

Foreword



“Despite the global crisis, growth prospects remain good but sustained reform will be critical.”

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The past year has been a tumultuous one for the global economy. After a period of mounting pressures in the financial markets, the crisis originating in the advanced economies of the United States and Europe has finally hit the transition region with full force. The resilience of the countries in the region to the early phases of the crisis is a testament to their remarkable achievements in establishing credible macroeconomic frameworks and reforming their institutions. Yet as part of the process of integration with the international economy, their exposure to the current crisis has increased, albeit with varying degrees of vulnerability.

The manifestations of the crisis are everywhere. Stock markets have plunged and several countries have experienced rapid capital outflows and pressures on their currencies. Inter-bank rates have also increased markedly. Growth in the region as a whole fell from 7.5 per cent in 2007 – the highest that has been achieved since transition began – to a projected 6.3 per cent in 2008 with a further, significant fall expected in 2009. However, only some of this slowdown can be attributed to the financial crisis.

There are now increasing signs that the wider economy is being affected, with industrial production slowing down and even contracting in many countries. These developments stem not only from more expensive credit and a rapid reduction of growth in key export markets, but also increasingly from the shutdown of traditional lending channels. Lending by local banks, many of which are owned by parent banks based in western Europe – themselves adversely affected by the crisis – has widely contracted. In addition, governments themselves are being hit directly through lower ratings and speculation against individual currencies that in some cases have already forced governments to seek support from the International Monetary Fund and other agencies.

The depth and duration of the global crisis are still unclear, but the region is now bracing itself for higher unemployment and lower consumption growth. The focus of policy-makers has quickly shifted from containing inflationary pressures to protecting domestic financial institutions and mitigating the impact on the real economy. The scale of the crisis makes the policy response of individual governments difficult to design and coordinate with those of other affected countries. Nevertheless, despite these limitations the policy response has mostly been appropriate.

While the global financial crisis has unsurprisingly dominated the attention of policy-makers, there is a danger that this focus can divert needed attention away from the key long-term growth challenges that face individual countries and the region. The region's economy has expanded rapidly since 2000, but this growth came after a protracted period of recession. To put this in perspective, by the end of 2007 the Commonwealth of Independent States and Mongolia (CIS+M) on average had a GDP level roughly comparable (in real terms) to that reported in 1989. In central eastern Europe and the Baltic states (CEB), GDP was on average only 50 per cent higher than it had been in 1989, while in several countries in south-eastern Europe (SEE), it was significantly lower than in the pre-transition period. Therefore, while the acceleration in growth has been significant, the scope for the transition economies to grow further remains substantial. The analysis in the *Transition Report 2008* suggests that countries that have implemented key market-enabling and market-deepening reforms – such as price liberalisation, privatisation and financial sector reform – have reaped benefits in terms of growth.

The challenges now are to implement the often more difficult and protracted market-sustaining reforms (such as competition policy, governance and company restructuring) that are essential for long-term growth, while

trying to surmount the shorter-term pressures thrown up by events in the international economy. Failure to keep inflation under control and to ensure the stability and functioning of the financial system will make it hard, if not impossible, to implement effectively policies aimed at raising the long-term growth potential of these economies.

It is now widely accepted that the ability of an economy to innovate is central to its prosperity and dynamism. Innovation can involve both the successful adoption of existing technologies and the invention of new ones. In the transition region, the challenge to date has mostly been about the former strategy but, in the longer term, countries will want to develop their own innovations. This Report focuses on two features – competition and education – that are essential prerequisites for sustained growth. While competition can help motivate innovation through the adoption of existing technology or the creation of new products, there is nevertheless a need for a sub-structure of “capabilities” in an economy – meaning not only a good physical infrastructure and business climate but also appropriate skills and education among its workforce. Transition countries typically have higher levels of human capital than other countries at roughly comparable income levels, but they have often failed to build effectively on these foundations. The Report consequently proposes a variety of policies that can help extend investment in education and skills acquisition in the region, arguing that such investment can reap clear rewards in terms of innovation and growth. Building human capabilities will be a major determinant of the rate of subsequent growth and its sustainability.

The Report also explores what each country produces and, in particular, the composition of its exports. The latter provides a good indication of a country’s relative advantage in the international economy. The results of the analysis for the transition region are broadly positive. Many countries – particularly in CEB – have changed their structure and direction of trade, improving the value

of existing products and moving into new and higher-value exports. This is not, however, the case for some of the commodity-exporting countries of the CIS+M, for which the need to improve and diversify their capabilities – not least through sustained investment in education – must be a central objective.

The challenge of sustaining long-term growth in the transition region raises important questions about the respective roles of government and the private sector. Many governments have, at one time or another, actively pursued various forms of industrial policy. Although the experience has often been quite negative, some recent instances show that there can be justification for selective industrial policy that goes beyond the implementation of so-called “horizontal” policies that aim to improve the business environment. Targeted or “vertical” policies can, for example, be deployed to address failures in markets or where there are benefits from the coordination of investment.

The Report’s analysis focuses on several areas where intervention may be warranted in some transition countries, particularly finance for innovative activities, assistance with forming agglomerations or clusters of economic activity, and building the key capabilities that countries need to diversify and improve the quality of their products. However, to avoid the pitfalls that clearly exist, vertical industrial policy should be directed at activities that are as far as possible subject to the discipline of market competition and private sector participation, while avoiding targeting specific products. Moreover, recent experience in the transition countries shows that the way in which such interventions are designed will be critical to success or failure.

The *Transition Report 2007* showed that many people in the region have found transition to be a very difficult experience but have remained optimistic about the future. The *Transition Report 2008* provides further grounds for

optimism, as most transition countries have continued to make economic progress and have largely sustained the momentum of reforms necessary to reinforce future growth. Nevertheless, events that have originated outside the region, combined with shortcomings in policy and institutions within it, now pose major risks of instability and, in some cases, recession. Furthermore, implementation of more complex market-sustaining reforms will be essential if structural constraints are to be surmounted, while the quality of education must be raised to deliver lasting improvements in human capital and productivity.

Finding resources and political will to implement these needed reforms may prove more difficult in the current environment. Indeed, there is now some concern that economic reforms may be reversed and some of the cumulative achievements of the past two decades will be undone. This would be highly undesirable. Support for a sustained reform agenda – despite difficult economic times – remains a key objective of the EBRD.