



EBRD

**Transition
Report 2008**

**Erik Berglof
Chief Economist**

Transition Report 2008
Growth in transition



European Bank
for Reconstruction and Development



Crisis: impact on the region

- **Growth slowdown accelerating:** sharp adjustments in some countries and possible collapses
- **Transition has progressed,** but slowdown likely and reversals possible, particularly in finance and trade
- **Fiscal difficulties:** threat to much-needed growth-inducing investments in education
- **Increased government intervention unavoidable:** sector-specific industrial policy is risky - must maintain market incentives and transparency when intervening

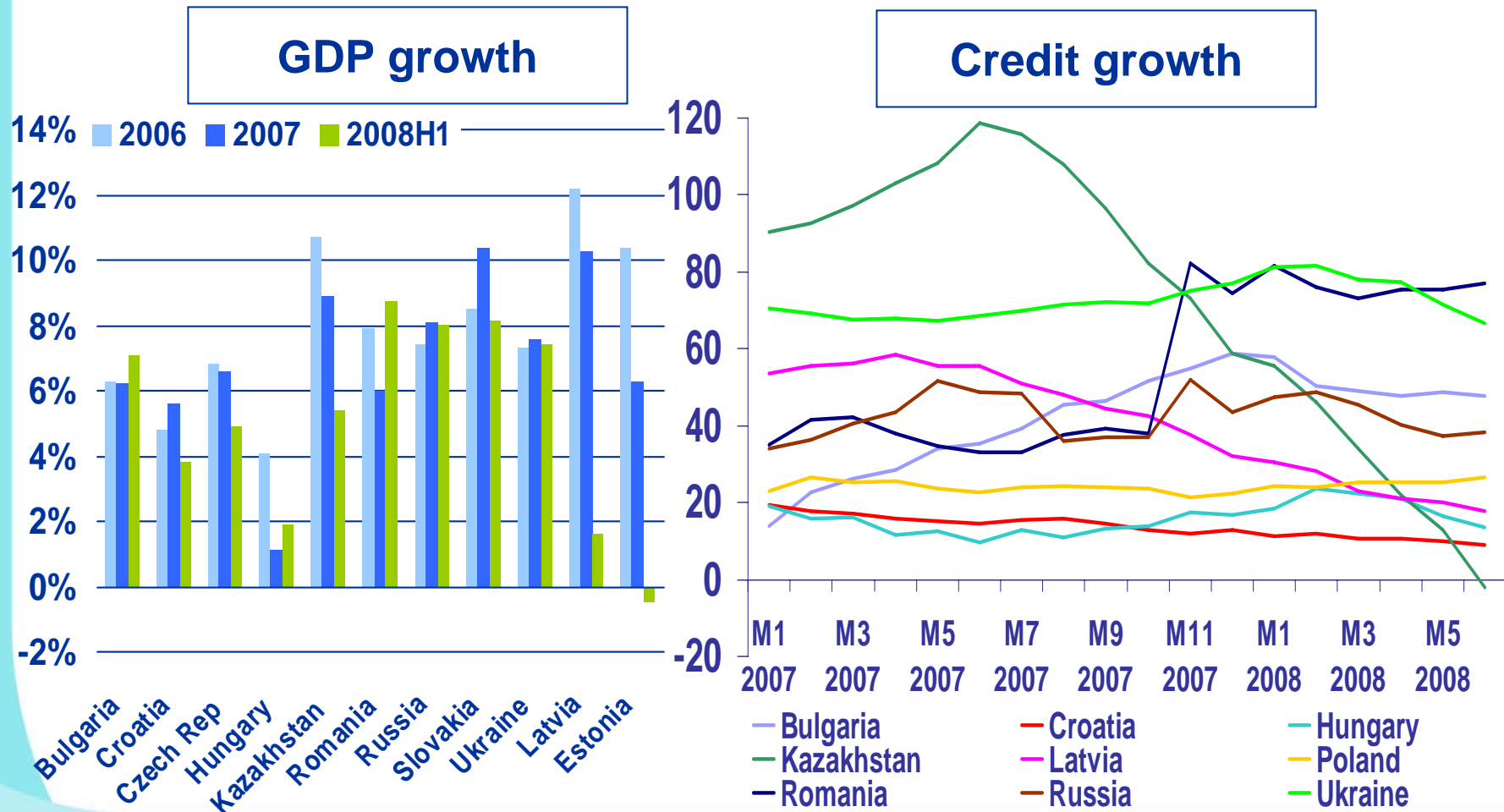




I. The Crisis and its short-term impact

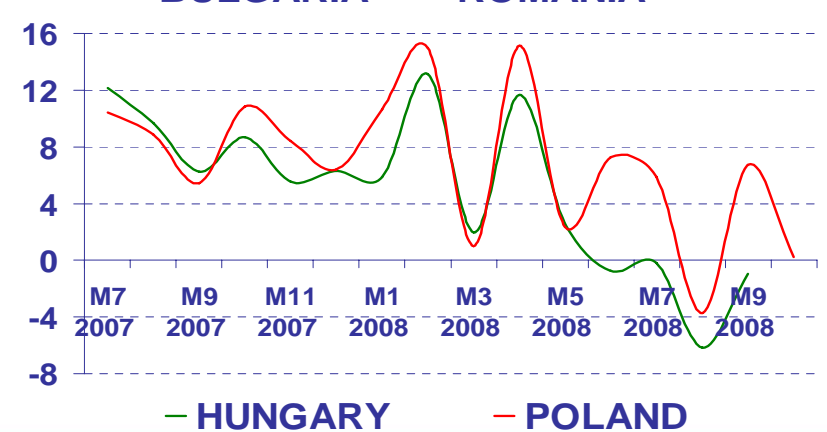
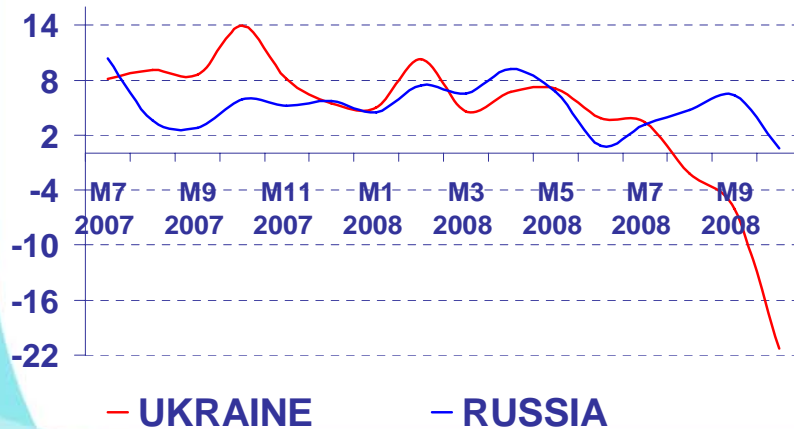
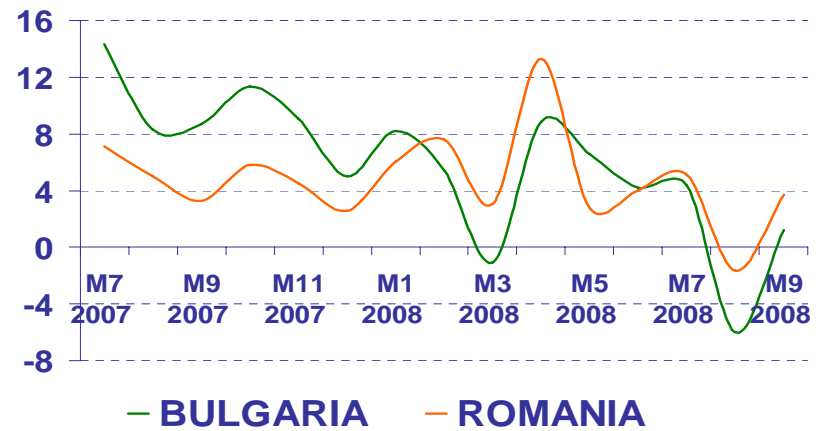
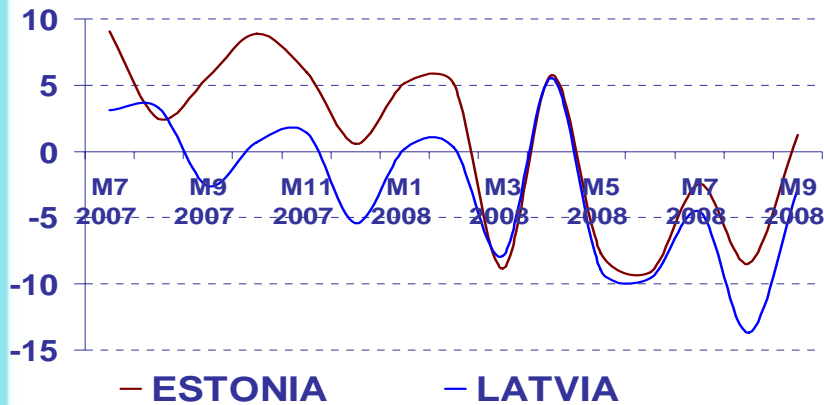


Most transition economies remained buoyant in the first half of 2008 ...



... but many countries now slowing sharply

Industrial production

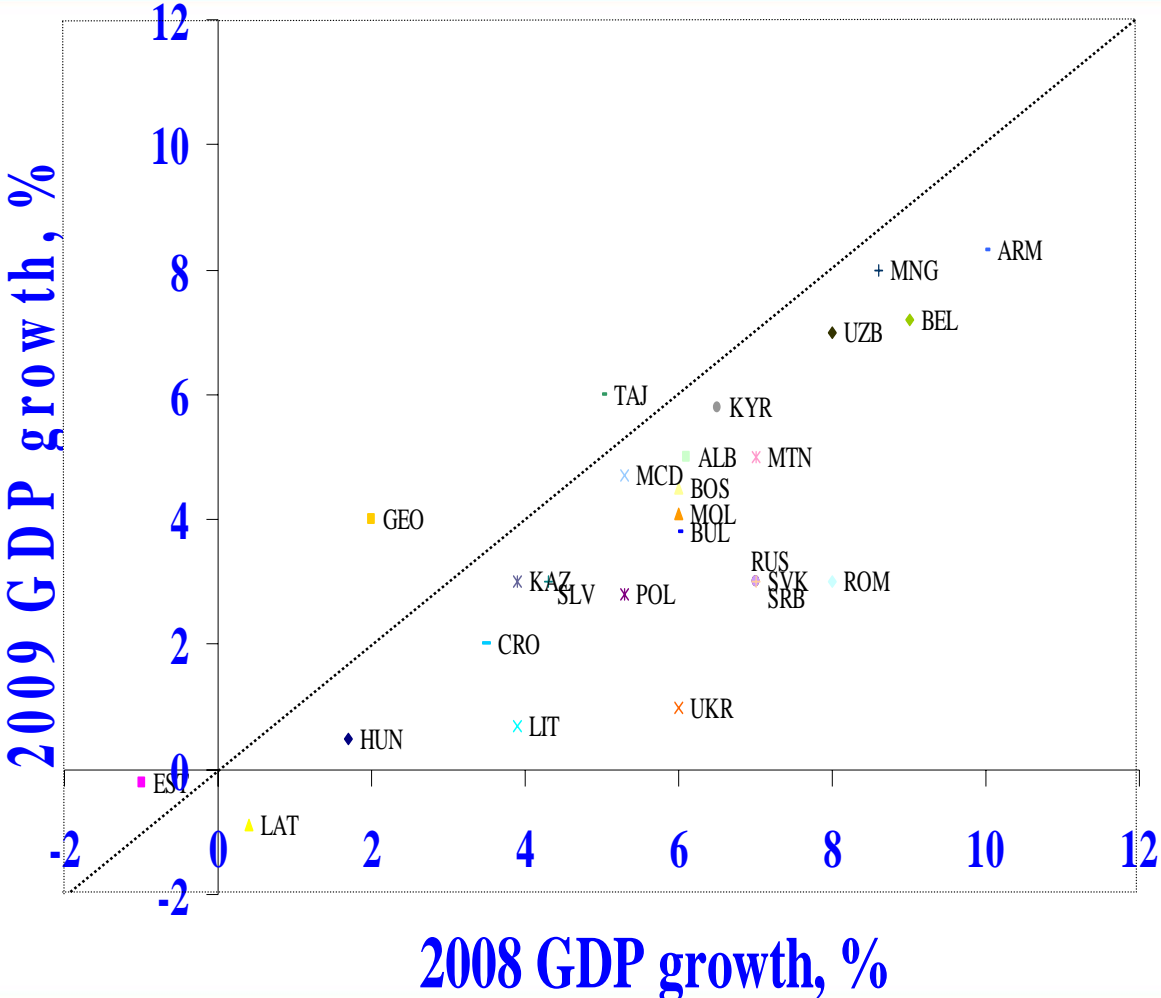


Impact of the crisis

1. Capital inflows now slowing dramatically:
 - Syndicated lending and bond markets dried up
 - Foreign parent banks deleveraging
2. Large external private refinancing needs
3. Slowing growth feeds back into financial sector stress, lower confidence
4. Commodity prices no longer supportive
5. Sharp slowdown in export markets



In most countries, growth to slow sharply or stop in 2009



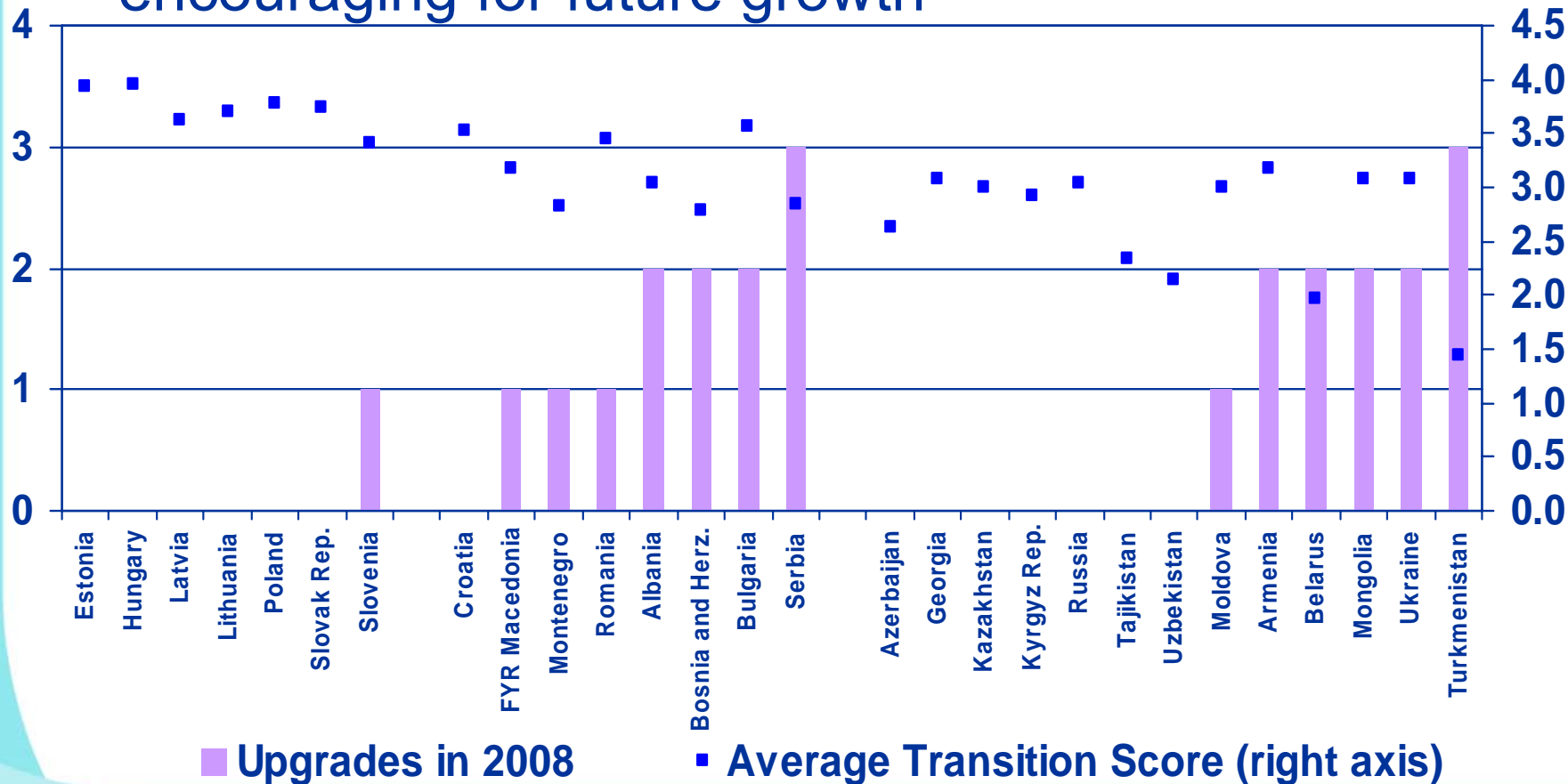


II. Transition: recent progress and risks



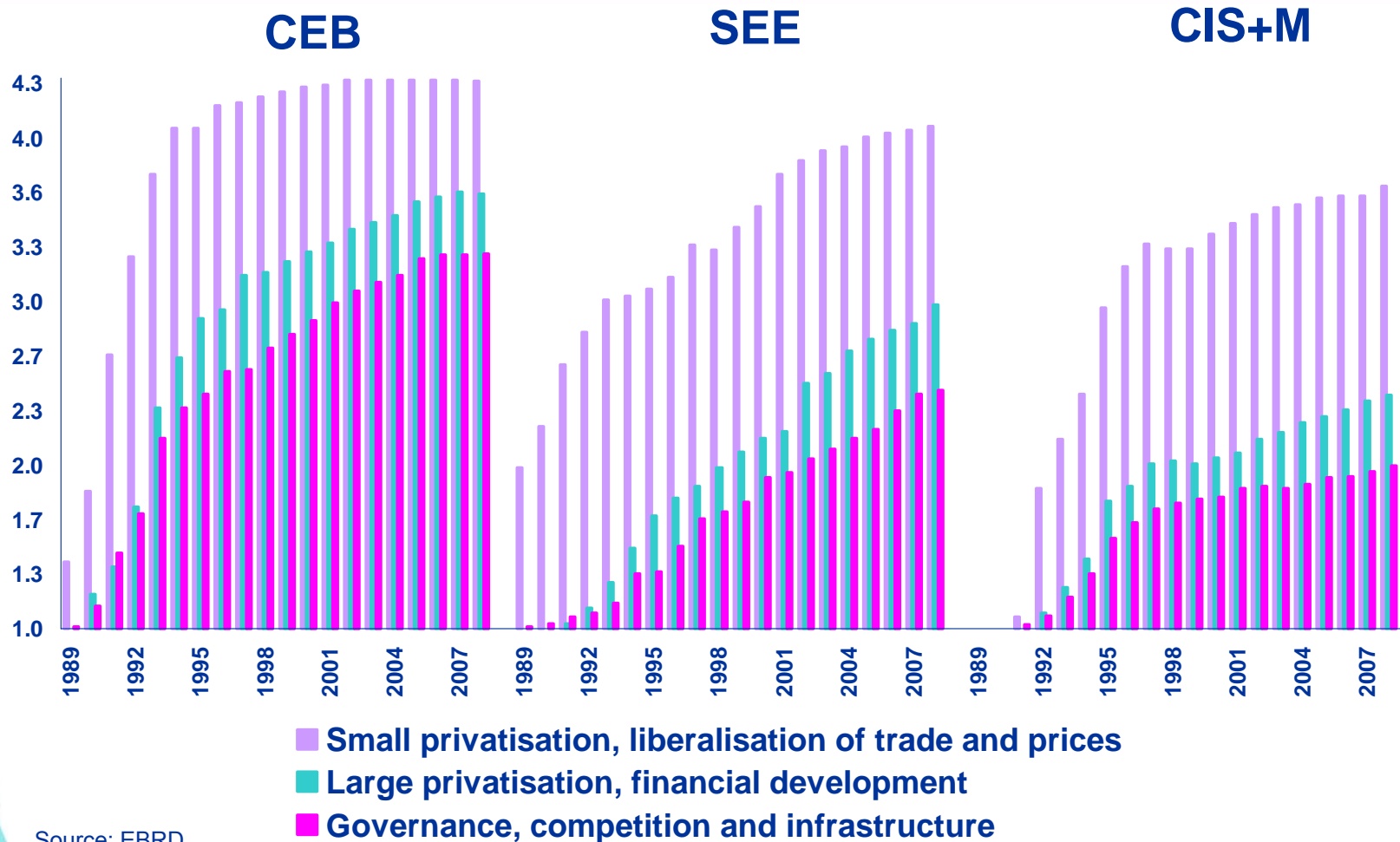
Progress in transition in 2008...

- Significant progress in some less-advanced countries – encouraging for future growth



Source: EBRD

...but much still to do on second- and third-stage reforms



Source: EBRD.



Crisis impact on transition

- Financial development likely to regress, with most immediate impact on SME sector
- Trade liberalisation challenged
- Large-scale privatisations could be reversed
- FDI may fall sharply → less transfer of new skills and know-how
- Private sector participation in large infrastructure more difficult (but more needed)



III. Challenges for long-term growth



Special Theme: *Growth in Transition*

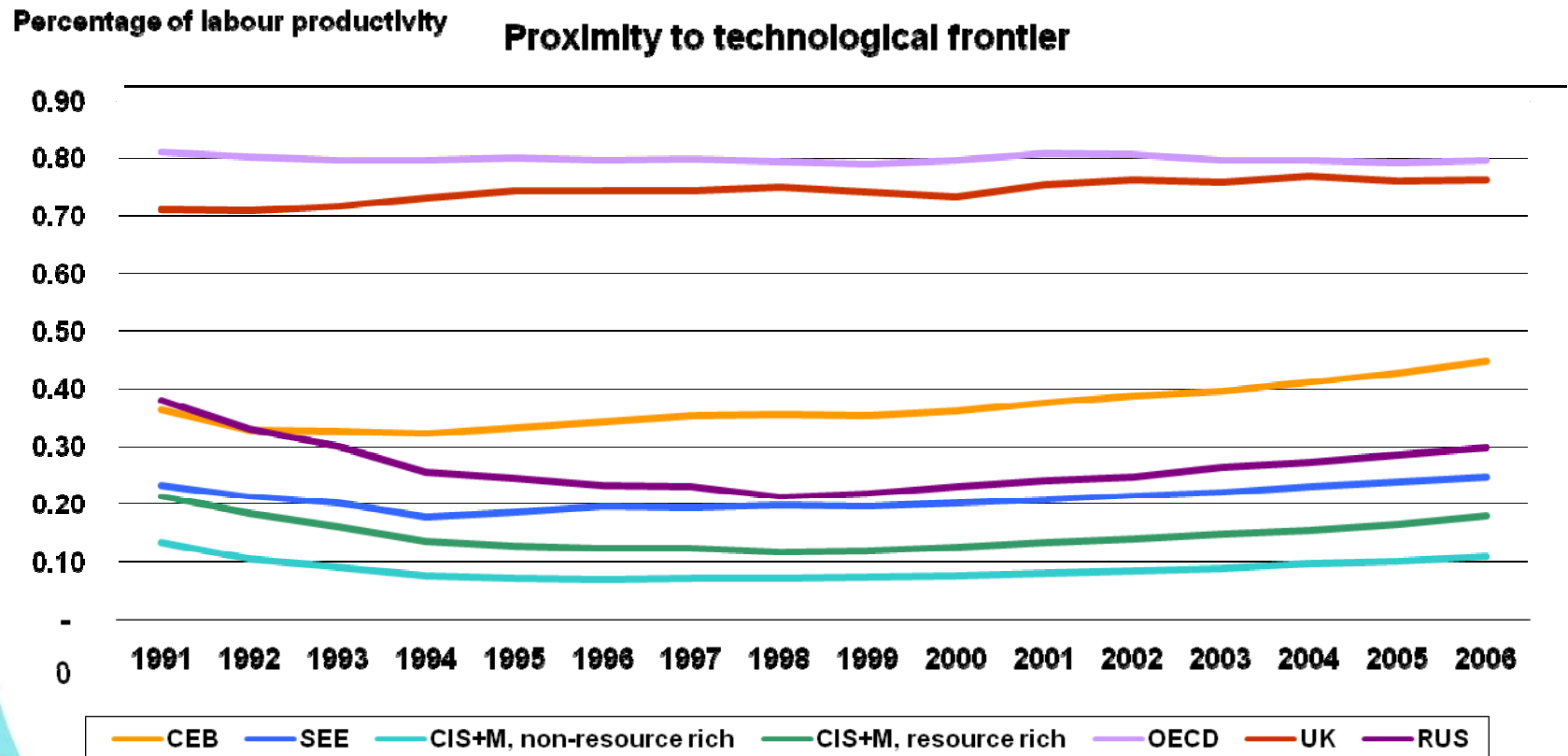
Education, competition and product mix

- All are amenable to policy reforms and important for transition countries
 - Regulatory institutions
 - Legal framework
 - Spending on education and innovation
 - Selective use of industrial policy



Large gaps in productivity remain

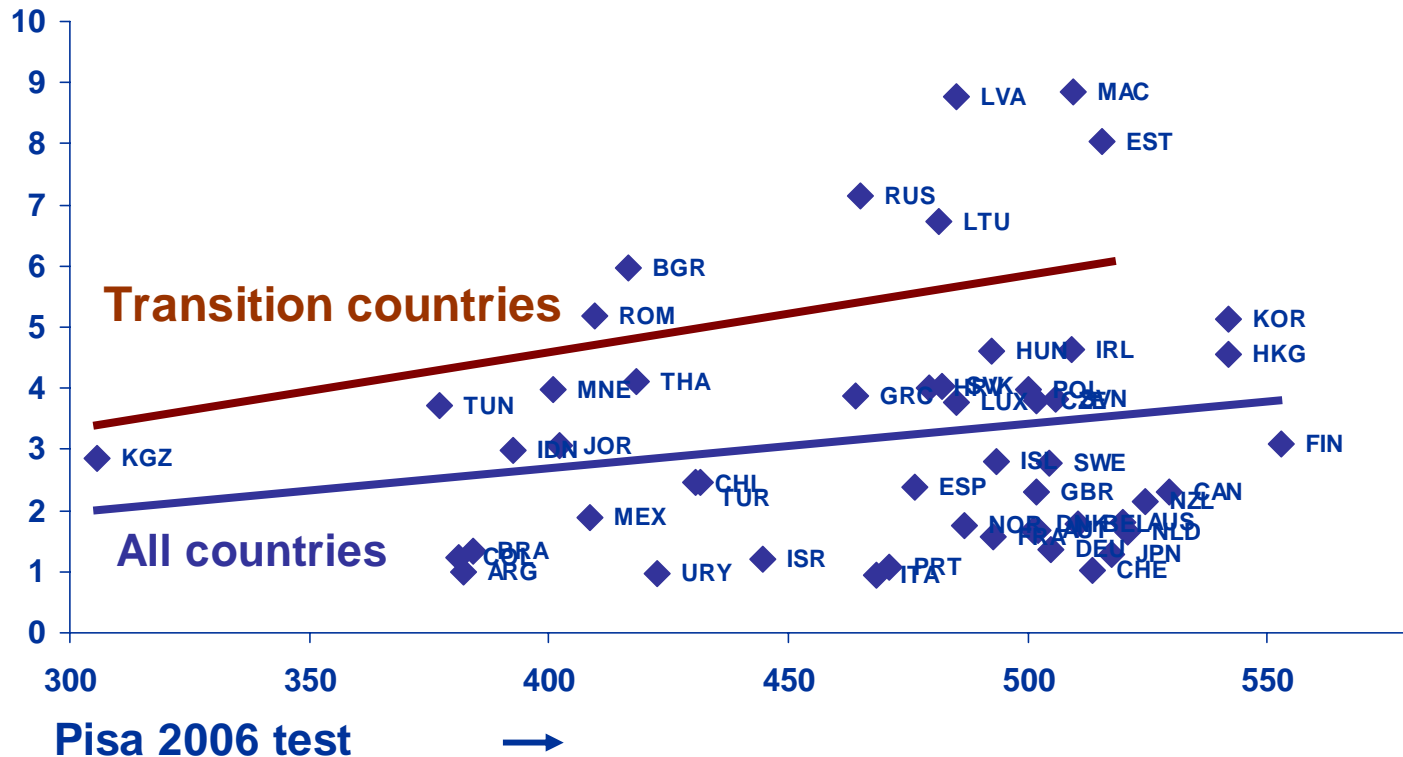
- Labour productivity is 10-40 percent of United States



Driver 1: Education

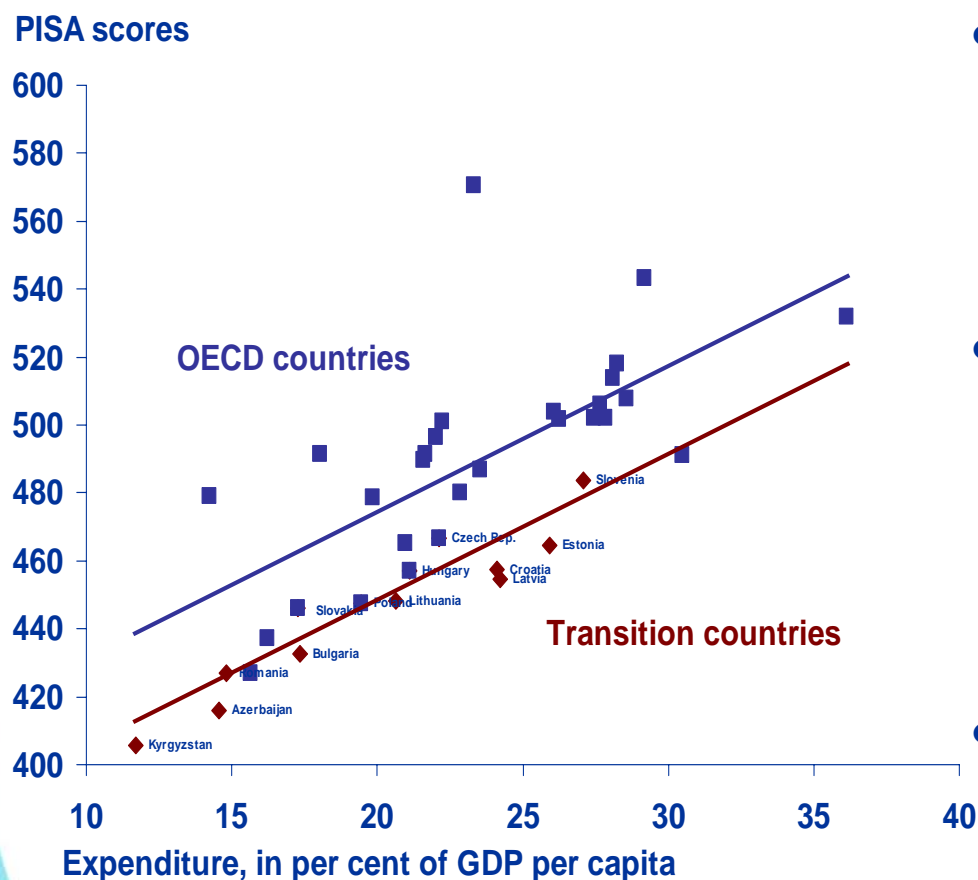
- Education quality matters for growth

Real GDP per capita growth, 2006 (%)



Source: World Development Indicators, 2008 and OECD

Educational quality is lagging in transition economies



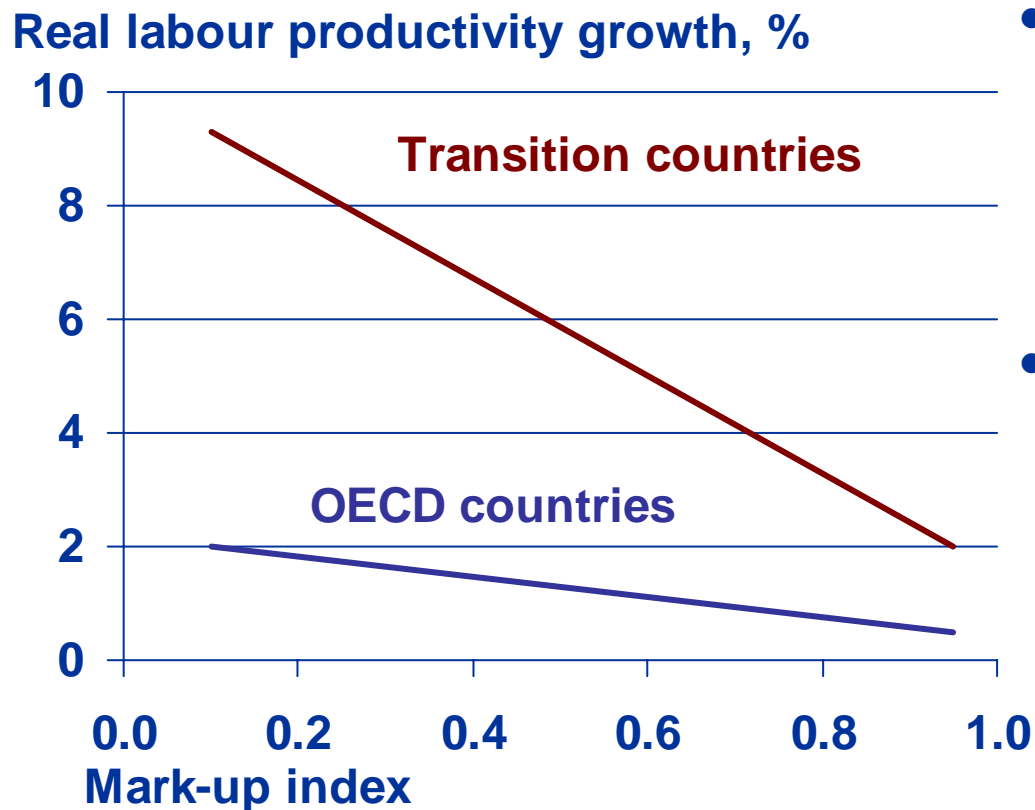
- PISA scores for primary and secondary education below OECD averages
- Clear relationship between scores and educational expenditures per student
- Both expenditures and enrolment lower

Policy implications: focus on quality of secondary education

- Improving quality of secondary education prerequisite for building a skilled workforce
- Mechanisms for quality assurance:
 - Teacher training (undergraduate education)
 - International benchmarking (such as PISA)
 - Maintain spending in all phases of business cycle
- University education not critical for current competitiveness, but need to start (re)building



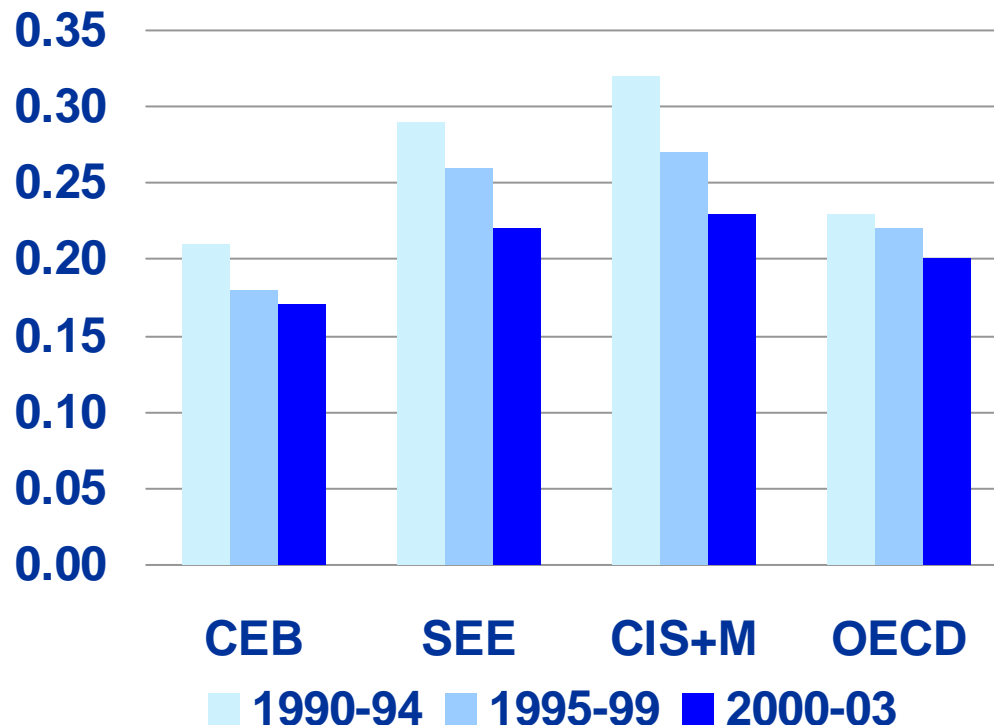
Driver 2: Competition



- Strong evidence of link between product market competition and growth
- Higher mark-ups (lower level of competition) are associated with lower productivity, especially in transition countries

Overall competition increased in the transition region

Mark-up index



- CIS+M and SEE lag CEB in terms of product market competition
- Rate of entry increased in transition region and close to OECD levels

Policy implications: focus on lowering barriers rather than on policing firms

- Broad deregulatory framework
- Easy and quick licensing and registration
 - One-stop shop licensing
 - Efficient and quick property registration
- Pursue anti-competitive behaviour not just by firms, but by government bodies at all levels
- Transparent, independent and rules-based competition authority

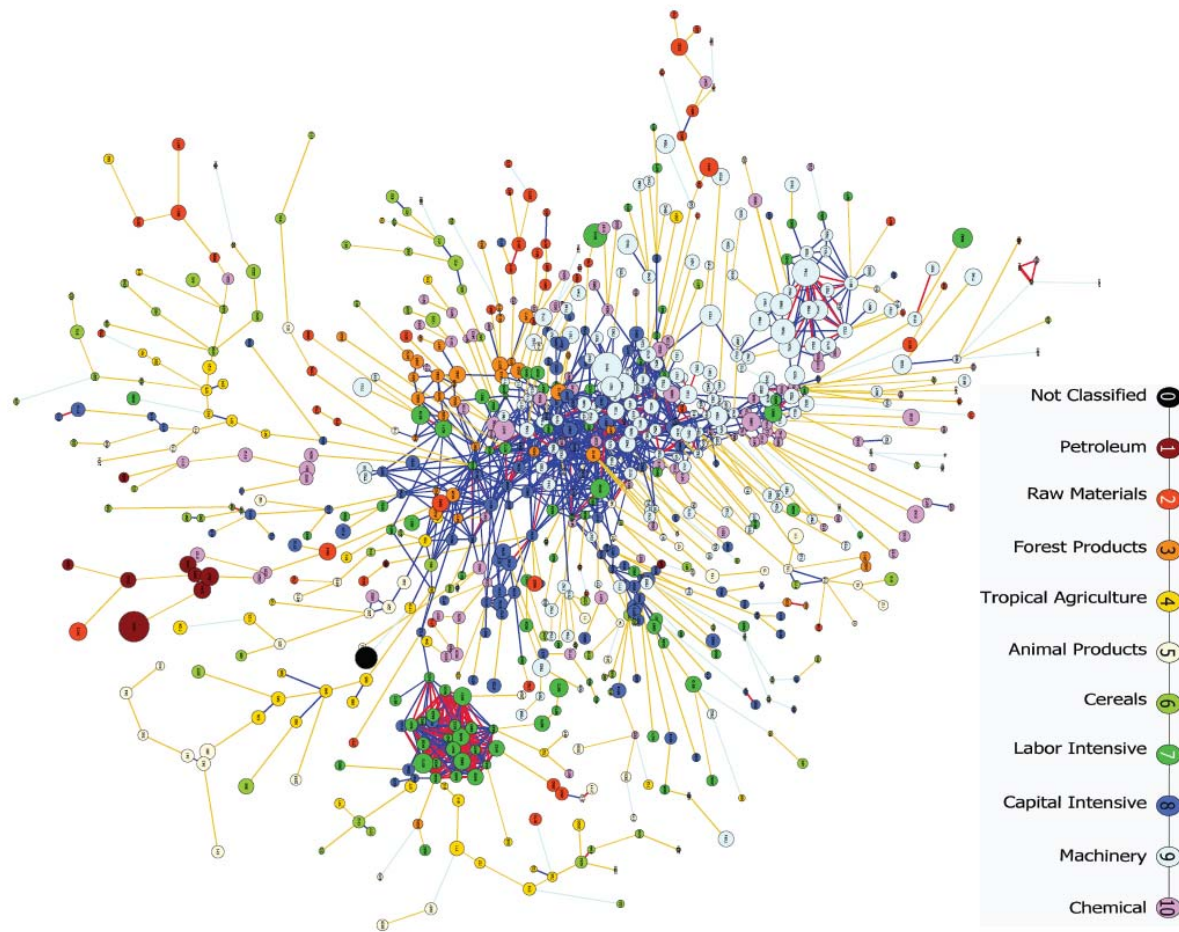


Driver 3: Trade and the product mix

- Countries successful in export markets tend to grow faster (export-led growth)
- *Composition* of exports is linked to future growth
- Existing product/export structures differ in terms of their “*connectedness*” to other products
 - “more connected” implies greater ease of producing these products in the future

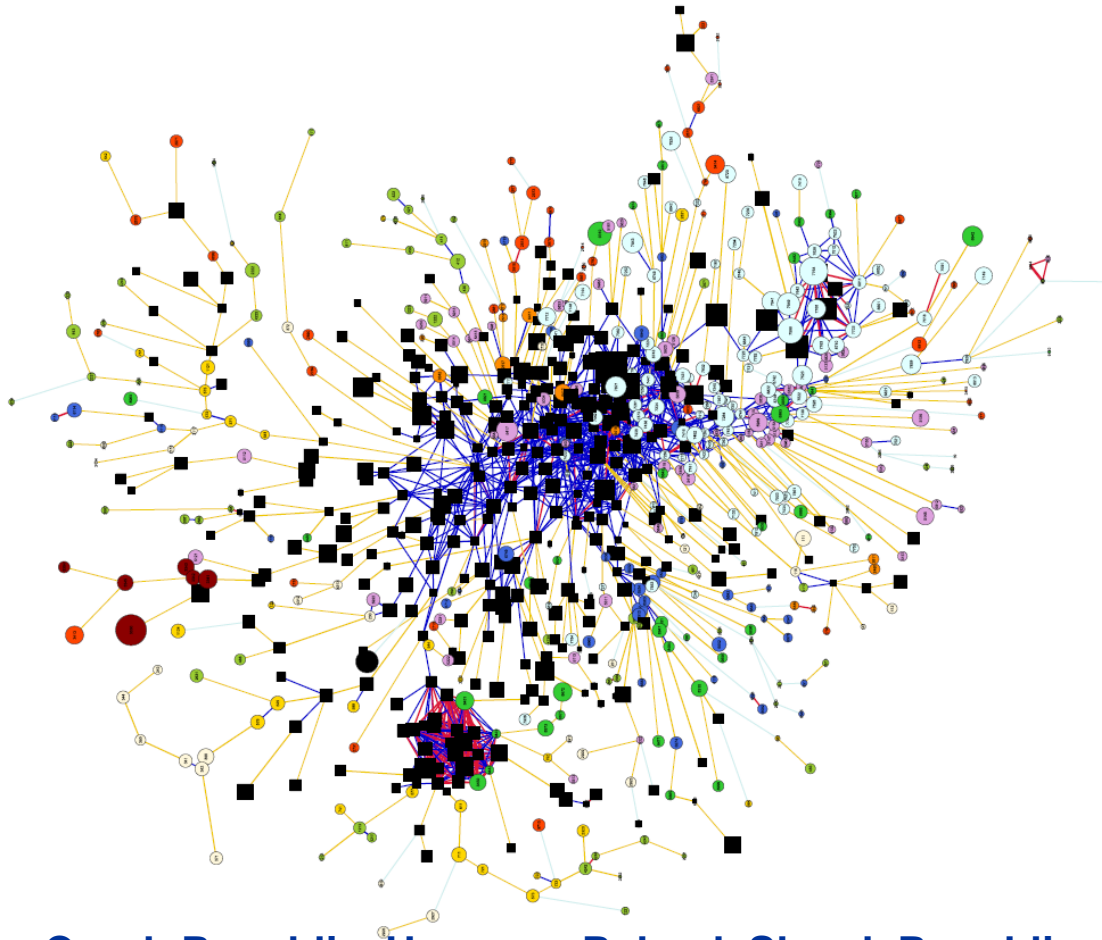


The Global Product “Forest”, 2000



Source: Hidalgo et al 2007

Central Europe Exports, 2000

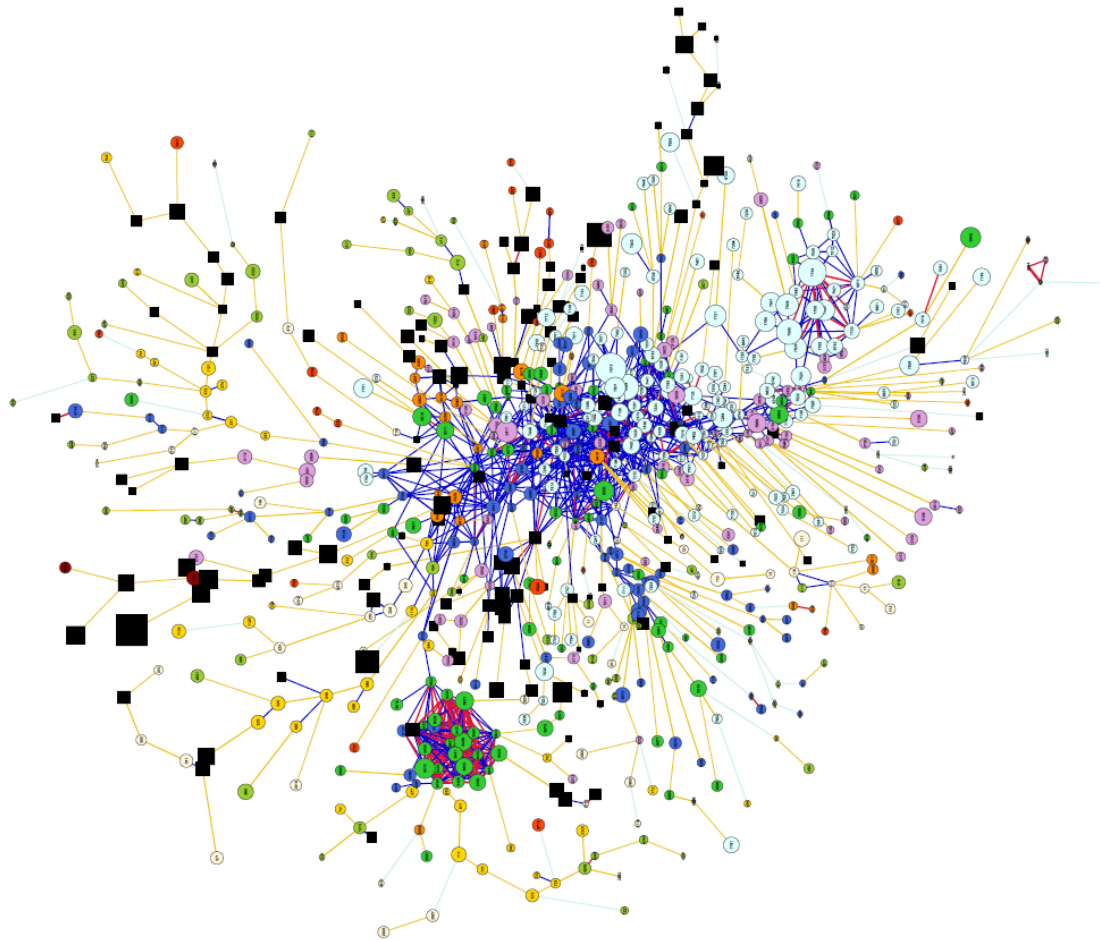


Countries: Czech Republic, Hungary, Poland, Slovak Republic, Slovenia, Hungary.

Source: Hausmann and Klinger 2008



Western CIS Exports, 2000

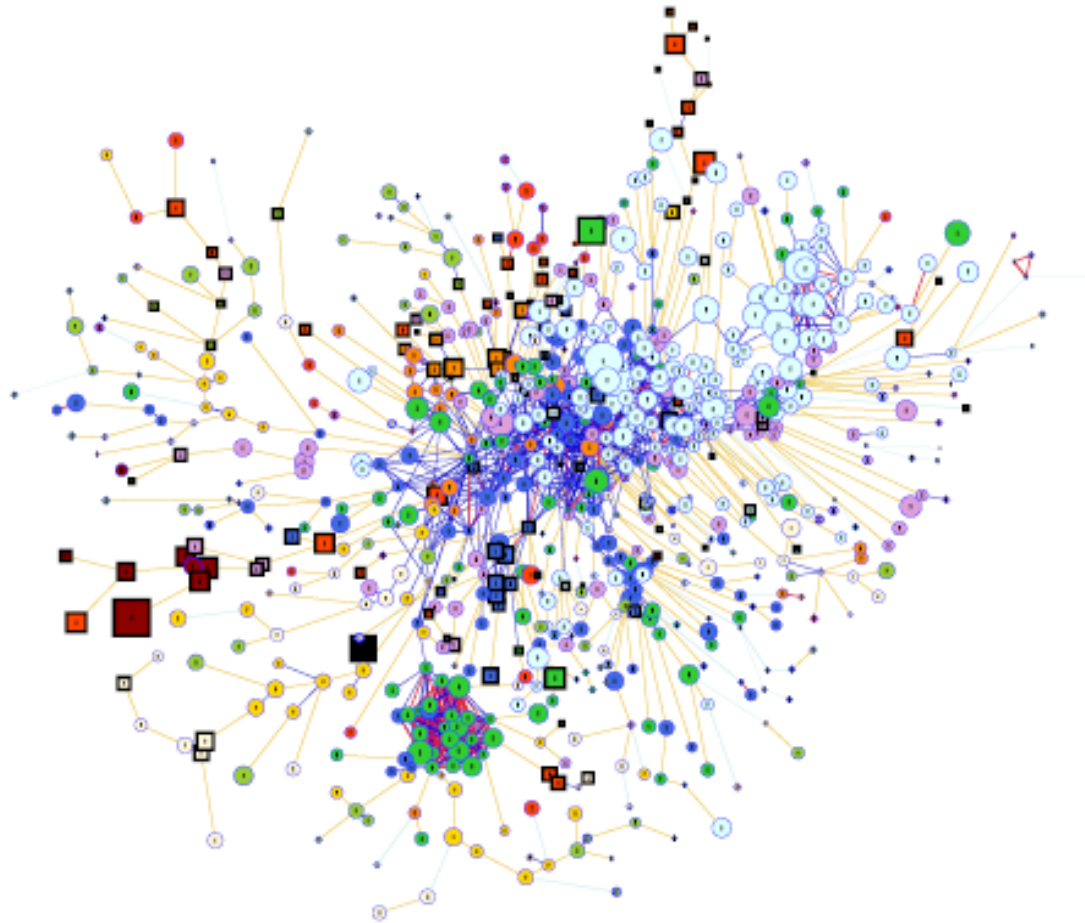


Countries: Belarus, Moldova, Russia, Ukraine, Moldova.

Source: Hausmann and Klinger 2008



Russia Exports, 2000



Source: Hausmann and Klinger 2008

Implications for the region

- **CEB:** quality upgrading and movements towards higher value manufactures – likely to continue.
- **SEE:** experience is more mixed, but most countries should be able to grow through further product diversification.
- **Russia:** not yet succeeded in developing new, higher value, manufacturing industries; heavy reliance on fuels and raw materials
 - Movement into new sectors in the commodity-exporting CIS is likely to be difficult and costly



Changing the product mix: A case for industrial policy?

Two types of industrial policy

- **Horizontal policy:** State intervention to improve the environment in which firms operate
 - Education and human capital
 - Infrastructure
 - Access to finance
 - Supporting innovation
 - Improving legal framework and government services
- **Vertical policy:** State intervention that promotes particular products or sectors
 - Through sectoral/firm targeting of above instruments
 - By subsidising the activities of particular sectors/firms directly



Vertical policies: design and implementation are critical

- Subsidising new products or sectors is almost never a good idea
 - Risk of getting it wrong
 - Failure to address underlying obstacles
 - Large potential for rent-seeking and abuse
- Instead, any vertical policy should target building of capabilities
 - Loosening sector specific financing or infrastructure constraints
 - Some successful examples, e.g. Israel high-tech VC fund
- Successfully designed vertical policies incorporate market discipline
 - e.g. competitive processes for allocating finance, driven by commercial prospects; private market cofinancing



Conclusion

- **Crisis response: domestic challenges**
 - protect core financial system;
 - improve governance and structure of financial sectors
 - maintain SME financing
 - fiscal adjustment needed in some cases to “soften the landing”
- **Crisis response: global challenges**
 - provide liquidity to, and safeguard stability of, parent banks
 - address supervisory and regulatory failures
- **Long-run growth requires:**
 - invest in improving quality of education
 - reduce barriers to entry
 - strengthen competition
 - better access to finance
 - selective pursuit of industrial policy

