

# Executive summary

---

## Chapter 1 Structural and macroeconomic impact of the crisis: an overview

The past year of financial and economic crisis has proved exceptionally difficult for policy-makers across the transition region. There have been few new reforms, as reflected in the lowest number of upgrades to the EBRD transition scores since the start of transition. More encouraging, however, has been a near absence, so far, of reversals in transition, with only four downgrades.

The emerging global crisis left most transition economies largely unaffected until mid-2008, after which it hit hard as commodity prices collapsed, exports contracted and capital inflows stopped. This led to extraordinarily sharp output declines later in the year and in the first quarter of 2009. By the third quarter of 2009 there were signs that the downturn was bottoming out. However, unemployment and the volume of non-performing loans are expected to rise for several quarters to come, complicating and slowing the recovery in many countries.

Although there have been dramatic declines in national outputs, collapses of banking systems and currencies have to date been largely avoided (unlike the experiences in previous emerging market crises), for three reasons. First: although the region approached the crisis with large macroeconomic imbalances in many countries, financial sectors were relatively sound (compared with the Asian countries in the 1990s, for example). Second: except in a few countries, such as Latvia, Russia and Ukraine, reversals in net capital flows were mild across the transition region compared with the experience in previous crises. Lastly: there was an effective coordinated policy response to maintain financial stability, involving national authorities, international organisations and regional banking groups.

## Chapter 2 Understanding the crisis in the transition region

Although net capital outflows from the transition region in late 2008 and the first quarter of 2009 were generally more moderate than expected, output declines were unexpectedly sharp. These sudden declines can be attributed to: the collapse of exports in the fourth quarter of 2008; the fact that the boom was coming to an end in several transition countries even before the eruption of the crisis; and to the macroeconomic imbalances that had accumulated during the boom. Because of these imbalances, financing needs in the region were much larger than in other emerging market countries, implying that even relatively moderate net capital outflows would have a significant impact.

Differing macroeconomic imbalances also help to explain the large cross-country variations in the depth of output declines within the transition region. Countries with larger pre-crisis credit booms and higher levels of private external debt at the end of 2007 have tended to suffer larger declines. In contrast, foreign bank ownership seems to have helped to stabilise output. The likely reason for this is that foreign bank presence mitigated the capital outflow, as parent banks continued to refinance their subsidiaries and branches. This mitigating effect can be confirmed using statistical analysis both for the transition countries and a larger sample that includes many non-transition developing and emerging market countries.

## Chapter 3 Development based on financial integration?

Financial integration – in the form of large debt flows and foreign direct investment, and an increasing presence of foreign banks – has been an integral part of the “development model” of transition countries (particularly in Europe) over the last decade. The region’s slide into deep recession has raised questions about whether the growth benefits associated with this model may have been short-lived and whether the model created vulnerabilities that have been a contributing cause of the crisis.

Macroeconomic and sector-level analysis shows that financial integration did in fact boost long-term growth in the transition region (unlike other emerging market regions, where the evidence is not so clear). At the same time, there is evidence that the process of financial integration – particularly large inflows of foreign financing – has indeed contributed to credit booms and foreign currency lending. These, in turn, made the crisis deeper and complicated its management.

While financial integration cannot and should not be reversed, its risks must be better managed. This means addressing the bias toward foreign currency lending through macroeconomic policies, regulation, and the creation of legal frameworks and market infrastructures supporting local currency finance. It also requires countercyclical financial sector policies that mitigate credit booms, regardless of whether they originate from capital inflows or domestic sources. To be effective, these policies need to be consistent across jurisdictions, or formulated at a regional level.

---

## Chapter 4

### Development based on commodity revenues?

Commodity-rich transition countries, such as Azerbaijan, Kazakhstan, Russia and Turkmenistan, have been on an exceptionally fast-growth trajectory since the late 1990s. In the long term, however, these countries tend to grow more slowly than their resource-poor peers because they have higher macroeconomic volatility and because commodity “rents” undermine incentives to improve economic institutions (since good institutions, by definition, make it more difficult for elites to appropriate these rents).

To avoid this “resource trap”, resource-rich economies can attempt to: diversify, mainly by improving the business environment; build stabilisation buffers and deepen financial sectors to reduce the impact of commodity price volatility; and reduce inequality as a way of distributing rents more widely (including through higher public spending on education).

Resource-rich transition economies have embraced these strategies to varying degrees. In some respects – particularly in financial development and in building and managing stabilisation funds – they have been fairly successful. Partly for this reason, the impact of the crisis on resource-rich transition countries does not appear to have been worse than elsewhere. However, raising the share of non-commodity tradeable sectors in GDP or exports has so far proved elusive, perhaps because success in diversification, as empirical analysis shows, itself depends on institutional quality. Escaping from this conundrum – namely, low diversification inhibiting institutional development, and vice versa – is difficult but not impossible. One approach is to deepen reforms in areas such as macroeconomic, financial sector and competition frameworks where resource-rich transition countries have already demonstrated their ability to make progress.

---

## Chapter 5

### Transition: where does it stand and where should it go?

There has been increasing recognition that successful transition involves not only market mechanisms and private economic activity, but also effective interaction between the state and private sectors and high-quality state institutions. Analysis of the business environment, level of competition by sector and managerial practices shows the heterogeneity of the transition region, while an assessment of remaining transition “gaps” exposes the size of the challenges still facing some countries.

Firms in central Europe and the Baltic states (CEB) tend to rate their business environment better than most other emerging market regions, while firms in Central Asia, eastern Europe and the Caucasus (EEC), Russia and Central Asia view it less favourably. With respect to managerial practices, the Central Asian countries and Russia lag behind not only Western benchmark countries but also China, while the CEB countries rate about the same as Greece, Ireland and Portugal. Firm-level data for three countries in south-eastern Europe (SEE) suggest that their levels of competition lagged behind CEB and other developing country benchmarks.

Sector-level analysis shows that the remaining transition gaps are mostly small in EU member countries, with medium gaps remaining in energy efficiency, transport infrastructure and in the financial sector. Gaps are typically medium in Armenia, Georgia, Kazakhstan, Russia and most SEE countries, and predominantly large elsewhere. These results imply that those countries which are least advanced in terms of reform will be left further behind once economic recovery takes root.

---

## Chapter 6

### Transition in crisis? The impact of the crisis on reform

Economic crises have sometimes led to major reactions against the status quo. On other occasions they have left prevailing political and economic regimes in place but triggered policy reforms within those regimes. How crises turn out depends on a variety of factors, including their scale, the maturity of pre-crisis institutions, social cohesion, pre-crisis political regimes, external anchors, and which (if any) aspects of the pre-crisis status quo were viewed as responsible for the crisis.

The 2008–09 crisis has led to a slow-down in reform. However, unlike the 1998 crisis in Russia, it has not triggered a major reversal. An analysis of government changes since early 2008 suggests that the political and reform orientation of governments has generally been preserved and, if anything, favoured pro-reform parties. The lack of an anti-reform backlash reflects more mature economic institutions and political systems compared with 1998, better integration into regional and global institutions, and a more successful crisis response which has prevented high inflation and banking system collapses.

However, a major round of new reforms also appears unlikely. This is true for EU member countries, in which the distance from the transition frontier is moderate and the reform effort needed to reach the frontier is typically greater, and for countries further east, where reform progress has been less consistent and support for market institutions weaker. The scope for new reforms is greatest in the Western Balkans and some eastern European and Caucasus countries and in the financial sector, where initiatives are under way across a diverse range of countries.