

Foreword by the Chief Economist



Sustained progress in transition requires strong political will.

The publication of this *Transition Report* coincides with the 15th anniversary of the fall of the Berlin Wall. Much has been achieved since then, even if transition has proved a long and sometimes painful process. In most of the 27 transition countries, the transformation of the state from sole producer of the vast majority of goods and services to regulator of economic activity, financier (but not necessarily supplier) of public goods and provider of a social safety net is advancing rapidly. However, the limited experience of the state in its new roles is still apparent.

Most countries have successfully redirected their trade towards the global economy and have moved away from the old trade patterns of the Council for Mutual Economic Assistance. They have achieved moderate to high rates of growth for several years and have attracted an increased level of foreign investment, admittedly from a low starting point and concentrated in a few sectors and countries – predominantly the natural resources sector and central eastern Europe and the Baltic states.

Chapter 1 shows that, despite initial hardships, the liberalisation of markets and the introduction of structural reforms are rewarded by better economic

performance in the longer term. Macroeconomic policy is another important factor that determines the pattern of growth across the region. Over the past few years, growth in the transition countries has consistently exceeded the world average, and is expected to do so again in 2004, reaching just over 6 per cent. Since 1999, regional output has increased by more than 25 per cent. Chapter 2 looks at macroeconomic performance in more detail.

Of course, not everything is working well in the transition countries. The Commonwealth of Independent States (CIS) continues to rely too heavily on high but volatile prices for oil and other commodities. Diversification into other sectors remains a challenge for all countries that export natural resources. Macroeconomic vulnerabilities remain even in the most advanced countries. For example, persistent and unsustainable fiscal imbalances are still a cause for concern in the larger countries of central Europe. Unemployment continues to be high, particularly in central Europe and the EU candidates of south-eastern Europe. In the CIS and the western Balkans, poverty levels have started to decline but still remain high.

Enterprise surveys continue to identify serious shortcomings in the business environment. They include barriers to business expansion, market entry and exit, weak judicial and regulatory systems, and widespread corruption. Much of the region's infrastructure needs to be upgraded. Many of the networks have been under-funded, badly maintained or poorly managed. And despite several years of rapid growth in credit, access to finance remains inadequate. It is easy to find evidence of market, regulatory and government failure even in the most advanced economies of the region. The transition process still continues.

With so much still to be done, it is important that governments maintain or renew their commitment to reform and to sound and sustainable macroeconomic policies. This will not be easy, especially as most countries have now entered a phase of complex and controversial institutional reforms.

Sustained progress in transition will require strong leadership, a willingness to take on vested interests and the readiness to endure periods of political unpopularity. In some central eastern European and Baltic countries, public willingness to accept the immediate hardships of further reform may diminish now that EU membership has been achieved. In their first European Parliament elections, for example, voters in the new EU member states abstained in large numbers. Maintaining support for fiscal restraint or even retrenchment represents a significant challenge in the four largest central European countries.

The experience of the transition countries since the fall of the Berlin Wall underlines the importance of the political aspect of the EBRD's mandate. Economic reforms have been successful only where they were accompanied by a commitment to democratic principles and political freedoms. Adherence to the rule of law, control of corruption, respect for human rights and the protection of civil and political liberties are key factors in the transition process. They are also at the core of the EBRD's mandate. These principles are well entrenched in central eastern Europe and the Baltic states but progress elsewhere is mixed. For example, independent monitors have indicated failures across the CIS to meet international standards for free and fair democratic elections. Assessments in the past year by the Organisation for Security and Cooperation

in Europe, the Council of Europe and human rights organisations such as Freedom House have also expressed concern about abuses of power and the curtailing of media freedom in many transition countries.

Sustained progress in reform will continue to require commitment from the donor community. Without ongoing international assistance, the poorer countries in the CIS and south-eastern Europe in particular will struggle to establish functioning market economies and to win the fight against poverty. However, even maintaining existing aid levels cannot be taken for granted, given competing global needs and, in some donor countries, shrinking aid budgets. South-eastern Europe, where many countries still rely heavily on donor assistance, will be particularly affected by this. The prospect of closer ties with the EU has helped to encourage reform in south-eastern Europe over the past year but the western Balkans, at least, have still not attracted sizeable private investment.

One area where much remains to be done is infrastructure, as shown in Chapters 3 and 4 of this Report. For many years international financial institutions and development organisations sought to gradually reduce their involvement in the core infrastructure services of power, telecommunications, transport and water. This was on the assumption that with proper regulation the private sector could finance and operate these services.

Two factors changed this perception. First, discussions leading to the development of the Millennium Development Goals led to a renewed realisation of the importance of good infrastructure for economic development and the alleviation of poverty. They also underlined the continuing need for public financing (both domestic and from official sources) alongside private investment in infrastructure services. Secondly, the global economic slowdown from the beginning of 2000, which coincided with crises in the international telecommunications and electricity markets, led many international operators to scale back their engagement in the emerging markets.

These developments were felt in the transition countries, even though their infrastructure challenges differ in some ways from those in other emerging markets. The main issue for transition countries is to maintain and upgrade service networks – which are

often too extensive for current needs and in a poor state of repair – rather than extend networks, as is the case in developing countries. The transition countries also need to develop the rules and regulations that encourage efficient, cost-effective, environmentally sustainable and affordable services.

Infrastructure services in the transition countries need to be redesigned to improve regional and global integration and trade expansion. Since the publication of Adam Smith's *Wealth of Nations* back in 1776, economists have known that the division of labour (and the associated gains in efficiency and productivity) may be limited by the extent of the market. In other words, transaction and transportation costs restrict competition and limit the benefits of economies of scale and scope. Transaction costs can be reduced by eliminating administrative barriers to trade, by implementing transparent regulation and by investing in new technologies. Transportation costs can be minimised by cost-effective investment in infrastructure networks.

Transition countries have sought private sector assistance both in financing the upgrade and maintenance of infrastructure services and in improving the management of networks. Notable successes have been recorded, in particular in reducing losses and improving the collection of payments. There have also been some high-profile failures. With hindsight, we know that expectations about the potential impact of private sector participation were often unrealistically high. Private sector participation is not a panacea.

Nevertheless, private entrepreneurs are involved successfully in providing a large and growing number of infrastructure services throughout the region. However, as lessons from past projects are absorbed, the shape of private sector participation is changing. Increasingly, the private sector is invited to provide management skills rather than to finance capital investment. This makes the arrangements less risky for both partners but no less difficult to structure.

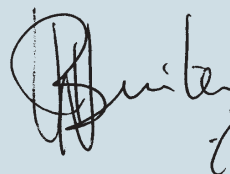
One reason why private sector participation in infrastructure has not been as successful as hoped is the existence of institutional weakness and political constraints. The private sector can perform effectively only if it is allowed to do so. The commercialisation

and privatisation of infrastructure services vastly increase the need for regulation, and experience has shown that regulatory requirements do not necessarily diminish as services become more competitive. This is clearly the case in mobile telecommunications, which is highly competitive but subject to licensing and regulated arrangements regarding interconnection.

Throughout the region, progress in infrastructure reform has been hindered by a lack of efficient regulatory institutions and by vested interests seeking to protect their position of strength. This is particularly evident in the area of tariff reform, where well-connected interest groups have often succeeded in blocking the tariff adjustments needed to put infrastructure services on a sound and sustainable financial footing.

There are justifiable concerns about the impact of tariff reform on poor consumers, who may not be able to afford steep price rises. However, there are a number of ways to address these concerns, such as "lifeline" tariffs that allow a certain level of services to be provided free of charge. Organisations such as the EBRD are now paying more attention to this issue. Infrastructure reform may be difficult but it is not impossible.

As a transition bank, the EBRD needs to understand the complex processes of transition. The *Transition Report* is a contribution to this learning curve. It is also a way for the EBRD to share its analysis and findings with other investors, policy-makers, the research community and the public at large.



Willem Buiter

Chief Economist
and Special Counsellor to the President

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