
Foreword

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.



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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 south-eastern Europe, the commodity-rich countries have had to manage the complications of rapid inflows of foreign currency. In some countries this has led 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.