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Structural Reforms – Is South East Europe Stuck?

Abstract: This chapter explores the record on structural reform in SEE in more detail. It finds that considerable advances were made in restructuring during the first two phases of transition described above, but progress since then was meagre. While it is heartening that there is little evidence of these early reforms being reversed, the appetite for further reforms (which are urgently needed) in the prevailing climate of slow growth and high unemployment is limited. Worryingly, the crisis and its aftermath have damaged public support for markets and faith in democracy, and eroded trust in public institutions – especially in the political process. This will make the task of reinvigorating the reform agenda even more difficult.

From the viewpoint of early-2015, prospects for South East Europe (SEE) appear to be a bit gloomy. As the previous chapter showed, most of the region has suffered prolong periods of stagnation or recession since the onset of the global crisis in the second half of 2008. The Euro-area crisis, which began in 2010, was a further blow to the region. Among different emerging market regions, SEE stood out as one with a highly unbalanced pre-crisis growth model, relying on easy credit and major inflows of foreign capital, rather than reform-driven productivity and efficiency improvements. Since 2008 there has been much talk of the need for a “new growth model” based on innovation, investments into productive sectors and greater reliance on domestic sources of finance. But in SEE there is a widespread sense that the reforms necessary for this model to develop have either stalled or taken a backward turn. Much of the region, echoing the title of the European Bank for Reconstruction and Development’s (EBRD) 2013 Transition Report, is seen as “stuck” in its transition towards the development of well-functioning market-oriented economies. This is worrying for SEE because of the adverse implications for future prosperity.

There is an extensive literature on the link between economic growth and reforms, such as market liberalisation, privatisation, financial deepening and improved corporate governance. While results may differ from one study to another, there are three broad conclusions that can be derived from this research. First, reforms have a positive and well-determined impact on growth, although usually with a lag. Second, there is a positive feedback from growth to reforms. This is consistent with the intuitive notion that it is easier to implement potentially unpopular measures when the economy is performing well anyway. But there is also a third conclusion: too much growth can retard reforms, especially when the source of growth is divorced from market-oriented reforms. With the benefit of hindsight, many SEE countries may have fallen into this trap pre-2009, as rapid growth rates engendered a sense of complacency and disguised the flimsy and unsustainable nature of the transition process.

In this chapter, we take a critical look at the state of reforms in South East Europe and at the current appetite for future reforms, on the part of both policy-makers and the general public. The chapter focuses on the real economy. It also sets the stage for the discussion in the following chapters on fiscal and financial sector reforms. Our approach draws partly on a well-established methodology developed by the EBRD that analyses different sectors and distinguishes between reforms aimed at