



USAID
FROM THE AMERICAN PEOPLE

20 YEARS OF USAID ECONOMIC GROWTH ASSISTANCE IN EUROPE AND EURASIA

7/24/2013

20 YEARS OF USAID ECONOMIC GROWTH ASSISTANCE IN EUROPE AND EURASIA

7/24/2013

This publication was produced under the direction of the United States Agency for International Development. It was prepared by SEGURA Partners LLC under the SEGIR Global Business, Trade and Investment II Indefinite Quantity Contract (IQC), Number EEM-I-00-07-00001-00 Task Order # 05, Regional Competitiveness Initiative.

Table of Contents

DEDICATION	ii
ACKNOWLEDGEMENTS	iv
LETTER FROM USAID ASSISTANT ADMINISTRATOR, PAIGE ALEXANDER	v
LIST OF ACRONYMS	vii
Highlights of Economic Assistance in the E&E Region	1
Executive Summary.....	2
I. LESSONS LEARNED	12
II. INTRODUCTION	16
SEED and FSA Acts.....	16
USAID’s Operational Response	19
III. CONTEXT FOR ECONOMIC ASSISTANCE	22
Requirements to Transition to a Market Economy	23
Differences among the Countries.....	25
IV. USAID APPROACHES BY TECHNICAL AREA	28
Overview	28
Macroeconomics and Fiscal Reform.....	29
Privatization	36
Financial Sector and Capital Market Development	41
Private Enterprise Development.....	59
Energy/Infrastructure.....	72
Agriculture/Land.....	86
IV. TRANSITION SCORECARD – INDICATORS OF PROGRESS	94
V. CHALLENGES REMAINING	100
APPENDICES	102
Appendix 1 - Chronology of USAID Presence in the Region	103
Appendix 2 - Chronology of Major Events in the Region	104
Appendix 3 – List of Interviews.....	109
Appendix 4 – Bibliography	112
Appendix 5 – Legacy Institutions.....	116
Appendix 6 – Funding Summary.....	120
Appendix 7 – U.S. Objectives and Measuring the Contribution of Aid.....	125
Appendix 8 – Interpreting the “Transformation Depression”	129
Appendix 9 – Twenty Years of USAID EG Work in Russia	135
Appendix 10 – Country Groups and Classifications	138
Appendix 11 – Guidance for Revised AEECA Phase-Out Framework.....	140
Appendix 12 – The Development Credit Authority – Europe and Eurasia Region.....	148
Appendix 13 – The Enterprise Funds in Europe and Eurasia: Successes and Lessons Learned (excerpt).....	150

DEDICATION

Dedicated to the nationals of the 29 countries in the Europe and Eurasia region who over more than 20 years became our friends, co-workers, counterparts, and partners in what might well be the greatest political and economic transition in modern history. Thank you for the manner in which you received the assistance that the American people sought to give; and thank you for what you gave to us in return. Together we were able to tear down a wall, assist in your historic economic and political transformation process, and create jointly the institutional, legal and regulatory frameworks that underpin a market economy; from independent central banks to advocates for business interests; from high value agriculture to increasing eco-tourism; from sound pension schemes to inclusive economic opportunity. Together, we are traveling the path toward competitive markets and individual fulfillment.

**“General Secretary Gorbachev, if you seek
prosperity for the Soviet Union and Eastern Europe,
if you seek liberalization, come here to this gate.**

“Mr. Gorbachev, open this gate.

“Mr. Gorbachev, tear down this Wall.”

*Delivered June 12, 1987 by Ronald Reagan from the
Brandenburg Gate.*

“A society in which individuals have freedom of economic choice, freedom to own the means of production, freedom to compete in the market place, freedom to take economic risk for profit and freedom to receive and retain the rewards of economic decisions is a fundamental objective of the A.I.D. program in less developed countries. Such a private enterprise economy is held to be the most efficient means of achieving broad-based economic development. Private enterprises that respond to profitable opportunities in a free market produce jobs, managerial skills and economic growth. They contribute wealth to society and improve the quality of life. Moreover, significant equity objectives can be achieved when market forces operate to stimulate an economy toward full employment.”

A.I.D Policy Paper: Private Enterprise Development,
March 1985

“The Congress finds that the development of private enterprise, including cooperatives, is a vital factor in the stable growth of developing countries and in the development and stability of a free, open and equitable international economic system. It is therefore in the best interest of the United States to assist the development of the private sector in the developing countries and to engage the United States private sector in that process.”

The Private Sector Investment Program
Section 108 of the Foreign Assistance Act of 1961, as amended

ACKNOWLEDGEMENTS

The findings in this report reflect a great number of interviews with current and former U.S. government officials, Congressional staffers, implementing partners, international financial institution staff, and counterparts, both U.S. citizens and nationals from the region. The authors thank all of them for the time allotted to share their personal papers, knowledge and experience. The team also reviewed key documents produced by USAID as well as other leading donors such as the World Bank, IMF, and EBRD. (See appendices 3 and 4 that list those interviewed and key documents reviewed.)

The idea for initiating this 20 Year Review originated in the Office of Economic Growth within USAID's Europe & Eurasia Bureau. Technical guidance was provided by: Jerry Bisson, Steve Eastham, Neal Nathanson, Robert Archer and Skip Kissinger.

The team of authors was contracted by SEGURA Consulting LLC under the Regional Competitiveness Initiative. Team members included the following section leaders: Writer/Chief of Party - Teresa Mastrangelo, Macroeconomic and Fiscal - Prof. Paul Marer, Private Enterprise Development - Stephen Silcox, and David King of Cardno Emerging Markets, Ltd., Financial Sector Development - Jean Lange and Lori Bittner of Deloitte Consulting, Energy/Infrastructure - Alain Streicher, and Agriculture/Land - Marcus Winter.

Additional support was received from Richard Burns in the field of privatization and financial sector development, and from Deloitte team members in the field of Macroeconomics and Fiscal Reform. The authors gratefully acknowledge the immense project and document management efforts of Anne-Sophie Samjee of SEGURA Consulting and the support of Jorge Segura.

The scope of work is limited to an examination of USAID's strategic approaches to economic assistance, not its entire portfolio, and is not an evaluation of the impact of particular projects. For more project details, we have compiled a digital volume of the reports for the countries in the region that have graduated from USAID assistance, a report on the Enterprise Funds, and other similar retrospectives produced by individual country missions reflecting on the past 20 years (see Appendix 14).

LETTER FROM USAID ASSISTANT ADMINISTRATOR, PAIGE ALEXANDER

Dear Readers,

The economic assistance to the Europe and Eurasia region was multi-dimensional and complex in terms of time, geography, sectors, and operational approaches. USAID and the E&E Bureau have a great story to tell about their role in helping the countries of the region transform from centrally planned economies to market-oriented ones. Evidence of the change is more easily apparent in the strategic reliance we place upon each other to maintain a safe and secure world. What has been less understood is the role that we took as partners and advocates for economic reform and restructuring. USAID, in collaboration with its host country counterparts and other donors, provided expert advisors to transfer knowledge and experience; promoted a sound business environment and commercial law to allow international and domestic investment; fostered small and medium business growth; put in place functioning financial systems; adopted modern business accounting; and encouraged innovation and entrepreneurship.

The American people can be proud of our results which have contributed to the economic stability and increased prosperity critical to strengthening democracy:

- Thousands of enterprises and banks privatized, often with foreign investment that adopted modern practices and increased efficiency so consumers could have a wider choice and improved quality of goods and services to buy
- Dozens of effective financial sector regulatory bodies established based on international standards, and staffed by well-trained professionals
- Electricity supply reliability is greatly improved through private sector investment and reforms aimed at energy efficiency are underway
- Hundreds of business advocacy organizations created, and improved government agencies whose human capital we helped to build so that they could be instrumental in streamlining processes and optimizing regulations to improve the business environment
- Tens of thousands of small and medium enterprises in key sectors established or upgraded, which in turn created millions of new jobs and increased incomes by connecting them with sustainable markets

In addition, 10 countries have since joined the EU with USAID's economic assistance, and an eleventh (Croatia) is to be admitted in 2013. Others remain candidates which we continue to assist. We are also proud that many of the countries met development goals allowing us to concentrate our support to those with greater needs by graduating 13 countries from intensive, on-the-ground assistance.

It is simply not enough, however, to declare our task done and depart the region, given the region's current economic challenges which threaten to undermine democratic progress — high unemployment, fragile financial sectors, eroding support for improved economic governance, and impacts of the Eurozone financial crisis. We must continue supporting regional economic growth so that the institutions of the market-based economies remain sufficiently robust and that markets thrive, grow, and change to meet the needs of our globalizing world. We must stay ahead of the change, in order to preserve the economic well-being of the many friends we now

have in the region as well as to protect our national security, but we must do so in a focused and financially modest manner.

Thank you for all of those who contributed to our successes during the past 20 plus years and I look forward to our continued partnership.

Paige Alexander

USAID Assistant Administrator
USAID/ Europe and Eurasia

LIST OF ACRONYMS

AEECA	Assistance for Europe, Eurasia and Central Asia
API	Agribusiness Partnership Component
BEE	Business Enabling Environment
CARs	Central Asian Republics
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
DCA	Development Credit Authority
DOE	Department of Energy
E&E	Europe and Eurasia
EBRD	European Bank for Reconstruction and Development
ECA	Europe + Central Asia
ECSEE	Energy Community of South East Europe
ERRA	Energy Regulators Regional Association
EU	European Union
FDI	Foreign Direct Investment
FDIC	Federal Deposit Insurance Corporation
FSA	Freedom for Russia and Emerging Eurasian Democracies and Open Markets (FREEDOM) Support Act
FSNs	Foreign Service Nationals
FSRP	Food Systems Restructuring Project
FSU	Former Soviet Union
FtF	Farmer to Farmer
GDP	Gross Domestic Product
GMO	Genetically Modified Organism
IFIs	International Financial Institutions
IMF	International Monetary Fund
IQC	Indefinite Quantity Contract
LED	Low Emission Development
LiTS	Life in Transition Survey
LTMC	Long-Term Marginal Cost
MCP	Monitoring Country Progress
MPP	Mass Privatization Programs
NARUC	U.S. National Association of Regulatory Utility Commissioners
NGO	Nongovernmental Organizations
NIS	Newly Independent States
SEC	Security and Exchange Commission
SECI	South Europe Cooperation Initiative
SEE	South East Europe
SEED	Support for Eastern European Democracies
SOE	State-owned Enterprise
TA	Technical Assistance
TIFS	Training Institute for the Financial Supervision
USAID	United States Agency for International Development
USDA	United States Department of Agriculture
USEA	United States Energy Association

Highlights of Economic Assistance in the E&E Region

The collapse of Communism in Europe was dramatic. After dominating Eastern Europe for more than 50 years, the Communist regimes collapsed within a matter of six months in 1989. Two years later the Soviet Union also collapsed, bringing to an end the system that had ruled for most of the 20th Century.

When the Communist systems collapsed, neither the governments nor the productive sector of these countries had any real experience with private enterprise based on supply and demand, profitability, prices, quality and competition. Instead, production was the objective, driven by the centralized Five-Year Plan, and meeting mandated production targets was the key achievement measure. Failure of that system had led to widespread dysfunction, corruption, food and energy shortages, and a dispirited population.

The U.S. government's response to the fall of the Berlin Wall and subsequent breakup of the Soviet Union was rapid and generous. USAID and other donors had to start from scratch in shifting the mindsets of government, company managers, and the population away from dependence on the collective state and toward the risks and rewards of profit-oriented private enterprise.

- The E&E countries' success in building financial sectors, which fueled private-sector led growth, was a major achievement. USAID contributed enormously to accelerating the development of market-oriented financial sectors in Europe and Eurasia. It became a key partner to these countries as they developed sound private financial sectors based on U.S./Western commercial and regulatory principles and practices.
- While not without some unintended consequences, USAID-supported privatization transferred the ownership of thousands of state-owned enterprises into private hands. Privatization and de-collectivization of agriculture transferred land to millions of individuals.
- USAID's energy programs facilitated the efficient and reliable supply of energy (principally natural gas and electricity), and worked to reduce the extent to which countries in E&E are dependent on Russia for energy. Efficient and reliable energy is essential for both competitive enterprise growth and for the health and welfare of individuals.

While much work remains to be done in the region to ensure reliable energy supplies, efficient agricultural production, robust sound financial markets and good corporate governance, USAID helped accelerate reforms in all these areas and put in place the fundamental public and private institutions necessary to continue the reform process. E&E's economic growth and private sector development assistance continues to have impact beyond the timeframe of specific projects in

two ways: 1) long-lasting business relationships brought about through improved competitiveness, and 2) the creation of capabilities in people and institutions to carry out policies, strategies, and activities. However, continued USAID technical support for private sector development and industrial and employment growth remains a priority in those countries where the reform process was more difficult for either political or economic reasons.

The evidence is quite convincing that USAID, working with local decision makers in the E&E region, succeeded in supporting the transformation of all or most countries from centrally planned to market-driven economies. Since none of the countries is likely to go back to the Soviet, communist model, USAID can be proud of an unqualified success in establishing the irreversibility of reforms in all of the Central, Eastern and Southeastern European countries.

Two relevant measures of the significance of U.S. transition assistance are: 1) the relative costs of the transition assistance compared to Cold-War military assistance; and 2) the economic gains accruing to U.S. economic interests as a result of the regional transformation.

According to a Cato Institute study,¹ U.S. military expenditures for the period 1948-1986 totaled \$6.3 Trillion, or about \$163 billion per year. By comparison, the total expenditure by the U.S. government in support of the transformation from 1990 – 2012 was \$20 Billion, or about \$900 million per year.

Prior to 1990, the markets of Eastern Europe and the Soviet Union were essentially closed to U.S. businesses. However, U.S. exports to Russia in 2012 exceeded \$10 billion² – an amount equal to approximately one half of the total 22 year expenditure by the U.S. in transformation assistance.

EXECUTIVE SUMMARY

The transition to vibrant, free-market democracies in Central and Eastern Europe and the former Soviet Union has been dramatic over the 23 years period reviewed (1989-2012). Countries previously hidden from view behind an Iron Curtain are now open, engaged, and active participants in the global economy.

We nostalgically remember the election of the Solidarity party in Poland, the fall of the Berlin Wall in 1989, and perhaps most significantly, the collapse of the Soviet Union. In contrast, we may find it is easy to forget the images of people spending their days standing in long lines for bread and other goods in perpetual shortage and the real concerns of mass starvation, civil war, and the possibility that the nuclear arsenal of the Soviet Union might fall into rogue hands.

¹ “U.S. Military Spending in the Cold War Era: Opportunity Costs, Foreign Crises, and Domestic Constraints”, by Robert Higgs (1988).

² <http://www.foxbusiness.com/news/2012/10/18/analysis-us-manufacturers-turn-to-russia-with-love760849/#ixzz2Ow9JhVRr>

While the transition was not without some pain and suffering, and while the results are not uniformly positive in all places, for the most part the pace and scale was nothing short of remarkable. The people of the region, anxious for greater personal freedom and rights of liberty and property deserve the greatest credit for the positive outcome. But the United States, European Union(EU), and international organizations such as the International Monetary Fund (IMF) the World Bank and the European Bank for Reconstruction and Development (EBRD) contributed substantially to the successful outcome by providing technical guidance and financial resources to accelerate the transition.

Throughout the region, the population rejected the centrally planned systems in favor of democracy and pro-market reforms, and we can observe the tremendous changes that have occurred. Today, in every country of the region more than half of GDP is produced by the private sector, and free and fair elections are commonplace in the majority of the countries.

The U.S. government's response to the fall of the Berlin Wall and subsequent breakup of the Soviet Union was rapid, meaningful and generous. The strong consensus in the U.S. led Congress to quickly pass the Support for Eastern European Democracies (SEED) Act in 1989 that provided the legal and financial basis to support the historic transformation for Central Europe. Additional programs for the former Soviet Union and additional countries in Central and Eastern Europe were authorized by the FREEDOM Support Act (FSA) that followed in 1992.

The principal objective of the assistance to the E&E region was to support and accelerate the transition to market-oriented democracies. The U.S. assistance effort was coordinated at the policy level by the State Department. The United States Agency for International Development (USAID) was the U.S. government agency that implemented the largest portion of the program. Supporting the transformation was an unprecedented challenge in terms of the sheer number of countries, and the massive needs of the populations facing severe economic distress without the institutional and legal foundations to support a market democracy. At the same time, it was an opportunity to wipe away the most significant threat to world peace and stability that had existed since the end of World War II.

As the old political systems fell, economic order rapidly collapsed and the economic system needed expeditious structural reform. The United States began by assisting two countries (Hungary and Poland). Soon after, this assistance was expanded to more countries in Central and Eastern Europe, and then all of the former Soviet Union. By the time peace was re-established in the Balkans and programs began there in 2001, the U.S. Government had assisted 29 countries with market and political transition. Over the next decade to 2012, as countries succeeded in putting in place the laws and institutions of market economies, the United States has gradually withdrawn its bilateral support, and now is focused on a few countries in the Balkans and Eurasia.

U.S. economic assistance to the region was unparalleled in its person-to-person approach. Volunteers ranging from newly-minted MBAs to retired executives to farmers were eager to engage with their E&E regional counterparts. USAID and other U.S. government agencies funded numerous study tours and exchanges to build understanding of democratic market

economies function on a daily basis. The Peace Corps deployed a different profile of trained men and women, drawing on mid-career professionals with business expertise instead of recent college graduates. These kinds of exchanges had significant positive impact on the development of business acumen, English language proficiency, and adoption of Western attitudes and practices in the region. They contributed enormously to the success of U.S. economic technical assistance programs.

A number of key factors shaped USAID's programmatic approach. In the earliest years of the transition, because of the decades of isolation, few people in the United States understood and appreciated the complexity of the transition process. However, it soon became clear that successful transition would require far more than a few quick changes here and there.

The basic foundations of a market economy were not in place, and in fact the existing legal framework considered private sector market economics harmful. Rather than facilitating business operations, the institutional frameworks under Communism were designed to repress and even outlaw private market activities. New laws had to be written across a broad range of topics, governing institutions needed to be created, strengthened, and reformed, a functioning financial sector had to be developed, and systemic infrastructure reforms were required to achieve extensive modernization. Most significantly, it was necessary to change the mindset of a population that had been educated to believe that capitalism and western democracies were concepts to be feared, not embraced. Comprehensive technical assistance and transfer of skills and expertise were essential to the acceleration of reforms within politically acceptable timeframes. There was a trial-and-error experimenting (something that legislation and management policy encouraged) at the beginning of assistance with the result that many efforts were found to be not effective and were abandoned. From the start, however, the objective was clear – build pro-democratic market economies – and this clarity helped guide the evolution of approaches to the point that a sequence of specific economic growth measures were implemented in each country.

USAID's approaches and outcomes had to be tailored, of course, and were substantially influenced by the length of time countries were under a centrally planned system. The longer a command economy had been in place, the more difficult it was to shift the mindset of both the government and the population toward private markets. Reforms were often delayed and bumpy due to political reversals. Other factors causing differentiated programmatic approaches included: the large number of new countries following the breakup of the Soviet Union and Yugoslavia that lacked normal sovereign governing institutions and experience; post-conflict situations which had devastated war-torn economies; and the lack of committed market reformers, particularly in the former USSR.

The Agency used existing contracting mechanisms and established partnerships with development assistance consulting firms, international nongovernmental organizations (NGOs), and U.S. companies to implement its programs. They worked hand-in-glove with international financial institutions such as the World Bank, the IMF, the EBRD, the EU, individual European countries, and others who were shaping structural reform and meeting the transforming governments' financing needs.

The sense of urgency underlying these extraordinary changes led to a significantly different approach to development programming than elsewhere in the world. USAID rapidly deployed teams to work on specific initiatives, replacing traditional, more time-consuming steps in the project development cycle with on-the-ground shaping of project design and a flexible response to unfolding needs while simultaneously providing technical assistance. The Agency put in place innovative contracting mechanisms to facilitate this rapid response.

Much of what has become standard practice for USAID globally for encouraging private sector development was pioneered in E&E region programs.

At first, expertise, project management, and decision making was consolidated in a Washington-based Europe Mission, with only small country-based USAID representative offices. The SEED and FSA Acts gave USAID the authority to hire technical staff in Washington, D.C. with specific expertise that did not exist within the Agency. This resulted in a relatively homogeneous set of programs for countries and easy exchange of lessons learned. Over time, this structure was replaced by country missions that could provide better hands-on-management and monitoring to ensure results and to respond flexibly to more unique, country-specific needs.

In E&E, USAID also broke with its traditional approach that allows host governments to approve activities. This was an important innovation. USAID worked extremely closely with the governments, building strong relationships with senior officials and technocrats. We listened to their priorities and fulfilled the majority of their requests for assistance particularly to overhaul and strengthen the key public economic institutions and work on legal and regulatory reform. However, because USAID did not require host government approval for the full range of its activities, it had the freedom and flexibility to find the optimal entry points and counterparts for providing assistance. From the beginning, particularly in countries where political will to take reforms was lagging, USAID worked directly with the private sector, municipalities and NGOs to achieve tangible results, build partnerships with citizens, and gain valuable knowledge until more committed, reform-minded central governments were in place. One important USAID legacy is the large number of motivated, quality local professionals who now form a cadre of competent and committed leaders (public and private), and a large number of legacy institutions that still function as sustainable local organizations (see Appendix 6).

Elements of Success: Lessons Learned

Transformation requires a comprehensive assistance approach focusing on structural reform by:

- Creating the fundamental elements of a market economy that are absent
- Accelerating pace of transformation to overcome the weak political will or conflict
- Creating and strengthening key market institutions

New development and procurement approaches are needed to meet urgent challenges

- Quickly hiring staff with skills specific to the transformation tasks, e.g., privatization, fiscal and banking reform or energy, and placing them in a central bureau to work across countries
- Designing, competing and beginning work quickly in 3 to 6 months as opposed to years
- Initiating smaller projects to start the work and then scaling up as knowledge grows and reforms gain momentum

The focus on structural reform combined with USAID's streamlined operational processes allowed the Agency to reduce its assistance as countries develop the legal framework, institutions, and resources to take responsibility for their own democratic and economic development.

USAID's economic growth program was conducted principally in six specific technical areas: macroeconomic and fiscal reform, privatization, financial sector and capital market development, private sector development, energy reform, and agriculture and land reform. USAID's programs helped to establish and strengthen all the key inter-related elements that form a market-based economy that were absent from the centrally planned system, including rule of law that encourages and protects private sector ownership and investment; competition policy that promotes markets; financial intermediation based on market criteria; fair and efficient taxation and expenditure policies; and an economically and environmentally sustainable energy sector. Underpinning these activities was the goal of promoting effective economic governance and appropriate government oversight of private sector activity.

Macroeconomic and Fiscal Reform: There were three immediate macroeconomic and fiscal impacts from the collapse of the centrally-planned economic systems:

- A massive decline in production output in the magnitudes of 30% or more
- Hyperinflation, both as a result of supply shortages and adjustments to world market prices
- The loss of governments' source of revenue (previously the governments had been funded by the proceeds of state-owned enterprises)

The U.S. government responded to supply shortages (particularly food and energy) with direct emergency assistance. Stopping the hyperinflation became an urgent matter as well because other efforts at transition to a market economy could not proceed until hyperinflation was tamed.

Additionally, assistance was required to help the longer-term task of constructing an entirely new fiscal system supportive of a market economy. This was a critical but difficult task since much of market-based fiscal policy and practice is based on concepts that were foreign to these governments and populations. USAID's primary objective over the two decades was to promote modern accountable and transparent tax and budget systems, requiring major structural changes including new legal and regulatory framework, the overhaul of finance ministries, and the education of both parliament and citizens to understand collection and allocation of government resources in a democratic, market economy.

Privatization: Under the Communist system, almost all productive assets were state-owned and these enterprises were largely obsolete when the system collapsed. From a fiscal and economic recovery perspective, most country leaders saw no alternative to the rapid transfer of ownership to private hands, although approaches to achieve this goal differed. Privatization models ranged from auctioning small and medium enterprises in strategic sales, sometimes to foreign investors, to de-collectivization of farms to mass privatization. The mass privatization programs that USAID supported often relied upon vouchers distributed to citizens which could be redeemed for shares. Mass privatization required the transfer of tens of thousands of enterprises quickly and legally to private hands, creating huge numbers of publicly traded companies and millions of shareholders who needed a fair and secure environment in which to hold and trade their shares.

All of the privatization methods were built on the precept that market economies entail widespread private ownership. However, without much understanding of the concept of

shareholding, citizens often sold their vouchers for cash, foregoing potential longer-term financial benefits of stock ownership. In many instances, particularly in the former Soviet Union, privatization processes were fraudulently manipulated by politically-placed insiders, giving rise to the dominance by oligarchs. USAID's privatization efforts have been criticized by some for allowing this to happen, but the reality is more complex.

Particularly in the USSR, insiders within the state-owned enterprises and planning agencies were well along toward "spontaneous privatization" before the international organizations arrived. Many of the larger monopolistic State-Owned Enterprises ("crown jewels") were never included in the privatization process. Despite the best efforts of international organizations and many donors, including USAID, this course was already on its way and could not be derailed.

Recognizing that privatization was just the first step in transformation, USAID programs turned greater focus on addressing other systemic elements critical to promoting a well-functioning private-sector economy and upgraded business management practices.

Privatization of state-enterprises introduced a series of other unanticipated social issues. Most state enterprises were overstaffed with redundant labor, and as they were privatized, large numbers of employees were released. In addition, within the socialist system, much of the social support structure – health care, child care, education, and housing – was inside these enterprise "*combinats*". Once privatized, the owners were not willing to fund these non-business costs, and the burden of supporting these services were shifted back to government. USAID launched social transition programs to help governments take on these additional responsibilities.

Financial Sector and Capital Markets: The financial sector in Communist countries consisted of state-owned banks, generally part of the central bank, which provided directed credit to state-owned enterprises to meet targets set by government five-year plans. They did not perform the typical financial intermediation role as necessary in a market economy. With the collapse of the economy, the banks were saddled with bad debts and were essentially bankrupt.

To build the foundations of a sound, private, market-oriented financial sector, USAID took a comprehensive approach that simultaneously introduced bank supervision, conducted commercial banker training and undertook privatization/restructuring activities. Working in close collaboration with the IMF and the World Bank, there was early success in many countries in establishing well-functioning bank regulatory authorities, steadily moving toward international standards and practices. This was a factor in confidence restoration, deposit growth, and significant investment in the banking sector, mostly by European banks, which brought modern banking practices to the region, thereby accelerating the transformation.

To facilitate the anticipated large volume of privatization share transactions, USAID supported companion efforts to build basic capital market infrastructure. It was hoped that establishing stock exchanges would facilitate market behavior on the part of firms and shareholders. However, once the initial wave of privatization-related activity subsided, trading volumes declined substantially. In response, USAID is now assisting local exchanges in dealing with problems of scale by harmonizing or merging with other exchanges in an effort to regionalize.

Private Enterprise: While privatization transferred the ownership of state-owned enterprises to the private sector, many privatized, formerly state-owned enterprises were neither commercially viable nor able to produce quality goods that were in demand. Defunct state-owned enterprises resulted in a huge number of unemployed. New private-sector businesses that could compete in domestic or regional markets had to be encouraged to provide employment and income to the region's population. USAID programs sought to accelerate private sector growth with accompanying workforce development efforts to reduce growing unemployment.

As the private sector grew, USAID introduced several different models and approaches helping individual enterprises and entrepreneurs learn business skills while at the same time working with governments to create more supportive business environments. USAID was flexible in determining the mix of enterprise-level, industry-level, and policy-level interventions over the 20-year period, seeking the most cost-effective approach to reach the greatest number of enterprises and thus have maximum impact on income and employment. USAID's approach to assistance evolved from working directly with enterprises by establishing local business centers, to working more strategically in economic sectors that had the potential to become competitive in the global marketplace. At the government level, USAID worked to remove the legal and regulatory obstacles to entrepreneurship and help countries improve performance as measured by the World Bank/IFC's "*Ease of Doing Business*" indicators.

As the business environment improved, and the number of successful private enterprises and business professionals increased, USAID's approach became more sophisticated, and was based on the principle that by linking producers with markets, businesses flourish. By facilitating awareness of product design, quality, technology, and market practices, USAID has made a significant contribution to strengthening these nascent enterprises. Furthermore, as the private sector grew, a domestic constituency emerged for ongoing reform and dialogue with the government on policies and regulations affecting business success.

USAID projects were able to empower a range of interests and organizations to take charge of progress in creating a robust private sector, ensuring sustainability of reforms. This, combined with a high level of engagement across government, business, labor, universities, trade associations, and research institutions, indicates that market behavior had been embedded throughout society. While progress is uneven and subject to ups-and-downs of the global market, all but one of the 29 countries assisted by USAID has reached the target threshold of having more than 50% of the economy's production in private hands.

Energy: By 1990, energy systems in the region were uneconomic, inefficient, polluting, and corrupt; blackouts were common, businesses suffered, schools closed, and political and social unrest were common. Furthermore, most of the countries were dependent on Russia for energy, which made them vulnerable to Russia's political influence.

Working closely with the World Bank, EBRD and IFC, USAID financed the technical assistance for the "unbundling" of the electricity monopolies into separate generation, transmission and distribution companies to achieve greater transparency and accountability. Of equal significance was the development of a modern legal and regulatory framework including the establishment of nineteen autonomous energy regulatory bodies. With this basic foundation in place, USAID

continued its collaboration with the banks and the reformers in each country to support the strategic privatization of the electricity distribution companies which were key instruments of corruption for the vested interests. The distribution privatization and transmission planning efforts led to \$2 billion and \$2.5 billion in investment over the last 15 years.

Anticipating the need for regional approaches to expand electricity trade, USAID supported the establishment of the Energy Regulators Regional Association (ERRA) which now consists of 26 energy regulatory bodies that exchange information, experience, and professional development through an international training program. After cessation of hostilities in Yugoslavia, USAID helped convene experts from the Balkans to identify future transmission "highways" to re-connect the new countries, resulting in \$2.5 billion in transmission investments. In addition, USAID's energy strategy included a focus on energy efficiency, and made efforts to develop private sector and non-governmental institutions to address this long-term problem.

Five national energy efficiency centers were developed in Poland, the Czech Republic, Bulgaria, Ukraine and Russia that continue promoting and providing energy efficiency services to date. The early emphasis on energy efficiency in municipal buildings contributed to the Bureau's Democracy and Governance efforts. A key breakthrough was achieved in the application of the Development Credit Authority in Bulgaria for municipal energy efficiency borrowing from private banks. This breakthrough mobilized \$150 million follow-on funding by the World Bank and EBRD in Bulgaria and further funding throughout the region.

Agriculture/Land: If countries in the region were to transform, the predominance of collective farming in agricultural sector as well as the absence of personal property had to be urgently addressed. Collective farms used obsolete equipment and technology and were often even less efficient than state-owned enterprises. The chronic food shortages before the collapse initially worsened after the collapse due to disruptions in the supply and distribution chains.

Parallel to the privatization of enterprises, countries moved quickly to decollectivize agriculture, with the objective of benefiting farmers and promoting effective food production. Typically the land and other assets of collective farms were distributed to the workers, with each family receiving a small plot of land. USAID's programs focused on establishing the laws, institutions and systems to secure private property rights and titles. However, these basic reforms did not easily translate into vibrant, productive farms or land markets. Farmers continued to employ outmoded techniques and processes, and without a system for maintaining the infrastructure and other support systems, productivity and output continued to stagnate.

Although the prospect of massive food shortages and starvation have subsided, still today millions of households in the rural areas of the former Soviet Union live barely above the subsistence level producing low volumes of poor quality agricultural products. More recently, programs to develop high value agriculture by linking producers with sophisticated end-markets as part of a private enterprise development strategy have been more successful in promoting a modern agricultural sector.

In all of the above technical areas, USAID's overarching objective in structural reform was to provide to provide countries with the policies, institutions and capability to grow and to address their own economic and political goals, thereby reducing their reliance on foreign assistance. At the present time, we can observe four groupings of countries.

Group 1: Eleven countries that no longer receive bilateral assistance. Beginning in 1996, USAID "graduated" countries that met certain economic and political transformational criteria, later formalized in USAID's annual Monitoring Country Progress (MCP) report. Graduation allowed USAID to focus on countries where more time and resources were needed to transform to market-oriented democracies. Of the eleven, 10 have joined the E.U., and the 11th, Croatia, is a candidate in 2013.

Group 2: Western Balkans. Of these six remaining countries, most do not yet meet the MCP economic and political transformational criteria, in large part due to the legacy of conflict in the region. Even though some of these countries have an EU candidacy status for several years, none of them are going to enter the EU before the end of this decade mostly due to complex political issues. The U.S. government remains committed to support peace and stability in the Balkans, which influences decisions regarding ongoing assistance.

Group 3: Eurasia. Most of the former Soviet republics in Eurasia continue to receive some assistance, but substantially less than a decade ago. None of the countries in this group meet the MCP transformational criteria, nor are they candidates for EU membership.

Group 4: Central Asia. Five countries in Central Asia also fall substantially below the MPC threshold criteria. They now receive specialized assistance from the Asia Bureau, integrated with regional programs that include their southern neighbors.

Transformational reforms and economic well-being reached the desired level in Group 1 countries, and USAID appropriately ended its bilateral support. Innovative regional programs with modest funding were put in place to sustain institutional development for graduated countries. Legacy institutions, formed with USAID assistance that now stand on their own, also contribute to economic progress and goodwill.

In Groups 2 through 4, transformation is taking longer and USAID efforts continue to consolidate achievements to date and leverage other donors. In a number of countries, lack of political progress is delaying the economic transition process; in these countries, transformation will continue to be slow irrespective of USAID's additional time and resources. Semi-authoritarian regimes in Azerbaijan and the Central Asian Republics substantially impede progress there.

While several countries are on a trajectory to meet structural reform objectives, this has not yet translated in a vibrant private sector that contributes to the prosperity of the general population, demonstrated by huge unemployment, low labor productivity, and significant income disparity. The lack of prospects for EU and global integration and poor economic situation of the majority of the population make these countries vulnerable to nationalism, political manipulation and reversal of democratic reforms.

Using the expertise built up in the past 20plus years, much of which is among country nationals in USAID Missions, USAID has the means to effectively address constraints to economic growth, even with modest financial resources. With recovery from the 2008 global financial crisis fragile, governments in the region are facing new difficulties. USAID has the credibility, trust, expertise and long-term relationships with counterparts in the region in key institutions to continue to help countries meet these challenges.

Another way to measure the success of the transformation effort is with cost-benefit analysis. A Cato Institute study estimated the military cost of the Cold War to the U.S. was \$6.3 Trillion from 1948-1986. By comparison, the U.S. transformation assistance from 1990-2012 was \$20 billion. Transformation support cost the U.S. approximately .35% of the military cost of the Cold War.

Before 1990, these countries were essentially closed to U.S. businesses. In 2012, Russia alone represented a \$10 Billion export market for U.S. products. In other words, U.S. exports to Russia alone each year generate 120% of the amount spent by the U.S. over the entire 22 year transition period in all 29 countries.

At an average of \$345 million per year, the U.S. expenditure on the CEE/USSR transformation was barely 10% of the average annual development assistance expenditures in Iraq and Afghanistan over the past ten years.

I. LESSONS LEARNED

The lessons learned over the last 20 years in helping transform Central and Eastern Europe and the former Soviet Union, from centrally planned to market economies, have broader application throughout the world. While circumstances will not precisely match those encountered in 1992, there are some lessons that can be applicable to post conflict countries, and in countries transforming from autocratic governments in which the state plays a large role in the economy both formally by owning enterprises and distribution channels and informally through preference given to certain elements in the private sector and other special interests (economic elites).

Lesson 1: A clear objective fosters success.

Congress specified a very straight-forward objective – “*the transformation to market democracies*” in the SEED and FSA legislation. The clarity of objective provided focus and directed the approach, strategy and tactics of the economic assistance program.

Lesson 2: Successful assistance strategy, approach and tactics requires a supportive operational framework for implementation.

The legislative authority in the SEED/FSA legislation facilitated the E&E bureau of USAID to move quickly, streamline decision-making, take calculated risks, and engage technical expertise in Washington.

The sense of urgency originated from the desire within the government and population to show strong support to the people who had ended the Cold War peacefully. There was also an enormous pool of U.S. citizens and organizations waiting to be tapped³ to serve as USAID partners. E&E’s mandate to accelerate reform created a bias for action. USAID was an effective “first responder.” World Bank and IMF, among others, admired the Agency’s nimbleness and flexibility and also its capacity to get the right technical experts quickly to where they were needed.

As the assistance program ramped up, the benefits in using small 6-12 month task orders through pre-competited blanket contracts was invaluable. It gave the E&E Bureau and Missions flexibility to respond quickly to new conditions, crises, opportunities and change of governments, facilitated hands-on contract management, allowing the agency to “learn-while-doing”, expanding successes while terminating unsuccessful efforts. The new “outside” expertise combined with more traditional USAID development expertise often created synergies and innovative approaches. Flexible contracting mechanisms allowed specialized skills to be brought on board quickly.

If E&E’s innovative and streamlined contracting mechanisms had not been put in place, the sense of urgency and need to respond quickly and with flexibility could not have been operationalized. It was possible to build credibility with counterparts, learn and understand their needs, develop effective program design, pick the right implementers, and conduct proper oversight while maintaining a clear sense of the ultimate objective.

³ A good example of this was that as E&E work starting up, the S&L crisis was winding down in the US. That meant a large number of experts – regulators, bankers, work-out specialists were available and had just the right skills and recent experience with bank crisis that the E&E countries needed. A downside of which was the flood of unsolicited proposals that received Congressional or White House support and which the Agency found difficult to deflect.

The use of centralized skills in the Regional Mission in Washington resulted in efficient use of resources and allowed for easy adaptation of approaches and knowledge transfer from one country to the next. E&E centralized technical staff served as project officers who were specialized in a set of countries with common development issues. The SEED and FSA Acts allowed the E&E Bureau to engage personal services contractors in Washington (PSCs) to augment its own expertise with specialists in the energy, financial, and other sectors, unlike other donors or domestic agencies in which employees had to be hired through lengthy civil service processes.

As transformation proceeded and the private sector emerged, and as program management shifted to the field, operating with a longer-term perspective and long-term advisors became a more suitable approach.

Lesson 3: A comprehensive, multi-layered approach focusing on the root causes and systems is required to achieve true transformation.

E&E had the mandate, resources, processes, and talent to put in place mutually reinforcing, integrated activities designed to promote reform across all facets of the economy. There is no one panacea, but rather assistance should focus on key market institutions and work at multiple levels to accelerate the change. Simultaneous programs help countries address the building blocks of a market-based system such as financial sector stability, property rights, rule of law, energy efficiency, and reliable infrastructure.

Lesson 4: Institutions matter to sustain economic progress.

Policy or political change must be accompanied by institution building and human capital development. Creating well-functioning, accountable, professional institutions both public and private is critical to achieving and maintaining momentum for reform. E&E focused on helping countries build and reshape institutions that matter to the transformation, and on human capital development allowing for new leaders and technical professionals to emerge. This is the key element to establishing good governance and accountability, decreasing corruption, and promoting the rule of law. It is the best way to reduce and ultimately eliminate countries' reliance on foreign assistance.

All economically successful countries require well-functioning, strong public institutions - Central Bank, Finance Ministry, commercial courts, tax and budget authorities, administration and regulatory authorities - all staffed by trained, competent professionals. Economic governance requires public sector institutions that have legitimacy.

Lesson 5. Economic transition takes time and requires matching the size of resources with the political commitment to reform. Graduation is an important goal.

The countries of the E&E region had high literacy rates, seemingly educated work forces, an industrial base (i.e., non-agrarian economies), and developed infrastructure. Yet, the transition to market economy was a huge endeavor because of their lack of experience with a private market economy, insufficient adherence to rule of law, and the cradle-to-grave social programs. In particular, changing the nature of government's role in the economy away from a control function to an oversight function, and providing a level playing field for the new private sector is essential to promoting both sustainable and inclusive economic growth. It is hard to do and takes time. Until this happens, transition to market economy will be incomplete and economic growth even if robust will create inequalities.

It has taken the longest time to achieve fundamental change in the countries of the former Soviet Union that had never known market economies and in countries affected by conflict, such as the Western Balkans. In contrast, in those countries that had a history of private sector activity and the incentive of joining the E.U., the transformation took less time.

USAID's approach evolved along with the stages of transformation – as countries gradually progressed and the private sector emerged, the nature of the work changed. It is better to ramp up the amount of assistance – knowing where the true problems and barriers are, understanding who are the true reformers (compared to those who give lip service to reform), and building up the absorptive capacity in institutions, both public and private to implement reforms.

While US assistance needed more time than originally anticipated, it was always understood that E&E would end. The goal of graduation helped to focus assistance on the fundamentals of a functioning market economy and develop its accompanying systems. In those countries that made strong, early transformational progress and had the promise of EU accession, programs were phased out sooner. Those countries were ready to take responsibility for their own development. In contrast, reducing assistance to the relatively new and still fragile democracies and economies is neither good development practice nor foreign or national security policy.

Lesson 6. Effective counterparts for reform exist both inside and outside the government. Avoid assistance agreements that limit programming and the targets of assistance.

Economic growth and reform programs have more chance of success if not constrained by overly prescriptive requirements contained in government-to-government assistance agreements. E&E had no requirement to work directly with or only with central government under its initial agreements; it had the flexibility to work where the opportunity for effective reform was greatest. If political will lagged or former Party operatives obstructed reform, USAID could still make progress by working directly with the business community, reformist mayors, and other non-government actors. Local government and business leaders often put pressure on central government officials who became subsequently engaged. Often this paved the way to return to work at the central level on key structural reforms.

One objective of USAID assistance projects was to shift the vision of government from one of controlling the economy through state-ownership to one of facilitating private ownership. But it has not always been easy to instill this new vision of effective, transparent government institutions that provide: macroeconomic stability; good fiscal policy; a business environment which facilitates private sector activity and competition; and, appropriate regulatory oversight of the private sector. Technical assistance was most successful when it helped government navigate the balance between reducing its control while at the same time strengthening economic governance.

Public education and outreach can also build support outside government. The concerted effort to include volunteerism, exchanges, education, and training in economic assistance has radically changed the relationships between people in the region and U.S. citizens to accomplish a transfer of mindset to complement institutional change. It broke down Cold War barriers and created partnerships between individuals, businesses, universities, government agencies, and civil society.

Lesson 7: Economic and democratic gains are correlated.

Economic gains are critical to sustaining democratic progress. The two dimensions of assistance are mutually-reinforcing. Private sector development relies on sound governmental policies that support rather than impede business activity. Private property rights, reliability of judicial processes, fairness and efficiency in enforcement of regulations, etc. all are essential to enterprise growth. At the same time, a successful and growing private sector improves individual well-being and reduces the extent to which individuals are dependent on government. Citizens are willing to support democratic institutions when they experience economic progress. If economic stabilization and then recovery had not happened relatively quickly, breeding optimism about the future, many of the democratic gains could not have been sustained. In the wake of the global financial crisis and ongoing EU financial turmoil, the response to negative growth prospects and increasing unemployment has been growing populism and increased democratic backsliding.

Lesson 8: Technical assistance is important to assist countries to meet Multilateral Financial Institution (MFI) policy and practice recommendations and establish the system reforms needed to unlock MFI funding.

The IMF generally provides intermittent short-term technical assistance and countries must pay for the World Bank longer-term assistance as part of loans. E&E has a comparative advantage when providing technical assistance to implement new reforms and policies. For example, in E&E, USAID assistance helped regulatory authorities meet conditions relating to bank regulations and privatization in the early days and implement recommendations to improve financial sector stability and development under joint IMF/World Bank Financial Sector Assessment Programs. Beneficiaries and MFIs acknowledged this direct contribution as significant to building knowledge and institutions required for transition.

Lesson 9: The private sector invests only after the elements of a market economy are in place. Private investment will follow business opportunities. In large countries and those rich in natural resources, the private sector may be willing to risk a less stable business environment because of the scale of the opportunity. However, more typically, assistance is necessary to accelerate business reforms, leading to a more favorable business environment, and thereby attracting private investment.

Lesson 10: Russia is a special case and necessitated a different relationship.

Russia, as the largest and most dominant country of the Soviet Union, never fully accepted its status as a donor recipient. There were (and still are) many forces within Russia that were not so comfortable with the western economic model, and others that had strong political and financial interests in keeping the West at some distance. The relationship with Russia was fundamentally a foreign policy one, less conducive to development approaches successful elsewhere in the region. In hindsight, a focus on technical cooperation and a partnership with mutual learning may have resulted in continued engagement in economic growth.

II. INTRODUCTION

SEED AND FSA ACTS

In May 1989, Hungary began to open its borders to the West, and in June, the Polish Solidarity party triumphed in national elections. The George H.W. Bush Administration proposed to the U.S. Congress⁴ an assistance program in central Europe, focused mainly on economic engagement with Hungary and Poland. The 41st President visited the region in July and advocated that it was U.S. responsibility to join forces with the people left in political, social and economic turmoil as the Communist system collapsed. After the opening of Hungary and Poland, the Velvet Revolution in Czechoslovakia, and the breaking down of the Berlin Wall, the dominance of the centrally planned states in Europe ended.

As discussion between the Administration and the Congress proceeded, consensus among U.S. policy makers emerged. The United States needed to provide assistance to support the transformation of economic and political systems. What emerged as the primary objective of U.S. economic assistance policy was the transition from centrally planned to market-oriented economies for the countries and to make that transition irreversible—first in Eastern Europe and subsequently in the Soviet Union. The presumption at the time was that having 50 percent of the economy in the private sector would achieve that goal. This economic objective complemented other foreign policy objectives of containing nuclear weapons and preserving territorial integrity of newly independent states.⁵

The Support Eastern European Democracies (SEED) Act of 1989 (P.L. 101-179) was signed into law on November 28, 1989, and a significant assistance program began. The SEED act: 1) promoted the development of a free market economic system; and 2) contributed to the emergence of democracy (See box next page.). It also authorized a substantial program of food aid to stave off fears of shortages, starvation, and social unrest.

Timeline for the Start of USAID Assistance

- In 1989-90, the northern tier of Central Europe (Hungary, Republic of Poland, Czech Republic, Slovak Republic)
- 1990, Southeastern Europe but not Yugoslavia (Republic of Albania, Republic of Bulgaria, Republic of Romania)
- 1991, the Baltics (Republic of Estonia, Republic of Latvia, Republic of Lithuania)
- 1992, Russian Federation
- 1992, Central Asia (Republic of Kazakhstan, Kyrgyz Republic, Republic of Tajikistan, Turkmenistan, Republic of Uzbekistan)
- 1992, Western NIS (Ukraine, Moldova, Belarus)
- 1992, Caucasus (Republic of Georgia, Armenia, and Azerbaijan)
- Western Balkans: Bosnia and Herzegovina (1994), Croatia (1992), Kosovo (1999), Macedonia (1993), Montenegro (2001), Serbia (2001), Slovenia (1993)

Source: Authors' analysis, country names per CIA World Factbook

⁴ Bush, G.H.W. 1989. Making the History of 1989, Item #35. Washington, DC: German Historical Institute. Accessed October 8, 2012 from <http://chnm.gmu.edu/1989/items/show/35>

⁵ Personal communications in interviews with former Congressional staffer and U.S. Ambassadors, October, 2012.

USAID was one of many agencies slated to provide assistance. The U.S. Treasury and Departments of Agriculture, Commerce, Energy, and Labor, among other agencies, were also invited to provide their expertise. The multiplicity of agencies caused the Congress to name a single Assistance Coordinator for Europe, resident in the State Department, who was responsible for policy and budget coordination.

The State Department and USAID had specific legislation and funding for such international activities. Other agencies received funds transfers from USAID because the domestic agencies were unwilling (or not authorized) to expend their funds for E&E economic assistance.⁶ Only the U.S. Treasury secured its own funding for the creation of the Office of Technical Assistance (OTA). USAID was the initiator of economic assistance programs with a strategy formulated by the Mission in Washington and approved by the Coordinator's Office. The FDIC, SEC and Department of Commerce also had small programs aimed at helping to create market economies.

**Excerpts from SEED Act
Signed by the President on 11/28/1989
Became Public Law No: 101-179**

...A program to support East European democracy by providing assistance to Eastern European countries which have taken substantive steps toward institutionalizing political democracy and economic pluralism.

I: Structural Adjustment - Directs the U.S. ...to develop and implement economic reforms, to: (1) mobilize international financial institutions to provide resources to help Poland and Hungary...

Requires the U.S. Government to: (1) make available agricultural assistance to Poland to alleviate food shortages and to facilitate the transition to a free market economy; and (2) encourage parallel efforts by the European Community....

Directs the President to take actions to encourage innovative approaches to debt reduction of East European countries....

II: Private Sector Development - Authorizes the President to designate two private, nonprofit organizations such as the Polish-American Enterprise Fund and the Hungarian-American Enterprise Fund to promote development of the Polish and Hungarian private sectors. Authorizes appropriations for the Funds....

Requires the Secretary of Labor to provide technical assistance ... for the implementation of labor market reform and to facilitate adjustment during the period of economic transition and reform. Outlines administrative authorities and types of assistance authorized. Authorizes appropriations.

Directs the Agency for International Development (AID) to implement a technical training program for Poland and Hungary to enable such countries to develop market economies...

Declares that it is U.S. policy that: (1) U.S. persons, financial institutions, and other persons may provide financial and technical assistance to credit unions in Poland and Hungary; and (2) federally insured depository institutions may provide technical assistance to such credit unions ... consistent with safe and sound banking practice.

III: Trade and Investment - Amends the Trade Act of 1974 to remove Poland from the list of countries ineligible for designations as beneficiary developing countries....

IV: Educational, Cultural, and Scientific Activities - Declares that the United States should: (1) expand its participation in educational and cultural exchange activities with Poland and Hungary especially activities that assist the development of free market

VI: Additional SEED Program Actions - Requires the President to designate a SEED program coordinator within the Department of State.

Directs the President to establish a SEED Information Center System to serve as a clearinghouse for information relating to business needs and opportunities in, and voluntary assistance to, Eastern Europe....

Source: *Bill Summary & Status: 101nd Congress (1989-1991) H.R.3402. (Final version), CRS Summary. (1989).* Retrieved October 15, 2012 from the Library of Congress, THOMAS Web Site: <http://thomas.loc.gov>.

⁶ The initial concept from the Bush Administration was that this should be a “whole of government” effort, employing the knowledge, experience, and expertise of the U.S. domestic agencies. However, Congress balked at allowing domestic appropriations to be used to fund international programs, so most of the funding was channeled through USAID and the State Department and then transferred to relevant domestic agencies.

During the initial years, multiple U.S. Government agencies were implementing programs in the region. The enthusiasm and commitment to the transition was widespread throughout the government. Unfortunately, some of these programs disappointed for two reasons: 1) they were not relevant to transition; or 2) the particular agency had no expertise in overseas assistance. Frustration grew, too, at embassy levels, due to the multiplicity of assistance programs.⁷

**Excerpts from FREEDOM Support Act
Signed by President 10/24/1992
Became Public Law No: 102-511**

I. Directs the President to designate a coordinator within the Department of State to be responsible for coordinating assistance

II. Amends the Foreign Assistance Act of 1961 to authorize the President to provide assistance to the independent states for the following activities... creating private enterprise and free market systems based on the principle of private ownership of property... promoting trade and investment... promoting market-based mechanisms for food distribution and encouraging policies that provide support for the agricultural sector... promoting energy efficiency and production...

III. Encourages the President to establish American Business Centers in the independent states... [USAID must]...conclude a reimbursement agreement with...the Secretary of Commerce [to] implement programs to provide commercial and technical assistance to U.S. businesses seeking markets in the independent states.

...IX. Other Provisions - Amends the Foreign Assistance Act of 1961 to remove Czechoslovakia, Estonia, East Germany, Hungary, Latvia, Lithuania, Albania, Bulgaria, Poland, Yugoslavia, Romania, and the Soviet Union from the list of Communist countries to which assistance is prohibited...

Amends the SEED Act of 1989 to authorize the President to conduct SEED activities in any East European country similar to those being conducted in Hungary and Poland (with specified exceptions).

Includes Albania, Bulgaria, the Czech and Slovak Republic, Estonia, Latvia, Lithuania, Romania, and states that were once part of Yugoslavia in the definition of "East European countries" for purposes of the SEED Act.

Source: *Bill Summary & Status: 102nd Congress (1991-1992) S. 2532, CRS Summary. (1992).* retrieved October 15 2012, from The Library of Congress, THOMAS Web Site: <http://thomas.loc.gov>.

By the time of the dissolution of the Soviet Union in December 1991, U.S. government agencies had two years of experience supporting transformation. Congress began to realize that specialized development expertise was necessary as the depth of needs became clearer. Recognizing that there was continued U.S. political support for funding, the Bush Administration transmitted a draft of the Freedom for Russia and Emerging Eurasian Democracies and Open Markets Support Act of 1992 (the FREEDOM Support Act or FSA). By amending the Foreign Assistance Act, Congress gave USAID the go-ahead as the major implementer. The law duplicated the policy coordination role of the State Department and an Assistance Coordinator for the Newly Independent States was named. FSA added the remaining countries of Central and Eastern Europe and the 12 countries of the Newly Independent States (NIS) to the development program. When Bill Clinton assumed office in 1993, his administration executed assistance efforts through creation of the Interagency Working Groups on Central and Eastern Europe and Presidential Directives. While peace in the Balkans and focus on Bosnia were important in Clinton's first term, the foreign policy of Clinton's second term included the integration of eastern and western Europe without provoking tensions with Russia.⁸ The unprecedented nature of the challenge loomed large because of the numbers of countries and depth of needs. In 1989,

⁷ Private interviews with former senior officials, September and October, 2012. As of FY2013, 12 agencies and multiple Bureaus of State and USAID receive funding.

⁸ <http://www.clintonpresidentialcenter.org/archives/>. Retrieved November 29, 2012.

there were two countries (Hungary, Poland) to help transition, followed quickly by Czechoslovakia. With the breakup of the Soviet Union and later the Republic of Yugoslavia, ultimately there were 29 countries to which the U.S. provided assistance.

USAID’S OPERATIONAL RESPONSE

As articulated in USAID’s strategic objectives, creating open, competitive, market-driven economies was critical to addressing the overall social transition concerns in health, environmental degradation, and conflict. Market-oriented democracies would replace “command and control” economies of Communist system. The clarity of this objective was a major factor in determining USAID programming. USAID strove to build transparent and accountable public and private sector institutions to offer the region a better quality of life. Accountable institutions in both the private and the public sectors were expected to govern in a manner that responded to needs and the demands of stakeholders.⁹ Over the two decades of U.S. assistance, USAID emerged as the major implementing arm of the SEED and FSA acts.

Assistance to the Europe and Eurasia region represented a sea change in USAID’s organization and operations; the Agency “broke the mold” of how assistance could be delivered. The Agency’s technical assistance capacity and programming was in the Regional Mission for Europe in Washington with representative offices in the countries. The historical “arm’s length” relationship between USAID and the State Department became a very different one with the Europe Mission under the Coordinator’s direction regarding priorities and budget allocation.

The evolution of USAID’s role and its operational response can be divided into distinct time periods. Between 1989 and 1992, there was an under-appreciation of the immense complexities of the transition process. Initially USAID launched projects of a pilot or demonstration nature, but these were fragmented, disconnected, and insufficient to address the enormity of the need. Being housed and implemented from a single location did mean that the programs were relatively homogeneous and allowed cross-fertilization and ease in incorporating lessons learned.

By 1992, USAID and its partners came to realize that transition would be complex and difficult and would require multi-faceted responses. On-the-ground presence was vital. While program homogeneity was generally suitable for Eastern Europe, more tailored responses would be required for the greater diversity of conditions in the former Soviet Union.. In contrast to the centralized operations of the Regional Mission for Europe, the operational approach adopted in the NIS was to create local offices with full Mission status.

USAID’s Foreign Service officers initially lacked specific regional knowledge and language skills. In the field, USAID hired skilled Foreign Service nationals so that the Agency could bridge the cultural and language gaps of its direct-hire personnel and tailor its ongoing programs for the current tasks. USAID added staff with technically advanced specialties in areas such as business, banking, capital markets, and investment. When the two operational units, the Europe Mission and the NIS Task Force were merged into a single Bureau (now analogous to the Europe and Eurasia Bureau), a hybrid approach was adopted and several representative offices in Europe were upgraded to full Missions.¹⁰

⁹ USAID internal papers, excerpt on vision and assistance rationale presented to State Coordinators office.

¹⁰ Private Interviews with former USAID senior officials, October 2012.

Another operational attribute that helped USAID was spending flexibility in the SEED and FSA Acts that was not in the Foreign Assistance Act. As a result, the usual USAID processes of country strategies, project design, and evaluation could be leapfrogged and teams could be deployed rapidly to the field. The NIS team, which faced a more daunting task, concluded that the region could not afford to employ the full programming rigor that the Agency previously followed. There was a narrow time window to effect change before either the region collapsed altogether or the forces of repression regained a political foothold. USAID was proud of its rapid response capability, and could deploy highly skilled technical teams in as quickly as a few days from the identification of a need. Rapid response was critical during this period of economic and political fragility in order to forge trust with potential counterparts and maintain momentum toward the transition. USAID was praised both by country beneficiaries and U.S. embassies as having provided the right skills quickly to tackle transition issues.

Voices from the Field

“USAID sent technical experts who took time to understand our problems and without them we could not move as quickly to meeting international standards and best practices and restart sound lending to the private sector.”

Ivan Steriev

Worked at the Bank Rehabilitation Agency of the Republic of Macedonia in 1994-1996

USAID’s lead role in assistance emerged again in post-war former Yugoslavia. With the signing of the Dayton Accord in 1996, USAID responded with a huge program to promote economic reform and recovery to Bosnia and Herzegovina, a country with a shattered economy and political system. It not only needed to transition to a market economy, but to peace from a war-time economy. These approaches were later taken into consideration when USAID designed programs for post-conflict circumstances in Iraq, Sudan, and Afghanistan.

It was taken as self-evident that sustained economic performance benefiting a large majority of the people would strengthen democracy, and as well that a political system in which people had a meaningful voice would be more conducive to sustained economic performance. Coordinated programs linked government, business and labor, and local government decentralization with a focus on economic development. USAID programs were also readjusted to take advantage of the political sentiment for freer societies and open markets, such as Kosovar independence, the Rose revolution in Georgia in 2003, and the Orange revolution in Ukraine in 2004. For several years thereafter, democracy and economics programs were relatively balanced in resources and intensity, but more recently economic assistance programs have declined, while democracy and governance assistance has increased.

Dramatic economic and democratic changes took place throughout the 1990s, after which the countries in the region began to consolidate reforms and the rate of change slowed. Plans were made to withdraw direct presence in those countries with the greatest progress. Eight CEE countries were the first to graduate from USAID assistance—Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary and Slovenia. However, even after withdrawing USAID presence, these countries were still incorporated into development initiatives through innovative regional programs which addressed continuing development needs without requiring a brick and mortar presence in those relatively advanced countries. The technical leadership and strategy focus from the Regional Bureau assisted USAID’s field missions in initiating programs

concentrating on market needs. When 10 E&E countries became candidates to join the EU, specific economic assistance programs helped them meet the requirements of the *acquis communautaire*.¹¹ Those countries have since joined the EU and an eleventh (Croatia) was admitted in 2013.

With the final breakup of Yugoslavia, USAID began comprehensive assistance programs for Serbia, Montenegro and Kosovo in 2001. Around the same time, USAID began to plan to close Missions for the remaining European countries. Bulgaria, Croatia, and Romania graduated from assistance by 2008.

In 2009, USAID separated the five countries in Central Asia from the E&E region and reassigned them to the Asia region. This split was in response to changing foreign policy objectives. As the transformation objective began to fade, greater regional security concerns emerged. How would these countries be positioned once U.S. troops left their southern neighbor, Afghanistan? Significant economic assistance has begun as part of the “New Silk Road Initiative” to orient markets toward the south to increase trade with India, and provide stability to Afghanistan and Pakistan.

Accordingly, in 2013, the following countries receive USAID economic assistance, managed through country missions with technical leadership and support from the Economic Growth office of the E&E Regional Bureau in Washington: Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, Georgia, Kosovo, Macedonia, Serbia, Ukraine, Belarus, and Moldova. While Montenegro is eligible for assistance and receives services from regional activities, there is no bilateral funding for the country.

¹¹ *Acquis communautaire* is a French term referring to the cumulative body of European Community treaties, regulations and directives passed by the EU institutions. The term is most often used in connection with preparations by candidate countries to join the Union. They must adopt, implement and enforce all the *acquis* to be allowed in, which typically involves introducing or changing national laws and setting up or changing the necessary administrative and judicial bodies which implement the legislation.

III. CONTEXT FOR ECONOMIC ASSISTANCE

When the SEED Act passed, it was thought by some that Central Europe could complete the transformation in three to five years. As history has shown, the United States and our partners, as well as the populations and the emerging leaders of the post-Communist countries, had unrealistic expectations about the results and speed of transition. The magnitude of transition tasks was underestimated—certainly in terms of time, but also in terms of

resources. The elements of a comprehensive strategy for transition had no precedent. Free-market advocates believed that if prices were liberalized and if state-owned companies were privatized, ‘good things would automatically happen.’¹² While we knew that there were long lines and a lack of consumer goods, we did not appreciate that so much of the economy created under central planning was dilapidated, outmoded, inefficient, and often dysfunctional.

The reasons for underestimating the length of time transformation would take were: 1) the number of tasks to be done and how dependent the success of one task was on the others; 2) there was highly inadequate local expertise to understand implementation; 3) the amount that had to be accomplished in new democracies with high economic expectations; and 4) a sharp, multi-year economic decline resulting from the system break-down. In some countries and regions, war and conflict also played a big role in delaying reforms, particularly in the Caucasus and Balkans.

Another reason for U.S. surprise was that according to generally applied social indicators, particularly the high level of education and literacy rate,¹³ these were middle-income, developed countries. Literacy, we later learned, cannot be equated with economic and institutional knowledge. The education systems in the former Communist countries did not equip a large portion of the population with the skills and mentality needed for a market-oriented economy. According to one retired USAID official, we were “naive about how our paradigm was so different. Supply and demand understanding was completely absent. Our assumption—that once the yoke of political tyranny was lifted, markets would prevail—was incorrect.”¹⁴

Gender Practices in E&E

The Socialist ideal called for full gender equality in all aspects of life. In theory there were no limits on the roles women could play in the economy and society. In practice, however, there was a clear division of labor within the state-owned enterprises. Production jobs were for men while women handled accounting and administrative functions (as well as teaching, nursing, and secretarial functions).

Interestingly, when the economies opened up in the 1990s, this separation actually gave women some advantages since many of the growth areas were in financial services, sales, marketing, and management, while the inefficient production jobs disappeared. However, it did not take long for men to take a more dominant role in many of those areas, pushing women back into secondary roles. In addition, because of limited access to financing and other key prerequisites, women have fallen behind men in new business startups.

From the outset, USAID programs emphasized gender balance. The performance indicators show that women were significant participants in banking and financial sector programs as well as the small-scale privatization efforts. More recently, because of the relatively slower pace of women-owned business start-ups, USAID has expanded its support for women's entrepreneurship and for the development of labor skills in advanced technology suitable for 21st century employment.

¹² Private interviews with former senior officials, October 2012.

¹³ 99.67% in 1990 compared to 60 to 80 % in other USAID assisted countries. Source: World Bank

¹⁴ Private interviews with former senior officials, October and November, 2012.

By the time assistance began under the FSA, while we did understand more about the transforming economies, the countries themselves were further burdened by huge supply disruptions, hyperinflation, and in many cases, open conflicts. In addition, conditions in the former Soviet countries were magnified many times over. Having functioned under Communism for almost twice as long as Central and Eastern Europe, the FSU countries were not nearly as enthusiastic about transformation as were many Eastern European countries.

REQUIREMENTS TO TRANSITION TO A MARKET ECONOMY

The collapse of the old economic system was an immense shock to all the E&E countries. Most of these countries were completely unprepared for the challenges they faced, resulting in severely disrupted production and trade, and more serious multiplier effects throughout the economies of the region. The prospect of a total economic meltdown was terrifying for the new “democratic” governments as there were few functioning social safety nets in place. Much of the productive capacity was obsolete and products created under central planning were not competitive on the world market. Production was based upon what political leaders wanted, not market demands. Uneconomic, inefficient, polluting, corrupt, politicized energy systems were in place. Blackouts were common, and businesses suffered. In the aftermath of the collapse, the freeing of resources was a necessary but insufficient condition for creating meaningfully sustainable economic growth.

Disintegration of the Economic Space of the former Soviet Bloc

- Collapse of the integrated payments and inter-enterprise settlement system.
- Financial flows and settlements within and (especially) across the new borders dried up.
- Inter-enterprise links under the widely practiced informal enterprise networks (managed by the *tolkachi*, or expeditors) broke down.
- Budgetary and investment subsidies were eliminated.
- Large, implicit energy price subsidies to the Republics and to the European countries were discontinued.
- Formal and informal trade barriers were erected not only among the NIS but also within countries.
- Integrated power grids collapsed as did much of the integrated water systems (especially impacting the CARs).
- Three million ethnic Russians returned to the mother country from the other CIS republics, finding, and causing, significant resettlement problems in an economically depressed Russia.
- Unrest and civil war broke out in Georgia, Armenia, Azerbaijan, the former Yugoslavia, Tajikistan, and Moldova.

Marxist economic philosophy held that competition was duplicative and wasteful and consequently, during the central planning era, only a handful of firms typically would produce a particular product for the entire bloc. For example, Belarus produced tractors for the entire Soviet Union. There was little product differentiation, and the monopolization kept innovation from entering the economic system. Economies were highly integrated. An extensive transport infrastructure, operating with large implicit subsidies and without consideration of cost and economic rationale, made this possible.¹⁵ The disintegration of this economic edifice had already started as a result of Gorbachev’s 1987 reforms. Inter-enterprise links had begun to break down, along with a loss of central control over sub-national authorities.

¹⁵ See, for example, Linn, J.F. 2004. Economic (Dis)Integration Matters: The Soviet Collapse Revisited. Washington, DC: Brookings Institute
<http://www.brookings.edu/~media/research/files/papers/2004/10/russia%20linn/200410linn.pdf>.

Reversing the economic disintegration went beyond macro-economic stabilization, price liberalization, and privatization, requiring systemic legal and regulatory reforms and the building of market institutions. If our goal was to develop a successful market economy, then we needed to incorporate the elements of developed market economies into those countries. A well-functioning market economy would require:¹⁶

Predominant private ownership. A key need was to shift the goods, services and factors of production from the government into private hands. Privatization was needed for market pricing as well as for innovation, both of which are key drivers of efficient allocation of resources and economic growth. The objective was to transfer ownership and management to the private sector.

Rule of law and fair competition policy to support commercial activity. Market efficiency is facilitated by accountability and transparency achieved through sound commercial law. Laws for protection of private property, enforcing contracts, organizing and operating enterprises, and licensing of economic activity generally did not exist. Coordinated efforts between parliamentary bodies, the executive branches, and civil society to develop commercial law were absent. There was no check on monopolistic behavior, and no process under which to restructure bankrupt enterprises. No regulation of economic enterprise existed to protect owners, consumers, or workers, or meet public policy objectives, and no institutions supervised compliance or enforced this body of law.

A system of financial intermediation including an independent central bank and real financial institutions. No independent institution implemented monetary policy, and no sound private financial sector existed to allocate savings, make payments or provide services. There was no financial sector regulatory institution to supervise the structure in which financial institutions operated. Use of credit cards or other instruments of retail banking did not exist. Once prices were liberalized, inflation needed to be brought under control yet but there were no instruments for implementation of monetary and fiscal policy.

Robust level and structure of private investment. Before the transformation, authorities directed capital investment and set wages and consumer prices. Capital investment was managed bureaucratically, resulting in many projects with political, not economic aims. Private investment would be required if the newly privatized enterprises were to be restructured and operated along market principles, and if new businesses were going to be started to meet demand. Foreign direct investment was needed to bring capital and technology into the region's economies.

An effective system of fiscal budgeting and taxation. Under the Communist system, state-owned enterprises funded government services. With privatization, governments had no revenue with which to provide public services and a social safety net. There were no systems to generate government revenue and then allocate it based upon societal need.

Good government. Finally, in a free market economy, we expect that government should be reasonably efficient, not excessively corrupt, and held accountable to delivery of public services. The political patronage of the Communist Party created a system in which influence prevailed

¹⁶ Marer, internal memorandum, 2012

over merit. A civil service to promote rather than hinder business activity was missing. There existed no partnership between the public and private sectors to promote economic growth.

DIFFERENCES AMONG THE COUNTRIES

In all the E&E countries, the State was dominant in all aspects of personal and economic life. With a few exceptions, there was no private sector economy. The state was nearly omnipotent: responsible for investment and production decisions, for everyone's education and choice of profession, employment, compensation, the social safety net, what and how much could be consumed, and how much everything cost, e.g., healthcare. The transition had to change the relationship between the individual and the state—where to redraw the line between the responsibilities of private citizens, enterprises and the state.

While there were similarities and common characteristics among all of the countries, there were differences from country to country based on history and other special conditions. Communism came to the Central European countries after WWII, and there was some institutional memory of private market economics. The Soviet Union had experienced 70 years of Communism, so almost none of the population had experience with private property rights or private enterprises. Gorbachev's *glasnost* (openness) and *perestroika* (reform) policies introduced some decentralization of economic decision making, but this backfired because of the absence of competition and other key market features. Hungary had undergone partial reforms affording a limited, albeit frequently changing, scope for private economic activities. Socialist Yugoslavia had some elements of private markets, but was devastated by the years of war. Albania's isolationist regime resulted in an extreme low level of development. Conflict in the Caucasus held back transformation in those countries.

Five distinguishing features had to be taken into account in addition to economic and population size, levels of development, and ethnic, cultural, religious, and linguistic compositions that were region- country-, or sub-country-specific:

1. "Mindset." The most profound challenge to effective economic transformation was the extent to which people had become dependent on the State, rather than taking personal responsibility for actions. This mindset was much deeper in the FSU countries, but present throughout. In a system used to propaganda, there was a high level of skepticism as new public education campaigns were launched with pro-market messages.

2. Recent conflict. The difficulty of transition was compounded in locations that also experienced conflict. In nearly all countries that had experienced armed conflict it was necessary to deal simultaneously with humanitarian assistance, reconstruction, and transformation. Economists have quantified the impact of conflict as being on average about 16 percent of GDP,¹⁷ and as well the conflicts delayed transformation by as much as a decade. For example, Serbia's economic reform efforts began only after conflicts ended in 2001.

¹⁷ Selowsky, M. and R. Martin. 1997. Policy performance and output growth in the transition economies. The American Economic Review, 87(2), 349-353. Nashville, TN: American Economic Association.

3. Territorial integrity/sovereignty/statehood. Many countries of Central Asia had no previous histories as modern states. Many institutions of national government were not developed before Soviet times. Others (i.e., republics of the former Yugoslavia, Ukraine) had not developed recognized sovereignty, and were lacking the institutions of a workable government. National boundaries did not reflect ethnic allegiances and historical facts.

4. The severity of the post-1989 depression. Sub-regions with seemingly acceptable pre-1989 living standards suddenly became poor owing to the so-called “transformation depression” (20 to 50 percent declines in GDP).

5. Sense of social cohesion and economic vision. Some governments and their populations had a vision of the economic model they wished to adopt, while others did not. Hungary sought to be like its neighbor, Austria, while the Baltic countries aspired to achieve the level of social programs of neighboring Scandinavia. In Czechoslovakia, the Czech half aspired to be like its western neighbors, while Slovakia was slow to reject socialism, one factor in the “velvet divorce.” For several countries, the “carrot” of joining the EU was so powerful that these countries were willing to adopt the norms and institutions of a market economy in order to do so.

Others, e.g., Bulgaria and Moldova, had no coherent popular vision, but were rather bipolar, as some of their population wanted to look westward, while others wanted to look eastward toward Russia. Albania was so isolated and backward during the Communist period, and had so little contact with the West that it was unclear as to what face it wished to put on the market economy. While generally all the countries were “pro-American,” and welcomed U.S. assistance, absence of a uniformly acceptable vision of the future meant that assistance was difficult to absorb, or was met with resistance, or progressed more slowly than in those countries where assistance directly contributed to a common vision.

It was even more complicated in the countries of the FSU. The conditions of the post-Stalinist period meant that Communism was further entrenched; there was more fragmentation of trading, supply, and consumer relationships. The “self-privatization” trend, started under Gorbachev’s opening, was nearly as difficult to reverse as Communism; managers began to control the assets of their enterprises without legal ownership. The internal dichotomy between reveling in new independence and fear of being on one’s own without former alliances was an obstacle to liberalization and reform. Often, country leadership would declare an intention to liberalize, while government officials would not facilitate the practical aspects of opening the economy. USAID officials often characterized the search for a particular outcome for a sound market economy, such as land privatization, as a battle between those with a view to making markets work and those wanting to keep the vestiges of privilege for the Party bureaucracy.

For a variety of reasons Russia presented a unique case. The Cold War history made Russia wary of too much western influence. Russia’s pride in its history; its swings between oppression and free will; its intercontinental ballistic missiles; a determination not to appear weak; and absence of a coherent vision affected transition. Some Russian reform leaders such as Anatoly Chubais and Yegor Gaidar had in mind where the country should head, but without practical experience of how a market economy works and the ability to gain political power.

Also, the dominance of its natural resource companies, such as Gazprom, allowed Russia to manipulate the economic success of its neighbors. The ability to sell its natural resources in world markets provided revenue to the government and its insiders. Russia has emerged as a mixed economy comprised of a state sector coexisting with oligarchic enterprises dominated by economic elites who benefited from the transformation, alongside an active but less influential independent private sector.



IV. USAID APPROACHES BY TECHNICAL AREA

OVERVIEW

The multiple dimensions of USAID's programs among technical areas, and across time and geography, make description of its entire assistance effort difficult to express simply. The actual story and work on-the-ground was more complex. The importance of the timing, sequencing, and inter-connectivity between different activity areas is now much better understood than at the beginning. For example, without capital markets to trade shares, privatization of enterprises *en masse* cannot meet its goal of creating thousands of new shareholders. Legal and regulatory reform of the business climate must accompany direct help to new companies. Enterprises need support to access financing, and Central Banks require supervisory infrastructure to encourage financial institutions to extend financing prudently.

Nevertheless, for the purposes of this report, we have separated the description of the main technical areas of economic assistance. While this section describes each technical area independently, we have attempted to point out the technical inter-connections between the different programmatic elements whenever possible.

From 1989 to the early 90s, the major focus of USAID's programs was macroeconomic stabilization and privatization, implemented through a variety of contracts, agreements with voluntary organizations, and funding transfers to other U.S. government agencies. These initial projects were rapidly followed by programs aimed at: promoting fiscal, financial and energy reform; creating a body of commercial law supporting private sector and private property; and building and strengthening private enterprises. Across all these areas, there was emphasis on the transfer of skills to build human capacity. These general reform efforts had to be tailored based on country conditions.

Within the comprehensive strategy, each technical area had multiple, smaller activities, short in duration (up to 1 year), and narrow in scope which allowed intensive support to overcome constraints to market development. As more constraints were encountered, USAID moved quickly to provide a response. Often, four or five projects in a technical area would be simultaneously working on different aspects of a problem, and when one project would finish, another would follow to build upon and consolidate the progress made. In response to the lengthy nature of development, projects had to follow one another beyond the usual three to five years of a funding stream. This was only possible because of the use of flexible and innovative procurement by the E&E Bureau.¹⁸

Within each technical area, the geographic sequencing of USAID's involvement across the region followed the opportunities that opened up in the Northern Tier, Albania, Romania, Bulgaria, then in the Baltics, east to Russia, south to the Central Asian Republics, west to West

¹⁸ The most responsive of these procurement tools were a series of indefinite quantity contracts (IQCs) through which the Agency had access to hundreds of experts. USAID required that the organizations that participated deploy the expertise rapidly, often within days of a request by counterparts or identification of needs by USAID technical staff. A sense of urgency was shared by USAID technical staff, contracting staff and implementing partners.

NIS (Ukraine, Moldova, Belarus) and in the Caucasus, then on to the remainder of south Central Europe and Southeastern Europe which was the former Yugoslavia (See Map). In the sections below, we discuss how approaches were adjusted as USAID moved eastward and then south and westward into the post-conflict Balkans.

USAID Presence in Europe and Eurasia Over Time



MACROECONOMICS AND FISCAL REFORM

Objectives

USAID's primary objectives were to promote macroeconomic stability and fiscal sustainability. The countries needed assistance to construct entirely new fiscal systems for revenue generation and budgeting, for maintaining price and currency stability, and for encouraging the growth of a market economy based on private sector investment.

Context

When the Communist economic system collapsed, several problems immediately arose. Inflation soared due to the combination of supply disruptions, price liberalization, and sharp exchange rate devaluations. The countries confronted these problems without the institutions, expertise, or tools

required to ameliorate those challenges. These challenges required strengthening the key government economic institutions and adopting and implementing policies to:

- Continue price liberalization while bringing inflation to single-digit levels
- Limit unsustainable levels of government expenditures
- Implement an efficient and fair modern tax code and tax administration
- Avoid balance of payments problems (i.e., current-account deficits) to reduce the accumulation of excessive, unsustainable external debt
- Keep unemployment at levels that are socially tolerable
- Restructure the sector and product composition of the economy.

As prices soared, bringing inflation down became the highest priority of each country's macro-stabilization effort. These nascent "market" economies with huge underlying systemic problems, unclear political legitimacy, limited financial discipline, and weak economic institutions had to adopt and implement a huge number of new, not well-understood policies. To promote sustainable economic growth and keep inflation down at single-digit levels over the medium-to-long term would require the complete structural reform of the economy and the transformation of the economic institutions, policies and practices.

The governments also inherited the burden of funding the retirement and social safety-net systems built up during the Socialist period. While funding these expenses largely had been the responsibility of the state-owned enterprises, once the SOEs were privatized, the burden fell to the governments which had to accept the responsibility or face civil unrest.

Over the medium term, the top priorities for assistance were:¹⁹

- (1) Strengthening the competence and know-how of the Central Bank (or monetary authority in a few cases)²⁰ to establish and implement an appropriate monetary policy framework and introduce standard monetary policy instruments including open market operations—the buying and selling of financial assets.
- (2) Building the domestic and international credibility of the Central Bank. This is important because it impacts inflation expectations, which is a key determinant of the outcome of wage bargaining throughout the economy. In most of the CEEs (including the Baltic States), Central Bank independence was established quickly and credibly because it was an aspect of IMF conditionality, as well as a membership requirement in the EU.

¹⁹ USAID technical assistance programs outside the macro-fiscal areas focusing on building a market-oriented banking sector, an effective bank regulatory authority and enterprise and bank privatization also played a key role in helping these countries to achieve several of these listed objectives including Central Bank credibility, a well-functioning banking system and hard budget constraints imposed on SOEs.

²⁰ With the breakup of the Soviet Union and Yugoslavia, each new country had to establish a Central Bank. This was usually done by transforming the republic level branch of the previous Central Bank into the new Central Bank, assuring some level of organization, staff and experience existed at the start. These countries also had to establish their own currencies, though several CIS countries continued to use the Russian ruble for many years and Montenegro and Kosovo adopted the Euro.

- (3) Establishing currency convertibility for international transactions as soon as possible to ensure meaningful import competition and the establishment of relative prices to guide resource allocations.
- (4) Adopting prudent fiscal policy is also essential for inflation control. A separate section below focuses on the fiscal problems and reform efforts in the region.
- (5) Imposing hard budget constraints on firms and financial institutions to reduce budget expenditures, change lending practices at banks and prevent further misallocation of resources.

Approaches

Macroeconomic Stability

In the short term, these countries needed to adopt tight monetary policy until inflation had been brought under control.²¹ This was done relatively early and consistently by eight of the ten CEE countries, although much less so in Romania, Bulgaria, Russia, and the other FSU countries. Poland is an excellent case study showing how strong domestic determination and leadership, combined with external support, could implement drastic macro-stabilization. In 1989, Poland's inflation exceeded 600 percent. Something had to be done quickly and decisively. In January 1990, Poland introduced a painful but effective stabilization program (referred to as "shock therapy").²² It was followed by Czechoslovakia (facing somewhat lower inflation, so its quick and successful stabilization was less painful), then, more gradually, by the other CEE countries.

The IMF played a leading role throughout the region in providing both policy advice and balance of payments/budget support through their sizeable lending programs to promote macroeconomic stability and start the necessary institutional reform and modernization. To help these countries tackle their serious economic imbalances, price and trade liberalization were initially the highest priorities. The early IMF programs also included measures to control expenditures, set interest rates and credit ceilings, impose new tax measures, and establish a two-tier banking system. The World Bank, OECD, EU, UNDP, U.S. Treasury and other bilateral donors were involved in policy advice and technical assistance.

²¹ One immediate task of the stabilization programs was to wipe out the liquidity overhang—the excess supply of money relative to the supply of goods and services—inherited from the central planning regime. This was accomplished mainly with a sharp jump in the price level, through deep cuts in consumer and producer subsidies, accompanied by fiscal and credit restraint. The subsidy cuts, along with some harmonization of indirect tax rates, also contributed to an economy-wide realignment in relative prices.

²² Poland's stabilization package was introduced on January 1, 1990. The objective was to reduce Poland's annual inflation approaching 1,000 percent in 1989 to about 1 percent per month by the second half of 1990. The package's main measures focused on a steep reduction of domestic demand by (1) the drastic reduction of the huge budget deficit; (2) severe restrictions on credit creation; (3) a sharp devaluation of the zloty, keeping it fixed for a year so it could serve as a nominal anchor; (4) introducing current-account convertibility and import competition; (5) a tax-based incomes policy, with prohibitive taxes on any increases in the wage bill that exceeded a predetermined indexation coefficient linked to the current rate of inflation; and (6) comprehensive price liberalization. Interestingly, Poland's shock therapy was more successful (and more popular) than the austerity measures of 2012; it is likely that in retrospect current day economists would not have supported it based upon today's experience in Europe.

Fiscal Reform

For the most part, the wave of hyper-inflation subsided by about 1994-95. Once macroeconomic stability was generally achieved, USAID turned its attention to helping modernize the operations of the Finance Ministries and Tax Authorities to develop competent and well-trained government officials, and to strengthen the tax and budget legal framework. It was well understood that reform of both the tax and budget systems would require major structural changes—from new laws/policies/procedures to the overhaul of key institutions, to the transfer of skills and expertise to tax/budget officials, and to the education of both parliaments and citizens. Much of Western fiscal policy and practice was based on concepts foreign to the governments and populations of the region.

Unlike in most Western economies where a strong finance ministry is the central fiscal authority controlling tax and budget policy and implementation, in the Communist countries, the center of power was the planning ministry, which determined the size and allocation of resources. Finance ministries mainly played an accounting function, keeping the books and recording the transfer of resources.

Fiscal reform and the construction of a totally new tax and budget system was thus a critical aspect of the transition to a democratic market economy. It was in fiscal reform where these new democratic countries had to answer basic questions of what economic and social responsibilities should be assumed by the state, how much should the state spend on them, how the revenues required to finance them should be collected, and, on the other hand, which responsibilities should be left to individuals and the private sector. In sum, what was to be the role of the state in the economy and in society? And what was society willing and able to finance through taxes? This was a daunting task, not just a matter of adopting new laws and policies, establishing new and/or modernizing existing institutions: it required a fundamental change in mindset of both politicians and the population.²³

Within a few years USAID became (and has remained) the leading provider of technical assistance in fiscal reform in most of the countries through hands-on technical involvement. While the fiscal reform programs varied in size and focus, political commitment, and absorptive capacity, they all shared common elements as countries faced similar challenges. As with other economic reform areas, USAID fiscal programs took a comprehensive approach, working on:

- Tax policy—developing modern Western-style tax codes (covering income, corporate/profit, value added, and excise taxes) based on transparency, simplicity, efficiency and equity
- Tax administration—including taxpayer registration, modernizing collection procedures and enforcement, audit and taxpayer services

²³ Even in the CEE, where the leaders and populations generally understood the distinction between the private and public sector, there was, not surprisingly, reluctance to give up much of the cradle-to-grave government support (albeit at minimum levels); citizens wanted the government to immediately provide large West European social welfare programs without, however, the resources to support them.

- Budget formulation and execution—including introducing budget processes and Treasury operations, macroeconomic and revenue forecasting, and expenditure accounting
- Intergovernmental fiscal relations—including sharing of revenue and spending authorities between the central and local governments
- Pension reform—reforming existing pay-as-you-go systems and promoting a mix of public and private systems.

There were early successes in helping countries to gain parliamentary support for new tax codes. However, even when new taxes were adopted, there were few tools and practices in place to collect the revenues. In the short term, deficit reduction critical to macroeconomic stability had to rely more on controlling expenditures. In this regard, USAID programs focused on helping the Ministries of Finance increase their capacity to limit spending (as opposed to supporting the medium-term work to reform budget formulation and execution). In particular, USAID continued the work that the IMF had initially undertaken to set up and strengthen a Treasury function (which had not previously existed) in the Ministries of Finance. The establishment of Treasury accounts through which all budget transactions must pass was essential to enabling the government to implement tight spending controls, minimize extra-budgetary transactions and thereby help control the budget deficits.²⁴ This also required a key reform—the introduction of a new budget classification system based on the IMF’s Government Financial Systems, which USAID programs helped to operationalize.

An important feature of USAID fiscal reform programs was the extensive use of long-term technical advisors (supplemented by short-term experts) resident in counterpart institutions (generally Ministries of Finance/Tax Authorities). They became an integral part of the local team, often serving many years in countries of the region, thereby gaining credibility. USAID programs also made a point of working across all levels of counterpart organizations. This approach helped deal with the frequent change in the top officials, assuring that departures did not undermine the program. Additionally, it built commitment and continuity from the officials charged with implementation and enforcement of the new policies. In some cases, detailed Memoranda of Understanding with the counterparts were effectively used to promote buy-in and focus on reforms required.

One of the most important tasks that USAID took on was to strengthen and modernize the Ministries of Finance and Tax Administration Departments. These institutions were weak and were unprepared to take on a myriad of totally new roles. There was limited capability to carry out the most basic fiscal functions of tax policy formulation, as well as the economic forecasting and analysis on which good fiscal policy rests. The most highly educated officials had only rudimentary understanding of the concepts of modern tax and budget policy and execution. Training had to begin essentially from scratch and much of it had to be done on-the-job. Furthermore, there were essentially no data collection systems (outside of Russia where all the information had been centralized). New data collection systems were urgently needed.

²⁴ In the previous centrally planned system, it was the banking sector which in large part was responsible for recording and accounting for financial flows.

In the late 1990s USAID's programs shifted focus toward promoting deeper structural reforms of the fiscal systems, working in areas that not been considered high priorities in the early years. For example, many countries had adopted relatively good tax codes that were viewed positively by the private sector and foreign investors. However, compliance was a significant problem and revenue collection remained low as few resources had been devoted to building a corporate tax administration system which was required for effective revenue collection. This was a huge multi-year task which required not only organizational/procedural reforms and appropriate automation and computerization to support these reforms, but also extensive training of thousands of staff. Taxpayer registries had to be established, useable tax forms developed, taxpayer service units had to be formed and audit policies and procedures instituted. Much of USAID's assistance was done in conjunction with World Bank programs that were funding computerized systems.

On the budget side, programs moved from a focus on spending control to the medium- and longer-term goals of effective budget formulation and execution. USAID also began to focus on helping to put in place key analytical functions/units within the Ministry of Finance, such as a Macroeconomic and Forecasting Office, which provided the economic context in which annual budgets were formulated. Strengthening the budgetary process involved working not just with the Executive Branch/Ministry of Finance, but with Parliaments which now had an active legal role to play. As spending decisions in the previous system were determined by a relatively small "inner circle," this was another area where expertise was lacking. Education efforts were needed before intensive training could begin. USAID designed programs to help both the parliaments and the ministries of finance conduct meaningful budget analysis, a key to setting priorities and the formulation of budgets. This was achieved through a fiscal analysis unit in the parliaments.

Successes in Promoting Macroeconomic Stability and the Foundations for Modern Fiscal System

Kazakhstan, with the help of USAID technical assistance, was the first country in the NIS in 1995 to adopt a comprehensive Tax Code, which then served as a model for other NIS countries (such as Kyrgyzstan in 1996). One of its most important features was to provide a positive tax environment for foreign investment without providing any special incentives. Kazakhstan also implemented a Treasury system that allowed the Ministry of Finance to consolidate, control and account for all government revenues and expenditures in a single account. Moldova established the Center for Budgetary and Financial Analysis in 1996. It was the first country to establish an independent capability to support the Parliament.

As the architecture of budget formulation and execution took hold, USAID began assisting in promoting the longer-term goal of establishing results-oriented budgeting systems. The goal was to change the focus of budget decisions from meeting spending targets to achieving results, in principle allowing governments to deliver better services to citizens.

Another major emphasis in all fiscal programs was promoting fiscal transparency, including the openness of tax and budget processes, audits of public sector spending and anti-corruption measures. Activities worked to improve government procurement laws, ensure less arbitrary enforcement of tax laws, promote adoption of ethics codes of civil servants, and strengthen parliamentary oversight.

Pension System Reform

Within the Communist systems, the funding of pension and retirement benefits was largely the responsibility of the individual state-owned enterprises. However, as the state-owned enterprises collapsed and/or were privatized, governments generally took on the responsibility for pension and retirement benefits. This placed a huge financial burden on governments, but the risk of social unrest meant that governments could not simply repudiate those responsibilities.

Most systems were in crisis and technically bankrupt due to aging populations, low retirement ages, high nominal contribution rates but low compliance. The financial burden of the “socialist” safety net was crowding out needed investments in infrastructure and education as well as burdening businesses with high contribution charges.

Improving the “safety net” became a high priority, and USAID fiscal programs started to devote resources to pension reform. The primary model for pension system reform was Chile which had faced (and solved) a similar crisis in the 1980’s. To stabilize the burden of immediate outlays, governments were encouraged to raise retirement ages and reduce benefits. At the same time, longer term stability was strengthened by encouraging the introduction of mandatory and voluntary private pension funds.

In Eastern Europe, USAID became one of the primary providers of technical assistance to support pension reform, working in some aspect of the reform process in twelve of the fifteen countries. This ranged from analysis of systems and advice on parametric changes to improve efficiency in Bosnia, Montenegro and Serbia to helping establish pension regulatory institutions in Bulgaria, Hungary and Macedonia. To governments in those countries, at first, comprehensive pension reform was controversial and politically fraught since it could be seen as breaking promises. USAID’s technical assistance programs supported public education and awareness campaigns in several countries, for example Bulgaria and Croatia, and were instrumental in helping win political support for pension reform. In addition, USAID programs helped develop collection and information tracking systems to promote confidence in the system with an added benefit of improved customer service.

In Kazakhstan, Ukraine and Armenia, USAID provided critical support to the governments helping them put in place the overall strategy for reform, providing economic models, and helping to draft legislation and regulations. Kazakhstan was an early success story in establishing a multi-pillar pension system.

Successes, Disappointments, and Remaining Work

Successes. USAID made a major contribution to the short-term goal of promoting macroeconomic stability, especially deficit reduction, as part of IMF programs. Programs also helped establish infrastructure for a fiscal system that promoted private sector led growth. USAID’s comprehensive technical assistance helped to strengthen ministries of finance with increasingly competent staffs to: (1) enforce tax policies and increase revenue collection; (2) perform budget formulation and execution; and, (3) in so doing, promote a foundation for fiscal discipline underpinning sustainable economic growth. These programs worked because USAID recognized the need for long-term resident advisors in fiscal reform and because they were

designed and implemented in collaboration with the U.S. Department of the Treasury, other donors and IFIs, particularly the IMF and World Bank.

Disappointments. In many cases, the longer-term goal of designing and establishing fiscal systems—both budget and tax—did not mesh well with short-term expediency of promoting macroeconomic stabilization. E&E governments experienced early successes with the help of IFIs, including USAID, in adopting new tax codes were out of sync with capacity to collect taxes. This set back the cause of tax reform as poor compliance and ineffective administration discredited new laws. A better sequencing of policy and administrative reforms would have avoided this situation. Despite a large amount of resources devoted to tax administration, it still remains non-transparent, inefficient, and subject to politicization and corruption in many countries within the E&E region. On the budget side, the realization was that it may take years to implement program budgeting; it requires a generational change in mindset, including rigorous evaluation capabilities to assess government programs and design more effective ones. Social safety nets are still largely dependent on government assistance and historical levels of cash flow for retirees are anticipated to be strained for decades or longer. Pension reform is constrained by political will and extremely sensitive given workers' and pensioners' belief in past promises. It continues to face challenges due to policies that do not promote the growth of private savings for retirement.

Remaining Work. Many of the countries remaining in USAID's 2013 portfolio do not have accountable fiscal authorities. Taxation and spending are undoubtedly the most politicized areas in E&E countries, requiring fortuitous alignment of public and private interest. Additional technical assistance is required to promote budgeting, tax simplification, technology and computerization to monitor tax compliance and spending, and improve understanding of fiscal systems. This will help reduce corruption in tax administration and government spending. On the pension front, assistance would accelerate public awareness of benefits of pension reform for sustainable old-age and disability retirement. This will encourage continued social stability and public sector fiscal soundness, both keys for long-term economic growth.

PRIVATIZATION

Objectives

USAID supported privatization as essential to open, competitive markets, believing that the key to living in a democracy was valuing private, not state, ownership. In each of the 29 countries that received economic assistance, support to some form of privatization sought to reach the goal of having more than 50% of the economy under private ownership. Speed and the creation of a shareholder class, even if the process was imperfect, were viewed as necessary to achieve private ownership.²⁵

Context

Centrally planned economies were dominated by heavy industries with unusually high energy- and material-intensive modes of production (in contrast to the U.S. in which the service industry

²⁵ Jesse, D. et al. 2003. Strategic Objectives. Washington, DC: USAID Office of Market Transition.

and small businesses dominate). Under Communism, these state-owned enterprises (SOEs) were viable largely due to policy-driven, non-market factors. Much of the production was geared to serve the economic and political interests of the state. Successful transition to a market-oriented economy meant having to discard an enormous amount of unsuitable production and capacity, and led to large declines in output and massive, painful losses of jobs and incomes. The nascent private sector could not pick up the slack quickly enough to avoid a depression era-like collapse.²⁶

As the economies opened up, the budgetary implication of keeping these now non-viable SOEs operational, even at low levels, was enormous. Hard budget constraints on the enterprise sector were required to lay the foundations for macroeconomic stability and the implementation of market-oriented fiscal and monetary policies. This meant giving priority to removing the state from ownership of both financial and non-financial enterprises. Consensus among reformers was to sell or give private owners shares in large and large-medium industrial SOEs, storefronts, warehouses, housing and land as the first critical step toward a market economy. It was believed that privatization needed to be accomplished as soon as possible to grant economic freedom and prevent any turning back to communism.

Much of the design of privatization was in the minds of the Eastern European reformers before USAID and our Western partner aid agencies began to engage with them.²⁷ Enterprise privatization activities were divided into five basic programs: mass privatization (MPP), case-by-case (large enterprises involving direct investment, including banks), strategic (involving the major infrastructure *parastatals* in the telecommunications, energy, transportation sectors), small scale (with the objective of privatizing distribution channels), and land privatization (described in the section on agriculture and land below). In some countries, USAID assisted with all types of privatization, in others, its efforts were more limited.

MPP was the process through which shares of companies were auctioned to the general population either directly or through exchange of vouchers for shares. Companies did not go through a preparation process similar to a market-based merger in an investment banking world; they were sold “as is.” MPP came to be viewed as the best way to quickly remove the state from both the management and the financial problems of thousands of companies, which weighed on the budget while giving citizens the “benefits” of ownership.

Case-by-case and strategic privatization, in contrast, required greater preparation of each enterprise sold. These enterprises were given a market valuation and usually the sale was conducted through negotiations. Government structures were put in place to identify the owner

²⁶ As we say earlier, at the start of the transition, this reality was not well understood among some U.S. policy makers who believed that these countries were not “underdeveloped” but “mis-developed,” so all that was required was to privatize, promote private investment and get the government out of the way. A few years into the process, it was recognized that transition required more fundamental changes in institutions, policies and behavior and well-functioning government institutions which played their appropriate roles in a market economy.

²⁷ Leadership in Poland was a team led by Leszek Balcerowicz, Poland's leading economist, Minister of Finance and Deputy Premier. In Czechoslovakia, Vaclav Klaus, also an economist, Minister of Finance and second President of the Republic led the design of voucher privatization. In Russia, having gained consensus between both Parliament and Yeltsin's Coalition Government, Anatoly Chubais and others seized the opportunity to set out the programmatic design for a mass privatization program.

of the enterprises as well as the seller— in some countries they were one and the same (e.g., state property agencies); in others, the enterprises were owned by a national trust and sold by the Ministry of Privatization. Small scale privatization was conducted through auctioned sales directly to individuals, usually for cash. Unlike mass privatization or case-by-case, small scale objects were usually “owned” by the local governments and not by a national state property agency or line ministries.

Approaches

Northern Tier, Bulgaria, Romania and Russia

The first projects in USAID’s economic assistance portfolio were MPP. In most cases, USAID’s efforts were to fund implementation of the process, not the design. This included steps to inventory the “companies” to be privatized, transfer them into corporate entities, register potential buyers (usually the entire adult population), and support state and local privatization agencies in organizing the sale/auction. USAID assistance supported the building of an institutional network (staffed domestically) of over 700 privatization centers key to the registering of buyers, exchanging of vouchers, and sales. USAID project teams handled corporatization (changing the company from part of its line ministry into a joint stock company or similar corporate entity which could actually be sold) and preparation of lists of companies for sale.

A few countries that received USAID assistance, such as Hungary, did not undertake mass privatization but instead wanted strategic investors. In Hungary and Czechoslovakia, USAID provided support for privatization with interested foreign acquirers. USAID funded teams of International Executive Service Corps volunteers and investment bankers to work with state property agencies to prepare large enterprises for sale and negotiate those with individual foreign buyers. Preparation included identifying companies the government had decided to sell, valuation, negotiation of starting price, and managing the information disclosure process.

In most cases, USAID used contractors as implementation partners for both the mass privatization as well as the case-by-case and strategic programs. They had little influence on the decision as to which companies were to be offered for sale, and USAID was often in the situation in which it had to prevail on the State Property Agencies for transparency in allocating which companies were to be sold. The greater participation USAID and its partners had at the policy level in determining the approaches to privatization, the greater chance there was for transparency. In this way, tactics to divert enterprises to political insiders (one such was the creation of holding companies) could be foiled and real privatization could take effect.

Central Asia

The goal of privatization of small scale assets at the municipal and local levels was to put bakeries, shops, and small manufacturing enterprises into private hands. The small scale projects in Central Asia, especially Kazakhstan, serve as the best examples of USAID’s approach. The nature of the former Soviet centrally planned system was vertical integration of enterprises from production through to the retail level. While mass privatization or case-by-case privatization targeted conversion of the means of production into private hands, the retail distribution system was largely ignored by MPP. In order to allow private distribution channels to develop in Central

Asia, and to a similar extent in Moldova, retail shops, warehouses, and other distribution system elements (this included trucks) were sold to private owners. Small enterprises were privatized by auction, often resulting in acquisition of the enterprise by existing managers or employees of the companies who had the expertise to operate the business.²⁸

USAID's approach was to use the services of its implementing partners in various components of the process;²⁹ in particular for enterprises that needed to be segmented between MPP and small scale (size was determined by the number of employees). The contractor was responsible for posting those objects to be sold, advertising, scheduling, registering bidders, negotiating the auction starting price, monitoring the auction, and overseeing closing documents.

Successes and Disappointments

Successes. Having implemented mass privatization early, most countries of the region reached predominantly private sector ownership early in the transition. MPP resulted in 1,000 enterprises sold in Bulgaria, 5,000 in Romania, 7,000 in Czechoslovakia, 8,500 in Poland, and 20,000 in Russia. The fact that thousands of enterprises moved out of government control to private owners with proper legal titles is a huge accomplishment. Without USAID-supported privatization, the "self-privatizing" trend might have continued, and the informal economy would have expanded.

The political objectives of privatization would not have been achieved if vouchers had not been available and if buyers had had to use cash. Yet, privatization met only one condition of the transition to a market economy. To establish a market economy, it was necessary to systematically assist sectors in areas such as business environment and commercial law, enterprise development, financial sector development, land and property rights, and workforce development (including public education).

Small scale privatization and urban land privatization were easier to implement than MPP. In retrospect, though, one error made in the first round of the small scale program, was USAID's support for local government mandates that business premises continue in their former lines of business, especially if they produced staple foods. The reasoning was this: if bakeries were not ordered to continue to bake and sell bread, then all the shops would turn to the more profitable sales of vodka and chocolate, creating the same shortages of critical food staples as before. The rate of business failure post-privatization, accordingly, was quite high. In contrast, once this requirement was lifted, new businesses took off on the premises of former state-owned businesses, evidence that while the assets of the small scale companies may have been of value, as "going concerns," the businesses were of little or no value.

By the late 1990s, the impact of new business growth was more apparent in the physical change in commercial centers and business districts than in official statistics. Because of the lag between small scale privatization and liberalization of the economy post-collapse, many new businesses sprung up without any premises. They occupied kiosks on sidewalks; it was not unusual to see rows of empty shop windows with "shacks" conducting a bustling business five feet in front.

²⁸ Interviews with USAID implementing partners, November 2012.

²⁹ Internal memo, 1992.

Over time, those shacks became more elaborate kiosks with better signage and more permanent structures. With the support of the small scale auction program, and USAID's emphasis on urban land privatization to allow for occupation of those abandoned shops, after a few years, kiosks came down and businesses could occupy real commercial premises.

Local bureaucracies often were obstacles to privatization if proper incentives were not put into place. In Ukraine, a USAID program promoting urban land privatization had success by ensuring the municipality received part of the proceeds when land was sold. Municipalities then used those funds to provide infrastructure and services to citizens, providing an incentive for privatizing potential commercial real estate. Some parcels were sold and some were leased using long-term leases, but both succeeded in transferring the land into private hands. Strategic privatization was the most difficult as there was greater resistance among the government bureaucracy for selling the country's "crown jewels," like the energy or telecommunications companies. Moreover, these massive enterprises required more significant restructuring commensurate with their size and obsolescence.

Surprises and Disappointments. Upon privatization of state-owned assets, the problem emerged about what to do with the non-productive assets of large enterprises—seaside resorts, clinics, sporting clubs, and kindergartens. Social asset divestiture had to be part of the assistance provided. USAID staff and its implementers realized that entire social structures were built around SOEs, and that no other social safety nets were in place.

Privatization has a mixed history in the transition economies. Privatization programs in Russia and other former Soviet countries are criticized for the fact that "oligarchs" and other well-placed insiders gained control of vast wealth while excluding the general population. It may be correct to say that internationally-supported privatization initiatives gave some legitimacy to this corrupt wealth-grabbing. On the other hand, much "spontaneous privatization" was well underway before the international community arrived. USAID and other international advisors were aware of these issues. Tension between rapid privatization and good corporate governance developed. Since the insiders still dominated the government and power structures, it is unlikely that outsiders like USAID and others could have substantially altered the outcome.³⁰

People were not well informed or sold their vouchers cheaply and company management acquired many shares. In hindsight, one misstep was that the value of the privatization vouchers were not indexed to inflation. As hyperinflation exploded, the vouchers denominated in rubles lost much of their value. Although the program promised to distribute enterprises to the general public, popular support turned to disillusionment over results. Without adequate capital markets and shareholder protection, many shareholders benefited little and insiders acquired control over assets.

³⁰ In 1995, the Russian government adopted a loans-for-share scheme whereby some of the strategic state industrial assets, including in the oil and gas and metal sectors were leased through auctions for money lent by commercial banks to the government. While supporting early privatization efforts as a way of achieving political stability, USAID explicitly stayed away from the loans-for-shares program. In 1996, the New York Times stated, "a few Kremlin-favored banks lent the Government money last year in return for a chance to buy shares in some of the state's most valuable assets at dirt-cheap prices."

Though the euphoria of a market economy created overnight was overblown, it is hard to imagine a better alternative to meet the critical need to move quickly before instability set in.

FINANCIAL SECTOR AND CAPITAL MARKET DEVELOPMENT

A private-sector, market based economy cannot function without a strong, stable financial sector. Stable commercial banks provide businesses and individuals a safe and secure place to deposit savings, and the banks use those deposits to lend back to businesses and individuals to fund capital investments and stimulate growth. The network of commercial banks needs a capable, independent, Central Bank to provide supervisory oversight, to ensure that banks are not undertaking undue levels of risk, and to provide liquidity to the banks when emergencies arise. The Central Bank also carries out monetary policy on behalf of the government to manage interest rates and ensure a stable currency and exchange rates.

Although each of the countries had a “Central Bank” and other institutions called “banks”, their purposes and functions were quite different from what is needed to support a viable private sector market economy. The institutions, procedures, processes and regulations had nothing to do with ensuring sound, prudential banking practices in a market economy. They were designed to control, not supervise, the activities of state-owned banks.

Objectives

Since the elements of a viable financial sector were largely absent from the E&E countries at the start of the transition, a successful transition required nothing short of the total creation of a financial sector from the ground up. The financial sector objectives for USAID, primarily in partnership with the Department of the Treasury and the IFIs were:

- Train and equip the Central Banks to monitor and supervise a network of private commercial banks.
- Train and equip the Central Banks to carry out monetary policy
- Introduce a legal and regulatory framework conducive to private sector market activity, particularly commercial lending to businesses and individuals and a safe and secure system for business and individual savings and deposits.
- Stabilize the existing state-owned banks, provide support for their eventual privatization, and open the market to the entry of new private-sector banks.
- Introduce into the commercial banks the knowledge and culture of lending, particularly commercial lending in support of SME growth.

USAID also encouraged capital market development, initially as a means of supporting mass privatization and the belief that the establishment of a shareholder society would accelerate the transition. On a longer-term basis it was hoped that non-bank capital market institutions (stock exchanges, insurance companies, pension funds, etc.) would broaden and deepen the financial sectors, providing more sophisticated forms of finance and investment as the economies matured.

Enterprise Funds

A parallel U.S. Government program to enhance the financial sector was the funding of 10 Western-style investment funds known as the Enterprise Funds to fill a void by providing investment capital to the region to promote the private sector. USAID provided aggregate grant funding of approximately \$1.2 billion USD to these 10 Enterprise Funds which collectively covered 19 countries. While USAID provided oversight, by statute in line with Congressional intent, the Funds operated independently and were managed by an independent board of directors whose members were selected from the private sector. An excerpt from an E&E Bureau Lessons Learned paper can be found in Appendix 13, and the complete paper is included on the accompanying CD and/or memory stick.

Context

At the beginning of the transition, the financial sector in the former Communist countries was not designed or equipped to perform most of the roles required in a market economy. They handled payments functions and directed credit to state-owned enterprises to meet company production targets set by governments' five-year economic plans. Individuals' use of banks was limited generally to small savings accounts and some payment services. The state-owned banks were run by party functionaries and staffed not with bankers, but with bookkeepers, who understood neither credit and financial analysis nor risk. Loans to SOEs were not expected to be repaid, but continually renewed—thus there was no “credit culture.”

USAID and the international community recognized that financial sector reform and development would be critical to the transition to a market economy and democracy. Robust financial intermediation would be essential to ensure that privatized companies and nascent firms would have the funding and working capital to survive and thrive.

Capital market institutions for the most part did not exist, although some of the countries did issue a type of savings bonds. There were no functioning stock exchanges or supporting infrastructure.³¹ While most countries wanted a “stock market,” there was little understanding of how capital markets functioned or what was required to make them work. The legal/regulatory framework in place did not contemplate nor was it appropriate to promote a modern, well-functioning, market-oriented financial sector with new products or services.

The shock of transition caused rapid economic downturn as many of the SOEs – once the jewels of the system –required heavy subsidies to be viable and were illiquid without them. This, coupled with a sharp rise in inflation, meant that banks were immediately saddled with non-performing loans and were essentially insolvent. Household savings which had not been indexed to inflation were wiped out. Moreover, in many countries, with little or no government oversight nor meaningful laws in place to govern a private financial system, small private banks received licenses for the asking, took depositor funds and lent to themselves, and facilitated capital flight and money-laundering. A wave of investment schemes (most of which were fraudulent

³¹ Both Hungary and Yugoslavia had a stock exchange prior to 1989 but few companies were listed, daily trading volumes were low; and they were primarily vehicles to trade government securities.

pyramids) promised huge returns but mostly produced only losses³². What confidence in the banking system there was evaporated as the countries' payments systems stopped functioning and currency reserves dwindled in the wake of the fiscal and monetary collapse.

In sum, these countries began their transition to a free market economy with no private financial sector, a completely dysfunctional banking system and legal/regulatory framework, no capital markets institutions, and no financial sector personnel trained in market practices. Instead of promoting economic development through intermediation, the banking sector acted as a drag on growth, while requiring budgetary resources to keep liquid. By 1993, as banking crises were rampant, and liquidity had dried up, the budgetary costs of keeping banks and SOEs operating were huge. From this point on, financial sector reform began to gain higher priority in USAID's strategy, budget and programs.

The Banking Sector

Approaches

It is important to note that USAID made a critical decision to focus on rehabilitating and strengthening the core banking sector rather than constructing alternative mechanisms to deliver credit to emerging small businesses.

Considering the depth of the dysfunction, USAID might have chosen the more expedient

alternative. However, the decision was made to build a modern financial sector that would mirror those in other western market economies – a decision which in retrospect seems to have been the correct one.³³

The Importance of Building Well-Functioning Bank Supervision Authorities

Competent Central Banks and other regulatory authorities, that have legitimacy with the public, are a sine qua non not only for sustainable economic growth but also for sound, dynamic banking sectors. From 1994 on, USAID played an instrumental role in the establishment and strengthening of strong credible Bank Supervision Authorities, primarily at Central Banks in 23 CEE/FSU countries. Through extensive and intensive hands-on technical assistance over multiple years, using experienced U.S. bank regulatory experts as long-term resident and intermittent advisors, USAID took the lead among donors in helping to put in place all elements necessary to supervise a market-oriented private banking system – the legal regulatory framework, licensing, on-site supervision, off-site reporting analysis, problem bank resolution, enforcement authorities, and a professional bank supervision staff that could implement the new laws/regulations, policies and procedures. USAID established a reputation for excellence among Central Banks and was recognized by both the IMF and the World Bank for our work.

This arduous work – the wholesale reform and modernization of Central Bank regulatory departments, creation of a new culture, and building a professional staff – has paid huge dividends. First, it was key to building confidence in the new banking systems. Second, the presence of a good bank supervision framework was an important factor in the rapid entry of EU banks into the region, particularly the CEE. And currently, during the recent financial crisis, even the most vulnerable CEE/FSU banking sectors have remained stable and resilient (to the surprise of many outsiders). The IMF and others have contributed to strong bank supervision capability at the Central Banks of the region.

³² One of the last, and biggest, took place in Albania in 1996-97 and popular anger over the huge, widespread losses brought about violent upheaval and overthrow of the government.

³³ There were a few exceptions – most noteworthy being in two post-conflict areas and with the Enterprise Fund program. In Bosnia, USAID set up an on-lending program in which the banks took no risk (see box). In Kosovo, USAID worked with local authorities to establish a de novo bank. The Polish-American Enterprise Fund early on set up successful on-lending windows in banks to promote SME lending. In the second decade, several Enterprise Funds established banks, including mortgage banks, as well as leasing companies. Successful USAID microfinance programs mainly through NGOs were put in place in many of the CEE/FSU countries, but these were viewed as poverty reduction programs primarily for rural areas.

The initial focus on the banking sector in virtually every country for the first several years emphasized three key aspects of structural reform: 1) legal/regulatory reform and building a strong bank supervision capability focusing on safety and soundness, implementation of prudential standards and adopting international standards; 2) bank privatization/rehabilitation; and 3) intensive training of commercial bankers and establishment of sustainable bank training institutes.

The second stage of assistance activities began at different times depending on individual country's progress in putting in place the fundamental financial sector architecture and the legal/regulatory framework, as well as the development of the private business sector. This more or less coincided with the second decade; USAID's financial sector assistance programs broadened to focus more on expanding the size and sophistication of the financial markets, promoting new banking and capital market products and services (e.g., mortgage finance, corporate bonds), and increasing access to finance for SMEs and households. Many financial sector programs added new elements such as establishing credit bureaus and modernizing the legal framework for mortgage finance.

USAID recognized that success in deepening the financial sector also required major improvements to both the business environment and corporate practices. Thus, many financial sector programs in the second phase were done in conjunction with other ongoing USAID activities: 1) to reform and modernize the commercial law framework, strengthen contract enforcement, establish collateral registries, and ingrain land reform/titling; and 2) to help the nascent private sector improve its ability to demonstrate creditworthiness through better financial reporting and accounting practices.

Progress in these areas was especially important to banking sector expansion because banks had little incentive to expand lending to SMEs which were viewed with justification as risky borrowers with poor financial statements and limited credit history or collateral. In addition, the introduction of normal prudential bank supervision standards made banks even more cautious. Tapping the capital markets through bonds or equity also was not a realistic source of funding. Generally local businesses resisted efforts to disclose information, open up to outside ownership, and/or adopt needed corporate governance practices.

Another important aspect of USAID's work in the banking sector in the second decade was done under the newly established (1999) Development Credit Authority (DCA). DCA began to be effectively used in the region to promote lending to underserved sectors, e.g., SMEs and agricultural entities. By that time, in most E&E countries, there were a number of financially sound, well run, liquid private banks which could qualify to work with DCA (thanks in part to USAID's bank reform programs). DCA's model works by sharing risk with private financial sector institutions, providing partial guarantees (generally 50 percent of principal). This risk-sharing feature provides a huge benefit that credit lines do not, namely allowing banks to get into new and riskier lines of business. For most EBRD and World Bank credit lines, the total risk is on the banks. Additional data on DCA in the region can be found in Appendix 12.

By 2009, when the financial crisis hit, only a few countries in the E&E region had stand-alone financial sector programs and these emphasized access to finance with little or no focus on safety and soundness. The E&E region was severely impacted, and those countries which had been the most successful in integrating into the international financial system, e.g., Ukraine and others in Southeast Europe, were hit particularly hard. Through the Partners for Financial Stability (PFS), program, an ongoing regional financial sector development initiative, USAID was able to immediately respond to requests from E&E central banks, regulatory authorities, and governments to help them address serious financial sector vulnerabilities and maintain public confidence.³⁴ This has included work in conducting crisis management assessments and advising regulatory officials on how to prevent or mitigate a financial crisis, strengthening deposit insurance, dealing with growing non-performing loans, adopting international standards and best practices for financial sector development, improving cross-border cooperation, and promoting access to finance.

PHASE I – Fundamental Reform

Initial banking sector assistance focused on providing commercial banker training and placing advisors in state-owned banks as part of an effort to help restructure and reorient their business strategy towards the private sector. Advisors were also sent to Central Banks to train regulatory officials. This training was valuable, but could not be utilized effectively by the institutions still operating under outdated legal and regulatory frameworks and the socialist mentality. Also, it was difficult for the state-owned banks to change their practices given their dire financial condition and lack of liquidity. In addition, many banks were held captive by state-owned industrial sectors, and instead of financing new private firms, such banks lent primarily to their affiliated companies, leading to continued misallocation of resources.

By 1993, it became evident that the magnitude of banking sector problems was dragging down economic growth and constraining recovery. A new approach was needed. USAID significantly increased funding for banking sector reform programs. Working hand-in-hand with the IMF and World Bank,³⁵ USAID took a holistic approach to providing technical assistance, expertise, and know-how that allowed the borrowing countries to implement the needed policy reforms and meet many of the banking reform conditions. Comprehensive interlinked programs were designed to help these countries simultaneously restructure and privatize their banking systems, while putting in place the fundamental architecture of a modern market-oriented banking system. The latter led to a significant focus by USAID programs to help establish a strong credible bank regulatory authority, be it part of the Central Bank or an independent agency.

³⁴ PFS was first established in 1998 in the wake of the Asia/Russian financial crisis to consolidate financial sector gains made in the graduating countries using innovative approaches and cost sharing. The current PFS is demand driven working with SEE and Eurasian countries to address common financial sector challenges impacting the region. A hallmark of the program is using mentors from the more advanced northern tier countries that have more recent experience in financial sector reform.

³⁵ In somewhat simplistic terms, USAID provided the technical assistance, expertise and know-how that allowed the borrowing countries to implement the policy reforms and meet many of the banking reform conditions. While both the IMF and World Bank provide what they call “technical assistance,” it is very different from a USAID technical assistance program. For the former, it is intermittent and very short-term. For the World Bank, a technical assistance activity generally means one advisor to a senior government official and countries must borrow to fund such advisors.

USAID also spent considerable resources, particularly in CEE/SEE countries, to promote bank restructuring, rehabilitation and privatization programs (in other countries, the U.S. Treasury technical assistance program took the lead) generally in conjunction with the World Bank programs, to establish bank privatization and rehabilitation agencies. While much good technical work was done, bank privatization was ultimately still a political issue and encountered resistance. Governments depended on the state-owned banks to keep troubled SOEs afloat and maintain employment in the early days of political transition. There were also difficult fiscal issues to resolve concerning who would assume risk and potential losses on existing loan portfolios.

Developing professional financial sector

practitioners was also a priority. Over the first decade USAID established 16 commercial banking training institutes whose goal was the rapid transfer of a wide range of credit and risk-management skills and financial know-how needed by the newly developing financial sector profession. The reality was that the curriculum had to be adjusted to the basics of market economics, finance and banking principles. The underlying goal was to promote self-sustaining centers that benefited the commercial banking sector and could easily be transitioned to local partners.

Given that the banking sector in every E&E country was dysfunctional and suffered from similar problems, USAID intended to take a similar approach to banking sector reform across the board. However, relatively quickly, the banking sector programs became more differentiated due to varying absorptive capacity, political will/reform champions, severity of banking crises, and post-conflict issues. Geography played a role especially for countries with a prospect for earlier EU accession. USAID tailored banking programs to country circumstances and particularly, in post-conflict situations, put in place innovative programs to deal with some unusual circumstances.

Voices from the Field

“The program has left a lasting influence on institutional development and capacity at GINB/NBP. ... effects were long-term as the beneficiaries of the USAID assistance – Polish bank supervisors - took full ownership of the jointly developed tools, methodologies, manuals and continued their developments. The products were not put on the shelf but were further improved, adopted to ever changing legal and economic circumstances and assimilated by the new generations of the examiners. No surprise that this heritage of 90-ties finds today’s expression in the upcoming fourth edition of the On-site examination manual (first edition was issued during USAID program in 1996) – a guidance for bank examiners and good source of information on supervisory expectation also for the banks while Uniform Bank Performance Report issued for the first time in 1998 is still in use by supervisors and banks. These robust projects are also shared with other supervisors under TIBS and now TIFS.”

Piotr Bednarski

Senior regulatory advisor at PWC Poland, former director in the General Inspectorate of Banking Supervision of the National Bank of Poland, and director of Inspection Department in Polish Financial Supervisory Authority

Bankers’ Training Institutes developed with the assistance of USAID continue to provide thought leadership and professional development in countries such as Poland and Ukraine. Poland’s Training Institute with the backing of their Government now provides support and technical assistance to lesser developed E&E countries.

Northern Tier, Central and Eastern Europe

As a general rule, the countries in the Northern Tier³⁶ were able to move much more quickly in putting in place many of the fundamental reforms compared to the countries in the FSU. Poland is an excellent example of a country that, despite its severe economic problems at the start of the transition, was politically committed to structural reform of its financial sector, had champions at the Central Bank and elsewhere in the government, and demonstrated a high absorptive capacity. After Poland put in place a strong shock therapy/economic liberalization program, the National Bank of Poland became the star pupil in terms of its strong support for adopting a strong bank regulatory program as a prerequisite for modernizing the banking system. USAID (with support from the World Bank) responded by putting in place its first comprehensive bank supervision technical assistance and training program which focused on the introduction of on-site supervision, off-site reporting and analysis (which required bank accounting reform), problem bank supervision, licensing, legal/regulatory reform, and extensive on-the-job training supplemented by classroom instruction and study tours.

This comprehensive approach became the model for almost every other banking supervision program in the region. By 1998, Poland's bank supervision program was so well respected by other countries that they were swamped with requests from their peer regulatory institutions to receive study tours. This led to the establishment of the Training Institute for Bank Supervision (now the Training Institute for Financial Supervision (TIFS) which USAID supported both financially and technically in its startup years.³⁷

In other countries, political will to undertake structural economic reform lagged, particularly in the Baltics, Albania, Bulgaria and Romania. There were few early champions, so USAID started with very modest banking sector programs. In several countries, e.g., Latvia (1995) and Bulgaria (1997), it took severe banking crises for the governments and central banks to begin to seriously consider fundamental reform.

Likewise, the collapse of the pyramid scheme in Albania in 1998 (in which 50 percent of the population lost their savings) led the way to a political commitment to reform of the banking sector and a focus on strengthening bank supervision. In all three cases, USAID responded quickly and flexibly with inter-related technical assistance programs to help the new reformers put in place strong laws, modernize the bank regulatory operations, and adopt Western supervision principles and practices.

³⁶ It should be noted that several countries in Central and Eastern Europe showed less or little interest in receiving support from the IMF, World Bank and USAID particularly regarding bank supervision and privatization. This group included the Czech Republic, Estonia and Slovenia. All of these countries had successful, though not totally smooth, transitions and all were early new members of the EU in 2004. USAID ended the small bilateral assistance programs in the period 1996-1998. Nonetheless, it is interesting to note that Slovenia is currently suffering economic problems in part due to the interrelated issues of state-owned banks, poor asset quality and weak bank supervision.

³⁷ TIFS remains a highly respected training institution in the region and in the EU. It continues to conduct numerous training programs on current financial market supervision topics—banking, capital markets, pension funds and insurance, not just for CEE and FSU countries but the entire EU. Its goal is to promote best practices and solutions in financial supervision and to promote cooperation and effective communication.

Southeastern Europe/Former Yugoslavia

The *former Yugoslavia* also was a special case due to the war and violence that accompanied its breakup. In all the former Republics, the once functioning state/socially owned banking system was in terrible shape and needed complete restructuring and reform. As the fighting ebbed, a large portion of USAID's resources were devoted to banking sector reform as a key element of economic recovery. USAID designed the programs to resemble what had been successfully pioneered in Poland, emphasizing the importance of bank supervision and legal/regulatory reform to restore confidence and repair the broken banking system.

Following the Dayton Peace Accord, USAID quickly set up an innovative \$278 million lending program in *Bosnia* to jumpstart the war-ravaged economy and create jobs for returning refugees and demobilized soldiers as the capital and assets of the banking system had essentially been wiped out. This was part of a much larger banking reform program to establish and quickly train new bank regulatory authorities in each entity, adopt new banking laws and prudential regulations, and privatize the banks. (Treasury provided coordinated technical assistance for the latter.)

Bosnia Business Development Program (BDP): A Model Integrated Lending, Business Development and Banking Sector Modernization Program.

The \$278 million BDP was the U.S. Government's flagship economic reconstruction and recovery program in Bosnia following the signing of the Dayton Peace Accord. It provided urgently needed quick disbursing balance of payments support that would be used to provide credit to the productive sector. Its primary short-term objective was to jump start the economy and create jobs for the general population, including refugees and demobilized soldiers. The BDP was always more than a lending program. From the start, it was designed to help create a vibrant private enterprise sector and a modern banking system. In this context, the BDP had several important features:

- USAID put in place three tightly related and well-funded technical assistance activities from the beginning which were critical factors in helping BDP successfully meet its objectives: (1) Enterprise Advisory assisting potential and successful borrowers; (2) Commercial Bank Training to strengthen and modernize Bosnian banks; and (3) Strengthening Bank Supervision to provide the incentives for market-based sound lending practices and work with banks to meet capital adequacy requirements.
- The BDP was market driven; the main criteria for making a loan was the creditworthiness of the borrower and the loan purpose/expected increases in employment.
- To have maximum employment impact; initially loans were not focused on SMEs (different than most other USAID lending program) and could also be made to state-owned enterprises. Within two years, when the business environment improved, an orientation toward SMEs was put in place.
- Given that the entire Bosnian banking sector was fragile, under-capitalized, illiquid and lacking credit skills, an On-Lending Management Unit (OMU), initially staffed by experienced US commercial bankers, made all loan decisions and took all the risks on non-payment.
- However, the OMU relied on loan applications submitted by the local Bosnian banks, as they were the ones with knowledge of the local business sector. Licensed Bosnian commercial banks which met certain criteria qualified to become agent banks and receive fees for monitoring and collecting the loans.
- The BDP evolved over time, eventually providing credit lines to local banks once they had the financial strength and skills to undertake sound lending and at the end of the program, selling loan portfolios to these banks.

As almost everywhere else, privatization proved to be difficult. USAID, in collaboration with the IMF and World Bank, also took on the challenging task of completely overhauling the Bosnian payment system, which was not only an instrument of government control and economic management, but one that had been completely corrupted and politicized during the war. USAID devoted significant leadership, technical assistance and resources to 1) eliminating the powerful and non-transparent Payments Bureaus, and 2) setting up a real-time gross settlement payment

system at the Central Bank which allowed commercial banks to provide payments services directly to customers. Without this reform, Bosnia's economic recovery based on a functioning banking system would have been much more difficult.

In *Serbia*, once transformation began, it proceeded quite quickly. USAID (and the IMF/World Bank) became involved only after the fall of Milosevic in late 2000. The new reformist Serbian government had carefully studied the lessons learned during the first 10 years of transition and acted aggressively, with significant USAID assistance, to restructure their insolvent and illiquid banking sector in record time. In February 2001, in order to prevent a complete collapse of the Serbian banking system, USAID, at the request of the IMF, sent a team of 12 seasoned U.S. supervision experts, all of whom had years of experience working in the E&E region, to conduct financial and regulatory diagnostic reviews of 26 Serbian banks which accounted for more than 70 percent of banking system assets.

The detailed banking data provided gave the new regime the facts to act quickly. Within four months, six banks were placed in the Central Bank's Problem Bank Unit, seven banks had their licenses revoked, and four small banks were deemed insolvent. In January 2002, the Central Bank then closed the four biggest and most powerful state-owned banks. The record time frame in which the Central Bank acted opened the way for the quick entry of private, primarily EU banks into the system, and rapid restoration of confidence, which led to a huge growth of deposits and a renewal of credit to the economy.

Former Soviet Union

Progress in the structural reform of the FSU banking sectors – building strong independent bank supervision authorities and privatizing/restructuring – went much more slowly than in the CEE and required more patience. In general, there was less interest at the Central Banks in setting up the necessary infrastructure for market-oriented banking supervision. This might have been related to the dominance and political clout of state-owned banks, generally more government direction of the economy and less interest in transparency. In addition, under USAID-funded bank supervision programs at the Central Banks, the advisors were kept more at arm's length and not actively involved in issues facing the supervisors or Central Bank. This was a drastic difference from the experiences USAID advisors enjoyed in other countries.

Ukraine is the country that has received perhaps the longest continuous USAID banking sector support. USAID began a series of comprehensive bank supervision programs beginning in 1995 modeled in large part on the Poland program, i.e., legal/regulatory reform, on- and off-site supervision, accounting reform, regulatory reports, and working with problem banks. The National Bank of Ukraine (NBU) over time adopted policies and practices based on international standards to provide incentives for reform and restructuring of the banking sector. USAID's technical assistance programs built strong capacity and expertise within the bank supervision department at the NBU, which still remains in place today. Yet, these positive changes within the NBU did not have the same impact on modernizing the banking sector as did similar programs in CEE/SEE. This reflects in large part the lack of political will to take on vested interests and promote an open competitive financial system.

Phase II – Consolidating Gains and Deepening the Financial Sector

The second decade for most countries in the E&E region was a time of growing optimism, expansion and improving financial and economic metrics. Many countries were finally surpassing their pre-1989 GDP levels. Although the broad trends were positive, the transition was incomplete. Market-oriented corporate behavior lagged and competition remained limited. The basic commercial law framework for a market economy was in place, but implementation and enforcement was weak and uneven. The number of SMEs was increasing but their ability to expand remained a challenge. While the basic infrastructure was in place in most countries and lending was expanding rapidly, financial sectors remained small and unsophisticated.

During the second decade, there were significant changes to USAID’s country focus, which impacted financial sector development programs. For example, USAID introduced the Partners for Financial Stability (PFS) program, an innovative regional financial sector initiative, in 1998, as the Northern Tier countries began to graduate from USAID bilateral assistance. PFS was designed to fill the gaps in the institutional development of the financial sector, consolidate gains achieved, and build upon progress made by USAID in developing strong relationships with partner organizations during the previous years. Technical assistance provided was demand-driven and required cost-sharing. The program is still operating today, but the focus has shifted over time from the graduate countries to countries in SEE and Eurasia.

Voices from the Field

“Without USAID’s assistance, the Agency would not have been able to quickly restore public confidence in the banking system of the country. On this basis, with the assistance of USAID and other donors, the Agency was established as a non-profit, independent, financial institution at the state level, with full authority under the Law of the State. We can say that without the assistance of USAID, the question is whether the deposit insurance scheme would come to life at all nor would the Agency be what it is today - an equal participant of the financial safety network of Bosnia and Herzegovina with its independence completely preserved.”

Sanja Stanković - Trubajić
International Relations Assistant
Deposit Insurance Agency of Bosnia and Herzegovina/Banja
Luka
On behalf of Mr. Josip Nevjestic

By 2001-2002, most CEE and a number of FSU countries had enacted an adequate legal/regulatory banking framework and had put in place the fundamentals of good bank supervision based on international standards and practices. Over the first 10 years, the banking system in CEE had been transformed. Most of the countries had encouraged the acquisition of its local banks by larger European multi-nationals, and by the mid-2000s EU banks accounted for over 80 percent of the banking system. This gave a huge boost to confidence, and deposit growth increased sharply. Credit to the private

sector was growing at double digit annual rates in many countries, albeit remaining small as a percentage of GDP compared to more advanced economies. The banking sector was starting to generate substantial profits and create jobs. (In fact, for many of the EU banks in the region, profits made in CEE comprised a huge portion of their total worldwide profits.) This was very positive news on the macro level; however, the vast majority of SMEs, and agricultural and rural enterprises still found it to be very difficult to access credit, underscoring the need for USAID to seek ways in which to improve financial intermediation.

USAID’s response was to give greater emphasis to other aspects of financial sector infrastructure—collateral registries, accounting reform, foreclosure policies and procedures, credit

bureaus, land reform and titling, mortgage finance, financial literacy, and consumer protection. Also, it became clear that many SMEs did not know how to prepare good financial statements, and business plans needed to demonstrate their creditworthiness. As such, assistance was needed in this arena as well. Much of the work, particularly regarding collateral issues, foreclosure, and land reform, was done under USAID's enterprise development or business enabling environment activities.

While many banking programs in the first decade included money laundering prevention (e.g., know your customer rules, and reporting of cash transfers over a certain threshold), training on counterterrorist financing was absent. The latter was incorporated in subsequent technical assistance and training programs, particularly after the September 11, 2001 attacks and the growing awareness of global terrorism. For example, bank supervisors were trained in how to inspect banks' policies and procedures, and document evidence for use in court cases.

However, as banking sectors became more sophisticated and began to offer more complex products and services, bank regulatory authorities needed to upgrade their capacity to manage new risks. While, in general, resources for bank supervision fell, USAID responded favorably to Central Bank requests for technical assistance to help them keep up with changes in the banking system and meet the new international standards adopted in the wake of the Asian/Russian financial crisis in 1998.

By mid-2000's, there was widespread sense that financial sector problems in the region were largely solved, and for that matter the region as a whole was well on its way toward global integration and parity. Rates of GDP growth ranged from 3%-4% at the low end (Balkans and Moldova) up to 20% (Azerbaijan and other oil-rich countries). USAID's support for economic growth diminished substantially, and most of all in the financial sector programs. But in 2008, starting with the financial crisis and recession in the U.S., followed by deeper and more prolonged European crises, countries of the E&E region suddenly encountered unanticipated vulnerabilities.

With 80% of banking assets controlled by European multi-national banks, as the parent banks experienced their own liquidity problems, capital and liquidity for the Eastern European branches suddenly dried up. In addition, these banks had employed lending programs that offered Euro-based loans at substantially lower interest rates than local currency loans. As local currencies collapsed, borrowers who earned their incomes in local currency suddenly found that they needed to earn substantially more to convert to Euros and repay the loans. Many could not

Anti-Money Laundering in Azerbaijan

After the September 11, 2001 attacks, U.S. and EU banking officials developed new and more rigorous guidelines to restrict money laundering and the finance of terrorism. As those procedures came into effect, Azerbaijan's banks found themselves on the "black list," not so much because of overt actions but because the new procedures had not been incorporated into standard banking practices. The Central Bank of Azerbaijan (CBA) contacted the U.S. Embassy and USAID asking for technical assistance to improve the situation. USAID responded with a series of technical assistance and training interventions to improve the local legislation on Anti-Money Laundering and Counter Terrorist Financing, establish Financial Monitoring Service (financial intelligence unit) under the CBA, and to develop both institutional and human capacity of the new entity to implement AML/CFT activities in the country. Over the course of several years, the relationship between USAID and CBA has grown and strengthened to the point where USAID now assists and advises the CBA on a wide range of management and operational issues.

handle the repayment burdens, and a wave of defaults hit the region. Ironically, some of the countries that were considered the “success stories” were the hardest hit (Hungary, Slovenia, and Ukraine) because they were more integrated into the European financial market. Albania, Kosovo, Bosnia, and Moldova, by contrast, suffered from declining regional markets, but did not face the same financial-sector impacts because they were less integrated into the European financial markets.

Capital Markets

Stock Exchanges

As noted previously, one of USAID’s first engagement with the region’s capital markets was as support to the mass privatization initiatives. With the expectation that thousands of companies would be issuing and listing shares, and millions of individuals would become shareholders through various voucher and auction processes, USAID (along with the international financial institutions) embarked on initiatives to build market mechanisms that could handle the anticipated transaction volume. USAID played an exceptionally important role as the primary player supporting the development of capital markets (across the donor and international financial institutions). The United States was generally viewed in the transition countries as the world leader in capital markets, with by far the broadest, deepest, and most innovative markets. U.S. assistance was welcomed and its advice heeded. Assistance was almost always based on U.S. models, which at the time seemed the most successful in bringing capital to where it was most needed, and in creating a shareholder society. However, many people in countries just coming out of Communism often had initial difficulties in understanding how for-profit, privately owned, self-regulating firms were to function.

There were tens of thousands of enterprises to be privatized, and virtually no functioning capital market infrastructure. The early cases of mass privatization programs, particularly in Russia, clearly demonstrated that capital markets development had to accompany MPP in order to be successful and for citizens to benefit from it. Because of this, supporting voucher privatization became the main driver of USAID capital markets assistance and led to its becoming a major program area in many countries.

The required capital market institutions needed depended somewhat on the exact details of the MPP program. General, however, exchanges and supporting institutions had to be capable of dealing with a large number of companies and shareholders. Share depositories and registries were required to record and maintain ownership; trading, clearing and settlements systems were needed to permit selling and buying shares; regulatory legislation and agencies had to be set up to promote transparency and a level playing field and protect against fraud. If shares were to be held in mutual-fund type investment funds, these had to be set up and regulated to permit shareholders to pool their risk and attempt to exercise some degree of corporate governance.

A challenge was that most companies in mass privatization programs could not meet minimum disclosure or accounting requirements of normal stock exchanges, so this had to be accommodated through separate exchanges or floors within markets aimed at such companies.

USAID also funded companion activities such as developing the Russian Securities and Exchange Commission.³⁸

The early vision was to quickly create capital markets infrastructure that could support these unprecedented complex mass privatization programs but also eventually become the foundation for vibrant, sustainable capital markets. Most of the transition countries tried one form or another of mass privatization, some more successful than others, giving a great impetus to capital markets development in the region. USAID support was dominated by technical assistance from U.S. capital market experts, but the need to set up new institutions and trading platforms also required significant commodities, e.g., computers and software, as well as training. Romania (see box below) is the best example of a comprehensive capital markets program carried out in direct support of mass privatization. Other large programs included Russia, Ukraine, Latvia, and parts of Central Asia. In other countries, more targeted assistance to institutions was provided, such as new share registries or a securities commission. In other cases, such as Poland, separate over-the-counter markets to accommodate companies that could not qualify for the main exchange were established with USAID assistance.

The Romania RASDAQ: Model Capital Markets Project?

In 1995, when Romania decided to implement a major MPP, it requested assistance and support from the international donors and the IFIs; USAID agreed to take on the capital markets component. This required creating a completely new legal regulatory framework for capital markets and a set of new institutions. The Bucharest Stock Exchange had recently reopened but was not in a position to deal with the huge number of volume of listings and transactions. The Securities Commission was also new and weak. Under the leadership of a U.S. SEC official on loan to USAID, and with strong support from the U.S. Embassy and Romanian reformers, a privately owned and managed Romanian over the counter market was designed including, a share registry, depository, trading system, broker/dealer network and strengthened regulation. The system was closely modeled on the U.S. NASDAQ and was celebrated by the USAID Administrator in a ceremony at NASDAQ Headquarters in Washington in 1996.

The MPP was successful, with over 5,000 companies transferred to about 17 million shareholders. This immediately made the RASDAQ one of the largest exchanges in Europe and seemingly a flagship capital markets project where USAID had been able to quickly mobilize technical resources to both contribute to the success of a major MPP and greatly jumpstart overall capital markets development in Romania. It was considered by many to be USAID's most successful capital markets activity. Over time, however, some questions were raised regarding USAID's substantial investment. Funding for all aspects of the capital market was very costly and therefore difficult to replicate elsewhere. After an initial burst of transactions volume, many of the privatized firms were not viable and did not trade. Trading volume diminished and did not appear large enough to sustain the exchange.

Eventually, in 2005, the RASDAQ merged with the Bucharest Stock Exchange and remains as a section of the BSE. The initial exchange designed for MPP did not prove to be a fully sustainable institution but still played a key role in Romania's privatization and reform program.

By the end of the first decade, most mass privatization programs had been completed, and basic capital markets institutions had been set up. Capital market development assistance became more focused on the introduction of new products, such as mortgage offerings, investment products for pensions, and local currency debt issuances. In Ukraine/Moldova, for example, assistance was provided in corporate bond issuance, including mortgage bonds. There also was continued

³⁸ USAID's Capital Markets program in Russia met a significant setback when two employees of its grantee, Harvard Institute for International Development, were accused of fraud. The US government ultimately settled the matter and recovered a large amount of its funding. Readers who wish more information on the case of the U.S. versus Harvard, Hay and Schliefer may research articles by David Warsh, Boston Globe financial writer, and others.

assistance to the regulatory authorities to strengthen rules relating to transparency and corporate governance. The current challenge for many markets is sustainability as the financial crisis has significantly decreased trading volumes. To help address this challenge, USAID is working to help build an integrated capital market in Southeastern Europe. The proposed “single” market, involving stock exchanges in Albania, Bosnia, Croatia, Macedonia, Montenegro, Serbia, and Slovenia, would allow investors to buy and sell stocks or bonds of blue chip companies from each country through a single, seamless trading and settlement platform.

While the newly created capital markets fulfilled their role in facilitating mass privatization, most were not successful in promoting capital formation and other roles of capital markets in advanced economies. These functions developed much more slowly and unevenly. The majority of the countries of the E&E region have completed the privatization process and their privatization ministries or state property agencies have been disbanded since the mid-2000s. The enterprises, if any, which remain to be privatized, are the larger strategic enterprises such as the oil and gas companies.

Many individual markets have faced challenges with low levels of trading, revenue, and a declining number of eligible listed firms. Local markets face competition to list blue chip companies from larger exchanges such as Warsaw, Vienna and London. Although some were tenuous, the establishment of the basic capital markets infrastructure not only permitted mass privatization to take place but paved the way for the regionalization of the capital markets.

Other Capital Market Initiatives

As noted previously, the State-Owned Enterprises in the Communist system were largely responsible for the healthcare and retirement programs of employees. However, as many of these enterprises became insolvent and were privatized or liquidated, the means of funding these programs evaporated. Governments felt obligated to maintain these promises or face the possibility of open revolt by the population. Consequently they were forced to develop new ways of covering the obligation without bankrupting the country.

As the banking sector strengthened and incomes rose, USAID began to look at ways to nurture the pension and insurance industries. In advanced economies, these are the largest sources of funding for the private sector. Moreover, at the insistence of the IFIs, most countries in the region were undertaking significant pension reform to reduce structural fiscal deficits and to promote macroeconomic stability. The World Bank, in particular, encouraged countries to reform their pay-as-you-go pension systems and introduce a multi-pillar pension system which relied on private pension funds. USAID supplied much of the technical assistance needed as part of World Bank programs in numerous E&E countries.

Political support to make self-directed and private pension funds a key element of the social safety net required confidence that these funds were safe investments and well managed. Furthermore, there was concern about whether these new pension funds, with long-term pay-out horizons, could find sufficient products in which to invest. Thus from the financial sector development perspective, a well-functioning private multi-pillar pension system required both 1) a new regulatory authority to ensure that pension funds fulfilled their fiduciary duty and

protected the citizens'³⁹ retirement savings, and 2) high quality products, particularly longer-term products for pension funds to invest in. USAID began a series of technical assistance activities to support a strong pension regulatory framework and supervision capacity as well as promoting more diversified and longer-term financial instruments (such as corporate bonds and mortgage products) which did not (and still do not to any great extent) exist.

The insurance sector in the region began to develop with casualty insurance and with the adoption of mandatory car insurance. Within the universal banking model adopted in most countries, banks and bank holding companies were setting up their own insurance firms leading to growing risks in the financial sector. As concerns grew about both adequate capital and management practices at the insurance companies as well as evidence of abusive practices, numerous governments in the region requested USAID help to promote: 1) better risk management at the insurance companies, including an actuarial profession which heretofore had not existed, and 2) a stronger regulatory system and supervisor to protect both consumers and the overall financial sector. As incomes grew in the region, USAID also supported the growth of life, health and unemployment insurance products, recognizing that these would be useful as well to promote lending to SMEs and households.

Another initiative that was an outgrowth of financial sector activity was Accounting Reform. Within the Communist System there was meticulous accounting of expenditure – but mainly for the purpose of minimizing theft and fraud. There was little understanding of, or need for, financial statements common to companies in private-sector markets. First as part of the efforts to privatize banks and companies, and later as a way of determining credit-worthiness of potential borrowers, a major effort was undertaken to change the way accounting was done in these countries.

The adoption of International Accounting Standards (IAS now IFRS) started in the banking sector as the bank regulatory framework required banks to report their capital, liquidity, and risks on their balance sheets, things impossible to do under the socialist accounting principles. An added incentive for the governments was the desire to privatize through attracting foreign investment. This required transparent financial statements. Moving towards IAS was not easy and required a cultural change and a new understanding of how to evaluate a firms' financial position. The banking sector's adoption served as an impetus for spreading accounting reform to the rest of the private sector.

³⁹ In Kosovo, pension reform by necessity was one of the first reforms put in place as there was no operating pension system under the control of Kosovars (pensions were held in Belgrade.) Because this was totally out of sequence for financial market development, i.e., there were no domestic investment products available at this stage, it was required by law that all pension proceeds be invested outside of Kosovo in highly rated government paper, such as U.S. and German government securities. That meant that the Kosovar savings were financing rich countries, not normally something the USG would promote. This is why USAID has worked hard to promote the development of a wide variety of investment products in E&E.

Successes, Disappointments, and Remaining Work

The complete transformation of the financial sector landscape across the E&E region was a significant achievement of the international community. By 2002, most of the 29 countries had functioning private banking sectors that were increasingly expanding lending to the private sector. The public had confidence in the banking sector and deposits were growing. A thoroughly reformed legal/regulatory framework appropriate for a private banking sector was in place. Effective bank supervision authorities had been established, which were enforcing prudential regulations based on international standards. The institutional building blocks of a capital market had been created—stock exchanges, securities and exchange commissions, clearance and settlement functions. New financial products and services were developing. A growing well-trained cadre of financial sector professionals existed. By any measure, the transition to a market-oriented financial sector in the region was a huge success, but it was not pre-ordained. And while the recent global financial and Eurozone crisis uncovered vulnerabilities in the region’s financial sectors, in general, they have remained resilient—another testament to success.⁴⁰

Voices from the Field

“The future of capital markets in the region now rests on their ability to help companies raise capital through debt, preferred or common shares...”

Robert Singletary, former USAID, SEC Attorney

Successes. The E&E countries’ success in building financial sectors, which fueled private-sector led growth, was a major achievement. USAID contributed enormously to accelerating the development of market-oriented financial sectors in Europe and Eurasia. It became a key partner to these countries as they developed sound private financial sectors based on U.S. commercial and regulatory principles and practices. Factors underpinning success included: an ability to respond to counterpart requests for assistance in a timely manner; program flexibility and responsiveness; high-quality technical assistance with deep expertise; adequate long-term funding leading to strong partnerships with counterparts; and substantial coordination with other donors and IFIs.

Banking. Through the establishment of commercial banker training institutions, USAID worked with the banking industry to deepen capacity to lend and to understand and manage risk. It helped develop credit bureaus and collateral registries key to broadening access to finance. The assistance that USAID provided to Central Banks and other regulatory authorities to put in place strong supervisory/regulatory regimes should be recognized as one of its most successful economic growth programs. Bank supervision programs can be credited with providing confidence in the banking sector, the rapid entry of EU banks, and integration into the global financial system. The rapid emergence of a functioning banking system and robust loan growth to businesses and households was an essential element of private-sector led economic growth. When the global financial crisis hit in 2008, affecting the region in 2009, USAID’s focus and investment in bank supervision seemed prescient. The banking systems in most E&E countries proved resilient (with some exceptions, e.g., Ukraine). There were very few instances of panic withdrawals; today deposit growth has resumed, and credit flows are expanding much faster than GDP.

⁴⁰ In 2009, at the height of the global financial crisis, Poland was the only country in the European Union that did not experience negative GDP growth.

Why did they work? The most important factor was the leadership provided by the Central Banks/regulatory authorities and their openness to change and absorptive capacity. Willingness, even encouragement, to accept external investment and ownership brought new capital and modern practices, mainly from Western Europe. Other factors were close collaboration with the IMF and World Bank in the design and implementation of the programs so that they were integrated into Central Bank/banking reform. Programs employed long-term resident banking advisors with substantial experience in U.S. regulatory institutions. They were able to build the trust of local officials and establish good communication channels, which accelerated the transfer of skills.

Capital Markets. The major objective of capital markets development in the first decade was supporting mass privatization. Most projects were successful at doing that. While the overall success and impact of MPPs themselves was mixed, the capital markets functioned adequately.

The viability of many small markets created with USAID assistance has been questioned, but the majority of these capital markets institutions still function. Moreover, these small markets had good infrastructure and were successful in becoming part of regional markets during the second decade, particularly in CEE. The Vienna Borse, under the “CEE Stock Exchange” brand, now owns and operates the Budapest, Prague, and Ljubljana Stock Exchanges. NASDAQ/OMX operates nine European stock exchanges, including the three Baltic States and Yerevan. The Warsaw Stock Exchange bought the USAID-funded Warsaw OTC. These consolidations have strengthened local markets and brought them into the global economy. This could not have happened without the previous country-by-country USAID assistance. Stand-alone capital markets projects prepared local markets to join regional alliances affording smaller countries access to capital market functions.

Why did they work? In addition to the support of politically connected champions in the host country, other important key factors were: USAID assistance in funding the creation of registries, depositories, exchanges, and broker/dealer groups. USAID also recruited staff with the specialized knowledge of how capital markets function. Without this expertise, it would have been extremely difficult to design, implement, and monitor capital market activities. The Agency relied on long-term resident advisors experienced in regulatory institutions, Wall Street, and the SEC, which helped accelerate the transfer of know-how. Early on, programs were encouraged to coordinate with international organizations such as the International Organization of Securities Commissions (IOSCO) and numerous study tours were organized to give firsthand experience.

Disappointments. Even before the financial crisis hit the region in 2009, financial markets still remained small (as a percentage of GDP) and unsophisticated. They were also risk averse to non-urban areas. In banking, programs that worked well in CEE/SEE did not yield the same impact in the FSU. Longer-term lending products remain rare. While mortgage finance showed substantial growth, much of the lending was denominated in foreign exchange to obtain a lower interest rate. When the crisis hit, these loans could not be repaid and mortgage lending has evaporated. Access to finance remains centered on top tier clients and banks are not aggressively developing new products. Promoting strong regulatory authority could not prevent crony capitalism. Eurozone

bank domination of CEE/SEE banking systems was key to integration into the global system, though once the global financial crisis hit, these banks were a huge source of vulnerability.

In capital markets, those created during the first decade fulfilled their role in facilitating mass privatization, but most were not successful in promoting capital formation and other roles of capital markets. These functions developed unevenly and the sustainability of the capital markets is in question for many exchanges. Markets are not adept at promoting additional sources of capital (e.g., commercial paper, currency debt, preferred stock listings). Suggestions of regionalization were largely ignored; having a stock market was often a matter of national pride. The regionalization of many local markets in the second decade, and their acquisition by global players, was a somewhat unexpected change that will greatly enhance their viability.

In some countries, the introduction of private pension funds has just begun to have an impact on the financial sector's sophistication. Insurance products remain rooted in casualty and auto liability; life insurance and other risk mitigation products for individuals and businesses (e.g., crop insurance, private health, and mortgage) remain underdeveloped. The sector remains constrained by historical practices such as setting actuarially unsound premiums which deters new and innovative product development.

Remaining Work. Prior to the global financial crisis, the financial sectors remained small and unsophisticated and bank-dominated in the remaining E&E countries, but were performing their most important function—financial intermediation. The trends were moving steadily in the right direction in the context of strong economic growth and rising prosperity. Since the global financial crisis, this has all changed, as vulnerabilities were unmasked and most of these positive financial trends have gone sharply into reverse. The region's trade linkages and financial sector ties with the Eurozone, previously beneficial, helped push most of the countries into recession in 2009. Concerns about financial sector stability have grown. Credit has evaporated as the region's banks were consumed by problem loans granted during the pre-crisis boom and are now risk averse. In the context of 'deleveraging' of banks in the Eurozone, during 2011 the size of the financial sectors actually contracted across the region. Post-crisis trading activity and new offerings of equity and debt instruments have declined to such low levels that the viability of the stock exchanges in the smaller countries of the region is threatened.

Until financial sector stability returns to the region it will be hard to expand access to finance, and promote greater product sophistication essential for more robust economic growth and job creation. The following financial sector areas require extensive assistance:

- Developing transparent, predictable methods based on international standards/best practices to deal with systemic financial instability;
- Strengthening the ability of regulatory officials to respond to or to mitigate the effects of a financial crisis to include improving the process of bank resolution to deal with problem/failing banks on a cost-effective basis;
- Improving legal procedures regarding foreclosure and liquidation of collateral and helping banks deal with the overhang of bad debt;
- Strengthening risk management procedures;

- Promoting the development of innovative financial products and services tailored to the needs of SMEs and those enterprises operating in the rural areas, e.g., leasing, factoring, mobile banking, to achieve greater and more inclusive financial intermediation;
- Promoting the integration/consolidation of small stock exchanges to gain scale;
- advancing the adoption of international best practices and standards with respect to financial sector development in support of EU accession.

PRIVATE ENTERPRISE DEVELOPMENT

Context

When the Soviet Union collapsed, neither the government nor the productive sector of these countries had any real experience with private enterprise based on supply and demand, profitability, prices, quality and competition. Instead, product output according to the Five-Year Plan was an objective, and meeting those targets the key achievement measure.⁴¹ USAID and other donors had to start from scratch in shifting the mindsets of government, company managers, and the population away from dependence on the collective state and toward the risks and rewards of profit-oriented private enterprise. This massive economic region had long labored under a system of skewed incentives completely contrary to a market economy. As a consequence, communism had spawned networks of privilege and vested interests in government and industry, a hugely inefficient and non-competitive industrial sector with no understanding of how a market economy works, and pockets of vested interests that actively resisted reform.

Objective

The overarching objective of USAID’s private enterprise development strategy was to help rapidly grow a business sector that would reduce increasing unemployment resulting from privatization and disintegration of integrated state-owned enterprises. The population’s income dropped commensurate with the sharp drop in GDP. The strategy was also predicated on the belief that with greater economic freedom, the political trends that led to the collapse of the communist system could not be reversed. Helping to jump start growth in private sector activity would result in good jobs, promote economic prosperity and reduce growing poverty in the region, thus stifling any desire of the population and politicians to slip back into the past and return to the supposed “good old days of Communism.” Growing economic instability and high inflation throughout the region were viewed as serious threats to the nascent democracies. Consequently, the approach to reform was urgent, aggressive, and donor-directed. Later, when political risk receded, programs became more “demand-driven” and emphasized local buy-in and local implementation.

USAID sought two major intermediate outcomes. One focused on assisting governments to put in place the commercial law to legalize private sector activity and, once in place, improve the business environment primarily by streamlining the commercial regulatory environment. The other focused on supporting enterprises to deliver goods and services efficiently. Given the huge

⁴¹ Even in the former Yugoslavia, the major SOEs manipulated their export prices simply to generate sales volume so that they could meet state-mandated foreign exchange revenue targets, without regard to profitability. As a result, export prices could be considerably lower than domestic market prices for the same product sold by the same company.

numbers of enterprises in an economy, the challenge for USAID and the donor community was to reach the largest numbers of firms in a cost effective manner.

Approaches

USAID's approach rested on the principle that all economic growth ultimately takes place at the level of the productive enterprise. In theory, improving productivity and competitiveness of individual firms was the focus of assistance programs, spanning a wide range of needs, both external and internal to the firm itself. As USAID gained greater understanding of the huge gaps and needs in the enterprise sectors in the region, (as well as differences between geographic sub-regions) it incorporated the lessons learned and set new priorities. While the approaches to private enterprise development evolved over the two decades, they all focused on assisting both existing and new private enterprises and industries to better understand the commercial market and its demands, and to gain the capacity to deliver a competitive supply in response. In rough chronological order, USAID's approach to enterprise development can be broken down into six principal themes over the two decades:

- *Firm-level capacity building.* In the early years, E&E programs sought to make large numbers of firms capable of operating in the competitive market through hands-on, labor intensive in-company consulting and the establishment of USAID project-run business assistance centers. This approach was in response to the need to introduce business practices broadly, without a need to differentiate by industry type.
- *Business development services (BDS).* Partly in reaction to the expense of such intensive firm-level assistance, and in pursuit of sustainable results, this set of projects sought to build networks of domestic service providers that would provide needed advisory and other services to a group of enterprises. In this way, USAID assistance could help a larger number of private enterprises, keeping up with the increase in business activity as the market economy took root. Cost sharing of services was introduced, with enterprises covering costs such as accommodation. Though these networks were principally reliant on USAID funding, they reached many more firms and had an impact on increasing business acumen and business expertise.
- *Business environment reform.* In parallel with activities directly supporting better business practices, the realization that the private sector was also hindered by the persistence of numerous bureaucratic obstacles to entrepreneurship, (for example, time consuming and expensive registration and licensing procedures), led to a new focus on the microeconomic foundations of growth. The creation of the World Bank/IFC's cross-country *Doing Business* ratings both popularized the critical idea that successful private sector development required reforming the business environment and provided the correct incentives for entrepreneurship and competition. The *Doing Business* reports also provided a helpful framework of metrics to highlight individual country weaknesses and then measure progress in reform. In allowing countries to compare their performance against their neighbors and other countries, they also provided incentives for countries to compete to do better. With the rise of demand for assisting on *Doing Business* issues, USAID revised the methodology to track the World Bank framework while targeting reforms beyond the narrow indicator sets used there. That being said, these are just

indicators focused on ten discrete factors, and do not tell the whole story about the business environment. It is important to take other factors into account as well.

- *Cluster competitiveness.* At the same time as USAID was adapting its programs to take account of evolving needs in the E&E region, the cluster approach to country competitiveness emerged from academia as an organized model of describing successful enterprises and the relationships between business and government to foster economic growth. USAID staff incorporated these competitiveness principles into many of its projects, as the business sector in the transitioning countries began to advance. By this time, there was both a sufficient mass of private firms to work with as well as a much greater understanding of the countries' comparative advantages, so that the idea of developing a cluster of firms to meet the needs of the market for goods or services resonated with USAID and local business counterparts. USAID teams realized that by narrowing the sectors assisted to those with a comparative advantage in a country, based upon a number of attributes, assistance gained greater potential to have impact on income and employment growth.
- *Value chain development.* Enterprise development project design took a further step, driven both by the need to find cost-effective ways of working and by the explosion in private enterprise activity. Based upon work originating in the agricultural sector projects in the region, USAID found that selected sectors could be best assisted by analyzing the activities along the value chain. By using the value chain framework as a way to deliver assistance, USAID could facilitate linkages between established producers and processors, as well as support the development of new complementary businesses along the value chain.
- *Trade facilitation.* With one foot in business environment reform and the other in firm-level competitiveness, the goal of these programs was to advance private sector development by focusing on assisting countries with WTO accession requirements and helping firms to meet international safety and product standards necessary to export.

From the beginning, all of these approaches had attributes in common, and the evolution of USAID's focus was more a matter of learning, cost-benefit analysis, and increased sophistication of the E&E enterprise sector. Three major trends in emphasis were evident: the first was a move from what might be termed "retail" intervention at the level of the firm to "wholesale" assistance to groups of firms. Firm-level consulting gave way to facilitative approaches—training BDS providers, fostering cluster development or value chain linkages, stimulating policy reform, and supporting trade certifications. The second trend was toward local implementation and sustainability. The staff makeup of enterprise development projects changed radically, from early ones with 20 or more resident expatriate consultants to only one or two in key leadership positions; even there, transition to local leadership halfway through the project became common. A third trend was moving from donor-driven interventions to ones driven by local businesses that focused on market demand. We review these six thematic approaches below in more detail.

Firm-level Capacity Building

Enterprise development in Russia, Moldova and Ukraine was initially driven by the desire to build the entrepreneurial foundation of a working market economy and consolidate the democratic revolution. It seemed that assistance programs should directly address constraints at

the firm level, delivering consulting services to help firms develop viable business strategies, improve productivity, manage finances, and market and sell. USAID projects branded and promoted themselves as “business assistance centers,”⁴² and organized their expatriate-led teams to cover broad portfolios of companies. Centers were built in eight cities in Russia and four in Ukraine and Moldova according to this model. Newly privatized as well as newly founded businesses needed capacity building in market economy skills—such as cost accounting, strategic planning, product promotion, sales skills, and customer service.

These projects sought to stimulate the emergence of a viable SME sector. Their point of departure was on the supply side—what firms were already capable of producing—based on natural comparative advantage and industrial experience; that seemed the quickest route to success. With virtually no business skills among the local population, the needs were great everywhere. USAID projects provided consulting across many industries; the focus was broad rather than deep. Moreover, until local staff could be trained, most of the centers lacked sustainability as expatriate advisors had provided heavy technical assistance without requiring co-payments.

They provided direct assistance to beneficiary companies, worked little through local partners, and often assisted commercial business, e.g., a U.S. expatriate advisor would arrange a successful but one-off export deal between a company and a U.S. buyer. In most cases, at project end, the business assistance center folded due to the inability to sustain the infrastructure costs. The centers that achieved sustainability did so largely in cases where the projects had large local staffs intensely trained in business skills. After project end, some centers were thus able to establish consultancies that marketed to local firms or facilitated foreign financial and strategic investment.

Following the efforts in Russia and Ukraine, similar versions sprung up throughout the region. Other U.S. government agencies, such as the Small Business Administration and the Department of Commerce, provided technical assistance and funding to establish centers to serve businesses in Hungary, Slovakia, and other Central European countries. Commerce made a particular effort to link U.S. businesses to these centers, for example through its Washington-based BIZNIS office, partnering with USAID projects in the region. Subsequently, USAID economic growth projects from Eastern Europe through Central Asia incorporated a business center type approach to delivering firm level assistance. The contribution of USAID’s firm-level capacity-building projects should not be understated; they supported a number of companies that ultimately prospered and became important employers and industry leaders. Firm-level assistance demonstrated effectiveness and brought stakeholders on board for procedures and policies to build company competitiveness. However, given the numbers of unemployed and the economic downturn that followed the collapse, USAID sought to do more.

Business Development Services

⁴² The FREEDOM Support Act “*Encourages the President to establish American Business Centers in the independent states. . .*” – see excerpt on Page 2

Due to expense and lack of sustainability of firm-level assistance, by the second half of the 1990s, establishing “business development services” (BDS) rose to prominence as an alternative approach. By this time, through participation in training in-country or by studying abroad through the many exchange programs offered, a sufficient number of people existed with nascent skills useful in the business world to form the basis of BDS providers. The approach relied on delivery of similar services as in business centers, but on a more commercial basis to generate income for sustainability by selecting clients based on their willingness to pay, who would therefore value the services and incorporate them into their businesses. The best examples are projects in Croatia, Bosnia, Macedonia, and Kosovo in which USAID consultants built capacity in local consulting firms which could continue to provide services needed to build competitive firms after assistance ended. Advisors moved into “train the trainer” roles to develop cadres of local service providers. A common project goal was to stimulate the emergence of a viable BDS industry.

BDS projects initially found it difficult to “sell” services in the absence of large donor subsidies—especially since the previous firm-level assistance projects had provided services for free. To overcome the confusion on the part of new businesses, BDS projects worked to match businesses with need of services with service providers to find paying customers.⁴³ In the post-conflict example of Bosnia and Kosovo, USAID designed parallel BDS and business finance projects as part of the reconstruction assistance. The BDS projects assisted enterprises not only to prepare bankable documents to qualify for loans from the business finance project but also to provide ongoing technical assistance to improve borrowers’ chances of success (measured by income and employment growth.)

A closely associated theme in USAID assistance was *business membership organization (BMO) strengthening*. Historically, E&E countries had chambers of commerce but mostly they were quasi-governmental in nature. They often carried out regulatory type services mandated by governments. USAID projects turned instead to strengthening the emerging industry-level BMOs that actually represented the interests of new private owners. These chambers and industry associations then looked to business service provision as a means to viability by charging fees for services to their members. USAID programs also provided assistance to educational institutions to increase their capacity to teach business management skills. Since many institutions had support from education budgets, they could provide affordable services to local businesses.

- Business Services
Advanced by USAID
Projects**
- Accounting
 - Marketing, including market research, branding, sales agents
 - Business strategy and financial planning
 - International trade standards and certifications
 - Access to finance
 - Production operations and technology
 - Quality management
 - Information technology
 - Transport and logistics

Business Enabling Environment (BEE) Reform

The goal of BEE reform is to enable businesses, and those supporting them (especially financial institutions), to operate within a reliable and effective set of rules and regulations that facilitate (and not interfere with) business activity. Under communism, private business activity was considered illegal, and rules existed to constrain or limit those

⁴³Tanburn, J. 2008. The 2008 Reader on Private Sector Development from the ILO ITC. Geneva, Switzerland: International Labour Organization.

activities. To overhaul this legal framework, USAID designed a series of projects with a focus on improving the commercial, legal, and regulatory environment. Enterprises could not advance unless legacies of red tape and repression of free enterprise left from the prior regime was eliminated.

USAID's efforts in BEE reform were given a big boost following the introduction of the World Bank/IFC "Ease of Doing Business" indicators in 2004.⁴⁴ The indicators first focused on regulatory obstacles to market entry—later known as "starting a business" that demonstrated that economies with more streamlined regulations grew faster. "Doing Business" reports provided a scorecard ranking countries, creating competition among reform-minded countries. This led to a more receptive climate for USAID's technical assistance activities. However, USAID soon recognized that it was necessary to work more broadly than just on the ten indicators in "Doing Business" in order to achieve robust reform.

USAID developed tools to analyze the institutional foundations of commercial legal frameworks through the Commercial Legal and Institutional Reform (CLIR) Project. Using the "Doing Business" indicators as a foundation, but going beyond them, USAID developed the BizCLIR series⁴⁵ to identify and treat legal, regulatory, and institutional obstacles to competitiveness. In practice, business environment improvement projects focused on streamlining permits and inspections. They polled businesses as to their problems with the regulatory environment, "inventoried" regulations across ministries and agencies, and applied "bulldozer" and "guillotine" tactics to expunge red tape. BizCLIR diagnostics have helped over 30 countries to improve their business enabling environments complementing USAID's ongoing efforts to promote enterprise development more directly.

USAID's CLIR project organized the basic set of 11 "core laws" into four areas:

1. Property rights: real property, personal property and collateral, and intellectual property;
2. Contract rights: contracts, international trade, and foreign investment;
3. Business rights: company law, bankruptcy, and competition policy; and
4. Access to justice: court administration and commercial dispute resolution.

This aided countries to understand and reform their legal system. In particular, improvements to laws related to company formation and registration have eased market entry and helped expand the number of SMEs in the E&E economies. Legal reform driven by USAID projects in the early years catalyzed effective public-private dialogue mechanisms. For example, foreign investment councils became formally registered organizations advocating for improved laws and critiquing those that were in place through the annual or bi-annual publication of "White Books."

Both ad hoc and long-lasting public-private dialogues have had positive effects on streamlining regulation flowing from the commercial legal structure. Some countries in E&E—Georgia, Estonia, and Macedonia are good examples—moved aggressively to reduce the number of procedures, cost, and time that it takes to start a business, to register property, to obtain

⁴⁴ Djankov, S. et al. 2002. The Regulation of Entry. Quarterly Journal of Economics 117.1 (2002): 1-37. Oxford: Oxford University Press.

⁴⁵ Business Climate Legal and Institutional Reform. See www.bizclir.com

construction permits and to pay taxes. Projects that have helped elevate public-private dialogue in awareness, and publicized the cost of obstructive regulations, have had more success.

Legal and regulatory reform projects also engaged with civil society organizations in the process of generating pressure for reform and for public review of new draft legislation. Enterprise development projects increasingly emphasized the cross-cutting issues of gender, inclusion, and environmental sustainability. These themes stimulated work with civil society-based NGOs, working groups, and dialogue mechanisms supporting women's economic empowerment, economic inclusion of persons with disabilities and those facing discrimination due to ethnicity and environmental protection. Civil society was also the target of a wide variety of public education activities in many private sector development projects to "change the mindset" of citizens in the formerly command economies.

It needs to be recognized, however, that simply changing laws and regulations does not automatically guarantee a change in actual practice. Implementation and enforcement of these laws remains a work in progress. Therefore, rankings can be misleading because they only measure the enactment of laws not the enforcement of laws.

USAID also supported units in government that promote enterprise development and helped these organizations change their perspective from one of controlling business to one of business promotion. For example, Ukraine established the State Committee for Enterprise Development, which led the regulatory reform effort on behalf of government. Bulgaria created an Office for the Promotion of Small and Medium Enterprises, and Montenegro established a similar agency. In other countries, the functions of promoting enterprise development have fallen under the ministry of trade and industry or the ministry of finance. In some cases, the foreign investment promotion agency—Macedonia is a good example—became an effective champion within government for legal and regulatory reform to facilitate inward investment. While USAID often provided technical assistance for capacity development, and sometimes limited financial support (for example, for ICT to help enable e-government initiatives), the success of these governmental units has been uneven, depending upon the political environment and the capabilities and influence of their ministers or directors.

Cluster Competitiveness

By the late 1990s, USAID technical staff began to view enterprise development more holistically. The next wave of USAID projects promoted the cluster mode, a paradigm popularized by Michael Porter⁴⁶. This coincided with the growth of large numbers of private businesses as well as more sophisticated knowledge of the strengths and weaknesses of the local and regional markets. The idea was that businesses operate in highly interdependent geographic agglomerations, so that enterprise development must have a point of view greater than the individual firm. Assistance moved from "retail" (firm-level) to "wholesale" (groups of firms).

USAID projects in the Balkans became facilitators of networking among companies around a product or service category, generally one with potential for value added. For example, USAID might bring together enterprises in the same sector and thereby increase their access to trained

⁴⁶ Porter, M.E. 1990. *The Competitive Advantage of Nations*. New York, NY: Free Press.

people, through job fairs and cooperation with facilities in universities, and technological factors of production⁴⁷ by linking them with design centers or engineering institutes. Through business-to-business events, USAID projects connected local suppliers with larger companies linked to global markets, resulting in local content replacing imports. Cluster competitiveness projects also enabled SMEs to join together in investments and therefore reap benefits of scale previously available only to larger firms. For example, by joining together to sponsor representation at an international trade show, a group of SMEs could present a wider product range to buyers than a single enterprise might have done. Joint action in operational areas, such as sharing production technologies and input purchasing, also saved costs.

Meanwhile, USAID projects continued to provide capacity building in business and production management, marketing, access to finance, and quality assurance, often leveraging local skills developed in BDS and business association strengthening projects. Clustering encouraged the emergence of local constituencies for joint lobbying of government for improvements in the policy and regulatory environment. For example, a furniture cluster, whose primary objective was export expansion, could lobby government for changes in laws regarding timber harvesting and policies to meet the demands of “green design” and environmentally conscious consumers. Some cluster initiatives also encouraged business incubation centers and special export zones.

By the time these projects were extended to include the Caucasus and Central Asia, the ardor for clustering had cooled as it became clear that such approaches did not address all obstacles to competitiveness. For example, efforts to launch industries *de novo* were often not successful, however, if some domestic product or service firms were already forming and needed strengthening, USAID assistance had a big impact. These “second generation” projects focused more on existing enterprises and industries, identifying the critical constraints at the firm, industry, and policy with the objective of removing them to improve overall growth.

Local Capacity Development for Competitiveness

Projects that develop a local constituency for reform achieve lasting results. A good example was in Bulgaria, where the USAID project acted as a secretariat for the IT industry to promote a national strategy for development of the sector, and connect international IT companies and local software development firms. Notably, the project facilitated a cluster that had already been formed by the private sector itself. In the end, the strategy developed by the cluster was adopted by the government of Bulgaria. (*Assessment of the Bulgarian Enterprise Growth and Investment Project (EGIP)*, Silcox et al., USAID February 2005)

Value Chain or Sector Development

In successful market economies, products pass through several activities in a chain from their raw state to become a processed product. Under communism, state-owned enterprises were themselves vertically and horizontally integrated, and, as a result, most of the processing or value-adding activities were done by a single enterprise. In some E&E countries, there were gaps in the value chains left by the failure of these enterprises; in others, critical parts of the chain never existed because of the obsolescence of the industry or parts of the value chain were in geographic areas no longer easily linked. After the collapse of central planning, the countries in the E&E region were often only able to export raw materials as they had lost much of their

⁴⁷ Solvell, O., G. Lindqvist, and C. Ketels. 2003. *The Cluster Initiative Greenbook*. Stockholm: Swedish Agency for Innovation Systems.

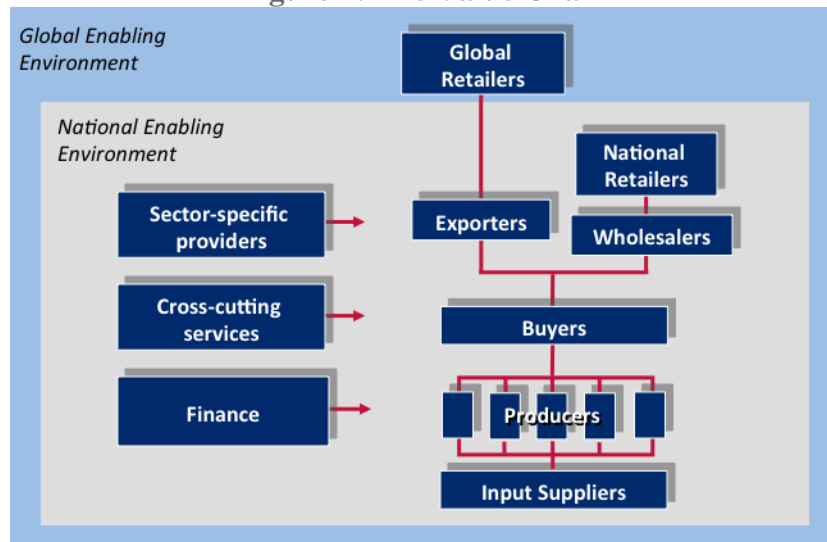
processing capacity. Consequently, E&E domestic enterprises were not gaining any benefit from profits that could be made by processing those products. One example might be Bosnian beech wood, which when exported to Italy was made into quality furniture, sold at high prices—Bosnian enterprises did not have the designs, craftsmen, or distribution channels to produce and sell furniture that would compete with the Italian makes, until USAID assisted in making these linkages.

The value chain model helped identify and address obstacles to competitiveness. The model encompassed both vertical business relationships as well as cross-cutting services, so it incorporated cluster and BDS concepts which USAID had already introduced. The model highlighted the role of access to finance, workforce development, and the business, legal, and regulatory operating environment, both within the country and in the global economy. Cluster and value chains projects both focused on specific industries and/or sectors. In some cases, USAID directed implementation to pre-selected sectors while in other cases, projects were required to analyze and select value chains during the initial months of assistance. Based on sub-sector analyses, value chains that had the best prospects for growth in that country's economy were selected—the impact of those sectors on overall economic health was paramount.

Typically, program objectives were improvements to metrics such as revenue, employment growth, exports, and finance. These value chains often included metal products, wood, construction and building materials, processed foods, apparel and leather products, and tourism. In sub-regions, such as the Balkans, due to the fact that comparative advantage in a particular sector went across country borders, USAID often supported the same sector in several countries. This has facilitated regional integration and is a pathway for greater competitiveness vis-à-vis other integrated markets. In addition, USAID sometimes supported nontraditional sectors such as Information and Communication Technology (ICT), which provides cross-cutting services to all economic sectors.

The value chain approach integrated a number of assistance approaches—business environment, business services, and competitiveness—that previously had been independent, and focused on enabling firms to reach their sophisticated end markets, the highest point, as shown in the graphic above. Practitioners saw “market facilitation” as the tactical approach to applying the value chain model. Market facilitation meant that USAID projects would not occupy a link in the value chain, as it did when directly funding business centers. Instead, projects assisted firms to grow through building their capacity to serve markets more effectively. This furthered the progressive trend toward assistance to generate sustainable, domestically led impact that had started in enterprise development.

Figure 1: The Value Chain



Cluster and value chain projects have had much in common, and USAID missions in the E&E region have embraced them. Since starting in Croatia and Bulgaria in 1998, 14 missions have launched economic growth projects based entirely or partly on these approaches. Six countries have completed “first generation” projects (cluster-based), and have subsequently launched “second generation” projects (value chain-based).⁴⁸ Actual and anticipated funding for these initiatives from 1998 to present exceeds \$300 million.

Table 1: Cluster and Value Chain Competitiveness Projects

Country	First Generation Launch	Second Generation Launch
Bulgaria	1998	Graduated
Croatia	1998	Graduated
Macedonia	2002	2007
Serbia	2002	2007
Albania	2003	2009
Bosnia & Herzegovina	2004	2009
Georgia		2010 ⁴⁹
Kosovo	2003	2008
Romania	2003	Graduated
Moldova	2004	2010
Armenia	2004	2011
Azerbaijan	2008	2010

Trade Facilitation

While trade was important, few companies had products or services that could compete in global markets. Other than in energy products, trade relationships between the countries that emerged from the Soviet Bloc had mostly collapsed, since under a command economy they were based on

⁴⁸Nathanson, N. 2011. An Overview of Competitiveness Projects in the E&E Region. Washington, DC: USAID.

⁴⁹ Georgia’s EPI Project, launched in 2010, is more accurately considered a “second generation” project, even though Georgia never launched a project with the characteristics of “first generation” projects.

supply and distribution, not on supply and demand. Trade facilitation encouraged enterprise development projects to become competitive. Trade can only take place when: 1) a trade policy and customs environment exists; 2) enterprises produce competitive goods or services; 3) linkages are established between local producers and buyers; and 4) viable and cost effective transport facilities are available. The last three of these conditions are goals of enterprise development projects.

As private enterprises became more competitive, focus on international trade gained prominence. This approach coincided with the emergence of “globalization” as the principal driver of growth; if firms were incapable of competing globally, their economies would not prosper. Large corporations in advanced economies expanded outsourcing of production and services to lower-cost foreign operations, enabled by advances in ICT that supported supply chain management across regional operations.⁵⁰

USAID’s trade strategy was two-pronged. First, they helped countries accede to the WTO, which involved policy and legal reforms complementary to business enabling-environment projects, promoting competitiveness. Second, trade facilitation activities targeted industry- and firm-level prerequisites including: obtaining certifications to export products to the United States, the EU, and OECD countries; adopting product health and safety standards, such as HACCP, and consumer-driven standards such as Fair Trade and chain-of-custody certification, as well as non-mandatory quality management system certifications. USAID-sponsored trade fair participation and industry-specific study tours helped business people become acquainted with modern production and marketing techniques, and to make linkages with foreign businesses.

An exemplary project was the TRADE Network in Southeastern Europe, which stimulated trade among Croatia, Hungary, Bulgaria, and Romania by developing intra-regional trade linkages and helping businesses obtain certification. The need for standards and certifications in international trade are now an important element in assistance. These conditions were achieved fairly rapidly in Central Europe, but in the FSU, they remain a work in progress. In helping countries prepare for accession to EU and WTO, and to advance transport logistics and customs reform, trade facilitation projects opened up economies so that firms could export more easily to each other and to Western markets.

Successes, Disappointments, and Remaining Work

Successes. It is no exaggeration to say that millions of people have benefitted from the transition to private sector economies in the E&E Region. Thousands of individual enterprises gained valuable knowledge from the assistance and services provided by USAID’s enterprise development programs, and today many of them operate successful, profitable, job-creating enterprises in every country of the region.

Many institutions that USAID had supported continue to effectively market their services to local business, foreign investors, and local government (see Appendix 5 on Legacy Institutions). These include business associations, business service centers, business consulting firms, trade

⁵⁰ United States Agency for International Development. 2003. Building Trade Capacity in the Developing World. Washington, DC: USAID

and industry associations, think tanks, and product safety and quality standards certification bodies. Often, the transition to financial independence was achieved only by moving upmarket to provide services to businesses that could afford to pay, frustrating some objectives of USAID and other donors to focus on serving small and micro enterprises. A USAID review of enterprise development concluded that firm size should not in itself be a key factor in project design; in other words, both large companies and SMEs should be candidates for support.⁵¹ Other private sector institutions catalyzed by USAID projects have survived by gaining a critical mass of dues-paying members, without having to market consulting services.

This is true of the foreign investor councils, cluster organizations, business improvement districts, competitiveness councils, and public-private dialog advocating for better policy and business enabling environment reform.

An example of a multi-country private institutional initiative supported by the USAID E&E Bureau's Regional Competitiveness Initiative (RCI)⁵² is the Center for Entrepreneurship and Executive Development (CEED)⁵³. CEED provides executive training, promotes networking with investors, and facilitates entry into new markets through branches in several countries and regular multi-country conferences.

Success in USAID's investment in private sector development can be assessed in three dimensions: technical approach, business results, and sustainability.

Technical Approach: USAID's assistance approach evolved dramatically, starting as expatriate-dominated consulting, and ended up as a facilitative, systemic model implemented through local partners developing their own strategies. This success has been applied in enterprise development projects throughout the developing world.

Business Results: The countries of E&E are now all sizeable exporters, most with dramatic advances in their export/GDP ratios between the mid-1990s and now.⁵⁴ This is a broad measure of substantial improvement in the business results of individual firms. Since economies are now significantly larger; this translates into greater export incomes, external demand, and increased imports. This benefits not only themselves, but exporters in the United States and other donor countries. Virtually all enterprise development projects have tracked business results of beneficiaries, which have shown large returns on the USAID investment.

Sustainability: Private sector development assistance lasts beyond the support project in two ways: 1) long-lasting business relationships and results brought by improved competitiveness and business connections, and 2) the creation of capabilities in people

⁵¹ Snodgrass, D.R., and Packard Winkler, J. 2004. Enterprise Growth Initiatives: Strategic Directions and Options. Bethesda, Maryland: Development Alternatives International.

⁵² www.rciproject.com

⁵³ www.ceed-global.org

⁵⁴ The only countries in the region whose ratios did not rise over the period were the Russian Federation, Moldova, Belarus, and Romania, probably reflecting the extended depression of their GDPs during the early 1990s, which caused the share of exports in the base period to be artificially high.

and institutions to carry out policies, strategies, and activities. The number of private sector development supporting institutions whose capacities have been improved or have been created *de novo*—business associations, cluster organizations, training providers, development agencies, chambers, business improvement districts, investor councils, competitiveness councils—has been manifold. This is a remarkable USAID legacy.

Disappointments. Business professionals throughout the region have often been constrained by mixed political will and vested interests (both in the bureaucracy and among the economic elite), and the drive toward enterprise development reform has been more widespread and ambitious in some countries than others. Countries that have acceded to the EU have shown considerable progress but now experience inertia. Although GDP growth was strong in most countries from 1998 to 2008, the private sector failed to create enough new jobs. In these countries, unemployment remains high (often above 30%), characterized by massive long-term and youth unemployment. The gray economy is still pervasive, which paradoxically is a stabilizing factor in keeping up living standards.

Many E&E countries remain well down the list in the rankings of their business enabling environment, competitiveness, economic freedom, and corruption. The radically reformed legal environment still needs time to be fully implemented. A good example is bankruptcy law, which USAID BEE projects helped develop and adopt. In practice, the number of cases of successful use of bankruptcy law has been minimal, due to lack of dedicated commercial courts, a relatively small number of bankruptcy judges, and a limited number of professional advisors to assist companies navigate the process.

The same can be said for laws to facilitate private sector development as well as a range of policies supporting public-private collaboration. Virtually all E&E countries have adopted a range of policies, strategies, and action plans for export promotion, SME development, innovation, investment promotion, access to finance, and development of industry sectors—either on their own initiative or through donor-funded projects. These documents are “checked off” then sit on shelves, unimplemented. USAID provided assistance to move the implementation of these policies to the level of the budget—but constrained resources and different political priorities mean the institutions responsible for their implementation are unable to move forward.

Work Remaining. USAID continued support for private sector development and industrial and employment growth remains a priority in those countries not yet ready to put in place incentive structures for enterprise growth. As is normal, change has benefitted urban centers more than rural regions and private enterprise development activities should focus on less developed areas to achieve more balanced growth. In addition to support to central and local governments for economic development, partial donor support to build the capacity of business advocacy groups to continue to promote the interests of the business community is also needed. Until the economies of countries in the western Balkans and Eurasia are fully capable of providing such support from their own budgets, some degree of donor assistance remains necessary and justified to the extent that the development of these economies is in the national interest of the United States and other donor countries. This assistance should be based on a close partnership with countries and be primarily implemented by local organizations.

An important area for concentration is regional integration. The external trade of the countries of E&E remains excessively on a “hub-and-spoke” basis with the OECD economies, while their trade with each other is far below what it could be. Most of the countries have internal markets that are too small to accommodate the business activity of the medium-sized firms that drive employment growth in developed economies. The only way market size can grow for many companies is through fluid, completely unobstructed trade with their neighbors.

Despite some advances, cross-border trade in E&E is far from frictionless. Agreements are reached to reduce tariffs but non-tariff barriers exist and new ones can arise ad hoc. Furthermore, unfortunately, there are numerous legacies of ethnic division that prevent people from freely trading across borders as well as within their own borders. This is a serious problem for private sector development that needs to be overcome.

We still need to encourage and advance implementation of legal and regulatory reforms. This is primarily a question of institutional development and strengthening. The supporting institutions of the advanced economies have been built over many decades, and are still being improved, so it is not surprising that this process is unfinished in the E&E region. Development assistance programs are typically designed with shorter time frames, so the need for follow-on support must be assessed and strategies planned even as budgets decrease and USAID begins to phase out of countries.

ENERGY/INFRASTRUCTURE

Objectives:

Efficient, reliable and environmentally sound energy is essential for both the competitive enterprise growth and for the health and welfare of individuals. USAID’s energy-support initiative had two primary objectives: (1) enhancing energy security through import diversification, resource development and energy efficiency; and (2) addressing climate change.

Context

Before 1989, the energy systems in the region were highly centralized because of their political and social importance.⁵⁵ Investment and management decisions were politically and socially driven, rather than economically, financially or environmentally. Prices and tariffs of fuels, heat and electricity were extremely low and did not reflect true costs. Inefficiencies and losses were staggering, both because of productivity problems and theft or non-payment. For example, in Georgia, in 1992, total losses in the power sector were over 75% of the amount produced and the collection rate was less than 10%. Nuclear power plants presented huge safety risks, as demonstrated by the 1986 Chernobyl disaster. In the power sector and across the region, generation systems were not well maintained, transmission and distribution losses were very large, collections were low and service quality was abysmal.

In addition to the systemic inefficiencies, the energy systems were significantly impacted by the breakup of the Soviet Union and subsequently Yugoslavia. This resulted in energy systems that

⁵⁵ Lenin is quoted as saying: “Communism is Socialism plus electricity”

were incorrectly sized for their new country boundaries which, combined with the collapse of many major industrial sectors, left countries with either excess capacity or shortages. These conditions led to the conclusion that a breakup of the old systems and restructuring within countries and across borders was necessary. These circumstances continue to exist today and be problematic for most E&E countries.

The Soviet practice of pricing energy below cost for social reasons led to highly inefficient use in manufacturing and for heating and lighting of buildings. As a result, the region required 3-4 times the energy to achieve the same output as other regions of the world. However, because the energy users were accustomed to low prices and widespread non-payment, transition to market pricing has been quite difficult politically, and remains today a huge unresolved problem.

Approaches

USAID in close cooperation with the IFIs -- the World Bank, IFC, and EBRD -- advocated a strategic approach that emerged in early 1990s focused on breaking apart the old centralized national monopoly electricity systems both in terms of national governance and the organizational structure. Under Communism, the energy policy, regulation, ownership and operation were often in one or two bodies. Consistent with modern practices, the market-oriented objective was to separate the functions of policy, regulation and ownership/operation into separate ministerial, regulatory and corporate organizations. This called for reconstructing them on a decentralized, transparent, regulated model

In addition to this systemic reform, concepts of energy efficiency particularly within large public building were introduced to demonstrate how cost-savings could offset the transition to market pricing. The approach taken in energy efficiency initially focused on industry for the first four years and, with energy prices moving to competitive levels for many industries, then shifted to the municipalities which faced significant budget problems due to rising energy bills.

As national reform efforts began to take hold (around 1998), USAID began addressing the need for regional arrangements to better balance the supply and demand requirements, particularly for the smaller countries. This dual approach at the national level by the newly established USAID Missions and at the regional level by the E&E Bureau energy team continues today.

Institutional development was a common strategic effort across all the activities and resulted in the establishment of successful and sustainable organizations and practices that continue the reform efforts throughout the E&E region.

Work started with industrial energy efficiency and pricing in Eastern and Central Europe to demonstrate quickly the benefits of these measures and use their results to expand the concepts of economics and private sector/commercial decision making. After 1993, activities were expanded to the NIS with a major effort in Ukraine (power sector restructuring and energy efficiency); Russia (energy planning, power sector restructuring), the Caucasus and the Central Asian countries (restructuring, privatization).

Starting in 1999, USAID moved its assistance from a phase of “fixing” to “building” or “consolidating” lasting and sustainable local and regional energy institutions using

“partnerships” to transfer knowledge and expertise. This was done primarily using practitioners such as U.S. regulators and utility executives and managers via cooperative agreements (the National Association of Regulatory Utility Commissioners or NARUC, the U.S. Energy Association or USEA). By 2001, the geographic focus shifted back to Southeastern Europe and the Caucasus, with activities in Russia and Ukraine greatly reduced. Although the establishment of a regulatory framework and its pricing corollary had always been part of USAID’s energy activity, during the second decade the privatization of distribution entities and implementation of new regulatory systems became a primary focal points of activity.

USAID also engaged in the Stability Pact for Southeastern Europe to deal with the post-conflict political situation in the Balkans. The Athens Memorandum of Understanding was the beginning of numerous peer reviews that were critical in improving performance by both regulators and transmission companies. USAID worked side-by-side with other donors, especially the World Bank, the EBRD and the EU, as well as bilateral donors.

Starting in 2008, USAID energy strategy broadened its objective of energy security through economic and social development to embrace the new Climate Change umbrella. Although energy efficiency had always been one of the program pillars, the Low Emissions Development (LED) Strategy framework was articulated, with increased reliance on clean energy. While still emphasizing economic pricing and efficiency, the new LED Strategy adds strategic planning, market development and regional transmission to the overall USAID institutional development of the region’s energy sector.

Regulation

When the energy supply functions were imbedded in ministries, short-term political needs overrode long term utility system investment and operational needs. Consequently, the need to create separate energy regulatory commissions to provide greater transparency, public involvement, and competence to oversee modern electricity systems became a central part of the assistance effort. Global and European surveys indicated the critical role of regulation in investors’ decision-making. From the mid-1990s the USAID assistance supported the establishment and development of autonomous energy regulatory bodies in 21 countries in the E&E region. This was implemented through the National Association of Regulatory Utility Commissioners (NARUC) which provided access to U.S. regulatory practices through Regulatory Partnerships. U.S. regulators volunteering to support the E&E regulators made a significant difference in the implementation of the regulatory practices and policies of their counterparts. In a practitioner-to-practitioner relationship, NARUC regulators demonstrated to their counterparts the key skills to master as effective professionals, e.g., how to advocate for rate increase based on sound economics; how to communicate; how to conduct public hearings.

Based on the common interests and requests of the regulatory bodies, USAID supported through NARUC the design, development and sustainable institutionalization of a regional regulatory network—the Energy Regulators Regional Association (ERRA). Fully funded by USAID at the beginning in 1998, the USAID support gradually diminished as ERRA's 26 member regulatory commissions took financial responsibility. Since 2008 ERRA has been a financially and professionally sustainable organization without USAID support. ERRA provides a regional

platform for the exchange of information and experience and professional development through its regulatory training program.

From the start in 1992, pricing policy has been at the center of USAID work. Often as a component of pre-privatization advice, utility pricing methodologies became and remained a key component of energy sector reforms. Pricing reform has been and remains the hardest challenge. By 2012, it is estimated that half of the E&E countries still had some prices at less than 50 percent of true economic costs. Much work remains to be done but achieving pricing reform in the sector is not only a technical issue, but more significantly, a matter of political will.

Privatization: Means to an End

Transformation and privatization of the energy systems entailed unique features different from the other mass privatizations of businesses, property, and housing. The supply and cost of energy affects all aspects of economic and social systems. The adverse impact of unreliable supply on businesses, schools, hospitals, and households, and at the same time the cost of the systems on government budgets created an environment for change. At the same time the prospect of higher costs and loss of control and independence was a politically difficult choice for governments.

It was necessary to undertake simultaneous restructuring of the legal and regulatory framework, while at the same time preparing the existing energy companies for eventual privatization. The energy systems needed new technology, capital investment, and management from multinational investors. However, external investors generally were not willing to step into the inefficient, unreliable, and often corrupt operations, or to face the problems of widespread non-payment by users.

In support of this two-pronged strategy, USAID provided technical assistance to the regulators, ministries and occasionally to the utility directly. In close coordination with IFIs, USAID assisted in financing some of the transformation and capital investment requirements. Competitive international tenders with international transaction advisors financed by the IFIs were introduced. This was necessary to attract international, experienced companies not tied to domestic vested interests.

The privatization of energy systems was essential to attract modern management and technology, investment and to break the grip of corruption in the energy sector. For example, the successful privatization of 60 percent of Moldova's distribution companies by Union Fenosa (Spain) eliminated the corrupt diversion of \$50 million/year of electricity and funds, and restored 24 hours per day electricity within four months. The Moldovan energy distribution privatization was that country's largest foreign investment.

Privatization of distribution companies combined with the regulatory development of the investment environment has been the most visible and the most important element of the power sector reform. Private ownership improves management and operations and improved collection leads to expanded investments. Without the adequate level of collection based on economic tariffs there cannot be a sustainable sector; low income people and environmental protections suffer the most.

Distribution privatization was carried out successfully in Ukraine, Moldova, Georgia, Armenia, Romania, Bulgaria, Macedonia and Albania with Kosovo in process. During 1999-2012, the privatizations brought in initial investments approaching \$2 billion, not counting subsequent system improvement investments. Bulgaria, for example, successfully privatized its six distribution companies for \$828 million to three European utility companies. This success was due to close and effective donor involvement and coordination with an effective reform-oriented Minister of Energy. With World Bank/IMF policy leadership and dialogue, EBRD financed the transaction advisor BNP Paribas, and USAID provided expert advisors to develop the regulatory framework acceptable to investors.

The privatization of the United Energy Distribution Company of the Republic of Georgia in 2007 brought in \$120 million to the Georgian treasury and is widely viewed as one of the most exemplary cases of privatization within the energy sector. This electricity

distribution company, covering all Georgia except Tbilisi, served 70 percent of the nation and was notorious for being considered the single most corrupt company operating in the most corrupt sector of the Georgian economy. It was a drain on state finances and provided as little as 2 hours of unreliable power per day. Over four years, the USAID contractor, empowered through an unprecedented full authority management contract, turned around the organization and restored 24 hour electricity supply and collections approaching 100 percent. The company's labor force was reformed (with about a 70 percent turnover, and 50 percent staff reduction), new systems were introduced, and the USAID team supported the prosecution of the former management for corruption, leading to over 30 criminal convictions. Finally, in 2007, the company was fully privatized to a Czech utility company in the single largest privatization transaction in Georgia. Georgian nationals trained under USAID funding assumed major management roles.

Post-privatization has been a precarious period in several countries as vested interests strike back and governments (and regulators) do not meet their responsibilities. The lesson learned, particularly from Bulgaria, Macedonia and Albania, is that the donors need to maintain a consistent united presence to assure the process stays on track.

Energy Efficiency—Industrial First, Then Municipal and Buildings

The concept of and methods for energy efficiency were virtually unknown in the FSU. Over the years, energy efficiency is gradually recognized as a tool to achieve multiple objectives: (a) improve competitiveness of businesses and industry; (b) improve balance of payments through reduced energy imports; (c) empower municipal officials burdened by wasteful budgetary energy

Voices from the Field

Restoring light and life in Georgia

“When the energy crisis was at its peak, Kutaisi, our regional capital, was dead, its people were dreary, and enterprises could not function. As a resident, I led demonstrations throughout the city against the electric company. Soon after the consultants came, metering started, illegal connections were cut, power started to flow. I was offered a job at the company and took it, hoping to contribute to the positive changes that were becoming apparent. For a year we continued to battle corruption, energy theft and threats from criminal gangs. Today I am proud, Kutaisi is alive again. It has power, business is developing, and its people are grateful to the USAID consultants and colleagues, both Georgian and foreign, my idols of professionalism, my idols of heroism, my idols with their love for Georgia.”

Temur Suladze
Head of Sales Department

costs; (d) ease the burden on households of rising energy prices; and (e) improve environmental performance through efficient use of energy.

The work in the early 1990s developed institutional capacity in the private sector, and non-governmental organizations to continue energy efficiency work in the region. The initial 1991 work focused on 48 industrial companies in nine countries utilizing a USAID contractor teamed with local private engineering consultants. One of the most significant achievements was the introduction of financial analysis ("payback" period and rate of return) into industrial investment decision making—something almost entirely lacking among the technically proficient engineering community. This teaming was designed to create a small cadre of companies that could market energy efficiency, provide industrial energy audits and, as a result of the USAID project, serve as representatives of US energy efficiency equipment manufacturers. To support them, USAID joined with the U.S. Association of Energy Engineers (AEE) to assist the local engineering service companies to establish local AEE chapters to advance their profession.

In the mid-1990s USAID supported, through the Department of Energy Battelle National Laboratory, the development of five independent non-governmental energy efficiency centers in Poland, the Czech Republic, Bulgaria, Ukraine and Russia. These NGO centers grew to provide a range of energy efficiency services in and beyond their borders. Today, they continue to advocate for sound policies, planning and programming, raise awareness and provide technical services long after the period of assistance.

As energy suppliers moved toward market pricing, the need for energy efficiency at the municipal level grew. The responsibility for paying for energy became a serious burden for municipalities in their buildings, schools and hospitals. USAID's early engagement in municipal energy efficiency broke ground for other donors. Two examples demonstrate this.

USAID established a municipal energy efficiency loan guarantee program in Bulgaria through the USAID Development Credit Authority (DCA). In 1996, loans in Bulgaria typically were one year with collateral requirements of 200% or more - terms unsuitable for energy efficiency loans. This pilot, carried out through United Bulgarian Bank with USAID technical assistance in loan preparation and evaluation, led to the successful completion of 33 loans for municipal energy efficiency projects with no defaults resulting in municipal cost savings and improved governance. This loan facility featured five year loans with only 50% collateral requirement. Enhancing municipal government efficiency also advanced the "Democracy and Governance" agenda of the E&E Bureau.

Subsequently both EBRD and the World Bank followed with approximately \$150 million in credit lines and technical assistance. These credit lines offered more attractive terms than USAID's DCA arrangement. Subsequent DCA facilities established for energy efficiency lending in Macedonia and Bosnia have been significantly underutilized partly due to the availability of easier terms from other donors' credit lines. Unfortunately, there appears to be growing trend toward greater subsidies rather than toward commercial terms, and these may not be sustainable over the long term.

The second example of energy efficiency addressing municipal budgetary needs was the cross-cutting collaboration of the E&E Bureau energy team with USAID Macedonia's Offices of Education and Local Governance. With decentralization of tax authority and responsibility for the costs of schools, Macedonian municipalities faced energy costs in their schools they could not cover. To address this, the three offices collaborated to design a program for energy efficient school renovations that reached over 100 schools. This ground breaking approach was further pursued by the World Bank.

Looking ahead, energy efficiency can play a role in facilitating price reforms necessary for regional competitive markets and expanded investment. Politically and socially, price reforms require addressing the low-income affordability issue. The two current tools, assistance payments and tariff subsidies, both have problems. Residential energy efficiency can be a third complementary social safety net tool. No country or donor has been able to find a sustainable approach to wide scale residential energy efficiency investment that includes low income households. USAID has initiated collaboration with Habitat for Humanity in selected E&E countries to establish sustainable market-oriented financing arrangements and a lending environment that include low income households.

Preparatory work has leveraged significant investments from the World Bank, Global Environmental Facility, and EBRD. As a result, tens of millions of dollars of energy efficiency projects have been implemented in Serbia, Bulgaria, Armenia, Ukraine, and Macedonia. Commercial financing has been stimulated in Bulgaria by DCA guarantees and shows the way for future market development in the region.

Strategic Planning and Policy Analysis

Between 2005 and 2012, USAID carried out a major energy planning and policy analysis program in eleven countries in the region in coordination with the European Energy Community. The program's objective is to develop national capability in strategic energy planning by training national planning teams in each country and to strengthen the ability of the ministries to do policy analysis. The modeling and analysis addresses long-term investment planning requirements to meet Energy Community targets for renewable energy and energy efficiency. This work supported the development of National Energy Efficiency Action Plans and National Renewable Energy Action Plans for several countries. Today, eleven countries have professional planning teams running energy scenarios to help guide their national energy policy.

Regional Initiatives: ERRA, Energy Community, SECI, and the Black Sea

As the national energy reforms took hold during the 1990s the need to address the regional dimension of the energy reform process became clearer. Starting in 2000, USAID initiated expanded regional work initially in the post-conflict Balkans, followed by the Black Sea Region (the Caucasus, Ukraine and Moldova). The breakup of the Soviet Union and Yugoslavia resulted in many small nations with utility systems not designed for their new circumstances. Centralized control was gone; there was a need for new collaborative arrangements and larger regional markets to achieve economies of scale and operations.

The early regional assistance in the post-conflict Balkans was an indicator of what was to follow: the Energy Community Treaty among the Balkan countries and the European Union. Energy was

seen as the first step toward EU membership. The Treaty was to serve as the Europe Coal and Community did in 1950 as a forerunner to the creation of the European Union.

- The establishment of the **Energy Regulators Regional Association (ERRA)** in Budapest in early 2000 was demand driven by the national regulators in fourteen countries. A steering committee consisting of Ukraine, Russia, Hungary, Poland, Armenia and Romania developed the principles and Constitution. A respected organization, ERRA helps ensure that regulators are trained to world standards and become key agents of change in developing energy markets that meet private sector as well as societal needs. USAID support to ERRA is widely acclaimed as a major success story evolving from full USAID financing at the start to full ERRA sustainability on its own ten years later. This initiative has since been replicated in other regions, e.g., Africa.
- **USAID Support for the Energy Community of Southeastern Europe** preceded the 2006 Treaty. The Energy Community of South East Europe (ECSEE) seeks to establish integrated regional markets in Southeastern Europe, closely linked to the EU internal energy market, and enhance the energy security of Southeastern Europe and the EU. The Energy Community framework provides the template for reforms at the national level and for the development of regional market arrangements and institutions. USAID has provided timely and responsive assistance at both the national (Albania, Bosnia, Kosovo and Macedonia) and regional levels to advance the regional market development for the Balkan countries, and more recently Ukraine and Moldova.
- **Regional electricity transmission planning** has been strengthened through the Southeast Europe Cooperative Initiative (SECI) and the Black Sea Transmission Project (BSTP). Support to SECI started in 2001 in post-conflict Balkans with the vision of collaboration among the new countries emerging from the former Yugoslavia and electricity integration with the European Union. The planning work identified the investments needed to establish the electricity transmission "highways" to reconnect the countries and the region with Europe to create a regional electricity market and expand trade. The first analysis titled "*Development of Interconnections for SECI Countries and Interconnection with Europe*" captured the purpose of the effort. In response to similar circumstances in the Black Sea region, USAID established 2008 in the Black Sea Transmission Planning (BSTP) initiative to foster transmission investment and expand electricity trade including renewable energy initiative. Both initiatives aim to facilitate regional market development and trade, improve the reliability of the power systems and minimize the requirement for new investments in generation. This collaborative transmission planning has contributed to investments totaling nearly \$2.5 billion over the last decade. Because of the critical role of the regulatory framework in investment decision making, USAID initiated the Black Sea Regulatory Initiative (BSRI) bringing together the regulators from Ukraine, Moldova, Georgia, Armenia, Azerbaijan and Turkey to establish regulatory principles for expanded regional trade and renewable energy investment and to harmonize national regulatory frameworks.

Clean Energy and Climate Change

Recently E&E's energy strategy has shifted to mesh with USAID's global Climate Change and Low Emission Development Strategies (LEDS). The current phase of the E&E energy program

integrating LEDS is concentrated in four countries and represents a substantial part of the USG's global commitment for LEDS support. The regional strategy work for the Energy Community has identified the investment requirements to meet the clean energy goals in the region. Regionally USAID is supporting the development of the countries' capacity to develop key data and monitor and verify performance against commitments. The LEDS work provides the basis to define the implementation phase ahead.

Natural Gas and Petroleum

The geo-political character of natural gas in the region was made very clear in 2006 and again in 2009 with the cutoff of Russian gas to Ukraine and Europe, particularly the Balkans. Energy security remains a prevailing consideration in energy decisions. USAID has provided assistance at the national regulatory level including pricing, licensing and monitoring. Two accomplishments merit mention. With the emergence of Azerbaijan as a major exporter of oil and gas, Georgia has become a key transit country. In the 1990s USAID provided the technical assistance to the Government of Georgia to establish the Georgia International Oil Company (GIOC). GIOC was supported by USAID advisors in its negotiations with the international Azerbaijani consortium for the terms of the construction and operation of the Early Oil Pipeline (EOP) that shipped over 100,000 barrels per day from Azerbaijan through Georgia for export across the Black Sea. The success of the EOP provided investor confidence that the Baku-Tbilisi-Cehan (BTC) one million barrels per day pipeline through Georgia and Turkey could be built. The long discussed Balkans Gas Ring, dependent upon decisions from Azerbaijan and Turkey regarding Caspian gas, will require regional regulatory harmonization. At the request of the Albanian regulator, ERE, USAID provided technical assistance to develop the regulatory framework for natural gas pipeline development and transit through Albania. Recent indications of international support for the Trans Adriatic Pipeline from Turkey through Greece and Albania to Italy give promise to this possibility.

Successes, Disappointments, and Remaining Work

Successes. Utilities are now separated from ministries in all countries that have received USAID reform assistance. There are independent or quasi-independent regulators in all countries. Distribution companies in eight countries are now in private hands. Energy efficiency services are advancing with the support of private and NGO service providers in several countries. Pricing is closer to economic values in 50 percent of the countries. Two main lessons emerge: first, the need to set the stage right from the beginning and second, the need for the right sequencing of activities. It is also possible to distill a number of more specific lessons—good and bad—that can be helpful for guiding future programs within and outside the region. At the activity level, the most successful institutional reform process has been the one leading to commercial operation of power utility operations, including privatization, with the support of the new energy regulatory bodies.

Based on experience over these last 20 years, privatization is one part of the sequence of power sector reform steps. The chances of sustainable privatization are greatest if the following steps are taken;

1. *Development of the Legal/Regulatory Framework:* This is essential for successful privatization and includes establishment of an energy regulatory body with sufficient autonomy, authority and accountability to provide a sound predictable investment environment. Investor surveys show the importance of this.

2. *Restructuring:* The de-monopolization of the power sector involves some degree of separation or “unbundling” of the monopoly company’s generation, transmission and distribution with the objective of increasing transparency, accountability, efficiency and introducing competition.

3. *Commercialization:* Some targeted assistance measures to reverse poor performance, such as billing and collections and initiating commercial practices, may be useful to prepare for privatization. In selected cases, USAID has provided metering to facilitate the reduction of corruption and initiation of management reforms.

4. *Preparation for Privatization:* To attract international strategic investors or regional investors, it is important to establish a clear privatization strategy with a regulatory framework consistent with international practices. Country-specific issues may arise such as sector debt, judicial weakness, labor terms, and social safety net problems if tariffs are not at cost recovery levels.

5. *Privatization Process:* It is important to have an experienced transaction advisor working with the government. There is also a role for an independent advisor to the government to provide objective advice and assessments.

6. *Post Privatization:* Based on experience over the last 15 years, this may be the most important step. There is a need for continued limited technical assistance and advanced training for the regulator for a period beyond privatization. Major international strategic investors bring sophisticated legal, regulatory and accounting expertise on tariffs, regulatory reporting requirements, and quality of service and cross-border issues that push the regulator into new dimensions of regulation. Rising customer expectations require stronger regulatory performance on monitoring quality of service, dispute resolution and public outreach and participation.

7. *Electricity Market Development:* With unbundled monopolies, the potential for the introduction of national or regional competition is established. In smaller countries, the development of a regional electricity market opens up opportunities for wider trading and achievement of economies of scale and energy security. This is a long term effort.

Example of a Restructured Power Sector The Case of Ukraine

The case of Ukraine is quite exemplary. Before the reform process, the power sector was one of the largest ones in the world with a high number of large coal-fired, nuclear and hydropower stations, a massive high voltage interconnected transmission system and a dozen distribution companies, all owned and managed by the central government. At the beginning of the reform process in 1993, the sector was in a dire state of operation, almost bankrupt and still trying to recover from the Chernobyl disaster. Collections were abysmal at less than 10 percent, coal miners were unpaid and the reliability of the system, once a model for the region, was failing rapidly because of a lack of investment.

It took over 10 years, many steps backwards for each step forward, and a massive and coordinated effort of more than 20 donors to restructure the sector according to market principles. Today under the new structure all distribution companies (27) have been privatized, average collection rates are in excess of 75 percent and electricity costs have been stabilized. There has been an independent regulator in place since 1995. A generation wholesale market has been established and energy efficiency has been a major activity of NGOs and private energy service companies.

USAID has provided assistance in all of these areas to varying degrees in Ukraine, Moldova, Georgia, Armenia, Romania, Bulgaria, Macedonia, Albania and Kosovo. (See box.)

The program overall has been of historic magnitude. First and foremost, USAID has leveraged several billions of dollars in investments (over \$1 billion through privatizations, \$2.5 billion in regional transmission investments) and socio-economic benefits through a blend of USAID contracts (\$200 million), cooperative agreements (\$70 million), commodity programs (\$100 million) and financial guarantees. Investment benefits in developing independent energy regulatory agencies in over 20 countries (less than \$50 million or 10 percent of program costs) are difficult to quantify, however, they amount to many times the investment due to reduced corruption, better pricing, increased collections, and perhaps more importantly through privatization of generation and distribution.

USAID's Three-Pronged Assistance Approach to sector reform was invaluable in providing new regulators access to advice and actual experience: 1) bilateral technical assistance on regulatory and pricing reform, 2) a U.S. Regulatory Partnership to introduce U.S. regulatory practices, and 3) participation in the Energy Regulators Regional Association to learn of their neighbors' experience.

USAID's contribution to the Energy Community Treaty was timely, responsive and very effective. The overall Energy Efficiency development effort was successful both in the public and private sectors and in civil society levels, which served industry, buildings and municipalities.

The donor coordination approach is where USAID receives accolades for its leadership, vision and steadiness that have granted it convening power and respect from all parties. Collaborating with IFIs and the European Union enhanced outcomes.

Initiatives in regional transmission integration and investment planning achieved an unparalleled degree of leverage. Perhaps more importantly is the recognition that it does not require much money to trigger and bring change ("institutional leverage"). In over a dozen countries, USAID has funded several years of support with only \$2-4 million per country. It has helped establish and develop independent regulatory agencies which had the single biggest impact on the overall

**Success Story: Bulgaria Energy Regulatory Project
Development of a Strong Regulatory Framework that
Supports Energy Sector Privatization and Future
Investment**

A key factor in the high value of the offers received by the Bulgarian government for its distribution company has been the establishment of a modern legal framework for the energy sector and a responsive and competent energy regulator with accountability. The success of the privatization process was greatly aided by the introduction of an understandable, transparent and predictable legal framework for the energy sector that limits opportunities for political interference in the regulatory process. With USAID support provided through the law firm Pierce Atwood, Bulgaria developed and adopted an Energy Law that promotes the creation of competitive energy markets, incorporates international best practices in energy sector regulation, and meets the requirements of the EU electricity and gas directives of July 2003. The new law established SERC as a truly independent regulator with sufficient authority. Modern regulation requires that consumer prices and tariffs be based on the actual costs incurred by sector licensees in the provision of energy services. USAID supported SERC in developing the requirements for a universal and transparent accounting and regulatory reporting system that ensures a consistent, accurate and proper allocation of costs and expenses incurred by energy companies. This is key to developing investor confidence and ultimately results in a market-based transaction value.

sector restructuring where billions of dollars in private sector capital were mobilized to generate several times their amount in local socio-economic benefits.

Why did those work? Unique factors created the right environment for the program to succeed: A very original and almost opportunistic entry strategy showed short-term results of bottom-up market based practices, e.g., industrial energy saving measures, rather than top-down macro initiatives. Using this highly productive approach, USAID quickly became accepted and leveraged early successes into larger initiatives, such as regulatory and sector reforms, which led to its position of a recognized “honest broker.” USAID held a very strong focus on effective donor cooperation to achieve common objectives. The World Bank, the EBRD, and the EU have recognized its critical role as federator of interests and a source of early co-funding for technical assistance when the IFIs needed it. When donors spoke with a single voice, results were faster to achieve.

The Agency identified **reform leaders and champions** who became the backbone of the region’s energy revolution, e.g., the first head of the Hungarian energy regulatory agency is now the head of ERRA with 26 members. Two Georgian energy experts emerged from USAID supported programs to become Ministers of Energy. USAID upheld the quality of technical assistance. In general the quality of USAID contractors was rated “high” or “very high” by interviewees. USAID provided highly competent, cohesive and sustained central management effort in Washington, each having a minimum of 10 years’ prior experience. This feature was often ranked first by interviewees at the donor and country levels. This was supplemented by adequate levels of support and competence of the Missions including the growth of the Foreign Service national employees who contributed immeasurably.

Systemic energy reforms are a long-term process. The ability to maintain focus and obtain the (limited) resource commitment was critical to maintaining progress to complete the “first stage” of the reforms.

Energy ministries (and politicians) were often left behind. The USAID (and donor) focus on regulatory development, utility reforms and investment did not include sufficient attention to modernizing the ministries and what should have been their new role: policy, research, legal reform, data and information. The consequence often was regressive behavior undermining the reforms.

Disappointments.

Years of under-investment in the energy infrastructure had reduced the output of many energy facilities (power, oil and gas) and the overall supply-demand equation has not improved. Today many countries remain in a precarious position as energy issues threaten to constraint economic and social development. In a recent report, the World Bank forecasts a major power crisis in the region in the next few years. Moreover, in several countries, including Bulgaria and Ukraine, old style politics are back in play and many institutional gains are being challenged. The absence of political will has slowed the reform process in some countries and discouraged investment needed to address the looming shortages.

The strength of the energy regulators has diminished as autonomy has been undermined by ministries' efforts to get back authority over pricing and investment approval processes. A major disappointment has been the decisions of many governments to place renewable energy investment project approval within ministries rather than involving more transparent participation of the regulators. The initial signs of corruption and favoritism have appeared in Albania and Ukraine.

Pricing and tariffs still remain the critical unresolved issue. Less than half of the E&E countries have tariffs above 75 percent of their long run marginal costs. Without tariffs close to economic costs, investments in the sector cannot be obtained on the financial markets.

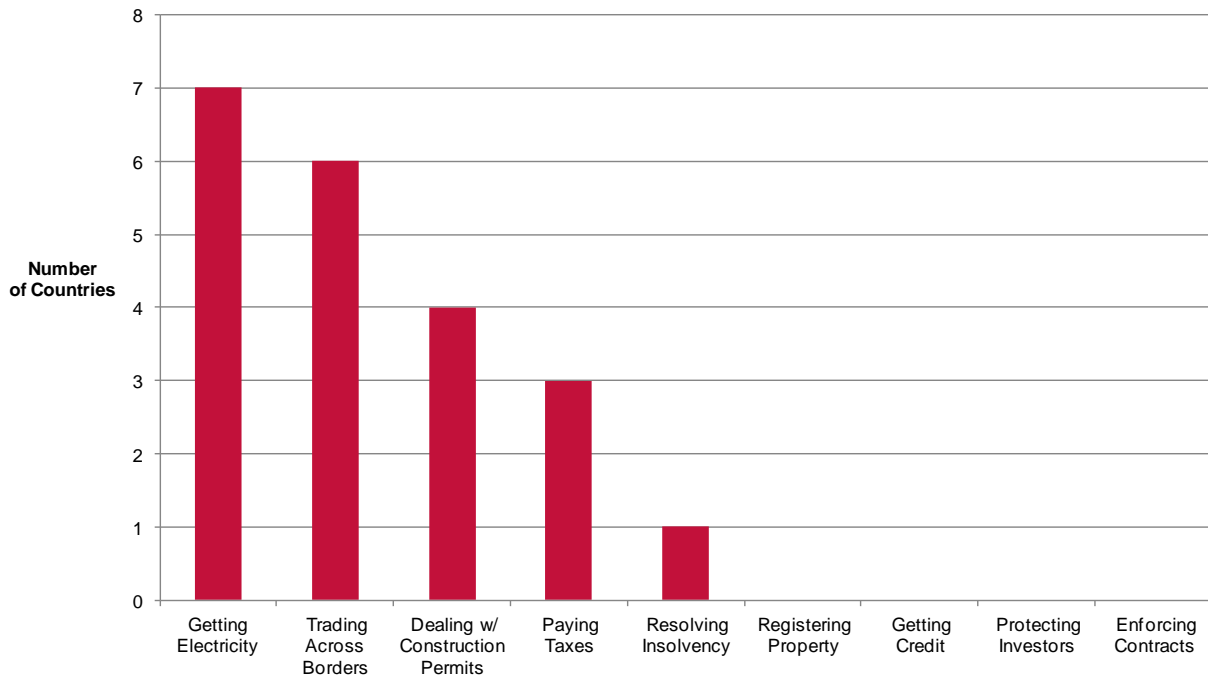
In addition to pricing, interviewees listed areas of disappointment or straight failures. They are the lack of progress in open and functioning markets (Albania, Georgia) with some increased lack of transparency. Some distribution company privatization, e.g., Bulgaria, Macedonia and Albania, faced post-privatization push-back after having been success stories. Kosovo needs to take notice as their privatization begins. Company corporatization before cash collection, the "debt overhang" and reforming distribution companies (Ukraine) was out of sequence and ineffective. The "cookie cutter reform model" of unbundling, independent regulator and privatization (case of early work in Ukraine) was also voiced by some donors (but no alternatives were proposed).

Work Remaining.

The highly publicized World Bank report "Lights Out" (2012), concludes that the future may bring more challenges than the previous decade. This is in part because the strong economic growth in the past 12 years has eliminated most of the power surpluses resulting from economic recessions of the 1990s. Now the power supply-demand balance is tight and power curtailments—which are happening routinely in Albania and Kosovo—could become a major constraint to economic growth. Recent estimates from the Energy Community put the 20-year investment needs for the power sectors of their member states at over \$28 billion, a number that seems almost out of reach given the situation of the capital markets in the Europe. As a result, a power crisis is on the horizon and obtaining a reliable supply of electricity is the major concern of businesses surveyed by the World Bank (see Chart 1 below).

According to interviewees, this is not the time for the international community to reduce its efforts in the energy sector, but a time for all donors to revisit their assistance strategy and refocus their efforts to consolidate historical progress over 20 years and allow the host countries to take full ownership of their energy sector reform agenda. A lot of experience was gained and mistakes made but the result is that the countries in the region are now in a much better position to take leadership roles and make their own decisions about their energy future.

Chart 1 – Most Problematic Business Constraints in E&E Eurasia



Current USAID energy programs focus on climate change issues and seek to improve the overall energy situation and its environmental and societal dimensions. An integral component of the Low Emissions Development Strategies and Clean Energy Development Project includes support of target countries (Albania, Macedonia, Serbia, Moldova, Ukraine, Armenia and Georgia) in their integration and participation in the Energy Community, as well as other regional initiatives focused on the Energy Community at large.

Energy security, reliability, access to services and poverty remain major socio-economic issues. Many municipal district heating systems are still in poor shape and some are on the verge of economic collapse (Serbia). To address under-investment, changes are needed in policy, institutions, resource development, utility performance, resource planning (both demand and supply side), and investment attraction; these are all areas supported by USAID. Achieving energy security will take more time and will need more support from the Energy Community and donors. Creating a favorable investment environment for energy sector investments is a complex and lengthy task which involves many types of actions, from policy to legal and regulatory changes, but also to cultural and technological adaptation. Of most importance, capital investment will not happen if energy pricing is not right. Although a number of countries now have retail tariffs at or above long-term marginal cost, many others do not. Climate change will be another difficult issue to deal with as most E&E countries have traditionally used coal. USAID should continue to be a powerful force behind the transformation process and the “honest broker” countries need to move forward toward more reliable and efficient energy markets.

AGRICULTURE/LAND

Context

Under communism, forced collectivization of agriculture drove out small, private farming and led to chronic food shortages and even famine in many parts of the Soviet Union. Commercialized agricultural production came primarily from large, inefficient collective or state-owned farming enterprises.⁵⁶ Where products were available, quality was low and undifferentiated. Economic upheavals had hit the agricultural sector hard.⁵⁷ State-run systems collapsed, subsidies were eliminated, fixed prices were abandoned, demand fell, and trade worsened. Potential for widespread hunger became a real concern. A considerable amount of assistance from the United States in the 1990-1992 period was food aid, based on fear of widespread starvation.⁵⁸ The SEED Act (see page 2) was partly about transformation, but also authorized and supported substantial food aid. As the collectivized farm system deteriorated, infrastructure including irrigation systems, farm machinery pools, processing facilities, input supply networks and distribution channels fell into disrepair. State-funded research and extension support virtually disappeared. Much of the agricultural sector to this day operates using outdated techniques and practices.

Goals

USAID's agricultural assistance objectives were to restore and increase food availability, improve the efficiency of farm production and marketing systems, and install a privatized system of off-farm services.

Approaches

USAID technical assistance and training have had the best project results in establishing marketing and processing entities, in developing producer and marketing cooperatives, associations and businesses, and in supplying technical information. Short- and long-term experts helped raise agricultural output and develop the systems of information, inputs, organizations and services for small and medium-sized farmers to produce higher volumes of quality products. Many have also helped establish credit sources.

Technical assistance and training were often less successful in the policy arena where reluctant governments have been skeptical of the need for changes. Concerns about food security have limited the willingness of some governments to open the agricultural sector to external

Use of American Business and Farmer Volunteers

USAID utilized the services of American business and farmer volunteers extensively during the first years after the collapse of the Soviet Union. A number of new volunteer organizations were born due to the increase in the number of volunteers being used. A staff member of ACDI/VOCA stated in 1999 that prior to the collapse of the Soviet Union they would provide about 100 volunteers a year to countries around the globe. In the immediate years after the collapse, they were providing 1000 volunteers a year, with about 900 of them going to the E&E region. As budgets in the region decreased and as USAID programs started to focus on developing local business service capacity, volunteer programs also tended to decrease.

⁵⁶ Garden plots for mainly household consumption were an important source of non-commercialized production.

⁵⁷ The State of Food and Agriculture, Rome, 1998.

⁵⁸ A staple of U.S. food aid were frozen chicken leg/thigh combinations, which to this day are still known in the former Soviet Union as "Bush legs", in honor of George H.W. Bush.

investment. Privatization of large-scale collectivized farms has resulted in very broad-based ownership of land, but often fragmented into small unproductive plots.

Food shortages largely disappeared within the first few years of transformation, but most of the countries of E&E still import a high percentage of their total food requirements. There has been a shift over time to a focus on competitiveness, value chains, exports and value-adding. Today, with perhaps exceptions in Tajikistan, Turkmenistan and Kyrgyzstan, all agriculture/land assistance focuses on competitiveness and value chains for high-value crops.

Agriculture

Northern Tier Countries, Romania and Bulgaria

Poland benefited from the largest agricultural assistance program with technical assistance and training for nearly all of their agricultural needs. In the Czech Republic, technical and training assistance was provided to farmers and cooperatives while in Slovakia, U.S. university staff helped upgrade agricultural management training and improve farm productivity. Agricultural enterprise restructuring was supported in Estonia and Latvia, and Lithuania received technical assistance to agricultural processors and cooperative farms. Substantial numbers of Farmer-to-Farmer (F2F) volunteers served in eight CEE countries. By the end of the 1990s, USAID agricultural assistance had ended in most CEE countries but, where continued—Romania and Bulgaria—attention post-1999 was placed on marketing and competitiveness with an eye toward EU accession.

Russia, Ukraine, Moldova and Belarus⁵⁹

USAID assistance in Russia, Ukraine and Moldova was quite different from CEE assistance. Some of the large U.S. agribusiness corporations (seed, fertilizer, and equipment suppliers) saw Russia and Ukraine as potentially large markets for their products. Several large projects with substantial private-sector matching funds facilitated the introduction of these corporations into several countries of the FSU (Russia, Ukraine, Moldova, Kazakhstan, Georgia, and Kyrgyzstan). Grant-funds helped create numerous joint ventures between U.S. local agricultural interests. Farmer-to-farmer programs worked with the joint ventures in an effort to upgrade and expand farm enterprises.

By 1996, over 2,200 volunteers had provided short-term assistance to individual farm enterprises, cooperatives and other farmer organizations, agribusinesses, rural credit institutions and agricultural education institutions. Farmer to Farmer (F2F) assistance continued in Russia until 2008 on a limited scale and is ongoing in Ukraine, Moldova and Belarus.

Poland

In 1990 EUR 10.0 billion deficit in agricultural balance of trade. By 2010 EUR 2.5+ billion surplus

Source: EU

However, within a couple of years, concerns arose about the reliability and viability of some of the joint-venture partnerships. Particularly in Russia, nationalistic tendencies and concern about

⁵⁹ Only Farmer-to-Farmer assistance has been provided to Belarus.

U.S. encroachment into Russian agriculture led to limits on the program expansion, and by the end of FY 1994 USAID/Russia funding was largely halted.⁶⁰

Successful assistance efforts started in 1998 to develop the Rural Credit Cooperative Development Fund in Russia; by project end in 2004, there were 60 cooperative members, with over 150 today.

In Moldova, successful partnerships were developed with local and international companies as part of projects from 2001 through today. Sequencing is evident as projects have progressed from input supply to output marketing, development of producer and marketing organizations and export expansion. Direct USAID assistance to the agricultural sector in Moldova via Farmer-to-Farmer continues, as it does in Belarus.

Moldova

Agribusiness Development Project results: \$105 million in exports by client companies, 8 producer marketing organizations created or strengthened, \$7.5 million in new investments generated, \$4.9 million in lending facilitated 10,000+ individuals trained, 124 technical reports completed.

Source: ADP Final Report

The Caucasus

The USAID-funded and USDA-implemented Armenia Agricultural Extension Collaboration Program (1992-2005) evolved from extension to marketing, relying on technical advisors from U.S. Land Grant Universities. It developed an agricultural training center which became a degree-granting department of the Armenian State Agricultural University. USAID assistance to Georgia has addressed major agricultural areas and some sequencing toward current emphasis on competitiveness and value chain development is evident. However, the approach has been on a project-by-project basis with no systematic effort to deal with requirements of the agricultural sector on a sustained or comprehensive basis. Assistance to Azerbaijan was limited from 2000-2005 to three small projects to support expansion of in-country value-added processing and creation of a rural credit cooperative system. Through multiple projects from 2005 to the present, assistance with specific value chain development has taken place along with some support to improve the overall economic policy environment and to expand international trade.

Central Asia

From 2004-2011 a very successful regional Water User Associations Support Program was implemented in Tajikistan, Kyrgyzstan and Uzbekistan, which expanded capacity of 110 associations. A parallel project from 2004-2007, also in Tajikistan, Kyrgyzstan and Uzbekistan, focused on developing linkages to markets and strengthened service providers. There are extensive plans to expand assistance in Tajikistan, the only country within the FSU designated as a “Feed the Future” priority country.

Southeast Europe

Agricultural assistance started in Albania in 1991 and has been a major USAID focus since agriculture provides 45 percent of Albanian employment.⁶¹ The agricultural sector continues to grow, and exports have increased. The European Commission reports problems in migration,

⁶⁰ Including small efforts to develop an agricultural cooperative, to improve grain and potato storage and a soybean processing endeavor—none of which achieved significant results. There was also a very small activity in the North Caucasus that was started much later (2007).

⁶¹ Down from over 60 percent of employment and 52 percent of GDP in 1992.

limited size of holdings, poor marketing, and underdeveloped irrigation.⁶² USAID assistance in Macedonia began in 1992 with over 215 farmer-to-farmer volunteer assignments completed. The Macedonia Agribusiness Marketing Activity targeted the meat and dairy industries (1998-2003). Working with the Land-of-Lakes Dairy cooperative, Macedonia introduced the successful “Seal of Quality” program to encourage consumers to shift away from imported EU products that are more expensive but perceived as having higher quality.

The common thread throughout most of USAID’s agricultural-support activities in Southeast Europe has been commercialization of higher value, export oriented production, particularly into European Union countries. A competitiveness project in Serbia has helped increase sales and productivity in six high potential agricultural sub-sectors: berry fruits, dairy products, herbs and mushrooms, livestock and meat, tree fruit, and vegetables. USAID Romania helped facilitate the opening of a Smithfield Foods pork processing facility, creating a new market for farmers’ products. Multi-year agricultural development programs in Croatia, Bosnia-Herzegovina, Albania, and Kosovo all have shown success in improving output, sales, and exports of a variety of products including fresh vegetables, dairy products, livestock, and wine. Facilitating those production and export activities entails a variety of efforts including the introduction of new crop varieties, new production methods, improved post-harvest handling, and certification of production and processing facilities to meet European Union standards and requirements.

Land

Northern Tier Countries Plus Romania and Bulgaria

Collectivization of agriculture occurred after WWII in CEE countries meaning private land ownership was still a living memory for the new post-soviet era leadership. This resulted in decisions by CEE governments that privatization should be accomplished through restitution of land.⁶³ There were differences in implementing these decisions, and the amount of land remaining in state hands varied. Land privatization happened rapidly and land reform was completed with limited USAID attention. Exceptions were in Bulgaria where a \$10 million grant generated currency for land reform, and in Romania where assistance to develop water user associations brought land back into production.

Prior to 1990, throughout the region, less than 10% of agricultural land was privately held. By 2000, in most countries at least half to two-thirds of the agricultural land was in private hands.

Russia, Ukraine and Moldova

In the NIS, land privatization proceeded quite differently than in the CEE. None of these countries restituted land to previous owners. Instead, former state and collective farm members were given land shares with ownership or ownership-like rights. In Russia, USAID attempts to assist land reform began as part of a larger privatization effort in 1994-1995. USAID restructured a few collective farms on a pilot basis, however, within a few months, discontinued assistance. Systematic support to restructured farms was tested via the Market-oriented Farm Support Activity (MOFSA) (1996-1998) with scant results and a lack of Russian interest subsequently making agricultural land reform a lower USAID priority. No further assistance was provided

⁶² "Albania-Agriculture and Enlargement." Economic Commission, Agriculture and Rural Development, 2011.

⁶³ In Albania, land was not subject to restitution, but was quickly privatized with 98 percent of agricultural land in private hands by 1992. See Balkans section below for further discussion.

after the activity ended. In Ukraine, USAID pursued a successful effort in farm restructuring and land reform.

With limited Ukrainian government support, USAID assistance from 1995-2000 restructured agricultural enterprises into small- and large-scale corporate farms; over 235,000 land titles were issued. Following a 1999 Ukrainian decree on land reform, the Ukraine Land Titling Initiative (2001-2006) supported issuance of over 1,800,000 State Acts. The conversion of collective to corporate ownership is almost complete using a land leasing model, but a government ban on sales remains. In 2011, USAID's Agro-Investment Project began providing land rights information to holders of State Acts. In Moldova, land reform assistance from 1998-2000 (see results below) was even more successful. Communist government efforts to re-collectivize agriculture in 2000 were "not accepted by the people"⁶⁴ and abandoned.

The Caucasus

Privatization of agricultural land in Armenia was completed quickly. By the end of 1991, most collective farms had been converted into 300,000 family farms. In Georgia, the 1992 "small parcel" reform transferred ownership to over 1 million people. Azerbaijan did not undertake land reform until the mid-1990s. In Georgia, USAID's involvement began in 1997 with guidance over time from the experience in Moldova. After multiple projects by 2010, some 2.4 million parcels had been registered and the Association for the Protection of Landowner's Rights (APLR) was operating effectively. A 2011 evaluation concluded that the association continues as a driving force behind reform.

Central Asia

The NIS land share model of privatization has been followed with implementation varying by country. Kyrgyzstan has been the most proactive with land titles distributed to private farmers. In Kazakhstan, the government distributed land shares from 1994-1997, but has retained a corporate farm model while discouraging small private farms. In Turkmenistan, most land remains state-owned although small household plots can be privatized. In Uzbekistan all land is state-owned with leases of 30-50 years. USAID has assisted land reform since 1997 in Kyrgyzstan when a pilot land registration project and legislation reform project were supported. A larger 2005-2008 Land Reform Project in Kyrgyzstan reached over 140,000 farmers. Another (2008-2010) activity included stimulation of a private market for land, a pilot land consolidation program, and efforts to improve management of state-owned land. In Kazakhstan, Uzbekistan and Tajikistan, a regional Land Tenure Reform project was implemented from 2003-2005 with modest impact.⁶⁵ Finally, a Land Reform project in Tajikistan (2011-2014) is helping implement market-driven land policies and legislation. Land reform assistance has not been provided in Turkmenistan.

Voices from the Field

"When the communists regained control of the government in 2000 they wanted to go back to the old collective farm system, but this was "not accepted by the people" so the communist government had to collaborate and support the new system."

Sergiu Botezatu, Senior FSN staff member, USAID/Moldova

⁶⁴ Personal communication, September 2012.

⁶⁵ *Land Tenure Reform in Kazakhstan, Uzbekistan and Tajikistan, Final Report*. USAID/Central Asia. October 31, 2005.

Successes, Disappointments and Remaining Work

Successes. In the CEE, food lines are gone and countries now have more productive agricultural economies than in 1990.⁶⁶ State-owned and collective agricultural entities have been dismantled or are in private hands. Marketing and processing entities compete on world agricultural markets. Land transactions are taking place. Trade has grown with the 10 countries joining the EU and WTO. Croatia will enter the EU soon, while Macedonia, Montenegro and Serbia are candidates.

USAID successes include: a) the Seal of Quality for meat products in Romania and dairy products in Albania; b) credit supply systems in Poland, Bulgaria and Slovakia; c) strong dairy production and processing cooperatives in multiple countries; d) extension services in Poland; e) privatized processing and marketing entities in Hungary; f) the 2002 Young Scientists program in Romania, implemented worldwide; and g) revitalization of Romanian irrigated land.

In the FSU, state-owned and collective agricultural entities are now in private hands. Private banks and non-bank sources of credit are more available. Marketing and processing entities compete in regional markets with some entrance into international markets. Land has been privatized in Moldova and in Ukraine and agricultural land leasing markets are active. Russia, Ukraine and Moldova are WTO members. The importance of U.S. agricultural assistance in effecting these changes varies significantly: little impact in Russia; a larger impact in Ukraine and a very substantial impact in Moldova. In Moldova and Ukraine, USAID focused on private farmers with transformational impact visible in both.

In Ukraine, privatization moved government-run functions to the private sector. In Moldova, land reform and agricultural sector assistance enabled over 99 percent of collective farms to be privatized with land shares distributed to over 1 million individuals. In the Caucasus, impacts are fewer than in the CEE countries or Ukraine and Moldova, however, sector structures are now clearly private sector-driven. In Georgia, market chains generated \$37.7 million in sales and 2.4 million land certificates were issued. USAID assistance in Armenia and Georgia enabled firms to compete in international markets.

Central Asian countries now have ample food supplies and Kazakhstan is recognized worldwide as a major grain producer. Regional water user association development in Tajikistan, Kyrgyzstan and Uzbekistan reached 750,000 beneficiaries and expanded capacity of 110 water user associations. Other successes include input supply in Kyrgyzstan and value chain member support in Uzbekistan and Tajikistan. Land reform in Kyrgyzstan has also been a success.

In the Balkans, there has been an overall transition to market-based agricultural economies and food supplies are adequate. All states have a legacy of associations and cooperatives in place.

In Kosovo, projects have transformed a subsistence-focused sector into an exporter. In Macedonia, the Seal of Quality program had a major impact on local production and improved exports. Albania has an array of private organizations and is exporting to EU and other markets. Serbia has transformed from a low quality, bulk exporter of agricultural products into a value-adding, high quality exporter.

⁶⁶ FAO Statistical Summary.

Disappointments. While privatization was successful in transferring ownership to private individuals, it neither led to efficient agriculture nor a vibrant land market. Industrial privatization centered on keeping the enterprise intact while expanding the ownership to many shareholders. Agricultural privatization, by contrast, broke the large land-holdings into small land parcels. Every family that was associated with the collective received a piece of land, and in some instances the equipment was similarly distributed out. Unfortunately, as a result, there are now literally millions of “farmers” each with tiny, unproductive land plots, often employing techniques and practices little changed from the 1970s.

In many instances the titles to these properties are not clear. Individuals often received “privatization certificates” or other evidence of the distribution, but the land title registries do not fully correspond or recognize the ownership. In many places the land itself is registered one way and the buildings and improvements registered differently. As a result, using the land as collateral, or selling the property outright, can be very difficult. Beyond these technical problems, because of the turmoil of the recent past, people are reluctant to sell their land. These small land-holdings are seen as the final insurance policy. If all else fails, one can survive by returning to the land. As a result, efforts to consolidate these small holding into more productive, professional farms have been largely unsuccessful.

In some places farmers have been able to develop larger holdings mainly through the leasing of municipally-owned or corporately-owned land. However, even in these cases (particularly the municipal land leases), the leases are short-term and farmers are reluctant to make longer term investments that would increase productivity.

In Ukraine a government imposed moratorium on the sale of farmland is now almost a decade old. Until recently USAID had been advocating for the removal of that moratorium in order to encourage a more normal market for agricultural land. But USAID is now wary of proposals by the government because they do not provide adequate protections for individuals operating legitimately on leased land. There is concern that newly-proposed legislation could be a back-door method for insiders to retake land from private farmers.

In the public sector, USAID activities devoted minor attention to developing public institutions. For EU accession countries, this has not been a problem since the accession process required development of public agricultural entities, but in most other countries public sector agricultural institutions are generally weak and poorly financed. Activities helped increase the capacity in ministries of agriculture in Moldova, Georgia and Kosovo, the statistical service in Albania, extension services in Armenia, land registries and training in many countries, and development of departments of water resources in Central Asia. Yet an effective agricultural research network capable of developing or adapting technologies suitable for small farmer use is still lacking in many EE countries. Education is not producing the manpower the sector will need to compete, and government budget amounts allocated to the agricultural sector is a particular problem in most non CEE countries. In the CEE, legal reforms are needed to entail food safety, import/export restrictions and acceptability of GMO products. In Central Asia, legal reform is still necessary to allow land privatization. In the private sector, nearly all USAID assistance emphasizes development of private organizations. The limited number of associations and

cooperatives is a constraint to sector development, particularly in the Central Asian Republics. Civil society development has not been a focal point of assistance except in Georgia.

Remaining Work. The largest unresolved issue is completion of land reform and development of land markets. Challenges include: lingering land ownership and registration issues in Albania; conflict-related issues; and fragmentation of holdings. Belarus and Turkmenistan have not yet distributed land shares and land privatization is still underway in Tajikistan. In Georgia, disposition of remaining government-owned land is pending. Ukraine still prohibits land sales. State-owned land in several countries could be used more productively. Complications remain around legislation, land share allocations, surveying, title issuance, and registration and leasing terms.

Resolution of these issues needs to occur on a country-by-country basis. Effective assistance needs to reflect unique geography and economics. For the Balkans and Central Asia, product quality control constrains exports. Attention to water use would have important impacts in these regions. Policy advice in Moldova is more accepted now with a reform-minded government, and Georgia may also be more receptive. In Georgia, assistance to improve competitiveness would be helpful. A former Minister of Agriculture in Georgia said that to achieve synergy, donors' priorities should align with governments' priorities, and that donors should help design a strategy owned and shared by governments."⁶⁷

⁶⁷ Private communication, September, 2012.

IV. TRANSITION SCORECARD – INDICATORS OF PROGRESS

As previously stated, at the start of the transition it was thought that having 50% of economic activity within the private sector would render the transformation irreversible. By that target, the transformation is a clear and unequivocal success. Chart 2 below tracks the private sector share of GDP by four sub-regions from 1990 – 2010. By country groupings, in every case the private sector share of GDP exceeds the 50% threshold. The Central Asian Republics have performed the poorest, crossing the 50% threshold around 2002, and stabilizing at around 52% thereafter. The best performers are those that have graduated and entered the European Union – with private sector shares now exceeding 80% of GDP. The Balkans and Eurasia countries fall in between those extremes, ranging from 60% to 70%

The achievement of USAID's economic assistance program in the 29 E&E countries receiving assistance can be summarized as follows:

- Eleven countries achieved economic and political transformation to a level such that they are able to continue the transition process with their own resources and have “graduated” from U.S. assistance
- Ten of those countries became members of the European Union and the 11th will become an EU member in 2013
- Six countries in the Balkans continue to receive assistance and of those, half are on a trajectory to meet the Bureau threshold criteria for economic and political transformation.
- In Eurasia, none of those countries are nearing the threshold criteria. Several countries in Eurasia continue to receive assistance, while others do not, for foreign policy reasons.
- Five countries in Central Asia were categorized with distinct assistance needs, due to their proximity to Afghanistan and Pakistan, and so are receiving specialized assistance from the Asia Bureau, integrated with regional programs that include their southern neighbors

USAID's Country Groupings

- European countries that met transformational threshold (11): Republic of Bulgaria, Croatia, Czech Republic, Republic of Estonia, Hungary, Republic of Latvia, Republic of Lithuania, Republic of Poland, Republic of Romania, Slovak Republic; Slovenia
- Balkan countries (6): Republic of Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro*, Serbia
- Eurasia (7): Armenia, Azerbaijan, Belarus*, Republic of Georgia, Moldova, Russian Federation*, Ukraine
- Central Asia (5): Republic of Kazakhstan, Kyrgyz Republic, Republic of Tajikistan, Turkmenistan, Republic of Uzbekistan

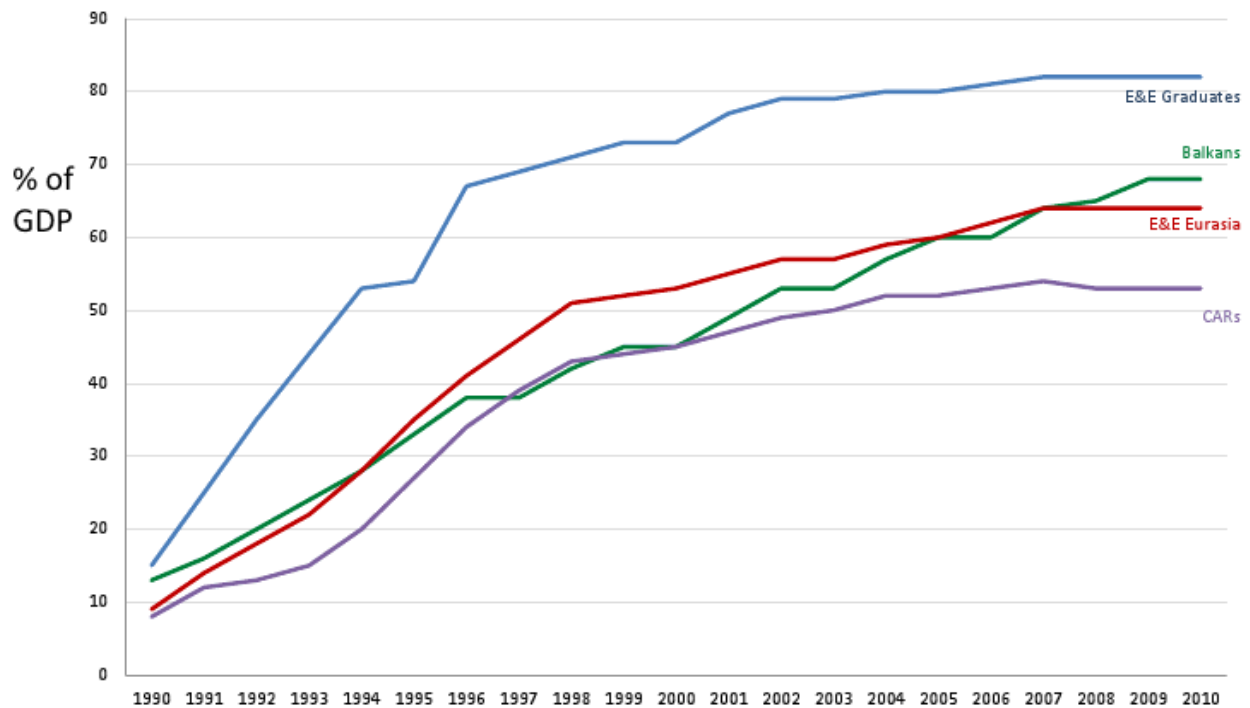
*No longer recipients of USAID assistance for reasons OTHER than meeting transformational threshold

Source: Ron Sprout, “Regional Trends in Economic Growth in Eastern Europe and Eurasia,” 2012 and interview, 2013.

The SEED and FSA acts did not include a formal process to determine when a country was ready to take responsibility for its own development. The Office of the Coordinator of Assistance at the State Department, in close consultation with USAID and U.S. Embassies, began to phase-out assistance in those countries that were making strong transformational progress. In 2004, the Coordinator initiated a “*planned and orderly graduation process, driven by development criteria and a careful consideration of foreign policy interests....The basic premise behind the*

framework was to use SEED and FSA assistance to help countries reach a point of “irreversible” reform, defined as the point where they are firmly established as market-based democracies and very unlikely to return to authoritarianism.”⁶⁸

Chart 2 – Economic Structural Change: Private Sector Share of GDP



Sources: EBRD, *Transition Report* (2011 and earlier editions)⁶⁹

Economic Transformation and Democratization

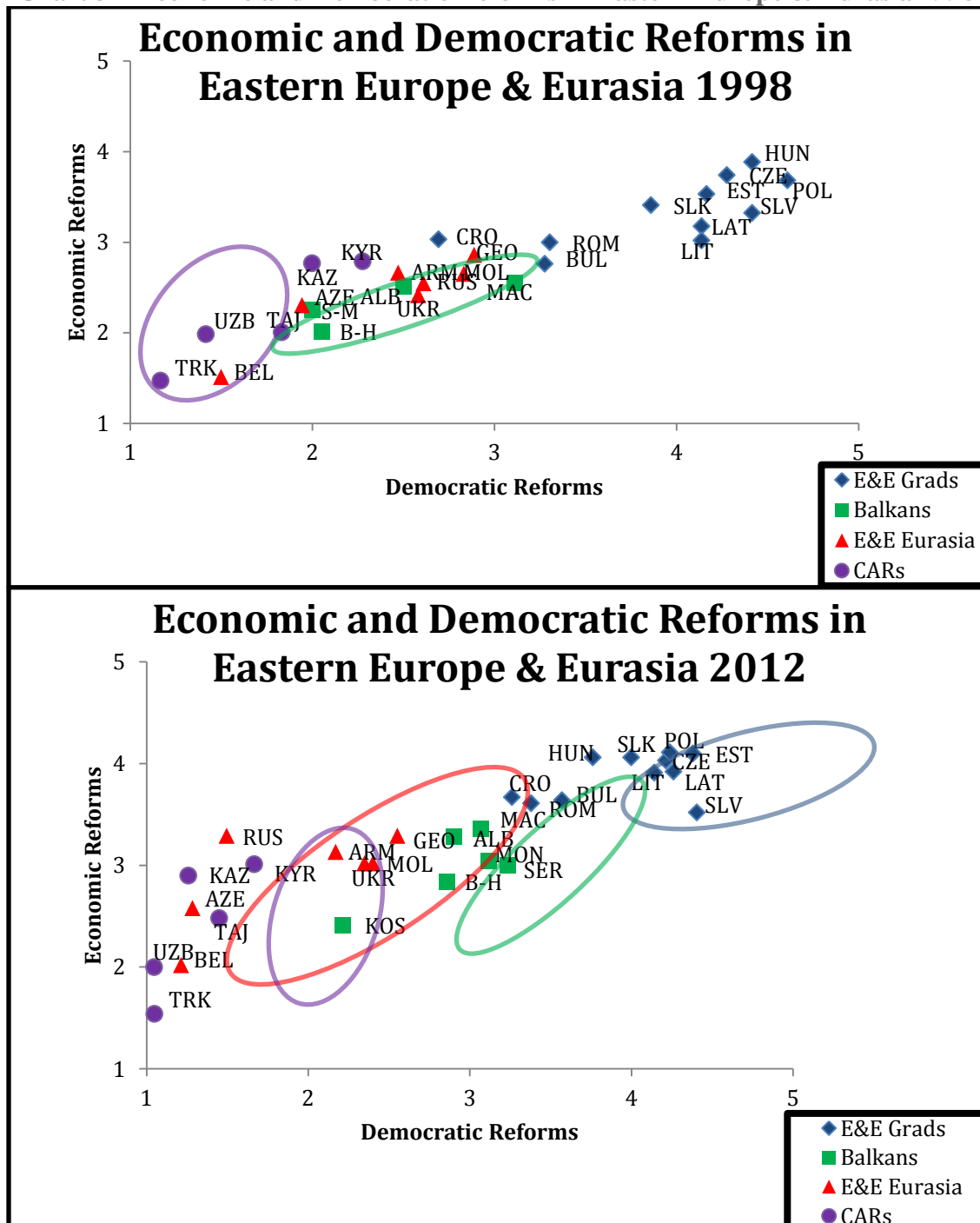
There is ample evidence that as more and more market institutions take root, the economy performs well and expands the middle class. Gradual democratization of the political system inevitably follows; Chart 3 below is a visual summary of how far the 29 countries in the E&E region have come during the first two decades of their post-Communist era with respect to **economic transformation** toward a market economy and **political transformation** toward a democratic form of government. Chart 3A on the next page (left) indicates where the countries were after approximately one decade, and 3B (right) shows the same progress after two decades. Colors indicate the four categories into which the 29 countries are grouped (see box for grouping details).

⁶⁸ Office of the Coordinator of Assistance to Europe and Eurasia, *Guidance for Revised AEECA Phase-Out Framework*, December 2010. See full text of the document in Appendix 12.

⁶⁹ Ron Sprout. E&E/PO/SPA.USAID, *Monitoring Country Progress* (MCP) system.

Combining and then averaging many indicators, separately for economic and for political transformation, each country earns two scores. A score of 1 means that the country has made little progress; a score of 5 indicates full transformation: the country has become comparable to the functioning democracies and established market economies of the West.

Chart 3 – Economic and Democratic Reforms in Eastern Europe & Eurasia 1998 vs. 2012



Ratings are based on a 1 to 5 scale, with 5 representing most advanced worldwide. Freedom House, *Nations in Transit* (June 2012) and *Freedom in the World* (January 2013); and EBRD, *Transition Report 2012* (November 2012).

The most striking pattern revealed by Chart 3 is the high correlation between political and economic transformation. Causation runs both ways. Although the methodologies undergirding the results are solid (Appendix 7 offers details), judgments are certainly involved in the selection and in the weighting of the indicators. It is also difficult to quickly reflect reversals that may occur from time to time. For example, until just a few years ago, Ukraine (after the Orange Revolution) was certainly more democratic than Russia (as is shown on the Chart). However, reversals after the 2010 elections are likely to be reflected in future scores.

As the Chart shows, the 11 Central and Eastern European countries are the most advanced in their democratic as well as economic transformations. There is no country among the remaining 18 that is further ahead in either aspect of transformation than those that have become or are soon to become, EU members. As mentioned previously, critical factors made transformation easier where there was a history of private sector activity and a relatively short period of time under communism (less than 40 years). While the impact of conflict and existence of a cohesive vision of what model the country would adopt in transforming varied among those 11, there was generally strong internal political support for reform and receptivity to U.S. assistance. These factors all contributed to the effectiveness of U.S. support and the progress that the country made in reforming economic policies and establishing the key institutions of a market economy.

No country has achieved the perfect 5 score, however, their transformation progress has been remarkable. Thus, the U.S. Government can take pride in the multi-dimensional and effective transformation support provided. It was also a prudent decision to “graduate” them (at various dates 1996-2008⁷⁰), on the grounds that the marginal benefits of focusing USAID’s scarce resources on the remaining 18 countries would be greater.

Five of the six Balkan countries have made impressive transformation progress. Although political and economic transformation lags behind Central and Eastern Europe, in almost all instances they are ahead of every member of the two Eurasian groups.

It is important to recognize that the Bosnia and Kosovo wars delayed the start of Balkans transformation assistance, and required initial steps of post-conflict rebuilding. True transformation activity in the Balkans has been underway only about 10 years. With the exception of Kosovo, the other Balkans countries’ scores are in the 3.2 range, which is not far off from the averages of the Group 1 countries in 1998. If progress can continue, most of the Balkans countries could reach the graduation threshold conditions by the end of this decade.

Kosovo is the laggard in Southeastern Europe. However, considering the circumstances under which it became independent, pride should be taken in its progress. Assistance began there in 2001. Judging by its scores, Kosovo is about half-way into its transformation. The intensity of USAID and European support contributed to building market institutions where none had existed.

The combined democratic and market scores of the seven Eurasian countries—Russia, Ukraine, Belarus, Moldova and the three nations in the Caucasus—clearly lag behind just about all the

⁷⁰ The dates when each country “graduated” can be found in the Appendix 1.

European countries (Central Europe, the Baltics, and Southeastern Europe). This group as well has the widest country-to-country divergence. Georgia ranks as one of the most advanced reformers, while Belarus is the least. Scores for Georgia, Armenia, Moldova, and Ukraine are within the same range as the Western Balkans, while Russia and Azerbaijan are more similar to Central Asia – particularly in democratic reforms.

Accordingly, recent USAID efforts have focused on civil society building under the democracy and governance program. The level of funding for economic assistance has declined substantially over the 20 years and, in Russia, no economic growth assistance has been provided since 2003. USAID announced that its assistance to Russia will cease in 2012 following the Russian government decision.⁷¹

As a group, the five Central Asian Republics (CARs) lag behind the most, especially in democratic transition where scores range between 1 and 1.6. Their history of fragile national sovereignty and current semi-authoritarian rule has made it difficult for democracy to take root. Regardless of this, all five have made some progress in establishing viable market institutions. For example, the scores of around 3 for Kyrgyzstan and Kazakhstan are significant. Although economic assistance has continued in the region since 1992, lagging political reforms still constrain economic reforms, so that USAID has condensed its economic growth program to a smaller sub-set of sectors.

As noted in Chart 3, what is particularly important is that democratic reforms and economic progress are closely inter-related. We can observe that the E&E graduates and Balkan countries are advancing on both dimensions over the medium term and becoming more cohesive (notwithstanding Kosovo's outlier status); the E&E Eurasia and CARs are advancing on economic reforms while backsliding on democracy (except for static Turkmenistan), and becoming somewhat less cohesive.

It is clear that USAID, working with local decision makers in the E&E region, succeeded in supporting the transformation of all or most countries from centrally planned to market-driven economies. Since none of the countries is likely to go back to the Soviet, communist model (with the exception of Belarus), USAID can be proud of an unqualified success in establishing the irreversibility of reforms in all of the Central, Eastern and Southeastern European countries.

Cost-Benefit Considerations in the U.S. Transition Assistance

Two relevant measures of the significance of U.S. transition assistance are: 1) the relative costs of the transition assistance compared to Cold-War military assistance; and 2) the economic gains accruing to U.S. economic interests as a result of the regional transformation.

According to a Cato Institute study,⁷² U.S. military expenditures for the period 1948-1986 totaled \$6.3 Trillion, or about \$163 billion per year. By comparison, the total expenditure by the U.S.

⁷¹ <http://www.guardian.co.uk/world/russia>

⁷² “U.S. Military Spending in the Cold War Era: Opportunity Costs, Foreign Crises, and Domestic Constraints”, by Robert Higgs (1988).

government in support of the transformation from 1990 – 2012 was \$20 Billion, or about \$900 million per year. In other words, the amount spent in support of the transformation was about 0.3% of the cost of Cold War military costs.

Prior to 1990, the markets of Eastern Europe and the Soviet Union were essentially closed to U.S. businesses. However, as these markets have opened, and economic conditions improved, they have been important markets for U.S. products. It is difficult to find a single number that reflects this market opportunity. However, U.S. exports to Russia in 2012 alone exceeded \$10 billion⁷³ – an amount equal to approximately one half of the total 22 year expenditure by the U.S. in transformation assistance to the entire E&E region.



⁷³ <http://www.foxbusiness.com/news/2012/10/18/analysis-us-manufacturers-turn-to-russia-with-love760849/#ixzz2Ow9JhVRr>

V. CHALLENGES REMAINING

The foreign policy objectives of the United States to support the transformation from centrally-planned to free market economies in Central and Eastern Europe and the former Soviet Union were broadly achieved, as measured by private sector activity. The foundations of a market economy exist, and citizens have economic freedom and opportunity. All the countries have working diplomatic and commercial relations with the United States. Yet, the full promise of a market economy is not fulfilled. Due to the legacies of the former state-dominated economy, the infancy of rule of law based on private property, and nascent market institutions, a disproportionate share of economic wealth is in the hands of special, vested interests.

These vested interests also have political influence that has impeded further reform, keeping competition low, weakening institutions, and leading to unequal economic opportunity. In several countries, politics has obstructed further progress in economic growth. The remaining challenges these countries face are to strengthen economic governance and to consolidate the previous legal and institutional gains made with the help of USAID and the international community over the last two decades. In this way, these countries will have the tools, resources and ability to govern and finance their own economic development and progress.

Despite impressive economic growth up to the mid-2000s, the transformational reforms remain incomplete across the region, particularly in those countries most affected by conflict and those which had the longest period of Soviet domination. Institutional vulnerabilities still exist in commercial law, competition policy, energy infrastructure and policy, sound financial intermediation, and effective fiscal budgeting and taxation, among others, creating a backslide in economic growth and public sentiment. Those countries that continue to struggle to institutionalize economic reforms can benefit from an assistance approach that focuses on systemic reform and institution building, based on international standards for sustainable economic progress.

Another challenge is maintaining the public belief that a private sector-led economy is the best model to make their lives better. Despite tremendous achievement in economic and political freedoms, in many countries, transformational fatigue has set in and lack of broad-based economic progress has created nostalgia for the previous regime. “Mindset” is the most difficult change to make, yet is the most critical. The needs for public education include: 1) accepting that profit-making enterprises provide jobs; 2) building support for greater fiscal transparency; and 3) providing sustainable social safety nets. As a complement to these efforts, USAID assistance in volunteerism, scholarships for U.S. study, and cultural exchanges has proven effective in changing attitudes.

Given the challenges of institutional deficiencies and mindset/cultural barriers in the context of a sharply divided political landscape in many countries, the remaining work to be done, as described more fully in Chapter 3, includes:

- promoting a more sophisticated and stable financial sector;
- ensuring reliable power and energy security;
- developing the private sector workforce;

- reducing informal barriers to regional trade;
- strengthening legal and regulatory frameworks across a range of systemic areas such as business start-up and land;
- implementing accountable transparent tax administration and expenditures policies.

Moving forward, the types of activities needed to have systemic impact require time and significant resources from the international community. Over the 20-plus years of transformation, the European Union, in particular, has established large numbers of programs to assist the countries who are on the path to E.U. accession, as well as to support the Eurasian countries.

Much of the European assistance is linked to modernizing infrastructure in the region. For those 11 countries that are still USAID recipients in 2013, absorption of E.U. funding is relatively low and USAID technical assistance and local capacity building can help unlock the barriers to those funds.

Moreover, U.S. assistance can continue to be successful by working with committed reformers in both the public and private sectors to complete policy forms and institution-building. USAID has earned the good will of the leaders in the E&E region, due to long-established working relationships with key counterparts in most sectors. Because of its ability to work directly with the private sector, local government, and advocacy groups in addition to the central government, and the on-the-ground presence of USAID or State Department personnel, USAID can play a role as a convener of people for exchange of information and mutual learning, followed by demand-driven, timely, and targeted technical assistance. Reform efforts can be successful where local governments and businesses partner to clear the constraints to economic growth.

Furthermore, USAID has the ability to work at both the regional and bilateral level; regional activities have been a powerful complement to bilateral programs, with consistent approaches across sub-regions as countries face similar challenges. By advocating a strategy which considers the entire spectrum of market needs and the rule of law, USAID can play an important role in supporting local approaches that address both petty and grand corruption.

APPENDICES

- Appendix 1 - Chronology of USAID Presence in the Region
- Appendix 2 - Chronology of Major Events in the Region
- Appendix 3 – List of Interviews
- Appendix 4 – Bibliography
- Appendix 5 – Legacy Institutions
- Appendix 6 – Funding Summary
- Appendix 7 – U.S. Objectives and Measuring the Contribution of Aid
- Appendix 8 – Interpreting the “Transformation Depression”
- Appendix 9 – Twenty Years of USAID EG Work in Russia
- Appendix 10 – Country Groups and Classifications
- Appendix 11 – Guidance for Revised AEECA Phase-Out Framework
- Appendix 12 – The Development Credit Authority – Europe and Eurasia Region
- Appendix 13 –Enterprise Funds in E&E: Successes and Lessons Learned (excerpt)
- Appendix 14 – List of Documents Compiled Electronically

APPENDIX 1 - CHRONOLOGY OF USAID PRESENCE IN THE REGION

	Country	Comments	Active in 2012	First Activity	USAID Mission	Graduation	Non-presence activities until
1	Albania		Yes		1992	-	-
2	Armenia		Yes		1992	-	-
3	Azerbaijan		Yes		1992	-	-
4	Bosnia and Herzegovina		Yes		1994	-	-
5	Georgia		Yes		1992	-	-
6	Kosovo		Yes		1999	-	-
7	Macedonia		Yes		1993	-	-
8	Russia		Yes		1992	-	-
9	Serbia		Yes		2001	-	-
10	Montenegro	<i>*Mission in Serbia</i>	Yes	2001	-	-	-
11	Ukraine	-	Yes		1992	-	-
12	Belarus	<i>*Mission in Ukraine</i>	Yes	1992	-	-	-
13	Moldova	<i>*Mission in Ukraine</i>	Yes	1993	-	-	-
14	Bulgaria		No	1990	1991	2008	2010
15	Croatia		No		1992	2008	-
16	Czech Republic		No	1990	1991	1997	
17	Estonia		No	1991		1996	
18	Hungary		No	1989	1991	1999	-
19	Latvia		No	1991	1991	1999	2008
20	Lithuania		No		1991	2000	
21	Poland		No	1989	1992	2000	2012
22	Romania		No		1990	2008	
23	Slovakia		No	1990	1992	2000	2002
24	Slovenia		No		1993	1997	
25	Kazakhstan	<i>Since 2009, countries are under USAID Asia Bureau</i>	Yes	1992	1992	-	-
26	Tajikistan		Yes	1992	1992	-	-
27	Uzbekistan		Yes	1992	1992	-	-
28	Turkmenistan		Yes	1992	1992	-	-
29	Kyrgyzstan		Yes	1992	-	-	-

APPENDIX 2 - CHRONOLOGY OF MAJOR EVENTS IN THE REGION

Year / Country	Event
1989	
Poland, Hungary, Romania, Czechoslovakia	Fall of communist regimes
Poland	Free Elections bring Solidarity to power
Hungary	Border of Hungary with Austria is opened. Communist state in Hungary is dismantled and a transition to a multi-party democracy starts.
Czechoslovakia	200,000 protesters in Prague call for the resignation of the country's communist government in the "Velvet Revolution." Václav Havel elected President.
Romania	Communist leader Nicolae Ceausescu ousted and executed; elections announced for April 1990.
Armenia / Azerbaijan	Conflict over Nagorno-Karabakh region begins. It lasts intermittently for five years.
Lithuania	Parliament approves declaration of Lithuanian sovereignty, stating that Lithuanian laws take precedence over Soviet ones.
Slovenia	Parliament confirms the right of the country to secede from the Yugoslav federation.
Bulgaria	Amid escalating street protests, Communist party leader Mladenov gave way and announced on 11 December 1989 that the Communist Party had abandoned power.
Georgia	Anti-Soviet demonstration dispersed by the Soviet Army, resulting in 20 deaths and hundreds of injuries.
1990	
Romania	New government embarks on reform program
East Germany	German reunification
Poland	Market reforms, including large-scale privatization, are launched.
Armenia	Nationalists win parliamentary elections. Independence is declared, but ignored by Moscow.
Albania	Independent political parties formed. Albanians granted right to travel abroad. Thousands try to flee through Western embassies.
Kazakhstan	The Supreme Soviet elects Nursultan Nazarbayev first Kazakh president and on 25 October declares state sovereignty.
Tajikistan	State of emergency declared and some 5,000 Soviet troops sent to the capital, Dushanbe, to suppress pro-democracy protests. Supreme Soviet declares state sovereignty in Tajikistan.
Uzbekistan	Communist Party declares economic and political sovereignty. Islam Karimov becomes president.
Turkmenistan	Turkmen parliament declares sovereignty and elects Saparmyrat Niyazov as its chairman.
1991	
Former USSR	Soviet Union collapses. Commonwealth of Independent States (CIS) is formed Independence of Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Turkmenistan, Ukraine, Uzbekistan
Hungary	Soviet forces withdraw. The Warsaw Pact is dissolved
Lithuania	Start of mass privatization. Lithuania joins OSCE and UN.
Former Yugoslavia	Slovenia, Macedonia, Croatia, BiH secede from Yugoslavia; Montenegro supports union with Serbia.
Bulgaria	New constitution proclaims Bulgaria a parliamentary republic and provides broad range of freedoms.
1992	
Czechoslovakia	Federal Assembly adopts legislation enabling the federation to disband
Poland	Soviet troops start to leave Poland.
Albania	Democratic party wins elections
Russia	Price controls lifted
Moldova	An upsurge in fighting in the Trans-Dniester region leads to a state of emergency being re-imposed. Russian peacekeepers are deployed after a ceasefire agreement.

Armenia / Azerbaijan	Hostilities develop into full-scale war over Karabakh region in Azerbaijan
Georgia	Fighting breaks out in Abkhazia between Georgian government troops and separatist forces.
Tajikistan	Anti-government demonstrations in Dushanbe escalate into civil war
1993	
Czechoslovakia	Czechoslovakia completes "velvet divorce" which results in two independent countries, the Czech Republic and Slovakia
Czech Republic	Vaclav Havel elected president—privatization of the public sector as top priority
Latvia	First independent elections to the 100-seat parliament.
Slovenia	Slovenia joins the International Monetary Fund
Bulgaria	Mass privatization program
BiH	Ongoing conflict between Muslims, Croats and Serbs. UN safe havens for Bosnian Muslim civilians are created, to include Sarajevo, Gorazde and Srebrenica.
Kazakhstan	A major privatization program launched
Turkmenistan	Turkmenistan introduces the manat as its national currency and begins program of cautious economic reform
1994	
Tajikistan	Ceasefire between government and rebels
Uzbekistan	Uzbekistan signs an economic integration treaty with Russia, and an economic, military and social cooperation treaty with Kazakhstan and Kyrgyzstan
Armenia	Demonstrations in Yerevan over shortages of food and energy.
Azerbaijan	Azerbaijan signs what it calls the "contract of the century" with a consortium of international oil companies for the exploration and exploitation of three offshore oil fields.
Georgia	New constitution adopted which provides for a strong executive presidency. New currency, the lari, introduced.
Belarus	Alexander Lukashenko becomes president. He introduces policies designed to strengthen ties with Russia.
Moldova:	A new constitution proclaims Moldova's neutrality, grants special autonomy status to Trans-Dniester and the Gagauz region, and declares Moldovan to be the official language.
1995	
Lithuania	Lithuania's two largest commercial banks collapse. Political scandal ensues.
Slovakia	New law restricting official use of any language other than Slovak gives rise to international condemnation.
Armenia	The government launches privatization and price liberalization program
BiH	Thousands of Bosnian Muslim men and boys massacred, NATO air strikes against Serb positions in Bosnia. Dayton peace accord signed in Paris. An international peacekeeping force is deployed in Bosnia.
1996	
CAR	Uzbekistan, Kazakhstan and Kyrgyzstan agree to create a single economic market
Balkans	The International Criminal Tribunal for the former Yugoslavia begins work in the Hague.
Ukraine	New, democratic constitution adopted. New currency, the hryvna, introduced in Ukraine
1997	
Poland	Polish parliament adopts a new constitution
Romania	Economic reform program announced. Securitate files opened.
Slovenia	The EU opens full membership talks
Albania	Fraudulent pyramid investment schemes collapse, costing thousands of Albanians their savings and triggering anti-government protests
Bulgaria	Mass protests over economic crisis. Interim government installed until elections, when UDF leader Ivan Kostov becomes prime minister. Bulgarian currency pegged to German mark
Turkmenistan	Turkmenistan legalizes private ownership of land
1998	
Poland, Hungary	The EU opens talks on Polish and Hungarian membership
Slovakia	New coalition pledges to strengthen democracy and put Slovakia back on the road to European integration
Russia	The ruble collapses and government gives notice of intention to default on foreign debts.

Belarus	The Belarus ruble sees its value halved. Food rationing is imposed. Belarus signs an accord with Russia, which would see their currencies and tax systems merge.
Serbia / Kosovo	Kosovo Liberation Army rebels against Serbian rule. Serb forces launch brutal crackdown. Hundreds of thousands of Kosovo Albanians flee.
1999	
Kosovo	NATO launches air strikes against Yugoslavia lasting 78 days before Belgrade yields. Hundreds of thousands of Kosovo Albanian refugees pour into neighboring countries. The UN sets up a Kosovo Peace Implementation Force (KFOR) and NATO forces arrive in the province. Milosevic agrees to withdraw forces from Kosovo. Kosovo becomes UN protectorate but remains de jure part of Serbia.
Montenegro	Montenegrin president Milo Djukanovic declares Montenegro not a party to the conflict over Kosovo; Montenegro abandons dinar in favor of German mark.
Armenia	Gunmen open fire in the parliament. The prime minister, parliamentary speaker and six other officials are killed.
Turkmenistan	Parliament votes Saparmyrat Niyazov president for life
Uzbekistan	Islamic Movement of Uzbekistan declares "jihad" and demands the resignation of the Uzbek leadership
2000	
	Milosevic ousted by pro-Western reformers in Belgrade. Montenegrin leadership becomes increasingly independence-minded.
	Tajikistan: A new national currency, the somoni, introduced
2001	
Romania	Parliament approves a privatization law
Albania	Uprising by ethnic Albanians. National Liberation Army emerges demanding equal rights for ethnic Albanians.
Macedonia	Macedonian Government and rebels sign western-backed Ohrid peace agreement involving greater recognition of ethnic Albanian rights. NATO carries out month-long Operation Essential Harvest to disarm rebels.
Ukraine	Viktor Yushchenko government dismissed following no-confidence vote in parliament.
Kazakhstan	First major pipeline for transporting oil from Caspian to world markets
Tajikistan	Tajikistan offers support to the US-led anti-terror coalition; Settles a century-old border dispute with China by agreeing to cede some land
Uzbekistan	Rapprochement Uzbekistan-USA
2002	
Former Yugoslavia	Trial of Slobodan Milosevic on charges of genocide and war crimes begins in The Hague
Montenegro	Montenegro adopts euro as its currency. Yugoslav, Montenegrin and Serbian leaders sign EU mediated accord to set up new state, to be called Serbia and Montenegro, in place of Yugoslavia.
Belarus	US and 14 EU states impose travel ban on president Lukashenko and several government ministers over poor human rights record and after OSCE officials are told to leave. (removed in 2003)
Azerbaijan	Construction work starts on multi-billion-dollar pipeline to carry Caspian oil from Azerbaijan to Turkey via Georgia.
2003	
Georgia	"Rose Revolution" topples president Shevardnadze. It is triggered by opposition allegations of irregularities in parliamentary elections.
Serbia	Yugoslav parliament consigns Yugoslavia to history by approving constitutional charter for Union of Serbia and Montenegro. (Feb); Serbian Prime Minister Zoran Djindjic assassinated in Belgrade (Mar)
2004	
Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia	EU Accession, May 1 st , 2004.
BiH	NATO hands over peacekeeping duties in Bosnia to a European Union-led force, Eufor.
Kosovo	President Rugova's pro-independence Democratic League tops poll in general election
Serbia / Kosovo	Clashes between Serbs and ethnic Albanians in divided town of Mitrovica. NATO sends

	reinforcements. Democratic Party leader Boris Tadic elected Serbian president, pledges to steer Serbia towards the EU.
Ukraine	Official count indicates presidential election victory for Prime Minister Viktor Yanukovich; Opposition candidate Viktor Yushchenko launches campaign of mass street protest and civil disobedience. Supreme Court later annuls result of poll. Opposition candidate Viktor Yushchenko tops poll in election re-run.
2005	
Romania	Agreement signed which will allow U.S. to use Romanian military bases.
Romania	New leu currency introduced as four zeroes are stripped from old leu
Uzbekistan	Agreement signed on closer military cooperation between Uzbekistan and Russia
Macedonia	Macedonia becomes a candidate for EU membership.
2006	
Montenegro	Montenegro holds an independence referendum. Just over the required 55% of voters say yes. Montenegro declares independence and becomes the 192nd member of the UN
Kyrgyzstan	Mass protests demand constitutional reform
2007	
Georgia	State of emergency declared in Georgia. Riot police battle protesters demanding president's resignation.
Russia	President Putin's United Russia party wins a landslide victory in parliamentary elections, which critics describe as neither free nor democratic.
Kosovo	UN envoy Martti Ahtisaari unveils a plan to set Kosovo on a path to independence, which is immediately welcomed by Kosovo Albanians and rejected by Serbia.
2008	
Bulgaria, Romania	Bulgaria and Romania join the European Union, raising the EU membership to 27
Georgia	Tensions between Georgia and Russia escalate into a full-blown military conflict after Georgia tries to retake South Ossetia by force after a series of lower-level clashes with Russian-backed rebels.
Kosovo	Kosovo declares independence. Serbia says declaration illegal. Europe's major powers and the United States recognise independence.
Belarus	US Ambassador Karen Stewart leaves country indefinitely after Belarus asks her to leave. Belarus withdrew its own ambassador from Washington the previous week. Belarus expels 11 U.S. diplomats in row over U.S. criticism of Belarus' human rights record.
2009	
Albania	Albania formally applies for membership of the European Union.
Macedonia, Montenegro, Serbia	Visa-free travel within EU's Schengen zone comes into effect for Macedonia's, Montenegro's and Serbia's citizens.
Russia	President Medvedev and Barack Obama reach an outline agreement to cut back their countries' stockpiles of nuclear weapons
Serbia	Serbia submits formal application to join EU.
Moldova	Ruling Communists declared winners of disputed election. Result triggers violent protests and political deadlock.
Georgia	Opposition launches "national disobedience campaign" in effort to persuade President Saakashvili to resign.
Uzbekistan	The EU lifts the arms embargo to Uzbekistan
2010	
Turkmenistan	Turkmenistan opens second gas pipeline to Iran
Kyrgyzstan	Revolution and a new constitution; Kyrgyzstan becomes parliamentary republic
2011	
BiH	Bosnia's Muslim, Croat and Serb political leaders reach agreement on formation of new central government, bringing to an end 14 months of deadlock since 2010 general election.
Moldova	Anti-corruption campaigner Yevgeny Shevchuk defeats pro-Russian candidates in Trans-Dniester's presidential election. Pledges to establish "friendly relations" with Moldova while continuing to press for the independence of the separatist region
Kazakhstan	President Nazarbayev wins re-election in a poll boycotted by the opposition; State of emergency declared - clashes between striking workers and police leave 16 people

	dead
2012	
Russia	Vladimir Putin wins presidential elections in Russia. Opponents take to the streets of several major cities to protest at the conduct of the election, and the police arrest hundreds. Russia formally joins the World Trade Organization after 18 years of negotiations.
Serbia	The European Union grants Serbia candidate member status.
Belarus	The European Union recalls its ambassadors from Belarus after the government expels the EU envoy
Uzbekistan	Government announces plans to sell off hundreds of state assets in a drive to expand the private sector
Georgia	Tens of thousands of protestors attend a rally by leading opposition figure Bidzina Ivanishvili in Tbilisi, in the largest anti-government demonstration in years.

APPENDIX 3 – LIST OF INTERVIEWS

Name		Category	Title ⁷⁴
Adams	Tom	State Department	State Coordinator
Alexander	Paige	USAID	Assistant Administrator, E&E Bureau
Archer	Robert	USAID	E&E, Energy
Bahensky	Jerry	Implementer	
Ballantyne	Janet	USAID	Mission Director/Russia
Birnbaum	Ira	USAID	E&E, Energy
Botezatu	Sergiu	USAID	FSN/Moldova
Brown	Ian	Other donor	EBRD
Buck	Craig	USAID	Mission Director/Kosovo, BiH, Macedonia
Burns	Richard	USAID	Senior Staff/Office of Market Transition
Burns	Steve	USAID	E&E, Energy
Butler	Malcolm	USAID	AA/Acting AA; DAA/Acting DAA
Camp	Lawrence	USAID	Senior Staff/E&E
Castelli	Brian	Implementer	
Chandler	Bill	Implementer	
Cipielia	Cecilia	USAID / Implementer	Senior Staff/Russia
Collins	Jim	State Department	Ambassador to Russia
Costello	John	Implementer	
Cowles	David	USAID	Senior Staff/E&E
De Terra	Niels	Implementer	
Eisendrath	Allen	USAID	Senior Staff/E3
Feeney	Paula	USAID	AA/Acting AA; DAA/Acting DAA
Filippov	Alex	Implementer	
Frej	Bill	USAID	Mission Director/CAR; Office Director, Market Transition, E&E
Fritsch	Conrad	Implementer	
Galper	Harvey	Implementer	
Gonyea	Steve	USAID	Senior Staff/Macedonia and Poland
Gulati	Mohinder	Other donor	World Bank
Gulliver	John	Implementer	
Hadley	Steve	USAID	Senior Staff/EGAT, Senior Staff/Ukraine
Heron	Lena	USAID	Advisor, EGAT
Hester	Sharon	USAID	Senior Staff/E&E, Kosovo
Hobson	Robert	Other donor	EBRD
Hopkins	Mark	Implementer	
Ichord	Robert	USAID	E&E, Energy
Ingram	George	USAID	AA/Acting AA; DAA/Acting DAA
Jessee	David	USAID	Agr Staff E&E
Keith	David	Implementer	

⁷⁴ Interviewees are identified by their organization/title in connection to the work presented in this report, which might be different from their current employment.

Kirvalidze	David	Local	Minister of Agriculture, Georgia
Kissinger	Skip	USAID	Senior Staff/E&E
Kogalniceanu	Violeta	Local	Energy Community
Lanza	Ken	USAID	Senior Staff/EGAT
Lee	Jeffrey	USAID	Agr Staff E&E
Lee	Robert	Implementer	
Levitt	Mike	Implementer	
Lewarne	Steve	Implementer	
Linden	Gary	USAID	Senior E&E staff/Kazakhstan, Ukraine and Moldova
Miller	Douglas	Implementer	
Morton	Raymond	USAID	Ex USAID Staff
Myers	Greg	USAID	Land Advisor EGAT
Nooter	Rob	Implementer	
Nyman	Kari	Other donor	World Bank
Parshad	Nandita	Other donor	EBRD
Pascual	Carlos	USAID	State Coordinator; Ambassador to Ukraine, Senior Staff
Piper	Alan	Implementer	
Pollen	Will	Implementer	USEA
Postel	Eric	USAID	AA/Acting AA; DAA/Acting DAA
Pressley	Don	USAID	AA/Acting AA; DAA/Acting DAA
Ramos	Fernando	Implementer	
Rosenblum	Dan	State Department	State Coordinator
Russo	Robert	Implementer	
Sainclair	Robert	Implementer	
Sanfey	Peter	Other Donor	EBRD
Sharma	Dennis	USAID	Ex USAID Agr Staff E&E
Shvets	Ivan	USAID	FSN/Ukraine
Singer	Jeffrey	Implementer	
Singletary	Robert	USAID / Implementer	
Skootsky	Erjn	Implementer	
Stern	Robert	Implementer	
Stuggins	Gary	Other donor	World Bank
Szoreny	Gabor	Local	ERRA Chairman
Thomas	John	USAID	ADO in Russia
Tugenhat	Eduardo	Implementer	
Uphaus	Charles	USAID	Agr Staff E&E
Vucetic	Vlado	Other donor	World Bank
Wallin	Bob	USAID	Ex USAID Staff E&E
Ward	Mark	USAID	Senior Staff/Russia
Webster	Russ	Implementer	
Weller	Julia	Implementer	
White	Dean	Implementer	

Worthington	Barry	Implementer	USEA
Yarmov	Nikolay	USAID / Local	CEED/Bulgaria (former FSN USAID/Bulgaria)
Zaheer	Salman	Other donor	World Bank

APPENDIX 4 – BIBLIOGRAPHY

Documents Cited

- Bush, G.H.W. 1989. Making the History of 1989, Item #35. Washington, DC: German Historical Institute. Accessed October 8, 2012 from <http://chnm.gmu.edu/1989/items/show/35>
- Djankov, S. et al. 2002. The Regulation of Entry. Quarterly Journal of Economics 117.1 (2002): 1-37. Oxford: Oxford University Press.
- Doernberg, A. 2007. Transformational Development: Lessons From the Energy Transition in Europe and Eurasia. Energy Update. March/April. Washington, DC: USAID
- Elder, M. 2012. USAID Covertly influencing political processes, says Russia. London, UK: The Guardian. Accessed from <http://www.guardian.co.uk/world/2012/sep/19/usaid-covertly-influence-politics-russia>
- European Commission. 2011. Albania-Agriculture and Enlargement. Brussels: European Commission for Agriculture and Rural Development.
- Food and Agricultural Organization of the United Nations. 1998. The State of Food and Agriculture. Rome; FAO
- Freedom House. 2011. Nations in Transit 2011. Washington, DC: Freedom House
- Freedom House. 2012. Freedom in the World. Washington, DC: Freedom House.
- Harberger, A. 2005. On the process of growth and economic policy in developing countries (No. 13). Washington, DC: USAID Bureau for Policy and Program Coordination.
- Jesse, D. et al. 2003. Strategic Objectives. Washington, DC: USAID Office of Market Transition.
- Linn, J.F. 2004. Economic (Dis)Integration Matters: The Soviet Collapse Revisited. Washington, DC: Brookings Institute
- Nathanson, N. 2011. An Overview of Competitiveness Projects in the E&E Region. Washington, DC: USAID
- Porter, M.E. 1990. The Competitive Advantage of Nations. New York, NY: Free Press.
- Selowsky, M. and R. Martin. 1997. Policy performance and output growth in the transition economies. The American Economic Review, 87(2), 349-353.
- Silcox, S.C. 2005. Assessment of the Bulgarian Enterprise Growth and Investment Project (EGIP). Washington, DC: USAID.
- Snodgrass, D.R., and Packard Winkler, J. 2004. Enterprise Growth Initiatives: Strategic Directions and Options. Bethesda, Maryland: Development Alternatives International
- Solvell, O.,G. Lindqvist, and C. Ketels. 2003. The Cluster Initiative Greenbook. Stockholm: Swedish Agency for Innovation Systems.
- Stephens, P. 2006. Mission Improbable. London, UK: Financial Times.
- Tanburn, J. 2008. The 2008 Reader on Private Sector Development from the ILO ITC. Geneva, Switzerland: International Labour Organization.
- The European Bank for Reconstruction and Development. 2011. Transition Report 2011. London, UK: EBRD.

United States Agency for International Development. 2007. Assessment Report: Seventeen Years of Partnership in Transition, 1990-2007. Washington, DC: USAID.

United States Agency for International Development. 2003. Building Trade Capacity in the Developing World. Washington, DC: USAID.

United States Agency for International Development. 2005. Land and Tenure Reform in Kazakhstan, Uzbekistan and Tajikistan, Final Report. 2005. Washington, DC: USAID.

White, D. Unpublished Paper. Pasadena, CA: Tetra Tech.

World Bank. 2012. Doing Business 2012, Doing Business in a More Transparent World. Washington DC; World Bank.

World Bank. 2010. Lights Out? The Outlook for Energy in Eastern Europe and Central Asia. Washington, DC: World Bank

Additional Bibliography

- The following documents, while not directly cited in the report, are considered
- A Decade of Change: Profiles of USAID Assistance to Europe and Eurasia, USAID
- Economic Reforms, Democracy and Growth in Eastern Europe and Eurasia, USAID, 2005
- Monitoring Country Progress in Europe and Eurasia, 10th Edition, USAID, September 2006
- Labor Markets in Eastern Europe and Eurasia, USAID, January 2007
- Divergence and Convergence in the E&E Region: One Transition Path or Two? USAID, January 2007
- Promoting Female Sustainable Livelihoods in the Europe and Eurasia Region, April 2011
- Assessing the Impact of U.S. Government Assistance on Job Creation, USAID, 2008
- Local Economic Development in Europe and Eurasia: Strategies that Work. Final Report, USAID, February 2005
- USAID: Gender Issues in Eastern Europe and Eurasia: An Overview of the Literature, June 2006
- USAID Monitoring Country Progress
- Monitoring Country Progress in Eastern Europe and Eurasia, USAID/E&E/PO, August 2006
- Monitoring Country Progress in Eastern Europe and Eurasia, USAID, October 2011
- An Overview of Corruption in Central and Eastern Europe and Eurasia, USAID, March 2002
- Capital Markets in Southeast Europe and Eurasia: A Future in Question, June 11, 2011
- High Levels of Problem Loans in Southeast Europe and Eurasia: The Silent Killer of Economic Growth, September 2011
- The Global Financial Crisis and the Impact on the Financial Sectors in Southeast Europe and Eurasia: Financial Stability, Vulnerabilities and Lessons Learned, June 2011
- Regional Comparison and Financial Sector Overviews for 12 Countries in Southeast Europe and Eurasia, February 2012
- Economic Growth Event Tirana May 2012
- Overview of Regional Trends in Economic Growth in Eastern Europe and Eurasia
 - Access to Finance and Financial Sectors Stability in the E&E Region: How Countries Stack Up
 - Facilitating Regional Trade and Investment in South East Europe
- Crisis in Transition: The People's Perspective, EBRD Transition Report, 2011
- Forecasting Growth in Eastern Europe and Central Asia, EBRD December 2011
- Public-Private Partnerships in Europe and Central Asia, The World Bank, May 2011
- Fiscal Policy and Economic Growth: Lessons for Eastern Europe and Central Asia, The World Bank 2007
- Environmental and Economic Impact Assessment of Land Privatization In Eastern Europe and Eurasia, September 2006

USAID Energy Programs in Europe and Eurasia, Presentation to NARUC, Annual Meeting, February, 14, 2010

USAID Azerbaijan, Georgia and Turkey, AGT Power Bridge Project. Working Group Phase II Final Report: Study of Technical Potential for Trade of Electricity between the Countries of Azerbaijan, Georgia and Turkey, March 8, 2012.

USAID Black Sea Regional Transmission Planning Project: Renewable Energy Compendium Report Phase III, March 19, 2012

A Regional Review of Social Safety Net Approaches in Support of Energy Sector Reform, USAID, October 2003.

Europe and Eurasia, Infrastructure, Reform and Finance (IRF) Project, USAID May 2009

Alternative Business Enabling Environment Rankings - A Review, Business Growth Initiative Project, USAID, June 2008

Agrarian Reforms In Eastern European Countries: Lessons From International Experience, Klaus Deininger, Journal of International Development, J. Int. Dev. 14, 987–1003 (2002)

Volume 2. Land Tenure and Property Rights Regional Report, Awareness Framework: Property Rights and Natural Resource Management Project, USAID, 2007

- 2.7 The Balkans and the Caucasus [The Balkans: Albania, Bosnia and Herzegovina, Croatia, Kosovo, Republic of Macedonia, and Serbia and Montenegro; The Caucasus: Armenia, Azerbaijan, and Georgia]
- 2.8 Central Asia [Kazakhstan, Kyrgyzstan, Russia, Tajikistan, Turkmenistan, and Uzbekistan]
- 2.9 Eastern Europe [Belarus, Bulgaria, Moldova, Romania, and Ukraine]

APPENDIX 5 – LEGACY INSTITUTIONS

Sustainability/Legacy Entity	Website
ALBANIA	
	http://albania.usaid.gov/
ACER - Albanian Center for Economic Reserach	http://www.acer.org.al/
AITA - Albanian IT Association	http://www.aita-al.org/
Albanian-American Development Foundation	http://www.aadf.org/
ATA - Albanian Tourism Association	http://www.ata.org.al/english/
Bank of Albania	http://www.bankofalbania.org/
Foundation for Economic Education of Youth/Albanian Junior Achievement	www.jaalbania.org
Tirana Stock Exchange	www.tse.com.al
ARMENIA	
	http://armenia.usaid.gov/en/home
EIF - Enterprise Incubator Foundation	www.eif.am
Junior Achievement of Armenia	www.jaarmeria.org
MIC - Microsoft Innovation Center Armenia	http://www.micarmenia.am/
UITE - Armenia IT Association	http://www.uite.org/en/index.php
AZERBAIJAN	
	http://azerbaijan.usaid.gov/
International Division of the Central Bank	http://www.cbar.az/pages/international-relations/cooperation/
BOSNIA AND HERZEGOVINA	
	http://www.usaid.gov/ba/
AgroLink	http://www.agrolink.ba/
ARTECO - Wood Technology Center	http://www.arteco.ba/portal/index_en.html
Association of Accountants and Auditors of the Federation of Bosnia and Herzegovina, Republic of Srpska	www.srrrs.org
BAIT - IT Association of Bosnia and Herzegovina	http://www.bait.org.ba/
Banja Luka Stock Exchange	http://www.blberza.com/
Exploring Bosnia and Herzegovina	http://www.exploringbosnia.com/
Insurance Agency of Bosnia and Herzegovina	http://www.nados.ba/
Insurance Agency of Republika Srpska	
MTTC - Center for Advanced Technologies	http://www.mttc.ba/index.php?lang=en
Sarajevo Stock Exchange	http://www.sase.ba/
Securities Commission of Republika Srpska	www.sec.rs.ba
Securities Commission of the Federation of Bosnia and Herzegovina	www.komvp.gov.ba
GEORGIA	
	http://georgia.usaid.gov/
Georgia ICT Business Council	http://www.ictbc.ge/
KOSOVO	
	http://www.usaid.gov/locations/europe_eurasia/countries/ko/
CEED - Center for Entrepreneurship and Executive Development Kosovo	http://www.ceed-kosovo.org/web/default.aspx
Central Banking Authority of Kosovo	www.bqk-kos.org
Kosovo Crimson Finance Fund	http://cffkosovo.com/english1.htm
STIKK - Kosovo ICT Association	http://www.stikk-ks.org/
MACEDONIA	
	http://macedonia.usaid.gov/en/index.html
Agency for Supervision of Fully-Funded Pension Insurance (MAPAS) – Macedonia	http://www.mapas.gov.mk
CEED - Center for Entrepreneurship and Executive Development Macedonia	http://www.en.ceedmacedonia.org/

Center for Economic Analysis (CEA)	http://www.cea.org.mk
Digital Media	http://www.digitalmedia.org.mk/#
EPI Centar - Economy Planning Innovation	http://www.epicentar.com.mk/default.asp?lng=en&pgID=1
Exploring Macedonia	http://www.exploringmacedonia.com/
Junior Achievement Macedonia	http://www.jamacedonia.org.mk
Macedonia SME Commercial Finance Fund	
Macedonian Stock Exchange	http://www.mse.mk/en/
MASIT - Macedonia ICT Chamber of Commerce	http://www.masit.org.mk/
Securities and Exchange Commission of the Republic of Macedonia	www.sec.gov.mk
MOLDOVA	http://moldova.usaid.gov/
ATIC - Moldovan Association of Private ICT Companies	http://www.ict.md/
ESI Eastern Europe Qlab in Moldova	
Junior Achievement Moldova	www.jamoldova.org.md
MONTENEGRO	http://serbia-montenegro.usaid.gov/
CEED Consulting	http://www.ceed-consulting.com/en/
Central Bank of Montenegro	www.cb-cg.org
Central Bank of Montenegro	www.cb-cg.org
CSTI - Center for Sustainable Tourism Initiatives	http://www.cstimontenegro.org/
FORS - Foundation for Development of Northern Montenegro	http://www.forsmontenegro.org/
ISSP - Institute for Strategic Studies and Prognoses	: http://www.isspm.org/gdp.htm
MBA - Montenegro Business Alliance	http://www.visit-mba.org/eng/
Montenegro Adventures	http://www.montenegro-adventures.com/index.php
Montenegro Stock Exchange	http://www.montenegroberza.com
New Securities Exchange Montenegro	: http://www.nexmontenegro.com
Securities Commission of the Republic of Montenegro	www.scmn.me
SERBIA	http://serbia-montenegro.usaid.gov/
AIESEC Serbia	http://www.aiesec.org.rs/
Association of Serbian Banks	www.ubs-asb.com
Belgrade Stock Exchange	http://www.belex.rs
CEED - Serbia	http://www.en.ceedserbia.org/web/default.aspx
CPM - Center for Project Management	http://www.cpm.rs/eng/index.php
Junior Achievement & Young Enterprises in Serbia - JAS	http://www.ja-serbia.org
NALED - National Association for Local Economic Development	http://www.naled-serbia.org/
National Bank of Serbia	http://www.nbs.rs/
National Bank of Serbia	http://www.nbs.rs/
Securities Commission of the Republic of Serbia	http://www.sec.gov.rs/
GRADUATED MISSIONS	
BULGARIA	http://www.usaid.gov/locations/europe_eurasia/countries/bg/
America for Bulgaria Foundation	http://www.americaforbulgaria.org/
Association of Dairy Processors in Bulgaria	www.milkbg.org
Association of Meat Processing Enterprises in Bulgaria	amb.dir.bg

Authentic Bulgaria Association	http://www.authenticbulgaria.org/
BASSCOM - Bulgarian Association of Software Companies	http://www.basscom.org/
Branch Chamber of Industrial Bread Producers and Confectioner in Bulgaria	
Bulgarian ICT Cluster	www.ictalent.org
Business Center Serdon	http://bcserdon.com/
Business Foundation for Education	http://www.fbo.bg/
CED - Center for Economic Development	http://www.ced.bg/
CEED - Bulgaria	http://www.en.ceed-bulgaria.org/web/default.aspx
CLS - Center for Liberal Strategies	http://www.cls-sofia.org/
CSD - Center for the Study of Democracy	http://www.csd.bg/
eFLAG	http://www.eflag.cc/
EnEffect - Center for Energy Efficiency	http://www.eneffect.bg/
ESI - European Software Institute Center Bulgaria	http://www.esicenter.bg/
FLGR - Foundation for Local Government Reform	Zdravko Sechkov, Director Email: flgr@flgr.bg Web address: http://www.flgr.bg/en
IME - Institute of Market Economics	www.ime.bg
Junior Achievement Bulgaria	http://www.jabulgaria.org
Nachala	http://www.nachala.bg/
NAMRB - National Association of Municipalities in the Republic of Bulgaria	http://www.namrb.org/
Union of the Processors of Fruits and Vegetables of Bulgaria	http://www.org-bg.net
Ustoi Microfinance	http://www.ustoi.org
VOCA Consult	http://www.vocaconsult.com
CROATIA	http://www.usaid.gov/locations/europe_eurasia/countries/hr/
cro.ict - Croatian Ict Cluster Initiative	http://www.cro-ict.net/
Illyricum consulting Ltd.	N/A
IMO - Institute for International Relations	http://www.imo.hr/
IPF - Institute for Public Finance	http://www.ijf.hr/eng/index.php
Junior Achievement Croatia (JAC) Foundation	
Konagra	http://www.konagra.hr/vision.htm
MIC - Microsoft Innovation Center Varazdin, Croatia	http://www.microsoft.com/croatia/mic/varazdin/default.aspx
Microgrupa	http://www.microgrupa.hr/en/
Zagreb School of Economics & Management - Croatia	http://www.zsem.hr
Zagreb Stock Exchange	www.zse.hr
CZECH REPUBLIC	http://www.usaid.gov/locations/europe_eurasia/countries/cz/
Junior Achievement Czech Republic	http://www.jacr.cz
HUNGARY	
Hungarian-American Enterprise Scholarship Fund	http://www.haesf.org/
LITHUANIA	
Vilnius Stock Exchange	http://www.nasdaqomxbaltic.com/en/exchange
POLAND	http://www.usaid.gov/pl/
BRE Bank SA - Warsaw, Poland	http://www.brebank.pl

CEED - Poland	
Firma 2000	http://firma2000.pl/en
Gdansk Academy of Banking	http://www.wsb.gda.pl
Junior Achievement Foundation Poland	http://www.junior.org.pl
Polish-American Freedom Foundation	http://www.pafw.pl/
Polish-Ukrainian Cooperation Foundation - PAUCI	www.pauci.org
Unilob	http://www.unilob.pl/
University of Gdansk – Gdansk, Poland	http://www.univ.gda.pl
University of Wroclaw – Wroclaw, Poland	http://international.uni.wroc.pl/pl
Warsaw Actuarial Summer School	http://www.wne.uw.edu.pl
Warsaw Stock Exchange	http://www.gpw.com.pl/
ROMANIA	http://www.usaid.gov/locations/europe_eurasia/countries/ro/
CEED - Romania	http://www.en.ceed-romania.org/web/default.aspx
Junior Achievement Romania	www.jaromania.org
Romanian-American Foundation	http://www.rafonline.org/
RUSSIA	http://russia.usaid.gov/
Junior Achievement of Russia	http://www.ja-russia.ru
US-Russia Center for Entrepreneurship	http://www.cfe.ru/en/
US-Russia Foundation for Economic Advancement and the Rule of Law	http://www.usrf.ru/index.html
SLOVENIA	http://www.usaid.gov/locations/europe_eurasia/countries/si/
CEED - Slovenia	http://www.ceed-global.org/web/default.aspx
Center of Excellence in Finance	www.cef-see.org
SLOVAKIA	http://www.usaid.gov/locations/europe_eurasia/countries/sk/
Junior Achievement Slovensko - Mládež pre budúcnosť	www.jasr.sk
Slovak-American Foundation	http://www.slovakamericanfoundation.org/
REGIONAL / SUBREGIONAL	
Baltic-American Freedom Foundation	http://www.balticamericanfreedomfoundation.org/
International Organization of Pension Supervisors (IOPS)	http://www.iopsweb.org
US-Central Asia Education Foundation	http://www.us-caef.com/
Western NIS Enterprise Fund - <i>pending</i>	http://www.wnisefk.com/

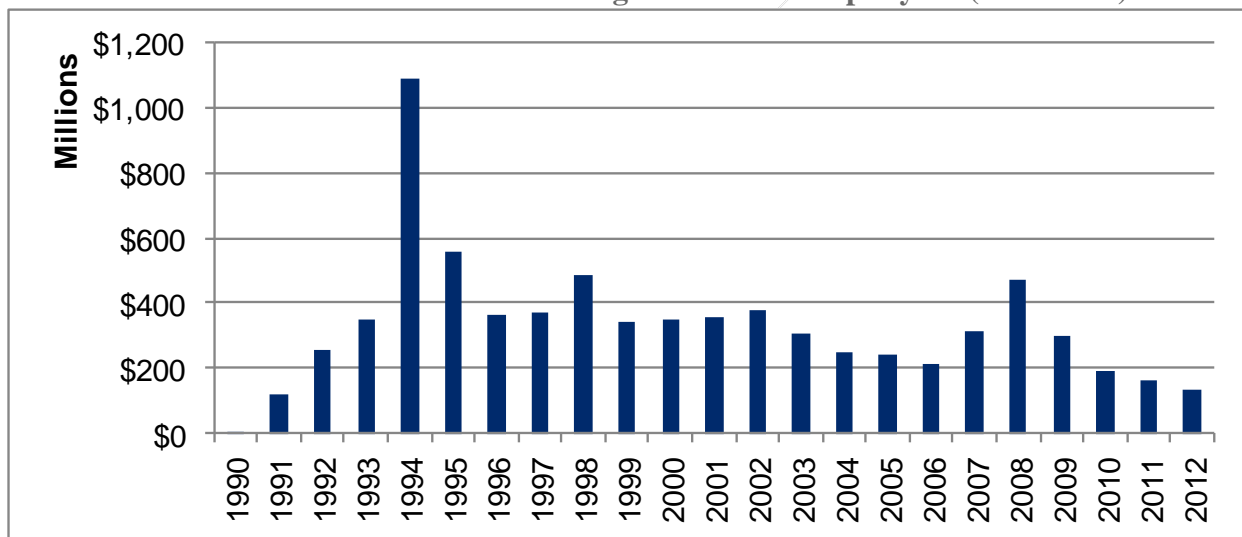
Source: This list was compiled by the Regional Competitiveness Initiative (RCI) and the Partners for Financial Stability (PFS) projects for USAID.

APPENDIX 6 – FUNDING SUMMARY

During the 22 years between 1990 and 2012, the United States government provided about \$20 billion to assist in the transformation of the E&E countries to market-oriented democracies. Over one-third of the overall USG assistance, or roughly \$7.6 billion, funded economic growth activities managed directly by USAID as generally described in this paper.⁷⁵

Beginning in 1993, as USAID’s economic assistance ramped up, outlays for the next ten years for economic programs were in the range of \$350 million annually. However, as illustrated in the charts below, there were two notable years in which funding were higher. In 1994, assistance for economic growth activities skyrocketed to nearly \$1.1 billion (over half of which was for Russia) and in 1995, economic assistance flows to the region reached almost \$600 million. As the charts also show, funding for the economic growth began to decline in 2003 as more and more countries joined the EU and overall U.S. government priorities changed from assistance to this region to assistance to Iraq and Afghanistan. When the global financial crisis hit the region hard and the Republic of Georgia needed immediate post conflict assistance from the Russian invasion, budgets for economic growth programs again spiked in 2007-2009 before funding once again began a steady decline.

Chart 1 – EG Assistance to E&E Region Breakdown per year (1990-2012)



Source: Tables and Graphs based on data from Office of Coordinator of U.S. Assistance to Europe and Eurasia at State Department. Note: USAID EG assistance does not include Enterprise Funds or transfer to other US agencies such as Treasury, USDA, USTDA, State Department, Justice Department, and Labor Department

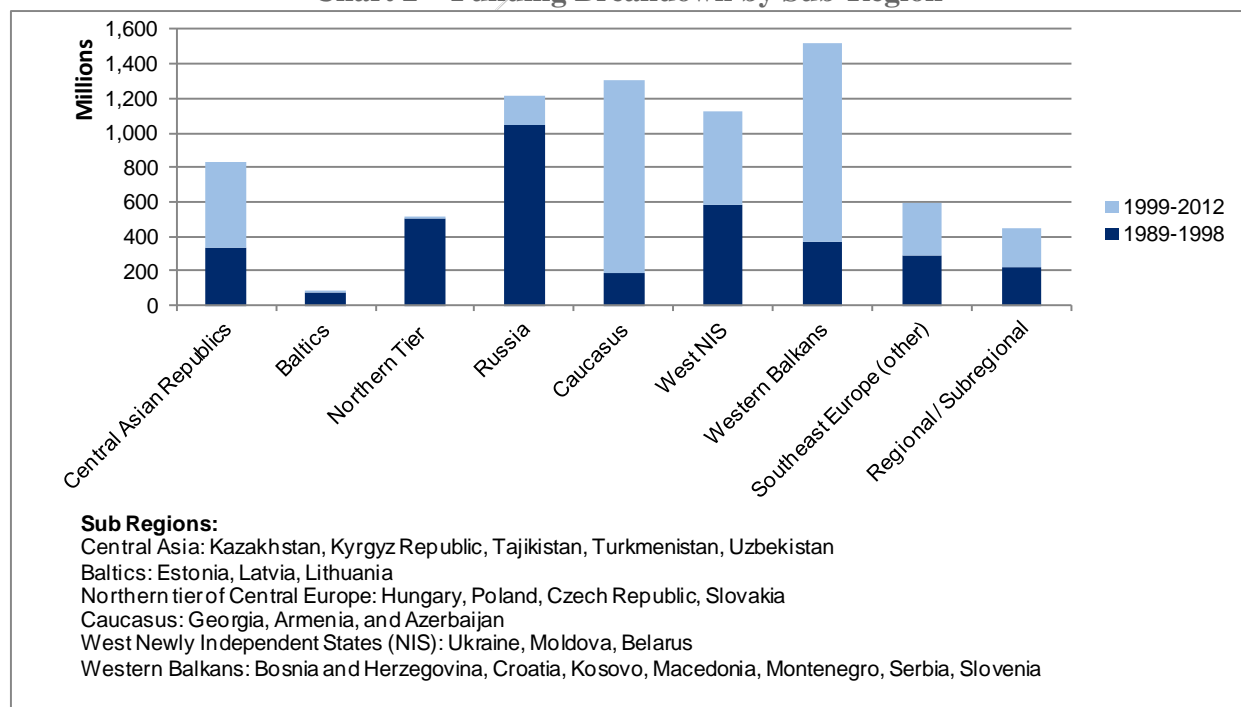
⁷⁵ This excludes the \$1.2 billion of funding for ten Enterprise Funds, as well as about \$850 million of programs managed by the U.S. Treasury, Commerce, Agriculture, and OPIC. However, because of investment returns, a substantial part of the Enterprise Fund outlays has been returned to the U.S. Treasury.

Table 1 – EG Assistance to E&E Region by Year 1990-2012 (in millions)

Year	Funding
1990	\$8
1991	121
1992	253
1993	352
1994	1093
1995	554
1996	366
1997	372
1998	489
1999	340
2000	349
2001	353
2002	381
2003	308
2004	249
2005	242
2006	212
2007	314
2008	469
2009	300
2010	192
2011	163
2012	133
TOTAL	\$7,613

An analysis of the funding at the sub-regional level, illustrated by the chart below, also tells a story of changing geographic priorities. The first decade focused on Russia, Ukraine, the Northern Tier, and Bulgaria and Romania. Significant economic progress in the Northern Tier leading to EU membership, lack of commitment to market reforms in Russia and several other countries, combined with post-conflict needs and opportunities in the Former Yugoslavia, shifted the focus in the second decade to the Caucasus and Southeastern Europe. Reformist governments were in place in Georgia and Armenia while the final break-up of Yugoslavia, including Kosovo’s split from Serbia and the fall of Milosevic, led to new opportunities to fund economic reconstruction and programs to promote market institutions and reforms. The chart also highlights that assistance has remained fairly stable over time to the West NIS (Ukraine, Moldova) and the Central Asian Republic.

Chart 2 – Funding Breakdown by Sub-Region



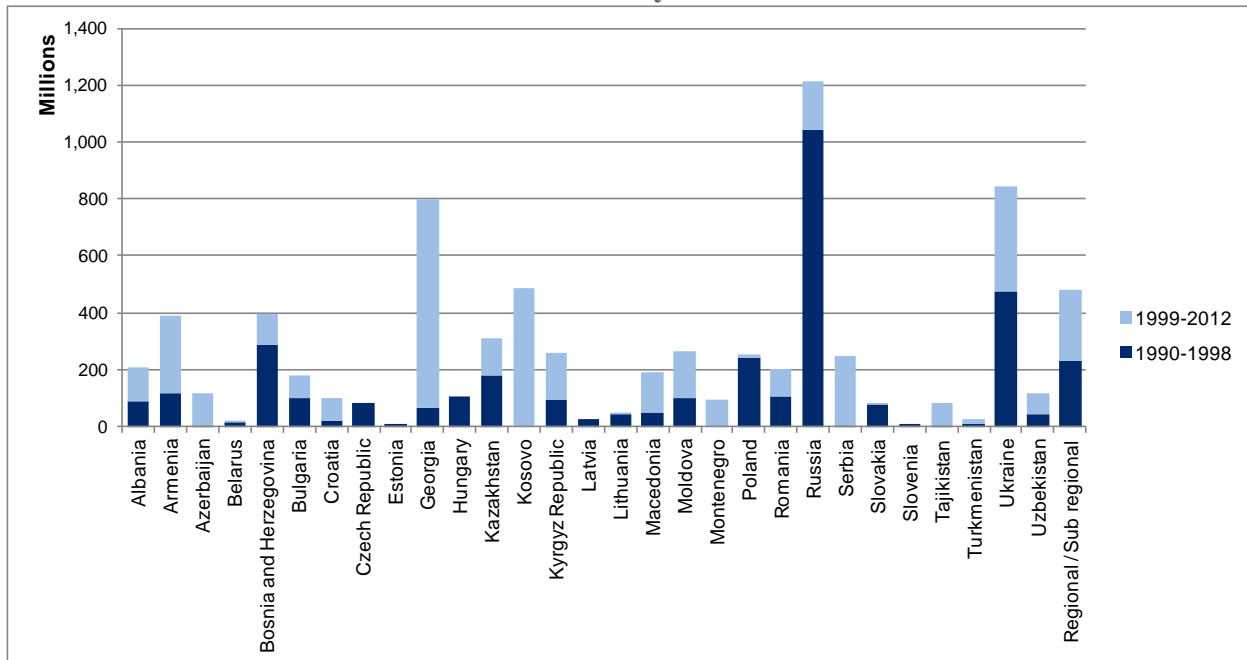
The breakdown of funding on a country-by-country basis further highlights U.S. government priorities. The six largest recipients of USAID economic assistance were Russia, Ukraine, Georgia, Kosovo, Bosnia and Armenia. Poland would have been the third largest if its sizeable \$245 million Enterprise Fund and \$199 million Stabilization Fund was also included in the total for U.S. assistance. The level of assistance also reflects the countries' relative size -- Russia, Ukraine and Poland all have large populations – 142 million, 46 million and 38 million respectively.

On a per capita basis, it is several small countries that were by far the largest recipients of USAID economic assistance. The top slot for economic assistance goes to Kosovo (population 1.8 million) with \$270 per capita, followed by Georgia (population 4.6 million) with \$171 per capita, Montenegro (population 670,000) with \$138 and Armenia (2.9 million) with \$133. This compares, for example, to Russia, Ukraine and Bulgaria with \$9, \$18 and \$26 per capita, respectively.

Table 2 – Breakdown per Country 1990-2010 (in millions)

Country	1990-1998	1999-2012	Total 1990-2012
Albania	\$91	\$119	\$209
Armenia	117	271	388
Azerbaijan	4	114	119
Belarus	12	6	19
Bosnia and Herzegovina	286	109	395
Bulgaria	99	82	181
Croatia	19	79	98
Czech Republic	80	-	80
Estonia	11	-	11
Georgia	66	732	798
Hungary	106	-	106
Kazakhstan	177	130	307
Kosovo	-	487	487
Kyrgyz Republic	94	165	259
Latvia	25	-	25
Lithuania	42	1	44
Macedonia	50	139	189
Moldova	98	165	264
Montenegro	-	93	93
Poland	239	12	251
Romania	104	99	202
Russia	1,041	171	1,212
Serbia	4	242	246
Slovakia	75	.5	76
Slovenia	8	-	8
Tajikistan	2	80	82
Turkmenistan	11	16	26
Ukraine	477	365	842
Uzbekistan	41	74	115
Regional/Sub-regional	229	253	482
Total	\$3,608	\$4,005	\$7,614

Chart 3 – E&E Country Totals 1990-2012



The Office of Coordinator of U.S. Assistance to Europe and Eurasia at State Department maintains data by programming category. These categories have evolved reflecting the evolution of the technical programs and were not set in place during the first decade of assistance. It would also have been useful to show a breakdown of the funding over the 22 year period by programmatic elements reflecting the six technical areas in the narrative – macroeconomic and fiscal policy, privatization, financial sector, private sector, energy and agriculture. However, USAID/State budget data is not consistently organized according to these six areas. Among development practitioners, these six categories are well understood and were the basis on which U.S. economic assistance strategies were built and programs designed. They are thus qualitatively easy to define and discuss. After examining the various budget categories that programs were placed into over the 22 years, the authors found that it would be difficult to assign numbers accurately with any consistency to each of the six technical areas used in the narrative.

Moreover, using the current budget categories provides a very misleading picture of how the economic growth money was spent. There are a number of reasons for this. First as the narrative states, many of the programs were cross-cutting among the six categories and thus it is hard to determine the appropriate category. In looking at SEED country-by-country budget data from 1990-98, the “Economic Restructuring Category” had 8 sub-elements, but no separate sub-category for the sizeable financial sector programs, which were included under “Privatization and Assistance to Enterprises.” For example, the significant Bosnian Business Development Program (see box on page 32) had elements of financial and private sector development and disaggregating between those two technical areas would be time-consuming, requiring analysis at the project sub-component level. Likewise, many programs which directly benefitted the agricultural sector were categorized as private sector or business development programs, as agriculture/agribusiness was one of multiple sectors supported by a single project, in addition to so-called “stand alone” agriculture projects.

In sum, we have confidence in the aggregate funding total for economic growth activities for the period 1990-2102, as well as the country specific totals, but decided that the data in the current budget breakdowns did not provide a consistent or accurate picture of funding over time by technical area. At the same time, based upon the extensive research done as part of this exercise and the cumulative experience of the authors, we can also confidently state that in most countries where USAID had active economic growth programs (excluding e.g., Belarus and Turkmenistan), the six technical areas had robust funding over the period consistent with country needs and commitment to reform.



APPENDIX 7 – U.S. OBJECTIVES AND MEASURING THE CONTRIBUTION OF AID

By Paul Marer

The Collapse of Communism and U.S. Aid Objectives

The principal objective of the USG and people was to support the transformation of the Communist political and centrally planned economic systems into a political regime in which the people had a voice (democracy, for short) and a predominantly market-driven economy (capitalism, for short).

There were two dominant rationales behind these interlocking objectives. First, that a political and economic system so transformed would offer a much better life for the citizens of those countries than they had under Communism. Second, that as their elites became politically accountable to their people, and the average citizen became economically better off, that would make the world a much safer place than it was during the Cold War (with its ever-present danger of open confrontation in a nuclear age), since democracies are less prone to military conflict.

It was taken as self-evident that sustained good economic performance, benefiting a large majority of the people, would strengthen democracy, just as it was assumed that a political system in which people had a meaningful voice would be more conducive to sustained economic performance (in the long run, certainly) than dictatorships were, or are.

Achieving sustained improvement in the standard of living for a large majority and, simultaneously, a well-functioning democracy, is exceedingly complex and difficult, especially in view of the hugely adverse initial conditions the transforming nations had faced. A country's success in achieving it—and its ability to maintain it—is influenced, if not largely determined, by its own history, political-social-economic culture, location, resource endowment, and the economic and political environment abroad, especially in its neighborhood.

The outcome can also be influenced—but not determined—by the institutions and policies of those “successful” nations to which a “transforming” or “emerging” country looks for example, guidance, and assistance.

When Communism collapsed in Eastern Europe and the Soviet Union, it was generally acknowledged that the United States—along with the countries of Western Europe and a few other developed countries—had the most successful political and economic systems.

In this context, the view of the United States and its allies was that the best way to assist the political and economic transformation of the 29 countries in Eastern Europe and the former Soviet Union was to help them establish and strengthen those basic institutions—especially economic institutions—that are essential for an effectively functioning market economy. This was the overriding task, especially as it became clear that none of the transforming nations had in place any—literally any—of the basic market institutions that those living in the United States and in other economically advanced countries had taken for granted.

How Should the Success of U.S. Aid Efforts Be Judged?

The almost automatic instant answer that springs to mind is likely to be: “judge the effort by the outcomes.” That is, how democratic are those 29 countries and how well have their economies performed during their first two post-communist decades?

Focusing on the **economic performance** of the 29 transforming nations, there are important reasons why relying **just** on such an approach would be a mistake. One reason is that linking cause and effect is problematic; another, that there are the pitfalls in interpreting properly the indicators that we do have. The next few paragraphs explain and illustrate these statements.

Linking Cause and Effect

One reason why it is problematic to establish cause and effect was already mentioned: that a country’s long-term economic success is influenced, if not largely determined, by its own history, political-social-economic culture, location, resource endowment, and the economic and political health of its neighbors. Therefore, it would be inappropriate to attribute economic success or failure, however defined, **directly** to the efficacy—or lack of it - of U.S. (and other) aid efforts.

For this and other reasons, a more appropriate approach to assessing the impact of U.S. aid efforts is to document the successes and failures in establishing or strengthening those basic market institutions that are absolutely necessary, but not sufficient, conditions for sustained good economic performance. The results can be summarized as follows: “In those countries or country groups (in some cases, regions within a country) where local conditions were (more) supportive of building market institutions and implementing good economic policies, U.S. (and partner) aid efforts were able to contribute more and achieve impressive results more quickly than in those areas where local conditions were less (or not) supportive.” Examples will be [are] given throughout the report, along with comments on the successes and failures, depending on the appropriateness of program designs and the implementers to adapt to local conditions.

Measurement and Interpretation Pitfalls

Leaving aside the perennial problem of the quality of official statistics—basically the source on which international economic organizations also rely on for the data they publish—several other considerations cause statistical measurements and their standard interpretations to be especially problematic in the transforming economies.

1. **GDP growth**. The most often used measure of a country’s economic performance is GDP, its level and rate of growth over time, total and per capita. The more rapid is GDP growth, the “better” the country is perceived to be performing.

Transformation Depression. One problem with the use of this measure during the early stages of transformation—lasting up to a decade or even longer in some countries—is that none of the transforming economies could avoid experiencing a so-called “transformation depression,” that is, GDP declines ranging from 20% to 50%, or more. “Transformation depression” is really a misnomer because the economic plunge was not caused by the systemic transformation *per se*, but by two other factors. One was the sudden revelation, as real markets were introduced, that so much of the capacity and products created under central planning directed by politicians was

simply useless and had to be abandoned. The other factor was the collapse of the USSR, which suddenly severed so much of the production and so many of the trade linkages that had been built over several generations. The adverse consequences of this factor were more severe, the smaller and more specialized were the economies of the Newly Independent States (NIS) of the former Soviet Union.

Growth Sustainability. Even after a semblance of “normalcy” had been achieved, GDP growth figures do not take into account the sustainability of growth. In some cases, rapid growth can be achieved through the depletion of natural resources and the degradation of the environment (a problem, for example, in Russia and the other energy-rich Central Asian countries). Another example of non-sustainability is if GDP (and consumption) growth rates are based on excessive foreign borrowing—a problem that for years prior to the Great Recession (2008-10), several E&E countries, including the Baltic States, had shared with several EMEs (for example, the Mediterranean countries as well as the US).

2. Growth and Distribution. The growth of per capita GDP is often used as a proxy for the growth of income and the population’s standard of living, although it is neither. Even if the growth of per capita GDP would parallel the growth of per capita income, the former statistics says nothing about income distribution, which may not only be highly unequal but may be becoming more so as the economy grows. If that is the case, then most of society can be worse off, even if a few are much better off as the average increases.
3. Growth and Opportunity. What also matters is not just the inequality of income or consumption, but also inequalities in the opportunities, capacities, and thus life chances of those born under different circumstances. If the capabilities of disadvantaged children improve (deteriorate) relative to those of the more advantaged children, for example, by having adequate (inadequate) nourishment and access to the literacy required for economic success, would it mean an improvement (deterioration) in the country’s long-term capacity to grow. Coincidentally, success or deterioration in this statistics also generates greater and broader (smaller and lower) support for the capitalist system. However, such statistics are rarely measured.⁷⁶
4. Growth and Well-Being. What systemic changes should really aim to foster are improvements in the individuals’ sense of well-being. Those are affected not just by material goods and services (a portion of which is not measured in GDP statistics), but also by such other metrics as their sense of economic security. It must be admitted that the transition to a more dynamic but less predictable economic system has meant increased worries for many. Again, these aspects are not measured in standard economic statistics.
5. Transition and the Quality of Life. Offsetting the negative of increased economic insecurity, felt especially by the older generation, have been dramatic improvements in

⁷⁶ The World Bank’s *Human Development Index* (HDI) has been collecting such statistics and is aggregating a number of indicators to yield “average performance” in various fields at country levels, which often yield quite different global rankings than per capita income indicators, especially for the transition and emerging economies. However, even such indices ignore the distribution of individual conditions within each country. Furthermore, the weights to construct the HDI are arbitrary, since there is no global consensus on what would be the most appropriate weights.

other, non-economic areas. The ability to participate as full citizens in the framing of policies and to be able to speak and dissent without fear, have greatly improved in most countries. The extent of improvement is a function of how well democracy functions, whether suffrage is universal, the media free, civil-society organizations are numerous and active, the extent to which the rule of law prevails, and on how various institutions (e.g., the police, the judiciary, and various administrative services) function (are they mostly free from corruption and political interference?), and can they be held accountable for their decisions. The few such indicators available highlight the vast differences between the transitioning economies, especially between those with a long history of democratic functioning versus those that have moved from authoritarian to quasi-democratic regimes only more recently (Stiglitz).



APPENDIX 8 – INTERPRETING THE “TRANSFORMATION DEPRESSION”

By Paul Marer

The most striking fact revealed in text is the length and depth of the so-called “transformation depression” that all the countries had experienced after the collapse of Communism and central planning. Even in the countries of Central Europe—impacted less severely (20 to 25% decline in real GDP) and for a shorter period (up to five years) than the rest of those in transition—the apparent contraction was about as long and severe as the Great Depression of the 1930s was in the West.⁷⁷

There are very important conceptual, statistical, and interpretation issues concerning the “transformation depression” and the ensuing tempos of recovery, each addressed here briefly. As described in Chapter II, the conditions in which the various countries of the region found themselves upon the introduction of real markets were significantly different. Nevertheless, all had from large to immensely large measured declines in output. The plunge in GDPs during some early phase of introducing real markets has often been labeled as “transformation depression.” This term is really a misnomer because the economic plunge was **not caused** by the systemic transformation *per se*, but by two other factors. One, to the extent that the production of unneeded goods, and the capacity that had been built to produce them, were abandoned, the actual GDP decline is overstated. That is, a significant portion of the GDP produced was not useful in a market economy (their production was ordered by the Party for ideological or prestige reasons), or was produced so wastefully that the finished product (ex: steel) cost more than the value of its key inputs (ex: iron ore and coal). For these reasons, the decline in welfare was considerably less than the plunge in measured GDP. This is an important distinction that is rarely made when assessing the performance of these countries during the early post-Communist period.⁷⁸ Furthermore, the other, even more important, factor causing the dramatic GDP plunge was the disintegration of economic space in the former Soviet bloc.

There is considerable evidence that the true extent of the “transformation depression” is overstated by the official statistics, whereas the pace of subsequent recovery is understated. The starting GDP levels (1989 for the Central and Eastern Europe and 1991 for the NIS) are overstated because the incentive system in centrally-planned economies motivated all stakeholders to exaggerate both GDP and its growth rates, as has been well-documented by experts. A major reason for the **upward bias** in pre-transformation GDP levels was the production of goods and services that would not have been bought in a true market system, or would have been worth much less than actually valued. One of several factors introducing a systematic upward bias into GDP growth statistics is inadequate accounting for inflation.⁷⁹ And the major reason for the **downward bias** in the tempo of subsequent recovery is that official statistics do not adequately capture the contribution of the fastest-growing unreported (“shadow economy”) production, which, for quite some time, accounted for a growing share of GDP.

⁷⁷ The depression’s length and depth for the E&E group is slightly overstated here by the inclusion of Croatia, whose economy had suffered additional damage during the post-1989 Balkan wars.

⁷⁸ Anders Aslund is one of the few economists who did call attention to this: “The Myth of Output Collapse After Communism.” Washington, D.C.: Carnegie Endowment for International Peace, 2001.

⁷⁹ See Paul Marer, et al. *Historically Planned Economies: A Guide to the Data*. Washington D.C.: The World Bank, 1992.

Another statistical issue is the difficulty of proving or disproving the accuracy of the statement that the impact of economic disintegration of the Soviet bloc as a cause of the “transformation depression” may well have been greater than the immediate effects of systemic economic reform. However, the fact that this argument was carefully made by the former Vice President of the World Bank for the Europe and Central Asia Region, supported by a review of a vast literature on the topic, suggests that the statement’s plausibility should not be easily dismissed.

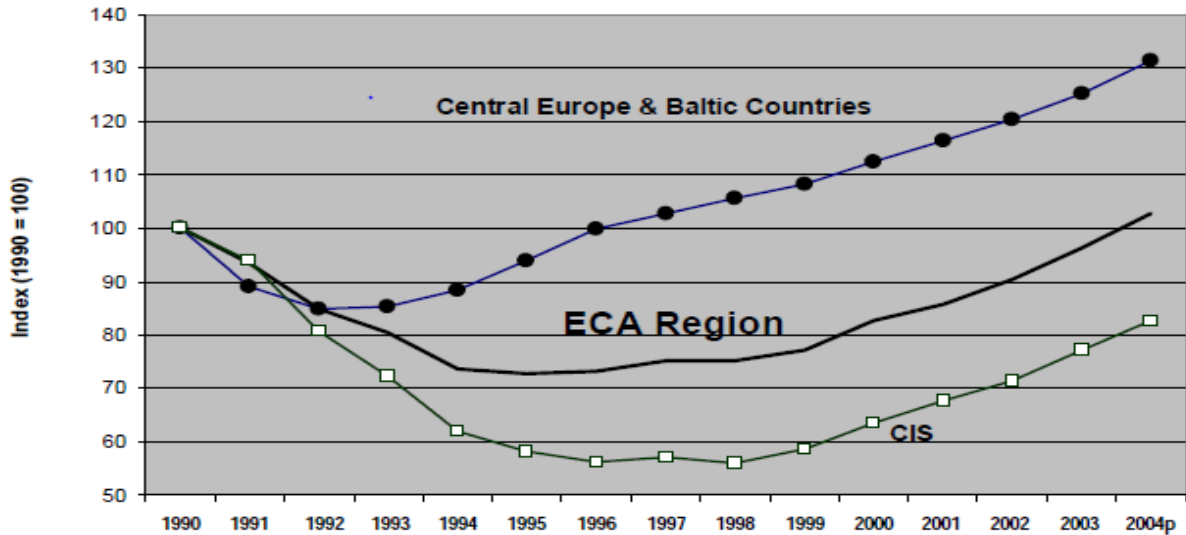
Strong, although largely circumstantial, evidence supports the “disintegration” hypothesis. It is appropriate to quote its author at some length because it bears directly on the interpretation of the 20-year growth trends of the transitioning economy country groups, (text Chart 1):⁸⁰

“At the most aggregate level, the disintegration story is consistent with the fact that the transition recession was most severe for the small, land-locked CIS republics, which were the most dependent on external links and financial transfers. In contrast, the transition recession was least serious for the countries of CEE, which were the least integrated into the Soviet system, although they too suffered disintegration shocks. Russia, Ukraine and the Baltic countries fall in between the two extremes in terms of the severity of both the transition recession and of the disintegration shock. The fact that the Baltic countries experienced a much more severe recession than the CEE countries must to a large extent be due to the fact that they were much more integrated with the rest of the Soviet Union at the time of the breakup than was the case for the CEEs. The fact that they recovered earlier and more quickly than Russia and Ukraine can be attributed both to their more effective reforms as well as to their progressive integration with Western Europe. They also did not suffer from the internal disintegration which characterized Russia and Ukraine.”

Appendix Chart 1 below shows the slump and recovery of real GDP, based on official statistics, separately for the CEEs (including the Baltic States) and for the CIS. The middle line (“ECA Region” = Europe + Central Asia) is the average for the two groups of countries (note that the base year is 1990, not 1989, as in text Chart 3).

⁸⁰ Johannes Linn, *op. cit.*, p. 9.

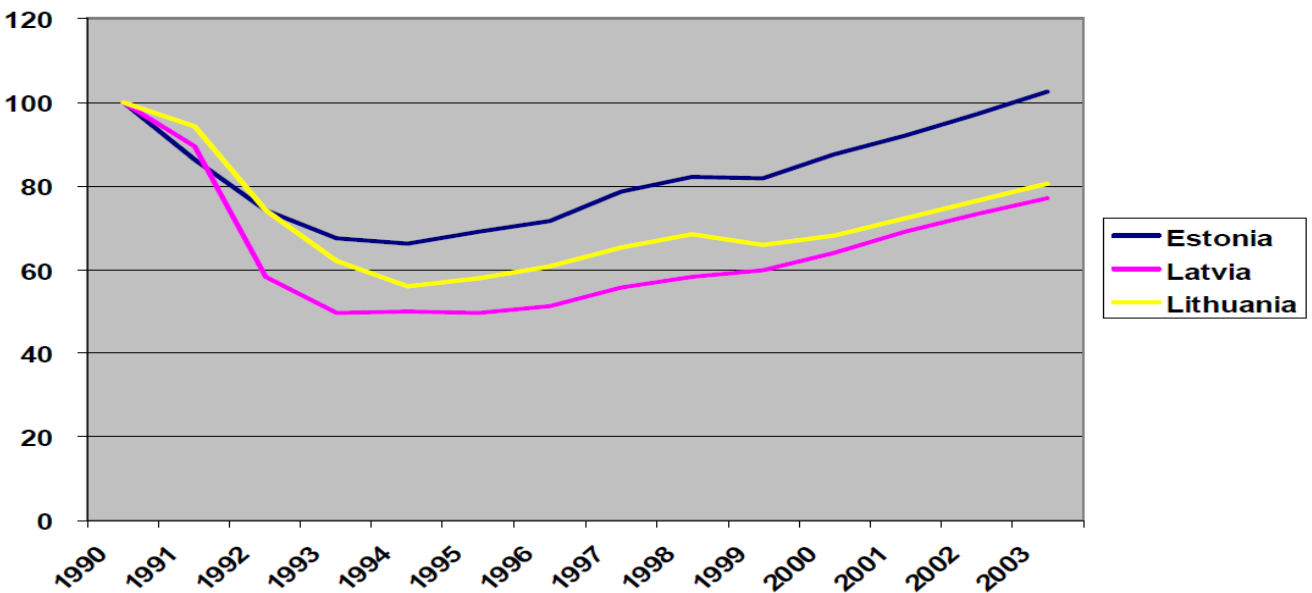
Chart 1 – Index of Real GDP – Europe and Central Asia (ECA) (basis: 1990)



Source: Linn (2004)

Appendix Chart 2 below shows the same set of statistics just for the three Baltic States.

Chart 2 – Index of Real GDP – Baltic States (basis: 1990)



Source: Linn (2004)

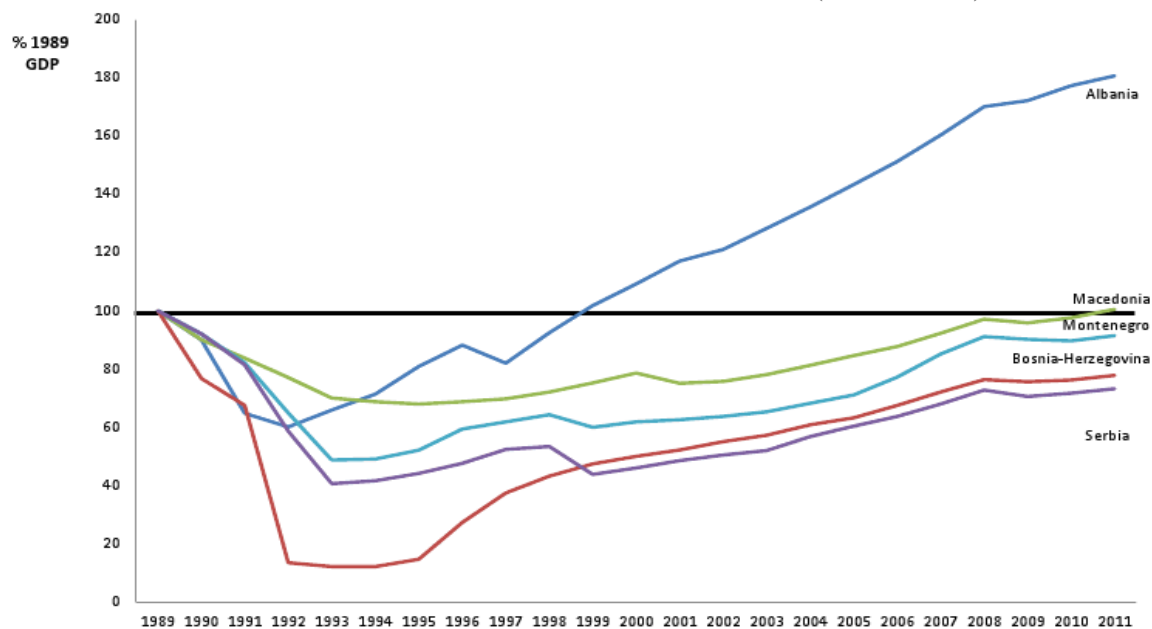
Whereas the trough of the “transformation depression” for the CEE countries (with 1990 as the base and including the Baltic states) was 1992 and 15%, for the Baltic States it was 1993-94 and range from 30% (in Estonia) to 50% (Latvia). This is consistent with the disintegration hypothesis as the main cause of the “transformation depression.”

Many people, politicians, and even distinguished Western experts⁸¹ attribute plunges in GDP, painful declines in welfare, and economic difficulties, especially in the CIS, to the failures of market-oriented reforms, or to their sequencing and timing. If it can be demonstrated (as it has been shown for Armenia⁸²) that the cost of disintegration had exceeded the actual decline in GDP, and reforms had improved the situation, this would help put to rest misplaced arguments about the supposedly negative effects of market-oriented reforms.⁸³

Further circumstantial support for the “disintegration” hypothesis can be found when comparing the relative GDP declines of countries in a given region.

Particularly badly hurt were the Balkan countries of Southeastern Europe. The disintegration of Yugoslavia and the ensuing ethnic wars and “cleansing” imposed huge economic burdens and human suffering. This explains why it had taken this group the longest, nearly a decade, to reverse the decline, and about two decades to recover where they were in 1989. The country-specific trajectories are shown below in Chart 3.

Chart 3 – Index of Real GDP – Balkans (basis: 1989)



Source: Linn (2004)

⁸¹This group includes Nobel Laureate Joseph E. Stiglitz, “Whither Reform? Ten Years of the Transition.” Keynote Address at the World Bank Annual Conference on Development Economics. Washington D.C.: World Bank, April 28-30, 1999.

⁸²Avanesyan, Vahram, and Lev Freinkman. (2003). “Costing out the Big Bang: Impact of External Shocks on the Armenian Economy at the Outset of Transition.” Working Paper 03/01. Armenian International Policy Research Group, January.

⁸³Johannes Linn, op. cit., p. 11.

Appendix Chart 3 shows that the economy of Bosnia-Herzegovina had suffered the most, with a more than 80% (!) decline in GDP during 1991-1995; today (2012) its GDP level has still not quite recovered to where it stood in 1989, a situation it shares with all the newly independent states of the former Yugoslavia.

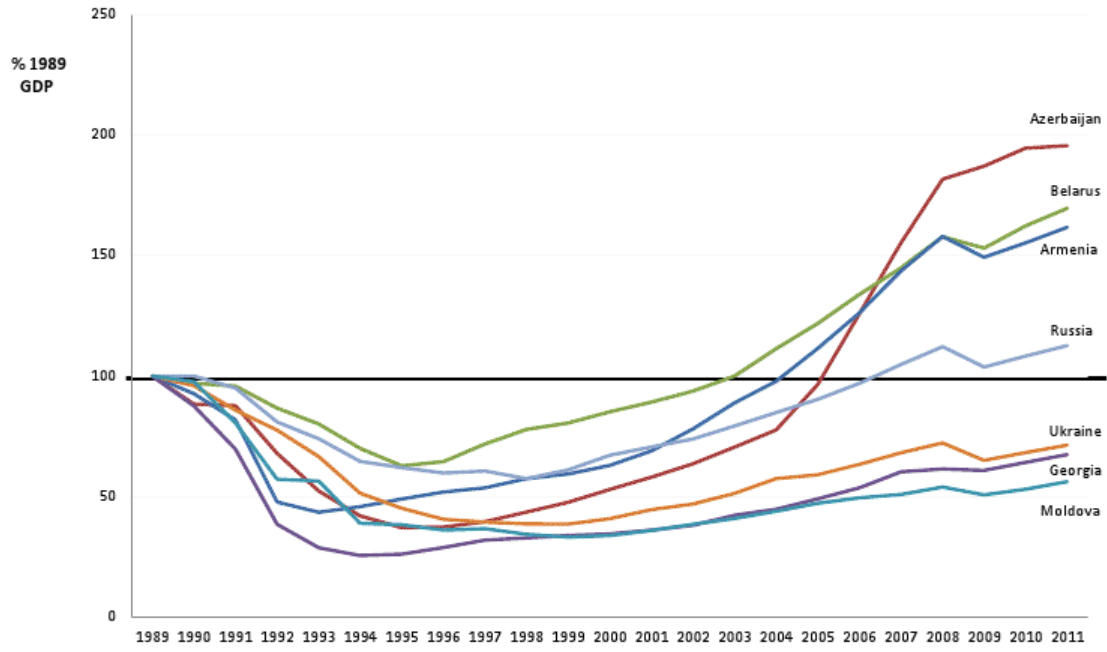
Surprising is the apparently good performance Albania, not only vis-à-vis its troubled Balkan neighbors, but also in comparison with the growth rates achieved by the CEEs. (Albania is shown to have exceeded by 2011 its 1989 GDP level by nearly 80% versus only by 30% by the CEEs.)

Several explanations come to mind. First, it was subject to the same upward bias in its GDP level as the other traditional centrally planned economies—certainly much more than Yugoslavia, which was neither centrally-planned nor a full-fledged market economy by the 1980s. More importantly, for about three decades (1961-1991) Albania had isolated itself, therefore, it did not experience anywhere near as great a disintegration shock as did the rest of the Balkans, the NIS, or even the countries of CEE.⁸⁴ At the same time, as the most extreme case of a central planning among the 29 countries, trying to remain autarkic, it probably had the most to gain as it became integrated with the rest of the world, replacing grossly inefficient, high-cost production with trade based on comparative advantage. Furthermore, during the transition's first two decades, nearly a third of Albania's 3 million population had emigrated (temporarily or permanently) to find work in Italy, Greece and elsewhere, and sent back relatively large funds to family and friends; this probably helped greatly its GDP growth rates.

Appendix Chart 4 shows trends in real GDP levels of the seven Eurasian countries. We find that their transformation depressions were, on balance, much deeper (30% to 70%) than those in Central and Eastern Europe. The chart also shows that those involved in domestic ethnic struggles or conflicts with neighbors (Moldova and Georgia) were the poorest growth performers during the first two post-Communist decades. Ukraine is also in this category, owing to such factors as its long-delayed economic and political reforms (and their recent reversals) and the country's very high dependence on energy imports. By contrast, countries rich in energy and other natural resources whose world prices had risen dramatically have been able to accelerate their "post-transformation-depression" growth rates. This latter group includes several Central Asian Republics. Thus, large differences in natural resource endowments, and the impact of those differences on the medium-term tempo of GDP growth, is another reason why growth rates would be inappropriate indicators of transformation's (and USAID programs') progress. [As was mentioned in the text, rapid growth based upon exploitation of natural resources may be unsustainable. Therefore, the tempo of growth will not be a good indicator of successful transformation.]

⁸⁴ A point made also by Johannes Linn, *op. cit.*

Chart 4 – Index of Real GDP – Eurasia (basis: 1989)



Source: Linn (2004)

APPENDIX 9 – TWENTY YEARS OF USAID EG WORK IN RUSSIA

The following is an illustrative sample of the many significant contributions made by USAID's programs in Economic Growth and related areas in Russia over 20 years.

ECONOMIC GROWTH

Promoted growth of the Russian private sector and a healthy climate for private investment.

TUSRIF

The U.S. Russia Investment Fund ("TUSRIF") was formed in 1995 with a grant of \$329 million from the U.S. Government. Under private management, TUSRIF's mission is to promote the development of a free market economy in Russia by providing investment capital—equity and debt—to well-conceived, potentially high-growth entrepreneurial companies. TUSRIF has generated in excess of \$350 million in investment proceeds, and attracted an additional \$1.2 billion in outside equity, debt and co-investments. In 2002, TUSRIF founded The U.S. Russia Center for Entrepreneurship ("CFE") to further support Russia's emerging entrepreneurial culture by providing Russian entrepreneurs with the knowledge, skills and abilities to take their growing companies to a higher level.

A few of TUSRIF's many contributions include:

- Creation of Delta Bank, the first to provide consumer credit cards for Russian middle class (100,000 credit cards in the first four years);
- Pioneered private mortgage lending in Russia by backing the first private bank to offer mortgages;
- Invested in 44 small or medium enterprises through loans and private equity, with transfer of invaluable management skills and payback with interest nearing 100%;
- Provided Russian manufacturers with their first access to leased equipment through Delta Leasing in 1998, helping over 800 domestic manufacturers in over 27 regions of Russia access modern production equipment;
- Funded a legacy institution, the U.S.-Russia Foundation for Economic Advancement and Rule of Law, with one-half of the TUSRIF proceeds to continue to support the development of the Russian private sector.

Russia Microfinance and Other Lending Programs: In Russia, small businesses make up only 12 percent of the economy while in the U.S. and Europe, they make up 50-70 percent. Small businesses consistently say that lack of access to credit is one of the most serious obstacles to growth. Starting in 1994, USAID's microfinance program created a "non-bank" credit model to facilitate the access of small and medium sized businesses (SMEs) to both bank and non-bank credit, and a network of microfinance agencies offering small loans to SMEs. The program brought world-tested methodologies to Russia, and provided training for Russian partners to become managers of these loans and lending institutions. The Russian Microfinance Center

(RMC) was subsequently formed in July 2002 through the microfinance program to build and extend microfinance capabilities within Russia, develop the legislative framework for microfinance institutions (MFIs), and encourage the government and private lending institutions to support the growth of the sector. Now RMC is a key partner of the World Bank's Consultative Group to Assist the Poor (CGAP), and has received World Bank funding for multiple programs. The RMC also participates in various programs sponsored by the EBRD to support and finance MFIs to include important work that the EBRD is doing in the North Caucasus.

Through USAID's Development Credit Authority (DCA), over \$15.0 million in credit guarantees were mobilized in 2012 to promote MFI lending in the North Caucasus. This initiative was undertaken as part of USAID/Russia's strategy to mitigate drivers of conflict in the region and enhance stability through economic growth, and, more specifically, through the development of a well-functioning regional microfinance sector.

Capital Markets System: USAID helped establish a number of financial institutions critical to a functioning free market system including:

- National Association of Securities Market Participants (NAUFOR), a regulatory system analogous to the U.S. National Association of Securities Dealers.
- Russian Trading System (RTS), an over the counter trading system equivalent to the NASDAQ, which lends transparency to Russia's securities trading operations, and since merged with the Russian stock exchange MICEX to form the largest Russian stock exchange.
- Federal Commission on Securities Markets (FCSM), the Russian version of the U.S. Securities and Exchange Commission (SEC), which has since been strengthened and transformed into the "Federal Service on Financial Markets (FSFM).

Improved Regulatory Environment for Small and Medium Businesses: The USAID-funded Center for International Private Enterprise (CIPE)'s policy advocacy program in support of small and medium-sized enterprises (SME) provided support to more than 200 business associations in 17 regions across Russia and consultations to more than 5,000 entrepreneurs annually. At the regional level, 44 recommendations made by CIPE on SME legislation were implemented; federal level policies on eliminating barriers to doing business in Russia also reflected expert recommendations made by CIPE. One example of the success of CIPE's regional coalitions is in Krasnodar: after joining the program in 2003, the Krasnodar Coalition assisted over 3,600 entrepreneurs, helped solve over 800 conflicts between business and inspectors, and won more than 40 lawsuits in favor of entrepreneurs. CIPE worked for 6 years with national and regional coalitions of business associations in Russia to advocate for governmental reforms that would improve the business environment for small and medium sized businesses. When President Medvedev was elected to office, one of his first official acts was to issue a decree directing the government to enact measures to eliminate administrative barriers to doing business in Russia. The decree echoes the exact recommendations made to the Russian government by CIPE's regional and federal level partners, and demonstrates that grassroots programs for pragmatic reform can be effective in Russia.

Developing Young Entrepreneurs–Junior Achievement: Russia’s Junior Achievement Program is the largest in the world, and has been adopted into the Russian School system as an elective course. It was initiated and funded by USAID.

ENERGY

Electricity reform and market design

The Russian electricity sector has successfully undergone substantial restructuring and reform since 1992. The early USAID assistance focused on the restructuring and particularly the design of the future competitive electricity market. The principles and design developed are substantially in place in today’s electricity market implemented by the Government, the electric utility system companies and their advisors. The electricity sector has since achieved a higher level of reliability and increased investment.

Coal Mine Safety

USAID supported cooperation among a consortium of U.S. labor unions, mining companies and manufacturers. The consortium worked with the Russian Government and coal mines to improve mine safety and to reduce the extremely high death rates that were the norm. This work led to cooperation between the Government of Russia and the World Bank on a \$500 million mine and safety improvement program.

Center for Energy Efficiency

USAID provided the financing through Battelle Memorial Institute (a U.S. Department of Energy institution) to support the establishment and initial operations for the first three years of CENEf a non-profit, non-government organization founded in 1992 to promote energy efficiency and environmental protection in Russia. This was one of the five energy efficiency centers established in transition economies by the USAID-DOE collaboration.

CIVIL SOCIETY

Eurasia Foundation: The Eurasia Foundation, supported by USAID since 1993, has promoted private enterprise development in Russia through grants and operating programs. In recent years, the Eurasia Foundation shifted focus to building partner foundations in the region. The New Eurasia Foundation (FNE), launched in Moscow in 2004, was the first such partner institution and has raised more close to \$13 million in the last two years to operate programs. Program highlights include:

- A Local Economic Development program to promote economic growth and employment in territories outside of Moscow that has reached more than 800,000 citizens to date.
- The Small Business Support Fund that has provided more than \$1.1 million to finance business start-ups to date.
- The Enhancing Research and Entrepreneurial Capacity of Russian Research Universities Program (EUREKA) program that supports economic researchers in Russia through grants and mentorship.

APPENDIX 10 – COUNTRY GROUPS AND CLASSIFICATIONS

USAID publications as well as the broader (academic and other) literature on transitioning economies, has different country group classifications. Here we list, define, and explain briefly those country groupings that are relevant for this Report because we cite various kinds of summary data that are available according to those groupings.

A. The Northern versus Southern Tier Europe and Eurasia (n = 29)

While this appears to be a classification based on geography (see map below), it also reflects quite well differences among the countries in transformation's progress.

Most advanced is Northern Tier Europe (n = 8): Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland Slovakia, and Slovenia.

Less advanced is Southern Tier Europe (n = 9): Bulgaria, Romania, Croatia, Bosnia-Herzegovina, Macedonia, Serbia, Montenegro and Kosovo (the three still listed on the map together as the Federal Republic of Yugoslavia), and Albania.

Eurasia (n = 12): Russia, Ukraine, Belarus and Moldova—the four that are fully or partly in Europe—plus the three countries in the Caucasus (Armenia, Azerbaijan and Georgia), and the five in Central Asia (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan). All and all, these are the 29 economies in the region that have benefited from USAID assistance.

B. EE Graduated + Balkans + Eurasia + Central Asia (n = 29)

This four-fold classification of the 29 countries is particularly useful. One reason is that it separates the 11 countries that had already been weaned (“graduated”) from USAID assistance (after anywhere from 6 to 18 years of support). The remaining 18 countries, where USAID remains active, are divided into three geographic groups, a partition that also makes sense from the point of view of the transformation tasks and challenges that the different groups have faced. Another reason why this classification is useful is that a great deal of data on the transformation progress of the 29 countries has already been collected and comparatively and colorfully presented, according to this classification, in a recent USAID study.⁸⁵ This Report makes extensive use of it.

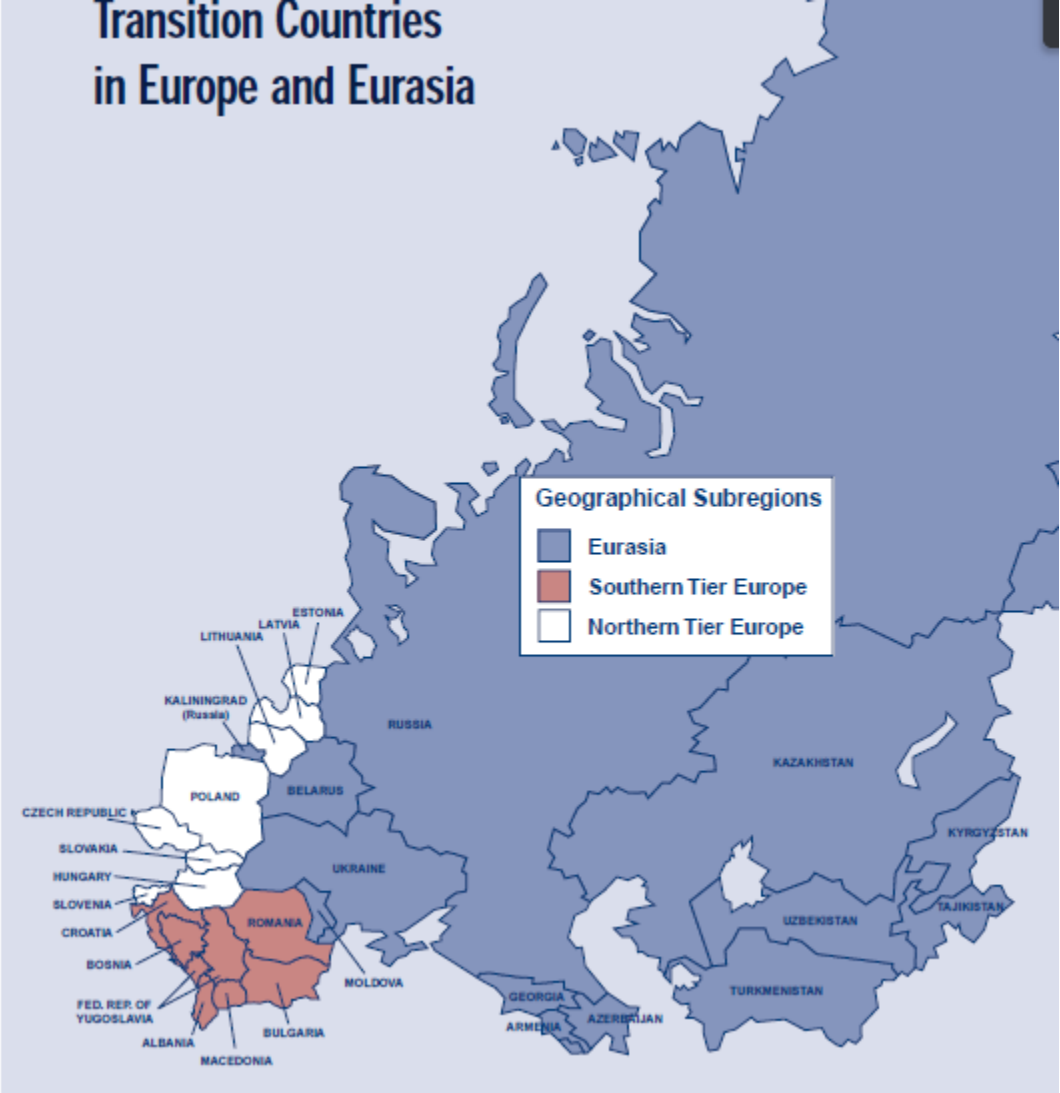
EE Graduates (n = 11): Czech Republic, Estonia, Latvia, Lithuania, Hungary Poland, Slovakia, Slovenia, Bulgaria, Romania, and Croatia. Not coincidentally, ten of these countries are EU members and the last (Croatia) will become a member in 2013.

The Balkans (n = 6): Albania, Bosnia & Herzegovina, Kosovo, Macedonia, Montenegro and Serbia.

Eurasia (n = 7): Russia, Ukraine, Belarus, Moldova, Armenia, Azerbaijan, and Georgia.

⁸⁵ Ron Sprout, “Regional Trends in Economic Growth in Eastern Europe and Eurasia” (May 15, 2012).

CAR = Central Asian Republics ((n=5): Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan).



APPENDIX 11 – GUIDANCE FOR REVISED AEECA PHASE-OUT FRAMEWORK

Office of the Coordinator of U.S. Assistance to Europe and Eurasia, DRAFT, December 2010

I. INTRODUCTION

The primary objective of the two legislative acts that authorized U.S. assistance to the countries of Eastern Europe and the former Soviet Union (the Support for East European Democracy (SEED) Act and the FREEDOM Support Act (FSA)) was to promote the transition of countries in the region from Communism to market-oriented democracy. Between 1989 and 2008, 11 countries (Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia) were “graduated” from development-type assistance, leaving 18 countries of the Balkans, Eurasia and Central Asia still receiving SEED/FSA support.⁸⁶ For these 18, the transition has taken longer than the authors of SEED and FSA may have expected, and there have been significant setbacks along the way, including the Balkan Wars of the 1990s, the Georgian conflict with Russia in 2008, and backsliding in democracy in the former Soviet states. In addition, whereas the earlier graduates had the powerful pull of NATO and EU membership as an incentive to accelerate difficult political and economic reforms, the remaining 18 countries by and large lack the same impetus: a minority has any reasonable prospect of EU and NATO membership, and none are likely to enter the EU within the next five years. Nevertheless, the ultimate goal remains the same—successful transitions and the phasing-out of SEED and FSA assistance (now provided through the “Assistance to Europe, Eurasia and Central Asia” or AEECA account).

II. BACKGROUND ON THE 2004 PHASE OUT FRAMEWORK

In 2004 EUR/ACE led an interagency process aimed at establishing target dates for phasing out SEED and FSA assistance (though not FMF, IMET and other security-related aid) to all SEED and FSA countries. The 2004 “phase-out framework” was intended to establish a more informed basis for determining when a country was ready for phase-out, and to allow for a planned and orderly graduation process, driven by development criteria and a careful consideration of foreign policy interests. This effort was carried out at the initiative of the Coordinator of Assistance; no other part of the executive branch directed it, nor did Congress require it.

The basic premise behind the 2004 Phase-out Framework was to use SEED and FSA assistance to help countries reach a point of “irreversible” reform, defined as the point where they are firmly established as market-based democracies and very unlikely to return to authoritarianism. Realizing that this was a subjective standard and that some analytical approach to determining “irreversibility” was needed, EUR/ACE turned to a performance measurement tool that had been developed by USAID’s Europe and Eurasia Bureau in the mid-1990s called “Monitoring Country Progress” (MCP). This system measured the progress of the post-Communist countries on four indices, drawing primarily from annual analytical reports prepared by Freedom House and the European Bank for Reconstruction and Development (EBRD), as well as data supplied by the World Bank and various UN sources. Two of the four indices capture progress on economic and democratic reform, and the other two measure economic performance and the state

⁸⁶ In the “graduate” countries, non-AEECA U.S. security assistance related to objectives like military cooperation, peace-keeping, non-proliferation and counterterrorism continues.

of “human capital” (mainly by tracking health and education indicators). By plotting each country’s “scores” on a graph, the MCP index allows anyone to see how these countries are doing on reform relative to an EU standard and relative to one another, and to track their progress over time. As a proxy for “irreversibility”, EUR/ACE decided to use the average scores of Bulgaria and Romania at the time they were invited to join NATO in 2002 (these countries became NATO members in 2004, and joined the EU in 2007). EUR/ACE reasoned that meeting the criteria for an invitation to join NATO was an indication that their reform processes were “irreversible”.

Over a period of several months, the interagency considered the case for each SEED and FSA country separately. Romania, Bulgaria, and Croatia were already headed for graduation in 2006 or 2007. For each of the rest, the interagency looked at reform progress, performance, and likely future trends in four sectors: economic, democratic, social (primarily health and education), and law enforcement. For each sector, the interagency made a “best guess” as to how many more years of assistance would be required to help a particular country reach the Bulgaria-Romania 2002 standard, or the “phase-out bench mark” as it came to be called. Importantly, those target phase-out dates were explicitly linked to certain assumptions. For example, in the case of Georgia—which had just experienced the “Rose Revolution” and seemed to have made a decisive turn toward democracy—the assumption was that the democratic gains begun by the Rose Revolution would be consolidated and there would be no retrenchment. Based on that assumption, democracy assistance to Georgia was targeted for phase-out in 2012.

The phase-out target date was defined as the “final year of new budget authority.” That is, it would be the final fiscal year in which new funds would be explicitly budgeted for a given sector in a given country. It was assumed that money would continue to be obligated and expended for several years beyond that date. It was also agreed that whenever a phase-out target was within five years or less, the post in question would be expected to prepare a phase-out plan for the given sector.

Over the ensuing five years, several sector phase-outs were considered, including economic reform programming in Russia, Kazakhstan, and Ukraine (the first two were confirmed; the third postponed); and all sectors in Macedonia (they were all extended for varying lengths of time). By late 2009, however, EUR/ACE had determined that the 2004 Phase-out Framework and the processes it had created were in need of revision. So with the agreement of the interagency, ACE froze any further phase-outs pending a thorough review of the 2004 Framework and a reexamination of the target dates.

III. CONCLUSIONS OF THE REVIEW OF THE 2004 PHASE-OUT FRAMEWORK

At the end of 2009, EUR/ACE formed an interagency working group to review and make recommendations to revise the 2004 Phase-out Framework. The working group confirmed the importance of eventual graduation from AEECA funding for all countries in Europe, Eurasia and Central Asia. The group agreed that while there is no specific language in the FSA and SEED Acts about phase-out, the notion is implicit in these Acts, which were intended to promote a rapid transition of formerly Communist countries to democracy and free markets. Further, the

group agreed that much had been learned in the past six years and that the time was right for revision. They identified the following weaknesses in the 2004 Phase-Out Framework:

- The fact that Bulgaria and Romania continued to receive SEED assistance for another 4-5 years after 2002 undermines the relevance of that year as the phase-out benchmark date. While it could be seen as a “trigger” benchmark—i.e. when a country reaches this point, it can be assumed to be 4-5 years from actual phase-out—past experience with such assumptions has proven problematic given the non-linear nature of transition.
- The target dates set in 2004 rested on a number of assumptions that turned out not to be valid. It is difficult to predict reform trajectory five years or more into the future, especially in a volatile region like the Balkans and the former Soviet Union. Since MCP data were not reexamined annually with target dates adjusted accordingly, the original dates were quickly overtaken by events and became increasingly irrelevant.
- The Monitoring Country Progress indices, while providing a good sense of the reform trajectory and serving as a useful tool for comparative analysis, gave an incomplete picture. Since 2004, the economic performance and human capital indices have been improved with additional indicators, and a new “peace and security” index has been developed.
- The four-sector approach of the 2004 Framework neglected to take into account the interrelationship between development objectives. It posited that once a certain benchmark was reached with respect to, for example, economic reform, all economic-related programs, now and forever, would be phased-out while continuing to fund other sectors. However, the sectors and the programs within each are often mutually reinforcing and the notion of ending all assistance in a sector after the cut-off date eliminated any flexibility to re-engage in that sector or provide funding to selected programs. The transition process is complex and requires that the full range of possible programmatic interventions be available to U.S. policymakers. While certain assistance in various sectors may be appropriately emphasized or deemphasized over time to reflect a country’s developmental progress, the sector-by-sector approach is overly rigid.

IV. THE REVISED AEECA PHASE OUT FRAMEWORK

The Revised AEECA Phase-out Framework reaffirms that the goal of SEED/FSA funding is to help countries create and maintain stable political, economic and social institutions that will allow them to be reliable U.S. allies and partners. The concept of irreversibility utilized in the 2004 Phase-out Framework also carries over to the Revised Phase-out Framework—“irreversible” reform is defined as when a country is firmly established as a market-based democracy, and very unlikely to return to authoritarianism.⁸⁷ However, the Revised AEECA Phase-out Framework has put in place three significant changes to address the weaknesses described above: a new

⁸⁷ While EU accession does not guarantee that there will be no backsliding, the general operating assumption is that AEECA assistance will not be given to an EU member state. However, we should not categorically exclude making exceptions to this rule if there is a good national interest justification for doing so.

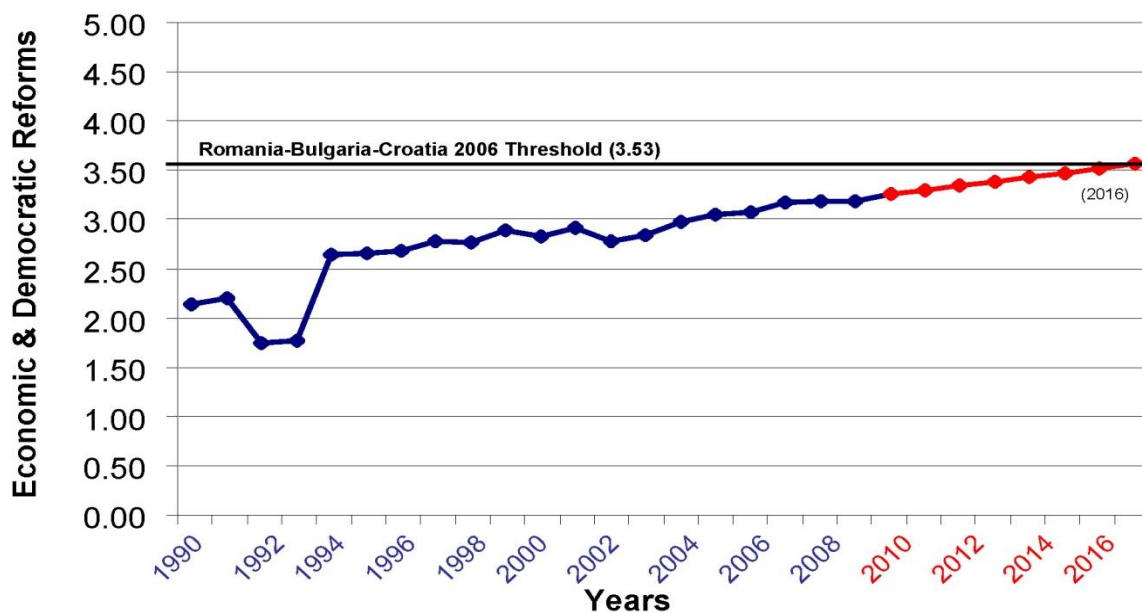
benchmark; elimination of the four-sector approach; and institution of an annual review process in lieu of pre-determined phase-out target dates.

A. THE NEW BENCHMARK

The Revised Framework uses a new bench mark for phase-out: the average of the MCP scores for Bulgaria, Romania, and Croatia in 2006, their last year of AEECA (then SEED) assistance. This bench mark is a more accurate indicator of irreversibility than the old one because it measures where these most recent graduates stood at the point their assistance actually phased-out, and the point at which two of them actually joined the EU. The data set is also broadened by the addition of Croatia. Since as noted earlier, a number of the remaining AEECA recipient countries are unlikely to attain EU or NATO membership for the foreseeable future, it is useful to have the example of a country that was deemed ready for phase-out despite being a number of years away from EU and NATO membership. The new benchmark is also consistent with the European Commission's analysis of political and economic criteria used for assessing readiness for EU membership. The new benchmark translates into an MCP consolidated score of 3.53 out of 5, representing the average of democratic and economic reform progress.

B. ANNUAL REVIEWS AND PROJECTING YEARS TO THE BENCHMARK

Each year when new data are available for the previous year, the USAID/E&E MCP team will update each AEECA country's MCP score on democratic and economic reform, take the average and compare it to the benchmark. They will estimate the number of years it will take a country to reach the benchmark by projecting annual changes in each country's score based on the average annual rate of change from the most recent five-year period for which data are available. When a country is projected to be five years from reaching the bench mark, it will be reviewed for possible phase-out. Because each country's progress is not necessarily linear or easily predictable, the USAID/E&E MCP team will update each country's forecast each year, when new annual data become available. For example based on data reported from 2004 through 2009, country X below is projected to reach the bench mark in 2016. Thus, the phase-out review should occur in 2011.



Source: Most recent available EBRD Transition Report; Freedom House Nations in Transit (various years). Extrapolation, shown in red, is based on annual average rate of change from 2004-2009.

It must be acknowledged that the same pitfalls inherent in the 2004 attempt to establish phase-out “target dates” by projecting current conditions into the future are also inherent here. Assuming linear progress is always “iffy”. But at least under the new Phase-Out Framework, the baseline will be adjusted and projections revised annually.

C. THE PHASE-OUT REVIEW

Once a country is within five years of the bench mark, EUR/ACE will convene a **phase-out review committee**. This committee is responsible for considering a range of factors, gathering data, analyzing them, and submitting a recommendation to the Coordinator as to whether the country in question should begin phase-out planning. Membership on the committee will be drawn from EUR/ACE, Washington implementing agencies of AEECA assistance, interagency representatives without a particular connection to the country under review, and post. Its work should be completed in no more than three months. The committee will solicit input from others within State, USAID, representatives of all USG implementing bureaus, departments, agencies and offices with a policy or assistance relationship with the country, and any other appropriate outside experts to help them with their deliberations.

A general outline of a phase-out review committee’s responsibilities includes:

1. Acquire and review information on the country’s past and current development indicators, assistance strategy, program performance, its regional/international significance and relationships, and U.S. foreign policy interests. Data sources should include USG, academic and think tank literature, NGO, IO, and IFI publications, and any other materials relevant to assessing a country’s current and projected progress.
2. Develop a set of questions to explore and solicit comments/answers to them from relevant stakeholders and experts. The fundamental question for the phase-out review

committee is: Considering a broad array of developmental and foreign policy factors, is this country within five years of reaching the point of “irreversibility” and should it therefore be put on a path of declining funding, leading to the phase out of all AEECA assistance? Specific questions include:

- What is the current state of this country’s political, social, and economic and security development? Which sectors are showing the greatest progress? To what extent has this country demonstrated consistent progress over the past ten years?
 - Is host-country government funding available for development priorities? What is the capacity and political will of the government to garner revenue (taxes, fees, customs duties, etc.) and use it for the public good?
 - Is there clear evidence that AEECA funding has contributed and is contributing to this progress? Are these gains sustainable?
 - What are the U.S. foreign policy and development objectives in this country and how might phasing-out of USG assistance affect them? What would be the possible unintended consequences for U.S. foreign policy objectives of USG phasing-out of AEECA assistance over the next several years?
 - Are there national security considerations (e.g. related to non-proliferation concerns or other transnational threats) that might favor prolonging engagement with the country through various foreign assistance instruments? If yes, which ones?
 - What other donors are providing assistance to this country, for what yearly amounts, and in what areas?⁸⁸
 - Are there any unique opportunities in the near future in this country where targeted USG assistance funding could make a substantial and significant positive impact?
 - Is this country (government, economic and financial sector, and popular opinion), looking west and toward integration into western-oriented institutions?
 - Does this country have a realistic prospect of joining the European Union, or another supranational body that might work with it on its future development?
 - Are there other factors related to the region that should be considered as we phase-out USG assistance?
3. Analyze and synthesize all of the information reviewed and the perspectives of those consulted, discuss the answers to the questions, and then write a paper of no more than ten pages that should contain sections on: questions explored; summary of findings and major conclusions; and the recommendation of whether or not the country should begin planning for phase-out.
 4. Circulate the paper with background materials to interagency for comment. Revise the paper, if appropriate and submit it with background materials and comments to the Coordinator for decision. Communicate decision to the interagency and Hill.

D. PHASE-OUT PLAN

If the Coordinator decides that a five-year phase-out plan should be developed, EUR/ACE and post will establish a **phase-out plan working group** that will develop an over-arching phase-out

⁸⁸ We would note that figures available for assistance funding from the European Union, the major source of development assistance to Europe and Eurasia, are typically set in terms of “available” funds. Notably in the case of Instrument for Pre-Accession (IPA) funding, it is often difficult for potential beneficiaries to access these funds, and the amounts ultimately expended may therefore fall short of the figures initially provided by Brussels.

strategy and a resource plan that demonstrate program area, personnel, and budget reductions over a five-year period. The plan should focus particularly on how to protect past USG investments by intently focusing on sustainability and legacy planning/development during the final years of AEECA assistance.

The phase-out plan will be made up of two parts. The first part—the **over-arching phase-out strategy**—should describe the general approach to phasing-out the AEECA-funded development objectives and programs. It should discuss assistance priorities and provide rationales for why and how various programs will be ended, modified, and/or scaled down. It should discuss trade-offs needed such as curtailing some programs in order to make a final push on others of greater priority/need, identifying where progress toward one developmental objective is acutely dependent on progress toward another. And, it should sketch a vision of program sustainability including the institutions, processes, skills, attitudes, etc. that will remain (or grow) after AEECA assistance ends, and we can ensure that this vision is realized. (Given the unfortunate experience of previous AEECA graduates, where corruption and high-levels of criminal activity persist, it will be necessary to give special attention to the rule of law sector, making intensive efforts in the final years of our assistance to ensure supporting institutions are functioning and sustainable).

The second part of the phase-out plan is the **resource plan**. It should provide, by program area (and program element, if appropriate), financial information that shows how the over-arching phase-out strategy translates into declines in AEECA funding over the next five years (the glide path). Greater detail on the format and data requirements for the resource plan will be forthcoming.

E. PHASE-OUT PLANNING PROCESS

The phase-out plan working group will be chaired by EUR/ACE and made up of representatives from post, State, USAID, and others with USG assistance and policy interests in the country. All relevant USG stakeholders, including OMB, will have an opportunity to review and comment on the phase-out plan. The entire phase-out plan should be developed and presented to the Coordinator in no more than four months from the Coordinator's decision to move to phase-out planning. The Coordinator will be responsible for making final phase-out plan decisions in consultation with the interagency. It will always be the prerogative of the Chief of Mission in the country in question to engage with the Coordinator on any adjustments needed to the phase-out plan. The phase-out plan will be reviewed periodically and discussed during the Annual Budget Reviews (ABRs) conducted by EUR/ACE in the fall with the country's USG implementers of AEECA assistance. The ABRs will take the phase-out plan into account as budgets are prepared.

The steps for the development of the entire phase-out plan include:

1. Upon the decision of the Coordinator to initiate phase-out planning, EUR/ACE will notify post, the relevant USG assistance implementers, OMB, and the Hill, and provide more information on how the process will unfold.
2. The phase-out plan working group will be formed. It will read the phase-out review paper and background materials, consult with relevant stakeholders, and hold meetings via DVC and/or at post.
3. The working group will draft the five-year over-arching strategy and the resource plan and submit it to the COM and the Coordinator. Revisions will be made, if needed.

4. The phase-out plan will be sent to the interagency for comment. The Coordinator will convene an interagency meeting to discuss the phase-out plan.

F. BUDGETARY CONSIDERATIONS

While we remain committed to the original intent of the SEED and FSA Acts—to promote the transition of countries in the region from Communism to market-oriented democracy—and believe in the importance of using a rigorous analytical process to review a country’s progress, we must also be cognizant of the increasingly constrained budget environment domestically and the potential for sharp reductions to the AEECA account. As such, the Coordinator will take into account budgetary considerations in deciding whether it is necessary to initiate an early phase-out review and planning process for a given country, limit the length of time allotted to a phase-out plan, accelerate already planned phase-outs, and take other steps to deal with resource constraints.

V. SUMMARY OF REVISED AEECA PHASE-OUT FRAMEWORK

STEP 1:

- A. Each year in June calculate MCP scores for all AEECA countries and based on the past five years of available data, determine the projected time it will take to reach the bench mark (defined as the average MCP scores of Bulgaria, Croatia and Romania in 2006).
- B. Determine which countries are within five years of the bench mark.

STEP 2: Within three months of step 1, **phase-out review committee** makes recommendation to the Coordinator of whether those countries within five years of the bench mark should move to phase-out planning.

STEP 3: Coordinator decides whether or not to proceed with phase-out planning.

STEP 4: Within four months of the Coordinator’s decision to proceed with phase-out planning, the **phase-out planning committee** develops the plan.

STEP 5: Coordinator consults with the inter-agency on the phase-out plan.

STEP 6: Phase-out plan is implemented.

APPENDIX 12 – THE DEVELOPMENT CREDIT AUTHORITY – EUROPE AND EURASIA REGION

Leveraging Private Sector Capital for Development

The Development Credit Authority (DCA) in the E&E region has enabled thousands of small and medium enterprises (SMEs) to access credit in productive sectors such as agriculture, manufacturing, trade and commerce, tourism, and services. DCA has also permitted several municipalities to access commercial financing for their infrastructure projects. As the financial sector in the E&E region evolved and reforms were implemented, the demand for credit guarantees as risk management tools increased. DCA guarantees have been used to complement USAID financial sector programs in the region.

Credit guarantees have had a long history in the E&E region. E&E Missions began implementing credit guarantees in the region in the mid-1990s through the Micro and Small Enterprise Development (MSED) program, the predecessor program to DCA. Nineteen MSED guarantees totaling \$47 million were implemented in eight countries at a cost to USAID of \$2.8 million, mobilizing financing for 2,100 borrowers.

DCA's mission is to design and deliver investment alternatives that unlock private financing in support of USAID priorities. DCA works in support of USAID Missions and has leveraged \$2.7 billion over the last 13 years in more than 60 countries. In the E&E region, \$482 million in credit has been made available at a cost to USAID of \$24.5 million since 2000. The region's 76 DCA guarantees spanning 14 countries have mobilized considerable private capital achieving a leverage ratio of 1:20.

E&E's DCA Portfolio⁸⁹

Country	# of DCAs	Target Sectors	Private Capital Mobilized	Actual Disbursements	Utilization %	# of Loans	Claims Paid by USAID	Cost to USAID	Leverage
Albania	5	SME, Ag, Infra	\$28,697,366	\$10,817,865	37.70%	54	\$105,214	\$2,064,052	13.9
Armenia	8	SME	\$32,422,487	\$4,615,563	14.24%	53	\$22,038	\$1,263,378	25.66
Azerbaijan	4	Ag	\$9,710,256	\$3,100,850	31.93%	147	\$0	\$547,180	17.75
Bosnia	7	SME, Ag, Energy	\$94,285,658	\$38,396,624	40.72%	222	\$1,690,312	\$4,190,726	22.5
Bulgaria*	6	Ag, SME, Energy, Infra	\$65,000,000	\$95,299,952	100.00%	220	\$1,373,011	\$2,299,083	28.27
Croatia	4	SME, Ag, Housing	\$55,400,000	\$6,457,373	11.66%	657	\$0	\$662,495	83.62
Georgia	8	Ag, Micro, SME, Health	\$47,567,660	\$19,081,885	40.12%	84	\$0	\$3,010,940	15.8
Kosovo	10	Ag, SME	\$40,572,010	\$10,934,276	26.95%	1,029	\$577,438	\$4,148,870	9.78
Macedonia	6	SME, Energy, Micro	\$24,000,000	\$9,102,346	37.93%	719	\$0	\$1,104,500	21.73
Moldova	10	SME, Ag	\$34,473,000	\$21,974,930	63.75%	1,810	\$87,796	\$2,119,676	16.26
Romania	1	Housing	\$7,000,000	\$7,000,000	100.00%	1	\$0	\$217,700	32.15
Russia	3	SME	\$17,000,000	\$14,568,810	85.70%	191	\$0	\$770,200	22.07
Serbia	2	Infra	\$18,113,737	\$5,873,986	32.43%	4	\$0	\$1,899,400	9.54
Ukraine	2	Ag, Infra	\$7,500,000	\$3,748,332	49.98%	272	\$78,584	\$277,050	27.07
TOTAL	76		\$481,742,174	\$250,972,792	41.12%	5,463	\$3,934,393	\$24,575,250	19.6

*Initial DCA guarantees were permitted to revolve which is why disbursements exceed private capital mobilized for Bulgaria.

⁸⁹Data compiled reflects activity as of the close of FY 2012.

Regional Highlights:

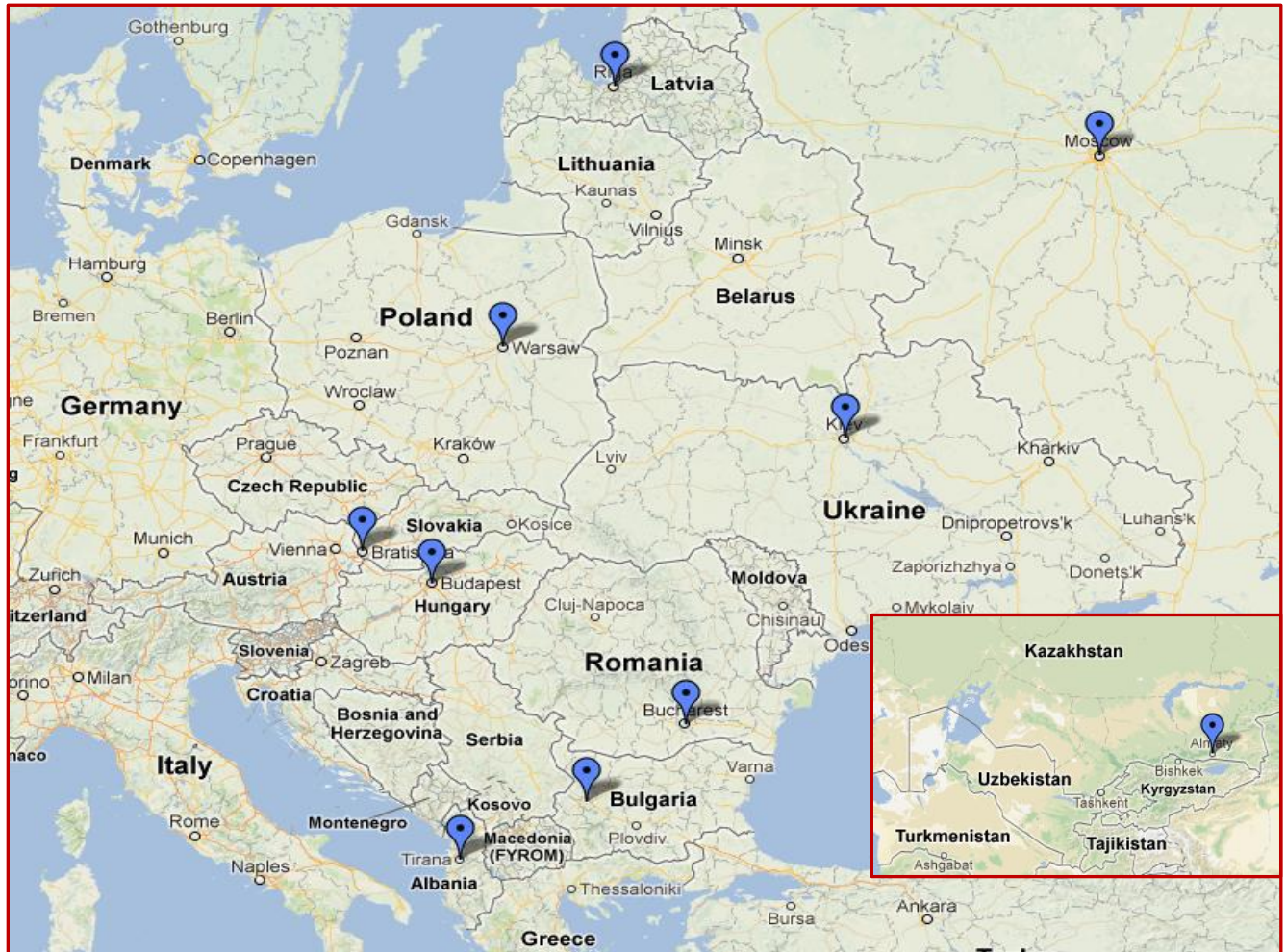
- The important partnership between USAID and the Swedish Development Agency (Sida) began in the region with two joint-guarantee agreements in Bosnia with Raiffeisen Bank and Volksbank, to stimulate \$40 million in total lending to small and medium-sized enterprises (SMEs) in productive sectors such as agriculture, tourism, wood-processing or metal working.
- Lending for energy efficiency was successful in Bulgaria through a loan portfolio guarantee for \$10 million with United Bulgarian Bank (UBB). The facility was completely utilized largely due to targeted technical assistance to both the potential borrowers with their energy investment plans and also to the financial institution in understanding how to lend to municipalities with enhancing project evaluation and risk mitigation. This guarantee was also one of the first DCA activities to be implemented in the region.
- A guarantee company was established by former DCA partners in Moldova. Largely inspired by their DCA experience, they incorporated key DCA principles into the design of the new entity. They recognized the importance of guarantees to share risk in order to create new lending opportunities.
- DCA's largest health infrastructure guarantee is in Georgia with TBC Bank, supporting a \$20 million investment portfolio for hospital refurbishment/construction, as part of the country's healthcare privatization program.
- The first municipal bond issuance was facilitated in Serbia for the city of Novi Sad to finance the construction of infrastructure projects (major urban thoroughfare and a modern water and sanitation system), targeting institutional investors and pension funds.
- The Ministry of Agriculture in Kosovo paid for the subsidy cost (\$3 million) of a \$26 million multibank loan portfolio guarantee with 6 financial institutions to support lending to the agricultural sector.

**APPENDIX 13 – THE ENTERPRISE FUNDS IN EUROPE AND EURASIA:
SUCCESSSES AND LESSONS LEARNED (EXCERPT)**



USAID
FROM THE AMERICAN PEOPLE

THE ENTERPRISE FUNDS IN EUROPE AND EURASIA: Successes and Lessons Learned



EXECUTIVE SUMMARY

BACKGROUND

W

With the fall of the Berlin Wall in November 1989, and the collapse of the Soviet Union on December 25, 1991, 19 countries in the former Soviet bloc began the transition process from centrally-planned to market-based economies. Realizing that these new states lacked the financial sector capacity necessary to support this historic transition, the United States Congress authorized nearly \$1.2 billion through the U.S. Agency for International Development to establish ten (10) new investment funds, collectively known as the “Enterprise Funds” (or the “Funds”), throughout Central and Eastern Europe and the Former Soviet Union. For each fund, USAID identified and the White House designated an independent Board of Directors, to serve on a pro bono basis, to guide the Fund’s strategy and provide supervisory oversight. Although many challenges were encountered, including slow starts and organizational difficulties, after 20 years of operations throughout the Europe and Eurasia region (E&E), it is clear that, collectively, these ten (10) Enterprise Funds have been successful both in accomplishing their original economic development objectives, as well as achieving substantial financial returns, although there has been significant variation in the performance in individual funds.

IMPACT OF THE ENTERPRISE FUNDS

T

The Enterprise Funds are one of the very few development programs to *achieve sustainable economic development impacts while leveraging additional investment resources, generating significant program income to endow long-term host country Legacy Foundations, and ultimately returning a significant portion of their original grant funds to the American people.*

The following is a summary of the substantial economic and development impacts provided by the Funds as of September 30, 2012:

\$1.2 billion of USAID/USG funding has been invested into enterprise development in 19 countries

\$1.7 billion of net proceeds realized from successful investments have been reinvested by the Funds allowing them to leverage the use of their initial funding

The convincing value proposition of the Funds allowed **\$6.9 billion** of private capital to be raised from outside the USG; total investment capital of **\$9.8 billion** over the life of the Funds

Significant development capital was provided to SMEs and entrepreneurs operating in early-stage transition countries where private investment capital was limited or non-existent, which helped create an environment where the culture of private enterprise could flourish

Over 300,000 jobs were created or sustained through investment and development activities

The Funds provided **\$77.7 million** in technical assistance for skill-building and technical training in finance and management to assist SMEs and to strengthen the private sector

To date, the Funds have returned **\$200.5 million** to the USG and are on track to return over **\$400 million** of the original USAID funding

Remaining proceeds of **\$1.3 billion** will endow ten (10) long-term philanthropic “legacy” institutions, which will continue to strengthen private sector and civil society development, and build goodwill between the US and their host countries

The E&E Enterprise Funds were modeled after western style venture capital funds and created an important cadre of local financial sector professionals

As a result of their investment activities, the Enterprise Funds have had a catalytic affect and transformational impact on the economies of the E&E region

DESCRIPTION OF ACTIVITIES

I

n addition to making direct equity investments and loans to small and medium-sized enterprises (SMEs), the Enterprise Funds played a key role in introducing new financial products into the region, such as home mortgage lending, mortgage securitization, credit cards, mezzanine financing, equipment leasing, and investment banking. In cooperation with other USAID-funded development programs, the Enterprise Funds played a pivotal role in removing institutional and regulatory roadblocks to market-driven private investment. Enterprise Funds have been instrumental in the transformation of renters into home owners and small business owners into citizen-stakeholders, who are vested in creating sustained economic growth in their countries.

As might be expected, the effectiveness of the ten E&E Funds varied greatly by country, based on the economic and political conditions on the ground, as well as the overall investment strategy and specific investment decisions made by each Fund's Board and management team. In the early years of operations, the performance of certain Funds was less than anticipated. However, as the Funds gained experience in the region, the long-term results have been significant. In the E&E region, the Enterprise Funds were created before traditional venture capital funds were willing to invest. Thus, the Funds were pioneers in demonstrating that private sector investment in this region was feasible and could be profitable. Over time, this demonstration effect helped attract substantial foreign direct investment capital to further promote private sector development in the E&E region.

As the Enterprise Funds complete their investment phase, investment proceeds are liquidated and used to establish long-term philanthropic or "legacy" institutions ("Legacy Foundations") that will continue to strengthen and promote private sector and civil society development in their host countries. These new Legacy Foundations will continue to advance USAID, USG and host country economic development objectives without additional USG funding. In addition to providing economic and development assistance on a sustained basis, they will also continue to generate goodwill between the U.S. and these countries for many years to come.

Legacy Foundations now operate in: Poland, Hungary, Central Asia, Bulgaria, Romania, Slovakia, Albania, Russia, and the Baltics. The Western NIS Enterprise Fund will complete its investment phase in 2013 and is expected to return additional funds to the US Treasury and use the balance of their assets to establish a Legacy Foundation that will operate in Ukraine, Moldova, and Belarus. This ensures that there will be a continuing flow of USG support for economic development in these countries long after the Enterprise Funds have completed their active investment phase.

LESSONS LEARNED AND RECOMMENDATIONS

T

he following section sets forth the 'lessons learned', from the perspective of USAID, in the creation and implementation of the Enterprise Funds, and incorporates recommendations to inform further discussion regarding any potential new Funds utilizing the Enterprise Fund structure. Given the unique and historic challenges in the E&E region when the Enterprise Funds were being formed, the Enterprise Fund model has proven itself as a viable economic development tool. Collectively, the funds have proven themselves successful from the dual mandate, or double bottom line, perspective of achieving economic development

impact as well as overall positive financial returns. Nevertheless, with the benefit of hindsight, there are certain important lessons that can be taken from this experience, which could assist in designing, implementing and overseeing any similar such funds in the future.

GOVERNING IDEOLOGY

In order to be successful, Funds need to be implemented in parallel with the work of USAID, other donors and host country leaders, to provide a wide range of traditional economic and technical assistance tools to create a supportive business enabling environment.

The work of USAID missions and other donor organizations, along with the committed efforts of host country citizens and counterparts, in providing long-term, in depth technical assistance, training, judicial, legal, and regulatory reform, has been the cornerstone for building well-functioning economies in the transition countries within the E&E region. Without this broad range of assistance to reform the overall business enabling environment, as well as capacity building assistance for economic regulators, entrepreneurs, and business owners, the work of the Enterprise Funds would have been a much greater challenge and likely could not have been as successful.

Successful Fund and management performance should be based upon a demonstration of profitable investing as well as the support of targeted development objectives – the “dual mandate” or “double bottom line.”

When the SEED Act and the FSA were drafted, Congress and development experts were not primarily concerned with the level of profits that the Enterprise Funds might generate. They were focused on how the former Soviet countries and satellite states could transition from centrally planned economies to free market economies without pre-existing modern banking and financial sectors, legal regulations, and property rights. The grants given through the Enterprise Fund program were designed to “jumpstart” the newly emerging market economies and financial sectors. For example, while the profitable sale of Delta Credit Bank by the Russian Fund was important, the fact that this Fund promoted the introduction of mortgage legislation was equally important, as the latter financial tool is now in place to help individuals and companies in the future. When evaluating the performance of a Fund or the Fund’s management, the USG (i.e. State, USAID, and Congress) should take into account the “dual mandate” to: (1) support targeted development objectives and (2) provide a demonstration of profitable private sector investing.

Effective oversight and maintaining close working relationships between USAID and the Funds’ Board of Directors and managers are critical to the long-term success of the Funds.

Early on in the investment phase of the Enterprise Funds, USG oversight roles and responsibilities for the Funds were not clearly defined. In cooperation with the Funds, Congress and USAID developed a reporting structure and format to satisfy necessary requirements for USG oversight. This structure included regular meetings between USAID and the Board, the creation of individual Fund management teams, semi-annual reviews to ensure management compliance with the terms of the grant agreement, the right for USAID to conduct site visits and independent evaluations, as well as independent audits to verify financial reporting. The Bureau for Europe and Eurasia maintains a team of professionals that reviewed submissions from the Funds and independent auditors and meets regularly with the Funds’ Boards and management teams. Based on early experience, it was understood that USAID should not take an entirely “hands-off approach” to its role, as was originally intended. Rather, USAID maintained effective oversight and close working relationships with the Boards of Directors and Fund managers, similar to other USAID grants, while not participating directly in the Funds’ investment and programmatic decisions.

Funds should be given maximum flexibility to use a variety of investment tools to meet development objectives.

Initially, it was anticipated that the Enterprise Funds would take equity stakes in companies being privatized and sell those stakes at an appropriate point in time. In practice, the Enterprise Funds used a variety of investment approaches. For example, in some countries, poor corporate governance and weak legal structures and financial environments made direct loans to companies a much more effective means of managing investment risk than a straight equity investment. In other situations, Funds took majority equity stakes in order to effectively manage the risk and return of their investments and to protect their rights as

outside investors. And yet in other cases, Funds have been very successful in developing new financial instruments and markets, such as residential mortgage programs and small business finance, by establishing new banks, leasing companies, insurance companies, and other financial institutions, as well as investing in new greenfield projects offering new goods and services that were not adequately developed in the region. The clear lesson is that the Fund Boards and managers need to have sufficient flexibility from the USG to develop a suitable investment strategy based on local conditions. In addition, Funds need to be free to choose which businesses and economic sectors to target rather than have them influenced by political or other outside interests.

The pace of investments made by the Funds should parallel the ability of management to find good investments within the host country environment. Expenditure of grant funding will likely be slower than traditional USAID grants.

Funds should be encouraged to undertake research and form an understanding of their host country investment environment, while being given wide discretion regarding specific investment decisions. For example, while the Polish-American Enterprise Fund (PAEF) initially planned to make equity investments, it quickly discovered that it did not have enough information about the Polish investing environment for its investments to ultimately become profitable. Pulling back, it shifted its strategy toward making direct loans to businesses rather than acquiring an equity interest, while gaining knowledge and expertise in Poland's investment environment. As conditions improved, PAEF began making equity investments as well. Future funds should be encouraged to pursue attractive investments in viable enterprises and development projects based on the business judgment and experience of Fund managers and the strategic guidance of their Boards of Directors.

The investment time horizon for each individual Fund should be carefully established based on the overall state of a country's economy, the respective legal and regulatory environment and the country's development priorities.

In order to operate efficiently, the Funds' Board of Directors must select a strong management team, which is able to explore the investment opportunities in local markets, and conduct due diligence, among other required start-up tasks. In many cases, this start-up period took up to 24 months before the Funds were ready to make their first investments. Even after the Funds were operational, many exercised great caution in their investment strategy, due to the uncertainty in local markets and the lack of attractive investment opportunities in the region. Early on, many of the Funds were not considered successful by traditional development aid grant standards wherein the success of a development program is partially associated with the relatively fast expenditure of grant funds along with the achievement of demonstrable results. The Enterprise Funds, however, represent a unique economic development concept, and their success is difficult to fully judge using traditional development measures. Ironically, in later years, after some of the Funds achieved significant financial success with their investments, there was a tendency by some to analyze and judge the Funds based solely on their financial rate of return, rather than the original economic development objectives. The Funds were operating in extremely fragile, transitioning markets with high investment risk and minimal protections for investors. The long-term investment horizon of the Funds allowed the markets to develop sufficiently, investments to mature, and in many cases, for the Funds' investments to ultimately generate attractive financial returns while also contributing to broader economic development goals. Based on the experience of the Enterprise Funds, similar programs should be given an operating and investment timeline of 10-15 years to allow for the challenging investment environments expected within the host countries.

Enterprise Funds do not necessarily require large amounts of capital to be successful. The amount of USAID financial support for Enterprise Funds within a country should be determined based on the specific needs and development objectives existing in each country.

Population size and geographic distribution are not the only factors to consider when appropriating funding for specific countries. A country's economic progression, diversity in employment opportunities, financial sector maturity, transparency, private property rights, enforceability of laws and regulations, and other considerations must be accounted for to sufficiently scale the Funds' ability to meet the varying needs of their host country environments. The Funds must have enough capital to cover operating costs for the life of the

Fund, and to attract a professional, qualified staff, capable of achieving the desired development impacts. However, there does not have to be a strict proportionality between a country's region or population size and the size of the fund, as was initially assumed. Critics of the Enterprise Fund model have often argued that, for Funds to be truly successful, they require a substantial amount of investment capital and funding—i.e. hundreds of millions of dollars. The Enterprise Funds, however, have demonstrated that this is not necessarily the case.

The smallest Enterprise Fund was the Albanian-American Enterprise Fund (AAEF) with an initial investment capital of \$30 million. The Fund has taken its original \$30 million appropriation and, through reinvestment of profits, has directly invested \$111 million in 77 investments in 40 companies. Over five thousand new jobs have been created and \$1.2 billion has been contributed to Albania's GDP by current and former portfolio companies. During the time that the Fund was the owner of the American Bank of Albania, now Intesa Sanpaolo Albania, the Bank provided \$977 million in financing to companies in Albania that contributed \$2.2 billion to the Albanian GDP. More than \$300 million in additional foreign direct investment was attracted to Albania by AAEF investments. Starting from this modest capital base, the Fund was able to profitably finance infrastructure and banking projects, including the creation of the following: the Mother Theresa International Airport; the first biometric identification card for all citizens and the first biometric passports; the American Bank of Albania

The Fund took the U.S. Government grant of \$30 million and turned it into an investment portfolio worth approximately \$208 million. After returning half of the original capital to the USG, more than \$150 million was used to create the Albanian-American Development Foundation. As the remaining assets are liquidated, the additional capital will be added to the Foundation. The current estimated value of the Fund and the Foundation equals 700% of the original USG grant amount. Similarly, working with an initial \$50 million grant, the Baltic-American Enterprise Fund (BaleEF) was able to raise over \$300 million in multilateral and commercial bank funding and ultimately invested \$749 million in the Baltic region.

At the other end of the spectrum, the U.S. Russia Investment Fund (TUSRIF) was the largest of the Enterprise Funds, with an original grant funding level of \$329 million for economic development activities in Russia. Due to the vast geographical and political challenges facing Russia when the Funds were founded, it was assumed that TUSRIF needed a large amount of funding in order to achieve the desired development impacts, and that smaller levels of funding would be insufficient to achieve these goals. However, the Fund has greatly benefited from effective management oversight and has successfully invested its grant funding realizing investment reflows in excess of \$300 million, and attracting an additional \$1.2 billion in equity, debt, and co-investments. TUSRIF has achieved its development impact goals by establishing Delta Credit Bank, a mortgage bank designed to develop best practices for the home mortgage market, funding Delta Bank, which introduced western-style credit cards to Russia, and founding the U.S. Russia Center for Entrepreneurship, which provides short-term practical training and networking events targeting the growth needs of entrepreneurs and business owners.

The successful experience of the AAEF, BaleEF, and TUSRIF provides additional evidence that the success of an Enterprise Fund is not directly tied to the size of the Fund. Rather, successful Funds should be tailored to the specific needs and existing conditions of the host country. It may be that \$30 million represents the lower range for a viable fund able to cover overhead and start-up costs and achieve a positive economic return on the overall portfolio.

Regional or multi-country Funds pose significant logistical, operational, and political challenges and are often considerably more expensive to operate than Funds based in a single country.

The investment needs of a region should be closely examined before deciding whether one large fund or several smaller, independent funds would be best suited to the stated development objectives. Countries often have major cultural, legal, political, and linguistic differences, making management of investments in multiple countries difficult and expensive. For example, while standardization of products and services has been possible across all three Baltic countries involved in the Baltic-American Enterprise Fund, the other two multi-country Funds (the Western NIS Enterprise Fund, and the Central Asian-American Enterprise Fund) determined for political reasons that they would need to establish an office in each country within their sub-region, making it somewhat redundant and more expensive to have a multi-country Fund. In the case of the Western NIS Enterprise Fund, an office was opened in Belarus for diplomatic reasons and at the request of

the USG, even though the environment was not particularly conducive to profitable investment at that time. Correspondingly, if a Fund is tasked with investing in a geographic region composed of many different states, Fund managers should be permitted to choose investments based on objective economic criteria, and not based on political influence or mandates to allocate capital in various countries or investment sectors.

Fund managers should balance cost efficiency with the need to cultivate a professional business work environment and supportive organizational structure.

The unique structure of the Enterprise Funds allowed individual Fund management teams to develop and implement strategies that specifically targeted individual country needs based on their varying economic and political environments. A few Fund managers attempted to minimize operating costs in the management offices so that more funds were available for direct investment in the capital and financial markets of host countries, thereby compromising the technical capabilities of the fund to invest and manage. A professional and orderly atmosphere encourages professionalism amongst the staff and emphasizes the business aspect and private sector approach of the investment funds.

The institutional capacity-building legacy of the Enterprise Fund process should include the development of a cadre of seasoned host country investment professionals who can continue to use their skills to promote private sector development and attract additional foreign direct investment to the region.

One of the major contributions of the Enterprise Funds is the transfer of knowledge and expertise to local financial professionals, businesses and investors. In the countries where the Enterprise Funds have been active, there has been a recognizable contribution to creating a professional investment network in host countries (an “alumni effect”) among the individuals who have worked for or with the Enterprise Funds. The Hungarian-American Enterprise Fund (HAEF) did just that with the establishment of a subsidiary called the Hungarian Innovative Technologies Fund (HITF), an investment team focused on cutting-edge technology firms; a new management company, MAVA Capital; and a private fund called Hungarian Equity Partners (HEP). These new investment teams raised additional private capital and used the skills they gained as investment professionals over the 15-year lifecycle of the Fund.

In Poland, to attract private capital, the investment team formed the Polish Enterprise Investors (EI), which is now considered to be one of the largest private equity funds in Eastern Europe. Funds are encouraged to leverage their grant resources to attract investments from other international donors and private sector investors. This strategy has been highly successful for both Enterprise Fund investments and in raising capital for the private equity funds that have been “spun-off” as the Enterprise Funds mature and approach the end of their active investment phase.

USAID should encourage regular cross-border communication between Enterprise Funds and similar development investment funds and Legacy Foundations operating in other countries and regions.

At their inception, the Funds did not generally communicate with one another at a high level. Each Fund developed and implemented its own unique investing and development strategy and reported directly back to USAID. As time progressed, Funds realized the inherent benefits of sharing experiences and thus began communicating their investment strategy and individual lessons learned. An informal association of active board members and management teams was formed. This Enterprise Fund Association met regularly for several years, once its members saw the value of sharing their experiences.

As they have evolved, the Funds’ Legacy Foundations have expressed an interest in sharing experiences with other Legacy Foundations. This information sharing among Funds and Foundations contributes to a comprehensive understanding of the investment and development alternatives in the region, and their ability to identify and implement Legacy Foundation projects, which continue to contribute to private sector development.

USAID should work with the Boards of Directors and managers of Enterprise Funds to establish appropriate internal policies and practices to ensure that the Funds operate at all times on an ethical and transparent basis.

In conducting semi-annual reviews with the Funds (at least one in the U.S. and one in the host country) the E&E Economic Growth staff monitored the Funds’ overall investment practice along with organizational policies, meeting regularly with the Funds’ Boards of Directors as well as each Fund’s professional investment

staff. The face to face meetings, including at least one annual review in the field, and visits to the Funds' offices and investee clients, is critical to allowing USAID to fulfill its monitoring and oversight role.

USAID and the USG must have the specific legal authority and bureaucratic willingness to make changes, if necessary, in the composition of the Funds' Boards of Directors, to ensure each Fund is continuing to address the mandated financial and developmental goals, or any other issue requiring a change.

During the course of the Funds' operating history, we have been fortunate to be able to identify an exceptional group of senior level financial and business professionals from the U.S. private sector, who have provided their strategic guidance and oversight of their respective Funds, on a pro bono basis, in many cases throughout the 15-20 year life of a Fund. One of the fundamental lessons learned during this period is that— if you get the Board right—everything else will likely fall in place. That fact cannot be over-emphasized. Occasionally, the make-up of a Board may evolve to where it is not functioning in a way that is the most effective in terms of meeting the dual mandate objectives of an Enterprise Fund. In such cases, it is critical that USAID, State, and other parts of the USG exercise its legal authority and take the necessary steps to re-constitute the Board so as to best meet its stated objectives. In the E&E experience, the great majority of the Funds' Directors have contributed their investment, business and strategic experience over many years with an exceptional level of commitment and professional skill. In the few cases when changes in Board make-up was considered necessary, all effort was made to do so in a respectful manner, seeking input and collaboration with the existing Board. USAID's willingness to exert its rights to make changes in Board composition should be done sparingly, so as not to interfere with normal Board decision-making, but pursued actively when deemed to be in the best interests of the Fund, and the development and foreign policy goals of the USG and the American people.

INITIAL FUND STRUCTURE AND SETUP

1. *Alternative approaches to the Enterprise Fund model should be considered, based on existing conditions in the host country and availability of funding.*

Private Equity Model – Request for Proposals (RFP)

In certain circumstances, where the size or economic conditions were not considered appropriate for an Enterprise Fund, USAID has elected to establish investment funds in countries using alternative approaches. As an alternative to the Enterprise Fund structure, an RFP may be issued to solicit proposals from existing international investment managers, with experience in managing private equity investments in developing countries. In such cases organizations such as Small Enterprise Assistance Fund (SEAF), with extensive experience managing international investment funds, were able to leverage an initial grant from USAID to attract investment capital for a new fund from other donor groups such as the EBRD, SIDA, Norvest, and others.

USAID Development Credit Authority (DCA)

Another alternative to be considered in certain circumstances is the expanded use of USAID's DCA program, which provides a partial guarantee for loans made by existing financial institutions to small and medium business enterprises. In countries where there are existing financial institutions with available liquidity, it may be preferable to consider a combination of loan guarantees along with technical assistance on both the demand side (existing businesses) and the supply side (financial institutions) to serve as a catalyst for increasing lending activity and building on the capacity of the existing financial institutions.

There are pros and cons to each of these approaches and they should be carefully analyzed and considered, based on the conditions existing in the host country, before choosing the most appropriate structure. Prior to proceeding, a thorough study of the current historical socio-economic and political environment is critical.

2. *An appropriate compensation plan, including consideration of incentive compensation, should be established from the outset to incentivize fund management and reduce personnel turnover. Likewise, to avoid the potential for excessive compensation, setting a maximum cap on annual and overall compensation should be strongly considered.*

Investment professionals are typically well compensated for their skills, and the Funds need to compensate their managers accordingly. Many funds reported difficulties obtaining qualified management staff, due to the

Congressionally mandated salary cap of \$150,000 which was established in the early 1990s, and has not been adjusted over the 20 years of Enterprise Fund activity. Several Funds also experienced difficulty maintaining a qualified and committed staff of investment professionals, where no incentive compensation plan was in place. Thus, to attract and maintain high quality staff, several Funds proposed to USAID that they be allowed to design incentive programs for their management staff. It is important to consider this issue at the outset of establishing a Fund, in order to avoid loss of momentum and complications in designing incentive compensation after the Fund has actively commenced its investment program. It is also critical to establish some reasonable “cap,” or maximum overall compensation for Fund management to avoid potential criticism regarding excessive compensation received from USG funded projects. It is possible for a Fund established in countries undergoing economic transition, to reap substantial profits on investments made during the early years of the transition process. Care must be taken to consider and evaluate the appropriate level of incentive compensation based on the degree of risk assumed by Fund managers (generally they have no personal capital investment in an Enterprise Fund) and other relevant factors, when compared to a private equity model in the U.S. private sector.

3. *Clear expectations and guidance for the wind-down and termination of Fund investment activities should be considered and defined at the outset.*

As previously stated, the flexible and long term investment time horizon of the Enterprise Funds was central to their success. Giving the Funds complete control over the timing of asset sales and allowing the Funds a sufficient investment period (i.e. a 10-15 year window of operation) allows them to respond appropriately to market changes. Within this timeframe it is important to have a well-defined plan that encompasses the investment lifespan of a Fund. It is very important for USAID, in cooperation with the Board of Directors and the Fund’s management teams, to establish expectations and guidance concerning the use of investment reflows following the end of their active investment phase. In the case of the Enterprise Funds in the E&E region, there was no clear determination at the outset which defined the use of the assets remaining at the end of the Funds’ investment phase. Resolving this issue several years after the Funds were established was extremely difficult and time consuming. (It should be noted that current legislation authorizing Enterprise Funds in Egypt and Tunisia require that all investment reflows shall be returned to the U.S. Treasury.)

4. *Determining the appropriate use of investment reflows and the amount of assets to be transferred to a Legacy Foundation should be based on objective criteria, rather than any pre-determined formula.*

Due to the varying economic environments in the host countries and the differing degrees of success experienced by the Funds, decisions concerning the use of investment reflows should be determined individually for each Fund. Historically, a portion of the reflows have been returned to the U.S. Treasury and the remainder has been used to establish legacy institutions (Legacy Foundations) in the host countries. Legacy Foundations allow the host countries to continue to receive economic development benefits from USG funding, and allows the U.S. to maintain meaningful partnerships in these countries after the Enterprise Fund’s active investment phase is completed, and USAID is no longer present in the country. Maintaining this Legacy Foundation continues to strengthen ties between the US government and the host country, fosters goodwill between participant nations, and helps to continually improve economic opportunities and stability in the region.

In the event that all or a portion of a Fund’s investment proceeds are allowed to remain in the host country to establish a Legacy Foundation, care should be taken to provide an adequate level of resources to provide meaningful grant activity, which continues to support private sector development. In certain cases within the E&E region where a specific Fund has achieved an exceptional degree of financial success, consideration should be given to capping the total assets transferred to a Legacy Foundation when the level of assets may be excessive or disproportionate to the needs of the country. Rather than relying on any specific formula, a determination of the appropriate level of resources for a Legacy Foundation should be based on population, level of development achieved, or other identified criteria.

5. *Funds should actively promote and publicize their investment and related development activities within the host country.*

The Funds should actively work to promote a solid public image in their communities by developing and distributing educational and promotional material detailing the Fund’s activities. The creation of a “brand

name” and platform provided by the marketing materials can generate public support and interest in the Enterprise Funds, and maintain a high level of credibility for their investments and legacy activities. The material disseminated should recognize the differing interests and technical knowledge of the targeted audience such as policy-makers, international fund managers, potential high-value investors versus general business/FDI community seeking opportunities in the host country.

INVESTMENT CHOICES

Investment decisions must be made within the local context.

Funds should analyze existing banking and financial sectors, look for opportunities in existing markets, and base their investment decisions on what best fits the local environment. Western-style investments and strategies may not be appropriate in the early stages of transitioning economies. It should be left up to the Fund’s Board and management teams to determine whether equity investing, loans, mezzanine financing structures, or other investments best fit the local environment. Central to the Enterprise Fund model and their success is the idea that the Funds themselves should identify existing gaps in capital markets and seek innovative ways to provide profitable solutions and development impact within their countries, while taking into account the interest risks of investing in the target country.

In making investment decisions, funds should balance anticipated financial reward and potential for overall development impact.

The core programs could include loan programs for SMEs, a micro-lending program, direct equity investments, mortgage financing, and technical assistance. As with any investment fund, Fund managers in the E&E region attempted to minimize their investment risk by diversifying their investment portfolios over a broad range of investments. While some investments were extremely profitable, generating a high cash return, others did not recoup the original investment. The careful balancing of risk and return allows Funds to compensate for investments which achieve important development objectives, but are not as likely to achieve a strong financial return on their investment. In some cases trying to maximize financial returns on a specific investment may compromise development goals.

Funds should assess the optimum level of shareholding ownership to minimize the risk of being a minority shareholder.

The original USG grant encouraged the Funds to initially acquire a minority ownership position in the investee companies. It was thought that by making a significant number of smaller investments, the Funds would achieve greater economic impact and spread their risk over a larger number of businesses. In some cases, the Funds’ management teams and Boards did not anticipate the difficulty they would experience with this approach, due to insufficient legal frameworks and regulations protecting the rights of minority shareholders. Fund management teams were often frustrated by their inability to influence a company’s business decisions and realize profitable investment returns, due to corporate management’s disinterest in paying dividends to shareholders, selling assets, and/or pursuing an IPO. If taking an equity position, Funds should acquire the appropriate ownership interest in portfolio companies that will allow them to sufficiently influence key management decisions and protect their investment in the business.

Where appropriate and necessary, Funds should consider investing in the host country’s financial infrastructure.

Many of the Funds operated in countries severely lacking a well-functioning banking and financial infrastructure. The creation of financial institutions and improvements to financial sectors not only increased the ability of Fund managers to negotiate business transactions, but these improvements also directly impacted the lives of countless individuals by opening a window of investment opportunities that may not have otherwise been possible. The strengthened financial sectors and availability of functioning commercial banking systems can provide necessary support for the introduction of home mortgages, credit cards, small loans, ATMs, and other types of financial tools by maintaining a level of macroeconomic stabilization in the region. A strong level of economic stability and financial infrastructure are important to securing sound investments, profitable returns, and sustained development activities.

A significant day-to-day management presence on the ground and input from locally hired staff and advisors can contribute greatly to Fund performance.

CEOs from the earlier E&E Enterprise Funds initially conducted their operations from a base within the United States, rather than in the country or region where the investments were being made. This clearly hindered the early performance of the Funds. One key reason the Russia Fund was slow to develop was because early-on, senior managers were not located in-country and were not involved on a daily basis with Fund operations. This, alongside knowledge of the local markets and opportunities that come from in-country presence, are critical ingredients for long-term success. Over time the Funds all decided to base their day-to-day management on the ground in the host countries.

6. *The Funds, in conjunction with USAID and other donors, may wish to identify and address specific concerns related to the investment climate prior to initiating intensive investment activities.*

At the inception of the Funds, many countries in the Europe and Eurasia region were experiencing varying degrees of economic and democratic instability, which influenced the Funds' ability to engage in an aggressive investment and development campaign. The Board members and management team of an Enterprise Fund can be an important resource for technical assistance in the host country. Likewise, the economic and political teams within the U.S. Embassy and USAID have insights into the local business environment and can be very helpful in providing information and understanding the realities of operating in the host country. If existing laws or policies inhibit the ability of a Fund to invest prudently and profitably, that Fund should take advantage of opportunities to affect policy, legal reforms, and regulatory changes. Examples of this can be seen in the Baltics, Bulgaria, Poland, and Russia, where the Funds worked extensively to promote changes in regulations and legislation, to enable the development of innovative investment programs such as mortgage lending, equipment leasing, and syndication of loans.

7. *Based on the availability of long-term, patient investment capital, the Funds are well suited to initiate systemic economic reform that is related, directly and indirectly, to their investment activities.*

Overall, the Funds have worked to improve legal and policy environments, corporate governance, and contract and judicial decision enforcement when these institutions had the potential to impact the success of their own investments. While important, the regulatory changes the Funds influenced have been piecemeal. Systemic changes in the business enabling environment are best addressed by donor activities that target necessary changes to existing policy and legal and regulatory framework. Funds initiated change directly related to their activities by financing mortgage lending programs and learning from their own difficulties in the lending environment. Through this process, several Funds were able to identify and influence substantial reforms to existing laws and regulations.

CONCLUSIONS

T

he establishment of the Enterprise Funds in the E&E region to assist in the historic economic transformation of Central & Eastern Europe and the Former Soviet Union was truly an innovative approach to economic development. As one of the earliest projects to utilize the structure of large-scale public-private partnerships for economic development, their success and contribution as part of USAID's broader assistance efforts, introduced the idea that development programs can profitably invest in a host country's financial, political, and social development sectors and **achieve significant development objectives while making a financial profit**. The re-payment of \$120 million by the Polish American Enterprise Fund to the USG marked an exceptional moment in the history of USAID's global foreign assistance programs. Subsequent repayment by the Hungarian-American Enterprise Fund (\$13.0 million), the Bulgarian American Enterprise Fund (\$27.5 million), the Albanian-American Enterprise Fund (\$15 million), and the Romanian-American Enterprise Fund (\$25 million) followed. While not all of the ten (10) E&E Enterprise Funds were financially profitable, each of them made a contribution to the development needs of the countries where they operated and, through their Legacy Foundations, will continue to do so for many years in the future. Taken collectively, the

Funds' repayment rates demonstrate the benefits of using U.S. private sector skills and resources in conjunction with USG funds to achieve public policy objectives.

In the right economic and political circumstances, and with the assistance of a committed Board of Directors and appropriate USG/USAID monitoring and oversight, the Enterprise Fund model can serve as a critical catalyst to: (i) transform weak economic environments; support and encourage democratization and economic policy reforms; (ii) establish well-functioning and transparent financial and banking institutions; and (iii) provide growth capital and technical assistance to a wide range of SMEs within their host countries. Many regions of the world are still struggling with economic instability, a lack of sound financial institutions, and insufficient access to private sector capital, much like the E&E region in 1989. The Enterprise Fund model has the potential to achieve substantial economic development, and make improvements to the business and macroeconomic environment of a country, while also achieving profitable investment returns.

FINANCIAL & DEVELOPMENT ACHIEVEMENTS

Fund	Liquidation and Legacy
Albanian-American Enterprise Fund	Returned \$15 million of original \$30 million USAID grant to the US Treasury Endowed the Albanian-American Development Foundation with an estimated \$190 million to continue to promote broad-based private sector development.
Bulgarian-American Enterprise Fund	Returned \$27.5 million of original \$58 million USAID grant to the US Treasury Endowed the America for Bulgaria Foundation with approximately \$422.5 million to promote broad-based private sector development.
Baltic-American Enterprise Fund	Is expected to return \$25 million of original \$50 million USAID grant to the US Treasury Has endowed the Baltic-American Freedom Foundation with \$37.2 million to provide internships, research and scholarships.
Central Asian-American Enterprise Fund	17 million from an original grant of \$106 million, will benefit the US-Central Asian Education Foundation for business and economic education in Central Asia.
Hungarian-American Enterprise Fund	\$13 million from an original grant of \$73 million has been returned to U.S. Treasury (An additional \$2-5 million is expected) Has endowed the Hungarian-American Enterprise Scholarship Fund with approximately \$13 million to promote internships and scholarships; an additional \$2-5 million is expected.
Polish-American Enterprise Fund	Returned \$120 million of original \$255 million USAID grant to the US Treasury Endowed the Polish-American Freedom Foundation with \$263 million to continue to promote private sector development.
Romanian-American Enterprise Fund	Has returned \$25 million of original \$50 million USAID grant to the US Treasury Will endow the Romanian-American Foundation with \$125 million to continue to promote private sector development.
Slovak-American Enterprise Fund	Proceeds of approximately \$4 million of the original grant of \$64 million will benefit the Slovak-American Foundation for business and economic education and internships in Slovakia.
U.S.-Russia Investment Fund	Is expected to return approximately \$150 million of original \$328.9 million USAID grant to the US Treasury Has endowed the US-Russia Foundation for Economic Advancement and the Rule of Law with \$150 million to continue to promote private sector development.
Western NIS Enterprise Fund	Liquidation process has not yet begun

Appendix 14 – List of Documents Compiled Electronically on Accompanying CD USAID Graduation Reports and Retrospectives

Regional USAID A Decade of Change: Profiles of USAID Assistance to Europe and Eurasia, USAID

Regional USAID The Enterprise Funds in Europe and Eurasia: Successes and Lessons Learned, USAID, 2013

Bulgaria Legacy Mechanism as a Sustainable Partnership Tool: Lessons Learned for USAID Missions Approaching Phase-out, March 24, 2008, USAID, 2008

Bulgaria USAID/Bulgaria Assessment Report - Seventeen Years of Partnership in Transition 1990-2007, USAID Bulgaria, 2007

Croatia Overview of Programs, April 2007, USAID Assistance to Croatia, USAID Croatia, 2007

Czech Rep. Partnership for Change, USAID in the Czech Republic, 1997

Estonia Country Profile, Estonia, April 2008, USAID Estonia, 2008

Estonia Estonia Graduates from U.S. Foreign Assistance, USAID Estonia, 1996

Hungary Ten Years of Collaboration, A Retrospective Look at USAID's Role in Hungary's Transition, USAID Hungary, 1999

Latvia USAID in Latvia - Making a Difference, USAID, 1999

Lithuania Celebrating Lithuanian - American partnership, USAID Lithuania, 2000

Macedonia USAID in Macedonia: 1993-2011. A Story of Partnership and Progress, USAID Macedonia, 2011

Poland USAID and the Polish Decade, USAID, 1999

Romania Celebrating the Romanian - American Partnership, USAID Romania, 2007

Slovakia Slovak - American Development Partnership, USAID Slovakia, 2007

Slovenia Partnership for Transition, USAID Slovenia, 2011