FOREWORD

In this year's *Transition Report*, we discuss the challenge of sustaining economic growth in the EBRD's countries of operations. This challenge is threefold. First, while the countries of the EBRD region enjoyed strong growth and convergence with their richer neighbours prior to the global financial crisis of 2008-09, since the crisis their growth rates have consistently been lower than those of similar emerging markets elsewhere in the world. Second, many of those countries have now reached middle-income status and have to overcome the problem of the "middle-income trap". And lastly, in order to ensure that growth is sustainable in the long run, those countries need to develop environmentally friendly growth models.

The term "middle-income trap" is used to describe the marked slow-down in economic growth that is observed as emerging market economies reach middle-income levels. There is no consensus as to whether this trap is a universal phenomenon or whether it occurs at a specific income level. But the middle-income trap is a useful concept that qualitatively describes the experiences of many emerging markets in terms of the evolution of their growth models.

While transition from low to middle-income status is usually based on industrial development, most of which is concentrated in low-value-added sectors, further convergence involves the establishment of high-value-added industries and knowledge-based services. Whereas earlier stages of the convergence process require the adoption of existing technology and investment in basic education and physical capital, later stages are dependent on higher levels of education, research and development, and innovation.

Consequently, moving beyond middle-income status involves transition to a new set of political and economic institutions that provide incentives to develop new products and services. Such institutional changes may be hard to bring about – for example, because they run counter to the interests of incumbents that are benefiting from the existing growth model. Countries' failure to move to a new growth model lies at the very heart of the middle-income trap.

The nature of the middle-income trap in the EBRD region is somewhat different from that observed in other emerging markets. Most post-communist countries already had high levels of education, urbanisation and industrial development when they embarked on the transition process. Prior to 2008, their strong convergence with more advanced economies tended to be driven not by the accumulation of factors of production (capital, labour and human capital), but by increases in total factor productivity (that is to say, the efficiency with which those factors of production were used). However, as the inefficiencies inherited from the central planning era have been eliminated, those countries have encountered the typical challenges posed by the middle-income trap. This year's *Transition Report* uses country-level, industry level and firm-level data to examine those challenges in detail.

We start by documenting the post-crisis slow-down that has been observed in the EBRD region. In recent years, those countries' growth rates have not only been below the levels recorded prior to the crisis, they have also lagged behind the rates seen in comparator countries with similar levels of development. In this sense, the countries of the EBRD region have certainly faced greater middle-income growth challenges than other emerging markets.

The other distinguishing feature of the middle-income trap is the "environmental Kuznets curve". On average, middle-income countries tend to have higher levels of pollution per unit of GDP than both poorer countries (which have not yet established polluting industries) and advanced economies (which have moved on and developed greener post-industrial growth models).

This issue is especially salient in post-communist countries that inherited an industrial base with disproportionately high pollution levels. As part of their transition to market economies, the countries of the EBRD region have reduced their pollution levels substantially, but they remain significantly less green than other middle-income countries.

In order to free themselves from this environmental element of the middle-income trap, the countries of the EBRD region need to adopt environmentally friendly economic policies (with the removal of energy subsidies featuring high on the list of priorities) and develop institutions that will help to finance investment in the green economy. Green debt instruments (such as green bonds) have a key role to play in this regard, but so do equity markets. By definition, equity investors have a stake in the long-term value of the assets that they hold. They therefore have incentives to select projects that will not be "stranded" in the future once every country has adopted a green policy mix.

Our analysis shows that listed companies where green revenue accounts for a larger percentage of total revenue already have higher equity values per US dollar of current profits than other firms – that is to say, that equity markets are optimistic about the future profits of green companies. Of course, well-functioning equity markets require strong political and economic institutions. Improving governance at both country and firm level is an essential part of breaking free from the middle-income trap.

Sustaining growth in transition economies will not be easy. There is no silver bullet – no one-size-fits-all solution. However, the experiences of countries that have successfully achieved the transition to high income levels provide grounds for optimism. By strengthening their institutions, supporting firm dynamics and innovation, integrating their firms into the global economy and investing in sustainable infrastructure, the countries of the EBRD region should be able to complete their transition to sustainable market economies.

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MOVING BEYOND MIDDLE-INCOME STATUS INVOLVES TRANSITION TO A NEW SET OF POLITICAL AND ECONOMIC INSTITUTIONS THAT PROVIDE INCENTIVES TO DEVELOP NEW PRODUCTS AND SERVICES.