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.

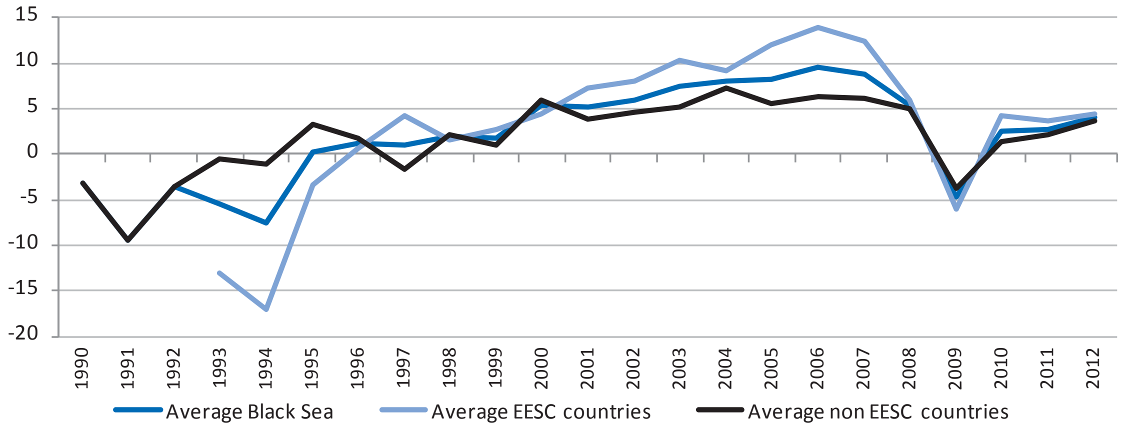
The EESC countries are well placed to link their vast resources to future growth in the global markets. With appropriate policies, this region can contribute to meeting the increasing global demand for food and energy. By 2050, feeding an additional 2.3 billion people globally will require a 70% increase 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.

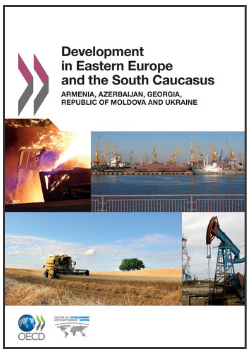
Another priority for EESC countries would be to improve access to finance for SMEs, mostly start-ups, whose growth prospects are often held back by high interest rates and collateral requirements. With the global crisis, credit tightening further limits SMEs' access to finance. Channelling the large 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.

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