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TRANSITIONAL ECONOMIES AND INTERNATIONAL COMPETITIVENESS

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Foreword

The Northern Dimension Research Centre (NORDI) is a research institute run by Lappeenranta University of Technology (LUT). NORDI was established in the spring of 2003 in order to co-ordinate research into Russia.

NORDI's mission is to conduct research into Russia and issues related to Russia's relations with the EU with the aim of providing up-to-date information on different fields of technology and economics. NORDI's core research areas are Russian business and economy, energy and environment, the forest cluster, the ICT sector, as well as logistics and transport infrastructure. The most outstanding characteristic of NORDI's research activities is the way in which it integrates technology and economics.

LUT has a long tradition in conducting research and educating students in the field of communist and post-communist economies. From the point of view of these studies, LUT is ideally located in the Eastern part of Finland near the border between EU and Russia.

This book deals with various aspects of international competitiveness in twelve transitional economies, eight of which belong to EU. In this context, qualitative as well as quantitative indicators have been used. Business environments in countries under review are strikingly dissimilar.

I want to express my gratitude to Mr. Boris Karandassov M.Sc. (Tech.), who has helped me to compile statistics, and Ms. Rita Sergeeva, who helped me to finalize the book.

Lappeenranta, May 2006

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1 Introduction

Competitiveness is one of the key words in the modern global economy. In the early years of the 21st century it has become evident that resource base is an important factor in economic success. Especially hydrocarbon containing materials contribute essentially to wealth of certain nations.

In the late 1990s, the European Union had 15 member countries, all situated in Western Europe. The declared aim of the Union was to become the most competitive economic region in the world. Creation of EMU (European Monetary Union) with the common currency, euro, challenged the dominance of US dollar in the global economy.

In 2004, the historically important Eastern enlargement of EU took place bringing 10 new member states into the common European market. Eight of these new EU countries are former communist countries called transitional economies, or TEs. The precondition was that the New Member States (NMS) have functioning market economy. Competitiveness was demanded from the NMSs in the ante-integration period. The EU entry of two TEs – Romania and Bulgaria – was postponed.

The present EU of 25 member states has a low resource endowment, especially in the production of energy bearers, which are available in large scale in Russia. Therefore, co-operation between EU and Russia is of utmost importance.

It is rather difficult to measure relative competitiveness of nations in a comprehensive manner. However, there are some composite indexes compiled annually by certain international organizations attempting to measure it. Quantitative and qualitative components are included in some of these measurements, in which Nordic countries normally score well.

Some of these composite indexes are annually brought up in the international financial press. Therefore, it can be assumed that these measurements are used by companies making foreign direct investment (FDI) decisions.

Obviously, multinational companies (MNCs) collect plenty of quantitative material on potential new target markets. In FDI decisions, it is important to know various cost factors, especially labour costs, in countries targeted via FDIs. In market-seeking FDIs, it is essential to estimate purchasing power in the new location of operation.

This short research report includes 12 TEs covering 8 NMS-countries, 2 EU-likely members – Romania and Bulgaria, as well as Russia and Ukraine from the former Soviet Union (FSU). The first chapter tries to shed light on business environment in the selected TEs in comparative manner. The second chapter deals with living standard, wages and purchasing power in countries under review. This quantitative part of the study describes development trends in the early years of the 21st century.

2 Business Environment in TEs

The World Bank (IBRD) and her daughter company, International Financial Corporation (IFC), published in 2006 a report called “Doing Business in 2006. Creating Jobs”. This highly interesting report assesses business climate in a large group of countries including almost all transitional economies.

The IBRD report 2006 covers ten indicators on business regulations and their enforcement across 155 countries. The 10 indicators are as follows: starting a business, dealing with licenses, hiring and firing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, closing a business. These components are measured separately. The report provides at the end a composite index, called the ease of doing business ranking countries reviewed from 1 to 155. The composite index is calculated as the ranking on the simple average of country percentile rankings in each of the 10 topics covered. The ranking on each topic is the simple average of the percentile rankings on its component indicators.

In the very beginning of the report, the topic is clarified with following examples:

“If you were opening a new business in Lao PDR, the start-up procedures would take 198 days. If you were opening one in Syria, you would have to put up $ 61.000 in minimum capital – 51 times average annual income. If you were building a warehouse in Bosnia and Herzegovina, the fees for utility hook-up and compliance with building regulations would amount to 87 times average income. And if you ran a business in Guatemala, it would take you 1.459 days to resolve a simple dispute in the courts. If you were paying all business taxes in Sierra Leone, they would take 164% of your company’s gross profit.”

It is evident that none of the composite indexes published regularly on business climates in various parts of the global economy can give exact information for investors choosing new target markets. This fact is recognised in the World Bank report:

“There remains an unfinished agenda for research on what regulations constitute binding constraints, what package of reforms is most effective and how this is shaped by country context. The Doing Business indicators provide a new empirical dataset that may improve understanding of these issues. The ease of doing business index is limited in scope. It does not account for a country’s proximity to large markets, quality of infrastructure services (other than services related to trading across borders), the security of property from theft and looting

or macroeconomic conditions or the strength of underlying institutions. Thus while Jamaica ranks similarly (at 43) on the ease of doing business to France (at 44), this clearly does not mean that businesses are better off operating in Kingston rather than in Paris. For example, crime and macroeconomic imbalances – 2 issues not directly studied in *Doing Business* – make Jamaica a less attractive destination for investment."

The Ease of Doing Business Index contains in its ranking plenty of post-communist countries. However, two CIS countries are excluded: Tajikistan and Turkmenistan. The former has the lowest figure of FDI per capita within CIS, and thus, is obviously of little interest for international companies. Turkmenistan is because of her considerable natural gas reserves potentially important market, but it is not an information-friendly country.

In Table 1, 20 countries at the top of the list are mentioned. After that, post-communist countries with their ranking are picked up.

Table 1. Ease of Doing Business Ranking

Rank	Country
1	New Zealand
2	Singapore
3	United States
4	Canada
5	Norway
6	Australia
7	Hong Kong, China
8	Denmark
9	United Kingdom
10	Japan
11	Ireland
12	Iceland
13	Finland
14	Sweden
15	Lithuania
16	Estonia
17	Switzerland
18	Belgium
19	Germany
20	Thailand
26	Latvia
37	Slovakia
41	Czech Republic
46	Armenia
52	Hungary
54	Poland
62	Bulgaria
63	Slovenia
78	Romania
79	Russia
81	Macedonia, FYR
83	Moldova
84	Kyrgyz Republic
86	Kazakhstan
87	Bosnia and Herzegovina
92	Serbia and Montenegro
98	Azerbaijan
100	Georgia
106	Belarus
118	Croatia
124	Ukraine
138	Uzbekistan

Source: IBRD, Doing Business in 2006.

New Zealand is in the first place in the above ranking which measures the institutional framework of doing business in various national economies. All Scandinavian countries are among the fifteen best performers. The Nordic states are well positioned in many composite indexes measuring international competitiveness.

It is rather surprising that two transitional economies, Lithuania (15th) and Estonia (16th) are among the 20 best countries of 155 competitors. Both of them score better than Switzerland or Germany. The other 6 TEs, which are EU-members since 2004, are Latvia (26th rank), Slovakia (37th), the Czech Republic (41st), Hungary (52nd), Poland (54th), and Slovenia (63rd).

These 8 post-communist EU-members were closely monitored in the 1990s and in the early 21st century by EU-officials in the economic policy-making procedure. The candidates were asked to apply Western models in order to create institutions and rules suitable for a viable market system. Administration was not supposed to manage the economy anymore, but shape an environment, in which private businesses can prosper by reacting on market signals. In this context, EU-officials also monitored, how rule (law) enforcement takes place.

Obviously, European integration is really vital for the Baltic States, which are small and thinly endowed with natural resources. Thus, it was essential in the Baltics in the early period of transition to establish institutional frames, in which local and foreign businesses can function properly. It can be assumed that Lithuania, Estonia, and Latvia are not high up in the above ranking by accident: much attention has been paid to the development of favourable business environment.

Slovenia is the most prosperous TE within EU with 2 million inhabitants only. It is in the 63rd place in the above table, behind Bulgaria, which was not able to enter EU in 2004. These two rankings are rather surprising. The Czech Republic (41st) and Hungary (52nd) have attracted plenty of FDI (in relative terms), but offer no perfect business climate. Poland (54th) has somewhat lower ranking than Hungary.

The best CIS country in the above table is Armenia which is 46th in the ranking. Armenia is a small, land-locked country with scarce natural riches. Thus, it must create favourable business environment to survive. Therefore, her relatively positive ranking in the index is not completely surprising.

Russia is the second best CIS country in the above table, but her rank (79th) is relatively modest. In actual fact, Russia's large and resourceful national economy offers plenty of potential for international companies, but doing business on the spot is not necessarily easy: business climate in Russia is sub-optimal from the point of view of institutional framework (see J. Hellevig, A. Usov, T. Tiusanen: The Russian Tax Reform Paving Way for Investment. NORDI publication No. 21, Lappeenranta, 2005).

Moldova has the 83rd rank in the index, and Kazakhstan the 86th position. These two CIS countries differ from each other fundamentally. Moldova is a small and relatively poor country with low natural endowment, and thus, rather unattractive for foreign investors. Her position shows that the institutional business background is far from perfect. Kazakhstan is a country of huge territory with natural wealth, which has attracted the highest per capita FDI inflow in the CIS region. Her ranking indicates that it is not necessarily easy to do business within the largest CIS country in Central Asia. Kyrgyzstan is between Moldova and Kazakhstan, with rank 84.

Azerbaijan (98th) and Georgia (100th) are close neighbours geographically and in business ranking. The former has oil, and thus, high FDI stock figure, while the latter is lacking both. These two countries ought to pay attention to improving their respective investment climates.

Belarus has a favourable geographical location close to EU. In her transition, institutional reforms have been very slow. The country has an authoritarian rule and rather mild decentralization of the economy. Thus, the country, which in the above index is on the 106th place, is hardly able to attract FDI in large scale.

Ukraine with almost 50 million inhabitants offers plenty of business potential, but her economic reform has been far from perfect: her position (124th) in the World Bank index partially explains her very low FDI stock per capita.

Uzbekistan is the worst-ranked CIS country in the business environment index: her position is 138th in the list of 155 countries. However, Uzbekistan is the most populous CIS country in Central Asia, and has interesting natural resources. Thus, Uzbekistan is potentially interesting target market for Western investors. Increasing FDI inflow obviously presupposes improvement in the institutional framework.

CIS region offers a huge variety of countries with different size, living standard and mineral wealth. The World Bank business environment index shows that the transition from Soviet central planning to decentralized market economy has advanced unevenly in the FSU. The former Soviet republics in the Baltics have carried out market-oriented reforms with remarkable speed. The twelve countries under review in this report are assessed separately below on the basis of the World Bank report.

2.1 Lithuania

Lithuania is a small NMS with less than 4 million inhabitants and with a very moderate resource base. Therefore, it is essential that the country pays attention to her economic stability and her business environment. Lithuania is seriously interested in entering the euro-zone in the near future (for details, see T. Tiusanen, J. Kinnunen: EU's Eastern Enlargement and the Future Expansion of the Eurozone. NORDI publication No. 23, Lappeenranta, 2005).

In Table 1, Lithuania occupies rank 15, the highest position within the 12 countries under review. It means that the country has the best institutional framework within TE-group of countries. The report gives per capita income in every country assessed. In the Lithuanian case, it is USD 5.740 (GDP per capita).

It is not possible to cover all details of the World Bank composite index. Only some most important components are dealt with. The first category of ten is called "starting a business". In Lithuania, there are 8 procedures requiring in average 26 days to settle. Costs involved are 3,3% of income per capita. Minimum capital required is 57,3% of income per capita.

The second part of the index deals with licenses (permits). In Lithuania, the number of procedures is 14, which together take 151 days to settle and cost 17,5% of income per capita. The third index category covers labour market issues. The most important point in this context is firing workers. In Lithuanian case, firing cost is 34 weeks salary. The fourth ingredient of the index is registering property, which in Lithuania has only 3 procedures taking in average 3 days to settle and cost only 0,8% of property value.

In the market economies it is important to be able to check the creditworthiness of potential business partners. The fifth part of the index deals with credits. In this category, there is a sub-index called "Depth of Credit Information". The index ranges from 0 to 6: the higher the index number, the more credit information is available from either a public registry or a private bureau to facilitate lending decisions. Lithuania scores full 6 points in this sub-index, which means that information concerning credits is easily available.

In the Nordic welfare states, taxes are rather high, and thus, public services good. Taxes are continuously discussed in media and in private meetings. The business community pays a variety of taxes everywhere in the global economy ranging from income tax, value added tax (VAT), land tax, property tax, ecological tax, etc. Naturally, there is no universally valid list of taxes.

The World Bank report mentions Belarus as a warning example, in which the taxpayer is subject to 11 taxes, including an income tax, VAT, transport duty, land tax, property tax, ecological tax, fuel tax and a turnover tax. Taxes are paid on inputs and again on outputs. Required payments add up to 122% of gross profit leaving the business with two choices: stop operating or start evading. The business would make 113 tax payments to 3 agencies, all by paper, and spend 1.188 hours doing so. Tax refunds would take 2 years to process. Thus, the system is among the world's most burdensome.

Lithuania's tax system is very far away from this nightmare scenario of the neighbouring Belarus. In this paying taxes section, Lithuania has 13 payments to be made, which requires 162 hours work. Total tax payable (percents of gross profit) is 41,6.

These six items (starting a business, dealing with licenses, firing workers, registering property, depth of credit information index, and paying taxes) are selected here from the context of the composite index, which other ingredients of the measurement are neglected to keep the length of the report under control.

To clarify the points interpreted above, a simple calculation can be given. As mentioned, the required minimum capital in the Lithuanian business life is 57,3% of income per capita. The given income per capita is USD 5.740, and thus, the minimum capital of starting a business is USD 3.289. Cost of licenses is 17,5% of income per head, or in absolute sum USD 1.005.

2.2 Estonia

Estonia is the smallest NMS with a population of only 1,35 million. Estonia has no extensive resource base, but the country has plenty of oil shale (so called "burning stone") or sand containing oil. This natural resource is used in energy generation.

As a very small country, Estonia has vital interest in taking care of her business environment. In the transitional period, Estonia has been extremely successful in attracting FDI to her territory (in relative terms). Foreign investors obviously appreciate the good shape of Estonia's institutional framework.

Estonia is on the 16th place, right after Lithuania, in the IBRD ranking list. Estonia's per capita income is with USD 7.010 somewhat higher than in Lithuania.

Starting a business requires in Estonia 6 procedures, which demand 35 days to settle costing 6,2% of income per capita. Minimum capital is 41,4% of income per head, or USD 2.900. Dealing with licenses contains 12 procedures and take 116 days to take care of. Cost involved is 41,4% of income, or USD 2.900, which is clearly more expensive than in Lithuania.

In the Estonian labour market, it is rather convenient to fire workers, which can be done by paying 33 weeks salary, or one week less than in Lithuania. Registering property in Estonia involves 4 procedures taking 65 days to settle. Cost of the exercise is low, only 0,5% of property value. The depth of credit information index in Estonia is marked with 5. It means that it is rather easy to acquire information on creditworthiness of potential business partners. Paying taxes involves 11 positions and takes 104 hours per year to prepare. Total tax burden is 39,5% of gross profit, which is marginally lower than in Lithuania.

In sum, Estonia and Lithuania are rather close together in those sub-indexes covered above. However, in dealing with licenses, Lithuania is clearly cheaper than Estonia.

2.3 Latvia

Latvia is geographically between Estonia and Lithuania. It is the same in terms of population: Latvia has about 2,3 million inhabitants – more than Estonia, but less than Lithuania.

There are no minerals of importance in the Latvian territory. Therefore, Latvia must pay attention to her competitiveness in order to be able to pay for imported input goods.

Latvia's rank in the World Bank composite index is 26, which is clearly worse than in Lithuania and Estonia, but better than Spain's rank (30^{th}) and Austria's scoring (32^{nd}). Latvia's position is better than any transitional economies' rank in the Central Eastern Europe (CEE) region.

It is rather easy to start a business in Latvia. There are only 7 procedures and it takes only 18 days to settle them. Cost involved is 4,2% of income per capita. As the latter in Latvian case is USD 5.460 in the IBRD study, the cost registering a new business is very moderate, USD 229. Minimum capital is 31,8% of income per capita, or in absolute figure USD 1.736. On the other hand, dealing with licenses is relatively complicated in Latvia: there are 21 procedures, which take 160 days to deal with and cost 43,9% of income per capita (USD 2.397).

In the Latvian labour market, the situation is very advantageous from the point of view of employers: firing cost comprises only 17 weeks salary payment, which is essentially less than in Estonia and Lithuania. Registering property in Latvia includes 9 procedures, which take 54 days to settle. Cost is 2,1% of property value.

Latvia scores moderately with 3 in depth of credit information index, in which Lithuania got full points (6), and Estonia also got a good mark (5). It means that it is rather difficult to get reliable information on creditworthiness of business partners in Latvia.

Business must deal with no less than 39 different taxes, which take 320 days per year to work out. Lithuania and Estonia are more convenient countries in this respect. However, total tax payable is with 38,7% (of gross profit) the lowest figure in the Baltic states.

2.4 Slovakia

In the World Bank business environment index Slovakia is on the 37th place. This country of the former Czechoslovakian Federation was very slow in carrying out economic reforms in the 1990s. However, in the turn of the century, Slovakia with some 5,4 million inhabitants improved rapidly her economic institutions and became an EU-member in 2004 alongside with other seven TEs. Slovakia has a narrow resource base, and thus, is highly dependent on competitiveness, as many other TE under review.

It is rather easy to start a business in Slovakia: 9 procedures taking only 25 days to deal with are required. Cost as a percentage of per capita income is only 5,1. As given per capita income is USD 6.480, the starting a business fee is only USD 330. Minimum capital is 41% of per capita income, or USD 2.657.

Dealing with licenses has 13 procedures, which take altogether 272 days to settle. Cost as a percentage of per capita income is 18, or USD 1.166. Slovakia has created rather flexible rules to firing employees: only 13 weeks salary is paid to workers made redundant. Registering property involves only 3 procedures, which take 17 days to take care of, and cost only 0,1% of property value. In the depth of credit information index, Slovakia is scoring only 2 points, which indicates that it is rather difficult to get knowledge on credit standing of potential local business partners.

There are 31 types of taxes Slovakian businesses must deal with. It takes 344 hours period per year to settle all tax issues. Total tax payable is 39,5% of gross profit.

2.5 Czech Republic

The former federation partner of Slovakia, Czech Republic with about 10 million inhabitants is in the 41st place in the ease of doing business index of the World Bank. The country has long industrial tradition and a relatively high living standard in the group of TEs under review.

Starting a business in Czech Republic involves 10 procedures, which take altogether 40 days to settle. Per capita income in the Czech case is USD 9.150. Cost as a percentage of per capita income is 9,5, or USD 869. Minimum capital is 39% of per capita income, which is 3.569 in US dollar terms.

There are no less than 31 procedures in dealing with licenses requiring 245 days to take care of. Cost is 16,1% of income per capita, or USD 1.473. Firing workers costs 22 weeks salary. Registering property in Czech Republic only involves 4 procedures demanding 123 working days to settle. Cost is 3% of property value.

Czech Republic scores 5 points in depth of credit information index, which means that it is easy to check the creditworthiness of local business partners. When it comes to taxes, there are 14 different tax payments in Czech Republic taking in average 930 hours per year to deal with. Total tax payable is 40,1% of gross profit.

2.6 Hungary

Hungary is the most successful country in attracting FDI in the Central Eastern Europe. According to the World Bank study, per capita income in Hungary is USD 8.270. Hungary's rank in the composite index is 52.

It is relatively expensive to establish a business in Hungary. In this context, 6 procedures are involved requiring 38 days to settle. Cost is 22,4% of per capita income, or USD 1.852. Minimum required capital is 79,6% of per capita income, which in dollar terms is 6.583. There are 25 procedures in licenses, which take 213 days work input. Cost (percentage of per capita income) is no less than 279,1%, or USD 23.082. This is a very high figure in comparison to TEs mentioned above.

A fired worker in Hungary receives 34 weeks salary, which is essentially more than in neighbouring Slovakia, and also higher than the equivalent figure in Czech Republic.

Registering property includes 4 procedures and takes 78 days to deal with. Cost is 11% of property value.

Hungary scores 5 points in depth of credit information index. This figure indicates that it is rather easy to get information in this important sphere. Paying taxes comprises 24 positions requiring 304 hours a year to deal with. Total tax payable is 56,8% of gross profit, a comparatively high figure.

2.7 Poland

Poland is the most populous country in the CEE-region with 38,2 million inhabitants. Her rank is 54 in the World Bank composite index. Per capita income in Poland is USD 6.090.

Starting a business in Poland comprises 10 procedures taking 31 days to deal with. Cost is 22,2% of per capita income, or USD 1.352. Minimum capital is 220,1% of per head income, which is 13.404 in dollar terms. License dealings have 25 procedures demanding 322 days to settle. Cost is considerable, 83,1% of per capita income, or USD 5.061.

Firing a worker in Poland is not extremely expensive: it takes 25 weeks salary to make an employee redundant. Property registration has 6 procedures in Poland and takes 197 days to settle. Cost is 1,6% of property value. Depth of credit information index shows 4 (of maximal 6) points indicating that creditworthiness control is functioning, but not perfectly well.

Taxes eat up 55,6% of gross profit, which is relatively high figure, but below the Hungarian equivalent. Tax payments comprise 43 positions and take 175 hours a year to take care of.

2.8 Bulgaria

Bulgaria was one of ten TEs candidating for EU-membership after the collapse of communism. However, the Eastern enlargement of the Union in 2004 relegated two applicants: Bulgaria and Romania. Bulgaria's per capita income is according to IBRD rather low with USD 2.740. The population is 7,8 million. Bulgaria is 62nd in the World Bank composite index ranking.

Starting a business in Bulgaria includes 11 procedures consuming 32 working days. Cost is 9,6% of per capita income, or USD 263. Minimum capital is 104,2% of per capita income,

which in dollar terms is 2.855. Dealing with licenses comprises 24 procedures, which take 212 days time to settle. Cost is very high, 325% of per capita income, or USD 8.905. Fired workers are due to get 30 weeks salary.

Registering property in Bulgaria is relatively simple – there are 9 procedures. Cost is 2,3% of property value. Credit information index is marked with three indicating that the system is rather far from perfect.

There are 27 taxes Bulgarian businesses must deal with. Annual time required to settle tax issues is 616 hours. Total tax payable is a relatively moderate figure of 38,6% of gross profit.

2.9 Slovenia

Among 12 TEs under review here, Slovenia is the richest one with per capita income of USD 14.810. This small national economy with only 2 million people is on the 63rd position in the World Bank composite index.

The first sub-index in Slovenia, starting a business, involves 9 procedures, which can be settled in 60 days. Cost is 10,1% of per capita income, or about USD 1.490. Minimum capital is 17% of per capita income, which is USD 2.518. The second one, dealing with licenses, comprises 14 procedures taking 207 days to settle. Cost is 128,7% of per capita income, or no less than USD 19.060.

Firing workers in Slovenia is rather expensive: 43 weeks salary must be paid for an employee leaving the enterprise. Registering property comprises 6 procedures is Slovenia. It takes 391 days to settle the issues and cost 2% of property value. Depth of credit information index shows a moderate figure of 3. Businesses functioning in Slovenia must deal with 29 taxes, which together swallow 47,3% of gross profit.

2.10 Romania

Romania's EU entry was postponed in 2004. The country has a rather modest living standard of USD 2.920 per capita income, which is more or less on the same level as Bulgaria. Romania's population is almost 22 million.

Romania is on the rather modest 78th place in the World Bank composite index. Starting a business in Romania is rather easy comprising only 5 procedures and costing 5,3% of per capita income (USD 155). There is no minimum capital requirement. Dealing with licenses is more complicated, because there are 15 procedures taking almost 300 days to settle. Cost is 187,7% of per capita income, or USD 5.481.

In Romania, fired workers get 98 weeks salary (or almost two years pay). Registering property is with only 8 procedures rather simple. Cost is 2% of property value. Paying taxes has in Romania no less than 62 categories. Total tax payable is rather high with 51,1% of gross profit.

2.11 Russia

Russia is in many sense a special case within TE-group of countries. In her vast territory, Russia has enormous resource base. Her population of 143 million is about as big as population in the other 11 TEs under review taken together. In The Ease of Doing Business Index, Russia's rank is 79th. The income per capita given by World Bank is USD 3.410 in Russia.

It is rather easy to start a business in Russia: only 8 procedures are involved. Cost is 5% of per capita income (USD 171). Minimum capital is 4,4% of per capita income, or USD 150. However, dealing with licenses in Russia comprises 22 procedures involving cost equivalent of 353,7% of per capita income, which is in dollar terms 12.061. It takes 528 days to settle the license issues.

Firing workers in Russia is not expensive costing only salary of 17 weeks. Registering property has 6 procedures with cost of only 0,4% of property value. In the depth of credit information index Russia scores zero points, which indicates that there is no official channel to deal with creditworthiness of potential business partners.

In the early years of the 21st century, Russia has clarified rules in paying taxes. There are presently only 27 payments involved. Total tax payable is 40,8% of gross profit (for details, see J. Hellevig, A. Usov, T. Tiusanen: The Russian Tax Reform Paving Way for Investment. NORDI publication No. 21, Lappeenranta, 2005).

2.12 Ukraine

Ukraine is a TE with a population of 48 million, and a per capita income of USD 1.260 according to IBRD's study "Doing Business in 2006". The country is on the 124th place in the World Bank composite index ranking.

Starting a business in Ukraine involves 15 procedures and costs 10,6% of per capita income (about USD 130). Minimum capital is 183% of per capita income, or USD 2.306. Dealing with licenses has 18 procedures involving cost 229,4% of per capita income (USD 2.890).

Fired workers are getting a compensation equivalent of 17 weeks pay, which is a low figure. Registering property has 10 procedures and cost 3,8% of property value. Like Russia, Ukraine scores zero points in depth of credit information index. This is obviously a clear handicap in attracting FDI.

Paying taxes has no less than 84 categories. Thus, the tax system ought to be simplified in Ukraine. Total tax payable is 51% of gross profit. It is a rather high figure, but not the highest in our selection of TEs. Altogether, Ukraine has the worst business climate within twelve TEs under review here – measured by World Bank composite index.

2.13 Foreign Direct Investment in TE-region

Foreign direct investment (FDI) development is monitored by several international organizations. There is no uniform method counting FDI flows and stocks. Thus, FDI statistics show differences depending on sources used. However, these differences in statistics covering the FDI scene in TEs are not remarkable.

United Nations Conference on Trade and Development (UNCTAD) is one of the international information centres which monitors closely FDI trends in global scale. UNCTAD publishes every year a handbook dealing with FDI called World Investment Report.

Table 2. FDI Inward Stock, 2004

	USD, Bn	Per capita, USD
Czech Republic	56,4	5.640
Estonia	9,5	7.037
Hungary	60,3	6.030
Latvia	4,5	1.956
Lithuania	6,4	1.829
Poland	61,4	1.607
Slovakia	14,5	2.685
Slovenia	5,0	2.500
Bulgaria	13,0	1.667
Romania	18,0	818
Russia	98,4	688
Ukraine	9,2	192

Source: UNCTAD, World Investment Report 2005

In the above table, the eight NMSs are listed in alphabetical order, followed by Bulgaria and Romania (likely to join EU in the near future). Russia and Ukraine, which both belong to CIS, are at the bottom of the list. The table covers FDI inward stock in 2004 (in billions of US dollars). The same is given in relative terms (reflecting FDI stock per capita in TEs under review), in US dollars.

The very small national economy of Estonia has attracted more FDI per capita (about USD 7.000) than any other TE in the above table. In the light of the World Bank composite index measuring the ease of doing business, Estonia has the second best ranking within 12 TEs under review, as shown above. Thus, advantageous business environment has obviously helped to attract foreign investors in the Estonian case.

Less than 20% of Estonian inward FDI stock is in manufacturing (for details, see T. Tiusanen: Foreign Investors in Transitional Economies: Cases in manufacturing and Services. NORDI publication No. 27, Lappeenranta, 2005). Therefore, it can be concluded that the big bulk of Estonian inward FDI (over 80%) is in market-seeking services, and only a rather marginal share of FDI is supply-oriented (looking for cheap cost factors in the sphere of manufacturing).

In the relative FDI comparison, Hungary is on the second place with a per capita FDI stock figure of somewhat over USD 6.000. In the ease of doing business ranking, Hungary is on the 52nd place, far below Estonia. Thus, it can be maintained that Hungary has been very successful in attracting FDI, even if her business environment in the World Bank comparison is far from perfect.

In the early period of transition, Hungary was very successful in attracting manufacturing FDI via giving special perks, like tax holidays. In the early years of the 21st century, Hungary had a high share of manufacturing activities of her FDI stock, about 46%. Therefore, it can be concluded that foreign investors in Hungary have had a stronger supply-orientation (looking for low costs) than Western investors involved in the Estonian economy.

The Czech Republic is on the third place in the above table with a per capita FDI figure of about USD 5.600. This country has a better business environment rank (41st) than Hungary, but is clearly behind Estonia. About 38% of FDI in Czech Republic is in the manufacturing branch. In comparison to Hungary, this figure is clearly lower, but it is essentially higher than in Estonia.

These three TEs (Estonia, Hungary, Czech Republic) form the elite group of attracting FDI. In the second category, there are two countries, Slovakia with per capita FDI figure of USD 2.700, and Slovenia with an equivalent amount of USD 2.500. In the former, manufacturing branch counts for about 37% of all FDI, while in the latter the equivalent share is rather high, over 43%.

Latvia, Lithuania, and Poland joined EU in 2004, together with Estonia, Hungary, Czech Republic, Slovakia, and Slovenia. Per capita FDI stock in Latvia is just below USD 2.000. Only about 15% of this investment stock is in manufacturing. Lithuania has received over USD 1.800 FDI per capita, of which less than a third (29%) is invested in manufacturing. The equivalent figures in Poland are USD 1.600 and 36%.

Lithuania has the best ranking in the business environment index (15th) discussed above. Latvia also scores well in the same ranking (26th). However, these two Baltic states are far away from Estonia, Hungary, and Czech Republic in FDI statistics (counted per capita). Poland's rank in the ease of doing business is 54th, which is not far from Hungary's position. However, Poland has received essentially less FDI per capita than Hungary.

Bulgaria is not an EU-member, but her per capita FDI figure (close to USD 1.700) is higher than the equivalent stock in Poland. Bulgaria (62nd) and Slovenia (63rd) score rather modestly in the World Bank composite index. Manufacturing comprises just one third of FDI in Bulgaria.

Romania without an EU-membership has a modest FDI per capita, only USD 820. Her business environment rank is also rather low (78th), just before Russia. In the FDI per capita comparison, Russia is behind Romania with USD 700.

Ukraine's FDI stock per capita is with less than USD 200 clearly at the bottom of the scale in the 12-country comparison. Estonia at the top of the relative FDI scale is no less than 35 times better than Ukraine, which is in a low position (124th) also in the business environment index discussed above.

The review allows to draw some conclusions. Firstly, per capita figures of FDI in the chosen TEs show an extremely uneven distribution of Western investment. In this context, it is worth mentioning that the group of 12 countries under review does not cover homogenous units. There are 8 countries with and 4 states without EU-membership. It can be maintained that TEs with EU-membership are more attractive than non-members in the eyes of foreign investors. However, Bulgaria outside EU has more per capita FDI than Poland within the Union.

Secondly, it was assumed that there is a clear positive correlation between the business environment index ranking and per capita FDI results. However, this anticipated correlation is not very clear. Lithuania and Estonia are more or less on the same level in the ease of doing business ranking, but the latter has almost four times more FDI stock value per capita than the former. Hungary is superior in attracting FDI in comparison to Lithuania, Latvia, Slovakia and Czech Republic, each of which have a better ranking than Hungary in the World Bank composite index. However, Romania, Russia and especially Ukraine score low points in both accounts, in FDI per capita statistics, as well as in the composite index.

One of the best-known qualitative indices measuring business climate is called Corruption Perception Index published annually by non-profit organization Transparency International. This index (CPI) is compiled by interviewing several thousands of people involved in international business. The respondents as asked to assess corruption in almost 150 countries. The scale is between 10 and 0 points: an entirely honest country gets the maximum of ten points, while an entirely dishonest country scores zero points (indicating maximum corruption). The CPI has been published annually for more than ten years. The results are extensively covered in financial press. Scores and ranks of countries involved do not fluctuate strongly from year to year in CPI table.

Table 3. Corruption Perception Index (CPI), 2005

Rank	Country	Score
1	Iceland	9,7
2	Finland	9,6
3	New Zealand	9,6
4	Denmark	9,5
5	Singapore	9,4
6	Sweden	9,2
7	Switzerland	9,1
8	Norway	8,9
9	Australia	8,8
10	Austria	8,7
27	Estonia	6,4
31	Slovenia	6,1
40	Hungary	5,0
44	Lithuania	4,8
47	Czech Republic	4,3
47	Slovakia	4,3
51	Latvia	4,2
55	Bulgaria	4,0
70	Poland	3,4
85	Romania	3,0
107	Ukraine	2,6
126	Russia	2,4

Source: Transparency International, 2005

The above table covers the top ten countries in the global economy. Normally, the small Nordic countries (Iceland, Finland, Denmark, Sweden, Norway) are within the ten highest scoring states.

In addition, the CPI list of 2005 covers all twelve TE under review. The best country in this group is Estonia, which in the latest index improved her score and global ranking in comparison to 2004 results. Estonia's ranking is 27th and score 6,4. As pointed out above, Estonia has the highest per capita FDI stock in the TE-group under review. Obviously, rather moderate level of corruption is an attraction to invest in Estonia.

Slovenia comes after Estonia in the above table with 6,1 points and with 31st position in global ranking. Slovenia is the richest country in our selection of TEs. It is often maintained that relative poverty causes high corruption. The rather well-off Slovenia is not suffering of extensive corruption, but in CPI ranking it is behind Estonia, which is poorer than Slovenia.

Hungary is almost on the same level with Estonia in FDI per capita statistics, but clearly behind Estonia in CPI: Hungary scores 5,0 points and occupies the 40th rank together with Italy and South Korea.

Lithuania is the best TE under review in The Ease of Doing Business Index. However, in CPI-ranking she is only on the 44th place with 4,8 points. Thus, Lithuanian business environment is far from perfect.

The Czech Republic and Slovakia, former federation partners in Czechoslovakia, are on the same level in CPI measurement with 4,3 points each in the shared 47th position. Latvia is next in the above table with 4,2 points justifying the 51st position.

Bulgaria, a non-EU country, is with 4,0 points in the 55th rank in CPI table beating clearly EU-member Poland with only 3,4 points and 70th rank. Romania without EU-status is even lower with 3,0 points on the 85th rank in global scale.

The two CIS-countries, Ukraine and Russia, are at the bottom of the above table. The former scores in CP index 2,6 points occupying the 107th place, the latter has equivalent figures of 2,4 and 126th.

It is often maintained that paying bribes means paying unofficial taxes on the top of the official ones. Thus, high corruption level is an impediment in attracting FDI. Romania, Ukraine, and Russia are at the bottom of the scale in both FDI per capita statistics, as well as in CPI table.

In the CPI comparison, Estonia is more or less on the same level as Malta and Portugal. Thus, in EU corruption occurs outside of TEs. Within 12 countries under review, CPI-scores show essential differences.

The next chapter concentrates on quantitative data relying on information compiled by The Vienna Institute for International Economic Studies (WIIW). Special attention is paid to labour costs in chosen 12 TEs.

3 Economic Trends in TEs

3.1 Living Standard

In the Cold War period, it became relatively early obvious that the communist system of central planning cannot compete with the Western system of decentralized economy with public sector social safety net. In Europe, a living standard gulf between East and West emerged and became deeper in the 1970s and 1980s. This welfare gap caused the collapse of communism in the turn of 1980s and 1990s.

In the early period of transition, all TEs suffered an economic slump. However, a recovery started in the mid-1990s, but economic revival under market circumstances has not advanced with equal speed in all TEs. Thus, there are considerable living standard differentials within TE group of countries.

In the first years of the 21st century prices of energy bearers have increased essentially in the global market. This oil price boom has had a very positive effect on resource-rich Russia, while other TEs under review have suffered because of increasing import bill. However, the global energy market shock has not caused any severe economic harm in the region under review.

In the last ten years, the mature market economies of Western Europe (also called EU-15) have not been doing too well. The reasons for the slow economic growth are well-known: high wages, low level of working time (e.g. long holidays), early effective retirement age, low flexibility of labour market, “China effect” (movement of labour intensive activities to low-cost countries), etc.

It is not the aim of this report to analyse economic dynamism in EU-15 in the turn of the century. It suffices to state that in the recent past TEs under review have grown faster than EU-15. As a result, development differences between East and West (to use the Cold War terminology) have become more moderate. However, it takes some decades before the welfare gap mentioned above will be evened out.

The most frequently used measure in international living standard comparisons is the Gross National Product (GNP) or the Gross Domestic Product (GDP) per capita. GNP differs from GDP in that the latter does not include a country’s net income from abroad (a significant

difference only for a few countries, like Kuwait, which have a high proportion of investment overseas). GDP figures are presently used more frequently than GNP data.

Obviously, in every international comparison of GDP per head of population, results must be converted into one currency, normally into US dollars or euros. The latter is used in this report. It is a relatively well-known fact that current exchange rates (ERs) are not a reliable means to convert euros into all other monetary units. Because of the imperfections of the exchange markets they may overvalue some currencies and undervalue others. Typically, EUR 100 can buy more goods and services in a poor country than in a rich one. If that is so, then the local currency of the former is undervalued at current exchange rates. Currencies in TEs are undervalued (for details, see T. Tiusanen, J. Kinnunen: The Commonwealth of Independent States – CIS Countries in Transition. NORDI Publication No. 24, Lappeenranta, 2005). GDP figures are thus made more accurate if euros (dollars) are converted into other countries' currencies via ERs calculated on a purchasing power parity basis – that is, ERs need to be adjusted such that an identical sample of basic goods and services costs the same in one country as another.

In the ideal world of perfect markets, exchange rates would tend to purchasing power parity for those goods and services which are actually traded internationally. In practice, services are traded less than goods. It is generally assumed that international differences are less pronounced in services than in manufacturing. A teacher, doctor or lawyer in a low-income country will deliver something closer to the level of service in a high-income country than a worker in manufacturing. This is not necessarily reflected in the relative pay of teachers, doctors, and lawyers in low-income countries, in which service sector wages are held down by the low wages prevailing in the industries producing traded goods. As a result, relative GDP per capita in poor countries may be understated by two, three or even four times when measured using official exchange rates, rather than PPP-adjusted measures.

Generally speaking, all TE currencies are undervalued. However, undervaluation of currencies in the TE-region under review shows considerable differences. The degree of undervaluation of a currency can be measured via exchange rate deviation index (ERDI), which is calculated by dividing PPP-adjusted GDP figures through GDP-figures at official ER.

In this context, it is important to note that PPP-adjustment is made on the basis of a consumer basket, which has the same content in every country involved. Obviously, it is impossible to create a basket of goods and services covering all economic factors. In many sectors there are

odd biases in prices. For example, it costs more than USD 26 to rent a square foot of space in a large warehouse close to London's Heathrow airport, while the equivalent rent near Moscow is about $ 15. This rent near Moscow is more expensive than in Stockholm, Vienna, Barcelona or Frankfurt, which are prime locations in the rich part of Europe (The Economist, February 18th, 2006). It is a well-known fact that office space rents are more or less on the same level in Moscow, Paris and London.

These oddities in rents are directly linked with local demand and supply factors. Economic boom in Russia has strongly increased demand for office and warehouse space, while supply in this sphere improves only slowly. Thus, rents are high for offices and warehouses: "a basket" consisting of these two items "overvalues" rouble. This special basket of services does not reflect average consumer's spending.

Some prices linked with international tourism have nothing to do with local average consumer basket. A night in Hilton hotel in Budapest or Prague has a price tag on it, which is not affordable for a local average consumer. Luxury hotel prices are everywhere set on a high level determined by special demand coming from travelling business people and rich individuals enjoying tourism.

In emerging markets, many poor people may not be in close contact with the money economy – they may neither sell the product of their work, nor buy many goods or services. Much of what they consume might be provided by themselves or bartered for in unrecorded trade. Subsistence farmers fall into this category. In the informal economy there may be many actors, who are integrated into the monetary economy, but will not disclose their output or incomes.

Considering these points it can be stated that GDP statistics calculated per capita with PPP adjustment cannot be completely accurate in comparisons including emerging markets. In the context of this report it can be assumed that unofficial (unrecorded) economic activity is the higher, the lower the living standard is in the light of figures.

Every living standard comparison based on GDP figures only shows a mathematical average income in countries involved without telling anything about income disparities between rich and poor. In welfare states of Western Europe, public sector evens out income differentials to a certain extend. This income redistribution via the state is more moderate in TEs than in the "old EU-states".

In the early years of the 21st century, living standard in TEs is clearly below the level achieved in EU-15 (or EU-members before the Eastern enlargement of the Union). Welfare differentials are remarkable within the group of our selection of TEs.

Table 4. GDP per capita, 2005 (Euro-Based)

	A	B	B/A
	GDP nominal	GDP at PPP	ERDI
Slovenia	13.868	18.900	1,36
Hungary	8.812	14.490	1,64
Estonia	7.628	12.900	1,69
Czech Rep.	9.713	16.840	1,73
Slovak Rep.	6.928	12.630	1,82
Poland	6.299	11.550	1,83
Lithuania	5.844	11.850	2,03
Latvia	5.254	10.700	2,04
Russia	4.292	9.000	2,10
Romania	3.542	7.440	2,10
Bulgaria	2.759	7.490	2,71
Ukraine	1.330	6.210	4,67
Portugal		16.574	
EU-15 average		25.164	
EU-25 average		23.226	

Source: WIIW

The figures in the above table originate from The Vienna Institute for International Economic Studies (WIIW), which has an extensive database on transitional economies. Figures marked with an "A" cover GDP per capita at official exchange rates, while B-figures count the same purchasing power parity adjusted. All A- and B-figures (in every country) ought to be identical: in that case official exchange rates would reflect local price level correctly.

However, B-figures in all twelve TEs listed in the above table are clearly higher than the "original" A-figures, which means that GDP per capita in TEs understate living standard in countries under review. Therefore, it is worth while to concentrate on B-figures (GDP per capita at PPP) to get a realistic picture of living-standard differentials.

Slovenia is far the best-off TE in the above table, in which Portugal is also included for comparison. Living standard (PPP-adjusted) is higher in Slovenia (EUR 18.900) than in Portugal (EUR 16.574) which is the poorest country of EU-15. However, Slovenia's B-figure is still clearly below the average of EU-15 (EUR 25.164).

The second wealthiest TE in the table is Czech Republic with a GDP per capita figure (PPP-adjusted) almost exactly on the Portuguese level. Hungary with a figure of about EUR 14.500 is below her Czech neighbours (about EUR 16.800). The equivalent figure in Estonia is EUR 12.900, and in Slovakia EUR 12.600; Lithuania (EUR 11.850) and Poland (EUR 11.550) are not far behind. Latvia with EUR 10.700 is the last in the list of NMS-group.

Romania and Bulgaria were unable to enter EU in the 2004 enlargement process. These two countries with EU candidate status have GDP per capita at PPP of about EUR 7.500 each. Russia is above these two countries with an equivalent figure of EUR 9.000.

Ukraine is very clearly at the bottom of the scale in the B-figure comparison scoring only about EUR 6.200 GDP per capita purchasing power adjusted. It is about one third of the level achieved in Slovenia at the top of TE-scale. Thus, living standard differentials are quite remarkable within the group of TEs under review here.

In addition to A- and B-figures measuring living standard, the above table contains exchange rate deviation indexes for countries involved. This index (ERDI) measures how much the official exchange rate is undervalued. ERDI values are derived in the above table by dividing the B-figure by the A-figure in each country. Equilibrium ER is one (1): if GDP per capita figures at official ER are identical with GDP per capita figures at PPP, the official exchange rate is on the "right" level (reflecting prices correctly). If ERDI value is over one, the official ER understates the value of the currency in question.

Slovenia, the richest TE in the above table, has the most moderate ERDI value of 1,36 indicating that Slovenia's currency is undervalued by only 36%. Thus, in wealthy Slovenia official ER deviates from the equilibrium rate moderately.

Alongside of Slovenia, Hungary, Estonia, Czech Republic, Slovakia, and Poland have ERDI values less than two (from Hungarian figure of 1,64 to 1,83 in Poland). These deviations can be called relatively moderate.

Lithuania (2,03), Latvia (2,04), Russia, and Romania (2,10 each) exceed two in the deviation index. In Bulgaria, ERDI has a relatively high value of 2,71, while Ukraine's equivalent score is exceptionally high with 4,67.

Undervaluation of a currency is occasionally called "exchange rate protectionism", because it makes import prices expensive and improves price competitiveness of exportables.

Understated currency helps create relative equilibrium in the current account by boosting export income and by moderating import expenditure. Many currencies in emerging markets are undervalued.

Generally speaking, ERDI values have clearly decreased in transitional economies during the last ten years (for details, see T. Tiusanen, J. Kinnunen, S. Kallela: EU's Enlargement Process: Investment Climate in 10 Transitional Economies. NORDI publication No.7, Lappeenranta, 2004.) With maturing of TE-markets linked with increasing competitiveness of export activities, currencies have the tendency to become "harder", which means that the level of undervaluation becomes more moderate.

On the top of the list in the above table is Slovenia with a very moderate ERDI value, while Ukraine at the bottom of the living standard scale has an ERDI figure far exceeding all other TEs under review. Thus, it can be maintained that there is a negative correlation between living standard and ERDI: the higher the former, the lower the latter.

However, this negative correlation is not perfectly clear. Czech Republic has the second highest living standard in our comparison of TEs, but her ERDI is higher than in Hungary and Estonia, both of which are behind Czech Republic in wealth.

It is remarkable how strongly Ukrainian ERDI deviates from the TE average. Her ERDI of some 4,7 gives her a very strong weapon in competition within TE-group of countries (in terms of prices). It is likely that this advantage of extreme undervaluation will erode with an assumed recovery of Ukrainian economy.

A snapshot of living standard comparison can be provided via some simple relative figures. The table below gives GDP per capita at current PPPs in two years, 2000 and 2005. EU(25) average equals 100 in both years. Thus, eight TEs (NMSs) are included in the basis of the index.

Table 5. GDP per capita at Current PPPs, 2000 and 2005, EU(25) Average=100

	2000	2005	Change 2000-2005, %
Bulgaria	27	32	18,5
Czech Rep.	64	72	12,5
Estonia	41	56	36,6
Hungary	53	62	17,0
Latvia	35	46	31,4
Lithuania	38	51	34,2
Poland	47	50	6,4
Romania	25	32	28,0
Russia	30	39	30,0
Slovak Rep.	47	54	14,9
Slovenia	73	81	11,0
Ukraine	19	27	42,1

Source: WIIW

It is self-evident that the ranking in the above table of TEs is the same as in the previous one: Slovenia is the highest ranking TE with a living standard of 81% of EU average, while Ukraine is at the bottom of the pyramid with an equivalent figure of 27%.

The most important message in the above table is the growth index figures between 2000 and 2005. In every country involved, the relative position has improved in the early period of the 21st century.

The most striking improvement has taken place in Ukraine, where growth has been no less than 42% (2000-2005). However, her living standard in 2005 was only a bit more than one quarter of the EU(25) average.

Vigorous relative improvement has taken place in the Baltic States: the growth in Estonia was 36,6%, in Lithuania 34,2%, and in Latvia 31,4%. Estonia's living standard was clearly over 50% of EU average. Lithuania's equivalent figure was just over 50% mark, while Latvia remained below that limit.

Russia has experienced an oil-related boom in the early years of the new century. In her case, growth in the given period is exactly 30%. Russia's living standard in 2005 was 39% of EU average.

Romania and Bulgaria, both waiting for the EU entry, have improved their relative position. In the former, the growth rate in the given period was 28%, while the latter achieved an

equivalent figure of only 18,5%. These two TEs had in 2005 a living standard of just under one third (32%) of EU average.

The above table shows a relatively modest growth of 17% in Hungary, in which living standard in 2005 was 62% of EU average. The neighbouring Slovakia had lower figures in both accounts: 15% growth and 54% of EU wealth.

Czech Republic reached 72% of EU welfare level in 2005. In this relatively rich TE, the growth rate under discussion was only 12,5%. In the richest TE, Slovenia, the equivalent figures were 81% and 11%.

In Poland, growth rate deviates clearly from the general trend: the result is rather meagre, only 6,4%. In this context, it is worth to note that Poland went through a period of vigorous growth in the 1990s. In 2005, Polish living standard was just half of the EU average.

Altogether, TEs under review are catching up with the old EU countries (15), which have had a period of disappointing growth performance in the first years of the new century. Among eight NMSs only Latvia has a living standard below the 50% mark of EU average.

3.2 Prices

The history of inflation in communism and post-communism is an exciting topic. In central planning system, prices were fixed by the state. Administratively set prices were not “market clearing”: very often goods with official (cheap) prices were not available. Shortage became the rule, not the exception. Goods, which were not officially available, could easily be found in the “black market” – to market (high) prices.

It is not surprising that the systemic change with free prices caused an extraordinarily strong inflationary wave in all TEs. Economic activity decreased, while prices increased continuously.

In the turn of the century, inflation clearly started to decelerate in many TEs (see T. Tiusanen, J. Kinnunen, S. Kallela: EU’s Enlargement Process: Investment Climate in 10 Transitional Economies. NORDI publication No.7, Lappeenranta, 2004.). However, in Russia annual inflation rates (measured with CPI, consumer price index) have continuously been double digit. Ukraine has also had difficulties in reaching price stability.

From the point of view of international competitiveness, it is essential for TE-group of countries to reach inflation rates which are in harmony with the rest of the world (ROW). A country running inflation rates over and above the international average will lose competitiveness (in terms of prices). Exchange rate of a high inflation country must be adjusted somehow. High inflation rates and devaluations go hand in hand causing instability in the economy.

It is not the aim here to discuss price development in TEs in long and detailed form. It suffices to compare price levels in TEs with EU average in the early period of the 21st century and to analyze the trend in relative prices.

The table below marks average EU price level with 100 in two years (2000 and 2005) and counts growth rates between these two years.

Table 6. Price Level in TEs, 2000 and 2005, EU(25)=100

	2000	2005	Change 2000-2005, %
Bulgaria	31	37	19,4
Czech Rep.	46	58	26,1
Estonia	52	59	13,5
Hungary	47	61	29,8
Latvia	50	49	-2,0
Lithuania	46	49	6,5
Poland	52	55	5,8
Romania	36	48	33,3
Russia	32	48	50,0
Slovak Rep.	43	55	27,9
Slovenia	72	73	1,4
Ukraine	18	21	16,7

Source: WIIW

As pointed out above, TEs under review have in the early years of this decade been able to narrow the living standard gap between West and East (using EU-25 average as a comparison.) A similar tendency is visible in prices: TEs are still cheaper in prices than EU average, but price level differentials show a narrowing trend.

Russia has far the highest growth rate in the above table. In 2000, her price level was only 32% of EU average, while the equivalent figure in 2005 reached already 48% indicating a 50% jump in the given period. In the growth rate, Romania is on the second place with 33,3%. In 2005, her price level was also 48% of EU average.

Export structures in these two countries differ from each other essentially. In Romania, the share of manufactured goods of total exports is 83%, while the equivalent figure in Russia is only 21% (according to World Bank data). The former ought to pay prime attention to her price competitiveness of manufacturers, which is of secondary importance only for Russia with huge oil and natural gas exports.

Hungary (30%), Slovakia (28%), and Czech Republic (26%) show rather high growth rates in the above table. These three countries rely on manufacturing in export business. In Hungary, price level exceeded the 60% mark in 2005 (of EU average). The equivalent figure in Czech Republic was 58% and 55% in Slovakia.

Bulgaria's growth rate in the above table is with 19,4% more moderate than that in the neighbouring Romania. Price level in Bulgaria in 2005 was 37% of EU average. Thus, prices in Bulgaria are essentially more advantageous than in the other EU-candidate country (Romania).

Ukraine is far the cheapest country in the table: her price level is only about one fifth of the EU equivalent. Growth in 2000-2005 was relatively modest with about 17%.

In the three Baltic states, price development is rather interesting. Latvia with the lowest living standard of EU-newcomers is the only TE in the above comparison with declining relative prices. Her price level indicator in 2000 was 50% (of EU average), and 49% in 2005. In Estonia, the equivalent figures were 52% (2000) and 59% (2005); growth between these two is 13,5%. In Lithuania, the relative price level grew from 46% to 49%, or by only 6,5%. Thus, Estonia is quite clearly the most expensive country among the three Baltic states. Poland on the Baltic Sea region has a price level indicator of 55% in 2005 with some 6% increase since 2000.

Slovenia with her high living standard has also rather high price level which is only 27% below the EU average. Her relative price level indicator has grown only 1,4% between 2000 and 2005. It is not surprising that the wealthiest country of the region is the most expensive one. Also in this context, it is worth while to mention the difference between the top and the bottom of the scale: Slovenia's price level is almost three quarters of EU average, while the equivalent share in Ukraine is about one fifth.

3.3 Wages

Average monthly gross wages calculated in euros are continuously relatively low in TE-region. However, differences between countries under review are considerable. In Finland average monthly gross wage is about EUR 2.300, which exceed comparative figures in TE-group by far.

Table 7. Average Monthly Gross Wages EUR (ER), 2000 and 2005

	2000	2005	Change 2000-2005, %
Bulgaria	115	164	42,6
Czech Republic	382	641	67,8
Estonia	314	513	63,4
Hungary	337	639	89,6
Latvia	267	341	27,7
Lithuania	262	368	40,5
Poland	472	584	23,7
Romania	142	268	88,7
Russia	85	242	184,7
Slovak Republic	268	448	67,2
Slovenia	935	1.234	32,0
Ukraine	46	126	173,9

Source: WIIW

Slovenia is the only country in the above table, in which the average monthly gross pay exceeds the thousand euro limit. Workers in Slovenia earn EUR 1.234 a month, which is almost ten times more than the equivalent figure in Ukraine (EUR 126). However, monthly pay in Ukraine grew in 2000-2005 no less than 174%, while in the same period workers in Slovenia got a 32% pay increase.

Russia achieved even higher pay increase in 2000-2005 than Ukraine: monthly earning increased from the modest EUR 85 in 2000 to EUR 242 in 2005, a growth of no less than 185%. Rather vigorous pay improvement has taken place also in the early years of the new century in Hungary and Romania, both with almost 90% wage hike. The former earns with EUR 640 a month more than double of the latter in average (EUR 242).

The Czech monthly pay cheque of EUR 641 is on the same level as in Hungary. Since 2000, the growth was about 68%. Poland is not very far away from the Hungarian and Czech wage level with EUR 584 a month. Growth between 2000 and 2005 was rather modest, 24%. Slovakians earn considerably less, only about EUR 450 a month. Growth in the given period has been clearly faster in Slovakia (67%) than in Poland.

Bulgaria is very close to the bottom of the pay scale with monthly wage of only EUR 164. Growth in 2000-2005 is moderate, only 42,6%.

Clearly highest wages in the Baltic states are paid in Estonia, where average pay is EUR 513 a month. Since 2000, the pay has improved by over 63%. The equivalent growth figure is 40,5% in Lithuania, where average pay is about EUR 370. In Latvia, people are earning somewhat less, EUR 341 a month, which is about 30% more, than in 2000.

Figures in the above table are calculated at official ERs, which do not reflect local price levels in TEs. Therefore, nominal wage figures give a considerably biased picture of local purchasing power in TEs. Data used in the table below measures average monthly gross wages in euro at PPP (nominal wage multiplied by ERDI in each country).

As a big bulk of foreign direct investment is done in the sphere of services (retail trade, financial intermediation, restaurants, mobile phone operators, etc.), it is important to be able to calculate income at PPP, in order to know how much money local population in different TEs has for consumption.

Table 8. Average Monthly Gross Wages EUR (PPP), 2000 and 2005

	2000	2005	Change 2000-2005, %
Bulgaria	365	444	21,6
Czech Republic	833	1.112	33,5
Estonia	597	867	45,2
Hungary	718	1.053	46,7
Latvia	531	695	30,9
Lithuania	568	746	31,3
Poland	915	1.070	16,9
Romania	397	563	41,8
Russia	267	507	89,9
Slovak Republic	626	817	30,5
Slovenia	1.299	1.681	29,4
Ukraine	251	588	134,3

Source: WIIW

There are four TEs in the above table with a figure exceeding the thousand euro limit of gross "real" (PPP-adjusted) average monthly pay. Not surprisingly, Slovenia has the highest earning figure, about EUR 1.700 a month with a growth rate of almost 30% between 2000 and 2005. Equivalent figures in Czech Republic are EUR 1.110 and 33,5%, which means that the best-off country (Slovenia) is about one third better off than the second-ranking TE in real monthly pay.

Poland's average monthly pay is with EUR 1.070 not far away from the Czech equivalent figure, but the growth (2000-2005) is with about 17% the lowest figure in the above table. Hungary's average earning is with EUR 1.053 not far away from the Polish equivalent, but there is considerable difference in dynamism: in Hungary, earnings increased by 47% (2000-2005), about three times faster than in Poland. Slovakia's PPP-adjusted monthly wage is relatively modest, less than EUR 820; growth figure (2000-2005) is slower than in neighbouring Hungary, but more rapid than in Poland, about 31%.

In the Baltic states, Estonians are top earners with about EUR 870 a month. Growth in the period under review was with 45% almost as fast as in Hungary. Lithuanians earn in average EUR 750; pay increase is with 31% clearly more modest than in Estonia. In Latvia, average monthly pay is below EUR 700 showing the same growth (2000-2005) as in Lithuania (31%).

Romania is essentially better off in the above table than Bulgaria. In the latter, monthly earning is only EUR 444, while in the former the equivalent figure is EUR 563. Romania's pay growth in the given period is about 42%, or almost double of Bulgaria's equivalent (22%).

Ukraine shows far the fastest pay increase of no less than 134%. However, the monthly earning of EUR 588 is still relatively modest. High ERDI value in Ukraine is boosting the PPP-adjusted wage. Russia's growth rate in the given period is also very high, about 90%. The monthly earning of about EUR 510 is, however, rather modest.

In the sphere of manufacturing it is important to pay attention to labour costs per production unit (unit labour costs, or ULC). Nominal labour costs in TEs are very advantageous in West European comparison. Obviously, high wages in Western Europe are linked with high productivity. In ULC figures productivity is taken into consideration. In the table below, there are some simple index figures dealing with ULC. Austria's level is marked with 100, and TEs under review are compared with that level. Figures are PPP-adjusted.

Table 9. Unit Labour Costs, 2000 and 2005, PPP adj., (Austria=100)

	2000	2005	Change 2000-2005, %
Bulgaria	16,93	19,32	14,1
Czech Republic	31,59	42,77	35,4
Estonia	36,47	42,31	16,0
Hungary	27,74	40,96	47,7
Latvia	34,69	31,61	-8,9
Lithuania	31,63	30,64	-3,1
Poland	43,81	43,43	-0,9
Romania	31,31	36,10	15,3
Russia	14,39	30,50	112,0
Slovak Republic	25,35	33,41	31,8
Slovenia	66,43	74,36	11,9
Ukraine	11,44	21,22	85,5

Source: WIIW

The most advantageous ULCs can be found in Bulgaria and Ukraine. In the former, the figure for 2005 is somewhat below 20 and in the latter a bit above 20. In concrete terms it means that with a wage of one Austrian, five Bulgarians or five Ukrainians can be hired. In 2000-2005 period, relative ULC figure has grown 86% in Ukraine, while the equivalent increase in Bulgaria is only 14%.

On the top of the ULC scale is Slovenia, where unit labour costs were just about two thirds in 2000, and about three quarters in 2005 of the Austrian level: the relative figure has grown about 12%. Thus, ULC gap between Slovenia and Austria is very modest.

Four other TEs in the above table exceed the 40% mark: Poland and Czech Republic (43 each), Estonia (42), and Hungary (41). The relative figure has declined in Poland by 1% (2000-2005), while Hungary shows rapid increase of no less than 48%. The equivalent growth in Estonia is 16%, and essentially higher in Czech Republic (35%).

Decreasing trend in ULC figures signals improvement in TE competitiveness – unit costs of labour become more advantageous in Austrian comparison. (Austria here is used as proxy for EU-15, or Western Europe). Alongside with Poland, there are two other TEs in the above table with declining ULC tendency in 2000-2005: Lithuania and Latvia. In the latter, ULC relative figure went down almost 9%, while the equivalent drop in Lithuania was 3% in period under review. In the Baltic region, Latvia and Lithuania offer clearly more advantageous ULCs than Estonia in 2005.

It is actually surprising that Romania is more expensive than Slovakia in terms of ULCs. In the latter, ULC level is one third of the Austria's equivalent, while in Romania the figure is with 36% a bit higher. Growth in Slovakia in the given period was 32%, but in Romania only 15%. In comparison to Czech Republic, Hungary and Poland, Slovakia offers in 2005 very cheap labour.

In Russia, the relative ULC figure more than doubled between 2000 and 2005. This growth rate (112%) is far the highest in the table, clearly exceeding the 86% increase in Ukraine. Russia's strong economic boom linked with high world market prices of energy bearers in the early years of the 21st century is the most important background factor in the vigorous ULC growth.

ULC statistics show remarkable differences within the group of selected TEs. In Latvia, Lithuania and Poland, the relative ULC figures (in comparison to Austria) show decline, while Ukraine and especially Russia have very rapid ULC growth.

If Slovenia's high figure of ULCs was left out of comparison, the average ULC level in the above table would be just about one third (unweighted average) of the Austrian niveau. Thus, it can be concluded that TE-region in 2005 offers still a very advantageous ULC-picture from the point of view of potential employers.

3.4 Employment

For potential foreign investors it is important to know, whether labour force is available for hiring. Thus, labour market details are of interest. In the table below, unemployment figures in thousands are calculated with labour force survey (LFS) method, which is also called ILO (International Labour Organisation) counting. Thus, figures below are internationally comparable.

Table 10. Unemployment, LFS Definition, Annual Averages

	In 1000 persons			Rate (%)		
	2003	**2004**	**2005**	**2003**	**2004**	**2005**
Bulgaria	449	400	330	13,7	12,0	10,0
Czech Republic	399	426	410	7,8	8,3	8,0
Estonia	66	64	53	10,0	9,6	8,0
Hungary	245	253	304	5,9	6,1	7,2
Latvia	119	119	104	10,6	10,4	9,2
Lithuania	204	184	135	12,4	11,4	8,4
Poland	3.329	3.230	3.070	19,6	19,0	18,0
Romania	692	800	595	7,0	8,0	7,0
Russia	6.231	5.988	5.629	8,6	8,2	7,6
Slovak Republic	459	481	430	17,4	18,1	16,0
Slovenia	65	64	65	6,7	6,3	6,3
Ukraine	2.008	1.907	1.780	9,1	8,6	8,0

Source: WIIW.

In the area comprising eight NMSs plus Bulgaria and Romania, there are over 5 million people out of work. Russia's equivalent figure in 2005 is over 5,6 million, and in Ukraine 1,8 million.

As pointed out above, Bulgaria and Ukraine offer far the lowest pay levels in the region under review. However, the modest wage niveau has not caused full employment: together these two TEs have over 2 million people out of work. Unemployment rate has decreased from almost 14% in 2003 to 10% in 2005 in Bulgaria. Equivalent figures in Ukraine are 9% and 8%. Thus, positive trends can be observed in these two national economies.

In the light of a multitude of indicators, Slovenia is far the most prosperous TE in our comparison. This high income country has the lowest unemployment rate, somewhat over 6%, which in pan-European comparison can be called relative full employment.

The highest unemployment rate in 2005 can be found in Poland, the largest NMS. Even though her labour market has improved slightly since 2003, her unemployment rate of 18% is worryingly high. Slovakia is not far behind with 16%. Also in Slovakia, some improvement has taken place since 2003.

Unemployment rates in Czech Republic, Hungary and Romania are between 7 and 8%. In the three Baltic states, unemployment rates were in 2003 in double-digit figures. Strong economic growth in these three small countries has brought the rates in one-digit numbers.

Russia's unusually strong economic boom has affected the labour market relatively moderately. However, unemployment rate has come down from 8,6% in 2003 to 7,6% in 2005.

3.5 Productivity

In the communist era, no attention was paid to cost savings and productivity improvement, because companies were not guided by profit motive. Centrally planned output quotas were supposed to be achieved, whether there was demand or not for produced goods. Full employment was guaranteed by the system, in which waste of resources was the rule, not the exception.

After the systemic change, rapid productivity improvement was achieved in many TEs in the 1990s. However, in some of them, e.g., in Russia and Ukraine results in this respect were disappointing.

Labour productivity in a national economy is measured by dividing output figures with the number of active population. Overall labour productivity calculations over a period of time require output (GDP) figures cleaned of inflation, otherwise results would be distorted.

In the table below, GDP figures per employed person in 2000 and 2005 are given in national currencies of TEs under review, at prices of 2000. The essential part of the information here is the dynamism of productivity in the early years of the 21st century.

Table 11. GDP per Employed Person, 2000 and 2005

Country (local currency at 2000 prices, thousands)	2000	2005	Change 2000-2005, %
Bulgaria (BGN '000)	9,57	11,34	18,4
Czech Republic (CZK '000)	454,40	533,92	17,5
Estonia (EEK '000)	162,34	216,89	33,6
Hungary (HUF '000)	3.410,29	4.154,05	21,8
Latvia (LVL '000)	4,98	6,63	33,1
Lithuania (LTL '000)	32,57	44,68	37,2
Poland (PLN '000)	51,26	60,64	18,3
Romania (RON '000)	7,47	11,55	54,7
Russia (RUB '000)	113,70	144,25	26,9
Slovak Republic (SKK '000)	444,44	534,22	20,2
Slovenia (SIT '000)	4.772,86	5.336,14	11,8
Ukraine (UAH '000)	8,43	11,89	41,0

Source: WIIW

Romania shows the clearly highest productivity growth rate in 2000-2005 of almost 55%, followed by Ukraine with a 41% marking. Bulgaria, which with Romania and Ukraine is at the bottom of the scale in our living standard scale, has a rather modest productivity growth of 18,4% in the given period; Polish figure (18,3%) is virtually on the same level.

It is not surprising that Slovenia with her sophisticated and rich economy has the lowest productivity growth in the table with 11,8%. Czech Republic with the second highest living standard scores 17,5%, exceeding Slovenia's performance. Hungary (21,8%), and Slovakia (20,2%) surpass the 20% mark in productivity growth.

The Baltic states have gone through a period of rampant economic growth in the period under review here. Therefore, it is not surprising that in this region strong dynamism in productivity trend can be observed: in Latvia the growth rate is 33,1%, in Estonia 33,6%, and in Lithuania even higher – 37,2%. Russia's productivity growth of 26,9% is rather encouraging, even if it is below achievements in the Baltic states.

European Bank for Reconstruction and Development (EBRD) was established in the early 1990s to assist post-communist countries in their transition. This bank publishes yearly its Transition report comprising plenty of data on TEs, among them labour productivity in industry.

Table 12. Labour Productivity in Industry in 2000-2004, Annual Change (%)

	2001	2002	2003	2004	Index 2000=100 2004
Bulgaria	5,1	8,2	9,6	11,5	139,0
Czech Republic	4,2	4,9	8,6	11,1	131,9
Estonia	7,7	19,5	3,9	1,1	135,2
Hungary	1,8	2,9	7,6	5,0	118,3
Latvia	19,2	-0,8	6,7	8,2	136,5
Lithuania	19,9	0,2	14,1	11,9	153,4
Poland	4,4	3,7	12,4	11,6	135,8
Romania	7,5	13,4	15,5	5,0 [a)]	147,8
Russia	5,0	6,8	5,0 [a)]	5,0 [a)]	123,6
Slovak Republic	5,8	4,3	6,3	2,9	120,7
Slovenia	-1,3	0,8	8,8	5,0 [a)]	113,7
Ukraine	4,4	9,4	17,9	5,0 [a)]	141,4

Source: EBRD, Transition Report 2005.

[a)] The annual change of productivity in Romania, Russia, Slovenia and Ukraine was not partly available for 2003 and 2004. Annual change was estimated to be lower than average and conservatively assumed to be 5%.

Productivity data is not easy to come by. In the above table, the period of 2001-2004 was not completely covered in the source. Therefore, some estimates have been used to construct an index, in which year 2000 is marked with 100 and 2004 figures are compared with that starting point of the index. Results do not reflect reality completely accurately.

The best productivity growth in manufacturing in 2000-2004 was achieved in Lithuania with 53,4%, followed by Romania (47,8%), and Ukraine (41,4%). The two latter ones contain estimates for one year (2004). Bulgaria's productivity growth in industry is not far from the 40% mark (39%) in the given period.

Thus, industrial productivity shows vigorous increase in the least developed TEs in our selection – Romania, Ukraine and Bulgaria. The highest yearly productivity hike, no less than 17,9% in 2003, can be found in Ukraine. However, the best overall performance in the given period was in Lithuania.

Slovenia's mature economy has the slowest increase in industrial productivity with only 13,7%. Also Hungary (18,3%) and Slovakia (20,7%) have relatively modest results in the above comparison. Poland (35,8%), and Czech Republic show clearly better figures in the productivity trend comprising industrial activities.

In the Baltics, Latvia (36,5%) and Estonia (35,2%) have in productivity competition achieved good results, even if these two countries remained below Lithuania's growth rate.

EBRD has Russian industrial productivity figures missing for two years (2003-2004). Assumed that yearly increase in both cases was 5%, the growth since 2000 is 23,6%. This estimate figure is more or less on the average level in the above table.

Investment is obviously a key component in every national economy, contributing to current growth and laying down the foundation for future expansion. Economist call new investment in physical assets "gross domestic fixed capital formation". Gross because it is before depreciation; domestic because it is at home rather than overseas; fixed because it does not include stocks of goods; and capital formation since it distinguishes physical from financial investment.

Fixed investment is spending on physical assets including infrastructure such as roads and airports; buildings such as dwellings, factories and offices; machinery, equipment and

vehicles such as computers, airplanes and machine tools. These generally provide the potential for higher output in the future.

The potential for future output will be boosted especially by investment in machinery and equipment. The renewal of "machinery park" (the overall stock of machines and equipment in use) is essential in the context of productivity increase. New technology is a core component in overall productivity, which basically determines living standard level in every national economy.

The table below covers gross fixed capital formation in TEs under review in the form of one simple index, in which year 2000 is marked with 100. Gross fixed capital formation is replaced with the term "investment" in the text interpreting the next table.

Table 13. Gross Fixed Capital Formation in 2005, Real (Index 2000=100)

	Index 2000=100 2005
Bulgaria	198,0
Czech Republic	123,8
Estonia	165,0
Hungary	139,5
Latvia	190,8
Lithuania	177,7
Poland	95,4
Romania	156,1
Russia	157,2
Slovak Republic	128,1
Slovenia	117,1
Ukraine	228,6 I-IX

Source: WIIW

Investment trends in twelve transitional economies in the early period of the current decade are extremely dissimilar. In Ukraine, there has been a very strong investment boom with an extraordinary growth rate of 129% between 2000 and 2005. The figure of 2005 covers three first quarters of the year. Bulgaria, a TE with a low development stage, has roughly doubled her investment in the same time frame. Latvia has the lowest living standard within NMS-group, in which her investment growth is the highest, 91% in the given period. In the Baltic region, Lithuania (78%) and Estonia (65%) have also very positive investment trend.

One TE in the table, Poland, shows negative investment development with a decline of almost 5%. In the upper part of the TE living standard pyramid, investment growth in the first half of

the current decade is rather moderate: 17% growth in Slovenia and 24% in Czech Republic. Slovakia with an equivalent figure of 28% is performing rather moderately. Hungary has more dynamism with 40% investment growth. Romania's corresponding figure is 56% and Russia's 57%.

It is a well-known fact that investment is highly cyclical. Investment activity declined in several TEs in the previous decade.

Table 14. Gross Fixed Investment in 1999 (Index 1989=100)

	Index 1989=100 1999
Czech Republic	103,4
Hungary	125,3
Poland	203,5
Slovak Republic	103,5
Slovenia	164,0
Bulgaria	58,6
Romania	47,9
Russia	22,7
Ukraine	20,9

Source: WIIW

Unfortunately, the table above is not complete, because comparable investment figures are not available on the Baltic states (Estonia, Latvia, Lithuania). However, the TE investment scene in the 1990s is worth of some comments.

Investment more than doubled in Poland during last decade. Also Slovenia had dynamism in her investment in the early period of transition with over 60% growth in the given period. Hungary's equivalent figure of 25% is rather moderate. Investment in Czech Republic and Slovenia virtually stagnated in the 1990s.

As mentioned above, Bulgaria and Romania applied EU membership in the 1990s, but were not allowed to enter the Union in 2004 alongside with other eight TEs. The most important reason for this relegation was the slow pace of institutional reforms, and thus, emergence of an unfavourable investment climate. In Bulgaria, investment decreased by some 40%, and in Romania even over 50% in the previous decade. There was a real danger that these two former members of the Eastern Bloc will enter a "poverty trap" with permanently decaying economy. Bearing this scenario in mind, it is important to pay attention to substantial differences in two previous tables: in Romania, investment decreased by over 50% in the

1990s, but increased over 50% in the early period of the second decade of transition. In Bulgaria, the turnaround has been even more dramatic: a decline of investment activity of over 40% (in the 1990s) has followed by a growth of about 100% in 2000-2005.

However, Russia and Ukraine are able to beat Bulgaria and Romania in the investment scene. In Ukrainian case, investment activity virtually collapsed altogether in the 1990s, when there was a decline of about 80%. Very similar situation came also into being in Russia. In the latter, a very healthy recovery of some 60% took place in 2000-2005, while in the former the growth rate was simultaneously about two times higher than in Russia.

In sum, it can be stated that TEs under review are in the new century going through a sound period of economic growth without any excessive inflationary pressure. An investment boom is on, labour productivity is developing favourably. However, the boom period of TE-region has not helped to reach relative full employment in the countries under review, even though labour costs in East-West comparison are still very moderate in TEs. In this respect, TEs are not able to offer absolute advantage in labour costs: several emerging markets in Asia are more advantageous in many industrial branches.

On macro-economic level, competitiveness of national economies can be measured by current account (CA). Several TEs are not able to earn enough money in their external economy to cover their expenditure against the outside world. Thus, there are disequilibria in CAs in TE-region (for detail, see T. Tiusanen, J. Kinnunen: EU’s Eastern Enlargement and the Future Expansion of the Eurozone. NORDI publication No.23, Lappeenranta, 2005.).

The most practical way measuring current account disequilibrium in anyone country is to take the deficit or the surplus of the CA and count it as a percentage of local GDP. This method is used in the table below covering results of 2005.

Table 15. Current Account in % of GDP in 2005

	% of GDP
Bulgaria	-14,0
Czech Republic	-2,5
Estonia	-10,7
Hungary	-7,9
Latvia	-13,1
Lithuania	-7,4
Poland	-1,5
Romania	-9,1
Russia	11,3
Slovak Republic	-5,9
Slovenia	-0,7
Ukraine	3,2

Source: WIIW.

There are two countries involved with CA surpluses, Ukraine and Russia. In the latter, CA surplus in 2005 was over 11% of GDP. This very high relative figure means in actual fact that Russia is an important net exporter of capital (the country is financing the rest of the world with a 11% stake of her GDP). In the period under review in this report, Russia has permanently earned high CA surpluses (for details, see T. Tiusanen, J. Jumpponen: Russian Transition in the Early 21st Century. NORDI publication No.22, Lappeenranta, 2005). The most prominent background factor is the permanently high level of oil in the global market. As an important exporter of energy bearing materials, Russia is a special case within TEs under review.

Ukraine earned a CA surplus of 3,2% of GDP in 2005. As shown above, Ukraine has far the highest ERDI value in our selection of TEs. It means that the extraordinarily severe undervaluation of Ukrainian currency creates very advantageous price competitiveness for exportables and keeps importables artificially high in price. Ukrainian ERDI deviates clearly from the equivalent value in other TEs under scrutiny here.

For several years, the Slovenian CA has had the tendency to be in relative equilibrium. In 2005, there was a very modest CA deficit of below 1%. The equivalent figure in Poland is 1,5% indicating that the country has no big worries with her competitiveness. Obviously, the relative stagnation of investment has helped to bring Polish CA close to balance (importing of machinery in large scale has not taken place lately). Also in Czech Republic, CA deficit is rather well under control: in her case the relative figure is 2,5%. In Slovakia, the equivalent figure is less modest with about 6%, and even higher in Hungary (about 8%).

In the relatively modestly developed TEs, Bulgaria and Romania, rapid economic growth has taken place in recent years. There seems to be certain signs of "overheating", especially in Bulgaria: her CA deficit is the highest in the table with no less than 14%. The equivalent figure in Romania is with 9% more moderate, but very far from equilibrium.

Also the Baltic states are going through a strong boom period, and thus, have some difficulties in balancing CAs. In Latvia, CA deficit is over 13%, followed by Estonia with about 11%, and Lithuania over 7%. Estonia is the most expensive country of the three, while Latvia has a lower price level and more advantageous unit labour costs than her northern neighbour.

Thus, there are some paradoxical features in the economic trends in the target region. Bulgaria is the most competitive country in our selection of TEs as far as unit labour costs are concerned, but it has the highest CA deficit of them all. In spite of very clear labour cost advantage, the country spends much more vis-à-vis the external world than earns money from abroad. Thus, ULC advantage (with cost competitiveness) is not able to guarantee CA equilibrium. Latvia has a ULC advantage in Northern Europe (very low labour costs), which does not give enough export competitiveness to cover her import bill (import of goods and services exceed clearly export earnings). Slovenia, the far most expensive TE and also the highest ULC country in our comparison, has reached relative CA balance.

There are two basic ways to finance current account deficits, either by borrowing money from the outside world, or attracting risk capital inflow (in form of foreign direct investment, or portfolio equity investment). Unlike debt, risk capital does not need to be serviced.

There is a multitude of debt crises in the recent history. In the 1980s, many Latin American countries became victims of excessive borrowing. The financial crisis of the late 1990s set back several emerging markets in South-East Asia. Argentina became credit unworthy in 2001.

It is often maintained that foreign direct investment (FDI) is the most convenient form of capital import (from host country point of view). FDI normally does not flee at short notice, and the provider of FDI bear the risk attached to the investment. In the framework of FDI, new technology and management know-how flow in (into the FDI receiving country). Often FDIs in emerging markets are export-oriented: therefore, FDI improves CA by increasing exports and substituting imports in the host country. FDI inflow in car manufacturing has, for example, improved export capability in several TEs (see T. Tiusanen: Foreign Investors in

Transitional Economies: Cases in Manufacturing and Services. NORDI publication No.27, Lappeenranta, 2005).

However, over the long term, FDI may be a more expensive form of finance than debt because the outflow of remitted profits usually gives this kind of investor a bigger return than foreign bank or bondholder could expect to receive. In this context, it is useful to bear in mind that rents, interest payments, profits and dividends are included in CA calculations. These reflect past capital flows: countries with CA surpluses acquire foreign assets which generate further CA income in future periods and vice versa (deficit countries pay compensation for the capital imported).

As discussed above, Estonia has in relative terms received more FDI than any other TE under review. Bulgaria and Latvia have had rather modest results in this respect so far. Therefore, Estonia has been able to finance her rather high CA deficit conveniently via FDI inflow. It is far from certain, that Bulgaria and Latvia, with the highest CA deficits in the above table will be able to use “the Estonian model” (finance high CA deficits mainly by risk capital inflow).

Obviously, CA deficits of some 10-15% of GDP are not sustainable. Export earnings compared to import expenditure must be increased on the long term. This adjustment may lead to manipulation of exchange rate in countries with high and permanent CA deficits. In plain language it means that devaluations of currencies in certain TEs cannot be excluded in the future.

In this context it is useful to point out once more that in Ukraine exchange rate is already undervalued in an extreme manner helping the country to earn a clear surplus in her CA. The same can be said in a different way: Ukraine’s exchange rate deviation index of 4,7 makes her exportables highly competitive (in terms of prices) and her importables highly expensive (in the eyes of local buyers).

Russia is a special case within our group of 12 TEs. Her resource base is the most important CA background factor: it is likely that Russia will earn more export income than she is spending for her import needs, and thus, her CA is likely to be in substantial surplus on the medium term.

4 Conclusion

The World Bank report on business environment in different national economies covers all post-communist countries in Europe, as well as all former Soviet republics in Asia. This comprehensive study on institutional circumstances comprising no less than 155 countries allows to evaluate the relative development in TE-region under review from the point of view of doing business in different societies.

In the first part of this short study, TEs involved are analysed in the light of World Bank's report results. The three Baltic states, Lithuania, Estonia, and Latvia, have the highest ranking in IBRD's business environment list within the 12 TEs covered here. The first two countries are among the best 20 in the world; Latvia is not far away from her Baltic neighbours. In these three small countries, there has been vigorous economic growth in the early years of the new century, even if the Baltic states have a modest endowment of resources.

Ukraine with rather large population is the worst scoring TE under review in the business environment assessment on the 124th rank of 155. Uzbekistan in Central Asia is the only TE ever below (138th) Ukraine. Thus, there is an urgent need to accelerate institutional reforms, which is not necessarily easy because of political uncertainties in Ukraine.

There is plenty of evidence that FDI inflow in the post-communist period has had a very positive impact on economic development in TEs. It can be maintained that TEs compete with each other, in order to receive FDI from the West. However, there is no "perfect competition" in this sphere. Russia has deliberately limited her FDI inflow by creating special rules for foreign companies willing to enter mining sector, including oil and gas extraction, as well as in financial services (in banking and insurance). Therefore, it can be maintained that Russia is not interested in maximizing her FDI inflow, which by definition contains foreign economic influence.

TE-region's FDI stock is extremely unevenly distributed between individual countries. The smallest TE under review, Estonia has far the largest FDI stock per capita in the region, about USD 7.000. Hungary and Czech Republic are not far away, while Ukraine at the bottom of the list has a very modest figure of only USD 200.

It is rather generally assumed that EU membership is an important background factor in FDI movement. Before 2004, foreign companies were said to prefer TEs with anticipated early EU

entry. Now, after Eastern enlargement of EU, it is visible that NMS-group has higher FDI figures (in relative terms) than other TEs. However, Bulgaria is scoring in FDI competition better than Poland. Romania, Russia, and Ukraine (non-members of EU) are below NMS-group in attracting FDI.

One of the most quoted business climate indicators is called corruption perception index published annually by Transparency International, a non-profit organisation. In this index (CPI), a high number of people are interviewed and asked how they perceive corruption in about 150 countries. No TEs are on the top of the list (they are not classified as entirely honest countries).

In those TEs, which are perceived as least corrupt in CPI-assessment, is the highest concentration of FDI (in relative terms). Poland, Romania, Ukraine, and Russia have a low ranking in CPI-table and a rather modest FDI stock.

It is a well-known fact that Western Europe is better off than post-communist part of the Old Continent. However, the gap in living standard between these two is not very deep when differentials in price levels are taken into consideration. Generally speaking, prices are lower in the East than in the West. Therefore, comparisons in wellbeing must take purchasing power parity corrections into consideration. GDP per capita figures PPP-adjusted show that living standard in Slovenia is higher than in Portugal. Slovenia is far the richest TE in our comparison.

All TE-currencies are undervalued, but not in the same manner. Slovenia's undervaluation is very modest, while in Ukraine it is remarkably high. Differences can be measured via exchange rate deviation index (ERDI).

Nominal wages are still very advantageous in TE-region in average. Countrywide differences are remarkable. "Real" wages in TEs are much higher than "nominal" ones: "real" income figures are PPP-adjusted.

In cost level comparisons, it is important to note that less than half of FDI stock in TE-region is invested into industry (manufacturing). Actually, about two thirds of that stock is in assets linked with service sector.

There are capital intensive and labour intensive branches in manufacturing. Obviously, firms belonging to the latter, have special interest in starting activities in TE-region with relatively cheap labour costs. Thus, price and wage issues in TE-region are of importance.

Unit labour costs (ULC) were very advantageous in TE-region in 2000 compared with Austrian level, PPP-adjusted (Austria is taken as proxy for EU-15). However, ULC in TE-region shows increasing tendency in 2000-2005 (in comparison to Austria). The relative ULC figure, however, has in that period decreased somewhat in Latvia, Lithuania, and Poland.

In Slovenia, ULC figure in 2005 was about one fourth lower than in Austria. Thus, ULC gap between these two neighbouring countries is not remarkable. If Slovenia with her rather high income level was left out of the calculation, the average ULC level in TE-region (eleven countries) would be just about one third of the Austrian level. The cheapest ULC figure can be found in Bulgaria and Ukraine, which have both ULC levels of about one fifth of the Austrian equivalent. Thus, labour cost savings can be achieved by moving labour intensive activities in production from the West to the East in European framework.

Especially cheap labour in Bulgaria has not been able to guarantee equilibrium in current account. Far the most expensive ULC figure is in Slovenia (within TE-group), which has a well balanced CA. Thus, modest-level ULC cannot be linked with overall competitiveness which is supposed to be reflected in CA results. Furthermore, Slovenia has an essentially lower unemployment rate than Bulgaria.

In the second decade of post-communist development, a very diversified picture can be observed within the selected twelve TEs. Differences are very visible both in institutional frameworks, as well as in economic results between individual transitional economies.

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Transitional Economies and International Competitiveness

This 31st volume in the series of NORDI deals with various aspects of international competitiveness in twelve transitional economies, eight of which belong to EU. Although in the early years of the 21st century transitional economies have grown clearly faster than traditional market economies in Europe, business environment comparisons show striking dissimilarities within the countries under review. However, the majority of transitional economies is very competitive in labour costs.

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