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Transition Indicators of the European Bank for Reconstruction and Development: A Doubtful Guide to Economic Success

MARTIN MYANT
University of the West of Scotland

JAN DRAHOKOUPIL
University of Mannheim

The European bank for Reconstruction and Development (EBRD) has produced indicators of success in creating market economies in Eastern Europe and the former Soviet Union. These have been helpful for researchers, but suffer from a limited view of transition based on liberalization and private property. A good score in transition indicators need not correspond to creation of a successful, modern economy. Shortcomings have been acknowledged, but changes have not overcome the weaknesses in the indicators.

KEYWORDS EBRD, transition indicators, privatization, Russia, Czech Republic

Introduction

The 'transition indicators' developed and published by the European Bank for Reconstruction and Development (EBRD) since 1994 have become one of the most used sources for scholars and other analysts studying economic and social developments in Eastern Europe and the Former Soviet Union. They have proved extremely popular despite a number of questions about their validity – that is, what they actually measure – and their poor record in providing an accurate guide to the progress of individual countries in building sustainable market economies. The failure of the transition indicators, we argue in this article, is linked to a flawed understanding of 'transition', one which has been and still is based on a narrow concept of private ownership rather than on a broader perspective of economic development.

The initial agreement to set up the EBRD was signed on 29 May 1990. This was at the instigation of Western European political leaders, after the sudden collapse of

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communist regimes in Eastern Europe and the Soviet Union after 1989. Its aim was to help the reconstruction and modernization of economies that had fallen significantly behind the world's richest countries. It has subsequently expanded its role to cover 29 countries, including those of central Asia. However, there was no commitment to financial assistance on the massive scale of the post-Second World War Marshall Plan. Therefore its contribution in terms of providing additional capital has been small when set against the area's needs; creating functioning market economies and democratic political systems would, it was believed, open the way to economic prosperity.

The remit of the EBRD has been to 'foster the transition towards open market oriented economies and to promote private and entrepreneurial initiative' (EBRD, 2006: 5). It was to be, in the first instance, about systemic change, so-called 'transition'. It was not primarily concerned with 'reconstruction and development', which differentiated it from other international financial institutions, notably the World Bank, although there was some overlap in their roles. In line with its philosophy, it has supported projects that promote development, including environmental improvement, but almost exclusively by providing credits to private enterprises that fulfil their criteria. The focus of the EBRD's research and advice has been limited to those areas that are considered to fall under the heading of creating market systems. This has included advice on price liberalization, privatization and legal frameworks for business.

The assumption was that development would follow once the objective of installing a market economy had been achieved. This partly reflected the reality that there were no funds available for a more ambitious role, but it was also reinforced by a conception of transition that has remained largely unchanged through the period from 1990 to the present. This was despite considerable difficulties and disappointments along the way, as well as apparent successes.

Our view is that the EBRD has been a valuable source of information, assisting researchers who want up-to-date information and analysis on the transition countries of Eastern Europe and the Former Soviet Union (its remit always expanded beyond Europe alone) that were encouraged to abandon central planning in favour of market economies. However, its conception of transition is at best highly questionable.

A set of 'transition indicators', intended to show how far countries have progressed along the road to a market economy, embodies the central thesis of the bank's understanding of transition. It by no means represents the totality of the EBRD's activities, but it is important and central enough to warrant its discussion as a focus for assessing the bank's role in influencing the broad strategies for, and approaches to, transition.

The EBRD indicators may be a fairly accurate reflection of what they attempt to measure, for example how much of the country's assets have been transferred into the private sector. High ratings are consistently given to those countries that have moved rapidly towards a free market, with more negative assessments for those that have taken slower or more gradualist routes; notably Slovenia, which remained the country with the highest per capita GDP. This article therefore looks at the EBRD transition indicators, asking three questions:

- What is the theory behind the choice of indicators?
- Do high scores indicate genuine success in creating an economic system that can lay a basis for growth and prosperity?
- Have indicators been revised, or country rankings changed, in the light of the problems that have emerged during transition?

We continue by examining three key areas: privatization and private sector development, price and trade liberalization and the development of financial institutions.

The EBRD system gives a score of 1 to 4 (sometimes 4+) for each country for each year on the basis of nine transition indicators. In 1998, a set of indicators on 'the market-oriented development of infrastructure' was added. The EBRD's conception of transition does not include quantitative indicators of either a country's level of development or of its macroeconomic stability. The core focus is on the development of the private sector for which the EBRD examines the progress of large-scale and small-scale privatization. It is accepted that this needs to be accompanied by enterprise restructuring, for which an indicator is provided. However, most attention, as we illustrate below, goes to clearly measurable figures, such as the extent of privatization and share of the private sector in GDP. A second key area is the development of markets, and for that the key indicators are price, trade and foreign-exchange liberalization and competition policy. The third key area is the development of financial institutions as a means of enabling growth by channelling savings into investment.

Privatization and enterprise restructuring

The small print in EBRD publications acknowledges problems with at least some of these indicators. With regard to privatization, it is recognized that the state continues to play a role and that 100 per cent privatization would not be desirable (75 per cent of enterprise assets in private ownership is the threshold for a 4+ rating). It is also recognized that speed may not be the most important criterion when other elements of transition are lagging behind. Moreover, evidence of 'support for corporate governance' was a requirement to achieve the highest score in 1994 (the 4+). The notion of 'effective corporate governance' was added later, but none of the transition countries managed to reach it.

Nevertheless, the message of the indicators is clear: rapid privatization receives praise and a good assessment, which is then reflected in higher scores in relation to enterprise restructuring. The questions of corporate governance, incentives for stakeholders and key competencies and abilities within the companies took a back seat in the actual scoring practice, figuring in a general indicator for enterprise restructuring that focused more on formal tightening of credit and subsidy policies. Thus the EBRD was quick to give a positive assessment to the Russian and Czech Republic voucher privatizations (scores of 4 and 3, respectively, by 1994), implicitly praising the speed of transformation into formally private ownership, but overlooking the negative consequences. In both cases, the results of voucher privatization were chaotic ownership structures in which large sums of money could be made and exported without creating a viable business structure, as explained below (Myant & Drahokoupil, 2011).

How is this reflected in the transition indicators? The Czech Republic was and is considered to be the absolute 'star performer' in large-scale privatization. The architects of their voucher method consequently won international standing and promotion to the role of advisers in other countries. In addition, the Czech Republic continued to gain high marks for enterprise restructuring (a score of 3 from 1993). This was despite the fact that some major enterprises privatized by vouchers and direct sales to domestic owners suffered financial catastrophe in the late 1990s and were, in a number of cases, brought back into effective state control, slimmed down and sold off to foreign firms, often with little better performance in the following years. Their accumulated debts were covered at considerable cost to the state budget. Despite the chaotic experience of privatization, reversals and hasty improvisation, there was no revision of indicators on the part of the EBRD and transition continued to be portrayed as a steady advance towards the ultimate aim of a market economy.

For Russia, the gap between the reality and the impression conveyed by the transition indicators is even more remarkable. Privatization in the early 1990s was accompanied by a desperate struggle for survival by enterprises, often with wage payments delayed and with normal financial relationships replaced by barter. The EBRD shows very good scores for large-scale privatization from the early 1990s (rising to 3.33 in 1997), when assets were in effect handed to the so-called oligarchs in the notorious loans-for-shares deal; this was reversed in 2005 after Putin's government renationalized some of the oligarchs' wealth. Enterprise restructuring also scores moderately well, but experiences a temporary reversal in 1999, just as barter was giving way to more normal economic relations. This also coincided with a change from stagnation to some degree of growth among Russian firms, although, in general, firms not involved in export-orientated raw-material extraction were typically surviving by dint of a degree of protection from foreign competition.

Liberalization

Price, trade and foreign exchange liberalization should be less problematic, but there are difficulties here, too. The foreign exchange crises experienced by a number of countries cast doubt on the appropriateness of rapid liberalization. Under these circumstances, high scores might therefore be more appropriate for a country that takes a more gradualist approach to trade liberalization. In fact, Bulgaria was among the countries with the then highest score of 4 from 1994, rising in 2000 to 4.33, yet the country suffered a financial crisis linked to foreign exchange liberalization in 1996–97.

Russia, too, won accolades in the lead-up to financial meltdown in 1998, after which its score fell markedly (from 4 in 1997 to 2.33 in 1998) without ever regaining the high scores of the pre-crisis years. Ironically, however, lower scores in later years were associated with greater stability and economic growth. Again, the EBRD measured the speed of movement towards a free market, in this case meaning financial openness, but speed alone appears to have been a questionable approach for Russia at that time.

Financial institutions

Banking and finance are even more problematic areas. The EBRD assumption was that banks would play a role in transferring savings into productive investment. This would be aided, in their view, by a scenario whereby competition existed between a large number of independent banks. In fact, banks were frequently used as a means of channelling savings into private wealth – for example, by owners granting credits to themselves which they never repaid – and the more independence they enjoyed, the more likely this was to happen. As a result, deposit levels often remained very low and it was only in a few countries that banks played their expected role of granting credits to businesses for productive investment on a significant scale. This was largely confined to those banks in Central Europe and even then credits were often misdirected and poorly controlled.

Problems were clear from very early on, with banking crises occurring in a number of countries. Latvia had the second-highest EBRD score for bank transformation in 1996 (3 from 1994 to 1997), after liberalization measures aimed at turning the country into a Baltic Switzerland. In fact, much of the banking activity was unsound and about 40 per cent of deposits and assets were compromised in the crisis of 1995–96. Russia scored less well than Central European and Baltic countries, but still achieved a reasonable assessment, although its banks were playing no substantial role in supporting productive investment. On the contrary, their overall contribution could be viewed as negative as they were more concerned with speculation and helping transfer money out of the country. There was an improvement in the relevance of Russian banks to economic development after the crisis of 1998 and credits to businesses increased as did customer deposits. However, this was rewarded with a lower score in the EBRD's transition indicators (falling as low as 1.67 from 1999 to 2001).

The EBRD also saw an important role for other elements of the finance system, such as stock markets. These are conflated under the heading of 'Securities markets & non-bank financial institutions'. This too contained some deceptive indicators. Trading in shares took off in countries that experienced voucher privatization and, as such, in 1994 the Czech Republic and Slovakia were earning the highest scores (albeit still modest levels of 2.67) on this broader indicator. Russia overtook them both in 1996 (reaching 3). However, high levels of stock market activity did not indicate trading in shares in such a way as to exert disciplinary pressures on management. Rather, they reflected management, able to acquire funds from bank loans and traders of uncertain backgrounds, buying and selling control over companies.

When the frantic activity in buying and selling companies subsided, share trading also declined and stock markets came to play very small roles in all transition economies. The narrowly defined EBRD indicators on regulatory structures and institution building therefore tell us little about the significance for the economic system of an area that, as Joseph Stiglitz (1994: 228) remarked, should be regarded as a 'side show'.

Infrastructure

The EBRD transition indicators include a set of measures, incrementally added from 1998, for parts of the infrastructure, in particular telecommunications, railways, electric power, roads, water and waste. These are certainly important for a country's development potential, but the indicators tell us nothing about the quality of these activities and their public service functions. It is all about the extent of marketization. Thus for railways the key issues include the commercial orientation of their operations, sub-division of activities and avoidance of cross-subsidization. There would be substantial variation in scores for Western European countries using these criteria and plenty of scope for arguing about their importance.

Where now for the EBRD and transition?

We conclude with two points. The first is to re-emphasize the limitations of the EBRD's transition indicators. They provide no reliable guidance regarding a country's progress towards an economic system that can bring growth and prosperity. They are only indicators of progress along a road to an economic system defined by private ownership and free markets. Experience has demonstrated many areas in which these two do coincide, but many others in which they do not. Recently, this has been underscored by the very different impacts of the crisis of 2008 on transition economies: some of the countries that followed the liberalizing road most enthusiastically (such as the Baltic republics) were among the most severely affected; some others that also liberalized rapidly, notably in Central Europe, seemed to do relatively well.

The EBRD's indicators are therefore an unsatisfactory guide to countries' progress. They are of some help if used alongside other indicators, but positively misleading if used on their own. However, given the notorious difficulties inherent in accessing comparative data on the region, researchers often found the EBRD indicators the only data on institutional and structural change with any apparent validity and reliability available across the transition countries. They were thus often used alone as key indicators on various aspects of the transition countries.

The second point is to ask whether the indicators and judgements have changed in the light of experience. In fact, there were only minor adjustments in the conceptualization of individual scores in the period 1994–2010. However, the apparent failure of the indicators to identify vulnerabilities and important differences that were exposed in the crisis of 2008 led the bank to reflect on its methodology.

In its 2010 Transition Report, the EBRD acknowledged that its indicators 'may have exaggerated the actual progress' (EBRD, 2010: 2) and should be revised in the light of the crisis to give greater weight to 'the quality of regulatory and supervisory institutions' (ff. ii). However, in the same document, the bank's response wavers between assertions that a return to the growth model of the past was 'neither feasible nor desirable' (ff. iii) and that past strategies were 'fundamentally successful' (ff. v).

Practical revisions remain relatively minor. The EBRD's current indicators continue to emphasize the benefits of large finance and real estate sectors while failing to incorporate features that, in its own analysis, could mitigate vulnerability. This has resulted in a number of countries that have suffered severely from the crisis scoring extremely well.

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Notes on contributors

Professor Martin Myant is a specialist in Czech and Slovak economic and political developments and teaches at the University of the West of Scotland. He has previously contributed to the Economist Intelligence Unit.

Jan Drahokoupil teaches at the University of Mannheim. Myant and Drahokoupil's latest work is *Transition Economies: Political Economy in Russia, Eastern Europe, and Central Asia* (Wiley, 2011).

Correspondence to: Martin Myant, Business School, University of the West of Scotland, High Street, Paisley PA1 2BE, UK. Email: martin.myant@uws.ac.uk