Part II

Towards Sustainable Market Economies
Chapter 6
Rethinking Transition

Introduction

The global financial crisis came as a profound shock to the international financial community. After a period of success for the EBRD and its countries of operations the effects were devastating as economic growth slammed into reverse. There had been serious disruption in many transition countries a decade earlier when the Russian crisis hit. But then a swift recovery followed. This time the downturn was deeper, more widespread and prolonged.1 Whereas the Russia crisis had dented the transition process, this time it was under much more serious threat.

As unemployment rose and banks deleveraged, and as growth prospects diminished, the boardrooms of corporates that had invested in the east heard executives no longer asking “How do we get in?” but “How do we get out?” The world of transition appeared to have been turned on its head. Gains from the convergence of economic systems no longer looked a sure-fire bet.

Dissatisfaction grew. Transition was not at fault per se but it did not seem to be helping. In 2010, less than one-half of respondents to a large survey of the EBRD region expressed satisfaction with their lives compared with almost three-quarters of those surveyed in western Europe. Two-thirds of households in transition countries had suffered as a result of the crisis, through lost jobs, reduced wages and remittances; and a large proportion were compelled to reduce their consumption of basic necessities. The harder the impact of the

---

1 GDP growth in Russia fell from 1.4 per cent in 1997 to -5.3 per cent in 1998 before recovering the next year, while growth in CEB remained steady in these years at 2.4 per cent and 2.7 per cent, respectively (and again the following year with growth of 2.0 per cent).
crisis, the lower the satisfaction level. Overall, in more than half the EBRD countries surveyed respondents felt the position had worsened since 2006.²

The same survey showed support for markets and democracy also fell significantly in more advanced transition countries as a result of the crisis. Trust in banks, financial institutions and foreign investors fell. The more citizens were personally affected by the crisis the more they turned away from democracy and the free market.³

Doubts had been sown by the experience of financial failure. But an even longer-standing and pernicious problem was that of corruption. This was perceived to be worse than before the start of the transition and deteriorating rather than improving. The general level of trust in society was also low. The path ahead was no longer clear.

The severe consequences of the great recession called into question the robustness of transition and the model on which it had been built. Western investment and support, including by the EBRD, had undoubtedly been valuable in kick-starting a moribund economic system and leading it towards a more successful, market-oriented economy. But now that the tide of market exuberance had turned and been replaced by market adjustment and economic hardship, the value of markets and liberalisation were being called into question.

The EBRD itself was not immune from this self-examination. A previously implicit presumption of a more or less linear transformation from planned to market economy and from communism to democracy looked at odds with the facts. A turning away from the EBRD founders’ belief in market democracy had already been seen in Russia after its crisis. It was now apparent that a similar course could occur elsewhere in the region. The risk of transition reversals in countries of operations became a major topic of conversation.

This was the context for the start of a rethink within the EBRD about transition. Drawing on academic developments and its experience in the field and the world of finance, management embarked on a major reconsideration of the concept underlying transition and its application to the Bank’s operational activities.

Over the next decade this rethink allowed the EBRD to remodel itself and establish a firmer base for delivery of its transition mandate. It became

based on a revised view of what was needed for the transition to a sustainable market economy, one that could survive the vagaries of market turbulence, drawbacks and inequities, and adapt to democratic pressures.

The changes made also helped to remove the sense of an anachronistic organisation tied to the past, and placed the EBRD at the forefront of MDB actions to meet development needs by transforming markets to support private sector development. The EBRD successfully partnered with private sector and other players to leverage funds for global public goals, such as tackling climate change and improving equality of opportunities for people.

1. Methodological Strains

The internal strains that emerged over the EBRD’s future from the debate on graduation in the early 2000s partially eased over time as a new geography opened up to the Bank’s realm of operations.\(^4\) The philosophical debate as to whether the Bank was there solely to help former communist countries develop a market and democratic orientation became resolved. The EBRD’s remit could be applied to a wider group of countries, at least within the European arena, though the issue of winding down activities in more advanced countries remained.

Strains arising during the same period over the understanding of the ultimate goals of transition did not diminish, however. What exactly did an open, market-oriented economy involve? Was demonopolisation and privatisation of state assets, or the putting in place of western market structures, sufficient for successful transition? And what else might be needed to ensure that countries would continue to evolve in an open, competitive, market-based and democratic manner?

The pressures to curb business in some countries from ideas on graduation and differing interpretations of transition renewed tensions within the Bank between economists and bankers. This was exacerbated by the economists’ major influence over project approvals. That influence was exerted through their management of an independent project scoring system whose

\(^4\) Described in Part I. See also Kilpatrick, *After the Berlin Wall*, Chapter 12.
scores and transition impact assessments fed into project documents seen by the Board and into the Bank’s annual corporate performance scorecard.\(^5\)

By the mid-2000s, after more than 15 years of studying and assessing transition, the EBRD’s economists were pleased with the transition impact assessment system that was by now deeply embedded in the operational mechanics of the Bank. But, even though the prospect of Turkey as a new country of operations boosted hopes for business, bankers faced practical uncertainties from the pressures to shift business away from EU countries expected to graduate by the end of the decade. They began to take aim at perceived constraints to the growth of their operations. Among them was the methodology that applied to the transition assessment of projects.

In several areas—for example, projects with repeat clients and debates over outcomes versus structures—there were increasingly heated arguments between bankers and economists. One big issue concerned conflict of interest, with bankers influenced by the interests of their clients rather than the public interest in a competitive playing field.

Then, as a new stream of business in sustainable energy expanded in the second half of the decade, environmentalists joined in pushing back against the economists who saw themselves as guardians of the EBRD’s mandate. The Bank’s senior management looked to the transition architects in the Office of the Chief Economist (OCE) for solutions, hoping that peace might break out before long.

Responding to the challenge, Erik Berglof, as Chief Economist, and Hans Peter Lankes as his deputy began to tackle questions the bankers had raised. The main disputes were clustered around three areas: repeat clients and critical mass;\(^6\) the role of state enterprises; and environmental and gender issues.

Repeat clients and critical mass

In most countries in the EBRD region, the number of well-established local corporate players and influential financial institutions was small. The Bank had helped to establish many of them. As a result, the bankers knew these

---

\(^5\) See Kilpatrick, *After the Berlin Wall*, Chapter 10 for a description of the evolution of the project assessment system and later in this chapter for further developments.

\(^6\) The notion that the sum of a large number of projects can have a wider effect than the sum of their parts and lead to a “take-off” point for wider, self-sustaining diffusion of the technologies or products behind them.
clients very well, having spent years building up relationships with them, and often used them to branch out into new business areas.

However, some projects were simply replicas of earlier investments: for example, repeated lines of credit for working capital for the new grain harvest, investment in a second turbine at a power plant, extension of a processing plant or production line, a further credit line for on-lending to SMEs to the same bank, and so on.

Viewed from the perspective of systemic change—a key objective of transition—these types of project won little favour from the economists in charge of rating bankers’ projects for their transition impact. Unless a radical new process or management change was introduced, the incremental systemic value of similar projects was low. The economists’ preference was thus for projects with new clients and new business areas where the boundaries of the market might be broadened. But this was more difficult for bankers to engineer.

The economists were also concerned about additionality, the notion that projects would not otherwise happen without the EBRD’s intervention, especially in more mature market areas.

In earlier days this was an intermittent problem, but the cumulation and growth of EBRD operations led to more frequent repeat projects with well-established clients where it became harder to argue they had no market access. The speed with which bankers found new clients or activities did not match that of investment volumes, so repeat business with the same clients increased, and with it clashes with tests of systemic impact and additionality.

This was not an easy problem on which to reach agreement. Hints were given on the idea of accepting a combination of repeat projects where a critical mass effect might apply and the use of investment frameworks, which badged similar projects under one umbrella, helped to ease the tensions a little. But it was only later that packaging a combination of investments, technical assistance and policy advice under integrated approaches provided a more promising solution.

Public infrastructure and state-owned enterprises

The Banking Department and OCE were also often at loggerheads over infrastructure projects financed with sovereign or sovereign-guaranteed loans.

In many less advanced transition countries, infrastructure needs were large and a primary source of business for the EBRD. There was no doubt that
such investments were needed. Bankers pointed out that the private sector could hardly thrive where power supplies were constantly interrupted, roads were barely passable and docks lacked the capacity to process container ships. In principle, such projects met a basic requirement laid down in the Articles of the Agreement Establishing the Bank (AEB) to allow public infrastructure investment where it was deemed “necessary for private sector development”.

But the economists argued that supporting state-owned institutions per se did not foster competitive market-oriented solutions in line with the Bank’s rationale. For them, more was needed: either investment in a state-owned enterprise on a path towards commercialisation and privatisation or improvements to regulation and legal requirements which would eventually permit private sector participation. Where these routes were missing bankers first had to engage intensively with the authorities in policy discussions.

Policy advice was not something the average private sector investment banker expected to undertake or was trained to do, and it was especially difficult in countries where administrative capacity was weak. It took time to develop policy capacity within the Bank and time-consuming efforts with authorities to find ways of making such investments work satisfactorily. Bankers baulked at the idea that a US$ 100 million loan for, say, a new turbine generator which would increase reliable electricity supplies might be blocked by the economists without a parallel dialogue on tariff setting, dispatch rules or the establishment of an independent regulator.

Nonetheless, as senior bankers gained knowledge and experience of the local conditions and as the Bank pushed further into less advanced countries, policy became a more accepted activity by bankers in infrastructure projects and better integrated with the investment process. Importantly, they were helped by lawyers in the Bank, especially from the Legal Transition team, and by advisory staff and consultants employed through technical assistance contracts.

Internally, however, tensions with economists exploded from time to time over the extent of policy inputs required. Agreement was needed on a better way forward than a series of lengthy negotiations and ad hoc solutions.

Environmental and social issues

Another area of concern was environmental and social standards. For many years, the environmental experts in the Bank had argued that projects which
cleaned up the environment, such as reducing pollution in the Neva Basin near St Petersburg, were in line with the Bank’s purpose (under Article 2). The economists accepted their environmental value, but not as a source of systemic impact in relation to the transition towards a competitive, market economy.

Similarly, social standards, including gender, were seen as outside the economic perspective taken on transition impact.

This led to a growing tension between the focus on environment and transition impact. The obvious metrics for establishing impact in environmental projects were outcomes, such as the amount of pollutants reduced or carbon saved. This was something shareholders and donors understood. Measures of transition impact, on the other hand, looked mainly at intermediate goals towards market development, such as the dissemination of a new process or introduction of an energy management system, and tended to be more complex and difficult to aggregate across different projects. The emphasis on the approach taken (a new energy management system), rather than outcomes (reduction in emissions), made it harder for the economists to explain their position.

As the Bank geared up its efforts on sustainable energy (see Chapter 9) dissent grew over the value of improvements in energy use, particularly in repeat projects and public utilities, where CO₂ was reduced even if there was no apparent systemic market effect. Bankers and environmentalists argued that the value of the project to the environment was being ignored or discounted. If an investment in a new combined cycle gas turbine public entity increased efficiency and reduced CO₂ emissions surely the operation met the Bank’s mandate, even if the market structure was unchanged? Was another line of credit to a bank for on-lending to SMEs for energy efficiency purposes not as valuable in its impact as the first one?

Berglof and Lankes responded to these concerns with a paper issued in April 2008 that linked environmental considerations more closely to the transition methodology. It introduced the notion of “strategic fit” in the context of efforts to achieve aggregate transition impact, for example through a comprehensive programme of projects, policy dialogue and

---

7 Improvements to street lighting was one such contentious example, or energy efficiency improvements to public buildings.
technical assistance targeting sustainable environmental improvements. The idea was to maintain the project-level impact assessment, but add the environmental dimension at a programmatic level and allow the monitoring of outcomes to be conducted there. This later became generalised into an ‘integrated approach’.

Workarounds to broker solutions and accommodate particular cases only worked so far, however. The system continued to be seen as complicated and lacking transparency. Bankers hankered after a simple, easy-to-understand judgement on the transition value of their projects. More holistic solutions were needed. Then the financial crisis intervened.

2. Balancing Markets and the State

The crisis forced a fundamental rethink within the EBRD: about its role, past misconceptions and mistakes over transition and how to operationalise its mandate in the post-crisis environment. Already by early 2009, the Bank’s management began a process of reflection on the implications of the crisis for the transition process and what the EBRD should look out for and where it could do better.

Management was also conscious of the first Life in Transition Survey (LITS) in 2006 which showed that even when growth had been good people in transition countries were not yet convinced their lives were changing for the better. With a low degree of trust and two-thirds of respondents saying corruption was as bad or worse than before the transition began some

---

9 An Index of Sustainable Energy was constructed to help. This was based on three equal components measuring energy efficiency, renewable energy and climate change. Within each, there were measures of the quality of relevant institutions and policies (e.g., laws, regulatory policies, project implementation capacity); market incentives such as pricing, methods to generate energy savings, support for renewables and market-based mechanisms for climate change mitigation; and outcomes such as energy and carbon intensity and use of renewables compared with global benchmarks. The index showed Slovenia, Lithuania, and Hungary as the top three performers (closely followed by several other EU countries), with the Kyrgyz Republic, Turkmenistan and Tajikistan the worst performers.

10 One immediate development concerned whether repeated finance to existing clients via short-term or working capital lines, or refinancing operations to help stave off bankruptcy in the crisis environment, might count as transition impact. This was proposed on the basis of preserving existing transition achievements—where previously strong or impact-minded companies were at risk of going under—but without advancing transition as had been required in previous assessments. Flexibility in interpretation was adopted by taking a view of the probable counterfactual to decide the extent of the likely transition reversal, something that could only be done on a case-by-case basis.
deeper aspects of the transition picture were particularly worrying. A similar survey was planned for 2010, with the effects of the recession expected to reveal further problematic results. 

Deepening transition: The 2010 capital resource review

The timing of the rethink coincided with the run-up to the next five-year corporate strategy planning period for 2011–2015, Capital Resource Review 4 (CRR4), due to be signed off by Governors at the Annual Meeting in Zagreb in 2010. As well as work to support a gearing-up of the EBRD’s business volume as part of its counter-cyclical response (see Chapter 2), there was an effort to learn lessons from the crisis and how the path of transition had been evolving beforehand.

An important preliminary paper, ‘Fighting the Crisis, Promoting Recovery and Deepening Transition’, had been sent to Governors in April 2009 ahead of the May Annual Meeting in London. In his covering letter, Thomas Mirow pointed to the region’s vulnerabilities—a strong dependence on capital inflows, high levels of foreign currency denominated debt and in some cases excessive reliance on commodities—and the risk that important transition achievements could be reversed. He envisaged a need to improve the “quality of both public and private institutions” and ensure that they worked well together.

The paper took up this theme in more detail: “Our understanding of the transition process and the Bank itself have evolved [and] given rise to a careful reassessment of ... the meaning of transition itself [and, in particular,] an even stronger focus on the quality of institutions.”

---

11 LITS I surveyed 29,000 people in 2006 across the Bank’s regions. Only 10 per cent believed that their “household lives better today than in 1989”, although they were more optimistic about the future. A particularly striking finding was that less than 15 per cent of respondents thought there was less corruption than in 1989 and two-thirds believed it was as bad or had increased since the transition began. The view on whether people could generally be trusted was very low. Less than one third of respondents in 2006 believed people could generally be trusted compared with two-thirds holding these views of the period before 1989.

12 Management fears were indeed borne out by the LITS II survey which showed widespread suffering as a result of the crisis and continuing dissatisfaction and distrust, as described in the introduction to this chapter. See ‘Life in Transition: After the crisis’, Life in Transition Survey II, EBRD, 29 June 2011.

13 Although this referred to a lack of diversification, one vulnerability of concern at the time that is less remembered today came from the food price crisis of 2007-8 which had a significant impact on several EBRD countries of operations where food costs formed a high percentage of household expenditures. These were estimated at more than 50 per cent in Ukraine, for example, and over 40 per cent in Romania and Moldova, according to LITS I.
It was the case, nonetheless, that “vast improvements” had been achieved over 20 years of transition, in terms of resource allocation and economic performance. The EBRD had been established at a time when there were severe limits to market development, entrepreneurship and democracy in its region: “Transition was about reducing direct state intervention in the economy and establishing some basic market mechanisms.”

This path of advancement could be seen in the EBRD Transition Indicator scores, published annually in the *Transition Report*. These showed progress towards levels equivalent to an advanced industrial economy (a score of 4.3) based on an array of indicators relating to privatisation, market liberalisation, trade and financial development. As Figure 6.1 illustrates, significant progress was made against these yardsticks in the 1990s, although the rate differed across the region. Countries further away from central Europe tended to make fewer gains, and by the turn of the millennium CIS countries were lagging behind.

---

14 For more details, see Kilpatrick, *After the Berlin Wall*, Chapter 10, pp. 270–274.
But it was clear from the early 2000s on that the pace of progress had showed. Even before the crisis the next stage of transition was proving harder to reach. And, when the crisis came, even central Europe and the Baltics, where most second-stage reforms were in place, suffered serious setbacks—and their economic performance disproportionately so compared with their western European counterparts. Questions were raised, as emphasised by the title to the 2009 Transition Report published that November, ‘Transition in Crisis?’.

The final paper for Governors made clear that the consequences for transition and the model on which it had been built might be serious:

The most important impact of the crisis may be political ... Questions about the market and globalisation are being asked ... [and] may erode confidence in the model that the transition countries have been encouraged to follow for the past 20 years.

While in the early years of the Bank it had been right to pursue “less state and more market” it was now important to recognise:

Transition is not just about the size of the state’s footprint in the economy, but about where and how the state treads: that is, what the state does to affect economic outcomes, and how it attempts to do so.

The implication was that the quality aspects of transition were as essential as the presence of a private sector. This applied to state interventions, such as enforcing laws or collecting taxes, as well as to non-state interventions since markets could not function well if there were barriers to entry or poor corporate governance for instance. “The state and private institutions generally are not substitutes”, the paper said:

Transition is about building markets and the private sector, but it is also about redefining the state as opposed to minimising it ...Going forward, the emphasis on quality—private and state—is perhaps the most fundamental challenge for transition.
The Besley Commission

The financial crisis was a trigger for Berglof to put into play an idea he had been considering for some time. He was well aware of developments in academic economic thinking, especially the role of institutions in shaping economies and markets, and decided the time had come to incorporate some of these ideas in the EBRD context. Academics could provide an external view of the transition assessment methodology, and its tools, as well as on some of the issues that had arisen with Banking.

Berglof knew Professor Tim Besley at the London School of Economics (LSE) well and contacted him to see if he would chair a panel of experts to consider the issues. Besley, a policy expert on development economics and political economy, agreed and was joined in the task by two other distinguished economists: Matthias Dewatripont, professor at Université Libre de Bruxelles, a specialist in contract theory, incentives and industrial organisation, and Sergei Guriev, then Professor and Rector at the New Economic School in Moscow, whose knowledge of the economics of development and transition and corporate governance completed the team.

The group was asked to look at the transition concept in the context of a broader discussion of development and institutional change and consider the appropriateness of the methodology used to assess transition progress and the Bank’s operations. This was to be done with reference both to academic work and interviews with staff and management.

The Besley Commission, as the group became known, presented their report, ‘On the Concept of Transition and Transition Impact: Implications for the EBRD’, to the Board in June 2009. They started by noting that transition should be seen as part of a wider process in which economies develop a “balance between state and market”, and where there are “multiple solutions to providing an effective market economy”. Whereas traditional economics largely took for granted the institutions needed for a market economy to flourish, they said, a modern institutional approach looked at the appropriate roles for states and markets and, in particular, whether the state has appropriate incentives to deliver its proper role.

Two particular challenges for state involvement could be commonly identified in emerging economies: the competence of the state as an institution

---

15 Guriev was appointed as the EBRD’s Chief Economist in 2015.
to allocate resources and the role of competing interests. In the Commission’s view, good governance required a system that allowed the market to flourish while holding “powerful interests that try to influence the state in malign ways ... at bay”, and the best way to achieve this was through building effective state institutions. This included a role for various groups to be able to hold the state to account, such as the media, unions, business associations and NGOs.

One example of this thinking concerned privatisation.

Whether ownership should be private or public to achieve the best outcome is far from clear a priori ... setting up transparent, competent and efficient institutions to ensure that these industries are run in the public interest matters more than who owns the assets.

The report touched on the role of democracy, where they noted the link between effective markets and democracy was indirect and experience “heterogeneous”. Nonetheless, the report pointed out there was a “strong correlation between prosperity and democracy” and to understand the relationship it was important to look at specific institutional structures and cultural norms.

In thinking about the activities of the EBRD in the context of a more modern approach to economics, the Besley team concluded that the Bank’s original mandate was still valid since it was consistent with broader goals. In particular, they argued, social cohesion and broad-based increases in living standards were needed to deliver well-functioning and sustainable market economies. “Without these foundations, there is always a risk of reversal of past progress.” Hence, they felt better recognition, especially in the assessment of operations, was needed for measures that reduced inequality of opportunity and promoted the legitimacy of market-supporting institutions.

The Besley Commission also highlighted sectors like health and education that had featured prominently as issues of concern to people in the Life in Transition Survey. They nonetheless realised this might be controversial and not within the immediate reach of an institution like the EBRD with its focus on the private sector.

The transition assessment process generally functioned well and they were impressed with how far the question of transition impact was “ingrained
in the corporate culture of the EBRD and provides coherence to its activities”, a lasting impression on Guriev as he confirmed over a decade later.16 Furthermore:

The internal discipline of transition impact measurement and the EBRD’s mission-driven corporate culture reinforce each other. This is an achievement that should not be underestimated. As the economic literature on mission-driven institutions suggests, the co-existence of non-profit mandates and for-profit incentives is very delicate. EBRD is an institution that has both; hence, it is quite remarkable that it has both been profitable and has been generally promoting its original mandate.

They did pick up on some of earlier controversies, however, noting that: “... the current framework seems less robust on how transition impact is to be assessed in more contentious areas like public utilities”. On the issue of critical mass, they argued the notion that the systemic impact of further projects in the same sector suffered from diminishing returns should be revised. They suggested instead a more programmatic approach be considered, or at least one where irreversibility effects, such as demonstration effects, network gains and innovation, could be valued more effectively.17

The Besley Commission analysis also considered the Bank’s transition indicators. The nine indicators of transition progress first compiled for the Transition Report 1994 for each country of operations covered areas that were relevant at that time, including enterprise privatisation and restructuring, markets and trade, financial institutions and infrastructure reform. They were highly visible externally and used by other international institutions and academics.

The Besley Commission felt however that the indicators were not properly linked to the analysis of projects and the sector transition gaps that had emerged with the Bank’s business expansion; nor did they fit country

16 Interview, February 2021.
17 In the past programmatic approaches had been frowned upon as they were associated with the World Bank’s method of allocating large sums to governments to spend in areas like health and education which were largely outside the EBRD’s agenda. The Chairman’s Report on the AEB notes on Article 13, sub-paragraph (ii), “Delegates described the precise form of programme lending in which the Bank could become involved as ‘projects, whether individual or in the context of specific investment programmes’, so as to make clear that fast-disbursing policy-based lending is not included.” See Kilpatrick, After the Berlin Wall, Chapter 1, p 35.
strategies. The lack of an aggregation process made it difficult to assess the overall impact of the EBRD.

On the other hand, looking at the story so far, the Commission felt reassured by the positive relationship between increases in EBRD lending and improvements in the indicator scores, and that EBRD lending scaled by GDP was greater in countries with poorer indicator scores. The group also felt that other indicators compiled by OCE, such as the Sustainable Energy Index and the Business Environment and Enterprise Performance Survey (BEEPS), as well as the Life in Transition Survey (LITS) could be better integrated with the transition assessment methodology. Similarly, they called for an additional series to measure the quality of state institutions along the lines of the World Bank/IFC’s Doing Business Survey.

Wrapping up their assessment, the Besley Commission emphasised that while initially there had been a lot of optimism on reliance on markets, “reversals are possible” and that it was “crucial to focus on factors that create resilience and sustainability in markets”. Emphasising the role of “market supporting institutions, including an effective state” they concluded: “Transition is about building ‘well-functioning and sustainable markets’.”

3. Incremental Methodological Improvements

The Besley Commission’s report did not lead to wholesale immediate change—nor was it intended to do so—but it helped to progress a series of steps designed to improve the operational aspects of the transition methodology.

Integrated approach

One of the first actions following the Besley Commission’s report was the introduction of what was called the Integrated Approach (IA). The idea was first explained in an information session for the Board in November 2009. Following the observation that the link between the project level and country level analysis was weak, OCE set out how this might be tackled. But rather than tying project objectives directly to country objectives the focus was on the next level up, by adopting sector reform packages, which fitted more comfortably with the project origination structure in Banking.
An IA was defined as a “coordinated sequence of investment projects, technical assistance, policy dialogue and cooperation with other stakeholders ... that aim together to deliver measurable sector reforms ...”.\textsuperscript{18} It gave room for portfolio solutions that went beyond the use of frameworks which to that point had been mainly based on collections of similar small projects, such as wastewater treatment projects in multiple municipalities. Instead, it prompted an ex ante assessment of a particular market and the transition challenges it faced and how a selection of projects and their cumulative impact (and thus critical mass effects) could improve its functioning, especially when combined with technical assistance, for training staff in new methods, and policy dialogue to change market regulations, for example.

Overall, it attempted to coordinate the economists’ understanding of sectoral structural needs with bankers’ projects and regional offices’ knowledge of local conditions and make use of their contacts, particularly with relevant government ministers and officials. Care was taken to explain that an IA did not amount to programmatic lending nor was it a policy-based finance product. Each project within the IA had to have its own valid transition rationale but the presumption was that taken together the impact of the set of projects and associated work would be greater than the sum of the parts. It matched the Besley Commission’s view that a critical mass of projects might support structural and institutional change more readily than a single project.

IAs started to appear in 2010, beginning with urban transport in Belgrade and then the Ukrainian power sector, and later involved sectors such as agribusiness, district heating, railways, private equity, venture capital, gas, renewables and some others.

Transition indicators

Following advice from the Besley Commission that the existing transition indicators no longer served the purpose for which they were originally constructed, a decision was taken in 2010 to switch to a set of sector indicators. These were based on a comprehensive assessment of transition challenges (ATCs) across the EBRD region and illustrated the scale of sector transition gaps facing each country. These were more relevant to the types of operations conducted by the Bank than the original indicators.

Instead of broad themes such as large-scale privatisation or price liberalisation, the new indicators comprised 16 sector categories, five each for infrastructure and financial institutions and three each for industry and energy. The degree of advancement in transition was again represented on a scale from 1 to 4+, with 1 representing little or no transition progress and 4+ indicating that “the standards of an industrialised market economy” had been met.

A variety of indicators from external sources and surveys relevant to individual sectors, including some of those employed previously, were used to build the composite picture. The choice of indicators allowed each sector gap to be divided into two categories: ‘market structure’ and ‘market-supporting institutions and policies’. The gaps were then measured against industrialised market economy yardsticks and assigned to categories from ‘negligible’ (advanced market level) to ‘large’ (little or no progress from a state-run economy).

The indicators provided a basis for setting priorities in country strategies and a starting point for project appraisal. The annual Transition Report also identified progress in transition using these sectoral indicators. Over time the number of sectors expanded and some areas were subject to detailed analysis to identify and monitor particular gaps, for example in SME requirements, sustainable resources, youth, gender and (within country) regional gaps.

Low-carbon transition

Attention to the environment, particularly when it came to activities in the public sector, remained a prominent concern.

Following the introduction of the Sustainable Energy Initiative (SEI), the scaling up of the EBRD’s green activities had begun in earnest. The

---

19 Infrastructure comprised roads, railways, urban transport, waste and wastewater, telecommunications; financial institutions covered banking, insurance and other financial services, capital markets, private equity, MSME finance; industry was made up of agribusiness, general industry, real estate; and energy was composed of electric power, natural resources and sustainable energy.

20 For example, the agribusiness sector’s aggregate score was based on a 50:50 weighting of market structure and market-supporting institutions and policies, where the former was made up of the components development of private and competitive agribusiness (40%), development of related infrastructure (25%), development of skills (20%), and liberalisation of prices and trade (15%) and the latter legal framework for land ownership, exchanges and pledges (40%), enforcement of traceability of produce, quality control and hygiene standards (40%), and creation of rural financing systems (20%). 28 sub-indicators were used in all. See Table 1.1.1, ‘Recovery and Reform’, Transition Report 2010, p. 6.

21 The Sustainable Energy Initiative is described in Chapter 9, p. 349 et seq.
Besley Commission had encouraged the Bank to consider environmental sustainability as part of the system, and international interest in climate change solutions was growing more generally. For instance, the EBRD’s former Chief Economist, Nick Stern, one of the key global influencers on the economics of climate change, was promoting at the LSE and in a new book his concerns about the slow pace of actions to tackle climate change.22

The EBRD’s pursuit of climate goals through investments in public entities, such as electricity generating companies, continued to put pressure on the economists to accept carbon reduction as a transition activity. The Besley Commission had also emphasised the value of multiple projects in a particular area as a means of generating momentum for change. Climate-related activities fitted the bill admirably.

The existing system was under considerable stress.

In a nutshell, the problem was how to account for the value of non-market elements that lay outside the formal project, such as CO₂ reductions.

The Besley Commission gave impetus to those seeking changes to the transition impact system, so in September 2009 a further step was introduced.23 Investments in, and subsidies for, sustainable energy were treated as compensating for inadequate price signals.

The scale of environmental outcomes was seen as relevant since the commitment by countries to carbon reduction targets indicated an urgency of action.24 As such, large investments achieving significant CO₂ reductions or a critical mass of smaller investments doing likewise were factored into the analysis. Transition impact could be achieved in this context by fostering innovative solutions and supporting their diffusion to the critical point from which the private sector was able to take over and finance projects without EBRD support.

This interpretation relied on identifying a pre-existing ‘best available technology’ (BAT). Should the investment yield material carbon reductions (or reductions of other pollutants) in excess of a BAT baseline in a given sector and country, the demonstration of an improved use of technology was

22 Nicholas Stern, A Blueprint for a Safer Planet: How to Manage Climate Change and Create a New Era of Progress and Prosperity (London: Bodley Head, 2009).
24 The UK introduced the first global legally binding climate change mitigation target set by a country with the passing of a Climate Change Act in 2008. https://www.lse.ac.uk/granthaminstitute/explainers/what-is-the-2008-climate-change-act/
counted as having transition impact. Where policy dialogue led to a similar result in reducing carbon emissions, for example through the development of carbon trading, this too was considered valid transition impact.

The modification of the system brought some relief. But pressures from the business side to expand climate change activities and from the policy perspective as the EBRD became more heavily engaged in the global climate change agenda meant that further adjustments were needed. These came with the next stage of thinking on the transition concept, and as advocates of a low carbon transition built a strong argument in favour of valuing carbon reduction outcomes as much as economic impacts. The Green Economy Transition (GET) programme (see Chapter 9) provided the methodological underpinning for a more general approach towards ‘green’ outcomes.

4. Modernising the EBRD

The new President launches a ‘modernisation’ drive

When Suma Chakrabarti arrived as President at the EBRD in the summer of 2012 the Bank was in good shape. Business volume was at an all-time high and there had been a return to profitability after the significant losses of 2008 and 2009.

Like many of his predecessors, he began with an internal stocktake. Chakrabarti had ideas for shaking up the organisation to what in his view would make it more effective and efficient through the introduction of modern management practices and with a focus on results. But he also had an eye for the EBRD on the world stage.

Two decades earlier Chakrabarti had attended the Bank’s inauguration as private secretary to the UK’s Development Minister and, as a former head of the UK Department for International Development (DfID), had a good understanding of the role of the EBRD in the wider development context.

He was aware that over the years a tension had grown between the original view of transition and current development thinking. Whether it should be called transition or not, he thought the issue was what the EBRD needed to do then to help its countries of operations transform their economies into more sustainable markets that were able to grow and compete in a globalised world.
He valued highly the role of reform and the part that policy dialogue played in achieving change in developing economies and wondered whether the EBRD was getting enough leverage from its substantial investments in countries of operations. The passage of time since 1989, the widening of the EBRD’s shareholder base and a new region of operations also pointed to the value of some updated thinking on the Bank’s conceptual underpinnings, especially if the EBRD was to feature more prominently in the development milieu and retain its relevance in a ‘post-transition’ world.

There were also structural management issues to sort out. The Besley Commission’s advice and ideas had not resulted in a comprehensive solution to underlying methodological questions, nor had the subsequent changes fully resolved tensions between the economists and the Banking Department.

So, as Chakrabarti embarked on a radical shake-up of top management and the Bank’s processes in search of effectiveness, he gave a green light to further thinking on the transition concept and the methodology that underpinned the Bank’s investments, advice and strategies.

The starting point for change was a series of internal reviews of structures and processes. Chakrabarti was keen to set his own stamp on internal arrangements. The programme began with an efficiency drive and changes to the top management team structure.

A number of task forces were set up in the second half of 2012 to look at ways to improve efficiency and effectiveness. Some focused on the banking side, such as the Task Force on Sector and Product Innovation, while others considered issues surrounding the transition methodology (on results and IAs) and policy dialogue. The most significant changes were seen in results reporting—an area in which the Bank was regarded as weak compared with its MDB counterparts. Efforts were also made to improve the incentives for bankers to take on more difficult projects, including through IAs. Work on policy dialogue only began to make real progress a few years later.

In keeping with the President’s view on the need to improve the EBRD’s strategic focus and policy capacity, a new senior management committee was set up, the Strategy and Policy Committee (SPCom). Henceforth

---

25 The Task Forces reported in November 2012.
26 Its membership comprised the Vice President Policy and Partnerships as Chair, a Banking representative, one from CSE (later renamed Economics, Policy and Governance (EPG)), one from Corporate Strategy, one each from the Offices of the Secretary General and the General Counsel, with the Country Strategy and Results Management (CSRM) team acting as secretariat.
country strategies, donor funding issues, evaluations and other strategic and technical questions not considered appropriate for the Executive or Operations Committees would be fed through this committee.

The terms of reference of the previous Vice President for Operational Policies were revised\(^{27}\) to create a new position of Vice President, Policy and Partnerships (called VP\(_3\)), who acted as Chair of the committee. The role reflected Chakrabarti’s view that the Bank needed to strengthen the visibility of its policy work and take a closer interest in its growing reliance on donor funding.

The changes had consequences for the role of the economists. OCE was split with the research group remaining under the Chief Economist while the other parts of the Department, covering projects and country work, were assigned to the new vice presidency under a new banner, Country and Sector Economics (CSE). In due course (in 2015), VP\(_3\) was merged with the Banking department to create the Client Services Group (CSG).

This finally brought about a change Chakrabarti had sought from the beginning, which was to integrate the majority of the economists more closely with bankers, including a shift of economists into the field. The hope was to lessen the long-standing conflicts between the two departments and improve understanding on both sides, as well as use the economists’ sectoral reform expertise more effectively.

While OCE remained an independent voice under its Chief Economist, who reported to the President as before, transition assessment and the rating of projects fell to VP\(_3\). When VP\(_3\) was integrated into CSG, the reporting line of sector and country economists switched to the First Vice President, the most senior member of the Banking Department. This raised questions about conflicts of interest and the potential objectivity of the project appraisal process.

An innovative plan was then launched to streamline procedures and minimise this risk. The idea was to simplify the project assessment process and reduce the role of sector economists’ judgement by providing bankers with a menu of questions to fill in for their projects.\(^{28}\) The self-assessment system subsequently became integrated in a wider revamp of the Bank’s project systems and processes under a broader efficiency drive (called Operational Effectiveness and Efficiency, or ‘OE&E’) and related IT enhancements.

\(^{27}\) In two iterations: first to Vice President, Policy and then to Vice President, Policy and Partnerships.

\(^{28}\) Project Christopher, as it was known, is described in more detail later in this chapter.
For the majority of projects, this provided adequate guidance on their suitability and tracking against results’ targets. With complex cases, or those where issues arose as with the use of concessional finance or local content requirements for example, the views of OCE could be sought though need not be decisive. Ultimately, project decisions rested with the members of the Operations Committee.29

‘Stuck in Transition’ and its implications

While the task forces conducted their work, Jeromin Zettelmeyer, Berglof’s new deputy, and his research team grappled with more fundamental developments.

Although most economies in the EBRD region had begun to recover from the immediate effects of the global and eurozone financial crises, growth in 2013 remained sluggish nearly everywhere. A projection in that year’s Transition Report pointed towards a much lower long-term growth path than pre-crisis.

A comprehensive analysis picked out a number of reasons behind this conclusion and why many EBRD countries now appeared to be stuck in transition.

Initially, the large productivity gap between east and west had been reduced by market-based reforms. Price liberalisation, privatisation, foreign investment and an opening up of trade in the 1990s together provided a solid start to the convergence of transition countries with the more advanced west. Overall, productivity improved rapidly as the poorly used or idle resources of Soviet times were put to better use. As markets developed and expanded, incomes began to accelerate towards more advanced economy levels.30

However, many of these changes were one-offs as obsolete capital was eliminated and the production structure adjusted to the requirements of market economies. By the time the new century dawned, as the authors of the Transition Report noted, “the ‘productivity catch-up’ phase associated with opening up to the outside world and international integration has ended in most transition economies.”

29 As part of the changes, the Chief Economist no longer remained a member of OpsCom.
30 In economists’ jargon, improvements in total factor productivity drove the productivity increase more than growth in the labour force or capital stock.
By the mid-2000s, the good news was that productivity in EBRD countries of operations had reached comparable levels to those of other emerging economies with similar income levels. Further progress however depended on reform, especially to market-supporting institutions.

The Chief Economist explained the next steps that were needed to raise the quality of economic institutions:

Beyond liberalisation, stabilisation, and privatisation, this encompasses regulation, effective government, strong rule of law, low corruption, and other aspects of the business environment ... [and] ... their ability to provide economic opportunities to individuals regardless of gender, region of birth or social background.31

But the reform process had been losing momentum. Berglof wrote that a “compelling concern is the stagnation in reforms and in improvements to market-supporting institutions in most countries in the region since the mid-2000s”.

Unless reforms to economic and political institutions accelerated, the view was that the EBRD region would be destined to remain in a low growth orbit over the longer term with the result that “convergence with Western living standards ... will not be achieved in most countries”.

Behind this view was an analysis which showed a clear correlation between inadequate economic and political reforms and a lack of economic progress. An earlier assessment had shown that during the first decade of transition successful reforms were more likely to occur in countries with stronger political competition and less polarised electorates. The new analysis demonstrated a strong causal impact of democracy on the success of reform. Political turnover and strong executives helped to push back on elites who otherwise profited from state subsidies, insider privatisation and weak enforcement of the rule of law.

The Transition Report thus argued economic institutions could improve on the back of political reforms and that this was a reciprocal process:

Just as stronger economic institutions support democracy so democratic change can influence the quality of economic institutions ... Successful economic and political institution building reinforce each other.

But it also suggested the stifling of opportunities could lead to a dwindling of public support for reform:

Market reforms that fail to benefit the population as a whole will not enjoy public support for long. ... As in the case of Egypt, a lack of inclusion might help to explain why populations turn against market-oriented reform ...

Berglof summarised the overall picture in a frank but sobering conclusion: “The recent history of transition has shown that weak political institutions and entrenched interest groups can cause countries to become ‘stuck’ in transition.”

Chakrabarti quickly latched onto the implications for the Bank. The Transition Report vindicated the rationale behind the EBRD’s economic and political mandate. As the Besley Commission had suggested, transition was first and foremost a political economy process. It was not a simple task of applying propositions found in standard economics textbooks.

Tangible improvements from market engagement were needed. A new catchphrase, “We invest in changing lives”, appeared alongside the Bank’s logo to reflect this view, added by Jonathan Charles, the Managing Director of EBRD’s Communications. Structural reforms, difficult though they were for investment bankers to manage, began to be regarded as important to the Bank’s work as raising the stock and quality of capital through its investments.

What the analysis brought home clearly was the importance of good governance and inclusion in designing a successful transition strategy, as well as the traditional need to develop competitive and integrated markets. Chakrabarti understood that the EBRD had to strengthen these aspects of its work in a way that aligned with its investment banking objectives. The Report provided the intellectual underpinning for this, and for the internal reorganisation which promoted the policy dimension and brought the economists’ understanding of structural reforms together with the investing and execution skills of the bankers.

The hoped-for result would be a stronger role for policy work alongside investment efforts. And, if it could be managed, to be able to use the EBRD’s investment and advisory capacity as leverage for reform—political and economic—to advance the transition process, even if that meant pulling back when reforms were heading in the wrong direction.
Work remained to be done, however, especially on the transition concept and how any update might be translated into the deeply embedded operational assessment system.

Inclusion

A little ahead of publication of the 2013 Transition Report a paper to the Board reported on work to modernise the transition impact methodology.\textsuperscript{32} This was the culmination of discussions that had been taking place since the Results Task Force had reported the previous year. There were two important developments: one on how to relate inclusion to transition while the other dealt with the project scoring and incentive system.

The Besley Commission had set the ball rolling on thinking about the role of social outcomes in transition and was followed in 2012 with the publication of an influential book in development economics by Daron Acemoglu and James Robinson.\textsuperscript{33} The authors argued that inclusive economic institutions supported prosperity by raising productivity and generating incentives that encouraged investment and innovation, whereas systems that mainly benefitted a well-connected elite failed to successfully deliver long-run growth. But it was the impact of the Arab Spring and the arrival of new countries of operations with glaring deficiencies in gender equality and large-scale youth unemployment that accelerated the Bank’s work on inclusion.

The paper explained how inclusion issues could be integrated into the transition methodology, not as a matter of political economy, although this was relevant, but as a matter primarily of market efficiency. The focus was on economic rather than social inclusion. Defining inclusion in relation to equality of economic opportunity and selecting three prominent areas of (ex ante) inequality to address—gender, youth and regional disparities—the issue fitted neatly into the existing framework, albeit with a new look in some areas. The key channels for responding to demands for more inclusive market economies covered market expansion (via access to labour markets and market-based finance), skills enhancement, higher business standards and corporate governance and through demonstration effects.

\textsuperscript{32} ‘Modernising the Transition Impact Methodology’, 17 June 2013.
An important innovation, in keeping with the transition impact methodology, was to build specific transition gaps by country for each of the three components.\textsuperscript{34} Once done, a pilot study was run to gauge the feasibility of applying the assessment of inclusion to projects. This was necessary as there were some uncertainties whether bankers would find a role for inclusion in their projects which were normally justified on grounds such as increased competition or a new production process.

It turned out—in some cases to the bankers’ surprise—that about one-third of the sample of almost 90 projects in the pilot showed potential impacts from inclusion. What was especially encouraging was that many clients showed a willingness to tackle inclusion issues, helping to reassure bankers there was mileage in the idea from a business perspective. The southern and eastern Mediterranean (SEMED) region showed the largest potential.

Some Board Directors were nonetheless wary of any extension of the existing methodology, fearing it could prove a distraction from delivering on the core of the Bank’s mandate. There were arguments too over whether inclusion should be treated outside the existing transition assessment system rather than inside it. But a wider group agreed with management’s view on its incorporation within the existing methodology and there was genuine enthusiasm among many Directors to see progress in opening the Bank up to these new areas, especially on gender equality and improving the skills of young people where the challenges in the SEMED region, and in Turkey on gender issues, were clearly very large.\textsuperscript{35}

**Expected transition impact (ETI)**

The second strand to the “modernising transition” paper was more technical. In accounting for its results to the Board, emphasis was laid on transition impact as well as business volume and profitability. Its basis was the project-level scoring system carried out by the economists whose results were aggregated into an overall Bank performance indicator. Bankers’ scorecards and performance rewards were related to this measure at the sectoral level.\textsuperscript{36}

---

\textsuperscript{34} See the *Transition Report 2013*, Chapter 5 ‘Economic Inclusion in Transition’.

\textsuperscript{35} For more on inclusion, see Chapter 7.

\textsuperscript{36} A further gripe among bankers was the fact that there was no similar scorecard, or hard-edged constraint, for economists.
For some time there had been concerns among Board members that the system did not incentivise bankers to go the extra mile in search of more difficult projects. Many bankers did in fact try hard to find bankable deals in difficult territories and to encourage clients to take on extra risks with their support. But this was not always the case and there was an element of truth to the Board’s concern.

Another weakness of the system was its limited treatment of risk to the delivery of transition results. Projects were rewarded on their potential but the risks involved in whether promises or aspirations made were actually met were simply noted. It meant, for example, all kinds of reform promises might be agreed between a banker and, say, a state-owned client to cut a deal which would offer enough potential impact to pass the transition test but realistically might have negligible chances of being delivered.

The proposal made was that the expected transition impact of projects should be the basis of assessment. In other words, the combination of a project’s potential impact and the probability of its delivery in full. This was a more logical approach, and one which mirrored the appraisal of financial risk.37 To make it work, a system of numerical scores (rather than labels such as “Good”) was introduced, based on a statistical analysis, which balanced the two components. There was enough evidence from the previous system of scoring to assess probabilities of success at different levels of potential impact and assign these probabilities to the new system.

A further advantage of the new approach was to be able to tilt the scores in a progressive way to reward bankers’ efforts to pursue the most difficult or risky (from a transition perspective) projects. A previous top-scoring project (“Excellent”) was now, at 100, worth almost twice as much as its previous next level down (“Good”) at 60. This mattered to the average score on which the Bank38 and bankers’ rewards were judged39: previously an “Excellent” project had been valued the same as a “Good” project.40 Similar incentives were

37 The notions of probability of default (PD) and loss given default (LGD) mapped into transition impact potential (impact given delivery) and risk to delivery (probability of success).
38 The target for ETI set at Bank level was a minimum annual annual average score of 60 across all new rated projects. There was an analogous system for the portfolio, Portfolio Transition Impact (PTI), which also had an annual target. See ‘EBRD Scorecard: Proposed Expected Transition Impact (ETI) Matrix’, 6 November 2013, p. 12 and Kilpatrick, After the Berlin Wall, Chapter 10, section 5.
39 Rewards were based on several additional indicators of success, especially business volume, profitability and disbursement of funds. Nonetheless, the EBRD placed a high weight on transition parameters.
40 The previous scorecard target was based on reaching “at least 80 per cent Good or Excellent projects”. See ‘EBRD Scorecard’, p. 4.
offered for projects seeking to tackle difficult delivery risks, as often seen in less advanced countries. An ETI Matrix set out the parameters accordingly.41

The Board welcomed the ETI approach and it was introduced for all projects from 2014 onwards.

Country strategies

For many years country strategies had played only a limited role in the formulation of policy and strategic direction at the EBRD. For the most part, they resembled a wish list of projects bankers hoped to sign over the coming period.

An effort was made to improve the situation in late 2010, when management declared they intended to produce “streamlined and more focused strategies” with “clearer prioritisation”, and in 2013 there was a further push. But neither added up to a major change of outlook. A year later a country strategy results framework (CSRF) was introduced.

It was the arrival in 2015 of Philippe Le Houérou, a former World Bank Regional Vice President, that started a more radical overhaul of country strategy work. The timing coincided neatly with a rethink on the transition concept that was launched around the same time (see below) allowing a closer integration of project and country level activities.

Looking at the existing procedures and their deficiencies, Le Houérou, who took over as the new Vice President for Policy and Partnerships, referred to medical practices. “If you plan to treat a patient,” he would say, “you must first make a thorough diagnosis”. Yet, the strategies on which the EBRD planned its investments and advice offered no such diagnostic work.

Although Le Houérou left the EBRD in early 2016, after being appointed as Chief Executive Officer of the IFC, country strategies thereafter were built on the three pillars he had advocated: sound diagnostics, targeted interventions where the EBRD could make a difference, and good coordination with other international actors active in the country.

A new group in VP3, Country Economics and Policy (CEP), led by its director, Artur Radziwill, a former Polish Deputy Finance Minister, set about preparing diagnostic studies focused on barriers and opportunities facing the private sector in a number of countries. More sensitive political dimensions were left to the country strategy documents themselves. The

41 ‘EBRD Scorecard’, p. 10.
analyses were designed to provide an understanding of the economic situation and structural factors in each country and a rationale for the intended interventions by the Bank in its country strategies.

The first diagnostic report covered Egypt and was presented to the Board in September 201642 as a first step towards the EBRD’s inaugural strategy for the country. An in-depth diagnostic for Kazakhstan43, a country the Bank knew well, followed in November and thereafter diagnostic analyses came with the regular flow of country strategies. One feature of the Kazakh study, and used in later studies, was work by the sector economists which drew on developments initiated by the transition concept review, in particular, an assessment of transition qualities by country.

Policy dialogue

As part of the effort to improve country strategies and delivery of transition results Le Houérou was keen to raise the EBRD’s capacity to conduct policy dialogue with country authorities. Supporting reform-minded governments effectively was an important goal which President Chakrabarti also strongly supported.

Le Houérou’s World Bank knowledge, where policy discussions formed a major part of country assistance, was one motivating factor. Those operations were mostly sovereign loans, whereas the great majority of EBRD lending was to the private sector. At the IFC, the World Bank’s private sector lending arm, policy efforts were left primarily to the World Bank’s global practice expertise. There was no such constraint at the EBRD.

Unlike the IFC, the EBRD provided a moderate amount of sovereign lending and so would engage with governments. It also was heavily involved in dealing with state-owned entities and public-private partnerships (PPPs), and with the municipal sector. The EBRD’s presence on the ground with active local offices in every country gave it visibility and access; and as a major international investor it was a key interlocutor with convening power in many of the smaller countries it served. There was significant potential for policy engagement (a term Le Houérou preferred

to policy dialogue) with the authorities, particularly when matched with investments and expert technical help.

The Strategic and Capital Framework (SCF) for 2016–2020, Re-energising Transition, agreed by Governors in May 2015, made the objective clear: “The Bank will have a significant, structured policy dialogue capacity, leveraging its project work and aimed at sector reform and institutional and governance improvements.”

A paper was presented to the Board in September 2015. At its core was a focus on supporting policy reforms. The view was that policy priorities should be decided up front as part of the country strategy, based on the diagnostic analysis and concentrating on areas where the EBRD held comparative advantages. A stronger role for policy advice and reform advocacy was introduced, including ‘communities of practice’ to strengthen knowledge management and share the work programmes of different teams engaged in reforms and policy dialogue. A better linkage between demand-driven investments and policy reforms to improve the business environment and raise standards was envisaged. Here it helped that bankers and economists were working closely together in the field and at London headquarters, as part of CSG, with VP3 and Banking jointly responsible for delivery of results.

Le Houérou’s temporary successor before the arrival later in 2016 of Pierre Heilbronn, a top French civil servant, was Alain Pilloux, a very experienced EBRD insider. Pilloux pushed hard to embed the improvements quickly and fully, especially within Banking. He was in a good position to do so with over 20 years of banking experience, including running country offices. His efforts, together with those of Mattia Romani, the VP3 Managing Director of Economics, Policy and Governance (EPG), led to the introduction of priority policy objectives as part of bankers’ and economists’ annual objectives. These formed a qualitative measure of every participant’s performance, which were reviewed region by region by the Vice Presidents of Banking and VP3 each year.

5. A Revised Transition Concept

Berglof, the longest serving Chief Economist at the EBRD, left the Bank at the end of 2014 to head the Institute of Global Affairs at the LSE.44 Follow-

44 Berglof was appointed as Chief Economist at the Asian Infrastructure Investment Bank (AIIB) in 2020.
ing his departure, Lankes who was Managing Director, Corporate Strategy, acted as Chief Economist before Guriev arrived to take up the role in September a year later.

Chakrabarti now turned his attention towards the transition concept. The issue for him was whether to keep it.

His development background—where he was strongly associated with DfID’s goal of reducing poverty—chimed with a wider questioning of the concept of transition. There was a matter too of how the concept might fit with his vision for a coordinated skills-based MDB architecture, an idea he had recently espoused in a lecture at the Petersen Institute alongside Donald P. Kaberuka, President of the African Development Bank.45 Was the notion of transition still relevant or “somewhat passé” as the Besley Commission had themselves asked?

The SDG agenda

There were important additional reasons for pushing forward with a review of the transition concept in 2015. This was the year the 2030 Agenda for Sustainable Development—and the Sustainable Development Goals (SDGs)—was due to be agreed (by 193 countries) at the UN General Assembly in September. It was to be preceded by the Third UN International Conference on Financing for Development in Addis Ababa in July.46 It was evidently going to be a highly significant year for development.

The agenda was particularly relevant to the EBRD because most IFIs and their government shareholders had come round to the view that the private sector was critical to the delivery of the now expanded set of global development goals. Plans were in train for the Heads of MDBs to promote the idea of ‘billions to trillions’—the notion that public sector institutions could work together with the private sector and leverage huge sums of finance for development—at the Spring Meetings of the IMF and World Bank in April.

With the promotion of private sector finance lined up to be a major plank of the forward development agenda, this was a major opportunity to show how the EBRD had the tools and knowledge to meet these

45 Among the ideas was the suggestion of joint ventures, something that had been discussed separately with the African Development Bank. Suma Chakrabarti, ‘The New Multilateralism: The Role of Regional Development Banks’, lecture at the Petersen Institute for International Economics, 8 October 2014.
46 The previous conference was held in Doha, Qatar in 2008.
ambitions. Chakrabarti did not want the EBRD to be left on the sidelines as a result of being seen to follow an outmoded concept at such an important moment.

Taking stock

Lankes, who knew the history of the transition concept better than anybody else in the Bank and had helped steer much of the earlier work by the Besley Commission, took up the challenge almost immediately on his appointment as acting Chief Economist. He launched an internal review to consider the relevance of the concept for modern market-oriented economies and its operational status.

At an information session with the Board to launch the Transition Concept Review in February 2015 he argued that the post-war focus on a distinction between public and private goods, where the latter were viewed as best left to markets, reached a peak with market liberalism in the early 1990s, just as the EBRD was establishing itself. However, since then the emphasis of economists had shifted towards new dimensions that needed to be taken into account. In particular,

- The role of market-enabling institutions, particularly in the context of important externalities such as climate change;
- Recognition of the complexities of sound market regulation and its enforcement;
- The role of incentives, social capital, trust and corruption;
- An increased focus on inclusion; and
- A more nuanced view of the state in industrial policy, including support for SMEs.

In the early phase of transition, privatisation had been used to strengthen incentives and governance but when it occurred in a poor institutional context it resulted in unfair outcomes and poorly-run firms. Poor quality competition policies and state capture by private interests elsewhere also imposed costs on growth.

The experience of many EBRD countries of operations, especially outside central Europe and the Baltics, had shown corruption to be serious. It was worse among resource-rich countries. The Besley Commission’s earlier
advocacy of a free media, free elections and an independent judiciary to reduce
the extent of corruption had been hard to put into practice in many countries.

The focus on institutions, with reference to world-wide experience, pointed
towards a view that while transition had a clear direction there was
no unique end-point. Differences in history, culture, economic structures
and individual preferences meant that routes taken and solutions found
need not match precisely. But, as could be seen in differences between insti-
tutions in European countries and the USA, successful democratic market
economies could emerge despite these differences.

Building on the Besley Commission assessment and the 2013 Transition
Report, Lankes reminded the audience that a lack of social cohesion and
inclusion undermines the legitimacy of market systems. It was the absence
doing of central planning and inequality of opportunity threatened a similar fate
in other systems, as had been seen in the Arab uprisings of 2010-11. Inclu-
sion needed to be taken into account since it could help build constituencies
for market reforms and democracy, as well as adding to economic efficiency
and avoiding blocks on market liberalisation resulting from excessive wealth
accumulation in the hands of the few.

In addition, modern economies increasingly relied on information
and knowledge, which were public goods. Knowledge creation, such as
in research and development (R&D), involved risky projects. Their social
returns are generally higher than private ones since other players can ben-
efit from new knowledge. As such, public-private solutions were often needed
with, for example, the state providing some risk capital for start-ups along-
side private finance to leverage successful innovation for subsequent market
deployment and viability.

The description of how Lankes and his team saw the building blocks of
the modern-day economy, and the contrasts with the thinking of 20 years
earlier, was well-received by the Board who, like management, hankered
after an updated view of transition ideas. The next step would be the prepa-
ration of a paper with a set of methodological proposals.

Besley II

The Besley Commission six years earlier had provided valuable method-
ological insights that helped the Bank adjust some of its methods. However,
these changes were made mainly within the limits of the system that had been introduced in 1997. With the EBRD’s 25th anniversary due in 2016, Chakrabarti and Lankes hoped that the revamp envisaged under the concept review might lead to a new approach to transition.

As part of the preparations for the review, Lankes contacted Besley that autumn to see if he would lead a group of experts again, this time focusing on improving the qualities of market economies and the outcomes they generated. Lankes asked Besley for a framework that “should be simple and understandable for a broader audience, and lend itself to being operationalised.”

Besley once more assembled a panel of experts. Guriev, now at Sciences Po in Paris and known to be coming to the EBRD as its next Chief Economist, remained on the panel but Dewatripont was replaced by Beata Javorcik, a Professor of Economics at the University of Oxford. Their report was submitted in March 2016.

The intervening years had reinforced the message of the Besley Commission of 2009: “Specifically, it suggested a greater focus on the importance of stability, governance, a concern for gender equality among other dimensions of inclusion, competitiveness, and innovation ... and a more intensive appraisal of the appropriate role of the state ...”

The experience of financial crises, rising inequality of income and wealth within countries and a change in the Bank’s geographic focus towards countries with young, growing populations facing serious problems of inequality of opportunity pointed to important new dimensions that the EBRD needed to explore under its transition mandate.

The terms of the debate concerning transition had changed since the euphoria of the fall of the Berlin Wall and its immediate aftermath. The then ‘model’ market democracies, such as the USA and UK or Sweden, had demonstrated they contained major fault lines. In truth, they offered no ultimate assurance of stability or guarantee of progress. The once lauded idea of an ‘end of history’ was a mirage. The move from plan to market was just one step; the road from market towards a high-income economy was vastly more complex.

---

47 Javorcik became the EBRD’s Chief Economist in 2019.
Becoming stuck in a middle-income trap\(^{49}\) was not unique to the EBRD region. Countries needed to find their own policy routes to become successful market economies. Furthermore, failure to include disadvantaged and disenfranchised groups in the political economy process along the way was likely to hold back progress in transition or, worse, put it into reverse.

Beyond the EBRD region the world and its policy preoccupations had changed too. The Cold War stand-off between east and west had been replaced by a new existential threat: the perils of climate change for the planet and with it the quality of human life. The EBRD had been quick to recognise this and act on it. But more needed to be done. Furthermore, greater attention in the development context was being given to the issue of gender equality, a matter which the EBRD had also begun to address.

The panel felt the EBRD had a strong ability to apply its investments and advice to both causes while continuing to help many of its countries of operations escape the middle income trap. But to be effective in doing so the Besley team believed that the Bank needed to reorient itself and give more prominence to the actions it was able to take to deliver on these global public goals. They said:

The EBRD’s capacity to contribute to the wider debates about economic development and its determinants is less clear, ... the EBRD needs to develop a distinctive voice ... the transition impact framework needs refreshing in line with wider goals, many of which have become de facto areas of interest for EBRD.

Although the group called for a “fresh interpretation” of the transition concept and its application they saw no case for changing Article 1 of the AEB. This “gives a distinctive mandate for EBRD and makes it unique among IFIs”, they said. But, they added, “a market economy is no guarantee of success in and of itself” and requires “a complementary role of an effective state”. Here, they argued, legal capacity (the ability to enforce contracts and regulate fairly), collective capacity (insurance to cover the inadequacies of market provision), and fiscal capacity (non-distortionary revenue raising) were essential for a well-functioning market economy.

\(^{49}\) The tendency for emerging economies to make only slow progress after reaching certain levels of per capita income.
They recommended that the organising principle for the EBRD should not be transition as it had been understood in the past but as:

Supporting a move towards a competitive, well-governed, sustainable and inclusive market economy. This means paying attention to building state capacities as well as investing in private capital.

The Besley panel’s conclusions were important since they brought together areas which the Bank had begun to pursue in a somewhat disjointed way without clearly articulated links to its mandate. The proposed refreshed interpretation of transition provided a coherence that had been missing. A well-functioning market economy was thus not simply one that followed competitive and integrated markets, but one that was also well-governed, being supported by an effective state, inclusive and environmentally sustainable.

A number of other recommendations were made by the panel, notably concerning country strategies which they believed should be given a more central role and be more closely linked to the Bank’s operational strategy and project-based lending.

Qualities of a sustainable market economy

The Besley team, supported by Nik Milushev and Alex Plekhanov in OCE and Lankes, interacted intensively with the Board during the months in which they prepared their analysis. First at a workshop in November 2015 and next at a Board retreat held at the LSE in February 2016 for which several Directors, who had been encouraged to offer feedback and ideas, issued “gray” papers of their own on how they saw the transition concept 25 years on and matters concerning its implementation. Lankes later described the process of Board involvement as “the most significant in [his] 30 years of working in IFIs!”

The panel’s paper was well-received when it was discussed at a further Board workshop in March. At the final workshop on 21 April the Director for the Netherlands, Paul Vlaanderen, acting as a coordinator of Directors’ 50 ‘Grays’ is a term used at the IMF for written statements by Directors ahead of meetings. It derives from the colour of the paper on which such papers are printed.
informal inputs, including his own, summarised their thinking on the topic. Although there were differences in emphasis it was essentially in line with the approach suggested by the Besley panel and the Lankes team. There was almost universal agreement that the transition concept needed refreshing and that the paper provided a sound basis on which to do so.

Based on those discussions, two more qualities of sustainable market economies were added to the list: resilient and integrated. Emphasis on resilience reflected the scars of the global financial crisis. Integrated highlighted the importance of countries’ internal and external connectivity, such as the integration of capital markets, infrastructure, trade and knowledge.

Following the panel’s report and a further period of collecting views from Directors and others in the Bank a paper, *Transition Concept Review*, was prepared and presented to the Board on 2 November 2016. Taking its cue from the Besley panel, it set out a fresh interpretation of the transition concept.

There were two key propositions which the Board was invited to endorse. First, there was a clarification that the Bank’s mandate was to foster sustainable market economies. This was argued to be fully consistent with Article 1 of the AEB. Second, that such an economy may be characterised by six primary qualities so that “a sustainable market economy is competitive, well-governed, green [environmentally sustainable], inclusive, resilient and integrated”. This implied a focus on outcomes, and on market-based decision-making that leads to those outcomes, rather than stopping at market structures per se. The authors of the paper regarded this as its core conclusion.

The six transition qualities also formed the basis of project and country level assessments of transition, on the one hand by asking bankers to explain the main transition qualities their projects were targeting and on the other hand by dissecting country diagnostics and strategies according to the transition gaps shown for each quality.

A great advantage of the “qualities” proposal was its simplicity—something the bankers welcomed with great relief—and that outcomes at last appeared to matter to the Bank. They always had done but they were no longer obscured by a focus on the structural characteristics of markets. What was left unsaid in the propositions the Board endorsed, but was made clear in the paper, was that the EBRD remained a bank which pursued systemic change and the transformation of markets to make them more sustainable.
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. This choice was based on the conviction that a well-functioning market economy and private initiative—set within a political framework of democracy and pluralism—are most effective at delivering on people’s aspirations. The Bank’s mandate is therefore unique only in degrees: it targets the means rather than the ends, but it cannot lose sight of these ends.

No-one disagreed with that.

The Six Qualities of a Sustainable Market Economy

Competitive
A competitive market economy has:
- Market structures with enough players to ensure competition among firms, and rules making it easy to enter and exit;
- The capacity for firms to generate added value by producing more efficiently or innovating; and
- Incentives to compete and advance, based on private ownership and management, and, with public entities, governance that ensures commercially sound decision-making.

Well-governed
Governance concerns authority, decision-making and accountability in all domains. At its core, governance is about the quality of institutions and the processes that they support.

A well-governed market economy rests on two pillars:
- National or subnational economic governance, that is the institutions and processes that support economic activity and economic transactions by establishing the rule of law, transparency, accountability, checks and balances and fair play;
- At the corporate level, the system of rules, practices and processes by which companies are directed and controlled in accordance with international standards.
Green
A green or environmentally sustainable market economy is one in which economic decisions reflect the full value of resources to present and future generations.

Operationally, it is where economic decisions seek to limit the impact on the environment, achieve ambitious outcomes—such as carbon emissions reductions—and where market failures are addressed through policy and legal frameworks.

Inclusive
An inclusive market economy ensures that anyone—regardless of their gender, place of birth, socio-economic environment, age or other circumstances—can access labour markets, finance and, more generally, economic opportunity.

Promoting an inclusive market-based system is about efficient (human) resource allocation rather than social policy. But there is also a political dimension to inclusion. Democratic institutions make access to power more open, directly supporting inclusion and the political and social sustainability of market economies.

Resilient
A resilient market economy supports growth while avoiding excessive volatility and lasting economic reversals. It is about the ability of markets and market-supporting institutions to resist shocks, about policy predictability and about balance and sustainability in financial and economic structures.

Resilience objectives are most commonly associated with the nature, conduct and structure of financial systems. Financial stability refers to a financial system’s ability to withstand shocks without major disruption in financial intermediation and in the supply of financial services. At best, it also suggests the absence of excess volatility, stress or crises.
Integrated
Integration refers to connectivity with the global economy through trade and investment and other cross-border dimensions and to the (geographic) integration of domestic markets.

An integrated market economy has the policies, institutions and connectivity—through energy, infrastructure and information technology links—to minimise the transaction costs of trade, support competition in product and services markets, and tap a wide range of financing channels.

Integration is a central element in any economy’s competitiveness. It enables trade at greater speed, lower cost and better quality. It is critical to growth and job creation.

6. Operationalising the Changes

In order to operationalise the revised concept a system built around the six transition qualities was needed. The qualities worked well for banking teams\(^51\) so the framework could remain principally sector-based as before and would pay attention to the country context. An additional advantage of the qualities approach was that it could be linked more easily to the SDGs than the previous system.

Project Christopher\(^52\)

As the transition concept review got underway a parallel exercise was conducted to improve the transparency and predictability of the impact

\(^51\) There were some obvious matches where qualities like resilient would be frequently cited in transition impacts by financial institutions’ teams, green with energy efficiency and climate change work, competitive in industry, commerce and agribusiness projects, and so on. Nonetheless, these were not exclusive: green and inclusive worked across all sectors for instance.

\(^52\) The project was named after the code-breaking effort using one of the earliest computers, the Enigma machine, designed and called Christopher by Alan Turing, which was used to crack Nazi Germany’s coded messages during World War II. It was the subject of a film, *The Imitation Game*, released at the end of 2014, starring Benedict Cumberbatch in the lead role.
assessment system. The sector economists engaged in what was essentially a decoding and distilling of past project assessments by sector to extract the core questions that needed to be answered to pass a test of transition impact adequacy; and from there the degree of impact that was associated with different levels of ambition. A greater impact could be expected, for example, to result from the training of SME suppliers of a large retailer with the view to expand supply networks and upgrade the quality of SME products, or from dedicated policy work to structure public service obligations of municipal water companies.

Under Romani’s guidance, and interactions with the banking teams, a semi-automated system based on sets of questions relevant to particular sectors was built up over time, piloted and integrated into work designed to simplify the full set of processes followed by the Bank in its operations (Project Monarch\(^53\)).

The core of Project Christopher identified the primary transition quality being addressed by the project, along with a secondary quality (which received less weight), and generated a preliminary score to reflect the strength of its potential impact. This was then adjusted for the context in which the investment was being made: first for the degree of challenge it faced (the “transition quality gap”), and then for the extent to which it targeted a country priority, with the very best such projects receiving a bonus score (“star projects”). Additional adjustments were introduced for equity and local currency to reflect their particular value and difficulty and to provide an additional incentive for bankers.

Transition quality gaps: the ATQs

The ATCs which had provided an overview of the transition challenges by sector were replaced by a similar system based on transition qualities, the assessment of transition qualities (ATQs). These were first published in full in November 2017,\(^54\) although had begun to be used internally as part of Project Christopher before this, and like the ATCs were designed to test the degree of advancement in the transition of EBRD countries of operations.

---

\(^53\) Project Monarch was the name given to the successor to OE&E when the Bank’s operational processes were brought together under one systems-wide data management IT project.

Transforming Markets

For the purposes of country diagnostics and country strategies the analysis of qualities showed where a country was most lagging behind—in terms of, say, its competitiveness or inclusion credentials. Projects in areas with larger gaps were given a rating uplift.  

Mapping the system to the SDGs

Unlike the Millennium Development Goals, which focused on reducing poverty and other social outcomes like health and education, the SDGs were broader and emphasised issues such as the environment, employment, infrastructure, and inequality which were more relevant to the activities of the EBRD. At the same time, the notion of transition qualities encompassing the green economy and inclusion matched the SDGs far better than the previous system.

Figure 6.2 The Six Transition Qualities and the SDGs

---

Of the 17 SDGs, the revised EBRD transition impact assessment system was associated with 13 of them, from gender equality and decent jobs to sustainable cities and climate action, as illustrated in Figure 6.2. This helped with the presentation of country strategies to audiences outside of the Bank, since it was easy to see where and how the EBRD was tackling various SDGs.

Conclusion

The outcome of the transition concept review was an almost universally accepted success. Although contrary views were heard at the Board when it was agreed in November 2016—on the basis that it diverted the Bank from the original concept and its mandate—the vast majority was in favour of its adoption.

Lankes, who was about to leave to join Le Houérou at the IFC as Vice President for Economics and Private Sector Development, was widely praised at the meeting for leading the thorough review and for his many contributions to the Bank’s development since his arrival at the EBRD in its early days. Directors applauded especially the open way in which their views had been sought during the course of the review.

Within the Bank too the new system settled in well. Bankers in particular were pleased with the results. One senior banker said enthusiastically “At last I can explain transition to my clients and what our investments relate to!” It was a far cry from their refrain a decade earlier.

For Chakrabarti it was a vindication of his perseverance to modernise the EBRD. The Bank was better placed among its peers than before and more visible in its tackling of problems facing emerging markets and developing countries in the third decade of the 21st century.

Rather than banishing the concept that underpinned the Bank’s philosophical stance Chakrabarti embraced the new interpretation as a relevant metric for developing economies and the future. Efforts could now be focused on transforming markets towards sustainability through each of the six quality dimensions.

The initial EBRD goals of competitive and integrated markets had been connected to qualities of resilience, inclusiveness, good governance and “greenness” through a better understanding of developments in economics and the role of the state, practical experience and lessons from the crises of the past decade. Financial meltdown had pointed to the need for resilience.
Inequality of opportunity and corruption, notable in the Arab Spring and Ukraine, showed inclusion and good governance were key to ensuring the legitimacy and irreversibility of democratic and market orientations. The climate crisis indicated how human progress would be undermined without market-based solutions supported by public interventions and incentives.

Building towards the sustainability of market economies was the way forward.