Industrial Development in Transition Economies: Lessons and Implications

Masahiko Gemma

It was ten years ago when drastic changes in political and economic systems in Central and Eastern European countries started. The collapse of the former Soviet Union followed in the early stage of the ten years. As a consequence of the alteration and disintegration, a great number of economies has been in transition in the Eurasian Continent. Many are still in struggle with economic development under new economic principles. It is a worthwhile exercise to review the experiences of these transition economies and to learn the lessons from them.

Industrial development is a necessary condition for economic growth. Historical data show that the growth rates of industrial sectors have been much higher than those of primary industries such as agriculture. The contribution of industrial development to economic growth has been large. Even for transition economies, the same trend has been observed.

In this paper, determinants of industrial growth in transition economies are reviewed using existing literature and data. Statistical methods are utilized for data analyses. Policy implications are then derived based upon the observations from the first section and relevant Japanese experience.

Conditions for the Growth of Enterprises in Transition Economies

In transition economies, enterprise development is a prerequisite for industrial development. The dominance of large state companies in most markets and distorted incentive structures had resulted in production inefficiency and low profitability under the old centrally planned systems. Substantial reforms in enterprises have been essential in transition economies.

What have been the ingredients for the success of enterprise development in

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2) The utilized data are summarized in Appendix 1.
transition economies? EBRD (Chapter 7, 1999) showed the findings from an empirical study on the relationship between the growth of enterprises and competition in output markets. The connection of the performance of the surveyed enterprises to budget constraints was also analyzed in the same study. A major conclusion is that the competitive environment among enterprises resulted in higher growth rates of participated enterprises in the same markets. The growth of business activities was found to be slower for the enterprises operated under softer budget constraints. For the latter examination of the cross-country study, the growth of the enterprises was measured in terms of the share of the enterprises that have developed new products in the markets. The seriousness of budget constraints was measured as the ratio of the number of the enterprises that delayed their tax payments to the total surveyed number of enterprises. The creation of competitive and financially disciplined economic environments has been proven to be a key for the growth of enterprises in transition economies.

The same study also showed that the growth in sales has been slow for state enterprises in Central and East European and the Baltic countries. Newly created private companies and privatized former state enterprises have expanded their sales activities faster. In Central Asia (Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan) and the Caucasus (Armenia, Azerbaijan and Georgia), the real values of total sales declined overtime after independence. The decrease was the largest for the privatized former state companies. The privatized companies have been facing difficult time in the periphery areas of the CIS. Privatization has not provided an opportunity for business expansion. It has rather created worse economic and social conditions in many local communities where these former state firms are located.

How have the efforts on enterprise reform and competition policy made a difference in economic performance? Equation 1 shows the relationship between enterprise reform and economic growth for Central and Eastern European countries and the CIS countries. Equation 2 also examines the relation between competition policy and economic growth. A significant correlation was found in each equation. This implies that higher achievements in enterprise reform and competition policy are the contributing factors for higher economic growth in these transition economies.

\[
\text{GDP} = -18.88^{***} + 6.01^{***} \text{ENTREFORM} \quad (1)
\]
\[
(\text{Adjusted } R^2 = 0.26 \quad \text{D.F.} = 23)
\]
\[
\text{GDP} = -14.73^{***} + 4.53^{**} \text{COMPETITION} \quad (2)
\]
\[
(\text{Adjusted } R^2 = 0.19 \quad \text{D.F.} = 23)
\]
The average annual growth rate of GDP (Gross Domestic Product) for the period between 1990 and 1998 was regressed on the indices of enterprise reform and competition policies in these equations. The numbers for the GDP growth were obtained from World Bank (pp. 250-251, 1999). The indices for enterprise reform and competition policies were taken from EBRD (1999). The higher the numbers are, the deeper the extent of reform is for these indices. The data were collected from 25 countries in Central and Eastern Europe and the CIS.

Reforms in other areas of the economies are also important for better economic performance. The following equations prove the importance of banking sector reform and improvement in legal effectiveness of company law. Both indices were prepared by EBRD (1999).

\[
\text{GDP} = -15.90^{***} + 4.40^{***}\text{BANKREFORM} \quad (3)
\]
\[
\begin{array}{c}
\text{GDP} = -12.30^{***} + 2.49^{*}\text{LEGAL} \\
\text{Adjusted } R^2 = 0.27 \quad \text{D.F.} = 23
\end{array}
\]

\[
\text{GDP} = -1087.53 + 940.18^{*}\text{COMPETITION} \quad (5)
\]
\[
\begin{array}{c}
\text{FDI} = -1087.53 + 940.18^{*}\text{COMPETITION} \\
\text{Adjusted } R^2 = 0.11 \quad \text{D.F.} = 23
\end{array}
\]

*** one percent significance level   ** five percent significance level   t-statistics in parentheses

GDP: average annual growth rate of GDP for 1990-1998
ENTREFORM: EBRD index on enterprise reform for 1998
COMPETITION: EBRD index on competition policy for 1998
\[ \text{NETFLOW} = -1249.18 + 1353.39 \text{ COMPETITION} \]  \hspace{1cm} (6)  
\[ (\text{-0.64}) \hspace{1cm} (1.52) \hspace{1cm} \text{Adjusted } R^2 = 0.05 \hspace{1cm} \text{D.F. = 22} \]

* ten percent significance level  \hspace{1cm} t-statistics in parentheses

FDI: foreign direct investment for 1997 in million US dollars  
NETFLOW: net private capital flow for 1997 in million US dollars

The data for the dependent variables were obtained from World Bank (p. 270, 1999). Net private capital flow covers a wider range of capital movements. It consists of private debt and non-debt flows. Private debt flows here include commercial bank lending, bond and other private credits; non-debt private flows comprise foreign direct investment and portfolio equity investment.

**Employment Effects**

The transformation process from centrally planned economies has required drastic changes in the places of work for a large number of people. In the former state companies, many workers have had to give up their old jobs for the sake of the success in privatization. On the other hand, newly created businesses have given the opportunity for employment to many displaced people.

What type of enterprises has created more jobs than others? Bilsen and Konings (1998) proved by a case study using the data from Bulgaria, Hungary and Romania that newly created enterprises had created the largest number of employment. With a larger number of samples from most transition economies, EBRD (Chapter 8, 1999) also showed that new employment was mostly created in the newly started enterprises in transition economies. These conclusions suggest that newly created private enterprises be important targets for labor policy.

**Performance Difference among Enterprises**

How does the economic performance differ among state enterprises, privatized companies and newly created firms in transition economies? Frydman, Gray, Hessel and Rapaczynski (1997) employed a set of enterprise data from Czech Republic, Hungary and Poland to examine the performance difference among these three types of businesses. A major finding is that the performance and new employment contribution were the highest for the privatized enterprises. Among the privatized and newly created companies, the profitability and newly created jobs were larger for the enterprises that have shareholders outside of the organizations. The privatized companies that were bought by the management group and/or workers did not perform better than others.
Djankov (1998) conducted a similar study for a selected group of the former Soviet Union countries. The micro level data from Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia and Ukraine did not demonstrate a significant difference in labor productivity by types of the ownership among the surveyed enterprises. This might be considered as an evidence of the delays in privatization and creation of the competitive environments in these economies. Private enterprises seem to have been facing difficulties in improving productivity.

**Barriers for Market Entrance**

What have been the major obstacles to enterprises when they have entered to new markets in transition economies? An enterprise survey conducted by the EBRD showed that the existing tax policy and regulations were considered the highest hurdles to the surveyed firms (EBRD, p. 151, 1999). Inflation, lack of financial services, corruption, non-competitive behavior and lack of infrastructure followed them in the ranking list of the barriers to market entry. Tax policy and regulations, Inflation and lack of financial services received significantly higher marks than the other reasons.

For Central Asian and Caucasus countries, the indexes that show the levels of hurdles were lower than the average of the all surveyed transition economies for the barriers on tax policy and regulations, lack of financial services and non-competitive behavior. For the obstacle indexes for inflation, corruption and lack of infrastructure, the numbers were higher than the overall average. Urgent needs exist for improvement in these latter three areas in the Central Asian and Caucasus countries.

An interesting finding was obtained in this survey regarding the conditions surrounding state enterprises. The share of the answers that indicated the concerns on the lack of financial services was higher for the state companies than private enterprises. Even state companies are struggling in finding financial resources under the new economic environments.

The relationships between financial services and reform measures were examined using the data from World Bank (pp. 260-261, 1999) and EBRD (1999). The results showed that domestic credits provided by the banking sector were larger in the economies with higher achievements in enterprise reform, large-scale privatization and small-scale privatization. The financial sector activities are certainly larger in the reformers of enterprises. Larger bank credits should help these economies to grow faster.

\[
\text{BANKCREDIT} = -10.14 + 17.70^{**} \text{ENTREFORM} \\
\text{Adjusted } R^2 = 0.18 \quad \text{D.F.} = 18
\]
\[
\text{BANKCREDIT} = -4.91 + 11.99^{**}\text{LGPRI} \quad (8)
\]
\[-0.29 \quad (2.16) \quad \text{Adjusted R}^2 = 0.16 \quad \text{D.F.} = 18 \]

\[
\text{BANKCREDIT} = -23.92 + 14.54^{**}\text{SMPRI} \quad (9)
\]
\[-1.02 \quad (2.36) \quad \text{Adjusted R}^2 = 0.19 \quad \text{D.F.} = 18 \]

\[
** \text{ five percent significance level} \quad \text{t-statistics in parentheses}
\]

\text{BANKCREDIT: domestic credit provided by the banking sector as percentage of GDP}
\text{LGPRI: EBRD index on large-scale privatization}
\text{SMPRI: EBRD index on small-scale privatization}

\textbf{Roles of Small and Medium Sized Enterprises}

Under the old centrally planned system, it was commonly observed that a small number of large state enterprises dominated each market in production and provision of services. Marketing of the outputs was carried out also by a few marketing organizations. In the market economy, different sized companies coexist in many markets. Large sized operation does not necessarily guarantee the lowest average cost of operation. In many markets, there are cases that small sized enterprises are performing better than large corporations. For large enterprises, purchase of input materials on demand from outside suppliers, which are in many cases small and medium sized companies, makes sense for improving their financial positions. Therefore, the coexistence of large and small sized enterprises is economically rational phenomenon in the market economy.

In the transition economies, we have observed that newly created enterprises have been mostly small and medium sized businesses. For this type of the enterprises, the production values have been increasing fast and net employment numbers have been expanding. EBRD(Chapter 8, 1999) found that 95 percent of the total number of newly created enterprises was small and medium sized among the surveyed firms. Within this particular group, 54 percent had less than 9 employees. The companies with the number of employees between 10 and 49 explained additional 27 percent. For the group of the enterprises with less than 9 employees, newly created enterprises occupied 89 percent of the group population in the EBRD survey. This confirms the fact that the number of small sized enterprises was much smaller before. As for new employment creation in transition economies, Konings, Lehmann and Schaffer (1998) showed that the smaller sized enterprises have increased their net employment more than the bigger sized businesses using a set of data from the Polish manufacturing sector. Overall, small and medium sized businesses have been key players in the tran-
sition process of the enterprises. This was the case for especially in the industrial and service sectors.

**Barriers for the Development of Small and Medium Sized Enterprises**

I have already discussed in the above that problems related with tax policy and regulations are the major barriers to market entry in transition economies in general. How much extend is this observation relevant to small and medium sized enterprises in these countries?

In a macro-level comparison of the transition economies, EBRD (p. 157, 1999) found that tax systems are simpler in the economies with better macroeconomic performance. Simple tax systems can reduce the room for corruption. The levels of the taxes on business profits are lower in the relatively successful economies. Since most progressed enterprises are small and medium sized in these countries, simple, easy to understand tax systems and low rate of business taxes must have been of benefit to the development of small and medium sized enterprises.

We observe that preferential tax and financing policies exist for the small and medium sized enterprises in every transition country. However, we have not found obvious performance difference between the sectors at target and the rest of the economies. The existence of such specific programs does not seem to be a sufficient condition for the improvement in the performance of the targeted sectors and overall development of the country's industrial development. Rather a tax reform to make overall tax system simpler seems to be more effective for industrial development.

**Characteristics of Small and Medium Sized Enterprises**

Characteristics of small and medium sized enterprises will be considered here. In Japan, the small and medium sized enterprises occupy 99 percent of the total number of enterprises, 55 percent of the total value added and 70 percent of the total employment in the industrial sectors (Agency for Small and Medium Sized Enterprises, 1998). In the service sectors, these shares are even higher.

The value added share is higher than the employment share by 15 percent in the Japanese industrial sectors. Using 70 percent of the total labor input, only 55 percent of the total output is produced. This implies that labor productivity is lower for small and medium sized enterprises than large corporations. Why has the development of small and medium sized economies been feasible in Japan in spite of this structural disadvantage?

Here is an explanation. Labor productivity can be decomposed into two parts as follows.
Labor Productivity = \( \frac{Y}{L} \) = \( \frac{A}{L} \times \frac{Y}{A} \)

Labor Productivity = \( \frac{Y}{L} \) = \( \frac{A}{L} \) / \( \frac{Y}{A} \)

Capital-Labor Ratio = Capital (Fixed Assets) (A) / Number of Employees (L)
Investment Efficiency = Value Added (Y) / Capital (Fixed Assets) (A)

Capital-labor ratio shows the amount of fixed assets per employee. Investment efficiency is the index to demonstrate how much output in values one unit of capital (fixed assets) can create. Large enterprises generally have sizeable investment on fixed assets and this capital-labor ratio is much higher than the small enterprises. This discrepancy creates the difference in labor productivity among different sized enterprises. Capital efficiency, on the other hand, is higher for small and medium sized enterprises than large companies. Smaller firms are more efficient in terms of the use of fixed assets.

In Japan, the average level of labor productivity is about 45,000 dollars per employee for the small and medium sized enterprises (Agency for Small and Medium Sized Enterprises, Appendix p. 24, 1998). Here, the small and medium sized enterprises were defined as the companies with less than 100 million Japanese yen of principle capital. The large firms have the average labor productivity of approximately 90,000 dollars. The capital-labor ratio of the small and medium sized enterprise is 67,000 dollars on average, while the same ratio for the large enterprises is 205,000 dollars. The difference is three times. However, the investment efficiency ratio for the small and medium sized firms is 50 percent higher than for the large companies. The former group holds the average investment ratio of 0.67 and the latter holds the ratio of 0.44.

High capital-labor ratio generates high profit when the amount of sales expands. However, when the sales amount declines, the company's profit shrinks fast because of the existence of high fixed costs. This gives instability in financial management of the firm. Therefore, low level of capital-labor ratio for the small and medium sized enterprises makes economic sense for the maintenance of stability in profit making over time.

For the investment efficiency ratio, the higher the ratio is, the better for any enterprise regardless of the size of the operation. Small and medium sized enterprises have been maintaining higher ratios as a result of better management of the allocation of scarce resources, technical innovation and employee training. Large firms such as Sony Corporation and Honda Automobile Company used to
be in a small operation at the beginning of the company development process fifty years ago. Continuous efforts for better allocation of human resources and other input resources and technical innovation have been the sources for the success in business development. The investment efficiency ratios for these firms have been always high. Technical innovation has been size neutral. With superior technology, small and medium sized enterprises can be quite competitive.

Promotion of Small and Medium Sized Enterprises

Small and medium sized enterprises are competitive if the investment efficiency ratio can be maintained high. Better management of the allocation of scarce resources, technical innovation and employee training are the secrets of success for high investment ratio. Then, what would have to be done for achieving this? What can be the roles of the government to improve this ratio?

Obtaining the financial resources, investing money and human resources in research and development activities, and developing human resource are the critical issues for small and medium sized enterprises when they make efforts to improve the investment efficiency ratio. Large firms with a substantial amount of fixed assets can borrow money from banks by putting the assets as collateral. Large corporations can also obtain investment funds directly from capital markets through issuing new stocks and bonds. For small and medium sized enterprises, which have typically little collateral and market recognitions, the possibilities for bank loans and direct financing are limited. There exists a trap for them to use high interest rate financing. Provision of preferential loans to the small and medium sized enterprises with reasonable business plans by the public sector should be allowed to encourage the business activities of this group of the firms.

As for the activities of technical innovation and human resource development, small and medium sized enterprises are in many cases behind large corporations. The numbers of out flow of employees are also larger for small and medium sized companies because of lower wages. Improvement of skills and knowledge of employees can contribute to the increase in labor productivity and may help to reduce transaction costs for hiring. The government programs to encourage training of the employees of the small and medium sized enterprises would be valuable assistance to this group of companies.

In Japan, the Agency for Small and Medium Sized Enterprises was created in the early stage of economic development under the Ministry of Industry and International Trade. Information gathering, and policy making and executions have been conducted by this organization for the development of this sector. During the rapid economic growth period, sector specific promotion policies, preferential treatments on tax and financing, support for establishing business asso-
ciations and organization of training and advisory programs and services were undertaken by this agency. In this period, many small and medium sized enterprises established close ties with large corporations as input suppliers in the manufacturing sector. Besides this vertical integration of different sized enterprises, horizontal cooperation also emerged. At the end of this period, the programs to help small and medium sized enterprises for the improvement of labor productivity were introduced. Labor cost became relatively expensive and mechanization was required for staying competitive in the same markets. The government helped the small and medium sized enterprises with preferential credits.

After the first oil shock in 1973, shifts of production across markets took place. Energy saving technology had to be introduced to reduce the cost of production. Diversification of production was observed as a means to reduce the risk on major failure in sales. In response to the changes in the needs of small and medium sized enterprises, the government altered its programs toward this group of firms. Advantageous credits were offered for the efforts to diversify and switch.

After the Plaza Agreement in December 1985, the Japanese currency of yen started its continuous appreciation against U.S. dollars and U.S. dollar pegged currencies in Asia. This accelerated the process of moving of production sites to abroad for large corporations, and also initiated new openings of business and production sites in abroad for many small and medium sized enterprises. The Japanese government helped latter group of the companies to expand their activities to abroad through preferential credits. The government programs have been flexibly adjusted to the changes in business climates surrounding small and medium sized enterprises over time.

Implications to Transition Economies

What are the implications of the lessons learned from the last 10 years experience of transition efforts and the Japanese experience of promotion of small and medium sized enterprises?

The impacts of enterprise reform, competition policy, bank reform and legal effectiveness of company law on economic growth were significant in the statistical analyses. Further advancement in the reform measures in these areas should lead to faster economic growth in the transition economies. Competition policy has also been influencing the decisions on foreign direct investment. Freer environments in the entrance to the domestic markets seem to attract more investment from abroad in these countries.

The activities of the financial sectors have been larger for the economies with faster advancement in enterprise reform and privatization. More efforts in enter-
prise development should stimulate financial activities in the former centrally planned economies. Financial deepening is a necessary process in economic development, especially for transition economies.

Tax policy and regulations, inflation, lack of financial services, corruption, non-competitive behavior and lack of infrastructure should be lowered or removed as much as possible. These factors were found as the barriers to business activities in the surveyed economies.

Most companies that have been created in recent years are small and medium sized in the transition economies. This type of the firms has been the source for the creation of new employment. As the Japanese experience shows, as long as investment efficiency is high, small and medium sized enterprises can be as competitive as large enterprises in the markets.

Release of preferential credits, offer of tax exemptions, provision of consultant services and training courses to employees and institutional building have been the tools of the governmental assistance to small and medium sized enterprises in Japan. However, the overall size of the governmental supports has been minimal. For example, the share of the investment money that has been allocated through the governmental channels has been very small. This source of money has occupied only a few percent of the total investment fund allocated to the industrial sectors. The activities of private financial institutions have not been pushed away by the government provision of soft loans. Distortions created by government interventions in financial markets have been small. The government roles to create suitable economic environments that have allowed new market entries and competitions have been more critical for the growth of enterprises, especially better performed and employment absorbing small and medium sized enterprises.

Needless to say, along with the supports on financing, advisory services and institutional building, the maintenance of sound macroeconomic environments, which can promote firm growth of domestic industries, is a required role for the government. Without macroeconomic stabilization, any micro level attempts would fail. This seems to be very important for the transition economies, which have been in battle with inflation and balance of payment problems.

Deregulation can also stimulate business activities and result in further industrial development and better consumer satisfaction. A World Bank study (1994) was an endeavor to explain the rapid economic growth in East Asia. An observation made in this study was that in spite of active government involvement in industrial development, the economies in East Asia achieved fast economic development because of the existence of relatively competitive markets. The rates of growth would have been even faster, if the governmental intervention had been
less significant, the same study implied.

At the time of the start of the Asian economic crisis in 1997, unclear process of policy decision making and indeterminate exit rules were partly blamed for the sharp decline of the investor confidence. Transparency in government operations seems to be most critical for sustained economic growth. In this regard, the following equations show interesting pictures regarding the relationship between political conditions and economic performance in transition economies. Larger numbers in the political right index implies less freedom in political activities here. Although the coefficient is only significant at the 15 percent significance level, a tendency of poorer economic performance in the countries with less political freedom is observed in equation 10. The accomplishment in enterprise reform has been subjective to the political conditions, we can also observe in equation 11. Freer political environments would promote better economic performance in the former socialist countries.

$$\text{GDP} = -2.36 + -0.85 \text{ POLRIGHT} \quad (10)$$

$$(-1.09) \quad (-1.62) \quad \text{Adjusted R}^2 = 0.06 \quad \text{D.F.} = 23$$

$$\text{ENTREFORM} = 2.87*** + -0.18*** \text{ POLRIGHT} \quad (11)$$

$$(21.37) \quad (-5.39) \quad \text{Adjusted R}^2 = 0.54 \quad \text{D.F.} = 23$$

*** one percent significance level  t-statistics in parentheses

POLRIGHT: political right index for 1999 developed by Freedom House (2000)

References
Appendix 1  Selected Data on Transition Economies

<table>
<thead>
<tr>
<th></th>
<th>GDP Percentage</th>
<th>ENTREFORM Index</th>
<th>COMPETITION Index</th>
<th>BANKREFORM Index</th>
<th>LEGAL Index</th>
<th>FDI $ Million</th>
<th>NETFLOW $ Million</th>
<th>BANKCREDIT GDP Ratio</th>
<th>LGPRI Index</th>
<th>SMPRI Index</th>
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Definitions and sources are explained in the text and references.