European Bank
for Reconstruction and Development

TRANSITION REPORT 2012

INTEGRATION ACROSS BORDERS

ABOUT THIS REPORT

The EBRD is investing in changing people's lives and environments from central Europe to central Asia and the southern and eastern Mediterranean. Working together with the private sector, we invest in projects, engage in policy dialogue and provide technical advice that fosters innovation and builds sustainable and open market economies.

The EBRD seeks to foster the transition to an open market-oriented economy and to promote entrepreneurship in countries from central Europe to central Asia and the southern and eastern Mediterranean. To perform this task effectively, the Bank needs to analyse and understand the process of transition. The purpose of the Transition Report is to advance this understanding and to share our analysis with our partners.

The responsibility for the content of the Transition Report is taken by the Office of the Chief Economist. The assessments and views expressed in the Transition Report are not necessarily those of the EBRD. All assessments and data in the Transition Report are based on information as of early October 2012.

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Country abbreviations

Albania	ALB	Morocco	MOR
Armenia	ARM	Poland	POL
Azerbaijan	AZE	Romania	ROM
Belarus	BEL	Russia	RUS
Bosnia and Herz.	BOS	Serbia	SER
Bulgaria	BUL	Slovak Republic	SVK
Croatia	CRO	Slovenia	SLO
Egypt	EGY	Tajikistan	TJK
Estonia	EST	Tunisia	TUN
FYR Macedonia	FYR	Turkey	TUR
Georgia	GEO	Turkmenistan	TKM
Hungary	HUN	Ukraine	UKR
Jordan	JOR	Uzbekistan	UZB
Kazakhstan	KAZ		
Kyrgyz Republic	KGZ	France	FRA
Latvia	LAT	Germany	GER
Lithuania	LIT	Italy	ITA
Moldova	MDA	Sweden	SWE
Mongolia	MON	United Kingdom	UK
Montenegro	MNG		

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EXECUTIVE SUMMARY

CHAPTER 1

The past year has been a difficult one for the transition region as growth weakened and the economic outlook worsened significantly. Nevertheless, there was no wholesale reversal of reforms, and progress has been made in some important areas. Policy-makers generally remain committed to the principles of markets and competition. Trade integration has been enhanced this year by the accession of Montenegro and Russia to the World Trade Organization. However, there is no sign of the major reform drive needed to boost growth rates towards their long-term potential.

A sectoral analysis of reforms and remaining challenges shows that most sectors across the region still face transition gaps that can be characterised as "medium" or "large". The largest gaps are typically in Central Asia and other parts of the former Soviet Union, but significant gaps also remain in the more advanced countries in central and eastern Europe. Over the past year, there have been reform reversals in the energy sector in Bulgaria and Romania, both EU members, and in Kazakhstan, as well as a downgrade in Hungary in the natural resources sector. In all cases, the downgrades reflect growing state interference and a move away from market forces. However, important progress has occurred in other sectors – notably in the financial sector where local capital markets have developed further – as well as in certain transport sectors.

For the first time in the Transition Report, this chapter discusses the reform histories of the southern and eastern Mediterranean (SEMED) countries and considers their current structural and institutional development. The analysis indicates that the region is in "mid-transition"; trade and capital flows in the SEMED region have been predominantly liberalised, and large parts of the economy are in private hands, albeit with important exceptions. However, while reforms carried out over the past two decades have improved the ease of doing business, market structure and institutional reforms need to be accelerated to enhance competitiveness, efficiency and productivity. Subsidies for basic foods and fuels tend to be more pervasive in SEMED distorting markets and placing heavy burdens on state budgets. At the sector level, power and energy stand out as the least reformed areas.

CHAPTER 2

Over the last year the transition region has experienced a significant worsening in the external environment. The *Transition Report 2011* presented a picture of ongoing recovery from the global financial crisis while pointing to risks from the region's exposure to the eurozone. Since then, as the eurozone sovereign debt crisis deteriorated, recovery has stalled in many countries that are particularly integrated with the single currency area. Growth has slowed down as exports and capital inflows declined. Crucially, the region's banks have lost significant external funding as eurozone banks reduced cross-border lending and withdrew financing from their subsidiaries in transition countries. This has depressed credit growth, which in turn contributed to slower output expansion.

An empirical analysis relating growth in transition countries to the fortunes of the eurozone, Russia and the world at large, along with oil prices and volatility in global financial markets, confirms that central and south-eastern Europe is more intertwined with the eurozone and eastern Europe and central Asia with Russia. The analysis also reveals that Ukraine is particularly exposed to developments both in Russia and in the eurozone, while Poland appears to be surprisingly resilient to changes in its external environment.

The outlook for the region continues crucially to be driven by developments in the eurozone crisis and its global repercussions, including its impact on commodity prices. In the baseline forecast, the region will see a substantial slow-down relative to 2011 both in this year and next as a result of the crisis. Central and south-eastern Europe will experience particularly slow growth and some of the countries have entered or will re-enter mild recessions. But countries further east have also already started feeling the impact of the crisis and are likely to grow more slowly as well. Possible further deterioration of the turmoil in the euro area poses the largest risks to already-slower projected growth in the region for 2012 and 2013.

CHAPTER 3

A eurozone-based "banking union" which would create an ECB-led single supervisor and pave the way for the direct recapitalisation of failing banks from the European Stability Mechanism (ESM) is likely to be crucial for making the eurozone more stable. But would it also address the deficiencies of nationally based supervision and resolution of multinational banks which have plagued financially integrated Europe in the last decade? Multinational banks have been a force of financial development and growth, but they have also exacerbated credit booms, adding to the pain of crises – particularly in emerging Europe. The prevention and mitigation of these crises has been complicated by poor coordination and conflicts of interest between the home and host countries of these banks.

Current official banking union proposals address these problems only in part, and may introduce some new complications. Bank resolution would still be handled by national authorities. Apart from continued coordination problems in resolving failing multinational banks, this could lead to moral hazard, since national authorities may not have the incentives to minimise fiscal losses when resources for recapitalising banks are available at the European rather than the national level. Furthermore, non-eurozone members could not access the ESM even if they opt into the single supervisory mechanism, putting the banking systems of these countries at a potential disadvantage.

A number of extensions or modifications to the proposed banking union may alleviate these and related concerns. In the absence of a European resolution authority, cross-border stability groups involving the European Central Bank (ECB) and the authorities of both home and host countries of multinational banks could help improve crisis management and develop burden-sharing models. To assuage concerns that the ECB might not be as concerned about local stability as national supervisors, the latter should be given a strong voice in the governance of the ECB's supervisory function, and retain certain macro-prudential instruments. Lastly, countries receiving ESM support could be required to share banking-related fiscal losses up to a pre-determined level.

Non-eurozone countries that opt into the supervisory mechanism should also have access to the possibility of direct recapitalisation by the ESM. In addition, intermediate options could be considered for European countries that either cannot or do not want to become full members of the banking union. This could include an "associate member status" through which non-eurozone countries would benefit from ECB liquidity support but not from fiscal support, and sharing of supervisory responsibility for multinational groups between the ECB and host country authorities.

CHAPTER 4

At the start of transition many old economic ties within and between countries in the former communist bloc were severed. However, economic fragmentation quickly gave way to the forces of regional integration initiatives, both among transition countries and with new trading partners in the West. One of the latest developments in regional economic integration is the creation of the Common Economic Space of the Eurasian Economic Community. In November 2009 Belarus, Kazakhstan and Russia agreed to establish a customs union. Further steps have since been taken towards deeper economic integration between these countries. New supranational institutions have been created and future geographical expansion of the union is being discussed.

There are many potential benefits of regional integration, including trade creation within the region, facilitation of exports to the rest of the world, more efficient markets across member countries, and an opportunity to build stronger economic institutions. The chapter considers the extent to which these benefits are likely to apply in the new customs union, drawing on early evidence on the impact of the customs union on trade, non-tariff barriers and export structure.

Common external tariffs introduced in 2010 had some impact on regional trade flows but the magnitude of this impact is small. Much of the rapid growth in trade between the three countries is explained by post-crisis recovery trends. The lowering of non-tariff barriers within the customs union also played a role. There is evidence that the benefits from reducing non-tariff barriers and improving cross-border infrastructure are much larger than from changes in tariffs.

The structure of exports from Belarus, Kazakhstan and Russia suggests that regional economic integration has the potential to act as a springboard for exports to the rest of the world. Goods first exported within the regional bloc are likely to later be exported to other destinations. Lastly, the quality of institutions in countries within regional economic blocs tends to converge, either towards the average or towards the higher level, in particular in the case of those blocs with deeper institutional integration. Within the Eurasian Economic Community there is currently little variation in terms of quality of institutions. However, the Community represents an opportunity to create supranational institutions with strong governance that have demonstration effects and could trigger demand for better domestic institutions.

CROSS-BORDER INTEGRATION – AN IMPORTANT RESPONSE TO THE CRISIS

This is the fourth consecutive Transition Report to be written in the shadow of an economic crisis in the transition region. Our 2008 report, dedicated to how growth in the region could be made more sustainable, was written as the storm was brewing. The 2009 report was entirely dedicated to the crisis – its causes, its impact and its possible long-term effects. In 2010, as the region was entering a fragile and uneven recovery, we focused on the post-crisis reform agenda, only to find new clouds gathering in 2011, when our report documented the effects of the 2008-10 crisis on households – both in economic terms and in their attitudes towards markets and democracy.

The nature of the crisis has changed fundamentally since 2008. What started as a banking crisis in a small group of countries has transformed into a sovereign crisis in the eurozone which has in turn weakened European banks and led to a withdrawal of funding from emerging Europe and to some extent from the southern and eastern Mediterranean (referring to Egypt, Jordan, Morocco and Tunisia and covered in full for the first time in this report). Unlike 2008, the new crisis has not hit emerging Europe at the height of an unsustainable boom. External imbalances have decreased and most governments have undertaken significant fiscal adjustment, some involving considerable sacrifice and leading to remarkable results. Yet, as Chapter 2 discusses, the region is still vulnerable, both because of legacies from the previous crisis and pre-crisis periods – high non-performing loans and foreign currency-denominated debt – and its strong dependence on the eurozone. Some of the southern and eastern Mediterranean countries which have experienced popular uprisings have also developed large fiscal deficits and would benefit from adjustment supported from the outside.

Slow-downs are projected in every central European, Baltic, and south-eastern European country and negative or near-zero growth in 2012 is expected in eight out of the 17 countries in this group . Importantly, the slow-down has begun to extend beyond the area most closely integrated with the eurozone, as growth in Russia has begun to decelerate, and with it economic activity in countries that depend on it through remittances and trade. In contrast, some southern and eastern Mediterranean countries are projected to recover somewhat this year as their economies emerge from the economic dislocation associated with political and social turmoil in 2011.

How the region will evolve in 2013 will depend largely on the policy response, both inside the region and particularly outside. An important dimension of this response, and one which will have implications beyond the crisis, is institutional integration: attempts to build stronger supranational institutions and legal frameworks. The foremost such attempt within the eurozone – which by now encompasses three transition countries: Estonia, the Slovak Republic and Slovenia – is the September 2012 "banking union" proposal made by the European Commission at the behest of the European Council. It suggests a single supervisory mechanism for the eurozone, with an "opt in" option for non-eurozone countries, which would potentially allow direct recapitalisation of eurozone banks using funds from the European Stability Mechanism (ESM).

To the extent that the proposed mechanism backstops European sovereigns in their current efforts to resolve failing banks – which was not assured as this report went to press, with some eurozone countries arguing that the proposed backstop should not apply to "legacy debt" – it could prove essential in stopping the ongoing crisis. This would benefit all of Europe, including emerging European countries that are outside the eurozone. At the same time, the proposed plans leave significant gaps and have raised concerns among emerging European countries. One concern is that the single supervisor will pay attention mainly to eurozone-wide stability threats and not sufficiently to financial system soundness for each member country. Another fear is that emerging European countries may become fiscally responsible for crises elsewhere. This is compounded by the fact that the banking union plans would, for the foreseeable future, leave the responsibility for resolving failing banks in national hands. Given that ultimate fiscal responsibility could be eurozone-wide, this creates a potential for moral hazard.

There are also concerns on the side of host countries of eurozone banks that do not expect to join the banking union anytime soon. Among them is a worry that supervisory coordination failures, which marred attempts to control national credit booms before the crisis, will persist when eurozone home supervisors are replaced by a single, powerful home supervisor – the ECB. Another fear is that the banking union would tilt the competitive balance inside the European Union against banks headquartered outside the banking union, as the latter would not be covered by the fiscal safety net provided to banking union members.

CROSS-BORDER "STABILITY GROUPS"

We argue in this report that it is possible to address both sets of concerns. A move towards supranational resolution mechanisms remains essential over the medium term, but if it cannot be achieved in the short term, the current proposal can be improved by other means. Moral hazard could be addressed by requiring countries receiving ESM fiscal support to share banking-related fiscal losses up to a pre-determined level. Coordination gaps can be reduced by cross-border "stability groups" that include home and host country authorities (including Ministries of Finance), the ECB and the European Banking Authority (EBA). These could draw up plans on how failing cross-border banks would be resolved. The governance structure of the single supervisory mechanism can

and should be designed to give sufficient voice to smaller member countries. Lastly, non-eurozone countries that opt into the single supervisory mechanism should also be allowed to opt into the ESM. Apart from full membership, intermediate options could also be considered which would extend some but not all benefits and obligations of membership to all financially integrated European countries – including countries outside the European Union (EU).

While the EU is focused on the institutions that manage financial integration, a different sort of institutional integration is unfolding further east. In November 2009 Belarus, Kazakhstan and Russia agreed to establish the Eurasian Economic Community (EEC), reinforcing the customs union between the three countries from 1999. A common external tariff was introduced in 2010, and further steps, including new supranational institutions, have since been taken. Initial concerns that the customs union would slow down, even prevent, Russia's World Trade Organization (WTO) accession turned out to be exaggerated; as it finally joined the organisation in August 2012 after 18 years of negotiations. Yet, important questions remain as to whether the customs union will facilitate or hinder the further integration of its members into the global economy. We present an early assessment of the arrangement, focusing on changes in tariff and non-tariff barriers, trade patterns and the geographical structure of exports.

Although the main rationale for the EEC was not the crisis but rather long-term economic and institutional benefits, we find evidence that its introduction helped the post-2009 recovery of trade in the three member countries. The driving force behind this was not so much the change in tariffs as the removal of non-tariff barriers such as trade regulations and customs. The report also presents evidence that suggests many of the non-tariff benefits of the arrangement may still lie ahead: for example, by helping to coordinate better cross-border infrastructure.

REGIONAL INTEGRATION

Perhaps most encouragingly, the report presents evidence that regional integration can act as a springboard for exports. Higher-value-added goods that are initially exported within the customs union can subsequently be exported elsewhere. Export patterns currently observed for Belarus and Russia suggest that this effect may already be at work. This means, for example, that the customs union might help Russia diversify its export structure away from natural resources. It might also help improve economic institutions in its member countries, although this will be challenging. International evidence suggests that customs union membership can enhance the institutions of its weaker members, but within the Eurasian Economic Community there is currently little variation in terms of institutional quality. However, it is possible that supranational institutions with strong governance at the level of the Community could trigger improvement in domestic institutions.

Many transition countries may go into a second dip of the crisis, with uncertain prospects of recovery. The outlook in the southern and eastern Mediterranean region, where countries are struggling with their respective political and economic transformations, is similarly unsettled. At the same time, the cliché that crisis breeds opportunity seems to hold some truth particularly when it comes to the new integration efforts. This is true in the east, where both institutional integration and actual economic integration have lagged, the new regional trade arrangement is reducing non-tariff trade barriers and may help its members become more competitive. In the west, the lag between financial integration and institutional integration has been threatening the sustainability of the former. A carefully executed banking union would address this tension. In the south, intraregional trade and investment are miniscule relative to potential, as are institutional structures supporting such integration, but in the wake of the Arab uprisings the governments of the southern and eastern Mediterranean are undertaking renewed efforts to revive regional cooperation. They are also seeking to expand and deepen their ties to the EU. Together, these new efforts could give Europe, its neighbourhood and the transition region at large a better foundation from which to resume its quest for prosperity and convergence.

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