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Transition in crisis?

This year has witnessed the worst output collapse since the great "transitional recession" that followed the end of communism. Five countries are expected to suffer double-digit declines. On average, GDP will shrink by about 6 per cent. Non-performing loans and unemployment are rising, extending the crisis and complicating recovery in many countries.

So there is no doubt that the transition region is in deep crisis. But is transition itself in crisis? How have the institutions and policy frameworks that were the outcome of the transition process coped? Are the ideas that drove transition, which in addition to market reforms and trade integration also encompassed financial liberalisation and integration, still attractive? Lastly, is the future of transition in doubt? Will the crisis lead to a backlash against market-oriented reforms?

These are the main questions addressed by the Transition Report 2009, which also happens to coincide with the 20th anniversary of the fall of communism in several eastern European countries. A crisis is a strange way to celebrate an anniversary. At the same time, it puts the structural transformation of the last 20 years to the test. What does this test reveal?

While the transition region was the emerging market region to suffer the most in the crisis, it has generally avoided the currency collapses, systemic banking crises and spikes in inflation that were the staple of previous crises. This is less contradictory than it seems initially. It relates to the special role of integration with advanced countries – economically, financially and even politically – in the region's development model. This has cut both ways. On the one hand it has created economic ties and financial dependence that have made many transition countries highly susceptible to the crisis in the West. On the other hand, it has mitigated the large capital outflows that were a destructive force in past crises, it has contributed to more mature institutions and domestic policy responses, and it has mobilised vigorous international support. The latter included an unprecedented effort to coordinate public and private financial sector crisis responses, of which the EBRD is proud to have been a part. For all these reasons, this crisis has not spiralled out of control. Continues on back page

Erik Berglöf, Chief Economist and Special Adviser to the President

Prior to joining the EBRD, Erik Berglöf (PhD, Stockholm School of Economics, 1991) held the position of Director of the Stockholm Institute of Transition Economics (SITE) and Professor at the Stockholm School of Economics. He was previously Assistant Professor at the Université Libre de Bruxelles and has held visiting positions at Harvard, Stanford and the Massachusetts Institute of Technology (MIT).

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In January 2006 Erik Berglöf took up his current position of Chief Economist and Special Adviser to the President at the EBRD.
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 policymakers 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 towards 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.
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.

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.

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.
The two faces of integration have been particularly visible in the financial arena. Aside from fuelling the boom years, financial integration has been an important force for long-term growth in the transition region, as shown in Chapter 3. At the same time, it has no doubt contributed to excessively fast expansions in private sector credit, and excessively high levels of private sector debt. It is also likely to have encouraged indebtedness in foreign currency, which has complicated the crisis in many countries. The lesson from this experience is not to attempt to reverse financial integration – that would be both unfeasible and unwise – but to mitigate its risks, particularly through policy frameworks and institutional development that address the problem of foreign currency lending and that lead to a better management of future booms.

Further east, the resource-rich transition economies are facing what is arguably an even bigger challenge. Like the financially integrated economies of central and southeastern Europe, the commodity-rich countries have had to manage the complications of rapid inflows of foreign currency. In some countries this has lead to similar problems, such as credit booms and private sector debt. But unlike some forms of financial integration, commodity inflows are not necessarily conducive to the financial and institutional development that would mitigate the risks of sudden reversals. This creates an even more difficult problem for domestic policy-makers. In some areas, particularly macroeconomic management involving the accumulation and use of stabilisation funds, resource-rich transition countries have performed fairly well. But the ultimate goal – diversification and associated improvements in economic (and political?) institutions and the business climate – has mostly proved elusive.

The crisis has also tested ideas about the ultimate aims of transition. It has confirmed a view which has been gaining traction over the last decade, namely that transition to a market economy is about much more than building markets and shifting economic responsibilities from the state to the private sector. It also involves developing certain state functions, and improving how the state interacts with the private sector. The crisis has brought home the importance of market-supporting policy institutions and policies, particularly in the financial sector. This does not necessarily mean more regulation, but it certainly means better regulation, focused on improving incentives.

Based on this extended concept of institutional change, Chapter 5 attempts to gauge the remaining reform needs in the transition region, including through the use of an exhaustive study at the sector level. Not surprisingly, the largest scope for reforms is found to be in countries with low transition indicator scores, particularly in Central Asia and some eastern European and Western Balkans countries. However, significant reform needs remain in specific sectors even in some central European and Baltic countries, particularly in sustainable energy and energy efficiency; transport; and in the financial sector, where regulatory and supervisory regimes require strengthening, finance to small and medium-sized firms needs to be further improved, and local capital markets need to be developed.

However, in light of the crisis, what is the likelihood of such reforms actually being implemented? Will this crisis act as a catalyst for reforms, or will it lead to a backlash against the market model? One year into the crisis in the transition region, we can almost rule out the latter. While the crisis has clearly slowed the pace of new reforms, it has led to far fewer reform reversals than in 1998-99, for example, following the crisis in Russia. Furthermore, government changes since early 2008 have either led to no change with respect to the reform stance, or indeed favoured pro-reform parties (see Chapter 6). However, a significant acceleration of reforms also appears unlikely. The main exception could be the financial sector, where the crisis appears to be stimulating political will for reforms in a number of countries, reinforced by the movement towards reform in the advanced market economies.

To conclude, the answer to the title question of this Report “Transition in crisis?” is a qualified “no”. The global recession has plunged the transition region into crisis, but at the same time demonstrated the resilience of reforms and economic integration achieved over the last 15 to 20 years. It has also highlighted some pitfalls of the development models that countries in the transition region have pursued. However, it is clear that the way to address these pitfalls is to extend the transition agenda, not to replace it. It would be a shame if, after all the hardship, the region did not seize the opportunity for transition in the crisis.

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