EXECUTIVE SUMMARY

The *Transition Report 2017-18* focuses on the challenge of sustaining growth, with particular reference to the experiences of middle-income economies. The analysis in this year's report builds on various existing country-level, industry-level and firm-level datasets, as well as unique data on upgrades to road infrastructure and the performance of EBRD-supported infrastructure and energy projects. This report also provides an overview of progress in the area of structural reform and introduces a new assessment of the progress made by the countries of the EBRD region in their transition to sustainable market economies.

This report finds that middle-income economies tend, on average, to experience a slow down in productivity growth at income levels of between one-third and two-thirds of that of the United States of America. Furthermore, in many economies in the EBRD region, growth is lagging behind that of comparable middle-income countries elsewhere in the world. Having exhausted the advantages that used to underpin their strong growth performance in the past, the countries of the EBRD region now require a new growth model.

That model needs to be based on innovation, going beyond the importing of technology. The analysis in this report shows that the recent slow-down in the EBRD region's productivity growth partly reflects the fact that the region is home to many small firms, which remain small and relatively inefficient. Increased competition from imports, access to export markets and integration into global value chains can all encourage firms to raise efficiency levels through innovation and investment in modern capital stock.

This report estimates that investment in infrastructure accounts for around 40 per cent of all capital needs in the EBRD region. Over the next five years, the region needs to invest €1.9 trillion in infrastructure in order to support its growth. Evidence from major upgrades to Turkey's road network suggests that improvements in market access generate new trade links and broaden the range of products available to consumers, while the resulting rise in employment can reduce emigration from previously isolated regions. Thus, in addition to contributing to competitiveness and integration, transport infrastructure can also help to create opportunities for income growth in historically disadvantaged regions.

Despite significant progress since the 1990s, emission levels across the EBRD region are still substantially higher than those seen in comparable emerging markets elsewhere in the world, raising concerns about the long-term sustainability of growth. Stronger policies are needed in order to meet the commitments made under the Paris Agreement, starting with the elimination of energy subsidies.

BEYOND THE MIDDLE-INCOME TRAP

Middle-income countries appear to experience weaker productivity growth, with this slow-down happening at income levels of around one-third to two-thirds of that of the United States of America. As economies' incomes rise, productivity growth fails to keep up, with countries finding it difficult to switch from a growth model based on investment and the adoption of technology to one involving innovation and the development of new technology. This is one reason why episodes of strong growth have, historically, been difficult to sustain for more than a decade or two. Moreover, more than 40 per cent of all long periods of strong growth end in protracted periods of poor growth performance.

Middle-income economies also tend to have the most carbon-intensive production structures (in terms of emissions per US dollar of GDP), as these countries tend to have established manufacturing industries, but their firms may not yet be using the most advanced environmentally friendly technology. Chapter 4 looks in more detail at the challenge of increasing energy efficiency and cutting emissions in middle-income economies.

Having achieved middle-income status, many economies in the EBRD region are now in need of a new growth model. In the 1990s and the 2000s, the region's economies consistently outperformed comparable emerging markets elsewhere in the world. In sharp contrast, however, the region's average performance has consistently been weaker than that of its emerging market peers since the 2008-09 financial crisis.

While the region's growth prior to 2008 was driven predominantly by rising productivity, the main contribution to growth in recent years has come from the accumulation of fixed capital. And yet, in virtually every country in the EBRD region, investment still lags far behind the levels seen in comparable economies elsewhere in the world. The cumulative capital stock gap between countries in the region and other emerging markets is now estimated at €2.2 trillion (equivalent to 18 per cent of the region's total capital stock). Increasing investment in infrastructure could give growth in those countries a much-needed boost, as discussed in Chapter 3.

Analysis of recent episodes of sustained strong growth shows that investment, the availability of domestic savings in order to finance it and the quality of infrastructure play by far the most important role in explaining episodes of both strong and weak growth. Indeed, most sustained periods of income convergence, such as that seen in South Korea, involve rapid capital accumulation, often leveraging earlier advances in productivity. The quality of economic and political institutions also plays a major role when it comes to explaining growth performance, as do the development of equity markets and demographic variables.

http://2017.tr-ebrd.com/beyond-the-middle-income-trap

FIRM DYNAMICS AND PRODUCTIVITY

Chapter 2 takes an in-depth look at the factors underlying productivity slow-downs in the EBRD region and other emerging markets. It discusses the effectiveness of various policies in terms of avoiding such a slow-down as countries transition from low-income to high-income status.

This chapter introduces the Schumpeterian growth framework, which regards market competition and the establishment, growth and exit of firms as the building blocks of economic development. This framework forms the basis for a discussion of how market incentives affect firm-level innovation and aggregate productivity growth. Most importantly, it shows how countries' policy priorities should change at different stages of their development, building on a number of stylised facts about businesses across Europe.

First of all, when compared with EU countries in western Europe, the transition economies of the EBRD region have disproportionate numbers of small and non-innovative firms, which lag far behind larger firms in terms of productivity. Second, firms in the EBRD region often fail to grow. Third, while larger firms in the region have achieved higher rates of productivity growth relative to their counterparts in developed economies, smaller firms have not caught up to the same extent.

The fact that small firms are failing to grow is translating into lower levels of aggregate productivity. This phenomenon can be seen in industry-level data across the EBRD region. This chapter shows that productivity growth within individual industries can be supported by increasing cross-border integration. In particular, increased competition from imports and access to foreign markets through exporting can help industries to achieve and maintain higher rates of productivity growth. Greater integration into global value chains can also help countries to sustain productivity growth as a country's GDP per capita rises. Furthermore, this chapter also shows that more productive industries in the EBRD region are more likely to create than destroy jobs, thus emphasising the need to reallocate capital and labour away from inefficient sectors.

Replacing obsolete capital with modern equipment is crucial when it comes to raising firms' productivity levels. In line with the Schumpeterian view of the world, one of the key messages that emerge from the analysis in this chapter is that physical investment should be accompanied by innovation. Moreover, policies aimed at improving the quality of economic institutions should also be adopted, in order to enable small productive firms to drive economy-wide growth.

http://2017.tr-ebrd.com/firm-dynamics-and-productivity

INFRASTRUCTURE AND GROWTH

High-quality infrastructure connects people and markets, facilitating the efficient allocation of resources, while inadequate infrastructure hinders productivity. Most of the countries in the EBRD region have basic infrastructure, but there is still room for improvement in terms of sanitation and the supply of energy in poorer countries, and most of the region is lagging behind in terms of access to broadband internet. Meanwhile, firms in many EBRD countries of operations regard poor transport infrastructure as a major constraint on their business.

Estimates of country-specific infrastructure gaps reveal that infrastructure investment totalling €1.9 trillion is needed over the next five years in order to support the region's growth. Those investment needs, which equate to annual expenditure totalling 9 per cent of the region's GDP over that five-year period, vary widely across countries. Some economies require large amounts of investment in order to bring their infrastructure up to the levels that one would normally expect of countries with such economic characteristics, while other economies need to focus on maintaining their large existing networks and expanding them in order to support future population and income growth.

Evidence from major upgrades to Turkey's road network suggests that improvements in transport infrastructure boost domestic trade, with new trade links allowing firms to obtain inputs from different sources and broadening the range of products available to consumers. Improvements in market access lead to increases in employment and reduce outward migration from previously isolated areas. These findings suggest that comprehensive infrastructure upgrades have the potential to improve economic prospects in underperforming regions.

Infrastructure investment programmes should be designed in the context of the relevant country's needs, taking account of complementarity between infrastructure sectors such as telecommunications and roads. Many countries will need to look beyond their domestic economies in order to finance such investment. Recent research points to the existence of large pools of private savings in search of longer-term investment opportunities, and countries will need to tap into those sources of finance.

International financial institutions can facilitate such investment by providing region-specific expertise and by helping governments to design tender procedures that increase transparency and reduce the likelihood of costly overruns and corruption. In addition, a study of 46 completed infrastructure projects with EBRD involvement shows that the way in which project finance is structured has a major impact on a project's success. For instance, greater government involvement in projects is associated with delays in completion, while dispersed ownership of special-purpose vehicles underpinning project finance is associated with higher cost overruns.

http://2017.tr-ebrd.com/infrastructure-and-growth

GREEN GROWTH

At the start of the transition process, the EBRD region was an outlier in terms of its very high levels of greenhouse gas emissions, which were partly a result of polluting industries accounting for a large percentage of economic output. Aggregate greenhouse gas emissions have fallen since the 1990s, but they remain above the levels observed in comparable emerging markets elsewhere in the world. Moreover, declines in emissions have been driven mainly by improvements in energy efficiency, rather than reductions in the carbon intensity of energy production.

Stronger policies are required in order to put the region's economies on the path to green growth, starting with the elimination of energy subsidies. As long as electricity and fuel are cheap, firms will choose more energy-intensive production structures. When energy is appropriately priced, well-managed firms respond to price signals and reduce their emissions. The transition to a green economy will be especially challenging for major exporters of fossil fuels, which tend to have high energy subsidies. However, other parts of the EBRD region are relatively well placed to enjoy success in the low-carbon economy, exhibiting strong potential in the area of green innovation, albeit many countries continue to lag behind the frontier in terms of emissions, green manufacturing processes and the production of green goods and services.

While volumes of green goods and services are still relatively small, they are growing rapidly. Among publicly listed firms, green revenue typically accounts for a larger percentage of total revenue in smaller, younger firms. Those firms tend to have higher valuations, despite their returns on equity being lower than those of non-green peers. This suggests that investors expect higher future returns in this sector and place a premium on firms' environmental performance. The analysis in this chapter also shows that equity instruments are better suited to supporting green investment, while banks tend to provide funding for mature, older technology. As a result, increases in the development of stock markets relative to bank credit are associated with declines in pollution across industries and countries.

Channelling investment to cleaner and more productive firms will require effective regulation. The removal of energy subsidies and the pricing of carbon emissions are priorities in this regard, but countries will also need to embrace measures such as efficiency standards (in order to encourage energy savings), as well as subsidies promoting low-carbon technology. Additional measures (such as more comprehensive social safety nets and retraining opportunities) may also be required in order to soften the structural impact of transition to a low-carbon economy.

http://2017.tr-ebrd.com/green-growth

MACROECONOMIC OVERVIEW

After five consecutive years of economic slow-down, the average annual growth rate in the EBRD region rose to 1.9 per cent in 2016. Nevertheless, that growth rate remains below that observed in a group of comparator economies.

The stronger growth recorded in 2016 continued in the first few months of 2017, with all countries bar Azerbaijan and FYR Macedonia reporting positive growth. This improved growth performance reflects recoveries in the prices of oil and other commodities, which have supported growth in Russia, Central Asia, and eastern Europe and the Caucasus. Growth in central Europe and the Baltic states also accelerated in the first half of 2017, boosted by stronger investment activity in several countries.

In contrast, declining revenue from tourism, partly owing to security concerns and geopolitical risks, is continuing to weigh on the economic outlook for the southern and eastern Mediterranean. Growth in the EBRD region is expected to strengthen further in 2017 and 2018.

http://2017.tr-ebrd.com/outlook

STRUCTURAL REFORM

In light of the challenges that countries currently face in trying to achieve sustainable growth, the EBRD has reviewed its transition concept. Under that updated interpretation of transition, a sustainable market economy is regarded as being competitive, well governed, green, inclusive, resilient and integrated. Looking at reform efforts across the region over the past year, it is noticeable that many relate to competitiveness and resilience. Improving the competitiveness of businesses and sectors and strengthening financial systems seems to be a concern for many countries in the EBRD region. In addition, a number of countries have implemented reforms in order to improve aspects of governance – an area where the EBRD's new transition scores suggest that many countries have room for improvement.

http://2017.tr-ebrd.com/reform