Institutions, Markets and Economic Performance
What drives growth in the transition countries?

Foreword

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Transition has been the most ambitious and important socio-economic and political experiment in the last 100 years, rivalled only by the socialist experiment it was meant to undo. Transition has had a direct impact on a quarter of the world’s population and changed the social and political landscape far beyond the countries immediately affected. The transition experience has also affected how we think about economic growth and development. In particular, our understanding of some fundamental questions has improved significantly: Why have certain countries grown rich and others have not? Why are some reforms implemented while others are not? Why are some development projects succeeding while others fail?

Providing answers to these large questions is important to a development institution like the European Bank for Reconstruction and Development (EBRD), which was set up in 1991 to promote the transition of central and eastern Europe and the former Soviet Union to functioning market economies and multiparty democracies.

At the time there was very little systematic thinking, directly relevant experience or data to help in the design and implementation of policies or projects to support transition. Private sector development, now a core approach to development policy, was still in its infancy. The EBRD, like other organisations, governments and individuals that became involved in transition, had to improvise, largely through trial and error.

Over time, understanding of transition has improved in the academic and policy-making communities. Today, conceptual models and massive amounts of data on improving quality and accumulated experience can help guide policy choices. The EBRD has also learnt through its operations how to better promote transition, and it has acquired its own tools of assessing its performance. After more than a decade of transition in Europe it seems timely for the EBRD experience and methods to be confronted in a more systematic fashion with that of the broader research community. Thanks to generous support from the Japan-Europe Cooperation Fund (JCEF), the EBRD’s Office of the Chief Economist launched a broad review with the help of most of the leading economists involved in research on transition.

Perhaps the most profound insights of the review concern the role of institutions in supporting and possibly frustrating economic growth and development. In itself, the acknowledgement that institutions matter is not new; much of traditional development economics is about institutions. But the ability to analyse and measure institutions, and understand the magnitude of their influence, has improved dramatically. The project supported by JCEF contains many examples of this line of work. This brief publication summarises some of the main findings from this review.
Introduction

Economic performance has varied widely across the transition countries of Europe since 1989. All suffered a large decline in economic activity in the first few years. But the countries of central eastern Europe – the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia – stopped the decline and started growing sooner and faster than the Baltic states of Estonia, Latvia and Lithuania, the south-eastern European countries and Russia, Ukraine and the other members of the Commonwealth of Independent States (CIS). The Baltic states and the CIS experienced a deeper decline, a later turn-around but faster growth since 1998.

What can explain these differences and the broader contrasts in economic growth and development around the world? Why have the ‘Asian tigers’ experienced a successful economic take-off, whereas the economies of most African countries have been decimated by misery, war and disease? Why has the Argentine economy, one of the richest in the world in the early 20th century, fared so badly, whereas China has been growing at over 8 per cent a year throughout its past two decades of development?

An EBRD research programme funded by the Japanese government through the Japan-Europe Co-operation Fund (JCEF) has brought together a group of leading economic researchers to explore these issues, focusing on the role of institutions and institutional change in driving a country’s economic performance. A series of studies has examined not just the traditional economic institutions of the market but also political, legal and cultural institutions – including customs and traditions, property rights, the political system, the judiciary and the governance of these institutions.

Economists often refer to the transition economies of the former Soviet Union and central and eastern Europe. But as Gérard Roland has pointed out, for these countries, transition involves far more than the economy. They are also creating their institutions of democracy and governance, including the executive, legislative and judicial branches of government; a free press; an openness to private organisations and entrepreneurship; a network of regulators; a new network of contractual relationships, both domestic and abroad; and new social norms and values (Roland, 2002).

Economic transition is intimately connected with these institutional transformations, requiring large-scale changes in the technology, organisation and ownership of firms; the allocation of labour; and the way capital is apportioned for investment. Jan Svejnar calls these ‘Type II reforms’, contrasting them with the ‘Type I reforms’ of macroeconomic stabilisation, price liberalisation and the dismantling of the institutions of communism (Svejnar, 2002).

Type II reforms include:

- the privatisation of large and medium-sized enterprises
- the establishment of a market-oriented legal system labour market regulations and institutions related to public unemployment and retirement systems
- the development of a viable commercial banking sector and the appropriate regulatory infrastructure.
Svejnar argues that all these institutional changes require not only the withering away of an omnipresent dictatorial state but also the creation of a reliable state apparatus that provides a ‘level playing field’ for the market economy.

The EBRD research programme has examined the institutional drivers of growth performance at the broad national level, as well as key institutions within particular markets and sectors of the economy. It has explored what kinds of institutional changes have positive and negative effects on improvements in productivity in the private sector, on unemployment and restructuring in the labour market and on the emergence of an effective financial system.

The studies have focused primarily on the experiences of the former command economies of Europe, though some have also looked at the relationship between institutions and economic performance in Asia and Latin America.

The researchers have tried to answer these questions about the relationship between institutions, markets and economic performance using a variety of sophisticated analytical techniques and a range of data sources, including the EBRD’s Business Environment and Enterprise Performance Survey (BEEPS) and Banking Environment and Performance Survey (BEPS), both funded through the EBRD-Japan research programme.
Institutions and economic growth

What do economists mean when they talk about institutions? An overview of ‘the new institutional economics’ by Oliver Williamson suggests four levels of analysis: first, customs, traditions, norms and religions, which change very slowly; secondly, the institutional ‘rules of the game’ – property rights and the working of the political system, the judiciary and the bureaucracy; thirdly, the ‘play of the game’ or the governance of institutions; and fourthly, resource allocation and employment (Williamson, 2000).

It is now widely agreed among economists that institutions at each of these four levels are of great significance in determining a country’s long-term economic growth performance, and that all of them are susceptible to economic analysis. But what are the most important institutions for successful development in transition countries? What are the key drivers of the institutional change needed to support the emergence of well-functioning markets? And what are the constraints on such reforms?

The EBRD-Japan research programme has provided new insights into the factors that contribute to the development of market-supporting institutions, particularly the role of political, legal and cultural institutions and the extent of transition countries’ integration into international markets.

To understand the complex relationships between institutions, markets and economic performance, questions need to be answered about the definition and measurement of institutions (in terms of their extensiveness and effectiveness), the assessment of which institutions are most important for growth and an understanding of what drives institutional reforms and what holds them back.

Institutional persistence and institutional change

The research paper by Daron Acemoglu and James Robinson sets out an analytical framework for studying institutional persistence and change, which emphasises the importance of the historically determined structure of political and economic institutions.

Acemoglu and his colleagues have published several papers arguing that institutions play a more prominent role in development than has been generally accepted. One argues that countries that were relatively rich in 1500 are now relatively poor, a point that is inconsistent with the view that geography is destiny (Acemoglu et al, 2002). The argument, supported by empirical evidence, is that this reversal is due to colonising countries treating rich and densely populated countries differently from poor and sparsely populated countries. In the former, they followed policies of extracting wealth, while in the latter they followed policies that encouraged investment.

Another paper uses the differences in mortality rates faced by Europeans in different countries to study further the degree to which different policies lead to different institutions, which in turn lead to different development paths (Acemoglu et al, 2001). Some of the methods and conclusions of this paper are still being debated, but this line of work has already stimulated substantial research that rethinks the development process.

Their research paper develops a framework for thinking about the determinants of prosperity and democracy. The approach emphasises that economic institutions are the primary determinant of prosperity but that the economic institutions that emerge in a society depend on the distribution
of political power. Key determinants of political power are the political institutions, notably the institutions of democracy. Economic institutions that promote prosperity are those that provide incentives for the broad mass of society and such institutions may be associated with democratic political institutions, since democracy tends to give political power to the broad mass of people.

But while prosperity and democracy may be related, this does not mean that income causes democracy or that democracy causes a society to be prosperous. Of more importance is the historically determined structure of political and economic institutions and critical historical junctures such as European colonialism. The beginning of the transition in the formerly planned economies of Europe might be seen as another key juncture.

*The institutions that really matter for growth*

The series of studies by Daron Acemoglu and his colleagues provide empirical evidence of the causal impact of institutions on growth. But as the research paper by Jon Jellema and Gérard Roland argues, progress needs to be made in understanding the precise channels between institutions and economic performance on at least two fronts.

- First, measurement issues: most cross-country analyses of how institutions affect economic performance use aggregate measures of institutions. These are usually based on subjective evaluations of institutions, which can be volatile. More importantly, these measures are likely to be affected by perceptions that are inevitably tainted by a country’s economic performance.

- Secondly, and more importantly from a policy point of view, the institutions that are most relevant for growth. There are data on three broad categories of institutions: legal, political and cultural. But there is very little research comparing the relative effect of specific institutions.

Jellema and Roland attempt to assess which institutions really matter for economic growth using a technique called ‘principal components analysis’. They draw on the large number of available measures of institutions that are completely or mostly objective, and aggregate them into ‘institutional clusters’.

Their measures of legal institutions draw on a series of papers by Andrei Shleifer and colleagues, which gather details of specific laws and procedures on the books in countries’ legal systems, especially rules covering quintessentially economic transactions such as selling labour or buying securities.

For example, one paper covers the power and reach of the judicial system for 71 countries, including judge tenure, case law, judicial review and constitutional rigidity (La Porta et al, 2004). Others cover different aspects of the regulatory burden, the number and type of laws governing formal employment contracts, and the rights and responsibilities guaranteed to corporate shareholders and creditors.

Measures of political institutions include those compiled by Torsten Persson and Guido Tabellini: electoral rules, executive regime types and numbers of legislators and legislative districts (Persson and Tabellini, 2003).
Other data sources measure the number and strength of checks on the power of both legislature and executive; the extent of revenue and regulatory authority for local and regional governments; where a country lies on a scale between ‘institutionalised democracy’ and ‘institutionalised autocracy’; and the degree of freedom in terms of both political rights and civil liberties.

For cultural institutions, the research draws on the World Values Survey, which is designed to provide a measurement of cultural values in all major areas of human concern.

Categories include ‘perceptions of life’ (what respondents consider is important in their lives – friends, family, politics, work, etc.); ‘work’ (what they consider is important in a job – good pay, good hours, respect from colleagues, etc.); ‘politics and society’ (what they think about the role of government and citizens, and their confidence in various sectors of society); and ‘national identity’ (how strongly they identify with their city, region and country, and how they feel about other countries and supranational bodies).

The impact of political institutions on economic performance

The main result that emerges from Jellema and Roland’s analysis is that the institutions that matter the most for long-term growth are the political institutions of checks and balances limiting the power of the executive. A secondary effect is played by anti-authoritarian values. A modest role is also played by constitutional stability but, perhaps surprisingly, the legal institutions that they look at play no role.

It is important to note that these results are not about the size of government, and they show that it is not one specific institution but rather a broad set of institutions of separation of powers that matters. Intuitively, these are political institutions that favour protection of private property rights and limit government encroachment on the private sector. The research also suggests that institutional fine-tuning will not deliver miraculous results. Rather, it is commitment and adhesion to the values of institutions creating checks and balances that are the most secure path for long-term growth.

While political institutions appear to be most important for growth, there is sufficient evidence that they are intertwined with a democratic and participatory culture. This qualification is not trivial because it suggests that while political institutions can change rapidly, they need to be supported by a set of values and beliefs that is shared by a sufficiently large part of the population.

As an example of how significant political change is for economic transition, the research paper by Evgeny Yakovlev and Ekaterina Zhuravskaya looks at the institutional determinants of Russia’s progress in deregulation across its different regions. The central question they explore is what determines whether deregulation started by a central government in a large federation will yield results at the local level.

Through a series of annual surveys, the Centre for Economic and Financial Research in Moscow, in cooperation with the World Bank, has been monitoring the regulatory burden imposed by government agencies on small businesses. Their analysis looks at various measures of the quality of political governance and the extent of civil society as potential determinants of local enforcement of federal deregulation laws.
On the whole, the survey results give some grounds for cautious optimism. In terms of subjective assessments of the business environment, there has been a marked improvement, although the pace of progress appears to have slowed over time. The effect of new laws on business regulation and taxation has been positive, but the burden on small firms remains high and the observed situation does not conform to the norms spelled out in the laws.

In terms of variation in the regulatory burden across Russia’s regions, the research finds that there are three factors that have a significant and positive effect on reform progress:

- the initial (pre-reform) state of government transparency in a region
- the extent to which regional authorities are under the influence of powerful industrial groups representing large regional businesses
- the extent to which regional budgets comprise the local government’s own revenues rather than transfers from the federal centre.

These findings confirm the importance of fiscal incentives for local governance in a federation and the benefit of creating demand for positive institutional change on the part of large industrial lobbies.

The impact of cultural beliefs on economic performance

The research paper by Rafael di Tella and Robert MacCulloch looks in more detail at the effect of cultural institutions on economic performance, focusing on cultural beliefs and, within them, economic beliefs – those broadly concerned with meritocracy and poverty – and non-economic beliefs. Like Jellema and Roland, they analyse data from the World Values Survey documenting the patterns of beliefs across countries and regions, their impact on economic performance and the characteristics of nations that cause different kinds of belief systems to evolve.

The evidence these researchers gather indicates that economic beliefs can be divided into two factors.

- First, beliefs about poverty and the role that individual needs should play in determining income.
- Secondly, the role of merit in determining income and attitudes about the desirability of private ownership of property.

Non-economic beliefs have far less clear divisions, though there is some evidence that suggest a factor embodying the desirability of tradition relative to technology and the extent to which the environment should be given priority over economic growth. But overall the researchers have found that variations in non-economic beliefs have no effect on economic performance.

In contrast, economic beliefs about the role of merit and luck in determining income do have significant economic effects. Controlling for the initial level of GDP (to take account of convergence), openness to trade, legal origins (as a proxy for institutional quality) and latitude of the country (to capture geographical effects), it turns out that countries with economic beliefs that place less weight on merit and hard work (and are more concerned with the unfairness of
being poor, not being able to escape poverty and government help for the poor) have lower growth rates.

These results indicate that economic beliefs may have a strong direct economic impact in addition to any indirect effects via their impact on trade policies and institutions (though it should be noted that causality may well flow the other way too, with economic outcomes influencing economic beliefs). One potential mechanism could be that beliefs about the difficulty of escaping from poverty and (economic) life being unfair leads individuals to try less hard at work and less hard at searching for a good job. The effect is to lower overall economic performance.

It remains possible, of course, that other beliefs – for example, that the government should do more to help the poor – lead voters to support different political parties. Consequently, beliefs may also have a strong indirect effect on economic performance to the extent that they lead to parties changing institutional arrangements and policies.

The paper also tests for the importance of the dispersion of beliefs on economic performance, finding some weak evidence to suggest that more dispersed beliefs may potentially damage a nation in terms of its rate of GDP growth.

The researchers also seek to identify some of the factors affecting the formation of beliefs. With respect to economic beliefs, they find that higher ‘country risk’ pushes people strongly towards the views that the poor are not lazy or lack willpower, that there is little chance of escaping from poverty, that the government should be doing more for the poor and that employees and/or the government should be more involved in running businesses.

Greater dependence on natural resources has the same effect as higher country risk on people’s views about government help for the poor. By contrast, these factors have strikingly different effects on people’s non-economic beliefs. For example, higher country risk and more natural resources reduce people’s conviction that the environment should be afforded more protection. Higher country risk also tends to make people less tolerant of other groups (though country risk could be high because people are less tolerant of other groups).

Overall, the evidence from di Tella and MacCulloch’s research supports the view that cultural specificities may be able to explain why certain institutions cannot be transferred to other countries with different cultural histories and underlines the limits to policy activism.

*The impact of international integration on economic performance*

Over the past two decades, the world economy has become increasingly integrated, notably in terms of openness to trade in goods and services. The transition countries are particularly striking examples of this process, but the process of international integration has not been uniform. Integration has been rapid and deep in the countries of central eastern Europe and the Baltic states, all of which acceded to the European Union in 2004. But in south-eastern Europe and the CIS, there has been far less integration into the world’s product and capital markets.

Openness and international integration can lead to dramatic improvements in economic performance through the introduction of new technologies and access to larger markets. (These positive effects – operating particularly through competition from foreign entrants and foreign
At the same time, integration places significant demands on a country’s economic, political and social institutions. Trade across long distances and between new trading partners requires confidence in the enforcement of contracts. And the increased competition resulting from participation in global markets can force costly adjustment on some previously protected sectors.

Therefore, open trade policies need to be accompanied by a strong institutional framework that can enforce contracts and support the process of adjustment – particularly in the labour market – if international integration is to be lasting and successful. The challenge is to find a way of encouraging transition countries to undertake the necessary institutional reforms together with the liberalisation of trade.

The research paper by Susan Helper, David Levine and Christopher Woodruff looks at how public investment in education in Mexico and subsequent educational outcomes – enrolment rates, pupils’ achievements and repetition rates (when underachieving pupils have to repeat a year’s education) – were influenced by the confluence of three forces that bring together international integration with domestic institutional change.

These forces were economic liberalisation through Mexico’s participation in the North American Free Trade Agreement (NAFTA); democratic opening, with elections at all levels becoming much more competitive and opposition parties capturing several governorships and in 2000, the presidency; and decentralisation of education, giving the states more responsibility. Their analysis leads to three conclusions.

- First, following implementation of NAFTA, agricultural countries showed the largest gains in education enrolment and attainment and the greatest decline in repetition rates. This is consistent with the government’s shift in resources to low income states and its policy of compensating the losers from NAFTA.
- Secondly, when states and municipalities are governed by the same parties, school enrolment is higher and repetition rates are lower, especially when budgets are tight.
- Thirdly, there is little systematic evidence that growth in manufacturing was associated with better educational qualifications. Manufacturing appears to be negatively associated with enrolment rates, especially in the 16-to-18-year age range, but manufacturing is positively associated with changes in educational achievement.

Openness to trade in Central Asia

The EBRD’s efforts to foster the transition to an open market-oriented economy encompass the former Soviet Union countries of Central Asia. The research paper by Clemens Grafe, Martin Raiser and Toshiaki Sakatsume investigates barriers to trade within this region.

The study looks at data on consumer goods prices in the region, notably Kazakhstan, the Kyrgyz Republic and Uzbekistan, and reaches the surprising conclusion that regional market integration is quite high. It seems that ‘shuttle trade’ – unofficial trade – is effective in taking advantage of
arbitrage opportunities and hence making price variations across borders much smaller than conventionally thought.

At the same time, it seems that within-country barriers to trade are significant and go beyond simple transport costs related to the distance between two locations. Rather, internal barriers to trade, such as numerous roadblocks and attempts by local governments to restrict access to markets and bazaars, are driving up price differences across regions to levels that are at least as high as differences across countries.

Policy implications

The most important institutions for long-term growth are the political checks and balances that limit executive power. But new political institutions need to be based on values and beliefs that are supported by a large part of a country’s population.

The link between domestic institutional reform and integration into the world economy is of central importance to the transition countries. While EU accession has played a crucial role in supporting far-reaching institutional reforms in the countries of central eastern Europe and the Baltic states, international integration of the countries of south-eastern Europe and the CIS is far from complete. Moreover, the lack of regional cooperation, particularly in Central Asia, greatly increases transport costs, weakening the potential for access to world markets.

Overcoming limited international integration requires change in three areas.

- The first is to improve market access, in particular to the region’s most important market, the European Union.

- The second area is the link between improved market access and the introduction of structural and institutional reforms. Neither the World Trade Organization (WTO) nor the European Union’s commercial relations with non-EU members are likely to generate the same depth of domestic reform as EU accession. But, indirectly, both could provide a significant boost to reform by providing incentives for more liberal trade policies and better economic governance.

- The third area is support for closer regional cooperation and integration to complement the process of international integration. Throughout the region, preferential trade arrangements and other forms of closer regional integration need to focus on enhancing rather than diverting trade, transit and transition.

Summary: Institutions and economic growth

The institutional framework plays an important role in determining a country’s long-term economic growth. But what are the most important institutions for successful development? What drives the institutional change that is needed to support the emergence of well-functioning markets? And what holds back these reforms?

The EBRD-Japan research programme has provided new insights into the factors that contribute to the development of the political, legal and cultural institutions needed to support market
economies. It has also examined the extent of transition countries’ integration into international markets.

Analysis has revealed that a complex relationship exists between institutions, markets and economic performance. The programme has studied these links in detail and reached the following conclusions.

- The most important institutions for long-term growth are the political checks and balances that limit executive power. Anti-authoritarian values also play an important role.

- Institutional fine-tuning is not enough. A firm commitment to a system of checks and balances provides the most secure path for long-term growth.

- Political institutions need to be based on values and beliefs that are supported by a large part of the population.

- Open trade policies need to be accompanied by a strong institutional framework that can enforce contracts and support change – particularly in the labour market – if international integration is to be lasting and successful.
Institutions and the performance of firms

The performance of firms is of central importance to how the economy of the country as a whole performs. But what are the institutions that matter most for generating improvements in the performance of firms in the transition countries? How can the productivity gaps with developed countries be narrowed? And how do increased competition (including new market entry, particularly by foreign firms), changed ownership structures and greater foreign investment affect the productivity of firms in different sectors and at different levels of productivity?

The EBRD-Japan research programme has examined the types of institutions that are most appropriate at particular stages of a country’s economic development and how they can contribute to enhancing the productivity and growth of enterprises. It has also analysed how firms are affected by the interplay between institutions, competitive pressures and a country or sector’s state of technology, helping to map out the sequencing and priorities for reform strategies.

Productivity and the significance of ‘distance from the frontier’

Understanding the relationship between appropriate institutions and the level of technological development is particularly important in transition countries because in many of these countries there is a large distance between their level of technological development and the technological frontiers in OECD countries. As several of the research papers show, the interdependence between production technologies and market institutions has important implications for the design of reforms for understanding the process of catch-up growth.

The research paper by Daron Acemoglu, Philippe Aghion and Fabrizio Zilibotti provides a theoretical framework for thinking about structural reform and productivity at the enterprise and country levels. The central idea is that productivity growth can be generated either by implementation activities aimed at imitating or adapting the current world technology frontier in the corresponding industry or by frontier innovations that improve on the previous local technology.

The closer a country or sector is to the technological frontier, the more it must rely on frontier innovation to maximise productivity growth. In contrast, far-from-the-frontier countries will gain more by emphasising implementation activities. It is important to recognise that the institutions or policies that encourage implementation activities are not the same as those that encourage frontier innovation.

Acemoglu and his colleagues focus on four types of policies:

- first, competition, entry and openness, which are more growth-enhancing for sectors closer to their technological frontier
- secondly, the financial sector, which should favour large-scale investment (which is more capital intensive) far from the frontier and selection of investment in innovative projects closer to the frontier
thirdly, labour markets, which should emphasise long-term specific investments in skills far from the frontier and flexibility closer to the technological frontier

fourthly, the internal organisation of firms, which should be more centralised far from the frontier where growth relies more on implementation, but more decentralised closer to the frontier where growth relies more on employees’ initiatives and ideas.

These ideas partly underlie the empirical studies conducted in the other research papers on competition, institutions and firm performance.

The impact of competition on the performance of firms

The importance of competition for the performance of firms has long been a central tenet of economics, but until relatively recently there has been a lack of detailed data on firms’ inputs, outputs and competitive situations to test the theory. In the mid-1990s, Stephen Nickell published an influential paper which showed that increasing the intensity of product market competition raises innovation and productivity.

Nickell also opened up two major new areas for future research on productivity: the significance of ‘diffusion’ – of new technologies and new ways of organising firms; and how the productivity of firms can vary, not just between industries but also within industries and even within firms (Nickell, 1996).

So how does competition affect productivity growth? There seem to be three ways, all arising from the phenomena of the entry and exit of firms from an industry.

• First, the threat of new firms entering the market may increase the efficiency and innovative efforts of incumbent firms.

• Secondly, entry and exit means that low-productivity plants are replaced with high-productivity entrants, and hence increases aggregate productivity.

• Thirdly, entry may induce incumbent firms to organise work more effectively and to learn by imitating new entrants who are using superior technology or superior organisational structures.

Studies by Philippe Aghion and colleagues have looked at the relationship between market entry and productivity growth of incumbents in the United Kingdom and India. While these studies find a positive relationship, there is substantial variation. In particular, the impact of entry is strong in technologically advanced industries; it is weak or negative in technologically laggard industries. For industries near the technological frontier, productivity growth increases sharply with the threat of entry by new firms; for industries behind the frontier, it declines (Aghion, Blundell, Griffith, Howitt and Prantl, 2004; and Aghion, Burgess, Redding and Zilibotti, 2004).

The explanation is that incumbent firms that are sufficiently close to the technological frontier can survive and deter entry by innovating. An increased threat of entry therefore results in more intense innovation aimed at escaping that threat.
In contrast, firms and sectors that are far from the frontier are in a weaker position to fight external entry. For these firms, an increased threat of entry reduces the expected payoff from innovating since their expected life horizon has become shorter.

The research paper by Philippe Aghion and Evgenia Bessonova looks at how increased entry affects productivity growth across the Russian manufacturing sector. The main finding, which mirrors Aghion and his colleagues’ findings for the United Kingdom and India, is that increased entry enhances productivity growth in incumbent domestic firms that are initially closer to their technological frontier, whereas it discourages productivity growth in firms that are far from the frontier. Indeed, firms and industries that are far from the frontier may actually be harmed by liberalisation.

The impact of ownership on firm performance

A significant feature of the transition process has been the change of ownership of firms, as state-owned firms have been privatised or closed down. Many studies show that private firms have performed significantly better than state-owned ones but some research has found varying performances among different types of private firms. For example, it has been argued that new private firms have tended to perform better than privatised firms. There are also questions about the impact of the concentration of ownership of private firms.

The analysis in Acemoglu, Aghion and Zilibotti’s research paper suggests that firms in more advanced sectors or sectors facing a higher degree of uncertainty should decentralise decision-making to lower levels within their organisations in order to grow faster and increase profitability. This suggests that the significance of the relationship between ownership and control depends on the sector in which a firm operates.

The research paper by Irena Grosfeld uses a panel of all non-financial Polish firms listed on the Warsaw Stock Exchange to analyse the determinants of ownership concentration and the circumstances under which ownership concentration enhances firm performance. The Warsaw market was created in 1990-91 and its market capitalisation grew steadily through the 1990s with the number of listed firms rising from 8 in 1991 to 230 in 2000.

The quality of the data is unusually high for a transition country as the information requirements of the exchange are comparable to those of western European stock markets. The information from the audited balance sheets and income statements is extended by additional information on the origin of the firm (new versus privatised); the method of privatisation; ownership data on the percentage of cash flow rights and voting rights for all shareholders; the identity of all shareholders; and daily stock prices.

Grosfeld’s research tests the hypothesis that owners’ monitoring of managers may be less valuable in an uncertain environment. In such an environment, managers may know more than shareholders about the project or the activity that should be chosen. If the managers do not have such information, they should have appropriate incentives to innovate and to look for valuable investment opportunities. Excessive monitoring may be potentially costly in terms of suppressing managers’ initiative so the owners might prefer to limit their equity holding in order to provide a commitment to non-intervention.

The implication is that ownership concentration will be lower in firms (and industries) in which it is less well known what should be done and how. In such a situation, there is greater need for
imaginative and innovative action from managers, and a more dispersed ownership structure may limit the cost in terms of suppressing managers’ initiative.

This is precisely what Grosfeld finds in the data:

- first, ownership concentration is significantly lower for high tech firms or for firms with a higher share of their total capital consisting of intangible assets
- secondly, ownership concentration is more negatively correlated with productivity performance in high-tech sectors.

**How foreign direct investment and ‘knowledge spillovers’ affect firm performance**

Foreign direct investment (FDI) is widely considered to be an important catalyst of economic development. Both economists and policy-makers believe that FDI can improve host countries’ technological capacities and managerial style because of both the direct effect on the companies that receive FDI and ‘spillover effects’ on domestic companies in the same industry and in upstream industries.

In order to strengthen these effects, governments in many developing and transition countries introduce special policies aimed at attracting FDI and/or enhancing spillovers. In particular, the regulation of FDI has become one of the key issues for many recently negotiated preferential trade agreements and bilateral trade agreements.

The rationale for the direct effect of FDI on firms’ productivity is that FDI can only be made if the investor has an advantage over local firms either because of superior technological knowledge or because of better managerial techniques, distributional networks, etc. As a result, firms with FDI should usually be more productive than domestic firms. This prediction is supported by virtually all empirical studies conducted both for developing and developed countries.

Research on FDI and its effects on domestic firms usually concentrates on productivity differences between firms with FDI and domestic firms and on productivity spillovers from firms with FDI to domestic firms. At the same time, theoretical considerations used to justify empirical analyses usually state that firms receiving FDI should possess different technologies and that their entry should stimulate technological upgrade by domestic firms.

Therefore, the theory may be reinterpreted as suggesting that foreign firms have different production functions than domestic firms and that market entry by firms with FDI stimulates production function change by domestic firms. In addition, more productive foreign firms with superior technologies should have a larger impact on both the productivity and the production function of domestic firms.

The research paper by Irina Tytell and Ksenia Yudaeva looks at the evidence from four transition countries – Poland, Romania, Russia and Ukraine – and demonstrates that this new interpretation of the theory is confirmed by the data.

In the more developed countries with better institutions and larger FDI inflows (Poland and Romania), a foreign presence is associated with higher capital intensity and lower labour intensity of domestic firms. Even though foreign entry causes capital-labour ratios to decline
initially, further accumulation of foreign capital tends to stimulate changes in production by domestic firms toward more capital-intensive activities.

This effect may reflect better technologies brought in by foreign firms once they become established in the host country, as well as their increased willingness to outsource more sophisticated parts to local producers. The absorptive capacity of domestic firms is also important: the evidence of the change in production towards more capital-intensive technologies is strongest in areas where the labour force is more educated.

In contrast, in countries with worse institutions and correspondingly smaller FDI inflows (such as Russia), a foreign presence is associated with lower capital intensity and higher labour intensity of domestic firms. The shift to more labour-intensive technologies happens primarily where foreign capital is more abundant. Domestic firms may choose to adapt this way in order to secure a separate market for themselves by specialising in serving relatively poor segments of the population.

This effect may also reflect the reluctance of foreign firms to outsource anything but the production of simple labour-intensive components to domestic suppliers. This reluctance may be because of the lack of confidence in the quality of domestically produced goods and the ability of local firms to deliver their products on time.

The effect on production is observed only in the relatively more educated and less corrupt regions. In highly corrupt regions, foreign firms do not exhibit any productivity advantage over domestic firms, possibly as a result of the attitude of local authorities, which in turn is lobbied for by domestic producers.

As for conventional productivity spillovers, the study fails to find evidence of their presence except in a few special cases. In Romania, a foreign presence leads to lower productivity by domestic firms after one year, but this effect is present only in low-education regions and appears to lessen as more foreign capital is accumulated.

In Ukraine, a foreign presence is associated contemporaneously with higher output by domestic firms in regions with high levels of education. In Russia, negative spillovers occur in the less corrupt regions, where foreign firms are more than twice as productive as domestic firms. Also, importantly, export-oriented foreign firms in Russia generate positive spillovers on domestic firms. Since these foreign firms bring cutting-edge technologies to host countries, the scope for knowledge spillovers is higher for those domestic firms that compete with or work as suppliers for export-oriented foreigners.

More generally, the productivity of foreign firms matters: in areas where foreign entrants are more productive, domestic companies show higher productivity in the following year, as well as larger capital-labour ratios.

**Institutional constraints on enterprise success**

The quality of the business environment varies considerably across the transition countries. Even within individual countries, assessments differ greatly from firm to firm. The research paper by Wendy Carlin, Mark Schaffer and Paul Seabright investigates the dimensions of institutional quality that matter most for generating improvements in enterprise performance.
They measure the value of different constraints by using data from a survey of managers in more than 50 countries about which aspects of the business environment inhibit the operation and growth of their firms. The data collected on the relative importance of different constraints enables them to identify the most important public goods and services for the state to improve as well as priorities for reform.

The researchers use the data to draw conclusions about the relative importance of different constraints on growth and how these vary across countries and types of firm. The evidence suggests that:

- telecoms infrastructure is never an important policy priority for any country
- transport is important only for some very poor or war-torn countries
- electricity is the only form of physical infrastructure whose failings rank as important for a large group of countries, mainly in Africa and southern Asia
- crime and corruption are important in many countries, especially in central and Latin America, and weaknesses in the administration of the tax system are of particular importance in the CIS
- labour regulation is a concern only for relatively prosperous countries
- more efficient firms are especially constrained by poorly-functioning customs regulations and inadequacies in the legal system
- it is private rather than state-owned firms that are the likely beneficiaries of improvements in macroeconomic stability and policy predictability as well as in the functioning of the legal system and of reductions in corruption and crime.

The Business Environment and Enterprise Performance Survey

The EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS) has compiled the experiences of approximately 20,000 firms in 26 transition countries plus Turkey in three rounds: 1999, 2002 and 2005. Furthermore, to set a benchmark for the transition countries, a survey of comparator countries was conducted in 2004-05 covering Germany, Greece, Ireland, Portugal, South Korea, Spain and Vietnam.

The survey examines the quality of the business environment as determined by a wide range of interactions between firms and the state. The findings are described in detail in the Transition Report 2005: Business in Transition.

Competition policy, privatisation and economic performance

Competition through the entry of new firms into the market is an essential element of transition towards a market economy. But which policies are needed to enhance the intensity of competition most effectively? In principle, a broad range of economic policies can promote rivalry, including competition policy, trade liberalisation and policies aimed at encouraging
entrepreneurship and reducing barriers to entry and exit.

Privatisation can also, in principle, lead to the creation of a more competitive environment. But because of the transition countries’ legacy of pervasive state-owned monopolies, there is a clear danger that privatisation simply implies the move from a state-owned monopoly to a private one.

Barriers to entry that arise from high levels of market concentration, state ownership and control, and rigidities and bottlenecks in the mobility of resources are all likely to be prevalent in transition countries, and can often encourage anti-competitive behaviour by enterprises. Most transition countries (as well as many mature market economies) still have a larger number of administrative and regulatory barriers to competition, including the discretionary granting of various forms of subsidies to loss-making enterprises.

The research paper by Maria Vagliasindi explores some of the main drivers behind the varying intensity in competition across countries and at the enterprise level. The focus is on the effective implementation of competition policy, which, given the initial conditions prevailing in transition countries, is a much more challenging task than in advanced countries.

The study examines the main policy and structural determinants of the intensity of competition at the enterprise level across transition countries, using data from the three BEEPS. The key findings are as follows.

- At the country level, competition policy implementation is significantly and positively correlated with the intensity of competition.
- In contrast, privatisation is either uncorrelated or is negatively correlated with the intensity of competition. This confirms that in the absence of the development of adequate market-supporting institutions, privatisation alone does not lead to a more competitive environment.

Policy implications

Research on the importance of competition in driving productivity growth has direct implications for policy debates around the world on privatisation, deregulation and competition policy. Of course, competition should be encouraged not only at the national level, but also by openness to the international economy. Policies that encourage trade liberalisation, foreign direct investment and regional integration are all significant here.

The research confirms the importance of reinforcing the powers of the national competition authorities. It also suggests the value of general policy measures encouraging the start-up of new, innovative enterprises and taking a more relaxed view of failures – for example, in how bankruptcies are handled.

The studies of market entry and productivity growth suggests that policies aimed at decreasing or removing entry barriers alone may not be sufficient to foster productivity growth of incumbent firms in all sectors, even though such policies are likely to be growth-enhancing on average.

Two particular inferences may be drawn from the analysis of business constraints. First, aspects of the business environment that are reported as constraints may help policy-makers to target
potential areas for reform. For example, new private firms have been the engine of growth in many transition countries and loosening the constraints affecting these firms in particular could have broader benefits.

Secondly, it may be possible to identify constraints that affect certain types of firms in transition countries but not in mature market economies. Such differences can indicate areas where countries need to make further progress to complete the transition.

Summary: Institutions and the performance of firms

The performance of firms is of central importance to the economic performance of the country as a whole. But what are the institutions that matter most for generating improvements in the performance of firms in the transition countries? How can they get closer to the productivity levels of developed countries? And how does competition – including the entry of foreign firms, new ownership structures and greater foreign investment – affect the productivity of firms?

The EBRD-Japan research programme has examined the types of institutions that are most needed at particular stages of a country’s economic development and how they can contribute to enhancing the productivity of enterprises. It has analysed how firms are affected by the interplay between institutions, competitive pressures and advances in technology. This has helped to clarify the priorities and order of reforms that are needed in the transition process.

The programme has identified a number of factors that are central to improving the performance of firms.

- The transition countries need to improve their level of technological development in order to compete with OECD countries. How best to achieve this depends on how far a country is from the technology frontier.

- Competition affects productivity in three ways. First, the threat of new firms entering the market may increase the efficiency of existing firms. Secondly, the arrival of new companies and the departure of failing ones replace low-productivity enterprises with high-productivity alternatives. Thirdly, new companies may prompt existing firms to become more efficient by learning from the new entrants.

- Private firms perform significantly better than state-owned firms but there are also differences in performance among different types of private firms, for example, new private firms tend to perform better than privatised firms.

- Foreign direct investment (FDI) is an important catalyst of economic development. It can help countries to improve their technological capacities and managerial style because of its impact on the companies receiving FDI and the ‘spillover effect’ on other companies.

- The quality of the business environment plays an important part in generating improvements in enterprise performance, but some aspects of the institutional framework are more important than others.
Institutions of the labour market

Contrary to the initial expectations of many economists, the rate of unemployment in most transition countries has remained at relatively high levels. How did unemployment get so high and why has it been so persistent? Which policies could be implemented to address the problem? And what have been the roles played by key institutions of the labour market, such as social security benefits, labour taxes, employment protection and systems of wage determination?

The EBRD-Japan research programme has explored the role of labour market institutions and social ‘safety nets’ in promoting economic flexibility and in managing unemployment and the social consequences of change. It has also looked at possible impediments to the reallocation of workers and jobs that transition requires, including mismatches between jobseekers’ skills and the skill requirements for vacant jobs, as well as geographical mismatches between the demand for and supply of skills.

The problem of high and persistent unemployment

It was widely assumed that unemployment would rise at the start of transition but would follow an inverted U shape with the speed of rising unemployment being driven primarily by the speed of restructuring and firm closures. But while there has been significant variation in both levels and changes in unemployment across transition countries, very few have experienced an inverted U shape for unemployment.

- Only in Hungary did unemployment rise sharply at the start of transition before falling steadily.
- In Poland, the early rise was followed by an equally sharp fall in the mid-1990s before a subsequent and sustained increase.
- In the Czech Republic and the Slovak Republic, unemployment has tended to increase throughout the period, although the level in the former has been far lower.
- In Romania, after a sharp increase at the start, unemployment has remained roughly constant since the mid-1990s at around 8 per cent.
- In Russia, unemployment increased more gradually before stabilising at around 9 per cent after 2000.

In addition to high and persistent unemployment, there has been a large shift out of the labour force and into non-participation or labour market inactivity, where substantial numbers of people of working age are neither in work nor looking for a job. The employment rate in central eastern Europe has declined very substantially, reaching a rate of below 60 per cent by 2004.

As unemployment has increased, there have also been changes in its composition. In particular, there has been a sharp rise in the share of long-term unemployment (people who have been out of work for a year or longer). By 2004, long-term unemployment as a share of total unemployment in central eastern Europe and Romania was around 50 per cent or more, while in Russia the share was under 40 per cent.
In terms of educational qualifications, unemployment is characterised by relatively high shares of the unskilled. With the exception of the Slovak Republic, where unemployment is particularly high among people with secondary education, unemployment rates for those with just primary education lie significantly above the average rate, while the reverse is true for those with tertiary education. For example, in the Czech Republic, the unemployment rate for people educated only to primary level is nearly 10 times higher than for those with tertiary education.

There are a number of potential explanations for high and persistent unemployment.

- First, the process of transition might still be at work. Countries are still reallocating resources, moving from an inefficient initial allocation of labour and capital to more efficient uses. This process might have been hindered by a series of macroeconomic shocks – such as the tightening of monetary policy, delays in the implementation of reforms or the effects of the Russian financial crisis in 1998 – which might have also contributed to an increase in the ‘equilibrium’ unemployment rate.

- Secondly, job reallocation arising from the initial (pre-transition) conditions is largely over, but it has left a legacy of unemployable workers, either those with the wrong skills or those located in the wrong regions. This group of unemployable workers might be the main cause of the higher levels of unemployment.

- Thirdly, countries are experiencing high unemployment rates because they might have adopted the wrong labour market institutions, thereby systematically increasing the long-term equilibrium rate of unemployment.

In addition, the Transition Report 2006: Finance in transition notes the importance of the informal sector. According to some estimates, at least a third of official GDP in most transition countries is generated by workers who do not pay regular taxes and who are excluded from the social security framework.

This ‘informal’ economy, which varies widely in size from country to country, arose because of the collapse of traditional sectors in the early years of transition, when many people were forced to take on any kind of job in order to survive. Informal activities persist partly because taxes, social security contributions and other requirements for operating legitimately can be onerous, and partly because many people need some sort of job, however poorly paid, to survive.

The continuing process of job creation and job destruction

The research paper by Giulia Faggio tries to assess the importance of the first potential explanation for the persistence of high unemployment: that more than 15 years into the transition, the process of job reallocation might be still at work.

Since the early 1990s, the size of the old state sector has significantly shrunk in most of Europe’s transition countries and a new private sector has grown. But the private sector has not yet grown to the extent of replacing the old state sector. EBRD estimates of the private sector’s share in GDP for central and eastern Europe, Russia and Ukraine in 2003 ranged between 65 per cent and 80 per cent (EBRD, 2004). Estimates of the private sector share in employment were slightly lower.
In order to identify whether the process of job reallocation is still at work and, more importantly, whether the high rate of unemployment today is a direct consequence of how the reallocation process has occurred over time, Faggio’s study looks at the relationship between job creation, job destruction and unemployment when initial (pre-transition) conditions and policies vary across countries.

The analytical framework suggests that unemployment affects the rate of job creation in the private sector. In addition, when distinguishing between short- and long-term unemployment, the analysis predicts that long-term unemployment depends on the history of past unemployment rates and thus, on the speed and rate at which jobs have been destroyed in the state sector.

The analysis is conducted at both country and firm levels. At the country level, the results suggest that there is a negative correlation between job creation in the new private sector and the unemployment rate. A negative correlation seems to indicate that higher unemployment might be associated with higher unemployment benefits, higher taxes and, therefore, lower job creation in the new private sector. The correlation remains after controlling for initial conditions and policies affecting creation.

At the firm level, the research explores the determinants of private sector growth and compares the behaviour of state-owned, foreign-owned and domestic private firms. As might be expected, private sector growth is positively associated with a firm’s profitability, the intensity of its investment in research and development and foreign participation its equity. In addition, wages and the cost of capital that are higher than the industry average within a country reduce private sector growth.

Comparing state-owned, foreign-owned and domestic private firms, the study finds that majority state-owned firms tend to adjust employment and wages less substantially than any other type of firm (the only exception being Estonia). Majority foreign-owned firms also adjust wages and employment more aggressively than state-owned firms and in a similar manner to domestic private firms.

**The impact of skills mismatches on unemployment**

The research paper by János Köllő addresses the second potential explanation for the persistence of high unemployment: unemployed people not having the skills that employers require. He finds that there are indeed significant ‘mismatches’ between the demand for skills and the skills of people with fewer qualifications – primary education and apprentice-based vocational education – across a number of transition countries.

The study analyses the phenomenon of people with only a primary school education being squeezed out of employment, a problem that largely contributes to the low level of aggregate employment in central eastern Europe. It uses data from the International Adult Literacy Survey to compare education, level of skill and workplace skill requirements in the Czech Republic, Hungary, Poland and Slovenia with those in a group of western European countries.

The results predict strong competition for a decreasing number of unskilled jobs on the part of workers with primary education and apprentice-based vocational education. The employment and wages of these groups are studied using Hungarian data in 17 occupations and four levels of education from 1986 to 2003.
The analysis is supplemented with firm-level estimates of the employment share for 1997-2000. Simultaneous increases in skilled workers’ employment shares and relative wages (which are characteristic of skill upgrading) were observed only in industry and services. Differences in the two groups’ wage responsiveness may provide an additional explanation as to why primary educated workers were crowded out by their vocationally trained counterparts. The detailed evidence for Hungary shows that the use of more educated workers for even blue-collar jobs can be attributed to technological change and its associated skills bias.

The exclusion of the less educated from employment remains a major social challenge in the transition countries and one that will require raising the quality of the education system as well as using active labour market policies to aid reintegration into the labour force.

The research paper by Stepan Jurajda and Katherine Terrell looks at the spatial or regional dimensions of unemployment, focusing, like Köllö’s study, on unemployment among people with relatively low levels of education. There is now a body of evidence that indicates wide variation in regional unemployment rates within countries. This research is organised around the conjecture that such a variation can be related to differences in skill levels at the regional level.

The researchers find that differences in stocks of regional skills can indeed help explain much of the variation in regional unemployment rates, while also affecting the migration of skilled workers and inflows of foreign direct investment. Furthermore, unemployment of the least skilled workers tends to be lower in areas with higher proportions of skilled labour.

*The impact of labour market institutions on unemployment*

The research paper by Olivier Blanchard, Simon Commander and Axel Heitmueller focuses on the third potential explanation for the persistence of high unemployment: the impact of key institutions of the labour market such as benefits and employment protection.

In western Europe, a body of research has shown how labour market institutions explain a significant part of the increase in unemployment since the 1960s while also being important in sustaining unemployment rates. For example, Stephen Nickell and colleagues analyse data for the OECD and find that over half of the upward shift in equilibrium rate of unemployment from 1960 to 1995 can be explained by changes in institutions. In particular, they find that institutions have materially affected unemployment in the following order of importance: the benefits system; labour taxes; unions; and changes in laws for employment protection (Nickell et al, 2005).

Blanchard and his colleagues ask whether the same types of factors have been important in eastern Europe. Replicating this type of analysis is obviously problematic for the transition countries. First, the time series dimension of the data is small. Second, the concept of a relatively stable equilibrium unemployment rate has less relevance given the initial conditions and the need for large-scale restructuring and reallocation.

Nevertheless, the persistence of unemployment suggests that there have been factors at work that have stopped an efficient reallocation of workers and jobs occurring. Given that the transition countries started with relatively generous systems of social benefits – at least compared with countries at comparable income levels – it is reasonable to ask whether it is institutions that have, as in western Europe, contributed to maintaining high unemployment.
The researchers provide detailed evidence on the scale and scope of benefits programmes as well as other key features of the labour market, focusing on six transition countries: the Czech Republic, Hungary, Poland, Romania, Russia and the Slovak Republic.

They pay particular attention to the level of unemployment benefits, the duration of benefits and the coverage of the benefits system – defined as the ratio of beneficiaries to total unemployed – as well as the strictness with which the benefits system has been operated. In addition, they consider the weight and strength of trade unions, the extent of employment protection operating in these countries and the level of labour taxation. Wherever feasible, these measures are calculated in a way consistent with those used by the OECD.

The main finding of the analysis is that, unlike in western Europe, labour market institutions cannot account for much of the variation in unemployment rates over time or the variation across this group of countries at any given time. If institutions matter, they must be working in combination with other factors to explain unemployment.

**Different explanations for different transition countries**

The research paper by Daniel Münich and Jan Svejnar takes a slightly different approach to assessing the causes of unemployment. It posits three hypotheses and then makes comparisons between the transition countries of central and eastern Europe and the ‘benchmark’ market economy of the former West Germany.

- The first hypothesis stipulates that transition is still unfinished. This would be consistent with the observation that inflows to unemployment (presumably from old command economy jobs) are high, outflows from unemployment (job creation in the new market economy) are fine, and unemployment is high because of the high inflows.

- The second hypothesis states that matching between the unemployed and job vacancies is fine but that high unemployment is being caused by low demand for labour arising from restrictive macroeconomic policies, overvalued exchange rates or globalisation shocks. The manifestation of this would be a low level of vacancies relative to inflows, irrespective of unemployment.

- The third hypothesis is that high unemployment is caused by inefficient matching brought about, for example, by inadequate labour market institutions or geographical or skill mismatches. In this case, both unemployment and vacancies would be high, but not necessarily in the same districts or skill groups.

The results suggest that the situation differs across the sampled economies and different hypotheses receive support in different countries. The former West Germany is an economy with rising unemployment and rising inflows, declining vacancies and relatively efficient matching of workers to jobs. This outcome is most consistent with the first and second hypotheses.

The Czech Republic appears to be in a similar situation. But since the Czech Republic has increasingly pursued a policy of low interest rates and fiscal deficits, the support for the second hypothesis implies the presence of negative demand shocks from outside the country.
The results from the former East Germany are also in line with the first and second hypotheses in that the region has relatively high unemployment and inflows, a low vacancy rate and very efficient matching of workers to jobs (including outflows into training programmes).

The Slovak and Hungarian economies provide the two extremes. The Slovak economy (and probably also the Polish one) displays relatively low efficiency in the matching of workers to jobs, and until recently it has suffered from very high unemployment, rising inflows and a low vacancy rate. It has also had relatively loose monetary and fiscal policies and a floating exchange rate. This outcome is consistent with a combination of all three hypotheses.

Finally, over the last several years, Hungary has managed to lower its unemployment rate to around 8 per cent and it displays the greatest efficiency in matching workers to jobs. Given its low vacancy rate relative to inflows, the existing level of unemployment seems to be consistent with the first and second hypotheses.

Overall, the findings suggest that the transition countries contain two broad groups of countries.

- The first group comprises the Czech Republic, Hungary and (possibly) the former East Germany – and it resembles the benchmark of the former West Germany. These countries display efficient matching of the unemployed and vacancies, and their unemployment appears to be driven by restructuring and a low demand for labour.

- The second group comprises Poland and the Slovak Republic. In these countries there is evidence of low efficiency in the matching of workers to jobs. This, combined with rising inflows to unemployment and low vacancy rates, points to a problem of structural mismatch. The case of the former East Germany is complex because of its active labour market policies: broadly it resembles more the second group of countries.

The impact of benefits and labour market policies on job reallocation

The research paper by Katalin Balla, János Köllő and András Simonovits presents a model of the relationships between labour market policies, labour market outcomes and overall economic performance during the transition. In general, they conclude, there was a particularly wide scope for bettering (or worsening) labour market outcomes through various policy instruments.

It seems that the worst conceivable policy was combining fast job destruction with high benefits for job losers and no assistance for low-productivity workers and regions. In countries opting for fast elimination of the state sector and generous compensation for the job losers, there was a strong case for assisting low-skilled workers and badly affected regions. Failure to do so threatened substantial inequality and an unnecessarily sharp decline in aggregate employment during the transition.

In contrast, slow transition implied slower increases in income levels, although it helped to keep inequalities low. A gradualist policy combined with subsidisation could nevertheless achieve income levels similar to that achieved in a ‘fast and generous’ regime.

The best conceivable scenario arising in the model is one where the state sector is closed fast, benefits are parsimonious (but not very low) and low-productivity groups are assisted in entering the emerging private sector.
These predictions help to ‘map’ the mix of policies pursued by governments in transition countries. The Czech Republic, for example, adopted a gradualist policy of job destruction combined with parsimonious benefits and significant expenditures on active labour market policies. In the early stage of the transition, the country managed to keep unemployment at exceptionally low levels compared with other transition countries, but it may have sacrificed economic growth in the long run.

Hungary, a fast reformer operating an initially generous unemployment compensation system combined with modest expenditures on active labour market policies is a good example of the other extreme. The model suggests that once the government had chosen high job losses, it would have been advisable to choose low levels of benefits and high levels of active labour market policies in order to avoid serious damages to aggregate employment and equity.

It seems likely that Hungary’s failure to follow this strategy has contributed to its post-transition problems. The country has one of the lowest aggregate employment rates in the OECD with an unprecedented 50 percentage point difference in the employment ratios of people educated to primary school level and people who are college graduates. The economy also continues to be characterised by severe regional inequalities.

The results of this study also confirm that setting tight benefits – as in Russia – may not help if the state sector is closed very slowly and/or the losers of the transition are not assisted in getting a job in the private economy.

The research paper by Tito Boeri also looks at the consequences of systems of unemployment benefits, analysing institutional and labour market data from a large number of countries around the world. He argues that such benefits improve both the amount and quality of job reallocation, albeit at the costs of increasing the duration of unemployment. As such, unemployment benefit systems can increase structural change and job turnover rates, with a particularly high impact in terms of job destruction.

The impact of benefits on labour market inactivity

An open issue in the research paper by Olivier Blanchard and colleagues is whether the researchers would have had more success using labour market institutions to explain non-employment rather than unemployment. Benefits such as disability and early retirement pensions may well have provided incentives to leave employment and ultimately the labour force. For example, in Hungary, disability benefits have been in place throughout the 1990s and there has been little change in entitlement rules over time.

The research paper by Zsombor Cseres-Gergely looks in detail at the impact of the Hungarian pension system on the country’s low labour market activity during the 1990s and early 2000s. His examination of the incentive structure of the Hungarian old age and disability pension system reveals that it provides very little to no incentive for extending active life. It is an accessible exit route from the labour market that provides a minimal but secure income flow. It seems that the average Hungarian household accommodates this possibility and does not seek alternative income sources.

Part of the problem is that the retirement age in Hungary is lower than that in a typical EU country, with an average retirement age of 55 for women and 60 for men. Although retired people are allowed to work, there is practically no pension bonus attached to working longer. A
change in the legal framework regulating employment is connected to age, not pensioner status, which gives no incentive to defer retirement. Because of this, there is nothing to lose from claiming a pension so people do so as soon as possible, and only a few work after retirement, adjusting to the lower income level that retirement brings.

Another factor contributing to low activity is early retirement, partly independent from the low official retirement ages. Those taking early retirement have to face a more difficult decision than those retiring at normal ages. Using disability retirement or early retirement as an exit route, the available pension is considerably smaller. This might indicate that claiming such a pension is not really a decision but rather the workings of a severe constraint on employment possibilities. The research shows that given the legal framework, employment chances and rigour of the unemployment benefit system, there are particularly strong incentives for people to retire and not work afterwards.

China’s labour market in transition

The economic transition strategies pursued by most countries in eastern Europe and the former Soviet Union were typically rapid, ‘big bang’ style reforms. They stand in sharp contrast to the gradual approach to transition pursued by China’s economic reformers. The research paper by John Giles looks at how the Chinese labour market fared under this approach.

He notes that the difficult process of restructuring large-scale state-owned enterprises was deferred until the mid-1990s. When this restructuring finally began in earnest in 1997, China witnessed sharp declines in employment of urban residents. While some unemployed state sector workers moved into the non-state sector, large numbers of laid-off workers spent long spells unemployed or even out of the labour force.

This outcome was probably a function of both the generosity and duration of benefits received by laid-off workers, and the reluctance of workers to move to private sector firms that were not willing to make the required pension and health insurance contributions for their employees. In addition, much of the move out of the state sector occurs through early retirement and exit from the labour force, while workers entering the private sector tend to be young, with many taking their first job in private sector firms.

Analyses of unemployment duration show that subsidies used to support unemployed workers create a disincentive for a return to the workforce. Younger workers with better qualifications find new employment more quickly, while workers with smaller family networks and fewer sources of information and job referral take longer to find new employment.

On the other hand, there is also evidence to suggest that departure from the job market reflects a choice. Women left the labour force in great numbers after 1996, but those women with adult children of college age are 60 per cent more likely than other women to be re-employed within a year.

Policy implications

The research paper by János Köllő concludes that the exclusion from work of the less well educated is among the most severe social problems of transition countries. Even if they can find
casual employment in the informal economy, they are deprived of the long-term gains of having a steady, registered job.

Köllö argues that the communist school system and technology are clearly responsible for this failure. The collapsing system left behind a sizeable low-skilled population that was able to do simple repetitive tasks, but deprived of the competencies required in a modern, post-industrial market economy. If this depiction is accurate, serious efforts are required in the education and employment policies to overcome this legacy.

The role for minimum wage policies and job search assistance in place of passive income support remains a question to be solved in both eastern and western Europe. Some economists propose minimum wages and higher benefits as a remedy, but empirical support for their suggestions needs to be collected.

The strong positive contribution of wage-sensitive assembly plants and related exports to unskilled employment calls for caution (and so does the experience with Hungary’s aggressive minimum wage policies that brought about a further fall in unskilled employment). The search for proper policies is all the more desirable as, if the unskilled unemployment problem is neglected, aggregate employment will remain at its current level.

Summary: Institutions of the labour market

Contrary to initial expectations, the rate of unemployment in most transition countries has remained relatively high. How did unemployment get so high and why has it been so persistent? Which policies could be implemented to address the problem? And what have been the roles played by key institutions of the labour market, such as social security benefits, employment taxes, employee protection and pay bargaining?

The EBRD-Japan research programme has explored the role of labour market institutions and social ‘safety nets’ in managing unemployment and the social consequences of change. It has also looked at the difficulties in reallocating workers to the jobs that the transition process requires. In particular, it has examined mismatches between jobseekers’ skills and the requirements for vacant positions as well as mismatches between the demand for and supply of skills in different parts of the region.

The programme has examined three explanations for persistently high unemployment.

- The process of transition might still be in progress. Countries are still moving from an inefficient initial allocation of labour and capital to more efficient uses. This process might have been hindered by a series of macroeconomic setbacks – such as the tightening of monetary policy, delays in implementing reforms or the effects of the Russian financial crisis in 1998 – which might also have contributed to an increase in the equilibrium unemployment rate.

- Changes in employment triggered by the transition process are largely over but there is a legacy of unemployable workers who either have the wrong skills or live in the wrong regions. This group of unemployable workers might be the main cause of the higher levels of unemployment.
Countries are experiencing high unemployment rates because they might have adopted the wrong labour market institutions, leading to an inevitable increase in the long-term equilibrium unemployment rate.
Institutions of the financial sector

Transition requires a fundamental change in the way capital is allocated for investment. This involves transforming state-controlled banking systems into market-oriented ones through a wide range of reforms, including financial liberalisation, restructuring and privatisation of state-owned banks, the entry of new banks (including foreign banks) into the market and the development of financial laws and regulations.

How have these reform programmes affected the economic performance of banks – their profitability, their risk management and their lending to various sectors of the economy? And what about the businesses in which they invest?

The EBRD-Japan research programme has investigated how institutions and competition influence financial development and financial stability in transition countries. It has also looked at the many multilateral and bilateral development agencies – including the EBRD itself – that have implemented specialised programmes to expand access to finance for micro, small and medium-sized enterprises.

This work links directly to the wider context of the EBRD’s activities, including analysis described in the Transition Report 2006: Finance in Transition, in which the special topic is the evolution of the financial system. The report summarises the state of the financial sector in transition countries as follows.

- Financial markets have grown in size and complexity, and the performance of banks is improving, but because of institutional constraints financial markets are still shallower than in other countries with the same income levels.

- Foreign banks are more efficient than domestic banks and their presence can accelerate financial sector development, but foreign entry is not a substitute for institutional reform.

- The financial sector remains dominated by banks, but stock markets, bond markets and a small private equity industry have become important complements to the banking system.

Banking development in transition

Since economic transition began in 1989, it has fundamentally transformed banking systems in eastern Europe. Under the command economy, state authorities directed credit allocation with scant regard for capacity to repay, using state-owned banks to channel funds to state (or socially) owned enterprises for inputs and investments authorised under planning.

To direct resources in this way, banks specialised according to economic sector (or foreign trade) rather than diversifying across them. State savings banks specialised in collecting deposits from households, although most saving was forced on households by the state. The payment system consisted of a cash circuit for households and commercial transfers among enterprises handled by the Central Bank.
At the same time, without a profit incentive, state-owned banks were not encouraged to compete for loans and deposits or to control costs. Because of this structure of state-controlled banking systems, and with the start of transition towards a market economy, banks had to carry out a fundamental restructuring of their outputs and use of inputs.

Governments and central banks in eastern Europe have implemented several types of policies aimed at transforming state-controlled banking systems into market-oriented ones.

- Banking systems were liberalised by freeing interest rates and decentralised by transferring commercial banking activities from the Central Bank to state-owned banks.

- State-owned banks were restructured and privatised, and new private banks – both domestic and foreign – were allowed to enter the market.

- To support arms-length lending relationships between banks and their borrowers and to foster confidence of depositors in banks, legal frameworks were overhauled (including the strengthening of creditor rights) and systems of prudential regulation and supervision were initiated.

In broad terms, the main policies for promoting the transformation of banking were therefore interest rate liberalisation, bank restructuring and privatisation, market entry of new banks and fundamental institutional change.

The research paper by Rainer Haselmann and Paul Wachtel describes four stages of banking development in the transition countries.

- The first stage of banking transition involved the establishment of banking institutions in the early 1990s.

- The second stage involved bank failures and systemic crises that at one time or another affected every transition country in the middle of the 1990s.

- The third stage involved a lengthy process of restructuring through privatisation and the entry of foreign banks. By 2000, most banks were privately owned and, in virtually all of the transition countries in the EBRD’s Banking Environment and Performance Survey (BEPS) conducted in 2005, foreign banks were predominant.

- The fourth stage comes to the present: in most transition countries, banks are largely sound, appropriately regulated and competitive institutions. By the time of the BEPS, banking in the countries surveyed had largely shaken off its command economy heritage.
The Banking Environment and Performance Survey

The EBRD’s Banking Environment and Performance Survey (BEPS) was conducted on a random sampling of banks in 20 countries in the summer of 2005.

A common questionnaire, translated into each local language, was presented to a senior bank officer in an interview. In all, 220 banks responded to the questionnaire. The survey responses provide detailed data on the credit and deposit activities of the banks (greater detail than is available from bank balance sheets) and the other business activities of the bank (such as commission-generating activities).

The survey responses also contain information on the type of collateral that banks accept while making a loan. In addition, the respondents were asked about their use of risk management techniques and their perceptions of the security rights of lenders, bankruptcy law and its application, and the effectiveness of regulatory policy.

The BEPS provides information that may be relevant to credit creation by banks in the transition countries. For example, many banks in these countries are owned by foreign banks and foreign non-financial firms. Is the growth of loans at these foreign-owned banks more or less sensitive to the perceived quality of creditor rights? Are the foreign-owned banks more likely to accept certain types of assets as collateral?

The BEPS also contains information on the percentages of loans made to different types of customers, such as households, large corporations and state firms. Are the banks that lend primarily to private corporations influenced more by creditor rights than some banks that lend primarily to state-owned firms? Do the banks that lend primarily to small corporations ask for personal guarantees more frequently?

The impact of market entry and privatisation on bank performance

It has generally been assumed that privatisation would have a beneficial effect on the performance of the financial sector and research confirms that this has been the case. An example is the research paper by Steven Fries, Damien Neven, Paul Seabright and Anita Taci, which examines how market entry and privatisation have affected the structure of margins on loans and deposits and the costs of providing these services for banks in a number of transition countries.

Given the starting point of transition, attracting demand for loans and deposits and controlling their costs were central to the process of change in these banking systems. This required competition among banks, including effective legal institutions to support banking activities, as well as the incentive of profitability and the constraint of effective prudential regulation.

1 Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Hungary, Kazakhstan, Latvia, Lithuania, Moldova, Poland, Romania, Russia, the then Serbia and Montenegro, Slovak Republic, Slovenia and Ukraine.
The analysis in this paper uses a large panel data set of banks in 15 transition countries for the period 1995-2004, grouping banks by their origin – domestic or foreign – and ownership – state-owned, privatised or newly established private banks. By dividing the entire period into three roughly equal sub-periods, the researchers were able to assess how the determinants of margins and costs varied over time. The analysis reveals the following.

- In the first sub-period (1995-98), privatised banks had significantly higher average margins on loans and deposits than newly established banks or state-owned banks. But by the third sub-period (2002-04), it was the private domestic banks, both newly established and privatised, that earned the highest margins.

- This finding indicates that privatised banks initially and domestic banks subsequently had either a greater capacity to attract demand for their services – perhaps due to service improvements and established reputations – or lower marginal costs.

- Newly established foreign banks initially had significantly lower marginal costs than state-owned banks, but the differences in marginal costs among the other types of banks are not significant. By the third sub-period, the foreign-owned banks, both newly established and privatised, had the lowest marginal costs. They also had the lowest average costs.

- Combining the evidence on margins and marginal costs to calculate mark-ups indicates that initially the privatisation of state-owned banks was associated with greater demand for lending and deposit-taking services. But these effects did not endure for privatised banks with majority foreign ownership. By the third sub-period, newly established foreign banks and privatised domestic banks had the highest mark-ups.

- Both foreign bank entry and bank privatisation appear to have contributed to attracting greater demand for banking services. But surprisingly, this effect did not persist for privatised banks with majority foreign ownership.

Complementing this work is a research paper by Steven Fries and Anita Taci, containing a more detailed study of cost efficiency in 289 banks in 15 transition countries. The researchers focus on cost efficiency as an indicator of progress because greater relative cost efficiency may be associated with the changes in incentives and constraints in banking that are related to structural and institutional reforms and to the more efficient provision of public services by the state, such as the rule of law.

They find evidence that an average-sized bank in the sample operates at a point that is close to constant returns to scales (that is, it does not need to be bigger to reap economies), while the smaller banks in the sample operate with significant unrealised economies of scale. This suggests that consolidation of smaller banks in the region would contribute to greater cost efficiency in banking.

Country-level factors that increase cost efficiency are lower nominal interest rates, a greater market share of majority foreign-owned banks, and a higher intermediation ratio. In other words, greater macroeconomic stability and competition in banking from foreign entry, as well as the development of the supportive institutions, promote cost efficiency.
Progress in banking reform has a non-linear association with cost efficiency. In the initial stages of banking reform, cost efficiency increases significantly, but it then declines as reforms advance further. This may reflect the transition by banks from defensive restructuring – cost-cutting – to deeper restructuring that increases the quality and value added by banking services – innovation. Banking systems with higher ratios of capital to total assets and banks with lower loan losses also tend to have lower costs. This may be associated with lower risks in banking sectors.

In addition, private banks are more cost efficient than state-owned banks, though there are significant differences among private banks. Privatised banks with majority foreign ownership are the most cost efficient, followed by newly established private banks, both domestic and foreign-owned. Privatised banks with majority domestic ownership are the least efficient private banks, though they are still more efficient than state-owned banks.

The impact of institutional reforms on bank lending and risk management

The research paper by Rainer Haselmann and Paul Wachtel examines factors that influence risk-taking by banks in transition countries and how they seek to manage these risks. Their analysis is based on the BEPS combined with detailed accounting data on the respondent banks from the Bankscope database. This unique combination of data on banks provides a number of valuable insights into their risk taking and risk management practices.

The research seeks to explain variation in risks among banks using several measures of risk, including loan default probabilities, liquid asset ratios and return on assets. It finds that much of the variation in risk taking is not explained by bank ownership (private versus state-owned and domestic versus foreign-owned) but rather by country level factors. In particular, banks appear to take on more risk when they have more positive perceptions of banking regulators and legal institutions.

This result is given support by the research paper by Rainer Haselmann, Katharina Pistor and Vikrant Vig, which looks in more detail at how laws affect bank lending. Like Haselmann and Wachtel, they use bank level data and control for differences between countries to analyse the effect of legal changes on different types of lenders.

Analysing variations in changes made to the protection of creditor rights within different countries, they find that lending volume increases subsequent to legal change. They also find that new bank entrants respond more strongly to legal change than incumbent banks do. In particular, foreign-owned banks extend their lending volume substantially more than domestic banks do, be they private or state-owned. The same holds when they use newly established foreign banks as proxies for new entrants.

The research paper by Takeo Hoshi also examines the link between institutions and bank lending, and finds further evidence that expansion of bank lending is positively related to progress in legal and institutional reforms. The paper uses the BEPS to construct some new measures of banks’ perceptions of the legal environment in the transition countries and their use of collateral in extending loans, and examine how these variables are correlated at both country level and bank level.

Hoshi finds substantial variations in the perceived quality of creditor rights and other aspects of the legal environment among banks and especially across different countries. There is some
evidence that the perceived legal environment correlates with the choice of collateral for bank loans and the growth rate of loans. For example, stronger mortgage rights encourage banks to accept land as collateral more often, and wider acceptance of land as collateral tends to increase loan growth.

*The impact of bankruptcy law on corporate finance*

The research paper by Rainer Haselmann, Katharina Pistor and Vikrant Vig finds that collateral law matters more for the development of financial markets than bankruptcy law. The paper by Katharina Pistor looks more closely at bankruptcy law through the legal regimes in two transition countries: Hungary and Russia.

The paper begins with the question: ‘Who tolls the bells for firms?’ The data reveal that the tax authorities play an important, and at times dominant, role as bell-tollers in these countries. This stems from the critical role the state has played as ‘involuntary creditor’ during the transition period when it was either unable or unwilling to enforce taxes. Without access to alternative sources of external finance, many firms resorted to non-payment of taxes as an additional source of liquidity.

These findings prompted Pistor’s analysis of the impact the presence of the tax authorities may have on the debt structure of firms. She argues that while effective tax enforcement is important to harden firms’ ‘soft budget constraint’, in the context of transition countries a shift from a low to a high enforcement regime raises two major concerns.

- First, tax enforcement may be used as a means for the state to reinstate control over critical parts of the economy as has happened with Yukos.

- Secondly, even if the tax authorities’ intentions are less predatory, improved enforcement may, at least in the short term, crowd out private creditors. Given that most firms accumulated tax arrears during the transition period, enforcement actions may drive a firm into insolvency that would otherwise be viable.

This negative effect of the tax authorities as residual claimants of firms may go far beyond what the bankruptcy data reveal. In Hungary, the tax authorities triggered the majority of all liquidation cases over the past five years, even though they initiated only 36 per cent of all bankruptcy cases. Therefore, the fact that firms continue to lack access to external sources of funds, including debt finance, may at least in part be attributed to the shadow of the taxman.

*The impact of bank lending on the performance of the small business sector*

The small business sector has made a significant contribution to economic growth, innovation and job creation in the transition countries. The research paper by Karin Jõeveer, Francesca Pissarides and Jan Svejnar assesses how the provision of credits by banks to micro, small and medium-sized enterprises affects firm performance. In particular, it evaluates the impact of EBRD lending programmes with local banks that help build capacity for lending to small businesses.
This evaluation is based on a new survey of enterprises that had received credits from these programmes in four transition countries in 2002 – Bulgaria, Georgia, Russia and Ukraine – and a control group that did not receive any of these loans.

The study indicates that bank loans have a significant positive effect on most performance indicators of micro, small and medium-sized enterprises in the transition countries. In particular, exit rates related to cessation of business are higher for companies that did not benefit from EBRD loans (even though they may have benefited from non-EBRD loans) than for companies that benefited from EBRD loans.

Net job creation rates are positive and almost everywhere larger for companies that benefited from EBRD loans than for companies that did not. Both EBRD and non-EBRD loans have a positive effect on investment and fixed assets, and they suggest that in the imperfect capital markets of the transition countries, firms use even short-term (non-EBRD) loans for investment in fixed capital. The positive effect of EBRD and non-EBRD loans extends to revenues, labour cost and employment. Hence the loans serve the purpose of enabling small businesses to expand production beyond the scale that they could achieve without this source of credit.

Interestingly, the two sets of loans differ in their effect on profitability. The EBRD loans have a positive effect on profit while the non-EBRD loans have no significant effect. The relatively limited effect on profitability is intuitively acceptable, given that firms use the loans to expand both revenues and input use. Moreover, in a competitive environment, one would expect the effect to translate primarily into expanding scale.

As might be expected, the effect of loans on the performance indicators varies somewhat across countries. Moreover, many of the effects do not vary with the size of the loan and some loans may be too big in the sense that they bring about a diminishing return or even decline in performance.

In terms of the determinants of loans, the research confirms that prior credit (loan) history is an important determinant of the ability of firms to obtain subsequent loans from the same provider but not from different providers. The age of the firm, the adoption of international accounting standards and having a male CEO all increase the probability of receiving credit from a non-EBRD provider. In terms of determinants of the size of EBRD loans, what matters is past credit history and having adopted international accounting standards.

Policy implications

The financial system remains largely – but not exclusively – bank-based in most transition countries. Foreign banks have entered or acquired banking assets, particularly in central eastern Europe and the Baltic states, and these banks have tended to be profitable and strong performers.

The research paper by Steven Fries and Anita Taci indicates that the policies that many governments and central banks in eastern Europe adopted to promote the transformation of state-controlled banking systems into market-oriented ones have contributed to increased cost efficiency, a useful indicator of progress.

Banks’ portfolios have also seen diversification as lending to households and smaller firms has grown. New instruments, such as mortgage lending, have come into play, not least because of clear improvements in the institutional – particularly the legal – environment. There has also
been growth in non-bank finance, as public equity markets have grown in size and liquidity. Furthermore, a small but growing private equity industry has emerged in a number of countries.

All these factors have greatly helped to improve access to finance. Lending to large firms has declined in relative terms and the evidence indicates that smaller businesses can use external finance effectively when they get access. Consumers have likewise had greater access to financing on more competitive terms. Yet despite these improvements, the clear challenge is to try and ensure that access continues to be raised, not least by improving the quality of supervision of the banking system and by encouraging the growth of non-bank finance.

Looking ahead, some national banking sectors will face major new challenges in the form of greater competitive pressures with their countries’ accession to the European Union. In these countries, policy-makers can draw on lessons from the past and promote further cost efficiencies in banking by sustaining progress in legal and regulatory reforms, completing the transition from state-owned banking systems to largely private systems and allowing for the market-led consolidation of smaller banks to achieve unrealised economies of scale. At the same time, banking markets should remain open and contestable, including through the entry of foreign banks.

In other countries in eastern Europe, however, the banking systems remain at least partially mired in the past (see Berglöf and Bolton, 2002, on the divergent paths of banking development in transition countries), often because governments continue to use some banks to direct the allocation of resources. To make a clearer break with the past, these countries need to learn from the experience of the countries that are more advanced in the transition process.

**Summary: Institutions of the financial sector**

Transition requires a fundamental change in the way that capital is allocated for investment. This involves transforming state-controlled banking systems into market-oriented banks through a wide range of reforms, including financial liberalisation, restructuring and privatisation of state-owned banks, the entry of new banks (including foreign banks) and the development of financial laws and regulations.

How have these reform programmes affected the economic performance of banks – their profitability, their risk management and their lending practices? And what about the businesses in which they invest?

The EBRD-Japan research programme has investigated how institutions and competition influence financial development and stability in the transition countries. It has also examined the development agencies – including the EBRD itself – that have implemented programmes to expand access to finance for micro, small and medium-sized enterprises.

Governments and central banks in the transition countries have implemented various policies, such as interest rate liberalisation, bank restructuring and privatisation, the promotion of market entry and fundamental institutional change, to assist the transition from state-owned to market-oriented banking systems.

These policies have contributed to greater cost efficiency and a more diverse range of financial products. They are also gradually making it easier for enterprises to gain access to credit. However, a number of challenges lie ahead.
• Some national banking sectors will face major new challenges in the form of greater competitive pressures following their countries’ accession to the European Union.

• In these countries, policy-makers can promote further cost efficiencies in banking by sustaining progress in legal and regulatory reforms, completing the transition from state-owned to largely private systems and encouraging the consolidation of smaller banks to achieve economies of scale.

• Banking markets should remain open and competitive, including through the entry of foreign banks.

• In the less advanced transition countries, the banking systems are still hampered by partial state control, with governments continuing to use some banks to channel state funding. These countries need to learn from the experience of the countries that are more advanced in the transition process.
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