

Revisiting transition reform

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Revisiting income convergence and structural reforms experience in CESEE countries

- Taking into account both the unique transition experience of the early 1990s and the most recent developments following the 2008-09 global financial crisis and moderation of commodity price increases
- Nature of the reforms and their impact on productivity growth
- Multiple factors contributed to the rapid income growth between the mid-1990s and the mid-2000s:
 - Better utilisation of existing physical and human capital
 - Entry into the European and global value added chains
 - Deepening of economic and political integration with EU-15
 - Rapid entry of foreign banks and the resulting credit boom
- By the end of the 2000s, all these drivers had been largely exhausted
- Hence the need for the region to pursue a modified growth model



Convergence experience (Where are we today?)



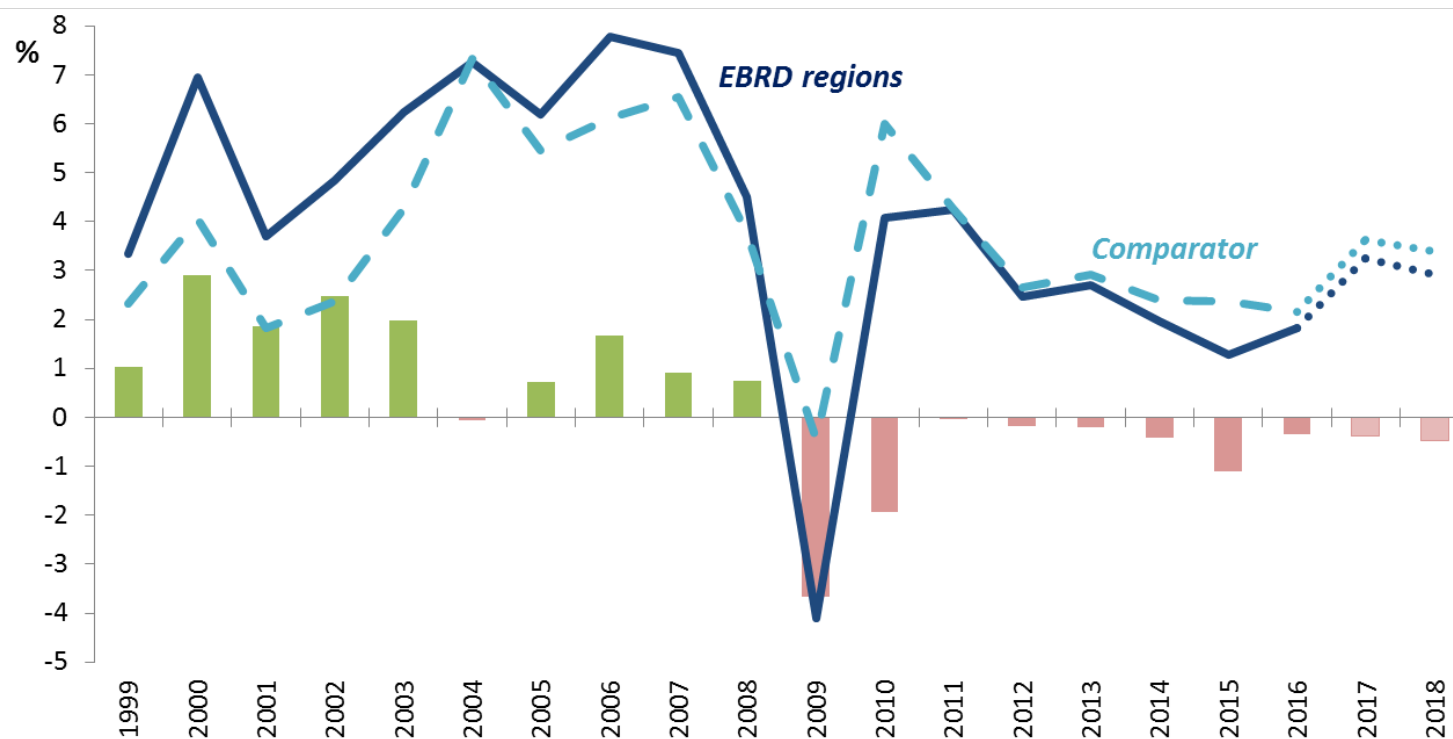
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EBRD regions consistently outperformed 1998-2008, underperformed since 2009

EBRD regions' outperformance yielded 15% higher output; underperformance cost 9% of output

For each country, construct synthetic comparator (15+ countries with max weight 15%) in each year (income per capita, population)

EBRD regions: Growth, %

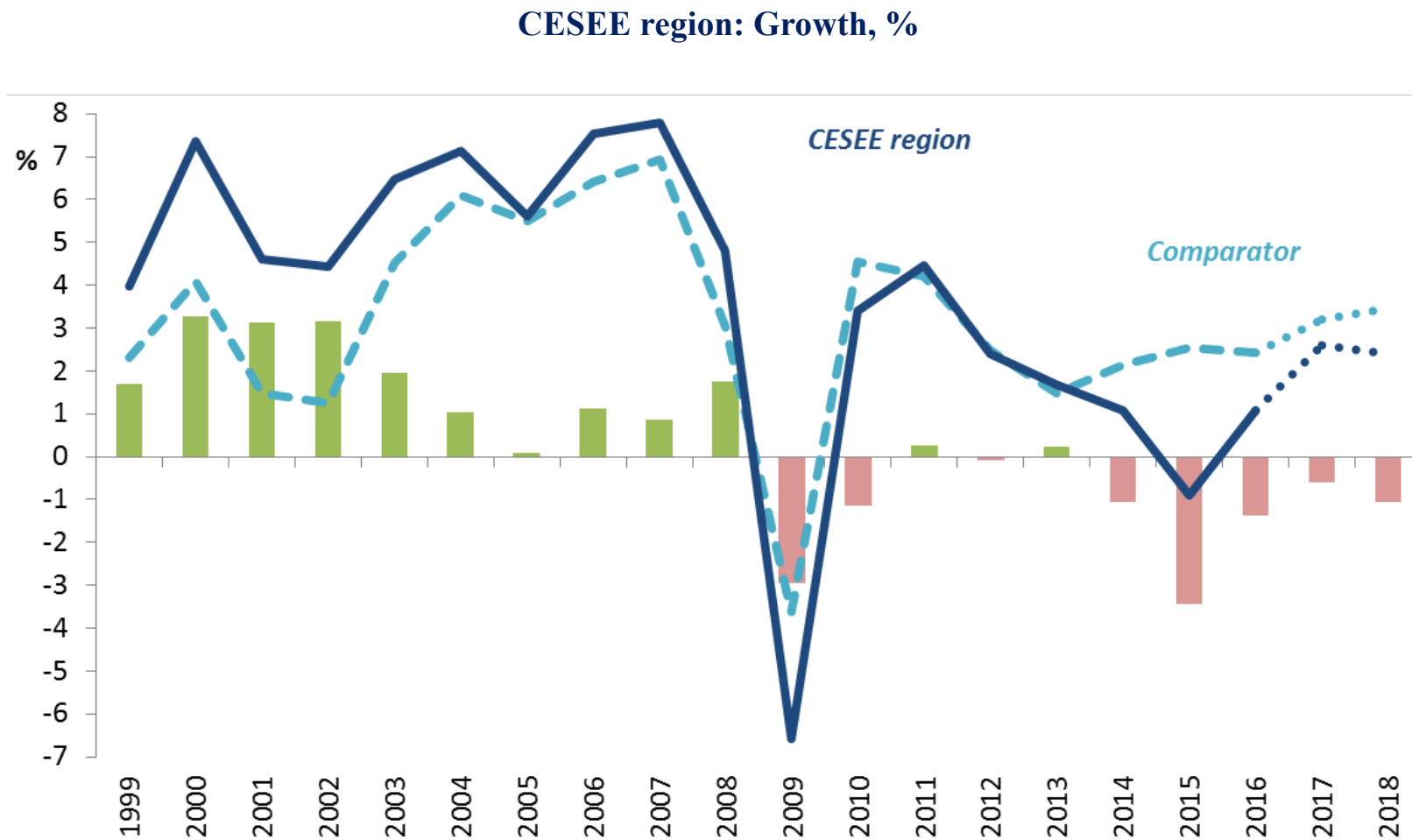


Sources: IMF WEO and authors' calculations.

For instance, Tunisia's comparators include Ecuador, Indonesia, Sri Lanka, ++.



Very similar picture for the CESEE region due to broad overlap in country composition



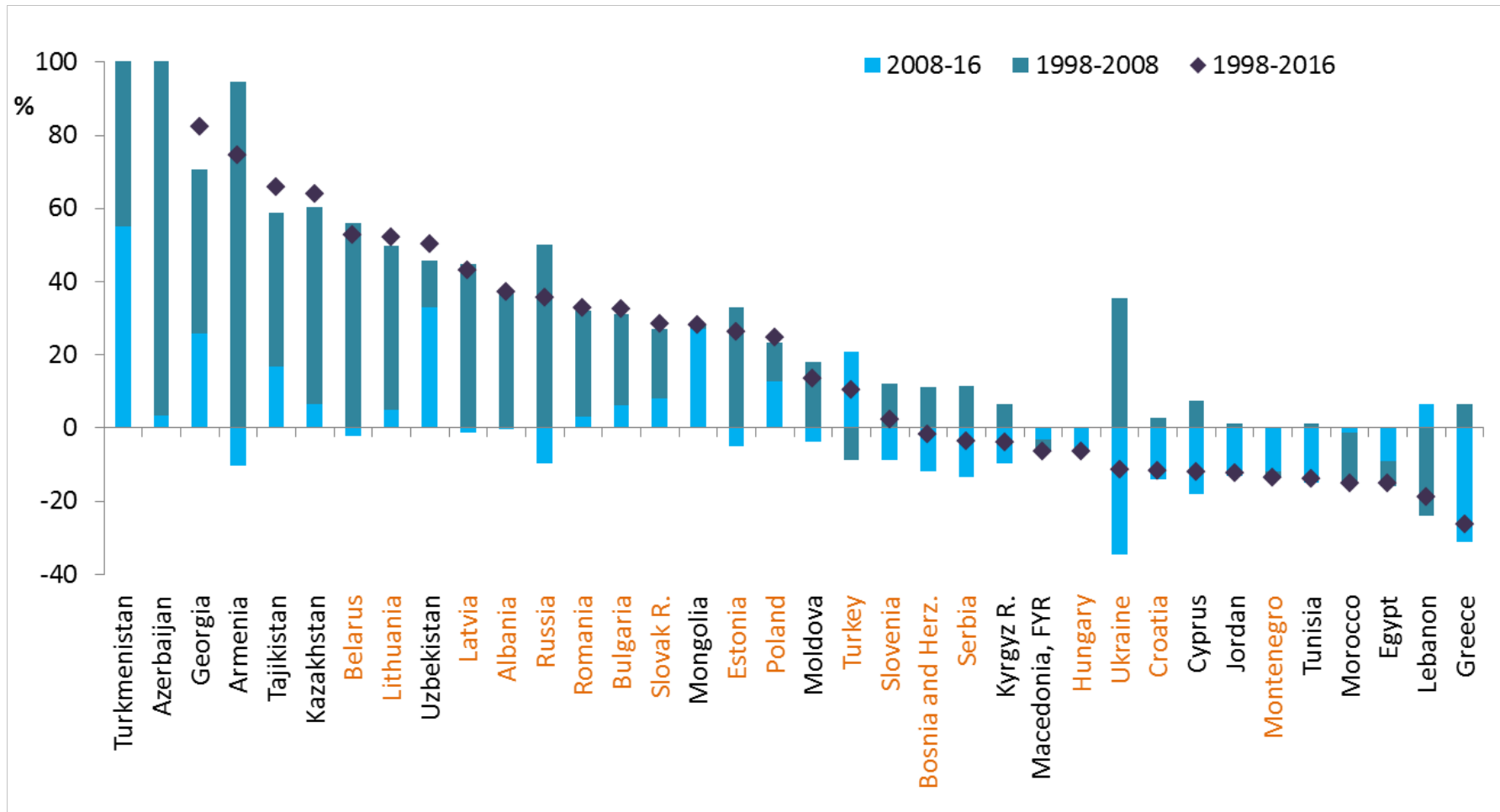
Sources: IMF WEO and authors' calculations.

For instance, Tunisia's comparators include Ecuador, Indonesia, Sri Lanka, ++.



Relative performance by country

EBRD region's per capita growth, relative performance to comparator, %

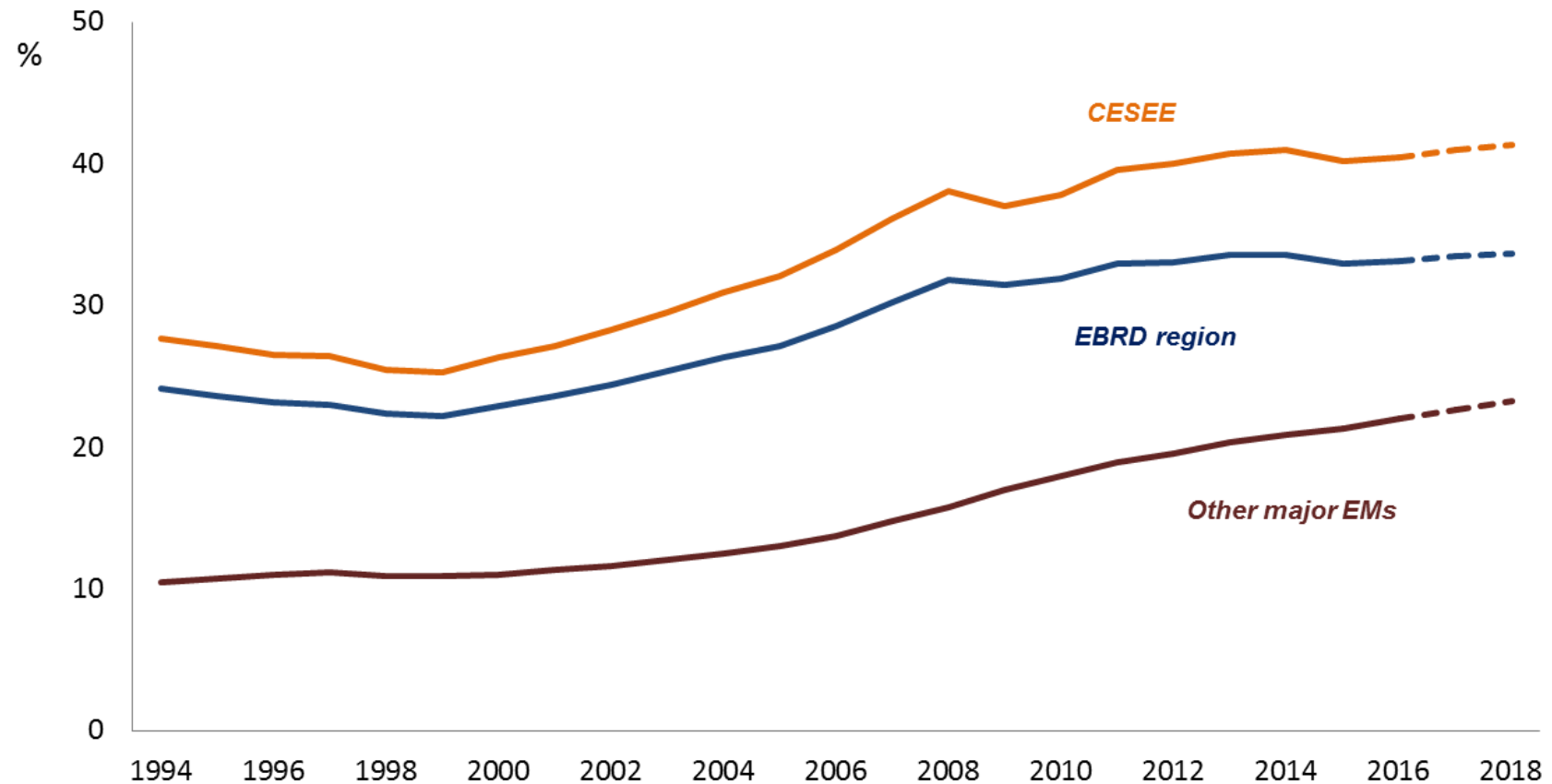


Sources: Penn World Tables, IMF, World Bank and authors' calculations.



Post-crisis slowdown in convergence became more protracted, affected emerging markets globally

Average GDP per capita at PPP, in % of US



Sources: IMF and authors' calculations. Weighted by population.



Evolution of TFP growth



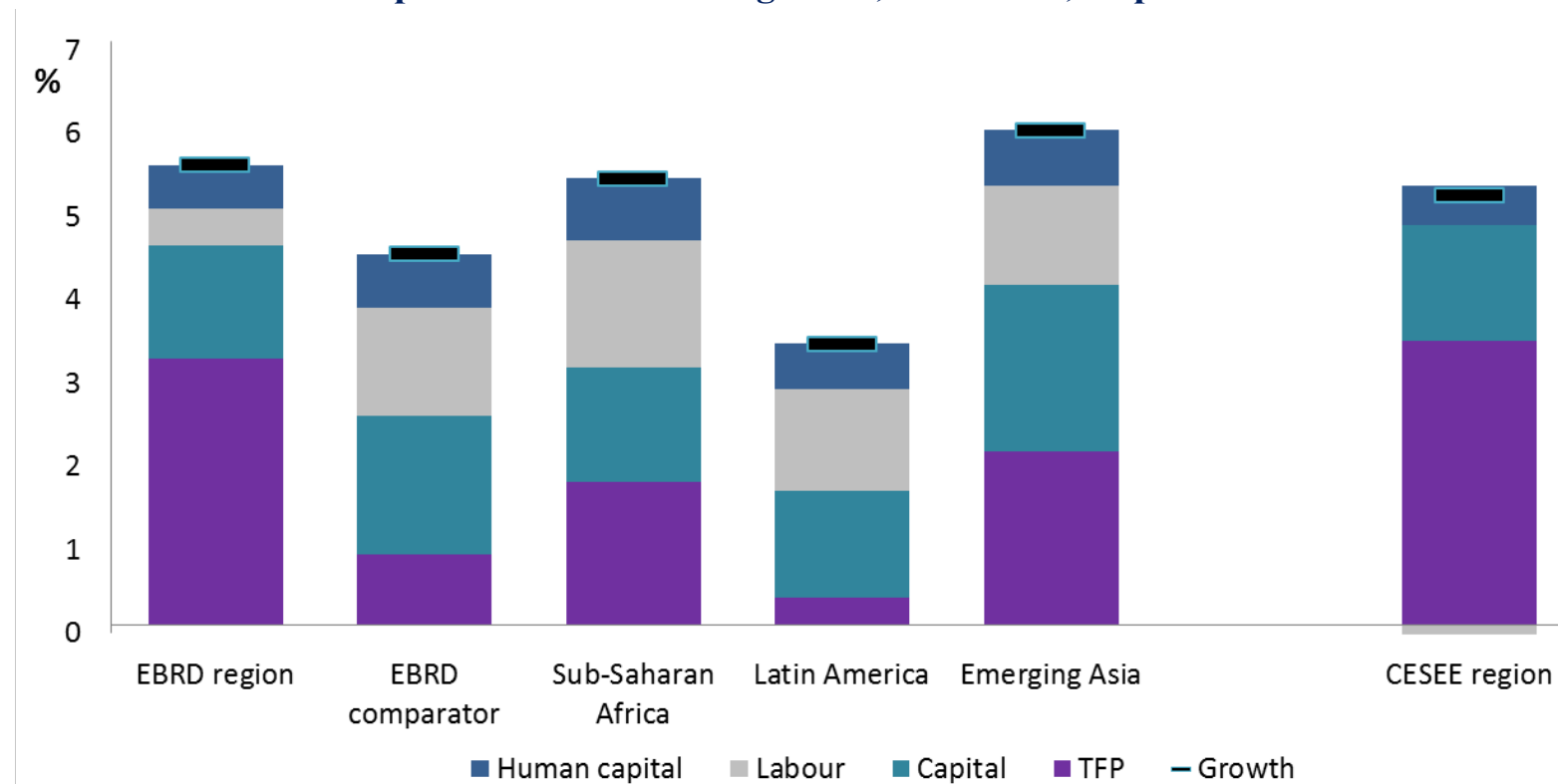
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Growth in 1998-2008 driven by total factor productivity which supported fast income convergence

High levels of education, urbanisation and industrial development but factors of production had been combined inefficiently under central planning

Market reforms helped to improve efficiency of factor use, boost productivity and close TFP gap

Decomposition of sources of growth, 1998-2008, % per annum



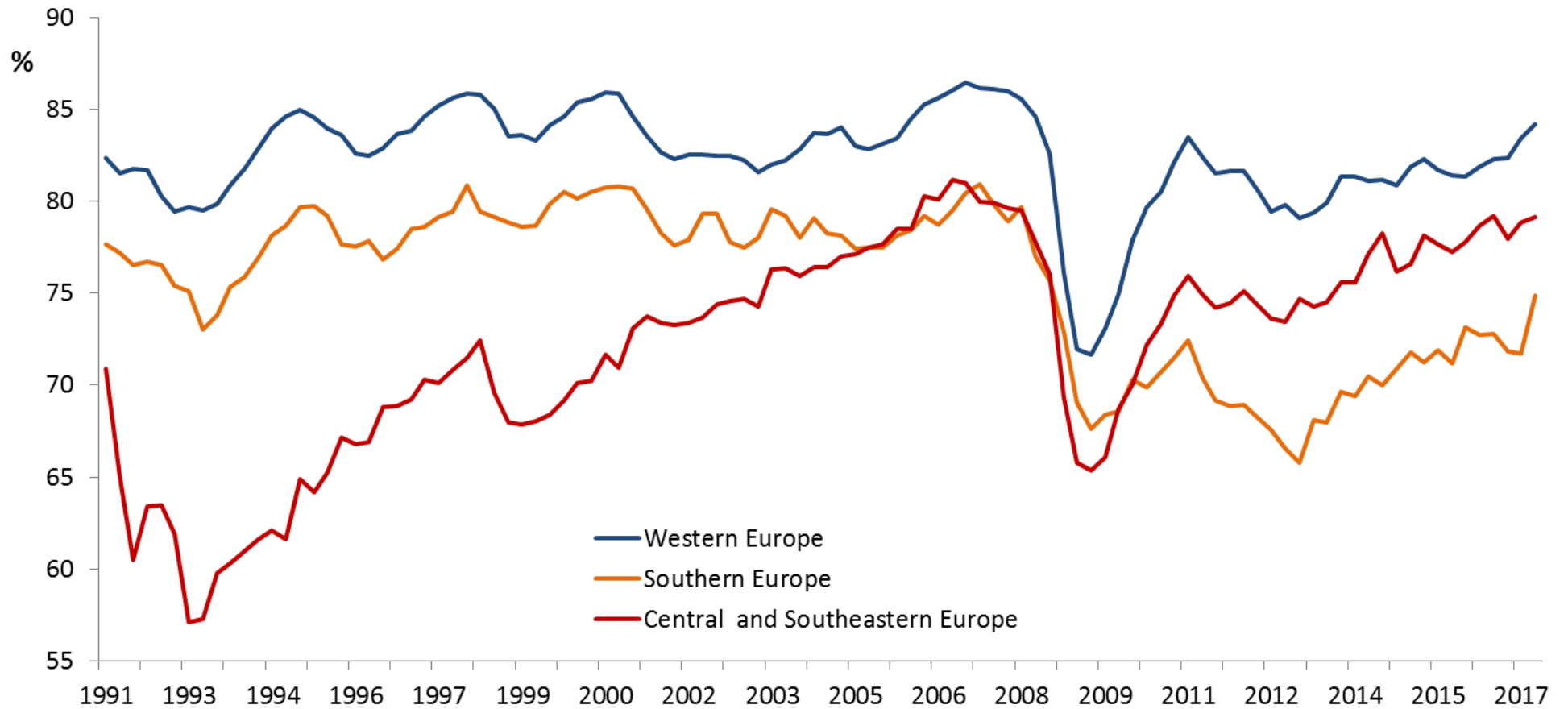
Sources: Penn World Tables, IMF, World Bank and authors' calculations.



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In part reflecting better capacity utilisation in the industry

Capacity utilisation in the industry, % of total capacity



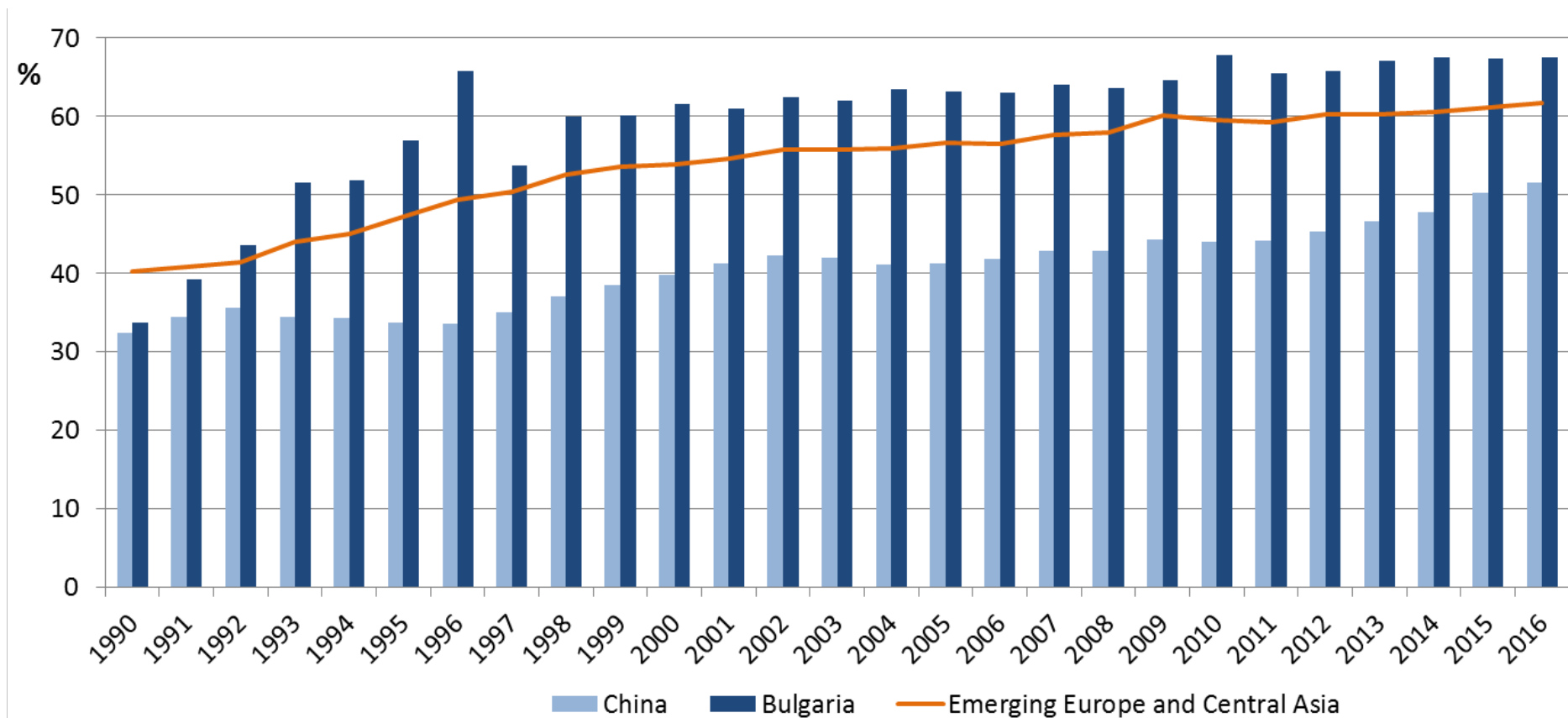
Sources: Eurostat and authors' calculations.



Initial sets of reforms aimed to boost TFP, alongside very fast shift towards services

While many other EMs, including China, have been undergoing this transformation from similar services-to-GDP ratio (35-40%), the pace in Emerging Europe was unique

Share of services in GDP, %



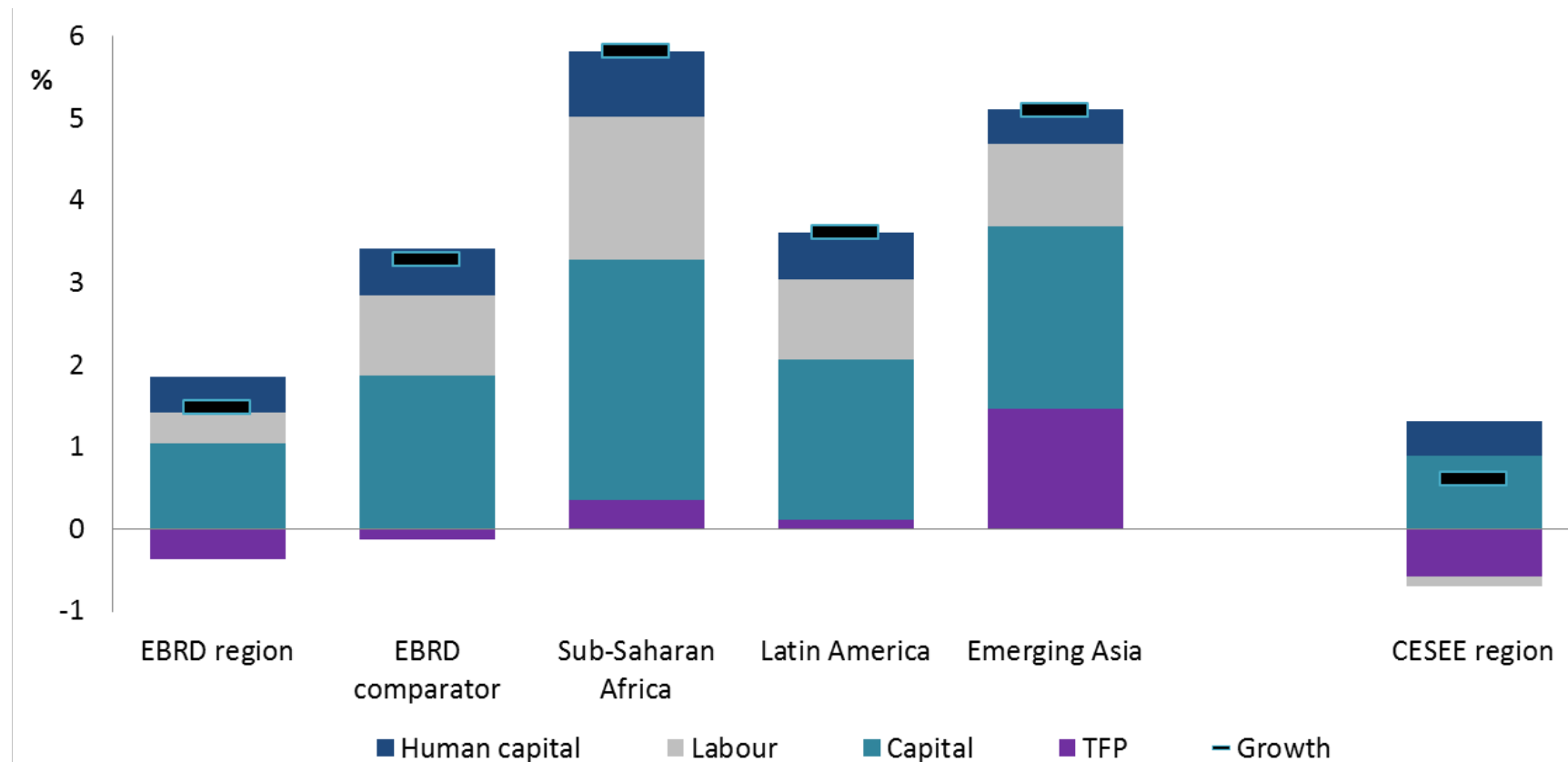
Sources: World Bank WDI and authors' calculations.



Growth since 2009 driven by capital accumulation; TFP growth slow

TFP slowdown also in (small) part reflects lower capacity utilisation (limited data)
Growth now driven by capital accumulation (as in most EMs)

Decomposition of sources of growth, 2008-14, % per annum

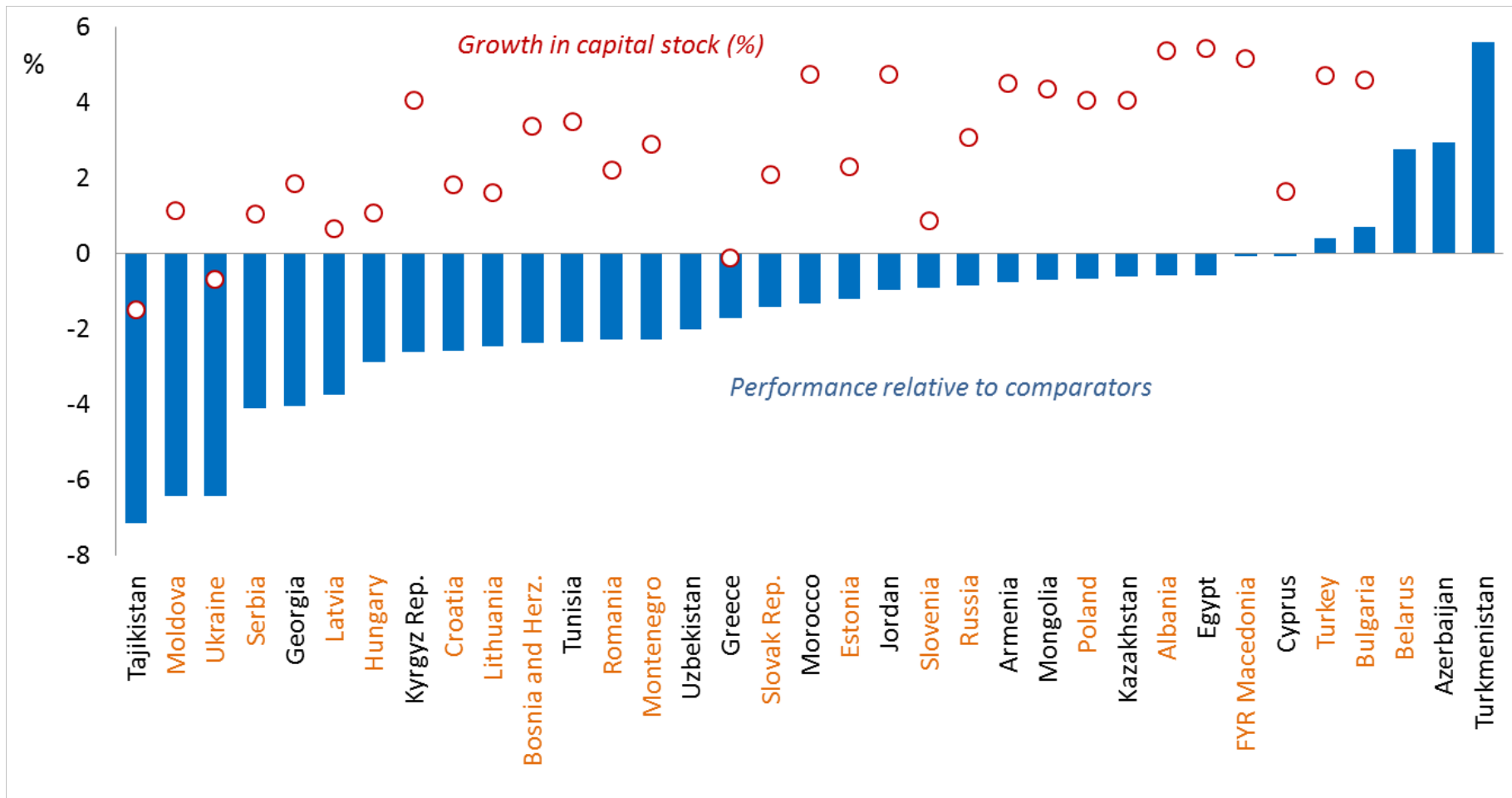


Sources: Penn World Tables, IMF, World Bank and authors' calculations.



Yet investment in most EBRD economies has been well below comparators' levels

Average annual growth in capital stock, 2008-14



Sources: Penn World Tables, IMF and authors' calculations.

As low-hanging fruit harvested, deeper reforms needed to boost productivity

Boost human capital

Boost physical capital, infrastructure

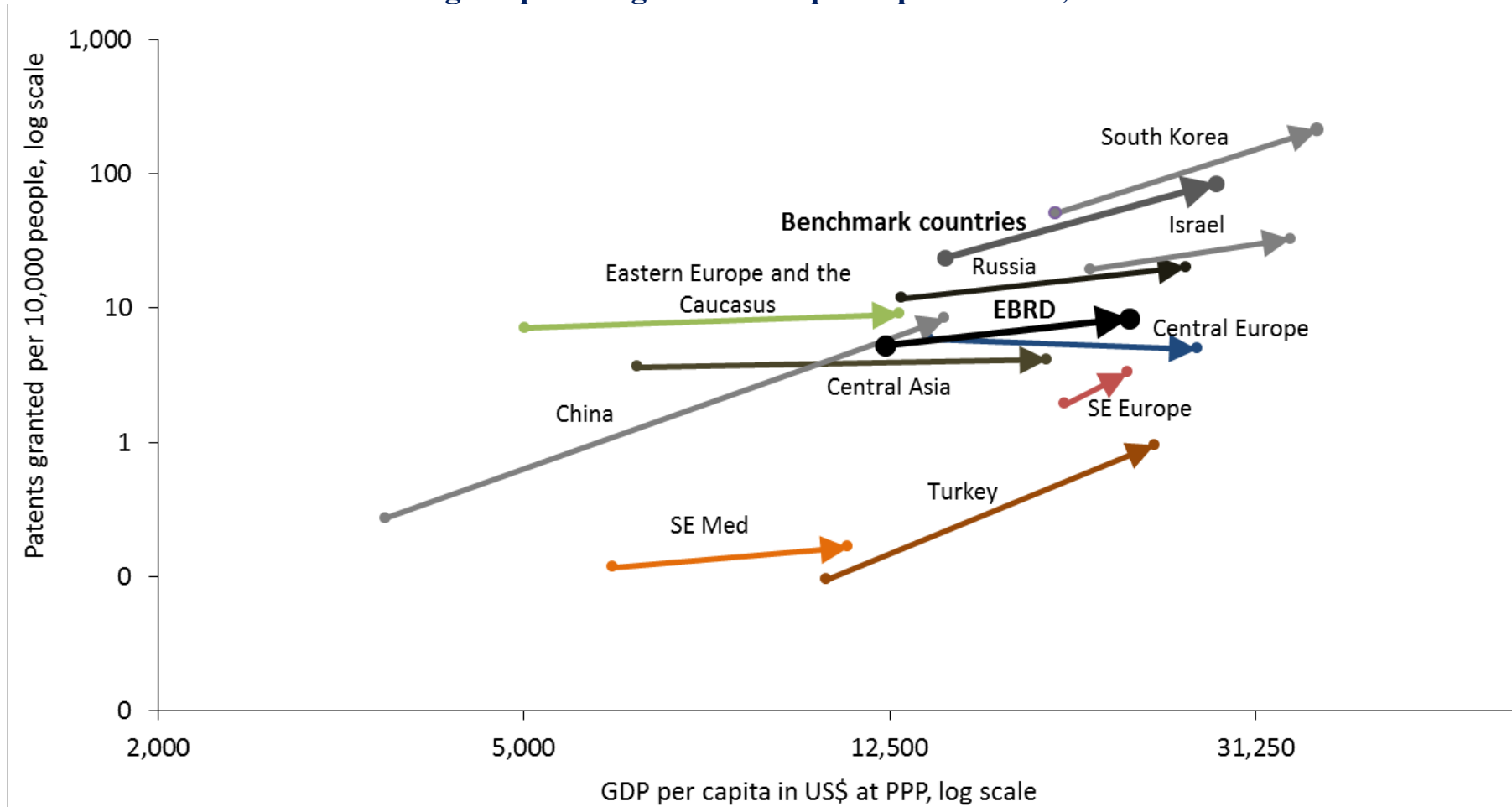
Innovation – to drive firm productivity
growth



Growth in EBRD countries has been "innovation-light"

<1% of firms introduce a product that is new to the world

Change in patents granted and per capita income, 2002-15



Sources: Penn World Tables, IMF and authors' calculations.

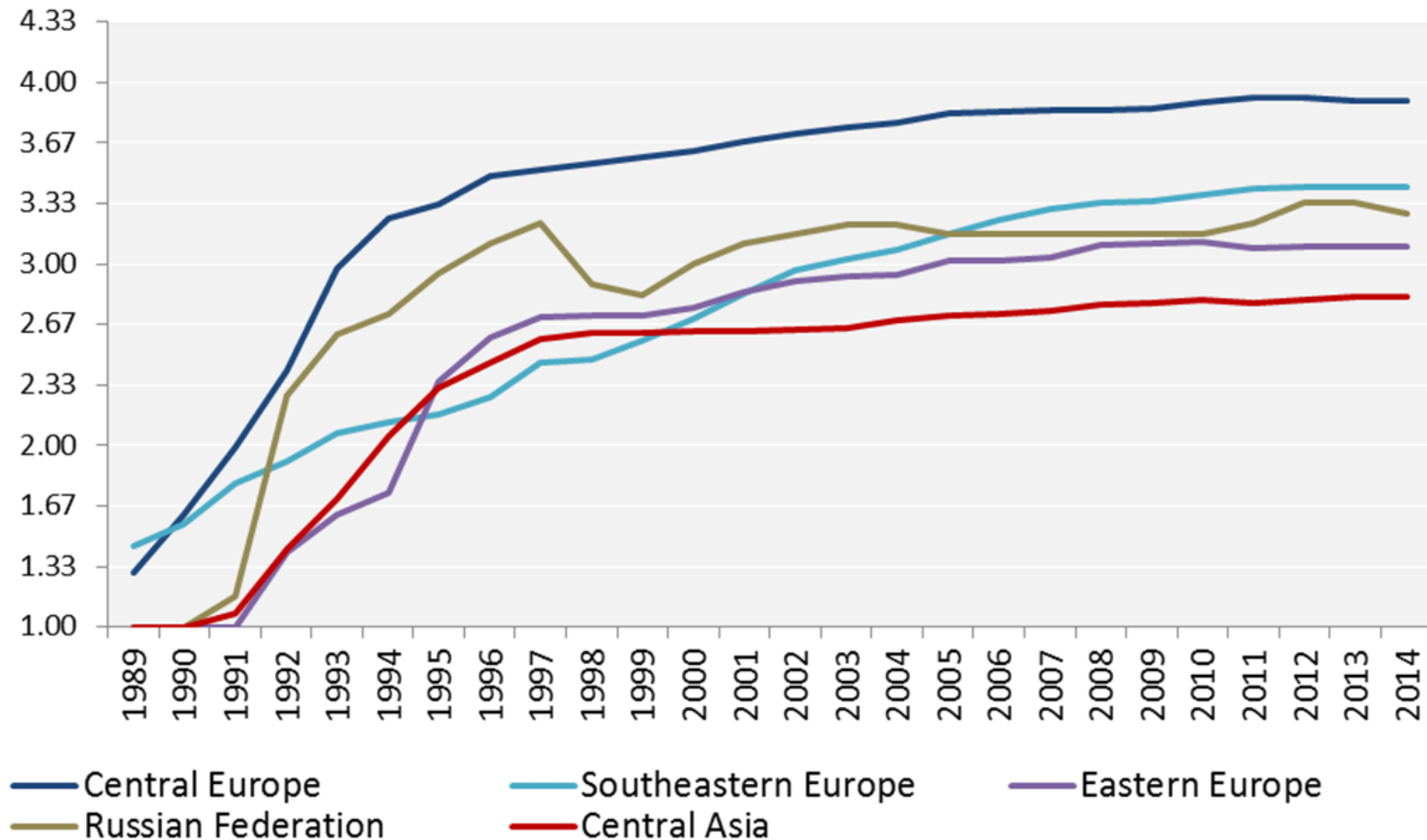
Slowdown of reforms and decline of support for markets and democracy



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In many countries reforms are stalled, in some even reversed

Average of 6 country-level transition indicators

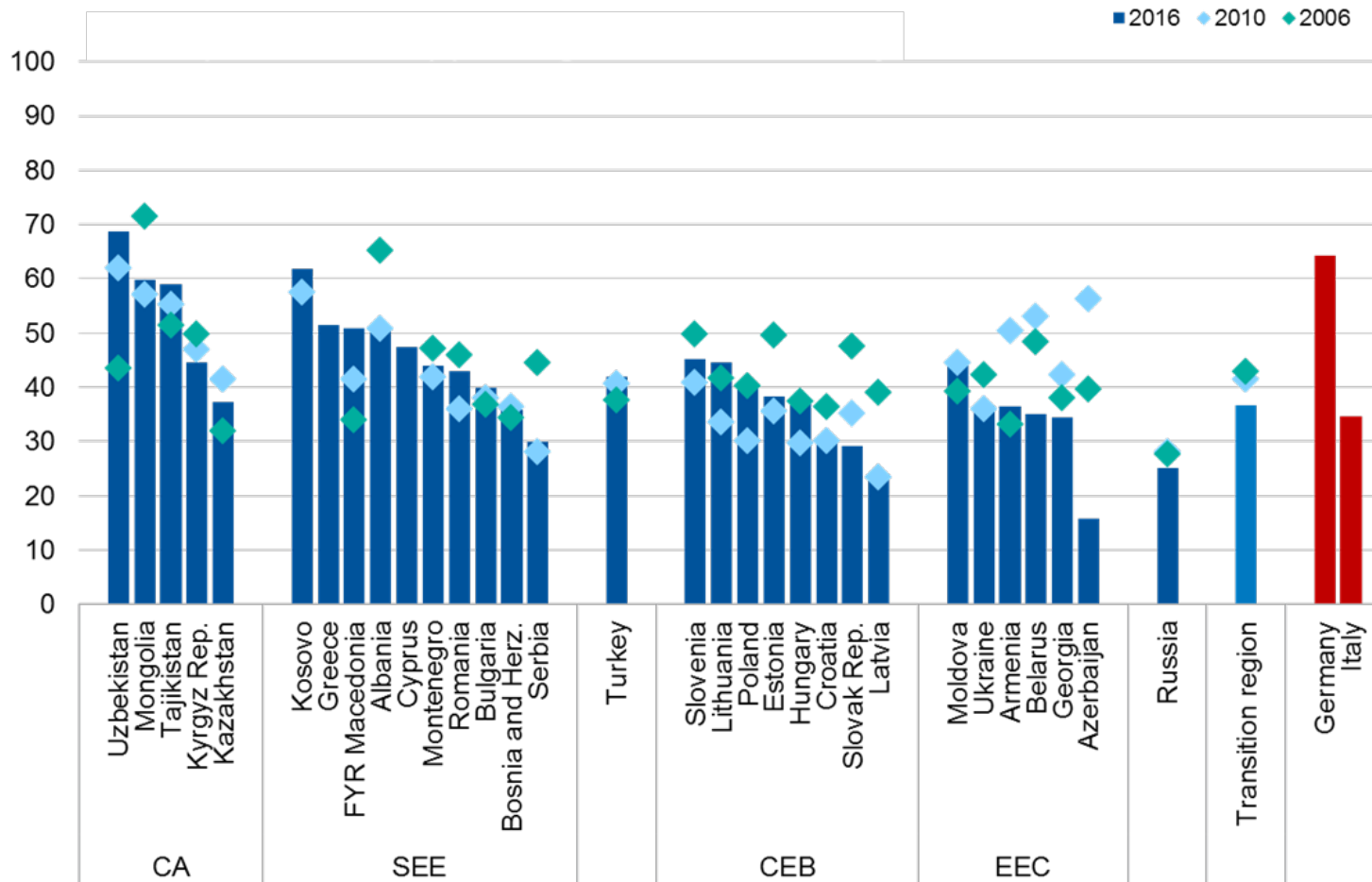


Sources: EBRD Transition Indicators (2014).



Support for reforms is low 1/2

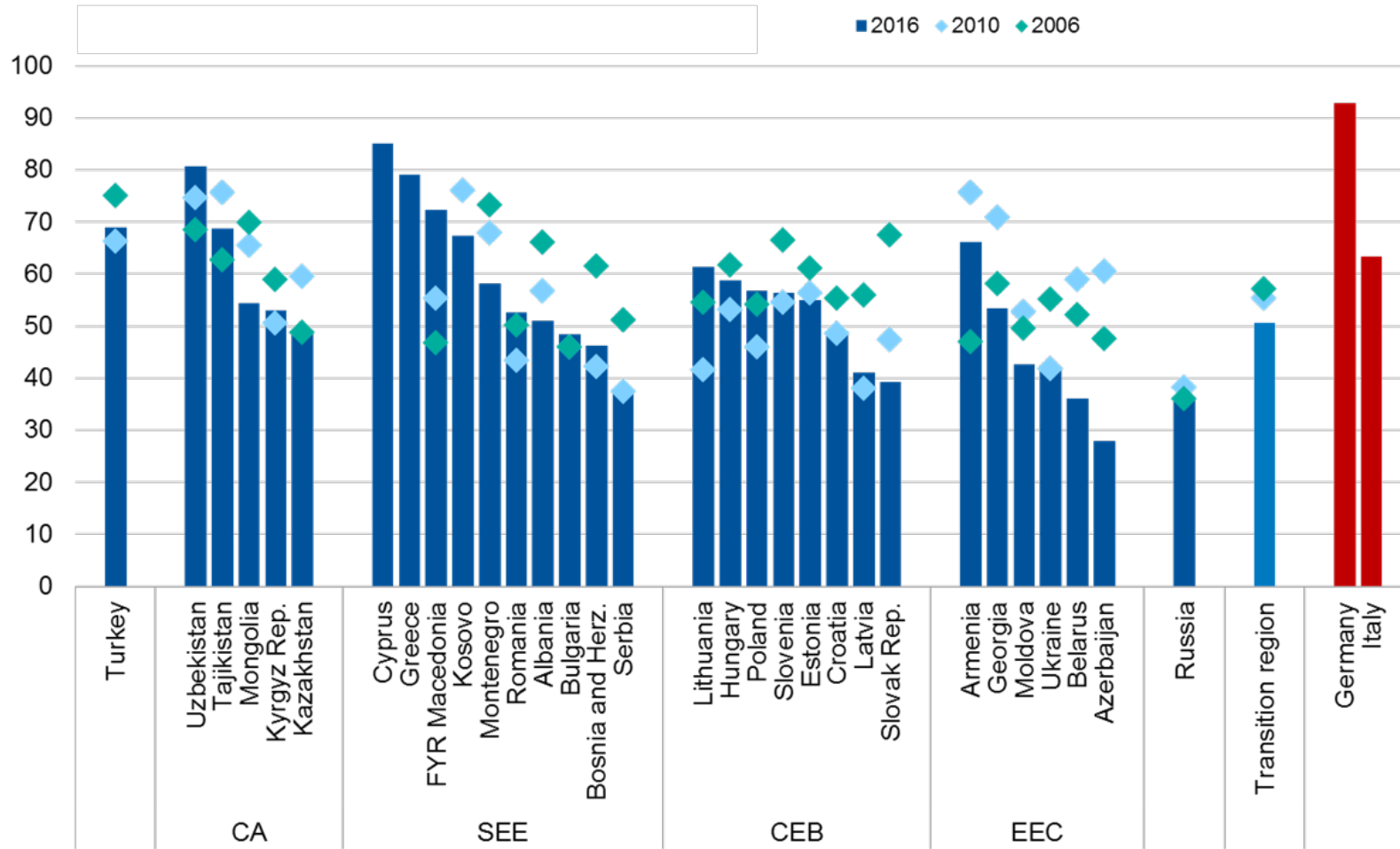
% of respondents supporting market economy



Sources: LiTS I (2006), LiTS II (2010), LiTS III (2016).

Support for reforms is low 2/2

% of respondents supporting democracy



Sources: LiTS I (2006), LiTS II (2010), LiTS III (2016).



Transition and inequality



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Initial reforms aimed at introducing market interactions and eventually boosting TFP

- Liberalisation of prices
- Liberalisation of interest rates and international trade
- Privatisation of large enterprises
- Privatisation of small and medium-sized enterprises
- Foundations of corporate governance
- Establishing competition rules in the new markets.

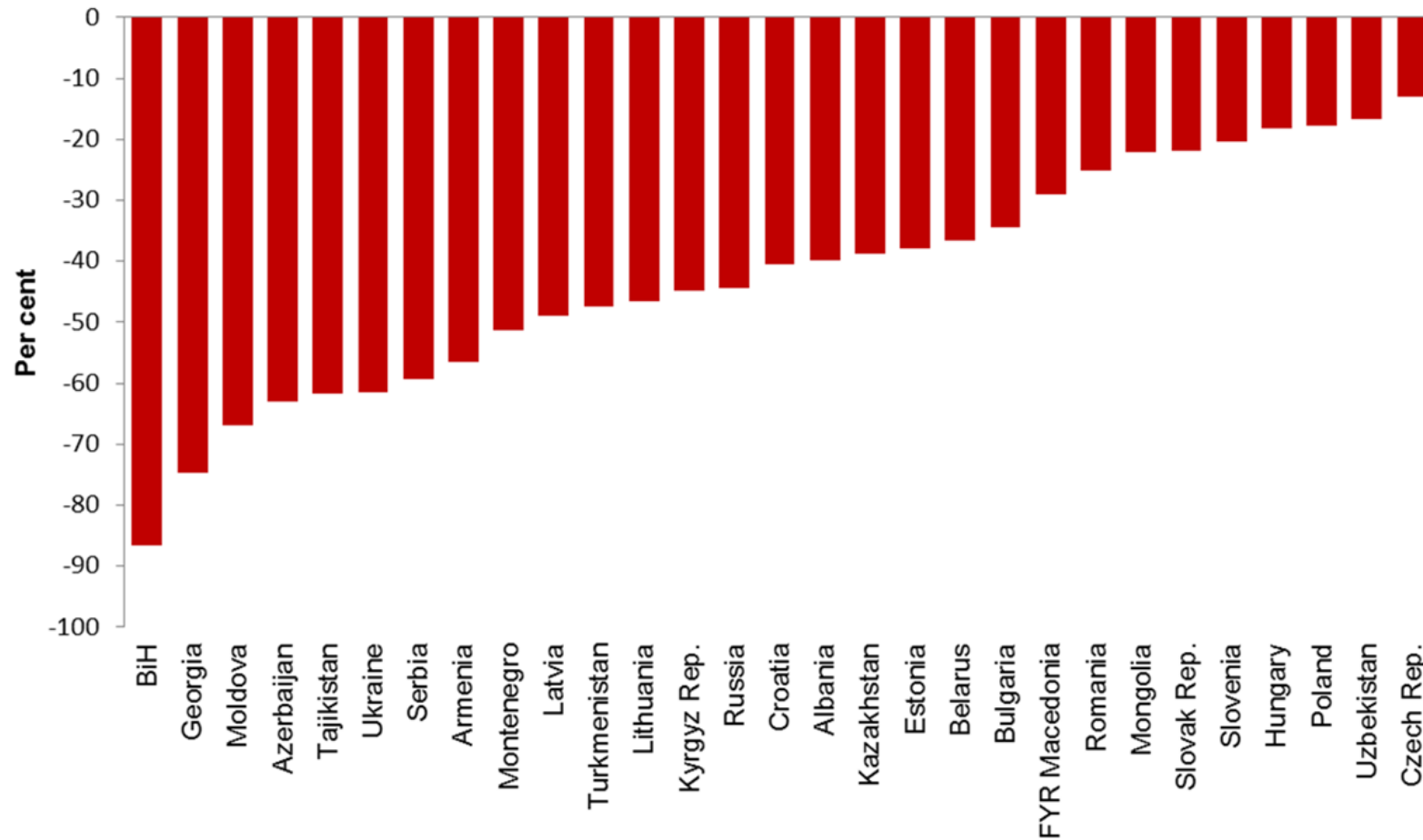
- Further reforms aimed at establishing markets in the infrastructure sectors and regulated industries, such as railroads, municipal transport and telecommunications

- As well as development of capital markets and pension systems



Initial reforms coincided with deep transition recession (-10% Czech to -70% Central Asia)

Cumulative contraction in real GDP

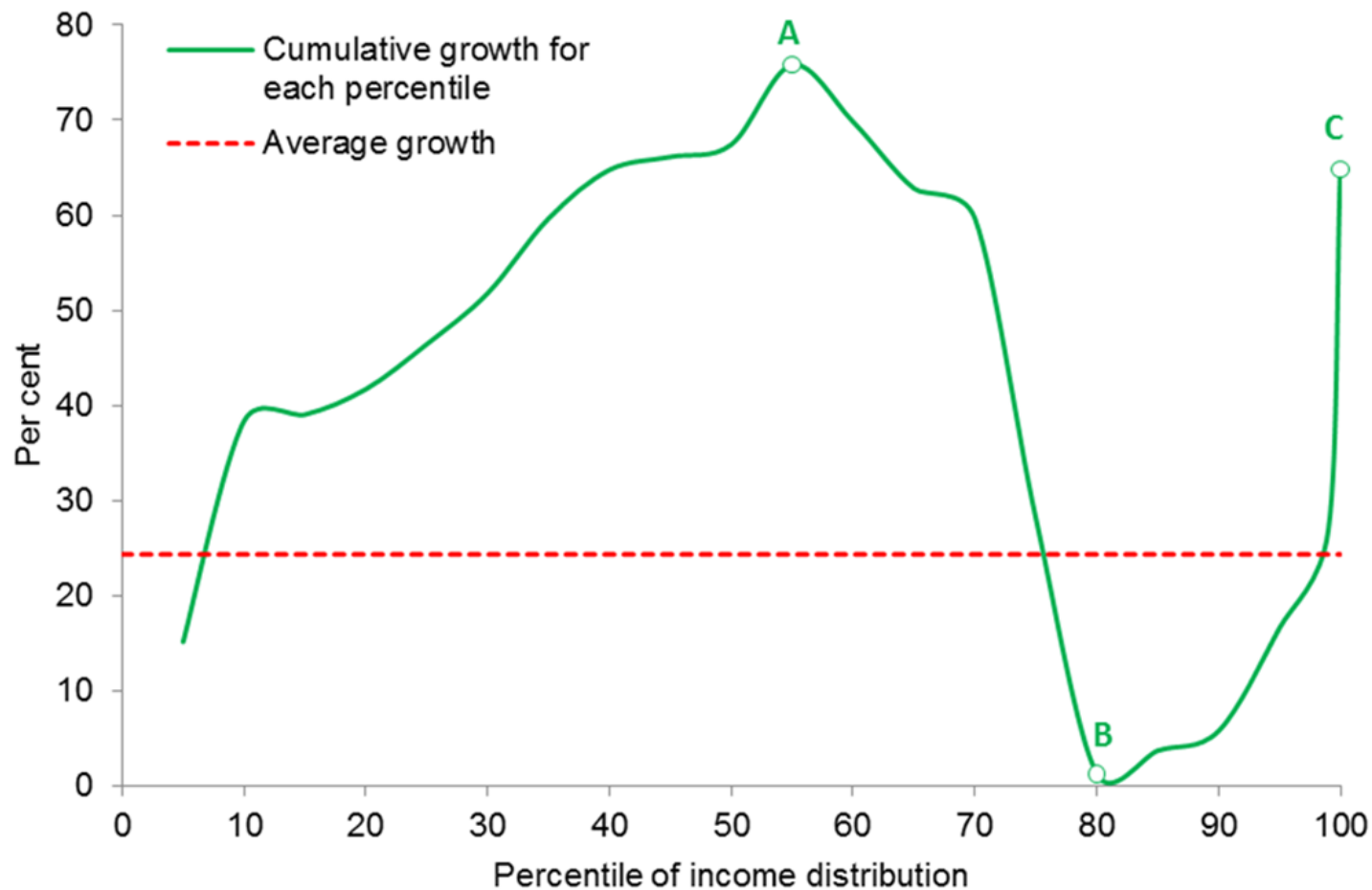


Sources: IMF WEO, WDI, national authorities, EBRD calculations.



Global experience – Milanovic’s “elephant curve” – Lower middle class in advanced economies losing out

Relative gain in real per capita income by global income level, 1988-2008

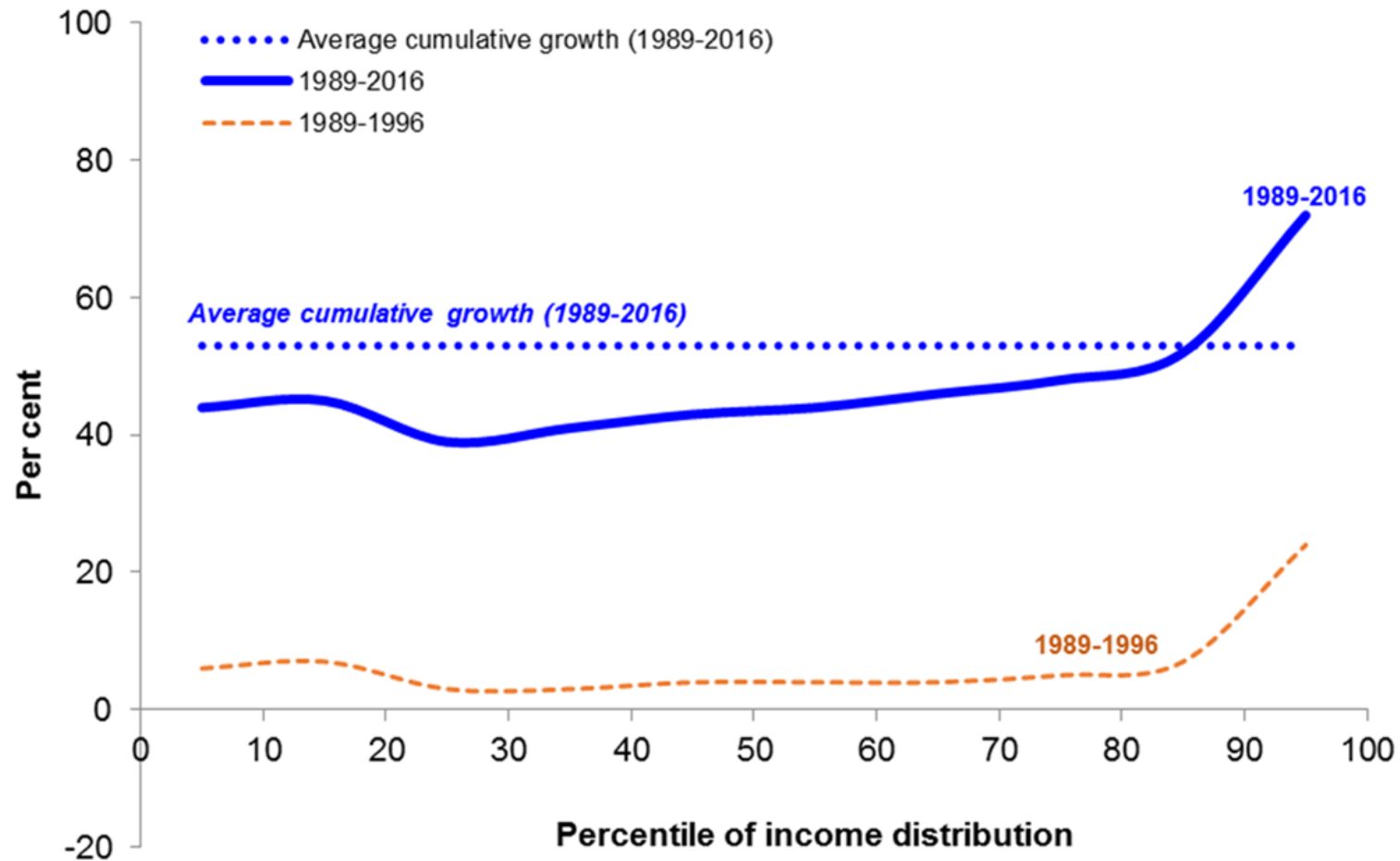


Sources: EBRD Transition Report 2016-17.



“Elephant curve” for the US

USA: Cumulative income growth since 1989 by income decile

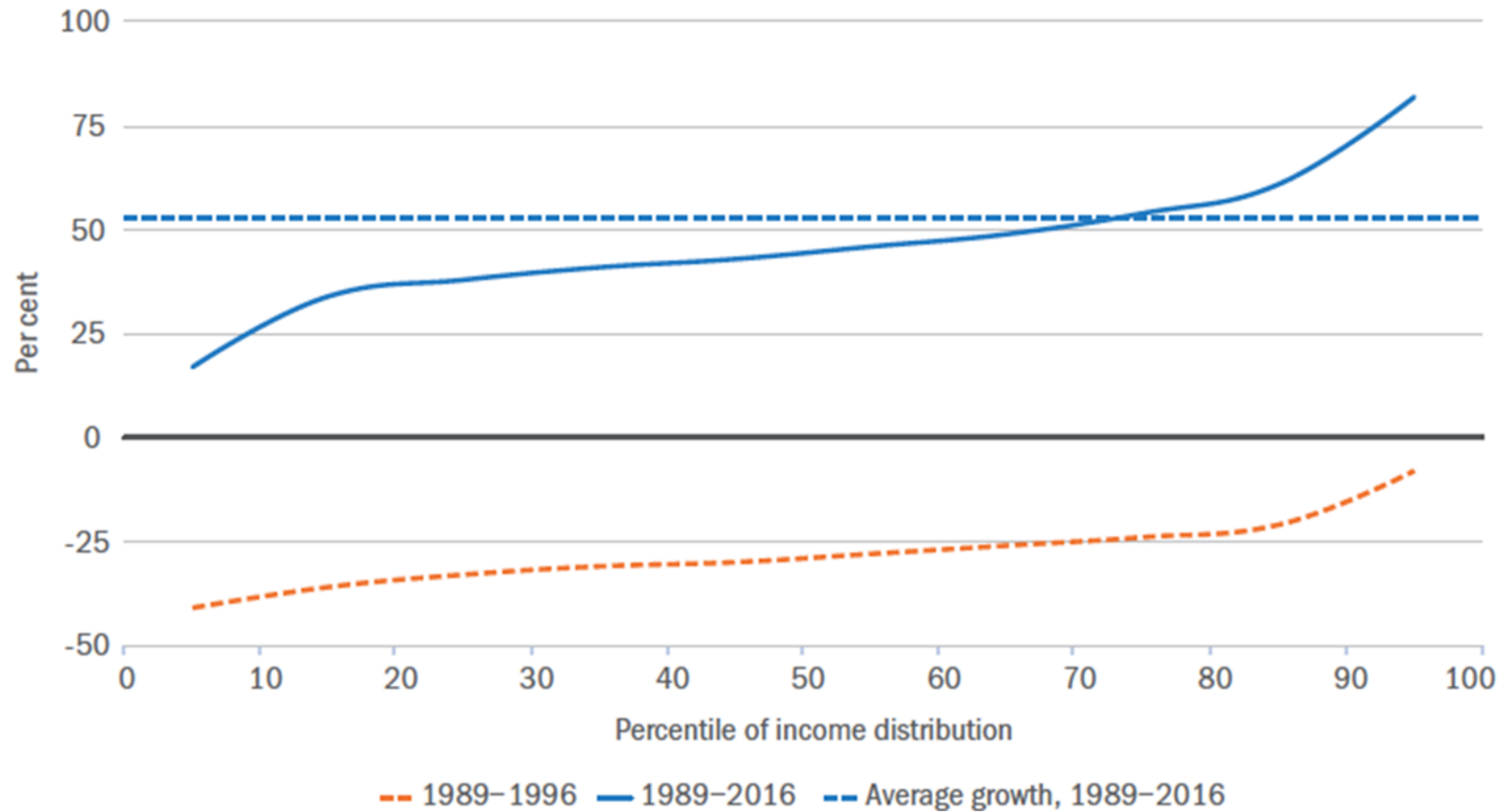


Sources: EBRD Transition Report 2016-17.



In post-communist countries: winners are in the upper deciles

Post-communist countries: Cumulative growth in income since 1989 depending on initial income

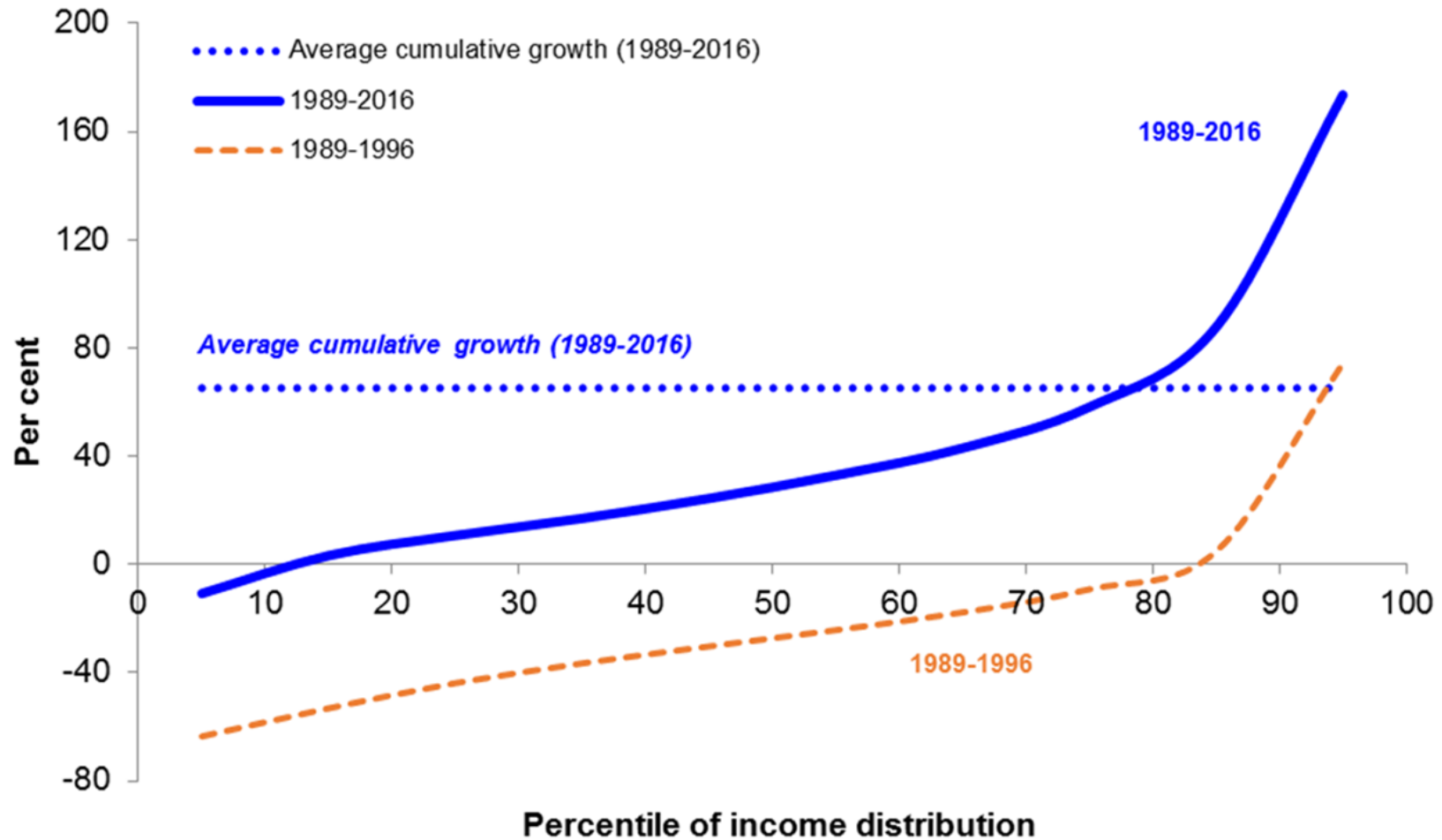


Sources: EBRD Transition Report 2016-17.



Within countries: Impressive income growth on average – but gains depend on one's place on the income ladder

Russia: Cumulative growth in income since 1989 depending on initial income

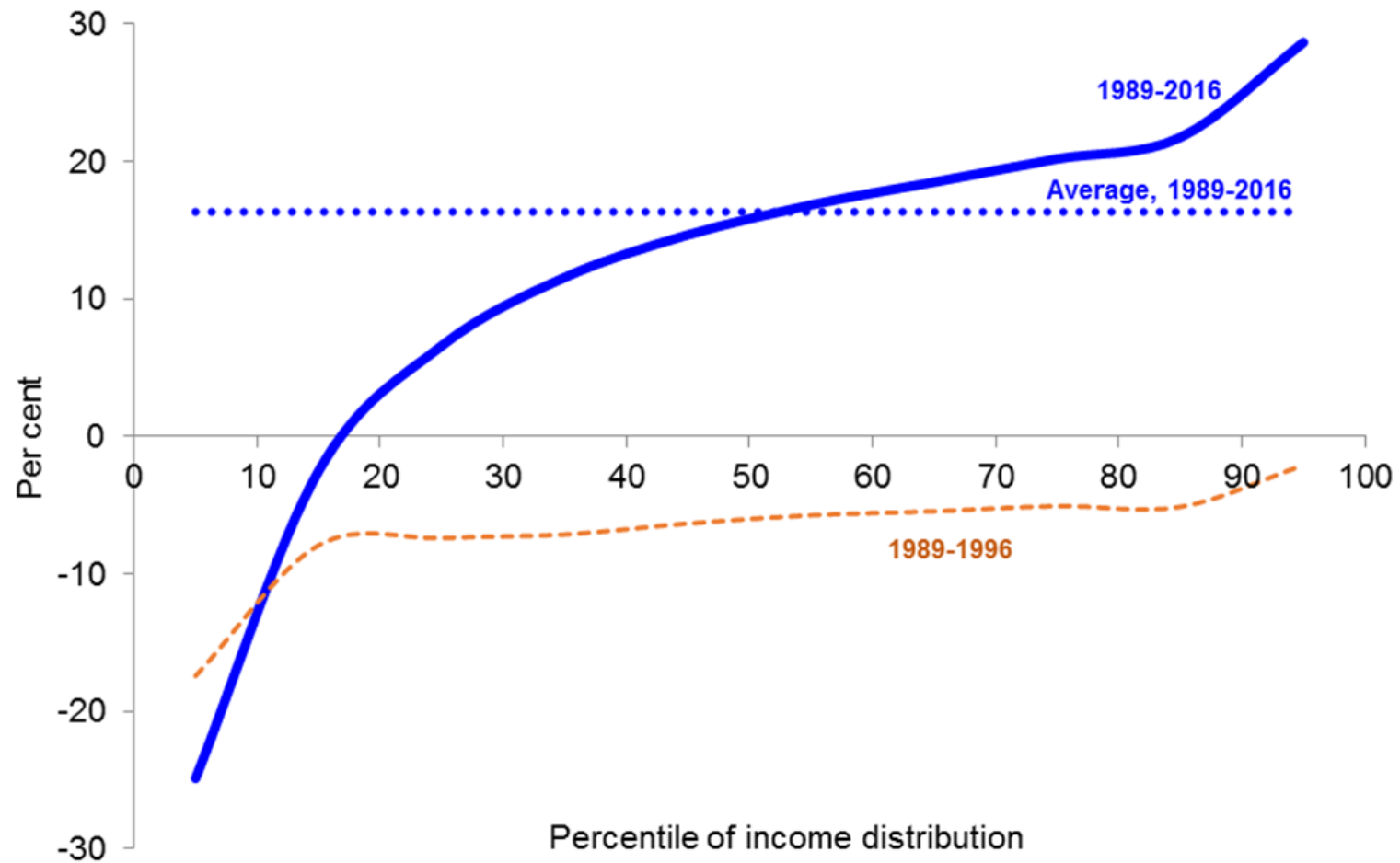


Sources: EBRD Transition Report 2016-17.



A similar pattern in Hungary

Hungary: Cumulative growth in income since 1989 depending on initial income

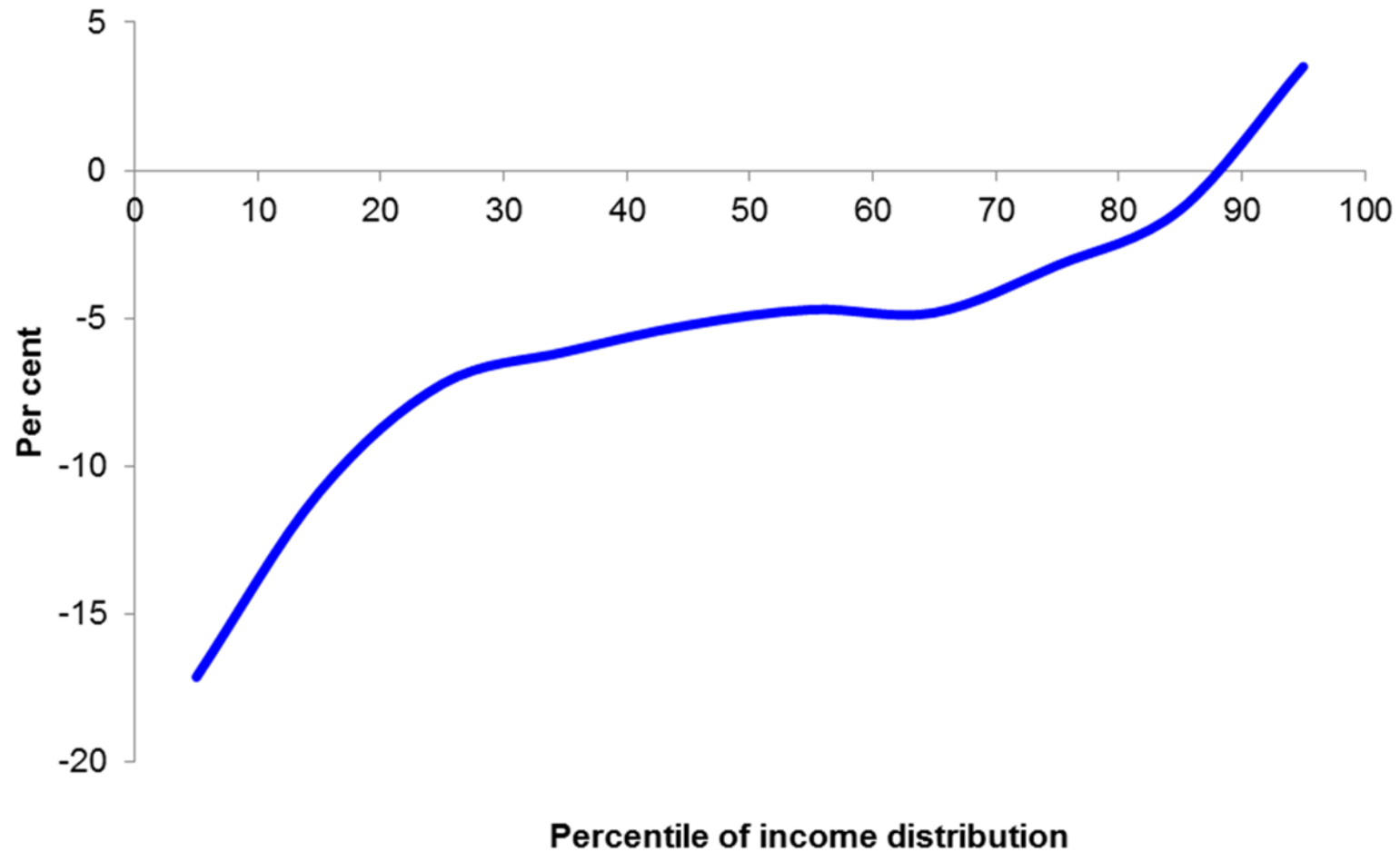


Sources: EBRD Transition Report 2016-17.



A similar pattern during the Great Recession

Hungary: Cumulative growth in income 2007-2012



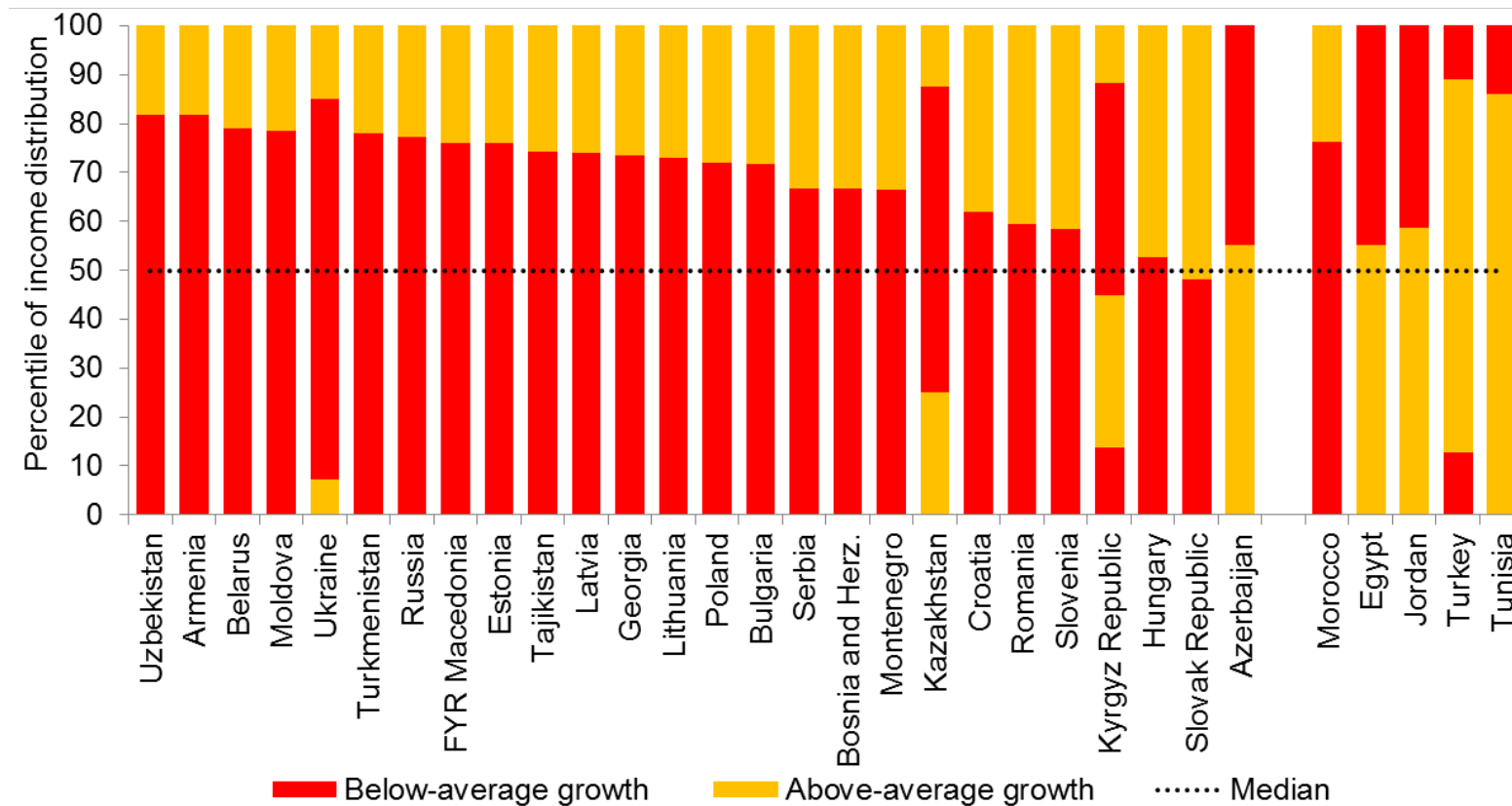
Sources: Povcalnet, authors' calculations.



Market-oriented reforms led to a rise in income and wealth inequality

- Headline growth in the region corresponds to the experience of someone at around 75th percentile of income distribution
- Hence $\frac{3}{4}$ (and the median voter) experience much slower growth

Percentiles of population with below-average income growth (1989-2016)



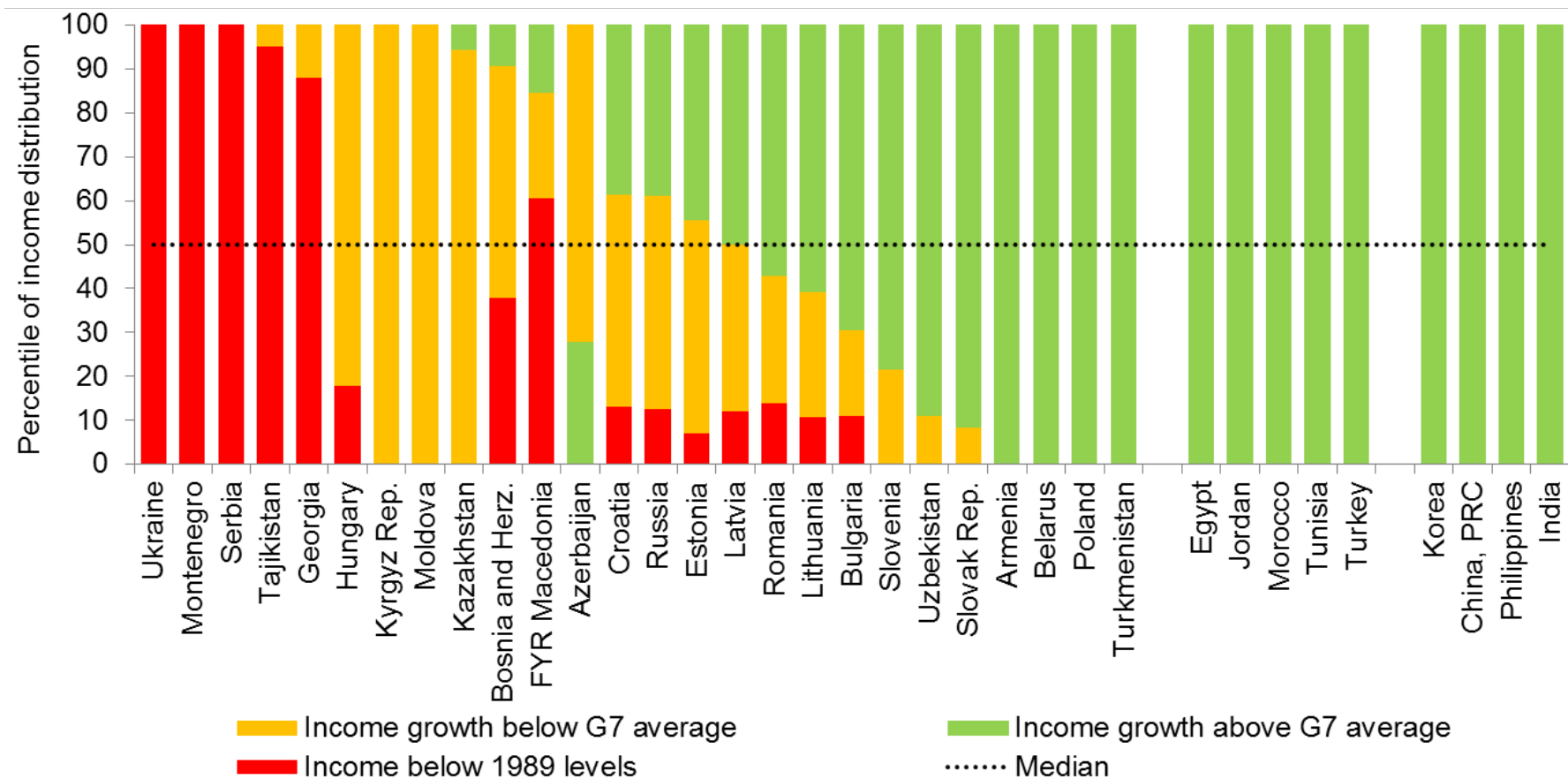
Sources: Povcalnet, IMF, World Bank, UN, Transition Report 2016-17.



Many have not experienced long-term income convergence with G7 – unlike in other EMs

Income growth above G7 average for 44%

Share of the population with income growth above/below the G7 average, 1989-2016



Sources: Povcalnet, IMF, World Bank, UN, Transition Report 2016-17.



Hence the importance of taking distributional effects of reforms into account

- Certain reforms may substantially benefit average growth while benefitting only a minority of the population
- 44% estimated to have experienced personal income convergence
- This may partly explain strengthening pushback against market reforms in parts of the region in recent years
- Losers (even if they are a minority) tend to have a louder political voice than the beneficiaries of reforms



Transition and governance?



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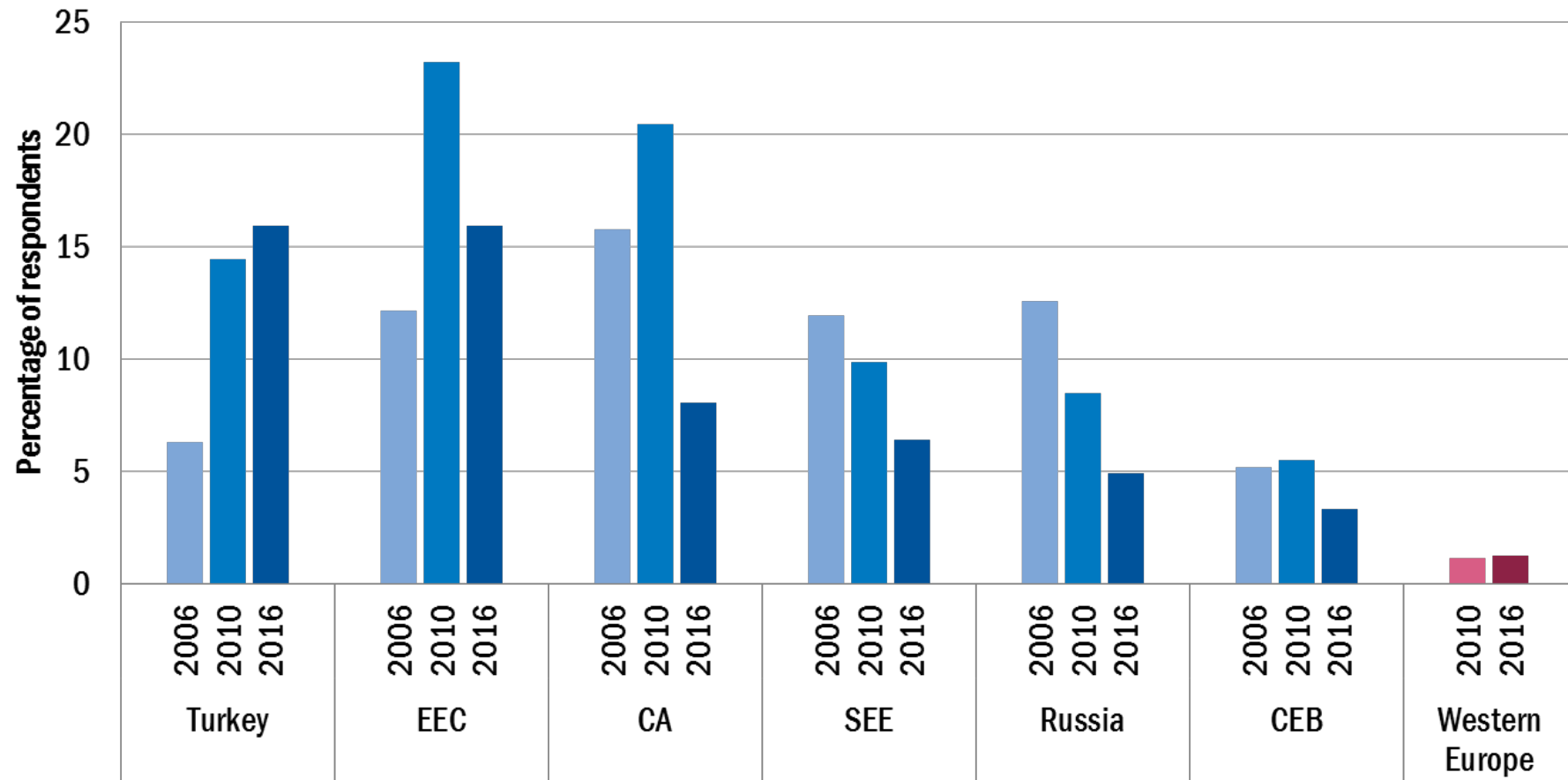
Corruption, governance and the quality of institutions

- Corruption remains prevalent in the region and continues to dominate reform debates
- Life in Transition Survey shows that “corruption experience” is a more reliable measure of corruption than “perceived incidence of corruption”
 - Possibly due to media bias
- Corruption undermines economic development and trust in institutions
 - Results based on a panel of 1500 locations in LITS 2010 and LITS 2016



Over the past decade, perceived incidence of corruption in the region has declined...

Perceived corruption in 2006, 2010 and 2016 by region

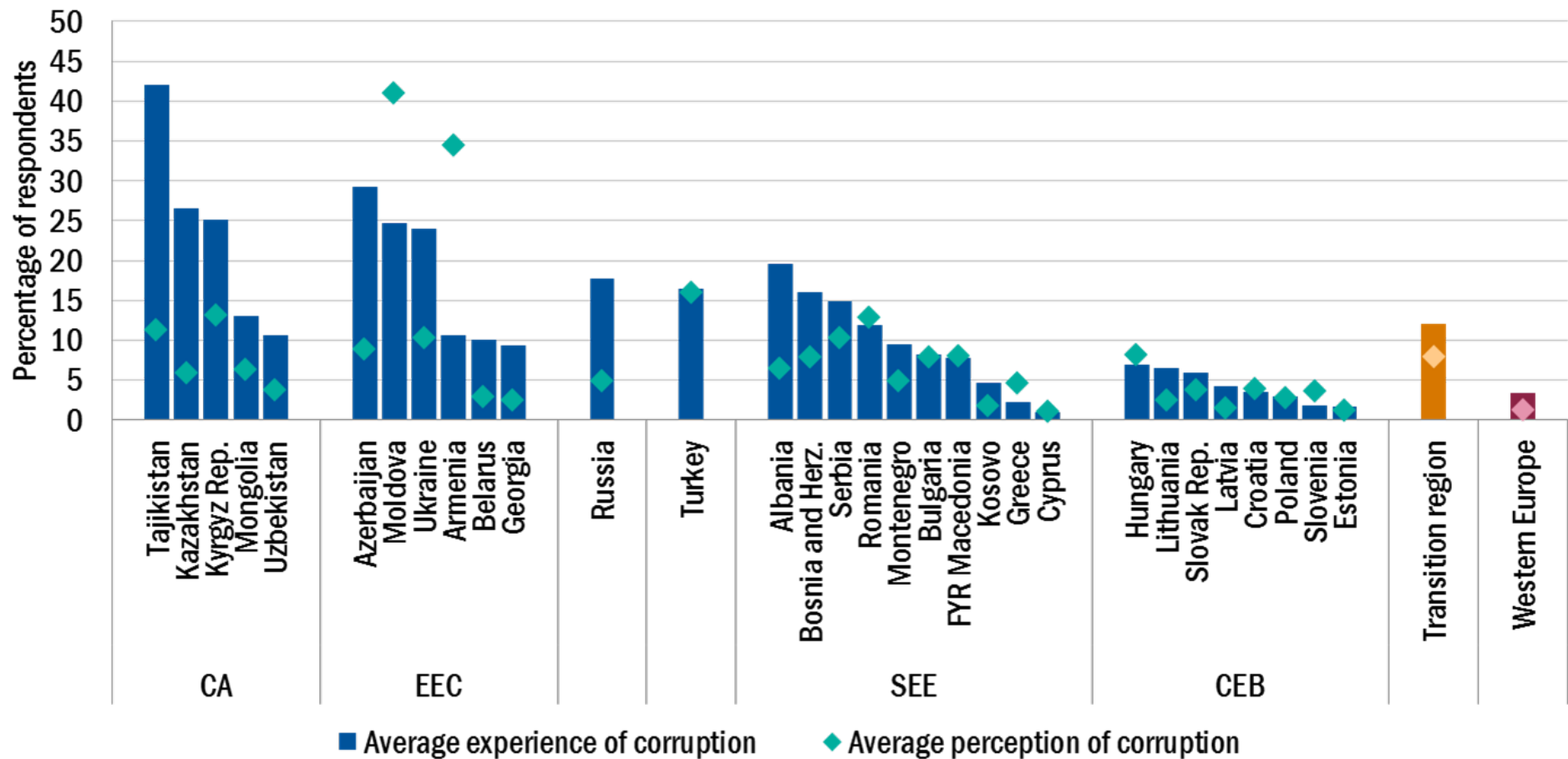


Sources: LiTS I (2006), LiTS II (2010), LiTS III (2016).



...but people tend to experience more corruption than is reflected in perceptions, particularly in Eastern Europe

Experience versus perception of corruption in 2016 by country



Sources: LiTS III (2016), authors' calculations.



Trust in government rises where people believe corruption is falling

Outcome is →	Trust in president	Trust in government	Trust in parliament
There is less corruption now than 4 years ago	0.178*** (0.016)	0.200*** (0.017)	0.194*** (0.020)
Unemployment	-0.029* (0.017)	-0.019 (0.013)	-0.012 (0.009)
Log income	0.025 (0.016)	0.007 (0.012)	-0.005 (0.007)
R-squared	0.38	0.39	0.40
N	13544	13779	13636
Number of PSUs	1489	1489	1489

Sources: LiTS II (2010) and LiTS III (2016).



Experience of corruption makes people less likely to believe government is improving

Outcome is →	Local government has improved over the last 4 years	Regional government has improved over the last 4 years	National government has improved over the last 4 years
Corruption experience	-0.065*** (0.018)	-0.071*** (0.015)	-0.040** (0.017)
Unemployment	-0.035*** (0.010)	-0.016 (0.014)	-0.030*** (0.009)
Log income	0.006 (0.007)	0.022** (0.008)	0.017** (0.008)
R-squared	0.29	0.39	0.37
N	14060	11219	13479
Number of PSUs	1489	1489	1489

Sources: LiTS II (2010) and LiTS III (2016).



Satisfaction with local government positively affects attitudes toward democracy and market economy

Outcome is →	Support for democratic regime	Support for authoritarian regime	Support for market economy
Satisfied with local government	0.030*** (0.010)	-0.005 (0.006)	0.034** (0.012)
Unemployment	-0.022 (0.013)	0.001 (0.008)	-0.037*** (0.011)
Log income	0.032*** (0.009)	-0.003 (0.005)	0.025*** (0.007)
R-squared	0.28	0.22	0.26
N	14487	14487	14487
Number of PSUs	1489	1489	1489

Sources: LiTS II (2010) and LiTS III (2016).



Fairness and equality of opportunity



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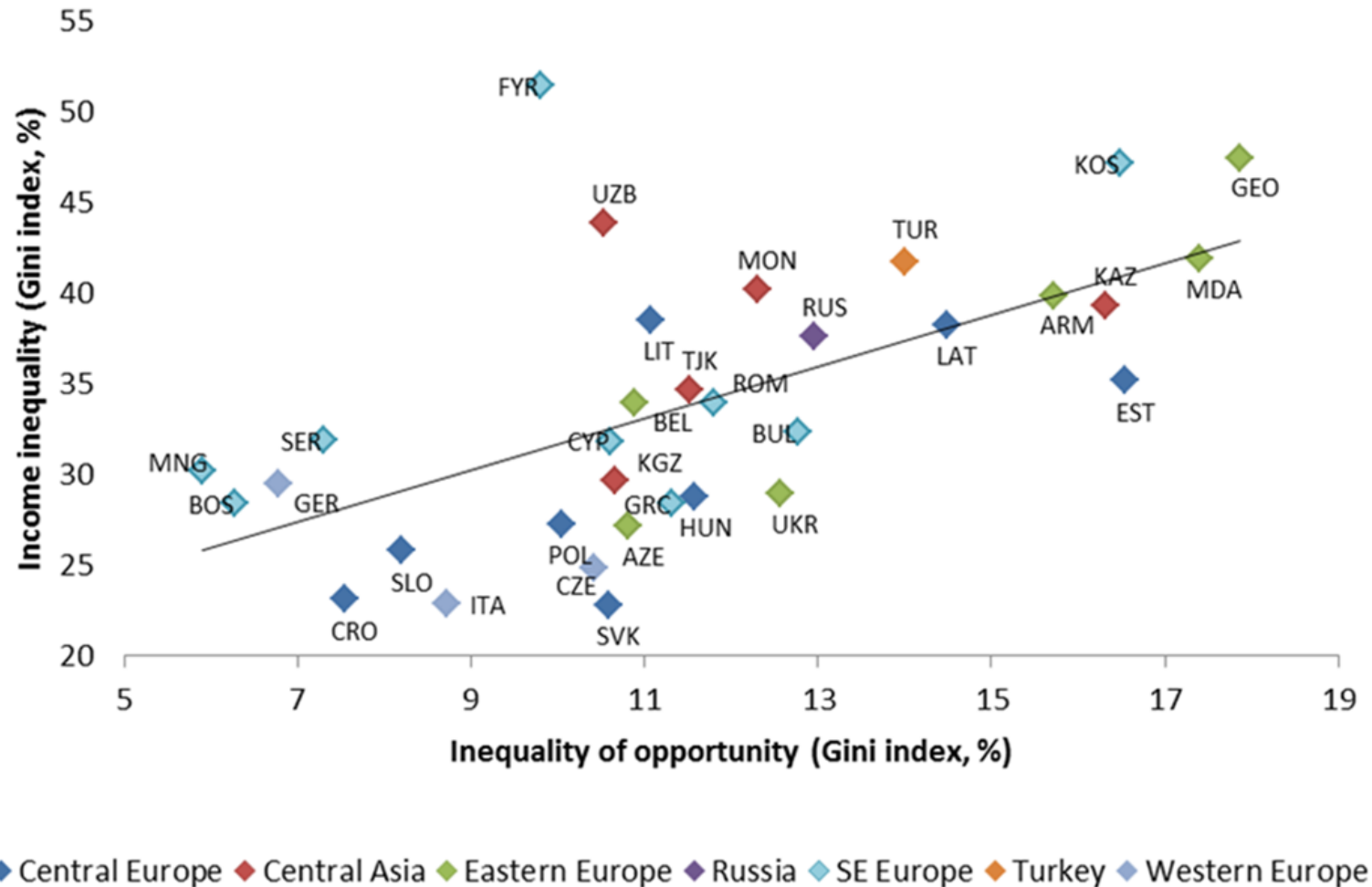
Inequality of opportunity

- Opportunity to have education, good job, income should not be limited by circumstances
 - In practice, gender, race, place of birth, and / or parental background have an impact
- Inequality of opportunity is inefficient:
 - prevents people from making the best use of their skills or from realising their entrepreneurial ideas
- Inequality of opportunity is unfair:
 - may lead to the loss of confidence in the key economic and political institutions that underpin societies and a market-based economic system



20% to 50% of income inequality in the EBRD region is due to circumstances at birth

Higher than in western Europe but modest compared with other emerging markets and the US



Sources: EBRD Transition Report 2016-17.



Inequality of opportunity and support for the reform

- We decompose inequality into
 - “unfair” inequality of opportunity (explained by gender, race, place of birth, and parental background) and
 - “fair” inequality (residual, explained by effort)
- It turns out that support for market economy is negatively correlated only with the inequality of opportunity
- The “fair” component of inequality is positively correlated with support for markets and economy
 - Consistent with Starmans et al. (2017) – people prefer fair inequality to unfair equality



Inequality of opportunity reduces support for markets and democracy – unlike the “fair” component of inequality

	Support for markets			Support for democracy		
	1	2	3 (LPM)	4	5	6 (LPM)
Direct channels						
Inequality of opportunity: income	-4.508* (2.112)	-4.169* (2.085)	-1.093* (0.480)	-1.899 (3.042)	-1.783 (3.034)	-0.314 (0.687)
Indirect channel						
Perception of relative economic wellbeing		0.077*** (0.022)			0.033 (0.022)	
Controls						
Income decile	0.042*** (0.011)	0.035** (0.011)	0.010*** (0.003)	0.040*** (0.011)	0.037*** (0.011)	0.009*** (0.002)
“Fair” income inequality	4.424** (1.587)	4.516** (1.600)	1.046** (0.354)	5.218** (1.832)	5.228** (1.828)	1.061** (0.374)
Level of democracy (polity2)	0.058** (0.020)	0.061** (0.019)	0.014** (0.004)	0.064** (0.022)	0.064** (0.022)	0.014** (0.005)
Additional individual, region and country controls	Yes	Yes	Yes	Yes	Yes	Yes
Observations	12,258	12,185	12,258	12,514	12,433	12,514

Sources: LiTS III, IMF, authors' calculations. Also controlling for unemployment, GDP growth, inequality of opportunity with respect to jobs and education, other characteristics.



So, how should we measure reforms?

New Transition Concept of the EBRD



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Article 1 of the EBRD's Agreement and the components of a market economy

- Article 1 of the Agreement Establishing the Bank (AEB) defines the purpose of the Bank in terms that differ from conventional development institutions:

“In contributing to economic progress and reconstruction, the purpose of the Bank shall be to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism and market economics.”

- In other words, the Bank is to foster a change in economic systems, i.e., in the way that economic decisions are made, rather than directly pursuing development outcomes.
 - What exactly constitutes a “market-oriented economy” is not specifically defined in the AEB but the main methods for achieving that objective - decentralisation, de-monopolisation and privatisation, as referred to in Article 11.2(ii) of the AEB - suggest a limited role for the state in the ownership and running of the economy.
-

New Transition Concept key elements

- **Shift in transition focus:**
 - From promoting the “structure” of a market economy (what does a market economy consist of?)
 - To promoting “qualities” of a market economy (what outcomes should we expect from a well-functioning market economy?)

 - **Three propositions:**
 - *Proposition 1: The Bank’s mandate is to foster sustainable market economies*
 - *Proposition 2: A sustainable market economy is competitive, well-governed, green, inclusive, resilient and integrated*
 - *Proposition 3: The framework of priorities and measurements against which the transition impact of Bank operations is assessed should reflect country circumstances*
-

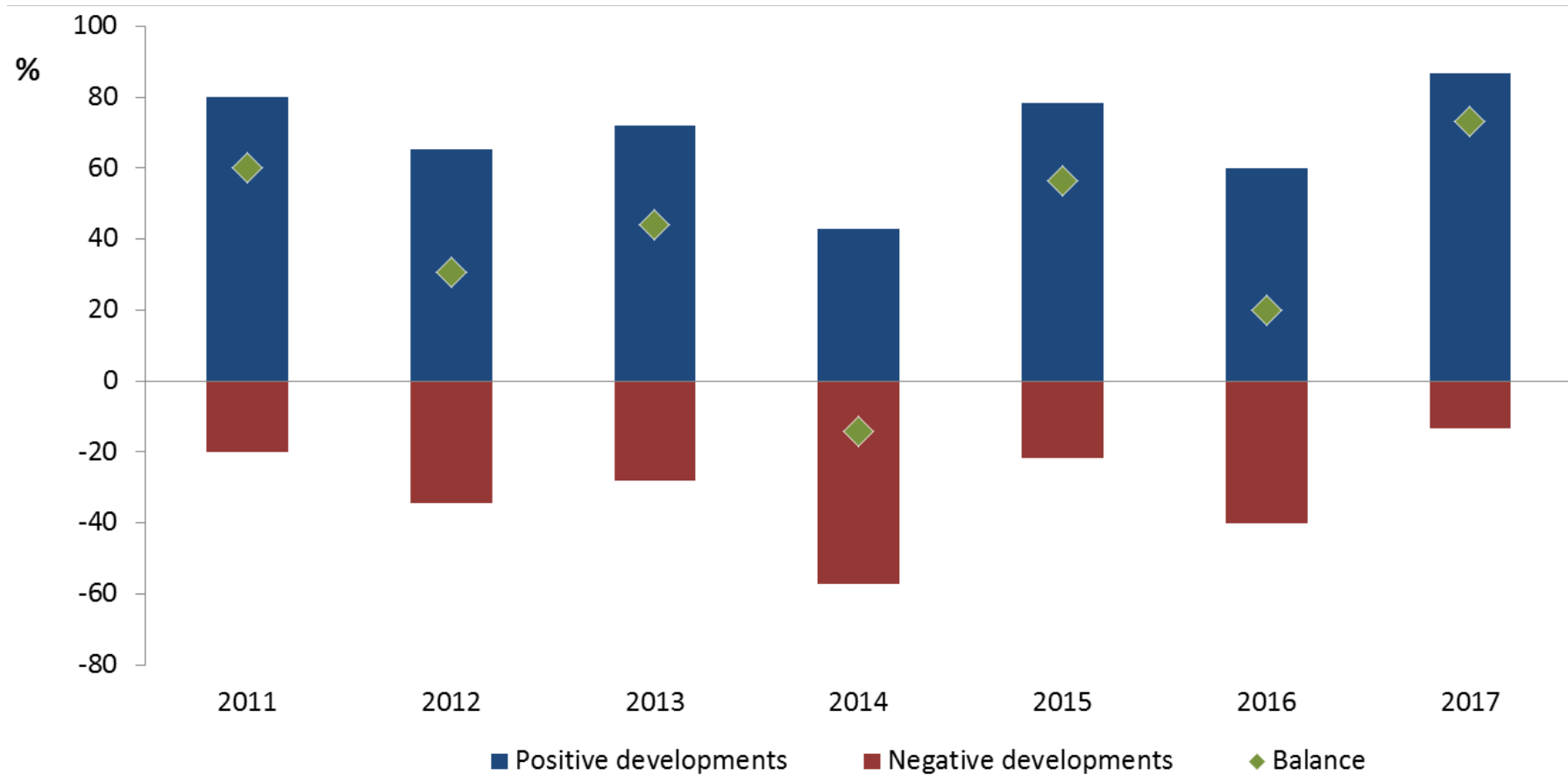
What do these measures tell us?



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Reform appetite seems to have returned to the region

Number of revisions to sector reform indicators, %



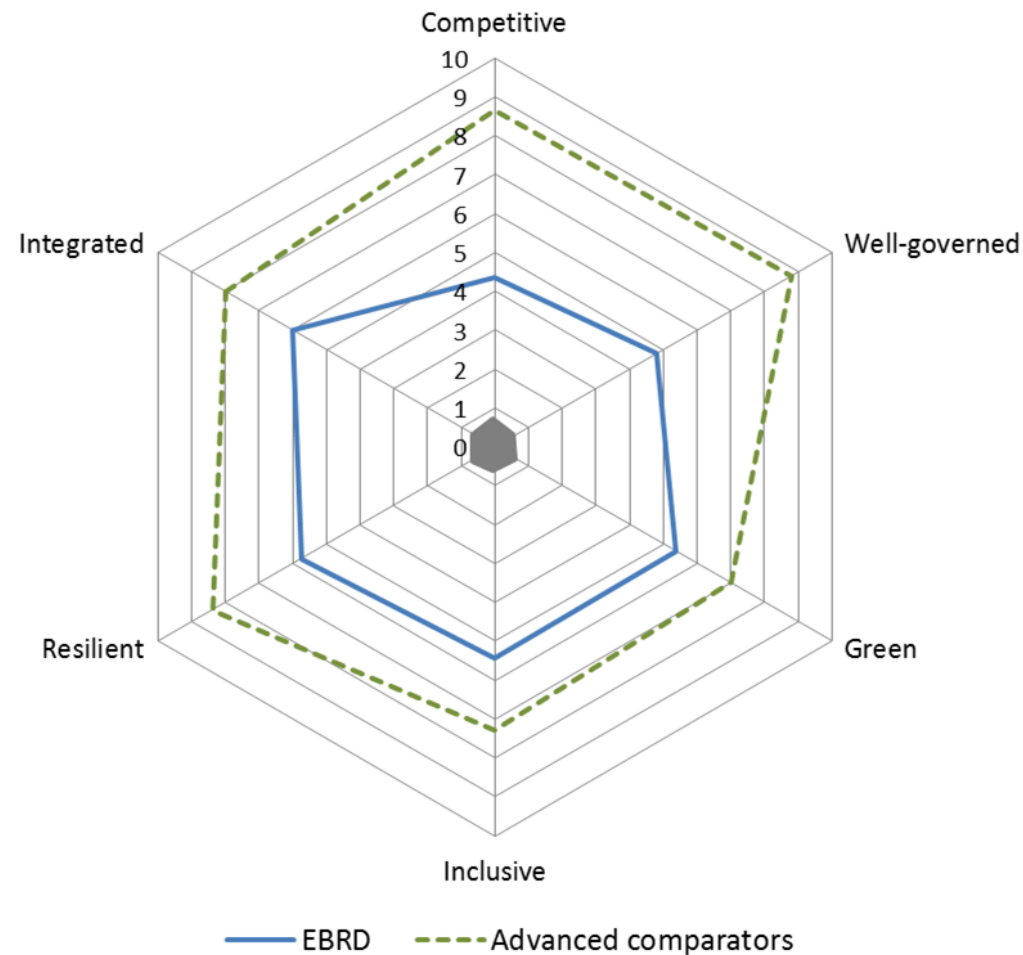
Sources: EBRD.



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The EBRD region performs weakest in Competitive and Well-governed compared to advanced comparators

Assessment of transition qualities in EBRD countries



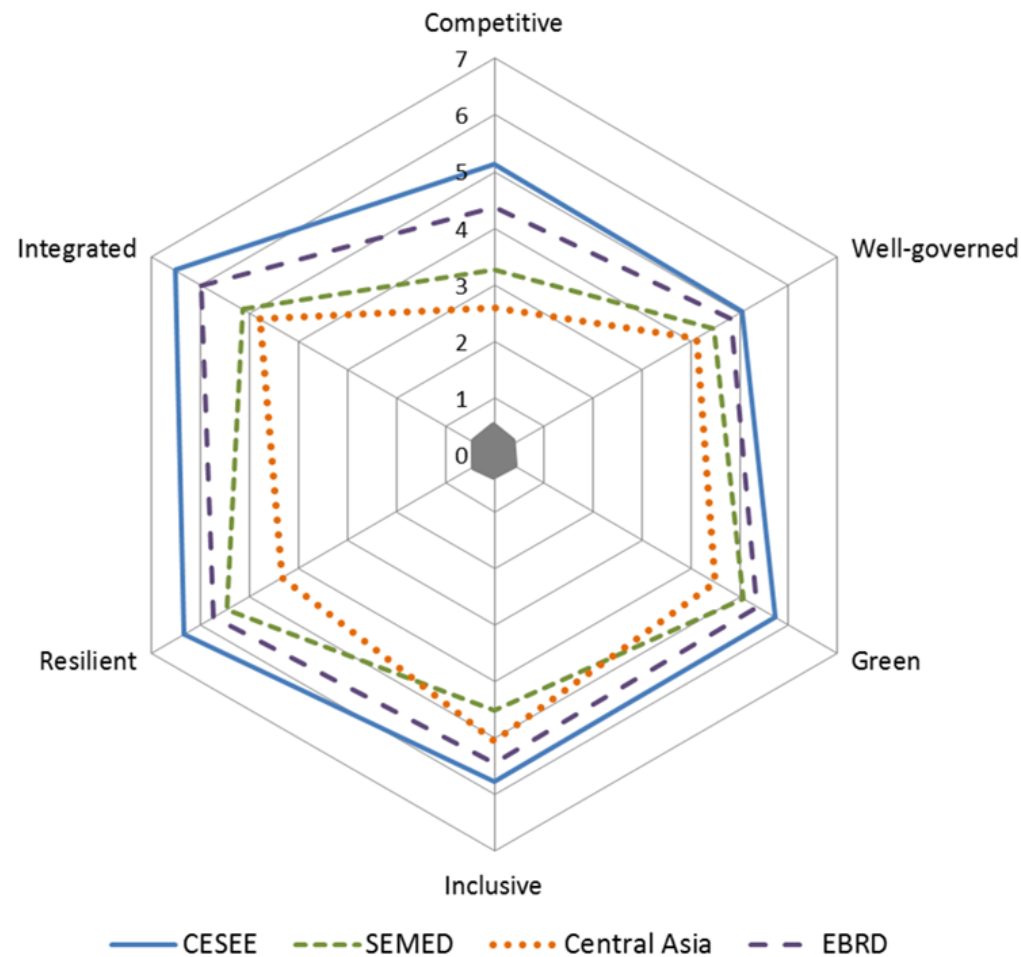
Sources: EBRD



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The CESEE region outperforms the residual EBRD countries in all transition qualities

Assessment of transition qualities within EBRD countries



Sources: EBRD.



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Concluding remarks



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Concluding remarks

Impressive convergence before the crisis

- but currently slowing down
- need a new growth model

Initial reforms successful in bringing total factor productivity from very low levels to levels in line with other EMs

- Economic openness, external anchors played a key role
- But reform agenda remains incomplete

Reforms are unpopular

- Need to focus on distributional impact of reforms
 - And on governance/fairness
-

External anchors of reform



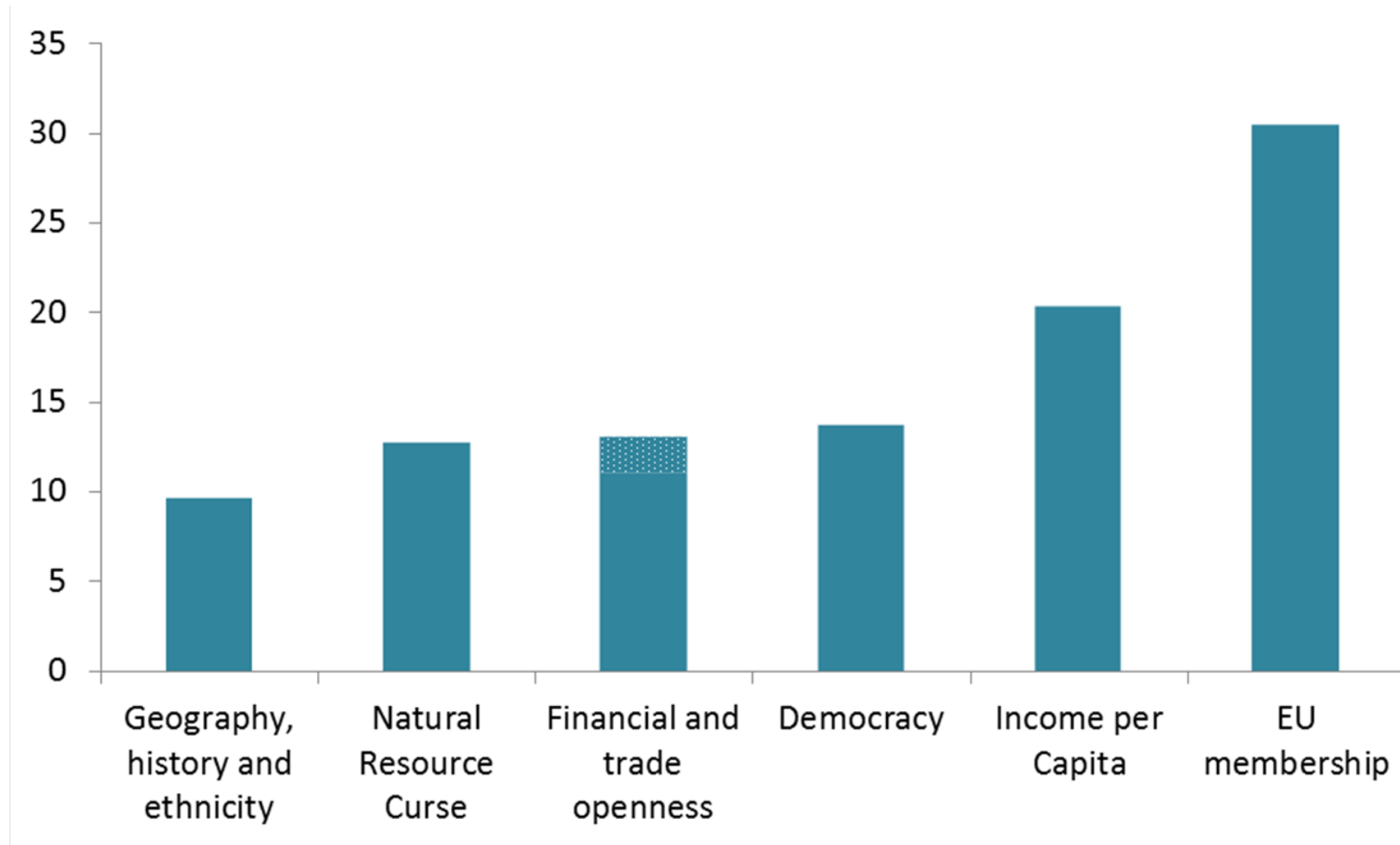
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External anchors have played an important role

- EU Accession has been an important anchor of reforms in Central and South-Eastern Europe
 - Other countries used different external policy benchmarks:
 - WTO accession
 - OECD accession
 - International financial centre projects
 - Doing Business
 - Belarus, Russia and others have adopted formal targets
 - “Yardstick competition” can be effective (Besley and Case (1995) for the US)
-

Crucial factor for institutional quality in EBRD countries is EU membership, income and democracy

Factors explaining institutional quality difference between top and bottom transition countries:

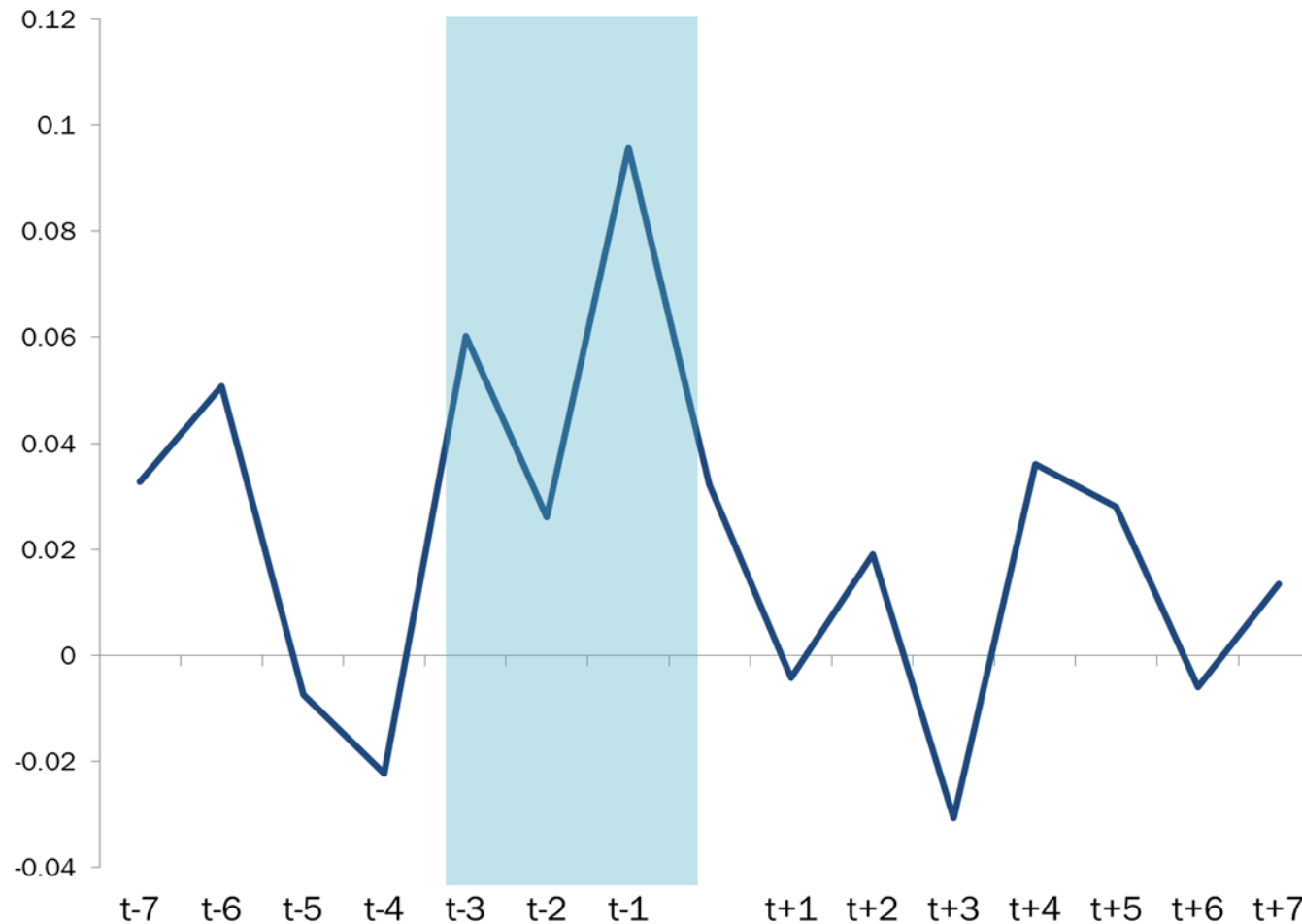


Sources: Stuck in Transition?, authors' calculations, based on time period 1997-2014.



EU accession played an important role – but a weaker anchor post-accession

Average annual change in governance indicators in EU-10 relative to accession year



Sources: World governance indicators, authors' calculations. On -2.5 to 2.5 scale; standard deviation is 1.

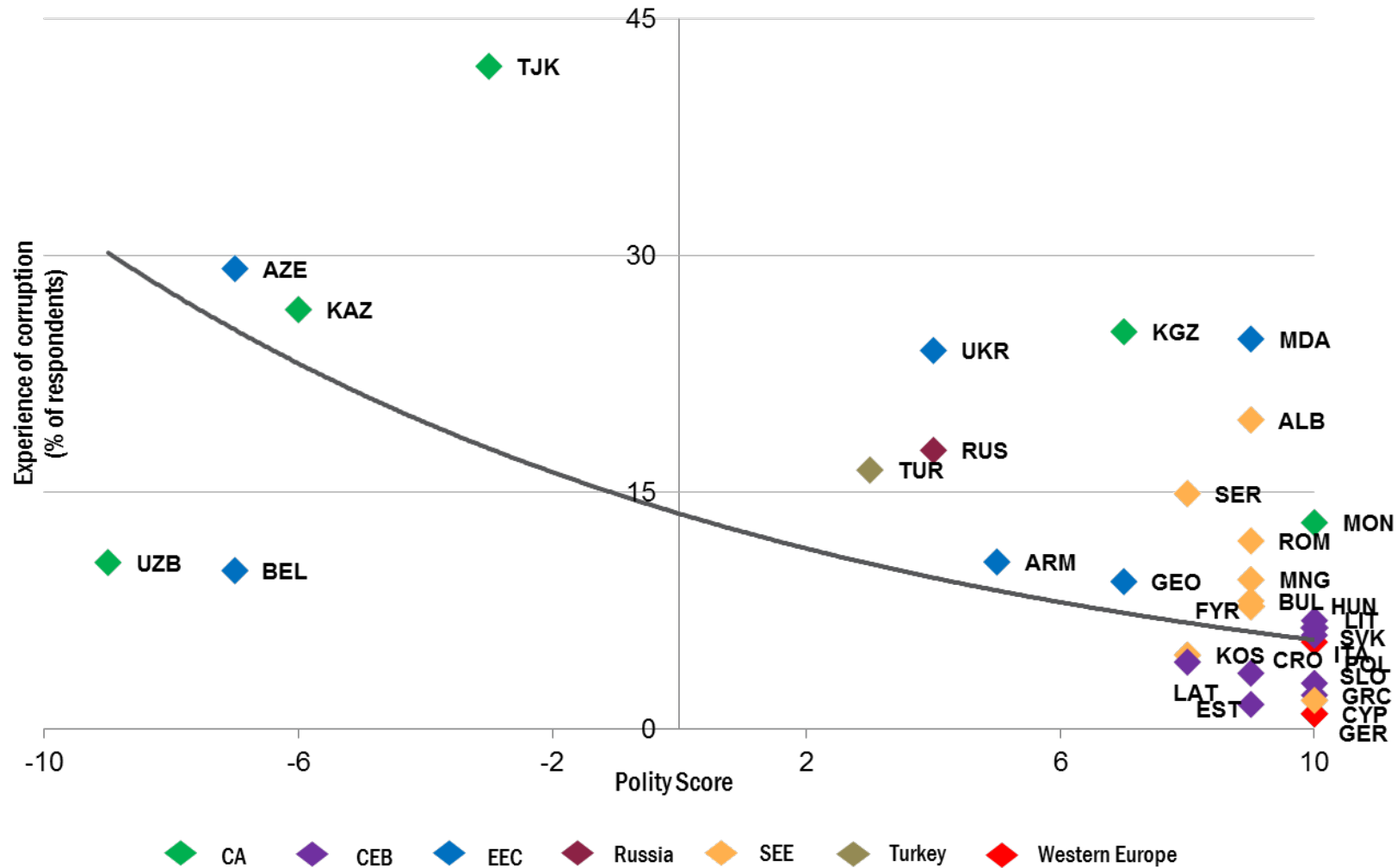


Background slides



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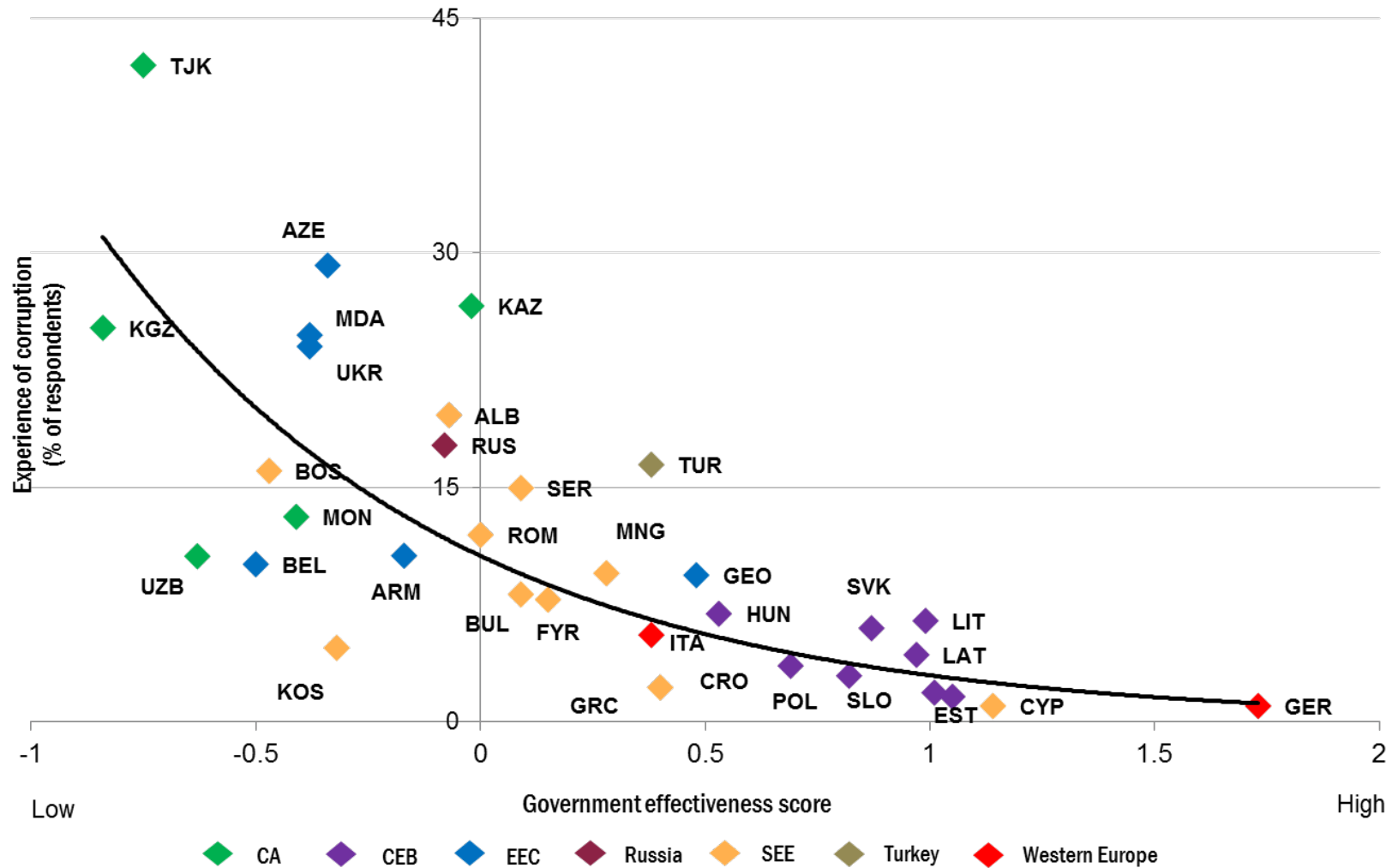
Democracy tends to go hand in hand with greater transparency and lower corruption



Sources: LiTS III (2016), Polity IV (2015), authors' calculations.



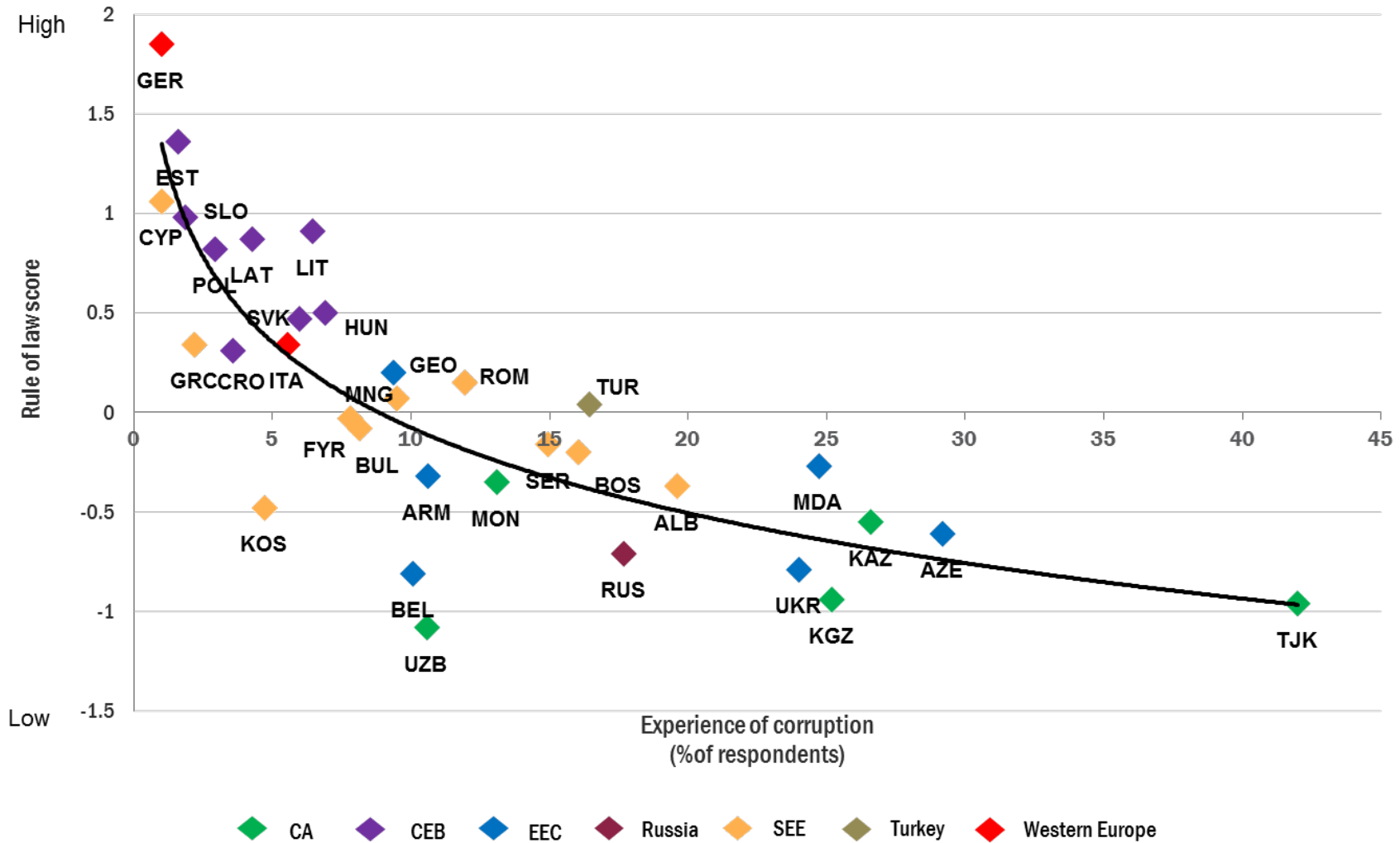
People in countries with more effective governments are less likely to experience corruption



Sources: LiTS III (2016), World Governance Indicators (2015), authors' calculations.

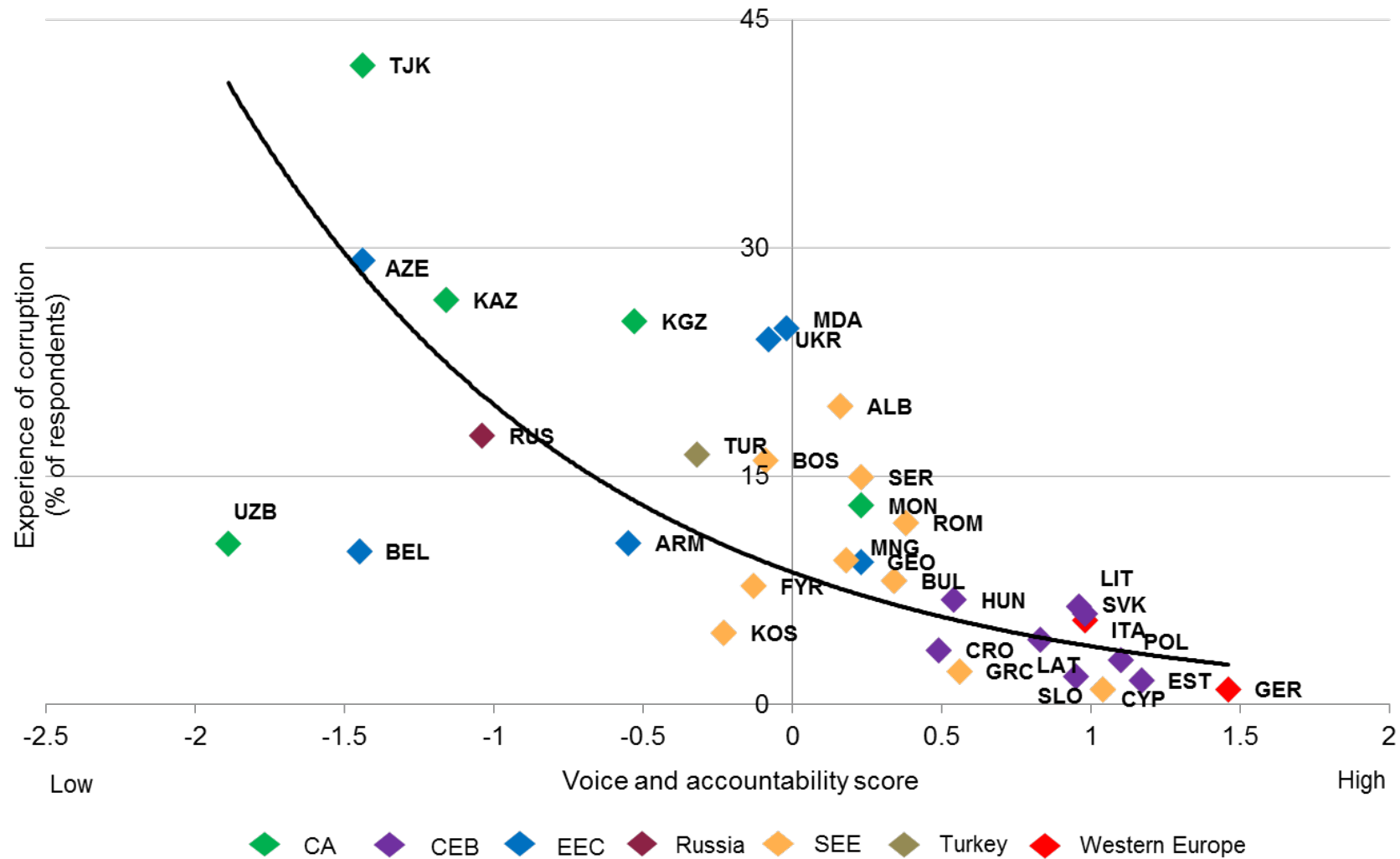


Corruption within the law enforcement and justice is correlated with weaker rule of law



Sources: LiTS III, World Governance Indicators (2015), authors' calculations.

People in countries with more accountable institutions are less likely to experience corruption



Sources: LiTS III, World Governance Indicators (2015), authors' calculations.



Better educated and those who support democracy and markets are more likely to stand up to corruption

Outcome is →	Ordinary people cannot do anything	Refuse to pay bribes	Report corruption when you experience it
Age	0.127*** (0.031)	-0.040*** (0.010)	-0.069*** (0.019)
Male	-0.013*** (0.004)	0.009** (0.004)	0.020*** (0.004)
Married	-0.009** (0.004)	0.015*** (0.004)	0.001 (0.004)
Tertiary education	-0.049*** (0.005)	0.045*** (0.005)	0.031*** (0.005)
Support democracy	-0.007 (0.005)	0.046*** (0.005)	0.012*** (0.004)
Support market economy	-0.008 (0.005)	0.029*** (0.005)	0.005 (0.005)
R-squared	0.05	0.03	0.04
N	42278	42278	42278

Sources: LiTS III (2016).

