.6	1 278.3	1 409.3	1 550.0	1 644.6
Textiles and sewing industry	32.7	51.1	72.0	59.4	76.5	62.1
Manufacture of leather, leather products and footwear	2.7	4.5	6.9	16.2	17.0	15.3
Manufacture of wood and wood products	1.9	9.6	12.2	18.4	15.6	8.0
Pulp and paper industry; publishing	6.0	26.2	31.9	37.2	57.0	50.6
Manufacture of refined petroleum products	560.9	836.8	1 821.2	2 118.2	2 400.0	1 345.6
Manufacture of rubber and plastics products	3.1	23.5	27.7	37.1	70.0	53.4
Manufacture of other non-metallic mineral products	23.1	135.4	165.1	253.0	352.5	359.1
Metallurgy industry and fabricated metal products	11.6	328.2	403.4	403.6	515.6	170.6
Manufacture of machinery and equipment	34.0	36.6	60.1	98.6	120.0	78.8
Manufacture of electrical optical and electronic equipment	10.8	25.9	34.0	48.3	56.2	64.4
Manufacture of transport means and equipment	57.7	165.2	173.9	169.3	206.8	203.2
Other sectors of manufacturing industry	6.9	34.6	30.8	38.8	44.5	33.1

Source: State statistical Office of Azerbaijan.

Construction and infrastructure

Construction grew from independence, with fixed assets reaching AZN 8 342 million in 2008, from AZN 667 million in 2000, but declining to AZN 2 438 million in 2009. The sector employs 225 000 people (5.5% of the total workforce) and the average monthly nominal wages of construction employees increased from AZN 83.3 in 2000 to AZN 449.9 in 2009. The sector accounted for 7.4% of GDP in 2009.

The construction boom began with the BTC pipeline construction in 2001 and continued until 2004, leading the sector to record the highest growth, next to oil, between 2001 and 2005. Pipeline construction generated confidence in the national economy and, along with the expansion of the state budget starting from 2005, a considerable increase in incomes, which boosted demand for real estate, led to a construction boom, particularly in the capital. This was accompanied by constant increases in real estate prices, which, however, went down after the start of the crisis.

The construction sector experienced a slowdown in 2009 due to the international crisis and the value of works at AZN 3 191.4 million, was down by 15.7% compared to 2008. The decrease affected both private and public construction volumes, by 10.2% and 16.8% respectively. However, it did not reflect a decrease in prices in the domestic market for real estate. As an anti-recession stimulus measure, in the middle of 2009 the government resumed mortgage lending which had been paused since 2007.

Capital investments in infrastructure had increased since 2003 and, backed by oil revenues, had tripled since 2006, but were slightly cut due to the crisis. Main public infrastructure projects such as power, roads and water had been a priority, followed by the social sectors. Improvements in power supply sparked development in the light industry, food processing and other manufacturing, while improvements of roads reduced transportation costs, mostly in corridors promoting cross-border trade and transit of goods. Improvements in these infrastructure projects are very important and will likely be continued, offering potential for growth and employment creation. There is some evidence that infrastructure projects have attracted some FDI in support of public spending, but manufacturing, assembly and related services have not.

Updating and expanding the infrastructure of the country remains a priority for Azerbaijan, since it is fundamental for the development of the non-oil sector and for attracting investment. The country will positively benefit from improving and modernising the Europe-Caucasus-Asia (East-West) and North-South corridors. Indeed, total cargo transportation via the East-West corridor on the Azerbaijani side increased from 20 million tonnes in 2000 to 47 million tonnes in 2009, while the share of transit cargo turnover accounted for 50% in 2009. So construction and rehabilitation of major projects in these directions require acceleration which would increase volume and favour faster movement of goods to domestic and international markets with lower operating costs and higher efficiency.

In addition, the sector's development is constrained due to insufficient administrative capacity to implement necessary projects. It also suffers from the slowness of fixed asset renewals and of the rapidity of their depreciation, underdevelopment of integrated systems, low information provision for the sector's activity and legal inconsistencies.

Policy implications

The government has undertaken several steps and adopted state programmes since 2006 to integrate into the international system, enhance transit potential and support competitiveness. According to the World Bank, the government intended to accelerate rehabilitation of regional and local roads from 2008. It was also estimated by the bank that approximately USD 1.1 billion is needed annually to develop infrastructure utilities and public services over the next ten years.

The private sector share in construction increased to 87% in 2008 from 63% in 2000. However it averaged 95% between 2002 and 2005. The constraints faced by the construction sector stem from the large role played by the state, the huge regulatory burden and the absence of competition. Construction permit formalities need to be reduced to attract more investment to the sector and create a more competitive environment.

There is also potential for the oil and gas industry, by supplying demand for basic equipment and machinery, metalworking, technical services, transportation, food, and chemical and petrochemical industries. Local enterprises will need to comply with international standards and will require solid capital resources, improved delivery requirements and developed capacity to respond to large orders.

Services

The share of services in GDP accounted for 44.4% in 2009; overall, services grew by 9.1% in the same year. The sector accounted for approximately 49% of total employment in 2008. The major share of employment in the sector is in trade and repair (16% of employment), education (8.5%), construction, real estate and tenancy (10%), transport, communication and warehousing (5%).

Furthermore, the country has a fairly liberal services sector. The share in GDP of liberalised activities in some sectors reaches up to 99% (99% for trade, 87% for construction and 82% for transport) while the overall private sector contribution to GDP is 85%. As a very dynamic branch of the non-oil economy between 2000 and 2008, growth of this sector was due to increasing demand for services and the favourable location of the country for trade and transport.

The demand for services grew rapidly in line with the development of the oil industry and associated sectors, indirectly increasing employment in other sectors.

Telecommunications

Telecommunications in Azerbaijan have generated a competitive environment with a decent level of competition. There were more than 70 enterprises competing in the telecommunications market, 80.3% of which were private (up from 73.7% in 2006). Currently, telecommunications companies can render more telecommunications services than consumers demand. Moreover, negotiations between the Ministry of Communications and Information Technology of Azerbaijan and several communications companies were underway in 2010. These will result in the country's first communications satellite, planned for early 2012.

According to the Ministry of Communications and Information Technology of Azerbaijan, the information and communication technology (ICT) development indicator of Azerbaijan has twice exceeded its world growth rate as a contribution to GDP (13.1% in Azerbaijan). At the end of 2009, the number of new connections in the mobile communications market in Azerbaijan was 1.1 million and 85.6% of the population had a mobile phone – above the world average of 25%. The implementation of the 3G system also became one of the events in the mobile communications market in 2009. However not every mobile communications company bought a licence to provide 3G. There are three mobile communications operators in the country under GSM (global system for mobile communications) standard, which are Azercell Telecom Ltd.,[10] Bakcell Ltd. and Azerfon Ltd., and two CDMA (code division multiple access) operators, Catel Ltd and Naxel Ltd. If it is true that only Azerfon provides 3G technology, there are no market restrictions and the sector is open for new investment for other operators to be equipped with the technology. By providing a wide area of wireless interactive connections (including telephone, Internet, video calls and TV), the 3G system could help promote a more dynamic and challenging business environment by further connecting the country to its main trading partners.

The telecommunications sector accounted for 2% of GDP in 2009. The value of communication services increased from AZN 154 million in 2000 to AZN 1.03 billion in 2010 and its average volume growth for the last five years reached 35%. Mobile services account for more than 60% of total revenues of the communications sector, the world average being around 30%. This can be characterised as an absence of commercial motivation of fixed operators (as well as mobile communications operators, to a certain extent) to build networks and render services in regions (in countryside and settlements with a low population density). The telecommunications market of Azerbaijan is stable following privatisation and structural reforms and the state continues to hold stocks in major Azerbaijani communications operators.[11]

The level of Internet penetration in Azerbaijan exceeded 40%, according to the ministry, with more than 30 Internet providers in Baku; competition is much lower, if at all, outside the capital. However, a European Bank for Reconstruction and Development factsheet (EBRD 2011) evaluates the penetration to be as low as 14%, while 70% of subscribers use dial-up connections. Internet tariffs have steadily decreased, by eight times since 2007, but remain among the highest in the region. There is room for more competition in this sector, as only two companies can supply backbone platforms to providers and a few companies can bring Internet to final consumers through fixed-line centres, which could result in an oligopoly if new companies do not enter the market. Moreover, Azerbaijan plans to fully shift to digital TV in 2012. There is also great potential in this area, as local cable TV companies will be able to provide Internet directly to the final consumer, bypassing fixed line centres.

Transport

Azerbaijan is located at the crossroads of main international traffic routes, such as the Silk Road and the North-South corridor. Therefore, transport plays a significant role for regional economic development and greater co-operation.

Road transport is the most important form of transportation in Azerbaijan. Others include railways, aviation, maritime and pipeline transport. In 2009, transport's share in GDP was 6.6%, while transportation of goods rose by 3.7%, compared to 2008. This indicator has risen 1.6 times from AZN 117 million in 2004 to AZN 190 million in 2009. In 2009, 49.7% of overall freight was carried by road and 32.7% by pipeline. The private sector accounts for 83.9% of the transport sector.

Azerbaijan has three major export pipelines, which are the BTC,[12] Baku-Novorossiysk and Baku-Supsa[13] pipelines. BTC is the most important route, with a capacity of 1 million barrels a day,[14] and began exporting Azeri Light oil in July 2006. In 2009, its capacity expanded to 1.2 million barrels per day by using drag-reducing agents. In 2009, 50.5 million tonnes of oil passed through oil pipelines. BTC accounted for 38.2 million tonnes in 2009 (of which 1.9 million tonnes are Kazakhstan's oil) and 124.7 million tonnes since its commencement to June 2010. The first volumes of oil from Kazakhstan arrived in BTC in late 2008. Later deliveries were suspended due to dissatisfaction over the tariffs for pumping. Russia and Azerbaijan agreed on transit of the Azerbaijani oil via the Baku-Novorossiysk pipeline in 1996, assuming 5 million tonnes of oil per year at a tariff of USD 15.67 per tonne, whereas tariffs for transportation of oil via BTC and Baku-Supsa vary from USD 3-4 (for AIOC shareholders) and from USD 2-4 respectively. Therefore volumes of Baku-Novorossiysk decreased substantially with the start of BTC from 4.5 million tons in 2006 to 1.3 million tonnes in 2008 (however it increased to 2.5 million tonnes in 2009).

A "Transport Sector Development Strategy for Azerbaijan" has been drafted by the Ministry of Transport, with the assistance of international consultants and the financial support of the Asian Development Bank (ADB). This strategy sets the agenda and the key priorities in transport policies and managerial structures for 2006-16. It aims at improvement of the country's transport sector performance, identification of strategic priorities and assessment of transport facilities as well as being a guide for the government's investments in the sector and the lending strategy for both domestic and international sources.

Banking and financial sector

Positive macroeconomic trends, such as the absence of large-scale bankruptcies and steady growth, outline the development of the banking system of Azerbaijan since 2005. From independence, the number of banks in Azerbaijan was considerably reduced owing to bankruptcies, mergers and licence withdrawals, which forced the remainder to strengthen by mergers and acquisitions. Thanks to this process, the Central Bank managed to increase equity requirements. Measures were also taken on restructuring and tightening minimum capital requirements and increasing the capital adequacy ratio. The total regulatory capital of banks increased 2.9 times between 2006 and 2009 to AZN 1 758.9 million. Assets tripled over the same period to AZN 11 665.2 million.

The growth of local banks was intensive, thanks to international borrowing and the growth opportunities before 2008. In 2009, bank assets grew by 13.5% (AZN 1.4 billion). While total assets decreased in the first half of the year due to the repayment of an external debt, the trend reversed in the second half. Moreover, in 2009, bank loans grew by 17.3% (AZN 1 214 billion), reaching AZN 8 230 billion at the end of the fiscal year.

To exploit its economic potential, Azerbaijan has been urging the financial sector to make credit more easily available, but financing is provided against collateral. Indeed, property rights do not allow clarity on collateral (both the banks' and the borrowers' rights are ill-defined). It is therefore difficult to collect credit information and to access credit. However, with the population's trust in banks beginning to increase, the lending sector's aversion trend is rapidly reversing.

The Azerbaijani banking system remains very attractive for neighbouring countries and the EU. There is, however, a dilemma because, although restricting access of foreign banks to the domestic market would protect domestic banks, it would also negatively affect the global competitiveness of Azerbaijani enterprises.

Azerbaijani banks are currently focusing on the domestic market, apart from the International Bank of Azerbaijan[15] (IBA) which has two subsidiary banks, in Russia and in Georgia, and also has representative offices in London, Frankfurt, Luxembourg, New York and Dubai.

Policy Implications

The economic development and business activity accompanying growth in the banking and financial system has increased demand in the domestic economy for credit. The banking system has, therefore, increased its credit volumes to AZN 8.2 billion in 2009 – from AZN 2.4 billion in 2006. The highest growth of credit activity was in private banks, where the share of loans in the total at the end of 2009 reached 51.4%.

In addition, the regulatory authorities have successfully implemented several policies and procedures towards strengthening the financial system of the country. Much attention nowadays is given to risk management with new rules established for lending. Since 2004 the Central Bank made Corporate Governance standards[16] obligatory, while considering the Basel 2 recommendations. Moreover, in February 2009, a new law was adopted on "Combating Money Laundering and the Financing of Terrorism". Finally, a Financial Monitoring Organ was established and due diligence procedures are now being discussed. Nevertheless there are still shortages in equity-capital, insufficiency of base deposits, poor credit culture, high probability of deterioration of assets and low operational efficiency. Moreover, many private banks are closely connected to industrial and trading groups. Such positions create serious risks in information and corporate governance and can affect estimations of risks. With 47 banks operating in the country, there is still a need for structural reforms, consolidation and a further reduction in the number of small and impractical banks. Additional problems include raising the level of financial intermediation, expanding the range of products, diversifying sources of incomes, raising efficiency and developing new tools and mechanisms for improving the quality of operational activity and risk-management.

A growth of micro lending in the banking sector is a recent qualitative tendency. Its basic advantages are high profitability, considerably smaller risk and larger coverage of the economy, both geographically and in the client base. Micro credit also has important macroeconomic value in supporting self-employment, particularly in rural areas.

MAIN MACROECONOMIC POLICIES

General overview

There is sufficient macroeconomic stability in Azerbaijan based on solid foreign reserves. These reserves had reached USD 22 billion by the first quarter of 2010, which in turn guaranteed the state budget durability and partially compensated for the reduction of any external sources of liquidity in the economy. As a whole, economic growth and employment have been protected from the global crisis, precisely due to these reserves.

Fiscal policy

The fiscal position of Azerbaijan has been strengthening since 2005, with budget revenues increasing by 30-40% on average annually, from AZN 1.2 billion in 2003 to AZN 10 billion in 2008 and 2009. These resources benefit from high oil revenues, but fall under pressure from lower prices with consequences for the macroeconomy. High inflation expectations also rose with the oil boom.

The government[17] supported the banks and the state companies by financing those with difficulty in repaying foreign debt obligations in 2009.

Taxation

There are two tax system regimes in the country, the statutory tax regime governed by the Tax Code and the Production Sharing Agreements (PSAs) concluded by the oil companies.

The tax ministry lacked the resources planned in 2009, as only AZN 4 113.5 million was collected that year (around 71.5% of total planned resources) – 27.8% less than in 2008 (for a total of AZN 5 695 million in 2008). Of the AZN 4 113.5 million collected in 2009, 30.9% (AZN 1 272.6 million) and 12.5% (AZN 513.2 million) came from SOCAR's and AIOC's profit taxes shares respectively. In 2010, taxes contributed to 41% of the budget and reached AZN 3 127.5 million, around AZN 19 million more than planned.

Table 2.7. Taxes (percentage revenues)

	2000	2009
On goods and services	46.3	59.8
On incomes, profits and capital gains	30.8	32.4
On international trade	8.9	4.2

Source: The Statistical Committee of Azerbaijan Republic.

Since 2008, all value-added tax (VAT) operations (off-sets) are held in a VAT depositary account, run by the State Treasury of Azerbaijan. Although centralised VAT prevents fraud and corruption, it delays money circulation and decreases circulating assets, which are major concerns of local SMEs. Indeed, previously, payments were circulated just between counterparts in only one payment, which was susceptible to concealment. Since 2008, all VAT payments are required to be wired to the opposite taxpayer's special tax ID account opened at the central treasury agency. Subsequent off-set settlements are held by this account. Thus each payment made by a buyer is paid with two payment orders which consist of basic payment for goods or services and VAT.

The main revenue – income tax (levied on the employee's income at progressive rates ranging from 0% to 30%) has been lowered from 35% to 30% (the maximum rate), along with the profit tax from 22% to 20% since January 2010. Nevertheless, direct tax rates are still high in Azerbaijan which is not necessarily attractive both for domestic and foreign investments in the non-oil sector. It also increases the incentives for firms to operate informally.

Budget

The persistence of the government on setting the price for oil at USD 70 a barrel in the state budget for 2009 had a significant negative impact. As prices for oil fell, the approved 2009 state deficit of AZN 178 million widened to AZN 241.1 million (0.7% of GDP). The approved 2009 budget revenues were issued at AZN 12 177 million, but its execution only cost AZN 10 325.9 million (84.8%), below the 2008 figure of AZN 436.8 million (4.1%). The State Oil Fund contribution reached 47.6% of total revenues. Expenses of the state budget of 2009 were approved at AZN 12 355 million.

Table 2.8. The 2010 budget

Budget deficit (% GDP)	3.9
GDP growth (%)	7.4
CPI growth (%)	3.0
Exports growth (%)	32.1
Imports growth (%)	25.0
Minimum subsistence level (AZN)	87.0
Social aid poverty criteria (AZN)	65.0
Minimum monthly wage (AZN)	85.0*
SOFAZ** growth (AZN billion)	11.4

Notes: *As of 1 September 2010; ** State Oil Fund of the Azerbaijan Republic.

Sources: EIU, IMF, State Statistical Committee.

In 2010, the government decided to end the tendency of increasing the state budget every year; the 2010 budget was even ratified below that of 2009. State budget revenues were expected to reach AZN 8.0 billion (USD 10.0 billion) and expenditures AZN 8.1 billion (USD 10.1 billion), a deficit of AZN 1 249 billion with an oil price set at USD 45 per barrel. However, according to international forecasts, the price of oil in 2010 was expected to reach USD 70 per barrel, thus solving Azerbaijan's deficit problem. The barrel finally reached USD 88 in December 2010. The budget was finally executed with revenues of AZN 7.5 billion and expenditures of AZN 6.8 billion, which resulted in a budget surplus. Out of this budget, 48% of income came from SOFAZ and 42% from taxes. 30% of all expenses was directed to construction and natural resources and 25% for social protection and education. Transport and communication only received 0.5% of the total budget, while housing barely reached 2%. The 2011 state budget has been drafted for revenues totalling AZN 12 billion and expenditures of AZN 11.6 billion.

The State Oil Fund of the Republic of Azerbaijan (SOFAZ)

SOFAZ was established in 1999 "to ensure inter-generational equality of benefit with regard to the country's oil wealth". The fund accumulates surpluses received from hydrocarbon sales. SOFAZ also works toward socio-economic progress and macroeconomic stability, shifting development to non-oil sectors. The creation of SOFAZ was also necessary to prevent the potentially negative impact of substantial currency inflows to the national economy that could have led to its appreciation and to the decline of domestic competitiveness. The assets of SOFAZ grew by 32.8% year on year (yoy), as of 1 January 2010, accounting for AZN 11.97 billion (USD 14.90 billion), compared to AZN 1.28 billion (USD 1.39 billion) in 2005.

Monetary policy

The government pursues a policy of stabilisation of the exchange rate, in the light of oil revenue growth. The Central Bank has been buying the surplus of foreign currency from the domestic market since 2005, as energy and transit revenues flow into the country, and this explains the growth of its reserves – part of those reserves were sold during the crisis to maintain the macroeconomic and financial stability.[18]

The main objective has been to peg the manat to the US dollar as the stability of the exchange rate is closely linked to the country's macroeconomic improvement; the main source of income being the international trading of oil in US dollars. Among the possible intermediate monetary indicators, the rate of the manat, even more than money supply or the refinancing rate, is the most controlled and predictable reference point for achieving the objectives of price stability and the positive functioning of the financial system. Inflows of money usually cause appreciation of the national currency by increasing currency reserves, thus complicating the inflation tightening. To prevent the strengthening of the manat, the Central Bank influenced the nominal exchange rate, which, in 2010, was equal to zero against other currencies.

Recent developments

The deterioration of the economic situation in 2008 was due to falling remittances and construction, blockage in the bank lending process and the collapse in exports, worsening the balance of payment indicators.

Table 2.9. Monetary effects of the crisis in 2007, 2008 and 2009

Year	2007	2008	2009
Current account balance (USD billion)	9.0	16.4	8.3
Current transfer balance (USD billion)	1.0	1.1	0.7
Consumer Price Index (%)	4.4	8.9	2.9
Total deposits (AZN billion)	1.66	1.94	1.92
Total deposits in foreign currency (AZN billion equivalent)	1.75	2.82	2.74
Exchange rate AZN/USD decrease (%)	-2.99	-5.24	0.26

Sources: The Central Bank of Azerbaijan Republic, the State Statistical Committee of Azerbaijan Republic, WEO 2010, EIU.

Inflation and prices

Maintaining price stability is the main priority of the Central Bank of Azerbaijan. Inflation has been increasing since 2004, mostly due to fiscal expansion that has supported domestic demand. Between 2004 and 2008, inflation averaged 12.8%, while it was as low as 2.1% on average between 2000 and 2003. In 2009, inflation fell dramatically to 1.5% as international commodity prices fell along with domestic and external demand. Exchange-rate policy also played a vital role. The IMF forecasts the possibility of inflation increasing to around 4% in 2010, as does the Central Bank projection, but the latter hopes to maintain inflation just one point below the IMF's projection, not excluding further amendments imposed by the effects of increased demand.

Table 2.10. Inflation rates
(percentage)

	2008	2009	2010*
CPI	20.8	1.5	5.5*
PPI	11.6	-19.3	31.4*
CI	22.1	1.6	1.9**

Notes: *from January to November; **from January to April.

Source: The State Statistical Committee of Azerbaijan.

Difficulties in predicting price rises in the economy relate to the unpredictability of the cost of commodities and foodstuffs in the world market. Azerbaijan has been warned by the international financial organisations that inability to constrain inflation could worsen the investment climate. Moreover, price rises pose risks to the welfare of the population and the national economy.

Monetary aggregates (M2, Reserves)

The Central Bank achieved neutralisation of the money supply by injecting liquidities into the economy through market operations in 2009 – AZN 3.7 billion on 1 May 2009 and AZN 5 billion on 1 January 2010, for example. The monetary base began a negative trend in Q1 2009, before returning to positive growth starting the second quarter. It was AZN 4.9 billion at the end of that year.

Net foreign assets of the Central Bank decreased by 16.7% yoy amounting to AZN 4.3 billion in 2009, down from the record level of AZN 5.2 billion yoy (16.2%), compared to an increase of 44.9% (from AZN 3.5 billion) in 2008. Net domestic assets accounted for AZN 650 million at the end of 2009. In 2009, M2 was AZN 6.2 billion, increasing by 1.5% (AZN 0.9 billion) yoy against a growth in 2008 to AZN 1.7 billion (38.2%). In 2009, the money reserves of the Central Bank dropped by 15.7% (USD 961.4 million) compared to a 52.8% growth in 2008 (USD 2.1 billion). They increased by 19.6% (USD 1.17 billion) in 2010. Total reserves of the Central Bank amounted to USD 5.96 billion as at November 2010.

Exchange rate

In early 2008 the Central Bank began implementing a two-currency basket regime (the US dollar and the euro), which is regularly revised. The basket proportion in 2010 was 90% USD to 10% EUR, while initially it was set at 70% to 30% respectively.

The rate of the AZN against the USD throughout 2009 was reduced by only 0.26%. The country's currency market was subject to pressure in the international markets, an increase in service charges of external obligations of the banking system and psychological waves of consecutive devaluations in the neighbouring countries (Central Bank of Azerbaijan Republic, 2009). However, these factors were neutralised by the active intervention of the Central Bank and a stable rate of national currency was maintained. The peak pressure of the market came in January-March 2009. As a result, sales of currency by the Central Bank in the foreign exchange market reached USD 1.26 billion, 1 billion of which was sold in the first quarter of 2009. During 2009, activity in the domestic exchange market remained at a high level and the volume of operations in the market reached USD 31.8 billion.

The containment of the exchange rate AZN/USD in 2009 by the government helped to prevent an excessive rise in imported goods prices, depreciation of deposits, increased foreign borrowings and high dollarisation.

The surplus of the balance of payments was also a key factor in maintaining the stability of the AZN. Therefore, as long as the Central Bank can secure the surplus of the balance of payments, the manat's stability will be assured.

On 10 January 2010, the Central Bank moved to a bilateral exchange rate (AZN/USD) and abandoned the use of a dual currency basket (USD/EUR) to determine the manat rate, as it aims to expand exports and economic growth.

External sector

The government of the Republic of Azerbaijan has been negotiating to join the World Trade Organization (WTO) since 1997. There are still legislations which diverge from WTO regulations and therefore require adaptation. A legislative programme to make the necessary amendments required by the WTO principles has been established.

Main figures

The foreign trade balance dropped by a factor of 1.6 between 2008 and 2009, from USD 23 billion to USD 14.6 billion. Exports dropped from USD 30.6 billion to USD 21.1 billion (1.45 times), while imports fell from USD 7.6 billion to USD 6.5 billion (1.16 times) over the same period. Azerbaijan's main trade partners in 2009 were Italy (20%), United States (11%), France (7%), Israel (7%), Turkey (6%) and Russia (6%).

Exports

Crude oil accounts for USD 17.9 billion of the total USD 19.1 billion of oil product exports. AIOC's share in crude oil exports made up USD 17.1 billion. The country's non-oil-gas exports accounted for USD 1 127.3 million in 2009. Azerbaijan's goods export structure shows a clear specialisation in oil and oil-related products (more than 90% of total exports in goods) in which it has a RCA (relative competitive advantage), very different from the other South Caucasus countries and Ukraine (conformity index close to 0).

Table 2.11. Share of main exports of goods by category in total exports, 2009

Classification	Exports (USD thousand)	Share (%)
Total	**14 698 496.5**	**100**
Of which:		
Live animals	665.8	0
Vegetables and plant materials	226 126.2	1.5
Animal and vegetable fats and oils and related products	128 867.5	0.9
Food products, beverages, spirits and vinegar, tobacco	170 431.2	1.2
Mineral products	13 644 201.8	92.8
Products of chemical industry	33 682.2	0.2
Plastic, rubber and articles thereof	60 783.2	0.4
Rawhides and leather articles	7 838.6	0.1
Wood and wood articles	942.6	0
Paper and paperboard	2 476.3	0
Textiles	45 448.0	0.3
Footwear, headwear	159.2	0
Articles of stone, cement and ceramic	1 191.4	0
Pearls, precious stones, precious metals	24 949.5	0.2
Miscellaneous articles of base metal	121 198.9	0.8
Machinery, electrical technological equipment	29 599.5	0.2
Vehicles other than railway or tramway rolling stock, ships and air-transport facilities	171 387.7	1.2
Musical instruments, medical and other equipment	5 292.4	0
Miscellaneous manufactured articles	6 745.1	0
Works of art, collection pieces and antiques	445.3	0

Source: The State Statistical Committee of Azerbaijan Republic.

Imports

Imports of consumer goods accounted for USD 2.6 billion with USD 826.7 million as the share of foodstuffs. Machinery-equipment accounts for 11.9% (USD 773.3 million) and is partly a result of foreign investments. Intermediate products, such as machinery, chemicals, ferrous and non-ferrous metals, were imported for further manufacture, and were worth USD 3.2 billion.

Table 2.12. Share of main imports by category in total imports, 2009

Classification	Imports (USD thousand)	Share (%)
Total	**6 119 724.7**	**100**
Of which:		
Live animals	65 725.0	1.1
Vegetables and plant materials	313 819.2	5.1
Animal and vegetable fats and oils and related products	72 446.6	1.2
Food products, beverages, spirits and vinegar, tobacco	519 606.2	8.5
Mineral products	171 947.9	2.8
Products of chemical industry	401 747.8	6.6
Plastic, rubber and articles thereof	169 624.6	2.8
Rawhides and leather articles	3 070.4	0.1
Wood and articles of wood	86 503.1	1.4
Paper and paperboard	128 862.1	2.1
Textiles	53 180.1	0.9
Footwear, headwear	8 095.3	0.1
Articles of stone, cement and ceramic	156 357.6	2.6
Pearls, precious stones, precious metals	21 132.1	0.3
Miscellaneous articles of base metal	663 282.6	10.8
Machinery, electrical technological equipment	2 128 996.5	34.8
Vehicles other than railway or tramway rolling stock, ships and air-transport facilities	780 801.6	12.8
Musical instruments, medical and other equipment	213 439.4	3.5
Miscellaneous manufactured articles	68 493.5	1.1
Works of art, collection pieces and antiques	11 998.5	0.2

Source: The State Statistical Committee.

Balance of payments

Overall, the balance of payments surplus increased by 4.2 times, from USD 2.9 billion (8.8% of GDP) in 2007 to USD 12 billion (24.7% of GDP) in 2008, driven mainly by the current account surplus of USD 16.5 billion. In 2008, crude oil exports increased by 2 million tonnes at average prices per barrel rising from USD 72.9 to USD 96.5, resulting in crude oil export gains of USD 26.3 billion (an increase of 1.4% yoy), while total oil commodities exports accounted for USD 29.1 billion. AIOC's share in total crude oil exports was worth USD 24.2 billion with USD 14.7 billion and USD 9.5 billion for Azerbaijan's share and to Contract of the Century's foreign participants respectively. The foreign trade balance increased by 1.5 times in 2008, amounting to USD 23 billion. Oil and oil-related goods' share in total exports was 93.1% in 2008. Non-oil exports accounted for USD 1.4 billion (33.7% increase over 2007) driven by chemical goods and ferrous and non-ferrous goods. The capital and financial account, which had a negative balance of USD 3.6 billion in 2008, was, however, covered by the current account, which doubled in 2009 to USD 6.1 billion before decreasing by a third in

Q1-Q3 2010, to USD 2.6 billion. The positive balance in the oil-gas sector provided the foreign currency demands of the economy and increased reserves inflows to USD 8.3 billion in Q1-Q3 2010.

Consumer goods imports increased by 19.1% between 2007 and 2008 amounting to USD 3 billion, with a 34.5% increase for food products.

Table 2.13. **Balance of payments**
(USD million)

Balance of payments	2006	2007	2008	2009	Q1-Q3 2010
Current account	3 708	9 019	16 454	10 173	11 977
Goods and services (balance)	5 822	13 093	20 669	12 970	14 266
Goods (balance)	7 745	15 224	23 012	14 583	15 418
Services (balance)	-1 923	-2 131	-2 343	-1 613	-1 152
Income (balance)	-2 681	-5 079	-5 266	-3 519	-2 685
Current transfers (balance)	566	1 005	1 050	722	397
Capital and financial account	-1 735	-5 760	-3 558	-6 019	-2 618
Capital account	-4	-3	11	9	-
Financial account	-1 732	-5 757	-3 569	-6 028	-
Direct investment	-1 306	-5 103	-545	146	326
Portfolio investment	-12	-26	-347	-139	2 944*
Other investment	-430	-696	-2 680	-6 036	-
Reserves assets	-1 716	-2 898	-12 050	-2 691	-8 305
Net errors and omissions	-256	-361	-846	-1 463	-1 054

Note: *including portfolio and other investment.

Source: The Central Bank of Azerbaijan Republic.

The non-oil sector deficit of USD 4.7 billion was covered by a USD 19.3 billion surplus in the oil-gas sector. The current account surplus almost tripled from USD 3.7 billion to USD 10.2 billion in three years, between 2006 and 2009, and totalled USD 11.9 billion in Q1-Q3 2010.

Total services increased from USD 3.3 billion in 2005 to USD 5.2 billion in 2009, with negative balance averaging USD 2 billion over the same period. However, this negative balance's correlation to GDP decreased from 15.7% to 4.6% between 2005 and 2009, thanks to the growth of nominal GDP. The negative balance of services has been related to activities in the country's oil and gas sectors. The lion's share in services belongs to construction and transport. Construction is related to international agreements in the oil and gas sector, while transport largely reflects transit cargo transportation between Central Asia and Europe within the network of TRACECA (Transport Corridor Europe-Caucasus-Asia). The share of transport in total services averaged 26% between 2005 and 2009 increasing from USD 0.4 billion to USD 0.8 billion and from USD 0.2 billion to USD 0.7 billion, respectively. Tourism receipts accounted for USD 0.35 billion in 2009 increasing 4.5 times over USD 0.08 billion in 2005. Business-trip receipts accounted for 44% of total receipts in 2009. Services provided to Azerbaijani tourists also grew from USD 0.16 million in 2005 to USD 0.38 billion in 2009.

Table 2.14. Main services
BoP data (USD thousand)

	2008			2009			H1 2010		
	Inflow	Outflow	Balance	Inflow	Outflow	Balance	Inflow	Outflow	Balance
Balances on services	1 546 904	3 889 464	-2 342 560	1 776 287	3 388 930	-1 612 643	918 417	1 694 239	-775 822
Transport	793 929	682 511	111 418	662 060	801 436	-139 376	293 336	375 809	-82 473
Tourism	190 247	341 103	-150 856	352 805	380 114	-27 309	242 974	310 927	-67 953
Communication	46 929	27 986	18 943	71 971	46 451	25 520	33 623	27 452	6 171
Construction	109 104	1 440 757	-1 331 653	174 289	773 739	-599 450	95 306	187 962	-92 656
Financial	117	12 511	-12 394	286	15 384	-15 098	231	3 506	-3 275
Governmental	92 898	63 358	29 540	80 470	60 764	19 706	42137	29 287	12 850
Other services	313 680	1 321 238	-1 007 558	434 406	1 311 042	-876 636	210 810	759 296	-548 486

Source: The Central Bank of Azerbaijan Republic.

MILLENNIUM DEVELOPMENT GOALS

In 2000, Azerbaijan agreed to the MDGs to achieve poverty reduction and promote human development. Initial discussion of country goals and approach had taken place in the principal policy document, the Azerbaijan Poverty Reduction Strategy Paper and the State Programme on Poverty Reduction and Economic Development 2003-05 (SPPRED). The SPPRED, on the development of the principal strategic directions and goals over 2003-05, liberalised the investment environment and stimulated large inflows. The subsequent State Program on Poverty Reduction and Sustainable Development 2008-15 (SPPRSD) has been closely aligned with the MDGs and strategically aimed at enhancing the quality of and ensuring equal access to basic health and education services.

The Azerbaijan National Coalition on Global Call to Action against Poverty expects Azerbaijan to achieve most of the MDGs in 2015, as the country benefits from growth of its economic potential, but also from speeding up existing reforms in education, health and other fields.

The country's development has been slowed by the unresolved issue of the Nagorno-Karabakh region, which has led to around 700 000 internally displaced people in Azerbaijan and some 300 000 refugees. On the other hand, in order to improve the social environment, and with the assistance of the International Development Association (IDA), the government has established a poverty-reduction strategy as well as an implementation of significant reforms in social sectors and infrastructure.

Basic indicators

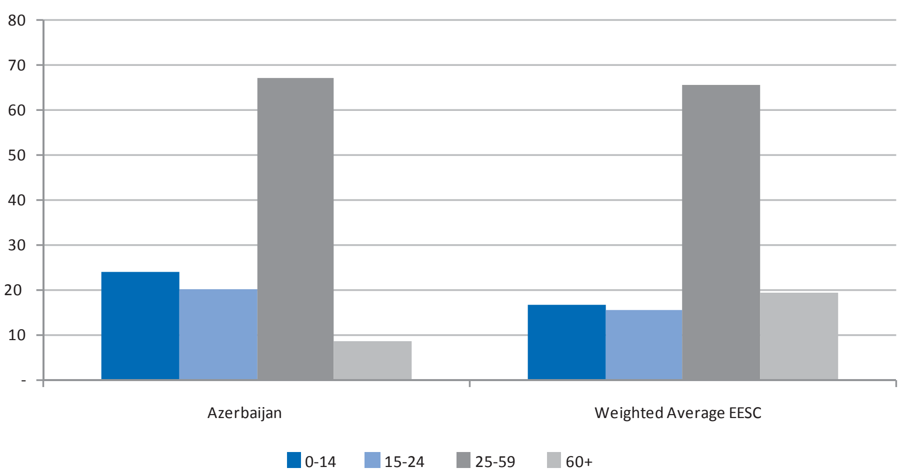
As of January 2010, the population was 9 million; an increase of 1.05 million people compared to 1999. Some 54% of the population lives in urban zones and the remainder in rural areas. The birth rate has decreased, compared to Soviet times. According to the State Statistical Committee of the Republic of Azerbaijan, the number of abortions increased from 20 867 in 2006 to 25 256 in 2008.[19] The State Statistical Committee stated that between 2003 and 2006 the birth rate in Azerbaijan rose by 31%, while according to a 2006 UNICEF[20] survey, the fertility rate of 20-24 year olds decreased by 23.36%, to 1.64 children per woman from 2.14, over the same period. Another important figure is the fertility rate of 25-29 year olds which collapsed by 45% (to 1.08 children per woman in 2006 compared to 1.97 in 2003).

Table 2.15. Age-Population distribution comparison

Age category	0-14	15-24	25-59	60+
Percentage of total population (in 2010)	23.9	20.2	67.4	8.7

Source: WB WDI, 2010.

Figure 2.7. Age-population distribution comparison



Source: World Bank 2009a.

The share of youth in Azerbaijan, both in the 0-14 and the 15-24 age ranges, is higher than the average of the EESC countries – the opposite being also true for the 60+ range – indicating the preponderance of this age group in the country. Moreover, the median age in Azerbaijan was 28.2 years old in 2009, against an average of 33.5 in the EESC countries.

According to the State Statistical Committee, life expectancy rose from 71.8 in 2000 to 73.5 in 2009. Females' life expectancy was 76.1 years, while males' was 70.9. However, according to the CIA, life expectancy of the total population of the country is only 66.7.

There were some amendments and additions in late 2009 to the Law "About labour pensions", which are worth mentioning. According to the former legislative base, men who have reached 62 years, and women 57, both having at least 12 years of work experience, could retire. According to the amendments to the Law, the pension age will increase by six months every year, from January 2010 until January 2016, to reach 63 and 60 respectively for men and women.

Goal 1: Reduce poverty

Target: Achieve full and productive employment and decent work for all

According to the International Labour Organization (ILO), the total of unemployed[21] people decreased by 143 300, from 404 700 in 2003 to 261 400 in 2008, while the total active population increased by 516 000, from 3 801 400 (46% of the total population) to 4 317 400 (49.5%) over the same period. Youth unemployment, covering 15-24 year olds, also decreased by 72 500, from 165 600 to 93 100 between 2003 and 2008. According to the World Bank, there was a small contraction of the labour force between 2000 and 2008. The country also hosted about 15 000 immigrants employed primarily in the construction sector until the crisis. On the other hand, remittances increased ten-fold between 2000 and 2008, reaching approximately USD 1.2 billion.

Table 2.16. Employment evolution
(percentage)

	2006	2009
Unemployment	6.8	6.0
Youth employment*	40.7	34.5

Note: *15-24 years old.

Sources: The State Statistical Committee of Azerbaijan Republic (Similar figures provided by the ILO).

Target: Eradicate extreme poverty and hunger

Objectives: Reduce by 2015 the proportion of people whose per capita monthly consumption expenditure is below the country's absolute poverty line, and the proportion of people in extreme poverty. Halve the share of the population below the relative poverty line of the country.

There is a disconcerting lack of data concerning poverty indices in Azerbaijan; missing data are compounded by outdated material. Any analysis, therefore, including our own, must be treated with caution. Following the government's economic development programme, poverty is on a downward trend.

The lowest 10% and the highest 10% of the population hold, respectively, about 6% and 18% of total revenues in Azerbaijan.

Table 2.17. Poverty indicators

	2001	2005
Poverty gap at USD 2 a day PPP (%)	6.8	0.5
Poverty headcount ratio at USD 2 a day PPP (% population)	27.1	2

Source: WDI 2010.

The poverty level decreased from 49% to 11.2% between 2001 and 2009. According to the World Bank,[22] some 2.5 million people in Azerbaijan have moved out of poverty in recent years. Overall, the poverty rate has dropped by 3% annually between 2001 and 2008. Thanks to the rapid economic growth and social assistance programme launched in 2006, some good results have been obtained, even compared to developed countries. Azerbaijan has a better chance to achieve this MDG by 2015 than most other CIS countries by distributing oil revenues more equitably, developing the non-oil sector prudently and improving the investment and business environment.

Poverty is higher in rural areas (51.2% of the poor) than in the towns (48.8%).[23] About 30-35% of the rural population live below the poverty line and about 10% of these live in extreme poverty. Rural communities have major problems in education, health and utilities. The government's social aid programme has been in place since mid-2006 and targets the poorest of the population whose monthly income is below AZN 65 (USD 80.9). The government estimates that the number of families receiving this help should reach 150 000, with the poverty line set at AZN 110 (USD 137). AZN 210 million (USD 261.5 million) was allocated in the state budget for the purposes of this social assistance.

Poverty overall, particularly in the capital, would appear to be rapidly decreasing. One reason for this has been the six-fold increase in wages and labour fees since 2001 and the increase in volume of incomes transferred to the poor – in 2004, 20% of the poor households benefited from a 35% increase in government aid. Pensions also increased by 44%, while households have largely benefited from transfers from their relatives working abroad.

However, according to a study published by the Economic Research Center (ERC, 2010), an Azerbaijani non-profit research centre, official data on poverty understate the problem and the real figures are higher than those announced. Indeed, the ERC shows that the cost of the minimum consumption basket is AZN 119, higher by 41% than the official basket of AZN 84.

Goal 2: Achieve near-to-universal secondary education

Target: Complete full primary education

One of the greatest legacies that Azerbaijan inherited from the Soviet era is a strong educational system. Enrolment rates in basic education are close to 100%, although the poor have higher dropout rates. There are 4 533 government-supported schools and 17 private schools. The number of state institutions of higher education was increased to 34 in 2009 from 29 in 2000, while private institutions decreased from 18 to 14 over the same period. General education schools cover 11 years of compulsory education where almost all fees are covered by the government.

Education has been kept under state control, receiving around 3% of GDP, of which approximately 85% goes to wages. Thus, only 15% of funds are directed to equipment and technology purchases.

The problems of this sector lie in the quality of education in the context of a need for skills and knowledge to overcome the skill gap accentuated by globalisation. More attention needs to be given to the improvement of the quality of education and its outcomes in order to achieve this MDG.

According to official statistics, however, only 108 000 pupils received high school diplomas in 2009, compared to 173 000 in 1998. Besides, 23 000 school-leavers failed to graduate. Thus only 60% of school students finish general school. In general, one out of ten school-leavers is able to go to university on the basis of educational attainment.

According to a World Bank report, there are low enrolment rates in higher education and serious inequalities in pre-school and tertiary education (World Bank, 2010c). Inadequate levels of education substantially restrain the development of the country. A major problem is the poor condition of education infrastructures and the quality of the personnel. There is also a problem of incentives, since education does not seem to provide significant economic advantages. Only 17% of the population opts for higher education, compared to 50% in developed countries.

Table 2.18. Main education data

	2000	2009
Number of children in pre-school institutions	111 020	103 617
Number of pupils in general schools	1 653 703	1 428 859
Of which: female (%)	48	47
Number of teachers in general schools	161 492	174 378
Of which: female (%)	69	73
Number of pupils in vocational schools and vocational lyceums	22 944	25 184
Of which: female (%)	37	30
Number of students admitted to secondary education	14 823	15 681
Number of students in specialised secondary educational institutions	42 612	52 759
Of which: female (%)	69	69
Number of students of specialised secondary educational institutions per 10 000	55	63
Number of graduates of specialised secondary educational institutions per 10 000	15	21
Number of students in higher educational institutions	119 683	136 587
Of which: female (%)	15	46
Number of students in higher educational institutions per 10 000 people	154	162
Number of graduates of higher educational institutions	24 488	32 580
Number of graduates of higher education per 10 000 people	32	39

Source: The Statistical Committee of Azerbaijan Republic.

Goal 3: Ensure gender equality

Gender norms have changed since the end of the Soviet regime. Formerly, both women and men achieved high levels of education and had broad work experience in the Azerbaijan economy and government. However, today women are more likely to be under-employed or unemployed than men and to receive lower relative wages. Women engage in informal work such as part-time, temporary or home-based jobs in order to take care of their families. Women also lag far behind in business ownership, except at the micro level. Women are mostly to be found in lower and line management, except in female-dominated, lower-paid sectors such as education, health care and natural sciences, and in agriculture where the average monthly salary is lower than the national average.

Women make up 51% of the population. Their poverty level is higher and half of them live below the poverty line. Of the officially registered total number of unemployed persons, 47% were women in 2008. Few women are represented in the highest levels of power. The main reasons for this are lack of interest, time and understanding of what leadership means, as well as a cultural issue, as women are convinced that a leader has to be a man. As a result, only 11.2% of parliamentarian seats are held by women in Azerbaijan.

There is no significant gender difference in enrolment rates at the primary level, but disparities at the secondary level, especially in rural areas, are a concern. There is a need to encourage more women into tertiary education and expand their choices in educational specialisation. However, the labour market needs to provide women with opportunities to use their skills.

The State Committee on Women's Issues was established in 1998, and gender issues have been shown to be a part of the democratisation of the country. Hence, it has become a priority to involve larger numbers of women in the decision-making process. Success in achieving this goal requires a long-term strategy on changing public opinion and overcoming traditional stereotypes by focusing on educational programmes. On the legal level, the government adopted the Law on Gender Equality in 2006 and in 2000 the President issued a Decree on the State Women's Policy in the Republic of Azerbaijan.

Health issues

Main indicators

Azerbaijan has yet to achieve significant improvement in maternal medical care. The years 2008-13 are decisive in achieving this goal. According to the SPPRSD, Azerbaijan should decrease under-1 and maternal mortality rates to the average of the European countries. Funds allocated from the state budget for health were increased by more than 9.8 times between 2000 and 2009, but this is still less than 1% of total GDP. Health spending per capita was USD 56 in 2009, far from the USD 150 recommended by the World Health Organization (WHO).

Table 2.19. Major causes of death

Category (per 100 000)	2000			2005			2008		
	Total	Urban	Rural	Total	Urban	Rural	Total	Urban	Rural
Total deaths by major cause	589.0	583.3	595.0	628.2	641.2	614.3	615.8	627.4	603.9
Diseases of the circulatory system	330.5	354.7	305.4	355.3	374.9	334.5	363.6	371.0	355.7
Disease of the respiratory system	53.1	28.4	78.6	37.1	23.9	51.2	33.3	22.9	44.5
Neoplasm	64.1	66.1	62.0	77.2	84.1	69.7	76.1	84.3	67.3
Injuries, poisoning, external reasons	26.4	30.0	22.8	32.6	37.1	27.8	28.6	31.1	25.9

Source: The Statistical Committee of Azerbaijan Republic.

Goals 4 and 5: Reduce maternal mortality and mortality rate under-5 by 17% each

According to UNICEF, under-5 mortality in Azerbaijan in 2007 was 39 per 100 000, ranking 77th among 194 countries. This mortality mainly occurs due to poor access to medical care, poorly qualified and motivated doctors, women's non-attendance at maternity welfare centres, incompetent and untimely medical care and home-based birth. According to the State Statistical Committee, the maternal death rate fell from 37.6 (per 100 000 live births) in 2000 to 24.3 in 2009, with the lowest rate of 18.5 in 2003 and the highest of 35.5 in 2007, revealing high volatility. There is some inconsistency between UNICEF and official figures as for 2007 the latter estimated 12 child deaths out of 100 000 births, while the former recorded 34.The figures for 2006 show that infant and under-five mortality rates have been reduced to half since 2001, but this is still considerably higher than in the developed countries. The major causes of child death in Azerbaijan are respiratory diseases and diarrhoea.

Infant mortality also increased in 2005, 2006 and 2007, to 1 580 per 100 000 live births (12.7%), 1 882 (11.9%) and 1 756 (12.1%) respectively. Although there have been some reforms, a strategy reducing child and maternal mortality rates has not been established. Moreover, declining marriage, low use of contraception, extra-marital birth and the spread of abortion will add to the problems in achieving this goal.

Goal 6: Combat HIV/AIDS, malaria and other diseases

Target: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS

Azerbaijan is a country with a low level of HIV (below 0.2%). Only 2 264 people were officially registered as HIV-positive in 2009. However there is a growth trend (in 2000 there were 64 infected people), particularly among high-risk groups, with a threat of rapid increase. Furthermore, this number may well be higher than the official data suggest. The overwhelming majority of the infected persons are men (around 85%) but growth in the number of HIV-infected women is also preoccupying. One-third of all HIV-infected patients are returning emigrants to Ukraine or Russia where the AIDS epidemic is expanding.

The law "About prevention of spreading of AIDS" was adopted in 1996 but does not meet requirements. A new law was being drafted by the parliament in 2010 and will cover issues such as international best practices, preventive measures, diagnostics, treatment and inspection, as well as the rights of HIV-infected people.

Tuberculosis

Tuberculosis is still a serious disease in Azerbaijan. The situation has become even more complicated with the arrival of multidrug-resistant forms of the disease. In 2001, there were 4 847 patients in the country and 5 130 in 2008 with a decreasing trend (in 2007, 6 530 persons were treated for tuberculosis in Azerbaijan). The 20-40 age group accounts for approximately 80% of the total patients and the situation is particularly bad in prisons. The level of awareness of the population about tuberculosis is very low.

Since 1995, the government has carried out programmes with the help of international organisations to fight tuberculosis. There have been improvements in health services, obtaining modern medical equipment and in statistical data, but rates of detection and treatment remain below the international standards. Complicating the picture are more than 1 million refugees and internally displaced persons (IDPs) and, though their living standards have been improving year by year, their health situation is still dire.

Main health reforms

Legislative attention to health matters became a priority from 1998, with the formation of the State Commission on Reforms in the field of public health services. A National plan on fighting diseases, such as AIDS and tuberculosis, was developed. As a result, in 1998, the WHO recommended a three-fold increase of aid to Azerbaijan. This is unusual since little, if any, external financing is usually for public health, which is generally financed by internal funds. Indeed, external resources as a percentage of total expenditure on health decreased from 3.9% (AZN 184 million) in 2000 to 0.7% (AZN 275 million) in 2008.

In 2003 the sum allocated by the government to health services increased from AZN 55.3 million to AZN 400 million in 2009. It is planned to increase this figure to AZN 600 million by 2013. Since 2008, medical institutions financed by the state have rendered free medical services to the population. In 2009, more than 60 medical institutions of vital importance in the country were constructed or completely overhauled.

Table 2.20. Main health expenditure

2008	Azerbaijan	OECD
Private health expenditure (in % GDP)	3.8*	3.0
Public health expenditure (in % GDP)	1.2	1.1
Out of pocket expenditure (% private expenditure)	80.4	86.4
Health spending per capita (USD)	56	102**

Notes: *2002, **2006

Source: WDI 2009.

There is little private-sector activity in health services and the majority are provided by the state. Medical institutions are divided between the Ministry of Health and local authorities. Private clinics, mostly located in the capital, are keen to reach western standards on the quality of services, but these are limited to small clinics. They are short of medical supplies and not many of them have advanced equipment. Since independence, almost all the pharmaceutical sector has been privatised, but it is still regulated by the Ministry of Health. The majority of chemists are private enterprises, with only a small number remaining under state ownership. The manufacture of medicines has also passed into private hands. Unfortunately, there are no updated data to assess the proportion of the population with access to private hospitals.

Goal 7: Ensure environmental sustainability

Target: Halve, by 2015, the proportion of people without sustainable access to safe drinking water

The introduction of new technologies has improved the environmental situation in the Caspian Sea to some extent – but many problems remain, particularly associated with old oil fields in the Absheron peninsula. Water supply and water quality are also of major concern, threatening both urban and rural communities. The river Kura, which is the main source of water for three-quarters of the population, is soiled by the population and by the industrial facilities of Armenia and Georgia, as well as Azerbaijan. Co-operation between the three countries regarding water-resource sharing has become an important issue.

According to recent analyses by the United Nations Country Team (UNCT) only half the population have drinking water directly piped into their houses, with a huge difference between urban and rural households (78% against 19%, respectively). However, almost all urban households (91%) and slightly more than half of rural households (55%) have access to clean drinking water outside their homes. A total of 78% of all households use improved sanitation facilities.

Target: Reduce pollution

Objective: Integrate the principles of sustainable development into country policies and programmes and reverse the loss of environmental resources.

Domestic waste and the absence of adequate transportation and disposal systems have negatively affected health and general living conditions, with intensive land use and the growth of slums on the outskirts of the capital.

By 2010, the quantity of greenhouse gas emissions in Azerbaijan considerably decreased, compared to 1990, since many sources of pollution (mostly enterprises) have stopped working following the collapse of the USSR. However, air pollution is expected to increase significantly with the recovery of the heavy industry in the Baku-Sumgayit area. Around 70 million tonnes of carbon was emitted in 1990 against 46 million tonnes in 2005. However, transport's contribution of air pollutants also increased from 43% in 2000 to 70% in 2009, which is related to the more than doubling of the number of automobiles over the same period. Its share is especially high in the capital.

Yet, Azerbaijan has joined the Kyoto protocol and has therefore been preparing the national strategy for fighting global warming. The government is working on the development of alternative energy sources. Solar energy in Azerbaijan, which has more than 250 days of sunshine per year, is also promising. The year 2010 was proclaimed as the Year of Ecology in Azerbaijan.

Table 2.21. Environmental data
(thousand tonnes)

Emission of air pollutants from mobile sources by ingredients		
	2000	**2009**
Carbon oxides	148.2	496.3
Nitrogen oxides	31.3	58.6
Hydrocarbons	56.4	95.5
Specific pollutants	156.8	46.7
Total	392.7	697.1
In Baku (%)	58.5	68.0
Air pollutant emissions from stationary sources by ingredients		
Gaseous and liquid matters	496.2	280.2
sulfuric anhydride (SO2)	35.1	4.3
carbon oxides (CO)	26.3	27.6
nitrogen oxides (NO_2)	24.2	24.2
Total	515.4	300.0

Source: The Statistical Committee of Azerbaijan Republic.

PRIVATE SECTOR DEVELOPMENT

The impact of the financial crisis on Azerbaijan was less severe than in other countries of Eastern Europe and the South Caucasus (EESC). High GDP growth (9.3%) in 2009 (IMF, 2010) was directly linked to the contribution of the oil sector, thanks to increasing oil exports and higher global oil prices. According to IMF forecasts, GDP growth in 2010 and 2011 is expected to slow down to 2.7% and 0.6% respectively. For a return to former growth rates, Azerbaijan will need to enhance the competitiveness of its economy which calls for policies that stimulate private-sector development and foster diversification, especially outside the energy sector.

The private sector is a source of knowledge, skills and resources, and a key engine of growth for industrial development. In this context, the role played by micro, small and medium-sized enterprises (SMEs), which, on average, account for over 90% of enterprises in the world and contribute to 50%-60% of employment in developing countries, is particularly important (WBSCD, 2007). Efforts to foster private sector growth could focus on improving the business environment for SMEs by providing a regulatory framework conducive to entrepreneurship through better policy design including improving business regulation, strengthening the education system and providing access to finance for SMEs that would encourage the entry of new firms as well as increase the share of employment and contribution to GDP in the private sector.

The methodology applied in this section is based on the OECD Policies for Competitiveness Framework (PFC) which has been developed as an assessment tool based on the Policy Framework for Investment (PFI) instrument. This tool follows a horizontal approach, looking systematically at key policy dimensions affecting the business climate to identify and analyse key constraints in the ability of firms to produce, invest and grow. Apart from giving a general introduction to the business environment, three key dimensions are featured in this section covering skills development, access to finance and investment framework conditions affecting SME growth.

General overview

During eight years of small- and large-scale privatisation, 30 000 small enterprises were transferred into private ownership and 1 500 medium and large enterprises were transformed into joint-stock companies. Nevertheless, the presence of monopolies in various sectors of the economy continues to create barriers to entry and obstructs the creation of a level playing field within the private sector. In Azerbaijan, the private sector accounts for 75% of GDP (EBRD, 2010) and is dominated by small enterprises (6.8%) and individual entrepreneurs (92.6%). These figures do not take into account the large informal economy estimated at 52% of GDP (Schneider, 2010), one of the highest in the EESC region. It should be noted, however, that official figures for informality are much lower.

In 2009, Azerbaijan was one of the top reformers in simplifying business regulations according to the World Bank's *Doing Business* report (World Bank 2009b). The country made significant progress in improving the overall business environment for entrepreneurial activities, including start-up costs and time to start a business. Nevertheless, the SME sector in Azerbaijan is still highly dependent on the prosperous oil industry which, together with other sectors related to extractive industries, accounted for 67.1% of GDP in 2008. Moreover, the services sector (catering, hotels and wholesale trade) is thriving as a result of oil-sector spillovers, and hence is not sustainable in the long term. The government should work towards diversification of the economy and decrease the country's dependence on the oil sector, not least since oil production is expected to start slowing down in 2015 (Rabobank, 2009).

Specific challenges to competitiveness and private-sector development include the need to upgrade the education system as the lack of an adequate labour force is one of the key constraints to business growth. More emphasis needs to be put on the development of vocational education as well as continuing education and training on the job to ensure that labour-market needs are met. In 2007, Azerbaijan spent 1.7% of GDP (World Bank 2010a) on education which is less than in any other EESC country. Low levels of spending can have a negative impact on the quality of education through the loss of qualified teaching staff.

Access to finance remains another key hurdle, especially for SMEs operating in non-oil sectors. In 2009, domestic credit to the private sector reached only 24.3% of GDP (EBRD, 2010), among the lowest values in the region. The largest share of credit is concentrated in the energy sector or related areas while the rest of the economy remains underfinanced. Moreover, the large exporting energy industry leads to a strong national currency which makes other sectors of the economy less competitive in external markets.

FDI inflows are mainly concentrated in the energy, transportation and communication sectors. A comprehensive investment promotion strategy should thus focus on diversification of inflows of foreign direct investment to support the development of productive industries in other parts of the economy. To better attract foreign investors, Azerbaijan will have to further liberalise its investment policy framework and ensure higher transparency in registration and licensing procedures.

The increasing role of the private sector

Currently, the private sector represents 75% (EBRD, 2010) of GDP and employs about 63.6% which is lower than in most countries of the region. In 2007, only 4 945 new micro, small and medium enterprises registered a new business, fewer than in 2005, and at a lower rate (7.13%) compared to the business entry rate of the Europe and Central Asia (ECA) region (10.10%) (State Statistical Committee of the Republic of Azerbaijan, 2010).

The SME sector mainly consists of individual entrepreneurs (sole owners who do not form a legal entity) and small and medium enterprises (legal entities) that fall under the "small business units" definition.[24] The definition of a "small business unit" was set by the Cabinet Council of the Azerbaijan Republic on Criteria for Defining Small and Medium Enterprises Based on the Economic Activity #57 in 2004. Small enterprises are defined based on the number of employees and turnover. In construction and industry, a firm is small if it has fewer than 40 employees and an annual turnover of less than AZN 200 000 (USD 247 000). In agriculture a small firm has fewer than 15 employees and a turnover of less than AZN 100 000 (USD 123 500). The wholesale trade figures are 10 employees and a turnover of less than AZN 300 000 (USD 370 500). In other sectors the number of employees should be fewer than 5 and the turnover less than AZN 100 000 (USD 123 500).

According to the 2008 *Statistical Yearbook of Azerbaijan*, 13 465 small enterprises and 195 732 individual entrepreneurs were registered in 2007,[25] which represent 6.8% and 92.6% of the total registered business population respectively. At the same time, if individual entrepreneurs are excluded, small enterprises represent 92% of the total number of enterprises and account for 61.5% of employment. The high share in the business population and employment is due to the very concentrated oil sector, which contributed to only 1.1% of employment in 2008. According to an International Finance Corporation (IFC) study of the SME sector in Azerbaijan, individual entrepreneurs account for approximately 90% of the SME sector employment.[26] Due to the extensive oil production in Azerbaijan (52.7% of GDP in 2008), which is dominated by large enterprises, SMEs' share in GDP is relatively low. According to the IFC, SMEs contributed to only 15% of GDP growth in 2006 (IFC, 2009). On the other hand, in 2007, retail and wholesale trade, a low value-added sector that contributed to only 5% of GDP (7% in 2009), was the main area of activity for 45% of small enterprises and 66.6% of individual entrepreneurs.

It is important to note that the informal sector is relatively large which is why any statistics on private sector size and contribution to GDP need to be regarded with care. According to BEEPS 2009, only 85% of firms were registered when starting operations (EBRD/World Bank, 2009). Therefore, the estimates for the number and share of employment of the SME sector are likely to be underestimated.

The presence of an extensive and prosperous oil sector affects the economy and small businesses in particular. The strong position of the gas and oil industry also underlined impressive growth rates in the non-oil sector (15.7% in 2008), even more than in the oil sector. On the other hand, the excessive dependence on oil and gas products makes the economy particularly sensitive to price shocks within the oil industry, and represents a risk for non-oil-related manufacturing through increases in the real exchange rate. The capital-intensive oil sector also means that income generation is concentrated in this sector and distribution is uneven. Moreover, many small enterprises related to the oil sector depend on large firms, rather than on internal competitive advantages.

Business environment

Azerbaijan has made significant progress in improving the business environment for entrepreneurs and small businesses. In 2009, it was one of the leading reformers of business environment regulations (World Bank, 2008). In 2011, the country ranked 54th and 15th, among 183 countries, for ease of doing business and starting a business, respectively (World Bank 2010b). Since 2003, the start-up cost has decreased from 16.8% to 3.1% of gross national income (GNI), while the time required to start a business was reduced from 105 to 8 days.

Nevertheless, the business environment in the non-oil and gas sectors clearly requires implementation of additional market-oriented reforms. There are still many constraints on the business environment that limit the development and growth of private enterprises, especially those operating in the non-oil sector. The complex tax and customs system and bureaucratic delays in issuing licences and permits continue to pose major constraints to private enterprises, particularly those of small size. Corruption is also a key obstacle to enterprise growth. Azerbaijan ranks 134th among 178 countries in the Transparency International Corruption Perceptions Index 2010. According to BEEPS 2009, 43.24% of entrepreneurs report they have been expected to give gifts in meetings with tax officials, while the regional average for EESC countries is at 12.9%.

The business-operating environment has to be further improved by taking appropriate measures which will have a positive impact on employment and economic growth. The volume, the quality and the targeting of social services geared to poverty reduction has to be improved. Considerable efforts have to be made in order to raise the education level, especially concerning secondary and higher education. Finally, yet importantly, the ecological balance and environmental sustainability have to be seriously taken into consideration. It is worthwhile to note that 2010 was declared as the Year of Ecology in Azerbaijan.

The government is implementing programmes to support SMEs and create a level playing field for all businesses. As part of the State Programme on Socio-Economic Development for 2009–13, Azerbaijan took measures to promote the development of entrepreneurship (including SMEs) and sustainable business development. In October 2009, President Aliyev signed into law the Statute and Rules of use of the National Fund for Entrepreneurial Support, which is managed by the Ministry of Economic Development. Nonetheless public-private sector co-operation is still limited in Azerbaijan.

Several institutions have been created that focus on improving the business climate and increasing the government's support to SMEs. The Entrepreneurship Council, composed of local and foreign entrepreneurs, was set up under the President of Azerbaijan in 2002 to conduct periodic studies of current problems, provide corrective measures and help improve the business climate. The National Fund for the Support of Entrepreneurship, established under the Ministry of Economic Development in 2002, supports state economic policy and develops entrepreneurship in the non-oil sector. The Azerbaijan Investment Company, established in 2006, aims at regulating state policy to support entrepreneurial development and ensure an attractive environment for investment in Azerbaijan. The Azerbaijani Export and Investment Promotion Foundation (AZPROMO) is a joint public-private initiative established by the Government of Azerbaijan in 2003. The organisation is empowered to play a key role in public-private dialogue, serving as a bridge between investors, local producers and the government.

Specific policy challenges for Azerbaijan include skills development, access to finance and the investment framework for SME growth. These three areas have been identified as key to create better conditions for private sector development, competitiveness and investment. The OECD conducted a policy assessment based on government self-evaluation and feedback from private sector representatives. This assessment aims to gauge the current policy environment and identify areas for reform.

Human capital development

Strengthening skills development has been identified as one of the key contributors to competitiveness. The positive correlation between human capital and productivity has become increasingly important in the globalised world. Razzak and Timmins (2008) report a strong positive relation between the increase of university-qualified workers and the levels of labour productivity as measured by GDP per person. It is believed that natural resources, cost competition and strategic alliances do not alone suffice for achieving sustainable development (Memon *et al.*, 2009).

Enhancing competitiveness in Azerbaijan will require a higher commitment to invest in human capital as well as introduce reforms which will ensure that the educational system produces skills that match the demand of the labour market and further support private sector development. Five areas have been selected for an in-depth evaluation of the education system including:

- Strategy formulation
- Inputs to initial education
- Vocational education and training (VET)
- Continuing education and training (CET)
- Human capital outcomes

Two areas have been identified as being particularly important to support business development and need further reforms: the underdeveloped VET/CET systems and the lack of private-public dialogue in policy formulation and implementation.

The low quality of the educational system creates significant barriers for business development. Under the Soviet regime, the educational system in Azerbaijan was centralised, but the Law on Education of 1992 introduced a decentralised model and gave more autonomy to university-level institutions. During the transition years, the quality of the educational system deteriorated, due to insufficient funding and an outdated curriculum. The quality of the educational system now ranks 104th out of 139 according to the World Economic Forum Global Competitiveness Report 2010. In the 2009 Programme for International Student Assessment (*PISA*), Azerbaijan ranked 74th out of 75 countries, coming only above Kyrgyzstan. In *PISA* 2006, Azerbaijan scored 55th out of 57 countries in both reading and science. In mathematics it scored much higher, but still below the OECD average.[27]

Expenditure on education decreased from 23.47% of total government expenditures in 1990 to 12.63% in 2007. The lack of funds is reflected in shortages of learning materials, equipment and low salaries for teaching staff.

The OECD assessment showed that the main problems within the educational system are related to underdeveloped VET and CET systems. In 2005, Azerbaijan approved a National Employment Strategy. Its main goal is the modernisation of the VET system, which was further consolidated in the

Concept for the Development of VET (2007-12). The VET system is historically the most underfunded sector. In 2007, government spending on VET constituted 1.8%-2% of GDP which covered wages and scholarships only (DVV International, 2008). In 2008, the spending increased to 2.2% of GDP.

Other objectives of the National Employment Strategy are to match the skills supply with demand, and to introduce a functional CET. There is insufficient co-operation between business and the government bodies that are responsible for drafting and approving the curricula. The skills and knowledge provided by higher educational structures do not correspond to labour market needs. A study on the link between education and employment (ETF, 2005) has shown that only 7.6% of the respondents were employed in a job that corresponded to their educational qualifications, for 3.5% it corresponded only partially, and for 17.6% it did not correspond at all. Projects on VET development tend to be initiated by employers rather than by the educational authorities. Following the employers' request, one VET school of tourism and hotel management has been established in Gabala and another one is being built in Ismayilli.

Several other projects that aim to modernise the VET curricula are under development: the "Vocational Education and Training Reform Strategy and Pilot Implementation in a selected region in Azerbaijan" with the technical support of the European Commission and the British Council; the "Azerbaijan Vocational Training Improvement Project" with UNESCO; and the building of the "Vocational Education Centre of High Technologies" with Dew International Company (Korea) that will train staff in information technology, car repair, electronics and engineering. The modernisation of the VET system so far is moving in the right direction, but, despite international support, it will require further financial commitments from the Azerbaijani government, for research of labour market requirements, materials and other needs.

Moreover, the government has to take stronger steps towards building a comprehensive system of continuing education and training. Given that Azerbaijan has an excess supply of general education graduates, private-public co-operation in the framework of CET/VET systems would allow the workers to improve their skills or change profiles according to labour market requirements.

Access to finance

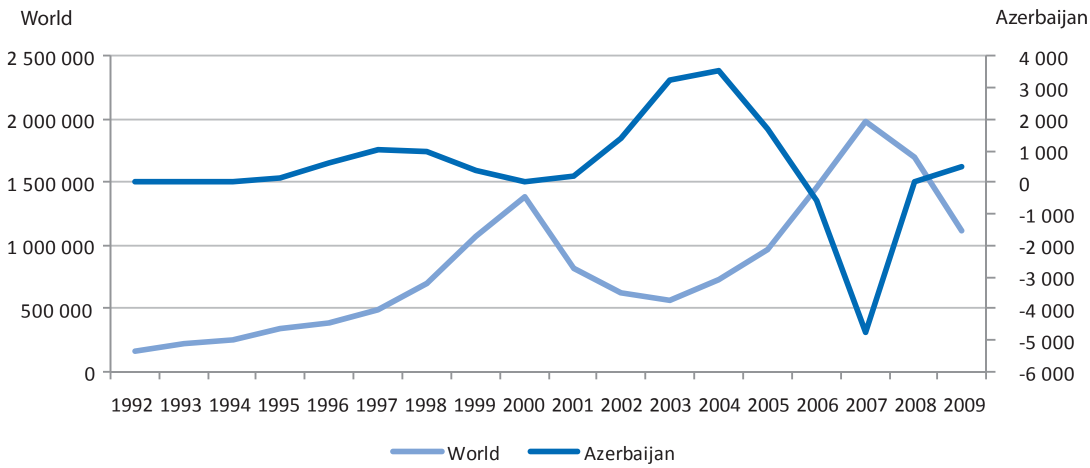
In 2008, domestic credit provided to the private sector was only 16.5% of GDP (EBRD, 2010), the lowest value in the region, and only 17.1% of it had been provided by the banking system. The banking market, even if rapidly developing (in 2010 there were 34 more financial institutions than in 2004, and one fewer national bank) and benefiting from no restrictions on currency transactions and capital flows, is still dominated by a state-owned bank that controls around half of total bank assets. Nevertheless, as shown by the rapidly increasing number of local branches of private banks and diminishing availability of branches of the state-owned bank, the sector is moving towards a more modern setting.

Access to finance has been reported by entrepreneurs in Azerbaijan as one of the key constraints. Despite having the lowest commercial loan refinancing rate and collateral requirement (102.43%) (IMF, 2010) in the region, only 19% of the companies use banks to finance their investment (EBRD/World Bank, 2009). Some 20% of firms have a line of credit or loan from financial institutions, which is a low share even compared to the regional averages of 37% and 35%. One of the main reasons is that most financial flows are concentrated in energy and energy-related sectors. To support economic diversification, the government should consider further developing innovative sources of financing such as micro-finance facilities and venture capital.

Investment framework for SME growth

Since 2002, Azerbaijan has attracted large investments in the oil and gas industry as well as in the construction and transportation sectors (the supporting sectors of oil and gas). However, net FDI inflows between 2002 and 2008 were below world average due to disinvestments in the oil sector in 2006 and 2007. The compound annual growth rate (CAGR) of investments for this period was thus only 3.2%,[28] compared to 14% for the world. Within the framework of Azerbaijan's diversification strategy, measures should be taken to attract FDI inflows to the underfinanced non-oil sector.

Figure 2.8. FDI net flows, 1992-2009
(Current USD million)



Source: UNCTADstat.

The legal regime for foreign investment in Azerbaijan was established by the 1992 Law on the Protection of Foreign Investment and the 1995 Law on Investment Activity. Foreign investors may invest in all sectors of the economy, except those related to national security. Investments in strategic sectors, such as energy and communications, are carefully controlled. By law, foreign investors enjoy non-discriminatory treatment and have the right to repatriate profits, revenues and other means legally earned in connection with an investment project.

In 2003, AZPROMO was established as a joint public-private initiative to build balanced economic development and to implement measures necessary to attract investments that would create new jobs, particularly in rural regions, within the poverty-reduction strategy framework.

A law on special economic zones entered into force in June 2009, stipulating notably that special economic zone residents shall be subject to simplified tax of 0.5% payable from gross sales and non-sale revenues. Provisions concerning the procedures for the registration of residents in special economic zones and related certificates were adopted in December 2009.

As FDI inflows are mainly concentrated in the energy, transportation and communication sectors, Azerbaijan should focus on developing a comprehensive investment promotion strategy to strengthen the sector competitiveness of productive industries through diversification of FDI inflows. To better attract foreign investors, Azerbaijan will have to further liberalise its investment policy framework and ensure higher transparency in registration and licensing procedures.

NOTES

1. Potential reserves estimated at 6 billion barrels of oil.
2. Which includes Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine.
3. As a necessity to improve the profitability of public utilities (providing profitable tariff levels by overtaking cost price to attract private businesses to the sector) by reforms within the framework of the "Country partnership 2007-10" between the government and the World Bank.
4. Social protection, health, education, culture and arts, information, sport and other state social spending.
5. Informal economy refers to all legal production activities that are deliberately concealed from public authorities for the following kinds of reasons: to avoid payment of income, value-added or other taxes; to avoid payment of social security contributions; to avoid having to meet certain legal standards such as minimum wages, maximum hours, safety or health standards, etc. (OECD, 2002, p. 139). It does not concern illegal activities.
6. Including Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine (authors' calculation).
7. Laws "About bases of agrarian reforms", "About reforming of state farms and collective farms", "About land reform" and other major legislation accepted during 1995-96. Following acceptance of the Law "About land reform", the transfer of lands from state to private property began.
8. More programmes on BP's website: www.bp.com/genericarticle.do?categoryId=9029616&contentId=7059931
9. AIOC consists of British Petroleum, Chevron, SOCAR, INPEX, Statoil, ExxonMobil, TPAO, Devon Energy, Itochu, Delta Hess.
10. The largest national GSM-operator with more than 4 million users.
11. The largest GSM-operator Azercell ltd. was privatised (remaining state shares privatised) in 2008.
12. Shareholders of BTC are: BP (30.1%); AzBTC (25%); Chevron (8.9%); StatoilHydro (8.71%); TPAO (6.53%); ENI (5%); Total (5%), Itochu (3.4%); INPEX (2.5%), ConocoPhillips (2.5%), and Hess (2.36%).
13. App. 5 million tonnes per year capacity; USD 600 million project; established in 1997.
14. 1.2 million b/d from 2009.
15. The leading bank in the country with about 45% of total assets in the national system, it is also the only state-owned bank yet to be privatised.
16. Prudential standards, which banks must implement.
17. According to the amendments put into force in mid-2009 in the Law "About the Central Bank of Azerbaijan Republic" , the Central Bank may issue loans and subordinate loans to banks as well as real sector participants (through local banks) for a longer term and in various currencies.
18. The Central Bank injected AZN 1.8 billion into the domestic market during 2009 (5% of GDP).
19. However, real figures could be higher.
20. *Azerbaijan Demographic and Health* Survey *2006.* Accessible at www.measuredhs.com/pubs/pdf/FR195/FR195.pdf.
21. Men aged 15 to 61 years; women aged 15 to 56 years.
22. April 2010, covered the period before the global crisis.
23. World Bank, figures for 2008.

24. The State Statistical Committee also provides data for "joint stock companies" and "stock exchanges", but it is not clear whether these are the only categories used in the classification of enterprises.
25. The State Statistical Committee of Azerbaijan classifies "firm" as individual entrepreneurs, small enterprises, joint-stock companies and stock exchanges. This classification makes it rather difficult to make any comparisons and is not very clear from a methodological point of view.
26. Estimate based on the following formula: (Average number of employees per small enterprise – 2) x number IE = Total number of employees working for individual entrepreneurs.
27. UNICEF Country Profile, *Education in Azerbaijan*.
28. Severe disinvestment occurred in 2007, when net FDI inflows dropped and turned negative decreasing the stock of FDI of the previous year by 42.5%.

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CHAPTER THREE

GEORGIA: COUNTRY REVIEW

SUMMARY

The reforms implemented between 2004-08 aimed at deregulating the economy, reducing corruption, setting up free-trade principles and creating effective administration mechanisms to ensure economic development in Georgia. Gross domestic product (GDP) grew significantly and new jobs were created. Real GDP growth rates exceeded 9% in 2005 and reached 12.3% in 2007. The World Bank's *Doing Business* analysis ranked Georgia as the number one economic reformer in the world in 2007, when its position improved from 112th to 18th in terms of ease of doing business over the previous year.

Despite two major crises, the Georgian economy has proved to be flexible and functioning. GDP is expected to increase by 2% in 2010 after a significant 4% decline in 2009. However, the Georgian economy still experiences difficulties that were insufficiently addressed during the boom period of 2004-08. The structure of the Georgian economy is too dependent on the production of low-value commodities. Imports exceed exports considerably and a large majority of the consumers' products are imported. The country's global competitive position has been weakening in the post-war period (from 90th place in the WEF Global Competitiveness Report of 2008 to 93rd in 2010), which makes the sustainability of the economic development uncertain.

Poverty reduction, access to quality lifelong education, sustainable environment development, health issues, the spread of HIV/AIDS and gender equality are areas that have to be addressed by the Georgian authorities. Some progress towards the Millenium Development Goals (MDGs) and advancing the broader development agenda has been made, however, and the quality and institutional setup of the educational system have improved.

The report identifies the main challenges and provides recommendations on how certain aspects of the system could be strengthened to overcome the results of the August 2008 war and the global economic crisis and accelerate economic growth:

- A next phase of economic reforms has to be introduced.
- The insufficiently developed small and medium-sized entreprise (SME) sector has to be reinforced.
- The global competitive position should be strengthened focusing on technologies and education.
- Export capabilities potential needs to be developed.
- The share of population benefiting from Georgia's economic reform has to be augmented.

Overall, the report finds progress in the reform agenda and improved performance in many areas of economic activity.

INTRODUCTION

Since 2003, the government has carried out a large number of reforms to create competitive market conditions and a business-enabling environment to attract foreign direct investment (FDI). The reforms also aimed at trade liberalisation and eradicating corruption.

The spectacular growth of 9.7% on average from 2003 to 2008 fuelled a significant increase in tax collection (and thus in tax to GDP ratio) thanks to a simplification of the tax system, a rapidly improving business climate led by increased privatisation of state-owned assets and reduced bureaucracy, increased FDI inflows, and high international and domestic demand. At the same time, however, imports rose twice as much as exports, increasing the current account deficit.

The August 2008 war, followed by economic crisis, put a stop to this prosperous period. By the end of August, many buildings and infrastructures were destroyed and more than 100 000 people were displaced. Less than a month later, the overheating of the economy and the onset of the global crisis led to a strong fall of both national and international demand, and of FDI flows world-wide.

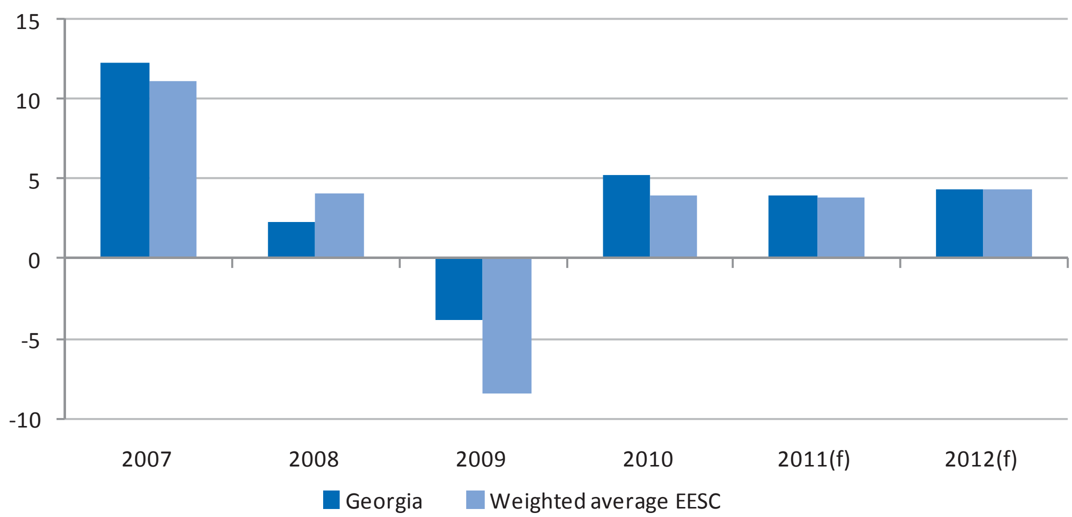
These developments have highlighted the weaknesses of the Georgian economy, in terms of education (skill gap), technology availability, modernisation and mechanisation, and SME financing (poor financial background).

RECENT ECONOMIC DEVELOPMENTS

General overview

Georgia benefited from high growth between 2003 and 2008 with an average annual rate of 9.6%. The increase in international and domestic demand, as well as increased FDI inflows, mostly in very large pipeline projects and privatisations contributed to this high GDP growth. In 2007, the average growth rate of the Georgian economy was 12%, around 2% above the average of the countries covered by this publication.[1]

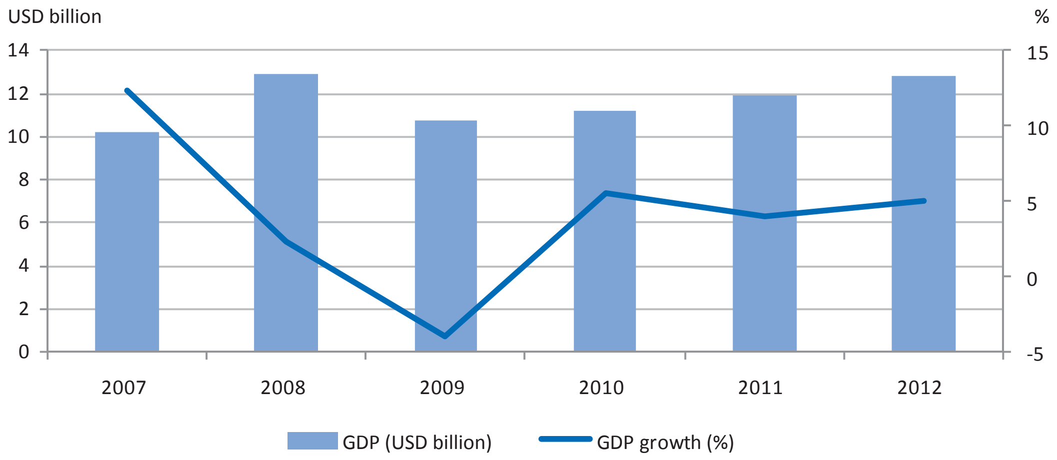
Figure 3.1. Real growth rates in Georgia
(annual percentage change)



Source: IMF, WEO, January 2010.

The August 2008 war, accompanied in early September by the international crisis, led to a severe decrease in GDP in the second half of the year. Overall, annual GDP growth only reached 2.3% in 2008 instead of 9%, as forecast by the IMF in April 2008. In 2009, GDP further decreased in constant prices to GEL 11.9 billion (from GEL 12.5 billion in 2008), a reduction of 2.3%.[2] This level of decrease remained below the Eastern European and South Caucasus (EESC) countries' average (-5.7%[3]) due to the dramatic fall in Armenia and Ukraine (which both slumped by 14% and 15% respectively). Positive reforms by the government to overcome the crisis (tax and corruption) are paving the way to slow recovery alongside the resumption of international trade. GDP growth is expected to reach 5.5% in 2010 and to stabilise at 5% in 2012.

Figure 3.2. Nominal GDP and real GDP growth

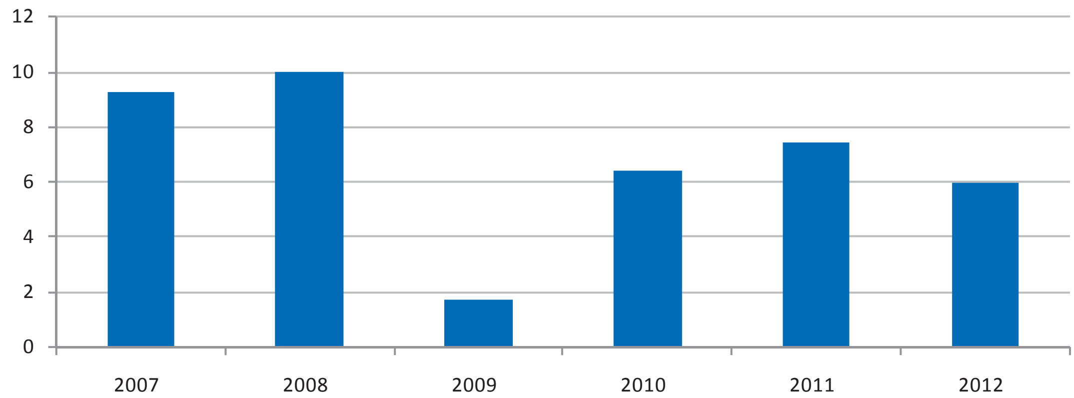


Sources: IMF, WEO, October 2010; Ministry of Finance of Georgia.

Inflation

There was a strong inflation rate in 2007 due to rising energy and food prices, accompanied by large capital inflows. Monthly inflation has been very volatile since 2008, with dynamics of consumer prices being strongly affected by fluctuation of the exchange rate and nominal wages. Though it had little annual impact, the volatile international price for oil impacted monthly trends; it strongly decreased in the first half of 2008 before peaking in the second. On the other side, food prices (fruit and vegetables) continued their increase due to high seasonal effects of agriculture, along with the November increase in prices of medicaments. Import prices strongly increased until September 2008 due to high international prices. A deflation trend can, however, be observed at the end of that year as a consequence both of the August war and the arrival of the global economic crisis which pushed prices down due to a shortage of total demand. Monthly inflation decreased by 4% in September despite an increase in food and household equipment prices. Yet, annual inflation remained high and reached 10% and consumer price inflation (CPI) 7.2%.

Figure 3.3. Inflation, average consumer prices
(annual percentage change)



Source: IMF, WEO, January 2010.

In 2009, inflation remained slightly positive (1.7%) due to lower total demand that carried all prices down in the first half of the year and to the shallow growth of the second semester. With the pick-up of economic activity in 2010, annual CPI growth totalled 6.3% up until October. The annual inflation rate is expected to increase to 6.2% in 2010 and is forecast at 7.4% and 6% in 2011 and 2012 respectively.

Analysis by account

Consumption

The economic growth of 2004-08 was accompanied by improvements in several indicators of households and per capita income. In H1 2010, monthly average income totalled GEL 581.8 (USD 328.1), slightly increasing from GEL 572.5 (USD 322.8) in 2009 (EIU).

Table 3.1. Average monthly income
(GEL)

	2004	2007	2008	Q1-Q3 2009
Per household	320.4	422.2	537.4	561.8
Per capita	84.7	115.2	146.4	152.6

Source: Geostat, 2010.

Monthly expenditures for "food, beverages and tobacco" increased by 66.4% between 2001 and 2008, reaching GEL 167.1 in total monthly expenditure per household in Q1-Q3 2009. Cash consumption expenditure patterns have changed since 2001, with a decreasing share of food and household goods, representing a third of total consumption expenditures and the increase of "other cash expenditure on consumption", which more than doubled, and of health care (by 73%).

Health care, fuel and electricity, and transportation expenditures have increased significantly since 2001 and represent important categories in the monthly consumption expenditure of households, as average wages increased from GEL 96.1 in 2001 to GEL 534.9 in 2008 (and further to GEL 556.8 in 2009). On the other hand, total monthly expenditure per household in 2008 left no scope for savings, as it reached GEL 535.7.

Table 3.2. Average monthly expenditure per household
(GEL)

	2001	2007	2008	Q1-Q3 2009
Total consumption expenditure	**294.4**	**396.8**	**472.8**	**464.4**
Total cash expenditure on consumption	**201.8**	**322.6**	**386.2**	**377.1**
Food items, alcohol, tobacco	106.3	155.7	177.5	167.1
Clothing and footwear	12.2	15.3	17.7	15.2
Household items	25.6	12.3	13.8	12.8
Health care	11.5	27.6	38.2	46.7
Fuel and electricity	17.1	36.3	46.6	46.0
Transportation	12.4	30.0	39.5	37.7
Education and recreation	7.3	12.8	13.5	15.1
Other cash expenditure on consumption	9.2	32.6	39.3	36.5
Consumption in kind	92.8	74.1	86.6	87.2
Other expenditure – total	27.2	46.6	62.9	65.8
Agriculture	5.8	8.5	9.3	9.6
Social transfers	0.7	12.4	12.6	13.5
Savings or lending	20.6	21.3	31.5	38.1
Investment	-	4.4	9.5	4.5
Total cash expenditure	**228.9**	**369.2**	**449.0**	**442.9**
Total expenditure	**321.7**	**443.4**	**535.7**	**530.1**

Source: Geostat, 2010.

Table 3.3. Average monthly expenditures
(GEL)

	2004	2007	2008	Q1-Q3 2009
Per household	379.1	443.4	535.7	524.0
Per capita	100.2	120.9	145.9	142.3

Source: Geostat, 2009.

The 2008 August war and the global financial crisis deeply affected households' consumption. The structure of their expenditure changed considerably. According to a survey by Caucasus Barometer in 2009, 14% of households believed they had enough money for clothing and food, but not enough for other expenditures;[4] 28% of respondents indicated that they had enough money for food, but not enough for clothing; while 22% of respondents replied that they did not have enough money for food. Only 2% indicated that they had enough money for both food and clothing and could afford durables such as a refrigerator.

Government expenditures and revenues

Thanks to lower taxes that enhanced tax collection, and to the several reforms in this field, the government's revenues increased seven-fold, from GEL 0.8 billion in 2002 to GEL 5.5 billion in 2008, before declining to GEL 4.9 billion in 2009 due to the crisis (-10.9%). The share of taxes in total revenue increased from 70.1% in 2002 to 84.6% in 2009, for a 7.3-fold increase of taxes in the same period, from GEL 567.9 million to GEL 4.2 billion. In order to recover from the August 2008 war, Georgia also received grants and credits from international organisations for a total of USD 4.5 billion over 2008-10 to rebuild damaged infrastructure and allocate social help for displaced persons.

Table 3.4. Donor pledges by sector
(USD million)

	Pledge
Banking	853
Transport	682
Budget and macro-financial support	586
Energy	381
Internally displaced persons	350
Private and financial sector	252
Urban and municipal	211
Immediate	100
Other	355
Not allocated	366
Total	**4 536**

Source: World Bank.

Due to the crisis, increases were made in the budget under the items "social expenditures: other expenses" (28.5%), "subsidies" (23.4%) and "social benefits" (10.4%).

Table 3.5. Evolution of government debt, revenue and expenditure
(GEL million)

	2002	2008	2009	2010
Revenue	802.7	5 517.7	4 917.0	5 188.2
Taxes	567.9	4 541.6	4 161.7	4 382.0
Social contributions	154.8	-	-	463.2
Grants	22.6	617.2	387.7	343.0
Other revenue	57.4	359.0	367.5	5 476.3
Expenses	839.7	5 554.7	5 367.2	1 046.0
Compensation of employees	93.9	913.1	941.6	856.2
Use of goods and services	183.1	1 508.8	879.9	229.9
Consumption of fixed capital	-	-		225.5
Interest	146.7	119.3	167.2	979.8
Subsidies	92.0	362.5	447.3	1 488.2
Grants	65.1	858.9	861.2	650.8
Social benefits	258.9	1 286.1	1 419.9	-288.1
Other expenses	0.0	506.1	650.1	-
Net operating balance	-37.0	-37.0	-450.3	-
Net acquisition of non-financial assets	100.0	324.6	746.7	-
Net lending (+) / borrowing (-)	-137.0	-361.6	-1 197.0	-
Debt at the end of the period, of which:	4 843.3	5 153.6	6 225.2	-
Domestic debt	1 520.3	1 458.9	1 693.2	
Foreign debt	3 323.0	3 694.7	4 532.0	

Source: Ministry of Finance of Georgia.

The crisis increased Georgia's total external debt. In 2008, it grew by USD 900 million to USD 7.9 billion, with 75% of public debt. In 2009, external debt grew further by around USD 1 billion to USD 8.7 billion, with 95.2% denominated in foreign currency.

Table 3.6. Gross external debt position
(USD billion)

	31 December 2008	31 December 2009	31 June 2010
Total external debt	**7.87**	**8.71**	**8.72**
Total external debt in foreign currencies	7.49	8.28	8.29
Total external debt in national currency	0.38	0.44	0.43

Source: National Bank of Georgia (NBG).

Public sector, banking sector and intercompany debts represent a little more than 70% of Georgia's total debt.

Table 3.7. Total external debt by sectors
(30 June 2010)

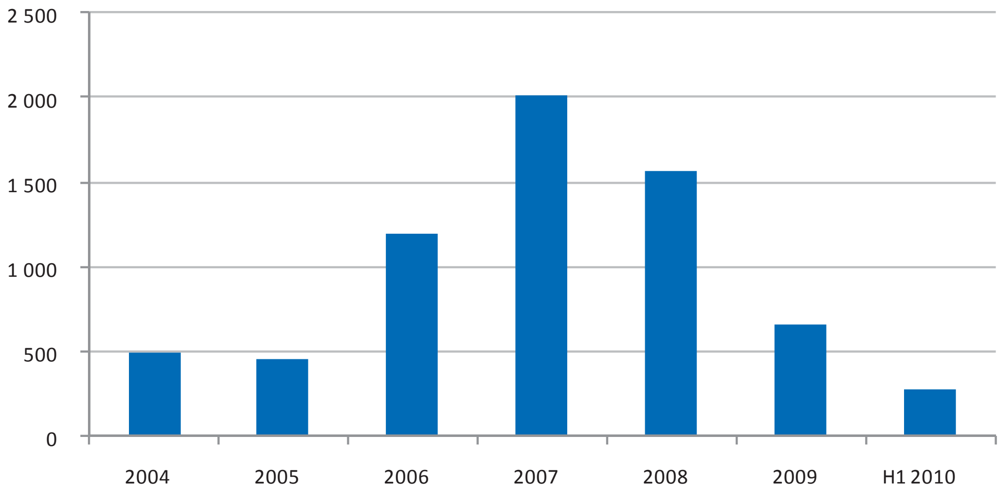
	USD billion	% total debt
Total external debt	**8.7**	**100.0**
Public sector debt	2.9	32.8
NBG debt	0.9	9.7
Banking sector debt	1.5	16.7
Intercompany lending	2.2	25.3
Other sectors' debt	1.3	15.4

Source: tabled by authors, NBG, 2010.

Investments

FDI strongly increased between 2003 and 2008, from around USD 0.5 billion to USD 2.0 billion in 2007. Its share in GDP also more than doubled, from 8.4% to 17.2%, mostly due to foreign investment in the pipeline projects. Indeed, until 2005, FDI was primarily directed to the construction of the two main oil and gas pipelines, the Baku-Tbilisi (BTC) and the South Caucasus (SCP) pipelines. At the end of BTC pipeline construction, FDI was mostly directed towards the energy sector, transport and communication, real estate, and mining and mineral processing. Other capital inflows were invested in the banking sector and tourism. Investments in these sectors balanced the negative effect of the completion of pipeline-related inflow.

Figure 3.4. Yearly foreign direct investment inflows
(USD million)



Source: National Statistics Office of Georgia (Geostat).

As a result of the August conflict and the economic crisis, net FDI fell to USD 1.5 billion in 2008 and to USD 759.1 million in 2009 due to sluggish growth. It is expected to decrease further in 2010, as economic activity will be slow to pick up. Data for Q2 2010 already showed that FDI had reached USD 197.0 million. FDI inflows for H1 totalled USD 272.6 million, 6.3% below its year-on-year (yoy) level in 2009 of USD 281 594 million (down from USD 1 143 031.8 million in H1 2008).

In 2007, the European Union (EU)27 accounted for over 56% of FDI while in 2008 the EU, the United Arab Emirates (UAE) and Turkey were responsible for nearly 60% of total FDI. In 2009, the EU27 remained the major trade partner, followed by Turkey, Azerbaijan, Ukraine and the United States. In H1 2010, the Netherlands were the main foreign investors, with a share of 31.3% of total FDI inflows.

Table 3.8. FDI in Georgia by economic sectors
(USD thousand)

	2009	Q1-Q3 2010
Industry	139 805.12	69 425.72
Construction	105 218.80	-5 359.86
Transport and communications	98 432.03	129 235.41
Real estate	147 410.29	69 576.89
Financial sector	49 663.41	72 279.96
Other services	51 580.22	60 012.13
Energy	-2 130.63	32 763.01
Hotels and restaurants	37 542.34	-1 971.54
Agriculture	22 326.87	5 856.50
Total	**658 400.59**	**433 036.08**
Other	8 552.15	1 217.87

Source: Geostat, 2010.

Imports have grown steadily because of the insignificant amount of investments directed towards manufacturing and export-oriented spheres.

Georgia's FDI policy is facing serious challenges related to the lack of investor interest in setting up production facilities. Accordingly, the main emphasis of the investment policy must be to convince investors not only that Georgia has simplified administrative procedures and land-use regulations for issuing construction permits, but also that production in Georgia will be competitive enough to replace imported products on the domestic market and even to export internationally.

Despite these measures, and following the August 2008 war, the government has failed to increase the level of investors' confidence in the country. Moreover, FDI sources will tend to decrease as the bulk of FDI inflows related to privatisation is near completion.

Trade

Although the Russian embargo had a negative impact on overall export revenues, efforts to redirect domestic output to other markets have proved partially successful. Overall there has been a shift in export composition away from foodstuffs and agricultural products towards resource-based exports and, to some extent, high-technology products. Five main categories of products account for over 70% of Georgia's export structure: prepared foodstuffs, cement, mineral products, base metals, chemical products, and machinery and equipment. Metals including ferrous metals, copper, gold and other minerals account for 20% of exports. Moreover, in 2007-08 Georgia's main cement factories were rehabilitated giving rise to a sharp increase in cement export.

Table 3.9. Trade, repairs and motor vehicles, personal and household goods sectors

	2007	2008	2009	Q1-Q3 2010
Turnover (GEL million)	7 617.8	9 238.0	7 279.1	5 733.6
Production value (GEL million)	1 150.5	1 464.7	1 211.4	1 426.4
Number of employed (persons)	51 148.0	55 278.0	48 892.0	63 527.5

Source: Geostat, 2010.

Foreign trade has significantly picked up since 2000, with a seven-fold increase from USD 1.33 billion in 2000 to USD 7.8 billion in 2008. Exports increased by USD 1.2 billion (from USD 0.3 to 1.5 billion) compared to a nine-fold increase in imports (from USD 0.7 to 6.3 billion). Imports have been significantly increasing due to the increase in domestic demand (led by higher wages, economic boom and easy lending), the need for major commodities (for construction, oil and gas) and the inability of the domestic production to supply increasing demand. Exports were fuelled by increasing international demand until September 2008.

Table 3.10. Georgian foreign trade
(USD million)

	2000	2007	2008	2009	Q1-Q3 2010
External trade turnover	1 032.1	6 447.0	7 553.2	5 500.1	5 230.2
Export (FOB)	322.7	1 232.9	1 497.5	1 130.6	1 227.6
Import (CIF)	709.4	5 214.1	6 055.6	4 369.5	4 002.7
Balance	-386.6	-3 981.2	-4 558.2	-3 238.9	-2 775.1

Source: WITS, Geostat 2010.

The massive trade balance deficit is mainly due to traditional transition country components: declining share of agriculture and the need for imported foodstuffs, the Russian ban on Georgian agricultural products (wine) and the need to import products that are not produced domestically (oil and gas, machinery, transport equipment, clothing). Georgia's large negative trade balance has been financed by large capital inflows (around USD 1.2 billion are used to finance the import of goods), which is unlikely to be sustainable.

Due to the crisis, total foreign trade fell to USD 5.5 billion in 2009 (a fall of 26.6% compared to 2008), with trade balance decreasing by 29% yoy. As for Q3 2010, trade turnover had already reached USD 5.3 billion, showing a smooth increasing trend in total trade volume. Due to falling prices and the 2009-10 devaluation of the lari in USD terms – which lost a further 10% in June-July 2010 – trade value is expected to be stable in 2010.

Major exports until 2008 were low-value industry products such as iron and steel (ferro-alloys), ores and metal scrap, motor cars and fertilisers. However, to cope with changing patterns in international demand, the export structure slightly changed in 2009, with the predominance of iron and steel, beverages, precious stones, and edible fruits and nuts (for 54.2% of total exports).

On the import side, the trade structure has not changed, including mineral fuels and products, gas, motor cars, pharmaceuticals, electronic, computer and telecommunications equipment and wheat, with the addition of electric machinery and equipment in 2009. Due to growing domestic demand, and despite rising commodity and energy prices, import volumes increased significantly in 2000-07. The largest category of imports is hydrocarbons (oil and gas).

The share of Commonwealth of Independent States (CIS) countries in Georgia’s foreign trade is declining steadily. Export volumes declined from 49% in 2002, to 36% in 2008 and to 29.7% in 2009. In H1 2010, Azerbaijan became Georgia’s main exports trading partner with a share of 15.9% in total exports.

Georgia’s main trade partner is the EU27 with which it maintains a dynamic exchange of goods and services, accounting for roughly one-fifth of exports and over one-quarter of imports. Mineral fuels and agricultural products dominate Georgia’s export potential. Most ferrous metals outputs were sold in 2008 to partners from the United States. Georgia has become a net importer of agricultural products, from being a net exporter under the Soviet Union. Azerbaijan has become the main buyer of Georgia’s cement production and main supplier of oil and gas.

Table 3.11. Current account balance

	2007	2008	2009	2010(e)	2011(f)	2012(f)
Current account balance (USD billion)	-2.00	-2.92	-1.26	-1.35	-1.49	-1.48
Current account balance (% GDP)	-19.65	-22.65	-11.72	-12.04	-12.49	-11.52

Source: IMF, WEO, October 2010.

In 2009, the current account deficit amounted to USD 1.6 billion, down from USD 2.9 billion the previous year, largely due to the drop in total demand and in world prices (trade value), and to increased FDI.

Informal economy[5]

Before the Rose Revolution in 2003, Georgia was considered as one of the most corrupt states among transition economies. According to Schneider,[6] the average size of the informal economy was found to be 38% of official GDP in transition countries in 1999/2000, down to 36.4% in 2005. Georgia has had by far the largest informal sector, though declining, among the 23 transition economies studied, amounting to 67.3% of GDP in 1999 and to 62.1% in 2007. In this ranking, Georgia is followed by Azerbaijan (60.6% in 1999 and 52.0% in 2007) and Ukraine (52.2% in 1999 and 46.8% in 2007). The EESC countries’ average was 43.7% in 2007, down from 47.6% in 1999. As a comparison, the average of the OECD countries was 13.4% in 2005.

At the time of the study, Georgia was still in the transition process from the former Soviet economic system to a liberalised economy. With job losses created by the recession at the end of the Soviet Union in 1991, the informal economy was seen as a coping mechanism for this loss of incomes, mostly in subsistence agriculture and in manufacturing, thus explaining its high share of GDP.

In 2008, the unemployment rate was 16.5%; the highest among the post-Soviet countries. Moreover, more than half the Georgian population lived in rural areas, where low-intensity self-sufficient farming has been the major type of activity. Since the Rose Revolution, serious far-reaching reforms of labour regulation have been undertaken in order to fight the unemployment problem.

Since the Rose Revolution in 2003, the government worked on reducing corruption and improving the tax system in order to bring companies back into the formal system. The number of taxes was drastically reduced, from 21 in 2004 to 4 in 2008 – VAT (18%), corporate profit tax (15%), personal income tax (20%) and property tax (1%) – stimulating an increase in tax collection as the value of these taxes also declined.

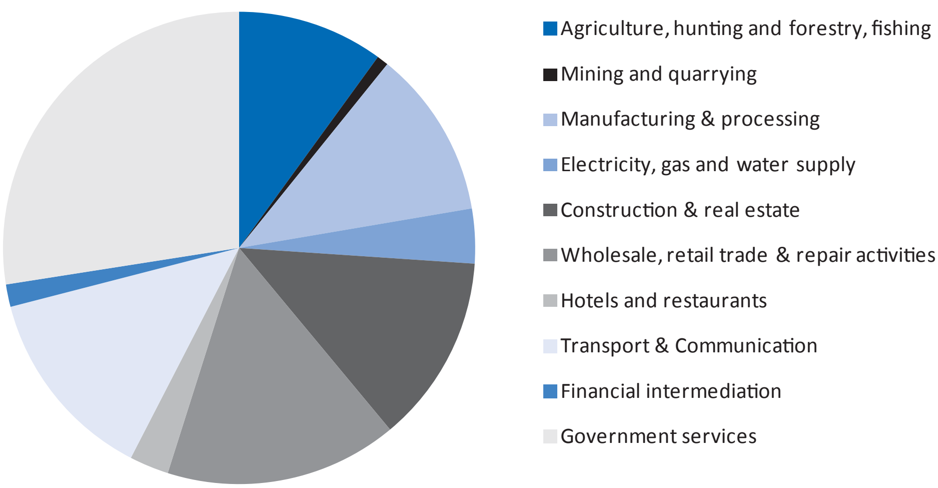
Consequently, the number of registered companies rose to 51 000 in 2007, from 36 000 in 2005 (WTO, 2009). The dramatic rise in public sector salaries, deregulation measures and simplifications of administrative procedures in the business sphere had positive consequences on the radical reduction of the shadow economy since 2004. Privatisations – mostly in energy and transport sectors – and an eased licensing system (one-stop shop and "silence is consent") have also played a major role in reducing corruption.

Nevertheless, high-level corruption was mentioned by the 2009 *Human Rights Report* as an issue of persistent concern. Problem areas included weak democratic institutions, the lack of civil society involvement in the planning and execution of public policy, poor property rights, and elite corruption (US Department of State, 2010). Overall, these factors are barriers to eradicating the informal economy.

ANALYSIS BY ECONOMIC SECTOR

GDP growth mainly came from a small number of sectors, including construction and real estate, trade services, telecommunications, the banking and financial sector, and manufacturing.

Figure 3.5. Components of nominal GDP by sector in 2010



Source: Charted by the authors, from Geostat, 2010.

The service sector has always been dominant, with a share in GDP of 70%. Industry comes second, accounting for 20% and agriculture third with a modest 10%.

Agriculture

During the last two decades, agriculture's contribution to GDP has declined. In 1997, the agricultural sector accounted for 27.5% of the overall GDP, while in 2009 it had decreased to 9.6%. Georgia's main export commodities are vegetables, hazelnuts, tea, citrus fruits, wine, mineral water and brandy. Currently, approximately half of the population lives in rural areas and 53% of the labour force is employed in agriculture.

General overview

Table 3.12. Agricultural performance

	2005	2006	2007	2008	2009
Real GDP growth (GEL million)	11 620.9	13 789.9	16 993.8	19 074.9	17 949.0
Total output of agriculture (GEL million)	2 330.3	2 134.2	2 250.9	2 415.8	2 117.4
Share in GDP (%)	20.0	15.5	13.2	12.7	11.8
Plant growing (GEL million)	1 184.5	911.4	1 051.6	998.1	927.5
Animal husbandry (GEL million)	1 105.3	1 165.3	1 138.8	1 353.2	1 131.4
Agricultural services (GEL million)	40.5	57.5	60.5	64.5	58.5

Source: Tabled by the authors, Statistical Yearbook 2009.

Following independence, Georgian agricultural export products were predominantly sent to the Russian and CIS markets. However, since 2000, an increasing amount of wine, hazelnuts and mineral water has been exported to EU markets. The share of agricultural products exported to the EU has increased from 10% in 1997 to 40% in 2007, while the share of exports to CIS markets has decreased from 90% to 55% over the same time.

Table 3.13. Agricultural trade
(USD million)

	2005	2006	2007	2008	2009	Jan-Oct 2010
Total imports	**437.5**	**606.3**	**832.5**	**864.5**	**566.9**	**738.4**
Food imports	237.1	343.2	491.0	738.3	176.4	618.6
Total exports	**303.9**	**234.9**	**298.6**	**242.7**	**169.0**	**233.9**
Food exports	123.4	102.2	134.5	104.4	138.1	118.7

Source: Statistical Yearbook 2009 and WITS (tabled by the authors).

Georgia lacks large-scale agriculture, machinery, high-value fertilisers and, most of all, access to credit. Agriculture has always been neglected in favour of services, even during the Soviet period, and remains a subsistence-based sector as land is divided into small plots usually owned by households (specialised in fruits, vegetables and cereals). The sector employs about half of the registered labour force and a higher share of the active population.[7] Rural living standards have been declining since 1990 with the ageing of infrastructures. Despite this, the agriculture sector received only 1.5% of budget allocation in 2009.

Government policy in agriculture focuses on the creation of agricultural and food-processing enterprises through subsidised purchases of land, privatisations, allocations for livestock breeding, agricultural machinery and irrigation infrastructure, and the abolition of tax on agricultural property transactions.

In 2007, 53.3% of the economically active population (about 1 million people) was employed in agriculture. Average monthly wages remain at the second-lowest level, compared with other sectors (with the highest average in the financial intermediation sphere – GEL 1 343.5 and lowest average wages in agriculture (GEL 299.3) and fishing (GEL 211.1). Moreover, households' incomes are lower in rural areas than in urban ones.

Low monthly revenues of rural households are responsible for the high rate of poverty and poor living conditions, which are, however, improving very slowly. Although poverty incidence has diminished, most agricultural areas are linked to poor living standards.

Georgia imports most of its agriculture needs as domestic production is specialised in tea, citrus and grape crops. Food security is therefore a major issue in the country.

Table 3.14. Distribution of average monthly incomes per capita by urban and rural areas
(GEL)

	2007		2008	
	Urban	Rural	Urban	Rural
Cash income and transfers	104.3	57.2	133.9	72.8
Wages	56.1	15.6	72.3	18.7
From self-employment	16.7	6.3	21.5	7.4
From selling agricultural production	0.5	14.6	1.2	15.2
Property income (leasing, interest on deposits etc.)	1.8	0.3	1.4	0.5
Pensions, scholarships, assistance	10.8	11.7	16.1	18.3
Remittances from abroad	7.0	2.4	7.1	3.4
Money received from family and friends	11.4	6.3	14.4	9.3
Non-cash income	6.0	35.0	7.5	39.5
Income, total	110.3	92.2	141.4	112.2
Other cash inflows	14.6	12.9	24.0	15.5
Property disposal	2.0	1.2	4.6	1.1
Borrowing	12.7	11.7	19.5	14.3
Cash inflows, total	118.9	70.0	158.0	88.2
Cash and non-cash inflows, total	124.9	105.1	165.4	127.7

Source: Geostat 2010.

Since mid-1990, production has diversified a little, with the addition of vegetables, horticulture, tobacco, perennial plants and livestock (cattle, pigs, poultry and sheep). The share of agriculture in total GDP has been decreasing since 2005 to 9.6% in 2009 (from 16.4%). This can be attributed to the increase in the share of other sectors. Production decreased by 13.3% in real terms between 2005 and 2009, to USD 1.4 billion. Agriculture's share in GDP is expected to stabilise at around 10% of GDP in 2010 (as registered in Q1 2010).

Table 3.15. Gross harvest of agricultural crops
(thousand tonnes)

	2002	2003	2007	2008	2009
Potatoes	415.3	425.2	229.2	193.4	216.8
Vegetables	405.6	430.1	190.3	165.0	170.3
Perennial plants	86.1	130.8	8.8	30.2	37.6
Fruit	172.6	260.0	227.5	157.6	181.2
Citruses	33.1	59.2	98.9	55.2	70.3
Grapes	90.0	...	227.3	175.8	150.1
Tea	24.0	25.5	7.5	5.4	5.8

Source: Statistical Yearbook of Georgia, 2009.

Table 3.16. Livestock production
(thousand tonnes)

	2002	2003	2007	2008	2009
Meat (slaughtered weight)	106.9	108.9	69.4	53.7	54.4
Milk	742.1	765.1	624.7	694.6	551.4
Eggs (million)	408.8	458.1	438.1	437.5	430.6
Wool	2	2	1.9	1.7	1.8

Source: Statistical Yearbook of Georgia, 2009.

Since joining the World Trade Organization (WTO) in 2000, Georgia has no quantitative restrictions on trade, has low tariffs (MNF) and free trade agreements with several countries, notably the CIS countries. However, agriculture's share in total exports[8] is very volatile, depending as much on the export performance of the industry and services sectors, as on the yearly harvest. In 2000, its share was 11.9% of total exports, falling to 8.6% a year later. The share had been stable between 2003 and 2005 at around 15.4% on average. The ban of Georgian wine by Russia in 2006 – which was the main importer of the country's major export commodity at that time – alongside the export performance of the industry sector since 2005 (due to high international prices), led the share of agriculture to fall and to reach a level as low as 6.9% in 2008. It only picked up to 12% in 2009 due to the dramatic decline of industrial and services exports, linked to the crisis.

Figure 3.6. Share of agriculture in H1 2010 (percentage)

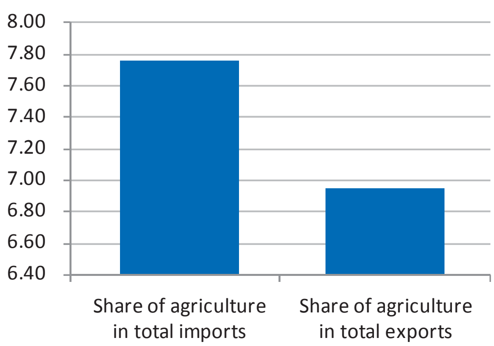
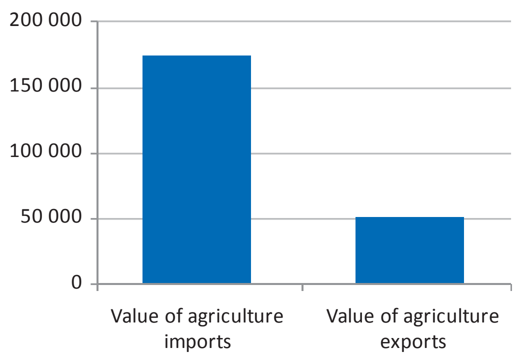


Figure 3.7. Value of agriculture in H1 2010 (USD thousand)



Source: Tabled by the authors, from Geostat.

In 2009, agricultural imports and exports were similar to the 2008 figures in terms of value, but reversed in terms of share, as exports outpaced imports (12.2% against 6.7% respectively).

Viticulture and wine-making are very important and Georgia is one of the oldest centres of expertise in this field. The country used to be the major wine producer during the Soviet Union, but after independence, production collapsed due to outdated equipment. Nonetheless, the wine industry peaked between 2000 and 2006 when Russia was importing 80% of total Georgian wine per year (59.3 million bottles).[9] However, the 2006 Russian ban on Georgian wine (reportedly for falsification and counterfeiting) deeply harmed the sector and caused losses of USD 50 million (assuming that wine exports in 2006 remained at the same level of the previous year), approximately USD 13 million for mineral water and USD 12 million for ethyl spirits. The overall cost of the Russian ban on Georgian exports amounted to USD 100 million in 2006 (NBG, 2006).

Many European investors have invested in the wine industry in Georgia, such as the French group Pernod Ricard, the largest shareholder in the Georgian Wine & Spirits Group. In January-August 2008, the value of wine exports was USD 22.2 million. The priorities of the wine industry are now to develop new export markets – such as the CIS, EU (mainly the United Kingdom and Poland), the United States and China – and to improve quality according to Levan Koberidze, Director of GWS.[10]

Major problems

Georgia's poor agriculture can be explained by:

- ageing agricultural infrastructure (irrigation systems, etc.);
- weakly developed processing industry, low quality of production and of fertilisers;
- lack of modern technology;
- lack of Research and Development (R&D) centres and of information and consultation (extension) services;
- lack of greenhouses, production depending solely on weather conditions leading to uncertain outcomes year-on-year;
- the lack of slaughterhouses, with questions of sanitary and phytosanitary measures;
- unprotected designations of origin, geographical indicators and trademarks, far from international standards;
- little access to financial resources, high interest rates and low activity level of the insurance bodies.

In this context, production volatility is one of the main reasons why the banks[11] are reluctant to issue loans to farmers, who, in turn, cannot buy the machinery, fertilisers and technology necessary to increase production, and thus to improve quality. Other reasons include: length of return on investment, underdeveloped infrastructures and weak production management. Crop production is also hindered by other important factors, such as insurance companies' refusal to insure crops. Consequently, interest rates are very high and bank borrowing very costly, meaning that only a small number of farmers can access loans. Farmers lack investment resources and they operate on limited working capital. Thus, the improvement of credit and financial mechanisms, alongside modernisation and crop development are crucial for the development of the sector.

The issue of meat production is directly tied to the development of annual and perennial hay cultivation. In 2003-08, the two dropped dramatically from respectively 48 800 and 130 800 tonnes in 2003 to 5 000 and 30 200 tonnes in 2008. The serious decline was also observed in meat production, as it slumped from 106 900 tonnes in 2002 to 53 700 tonnes in 2008.

Irrigation is of particular importance for Georgian agriculture. East Georgia, with its dry continental climate, requires intensive irrigation while the surplus of water in certain regions of western Georgia necessitates efficient drainage systems. In 2009 various sections of irrigation infrastructure with a total length of 150 km were renovated and two main supervisory control stations were built.[12] Low use of chemical fertilisers means that Georgia has considerable potential to develop organic agriculture. As most of the farmers are owners of small land plots, preventing large-scale production, focusing on increased product quality would lead to a higher value-added product, and thus to a higher market price and increased farmers' revenues.

Policy implications

The government's agricultural policy focuses on the creation of agricultural and food-processing enterprises through subsidised purchases of land, privatisations, allocations for livestock breeding, agricultural machinery and irrigation infrastructure, the abolition of several taxes, and access to credit and technology. Several policies have been adopted since 2005. In 2009, the government even implemented 60 projects for clean water and irrigation systems worth GEL 58 860 754 (according to the Ministry of Infrastructure).

In order to attract capital, the "Law on Privatisation of Agricultural Land Existing in State Ownership" entered into force in July 2005 and is still ongoing. Its main objective is to create large farms. The remaining 360 000 ha of state-owned agricultural land[13] was considered for privatisation, with a minimum land area of 3 ha per purchase. The process is supervised by the Ministry of Economic Development of Georgia (and its regional offices). Non-leased, state-owned lands are subject to special auctions (followed by open auctions) to Georgian nationals – individuals or communities. On the other hand, leased agricultural land is subject to direct sales or direct sales under competition and is not bound by the buyer's origin.

To attract further foreign capital, tax cuts were allowed by the government which, under the liberalisation of the tax system, abolished taxes on property (on plots smaller than five ha), property transactions, profit tax, VAT on primary supply of agricultural products and import duty on agricultural equipment.

The project "100 New Enterprises of Rural Areas" was launched in 2008 for a year. Its main objective was to target rural employment to create jobs by facilitating the establishment of rural enterprises and exports. Entrepreneurs are allowed to purchase state-owned agricultural land at preferential prices on condition that they foster infrastructure development and employment. By mid-2010, four projects had been developed for a total amount of GEL 15 million; half from domestic and half from foreign capital.

The "Cheap Credit" programme was also launched in 2008 and is supervised by the Ministry of Economy and Sustainable Development. The programme aims at enterprise development in agriculture, recycling and tourism, promoting easier access to credit at lower interest rates and long maturity terms.[14] Loans are issued on favourable conditions with grace periods, lower interest rates and longer terms. That year, 117 projects were financed by this initiative for a total of GEL 62.4 million, of which GEL 27.6 million were allocated to 37 agricultural companies (mainly in fruits and vegetables, tea, poultry and juice, nuts and grain processing, dairy and meat-collecting companies) for approximately 25 800 beneficiaries (Ministry's primary estimates). In 2009, 17 new projects were financed for a total of GEL 2.5 million, out of the allocated GEL 20 million.

A final measure was due to enter into force in 2009, following the crisis. The Agricultural Development Strategy (2009-10) was aimed at fostering food safety, modernising machinery and promoting organic farming but was not approved by the government.

Next steps in the agricultural sector are:

- Increasing effectiveness and commercialisation of the agricultural sector – the direct share of the average farming enterprises in the agricultural sector. By 2015, agriculture products' exports are to be brought up to 25% of the total and lands supplied with irrigation systems will be enlarged 2.5 times (from 130 000 to 300 000 hectares).
- More than 200 enterprises for processing agricultural products will be created – more than 10 000 people will be employed and about 100 000 persons will be involved in the process. Development of the agricultural sector will enhance successful implementation of the governmental programme "100 New Processing Plants in Rural Areas".[15]

The Georgian government has started the process of harmonising its legislation with EU food law, compatible both with the EU and the WTO, and the development of secondary legislation to ensure its enforcement and smooth operation. The "Law of Georgia on Food Safety and Quality" was adopted in December 2005. Due to the fragmented structure of the agro-food sector and the important role of household agriculture in ensuring food security, it was decided to exclude small and artisanal food-processing firms from the list of the official control of food safety due to the fragility of their business.

The implementation process of the special enforcement clause of the Laws on "Food Safety and Quality", on "Veterinary Medicine", and on "Protection of Plants against Harmful Organisms" were postponed in 2009 for a further two to seven years.

Policy recommendations

On value-added (product quality):

- Develop the production of organic products. Georgia already has a niche in the market due to a lack of chemical fertilisers.[16]
- Create agricultural R&D centres: to improve technological inputs (and thus output quality), to meet international standards for sanitary and phytosanitary measures.
- Reinforce the Ministry of Agriculture and Food's scope to provide sound economic trends of domestic and international agriculture markets.
- Create pharmaceutical alcohol out of viticulture (not only wine).

On the quantity produced:

- Diversify agriculture towards fisheries or other types of crops (fertile land where many crop species can be cultivated).

On rural employment:

- Develop agri-business.
- Develop other rural sectors.

On financing:

- Ease access to bank loans.
- Develop new means of financing through different institutions (micro-credit, stock exchange) and FDI.

Industry

General overview

The industrial sector accounted for 21.4% in 2009, down from 26.8% in 2005. Under the Soviet system, Georgia was allocated mostly the production of iron and steel and of machine tools, but also in aircraft factories and in auto plants. The sector now includes mining (minerals and water), energy (electricity), manufacturing (mineral fertilisers, cement and chemicals), food-processing, breweries and distilleries, and construction.

In 2009, industry accounted for 87.4% of total goods exports and 93.4% of total goods imports. The main imports include mineral fuels, motor cars, electrical machinery and medicaments, while the main exports are iron and steel, and processed agricultural goods.

Industry employs around 10% of registered workers, 80 710 persons in Q1 2010, but the construction and mining sectors are known to include a large share of informal employment. The sector has benefited most from reforms since 2003, mostly in the energy sector which has been growing rapidly in the last three years. However, a decline was observed even before the two crises in 2008, though they considerably accelerated the recession in industry with diminishing employment rates in the sector.

Table 3.17. Annual average number of employed in industrial sectors
(per thousand persons)

	2006	2007	2008	2009	H1 2010
Industry, total	**87 303**	**86 096**	**83 665**	**31 2678**	**166 999**
Mining and quarrying	7 865	4 447	4 260	17 375	9 524
Manufacturing	54 646	58 305	56 964	208 809	116 655
Electricity, gas, water supply	24 792	23 344	22 441	86 494	40 820

Source: Geostat, 2010.

Table 3.18. Output of products in industrial sector
(GEL million)

	2006	2007	2008	2009	H1 2010
Industry, total	**2 779.0**	**3 583.3**	**3 821.8**	**3 310.9**	**2 052.2**
Mining and quarrying	235.1	277.3	262.0	212.6	119.7
Manufacturing	1 919.1	2 532.9	2 804.5	2 333.4	1 503.4
Electricity, gas, water supply	624.8	773.1	755.3	764.9	429.1

Source: Geostat, 2010.

The main feature of the Georgian industry sector is the lack of SMEs and the extremely high share of large enterprises in total turnover and employment (*e.g.* extreme monopoly in the commodity market). Large firms have been benefiting much more from the economic development than small enterprises.

Table 3.19. Figures by size of enterprises
(2008)

	Total	Large	Medium	Small
Share of turnover of enterprises (%)	**100**	89.8	6.9	3.3
Number of employed persons	**349 250**	209 532	74 443	65 276

Source: Entrepreneurship in Georgia, Department of Statistics, 2009.

There are major business opportunities in this sector, for example in automobile plants (for motor parts), pharmaceuticals (medicaments), information technology and food-processing. Manufacturing, mining and construction provided employment to 10.5% of the total employed labour force and contributed 21.7% of GDP in 2008. Energy and agro-processing, however, represent the most important constituents of the sector.

Energy sector

The energy sector has mostly benefited from macroeconomic reforms since 2003. The sector has suffered from ageing infrastructures, disruptions in supplies and massive corruption (mostly in electricity in terms of collection and price control). Reforms resulted in better payment collection, ending electricity sector debts and diversifying supply in the gas sector. Tariffs were privatised and are managed by an independent body which has considerably lowered corruption. Liberalisation for the industrial market in the gas and electricity spheres was completed in 2006 and 2008 respectively. The Ministry of Energy is responsible only for policy making with the objectives of ensuring energy safety, supporting the construction of new power plants and renovating infrastructure systems via privatisation and reforms, diversification of energy sources, and commercialisation and promotion of the sector domestically and abroad.

Electricity

Since the country's independence electricity has been subject to blackouts and was the most corrupt sector of the economy. Privatisation and deregulation have helped to raise capital to modernise infrastructures, and improve billing and collection methods. The quality of services in the electricity sphere improved thanks to investments in the energy infrastructure and to better maintenance. Electricity, gas and water supply made up 32% (GEL 362.4 million) of total industry production in the first quarter of 2010. Since privatisation, the state function is focused on policy development and regulatory functions, while the private sector has become the operator.

Though the production, generation and distribution of electricity are privately owned,[17] the state still runs transmission lines and owns the three major generation plants: Enguri HPP, Tbilsresi TPP, and Vardnili HPPs. As a result, not only did Georgia succeed in drastically reducing corruption and stabilising a 24-hour electricity supply, but the country also exported the production surplus to neighbouring countries (Armenia, Azerbaijan, Russia and Turkey). Average consumption of electricity, from 2006 to 2009, amounted to 8.4 billion kWh of the 8.6 billion produced, of which 85% came from hydropower plants (green energy) and 15% from thermal sources. Yet, Georgia is far from full capacity as, according to the Ministry of Energy, hydropower plants have an annual potential of 15 000 MW while current production only uses 15% of these resources. Utilisation of this capacity would ensure increased exports and increased revenues for the country.

Overall, 8.3 billion kWh electricity was produced in Georgia in 2008, *i.e.* 1.3% more than in 2007. Despite the fact that electricity consumption increased more rapidly (by 3.4%) than production, the annual balance for 2008 remained positive, to a surplus of 30.9 million kWh; hydropower plants produced 5% more electricity, while thermal power plants produced 15.2% less yoy.

Table 3.20. Balance of electricity
(kWh billion)

	2007	2008	2009
Total generation	8.3	8.6	8.9
by HPP	6.9	7.3	7.7
by thermal PP	1.5	1.3	1.2
Import/export	0.2	0.3	0.5
Consumption	8.1	8.3	8.4
Transmission losses	0.2	0.2	0.2

Source: Ministry of Energy of Georgia.

Due to these increases in production, it became possible to export approximately 680 million kWh in 2008, of which 63.8% went to Russia, 31.8% to Turkey and 4.4% to Azerbaijan. Despite this consequent increase of exports, Georgia still needed to import 649 million kWh at the same time, of which 560.1 million kWh from Russia, 34.6 million kWh from Azerbaijan and 54.3 million kWh from Turkey.[18]

There will be no increase in electricity production without the construction and rehabilitation of transmission lines. Domestic, high-voltage transmission lines are already established and are linked with Azerbaijan, Russia and Turkey, which represent the most profitable export potential. New transmission lines are being built to support 400-500kV between Georgia and Turkey (to be completed in 2011), and between Georgia and Armenia to start by the end of 2010. Consequently, export capacity will significantly increase. For example, export capacity to Turkey is expected to increase annually from 700 GWh to 8 000 GWh, with further increases to 2 200 GWh to Azerbaijan, and to 1 000 GWh to Armenia.

This regional synchronisation should lead to a better coverage of the population in these countries, increasing market share and decreasing tariffs. This, in turn, could increase competitiveness and thus exports.

However, there is a major problem with electricity supply security. Indeed, the most productive hydropower plant is located in the separatist region of Abkhasia: the turbines and generators are in the conflict zone, while the dam itself is in the conflict-free territory of Georgia. Increasing the production capacity of other plants in the country should be a major focus, in order to avoid possible blackouts resulting from political uncertainties and tensions in Abkhasia.

The energy infrastructure in Georgia consists of 20 hydropower plants with a total installed capacity of 1 480 MW, worth USD 2.2 billion in investments. Two new hydropower plant construction projects started in 2009: Bakhvi (capacity of 6 MW, cost of USD 10 million), Mtkvari (capacity of 36 MW, cost of USD 60 million). In addition, four new hydropower plants will be built in coming years. Forty-six power plants are operated by foreign and domestic investors: Inter-Rao (Russia), Energo-pro (Czech Republic), EPC (China) and German, Ukrainian, Georgian companies. The distribution sphere is mainly managed by three private companies: Inter-RAO, Energo-pro and Akhema Group (Lithuania). Two companies have been operating in the transmission sphere, one owned by the state and another in a state partnership with Inter-Rao.

Oil and gas pipelines

Georgia has minimal oil and gas reserves and relies on imports mainly from Russia and an increasing share from Azerbaijan. Since 2004, state subsidies have been invested in projects aimed at the rehabilitation and modernisation of natural gas pipelines. In 2007, 40% of gas was imported from Azerbaijan and 60% from Russia. Despite the drop in international oil prices in 2008, the impact on the local fuel market was masked by monopolist importers and distributor companies who were reluctant to reflect this decrease.

In order to reduce dependence on Russian gas, an agreement was signed in December 2008 with Azerbaijan to supply Georgia for five years on the basis of a pre-defined price scheme. The August 2008 war demonstrated the need for Georgia to build underground natural gas storage. The storage can reduce the risk of interrupted supplies. An appropriate geological region has been identified in Ninotsminda where gas storage reserves will be built.

In 2008, 1.47 billion m^3 of gas was supplied to Georgia, 12.7% less than in 2007. The main reason for this decline is that cement factories decreased their consumption by 153 million m^3 – which was replaced by coal.[19]

Table 3.21. Natural gas supply to Georgia
(m^3 million)

	2007	2008	2009
Total supply of natural gas	1 683.8	1 471.0	1 184.0*

Note: *Imported.

Source: Georgian National Energy and Water Supply Regulatory Commission, 2009.

Thanks to the large-scale rehabilitation and modernisation of gas pipes, implemented by international energy companies and foreign donors, energy security in the country has improved.

Georgia became a main transit corridor for energy commodities with three main pipelines running through its territory. In 2009, crude oil transition on the territory of Georgia increased by 25%.

Box 3.1. Major pipelines in Georgia

- **Baku-Tbilisi-Ceyhan (BTC)** crude oil pipeline, from Azerbaijan to Turkey (on 249 km, out of 1 768 km), linking the Caspian and Mediterranean Seas, for a total cost of USD 4 billion. In 2009, 285.7 million barrels from Azerbaijan were transported by BTC, a yoy increase of 15%. The current capacity is 675 900 barrels of oil a day (from a total capacity of 1 million).
- **Baku-Suspsa (WREP[20]),** from Azerbaijan to West Georgia (on 375 km out of 830 km), operated by BP since 1999 and owned by Azerbaijan International Oil Consortium (AIOC). The capacity of Supsa Terminal is 220 000 barrels per day (around 80 million per year). In 2009, 31.4 million barrels were transported by WREP to Supsa Terminal, a six-fold increase yoy.
- **Baku-Tbilisi-Erzrum (BTE)** South Caucasus Gas Pipeline cost USD 1 billion and has a current capacity of 8.8 billion m^3 per year (up to 20 billion m^3 in 2012), from Azerbaijan to Georgia, Turkey and Europe. The agreement allows for transit tariffs to be replaced by Georgia's taking 5% by volume of the gas passing through the pipeline. In addition, Georgia was granted a concession to buy additional quantities up to 0.5 billion m^3 annually at an initial price of USD 55 per 1 000 m^3, rising by no more than 1.5% per year to 2030.

The **North-South** Main Gas Pipeline Rehabilitation project is financed by the US Millennium Challenge Corporation and cost USD 44.5 million. It runs entirely through Georgia for 221 km to guarantee gas supplies from Russia to Georgia and Armenia. The purpose of the project is to rehabilitate damaged sections of the pipeline (22 sections).

Other pipelines include the **Nabucco, White Stream** and **Trans-Caspian** pipelines (projects signed in 2009, to begin in 2010-11).

The revenues from pipeline transportation in 2006 were USD 89.8 million, compared to USD 38.6 million in 2005 (NBG, 2006).

In 2009, 4 787.9 million m^3 of gas was transited by SCP pipeline from Shah Deniz gas field to Turkey, 6% more than in 2008. In parallel, 2 054.3 million m^3 of natural gas was transported by North-South main pipeline to Turkey in 2009, 45% less than in 2008.

Crude oil extracted in the country in 2009 amounted to 54 000 tonnes (385 000 barrels) and has been stable since.

Manufacturing sector

General overview

Manufacturing represented 63.3% (GEL 712.1 million) of total industrial output in the first quarter of 2010 while mining and quarrying constituted some 5.0% (GEL 57.1 million). The major manufacturing sectors are food, beverage and tobacco products (44%), basic metals (24%), chemical products (9%), and transport equipment (7%).

Manufacturing

Aggressive privatisation, a significant element of the reform agenda, created favourable conditions to mitigate negative effects of the transition period on the manufacturing sector. Competitive privatisation helped to attract foreign investors. The external demand for cement, metals, fertilisers and the domestic demand for processed food, timber and building materials stimulated manufacturing growth.

Table 3.22. Turnover and production value of industry

	2008	2009	Q1-Q3 2010
Turnover (GEL million)	4 637.6	4 021.6	2 595.1
Production value (GEL million)	3 821.8	3 310.9	3 256.2
Number of employed (persons)	85 711.0	79 777.0	86 747.3

Source: Geostat 2010.

A 2009 World Bank study identified the most attractive sectors for local and foreign investors as wine, fruit and vegetables, construction materials, apparel, pharmaceutical and medical devices.[21] To promote investment, the government has implemented structural reforms in privatisation, business regulations, the finance sector, trade liberalisation, and standardisation.

Table 3.23. Investment in fixed assets in industry by economic activity
(GEL million)

	2006	2007	2008	2009
Manufacture of food products, beverages and tobacco products	97.3	172.3	105.6	95.6
Manufacture of chemical products	118.4	29.1	22.7	15.3
Manufacture of other non-metallic mineral products	14.9	75.5	145.4	57.1
Manufacture of rubber and plastic products	4.3	19.2	13.0	9.4
Manufacture of basic metals and fabricated metal products	9.3	6.7	146.7	32.1

Source: Geostat 2010.

Three free economic zones (FEZ) have been operating in Georgia since 2008. The clusters are relatively new and some parts of the projects are still under development. Full capacity should be reached in 2011-12. Enterprises in these clusters are exempt from property and profit taxes, from customs duties and VAT, and are not bound by restrictions on capital repatriation or on trade control. These clusters benefit from a central location and access to the transition countries of the EU and the CIS, with their growing market potentials (approximately 1 billion potential consumers).

Kutaisi FEZ was created in 2009 for heavy industry and household equipment. The city is located in a mountainous region, close to the Black Sea coast – accessible by river or by road. In 2009, around USD 55 million were invested in Kutaisi by the Egyptian company FRESH, with 3 000 new jobs created. A further USD 270 million and USD 217 million should be invested in 2010 and 2011 respectively to reach a total production capacity of 12 companies employing 15 000 persons.

Poti FEZ was established in 2008 by the RAK Investment Authority (RAKIA), a UAE company, for an initial investment of USD 200 million. The main activities include industry, logistics and business centres. Its employment capacity should reach 16 000 jobs. The main advantage of Poti is its direct link to the Black Sea and therefore trade with, and access to markets of, neighbouring countries.

Tbilisi FEZ is still in development and will focus on services (universities, hotels, warehouses, offices).

These clusters could be an important means to create jobs and prosperity in the country. Though the government will perceive no revenues directly from the companies, it will benefit from income taxes on employees. The FEZ are expected to create a significant amount of new jobs for nationals, which will lower the unemployment rate and increase income tax collection.

Food processing

Until 1991 the Soviet republics were importing 95% of Georgia's processed tea, 62% of its wine, and 70% of its canned goods. After the end of the USSR, these figures collapsed, turning Georgia into a net importer of agricultural products and foodstuffs.

Major imported agricultural products and foodstuffs in 2008 included: meat and meat products (12.6%), wheat (10.7%), wheat flour (8.8%), sugar (8.6%), vegetables (7.6%), and milk and milk products (6.3%). As of 2007, the country's main agricultural exports were shelled hazelnuts, distilled alcoholic beverages, non-alcoholic beverages and wine. Food products, beverages and tobacco products accounted for 44.0% of total manufacturing products in the first quarter of 2010.

Food-processing companies have been producing a wide range of products under different brand names (meat products, packaged and fresh fish, dairy products, ice cream, soft beverages, pastry and wine).Their total output in 2008 reached GEL 901.8 million, with declining volumes following the crises. Employment and output have also been gradually decreasing since 2007.

Table 3.24. Manufacture of food products, beverages and tobacco

	2006	2007	2008	2009	H1 2010
Production value (GEL million)	924.6	1 116.8	991.3	1 202.2	615.3
Number of employed	21 309	19 857	18 524	19 534	18 633
Share of selected economic activities in total industrial output (%)	33.3	31.2	25.9	31.7	30.0

Source: Geostat 2010.

The availability of capital, however, remains the key to unlocking untapped SME opportunities in the food-processing sector. High start-up costs and the lack of technical knowledge have been stalling the food-processing sector's development in Georgia. A major problem is that local knowledge of modern techniques is weak or non-existent, requiring expensive training and consultation.

Construction, real estate and infrastructure

Construction

The construction sector showed the first signs of a boom in 2005, growing by 14% annually, mostly due to two hydrocarbon pipeline projects – the BTC oil pipeline became fully operational in mid-2006 and the gas pipeline in early 2007. Growth slowed in 2006, but rebounded to 14.3% in 2007. Increased demand for housing and the development of tourism infrastructure brought an augmentation of construction activities and employment. In the same year, the construction industry contributed around 8% of GDP and employed over 4% of the country's workforce. Following the crises, construction share in GDP decreased slightly to 7.4% in 2008 and has since remained quite stable, reaching 7.1% of GDP in Q1-Q3 2010.

Table 3.25. Turnover and production value of construction

	2007	2008	2009	Q1-Q3 2010
Turnover (GEL million)	1 604.6	1 412.0	1 736.3	1 052.9
Production value (GEL million)	1 718.2	1 434.7	1 752.6	1 047.0
Value-added (GEL million)	630.6	482.3	605.2	...
Number of employed (persons)	52 572.0	38 109.0	43 452	30 756.0

Source: Geostat, 2010.

In order to simplify administrative procedures and land-use regulations for issuing construction permits, the government of Georgia implemented a comprehensive construction reform. The number of procedures required for obtaining a construction permit fell from 29 to 12 and the average time needed for obtaining permits was reduced from 285 to 113 days.[22] As a result, a large number of companies, regardless of size, expressed interest in investing in the sector.

Table 3.26. Investment in construction by size of enterprises
(GEL million)

	2006	2007	2008	2009	Q1-Q3 2010
Large companies	194.8	223.0	126.3	92.2	825.8
Medium companies	11.4	13.1	11.2	9.0	97.9
Small companies	70.4	4.3	4.7	9.4	129.2

Source: Geostat, 2010.

Real estate market

In 2000-07, the real estate market was the fastest growing market in Georgia, attractive both for investment and speculative acquisition on anticipating future price increase. High demand for commercial and residential spaces was accompanied by evolution of the development and construction companies. Prices on real property increased six-fold in 2000-08 making the sector most profitable for commercial transactions. Expectations of price acceleration attracted large numbers of local and foreign developers. Significant funds were invested in real property. Projects were financed from three sources: advanced sales, operating companies' capital and bank loans.

Following the August war and the economic crisis, sales figures plunged close to zero in autumn 2008. Demand for real property and real estate prices also decreased. While waiting for political and economic stability Georgian construction companies have started offering more flexible conditions to their customers by making special offers and discounts, and finally lowering prices in the long run. For example, secondary house prices decreased by 40% between Q4 2008 and Q1 2010 compared to their pre-crisis levels.

Table 3.27. Real estate, renting and business activity

	2007	2008	2009	Q1-Q3 2010
Turnover (GEL million)	459.7	520.3	488.1	481.6
Value-added (GEL million)	270.4	328.3	...	...
Number of employed persons	25 213	25 401	21 804	28 302
Earnings per employee in the construction sector (GEL)	615.0	655.0	716.0	758.2

Source: Geostat, 2010.

To avoid the decline of the construction sector in the post war period, the government of Georgia jointly with the Tbilisi municipality initiated the project of state support to construction companies. The municipality would warrant bank loans to private companies which, in turn, would finalise ongoing construction projects and deliver new apartments to the owners of houses in "emergency condition" (those living in decrepit houses) located in the central district of Tbilisi in lieu of the property possessed by these owners and upon their consent. At final stage the municipality sells the concerned land parcels by tender to the companies for their subsequent development or sale.

Two tranches of the project "New Life for Old Tbilisi" were financed by commercial banks with a total amount of about GEL 100 million, with the participation of dozens of development and construction companies. However, these projects are not sufficient to enable the real estate sector to overcome the crisis and restore households' confidence.

Services

The services sector has undergone rapid development since early 2004. Trade, transport, financial services and public administration accounts for around 70% of GDP and employs over one-third of the labour force. Services remain labour-intensive, however, and their share in GDP is expected to decrease as the economy progresses.

Telecommunications, real estate, restaurants and hotels benefited most from FDI inflows and accumulated high growth rates.

Tourism

Mass tourism used to be a major industry for Georgia during the Soviet period, with approximately 5 million visitors per year. Although these numbers dramatically fell from the early 1990s, they expanded more than three-fold in 2000-09, reaching nearly 1.5 million. Most tourists come from neighbouring countries – Turkey, Armenia and Azerbaijan – which accounts for over three-quarters of the total. The average length of stay is 10.5 days while average expenditure per tourist is around USD 850. The share of tourism revenues in Georgia's GDP has been stable at around 4% since 2004.

The 1.5 million visitors to Georgia in 2009 represented an increase of 16% compared to 2008. The largest share came from CIS countries – 64.3%. This growth was underpinned by the development in infrastructure (two new airports, new highways and reconstruction of existing roads, improvements in hotel infrastructure and transport facilities), changes in legislation (visa regime), security reforms (criminality decreased dramatically), and special state programmes for attracting foreign tourists (agreements with several countries were signed for co-operation in this field). Comparable to export activities, inbound tourism revenues were freed from VAT.

There are no visa requirements for the nationals of 67 countries, including Israel, Japan, Canada, the United States and European Union (EU) countries. CIS nationals do not require visas, except those from the Russian Federation and Turkmenistan, nor do passengers on cruise ships staying in Georgia for fewer than 72 hours. As a result, the number of visitors to Georgia in H1 increased by 33% compared to 2009.

The development of basic infrastructure, the improvement of energy and water supply systems and the maintenance of roads and highways had positive results for the tourism industry. Tbilisi and Batumi airports offer direct flights to 32 international destinations.

Overall, Georgia has a vast natural and cultural heritage which can position the country as an internationally competitive destination. Investment in hotels has been rapidly growing around the country. SAS Radisson, the Sheraton and two Marriott hotels provide high-class accommodation in Tbilisi, while Intercontinental, Kempinski and Hyatt are forthcoming.

In the first semester of 2010, the number of visitors was 782 932, which is 36.4% higher than in the same period in 2009.[23] In 2008, the US Trade and Development Agency assisted the government of Georgia to prepare the "National Tourism Development and Investment Plan and Strategy". This strategy aims to increase international arrivals from 1 million in 2007 to 2.5 million in 2015, to use USD 1 billion in export earnings, creating at least 114 000 jobs directly or indirectly related to tourism on the basis of a 100% increase in the amount of four and five-star accommodation available.[24]

However, a number of serious weaknesses still impact the quality of tourism in Georgia and prevent the country from becoming an international tourist destination, including the lack of cheap air services, inadequate guesthouses for foreign groups, insufficient transportation capacity, lack of information and signalling, lack of shopping opportunities and a shortage of clean and modern toilets. However, with the increased presence of international brand quality standards, the pressure is increasing on the local tourism industry to improve its service standards.

Finally, there are still high security risks in regions such as Abkhazia, South-Ossetia and the Pankisi Gorge.

Transit and transport

Georgia emerged over 1990-2010 as a strategic transit corridor for pipelines carrying Caspian oil and natural gas to world markets. This function brought a certain amount of revenue in transit fees, but the main consequence for Georgia is the guarantee of international energy supply security.

The government of Georgia has announced the priorities in the infrastructure sector to be the East-West highway from the extreme eastern border (Red Bridge) to Poti port and the Turkish Border, and the rehabilitation of selected sections of secondary and local roads. The government has committed itself to increasing funding of the road sector to stimulate the economy in the long term through improved road infrastructure and connectivity and through job creation in the short term.

According to the 2009 Activity Report of the Ministry of Regional Development and Infrastructure of Georgia, GEL 416 million was spent on road works: GEL 236.4 million on road maintenance (on 680 km), GEL 169 million on highway construction (on 48 km), GEL 108 million on existing bridge reconstruction, and GEL 10 million on new bridge building. In 2010, the Georgian government allocated GEL 696.6 million for road works.

The same report mentioned that the main priority was water infrastructure at GEL 170 million (double the 2008 amount). Basic infrastructures – roads and highways, energy systems and water supply systems – are rapidly developing and will benefit the tourism sector. The modern highway crossing the country is expected to be operational from 2012.

Donors' commitment to economic growth remains strong in view of the large export of transit services.

Table 3.28. **Donor funding for roads**
(USD million)

Donor and project title	**October 2008 - March 2009**	**March 2009 - March 2010**
WB - additional financing for second East-West highway project (Igoeti-Sveneti)	20	-
WB - additional financing for secondary and local roads	70	-
WB - third East-West highway project (Sveneti-Ruisi)	-	147
WB - Kakheti regional roads upgrading project	-	30
WB - additional financing for the first East-West highway improvement project (Rikoti Tunnel)	-	28
MCC - additional financing for Javakheti road rehabilitation project	60	-
ADB - Ajara by-pass roads	-	119
JICA - rehabilitation of the Zestaponi-Kutaisi-Samtredia section of East-West highway	-	197
TOTAL = USD 671 million	**150**	**521**

Source: World Bank.

The construction of the new railway route "Baku-Tbilisi-Kars", connecting Turkey, Georgia and Azerbaijan, was underway in 2010 and was expected to have a positive regional impact. This project will attract new freight flows from Asia, using Georgian and Turkish railway systems, and on farther to Western Europe. In its early stages, the carrying capacity of the new railway line will be 5 million tonnes per year.

Table 3.29. Turnover in transit and transport sectors
(GEL million)

	2000	2008	2009	Q1-Q3 2010
Road transport, pipeline transportation	139	631.1	569.9	512.3
Water transport	5.7	0.5	1.8	3.2
Air transport	55.7	142.6	138.7	117.1
Complementary transportation, tour-operator activities	267.6	1 045.7	1 060.1	985.7

Source: Geostat, 2010.

Georgia's two major Black Sea ports, Poti and Batumi, play a major role in regional economic development. The oil terminal of Kulevi, located to the north of Poti's port, is owned by the Azerbaijan state-owned company SOCAR. It has a capacity of 4 million tonnes of liquid cargo per year and handled 2.1 million tonnes in 2009.

In 2008, Georgian Railways transported about 19 million tonnes of freight consisting 73% of transit traffic, 19% of import traffic and 8% of export traffic. The Georgian railroad system is vital for neighbouring South Caucasus (Armenia, Azerbaijan) and Central Asian (Turkmenistan, Kazakhstan) countries, ensuring their access to Black Sea ports.

Non-oil transit in Georgia has low performance. The main factors impeding efficiency in non-oil transits for neighbouring countries are long transit times and poor road conditions. In order to eliminate these barriers and to ensure a substantial increase in transit efficiency, the government has committed itself to rehabilitating decaying physical infrastructure to take full advantage of its geographical position between the South Caucasus, Central Asia and Europe.

Banking and financial sector

In 1995, as a result of privatisation, a two-tier banking system was established in Georgia (one tier remaining with the central bank). Since then, bank consolidation and reforms have been instituted by the National Bank of Georgia (NBG) accompanied by strong capital and reporting requirements. The banking sector grew dynamically over the last 15 years to 2010. Its growth rates significantly exceeded the growth rates of other sectors in the Georgian economy.

Table 3.30. Total assets of commercial banks
(GEL million, as of December)

	1995	2000	2008	2009	2010*
Total assets	219. 7	765.2	8 331.0	8 292. 6	9 827.5

Note: *As of October 2010.

Source: NBG, 2010.

Since 1 July 2010, the banking sector in Georgia has been represented by 19 commercial banks, including 13 foreign-controlled banks and 2 branches of non-resident banks. The share of foreign capital in banks' total paid-in capital equals 78.8%.

There was a rapid expansion of the total loan portfolio between 2004 and 2007 at an average annual rate of around 57%.

Table 3.31. Total loans to the national economy
(GEL million, as of December)

	Dec 2004	Dec 2007	Dec 2008	Dec 2009	Nov 2010
Total loans	855.65	4 255.05	5 742.17	4 898.03	5 509.59

Source: NBG, 2010.

The profitability of Georgian commercial banks was high in 2004-08. The rate of return on equity (ROE) reached the level of 10-15%.

The August 2008 war significantly affected the commercial banking system and resulted in a significant withdrawal of deposits. The second big outflow of deposits happened in the first half of 2009 in a context of relative political instability in Georgia.

Table 3.32. Change in total of non-bank deposits
(GEL million)

	July 2008	April 2009
Non-bank deposits	3 543.0	2 927.0

Source: NBG, 2010.

The direct impact of the August 2008 war was an immediate mom decrease in August of 8% of banks' total assets, and a decrease of 4% to GEL 7 873 million in October following the global crisis. Overall, total assets only decreased yoy by 6% in December 2009. There was a pick-up of banks' total assets in 2010, which increased yoy by 27% in November. On the other hand, banks' total liabilities continued to increase, though at a slower rate, totalling GEL 8 375 million.

As a result of the dynamic development of the Georgian banking sector and the absence of entry barriers, the interest of foreign investors in Georgian banks has been intense. In 2006 the share of foreign investments in resident commercial banks reached 58% of total capital. By July 2010 the share of foreign capital in banks' total paid-in capital equalled 78.8% while 88% of system assets were under foreign ownership.

In 2010, the share of the five banks with the largest assets was 78.6% of the total banking sector assets, 90% of total outstanding loans and about 89% of total deposits. These banks are Bank of Georgia, TBC Bank, Société Générale, Prokredit and VTB.

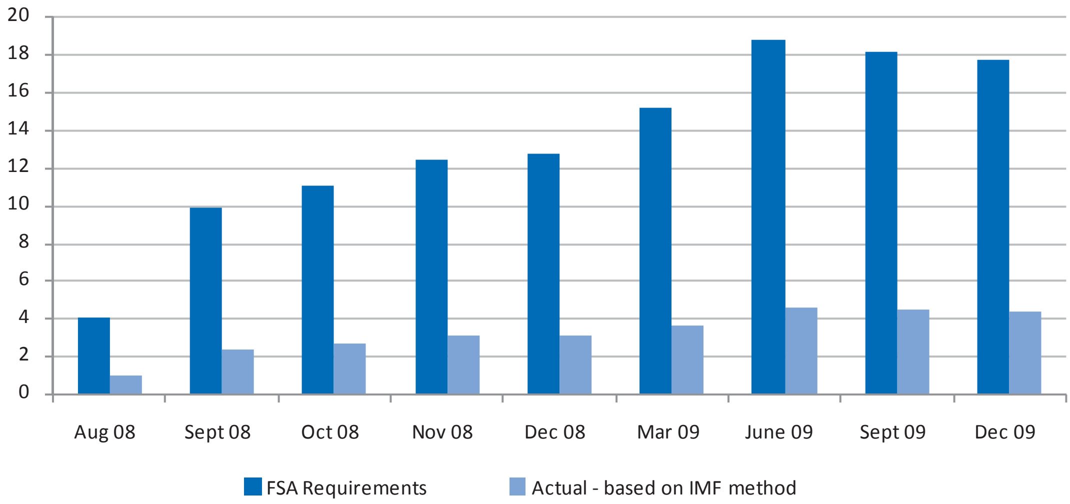
High levels of capital and liquidity and significant international assistance helped Georgian banks to survive the crisis. International aid to the banking sector since the August 2008 war amounted to more than USD 1 billion in 2010.

Georgian banks are still regulated on the basis of the Basel-I Agreement, which clearly is an outdated system in the light of the substantial changes the financial sector experienced since 1989. Only two banks are under Basel-II Agreement: Société Générale[25] and HSBC. Though Basel-II is more self-regulatory than Basel-I, it is better suited to operations of highly sophisticated first-tier banks.

However, the regulatory framework of the Georgian banking system is based on higher capital requirements, making it highly capitalised. This means that the NBG is able to decrease capital charges during a crisis as part of its counter-cyclical measures.

The main weaknesses of the banking sector remain related to a high level of dollarisation, high proportions of foreign currency deposits and loans and the narrow base of the Georgian economy.

Figure 3.8. Banking sector resilience - NPL to total loans



Note: *NPL: Non Performing Loans / FSA: Financial Services Authorities.

Source: Central Bank of Georgia.

Telecommunications

Total revenues of electronic communications services reached a total of GEL 1.32 billion, exceeding their 2007 result by GEL 199.1 million. The average monthly expenditure per capita was GEL 9.48 in 2003, GEL 21.1 in 2007 and GEL 25.0 in 2008.

The share of the electronic communications service in GDP has been increasing since 2000. It grew from 3.8% in 2001 to 7.5% in 2006. In 2007, however, its share decreased against an unprecedented GDP increase (which can be explained by the development of other sectors of the national economy) slightly increasing again in 2008.

Table 3.33. Share of communications sector's revenues in GDP

	2003	2005	2007	2008
Communications sector revenues (GEL million)	454.1	703.7	1 113.6	1 312.6
Share of communications sector revenues (% GDP)	5.1	6.1	6.5	6.9

Source: Georgian National Communications Commission.

The revenues received in absolute terms in three segments of the communications market are detailed in the table below.

Table 3.34. Development of market segments of communications service
(GEL million)

	2004	2007	2009
Fixed telephony	208.9	328.9	381.2
Mobile telephony	354.9	704.6	830.9
Broadcasting	25.9	80.1	100.5

Source: Georgian National Communications Commission.

The revenues of mobile communication companies had increased by 58% in 2003, 60% in 2005 and 65% in 2006. The number of Internet service users steadily increased since 2003. The number of ADSL users increased from 4 245 in 2004 to 15 263 in 2005 and to 41 234 in 2007, reaching 96 131 in 2008. The number of Internet consumers in 2008 exceeded 903 000.

Table 3.35. Communications sector

	2001	2005	2007	2008
Revenues (GEL million)	261.4	703.7	1 136.6	1 312.6
Subscribers of fixed communications networks (thousand)	-	544.4	556.1	618.0
Mobile network subscribers (thousand)	153.0	1 152.0	2 600.0	2 755.0

Source: Geostat 2010.

The mobile telephone industry has been growing rapidly. In 2008 three mobile telephony operators provided services for over 2.7 million subscribers up from 430 000 subscribers in 2002. The mobile market, dominated by Magticom and Geocell, is effectively a duopoly.

Georgian cellular market monopolist companies Magti and Geocell have been maintaining the service price unchanged over a recent period of 15 years (USD 0.16/minute). During the same period international cellular communications costs have been decreasing gradually.

Table 3.36. Mobile communication companies
(31 December 2009)

Company name	Number of customers	Share (%)	Income (GEL, excluding VAT)	Share (%)
Geocell	1 370 385	44.6	303 680 072	44.3
Magticom	1 347 254	43.8	328 578 387	47.9
Beeline	357 504	11.6	53 818 305	7.84
Total	**3 075 143**	**100.00**	**686 076 763**	**100.00**

Source: Georgian National Communications Commission (GNCC), 2010.

Georgia has the third highest comparative mobile communications tariffs in the world (among 186 countries) and the highest among the post-Soviet states. These figures are worked out on the cost of a special package of 2 952 minutes, 600 SMS and 12 MMS – spread among different networks and fixed lines in the same proportion. Its price in Georgia averages USD 621 compared to USD 142 in Denmark. Based on the same package, prices of cellular communication services have fallen by 21% around the world since 2000 but remained stable in Georgia.[26]

Due to restricted call duration in 2009 in Georgia, the average monthly revenue for mobile communication services fell to GEL 22 per customer instead of GEL 27 a year earlier.

MAIN MACROECONOMIC POLICIES

General overview

Georgia enjoyed high economic growth in 2004-08, attracted a significant amount of FDI and substantially improved state revenues. However, the trade deficit increased in the same period, reaching 28% of GDP in 2007, accompanied by high inflation rates, peaking at 12.2% in Q1 2008. Finally, the August 2008 war shook macroeconomic stability.

The government prepared a strategy to deal with the post-war and global financial crisis problems, which helped Georgia to minimise the negative effect of the twin crises. The following factors have contributed to achieving a smooth exit strategy from this difficult phase. First, the liberal economic policies and market reforms created an open and diversified economy. Then, unprecedented international support of USD 4.5 billion, granted in October 2008 at the Brussels Donor Conference, sustained foreign inflows to Georgia and contributed to stabilising the economy. Finally, and as a consequence of the international loans, the banking sector proved to be resilient and helped to maintain relative stability in the country.

Georgia's real GDP grew by 4.5% yoy in Q1 2010, from nominal USD 2.3 billion to USD 2.47 billion. Preliminary estimates show GDP grew by about 7% yoy in Q2 2010.[27] Growth was recorded in various sectors, especially in exports and tourism. Overall, annual GDP is expected to grow by 5.3% in 2010.

Fiscal policy

As a consequence of the twin crises in 2009, the Georgian economy contracted by 3.9% leading in turn to a 7.7% decline in tax revenues of the consolidated budget.

Table 3.37. Consolidated budget revenues in 2009-10
(GEL thousand)

	2009	**2010**	**2010/2009** (%)
Tax revenues	275 107.4	290 131.6	5.5
Personal income tax	75 496.1	73 261.9	-3.0
Profit tax	8 871.1	10 510.0	18.5
VAT	144 781.8	162 190.9	12.0
Excise tax	35 125.5	30 766.3	-12.4
Customs tax	2 998.5	4 839.5	61.4
Property tax	4 431.4	5 289.3	19.4

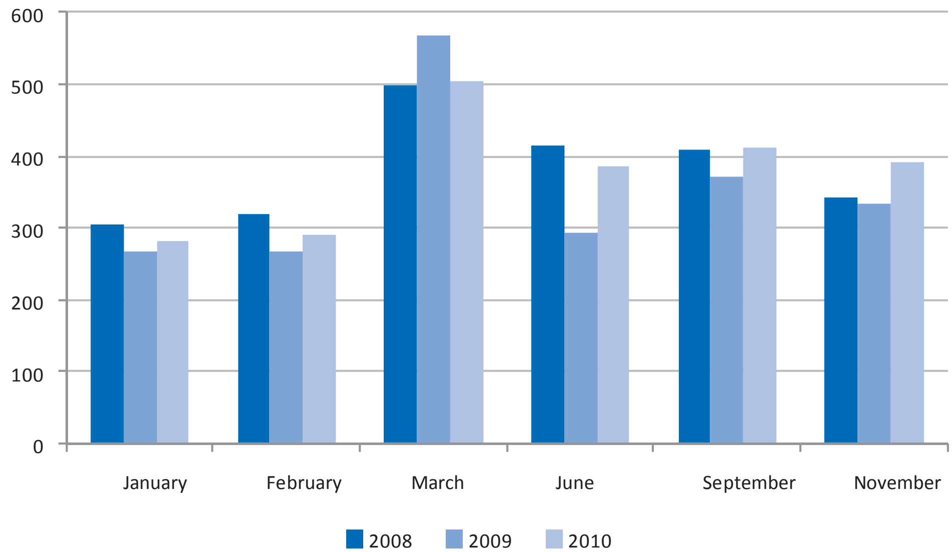
Source: Geostat, 2020.

Grants and revenues in the 2009 consolidated budget were GEL 5.3 billion, a reduction of GEL 1.3 billion over the previous year. Despite projected growth of 2%, GDP growth was -3.9% in 2009. The state budget revenues were also decreased from a projected GEL 5.5 billion to 4.9 billion.

Tax revenues were significantly increasing over 2004-07 (up to 25-40%). However, the economic crisis deeply affected the volume of tax revenues which fell by 7.7% in 2009. The consolidated budget-to-GDP ratio remained stable in 2009 and 2010, at around 35%. Tax revenues grew by 8% in 2008, while the consolidated budget revenues increased by 18% mostly due to the post-war grants received from donor countries and international financial institutions. The 2009 budget made provision for the widening of budgetary deficit to 8.8% from 6.2% of GDP. It is worth noting that deficit financing from privatisation proceeds tended downward, while foreign liabilities continued growing. Despite the decline in revenues, state budget expenditures were increased by GEL 198 million in 2009, before decreasing back to their 2008 level in 2010.

In 2009, the deficit increased to a level of 9.2% of the consolidated budget. Cutting the budget deficit will be the top item on the agenda for macroeconomic stability, as it will be bound to a maximum of 3% of GDP as of 2012 in accordance with the Act on Economic Freedom.[28]

Figure 3.9. Fiscal revenue performance
(GEL million)



Source: Ministry of Finance of Georgia.

Debt to the International Monetary Fund (IMF), the World Bank, the Asian Development Bank and Germany has been steadily increasing since 2005. In 2009, external debt, including that guaranteed by the Georgian government, increased by GEL 1.2 billion, reaching 32% of GDP. To finance the budget deficit, the Ministry of Finance issued short-term treasury bills. As a result, GEL 270 million of treasury bills were issued in 2009, raising the share of domestic debt in GDP to 9.6%. In 2009, the total state debt-to-GDP ratio reached 41.6%.

Table 3.38. State budget receipts
(GEL million)

	2007	2008	2009	2010(e)
Receipts	5 324.9	7 175.1	6 362.5	6 759.7
Revenues	4 469.1	5 517.7	4 917.0	5 118.2
Taxes	3 010.5	4 541.6	4 161.7	4 382.0
Social contributions	722.0	0.0	0.0	463.2
Grants	208.7	617.2	387.7	343.0
Other income	527.8	359.0	367.5	6 759.7
Decrease in non-financial assets	518.3	568.8	160.3	5 476.3
Decrease in financial assets	171.2	15.4	238.8	787.0
Increase in liabilities	166.2	1 073.2	1 046.4	38.9
Expenses	5 237.1	6 758.8	6 754.1	1 114.1
Change in residual (+accumulation/–use)	87.7	416.3	- 391.6	0.0

Source: Ministry of Finance of Georgia, January 2010.

The Parliament approved the 2010 state budget on 4 December 2009, which sets revenues at GEL 5.171 billion (against GEL 6.46 billion in 2009) and expenditures at GEL 5.459 billion (against GEL 6.95 billion in 2009). Amendments were endorsed on 17 June 2010 envisaging an increase of expenditures by GEL 230 million. These were made possible because of a "surplus in tax revenues" of GEL 150 million and expected grants from international organisations, mainly from the EU. As a result, the approved budget deficit decreased to 6.5% from the initial 7.3%.

Table 3.39. The 2010 budget
(GEL million)

	Q1-Q3 2010	2010 (e)
Revenue	3 906.5	5 188.2
Taxes	3 377.2	4 382.0
Grants	284.2	463.2
Other revenue	245.1	343.0
Expense	3 965.5	5 476.3
Compensation of employees	728.6	1 046.0
Use of goods and services	577.1	856.2
Interest	133.2	229.9
Subsidies	139.4	225.5
Grants	857.7	979.8
Social benefits	1 120.7	1 488.2
Other expenses	408.8	650.8
Net operating balance	-59.0	-
Net acquisition of non-financial assets	509.3	-
Net lending (+) / borrowing (-)	-568.3	-
Net incurrence of liabilities	891.8	-

Source: Ministry of Finance of Georgia.

The draft budget 2011 was presented to the Parliament on 12 November 2010. According to the EIU, state revenues have been projected at GEL 5.9 billion against GEL 5.8 billion for expenditures. Key spending priorities have been set in health care, social benefits, education, infrastructure, communications, free economic zones and privitisation.

Taxation

According to the 2005 Tax Code, there are only six taxes, including five state taxes (personal income tax, corporate income tax, customs tax, value-added tax (VAT) and excise tax) and one local tax (property tax).

Table 3.40. Main taxes
(GEL million)

	2009	Q1-Q3 2010
Total taxes	**4 161.7**	**3 377.2**
Income, profits and capital gains tax	1 570.9	1 248.7
Goods and services	2 494.9	2 030.3
Trade and transactions	35.9	52.6
Other taxes	60.0	45.6

Source: Ministry of Finance of Georgia.

In 2007, important changes were made to the Tax Code with the social tax being replaced by a unified income tax and the profit tax rate reduced from 20% to 15%. In addition, significant procedural and institutional reforms were carried out; a simplified system of tax disputes discussion was established to increase investment interest in the country. Only companies producing taxable supplies exceeding GEL 100 000 within a 12 month period have to register for tax.

The bulk of this tax reform was mainly the improvement in tax administration alongside the state's political will to tackle systemic corruption, as it was impeding the tax collection process.

In January 2010, VAT revenue, which normally is highly sensitive to GDP growth, grew by 12%, while overall tax revenue collection was up by 5%. The turnover figures of VAT registered companies showed positive signs in Q4 2009 and January 2010. Turnover increased by 1.5% in Q4 2009. In December, the turnover growth accelerated to 2.7%.

The Parliament of Georgia adopted on 17 September 2010 a new tax code which will come into force at the end of January 2011. This is the second attempt in a decade to modernise the tax code, changing current norms which have been in force since 2005.

The new Tax Code, implemented on 1 January 2011, aims at creating favourable conditions for SMEs by facilitating the administrative burden and reducing taxes. It introduced a new specification of businesses in Georgia - micro, small, medium and large - with micro-businesses (companies with annual returns below GEL 30 000 and no employees) enjoying tax exemption (including income tax).

However, the new tax code keeps unchanged most tax rates, abolishing the Customs Code and transferring its provisions into the Tax Code. Rates of customs tariffs remain between 5% and 12%, but 0% customs duty, applied to some category of goods since September 2006, is no longer envisaged. A tax ombudsman position has finally been opened to present to the parliament annual reports on taxpayers' rights.

Monetary policy

Recent developments

The deterioration of the economic situation in 2008 was due to falling remittances and construction, blockage of the bank-lending process and the collapse in exports, worsening the balance of payment indicators.

Table 3.41. Monetary effects of the crisis

Year	2007	2008	2009	H1 2010
Current account balance (USD billion)	-2.0	-2.9	-1.2	-0.5
Current transfer balance (USD billion)	0.7	1.1	1.0	0.5
Consumer Price Index (%)	9.25	10.05	1.7	5.1
Exchange rate GEL/USD	0.58	0.67	0.58	0.6

Source: NBG.

Inflation and prices

The National Bank of Georgia initiated an inflation-targeting monetary policy and determined a mid-term inflation target. In 2009, the consumer price index inflation rate was set at 9%. In Georgia, the short-term interest rate is the main instrument of inflation-targeting monetary policy which is specifically presented by a one-week refinancing rate. Short-term monetary market changes are reflected in longer maturity monetary interest rates, which affect the bank lending rate. An increase in interest on the bank's loan reduces aggregate demand while interest-rate cuts stimulate demand. However, the interest rate transmission mechanism is inefficient due to insufficient development of the lari money market in Georgia. In 2009, the NBG continued its monetary policy by means of quantitative regulation of monetary aggregates.

Table 3.42. Annual inflation
(percentage)

	2003	2007	2008	2009	2010
Inflation	4.8	9.2	10	1.7	7.1

Source: NBG.

Annual growth rates of consumer prices slowed down to 5.5% between November and December 2008. In 2009, inflation did not pick up. According to the National Statistics Office of Georgia, consumer prices grew by 2.3% by end-June 2009, while the average annual inflation rate was 5.4%. Overall, inflation was considerably lower than the 2009 target which was expected at 9% (NBG, 2009). Large demand contraction led to lower prices, hence orienting monetary policy towards economic stimulation.

For 2010-12, the Central Bank of Georgia had set the average annual inflation target at 6%. However, in 2010, annual inflation picked up to 7.1% (a yoy increase of 11.2% in December). Between January and October, CPI had already grown by 6.3% on average and PPI, in Q3 2010, by 12.2% yoy.

Money supply

The monetary base was GEL 1 874.9 million in 2009. Reserve money contracted by 7.8% in 2008 following the two crises. From January 2009, reserve money trends resumed, exceeding 20% annual growth at the end of year. The accumulation of liquid funds on commercial bank's accounts and an increase in cash volumes in circulation were proof of monetary base expansion. An increase in national currency deposits induced growth of M2 broad money of GEL 130 million. M2 expanded overall by 14.9% in 2009 totalling GEL 2 139.4 million. M3 increased to GEL 4 656.8 million, an annual growth of 8.2%. Foreign currency-denominated deposits grew by 3.1% that year totalling GEL 2 470.1 million. In November 2010, monetary aggregates were higher than in 2009, M3 having increased by 26%, to GEL 5 856.3 million.

Table 3.43. Monetary aggregates figures
(GEL thousand, as of December)

	2007	2008	2009	2010 (Nov)
M3	4 027.5	4 305.2	4 656.8	5 856.3
M2	2 149.3	1 862.5	2 139.5	2 615.9
M1	1 846.6	1 625.3	1 859.3	2 233.8

Source: NBG.

Regulation of the monetary mass is handled by the NBG through the refinancing loans for commercial banks. By means of refinancing loans, a reliable and low-risk source of short-term liquidity became available to commercial banks, positively affecting the money market and financial stability. Following the crises, banks' participation in the refinancing auctions was intensified. As a result, in 2009 the turnover of refinanced loans increased to GEL 1 093.7 million (NBG, 2009).

Exchange rate

The August 2008 war and the economic crisis had a deeply negative impact on exchange-rate dynamics. On 6 November 2008, the GEL/USD exchange rate at the Tbilisi Interbank Foreign Exchange (TIBFEX) was 1.44. The next day, it fell to 1.49 GEL/USD; this led to some confusion and intensive operations at foreign exchange bureaux. Ultimately the exchange rate stabilised at USD 1.65 on 10 November. From August to November 2008 the NBG's TIBFEX interventions were aimed at maintaining the stability of the GEL exchange rate against the USD.

Table 3.44. Exchange rate dynamics
(as of 31 December)

	2007	2008	2009	2010
GEL/USD	1.67	1.49	1.67	1.78
GEL/EURO	2.29	2.19	2.33	2.37

Source: NBG.

Domestic currency appreciated prior to the August 2008 war due to increasing capital inflows. FDI dramatically decreased after the war, affecting the currency trend and leading the lari to depreciate against the backdrop of excessive demand for foreign currency. In order to avoid sharp movement of the lari exchange rate versus the US dollar and negative economic consequences due to unfounded market turmoil, the NBG practically pegged the lari to the US dollar.

The NBG's foreign exchange policy aims to avoid sensitive short-term fluctuations. The Tbilisi Interbank Foreign Exchange was abolished in March 2009. The introduction of the NBG's FX auctions in May 2009 essentially decreased the Central Bank's role in the foreign exchange market. The NBG's net sales during 2009 in the FX auctions totalled USD 188.5 million. The equivalent of GEL 50 million was supplied to commercial banks by FX swaps issued by the NBG. The average exchange rate depreciated 12% in 2009, from 1.49 to 1.67.

Downward pressure on the lari picked up in Q2 2010 when the USD/GEL depreciated to 1.89 in June, notably due to a widening trade balance. The National Bank of Georgia therefore raised the refinancing rate to 7.50% in October 2010 (by 250 basis points in January-October) to prevent further depreciation. As a result, the lari slightly appreciated to 1.76 in December, leading to an annual average of 1.78 in 2010. Preliminary results for January 2011 show the lari's stability.

External sector

Foreign trade in Georgia grew in 2003-08. Following the two crises, both imports and exports fell drastically on both a quarterly and annual basis. External trade turnover contracted in 2009 by 29.3% to USD 5 513.3 million, out of which goods and services exports reached only USD 1 135.0 million and imports USD 4 378.3 million. As a result, the trade deficit fell by 32.5% in 2009 compared to 2008, to USD 3 243.4 million.

Exports

In 2009, the main destinations of Georgian exports were Turkey, Azerbaijan, Canada, Armenia, Ukraine, Bulgaria and the Russian Federation. These trading partners accounted for 76.6% of total exports. Some changes had taken place as compared to 2008, with Ukraine downgrading from the third to the fifth position because of a sharp decline (37.4%) in Georgian exports and Armenia moving up from the fifth to the fourth position, despite a drop in exports to this country of 27.9%.

The export commodity structure also changed significantly in 2009. Walnuts joined the top seven groups of export commodities and significant growth (3.5%) was seen in the share of unprocessed gold taking the second place in the list. The share of ferroalloys decreased by 5.7% and copper ore and concentrates moved down from the third to the fifth position. In 2009, ferroalloys were exported to Turkey and the United States. The share of black metal scrap in total exports diminished by 3% compared to 2008. Turkey remained the main partner importing 86.8% of black metal scrap.

Starting from Q4 2008, new export items included live sheep and bovine animals. In 2009, annual exports of sheep were worth USD 17.0 million, whereas in Q4 2009 alone it had increased by 11.9 times yoy, to USD 12.7 million. The sheep were mainly exported to Saudi Arabia. Exports of bovine animals in 2009 amounted to USD 16.9 million.

Table 3.45. Georgian goods exports

SITC Rev3 (2009)	Trade value (USD 1 000)	Share (%)
Food & live animals	138 112.1	12.2
Beverages & tobacco	30 881.5	2.7
Mineral fuels	101 020.9	8.9
Chemicals	939.7	0.1
Textile	57.9	-
Iron & steel	0.4	-
Machinery & transport equipment	350 539.5	31.0
Clothing	20 901.6	1.8
Footwear	8 275.5	0.7
Commodities and transactions not classified elsewhere in SITC	9 858.3	0.9
Total of above	**660 587.5**	**58.4**
Total of all exports	1 130 555.4	100
Other categories of exports	469 967.8	41.6

Source: Geostat, WITS.

Imports

The major trading partners in imports were Turkey, Ukraine, Azerbaijan, Germany, the Russian Federation, the United States, China, Bulgaria, Italy, and Romania, accounting for 67.8% of total imports. The reason for the decrease in volume of imports in 2009 was the decline in the economic activity and a notable decrease in state expenditure. The volume of imports shrank in each of the largest commodity categories. Significant changes were observed in the structure of imports with the share of motor vehicles plummeting by 5.4%. TV and radio equipment imports almost halved. An increase, however, was seen in the shares of oil products, wheat and pharmaceuticals. The largest suppliers of oil and oil products in 2009 were Azerbaijan, Romania and Bulgaria with respective shares in total imports of 41.1%, 17.8% and 9.5%. Motor vehicle imports declined by 2.8% in 2009 and were mainly imported from the United States (31.9%), Germany, (23.5%) and Japan (19.9%). Turkey remains the largest supplier overall to Georgia, despite a notable share decrease in 2009.

Table 3.46. Georgian goods imports, 2009

SITC Revision 3 (2009)	Trade value (USD 1 000)	Share (%)
Food & live animals	176 389.3	4.0
Beverages & tobacco	390 562.9	8.9
Mineral fuels	499 892.5	11.4
Chemicals	35 935.5	0.8
Textile	1 658.3	-
Iron & steel	174.8	-
Machinery & transport equipment	556 138.8	12.7
Clothing	372 984.3	8.5
Footwear	297 579.8	6.8
Commodities and transactions not classified elsewhere in SITC	169 902.6	3.9
Total of above	**2 501 218.9**	**57.24**
Total of all imports	4 369 496.5	100.0
Other categories of imports	1 868 277.5	42.8

Source: Geostat, WITS.

Balance of payments

In 2009, the current account deficit reached its lowest level since 2000. Both exports and imports contracted, but imports dropped more than exports. Both the balances of service trade and of income were negative, at USD 331.9 million and USD 158.4 respectively in 2009. Current transfers are the largest positive component of the current account covering 40% of the trade deficit in 2009.

Georgia's positive balance of service used to counterbalance the negative trade balance. Service exports increased by 15.2% in 2008, against imports by 32.7%. Transportation was about half of the service trade in 2008, with a share of 48.7% of exports and 51.9% of imports. In 2009, transportation service exports amounted to USD 613.6 million and imports to USD 507.3 million (30.8% increase).

Pipelines had the highest share in transportation service exports in 2008 of 43.8% (USD 268.8 million). Railway transportation incomes increased by 8.8% in 2009 but sea service exports decreased by 23.0% yoy. Imports of motor vehicles recorded the highest growth rate (33.9%) in 2009.

In 2008, the balance of services was USD 22.8 million but decreased to USD -28.1 million. In Q1 2010 the trend reversed and the balance rose to USD 87.4 million.

The capital and financial account was positive in 2009 at USD 957.06 million but was still 55.8% less than in 2008. FDI decreased by 51.2% in 2009 while the balance of direct investments came to USD 659.46 million that same year. As of 31 December 2009, external debt increased by USD 233.9 million to USD 8 631.9 million, while the international reserves rose by USD 615.9 million to USD 2 110.4 million.

Table 3.47. Balance of payments
(USD million)

Balance of payments	2006	2007	2008	2009	Q1-Q3 2010
Current account	-1 256.6	-2 122.9	-3 234.6	-1 366.6	-833.3
Goods and services (balance)	-1 861.6	-2 734.7	-3 812.2	-2 067.2	-1 423.3
Goods (balance)	-2 019.4	-2 895.8	-3 833.2	-2 399.6	-1 807.0
Services (balance)	157.8	161.2	21.0	331.9	383.7
Income (balance)	162.4	36.3	-160.5	-158.4	-108.2
Current transfers (balance)	442.6	575.6	738.2	951.6	698.2
Capital and financial account	1 651.5	2 352.7	2 164.4	1 261.5	336.3
Capital account	169.0	127.9	112.3	180.4	120.8
Financial account	1 482.6	2 224.8	2 052.2	834.4	215.4
Direct investment	1 185.9	1 673.9	1 494.1	764.6	428.0
Portfolio investment	140.3	21.0	118.8	4.8	253.2
Other investment	156.3	528.9	431.5	928.9	-466.0
Reserves assets	-438.6	-377.0	-130.7	-616.4	-38.2
Net errors and omissions	-64.6	-35.1	-36.2	50.8	-3.5

Source: National Bank of Georgia.

In Q1-Q3 2010, the current account deficit decreased by 9% yoy and is expected to be about 12.6% of GDP annually. The financial account decreased yoy by 58%, to USD 215.42 million, showing that investments continued to fly the country. In Q1-Q3 2010, FDI totalled USD 428.8 million, an 8.3% yoy decrease. Reserves increased yoy by 61% in Q1-Q3 2010 (by USD 190 million).

MILLENNIUM DEVELOPMENT GOALS

Georgia was one of the signatories of the UN Millennium Declaration, on 8 September 2000, in New York, alongside 146 other nations. A General Commission was established by presidential decree on 26 August 2003. It is headed by the State Minister. Accordingly, Georgia agreed to adopt measures aimed at improving the situation in poverty reduction, education quality, sustainable environment development, maternal health and child care, gender equality, and HIV/AIDS reduction by 2015.

Table 3.48. Progress towards achieving the Millennium Development Goals in Georgia

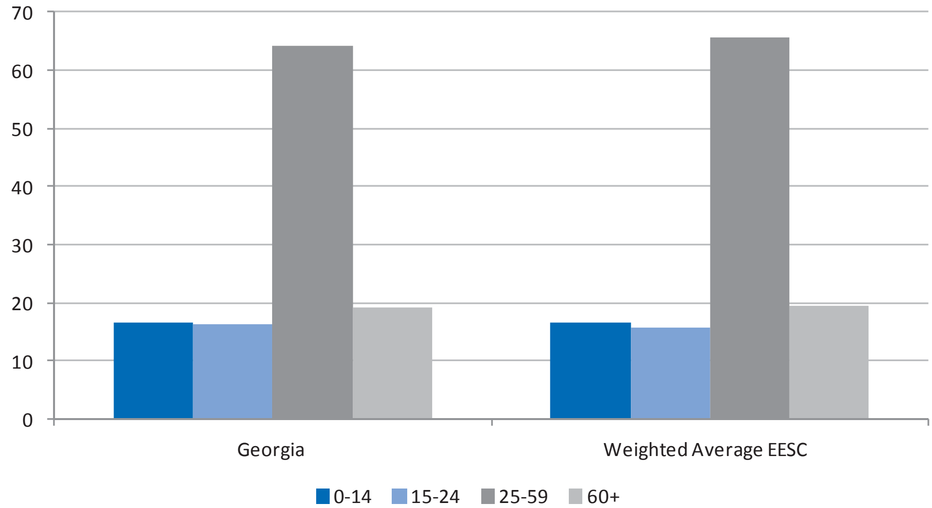
Goal 1	**Eradicate extreme poverty and hunger**					
Objective:	Baseline		Current data		Target	
Halve the proportion of people living under the poverty line and of those suffering from hunger	Year	Value	Year	Value	Year	Value
Proportion of population living below poverty line	2000	51.8	2003	54.5	2015	20-25
Prevalence of underweight children (under-5)	2002	21.0	2006	12.0	2015	11.0
Goal 2	**Achieve universal primary education**					
Objective:	Baseline		Current data		Target	
Improve the quality of universal primary education	Year	Value	Year	Value	Year	Value
Net primary enrolment ratio (%)	2004	91.4	2008	98.7	2015	100.0
Persistence to grade 5, total (% of cohort)	2004	88.1	2008	95.1	2015	100.0
Goal 3	**Promote gender equality and empower women**					
Objective:	Baseline		Current data		Target	
Eliminate gender disparity in all levels of education	Year	Value	Year	Value	Year	Value
Female primary ratio (% male ratio)	2000	98.7	2008	95.8	2015	-
Female secondary ratio (%male ratio)	2000	95.7	2008	119.2	2015	-
Goal 4	**Reduce child mortality**					
Objective:	Baseline		Current data		Target	
Reduce by 2/3 under-5 mortality rates	Year	Value	Year	Value	Year	Value
Under-5 mortality rate (per 1 000)	2000	34.8	2008	29.7	2015	11.6
Proportion of infants immunised against measles (% of children of 12-23 months)	2000	73.0	2008	96.0	2015	100.0
Goal 5	**Improve maternal health**					
Objective:	Baseline		Current data		Target	
Reduce maternal mortality by 3/4	Year	Value	Year	Value	Year	Value
Maternal mortality ratio (per 1 000 births)	2000	47.1	2003	51.2	2015	11.8
Births attended by skilled health staff (% of total)	2000	95.7	2005	98.3	2015	100.0
Goal 6	**Combat diseases**					
Objective:	Baseline		Current data		Target	
Halt and reverse spread of HIV/AIDS and tuberculosis	Year	Value	Year	Value	Year	Value
Tuberculosis incidence (per 100 000 people)	2000	106.6	2008	106.6	2015	53.3
Prevalence of HIV, total (% of population ages 15-49)	2000	0.1	2008	0.1	2015	53.3
Goal 7	**Ensure environmental sustainability**					
Objective:	Baseline		Current data		Target	
Halve the proportion of people without access to safe water	Year	Value	Year	Value	Year	Value
Access to improved safe water (%)	2000	87.0	2006	99.0	2015	100.0

Source: Tabled by authors (WDI, Geostat).

Basic indicators

Georgia had a population of 4.4 million in 2010, excluding Abkhazia and South Ossetia according to Geostat. This figure has been stable since 2000, mitigating migration trends. Georgia's age structure is similar to the average of the EESC countries, though with a slightly older population.

Figure 3.10. Age-population distribution comparison



Source: World Bank (2009).

The youth population (0-24) declined by nearly 11% over the decade 2000-10, from 1.64 million to 1.46 million, mostly due to the nearly 20% drop of the 0-14 age group. Consequently, median age increased to 37.8 years in 2010 (from 35.7 five years earlier). Average life expectancy at birth was estimated at 76.7 years in 2009, with a seven-year difference between women (80.4) and men (73.4).

Table 3.49. Life expectancy at birth
(years)

	2000	2004	2008	2009
Both sexes	71.3	71.6	74.2	73.6
Males	67.5	67.8	69.3	69.2
Females	75	75.1	79.0	77.7

Sources: Geostat, 2010.

Goal 1: Reduce poverty

Despite increasing per capita GDP since 2000, higher wealth disparity restrained the impact of growth on the population. However, at the same time the poor experienced an increase in their monetary purchasing power. For the poorest 30% of the population non-monetary income substantially improved including access to electricity, natural gas, safe water, health and higher education.

Table 3.50. Poverty level
(percentage)

	2004	2007	2008	2009
With respect to 60% of the median consumption	24.6	21.3	22.1	21.0
With respect to 40% of the median consumption	10.9	9.2	9.5	8.8

Source: Geostat 2010.

The subsistence minimum in Georgia was well below the average income in 2009 for both average consumers and households while it was above the income of the average consumer in 2004. However, the subsistence minimum for an average family increased by half from 2004 to 2010, to GEL 213.9. Poverty followed a similar trend. In 2007 the incidence of poverty in Georgia was 23.6%, while the indicator of extreme poverty was 9.3% (World Bank, 2009). Yet, poverty remains a major issue in Georgia, both in rural and urban areas.

Target: Achieve full and productive employment and decent work for all

Employment is a major issue in Georgia. Following the crises, the unemployment rate reached 16.4% in 2009. In order to respond to the problem, the government tried to minimise jobs in the informal sector and promote job creation in the formal sector by adopting a new Labour Code in 2006 (in compliance with International Labour Organization (ILO) standards). However, the economic crisis put an end to GDP growth, and therefore to employment patterns.

Table 3.51. Unemployment
(percentage)

	2000	2009
Unemployment	10.3	16.4

Sources: IMF and Statistical Office of Georgia.

Table 3.52. Distribution of population aged 15 and above by economic status and age groups (2009)

	15-19	20-24	25-29
Active population (labour force), total (thousand)	36.0	166.5	191.8
Employed (thousand)	24.0	100.1	134.5
Unemployed (thousand)	12.0	66.4	57.3
Population outside labour force (thousand)	212.7	132.3	71.5
Unemployment rate (%)	33.4	39.9	29.9
Economic activity rate (%)	14.5	55.7	72.8
Employment rate (%)	9.6	33.5	51.1

Source: Geostat, 2010.

In 2009 youth unemployment was significantly higher than the average rate: among the age groups 20-24 and 25-29, the rate is more than twice the national average, while the older age groups (50-54, 55-59 and 60-64) have unemployment rates below the national average (12.1%, 10.4% and 6.4% respectively).

The flows of migrants from Georgia are mainly directed towards the Russian Federation, the United States, Greece, Germany, Turkey, Austria, France and Spain. The 2002 Census shows that since the 1989 Census, Georgia lost almost 20% of its population to emigration. The number of migrants/people in the diaspora reached 1 024 598 in 2005 with 22.9% of the total population (World Bank, 2008).

Immigrants to Georgia come mainly from the Russian Federation, Ukraine, China and Turkey. The majority of temporary residence permits are granted for the purpose of employment, mainly to Turkish and Chinese applicants, whereas permanent residence permits are granted mostly for family reasons, with the majority of applicants from the Russian Federation.

Table 3.53. Net migration
(thousand)

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
-35.2	-32.6	-27.8	-27.5	5.5	76.3	-12.1	-20.7	-10.2	34.2

Source: Geostat, 2010.

Target: Eradicate extreme poverty and hunger

The World Bank estimated that around 30% of the total population was living with less than USD 2 a day in 2005 and as much as 54.5% of the population was living on the national poverty line in 2003 (17.1% even under the extreme poverty line). In the Republic of Georgia, the poverty line equals the subsistence minimum, down to GEL 112.9 in H1 2010. Though there is no big difference in figures between rural and urban poverty, the overall situation in Abkhazia and South Ossetia is worrying.

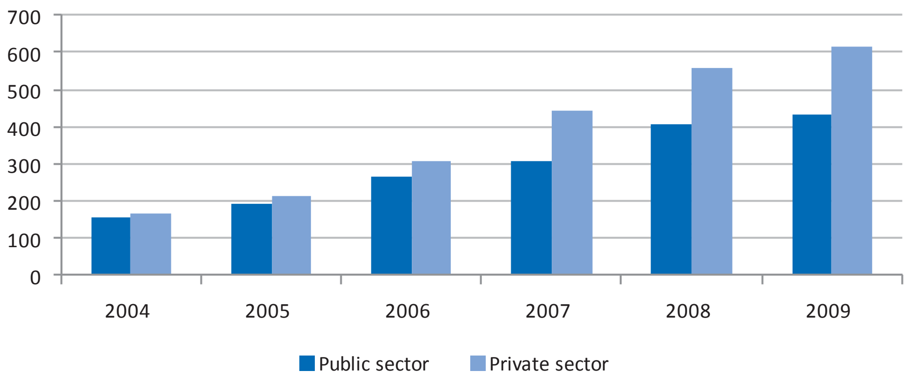
Table 3.54. Poverty indicators by urban and rural areas
(percentage)

	2007		2008		2009	
	Urban	Rural	Urban	Rural	Urban	Rural
Poverty incidence						
With respect to 60% of median consumption	17.9	24.9	18	26.2	17.6	24.3
With respect to 40% of median consumption	6.5	12.1	7	11.9	7.3	10.2
Poverty depth						
With respect to 60% of median consumption	5	8.8	5.3	8.7	5.4	7.8
With respect to 40% of median consumption	1.6	4	1.8	3.6	2	3.2
Poverty severity						
With respect to 60% of median consumption	3	4.9	2.3	4.2	2.5	3.7
With respect to 40% of median consumption	0.6	1.9	0.7	1.7	0.9	1.5

Source: Geostat, 2010.

Job losses following the economic crisis are likely to increase poverty at least until economic recovery, and so is the issue of displaced people due to the August 2008 war. However, poverty conditions are to be attributed to governmental policies. Had these crises not taken place, the United Nations (UN) had already forecast in 2004 an upward trend of poverty, under the socio-economic conditions at the time; even forecasting 69% of the population falling under the poverty line and 29% under the extreme poverty line in 2015. Despite strong increases in GDP per capita and monthly salaries, it is quite unlikely that Georgia will meet its target of reducing the proportion living under the extreme poverty line to 4%.

Figure 3.11. Monthly salary of employed in state and non-state enterprises
(GEL)



Source: Geostat.

On the other hand, Georgia is likely to reach its hunger target as undernourishment has been decreasing since independence (from 2.5 million people in 1990 to 0.6 million in 2006, less than 13% of the total population, according to the Food and Agriculture Organization (FAO)). In 2010, the average share of food in total consumption expenditure equalled around 50%, higher in rural households (around 70%) than in urban ones. Efforts have also been made on malnutrition which concerns less than 2% of under-5 children.[29] Moreover, with recent developments in the agricultural sector, and in imports, food security is forecast to be completed by 2011-12.

In total, about 300 000 persons were displaced in Georgia due to violent conflicts in the early 1990s. According to the latest statistics, Georgia currently hosts 228 142 internally displaced persons (IDPs) from Abkhazia and the Tskhinvali region.

In August 2008, following the war with the Russian Federation, the number of IDPs in Georgia increased by some 26 000.

Some IDPs are accommodated at premises of compact settlement or collective centres, whereas others have found shelter individually. Approximately 45% of IDPs live in collective centres, and the other 55% with host families or in rented or purchased flats. Living conditions at the majority of collective centres are difficult. IDP families living in the private sector face similar difficulties.

The government of Georgia pays particular attention to the socio-economic conditions of these IDPs, concentrating on two main issues:

- creation of conditions for dignified and safe return of IDPs to their currently occupied properties; and
- integration of the displaced population.

The improvement of living conditions of IDPs depends upon access to adequate social services, first of all in the spheres of health care and education.

Goal 2: Increase access to quality life-long education

The reforms undertaken in the education system in 2004-07 aimed at eliminating rampant corruption and implementing conceptual and structural changes in line with the principles of the Bologna Process.

The reform agenda implied the following activities:

- new legislation on higher education (2003), general education (2004) and vocational education (2007);
- reform of the financing and the governance of the education institutions by introducing the per capita financing principle (with money following the student) in general and higher education; also planned for Vocational education and training (VET);
- introduction of unified entrance examinations across a range of subjects, administered by the new National Examination Centre, for the first time in 2005 and 2006; and
- introduction of a three-cycle degree system and a European credit transfer system (ECTS) in line with the principles of the Bologna Process.

Target: Complete full primary education

Achieving full universal primary education is not a problem in Georgia. Having inherited full education from the Soviet Union, the education rate is very high. However, the quality of the education system is under severe falling trends due to absence of national standards, weak links between vocational education and job skills, and lack of financing. The total number of pupils has decreased since 2000 by 73 400 pupils to 643 300 in 2008/2009. Overall drop-out rates are significantly different, depending on sources used. According to UN data, these rates have been severely increasing, from 0.6% in 1999 to 14.3% in 2004, with a higher rate for males (17.0% in 2004). However, according to Geostat, the total drop-out rate for 2005 reached only 7.5%; a yoy fall of about a half, which cannot be realistic. According to the same national source, drop-out rates further decreased to 5.4% in 2009/2010.

Table 3.55. Main education data

	2000	2008
Pre-primary enrolment rate gross (%)	37	62.5
Primary enrolment rate gross (%)	97.2	107.4
Drop-out rate*	5.1	5.4
Primary education students to teacher ratio (%)	16.8	8.7
Continuation to secondary education (%)	98.1	99.4
Secondary enrolment rate gross (%)	78.6	90.0
Secondary education students to teacher ratio (%)	7.5	7.5
Tertiary enrolment rate gross (%)	38.0	34.3

Note: *Geostat.

Source: WB, WDI 2010 (2009 data not available on WDI or on Geostat before publishing, November 2010.

The VET system is administered by The Ministry of Education and Science (MES), with the assistance of several state agencies, which deal with accreditation, curriculum and teachers' development. The youth VET sector reform launched in 2005 has already undergone three phases. Up to 2007 the MES invested in VET infrastructure and prepared for the opening of the National Professional Agency (NPA) foreseen in the new VET legislation.

Table 3.56. Spending on vocational education
(GEL thousand)

	2005	2006	2007	2008	2009	2010 (e)
MES budget	80 947	358 165	410 829	458.337	519.364	550 000
Vocational education and training support programme	1 547	1 717	5 846	8 413	9 800	9 000
President's national programme"Rehabilitation of vocational schools"	-	3 999	6 754	688	0	2 500
LEPL – National Professional Agency	-	-	0	535	0	0
Secondary vocational schools support programme	2 152	2 063	0	0	0	0
Total expenditure on VET	3 699	7 779	12 600	9 636	9 800	11 500

Source: Matching vocational education in Georgia with labour market needs, GTZ 2010.

In 2008, attempts were made to privatise the VET infrastructure. Later, the ministry concentrated on development systems to finalise the VET strategy elaboration and strengthen the relations with donors. The European Union and bilateral donors have been providing assistance to the Georgian government aiming at modernising the VET system. Directors of the VET centres have participated in training and study tours abroad. Special training courses were organised for faculty and administrative staff in teaching methodologies and career counselling. The new VET strategy sets clear targets regarding investment in VET infrastructure and the strengthening of a group of 25 VET centres that will also act as resource centres.

However, enrolments at VET programmes are very low in Georgia. In 2007, enrolment declined compared with previous years, as the reformed programmes started. In 2007/08 approximately 6 200 students were admitted and only 5 050 in 2008/09 (ETF, 2010). Currently, the VET system cannot satisfy the considerable demand existing in the different sectors of the economy. There are no VET programmes delivered in the gas, electricity, mining and processing, rail and logistics sectors, though demand is high. There is also a high demand for industrial skills: mechanical, electrical and welding.

At the same time, a large and growing proportion of young people after secondary school remains outside viable further education and training because of a decrease in the service capacities of higher education institutions.

Table 3.57. Enrolment in the educational institutions

	2005	2006	2007	2008	2009
Enrolment in general education schools (thousand)	634.7	636.0	614.7	643.3	624.5
Enrolment in higher education institutions (thousand)	144.3	140.8	112.1	93.6	102.7
Number of post-graduate students (persons)	1112	496	786	1588	2986

Source: Geostat, 2010.

The Ministry of Education and Science has introduced special authorisation procedures which will reduce the number of higher education institutions in the near future.

Goal 3: Ensure gender equality

Targets have been established to promote gender equality and empower women, ensuring gender equality in the employment sphere throughout the country and equal accessibility for females and males at all management levels.

The following targets were established by the Presidential Decree of 26 August 2003:

- gender equality in employment (labour market profile in the prism of gender parameters; comparison between males' and females' average wages);
- equal access for women and men to basic, vocational, higher and continuous education; and
- equal access in the political domain and all levels of management.

Labour market analysis reveals positive trends in terms of improvement in the employment status of women. However female achievement figures are still lagging behind males' performance. In 2008 employed women only accounted for 39.0% of the economically active population. Some 30% of women in the total female employed population above 15 years of age are contractually employed. The remaining 70% are self-employed or non-identified workers. Most self-employed women work on family farms or in businesses for no remuneration. Employment opportunities are legally equal. However, women have limited access to managerial positions both in the public and private sectors and their remuneration is usually lower.

Table 3.58. Average monthly nominal salary of employees by economic activity and gender
(GEL)

	2009		
	Total		
		Female	Male
Agriculture, hunting & forestry	264.0	251.9	268.8
Fishing	257.2	194.4	268.6
Mining & quarrying	677.7	393.3	722.2
Manufacturing	447.9	332.0	507.6
Electricity, gas & water supply	766.8	724.6	786.7
Construction	626.1	453.7	637.9
Wholesale & retail trade; repair of motor vehicles, motorcycles & persona & household goods	517.7	407.5	603.5
Hotels & restaurants	364.7	307.2	459.7
Transport & communications	729.3	610.3	765.1
Financial intermediation	1 319.0	1 023.7	1 748.6
Real estate, renting & business activities	640.3	478.2	730.7
Public administration & defence; compulsory social security	888.8	816.0	909.3
Education	269.3	255.9	320.2
Health & social work	366.7	317.2	552.9
Other community, social & personal service activities	411.1	357.6	465.3
Average	569.8	461.6	649.8

Source: Geostat, 2010.

The share of women in paid employment outside the agricultural sector has been increasing, though employment opportunities for women still remain low.

Table 3.59. Distribution by economic status and gender of population aged above 15 years old
(thousands, 2009)

	Female	Male
Active population	920.5	1071.3
Employed	778.6	877.6
Unemployed	141.9	193.7
Population outside labour force	774.4	364.9
Unemployment rate (%)	15.4	18.1
Economic activity rate (%)	54.3	74.6
Employment rate (%)	45.9	61.1

Source: Geostat, 2010.

There is no gender disparity in the education system in Georgia with an even ratio of girls to boys in gross enrolment, girls staying longer in the system than boys.

Health issues

The health system in Georgia has shown an improvement in overall performance since 2000. Specifically, in health insurance coverage and primary health care, the country is on the way to implementing significant reforms to attain national objectives.

Main indicators

The crude death rate remains slightly higher than the average of the EESC countries, though increasing from 10.3 per thousand in 2000 to 12.0 in 2008. At the same time, the birth rate remained stable at 12.1 per thousand. The main cause of death is from respiratory diseases (up to 38.5% of the total in 2009), such as chronic obstructive pulmonary disease, pleurisy, lung cancer and pneumonia.

Table 3.60. Major causes of death
(percentage change between 2000 and 2009)

Tumours	-56.0
Respiratory organ failure	-66.0
Accidents, poisoning and traumas	-53.0

Source: Ministry of Labour, Health and Social Affairs of Georgia.

Goal 4: Reduce under-5 mortality rate by two-thirds

Data concerning child mortality are worrying. According to the World Bank, the infant mortality rate (per 1 000 live births) is high, though declining by nearly 14% to 26.5 per thousand in 2008, down from 30.7 per thousand in 2000. The under-5 mortality rate follows the same trend, with a decline from 34.8 per thousand in 2000 to 29.7 per thousand in 2008.

Table 3.61. Under-5 figures

	2000	2005	2008	2009
Measles immunisation (% of children aged 12-23 months)	80	84	96	83
Infant mortality rate (per 1 000 live births)	31	28	27	26
Under-5 mortality rate (per 1 000)	35	32	30	29

Source: World Bank, WDI 2010.

Measles immunisation covered 96% of infants between 12 and 23 months in 2008. The causes are therefore to be found outside immunisation issues, for example in post-natal care, maternal health during pregnancy, lack of appropriate monitoring of children (with no accurate statistics) and a lack of medical skill concerning infant issues.

Reducing the under-5 mortality rate to around 11.5 per thousand in 2015 seems unrealistic.

Goal 5: Reduce maternal mortality ratio by three-quarters

Table 3.62. Maternal mortality figures

	2000	2005	2008
Births attended by skilled health staff (% of total)	99.0	98.3	…
Fertility rate, total (births per woman)	1.6	1.6	1.6
Adolescent fertility rate (per 1 000 women 15-19 years old)	55.0	47.0	44.0
Maternal mortality ratio (per 100 000)	50.0	52.0	48.0

Source: World Bank, WDI 2010.

The adolescent fertility rate has declined, from 55 per thousand in 2000 to around 44 per thousand in 2008. However, the number of registered abortions increased since 2000 to 24 300 per year in 2009. Important bleeding risks are linked to this practice and can partly explain the high maternal mortality rate (48 per 100 000 in 2008). Despite the high level of births attended by skilled staff (around 99%), bleeding is still common during birth with severe infections from the medical equipment used.

Medical resources should therefore be used for maternal health monitoring in order to further decrease the mortality rate. These measures can include better health protection covering maternity expenses to the poor and women in rural areas who, due to lack of money, still often give birth at home, without the necessary medical care.

Goal 6: Slow down and reverse the spread of HIV/AIDS and other respiratory diseases

Table 3.63. Main HIV/AIDS and respiratory casualties

	2000	2005	2009
Total number of registered patients (persons)	186	880	2236
Total number of HIV/AIDS linked deaths (persons)	28	191	494
Tuberculosis case detection rate, all forms (%)	86.9	83.3	96.1
Tuberculosis treatment success rate (% of registered cases)	62.7	67.6	75.5

Source: Geostat 2010, WB WDI 2010.

Spread of HIV

HIV incidence is very low in Georgia, compared to Ukraine, for example. Only 0.04% of the population was infected in 2009, according to national statistics. However, the number of infected people has significantly increased since 2000. While HIV only concerned 186 registered patients in 2000, it increased to 2 236 in 2009 (eight-fold increase), indicating poor HIV/AIDS prevention.

The number of deaths also increased but significantly slower than the contamination rate, from 28 patients in 2000 to 494 in 2009.

Life expectancy overall has improved, though diseases such as respiratory illnesses, digestive and cardiovascular diseases have remained the most significant causes of morbidity and mortality.

Table 3.64. Morbidity by main disease groups
(thousand)

	2000	2004	2008	2009
Diseases of the respiratory system	150.6	235.5	299.8	447.5
Diseases of the digestive organs	28.0	42.0	92.4	166.0
Diseases of the circulatory system	44.5	70.7	74.4	96.0
Diseases of the urogenital system	21.2	31.6	48.3	64.7

Source: Geostat, 2010.

The reported rate of morbidity due to respiratory disease has almost tripled from 150 600 in 2000 to 447 500 in 2009. The rate of diseases of the digestive organs increased five-fold, between 2000 and 2010 while the rate of diseases of the circulatory system doubled in the same period. Neoplasm remains the second leading cause of mortality and has not improved since 2001.

Main health reforms

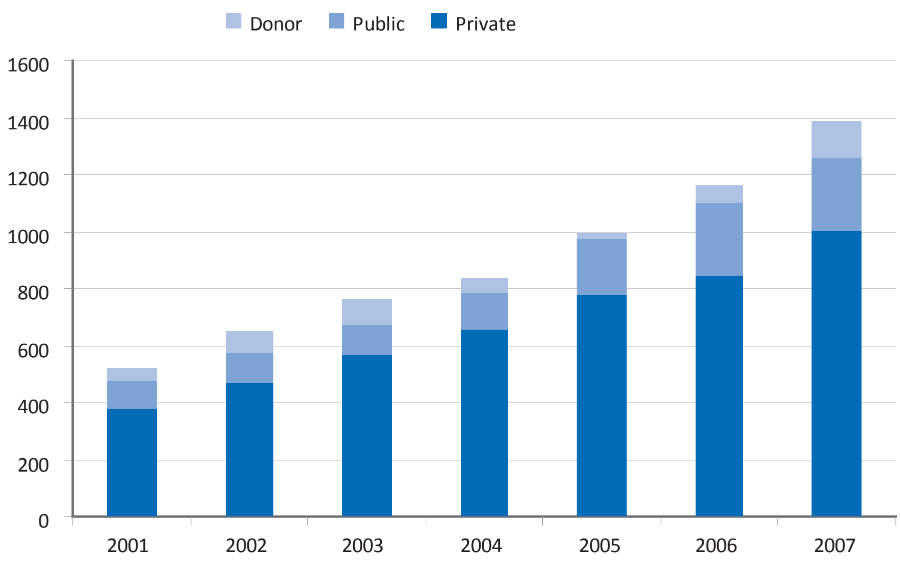
Three strategic objectives were proclaimed by the Ministry of Health, Labour and Social Affairs (MoLSHA), as part of the framework of the Programme of the Government of Georgia 2008-12, "Georgia without poverty", in order to strengthen the health sector:

- increase the well-being of the population through developing a more efficient social security network and improving the health of the nation;
- ensure national security through minimising public health problems and threats and through creating a healthy environment and postgraduate medical education sector; and
- strengthen the capacity of MoLSHA and affiliated agencies to achieve better efficiency, effectiveness and responsiveness to the challenges related to access to quality health services by the Georgian population.

Nine major principles of sector reform were also drawn up by MoLSHA in close collaboration with the major health system stakeholders: improving health system stewardship; improving the health information system; ensuring efficient allocation of health system resources; improving the efficiency and effectiveness of health services; improving financial, geographical and informational accessibility of the health system; improving equity and financial protection in the health system; improving health promotion, healthy behaviour, prevention, monitoring and detection.

The national health system is financed through state budget revenues with targeted benefits for the poor and relatively limited coverage for the rest of the population. A considerable share of public resources (including a health programme for the poor) is contracted out to private insurance providers.

Figure 3.12. Health revenues by source
(GEL thousand)



Source: National health accounts.

According to the new master plan adopted by the government in 2007, a private primary health-care system is based on insurance. The state aims at funding the full package of primary health-care (PHC) services for social groups living below the poverty line. In 2007, a pilot programme was implemented, subsidising health insurance for people below the poverty level. It included all types of services, PHC as well as hospital, but did not cover expenses for pharmaceuticals (OXFAM, 2009). In 2009, the government introduced an insurance package for the whole population, called the "cheap insurance scheme".

However, contradictions remain and private health insurance still faces significant challenges in dealing with the most important problem of how to ensure universal access to private health insurance services. Priority problems to be addressed immediately by the government are as follows:

- to ensure universal access to services within the private health insurance context;
- to provide access to health care for people who cannot afford private insurance: people officially registered as being under the poverty line; those who are officially registered but not covered yet by the state-funded private insurance programme; and those who are not registered but cannot afford to buy private insurance; and
- to ensure access for all with at least a basic benefit package, which should include essential medicines (OXFAM, 2009).

Another important element of the reform is the hospital-sector transformation. The government approved the complete substitution of the hospital infrastructure for new hospitals in which ownership would be transferred from the state to the private sector under the conditions that the state receives no financial revenues from the privatisation of hospitals and that the private capital has to be reinvested by the new owners into the development of privatised hospital infrastructures. Investors are obliged to keep the profile for at least seven years.

However, due to investors' delay in the schedule there is scepticism with regard to the soundness of the programme.

Georgian health system priorities are:

- to ensure the quality of health services by creating and enforcing the necessary regulatory environment;
- to ensure the accessibility of quality medical services by the continuous development of medical infrastructure and competent human resources;
- to ensure the overall affordability of basic health services and protect the general population from catastrophic financial health risks; and
- to increase health system efficiency by capacity building in the ministry and its subordinate institutions and through the introduction of sound managerial principles.

Goal 7: Ensure sustainable environment development

The Georgian National Environment Action Plan adopted in 2000 sets out nine priorities: water supply and pollution; air pollution; resource use; waste and chemicals management; land resources; protection of the Black Sea; forests and forestry; global environmental problems; and problems in the state system for environment and nature use management. A National Environmental Health Action Plan was approved in 2003 and selected municipalities are elaborating local environment action plans.

Georgia has adopted some sector- and issue-specific legislation such as on air quality, waste management, water quality, soils, nature protection and chemicals. Georgia has participated in the Danube-Black Sea Task Force. It has ratified several international and regional environment conventions to which it is party, and has in particular acceded to the Kyoto Protocol on climate change. Georgia has signed, but not yet ratified, the Strategic Environmental Impact Assessment Protocol of the Espoo Convention on Environmental Impact Assessment. Sector-specific programmes have been prepared including on integrated coastal zone management, forest management, water management and environmental impact assessment.

According to the government's strategic document of Basic Data and Directions in 2009-12 the main activities to be undertaken are:

- switching to a new system of pool management of water resources;
- development of environment protection;
- development of environment monitoring and forecast system.

The Ministry of Environmental Protection and Nature Resources drew up concrete measures for addressing various problems within these activities and prioritised the forecasting and prevention of natural disasters at the state level. Perfection of the system of Environment Monitoring and Forecasting has also been added to the priorities of the ministry.

Target: Ensure environmental sustainability

Despite the positive legislation, law enforcement mechanisms and popular awareness are lacking. It is highly unlikely that Georgia will meet this target by 2015 due to the increase of all pollutant components since 2000.

The Environment Impact Assessments (EIA) is the major tool for biodiversity protection and sustainable use of its components according to the Convention on Biological Diversity and to the Ramsar Conventions. The EIA system operating in Georgia does not meet these requirements. The EIA legislation falls short of ensuring the avoidance of harmful impacts of industrial projects on biodiversity. No legal procedures are available for implementation; the procedures for approval of management plans of protected areas, forestry and hunting farms either do not exist at all or need to be improved. Unfortunately, due to weakness and/or absence of legal procedures, the ministries often fail to make decisions or the decisions are inefficient.

During the establishment of protected areas, traditional land-use patterns are ignored hence creating enormous problems for the protected areas. For example, the oil wells, located in the Sagarejo district, appeared within the Tbilisi National Park. The visitors' zone of the same park appeared to be crossed by the Tbilisi bypass railway project route. As a result, the territory of the park was split. Inclusion of agricultural plots, pastures and firewood production areas inside the protected areas created a number of problems for the protected areas and discredited the goals (and environmental ideas) of their establishment to a certain extent (Green Alternative, 2010).

Table 3.65. Environmental data
(thousand tonnes)

	2000	2006	2008
Harmful substances, total	28.7	57.3	114.0
Solid	9.2	34.5	91.4
Gas and liquid	15.5	22.8	22.6
Sulphur anhydride	0.4	0.9	0.9
Carbon	3.7	12.1	11.1
Nitrous oxides	4.1	2.8	4.6
Hydrocarbon	8.1	6.6	4.5
Other	3.2	0.1	1.7

Source: Geostat, 2010.

Areas of high conservation value were severely affected by the August 2008 war and biodiversity of global significance was put at risk, which negatively affected the environmental climate in Georgia. In the Borjomi Gorge of central Georgia, which includes the Borjomi-Kharagauli National Park,[30] hundreds of hectares of unique forests were burned. The Russian military attacks in western Georgia, which resulted in blasting and sinking Georgian vessels in the Georgian Black Sea port of Poti, caused spillage of large amounts of hydrocarbons and hydraulic oil from the vessels. This caused pollution of the Black Sea and, consequently, negatively impacted the Kolkheti National Park and the wetlands protected by the Ramsar Convention.

Target: Halve the proportion of people without sustainable access to safe drinking water

Despite rich water deposits, Georgia is still experiencing difficulties in supplying the population with safe drinking water in rural areas. In 2010, the number of households and organisations with direct access to drinkable water were 237 174 and 6 808 respectively.[31] The Tbilisi water supply system provides a daily supply of water equal to 800 litres per capita per day.

Underground water deposits remain the main source of drinking water, providing 90% of the water supply system. The aged water supply infrastructure is in poor condition; consequently the leakage of water is huge. Loss is estimated at around 75%, with no rehabilitation investments made since the systems were constructed in the 1960s and 1970s (ADB, 2010b).

Sewage is discharged into water channels and rivers, hence affecting drinking water quality. Poor social groups suffer from a shortage of regular water supplies, poor water quality, sewage pollution, and poor urban environmental sanitation. The basins of rivers Alazani, Inguri, Kura and Rioni are affected by sewage ejections from towns, out of which 344.1 million m^3 (67%) is discharged by communal sector while the industrial sector accounts for 173.4 million m^3 (33%).[32]

In 2009, the government consolidated 66 water companies into three regional water companies - East, West and Ajara (for the Autonomous Region). Since 1996, international donors invested approximately USD 350 million in water supply and sewage systems. Funds were channelled through the Municipal Development Fund with on-lending to local governments, except in Batumi where the German development co-operation through KfW is developing infrastructure directly through the local government.

Regulation of water supply and sewage is maintained by the Georgian National Energy and Water Regulatory Commission (GNEWSRC) which plans to develop a legal and regulatory framework and tariff fixation methodology. In order to achieve transparent and accountable regulation of the services, the Water Law adopted in 1997 needs to be aligned with the reform agenda.

PRIVATE SECTOR DEVELOPMENT

Georgia experienced an average annual GDP growth of 7.1% over 1998-2008 which dropped to -4.0% in 2009 as a result of the crisis (IMF, 2010). According to IMF forecasts, GDP growth of 2.0% and 4.0% is expected for 2010 and 2011, respectively. The economy today is relatively diversified and has moved towards higher value-added sectors. Georgia is still dealing with post-war issues that demand considerable government funds, for example, aiding internally displaced people. Enhancing competitiveness in Georgia calls for policies that foster the stability of the economy and recovery of investor confidence.

The private sector is a source of knowledge, skills and resources, and a key engine of growth for industrial development. In this context, the role played by micro, small and medium-sized enterprises, which, on average, account for over 90% of enterprises in the world and contribute to 50-60% of employment in developing countries, is particularly important (WBCSD, 2007). Efforts to foster private sector growth should focus on improving the business environment for SMEs by providing a regulatory framework that enhances entrepreneurship through better policy design, including improving business regulation, strengthening the education system and providing access to finance for SMEs that would attract new firms as well as increase the share of employment and contribution to GDP in the private sector.

The methodology applied in this section is based on the OECD Policies for Competitiveness Framework (PFC) which has been developed as an assessment tool based on the Policy Framework for Investment (PFI). This tool takes a horizontal approach, looking systematically at key policy dimensions affecting the business climate to identify and analyse key constraints in the ability of firms to produce, invest and grow. Apart from giving a general introduction to the business environment, three key dimensions are featured in this section covering skills development, access to finance and investment framework conditions affecting SME growth.

General overview

In Georgia, the private sector accounts for 75% of GDP and is among the highest in the region (EBRD, 2010). The share of private sector employment in 2006 was 79.4%, compared to approximately 74% in 2000. According to National Statistics Office data, small and medium-sized enterprises contribute 42% of GDP and 40% of employment. These figures underestimate the real contribution of SMEs to GDP, as the informal sector remains large, around 62.1% according to Schneider (2010), and among the highest in the EESC region.

Georgia has opened up to trade and foreign investors and its recent economic reforms on anti-corruption, social welfare, business environment and fiscal management have been internationally praised, raising Georgia to 12th place in the World Bank's *Doing Business 2011* report (World Bank, 2010). Areas that need further improvement are mainly related to access to credit and protecting investors. To support private sector development, specific challenges remain in skills development, access to finance and the investment framework for SME growth.

One of the key obstacles to business growth in Georgia is the difficulty in accessing qualified personnel in line with labour market requirements. According to the OECD PFC assessment, improvements have been made in the implementation of systems for vocational education and training. However, there is a need for a national strategy in the area of workforce skills development as well as a comprehensive system of continuing education and training.

Significant challenges remain for SMEs in accessing finance to start a business or to expand business activities. According to the OECD PFC assessment, there is a lack of innovative financing mechanisms through credit guarantee schemes or venture capital, as businesses in Georgia still heavily rely on family capital and retained earnings as the primary source of financing due to high collateral requirements and expensive bank financing.

To further build a supportive environment in which SMEs can benefit from increasing internationalisation, Georgia will also need to unlock the full potential of investment opportunities across sectors and industries. In the past, Georgia benefited from significant FDI inflows stemming from privatisation. However, the challenge will be to create new greenfield investment opportunities to keep the level of FDI inflows stable. To support local economic development, Georgia should consider developing specific mechanisms such as linkage programmes that help SMEs benefit from foreign investor presence through enhanced participation in local and regional value chains.

The increasing role of the private sector

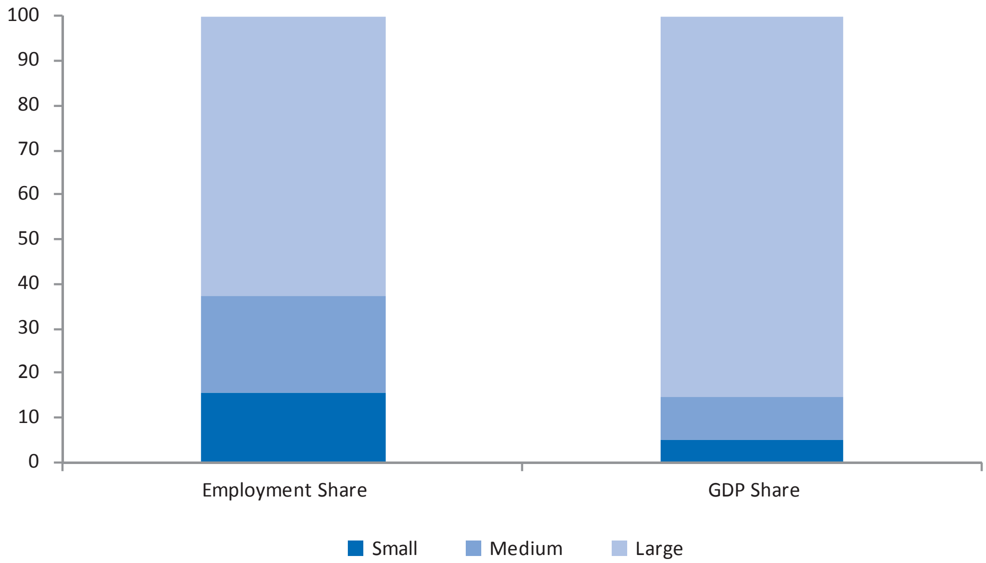
In Georgia, large-scale privatisation was launched in 1993, attracting private capital and introducing efficient management structures in former state-owned companies. In the early stages of the campaign, almost all SMEs were privatised. Later on, all sectors of the economy were opened for privatisation, which has taken a solid track starting from 2005. Between 2005 and 2008, the government received more than USD 1.4 billion in revenues from privatisation in telecommunications, energy (hydropower generation plants and energy distribution companies), large-scale real estate assets and, more recently, hospitals. In 2006 and 2007, income from privatisation was one of the main sources of budget financing, which was 17% and 15% of budget spending respectively. The 2008 proceeds from privatisation exceeded USD 420 million, which was 10% of total state budget expenditures (NBG, 2009). A gradual decline continued in 2009 hence the proceeds from privatisation will no longer represent the main source of financing of the budgetary expenses.

The private sector share in GDP rose from 65% in 2003 to 75% in 2010 and is among the highest in the region. The private sector accounted for 80% of employment in 2008 and has become increasingly important over the past years (EBRD, 2010). According to the National Statistics Office of Georgia, the total number of registered enterprises almost quadrupled from 84 239 entities at the beginning of 2003 to 324 917 entities in July 2010. The exact share of SMEs in the private sector is difficult to assess as many micro and small enterprises operate in the informal economy.

Small and medium-sized enterprises are defined in the Law of Georgia on "Small and Medium Enterprise Support" of July 1999 based on the number of employees and annual turnover: an enterprise is considered small if it has up to 20 employees and an annual turnover below GEL 500 000. A medium-sized enterprise can have up to 100 employees with an annual turnover below GEL 1.5 million. All firms beyond that definition are considered large enterprises.

According to official figures, small and medium-sized enterprises of up to 100 employees accounted for less than 42% of total employment and 19% of GDP. This is relatively low in international comparison, indicating that there is a large informal sector but also that SMEs still face significant barriers to enter the market. Out of the total figure of registered businesses, individual enterprises account for the major share of 68% (220 344 entities)[33] which shows that SMEs are the main driver of entrepreneurial activity in Georgia. Most SMEs are active in trade and repair, processing, hotels and restaurants, real estate, and transport and telecommunications (USAID, 2005).

Figure 3.13. Structural indicators of the private sector in Georgia in 2008
(percentage)



Source: National Statistics Office of Georgia.

Business environment

Georgia has significantly improved the business environment by introducing stronger market-oriented reforms and promoting privatisation. Particular efforts were made to fight corruption and improve stability and governance. As a result, Georgia was ranked 12th in the World Bank's *Doing Business 2011* report. As Georgia's ranking improved from 112th position in 2005 to 15th in 2008, the World Bank proclaimed Georgia as Europe and Central Asia's top *Doing Business* reformer in its 2009 report; a position kept by Georgia in 2010 and 2011.

According to *Doing Business 2011* Georgia is ranked second best worldwide in registering property, seventh in dealing with construction licences and eighth in starting a business. Georgia was ranked ninth in employing workers in *Doing Business 2010*, an indicator which is no longer covered by the report. While flexible labour market policies can help stimulate economic growth in good times it should be noted that there is an increased risk of poverty through unemployment in times of economic downturns creating a significant social challenge for Georgia. Georgia's ranking increased significantly by 15 positions in "getting credit" (15th position) and also in "protecting investors" (from 41st to 20th position). Georgia still ranks low in the areas of "closing a business" (105th) and "paying taxes" (61st), even though significant progress has been made in the latter (up from 112th in 2009).

According to BEEPS 2009 (EBRD/WB, 2009) the top six constraints faced by companies in doing business were related to electricity shortage, access to finance, tax rates, crime and theft, skills and education of workers and access to land. Power cuts in 42% of firms led to average losses of 5% of total annual sales and 64% of firms reported tax rates as a problem, while only 39% identified the tax administration in general as a constraint. More importantly, half of the companies indicated skills and education of available workers as a problem but only 19% of companies offer formal training to unskilled workers. Access to finance is a problem for 62% of companies, mainly due to unfavourable interest rates and collateral requirements. These barriers have to be further addressed by the Government of Georgia.

The Entrepreneur Service Centre was established in the Ministry of Economic Development of Georgia in December 2009 in order to promote a "one–stop shop principle". A Department on Export Promotion in the same ministry was also established. With the aim of enhancing co-operation between Georgia and foreign businesses, the Georgian National Investment Agency (GNIA) organised several business forums in different European countries. GNIA is also implementing several projects which aim at supporting SMEs and business development. A public discussion on SME development in Georgia was held in July 2009 and a "Wider Small Business Forum" took place in September 2009. Also, a draft law on supporting SME development in Georgia was forwarded to the Parliament. In addition, in October 2009, an Inter-organisational Small Business Committee was established.

In order to improve the business operating environment for SMEs, Georgia needs to usher in better policies addressing key areas that limit the competitiveness of SMEs. Obstacles, including access to finance and skills gaps, need to be tackled in the framework of state support of the SME sector.

Human capital development

Strengthening skills development has been identified as one of the key contributors to competitiveness. The positive correlation between human capital and productivity has become increasingly important in the globalised world. Razzak and Timmins (2008) report a strong positive relation between the increase of university-qualified workers and the levels of labour productivity as measured by GDP per person. It is believed that natural resources, cost competition and strategic alliances do not alone suffice for achieving sustainable development (Memon *et al.*, 2009).

Enhancing competitiveness in Georgia will require a greater commitment to invest in human capital and introduce reforms which will ensure that the educational system produces skills that match the demand of the labour market and further support private sector development. Five areas have been selected for an in-depth evaluation of the education system including:

- strategy formulation;
- inputs to initial education;
- vocational education and training (VET);
- continuing education and training (CET);
- human capital outcomes.

In Georgia, two areas have been identified as being particularly important to support private sector development in the country: a national strategy in the area of workforce skills development and the development of a system of continuing education and training.

Since 2004, the education achievement profile of the population aged over six years has changed through a significant increase in the category of those with higher education, accompanied by a reduction of those with vocational education. Nevertheless, the quality of education remains low, ranking 119th out of 139 assessed countries according to the World Economic Forum Global Competitiveness Report 2010. In the *TIMSS 2007*, Georgia ranked below the international average in both mathematics and science (IEA 2007).

Between 2003 and 2007, Georgia underwent an extensive series of reforms in the educational system, focusing on the synchronisation of the educational system to international standards,[34] improving the quality of education and rehabilitation and modernising educational structures. Furthermore, per capita financing was introduced in both general and higher education systems. All these reforms may be viewed as the components of a more extensive strategy of workforce skills development.

In 2006, a National Curriculum and Assessment Centre (NCAC) was established by the Ministry of Education and Science of Georgia. NCAC aims to improve the quality of education by developing and approving national curricula and drafting national assessments of the quality of education. The new programmes are developed by NCAC in co-operation with Georgian teachers and consultancy groups (however, it is not clear who is included in these consultancy groups).[35] Implementation of these programmes is complemented by teacher training and experience-sharing groups.

The accreditation of higher education led to a sharp drop in available study places in the relatively few accredited universities. The number of private universities has expanded, as private institutions are believed to provide better education than the public ones and they now represent 68% of higher education institutions. A survey among university graduates revealed that 86% of students from the five biggest private universities were able to find a job immediately after graduation, while in the public sector the highest number was 26% for the Faculty of Communications from the Tbilisi State

University (Hörner *et al*., 2007). However, annual tuition fees are almost twice as high in private universities (USD 2 095 in private universities, compared to USD 1 346 in public universities in 2009).

Co-operation between higher education institutions and businesses is weak. Any initiative comes mainly from non-governmental organisations (NGOs), development centres and the educational institutions themselves. The government is not participating in the consultation process, even though the Ministry of Education is the body responsible for drafting curricula and developing textbooks. The universities hold meetings with employers and present their programmes. Some of them (11%) also conduct labour surveys to identify the demand for graduate studies. However, only 10% of universities collaborate with businesses in developing their curricula (Hörner *et al.*, 2007).

Vocational education and training (VET) in Georgia is working quite well; however it is concentrated in several areas such as construction, textiles, office skills and hospitality, while evidence shows that there is mainly a demand for specialists in the chemical/pharmaceutical industry, electricity production and delivery, water and sewage works (GTZ, 2010). Agriculture, construction and tourism gained increased attention between 2004 and 2008. Many VET institutions are created based on co-operation with businesses and are even incorporated into factories.[36] A draft law on the creation of Technoparks in the framework of the Technical University would cover 80% of its existing departments. It will offer students the opportunity to gain practical experience through a job that gives them a better understanding of the skills required in the labour market. This project, however, is yet to be implemented.

Despite its large share of employment, the agricultural sector does not employ many skilled technicians but rather serves as a substitute for those lacking employment alternatives. Accordingly, labour productivity is relatively low and would need to be increased in order to support economic growth and development. In tourism, Georgia faces significant challenges in satisfying the demand for trained personnel in hotel and restaurant management, which limits the prospects for developing the sector. To boost the growth of the tourism sector, the Ministry of Education and Science is working out a VET concept on how to match labour market requirements with a skilled workforce.

Beyond VET systems, Georgia will need to further improve continuing education and training systems. So far, eight universities in Georgia offer special training programmes for the business sector, but a nation-wide strategy on work-related education and training would allow workers to improve their qualifications or switch profession in response to changing labour market requirements.

Access to finance

Access to finance is one of the critical issues for enhancing a country's competitiveness. At any stage of business development, businesses face a number of financial constraints. While there is a general recognition in Georgia that the availability of adequate financing is crucial for SME growth and development, SME financing mechanisms are mostly limited to traditional tools of debt and equity financing which, however, are difficult for SMEs to access due to high interest rates and collateral requirements.

According to an OECD assessment, limited domestic credit to the private sector, an underdeveloped capital market and a lack of early-stage financing are perceived as the main obstacles to business growth from an access to finance perspective. As a consequence, SMEs heavily rely on family or individual capital as their primary source of funds due to the inability to obtain affordable financing from banks, microfinance institutions, leasing companies and other institutions that provide loans or credit. Georgian banks, as in most former Soviet Union countries, tend to deal only with large clients who have a proven credit history.

Despite an expansion of uncollateralised loans to commercial banks, the banking system did not manage to improve lending rates and bank credit to the private sector, which dropped by almost 12% in 2009 (ADB, 2010a). In fact, with an average interest spread of 10.9% in 2008 and a request for collateral requirements around 185% of the loan value, SMEs mainly rely on the owners' capital and on retained earnings (EBRD/World Bank, 2009). The arrival of foreign banks in the system led to increased competition and improved the range of financial services offered by banks, including some micro lending activities to SMEs. Nevertheless, access to credit is still perceived by the private sector as one of the most important constraints to their business (35.27% of the surveyed firms according to BEEPS 2009).

The businesses' lack of interest in capital markets is due to the low level of development. Although Georgia has a functioning stock exchange (Georgian Stock Exchange, commonly referred to as GSE), its levels of activity are low even by emerging market standards. Around 250 companies are listed on the exchange, but most of them have done so only to comply with regulatory requirements, because listing is legally required of companies with more than 100 shareholders.

According to the OECD assessment, two mechanisms for SME financing need to be addressed in particular, namely credit guarantee schemes and venture capital/equity funding. Both instruments are already implemented to a certain extent but their scale of use is not sufficient to provide an alternative source of SME financing.

Several venture capital/private equity funds have been operating over recent years; however their total portfolio is not sufficient to be considered as an adequate supply for existing market demands. A number of problems are still impeding development of venture financing: lack of understanding of Georgian realities by the fund managers, weakness of the fund manager community knowledge, promotion of the development of venture industry in Georgia, and lack of trained and qualified specialists for venture capital business in Georgia.

Although there is no credit guarantee agency operating on the basis of public funds to satisfy the needs of SMEs for investment, export development or leasing, some funds have been allocated over the past two years for this purpose. The state programme "Cheap Credit" allocated approximately USD 30 million in 2007 and USD 10 million in 2008 to support debt financing of SMEs involved in tourism, agriculture and related sectors. So far, these are subsidised loan schemes and guarantee funds that are being extended to SMEs. Guarantee schemes were also introduced by international providers in Georgia to support new technologies, entrepreneurs and export-oriented sectors. Recent reports highlight, though, that Georgian SMEs still face significant constraints with respect to long-term banking finance.

Georgia should focus on further developing innovative financing mechanisms through venture capital or "business angel" networks that would allow start-ups to access capital other than bank financing. "Business angel" capital fills the gap in start-up financing from friends and family and provides seed funding as well as hands-on advice to entrepreneurs based on personal experience which increases the chance of success. To improve access to finance for SMEs, the government should also consider introducing new financial instruments such as guarantee schemes and leasing arrangements.

The European Bank for Reconstruction and Development (EBRD), World Bank and International Finance Corporation loan programmes and investments are changing attitudes and behaviour towards SME lending by promoting SME financial assistance programmes. The Small Enterprise Lending Program is the most interesting initiative: it is co-financed by the EBRD and TACIS, the Technical Assistance to the CIS programme, and it funds individuals and individual entrepreneurs, covering all sectors.

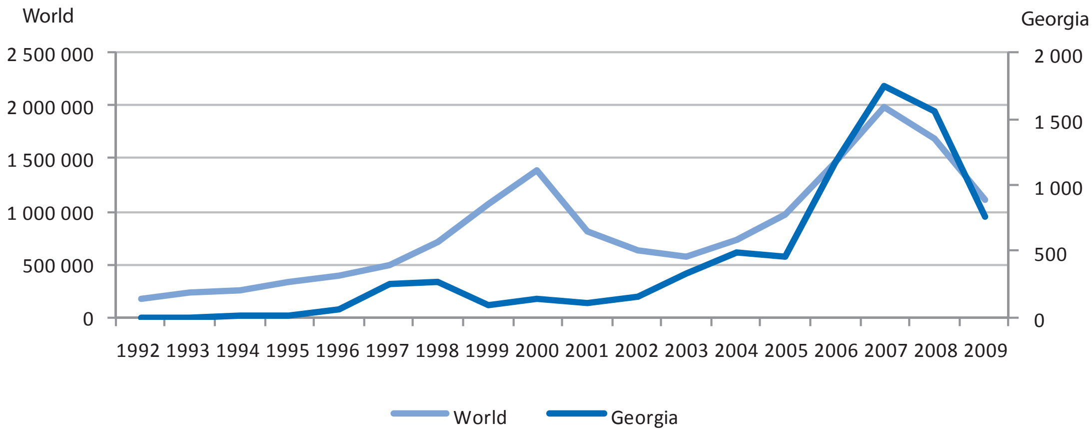
Investment framework for SME growth

FDI inflows into Georgia were hit hard by the economic crisis after five years of impressive growth rates (cumulative annual growth rate 37%) between 2002 and 2007, compared to 14% for the world. In 2008 and 2009, inflows were cut in half from an all-time high in 2007 (USD 1 750 million) to USD 764 million in 2009 (UNCTAD, 2010). According to preliminary data published by the Georgian government, investment inflows will continue to decrease dramatically as they only reached USD 272 million in the first half of 2010 and investors remain cautious.

The FDI inflow to Georgia has been dominated by two factors: geopolitics and privatisation. Georgia's strategic position in the routes of international pipelines has attracted investors to the construction sector (representing over 60% of FDI over 2003-06). According to the National Statistics Office of Georgia, the largest recipient of net FDI in 2007-08 was the transport and communications sector (23.6%), followed by energy (18.6%), and services (17.8%). Banking and agriculture received very little FDI, 4.5% and 0.8% respectively. As both sectors play a crucial role in increasing the long-term competitiveness of Georgia, the government should try to attract more investors towards those sectors. In 2008, approximately 20% of FDI inflows stemmed from privatisation; however, the share is expected to decrease as the largest part of state property has been privatised since 1992. One of the key challenges will be to create new investment opportunities to sustain FDI inflows beyond the privatisation period.

In 2009, about 34% of FDI inflows came from EU27 countries, mainly from the United Kingdom (USD 72 313 million) and the Czech Republic (USD 45 679 million). By far the biggest investor country in 2009 was the United Arab Emirates with a 25% share of total inflows. Other major investor countries include Turkey and Azerbaijan. Priority sectors which received the largest shares of FDI were real estate (22%), industry (21%), constructions (16%) and transport and communications (15%).[37]

Figure 3.14. FDI net flows
(current USD million)



Source: UNCTADstat.

Georgia is very open to FDI and highly committed to attracting further investors to the country. The legal framework governing foreign investments is mainly established by the Law of Georgia on "State Promotion of Investments" (2006), the Law of Georgia on "Georgian National Investment Agency" and the Law of Georgia on "Investment Activity Promotion and Guarantees" (1996).[38] Over the past few years, Georgia has dramatically simplified licensing and permission requirements to ease constraints on investments and business in general. Georgia has concluded 26 bilateral investment treaties and is currently negotiating 14 more.

The government ensures the principle of national treatment through its legislation and policies. Foreign and local investors/and business people enjoy equal rights and responsibilities when doing business in Georgia. Restrictions on the principle of equal treatment may apply where issues of national security are concerned, for example in sectors such as air and maritime transport, broadcasting, satellite communication and related activities. There are no approval procedures to screen foreign investment other than standard registration or licensing requirements. The Government of Georgia is only involved insofar as it conducts privatisation of state-owned property through tender or auction procedures.

Georgia still faces many challenges on its way to developing an investment-friendly environment. According to the World Bank's *Doing Business 2011* report, Georgia has risen from 41st to 20th position in the area of protecting investors, which is an important signal to the international investor community.

Georgia is inviting foreign investors based on an investment promotion and facilitation strategy that describes organisational structure, human resource needs and financial requirements to implement priorities and meet objectives. The government has set up an investment promotion agency to attract FDI – the Georgian National Investment Agency (GNIA) – which operates under the Ministry of Economic Development of Georgia. GNIA has a stable budget to cover all overhead and salary costs. While the agency monitors the implementation of investments it does not yet have an effective mechanism for monitoring and evaluating its activities. GNIA plans to create such a mechanism in the near future.[39]

GNIA serves as a one-stop shop and provides initial guidance and information to investors. It does not have the authority to approve regulatory and procedural requirements necessary to establish a foreign enterprise; however, it provides the necessary assistance to the foreign investor when dealing with relevant authorities. The agency has a client relationship management (CRM) process in place which still has some limitations in terms of scope and nature. For example, there is no CRM software system to support the management of the CRM strategy. However, GNIA does undertake follow-up conversations and meetings with interested foreign investors. Aftercare services are already provided to some extent and are expected to be expanded in the future.

In order to support the development of the domestic private sector, Georgia should consider implementing FDI-SME linkage programmes that introduce schemes to help SMEs benefit from the presence of foreign investors. This normally entails approaching local SMEs and conducting strategic audits to assess their capacity to participate in a specific linkage programme as well as defining a development plan, promotional campaigns and a database to generate interest by foreign enterprises. Experience suggests that linkages can lead to sustainable business networks which are invaluable to both foreign investors and domestic companies.

NOTES

1. Including Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine.
2. In USD terms, Georgian GDP plunged by USD 2 billion in 2009 (from USD 12.9 to 10.7 billion), a recession of 16.5% due to a high devaluation of the lari that year.
3. The average was -8.3% excluding Azerbaijan, which grew by 9% that year thanks to oil resources.
4. Caucasus Barometer, Caucasus Resource Research Center, 2009, www.crrc.ge/caucasusbarometer/documentation/.
5. Informal economy refers to all legal production activities that are deliberately concealed from public authorities for the following kinds of reasons: to avoid payment of income, value-added or other taxes; to avoid payment of social security contributions; to avoid having to meet certain legal standards such as minimum wages, maximum hours, safety or health standards, etc. (OECD, 2002, p. 139). It does not concern illegal activities.
6. Size and measurement of the informal economy in 110 countries around the world, Friedrich Schneider, July 2002 – updated October 21, 2010.
7. As rural people owning a farm are statistically counted as self-employed people – however, it can hide massive informal employment.
8. Agriculture in accounting terms covering Group 0 of the SITC Rev 3 classification (processed food and beverages excluded), calculated from both WITS (2000-08) and External trade Geostat (2009 and H1 2010).
9. Export-import analysis of agricultural products, Ministry of Economic Development of Georgia (2010).
10. GWS is the Georgian wine producers' union.
11. At present, there is no alternative to banks for the financing of the economy, especially in agriculture.
12. Ministry of Agriculture of Georgia, 2010.
13. Excluding pasturelands, cattle routes, sanitary protection areas, forests, areas of historical/cultural importance and protected territories.
14. Credit length of seven years for a 12% interest rate.
15. Programme of the Government of Georgia 2008-12.
16. For efficient productivity, the development of organic farming could be undertaken alongside environmental harmonisation policies for the preservation of biodiversity.
17. By predominantly Inter Rao (Russia), Energo Pro (the Czech Republic) and Akhema Group (Lithuania).
18. Georgian National Energy and Water Supply Regulatory Commission, 2009.
19. Georgian National Energy and Water Supply Regulatory Commission, 2009.
20. Also called Western Route Export Pipeline.
21. Georgia manufacturing sector competitiveness assessment, World Bank Group, ICAS, 2009.
22. Ministry of Economy and Sustainable Development.
23. Ministry of Economy and Sustainable Development, 2010.
24. Tourism Development and Investment Plan and Strategy, 2008.
25. Supervised by the National Bank of Georgia but also reports to the French Commission Bancaire.

26. Association of Young Financiers and Businessmen, 10 July 2010, Tbilisi, Georgia.
27. Government session, 3 August 2010.
28. Presidential speech to lawmakers, 6 October 2009, Tbilisi, Georgia.
29. Malnutrition prevalence, weight for age (percentage of children under 5) equalled 2.3% in 2005.
30. IUCN Category II; the only national park in the Caucasus granted a PAN Parks certificate in 2006.
31. United Water Supply Company of Georgia, 2010.
32. Georgia National Energy and Water Supply Regulatory Commission, 2010.
33. National Statistics Office of Georgia, www.geostat.ge.
34. In 2006, a law was passed on the compliance of Georgian higher education with the Bologna principles.
35. www.ganatleba.org.
36. The most recent examples are: co-operation between the Vocational Education Centre and Sartrial House through employing graduates in the textile industry; and a milk factory representing the actual educational institution or the vocational education students of the University of Gori (*Source:* website of the Ministry of Education of Georgia).[2]
37. National Statistics Office of Georgia, www.geostat.ge.
38. Other relevant laws include the Law on Entrepreneurs (2004), the Tax Code (1994) and the Customs Code (2006).
39. Law of Georgia on "State Promotion of Investments" (2006), Law of Georgia on "Georgian National Investment Agency" (2002), Law of Georgia on "Investment Activity Promotion and Guarantees", Georgian National Investment Agency.

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CHAPTER FOUR

REPUBLIC OF MOLDOVA: COUNTRY REVIEW

SUMMARY

In 2009 the economy was seriously affected by the global economic crisis and a tense political climate. Gross domestic product (GDP) declined by 6.5% year-on-year (yoy) to USD 5.4 billion, due to the collapse of domestic demand, exports, remittances and foreign direct investment (FDI). However, this fall was slightly less than the 9% forecast by the International Monetary Fund (IMF) forecast of 9%. Furthermore, industrial output was down by 25% and unemployment doubled by the end of 2009. At the beginning of 2010, improved external environment and liberalisation measures led to foreign trade and real GDP growth due to increases in industry, trade and transport activities.

Economic reforms have been slow because of weak market institutions, corruption and political instability. Nevertheless, the government's primary goal of EU integration has resulted in some market-oriented progress. The granting of European Union (EU) trade preferences and increased exports to Russia will encourage higher growth rates, but the agreements are unlikely to serve as a panacea, given the extent to which export success depends on higher quality standards and other factors.

The business climate has gradually improved over recent years, although significant challenges remain, such as effectively implementing laws and regulations. A resolute regulatory reform and reform of central public administration, accompanied by emphasis on rule-based governance, could help build investor confidence, raise credibility and attract FDI. A business-friendly environment is the main solution to the problems of the Moldovan labour market. Significant efforts should be made to attract more international investors and increase the profitability of companies so that they can afford to pay higher salaries.

The report identifies main challenges and provides recommendations on how best to move forward in order to stimulate both domestic and foreign investments:

- strengthen market institutions to improve the efficiency of the economy;
- decrease reliance on remittances and increase product and market diversification;
- invest in training and education and fight HIV/AIDS;
- ease access to finance for SME development.

INTRODUCTION

The Republic of Moldova enjoys a favourable climate and good farmland but has no major mineral deposits. As a result, the economy depends heavily on agriculture, with fruits, vegetables, wine and tobacco.

The Republic of Moldova's economic performance over the last several years was built on poor foundations. Growth depended on consumption of imported goods and was fuelled by remittances from abroad; these grew at an alarming rate, accounting for 30% of GDP in 2008 (among the highest in the world). Between 2006 and 2008, GDP grew at a yearly average rate of 5% (up to 6.5% in 2008), while monetary and fiscal positions were kept in check. The overall fiscal balance had a deficit of only 1% in 2008 and efforts have been made to bring inflation down**.**

The economic crisis came via plunging remittances (which fell by 27%) as economies in countries employing a significant amount of temporary Moldovan workers showed major signs of recession (mostly Russia). FDI fell abruptly to 2% of GDP from a pre-crisis level of 11.4%. Imports of goods and services declined further than exports, 35% and 22% respectively. Consequently, GDP declined by 9% in 2009.The recession has taken its toll on credit quality. The share of nonperforming loans of total loans increased by 10 percentage points from the beginning of 2010, amounting to 20% in February, and one medium-sized bank became insolvent in June 2009. Inflation increased considerably due to continuing structural imbalances leading to increased domestic prices of consumer goods because of over-regulation and weak competition, especially in the food industry, communications and trade, while tariffs for public utilities and transportation did not cover operating costs and led to increasing debt and lack of investment.

Worse still, throughout most of 2008-09 the Republic of Moldova did not respond with adequate, if any, anti-crisis measures. Disputed elections in April 2009 brought democracy issues to the fore. Early elections were held in July 2009, bringing to power on 25 September 2009 the government of Prime Minister Vladimir Filat and Acting President Mihai Ghimpu. Both the crisis and pre-election spending hikes resulted in a large fiscal gap. In 2009, budget revenue dropped over 10%, relative to 2008, due mainly to a drop in value-added tax (VAT) receipts, non-tax revenue and import duties, and to increasing demands on social safety-net expenditures. Taking into account that the parliament failed to elect a president in 2009-10, new elections were conducted in late November 2010, again without any consensus being reached. The new government, elected in January 2011, is still led by Vladimir Filat as Prime-Minister and Vladimir Voronin is Acting President until one is elected.

Though indicators improved in the first half of 2010, the unstable political and economic situation mean that it is far too early to talk about sustainable economic recovery in the country. There is a need for a consistent macroeconomic policy and a strategic approach to setting short-term and medium-term priorities for development.

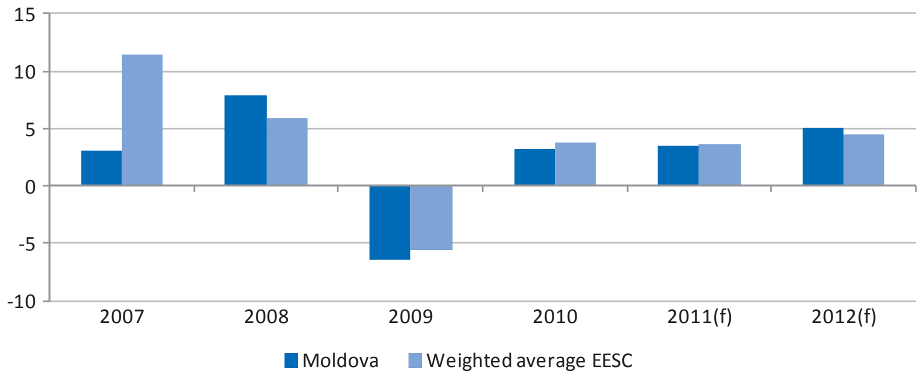
RECENT ECONOMIC DEVELOPMENTS

Until the global economic crisis, growth was led by the remittance- and FDI-driven consumption boom. This boom generated strong import demand, with substantial fiscal revenues from the value-added tax (VAT) on imports. As imports grew, the current account balance steadily widened. Capital inflows also put pressure on the exchange rate. Meanwhile, labour and skill shortages emerged.

Remittance inflows, accounting for 31% of GDP in 2008, contributed to the growth of disposable incomes and led to the rapid growth in final consumption and in construction expenditure, as labour migrants preferred investing in real estate, rather than in saving accounts.

The poorly diversified export structure exposed the country to various external shocks, such as the Russian trade embargo on wine and the ban on agricultural products (2006 and 2010), and to higher energy prices. Moreover, significant frosts and droughts devastated the agriculture sector because of a lack of greenhouses and poor irrigation systems. Despite these issues, the economy grew at an average of 5.9% annually between 2000 and 2008, reaching 7.8% in H1 2008 (USD 6.1 billion), prior to the crisis. At the same time, the regional average growth rate[1] reached 11.5% in 2007 (8.8% if excluding Azerbaijan).

Figure 4.1. Real GDP growth rate in the Republic of Moldova
(annual percentage change)



Source: IMF, 2009.

Overall, in 2008, Modolva's growth was higher than the Eastern European and South Caucasus (EESC) countries' average due to immediate effects of the crisis in neighbouring countries. In 2009, the Republic of Moldova's GDP fell by 6.5%, mostly due to a high decline in remittance inflows. This was below the region's average drop of 8.5% (excluding Azerbaijan), which was due to the spectacular drops in Armenia and Ukraine (around 15% each). In 2010, with the slow pick-up of remittances and FDI, GDP growth is expected at 3.2%, below the region's average.

General overview

The economy was seriously affected by the global economic crisis and a tense political climate in 2009 which resulted in a decrease of domestic and international demand with lower foreign trade, a substantial reduction in foreign investor shareholding and a prevalence of recovery of foreign loan repayments, though allocation of special drawing rights (SDRs) by the IMF and deferred payments on current arrears led to economic growth in other sectors.

That year GDP declined by 6.5% yoy to USD 5.4 billion, due to the collapse of domestic demand, exports, remittances and FDI. However, this fall was slightly less than the 9% forecast by the IMF. Furthermore, industrial output was down by 25% in the first half of 2009, investment was weak and officially recorded remittances declined by about one-third yoy. In USD terms, due to the devaluation, the downward trend lasted until 2010 before GDP began to pick up again, a trend expected to continue in 2011. In MDL, GDP fell from MDL 62.9 billion to MDL 60.0 billion in 2009, but the upward trend was significant in 2010, and the IMF expected GDP to reach MDL 66.2 billion in 2010 and as much as MDL 72.3 billion in 2011.

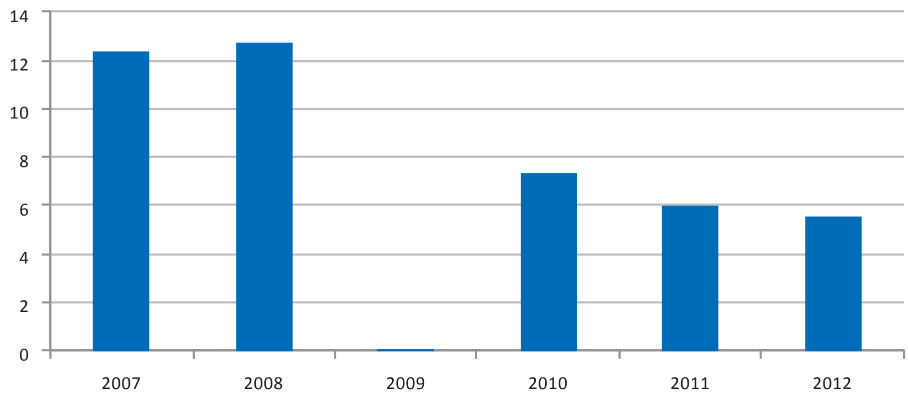
At the end of the fourth quarter of 2009 the number of unemployed reached 73 900, which had almost doubled yoy. Reduced disposable incomes, especially for the 40% of Moldovan households living on remittances, as well as an overall decrease in consumer confidence, resulted in deflationary pressures.

In late 2009, an improved external environment and liberalisation measures led to foreign trade and real GDP growth due to increases in industry, trade and transport activities. Economic decline in Q4 2009 was 2.4% yoy, which was significantly less than at the beginning of the year (-7% in Q1 2009).

Inflation

Double-digit inflation was a common feature of the Moldovan economy during the entire transition period up to 2008. Prices grew on average by 13.3% yearly, between 2000 and 2008 and overall by more than two-and-a-half times (261.5%), with some services and goods registering much higher growth rates. Apart from a monetary expansion policy, this high inflation can be explained by weak competition (meat, medicines, fish), poorly performing local industries (fruits) and, in particular, a 3% depreciation of the MDL against the USD; Moldovan consumption relies mainly on imports. Prices increased for fuel (by 19.3%), gas, vegetables and sugar, passenger transportation and hot water provision.

Figure 4.2. Inflation, average consumer prices
(annual increase)



Source: IMF, 2010b.

Due to the economic crisis and the fall of global demand, prices significantly decreased in 2009, resulting in 0.4% inflation, compared to 7.3% in December a year earlier. This is due to a downward trend registered for in the first nine months of 2009 (down from 7.3% in December 2008 to -2.3% in September 2009). The reverse of the trend starting October 2009, until the end of the year, was too low to have an important annual impact.

Annual core inflation (excluding food and energy prices) registered a downward trend, to 2.1%, in January-October 2009, then slightly increased to 2.9% in December. Annual CPI growth in 2009 was 2.5 percentage points lower than core inflation in the same period. Foodstuff and non-foodstuff prices decreased by 5.6% and 0.3% respectively, while prices for basic services decreased by 8.2%. Industrial producer prices increased at the beginning of 2009 by 1.0%, while those in the domestic market decreased by 0.5%. Prices in the processing industry increased by 1.2% and in the extractive industry by 7.1%, while electricity, gas and water prices decreased by 0.2%.

Table 4.1. Annual inflation rates by major component in 2009

Main component of inflation	Dec 2009-Dec 2010 (%)
Foodstuff products	5.7
Non foodstuff products	7.1
Medicaments	5.4
Fuel	25.1
Construction materials	3.2
Footwear	3.1
Clothing	3.4
Basic services	9.7
Tariffs on utilities	12.7
Water supply and sewage	1.7
Energy supply	23.3
Passenger transportation	3.4

Source: Tabled by the authors.

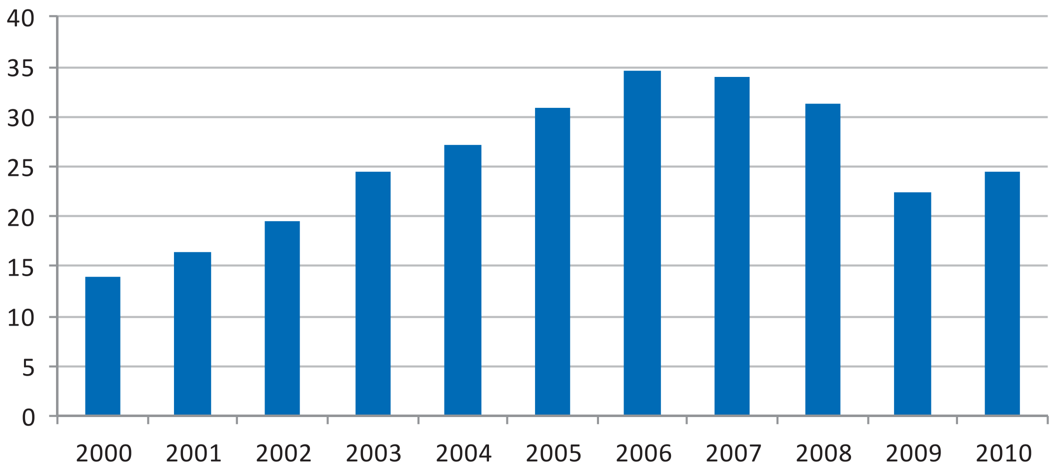
Due to improved trade performance and evidence of the acceleration of economic recovery, inflation increased in Q1 2010. It reached 8% in April 2010 because of increased electricity tariffs, alongside the devaluation of the leu and tax increases. Yoy, CPI reached 8.1% in December, exceeding the target band that the National Bank of Moldova (NBM) had fixed between 6% and 8% for 2010, due to anticipated increases in administratively set prices, imported inflation and growing production costs (due to climate risks and insecure harvests). Services increased yoy by 9.7% and non-food items by 7.1%. Core inflation in December 2010 increased yoy by 4.4%.

The NBM will have to address the challenges of increased inflation through a gradual and balanced tightening of monetary policy, without threatening the fledgling economic growth.

Remittances

Remittances grew at a fast rate, particularly after 2003, reaching a peak of USD 1 897.3 million in 2008 (around 31% of GDP). Due to the crisis, and to economic turmoil in countries employing Moldovan nationals, remittances fell by 36% in 2009, to USD 1 211 million. While remittances to urban areas were still rising (by 19%) in early 2009 remittances to rural areas had already decreased by 17%. A fall in remittances has a major negative impact on rural areas, for which it represents more than 25% of their income, and in particular on the 40% of households depending on remittances as sole revenue (UNDP/WB, 2009).

Figure 4.3. Remittances 1999-H1 2010
(total inflows, percentage of GDP)



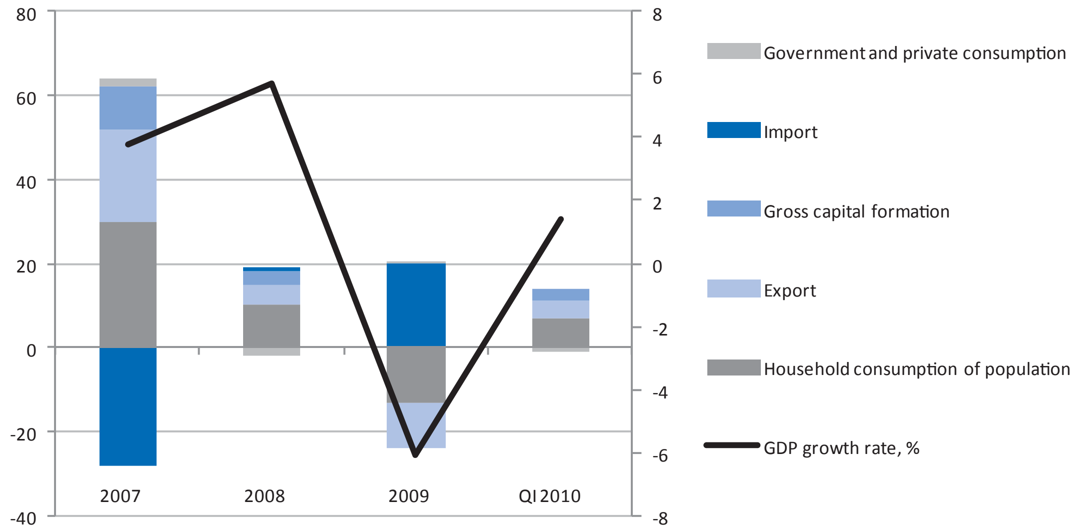
Source: World Bank, Migration and Remittances Factbook 2011.

As most of the economies in the region recovered from the crisis in 2010, remittances increased by 9% in US dollars (19% in leu) to expected total inflows of USD 1 316 million and their share in GDP picked up to a little less than 25%. Although the majority of workers will likely continue to remit large sums of money, this will not translate into a sustained growth in remittance inflows to the economy, unless these are ever-increasing proportions of migrant workers' earnings. This issue should be looked at with a lot of care when drafting the national budget as the government cannot rely on remittances for sustainable growth, which still represents between 25% and 35% of GDP.

Analysis by account

Figure 4.4. Contribution to demand components (percentage points) and annual GDP growth

(yoy)



Source: National Bank of Moldova.

Consumption

Consumption has been growing at an increasing rate since 2000 and by over a third between 2006 and 2009, reaching an average monthly total expenditure of MDL 1 283.2 per household. This increase was led by strong capital inflows, mostly composed of remittances. Due to the reduction of remittances, overall income of the population decreased in 2009,[2] with a deeper decline of 2% in the second quarter compared to 0.2% in the first quarter. Also, despite the increase in average wages reported by the NBS, household real revenues from salaries decreased.[3] Only social payments were on an upward trend, mainly due to the increase in pensions at the beginning of April, in the context of upcoming elections.

Falling remittances and negative expectations of the population caused a standstill in consumer demand in 2009. Consumer spending declined by 7.6% that year; non-food products, which accounted for 64.7% of total retail sales, were the worst hit by the crisis.

Table 4.2. Monthly expenditure evolution between 2006 and 2009

Total expenditure	2006	2009
Average monthly total expenditure per household (MDL)	953.3	1283.2
Share of food (% of total expenses)	44.4	43.7
Share of manufactured goods and services (%)	34.6	36.1
Share of non-consumption expenditures (%)	10.4	10.1
Loan to deposit ratio (Cr 1032)	44.2	54.1

Note: In 2006 the questionnaire survey of households changed; this is why it is taken as the comparison date with 2009.

Source: National Bureau of Statistics.

Consumption was the first macroeconomic indicator testifying to the presence of the economic crisis in the Republic of Moldova in September 2008. It had already decreased by 10% by the end of that year. Consumption in 2008 was on average largely concentrated in foodstuffs (44.6%), with significant spending on household and facilities (16.1%) and an almost equally large percentage on clothing and footwear (12.6%). Health-related spending accounted for 5% of consumption, whereas household appliances, transport and communications services constituted less than 5% each. Leisure, hotel expenses and alcoholic drinks made up in total about 5% of consumption. Alarmingly, education only represented 0.3% of total spending. We can deduce from this picture that Moldovans were constrained by a difficult economic situation and were barely able to pay for food and household maintenance and services, with very little left for other activities – education taking a more significant toll than other areas.

Private consumption maintained that rate of decline in 2009. Households reduced spending on all goods and services with the exception of education, dwelling maintenance and communication expenditure. The most socially harmful fall was a drop of 40% of the total household budget at the national level. Consumption was therefore cut to basic needs. Resources were reallocated from food consumption to dwelling maintenance, health and communications, which therefore increased food prices.

According to the national accounts, the national economy entered the recovery phase in the first quarter of 2010, largely due to economic stabilisation in the main trading partners and to slow economic recovery. This led, on the one hand, to an increase in transfers from abroad and to restoring people’s expectations, thus increasing final consumption and imports. On the other hand, demand for domestic products recovered in the same quarter, registering an increase of 11.8% (USD 35 million) compared to the first quarter of 2009. The goods sector’s value-added recorded a positive trend due to increases in both industry and agriculture. In addition, services’ gross value-added increased due to positive developments in trade, transport and communications. Even the construction sector (including home improvement) picked up in 2010 as remittances increased. These tendencies are confirmed by data from industry, and internal and external trade for the same year.

Policy recommendations

Sustaining private consumption by fiscal policies in times of economic crisis, is very important as it represents a central element for GDP growth. However, the former coalition government failed to take such measures, which should include VAT reductions on some goods and services, such as investments and durables.

Government expenditures and revenues

The structure of national public budgets in recent years has become more consistent with expanding social payments and has been composed largely of indirect taxes (particularly VAT). In 2007, national public budget revenues reached 41.8% of GDP, compared to 33.9% in 2000. Due to the crisis, these revenues fell slightly to 40.6% in 2008.

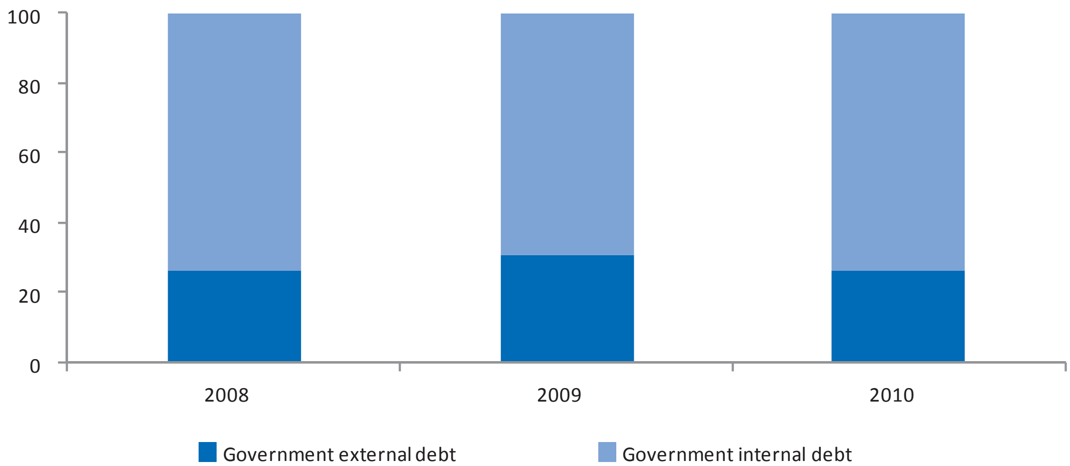
Table 4.3. Evolution of government debt, revenue and support

Debt, taxes and budget support	2000	2009	2010
General government net lending/borrowing (MDL billion)	-0.4	-3.8	-3.6
General government net lending/borrowing (%)	-2.4	-6.4	-5.4
Debt service on external debt, total (MDL billion)	1.8	4.4	...
Short-term debt (% of exports of goods, services and income)	62.6	50.9	...
General government gross debt (MDL billion)	14.3	16.5	21.8
General government gross debt (%)	89.5	27.6	32.6

Sources: National Bureau of Statistics, WB WDI 2010.

The main source of revenues is VAT, accounting for 35.6% of total expenditures, while non-fiscal revenues tend to decrease. The largest shares of direct revenues in total revenues in 2008 were contributions to the state social insurance budget (21.3%), income tax, including corporate income tax (8.6%), and insurance premiums for the mandatory medical insurance fund (4.5%). The former coalition government also needed to reach for international grants and loans to overcome the crisis. Therefore, the government took several measures to restore fiscal sustainability based on the rate of overall economic recovery, to yield fiscal savings of up to 6.8% of GDP. These measures were cutting capital spending while preserving road rehabilitation and maintenance, eliminating poorly targeted nominal compensation programmes, reducing the public sector wage bill, eliminating the excessive inflation adjustment and raising excise taxes.

Figure 4.5. Evolution of government debt
(percentage of GDP)



Source: Ministry of Finance, 2010.

Expenditures of the national public budget also increased to 41.6% of GDP in 2008 from 36.4% in 2000. Around two-thirds of expenditures of the national public budget were directed towards the social sector, for 68.5% of total expenditures in 2008 compared to 44.2% in 2000. According to the Medium Term Expenditure Framework (MTEF) 2010-12, budgetary allocations for this sector will be continually increasing due to increased health expenditures although expenditures on education and social protection will decrease (both as a share of GDP and total expenditures). Increases in public investment and infrastructure, undertaken in 2009, should also help the economy to pick up.

One of the main objectives of the government is to support individuals with low incomes and those at risk. Budgetary expenditures for this purpose revealed a continuous growth trend until April 2009, registering a major share of 31.8% of discretionary expenditures and about 13% of GDP. Staff expenditures are on an upward trend, reaching 9.7% of GDP in 2008.

Since the new social benefit regulation[4] following the 2009 elections, the average amount of social support received monthly has decreased because of a rising number of beneficiaries due to the crisis, a diversification of their profiles and changes in their incomes. This decrease is also likely to result from ill-informed households which are not aware of the change in the law and which could claim more benefits. However, in any case, state social support is not enough for many households to recover from lost incomes due to the crisis.

Table 4.4. Monthly average social payments
(December 2008 to June 2009)

Terms	Number of beneficiaries	Expenditures (MDL thousand)	Average level of social support
Dec-08	151	48 014	317.97
Jan-09	309	145 135	469.69
Feb-09	1 239	962 035	776.46
Mar-09	4 745	4 868 824	1 026.10
Apr-09	9 446	8 938 748	946.3
May-09	13 165	10 978 508	833.92
Jun-09	16 208	12 942 861	798.55
Average payment per beneficiary (MDL)			738.43

Source: Assessment of the Law Implementation, Law no. 133/2008 on the Social Support in the RM, 2009 .

At the beginning of 2010 the former coalition government implemented and extended a new targeted social assistance programme to protect the poor from budget cuts resulting from the development of an Integrated System of Social Services. The government needs to implement programmes to absorb skilled construction workers and should accelerate planned government investment in infrastructure. A programme that invests in youth education and skills training could mobilise youth for appropriate public works.

On 28 September 2010, the parliament was dissolved just after the former coalition government had changed the budget, the deficit increasing by MDL 80 million (5.4% of GDP). Pension and salary increases for teachers were indexed to the new budget line.

Investments

The investment climate has gradually improved over recent years, although significant challenges remain, such as effectively implementing laws and regulations. Fixed capital formation increased from just over 15% of GDP in 2000 to an estimated 34% of GDP in 2008. FDI also increased sharply from 3% of GDP in 2003-2004 to 11% of GDP in 2008.

However, in 2009, due to the crisis, fixed capital formation decreased by more than 37.2%, with a decrease of 27.6% in the construction sector. This largely contributed to the negative dynamics of GDP that year.

Moreover, in 2009 capital investment collapsed by 45% yoy, a sharp decline similar to those in the early 1990s. The crisis surely influenced this result but is not the only cause. Political violence during the April 2009 elections and the subsequent political turmoil led enterprises to withdraw their investments from the country. Consequently, FDI shrank around nine-fold in the first half of 2009, as domestic investments also contracted because of high interest rates on long-term banking loans, a shallow domestic capital market, lack of companies' own financial resources and pessimistic expectations.

The main structural factor in the investment decline is a 40% contraction of the construction sector – assembly plants – representing more than half of total capital during recent years. This has impacted on the loan market as domestic banks had previously invested a lot in this sector, about 15% of total loans. The sector's shrinking aborted investments in other sectors of the economy by drying banks' assets.

In 2010, the World Bank's *Ease of Doing Business* survey ranked the Republic of Moldova 94th out of the 183 countries included in the study. Particular problems included dealing with construction permits, employing workers, protecting investors, paying taxes and trading across borders.

These findings were broadly corroborated by the 2008/09 *Business Environment and Enterprise Performance Survey* (BEEPS). In this survey, 40% of Moldovan companies considered corruption to be a major or very severe obstacle to business, while tax administration and the practices of competitors in the informal sector were also seen as key obstacles. The economy remains non-diversified, with almost 40% of exports in 2008 deriving from agriculture or agro-processing and more than one-third of exports directed towards Russia and the western CIS countries. (EBRD/World Bank, 2009)

Trade

Since 2000, the Republic of Moldova has been characterised by a slow increase in exports and soaring imports, exports representing only a third of imports. In 2007 exports were 23% higher than in 2005, reaching USD 1 341.8 million, while imports had increased by 1.6 times, to USD 3 689.9 million.

Until 2008, consumption and investment booms both fuelled imports, which were financed by private capital inflows, remittances and other revenue sources. At that time, the appreciation of the MDL gave further stimulus to imports but also shows that foreign currency inflows were robust. Still, high exposure to external financing defined the vulnerability of the country, as in Romania, Bulgaria and the Baltic countries.

The country imports all its energy needs from Russia. Relations with Russia worsened in 2005 when gas was cut off by Gazprom, the Russian gas company, due to disputes over gas pricing, which increased the cost of imports. The same thing happened again in January 2009, though Russia had already increased gas prices in 2006. Furthermore, the 2006 Russian ban on Moldovan wine and agriculture products deeply harmed the country's exports, as 80% of wine production was directed to Russia.

Despite these events, the growth rate exceeded 7% in 2008, boosted by Russia's partial removal of the bans, solid fixed capital investment, and strong domestic demand driven by remittances from abroad, boosting trade in the first half, with exports increasing by 23% and imports by 45% before the crisis. In the second half, reducing gross capital formation and final consumption led to a reduction in imports of 19.3%, and the fall in external demand in trading partners resulted in a drop of exports by 7.8%. In 2009, the crisis accentuated the foreign trade decline with a drop of 19% of exports and over a third of imports.

Table 4.5. Moldovan foreign trade
(USD million)

Trade	2007	2008	2009	H1 2010
Exports	1 341.8	1 591.4	1 287.6	642.2
Imports	3 689.9	4 898.8	3 278.3	1 653.1
Foreign trade balance	-2 348.1	-3 307.4	-1 990.7	-1010.9

Source: Tabled by the authors.

In the first quarter of 2010 the macroeconomic situation had improved markedly and economic recovery accelerated. Trade growth resumed. Agricultural exports even grew in the first quarter of 2010 by 10.1%. Retail trade growth also showed growing consumer confidence. This enabled the government to improve its forecasts in 2010 to a real GDP growth of 2.5% and a budget deficit lower than the 7% of GDP previously estimated.

Table 4.6. Current account balance

	2007	2008	2009	2010	2011	2012
Current account balance (% GDP)	-15.3	-16.3	-8.1	-11.2	-11.4	-11.1
Current account balance (USD billion)	-0.7	-1.0	-0.4	-0.6	-0.7	-0.7

Source: IMF, 2010c.

The informal economy[5]

The crisis during the first years of transition saw the bankruptcy of many enterprises leading to job losses. The establishment of a new underground economy was a major coping mechanism for rising unemployment and income loss. Initially, it included subsistence activities with no legal status, evading taxes and undeclared wages, away from the social protection system. It now spreads to all sectors of the economy (trade and services, food products and other consumer goods). It mainly employs a less educated labour force.

Table 4.7. Informal sector patterns in 2008

Employees in the informal economy (%)	10.9
Population with an informal job (%)	31.1
Employees working without a collective labour contract (%)	25.0
Employees from the above line not knowing the existence of such a contract	16.4
Employees working on verbal agreement	20.0

Source: National Bureau of Statistics, Sociological Survey (Labour Institute, ILO).

The largest segment of the informally employed workforce is in agriculture, transport and construction. The smallest part is in public administration, education, health and social protection. The largest proportion of unofficial employees is in rural areas, where the greatest portion of the population is concentrated, and is involved in subsistence farming.

Table 4.8. Informal economy share to GDP in the Republic of Moldova
(estimation of contribution of informal economy to GDP in percentage)

	2000	2008
National Bureau of Statistics	34.6	20.8
Schneider (2007):		
In the Republic of Moldova	45.1	44.3*
In OECD countries	18.0	11.0
EESC average	54.3	49.3

Note: *In 2006.

Sources: NBS 2008, Schneider, October 2010.

According to official statistics, one in three employed persons in the economy receives a "salary in an envelope". The International Labour Organization (ILO) estimates that 18% of the population relies solely on informal employment, but the government estimates the figure as 10%. This indicates "double dipping" by at least 10% to 20% of formally employed people.

ANALYSIS BY ECONOMIC SECTOR

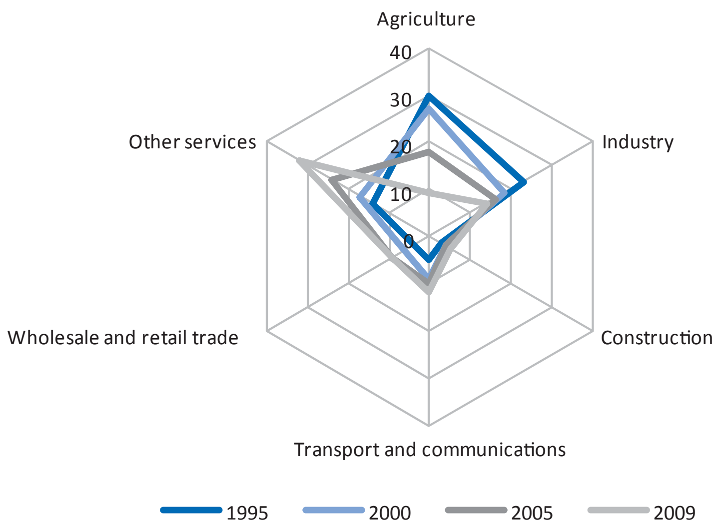
Table 4.9. Contribution of economic sectors
(percentage)

	Share in GDP		Share in employment		Share in total exports earning		Average annual growth of production		
	1995	2009	1996	2009	1997	2008	1995-2000	2001-08	2009
Agriculture	33.0	8.7	42.8	32.5	15.3	11.7	-0.6	-0.1	-9.8
Industry	28.2	15.6	11.7	12.3	68.6	53.9	-4.0	7.6	-22.2
Construction	4.0	5.2	3.3	6.8	0	0	-10.3	18.0	-30.7
Services	34.8	72.3	42.2	48.4	16.1	34.5	8.1	12.1	-3.8

Source: National Bureau of Statistics, National Bank of Moldova, Minister of Economy and Commerce.

Since the economic crisis, the production downturn in industry is higher than in trade and agriculture. Also, export-oriented activities are affected more seriously than domestically oriented ones. Nevertheless, employment and income effects resulting from the downturn in production levels have a social impact out of proportion to the sectoral GDP decrease.

Figure 4.6. Structural transformation of economy



Source: Ministry of Economy and Commerce.

Agriculture

General overview

The Republic of Moldova is traditionally dependent on agriculture, with more than 30% of the population involved in the agri-food sector that represents 15% of GDP (2008) and more than 50% of total Moldovan exports. Despite the decline of its GDP share since 2000, the amount of revenues generated by the agricultural sector doubled from MDL 8 268 million in 2000 to MDL 16 503 million in 2008. Profit generated by agricultural co-operatives and companies remained roughly the same, hovering at slightly over MDL 4 000 million since 2005 and registering a 50% increase in 2008 (compared to 2007) whereas individual farmers make up the larger share of agricultural income, MDL 10 325 million in 2008 (62.5% of total agricultural revenue). Individual farm revenues are up 20% since 2005 and in 2008 reached their highest numbers to date.

Due to a poor business environment, characterised by underdeveloped and imperfect markets and policy uncertainty, agricultural prices are low and the country has not been able to benefit as much from farm restructuring as other CIS countries, such as Ukraine or Georgia, with similar agricultural sectors.

Although late implementation of land reform and farm restructuring have delayed its recovery compared to other countries, the Republic of Moldova is now equipped with new independent farms which are more efficient. The share of agriculture in GDP decreased from 25.3% in 2000 to 10.5% in 2009. Moreover, the number of rural employed people more than halved in 2000-09 while the number of urban working people diminished four-fold. On the other hand, agricultural production benefits from the constant shrinking of agricultural plots since 2004. On average, plot size decreased by 4.1% from 2000 to 2009. In 2004, there was a peak of 54.7% in total volume of cereal production compared to a decline of 27.3% in 2009. Potatoes and vegetables experienced a negative trend throughout the same period (most field-grown vegetables experiencing a sharp decline in 2004, compared to 2000, before stabilising until 2009).

The main agricultural products are cereals and wine-grapes which bring in higher revenues due to increasing prices since 2000. The main agricultural export goods are: cereals, fruits and vegetables, wine and alcoholic beverages.[6] Exports to European countries have recently increased as a share of total exports; exports to CIS states remain large and, in many cases, still constituted the vast majority of exports in 2009. With the 2010 Russian embargo on Moldovan fruits and vegetables, exports to European countries may soon increase even further, with a significant share going to neighbouring Romania.

The Republic of Moldova is highly dependent on agricultural exports and food processing. The sector accounted for about 19% of GDP (30% including agro-processing) in 2010, and generated the majority of exports (59%). The sector is also very important in terms of employment (43% of the total), of income, and thus of poverty reduction in rural areas, where 68% of the population fall under the poverty line. It is a major issue as rural households derive 73% of their income from agriculture. Self-employed households are the most affected by these income losses; a fall of 24.6% in Q1 2009 compared to Q1 2008 was geographically concentrated in the central and southern regions. Consequently, the agricultural sector's growth is essential to sustaining and accelerating growth of the Moldovan economy in general, by raising incomes and employment opportunities in rural areas in order to increase purchasing power and domestic demand.

To generate sustained growth in the agricultural sector, the government should build on reforms by creating incentives for market-oriented production by independent farmers, and providing the support they need to take advantage of new opportunities.

By improving market opportunities, farmers will have easier access to markets and could sell their products with lower transportation costs, thus ensuring a higher profit margin. Increased farmers' income would in turn allow them to invest in appropriate machinery and technology needed for increased value-added products. This will increase farmers' profits and develop a whole structure in rural areas with job creation in the non-agriculture sector, such as in packaging, transportation and marketing services. Job creation in rural areas is also a key issue to refrain labour migration from the Republic of Moldova, which mostly goes to Russia and Italy to work in low-labour jobs, often in the informal economy.

Table 4.10. Main crops production
(thousand tonnes)

	2001	2008
Cereals and leguminous crops – total	2 627.7	3 169.5
of which:		
winter wheat	1 180.8	1 277.4
barley (winter and spring)	230.9	353.1
grain maize	1 117.6	1 478.6
leguminous crops	77.6	37.1
Sunflower	254.5	371.9
Soy	9.5	58.1
Sugar beet (industrial)	1 085.0	960.7
Tobacco	16.1	3.9
Potatoes	384.8	271.0
Vegetables	448.1	376.3
Melons and gourds	38.3	69.9

Source: National Bureau of Statistics.

Crop output in 2009 declined by about 18-19%, while livestock production increased by about 8%. As agriculture is dependent on weather conditions due to the subsistence structure of production and lack of greenhouses, these results should be analysed with care. The decline in crop production is explained by spectacular growth in 2008, thanks to good climatic conditions that year, while livestock production is recovering from the 2007 drought.

Negligible growth in the agricultural sector, of about 1.7% to 2.5%, is expected in 2010. Low cereals harvests are the main reason for falling agricultural production, only to some extent moderated by improved yields of some high-value crops (vegetables, fruits, grapes). Falling prices have been the main concern of farmers, even though, to some extent, farmers are victims of their own high producer prices and lack of investment co-ordination. The trend of small farmers leaving the sector will continue, mainly because of the severe financial constraints that they currently face.

As a result of the falling prices in 2009 the area sown with wheat for the 2010 harvest is expected to decrease by 20%. At the same time, corn areas increased by about 9-10% because farmers preferred to have their own (albeit low quality) fodder for the increasing number of cattle. No significant improvement in cereals productivity is expected because of the financial constraints impeding farmers from buying high quality fertilisers and other inputs. Total crop production in 2010 will increase by 5-6% in real terms and that will again be a recovery growth after the decline in 2009. Livestock is expected to register a positive but rather feeble growth of 3-4%. This growth will be driven by pork and poultry meat production and by egg production. Milk production is unlikely to increase because its price collapsed by a third, after strong growth.

Table 4.11. Main livestock production

	2001	2008
Cattle and poultry for slaughter (in live weight, thousand tonnes)	115	108
Milk (thousand tonnes)	579	543
Eggs (million units)	618	563
Wool (in natural weight, tonnes)	2 074	2 021

Source: National Bureau of Statistics.

The former coalition government agenda for 2010-13 was a set of priorities and projects scheduled for implementation within a specific timeframe and directed at agriculture, industry and information and communication technologies (ICT). After the reappointment of Mr. Filat as Prime-Minister in January 2011 and a new coalition government, it remains to be seen if those targets will remain untouched.

The former coalition governmental agenda included six goals for the agriculture sector aimed at raising the competitiveness of production on European markets and adjusting to EU norms and standards through:

- ensuring food security and increasing Moldovan agricultural products' competitiveness and exports;
- harmonising the national system of standards and technical regulation with the EU system;
- increasing efficiency of the agricultural subsidy programme;
- integrating agricultural assets in the general economic circuit and increasing investors' access to them;
- improving human resources for agriculture through agricultural extension institutions;
- stopping the degradation of soil resources.

To achieve these objectives, the former coalition government intended to undertake a set of measures to raise efficiency and improve the subsidy policy and fiscal facilities to attract FDI. A key element of subsidy policies proposed by the government is that a third of the cost of equipment required for processing, drying, freezing and packaging fruit and vegetables and drip irrigation will be covered by the state.

The government has developed a number of fiscal incentives to attract foreign investors into the sector:

- implementation of a special regime of taxation, which requires agricultural businesses to pay only one tax – land tax. Farmers would be exempt for five years from income tax, real estate tax, road tax and water tax;
- enterprises which make investments of over USD 250 000 are exempt from 50% of income tax during the following five years if 80% of the income tax is reinvested in the same company;
- VAT redemption on investments (capital spending), except for investments aimed at housing and investments in transport (beyond municipalities of Chisinau and Baltsi).

To raise investment opportunities in specific sectors, the government has taken some concrete steps:

- removing barriers on exports and simplified external trade procedures;
- creating a Payments Agency for Agriculture, aimed at managing and monitoring the efficiency of state financial support to farmers;
- establishing premises for the creation of a Moldovan-EU free trade area by improving phytosanitary measures in order to increase exports of value-added vegetal products to the EU and promotion of ecological agriculture, by substituting the chemical products with organic ones;
- simplifying procedures of land-plot rotation.

A set of financial incentives, preferential credits and financial advice, and guidance programmes have been projected to stimulate rural investments by farmers and entrepreneurs. The government has also set out to meet international standards, ensuring safety and health of Moldovan production; warding off the possibility of further trade embargoes from some of its existing partners.

Using ICT to increase productivity is also scheduled. The government is negotiating with the World Bank for the creation of an advanced weather forecasting and satellite imagery system that would help the Republic of Moldova become more prepared in the event of natural catastrophes and rapid changes in the climatic situation. Furthermore, the integration of modern technologies will lead the country to embrace high value-added agricultural production and achieve higher revenue levels from agricultural exports. The government is also going to create at least 14 irrigation systems that would cover over 15 000 ha of land and would help alleviate the effects of potential droughts.

Making use of the unexploited potential remains the main challenge for Moldovan agricultural producers and policy makers. There is more productivity potential in vegetables and fruit production than most countries in the region, but this potential is underutilised. The productivity indicators both in crops and livestock subsectors are very low and little evidence can sustain the weak positive (if not stagnating or mildly negative) trends that have caused production levels to drop in 2004-09.

As stated by the Economist Intelligence Unit (EIU), a EUR 79 million (USD 105.7 million) grant concerning agriculture development was signed on 26 November 2010 between the EU and the Republic of Moldova. This loan covers five main areas of the agriculture sector: economic stimulation of rural areas (EUR 45 million), biomass energy projects (EUR 14 million), knowledge and expertise transfer (EUR 7 million), access to clean water and sewage projects (EUR 10 million) and finally expanding municipal transports (EUR 3 million).

Policy recommendations

Implementing the new agricultural policy adopted by the former coalition government will be difficult. For instance, provision of food security requires two key preconditions: *i)* stabilisation of prices; and *ii)* constant increase in productivity indicators of the agricultural producers. These two goals should be at the top of the priorities list of any new agricultural policy.

For price stabilisation, the government will have to use market intervention (intervention reserves, forecast prices), but their expected impact is quite small because of limited government resources. With external prices for agricultural products constantly higher than domestic ones, the government has also to ensure free access of the Moldovan producers to foreign markets. Farmers cannot count exclusively on governmental support, however, and producers themselves have a big role to play in setting market prices by co-ordinating horizontally their investment plans. Producers' associations, unions and product councils have a key role in this.

Reaching sustainable productivity increases will probably take longer than stabilising prices. Productivity is linked to fundamental factors, such as competent and trained human resources, good seeds and genetic resources, rational use of fertilisers and a developed agricultural infrastructure (irrigation, agro-technical consultancy, competent veterinary service providers …). The targets of practical agricultural policy in 2010 and beyond should be providing these inputs, facilitating their provision and eliminating constraints that impede their provision by private actors.

Moreover, a key precondition for the success of the new policy implementation is a radical institutional restructuring of the Ministry of Agriculture and Food Industry, which in the past has been accused of acting as an agency implementing political orders from the Presidency, rather than designing meaningful policy. The reformed ministry will have to apply significant resources to ensure adequate training of the farmers in order to reduce the volatility of yields. It will also have to contribute to reducing price volatility, but here the producers' associations will have a bigger role in horizontal co-ordination.

Industry

Industrial production

The industrial sector consists of mining, manufacturing and the energy sector, accounting for 14.6% of GDP in 2008. The biggest share in the sector is manufacturing (88%) followed by the energy sector (10%). The industrial sector employs about 16 000 registered economic agents (slightly more than 12% of the total workforce); 679 large enterprises operate in the sector, of which only 7% are publicly owned.

Moldovan industrial output declined by 24.9%[7] in 2009, the worst result among the CIS countries after the Ukrainian crash (of 31.3%). The first signs of slowdown appeared as early as September 2008, with a series of shocks, including the onset of the economic crisis in Q4 2008. Difficulties in the sales market, decreased demand volume, insufficient raw materials and insufficient funds were mentioned by several companies to explain the decrease in production volumes. The industrial production decrease is determined by the drops in the mining industry (53.9%), manufacturing (28.7%), and energy sector (3.3%), which caused the decrease of the total volume of production respectively by 0.8%, 22.7% and 0.6%.

In January-October 2010, industry's total output had grown yoy by 7.6%, exceeding the 6% growth forecast for the year in 2009. Tobacco (+40.7%), machinery and equipment (+31.3%) and chemicals (+19.8%) contributed the most to industry's yoy growth in January-October 2010, contrary to sectors such as metals and metal products, which decreased yoy by 20.4%.

The wine industry

There is a long-standing cultural and economic tradition in grape growing and wine making. Despite recent shocks, the wine industry is the main sector leading the growth of domestic industry and is also considered an important driver for social development in rural areas as it affects the livelihoods of thousands of small grape growers who accounted for 2.3% of total GDP in 2007 and for 10% of all exports in 2008. This sector is the main source of income for 50 000 farmers, directly employs 7.5% of people working in the agricultural food processing industry (more than 7 000) and occupies more than 6.2% of all agricultural land.

In 2009, wine production decreased by 22.7% yoy, both due to the crisis and the continuing Russian ban.[8] Hopes for a quick market recovery are unrealistic. In addition to a loss of market growth, the ban resulted in 320 million litres of unsellable wine stock at the end of 2009, and in USD 105 million of wine sector banking debts (as of 1 January 2010). The crisis affected the number of operating companies, which decreased to 50, from the high number of 120 in 2006.

In January-October 2010, wine output increased by 9%, with Russia slightly loosening its Moldovan wine embargo. Moreover, the European Investment Bank (EIB) granted EUR 75 million (USD 100 million) to restructure the wine industry, which will be directed to existing enterprises (from vineyards to packaging companies), from 2011 to 2014.

The structure of Moldovan wine exports is slowly changing and the market has become more diverse, with about 77% of the exports directed to CIS countries compared to 90% in 2005. Russia remains the most important market for Moldovan wines but was temporarily supplanted by the Ukraine in 2009. Belarus remains the most stable market for Moldovan bulk wines. Sales to Eastern European markets are on the rise, especially to Poland and the Czech Republic, but also to Germany, demonstrating that the industry is producing wines appropriate for Western consumers in terms of quality and style.

The canning industry

In the vegetable- and fruit-canning industry, the steep production decline is related to the accumulation of large production stocks (about USD 25 million in September 2009). This is largely due to improper marketing strategies. Most of the companies in the sector continue operating under traditional management schemes and are very slow in improving their quality standards. This can be illustrated by the 20% decline (in real terms) in the meat-processing and meat products sub-sector in 2009, despite stable domestic demand and growing domestic production of intermediate goods. On the other hand, companies that have adopted quality management schemes are successfully exporting their products to the EU and have not been so dramatically affected by the crisis.

The main drivers of industrial growth will be the wine-making sector (with an expected production growth rate of 12%) and production of non-metal products, mainly construction materials (+15%). Such sectors as textiles, clothes and shoe production will stagnate or even fall further, because most of the companies lost their loan-processing contracts and it will take longer to find new customers or to put their own product lines in place.

Contrary to earlier predictions, the mining and quarrying industry has registered a 7.7% decline, thus becoming even more negligible than it already was. The decline can be explained by the same factors that caused the general recession of the economy in 2009.

The energy sector

The country needs diversification in energy supplies. The energy sector – including gas, electricity, hot water and heating – is almost totally dependent on gas imports from Russia. With import prices rising and no alternative supplier, this burden is being felt by final consumers, contributing to a growth in social inequalities. Electricity and gas tariffs for final consumption have been raised according to the revised tariff methodology and broadly reflect the increases in import prices.

The supply of gas was severely disrupted in January 2009 due to a dispute between Russia and Ukraine. Gas import prices increased several times in 2008 and were finally set by Gazprom at USD 333 per thousand cubic metres (tcm) for the first quarter of 2009, but subsequently declined to USD 255 per tcm in the second quarter and to USD 186 per tcm in the third quarter, in line with the decline in international oil prices. The energy sector will continue to register positive growth, though probably below 3%, driven by the growing demand from both households and industry.

The energy sector continues to face financial difficulties due to accumulated debts, partly due to the financial problems of Termocom, the district heating operator in Chisinau. Progress remains slow in resolving these issues. The energy sector regulatory institution, the National Agency for Energy Regulation (NAER), has recently adopted secondary legislation for calculating feed-in tariffs and certificates of origin for renewable energy generation, a necessary step in the development of the sector following the adoption of the law on renewable energy in 2007. In mid-September 2009 the Chisinau municipal council approved substantial tariff increases for water and public transport, following a tariff freeze for several years. This measure is expected to improve the financial sustainability of the two municipal utilities, reducing the need for less-efficient budget financing of water services and public transport.

Prices for urban housing services and other public services dominated the policy discussions in 2009. The issue of the tariff for centrally supplied heating in the Chisinau municipality was heavily politicised but failed to reach a sound solution. The government decided to intervene and to empower the NAER to set the tariff level. This is the practice in many European countries and should also be adopted in the Republic of Moldova. However, this is not enough to avoid public dissatisfaction with tariffs. The core problem is that the NAER, representing the Chisinau municipal authorities, does not have a clear understanding of the financial situation of these energy companies and of related economic costs. The companies (Termocom, power-generation plants, Moldova-Gaz) must be exposed to an independent financial and performance auditing in order for policy makers and the population to be sure of the validity of the tariffs.

Policy implications

Under the 2001-April 2009 communist government, there was a large gap between the officially declared policy and the real political process. It was officially announced that, together with regulatory reforms, the decentralisation of central administration was to be undertaken to achieve synergies in deregulation and improving the business environment. Yet, diversification of the functions of central government (ministries as political governance; regulators as monitoring and control functions; and agencies as providers of public services), was rejected – which actually cancelled the results of these regulatory reforms. Weak market institutions remain a major impediment to improving the efficiency of the country's economy.

The former coalition government, elected in 2009, brought some changes in industrial policy rhetoric and practice. More emphasis was put on technological competitiveness of the Moldovan companies and on more competent human capital and managers. It is believed the new coalition government will follow the same objective.

The major issue is the quality of corporate management in the industrial sector. The former coalition government deemed most of the regulatory agencies to be non-functional. As a result, many economic sectors were inefficient, while unrealistically high or low levels of prices had led to unfair distribution of income in the society. The government therefore started to clear some products from trust agreements (such as meat and fish markets).

Such activities have to be performed not by the Ministry of Economy (which is a policy development centre and not a regulatory body), but by the National Agency for Competition Protection which has the legal mandate. The Agency has to be effectively empowered (with human resources and a clear regulatory backup) in order to undertake effective market inquiries and enforce anti-trust rules. This means that the Agency should remain independent from the government, though stronger political support from Parliament may be necessary.

Continuous deregulation, together with reform of the central administration to improve efficiency and reduce bureaucracy, needs to be pursued. Moreover, enhancing transparency, as defined by law, is a priority to reduce corruption and increase government accountability.

Services

The services sector has proven to be the most resilient in the current economic recession. While it declined in 2009 by 3%, this was lower than feared, thanks to an improvement in the second half of the year. The sector is expected to grow by 3% in 2010. In 2009, transports were the most heavily hit sub-sector with freight contracting three-fold in only two-and-a-half months. The persistence in Moldovans' preference for Turkish, Bulgarian and Romanian resorts over domestic ones came as a surprise, especially during the crisis period. This once again underlines the country's inability to develop its own tourism because of the severe lack of infrastructure and because of the equal lack of investments and marketing expertise in both the Moldovan Ministry of Tourism and Moldovan tourism agencies.

The expected 3% rebound in 2010 is led by retail trade (6%) and basic services (8%). Despite the fact that the transport of goods and passengers began to increase after April 2010, their level remained half their 2008 pre-crisis level, while other services provided mainly to businesses (such as IT) saw moderate growth, for example mobile telephony grew by 18% in the latter part of 2010.

Information, communication and technology

The ICT sector has been one of the most productive and fastest growing industries since the end of the Soviet Union. Its contribution to GDP was 9.5% in 2008 (compared to 7.5% in 2004), which amounts to USD 580 million, equal to the agriculture sector.

ICT is an important employer in the country, with 20 500 people in the sector in 2008, a number expected to double by 2015 (ICT PC Association, 2009). It is also one of the highest-paying industries, alongside the financial sector. Country data indicate that the ICT sector is already a major pillar of the Moldovan economy, with IT being one of the most dynamically developing sub-sectors.

The ICT sector's share of GDP was 9.5% in 2008, dominated by telecom and equipment wholesale services. While the IT sub-sector alone only contributes less than 1% of GDP, it grew ten-fold between 2005 and 2010. The number of jobs in IT has increased annually by 68% on average over the same period. While official trade data are not available for service industries, exports of IT in 2008 were estimated at USD 26.3 million. There are around 519 known IT companies, although a large part of the sector operates in the shadow economy as unregistered independent contractors. Almost all of these enterprises are small or medium-sized.

Unofficial numbers and anecdotal evidence suggest that ICT is a rapidly growing sector which can seriously contribute to the economy both in terms of exports, employment and contributions to the national budget. Furthermore, ICT, and IT in particular, can be leading vectors of economic growth as an enabling sector for the development of most other sectors of the Moldovan economy. This fact was recognised by the government, which publicly announced ICT as a priority sector for development in the medium term, including broadband infrastructure development.

There are two main supporting industries for a competitive IT sector: infrastructure and education. The latter has benefited from the rapidly growing number of graduates, whose number doubled in the five years to 2010. As the market grows and competition becomes fiercer, the sector must move to a higher stage of development, which will require large numbers of highly trained IT specialists. Infrastructure, mainly Internet and mobile telephony, has grown more than ten-fold since 2004 but broadband connections still have an alarmingly low penetration rate.

The former coalition government introduced some quite ambitious measures in its programme and economic recovery plan, aimed to change the model of economical growth through drivers of job creation. The services sector is the second most important destination of workers moving from rural areas, after migration. It is planned to facilitate access for alternative operators (private, foreign, mixed) to the railway, air transportation and communications industries, and to liberalise these sectors further. However, some of these sectors have grown in recent years into political-economic conglomerates that spread their influence across many economic sectors and public administration layers. In some cases, freeing up the sector will require a complete reshuffle of the current management and of the regulatory environment. Fierce bureaucratic and institutional opposition is to be expected against implementation of these plans.

The government's programme for economic recovery provides for the implementation of a number of measures directly or indirectly to reduce the costs of doing business, including in the services sectors. A significant proposal was a reduction of the costs and time for business registration (which is already significantly lower than in many countries of the world). Equally importantly, the programme reduced the number of economic activities subject to licences. Moreover, reduction and streamlining of the procedures for obtaining sanitary permits and sanitary-veterinary permits is likely to boost companies in the food retail and catering industries.

According to the ICT Policy White Book drafted by the ICT Association, in five years, the ICT sector will be the main driver behind economic growth, augmenting labour productivity and enhancing international competitiveness through the wider use of ICT products and services across the economy and society (ICT PC Association, 2009). It will be driven by rapidly increased mobile telephony use and widespread broadband penetration, supported by an effective regulatory framework and a skilled and competitive workforce. To facilitate growth, the sector needs an efficient and transparent government procurement system, improvements in the fiscal environment for ICT and further investments in strategic areas, such as education and R&D. To achieve an effective and transparent dialogue with the government, a cohesive and focused ICT sector will have to ensure that changes introduced at the government level are matched by responses from the ICT sector companies. The sector will need to capitalise on offshore activities to make the country the offshore location of choice for IT services. This requires strong and consistent country positioning. Continuously increasing the quantity and quality of graduates from IT faculties whose skills are aligned with market needs will be a major priority. Investment in quality will be required for attracting offshore operations and R&D will be necessary for moving towards high value-added products. Government spending in this sector should encourage the use of local businesses. The government is supportive of the ICT industry, demonstrating an understanding of its growing importance and catalytic role for the entire economy.

Transport

Transport services are of great importance as international trade depends on them, and the country's growth is driven by external trade. Agricultural trade and growth depends on a well-functioning transport industry for goods and people. Investments and improvements in transports are, therefore, necessary as a basis for economic growth and to contribute to sound state finances.

Transport has suffered from a deep recession since 2008 and the government had promised to address the situation. However, the real problem is how to rehabilitate the infrastructure, which requires large, long-term investment. Against this backdrop, the former coalition government proposed a number of measures to streamline licensing and authorisation procedures. In the long run, these measures need to be accompanied by higher quality roads and more transparent collection of road taxes as well as efficient and transparent use of the Road Fund.

There was a 20% fall in freight in January-February 2010 compared to the same period in 2009; a year-on-year decline which was gradually slowed to 10% in the January-April figures and to 5% for January-June. However, the fact that tourism failed to rebound after the sharp drop of 2008 hints at more subtle issues, such as the continuation of trade disruptions caused by ongoing embargoes and the impossibility of companies to ship their production, thus severely and negatively impacting the transportation sector. Another problem is supporting the reorientation of exports to the European market by redrawing transportation routes (which will take time to achieve). A recovery of the transport sector in 2011 is unlikely.

Missing data and statistical errors cloud the picture of the employment situation in 2004 and 2005. According to the available data, the number of employed people in the transportation and communications sector dropped from 67 700 in 2003 to 400 in 2004, up to 500 in 2005, which seems somewhat unlikely.[9] In 2006, the figure is 65 300 people (roughly 2 000 fewer than in 2003). The number of people employed in transportation and communications continues to increase according to the official statistics until 2008, reaching 70 800 (the highest value between 2000 and 2009), before dropping back in 2009, to its 2003 and 2007 levels.

Limited domestic opportunities encourage Moldovan transport companies to increase their activities in regional markets, where they usually offer their services at lower prices. As a result, Moldovan international carriers can fall under anti-dumping measures in other countries and lose their contracts. Moreover, the Ministry of Transport is late with measures harmonising legislation with international standards. All this, together with huge corruption in the sector, creates high business risks and leads an increasing number of transport companies to transfer to neighbouring countries with more business-friendly environments (in Romania, Ukraine or Russia, for example).

Tourism

The tourism sector will remain largely at its 2009 level in 2010, without any significant breakthrough in developing national routes and attracting more tourists to the Republic of Moldova, as funding for the Tourism Agency remains mostly unchanged and no restructuring is in the pipeline. In these circumstances, there is little hope that the government will draw up a comprehensive tourism and accommodation programme to encourage domestic and foreign tourists. An achievement of the Tourism Agency, nonetheless, was the showcasing of Moldovan production and attractions at the Expo 2010 Shanghai.

Hotels and restaurants accounted for up to 1.46% of GDP in 2009, their peak level since 1997, but experienced slow progress to this level, rising from less than 1% before 2003, on average, to 1.7% estimated for 2010. This performance is far from capacity and reflects the very slow development of tourism as a whole.

Banking and financial sector

Financial services have almost doubled since 2000, with a peak share of 5.83% of GDP in 2009, despite the economic crisis, underlining the resilience of the financial sector.[10] Real estate transactions also grew in 2009 (as a share of GDP), more than doubling since 2000 and peaking at 5.05% of GDP.

The banking sector complies with Basel I standards and participates in consultations and discussions regarding the implementation of the Basel II framework. On this last point, the government requested further assistance in the implementation and logistics of the Basel II Pillar I (Minimum capital requirements for risk reduction) and Pillar II (supervision of capital), because of serious concerns about the ability of the National Bank to establish a timetable for implementation and its ability to oversee the distribution of capital in the economy, partly as a result of poor transparency and weak corporate governance. There are currently 15 banks licensed by the NBM able to operate in the country. All of these banks are international banks and, as such, supply all types of financial services, including agricultural banks.

The banking sector is quite stable because of the very conservative regulation of NBM. The main standards are in line with, or even stricter than, the Basel prudential norms. They stipulate financial reporting according to International Accounting Standards, a capital adequacy ratio of 20.5% as of October 2008, and loan provisioning on a gross loan basis without taking into consideration collateral because of the difficulties of valuing and realising collateral in a fuzzy business environment.

The banking system remained generally sound, as assessed by an IMF *Financial System Stability Assessment Report* in August 2008 (IMF, 2008). The global financial crisis did not affect the financial system, mainly because of the limited access of domestic banks to international capital markets, meaning they were unable to raise cheap funds during the economic boom period, and thus were not subject to large capital outflows during the downturn.

Local currency deposits declined by some 25% in nominal terms between December 2008 and June 2009, while foreign currency deposits have remained relatively stable, reflecting concerns about the prospects of the MDL and declining remittances. Some banks even suffered from temporary liquidity shortages and relatively large deposit withdrawals or conversions into foreign-denominated deposits.

Lending to the economy fell by half in nominal terms in H1 2009, compared to December 2008, most of which was attributable to the reduction of local currency loans for consumer lending. Small and medium-sized enterprises (SMEs) also reported substantial difficulties in obtaining bank credit, partly related to the impact of the global crisis on the real sector.

The quality of commercial banks' loan portfolios has deteriorated according to the NBM. The ratio of non-performing loans increased to 10.5% at the end of June 2009 compared with 5.9% at the end of 2008.

Partly as a result of the crisis, the commercial bank InvestprivatBank entered an orderly liquidation procedure in June 2009 and all its deposits were transferred to Banca de Economii, the state-owned bank. NBM has used various instruments to support the banking system and in May 2009 announced a programme of funding to Moldovan banks for terms of up to 12 months at the base rate to provide liquidity and support lending to the real economy at affordable interest rates. The programme is estimated to amount to MDL 1.5 billion (USD 135 million).

The banking sector is performing poorly in the financing of manufacturing and other long-term activities. Credits are too short-term (in general up to three years, rarely to seven years) and thus many long-term projects cannot be developed. The real interest rate is also quite high. There are some rudiments of mortgages, but they are very expensive and very short-term. The banking sector is developing new products such as credit cards for a limited set of clients and "internet banking" which does not allow active operations.

Leasing companies have been booming since 2004 and this could be a very promising part of the financial sector. However it may face serious problems with refinancing due to the world financial crises. This problem is magnified by weak regulation of leasing companies.

Falling real estate prices served as a rude awakening for construction companies, developers and banks. The authorities must reform the banking system in order to stimulate the development of new financial instruments to attract both savings and remittances.

The future of the financial sector lies in the entry of strategic investors into more banks and in the privatisation of Banca de Economii. This should lead to increased competition and the improvement of client services.

As the report *Doing Business 2010* notes, Moldovan legislation does not hold executive directors responsible to their shareholders, whether private or public, which results in extreme managerial inefficiency and asset funnelling (World Bank, 2009). The dramatic implosion of the Moldovan industrial sector is ultimately explained by managers' inability to adapt their companies to new market realities posed by the crisis and their exaggerated expectations of state support.

State-owned enterprises have been particularly inefficient during the crisis. To reverse this, it is imperative that the government adopts more severe standards of management of state-owned enterprises or restructures/privatises these companies, as appropriate. Regulatory agencies also urgently require clarified and enhanced powers.

The time has most definitely come to investigate objectively the performance of the corporate and financial management of state-owned companies in times of crisis and to decide on restructuring or privatisation.

MAIN MACROECONOMIC POLICIES

General overview

After the serious macroeconomic difficulties in the early 1990s, Moldovan governments promoted sounder macroeconomic policies between 2000 and 2008. Improved financial discipline led to average budget deficits of 0.3% of GDP, much better other transition countries in the same period (1.3% of GDP deficits on average). Running such small deficits was all the more salutary, given that inflationary pressures in the 2000-08 period were higher than in other transition countries (13.3% and 10% respectively). Despite this, the Moldovan government could not easily access international financial markets in order to cover potentially larger deficits. By committing itself to high fiscal targets, the government increased its fiscal risks: in 2008 the share of total public expenditures in GDP reached 41.6% and 46.8% in 2009. Increased wages, pensions and social benefits, despite lack of available attributed funds, led to severe imbalances in public finances. Wages contributed to both a high level and a substantial increase in public expenditures in 2009, while the share of investments in total expenditures declined. Overexpansion of the public sector resulted in crowding out of the private one.

In 2006–08, the government had already made a series of commitments to the IMF under the framework of the Poverty Reduction and Growth Facility (PRGF), as stipulated by the Memorandum of Economic and Financial Policies. The primary objective of this programme was to maintain macroeconomic stability against inflation through a strict fiscal policy. The second objective was to maintain the budget deficit at 0.5% of GDP during this period, by channelling income overflows into investments, with minimum impact on inflation. The fundamental challenge for the end of 2009 and during 2010 was to keep the budgetary deficit within the limits agreed with the IMF (9% of GDP in 2009 and 7% of GDP in 2010).

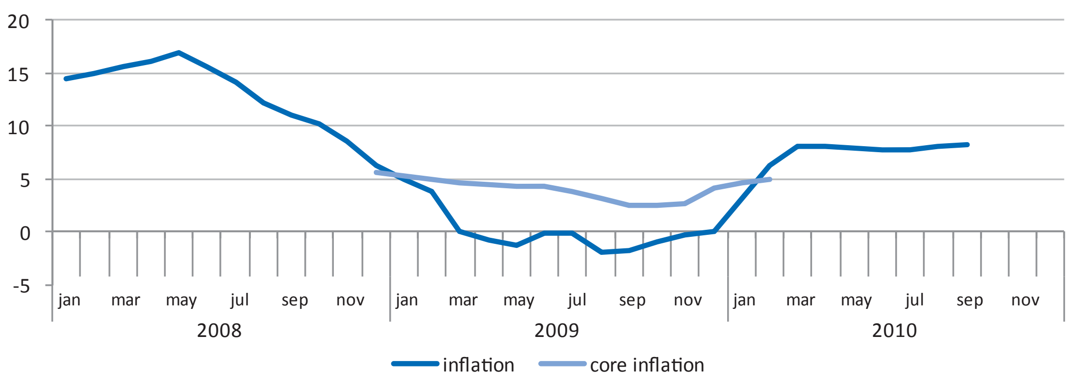
Financing the budget deficit in 2010 is challenging, despite international grants and loans and significant cuts in expenditure. Maintaining macroeconomic stability in the short term will require a careful mix of fiscal, monetary and exchange-rate policies, particularly fiscal policies. A return to growth in 2010 partly depends on the pace of the expected recovery in the main trading partners, but it will also need to be underpinned by further improvements in the business environment.

Fiscal policy

Fiscal balance is the main goal of the Moldovan financial authorities in 2010-13. Additional means will be implemented to provide investments in infrastructure and to consolidate social safety nets to mitigate the negative impact of energy tariff rises on the poorest. On the eve of national elections, in April 2009, a number of wage and pension increases were introduced by the former coalition government, draining limited budget resources even further. The fiscal deficit increased from 1% of GDP in 2008 to about 6% of GDP in 2009, financed mainly by a drawdown of previously accumulated balances in budget accounts and heavy domestic borrowing.

In subsequent years, fiscal and budgetary policies will be aimed at eliminating the structural budget deficit by streamlining public spending and stimulating private savings in order to create a stable macroeconomic background and sound competitive environment. Based on current forecasts, the overall balance of the state budget is expected to increase by about 5 percentage points over the next four years. It is also expected that the strengthening of the budget will occur mainly through the containment of current expenditures and their allocation, depending on their degree of priority, cost optimisation and the quality of structural reform. The strengthening of the MDL in 2008, the limited availability of credit, in spite of excess of liquidity, and the decrease in remittances in the third quarter led to a reduction in inflation from 17% to -2.2% between May 2008 and May 2009. Although the 2008 budget deficit only reached 1% of GDP, falling production and remittances weakened revenues and generous pre-election public expenditure commitments contributed to the increase of the budget deficit to more than 8% of GDP in 2009.

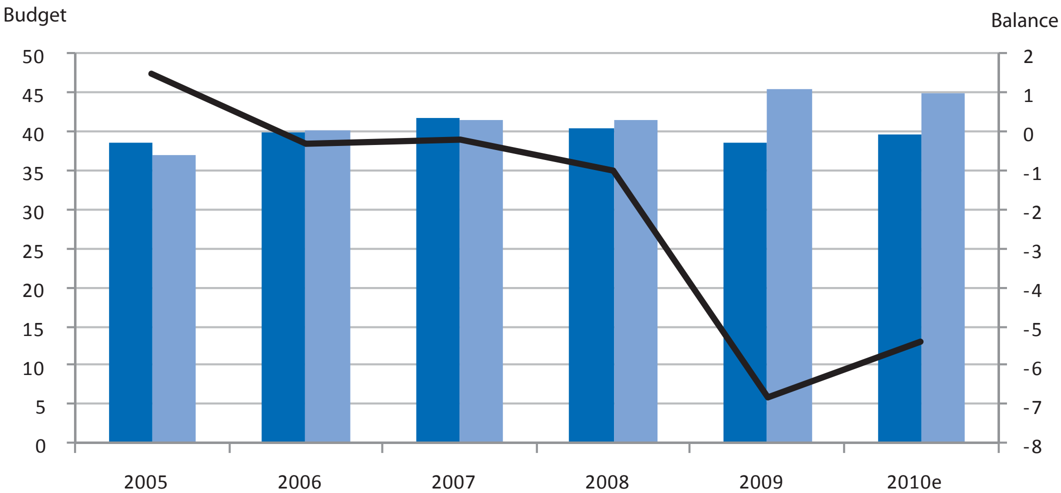
Figure 4.7. Inflation trends



Source: National Bank of Moldova.

The lack of significant fiscal reserves and the limited access to external finance have prevented the authorities from providing significant fiscal stimulus to the economy. Thus, the former coalition government's monetary response to the crisis was largely confined to reductions in the interest rate and in reserve requirements for commercial banks in 2009.

Figure 4.8. Fiscal deficit in 2009
(percentage of GDP)



Source: IMF, 2010.

Although in 2008 a strategy to deal with the crisis was not approved by the government, the former coalition administration made public certain measures for stimulating the Moldovan economy in 2009-10. Contributions to the social fund were to be reduced by 5 percentage points (a cut of 4 percentage points for employers and of 1 percentage point for employees). A flat-rate individual income tax of 15% is to replace progressive tax rates of 7% and 18%. Finally, VAT was to be increased by 2 percentage points to 22%. These measures raise two major concerns. On the one hand, reduction of the social tax is welcomed, as it will create incentives for the private sector to develop and reduce unofficial payments, but the introduction of a flat-rate income tax on individuals, although potentially increasing budget revenues, will hurt low-income groups disproportionately by doubling their taxes. On the other hand, a VAT increase, while raising budget revenues, could also have adverse effects on final consumers, most of whom have become vulnerable since the crisis.

Table 4.12. National budget of the Republic of Moldova
(MDL million)

	2003	2007	2008	2009	Jan-Oct 2009	Jan-Oct 2010
Total revenue	6 621.0	22 220.0	25 516.9	23 244.0	18 628.9	21 452.0
Profit taxes	578.0	1 388.0	1 479.6	1 478.5	1 186.6	1 263.4
Income taxes	623.0	1 329.0	717.5	429.3	371.8	358.6
VAT	2 792.0	7 587.0	9 097.2	7 595.6	6 171.3	7 404.3
Excise duties	888.0	1 437.0	1 631.3	1600.0	1 195.9	1 665.0
Grants	…	…	1 021.7	876.7	590.3	688.4
Total expenditures	**6 179.0**	**22 353.0**	**26 146.9**	**27 342.7**	**21 409.1**	**23 049.7**
General state services	506.0	1 266.0	1 418.1	1 412.4	1 123.7	1 050.8
Public order & national security	518.0	1 269.0	1 381.1	1 522.0	1 169.0	1 060.4
Education	1 498.0	4 248.0	5 178.3	5 666.0	4 367.9	5 166.6
Health	936.0	2 629.0	3 391.4	3 846.9	2 954.5	3 144.4
Social security	744.0	6 580.0	7 891.4	9084	7 440.6	8 289.6
Public debt service	580.0	610.0	721.6	834.2	742.2	462.8
Balance	**441.0**	**-134.0**	**-630.0**	**-4 098.6**	**-2 780.2**	**-1 597.7**

Source: EIU 2010.

Total tax revenues increased 2.5 times between 2003 and 2007, from MDL 4.9 billion to MDL 11.7 billion. In the meantime, total revenues increased slightly more than three-fold, to MDL 22.2 billion in 2007. Total taxes' share in total revenues has been declining since 2003, from 73.7% to 52.8% in 2007. In 2008, this share further decreased to 50.7%, though total taxes increased by 14.8% yoy, while total revenues reached MDL 25.5 billion (USD 24.9 billion). Taxes are thus insufficient to cover total state revenues. On the other side, the share of loans and grants from international organisations has increased in total revenues, reaching MDL 1 billion in 2008. The government therefore maintained the budget deficit in 2006–07 at 0.3% of GDP, and at 1% of GDP in 2008. However, with increasing population needs and economic breakdown associated with the global crisis, the budget deficit increased to 5.4% of GDP in 2009.

An austere budgetary policy was adopted in 2009 to bring the deficit under control. The economic crisis and pre-election spending hikes produced a large fiscal gap as revenue dropped, notably VAT and foreign trade taxes, while current fiscal expenditure was substantially increased in the run-up to the elections.

The share of fiscal revenues in GDP decreased during the first semester of 2009 to 32.6%, which was mainly caused by the shrinkage in final consumption. The revenues generated by indirect taxes were much more affected by the world economic crisis, which had a dramatic influence on total revenues and the deficit. Sales of state treasury bills during May-September 2009 created significant pressure on the state budget already by the end of that year, due to their short repayment period. The government thence committed itself to cut 4 000 civil service jobs, which succeeded in creating increases in unemployment and political costs.

In 2009, the share of taxes in total revenues declined overall to 47.8%, reaching a total of MDL 11 103.4 million (a yoy decline of 14%). Consequently, the deficit for 2009 increased 6.5 times yoy, to MDL 4 098.6 million (USD 3.6 billion). At the start of 2010, the government was likely to resort to cutting back and redistributing budget expenditures. It had already cut local budgets by 20%. Sectors such as agriculture might be the first to suffer from expenditure cuts and redistribution due to some unjustified subsidies. The released funds could be used to supplement the construction, transport and trade sectors that were hard hit by the crisis. These measures, together with an increase in the size and amount of unemployment benefits, will further increase the budget deficit. Moreover, the fact that the former coalition government had taken a reactive rather than proactive approach to managing the crisis will likely increase the time lag between actions and results.

At the beginning of 2010 signs of improvement in public finances were noticeable, given the decreasing fiscal gap and converging annual growth rates of public revenues and public expenditures. The annual increase in public revenues by 6.3% was determined mainly by the increase in indirect taxes: VAT receipts (+13.7), excise (+22.3%) and custom duties (+0.4%). At the same time, the revenues from payroll taxes decreased by 1.0%, which could be due to growth in the informal economy or a simple reduction in the absolute number of jobs. Either way, despite increases in domestic and external demand, stabilisation of the Moldovan economy is hardly a done deal. The IMF's USD 570 million loan in 2010 should increase the grant balance.[11] Moreover, a non-repayable financial aid package of USD 262 million was awarded by the US government on 12 January 2010 for road improvement and irrigation systems, increasing the government revenues for the year.

Total public expenditures increased in Q1 2010 by 5.3% in comparison with the previous year, driven by expenditure on social assistance (+13%.4%), health care (+0.4%) and education (+19.8%). The real challenge for the budgetary policy is related to managing the increasing internal and external public debt and tackling its effects on the economy. During Q1 2010, total income from sales of T-bills was three times higher in comparison with the previous year (MDL 1 130.1 million). The budget deficit in Q1 2010 had decreased to MDL 868.8 million (USD 69.5 million) compared to MDL 1 082.5 million (USD 86.6 million) in the same quarter a year previously. The budget deficit is expected to decline by 1.5% due to greater structural consolidation of public finances and the holding down growth in the current account deficit.

Table 4.13. The 2010 budget forecast

Budget deficit (% GDP)	5.4
GDP growth (%)	2.5
CPI growth (%)	10.8
Exchange rate (MDL/USD)	12.4
Exports growth (%)	13
Imports growth (%)	13
Nominal revenue growth (%)	33.5
Minimum subsistence level (MDL)	1 188.7
Minimum monthly wage (MDL)	600
Stabilisation fund growth (MDL billion)*	8 883.9

Notes: *From privatisation and issuance of domestic Treasury bills.

Sources: EIU, IMF, State Statistical Committee, Moldovan authorities.

The crisis has impacted both local and state budgets; especially since the former remain highly dependent on the latter. This dependence induces increased bureaucracy for local solutions and increases inefficiency, which considerably limited local authorities' options for responding to the crisis, particularly during the electoral campaign and a generalised political stalemate. With corporate income tax planned to be levied only in 2012, the narrow tax base at local level and high fiscal centralisation will remain an important issue unless more fundamental action is taken by the government. For instance, it can reintroduce the practice of VAT sharing with local governments. Additionally, it can increase the property tax which could become a more important source for local budgets. It is also necessary to improve the regulatory framework that will offer local governments clear possibilities for borrowing long-term loans on the capital market.

Monetary policy

The strategic directions of the NBM policy for 2010-13 include: price stability, the maintenance of a low level of inflation and collaboration with the International Monetary Fund. These objectives will be achieved using the main policy instrument: open market operations. To ensure and maintain price stability, the NBM set the objective of inflation, measured by consumer price index published monthly by the National Bureau of Statistics, at 5% with a possible deviation of 1 percentage point. In 2011-12 the NBM will ensure the qualification inflation by establishing an annual quantitative objective.

Recent developments

In 2008-09, the NBM spent about a third of foreign exchange reserves (more than USD 500 million) to protect the economy from currency risks, thus subsidising imports. In late 2009 the new leadership of the National Bank took steps to remedy the situation by restoring a significant portion of the lost reserves (USD 290 million), while enhancing the competitiveness of the economy.

The deterioration of the economic situation in 2008 was due to falling remittances and construction, blockage of the bank lending process and the collapse in exports, worsening the balance of payment indicators. Since September 2008 the central bank's monetary policy became more focused on stimulating economic growth. However, despite the central bank's attempts to loosen its monetary policy, the gap between its policy rate and annual inflation increased. Surprisingly, deflation undermined the efficiency of monetary policy, leading to a decrease in monetisation and the volume of credit offered by commercial banks. The central bank started to rely more intensively on liquidity and, since April 2009, sterilisation operations have not come into play.

Two monetary policy instruments were employed: Repo operations and direct loans to commercial banks. The depreciation of the national currency since the beginning of 2009 was caused both by objective factors (decrease in foreign currency inflows as a result of the decrease in exports, remittances and FDI), as well as by lower investor expectations. Increased demand for foreign currency caused the central bank to conduct massive interventions on the foreign exchange market in order to prevent the national currency from sliding.

Table 4.14. Monetary effects of the crisis

	2007	2008	2009
Current account balance (USD billion)	-695.5	-1009.4	-1936
Current transfer balance (USD billion)	1 167	1 561	969
Consumer Price Index (100=2005)	126.7	142.9	96.9
Total national currency deposits in MDL (%) *	23 086	27 196	25 031
Total national currency deposits in USD (%) **	2 039	2 615	2 025
Exchange rate MDL/USD (average)	12.14	10.39	11.24

Notes: *Calculated on the basis of end-of-year figures for total deposits in MDL, ** Total deposits in MDL divided by the end-of-December official MDL/USD exchange rate.

Sources: State Statistical Committee, WEO Oct 2010, EIU.

The anti-inflation policies were not as tight as had been expected in 2009, and, in fact, the National Bank of Moldova had no clear-cut monetary policy strategy and no effective tools to counter inflation growth. On the other hand, the government admitted to accumulation of price distortions: food became very expensive for a country with "agricultural traditions", while the prices for services, particularly for housing services, central heating, water and transport services, were artificially kept below cost-recovery levels.

Table 4.15. Inflation rates
(percentage)

	2008	2009	2010(e)
CPI	12.7	0.0	7.4
PPI	10.4	-3.0	7.9
CI	11.0	4.1	5.2

Sources: Bureau of National Statistics, National Bank of Moldova.

Monetary aggregates (M2, Reserves)

The monetary mass fluctuated in 2007-09, with an 18% rise in 2008 (compared to 2007) accompanied by a very mild 0.4% increase in CPI and an increase in all productive sectors as well as investments in capital. However, in 2009, the macroeconomic situation worsened as a result of the economic crisis and M2 contracted by 4% with a fall of almost 10% in agricultural and more than 20% in industrial production; investments fell by over 30%.

Since the beginning of the crisis, the main monetary policy of the NBM has been to thwart any inflationary trends by meeting established inflation objectives, and to stimulate demand and consumption which has, as yet, failed to take off. Changes in monetary policy are not expected in the near future, as inflation does not seem to be an issue with the slowly recovering demand but the NBM promises to take action should demand abruptly rise or should the threat of monetary depreciation become more pronounced.

The GDP was lower in 2009 than in 2008, but still higher than in 2007, with a similar trend for the value of the MDL. Reserves similarly declined in 2009 compared to 2008 – which was a positive year with the rise of all indicators compared to 2007. It is important to note that the stock of reserve assets in 2009 was higher than in 2007. However, the 2010 figures will help to get a clearer picture of the main trend.

Deposits held with domestic banks decreased in 2009 by 3.7% in comparison with the end of 2008, while credit to the real economy shrank by 4.9% in the same period. Lending conditions also worsened in real terms, despite the NBM's expansionary monetary policy. Lending to the economy declined in the context of rapid growth in the proportion of problem loans and bankruptcy. The National Bank's reserves and the resources of the Microfinance Institution (MFI) covered the current account deficit (of 9.5% of GDP in 2009). Given high credit interest rates that limit the access of businesses to financial resources, the former coalition government came to an agreement with the NBM to provide preferential credit to commercial banks with an interest rate of 10%. The credits will subsequently be provided to the economy at a 16% interest rate. While this is a somewhat late measure, it may help some businesses within the affected industries if not to invest in production, at least to pay back old credits.

Mirroring the consumer frugality, savings in the form of deposits in the commercial banks continued to increase until April 2009, despite the decrease in remittances. Since April, the rate of growth in deposits has decreased significantly and the bankruptcy of a Moldovan commercial bank in June 2009 shook popular faith in the banks. However, in August there was a slight increase in deposits.

Since April 2009 the NBM has not used its certificates as a sterilisation tool and has provided liquidity through Repo operations and direct loans to commercial banks. The first instrument was employed mainly from May to July and helped to inject MDL 346 million into the banking system. In March-September 2009 the NBM also provided MDL 1389.1 million in direct credits to commercial banks at its refinancing rate. The main condition was for the banks to pass on these resources to the real sector with a maximum margin of 5 percentage points.

Additionally, the NBM decreased the obligatory reserve rate, which offered commercial banks the possibility to free up more resources for crediting activities. The obligatory reserve rate decreased from 22% in September 2008 to a record low level of 8%, for national currency, fully convertible and non-convertible currencies.

Exchange rate

There is a floating exchange rate system. In 2008 the MDL/USD exchange rate was the strongest, compared to both 2007 and 2009, at MDL 10.38 to the USD. In 2009, the MDL dropped to MDL 11.11 to the USD and is on a worsening trend in 2010 (MDL 12.86 to the USD in H1 2010). As a result, the share in GDP of imports sharply decreased in 2009 (from 94% in 2008 to 73.6% in 2009) as did exports' share (from 41% in 2008 to 37.1% in 2009).

As a result of the expected increase in external debt, a major challenge for the government was to avoid any shocks related to the exchange rate which would increase the burden of external debt on the economy. During 2009, the official nominal exchange rate of the national currency against the USD depreciated by 18.3% (by 19.6% against the euro) following the depreciations of the main trading partners' currencies against the USD in September-December 2008; particularly by the drop of the Ukrainian hryvnia (70.5%), Polish zloty (29.6%), Turkish lira (27.9%), Russian rouble (19.4%), Romanian leu (17.7%).

The real effective exchange rate of the national currency (REER) in December 2009 was 99.3% of its December 2000 value, thus improving national competitiveness. This was due to lower levels of inflation in the Republic of Moldova than in its trading partner countries and to the appreciation of the USD against some currencies.

Despite the fact that the NBM's refinancing rate was set in September 2009 at the minimum historical level of 5%, it remained quite high in real terms. Taking into account that the interest rates applied by the central bank to its loans to commercial banks equal its base rate (7% on 3 August 2010), which is relatively high, the real economy will continue to be constrained.[12]

Policy recommendations

The NBM has to continue loosening its monetary policy given the deflation trends and the necessity to stimulate credit for the real sector. Otherwise, the continuous decrease in the monetary rates could lead to negative effects in the short term. This monetary expansion should be controlled in order to avoid a massive flooding of liquidities into the system, which could immediately boost inflation to dangerous levels and harm the economy.

The lack of confidence in the national currency is another key policy issue and challenge with which the NBM's foreign exchange policy should deal. Since April 2009 the annual indicator for monetary aggregate M0 constantly exceeds M2 which is associated with the decrease in the amount of time deposits denominated in national currency. This phenomenon makes the issue related to the shortage of broad money in the Moldovan economy even more acute.

External sector

Exports

The goods export structure shows a clear specialisation in food export and textiles, with very significant growth in the chemical industry alongside underdeveloped heavy industry. Low value-added agricultural products, beverages and tobacco, and textiles accounted for 60% of exports in 2009. Exports of household appliances (especially VCRs and audio recording devices) represented 10%; all other sectors accounted for less than 5%. In 2009, agricultural production volumes rose by almost 28%, compared to 2008; the share of the beverage industry, suffering from export embargo, dropped by 10% in total exports; and the textile industry, suffering from the regional economic recession, lost 18%. The chemical industry registered the highest sector growth rate (174.6% in 2009 compared to 2008) and constituted 4.5% of total exports in 2009.

The composition of exports diversified in the last couple of years when the share of food and drinks declined due to the Russian wine embargo. The transformation of the export structure is driven largely by SMEs. The difficulties they face in obtaining financing for investments and working capital hamper the process of transformation and production growth. The recent assessment of competitiveness in the Moldovan economy by IDIS Viitorul (2008) clearly points at the development potential. Moldovan products and services are gaining market share in European markets. However, the analysis also underlined the necessity of concerted action in key industries, such as wine, to respond to changing market architectures and to leverage the competitive potential of the economy.

Table 4.16. Share of main exports of goods by category in total exports
(2009)

Export of goods		
(SITC Revision 3)	**Trade value** (USD 1.000)	**Share** (%)
Food & live animals	328 225.5	25.5
Beverages & tobacco	281 010.8	21.8
Mineral fuels	14 386.6	1.1
Chemicals	26 851.0	2.1
Textiles and clothing	257 789.8	20.0
Iron & steel	294 14.9	2.2
Machinery & transport equipment	165 222	12.8
Footwear	263 76.2	2.8
Commodities and transactions not classified elsewhere in SITC	388 03.5	3.0
Total of above	1 168 079.8	90.7
Total of all goods exports	1 287 536.3	100.0
Other categories of exports	119 456.5	9.3
Export of services		
Transportation	253.5	1.0
Communication services	10 521.0	39.8
Financial services	675.2	2.6
Travel	168.2	0.6
Other	14 828.0	56.1
Total	26 445.9	100.0

Source: WITS and NBS – Calculation by the authors.

The 2006 export setback caused by the Russian wine embargo was overcome and both the direction and the composition of exports underwent positive changes. The share of exports to Commonwealth of Independent States (CIS) countries declined from 51% to 41% (for constant volumes) while it proportionally increased to the EU27. The export decline to Russia was compensated by soaring exports to Belarus and Ukraine, circumventing the wine embargo. Most of the export increase to the EU went to Romania. The main export destinations in 2009 were the Russian Federation (22.3%), Romania (18.6%), Italy (10.5%) and Ukraine (3.6%). Over half of alcoholic beverage exports went to Russia (33.2%) and Belarus (28%), followed by Kazakhstan and Ukraine (9.1% and 8.6% respectively). However, Moldovan producers still need to reach international standards in order to gain in competitiveness and thus in market share in traditional and new export countries, mostly targeting Bulgaria and Romania. These improvements will require significant new investments. Some wineries have invested in packaging and labelling but have problems with marketing.

Dry fruit and walnuts are significant export products with good potential to grow, though more modernised production technology and better packaging are necessary. Even more, integration into wholesale and retail networks should be developed to achieve higher prices for exporters, but there is further need to adopt new technologies, such as controlled atmosphere storage to take advantage of better prices during the off-season.

The textiles sector has become important due to low wages, mainly in manufacturing for Italian and German firms. However, this low-wage scheme (monthly wage of EUR 140) does not appear to suit Moldovan workers, which explains a labour shortage in the firms involved. Moreover, only a few Moldovan firms are able to move up the value chain as a quick-turnaround supplier to the European fashion industry.

The ICT sector draws on science and mathematics skills in the labour force, yet its rudimentary organisation and predilection for operating in the shadow economy severely limit its growth potential. Both policy reform and increased co-operation within the sector will be necessary to help the cluster graduate to greater economic prominence – supporting the conversion of the rest of the economy to information technology – and to develop its export potential.

The decrease in exports in 2009 could be attributed to three main reasons:

- the insufficient quality of export goods and services and/or the export of low value-added goods (*i.e.* raw agricultural produce instead of IT related activities, e-commerce and consultancy where the country could have a comparative advantage due to the low-cost workforce);
- the Russian embargo on Moldovan export products and the need for market readjustment and expansion to new markets; and
- the growing impact of the economic crisis on local producers that had to contend with lower sales revenues on the Moldovan market and were forced to reduce production in order to avoid losses.

Whereas, until 2009, both import and export prices constantly grew, in 2009 there was a decline in both, import prices being 32.7% lower than in 2008 and export prices being 19.2% lower.

Imports

The import structure is a lot less specialised than its export counterpart. The main import areas were: mineral resources (21.9% of total imports in 2009), cars and electrical appliances (14.3%) and chemical products (11.2%). All imports suffered contraction in 2009, the largest of which was in common metals and articles made thereof (51% contraction) so that metals imports in 2009 represented 5.6% of total imports.

Table 4.17. Share of main imports by category in total imports
(2009)

Import of goods		
(SITC Revision 3)	**Trade value** (USD 1.000)	**Share** (%)
Food & live animals, beverages & tobacco	497.6	15.2
Mineral fuels	718.2	21.9
Chemicals	366	11.2
Textiles, clothing	244.4	7.5
Iron & steel	183.7	5.6
Machinery & transport equipment	624.8	19.1
Footwear	22.2	0.7
Commodities and transactions not classified elsewhere in SITC	89.1	2.7
Total of above	2 746.0	83.8
Total of all imports	3 278.3	100
Other categories of imports	532.3	16.2
Import of services		
Transportation	-256.8	19
Government services, not included elsewhere		
Financial services	-704.0	51
Travel	-228.4	17
Total above	1 189.1	87
Other	-179.7	13
Total of all imports	-1 368.8	100

Source: WITS and State Statistical Committee – calculation by the authors.

The three main import partners in 2009 were Ukraine (14%), the Russian Federation (11.4%) and Romania (9.5%). Romanian and Ukrainian imports slightly diminished in 2009 to the benefit of Russian imports. These changes reflect an attempt at diversifying its trading partners. Therefore, trade with the European Union countries and to countries such as Turkey and China is increasing, more so since the crisis.

The structure of Moldovan imports has remained largely unchanged since 2000. All fuels are imported from abroad; petroleum, oil-related products and natural gas account for a stable share of around 19% of total imports annually. This trade dependency is particularly high and compensates for weak domestic production and the small domestic market. It concerns not only the energy sector but also a broad range of products, leading to a widening institutionalised trade deficit.

Balance of payments

External imbalances increased further in 2008. The current account deficit reached almost 17% of GDP that year but was successfully financed by commercial capital inflows and FDI, which increased to a record of USD 679 million, just above 11% of GDP. In 2009, the external account was undergoing a sharp adjustment owing to the drop in external demand. There has been a sharp fall in both imports and exports with the trade deficit declining by more than 40% yoy.

Table 4.18. Balance of payments
(USD million)

Balance of payments	2007	2008	2009	Q1-Q3 2010
Current account	-673.8	-987.4	-439.3	-452.0
Goods and services (balance)	-2 309.2	-3 207.9	-1 972.3	-1 607.3
Goods (balance)	-2 303.1	-3 220.4	-1 943.6	-1 563.4
Services (balance)	-6.1	12.5	-28.8	-43.9
Income (balance)	416.4	597.8	313.7	247.2
Current transfers (balance)	1 218.9	1 622.7	1 219.3	908.1
Remittances	826.5	1 032.8	627.2	277.0
Capital and financial account	559.5	910.8	376.8	-20.1
Capital account	-8.0	-14.6	-17.5	297.2
Financial account	567.5	925.4	394.4	151.1
Direct investment	522.0	691.5	79.5	3.5
Portfolio investment	-4.5	6.4	-5.8	-0.6
Other investment	579.3	678.6	119.9	307.7
Reserves assets	-528.9	-452.0	200.6	-164.5
Net errors and omissions	114.3	76.6	62.5	175.0

Source: National Bank of Moldova.

Official reserves declined by almost USD 500 million in 2009 to USD 217 million that covered just above three months' imports of goods and services. By the end of 2008, total external debt (45% of which was private) exceeded USD 4.1 billion (68% of GDP), which increased to USD 4.3 billion at the end of 2009 and has remained stable until the end of Q1 2010. The current account deficit fell to USD 439.29 million in 2009 and picked up in 2010, already reaching USD 452 million in Q1-Q3 2010. The goods and services trade deficit shrank by around two-thirds in 2009 due to the significant decline in imports following the international crisis and was USD 1 972.31 million (compared to USD 3 207.89 million in 2008). By Q1-Q3 2010, this balance was already showing a deficit of USD 1 607 million. Whereas the capital and financial account showed a surplus of USD 376.83 million in 2009, 2.5 times lower than a year before (USD 910.8 million), it was already showing a deficit of USD 20.1 million in Q1-Q3 2010, deficit which is expected to have further increased in Q4 2010.

MILLENNIUM DEVELOPMENT GOALS

The Republic of Moldova signed the Millennium Declaration in 2000. The government has pledged to reduce the percentage of the population living on less than USD 4.3 from 34.5% (2006) to 29% (2010) and to 23% (2015); to diminish the percentage of the population living in absolute poverty towards 20% in 2015; and to reduce the percentage of people living under the level of extreme poverty by 1% so as to reach a target of 3.5% in 2015.

By 2015, the government aims for an enrolment of over 98% in mandatory education, to maintain the degree of literacy of youth aged 15-24 at 99.5%, to increase child enrolment in pre-school programmes to 78%, and to reduce the discrepancy between urban and rural areas by at least 5%. The objective is also set on the quality of education and the skills gap.

In gender equality, the country is committed to raising the representation of women at all levels of public power and governance, while ensuring that male salaries do not exceed female ones by more than 10% (on average).

In health, the government aims to reduce child mortality, better control the spread of HIV/AIDS and sexually transmissible diseases, reduce the incidence of pulmonary and other diseases, and ensure access to qualified medical personnel and health services in general.

In environmental sustainability, the government aims to improve water treatment, ensure access to sanitation, as well as conserve the biological diversity of the country, all the while protecting natural resources from degradation.

General overview

The general economic situation worsened immediately after the world economic crisis hit the country and it would be unrealistic to expect that significant recovery of the production sector and the restoration of full employment could begin before 2011 and after the relative production recovery of 2010. Recovery of the social indicators, following this reasoning, is unlikely to begin in earnest before 2012.

The severe social impact of the crisis forced the government to make human capital protection a key aspect of governmental policies to mitigate the impact of the crisis. Social stimulus packages, in the form of temporary social payments to carefully targeted populations, as well as the creation and deeper development and expansion of social services, should remain an essential part of the government's policy until 2013. To be able to correctly evaluate the situation and the needs of the population, community-level inquiries are recommended.

The country is facing an increasing disparity between rural and urban areas, with rural areas falling behind in access to all social services as well as in access to an increasingly competitive and skills-oriented labour market. With a weak job market, which has worsened during the crisis, young adults, especially from rural areas, find themselves forced to migrate to other countries in order to find work. This has already had a very negative impact on the country by raising its dependence on remittances.

Basic indicators

The impact of the economic crisis slowed down progress towards the Millennium Development Goals (MDGs) and, in certain areas, reversed the positive trends previously registered. A number of factors are to blame. Since 1996, there has been constant depopulation, from 4.35 million people in 1989 to 3.56 million in 2010. Furthermore, the unemployment rate, which had successfully diminished to 51 700 in 2008, went back up to 81 000 people in 2009 (approaching its 2006 levels).

Half the population is aged 25-59 years, with a median age of 35.7 and a significant proportion (18.3%) of the population is comprised of young people aged 15-24.

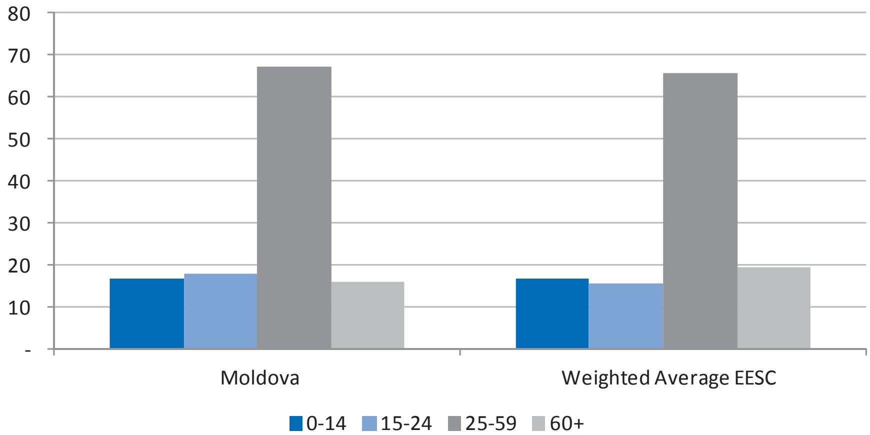
Table 4.19. Age structure

Age structure	0-14	15-24	25-59	60+
2010	16.7%	18.4%	50.9%	14.0%

Source: National Statistics Department.

Compared to other EESC countries, the Republic of Moldova is roughly similar in age structure, with the exception of the 15-25 group which is more pre-eminent than in other EESC countries. This category is a very important issue in the country as this high percentage of youth is most susceptible to emigrate because of high youth unemployment and a lack of professional opportunities.

Figure 4.9. Age-population distribution comparison



Source: World Bank 2009.

Goal 1: Reduce poverty

Target: Achieving full and productive employment and decent work conditions for all

While the unemployment rate has gradually decreased and more than halved in 2008 (reaching 4%), in 2009, as a delayed result of the economic crisis, it rose by 2.4 percentage points, reaching 6.4% of the total population. The country has thus lost two years of progress in reducing unemployment. Moreover, results for 2010 showed that employment failed to pick up with the economic recovery and that unemployment continued to increase.

Table 4.20. Unemployment figures

Unemployment rate	2000	2006	2007	2008	2009
Unemployment	8.5	7.4	-	4	6.4
Youth unemployment (% of total youth)	4.7*	16.0	14	-	16.0

Note: *in 2002 according to the UN.

Source: Unemployment – National Statistics Department; Youth Unemployment – UNDP Report.

While general unemployment fell up to 2008, youth unemployment rates grew until 2006 (according to UN statistics) and then started declining (according to United Nations Development Programme [UNDP] reports). The accuracy of the comparison is far from perfect due to lack of data – different sources have been used for the comparison (with possible different definitions of unemployment). Nonetheless, the same UN data indicated a rise in youth unemployment until 2005 and a negative trend between 2005 and 2007, followed by an increase. Based on these data, it is reasonable to assume that the Republic of Moldova is likely to face even more severe migratory trends in the near future, as youth are forced to seek jobs abroad.

Target: Eradicate extreme poverty and hunger

Employment and lost or reduced incomes were largely responsible for the social crisis, rather than the immediate drop in remittances (UNDP, 2009b and IOM, 2009). The first and worst hit were rural communities and the agriculture sector, where income from self-employment in agriculture (Q1 2009) contracted by 25%, compared to 2% for the whole country. Households with children were more vulnerable to the effects of the crisis than households without. These components increased poverty and worsened an existing trend. To achieve this target, emphasis is needed on the protection of human capital.

Table 4.21. Poverty indicators

Poverty indicators	2000	2008
Poverty gap at USD 2 PPP (%)	13.1	7.9
Poverty headcount ratio at poverty line (% population)	62.4	25-30

Sources: WDI 2010, World Bank.

While poverty levels have generally diminished since 2000 when the vast majority of the population (about 70%) lived below the poverty line (with significant efforts made in 2000-03), the percentage living in absolute poverty has stagnated since 2003, at 26.4% in 2008. This share is expected to rise slightly in 2010.

Table 4.22. Access to services

	2006			2008		
Access to services (% of population)	Total	Urban	Rural	Total	Urban	Rural
Electricity in houses	99.5	99.8	99.4	99.8	99.9	99.7
Drinking water via aqueduct	35.6	77.4	11.8	44.6	83.7	13.9
Hot water via public water system	7.0	18.9	0.2	10.1	23.0	0.01
Gas	39.1	73.4	19.7	47.7	80.0	22.4
Sewage systems	23.7	61.6	2.3	33.4	72.6	2.6
Telephone	71.3	86.9	62.6	83.2	93.1	75.5

Source: National Department of Statistics.

Efforts are being made to improve the standard of living through access to services and resources. A notable increase in the number of dwellings with access to gas, clean drinking water and hot water has been achieved. Sewage systems are also being built, especially in urban areas. In the countryside, telephony usage grew rapidly in 2006-08. It is, however, quite important to note that in the majority of cases, urban development happened much faster than in rural areas – a situation that leads to increasing disparity between access to services in the two areas. This, in turn, causes a further increase in the rapidity of urbanisation, which, coupled with recent increases in youth and adult unemployment, may lead to a further worsening of the migration situation.

Goal 2: Increase access to quality lifelong education

Target: Complete full primary education

There is a high level of enrolment in all levels of education – primary, secondary and tertiary/ university. Enrolment in pre-primary education has also been significantly increasing. On the other hand, enrolment rates in primary education have slightly diminished since 2000. Furthermore, the percentage of students continuing to secondary education is fairly high at around 90%.

Table 4.23. Main education data

	2000	2008
School enrolment rate, pre-primary (% gross)	42.5	72.6
School enrolment rate, primary (% net)	94.0	87.7
Primary completion rate, total (% of relevant age group)	97.8	91.4
Primary teacher to student ratio (%)	4.8	6.3
School enrolment rate, secondary (% net)	78.2	83.5
Secondary teacher to student ratio (%)	7.5	7.3
School enrolment rate, tertiary (% gross)	32.5	40.0

Source: WDI 2009, National Department of Statistics.

There has been a disturbing drop in the primary education completion rate since 2008. This has probably been influenced by the economic crisis and the increase in prices of transportation, materials and school items and other services – rendering the cost of continuing the children's education in rural areas a burden on the family.

There is no male/female disparity in primary and secondary school education, the number of students being roughly equal (the number of males or females never surpassing each other by more than 1 500 students, depending on the year). However, in university education, there is a clear dominance of female students, the difference being very significant: more than 10 000 in 2000-04 (with an average of roughly 40 000 males enrolled per year and 50 000 females); more than 20 000 people in 2005-08 (with an average of 50 000 males and 70 000 females enrolled in university education).

Starting in 1994, the Republic of Moldova has adopted a number of international conventions on non-discrimination against women in the workplace and equal remuneration of men and women. The National Development Strategy for 2008-11 is a first step in the implementation of these agreements and the eradication of discrimination should continue with the National Programme for Ensuring Gender Equality (2010-15).

Low achievements indicate the need to continue, consolidate and extend reforms in curriculum, assessment, teacher training and textbooks. Non-relevant skills and knowledge indicate the need to align the education offerings to the needs of the economy. In higher education, measures are needed to modernise education in order to be competitive and to fully participate in the European Higher Education Area.

Goal 3: Ensure gender equality

The Republic of Moldova is a signatory to several international agreements outlawing gender discrimination.

Women represent 58.6% of the labour force in services, 45.8% in industry and 45.5% in agriculture, with equal access to all levels of education. Furthermore, women hold 40% of all high-level public administration, business and social jobs; they hold 63.4% of all intellectual and research positions. Female representation in professional life is thus quite high.

However, women are still underpaid in comparison to men – on average a woman's salary is 26.7% smaller than a man's. This can in part be explained by the fact that women are employed at a lower level than men (60% of lower-position jobs are held by women). Activities generally considered as being dominated by women are: health care and social assistance (79.4% of women), education (74.3%), hotels and restaurants (73%), financial activities (65.8%) and cultural activities (54.1%).

There is also the issue of trafficking that needs to be seriously addressed and that concerns women specifically.

The main issues that gender discrimination currently encompasses are: the involvement of women in the political process, women's remuneration on the labour market and violence against women.

The wage differential is only part of the problem: many employers are not keen to employ young women for fear that they will leave to start a family, though it is the state that pays for maternity leave. More needs to be done to educate employers on their rights and obligations in this area.

The UN Women's Rights Committee has indicated that it was "concerned about the prevalence of violence, including domestic violence, against women in the Republic of Moldova". It is however very difficult to determine the exact number of cases of violence against women, since the number of complaints certainly does not reflect the reality.

The situation of women in politics has slowly started to get better with more and more women representatives coming forward in recent parliaments. However, it is also very important to note that women still do not play key roles in the workings of political parties.

Health issues

Main indicators

The birth rate slowly increased from 1% in 2001 to 1.09% in 2008 while the death rate decreased from 1.24% in 2005 to 1.18% in 2008. Nonetheless, there was still a population drop of about 100 000 people in 2000-09. This implies that, despite the general amelioration of the birth-death situation, the country is still losing people due to non-health related reasons, notably migration.

Table 4.24. Major causes of death
(percentage change between 2000 and 2009)

Tumours (% decrease)	-2.4
Respiratory organ failure (% decrease)	-0.6
Accidents, poisoning and traumas (% decrease)	-0.0
Alcoholic poisoning (% increase)	0.1

Sources: National Statistics Department.

Goals 4 and 5: Reduce maternal mortality by three-quarters and under-5 mortality rate by two-thirds

Since the 1990s, maternal deaths have continuously decreased with fewer than 25 deaths in 100 000 births registered on average in 2004-09. The main causes of maternal deaths are complications resulting from abortions, despite considerable progress in combating this issue.

Family planning centres have been established in many regions of the country, health care access has been improved and youth-friendly clinics have been created throughout the country. As a result, the number of abortions has diminished to 14 000 cases in 2008, from 37 000 in 1997. Moreover, about 98.2% of births have been assisted by professionally qualified medical staff since 2004.

Child mortality under-5 decreased by 47.4%, from 194 deaths in 2000 to 102 deaths in 2009. Again, increased access to public health care and the existence of family planning centres has played an important role in achieving these results.

Goal 6: Have halted by 2015 and begun to reverse the spread of HIV/AIDS

The number of HIV/AIDS related cases has started to steadily decrease after a peak of 5.2 cases per 100 000 people. In 2009, the indicator was situated at 2.1 cases per 100 000, still many times larger than in the pre-2003 period. However, conclusions on the spread of the disease are hard to draw knowing the questionability of data accuracy in this domain.

According to UNAIDS, the major transmission mechanism is by sexual relations, followed closely by drug injections (59.6% and 37.7% each). Male victims represent almost two-thirds of those affected by the disease but the strong increase of new female HIV cases is very worrying. Young people aged between 25 and 34 are the most affected group, representing half of new infections; this number goes up to over two-thirds for the 25-44 age group. Youths aged 15-24 also have a high rate of infection, equal to 25% of the total. The rate of new cases of AIDS, however, remains low with only 49 new cases registered in 2006.

Table 4.25. HIV/AIDS incidence in the Republic of Moldova
(number of cases)

	1987-91	1995	2000	2006	Share in 2006 (%)
New HIV cases per year, of which:	6	7	173	616	100.0
Drug injection	0	1	145	232	37.7
Sex	5	6	27	367	59.6
Mother-to-child	1	0	1	13	2.1
Transfusion	0	0	0	0	0.0
Other	0	0	0	4	0.6
Male	3	5	132	364	59.1
Female	3	2	41	252	40.9
0-14	1	0	1	14	2.3
15-24	1	2	80	155	25.2
25-44	3	5	88	411	66.7
45-54	0	0	3	29	4.7
55+	1	0	1	7	1.1
AIDS cases	1	1	5	49	-

Source: UNAIDS Moldova.

According to the Government of the Republic of Moldova's report on the achievement of the Millennium Development Goals", the disease is spreading faster among females than males, whereas at the beginning of the epidemic, males were more infected. The same report mentions an increase in the percentage of hospitalised (which means the majority in the Republic of Moldova) pregnant women tested for HIV/AIDS from 96% to 99.4% and, at the same time, an increase in HIV prevalence among this group – from 0.1% in 2005 to 0.23% in 2007 (the general HIV spread was also highest in 2007 and later dropped by more than half).

A particularly alarming situation lies in the separatist region of Transnistria where prevalence is estimated to be three times higher than in the rest of the Republic of Moldova (107.2 per 100.000 people in the Republic of Moldova and 292.63 in Transnistria, in 2009). It must also be taken into account that the National Department of Statistics does not measure data recorded in Transnistria and thus does not present a fully overall accurate picture of the situation in the country, which means that the government has to rely on external sources.

UNAIDS Moldova is a joint project between the UN and the Moldovan government whose aim is to implement policies and measures to fight HIV/AIDS in the country, both by prevention and better medical care (UNAIDS Moldova, 2001-05). The initiative was followed by the National Programme for the Prevention and Control of HIV/AIDS and sexually transmitted infections (STIs) in 2006-10. Financed largely by international donors, the programme supplied retroviral drugs free of charge to patients. The programme has also helped to create 56 counselling and testing centres. Although highly efficient in the post-infection stages, the programme is weak when dealing with prevention because of a lack of targeted anti-HIV/AIDS education. Young people are taught about the disease theoretically, but little is done to alter potentially risky behaviour.

Sexual relations are the dominant means of HIV transmission and transmission is higher among women than it is among men. This raises the issue of human trafficking and prostitution circuits. This situation requires urgent attention and action by the government and measures need to be adopted in order to fight the pandemic, both in the medical and social spheres.

Trafficking is an issue that is under surveillance but there are few reliable statistics. According to the Prosecutor General's Office, in the first semester of 2010, 246 trafficking crimes were pursued; 91 of the victims were adults, 5 were children, 6 concerned attempts to send the children abroad illegally (usually to join their parents, who had illegally migrated). The number of disappeared persons since 2005 varies between 290 in 2007, 142 in 2008 and 281 in 2009.

Specialists at La Strada Centre, based in the Netherlands and in countries where trafficking takes place, including the Republic of Moldova, noted a slight decrease in human trafficking in the country in 2009, but warn about the latent specificity of the phenomenon and about new ways of recruitment and exploitation by the trafficking networks. In 2009, cases of child exploitation were revealed in Chisinau and Balti. The most usual victims of trafficking are women aged between 18 and 25 years, although the number of trafficked men has also increased. More and more mentally retarded persons are being exploited. The methods of recruiting victims have changed. Previously, the traffickers used cars, now they prefer planes. Most of the captured women have been deluded with false work contracts. Afterwards, they are forced into prostitution.

As the western border is better controlled, less evidence of trafficking through Romania and more indications of trafficking through Ukraine to Russia is available. Internally, border control issues affecting the separatist region of Transdnistria and the autonomous territorial unit of Gagauzia in the south facilitate trafficking. The most popular destination countries are Russia (sexual exploitation and construction), Ukraine (agriculture), Turkey, Cyprus and United Arab Emirates (sexual exploitation).

Respiratory diseases

Tuberculosis had reached "epidemic" status in the 1990s, with the general state of economic disorder in 1997-2000, widespread poverty affecting over 70% of the population and a severe lack of anti-tuberculosis medicine. However, the numbers have since declined sharply towards 17.4 deaths per 100 000 people in 2008 (thus already almost reaching the MDG target of 15 deaths set for 2010). Alongside the decline in tuberculosis-related deaths, the number of hospital patients being treated for the disease has also fallen by more than 50%, which would appear to indicate that more efficient medical attention is available.

Nonetheless, whereas the number of newly declared tuberculosis cases in cities has gradually decreased over the years – by about 15% in 2009, compared to 2000 – in the rural areas, the situation has not improved to the same degree. On the contrary, it has degraded, with the number of new cases almost doubling since 2000. This is a sign that prevention is being neglected, even if treatment is improving. This is also an indicator of the worsening living conditions that exist in the rural areas and of the continuously improving living conditions in the cities. All in all, the number of new tuberculosis cases has increased since 2000, entirely due to the increase in rural incidence of the disease – an increase of 26% in the number of newly discovered cases. Thus, in 2009, there were 3 227 cases (or 0.0922% of the population).

The incidence of tuberculosis among men – 70% of total cases in 2009 – is much higher than it is among women. The difference was less important in 2000, when only 60% of patients were male. Incidence of the disease among prison inmates is 11 times higher than for the rest of the population, which is an indication of the sorry state of Moldovan prisons.

Pulmonary infection rates were also down in 2009, compared to 2000, with 5 cases per 100 000 people as opposed to 7.1, a slight rise from 4.6 cases per 100 000 in 2006. A number of prevention and public awareness campaigns, as well as better access to medical care, have contributed to these improvements.

Main health reforms

The health system has had support both from international donors and the Moldovan government. Public health is a priority and spending on the sector reflects this, with levels approaching those of OECD countries as a percentage of GDP.

The country has aligned itself with the 2005 International Health Regulations standards. The 1996 National Hospital Reform Programme aimed at bringing it closer to the European health-care standards but in general it failed to place modern technology, equipment and techniques where they are needed despite the acquisition of a number of modern appliances. The reform programme cut the number of hospital beds in half while failing to improve conditions in the remainder.

As a result of this generally disastrous situation, the Republic of Moldova is attempting to implement a World Bank Hospital Reform Programme, with the aid of a still (in 2010) publicly unknown foreign medical consulting firm. The problem is compounded by the difficulty of finding enough investors for the new programme (the European Commission, the World Bank and a group of other investors have pledged EUR 15 million, but this is not enough to cover the reform). The medical assistance sector reform is being financed by the European Commission which has pledged EUR 46.6 million.

Despite the overall progress in patient treatment from the use of more effective medicines, life expectancy still trails other European countries by about ten years.

Table 4.26. Main health expenditure

In 2008	Republic of Moldova	OECD
Private health expenditure (% GDP)	4.9	3.0
Public health expenditure (% GDP)	4.4	6.8
Out of pocket expenditure (% private expenditure)	97.7	86.4
Health spending per capita (USD)	90.0	3 365.0

Source: WDI 2009.

Goal 7: Ensure sustainable environment development

Target: Reduce pollution

In 2002, the Republic of Moldova signed the United Nations Framework Convention on Climate Change, and ratified it in 2005. Having acceded to the Kyoto protocol in 2003, the country undertook a number of measures and "has set itself an ambitious goal in developing the National Climate Change Adaptation Strategy" (Mr Gheorghe Şalaru, Minister of the Environment, 2009) (UNDP, 2009a).

Although the quantity of emissions has very slightly risen, because of its still underdeveloped industrial sector, the Republic of Moldova is still one of the smallest polluters in the world and is not even being included on international pollution charts. It is also active in the carbon emissions trading scheme, selling its right to pollute to other nations.

Table 4.27. Environmental data

	2001	2005	2008
Total emission of detrimental substances (thousand tonnes)	14.5	20.3	16.7
Solid	3.3	5.2	4.6
Liquid	11.2	15.1	12.1
of which: carbonic oxide	3.9	6.1	4.7
Captured/neutralised detrimental substances in percentage of total quantity of pollutants	91.2	87.6	91.6
Emission of ammonia (tonnes)	35.7	141.3	67.1
Household domestic waste in urban area (thousand m^3)	1 101.9	1 268.5	2 130.8
Fixed capital investments for environment protection			
Total	12 151.2	43 938.7	87 885.2
for protection and rational use of water resources	3 257.2	23 061.8	4 269.6
for protection and rational use of land	8 894.0	20 876.9	80 781.9
for atmospheric air protection	–	–	2 833.7

Source: National Bureau of Statistics of the Republic of Moldova.

The Republic of Moldova is only now starting to have projects related to renewable energy. The country does utilise hydropower, but generates only about 5% of its energy needs via hydropower plants. The World Bank has also launched an initiative to create renewable energy from agricultural waste. A number of schools have been given small biomass electricity production systems for this purpose.

While these initiatives are very welcome in a country that relies 100% on foreign gas imports, they come at a very slow pace and at insufficient scale, leading to very small or no impact on the population.

Target: Access to clean drinkable water

Water consumption has remained constant over the years, as a result of the lack of development in the Moldovan industrial and agricultural sectors and the relatively constant consumption of households.

Table 4.28. Water consumption use
(million m^3)

	2001	2005	2008	2009*
Number of water consumers, units	2 535	2 547	2 519	2 505
Water collecting from natural wells – total	874	852	861	865
of which, water collecting from underground springs	138	136	127	129
Water consumption (use) – total	797	785	794	795
for production needs	587	583	581	580
of which, drinking water	19	18	17	17
water supply for agriculture	36	35	37	38
water supply for households needs and for drinking	130	120	124	120
Losses during transportation	71	61	64	65
Quantity of water in circulation and used consecutively	367	350	359	334

Note: *Calculated by the authors.

Source: National Bureau of Statistics of the Republic of Moldova.

In 2009, over 94.35% of the water extracted from underground and surface water sources was deemed unpolluted and drinkable – as opposed to 2001, when only 78.67% of the extracted water resources were drinkable. This result has been achieved in no small measure by the continuous efforts made in the water purification plants. With over 110 million m^3 of water being purified each year, water pollution has been kept at bay. Another factor that has helped reduce water pollution is the insertion of more severe penalties for environmental pollution, set forth in the new Civil Code of 2002.

PRIVATE SECTOR DEVELOPMENT

The Republic of Moldova has gradually moved from a centrally planned to market economy independence. Diversification is underway, but is still very far from completion and from moving towards higher value-added sectors. Growth in the Republic of Moldova still depends heavily on external factors, such as remittances and foreign trade. The real GDP of the Republic of Moldova was estimated, in 2008, at 45% lower than the level attained in 1989 (EBRD, 2010) as a result of the severe economic downturn following the collapse of the Soviet Union. The economy contracted by 6.5% in 2009 and is expected to grow by 2.5% and 3.6% in 2010 and 2011, respectively (IMF, 2010b).

The business climate has improved since 2005, opening up to trade and, to a certain degree, to foreign investors, although significant challenges remain, such as ineffective implementation of laws and regulations. The Republic of Moldova is still the poorest country in Europe today; however, the country's ambition to build closer ties with the EU has motivated implementation of further market-oriented reforms (the Republic of Moldova was negotiating an Association Agreement in 2010 in the hope of becoming an accession country).

The private sector is a source of knowledge, skills and resources, and a key engine of growth for economic development. In this context, the role played by micro, small and medium-sized enterprises (SMEs), which on average account for over 90% of enterprises in the world and contribute to 50-60% of employment in developing countries, is particularly important (WBCSD, 2007). Efforts to foster private sector growth should focus on improving the business environment for SMEs by providing a regulatory framework that encourages entrepreneurship through better policy design, including improving business regulation, improving the education system and providing access to finance for SMEs to attract new firms. It would also increase the share of employment and contribution to GDP of the private sector.

The methodology applied in this section is based on the OECD Policies for Competitiveness Framework (PFC) which has been developed as an assessment tool based on the Policy Framework for Investment (PFI) instrument. This tool adopts a horizontal approach, looking systematically at key policy dimensions affecting the business climate to identify and analyse key constraints in the ability of firms to produce, invest and grow. Apart from giving a general introduction to the business environment, three key dimensions are featured in this section covering skills development, access to finance and investment framework conditions affecting SME growth.

General overview

The Republic of Moldova has privatised most of the state-owned enterprises, except for some large enterprises for which privatisation has been either postponed indefinitely or abandoned. The private sector accounts for approximately 65% of GDP and contributed in 2008 to 70% of employment (EBRD, 2010).

The country inherited a good education base from the Soviet Union and has the highest spending on education in the Eastern Europe and South Caucasus (EESC) region (8.3% of GDP in 2007[13]). Nevertheless, the quality of its human capital still lags behind regional standards, due to the slow modernisation of the curriculum, relative to the labour market's needs, and low salaries, which lead to the loss of qualified teaching staff.

Access to finance was identified as one of the key obstacles to business growth in the OECD's survey of businesses. While the micro-financing system is relatively well developed, it does not provide sufficient funds to cover the demand and targets mainly the agricultural sector. The use of bank loans and other means of bank financing, such as factoring, remains limited. The government's efforts should be directed towards broadening the spectrum of financing mechanisms, such as venture capital financing and developing "business angel" networks, to close the financing gap between credit from friends and family and bank lending.

While FDI inflows grew at above global average rates between 2002 and 2008, the Republic of Moldova still faces significant challenges that need to be addressed to improve the regulatory environment for foreign investors. Key issues include persistent discrimination against foreign investors, especially in regulations on land purchase, and enforcing intellectual property rights. The Republic of Moldova is the only EESC country not to have ratified the International Centre for the Settlement of Investment Disputes (ICSID) convention, which would allow for investment arbitration before a recognised international body.

The increasing role of the private sector

The number of private enterprises registered with the State Registration Chamber at the end of 2009 was 140 924. From 2005 to 2010 there has been an increase of over 20% in the number of registered enterprises, which is a healthy rate of new enterprise creation. However, net figures are expected to be significantly lower as inactive enterprises still appear in the statistics.

The number of monitored enterprises according to the National Bureau of Statistics (NBS) was 44 633 at the end of 2009. Since the Republic of Moldova has only 975 enterprises that are classified by the NBS as large (over 250 employees), the majority of active enterprises are SMEs (97.8% of the total), which are defined according to the following table.

Table 4.29. Definition of micro, small and medium-sized enterprises in the Republic of Moldova

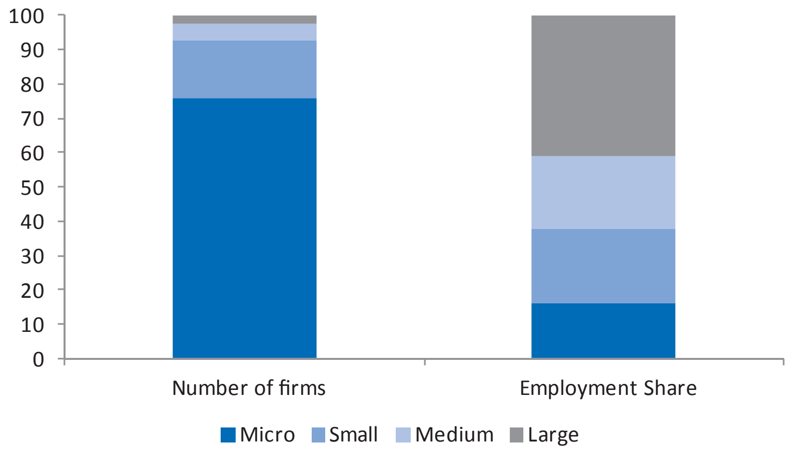
	Number of employees	**Turnover** (MDL)	**Total assets** (MDL)
Micro	1-9	< 3 million	< 3 million
Small	10-49	3 – 25 million	3 – 25 million
Medium	50-249	25 – 50 million	25 – 50 million
Large	> 250	> 50 million	> 50 million

Source: National Statistical Bureau of the Republic of Moldova, Law 206-XVI (2006) on Support to Small and Medium-Sized Enterprises.

On average, between 2005 and 2009, SMEs accounted for 57.3% of total employment in the enterprise sector,[14] but for only 41.6% of the sector's turnover, which is interesting in itself. This is largely due to the fact that medium-sized enterprises are more present in labour-intensive operations in the agriculture, winery and manufacturing sectors.

The SME sector is dominated by micro-enterprises (70% of the total). However, data on SMEs from the NBS cover only active enterprises (those that sent the completed statistical questionnaire) and hence tends to underestimate the size of the self-employed and microenterprise segment. Moreover, the presence of a large informal sector, estimated at 44.3% by Schneider (2010), further distorts the statistical figures.

Figure 4.10. Structural indicators of the private sector in the Republic of Moldova, 2009
(percentage)



Source: National Bureau of Statistics of the Republic of Moldova.

Over 65% of SMEs are located in Chisinau (2009 data), accounting for over 68% of total turnover and over 50% of total employment in the SME sector. However, during the 2005-08 expansion phase, SMEs located in the Northern and Central regions recorded faster growth in terms of turnover than SMEs located in the Chisinau area, while there was a considerable reduction in terms of employment, particularly in the agricultural sector. Overall, the SME sector performed quite strongly in the 2005-09 period of boom and bust. While the employment balance in the broad enterprise sector over the five-year period is negative, nearly all the job losses in the 2005-09 period were recorded in the large enterprise sector (-14.5%). The employment levels for SMEs remained fairly stable, in spite of the 2009 recession (-0.2%). Within the SME sector there has been a remarkable increase, both in numbers of active enterprises and employment at the micro-enterprise level (up +38% more enterprises and +26.2% more employees, including the self-employed). A positive but smaller increase has been recorded in the small-sized segment.

The SME population structure and the SME density indicators, as calculated on the basis of the NBS data, are broadly comparable to those of other countries with similar per capita income levels and are similar to the enterprise population data of other transition countries, for instance in the Western Balkan countries.

Business environment

According to *Doing Business 2011*, the business climate in the Republic of Moldova is mediocre at best (World Bank, 2010). The country is ranked 90th out of 183 countries in terms of overall performance and 19th out of the 25 Eastern Europe and Central Asia countries, performing significantly better than Ukraine (24th), but worse than all other Eastern Europe and South Caucasus economies. In order to enhance long-term competitiveness, the country needs to accelerate reforms in its judicial system and civil service, combat corruption, reduce red tape, support SMEs and step up spending on health care and education.

The country performs strongly in two areas, "registering properties" (18th) and "enforcing contracts" (20th), in absolute terms and in comparison with Eastern European and Central Asian peers. It performed quite well in 2010 on starting a business, particularly in comparison with direct peers, but lost 16 places in a year, down from 78th to 94th in the 2011 rankings and it continues to perform poorly in areas such as "dealing with construction permits" (159th), "trading across borders" (148th) and "protecting investors" (109th).

The cost of starting a business represents 10.9% of income per capita,[15] the highest in the EESC region. The picture that emerges from *Doing Business 2011* is that of an incomplete regulatory reform process. There has been improvement in some areas, which led to measurable impact on SME policy trends, such as the improvements in company registration that contributed to the increase of the number of new enterprises. However, significant regulatory obstacles remain which still penalise the most dynamic companies, such as those that are engaged in cross-border trading, hiring new workers and building new warehouses.

The Economic Stabilisation and Recovery Programme (2009–11), adopted in November 2009, foresees activities in support of SMEs, particularly in rural areas. This includes the reduction of the administrative and fiscal burden on firms and the facilitation of access to financing for launching, developing and rehabilitating a business. The Institutional Development Plan for 2009–11, prepared by the Ministry of Economy, also foresees a number of actions in support of SMEs. The State Commission for Entrepreneurial Activity brings together private and public sector members in a forum for consultation about planned reforms to improve the business climate.

The National Programme for the Economic Empowerment of Youth is expected to intensify the process of granting loans to finance private projects of young entrepreneurs with a grant component. This programme provided MDL 52 million (approx. USD 5 million) to 181 projects in its first six months of work (second half of 2008), but then both the number of beneficiaries (92) and the amount of funds (MDL 25.5 million, approx. USD 2.5 million) were reduced. This happened partly because of lack of initiative and a discouraging business environment, brought on by the financial crisis. The measures towards boosting entrepreneurial activity should be directed towards several issues at the same time (access to finance, business environment and entrepreneurial skills) because the lack of any of these pre-conditions stifles the effect of reforms in other areas.

In March 2010, in response to the difficult previous year, the Republic of Moldova adopted a medium-term strategic programme called Rethink Moldova. This programme will complement the goals of the IMF loans, enhancing responsible governance, reducing the bureaucracy that hampers business operations, supporting SMEs and improving education and health. Infrastructure development and particularly industrial parks (which are expected to boost exports) have been proposed for strengthening economic growth. Whatever the intentions might be, there remains the risk that the programme was an election manoeuvre, and therefore needs strict implementation and evaluation of results.

Human capital development

Strengthening skills development has been identified as one of the key contributors to competitiveness. The positive correlation between human capital and productivity has become increasingly important in the globalised world. Razzak and Timmins (2008) report a strong positive relation between the increase of university-qualified workers and the levels of labour productivity as measured by GDP per capita. It is believed that natural resources, cost competition and strategic alliances do not alone suffice for achieving sustainable development (Memon *et al.*, 2009).

Enhancing competitiveness in the Republic of Moldova will require a major commitment to investment in human capital, as well as to reforms which will ensure that the educational system produces skills that meet the demand of the labour market and further support private sector development. Five areas have been selected for an in-depth evaluation of the education system including:

- Strategy formulation
- Inputs to initial education
- Vocational education and training (VET)
- Continuing education and training (CET)
- Human capital outcomes

Low levels of public expenditure on education in the transition period were compensated for by various formal and informal private payments, which brought about corruption in the education system and a decrease in the quality of education. Despite increased expenditures since 2005 (8.3% of GDP in 2007), the quality of education in the Republic of Moldova still lags behind regional averages. According to the World Economic Forum Global Competitiveness Report 2010, the country's educational system ranks 96th out of 139 measured economies. In the Trends in International Mathematics and Science Study (*TIMSS 2007)*, the country ranked close to the international average in mathematics for 4th graders, but lower than average for 8th graders, and just below the average for both cohorts in science (IEA, 2007a and b). All respondents to the OECD PFC assessment have identified the lack of an effective teacher employment strategy as the main obstacle to the development of a qualitative human capital stock. Other weak areas include the lack of a national human capital development strategy and the skills gap.

There is no specific workforce skills development strategy in the Republic of Moldova. However, the National Development Strategy for 2008-11 incorporates a human-resource development component, which aims to increase the quality of human capital. The goal is to shift the Moldovan economy from a low-skill base to an economy with a highly qualified labour force. Objectives related to this goal are the improvement of workplace conditions, poverty reduction and measures to encourage social inclusion.

Reforms in the education and training systems are aimed at the integration of the Republic of Moldova into the European Education Area. Reforms have targeted increasing participation, in particular in general and higher education. There has been a clear shift from vocational education to general education during recent years. Participation in vocational education in the five years from 2005 has decreased from 22% to 8% of the population in secondary education, in a continuing decline. The obsolete equipment and ageing teaching staff of the VET sector is no longer attractive to students and their parents. The number of specialisations has decreased from 350 in 1990 to 85 in 2005 because of the big discrepancy between vocational training and the job market requirements (ETF, 2009). However, no new specialties were introduced in response to the changing market demands. As a consequence, half of the vocational schools have already been closed, mainly in smaller towns.

A recalibration of the VET system to market requirements is needed. In this regard, the government has been trying to reverse the demise of vocational schools, with the idea of abolishing craft schools and introducing a new type of full-secondary VET, the professional lyceum. The new structure of the VET system is maintained by a new Education Code (2008) and will be supported by international donor projects.

There is a significant mismatch between labour skills demand and supply. In an attempt to close the skills gap in the labour market, consultations among representatives of ministries, educational institutions and employers are held on an *ad hoc* basis. There is a government initiative to establish a National Council of Participation as a consulting body that would ensure the participation of the civil society and private sector in the process of policy development and implementation of the National Development Strategy. For better co-operation and skills match, vocational schools could be managed by councils composed of employers or associations of employers and government representatives. These would have the right to vote on many issues, including curricula. This is important because employers are the ones who need the labour force. The opportunity to vote and promote changes in curricula may also encourage employers to finance vocational schools.

The educational system suffers from a shortage of qualified staff due to teachers' low salaries (in 2005, the wage was only 65% of the average). So far, there is no explicit strategy that would aim to retain teachers in the educational system. The incentives provided by the government in the form of salaries based on experience and qualifications and bonuses for teaching in remote areas are not sufficient.

Labour migration is another problem that undermines the human capital base in the Republic of Moldova. The number of migrants increased from 138 300 in 2000 to 294 900 in 2009.[16] Among them, 10.7% had higher education and 47.1% had secondary professional education in 2000. In 2009, these figures increased to 31.5% and 83.6%, respectively. Migration is mainly due to a lack of job opportunities in the country.

Access to finance

Access to credit plays a crucial role in sustainable long-term growth. In 2009, 39.13% of Moldovan firms indicated access to credit as a major obstacle in their business operations (EBRD, 2010). In 2009, only 30.75% of local companies used banks to finance investments. Moreover, the value of collateral needed for a loan was 138.61%, the second highest value in the Eastern Europe and South Caucasus region (EBRD, 2010).

The development of lending to the private sector was particularly important between 2005 and 2010, and the distribution shows that 51% of the loans go to industry while only 16% go to the agriculture and food sector, the sectors that are dominated by SMEs. Credit to the private sector grew by 71% from 2004 to the end of 2008, an increase of 36.5% in terms of value of GDP. Nevertheless, lack of financing and, in particular lack of long-term financing, limits larger investment programmes and is a major obstacle to the development of competitive enterprises.

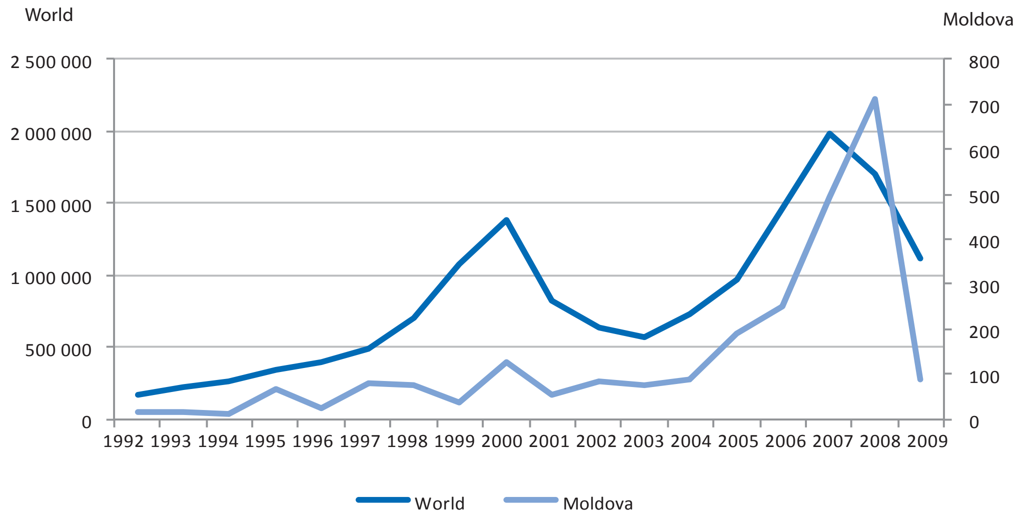
The level of development of domestic capital markets is too low to provide sufficient financial resources to SMEs. At the same time, access to international capital markets is limited due to the small size (by international standards) of most firms and the unfavourable risk profile of the economy. In this regard, micro-finance is a key component for economic growth as it provides access to finance for the smallest entrepreneurs. Micro-financing mechanisms are well developed and especially target agricultural businesses. According to the OECD PFC assessment, venture capital financing and "business angel" networks do not operate in the country and there is no political support for their development in the near future. More efforts should be given to encouraging the development of these types of innovative financing mechanisms, since the funds provided by micro-finance institutions and banks are not sufficient.

Growing attention to SME development is coming from international donors through the implementation of a series of supporting policies such as the Rural Investment and Services Project, which aims at supplying rural advisory services, rural business development services, rural finance, land re-parcelling pilots, project management, etc..[17] The European Bank for Reconstruction and Development (EBRD) is supporting companies to define their business needs through the Turn Around Management and Business Advisory Service (TAM-BAS) programme. From a financial perspective, TAM-BAS offers grants of up to 70% of the total net cost of a project, but not more than EUR 10,000 (excluding taxes). Particularly interesting for SMEs is also the Private Sector Investment programme (PSI), a subsidy programme of the Dutch Ministry of Foreign Affairs / Development Co-operation that supports innovative investment projects in emerging markets. The programme concerns all investment projects for agriculture, industry and service, and offers funds for non-commercial purposes and for a limited period (usually 30 months or 36 months for agricultural projects).

Investment framework for SME growth

During the past decade, FDI inflows to the Republic of Moldova grew rapidly at 26% annual cumulative growth rate between 2002 and 2008 compared to 14% in the world. Between 2005 and 2008, inflows almost quadrupled from USD 190 million to USD 707 million (UNCTAD, 2010). This increase was largely due to the privatisation of state-owned enterprises and an enabling global investment environment in which investors were willing to take bigger risks. As a result of the crisis, FDI dropped by 88% in 2009, to USD 86 million and is expected to increase only slightly in 2010.

Figure 4.11. FDI net flows
(USD million)



Source: UNCTADstat.

In the long term, FDI plays a major role in ensuring economic growth in the Republic of Moldova, taking into consideration that the share of foreign and joint venture companies in the GDP went up from 1% in 1995 to about 19% in 2008. In 2005-08 companies with foreign capital had bigger sales, compared with domestic enterprises. In most sectors, the growth of the number of companies with foreign capital was accompanied by the growth of the number of local companies and also by an increase of sales in the local companies.

FDI was traditionally present in the categories of processing industry, electrical and thermal energy, gas and water, wholesale and retail trade, car and motorcycle, household and personal items repairs. In 2007-08 the share of financial activity and transactions grew as a result of the expansion of several European banks, including Veneto Banca, Société Générale and Banca Comerciala Romana in the Republic of Moldova. In 2008, the biggest investor was the Netherlands (22%), followed by Russia (12%).

Key attractiveness factors that contributed to the largest investments in the Republic of Moldova over recent years were the privatisation programmes or, as in the case of the energy sector, conversion of debt, and favourable conditions of the domestic market, particularly in the financial and telecommunications sectors. Another contributing factor that attracted foreign companies to invest in the Republic of Moldova was the low cost of labour, particularly compared to Central and Southeast Europe and Russia. Thus, the average monthly salary per employee in 2009 in the Republic of Moldova amounted to about EUR 174, while in Ukraine it was EUR 198, in Russia it was EUR 481 and in Romania EUR 447.

The government is taking steps to develop a stronger economy and adopt reforms aimed at improving the investment climate. In accordance with the 2005 Action Plan with the EU, the Republic of Moldova has begun to harmonise its laws with those of the EU. The use of the legislative guillotine has helped reduce unnecessary legislation and policy directives that have hampered investment and business development.

The Republic of Moldova has a legal FDI framework which incorporates the principle of national treatment. Restrictions to national treatment have been progressively reduced, transfers of FDI-related capital can be made freely and foreign investors are allowed to own urban and residential land. However, in its Whitebook 2009, the Foreign Investors Association underlines that discrimination towards foreign investors has been persistent, especially in its regulations on land purchase.

The Republic of Moldova has a weak record of enforcing intellectual property rights. Although estimated software piracy has decreased from 96% to 90% (2005-08), the level of piracy is extremely high. The Republic of Moldova is also encouraged to reconsider its position on adhering to the International Centre for Settlement of Investment Disputes (ICSID) convention on arbitration of international investment disputes.

The country is in the process of developing its investment promotion agency and associated capacities. Crucial issues are: facilitation services at the pre- and post-entry phase of investment; developing a client relationship management system; and a process of monitoring the performance of its investment promotion agency. A new law on public-private partnerships is in force and the initial phases of creating a specialised unit with the assistance of the UNDP are underway. Much like other economies in the region, the Republic of Moldova would benefit from exchanges of best practices in this area.

In particular, the government has made significant efforts to streamline business registration. A "one-window" approach has been implemented to simplify document submission. The process reduced both the number of documents and the time necessary for business registration. In addition, on 1 January 2008, a 0% tax rate on reinvested corporate income entered into force. Fixed assets contributed in-kind to the charter capital are exempted from value-added tax and customs duties.

A number of measures are still needed to increase the institutional and associated capacities for investment promotion through facilitation of services for all phases of investment, developing a client relationship management system and establishing monitoring processes. Despite improvements, a number of issues remain to be resolved. In particular, corruption remains persistent and Transparency International downgraded the ranking of the Republic of Moldova in its 2010 Corruption Perception Index to 105th position out of 178 countries, down from 81st place out of 163 countries in 2006. Moreover, the Heritage Foundation considers that, too often, regulatory administration is non-transparent, burdensome and inconsistent. The country's economic freedom is ranked 125th in the Heritage Foundation's 2010 Index of Economic Freedom. This view is supported by the World Bank (World Bank, 2008) which highlights the institutional flaws and invasive special interests that distort the policy-making environment.

NOTES

1. Including Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine.
2. With a huge difference in data reported in the balance of payments and in the Household Budget Survey, not only in values but also in trends. This reflects the problem of reporting of remittances in the balance of payments, where also investments and payments for goods and services provided from the Republic of Moldova are included, which actually decreased prior to the decrease in real remittances used by households for consumption.
3. The budgetary revenues collected from taxation of salaries decreased and are much lower than in the previous period, denoting the delays in the wage payments and/or the forced unpaid leaves.
4. Changes to social payments established by Law No 133.
5. "Informal economy" refers to all legal production activities that are deliberately concealed from public authorities for the following kinds of reasons: to avoid payment of income, value-added or other taxes; to avoid payment of social security contributions; to avoid having to meet certain legal standards such as minimum wages, maximum hours, safety or health standards, etc. (OECD, 2002, p. 139). It does not concern illegal activities.
6. Tobacco constituted a major export commodity in 2000, but has since very significantly decreased and no longer represents a main export commodity.
7. According to the CIS Committee for Statistics.
8. Attributed by the Russians to "poor quality" of Moldovan wine, containing "harmful substances".
9. The Department of Statistics cautions against the usage of data regarding transport employment in 2004 and 2005.
10. That year, the National Bank of Moldova undertook a successful set of measures to resolve the bankruptcy of one of the commercial banks, thus preventing a further deterioration of the situation.
11. Issued to help in the recovery period, to restore fiscal and foreign trade balances, ensure financial stability, reduce poverty and increase economic growth and prosperity.
12. Knowing that commercial banks' interest rates on loans to the real sector are higher than the central bank's base rate.
13. World Bank WDI Database.
14. Both public and private sector.
15. World Bank WDI Database.
16. National Bureau of Statistics, Labour Force Survey.
17. MIEPO – Moldovan Investment and Export Promotion Organization.

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CHAPTER FIVE

UKRAINE: COUNTRY REVIEW

SUMMARY

Ukraine grew rapidly from 2000, with a yearly average of 7.4% growth until 2007. The country has strong potential from its position between Europe and Asia, large foreign direct investments (FDI), an educated labour force, fertile land and rich natural resources. Despite this, major structural problems and high resource and energy dependence led to a larger economic decline in 2009 than in many other countries. Forecasts in 2007 prior to the crisis had already predicted lower growth in 2008 (6%).

Growth had been based on external flows, but investments were not made in developing competitiveness in key sectors, rendering the pace of economic development unsustainable. The industrial sector suffers from inefficiency due to its lack of investments and obsolete equipment and the Millennium Development Goals (MDGs) have given unsatisfactory results with a high percentage of the population living under the poverty line. Finally, services suffered from the crisis in the banking and financial sector. Several policies were supposed to be implemented to respond to the crisis but the lack of political cohesion froze attempts at legislation. Moreover, Ukraine failed to comply with International Monetary Fund (IMF) conditions on a USD 16.4 billion agreement in November 2008.

The crude death rate is very high in Ukraine, above the Eastern Europe and South Caucasus (EESC) average with worsening conditions in child and maternal mortality and quickly spreading HIV/AIDS. Urban-rural inequalities are increasing. Most of the MDGs will not be reached by 2015.

The dominance of a narrow group of large firms prevents the development of small and medium-sized enterprises (SMEs). Due to high taxes and bureaucracy most small firms prefer to operate in the informal sector. Reforms have taken place – increased loans to the private sector and a significant decrease in the cost of business start-up procedures – but the *Ease of Doing Business* index still stresses unfavourable business conditions in Ukraine.

This country review provides an overview of the Ukrainian economy and its key sectors and an analysis of the government's policies designed to respond to the global crisis. It also highlights policy recommendations that need to be addressed if sustainable and equitable economic growth is to be achieved in the future:

- industrial and agribusiness sector modernisation;
- economic and export diversification;
- production and exports shift toward higher value-added products (*e.g.* refined steel);
- reinforcement and development of the SME sector;
- easier access to finance;
- tax system reform;
- promotion of jobs in the formal sector;
- fight against increasing mortality rates (child and maternal mortality, and HIV/AIDS).

INTRODUCTION

Ukraine has established itself as a strategic country in the region and is highly integrated into the world market. Despite a high level of economic growth in 2000-08, the country has not fully succeeded in achieving the transition from its previously centrally planned economy to an open market. Succeeding governments failed to modernise the key sectors of industry and agriculture. Significant inward foreign direct investment (FDI) flows, net Official Development Assistance (ODA) disbursement, heavy state and private borrowings also contributed to this comfortable growth leading to increasing income and declining poverty.

However, Ukraine's average growth has been half that of the South Caucasus which averaged 11% between 2000 and 2008 and was buoyed by oil exports from Azerbaijan. This position resulted from poor social indicators and declining attendance at primary school, added to high consumption and investments, increasing government indebtedness and a growing negative trade balance.

The international financial and economic crisis, acknowledged in August 2008, led to a collapse in demand, a sharp decrease of investments and of industrial production, and higher debt. As a consequence, real gross domestic product (GDP) fell by 15.1% in 2009. Following the liquidity crisis, real household income declined by 10.5%. In parallel, the unemployment rate rose to 8.8% of the total labour force aged 15-70 years in 2009, compared to 6.4% in 2008, following the International Labour Organization (ILO) definition. According to the Ministry of Labour, 1 million self-employed people lost their jobs, but these employment figures veil high hidden unemployment (or underemployment) as employers make use of specific arrangements such as putting employees on administrative leave, reducing the number of hours worked or accumulating wage arrears so as to avoid having to fire more people.

Ukraine must find new paths for development and sustainable growth. It must also deal with unresolved issues of industrial modernisation, domestic efficiency, export promotion and modernisation of social assistance and pension systems.

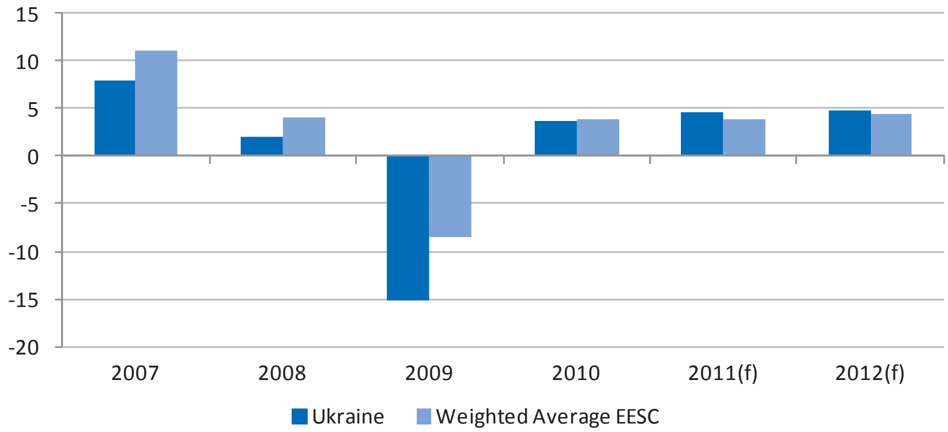
RECENT ECONOMIC DEVELOPMENTS

Ukraine's annual growth would have slowed to 5.6% in 2008[1] from 7.6% in 2007 had the crisis not taken place. Strong GDP growth in 2000-08 was supported by expansionary fiscal and incomes policies and high steel prices which fuelled very strong domestic demand growth, and by very rapid money and credit growth.

Due to the crisis, the growth rate only reached 2.3% in 2008 and fell to -15.1% in 2009 – against a loss of 6.1% in 2009 for the EESC countries[2] (10% if excluding Azerbaijan[3]). Armenia is the only country of the group whose annual decline in 2009 ranked as low as Ukraine's (-14.4%). According to the IMF, growth rates in Ukraine are projected to resume at 3.7% in 2010 and 4.1% in 2011.

Ukraine is the largest economy in the group, accounting for approximately 68.5% of the group's total GDP in purchasing parity power (PPP) terms of USD 422.7 billion in 2009. Yet, Ukraine lost 8% of its weight in total GDP since 2007 due to Azerbaijan's outstanding performance.

Figure 5.1. Real GDP growth in Ukraine
(percentage change, estimates for 2009 and 2010)



Note: Figures for 2009 and 2010 were forecast by the IMF in mid-2009.

Source: IMF (2008b, Table 2 and 2009, Table 1).

General overview

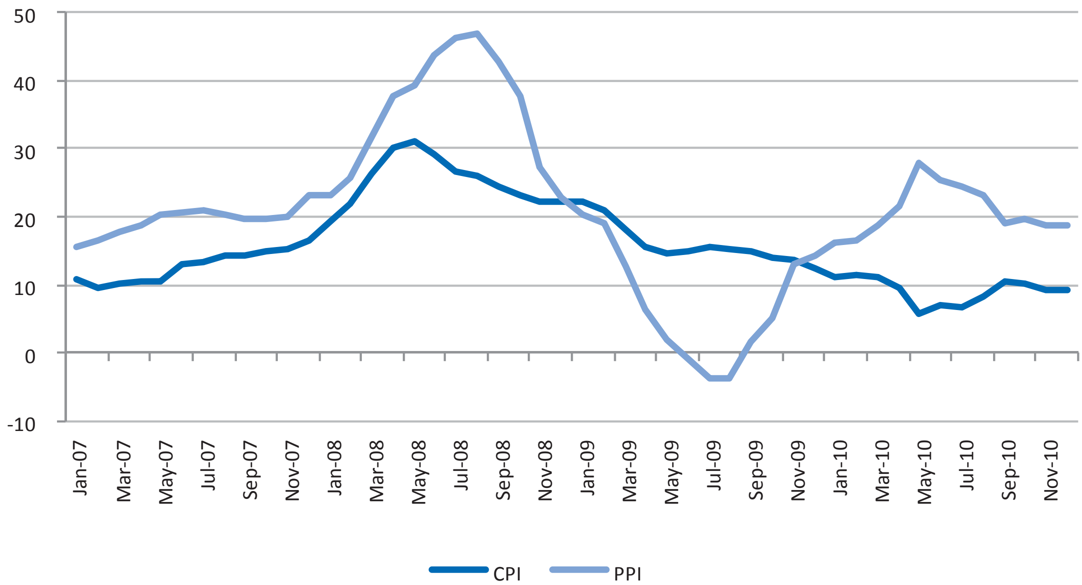
Real GDP fell by 7.8% year on year (yoy) in the fourth quarter of 2008 and by a further 20.3% yoy in the first quarter of 2009, reflecting a drop in export volumes,[4] followed by a sharp contraction of domestic demand, and the impact of the financial crisis. The sharp decline of export growth was driven by a collapse in external demand for steel and by the sharp decrease of world steel prices in 2008.

Inflation

Against this background, inflation has been declining fast, reflecting a slowdown in producer prices and labour costs, and a decrease of food and oil prices. The steep decline in inflation in H2 2008, following the crisis, was led by a nearly 80% fall in oil and steel prices. The first decreased until January 2009 (with an increase of 150% until March 2010) while the latter picked up in November 2008 and doubled by March 2010.

Another significant contributor to this slowdown in inflation has been the slow rate of utility price increases, and this is still a bone of contention with the IMF as the government refused to raise gas prices significantly before the Ukrainian presidential election in early 2010 and local authority elections in the autumn of 2010. Consumer price inflation (CPI) amounted to 15.9% yoy in December 2009, down from 31.1% in May 2008 and 22.3% in January 2009 and increased by 3.1% in H1 2010. Moreover, in H1 2010, producer price index (PPI) increased by 14.1% and the CPI by 3.1%. Nevertheless, CPI inflation remains significantly higher in Ukraine than in the other EESC countries, with the lowest value in the Republic of Moldova (0.44%) and the highest in Armenia (6.52%).[5]

Figure 5.2. Indicators of inflation in Ukraine
(yoy percentage change)



Source: State Statistics Committee of Ukraine.

The slowdown in gas price increases under the agreement reached between the Presidents of Russia and Ukraine in April 2010,[6] the reduction in prices of goods imported from the European Union (EU) because of the depreciation of the euro and the improved harvest should gradually ease inflationary pressures.

According to the IMF, end-year CPI in Ukraine is projected at 9.4% in 2010 and 9% in 2011.[7] The government of Ukraine is less optimistic, expecting end- year CPI at 13.1% in 2010.[8]

The PPI, however, turned positive again following a 3.7% (yoy) fall in August 2009 and is accelerating fairly fast, reaching 27.9% (yoy) in May 2010 (down to 18.7% yoy in December 2010), suggesting that inflation is proving extraordinarily resilient and continues to present a major problem for Ukraine.

Analysis by account

Household consumption

Economic and financial conditions in 2009 favoured the bursting of the consumption bubble previously created in Ukraine due to a stable increase in household real income and easy access to bank loans. Having suffered financial losses and perhaps loss of employment, deprived of savings and remittances, no longer having access to easy credit and with significantly increased debt obligations for existing loans denominated in foreign currency due to a sharp depreciation of local currency, Ukrainian households curbed their consumption.

In Q1-Q3 2010, total income increased by 17% yoy, to UAH 752 896 million, with only two sources of income not growing by 17% in this period, property income (+9%) and other current transfers (-1.1%). The growth was mainly due to an increase of the minimum wage and social benefits for 2010 by the former government, voted in October 2009, and to the recovery of the economy starting H2 2009. Minimum wage per month increased to UAH 825 in January 2010 and to UAH 875 in December 2010 and subsistence wage to UAH 869 and to UAH 922 respectively, an annual increase of 6%.

Table 5.1. Household revenues in Ukraine

2009	Q1-Q3 2010 (UAH million)	% total
Income total	**752 896**	**100.0**
wages and salaries	315 010	41.8
profit income	110 498	14.7
property income	25 993	3.5
social benefits, other transfers	301 195	40.0
social benefits	175 621	23.3
other current transfers	23 164	3.1
social transfers in kind	102 410	13.6
Disposable income	573 744	
Average monthly income per capita (UAH)	1 818.6	

Source: State Statistics Committee of Ukraine, SNA.

Real final household consumption dropped 14.2% in 2009, compared to an 11.2% increase in 2008. The largest drop in household consumption was in transport, furnishing and household equipment, recreation and culture, and miscellaneous goods and services, while the share of the two largest categories, notably food and beverages, and housing, water, electricity, gas and other fuels has further increased (to 40.1% and 12.5%, correspondingly).

Table 5.2. Evolution of household consumption expenditures

Category according to classification of individual consumption by purpose	2008			2009		
	Current UAH million	% of total	Real growth, yoy (%)	Current UAH million	% of total	Real growth, yoy (%)
Total household consumption expenditures	576 565	100.0	11.8	590 196	100.0	-14.2
Food and non-alcoholic beverages	224 076	38.9	3.2	236 901	40.1	-6.9
Alcoholic beverages, tobacco and narcotics	32 062	5.6	12.5	38 038	6.5	-8.9
Clothing and footwear	31 138	5.4	29.7	34 213	5.8	-5.1
Housing, water, electricity, gas and other fuels	64 835	11.2	12.8	73 611	12.5	-10.1
Furnishings, household equipment and routine household maintenance	23 481	4.1	24.1	24 598	4.2	-16.5
Health	22 480	3.9	13.1	28 492	4.8	-6.4
Transport	86 808	15.1	21.1	62 698	10.6	-41.0
Communication	18 312	3.2	11.1	18 212	3.1	-10.3
Recreation and culture	28 356	4.9	20.8	22 670	3.8	-28.6
Education	8 847	1.5	2.6	10 318	1.8	-1.7
Restaurants and hotels	14 728	2.5	-0.1	16 667	2.8	-5.6
Miscellaneous goods and services	21 442	3.7	18.2	23 778	4.0	-16.6

Source: State Statistics Committee of Ukraine, SNA.

Basic needs still hold the largest share of total household expenditures in Ukraine. Food and non alcoholic beverages accounted for 40% of these expenditures, followed by housing, water, electricity, gas and oil (12.5%) and transport (10.6%).

Government expenditures

During 2000-08, consumption was backed by the government's heavy borrowing,[9] both from national and international sources, while short-term debt widened. Total budget expenditures accounted for 47% of GDP in 2008, according to the World Bank.

Table 5.3. Budget 2008-09
(UAH million)

Actual performance	2008	2009
Revenues	**231 686.3**	**209 700.3**
Tax revenues, including:	167 883.4	148 915.6
Corporate income tax (CIT)	47 456.3	32 569.8
Value-added tax (VAT)	92 082.6	84 596.7
Excise for domestic goods	10 125.0	17 584.5
Excise duty for imported goods	2 553.0	3 690.0
Imports duty	11 932.8	6 328.8
Non-tax revenues	52 817.6	50 676.8
Revenues from capital operations	2 125.3	1 060.1
International grants and loans	135.2	645.3
Trust funds	1 022.7	633.6
Official transfers	7 702.0	7 769.0
Expenditures	**241 454.5**	**242 437.2**
Current expenditures	215 855.1	232 000.0
State employees' salaries	32 929.5	34 319.7
Payroll taxes	10 450.2	10 863.7
Medicaments and clothing	1 875.0	2 499.4
Food	16 628.8	1 828.6
Utilities and energy	2 632.7	3 104.0
Current transfers to households	51 010.2	52 503.6
Capital expenditures	25 533.4	10 436.9
Acquisition of fixed assets	7 119.5	3 716.7
Debt service	3 774.7	9 038.7
Internal	857.2	4 659.9
External	2 917.5	4 378.9
Official transfers	59 113.6	62 180.1
Lending	**2 732.5**	**2 780.3**
Financing (-deficit/+surplus)	**12 500.7**	**35 517.2**
Borrowing	17 675.6	120 961.7
Internal	11 648.6	62 782.1
External	6 027.0	58 179.7
Repayment	6 028.2	31 304.7
Internal	3 659.7	17 924.9
External	2 368.4	13 379.8

Source: Ministry of Finance; Annual Report of the State Treasury of Ukraine.

According to the National Bank of Ukraine (NBU), the central government's external debt increased by USD 5.8 billion in 2009 to reach USD 17.8 billion; amounting to 17.1% of total external debt and 15.2% of GDP. The increase in external debt is attributed to the IMF (special drawing rights (SDR)

3.1 billion as second and third tranches of the Stand-by-Agreement and SDR 1.2 billion as Ukraine's quota) and to loans by international organisations (USD 0.2 billion from the World Bank, the European Bank for Reconstruction and Development [EBRD] and the European Investment Bank [EIB]).

State revenues declined by 9.5% between 2008 and 2009 while expenditures roughly remained unchanged. Revenues from capital operations decreased by 50%, trust funds by 38% and tax by 11.5%. In 2009, the economy was mainly financed by international grants and loans which quintupled that year with the IMF Stand-By Agreement worth USD 16 million. As a consequence, debt service tripled to USD 9.1 billion. Total debt quadrupled in six years, from USD 25 billion in 2004 to USD 105 billion in 2010.

Increased amounts of both domestic and external debt have been mainly used to support the budget deficit (including financing of the structural gap of Naftogaz, generated by persistent under-pricing in the domestic gas market) and have thus played an essential role in cushioning the economic downturn and absorbing part of the bank restructuring costs.

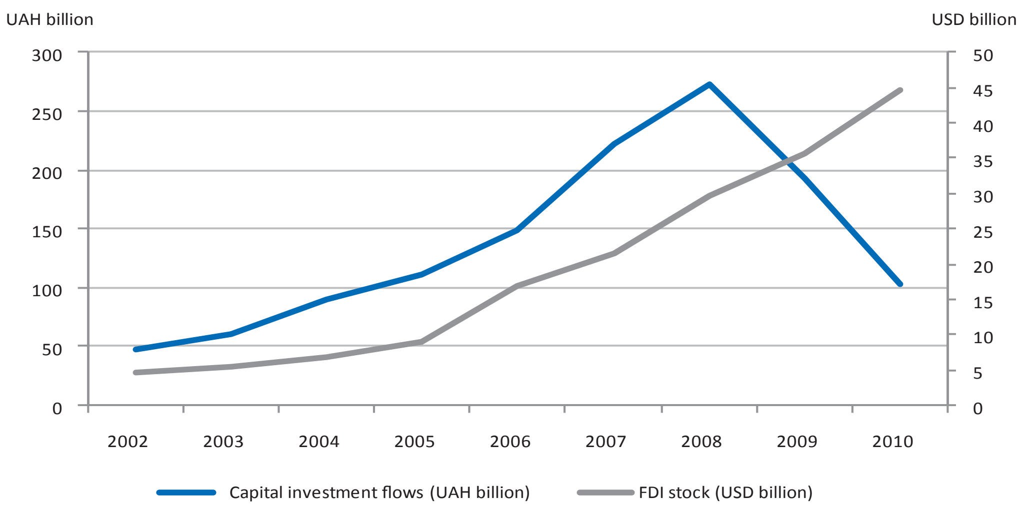
Investment

Ukraine has been attractive for investments given its skilled and relatively cheap labour force, its proximity to the EU market and the size of its domestic market. Before the crisis, growing productivity and some modernisation of industry driven by privatisation and the restructuring of enterprises and a booming construction sector supported strong investment demand. As a consequence, net new investments, measured by Gross Fixed Capital Formation (GFCF), increased from a growth rate of 19.2% of GDP in 2002 to 27.5% of GDP in 2007, mostly in buildings and equipment.

FDI increased to USD 52 billion by the beginning of 2010, or USD 1 132 per capita (11.1% increase yoy). However, it remains much lower than in many other transition economies in the region and is still far from its pre-crisis level.

The largest recipient of FDI is the financial sector, accounting for 31% of the total. 20% of FDI is concentrated in real estate, renting, engineering and business activities, 11.9% in metallurgy, 7.4% in wholesale trade, and 4.7% in construction. Thus, most knowledge-intensive and high value-added industrial sectors remain outside the line of vision of foreign investors. As yet, Ukraine remains a source of raw materials, an assembler of industrial components and a large and promising market for foreign-based goods and services.

Figure 5.3. Investments in Ukraine



Notes: 1. Capital Investment for 2010, from January to September; 2. FDI 2010, as of 1 January 2011.

Source: State Statistics Committee of Ukraine, SNA.

However, the sharp reduction in domestic consumption and exports highly restricted access to capital with skyrocketing costs. The rising price of imported natural gas and other energy materials, major problems with reimbursement of value-added tax (VAT) to exporters and ever-increasing social commitments hit severely the investment plans of Ukrainian enterprises. As a result, the rate of growth of GFCF decreased sharply following the crisis by 46.2% in real terms in 2009 (to 18% of GDP).

To increase competitiveness of goods produced in Ukraine, ensure sustainable growth and reduce dependency of domestic producers on imported energy materials, enterprises must significantly increase their investments in new technologies, particularly in energy-saving technologies.

Trade

The growing current account deficit is one of the causes of poorer GDP growth in Ukraine compared to that of the South Caucasus countries between 2000 and 2008 (*e.g.* 11% growth in Armenia in 2007). The trade balance sharply deteriorated, leading the current account deficit to reach 7% in 2008. From 2000 to 2008, exports quadrupled, from USD 14.5 billion to USD 67 billion, and imports grew six-fold, from USD 13.9 billion to USD 85.4 billion, both driven by high international demand (low price of raw materials and food products) and external capital.

Half of all imports concern mineral fuels and machinery, transports and financial services while major exports include ferrous metals and metal articles – iron and steel constitute 38% of total goods exports. Ukraine is a main transportation exporter (64% of total services exports) – mainly pipelines (20% of total services exports). The country transports 80% of Russia's gas to Europe.

Fuel imports account for one-third of total goods imports (including gas from Russia). Ukraine is the third exporter of grains in the world.

Informal economy[10]

Due to the high burden of taxation (both direct and indirect) and state regulation, coupled with generally low fiscal legitimacy and high corruption[11], the informal economy has been an integral part of the Ukrainian economy since the early 1990s. According to Schneider (2009), Ukraine ranks third out of 25 transition economies in terms of the share of informal economy in GDP, which increased from 52.2% in 1999-2000 to 57.3% in 2006-07.

Table 5.4. Comparative table of informal economies in the EESC countries

Informal Economy (% GDP)	**Armenia**	**Azerbaijan**	**Georgia**	**Republic of Moldova**	**Ukraine**
2002-03	49.1	61.3	68.0	49.4	54.7
2006-07	52.0	61.5	68.2	51.4	57.3

Source: Schneider, 2009.

National sources (estimates of the Ministry of Economy of Ukraine in 2008, based on an integrated approach), point to a smaller, though growing, informal economy, with 31.1% of GDP in 2008. According to preliminary estimates for the first half of 2009, the informal economy further increased to 39%. Data issues lead various experts to use other estimates, ranging from 50% to 60% (National Academy of Sciences of Ukraine, 2009, pp. 185-188).

As the economic crisis is analogous to the transition period of the early 1990s, where employment in the informal sector has been one of the major coping mechanisms to counter rising unemployment and income loss, it is reasonable to expect similar growth of the informal sector as a safety net. The sector still plays an important role for many households, mostly for people at the extremities of the age pyramid (15-24 and 60-70), the rural population and unskilled workers (OECD, 2008). According to the Labour Force Survey data by the State Statistical Committee of Ukraine, the informal sector employed around 4.5 million people aged from 15 to 70 years in 2009 (22.1% of the total employed in Ukraine). However, this is the lowest estimate of informal employment as it does not take into account double dipping[12] and so-called envelope wages paid to workers in the formal sector.[13] There are benefits linked to such informality such as cheaper goods and services, more job opportunities and sometimes better rewards which are unobtainable in the formal sector partly as a result of poor policy choices and the slow growth of the private sector. Due to financing problems and complicated tax and accountancy systems, small companies have strong incentives to enter the informal sector to avoid heavy legislation and bureaucracy.

Policy implications

Given the size of the informal economy in Ukraine, the government should put into place sound policies to reform the tax system, decrease the burden of regulations and minimise corruption in order to reduce the margin between formal and informal economies, improve the efficiency of the private sector and attract investments to recover previous growth rates. Also, there is an urgent need to reform the pension and social security systems, make the system of government expenditures more transparent and fair, and increase the quality of public goods in order to increase the government's fiscal legitimacy and induce citizens to pay taxes.

Analysis by economic sector

Restructuring of the Ukrainian economy, steadily rising household real incomes and living standards, and growing needs of manufacturing industries for modern infrastructure and services since 2001 have brought about catch-up growth in the services sector with the largest contribution coming from trade, transport and communication, financial intermediation, real estate, renting, engineering and business activities. The share of services (including public sector services) in GDP has therefore been increasing (from 49.8% in 2001 to 57.9% in 2007), while agriculture's share has been falling from about 16.1% in 2001 to 7.2% in 2007. The share of industry (the main export-oriented sector) was stable overall between 2001 and 2008 at approximately 30% of GDP.

All sectors of the Ukrainian economy have been affected by the ongoing crisis and its spillover effects, with particularly sharp contraction of output in export-oriented and credit-dependent industries and sectors, namely construction (45.9% yoy), manufacturing (26.6%), financial intermediation (16.2%) and retail trade and repair (15.7%) – the sectors that used to be the engines of growth in previous years. Agriculture was the only sector to experience growth in two quarters of 2009 and the lowest decline of 0.3% on a year-to-year basis.

Table 5.5. Changes in real gross value-added by economic sector
(yoy percentage change)

	2009	Q1-Q3 2010
GDP	-15.1	4.7
Agriculture, hunting, forestry	-0.3	2.1
Mining and quarrying	-10.5	3.6
Manufacturing	-26.6	13.3
Electricity, gas and water supply	-11.7	9.7
Construction	-45.9	-11.2
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	-15.7	5.7
Transport and communication	-9.1	4.1
Education	-1.2	3.0
Health and social work	-1.5	4.1
Financial activities	-16.2	-0.1
Real estate, renting and business activities	-6.1	1.2
Public administration and defence	-2.0	2.9

Source: State Statistics Committee of Ukraine, SNA.

Construction is the only sector that continued to decrease in the first three quarters of 2010, by 11% yoy. Manufacturing and electricity, gas and water consumption led recovery, increasing by 13% and 10% respectively yoy in Q1-Q3 2010. Although there was a resumption of GDP growth in 2010, these sectors will most likely need several years to reach their pre-crisis levels of output.

Agriculture

General overview

Ukraine is the third exporter of grains in the world. Agricultural and food items constitute the second largest group of Ukraine's merchandise exports. Important reforms since 2001 in the sector have favoured the recovery of agriculture and diversified trade. During 2001-05, the gross output of the sector increased by 10%, and by 12.6% in 2006-09 (National Academy of Sciences of Ukraine, 2010, p. 136). Prior to June 2010, estimates of the Ministry of Agricultural Policy forecast gross output to increase yoy by 2.8% in 2010 (to UAH 107 billion). The 2010 summer heatwave led to an expected 39 million tonne decrease in cereal harvest - against total output of 46 million tonnes in 2009. As a consequence, the government introduced exports quotas on cereals for Q4 2010, limiting exports to 2 million tonnes of maize, 500 000 tonnes of wheat and 500 000 tonnes of barley (AFP).

Despite fairly good performance of the sector since 2006, due to rather favourable weather conditions and high external demand, the agricultural sector has failed to invest in improved management schemes or implement policies that form the basis for sustainable growth. There is also an active policy of support to export-oriented agriculture, which depends essentially on the monoculture of grains, crowding out the labour-intensive crop and livestock production that forms two-thirds of the food basket of an average Ukrainian. The policy thus ignores the domestic need for diversified products from local producers and for the agro-food business.

The growth of agricultural production observed in recent years has failed to lower prices on domestically produced agricultural goods (prices increased by 12% between 2008 and 2009)[14] and has also failed, therefore, to improve the living standards of rural and urban populations. Continuous shrinking of wage employment in rural areas since the 1990s has contributed to a high incidence of rural employment in the informal sector (roughly 50% according to the Labour Force Survey (LFS) data, mainly in subsistence agriculture) and large outflows of rural workers to urban territories or abroad. According to the Ministry of Labour, agriculture accounts for 67% of the informal sector and as much as 95% of gross agricultural production is informal. All these negative developments are most likely to cause further depreciation of human capital, preservation of low standards of living and deterioration of human development in rural areas.

The government elected in January 2010 has declared its willingness to reform the agricultural sector, despite apprehension that it counts for half the country's employment. The process of capitalisation and land consolidation is underway, with an increase in the number of very large corporate entities. This process is mainly taking place through the development of vertically integrated "agro-holdings", primarily in the export-oriented grain and oilseeds sectors. The government wants to establish a system of co-operatives where farmers would work for a large company, thus maximising profits and reducing the costs of managing small plots. It still emphasises the importance of the export sector, to the detriment of domestic markets.

Crop production

Winter wheat, spring barley and corn are the country's main grain crops. Sunflowers and sugar beets are the main industrial crops. The sown area dropped by about 18% between 1991 and 2009, from 32.9 million to 26.9 million hectares, reducing the area for almost every category of crop except for grain and corn crops (of which the sown area increased even in the crisis in 2009) and sunflowers. The forage-crop area plunged by nearly 77%, in parallel with a steep slide in livestock inventories and feed demand. With decreased sown areas and increased volumes of production, efficiency has risen in Ukraine, mainly since 2000.

The production of grain and oilseed crops is dominated by large agricultural enterprises that were established alongside the restructuring of Ukraine's agricultural sector, which began by presidential decree in April 2000. A gradual transition of Ukraine's agricultural sector to a more market-oriented environment has introduced the element of hardening budget constraints and fiscal responsibility that induced most farm managers to make their enterprises as efficient as possible. The use of improved varieties and the increased application of fertiliser and plant-protection chemicals, a modernised fleet of agricultural machinery and enhanced management practices have resulted in increased crop yields per hectare of sown area.

Table 5.6. Sown area by categories of crop
(thousand hectares - 1991-2009)

	Total	Grain and corn crops	Sugar beets	Sunflowers	Potatoes	Vegetables	Forage crops
1991	32 909	14 671	1 558	1 601	1 533	477	11 555
1995	32 575	14 152	1 475	2 020	1 532	503	10 898
2000	28 675	13 646	856	2 943	1 629	538	7 063
2005	27 122	15 005	652	3 743	1 514	465	3 738
2008	26 953	15 636	380	4 306	1 413	458	2 752
2009	26 918	15 837	322	4 232	1 409	451	2 658

Source: State Statistics Committee of Ukraine.

Table 5.7. Crop yield per hectare of sown area
(metric centners - 1991-2009)

	Grain and corn crops	Sugar beets	Sunflower seeds	Potatoes	Vegetables	Fruits and berries
1991	26.5	234	14.6	95	128	23.0
1995	24.3	205	14.2	96	120	29.8
2000	19.4	177	12.2	122	112	38.4
2005	26.0	248	12.8	128	157	63.7
2008	34.6	356	15.3	139	174	64.4
2009	29.8	315	15.2	139	183	70.0

Source: State Statistics Committee of Ukraine.

However, a chronic lack of modern harvesting equipment and a shortage of on-farm storage capacity due to the difficulty for many farms to obtain large and long-term loans for capital investments remain the major obstacles to increasing crop output and quality in Ukraine.

Livestock farming

There was a catastrophic drop in livestock production during the 1990s as the removal of state subsidies, following the collapse of the Soviet Union in 1991, increased feed and production costs and reduced profitability for livestock enterprises. Former state and collective farms were unable to maintain livestock operations and to ensure sufficient feed supplies due to inefficient management.

Table 5.8. Total number of livestock by 1 January
(thousand heads)

	Cattle		Pigs	Sheep and goats	Poultry (million)
	Total	Cows			
1991	24 623.4	8 378.2	19 426.9	8 418.7	246.1
1995	19 624.3	7 818.3	13 945.5	5 574.5	164.9
2000	10 626.5	5 431.0	10 072.9	1 884.7	126.1
2005	6 902.9	3 926.0	6 466.1	1 754.5	152.8
2008	5 490.9	3 095.9	7 019.9	1 678.6	169.3
2009	5 079.0	2 856.3	6 526.0	1 726.9	177.6
2010	4 826.7	2 736.5	7 576.6	1 832.5	191.4

Source: State Statistics Committee of Ukraine.

The involvement of large investor groups ("agro-holdings") in agricultural production has also had an impact on livestock numbers. Due to low profitability of livestock in Ukraine,[15] large agricultural producers have been shifting away from cattle toward crop production and poultry farming – the most profitable livestock sector.[16] As a consequence, total cattle inventories and milk production continue to decrease.

Table 5.9. Main products of livestock farming

	Meat (thousand tonnes)	Milk (thousand tonnes)	Eggs (million pieces)	Wool (tonnes)
1991	4 029.1	22 408.6	15 187.8	26 646
1995	2 293.7	17 274.3	9 403.5	13 926
2000	1 662.8	12 657.9	8 808.6	3 400
2005	1 597.0	13 714.4	13 045.9	3 195
2008	1 905.9	11 761.3	14 956.5	3 755
2009	1 917.4	11 609.6	15 907.5	4 111

Source: State Statistics Committee of Ukraine.

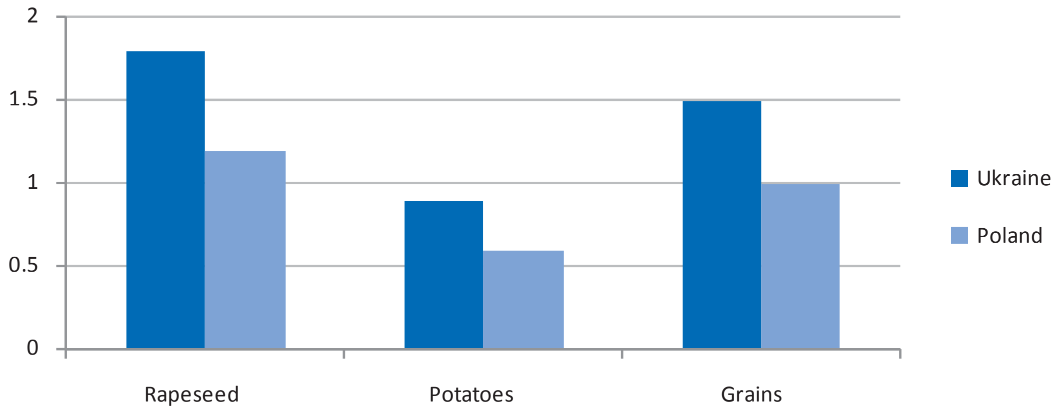
Domestic demand of both producers of food products and consumers for pork, beef and milk products is mainly satisfied by private producers and household farms (whose products are characterised by low quality) or increasingly by imported products of US, Polish and Latin American origin. However, there is great potential in meat exports to Western Europe, thanks to low labour costs and a vast sown area that provides low-cost animal feed, thus reducing production costs.

Biofuels sector

Ukraine has a solid economic basis for the production and distribution of biofuels: spare land for growing grain and oil plants, scientific and human resource potential, increasing internal demand for liquid biofuels (taking into account that Ukraine supplies only 10-12% of its own energy needs), and enormous export opportunities.[17] Biofuel production can be one of the answers to increasing energy prices. Consumption of biofuel and biodiesel was forecast[18] before the crisis to double between 2008 and 2010 from 49 million to 92 million and from 84 million to 174 million tonnes, respectively.

However, this potential is used by only 0.83% of the population. Local agribusiness is currently oriented towards supplying raw materials to countries with functioning biofuel capacities, notably to the European Union.

Figure 5.4. Comparison of inputs used for 1 tonne of bio-fuel production
(hectares)



Source: Centre for Social and Economic Research – CASE 2009.

Ukraine has to take serious steps toward the development of renewable energy sources, improvement of the investment climate and formation of a biofuels market. Although the government of Ukraine approved a programme of biodiesel production in 2006, setting a goal of building at least 20 plants by 2010 with an output of between 5 000 and 100 000 tonnes per year and an aggregate annual capacity of at least 623 000 tonnes of biodiesel, no budget spending to support these activities had been made, as of November 2010 (OECD, 2009).

Major reforms

The land reform, started in Ukraine in 2000, has not been completed because a ban on the sale of agricultural lands originally imposed until 1 January 2008, was extended for an indefinite period in late 2007. However, these changes are not perceived as urgent by agribusiness, the rural population or the general public, partly due to the existence of a well developed rental market for agricultural land (OECD, 2009).

The major reforms related to agriculture have been made in trade policies before and after Ukraine became a member of the World Trade Organization (WTO) on 16 May 2008. Between 2005 and 2008, Ukraine adopted 21 laws to bring the legislation in conformity with WTO requirements. As part of WTO membership requirements, Ukraine agreed to implement scheduled import tariff reductions, eliminate specific tariffs and maintain only *ad valorem* rates, apply no other duties and charges beyond ordinary custom duties, decrease existing export duties and eliminate obligatory minimum export prices.

However, agriculture is still heavily subsidised by the state. Many reforms have been implemented as the agricultural sector is set as a priority target to develop exports in agribusiness. Two major policies were implemented in 2004 and 2005: the Law on State Support to Agriculture (2004) and the abolition of free economic zones. These two policies, thanks to price and income support, credit concessions and input subsidies and tax concessions, primarily aim at achieving food security, increased efficiency and international competitiveness of the agricultural sector, integrated development of rural areas and improvement of social conditions for the rural population.

Policy implications

The government must tackle efficiency issues in the agricultural sector to ensure food security. Modernisation should be targeted by subsidising machinery and equipment, rather than output, in order to raise international competitiveness. Training should also be developed for the rural population in order to develop rural employment alongside agriculture. Land privatisation, which was frozen until further notice in 2007, should also reappear on the agenda. The system of government support must be reoriented from support of export-oriented large producers to support of farmers serving local markets in Ukraine, including those engaged in livestock farming and vegetable growing.

Industry

Raw steel production and manufactured goods make up 70% of Ukraine's merchandise exports. However, the sector has not benefited from technological and skills enhancement to increase production and competitiveness or to improve working conditions. Industry still suffers from underexploited potential, with ageing equipment, outdated technology and bad working conditions and wages. It also scores the highest share of informal activity in an economic sector. The fall in 2009 was accentuated by the delayed crisis impact (only 0.7% absolute drop in production in 2008), caused by the collapse of international and domestic demand.

Ukraine has failed to attract greenfield investments to meet the needs of export-oriented businesses.

Energy production

Ukraine is a very energy-dependent country and has to import over 50% of its total needs. The energy sector includes nuclear and coal industries, gas and oil sectors, as well as facilities for energy transit and energy generating enterprises – thermal power plants (TPP) and nuclear power plants (NPP).

Table 5.10. Energy sector key issues

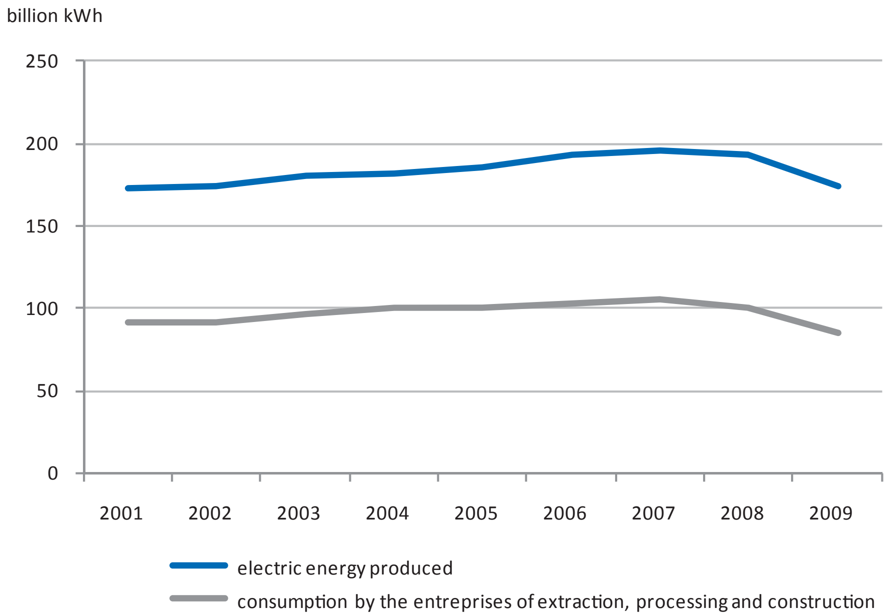
Gas production	Gas transit
-Current production covers one-third of total needs -80% of reserves are under falling extraction -4% of total resources extracted so far -Potential of resources to reach 1 500-1 800 billion m3	-80% of Russian gas exports to the EU -20% of the EU's gas consumption -Ageing infrastructure and capacity needs -EUR 1.85 billion to modernise infrastructure -Total gain could reach 30% of efficiency
Oil refinery	**Coal, mining and steel**
-2 Ukrainian companies for 20% share of market -18% of refining capacity utilised -Insufficient petrol/diesel production -Governance mismatch towards fuel production	-Coal losses: 15% total production -96% mines more than 20 years old -Two-thirds of mines unprofitable -Obsolete equipment -Corruption -High fatality rate (2nd after China)

Source: Tabled by the authors.

Ukraine is one of the largest gas transit countries in the world with over 35 000 km of gas pipelines, 122 compression plants (with a total capacity of 5.6 GWt), 1 380 gas distribution stations and 13 underground gas reservoirs for an overall volume of over 30 billion m^3. The annual capacity of the gas transport system is 290 billion m^3 at the entry point, almost 170 billion m^3 of which goes to the countries of Western, Central and Eastern Europe.

Electricity became a priority for development because its trade balance is positive. Unsatisfactory technological levels for power generation lead to significant losses. According to the State Statistical Committee of Ukraine, 22.4 billion kWh were lost in 2008 and 20.7 billion kWh in 2009, which accounts for roughly 12% of the total annual electric energy output of the country. The sector needs new investments to rationalise energy use domestically and to develop export potential. All the energy sectors suffer from low extraction levels and outmoded or lacking equipment. Educated engineers in the labour force are necessary to increase efficiency. Technology and machinery must urgently be modernised and the workforce trained to exploit new reserves. Modernising and repairing the pipeline infrastructure is another issue to ensure the security of gas transit to Europe and maximise gas storage potential. With efficient and modernised equipment, oil refinery production could be increased by a factor of five, to its estimated maximum capacity. It would be a significant source of revenue for both the government and the private sector.

Figure 5.5. Volumes of produced electric energy and consumed electric energy
(by extraction, processing and construction industries in Ukraine)



Source: State Statistics Committee of Ukraine.

The programme drafted by the government for the modernisation and technical upgrading of electrical enterprises includes:

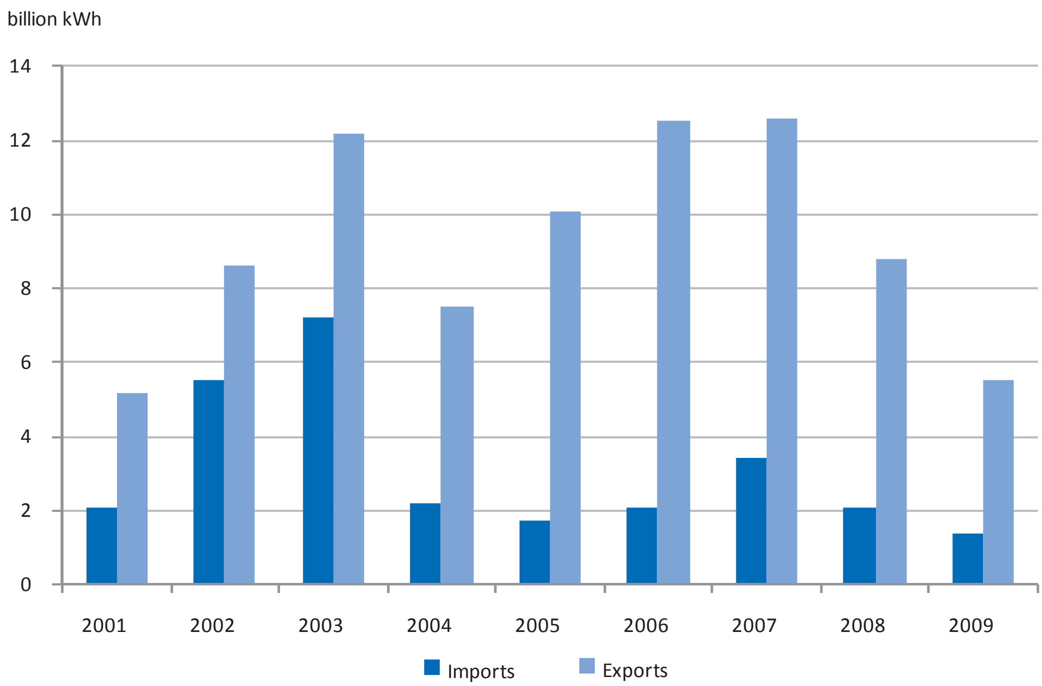
- improving the efficiency of NPP exploitations, modernising and reconstructing nuclear blocks and increasing safety;
- upgrading and modernising TPP through the introduction of new technologies for coal consumption;
- dismantling physically exhausted and obsolete equipment;
- constructing new power transmission lines, rebuilding and replacing equipment in power plants;
- developing fibre-optic telecommunications.

Rebuilding TPP, hydro-electric power stations and hydro-electric pumped storage power plants will cost about USD 1 billion. Ukraine is co-operating in this field with the World Bank and the EBRD, and with companies from Germany, Sweden, Denmark, France, the United States, Canada and Russia.

Ukrainian aggregate consumption of primary energy following independence was structured as follows: 41% of natural gas, 19% of oil, 19% of coal, 17% of uranium and 4% of hydro and other renewable sources. The world stock of organic fuel is composed of coal (67%), oil (18%) and gas (15%); in Ukraine these figures are, respectively, 95.4%, 2.0% and 2.6%. Thus, coal is likely to remain the main pillar of the fuel and energy strategy of the country.

Support for the coal industry was voted into law by a decree of the parliament of Ukraine, the Verkhovna Rada, on 16 March 2005, on the basis of the report by the Ministry of Fuel and Energy of Ukraine on the reorganisation of the energy sector. The decree stipulated in the chapter "Coal industry" of the *Energy Strategy of Ukraine until 2030* that GDP will grow three-fold and consumption of primary energy carriers by 47.5%, within which electric energy consumption will increase by 2.2% for a consumption of over 395.1 billion kWh. Export capacities are forecast to grow to 25 billion kWh, consumption of coal products will increase two-fold, to 130.3 million tonnes, consumption of natural gas will decrease by 36% to 49.5 billion m^3 and consumption of oil for internal needs will grow by one third to 23.8 million tonnes. This will decrease energy intensity from over 0.5 kg of standard fuel per hryvnia in 2009 to 0.24 kg of standard fuel per hryvnia in 2030.

Figure 5.6. Ukrainian imports and exports of electric energy



Source: State Statistics Committee of Ukraine.

Industrial production

The Ukrainian industrial sector covers iron and steel, fuels, food processing and packing, pulp and paper, chemicals and petrochemicals, machine-building and aerospace, building materials, pharmaceuticals, medical equipment, and power generation. In 2007, industry accounted for 30% of GDP and 19% of total employment. Industry has been the engine of economic growth in Ukraine and the leading export sector since 2000. However, it was also the sector most severely hit by the crisis.

The country's industrial production in the first quarter of 2009 fell by 31.8% yoy. Although all industries experienced considerable decline in 2009 compared to the previous year (- 21.9% overall), the sharpest declines were in transport equipment (- 57.9%), non-metallic mineral products (-38.5%), and machinery and equipment (- 37.6%). Most of these branches are export-oriented, sensitive to credit squeeze and domestic demand contraction.

Traditionally, over half the total sales of industrial production consist of metallurgy, food industry, mining and quarrying, manufacture of coke and refined petroleum products.

In the second quarter of 2009 Ukrainian industry showed the first signs of improvement, which strengthened by the end of 2009 and continued to gain momentum in 2010. The recovery has been driven by export-oriented industries such as chemical production and metallurgy that benefit from increasing world prices for steel and the resumption of international demand, driven primarily by emerging Asian and Latin American countries and Russia. These particular industries also benefited from improved competitiveness due to the sharp hryvnia depreciation in the autumn of 2008 and a set of government stimuli, adopted in late 2008 and effective till the end of June 2010. Specifically, on 10 November 2008 the Cabinet of Ministers signed a memorandum of understanding with owners of mining and smelting enterprises, the Federation of Metallurgists (employers' organisation) and the Federation of Trade Unions. On 17 November 2008 the Cabinet of Ministers signed a similar document with representatives of enterprises of the chemical industry and social partners. The instrument envisages government support for enterprises during the crisis, including gas-price subsidies to chemical enterprises, preferential cargo transportation tariffs for metallurgical and mining companies, negotiations with banks on releasing deposits of enterprises and extending credits aimed at the development and reinforcement of circulating assets of enterprises, quick VAT refund, negotiations with other countries on suspending antidumping investigations of Ukrainian chemical and metallurgical enterprises. Companies are obliged to preserve employment, wages and social benefits and make any changes in this sphere only through social dialogue.

A 23.8% (yoy) growth in the extraction of metal ores (mining and quarrying, with the exception of energy-producing materials) is closely related to recovery of metallurgy, while a relatively strong increase in machine-building (25.7% in total for the three machine-building sectors yoy) benefits from the strong economic recovery of the Russian Federation, which is the principal market for Ukraine's machinery. Based on increasing economic activity, the production of electricity, gas and water grew by 13.6% yoy in the first quarter of 2010. Although growth of the food industry in 2010 is modest compared to other sectors, it is one of the few industrial sectors that did not fall below the levels of late 2004 due to strong domestic and external demand.

Table 5.11. Changes in industrial production by sectors yoy and share of sector in total sales
(percentage change)

Sectors	2008 to 2009	2009 to 2010
Total industry	**-21.9**	**11.2**
Mining and quarrying	-10.6	3.7
Mining and quarrying of energy-producing materials	-5.7	-3.1
Mining and quarrying, except of energy-producing materials	-17.2	14.3
Manufacturing	-26.5	13.9
Manufacture of food products, beverages and tobacco	-6.0	3.2
Manufacture of textiles and textile products	-28.0	...
Manufacture of leather and leather products	-15.9	6.6
Manufacture of wood and wood products	-24.6	9.6
Manufacture of pulp, paper and paper products; publishing and printing	-18.7	10.8
Manufacture of coke, refined petroleum products and nuclear fuel	-3.4	-0.2
Manufacture of chemicals	-22.7	26.6
Manufacture of rubber and plastic products	-23.7	10.1
Manufacture of non-metallic mineral products	-38.5	8.5
Manufacture of basic metals and fabricated metal products	-26.7	12.2
Manufacture of machinery and equipment	-37.6	21.1
Manufacture of electrical and optical equipment	-28.2	24.2
Manufacture of transport equipment	-57.9	61.9
Electricity, gas and water supply	-11.1	9.5

Source: State Statistics Committee of Ukraine.

The manufacturing sector that lagged behind in recovery is of non-metallic mineral products (primarily construction materials) whose performance is closely linked to the performance of the construction sector.

Major problems

Industrial production in Ukraine is inefficient, energy-intensive[19] and environmentally unfriendly because of its obsolete equipment (with the degree of depreciation of fixed assets over 50%), outdated technologies, slow restructuring, low labour productivity and poor working conditions. Due to relatively low labour costs and prices of raw materials (including imported energy materials), industrial producers have little incentive for technological and skills enhancement to increase their production efficiency and competitiveness.

Innovation in Ukrainian enterprises has been very poor and was adversely affected by the economic crisis in 2009. According to the State Statistics Committee of Ukraine, between 2007 and 2009 the share of enterprises that implemented innovations declined from 11.5% to 10.7% of all enterprises, and the share of innovative products in total industrial sales fell from 6.7% to 4.8%.

Barriers to entry and exit are still substantial in Ukraine. There are also numerous obstacles to free competition and business growth such as corruption, political and regulatory instability, informal activities, unfair and non-transparent process of privatisation of state assets, unequal treatment of firms by the government through privileged tax regulations, direct and indirect subsidies and exemptions, privileges for land and infrastructure.

The oligopolistic structure of Ukrainian industry and its high dependence on external factors (including international steel prices and demand, price of natural gas imported from Russia and Turkmenistan, access to external borrowing) limits further the development of the Ukrainian economy and increases its vulnerability to external shocks.

Policy implications

Ukraine must pursue policies that promote innovation and competition, replace outdated machinery and equipment, introduce new, environment-friendly technologies and promote skills enhancement in response to market needs. It must also improve its energy efficiency through modernisation of both industrial and residential sectors. Modernising and repairing the pipeline infrastructure is another priority. Incentives must be provided to redirect industrial companies and investors towards the production of higher value-added goods, more diversification and reduced dependence on primary and intermediate goods.

Special attention should be paid to innovation-based economic development. Closer co-operation of Ukrainian producers with other countries in the region and beyond could promote innovation and technology transfers.

Efforts should also be focused on adapting production of the industrial sector to international standards in order to enhance its competitiveness, attract investments, increase safety conditions and improve environmental performance.

Construction

General overview

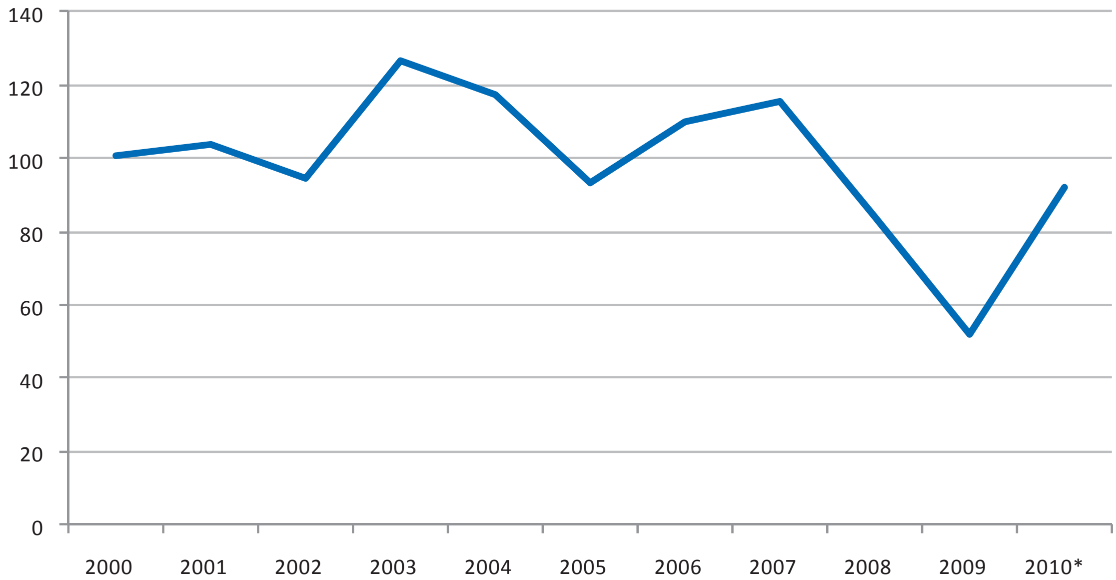
Construction has been one of the most dynamically developing sectors of the Ukrainian economy both in terms of output and employment since 2000. Its growth was led by increasing domestic demand, easy access to bank loans and speculative behaviour from both domestic and international investors. Sales reached a peak of UAH 107 175 million in 2007 out of UAH 358 451 million for fixed construction assets. The sector employed nearly 1 million people and the average monthly nominal wages of employees increased from UAH 230.17 in 2000 to about UAH 1 240 in 2008.

The construction sector experienced a slowdown in 2008, as the price for raw materials increased, followed by the credit and liquidity crises, and the strong devaluation of the hryvnia in 2009. Banks closed lending facilities, while households could not reimburse their mortgages. While real estate loans, in foreign currency, could account for 30% of monthly salary prior to the crisis, they went as high as 70% of income in 2009, following the crisis and the devaluation. Interest rates went up, so did inflation. Companies went bankrupt. The government kept investing huge means to sustain employment and incomes without major impact. As a result, the volume of construction works decreased in real terms by 15.8% (yoy) in 2008 and by 48.2% in 2009.

Lack of fiscal measures to stimulate domestic demand and support construction companies, restricted access to credit and weak investment activity explain the ongoing downsizing of the construction sector in 2010 (-20% yoy in January-May 2010), despite a very strong base effect and expected rising investment ahead of the European football cup to be held in Ukraine (and Poland) in 2012.

After an increase in 2006-07 as a result of growing prices for construction materials, volumes of performed construction works declined in 2008-09 with the slowdown in the business activity due to the onset of the financial crisis. The volumes of performed construction works accounted for over a half of their 2008 figure in 2009. The slowdown of this sector was also registered in January-September 2010 and led to an overall yoy decrease of 14%. As a result, construction companies' turnover amounted to UAH 64.4 billion in 2008; 16% below the 2007 level. Despite high declining figures in volumes, shares of performed construction works in total GDP finally amounted to 6.8% in 2008 and 4.1% in 2009; this is due to the simultaneous decline of GDP over these two years.

Figure 5.7. Index of volume of performed construction works
(index, 2000 = 100)



Note: * January-November 2010.

Source: State Statistics Committee of Ukraine.

The decline in the construction sector in 2008 occurred on account of the decrease in business activity across the board. The construction of buildings declined by 16.3%, while the installation of engineering equipment was down by 14.3%, and pre-construction works were cut by 10.3%. The trend was more severe in 2009. Volumes of construction of buildings shrank by 48.6%, installation of engineering equipment dropped by 44.9%, and pre-construction works fell by 41.4%. Construction work associated with power engineering, extraction and processing, however, increased yoy by 10.1% in 2009. As the economy picked up, there has been a gradual increase in the volume of work peformed in 2010 but it is still far from its pre-crisis level.

Major problems

The market structure of the sector, with the domination of a few large holdings and existing barriers to entry, is highly inefficient as it does not promote competitiveness, investment in new technologies, quality improvement, or responsiveness of prices to demand.

Non-transparent and extremely costly procedures of acquisition of land plots for building purposes, vague land legislation and corruption in municipal authorities are other factors detrimental to the development of the construction sector (Giucci *et al.*, 2008).

Policy implications

Given inflationary pressures in Ukraine, there is no room for demand-side macroeconomic policies (either fiscal or monetary) to tackle the recession in the construction industry. These policies cannot solve the underlying problems; they merely postpone implementation of the necessary reforms and might even create more hardships by artificially supporting high housing prices and hurting potential small buyers (Giucci *et al.*, 2008).

The government should implement structural reforms aimed at creating a more competitive environment and implementing a transparent procedure of acquisition of building plots that would result in cost and time savings. The government should also take measures to fight corruption and intervene in the disputes between households and indebted enterprises.

Resolution of the issue of high corruption in the construction sector seems to consist in thorough deregulation. For instance, obtaining an approval for getting a building plot usually takes around 220 days in Ukraine, while in Georgia it is 5 to 30 days.

The functioning of the Unified Approval Centres (UACs), which reduce the time required for obtaining a permit to 68 days, also needs be improved. Applicants should not have to make multiple visits to the UAC, especially since, according to research by the InMind marketing institute, such visits increase the likelihood of officials demanding bribes from the applicant, though businesses report fewer demands for bribes than in the past.

Services

General overview

From 2000 to the crisis, strong private consumption and investment growth contributed to solid growth in most services sectors, such as wholesale and retail trade, transport and communication, and banking and finance. The sector accounted for about half of total GDP and of total employment. Services have also enjoyed the highest increase in FDI compared to agriculture and industry.

Telecommunications

The sector is highly integrated into the international market and has enjoyed a boom with an increase of 60% since 2005. It also attracted 32% of total investments as a percentage of revenue in 2008, compared to 23% in 2000.

Information and communication technology (ICT) expenditure reached 7% of GDP in 2009 and has attracted, on average, more than 15% per year of total investments since 2000 due to its outstanding growth potential, a population of 46 million, a growing domestic mobile and internet subscriber base and the central geographical location of Ukraine.

The highest growth of the telecommunications sector has been in mobile communication. Mobile cellular subscriptions were 120.4% in 2008 and Internet users 22%. However, only 5% of the total population own a personal computer. In 2008, fibre-optic communication lines were developed to increase broadband speed. Internet is the only service that showed steady growth in 2009 (46% yoy).

The mobile market, similarly to most European countries and Russia, demonstrated saturation in 2007 when the figure crossed a hundred mobile subscribers per 100 citizens, or 100%. A well-developed secondary market of mobile phones and acceptable tariffs for pre-paid mobile connections offered by various mobile operators have contributed to supporting the tendency towards the increase in the subscribers' base. In 2009 the corporate sector actually retreated somewhat from telecommunications, presumably out of sensitivity to the crisis.

Table 5.12. Communications subscribers
(thousand people)

	As of 1 January 2009		As of 1 January 2010	
	Total	incl. home users	Total	incl. home users
Mobile subscribers	55 694.5	31 090.1	55 333.2	32 100.7
Cell	55 681.5	31 090.0	55 321.3	32 100.2
Trunked	12.3	0.1	10.6	0.1
Paging	0.7	0.0	0.3	0.0
Altai* type connexion	2.4	1.5	0.6	0.3
Cable television subscribers	3 486.2	3 472.8	3 478.7	3 469.0
Internet network subscribers	1 905.1	1 532.2	2 797.1	2 214.6

Note: * Non-Line-of-Sight WiFi Coverage for 3G Data.

Source: State Statistics Committee of Ukraine.

The number of Internet users registered a steep yoy growth of 46.8% in 2009, most of which was home-user increase (44.5%). This was partly due to the development and application of fibre-optic communication lines which significantly increased speed of network access (up to 100 Mb/sec) for an acceptable subscription fee (UAH 60-90 per month*, i.e.* USD 7.2-10.8).

Yet, the mobile Internet market development in Ukraine is lagging behind international trends. High-speed wireless Internet access services under the 4G standard providing maximum download speed of up to 20 Mb/sec and upload speed of up to 5 Mb/sec is offered by only two operators – Freshtel and Intellcom – that provide coverage only in Kyiv (though signal strength is not very high or stable even in some central districts of the city). The monthly subscription fee for this type of Internet access ranges between UAH 50 and UAH 179 per month, depending on the download/upload speed limit set by the operator.

Third-generation wireless data transfer standard (3G) is currently supported by a wider range of operators (MTS, Kyivstar, PeopleNet, Utel, Beeline, Intertelecom) but still fails to cover the whole country. The average cost per 1 Mb of transferred data is UAH 0.2; maximum speed is 3.1 Mb/sec.

Mobile Internet access service costs are much higher than landline access, owing to market growth and the absence of serious competition. It is expected that extension of coverage by the service providers in the future will contribute to a broader spectrum of choice for Internet users and lead to quality enhancement and the revision of tariffs.

Policy recommendations

The major issues to be resolved in the field of telecommunications were addressed by the National Commission on Connection Regulation in Ukraine in September 2010. These were:

- the spread of 3G technologies;
- economic arrangements for reciprocal payments by the cell connection operators;
- simplification of entry to the telecommunications market (reduction in the number of activities subjected to licensing, refusal of double licensing, and improvement of the procedure for registration);
- preparation of draft rules for the provision and use of telecommunication services in line with EU standards.

Transport

Transport plays an important role within the EESC region and Ukraine is its linchpin. Though declining in shares, transport services remain the primary services export sector in Ukraine, mostly due to pipeline transit. There has been a clear shift in transport services from exports to imports, from 77% in 2000 to 45% in 2008 of commercial service exports and from 13% to 40% of commercial service imports.

Major achievements have been made, including the extension of transport routes, improvements in the subway system, more efficient freight shipments (especially by air), and volume increases in maritime, road and passenger traffic. However, there is a growing disparity between the western and eastern parts of the country. Transport hubs, mainly in sea ports, are at capacity in the West and running under capacity on the other side of Ukraine.

However, the transport potential of Ukraine, which, in terms of volumes and infrastructure, is the largest in Europe, uses only 60% of its capacity overall and the transport budget runs an annual shortfall of USD 2.5 billion. This underutilised capacity can be explained by unsatisfactory installations in the maritime ports, deterioration of rolling stock and poor-quality roads.

Rail transport

Rail is the main means of transportation and is responsible for over 60% of freight, against only 8% in the EU. The operational length of railways was 21 700 km in 2009 out of which 9 700 km was electrified (a little under 45%). The number of passengers was 425 974 000 in 2009 - 4.4% less than in 2008. The annual volume of freight was 498 536 800 and 391 523 400 tonnes in 2008 and 2009 respectively. Transport delays also remain unacceptably long, especially for perishables, such as fresh fruit and vegetables.

Table 5.13. Availability of the Ukrainian rolling stock and its level of deterioration

Type of mobile mix	2007		2008		2009	
	Items	Deterioration %	Items	Deterioration %	Items	Deterioration %
Electric locomotives	1 812	52	1 834	48	1 871	40
Oil locomotives	2 472	44	2 442	49	2 429	51
Sections of electrical trains	332	25	318	24	320	25
Diesel trains	152	57	151	60	150	61
Freight wagons	146 541	75	143 798	77	142 834	77
incl. open-top wagons	63 411	81	63 570	76	63 570	79
Passenger coaches	7 247	61	7 293	64	7 349	59

Source: Syryychuk *et al.*, 2010.

Despite huge railroad transportation potential,[20] high levels of deterioration (77% in freight wagons and 61% in diesel trains) hinder the efficient development of the rolling stock. This leads to increased expenditures for repairs, maintenance and safety, which are more than twice what they should be. Locomotives would have been replaced up to three times more often in developed countries in the same period of time.

The sector needs cross-subsidisation and the involvement of private companies. Such cross-subsidisation would include setting economically justified tariffs for all categories of passengers and types of transportation. This would also make the state transporter's ("Ukrzaliznytsia") activities more transparent through the creation of public companies, even if the state retained 100% of shares. Together, these measures would contribute to an increase in profitability from transportation operations by rail and attract new investors. The absence of flexible mechanisms for co-operation between transporters and freight owners leads to overbooking that raises the cost of rail freight transport and drives freight on to other means of transport (which led to yoy decreasing freight-carrying volumes in 2009).

Despite its problems, the rail system has a developed network and high density (40 to 62 km/thousand km^2 in developed industrial regions of Donetsk, Luhansk, Dnipropetrovsk, Kharkiv, and Zaporizhzhia as well as Lviv, Zakarpattia, Chernihiv, and Vinnytsia). The following railroads are, therefore, important for domestic and international economic communication:

- Kyiv-Poltava-Kharkiv
- Kyiv-Odessa (to the Black Sea)
- Kyiv-Kovel-Khelm (to Poland and the EU)
- Odessa-Lviv-Peremyshl (linking South Caucasus to Europe)

Road transport

The average road density was over 270 km/thousand km^2 and the annual freight volume was 1 068.9 million tonnes, for a total of 1 694 900 km of roads in 2009. In order to reach European levels of road provision, almost 200 000 km of automobile roads must be built and/or modernised, 60% of which are in rural areas.

The main obstacles to this development in Ukraine are failure to meet transport standards – 70% of the locally produced "LAZ" and "ZIL" trucks cannot compete with imported models. In addition, the unsatisfactory length of quality roads, high accident rates and low vehicle ownership contribute to the lack of competitiveness of Ukrainian road transport.

The poor quality of Ukrainian roads and the low level of development of transport networks is partly a function of low population density (78 people/km^2), which leads to high per capital maintenance costs, compared to European countries.

The rapid increase in the number of privately owned automobiles and growing volumes of road freight are unmatched by increased road quality and driver education. One result of this is that in 2010 some 20 deaths and about 200 injuries occurred on the roads every day. The number of deaths per 100 automobiles in Ukraine is 2.5 times that in Poland, 5 to 6 times that of France and 10 to 11 times the number in Sweden. The cost of traffic accidents is equivalent to 1.4% to 3.5% of GDP, or about UAH 12 billion.

The most important highways of Ukraine include:

- Kyiv-Poltava-Kharkiv-Rostov-on-Don
- Kyiv-Moscow
- Kyiv-St. Petersburg
- Kyiv-Odessa
- Moscow-Kharkiv-Zaporizhzhia-Simferopol
- Kyiv-Zhytomyr-Rivne-Lviv-Uzhgorod
- Kyiv-Dnipropetrovsk-Donetsk-Mariupol

Some of the issues facing road transport can be tackled by measures including: i) creation of toll roads; ii) public-private partnerships in road development and maintenance; iii) amending the Rules of Hazardous Goods Transportation; iv) improving the training and professional development of drivers, etc..

Ties within the Black Sea area

In order to remain a major player at the regional level, Ukraine needs to maintain and increase investment in transport, in particular, maritime transport across the Black Sea to enhance and capitalise on regional synergies.

The maritime infrastructure of the Black Sea countries is part of international transport corridors linking the six countries of the Black Sea with the Ukrainian Danube, the Sea of Azov and the Caspian-Black Sea regions. Overall 5.2 million tonnes of freight and 9 900 passengers can be carried by the current fleet in 2010.

Four European corridors (to Central and Eastern European countries) transit the Black Sea region, (the so-called "Cretan Corridors"):

- #3: *Berlin - Dresden - Lviv - Kyiv;*
- #5: *Trieste - Ljubljana - Budapest (Bratislava) - Lviv;*
- #7: *(Danube) Vienna - Bratislava - Budapest - Belgrade - Reni - Izmail – Ust - Dunaisk;*
- #9: *Helsinki – St Petersburg - Minsk - Moscow - Kyiv – Odessa – Kishinev - Dmytrovgrad - Alexandroupolis.*

Of the 40 Black Sea and Sea of Azov ports, 12 river ports and 19 maritime ports are on Ukrainian territory. These maritime ports have a total capacity of about 120 million tonnes of dry freight and up to 30 million tonnes of raw oil and oil products, facilitated by the operation of 175 transhipment complexes and 8 dockyards. This potential, however, is under-utilised (only 50-60% of total capacity) due to the absence of ample loading equipment.

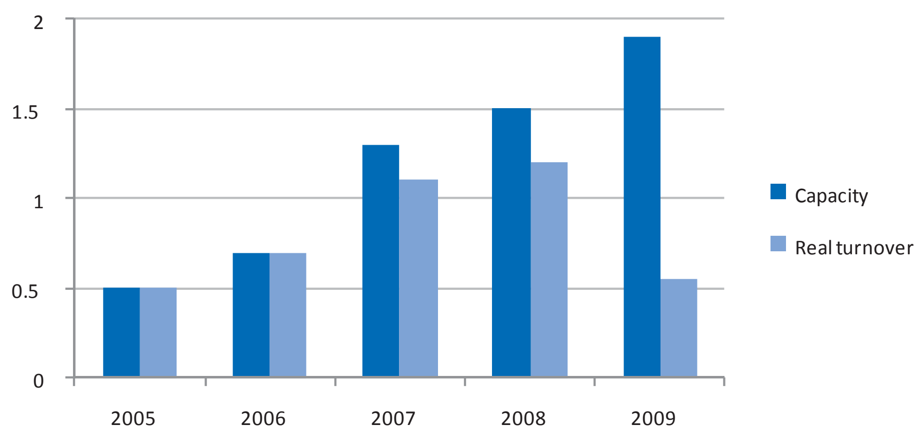
The maritime transport situation is characterised by undercapacity in the ports, uneven distribution of cargo between western and eastern facilities, and the obsolescence of equipment and transshipment complexes. For example, in 2008, over 5 million tonnes of containerised cargo was transshipped through Ukrainian ports, of which 90% went through the ports of Odessa and Illichivsk. In 2009, the decrease in maritime freight was about 60% (twice as much as the drop in any other means of transport).

Despite the general decline in volumes, previous congestions had already drawn attention to the development of capacities. Investments in a new container terminal in the Odessa port were worth USD 340 million in 2008-09. Overall cargo flow through Ukrainian ports is forecast to increase to 4.5 million twenty-foot equivalent units (TEU) by 2011, 5 million by 2013, and 10 million by 2015. Therefore, enhancement of ports capacities is a necessity.

The capacities of the main ports of Ukraine for containerised cargos per year are:

- Odessa: 38 million tonnes of freight and over 150 000 TEU of transship for a total area of 125 km^2
- Illichivsk: 24 million tonnes of freight and 600 000 TEU of transship,
- Mariupol: 12 million tonnes of freight and 50 000 TEU of transship.
- The development of the port of Yuzhny also looks very attractive for investors.

Figure 5.8. Capacity and real turnover of the Ukrainian maritime ports in 2005-09
(TEU million)



Note: *TEU = twenty-foot equivalent unit / 1 TEU = 20 feet (6.1m) long and 8 feet (2.4m) wide.

Source: Container market for peace: Black Sea and the pool / / Transport, № 46 (578). - 2009. - S.67-69.

12 countries of Europe-Caucasus-Asia participate in the TRACECA project, for the development of transport corridors. The realisation of the project is closely tied to issues of transporting oil and gas from the Caspian Sea area to the West across the Black Sea region.

Policy implications

Ukraine's needs for increased capacity (besides tankers and gas carriers) are for 117 cargo ships with a capacity of 1.1 million tonnes and 11 passenger ships of 4 500 places; this can only be met by attracting new investments.

Resolution of the issue of the development of Ukrainian ports is becoming even more urgent, given the intensification of inter-regional and international transport flows in the region of the Black Sea and the Sea of Azov, related to transportation of Caspian energy carriers to the world markets. Development of the transport infrastructure of the Black Sea countries has attracted the attention of western countries that see it as an indispensable element of their strategy of formation of the new global transport corridors.

The EU is particularly concerned with ferry and rail services linked to the Black Sea and the development of terrestrial facilities connected to the Cretan Corridors. Sizeable financial resources have been dedicated to the development of the ports. According to the estimates of the EBRD, initial investments in the network were EUR 700 million in 2009.

Ukraine has approved the programme of measures for the construction and modernisation of the entire range of transshipment complexes in Illichivsk, Odessa, Yuzhny and Mariupol and further development of the existing ferry connection between the ports of Illichivsk, Varna and Poti/Batumi. Moreover, a ferry service from Illichivsk to Poti has been established within the framework of the European-Asian oil transport corridor. Ukraine has also opened a rail ferry service between Illichivsk and Varna.

Financial and banking sector

The financial and banking services sector has benefited from a high level of investment since 2000. Foreign-owned banks increased to nearly 40% of total banks in Ukraine in 2008 because of the wave of privatisation in the banking system that year. Bank credit grew by more than 65% yoy with 50% of it in foreign currency, considerably increasing exposure to currency risks and hence the vulnerability of the entire banking system.

The financial system suffered most from the crisis in all service industries in Ukraine, with a sudden drain of deposits,[21] increased obligations of banks with regard to international debt due to the devaluation of the national currency during late 2008-09, and an increased number of non-performing loans since the onset of the crisis. Freezing bank loans to households and companies and lifting the ban on the early withdrawal of time deposits deepened the economic crisis. After losing some 20% of deposits between October 2008 and April 2009, aggregate deposits have stabilised and performed well, signalling some return of confidence in the banking system.

However, this stabilisation at the aggregate level concealed significant differences between banks, with foreign-owned, state and recently recapitalised state banks generally gaining deposits, and with small domestic banks continuing to experience significant money outflows and solvency problems.

Domestic currency lending recovered partly because of the 1-4% reduction in interest rates (at the end of 2009 foreign currency lending was banned by the National Bank of Ukraine until at least 1 January 2011) even though the rates still seem to be very high (24-25% for housing over five to ten years and 16% for car purchase). Ukrainian banks have continued to reduce their credit portfolios in foreign currency, the total of which was reduced to far below USD 20 billion in 2010.

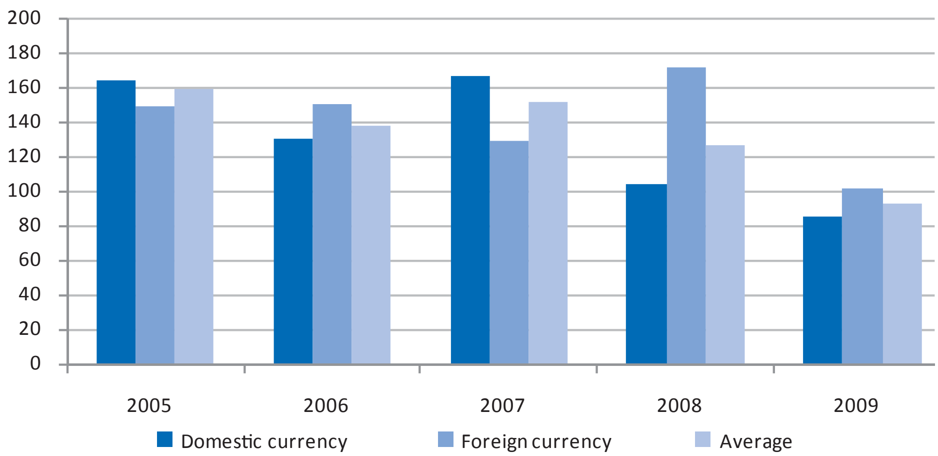
In 2009, the Ukrainian banking sector registered a deep decline in business activity and in the resource base, but an increase in the percentage of bad loans. In parallel, there was an increase in the statutory and regulatory capital of banks, higher adequacy requirements, and an upsurge of lending to corporations (especially in hryvnia), while lending to individuals was frozen.

In 2009, the expenditure of Ukrainian banks increased by 57.4%, and accounted for UAH 181.4 billion, as of 1 January 2010, mainly due to reserves accumulation. Reserves tripled within the year to UAH 75.4 billion. Thus, the ratio of banks' expenditure to their incomes was 126.9% in 2009 compared to 94.0% in 2008.

The amount of deposits attracted by banks for residents accounted for UAH 335 billion on 1 January 2010. This volume heavily depends on the macroeconomic situation in the country, dynamics of the hryvna exchange rate, and the level of trust of economic agents in the banking system. Overall, in 2009 deposit balances shrank by 6.9% during the year as compared to an increase of 26.7% in 2008.

Households' savings remained the largest share of deposits attracted by banks and provided the main cumulative gain of deposits in 2009. On 1 January 2010, the volume of household deposits accounted for UAH 214.1 billion. Deposit withdrawals in 2009 occurred mainly due to the decline in national currency resources by 14.2%. Deposits in foreign currencies increased by 2.5% exclusively due to the devaluation of the hryvnia against other currencies.

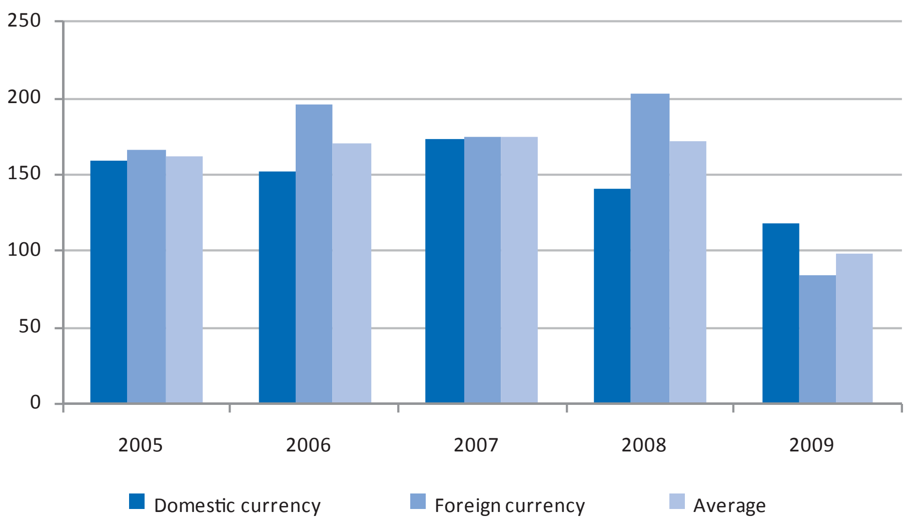
Figure 5.9. Deposits across currency type
(growth/decline rate per annum, pourcentage)



Source: Annual Report of NBU, 2009.

The trend of lending in Ukraine underwent significant changes during 2009. Following a four-year dynamic increase, lending growth rates gradually decreased in 2009 (107.6% in November 2009 against 172.0% in December 2008). Loans in foreign currencies also decreased. Credit indebtedness in foreign currency shrank by 15.2% in 2009 as a natural consequence of the ban on foreign-currency borrowing.

Figure 5.10. Loans across currency type
(growth/decline rates per annum, pourcentage)



Source: Annual Report of NBU, 2009.

In 2008-09, the NBU took multiple measures to stabilise the banking sector, while managing the crisis. According to resolution no. 319 "On Additional Measures Regarding the Activity of Banks" of the NBU's Board on 11 October 2008, a special year-long programme to support bank liquidity was introduced.

This was designed to support bank liquidity when the stability of the banking system was actually under threat. Indeed, bank liquidity was constrained by financial instability and the hryvnia exchange-rate fall, along with other circumstances leading to a significant decrease in the solvency of many banks or their customers. Overall, the volume of loans for refinancing of the banks amounted to UAH 169.5 billion in 2008, while in 2007 it was UAH 2.5 billion. Additionally, the NBU undertook deposit operations with the banks through issuing deposit certificates in 2008; the interest rate was determined on the basis of the general situation on the money and credit markets.

To stimulate deposit and credit operations by the banks in national currency, in January 2009 reserve requirements were strengthened. In particular, normative standards for obligatory reserves of term deposits in foreign currency of both companies and individuals were raised from 3% to 4%, while demand deposits in foreign currency had their reserve requirement increased from 5% to 7%. Reserve requirements for loans in the national currency remained at zero.

Policy implications

In order for the banks to attract resources on foreign markets, in a context of liquidity decline, interest rates on foreign liabilities for non-resident banks and financial organisations were decreased to 2% in February 2009.

Moreover, the government has been injecting a lot of money into the banking sector to prevent its collapse. Ukraine received a USD 31 billion aid package from the EBRD, the World Bank and the EIB. However, efforts need to be sustained to address the liquidity problem and to reschedule bank debt to allow domestic loans to resume. The procedure of restructuring of bad loans needs to be streamlined within the triangle "bank – borrower – state" given that the state usually protects households without taking into account interests of banks and financial institutions.[22]

MAIN MACROECONOMIC POLICIES

General overview

Ukraine was the first country to seek IMF assistance in overcoming the crisis. The Fund granted a two-year stand-by agreement of USD 16.4 billion, in four instalments, starting November 2008. Ukraine agreed on the main conditions, namely implementation of a flexible exchange-rate regime with targeted intervention, a pre-emptive recapitalisation of banks, prudent fiscal and incomes policy (with an objective of 3% budget deficit in 2010), and private-sector support policies.

However, Ukraine failed to meet all the requirements in the light of political tensions surrounding the elections. As a result, the IMF withdrew its assistance in November 2009 after disbursing USD 10.5 billion. The new government succeeded in negotiating a new USD 15.6 billion agreement with the IMF in March 2010 and has been meeting every deadline. Structural reforms target the pension system, public administration and the tax system with the following objectives:

- GDP growth of 5.5% in 2010;
- Reduction of budget deficit to 5.5% in 2010 (with 1% of GDP deficit for Naftogas) and to 3.5% in 2011 (with a balanced budget for Naftogas);
- Reduction of overall public debt below 35% of GDP by 2015;
- Complete bank recapitalisation by 2011.

Fiscal policy

Fiscal performance in 2008 and 2009

Rapid deceleration of economic growth since October 2008 caused a sharp worsening of fiscal performance at the end of 2008 and in 2009. Due to a 41% increase in tax revenues (in nominal terms) resulting from a robust growth in revenues from three main taxes – VAT, Personal Income Tax (PIT) and Corporate Profit (CP), as well as from excise taxes on imported goods in the first nine months of 2008, consolidated budget revenues grew by 35.4% yoy in nominal terms to UAH 297.8 billion.

Table 5.14. Parameters of consolidated budget during the crisis

	2008		2009	
	% yoy (nominal terms)	% of total	% yoy (nominal terms)	% of total
Total revenues	**35.4**	**100**	**-3.1**	**100**
Total tax revenues	40.9	76.3	-8.4	72.1
PIT	32.0	15.4	-3.1	15.4
CIT	39.1	16.1	-30.9	11.5
VAT	55.1	30.9	-8.1	29.3
Excises	21.0	4.3	69.2	7.5
Duties	24.4	4.0	-47.0	2.2
Non-tax revenues	24.6	20.3	22.4	25.7
Total expenditures	**36.8**	**100**	**-0.6**	**100**
Consumer expenditures	43.1	86.7	7.2	93.5
Capital expenditures	6.5	13.3	-51.5	6.5

Source: Pogarska and Segura (2010).

To comply with IMF conditions, the government agreed to tighten fiscal policy (freezing public sector employees' nominal wages, cutting expenditures of government agencies, etc.) but fiscal incentives were granted to the construction sector, agriculture, metallurgy and chemical industry, Naftogas and the State Pension Fund of Ukraine.

In December 2008, the deficit was raised to UAH 25 billion (2.6% of GDP) with increased reliance on domestic debt financing in opposition to IMF recommendations. The Ukrainian government committed to maintaining a balanced budget in 2009 but, after an initial deficit of more than 3%, the budget was revised several times and arrived at a deficit of 4-6% (excluding Naftogaz's deficit and excluding bank restructuring costs). To secure the deficit, the authorities: *i)* increased excises on tobacco, alcohol and diesel; *ii)* promised to increase the domestic prices for gas, electricity and coal; *iii)* initially took some measures to improve the financial condition of the Pension Fund but, in fact, failed to do this; and *iv)* sold carbon emission rights and adopted a financial plan for Naftogaz, which limits the subsidy to the company to the amount planned in the budget.

Deviations from the fiscal policy agreed in the programme with the IMF, irregular implementation of the flexible exchange rate regime, slow resolution of bank difficulties, failure to meet several continuous performance criteria, together with the sharp economic contraction since the approval of the programme and intensified political disagreements on policy adjustments contributed to a delay in the completion of the first and second programme reviews and therefore in the disbursement of the second and third tranches.

The run-up to the presidential elections in January 2010 gave rise to expansionary fiscal policies at the end of the year that aggravated existing imbalances. In particular, in October 2009 the Parliament approved a law that envisaged major increases in social spending (wages and pensions) starting from 1 November 2009, and another envisaging the transfer of NBU profits to the amount of UAH 10 billion to finance Euro-2012 infrastructure projects.

The overall budget deficit in 2009 is likely to be 9-11.5% of GDP when a number of expenditures (on bank recapitalisation, the Naftogaz capital injection and financing the actual deficit of the Pension Fund) are also included.

Budget 2010

The 2010 state budget law prepared by the government elected in January 2010 was approved with a deficit of 5.3% of GDP on 27 April 2010. The budget was developed based on a macroeconomic forecast of real GDP growth at 3.7% and consumer price index at 13.1% in 2010.

However, the tax revenue forecast of a 36% growth in 2010 still looks overly optimistic. In order to raise budget revenues, the Parliament has already increased excises on alcohol (beer, vodka and some wines), tobacco and gasoline products and duties on use of surface and subsurface water in the production of beverages. The government is also going to tighten tax administration, struggle against "envelope" payments of wages and increase non-tax revenues (in particular, privatisation receipts).

While the approved budget deficit includes expenditures to cover the cost of full implementation of the Law on Increases in Social Standards (approved in October 2009) and the forecast pension fund deficit, the size of the financial support to Naftogaz remains unclear. Taking into account that the new government is not going to raise natural gas prices for households and the utility sector, sustaining Naftogaz finances looks quite problematic in 2010, even with the new Russian-Ukrainian gas discount negotiated in April 2010.

Thus, a high overall budget deficit in 2010 and rising sovereign debt represent the major risk to financial stability of Ukraine in the medium term.

Table 5.15. Receipts, budget 2010
(UAH thousand)

Total income	**252 751 214.2**
Total revenues, excluding inter-governmental transfers	245 661 325.2
Tax revenues	188 223 498.0
Income, profits and market taxes	40 035 011.9
Corporate income tax	40 035 011.9
Royalties	1 626 500.1
Domestic taxes on goods and services	134 846 311.3
VAT	104 735 191.3
VAT refund	- 274 706 000.0
Excise duty	29 716 000.0
Taxes on international trade and external transactions	8 875 940.0
Including: Exports and imports duty	8 666 940.0
Non tax revenues	55 434 298.8
Incomes from property and business activities	25 557 259.3
Other revenues	2 047 446.6
Total financing	**54 095 369.9**
Funding debt operations	83 862 165.6
Borrowing	1 076 583 822.0
including internal	73 590 271.3
including external	34 068 110.9
Liabilities	- 237 962 166.0
including internal	- 17 061 988.4
including external	- 67 342 282.0
Revenues from privatisation assets	6 350 000.0

Source: NBU, Verkhovna Rada of Ukraine.

Table 5.16. Expenditures, budget 2010
(expenditure by ministry, UAH thousand)

Total Expenditures	**240 984 364.1**
Ministry of Interior	9 678 959.3
Ministry of Fuel and Energy	98 876.0
Ministry of Economy	294 892.2
Ministry of Coal Industry	62 254.9
Ministry of Education and Science	15 101 259.0
Ministry of Health	4 889 739.3
Ministry of Labour and Social Policy	3 869 158.8
Ministry of Industrial Policy	99 621.4
Ministry of Agricultural Policy	3.528.372.7
State Statistics Committee	443 169.4
Ministry of Transport and Communications	1 163 731.0
Ministry of Finance	22 097 047.1
Ministry of Justice	1 001 078.7
State Agency of Ukraine for Investments and Innovations	24 612.0
State Committee of Ukraine on Regulatory Policy and Entrepreneurship	32 631.7

Sources: NBU, *Verkhovna Rada* of Ukraine.

Policy implications

In June 2010, the new authorities (both the presidency and the government) declared their willingness to introduce a number of economic and structural reforms (including reforms of tax, pension and social security systems) in order to restore economic growth, modernise the economy, ensure financial stability and improve the standards of living in Ukraine until 2014.

However, the proposal of reducing the budget deficit (without bank recapitalisation costs) to 5.3% of GDP in 2010 and then by 1% annually to 2% of GDP in 2013-14 is considered insufficient by the IMF, as it may result in a growing public debt for several years before stabilising, undermining the commitment to fiscal consolidation, thus delaying the last instalment under the Stand-By Agreement.

Monetary and exchange-rate policy

The monetary policy of the NBU consists of a floating exchange rate, targeting inflation, price stabilisation and overall financial stability.

Recent events

In 2009 the economic situation was characterised by the liquidity crisis, blockage of the bank lending process and reduced investment activity, as well as by the collapse of external and domestic demand due to the fall of real incomes and real salaries.

In 2008, the CPI amounted to 122.3% which was mostly determined by the growth of prices for consumer products as a result of a bad harvest in 2007, improvement in the social standards (minimum salaries, pensions, minimum subsistence level), increase in salaries, payment of compensation for losses from devaluation of cash savings and increases in the prices for housing and municipal services. There was a slowdown in inflation in the consumer market in 2009 (12.3%), the lowest level in the past three years (in 2006, inflation was 11.6%).

Table 5.17. Main indicators of economic development of Ukraine

Year	Consumer price index (%)	Price index of industrial products manufacturers (%)	Current account balance (USD million)	Overall external debt, as of end of the year (USD million)	Official reserves as of the end of the year (USD million)	USD/UAH exchange rate (annual average)
2005	110.3	109.5	2 531	39 619	19 391	5.16
2006	111.6	114.1	-1 617	54 512	22 358	5.22
2007	116.6	123.3	-5 272	79 955	32 479	5.17
2008	122.3	123.0	-12 763	101 659	31 543	5.37
2009	112.3	114.3	-1 801	103 973	26 505	7.71
2010	109.1	118.7	-606	111 623	33 540*	8.04

Note: *As of November 2010 (IMF).

Source: State Statistics Committee of Ukraine.

In 2008 the deficit on the current account increased to USD 12 763 million, or by 7.1% of GDP (as compared to USD 5 272 million and 3.7% of GDP in 2007) due to the trade deficit (up to USD 17 billion) and the negative balance of incomes (to USD 1.5 billion). International reserves shrank by 16% and, as of 1 January 2010, were USD 26.5 billion, despite loans from the IMF (USD 10.6 billion) and from the World Bank (USD 399 million) in 2009.

Indeed, an IMF Stand-By Agreement was signed in November 2008 for a loan of USD 16.4 billion to be disbursed in four tranches over 2009. However, due to the failure of the former government to comply with IMF recommendations (*i.e.* the government increased pensions and social benefits on the eve of presidential elections), the programme ended in May 2009, after the disbursement of USD 10.5 billion.

In 2010, imports did not pick up as fast as pre-crisis levels, leading to a further decrease of the current account deficit, expected at USD 606 million (a third of that of 2009). Despite this good result, official reserve assets increased by around 28% that year, to USD 33 540 million and gross external debt by 7% yoy, to USD 111 623 million in October 2010.

Level of inflation and prices

In 2009, the policy of the National Bank of Ukraine was aimed primarily at reducing inflation and mitigating the impact of the crisis on the economy. Decreases in domestic demand, a good harvest, stabilisation of the hryvnia exchange rate as well as the implementation of anti-crisis measures by the government and the NBU contributed to safeguarding financial stability and, in particular, the stability of the banking system.

In 2009, the trend towards a slower annual growth rate of the CPI was observed, which at year-end was at 112.3% compared to 122.3% in 2008.

Table 5.18. Consumer price indices

	2008	2009	2010
Consumer price index (CPI)	122.3	112.3	109.1
Food products and beverages	124.5	110.9	110.6
Clothes and footwear	103.5	107.6	102.2
Housing, water, electricity, gas and fuel	128.2	108.2	113.8
Transport	122.5	119.2	106.6
Consumer price index basket	121.3	114.9	-

Source: State Statistics Committee of Ukraine.

The main factors slowing the growth of the CPI during the year were the reduction of external and domestic demand as well as stabilisation of the exchange rate in the second half of 2009. An additional factor was a good harvest.

However, accelerated growth in state expenditures compared to revenues (which began to decline in April) contributed to inflation in January-August 2009. The reduction of budget expenditures in Q4 of 2009 led to the slowdown of inflation. The main factor curbing the inflation of consumer prices during the year was low overall demand across the economy as a result of a drop in incomes and real salaries as well as the reduction of industrial production. The consumer price index basket, which remained high and was above the CPI for the whole year, was 114.9% in 2009 (compared to 121.3% in 2008).

Rapid action by the NBU in late 2008-early 2009, reassured the currency market, which both directly and indirectly helped reduce inflationary pressures. The gradual stabilisation of the exchange rate led to a decrease in narrow base inflation yoy from 17.5% in Q1 to 12.8% for the year. Moreover, the stabilisation of the situation on the foreign exchange market was the major factor in improving the economic agents' inflation expectations for 2010 from the maximum value of 20.6% in Q1 to 15.1% in Q4 of 2009.

Non-base inflation slowed to 9.7%, compared with 23.8% in 2008. A good harvest for the second consecutive year meant low price rises for raw food products – products with a low degree of processing (the increase was 5.2% compared with 21.6% in 2008). At the same time, fuel prices increased by 46.0% for the year (compared with the decrease of 8.3% in 2008) reflecting a recovery in prices on the world commodity markets in the second half of the year and the national currency devaluation in late 2008 - early 2009. The cost of services regulated by the state increased by 16.2% in 2009, compared with the increase of 29.5% in 2008 which occurred mainly due to rising prices for sugar (by 83.9%).

The manufacturers' price index of industrial products was 114.3% in 2009 (while in 2008 it was 123.0%).

Table 5.19. Price indices of industry

	2008	2009	2010
Price indices of industry	123.0	114.3	117.1
Mining and quarrying	122.3	111.3	144.4
Manufacturing	118.4	117.4	117.1
Food processing	116.5	120.3	118.9
Light industry	116.7	113.5	111.2
Coke, refined petroleum and nuclear fuel	84.4	142.9	125.1
Chemical and petrochemical industry	125.2	121.8	113.7
Basic metals	119.2	117.2	122.7
Machinery and equipment	121.1	109.1	106.1
Electrical and electronic equipment	112.6	114.7	106.9
Electricity, gas and water supply	142.2	103.9	112.5

Source: State Statistics Committee of Ukraine.

The prices for industrial products were determined by external and internal demand for metallurgical production and the dynamics of world prices for oil and petroleum products. The largest contributions to the growth of producer prices in 2009 were metallurgy, refined petroleum products and food processing. In 2010, mining and quarrying prices registered the highest yoy growth (44.4%) followed by refined petroleum (25.1%) and basic metals (22.7%).

Monetary aggregates

Table 5.20. Main monetary aggregates
(end of period, UAH million)

Aggregates	2006		2007		2008		2009		2010	
	Total	Growth	Total	Growth	Total	Growth	Total	Growth	Total	Growth
M0	74 984	24.5	111 119	48.2	154 759	39.3	157 029	1.5	182 990	16.5
M1	123 276	25.1	181 665	47.4	225 127	23.9	233 748	3.8	289 894	24.0
M2	259 413	34.3	391 273	50.8	512 527	31.0	484 772	-5.4	596 841	23.1
M3	261 063	34.5	396 156	51.7	515 727	30.2	487 298	-5.5	597 872	22.7
Liabilities excl M3[1]	1 417	–17.9	3 536	149.6	1 922	–45.7	447	-76.8	208	-53.4
Shares +equity[2]	55 634	77.2	99 527	78.9	233 751	134.9	250 931	7.3	277 972	10.8
Other items (net)	–2 442	-277.4	–7 749	217.3	10 911	-240.8	87 005	697.4	100 225	15.2
Net foreign assets[3]	67 041	-18.1	51 443	-23.3	-16 121	-131.3	16 507	-202.4	115 732	601.1
Domestic credit[4]	248 631	69.4	440 027	77.0	778 432	76.9	809 174	3.9	860 545	6.3

Notes: [1]Liabilities excluded from M3 are the sum total of transferable and other deposits of state and local government in national and foreign currencies; [2]Liabilities of deposit-taking corporations that include funds contributed by owners, retained earnings, current year result, general and special reserves, and valuation adjustment; [3]Net foreign assets mean a balance between claims and liabilities of deposit-taking corporations *vis-à-vis* non-residents; [4]Domestic credits include net claims of deposit-taking corporations on the central government and claims on other sectors of the economy. Net claims on the central government are a balance between claims and liabilities of deposit-taking corporations *vis-à-vis* central government.

Source: National Bank of Ukraine.

Monetary aggregates have followed closely the economic rhythms of Ukraine since independence. Strong foreign demand for Ukrainian exports, accompanied by surging imports led to an increasing current account gap that was financed by large amounts of foreign capital inflows and massive borrowings. Increased FDI (from the three privatisation peaks in 2005, 2007 and 2008) led to a three-fold increase in monetary aggregates between 2005, when M3 increased from UAH 194 071 million, and 2008, prior to the crisis, when they were UAH 515 727 million. In 2009, there was a deep liquidity crisis caused by increased risk aversion, the drying up of capital inflows and bank loan freezes. Money aggregates decreased by 5.5% to UAH 487 298 million. The resumption of growth, both on domestic and international markets, led to an increase of money supply to UAH 556 176 million by the end of August 2010.

As an effect of the crisis, liabilities almost halved yoy by end-December 2008, to UAH 1 922 million, only to soar in 2009 by nearly 77%, to UAH 447 million. The deep decrease of 2009 happened in December as, by end-November, liabilities still amounted to UAH 1 151 million.

Exchange rate

After the sharp fall of the hryvnia in Q4 2008 following the crisis (by almost 40%), high demand for foreign currency persisted in 2009 under the influence of devaluation expectations, decreases in currency inflows to Ukraine and large volumes of payments for imports contracts.

In order to stabilise the exchange rate, the NBU introduced an official exchange rate to the US dollar in April 2009 at the mid-weighted interbank rate for the previous business day with possible deviation of ± 2%. The NBU actively intervened in May-August 2009 to keep the official exchange rate within the pre-announced interval change. As a result, the hryvnia remained relatively stable throughout the first half of 2009, at an average of UAH 8 to the US dollar.

However, in early September 2009, negative market expectations over the devaluation of the hryvnia in 2010 led to drying foreign currencies on the interbank market. The hyrvnia further lost 30% of its value, to UAH 8.47 to the US dollar, while the cash rate varied between UAH 8.31 and UAH 8.83 to the US dollar. The NBU actively intervened and succeeded in strengthening the rate both on the interbank and cash markets during October-December to the deviation interval set in the Memorandum.

The hryvnia exchange rate to other world currencies reflected the same international situation. The official exchange rate to the euro declined by 5.47% in 2009 and by 0.74% to the rouble in 2009. In 2010, exchange rates remained fairly stable in all currencies, a sign of slow economic recovery.

Table 5.21. Official exchange rate of UAH to other foreign currencies
(per unit)

Exchange rate of UAH to foreign currencies (as of the end of the year)	**2007**	**2008**	**2009**	**2010**
USD (US dollar)	5.05	5.26	7.99	7.96
EUR (euro)	6.91	7.71	10.87	10.44
RUB (Russian rouble)	0.198	0.211	0.247	0.265

Source: State Statistics Committee of Ukraine.

External sector

Merchandise exports and imports

Total merchandise exports decreased by 40.3% in 2009 (to USD 40.4 billion), reflecting Ukraine's vulnerability to changes in global market conditions due to its highly concentrated, low value-added structure of exports, with about 40% accounted for by ferrous metals and metal products (where Ukraine has a competitive advantage) and 9-11% of minerals (until 2008). A gradual recovery of demand in the main trading partner countries since the second half of 2009 contributed to the improvement of exports since the end of that year.

In 2009, exports decreased in all categories of goods, with the largest decrease in exports of ferrous metals (by 55.4%). In contrast, exports of agricultural products only decreased by 12.2%, reflecting high exports of grain and vegetable oil due to good harvests in 2008 and 2009.

Across the regions, merchandise exports in 2009 reduced most to Europe, America and Russia (by 1.9, 3.7 and 1.9 times, respectively). As a result, the share of European countries in total exports decreased from 29.1% to 25.4%; the share of American countries from 6.1% to 2.8%; and the share of Russia from 23.2% to 21.0%. At the same time, the share of Asian countries increased from 23.5% to 30%, partly due to Lebanon and China joining the main importers of Ukrainian ferrous metals.

In 2009, total merchandise imports decreased by 46.2% (to USD 45 billion), with a sharp decline in the first quarter before slow growth in the subsequent three quarters due to the resumption of economic activity and relative stability of the exchange rate.

Imports of investment goods decreased by 60.2% in 2009 and imports of consumer goods and of intermediate consumption goods fell by 45.5% and 42.9% respectively. The largest decline of imports was in the merchandise group of machinery and transport (by 66%), largely because of a nearly six-fold reduction in the imports of cars and buses. The reduction in imports of metals and metal articles is mainly explained by a reduction of industrial production in Ukraine, and therefore lower demand.

Table 5.22. Major exports

SITC Revision 3, 2009	**Trade value** (USD million)	**Share** (%)
Food & live animals	10 168.1	32.2
Beverages & tobacco	672.6	2.2
Mineral fuels	2 130.8	6.7
Chemicals	2 515.2	7.9
Textile	103.6	0.3
Ferrous metals	9 454.5	30.1
Machinery & equipment	2 007.2	6.4
Clothing	609.3	1.8
Footwear	138.9	0.4
Other	176.0	0.5
Total of above	27 976.2	88.5
Total of all exports	**31 590.6**	**100.0**
Other categories of exports	11 726.6	11.5
Services, 2009	**Trade value** (USD million)	**Share** (%)
Transportation	6 256.5	65.7
including pipelines	2 104.0	22.1
Travel	298.3	3.1
Communication services	320.5	3.4
Construction services	123.1	1.3
Insurance services	80.2	0.8
Financial services	369.9	3.9
Other business services	95.0	1.0
Repair	428.8	4.5
Total of above	7 972.4	83.7
Total of all services exports	**9 520.8**	**100.0**
Other services	1 548.4	16.3

Source: NBU, BoP report for 2009.

Total imports of minerals fell by 35.5% in 2009, mainly due to a decrease in the value of imported crude oil and oil products (by 33.8% and 54.8%, respectively). Although the value of imported gas did not change significantly, its physical volume decreased by 28% with a simultaneous increase in the gas price of 17.1%. These changes resulted in the increase of the gas share in total merchandise imports from 9% to 16.5%. Finally, imports of chemicals decreased by 30.9% due to a sharp reduction in imports of plastic products (by 39.1%), while imports of agricultural and food products decreased by 23.5%, resulting from a significant reduction in the imports of vegetable oil and meat (by 38.9% and 32.6%, respectively).

Across the regions, the share of the Commonwealth of Independent States (CIS), which is traditionally dominated by Russia and Turkmenistan due to energy materials, increased from 38.6% to 43.4% of total merchandise imports, although the value of imports decreased by 1.7 times. The share of Asian, American and European countries in total imports decreased from 61.6% to 56.6%.

Table 5.23. Major imports

SITC Revision 3, 2009	**Trade value** (USD million)	**Share** (%)
Food & live animals	1 311.9	3.6
Beverages & tobacco	466.7	1.3
Mineral fuels	11 480.3	31.7
Chemicals	556.8	1.5
Textiles	652.7	1.8
Ferrous metals	1 168.1	3.2
Machines & equipment	2 779.2	7.7
Clothing	532.1	1.5
Footwear	312.1	0.8
Total of above	27 976.2	53.1
Total of all imports	**36 231.5**	**100**
Other categories of imports	11 726.6	46.9
Services, 2009	**Trade Value** (USD million)	**Share** (%)
Transportation	981.1	19.0
Including pipelines	2.2	0.0
Travel	282.5	5.5
Communication services	152.1	2.9
Construction services	157.8	3.1
Insurance services	124.1	2.4
Financial services	1 318.9	25.5
Other business services	156.8	3.0
Repairs	452.9	0.9
Total of above	3 218.6	62.3
Total of all services imports	**5 168.8**	**100**
Other services	1 950.2	37.7

Source: NBU, BoP report for 2009.

Balance of payments

The negative trade balance, weaker competitiveness of domestically produced goods and very strong domestic demand growth that exceeded output growth contributed to the rapid deterioration in the current account from a surplus of 2.9% of GDP in 2005 to a deficit of about 7% of GDP in 2008. In parallel, the capital and financial account surplus increased to USD 9.7 billion in 2008 thanks to sustained FDI (USD 9.9 billion) and other investments (USD 4.7 billion).

Although exports of goods and services experienced a sharp decline in 2009 (of 36.6%) due to continued weak external demand, a collapse in steel prices and a sharp devaluation of the UAH, imports fell at a higher rate (by 43.7%), reflecting the contraction of demand and higher import prices.[23] As a result, the trade balance deficit contracted to USD 2.2 billion. Consequently, the current account deficit in 2009 shrank to USD 1.8 billion (1.5% of GDP), compared to USD 12.8 billion (7% of GDP) in 2008.

Table 5.24. Balance of payments
(USD million)

Balance of payments	2007	2008	2009	Q1-Q3 2010
Current account	-5 918	-12 763	-1 801	-314
Goods and services (balance)	-7 876	-14 350	-2 022	-1 112
Goods (balance)	-10 572	-16 091	-4 655	-4 840
Services (balance)	2 696	1 741	2 633	3 728
Income (balance)	-2 117	-1 540	-2 440	-1 408
Current transfers (balance)	4 075	3 127	2 661	2 206
Capital and financial account	6 355	9 700	-11 925	-664
Capital account	3	5	595	169
Financial account	6 352	12 227	550	-833
Direct investment	9 218	9 903	4 654	3 587
Portfolio investment	5 753	-1 280	-1 732	3 026
Other investment	361	4 684	-8 026	952
Reserves assets	-8 980	-1 080	5 654	-8 398
Net errors and omissions	-473	531	656	978

Source: National Bank of Ukraine, Balance of payments reports for 2007 and 2009.

On the other hand, due to lower inflows of FDI in 2009 and net repayment of external debt accumulated before the crisis by both private and public sector, the capital account turned negative in 2009. The reduction of FDI in 2009 was attributed, not only to the crisis but also to high political and economic instability, increasing distrust of foreign investors, and decreasing returns on investment in domestic companies. The lowest net FDI inflow was in the first quarter of 2009 (about USD 883 million); in the other three quarters the net FDI inflow exceeded USD 1.2 billion. According to the NBU balance of payments report for 2009, most of these investments went to bank recapitalisation. Therefore, the share of FDI into the banking sector remained the largest (40%) in comparison with the other sectors.

In 2010, the deficits of the current account, the goods and services, and the capital and financial accounts shrank considerably compared to 2009, reflecting the slow pick-up of the economy.

Policy implications

Ukraine should diversify its international trade and develop new trade partnerships. Trade with the South Caucasus – Armenia, Azerbaijan and Georgia – could benefit the region and encourage growth of an integrated trade market supported by free trade agreements.

The Export Conformity Index shows that Ukraine has a different export structure from South Caucasus countries. The country could trade the mineral fuels (oil) from Azerbaijan needed for the refined oil industry. It could also not only compete with Armenia and Georgia on the iron and steel industry and with Serbia on agri-business, but also trade the resources it lacks. Increased competition with these countries could drive the modernisation of their respective economies and stimulate the region's GDP growth and increased prosperity.

On the balance of payments side, more effort should be directed towards the current account to reduce the goods deficit with increased exports and to attract portfolio investments and other investments to rebalance the financial account. Ukraine needs to take serious steps toward improving the overall investment climate in order to encourage both foreign and domestic investment and increase the innovative component of this investment.

MILLENNIUM DEVELOPMENT GOALS

Despite a promising launch, Ukraine has failed to meet the targets outlined in the agreed schedule, and is far from reaching its goals by 2015. At the 2000 UN Millennium Summit, Ukraine committed itself to achieve by 2015 poverty reduction, education quality improvement, sustainable environment development, maternal health and child care, gender equality, and HIV/AIDS reduction.

Basic indicators

Table 5.25. Millennium Development Goals, main figures

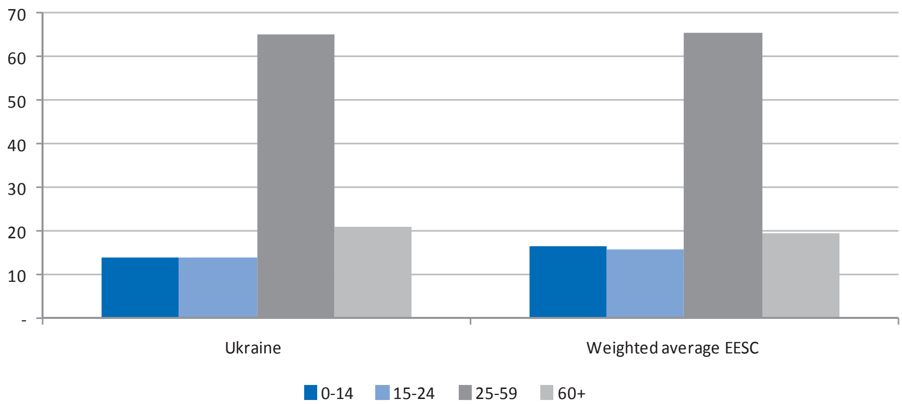
Goal 1*	**Eradicate extreme poverty and hunger**					
Objective:	Baseline		Current data		Target	
Decrease by 10 times people suffering from hunger	Year	Value	Year	Value	Year	Value
Share of population with consumption below the actual subsistence minimum	2000	71.5%	2010	20%	2015	7%
Goal 2	**Achieve universal primary education**					
Objective:	Baseline		Current data		Target	
All children to complete primary school	Year	Value	Year	Value	Year	Value
Net primary enrolment ratio (%)	2000	94	2008	89	2015	100
Continuation to secondary education (%)	2000	90	2008	84	2015	100
Goal 3	**Promote gender equality and empower women**					
Objective:	Baseline		Current data		Target	
Eliminate gender disparity in all levels of education	Year	Value	Year	Value	Year	Value
Female primary ratio (as % of male ratio)	2000	99.3	2008	99.9	2015	100
Female secondary ratio (as % of male ratio)	2000	100.5	2008	99.5	2015	100
Goal 4	**Reduce child mortality**					
Objective:	Baseline		Current data		Target	
Reduce by 1/4 under-5 mortality rates	Year	Value	Year	Value	Year	Value
Under-5 mortality rate (per 1 000)	2000	22.5	2008	24.2	2015	11
Goal 5*	**Improve maternal health**					
Objective:	Baseline		Current data		Target	
Halve maternal mortality	Year	Value	Year	Value	Year	Value
Maternal mortality ratio (per 100 000 births)	2000	24.7	2008	25.8	2015	13.0
Goal 6	**Combat diseases**					
Objective:	Baseline		Current data		Target	
Decrease tuberculosis morbidity by 20% (from the 2005 level)	Year	Value	Year	Value	Year	Value
Tuberculosis (per 1 000)	2000	60.7	2009	72.7	2015	67.4
Goal 7*	**Ensure environmental sustainability**					
Objective:	Baseline		Current data		Target	
Halve the % of people without access to safe and drinkable water	Year	Value	Year	Value	Year	Value
Access to improved safe water (%) Urban	2000	86	2008	88	2015	90
Rural		…		…		30

Note: *State Statistics Committee of Ukraine.

Source: World Bank, WDI 2010.

Ukraine has the highest depopulation rate in Europe, with a loss of over 1 million people since 2005, for a population of 45.9 million in 2010. This loss has been due to three main factors: low birth rates, high death rates and migration. Family structures have also significantly changed with an increase in the number of unregistered marriages, late marriages and having the first baby at a later age. There is also a clearly ageing population in Ukraine compared to the EESC countries, which have a higher proportion of young people. Indeed, the median age in Ukraine was 40.2 years old in 2010 against an average of 33.5 in neighbouring countries.

Figure 5.11. Age-population distribution comparison



Source: World Bank 2009.

Moreover, average life expectancy has slightly increased since 2000, from 67.7 to 68.2 years in Ukraine. Females are on top of the age pyramid, with life expectancy 11 years higher than men's, which brings the problem of low pensions into sharp relief, since most pensioners are widows.

Goal 1: Reduce poverty

Despite increasing per capita GDP since 2000, higher wealth disparity also occurred. The social policy of the government targets employment efficiency and the country's competitiveness, increased pensions and social health care, increased amount and diversification of subsidies, and implementation of the government's reforms in the social system.

Target: Achieve full and productive employment and decent work for all

Youth represented 17.8% of total unemployment in 2009, which was the highest of the age groups. Moreover, unemployment problems have led to strong emigration, ostensibly for seasonal work, involving about 10% of the population – with approximately 13 million migrants in 2005. Emigration is explained by low wages and Ukrainian families' need for remittances, which are often the major or only source of income.[24]

In response to the economic crisis, the unemployment rate, the incidence of administrative leave and involuntary part-time employment have increased significantly. Moreover, real wages have decreased while wage arrears have increased.

Table 5.26. Selected labour market indicators
(percentage change)

	2007	2008	2009
Employment rate of population aged 15-70 years	58.7	59.3	57.7
Unemployment rate of the population aged 15-70 years*	6.4	6.4	8.8
Youth unemployment rate of the population aged 15-24 years*	12.5	13.3	17.8
Incidence of administrative leave of the average listed number of staff employees	1.1	1.6	2.6
Incidence of involuntary part-time employment of the average listed number of staff employees	4.4	10.6	19.4
Nominal wage growth yoy	29.8	33.2	5.5
Real wage growth yoy	12.5	6.3	-9.2
Wage arrears (end-year stock), UAH million	668.7	1 188.7	1 473.3

Note: * ILO Methodology.
Statistics on administrative leave, part-time employment and wages do not cover employees of small enterprises (fewer than 50 employees) and those employed by entrepreneurs – physical persons as well as all persons employed in the informal sector.

Source: State Statistics Committee of Ukraine

Target: Eradicate extreme poverty and hunger

The fight against poverty and hunger has long been a major issue in Ukraine. However, there are some doubts about the accuracy of data on the scope of the problem and lack of focus on the measures to resolve it.

Despite the measures taken to mitigate and prevent poverty, including a "poverty reduction strategy" in 2010, quantitative indicators of poverty reveal high and persistent levels in Ukraine.

The results of domestic research show that the incomes of the wealthiest segments of the Ukrainian population are 30 times higher than incomes of the least affluent people; but 47 times higher according to the World Bank.[25] Even the lower figure demonstrates the asymmetry of social development. Living conditions have been worsening in rural areas; however, 90% of the population have access to sanitation and improved water sources.

Undernourishment and malnutrition affect 15% of the total population and 23% of children under-5. The age dependency ratio remains high with 43% of the population depending on their working counterpart to sustain living conditions.

Table 5.27. Poverty indicators

	2000	2008
Poverty gap at USD2 PPP (%)	1.0	0.5
Poverty headcount ratio at poverty line (% population)	40.0	25.6*

Notes: * Regional Statistical Yearbook of Ukraine 2009. Part I. - Kyiv: State Statistics Committee, 2009. – p. 369. Poverty gap = mean distance below the poverty line as a proportion of the poverty line where the mean is taken over the whole population (the non-poor having a 0 shortfall).

Source: WDI.

Estimates of absolute poverty vary between organisations. The UN estimates the level to be at 2% of the population and for the World Bank poverty in Ukraine ranges from 8% to 10%.[26]

The monthly subsistence minimum[27] per person at the beginning of 2010 was set by the law "On State Budget of Ukraine for 2010" at UAH 825 (USD 99). According to the State Statistics Committee of Ukraine, 7.4 million people received this subsistence minimum (16.1% of total population) in 2010.[28]

Despite indexing the monthly minimum wage to inflation, poverty has not decreased. According to the National Forum of Trade Unions, 26 million Ukrainians (56.5% of the total population) lived below the poverty line in 2009, below UAH 1 567 (USD 188) per month[29] and 56.8% of the poor received at least one type of social support (social relief, social assistance or subsidy), totalling about UAH 5 billion (USD 0.6 billion) of state social transfers annually.[30]

Finally, there is a problem of poverty among employees in Ukraine. The smallest nominal salary in 2008 was UAH 529 (USD 63.5) when the subsistence minimum was UAH 626 (USD 75.1). According to the Federation of Ukrainian Trade Unions, more than 20% of employees receive a salary no higher than the subsistence minimum, while these figures are significantly higher across certain activities. The issue of the working poor is a challenge that threatens social stability in the country and fails to stimulate employees to work more productively.[31]

Wages were increased by the former Tymoshenko government in the run up to presidential elections in 2010, which explains the mathematical decline in poverty in 2010 but does not solve the basic issues; even with the wage increase, the share of the population with consumption below the actual subsistence minimum remained at 20% (from 70% in 2000).

Table 5.28. Average monthly nominal wage for certain kinds of economic activity[32]
(yearly average)

Type of economic activity	UAH			USD		
	2006	2008	2010	2006	2008	2010
Fishing, fish farming	607	913	1 170	121	183	146
Agriculture, hunting and related services	553	1 076	1 417	111	215	177
Health care and social assistance	658	1 177	1 602	132	235	200
Industry	1 212	2 017	2 547	242	403	318
Financial activities	2 050	3 747	4 557	410	749	570
Air transport activities	2 053	4 061	6 697	411	812	837
Average monthly nominal salary in Ukraine	1 041	1 806	2 212	208	361	277

Note: The UAH was highly devalued in 2009 but was steady from 2006 to 2008.

Source: State Statistics Committee of Ukraine.

This figure demonstrates the urgency of official recognition of poverty, which was included in the Decree of the President "On the immediate measures for eradication of poverty" of 26 February 2010 and in the approved National Programme on Mitigation and Prevention of Poverty in Ukraine for 2010-15. The latter provides for the development of the "Strategy for prevention and overcoming poverty of Ukraine for 2010-15" and an improvement of social support for decent salaries and improved welfare. Only a shift from survival tactics to a genuine development strategy can ensure poverty reduction (Melnik *et al*, 2010). Reaching this goal will also contribute to the creation of new jobs through the increase in production and setting up the conditions for sustainable industry development.

Policy implication

With the economic crisis, there is a high risk of aggravation of social indicators. Households' loss of income is likely to widen the poverty gap and increase the number of poor incomes. Against IMF recommendations, a law was voted in October 2009 to increase minimum wage and subsistence minima. However, more state involvement is needed to reform social assistance and pension systems to make them more effective and less vulnerable to external shocks. Moreover, policy should be focused on modernisation, especially in the industrial sector which is a major source of employment and export potential. Favourable taxation legislation should also be enacted to reduce the size of the informal economy.

Goal 2: Increase access to quality lifelong education

Target: Complete full primary education

Ukraine's MDG database (UNStats) shows improvement in the education system since the start of the programme in 2001. From the Soviet Union, Ukraine inherited a well-developed education system and has therefore an important human capital mass. However, further validation is required as UNICEF contradicts national statistics, indicating that Ukraine has failed to achieve universal primary education.

Primary and secondary schools are 99% publicly owned and are equally funded by regional and state budgets. Giving general education schools more independence in managing resources from the state was agreed in the 2009 budget and has been in operation since 1 January 2010.

Table 5.29. Main education data

	2000	2008
Pre-primary enrolment rate (net %)	40	57
Primary enrolment rate (net %)	94	89
Primary education teacher to student ratio	20	16
Continuation to secondary education (%)	90	84
Secondary education enrolment rate (net %)	91	85
Secondary education teacher to student ratio (%)	6	10
Completion rate (%)	92	101
Tertiary education enrolment rate (gross %)	49	79
Tertiary education completion rate (%)	48	80

Source: WDI, NSS.

There is no gender difference in access to primary education; however, more females than males progress to tertiary levels (85% to 68%, respectively).

Policy implications

The Programme of Economic Reforms for 2010-14 ensures public elementary education by including the following measures:

Provision of pre-school education for at least 75% of children (currently 57%);

Reaching 100% of pre-school education for the children who are about to start school studies (currently at 93.5%).

A major issue is the falling share of highly educated labour (from 66% to 45% in 2002-05). The state should support education through provision of a greater number of grants to cover students' expenses. Education quality is not meeting the requirements of the economy and there is a growing imbalance between the number of educated specialists and demand for them on the labour market that needs to be corrected.

Goal 3: Ensure gender equality

There is little gender inequality in Ukraine, compared to western countries, since women are theoretically able to reach high positions. The female labour force accounts for 48% of the total with equal access to literacy and education. Women make up 55% of total non agricultural employment. Overall, women's unemployment is slightly lower than men's, 6% against 7% respectively, according to national statistics.

At the educational level, female unemployment with primary education is lower than male unemployment with the same education level, 5.7% against 11% respectively in 2007. The trend is the same for secondary education (48.2% against 55.6%) but reverses the higher the education level. For tertiary level, male unemployment is lower than female accounting for 33.5% against 46.2% respectively.

The only significant gender disparity from which Ukraine suffers is in life expectancy. Indeed, female life expectancy exceeds that of men by 11.8 years – 74.3 and 62.5 years old respectively in 2008.

Goals 4 and 5: Health issues

Main indicators

The birth rate in Ukraine remains lower than the overall crude death rate which was 16 per thousand on average between 2005 and 2010, above the 10 per thousand averaged by the region.

This figure indicates dangerous health conditions in Ukraine. Major causes of death in Ukraine are cardiovascular diseases and cancers for 65.3% and 12.3% respectively in 2009. Alcohol-related diseases and accidents accounted for about 2.4% of deaths in 2009. Deaths from blood pressure, problems of the digestive apparatus and infection/parasitic illnesses increased. All other causes scored a slight decrease.

Table 5.30. Major causes of death
(percentage change between 2000 and 2008)

Tumours (% decrease)	6.0
Respiratory organ failure (% decrease)	25.0
Accidents, poisoning and traumas (% decrease)	3.0
Alcoholic poisoning (% increase)	12.0

Source: WHO.

Goal 4: Reduce the under-5 mortality rate to 11 per thousand

According to the State Statistical Committee, the under-5 mortality rate significantly decreased from 16.0 per thousand in 2000 to 11.3 in 2009. The World Bank, however, shows a slight increase from higher initial rates; an increase from 22.5 per thousand in 2000 to 24.2 in 2008.

Under-5 mortality in Ukraine is due to neonatal deficiencies (45%), and to premature births (38%). Other major factors of infant death include HIV/AIDS and pneumonia/meningitis. While the first set of causes can be overcome by prenatal care and better treatment to decrease the number of miscarriages, the other set requires further policy development from the government. The rate of diseases between one and five years old has been slightly decreasing, again according to official data, from 11.9 per thousand in 2000 to 9.4 in 2009.

On the positive side, the ratio of low-birthweight babies decreased to reach 4% of total births in 2006 and is on a decreasing trend, possibly due to improvements in mothers' living standards.

Goal 5: Reduce maternal mortality to 13 per 100 000

Ukraine has achieved major improvement in maternal medical care. Due to increased wealth and changes in social behaviour (condom use), abortions have dramatically decreased since independence, from 32.1 per thousand in 2000 to 17.9 in 2009. Family planning centres, implemented in 1992, provide better medical support and information to adolescents in the area of reproductive health. The adolescent fertility rate decreased by 18% between 2000 and 2007, from 34.9 to 28.3 births per thousand women. Most pregnant women receive prenatal care and births are attended by qualified staff.

However, official data registered an increase in maternal mortality, from 17.6 per 100 000 live births in 2005[33] to 25.8 in 2009. A major reason is the increase of indirect obstetric causes – anaemia, malaria and heart disease – which tripled in four years, from 5.4 per 100 000 live births in 2005 to 16.4 in 2009. Moreover, consumption of alcoholic drinks and tobacco during pregnancy are other possible factors of maternal mortality. However, the major cause of maternal mortality remains inequality of access to quality medical care (related to incomes and place of residence, reflecting the shortage of skilled medical staff in rural areas).

The decline in social standards linked to the crisis and its spillovers on economic growth will prevent the country from reaching this target by 2015 and will impede the struggle to reduce the maternal mortality rate.

Goal 6: Reduce and slow down the spread of HIV/AIDS by 13%

HIV spread

It is still very controversial to openly discuss HIV/AIDS in Ukraine. However, an increasing number of people are infected by AIDS. Ukraine has one of the fastest-growing HIV infection rates in Europe (one-third of new infections), mainly due to unsterilised syringe use and unprotected sex (71% and 66% respectively in the 2000s).

Reliable data cannot be retrieved on HIV. Official sources estimated that 1.5% of young Ukrainians between 15 and 24 are infected by HIV, 25% of the total. UNAIDS estimates that 2% of the population has been infected by HIV/AIDS. According to the same source, annual new HIV cases were 17 687 in 2007. Most AIDS patients are from vulnerable sectors of the population, mostly in urban surroundings.

Policy implications

Prevention through education should be stepped up, as only 43% of people are aware of HIV transmission and impact. The spread of HIV should be stopped and reduced, as it is one of the major causes of death, not only for people infected but also for their children, as 45% of total HIV-infected persons are women. This number has continued to increase since 2000.

Respiratory diseases

Tuberculosis is the first cause of respiratory disease in Ukraine, accounting for 1.8% of total deaths; the highest among European countries in 2005. Approximately 40 000 people are infected with tuberculosis each year in Ukraine and 30 people die per day – 10 000 per year – from the disease. Co-infection with HIV is a growing problem with over 60% of HIV/AIDS deaths attributed to tuberculosis. The major factors behind the epidemic are poverty, multidrug-resistant tuberculosis, HIV co-infection and the spread of tuberculosis in prison. Better nutrition, housing, hygiene and health systems are needed in order to prevent tuberculosis. By 2014, the government aims to reduce the incidence of tuberculosis by 30%.

Chronic obstructive pulmonary disease is another source of death in Ukraine. It accounts for 25 304 of total deaths. Respiratory diseases concern mainly coal miners (higher rates of lung disease), as they are highly exposed to methane gas.

Finally, swine flu deeply affected Ukraine in 2009. The total number of deaths had exceeded 400 in November, while infections were spreading quickly. The government's response was immediate after the pandemic announcement in October 2009. UAH 500 million (USD 63 million) were granted for medical supplies to fight the virus. Public gatherings were prohibited and schools closed for a few weeks. Fighting swine flu was incorporated into all political candidates' campaigns for the 2010 presidential elections.

Main health reforms

Private clinics have been developing recently but few people can afford such care and they remain a small portion of the medical system.

Table 5.31. Main health expenditure
(in 2008)

	Ukraine	OECD
Private health expenditure (in % GDP)	3.5	3.0
Public health expenditure (in % GDP)	3.5	6.8
Out of pocket expenditure (% private expenditure)	90.0	86.9
Health spending per capita (USD)	90.0	3 365.0

Source: WDI, OECD.

Reforms have been slow to put in place. With proper medical care, however, half of all deaths could be avoided, according to the World Bank. Health care has been evolving from a centrally planned scheme to a regionally managed one. Yet, with the same number of hospital beds and level of care as the average in the EU, the medical sector has been performing poorly. There is still a difference in state support depending on the region because support is based on each area's revenues; richer oblasts have access to better health care.

In order to respond to this problem, a black market for medicines has developed. As the state covers only a small proportion of the costs of drugs, some 10% of households face huge drug bills.

Apart from the Millennium Development Goals commitments, the government aims at tackling "grey" payments within the health care system by reducing their share from 10-15% to 5-7% (within the Ukrainian economic reforms programme in health care in 2010-14[34]).

Goal 7: Ensure sustainable environment development

Ukraine ranks low in environmental protection. Pollution levels remain very high, mostly due to the industry and agriculture sectors.

Target: Reduce pollution

Since the Chernobyl catastrophe, Ukraine has invested heavily in environmental protection, including radioactive waste. Improvements have been modest so far.

Table 5.32. Environmental data

	2000	2006
Emissions of methane and nitrous oxides (% of total pollution)	21.9	15.0
in industrial production	64.3	68.7
Emissions of nitrous oxides (% of total pollution)	66.0	54.0
in industrial production	29.7	41.6
Total emission of CO2 per capita (metric tonnes)	6.2	6.9
Greenhouse gas emission (thousand metric tonnes of CO_2 equivalent)	780.0	1 390.0
Renewable energy production (metric tonnes)	262.0	582.0

Source: WDI.

Ukraine ratified the Kyoto Protocol in 2004. The share of green energy in total energy production increased slightly from 15.8% to 17.9% between 2000 and 2006. Ukraine has also tentatively developed the renewable energy sector but its share in total production remains insignificant.

Target: Access to clean and drinkable water

The provision of quality drinking water remains very unsatisfactory. Ukraine is water-deficient, with resources not exceeding 1 500 m^3 per person annually. The average of consumption hardly reaches 1 090 m^3 per person in good years and only 620 m^3 per person in poor years.

Almost 80% of the drinking water supply is drawn from surface waters[35] whereas, in Europe 70% of supply is from underground sources. The situation in Ukraine is worsening because of growing water pollution.

There are also major inequalities in water supply between the urban and rural populations. Centralised water supply is provided for 65% of the population, of which 88% in cities and 28% in rural areas (UNDP, 2010). Only 23% of rural areas have a public water supply.[36] In 2008, 66% of piped water in Ukraine's cities did not meet the requirements of the existing state standards. According to Y. Vystavna and V. Grynenko, in 2006 62% of analysed water samples from drinking water sources failed to comply with Ukrainian Water Quality Standard, so the situation is not improving (Vystavna and Grynenko, 2006). The quality of drinking water in Ukraine is monitored by 28 indicators against 63 in the European Union.[37] Water quality in Ukraine exceeds by at least twice (sometimes 20 times) the permissible limits in the EU in iron and manganese content, and overall hardness.[38]

About 11 million Ukrainians take their water from wells. According to official figures, 1.8 million wells are contaminated. Over 800 000 people in 13 rural regions are forced to import water of poor quality that is usually stored in unsuitable containers that do not comply with sanitary standards. Only half of the 120 water suppliers in the "Bottled Water of Ukraine" association have equipment that may be considered fit for operation. Meanwhile, the cost of imported water in the villages of the South-East is UAH 9-20 (USD 1-1.5) for 1m^3.

The degree of deterioration of the water-supply and sewerage networks is 50% to 80%. Over 30% of the total length of water and sewer systems are in need of urgent repair, causing secondary contamination of drinking water and contributing to flooding.[39] Up to 40% of drinking water in Ukraine is lost due to deterioration of water-supply networks. In some localities such losses can be as high as 78% which is far above the corresponding figures in Europe.

Taking into consideration that approximately 90% of human diseases are caused by consumption of drinking water of poor quality and the use of bad water for domestic purposes (showers/bath, swimming pools, washing/washing machines), the issue of access to safe drinking water in Ukraine is urgent and relevant.

Policy implications

The industrial sector is a leading pollution source in Ukraine. In order to keep the commitments made under the Kyoto Protocol, deep reform of this sector is needed. Numerous programmes, already in place, should be consolidated, together with the modernisation of equipment and technologies for heat and electricity production to make them more environmentally friendly or measures to reduce energy consumption and emissions during production. Transportation and processing are principally concerned by such initiatives. While international donors have supplied Ukraine with adequate funds in the past, poor governance and corruption resulted in ineffective use of the loans.

PRIVATE SECTOR DEVELOPMENT

Until 2008, companies in Ukraine benefited from a growing lending market, supported by foreign borrowing and increased liquidity. Domestic credit provided to the private sector reached 76.9% of GDP in 2009 (EBRD, 2010). The country was severely hit by the global crisis as bank reserve liquidity shrank to 3.9% in 2008 (from 78% in 2000) and annual real GDP growth contracted by 15.1% in 2009 (IMF, 2010). According to the IMF, a return to 3.7% and 4.1% of GDP growth can be expected in 2010 and 2011, respectively. Even if significant progress has been achieved in market-oriented reforms, a large amount of economic restructuring is still left to be done. Political instability has further blocked economic development. Moreover, overall growth in Ukraine depends heavily on external factors, such as international prices for metal (iron and steel) and external demand.

The private sector is a source of knowledge, skills and resources, and a key engine of growth for economic development. In this context, the role played by micro, small and medium-sized enterprises (SMEs), which, on average, account for over 90% of enterprises in the world and contribute to 50-60% of employment in developing countries, is particularly important (WBCSD, 2007). Efforts to foster private sector growth should focus on improving the business environment for SMEs by providing a regulatory framework that fosters entrepreneurship through better policy design, including improving business regulation, improving the education system and providing access to finance for SMEs that would attract new firms as well as increase the share of employment and contribution to GDP in the private sector.

The methodology applied in this section is based on the OECD Policies for Competitiveness Framework (PFC) which has been developed as an assessment tool based on the Policy Framework for Investment (PFI) instrument. This tool takes a horizontal approach, looking systematically at key policy dimensions affecting the business climate to identify and analyse major constraints in the ability of firms to produce, invest and grow. Apart from giving a general introduction to the business environment, three key dimensions are featured in this section covering skills development, access to finance and investment framework conditions affecting SME growth.

General overview

The biggest FDI privatisation waves were in 2005 (iron and steel), 2007 (communication) and 2008-09 (banking sector). In 2010, the private sector share of GDP decreased from 65% to 60% (EBRD, 2010) which shows that Ukraine continues to face challenges related to a necessary restructuring of the economy. Many legislative reforms are required and corruption needs to be contained. The lack of separation between politics and business prevents Ukraine from creating more balanced prosperity. The rural areas lag behind the cities and poverty remains an issue to be tackled before Ukraine can reach higher levels of competitiveness. The business sector still faces significant barriers for further development; most significantly in dealing with construction permits (179th) and paying taxes (181st), areas where Ukraine ranks very low in international comparison according to the World Bank's *Doing Business 2011* report (World Bank, 2010).

The business sector is dominated by monopolies and though SMEs represent the majority of the business population in the country (93.7%), they account for only 16.6% of sales (State Statistics Committee of Ukraine), mainly due to uncompetitive practices, small lobbying power, burdensome procedures and limited human and financial resources.

The lack of adequate skills in the labour market is one of main obstacles to business growth. The skills gap in Ukraine is combined with frequent over-qualification of workers due to a high demand for tertiary education, which is considered an assured way to find a job. However, skills that match labour market requirements need to be further developed through a nation-wide strategy for workforce skills development (including better systems of vocational education and training).

As another barrier to business growth, access to finance is a key issue, especially for SMEs with limited access to bank financing and capital markets. Early-stage finance, such as business angels and micro-financing, is still at a low level of development and needs further reform, while guarantee schemes to decrease collateral requirements on loans are not present at all. Efforts towards creating alternative financing mechanisms for small enterprises should be a priority, given their importance for private sector development.

Ukraine still imposes significant burdens on foreign investors, mainly through an opaque and inefficient system of property rights, the poor quality of contradictory laws and regulations, and weak enforcement. The IMF has granted several loans which are likely to further stabilise the economy and increase investor confidence in the short term, but in order to increase Ukraine's competitiveness and enhance the value-added per employee, the country needs to introduce better policies to support medium- and long-term growth. To further decrease dependence and vulnerability of the economy, Ukraine should also consider diversifying its energy sources as the country mainly relies on Russia for gas imports.

The increasing importance of the private sector

Privatisation began in 1992. In 1994 a Memorandum of Understanding was signed between the Ukrainian government, the World Bank, the United Sates Agency for International Development (USAID) and the EU, aiming at mass privatisation.

The end of small-scale privatisation came in 1996 and the end of large-scale privatisation in 1998. Over 2000-02, a State Privatisation Programme was adopted that aimed at privatising monopolies, strategic industries, infrastructure sectors and large technological complexes. The biggest privatisation waves were in 2005 (iron and steel), 2007 (communication) and 2008-09 (banking sector). The private sector share of employment reached 78.5% in 2008, according to the United Nations Economic Commission for Europe (UNECE), which is most likely understated due to the large informal economy, which represented 46.8% in 2007 according to Schneider (2010).

In 2008, the Law of Ukraine "On Amendments to some Legislative Acts of Ukraine on the Regulation of Business" introduced changes to the criteria for defining small businesses in the Commercial Code of Ukraine. According to this law, a small business is defined as an enterprise with the average number of employees during the reporting period (fiscal year) not exceeding 50 persons, and the amount of income (proceeds) of products (goods and services) not exceeding UAH 70 million. All data for 2006-08 have been recalculated based on the new definition.

According to the State Statistics Committee of Ukraine,[40] 93.7% of the 528 864 registered companies are small businesses.[41] The number of small enterprises almost doubled from 2000 to 2008, increasing from 44 to 75 units per 10 000 persons. Given the large informal sector and the fact that most of the unregistered enterprises are small in size, these numbers underestimate the real size of the SME sector. The regional distribution of SMEs is uneven, the largest concentration being in the municipality of Kyiv (243 per 10 000 people). Other regions where small enterprises thrive are Sevastopol, Crimea, Odessa and Kharkov. At the lower end are Rivnenska, Vinnitsa and Chernovtsy and Khmelnitsky with 41-45 small enterprises per 10 000 persons.

Small enterprises represent more than 90% of enterprises in all sectors except for agriculture, hunting and forestry (78.9%), and industry (85.7%). The largest enterprises are in the real-estate, trade and hospitality sectors (with an average number of employees over 50). Transportation and industry have the lowest average number of employees (11.5 and 11 respectively).

Despite their large number, the contribution of small enterprises to employment was only 25.2% in 2009, and they accounted for only 16.6% of total sales of products (services, operations etc.). Medium-sized enterprises as reported by the State Committee of Statistics represented 5.8% of the total number of registered enterprises accounting for 37.7% of total sales in the enterprise sector (works, services)[42] and contributing to 34.7% of total employment. There is no definition of medium-sized enterprises by law so it remains unclear which sizes of enterprises are counted within this category.

According to the data of the State Statistics Committee of Ukraine, the share of unprofitable small enterprises has steadily increased and almost reached 40% in 2009. In the same year, small businesses shared 29% of total losses in the economy, while they only got 23% of total profits. In this respect, the situation has improved compared to 2005 when small businesses shared 30% of losses and only got 8% of profits. Of the loss-making business activities in 2008, real-estate transactions topped the list (41.6% of small businesses of this type of economic activity), followed by transport and communication (40%) and communal services (39.3%). The biggest losses in monetary terms were incurred by trading companies (UAH 21.2 billion) and real estate companies (UAH 22 billion).

Business environment

Since 1997, Ukraine has undergone a series of reforms to decrease the administrative and financial burdens of SMEs that put them at a disadvantage, relative to other businesses in the economy. The country still ranks 145th out of 181 countries in the World Bank's *Doing Business 2011* report, being again at the same position as in 2009. Ukraine received the lowest ranking within the EESC region. The country made some progress mainly in the areas of "starting a business" and "protecting investors" (World Bank, 2010). Nevertheless, further steps are yet to be taken to create a fair and competitive level playing field. A lack of implementation of reforms and excessive state interference seem to be the main constraints on growth potential over the long run.

According to the 2009 Business Environment and Enterprise Performance Survey (BEEPS 2009), it requires 31 days to get an operating licence, again the highest figure in the region (EBRD/World Bank, 2009). Moreover, roughly 50% of businesses identified corruption as a major obstacle to their development. Other key obstacles indicated by firms relate to the issuing of constructions permits, and the weight of the tax burden (57.2% of the profit), which has been pointed out as a major constraint by 55% of the interviewed companies. The burden of the bureaucracy is also high in starting or closing business activities, as it takes 10 procedures and 27 days to open a new company with a minimum capital requirement of 153.5% of the income per capital. Besides, given that almost 40% of the companies indicate access to credit as a major constraint, facilitating the access to financial resources for SMEs represents a key component of the government's economic policy.

SME support is the subject of national, regional and international programmes. The National Programme for Small Business in Ukraine is one of the leading programmes that aim at creating favourable conditions for their development. In particular, it supplies the proper conditions for involving people in entrepreneurial activities. The whole programme, however, concerns only instruments of international relevance. Furthermore, in November 2008, an SME dialogue was initiated between the European Commission and the Ministry of Economy (as well as the State Committee for Regulatory Policy and Entrepreneurship) on the European Charter for Small Enterprises and the move towards co-operation based on the European Small Business Act. So far, the implementation of the Charter has been limited, one of the reasons being the change of the Ukrainian government in January 2009.

SME policy consists mainly of regulation and limited financial support to SMEs. Some progress has been made in reducing administrative burdens on businesses, the legislation and registries related to credit markets, and the presentation of interest of small businesses. Other improvements are the change in the inspections ideology from punitive to preventive, reduction of the number of inspections and simplification of taxation, accounting and reporting. A cluster model of rural development has been implemented to facilitate effective use of material and financial resources by SMEs and to attract new technologies for production. SMEs are provided with credit support to the amount of 0.15% of the budgetary revenues, a measure which is supposed to help entrepreneurs to obtain bank loans.

Ukraine does not have an integrated system of e-government for enterprises. Measures such as on-line registration are being implemented in isolation rather than as part of an overall plan for e-government.

Human capital development

Strengthening skills development has been identified as one of the key contributors to competitiveness. The positive correlation between human capital and productivity has become increasingly important in the globalised world. Razzak and Timmins (2008) report strong positive relation between the increase of university-qualified workers and the levels of labour productivity as measured by GDP per person. It is believed that natural resources, cost competition and strategic alliances do not alone suffice for achieving sustainable development (Memon *et al.*, 2009).

Enhancing competitiveness in Ukraine will require a greater commitment to investment in human capital and to introducing reforms which will ensure that the educational system produces skills that match the demands of the labour market and further support private sector development. Five areas have been selected for an in-depth evaluation of the education system including:

- Strategy formulation
- Inputs to initial education
- Vocational education and training (VET)
- Continuing education and training (CET)
- Human capital outcomes

According to the OECD assessment, the educational system in Ukraine has no workforce skills strategy for development in place. The National Doctrine of Education Development, approved in 2002, set its goal as developing and implementing policy reforms in education, developing the technical and scientific potential of the labour force, matching the direction of educational development to both individual demands of the individual and national interests. This document, however, does not include precise steps that would lead to the achievement of the stated goals.

The educational system inherited from the Soviet Union has ensured a high literacy rate among the population of Ukraine. According to the World Economic Forum Global Competitiveness Report 2010, the quality of education ranks 56th among 139 countries. The literacy rates are high and the rate of educational attainment is large compared to other countries (OECD average or regional average), with 90% of the population having either secondary or tertiary education.[43] Nevertheless, the overall quality of the human capital base in Ukraine is low. In the Trends in International Mathematics and Science Study (*TIMSS 2007*), Ukraine's rank was well below the international average both in mathematics and in science (IEA, 2007a and 2007b).

One of the main reasons for low quality of human capital is the lack of funding. The school system is overstaffed and underfunded. Spending on education decreased dramatically after the collapse of the Soviet Union, but recovered to 6.2% of GDP in 2007, which is comparable to the OECD average of 5% (2005). However, in absolute terms, the expenditure per student is only USD 147, which is much lower than in the developed countries, such as the United States (USD 2 472) and Japan (USD 1 269), and even compared to other transition countries, such as the Russian Federation (USD 270) and Belarus (USD 231). Given that 90% of financial resources are spent on salaries and utilities (Hörner *et al*, 2007), the lack of funds is felt in the form of poor equipment, outdated material in the educational institutions and a shortage of qualified staff due to low wages (around 80% of the national wage).

Given the rapid structural and demographic changes in the economy, the VET system is not properly synchronised with the labour market's needs, and lacks any consultation procedures with the business sector, as the OECD assessment indicates. A 2005 World Bank survey showed that 20% of Ukrainian employers thought the skills available on the market did not correspond to their needs and were an obstacle for the development of their business. There is a shortage of engineers, welders, electricians and mechanics. At the same time the share of graduates in these areas has gradually decreased in 1999-2008 from 31.86% to 20.24% and was replaced by graduates in more popular subjects such as economics, accounting, law and management, whose share in the total number of graduates has increased from 29.93% to 44.67% according to UNESCO. In the industrial zone of Donbass, there is even a shortage of qualified engineers. The Chamber of Commerce of Donetsk decided therefore to open colleges itself to teach and train students in this area.

The area of vocational training has been developed since Soviet times. Enrolment in technical and professional upper education institutions decreased by 30% in 1999-2007 and represented 34.86% of total upper secondary education students in 2008 (ETF, 2010). The decisions on labour requirements for VET schools were centralised under Soviet industrial planning. After the collapse of the Soviet Union, there have been significant structural changes in the economy that led to the destruction of a large number of industrial-sector jobs and forced people to find employment in other sectors, mostly in services.

According to BEEPS 2009, 43% of enterprises see the skills and education system in Ukraine as an obstacle to business growth, compared to 39% in 2005. On the other hand, as a result of cultural perceptions and the recent crisis, the demand for higher education is very high which leads to an over-qualification of 49% of university graduates as measured by job requirements. As a result, less educated students have to accept more precarious jobs that do not match their qualifications (ETF, 2009). Moreover, over-qualification encourages emigration of the skilled labour force in search of higher returns on their education. In order to avoid the inefficient use of overqualified labour, a synchronisation of labour-market needs and educational system outcomes is required both in terms of specialisation and levels of qualification. This could, for example, be achieved by supporting entrepreneurial education and teaching skills required for starting a successful business.

Ukraine lacks a proper system of continuing work-related training and education. Some universities offer industry-specific training and continuing education degrees. CET could be a solution for filling the skills gap between employers' needs and workers' skills.

Access to finance

Access to finance is a crucial determinant of SME growth and development. Due to their small size and lack of credit history, SMEs have limited access to bank financing and capital markets. Given that in Ukraine almost 40% of the companies indicated access to credit as a major constraint, facilitating the access to financial resources for the SME sector represents a key component for government economic policy. Only 30.76% of companies use banks to finance their investments. The high interest-rate spreads (7.9%) and collateral requirements (137.5% of loan value) make it more difficult for SMEs to use external financial resources.

According to the OECD assessment, early-stage financing and guarantee schemes are the main areas that need further reform. Despite the fact that domestic credit to the private sector constituted 78% of GDP in 2009, lending is concentrated in traditional sectors where tangible collateral can be given. This excludes SMEs with high growth potential based on their future value. The development of business angel networks and venture capital should be further developed as sources of financing.

So far, activities of business angels in Ukraine are low. Business angels are flexible investors who engage in early-stage risk financing and business coaching and who can lower the riskiness of their deals by providing hands-on advice based on personal experience to the entrepreneurs. At the beginning of 2007, the Association of the Private Investors of Ukraine was created as a first association of business angels. It is the first non-commercial organisation in Ukraine which unites private and corporate investors of all Ukrainian regions and also co-ordinates the work of informal associations of investors in cities such as Dnepropetrovsk, Donetsk, Odessa, Vinita and Chernigov. In February 2008, it became a full member of the European Association for Business Angels (EBAN).

Micro-financing is another mechanism that targets small business owners who are unable to access more institutionalised sources of finance. In Ukraine, the existence of such non-banking financial units as leasing companies and credit unions is particularly important in rural areas, where banking facilities are not widespread. Both have been growing from a low base but there is scope for further growth. This would support investment in the modernisation of plants and machinery in the regions and the development of the agricultural sector. Credit guarantee schemes are not yet developed in Ukraine. However the process of setting up a state export credit agency is underway and the necessary legal framework is currently being developed.

Credit information agencies act as information brokers that increase the transparency of credit which makes it easier for SMEs to access. While the assessment showed that the credit information system is well developed and regulated by the Law of Ukraine "On Organisation, Formation and Circulation of Credit Histories", the World Bank *Doing Business 2011* report shows that the private bureaux cover only 3% of individuals and do not include firms.

Ukrainian SMEs receive significant support from international donors. The support sets out to increase the availability of lending and to increase competition in the sector and thereby improve the quality of services provided to SMEs by attracting new partner banks and other financial providers, particularly regionally based institutions. At the moment, several credit lines and the Ukrainian Micro Lending Programme (UMLP) have the most relevant impact on SME financing.

The international support strategy aims at increasing sources of private equity funds. Despite some increased private equity activity, the environment remains difficult and substantial further reforms are necessary before a viable sector can develop that would allow investors to have feasible exit strategies.

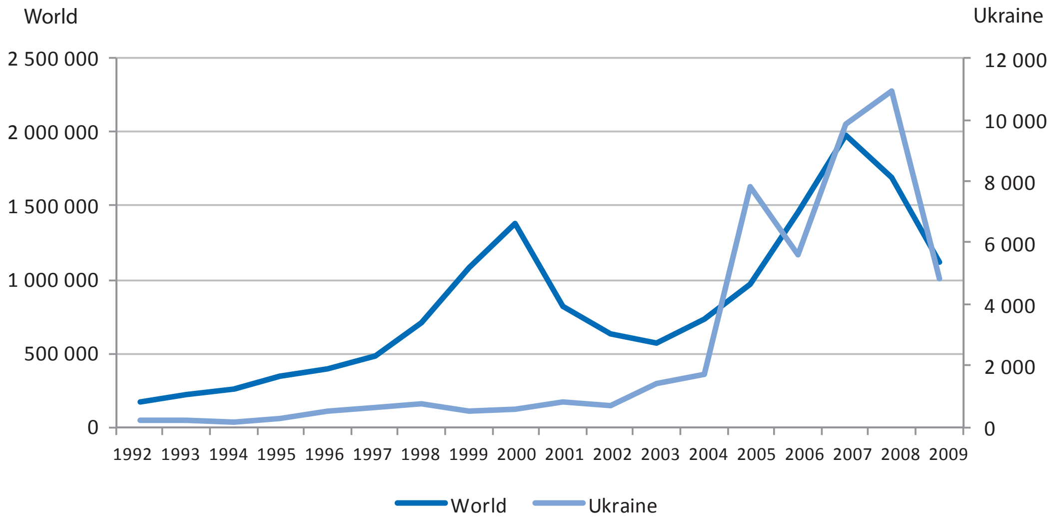
Investment framework for SME growth

Starting from 2001, Ukraine attracted above-average FDI inflows with a compound annual growth rate of 41%, compared to 14% for the world. FDI inflows increased from USD 680 million to USD 7.9 billion in 2007. In 2008, total FDI stock accumulated to USD 35.7 billion. Most of the FDI flows were directed towards privatisation of previously state-owned enterprises and only a few were used for greenfield projects. Almost 80% of FDI inflows originate in the EU and are directed towards construction (22.6%), primary processing industries (19.4%) and financial services (20%). Major investor countries include Germany, the Netherlands, Austria, the United Kingdom and the Russian Federation. Many investment opportunities remain but a more comprehensive investment policy framework is required to return to former growth rates.

The financial crisis hit Ukraine particularly hard. Net FDI inflows decreased from USD 10 913 million in 2008 to USD 4 816 million in 2009 (UNCTAD, 2010) and are not expected to recover in the near future due to a combination of policy barriers and unfavourable market conditions. From the policy point of view, there is no explicit procedure for the state registration of foreign investments and there are heavy regulatory procedures, a complex tax administration and technical regulations (certification and standardisation) to deal with. On the other hand, in the aftermath of the crisis, the Ukrainian market has a high risk of destabilisation, a shaky banking sector and a narrow spectrum of financing across the sectors for medium-sized investors.

Nevertheless, given the post-crisis prospects, Ukraine was able to improve the situation due to the anti-crisis restrictive measures introduced in 2009, the commitment of the government to reimburse overdue VAT payments and several governmental initiatives to streamline business-related administrative procedures.

Figure 5.12. FDI net flows
(current USD millions)



Source: UNCTADstat.

The legal framework for international investment activities in Ukraine is established by the Laws "On Investment Activity" (1991), "On the Treatment of Foreign Investments" (1996) and "On the Removal of Discrimination in Taxation of Subjects of Entrepreneurial Activity". Ukraine applies a few exceptions to national treatment, mostly based on public order and national security considerations (defence-related manufacturing and activities). Some others, such as limitations on foreign participation in the wholesale trade of books and newspapers or the refusal to allow foreign insurance companies to set up branches in the country should be gradually eliminated as a part of Ukraine's WTO/GATS (General Agreement on Trade in Services) commitments.[44] Foreign ownership of agricultural land is prohibited by the land code but a law reversing the ban was expected in late 2010. Investors can lease agricultural land or create a legal Ukrainian-registered business to purchase arable land.[45]

In general, there are no restrictions on the admittance of business personnel and investors may repatriate profits or revenues from liquidation. The importation of the means of production is exempt from import duties. Additional exemptions, for example on VAT payments, exist for investments in energy-saving technologies.[46] In general, FDI incentives may be available to investors who implement investment projects in areas promoted under the state programme of the development of priority branches of the economy, social sphere and territories.

Intellectual property rights (IPR) legal protection has improved as part of the country's efforts to comply with WTO requirements under the Trade-Related Aspects of Intellectual Property Rights agreement. However, IPR violations remain frequent due to weak law enforcement and limited awareness of IPR issues in Ukraine.

Investment guarantees are established by the Law of Ukraine "On Protection of Foreign Investments in Ukraine" which stipulates that expropriations may only occur in cases of a calamity, emergency, epidemic or epizootic risk and are subject to prompt, adequate and efficient compensation. Ukraine has signed more than 60 bilateral investment treaties on the promotion and mutual protection of investments which contain national treatment and most-favoured nation provisions and provide additional guarantees for investors. Moreover, Ukraine is a signatory to the New York and International Centre for Settlement of Investment Disputes Convention which allows for international investment arbitration.

Investment promotion activities in Ukraine are based on the Programme on Development of Investment Activity in Ukraine in 2002-10 which aims at deregulation and liberalisation of the business environment including reforms in key policy areas such as competition, tax, banking, education and others.[47] Several agencies and investment promotion centres have been created with overlapping responsibilities and an unclear mandate.[48] In 2005, InvestUkraine was founded by government decree as an independent investment agency to provide information and facilitation services to potential investors. In 2009, the National Agency for Foreign Investment and Development (UkrZovnishInvest), was set up as a central governmental body to implement state policies in the area of investment facilitation. It was merged in 2010 with the State Agency for Investments and Development (DerzhInvestytsii) which operates in parallel to InvestUkraine.[49]

Other steps towards a more friendly investment environment were the ratification of the Washington Convention of 1965 on the procedure for resolution of investment disputes between states and foreign citizens, eradication of administrative barriers to the entry of foreign capital,[50] and broadening investment capacities in collaboration with international financial organisations such as the EBRD and the World Bank in the fields of energy, transport and structural reformation. Moreover, should they wish to withdraw, investors have the right to repatriate their investment capital and profits guaranteed without payment of duties.

The agency has been mandated by the Cabinet of Ministers to co-ordinate the work of the central executive authorities in this sphere and to market investment projects of strategic priority to foreign investors by conducting road shows abroad and by establishing one-stop shop services. After a number of unsuccessful attempts in the past to establish an efficient investment promotion system, it is crucial that the new institutional setting does not represent just another layer of bureaucracy intervening in the investment selection process but addresses key obstacles for foreign investment. In light of international best practices, the new Ukrainian agency could participate more in designing and implementing policies to enhance the country's investment climate, including through "policy advocacy" efforts aimed at promoting legislative and administrative changes in support of investment.

According to the Law of Ukraine "On the Main Principles of the State Regulatory Policy in the Sphere of Economic Activity" each draft of a regulatory act is published with the purpose of receiving remarks and proposals from individuals and legal entities, associations and research institutions as well as from consultative and advisory bodies which may or may not be considered when changes to investment laws, regulations and policies are implemented. According to business representatives, consultations with the private sector, foreign investors, non-governmental organisations (NGOs), civil society and academia remain limited and happen only on an *ad hoc* basis.

In the long term, the programme of economic reforms for 2010-14 – designed to create a well-off society, a competitive economy and an efficient state – is expected to improve the business climate through enhancements to the regulatory approval system, licensing, administrative services, starting and liquidation of businesses, state supervision and control, technical regulations and simplified customs procedures. These measures will potentially help build the investment image of Ukraine and attract further FDI.

NOTES

1. As forecast by the IMF in July 2008 – or 6% as forecast by the Economist Intelligence Unit (EIU).
2. Including Armenia, Azerbaijan, Georgia, the Republic of Moldova and Ukraine.
3. Azerbaijan experienced GDP growth of 9.3% in 2009 (IMF World Economic Outlook Database, April 2010).
4. Exports make up around half of annual GDP.
5. End-of-year CPI in 2009 according to the IMF WEO Database, April 2010.
6. They agreed on an average monthly price of USD 234 per thousand m^3 of gas as of June 2010 (compared to USD 334 in 2009), in exchange for permission to extend the Russian army's naval base of Sevastopol for another 25 years.
7. IMF, WEO Database, April 2010.
8. Resolution of the Cabinet of Ministers of Ukraine No. 281 (24 March 2010) On the Major Projected Macro indicators of Economic and Social Development of Ukraine in 2010, used as a basis for the State Budget in 2010 (adopted on 27 April).
9. Ukraine and the Republic of Moldova have the highest share of government in GDP of the region.
10. Informal economy refers to all legal production activities that are deliberately concealed from public authorities for the following kinds of reasons: to avoid payment of income, value-added or other taxes; to avoid payment of social security contributions; to avoid having to meet certain legal standards such as minimum wages, maximum hours, safety or health standards, etc. (OECD, 2002, p. 139). It does not concern illegal activities.
11. Ukraine scores 2.2 in the 2009 International Transparency's Global Corruption Report (with values of 0 for the most and 10 for the least corrupt countries).
12. Double dipping is when a worker has two jobs: the main in the formal sector and the secondary in the informal.
13. An illegitimate wage arrangement whereby formal employers pay their formal employees both an official declared wage usually at some minimum level as well as a supplementary undeclared wage.
14. According to the State Statistics Committee of Ukraine, all basic food groups except for oil and vegetables registered strong price increases during 2009, with the highest increase being on sugar (40.5% from 2008 to 2009). A similar situation occurred with milk, butter and other milk products.
15. According to the State Statistics Committee, profitability of cattle meat production has been negative since 1995 (*e.g.* in 2008 it was -24.1%).
16. Poultry production is expected to grow by almost 50% during 2009-13.
17. Press release of International Industrial Conference and Exhibition "Biofuels. Ukraine – 2008" at www.biofuelsukraine.com/en/press.html.
18. Grelik, M. and J. Osyak (2007), *Bio-fuel Production Potential in Ukraine*, Presentation prepared for the Conference "Issues of Liquid Bio-Fuel Production and Consumption in Ukraine" which was held on 28 November 2007 (Center for Social and Economic Research – CASE). The study also showed that Ukraine does not hold an absolute advantage in production of biofuels as it uses more input than Poland to produce one cubic metre of bio-ethanol or biodiesel.
19. Energy use in 2006 in Ukraine was 487 kg oil equivalent per USD 1 000 GDP (in constant 2005 USD at PPP), compared to 182 in Armenia, 277 in Azerbaijan, 194 in Georgia, 245 in Serbia and 381 in the Republic of Moldova, http://unstats.un.org/unsd/mdg/SeriesDetail.aspx?srid=648
20. Ukraine is fourth after Russia, United States and Canada in terms of railroad transportation.

21. After the sixth largest Ukrainian bank (Prominvestbank) was put under receivership, at least USD 3 billion (4% of deposits) were withdrawn during the first three weeks of October 2008.

22. For example, in June 2009 the Parliament adopted a moratorium during 2009-10 on forced eviction of a mortgage borrower from his or her housing served as collateral for a loan, if mortgage interest was paid on time or with a maximum two-month delay and restructuring of the debt was officially agreed with the bank. This measure is aimed at protecting individuals who experience difficulties in paying the mortgage debt because of the crisis and sharp hryvna devaluation.

23. According to the National Bank of Ukraine Balance of payments data, www.bank.gov.ua/Balance/PB/2009/State_2009.pdf.

24. For the richer households, extra money will be invested in education, while it will be directed towards primary needs (food and housing) for the poorest ones.

25. Realities and Prospects for Poverty Reduction in Ukraine: http://portal.rada.gov.ua/rada/control/uk/publish/article/news_left?art_id=196321&cat_id=37486.

26. "Realities and Prospects for Poverty Reduction in Ukraine; Materials of the Round Table of the Verkhovna Rada of Ukraine for Social Policy and Labour", 2 July 2010: http://cpsr.org.ua/index.php?option=com_content&view= article&id=113:2010-07-02-05-12-54&catid=7:2010-06-03-10-29-16&Itemid=11.

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Development in Eastern Europe and the South Caucasus

ARMENIA, AZERBAIJAN, GEORGIA, REPUBLIC OF MOLDOVA AND UKRAINE

The economic crisis, the second economic shock to hit the Eastern Europe and the South Caucasus region after the collapse of the Soviet Union, has been a warning and a call to action. The region has many advantages and much potential, but some of this was squandered during the boom years of the 2000s. The studies contained in this volume demonstrate that the potential is still there and that the measures that need to be taken to realise that potential are feasible and affordable. Some of them can have an almost immediate effect, such as easing access to finance for small and medium-sized enterprises and opening up new markets for the region's goods. Others are more medium-term, such as redeveloping product lines in the steel industry or in agriculture. Some of the most critical reforms, like raising the level of education and improving health care, will require political and economic investment over the long term.

None of the recommendations in this book are, however, beyond the bounds of possibility. Governments and the private sector have an interest in implementing reforms to diversify the economy and improve the distribution of revenues. Given the enormous potential of the Eastern European and South Caucasus countries, the region has every reason to be confident about its future.

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