

Foreword by the EBRD's Chief Economist

Sustained growth improves living standards but reforms need a boost.

Countries in the transition region continued to grow at an impressive pace over the past year. Growth in the region as a whole was at an all-time high of 6.9 per cent for 2006 (weighted average), driven to a great extent by domestic consumption, investment and the expansion of domestic credit, but also by favourable market conditions. However, the recent turmoil in international financial markets has raised questions about whether market conditions will remain benign, as explained in a separate discussion in Chapter 1.

The global liquidity crisis that began in summer 2007 has so far had a limited effect on the transition countries. Most have strengthened their finances and institutional frameworks in recent years. Since the crises of the 1990s, foreign banks have invested heavily in the region, strengthening local banking systems. In many transition countries foreign-exchange reserves have grown to all-time highs, thanks to high oil and gas prices and prudent macroeconomic management.

Nevertheless, the re-pricing of risk and higher costs for inter-bank lending across the region will reduce demand for bank credit, lower consumption and investments and slow economic growth. A prolonged squeeze on global liquidity would have a significant impact on those transition countries with large external imbalances and on individual institutions with large financing needs. Households, many of which have borrowed in foreign currency, will also come under pressure in the event of currency depreciations.

Ongoing corrections in housing markets in some countries put pressure on banks and enterprises that are particularly exposed to this sector.

These vulnerabilities must be addressed through continued structural and institutional reforms aimed at strengthening the financial sector and promoting entrepreneurial activity. However, whether owing to fatigue for some countries following accession to the European Union, uncertainties over the chances of EU membership for those in the "waiting room" or complacency brought on by the large oil and gas windfall, the pace of reforms in 2007 was the slowest since the transition began. Most importantly, popular support for reforms is weakening in many transition countries. Opinion polls throughout the region tell a story of deep and widespread discontent and there have been more frequent changes of government in recent years.

It is this striking contrast between strong growth and improving living standards on the one hand and broad dissatisfaction with the outcomes of transition on the other that is the starting point of this year's *Transition Report*. Lack of satisfaction is important in its own right – economic results must be measured more broadly than just in terms of GDP growth – but it also undermines support for economic and political reforms. Moreover, understanding public attitudes and values is critical to the design of policy, not least for the delivery of public services such as health care and education.



For these reasons the EBRD initiated the Life in Transition Survey (LiTS), which asks a wide variety of people – from farmers and factory workers to stay-at-home carers and entrepreneurs – how transition has affected them and their frame of mind. This unique exercise, undertaken jointly with the World Bank in 28 out of 29 of the EBRD's countries of operations, combines a traditional household survey – employing objective measures such as expenditures, living conditions and labour market status – with a survey of people's perceptions.

The results show that most people recognise that their lives are better today than before the transition began. The LiTS data on the ownership of goods and household expenditure reveal the emergence of a solid middle class in many countries with all that this means for consumption patterns and political attitudes. At the same time, people have a profound sense that their household wealth has deteriorated in relative terms; a clear majority reported that their relative position on a ten-step income ladder had fallen. This has made them sceptical about how and whether the market can improve their lives and safeguard their livelihoods. It has also eroded their support for reform-minded political parties and has led them to expect more from their governments in terms of tackling social and economic problems and correcting past injustices.

Yet, one of the most compelling results from the LiTS is the strong support for democracy and markets across the entire region and the weak support for the repressive systems of the past.

Despite the many hardships brought on by transition, a large majority of the people who have lived through this experience have embraced the move to economic and political freedom. As expected, this is especially true for those made better-off by the transition, for the better educated and more highly skilled segments of the workforce and for the younger generation. Although transition has been difficult, most people believe that the next generation will be better-off than the present one.

Nevertheless, support for the broad concepts of markets and democracy does not translate into public support for all types of market and democratic reforms. One result from the LiTS that applies across almost all countries is the strong support for increased government intervention in the economy. Despite relatively low levels of trust in government institutions, many people in the transition countries appear to trust markets even less. While they do not wish to see a return to central planning, they want the state to take more responsibility for making markets function better, for redistributing wealth and for managing strategic assets, such as oil and gas and electricity.

In one important respect, the transition process still has a long way to go in many countries. According to the LiTS, volunteerism, membership in clubs and other local community groups, participation in demonstrations, strikes and other forms of civic activism are abnormally low compared with developed market democracies. Civil society was almost entirely absent during communist times, although a sense of community may have existed through bonds of trust and cooperation at the local level. However, 17 years of transition has led to an erosion of trust in society and lower levels of confidence in key market and political institutions. It has also resulted in the perception of higher levels of corruption. This reduces social cohesion in the community, an important ingredient in sustaining markets and supporting democracy, and weakens the consensus for further reform.

The LiTS results have important implications for public policy. People surveyed clearly expect more from their governments in delivering public services – health, education, housing and basic municipal services. The deterioration in these services is less visible in terms of quantity – for example, the number of doctors and teachers per 1,000 citizens delivering these services – than in terms of quality. Hospitals and schools have not always been able to keep up with technological advances and the basic infrastructure needs to be modernised. Improving access to, and raising the quality of, public services must be an important part of any government's response to the widespread popular dissatisfaction.

While some countries have the ability to respond with additional government spending, most do not. For example, in the resource-rich countries in the CIS, years of accumulated savings in oil funds can now be channelled into infrastructure and social sector investment to improve public services in health, education, and municipal services. However, even where money is available, the ability to spend it efficiently and modernise effectively is beyond the capacity of the local governments that normally provide these services.

Private-sector involvement – through partnerships with the public sector, concessions, long-term contracts or other arrangements – is beginning to address the persistent problems that governments have in upgrading public services. However, as illustrated by the example of health care in Chapter 5, the challenges in designing and implementing such partnerships are not trivial, given the importance of government regulation in the delivery of many public services. Moreover, the parties involved often differ greatly in experience, with the public institution usually entering such an arrangement for the first time while the private operator may have experience in numerous projects globally.

Experience has shown the importance of strengthening regulatory and administrative practices when it comes to handling tricky procurement issues, encouraging competition and overseeing projects. Reliable and independent courts are also needed to enforce contracts and settle disputes. But perhaps the key ingredient to making these partnerships work is the engagement of local communities.

Special-interest groups, non-governmental organisations, an independent media and the establishment of public awareness campaigns can provide the monitoring function needed to ensure that the providers of public services remain committed to access, affordability and quality, in accordance with negotiated agreements. Most importantly, transparency and consultation can ensure that the public is better informed and has more realistic expectations about the implementation of complex projects. Experience from other parts of the world shows that community-based monitoring can be highly effective in reducing corruption and improving public service delivery.

The EBRD can play a role in supporting government authorities at different levels in the process of delivering public services. By learning from other projects in the region and by actively strengthening the capacity of local governments to implement projects, we can help to improve the efficiency of private-sector involvement in the delivery of public services. Ultimately, these efforts will also strengthen the commitment of local people to this process and improve not only access to public services but also people's sense of well-being.

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