EBRD Transition Report 2013: Stuck in Transition?

Compiled by
Antje Hildebrandt

On January 27, 2014, the Oesterreichische Nationalbank (OeNB) and the Austrian Ministry of Finance (BMF) co-hosted a presentation of the 2013 Transition Report of the European Bank for Reconstruction and Development (EBRD), including January 2014 GDP growth forecast updates for the "EBRD region."[1] The event took place at the ministry's premises and was opened by *Harald Waiglein,* Head of the BMF's Directorate General Economic Policy and Financial Markets, and by *Doris Ritzberger-Grünwald,* Director of the OeNB's Economic Analysis and Research Department.

In his opening remarks, Waiglein emphasized the importance of the EBRD Transition Report as a source of up-to-date information about CESEE countries. Given the high share of trade between Austria and CESEE and the catalytic effect of eastward EU enlargement for the Austrian economy, Waiglein expressed some concerns about the latest developments in the region, as evidenced by the Transition Report: For instance, reforms are stalling or have even been reversed somewhat in some countries, and unemployment rates are running high, with youth unemployment constituting a particular challenge. At the same time, as pointed out by Waiglein, the region is characterized by heterogeneous developments: The Baltic economies, for example, are growing quite dynamically according to forecasts for 2013 and 2014 while others, such as Croatia or Slovenia, are showing no or very low GDP growth.

Ritzberger-Grünwald stressed that the title of the 2013 EBRD Transition Report comes with a question mark, which would imply that the gloomy assessment of recent developments may leave some room for optimism. While economic convergence of CESEE with the euro area will without doubt be a more protracted process than expected and while CESEE countries have lost some of their price competitiveness, these aspects are only one side of the coin. Indeed, CESEE countries have seen some improvements in other fields. For example, they were able to improve the quality of their exports, which has more than compensated the loss in price competitiveness. Under the heading "Stuck in Euroization?" Ritzberger-Grünwald went on to share the latest findings of the OeNB's Euro Survey of households in CESEE. Households continue to report holding large parts of their savings in euro, which continues to inspire more confidence than the local currencies. Evidently, the degree of euroization has not decreased substantially following the stabilization of economic conditions. One further finding is that CESEE countries are not overbanked in general but that large regional differences prevail.

After the introductory remarks, Jeromin Zettelmeyer, the EBRD's Deputy Chief Economist and Director of Research, summarized the EBRD's latest growth forecasts for the countries in the EBRD region and outlined the major messages of the EBRD Transition Report 2013 "Stuck in Transition?" He also addressed the key question of the report, namely whether the CESEE countries will ever catch up with the living standards of the most advanced market economies of the world. Last but not least, Zettelmeyer pointed out the importance of democratization and economic institutions for creating a reform-oriented environment.

[1] *The EBRD currently operates in 34 countries, ranging from Central, Eastern and Southeastern Europe, to Central Asia and the Southern and Eastern Mediterranean.*

Part I: The Short-Term Perspective: State of the Recovery and Outlook for 2014

According to the EBRD, economic recovery will be slow in the transition region. While SEE on average is expected to see some acceleration of growth in 2013 compared to 2012, other countries, such as Russia, Croatia, Slovenia or some Caucasian economies will miss out on growth. This outlook reflects the fact that, across the region, exports are still the main driver of economic growth (apart from Central Asia, where growth is mainly commodity driven). For growth to be higher, it would need to be driven by investments as well, but against the backdrop of low credit growth and high unemployment rates no recovery can be expected for the next year or two.

Moreover, as outlined by Zettelmeyer, concerns over monetary tightening in the United States prompted capital outflows from the region for the first time since the first quarter of 2011. CESEE also faced sluggish credit growth, of which local-currency loans have been the main driver. Last but not least, nonperforming loans and unemployment rates increased significantly from 2007 to 2012, indicating persistent legacies of the crisis.

Specifically, the EBRD expects real GDP growth in the transition region to reach 2.7% in 2014 compared to 2.0% in 2013. According to the forecast, Central Europe and the Baltic states will grow on average by 2.2% in 2014 (2013: 1.1%), largely driven by better growth prospects in the Baltics, Poland and the Slovak Republic. Slovenia, in contrast, is expected to remain in recession. Growth in SEE is almost unchanged in 2014 compared to 2013 (around 2%) while Turkey will see some deceleration of real GDP growth (from 3.7% in 2013 to 3.3% in 2014). In Russia economic growth will amount to 2.5% in 2014 (1.3% in 2013). Zettelmeyer summarized the first part of his presentation by stating that the overall picture for the 2014 outlook is blurred by a weak external environment, tight financing conditions as well as negative impacts of the crisis leading to slow economic recovery.

Part II: The Medium- and Long-Run Perspective: Resumption of Convergence?

In the second part of the presentation, Zettelmeyer explained that convergence is unlikely to take place in the absence of a reform of current economic and institutional policies. This negative view is largely driven by two facts: first, productivity catch-up is largely completed in CESEE and second, reforms have stagnated since the mid-2000s with the exception of SEE where the EU accession process of Bulgaria and Romania and the end of the war in the Western Balkan countries had prompted further reforms. Recent sector-level reform reversals were particularly pronounced in the energy and financial sector. In 2013, downgrades of country-level transition indicators will surpass upgrades for the first time.

Zettelmeyer elaborated that one cause of stagnation is an “underreform trap,” which involves imperfectly democratic and autocratic regimes, weak economic institutions, and low growth outside the resource sector. In the transition region, democracy and economic reforms are highly correlated – and causality can work both ways: Democracy can support the implementation of economic reforms (but, as evidenced by Belarus, a lack of democracy can also cause economic reforms to dry up). Vice versa, economic development and reforms can help support the creation of democracy by making societies richer and fostering private sector growth. The private sector is strongly interested in the creation of democratic reforms. In addition, the creation of competition and the weakening of special interest groups opposed to democracy can help create a democratic society. Admittedly, natural resources may break the link between rising incomes and democracy.

Zettelmeyer continued by raising the question how countries can break out of the underreform trap. In imperfect democracies moderate political shocks can positively influence economic institutions, such as the rule of law, regulatory quality and control of corruption. Apart from political shocks, feasible political reforms, openness to trade and foreign direct investment as well as education, in particular higher education, can improve economic institutions. He mentioned the Slovak Republic (pivotal election, 1998) and Georgia (Rose Revolution, 2003) as positive examples where the windows of opportunities were used to enhance economic institutions. In contrast, Romania (pivotal election, 1996) and Ukraine (Orange Revolution, 2004) missed windows of opportunity.

Zettelmeyer concluded by highlighting the factors that are decisive for a successful use of windows of opportunity. Thus, the priorities of the political leaders matter for the reform path a country takes. Additionally, experience has shown that success depends on external anchors and support. For many of the relatively new EU Member States the prospect of EU membership spurred reforms. Similarly foreign financial and technical assistance supported the implementation of economic reforms. In other words, deeper international integration can promote economic reforms, rising incomes and democratic changes.

The discussion after the presentation addressed a wide range of questions, including the complexity of the convergence process, which is, after all, not limited to a catch-up of GDP per capita. For example, quality of living standards or environmental issues can play an important role. The question was raised which countries have managed to catch up with advanced market economies. Japan and South Korea were mentioned as success stories. China, in contrast, holds no favorable indicators with respect to democratic structures. Despite its high growth of GDP it will take quite a long time for China to converge. In addition, large differences remain even within (EU) countries, as evidenced by the level of economic development of Northern and Southern Italy. Turning to the issue of migration, it was argued that migration from East to West mostly affected countries with poor returns to education. Furthermore it is an open question to what extent migration has an effect on factor productivity. Poland was mentioned as a country that is, in fact, seeing re-migration, having managed to get through the crisis with positive economic growth. Further questions related to tapering in the United States, the impact of which was found to differ considerably across CESEE countries. Generally one can observe some flight to safety (e.g. Poland), while countries with fragile macrofinancial fundamentals were hit more strongly (e.g. Turkey). Overall there was a general loss of confidence in emerging economies. Finally, it was noted that the macroeconomic indicators of Russia are looking relatively positive. The unemployment rate and external indebtedness, for example, are comparably low, and the country has substantial official reserves. However, as argued in the discussion, a resource-rich country should reach higher growth rates.